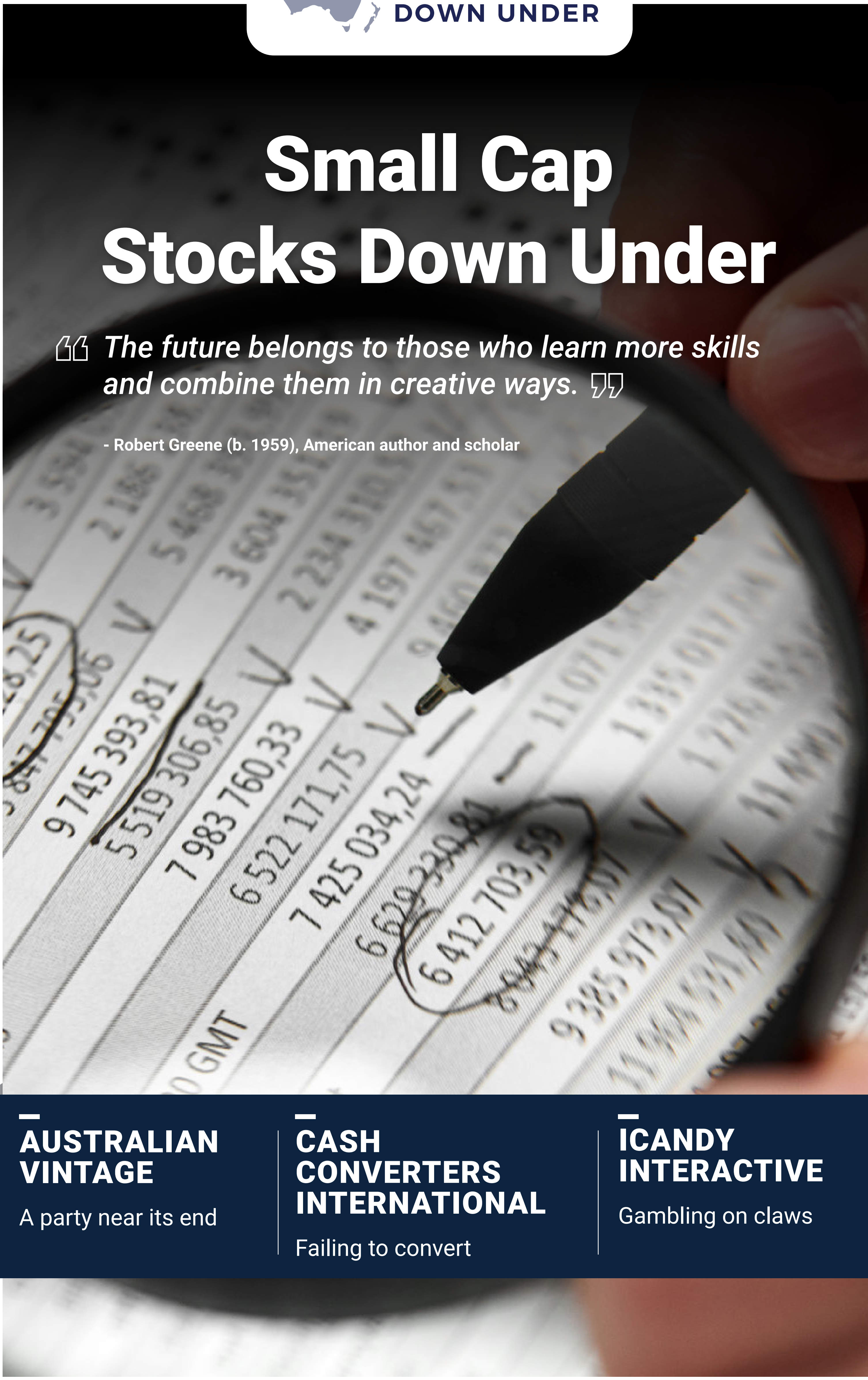
STOCKS DOWN UNDER

4 JUNE 2021

Small Cap Stocks Down Under



> *The future belongs to those who learn more skills and combine them in creative ways.*

- Robert Greene (b. 1959), American author and scholar

AUSTRALIAN VINTAGE

A party near its end

CASH CONVERTERS INTERNATIONAL

Failing to convert

ICANDY INTERACTIVE

Gambling on claws

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Stocks Down Under rating: ★★★

