STOCKS DOWN UNDER

25 JUNE 2021

Small Cap Stocks Down Under

It is during our darkest moments that we must focus to see the light.

- Aristotle (384 BCE – 322 BCE), Ancient Greek Philosopher

CARDNO LIMITED

The cards have been dealt

GENEX POWER

Not just for tree huggers

ASPEN GROUP

Perfect for yield junkies

CARDNO LIMITED

The cards have been dealt

Stocks Down Under rating: ★★★

ASX: CDD
Market cap: A$ 338M
Dividend yield: 1.7% (60% Franked)

52-week range: A$0.21 / A$0.97
Share price: A$ 0.91

Based in Brisbane, Cardno is an engineering services company. It offers a broad range of services ranging from asset and construction management to utility and structural engineering. Operational since 1945, the company listed on the ASX in 2004 and has been continuously improving and adding to its portfolio of services to keep up with the demands of modern engineering. While Cardno is a financially sound company, its share price has risen considerably in 2021, which might just mean that it is now overvalued.

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GENEX POWER

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Stocks Down Under rating: ★★★★

ASX: GNX
Market cap: A$ 251M

52-week range: A$0.15 / A$0.27
Share price: A$ 0.24

Genex Power is a Sydney-based renewable energy company. Having been in operation since 2011, there is not a lot that grants Genex an advantage over its competitors. The company primarily operates in the Kidston area, although it has achieved diversification both in terms of the renewable energy sources it uses and in terms of geography. We believe Genex is more or less at the start of the hockey stick curve when it comes to EBITDA growth and presents investors with an attractive long-term opportunity.

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ASPEN GROUP

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ASX: APZ
Market cap: A$ 147M
Dividend yield: 5% (0% Franked)

52-week range: A$0.97 / A$1.34
Share price: A$ 1.32

Aspen Group is a commercial real estate developer based in Surry Hills, New South Wales. With over 18 properties valued at over $200m Aspen operates a well-diversified portfolio of holiday parks, resorts and tourist destinations. The main draw of the company is the fact that they hold property worth more than their Enterprise Value. As expected, the company's share price witnessed a downturn during COVID-19, but the fundamentals never faltered and the company is beginning to bounce back as restrictions are eased and borders are reopened.

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Share price chart

Source: Tradingview

A swiss army knife

In terms of the services that it offers, Cardno is a swiss army knife. The total amount of services and solutions that the company provides cannot be listed here, but Cardno's portfolio can be roughly divided into three categories.

Since Cardno is primarily an engineering company, infrastructure forms the brunt of their work. Infrastructure works include everything from asset management to construction and civil engineering. Infrastructure work forms the vast majority of Cardno's profits.

Cardno also works on various environmental solutions. While these solutions are not as profitable for the company as their infrastructure work, they do help Cardno's image as a company pushing for more environment-friendly practices. The solutions provided include dealing with contaminated land, managing coastal areas and attaining environmental permits and compliance.

The last category that Cardno operates in is international development, which essentially means targeting underdeveloped areas with solutions that promote equality, reduce exclusivity and generally lead towards a better standard of living for the local population.

Cardno's International Development business takes place across the globe in developing regions. Apart from that, Cardno operates mainly in the Asia Pacific and the Americas. Since Cardno primarily provides engineering solutions, the brunt of their work takes place in developed communities and commercial areas.

However, that doesn't mean that Cardno only operates in a few countries. While their clients are concentrated in a few places, their work most definitely is not. Since they were founded, they have worked on projects in over 70 countries, ranging from the US to Timor-Leste.

Dividend is back on

Due to the nature of Cardno's business, i.e. a lot of project-based work, the share price has historically been quite volatile. The volatility of the share price is not affected by market movements, as Cardno's five-year monthly beta is only 1.1. Instead, the financial results of the company seem to impact the price more than anything. We believe this is because Cardno is not a growth stock. It has been listed on the ASX since 2004 and its business model is set in stone. Cardno grow's its business primarily by landing project-based work, the timing of which is unpredictable. So, keeping track of new order flow is essential for investors.

Cardno was doing well in FY17 and had a net income of $8.5m. The company stopped paying dividends and went on a share buyback campaign, something that continued during FY18 and FY19. However, Cardno lost money in both those years, which led to a declining share price during those years.

Share buybacks were halted during FY20, a year in which Cardno generated a net income of over $56m. This was an improvement of 227% compared to FY19, where the company incurred a loss of $44.5m. After these results were announced, Cardno's share price began to bounce back. We began to see a substantial upswing in the price once the company announced another buyback campaign in November 2020, followed by a dividend of 1.5 cents at the end of 1HY21, the company's first since FY15.

