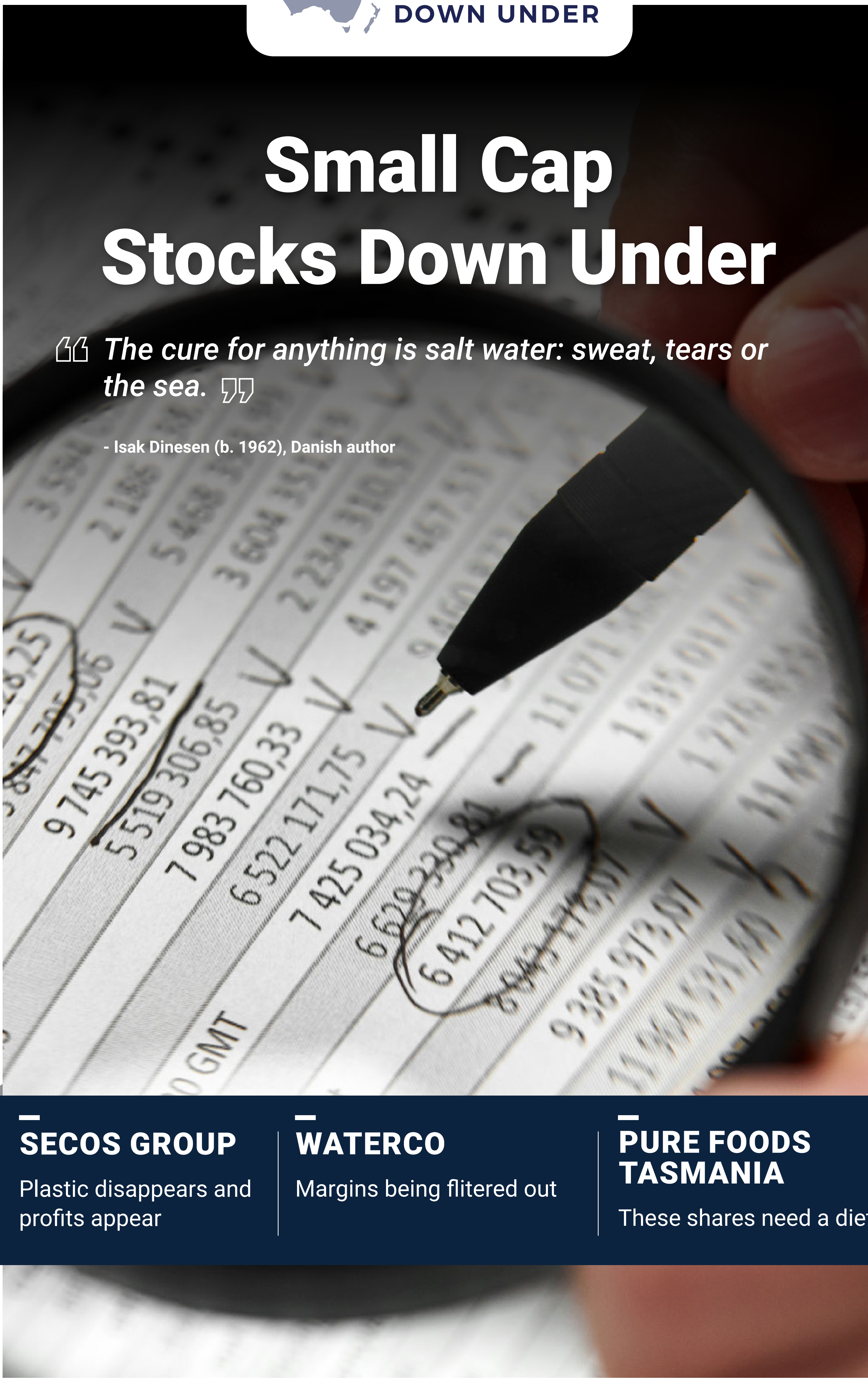
STOCKS DOWN UNDER

12 FEBRUARY 2021



Small Cap Stocks Down Under

The cure for anything is salt water: sweat, tears or the sea.

