STOCKS DOWN UNDER

16 JULY 2021

Small Cap Stocks Down Under

> *Go to Heaven for the climate, Hell for the company.*
>
> **- Mark Twain (1835 - 1910), American writer**

UNITED OVERSEAS AUSTRALIA

Investments to the rescue

HUBIFY

Growth hub

OVATO

Printing a ghost ship

UNITED OVERSEAS AUSTRALIA

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Stocks Down Under rating: ★★★

ASX: UOS
Market cap: A$1BN
Dividend yield: 2.6% (0% Franked)

52-week range: A$0.65 / A$0.82
Share price: A$0.76

United Overseas Australia has a bit of a confusing name as it sounds like a travel organisation. However, in actuality, it develops and resells land and buildings, owns and rents out properties, operates hotels and food outlets, and invests in the UOA REIT. Despite the difficulties of 2020, management pulled a strong result out of its hat, but you wouldn't know that from looking at the price of the stock.

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HUBIFY

Growth hub

Stocks Down Under rating: ★★★★

ASX: HFY
Market cap: A$40.8M

52-week range: A$0.025 / A$0.14
Share price: A$0.083

Hubify used to be a simple telecommunications services company, but has transformed itself into a service-driven technology company specialising in business connectivity. With the aim of providing low-cost solutions and exceptional customer service, Hubify is primed to face the challenges of the future. In 2020 and into 2021 Hubify has executed very well on that vision, in our view.

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OVATO

Printing a ghost ship

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52-week range: A$0.002 / A$0.019
Share price: A$0.003

Headquartered in Pyrmont, New South Wales, Ovato is back in action after having been suspended from the ASX following insolvency proceedings during the second half of 2020. The company believes its newly positioned balance sheet and consolidated operations will make for a strong comeback, but we are far from convinced. Instead of investors betting on the ship being righted, we believe they are betting on a ghost ship.

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Share price chart

Source: Tradingview

No flying required

UOS operates through two main divisions: land development & sale and investments. During 2020, the company generated $865m in revenue across these divisions, a decline of 14.1% year-over-year. Despite the decline in revenue, net income after tax increased 3.7% year-over-year to $145.2m. UOS' main source of revenue comes from land development and sale, where the company develops office and apartment buildings across Australia, Vietnam, and Malaysia.

When we look at profit before tax and total comprehensive income for the year, the results were less than perfect. Income tax dropped 41.6% year-over-year due to $10.6m of deferred tax provisions, causing a 3.7% increase in net income after tax. Excluding this drop in income tax, profit declined 9% year-over-year to $177.1m. Moving onto total comprehensive income and the result was hit hard by a loss from currency exchange rates of $122.5m, compared to a gain of $25.2m during 2019.

Despite the international nature of UOS' operations, we believe it is best to look at the company's earnings on a like-for-like basis. The company has operations in Australia, Vietnam and Malaysia. Since Vietnam and Malaysia are known for having currencies that are quite volatile, it is important for investors to keep in mind the operations' vulnerability to currency fluctuations.

2020: the year of investments

Unsurprisingly, the land development and sale division underperformed in the tough climate of COVID-19. Generating $483.9m in revenue and $97.7m in profit for the division represented a decline of 29% and 9.8%, respectively. The company was able to consolidate its general and administrative expenses rather significantly during this period, saving the land development division's profit from a serious decline. When we consider the fact that Malaysia, where this division's results originate from, has been walloped by COVID-19, we believe a 9.8% decline is actually a rather strong result.

What saved UOS' 2020 net profit from a serious decline was actually the investment division, primarily operating in Vietnam and Australia. The company owns shares in two Malaysian listed entities through this division and purchases investment properties for lease. However, for all intents and purposes, the equity investments seem to make up the majority of this division's results, although the company is far from transparent with the results.

