under the radar report
SMALL CAPS

ISSUE 598
02 MAY 2024

NEW COVERAGE:
5G Networks (5GN)

Management with skin in the game!

In Small Caps, you look for three things: business model, management, and financial risk. Small Caps have a higher risk rating because there is more uncertainty and consequently more pressure on management. That's why a lot of the stocks we cover are founder-led, like the new stock 5G Networks (5GN), which we cover today. This is also the case for other stocks we cover in-depth: Alliance Aviation (AQZ), Kogan (KGN), and Nick Scali (NCK). Okay, in the last case, Anthony is the son of the founder.

You will know all these companies, whose brands have grown in value since we have been backing them (and at various points, selling them). That's also why when stocks are at the high-risk end of the spectrum, you need a cash buffer. In **5G Network's** case, there is no debt, and the cash buffer actually far exceeds its market valuation.

We have had our eye on the IT software & services group for a number of years now, having been shareholders of the domain registry sales group Melbourne IT and then its successor Webcentral. We watched as value eroded at Webcentral, as much bigger operators like GoDaddy, Google owner Alphabet and Amazon entered the game. Needless to say, we were very impressed that 5GN, led by 18% shareholder Joe Demase, managed to sell the Webcentral business, making a profit of close to $100m in only two and a half years, which includes ownership of a third of the domains business.

5G Networks is trading at a discount because the company is making losses. But we have done the analysis and we believe the losses of the businesses it continues to own are reducing at a fast rate, in part because management is highly incentivised and also because management is very capable. These are judgements you can make when you watch over a lengthy period of time, and a large lick of cash certainly helps.

Richard Hemming
Head of Investments

the issue

NEW COVERAGE!

5G Networks took an underperforming business selling domain names and turned it into a $100m plus windfall, under 18% holder and CEO Joe Demase. The stock is trading at less than its cash value.

5G NETWORKS (5GN)	SPEC BUY

RESEARCH TIP UPDATES

ALLIANCE AVIATION (AQZ)	SPEC BUY
AUSTCO HEALTHCARE (AHC)	SPEC BUY
KOGAN.COM (KGN)	▲ SPEC BUY
NICK SCALI (NCK)	HOLD
REGIS RESOURCES (RRL)	HOLD

BEST STOCKS TO BUY NOW

These stocks are quality companies that we believe offer great return potential for the risks faced. Check them out online.

> Alliance Aviation is unique, owning its aircraft fleet… Bonza Aviation, which went into administration this week, like most regional airlines would have leased its aircraft.
>
> **Under the Radar Report**

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5G NETWORKS

SECTOR INFORMATION TECH **INDUSTRY** SPFTWARE

New Coverage!

What's New?
Late last year 5GN sold its domain name registry, consumer and email hosting businesses, Melbourne IT, and Webcentral domains for $127.7m, an impressive price by any standards, at 9 times cash flow (EBITDA), and at a $95m profit on its acquisition by 5GN in November 2020. 5GN is now sitting on over $60m in cash and owns a third of the Domains business purchased by a European private equity fund, which represents $20m of the sale value. 5GN also has an agreement to provide services to Webcentral's new owner.

5GN has also integrated cyber security consultant Security Shift, purchased for $4m in January for a combination of cash and scrip.

Bull Points
- Trading on a discount to net cash
- 2500 enterprise & wholesale customers
- Management Ownership

Bear Points
- Loss-making
- Opaque operations

Analysis: 5G Networks took an underperforming business selling domain names and turned it into a $100m plus windfall, under 18% holder and CEO Joe Demase. The share price spiked to over 30 cents on the news late last year at Christmas, but the stock is now close to half that. A key reason for investor nervousness was news that its new "core" business burned through about $10m in the six months to 31 December.

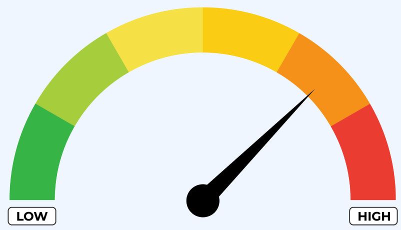
The company now has over $60m in cash and is trading at a discount to that valuation. There is a great deal of work to be done, but we believe that management has the track record to justify more faith than the stock price suggests, which is that the business will be loss-making for some time yet!

Why do we have that faith?
5GN continues to have exposure to the business it turned around, owning a third of Webcentral's domain business. The company reduced 300 staff three years ago to 85 when it sold the business.

