STOCKS DOWN UNDER

15 JANUARY 2021

Small Cap Stocks Down Under

"Power rarely ends up in the hands of those who start a revolution, power sticks to those who bring it to a conclusion."

- Robert Greene (b. 1959), American author

ECLIPX GROUP

Don't lease Eclipx stock, buy it

1300 SMILES

Not quite smiling

TOP SHELF

Only the best will do

ECLIPX GROUP

Don’t lease Eclipx stock, buy it

Stocks Down Under rating: ★★★★

ASX: ECX
Market cap: A$ 591M

52-week range: A$0.365 / A$1.98
Share price: A$ 1.83

Headquartered in Sydney, the Eclipx Group operates across Australia and New Zealand providing fleet management through its three core brands. While this company was not hit hard by COVID-19 corporate spending pullbacks, the business did take some damage. Despite this, the company still managed to produce a year-over-year growth in EBITDA, mainly through cost cuts and a massive turnaround of the business. The stock was ended the 2020 effectively flat, but we think the market is underestimating the company’s potential in FY21.

READ MORE

1300 SMILES

Not quite smiling

Stocks Down Under rating: ★★★

ASX: ONT
Market cap: A$ 148M

52-week range: A$4.69 / A$7.14
Share price: A$ 6.75

Headquartered Townsville, Queensland, 1300 Smiles (Smiles) owns and operates 32 full-service dental operations across Queensland, Sydney and Adelaide. The company’s stock took a serious drilling during COVID-19 dropping 30% to its 52-week low of $4.69 as practices were closed and patients became increasingly hesitant to show up. Since mid-July the stock has been on a tear as most of Australia largely shrugged off COVID-19 and appointments became possible again. If there is one thing COVID-19 has proven about Smiles, its that everybody needs dental care.

READ MORE

TOP SHELF

Only the best will do

Stocks Down Under rating: ★★★★

ASX: TSI
Market cap: A$ 84.4M

52-week range: A$1.81 / A$2.21
Share price: A$ 2.07

After what had been a crazy 2020, we can understand if you need a drink and not just any drink, but something Top Shelf. One of ASX’s newest listed companies is Top Shelf, an Australian whisky, vodka and mezcal distiller. Lets crack open a bottle and see if this liquor is really Top Shelf.

READ MORE

ECLIPX GROUP

Don’t lease Eclipx stock, buy it

Stocks Down Under rating: ★★★★

ASX: ECX
Market cap: A$ 591M

52-week range: A$0.365 / A$1.98
Share price: A$ 1.83

Headquartered in Sydney, the Eclipx Group operates across Australia and New Zealand providing fleet management through its three core brands. While this company was not hit hard by COVID-19 corporate spending pullbacks, the business did take some damage. Despite this, the company still managed to produce a year-over-year growth in EBITDA, mainly through cost cuts and a massive turnaround of the business. The stock was ended the 2020 effectively flat, but we think the market is underestimating the company’s potential in FY21.

Share price chart

Source: Tradingview

A turnaround success story

Eclipx has been struggling the last few years under the burden of a significant amount of debt and an overly complicated business. Recognising the trouble the company was in management began its “Simplification Plan” back in May 2019. The plan was completed during August 2020, a full 13-months ahead of schedule. When all was said and done the company had divested six of its nine businesses and achieved a 56% reduction in gross corporate debt from $350m to $155m. This has significantly de-risked the company bringing its leverage ratio from 3x during FY19 to 1.1x during FY20. The leverage ratio is a major part of corporate debt covenants and we believe this reduction will go a long way to granting the company access to lower interest rate debt.

We believe the strategic divesting of six of its nine business has made Eclipx a leaner and meaner growth machine. This reorientation of the business’ priorities management believes will allow it to more precisely target three main markets: corporate, Small and Medium Enterprises (SMEs), and novated lease agreements.

Popping the hood

Eclipx's FY20 results are a little more complicated than they first appear. The company has its normal FY20 results that showed an EBITDA of $59.5m. However, the company only completed the divestment of is 'non-core assets' in August. Therefore, the remaining assets, that we'll refer to as the 'Net Eclipx,' generated an EBITDA of $85.4m, a like-for-like increase of 4.3% over FY19. Eclipx now operates in three main divisions: Australia Commercial, New Zealand Commercial and Novated.

