STOCKS DOWN UNDER

29 JANUARY 2021

Small Cap Stocks Down Under

“Let him who desires peace get ready for war.”

- Publius Flavius Vegetius Renatus (~4th or 5th AD), Late Roman Empire writer

AUSTAL

In arms we trust

SEAFARMS GROUP

In a sea of opportunity

ACROW FORMWORK AND CONSTRUCTION SERVICES

A boom is coming

AUSTAL

In arms we trust

Stocks Down Under rating: ★ ★ ★ ★

ASX: ASB
Market cap: A$ 899M
Dividend yield: 3.6% (0% Franked)

52-week range: A$2.25 / A$4.54
Share price: A$ 2.51

Headquartered in Perth, Austal is a global shipbuilder and designer for commercial operations and the police and militaries of the world. Austal has seven shipbuilding facilities in four countries: Australia, the United States, the Philippines and Vietnam. The majority of this company's revenue is directly related to defence contracts. Indeed, in FY20 it was 85%. FY20 might have seen a significant increase in Asian maritime instability and the stock has been even riskier ending 2020 down around 30%. We believe this just proves that markets are not always efficient.

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SEAFARMS GROUP

In a sea of opportunity

Stocks Down Under rating: ★ ★ ★ ★

ASX: SFG
Market cap: A$ 218M

52-week range: A$0.03 / A$0.14
Share price: A$ 0.086

Headquartered in Perth, the Seafarms Group, as its name partly suggests, operates Australian prawn farms. Despite already being Australia's largest producer of farmed prawns, Seafarms is far from sitting on its laurels as it has embarked on the creation of a vertically integrated, land-based, prawn farm in northern Australia. The facility is slated for year-round production capability and a projected maximum annual production of 180,000 tonnes of prawns to be exported.

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ASX: ACF
Market cap: A$ 82.7M
Dividend yield: 4.3% (100% Franked)

52-week range: A$0.13 / A$0.41
Share price: A$ 0.365

Headquartered in Sydney, Acrow Formwork and Construction Services is one of Australia's largest providers and designers of formwork, scaffolding and construction screens with offices in every major Australian city. The company has old roots in Australia, being active since 1950, and has been part of every major construction boom in independent Australian history. As a producer of some of the most vital safety and formwork products in the construction industry, we believe Acrow is leveraged to the ongoing boom in infrastructure spending in Australia.

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Share price chart

Source: Tradingview

In the need for defence we trust

2020 saw the world not only smashed in the face by COVID-19, but we came arguably the closest to World War Three since the Cuban Missile Crisis. You may have noticed that 2020 saw the so-called 'Doomsday Clock' move to 100 seconds to midnight, the closest it has ever been since its founding in 1947. The Doomsday Clock is a normal clock face with midnight equating humanity reaching 'Armageddon.' The decision to move the clock hand forward, back, or for it to stay in place each year is made by the Science and Security Board in consultation with its Board of Sponsors, including over 13 Nobel laureates. The Clock is widely considered the leading indicator of the world's vulnerability to an end of the world style catastrophe, including a world war. The threat of a conflict breaking out in the Asia Pacific region due to its drastic increase in instability during 2019 was one of the main reasons for the moving of the hand last year. During the year things in the Asia Pacific region worsened instead of improved. In our opinion, the Asia Pacific region is more destabilised now than it was at the beginning of the 2020 when the hand was moved.

Asia Pacific maritime instability is bad, but not necessarily for Austal. Out of the Australian government's $270bn, ten-year defence investment plan, $75bn (28%) is slated for the Royal Australian Navy. A significant portion of this funding for the navy is slated specifically for new ships to be built. The United States has also prioritised a large part of its FY21 defence budget to the building of additional vessels with US$32.3bn in total slated for investment during the year. We believe Austal has substantial exposure to this spending focus as it owns one of the four largest naval yards in the United States.

Narrowing the focus

As of the end of FY20, Austal derived 85% of its $2.1bn of total revenue from defence contracts. This represents a continuation of Austal's trend away from the production of fast ferries and we expect FY21's total revenue to be even more defence-centric thanks to its two defence-oriented shipbuilding facilities in Australia and the United States.

