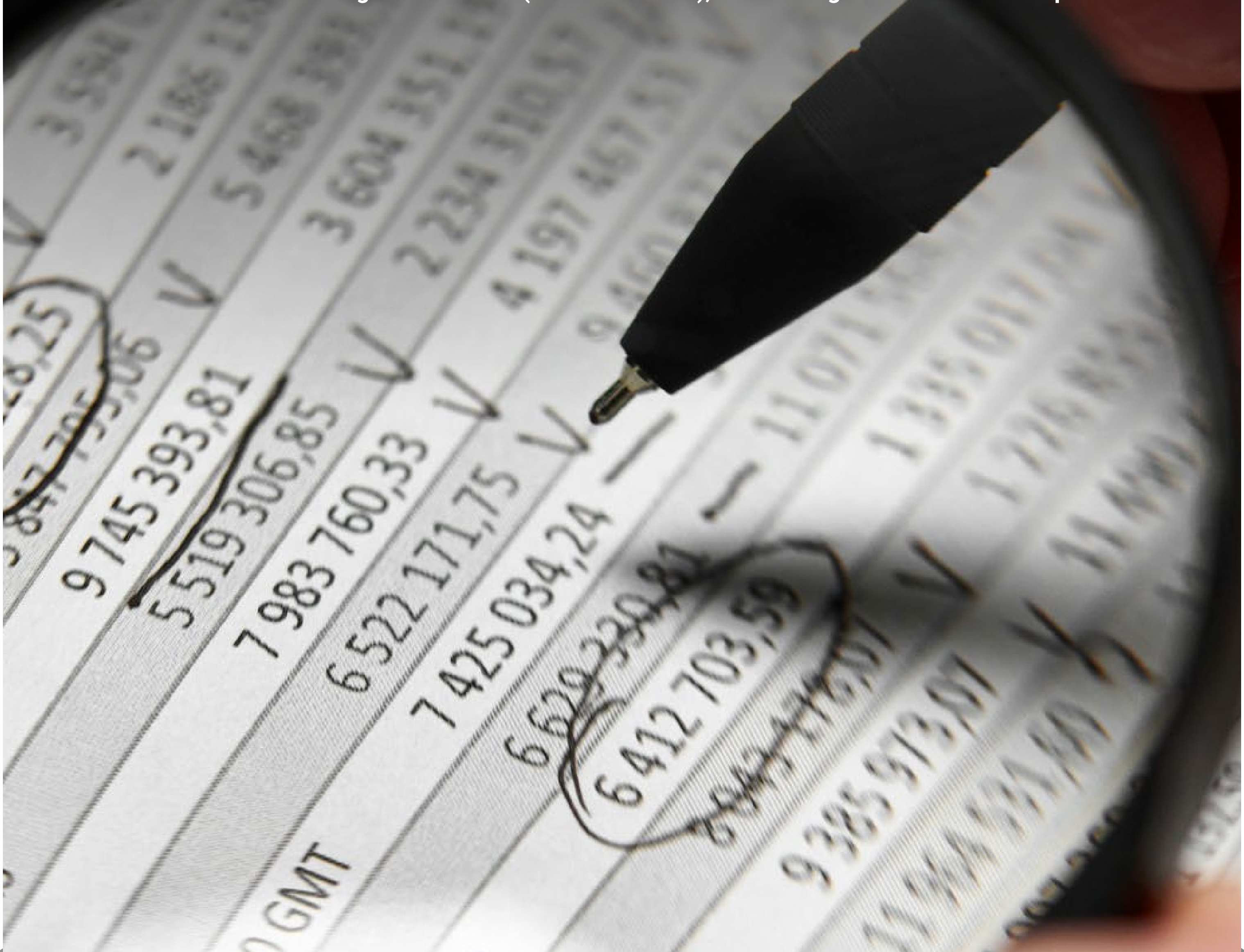
STOCKS DOWN UNDER

23 OCTOBER 2020

Small Cap Stocks Down Under

"He who desires peace, should prepare for war."

- Publius Flavius Vegetius Renatus (~383 - 435 C.E.), Poet during the Late Roman Empire



ASALEO CARE

Hold the line!

ACCESS INNOVATION

Caption this growth

SAUNDERS INTERNATIONAL

The stage has been set

ASALEO CARE

Hold the line!

