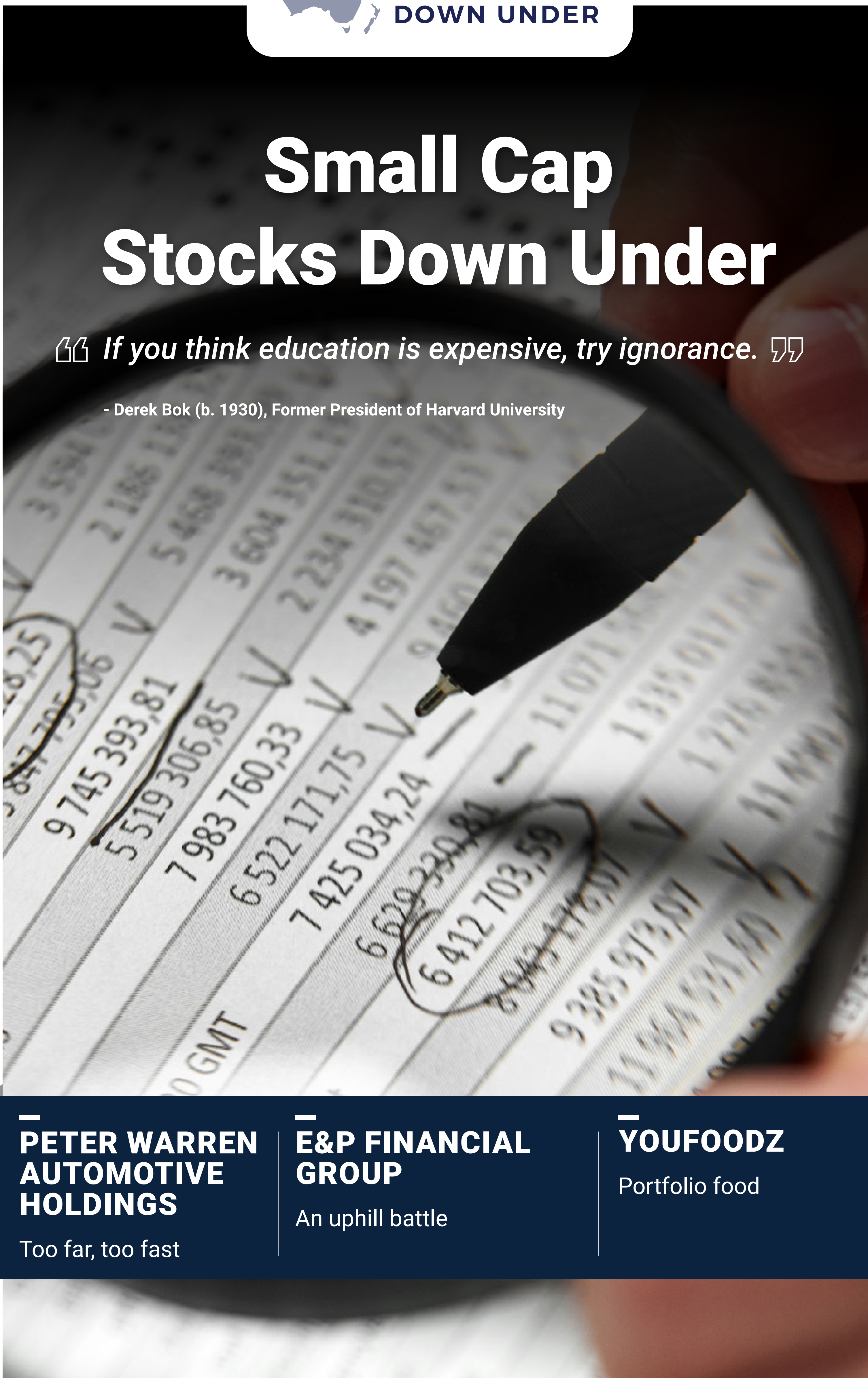
STOCKS DOWN UNDER

18 JUNE 2021



Small Cap Stocks Down Under

"If you think education is expensive, try ignorance."

