investors CHRONICLE

COMMENT

19 JUNE - 25 JUNE 2020

Small-cap specials

Simon highlights four small-cap situations that offer scope for significant outperformance

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Several of my Alpha Report small-cap companies have issued trading updates. They make for a good read, as does the overall performance of the 12 Alpha companies that I have published in-depth reports on during the past year.

If you invested in all 12 companies, exited three holdings at my target prices, or taken profits as advised, you will have made a 22.1 per cent average return on your capital (see table online). The same investment in a FTSE Aim All-Share index tracker has lost you 0.3 per cent.

A venture worth following

Aim-traded **Venture Life (VLG:72p)**, a developer, manufacturer and distributor of products for the self-care market, has released another bullish trading update that has prompted brokerage Panmure Gordon to push through its third major earnings upgrade on the company since March. Analyst Dr Mike Mitchell now expects 2020 revenue to rise by 50 per cent to £30.2m and pre-tax profit before amortisation to increase by 126 per cent to £5.2m. On this basis, expect adjusted earnings per share (EPS) to leap from 2.2p to 5.1p. For good measure, Dr Mitchell has upgraded his 2021 EPS estimate by a thumping 40 per cent to 6.3p.

Key drivers are the previously announced exclusive 15-year agreement worth €168m (£147m) with Venture's existing Chinese distribution partner, robust sales of hand sanitising gel brand Disinplus, and a contract extension with Alliance Pharma (APH:75p) that will see Venture appointed as second manufacturer of the larger group's Kelo-Cote products until 2026. Importantly, Venture has ample cash and low-cost debt facilities on hand to fund investment in scaling up manufacturing capacity.

The holding has delivered a 57 per cent gain on an offer-to-bid basis since I advised buying, at 45p, in my May 2019 Alpha Report, during which time the FTSE Aim All-Share Total Return index shed almost 9 per cent of its value. Following the latest earnings upgrade, I raise my target from 75p to 95p, equivalent to a 2021 price/earnings (PE) ratio of 15, not an unreasonable rating given expectations of 23 per cent earnings growth next year. Strong buy.

Exploit ThinkSmart's valuation anomaly

Shares in Afterpay Touch (APT:ASX), a A$14bn (£7.7bn) market capitalisation Australian Stock Exchange-listed technology group have now doubled in value since I published my April 2020 Alpha Report on Aim-traded finance company **ThinkSmart (TSL:19.5p)**.

That's important because Afterpay is part-owner with ThinkSmart of 'ClearPay', a UK payment platform that enables consumers to split the cost of their retail purchases into more manageable interest-free payments. The Australian group has already successfully developed and rolled out an interest-free point-of-sale retail consumer brand 'Pay Later' in Australia, New Zealand and, latterly, North America.

Indeed, a bullish trading update from Afterpay on its US operations has been the latest catalyst for the recent surge in the stock price. It's not the only one as Afterpay was included in the MSCI Australia index at the end of May, so tracker funds have been investing. Another reason for the re-rating is that technology giant Tencent (700:HK) has built up a 5 per cent stake in Afterpay.

The point is that the re-rating of Afterpay has very positive implications on the conservative valuation of ThinkSmart's 10 per cent stake in Clearpay. That's because Afterpay has a call option (exercisable from 23 August 2023) to buy ThinkSmart's 10 per cent holding. ThinkSmart has a put option (exercisable from 23 February 2024) to sell its stake to Afterpay, too. The price is calculated on agreed valuation principles that were used in determining the carrying value of the stake in ThinkSmart's accounts.

One of the principles is the market capitalisation of Afterpay, and that is now 100 per cent higher than when I suggested buying shares in ThinkSmart seven weeks ago. However, the company's share price has risen 'only' 35 per cent in the same period to give it a market capitalisation of £20.7m, of which £7.6m (7.1p) is backed by net cash.

Strip out £5m (4.7p) of other net assets embedded in ThinkSmart's last reported net asset value of £29m (27.3p), and the Clearpay stake is in the price for £8.1m, or half its £16.4m (15.5p) carrying value. Moreover, that valuation was based on the Afterpay stock price of A$29.75 at 31 December 2019, rather than the A$51.16 current price. In other words, when ThinkSmart's stake in Clearpay is revalued at the June 2020 year-end, it should be worth more than the company's own market value of £20.7m, thus leaving £12.6m (11.8p a share) of cash and other assets in the price for free.

Furthermore, it's not inconceivable that the Australian group may attempt to buy out ThinkSmart's residual holding in Clearpay well before the call option becomes exercisable in August 2023. My sum-of-the-parts valuation of 35p a share doesn't factor in this possibility. Offering 80 per cent potential upside, the shares rate a strong buy.

On solid foundations

SigmaRoc (SRC:40p), a company that is pursuing a strategy of buying, improving and integrating platforms of companies in the heavy building materials sector, is trading far better than the market is giving it credit for.

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The group's well respected management team is focused on acquiring cash-generative assets in niche markets that produce aggregates, concrete, precast and pre-stressed concrete. Since IPO in 2017, SigmaRoc has made nine acquisitions, all of which are asset-backed, control strong market shares in mainly regional markets, have strong customer relationships and offer scope to add value by improving operational efficiencies.