Stocks Down Under rating: ★★★

ASX: AHY
Market cap: A$ 570M

52-week range: A$0.845 / A$1.21
Share price: A$ 1.02

Headquartered in Melbourne, Asaleo Care is a manufacturer and distributor of eight different brands focusing on personal hygiene products. Some of Asaleo's more recognisable products are Libra tampons, Tena pads, Purex toilet tissue and workplace hygiene brand Tork. While many of these products saw panic buying during the opening salvo of the pandemic, the stock has not moved much itself, seemingly stuck in its 52-week range. However, with hardwood prices at all-time lows, the cost of goods sold is about to take a nosedive, just in time for lower sales.

READ MORE

ACCESS INNOVATION

Caption this growth

Stocks Down Under rating: ★★★★

ASX: AIM
Market cap: A$ 165M

52-week range: A$1.01 / A$1.51
Share price: A$ 1.10

Headquartered in Melbourne, Access Innovation is one of the more recent additions to the ASX after its IPO at $1.23 per share on 15 September 2020. Access Innovation touches more of our lives than many of us really notice. Anytime you see live TV captions, broadcast subtitles, transcripts, etc. there is a strong chance this company's AI-driven software created it. While the company's share price has not fared well since its IPO, we believe investors are overlooking the growth hiding in such an unassuming company.

READ MORE

SAUNDERS INTERNATIONAL

The stage has been set

Stocks Down Under rating: ★★★★

ASX: SND
Market cap: A$ 57.6M

52-week range: A$0.25 / A$0.70
Share price: A$ 0.58

Headquartered in the city of Bankstown, 22 km south-west of Sydney, Saunders International designs, constructs and maintains steel bulk liquid storage tanks, roads and bridges. Saunders services industries such as oil & natural gas, water utilities and even the Australian Defence Force. This last industry is of particular interest due to the drastic expansion of the Australian military in terms of both size and capability over the next decade. With management projecting EBIT growth between 94% and 146%, we believe FY21 is the year Saunders shows the market its true potential.

READ MORE

ASALEO CARE

Hold the line!

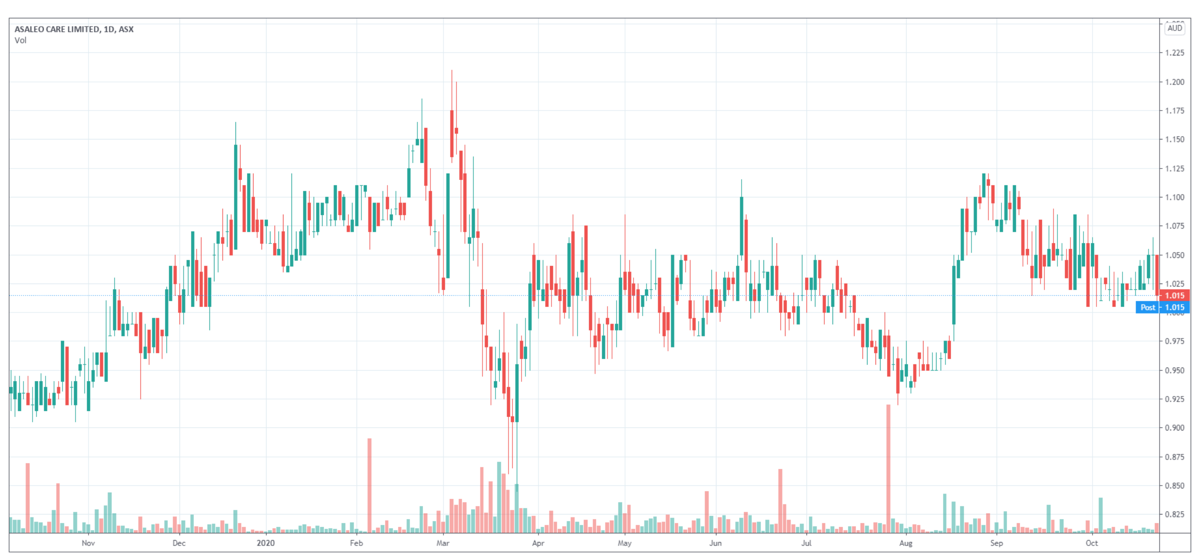
Stocks Down Under rating: ★★★

ASX: AHY
Market cap: A$ 570M

52-week range: A$0.845 / A$1.21
Share price: A$ 1.02

Headquartered in Melbourne, Asaleo Care is a manufacturer and distributor of eight different brands focusing on personal hygiene products. Some of Asaleo's more recognisable products are Libra tampons, Tena pads, Purex toilet tissue and workplace hygiene brand Tork. While many of these products saw panic buying during the opening salvo of the pandemic, the stock has not moved much itself, seemingly stuck in its 52-week range. However, with hardwood prices at all-time lows, the cost of goods sold is about to take a nosedive, just in time for lower sales.

