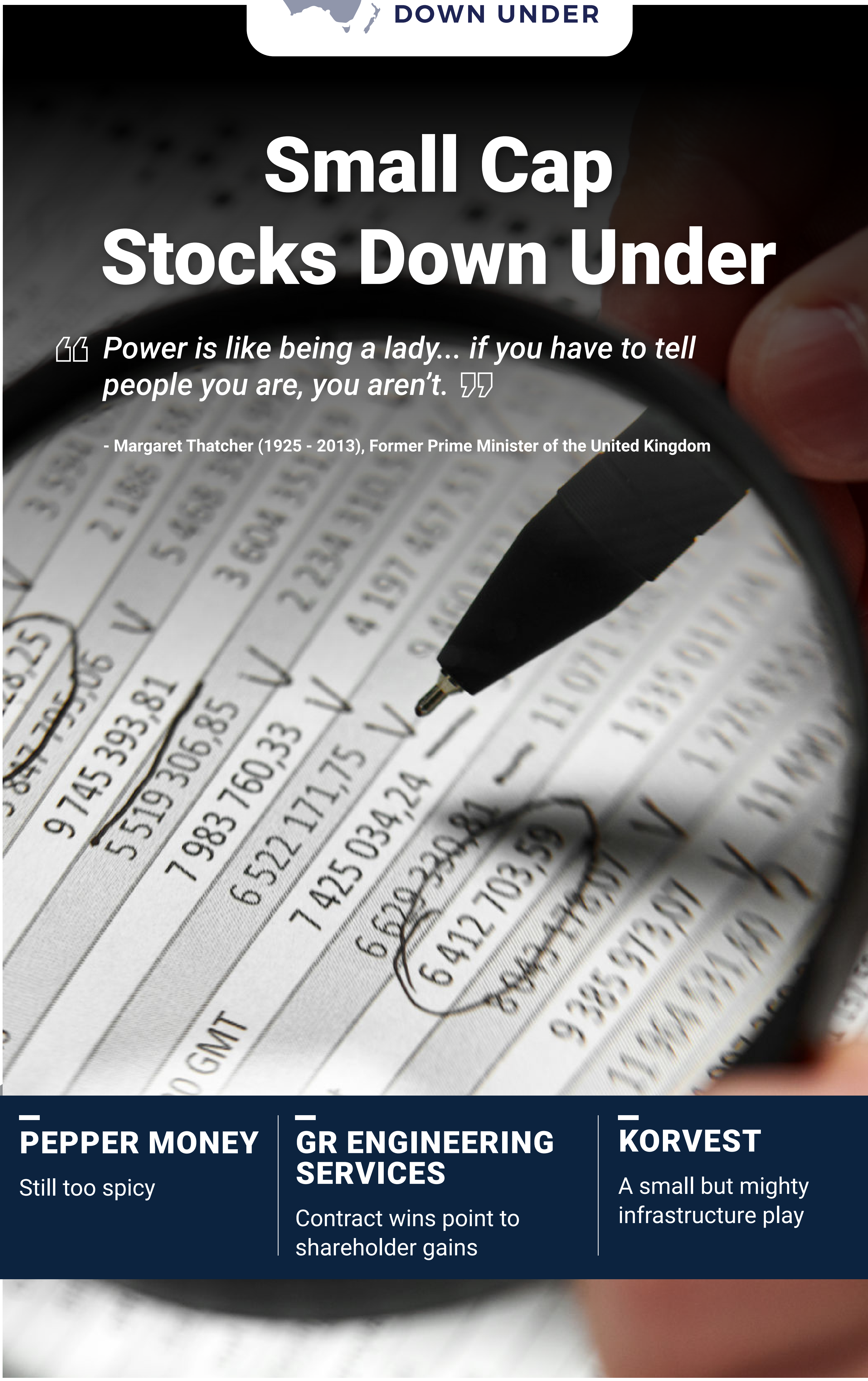
STOCKS DOWN UNDER

2 JULY 2021

Small Cap Stocks Down Under

"Power is like being a lady... if you have to tell people you are, you aren't."

- Margaret Thatcher (1925 - 2013), Former Prime Minister of the United Kingdom



PEPPER MONEY

Still too spicy

GR ENGINEERING SERVICES

Contract wins point to shareholder gains

KORVEST

A small but mighty infrastructure play

PEPPER MONEY

Still too spicy

Stocks Down Under rating: ★★

ASX: PPM
Market cap: A$1BN

52-week range: A$2.35 / A$2.78
Share price: A$2.64

Sydney-based Pepper Money's goal is to spread credit around the world. So far, Pepper has founded offices outside of Australia in New Zealand, Ireland, Spain, the United Kingdom and South Korea. Through this global network, Pepper offers consumers an alternative source of credit, focusing primarily on Australian home loans, but also offering car, personal and commercial loans. In order to expand its operations, the company decided to list on the ASX on 25 May 2021 at $2.89 per share. However, the market wasn't too fond of the IPO price and the stock has been hovering below that level since listing. Even at the current price, we don't think it's the time to buy right now.

