STOCKS DOWN UNDER

14 MAY 2021

Small Cap Stocks Down Under

We'll try to cooperate fully with the IRS, because, as citizens, we feel a strong patriotic duty not to go to jail.

- Dave Barry (b. 1947), Miami Herald humour columnist

DDH1

The Drilling Machine

K&S CORPORATION

Operational improvements pave the way to profits

SRG GLOBAL

Business looks good. Valuation looks even better

DDH1

The Drilling Machine

Stocks Down Under rating: ★★★

ASX: DDH
Market cap: A$ 326M
Dividend yield: 3.8%

52-week range: A$0.81 / A$1.10
Share price: A$ 0.94

DDH1 Group is likely one of the smaller mid cap companies worth a few hundred million that slipped through your radar. Headquartered in Perth, the group provides drilling contracting services to the Australian resources sector. The company started out in 2006 with one drill rig, but as of 2021 has 96 active rigs across Australia. Superior techniques and skills as well as safety have paved their continuous growth and now they have a scale advantage as well.

READ MORE

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ASX: KSC
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52-week range: A$1.16 / A$1.63
Share price: A$ 1.57

K&S Corporation is a small logistics company based in Melbourne that offers transportation, warehousing and fuel distribution services in Australia and New Zealand. The COVID-19 outbreak had a profound impact on the transportation industry. However, the company's efforts to improve operational efficiency and strengthen its liquidity have placed it in a good position for a rebound in economic activity. At 3.3 trailing 12-month EV/EBITDA, we find the stock offers good value as a way to invest in the transportation industry recovery.

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Headquartered in Perth, SRG Global is a small cap construction and engineering company that serves customers in Australia and internationally. There have been some positive developments in the business, including a growing asset services division, a shift towards annuity-style revenues and exposure to future growth in the mining sector. However, with SRG having climbed 70% over the last 12 months, our constructive criticism is that this share is too expensive.

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Share price chart

Source: Tradingview

Worker to Owner

DDH1 founders Matt Thurston and Murray Pollock began as drillers. They went on to pioneer a multiple intersection directional drilling technique and founded DDH1 Drilling in 2006. Until 2017 Thurston and Pollock grew the business organically. Oaktree Capital Management, the American private equity house, acquired a 50% interest in 2017 and later, in 2018, the company acquired Strike Drilling followed by Ranger Drilling in 2019. That took DDH1 Group up to 96 drilling rigs and three brands. The current CEO, Sy Van Dyk, is a veteran in resource sector contracting. Thurston has reduced his involvement, while Pollock remains a non-executive director.

There may be more acquisitions where Ranger and Strike came from. As of the March 2021 IPO, DDH1 has a net cash position of about $18m. Revenue has been growing steadily. In FY20 it sat at $250m, 18% better than the previous year, while EBITDA was up 19% at $64.5m. FY21 revenue is expected to reach $280m, allowing an EBITDA growth of 7% to $69m.

Why the slower EBITDA growth forecast? Basically, increased labour costs. DDH1's cost growth this year probably reflects the fact you need the drillers before you can deploy the rig. We also think there's potential for DDH1 to beat its forecast. You may have noticed that on 31 March the company announced it was taking its drill rig count above 100, although that won't kick in fully until FY22.

Booming Business

Virtually all mineral drilling activity is outsourced. And, believe us, there is a lot of drilling activity. In all stages of mining, drilling is required: exploration, development, production, closure and even sometimes for regulatory requirements. Even the big guys outsource. You might have heard of BHP, Rio Tinto or Newcrest Mining. They outsource to the DDH1 Group, as three of the group's 102 clients as of March 2021.

