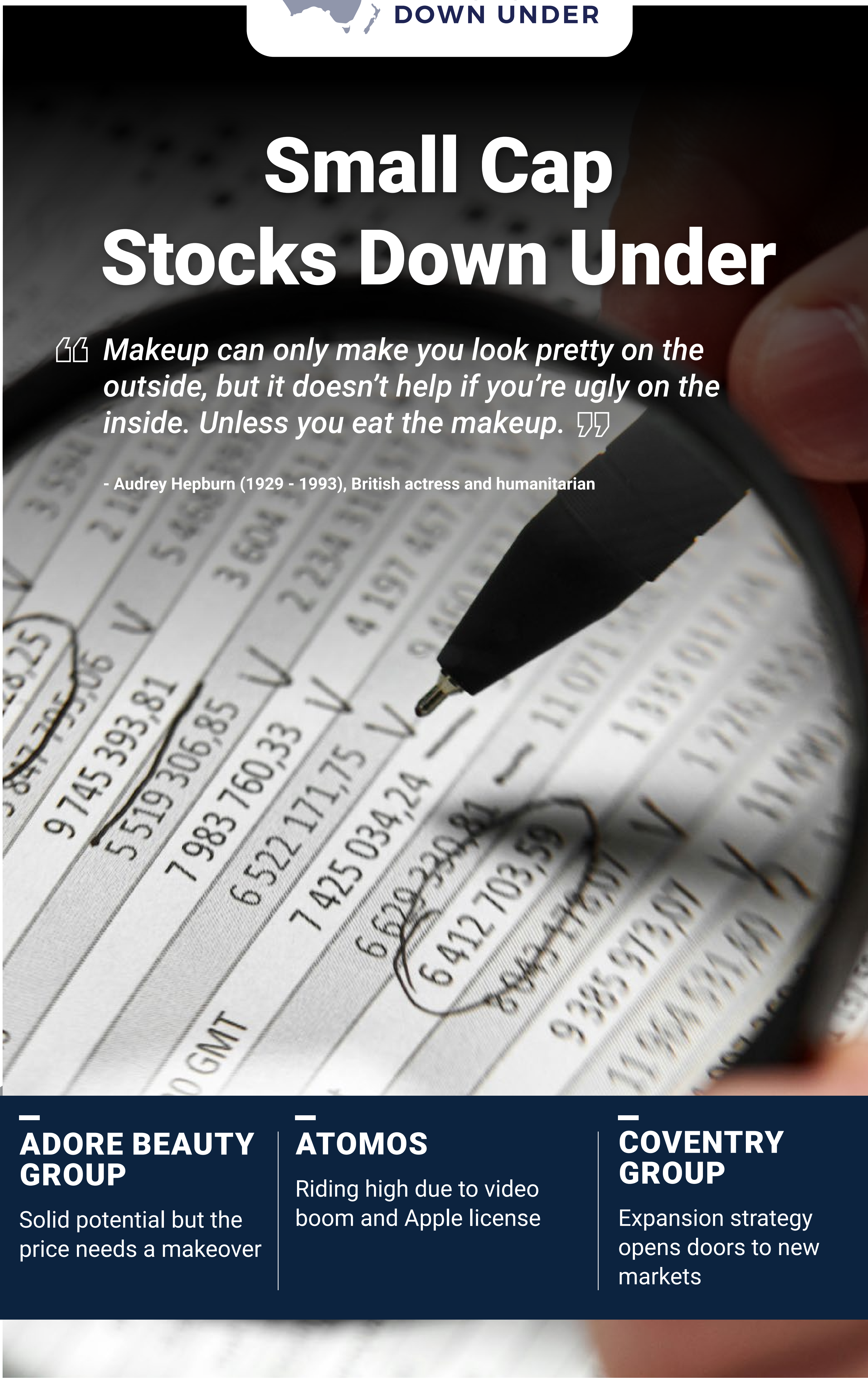
STOCKS DOWN UNDER

8 JANUARY 2021



Small Cap Stocks Down Under

> *Makeup can only make you look pretty on the outside, but it doesn't help if you're ugly on the inside. Unless you eat the makeup.*

