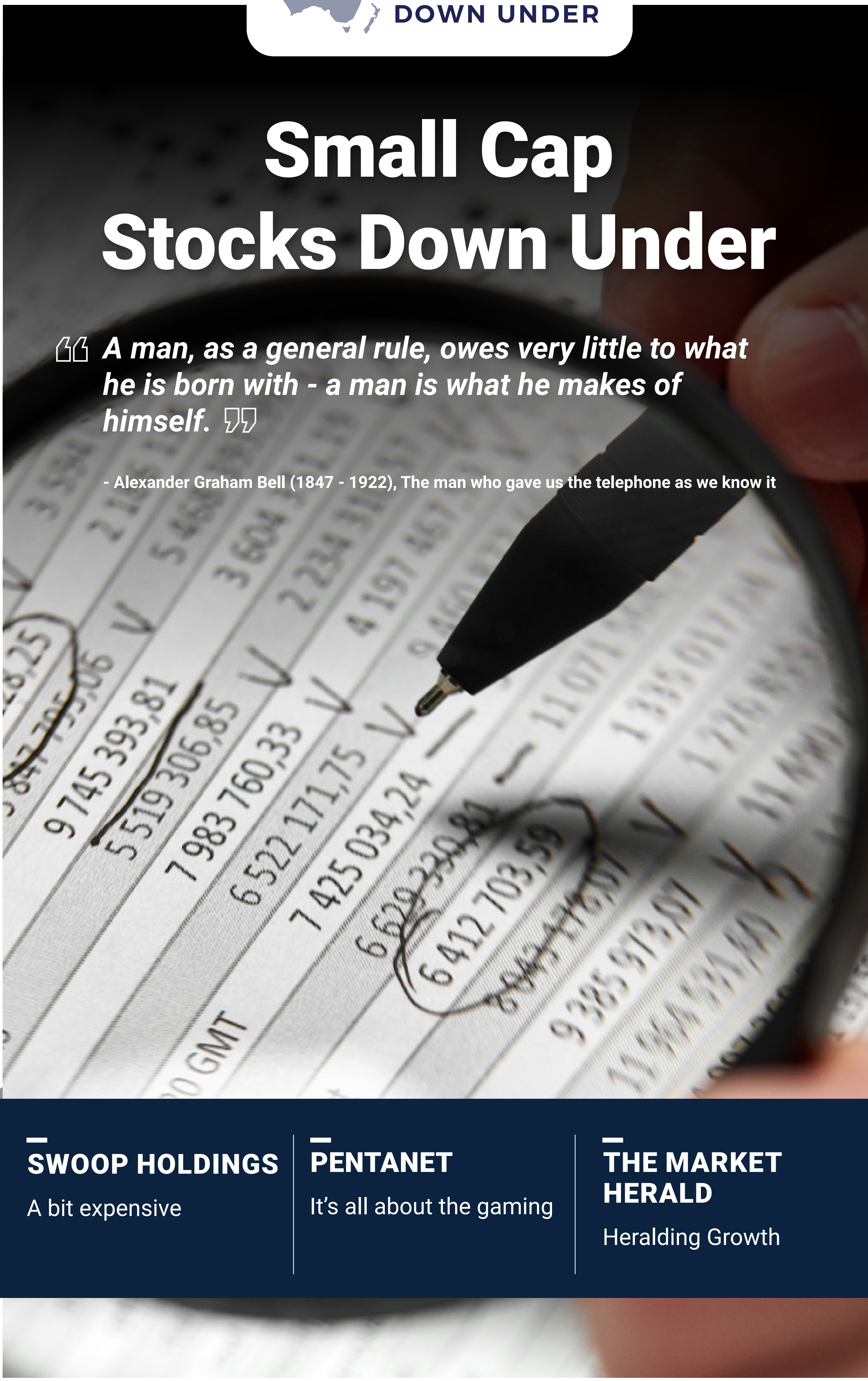

Small Cap Stocks Down Under

> *A man, as a general rule, owes very little to what he is born with - a man is what he makes of himself.*