Share price chart



Source: Tradingview

Essentials don't usually see revenue jump 9%

The first half of CY20 (Asaleo's financial year runs from January to December) was an unusually productive period for Asaleo as revenue increased around 9% while EBITDA increased 24.7% year-over-year. However, as most investors know, the first half of 2020 saw panic buying and widespread hoarding of the exact products sold by Asaleo, hygiene products and toilet tissue. Therefore, while the cost of goods sold increased accordingly to stay at approximately 61% of sales, fixed costs did not improve. This led to the 24.7% year-over-year increase in EBITDA, despite revenue only increasing 9%.

Overall current market consensus places full-year CY20 revenue at around $429m. Due to the $216m in revenue produced during the first half, this means the market is expecting revenue during 2HY20 to be around $214m. This would imply a year-over-year decline of around 1%. However, we remain sceptical that revenue declines will be capped at 1% after the significant flooding of the market that occurred during the first half. With the significant stockpiles that were created during the beginning of the pandemic, it seems unlikely to us that revenue would decline only 1% year-over-year.

Pulp has beaten a two star rating to a pulp

While we expect revenue to decline year-over-year, we most certainly do not expect EBITDA will. To explain, we need to give a bit of background. One of the most significant expenses that make up the cost of goods sold is the pulp that goes into manufacturing. Pulp prices are dictated by hardwood prices, a surprisingly volatile and cyclical commodity. Hardwood's RISI China Delivered Price reached its height at the end of 1Q19 and has since crashed by about 40%. Meanwhile, the cost of goods sold has, on average, a six-month lag in factoring in the price of pulp. However, we believe this lag was slightly longer during the first half of 2020 as the expense of the cost of goods sold remained at around 61% of sales.

So, what do all these numbers mean for investors you ask? Cost of goods sold is by far the largest expense Asaleo incurs. This indicates to us that despite the expected decline in revenue, EBITDA has a distinct possibility to beat consensus market expectations, as well as management's guidance. However, this will be dependent on just how far revenue declines. Additionally, the bottom of the hardwood commodity market has lasted for all of 2020, significantly longer than has historically been the case. While the pandemic clearly forces us to throw out many historically based assumptions, China's economy is in a strong recovery curve. Therefore, full-year results do have the risk of being overshadowed by a significant recovery in the price of hardwood. To clarify, we are not saying we expect the price of hardwood to rally during 2021, just pointing out that it is a risk.

Hold the line

Sitting squarely in the middle of its 52-week trading range of $0.85 to $1.21, Asaleo's shares have overall stayed mostly flat during 2020. Currently, the company is trading at a FY21 estimated EV/EBITDA of approximately 8x, in the ballpark of fair value for the market's 9% year-over-year EBITDA increase.

While we do believe the cost of goods sold will see a significant reduction from 61% of sales during the second half of FY20, the question of revenue performance hangs over the company. Panic buying caused revenue to increase significantly more than it usually would and caused a significant surplus of product already in the hands of consumers, in our view. To offer a comparison, the consensus revenue CAGR between FY20 and FY24 is only 2%. Full-year FY20 results should certainly be interesting and while we do believe there is a distinct possibility for a large EBITDA earnings beat, we question the performance of sales too much to issue a four star rating. Therefore, Asaleo receives a three star rating for now.

