STOCKS DOWN UNDER

28 MAY 2021

Small Cap Stocks Down Under

"Life is more manageable when thought of as a scavenger hunt as opposed to a surprise party."

- Jimmy Buffett (b. 1946), American musician

MORTGAGE CHOICE

Not our choice

EVOLVE EDUCATION GROUP

Time to learn

BISALLOY STEEL GROUP

A missed opportunity

MORTGAGE CHOICE

Not our choice

Stocks Down Under rating: ★★★

ASX: MOC
Market cap: A$ 243M
Dividend yield: 3.9% (100% Franked)

52-week range: A$0.635 / A$1.95
Share price: A$ 1.94

Headquartered in North Sydney, Mortgage Choice is one of Australia's largest mortgage brokers with over 500 registered brokers, 380 franchises and over 30 lending partners. The company's $54bn loan book is of a solid enough size that it has attracted attention from REA, who has offered to acquire 100% of the company's stock. With the acquisition likely to close and an extremely narrow gap between the offer price and current price, right now this is a three star stock, in our view.

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EVOLVE EDUCATION GROUP

Time to learn

Stocks Down Under rating: ★★★★

ASX: EVO
Market cap: A$ 164M

52-week range: A$0.67 / A$1.48
Share price: A$ 1.00

Headquartered in Auckland, New Zealand, the Evolve Education Group has 136 early learning centres across New Zealand and Australia. The company's centres do not all operate under the same brand. In fact, the company has seven separate ones. Since New Zealand has been chiefly COVID-19 free since mid-1HY21, Evolve's stock saw an initial strong performance followed by a period of consolidation that continues to this day. Does this mean we should avoid this education play, or is it time to start learning?

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Dividend yield: 4.5% (100% Franked)

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Do you need Australian made high-strength structural, wear-resistant and armoured steel plates made from quenched and tempered steel? If so, you only have one option; Unanderra, New South Wales-headquartered Bisalloy Steel. Steel has seen strong demand growth as the world begins to recover, but this company has an issue. Its largest USA-based competitor has been dumping steel in Australia. The government is investigating, but the share price has still taken a hit. Is now the time to buy?

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Share price chart

Source: Tradingview

The broking business is back on track

Mortgage Choice has two main divisions: its broking business and FinChoice. Combined, these generated $22.2m in gross profit and $9.7m in EBITDA during 1HY21, representing a year-over-year increase of 1.4% and a decline of 1%, respectively.

The broking business has a loan book of $54.1bn as of 31 December 2020, a slight increase from 31 June 2020, but representing a slight decline year-over-year. This is unsurprising from our perspective since the mortgage brokerage industry in Australia had an extremely tough 2HY20 and 1HY21 due to COVID-19. However, the Australian economy is finally on solid footing again and the property market has really starting to roar. As demand continues to spike for mortgages, Mortgage Choice has continued to recover, increasing the number of mortgage brokers to 516 during 1HY21 from 510 during 1HY20.

The FinChoice division encompasses Mortgage Choice's financial advisor operations. Unlike the broking business, which generated $10m in EBITDA during 1HY21, FinChoice currently operates at a loss after generating a negative $233,000 during the period. Fortunately, this division's loss has been shrinking, with 1HY20's loss at $333,000. However, this is a tough business with many companies choosing to avoid it all together. Therefore, until we see actual profits, we are far from confident in Finchoice's future results.

An acquisition providing a sizable bump

Mortgage Choice is currently in the process of being acquired. On 29 March 2021, management announced that REA Group had offered $1.95 cash per share for 100% of Mortgage Choice's outstanding shares. In response to this offer, management decided to fully support it and we are not surprised. When REA made its offer, Mortgage Choice was trading at slightly under $1.20, meaning the company was offered a 62.5% premium. More importantly, the last time shareholders saw the company's stock price anywhere near $1.95 was during May 2018, when the stock briefly reached $2.04 per share.

REA and Mortgage Choice are currently in a holding pattern as they wait for court approval for the proposed acquisition, which is expected soon. Accordingly, shareholders are expected to vote on the acquisition in early June 2021, with the acquisition being completed at the end of June. While it is impossible to make predictions, we would be shocked if this acquisition was not agreed to by shareholders.

