



Small Cap Stocks Down Under

📖 *Anyone who has never made a mistake has never tried anything new.* 📖

- Albert Einstein (1879 – 1955), Theoretical physicist

APPEN

Now at the next level

EARLYPAY

Just early enough

MCGRATH

Perfect time, perfect place

APPEN

Now at the next level

Stocks Down Under rating: ★★★★★

ASX: APX

Market cap: A\$1.3BN

Dividend yield: 1% (50% Franked)

52-week range: A\$8.36 / A\$34.44

Share price: A\$10.70

What the heck went wrong with Appen? On [22 May 2020](#), when we last wrote about this Sydney-based supplier of training data for artificial intelligence systems, the stock traded around \$24 and we called it four stars. Appen, the stock, subsequently went to more than \$40, but has since been as low as \$8.45 on 12 October 2021. Appen the company, however, is all set for the next stage of its journey. Yes, call us stubborn, but this is still four stars for us.

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EARLYPAY

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ASX: EPY

Market cap: A\$129M

Dividend yield: 5% (100% Franked)

52-week range: A\$0.325 / A\$0.53

Share price: A\$0.44

Headquartered in Sydney, EarlyPay is a business financing solutions provider, specialising in 'safer' loans. What we mean by this, is EarlyPay's three loan options all have a requirement that they be backed by something. For example, EarlyPay Invoice Finance provides loans against unpaid invoices. Despite the challenging climate, FY21 was a strong year for EarlyPay, with Net Profit After Tax (but excluding amortisation of acquired intangibles) increasing 13% year-over-year. More importantly, the number of active customers increased each quarter. With management forecasting growth of at least 40% during FY22, are we early or late to this stock's growth?

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MCGRATH

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ASX: MEA

Market cap: A\$110M

Dividend yield: 2.3% (100% Franked)

52-week range: A\$0.355 / A\$0.74

Share price: A\$0.68

While this is our first report on Sydney-based McGrath, it is not the first time we have covered the company. On 24 January 2020 in Marc and Stuart's inaugural episode of Friday Beers they spoke at length about McGrath. A lot has happened over the last 659 days, but the real estate market has been rallying hard recently and we don't think this is going to let up anytime soon.

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Share price chart



Source: [Tradingview](#)

We were right for a while, at least ... Appen did go from \$24 to \$43.50 a share between May and August 2020. Back then it was hard for investors not to be excited by a world leader in such a new and economically important field as AI, that is, Artificial Intelligence. Particularly in calendar 2019, when Appen grew revenue 47% to \$536m while underlying EBITDA was up 42% at \$101m.

Training Day at Appen

Appen's business is the provision of essential 'training' data for AI. Let's say you're an AI specialist working on a Siri-like app called 'Marc and Stuart', designed to answer user questions on ASX-related investment ideas. The user will say to his or her device 'Hey, Marc and Stuart, is BHP a buy right now?' and the Marc and Stuart app will reply with a coherent and well-reasoned answer and recommendation.

Behind the smooth voices of Marc or Stuart that you would hear on the device (the user would choose), there'll be a sophisticated series of algorithms designed to replicate the way the real-life Marc and Stuart think about stocks. Before this system can be released, however, market and other data would need to be fed into the system so that the algorithms can be optimised, in a process called 'machine learning'. Appen's speciality is

sourcing and selling that data. It used to be just language data sets. Now it's all sorts of data sets. In a world where AI is doing more and more for us without our even realising it, training data is becoming a big, and high margin, business.

So what went wrong that could trip up the share price after \$43? In a word, Coronavirus. Not when the evil virus showed up in March 2020, but about nine months later, once major clients had started *'reprioritising resources towards new product areas that enhance their long term resilience and value'*.

AI was actually more important than ever to the world in late 2020. Like, there was a lot more AI needed in supply chains so they could cope with increased e-commerce. Or, healthcare systems needed more AI to be able to better allocate scarce resources. And so on.

Global spending on AI was estimated to be rising at a 25-30% annual rate. And companies who regularly worked with AI had started to develop products that people were now discovering they needed. For example, there were way more equity investors in 2020 than in 2018, so it wouldn't surprise us to learn that someone in Silicon Valley was working on a system like the theoretical Marc and Stuart app we described above.