Webcentral has been the company's focus for the past two and a half years (the group's merged in mid-2021) and management can now turn its attention to the other businesses. Helping matters will be legacy revenues from Webcentral, which will amount to $4m in the first year, $2.5m in the second and then $5.5m over the following 3 years.

RADAR RATING: **SPEC BUY**

RISK RATING



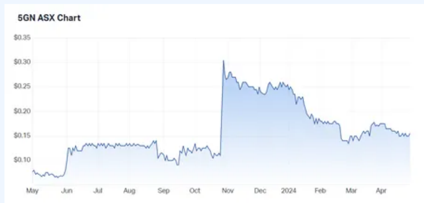
ASX CODE **5GN**

CURRENT PRICE **$0.15**

MARKET CAP $51M

DIVIDEND YIELD 0%*

NET CASH ($M) 64M*



DATA AS AT INITIAL COVERAGE:

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PRICE ($) 1.37

*Proforma

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The $10m group loss at the operating cashflow level included up to $7.4m of payments for restructuring and acquisition costs, which obscures the underlying performance of the business that remains. 5GN's new core business generated an operating loss (EBITDA) of just under $2m for the recent half, much improved from the $4.5m loss in the same period a year earlier.

What is the new core business?

The group is a telecommunications carrier servicing enterprise and wholesale customers. The 5GN business owns and operates data centres, private cloud, and fibre optic cables and provides managed IT services to 2,500 enterprise clients and 100 wholesale customers. 5GN currently owns and operates its own Nationwide and Internationally highspeed Data Network with points of presence in all major Australian capital cities, Singapore, USA, Hong Kong and New Zealand. In addition, 5GN offers managed cloud solutions through its Cloud and Data Centre capabilities, as well as managed services to optimise customers' IT and network environments. Supporting this is a capacity of over 1,200 racks through its owned and operated Data Centres across Melbourne, Sydney, Brisbane and Adelaide.

There is also its recent foray into cyber security, which we understand has been a success thus far, taking advantage of Australian Government guidelines that stipulate eight levels companies need to build up their cybersecurity credentials. 5GN has managed to generate business by getting customers onto level 1, which is simply backing up data onto a server.

Cash reduces risk

The company provides historic detail on the breakdown of revenue, but less information about costs, profitability and strategy, and operates in an industry with many larger competitors. The important factor is the cash 5GN has at its disposal when many of its competitors face difficult market conditions.

Another factor you have on your side as a minority investor is incentivised management. The CEO Joe Demase led the team that bought and sold Webcentral. He owns 18% and has been building technology and telecommunications businesses, domestically and offshore, some for sale, over the past 25 years.

Investment summary

The stock is priced so that you are buying a business for nothing, albeit currently loss-making. If management can turn an operating margin on the existing business, there will be money to be made, although only for those who have a high tolerance for risk. The company is still losing money, but the share price factors in bigger losses than we think are actually occurring. Over time as positive news flow occurs, and as long as the cash is spent wisely, we think the shares will be re-rated.

RADAR RATING: This stock is essentially an IT and telecoms cash box which has the cash resources to develop its operating business to profitability. We back management, but don't underestimate the high risks involved. The cash pile provides substantial reassurance.

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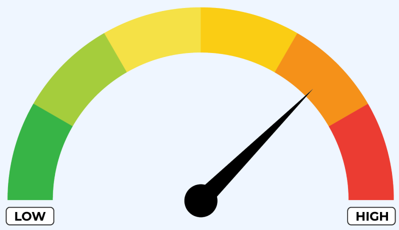
ALLIANCE AVIATION

SECTOR AVIATION | **INDUSTRY** CONTRACT AVIATION SERVICES

RADAR RATING: **SPEC BUY**

RISK RATING



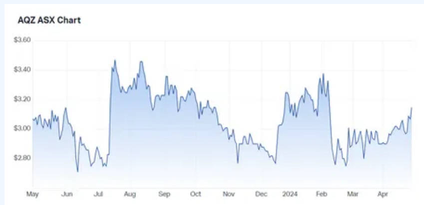
ASX CODE **AQZ**

CURRENT PRICE **$3.12**

MARKET CAP $506M

DIVIDEND YIELD 0%*

NET DEBT ($M) -245M



DATA AS AT INITIAL COVERAGE:

DATE 14 SEPTEMBER 2016

PRICE ($) 0.83

Research Tip Update

What's New?
The regional airline's funding concerns have been resolved, following the Embraer aircraft acquisition. Alliance has vendor financing commitments for the remaining aircraft from AerCap, plus ANZ Bank has extended the term loan facility by three years and increased it by $50m to fund capital expenditure.

