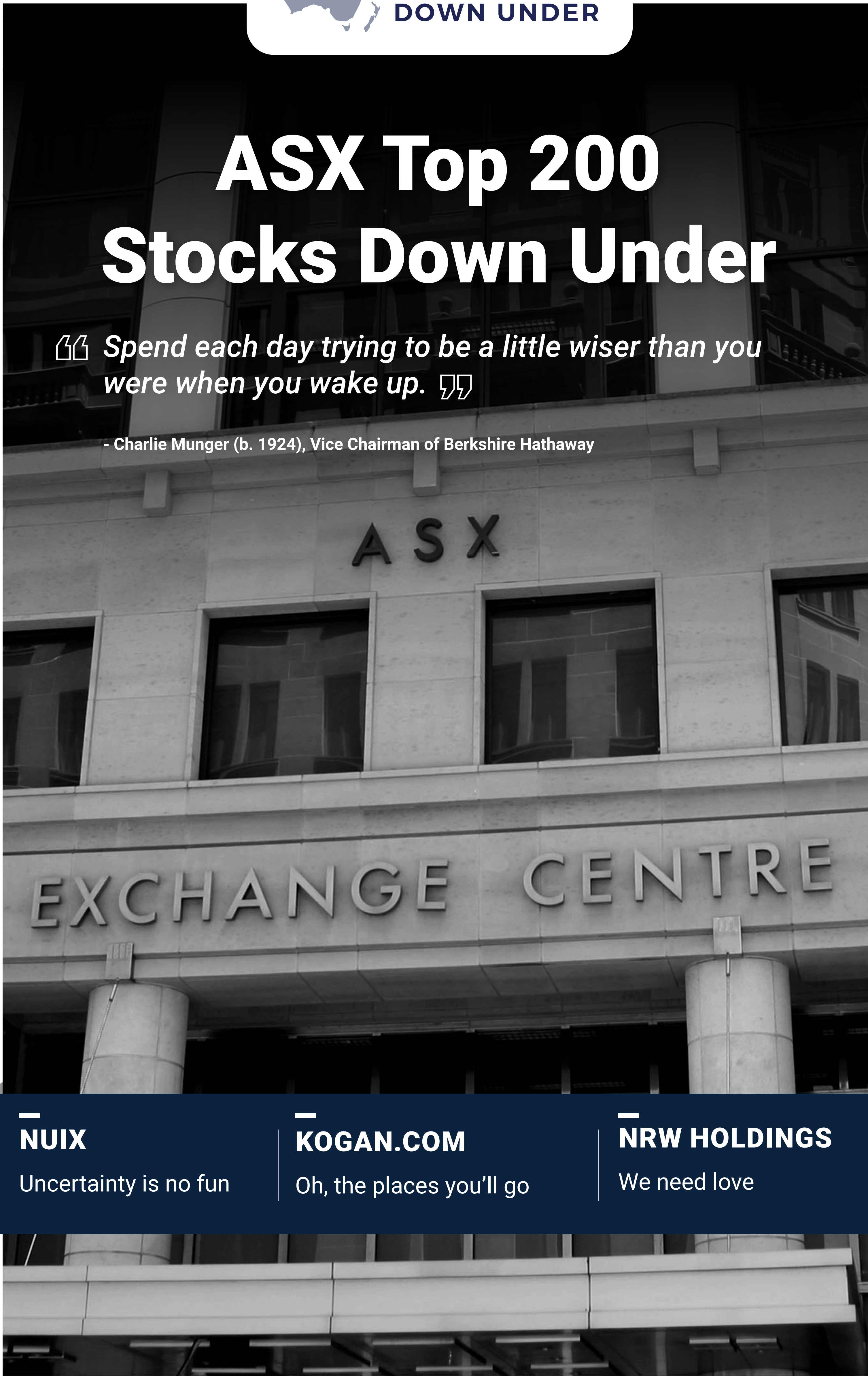
STOCKS DOWN UNDER

8 MARCH 2021

ASX Top 200 Stocks Down Under

"Spend each day trying to be a little wiser than you were when you wake up."

- Charlie Munger (b. 1924), Vice Chairman of Berkshire Hathaway



NUIX

Uncertainty is no fun

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Oh, the places you'll go

NRW HOLDINGS

We need love

NUIX

Uncertainty is no fun

Stocks Down Under rating: ★★★

ASX: NXL
Market cap: A$ 1.8BN

52-week range: A$4.99 / A$11.86
Share price: A$ 5.00

Headquartered in Sydney, Nuix was one of the better performing IPOs last year, with the stock ending 2021 up 67% on the December offer price of $5.31. In January it actually peaked close to $11.50. This company owns an algorithm that allows unstructured data to be made searchable and provides the structure for more elaborate analysis. Since its development as a use case for an Australian government agency, the Nuix algorithm has expanded into what is now known as the Nuix Engine, used by over 1,000 customers across 78 countries. After a disappointing half yearly result, which hit the stock badly, we ask whether this an overreaction or if there is more pain to come?

