STOCKS DOWN UNDER

6 NOVEMBER 2020

Small Cap Stocks Down Under

> *Truth is like poetry. Most people f**king hate poetry*
>
> **- Adam McKay (The Big Short), Screen Writer**

AUSTRALIAN FINANCE GROUP

Securitised and on the rise

FIDUCIAN GROUP

In the eye of the storm

SHRIRO

Perfect time, perfect position

AUSTRALIAN FINANCE GROUP

Securitised and on the rise

Stocks Down Under rating: ★★★★

ASX: AFG
Market cap: A$ 585M
Dividend yield: 5%

52-week range: A$0.89 / A$3.10
Share price: A$ 2.28

Headquartered in Perth, the Australian Finance Group encompasses 2,975 mortgage brokers nationwide per the end of June, allowing it to take full advantage of the low-interest rate mortgage boom. The company is a rather interesting case of an organisation getting its feet back under it following a continuous decline in net profit starting in FY18 due in no small part to the restructuring of its commissions scheme. Australian Finance seems the be on the rise and the way the Australian mortgage market is shaping up we are cautiously optimistic.

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FIDUCIAN GROUP

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Stocks Down Under rating: ★★★

ASX: FID
Market cap: A$ 172M
Dividend yield: 4.2%

52-week range: A$3.00 / A$6.27
Share price: A$ 5.49

Headquartered in Sydney, the Fiducian Group is one of Australia's smaller providers of platform administration, funds management and financial planning. Funds Under Management Advice and Administration (FUMAA) reached $8bn during FY20. The company has also developed the capacity to facilitate Separately Managed Accounts. Despite the company's 14% EBITDA growth, we have concerns about the source of FUMAA growth. Additionally, we remain concerned with the company's shrinking net profit margins and yet, with a solid 4.2% dividend, and a slightly discounted EV/EBITDA valuation, we believe the company is certainly not a two star stock.

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ASX: SHM
Market cap: A$ 77M
Dividend yield: 7.4%

52-week range: A$0.39 / A$0.87
Share price: A$ 0.815

Headquartered in Kingsgrove, NSW, Shriro is a distributor of well-known home appliance and consumer electronics brands like Casio, Blanco and Pioneer. However, Shriro has been expanding its distribution of company-owned brands over the last couple of years. This focus on company brands has driven increases in margin, reach and sales. The company also has a pristine balance sheet leading us to believe it's primed to take advantage of this low interest rate environment and really start to expand.

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Share price chart

Source: Tradingview

Mortgages, so a bank, right?

No, Australian Finance is not a bank. Mortgage brokers offer an essential service by navigating the complex world of mortgages to find the best one for the client. The company has two principal activities: the origination and management of home and commercial mortgage loans and the distribution of those loans in the company's branded Residential Mortgage Backed Securities programme. The mortgage broker side of the business is in a period of slight decline, as the company's margin continues to be squeezed. This trend has left it to Australian Finance's securitisation division to provide the company's profit growth. And despite this division only accounting for 14% of annual revenue, it's the results investors need to watch.

On track to return to the heights of FY17

FY17 was the height of financial performance for Australian Finance. Leading to a subsequent decline in gross and net profit, during both FY18 and FY19, deteriorating 5.8% and 15.5% respectively compared to FY17. FY20, however, saw the company' performance make a sharp turnaround as gross profit rose to $90.6m, a 24.8% increase over FY17's result. Net profit has yet to reach FY17's level of $39.1m due to significantly higher employment costs reducing FY20's net profit to $38.1m.

Mortgage margins are in decline

Between FY17 and FY20, the largest cost was commission and other cost of sales at an average of $0.90 per $1 of commission income. Unfortunately, during FY20, this ratio increased from FY19's $0.90 to $0.91. FY17 saw $0.88. This does, unfortunately, mean that the overall margins for the main business, the origination and management of home and commercial mortgage loans, have continued to decline despite the number of mortgage brokers remaining stable between FY19 and FY20.

During FY20, the company kept its mortgage broker numbers unchanged compared to FY19. However, broker efficiency has continued to fall. During FY17, the company's gross profit from its non-securitisation business was around $22.7k per mortgage broker and, during FY18 and FY19, consistently fell to the current $17.2k per mortgage broker.

Show me the securitisation

For those familiar with the phrase "show me the money", when it comes to Australian Finance, its really show me the securitisation, because that's where the money is. While the mortgage business remains a vital component of the company, the recent shift in focus to expanding the company's house brand of Residential Mortgage Backed Securities provides all the company's operational profit growth. The securitisation division operates on two main fronts: the packaging, creation, and sale of the securities and the management of the securities the company decides to keep on its balance sheet.

