Small Cap Stocks Down Under

No matter what I do with my life, or how successful I am, I will always be a socially awkward penguin inside.

- Wil Wheaton (b. 1972), American actor

SILK LASER AUSTRALIA

Things are getting hairy in lockdown

MURRAY COD AUSTRALIA

Still swimming strong

HGL LIMITED

Tummy tuck and all

SILK LASER AUSTRALIA

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Stocks Down Under rating: ★★★★

ASX: SLA
Market cap: A$ 208M

52-week range: A$3.28 / A$5.30
Share price: A$ 3.86

Silk Laser is headquartered in Parkside, South Australia. It owns and operates Australia's second-largest network of non-surgical aesthetic product and services clinics. Investors in the company's 15 December 2020 IPO have been on the road paved with silk as the stock has rallied 30% from its initial price of $3.45. However, despite raising $83.5m during the IPO, management has already come back to the market for an additional $20m. Therefore, the question needs to be asked, just how high-quality silk are investors buying?

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Headquartered in Griffith, New South Wales, Murray Cod Australia is rather aptly named as its business is breeding, growing and supplying Murray Cod. While the business may be in growing, its stock has been mired in long periods of sideways trading. That is, until early 2021 when the stock jumped approximately 100% in just three months. Although the stock has trended downwards since then, we think Murray Cod is on the right track and will just keep swimming.

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Share price chart

Source: Tradingview

Making our bodies as smooth as silk

Silk Laser controls the second-largest network of non-surgical aesthetic product and services clinics in Australia. This is not a report about a plastic surgery company, and yet, Silk certainly operates in the same sector. The company's network of clinics offers five basic categories of services, laser hair removal, cosmetic injections, skin treatments, skin concerns and skin programs. Basically, if you want to look better but are not interested in surgery, Silk probably has a program or service for you.

The company currently operates 116 clinics across Australia (102) and New Zealand (14) through a combination of corporate-owned (25), joint-ventured (26) and fully-franchised (65) clinics. A joint venture clinic has two types of operations, its either 50% or 75%-owned by Silk and the remainder owned by the franchise operator. The company has been growing aggressively in both size and earnings since it was first founded in 2009. However, this is far from the clear cut growth-through-acquisition story we are familiar with from other industry models, like the one operated by 1300 Smiles (ASX: ONT | see 15 January 2021 report). Let's dive in.

It's never enough

To paraphrase Five Finger Death Punch's song Never Enough, it's never enough, no it's never enough, no matter how many clinics I open. Silk started in 2009 as a single clinic in South Australia and has grown at an incredible rate, reaching 60 clinics as of 7 June 2021. This comes to an average of 4.9 new clinics per year, over the last 12 years. During 1HY21 alone, Silk opened ten new clinics, meeting its goal of opening ten clinics during all of FY21. In total, Silk opened 11 clinics in FY21, surpassing its organic growth goal.

However, management is far from content with expanding its clinical footprint organically, the company showed it was more than willing to make large acquisitions when it spent $50m in FY21 to acquire the ACS Group and its 56 clinics. The acquisition was funded through a combination of newly issued shares ($20m), new debt ($22.5m) and existing cash ($7.5m). Due to the nature of the clinic model, the acquisition is unlikely to result in large synergistic cost savings, currently estimated to be only $500,000 after a one-year implementation period. However, the ACS Group's clinics provide vastly similar products and services, and most importantly, grant Silk a foothold in two new markets: Victoria (14 clinics) and New Zealand (14 clinics).

What is so interesting about this acquisition is that it puts Silk well-ahead of schedule of its medium term plan. Silk's stated goal was to operate 150 clinics in its network and this acquisition brings its total clinics to 117 from 61. While there is no stated timeline as to what 'mid-term' actually means, it implies that if Silk doesn't acquire any additional clinics and just opens ten new ones a year, the company is only 3.3 years away from its goal. However, since we find it extremely unlikely that Silk will refrain from further acquisitions, we would be surprised if it did not reach 150 clinics in of the next year of two.

Growth is not entirely through new clinics

Silk is in a business with high levels of recurring clientele and we believe this is the fundamental basis upon which its growth is based. Yes, the company is aggressively acquiring competitors and opening new locations, but we believe there is ample evidence that FY21's 128% EBITDA growth, to $14.8m, is due in large part to solid organic growth. During FY21, Silk saw like-for-like growth in its network clinic sales rise 52% year-over-year, while the number of customers in its database rose 28.8% to 358,000. We like this sort of organic growth!