- Alexander Graham Bell (1847 - 1922), The man who gave us the telephone as we know it

SWOOP HOLDINGS

A bit expensive

PENTANET

It’s all about the gaming

THE MARKET HERALD

Heralding Growth

SWOOP HOLDINGS

A bit expensive

Stocks Down Under rating: ★★★

ASX: SWP
Market cap: A$395M

52-week range: A$0.85 / A$2.46
Share price: A$2.05

The Australian telecommunications industry is well and truly up for grabs and Sydney-based Swoop is looking to dive in and take its piece of the action. The company offers customers home internet, wireless, NBN, OptiComm and Voice over Internet Protocol (VoIP) plans. The offerings are pretty standard in a general sense, but Swoop is clearly doing something right as FY21's underlying EBITDA jumped 165% driven by a 104% increase in revenue and a 24% increase in Services in Operation year-over-year. In what is an extremely competitive industry, Swoop is clearly doing something right, let's find out what that is.

READ MORE

PENTANET

It's all about the gaming

Stocks Down Under rating: ★★★★

ASX: 5GG
Market cap: A$205M

52-week range: A$0.53 / A$1.14
Share price: A$0.71

Headquartered in Balcatta, a suburb of Perth, Pentanet is a fast-growing internet service provider, currently servicing over 80% of the Perth market. The company listed on the ASX at $0.25 per share on 29 January 2021 and much like its share price since then, FY21's results showed strong growth. However, despite still trading at over 100% its IPO price, Pentanet is trading well below its 26 April high of $1.14. We think this pull-back represents an opportunity to purchase strong growth at a discount.

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Share price chart

Source: Tradingview

An old industry up for grabs

For avid readers of Stocks Down Under, the Swoop story likely feels like a serious case of deja vu. We have covered a number of startup companies looking to take a bite out of the Australian telecommunication and internet provider incumbents. Previously, we have covered success stories like Pentanet (ASX: 5GG | see this edition's 2nd report) and Hubify (ASX: HFY | see 16 July 2021 report), but also those that are failing to properly grasp the current opportunity like 5G Networks (ASX: 5GN | see 30 March 2021 report).

Yes, many of these companies have been around for years and under normal conditions would never be referred to as 'up-starts'. However, much like Australia's Superannuation sector (e.g. Netwealth ASX: NWL | see 12 October 2020 report), the telecommunication and internet incumbents are experiencing loss of market share to smaller, innovative and better focused 'up-starts'. One of the main catalysts for this market free-for-all was arguably the creation of the NBN nation-wide. This situation can't last forever and while there is still plenty of money to be made, the question is what are the chances Swoop will be left without a chair when the music finally stops?

Swooping down on the market

Swoop started its life on the ASX on 27 May 2021 through a backdoor listing. The company raised $20m at $0.50 in what quickly seemed to be day-light robbery as the stock jumped 150% to close at $1.25 per share on its first day of trading. Swoop has continued its incredible climb, currently offering investors that got in at listing an eye-watering 310% profit in less than a year.

All of this would seem odd, if not for Swoop's outstanding 26 August 2021 results announcement. During the year, Swoop grew its revenue 104% to $22.4m, generating $2.2m in EBITDA (growth of 165% year-over-year) before restructuring and listing costs. A large portion of this growth has to do with the company's massive expansion during the year. In FY21, Swoop grew its infrastructure significantly, adding 131 towers (390 total) and increasing its on-net Services in Operation (SIO) percentage from 30% during FY20 to 46% during FY21. For those not familiar with the difference between on and off-net, if an SIO (Services in Operation) is classified as off-net, it means the provider in question does not own the NBN Points of Interconnection (PoI) in that area and, therefore, is forced to deal with another company to acquire access, hurting margins. By owning the access, it not only allows for more efficient operations (no middleman), but it is usually cheaper in the long-run (no ongoing extra fees).

Swoop saw its total SIOs across its residential, business and wholesale divisions increase 24% to 30,723 during FY21 and we believe the 16%-point increase in on-net SIO year-over-year explains a large portion of the 61%-points difference between revenue growth and EBITDA growth (before restructuring and listing costs).

