STOCKS DOWN UNDER

13 NOVEMBER 2020

Small Cap Stocks Down Under

"China is a pig on LSD, you never know which way it's going to run."

- Jim Chanos (Born 1957), American investment manager

PWR HOLDINGS
Definitely not cooling off

VMOTO
Scoot away

LARK DISTILLING COMPANY
Far from a lark

LIFESTYLE COMMUNITIES UPDATE
It feels good to open up

PWR HOLDINGS

Definitely not cooling off

Stocks Down Under rating: ★★★★

ASX: PWH
Market cap: A$ 466M
Dividend yield: 1.2%

52-week range: : A$2.50 / A$5.16
Share price: A$ 4.70

Headquartered in Ormeau on the Gold Coast of Queensland, PWR Holdings is an emerging developer and manufacturer of advanced cooling technology. If we had written this article before the company's FY20 report came out we would have called them a high-performance automotive cooling company. However, everything changed last year after the company expanded its development operations into aerospace, electronics and energy storage, and aluminium heat exchangers. All of these initiatives are focused around the company's base cooling technology. We don't see this company cooling its jets anytime soon.

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Stocks Down Under rating: ★★

ASX: VMT
Market cap: A$ 127M

52-week range: A$0.11 / A$067
Share price: A$ 0.47

Headquartered in West Perth, Vmoto is has four main products: two motorcycles and two scooters. The company is heavily dependent on exporting its products to China and Europe and management's commentary indicates the company is expecting this reliance to continue. Despite the company's strong growth during 1HY20, we remain concerned that the stock has scooted away from reality despite the recent retracement from the 60+ cent high

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LARK DISTILLING COMPANY

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Market cap: A$ 95.3M

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Headquartered in Hobart, Tasmania, Lark Distilling Company is an up and coming whisky distiller and whisky bar operator. While COVID-19 caused many problems for the industry, Lark took the opportunity to focus its operations, increase efficiency and production capacity and raise capital to funds its growth. While the company is still producing a net loss, we believe it is likely to produce its first net profit in the coming financial year. Drinking whisky might be a great activity with your mates but this company is far from a lark.

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Share price chart

Source: Tradingview

The breakdown

Excluding the new initiatives, PWR had two main operating divisions for the sale of its automotive cooling technology: PWR Performance Products (Australian and European operations) and C&R (United States operations). While the company actually saw a year-over-year decline in EBITDA of 0.9% to $21.6m ($23.4m post AASB 16) revenue stayed effectively flat at $65.7m as the United States and Australian regions picked up the sharp decline in European sales. From an existing operations perspective (excluding new initiatives), we would consider FY20 a wash. However, when taking into account the strong beating the automotive industry received from COVID-19, a wash is a strong result.

New and emerging technology

PWR acquired the development and production capacity for three new product initiatives during FY20: Micro-Matrix, Cold Plates and Additive Manufacturing.

The Micro-Matrix lab is fully operational as of 2HY20 and functions as both a Research and Development facility and manufacturing base for the company's motorsport and high-end supercar cooling technology. While this has been the company's standard product offering, we are classifying this as 'new and emerging technology' because this facility has allowed the company to begin pursuing both aerospace and military contracts for its micro-matrix technology. The company is confident that it will be able to adapt its existing technology to the demands of these two industries relatively easily and we agree that contracts with these industries would be a significant game change for PWR's operations.

The last 12-months of R&D has finally paid off for PWR as for the last two months (as of 30 October 2020) they have been supplying an unnamed military customer in the United States with the company's proprietary electronic cooling plate technology. While this technology has significant military applications, the company's cold plates are focused on cooling electronics and battery cells in high end motorsports (the originating industry), military, aerospace and battery storage. Now that the company has achieved its first customer, we expect the product's adoption in other industries to accelerate.

The last of the three new and emerging technologies being developed by PWR is a new type of additive for aluminium heat exchange. The company has partnered with Velo 3D to produce the machines required to manufacture the product. The partnership has already produced the first aluminium machine, which is currently at PWR's Australian headquarters. The stated goal of this product expansion is to provide customers with additional options in thermal management. While it is unclear how successful this venture will be, we view the company's strategic, vertical expansions among different types of proprietary cooling technologies to be a strong indicator of growth to come.

More than able to handle the heat

PWR not only survived COVID-19 but was able to successfully begin development and launch of three new proprietary cooling products. The company is not only adapting its current cooling technology and expertise, but is utilising its main product's cash flow to expand the technologies at its disposal. We believe this, while not necessary, does make the company more favourable to investors as they don't have to worry about excessive equity dilution to both fund the company's research and dividend payments. While not always a dealbreaker, we do find a company to be a less risky investment when they are able to fund R&D from operating cash flow.