Bull Points
- Management
- Contract retention

Bear Points
- Fleet utilisation risk
- Consumer weakness

Analysis: Alliance is unique, owning its aircraft fleet, giving the airline flexibility around maintenance. In addition, AQZ's earnings are resilient, with mining-based contracting revenues and high service standards.

Bonza Aviation, which went into administration this week, like most regional airlines would have leased its aircraft. Bonza would not have long-term contracts. AQZ has FIFO contracts with blue chip mining companies, on top of contacts with Qantas. Bonza had a limited line of sight on future revenues, dependent on consumer demand. Bonza competes with a myriad of airlines including, Qantas, Virgin and REX. AQZ is in the contracting space, where competition is much more limited. There is nothing like AQZ, although we note that REX is trying to enter the contracting space.

AQZ purchases aircraft in advance to cater for domestic demand for 100-seat aircraft, an ideal size for FIFO and regional business.

The aircraft acquisition program was initiated last year. The securing of funding highlights AQZ's strong financial status, with long-dated contracted revenue from predominantly investment-grade customers.

AQZ has a positive outlook for the balance of FY24 as it continues to capture growth and profit uplift from recent capital investment from increased capacity and higher utilisation. As a sign of business momentum, Qantas recently brought forward the wet-lease (AQZ crew) of four additional aircraft; AQZ's contract with Goldfields was extended for two years.

Portfolio risk rating: Higher than it has previously been because although funding issues have been addressed, debt is significant. Alliance is continuing to win work in a buoyant mining sector. An economic downturn is always a risk.

RADAR RATING: Expanding aircraft fleet will deliver growth. Revenue diversified through contracted FIFO, contracted wet lease, charters and aviation services.

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AUSTCO HEALTHCARE

SECTOR SERVICES **INDUSTRY** HEALTH CARE

Research Tip Update

What's New?
The nurse call specialist delivered a better-than-expected bottom line for the third quarter (3q24) with a net profit before tax of $1.6m, highlighting that scale is being achieved. Then last week announced a capital raise to fund the acquisition of Amentco (an Austco reseller). The raising was for $6.9m, $2.8m of which is a rights issue (non-renounceable) at 18.5 cents a share, just below where the company is trading now.

Bull Points
• Acquisition-led growth
• Contracted orders approaching $50m

Bear Points
• Non-health business distraction
• Integration risk

Analysis: The Teknocorp and Amentco acquisitions are bringing product resellers in-house.

The profit was better than expected, driven by a higher gross margin at almost 58% v 52% a year ago. Part of the uplift was due to four months of one of the two resellers AHC has purchases, Teknocorp (Nov 2023).

AHC now has proven direct sales capability in the US, Canada and Singapore and a reseller network elsewhere, which includes Australia, the UK, Asia and the Middle East.

Moreover, these acquisitions help AHC sell and install its advanced healthcare solutions. Victoria-based Teknocorp specialises in providing integrated nurse call, security, access control and complimentary systems. Queensland-based Amentco designs and installs integrated solutions that help enhance patient care including Customised Workflow, Real-Time Locating and CCTV.

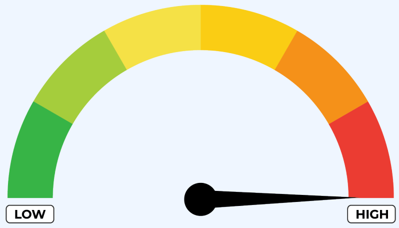
AHC is expanding its offering to Australian hospitals and aged care facilities, similar to its activities in offshore markets, notably North America and Singapore.

Portfolio risk rating: This company is still sub-scale. Growth driven organically and from M&A can be risky. Looking for new technologies for the portfolio and system integrators.

RADAR RATING: Ambitious strategic objective to build direct sales capability in Australia, expand market presence and diversify products/services.