Expect additional dilution in the future

Before we jump into Silk's valuation, there are two risks that we believe must be addressed. The first is shareholder dilution. As part of Silk's store opening and acquisition strategy, the company has previously relied heavily on additional influxes of capital from the market through the issue of new shares and we don't see this changing anytime soon. While the dilution is unlikely to be catastrophic, and the proceeds will be put to good use, it is still a risk investors must keep in mind. The second risk is the recent string of lockdowns and restrictions imposed across Australia in response to the Delta strain of COVID-19. Silk requires in-person appointments to operate, which is currently not feasible across large parts of the country. These lockdowns are clearly a risk to FY22's results. However, we believe the risk is not as large as it appears at first glance. Australia is quickly moving towards 70% fully vaccinated, a rate which the federal government has said will see restrictions ease. Even if the shops are not allowed to operate at full capacity, we believe Silk is likely to be one of the first stop for many people as they finally get out of lockdown.

The market is only expecting modest growth from Silk during FY22 due to the lockdowns. Still, 7.5% EBITDA growth during this troubling time is nothing to be ashamed of for an in-person service provider. During FY23, the market expects things to ramp up, with EBITDA growth accelerating to 43% as things hopefully return to normal. Despite this optimism, the stock has recently fallen hard in response to COVID-19 jitters, bringing its FY22 and FY23 EV/EBITDA ratios to 9.2x and 6.5x, respectively. When we factor in the company's strong operational track record and our belief that Silk will be many people's first port of call after lockdown, we believe the stock deserves a four-star rating at its current valuation.

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Share price chart

Source: Tradingview

According to the Food and Agriculture Organisation of the United Nations, the number of world fish stocks considered to be overfished has tripled in just half a century. Even more concerning, the organisation has found that one-third of the world's fisheries are overfished beyond their biological limits. Murray Cod is hoping to be part of the solution, not the problem.

The company prides itself on producing sustainable, open pond-grown Murray cod under the trade name of Aquna Sustainable Murray Cod. The name Aquna comes from a combination of Akuna, an aboriginal word defined as 'the way forward' or 'flowing water' and the letter 'q'. The letter 'q' is used to provide "synergy with aquaculture and represents our dedication to innovation".

Rivers are not ponds, are they?

Now, for those familiar with the Murray-Darling Basin, which we have written extensively on through our analysis of the widely misunderstood Duxton Water (ASX: D2O | see 18 September 2020 report), you may be confused by our use of the term open ponds. See, the Murray-Darling Basin is a river basin and the term open ponds refers to areas of the river that have been dammed up to farm the native Murray cod sustainably. It is widely believed that this method produces heathier and tastier fish, and is arguably more environmentally friendly and sustainable.

FY21 was a transformative year

During 1HY21, Murray Cod saw fish sales double and the company managed to continue this trend through 2HY21, resulting in FY21 generating $9.1m in revenue (133% growth year-over-year). Unfortunately, this positive result was slightly tainted by a net loss after tax of $1.2m, a sharp but expected decline from FY20's profit of $61,690.

Why was the decline expected? Murray Cod's management realises that the company is not much to look at in its current state. The business plan is solid and the fish produced is widely considered to be of high quality, winning a gold medal in the "From the Sea" category of the 2021 Delicious Harvey Norman Produce Awards. However, the company's production capacity leaves much to be desired in its current state. Therefore, Murray Cod began its multi-year expansion plan in earnest in FY21, completing stage one of construction on its new Whitton site during the March quarter, allowing the fish to be stocked in the eight completed units. Stage two is currently underway and comprises an additional six units. It is expected to be completed in time for these units to be stocked during the summer.

In order to facilitate the drastic expansion of its production dams and nursery systems, Murray Cod has also begun a significant campaign of expansion on its two hatchery sites at Silverwater and Euberta. The Silverwater hatchery saw construction begin on nine new larval rearing ponds, an additional bore as well as general building expansion and further water supply access. Euberta is constructing 17 new larval rearing ponds and a bore. When construction on these facilities is finished during October 2021, management expects to see an increase in its annual breeding capacity of approximately 30%. This step is vital if Murray Cod is ever expected to reach management's goal of 10,000 tonnes produced annually by 2030. Although the hatcheries had a record season of 1.7m fingerlings that spawned, and are being used to stock the company's production dams and nursery systems, we believe these hatcheries have a long way yet to go.

Reaching 10,000 tonnes of annual production is fine, but if you let it rot, it won't do investors much good. This is why Murray Cod is also developing domestic and export channels, as well as its production capacity. There are three vital domestic channels for a company like Murray Cod in Australia: Woolworths (ASX: WOW | see 19 April 2021 report), Coles (ASX: COL | see 1 May 2020 report) and Aldi Supermarkets. Therefore, it is quite an accomplishment that Aquna Sustainable Murray Cod was selected to be placed into selected Woolworths stores in June 2021. While we have yet to see the results of this offering, we believe (based on the quality of the product) that this is the first step in achieving full Woolworths distribution, a vital step in selling 10,000 tonnes annually. Relating to exports, the company's Japanese exporter has requested the company re-enter the market, but all other international expansion plans are currently on hold due to COVID-19.

