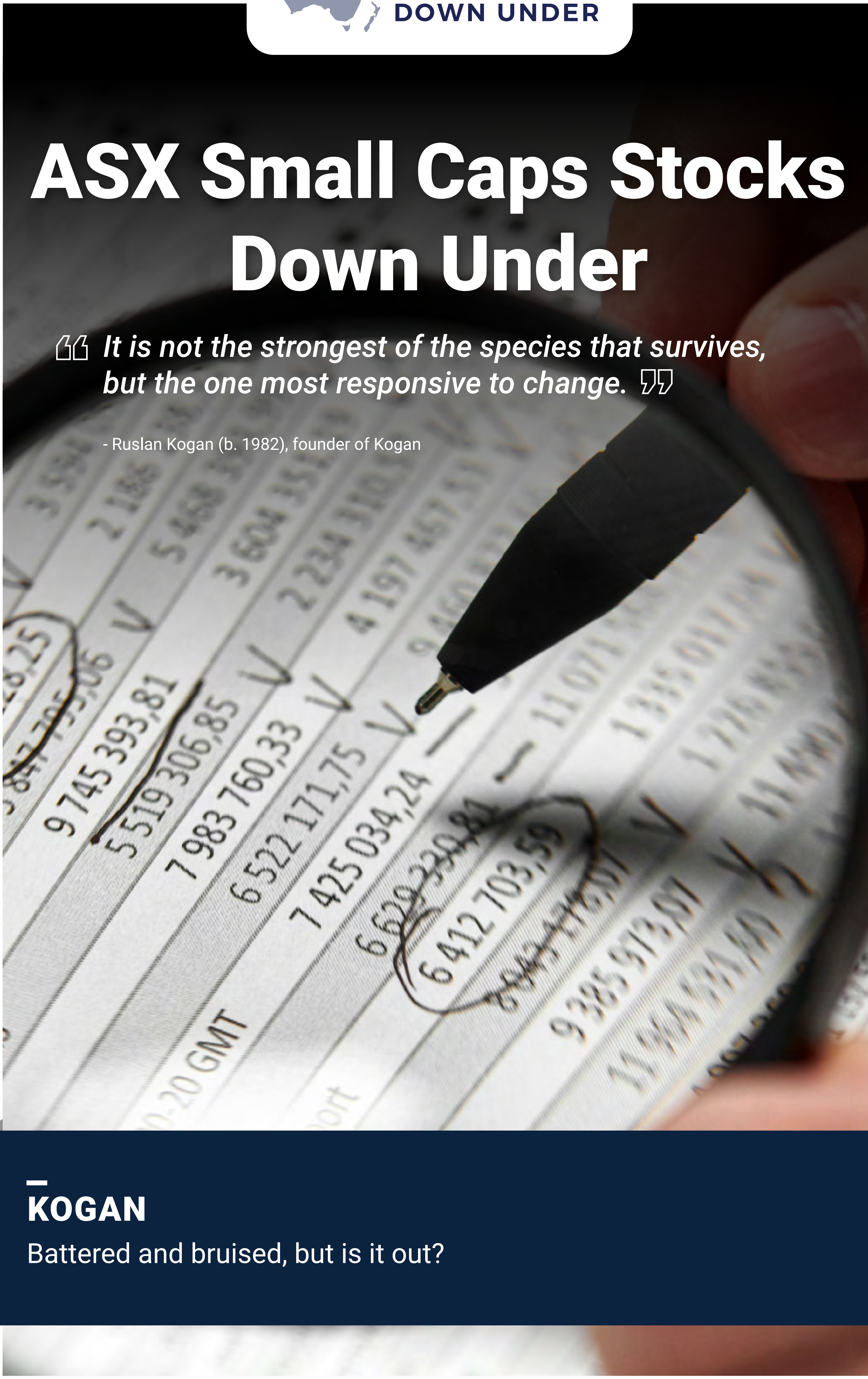
STOCKS DOWN UNDER

29 JULY 2022



ASX Small Caps Stocks Down Under

It is not the strongest of the species that survives, but the one most responsive to change.

- Ruslan Kogan (b. 1982), founder of Kogan

KOGAN

Battered and bruised, but is it out?

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Battered and bruised, but is it out?

Stocks Down Under rating: ★★

ASX: KGN
Market cap: A$509M

52-week range: A$2.66 / A$13.42
Share price: A$4.70

The ride Kogan shareholders have endured over the last few years is emblematic of the broader eCommerce sector. It's easy to forget that the company endured substantial growth in the latter half of the 2010s, but more steadily. Then after a lockdown-induced spending spree when the pandemic struck, shares are well down from their all-time highs as higher inflation and higher interest rates take their toll on consumer spending. Where to from here? We think there may be more turbulence ahead, but there is still room for growth in Australian eCommerce. Kogan is well positioned to capture a large share of it, in our view. But is it time to get in now? This is a question we're less sure about.