During FY20, securitisation interest income expanded 26.9% to $92.8m (13.6% of total revenue) while interest expenses remained effectively flat, producing an increase in operational profit of around 101%. The question remains, though, how solid are these securities?

Before we continue, we need to explain what data we considered. To determine the strength of the company's $2.9bn house branded Residential Mortgage Backed Securities portfolio, we looked mainly at the rate of principle covered insurance and the weighted average Loan to Value Ratio of the portfolio. To quickly clarify, the Loan to Value Ratio is simply the total loan divided by the valued of the property. Meanwhile, principle covered insurance is what it sounds like, its insurance that refunds the principle investment in the security if the borrower defaults on their mortgage. If the Loan to Value Ratio is above 80%, the security is required to have full principle covered insurance. As of 30 June 2020, the weighted average Loan to Value Ratio of the portfolio was below 70% with 63% that had at least some portion of the security covered by a lenders mortgage insurance policy. When we remove the securities with lenders mortgage insurance, the non-covered portfolio has a weighted average loan to value ratio of 24%, a significant improvement from FY19's 32% ratio.

Overall, we remain satisfied that the current state of Australian Finance's securitisation business and portfolio remains well within reasonable risk parameters. However, investors should remember to specifically check the statistics mentioned above with each portfolio update for any sign of deterioration.

A risk worth taking

Australian Finance has done an impressive job in transferring focus to the highly profitable securitisation division. We strongly expect this division's growth to continue during FY21, especially as interest rates continue to fall and demand for higher-yielding securities rises. Despite the mortgage broker division's oversized revenue generation compared to the securitisation division, we believe investors should view an investment in the company as a bet on the continuing success of the house branded Residential Mortgage Backed Securities.

We believe the mortgage broker division will provide both strong cash flow generation and mortgages for securitisation, but declining profit over the coming years. This places a higher level of risk on the company as the growth division is certainly still in its emerging stage and the Mortgage Backed Security industry is higher risk than mortgage brokerage.

However, we remain bullish on the Residential Mortgage Backed Security industry as we believe investors will be hunting for yield for at least the next couple of years while global Reserve Bank cash rates remain at record lows. Additionally, we believe the company is valued based on the brokerage growth trajectory. The market consensus FY21 P/EBITDA ratio is 9.8x and after taking into account the 5% dividend, we believe the valuation is more than reasonable at this time. Therefore, we are issuing a four star rating.

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Share price chart

Source: Tradingview

The three musketeers of Fiducian: Management, Planning and Administration

Fiducian has three main business operations: funds management, financial planning and corporate and platform administration. While all three of these operations have seen consistent revenue increases, financial planning is the only division to see a continual decline in operational profit.

Funds management is the highest margin business with a62.7% net profit margin. This high margin has allowed Fiducian's lowest revenue business to consistently provide the highest profit. The company's 10% year-over-year growth resulted in a profit of $9.4m for FY20. The funds management operation holds the majority of Fiducian's retail funds and as of 30 June 2020, manages $2.79bn, or around 35% of the company's total FUMAA.

Financial planning has expanded its revenue during FY20 to $20.8m (around 23% year-over-year) placing it squarely as the largest business by revenue generation, although the growth was mainly due to acquisitions. However, from a profit perspective, this business is by far the worst after expanding its operational loss from $729,000 during FY19 to around $1.7m in FY20. One of the main reasons given for why profit has seemed to elude this division is the continually increasing regulatory requirements placed on the financial advice industry in Australia, forcing extensive training and additional hires. Despite these challenges, Fiducian has continued

to make acquisitions in this industry, making three during FY20 alone. This business holds the majority of FUMAA as of 30 June 2020 at around 37.5%. We remain concerned about the likelihood of this business becoming profitable anytime soon.

Corporate and platform administration is a combination of mainly two services: acting as a Registrable Superannuation Entity and as a distribution entity for the software products and services developed by the company. Revenue for this business is significantly less than the other business operations at only 2.4%, allowing it to fall into second place in terms of revenue generation. However, the margins for this operation have continued to expand at a significant pace allowing for a profit increase of approximately 12.7% during FY20.

Operating profit margins expanded from 29% during FY19 to 38% in FY20. Unfortunately, management leaves it unclear if the company will be able to continue to increase the efficiency of this division during FY21.

Acquisitions seem likely to be driving FUMAA growth

Fiducian's reports on capital inflows for the year are slightly opaque. The company reports that acquisitions during the year saw capital inflows of around $412m during FY20 on the financial planning side of operations. Net inflows for the total company, meanwhile, are reported at $217m for FY20. It remains unclear where the majority of the estimated $195m outflow of capital originated. This lack of clarity makes us uncomfortable in speculating around the company's ability to attract organic cash inflows in future years. Fiducian's entire industry is currently undergoing structural, widespread adjustments causing many investors to pull their capital from many institutions. Unfortunately, it seems Fiducian has likely fallen into this category and is using acquisitions to at least partially fill the gap.

