STOCKS DOWN UNDER

16 OCTOBER 2020

Small Cap Stocks Down Under

"Damn the torpedoes, full speed ahead."

- US First Rear Admiral David Farragut (1801 - 1870)

OCEANIA HEALTHCARE

You can teach an old dog new tricks

VITA GROUP

Strong dividend and undervalued makes a winner

VEEM

Aye captain, full steam ahead

OCEANIA HEALTHCARE

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Stocks Down Under rating: ★★★★

ASX: OCA
Market cap: A$ 780M

52-week range: A$0.57 / A$1.28
Share price: A$ 1.28

Headquartered in Sydney, Oceania Healthcare owns and operates over 40 different retirement centres and villages around New Zealand. The company's retirement villages have a minimum age requirement of 70 years. However, with New Zealand's aging population, and KiwiSaver and Superannuation program, we believe this age requirement is likely not to be a problem. The company has plenty of villas, apartments and care suites stock on hand and we believe the future is bright for Oceania Healthcare.

READ MORE

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ASX: VTG
Market cap: A$ 177M
Dividend yield: 2.2%

52-week range: A$0.55 / A$1.63
Share price: A$ 1.05

Headquartered in Brisbane, the Vita Group operates three specific divisions, Telstra retail operations, Sprout and Artisan Aesthetic clinics. The company's stock has only slightly recovered from the COVID-19 market rout due to management's decision to institute a significantly reduced dividend for FY20. We believe the dividend reduction is likely temporary and EBITDA, revenue and net operating cash flow increased during FY20. Vita is a pure dividend play and we believe the market is being short-sighted in its punishment of the stock.

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Share price chart

Source: Tradingview

Meeting the village people

Oceania operates under three main revenue segments: aged care, retirement village and other. The aged care revenue segment provides traditional care beds and care suites in a conventional centre where accommodation, care and other related services are provided. While this revenue segment is, and will remain, an important part of Oceania's portfolio, the company is moving to shift its total portfolio holdings to reduce this segment's majority position. While management's decision in this regard will be discussed in more detail below, margins and demand are a large factor. The aged care segment saw a decline in underlying EBITDA of NZ$4.9m to NZ$20m between FY19 and FY20. While management did state that this segment's poor fiscal performance during FY20 was due, in part, to COVID-19 difficulties, it is important to note that aged care underlying EBITDA already declined NZ$4m in FY19.

The retirement village segment offers independent living and rental properties in a community-like setting. While this division's products provide more independent living, it still provides a wide variety of services in the company's retirement villages, such as activity organisation. Oceania has been spending a significant amount of resources building new units that fall under the retirement village category as it offers significantly better

margins. After the current development pipeline is completed, the company's portfolio will consist of 45.1% of its units in the retirement villages, a stark increase from the current 33.4%.

Despite COVID-19 causing some disruptions to the overall operations of Oceania, this division actually saw a year-over-year increase in underlying EBITDA of 7.7%, to NZ$61.3m. This EBITDA increase made a significant impact on EBITDA and allowed underlying EBITDA to only drop NZ$0.8m, despite the other two divisions providing a combined underlying EBITDA decrease of NZ$5.1m.

The third division is not really a division, but essentially houses all of Oceania's corporate overhead costs, like administration, marketing and operations. Therefore, this division consistently produces a loss.

Aging is winning the race in New Zealand

Between FY16 and FY17, the age group that grew the fastest in New Zealand, at 3.5%, was 65 years and older. Comparing this to the total population growth of 2.1% shows the population of New Zealand entering the retirement generation is progressing at a much faster rate than the rest of the population's age groups. Additionally, at 1.5m people out of 4.8m, as of 30 June 2017, the 40 to 64-year age group is the second-largest population group in New Zealand.

Unlike Australia, New Zealand provides two main sources of capital and income for citizens and permanent residents who have retired: Superannuation and KiwiSaver. Superannuation is basically a tax-funded pension for all New Zealand citizens and permanent residents so long as the individual has lived in New Zealand for at least ten years since they turned 20, or five years since they turned 50. Additionally, the applicant must be 65 years or older. While payments can differ depending on several factors, there are no earnings or net worth caps that cause an individual to be disqualified. KiwiSaver, on the other hand, can loosely be explained as a watered-down version of Australian Superannuation. While individuals are not required to save, employers are required to contribute at least 3% of gross wages. However, this can be increased up to 10% if the employer requests salary sacrifice.

All of this presents a strong bullish case for continual demand towards retirement villages and centres in New Zealand. The population is aging towards the 65+ age group and through New Zealand's KiwiSaver and Superannuation programs we can assume the majority of those entering retirement will be able to afford the villas, apartments and care suites offered by Oceania.

