**STOCKS DOWN UNDER**

15 OCTOBER 2021

# Small Cap Stocks Down Under

*"They always say time changes things, but you actually have to change them yourself."*

- Andy Warhol (1928 - 1987), American pop artist

## AMA GROUP

The house that Mr Gloss built

## SLATER AND GORDON

No objections, Your Honour

## MASTERMYNE

Master of its domain

# AMA GROUP

## The house that Mr Gloss built

Stocks Down Under rating: ★★★★

**ASX: AMA**
**Market cap: A$481M**

**52-week range: A$0.383 / A$0.87**
**Share price: A$0.465**

When we last looked at AMA Group on 1 May 2020, the auto smash repair powerhouse from the Gold Coast, the stock was $0.425 and we called it four stars. That was 1 May 2020 and COVID-19 had just smashed up the whole world, including AMA stock. 17 months later, the stock hasn't advanced much, but we still think it's four stars. Australia's eastern seaboard is now moving out of lockdown, so people will be driving their cars more. Unfortunately for motorists, that means more car accidents going forward. Fortunately for AMA Group, that means more business.

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# SLATER AND GORDON

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**ASX: SGH**
**Market cap: A$113M**

**52-week range: A$0.655 / A$1.10**
**Share price: A$0.80**

If you're an average Aussie, you've probably heard some good things about Slater & Gordon, the consumer law firm that specialises in personal injury law and class action suits. In 1994, Slater & Gordon gave millions of Aussies access to the legal system by pioneering the "No Win, No Fee" approach. However, if you're an investor, you probably recall the infamous 2015 to 2017 stock price collapse. But with strong FY21 EBITDA growth, it's time to take another look at the phoenix-like Slater & Gordon.

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For much of 2021 the share price of the mining services company Mastermyne has been on a tear. Not coincidentally, the price of coal has similarly rocketed upwards in the same time period. But investors aren't too late to the party. We think they might even be early to the festivities. In May, Mastermyne won its first $600m whole-of-mine contract for the Gregory Crinum coal mine in central Queensland.

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### Share price chart

***Source: Tradingview***

When people are locked down because of COVID, they drive less. Just look at the experience of Transurban (ASX: TCL | see 3 May 2021 report) in the world's most locked-down city for this pandemic, Melbourne. In the September 2019 quarter the average daily traffic on CityLink was 857,000 cars and trucks. By the September 2020 quarter it was only 355,000. It's a reasonable bet that when lockdowns end, and stay ended, motor traffic goes up. Sydney effectively moved out of a three-month lockdown on 11 October and Melbourne might get out of its sixth lockdown next week. The public mood suggests further lockdowns are unlikely. So, the nation, and AMA Group, can now get back to normal.

### The new Normal

'Normal' for AMA Group means a steady increase in revenue and earnings. Back in 2013 this company only enjoyed $64m in annual revenue as a player in 'vehicle aftercare and accessories', of which smash repairs was a relatively small part. The secret to AMA's subsequent success was 'Mr Gloss', which was the smash repairs part of the group. Mr Gloss was originally the name of a panel shop started up in the Melbourne suburb of Moorabbin around 1984. It prospered by focusing on prestige cars and in 2007 was sold to a Brisbane-based company called Allomak. When Allomak needed recapitalising in 2009, the man behind Mr Gloss, Ray

Malone, stepped up to the plate as Executive Chairman, fixed the balance sheet, changed Allomak's name to AMA Group and, from 2014, focused the company on growing in the business Ray Malone knew backwards. Malone stayed until 2019 and oversaw a massive expansion in both revenue and earnings.

Now fast forward in time. In FY21 AMA grew revenue 11% from continuing operations, while EBITDA rose 25%, to $71.5m. On consensus numbers FY22 is expected to see 19% EBITDA growth, to $85m – not bad when the EV/EBITDA multiple for that year is only 12x. In FY23, again, on consensus, EBITDA gets to $127m and in FY24 to $141m.