ASX: AVG
Market cap: A$ 219M
Dividend yield: 3.5% (62% Franked)
52-week range: A$0.39 / A$0.80
Share price: A$ 0.80

Do you like wine? If so, Australian Vintage might just be both the perfect investment and bottle for you. The company operates through four separate wine brands and has historically had very little exposure to China, protecting it from the current geopolitical conflict and wine tariffs. Shareholders were hit hard by the COVID-19 market crash and struggled to recover until November 2020, when prices jumped 37% during the month. They have continued to climb since then and are now up another 84% since November. Does this mean shareholders have sampled too much of the product, or is the party just getting started?

READ MORE

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ASX: CCV
Market cap: A$ 148M
Dividend yield: 4.3% (100% Franked)
52-week range: A$0.15 / A$0.29
Share price: A$ 0.225

Perth is home to the headquarters of Cash Converters, the global diversified, franchised loan operation. The company currently has approximately 700 different physical locations, either operated by the company itself or one of its many franchise owners. The company's loan book took a rather significant hit at the beginning of the COVID-19 pandemic and still has a long way to go until it recovers. With so much uncertainty surrounding its operations, we'll leave this one alone for now.

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52-week range: A$0.016 / A$0.235
Share price: A$ 0.071

Melbourne-based iCandy develops and publishes 'freemium' games for smartphones. This is a notoriously risky industry, but 2020's results indicate that this company could certainly buck the trend due to the launch of Masketeers: Idle Has Fallen, one of the company's hit games. However, with a high valuation, for any investment in iCandy to pay off, its latest game, Claw Stars, better knocks it out of the park.

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Share price chart

Source: Tradingview

Wine makes the world go round

Before we get started, we want to alleviate one concern you may have: China. It's no secret that Australian wine makers have been particularly hurt by the Australia-China political spat. However, Asia has historically only accounted for approximately 3.4% of Australian Vintage's overall annual sales.

Australian Vintage sells and processes wine for the three main geographical regions: Australia and New Zealand, the Americas and Europe. In total, the company generated $148.4m in revenues during 1HY21, an 8% year-over-year growth. During 1HY21, the company generated $24m in EBITDA (64% growth) on the back of strong wine demand from its three main geographical regions and a slight decline in expenses.

To further understand what Australian Vintage offers, we need to look at each of its four brands: Barossa Valley, Nepenthe, McGuigan Wines and Tempus Two. Barossa Valley produces red wine from fruit harvested from The Farms, Australian Vintage's vineyard in the southern region of Barossa Valley, South Australia. The Nepenthe brand has its vineyard in the Adelaide Hills of South Australia where the cooler temperature allows for the production of Chardonnay, Pinot Noir, Gruner Veltliner, Arneis and other white wines. McGuigan Wines is Australia's top-selling red wine and the third most-popular wine brand in the United Kingdom. This brand has vineyards in both the Hunter Valley, New South Wales and Barossa Valley, South Australia.

Tempus Two is branded as a more 'stylish' bottle of wine, ranging from whites to reds and Rosés. Basically, this brand takes wine from Australian Vintage's vineyards and packages it significantly more stylish.

Grapes cause serious profit upheaval

When looking at the historical results of any wine company, there is one major feature of this industry you need to be aware of: the grapes' value can fluctuate widely. This might not seem significant, but 1HY21 versus 1HY20 is a perfect example. In 1HY21, Australian Vintage generated a net profit of $13.3m, an increase of 125% year-over-year. The majority of this growth is due to cost-cutting and revenue growth that we described above, but $1.9m was due to the value of the grapes for the period.

As you will remember, during 1HY20, Australia was plagued (pun intended) by bush fires across most of the country as well as a drought. This caused serious damage to vineyards' grape production and Australian Vintage was forced to take a $1.8m loss on the fair value of its grapes during the period. During 1HY21, however, the company recorded a fair value gain of $98,000 on the balance sheet. Unfortunately, with rising global temperatures and the increasing frequency of 'once a generation' weather events due to climate change, major bush fires and droughts are likely to become more common in the future. We believe that this will lead Australian Vintage to report increasingly frequent swings in the fair value of its grapes.

