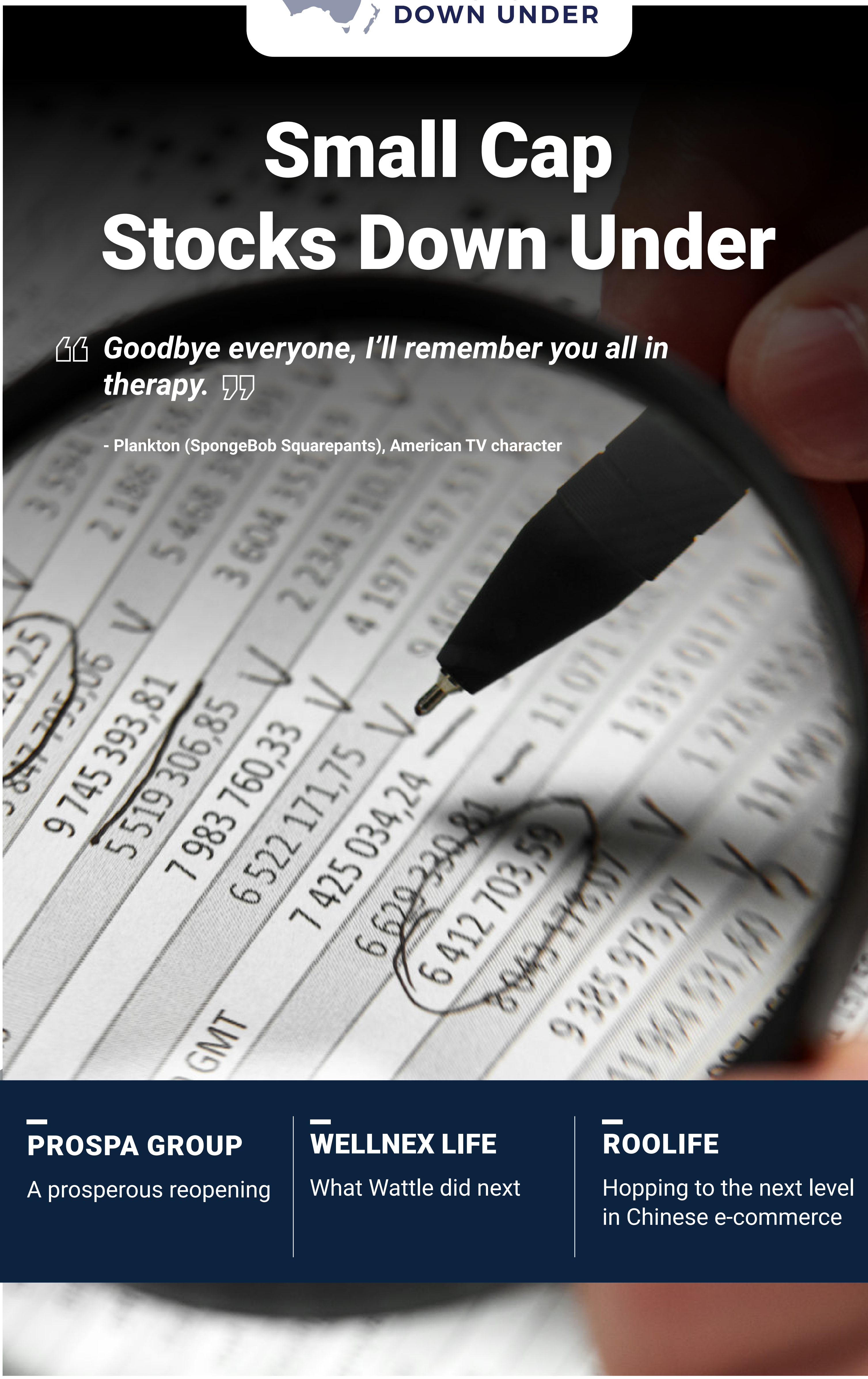
STOCKS DOWN UNDER

1 OCTOBER 2021



Small Cap Stocks Down Under

> *Goodbye everyone, I'll remember you all in therapy.*

- Plankton (SpongeBob Squarepants), American TV character

PROSPA GROUP

A prosperous reopening

WELLNEX LIFE

What Wattle did next

ROOLIFE

Hopping to the next level in Chinese e-commerce

PROSPA GROUP

A prosperous reopening

Stocks Down Under rating: ★★★★

ASX: PGL
Market cap: A$152M

52-week range: A$0.69 / A$1.25
Share price: A$0.94

Headquartered in Sydney, the Prospa Group had an extremely strong FY21, despite the considerable challenges the small businesses credit market faced during the year. In fact, the company passed a significant milestone towards the end of FY21, surpassing $2bn in lending. Despite the risks facing small businesses from COVID-19's new strains, we believe Prospa's shareholders are likely to prosper.