Look behind the curtain and pay no attention to the EBITDA loss

Reported EBITDA is not the most accurate overview of operating performance for Oceania as it includes the constantly fluctuating "change in fair value of IP, impairment of P&E and other." Due to Oceania owning the property on the developments and centres it builds, fluctuations in the fair value of the property is included in reported EBITDA. Therefore, we believe underlying EBITDA, which excludes these fluctuations, is a more accurate depiction of the operating performance of the company.

Utilising a trailing twelve-month underlying EV/EBITDA, we get a ratio of 18x. While that could be considered high, we would note that between FY18 and FY19, underlying EBITDA growth was only around 1%. However, this low growth is due to the declines in aged care revenue while retirement village EBITDA saw an increase of 14.3% between FY18 and FY19. EBITDA growth will come from the retirement village division and management's current construction plans mentioned above we believe warrant a higher forward EV/EBITDA ratio. We would also note that occupancy rates remain high and actually increased from 91% in FY19 to 91.5% in FY20.

We believe New Zealand has the aging population with the capital at their disposal to meet the supply from Oceania, and therefore, we believe the company deserves four out of five stars.

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Share price chart

Source: Tradingview

A mixed bag of activities

Vita's operations are split into two main operating segments: Information and Communication Technology (ICT) and Skin-Health and Wellness (SHAW).

The ICT segment provides the vast majority of the company's revenue at 97.3% of FY20's total. The ICT itself is divided into its Telstra retail operations and the accessories division, Sprout.

Regarding the Telstra retail operations, Vita operates, but does not own, around 100 Telstra retail and business points of presence as of FY20. COVID-19 provided a boost to revenues in non-business, consumer retail as consumers bought devices and increased their services as they worked from home more. While we don't believe this will recur in FY21, as the Australian economy continues to open up, we believe the business segment will rebound in a similar fashion as consumers return to offices.

The accessories division Sprout, on the other hand, is a technology accessories brand for different electronics, ranging from speakers to dashcams, which are sold in 300 retail stores. While we are not given any detailed specifics when it comes to Sprout's results, ICT's revenue and EBITDA growth were in large part due to hardware sales, of which Sprout is a significant component. Sprout provides a significant source of growth for

the ICT division, both in terms of sales and profitability with revenue growth of 14% during FY20, compared to retail ICT's 5% growth.

The odd man out

Despite only counting for around 2.6% of total revenue, SHAW (Skin-Health and Wellness) is an interesting division consistently performing exceptionally well. During FY20 this division saw a 47% increase in revenue, a 51% increase in gross profit, with a gross margin expansion of 1.8% to 72.6%. EBITDA grew 49%. However, EBITDA is still a negative $1.9m. Despite the insignificant earnings provided by SHAW, management is optimistic about this division and has predicted extremely strong, organic revenue and EBITDA growth during FY21.

We believe FY21 is really the test for the SHAW division. While we don't believe this division will stay with the company in the long-run, if FY21 is able to prove this division's real potential, as management expects, we believe this could indicate a strong shareholder return in the form of a spin-off or sale over the next three to five years.

However, management has not discussed this potential and is currently focused on growing the business. We believe a sale or spin-off is likely due to Skin-Health and Wellness not fitting with Vita's business model and portfolio. When this has happened with other, comparable companies, they usually grow the division until management can sell it or produce an equity spin-off.

How's that flow looking?

Net operating cash flow presented an increase in year-over-year growth of approximately 6.4%. Despite net cash outflows due to investing and financing activities, net cash increased by around $10.1m during FY20. It is important to note, however, that this was achieved in large part by the suspension of the interim dividend. Had the interim dividend not been suspended because of COVID-19 liquidity concerns, and assuming dividend would have stayed the same in FY20 compared to FY19, net cash would have increased by only $1m. Although net cash would have still seen an increase during FY20, we believe it was prudent for management to cut the final dividend and suspend the interim dividend to improve the financial position of the company.

While the economic climate is still uncertain, we don't believe FY21 will produce a decline in operating results. Therefore, we think it is likely that the interim dividend payout for 1HY21 will see significant improvement, although not to the level of FY19.

Put it all together, and you get an undervalued stock

Due to the economic uncertainty surrounding Australia right now and the dividend investment nature of Vita, we thought it would be best to look at the consensus estimate for FY22 rather than FY21. Between FY20 and FY22, revenue and EBITDA are estimated to increase by 5.1% and 4.7%, respectively. Taking the estimated revenue and EBITDA for FY22 gives us EV/Revenue and EV/EBITDA multiples of 0.2x and 3.7x, respectively. When taking into account the unusually low dividend of 2.2%, we believe the current valuation the market is assigning to Vita is too low. While this is mere speculation, we would like to point out that if FY21's dividend returned to half of FY19's at $0.046 a share, this would offer a yield of 4.4%. Therefore, we are issuing a four out of five-star rating.