Share price chart

Source: Tradingview

Substantial growth since listing

You'd know Kogan best for its online store. This is indeed the business' flagship division, but it is more than that. It offers mobile, insurance, internet and financial services. And even amidst its eCommerce store it sells its own products and exclusive Brands in addition to products made by third party companies. Exclusive Brands now account for more than half of Kogan's gross profit. The company also owns Mighty Ape, an eCommerce retailer in New Zealand, the eCommerce assets of Dick Smith and has a membership program called Kogan First that is designed to be similar to Amazon Prime. And most importantly, it has 31 warehouses to meet the demand of its 4.1m active shoppers – 345,000 of which are Kogan First members.

Kogan was founded in 2006 by Ruslan Kogan (hereafter addressed by first name to avoid confusion between him and the company) and listed in mid-2016. At the time it was $1.80 a share and it had a market capitalisation of under $200m. If you held for six years, you'd have a healthy gain of over 65%, but not if you bought at its all-time high of over $25.57 in September 2020. Shares have been in terminal decline since then, even with $1.2bn in gross sales, a $203.7m gross profit, $61.8m EBITDA and a $3.5m NPAT in FY21.

Obviously, investors have been more attracted to re-opening stocks as pandemic restrictions eased. We observe that shorters have become attracted to Kogan – it has over 8% of its shares currently shorted. We also think Amazon's gradual entry into Australia has investors wary of the impact that might have. But there were also operational issues that compounded Kogan's share price hit.

Dancing well after the music stopped

Having been swamped by demand when COVID-19 first hit, eCommerce companies, including Kogan, shifted from just-in-time inventory to just-in-case inventory – in other words overstocking themselves thinking the boom would last for longer. As a consequence of softening demand and inventory issues, Kogan's profit declined and has now dipped into the red on a quarterly basis. Freight costs and supply chains hit Kogan hard, because it sources most products from its house and exclusive brands from Chinese factories.

Amazon depicts better than anyone that success in eCommerce is built on scale and cheap prices. Ruslan has tried to become more capital light and argues the company will do better as consumers hunt down cheaper prices. But in these markets you have to be a monopoly or oligopoly to profit. And even Amazon took many years to become profitable. To be fair, many costs have emerged unexpectedly, for instance shipping delays result in demurrage charges (it copped one particular $3.9m hit in early 2021). To be fair, all eCommerce outlets have been hit – even Amazon saw eCommerce sales decline 3% year-on-year and free cash flow became negative in its recent quarterly.

We also think Kogan investors haven't liked the drying up of dividends, given all of the issues above, plus share sales by executives. Ruslan and co-founder David Shafer owned 69.5% of Kogan in 2016 but have sold down their stakes since so that they own barely over 19% today. In particular, Ruslan sold $114m when the Kogan share price was over $20. And recent history suggests that unless its FY22 results materially exceed expectations, there won't be a positive investor reaction. We address yesterday's update below. After positive NPAT in FY21, it sunk $11.9m into the red during 1HY22.

There's growth potential, but it'll be a long time coming

Consensus estimates for FY23 suggest $789.4m in revenue and $36.9m in EBITDA, up 2% and 66% from FY22 consensus estimates. And you can obtain this for multiples of 8.9x EV/EBITDA and 22.2x P/E. But remember, this is assuming consensus estimates for FY22 are accurate and we cannot have confidence given this company's record of missing forecasts. And even FY23 EBITDA is barely over half the $61.8m made in FY21. FY24 looks to be rosier with $852.2m in revenue and $51.6m in EBITDA – up 8% and 40% from FY24, but the latter is still below FY21. FY25 predicts a breakout and then some, with $127m in EBITDA. Evidently, analysts believe by that time interest rates and supply chains will have normalised.

If the company does achieve these figures, buying its shares is a no-brainer. We do think even if Amazon builds a more substantial presence in Australia, examples of companies like Wayfair depict competition can exist alongside them. We like Kogan's unique membership model, which will help brand loyalty. And we believe that eCommerce can grow as a share of Australian retail sales and given the above, so can Kogan.

But despite Kogan's potential, and yesterday's share price jump, we'd prefer to wait until there's a little more predictability so far as its earnings and costs are concerned. We acknowledge yesterday investors sent the company up after it reached positive quarterly EBITDA and released some unaudited metrics for FY22. We note profit was not one of them, but among those it did report, gross sales only grew 0.1% and gross profit fell 9.4%. It has also made some progress in unwinding its inventory. However, investors will have to wait for its full year results for certain other figures (particularly annual profitability). Ultimately, until economic conditions normalise, we think Kogan is a two-star stock. We also think that yesterday's unjustified share price jump strengthens that view.

Pitt Street Research Pty Ltd

3 Spring Street, Sydney, NSW 2000, Australia

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