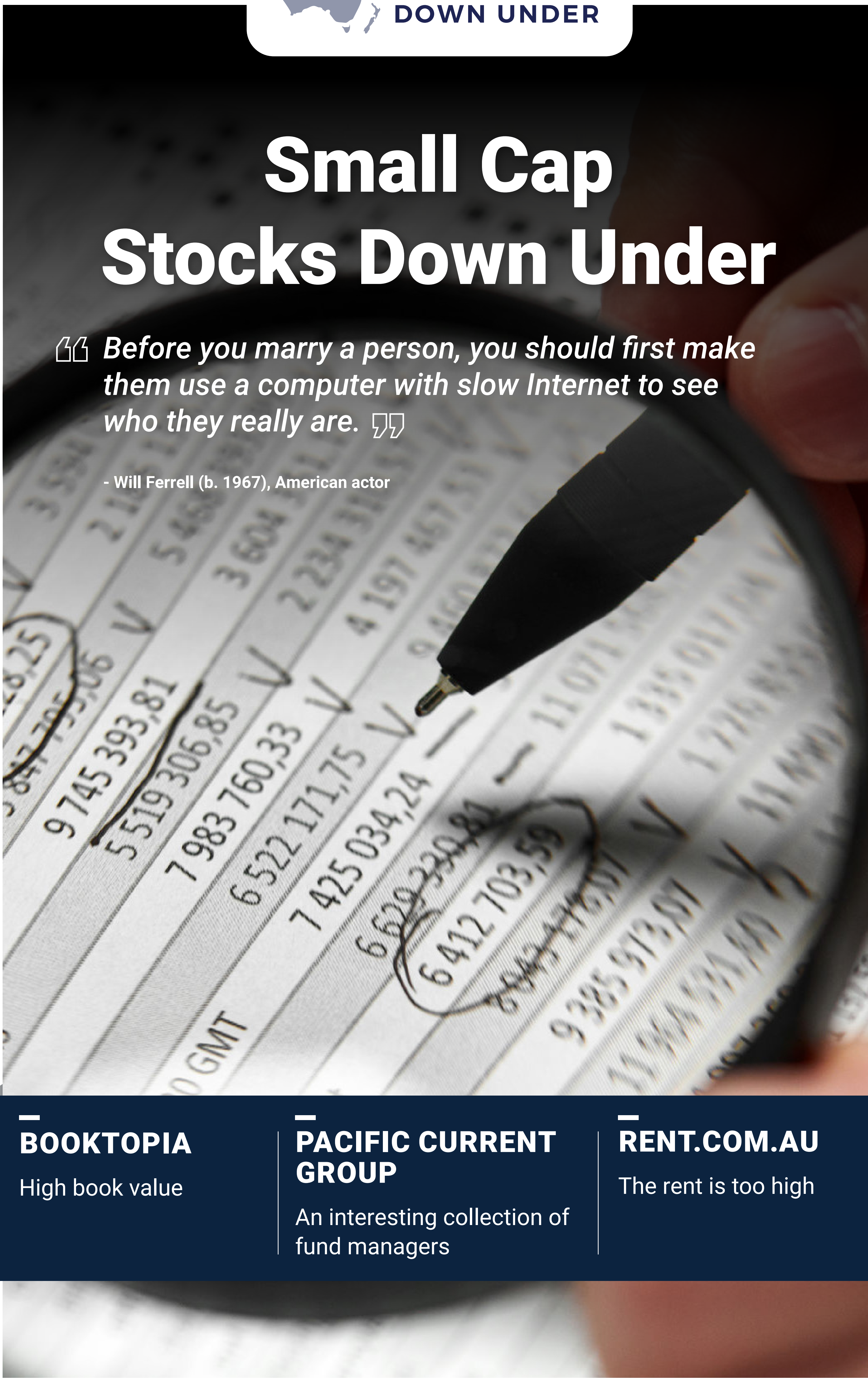
STOCKS DOWN UNDER

26 MARCH 2021



Small Cap Stocks Down Under

> *"Before you marry a person, you should first make them use a computer with slow Internet to see who they really are."*

- Will Ferrell (b. 1967), American actor

BOOKTOPIA
High book value

PACIFIC CURRENT GROUP
An interesting collection of fund managers

RENT.COM.AU
The rent is too high

BOOKTOPIA

High book value

Stocks Down Under rating: ★★★★

ASX: BKG
Market cap: A$ 335M

52-week range: A$2.35 / A$3.06
Share price: A$ 2.42

Headquartered at Lidcombe in western Sydney, Booktopia Group is like Amazon was in the early days. Since its establishment in 2004 as a side hustle on a budget of $10 a day, Booktopia is now worth in excess of $330m. And no wonder. Low shipping fees and fulfilment times that outdo Amazon et al., not to mention an increasingly growing inventory that surpasses any brick and mortar store, are allowing Booktopia to outperform all expectations.

