# Australian Small Caps: Opportunities Post the Recent Sell-off

Our weekly view on Australian equities.

23 March 2022

# Global Risk-off Environment Hits Small Caps Harder

Since the beginning of the year, the risk-off environment for equities has hit small-cap equities harder than large caps.

Global risk-off has been driven by twin threats of higher global interest rates compounded by the outbreak of conflict in Russia/Ukraine. In Australia, the relative underperformance of the Small Cap index vs the large-cap index is around 10% this year. A similar trend is evident in the US where the Russel 2000 has underperformed the S&P 500 since November 2000.

In historical terms, this level of underperformance by small caps in a risk-off environment is relatively modest both in terms of magnitude and time. We can point to four episodes during the last 20 years where underperformance is greater than 20%. In three of these periods, the underperformance lasted >18 months. Only in the March 2020 black swan event of COVID did the underperformance last for less than 6 months.

We continue to hold a constructive view around the Australian outlook, particularly relative to the rest of the world. On a valuation basis, small cap PER multiples have compressed almost 20% since the peak in 2020 and now sit in line with the 5-year average. This suggests Australian small caps are now approaching an oversold level.

With several macro risks lifting in the last week, the Federal Reserve meeting, and a possible pathway for peace in Ukraine, the risk-off discount in Australian small caps is vulnerable to snap-back.

Consumer tax relief in next week's Federal Budget, potentially via lower petrol prices, could provide additional impetus for the discount to close.

Inside we highlight several small-cap opportunities from our Wilsons Equity research team and additional names from our Investment Strategy team.

## Australian Small Cap Performance

The small-cap index is typically more vulnerable to global risk-off events. Lower levels of earnings and earnings diversification, smaller market capitalisation and lower traded liquidity generally work against small caps in risk-off events.

An interesting feature of this risk-off event has been the strong outperformance of resources companies, which dominate the top 10 performers.

Unlike many other global risk-off scenarios, when resources tend to underperform quite significantly (the threat of lower global growth) the nature of this risk-off event has meant resources have become the new safe haven. Resource related companies dominate the top small cap performers this year.

**Exhibit 1: Small caps have underperformed large caps by 7% in 2022**


Source: Refinitiv, Wilsons.

**Exhibit 2: Top 10 prices in small caps during 2022**

| Company Name | Ticker | Price Change YTD % | EPS Positive (FY1) |
|---|---|---|---|
| Genworth Mortgage Insurance | GMA | 28% | ✓ |
| Sims | SGM | 29% | ✓ |
| Cimic Group | CIM | 30% | ✓ |
| Karoon Energy | KAR | 30% | ✓ |
| Champion Iron | CIA | 31% | ✓ |
| New Hope Corporation | NHC | 31% | ✓ |
| Strike Energy | STX | 37% | X |
| Brainchip | BRN | 40% | X |
| Coronado Global Resources | CRN | 54% | ✓ |
| Whitehaven Coal | WHC | 54% | ✓ |

