Small Cap Stocks Down Under

"The best way to get a bad law repealed is to enforce it strictly."

- Abraham Lincoln (1809 - 1865), 16th US President

VULCAN STEEL

Living long and prospering

RAM ESSENTIAL SERVICES PROPERTY FUND

No reason for a premium

CTI LOGISTICS

Transporting shareholder profits

VULCAN STEEL

Living long and prospering

Stocks Down Under rating: ★★★★

ASX: VSL
Market cap: A$1.2BN

52-week range: A$7.08 / A$10.47
Share price: A$9.17

One of the newer additions to the ASX is Vulcan Steel, a steel processor and distributor from New Zealand. Vulcan listed on the ASX and NZX on 4 November 2021 at A$7.10 per share. After initially rallying approximately 10%, it has been traded sidewise. The market consensus forecast has FY24's EBITDA results as effectively the same as FY22, but with Australasia's construction and manufacturing activity re-emerging, does that seem likely? Let's find out.

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ASX: REP
Market cap: A$498M
Dividend yield: 6% (0% Franked)

52-week range: A$0.93 / A$1.05
Share price: A$0.945

One of the newer Real Estate Investment Trusts (REITs) on the ASX is the RAM Essential Services Property Fund, which listed on the ASX on 20 October 2021 at $1.00 per unit, a 6.1% premium to its Net Tangible Assets (NTA). We don't believe paying a premium for RAM makes sense, but the unit price has fallen over the last week, making the situation far more interesting.

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CTI LOGISTICS

Transporting shareholder profits

Stocks Down Under rating: ★★★★

ASX: CLX
Market cap: A$69.5M
Dividend yield: 4.5% (100% Franked)

52-week range: A$0.675 / A$1.06
Share price: A$0.945

Headquartered in West Perth, CTI Logistics provides logistics (obviously), transport and security services to clients across Australia. While FY20's results were disappointing, to say the least, CTI's FY21 results saw not only a return to pre-COVID-19 levels of profitability but expansion across the board. The results were so strong that management even felt comfortable paying a dividend of $0.02 per share. With additional growth plans already in motion, we believe this stock is ready to transport shareholders some profits.

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Share price chart

Source: Tradingview

Steel, there's more than one type

When Sir Henry Bessemer patented the first method of mass-producing steel (the Bessemer process) in 1856, the world changed. Before the Bessemer process, steel was used only for small items like knives and cutlery, but even those items were extremely expensive. Even war machines like cannons were not built of steel, and yes, until the switch cannons occasionally exploded when fired (even with proper maintenance). Still, it was not until 1874 that steel was really established as the backbone of modern life when the legendary steel magnate Andrew Carnegie (founder of Carnegie Steel, the precursor to US Steel, NYSE: X) used it to build the Eads Bridge.

The Eads Bridge was the first-time steel was used as a structural material on a large-scale project. The combination rail and road bridge became the first bridge (of any kind) to withstand the current of the Mississippi River (it still stands to this day – you can cross it any time you're in St Louis, Mo.), and steel's adoption as the go-to structural material quickly followed. The story of the bridge is fascinating, and its influence on modern life cannot be overstated. While we must move on, it is important to remind our readers that prior to the mass use of structural steel, bridge and building collapses were common around the world, and we would never have been able to build our skyscrapers. Structural steel was the catalyst that allowed prices to fall to where it could be used for other items like cannons.

More than just a middleman

Now that we understand steel's importance, let's dive into Vulcan's business. Vulcan provides two services through its 29 operating sites across Australia and New Zealand. The first is as a middleman distributor for steel and finished products. The second is processing the metal in house into general steel products like plates and coils or to exact customer specifications.

In FY21, Vulcan generated NZ$732m in revenue and NZ139m in EBITDA. Revenue was up 22%, but EBITDA really shot the lights out, up 48%, thanks to management successfully controlling the cost of sales while simultaneously bringing about a sharp increase in the price of finished steel products. We expect these prices to remain elevated for the next few years due to the supply chain issues everyone has been talking about lately. So, we were not surprised when management increased its FY22 EBITDA and Net Profit After Tax (NPAT) guidance to NZ$174-184m and NZ$93-100m, respectively. The new NPAT guidance was 25-35% better than Vulcan had previously announced. Talk about living long and prospering!