The party is tapering off

The market is currently expecting 20.2% EBITDA growth for FY21 due to increased COVID-19 wine demand. However, during FY22 and FY23, EBITDA growth is expected to drop sharply to 7.4% and 5.5%, respectively, as the COVID-19 lockdown party ends. Based on these estimates, FY22 and FY23 EV/EBITDA ratios are currently 7.6x and 7x, respectively.

We believe Australian Vintage has a strong share of the world's wine market with limited exposure to China and solid fundamentals. The company's brands are easily recognised in its main markets as illustrated by the strength of the COVID-19 revenue bump across these main markets.

While EBITDA is expected to drop from FY21's expected 20.2% year-over-year growth, we believe 7.4% growth is well within a reasonable range for the company's FY22 valuation. Unfortunately, we would note that due to the increasingly unpredictable and unstable growing conditions for grapes, predicting out past 12-months is harder for the wine-producing industry than most others. Therefore, we believe the company deserves a slight discount to fair value stemming from this risk. The stock's current rally may have a little more juice left in it, but we think it's definitely near its end. So, for us Australian Vintage is a three star stock.

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Source: Tradingview

Franchised loans

Cash Converters currently operates 700 stores across 16 countries in the United States, Europe, Southern Africa, the Middle East and the Asia Pacific region. The company operates through two main divisions: pawnbroking and financing. The company has 700 stores in total, split between 152 in Australia and 548 international, and 70 of the Australian stores are corporate-owned, while 82 are franchises.

All international stores outside of the United Kingdom and New Zealand are 100% franchise-owned. Cash Converters only owns 25% equity interest in Cash Converters' New Zealand operations. It is unclear how the international stores are split up or how many in the United Kingdom are corporate-owned.

For those not familiar with Cash Converters operations, it offers clients three main services: pawn broking, personal loans and vehicle loans. For our purposes, we have combined the company's store operations and franchise operations into the pawnbroking division. During 1HY21, this division generated $12.6m in EBITDA, a 37.8% year-over-year decline. Unfortunately, Cash Converters has struggled to entice shoppers back into its pawnshops after COVID restrictions eased, despite most locations being permitted to operate again. We believe the availability of low-interest credit due to continued COVID-19 monetary easing is at least partially responsible for these issues, along with the continued rise of online shopping for second-hand goods.

Despite the return of credit demand, especially in Australia, Cash Converters' financing division has struggled to return to normalcy. During 1HY21, this division generated $24.1m in EBITDA, a year-over-year increase of only 8.5%. You may be wondering why we said, 'only 8.5%.' While this might seem like solid year-over-year EBITDA growth, it was entirely generated by an approximate doubling of vehicle financing EBITDA. Personal financing saw a decline of 7.4% year-over-year. We are pessimistic about FY22's vehicle financing growth as we believe FY21's growth is due to the post-COVID-19 car sales bump rather than this being a long-term trend.

COVID-19 hurt

COVID-19 was rough on Cash Converters. The company's gross loan book value took a massive dive from $219.5m in 1HY20 to $160m per the end of June 2020. The drop continued throughout the rest of 2020, resulting in a total gross loan book of $151.1m by the end of December. The company's loan book has increased somewhat, to $163.1m per 31 March 2021.

For a company like Cash Converters, its loan book is an important indication of its future profitability as it generates interest off these loans. The fact that the company has struggled to bring its loan book back to pre-COVID levels a year after the crisis began is a worrying sign to us, especially when we compare this to other lenders listed on the ASX.

An uncertain future

We believe Cash Converters has a long way to go before it reaches pre-COVID-19 levels of profitability and gross loan value. Additionally, the Australian Federal Government is currently in a review phase of the National Credit Act regulations with an eye to making lending requirements stricter. Management has stated that this is likely to increase the cost of its loans and while there is no certainty that this legislation will be passed, it still is another potential hoop the company needs to jump through on its road to recovery.

Despite all of the uncertainty surrounding the company and with revenue and EBITDA declining 31% and 19%, respectively, during 1HY21, the company's stock is still valued at a trailing 12-month Price/Earnings ratio of 8.9x. We believe Cash Converters has a long way to go still in its recovery. The only positive note in its 1HY21 report, i.e. vehicle financing's EBITDA explosion, is more of a short-term, post-COVID-19 bump than a longer-term trend, in our view. Therefore, once we factor in all of the risks and the long recovery ahead, we believe investors should avoid Cash Converters until the situation becomes clearer, three stars.