- Audrey Hepburn (1929 - 1993), British actress and humanitarian

ADORE BEAUTY GROUP

Solid potential but the price needs a makeover

ATOMOS

Riding high due to video boom and Apple license

COVENTRY GROUP

Expansion strategy opens doors to new markets

ADORE BEAUTY GROUP

Solid potential but the price needs a makeover

Stocks Down Under rating: ★★

ASX: ABY
Market cap: A$ 506M

52-week range: A$5.08 / A$7.42
Share price: A$ 5.42

Melbourne-based Adore Beauty Group is an online retailer of third-party cosmetics and other beauty and personal care products. It is an emerging player in a $10.9bn Australian beauty and personal care market that has ample room for e-commerce penetration. Adore Beauty debuted on the ASX back on October 23rd with an IPO price of $6.75. Even with the shares having pulled back 20% since then, we find the price tag to be too high. The path to growth is clear given the ANZ region's increased online spending patterns on personal care products. But considering the intensifying competition and low barriers to entry in the online beauty market, we believe Adore Beauty still has much to prove to justify its current valuation.

READ MORE

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ASX: AMS
Market cap: A$ 210M

52-week range: A$0.24 / A$1.59
Share price: A$ 1.08

Headquartered in Melbourne, Atomos develops technology for video content creation. Its unique video equipment and software is becoming increasingly popular worldwide. With diversified revenue derived from the Asia Pacific (APAC), North American, European and Middle East & Africa (EMEA) regions, Atomos is building a strong presence in the global video production market. The media device company has well-established relationships with several major players within the content creation ecosystem, including Adobe, Apple, Canon, FUJIFILM, JVC Kenwood, Nikon, Panasonic and Sony. We are particularly optimistic about the Apple partnership, which is rapidly opening new doors with major camera manufacturers. This is giving Atomos some high-quality optics.

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Based in Melbourne, Coventry Group is an industrial products distributor that is becoming a good turnaround story. Its products are used by an increasingly diverse set of customers in the industrial, commercial construction, manufacturing, mining, defence, recycling and agriculture sectors. These customers rely on Coventry for fastening systems, fire suppression, hydraulics, lubricants and refuelling projects to keep their operations running smoothly and safely. Hardly a newcomer to the ASX (having been listed since 1966) Coventry has a sound growth strategy and good upside, in our view. Progress with acquisition integrations and turnarounds in the construction and infrastructure sectors bode well for product demand and profitability in the new year.

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Share price chart

Source: Tradingview

Seeking to penetrate the beauty and personal care market

Adore Beauty Group is the leading pureplay online beauty retailer in Australia. It sells approximately 11,000 body care, cosmetic, dietary supplement, fragrance, hair care, oral care and skin care products that are made by over 230 leading beauty brands. The company has come a long way since being founded by Kate Morris in a Melbourne garage 20 years ago. Today it offers popular beauty care products to customers in Australia and New Zealand through its content-integrated e-commerce platform. The website's educational and entertainment content helps drive traffic to the site.

The group has a growing active customer base of nearly 600k shoppers that browse the Adore Beauty site to find products that fulfill their personal care needs. Its growth strategy is focused on expanding this audience by broadening its product line-up and connecting with new and existing customers. This will involve not only creating better brand awareness, but entering into adjacent product categories and new markets.

In 2019, just 7% of Australia's beauty and personal care product sales were generated online. This significantly lagged other markets, such as the UK (15%) and the US (13%), and gives Adore Beauty reason to believe there is market share to be had. And given the rising popularity of online shopping and increasing consumer awareness of its website, Adore appears to be in a good position for long-term growth.

Results benefit from accelerated online shopping trend

As per the company's October 2020 prospectus, the last two results have demonstrated the type of growth Adore Beauty is experiencing. Revenue growth was 38.6% in FY19 and then accelerated to 65.5% in FY20. After slipping from 2.7% in FY18 to 2.2% in FY19, the EBITDA margin nearly doubled to 4.1% in FY20. Although Adore Beauty recorded a net loss of $1.2m in FY20 due to increased employee and marketing costs, the results in the two years leading up to the IPO overall were positive.

For all of FY20, Adore Beauty had over 18.5m website visitors. While this may make its active customer base look unimpressive by comparison, at this stage of the game, driving traffic to the site and harvesting market recognition of the Adore Beauty brand is a critical aspect of the company's growth trajectory.