The Australian mineral exploration bill in FY20 was a cool A$2.8bn, 18% more than the previous year. And this growth trend is expected to continue. Total metres drilled in Australia rose 61% from FY16 to FY20. Mining in Australia is transitioning from shallow to deeper deposits where more drilling is required. Diamond drilling is DDH1's most expensive service (and now you know where DDH1 gets its name from). Only a diamond drill rig can get down to 3000m and deliver intact samples. Basically, this company is a play on the future increased use of diamond drilling searching for the next big gold or copper mine Down Under.

Made in Australia

The drilling market in Australia is very fragmented and remains a path to business ownership for local entrepreneurs. We say local because new national standards have led to several international players departing the Australian drilling game. However, size does have its advantages because people know your name. DDH1 now operates the second-largest fleet in Australia. Only 7 companies operate over 30 mineral drilling rigs in Australia.

DDH1 Group is composed of 3 brands. DDH1 Drilling has 64 Diamond Core drilling rigs for highly technical services. Strike Drilling provides dual Air Core and Reverse Circulation exploration with 12 rigs. Ranger Drilling is a Reverse Circulation Drilling contractor focusing on the all-important iron ore projects of Western Australia. So DDH1 has the advantage of variety as well as scale. They can offer clients a broad range of drilling solutions to pursue whole mine, exclusive relationships. Another advantage the group holds is safety. Co-founder Murray Pollock introduced many safety solutions that are now standard in drilling operations. A measure of this is a company's total recordable injuries frequency rate (TRIFR). The ASX-listed drillers average rating is 11.9, where lower means safer. DDH1's rating has deceased from a high 10 to under 8 in 2021.

Diamond in the rough

The DDH1 came onto the market on March 9 at an IPO price $1.10. The transaction raised $41m in new capital, but allowed existing shareholders to sell $109m worth of stock. The IPO left Pollock and Thurston as well as the founders of Ranger and Strike with a collective 33% of the stock. Oaktree retains 22%. The group plans to use the new funds from the IPO to expand the fleet and increase utilisation of existing fleets to keep up with demand.

Initial reception of the stock has been cautious. The price fell 20% to 89 cents on the first day. Since then, however, the stock has begun trending back up towards the IPO price. The initial caution from investors may be to do with private equity firm Oaktree's historic involvement, but leave that to one side. Oaktree and the co-founders seem to have left a lot of money on the table. The FY21 EBITDA multiple on the company's numbers is only 5x. Not too bad for a company that ordinarily grows EBITDA by double digits and will do at least 7% this year. DDH1 aims to pay out around 3.6 cents in dividend, which implies a yield of about 3.8% at the current share price.

The current mining boom in the Australian resources sector is not going away anytime soon. Mineral exploration in particular has been given a head of steam by the commodity price recovery post-COVID and buoyant equity market conditions. And DDH1 is itself a tried and trusted player that remains in expansion mode.

However, we are always a bit wary when a Private Equity firm sells down. They typically do that because they don't see a lot more value going forward. So why should we buy when they are selling? The short answer is: we shouldn't. This one is three stars for us right now until the valuation becomes attractive enough to get in, i.e. around 4x EBITDA if the company is growing EBITDA by only 7% annually.

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Share price chart

Source: Tradingview

COVID slows transport demand

K&S Corporation provides transportation and logistics services to a range of customers in Australia and New Zealand. Its core business is transporting dry and liquid bulk loads by road, rail and sea along with related logistical and warehousing services. Together these Australian and New Zealand Transport segments accounted for about 85% of revenue last year. The other part of the business is fuel distribution to various farming, fishing and retail customers in the south-eastern part of South Australia.

Between lockdowns and government restrictions on non-essential business activity, COVID-19 has had a major impact on the company's operations. Reduced economic activity means there is less of a need to transport goods and therefore little demand for K&S logistic and fuel services. At the same time significant resources needed to be devoted to the safety of employees and getting workers setup remotely. To this end, K&S has received a much-needed compensation lifeline from the Federal Government in the form of $16.2m of JobKeeper subsidies and a $1.3m New Zealand wage subsidy. This, combined with business restructuring activity, translated to lower sales in FY20.