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Source: Tradingview

Nothing in life is ever free

Everybody knows the old adage, 'there is no such thing as a free lunch.' But this saying has truly taken on a whole new meaning in the digital age. So-called 'free games' are often far from free, full of ads and offering features, levels, perks, etc., that can only be accessed by paying with real currency. In fact, this is so common that it has brought about a new term to categorise these types of games, 'freemium.' This type of game can be extremely profitable with two of the world's most popular games, Fortnite and PubG, relying on this method of revenue generation. In 2020, these two games generated US$5.1bn and US$2bn in revenues, respectively, although the Fortnite number is a rough estimate based on Epic Games' court fillings in its 'war' with Apple as the company is not publicly traded. Additionally, while these games derive a large portion of their earnings from mobile applications, they are available on other platforms as well, like desktops and gaming consoles

In order to generate revenue from its 'freemium' games, iCandy relies on four approaches. The first is in-game purchases. This method offers players perks, in-game currency, etc., in exchange for real-world cash. These purchases often will speed up gameplay or enhance the player's character(s). The other method is advertising, usually in the form of popup videos or in-game banners. A third method of generating revenue is through monetising players' love of iCandy's brand through game merchandise sales. These real-life products feature either iCandy's branding or that of the specific games. Lastly, iCandy will partner with individuals or organisations to publish games for them. In exchange for this service, iCandy will receive a fee or part of the revenue generated. An example of this is iCandy's Garfield games.

While far from having the earnings power of top mobile giants, iCandy attempts to generate revenues using the same 'freemium' model of mobile games. Despite maintaining a broad portfolio of games, the company generated its first EBITDA profit during 2020 of $1.4m on the back of a single game: Masketeers: Idle Has Fallen. Due to the successful launch of this new game, revenue jumped 61% to $3.6m, although the company still produced a net loss of $46,270. In total, this represented the best performance across every earnings metric since the company listed in 2015.

Not a one-trick pony

When a company manages to produce a successful game, the largest risk for investors is that it will become a one-trick pony. Since Masketeers: Idle Has Fallen is solely responsible for driving iCandy into EBITDA profitability for the first time during 2020, this risk is front and centre.

Fortunately, management is not sitting on its laurels and has already presented three new initiatives that it believes will diversify growth away from its main success. The first is a new game called Claw Stars. While the game is not yet released, early trial results are already indicating a stronger performance than Masketeers. Additionally, Claw Stars has exceeded 500,000 pre-orders across the Apple App Store a Google Play, according to a 21 May 2021 market announcement. This game is currently scheduled to launch on 30 June 2021 and we would recommend investors save 1 July 2021 for a likely positive market announcement. However, estimating earnings at this time is impossible due to the 'freemium' nature of Claw Stars. It is important to note that it will be iCandy's first multiplayer game developed in-house.

The second initiative is a new partnership with Ohayoo, a Chinese game publishing platform. The goal of this partnership is to push hard into the Chinese market. When moving into the Chinese market, it is important to have a domestic partner and we believe that having Ohayoo as the face, iCandy is drastically increasing its chances of success.

Lastly, iCandy has announced a Joint Venture (JV) with Lemon Sky Studios in order to create 3D games with AAA visuals and animation. We are not currently overly excited about this JV as the other initiatives have more direct revenue generation visibility. However, it is nice to see iCandy continuing to expand its development capabilities.

Short-term punt on the success of Claw Stars

On a trailing 12-month basis, iCandy is valued at an EV/EBITDA ratio of 119x. Unfortunately, it is extremely difficult to predict the results of a 'freemium' game, as management has stated repeatedly. We believe that an investment in iCandy at this time would effectively be an educated, short-term punt on the success of Claw Stars. Based on our expectation that Masketeers: Idle Has Fallen will experience continued growth and given the initial numbers on Claw Stars ahead of its release, this new game may likely lead to a considerable jump in the share price, despite its current valuation. However, we believe that this would be nothing more than an education punt at this time, which is fine if you're a high roller. For the rest of us, iCandy is a three-star stock at this time.

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