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ASX: WNX
Market cap: A$30.3M

52-week range: A$0.098 / A$0.17
Share price: A$0.098

When Melbourne-based Wellnex Life started trading again on ASX on 15 July 2021, it was the end of an arduous journey that lasted almost two years. Wellnex is what has become of the old Wattle Health Australia. In our view, the phoenix that has arisen from the ashes of that failed organic dairy play is well worth paying attention to.

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Share price chart

Source: Tradingview

Credit makes the world go round

Prospa is a financial technology company (FinTech) specialising in offering small businesses across Australia and New Zealand a variety of credit products. FY21 might have seen total revenue decline 17.1% to $117.7m, but this decline was solely due to a sharp drop in loan originations during 1HY21. In 2HY21, the situation drastically rebounded with 4Q21 seeing a 798% increase in loan originations year-over-year to $182.7m. While 4Q20 was clearly heavily impacted by COVID-19, it is important to note that 4Q21's loan originations also represented a 51% sequential increase compared to 3Q21 ($120.9m). In fact, it is clear from Prospa's reporting that the entire business saw a strong return to growth during 2HY21. June 2021 saw the highest single month of loan originations ever at $79.8m, following $61.4m in May and $41.5m in April.

Prospa operates in Australia and New Zealand and we said growth was experienced across the board. So, how do these geographical divisions stack up? New Zealand saw the largest growth during FY21. In FY20, New Zealand accounted for 5% of Prospa's total loan portfolio, focusing exclusively on business loans that last for an average of 12 months with an average loan size of NZ$24,000. Fast forward to FY21 and New Zealand now comprises 15% of Prospa's loan portfolio. Ehat we find most impressive about this growth is that it was organic and not from launching new lending products. Prospa New Zealand still only offers business loans and has grown its customer base and average loan amount by 29% to NZ$31,000 on an average 15.1-month duration.

During FY21, the Australian division also experienced strong growth in its loan amounts and term limits. Australia, unlike New Zealand, offers businesses two options, a loan or a line of credit. The main difference between a loan and a line of credit is that a loan is given in a lump sum, while a line of credit allows a business to draw on it when necessary. This means a company might not have to be on the hook for the entire amount if it doesn't need the money (a line of credit does come with a fee for the privilege).

During FY21, the average business loan size increased 42% to $37,000 with an average duration of 15.9-months (FY20: 13.6-months). The average line of credit increased 18% to$46,000 with an average utilisation rate of 51% (FY20: 56%).

As far as Australia is concerned FY21 saw Prospa diversify further away from its two most important States: Victoria (percentage of total loan portfolio down from 26% in FY20 to 20% in FY21) and New South Wales (FY20: 34% vs FY21: 29%). All other Australian states saw an increase in their share of Prospa's total loan portfolio during FY21. We believe this type of loan diversification is an important risk mitigator and a strong indication that Prospa is succeeding in expanding into additional markets.

Reputation is everything

One of the main competitive advantages that we believe Prospa has over its competition is its reputation as a fair and high-quality lender for small businesses in Australia and New Zealand. Over the last three years, Prospa has won MFAA's National Fintech Lender of the Year award, while also receiving FinTech Australia's Finnie 2020 Excellence in Business Lending Award. During 4Q21, Prospa's net promoter score rose to 80+ from 77+. The company is also currently ranked as the #1 online lender to small businesses in Australia and New Zealand through Trustpilot.

During difficult times, like the COVID-19 pandemic, we believe a business' reputation becomes far more important than during times of stability. Clients want to believe they can trust their lender, but this trust is never more important than when the preverbal faeces hit the fan.

Barrelling towards profit

As we mentioned before, Prospa's FY21 revenue generation of $117.7m implied a decline of 17.1% year-over-year. However, spurred on by 2HY21's rapid recovery, Prospa reduced its net loss after tax from $24.9m in FY20 to $9.5m in FY21. In fact, the company actually generated its first EBITDA profit of $400,000 in FY21, compared to an EBITDA loss of $15.8m in FY20.

However, it seems the market doesn't believe Prospa will be able to further reduce its net loss during FY22. Current market estimates place the company's Earnings Per Share (EPS) at a loss of $0.03, still a markable improvement from FY21's loss of $0.06. This was achieved by Prospa cutting operating expenses significantly since FY19 (25.8% decline) and reducing loan impairment charges during FY21 to below even FY19 levels (10.8% decline). The market expects Prospa's losses to continue to decline, to -/- $0.02 per share in FY23, followed by a profit of $0.01 per share in FY24. The reason why losses are expected to decline at a slower rate is it seems unlikely that there is much room left to cut operating expenses and to a lesser extent, loan impairments.