Australia Commercial is Eclipx's fleet leasing and management division in Australia. This division saw a reduction in EBITDA of 6.5% to $51.5m during FY20. We are not too concerned about this decline as it was primarily due to a reduction in both new brokerage fees as the Australian business made cuts to expenses due to COVID-19.

The New Zealand Commercial division is comprised of fleet leasing and management. This division generated $27.3m in EBITDA in FY20, representing a 129% increase year-on-year. Importantly, this increase in EBITDA was mainly the result of a reduction in expenses through Eclipx's divestment and simplification plan. Additionally, the New Zealand division was not hit as hard by COVID-19 as the country was able to contain the epidemic far quicker than Australia.

The Novated division operates across Australia and includes both Eclipx's novated leasing and salary packaging services. A novated leasing agreement is mainly used in Australia and is quite simply a three-way agreement between an employee, employer and lessor (Eclipx). In exchange for the employer paying for the employee's vehicle lease and expenses relating to that vehicle, the employee takes a salary sacrifice. This division saw a decline in EBITDA of 20.8%, to $11.8m, in FY20. Much like the Australia Commercial division, this EBITDA decline was due to a decline in new business as a direct result of COVID-19.

Go FY21, go

We are certainly aware that the year after a seemingly successful turnaround has inherent risks associated with it and this excludes the economic risks we face going into 2021, such as China, additional fallout from COVID-19, etc. However, we believe management focused on the right divisions and is poised to start delivering as the Australian economy should be ramping up to full capacity during 2021. The market currently projects EBITDA growth of 14.5% to $88.6m during FY21. This projection indicates an FY21 EV/EBITDA valuation of 21.5x. We believe this is on the high side for Eclipx. However, we remain optimistic about the economic recovery during 2021 and view this company as having a direct benefit from the country's emergence from COVID-19 as employers start spending and increase hiring rates. Management has already proved it can do the work after smashing its own internal targets for Eclipx's turnaround. We see a bright future for this company. It's four stars from us.

1300 SMILES

Not quite smiling

Stocks Down Under rating: ★★★

ASX: ONT
Market cap: A$ 148M

52-week range: A$4.69 / A$7.14
Share price: A$ 6.75

Headquartered Townsville, Queensland, 1300 Smiles (Smiles) owns and operates 32 full-service dental operations across Queensland, Sydney and Adelaide. The company's stock took a serious drilling during COVID-19 dropping 30% to its 52-week low of $4.69 as practices were closed and patients became increasingly hesitant to show up. Since mid-July the stock has been on a tear as most of Australia largely shrugged off COVID-19 and appointments became possible again. If there is one thing COVID-19 has proven about Smiles, its that everybody needs dental care.

Share price chart

Source: Tradingview

Its all about the practice

With 32 locations across Queensland, Sydney and Adelaide, Smiles managed to reopen most of its practices rather quickly after Australia's COVID-19 lockdown. This quick reopening of most of Smiles' practices allowed for a rapid recovery in hours available. As total hours recovered, the pent-up demand saw a subsequent narrowing of productive hours versus hours available, ending the year at 78% utilisation. We all need to go to the dentist for everything from dental surgery to a teeth cleaning. This means that, while many don't find it pleasant, you can only hold it off for so long.

Smiles acquired two practices during FY20. Unfortunately, the company does not split out organic growth from acquisitions. Although we always look at this lack of transparency with a healthy dose of suspicion, what little information is provided indicates that the acquisitions did not yet significantly skew EBITDA generation in a positive direction during FY20.

A quick revenue breakdown

Smiles generated $39.8m in total revenue during FY20, a 1.3% decline year-over-year. Smiles' revenue is almost exclusively generated through the service fees it earns from the 33 dental practices it currently owns and operates. During FY20, service fees generated 95% of total revenue at $38m. Revenue from these fees declined 3% year-over-year due exclusively to the shutdowns and reduced operating capacity that COVID-19 caused towards the end of the

financial year.

The Other category generated $1.8m in revenue in FY20, a 61% year-over-year increase. Other revenue is usually comprised of interest, consulting revenue and other, small revenue sources.

