STOCKS DOWN UNDER

13 AUGUST 2021

Small Cap Stocks Down Under

"Hard work keeps the wrinkles out of the mind and spirit."

- Helena Rubinstein (1872 – 1965), Polish-American businesswoman

TUAS

A lot of uncertainty

MITCHELL SERVICES

Drilling for value

VERBREC

A lot in a small package

TUAS

A lot of uncertainty

Stocks Down Under rating: ★★

ASX: TUA
Market cap: A$348M

52-week range: A$0.47 / A$0.85
Share price: A$0.85

One of the biggest deals during 2020 was the merger between TPG Australia and Vodafone Hutchison Australia to create the new entity TPG Telecom (ASX: TPG | see 21 June 2021 report). As part of this merger, TPG Singapore was demerged to form Sydney-based Tuas. Tuas' stock has been trading mostly sideways since the start of the year, although we have recently seen a tiny bump.

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Market cap: A$101M

52-week range: A$0.36 / A$0.62
Share price: A$0.50

Headquartered in Seventeen Mile Rocks, 11km south-west of Brisbane's CBD, Mitchell Services is a provider of drilling services to the mining and energy industries in Australia. At Stocks Down Under we're quite bullish on the growth opportunities across the mining sector, especially the independent drilling industry. However, we don't believe the market has caught up yet to the opportunities available for companies like Mitchell, providing plenty of opportunity to drill for value.

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Headquartered in Brisbane, Verbrec is a company that does a lot in a small package. The company might only have a market capitalisation of $38m, but it spans six different businesses. The company operates mostly within the water utility, mining and hydrocarbon industries and is profitable with operations in Australia, New Zealand and Papua New Guinea. Shareholders were presented with a strong return of 40% during 2020, but the stock has recently taken back all of those gains and returned to its opening price from 2020. Is now a good time to buy?

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Share price chart

Source: Tradingview

The one left behind

In June 2020, it finally happened. The great merger of the two declining telecommunications giants TPG Australia and Vodafone Hutchison Australia closed. We first published a report on the new combined entity, TPG Telecom on 11 August 2020 when the stock was $8.15 per share, placing a two-star rating on it due to the declining nature of the two combined entities. We viewed this as an attempt to right the ship in an increasingly competitive industry environment by combining two slowly collapsing giants, a desperate measure that does not often work in the long run. With the share price declining to $6.21 since our first report, the market clearly agrees.

TPG Australia decided to spin off TPG Singapore into a new holding, Tuas, as part of the merger. TPG shareholders received one share in Tuas for every two shares of TPG they owned. Therefore, on 30 June 2020, shares in Tuas began trading on market with the stock closing at $0.67 per share. It quickly rallied to a 52-week high of $1.14 per share. However, much to shareholders' disdain, the shares quickly declined to around its 30 June 2020 closing price with yesterday's closing price at $0.85 per share.

A brief look at history

As we mentioned, we believe the new TPG Telecom entity is still likely to suffer from its predecessors' operating problems. To understand if Tuas risks falling into this same rut, we have to take a brief look at its history. As of 30 April 2020, TPG Singapore had approximately 7,000 paying subscribers and 412,000 free trial users on its 4G, SIM-only post-paid service. The company is one of the newer players in Singapore's telecommunications industry, only gaining its spectrum band licences on 14 December 2016. It took the company slightly over two years to launch its first free service trial and its first paid plan launched on 31 March 2020, achieving 99.7% overall outdoor mobile coverage in Singapore.

Currently, the company owns 11 4G spectrum band lots: two lots of 2x5 MHz in the 900 MHz spectrum band (30 June 2033 expiry), eight lots of 5 MHz in the 2.3 GHz spectrum band (30 June 2033 expiry) and one lot of 2x5 MHz in the 2.5 GHz spectrum band. The company constructed and owns its own telecommunications infrastructure.

Tuas believes it can easily upgrade to 5G technology. Unfortunately, the Singaporean government declined its application to acquire spectrum in the 3.5 GHz band. This does not mean Tuas is out of the 5G game, but it makes the company's likelihood of joining the 5G fight anytime soon significantly lower.

