STOCKS DOWN UNDER

21 JANUARY 2022

Small Cap Stocks Down Under

"Excuse me, sir! I... I can help. Let me help. I'm really strong, and I'm sticky.'"

- Peter Parker (Spider-Man: Far From Home), American movie

KOGAN.COM

Missing the point

ICOLLEGE

Using the Pandemic to its advantage

HARRIS TECHNOLOGY

The house that Garrison built

KOGAN.COM

Missing the point

Stocks Down Under rating: ★★★★

ASX: KGN
Market cap: A$791M

52-week range: A$7.16 / A$21.89
Share price: A$7.23

Melbourne-based Kogan.com is a stock that has been hitting the Stocks Down Under report card hard. From our first four-star rating on 24 August 2020, the stock has plummeted over 66.7% and yet, we repeated our rating in ASX Top 200's 8 March 2021 edition, and 3 December 2020 insight article Cyber Monday is the new Black Friday. Sure, Kogan.com is not growing EBITDA at the 57.9% it did in FY20, and EBITDA declined 32.3% in FY21. But you need to look deeper at the numbers to see that not only was this a temporary decline, but the fundamentals that foreshadow Kogan's margins and customers are more robust than ever.

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Share price chart

Source: Tradingview

A star pointing south

By 23 November 2020, the market had sold off shares in Kogan.com to $16.96 per share on concerns that the COVID-19 rally was just a temporary bump. But the stock has fallen a lot further since then, and we believe the primary source of the overwhelmingly negative sentiment can be traced back to a report from Morningstar's director of equity research, Johannes Faul. Published on 23 November 2020, the report valued Kogan at $10.50 per share, with the report's criticism boiling down to three main points.

The first was that Kogan was trading at multiples higher than its peers. When we first issued our four-star rating on 24 August 2020, FY21's EV/EBITDA ratio was 45x on 65% market consensus EBITDA growth. Far from a premium, but Kogan was trading a premium compared to its competitors' EV/EBITDA multiples.

This brings us to the second point of the report. Morningstar believed that the market was overestimating Kogan's future growth. According to the report, it was unlikely that COVID-19 opened up a new era for Kogan, forecasting that growth was most likely to fall back to pre-COVID-19 levels, if not outright decline, across the short to medium term.

The third reason was Mr Faul's expectation for "many omni-channel retailers to become increasingly competitive online". He is also quoted by the Australian Financial Review (AFR) as citing Amazon as a major future threat. In summary, we believe three things about the Morningstar report. First, it was well researched and not a hit job. The second was that a lot of the negative market sentiment persisting to this day has come from this report. It is also important to note here that this was right on the tail of Kogan's founders giving themselves 6 million in retention options valued at $100m for no good reason, upsetting both shareholders and the media. To be clear, we do not support this move and believe it was short-sighted, against shareholder interests and terribly timed.

Lastly, while the report did bring up a number of valid, short-term concerns, we strongly disagree that COVID-19 was a one-hit-wonder for Kogan. In hindsight, we should have been far more cautious about how long the COVID-19 growth spurt would last. Still, Kogan First membership and exclusive brands have continued to grow, and we believe the market underestimates these figures' strength as forward indicators.

There are Three Horsemen, not Four

Kogan's overall results have been struggling, that is undeniable. But we believe three elements of Kogan's results are telling a different story. You see, when it comes to Kogan, there are Three Horsemen of Profit, not Four Horsemen of the Apocalypse. These three Horsemen are 'exclusive brands', 'active customers' and Kogan First, and they are telling us a story of profits to come, not a return to pre-COVID-19 expectations.

Exclusive brands is a retail-specific term that means the company owns and manages the products. An example of this is Coles' (ASX: COL | see 3 May 2021 report) brand of canned corn kernels. They cost $2.38 per kilogram, compared to the other brands the company stocks like Edgell's at $4.52 per kilogram. At first glance, it might seem like Coles would make more money off the sale of the Edgell product, but despite being sold at 52.7% of the price, Coles earns more profit off the sale of its exclusive brands. The same logic applies to Kogan. Exclusive brands usually (but not always) sell for less than alternatives for sale at the company. Still, due to control over the supply chain, and no middleman costs, these products are usually the most profitable items sold. In FY21, Kogan generated year-over-year growth in exclusive brands revenue of 62.5%, bringing its portion of total gross profit to 51.6% - total gross profit was $203.7m in FY21. Management has talked about how exclusive brands are a key focus, and we believe this focus can translate into strong profit margin growth.

Still, Kogan would not have much of a business without customers to purchase Kogan's products, and the key statistic here is what's known as 'Active' Customers, that is, customers who have made a purchase within the last 12-months. Active Customers have continued to grow rapidly, reaching 3.4m as of 31 October 2021, increasing 4.8% against 30 June 2021 and 46.9% compared to 30 June 2020. A more advanced customer metric is Kogan First, the company's rewards membership program.

