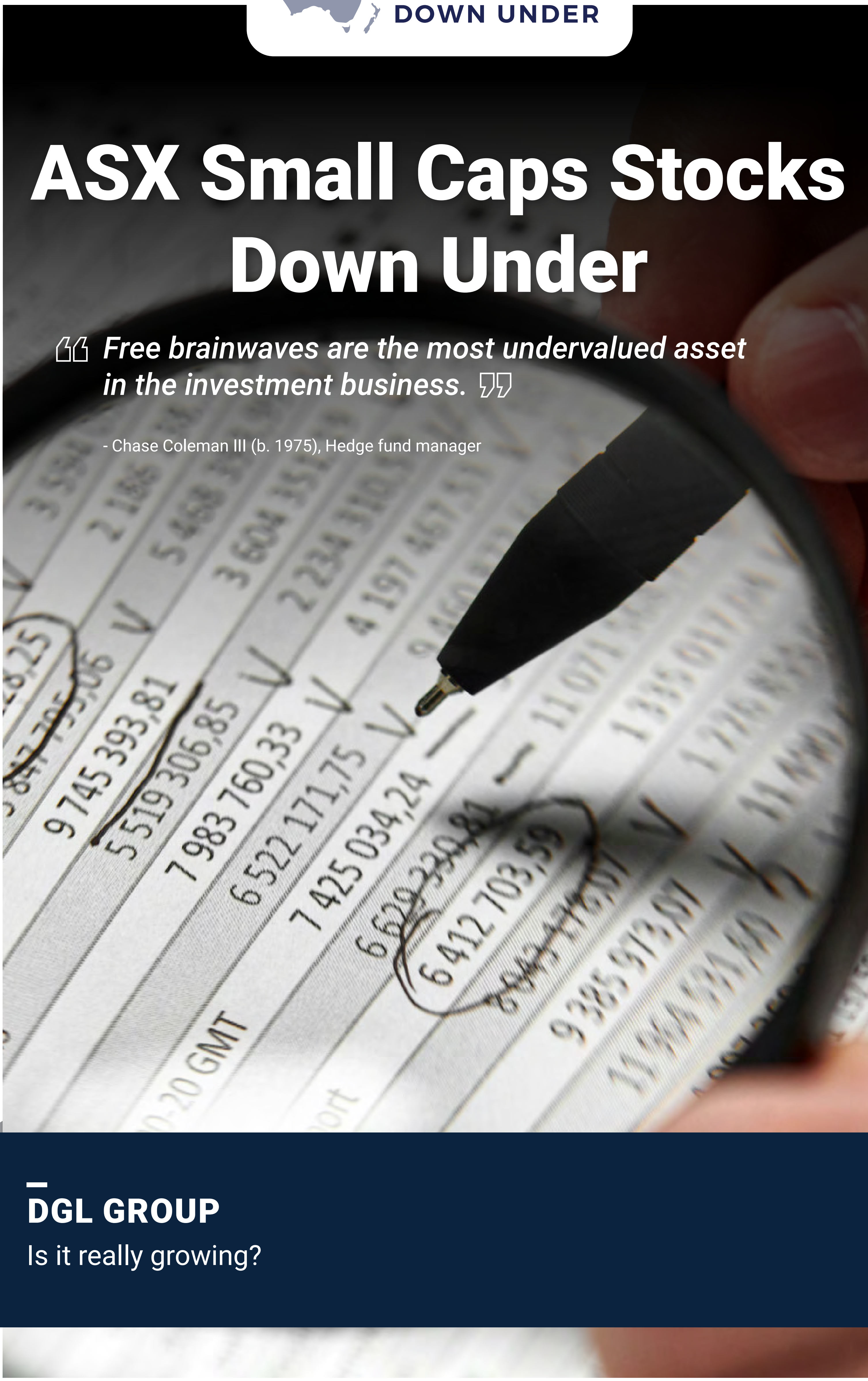
STOCKS DOWN UNDER

7 OCT 2022



ASX Small Caps Stocks Down Under

"Free brainwaves are the most undervalued asset in the investment business."

- Chase Coleman III (b. 1975), Hedge fund manager

DGL GROUP

Is it really growing?

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Stocks Down Under rating: ★★★★

ASX: DGL
Market cap: A$400.8M

52-week range: A$1.37 / A$4.49
Share price: A$1.51

DGL Group (ASX: DGL) was a market darling for much of 2021, listing at $1 and hitting an all-time high of over $4. Yes, there's those controversial comments made by its CEO, but shares took a particularly strong hit after its FY22 results. This was despite the company generating a record profit in its results. Are investors just profit-taking? Or do they have other problems with its results beyond an impressive bottom line? In our view, the answer is the latter. But are those concerns legitimate?

