STOCKS DOWN UNDER

20 NOVEMBER 2020

Small Cap Stocks Down Under

There is more to life than simply increasing its speed.

- Mahatma Gandhi (1883 - 1944), Indian lawyer and political activist

AUSSIE BROADBAND

Growing faster than NBN's speed

CREDIT CLEAR

Your choice is clear

KEYTONE DAIRY

Tone your portfolio

AUSSIE BROADBAND

Growing faster than NBN's speed

Stocks Down Under rating: ★★★★

ASX: ABB
Market cap: A$ 360M

52-week range: A$1.70 / A$2.22
Share price: A$ 1.83

Situated in the Latrobe Valley of South-Eastern Victoria, the town of Morwell is known for more than its brown coal deposits. Aussie Broadband has made this town it's home since its founding in 2008 and since then has expanded to become Australia's fifth-largest provider of NBN services. Since the company's IPO in October 2020, the stock has almost doubled. We believe the company's share price runup is mainly due to a poorly priced IPO and, unlike brown coal, we think this company's stock is not headed for a decline.

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Stocks Down Under rating: ★★★★

ASX: CCR
Market cap: A$ 119M

52-week range: A$0.44 / A$1.20
Share price: A$ 0.725

Headquartered in Melbourne, Credit Clear is one of the latest editions to the ASX after IPO-ing on 27 October 2020 at $0.35 per share. In the company's first week of trading its stock provided investors with a staggering 66% return. Investors are clearly excited about Credit Clear's proprietary billing and communication software. However, after such a fantastic IPO we need to take a step back and ask ourselves, should we be bullish or bearish on this stock right now?

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Keytone Dairy mainly operates in Sydney, Melbourne and Christchurch (New Zealand). With its headquarters in Sydney, Keytone is a manufacturer and exporter focused on dairy and nutrition products as well as the company's proprietary health and wellness brands. What makes this company unique among its dairy focused peers is its lack of focus on China. Keytone has seen phenomenal growth over the last financial year and FY21 has been no different. While its products specialise in health and wellness, we think Keytone's stock will offer investors a great chance to bulk up.

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Share price chart

Source: Tradingview

Growth through NBN

Australia is in an unusual position for a developed country with modern infrastructure; telecommunication companies firmly classified as growth. The massive development of NBN, population growth and increasing technological adoption across all aspects of the economy have created this perfect storm for telecommunication start-ups to break into the established marketplace. While Aussie Broadband has been around since 2008, the company is still well within its establishment phase of development. During FY20, the company had around 250,000 residential and business customers using its NBN service generating $190.5m in revenue. The company provides broadband services across its two divisions: residential and business.

Aussie Boradband's revenue is certainly no small matter, but the company's profit margins still leave a lot to be desired. During FY20, the company generated $1.6m in EBITDA for a margin of less than 1%. One of the main reasons for this is the company's reliance on leasing the infrastructure it uses to connect to the NBN. Across both the residential and business divisions network and hardware expenses account for 78.4% and 74.5%, respectively.

Fortunately, the company has realised this weakness. In response, as of May 2020, Aussie Broadband has begun to replace 63% of the backhaul infrastructure and 100% of the fibre optic cable the company is currently leasing. This endeavour is expected to be completed within the next two years with a useful life of 25 years. According to the prospectus, this project is expected to cost $67m, $26.5m funded by the IPO. Before we move on, we do want to remind our readers that using EBITDA to compare Aussie Broadband to competitors is misleading. Due to the high level of

depreciation most of Aussie Broadband's competitors have to deal with, EBIT is a far more accurate way to compare profitability for Aussie Broadband. Since the company has just started constructing its own networks, it has only issued guidance in the form of EBITDA at this time. We are expecting this to change once Aussie Broadband completes its infrastructure buildout in two years' time.

An IPO for the books

No, Aussie Broadband's IPO did not break any records, but it was still no less spectacular. The IPO was heavily oversubscribed, forcing the company to open it up to the maximum it had allotted, $40m. After issuing 190m shares at $1 a share on 16 October 2020, the stock quickly skyrocketed to close at $1.91 just a week later. A 91% return in a week is the stuff of dreams. We believe a question must be answered based on the company's moon-shot performance. Was this all too hard, too fast?

Strong 1Q21 performance

During Aussie Broadband's IPO management predicted FY21's results would be based on achieving 368,000 residential connections allowing the company to produce $338.1m in revenue and $12.7m in EBITDA. So far, the company seems to be well on its way to achieving its residential connection goals. On 12 November 2020, the Aussie Broadband released its quarterly market update stating its total number of connections had reached 308,720 as of 30 September 2020.

You may be wondering why we have switched from discussing residential connections to total connections. As we mentioned in the first section, the company has two main divisions: residential and business. Aussie Broadband is almost exclusively a residential-focused company with only 13% of its total revenue for FY20 being derived from its business connections. While the company doesn't specifically mention the number of business connections, we can subtract the residential connections from the total connections to estimate the total.