Operation: Profit improvement

The FY20 result showed that operating revenues fell 12.7% to $790.6m. Underlying profit after tax came in at $8.4m compared to $2.3m in FY19 on the strength of the pre-COVID results. Despite the effects of the pandemic and restructuring, K&S has made some encouraging operational improvements over the last year and a half. It has exited underperforming businesses to allow it to focus on its more lucrative operations and drive better underlying results.

Early in FY20, K&S completed the sale of its Regal General Freight business to Centurion Transport unloading a lagging part of its operations. This was followed by the January 2020 divestment of the Port Kemba bulk transportation business that flowed from the company's exit of the Illawarra Coal contract. In addition, K&S ceased operations of multiple underperforming chemical and energy transportation businesses in FY20.

It has also benefitted from a series of cost cutting initiatives and spending cutbacks. In the main Australian Transport business, supplier contracts were renegotiated and aging fleet assets were replaced to reduce costs. These steps helped strengthen its core business in a challenging FY20 and should continue to fuel higher earnings in FY21.

FY21 is off to a good start. Although some end markets continue to be impacted by COVID-19, overall trading conditions are getting healthier. In 1HY21 revenue was down 19% to $341.8m, but underlying profit after tax was up 67% to $6.5m. The mixed result reflected operational improvements, cost savings measures and procurement savings along with a $2.8m decline in depreciation expenses related to the revaluation of motor vehicle assets.

Aside from the headline numbers, the 1HY21 highlights included ongoing strength in steel volumes from major customers. The Western Australia haulage business was also an area of strength as K&S' mining customers have been relatively unaffected by the pandemic. On the other hand, the Aero Refuellers aviation refuelling business continued to suffer from weak demand with air travel still limited.

Lower debt, higher margins

In May of last year, the company did a complete overhaul of its debt facilities. It entered a new $200m debt package to refinance under better terms and liquidity. The improved liquidity position has certainly helped K&S navigate the coronavirus challenges and allowed it to maintain a solid balance sheet. The company plans to strategically deploy this funding to bolster its fleet and for various working capital needs. We are encouraged by the fact that the net asset position increased 6% to $255.4m in FY20 and that the gearing ratio decreased dramatically from 35.4% in FY19 to just 21.4% in FY20. Gearing was even further reduced in 1HY21 to 14.8% after $24.8m in debt was repaid in the interim period.

We also like the trend in margins over the last couple years. After recording a negative operating margin in FY16, operating margins have been positive in each of the last four years, including FY20 when they spiked to 2.92%. The net margin also improved significantly from 0.26% in FY19 to 1.42% in FY20. From a trailing 12-month perspective (including 1HY21), EV/EBITDA comes out to 3.3x. This speaks to management's effectiveness in cutting unnecessary expenses and re-focusing on higher quality revenue.

So, we like the direction K&S is headed in eliminating underperforming assets, gaining operational efficiencies and strengthening its balance sheet. However, we remain concerned that with borders unlikely to fully open until mid-2022, this recovering logistics operator has an uncertain and bumpy road ahead of it. So, for now it's three stars from us.

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Source: Tradingview

Transition to recurring revenues

Formerly Global Construction Services, SRG Global does construction, engineering, mining and maintenance contracting. Most of its revenue is generated in Australia (86% in FY20), but it also has an overseas business that is best known for its work on Dubai's Emirates Tower. The biggest part of the business is the Construction segment, which provides products and services to companies that build bridges, car parks, dams, high rise apartments, hospitals, hotels, office towers, recreational buildings and shopping centres.

The next biggest division is Asset Services, which offers a range of services across the asset life cycle to customers in the energy, power generation, water treatment, civil works, infrastructure and mining sectors. The third operating unit is Mining Services, which provides production drilling, ground and slope stabilization, design engineering and monitoring services to mining companies. Interestingly, these two smaller segments are SRG Global's most intriguing businesses because of their growth trajectory and recurring revenue.

