STOCKS DOWN UNDER

22 JANUARY 2021

Small Cap Stocks Down Under

Foolishness is right next door to strength.

- Wendy Rhoades (Billions), American TV show character

EROAD

A smooth but uneventful ride

ENERO GROUP

Definitely not mad

PARAGON CARE

Elective is the thing

EROAD

A smooth but uneventful ride

Stocks Down Under rating: ★★★

ASX: ERD
Market cap: A$ 401M

52-week range: A$3.63 / A$5.17
Share price: A$ 4.98

Headquartered in Auckland New Zealand, Eroad is a Software as a Service (SaaS) business with a niche: vehicle fleet management and related support features. The main story here is the difficulty and expense many businesses have in keeping track of their fleet of vehicles. Eroad's solution to this problem is a proprietary combination of hardware, cloud-based software and live customer service and support. COVID-19 has not been kind to companies in the fleet management business as clients down-sized the number of vehicles in operation. With the world finally seeing the light at the tunnel, does this mean its time for investors to hit the Eroad?

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ASX: EGG
Market cap: A$ 179M
Dividend yield: 3% (100% Franked)

52-week range: A$0.795 / A$2.15
Share price: A$ 2.09

Have you ever watched Mad Men and thought; as an investor I would love to own a modern version of this advertising company. Headquartered in Sydney, the Enero Group is one of the ASX's options for Mad Men-obsessed investors to consider. This company is the modern version, with what we hope is a modern HR department. Yes, we're looking at you AMP. This modern company handles the industry's main parts: creative and content, Public Relations and analytics. The question is; is this the company to make an investor feel like they are on Mad Men, or just mad?

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Share price chart

Source: Tradingview

Getting this tech on the road

Imagine you're a business owner and your company operates a fleet of vehicles, both large and small. How do you easily, and at a reasonable cost, ensure your employees are not speeding, going for a joyride; in a nutshell … not be a massive insurance liability? On top of that, how do you efficiently manage 7 years' worth of maintenance records, distance travelled and all other fleet needs? This is where Eroad comes in with easy to install hardware all managed and tracked on one cloud-based online portal for different types of vehicle fleets and needs.

The numbers don't lie

Eroad generates revenue mainly through its ongoing service contracts. These contracts allow for the connection of its hardware to the cloud-based software. Due to the essential nature of these contracts in the operation of Eroad's hardware, the installation and rental or sale of its technology is not broken out in its fillings. Therefore, all of its revenue is effectively listed as Software as a Service revenue. In fact, the hardware

is useless without access to Eroad's platform and even when a client purchases the hardware, Eroad retains the right to change the way that hardware operates at any time.

At the end of FY20, Eroad reported a 32% and 73% year-over-year increase in revenue and EBITDA, respectively. Revenue reaching NZ$81.2m during FY20 was due to three main catalysts. Firstly, the launch of seven new products and services ranging from variants on is tracking hardware to new services on its platform. Eroad plans to continue to invest heavily in its research and development at a rate of between 18% and 22% of revenue going forward. We believe this will help the company continue to attract additional clients as it adds products to its already broad hardware and software fleet management portfolio.

The second catalyst is the company's compelling argument for using its product. As of FY20, the company reported that the number of speeding events in its New Zealand market since it first launched had decreased 56% per 100 km travelled. Going back to the importance of its research and development spending, the number of speeding incidents has noticeably decreased as the company releases additional products and services. We believe Eroad's products offer tangible and rapid results that continue to improve as the company develops its suite of offerings.

Directly related to this point is the third catalyst. The company continues to achieve, what we consider to be, a very high rate of customer retention. During FY20, the company's asset-use retention rate increased to 95.2%; from 94.4% during FY19. In fact, Eroad's asset retention rate has historically been above 90%. We believe this is proof of the usefulness of the company's service, and this recurring revenue provides a solid bedrock to build future products and drive growth.

Stabbing should not be this hard

One concern we have when it comes to Eroad is that its expansion into the United States will be delayed by COVID-19. To clarify, we mean delayed, not smothered. The United States has consistently ranked as one of the worst countries hit by COVID-19. While multiple vaccines have been approved and are currently being disseminated across the country, the government's timetable is already proving to have been a fabrication of an overeager bureaucracy. To give some hard numbers, the United States government had said it would administer the first shot to 20m people by the end of 2020. The actual number? Only 2.8m received their first doses and only 14m doses have been sent out. The execution has been plagued by a combination of logistical breakdowns, miscommunications and even one doctor who was recently fired (and might be prosecuted) for intentionally leaving 500 doses out to spoil.