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PACIFIC CURRENT GROUP

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Stocks Down Under rating: ★★★★

ASX: PAC
Market cap: A$ 286M
Dividend yield: 6.2% (100% Franked)

52-week range: A$4.10 / A$6.49
Share price: A$ 5.50

Here at Stocks Down Under, we have written about many different fund managers. Headquartered in Sydney, the Pacific Current Group is not your average fund manager. This company invests in a variety of non-listed fund managers. However, when Pacific invests, they invest in the fund manager, not the actual funds these managers run. We'll explain what that means below. With exposure in everything from private debt, private equity, hedge funds, real estate, infrastructure and more, just how current are the Pacific Current Group's profits?

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Share price chart

Source: Tradingview

Pandemic Proof

Rain, hail or shine, Booktopia has performed well in recent years and the COVID-19 pandemic only benefitted the group. While physical stores were closed and shipping backlogs from overseas companies got worse, online traffic to Booktopia increased. In FY20, EBITDA grew 67% to $6m and the FY21 forecast as per the prospectus was for another 56% growth, to $9.4m. However, the group outperformed their own predictions in the first half of this financial year so handily that those forecasts had to be updated to an EBITDA of $12.9m for FY21. That would be a growth rate of 115% on the previous year. Wow!

Leadership and stability are two deciding factors in a company's success and we believe Booktopia has both. Two of the three founders - Tony Nash (the current CEO) and Steven Traurig (the Chief Commercial Officer) – have been working together since 1988. Few firms can go thirty years with the same management and this one did it while growing continuously.

You may have yet to shop at Booktopia, but you've probably bought from Angus and Robertson or the Co-Op Bookshop back in the day. These have both been successfully acquired by Booktopia, which gained the 156,000 loyal members of Angus and Robertson and the reliable thousands of students every year who go online to find compulsory textbooks. On top of this, out of the 5 million customers who've bought something from Booktopia over the years, 2.3 million have turned into repeat customers.

Reading in the Digital Age

If you're going to enter a market for books, Australia is a good place to go. Surpassing the US and the UK, 65% of the population read at least weekly and only 8% of adults are classed as non-readers. While book reading has slightly declined, reading across all forms of media is growing. Believe it or not, Bob Hawke's vision of Australia as a clever country appears to have come to pass in the current decade. Since older people read more than most and Australia's population is aging, demographic is working in Booktopia's favour.

The book market's major trend is the shift to the online channel, which accounted for 43% of sales in FY20 and is predicted to make up 50% of the market in the not-too-distant future. Booktopia holds just 6% of the market currently, so the sky is the limit for this early pioneer. We're also excited by Booktopia Publishing Services' prospects (for self-publishers, launched in 2017) and Booktopia Publishing (Booktopia as a publishing house, launched in 2019). These projects are still in the early stages, but just imagine if the next Patrick White or Colleen McCullough got discovered by the editors at Booktopia Publishing!

Profiting from 'Buy Australia'

Now, we know what many of you are thinking: Amazon has been doing this since Jeff Bezos and colleagues set up in Seattle in the 1990s. How can little Booktopia compete against the mighty Jeff? To answer that question, ask yourself the last time you ordered yourself a book off Amazon, how much you cursed knowing it was going to take weeks for your book to cross the Pacific. Or if you ordered a title from an Australian publishing house at Amazon and wondered why it cost so much. Now you know why Booktopia has a competitive advantage when it comes to online book retailing for our 26 million or so people. Although, Amazon is expanding its distribution centre in Melbourne.