A major strategic focus for SRG is to move away from project-based earnings in favour of more recurring sources of income. It is targeting recurring revenues to account for two thirds of overall earnings in FY21 and beyond. The move highlights the vulnerability of engineering companies to economic downturns, like during COVID-19. We like this direction the company has taken because it will give it greater stability in earnings.

Contract wins piling up

The Asset Services business was the star performer in FY20 after posting 11.8% sales growth. Several new contract wins in the segment helped the group deliver 7% higher revenue to $545m. Underlying EBITDA slipped to $20.5m due to COVID-19 related costs, restructuring charges and credit loss provisions.

SRG Global's leverage to the mining sector also goes in the plus column. Mining operations have been relatively unscathed during COVID-19 largely due to innovations within this sector. Miners are expected to benefit from increasing activity and higher commodity pricing over the next few years. Electric vehicle manufacturers and infrastructure companies will be particularly strong sources of demand. As global demand for metals like copper and iron grow, SRG will have ample opportunity to piggyback off growth in the mining sector because mining services will be in great need.

The Construction business also performed well in FY20. Revenue was up 10.6%. Multiplex awarded the group a $72m construction package for the One The Esplanade project at Elizabeth Quay in Perth. SRG Global will be involved with the concrete structure and the curtain wall façade for the 29-level building that will serve as the new headquarters for Chevron Australia. The project is part of an iconic development in Perth's central business district that has multi-billion dollars' worth of work left to be handed out, so there could be more where that came from for SRG.

In 1HY21, revenue was up 6% to $283m, EBITDA rose 32% to $20.5m and the EBITDA margin expanded from 5.8% to 7.2%. The recent contract wins have led to a record $1bn work in hand per 31 December 2020, which was up 41% from 30 June 2020. SRG also has an opportunity pipeline worth an estimated $6bn, 55% of which is in the annuity style Asset Services or Mining Services businesses.

On 8 July 2020, SRG announced that it was awarded an 8-year, NZ$25m maintenance contract from the Waka Kotahi New Zealand Transport Agency. Under the deal, SRG will provide inspection and specialised maintenance services on the Auckland Harbor Bridge. The project is just one example of a growing number of annuity style revenue streams flooding SRG's work at hand portfolio.

Bright outlook, high valuation

The contract wins have continued to roll in since the start of CY21. On 8 February 2021, SRG announced a pair of new contracts worth a combined $45m. It inked a 3-year agreement (with a 2-year extension option) with GFG Liberty Steel for engineered access solutions at the Liberty Steelworks site in Whyalla, SA. It also made a 1-year deal with Pit N Portal Mining Services to provide drill and blast services at the Great Western gold mine in WA. Both projects will add to SRG's growing stable of recurring revenue projects.

Then on 18 February 2021, SRG announced a 5-year, $150m contract with iron ore miner Fortescue Metals Group for the provision of multi-disciplinary services for Fortescue's mine, rail and port assets in WA. This mining portion of the deal will involve work at the Christmas Creek, Cloudbreak, Firetail, Kings Valley and Eliwana sites.

As you can see, SRG Global is in a good position to deliver growth for the rest of FY21 and FY22. Increased expenditure on infrastructure construction and maintenance services along with SRG's leverage to the mining sector should support well-diversified growth. These factors gave management the confidence to upgrade FY21 EBITDA guidance to $45m to $47m. At the midpoint this would represent 59% EBITDA growth over FY20.

SRG Global is trading at an EV/EBITDA of 3.9x for FY22, which is not bad given the 16% EBITDA growth the market is expecting for the coming financial year. On top of that you get a 3.3% dividend yield. So, SRG has a strong business model, balance sheet and liquidity position that will support its pursuit of growth opportunities as economic activity strengthens. And it's very attractively valued right now as well, so it's four stars from us.

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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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