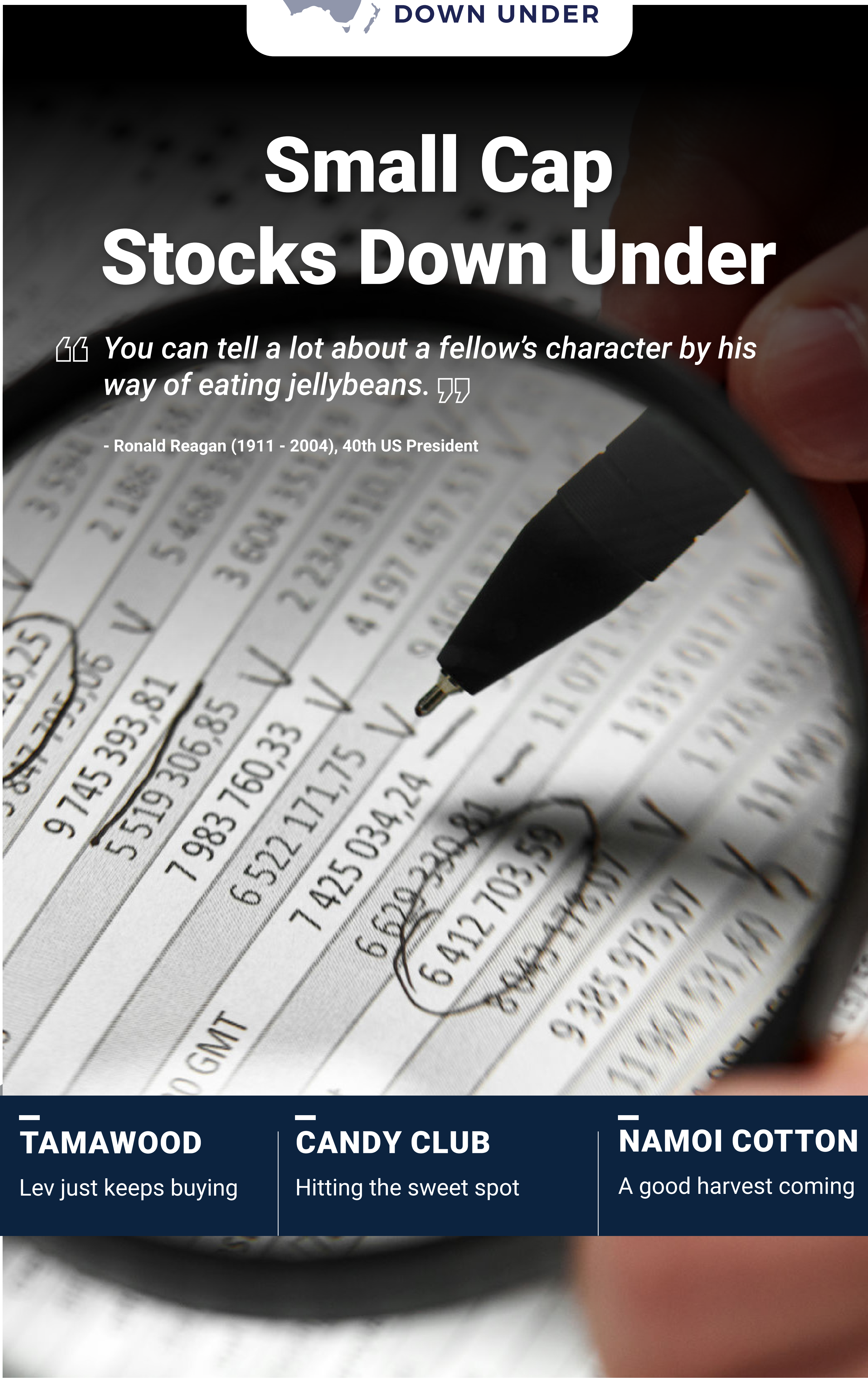
STOCKS DOWN UNDER

26 FEBRUARY 2021



Small Cap Stocks Down Under

"You can tell a lot about a fellow's character by his way of eating jellybeans."

- Ronald Reagan (1911 - 2004), 40th US President

TAMAWOOD

Lev just keeps buying

CANDY CLUB

Hitting the sweet spot

NAMOI COTTON

A good harvest coming

TAMAWOOD

Lev just keeps buying

Stocks Down Under rating: ★★★★

ASX: TWD
Market cap: A$ 103M
Dividend yield: 3.3% (100% Franked)

52-week range: A$2.36 / A$3.70
Share price: A$ 3.53

The Brisbane-based project home builder Tamawood has recovered nicely from the Corona Crash, a disaster that helped push the stock down to $2.38 a share by late April 2020. With the nation's housing market now heating up again as the economy returns to normal, we believe Tamawood with its Dixon Homes business is well placed to succeed.