Another global trend that we believe will be positive for Austal is the explosion in the synthetic drug market across East and Southeast Asia. The United Nations Office on Drugs and Crime report, issued in May 2020, noted that the price of methamphetamine has dropped to its lowest level in a decade as the region has become saturated in supply. Austal has produced a broad complement of border patrol and police vessels for clients such as the Australian Federal Government, Bermuda, NSW, Queensland and Trinidad and Tobago. We believe there is a likelihood of additional clientele and reorders as governments in the Asia Pacific region grapple with a strong resurgence in the international drug trade. These orders are classified under the umbrella of Austal's defence revenue.

The future is steel

Austal is currently an aluminium shipbuilder and while there is undoubtedly a market for these kinds of ships, most big money defence contracts are for steel vessels. This is why Austal is currently spending an estimated US$100m to expand its shipyard to include the capacity to produce steel ships. The company estimates this will be finished by mid-2022, allowing it access to an estimated 3x greater market (by revenue) than it currently has exposure to through its aluminium ships. We believe this a game-changer for the company and is one of the main reasons we are optimistic about its future. Half of the expansion project's US$100m bill is being paid for by the United States federal government.

A bright future with strong demand

Austal is currently trading at an estimated 3.8x EV/EBITDA for FY21 through FY23 as the market expects EBITDA to remain virtually flat over the next three years. This assumption includes EBITDA margins remaining around 9% over the next three years and revenue declining $100m to $1.9bn. We believe this is unlikely for two reasons. Firstly, margins are on the rise. Secondly, demand is likely to increase.

Austal has been expanding its margins through a three-year reorganisation plan, which was completed in 2020. This reorganisation saw the US division's margin rise to 8.1%, Australasia double to 6% and the combined support division's margin increase to 8.1% (7-8% is the current predicted long-run rate).

The Australasia division currently accounts for about a quarter of Austal's total revenue. Management has stated that they believe this division's margins will increase over the next few years until it is on par with the United States. We believe the potential for margins to increase an additional 2% will provide a strong tailwind for profit growth in the coming years.

We believe Austal is well place to win additional contracts, especially once it finishes its US shipyard upgrades, on the back of increasing tensions in the Asia Pacific region and the resurgence of drug trafficking in the area.

With an FY21 through FY23 EV/EBITDA valuation of around 4.1x, we think the company is well placed and priced to surprise the market. Four stars from us.

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Share price chart

Source: Tradingview

A bigger prawn for Bubba

Seafarms is well within its start-up phase. The company has operations in Queensland that produced $27.8m in revenue and a loss of $25.2m during FY20, but this was to be expected. You see, the Queensland aquafarms are demonstration farms to prove to the market that management's vision is not only obtainable, but commercially viable. Additionally, this offers management an important opportunity to tweak its processes and plans before investing in the end result. In this case, the end result is code-named Project Sea Dragon, and by the end of 2020 Seafarms considered it 'shovel ready.'

The Sea Dragon made of prawns

Project Sea Dragon will be executed over eight stages with stage one expected to generate over 6,000 tonnes of prawns per annum during its first 12-months of production. Keeping in mind that Seafarms' FY20 production across its three demonstration farms was only 1,300 tonnes, we believe this would be a game-changer for the company. When Project Sea Dragon is fully completed, management expects production to reach between 130,000 and 180,000 tonnes per annum. There is no timetable or viable proposal for funding the full construction at this time as it is estimated to cost well over $1bn and Seafarms total market cap is only $218m. The company has, however, made a promising start with stage 1a.

Management has already secured both the land, required government and indigenous approvals as well as confirmation that the Western Australian government will upgrade and seal the 7.5km of Moonamang road that leads to the Northern Territory border. This confirmation was critical to the project as it is the main roadway that Seafarms plans to use to move its prawns year-round. Without these fixes and upgrades, the project was likely to be untenable. Management has stated that it believes this confirmation will "significantly de-risk the project" and allow for financing to be completed easier. That is what Seafarms and investors are truly waiting for, word on the project's financing. Once that happens, the company is currently at the point where construction can go full-steam-ahead.

Major agreements? Check

Stage 1a of Project Sea Dragon is expected to increase the annual tonnes of prawns for sale by Seafarms more than fivefold from its FY20 total production. While we might be concerned about the company's ability to handle this drastic increase in production on the sales side, Seafarms has already secured offtake agreements of around 25% of its expanded annual production before the facility is even built. These agreements are split between three companies: Nussui, Sealord and Primstar. Nussui is focused on Japan and is listed on the Tokyo Stock Exchange. Sealord is 50% owned by Nussui and is focused on domestic Australian distribution. Primstar is a Netherlands-based seafood distributor focused on the European markets. We find a significant interest from two large international companies in a project that has not even broken ground to be an important proof of demand. This indicates to us that despite the drastic increase in production that Project Sea Dragon represents, worldwide demand exists to absorb it without causing significant price disruption.