Why so much growth? Well, part of it will come from good times at AMA's parts business, which now does more than $60m in revenue and benefits from shortages of new cars in Australia right now. But most of the growth will basically be the medium-term payoff from owning Capital SMART, a smash repair business acquired in October 2019 from Suncorp.

## Capital SMART really was smart

In case you're wondering, the capital letters in SMART stand for Small Medium Accident Repair Technology. It certainly was a smart deal for AMA, because it now became the '800-pound gorilla' and could negotiate decent rates with insurers. And Suncorp vehicle policy holders would still be coming to AMA because attached to the transaction was a 25-year service agreement where Capital SMART would remain as the 'recommended repairer'. Two years after this deal AMA is now extracting value out of what it acquired and all it needed was more panels to beat. Now that the politicians and health bureaucrats are letting us out of our houses, that will be coming.

We know what some of you are thinking…how in the heck can a prosaic 'mom and dad' industry like smash repairs allow AMA to potentially grow into a Top 200 company? The way we answer that question is with another question: How often do you fix your own car these days? If it's a modern car, probably not at all, because they're getting too complicated. The same dynamic works in smash repairs, so that the industry is set to rationalise in favour of the big guys, like AMA, who can afford the fancier equipment and skilled labour.

We think one of the reasons AMA Group is so inexpensive is because of the Capital SMART write-downs. In 2020 and again in 2021 AMA registered impairment charges related to that business - $47m in 2020, $91m in 2021. These charges made AMA's decision to acquire the business look silly to the uninitiated. For us it was just an accounting treatment related to the way COVID had put a temporary dampener on smash repairs. It didn't change the long-term picture.

## Drive safely, now

Possibly another dampener on the stock was the recent capital raising. A rights issue at $0.375 raised $100m and another $50m was raised via convertible notes that convert in March 2027 at $0.4688. This transaction provided liquidity in the event that lockdowns continued for much longer. Lockdowns might not last much longer, but at least the downside risk is covered in the event that the politicians try one on again.

We believe AMA has the potential to get back to pre-pandemic levels, i.e. above $1 per share, which comes to an FY23 EV/EBITDA ratio of 12.3x (on 49.5% year-over-year growth). If things don't work out in the near to medium term, $0.40 would be our stop-loss level. Sure, people might drive more safely in the post-pandemic world. But that wouldn't be normal, which is what we seem to be headed back to. AMA remains four stars.

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### Share price chart

***Source: Tradingview***

### A clear path forward

After founding their firm in 1935 in Melbourne, the original Messrs Slater and Gordon made a name for themselves by serving unions, with a particular focus on workers' compensation. This connection has been instrumental to the long-term success of the law firm. Even though it's Slater & Gordon's major class action suits that make it onto the telly, remember that only 5.6% of the firm's Work in Progress as of FY21 came from class actions. It is perhaps no surprise then that several politicians got their start at Slater and Gordon, including former Labour PM Julia Gillard and the current sitting Greens MP Adam Bandt.

The rise of Slater & Gordon was heavily tied to that deadly silicate material: asbestos. After managing the first successful asbestos-related cancer claim in 1984, the firm swiftly set up offices in Perth to serve 200 workers affected by blue asbestos at the Wittenoom mine. Slater & Gordon won the landmark Wittenoom group settlement in 1989 and from then you knew the firm to call if you had tragically been affected by asbestos. The subsequent Crimmins case in the High Court in 1999 allowed waterside workers to be compensated for asbestos-related diseases. The coup de grâce was the case against James Hardie Industries, Australia's largest asbestos manufacturer, which led to the establishment of a trust valued at $1.5bn to meet asbestos claims in 2006.

### Just one lousy acquisition…

Slater & Gordon made history again in 2007 when they were the first law firm in the world to debut on a stock exchange. At $1 per share, Slater & Gordon sought $35m. While many in the media pondered the ethical ambiguity of a company whose duty was split between the courts, their clients and their shareholders, these claims were overblown, mainly because all companies juggle conflicting stakeholder interests.

