STOCKS DOWN UNDER

24 SEPTEMBER 2021

Small Cap Stocks Down Under

“Don’t knock it till you’ve tried it.”

- Fonzie a.k.a. The Fonz (1974 - 1984), American TV character

BIG RIVER INDUSTRIES

COVID-19’s ‘big’ opportunity

GENUSPLUS GROUP

Nothing to see here

360 CAPITAL REIT

An investment in multiple REITs

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COVID-19's 'big' opportunity

Stocks Down Under rating: ★★★★

ASX: BRI
Market cap: A$159M

52-week range: A$1.24 / A$2.30
Share price: A$2.04

Headquartered in Junction Hill, New South Wales, buildings material distributor Big River Industries presented shareholders with an almost 100% return during 2HY21. A large part of this was excitement over a rather significant acquisition that was finalised in that period. However, we believe the company's efficiency improvements initiated during FY20 were masked by sky high lumber prices and Delta variant lockdowns. With lockdowns seemingly coming to an end, we believe the market is underestimating Big River's big opportunity.

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52-week range: A$0.87 / A$1.12
Share price: A$1.02

Headquartered in Belmont, Western Australia, the GenusPlus Group is on a mission to become Australia's leading services provider in the design, construction and maintenance of telecommunications and electricity transmission infrastructure. The company has a won a number of contracts with high profile companies, like BHP, FMG and Telstra. However, with the market valuing the stock at what we believe matches the company's future growth prospects, we don't see a lot of upside.

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Share price chart

Source: Tradingview

A builder's paradise

Big River Industries has seen some serious changes since it was first founded in the early 1900s as a family-owned timber business. While the company is still involved in timber, instead of producing it, Big River supplies timber, hardware and a range of services to the residential, commercial and industrial construction industries.

While the majority of Big River's revenue is generated through the sale of its products, the services division remains key. Through a combination of on-site services, such as on-site timber take off and estimation, delivery to site and technical support, the company aims to be a full service provider. This strategy certainly paid off during the 2020 post-lockdown renovation and construction boom that gripped Australia, and especially New South Wales.

Macro affecting the micro

First reported by Big River during its 1HY21 report, the company experienced sharp product price rises and international shipping rate increase during 2Q21. While not specifically mentioned, we believe one of the key costs that went up was the price of timber. Managing Director Jim Bindon told the Sydney Morning Herald a decline in prices was likely to only start around September 2021 (after rising around 30% to 40% prior to that). It is important to note however, that as far as timber prices go, Big River seemed to be able to mostly pass those on to customers as the percentage of revenue eaten by the raw materials and consumables used expense actually declined slightly from 71.2% during FY20 to 70.8% during FY21.

Fortunately, management was ahead of the curve and managed to increase EBITDA margins from 6.9% in FY20 to 8% in FY21. However, this had more to do with efficiency improvements that were already in the works before these pricing issues became apparent, mainly through the company's Enterprise Resources Planning (ERP) system. To quote FY21's full year results presentation, 'gross margin improvements also aided by improved functionality of a new ERP system implemented in FY20'.

What exactly is this magical system that was the driving force behind the EBITDA margin increasing 1.1%-points? An ERP system is software that organisations use for the daily management of business-related activities, such as accounting, materials procurement, risk management and compliance, supply chain management, etc. If that does not sound like it can increase margins on its own, consider the inefficiencies and mistakes that human errors can cause and how an automated, all-encompassing system like this one can drastically reduce those. As the saying goes, time is money.

Full year revenue increased 13% year-over-year to $281.4m, while EBITDA jumped 30.4% to $22.6m. Management credited the majority of this revenue growth to New Zealand, Victoria and Western Australia. Unsurprisingly, the main driver of revenue growth was the tentative return to 'normal' in the construction industry that most of Australia (Australia accounts for 90% of revenue) and New Zealand saw during FY21. Yes, the industry had multiple disruptions during the year, but when we compare it to 2HY20, the industry came back with a vengeance.

