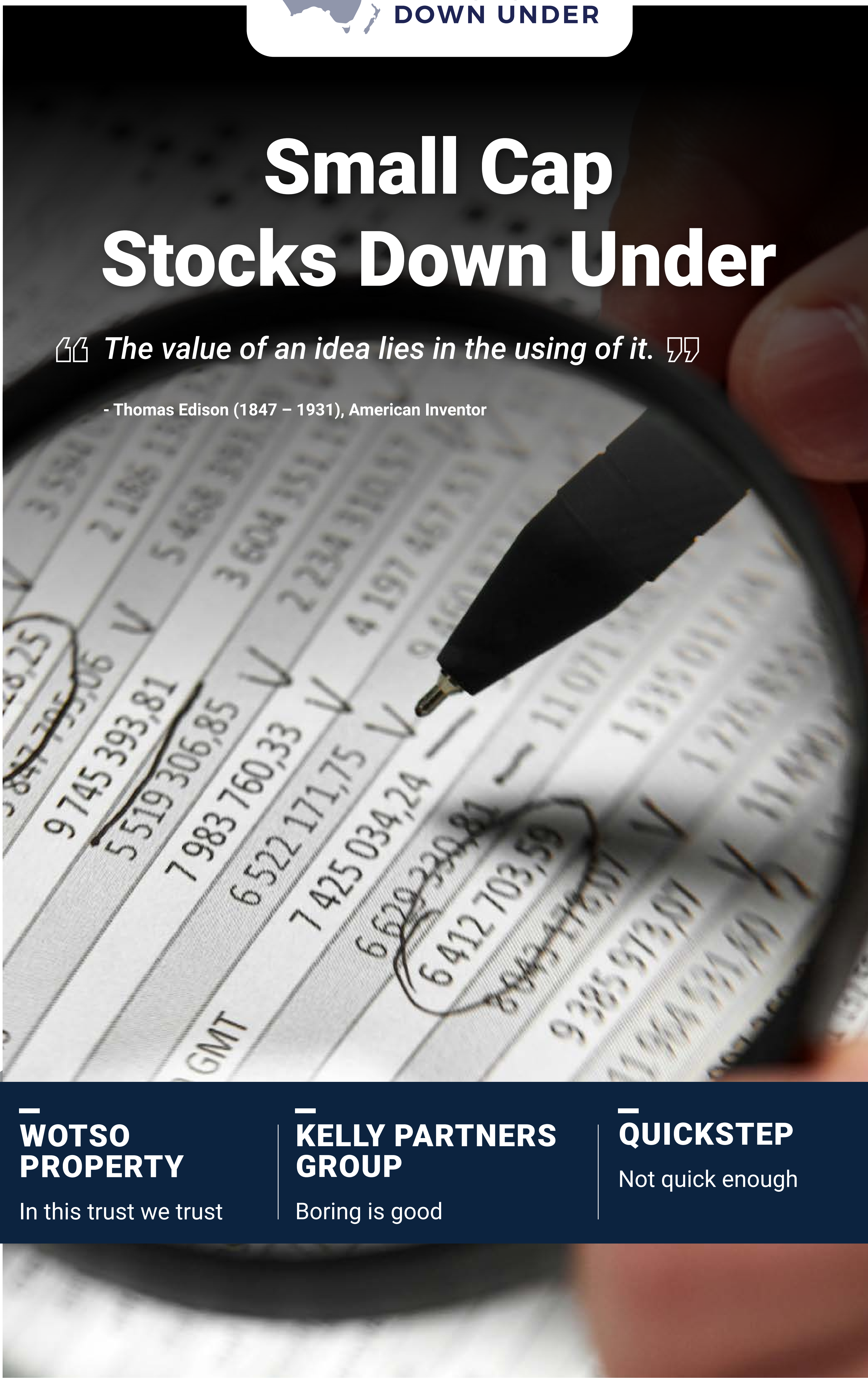
STOCKS DOWN UNDER

27 AUGUST 2021

Small Cap Stocks Down Under

“The value of an idea lies in the using of it.”