ACCESS INNOVATION

Caption this growth

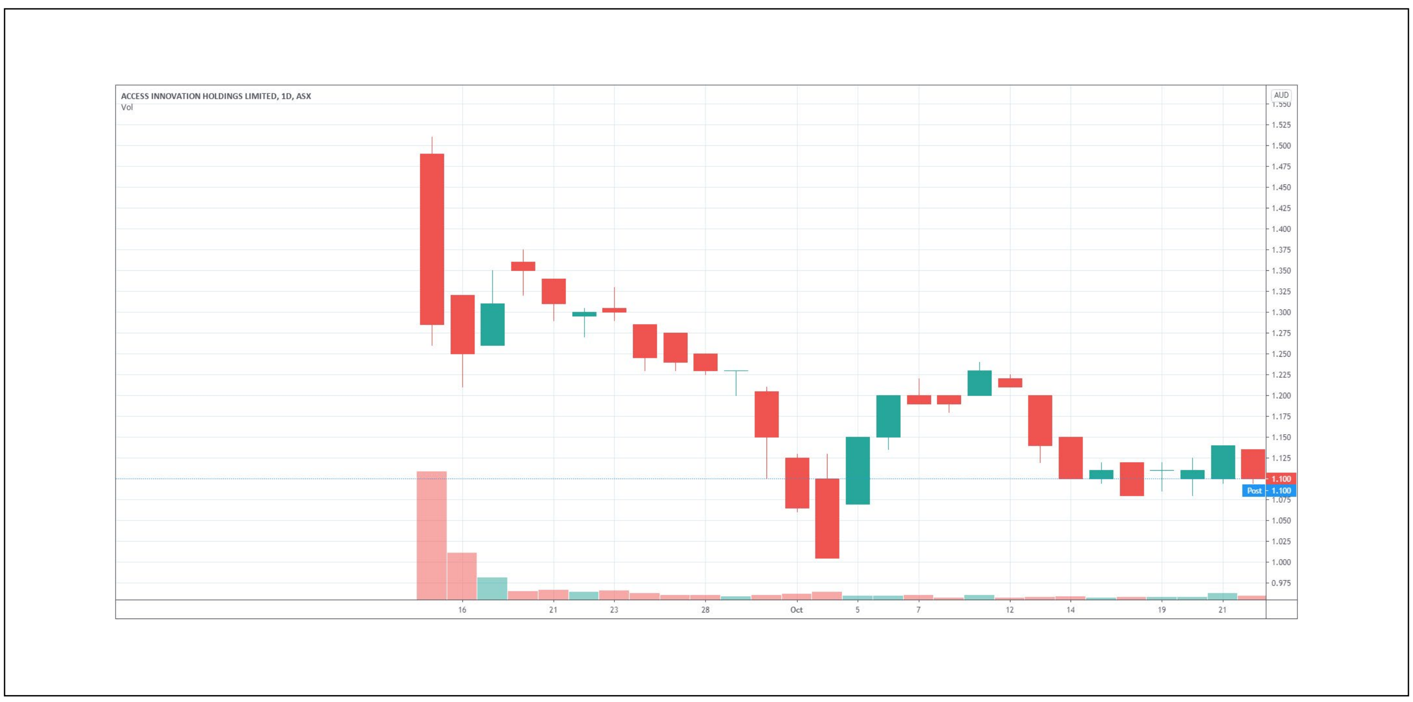
Stocks Down Under rating: ★★★★

ASX: AIM
Market cap: A$ 165M

52-week range: A$1.01 / A$1.51
Share price: A$ 1.10

Headquartered in Melbourne, Access Innovation is one of the more recent additions to the ASX after its IPO at $1.23 per share on 15 September 2020. Access Innovation touches more of our lives than many of us really notice. Anytime you see live TV captions, broadcast subtitles, transcripts, etc. there is a strong chance this company's AI-driven software created it. While the company's share price has not fared well since its IPO, we believe investors are overlooking the growth hiding in such an unassuming company.

Share price chart



Source: Tradingview

Moving closer to profitability, one caption at a time

Access Innovation's revenue is broken down into three main geographical regions: Australia and New Zealand, North America, and the Rest of the World, selling to everybody from television stations to video conference providers.

Australia and New Zealand produce the majority of the company's revenue at 44.8% of the total $43.9m, but contributed the least amount of revenue growth during FY20. However, 6.7% year-over-year revenue growth is nothing to look down on, especially if this is the lowest growth in the company. EBITDA, on the other hand, declined slightly year-over-year to $6.7m. However, we remain confident that this had more to do with expansion and COVID-19 related cost increases than the beginning of a continual EBITDA margin squeeze. Therefore, we believe EBITDA is likely to return to growth for this division during FY21.

North America is still an emerging division for Access Innovation and saw revenue growth of 19.7% year-over-year. This division acquired ACS Group on the 30 June 2020, further solidifying Access Innovation as a major player in the North American caption marketplace.

The focus for this division during FY21 is growing its market share through organic growth. Importantly, both the United States and Canada have strict disability accessibility legislation, forcing companies to use a service like Access Innovations. COVID-19 will likely continue to help the company facilitate the adoption of its products, specifically its AI-driven live caption service, as North America continues to suffer from large infection rates driving major events online. While it is unclear if the North American division will reach EBITDA profitability in FY21, we believe it will at least get close to the threshold.

