STOCKS DOWN UNDER

9 OCTOBER 2020

Small Cap Stocks Down Under

"A crying baby is the best form of birth control."

- Carole Tabron

BABY BUNTING GROUP

Who knew bunting babies was so profitable?

CVC LIMITED

Struggling to right the ship

NUCHEV

Milking China's demand for all its worth

BABY BUNTING GROUP

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Stocks Down Under rating: ★★★★

ASX: BBN
Market cap: A$ 629M
Dividend yield: 2.1%

52-week range: A$1.51 / A$5.09
Share price: A$ 4.87

Headquartered in Dandenong South, a suburb of Melbourne, Baby Bunting is one of the few companies whose name tells an investor exactly what they do. Baby Bunting is Australia's largest specialty retailer of baby goods. COVID-19 has had a longer lasting effect on Baby Bunting than many other retailers due to its large footprint in Melbourne. However, with Melbourne's harshest restrictions lifted, this company is in a position to finish the first half of FY21 strong.

READ MORE

CVC LIMITED

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Stocks Down Under rating: ★★

ASX: CVC
Market cap: A$ 199M
Dividend yield: 4.7%

52-week range: A$1.00 / A$2.29
Share price: A$ 1.70

Headquartered in Sydney, CVC is a diversified investment company whose principle activities during FY20 were property financing and development, funds management, and the investment of capital in listed and unlisted entities. Overall CVC has had a rocky last two financial years with net losses dropping from $22.7m in FY18 to $-2m and $-2.1m in FY19 and FY20, respectively. The company is reducing its number of investment strategies however, we feel investors would be better off placing capital in companies with a less diversified focus or a better track record.

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Share price chart

Source: Tradingview

Unwrapping the Baby Bunting

Investors looking at Baby Bunting need to be concerned about three things right now: total company performance, online revenue, and private label and exclusive products. These three areas have multiple areas of overlap so please do not add the results mentioned below together.

Total company performance for Baby Bunting was strong despite COVID-19 in FY20, and especially 2HY20. Total sales for 2HY20 grew around 10.5% year-over-year and 11.8% for FY20. While FY20's revenue growth was below the CAGR recorded between FY16 and FY20 of 14.4%, a difference of only 2.6% is impressive given COVID-19. While the Cost of Doing Business as a percentage of sales increase slightly to 27.9% during FY20, this was mainly due to the increased overhead from opening nine new stores between FY19 and FY20. However, improvements in other, larger costs, such as the average margin on products sold saw improvements which led to an increase in EBITDA margin of 80bp to 8.3%. It is important to remember that many of the company's stores are new and in the expansion phase of development. More established stores have EBITDA margins over 15% and this is one of the reasons we are very confident in Baby Bunting's ability to drastically expand its EBITDA margin.

Even before COVID-19 Baby Bunting was spending a lot of resources expanding its online presence and this paid off once lockdowns were triggered across Australia. Online sales grew 124% year-over-year, excluding Victoria where sales growth was 92%. Despite lockdowns ending, 1QY21 still saw online sales makeup 20.9% of total sales, 17.7% excluding Victoria. While we remain bullish on Baby Bunting's brick and mortar retail stores, we believe the online exposure bump COVID-19 provided Baby Bunting should offer a permanent expansion.

In retail, private label and exclusive products often are some of the highest margin items a company sells and therefore, if a company can shift its consumer consumption towards its exclusive and private label products without hurting sales, it is a huge win. Baby Bunting has seen increasing success with this strategy, and it is the other significant factor behind our confidence in Baby Bunting's ability to continue its track record of EBITDA margin expansion. For FY20 private label and exclusive product sales increased to 36.5% of total sales from 27.6% in FY19. Meanwhile, 1QY21 saw these products increase further to around 38% of total sales and management has reaffirmed guidance that private label and exclusive products will account for at least 40% of total sales in FY21. The ultimate goal is 50% of total sales.

Baby's finally getting out of Melbourne's corner

Out of 56 stores 12 are in metropolitan Melbourne and three in regional Victoria. Additionally, Baby Bunting's distribution centre and online operations are based out of its headquarters in Dandenong South, Melbourne. While these stores remained trading even in stage 4 lockdown due to the essential nature of the products sold, sales were still down year-over-year. Victoria is a significant market for the company, and we believe Melbourne's lockdown being lifted will provide a significant bump to 2HY21 earnings.