2021 – the year of Covid-induced transition

For Appen the COVID crisis meant, temporarily, less demand for data to train older, pre-COVID AI systems. That in turn led to a December 2020 profit warning that suggested EBITDA for 2020 wouldn't be much more than it had been for 2019. The market was still annoyed at this disruption in February 2021 when Appen guided to constant currency EBITDA growth of 17% to 27% for the year we are in right now.

That annoyance intensified in August when the 2021 half-yearly result came in. In this period, revenue actually came down 2% while underlying EBITDA was down 14%. That EBITDA decline, however, was almost solely due to 'growth investments' by Appen that increased its cost base. We were impressed with the fact that the guidance for calendar 2021 hadn't changed, except for a slight adjustment to account for Quadrant, a business Appen bought at the time of the half-yearly results whose speciality was 'point of interest' data.

Before Quadrant, Appen had been guiding to US\$83-90m in EBITDA. Now it was US\$81-88m. How does Appen manage to maintain that EBITDA range after such a weak first half? That's simple – Appen always gets more of its business in the second half of the year, so a slight revenue decrease in the first half was almost a non-issue.

A different company

The 1HY21 result impressed on us how Appen had changed a lot since the beginning of COVID as it pivoted with the market. By mid-2021 it was much less reliant on major US tech companies and much less reliant on its foundation language data sets. And the company has started to sell more 'products' and less 'services', allowing it to scale more easily.

We think if Appen can get to the end of 2021 without any more disruption to its new growth path, then the stock can recover nicely. This year has proved Appen can move with the times. No one is suggesting that the kind of products it sells are decreasing in importance in the AI world. And looking forward, the market is expecting >18% growth at the EBITDA line in calendar 2022, but the EV/EBITDA multiple is only 9.6x. That looks inexpensive. Which is why, even after being disappointed for over a year now, we're keeping this one at four stars.

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Share price chart



Source: Tradingview

EarlyPay is all about the power of three

EarlyPay is broken up into three distinct business financing product offerings. The first is simply called EarlyPay and provides businesses with secured loans. Yes, that's right we did not say loans, but rather secured loans. You see, each of EarlyPay's loan products is based on an asset the company has or is using the funds to acquire. The EarlyPay division bases its loans off unpaid invoices its clients issue. Think of it as a payday loan, but for a company. Approvals can be as fast as 24 hours with interest rates between 4.95% and 11.95% per annum and credit lines between \$50,000 and \$15m.

The second financing product is Equipment. Like the name suggests, this product provides financing based on an existing or new piece of equipment. The loans start at \$20,000 and go as high as \$1m with rates around 7.5%.

The final product is EarlyPay Trade. This product is rather simple. If you are looking to purchase local or overseas goods or supplies, but can't front the cash, EarlyPay Trade might be right for you. The product can offer up to 100% advanced payment without the need for real estate to be used as security. However, EarlyPay does require outstanding invoices are used as loan security.

Staying the course during FY21

During FY21, EarlyPay mainly stayed the course. The company generated \$43.9m in income, a decline of 7.7% year-over-year. However, due to a series of cost cutting measures, i.e. a decline in staffing costs mostly, the company managed to generate \$8.7m Net Profit After Tax adjusted for a \$1.5m non-cash amortisation of acquired intangibles (NPATA), 13% year-over-year.

The main source of income for EarlyPay has been the invoice financing division at \$28.3m (7.9% decline year-over-year). Unlike its other divisions, invoice finance includes two products: EarlyPay and EarlyPay Trade.

The equipment finance division was the only division to actually see an increase in income, growing a whopping 22.1% year-over-year to \$14m during FY21. While business slowed during lockdowns, many companies took the opportunity for renovations, expansion and took out loans on their equipment to help stay afloat. We believe now that business in Australia is finally reopening, both of these divisions will likely experience strong demand.

Early to the FY22 party

EarlyPay is certainly one of the smaller business financing providers we have covered with only 450 active customers by the end of 4Q21. Still, management steered the company through an extremely difficult business climate without suffering any real damage and has now forecasted at least 40% growth in both NPATA and income for FY22. Despite this fantastic growth, the stock is still trading well below what we would consider fair value at an FY22 P/E multiple of 10x and 8.2x for FY23.