The Rest of the World division saw the most significant growth at 133.5%, but also produced less than 10% of the company's total. One of the more interesting notes management made about this division was the significant rise of "multilingual recorded work from over-the-top broadcasters in Asia." Over-the-top broadcasting refers to film and TV content being delivered via the internet rather than cable or satellite providers. While it is unclear which providers in Asia they are referring to, we would like to point out that China has drastically expanded its international facing news broadcasting in an attempt to increase its soft power during COVID-19. It is possible Access Innovation benefited from this, and if so, we believe it is unlikely this increase will stop after COVID-19.

As shown in the company's FY20 results, COVID-19 has provided Access Innovation with a rare opportunity to drive fast adoption while at the same time proving the reliability of its products. Utilising the software developed for live TV captioning, the company has been able to offer this product in concert with Zoom calls. One of the main reasons this is so useful is the captioning's ability to work in a multilingual recording setting. In an increasingly globalised world, we find it hard to believe company's who were forced to use this technology will stop doing so after COVID-19 is all said and done.

Further equity dilution remains a possibility

In our opinion, the largest risk facing investors right now is the possibility of the company issuing new equity during FY21. With only slightly less than $3m in cash at the end of FY20 and a consensus-estimated EBITDA loss of $4.8m during FY21, we believe a subsequent equity capital raise is certainly in the cards. We also believe, due to the company's lack of profitability and the 8% per annum interest it was forced to offer on its convertible bond issue in late FY20, that either more convertible debt or an equity raise is the most likely.

It's time to access the innovation this company has to offer

Currently trading at a FY21 EV/Revenue multiple of 3.9x on an estimated year-over-year revenue growth rate of around 75%, we believe investors are currently leaving a lot of money on the table.

The truth is, we believe this company's product is essential, not just because of disability legislation requirements, but because of the increasing use of video conference calls, live streaming, etc. across the world even before COVID-19. Now that individuals and companies have been forcefully exposed to Access Innovation's products, we believe adoption is likely to continue to accelerate long after COVID-19 is a distant memory.

Additionally, FY22 is when Access Innovation is widely believed to become profitable, mostly through organic growth. Combining this with the company's expected revenue growth, we are not too concerned about the prospect of dilution during FY21 at the current valuation. Therefore, we are giving Access Innovation a strong four star rating while we eagerly anticipate 1HY21's results.

SAUNDERS INTERNATIONAL

The stage has been set

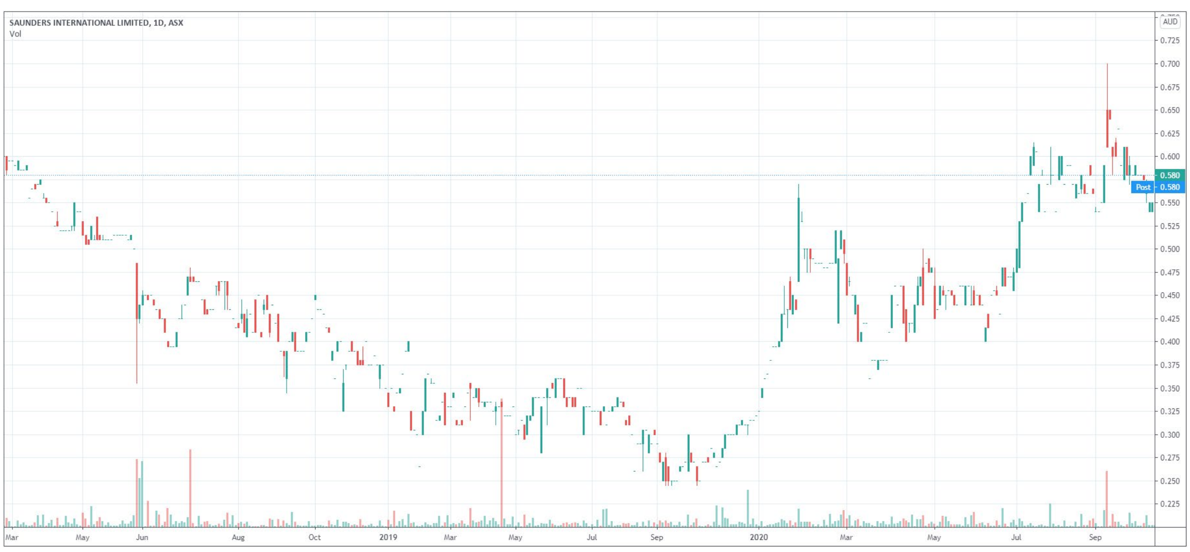
Stocks Down Under rating: ★★★★

ASX: SND
Market cap: A$ 57.6M

52-week range: A$0.25 / A$0.70
Share price: A$ 0.58

Headquartered in the city of Bankstown, 22 km south-west of Sydney, Saunders International designs, constructs and maintains steel bulk liquid storage tanks, roads and bridges. Saunders services industries such as oil & natural gas, water utilities and even the Australian Defence Force. This last industry is of particular interest due to the drastic expansion of the Australian military in terms of both size and capability over the next decade. With management projecting EBIT growth between 94% and 146%, we believe FY21 is the year Saunders shows the market its true potential.

