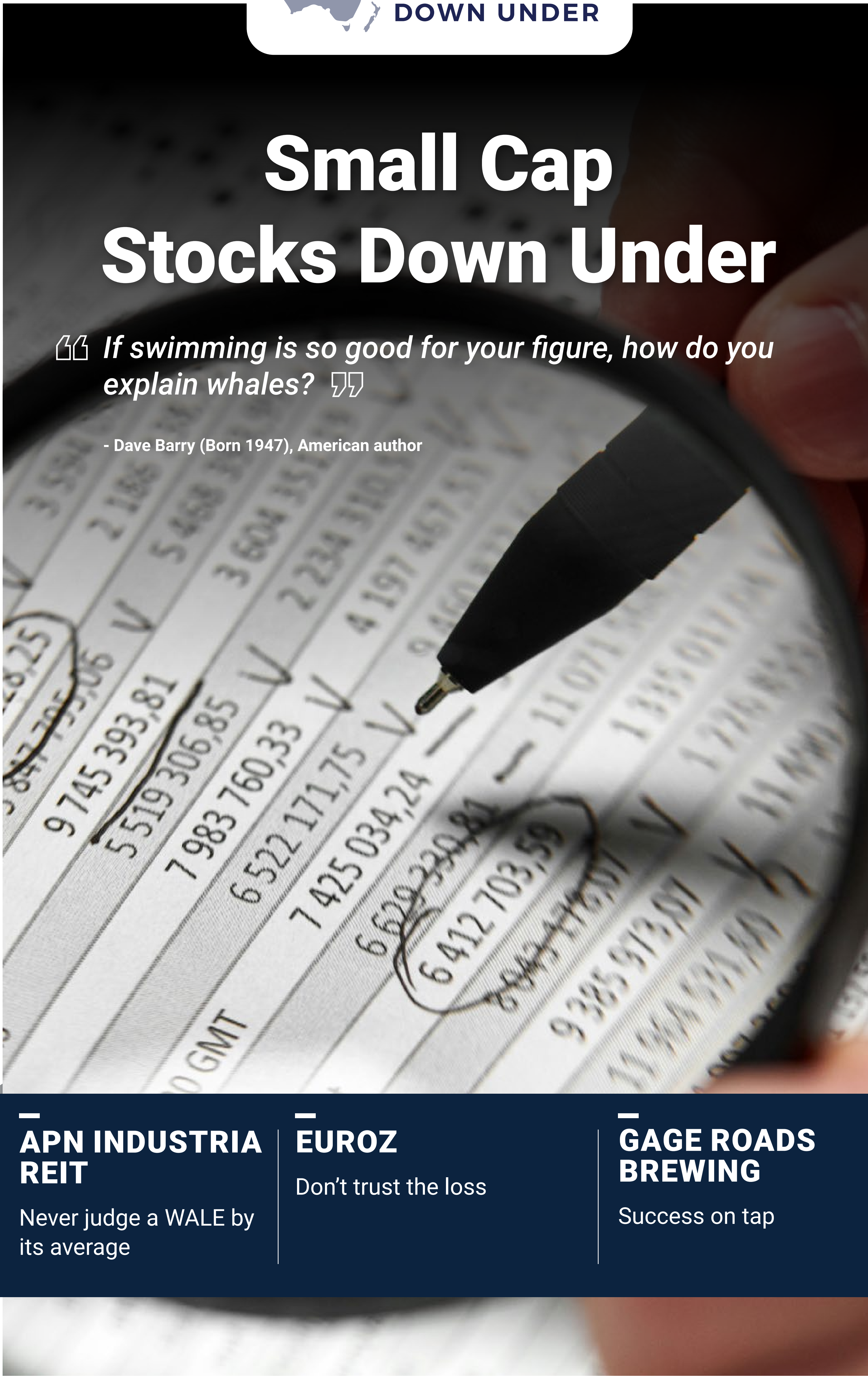

Small Cap Stocks Down Under

"If swimming is so good for your figure, how do you explain whales?"

