STOCKS DOWN UNDER

21 MAY 2021

Small Cap Stocks Down Under

"When our emotions are engaged, we often have trouble seeing things as they are."

- Robert Greene (b. 1959), American author

MAINSTREAM GROUP

Waiting for the fat lady to sing

HRL HOLDINGS

We want to hold these holdings

VYSARN

Liquidity event coming

MAINSTREAM GROUP

Waiting for the fat lady to sing

Stocks Down Under rating: ★★★

ASX: MAI
Market cap: A$ 367M
Dividend yield: 0.4% (50% Franked)

52-week range: A$0.43 / A$2.75
Share price: A$ 2.69

headquartered on Sydney's Pitt Street, the Mainstream Group is a growing Funds Under Administration operation that has attracted the attention of some powerful companies, leading to a takeover bidding war. Management has been playing ball with its potential new owners, but with the publicity these offers have received, we believe there's not enough meat left for new investors to risk an investment.

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ASX: HRL
Market cap: A$ 61.7M

52-week range: A$0.08 / A$0.145
Share price: A$ 0.12

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Share price chart

Source: Tradingview

Rare FUA growth

The Mainstream Group might sound like a media organisation, but it's the farthest thing from one. The company provides administration services to 1,364 different funds held by approximately 176,000 investors. In fact, even in its industry, the company is far from the mainstream, achieving consistent growth across the board. For example, during 3Q21, Funds Under Administration (FUA) grew 45% year-over-year, to $272.2bn, off the back of client growth of 5% and growth of the number of funds of 31%.

For avid readers of Stocks Down Under, you might remember our previous reports on Netwealth (ASX: NWL) and HUB24 (ASX: HUB), published on 12 October 2020 and 15 February 2021, respectively. Suppose you have not read our previous editions. In that case, all you need to know is that the FUA industry is experiencing a period of massive upheaval, starting back in 2019 with the findings of the Financial Services Royal Commission. Over the last few years, the incumbent FUA platforms have seen strong capital flight to newer, leaner organisations and Mainstream has been one of those upstarts snapping up the newly homeless capital.

A by-product of this industry capital bonanza has been consolidation among the upstarts and the established, declining organisations. One of the recent major acquisitions was incumbent IOOF's takeover of MLC, National Australia Bank's (ASX: NAB) wholly-owned wealth management business. The acquisition received the final

regulatory approval confirmation on 7 May 2021 and is expected to close shortly. Now, it's Mainstream's turn to join in the consolidation frenzy, although from the perspective of a company being acquired.

It's all about the per-share offer

On 9 March 2021, management announced that it had entered a Scheme Implementation Deed with Vistra to acquire 100% of Mainstream for $1.20 per share. The offer represented an 8% premium over the previous day's closing price of $1.10.

Fortunately for shareholders, this story was far from over. On 12 April 2021, Mainstream announced it had received a significantly higher offer from SS&C Technologies for $2.00 per share. Vistra declined to increase its offer, but the Apex Group jumped into the fray, offering an unsolicited, non-binding offer of $2.35 per share on 29 April 2021. SS&C Technologies quickly matched this offer, but not to be outdone, the next day Apex increased its offer to $2.55 per share.

Between 6 May 2021 and 18 May 2021, Apex increased its offer an additional two times, with the current offer standing at $2.65 per share. We believe it is important to note at this point that shareholders looking to jump on this bidding war bandwagon are likely too late. When we look at the size of the additional offers, the gap has significantly decreased at only $0.05 per share from Apex's latest offer. It is certainly possible that SS&C Technologies will match this current offer and that Apex will increase its offer once again. But we think it's unlikely that the increments will be any higher than 5 cents at a time.

No more room for war profiteering

Mainstream is clearly in the midst of a bidding war, but the unfortunate truth is that we believe shareholders who were not already invested in the stock have missed the opportunity for war profiteering. Additionally, we believe the company is likely to see a significant pullback to its pre-bidding war price of $1.10 if both offers fall through or if the deal does not receive regulatory approval. The company is currently trading at 19.3x Price/Tangible Book Value and a Price/Earnings ratio of 59.7x and 44.2x for FY22 and FY23 respectively. This is based on forecasted Earnings Per Share growing from $0.01 during FY21 to $0.04 and $0.06 in FY22 and FY23.

Basically, the current valuation is priced for perfection in an industry that is far too competitive. Furthermore, when you factor in the industry transition period, valuing a company based on the assumption of perfect execution seems absurd. However, based on how far SS&C Technologies and Apex have been willing to push this bidding war, it's highly likely that one of them will end up acquiring Mainstream.