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Share price chart

Source: Tradingview

What's making all this wash?

Wash refers to the waves made by a vessel making way. VEEM has four main operations, gyrostabilizers, propulsion, defence and engineering products and services. The gyrostabilizer division, however, had the most eventful FY20 and the defence division stands to benefit from the Australian Defence Force's new strategy shift.

We believe the gyrostabiliser division currently has the highest revenue generating potential and made its first proof of market sale during FY20. The sale of the first VG1000SD, as mentioned above, was to Dutch shipbuilder Damen. This was after extensive sea trials in 2018 and Damen has already ordered a second VG1000SD. Additionally, VEEM completed major construction of its gyrostabilizer assembly facility in Canning Vale, Western Australia during March 2020. Interestingly, the facility was officially opened by the Australian Minister for Defence, Linda Reynolds.

While there are many different growth avenues for VEEM's various divisions, we believe the gyrostabilizer division offers the clearest path to revenue. This is due to the company clearly stating the revenue generation potential of the Canning Vale assembly facility is $100m annually. To be clear, there is no timetable for capacity

to be reached and orders are not even close to significant enough. Although, Damen already ordering a second gyrostabilizer very quickly after its first order was delivered, which we believe is a very strong sign of demand. Furthermore, VEEM has stated that gyrostabilizer orders have "accelerated" in FY21. To clarify, prior to FY20 the company has been selling a number of VG models that are smaller than the VG1000. Projected sales for the first half of FY21 of all gyrostabilizer models combined will be at least $4.1m, based on the first six weeks' worth of in-hand orders. For the entirety of FY20, sales of gyrostabilizers were three times higher than FY19's at $4.8m.

Defence spending bodes well for VEEM

The defence division's operations are just as one would expect, sales of components to the Australian navy. The growth potential in this industry comes from Australia's decision to drastically increase its military size and ability. To quote Minister of Defence Linda Reynolds' oped in the AFR on 13 October 2020:

"We will increase the ADF's ability to address multiple and concurrent challenges, including its capacity to support civil authorities in response to national and regional crises, including natural disasters. This means developing more assured and resilient supply chains and expanding sovereign industrial capabilities — a necessity laid bare by the COVID-19 pandemic. Our $270 billion investment in defence capability will provide unprecedented opportunities for Australian industry while creating more Australian jobs."

We believe VEEM is likely to be one of the companies that see a boost in demand and contracts from this significant increase in defence spending due to its historical ability to win contracts and the Minister of Defence opening the new Canning Vale gyrostabiliser assembly facility. While we should not read too heavily into the minister's appearance of the Canning Vale facility, we believe it does indicate a positive relationship with the Australian Defence Force.

Propulsion and engineering providing stability at port and starboard

The propulsion division manufactures, develops, and sells propellers and shaft lines. While the company saw a decline of 10% in revenue in FY20 compared to FY19 at $14m, this was in large part due to expected manufacturing downtime in the early part of FY20 and the forced closure of production due to COVID-19 in April 2020. Based on management comments and our analysis of this division, we believe this decline was temporary.

Due to demand fluctuations and shutdowns in Western Australia, the company's most important geographic region for the engineering division, sales saw unusual declines during FY20. While demand has returned in Western Australia during 1Q21, this division should be considered as mainly supportive of the rest of the business. Basically, it provides generally consistent cash flow as well as a platform for training and maintaining the experience of the company's employees. Management has stated that this division's engineering skill and capacity is often used by the propulsion, gyrostabiliser, and defence divisions.

"Damn the torpedoes, full speed ahead!"

Management's outlook is extremely positive, and we agree that FY21 is likely to produce a significant improvement in both revenue and EBITDA over FY20's results. The shift into high gear on spending within the Australian Defence Force will likely result in a boon for VEEM.

Additionally, we don't believe the market has accurately considered the in-hand orders the company already received for the gyrostabiliser division. Using consensus EBITDA and revenue estimates for FY21 we get an EV/EBITDA multiple of 10x and an EV/revenue multiple of 1.7x. Consensus revenue and EBITDA growth for FY21 amounts to 18% and 52% respectively, which we believe clearly illustrates the market is undervaluing VEEM's growth potential. Therefore, we are issuing a four star rating.

Pitt Street Research Pty Ltd

95 Pitt Street, Sydney, NSW 2000, Australia

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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