STOCKS DOWN UNDER

2 OCTOBER 2020

Small Cap Stocks Down Under

> *Shut up you clown.*

- Joe Biden (2020 United States Presidential Debate)

HANSEN TECHNOLOGIES LIMITED

Growth by acquisition is not sustainable

SUPPLY NETWORK

Providing a network of profit

NATIONAL TYRE & WHEEL

Operating with only three wheels

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Stocks Down Under rating: ★★

ASX: HSN
Market cap: A$ 771M
Dividend yield: 2.06% (10% Franked)

52-week range: A$2.61 / A$4.20
Share price: A$ 3.90

Hansen Technologies is a global conglomerate style company focused on providing billing software to the gas, electricity, water and communications industry. Hansen Technologies has operations in Australia, Asia, North and South America, the UK and Ireland, the Nordic countries, Western and Eastern Europe as well as Middle and East Africa. With offices worldwide, the 'brains behind the operation' is headquartered in Doncaster Victoria, a suburb of Melbourne.

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Market cap: A$ 196.4M
Dividend yield: 3.22%

52-week range: A$2.99 / A$4.98
Share price: A$ 4.79

Headquartered in the Greater Western Sydney suburb of Pemulwuy, Supply Network owns the Multispares brand, which operates in Australia and New Zealand. Multispares' business is the sale and expertise around truck and bus parts. Even though Supply Network was ineligible for Australian government assistance during COVID-19, the company was able to cut discretionary spending, like advertising, in order to keep EBITDA margins steady while maintaining its employee base. Supply Network continues to impress, with an essential, and resistant, product and service.

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52-week range: A$0.205 / A$0.730
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Share price chart

Source: Tradingview

80 countries down, 113 to go

With the admission of South Sudan to the United Nations in 2011, the United Nations currently recognises 193 countries worldwide. Based on this fact, it is no small feat for Hansen Technologies to have a footprint in slightly over 80 internationally recognised countries, or approximately 41.5% of the world's total. Hansen breaks these countries up into nine different geographical portions, Australia, Asia, North America, South America, UK/Ireland, the Nordics, Western Europe, Eastern Europe and Middle and East Africa. This is further broken down into three divisions based off the industry serviced, energy, communications, and other.

Energy's principal revenue generation is based on the integration and support of proprietary billing software systems for companies and utilities in this sector. The energy division generates the most revenue at $179m, comprised of $175m in billing and $4.4m in other, one-time, revenue. In FY20, revenue increased approximately 18.6% year-over-year. The energy division is strongly concentrated in three geographical areas, Australia, North America and the Nordic countries.

Communications represented around 39% of FY20's total revenue at $117m, all of which is derived through billing customers for licences, support, maintenance and services. Total revenue for this division rose approximately $44m, or 59.4% year-over-year. As the name suggests, the communications division derives

the majority of its revenue from the integration, licencing and support services of billing software provided to companies involved in the communications industry.

If acquisitions are the only way you can grow, you're doing it wrong

During FY20, Hansen saw a rise in revenue of approximately $70m, or 30% growth year-on-year. Meanwhile, EBITDA grew approximately $20m, or 34% year-over-year. While this might seem like a highly successful year, unfortunately it was not. New revenue in FY20 following from the acquisition of Sigma in June 2019 was a little over $68m while EBITDA was slightly above $14m. Removing the revenue and EBITDA gained from the acquisition leaves the company with an organic, year-over-year, increase in revenues and EBITDA of around 1% and 10.6%, respectively. While the increase in EBITDA is encouraging, we do not believe this growth rate is sustainable just from autonomous growth, as we believe a large portion of the organic EBITDA growth can be attributed to synergistic savings, rather than organic growth.

When a company is mostly employing a growth-by-acquisition strategy in lieu of significant autonomous growth, the cash flow statement becomes one of the most important documents in the semi-annual and annual report. Usually, these companies pay dividends as a way to distract investors from the declining revenue. However, these companies also usually pay these dividends through the issuance of debt or by issuing new shares, not cash. Hansen, apart from FY20 due to COVID-19, follows this strategy to a tee.