The train has left the station

A few years ago, Cardno was considered to be a very reliable dividend-paying stock. We believe that the recent interest in the company is because investors think Cardno will once again become a dividend play.

While that may turn out to be true, we cannot see Cardno having significant growth potential. Since the company is not likely to change its operations and its business model anytime soon, we believe that it will continue to see only moderate growth over the next few years.

However, we believe the company will likely be able to increase its dividend going forward. The market consensus echoes the same sentiment with the expected total dividend in FY21 being more than 3 cents per share. After that it is expected to up to 5 cents in FY22. This would mean a dividend yield of 3.3% in FY21 and 5.5% in FY22. We think the company's expected EBITDA growth of 3% and 5.5% in the next two years is nothing to write home about. But we believe that this is a three-star opportunity, mainly for investors looking for a stable company with a dividend that will increase over time. If you're looking for capital gains, we believe Cardno at the current share price is not for you.

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Share price chart

Source: Tradingview

Big projects and even bigger dreams

Although Genex is based in Sydney, its main area of operations is Kidston, Queensland. The company was incorporated to set up renewable energy sources in the area and it secured a $4m grant from the Australian Renewable Energy Agency (ARENA) to conduct a feasibility study on a hydropower project while it began work on a 50MW solar plant.

Since then, the Kidston project has been on a successful path, but it has been moving forward at a snail's pace. A further grant of $8.85m was received from ARENA in September 2016, the second of many government funding payments received by Genex after listing on the ASX.

The Kidston project is not just about hydropower, though, as Genex is aiming to build a renewable energy hub there. Known as the Kidston Clean Energy Hub, the project has a 250 MW pumped storage hydro project, a 150 MW wind project and 2 solar projects cumulatively providing 320 MW potentially. The first phase of the project has been functioning since 2017. The 50 MW solar plant became operational in 2017 and ramped up to full capacity in the second half of 2018. The second phase involves a 270 MW solar plant and a 250 MW hydro project. The hydro project requires the biggest investment, with estimates starting upwards of $600m. It finally began construction in March 2021 and is expected to be operational in about four years.

The 270 MW solar plant has not yet been completed and the company has been relatively quiet about any updates, leading us to believe that it will only begin working on it once the hydro project is fully underway.

The third phase of the project, on the other hand, is obviously going to take a while. It involves setting up a 150 MW wind farm and Genex has done little more than secure funding for it through an agreement with J-Power, the Japanese renewable energy giant. The company's progress on the Kidston project has been quite slow. The hydro project was expected to begin construction in the second half of 2020 (after numerous delays), but Genex still missed its target by a few months.

However, the company has diversified some of its offerings by building a 50 MW solar project in Jemalong, NSW. The plant was energized in December 2020 and is currently producing revenues for the company. However, it will be a while before it hits maximum capacity. Apart from this, Genex is also working on a 50 MW battery project in Bouldercombe. It is currently undergoing construction and is expected to be operational in the first half of 2022.

Renewable Energy, same old methods

If there's one area of potential weakness for Genex, it's the fact that the company is not innovating in any way. While it is targeting the renewable energy sector, the technologies used by Genex have been around for a long time. Other companies on the ASX, such as Carnegie Clean Energy, have proprietary technologies that grant them a competitive advantage. In the case of Carnegie, they have CETO that can generate electricity from wave energy. Economically speaking, the power provided relative to the initial investment is much better for CETO as opposed to traditional hydropower.

A longer-term concern for Genex may be what the best energy mix is. Many scientists don't believe renewable energy to be the answer to climate change. Nuclear power is considered to be a much better alternative as the costs of setting up renewable energy projects is considered too high. Looking at the state of Genex's financials, we have to agree. However, we don't see Australia adopting nuclear energy any time soon.

How to read Genex's balance sheet

We could write an entire book about the times Genex has had to raise funds in the last five years. The nature of the company is such that a substantial amount of capital is still needed for it to complete its projects. Currently, Genex has just over $30m in cash and well over $200m in debt. The debt/equity ratio is an astounding 640x and it is almost certain that it will only go up over time. However, project funding, backed by recurring cashflows for the projects, is different from funding levels seen on a typical company balance sheet as energy projects typically have multi-year offtake agreements. Consequently, we believe the risks for Genex are much more contained than its current debt/equity ratio would suggest.

Not just for tree huggers

With an EV/EBITDA of 33.6x for FY22, Genex may seem very overvalued at first glance. However, that number comes down to 19.7x for FY23 and 9.2x for FY24. You could argue that FY24 is still a long time away, and you'd be right. However, when we look at consensus EBITDA growth in the next 3 years of 37%, 70% and 114% respectively, it appears Genex is leaving the start-up years behind indefinitely. And our beloved EV/EBITDA-to-EBITDA-growth valuation metric is flagging opportunity at just 0.35 for FY22, 0.31 for FY23 and 0.41 for FY24. So, we quite like Genex from a valuation point of view.