READ MORE

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ASX: CLB
Market cap: A$ 74M

52-week range: A$0.03 / A$0.27
Share price: A$ 0.25

The last couple of months have been sweet for shareholders of Candy Club, a US-based and primarily B2B supplier of, you guessed it, candy. The stock was only 11 cents back on 12 December. It's since been to 22.5 cents on 17 February, and not just because investors were looking for a Valentine-themed stock to give to their significant other. It's fair to say that Candy Club's 2018/19 pivot into the B2B space is now working out very well indeed.

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Share price chart

Source: Tradingview

You want to buy a new home in one of those 'house and land packages' in a new subdivision somewhere on the outskirts of town. So, you go to a project home builder like Tamawood. They have architect-designed display homes you can inspect. You select the design you want and the builders move in and put it up for you according to Tamawood's tried-and-trusted system on the land they're supplying it with. Tamawood started doing this in Brisbane in 1989 and by mid-2000, when it went public on the ASX, it was doing about $15m in revenue from which it netted $1.3m in after-tax profit.

From Russia, with love…for building project homes

Tamawood has proved to be one of the more dependable small-cap companies that you could have bought on the ASX in 2000. The IPO price was 50 cents a share and at the $3.80 all-time high of July 2019 your return excluding dividends was 11.3% per annum whereas the S&P/ASX2000 only managed 3.8%. That success has made founder Lev Mizikovsky, who emigrated to Australia from the Soviet Union in 1977, aged 21, a rich man. Mizikovsky currently owns 54% of Tamawood stock. He was an on-market buyer of stock as recently as 16 February, but has been doing so since late 2018, allowing him to establish majority control in 2019. Mizikovsky is also Chairman of Advanced Nanotek (ASX: ANO), a maker of sunscreens we wrote about in Emerging Stocks Down Under on 16 February 2021.

If you've never heard of Tamawood but you live in Queensland you will likely have heard of the company's main operating business, Dixon Homes, acquired in late 2000 shortly after Tamawood went public. Dixon is mostly known for its work in south-eastern Queensland although there are currently developments as far south as Wongawilli, a southern suburb of Wollongong, NSW, and as far north as Palm Cove, a suburb of Cairns in far north Queensland.

Growing in one of the fastest growing parts of the country

A good part of the secret to Tamawood's long-run success has been the rapid growth of southeast Queensland in terms of its population over the last couple of decades. For a long time now, Queensland has been a net gainer of people from other parts of Australia, as part of a multi-decade trend seen in many countries where people are choosing to move to their version of Sun Belt for work or retirement. Back in 2000 only 1.6 million people called metro Brisbane home. Now it's about 2.4 million. The ritzy Gold Coast to the south has gone from about 400,000 people to 700,000 over the same period. We believe that Covid-19, while it may slow Australia's population growth for a while, will not reverse the Queensland boom in a hurry, given the head of steam it's got. And while that lasts, Dixon Homes will have plenty of customers for what it does.

In FY20, as COVID-19 temporarily bit into the prospects of Australia's housing market, Tamawood saw a slight drop in revenue, to $91m, but still increased NPAT, from $4.0m to $4.4m, thanks to better cost management which included a shift to a wage-based sales force, from a more commission-based one previously. For the six months to December 2020 Tamawood boosted NPAT by 78%, to $3.2m.

We believe the rest of FY21 will see Tamawood benefit substantially from the Australian government's June 2020 introduction of a $25,000 HomeBuilder grant, which was designed to offset the initial COVID-induced downturn. You'll recall that the government initially allowed only a three-month period to start construction in order to qualify for that $25,000, but then extended that start period to six months. We think Tamawood will see the tailwinds from that change in the current half.

A play on the regions

Another thing to be impressed about with Tamawood is the spread of projects outside the big cities. There's a school of thought out there that suggests that in the future it will be regional areas that do better than the big cities due to the ease with which people can now work from home, and the fact that many people are priced out of the big cities. So, if you're a project builder in Cairns or Wollongong you'll do better than you would out the far-flung outskirts of Sydney or Melbourne.