The market is currently estimating year-over-year EBITDA growth of approximately 25% during FY21. Based on the company's ability to keep sales relatively stable during 2HY20, pipeline of new products launched during and after FY20 and COVID-19 risk receding, we believe this is likely a reasonable estimation.

Unfortunately, the company has not resumed its guidance at this time. This market puts a FY21 EV/EBITDA valuation of 16.5x on PWR. Based on the new products launched we believe this valuation does not adequately account for the new direction the company is moving into and therefore, it's a four star rating for us.

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Share price chart

Source: Tradingview

It's all about the fours

Vmoto is a company that is all about the fours; its four geographical divisions and its four main products, i.e. the E-Max Delivery, TS, TC and CU-X. The main geographical area for the company is China, specifically the city of Nanjing. This division's $20.8m in revenue during 1HY20 (January – June 2020) accounted for 79.4% of the company's total revenue and all of its operational profit. To be blunt, Vmoto's operations and growth are effectively made or broken by this division. As we will discuss later, we are highly concerned about the company's China operations being devastated by the Australia-China political and economic brinksmanship.

Sales and growth in Australia were effectively negligible at $3,355 during 1HY20 causing a loss of $475,657. While we do know that the company has received an order from eMoped, an Australia ride share company, for 50 Vmoto model CU-X to be accounted for during 2HY20, it is clear that the company is focused on sales outside of Australia.

With revenues of $2.2m, Europe effectively saw flat growth during 1HY20. However, Europe is where a solid portion of the company's growth is slated to come from going forward as the company is expecting higher

demand. The EU is implementing a stick and carrot approach to increasing the usage of electric two-wheel vehicles. As Vmoto already has an established operation in Europe, we believe the company should be able to benefit from this approach.

1HY20 saw the Singapore division premier with a splash. This division did not exist during 1HY19 and, therefore, it was impressive that it went from zero to the second largest revenue and profit generator in the company at $3.2m and $327,999, respectively. While this was obviously a strong start Vmoto has provided no insight into how this division is slated to perform during the rest of the year or in the future.

China is a pig on LSD

To go with the theme of this editions quote we believe China poses a risk to the company that makes it extremely hard to justify a positive stance on its stock. Before accounting for intersegment asset elimination, out of the company's total assets of $55.9m, 90.3% is attributable to the Chinese division.

Concerningly, while the company has provided insights into the European division's 2HY20 prospects, we have heard virtually nothing about China's. The reason we are watching the China division closely is because China has been taking large swings at Australian exports in general, both publicly, and through government pressure, privately.

However, during their 11 November 2020 conference call we were able to ask management if they have experienced issues with the Chinese government. They responded that due to the company's manufacturing base being in China, not Australia, they did not feel it was at risk of becoming victim to rising political and economic tensions. While this is certainly good news, we will be closely watching the company's EBITDA and revenue growth coming from China as we are still concerned around the lack of guidance there.

Ride, ride away

Over the last two years the company has seen around 4.5% EBITDA growth based off of 133% and 97% revenue growth during FY19 and FY20, respectively. Despite the company's high revenue growth, it has struggled to bring that growth down to the bottom line. The discrepancy between EBITDA and revenue growth seems to be strictly an issue of margins under pressure. We remain concerned that this trend of deflating margins is unlikely to improve in the future.

If we assume the company manages to double its EBITDA growth during 2HY20 and bring 2020's full year growth to 10.5%, it would still be trading at an CY20 EV/EBITDA ratio of 40.5x. We don't believe this valuation makes sense until we see vast improvements to the bottom line and therefore it's a two star rating for us.

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Share price chart

Source: Tradingview

Can't water down this company

Lark consists of three main business operations: whisky, gin and other. Despite the challenges posed by COVID-19 lockdowns, restrictions and supply chain freezes, the company still managed to grow its total revenue 46.4% to $8.2m. This drastic increase in revenue allowed it to reduce its annual EBITDA loss to $1.3m for FY20 from $4.3m during FY19.

Whisky consists of the company's Lark brand and is where the majority of both sales and growth comes from. This division increased its total revenue to $5.6m during FY20 allowing EBITDA to reach the cusp of profitability at a loss of $29,364 from $3.3m during FY19. Based on 1QY21's results and the company's whisky product expansion of we strongly believe this division will become EBITDA profitable during FY21.

The gin division consists of the company's Forty Spotted Gin brand. While this division generates 17% of the company's annual total revenue, both its revenue and EBITDA declined during FY20. Due to the focus on the Lark Whisky brand, we are unsure about the future growth and profitability of this division. However, we remain confident that this division's worst case scenario is a stable decline rather than a sharp one that throws the company's profitability path off course.