The bright light looms large

The current COVID outbreak has put a screeching halt to construction in many parts of Australia. However, vaccination rates are skyrocketing around the country and there seems to be a universal drive among the Federal Government and the State Governments to put an end to lockdowns once second dose rates get up to 70% and 80%. With these rates expected to be achieved in the fourth calendar quarter of 2021, we expect that FY22 will turn into a net positive for the industry, especially on the back of a strong 2HY22. Management released its FY21 report on 24 August 2021, well into the current Delta crisis, so it's guidance for FY22 revenue between $335m and $350m should be fairly accurate.

While management didn't provide EBITDA guidance, other than that growth will be in line or higher than revenue growth, we believe it will likely be higher than revenue growth for two reasons. Firstly, we expect the price of timber to decline towards the end of 2021.

Additionally, supply chain problems were another issue management cited as driving down margins. We don't expect this to be a major issue during FY22 as international logistics have managed to catch up significantly from the backlog of COVID-19's initial lockdowns. The system is still under considerable pressure, but nowhere near where it was during the latter part of 2020 and through March of 2021.

The market seems to disagree with our analysis, however, with current market consensus putting FY22 and FY23 revenue at $312.4m (FY22) and $358.45m (FY23), i.e. the market consensus is well below company guidance. Consensus EBITDA forecasts stand at $24.5m for FY22 and $30.5m for FY23. The market seems to believe management is not properly accounting for the lockdowns in its forecasts. We disagree, though, given that the most recent guidance was provided late August, so well into the company's first fiscal quarter.

However, even if we take the market's earnings estimates at face value, Big River still comes out on top. The market is estimating EBITDA growth of 8.4% during FY22 and 24.5% growth during FY23. These growth projections bring the FY22 and FY23 EV/EBITDA ratio to 8.3x and 6.7x, respectively. So, even if you disagree with our analysis, we believe the market is still pricing Big River well below its future growth, specifically for FY23. Four stars.

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Share price chart

Source: Tradingview

Building Australia's power

The GenusPlus Group has a long history of operations in Australia. The company has existed in one form or another as far back as the 1950s, when it was involved in the Shire of Wagin's conversion from Direct Current to Alternating Current and the installation of the original Perth Airport lighting works and control tower. Despite GenusPlus' long history, the company is a new addition to the ASX having raised $32.8m at $0.96 per share on 14 December 2020. Unfortunately, it seems the market has decided that the IPO price was right on the money as the shares have seesawed between $0.87 and $1.10, after coming down hard from its initial jump up to $1.12.

We believe the reason for the market's lacklustre view on GenusPlus is simple, the company achieved strong growth between FY20 and FY21, but when we look into the future, the company's growth prospects seem to be less than stellar.

Acquisitions a-go-go

Between FY20 and FY21, growth skyrocketed. FY21 revenue jumped 87.1% versus FY20 to $318m with EBITDA jumping 65.3% year-on-year to $32.4m. The all-important revenue from recurring works jumped 45.5% to $64m. However, most of this growth came from acquisitions.

GenusPlus operates through four main divisions: overhead power infrastructure, underground power and telecommunications, electrical services and mechanical fabrication, and high voltage testing and commissioning. During FY21, the largest division as measured by revenues was overhead power infrastructure at $257.1m. It generated $24.8m in Profit Before Tax. Unfortunately, a large portion of this division's growth during FY18, FY19 and FY20 was due to acquisitions. During FY18, the division generated 64% revenue growth, but only 20.4% was organic. During FY19, revenue growth was 20.7%, but actually declined 28% on an organic basis. Finally, during FY20, this division saw 71.7% revenue growth, but this dropped to 17.2% once acquisitions were taken out of the equation.

The underground power and telecommunications division generated $32.3m in revenue in FY21, representing a slight decline of 3.6% year-over-year, resulting in a loss of $1.3m. GenusPlus recently finalised the acquisition of Tandem, so we expect to see non-organic growth during FY22 from this division. It is unclear however, how this acquisition will affect the division's profitability this year.

Combined, the electrical services and mechanical fabrication and high voltage testing and commissioning divisions generated $43.4m in revenue in FY21 and a loss of $900,000 before tax. While this division did generate an increase in revenue of 171.2% during FY21, mostly from the electrical services division, it saw its loss before tax increase to $900,000 from a loss of $160,093 during FY20.

Management has released guidance for FY22, indicating revenue will grow 25.8% to $400m, with a large portion of this growth coming from a series of acquisitions announced earlier in the year.