Perhaps what the commentators should have worried about was the hubris of international expansion. In 2015 Slater & Gordon purchased the UK professional services business Quindell for the ridiculously inflated price of $1.3bn. Quindell's accounting practices were suspect, which would ruinously become a running theme for Slater & Gordon. The company's balance sheets were wildly inflated due to the overestimation of "Work in Progress" (WIP) fees, which is when lawyers calculate their expected fees for a service based on the probability of success.

In less than two years, an asset write-off left Quindell and, therefore, Slater & Gordon close to bankruptcy. The share price tanked. Shareholders were understandably livid and a class action taken up by rival Maurice Blackburn resulted in a $36.5m settlement. Hedge funds led by Anchorage Capital took over the company and the entire board was dismissed.

### You can't keep a good law firm down

Yet in 2017, Slater & Gordon was reborn and, better yet, recapitalised. Divorced from the horrendous UK operation, the company believed it had a strong brand name that could outlast the Quindell scandal and keep business coming in. And it did. Slater & Gordon partly catalysed the Royal Commission into the Big Four banks in February 2019. Major class action suits around this key period included the "Get Your Super Back" campaign, where the company tried to claw back Super for two million Aussies, which were gouged by excessive fees. Slater & Gordon was back.

The company can now make a solid case that Quindell is ancient history. In FY21 Slater & Gordon's EBITDA leapt 38%, to $48.6m. Remarkably, given that the margins are usually slim in people-intensive businesses, Slater & Gordon generates a 24.6% EBITDA margin (up 4.1%-points year-over-year). Chief executive John Somerville is pinning his hopes on a slimmed-down operation and has redirected the company's financial focus from WIP fees towards those impressive EBITDA numbers. The company is also digitally savvy. A sophisticated online claim assessment tool attracts 32,500 visitors every month. Your honour, we believe the evidence proves the turnaround is working.

### Would Messrs Slater and Gordon be buying?

The market-implied EV/EBITDA multiple for FY22 is 4.4x, which is a sure sign that Slater and Gordon are undervalued, in our view, given that estimates put EBITDA growth at 12.4%. The net debt level sits at a reasonable $69.2m.

On 30 September 2021, the Federal Government released an exposure draft legislation on the issue surrounding the rapid rise in class action lawsuits in Australia for consultation. The major point in the draft legislation was a proposed cap on total costs of 30% in relation to class action settlements. While this might not sound like a big deal, according to the Association of Litigation Funders of Australia (ALFA) Chair John Walker, 91% of case costs exceeded 30% and in 36% of cases, litigation costs alone were greater than 30%.

While Slater and Gordon have limited exposure to class actions, we believe news surrounding this legislation has the potential to increase volatility in the entire ASX-listed legal sector in the short to medium term. We believe the risk of sector spill-over is all the more relevant when you consider that Slater and Gordon have a trailing three-month average trading volume of only 20,000 shares ($17,000 as of yesterday's close).

Despite the risk of increased volatility across the sector, we believe Slater and Gordon stands out from the pack when we consider the fundamentals of the company and its lack of exposure to class actions. A lot of this has to do with the quality of the company's current directors and their prudent approach to debt, which is an essential part of the company's turnaround story. If bad debts nearly sunk Slater & Gordon in the mid-2010s, then the brass will be eager to avoid a similar failing. We expect the market will catch up to this bargain. Four stars.

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### Share price chart

***Source: Tradingview***

### Origins, contracts, accidents

Like Slater and Gordon, one of our other stories for today's issue, Mastermyne's origin story involves two mates going into business together. The difference, though, is that Andrew Watts and Darren Hamblin started Mastermyne in 1996 out of the back of a ute in Mackay. That's geographically significant, given that Mackay is in the Bowen Basin of central Queensland, which is home to the largest coal reserves in Australia. Unsurprisingly, most of Mastermyne's work still takes place in the Bowen.