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GR ENGINEERING SERVICES

Contract wins point to shareholder gains

Stocks Down Under rating: ★★★★

ASX: GNG
Market cap: A$241M
Dividend yield: 6% (100% Franked)

52-week range: A$0.70 / A$1.65
Share price: A$1.50

Perth-based GR Engineering Services is an engineering consultant and contractor that serves the mining, mineral processing, and oil and gas industries in Australia and overseas. The share price has advanced 77% in the past year and we believe there is likely plenty more upside after an impressive turnaround in 1HY21. A strong balance sheet, mounting contract wins and rising oil prices are just a few of the reasons why GR Engineering could build a lot more shareholder value in the years ahead.

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A small but mighty infrastructure play

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Market cap: A$56.6M
Dividend yield: 5.6% (100% Franked)

52-week range: A$3.91 / A$5.24
Share price: A$4.95

Based in Adelaide, Korvest provides a range of industrial products and galvanising services to several markets in Australia, including infrastructure, commercial, food processing, health, mining, oil and gas, power stations and utilities. After reaching the highest level since 2014, Korvest shares are off to a slow start this year. The 1% year-to-date dip presents a good opportunity to invest in a beneficiary of Australia's expected record level of infrastructure spending over the next ten years. The FY22 EV/EBITDA multiple of 6x is a price worth paying given the forecasted 23% EBITDA growth. And don't forget that high dividend yield!

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Share price chart

Source: Tradingview

Peppering the world with credit

Pepper Money is a diversified credit provider specialising in mortgages. The company offers mortgages, asset finance loans and third-party loan servicing. However, to understand Pepper's operations, you really only need to focus on Australian mortgages and asset finance loans, generating 99% of operating income during 2020.

Mortgages account for $10.7bn out of Pepper's $15bn in total Assets Under Management (AUM) as of 31 December 2020. Mortgages carry slightly more weight from an income-generating perspective than its AUM share suggests, accounting for 75% of Pepper's $318.9m 2020 operating income. While the company also offers mortgages in New Zealand, 99% of the mortgage portfolio resides in the Australian operation.

The main thing investors need to understand about this portfolio is its risk nature. Pepper is often used as an alternative source of credit, which is apparent in its mortgage risk profile. Prime mortgages account for 48% of the total portfolio, with a whopping 34% of these loans operating on interest-only terms. Prime loans currently have an average interest rate of 4.1% and a Loan-to-Value Ratio (LVR) of 70%. Near prime mortgages account for 38% of the portfolio with 16% interest only. Due to the riskier nature of these loans, the average interest rate is a whole basis point higher at 5.1% and an LVR of 72%. Euphemistically called Specialist loans make up the remaining 13% of the mortgage portfolio featuring an average interest rate of 5.8%, a 66% LVR, but only 10% of these loans are interest only. These loans are offered to customers with "life experiences that made it difficult to get a loan."

We feel the need to especially highlight the high rate of interest-only loans provided by Pepper. These loans offer significantly higher returns, but also carry exponentially higher risk. For those not familiar with the basic principle of an interest-only loan, instead of repaying part of the principle during repayments, the borrower only pays the interest, leaving the loan's principal balance unchanged. Therefore, the principal balance comes due as a lump sum, often referred to as a balloon payment.

We would remind readers that we have been in an extremely unusual period of low-interest rates for quite some time now. While we don't expect rates to rise sharply in the next few years, we cannot deny that it seems this historical period is likely in its final chapter based on current industry and political sentiment. We would be concerned that these loans, even those that are prime, could face difficulties if interest rates were to rise suddenly, especially with prime's average rate already at 4.1%.

The minor spice

As we mentioned above, asset finance loans generated 24% of total operating income during 2020, despite only accounting for $2.6bn in assets, or 17% of the total loan book ($2.6bn). This division was founded in November 2014 and focuses exclusively in Australia. As of 31 December 2020, NSW, Vic, Qld and WA accounted for 92% of loan origination, with the vast majority being offered to clients looking to purchase a motor vehicle. These loans are considerably smaller than a mortgage, averaging under $25,000 during 2020.

Unlike the mortgage division, asset finance has an even split of commercial and consumer clients. This division has also seen considerable growth since its inception. Between 2015 and 2020, its AUM saw 46% annual growth, although growth did slow considerably during 2020 to only 8.3%. However, we believe this decline in growth can be mostly attributed to COVID-19, but the division is maturing and we believe will likely see growth more in line with 2019's growth rate of 33% going forward.