- Thomas Edison (1847 – 1931), American Inventor



WOTSO PROPERTY

In this trust we trust

KELLY PARTNERS GROUP

Boring is good

QUICKSTEP

Not quick enough

WOTSO PROPERTY

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Stocks Down Under rating: ★★★★

ASX: WOT
Market cap: A$ 230M
Dividend yield: 4.6% (0% Franked)

52-week range: A$1.20 / A$1.47
Share price: A$ 1.40

WOTSO Property is a company we last wrote about on 14 August 2020, back when it was called the BlackWall Property Trust. On 9 February 2021, the company finished stapling its largest property tenant, WOTSO, and commercial property owner Planloc to its property holdings. The combined entity is now named WOTSO Property and just like its predecessor, BlackWall, we believe the market has heavily underestimated its true value, a sentiment Non-Executive Chairman Seph Glew has been backing with on-market share purchases.

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ASX: KPG
Market cap: A$ 153M
Dividend yield: 1.3% (100% Franked)

52-week range: A$1.17 / A$4.13
Share price: A$ 3.40

With the Australian Tax Office knocking on everyone's door around this time of year, we thought it would be fitting to report on North Sydney-based Kelly Partners Group, one of Australia's largest chartered accounting groups. The organisation was established in 2006 and has stayed true to its vision of mainly supporting private business owners navigating the complex finance world. Despite the wide nature of its services, the vast majority of the company's earnings is still generated through its accounting services, 100% of which is reccurring in nature. We think the strong management track record and complex business environment make Kelly Partners strong partners for your portfolio.

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Market cap: A$ 35.8M

52-week range: A$0.044 / A$0.095
Share price: A$ 0.054

Headquartered in Sydney, Quickstep provides the aviation market with a valuable service, i.e. the production and innovation of carbon fibre composite parts. These parts are lighter, faster and more cost-effective than most of its competition, leading to significant contract wins with major companies, like Lockheed Martin, Boeing and the Chemring Group. However, FY21's report came in highly underwhelming and we now must wait untill November for management's outlook. We think the company has come far, but we think its best to sit on the sidelines until we hear more in November.

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Share price chart

Source: Tradingview

New name, slightly new business

A lot has changed since we last wrote about Wotso Property Trust (known then as BlackWall Property Trust). The company has bought out the remaining shares of its investment in WOTSO, purchased Planloc and formed a whole new stapled entity. The new entity is split into three parts: BlackWall Property Trust, WOTSO and Planloc. BlackWall Property Trust owns 14 commercial, industrial and office properties in NSW, QLD, ACT, TAS and SA.

As of FY21, these properties have an NTA value per security of $1.44, featuring a leased rate of 82%, an improvement of 2%-points compared to 2020. However, many of these properties are leased by WOTSO, and therefore, are technically leased to itself.

WOTSO operates flexible workspaces, much like WeWork and Regus, except that WOTSO is well run, not a giant frat house and makes solid business sense. FY21 was a turning point for the company due to its consolidation into the stapled entity known as Wotso Property. As of 30 June 2021, WOTSO had an occupancy rate of 68%, an increase of 9%-points year-over-year. While most office property investments have been dealt serious blows due to COVID-19, we believe WOTSO's flexible office structure will reduce the damage from lockdowns and, when COVID-19 is mostly over, offer an attractive option to companies finally re-entering the office landscape. As the saying goes, 'the proof is in the pudding'. According to WOTSO's FY21 numbers, the company has seen strong improvements with EBITDA generating a profit of $2m, compared to a loss of $2.4m in FY20. However, once depreciation is factored in, the company still generates a loss after tax.

Director buy backs

No, one of the directors has not officially initiated a buy back program, there is no such thing. But with the frequency and number of shares Non-Executive Chairman Seph Glew has been purchasing he might as well have, and we do not say that lightly. Since WOTSO became a stapled security on 9 February 2021, Seph has purchased an additional 2,551,872 shares, in ten different on-market purchases.