The ten-foot pole might be too short

Currently, Fiducian's dividend is solid and more than adequately backed by cash generated from operations. The company is currently valued at around 10x Price/Tangible Book Value after growing around 15% to $0.54 per share during FY20. These two factors lead us to believe the company is trading at around the company's fair value, especially with the Reserve Bank of Australia, lowering the official cash rate to 0.1% this past week. This precludes us from place a two star rating at this time. However, we believe the uncertainty surround the company's performance makes this company a highly risky investment with a low level of potential reward. Therefore, it's a three star rating for us.

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Share price chart

Source: Tradingview

Starting on 1 January 2021, the company will begin operating on a July to June financial year basis. This means that FY21 will be a transition year and will therefore only be six-months long.

Damn COVID-19! Full speed ahead!

"Damn the torpedoes! Full speed ahead!" was said by United States Rear Admiral David Farragut during the American Civil War at the naval battle of Mobile Bay. The truth is, incoming torpedoes is certainly an apt analogy for the situation many emerging companies, like Shriro, were in during the brunt of Australia's COVID-19 waves. The company operates with three separate divisions based on the geographical location of sales. These three divisions are: Australia, New Zealand and international. However, international sales are very much in the beginning stages of development and Australia remains the basis for the majority of the company's revenue.

At 74% of total revenue, Australia remained Shriro's largest revenue generator during 1HY20. While the sale of seasonal and Casio-branded products saw a decline in demand during the period, demand for appliances grew. The main outperformers in the appliance division for Australia were the company's newly re-released and redeveloped Omega product lines. The Omega brand is one of the company's house product lines and we expect to see this brand continue to outperform during the remainder of 2020 and during 2021. The launch of Shriro's digital showrooms during 2HY20 should also help boost sales of the company's house product lines.

New Zealand remained the second largest revenue producer during 1HY20 with 21% of total revenue. However, despite the country generating 21% of total revenue, New Zealand is still very much an emerging target market for Shriro. While the company has had exposure to the country for a while, during 2HY20 Shriro will be launching a number of major initiatives in New Zealand, including a major E-commerce capability upgrade and the expansion of the commercial appliances division from Australia. We remain highly confident that the company has a lot of room to expand into New Zealand and we believe the next two years will see the country provide a significant amount of growth across the company's product lines.

The international division currently only accounts for 5% of total revenue and has a limited product line available. However, revenue increased 62.5% year-over-year and there are indications that the company will continue to see large growth from this division. The company's United States business is heavily dependent on sales through Amazon direct and so far, this strategy has met management expectations. While specifics were not provided, management stressed that margins have turned a corner for this division, and we look forward to the company's 2020 annual report for more information.

Balance sheet about as good as it gets

It is rare for us to go into the details of a company's balance sheet on Stocks Down Under. The reason for this is simple, since we are offering a 750 – 950 word primer on the many different companies listed on the ASX, we have to prioritise and most companies don't have issues with their balance sheets. In the case of Shriro, we believe it is necessary to briefly go over its balance sheet because it's effectively debt free. As of 30 June 2020, the company had total assets of $101.6m including $19.7m in cash. The company has total liabilities of $50.6m with no borrowings. Total liabilities are just made up of current payables, lease liabilities and provisions for bad receivables. We believe this will serve the company extremely well during FY21 and FY22 as it puts into action its major expansion plans, while expanding the development of its product lines. Additionally, debt is extremely cheap as the Reserve Bank of Australia recently lowered the official cash rate to a record low of 0.1% during its November meeting.

The time is now

Despite all that COVID-19 had to throw at Shriro, the company still returned an year-over-year EBITDA growth of 32.9%, despite revenue declining 1.8%. Additionally, the company's 3Q20 market update showed 2HY20 was off to an excellent start with revenue growth reaching 14% year-over-year.

If we assume that revenue for 2HY20 grows at 14% and the company's EBITDA margin remains unchanged, the stock's FY20 EV/EBITDA multiple is 3.3x. This is despite the company achieving an estimated 36.7% year-over-year growth in EBITDA and paying a solid 7.4% dividend.

We believe Shriro will continue to expand its EBITDA margin during the remainder of 2020 and that 4Q20 will likely see higher revenue growth due to the holidays compared to 3Q20.All-in-all, we believe Shriro has been heavily undervalued and ignored by the market and, therefore, we are issuing a four star rating at this time.

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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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