- Isak Dinesen (b. 1962), Danish author

SECOS GROUP

Plastic disappears and profits appear

WATERCO

Margins being flitered out

PURE FOODS TASMANIA

These shares need a diet

SECOS GROUP

Plastic disappears and profits appear

Stocks Down Under rating: ★★★ ★

ASX: SES
Market cap: A$ 173M

52-week range: A$0.046 / A$0.35
Share price: A$ 0.34

At its Melbourne headquarters is a company set on solving the world's plastic epidemic while making a monetary killing in the process. The world is drowning in plastic as over 91% is not recycled. To solve this, Secos has developed a plastic that is not just biodegradable, but compostable. The company has recently begun to achieve some major traction as its bags were added to Woolworths' catalogue, and we think this is just the beginning.

READ MORE

WATERCO

Margins being flitered out

Stocks Down Under rating: ★★★

ASX: WAT
Market cap: A$ 109M
Dividend yield: 1.6% (100% Franked)

52-week range: A$1.95 / A$3.11
Share price: A$ 3.03

Headquartered in Sydney, Waterco is the one stop shop for all your water filtration and sanitisation needs. Whether you just need your swimming pool or spa water filtered and heated, or you are running an aquaculture farm or purifying drinking water on an industrial scale, Waterco has what you need. Combine this with a healthy dose of share buybacks and we think Waterco is ready to filter out some profits.

READ MORE

PURE FOODS TASMANIA

These shares need a diet

Stocks Down Under rating: ★★

ASX: PFT
Market cap: A$ 37.8M

52-week range: A$0.165 / A$1.65
Share price: A$ 0.81

We are willing to bet that you can guess where Pure Foods Tasmania is headquartered. That's right, it's headquartered in Tasmania, more specifically in the state capital of Hobart. This food conglomerate-in-the-making focuses specifically on acquiring established Tasmanian producers of 'premium' products. Pure Foods stock had a strong opening to 1Q21, rallying over sixfold from $0.215 to $1.36 per share. Since that time, Pure Food's share price has almost exclusively declined and closed at $0.81 yesterday. So, was this a stock that just got too hot or one the market should keep an eye on?

READ MORE

SECOS GROUP

Plastic disappears and profits appear

Stocks Down Under rating: ★★★★

ASX: SES
Market cap: A$ 173M

52-week range: A$0.046 / A$0.35
Share price: A$ 0.34

At its Melbourne headquarters is a company set on solving the world's plastic epidemic while making a monetary killing in the process. The world is drowning in plastic as over 91% is not recycled. To solve this, Secos has developed a plastic that is not just biodegradable, but compostable. The company has recently begun to achieve some major traction as its bags were added to Woolworths' catalogue, and we think this is just the beginning.

Share price chart

Source: Tradingview

The world is drowning in plastic

Did you know that 'A whopping 91% of plastic isn't recycled?' That's the headline of a recent report from National Geographic and Great Britain's Royal Statistical Society. Billions of tons of plastic have been manufactured over the last few decades and most of it can't be used again. To be more specific, 8.3bn metric tons of plastic have been produced in total up to 2018 and 6.3bn metric tons of that became waste. With only 12% incinerated and 91% not recycled, the 400-year average degrading timeframe is a serious global issue, both from a pollution standpoint and from an urban planning pint of view. Landfills are quite literally filling up with the stuff. The report also suggested that by 2050, the oceans would contain more plastic waste than fish, ton for ton. There are a lot more statistics packed into this report and none of them are really all that positive.

With plastic being so cheap what could easily replace it without bankrupting our world economy? Must we choose between drastically higher costs or catastrophic environmental costs and damage?

The Melbourne-based Secos has an answer to this question and it's a resounding no. The company produces economically competitive, bio-resin plastics that are not only fully bio-degradable, but completely compostable. This means that a consumer can place their compost waste, enclosed in a Secos-made bag, directly into a compost bin and expect to not find any residue left over from the bag. While not unique to

Secos, this is unusual and fully meets the regulatory requirements from all countries who have instituted the phasing out of single use plastic bags, i.e. the European Union. More significantly, the production process, product and technology have been fully patented and are owned by Secos.