Fortunately, we can confirm that FY22 has so far seen a continuation of 2HY21's strong performance as management released a trading update for the first two months of FY22 on 9 September 2021. Loan originations grew to $41.8m in July and $44.9m in August (105% year-over-year). We believe the decline in growth between June and July 2021 was due to the company's large exposure to Victoria and New South Wales, which experienced restrictions and lockdowns during the period. Now that these States have a road map to open up permanently, we believe demand for loans and credit is likely to increase again.

All-in-all, we believe Prospa is a strong company with a solid reputation and a clear pathway to profitability in the coming years. When we combine that with its Price/Tangible Book Value of 1.3x, we believe it's a four-star stock.

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Share price chart

Source: Tradingview

Time was when anything dairy-oriented on ASX got a lot of investor support. China was rapidly becoming one of the world's largest consumers of dairy products, valuing the quality of what they could get from Australia and New Zealand. And a vast army of daigou operatives were regularly coming down here to get the good stuff for them. Then the game changed. First the daigou industry became more regulated. Then our borders were shut. And then China's leadership started blackballing our products. So, dairy players had to go back to the 'pre-China' ways of building their brands.

How Wattle got out of its mess

Wattle Health didn't survive this change. Its ambition had been to become a leading organic dairy company and to that end it had created 'Uganic', a range of organic infant formula products. That was a good move. What wasn't good, in retrospect, was the decision to try and get into making products. The company's stock was suspended from September 2019 while it tried to sort out a funding package to buy a dairy processing and packing business, called Blend and Pack, but it walked away from that transaction in April 2020. Then in August 2020 the Corio Bay Dairy Group, a would-be maker of organic milk powder, went into administration, having chewed up $44m of Wattle Health's money.

What ultimately got Wattle Health out of this mess was Uganic and another brand, called Little Innocents, which did baby skincare. Consumers seemed to like these brands and they had good distribution reach via Chemist Warehouse. The Wattle Health board, led by a new Executive Director named George Karafotias, went looking for businesses with similar products and they found Brand Solutions Australia (BSA), a pharmacy and grocery 'brokerage' that Zack Bozinovski had spent the previous decade building.

Wellnex has star power … just ask Mark Wahlberg

BSA would find new brands suitable for pharmacies or supermarkets. It would prepare those for the retail 'big time' on behalf of their owners and then launch and distribute. By the time BSA agreed to join forces with what was left of Wattle Health, in April 2021, it was doing in excess of $14m in annual revenue and had product going into more than 3,000 pharmacies around the country.

The product range was different from what Wattle Health had previously worked on – things like Compeed cold sore patches or an energy-boosting gummy branded called 'Wakey Wakey', now available at Coles. What BSA brought to the table was the ability to find and build health-related consumer brands. If you want a good example of what's coming for Wellnex, consider an August 2021 announcement related to 'Performance Inspired'. Never heard of it? It's a nutritional supplement range that's selling like hotcakes in America, helped by the fact that it was created by the actor (and fitness fanatic) Mark Wahlberg. The people that brought you BSA just jagged the exclusive distribution rights for Australia and New Zealand.

Wattle Health was able to get hold of the BSA powerhouse thanks to a 1-for-12 rights issue at 15 cents, plus $13.5m in recoveries from the Corio Bay dairy debacle. Wattle changed its name to Wellnex Life and, as we noted above, the stock came back from the dead in July. We believe the relisting now presents a great opportunity for investors unburdened by the baggage associated with the name 'Wattle Health'. As is usual with these kinds of transactions, there was a lot of stock whose owners had waited close to two years to sell. That means that Wellnex is now trading well below the 15 cents of the recent rights issue. We predict it won't stay down for that long.

The Lipstick Effect

The thing about the newly reborn Wellnex Life is that it benefits from, what marketers call, the 'Lipstick Effect'. Household budgets may be tight in an economic crisis, but what does a lipstick cost? Just about nothing on its own, but with substantial 'hedonic' benefits to the purchaser, that is, the female who controls said household budget. Most health and beauty products sold over-the-counter are like that, which is why, if you've visited Chemist Warehouse through this current crisis you'll have probably noticed that the store is packed. Wellnex has no plans to compete with lipstick makers, but the same people who buy lipstick also buy things like iron supplements. Or allow their male partners to buy sports drinks endorsed by Mark Wahlberg.