Yes, there is risk of further shareholder dilution as the company seeks additional funding for its projects, which will need to be backed by equity. However, as this additional equity will be used in part to attract debt capital for Genex's projects, we actually regard future capital raises as evidence of progress on the part of Genex.

We believe this is a four-star opportunity for all the tree huggers out there as well as for everyday investors who just want to make a buck.

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Share price chart

Source: Tradingview

Two decades of familiarity

Aspen has two subdivisions, Aspen Group Limited and the Aspen Property Trust. It is best to think of them both as one as they essentially do the same thing. The company was founded in 2001 to provide "value for money" accommodation and it stays true to that goal even today. The corporate arm of the company is quite small with only a handful of employees. However, hundreds of people indirectly operate under the Aspen group as employees of one or more of the properties it owns.

Aspen's core business has stayed the same. Through 20 years of existence, it has bought and sold numerous properties, utilizing both debt and equity financing. Aspen in its modern form began to take shape in 2016, with a huge share buyback campaign and a restructuring of the company. In total, Aspen repurchased 10.7 million shares.

Aspen also sold the Aspen Parks Property Fund (APPF), a fund that included a substantial portion of the company's properties. With this sale, Aspen eradicated all its debt and had $60m cash reserves left over. Essentially, the company restarted itself with a blank slate. The cash was used to rebuild its portfolio, with numerous acquisitions, including that of the Barlings Beach Holiday Park.

Acquiring new properties has been the main way through which Aspen has achieved expansion. The company secured an $80m credit line from the Westpac banking corporation in May 2017, which was reduced to $35m by Aspen in June 2018. The company also initiated another share buyback campaign during FY18 with $5.6m worth of shares bought back.

FY18 ended with two acquisitions worth $30m, including the acquisition of Koala Shores. The acquisition of Highway 1 Tourist Park in Adelaide was completed in FY19, further bolstering the company's portfolio. Numerous acquisitions have been made since then, although most of them are much smaller in size.

Keeping it simple

We must say, Aspen Group is one of the simplest companies we have ever come across. It acquires tourist properties and usually rents them out on a short-term basis. If it receives a good offer for one of its properties or it no longer thinks that a property can generate the targeted revenue, that property is sold.

When times are good, Aspen Group distributes its excess cash in the form of an increased dividend or share buybacks. When the company finds itself in need of cash, it either takes on debt or raises capital.

We believe that Aspen management is very capable, judging by the way it runs the company. It always takes a prudent approach to its finances and is a dream come true for value investors focused on the long-term. The best example of this is the way Aspen tackled the COVID crisis. As a company whose entire business model depends on people traveling and tourism in general, it wouldn't have been that much of a surprise if the company experienced massive losses during COVID-19. However, Aspen immediately shifted its focus to longer-term leases for its properties and increased its focus on retirees. 63% of its total dwellings were on a long-term lease at the end of FY20, a year in which the company turned a profit of almost $12m.

The company raised $17m in June 2020 through institutional placement and a further $3m through a security purchase plan. Both raises were done at $1 per share. The aim is to use this cash to fund growth opportunities both within the portfolio and through acquisitions.

A safe bet

It is easy to see that Aspen is not a company for investors looking for above-average growth. However, investors looking for a company with a well-diversified portfolio of assets, capable management and regular dividends will find Aspen to be an ideal investment.

Ever since its restructuring, the company has been paying an increasing dividend. Total payout was 4.6 cents in FY17, 4.2 cents in FY18 (with an additional special capital distribution of 5.0 cents), 5.0 cents in FY19, and 6.0 cents in FY20. The company is on track to increase its dividend in FY21, having distributed an interim dividend of 3.1 cents. Similarly, the revenues of the company have been on a consistent rise, from just over $15m in FY17 to over $30m in FY20.

In terms of valuation, Aspen is valued at a P/E of 15.6x for FY22, which implies a PEG ratio (P/E-to-growth) of 1.04x. For FY23 these numbers drop to 13.9x and 0.92x, which signals that the company is fairly valued and there's no need to rush in from a valuation point of view. Additionally, potential investors may be wary of the $57m debt that Aspen currently has.

However, we believe Aspen is a financially strong company generating consistent profits. The equally consistent distributions to shareholders show that management fully believes Aspen can comfortably handle its debt and has the right capital structure. For us, Aspen is a four-star investment, ideal for investors looking for yield.

Pitt Street Research Pty Ltd

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