An uncertain future

Tuas is slated to release its FY21 results (ending 31 July 2021) to the market on 28 September 2021. Unfortunately, management seems to have opted for the silent treatment until then, releasing a total of four announcements during all of 2021: an Appendix 3G, the FY21 reporting calendar, a change in company secretary and address and a new substantial holder. Due to the uncertainty surrounding this new, separate entity following its failure to win any of the 5G spectrum bands, we believe this lack of communication is not a good sign. Relying on the latest information provided, between 11 March 2020 and 4 September 2020, the company generated $4.3m in revenue, resulting in a loss after tax of $3.5m.

In conclusion, with a trailing 12-month EV/Revenue 56.1x, no management guidance and no clear path to achieving 5G spectrum coverage, we believe Tuas is a clear two-star stock.

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Share price chart

Source: Tradingview

Drill, Australia, drill

We are quite bullish on the long-term staying power of the current emerging commodity price boom, apart from iron ore. A prime example of this is copper, where a recent report from Goldman Sachs, titled "Copper is the New Oil", predicted an average price between US$14,000 and US$15,000 per ton in 2024. Not to rely on one report, our own analysis indicates that the low levels of inventory, coupled with lag time in bringing new mines online, makes this price target very achievable, in our view.

As prices continue to climb over the next few years, we expect many new mines to emerge and increased drilling across existing ones. The Australian Bureau of Statistics regularly releases a slew of data about the mineral exploration industry in Australia. We took the time to analyse its December 2020 release on expenditure and metres drilled. We found that during 1HY21, the total metres drilled in new deposits in Australia totalled 2,073.5m, resulting in the largest half-yearly number since the ABS began releasing data in 2003. Combined with the fundamentally-backed materials boom, we believe drilling is likely to result in record-breaking figures during 2HY21 and FY22.

Drilling into Mitchell's clients

Mitchell currently operates across all of Australia through its centres in Queensland, New South Wales, South Australia and Western Australia. During FY21, the company generated $191.4m in revenue (9% growth) and $35.7m in EBITDA (17.4% growth). Interestingly, much of this growth seems to be generated through contract wins with 'other clients'.

Mitchell splits its current client base into tier 1 clients and 'other clients'. Tier 1 clients are (unnamed) large and multinational mining and energy companies. Over the last three years, other clients have become an increasingly large portion of revenue, growing from 8.7% in 1HY19 to 19.6% in 1HY21. Since most tier 1 client revenue is generated through long life, low-cost existing mine sites, we believe revenues from new mine development are likely to be generated through smaller mining clients going forward. This explains the increase of other clients as a percentage of total revenue over the last few years.

Faux expectations driving the market

We believe the market does not follow Mitchell closely enough to truly understand its earnings potential. Currently, only one analyst, who is expecting underlying EBITDA to reach $32m in FY21, actively covers the stock. This is despite a 29 April 2021 3Q21 update putting underlying EBITDA guidance for the year between $34.6m and $38.6m. FY21's actual results ended up being $35.7m as stated in the company's recent 4Q21 earnings release.

Additionally, management has made many comments consistent with our own analysis, that demand for drilling services is entering a new boom. We expect this boom to continue well into FY23, which is why we think the market's FY22 and FY23 EBITDA forecasts of $40.5m (26.6% growth) and $39.4m (2.8% decline) are too low. We think it's unlikely that growth will be limited to just 26.6% during FY22 and that the company will experience a decline during FY23 based off of our industry and macro analysis. However, the market has clearly priced Mitchell as if FY23's market expected EBITDA decline is a certainty, at an FY22 and FY23 EV/EBITDA ratio of 2.7x and 2.8x, respectively.

There is one major risk to our investment thesis; that the mining boom we are expecting won't last through FY23. However, at the current valuation, we believe the downside is limited as the market has already seemed to price this in. Based on what we view as a low amount of risk for a significant amount of reward, Mitchell deserves a four-star rating from us.