Valuation is still too spicy

Pepper IPO-ed on the ASX on 25 May 2021 at $2.89 per share and the result could really only be described as very weak. The stock ended that day hovering around $2.60 per share and has come nowhere near its IPO price since. To be blunt, we agree entirely with the market's assessment. Pepper has experienced strong growth in the past, but it is a high-risk lender in what can only be described as the last chapter of a low-interest rate era.. The market is already skittish about interest rates rising slightly, and with Pepper's high exposure to interest-only loans, we believe the company likely IPO-ed right at the end of the good times.

Despite the drop in price, we don't believe the risk is properly accounted for in the valuation quite yet.

The company is trading at a Price/Tangible Book Value of 1.0x and an FY22 Price/Earnings ratio of 8.4x, but we believe a steep discount is required to make up for the company's high exposure to interest only loans. As we have seen, whenever the market hears the word inflation, stocks take a hit and we believe Pepper's portfolio interest rate risk will leave it more vulnerable to these market swings. Therefore, it is two stars from Stocks Down Under.

GR ENGINEERING SERVICES

Contract wins point to shareholder gains

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Share price chart

Source: Tradingview

Big turnaround in 1HY21

GR Engineering Services provides process engineering, design and construction services to the mining and mineral processing industry. The company is involved in a range of precious metal, base metal and industrial mineral projects, such as Dalgaranga Gold, Mt. Morgan and Nova Nickel. Its services run the gamut from the initial evaluation and study phase to design, construction, commissioning and operational support. Approximately 60% of revenues came from this core operation in FY20. The remainder came from the Oil and Gas segment, which provides offshore operations, maintenance and well management services to the oil and gas sector.

The company engineered a solid FY20. Revenue grew 22% to $222.4m, driven by a strong second-half performance. Despite the tough trading conditions in the mining and energy sectors, COVID-19 did not have a material impact on the FY20 result. Underlying EBITDA was $11.3m and the loss before tax was $9.7m. What did hurt profitability was the impairment of an outstanding receivable owed by Timor Sea Oil & Gas. Even with the $17.6m write off, the company's cash position increased to $37.5m allowing the FY21 project pipeline to move forward as planned. Absent the bad debt, profit before tax (PBT) would have been down 10% to $7.9m.

1HY21 got off to a very strong start with revenue up 85% to $176.4m, PBT swinging from a loss to a $12.6m profit and NPAT positive at $8.5m. Project, operations and maintenance activity was elevated in both the minerals processing and oil and gas businesses — and isn't likely to slow down in the back half of the year. Management expects the first half momentum to carry through and is predicting record revenue of $340m to $360m in FY21.

Leading gold EPC contractor

The company's strong level of cash generation in FY20 and 1HY21 helped bolster an already solid balance sheet. As at 31 December, the cash balance had swelled to $52.8m, putting GR Engineering in an even stronger position to execute its projects and seek new opportunities. It also supported the ability to issue a 5c fully franked dividend after handing out an unfranked 2c dividend for 1HY20.

GR Engineering has a strong order book that extends well into FY22. There are nine new or ongoing projects in the Mineral Processing segment, including eight in Australia and one in Mexico, where it is engaged in the US$4.5m San Dimas Silver Mine Project. The largest work is the $107.9m Lake Way Project, owned by Perth mineral explorer Salt Lake Potash (ASX: SO4) that we wrote about in Stocks Down Under on 16 July 2020. The size and quality of the order book are important as they dictate future cash flows — and ultimately shareholder returns. In addition to the contracted work, GR Engineering has a minerals pipeline of seven opportunities worth more than $600m.

The company recently added two new projects to its portfolio. On 10 February 2021, it was awarded a $57.2m contract with Perth-based gold producer Pantoro (ASX: PNR, see article on 28 April 2020) for the Norseman Gold Project located in the Eastern Goldfields of Western Australia. GR Engineering will engineer and construct a new processing plant and engineering works have already started.

Then on 29 March 2021, it secured an EPC contract win from Perth gold and silver miner Calidus (ASX: CAI, see article on 5 November 2020) for the process plant at the Warrawoona Gold Project in the East Pilbara district of WA. This contract is worth $75.5m and main construction activities are underway.

So, to put these wins in perspective, over the course of just a couple of months, GR Engineering executed two contracts worth $132.7m, more than half its revenue for all of FY20.

Higher oil a plus

We haven't spent as much time on the smaller oil and gas segment, but this is a key attribute of an investment in GR Engineering. Why? Through its wholly owned Upstream PS subsidiary, the revenue streams in this business are longer-term, because they involve extended contracts for operations and maintenance work. Upstream PS also does some project-based work, but the service revenue it generates provides a solid base that the company can augment with the more volatile, but lucrative mining project revenue.