Low growth and risk are a bad grouping

At an average daily traded share volume of 7,000 shares, GenusPlus' trading liquidity is extremely low, which represents a considerable risk for investors, in our view. On top of that, GenusPlus is only covered by one broker and it's not positive. Currently, that broker's analyst expects EBITDA to only grow by 9.6% to $35.5m in FY22 and by 3.9% to $36.9m in FY23. And he or she is probable right.

Therefore, we believe the FY22 and FY23 EV/EBITDA multiples of 4.1x and 3.9x reflect a fair value for the company. Once we factor in liquidity risk, we think the FY23 valuation may be on the high side. Overall, we don't see the stock moving much beyond the $0.90 - $1.05 trading range of the last nine month. So, investors are probably better off putting their money to work elsewhere. It's a neutral three stars from us.

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Share price chart

Source: Tradingview

Not your average REIT

What is a REIT? REIT stands for Real Estate Investment Trust, a category of investments that we here at Stocks Down Under have quite a strong interest in. When the long-suffering REIT market finally turned around in November 2020, following the sector's COVID Crash, we picked both the outperformers and the losers out of the 28 two- and four-star REITs we covered after the crash. For more information, please see our 19 November 2020 insights article, The November Property Bear Massacrec.

The vast majority of listed REITs on the ASX serve one main function, i.e. to allow investors direct access to property investments that would normally be far outside of their price range or ability to manage personally. Here is where 360 Capital REIT stands out. Instead of direct ownership of real estate investments, this trust has two main holdings: 12.8% of Irongate Group's (ASX: IAP) outstanding shares and a 50% investment in PMG Funds.

The assets that make up the assets

So, 360 Capital REIT is made up of three main investments, but what are the real underlying asset? To understand that, we need to do a brief dissection of the Irongate Group, Peet Limited and PMG Funds.

PMG Funds was established in 1992 and provides investors exposure to the New Zealand real estate market through 47 properties. These properties have a total value of $781.2m as of 31 July 2021, split between industrial properties (41.2%), office properties (37.7%), retail properties (15.1%) and childcare centres (6%).

The Irongate Group, secondly, has investments mostly in Australia, although 11.6% of its portfolio is based in New Zealand. The portfolio is currently valued at a Net Tangible Asset (NTA) value per share of $1.43. This NTA consists of metro offices (48.3%), industrial properties (33.7%) and CBD offices (18%).

Liquidity is dropping, but not dead

As of 30 June 2021, 360 Capital REIT reports a Net Tangible Asset value per share of $1.14. This implies that based on Thursday's closing price of $0.91 per share, the REIT is trading at a discount of 20.1%. However, unlike most REITs, this value is quite volatile due to its heavy reliance on an investment in a publicly traded company, i.e. the Irongate Group. Fortunately, we happen to know what price the 360 Capital REIT accounted for the Irongate Group at when calculating its NTA, $1.46 per share. The Irongate Group is currently trading at $1.58 per share, representing a gain of 8.2%. It is important to note that the Irongate Group last reported its NTA per share on 5 May 2021, and has since then announced a series of major acquisitions. In our view, the Irongate Group is likely undervalued at the $1.46 per share represented in 360 Capital REIT's own NTA, which is likely understated right now (Irongate has made a number of acquisitions since its last update). We are keen to get an NTA update by the company.

One of the main risks for an investment in a listed entity like 360 Capital REIT, that is heavily dependent on other entities when it comes to its own valuation, is whether an investor would likely be able to exit quickly if the need arose. While this has not historically been a concern with 360 Capital REIT, a red flag popped up on 22 March 2021, when the stock was dropped from the All Ordinaries index. However, liquidity has remained reasonable, even six months later, with the average three-month daily volume currently at 150,000 shares. When we account for Thursday's closing price of $0.91 per share, that comes to an average daily value traded of $136,500.

We believe a discount to NTA per share is warranted for 360 Capital REIT due to its reliance on outside entities. However, we believe the current discount of 20.1% is far greater than what we would deem fair (closer to 10%), especially when we account for the likely understatement of the Irongate Group investment. So, it's four stars from Stocks Down Under.

Pitt Street Research Pty Ltd

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