Adore Beauty provided an encouraging trading update on 1 December 2020 that showed sales were trending ahead of its prospectus forecast. Strong Black Friday and Cyber Weekend sales along with the prolonged lockdown orders in Victoria led to more people shopping for beauty products online. The favourable trading conditions prompted management to upgrade its 1HY21 revenue guidance to $95.2m, or 7% above its prospectus forecast. Management also said that it sees a probable uplift in its operating earnings forecast, although it refrained from offering profit guidance.

Nevertheless, if we double the half year forecast and assume Adore brings in $180m in revenue in FY21, this gives it less than 2% share of the ANZ beauty and personal care market and shows just how much room it has to grow. It'll certainly be interesting to see the first half results when the company next reports in February 2021.

Company needs time to grow into its valuation

Let's keep in mind that Adore Beauty competes with not only traditional beauty product retailers, but also with the companies that own the same brands that it sells. The company recognizes this risk. It has been clear about its intention to launch its own cosmetic brands to further diversify its portfolio and reduce its heavy reliance on third-party brands. While we aren't overly concerned about the risk given Adore sells more than 200 brands, we do think this is a step in the right direction.

With management expecting net profit after tax (NPAT) of $3.5m in FY21, Adore Beauty shares are trading at a forward price-to-earnings (P/E) ratio of almost 108x. This is a significant premium to peers such as Kogan.com and Temple & Webster Group which trade at roughly one-third that earnings multiple. So, while we recognize the company's strong growth potential in the up-and-coming online beauty products space, the lofty valuation makes us blush. Two stars for now.

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Source: Tradingview

Apple partnership holds tremendous value

Atomos makes innovative software and hardware products for the content creation market. From photography and social media content to professional video and cinema production, the company's offerings cover the full media spectrum. Its main product is a monitor-recorder which can quickly capture and process high quality images. What's unique about the technology is that it grabs images directly from a video camera sensor and transfers them to the camera's hard drive. These images are then enhanced, recorded and distributed for content creation purposes. In this way, even standard definition cameras can be turned into high resolution devices.

In contrast, images taken using traditional digital camera formats like JPEG suffer from compressed and lost data. This doesn't happen with the Atomos monitor-recorder, which can use retained information to produce higher quality content. The Atomos monitor is compatible with phones, tablets and video cameras, and can be used to view and edit video. Since its products work with equipment made by major camera manufacturers and software companies, the value proposition for users is a seamless workflow.

Atomos' strategic relationship with Apple is its most intriguing opportunity, in our view. Apple's latest recording format called ProRes RAW is highly regarded in the professional video production industry. So, where does Atomos fit in? It is one of only two companies worldwide that are licensed to use ProRes RAW. This gives it a major leg up on the competition. The ProRes format is being adopted by major software providers, like Adobe and Avid, which is adding credibility to the format and creating revenue growth opportunities for Atomos. And for the more casual video creators among us, Atomos products can also be used with iPhones.

Video market recovering from COVID-19

The company's FY20 result showed that revenue fell 17.6% to $44.5m, but the FY20 picture was heavily distorted by COVID-19. You see, revenue declined 60% to $11.9m in the back half of FY20 after increasing 35% to $32.6m in the first half of the year. After recording EBITDA of $1m in the first half, Atomos ended up with a $7.1m EBITDA loss for the full year.

However, the market shrugged off the revenue decline and instead chose to focus on management's upbeat outlook around the economic recovery and growth prospects. We tend to agree with this perspective and also laud the recent cost reduction efforts. Starting in April 2020, Atomos lowered its monthly cost base by 60% to about $1m monthly. Management noted strong revenue growth to start FY21 and said it expects to return to pre-COVID revenue levels by the start of CY21.

Despite the second half slowdown, the Atomos business was more or less unaffected by COVID-19. The pandemic initially shut down Atomos's key professional video market, but as economies have since reopened, activity in the industry has rebounded. If anything, the company may have even benefited from the accelerated trend towards streaming video services. Homebound consumers are increasingly embracing the original content offerings from the likes of Netflix, Disney, Apple and Amazon.

We also favour the strong balance sheet. Atomos had $19m of cash as at 30 June 2020 and access to an additional $5m credit facility. We believe this level of funding will help it get through any near-term market turbulence and will allow the company to carefully pursue strategic growth projects.