- Derek Bok (b. 1930), Former President of Harvard University

PETER WARREN AUTOMOTIVE HOLDINGS

Too far, too fast

E&P FINANCIAL GROUP

An uphill battle

YOUFOODZ

Portfolio food

PETER WARREN AUTOMOTIVE HOLDINGS

Too far, too fast

Stocks Down Under rating: ★★

ASX: PWR
Market cap: A$ 615M

52-week range: A$3.23 / A$3.85
Share price: A$ 3.61

Headquartered in Warwick Farm, New South Wales, is Peter Warren Automotive Holdings, which, as we are sure you guessed, is not involved in farming. The company is quite new to the ASX, listing on 27 April 2021 at $2.90 per share and raising $227.4m for Peter Warren. The company currently operates 70 franchise car dealership business across Australia under seven different brands. Since listing, the stock has done extremely well for early shareholders, rising 25% as of yesterday's close. However, we think this dealer has overplayed its hand.

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Stocks Down Under rating: ★★★

ASX: EP1
Market cap: A$ 148M
Dividend yield: 3.125% (100% Franked)

52-week range: A$0.395 / A$0.70
Share price: A$ 0.635

E&P Financial Group, better known as Evans & Partners, is a Sydney-based financial services group operating in multiple market segments. Providing everything from investment advice to wealth management and superannuation services, E&P was the epitome of a boring, but stable financial company until 2019. Instability in management, the onset of COVID with its resulting instability, and a lawsuit have changed all that. However, with share prices close to their historical lows, E&P may just be a bargain.

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YOUFOODZ

Portfolio food

Stocks Down Under rating: ★★★★

ASX: YFZ
Market cap: A$ 57.9M

52-week range: A$0.375 / A$1.32
Share price: A$ 0.425

Headquartered in Virginia, Queensland, is a company competing hard for the award of having the most annoyed shareholders on the ASX. Youfoodz listed on 8 December 2020, raising $70m at $1.50 per share and has since endured a rather consistent sell-off to its current level of $0.425. Basically, if you invested $10,000 in the Youfoodz IPO, you would be left with $3,267 in just six months later. But here's the weird part; its results have been far from catastrophic. So maybe an IPO investor's loss is an on-market buyer's gain.

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Share price chart

Source: Tradingview

The six horsemen of profit

Peter Warren Automotive was founded in 1958 by, you guessed it, Peter Warren, as a small car lot in southwest Sydney. Soon thereafter, in 1959, the company acquired its first franchise relationship with Volkswagen and the rest is history. Currently, the company operates 70 franchises across eight locations in Sydney and 40 others through nine locations in southeast Queensland and Northern New South Wales.

However, not all of Peter Warren's dealerships operate under the original brand. In fact, the company currently operates six different brands: Peter Warren Automotive, Frizelle Sunshine Automotive, Sydney North Shore Automotive, Mercedes-Benz North Shore, Macarthur Automotive and Euro Collision Centre.

The company has positioned itself well to generate revenue through more than just car sales as customers will often return for after-market car parts, repairs and other services. Combined, this generated $1.4bn in revenue in FY20 and management has forecasted $1.5bn in revenue during FY21. Unfortunately, the dealership business is not a high margin industry with FY20 EBITDA margins of 3.6%. Management expects EBITDA margins to grow to 5% during FY21, resulting in $76m in EBITDA as the cost of goods is expected to remain low with demand for new and used cars continuing to rebound during the post-COVID-19 period.

Another factor that should help improve sales during FY21 and FY22 is the continued closure of Australia's borders until mid-2022. We believe this will likely see an increase in domestic tourism during the period, leading to increased driving.

A 1HY21 update

1HY21 saw a solid improvement over 1HY20, with revenue rising 6.9% year-over-year to $745.9m. However, due to the continued lower cost of inventory mentioned above, EBITDA grew more than double the rate of revenue, at 13.5% ($55.6m). However, as the car market recovers from the pre-COVID-19 slump it was in, we don't expect this lower inventory cost to continue to boost EBITDA throughout FY22 and FY23, although it is possible it could continue to have an impact during 1HY22.

With management's EBITDA forecast of $76m and 1HY21 EBITDA at $55.6m, you might be wondering if management is forecasting a collapse in sales during 2HY21. Rest assured; this is not the case. Instead, the board of directors has determined that due to the growth and success Peter Warren Automotive has experienced during the post-lockdown period, it would be proper to repay the Australian Government the $13.3m in JobKeeper payments it received. This repayment has been slated to be recorded during 2HY21's results and will depress EBITDA accordingly.