A competitor analysis

Sector peer Pacific Smiles Group (ASX: PSQ) currently operates 100 dental practices in NSW, Victoria, Queensland and the ACT making it the largest of the ASX-listed dental practices. While Pacific Smiles is only active in two of the same states that Smiles operates in, NSW and Queensland, this geographical similarity makes them subject to similar industry demand conditions. Therefore, we believe Pacific Smiles' 8 December 2020 market announcement has a direct impact on Smiles. Pacific Smiles announced that the company was fully expecting its earnings momentum to continue for the remainder of FY21 after it saw same practice patient fee growth reach 14.6% year-over-year between 1 July 2020 – 8 November 2020. The company also increased its FY21 EBITDA guidance to between 35% to 45% from 25% before. Looking at Pacific Smiles' historical EBITDA growth breakdown, we believe the company's EBITDA growth is likely to be fully dependent on the planned opening of 14 new practices during FY21. This is why despite its projected FY21 EBITDA growth the stock is valued at only FY21 EV/EBITDA 14.2x.

What do we think this means for Smiles? Smiles released its own 1Q21 results on 9 October 2020 generating same practice revenue growth of 15.5% year-over-year. September alone saw 21.5% revenue growth. This means 1Q21 saw a continuing recovery trend starting in April with June reaching 15% year-over-year revenue growth compared to April and May's revenue decline. We believe Pacific Smiles' more recent announcement shows that not only is demand for dental services still strong, but Smiles is performing better than its peers.

This stock's teeth have already been fixed

We believe this industry will see continued demand throughout FY21 and the market seems to agree as it is expecting 21% EBITDA growth and 20% revenue growth. This results in an EV/EBITDA of 9.3x for FY21.

When it comes to valuing Smiles, we believe the company deserves to be trading at a discount for two main reasons. The first is its reliance on acquisitions for a portion of its growth. We believe it is clear that the company is not going to generate 21% EBITDA growth during FY21 through expanding its margins or existing businesses. The issue is the lack of transparency surrounding these acquisitions and organic growth levels makes it difficult to determine its organic EBITDA growth rate. This lack of transparency is concerning and while we do not believe it is likely to be hiding organic losses, we do believe that Smiles' organic growth rate is probably on the low side. Therefore, we believe a significant valuation discount is warranted.

Taking this all into account, we believe Smiles should be trading at an FY21 EV/EBITDA ratio closer to 10x, still a considerable discount to the market's FY21 EBITDA growth estimate of 21%. With not much upside it's three stars from us.

TOP SHELF

Only the best will do

Stocks Down Under rating: ★★★★

ASX: TSI
Market cap: A$ 84.4M

52-week range: A$1.81 / A$2.21
Share price: A$ 2.07

After what had been a crazy 2020, we can understand if you need a drink and not just any drink, but something Top Shelf. One of ASX's newest listed companies is Top Shelf, an Australian whisky, vodka and mezcal distiller. Lets crack open a bottle and see if this liquor is really Top Shelf.

Share price chart

Source: Tradingview

Pour me a drink and tell me a story

Australian spirits are on the rise and Top Shelf is moving to cash in on this trend. Between FY17 – FY18 (the latest information available) the Australian Bureau of Statistics found that spirits consumption rose around 5% with your average Australian aged 15 years and older consuming 9.5 litres of 'pure alcohol,' or slightly under 2.1 standard drinks daily. While the main benefactor from this consumption trend has clearly been wine and beer, spirits has begun to make a slight comeback in Australia breaking above 1.3 litres per capita consumed (pure alcohol) for the first time in FY18 since before FY13.

How does Top Shelf play into all of this? As the Australian producer of NED Whisky, Grainshaker Vodka and developer of Australian Agave, this company is looking to break hard and fast into the Australian, Chinese and United States markets, according to its prospectus. Yes, we see the China warning lights flashing and we will get to China later on. The important thing to note is while certainly not as large as the beer and wine market, Top Shelf is addressing a growing market for its spirits right here in Australia. Currently, its entire $7.7m in FY20 revenue was derived from Australian sales, a sharp increase of 255% compared to FY19's results. Although, only $4.3m in revenue was attributed to the Top Shelf branded alcohol with the remainder from third party canning and bottling services.