- Dave Barry (Born 1947), American author

APN INDUSTRIA REIT

Never judge a WALE by its average

EUROZ

Don't trust the loss

GAGE ROADS BREWING

Success on tap

APN INDUSTRIA REIT

Never judge a WALE by its average

Stocks Down Under rating: ★★★

ASX: ADI
Market cap: A$ 520M
Dividend yield: 6.5% (0% Franked)

52-week range: A$1.66 / A$3.26
Share price: A$ 2.61

Headquartered in Melbourne, APN Industria REIT specialises in office and industrial assets. Since the COVID-19 market crash during the second part of FY20, REITs have come heavily into investor focus as the industry began trading at significant discounts to Net Tangible Assets. However, APN has since recovered from the worst of its 2020 lows and while we believe it is well managed, its office portfolio's WALE warrants a discount.

READ MORE

EUROZ

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Headquartered in Perth, Euroz has three main business divisions: stockbroking, wealth management and funds management. While the funds management business has been rough for many companies around the world, Euroz has managed to keep things running relatively smoothly during the last year. With high liquidity and challenging times ahead for financial markets we believe Euroz is set to take full advantage.

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Success on tap

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Market cap: A$ 69.7M

52-week range: A$0.035 / A$0.094
Share price: A$ 0.05

Headquartered in Perth, Gage Roads Brewing is one of Australia's up and coming craft breweries. Unlike many of its peers, Gage Roads' deep roots in the Western Australian market have made COVID-19 a breakout period as the state remained open for most of 2HY20 with few restrictions on public interaction. Gage Roads was able to take advantage of the interstate and international supply disruptions to grab market share and retreat does not seem to be in its current vocabulary.

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Share price chart

Source: Tradingview

The CliffsNotes of APN's portfolio book

The industrial portfolio has a total book value of $465.5m, an average occupancy rate of 95% and a WALE (Weighted Average Lease Expiry) of 8.7-years. Interestingly, out of the 14 industrial properties in the portfolio, the Newcastle property is by far the most valuable with a book value of $222m. The remaining $243.5m is roughly evenly split between the other 13 properties. The Newcastle property is not only the most significant in terms of earnings and valuation, but also in the strength of its stability. The facility was purpose built for its one tenant, WesTrac, and has 14.2 years left on its 18-year lease. We believe financial strength and size of the property will enable it to act as an anchor for APN's overall real estate portfolio.

The office portfolio has a total book value of $361m, an average occupancy rate of 89% and a WALE of 2.4-years. Out of the 9 total properties, the three largest have a total book value of $239m. Therefore, like the industrial property portfolio, this portfolio also effectively consists of three main buildings with the remainder acting mainly as supplementary income.

We need to discount this WALE

The average WALE for the industrial portfolio may be 14.2-years, but six of the 14 properties have WALEs that are less than three years and only two of the properties are actually above the average of 8.7-years. The vast majority of industrial properties are based in Victoria and all of the properties with a WALE of less than three years are in Victoria. Despite Melbourne coming out of lockdown on 27 October 2020, we believe the economic performance of Victoria will largely still be up in the air. Therefore, the low WALEs in Victoria could end up being an issue if the economy of Victoria is in for a long-run contraction.

The office portfolio is in an even more precarious position than the industrial buildings as four out of the nine buildings have WALE's below two-years. Seven out of the nine properties are in Brisbane (two in NSW) and while Brisbane has been mostly unscarred by COVID-19, it does remain to be seen how office properties will perform over the next few years.

We certainly don't believe in the idea of an office Armageddon as some news pendants have been pitching since mid-March. In fact, we recently recommended some office REITs, like Blackwall Property Trust (ASX: BWR). However, we do believe the office space will certainly see some turbulence over the next few years and REITs like APN, with the majority of its office properties' rental agreements set to expire, are likely to get the short end of the stick.

A solid dividend is always good news

The biggest draw for investors to APN is the unfranked 6.5% dividend. Fully supported by FY20's operating cash flow, APN has managed to be one of the few REITs that did not cancel or dramatically reduce its dividend due to COVID-19.