Vulcan's largest revenue-generating division in FY21 was steel at NZ$450m. This division is responsible for distributing finished steel products (hollows, merchant products and plate and coil) and by processing steel plate and coil products to customer specifications. Vulcan's metals division did another US$281m in FY21, thanks to its customers' continuing need for stainless steel and 'engineering steel'. Engineering steel? That's just steel you can use in mechanical rather than structural applications, where that steel has to meet certain levels of elasticity, strength, 'ductility', toughness and fatigue resistance. Ductility, by the way, means the ability to draw out metal into a long, thin piece without damaging it permanently. It's a good thing we at Stocks Down Under have dictionaries close at hand.

The market is missing the mark

When Vulcan says its customer base is 'large and diversified', it is not joking. In FY21, the largest Vulcan customer only accounted for 2% of its total revenue, while the top 20 customers accounted for 13%. In Australia, the majority of Vulcan's customers operate in the construction industry, while in New Zealand, business is split between manufacturing and construction.

The low end of Vulcan's EBITDA guidance values the stock at an FY22 EV/EBITDA multiple of 8.4x. This multiple is based on an estimated EBITDA growth rate of 34%. We believe the valuation discount can be traced to an unreasonable assumption by the market that Vulcan's FY23 EBITDA will decline 7% year-over-year. We expect the high price of finished steel to remain high until the world's supply chain issues are resolved, and since Vulcan does not seem to have too much trouble getting its steel, we think that's got to be good for the FY23 numbers. We also don't see demand declining either, especially considering the diversification of Vulcan's customer base. We think the market has missed the mark here, which is why we're calling Vulcan four stars.

However, we need to end this report with one point of caution. Vulcan is primarily traded on the NZX. Of the approximately 131m shares quoted on the ASX at the end of December 2021, the ASX reported zero were held in Australia - although the ASX's monthly Foreign Entity Report does round down. Perhaps Vulcan Steel's motto should be 'live long and prosper, even if you live in Australia'.

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Share price chart

Source: Tradingview

This means WARR

RAM Essential Service Property Fund fell rather quickly below its listing price of $1.00 per unit, a 6.1% premium to its Net Tangible Assets (NTA). Let's take a quick dive into this Real Estate Investment Trust's (REIT) portfolio and see if RAM deserved that initial premium to its NTA.

As of late November 2021, RAM owned 33 properties, and we will get into a more detailed analysis of the properties later in this article. The 33 properties have an occupancy rate of 99.1% and a Weighted Average Lease Expiry (WALE) of 7.1-years. However, the Weighted Average Rent Review (WARR) is only 2.2%. You read that right. When that rent is up for review, the average increase is only 2.2%, and only 45% of the portfolio, as measured by gross passing income, is subject to fixed annual increases. You've seen the inflation numbers in Australia and heard everyone talking about how the word 'transitory' shouldn't be used to describe post-Covid inflation. Our view about WARR is further fortified when we consider that RAM's Weighted Average Capital Return (WACR) is only 5.9% as of 31 August 2021's valuation.

Okay, this isn't the end of the world, but not quite what we would expect from a trust demanding a 6.1% premium to NTA at the time of listing. Perhaps a more detailed look at the properties and pipeline will change our mind.

Opening the book on the properties

As indicated by its name, RAM's property investments are focused on medical and essential retail properties. As of August 2021, the property portfolio's breakdown by income was 45% medical, 49% essential retail, 3% gym and fitness and 3% non-essential. This includes the 11 medical properties valued at $128m which RAM acquired from the IPO proceeds. Management has stated that it plans on increasing its allocation towards medical assets in the future, but we have no specific details at this time.

Despite management's desire to increase the size of its medical asset allocation, out of the 17 different properties currently in the trust's value-add development pipeline, five are medical. This is not bad news, as it means the trust is in the process of increasing the value of 17 of its properties for an estimated total cost of $240m. Fortunately, shareholders won't have to wait too long as 11 of the 17 are forecasted to be completed in FY22, and the last one is slated for completion in 1Q26. Still, it is important to note that the only detailed plan to increase asset allocation is focused on essential retail.

A solid REIT, but no reason to pay extra

Okay, that convinces us. In a pandemic that threatens to trouble our healthcare system for years to come, RAM owns a suite of medical properties that will get well used by their tenants and are unlikely to lie vacant for very long. We believe RAM offers investors a solid portfolio of properties and a reasonable dividend. According to the Product Disclosure Statement released right before the company completed its IPO, the trust has an annual indicative dividend of 5.7%, which is pretty good. It's not franked, and not the highest REIT dividend on offer, but pretty good given the low risk involved.