RADAR RATING: **SPEC BUY**

RISK RATING



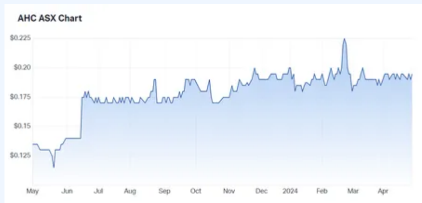
ASX CODE **AHC**

CURRENT PRICE **$0.195**

MARKET CAP $58M

DIVIDEND YIELD 0%*

NET CASH ($M) 3.39M



DATA AS AT INITIAL COVERAGE:

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PRICE ($) 0.10

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KOGAN.COM

SECTOR RETAIL **INDUSTRY** ONLINE RETAILER

Research Tip Update

Upgrade from Hold

What's New?
Kogan's trading update to 31 March (3Q24) revealed a decline in revenue, causing a 25% sell-off, eliminating the year-to-date gains amid the optimism after its second-quarter update in January. The fall creates a buying opportunity.

Bull Points
• Capital light business model
• Multiple growth drivers

Bear Points
• Sales growth stagnation
• Aus/NZ consumer demand pressures

Analysis: Far from a negative outcome, we view falling sales as evidence that management is doing its job!

Kogan's third quarter revenue declined of 2.4% to $196m resulted from skewing volumes towards profitable products and services, delivering a substantial increase in operating earnings (EBITDA) to $9m. A gross margin of 37% was 5 percentage points above the same period a year ago and increased the gross profit 14% to $39m. Group active customers of 2.66m include over 700k for Mighty Ape in NZ.

The subscription-based program Kogan First now has 472k members, an increase of 65k members (15%) in 12 months. A 30% price increase was implemented in April, which we don't think will slow demand. There is little information about the costs, where benefits include free delivery, rewards, double Qantas points, prizes, and other incentives. Mighty Ape's loyalty program in NZ, Primate, is also making progress.

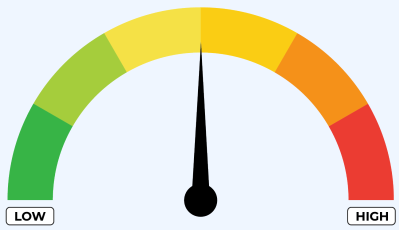
Portfolio risk rating: Trust is a factor when it comes to investing in a founder-led company. KGN issues stock reluctantly and constantly looks for buy-back opportunities. TICK. But management has also been rewarded with generous options packages, one of which was bought out by the company in early April for $17m at a $8.22 share price equivalent. CROSS.

Before that $17m payment, KGN had $34m cash, and no debt. Inventories were down 9% at $71m, and we think the balance sheet remains secure. FY25 operating earnings (EBIT) of $30m is not out of reach, giving an EV/EBIT multiple in the mid to high teens, which almost brings the EV/EBITDA ratio down to 10x.

RADAR RATING: A repaired balance sheet and now focussed on operating efficiency and lower capital platform sales to deliver better returns. There are 2.7m active customers, with multiple opportunities to capture margins.

RADAR RATING: **SPEC BUY**

RISK RATING



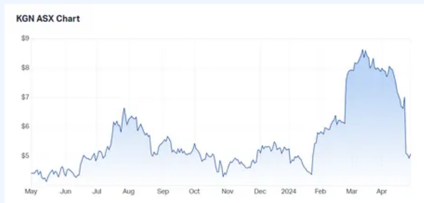
ASX CODE **KGN**

CURRENT PRICE **$5.045**

MARKET CAP $506M

DIVIDEND YIELD 0%*

NET CASH ($M) 34M



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NICK SCALI

SECTOR RETAIL **INDUSTRY** FURNITURE RETAILER

Research Tip Update

Hold/Buy SPP raising

What's New?
The furniture retailer announced a major expansion in the UK in the form of a rebrand and 21 outlets; The funding will come from a $60m capital raising via a placement and a share purchase plan at $13.25 a share.

Bull Points
• Management
• UK opportunity

Bear Points
• Weak consumer demand
• UK costs and risks.

Analysis: NCK is taking over the UK business Fabb Furniture, which operates 21 regional stores in England.

Funding will come from a $60m equity raise on top of $7m secured debt. In addition to the purchase price, NCK will invest $12m in working capital and rebrand as Nick Scali. We expect that to happen quite quickly, but then it's hard yards. The UK business is only expected to return to profitability in 18 months, with losses expected to increase in FY25 as a result of store refurbishments, rebranding and the introduction of the new product range

The UK market has big potential upside with no equivalent masstige brands and Fabb gives NCK scale. Brand spend will generate foot traffic, with an attractive mass-market product.