The 30 June 2020 Net Tangible Asset per share actually increased during FY20 to $2.82 from $2.71 during FY19. Based on yesterday's closing price of $2.61 per share, APN is trading at a discount to its Net Tangible Asset value of approximately 7%.

Due to the risks posed to APN's future performance by its near-term WALE, which is compounded by APN's properties' exposure to either office space or Victoria, we would normally issue a two star rating for APN at this time. However, APN's dividend of 6.5% is extremely enticing in the current rock bottom interest rate environment that we currently find ourselves in and there is a chance rates could go even lower.

Therefore, we must reduce what we would normally consider to be a reasonable discount to Net Tangible Assets for this REIT. Overall, unless the macro economic conditions considerably change, we believe a number of APN's properties are due for a reduction in book value during FY21. However, by comparing the discounts on other REITs and the company's total property portfolio, we believe the current uncertainty warrants a discount between approximately three and seven percent. Therefore, we are issuing a three star rating at this time.

EURØZ

Don't trust the loss

Stocks Down Under rating: ★★★★

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Dividend yield: 6.1%

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Share price chart

Source: Tradingview

In just two shakes of a lamb's tail

As we mentioned in our intro, Euroz has three main divisions: stockbroking, wealth management and funds management. While the stockbroking division has four main sections, we believe the most important one is its institutional dealing. Euroz's institutional dealing section specialises in trading small and mid-cap Australian equities and takes full advantage of the company's wealth and funds management divisions to facilitate its institutional connections. We believe the global low interest rate environment we are currently in will continue for at least the next couple of years driving considerable liquidity into the Australian equity markets. We also believe it is worth taking into account the continued expansion of Australian's index fund market and the superannuation industry's renewed focus on small and mid-cap Australian equities. Therefore, we believe Euroz's reputation as one of the largest institutional small to mid-cap dealing desks in Australia will continue to provide investors with strong earnings in the future.

The wealth management business was acquired early in FY16 and since then has proven to be one of Euroz's best performing divisions. Development of Funds Under Management are usually one of the strongest indicators of a wealth manager's success as a decline due to consistent poor performance will often be heavily compounded by withdrawals from investors. During its first year of operation under Euroz's ownership, this division ended with about $600m in Funds Under Management. The company has grown this through new investor inputs and positive performance to just slightly under $1bn as of 30 June 2020.

The FY20 paradox of the funds management division

Revenue from the funds management division was up around 2% year-over-year. This was predominantly derived from the management fees received from the two listed investment funds whose assets Euroz manages: Westoz Company (ASX: WIC) and Ozgrowth (ASX: OZG). As of 30 June 2020, Euroz owns 26.25% of WIC and 40.58% of OZG. While the company was able to produce a significantly better investment performance for these two funds than the stated benchmarks during FY20 (WIC 5.5% and OZG 5.2% outperformance), the company was not entitled to any performance fee income. While past performance is certainly no guarantee of future results, we are quite confident in the (funds) management skills within this division. Moving from FY20 to 1QY21, the company's extremely positive trading update was due in large part to the outperformance of this division. First quarter Net Profit After Tax was $7.1m.

At this point you might be wondering, alright so where is this paradox? While FY20 was a strong and overwhelmingly positive year for Euroz, the company actually produced a Net Profit After Tax loss of $1.4m. This is where the paradox comes into play as while upon close investigation the funds management division was the bright spot of FY20, this division was the sole reason the company suffered a loss.

During the year, the company decided to discontinue its Prodigy Investment Partners funds management partnership. Since the company owned 80% of this partnership, the resulting accounting adjustment of approximately $8m caused the Net Profit After Tax loss. Overall, we agree that the shuttering of this venture was the right move for Euroz as it was just not working out.

Signs point to yes

Overall, it is quite difficult to predict the earnings of companies involved in funds and wealth management unless you can see the company's current positions. Since fund managers are often in multiple positions that can be heavily affected by overall volatility, macroeconomic or company-specific events, earnings can be difficult to estimate. Therefore, we tend to focus on the past performance, financial position, and dividend yield of the company.