Third party canning and bottling

The third party canning and bottling division allows the company to install significantly greater canning and bottling capacity than it will use for its products over the next few years by selling the extra capacity to other companies. In fact, this has allowed Top Shelf to install 14x its FY21 projected litres of alcohol sold. This division's $3.6m in revenue accounted for 47% of FY20s total revenue. This use of production capacity is very common in the industry as it allows for incoming cash flow while the company produces and ages its alcohol and expand its sales channels.

Agave is the future of Top Shelf

Top Shelf is attempting to distil Australia's first agave-based spirit, also known as mezcal. Mezcal is most closely related to Tequila as they are both produced with agave. The difference is tequila is first steamed and then distilled in copper pots while Mezcal is cooked before being distilled in clay pots. Mezcal is know for having a stronger alcohol content and more pronounced agave flavour. However, this is still a number of years off as the company has only recently planted 120,000 agave tequilana plants in its Eden Lassie farm in Queensland with another 100,000 in nurseries. Top Shelf has stated that its goal is 1m plants by the end of 2024 with a production capacity of 200,000 cases of agave spirit 9L equivalent per year. According to the company's capacity this production estimate would exceed Australia's annual demand by 68%, allowing for significant export potential mainly to the United States. Importantly, this is the only agave plantation in Australia and we believe this will give Top Shelf a vital head start versus any potential competitors.

The only major risk we see with this plan is the recently signed free trade agreement between Australia and Mexico, which removed export duties on Mexican alcohol. We believe this is likely to increase the competition in the Australian marketplace and as this is a new Australian product, it is uncertain how successful it will be in competing against its more authentic Mexican rivals.

We did not last 200 years

Bertrand Russell once said, "you may reasonably expect a man to walk a tightrope safely for ten minutes; it would be unreasonable to do so without accident for two hundred years." We believe this is a perfect analogy for the Australia's relationship with China prior to 2020. This is a highly significant issue that we believe all Australian investors need to be asking themselves when looking at a company that aims to make a move into China. While we don't have the space to go into this type of analysis here, we will say that we believe the situation is likely to worsen for the remainder of FY21 as China continues its strategy of internal distraction through international 'Wolf Warrior Diplomacy.'

Top Shelf's prospectus has named China as a significant source of its future growth as it develops an internationally facing e-commerce sales channel. While it is true that China has not yet slapped Australian spirts with new tariffs, its willingness to hit Australian wine with up to 200% anti-dumping tariffs is a serious future concern, in our view.

Due to the recent nature of these developments and the company's newly listed status, it is unclear if management has decided to shift its international expansion plan more towards the United States. If they have not, we would view that as a significant ongoing risk for such an emerging company with limited resources.

Risky, but the price seems right

We believe Top Shelf faces two main risks in the near future: China and Mexican competition. These risks loom large for us upon reading the company's fillings, but we think the market has penalised Top Shelf's stock price too much considering the revenue growth it is experiencing in the Australian domestic market alone. Between FY19 and FY20 Top Shelf grew its revenue 255% and it is projected to grow its revenue year-over-year during FY21 and FY22 by 160% and 125% respectively. Despite this projected revenue growth, Top Shelf is currently trading at 6.1x FY21 and 2.8x FY22 EV/ Revenue. Yes, the company has some risks and obstacles to overcome, but we believe Australian agave spirits has a future and the market is undervaluing the company's head start. Combine this with the growth its other branded spirts are experiencing in Australia and we believe a current FY22 EV/Revenue valuation of 2.8x is very low. Four stars from 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.

You are receiving this email because you subscribed to our Stocks Down Under newsletter.

All rights reserved. No part of this publication may be reproduced or transmitted in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without prior written permission from Pitt Street Research Ltd Pty. All intellectual property relating to the Content vests with Pitt Street Research unless otherwise noted.

Stocks Down Under (Pitt Street Research AFSL 1265112) provides actionable investment ideas on ASX-listed stocks. The Content has been prepared for general information purposes only and is not (and cannot be construed or relied upon as) personal advice nor as an offer to buy/sell/subscribe to any of the financial products mentioned herein. No investment objectives, financial circumstances or needs of any individual have been taken into consideration in
the preparation of the Content. Financial products are complex, entail risk of loss, may rise and fall, and are impacted by a range of market and economic factors, and you should always obtain professional advice to ensure trading or investing in such products is suitable for your circumstances, and ensure you obtain, read and understand any applicable offer document