What makes Seph's buying spree an even greater signal in his confidence in WOTSO is that this is far from an isolated incident. When we last wrote about WOTSO's predecessor, BlackWall Property Trust, we included the fact that he purchased around 1.1 million shares at an average cost of $1.32 per share across nine periods between 14 April 2020 and 5 August 2020.

More than just its NTA

In our report on Blackwall last year, we were focused on things like the company's NTA per share, Weighted Average Lease Expiry and occupancy rate to determine a proper valuation. However, since the new company was formed, things have changed rather significantly in our view. In particular the addition of a growth model to the analysis. Yes, the property owned by the trust is still an important part of the valuation. However, we now view FY21's NTA per share of $1.44 as a floor rather than an indicator of the trust's valuation. Therefore, we believe a separation of the trust is in order to produce a valuation accurately. The office property owned by the trust is valued at $1.44, but what about WOTSO?

WOTSO operates on a growth model and the company had a strong showing during FY21, moving from an EBITDA loss to an EBITDA profit. However, this jump was mostly due to the absence of one-off costs in FY21 that were there during FY20 ($3.4m). After we account for the changes in accounting standard AASB 16 as well, adjusted EBITDA growth during FY21 falls to 8.3%. This is still a respectable number in our view, especially during such a trying time for the office industry. Additionally, absent any management guidance, we believe EBITDA growth of approximately 8.3% is around what we can expect from WOTSO going forward.

Therefore, putting everything together, we believe a fair value for Wotso Property is currently between $1.50 and $1.55, making this a four-star trust.

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Share price chart

Source: Tradingview

It's all about the accountants

At Stocks Down Under we love a good quote and George Soros once said, "if investing is entertaining, if you're having fun, you're probably not making any money. Good investing is boring." While we don't agree with the sentiment entirely, Kelly Partners' business certainly fits into Soros' 'boring, but profitable' adage. As this analyst likes to say, "I knew I never wanted to be an accountant the first day I spent as a child at my dad's accounting firm." Accounting can provide a highly successful and fulfilling career for many, but nobody has ever accused an accountant of having too much excitement at work. And yet, it is often these types of industries that can offer the greatest and most consistent rewards. With accounting revenue generating approximately 94% of total revenue during FY21, Kelly Partners is truly all about the accountants.

Kelly Partners was founded in 2006 as two offices, one in North Sydney and one on the Central Coast. The company has grown rapidly since that time, with an average revenue growth rate of 30% over the last 15 years. While the company has grown to 26 operating businesses across Greater Sydney, Melbourne and Hong

Kong, Kelly Partners is far from a growth-through-acquisition story. The company has managed to remain out of any negative press, a rarity when it comes to major Australian accounting firms in the last two years, and has used this reputation to consistently grow its client list as well as maintain its existing clients as their businesses and net worth grow.

In fact, Kelly Partners is well on its way to meeting its FY24 goal of $80m in revenue, which would result in 167% growth since its 2017 IPO. When we factor in the mostly consistent upward trend of its EBITDA margin from 29% in FY17, to 33.4% in FY21 and an estimated 35% in FY24, Kelly Partners' results are clearly far from 'boring.'

A quick dive into the books

As we mentioned above, the vast majority of Kelly Partners' revenue is generated through its accounting division. Out of the $48.9m in revenue generated in FY21, approximately $46m was through the accounting division and this is what we will focus on. One of the unsung heroes of the pandemic has been the accountants. While we have all been constantly confused and bombarded with restrictions, cash infusions from the government and new regulations, the accountants are the ones who have been forced to reconcile all of it for when the tax man comes calling. Still, don't pity them too much, for as Kelly Partners' results show, they have been justly compensated.

We believe the company has a lot of growth left in it as well, especially in its main field of accounting. Australian private business accounting is pretty competitive, but the industry has gone through a number of changes and scandals over the last few years. Kelly Partners, though, has managed to mostly stay out of the muck. Following the company's FY20 revenue number, it is currently number 23 in the Financial Review's list of Top 100 Accounting firms. However, only two of the top 20 companies, Moore Australia and DFK Australia New Zealand, beat Kelly Partners' revenue growth of 16% during the period. We believe the company is likely to continue to advance in the rankings through its proven ability to continue to attract firms to join its group, and the lack of any scandals.