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KOGAN.COM

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ASX: KGN
Market cap: A$ 1.5BN
Dividend yield: 2% (100% Franked)

52-week range: A$3.45 / A$25.57
Share price: A$ 13.72

Kogan.com is an internet-based conglomerate headquartered in Melbourne, offering something for almost every consumer. Often called the Amazon of Australia, Kogan.com has seen remarkable growth from its main platform, Kogan Retail, which has been expanding into other markets and industries. COVID-19 has only set to turbocharge the retail platform's growth and the market is currently involved in a great debate. Is this growth permanent or just a COVID-19 mirage?

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Share price: A$ 2.04

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Share price chart

Source: Tradingview

Welcome to your worst nightmare

We live in a world of data. What you might not know is just how much of a nightmare this can lead to in practice for those whose job it is to sift through that data. According to Michael Recker of Applied Discovery, email files average 100,099 pages per gigabyte, Microsoft Word documents average 64,782 pages per gigabyte, while Powerpoint averages 17,552 slides per gigabyte. As for garden variety images, you can squeeze 15,477 of them into a gigabyte.

This may be hard to visualise, so let's look at a specific example. The Mossack Fonseca Leak of 2016, an event more commonly known as the 'Panama Papers', consisted of 11.5m documents for a total of 2.6 terrabytes (TB) (2,600 gigabytes). To put this another way, the leak totalled 320,166 text documents, 1.1 million images, 2.15 million PDF files, 3 million database excerpts and 4.8 million emails. If you were to print this all out with 2,000 characters per page, the final document would be 650 million pages long. This was certainly one of the largest leaks in modern history, but if a small law firm like Mossack Fonseca in Panama had 2.6tTB of data to leak, how much data do you think a major law firm like Slater and Gordon (ASX: SGH) has on its servers?

Here's the important thing about with these vast troves of data; companies don't keep it just because they can afford to. Organisations keep this data because they need to, whether for compliance purposes, daily operations, inventory tracking, or whatever. But how can any organisation hope to not only track so much information, but easily derive anything even remotely useful from it? This is where Nuix comes into play.

The company has developed a search engine (Nuix Engine) that powers five different products: Nuix Workstation, Nuix Discover, Nuix Investigate, Nuix Enterprise Collection Center and Nuix Adaptive Security. How does this help corporations with their data problems? Let's find out.

The engine with the power

The Nuix Engine powers a number of different corporate offerings, as we listed above. However, all of these offerings do the same thing at the most basic level: Process, search, analysis and visualise your company's database or information. This allows an organisation to compile relevant files to comply with a court order, find patterns for the compliance team, help investigate a data breach and much more - even when you're talking about billions of individual data points.

Nuix has four main client groups: corporations, governments and law enforcement agencies, law firms as well as advisory and service partners. The most surprising to us is that when you break down FY20's revenue of $176m, it is distributed more or less evenly across these client bases. Advisory firms represent the largest chunk at 35%, although this is not overly surprising since one of the main functions of advisory firms is analysing vast swaths of data, and that's the Nuix Engine's speciality. The remaining 65% is split between governments (20%), corporations (19%), 'new and undisclosed markets' (15%) and law firms (11%).

Expectations of perfection never end well

Nuix was flying high after its 4 December 2020 IPO, having come on the market at a decent premium. However, after it announced its 1HY21 results on 26 February 2021, the party came to a rather abrupt and hard end. The stock has subsequently dropped to $5.00, offering investors in the IPO a a loss. So, what happened?

1HY21's results were not as catastrophic as you would expect from a 33% share price decline in a single day. In fact, we should not even use the word catastrophic. The results were virtually flat from a year-over-year perspective. Revenue saw a decline of 4% to $85.3m during 1HY21, while the EBITDA margin saw a slight increase driving EBITDA up by 3.3% to $31.6m.

Here is the issue, though: The market priced Nuix based on its prospectus forecast for FY21 of total revenues of $193.5m and EBITDA of $63.6m. Looking at the 1HY result, that prospectus forecast looks highly challenging as management will need to pickup a lot of it's 1HY assumed growth during 2HY.

Once bitten, twice shy

We agree – the 1HY21 result was unimpressive. However, the most interesting part of the result was management boldy reaffirming its full-year guidance. We hope future announcements will help us see how they plan on getting there. For now, however, we believe that despite the expected 29% EBITDA growth for FY22, the FY21 and FY22's EV/EBITDA multiples of 24x and 18x leave far too much risk given the recent disappointment. That said, Nuix has a very solid product suite that is in demand.Also, going against company guidance is not something to do lightly, especially after such a significant price correction. We are therefore staying on the sidelines for now to see where the stock is headed in the near term and giving Nuix a three star rating.