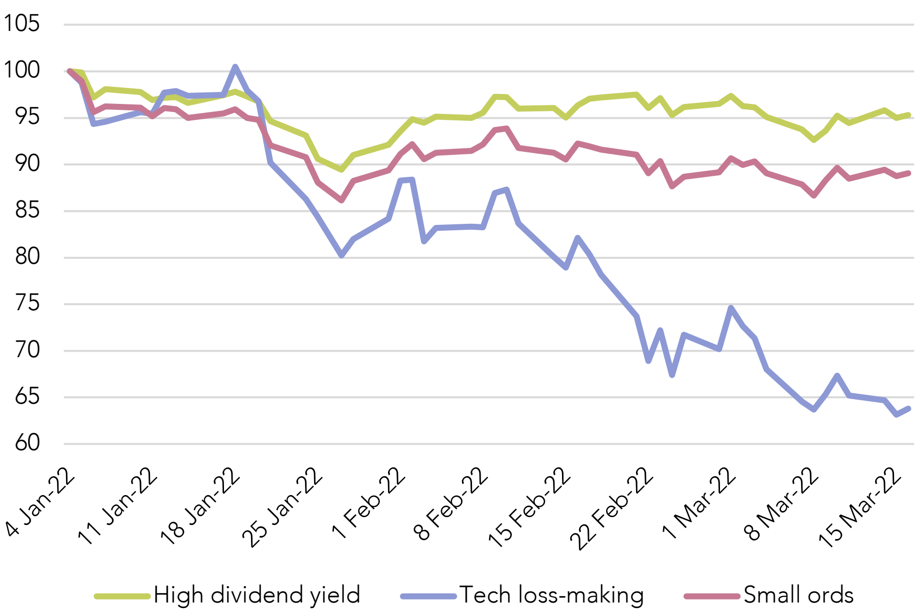
Source: Refinitiv, Wilsons

**Exhibit 3: Bottom 10 prices in small caps during 2022**

| Company Name | Ticker | Price Change YTD % | EPS Positive (FY1) |
|---|---|---|---|
| Zip | Z1P | -63% | X |
| Australian Ethical Investment | AEF | -52% | ✓ |
| Sezzle Inc | SZL | -52% | X |
| BWX | BWX | -51% | X |
| Redbubble | RBL | -49% | X |
| Fineos Corporation | FCL | -48% | X |
| Dubber Corp | DUB | -47% | X |
| Pointsbet Holdings | PBH | -45% | X |
| Marley Spoon | MMM | -44% | X |
| PPK Group | PPK | -42% | X |

Source: Refinitiv, Wilsons

**Exhibit 4: Price performance of small cap loss-making**




*Tech loss-making include: DUB, NEA, NXL, BRN, MP1, NVX, TYR, SZL, AD8, FCL.

Source: Refinitiv, Wilsons.

## Small Cap Loss-makers Performance

A notable feature of the recent sell-off has been the significant underperformance of loss-making companies, which disproportionally impacts the small-cap index. Within the small-cap index, 20% of companies are loss making, versus just 10% in the S&P/ASX 200 (mostly COVID recovery laggards).

The small-cap loss-making technology companies have been the most heavily impacted within the small cap index. The prospect of higher interest rates makes both debt and equity funding more expensive. Critical, as loss-making businesses typically require external funding.

The double whammy for loss-making companies is the impact of higher bond yields, which lowers the valuation of long-dated growth cash flows.

Small-cap loss-making technology companies have fallen by almost 40% this year and dominate the bottom performers of the small cap index this year.

## Large Cap Earnings Momentum Has Been Stronger

Large-cap earnings have remained in upgrade mode since the start of 2022 – the heavier weight to resources and energy helping. In contrast, small caps have seen earnings downgrades.

While negative earnings momentum has worked against small caps this year, they still offer significantly higher prospective growth during the coming 12 months with consensus forecast growth of 27% compared to just 3% in large caps. The differential between small caps and domestic growth is unusually high at present and suggests small caps are potentially oversold.

## Emerging Small Cap Valuation Appeal

The PER valuation differential of smalls vs large currently sits similar to the average level seen since 2018. This implies the market is not willing to pay up for small cap growth, despite the much higher prospective growth rate. This is not unusual post a risk off-event, where investor risk appetite remains subdued.

In our view, an opportunity is emerging in small caps relative to large, particularly if concerns around interest rates and Russia/Ukraine were to ease.