FY22 starts off with a bang

While nowhere near the revenue growth experienced during FY21, 1Q22 still saw significant revenue growth of 67% (to $10.3m) compared to 4Q21 due to a combination of organic growth and the first full three months' contribution of its Beam and Speedweb acquisitions. Unfortunately, management has declined to separate the two, but with SOI expanding 8% to 33,202 and on-net expanding to 49% of the total, it seems likely that organic revenue growth played an important part in 1Q22's revenue growth.

Prior to the announcement of the 1Q22 results, the market expected FY23 revenue and EBITDA growth to be 8.4% (to $49m) and 5.5% (to $11.6m), respectively. However, these numbers don't include the acquisition of voice services provider VoiceHub, which was announced on 6 October 2021.

VoiceHub was acquired for $6m, which is 4x its FY21 normalised EBITDA, of approximately $1.5m. So, the market consensus is out of date. And with profitable operations, $17.5m in cash and with management currently negotiating a debt facility, it seems unlikely that the company won't swoop down on additional acquisitions over the next two years.

If we use the market consensus earnings estimates as a baseline and add the EBITDA contribution from VoiceHub, Swoop's FY23 EV/EBITDA multiple comes in at 29.7x. We think this is pretty high considering EBITDA growth in FY23 is only expected to be about 5% (excluding any potential acquisitions). So, we're giving Swoop three stars for now. The risk we run with this rating is that if the company makes additional acquisitions in the next twelve months that are immediately accretive, EBITDA growth may come out a lot higher than 5%.

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Share price chart

Source: Tradingview

Australia feels the need, the need for speed

Like all countries in this technological age, Australia feels the need, the need for speed, internet speed that is. According to the Australian Government's July 2020 fact sheet on estimated demand for fixed-line broadband, requirements for 95% of households are estimated to more than double this decade, from 24Mbps in 2018, to 56Mbps in 2028. It was estimated that the average household data demand will increase even further, approximately quadrupling from 199 gigabytes per month to 767 gigabytes over the same period. According to the report, the growth in household data needs will mostly be a result of two trends: increased time spent online and use of more data-rich applications.

What is clear is that Australia has a need for higher internet speeds and with a plethora of new technologies becoming available, as well as the lower barriers of for NBN services, we believe this space is rife with opportunities for lean and mean start-ups.

Pentanet is a growth-focused telecommunications up-start, delivering high-speed internet to over 80% of Perth. This is achieved through Pentanet's wholly owned fixed-wireless network, the largest in Perth. This is an unusual asset for a company as small as Pentanet, but we believe it provides the company with an advantage on costs as well a measure of protection against competition.

However, these assets don't cover all areas, so the company resells fixed-line services, such as NBN, where its wireless service is not yet available. Pentanet's Perth fixed-wireless network is actually technically superior to the NBN in the area, a boon for customers and investors. Most importantly for our purposes, the margins have so far been attractive and are growing. This sets Pentanet apart from most other broadband providers, which only resell the NBN and, therefore, have much tighter margins.

Despite its success, Pentanet is not planning on sitting on its laurels just yet as it will also be part of the rollout of the next wave of subscription-based entertainment services: cloud gaming. And this is no vague promise either as the company has signed an Alliance Partner Agreement with NASDAQ listed NVIDIA. As the world's largest producer of specialised graphic chips used in gaming, NVIDIA has major exposure to computer gaming and the agreement allows Pentanet to be the first to bring NVIDIA's GeForce NOW technology to Australia in 2021.

1Q22 shows this growth is real

1Q22 was mostly a strong showing by Pentanet, besides its on-net customers, which declined 2%-points to 41% compared to the end of June 2021. For those not familiar with the difference between on and off-net, if an SIO (Services in Operation) is classified as off-net, it means the provider in question does not own the Points of Interconnection (PoI) in that area and, therefore, is forced to deal with another company to acquire access, which results in lower margins. So, it's better to have more on-net customers.