Time for a portfolio partnership

During FY21, KPG generated $18.7m in EBITDA and the market expects this to grow 13.9% to $21.3m in FY22. This is then expected to be followed by 13.1% in FY23 and 12.4% in FY24. Clearly, we are not the only ones who believe in the Kelly Partners story.

Fortunately for Stocks Down Under's subscribers, the market does not seem to have realised the company's expected, steady EBITDA growth, with FY22, FY23 and FY24 EV/EBITDA multiples of just 8.8x, 7.8x and 6.9x, respectively. Even before we factor in the company's 1.3% indicative annual dividend yield, these valuation numbers squarely put Kelly Partners in the undervalued bucket, in our view. Four stars.

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Share price chart

Source: Tradingview

Listen to the Colonel

Colonel William 'Billy' Mitchell is widely considered to be the founder of the modern United States Airforce and was the first American to fly across enemy lines. He once said "the future of our nation is forever bound up in the development of Air Power." Since he died in 1936, this has proven to be a significant foresight. Since World War Two unleashed the might of airpower and strategic bombing on the world, countries have time and time again proved air power's strategic importance. For example, one of the first things NATO did when it intervened in Libya's civil war was issue a no-fly zone and start bombing runs from the air.

Not only is air power vital to the military, but it's become essential to how our modern economy works. According to the World Bank, over 215m tons of goods were transported by air during 2019, in freight alone. Air travel has become such a vital part of our daily lives that we hardly even think about its impact anymore, and that's the sign of an essential service.

Fasten your seatbelts for some turbulence

One Australian company that has made it its mission to capitalise on the demand for air power is Quickstep Holdings. The company was founded in 2001 out of Perth, manufacturing carbon fibre composite parts for the commercial and military aerospace industry. Since then, Quickstep has expanded extremely quickly, reaching $85.1m in revenue and $7m in EBITDA during FY21. Over the last few years, this growth was due to major contract wins with some of the world's largest military and aerospace contractors. This includes Lockheed Martin, Boeing and the Chemring Group, to name a few.

Unfortunately, Quickstep has been hit by a combination of two factors that have led to disappointing FY21's result. The first is the rise of the Australian dollar. Since most of Quickstep's payments are in US dollars, the increase in value of the Australian dollar saw the company's EBITDA margin decline a whopping 1.9%-points to 8.2%. EBITDA dropped 14.7% year-over-year to $7m, despite revenue increasing 3.4%. The second reason for the decline is COVID-19 related expenses. Unfortunately, we believe both of these issues are likely to continue to plague the company in FY22, and maybe even FY23.

Executives are joining the fun

Despite the lacklustre FY21 result, executives have been buying Quickstep shares over the last few months, some a considerable amount. Three directors and director family members have been purchasing shares totalling 1.85m at an average price of $0.056 per share. We believe this can only be seen as a strong indication of director confidence in Quickstep's long-term prospects.

Its all about November

Unfortunately, we are currently left in a bit of a bind regarding Quickstep. We happen to be fans of the company's business strategy and believe management is more than up to the task in terms of execution. However, we do not believe the recent volatility of the USD/AUD exchange rate will go away anytime soon and neither will COVID-19. Management's current outlook is that the company is expected to delivery revenue growth and "substantially improved reported PBT and continued strong operating cash flows for FY22". However, we are not provided with numbers and this assurance came with a large caveat: "at current USD/AUD exchange rates".

Fortunately, management did provide us with a valuable piece of information. During the company's Annual General Meeting (AGM), we can expect significantly more information to be provided on the company's FY22 outlook. Therefore, we are in a waiting game until November.

Based on this information, we believe the current FY22 EV/EBITDA ratio of 6.6x would be reasonable prior to the company's unexpected FY21 report. However, with all the uncertainty we are facing, we believe it would be best to stay away and wait for management to clear things up in November. Quickstep has a strong track record and a competent management team, but with everything riding on November, we believe it is best to sit on the sidelines for now, so three stars.

Pitt Street Research Pty Ltd

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