Additionally, while it is impossible to predict regulators' whims, based on their past decisions in this highly competitive industry landscape, we would be shocked if the acquisition ends up not being approved. Lastly, for investors not already in the stock, with the shares at $2.69 we believe the market has already priced in the possibility of SS&C Technologies increasing its offer. All-in-all, three stars from us.

HRL HOLDINGS

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Share price chart

Source: Tradingview

What's HRL holding?

HRL is a holding company that provides services to clients across Australia and New Zealand through its five main divisions, i.e. food & environmental services, HAZMAT, Geotechnical and joint ventures. It generated revenues of $16.4m and EBITDA of $3.5m during 1HY21. HRL was originally listed as a geothermal exploration company called Hot Rock back in 2007.

Unfortunately, the company's business model didn't work out and in 2014 HRL changed its activities through the acquisition of OCTIEF. This acquisition brings us to the company's oldest division: HAZMAT. This division is run through two separate companies: OCTIEF (Australia) and Precise Consulting (New Zealand). HRL's HAZMAT division offers sampling and laboratory testing of everything and anything considered hazardous to humans and the environment. If you need to test a building for asbestos or a plot of land after an oil spill, OCTIEF and Precise Consulting have the skills you need. During 1HY21, this division generated $4.1m in revenue, a 12.8% decline year-over-year. As both the Australian and New Zealand construction and mining industries continue to see remarkable growth, we believe HAZMAT will see a strong recovery during the remainder of FY21 and in FY22.

Through its ownership of Analytica, HRL operates its food and environmental laboratory division. As the name describes, its Analytica's operations are rather straight forward, testing everything from drugs, food origin,

milk and dairy, and asbestos. Since this division was created during 2017 with the acquisition of New Zealand based-Analytica Laboratories, it has quickly risen to provide half of HRL's total revenue and 74% of its net profits. This division generated $8.6m in revenue during 1HY21, a year-over-year increase of 13.2%. Like the HAZMAT division, we believe Analytica is primed for growth as New Zealand's construction industry continues to boom. Additionally, after the strong rainfall experienced across Australia, Tasmania and New Zealand over the last few months, we believe demand for Analytica's food testing services are likely to continue to grow.

HRL's two smallest divisions are operated through Morrison Geotechnic (Geotechnic) and Octfolio (data management). Morrison Geotechnic generated $3.5m in revenue and Octfolio generated $413,000 during 1HY21. This represents a decline across both divisions of 8.8% and 5.7% year-over-year, respectively. The geotechnic division provides onsite mobile concrete and soil testing, construction phase verification, inspections and earthworks supervision. The data management division handles client data resulting from lab results as well as workplace health and safety data.

Don't judge earnings by its number

HRL has continued to generate steady growth for investors over the last three years from both a revenue and EBITDA perspective, despite COVID-19. Between FY18 and FY19, revenue grew 12.5% to $30.7m while EBITDA declined 43% to $3.1m due to an earn-out payment. This growth continued during FY20 as revenue grew 7% and EBITDA grew 68%, resulting in $32.8m and $5.1m, respectively.

You might be thinking to yourself, why is Stocks Down Under classifying FY19's EBITDA results as having grown? As part of HRL's 30 November 2017 acquisition of Analytica, management agreed to make two earn-out payments to the vendors based on the condition that the newly acquired company achieved EBITDA in excess of NZ$3m over the next 12 months. Analytica met this criterion and therefore, during FY19, the first payment of $5.3m was made out of a total of NZ$11m with the remainder paid during FY20. If we exclude this payment for an operational like-for-like comparison with FY18's results, we find that EBITDA did in fact grow year-over-year during both FY19 and FY20.

An old investor with a new yearn for shares

On 1 March 2021, management announced the appointment as Non-Executive Director of HRL, Alex White. This was a rather significant move as Mr. White also happens to be the Director of Richmond Hill Capital, HRL's largest shareholder. Richmond Hill had approximately 92.6m shares at the time of Mr. White's appointment to HRL's board after maintaining ownership in the company for the last six years. Some might wonder if HRL's largest shareholder demanding a new seat on the board should be seen as a positive or negative sign, we believe it was positive. Since Mr. White's appointment, Richmond Hill has purchased a 5m additional shares at an average cost of $0.119. In other words, Richmond Hill has increased its holdings in HRL by 5%. One other director has purchased 102,099 shares at an average cost of $0.12, Richard Stephens as announced to the market on 12 March 2021. We believe it is worth noting that the vast majority of these shares were all purchased at $0.12, HRL's current price. This means that investors have the ability to purchase shares at the same price that company's insiders have been snapping them up at.