Share price chart

Source: Tradingview

Over 2 decades of growth

DGL (which stands for Dangerous Good Logistics) was founded in 1999 by New Zealand Rich Lister Simon Henry, who retains a stake of over 50% in the business and has been an avid on-market buyer of shares since listing. The company has three different segments.

First, chemical manufacturing, which formulates and makes over 1000 different chemical products across Australia and New Zealand. This segment has the highest share of revenue (60%) as well as the strongest year on year growth (141%). Second, is logistics, where it stores and handles dangerous chemicals that if mishandled could cause spills, contamination and explosions. And third is waste management that provides services such as industrial waste collection, transport, disposal and recycling. These services are provided through over 54 sites across Australia and New Zealand, equating to 475,000m2 and $160m carrying value.

The company has grown organically and through acquisitions. It has undertaken acquisitions at a very rapid pace, buying 11 businesses during FY22 alone and announcing a further five in the first two months of FY23. But there are strong market conditions, particularly as DGL's customers onshore their chemical supply chain, opting to hold more on site. In FY22, DGL's revenues were $369.8m (up 88%), its EBITDA was $65.6m (up 133%) and its NPAT was $33.6m (up $197%). It was able to maintain its margins given its ability to pass through cost increases.

An uncertain outlook

So, why have investors continued to sell off the company in spite of its results? One reason was the outlook. The company said that given higher stock holdings, expanded capabilities, balance sheet strength and execution, the same earnings growth was unlikely to be replicated to the same extent and anticipated to flatten. As a consequence, no forward guidance was given, just a promise to provide a trading update at the company's Annual General Meeting.

Also, remember that acquisitions have been a key part of the company's growth and while they have increased the bottom line, they have done two negative things. First, they have begged the question as to if the company would really be growing without acquisitions. And second, the M&A had increased DGL's liabilities. DGL's net bank debt position grew from $1.1m to $66.2m and its gross bank debt to EBITDA ratio grew from 1.1x to 1.6x.

Taken in isolation, the impacts on FY22 do not appear that bad. Net gearing was only 22%, and its assets grew due to property price rises. But bear in mind that last year, it was in a net cash position of $22.8m and had a negative bank debt gearing ratio of –12%. Its operating underlying cash flow was positive, by $32.9m, but it was only 17% higher than the year before.

What could happen?

Consensus estimates for FY23 are more optimistic, but still suggesting slower growth than FY24. These predict $443m in revenue (up 20%) and $71.9m in EBITDA (up 10%). DGL's EV/EBITDA is 6.6x and 11.7x P/E. For FY24, $483.5m (up 9%) in revenue and $76.9m in EBITDA (up 6%). Still, as useful as consensus estimates are to have, you should always trust management's guidance first. This is because they will have access to internal company data that external analysts will not. We also note in this case we cannot ascertain an aggregate assumption of acquisitions which would inevitably be part of the forecasts for future years. While Simon Henry did not give specific figures, he conceded estimates earnings will flatten.

But back to analysts and some of them do have concerns despite forecasting growth. UBS analysts said it was difficult to justify the significant premium it previously traded on given its exposure to cyclical underlying markets and that a de-rating for the time being was fair.

We also note two things. First in relation to its acquisitions, it is clear the company will continue to undertake them for the time being and has typically done so with equity. Unless the share price recovers, it might have to start eating into its cash reserves as it will be less attractive to M&A targets. Second, notwithstanding its unblemished safety record, this is a risk in this industry that could cause serious harm, not just to broader society but even to DGL's own property. Rehabilitation costs on chemical manufacturing sites can often match or exceed the value of land.

We're backing this one. Here's why

Ultimately, we're giving DGL four stars given the following four reasons.

First, notwithstanding Simon Henry's comments at the CEO of My Food Bag, we admire his long-term record, his stake in the business and persistent on-market buying. Yes, there are plenty of CEOs with skin in the game and have bought shares on market, but few (if any) have to the extent of Simon Henry. Second, even though we share some concerns about how M&A will be financed, we think these ultimately grow DGL's market position which will mean growing revenues and pricing power. Third, even though it is clear there won't be the same growth in FY23 as in FY22, it is unlikely to go backwards. And fourth, the company's multiples are far more reasonable than a few months ago. Even though the short-term will be volatile, we think investors who stick around in this one for a few years won't be disappointed.

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