UOA Development (71% owned) and UOA Real Estate Investment Trust (34.05% owned) are the equity holdings in question. For 2020, this division generated $366.1m in revenue and $36.3m in profit, an increase of 20.9% and 73%, respectively. Exactly like the development division, a sharp decline in general expenses led to the sharp differences in profit and revenue for the investments division.

Some serious executive buying

On 13 May 2021, the Managing Director, Mr Kong, increased his holdings in UOS by 1m shares. While the cost was high, $725,000 at $0.725 per share, this off-market transaction only increased his holdings by less than 1%, as he already owned slightly under 1.1bn shares prior to the transaction. Still, we believe $725,000 is a large enough amount to be considered a sign of support for UOS' shares at $0.725.

Unfortunately, with no market or management forecasts available, there is still great uncertainty surrounding 2021's results. When we factor in the volatile nature of Malaysia and Vietnam's currency exchange rates and the damage done to both of these countries by COVID-19's ongoing outbreaks, the uncertainty translates into risk. Therefore, we would advise investors to avoid UOS at this time, especially with a free float of only 8.6% and an average daily traded volume of 40,000 over the last three months. We think the risk is too high, so it's three stars from us.

HUBIFY

Growth hub

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Share price chart

Source: Tradingview

New name, new focus

If the name Hubify does not immediately resonate with you, it's not your fault. Until November 2020, Hubify was known as United Networks (ASX:UNL). United Networks was primarily focused on telecommunications and was consumer-focused, providing Embedded Sims (eSIMS) for compatible smartphones in over 30 countries. eSIMS are programmable computer chips found in many smartphones, used to transmit data without having to insert or swap a physical SIM card. It was a great business once upon a time, but that was then, and this is now.

By 2020, after numerous acquisitions, such as Broadland, the scope of United Networks had become a lot wider than just telecommunications, instead focusing on business connectivity as a whole. The company was now providing fibre networks, cloud solutions and communication packages (e.g. hosting voice solutions). The company had made the important switch from being consumer-focused to being business-focused. So, a name change was in order.

Australia's bandwidth challenge is Hubify's opportunity

Australia is known for having one of the worst internet services relative to its standard of living. Since 2007, the Australian government has been developing the National Broadband Network (NBN). However, it has seen mixed results, with Australia's overall internet speed ranking continuing to decline over the last decade, according to research from Akamai.

This shows how Hubify can be useful. A company operating in remote parts of Australia or one that has an immense need for bandwidth would be much better off with a dedicated fibre connection if it is an economically feasible decision to make. Hence, the substantial revenue increase Hubify has seen over the last few years.

What COVID-19 taught us about working remotely

While segment data on Hubify is not available as the company accounts for all its operations under the same segment, the steady increase in revenues (amounting to A$9.0m in 1HY21) is very simple to understand. COVID has required businesses to switch to working remotely and Hubify has been there to assist them in this transition.

More importantly, companies are beginning to realise that many of them don't even need a physical, central workspace. According to Salesforce data, most employees can be as productive working remotely as they could be at the office. Once you consider the additional benefits of working from home (e.g. less commuting, more personal time and more employee satisfaction), it is not surprising that many companies across the world are interested in normalising working from home and continue it even after the pandemic.

As such, we believe Hubify is in a prime position to increase its customer base as more companies will require telecommunication solutions and cloud storage in the years to come.

The oldest strategy in the book - buy rather than build

The name change to Hubify reflects the company being a 'hub' for various business connectivity technologies. Under its current strategy, Hubify plans to grow by serially acquiring businesses of a similar nature.

At the beginning of March 2021, Hubify completed the acquisition of the Queensland telco database from Net Hoster. With A$6m in cash remaining after that acquisition, the company is already looking ahead to its next one, according to the CEO Victor Tsaccounis.

This, coupled with the aforementioned switch to remote working and the increase in demand for Hubify's services, should point to a bright and profitable future for Hubify. However, we must also consider the price of the company, as we believe some of the expected growth has already been factored in by investors.