The BSA track record suggests good times ahead. Just two years ago BSA did just about $5m in annual revenue. The final number for FY21 for Wellnex, which is mostly BSA with just a little Uganics and Little Innocents, was $18m and the company is projecting $22m for FY22. We don't think there'll be much profit for Wellnex the next couple of years since most of what the brands earn are likely to be reinvested for further growth. What we do expect is some decent top line growth and a gradual reduction in loss from the $4.5m cash loss after one-off and non-cash expenses for FY21. Ahead of what we think can be a good 1HY22 result, we rate the new Wellnex Life four stars.

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Share price chart

Source: Tradingview

2021 is turning out to be a great year for RooLife. This Perth-based company, whose specialty is helping international brands sell online in China, booked revenue of A$3.9m in the June 2021 quarter, which was close to four times the comparable figure for June 2020. This reflects the steady stream of new clients that have has signed with the company over the last few years. We think there's more where 2021's growth came from.

Profiting from the house that Jack built

If you want to do some background reading here, get hold of a 2016 book by Duncan Clark called Alibaba: The House That Jack Ma Built. You'll read how Alibaba, the Chinese e-commerce giant, created Taobao as a C2C platform and Tmall as a B2C marketplace. It quickly grew them to hundreds of millions of active users, while its AliPay unit became a major player in online payments.

Alibaba today is capitalised at about US$400bn and founder Jack Ma is worth US$50bn or so. That's because most people in China today routinely buy products online using mobile devices and annual online spending by Chinese consumers has grown into the trillions in US dollar terms. That market continues to grow at double digits and a lot of this spending is done on Western products, because they have prestige in China and are considered more trustworthy than local brands. Just ask A2 Milk (ASX: A2M | see 25 January 2021 report) and Blackmores (ASX: BKL | see 13 September 2021 report) why so much of their past growth has come from China.

RooLife benefits from all this because many owners of brands outside China don't know how to open a store on Tmall or promote on Weibo or work any of the multiple channels in China that can lead to online sales in that country. AliPay and its competitor WeChat Pay can also be a bit of a mystery to brand owners in terms of how to get paid. By contrast, Chinese e-commerce is RooLife's bread and butter and the folks at RooLife are pretty good at it. Founder and CEO Bryan Carr spent about ten years in Beijing for various companies getting to know the legal and cultural complexities of doing business in China and he's now gathered a team of specialists around him who know the market.

900 million customers for RooLife's brands

That expertise is attracting a steady stream of new clients. So, when AFT Pharmaceuticals (ASX: AFP | see 5 June 2020 report), the New Zealand maker of over-the-counter medicines, wanted to sell in China, it went to RooLife. So did another Kiwi company called Blis Technologies (NZX: BLT) for its probiotics. As did the Australian food company Murray River Organics (ASX: MRV). And so on.

RooLife clips the ticket on their sales and while most of the brands that have worked with RooLife up until now have been health, nutritional or beauty products, just about any consumer brand from the West tends to be attractive to the Chinese Millennials RooLife is targeting.

Also attracting those clients are the relationships that RooLife has been building. In April 2020 the company became an official marketing partner of Alipay's online platform and associated services. You can do e-commerce in China without Alipay, but you'd be missing out on something like 900 million digital wallets.

A global business

What's encouraging about RooLife right now is that it may be from Australia, but the business is effectively global. Colab, a 'dry' shampoo (so called because it can be applied to hair while it's dry) is British while Nuria, a vegan skincare brand (yes, that's a thing - it means the products you rub into your skin weren't made with any animal-sourced ingredients) is American. So if Beijing is, for whatever geopolitical reason, blackballing products made from Australia, RooLife isn't all that vulnerable.

Keep in mine as well that brand owners who used to address the Chinese market via daigou channels have been forced to adapt to the new realities of more regulatory scrutiny and, since 2020, closed borders. The search for trusted partners to go after more reliable e-commerce sales has led many to beat a path to Bryan Carr's door.

As at June 2021 RooLife had $3.8m cash and just after that it raised $1.7m at 2.3 cents. This makes RooLife's Enterprise Value just $8.3m. That's right… this stock is trading only around 1x FY21's $9m in revenue. Now you know why Bryan Carr and Executive Director Warren Barry recently bought stock on-market.

Why such a low multiple? We noted above possible erroneous concerns that tensions between Australia and China would be bad for business. More recently there may have been concerns that the Chinese economy is headed to a slowdown thanks to the imminent failure of Evergrande, however we think the underlying momentum in e-commerce will be hard to blunt so long as the Evergrande restructuring is handled well by the Chinese authorities. And in the meantime international brands continue to line up wanting to sell in China. For us that makes RooLife four stars.

Pitt Street Research Pty Ltd

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