STOCKS DOWN UNDER

11 JUNE 2021

Small Cap Stocks Down Under

"You could leave life right now. Let that determine what you do and say and think."

- Marcus Aurelius Antoninus (121 CE – 180 CE), Roman emperor

LYNCH GROUP

Flower power

SPORTS ENTERTAINMENT GROUP

Reviewing the call

XRF SCIENTIFIC

The science of making money

LYNCH GROUP

Flower power

Stocks Down Under rating: ★★★★

ASX: LGL
Market cap: A$ 437m

52-week range: A$3.12 / A$3.86
Share price: A$ 3.75

How does one make an empire from selling products that are lucky to last more than a couple weeks? Leo Lynch could tell you. His family had been in the flower game as a grower and wholesaler since 1915, but a century later sold majority ownership to private equity firm Next Capital. Lynch Group went public on ASX this year and is the only player of a national scale in Australia today as well as a leading grower with an emerging wholesale platform in China.

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Market cap: A$ 57.8M

52-week range: A$0.18 / A$0.32
Share price: A$ 0.25

Very few things create such a reaction of instantaneous love or hate as sports. People can form instant friendships or bitter rivalries with somebody when they only know one fact about them, their favourite team. Reactions like these are what the Victoria-based Sports Entertainment Group is attempting to monetise on with its sports-focused multi-media empire. The question is, will this team be a winner or a loser?

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Market cap: A$ 57.2M
Dividend yield: 3.3% (100% Franked)

52-week range: A$0.22 / A$0.44
Share price: A$ 0.43

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Share price chart

Source: Tradingview

The perfect gift

Rain, hail or pandemic, people are buying flowers just as they have been for thousands of years. In ancient Egypt, Greece and China, flowers have been used for everything from decorations to gifts to the gods. For any special occasion you can think of, flowers are an appropriate gift. The Australian floral sector alone is worth approximately $1.4bn. And in that space, the Lynch Group is one of the largest wholesalers. In recent years, the company has undergone a massive expansion. In 2015 Australian private equity firm Next Capital acquired a majority interest. Following this, the group acquired VDB Asia, a premium rose grower in China with a large market share.

The Lynch Group, based in the western Sydney suburb of Lidcombe, is no corner store outfit. Revenue reached $255m in FY20, almost identical to the $254m from FY19 despite the effects from COVID-19, while EBITDA grew 30% to $30.4m. 1HY21 has already outdone 1HY20. Revenue was up 9% to $138m, while EBITDA increased 50% from $13.6m to $20.5m. Around 93% of revenues was from Australia and currently only 7% from China. But we believe the massive growth isn't over just yet.

Believe it or not, flowers are still a growth business. Look at Lynch as a case in point. Just in Australia, they are expanding product ranges available in stores. Supermarkets are slowly becoming more popular to buy

your flowers from and the Group plans to capitalise on this. When buying flowers for your anniversary on your way home from work, would you rather go to a large shopping centre and find a florist or duck into your local supermarket? More and more people are choosing the supermarket.

China is a centre of booming growth itself. Studies have shown the correlation between GDP per capita rising and the demand for flowers. The Chinese floral industry, currently worth $19bn (compared to Australia's $1.4b), is expected to more than double and reach $43bn by 2023. To prepare for this, the Lynch Group is already increasing production capacity, forming relationships with retailers and consumers, and is increasing its infrastructure.

Ingredients to flourish

Flowers are a difficult product to supply. Due to their high perishability and short vase life, a complex and time-sensitive supply chain is needed. The Netherlands may be internationally famous for its flower fields, but Australia's climate is better for some flower breeds over the chill in Europe. And Lynch Group has a sophisticated supply chain across Australia and China. They operate three farms in Australia: one in Brisbane and two in Perth. They also have processing facilities in Sydney, Melbourne, Brisbane and Perth. In China, the Groups holds four farms in the Yunnan province and two processing facilities, located in Shanghai and Kunming. This infrastructure and scale are able to provide year-round, standardised products that can satisfy demand.

In the Australian market, the company has roughly 30% of the market. They are the only supplier of this scale in a highly fragmented market. Unlike international suppliers, Lynch Group is able to operate under the strict biosecurity regulations Australia imposes with their in-house expertise. Their sophisticated logistics gives them flexibility and speed that is highly competitive against small-scale firms. With a proven track record of 106 years in business, the Group has a comfortable seat at the floral table in Australia.