While we believe this REIT's properties will likely appreciate in value, we do not see a reason to pay a premium. Therefore, we would recommend waiting for the trust's price per unit to drop below $0.94 per unit. We believe long-term shareholders will be well-positioned between $0.84 and $0.90 per unit, a 5% and 10% discount to its NTA. Wait a little longer, and the yield might be even better. For now, three stars.

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Share price chart

Source: Tradingview

They do both kinds: transportation and logistics

When it comes to CTI Logistics, the only two divisions that matter are transport and logistics, which in FY19, FY20 and FY21 generated something like 96% of total revenue. We don't expect that situation to change anytime soon. But hold on… transportation and logistics…aren't those just two different words for the same thing? Sure, at first glance, the names can be confusing as logistics is often used interchangeably when discussing the transportation of goods and freight. But if you take a deep dive, you can see the differences are stark.

'Transport' for CTI means courier services, parcel delivery, the provision of 'taxi trucks', interstate and regional freight, and fleet management. The services offered by CTI's 'Logistics' division involve things like warehousing and e-commerce fulfilment and various other projects the company has in the works.

Be transported

CTI's Courier business offers a truly comprehensive service, ranging from push bikes that are allowed to operate in the CBD to two-tonne capacity vehicles. Still, the type of service is the same - on-demand transportation. With Taxi Trucks, CTI offers a similar service but focuses on larger deliveries ranging from two tonnes to semi-trailers. For less urgent or specialised matters, the transport division's parcel operation offers clients same day and overnight deliveries, focusing on Business to Business (B2B) and Business to Consumer (B2C) transportation. In other words, you would not hire CTI's parcel service to send your grandma some homemade cookies.

Interstate and regional freight provide scheduled road and rail transportation services between Perth, Adelaide, Melbourne, Sydney and Brisbane, and the regional areas of Southwest and Northwest of Western Australia. Transport also offers dedicated trucks and trailers to be permanently allocated via its fleet management offering.

Lastly, CTI's transport division offers other specialised transportation equipment like truck-mounted cranes and rail and wharf container management. The transport division has always been the backbone of CTI's operations, generating $139.6m in sales (FY20: $126.8m) to external customers in FY21, resulting in a profit before tax for this division of $13m (FY20: $11m).

Logistics, the unsung hero of our modern world

Okay, now let's talk logistics. In FY21, this division generated $93m (13% year-over-year growth) and managed to grow its EBITDA margin four percentage points to 24%. Management attributes the improved EBITDA to cost-cutting, system improvements and other efficiency tracking schemes put into place during the year. While this makes it unclear if we can expect the EBITDA margin to jump again in FY22 and FY23, we are confident that it at least won't revert to 20%.

The warehousing category is rather all-encompassing and offers clients everything from temperature-controlled and food-grade facilities to bulk product storage to other specialised warehouses. The E-commerce fulfilment service handles clients labelling, packing, shipment and inventory requirements and other logistical needs.

Two other CTI logistics businesses - CTI Projects and Flooring Services - are still related to the overall theme but are still slightly different. CTI Projects provide mineral and energy storage solutions, quarantine cleaning and fumigation, project labour services, and basic plant and equipment hire. Flooring Services offer an Australia-wide distribution network and carpet and vinyl cutting services, as well as specialised warehousing.

Don't judge a book by its cover

Just like you should never judge a book by its cover, a smart investor knows that the summary number rarely tell the whole story. In FY20, CTI generated a loss after tax of $4.4m. However, this was entirely due to an impairment charge caused by a revaluation of unoccupied land in the property division. Unfortunately for CTI's investors, we believe the lack of market focus on the stock has caused investors not to recognise this. Over the last three months, the average daily volume was only 10,000 shares, or $94,500, using 27 January 2022's closing price. In fact, it is not uncommon for the stock to have zero shares traded on a trading day.

Still, the market's lack of attention can often lead to an observant investor's reward. Management has not released any forward guidance, but we don't see any reason why FY22's results will not be at least half as strong as FY21's. So, even if we assume 10% EBITDA growth in FY22, FY22's EV/EBITDA multiple would be 4x on $42m in EBITDA. We believe the discount is far too steep even without the fully franked 4% indicative dividend yield. Four stars.

Pitt Street Research Pty Ltd

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