Like any good builder, Tamawood is financially conservative. At December 2020 it was debt-free and had $8.2m in cash. So, it is well placed to ride out any housing industry downturn that may be coming. However, with no such downturn in sight, and with Tamawood flagging 70% higher inquiries than a year previous when it held its AGM last October, that downturn is probably a long way away.

At the current market cap of around $100m, Tamawood is trading at roughly1x revenues, and if we extrapolate the NPAT from the first half, the shares are trading at a P/E of 14x. However, we suspect NPAT in the second half could be higher than what the first half suggests following the company's recent cost cuts. In other words, that 14x P/E might prove to be on the high side, implying an attractive valuation for Tamawood. We think investors would do well to follow Lev Mizikovsky's example. Four stars.

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Share price chart

Source: Tradingview

As we all can tell from the many news stories on the obesity epidemic, Americans are, by and large, a sweet-toothed people. In any one year they can go through at least US$35bn worth of sugar confectionary, chocolates and gum. And maybe by now it's more like US$40bn, which is what Candy Club believes. US$35bn would be about US$108 for every man, woman and child in the country each year. In 2015 the Los Angeles-based entrepreneur Keith Cohn set out to get a slice of that US$108 with the launch of Candy Club as a B2C offering.

Starting with B2C, then moving to B2B

Cohn's thinking was that consumers in 2015 were ready for a high-end candy offering and would pay a monthly subscription fee to be in his Club, where every month they would get shipped a curated box of candy, not knowing what was coming their way that month. That got Cohn started, but the real genius move came in mid-2018 and into 2019 when Cohn and his colleagues added a B2B component to the original B2C idea, selling Candy Club-branded candy to specialty market resellers. By the time Candy Club listed on the ASX, in an early 2019 IPO at 20 cents per share, the B2B business was in strong growth mode, because if you're a retailer, whether or not confectionary is what you're known for, you're always on the lookout for interesting new products, and Candy Club had what those folks were looking for.

Initially, investors were very sceptical of Candy Club. A year after listing, in early April 2020, you could get the stock for just 3.5 cents. Who in their right mind, it was argued, would pay $29.99 a month just to get candy shipped to their door that they may or may not like when they could just drive down to their local supermarket and pick up a reliably tasty sampler box of chocolates for a fraction of that price? What that reasoning ignored was the historic willingness of consumers to keep eating candy even when budgets were being tightened up elsewhere as well as the success that Candy Club was enjoying in the B2B space. It also ignored the quality aspect. 2020 may have been a recession year globally, but luxury goods have a habit of being recession-proof. In April 2020 Candy Club stock started to come back when it was revealed that in the March 2020 quarter gross revenues had risen 44% year-on-year.

Would you like Candy Club with that polo shirt?

The rest of 2020 confirmed that strong growth story from the March quarter. By the December 2020 quarter, gross revenue was at US$3.3m as against US$1.1 a year earlier. That didn't mean that Candy Club was profitable, with the EBITDA line in the quarter still US$0.72m in the red, but with Candy Club enjoying gross margins in the order of 40% another year of decent growth like that experienced in 2020 could arguably get it there, or close enough to breakeven.

What's the secret of Candy Club's success in B2B? Basically, the realisation in 2019 and 2020 by retailers in America that they weren't carrying enough high-end candy of the kind that would sit well in 'white space'. In brick-and-mortar retailing a 'white space' is a part of the counter where there's no merchandise but there reasonably could be without cluttering it up. White space is nothing new – if you've ever read Conrad Hilton's 1957 memoir Be My Guest you'll recall Paris' great-grandfather talking about finding white space in the retail parts of his hotels. It turns out all sorts of stores today are moving candy into their white space. An interesting case in point is Barnes and Noble. You and I may know them as a big name in bookselling. It turns out the same woman who steps into a Barnes and Noble looking for a nice gift for her girlfriend may come away not just with a set of Jane Austen novels, but also some Candy Club merchandise.

Candy Club is now available in places as diverse as Hallmark (the greeting card people), Caesars (the casino/hotel complex with the gift shop) and Polo Ralph Lauren (that's right, the place where you can get those fancy polo shirts).

Following James' lead

We think there's more growth in 2021 of the kind which Candy Club saw in 2020. In December's quarterly report the company noted that January 2021 had seen 515% growth in its B2B business compared to January 2020. Candy Club is funded to be able to grow towards breakeven, with $5m having been raised at 12 cents in November 2020. And director James Baillieu, one of the Melbourne Baillieus, has been a strong buyer of stock on-market recently. He now owns more than a quarter of Candy Club. We suggest that investors with risk appetite who have done their homework follow James's lead and think about joining this Club, at least in terms of its share register.