While they are newer in the Chinese game, they have been in the market for 16 years. That's as long as Twitter has been around. Small households make up 99% of floral growers in China. Those competitors have limited expertise, infrastructure and access to quality materials compared to Lynch Group. And the Australian company has cost and yield advantages. With the new acquisition of VDB Group in China, they have the potential to be a national supplier for the soon-to-be $40bn industry.

Up from here

Lynch Group came onto the market on 6 April at an IPO price of $3.60. Reception was wary, with the price ending the day at $3.40. This cautiousness was expected. When private equity firms are involved – and Next Capital retained 13.6% of the stock – investors are cautious about the price being initially overinflated with 35.4m new shares and 21.9m existing shares being sold. This left the company with net debt of $65.6m.

Revenue for FY22 is forecast to increase 7% to $339m, and similarly, EBITDA is expected to increase 10% to $57.6m. The FY22 EBITDA multiple on the company numbers is 8.9x, which we believe is very reasonable given the company's expected EBITDA growth rate. An additional attraction is the Chinese floral sector, which is set to grow $24bn in the next two years. Lynch Group has been around for over a century and is in a new era of expansion under relatively new management. Four Stars from us.

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Source: Tradingview

The teams

Before we dive into things, it's important to mention that until recently the Sports Entertainment Group was known as the Pacific Star Network. However, on 1 October 2020, the company announced that it had changed its name in order to reflect its sole focus on sports news and information.

Sports Entertainment has three main revenue lines: SEN, broadcasting and publishing. SEN stands for the Sports Entertainment Network and consists of four categories. The first is the company's 'old fashion' sports radio networks covering Melbourne, Sydney and South Australia. The second is the SENApp, which provides users access to the company's sports news, information, video highlights and podcasts all in one convenient place. This app has been downloaded over 250,000 times. SENTrack is a separate mobile application to SENApp as it only follows horse, harness and greyhound racing. Sports Entertainment decided to create a separate mobile application specifically paired with the company's dedicated horse, harness and greyhound racing radio stations. Lastly, SEN Spirit combines sports and music for Australian's living in the South West, an area not covered by most of SEN's other products.

Broadcasting has some similar types of media to the SEN division. However, they are not branded under the SEN umbrella. This division includes the Nation brand, covering AFL, NRL, Football and Big Bash, six other sports radio, six TV shows (mostly around footy) and two sports-focused podcasts.

The publishing division is the only one owned by Sports Entertainment that has a segment not directly related to sports. While it does publish and produce the weekly match day magazine, the AFL record, AFLW publications, AFL Season Guide and other AFL publications, it also includes Lifestyle1 Magazine. This magazine covers general information and news for South Australia's South East and Victoria's South-West regions.

There's more than one way to make money off sports

When it comes to multi-media companies like Sports Entertainment, the rule of thumb is usually that they are either seeing revenue and EBITDA decline or are making a flurry of acquisitions to cover their decline. Surprisingly, this company is mostly bucking the trend as revenue was mostly flat between FY19 and FY20 (0.3% decline to $66.8m). However, EBITDA did crash 60% year-over-year during FY20 due to a sharp COVID-induced increase in production and technical expenses as the company was forced to shift to working and recording from home. We believe this was an unusual situation that is unlikely to recur, and we believe 1HY21's results back up our thesis.

During 1HY21, revenue had almost entirely rebounded to pre-COVID-19 levels, declining 12% year-over-year to $34m. While this might seem like a sharp decline, it is important to note that compared to 2HY20, this represented a 21% recovery. EBITDA was a different story. On a year-over-year basis, EBITDA had a strong showing after growing 60% during 1HY21 due mostly to increased efficiencies in production and lower general and administrative expenses. We believe that working from home for a period of time forced Sports Entertainment to become a much more efficient organisation, which will likely continue for the foreseeable future.

Uncertain EBITDA future

Two main risks plague Sports Entertainment shareholders: liquidity and earnings risk. The company has only traded an average of 20,000 shares per day over the last three months, or a total of approximately $5,000 based on yesterday's closing price. This surprisingly low liquidity will make it difficult for shareholders to sell out of their positions, even if there is no rush to exit the stock.

The second risk is FY22's results. Unfortunately, there are no consensus estimates on Sports Entertainment and management has not given guidance, leaving us in a bind. While fans have come back to most Australian sports with a vengeance now that teams can finally compete again, there continue to be match cancellations and delays due to COVID-19. Additionally, international sports have taken a much larger blow as the world continues to suffer from the pandemic, limiting travel. While we are optimistic about Sports Entertainment's future EBITDA growth, we have to admit that there is a risk that these continuing issues will dampen enthusiasm for sports in the short term, hurting the company's performance.