If Hansen Technologies had not issued new shares and debt during FY18 and FY19, the company would have seen a decline in cash of around $88.2m and $173.9m, respectively in both years. This would have been exclusively due to the payment of dividends and acquisitions totalling approximately $85.4m during FY18 and $182.1m in FY19.

As of FY20, net debt (total debt minus cash and cash equivalents) stood at $135m, perfectly manageable at this time. However, Hansen will be forced to continue diluting investors and pilling on the debt unless it can turn around its conglomerate of companies. Most companies who fall into this growth by acquisition trap are unable to pull this off and we remain sceptical of Hansen Technologies' chances.

Valuation is out of whack

Hansen Technologies is valued as a company that generates significant top line growth while furnishing that growth through acquisitions. The company does have a small amount of organic growth, that is true. However, we find the continual payment of dividends concerning and believe dividend growth may be in jeopardy due to the inability to fund both its acquisitions and dividends through operating cash flow.

We believe that management will continue this strategy in FY21, after taking a break due to COVID-19 in FY20, as was stated in the 28 August 2020 FY20 ASX Media Release, "our twenty-year history of successful aggregation is set to continue."

Due to the reliance on acquisitions for growth, we believe using the last 12-months in order to estimate the valuation is in order. From an EV/EBITDA ratio perspective, Hansen Technologies is currently trading at around 19x. Meanwhile, EV/Revenue currently stands at 3.1x. We believe this valuation is out of step with the reality of Hansen Technologies' growth and therefore, we have no choice but to rate the company two out of five stars.

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Source: Tradingview

Few things in life are certain, only death, taxes and vehicles breaking down

Australia runs on buses and trucks, from our public transportation system to the majority of our domestic supply chain. As anybody who has owned any type of vehicle can attest, not much can be guaranteed when driving. But that parts will break is certainly a guarantee. Due to the reliance of Australia's economy, infrastructure and society on the constant running of buses and trucks that make up our logistics and public transportation systems, it can be argued that Supply Network provides essential products and services. You may be wondering, what service does Supply Network provide? While its services are not billable, Supply Network ensures that its sales staff are trained and able to provide expert advice on the parts it stocks.

Revenue and EBITDA growth has remained a constant for Supply Network with a Compound Annual Growth Rate over the last five years of 9.4% and 15.2% respectively. Through management's plan to continue increasing the efficiencies in distribution centres, introducing new transaction technologies, and by further expanding its operating network, management has guided that sales revenue will reach $150m by FY22. This would be an increase in revenue of approximately 9.7%. We believe, however, that management's goal of achieving $150m in revenue by FY22 is highly conservative. We believe FY21's results are already likely to

reach $150m in total revenue, barring any major, unforeseen issues. We do not believe a potential third wave of COVID-19 in Australia would derail Supply Network's growth trajectory as the majority of the company's clientele are essential to the operation of Australia, pandemic or not.

Dividends are nice, but we'd prefer they not be paid by debt

During FY19 and FY20 Supply Network's dividend payments have been around $5.7m and $6.1m, respectively. This implies a net cash from operating activities to dividend payments ratio of 0.4x and 1.8x, respectively. While this does not indicate a significant risk of the company's dividend payments being forced to be financed by equity issuance, we do believe the company is slightly putting the cart before the horse and would better serve shareholders by saving more cash and taking on less debt. However, there is no indication that a dividend cut will take place.

Low liquidity needs to be taken into account

Supply Network is one of the smaller, relatively unknown companies on the ASX, that are typically characterised by information asymmetry, i.e. their share prices are prone to more volatility following news flow. And while this does mean there is a greater potential for strong investor returns, there is also a greater potential for losses. With small caps, a discount, or premium, can often turn against investors really quickly in the short-term. Given small caps' lack of trading liquidity, if disaster strikes a company, investors will usually take significantly higher losses compared to large caps as everybody scrambles for the exit at the same time.

Over the last three months, the average trading volume for Supply Network's stock was 5,400 shares a day. Additionally, most days saw lower trading volume than 5,400 shares so liquidity in this company is often lower than the three-month average indicates. While this should not be taken as a giant stay-away sign, we believe investors need to understand that this company is riskier than other, more established, companies.