While the other division technically consists of anything that does not fall into the gin and whisky divisions, as of FY20 it mainly consisted of the company's whisky bar and hand sanitiser sales. Due to the sharp rise in need and demand for hand sanitiser during the pandemic, many alcohol producers started utilising some of their capacity to help fill that need. Unfortunately, we don't believe this is a long-term viable business and it is unclear what portion of the division's 36% year-over-year growth to $1.2m in revenue was due to hand sanitiser sales versus its whisky bar. However, due to lockdowns and restrictions, it is not unreasonable to assume it was a significant portion.

Houston, we are a go for launch

1QY21 was a very busy three months for Lark as the company had five big launches. The first was a new Whisky Club Limited Release of 8,500 bottles, which quickly sold out. The second was its new Sherry Cask Release of 300 bottles, which sold out in 24 hours. The third and fourth launch were the new Lark Whisky Symphony No1 and Lark Wolf Release whisky brands. Lastly, the company has also dived into the Rum Cask market with its 300 bottles selling out in 24 hours.

We believe that the strong success of these new product launches is a positive indicator of the company's ability to successfully market itself online as well as raise awareness on the global stage. During the International Wine and Spirit 2020 Awards, the company won two gold, four silver and one bronze award for its products and is one of the last four finalists for Worldwide Whiskey Producer of the Year (outside of Scotland). The results will be announced on 18 November 2020. We believe being one of the four finalists provides the company with a considerable amount of exposure.

Strong pipeline of assets for the future

Due to the maturing nature of whisky, Lark is currently heavily focused on increasing efficiency yields and maximising its whisky production. As of 30 June 2020, the company had a strong pipeline of maturing whisky assets ready to be sold during FY21 and beyond FY26. Between now and FY25, around 523,000 litres of whisky are slated to mature and become ready for sale with an average, estimated, net sales value at maturation of $14.5m per year. While the company still has a long way to go before it can reach that level of sales, it is good to know that Lark likely won't have inventory issues going forward. Meanwhile, investors don't have to worry about inventory spoiling while the company continues to expand its exposure, customer awareness and consumer demand.

Well on its way to maturity

Lark is truly an emerging growth company that we believe will reach profitability during FY21. However, not many people know about this company and, there are no market estimates for its FY21 results. Due to the company's strong revenue growth of 110% during 1QY21 and EBIT profitability of $71,039, we are highly confident the company will at least achieve the 46.4% revenue growth it did during FY20. However, we believe that is the minimum growth level the company should be able to achieve.

We are using it as our baseline growth rate to show that at an estimated FY21 EV/Revenue ratio of 7.8x, this company is primed for strong shareholder value appreciation. It's a strong four stars for us.

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Share price chart

Source: Tradingview

Describing the Lifestyle

Lifestyle's business model is simple, yet effective. While most community builders develop the parcel of land and at most maintain an amenity management presence, this company only sells the houses it builds and offers 90-year leases on the land. Keeping in mind that the average lifespan of an Australian in 2017 was 82.5 years (World Bank) and the minimum age of residence is 50, individuals do not have to worry about their leases expiring out from under their feet.

The cleverest feature of the leases, however, is the fact that when a homeowner sells their house, Lifestyle automatically issues a new, 90-year lease to go along with the purchase. This allows the company to both capture the value of the land (the most valuable part of any property) and update the fortnightly lease payments based on the land's updated value on a fairly regular basis. While we don't know the average timespan between housing sales, we can be fairly certain it is at most every 32.5 years.

What's changed? Everything.

We thought the business model of Lifestyle was fantastic from the beginning, but were concerned over the stage 3 and stage 4 lockdowns that had been put into place in Victoria and the greater Melbourne area. After all, Lifestyle's communities are in greater Melbourne. For the most part it seems our concerns did not come to pass as it seems the company has managed to prevent any major infection clusters from hitting its communities.

Additionally, now that the worst of COVID-19 seems to have passed, we believe the company is primed to capitalise on the people coming out of lockdown. One of the main features of Lifestyle's communities is the heavy focus on activities and socialisation and our analysis indicates there is likely to be pent up demand for this among people who are retired or at least over 50.

So, what's the news?

What we got wrong was the impact on operations Victoria's lockdown would have, not the future prospects of the company. However, that is wrong enough and hindsight is 20/20. Since our two star rating the company's stock has rallied around 23% and the question has to be asked is there more room to run? We believe the answer is a resounding yes. Australia has a clear trend towards an influx of individuals reaching retirement age and we believe the company's community and socialisation-focused setup is likely to resonate well with individuals over 50.

Additionally, the lease situation really changes the company from a likely dividend candidate to a solid growth play. Therefore, even though an FY22 estimated EV/EBITDA ratio of 11.9x might seem high for a real estate focused company, we think the company is well placed to reach at least 40% EBITDA growth between FY21 and FY22. Four stars from us.

To review our original article on Lifestyle Communities (ASX: LIC) please click here:

https://stocksdownunder.com/edition/amcor-lifestyle-communities-base-resources/

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