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Share price chart

Source: Tradingview

What passed was fast

We first issued a four-star rating on Kogan.com in 24 August 2020's edition, when the stock was trading at $21.74 per share. Our rating's crux had little to do with the actual growth rate of Kogan.com's EBITDA and revenue, but rather the growth in the company's active userbase and rewards program. We felt this indicated an acceleration of Australia's shift to online retailing rather than a temporary bump.

Currently in country

Kogan.com is an Australian success story and 1HY21's results proved it. The company generated adjusted EBITDA growth of 184.4% (this excludes unrealised Foreign Exchange, equity-based compensation and one-off non-recurring items), resulting in $51.7m in EBITDA for 1HY21. While that is very solid growth, let's look at the numbers that matter more for long-term growth: exclusive brands and the userbase.

One of the main contributors to EBITDA growth was Kogan.com's continued success in pushing its exclusive brands, leading 1HY21's EBITDA margin to rise 1.8 percentage-points to 9.4% for the half. The company's exclusive brands saw year-over-year revenue growth of 114.9% and gross profit growth of 174.9% as these brands are not only growing in popularity, but in margin as well. As a result of 1HY21's growth, exclusive brands accounted for 55.9% of Kogan.com's total gross profit, up from 51.3% during FY20. With Kogan.com continuing to funnel money into this division, we believe shareholders can expect overall profit margins to continue expanding over the next couple of years.

The best customers are the active ones

During 1HY21, the retail arm of Kogan.com reached a significant milestone as its active customers, excluding Mighty Ape, surpassed 3m. This represents an increase of 77% during 2020, but just how active are these customers? To help determine this, we zoomed in on what we believe are the two most important figures: repeat business and average gross sales per (active) customer.

An 'active customer' has purchased within the last 12-months, and a 'repeat customer' is an active customer who made a subsequent purchase. Unfortunately, Kogan.com does not release the actual numbers, but rather a numberless chart. However, we know repeat purchases increased 40% during 2HY20 (due to separate comments by CEO Ruslan Kogan). We can see in the chart that repeat orders and repeat customers grew at a greater rate during 1HY21 than during 2HY20. Therefore, we can say with reasonable certainty that the rate of growth was greater than 40% during 1HY21. Looking at average gross sales per customer, we see that this figure stayed flat during each month for 2020 at slightly over $350. When you factor in the 77% growth in active customers during the same period, flat growth indicates that these new active customers make just as many purchases as pre-COVID-19 users.

Opportunity rooted deep

Despite generating these impressive results, Kogan.com's stock has declined rather spectacularly since 25 January 2021, falling approximately 35%. Unfortunately for shareholder, the bears are currently running this stock, and they believe January's update only confirmed their fears. We strongly disagree with their view.

When January's update came in at 90% adjusted EBITDA growth and 54.6% growth in exclusive brands, we concluded that this was a strong result. Unfortunately, many have looked at this as a confirmation of Kogan.com's bear case by comparing it to 1HY21's adjusted EBITDA growth of 184.4%. Yes, growth is slowing back down to normal, but that does not mean that COVID-19 was just a flash in the pan. The company has kept its new customers, drastically increased its brand awareness and successfully pushed its exclusive brands. We expect future EBITDA growth (FY22 and beyond) to be driven by a combination of margin expansion and organic growth. Following the post COVID normalisation, we believe Kogan should be able to structurally grow EBITDA by 30% annually.

Kogan will likely continue acquiring

Another aspect that we don't believe the bear case is appropriately taking into account is the potential for another acquisition within the next couple of years. Kogan.com has a history of strategic acquisitions that have produced strong returns for shareholders in the long run. With a current balance sheet of $79m in cash and only $13.5m in total debt and lease liabilities, we believe management can more than handle another acquisition after Mighty Ape's integration is finished at the end of FY21.

FY21's expected EBITDA growth of 77% to $88m is not really debated among analysts, given the little variation between the predictions of the six analysts that cover Kogan. This expected EBITDA yields a reasonable EV/EBITDA multiple of 17x for FY21.

FY22 is where things get tricky, though. The lowest analyst prediction expects 0% year-over-year EBITDA growth, the median prediction expects 14%, and the highest predicts 36%. In other words, the range is quite broad, indicating that there is quite some uncertainty in the market around next year's results. Based on the average EBITDA forecast, the shares are currently trading at a multiple of 14.6x for FY22. Given the average expected EBITDA growth of 14.3% next year, that multiple is more than reasonable.

