STOCKS DOWN UNDER

24 DECEMBER 2021

Small Cap Stocks Down Under

> ***Be clearly aware of the stars and infinity on high. Then life seems almost enchanted after all.***
>
> **- Vincent Van Gogh (1853 - 1890), Dutch Post-Impressionist painter**

SEQUOIA FINANCIAL GROUP

Growth is much higher than its value would suggest

RETECH TECHNOLOGY

In the wrong place at the right time

BLACKWALL

A REIT-like investment, without the property ownership

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Stocks Down Under rating: ★★★★

ASX: SEQ
Market cap: A$89.9M
Dividend yield: 1.5% (100% Franked)

52-week range: A$0.37 / A$0.745
Share price: A$0.65

Headquartered in Sydney, the Sequoia Financial Group has had a strong start to FY22, with the stock rallying 16.1% so far. The company operates as an integrated financial services company that provides its clients with a combination of products and services that enable them to growth their assets regardless of their investment style. What's so interest about Sequoia is that the stock is currently valued at a trailing 12-month Price/Earnings multiple of only 15.8x, despite having an indicative dividend of 8% and the fact that it grew its Net Profit After Tax by 181% in FY21. So, what's exactly is going on here?

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Market cap: A$58.2M

52-week range: A$0.23 / A$0.305
Share price: A$0.25

Retech Technology is a technology solutions provider based in Shanghai, China. The company's main products involve e-learning platforms and courses. It collaborates with corporations, schools and learning centres to develop advanced and innovative teaching methods, often allowing its clients to take offline courses online. Good management decisions over the last few years have led to this company being an undervalued gem, in our view. However, the risk associated with the company being based in China, especially after the government crackdown of private tutoring institutions, may be a problem.

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Sydney-based BlackWall generates revenue through the fees it charges clients to manage their real estate investment structures. In other words, BlackWall is a property management company and helps its clients manage their property. Property management is not a simple endeavour, with many things that must be managed daily. BlackWall does have one unique feature, though, unlike many of its competitors, i.e. the company is linked to one specific Real Estate Investment Trust (REIT), WOTSO Property.

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Share price chart

Source: Tradingview

Neatly diversified operations

Sequoia Financial Group is an integrated financial services company split neatly into four divisions: wealth, equity markets, professional services and direct. The wealth division managed over $4bn in Funds Under Administration (FUA) through the company's approximately 400 advisors. However, these are not just standard advisors. Sequoia's wealth network supports specialists who focus on superannuation, risk insurance and aged care as well as more traditional financial and equity advisors. The wealth division has particularly strong macro winds behind it as Sequoia was not in the Royal Commission's crossfire and the company has generated a large portion of its growth over the last few years through capturing what the banks and insurer-owned advice groups are being forced to leave behind. Management has said it expects these conditions to last for another two to three years and based off our analysis, we believe this is likely a conservative estimate. There are plenty of wounded giants still kicking in this industry, like Insignia Financial (ASX: IFL | see 20 December 2021 report).

The equity markets division is focused on two overarching products and services: execution services and structured investment products. The execution services offerings are rather broad, including Australia and international shares and equity options for everything from online trading companies to fund managers. One of the major reasons this division has performed so well over the last three years, in our view, has the company's willingness to make significant technological and system investments. There have been a lot of changes in the market clearing space over the last three years and not everybody has been as willing to make improvements as Sequoia has been. We believe this will continue to provide a significant advantage going forward.

The professional services division has two parts, technological solutions for the accounting and financial planning industry and Self Managed Super Fund (SMSF) administration services, general insurance and finance services. Management put this division's market penetration in the Australian accounting industry at approximately 25% and further increasing this penetration further is this division's main goal. However, that 25% is far from locked down and management has stated that there are opportunities to expand its business with many of the accounting firms the company already does business with. The other major focus of this division is SMSF administration. Management has said it's targeting a 50% increase in the number of funds under administration by June 2022.

Lastly, the direct division is a cluster of three different operations, Sequoia Direct (online, no-advice-broking), Sequoia Asset Management (general advice business for self-directed investors) and the Finance News Network (a media platform for daily market news, company and webinars and events, CEO interviews and managed fund marketing).

The proof is in FY21's earnings

All four divisions saw sharp increases in EBITDA in FY21, with only the direct division experiencing a decline in revenue and this is why, for FY21, overall revenues increased 37% to $116.4m while EBITDA increased 138% to $11.5m. The largest source of both revenue and EBITDA was the wealth division, generating 36.3% revenue growth to $55.3m and 109% growth in EBITDA to $6.1m. The equity markets division generated $52.3m in revenue and $5.9m in EBITDA, representing 41.4% revenue growth and 63% EBITDA growth year-over-year.