Cashed up

Apart from acquisitions, Hubify plans to grow organically with expansion into new areas and unification of the brands under the Hubify banner to deliver revenue-driving synergies. At the beginning of 2021, Hubify had over A$6.8m in cash and no debt, allowing it to invest heavily in growth in the next few years, including acquisitions.

If the company continues to acquire the right targets, i.e. companies that can create synergies with their current brands, Hubify should be able to continue to grow at a reasonably high rate. Some of the fundamentals may point to the company being slightly overvalued currently, but considering the growth potential and current growth trajectory, Hubify looks like an interesting investment. Four stars from us.

OVATO

Printing a ghost ship

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Share price chart

Source: Tradingview

Printing a new ship

Ovato is in the marketing business, but not in the way you might think. Ovato in fact operates in printing, distribution as well as marketing campaign design and execution. Like many other companies in old school industries, like printing and distribution, Ovato has been struggling and actually collapsed last year.

On 21 December 2020, the New South Wales Supreme Court approved a scheme to combine and attempt to recapitalise four companies into a consolidated organisation, known today as Ovato. Through this approved scheme, the company could write off $35.9m of bad debts and obligations and raise $40m in a 10.93-1 rights offer at $0.005 per share. Additionally, bondholders had their remaining $15m in remaining debt converted to 3bn new shares, also at $0.005 per share. When all was said and done Ovato still had considerable debt on the books, with net debt at $34.7m on $39m in cash.

The details that make up the print

In FY20, total revenue amounted to $539.3m and like much of the print industry, this was far from profitable revenue. Unfortunately, the company splits its operations into New Zealand and Australian operations and is far from transparent. The Australian division is broken down by revenue, but the New Zealand division is not.

The Australian operations accounted for 83.3% of total revenue in FY20, which is significant enough to take the Australian operations as a gauge for the company's future revenues and earnings.

Historically, the company's primary business was printing, from commercial-sized jobs, catalogues, magazines, newspapers and packaging. In FY20, 69% or the $311m in revenues was generated through these printing operations.

The second-largest division in FY20 was distribution at 25% of revenues, or $280.5m. Ovato's distribution business handles residential catalogue, samples and newspaper delivery. The company also has a smaller business-to-business operation that delivers magazines to retailers, such as convenience and grocery stores.

The last division is marketing services, generating $26.6m, or 6%, of FY20's total revenue. The marketing division is the only service offered by Ovato that only operates in Australia. The division designs, creates and manages marketing campaigns from start to finish.

3Q21 not giving us much hope

After the recapitalisation, there was certainly hope in the market that this plan would work. As we mentioned above, the new shares were issued at $0.005 and leading up 3Q21 results, the stock stayed mostly above this issue price. That is, until April when it dropped and started bouncing between $0.006 and $0.005. Since 30 April 2021, when results were released, the shares have stayed below $0.005.

The reason for this is rather apparent as the 3Q21 results were far from the obvious turnaround management had been touting during the offer period. Cash and equivalents dropped $19.4m to $15.3m during this period after printing and residential distribution underperformed expectations, with COVID-19 being blamed. The company has now stated that it doesn't expect improvement until at least FY22. But with Ovato's historical track record, we are not so sure things will improve.

Betting on a ghost ship

The struggle to keep this newly printed ship afloat is why we titled this article Printing a ghost ship. For those who don't know, a ghost ship is a ship where the entire crew is absent. Historically, it is not uncommon for these boats to have slipped off their moorings and drift out to sea. The point being, these boats have no real substance and are often incur serious damage.

We see sharp parallels here to the new Ovato. The industry was already in rough seas long before COVID-19. And the pandemic has certainly made things a lot harder. We don't think the company is at risk of another receivership anytime soon. However, based on its cash burn rate during 3Q21 and management commentary on its future prospects, we believe the company will need to issue large amounts of new shares as it continues its attempts to right the ship.

All-in-all, we don't see how Ovato could sustainably improve its prospects. No sense betting on a ghost ship, two stars.

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.