As we indicated earlier, we believe Kogan should be able to grow its EBITDA around 30% annually, driven by its expanding margins, its expanding customer base and its ability to retain the new customers it has gained during COVID-19. Assuming 30% growth in FY22, the shares are currently trading at an EV/EBITDA multiple of 12.8x, which we believe is too low.

Although arbitrary, we believe 20x is much more appropriate valuation for Kogan given the growth we expect and the resilience the company has shown over the last 12 months. An EV/EBITDA of 20x for FY22 would imply a share price between $20 and $21, which is where we see KGN headed. And if the company can indeed demonstrate an ability to grow EBITDA around 30% annually, we believe there is substantial room for multiple expansion in due course as well, indicating more upside longer term. Four stars from us.

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Share price chart

Source: Tradingview

The two pictures with one thing in common

What do mining and civil construction have in common? They are both in the spotlight for the post-COVID-19 Australian recovery. Let's focus first on mining as many who pay attention to the industry know that iron ore demand and prices have skyrocketed recently. As the world's top producer of iron ore during 2019, Australia has benefited enormously from this while Brazil's production collapsed due to its out-of-control COVID-19 epidemic. Moving on to copper, the Australian Government's Geoscience division tell us that Australia is the world's fifth-largest producer of copper. As the world's recovery from COVID-19 begins, copper has also seen a massive increase in demand from construction and manufacturing. This has led the metal to recently rally to a nine-year high. Copper and iron ore are far from alone in this demand rally. These two metals showcase how the recovery is seeing a massive rally in demand for Australia's metal ore and its mining sector.

Civil infrastructure is another area that is in Australia's spotlight in the post-COVID-19 world. The Australian Government is set to invest $110bn on its rolling infrastructure plan over the next ten years starting from 2020-21. This plan's main focus is on improving road safety, increasing the prevalence of roads and other transportation infrastructure in the regional areas and improving freight transportation. The moral of the story: Roads are certainly in Australia's future.

Bringing NRW into the fold

NRW is heavily leveraged to all the prosperity we talked about in the last few paragraphs. While technically NRW operates under four different divisions, we are going to simplify it into civil and mining. Combined, these divisions generated a total of $1.2bn in revenue during 1HY21.

The mining operations are where the majority of the company's revenue comes from. During 1HY21, the combined mining, drill and blast, and minerals, energy and technology divisions generated $753.8m in revenue, an increase of 42.6% year-over-year. The mining division focuses mostly on iron ore, copper, lithium and coal mining. The services and equipment provided to its mining clients by NRW are far too elaborate to mention here. However, we wanted to highlight a few to give our readers a better idea of the mining operations. NRW provides mine management and development, maintenance services, explosives supply, drill and blast supply, load and haul services, offsite repair and fabrication services, belt and hybrid feeders to name just a few. In short, just about everything you'd need when developing and operating a mine.

The civil division generated $464.9m in revenue during 1HY21, representing 52% in year-over-year growth. This division's operations include roads, bridges, rail lines, airstrips, commercial and residential subdivisions, etc. Many of this division's operations are directly related to the mining sector, which means that NRW's civil division has a lot of experience building infrastructure in rural areas. With the new focus on rural development under the Government's infrastructure plan, we believe this will prove to be a distinct advantage as the company continues to submit tender offers.

The plunge

NRW shareholders were doing rather well during 2HY21 as it became apparent that Australia's resource industry was uniquely placed to benefit from the post-COVID-19 boom. However, as NRW's stock broke slightly above $3 a share, it suddenly plummeted on the back of a highly unusual amount of trading volume. During the last three months, average daily trading volume was 2.6m shares, representing significant liquidity. However, on 18 February 2021, 20.1m shares were traded as the stock dropped approximately 18% in one day. There was substantial selling by BlackRock on this day as its subsidiaries saw 3.3m shares sold. This is not unheard of and we don't think investors should take this as an overly negative sign.

EBITDA and pipeline growth: an excellent pairing

We discussed above how we believe NRW's industry focus makes it well-placed for strong growth and its pipeline seems to agree. Between June 2020 and December 2020, NRW's pipeline grew from $12.9bn to $14.1bn, split between mining ($10.1bn) and civil ($4bn). The company has also submitted $5bn in tender offers it is waiting on. So, the pipeline growth is real. How is the valuation?

We believe NRW's plunge offered an unusual opportunity for investors. The market is currently expecting only 8.8% in EBITDA growth during FY21, accelerating to 14% during FY22. Based on these growth expectations, the market is currently valuing its shares at an FY21 and FY22 EV/EBITDA ratio of 3.8x and 3.3x, respectively. Not only do we think that these valuation multiples are too low given the expected growth rates, we also believe these growth expectations themselves might be too low. With the expansion of Australia's mining and civil infrastructure spending that we expect during the next decade, NRW's pipeline is due for some serious growth. That makes NRW a four-star stock in our book.

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