While Euroz stock is currently trading around its 52-week high, the company increased its dividend during FY20 and while it is unclear if FY21 will also see an increase, we believe the first quarter results paint a hopeful picture.

We find Euroz to have a stellar balance sheet with total liabilities only having a claim on around $24.8m of the company's total assets of $139.2m. Based on the strong start to FY21 across all three divisions following the successful turnaround during FY20, and the solid, fully franked, 6.1% annual dividend yield we find Euroz to be primed to continue its share price breakout. Therefore, we are issuing a four star rating at this time.

GAGE ROADS BREWING

Success on tap

Stocks Down Under rating: ★★★★

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52-week range: A$0.035 / A$0.094
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Share price chart

Source: Tradingview

Cracking one open

FY20 was an extremely volatile year, with COVID-19 hitting 2HY20's EBITDA by around $3.2m alone. However, despite all of the problems FY20 threw at Gage Roads the company still managed to keep its gross profit margin at 66% and eke out a positive EBITDA of $600,000. Besides the strength of the company's management team, the main factor that pushed through FY20's positive EBITDA is the relative diversity of Gage Roads across its four main distribution channels: national chains (FY20 2.6m litres), independent retailers (FY20 2.9m litres), draught (FY20 1.5m litres) and brand-in-hand (FY20 0.9m litres). In our opinion, it was this intentionally wide distribution network that prevented FY20 from being a total write-off.

Manifest Destiny but to the east

During 1QF21 a significant strategic initiative was finally opened for business, the Atomic Beer Project Redfern. This is the company's first major expansion move into the eastern side of Australia and despite only operating at a guest capacity of 85, out of a possible 200, the first four weeks have seen extremely strong demand.

The Atomic Beer Project Redfern also serves as a small craft brewery and, therefore, will assist with eastern distribution. We believe this was a perfectly timed move by Gage Roads in terms of COVID-19 and drastically increases brand awareness as the company is really starting to get a handle on its growth.

Leadership does not just put its money where its mouth is, they eat it

In an announcement released to the market on 4 September 2020, Gage Roads announced that its entire board and senior management team had personally purchased around 2.2% of total shares outstanding in on-market trades at an average price of $0.05 per share. The total price tag for this show of faith was around $1.4m. While the purchase of shares by senior management or board members through on-market buying is not unusual, a team doing that together for a total of 2.2% of shares outstanding, is extremely unusual. We believe this indicates to the market that the management is extremely confident in its Sydney expansion completed on the 24 September 2020.

A beer and a punt

Before we continue, we have a confession to make. One of the Stocks Down Under editors is a self-proclaimed craft beer aficionado. He has claimed that Gage Roads produces some of the finest craft beers in Australia. The Atomic Beer Project should consider this fair warning that as soon as he can find parking in Redfern he shall arrive. All this analyst has to say on the matter is he is more of a vodka man himself.

All in all, Gage Roads represents about as educated a punt as an investor can make, but its still a punt. The company is still in relative infancy and the stock has significant liquidity risk. In the last five days average trading volume was less than 500,000 shares and that includes the 882,800 shares traded on 27 October. 500,000 shares traded per day only represents approximately $28,000 per day of liquidity. If something goes wrong and shareholders rush for the exit, we believe an investor would be within reason to assume there would be no buyers.

Due to the emerging nature of both the Australian beer consumer from COVID-19 restrictions and the company as a whole, it is very difficult to predict future earnings with any specificity. However, we believe that FY21's results will be at least as strong as what we saw in Q1. Total sales volume during 1QF21 increased 54%, with national chains seeing the strongest year-over-year growth at 250%. As we discussed above however, we believe Gage Roads' new Sydney pub is likely to force full year FY21's results higher than even 1QF21's stellar performance. In fact, management has stated EBITDA during FY21 will be well in excess of $5.5m. If we assume that EBITDA is exactly $5.5m for FY21, this gives us an EV/EBITDA multiple of 16.4x. We believe this valuation is more than reasonable given the EBITDA growth expected during FY21. Therefore, we are issuing as strong a four star rating as we have given a punt like Gage Roads.

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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