Share price chart



Source: Tradingview

Roads, bridges and liquid tanks, oh my!

Saunders operates across three main revenue streams: engineering and construction, services, and fabrication and construction.

The engineering and construction stream consists of long-term contracts for the design, construction, site establishment and testing of liquid storage tanks.

Services revenue is provided by maintenance contracts covering infrastructure assets and facilities, such as roads and bridges.

The fabrication and construction revenue stream encompasses contracts won by the company for the design, fabrication, construction, site establishment and testing of bridges.

Combined, we believe the three revenue streams create a relatively diversified operation. During FY20, engineering and construction provided 17% of revenues with services contributing 44%, and fabrication and construction contributing 39%.

Looking at Saunders' record-high order book of $136m as of 15 September 2020, we believe FY21 will produce a similarly diversified revenue breakdown. The $136m order book includes the defence contract the company announced on 15 September for Defence Fuel Infrastructure design, construction and installation at a total value of $26m, which will be carried out betweenFY21 through 1HY23.

FY20, the year everything changed

FY20 saw significant changes occur as Saunders went from a growing company with an uncertain future to a profitable, relatively stable entity. Don't get us wrong, with a market capitalisation of less than $60m and projected EBIT between $3.75 and $4.75m, Saunders is by no means a Commonwealth Bank or Worley. However, during FY20 Saunders grew its Net Income After Tax from a loss of $1.61m during FY19 to a profit of $1.27m and saw a net increase in cash of $3.1m for the first time due solely to positive net cash from operations.

Producing a net increase in cash strictly through cash from operations is a significant milestone for the company. During FY19 the company saw a net cash outflow from operations of $3.3m, which turned around to a net cash inflow from operations of $4.9m during FY20. The $4.9m cash generated was more than enough to fund all financing and investing activities during FY20 and we believe Saunders' will easily repeat this result going forward.

The most significant risk to the production is margins

The most significant risk to investors, we believe, is the thin margins Saunders' operates on. Projected EBIT margins for FY21 are between 3.75% and 4.75%, and while the low end of these projections would still be a large improvement over FY20's 2.9%, these margins are razor-thin, in our view. This means that any significant delays or issues on the company's major projects have the potential to drive that year's projected profit into an actual loss. While we believe the rewards outweigh the risks here, there is an underlying risk of issues arising in the construction and engineering industries. Therefore, we recommend investors stay on top of the market and news releases coming out of Saunders.

All the men and women merely players

For FY21 management guided to an EBIT of $3.75 – 4.75m, an increase between 94% and 146% compared to FY20. This implies a FY21 EV/EBIT valuation multiple of 12.7x to 10x. While margins are continuing to grow, we still recognise the considerable risk the slim nature of them induces. Additionally, Saunders' shares is not heavily traded with its average three-month daily volume at only 50,000 shares. While this may seem more than adequate, using yesterday's closing price of $0.58 a share, this only represents an average traded value of $29,000 per day.

However, as William Shakespeare once wrote, "All the world's a stage, and all the men and women merely players." For Saunders FY20 was the year its stage was set, and the play truly begins in FY21, in our view. We believe the Saunders play has all the markings of a growth classic, and 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.

You are receiving this email because you subscribed to our Stocks Down Under newsletter.

Stocks Down Under (Pitt Street Research AFSL 1265112) provides actionable investment ideas on ASX-listed stocks. The Content has been prepared for general information purposes only and is not (and cannot be construed or relied upon as) personal advice nor as an offer to buy/sell/subscribe to any of the financial products mentioned herein. No investment objectives, financial circumstances or needs of any individual have been taken into consideration in the preparation of the Content. Financial products are complex, entail risk of loss, may rise and fall, and are impacted by a range of market and economic factors, and you should always obtain professional advice to ensure trading or investing in such products is suitable for your circumstances, and ensure you obtain, read and understand any applicable offer document