Nothing to see here, move along

As soon as the proposed acquisition was announced, Mortgage Choice's stock price jumped from slightly under $1.20 to $1.91 per share. Since then, the shares have effectively traded sideways, indicating that the market expects this deal to go ahead. But let's assume for a second that it falls through; how does the valuation holdup?

Unfortunately for shareholders, without the REA offer, Mortgage Choice's valuation would basically be a pipedream. The market is currently expecting Earnings Per Share to stay mostly stable over the next three years at $0.07 (FY21), $0.08 (FY22) and $0.09 (FY23). However, despite this low growth rate, the company's current share price implies Price/Earnings ratios of 27.5x, 24x and 20.8x for those years. Long story short, if the acquisition falls through, Mortgage Choice is a clear two star stock. However, with the acquisition extremely likely to move forward, Mortgage Choice is a three star stock, in our view.

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Share price chart

Source: Tradingview

Education a new generation

The Evolve Education Group operates childcare centres across New Zealand (116) and Australia (10). While the COVID-19 lockdowns were, of course, hard on operations, management kept the company EBITDA profitable for 2020 at NZ$18.1m. The company does not operate these centres under one brand but rather seven separate ones. Each brand has its own childcare speciality. This allows Evolve to benefit from both diversification and the ability to offer clients a broad range of offerings to fit their child's individual needs.

The one major point we want to make regarding Evolve's profitability during 2020 was that it was due to a massive decrease in year-over-year employee expenses. This cut allowed the company to remain profitable during 2020, despite a 27% drop in revenues. We believe this represents a positive result when you factor in lockdowns and the drastic increase in the number of people working from home. Overall, we believe the company held up surprisingly well in what is likely the worst environment for childcare since the company listed on the ASX in 2014.

Time to spread the learning

On 5 March 2021, management announced its intention to acquire ten childcare centres in Australia with a total capacity of 816 children per day. Evolve has agreed to pay a total of NZ$32.13m for the centres, representing an EBITDA multiple of 3.9x on NZ$8.2m in EBITDA. The payment schedule is as follows, NZ$27.13m in cash upfront and NZ$5m if EBITDA totals at least NZ$8.2m 12 months after the acquisition closes. This deal will bring the total number of centres operated by Evolve to 116 in New Zealand and 20 in Australia.

Despite the small increase in total centres this acquisition represents, from an earnings perspective it's rather significant. Over the 12 months, ending on 30 September 2020, Evolve generated NZ$21.9m in EBITDA. Using these ten centre's historical EBITDA of NZ$6.93m, we estimate this acquisition will increase EBITDA by at least 31.6% annually. Therefore, we believe this is an excellent use of the company's cash (NZ$59.1m per 31 December 2020) and will provide strong returns for shareholders going forward.

The value of a solid foundation

Before we move into valuation, we first want to mention a major positive note issued by management in a two-sentence afterthought in its 5 March 2021 acquisition announcement. By 4QY21, management expects Evolve's earnings to be sufficiently strong enough to resume dividend payments. While it is impossible to know what the dividend will be, it is important to note that the last dividend payment announced during June 2018 was for $0.019 per share, an implied yield of 1.9%, unfranked.

Unfortunately, but understandably, management has not released any forward estimates to the market and we believe they are unlikely to do so at its Annual General Meeting on 29 June 20021. Therefore, we have to rely on Evolve's trailing 12-month EV/EBITDA ratio of 10.8x. After analysing Evolve and looking at the company's industry, we believe the only risk is COVID-19 making a resurgence in Australia and New Zealand, causing its centres to shut down again.

However, despite the increasing prevalence of new and extremely contagious mutations across the globe, we believe this represents an unlikely scenario at this time. Therefore, we fully expect Evolve's centres will continue to see demand from parents returning to the office and workforce, combined with existing clients becoming comfortable again with sending their children back to class. We also believe the likely resumption of an annual dividend and the company's latest acquisition point to strong shareholder value creation in the future.

Since the stock is currently in a pullback after it jumped during November 2020, we believe investors are being offered a discount on a fantastic company. It's time to learn, four stars from us.