VERBREC

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Share price chart

Source: Tradingview

A lot in a small package

For a company with a total market capitalisation of only $37.5m, Verbrec is involved in a lot of different industries. The main business operates in three industries: hydrocarbons, mining and infrastructure (hydro). Verbrec provides a whole slew of services to its clients, including project management and development, engineering and design, training, construction, etc. Unfortunately, the company's operations were heavily exposed to COVID-19 and this caused revenue and EBITDA to slide during 1HY21 to $47.6m and $4m, respectively. 1HY21's results were not all bad news, however. Despite the 26.2% decline in revenue, EBITDA margins still rose by 0.7%-points to 8.3%.

The company's revenue is split into two main sources: services and training. Services revenue generates the vast majority of Verbrec's revenue at $44.7m during 1HY21, split between Australia and New Zealand. These revenues declined 27% year-over-year.

Services is split into asset management, digital industry, pipelines, power and process plant. Asset management can be mostly described as a consultancy for pipelines and gas storage facilities. The digital

industry focuses on providing systems consultation, industry analysis as well as design and implementation of new digital systems. The main business Verbrec is involved in is its pipeline sub-division where it provides consultancy and construction services to oil, gas, water and slurry pipeline operators. If you are looking for assistance with power system modelling, design, testing or if you want to make sure its up to code, Verbrec's power services might be right for you. The last subdivision is called process plant, i.e. engineering and consultancy services for everything from gas storage facilities to stormwater pipelines. The services division could be classified as mostly consultancy and inspection services, but Verbrec defiantly offers its clients much more than that.

The training division is a small, but growing division, although you can't tell that from 1HY21's results. This division generated $2.9m in revenue during this period, a decline of 22% year-over-year. Despite the decline in revenue, we are rather bullish on this division's prospects. You see, a large reason for the decline in revenue was specifically related to COVID-19 and the concern around taking classes in person. While the company switched to online learning, as the company teaches specialised courses and site training for sophisticated industries like pipeline operation, the transition was definitely difficult. Now that industry has restarted in Australia, we believe demand is likely to rebound during 2HY21 and FY22.

Additionally, the company has entered into an agreement to acquire Site Skills, a competitor in the training industry. The cost is expected to be $1.4m, with the potential for another $2.9m to be paid in cash if certain performance metrics are met between the acquisition and August 2023. This acquisition is expected to triple the company's training revenue to approximately $18m per year, with around $2m in additional EBITDA from the acquisition alone.

Directors buying is always a good sign

Between 26 February 2021 and 12 August 2021, two company directors have acquired a significant number of shares on market. The Non-Executive Chair, Phillip Campbell purchased 520,000 shares during this period. However, it is important to note that while he joined Verbrec back in October 2019, he did not own shares before the recent share purchases. Non-Executive Director Matthew Morgan also joined the company in October 2019. During the period mentioned above, he purchased 378,205 shares, although he did also sell the 27,027 shares he owned before the 128,205-share purchase. This left him with a net position of 378,205 shares when all was said and done. While these purchases are far from earth-shattering, they are still significant enough to warrant a mention

A long-way to go

Like many companies listed on the ASX, Verbrec is not currently providing earnings guidance and, unfortunately, there are no estimates from analysts either. The only indication we have is the 28 June 2021 market update that the company's backlog has reached $70m, a 56% increase from 31 January 2021. Despite the rough 1HY21, we believe that this was mostly due to industry delays caused by COVID-19. Once Australia is largely COVID-19 free, or at least mostly vaccinated, we believe we will see a rebound sometime later this year or in 2022. We are bullish when it comes to the training division, especially after its Site Skills acquisition was announced in February 2021. However, we are still concerned about the future of the services division that accounts for the vast majority of revenues. Therefore, despite the company's fairly low trailing 12-month EV/EBITDA ratio of 4.3x, we believe VBC is a three star stock at the moment.

Pitt Street Research Pty Ltd

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