Value stuck in neutral

Peter Warren clearly has built a solid company and its IPO price of $2.90 was more than fair. However, the stock has since jumped 24% and we believe this is a kilometre too far for this dealership and we expect the share price to stall around current levels.

While the company is new to the ASX, looking at its historical results and industry averages, Peter Warren's revenue growth of 6.9% is around what we can expect of EBITDA (around 6.9%) in the future. Therefore, with FY22's EV/EBITDA ratio currently at 13.5x, we believe this stock should have shareholders in neutral because it's about twice the EBITDA growth rate.

The market cap certainly seems too stretched for now. With management having provided a trading update as recently as 25 May 2021 to the market, we believe an earnings beat for 4Q21 is extremely unlikely.

Once we factor in the company's current valuation as well as the industry and economic outlook, we believe investors should keep an eye on this stock, but wait for the inevitable pullback towards its IPO price. For now, it's two stars from Stocks Down Under.

E&P FINANCIAL GROUP

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Share price chart

Source: Tradingview

A marriage of financiers

In essence, E&P is a collection of financial companies that slowly came together through mergers and acquisitions. Its current form came about in 2017 when Dixon Advisory, a wealth management fund, merged with Evans & Partners, a broad financial services company. Both companies exist as subsidiaries of the E&P financial group and Dixon Advisory has a branch in both Australia and the US. The company was listed on the ASX on 11 May 2018 with the name of Evans Dixon. The name was changed to E&P Financial Group on 11 November 2018 to align it with management's long-term growth strategy and to increase market awareness for their services.

In our view, the major advantage that E&P has over its competitors is the fact that it offers almost every major financial service that a client could need, from wealth management and investment advice to superannuation plans and mergers and acquisitions. In total, E&P has over 9,200 clients and more than $20bn under management in its wealth advice division. The E&P division has over 180 institutional clients and provides stockbroking services and financial advice. Lastly, the funds management division targets corporations and simultaneously advises and executes transactions on behalf of its clients, mainly for liquidity management and asset procurement.

However, E&P has had trouble increasing its revenues, even though its operational performance has consistently risen. After FY18, revenues slipped as E&P failed to come up with winning investment strategies. There was a huge reduction in revenue in both the wealth advice and funds management divisions. 2020 was a similar story, with further pressure exerted by COVID-19 and changes in management. In fact, we believe there are multiple reasons to be apprehensive of E&P going forward.

Trouble in paradise

Since the end of FY18, E&P has been on a consistent fall. What began as a reduction in revenue due to unfavourable investment strategies spiralled into massive problems within the company. This led to changes in management, with CEO Alan Dixon stepping aside to manage the US Masters Residential Property Fund (URF), a fund indirectly owned by E&P.

David Evans became interim CEO, followed by the full-time appointment of Peter McKenzie Anderson. However, the replacement of the CEO was followed by a change in almost every major management position, including the CFO and multiple executive directors.

The advent of COVID further hampered E&P during the 2HY20, which caused a huge fall in capital markets worldwide, affecting financial companies in a significant manner. With the lockdowns starting to lift and the economy returning to a semblance of normality across the world, we expect E&P to be able to increase its revenue in FY21.

Perhaps the biggest problem facing E&P right now is a civil lawsuit by the Australian Securities and Investments Commission (ASIC). ASIC claims that E&P did not act in the clients' best interests by advising eight clients across 51 instances to invest in the previously mentioned URF. ASIC also claims that URF paid a substantial amount in fees to E&P's subsidiaries during this time, thereby creating a conflict of interest. With a total of 126 alleged contraventions, the maximum penalty is in excess of $100m.

The lawsuit is still underway, but a heavy penalty will be devastating for a company with only $42m in cash and a market capitalisation of less than $148m. This makes investing in E&P a huge risk.

Struggling along

Despite everything, E&P has still managed to achieve a reasonably stable performance and generate a profit. Apart from FY20, when the company impaired over $38m of goodwill, intangible assets and investments, E&P has not had a year where it showed a net loss.