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Share price chart

Source: Tradingview

Profit grows, but revenue falls

If you have been following the financial news during 1HY21, you would have heard about the rising demand and the rising prices for steel and iron ore. There are many different types of steel. Bisalloy Steel focuses on quenched and tempered high-strength, abrasion-resistant amour grade alloyed steel plates. The company has extensive distribution networks in Australia, China, Indonesia, Thailand and South Africa. Unfortunately, Bisalloy Steel benefited from the rising price, but not the rising demand. During 1HY21, revenue actually dropped 16.4% to $47.2m, resulting in a 37.5% increase in EBITDA year-over-year to $5.5m. EBITDA increased due to the higher price of steel causing significant margin expansion.

Normally we would focus on the different products produced by Bisalloy Steel. However, this is far from a normal situation when you factor in the anti-dumping investigation and COVID-19 supply disruptions. Therefore, we are going to focus on Bisalloy Steel's main source of revenue: Australia. Bisalloy Steel's Australian operations consist of its manufacturing plant in Wollongong, New South Wales, which was mostly unaffected by COVID-19 due to the automated nature of the plant.

The company clearly has a strong and profitable asset. With the Australian government's focus on domestic purchases for new Australian military contracts, this could prove to be highly profitable for the company in the near future.

Where did Australia go wrong?

The Australian segment saw the largest drop in revenue from $47m during 1HY20 to $38.6m for 1HY21 (82% of total revenues). This drop can be attributed to two things: lack of military contracts and alleged dumping from the United States. While we don't have a breakdown for 1HY21, during FY20, the company's Australian military contracts only accounted for 2% of total Australian sales. The Australian Defence Force has embarked on a massive spending spree on everything from new equipment, buildings, upgrades and everything in between. Unfortunately, despite the Memorandum of Understanding (MoU) Bisalloy Steel signed with K-TIG and Axiom to develop products and bid for Australian Defence contracts there have been no commercial announcements on this front. We believe this means nothing has come out of this partnership yet and Bisalloy Steel is still not taking advantage of the ADF's spending spree.

The company might have a monopoly on quenched and tempered steel plate production in Australia, but they certainly do not have a worldwide monopoly. This was made fully apparent during 1HY21 when Bisalloy Steel suffered significant Australian market share erosion due to alleged dumping from the United States. The company has alleged that this was started after Sweden implemented higher tariffs on quenched and tempered product from the United States in November 2019. This has led Bisalloy Steel to file a complaint with the Australian Anti-Dumping Commission, which has launched an investigation. However, our fear is that if the commission does find in Bisalloy Steel's favour, it will be too little too late. These investigations can take a long time, and most analysts do not believe the current sky-high prices for steel are likely to last for much longer. The current final recommendation date is no later than 17 August 2021, with a Minister's decision expected within 30 days of that recommendation.

The boat is likely missed

Unfortunately, there are no market estimates for Bisalloy Steel's 2HY21 or FY22 results. However, management has stated that they believe full-year FY21 results will be heavily impacted by continued dumping from the United States. We are concerned that Bisalloy Steel has likely missed the boat on taking advantage of high steel demand and high prices, especially if 2HY21 is going to be as bad as 1HY21.

Despite all of this bad news, Bisalloy Steel is still a solid business producing quenched and tempered high strength, abrasion-resistant amour grade alloyed steel plates in Australia. Despite the lack of news on the MoU signed last year, we still believe the agreement has a lot of financial potential over the next couple of years if the company can get it off the ground. We believe the Australian domestic manufactured aspect of the agreement will grant these companies a significant advantage when bidding for domestic contracts.

Yes, the company has significant negatives to overcome in the near term. However, we believe these are more along the lines of growth limitations rather than business threatening. We believe 2HY21 is still likely to see strong EBITDA growth as prices for steel are still high. The company has certainly missed out on a lot of growth, but at least we know where we stand.

The company's shares have taken a serious beating recently and on a trailing 12-month basis, its EV/EBITDA and EV/Revenue multiples are only 4.8x and 0.7x respectively. We believe this significantly undervalues Bisalloy Steel's growth potential, although the potential returns are unlikely to be as significant as we have seen with some of the iron ore miners. Therefore, we think it's a four star stock at its current valuation.

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