Mastermyne is a mining services contractor, which means it works in tandem with mining giants to drive costs down and output up. Anglo American, for example, with whom Mastermyne has worked extensively, can benefit by outsourcing duties to the Mackay-based company. Mastermyne helps with new mine development and general mine operations, and provides services like conveying, ventilation and longwall relocations.

Mastermyne's solid reputation is built off its strong relationships with Anglo and expertise in crafting feasibility studies. At Gregory Crinum, now owned by Japan's Sojitz, Mastermyne expect 11 million tonnes of coking coal as the run-of-mine. The seven-year contract will employ 180 full time personnel and deliver $80-$100m in annual revenue at full production.

### Which way is the wind blowing?

Mastermyne's first whole-of-mine contract comes after a fairly unimpressive FY20. Like all companies connected with the mining industry, Mastermyne is subject to the commodity cycle. The price of most types of coal in 2020 was depressed thanks to COVID's early economic impact.

The company has also been beset by safety concerns. On May 6, 2020, an explosion at the Grosvenor Mine run by Anglo American caused injury to five miners. Mastermyne have subsequently reinvigorated their safety procedures and six mines have now been injury-free for more than twelve months. Between COVID and a tight labour market, exacerbated by the events at Grosvenor, revenue dropped significantly. Re-entry into the Grosvenor Mine only commenced on 22 April of this year, nearly a year after the devastating accident.

If you glanced at the business news in late July, you might have noticed Japan announcing its intention to cut coal consumption by approximately 40% over time. Given that Japan—not China, as some might think—is Australia's largest market for coal, then this about-face may well give investors pause. The question, therefore, rears its ugly head: is this a headwind for companies like Mastermyne?

What tends to happen when one country cuts their dependence on our coal or iron ore is that other countries mop up the excess. In this particular case, developed nations, like Taiwan and South Korea, and developing nations, like India and Vietnam, will absorb the coal that Japan is discontinuing.

Asian steel demand remains a significant long-term tailwind for the company and there is a good decade left of shelf life for high-calorific Aussie coal. But it does bear mentioning that Mastermyne have recently upped the ante in pursuing opportunities in the hard rock sector (think copper, gold, uranium and zinc). The company have appointed new leadership for hard rock and have a suit of tenders underway in this new sector for the company. If successful, the tenders will start to slowly shift the balance away from coking coal, which is 95% of Mastermyne's revenue exposure.

### Slightly undervalued

The price of coal did not start rising until November-December of last year and the company's 1HY21 performance partly reflects the lacklustre price of the commodity. Total revenue ($233m) and EBITDA ($22.3m) for FY21 were down 20.4% and 22% year-on-year, respectively. Mastermyne attributed the drop in revenue to the completion of the Appin and Narrabri contracts in NSW as well as the closure of the Grosvenor Mine.

But dig a little deeper and there's gold (er, coal) to be found. Due to some shrewd equipment investment and cost management, Mastermyne managed to restrict its EBITDA margin decline to 9.6% (FY20: 9.8%). Partly thanks to having little debt to their name, Mastermyne currently have an EV/EBITDA multiple of 7x on historical numbers.

Consensus estimates have the stock trading at 3.2x and 1.9x FY22 (42% growth estimated) and FY23 (70.3% growth estimated) EV/EBITDA ratios, respectively. Remember, it had an order book of just over A$100m when it went public in 2010. A decade later, at the end of FY20, the book was A$656m. That's what we call a growth company.

The crux of Mastermyne's new commercialisation model is winning whole-of-mine contracts. It can't be overstated how important locking in the Gregory Crinum project is for Mastermyne. It proves to the industry that the company can play in the big leagues alongside heavy hitters like Perenti Global. And it tends to produce a domino effect. Mastermyne have already secured a second whole-of-mine contract for the Dysart East project for Bengal Coal in the Bowen Basin. Add to these recent wins the strong coal price of US$243.35/metric ton and a post-FY21 order book of $1.1 billion with $250m expected to be delivered during FY22, and it's four stars from us.

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