As HRL's EBITDA results normalise following the completion of the Analytica earn-out payments, the market expects EBITDA to grow 14% during FY22, which implies HRL is currently valued at a FY22 EV/EBITDA ratio of 8x. Based on our analysis of the company and expected EBITDA growth, we agree with Richmond Hill that at $0.12 per share, HRL is clearly undervalued. The company has some marco tailwinds as well as a fundamentally strong business. It also reaffirmed its FY21 EBITDA guidance of $7.3m in its 3Q21 update on 10 May. Therefore, our rating is four stars.

VYSARN

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Share price chart

Source: Tradingview

When most investors talk about drilling, they mean putting holes in the ground to find out if there's mineral resources down there. Vysarn's drilling is a little different. Its Pentium Hydro business does waterwell drilling, which is a vital part of the mining industry. Water has a habit of getting into mines from deep underground, meaning mines have to be dewatered so they can stay functional. When a mine is exhausted the environmental regulators often require that water be put back into a mine and Pentium Hydro does that too. And, of course, mine operations themselves need water, which requires drilling onto aquifers. And so on.

Introducing the new water diviner

Vysarn was a listed shell until mid-2019, when it acquired Pentium Hydro from Ausdrill, the mining services major now known as Perenti Global (ASX: PRN). Ausdrill, with its 2018 acquisition of Barminco, had outgrown its drilling contractor roots and was therefore ready to offload non-core businesses like Premium Hydro, which had been part of the Ausdrill stable since 2011. If you've been around the mining industry in Western Australia, particularly up in the Pilbara, you may have heard this business being called 'Connector Hydro'. Vysarn negotiated a good price for Pentium Hydro/Connector Hydro. The assets in the deal were independently appraised at $30.7m, but the new owner paid just $16m cash, funded through bank debt and a $7m equity raising at 5.4 cents per share.

Why $16m versus $31m? The latter figure is the replacement value of the assets, but the real value of any asset base is how productively it can be utilised, and the price reflected the fact that at any one time some of those rigs may be in the yard gathering dust or in the shed being repaired. Or unable to work because, say, a cyclone is hitting the Pilbara. For Vysarn the rigs have mostly stayed busy. For example, in August 2020 Vysarn was able to announce that Pentium Hydro's seventh rig had completed some work for Iluka, but that the rig would be redeployed the following month after some programmed repairs and maintenance. The fact that in May 2020 Vysarn was buying a few more rigs, funding them with a 3-for-10 rights issue at 4.5 cents, tells you that business has been good. The extra two rigs brought the rig count up to 12.

Coronavirus-proof

The beautiful thing about Pentium Hydro is that it has been Coronavirus-proof. Water tables don't care about pandemics and so you can't really defer or cancel a dewatering effort. You can bring the operation in-house, but why bother when the guys who really know their hydrogeology are ready to deploy at your say so? And this is a more complicated business than you'd think because a minor screw-up can wreck months of good work. On top of this, Pentium Hydro has been smart, focusing in particular on those three-quarters of all the iron ore mines in the Pilbara now going below the water table. Hancock, for its Roy Hill Iron Ore mine, and Fortescue Metals (ASX: FMG | 10 May 2021) have proved flagship customers and for those folks, business is now pretty good given the current price of iron ore.

In 2020, under the leadership of the new Vysarn CEO James Clement, Pentium Hydro completed an ISO accreditation process across its various systems. The thinking was simple – the better the quality, the more likely Pentium Hydro can dominate the hydrogeological drilling services game in Western Australia. Back in the day, if there was a major oilwell fire the first thought to go through the oil company CEO's head was 'We need Red Adair' because that Houston-based contractor was the arguably the best in the business when it came to handling those disasters. James Clement wants the folks at Newcrest, Anglogold Ashanti, Iluka and other tier-1 companies to keeping saying 'We need Pentium Hydro' when they deal with their water issues. It also wants the competitive moat to be so deep it will be too difficult for new entrants to cross.

A good second half coming

The six months to December 2020 proved to be a solid trading period for Vysarn. As we noted above, revenue was $11.5m and EBITDA $2.4m. Financially the company is in good shape, with $8.1m in cash as of 31 December balanced against $8.7m debt. The $2.4m EBITDA reflects the fact that, on average through the half, 7 of the 12 rigs were active. However, business has hotted up in recent months and Vysarn reckons it can do better in the second half. So, it's going for $6m EBTDA for the full year.

Vysarn stock re-rated nicely through the latter half of 2020, rising from 4.6 cents on 15 June to 13 cents on 15 December. It then cooled off for a while, but in early April sparked up again from the 8.9 cent level at the end of March. We think the good times for iron ore and a recent contract amendment with FMG have something to do with that, but it helps that Vysarn is on an EV/EBITDA multiple for the current year of only 7x. Not bad when this company can reasonably grow its top line at double digits for the next few years as it executes on its growth strategy. Four stars.

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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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