This leaves the two smaller divisions, direct and professional services. The direct division had a small decrease in revenue from $2.2m in FY20 to $1.9m in FY21, but EBITDA almost doubled from $310,000 to $590,000. Meanwhile, the professional services division saw revenue increase from $4.7m in FY20 to $7.1m in FY21 with EBITDA increasing from $1.5m to $2.1m.

To summarise what all these numbers mean, Sequoia is not only consistently capturing business, but it is making its existing operations more efficient.

Unseen by the market

Sequoia is currently trading at a trailing 12-month Price/Earnings multiple of only 15.8x despite the indicative dividend yield of 1.5% and NPAT growth of 181% in FY21. We believe the reason behind this disconnect between the company's valuation on the one hand and its results on the other can be explained by two factors.

Firstly, Sequoia is unknown and ignored by the market. Over the last three months, the average daily share volume traded on ASX was only 160,000 shares, an average daily value traded of only $115,200. While $115,200 is rather insignificant, its actually worse than that number suggests. for a lot of the time, fewer than 10,000 shares are traded daily and on 29 October 2021 alone, 4.8m shares were traded on one day, significantly skewing the average over the last three months.

The second reason for the disconnect is that small integrated financial services companies on the ASX don't usually have significant assets and a less diversified client base than large cap Financials. This means that one bad reporting period, or even just because a major client a large expense or loss they need to cover, can cause a significant and unexpected drop in the company's FUA. Remember, Sequoia only had FUA of $4bn in FY21.

Despite these risks, we believe Sequoia's growth is far too impressive to ignore. FY21's 181% growth in NPAT is clearly not a one-off event. We believe the result was due to the culmination of management's hard work and ability to increase its margins while capturing and retaining new clients across its four divisions. The company's two main divisions (wealth and equity markets) have demonstrated that they can grab customers from the 'wounded giants' and we expect this to continue over the next few years, especially with the technological investments Sequoia made during FY21. While Sequoia's long-term goal of $400m in annual revenue by 2025 is certainly a lofty one, FY21 was a vital step in the right direction and grants credence to management's ability to actually get it done. Four stars from us.

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Share price chart

Source: Tradingview

An industry expert with big-name clients

Retech Technology was founded in 2016 and listed on the ASX in June 2017. The company's primary business is providing e-learning solutions. To that end, it develops general software and courses as well as bespoke solutions for clients.

Most of the company's business consists of online training materials. Retech uses learning materials provided by its clients and uses those materials to create online training videos, articles and exercises to make employee training and retraining easier for large corporations. Since corporations may have tens of thousands of employees, training them individually or in groups can be costly. Using Retech's solutions can be a cost-saving measure for companies. It comes as no surprise that some of Retech's clients are well-known names, such as Mercedes-Benz, McDonald's and Huawei.

One of the company's most significant advantages is that it can pursue repeat projects using existing technology. For example, if the company develops courseware, it may be possible to use that product indefinitely. It is also possible for the company to leverage its existing software when developing bespoke solutions for clients, thereby cutting costs and delivering high-profit margins.

In the last three years, the company has made two significant changes: It has begun to switch from a pay-as-you-go model to a subscription model. It has also started to move into adjacent fields to leverage its expertise and improve standard practices considerably.

Recurring revenue as the primary goal

By the time Retech listed on the ASX, it had operations in both China and Australia. The company's next goal was to expand to other countries in Asia and build up a continent-wide presence, which it did through numerous shrewd acquisitions.

Net profit quadrupled to $7.6m in FY17 and continued to increase rapidly after that. However, despite increasing revenues, the company had a problem with volatility. Its profits depended on signing new clients and completing projects. As such, it began to switch to a recurring revenue model in December 2018 and moved into synergistic businesses.

The company signed a non-binding agreement to purchase 51% of the Victorian-based XJS coaching school, completing the takeover in June 2019. The school provides language tuition and Retech uses and tests its e-learning solutions in the company's six branches spread throughout the state.

Retech has also begun to offer ESG courseware on a subscription-only model, thereby allowing the company to have a consistent stream of revenue. The Software as a Service (SaaS) approach should enable the company to reduce the volatility of a portion of its revenues.

This approach is beginning to show results. Revenues almost doubled from FY17 to FY20 and are now at over $41m. Net profit has risen to $11.5m by FY20. Although the profit growth has begun to slightly stagnate in recent years (with net margins shrinking from 37.7% in FY18 to 27.8% in FY20), a lot of that can be attributed to the company massively expanding its scope of operations and the accompanying increase in Retech's cost base. Total revenues, a much better metric in such a situation, are still increasing at a rapid rate.

Should you be worried about the government?

In July 2021, the Chinese government ordered all after-school tutoring facilities to become non-profits, along with further business restrictions. The education sector has generally come under tight scrutiny in 2021, after years of the Chinese president Xi Jinping denouncing the after-school tutoring industry as a chronic disease (or similar terms).