Interestingly, Australia is a huge country, but Booktopia can provide fulfilment from a single warehouse in Sydney. The company will use part of the proceeds from the recent IPO to make its fulfilment engine more efficient. It uses third-party logistics, which means that your book gets to you by Australia Post, but that state-owned outfit has proven surprisingly efficient in keeping most customers happy.

Sell if Australians stop reading

Booktopia Group's IPO price was $2.30. The early reception was favourable with the stock reaching $3, but we're now almost back at the IPO price. That selloff is strange given the strong 1HY21 numbers, with revenue up 51% and EBITDA up 502%. It's also strange given the fact that Booktopia is debt-free, with net cash of $16m as of 31 December 2020. Critics of the Booktopia IPO will likely point out that 7.9 existing shares were sold alongside 10.9 million new shares. However, Tony Nash, Booktopia's largest shareholder, didn't sell a single share in the IPO. He's holding on to his 19% of the company.

We can guess why Tony is so bullish. Currently, you can get Booktopia at an EV/EBITDA multiple on FY21 consensus numbers of 25x. While that may seem high, we believe it's peanuts given the expected 115% growth rate for the year we noted above.

But it gets better. The consensus is expecting EBITDA growth for FY22 and FY23 of 43% and 51%, respectively. Yet for FY22's numbers, the EBITDA multiple is only 17x. So, unless Australians give up their long-held habit of reading in favour of playing video games or something in the next couple of years, there's plenty of upside still to be enjoyed in this stock. Four stars.

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Share price chart

Source: Tradingview

A quick look at the structure

As of 1HY21, Pacific's Funds Under Management (FUM) grew 21.5% to $113bn, which is split between 14 different fund managers. These fund managers are mostly based in the United States. However, two are based in the United Kingdom, one in Luxemburg, one in India and one in Australia. It is important to remember here that Pacific does not personally manage what it calls its own Funds Under Management. These FUM are actually managed by the fund managers Pacific has an ownership stake in. The purpose of this company is to find strong fund managers to invest in, not as a normal investor, but for an actual piece of the fund management company in question. This means Pacific makes money by taking a portion of the fund's fees, rather than the fund's investments profits.

Management fees are the future

During 1HY21, revenue from operations fell 33% year-over-year. This decline was mostly due to lower performance fees, which is not surprising since 1HY20 was a stronger period for investments than 1HY21. However, we don't believe this decline is indicative of Pacific's future results. The company will certainly see fluctuations in its revenue as the market fluctuates, causing its performance fees to drop from time to time. However, we believe that management has chosen a diversified portfolio of fund managers, spanning various investment industries (Private Equity, Hedge Funds, Real Estate, etc.) and ones that have historically produced strong returns.

Pacific's profits have mostly been derived from management fees for a while now. During FY18, management fees generated 45% of Pacific's Net Profit Before Tax, but during 1HY21, they accounted for 71%. All the while, Net Profit Before Tax has seen a considerable rise of approximately 75.4% between FY18 and FY20.

It is important to note that between FY18 and 1HY21, Pacific has only issued $12m in stock. Comparing this to the company's market capitalisation as of 25 March 2021 close this represents only a 4% dilution for a 75.4% increase in Net Profit Before Tax. We think that's an excellent deal any day, especially with an indicated annual dividend of 6.2% currently.

Solid outlook

The outlook for Pacific's invested funds is quite rosy. Many of the fund managers partially owned by Pacific had closed their funds to fresh capital due to COVID-19, but all are expected to reopen by 1HY22 at the latest. With the amount of liquidity sloshing through the world's financial system and the focus on management fees for revenue, we are quite bullish on Pacific's future revenue growth prospects. The company is also expecting to use its current cash hoard to make at least one other investment during the remainder of FY21. All-in-all, it seems like a lot of the past year's turbulence for Pacific has subsided.

There is one major concern facing Pacific's future: its focus on United States Dollars. The majority of its revenue is currently denominated in US Dollars and any decline in the USD/AUD rate has the potential to cause significant revenue growth disruption.

Market expectations are strong

The market's future earnings expectations for Pacific are just as bullish as we are. The current projections have EBITDA increasing 21% during FY21 and 17% during FY22. Based on these projections, the company is trading at FY21 and FY22 EV/EBITDA ratios of 7x and 8.2x, respectively. From a Price/Earnings perspective, the stock is currently trading at an FY21 and FY22 10.9x and 10.1x, respectively.