Even more concerning, federal officials have stated they are not entirely sure why these delays are occurring, according to the New York Times. Compounding to businesses troubles is the time it took Congress to pass a second stimulus deal. With economic uncertainty and hardship looking to continue well into 2021, we are concerned that investments in services like Eroad's in the United States will be put on the backburner for maybe another full year.

However, with a new administration coming in, this situation may change. We are just saying its completely unknown how long this COVID-19 business reality will continue and hence the pace of Eroad's expansion into the US is uncertain.

Great company, not so great price

We believe Eroad is fulfilling a real need among businesses of all sizes whose operations require vehicles. The market is currently expecting EBITDA growth of 10.7% for FY21. Eroad is priced at an FY21 EV/EBITDA multiple of 14.1x.

While we believe this company has a strong future, its recent run-up in stock price since its secondary listing on the ASX has raised the valuation towards what we believe is a fair valuation for the next little while given its expected EBITDA growth. This would change if the United States' economic situation improves substantially, causing business investment to surge. Eroad is a three star company for us at the current valuation.

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Tell me what to buy!

One of the more famous quotes by Henry Ford is, "if I had asked people what they wanted, they would have said faster horses." This is what marketing is all about. To give an example of what is arguably the most successful marketing campaign of all time, the two-month salary rule for diamond engagement rings from a De Beers marketing campaign. Not only was the "salary rule" a marketing trick by De Beers, but so was the entire concept of diamond rings to symbolise engagements in the modern sense. Marketing is effectively propaganda focused on the sale of products and services and is vital for any company. Just ask any entrepreneur, a business can thrive or die on the quality of its marketing.

The pillars

The Enero Group offers clients everything they need to utilise modern marketing power through its 'three pillars' approach of creative content development and production, Public Relations (PR) and data analytics all within one agency. This all-encompassing strategy is meant to increase customer retention and to cross-sell

by absorbing a client's needs and not allowing them the opportunity to think about looking elsewhere. What is unusual about Enero's approach to this business model is that instead of one company, each pillar has a few different brands that focus on different geographical areas and client industries. This totals eight different companies under the Enero umbrella after the completion of FY20's business consolidation.

The creative content development and production pillar is the only one with one company under the umbrella, the Sydney based BMF. This pillar used to have two companies, but FY20 saw Naked merge into BMF. BMF is clearly one of the feathers in Engro's cap as the company was named 'Australia's most effective agency' for 2018 and 2019 at the annual Australian Effie Awards (the main Australian advertising awards), while winning new business from some major clients like Coca-Cola, Rest Super and Voyages.

The Public Relations pillar is comprised of three companies: Frank, CPR and Hotwire. Frank has offices in London, Manchester (UK) and Sydney, while CPR just has offices in Melbourne. As the name suggests, Frank provides more traditional PR services and CPR is focused on crisis management. Hotwire is the giant of the group with 34 locations across the UK, US, France, Germany, Spain, Italy and Australia. The company is also active, without offices, in Asia, South America, the Middle East and northern Europe. Hotwire focuses specifically on consulting on 'alternative' technology-focused communications.

The data analytics pillar is comprised of four companies: Orchard, The Leading Edge, The Digital Edge and Ob Media. Orchard has offices in Sydney and New York, focusing on digital strategy, campaign development, social media and data analysis. The Leading Edge has an office in Sydney, where it provides clients with classic 'human analytics' utilising a range of sources. The Digital Edge is also Sydney based focusing on online communities and surveys. Lastly, Ob Media is an online media and advertising specialist.

Let's travel the world and see the industries

Enero splits its FY20 revenue of $135.7m by client industry and three central geographical regions: Australia, UK and Europe, and the United States. The company provides services for 11 different sectors with the four largest ones being information technology (29%), media (18%), consumer retail (14%) and healthcare (10%). This diversification across industries, combined with the ability to organically sign new clients during FY20, is why total revenue for FY20 increased 4.9% instead of declining like many of its peers as advertising took a massive hit because of COVID-19.

At the same time, Enero managed to cut costs and increase efficiency through its reorganisation program that was completed during FY20, which allowed EBITDA margins to rise from 16% during FY19 to 17.9% during FY20. This margin increase and organic client acquisition were among the main drivers behind the company's reported EBITDA increased of 17.7% to $24.4m during FY20.

The many fit into the one

The multi-company system is not uncommon for marketing giants like Enero. From an investment perspective, it is always important to make sure there is no significant overlap between the companies. We want to see them easily upselling clients to their sister companies, not competing. We believe Enero executes this well and its FY20 results during such a challenging time for the marketing industry are proof of this. Marketing spending went by the wayside for many organisations as they scrambled to cut costs. Therefore, we believe this company falls squarely into the 'post-COVID-19' category.