Ninja V driving stealth like revenue growth

The company's Ninja V product has been a standout performer. Demand for the 5 inch on-camera monitor-recorder has been strong since last year. What's behind the popularity of the product? Major global camera makers have been quick to integrate the ProRes RAW format. They recognize the value of the Ninja V, which records and plays video from small device hard drives. For example, Sony's new Alpha 7S camera can record Apple's ProRes RAW format via the Ninja V. Meanwhile, Atomos is building off this success by enhancing the Ninja V. In June 2020 it began shipping its AtomX SYNC module, which adds "wireless timecode, sync and control technology" to Ninja V.

Overall, there's a lot to like about this company and its upside potential. Atomos has a growing presence in the social and entertainment video markets worldwide and we think the runway for growth remains long. The rapid proliferation of social media platforms, such as YouTube and Instagram, along with the growing popularity of streaming video should together be major revenue growth drivers over the next several years. For these reasons, we think investors should tune in to Atomos. Therefore, it's four stars from us.

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Share price chart

Source: Tradingview

Seeking to be a leader in industrial supply

Coventry Group operates through two segments—Trade Distribution (TD) and Fluid Systems (FS). Trade Distribution, the bigger of the two divisions, imports and distributes industrial fasteners and hardware supplies as well as cabinetry hardware through a network of 62 branches in the ANZ region. The Fluid Systems business makes, installs and performs maintenance on lubrication, hydraulic fluid, fire suppression and refuelling systems through 12 Australian branches. Although most of the group's revenue comes from Australia-based customers, it also generates growth from its Trade Distribution New Zealand business.

Coventry's growth strategy includes store, product range and geographic expansion, which together are designed to increase its presence in current and new markets. It also plans to increase the size and capabilities of its business developments and sales rep teams. This should help it win more business from both new and existing customers. Meanwhile, management is working on fixing its underperforming branches through a combination of sales and cost initiatives.

Making sensible acquisitions will also continue to be a part of the growth strategy here. The company takes a disciplined approach to M&A by applying strict criteria in selecting new partners. It has noted a promising pipeline of potential acquisition opportunities. Overall, we see this strategy playing out well and leading to market share gains as Coventry's markets benefit from additional government stimulus and improving economic conditions.

Strong FY20 results and balance sheet

Coventry delivered a strong FY20 result that was the group's best in years and sent its shares flying higher back in July. Sales were up 22.3% (or 4.7% excluding acquisitions) and exceeded market expectations. Both segments recorded strong growth. Trade Distribution sales increased 27% and Fluid Systems sales advanced 15% (or 2% and 9% respectively, excluding acquisitions). EBITDA more than doubled from FY19 to $6.6m and statutory net profit came in at $0.8m.

Fortunately, COVID-19 had a minimal impact on the business. Lockdowns in New Zealand caused a 23-day closure of Coventry's operations there, but demand in Australia has been resilient.

Management has been in tune with the company's financial health and stability. The cash position has improved meaningfully due to inventory reduction and better operating cost management. As at 30 June 2020, the cash balance had increased more than 40% to $7.5m. Net debt was $3.3m, which marked a significant improvement from just three months prior when net debt was $10.9m. We also like that the liquidity position is solid with current assets comfortably exceeding current liabilities by $42.7m.

Growing organically and through acquisitions

There has been a noticeable turnaround in the company's main Konnect and Artia business, which falls under the Trade Distribution segment. Konnect and Artia Australia (KAA) sales were up 3.4% in FY20. The closure of underperforming locations and branch consolidation is helping here as are reductions in variable expenses. Meanwhile, the Konnect and Artia New Zealand (KANZ) business is also performing well. Despite the COVID-related closure, sales were up 1% in FY20.

Inorganic growth has certainly helped too. Last year's acquisition of Nubco has bolstered Coventry's Trade Distribution business while the October 2018 buyout of Torque Industries tightened the company's grip on the Fluid Systems market. The integration of Torque is said to be going according to plan. The Torque business recently relocated to a new custom-built facility in Adelaide, SA where it will join the Cooper Fluid Systems business. The Nubco acquisition is already having a major influence on the legacy Konnect and Artia business. Conventry is in the process of giving its KAA and KANZ locations Nubco-style makeovers to give the stores a more modern, customer-friendly flair to drive higher sales.

A healthy level of activity in the key construction, infrastructure and mining markets should support growth heading into 2021. Coventry Group shares are trading at a 20% discount to net asset value (NAV). So, we like that too! So, four stars.

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.