The name of the game is expansion

During Baby Bunting's Annual General Meeting on 6 October 2020, management reaffirmed plans to open between four and six new stores in FY21 with three in 1HFY21 alone. Historically, these stores opening have lifted total sales and only taken a small amount of traffic from existing stores. Overall, this expansion will be a net positive, however, it does have the potential to restrict the EBITDA margin growth for FY21. Newer stores have historically seen significantly less EBITDA margin while mature, established, stores produce over 15% EBITDA margin.

One of the most significant events so far during FY21 was the launch of Baby Bunting online into New Zealand. To clarify, Baby Bunting does not currently have any stores in New Zealand, this was a purely online launch. While we have not received any specific numbers yet, management is strongly upbeat with its tone surrounding New Zealand. We believe New Zealand has the strong potential to provide strong earnings growth for Baby Bunting and are excited to see how things turnout during FY21.

Baby just keeps on Bunting

Baby Bunting is a through and through expansion story with three main areas, footprint, sales, and margin. Baby Bunting is continually opening stores and drastically expanding its online capability and locations, despite COVID-19 sales increase 11.8% year-over-year (15.3% 2HY20), and its current EBITDA margin of 8.3% has a lot of room for growth. Factoring all of this in, we believe the market is currently underestimating Baby Bunting's earnings potential. FY21 has started off with a bang and now that Victoria has removed its harshest restrictions, this growth will continue to impress. Using consensus estimates of FY21 EBITDA the current estimate FY21 EV/EBITDA value is around 13.8x. We believe this valuation is lower than it should be and that FY21 EBITDA consensus estimates are likely on the low end, especially since the company has declined to provide its own. Therefore, we are issuing a rating of four stars.

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Share price chart

Source: Tradingview

CVC's investment breakdown

CVC's investment portfolio consists of three main categories: listed equities, private equity, and property.

In listed equities CVC uses multiple strategies including but not limited to, dividend income, equity accounted income, and occasionally director, advisory, and underwriting fees. The basis of the listed equity strategy is active management, however, there is no mandate that limits the type of listed equity investments CVC can make.

Private equity has an Internal Rate of Return minimum requirement of 20% on a cash in, cash out basis and ranges between $1m and $15m investments. CVC does not have a specific industry focus and does not always have an exit strategy prepared when the company initiates the investment.

CVC's property investments are further broken down into four categories: development funding, direct investment funding, indirect investment funding, and listed property. While the type of property has varied from housing developments, hotels, apartments, shopping centres, etc. the most common type of development has historically been apartment complexes. We are unable to determine if that will continue to be the case in the future.

A buyout will likely allow CVC to take some much-needed profit

On 25 September 2020, it was announced that Eildon Capital Group wishes to internalise its management function by acquiring the shares CVC owns for $4m. CVC owns around 46% of Eildon Capital Group as of the 25 May 2020, the latest calculation. Since this would be a large sale for CVC the proposal must be put to a shareholder vote. Due to the unanimous CVC board support enjoyed by this proposal has, and the high ownership interest in CVC the board controls, we believe the proposal has a high likelihood of success. Additionally, this will provide some much-needed cash inflow to CVC without the company being forced to sell unfavourable positions. The vote will take place at the Annual General Meeting of CVC shareholders on 13 November 2020 and assuming the vote passes the internalisation of Eildon Capital will be finalised by the 17 November 2020.

Due to its high dividend and share buybacks cash is dwindling fast

For FY20 net cash lost by operating activities was $34.4m compared to positive $21.2m in FY19. The difference is due to the decline in the proceeds from disposal of financial assets at fair value through profit or loss from $106.9m during FY19 to $38.3m during FY20. Despite the net profit loss derived during both FY19 and FY20, CVC still paid out $27.7m and $15.7m in convertible loan and equity buybacks and dividends during FY19 and FY20, respectively. This has put a serious dent in the company's cash position, seeing it fall from $71.1m at the beginning of FY19 to $22.6m at the end of FY20. This trend cannot continue and the inability to purchase share and pay dividends will cause a significant decline in share price unless CVC manages to right the ship completely during 1HFY21 in our opinion.