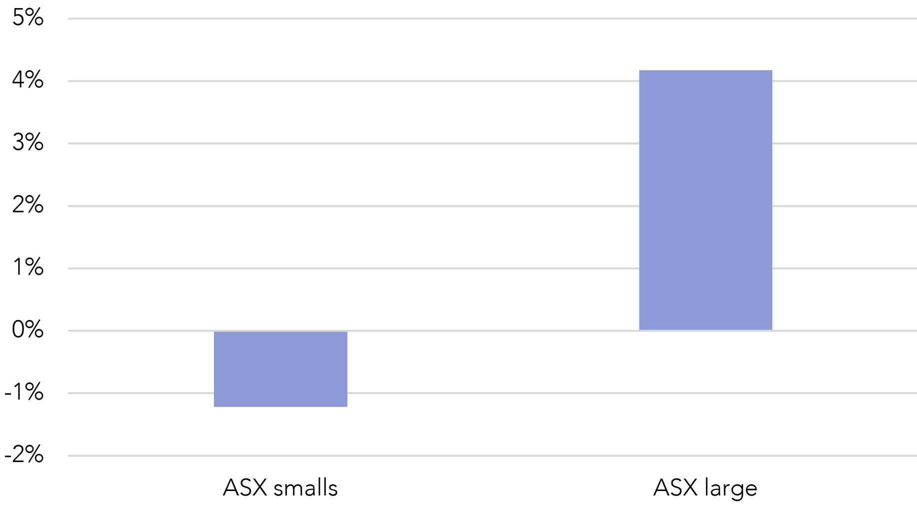
## Our Small Cap Ideas

We present three groups of small-cap ideas. Firstly, five companies from our Wilsons Australian Equity Focus List, which represent 12% of the Focus List. Only TLX is loss-making at present (profitable in FY24E). Our second group of ideas are the profitable names from Wilsons Conviction Insights. These companies represent our equity analysts' best ideas on a 12-month view.

> Read the latest Conviction Insights Report

Finally, we screen for profitable smalls caps that in our view have been disproportionally sold down this year, and where the outlook in our view has not significantly changed.

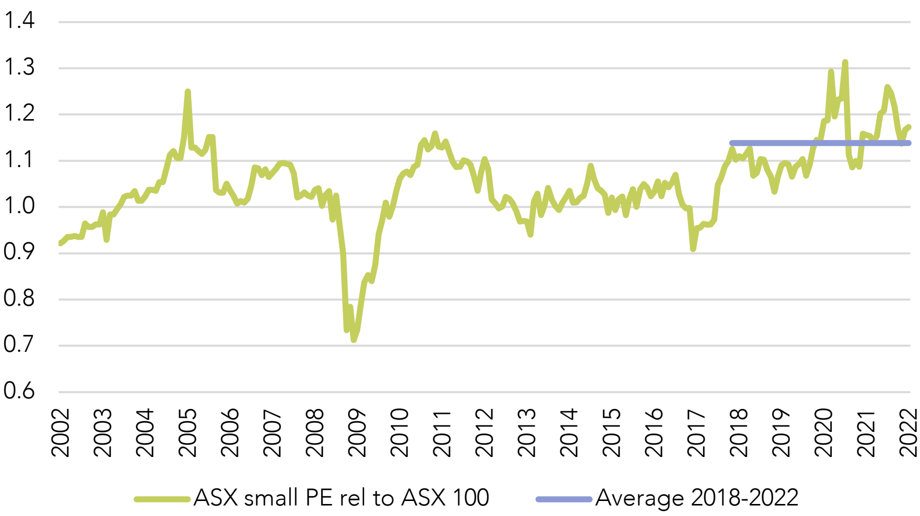
**Exhibit 5: Large caps have seen earnings upgrades so far during 2022**




*Earnings = 12mth FWD EPS.

Source: Refinitiv, Wilsons.

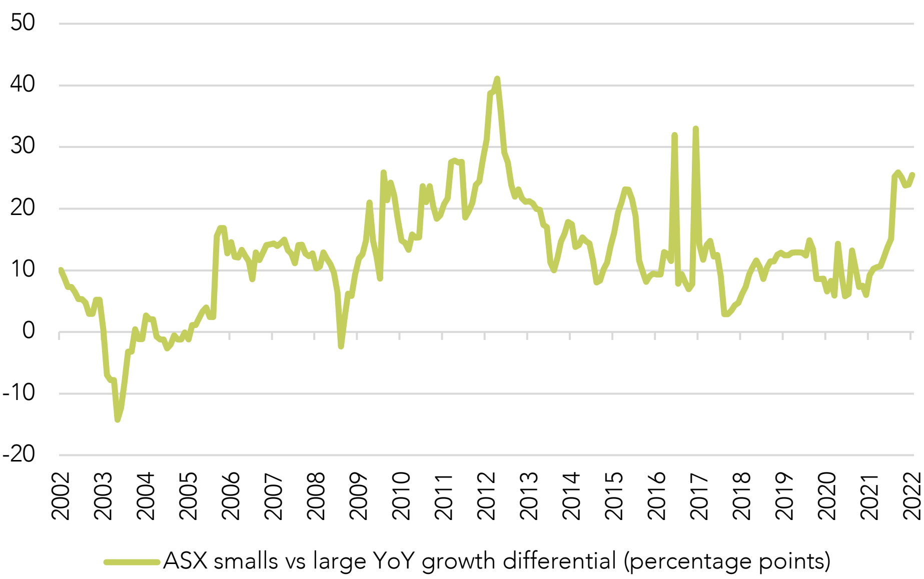
**Exhibit 6: Small cap vs large cap PER is currently in line with the average since 2018**