E&P has also had a consistent record of paying two dividends throughout the year, apart from FY20, when the company withheld payouts to preserve liquidity during COVID. The total dividend was 11 cps in FY18 and 8 cps in FY19. Due to the effects of COVID being less severe in FY21 than in FY20, E&P restated its dividend at the end of 1HY21 at 2cps.

Fundamentally, E&P is a sound company. The trailing 12-month P/E ratio for FY21 is around 16x, which is not too bad considering the problems E&P has had to face over the last two years.

It is up to investors to evaluate the potential risks with regards to the COVID aftermath and the ASIC lawsuit to see whether E&P is a company worth investing in. In our opinion, given the $42m in cash, the lawsuit poses the biggest threat and would damage the company's cash position considerably in case E&P has to pay a substantial penalty. So, we'd hold off for now in anticipation of the outcome. Three stars from us.

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Share price chart

Source: Tradingview

Youfoodz, delivery right?

Yes, we hear you, another meal preparation company. Still, Youfoodz has an interesting spin. The company is targeting the Australian consumer who wants to eat healthily, but does not have the time or skill to do a lot of meal preparation. Yes, the company delivers the means to the end-user, but what we find interesting is that Youfoodz has also managed to break into the Australian grocery and convenience store market. Since Youfoodz produces drinks and snacks as well as readymade meals. We believe this sales stream diversification will help maintain growth long after consumers fully return to restaurants.

Before we dive into Youfoodz earnings and growth strategy further, let's take a small step back and look the food the company delivers. All meal, snack and drink recipes are tested and created by Youfoodz. The company currently has 44 different readymade meals, 32 snacks and 36 drinks. Consumers who purchase directly through Youfoodz can either buy these products directly from the company through its website or through its business clients. Currently, the delivery business happens to be both the largest and fastest growth segment, generating $34.6m in revenues, i.e. 41.2% growth year-over-year during 3Q21. When we factor in total 3Q21 revenues of $50.2m, which grew 23.3%, it's quite clear just how important the direct-to-consumer division is to the company.

B2B to support growth

Despite the strong recent growth rates, we are somewhat concerned that the delivery industry may drop in popularity in FY22, assuming we don't have any more major COVID-19 scares in Australia. We are not saying that Youfoodz's delivery business will dry up, but we are not confident that it will power future growth during the post-COVID-19 period. Which is why we're excited about the company's exposure to grocery and convince stores longer term.

In the short term, though, the company was recently forced to lower FY21's guidance due to unexpected headwind in this division. Youfoodz's prospectus EBITDA forecast was $2.9m, but management now expects EBITDA to be between $1m and $2m. Despite this decline in guidance due to continued soft demand from its business clients, management has announced, without specifics, that its business customers have agreed to product range expansion starting during 4Q21. Management stated that this provides them with "confidence into FY22," and we must agree. We believe it is likely that demand will rebound in this division as consumers move back into the office, look to lose their COVID-19 weight, while not having time to cook at home as much as they have over the last year.

Growth is expected to pick-up

The market expects Youfoodz will continue to experience strong growth, while FY22 is currently forecasted to generate EBITDA growth of 85%. FY23 EBITDA growth is slated to skyrocket 138% as the B2B division fully emerges and as the B2C division stabilises under more 'normal' business conditions.

There is certainly a sizable amount of risk inherent in this thesis. For starters, our future growth thesis relies heavily on the B2B division seeing strong expansion in the post-COVID-19 era. Additionally, there is the risk that the B2C division will see not lower growth, but negative growth as consumers start to go into the office again at an increasing rate.

When we factor in these risks against Youfoodz forecasted growth and our own analysis, we believe a solid valuation discount is certainly in order. Still, we believe Youfoodz's shares have factored in an unreasonable discount since the company announced its 3Q21 results. The current valuation stands at 10.1x and 3.7x EV/EBITDA for FY22 and FY23, respectively. While this stock is certainly not for those averse to risk, we believe the risk reward ratio for the rest of us makes a lot of sense at this price. Be aware, though, that in the current market Youfoodz is unlikely to become a market darling anytime soon. But it's four stars from us.

Pitt Street Research Pty Ltd

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