An asset manager struggling to right the ship is not a solid investment

Since the beginning of April 2020 CVC shares have been on a continual upward trajectory, rallying approximately 68.3%. However, this has driven the company past its 29 September 2020 released FY20 Net Tangible Assets per share value of $1.43. Meanwhile, due to the company's fund management performance during FY19 and FY20, as well as its dwindling cash position, we believe the company should be trading at a discount to Net Tangible Assets per share, not a premium. Over the last three months the daily average trading volume has been around 10,000. Comparatively, between 10 August 2020 and 24 September 2020, CVC bought back 316,844 shares across 11 different purchases. This comes out to 45 days the market was open and an average of 7,041 shares per day. We believe this proves that a large portion of this rally was due to company led share buybacks, an expense we do not believe they can afford. Therefore, all-in-all we believe CVC deserves two out of five stars. However, it is important to note that the company is continuing share buybacks, and this will artificially inflate the share price.

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Share price chart

Source: Tradingview

Make goat milk products, not war

Tensions between Australia and China may be at all time highs, but so is China’s demand for Australia’s goat milk products and this is the trend that Nuchev hopes to capitalise on. China’s growing middle class has enabled a large portion of its population to demand a higher standard of food quality product by allowing them to afford that quality. Around the world there is one consistent category of product that people will always demand the highest quality: products for their children. Therefore, the constant, high profile, domestic food scandals have continually driven Chinese demand for infant formula made in Australia, where quality control standards are higher, and corruption is lower.

Asia, and more specifically China, is where the majority of Nuchev’s projected future demand is expected throughout its five goat milk and milk powder products. Nuchev’s five products are broken down into the target age range, Stage 1 (0-6 months), Stage 2 (6-12 months), Stage 3 (1-3 years), Stage 4 (3-7 years), and adult goat milk and milk powder.

According to Nuchev's industry research, goat milk infant formula demand is predicted to grow at a CAGR of around 18.8% between 2018 and 2023 in China alone. This is compared to the CAGR of 7.1% demand growth in China for regular infant formula across the same period. The majority of this demand is predicted to be for imported, and more specifically Australian, products. Due to the nature of the domestic demand for these products we believe it unlikely that China would ever target Australia's goat milk infant formula products, even if the geopolitical conflict were to continue escalating. While the domestic goat milk infant formula market is expected to continue expanding, that is expected to be a significantly lower CAGR of 5.6% between 2018 and 2023. For the Nuchev success story to materialise, it must find a seat on the China demand train.

There is the occasion when executive turnover is a good thing

Due to Nuchev's continued expansion into Asia, the board has decided to appoint to the board of directors Owens Chan. Ownes Chan brings over 30 years' experience in senior sales and distribution specifically in China, Hong Kong, Singapore, Thailand, Indonesia, and Vietnam. In order to make room for Owens Chan to join the board, and after successfully helping the company IPO, David Whyte as decided to step down. While executive turnover can often be a red flag, especially so soon after an IPO, we believe this is a positive development for the company, not a negative one. Asia is truly the growth story for Nuchev and the additional expertise Owens Chan should provide should be quite helpful.

Undershooting your prospectus forecasts never ends well

FY20 saw a significant amount of volume and revenue growth for Nuchev at 108% and 98%, respectively. To be frank, most company executives would be throwing parties and giving everybody double digit raises with organic growth like that. However, when your prospectus promises the market 109.8% volume growth and 100% revenue growth, the market might will not be happy. Consequently, since its IPO, Nuchev's stock price has declined around 42.9%.

It's not drill baby drill, its milk baby milk

Nuchev might not be profitable yet, but the company is certainly growing at a rapid pace and current consensus EBITDA projects put EBITDA profitability at FY23. Meanwhile, the company is trading at a FY21 consensus estimated EV/Revenue of 3.2x with estimated year-over-year revenue growth of 51.3% in FY21. To offer some competitor comparison, The A2 Milk Company is currently trading at 6.2x FY21 consensus estimated EV/Revenue with only around 6% revenue growth expected.

We believe the market has over punished Nuchev for missing its prospectus projections. While there are risks still existing from COVID-19's effect on global supply chains, we believe they will not have an overly material effect on Nuchev due to the high demand for its product. While the competitor space is not clear for Nuchev, the company has definitely proven that it can hold its own in the street fight for China's infant formula market share. Therefore, we are giving Nuchev a rating of four out of five stars.

Pitt Street Research Pty Ltd

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Pitt Street Research Pty Ltd is founded on more than 40 years of combined experience researching companies in a range of different sectors.

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