Most of the anticipated earnings growth is due to a combination of growth in management fees and the resumption of fresh capital inflows from Pacific's fund managers. Remember, the larger the FUM, the larger the management fees. However, before you get too excited, we need to point out the company's trading liquidity. When looking at the average daily trading volume across the last three months, we see that only 40,000 shares were traded on average. Unfortunately, this adds risk in case things go south for a few of the company's fund managers and Pacific Current investors want to get out of the stock at the same time. However, we believe the indicated annual dividend of 6.2% and substantial valuation discount more than make up for this risk. It's four stars from us.

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Share price chart

Source: Tradingview

We got properties and renters

According to management's calculations, there are approximately 7m renters in 2.5m rental households in Australia as of 30 June 2020. On 22 February 2021 Rent.com.au's website had just over a million comprehensive renter resumes stored in its databases. Based on the 7m total renters in Australia, the company's database covers 14% of Australia's total renters. Not only do we believe this represents a sizeable number that will continue to draw landlords to the platform, but it is also small enough to offer the company significant growth opportunities. So how has management done in capturing these renters?

To get a better idea of how fast the company's database has been growing, we used web.archive.org to view rent.com.au on 5 March 2020, 28 February 2019, and 24 February 2018.

Utilising these archives, we found that on 5 March 2020, the total number of renter resumes was 751,467. It was 487,067 on 28 February 2019 and 254,414 on 24 February 2018. In the year of COVID-19, this company managed to grow its renter database by 34%.

While this might sound impressive, Rent.com.au's renter database growth has been slipping over the past few years. In the years 2018-19 and 2019-20, the renter database grew 91% and 54%, respectively. So, the S curve might be nearing the top of the S, even after accounting for the issues presented during COVID-19. Since the company's biggest selling point to landlords and agents is its renter database, this decline in growth is a concern, especially since Rent.com.au is not yet profitable.

To monetise or not to monetise, that's not the question

To monetise or not to monetise is not really the question for Rent.com.au, but rather how the company will monetise. Management has decided that the best way to do this is through two main avenues: advertising and its portfolio of rental products.

The company's main revenue source is the renter product portfolio, generating $1.3m in revenue during FY20 representing a 6.5% year-over-year increase. This product portfolio consists of three main products: rent check, rent bond, and rent connect. Rent check allows renters to easily provide a verified ID and check for reported breaches in their tenancy history. Rent bond is what the company calls a 'move now, pay later' product. Simply put, this product allows renters to finance their bond through Rent.com.au. Rent connect, in partnership with AGL, allows renters to easily connect their utilities by ensuring everything is all set before they move in. Rent.com.au also charges fees to agents and landlords. However, at $153,982 in revenue for FY20 (1.6% increase year-over-year), generating 6% of total revenue, as a revenue stream, it's fairly irrelevant.

While not the largest revenue source, the company's advertising sales are currently the fastest growing source of revenue after generating $985,346 in revenue during FY20, representing year-over-year growth of 26%. This division generates revenue through sponsored listings and advertisements on its platforms. The more people use and view Rent.com.au's platform, the larger the revenue that can be generated. As we move further into 2021, we expect this division to show continued growth for a couple of reasons. The main one is related to JobKeeper, which is expiring. This means that many people will likely be forced to downsize. The second reason is similar. According to Rent.com.au's research, a significant number of leases are set to expire in early 2021. Combine these two factors and we believe Rent.com.au is set for a sharp increase in activity on its platforms.

The rent is just too high

We think Rent.com.au's product portfolio adds a lot of value to landlords, agents and renters. Combine this with the macro environment of JobKeeper ending and a substantial number of leases expiring during the first half of 2021, and we believe Rent.com.au is slated for a significant amount of growth over the next year.

Our issue with the company really comes down to its current valuation. While we expect strong results for FY21 and FY22, the slowdown in rental resume signups over the last three years is concerning. Following Bevan Slattery's investment in the company on 2 February, which drove the shares to a valuation of 15x EV/Revenue for FY22, we can't justify the price. We definitely believe this is one to watch, but for now, its two stars from us.

Pitt Street Research Pty Ltd

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Pitt Street Research Pty Ltd is founded on more than 40 years of combined experience researching companies in a range of different sectors.

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