These bags are truly economical, just check Woolies

Secos already has made it into the holy grail of direct-to-consumer sales in Australia, specifically a major supermarket. Under the brand MyEcoBag, the company has managed to get its product placed in Woolworths (ASX: WOW). That's no easy feat because giants like Woolworths are notoriously difficult to persuade when it comes to stocking anyone's product. We took a look at Woolies' online bag offerings and most of their small size eco type bags sell for around $0.15 per bag. MyEcoBag sells for $0.16 and comes in 8l instead of 12l. However, the other eco-type bags on offer are either made from a portion of recycled materials or partially made from cane-sugar. As far as we can tell from Woolies' website, MyEcoBag is the only fully compostable bag sold.

A quick reminder, we are separating out fully compostable as a higher standard than biodegradable. This is because bio-degradable is a broad standard, which can still take years. In our opinion this increased standard and larger range of use (normal bag, trash bag, compost bag, etc.) will more than make up for the $0.01 extra per bag cost and make the product cost competitive in the current marketplace.

It's not all about retail and bags

Secos generated $21m in sales during FY20 at a gross margin of 17.5% through its three divisions: film, bags and resin. While a gross margin of 17.5% might not be all that exciting, especially for a company that is not currently profitable, we would like to point out that this represented a year-over-year growth in margins of 86%. In fact, Secos generated positive EBITDA during 2HY20 and based on management's comments during FY21's quarterly updates so far, we are confident that full year FY21 will result in a positive EBITDA result.

While we have discussed the bags at length above, this isn't actually Secos's largest division, which is bio-resin plastic film. This represented slightly over 50% of its total sales during FY20. These types of plastic films are used for things such as magazine overwrap, food box liner, hygiene and medical applications, etc.

The second largest division is bags, which not only includes MyEcoBag, but also sales to city councils for the free bags they provide for food waste diversion programs, pet waste, etc. We also believe it is likely that Secos will be able to leverage its placement of MyEcoBag in Woolies to have it placed by other retail companies.

Interestingly, Secos has used its strong patent protection to sell the bio-resin plastic to other manufacturers and companies so they can produce their own branded bags. It is important to remember that there is a strong movement globally to outlaw single use plastic bags. Secos' patented bio-resin provides an alternative that will not fall under these bans.

EBITDA profitability here we come

Secos has shown some serious growth during FY20, both from additional revenue generation and through its 86% year-over-year increase in gross margins. The market is currently expecting revenue to grow 42% during FY21 to $30m driving an EBITDA profitability of $1.6m, or a margin of 5%. However, this really is only the beginning, in our view. Current projections have FY22's EBITDA margin more than double to 11%, followed by a 5%-point increase during FY23, to 16%.

For FY21 the EV/Revenue and EV/EBITDA ratios are 6x and 120x, respectively. This quickly drops to 5x EV/Revenue and 42x EV/EBITDA for FY22. The ratios might seem high at first glance, but we believe Secos' growth is more than adequate to meet the challenge. The need is great, the patents are strong and EBITDA profitability is effectively here. Four stars.

WATERCO

Margins being flitered out

Stocks Down Under rating: ★★★

ASX: WAT
Market cap: A$ 109M
Dividend yield: 1.6% (100% Franked)

52-week range: A$1.95 / A$3.11
Share price: A$ 3.03

Headquartered in Sydney, Waterco is the one stop shop for all your water filtration and sanitisation needs. Whether you just need your swimming pool or spa water filtered and heated, or you are running an aquaculture farm or purifying drinking water on an industrial scale, Waterco has what you need. Combine this with a healthy dose of share buybacks and we think Waterco is ready to filter out some profits.