Like Amazon Prime membership numbers, we believe Kogan First membership growth strongly indicates Active Customers' health and future growth. Excluding trial members, in FY21, Kogan First membership grew 99.7% to approximately 110,000. That's impressive. Even more impressive, however, was the 270% growth in Kogan First membership in the four months to 31 October 2021, to over 220,000. Kogan First members, who pay approximately $105 per year to get significant savings, reward points and many other perks, demonstrate stronger loyalty and repeat purchase behaviour than non-members. We believe the strong and consistent growth among Active Customers and Kogan First membership numbers give the lie to the notion that Kogan is over as a growth story, even if the COVID-19 situation changes in 2022.

Nothing but pessimism from the market, but we're optimistic

The market has hated on Kogan for a long time now. On 14 January 2022, 10.8% of shares outstanding were shorted, even though the stock was down 65% over the previous twelve months. The market has also continued to decrease its consensus EBITDA growth forecasts, but the current FY23 number of $68.7m still represents 30% year-over-year growth. That's right – those Three Horsemen are allowing not just double-digit earnings growth but double-digit-times-three earnings growth. And yet, Kogan stock is currently valued at an FY23 EV/EBITDA multiple of 11.3x. So, not only do we believe Kogan is highly undervalued and likely to beat the current market consensus estimates based on the Three Horsemen, but it is ripe for a short-squeeze rally. After all, Kogan is the second most shorted stock on the ASX. Maybe the Fourth Horsemen of this company's success will be a destruction of the shorts. Ahead of that massacre, Kogan is four stars for us.

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Share price chart

Source: Tradingview

College, but intelligent

University has traditionally been considered the only way to gain skilled, high-paying employment. However, that view has been changing in recent years due to a massive increase in costs, the availability of alternative options (e.g., online courses and trade schools), and the decline in the pay for graduates relative to non-graduates (except for the STEM fields).

Vocational schools that aim to instil technical skills for specific jobs (e.g., plumber or electrician) have seen an increase in students over the last few years. Growth in this field has been helped by changing attitudes and lower fees, skill shortages, and the ability to graduate in approximately half the time it would take to earn a bachelor's degree.

In the 2017 Australian federal budget, university fees were set to increase 7.5% for a four-year course by 2022. On top of that, debt repayments now begin at an income level of $42,000, compared to $55,000 previously. Similar cost increases are occurring all over the world. As such, it is no surprise that vocational training is in high demand. According to research from Wise Guy Reports, the global vocational training market was worth over $40bn in 2020 and is forecast to grow at a Compounding Annual Growth Rate (CAGR) of almost 10% to $60bn by 2027.

To help fill the increasing demand for alternative education courses from investors and students, iCollege listed on the ASX in 2009. Still, it was not until 2014 that the company launched its online portal and began providing accredited and non-accredited courses. iCollege has always emphasised meeting international training standards, allowing the company to enrol more foreigners than other vocational schools.

Hacking its way through COVID

The Pandemic presented an interesting problem for iCollege. On the one hand, the switch to online education could lead to higher revenues through the company's online courses. On the other, closed campuses and borders would cause significant losses as foreign enrolments would dry up.

While the company could do nothing about the closed campuses, it immediately went to work once the lockdowns lifted and switched its focus to enrolling domestic students. By July 2020, the company generated 70% of its on-campus revenue from domestic students. Before the Pandemic, domestic and foreign revenues were split more or less evenly.

Around this time iCollege was shifting its focus very much to online learning. In March 2020, iCollege acquired 80% of The Hacking School for $184,000 in cash payments and $184,000 worth of shares in ICT. The Hacking School? Like, as in, computer hacking? Yes, but 'hacking' in a positive way. The Hacking School is a boot camp-style coding course in India – indeed, the first of its kind. With The Hacking School, iCollege has both an in-person and an online platform that can be scaled internationally.

RedHill leads to BlackInk

In 1HY20, just before the advent of the Pandemic, iCollege generated its first positive EBITDA after revenues surged 103% to over $7m. During 2HY20, the company's performance took a hit, and EBITDA posted a loss of $1m, with a net loss after tax of $2.6m. Lockdowns were in place in parts of Australia well into FY21. But, iCollege had already found its footing by then and generated $16.3m in revenue and $2.9m in EBITDA. If we include RedHill, then the combined entity generated $59.8m in revenue and $11.2m in EBITDA – excluding one-time costs, e.g. issuing shares for the acquisition. RedHill was a listed competitor to iCollege which it acquired in late 2021 in a scrip-only deal. We think RedHill will now put iCollege on the map as an education provider to be reckoned with.

With post-Pandemic normalisation underway, we should also see both domestic and international students returning to campuses full-time in the near future. Not only does this bode well for iCollege, but we believe it makes the RedHill acquisition especially fortuitous. You see, FY21's combined entity revenue was 65.8% international and 34.2% domestic due largely due to RedHill's international student exposure. With the combined company (iCollege and RedHill) trading at an FY21 EV/EBITDA multiple of only 10.7x, we believe iCollege is a four-star investment.