Despite this result, revenue increased 18% quarter-over-quarter, Average Revenue Per User (ARPU) increased $1 to $92 Q-o-Q and the churn rate declined 0.02%-points to 0.80%. The company is not yet profitable, and despite gross margins increasing 4%-points to 50% compared to the end of June 2021, we believe the result was negatively affected by the decline in on-net customers.

Pentanet is working hard on increasing its coverage, especially when it comes to 5G connection through its neXus brand. which now covers 80sqkm compared to zero at the end of June 2021. And we're keen to see just how powerful the partnership with NVIDIA's GeForce NOW will be.

On a trailing 12-month basis, Pentanet is trading at a whopping 15.9x EV/Revenue, mostly due to its FY21 revenue growth of 118% and recuring revenue growth of 132%. 1Q22 proved that the company was more than able to keep these customers, but it did not prove that the company deserved such a high valuation.

Still, GeForce NOW did only launch on 20 October 2021 and we don't believe it would be wise to underestimate the draw that a major company like NVIDIA's cloud-based game streaming service offers. Therefore, we are giving Pentanet a four-star rating, hinging on strong growth from GeForce NOW and management's ability to continue to increase overall margins, while keeping churn rate amazingly low.

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Share price chart

Source: Tradingview

Equities are back in style

One of the trends that seems to have lasted throughout the pandemic is the strong re-emergence of retail investors into the stock market. At the start of 2020, between 14-17% of all trading on the ASX and Chi-X was from retail focused brokers. Between the start of 2020 and through the first quarter of 2021, the share of trading rose fairly consistently to between 24-31%. If that does not convince you of this trend, how about the fact that the ASX Investing in 2020 - The state of the market report found that 25% of all investors only started investing in the last two years.

This is an article on The Market Herald, a group of forums and other digital media platforms providing insights for Australian and Canadian investors and market participants. Unfortunately, the market for Canadian retail investors has not been as strong as Australia's during the pandemic. The Ontario Securities Commission study on the pandemic's effects on retail investors found 52% of investors had not bought or sold any investments during the pandemic. The other half of investors have been active in buying or selling investments, 63% of which saw a net increase in their holdings.

Canadian investors certainly were active during the pandemic, but retail investor activity did not spike like it has in Australia, which we believe it is a strong bellwether of our region's potential for growth.

Innovating to meet demand

Until 25 June 2020, The Market Herald was listed on the ASX as HotCopper (ASX: HOT). Since then, the company has been listed as The Market Herald, symbol ASX: TMH. Much like its name, the change was a true herald of growth to come. The truth is, the change was a long time coming. During HotCopper's Annual General Meeting in November 2019, management outlined a new strategy, culminating with the $22m acquisition of Stockhouse, bringing the total combined entities' monthly online page impressions to approximately 100m, as of 18 May 2020.

Jumping forward to today and The Market Herald reaches 5.7m investors on and off its platform, facilitating over 100m page impressions and 22m video streams per month. During FY21, the company had its best performance since it IPO-ed with revenue increasing 91% year-over-year to $23m and EBITDA skyrocketing 349% to $15.8m. The main driver behind this increase in revenue was a 25% increase in customer contracts, mostly bundled service contracts to listed companies. The main reason for the growth differential between EBITDA and revenue in FY21 is that outside of employee and director benefits expense, expenses stayed flat year-over-year. In total, expenses increased 41.9% year-over-year to $17.5m, but 65.5% of this growth was derived from employee expenses alone.

Looking back in order to move forward

Unfortunately, we don't have consensus estimates for The Market Herald's FY22 revenue growth and, therefore, we have to use a trailing 12-month EV/EBITDA multiple, which currently stands at 15x. This is quite reasonable, in our view, given the company's strong growth trajectory. We believe the COVID-derived boom in equities trading is far from over and The Market Herald has proven that it can capture a significant portion of this boom. Therefore, while we believe FY21's EBITDA explosion won't likely repeat itself in FY22, we still believe there is plenty of growth left in the tank, four stars.

Pitt Street Research Pty Ltd

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Pitt Street Research Pty Ltd provides issuer-sponsored research for Small & Mid Cap companies and is founded on more than 40 years of combined experience researching companies in a range of different sectors.

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