Share price chart

Source: Tradingview

The liquid of life

Water. Everybody needs it, everybody wants it, everybody knows this. What many people don't realise is just how many things we actually use water for. Large scale water usage is defined in Gigalitres (GL), where 1GL equals 1bn litres of water. That's right, 1,000,000,000 litres of water. In 2019 alone, Australia extracted from the environment 3,113GL of water for agriculture, 1,070GL for mining and 367GL for manufacturing according to the Australian Bureau of Statistics. Even if you did know this, you might not know that most water is required to have a high standard of purity for industrial use. The modern world truly does run on water filters.

Moving on to pools, a study by the Western Australia Department of Water found that a 33m pool has an average volume of 1.8m litres. This water has to be constantly filtered and replenished. That causes over three times the volume of water to be used on an annual basis, according to a 2006 study.

We have been specifically focusing on Australia, but here's the issue: Australia is a developed country with reliable water extraction, transportation and filtration. However, most of the world is not so lucky. According to the World Health Organisation's Drinking Water Fact Sheet published on 14 June 2019, over 2bn people use a drinking water source contaminated with faecal matter. Around 1m people die each year due conditions and diseases arising directly from a lack of access to clean drinking water. To hone in specifically on one of Waterco's main countries of operation, Malaysia, many regions experience strong rust contamination due to unprotected water pipes.

Increasing profits but declining margins

During FY20, Waterco generated $98.5m in revenue with an EBITDA margin of 7% leading to total EBITDA of $6.6m, a decline of 6% year-over-year. Revenue, on the other hand, increased 12%. This trend has been going on since FY18 where revenue increases but EBITDA's margin declined starting at 9.5%. This decline in profitability was mostly due to a large increase in raw materials and consumable expenses.

Taking the above into account, it is unfortunate that the two latest updates from management to the market only included revenue growth figures, not profit margins. The first update was in regards to 1Q21's results where management declined to issue FY21 guidance but stated that revenue grew 10% year-over-year during the quarter. On 19 January 2021, Waterco announced that it had entered into an acquisition that would increase annual sales by an estimated $3.3m per year. The customer in question is a Malaysian company involved in the manufacturing, sale and service of heat pumps and water heaters. The sale is expected to be completed by the end of February 2021.

At first glance we believe this is a solid opportunity for Waterco to expand its business into hot water system heat pumps, electric heaters and solar heaters. However, we remain concerned around the profit margin as it has yet to be disclosed and this is an ongoing issue with Waterco. We will, therefore, be reserving judgment on the soundness of this acquisition until we learn more, especially since the payment for the business was only $2m on $3.3m in annual revenue.

High valuation coupled with high uncertainty

Waterco is in an industry with significant recurring demand through service contracts and replacement. The company is certainly in expansion mode as we have seen revenue continually increase year-over-year. Our issue is three-fold. Firstly, Waterco is currently experiencing a significant profitability decline with EBITDA margin dropping from an already thin 9.5% during FY18 to slightly under 7% during FY20. We currently have no reason to expect this will change during FY21.

The second concern is valuation, or lack thereof. Waterco is currently trading at a FY20 EV/EBITDA ratio of 12x, which looks back at the last financial year. Unfortunately, management has declined to provide any FY21 profit guidance and the market does not currently have any projections available. And we can't really estimate EBITDA profitability with the information we have available for FY21, especially given the ongoing, declining EBITDA margins.

Our third issue is liquidity. We don't usually mention this aspect, however, Waterco's shares have very low trading liquidity. Over the last three months the average daily volume was only 2,800. So, while investors might be able to get into the stock with a bit of patience, getting out is hard without moving the dial too much. And usually when investors want out, they're in a hurry. So, all in all make it three stars from us.

PURE FOODS TASMANIA

These shares need a diet

Stocks Down Under rating: ★★

ASX: PFT
Market cap: A$ 37.8M

52-week range: A$0.165 / A$1.65
Share price: A$ 0.81

We are willing to bet that you can guess where Pure Foods Tasmania is headquartered. That's right, it's headquartered in Tasmania, more specifically in the state capital of Hobart. This food conglomerate-in-the-making focuses specifically on acquiring established Tasmanian producers of 'premium' products. Pure Foods stock had a strong opening to 1Q21, rallying over sixfold from $0.215 to $1.36 per share. Since that time, Pure Food's share price has almost exclusively declined and closed at $0.81 yesterday. So, was this a stock that just got too hot or one the market should keep an eye on?