From a valuation perspective, Sports Entertainment is currently trading at a trailing 12-month EV/EBITDA ratio of 10.4x. If the company did not have so much uncertainty going forward, we would definitely be rating this stock four stars. However, when we combine the uncertainty with the virtually non-existent liquidity, we have no choice but to recommend a neutral stance on this stock for now. Three stars.

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It's time to mine

Mining is back in fashion, according to the Australian Bureau of Statistics' December 2020 report on the mineral exploration industry's expenditure and metres drilled. According to the report, the total metres drilled in new deposits in Australia during 1HY21 totalled 2,073.5 million, resulting in the largest half (1H and 2H) since the ABS began releasing data in 2003. If this was not impressive enough, 1HY21 also resulted in the second-largest total metres drilled (new deposits and existing) on record at 3808.6 million. When we combine these record-breaking statistics for 1HY21 with the fundamentally backed price boom in raw materials, we believe the mining boom has begun and is here to stay through at least FY22.

For investors not interested in investing in mining, we have good news. There are plenty of companies whose businesses involves supplying products and services to miners without the risk that comes with owning a mine. What is interesting about this approach is that these companies normally see a delay in orders for products and services, potentially creating an opportunity for savvy investors to take advantage before the market reacts. XRF Scientific is one such company, and importantly, it is not one of the first that comes to mind when you say, 'mining boom.'

It's all about the purity

XRF develops and manufactures laboratory products and equipment that are vital to the mining industry. Through the company's equipment, products and consumables, miners are able to determine the metal purity of their new and existing extraction operations. However, this technology is useful to more than just miners. The construction and manufacturing industries require constant quality control through sample analysis. While these are certainly the main industries XRF is targeting, the truth is any company that requires in-house sample collection, creation or analysis is a potential client.

However, it is important to note that XRF has historically relied heavily on the mining industry for orders and growth, despite the breadth of potential client industries. Additionally, due to the forecasted mining boom, we do not expect this to change in the foreseeable future.

During 1HY21, XRF generated total revenues of $15m, a decline of 5% year-over-year. However, despite the 5% decline in revenue, profit before tax excluding government assistance increased 4% to $1.7m. Basically, 1HY21's results were far from anything special and management allowed profit to expand by slightly cutting costs across the board after revenue declined. If this were all there was to see, XRF would be a two-star stock for sure.

The third quarter changed everything

Remember how we said that companies exposed to the mining industry, but are not involved in the actual mining itself see a delay in their results during mining booms? Well, XRF certainly proves our point. The third quarter of FY21 had an extremely strong showing with revenue increasing 20% and adjusted Profit Before Tax (excluding the effects of COVID-19 subsidies) increasing 71% year-over-year. While management, unfortunately, does not comment on the reason for the disparity between revenue and Profit Before Tax growth, we believe it is most likely due to expenses remaining relatively stable during the period, leading to expanding margins.

An incorrect consensus

The market consensus currently places FY21 revenue at $31.2m, but the truth is after the third quarter result, we believe this will likely significantly underestimate FY21's total performance. For the first nine months of FY21, total revenue generated was $23.2m, after $8.2m for the third quarter. However, all XRF would have to do is generate $8m in revenue during the fourth quarter to meet the market's current consensus. Seeing as how the third quarter was the first time the mining boom had a significant impact on results, we expect the fourth quarter to generate revenues significantly higher than in the third quarter.

While management has not provided exact guidance for FY21, they made a few comments of note in the third quarter's release. Managing Director Vance Stazzonelli said, "based on the current level of activity, we expect the June 2021 quarter to generate a strong result." Additionally, the ramp-up in the mining industry was on full display and was referenced specifically in the discussion of why each division showed a strong result during the quarter. It was also noted that the industrial markets in Europe and North America are ramping, although not to the mining industry's extent.

Based on the market's projections, XRF is currently trading at an FY22 EV/EBITDA ratio of 9.3x with EBITDA expected to grow by 5% in that year. While this doesn't sound very appealing, please remember that we expect XRF to do a lot better in FY21 than the market is currently expecting. So, we might see solid earnings upgrades for FY22 on the back of that.

All-in-all, it is our opinion that XRF is heavily undervalued by the market and easily slated for a massive earnings consensus beat. With a solid business and strong macro tailwind, XRF is a four-star stock for us.

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