A good example is Channel Islands-based Ronez, previously a wholly owned subsidiary of Aggregate Industries, which was acquired for £45m in 2017. Ronez operates two quarries as well as multiple associated and downstream businesses. They offer a full range of construction materials for sale into the local market as well as providing services, including road contracting. The vertically integrated business has a dominant share of a low-growth but stable market in the Channel Islands, where construction accounts for 6 per cent of GDP.

It's worth noting that in the event of a downturn, capital expenditure at quarries with a 40-year life can be tightly reined in without impacting the quality of the assets. In a normal year, Ronez makes cash profit of around £7m and its £2.5m depreciation charge is in line with capital expenditure. So, even if cash profit declines by a fifth from £7m to £5.6m, capital expenditure can be reduced to protect Ronez's profits and cash flow, highlighting the defensive qualities of the business, which mitigate economic risk.

In the UK, SigmaRoc made three acquisitions (Allen, Poundfield and CCP) between October 2017 and January 2019, which form its pre-cast products group division. The group paid an average of 6.5 times cash profit based on total consideration of £40.1m including a deferred element of £6.5m. Strategically, the acquisitions have enabled SigmaRoc to take a strong position in the UK market for precast and pre-stressed products, targeting industrial and agricultural sectors, as well as housing and specialist infrastructure projects. The Conservative government's pledge to ramp up investment in infrastructure projects was a bull point when I suggested buying SigmaRoc's shares in my December 2019 Alpha Report ('A General Election winner', 12 December 2019).

The point that investors are only now cottoning on to is that SigmaRoc has remained profitable through the UK lockdown, adding weight to the ability of the group to continue to trade profitably this year. Pro-forma monthly revenues tracked 60 per cent of their normal run rate in April, rising to 98 per cent in May. Of course, the acceleration in profits this year that I had anticipated will not be as strong due to the lockdown. However, analysts at Peel Hunt still expect 2020 cash profit to rise by 16 per cent to £16.9m on revenue up 28 per cent to £90m, rising sharply to £24.4m and £102m, respectively, in 2021, when all nine of SigmaRoc's acquisitions should be operating normally. On this basis, expect adjusted EPS of 2.3p in 2020 to double to 4.7p in 2021.

The positive trading update, and news that SigmaRoc has increased its cash position during lockdown, explain why the shares have rallied back towards my 46p entry level, having previously been 16 per cent up prior to the stock market crash. Offering 50 per cent upside to my 60p target price, I continue to rate SigmaRoc's shares a buy on a 2021 PE ratio of nine and enterprise value to cash profit multiple of 6.5 times. Buy.

Hargreaves Services' value opportunity

Hargreaves Services (HSP:217p) has transformed itself in the past four years, exiting legacy assets, refocusing the business on growth areas in the industrial sector, and is now set to realise the hidden value in its vast land bank through land regeneration.

Indeed, after I suggested buying the shares, at 206p, in my March 2020 Alpha Report ('A high yielder offering significant hidden value', 19 March 2020), the group's joint venture, Unity, which is developing a 618-acre site surrounding the former Hatfield Colliery near Doncaster, exchanged contracts for the £25m sale of 32 hectares of land to a national retailer for construction of a 800,000 square feet (sq ft) distribution and training centre. This highlights the importance of the site from a logistical perspective, not to mention the potential to realise substantial value from the remaining 1.2m sq ft of industrial, commercial and logistics space with planning consent and 3,100 residential plots, too.

There are decent prospects of reaping hefty cash returns from the group's flagship 390-acre site at Blindwells, East Lothian, a former open-cast mine located 12 miles from Edinburgh. Hargreaves has planning for 1,600 new houses and has conditionally sold 10.75 acres to Bellway, and another 3.25-acre land parcel to Cruden Homes. The two land deals will realise more than £10m for 222 plots. The sales had been expected to complete before Hargreaves' 31 May 2020 year-end, but will now complete in the new financial year only because contractors had to down tools on infrastructure work due to the Covid-19 lockdown.

Importantly, management has confirmed that the property delays aside, underlying pre-tax results will be in line with the market expectations that had been in place prior to the UK lockdown. Analysts will reintroduce their forecasts at the time of the annual results on 29 July. This highlights the benefits of having a diversified revenue stream. For example, Hargreaves' industrial services division has substantial long-term contracts in place, including one in Hong Kong to support the power-generating operations of China Light & Power and Hong Kong Electric (mechanical, electrical, and access solutions at two coal power stations).

There has been good news on borrowings, too, as the directors confirmed that year-end net debt of £27.2m, equating to 21 per cent of net asset value and £8m lower than Investec had forecast, has fallen by a third from £40.3m last November. They are confident of securing appropriate facilities when the group's £50m banking facility expires on 31 August.

As the lockdown lifts across Europe, expect investors to be on the look-out for undervalued companies well placed to benefit from the economic recovery. Hargreaves is one such company. Moreover, as economies return to some form of normality, albeit at lower levels of output than before, the board will be able to review the dividend policy and reintroduce guidance. It doesn't have to be anything like the 20p per share of EPS analysts had previously been expecting in the 2020-21 financial year (prior to guidance being withdrawn) for the shares to rate a decent buy.

For good measure, Hargreaves' share price has formed a solid base formation (between 195p and 220p) and looks poised to break out. On a near-50 per cent discount to book value, there is considerable upside to my 320p target price. Buy.

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