Share price chart

Source: Tradingview

2015: The year it all began

Pure Foods was formed in 2015 with a singular purpose in mind: to acquire and develop 'premium' food businesses in Tasmania. That state may be known around the world only for its famous 'Devil' (Sarcophilus harrisii), popularised by Disney, but for Aussies the island has a strong brand cache because of all the mainlanders who've holidayed down there and greatly enjoyed the local cuisine. What many people don't realise is what a breadbasket Tasmania has become.

Did you know that nearly a quarter of Tasmania's landmass is dedicated to meat, vegetable, fruit and dairy production? So, it's not just apples they grow down there. Agriculture, forestry and fishing are the second largest source of Gross Value Added (GVA) for the state at $2.8bn during FY20, or so we are assured by Tasmania's Department of Treasury and Finance in their the 2020 State Accounts. GVA provides an estimate of the value of production by each industry. In case you are wondering, in first place, with $4.1bn in GVA, was healthcare and social assistance, which makes sense in a state with an ageing population. However, at least all those older folks eat well.

According to Tasmania's Department of State Growth – that's right, the state has a government department devoted solely to 'growth' – this prolific breadbasket has six main compartments: mixed farming (cropping, wool, livestock); dairy, fruit and vegetable production; viticulture and hops; pigs and poultry; and niche stuff like seeds, honey, ginseng, olives, nuts, truffles and so on. If you are going to specialise in a specific state of Australia to acquire and develop 'premium' food businesses, Tasmania certainly gives you plenty of variety to choose from.

Acquire, grow and develop

Since its founding in 2015, Pure Foods has acquired four companies: Tasmanian Pate, Woodbridge Smokehouse, Daly Potato and New Pastures. These acquisitions mean Pure Foods' product catalogue includes pate, trout and salmon, and pre-made potato-based meals and salad. Excluding Daly Potato, which had its acquisition finalised ahead of schedule on 2 October 2020, these products generated $4.3m in revenue during FY20, an increase of 11% year-over-year.

While Pure Foods managed to reduce its FY20 loss by 40%, this was mostly due to the non-recurring impairment charge the company took in FY19. EBITDA actually declined from $149,000 to $138,000 as the company's largest expense, Cost of Goods Sold (66% of total expenses) increased at a rate of 21%, almost double revenue growth, to $3m.

Early in February Pure Foods announced another acquisition, Lauds Plant Based Foods, which makes dairy-free cheese and butter. Lauds is small – Pure Foods is buying it for $276k in shares at $74k in cash – but a strong addition to the portfolio as the Lauds business is just starting to take-off. If you've noticed the growing popularity of vegan diets lately, you'll appreciate why plant-based cheese is about to become a thing many consumers go looking for.

Dilution is a real risk

During FY19 management issued $1.6m worth of shares and this more than doubled during FY20 to $3.3m, although this was also due in part to the IPO. Using Thursday's closing market cap of $37.8m, we can see that these share issuances represented a dilution of 4.2% and 9%, respectively. And during FY21 so far, management has issued $1.7m in new shares (4.5% of current market cap) to fund its acquisitions. We believe this ongoing dilution is one of the key things investors should keep an eye on, especially since a roll-up strategy is inherently risky.

These shares need to slim down

We believe Pure Foods has an interesting business model and a broad range of future strategic acquisition options. We also believe that management's past choices for acquisitions have been both strategic and well-chosen within its portfolio of products. Our issue with the company comes down to its future dilution risk and what we see as an inflated valuation.

During 1HY21 revenue increased 39%, in part due to the Daly Potato acquisition, but this still leaves a trailing 12-month EV/Revenue ratio of 6.3x, based on a combined 2HY20 and 1HY21 revenue. We think that is pretty high for a food company in full acquisition mode. All together, we view Pure Foods as a smart concept but with an over inflated valuation. So, only two stars for now.

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.

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