Candy Club shares are trading at around 5.5x revenues, based on the December-quarter annual run-rate. But the company's top line growth is so high that this multiple will come down substantially in the next year, which is why we believe this is a four-star stock.

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Share price chart

Source: Tradingview

The last nine months have been a great time to be selling cotton. Back at the end of March 2020 that industrial staple was changing hands on Nymex at under US$48 a pound. It's now above US$88 a pound and looking to go higher, with the market having only moved upwards since March. And no wonder. Once the global economy had been stabilised after the Corona Crash, demand for cotton was always going to come back. The re-opening of the Chinese economy meant that the recovery in cotton demand was faster than expected. Combine that with weather-related shortages in key cotton-producing countries, including Australia, and the result was good times for cotton producers with available product.

Cottoning on to a good thing

So now is a good time to be Namoi Cotton. The company is called Namoi Cotton because of the region it serves. The Namoi River in north-western NSW is part of the mighty Murray–Darling basin that yields so much of the Australia's agricultural riches. To find the Namoi, get in a car in Sydney and drive about 530 km northwest to a town called Narrabri and keep going another 40 km or so until you get to Wee Waa (pronounced 'Wee War'). You've now arrived in a globally significant cotton-growing district, one that was pioneered in the early 1960s when a couple of cotton farmers from California's Central Valley proved that the Namoi had near-perfect conditions for that crop.

Namoi Cotton grew up around the cotton farmers who followed from the 1960s. They set up a co-operative to gin their cotton and it remained a co-operative even after its 1998 ASX listing. It didn't get around to demutualising until 2017. Today Namoi Cotton has 11 cotton gins stretching from Goondiwindi in southern Queensland, where the MacIntyre Valley makes for great cotton country, all the way to Hillston, NSW, on the Lachlan River around 600 km south of Wee Waa. As well as running the gins, Namoi also markets the cotton through a joint venture with the major Dutch agricultural commodity trader Louis Dreyfus.

The drought you didn't want to have to go through

The year ended February 2020 was a really bad one for Namoi Cotton, because the truly disastrous 2016-2019 drought in eastern Australia had cut the amount of cotton that Namoi was able to gin from the area that it services by close to two-thirds. Namoi Cotton EBITDA plummeted from $23m to $4.3m as the gin volume fell from 1.2 million bales to only 0.45 million.

What excites us about Namoi right now is that the 2016-2019 drought broke around the time the 2020 result came out around a year ago, but the share price didn't move for the next year or so. Fair enough – in the six months to August 2020 gin volumes were still way down and Namoi was loss-making, because the good times for cotton were still a way off. The cotton growing season in eastern Australia lasts approximately six months, starting in September/October for planting and ending in March/April for harvesting. The harvest that ended in April 2020 was one of the worst on record. However, that was then and this is now.

Bring on 2021

Namoi Cotton's February 2021 result will hit the streets in April and that is likely to look much healthier in terms of the outlook given better cotton pricing and much better growing conditions. In February, the 2021 harvest was just about to get underway and early estimates suggest that the crop will be four times larger than the previous year. A good year for the Australian cotton industry sees 4 million bales harvested. 2020 saw only 600,000.

Recently Namoi Cotton's CEO, Michael Renehan, resigned suddenly after less than 18 months in the job. That's understandable – getting Namoi Cotton through a drought like 2019 would take it out of even the most resilient of agribusiness CEOs. What Renehan achieved was a restructure of the marketing side of the business to given Namoi less exposure to cotton price volatility. Namoi Cotton will now look for a new CEO and that new hire will get to enjoy the post-drought upside.

What Tim and Ian saw

The people who run Namoi Cotton can sense that good times are coming. Recently, Chairman Tim Watson was an on-market buyer of stock. That was important to us because Watson grows cotton down near Hillston and he is therefore close to the action in terms of understanding where the 2021 harvest will go. Another recent on-market buyer was Ian Wilton, a non-executive director best known as the Chairman of the major agribusiness company Elders (ASX: ELD).

We suspect that director buying is a major reason for the recent perking up of the Namoi share price, but there is likely more to come. We won't find out for a while how big the 2021 harvest will be, and in the meantime the Namoi Cotton Net Tangible Assets is a cool 83 cents per share on the August 2020 numbers, more than twice the current share price!

We think investors could do well following the lead of Watson and Wilton. Four stars from us.

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