The market is currently expecting 22% EBITDA growth, to $29m during FY21 while the stock is trading at an FY21 EV/EBITDA multiple of just 5.1x. We believe this discount has to do with the continued global uncertainty and the risk inherent in the industry. While we believe the vaccine won't begin to have any real effect until FY22, we believe the current valuation puts too high a discount on Enero. So, four stars from us.

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Share price chart

Source: Tradingview

The four pillars of Paragon

Paragon operates via four product lines: devices, diagnostics, capital and consumables, and service and technology. These product lines have historically focused heavily on the elective surgery market. Still, management was able to replace most of its lost revenue from the slow down in these operations during the end of FY20 with COVID-specific income streams, like supplying Personal Protective Equipment. While this was enough to prevent a significant revenue decline, with the company reporting a 1.8% decline to $231.7m during FY20, it was at the cost of a lower gross margin. The decrease in gross margin from 40.3% during FY19 to 37.5% during FY20 was why EBITDA declined 19% to $22.9m year-over-year.

Consisting of $75m in FY20 revenue, Paragon's devices products line was relatively stable compared to FY19, only declining 2% year-over-year. This product line focuses on eye care and orthopaedics providing the devices and equipment required to perform Optometry and Ophthalmic surgery, hip and knee prosthetics as well as pain management and surgical spine solutions.

Diagnostics reported a less than 1% decline in revenue during FY20 at $23.2m. This product line focuses on the equipment and products required by labs to research, analyse and diagnose patient samples and was able to replace most of its usual orders with those focused on COVID-19 detection.

The capital and consumables product lines were FY19 and FY20's largest revenue sources at $119.4m and $105.8m, respectively. These products focus on developing and providing urology, point of care, anaesthetics and Intensive Care Unit specific products and equipment.

A simple way of thinking about this division is that its a healthcare facility's equivalent of an office IT firm. It is responsible for support, preventative maintenance and the uptime of a healthcare facility's equipment. This was the only one of the four pillars to see an increase in revenue during FY20 with demand driving a 65% increase to $27.7m.

Elective surgery on the backburner during COVID

When it comes to Paragon Care the key driver is elective surgery and that's why the stock ended 2020 down almost 50% for the year. As many investors may remember, elective surgery was at a minimum put on the lowest rung of priority and at times even eliminated from contention during most of 2020 in Australia and New Zealand.

New Zealand's elective surgery shutdown was only for three months and yet the waiting list was already flooded to the point that this brought the backlog to 30,000 surgeries in a country with only 4.9m people. The average wait time during December 2019 was already 62.3 days; it rose to 95.3 during June 2020. For Australia, the hospital system is just as backed up with a net 149,500 surgeries being added to the waiting list during FY20. The moral of this story? Both New Zealand and Australia have had significant clogging of the elective surgery system before COVID-19 shut things down.

Playing catch-up

What we find to be the most interesting part of this issue is that it could actually prove to be an unforeseen, significant, boost to demand for Paragon products over the next few years. Both the Australian and New Zealand governments are under pressure to fix the long waiting lists and New Zealand has committed significant funds to alleviate it. Under New Zealand's 2020 budget, a specific line item saw "additional funding to deliver approximately 153,000 more surgeries and procedures, radiology scans and specialist appointments to help clear the COVID-19 backlog." This comes down to a one-off boost of $282m over the next three years to planned care, specifically to clear the backlog. Australia has not yet committed specific funding like New Zealand. However, the Australian Medical Association has been pressuring both Federal and State governments to invest more money. In NSW alone, the State Health Department estimates it will take six to nine months before the backlog reaches pre-pandemic levels, levels that were already too high. The Sydney Morning Herald reported that between 1 July 2020 and 16 September 2020, elective surgery programs were working at 100% capacity and some at 115% as they struggled to clear the backlog.

2021: the year of Paragon, not the Ox

Although Paragon has not given any guidance for FY21, we believe the company will likely see at least a return to FY19's profit levels when EBITDA was at $28.3m. Our reasoning behind this is simple; we expect the company's profit margins to rebound since elective surgeries have been resumed in both New Zealand and Australia for all of FY21. Also, we believe the sharp increase in demand, as the medical systems try and catch up, will be more than enough to return EBITDA to its FY19 levels.

This would translate into an FY21 EV/EBITDA multiple of 6x. Additionally, we believe the renewed attention on elective surgery backlogs due to the recent pandemic-related shutdowns in Australia is likely to cause governments to take more direct action to manage the problem. Therefore, we believe it is likely that demand for Paragon Care's equipment, services and supplies could exceed market expectations over the next few years as the medical systems get a healthy dose of Drano to clear the pipes. Four stars.

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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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