The oil and gas business is also expected to benefit from higher oil prices. With Brent crude oil prices having more than tripled from their April 2020 bottom, activity among oil producers has picked up considerably and will likely stay elevated as oil prices remain high. This means there will be more demand for upstream production services, including in the Perth Basin, Timor Sea, Queensland, and Victoria, where Upstream PS has a strong presence.

GR Engineering shares trade at roughly 10x for FY22 earnings, which is not a lot to pay for a company expected to deliver strong revenue growth and better margins. We also like the fact that corporate insiders own a large portion of the stock. More than 60% of shares are registered to founders, directors and senior management. Like these folks, we too see good growth ahead, hence our four-star rating.

KORVEST

A small but mighty infrastructure play

Stocks Down Under rating: ★★★★

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Share price chart

Source: Tradingview

Galvanising profit growth

Korvest's main operating segment is Industrial Products, which accounted for more than 90% of revenue in FY20. This business is involved in manufacturing cable and electrical support systems, sheet metal fabrication, safety access systems for mobile vehicles, fittings and torque and tension tools. Within the segment, the company operates three brands—EzyStrut, Power Step and Titan Technologies. EzyStrut holds the leading position in Australia's cable supports market. The other operating segment is Production, which is the Korvest Galvanising business. This unit provides hot dip galvanising services and owns the longest galvanising kettle in Australia.

The challenges of COVID-19 have had only a modest impact on Korvest's operations. In 2HY20, its supply chain and end markets faced little disruption, customer payment patterns didn't change and bid activity around major projects was unaffected. The company wisely built up its inventory of raw materials and key items, which helped it weather the storm. However, there was a brief period around May 2020 where a slowdown in major project work impacted revenue and qualified Korvest for $1.06m of JobKeeper income.

Overall, the FY20 result was solid as sales increased 3.7% to $63.1m while net profit after tax (NPAT) rose 39% to $4.0m. Interestingly, the much smaller Production segment had a great year with sales up 16.5% compared to 2.5% in Industrial Products thanks to increased project work, reduced electricity costs and lower zinc pricing. On the Industrial Products side, the EzyStrut business worked on two major projects in 1HY20 but none in 2HY20.

The improvement in profitability supported a 27% uplift in the dividend to 28 cents. As we'd expect, the first half of the fiscal year was stronger than the back half when Korvest recorded a $710k credit loss expense related to the pandemic.

Costs and competition pressure margins

The headline numbers for 1HY21 were not as strong as in FY20 and that is largely why the share price has trended lower since late January 2021. Sales fell 9.7% to $32.6m and NPAT growth slowed to 33% due to a decline in project work amid general market weakness. Sales and profitability were down in both operating segments. The key EzyStrut business had one less major project in the period and competitive pressures weighed on project margins.

Korvest took in additional JobKeeper funds during the period to bring the sum to $1.86m, but it did not qualify for Job Keeper 2. This was a good thing, though, because it showed that there is strength in the underlying business. However, the effects of COVID-19 were more pronounced in 1HY21 with international shipping delays and rising inputs costs weighing on performance. Production was also impacted by the 3-day lockdown in SA, although the Victoria branch continued to operate during that prolonged lockdown.

We like Korvest's balance sheet strength. The cash balance nearly doubled from FY19 to FY20 and after heavily investing in its factories in FY20, property, plant and equipment assets swelled to $15.9m. Much smaller amounts on the liabilities side of the balance sheet made for a $32.6m net asset position as at FY20, increasing in each of the last two fiscal years. This was no small feat given the challenges of 2HY20. The balance sheet continued to look strong in 1HY21, with net assets growing to $34.2m.

Strong infrastructure pipeline

Although Korvest is a small company and one of many players vying for infrastructure work, its diversification and reputation of the EzyStrut business should make it a significant beneficiary of the country's infrastructure plans. In FY20 the company secured a major infrastructure project that started in July 2020 and continued throughout FY21. Over the next three to five years Korvest's infrastructure project pipeline is strong thanks to the Government's record $110bn land transport infrastructure program. Korvest is in the bidding stage for multiple major projects, which are set for delivery over the next few years.

Like us, company insiders have recognised Korvest's growth opportunities ahead, including director Gary Francis. On 17 March 2021, Mr. Francis bought nearly $11k of Korvest stock at a price of $4.11. The on-market purchase brought his total interest to 8,947 shares. It's always good to see an insider with significant skin in the game, because it shows that people with intimate knowledge of a business have a positive view of where the company is headed.

We believe Korvest stock has upside potential stemming from elevated infrastructure activity in addition to offering a high dividend yield. This combination of growth and income is uncommon in the small cap share universe. Therefore, it's an 'Ezy' four stars from us.

Pitt Street Research Pty Ltd

95 Pitt Street, Sydney, NSW 2000, Australia

Pitt Street Research Pty Ltd is founded on more than 40 years of combined experience researching companies in a range of different sectors.

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