As of FY20, we estimate there were around 7,435 business connections. The 1Q21 total connection update represents an 18.1% increase in total connections and in our estimation the company is now 40% towards its FY21 residential connection goal (assuming 3% of connections are businesses, like in FY20). This indicates to us that it can be reasonably assumed management's revenue and EBITDA predictions for FY21 left room for upside.

The growth sounds good, but are there any macro risks?

In our view, NBN has a major risk coming down the pipeline, 5G, which could form a significant threat if incumbants, like Telstra and Vodafone, can successfully deploy fixed-wireless modems in the residential market. However, we don't believe the risk of 5G supplanting parts of the NBN network will affect Aussie Broadband in the foreseeable future. 5G's hardware operates on a relatively short-range wavelength with the first round of installations slated to target Australia's CBDs.

Aussie Broadband's focus on residential customers should help the company resist the industry challenge of 5G technology. Therefore, we think it is an area investors should be aware of and keep an eye on, but not one that should be considered a significant risk for Aussie Broadband at this time.

Keep the party going

According to the prospectus, management is expecting FY21 EBITDA to grow to $12.7m. However, as we mentioned above, we believe based on 1Q21's performance, it seems likely this estimate will prove to be on the low side. Therefore, we believe it would be prudent to value the company within a range of $12.7m at the low end and $14m at the top end, the latter number being a 10% beat of the company's own forecast. This would result in an FY21 EV/EBITDA range of 30.4x to 27.5x.

Between FY21 and FY22 the company is expecting to see 138% EBITDA growth. If Aussie Boradband is able to continue its strong customer acquisition and revenue growth, and can succeed in drastically increasing its margins through the development of its own infrastructure, we believe 138% EBITDA growth is certainly on the table. Keeping these conditions in mind, it's four stars from us.

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Share price chart

Source: Tradingview

Let's be clear about Credit Clear

Credit Clear has three main business divisions: Credit Clear, Credit Solutions and Oakbridge Lawyers. The company's business model is geared to effectively disrupt payment collections management across the entire spectrum of the industry through traditional offerings combined with the Credit Clear's proprietary software offerings. While the company has a diverse range of clients, the transport and financial services industries are of heavy focus for Credit Clear as they provided a combined 43.7% of total revenue.

Credit Clear, aside from the name of the company, is the name of the company's billing and communication digital platform. This division mainly handles the first stage of receivables management when tracking down individuals is not fully required. Credit Clear earns revenue through four main streams: per communication charge, per active account charge, international licensing income and integration and gateway fees. Now, if you're like us you must be thinking, per account and per communication charge? That sounds ridiculous. The numbers behind these charges actually explain a lot. The per communication charge is when clients send a message to an individual or company regarding an outstanding balance. Credit Clear charges them between $0.10 and $0.30 per message. On a per active account basis the charge is between $0.03 and $1.50. We believe the Credit Clear division is the company's main differentiator and sets it apart in a crowded industry.

Ramping up for war

When the collection of receivables becomes more difficult or takes longer than expected, companies will usually bring them to Credit Clear's two other divisions: Credit Solutions and Oakbridge Lawyers.

Credit Solutions is a more traditional receivables management offering. By traditional we mean this division operates out of call centres to help setup payment plans and begin the initial process of tracking down customer's clients who have not responded to previous attempts to collect payments owed. This division generally handles the second stage of the receivables lifecycle as money owed begins to take longer to collect.

Oakbridge Lawyers provides clients with the last resort option of going after receivables through the courts. While this may seem uninteresting on the face of it, we think this provides Credit Clear with a significant advantage as it offers clients a one-stop-shopping option. We believe this vertical integration of Oakbridge Lawyers provides strong customer attraction. Since the company has the ability to provide the customer with assistance even during the last stage of receivable collection, we believe it also decreases the chances the client will look for a replacement.

The big four, industries that is

Credit Clear's clientele is fairly diverse across four main industries: transport (22.9% of revenue), financial services (20.8%), government (10%) and utilities (9.7%). These four industries make up around 95% of the company's total revenue generation with contracts typically running between two and four years. The company has slightly more than 800 clients, per the end of FY20. We believe Credit Clear's 84% successful tender rate and ability to attract clients across specifically unique industries is a reflection of the company's proprietary software and service offerings for all stages of the collection process.

The time is right, the time is now

Receivables management and collection is always important for a company, but with businesses coming out of lockdown and the economy beginning to show signs of emergence from hibernation, this is now more important than ever. We believe the economic situation is truly perfectly aligned for a company like Credit Clear because companies are not just starting to reopen again, but the economic data is showing companies are still pinching pennies. What better way to cut costs than by more efficiently collecting the money that is already owed to you?