Liquidity risk warrants a discount

Due to the size of Supply Network, not enough analysts follow the company to provide a market consensus estimate for its FY21 EBITDA. However, assuming Supply Network reaches its FY22 revenue target of $150m a year early, in FY21, as we discussed above, is within reason and utilising FY20's EBITDA margin (15.3%) will provide a reasonable, but rather conservative, estimate of the company's FY21 EBITDA.

So using this FY21 EBITDA estimate, which implies around 12% EBITDA growth this year, the current FY21 EV/EBITDA multiple for Supply Network is 10.4x. Due to the higher than normal liquidity risk posed by Supply Network's shares, we believe this is within the range of what could be considered fair value for the company at this time. Therefore, we are issuing a three-star rating.

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Share price chart

Source: Tradingview

The wheels on the bus go round and round, unless the wheel is EBITDA, then it just goes down

During the beginnings of COVID-19, the sales of vehicles plummeted heavily in Australia. This had a harsh effect on the majority of adjacent industries, and wheels, tyres and other related accessories were no exception. Due almost exclusively to the impact of COVID-19, National Tyre's sales revenue declined around 5.7% compared to FY19. From a gross profit perspective, however, the sharp rise in the value of the US Dollar compared to other currencies during FY20 was the main reason behind the 14.6% decline in gross profit, as National Tyre's producers require payment in US Dollars. Most analysts predict FY21 will be a period of weakness for the US Dollar and, therefore, we believe this situation will likely see significant reversals this financial year.

While revenue has seen growth prior to COVID-19, EBITDA is a different story entirely. Over the last four years, EBITDA has been declining 6% on average, withFY20 seeing a decline of "only" 5% year-over-year. We don't think this lesser rate of decline is necessarily a positive sign, though, since it can likely be attributed to temporary expense reductions brought on by the economic downturn of COVID-19.

Solid cash flows should lead to resumption of dividends in 2HY21

Due to the financial situation arising from COVID-19, National Tyre's board rightfully suspended the final dividend for FY20 and announced that it was unlikely to authorise a dividend for 1HY21. The cash will instead be used to pay down debt and accumulate a stronger cash buffer. While Australia and New Zealand have mostly wiped the virus off the map, South Africa certainly has not, and the car market was already in decline during 2019. We believe management has made the right decision lowering the financial risk of the company. We strongly believe in the fundamental investor philosophy that dividends are only best for investors when they are not taking away from the best interest of the business.

Looking at the ratio of net cash from operating activities to cash dividend during FY20 and FY19, we find a reasonable ratio of 3.2x and 1.3x respectively. We do believe that net cash from operations will be sufficient during 2HY21 to reinstate the dividend, although perhaps at a lower level than before.

1HY21 guidance, what does it tell us about the EBITDA wheel on this bus?

The company's trading update from 30 September 2020 places EBITDA guidance for 1HY21 between $8m and $8.5m, up from $5.3m last year. However, this does include the gains made by the major acquisition of Tyres4U in August 2020 and it remains unclear just how much of this significant EBITDA gain is due to the acquisition rather than organic EBITDA margin growth. Additionally, the US Dollar has seen a significant decline from its peak in FY20. The weaking US Dollar will likely have a positive effect on EBITDA in the near term. Also, it was briefly mentioned that management has implemented some permanent cost reductions so far in FY21. Therefore, the company's 1HY21 EBITDA guidance seems quite feasible.

The market is not buying National Tyre's EBITDA forecast, but should you?

When we use the lower end of the 1HY21 EBITDA guidance range i.e. $8m - $8.5m, we get a year-over-year EBITDA growth rate of approximately 56.9% as of the first half of the financial year. Additionally, this would provide us with a 31 December 2020, trailing twelve-month EV/EBITDA multiple of approximately 5.1x. The truth is, we believe this company is in fine financial shape after this acquisition and has a solid revenue base. However, it is important to remember that the market clearly does not believe this EBITDA growth will be organic, or sustainable, and therefore, is pricing it at a significant discount.

We believe, due to the historical revenue growth and commitment by management to utilise 1HY21 cash flow to pay down debt, that the market is likely overestimating the risk to FY21's EBITDA results. Therefore, we are willing to go out on a limb on this one and give National Tyre four out of five stars.

Pitt Street Research Pty Ltd

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