Liquidity is an investors largest risk

Murray Cod had a strong FY21, there is no denying this. The company saw no adverse effects on the price of its product from its increased production and expects this to remain the case as it ramps up to 10,000 tonnes annually by 2030. However, when it comes to any farming, there are always environmental risks that must be taken into account. Despite all of this, we believe management has put Murray Cod on the right track towards meeting the current market consensus of an EBITDA profit of $240,000 and $7.3m during FY22 and FY23, respectively. Based on these predictions, the company is currently trading at an EV/EBITDA ratio of 26x for FY23.

Overall, we think Murray Cod's stock is likely to remain volatile over the next year and could certainly continue to trend downwards over the next couple of months. However, we believe that for investors with a high-risk tolerance, Murray Cod can have an above-average reward profile. So, it's four stars from us.

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Share price chart

Source: Tradingview

Private Equity, where only a few thrive

The ASX-listed Private Equity industry is a tough one to analyse. These listed entities allow for retail investors to gain access to companies that are either far too early-stage for the public markets, or are unwilling to join the public markets. In our experience, most companies are not mature enough yet to be publicly listed. For example, on 29 June 2021 we wrote about the Fatfish Group (ASX: FFG), which specialises in investing in start-ups across the Southeast Asia region. The company currently holds 15 different investments, most of which are still private, but some have been taken public, like another company we covered, iCandy (ASX: ICI | see our 4 June 2021 report).

A Private Equity company with 15 different portfolio companies, most of which are not listed, is hard to value, despite the periodical mandatory valuations carried out on balance sheet dates. To make matters even more complicated, due to the private nature of most of the portfolio companies, their financial records are opaque and mostly not public.

However, like everything difficult, the rewards can certainly be worth it. An investment in these ASX-listed Private Equity entities allows for access to technology and innovations that most retail investors don't have access to.

We prefer focus

As of the end of FY21, an investment in HGL Limited offers access to six Private Equity investments, accounting for 67% of HGL's portfolio. In other terms, these investments account for $0.166 out of the company's $0.248 Net Tangible Asset value per share. HGL's Private Equity strategy involves a target Internal Rate of Return (IRR) of at least 25%. The current portfolio consists of Mountcastle (industry: school wear | 39% of the portfolio), Pegasus (industry: health | 14% of the portfolio), SPOS (industry: retail marketing | 7% of the portfolio), BLC Cosmetics (industry: beauty | 4% of the portfolio), Provider Choice (industry: health | 2% of the portfolio) and FOS Capital (industry: lighting | 1% of the portfolio).

HGL's private equity investments are clearly diversified across a wide span of industries. Private Equity investments usually warrant a more hands-on approach to each investment, much like an activist investor in the equity markets. While there's not a lot of transparency on the performance of these private investments, we do know that BLC Cosmetics, Pegasus Healthcare and the Mountcastle Group generated $4.6m in EBIT as of 30 June 2021, representing 45% growth year-over-year. This type of diversification is not always easy to manage, but HGL seems to be handling it just fine. However, when it comes to these sorts of Private Equity funds, we prefer more focus in the portfolio, e.g. funds focused on Technology, Life Sciences, Food, Industrial etc. That way, expertise can be leveraged across multiple investments and the proposition for investors is much clearer.

An old and new line of work

As part of HGL's evolution, the company acquired Supervised Investments Australia during 1HY21 to expand its operations to include funds management. This may be a re-entry into the space, but we believe it will hopefully provide the company with a new way to raise capital without diluting shareholders. Management has gone full steam ahead with this new acquisition, announcing on 2 September 2021 that it was using it to launch a new fund called the H&G High Conviction Fund. This fund will focus on offering wholesale investors exposure to sub-$100m market capitalisation ASX-listed companies. However, before we get too excited, we won't be able to properly gauge the market's reaction until the fund presents its prospectus to investors, expected on 7 September 2021. For investors in HGL, this is certainly a 'save-the-date' moment. This is the first fund launched by the company since it re-entered the funds management sector and while we don't believe a poor market showing is likely, this must go off without a hitch.

So far, so good

Unfortunately, the stock is not well-covered by the market and management doesn't provide earnings guidance. So, in order to value HGL, we will have to use Net Tangible Asset (NTA) value per share, which is only published once a quarter.

HGL's NTA puts the company's 'true' value at $0.248 per share as of 1HY21, which ended on 31 March 2021. However, when we consider the lack of transparency surrounding the company's individual investments and the low liquidity of only 40,000 shares traded per day on average over the last three months, we fail to see how it would be reasonable to value HGL at a premium to this price. So, at the current share price, we believe the company is fairly valued.

When we combine everything, we believe HGL certainly has some interesting developments regarding its re-entry into funds management investors can look forward to over the next few months. However, we believe the fund lacks focus and is fairly valued – two stars.

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