However, vocational education has not been affected by this ruling. While Retech's share price fell by more than 20% in the wake of the announcement, it seems that the Chinese government still fully supports vocational training. After all, it invested over RMB25bn in vocational training in 2020.

That said, we believe the government crackdown does present a risk for all Chinese companies in the education sector. After all, it's view on companies like Retech could change if they became large enough. At the very least, investors may shy away from such companies for the foreseeable future, in our view.

Moving vertically and horizontally

In October 2019, Retech announced its first dividend, at $0.005 per share. However, this was a one-off and dividend was cut in FY20. We suspect this is partly due to COVID-19 and partly due to the company finding better ways to invest its surplus.

One of the ways was to purchase an 80% stake in Shanghai Pantosoft for $15.3m. Talks began in January 2020 and the acquisition was completed a year later. Shanghai Pantosoft is a software provider for vocational schools in China and should allow Retech to focus on expanding in its domestic market.

The company is aggressively expanding on all three fronts: Australia, China and the wider Asian continent. When Pitt Street Research last covered the company in June 2020, we upgraded our valuation to a range of $1.33-1.64 per share. With the added risk of the Chinese government intervention, that target seems unfeasible right now. Although the government scrutiny is mainly focussed on primary education, it will still impact the overall market confidence in companies such as Retech, with risk-averse investors tending to stay away.

Still, we believe the company is fundamentally sound. With a trailing 12-month EV/EBITDA ratio of 2.2x, Retech technology has a lot going for it. However, we can't deny the risk in both Retech's market and the stock right now. If the company had adequate liquidity, we would be giving it four stars, but with an average daily volume traded over the last three months of only 50,000 (most days see zero shares traded), we think the lack of liquidity amplifies the risk to an unacceptable level. Therefore, we don't believe the risk warrants the reward right now. Keep this one on your watchlist, but it's three stars for now.

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Share price chart

Source: Tradingview

No, this is not a deja vu

For avid readers of Stocks Down Under, the name BlackWall likely sounds familiar. If you can't quite place it, Blackwall is part of the WOTSO Property group (ASX: WOT | see 27 August 2021 report). To make things slightly more confusing, WOTSO Property is a stapled entity, combining WOTSO and the BlackWall Property Trust. Prior to 2021, BlackWall Property Trust was a singular trust under the name BlackWall Property Trust (ASX: BWR | see 14 August 2020 report). For the sake of clarity, when we discuss BlackWall we will say BlackWall, when we discuss the BlackWall Property Trust and WOTSO Property, we will say BlackWall Property. As of 30 June 2021, BlackWall controlled 15,375,201 units of WOTSO Property.

BlackWall generates the majority of its revenue through fees it earns for managing the real estate investment structures of BlackWall Property. During FY21, the company generated $3.1m in Net Profit After Tax (NPAT) from its operations, a decline of $1.2m year-over-year. However, this decline was due to the non-cash investment income boost from the WOTSO demerger (see our BlackWall Property report) to the tune of $2.7m in FY20. So, on a normalised basis, NPAT actually increased $1.5m year-over-year. Although taxes were $745,000 higher in FY20 compared to FY21, there's no denying that FY21 was an impressive year for BlackWall and we believe FY22 will generate similarly impressive results.

Like WOTSO, there are buybacks here too

On 27 September 2021, management announced that between 15 October 2021 and 14 October 2022, the company will run a buyback program for approximately 10% of the company's outstanding shares. While it is important to note that this does not guarantee that the company will buyback 10% of its outstanding shares during the period, both BlackWall and BlackWall Property have a long history of consistently buying back shares on market. Therefore, we are confident that BlackWall is likely to see a significant portion of its share purchased as part of the buyback in the near future.

Adding some further colour to our analysis of the buybacks are Non-Executive Charman JR Glew's recent purchases, who readers of our BlackWall Property reports will remember has bought shares so consistently that we have compared his purchases to an unofficial buyback. His purchases extend to BlackWall as well and on 30 November 2021 he purchased 16,001 shares at $0.595 per share. This brings his total holdings to 10,462,770 shares. JR Glew willing to increase his holdings at almost $0.60 per share is a strong sign, in our view, that management believes the stock is currently undervalued.

In BlackWall Property we trust

A purchase of BlackWall is essentially an alternative method of investing in BlackWall Property. However, instead of investing in the actual property, you are investing in the fees generated from the property upkeep and significant growth will only come from the trust acquiring additional properties. The company is currently trading at a trailing 12-month P/E of 12.1x, which gives us an indicative, fully franked, dividend yield of 8.5%.

It is our belief that those looking for capital growth should look at BlackWall Property (ASX: WOT). But those looking for an undervalued, fully franked, high dividend stock that, we believe, will stand the test of non-transitory inflation, BlackWall is a four-star stock that's worthy of your attention.

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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