So why is EarlyPay trading at such a low multiple? We believe it can mostly be put down to the market not really paying close attention to the stock. EarlyPay over the last three months only had an average daily volume traded of 200,000 shares. In other words, using yesterday's closing price the average value traded over the last three months was only \$92,000 and like most thinly traded companies, EarlyPay's trading was mostly around specific days, rather than nicely spread out.

Despite the risk that such low volumes add to the stock, we believe management's forecast of at least 40% NPATA growth during FY22, coupled with what we believe is a heavily discounted valuation, makes EarlyPay a four-star opportunity.



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Source: Tradingview

Can't douse the real estate fire

Australia's lockdowns tried, but you can't fully douse the Australian real estate boom. Across Australia's five capital cities, prices were up 0.3% during the first eight days of November and 1.3% during October according to data collected by Propertyupdate.com.au. Looking at the three main capital cities of Sydney, Melbourne and Brisbane shows an equally strong result.

Over the last 12-months, prices in Sydney have risen 25.7%, Melbourne 16.6% and Brisbane 24.4%. While there were concerns during the early stages of the COVID-19 outbreak that there would be a permanent mass migration out of the cities, it's become clear that while many certainly did leave for good, demand for property is still going strong.

Over here at Stocks Down Under, our view of the situation is that, unlike many other 'property bubble countries', Australia's housing boom has a heavy fundamental basis. What it really comes down to is that even with the shutdown of Australia's borders, the 2021 through 2022 Australian Federal Budget predicted a return to population growth of over 1% annually as soon as FY23. It's important to note as well, that these forecasts were limited based on much slower vaccination rate predictions and there are comments from the Federal Government that the borders nationwide could be open in the next few months.

Full service is good service

The only way you can really describe McGrath is as a diversified real estate machine. The company has four main divisions: sales, management, franchise and other, covering virtually all aspects of property outside of building them. In FY21, McGrath generated 33.5% revenue growth (to \$122.4m) and a whopping 161% EBITDA growth (to \$30.8m). The company's focus is on residential properties, highlighted by the fact that the sales division only facilitates the sale of residential properties on behalf of the organisations and individuals who own them. During FY21, 67% of total EBITDA was generated by this division alone.

The real estate management division is responsible for the upkeep of residential properties on behalf of its clients. Revenue is generated through commissions in the form of both a management fee and a portion of the leasing fees earned by the property. During FY21, this division generated 16% of total EBITDA through the management of 7,748 leased properties through 45 managers.

What might surprise you about McGrath is that the company actually operates mostly on a franchise system. Sure, as of 30 June 2021, the company controlled 29 offices across New South Wales (23) and Queensland (6). Still, that's only 29 out of 107 total offices and none of McGrath's own offices are in Victoria. As of 30 June 2021, McGrath had 48 franchise offices in New South Wales, 14 in Queensland, 15 in Victoria and 1 in the Australian Capital Territory.

If you assumed COVID-19 would put a damper on this division, you would be mistaken. While McGrath shut down wholly owned offices in New South Wales while opening one in Queensland, its franchise offices saw nothing but growth. It opened its first office in the Australian Capital Territory, three offices in Victoria and a staggering ten in New South Wales. But what about the cold, hard sales? During FY21, 11% of McGrath's EBITDA was generated from this division through 10,250 property sales and 25,993 properties under management.

Growth, but how much?

Unfortunately, management has not released any guidance for FY22, but based on the property market's continued boom, we believe McGrath is likely in for another strong FY result. No, we don't expect EBITDA to grow by FY21's 161%, but it is important to note that this was not due to massive cost cutting, but rather keeping expense increases low compared to revenue growth. In effect, McGrath managed to increase its EBITDA margin from 12.9% during FY20 to 25.2% during FY21.

It is also important to mention that McGrath has \$35.8m in cash as of 30 June 2021. With a market capitalisation of only \$110m, this means that 32.5% of McGrath's current market capitalisation is covered by cash. Therefore, it should be no surprise that McGrath's trailing 12-month EV/EBITDA multiple is only 4.5x.

When we factor in the strong macro tailwinds for the property market and the strong operational efficiency of McGrath's operation, we believe this is a four-stars stock.

Pitt Street Research Pty Ltd

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