There are risks but management is committed and CEO Anthony Scali is taking $4m of the placement. **These are the first shares that NCK has issued since we first recommended the stock in 2012!**

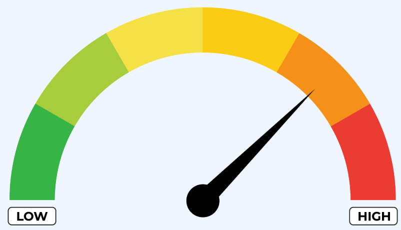
Interim revenue was down 20% to $227m producing a 29% fall at the EPS bottom line. The UK business currently generates around $65m revenue, and will be negative in FY25, but NCK will expect to increase sales quickly.

Portfolio risk rating: We are tempted to upgrade, but the acquisition could stretch NCK's financial and management resources. The financial risk should be containable, even if it all goes wrong (remember the Bunnings failure in the UK). Existing shareholders who have taken profits can buy more stock in the attractively priced SPP at $13.25.

RADAR RATING: The UK expansion capitalises on its business model albeit with risk and weak consumer conditions, similar to the domestic market.

RADAR RATING: **HOLD**

RISK RATING



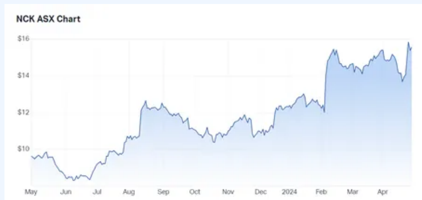
ASX CODE **NCK**

CURRENT PRICE **$14.83**

MARKET CAP $1.20BN

DIVIDEND YIELD 4.6%*

NET DEBT ($M) -3.4M



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**Forecast 70 cents*

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REGIS RESOURCES

SECTOR GOLD MINING **INDUSTRY** GOLD PRODUCER

Research Tip Update

What's New?
Regis has provided a timeline for the McPhillamys gold project in NSW, which had previously blown out in pre-production costs from $215m six years ago to around $1bn! A Final Investment Decision on the 200k ounce-a-year project is not expected before next year.

Bull Points
• No gold hedging
• Strong cash flow at current high gold prices

Bear Points
• Production declining from next year
• Development uncertainty

Analysis: Regis has been range-bound since investors became aware that the McPhillamys project in NSW was under a cloud in early 2021. The company has been working hard to get the project going, but still faces an uphill battle. Significantly, however, it has provided a timeline for the mine's development, but there still hasn't been a final decision, due next year! The company is talking about the possibility of mining in 2027, but based on the record thus far, we are not hopeful. The project was purchased about 10 years ago and hasn't reached a final investment decision.

Duketon North (WA) will be closing in the mid-year with production will solely from Duketon South (WA), estimated to be in the region of 200-250k ounces a year. On top of this is RRL's 30% interest in Tropicana (WA) which produces 130-150k ounces, implying a total of 335-400k a year, which compares to current production of 415k in FY24. You can see how important McPhillamys is, especially considering RRL's target of 500k a year.

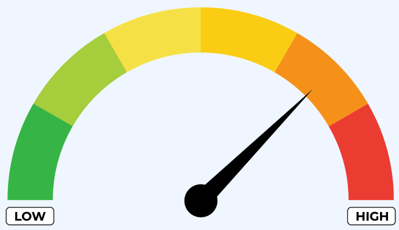
Positively, Tropicana continues to grow, replacing depletion and expanding reserves. A mine life of over 10 years is expected.

Portfolio risk rating: A high-risk rating considering the hole this company is in, although the saving grace has been a strong gold price, which complements its unhedged reserves, producing strong cash flow.

RADAR RATING: Full benefit of high gold prices but low future production and funding risk.

RADAR RATING: **HOLD**

RISK RATING



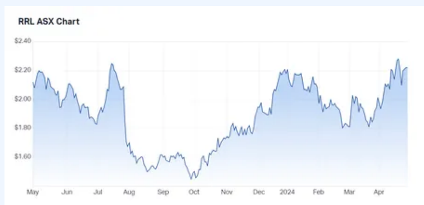
ASX CODE **RRL**

CURRENT PRICE **$2.09**

MARKET CAP $1.67BN

DIVIDEND YIELD 0%*

NET DEBT ($M) -211.5M



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99% of all financial news relates to the 40 to 50 biggest companies.
So what about the rest? They're Under the Radar.

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