While Credit Clear is not yet profitable and was not brave enough to issue forward guidance on either its revenue or EBITDA, it did release its 1Q21 digital communications growth. On a year-over-year basis Credit Clear's digital communications sent on behalf of customers grew 225% and we certainly do not believe this was a one off.

While the company's lack of guidance does add a large amount of risk, we believe Credit Clear deserves four stars given its revenue model, current growth rate and the current economic environment.

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Share price chart

Source: Tradingview

Turn the product over and get at the stats

Keytone has two main divisions: the sale of proprietary brands and contract manufacturing but the company only moved into Australia during FY20 (running from February 2019 through March 2020). The only countries where Keytone generated revenue during FY20 were Australia and New Zealand. This is important to note, because, as we will focus on later, FY21 has seen Keytone drastically expand its geographic footprint.

Keytone currently has four main proprietary brands focused on milk powder, ready-to-eat meals and snacks, high protein ready-to-drink solutions, and for a bit of variety, fudge. While this division's total revenue of $2m only represented 9% of FY20's total revenue, the year-over-year growth was 78%.

The contract manufacturing division generated $19.1m in revenue during FY20 and, at 84.8% of FY20's total revenue, Keytone is clearly a contract manufacturer. To quickly summarise what this means, contract manufacturing is when the company uses its facilities to produce products for third-party private labels. During FY20, due mostly to the expansion into Australia, this division's revenue saw staggering growth of 1,932% year-over-year. However, we expect the proprietary brands division to overtake this division in size in the coming years. You see, Keytone's main focus is on expanding the sale of its proprietary products through introduction into new markets and retailers that did not previously stock Keytone Dairy.

One of our concerns when we first looked into Keytone was what portion of its revenue growth was due solely to entering new markets. As a quick recap, the company's proprietary brands division and contract manufacturing division increased revenues by 785% and 1,932% respectively during FY20, i.e. including new markets. However, just in New Zealand these divisions still grew 20.8% and 140% year-over-year, respectively.

Where's China?

Many of Keytone's dairy peers, like A2 Milk (ASX: A2M) and Nuchev (ASX: NUC) are focused heavily on China for growth. Therefore, the geopolitical conflict with China that Australia has found itself in of great concern for them. Keytone, meanwhile, derived the majority of its revenue from Australia and New Zealand during FY20.

In the company's 2Q21 report (Ending 30 September 2020) it was mentioned the company had seen significant orders out of China, though, specifically for the contract manufacturing division, after an order from Walmart China. The company's overall 1HY21's recordbreaking $25.9m in revenue represented a year-over-year growth rate of 250%. While China certainly has the potential to offer strong growth opportunities going forward, the majority of revenue growth comes from Australia and New Zealand with the company's proprietary brand Tonik and Super Cubes in Australia recording $11m in revenue during 2Q21 alone.

It's very difficult for companies in the dairy industry to avoid China, the growth is just too enticing. The reason we think Keytone stands above its peers is because the company's significant growth is not reliant on China, but it is prepared to benefit from the opportunity there.

Keytone's New Zealand business saw a record quarter as well with $3.3m in sales, representing 172% in growth versus 1Q21.

While Keytone certainly has exposure to China, we believe the majority of the company's growth over the next couple of years is slated to come from Australia and expansion into the Middle East, Malaysia and other geographical locations.

Give me the risks

The risks facing Keytone investors currently focus mostly on the lack of profitability. During FY20 the company saw its EBITDA losses increase from $3.2m in FY19 to $5.9m. Unfortunately, there is no clear timetable for when Keytone will enter EBITDA profitability and we believe the company's continual expansion will likely inflate its expenses over the next year at least. This situation does lead to the risk of the company issuing additional equity to fund its expansion. However, we remain confident that Keytone's continual growth will more than make up for any dilution investors may have to face.

Let's bulk up

Like Keytone, Nuchev is not yet profitable either. However, the latter has significantly more exposure to China. The market currently expects Nuchev's revenue to grow by 5.6% during FY21. Nuchev's FY21 EV/Revenue currently sits at 2.9x. While we don't have any FY21 estimates for Keytone, if 1HY21 is any indication, the company is looking for another strong year of revenue growth, i.e. in the triple digits.

It is also important to remind our readers that Keytone does not have nearly as much China-specific geopolitical risk associated with it as Nuchev.

Yet, if we were to just take the $25.9m of revenue generated during 1HY21 and assume flat growth for 2HY21 as the company's full year FY21 revenue (an absurd prediction we are using for effect), Keytone would have a FY21 EV/Revenue ratio of 1.5x. In reality, though, this will turn out to be a lot lower, given the expected revenue growth in 2HY21.

In our view, Keytone seems to be a clear-cut case of the market not realising that this company even exists, which makes this a strong four star rating for us.

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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