A lot of promise

Seafarms' Project Sea Dragon is truly a game-changer for the company. The only issue is there is a lot unknown about when the financing is likely to emerge. Until Seafarms begins shipping out prawns from stage 1a, we don't see how the company will get to EBITDA profitability. Therefore, we would classify this as a Project Sea Dragon play.

The project is unique because it combines mass production with inland farming. This combination is viewed as likely to prevent disease from entering its prawn population. Due to the uncertainty surrounding the company's future, it is impossible to accurately predict its FY21 revenue forcing us to value the company based on its FY20 results. Without Project Sea Dragon, we do not see any significant value in Seafarms, especially with the company trading at 8.4x FY20 EV/Revenue.

However, we believe stage 1a is likely to become a reality; it's just a question of when. This stock certainly has a lot of potential, but there is a real risk that Project Sea Dragon never gets off the ground. We're willing to wait and take the risk as we believe Seafarms offers a sea of opportunity. Four stars from us.

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Share price chart

Source: Tradingview

A quick snapshot and definitions

Acrow has three main product lines: formwork, commercial scaffolding and industrial scaffolding. If you are not familiar with the construction industry lingo and wonder what those terms mean, don't worry, we have you covered in just two sentences. Formwork is the term for creating a temporary mould to support concrete walls and other structures during pouring. Scaffolding is a temporary structure built around the site in question to allow a safe and stable platform on which to move and work.

The boom is here

The Australian government is heavily focused on an infrastructure-led economic recovery and most construction projects cannot commence without the products supplied by Acrow. In terms of who will win the contracts offered by these new developments, we believe incumbent industry leaders are likely to get the majority of this business. This is because they already have a proven track record and are usually already large employers. The Acrow brand has had the last 50-years to embed itself in the Australian construction industry and we would fully classify it as an industry leader.

Even though the world is still immersed in COVID-19, demand is already starting to materialise in a big way. Between 1 November and 24 November 2020 alone, the company secured $4.4m in new hire contracts representing a new record month after beating the old record by 16%. The Sydney Waterloo Station formwork contract started in December 2020. We believe this is just the beginning and fully expect Acrow to score additional large contacts in the near future.

Formwork is the name of the game

Acrow generated $87m in revenue during FY20 with formwork leading the pack, contributing 66% of total revenue, which is comparable to the year before. FY20 was a great year for Acrow. Sales growth was 22% while EBITDA rose 30%, to $19.5m. We expect to see EBITDA margins to continue to rise during FY21 after successfully completing Uni-span's integration during FY20. The company is currently estimating cost savings of around $2.2m to materialise during FY21. This will be a one-off growth event, but we believe the acquisition of Uni-span's formwork and scaffolding products as well as the company's inherent market share was perfectly timed for the post-pandemic infrastructure boom.

Uni-span acquisition perfectly timed

Uni-span had a wide product offering across formwork and scaffolding, but one of the more significant additions to Acrow in our opinion was its industrial scaffolding offering. Acrow did not offer industrial scaffolding products before this acquisition. We believe this division is likely to become a key growth driver in the next few years.

One of the main things the COVID-19 pandemic highlighted about our infrastructure was industrial property's vital importance to the supply chain. As online shopping has soared during 2020, industrial property was in high demand and we don't believe this demand is going away anytime soon. In fact, some of 2020's best-performing REITs were in the industrial sector. According to an AFR article on 27 January 2021, titled 'E-commerce growth to drive another record year for industrial property', around 85,000 sq meter of warehouse space is needed for every $1bn spent online.

Right place, right time

The market is currently estimating Acrow will generate $22.3m in EBITDA during FY21, a year-over-year increase of 48%. Following this spectacular increase, the market is subsequently expecting EBITDA growth to slow to around 7% over the next two years. We are sceptical of this low EBITDA growth estimate for FY22 and FY23 due to what we view to be strong demand coming out of the construction industry during this period.

However, even assuming the market's EBITDA growth rate is correct, we believe it is still undervaluing Acrow's stock. Between FY21 and FY23, the market is currently valuing the company at an EV/EBITDA of 5.8x, 5.4x and 5.3x, respectively. Consequently, we believe Acrow's stock is an undervalued play on the coming building boom across Australia. Four stars.

Pitt Street Research Pty Ltd

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