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Share price chart

Source: Tradingview

Newly focused and digital-only

Harris Technology has seen more than its fair share of owners and leadership styles. Acquired by the Coles Myer Group in the late 1990s, Harris was sold along with Officeworks to Wesfarmers in 2007 and bought by Anyware Corporation in 2015. In 2016 Shoply merged with Anyware and the Harris Technology Group. The combined entity changed its name to Harris Technology and began trading on the ASX in August 2016. The next great change for Harris came in 2019, when the company went through a significant restricting, shifting its focus to online sales.

Harris Technology's specialty always has been consumer electronics - everything from the iPad you bought in lockdown to the USB cables that connect your devices. Its point of difference is its leading position on Amazon Australia, eBay, and Kogan (ASX: KGN). Customers tend to do a fair amount of research when purchasing, say, an expensive MacBook Pro. But if they buy the computer from an e-commerce giant, they probably don't know which company organised the products for sale and shipment. If you are in Australia, the device you're reading this report on might have come from Harris Technology without you realising it!

Retail vs online: take another look

In the mainstream media, the debate surrounding retail and online competition is often framed as the horse versus the automobile. Sure, online e-commerce behemoths like Amazon, eBay and Alibaba will defeat those tiny bricks-and-mortar retailers that make up the lifeblood of towns and cities, won't they? Harris Technology is itself partly responsible for spreading this viewpoint, having jettisoned its physical stores over the last three years. And the timing was exquisite: Did you know that ten years of e-commerce growth occurred in just 90 days at the height of the Pandemic last year?

We still think the retail versus online argument is a false binary, and former Marc & Stuart Top Pick Lovisa (ASX: LVS | see 21 Novembere 2021 report) is a perfect example to illustrate our point. Lovisa sells inexpensive jewellery through a perfect combination of significant retail exposure and an easy-to-use online store. Even if, as Morningstar Equity Research forecasts, Amazon Australia will account for 5% of the total retail market by 2030, then that still leaves most of the market to traditional retailers and hybrids. The simple fact is there's room for all kinds. What a company actually does in terms of user experience, whether it's a bricks-and-mortar store, hybrid, or digital-only venture, is far more important to long-term success than what category the company belongs to.

Who is the competition?

We point this out because the retail vs online binary skews investors' perceptions of who a company's competition might be. Moving back to Harris, one might initially suspect that the present incarnation of Harris Technology is competing with online titans like Amazon and eBay, or closer to home, Kogan. Not so. In June 2021, Harris Technology stacked up $1m of sales on eBay, a sevenfold rise from monthly sales in January of the same year. Think of it this way: Harris Technology has effectively outsourced its marketing and branding to giants like Amazon and Kogan, and with those huge costs out of the way, acts as a platform reseller. As the online behemoths grow, so will Harris Technology.

Harris' most formidable competitor, in our view, is JB Hi-Fi (ASX: JBH | see 20 December 2021 report), a hybrid retail-online company that cherishes its good old-fashioned bricks-and-mortar stores yet has done very well online shopping during the Pandemic. The two companies have similar margins despite the tremendous difference in size between Harris Technology and JB Hi-Fi—a David and Goliath scenario where the online reseller is the underdog. In FY21, JB Hi-Fi posted gross margins of 22.3%, up slightly from FY20. On the other hand, Harris maintained sales margins of 18.3% in FY20 and FY21. The key difference is that JB Hi-Fi haemorrhages money on advertising and marketing, a competitive advantage that will aid Harris Technology in the coming years as it pursues greater margins.

Impressive numbers and a lagging market

Harris' Managing Director Garrison Huang was noticed hoovering up the stock last year, always a good sign for us at Stocks Down Under. The stock hasn't really caught up with Garrison's optimism, but we think that day is coming.

The home office booms of mid-2020 and last year's lockdowns in Sydney and Melbourne may have sated Australians' appetites for laptops and printers—at least for now. But Harris Technology has the product range to go the distance, having made a motza selling PPE gear over the past year or so. Home appliances and kitchenware are soon to appear, too. The company also has short-term plans to launch private label products, a strategy we wholly endorse and believe will further lift margins and increase brand recognition.

There's no consensus numbers, but the trailing 12-month EV/EBITDA multiple stands at only 6.1x. That is staggeringly low considering FY21's 307% year-over-year EBITDA growth on 206% revenue growth. While we don't believe triple-digit growth is in the cards for FY22, 1Q22 generated 54% revenue growth year-over-year and no indication of a margin crunch. In fact, management has said it is focusing specifically on increasing profitability. We believe this indicates EBITDA growth is likely to outpace revenue growth once again in FY22. All-in-all, we believe the company is significantly undervalued. Four stars.

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