*Earnings = 12mth FWD EPS.

Source: Refinitiv, Wilsons.

**Exhibit 7: Large cap growth minus small cap growth. The current differential is unusually large**




Source: Refinitiv, Wilsons.

**Exhibit 8: Small cap ideas post global risk-off**

| Company Name | Ticker | Sector | Share Price | Price Change YTD % | Forecast Multiples 12mth fwd PE | Forecast Multiples 12mth fwd EV/EBITDA | EPS CAGR % (FY1-FY3) | 12mth fwd EPS Revision (1 month change %) | Dividend Yield % 12mth fwd | Consensus Recommendation Mean (5 = Strong Sell, 1 = Strong Buy) |
|---|---|---|---|---|---|---|---|---|---|---|
| **Focus List** | | | | | | | | | | |
| Pinnacle Investment Management Group | PNI | Financials | 10.26 | -34% | 21.2 | 20.1 | 17% | -1% | 4% | 2.0 |
| Healthco Healthcare and Wellness Reit | HCW | Real Estate | 2.00 | -11% | 26.0 | | 42% | 1% | 4% | 2.0 |
| Judo Capital Holdings | JDO | Financials | 1.82 | -15% | 39.3 | | 277% | 17% | 0% | 2.5 |
| Silk Laser Australia | SLA | Consumer Discretionary | 3.39 | -20% | 15.5 | 7.9 | 38% | -3% | 0% | 1.3 |
| Telix Pharmaceuticals | TLX | Health Care | 4.94 | -36% | | | | N/A | 0% | 1.6 |
| **Wilsons Conviction List (Postive earnings)** | | | | | | | | | | |
| Collins Foods | CKF | Consumer Discretionary | 10.26 | -23% | 19.0 | 8.6 | 11% | 0% | 3% | 2.0 |
| Ridley Corporation | RIC | Consumer Staples | 1.64 | 9% | 13.9 | 6.5 | 12% | 5% | 4% | 2.0 |
| Readytech Holdings | RDY | Information Technology | 3.03 | -22% | 19.1 | 11.4 | 18% | 1% | 0% | 1.8 |
| City Chic Collective | CCX | Consumer Discretionary | 3.40 | -38% | 20.8 | 12.2 | 29% | -8% | 1% | 1.8 |
| **Investment Strategy Group Picks** | | | | | | | | | | |
| Accent Group | AX1 | Consumer Discretionary | 1.67 | -32% | 13.3 | 5.4 | 45% | -2% | 6% | 2.3 |
| Super Retail Group | SUL | Consumer Discretionary | 10.31 | -17% | 11.6 | 5.3 | -2% | -2% | 6% | 2.2 |
| Temple & Webster Group | TPW | Consumer Discretionary | 6.70 | -38% | 79.6 | 39.1 | 47% | 0% | 0% | 2.2 |
| Integral Diagnostics | IDX | Health Care | 3.76 | -23% | 19.4 | 10.1 | 27% | -2% | 3% | 2.2 |
| Netwealth Group | NWL | Financials | 14.28 | -19% | 49.9 | 32.9 | 27% | -2% | 2% | 2.3 |
| Home Consortium | HMC | Real Estate | 6.91 | -13% | 26.6 | 22.4 | 4% | 15% | 2% | 2.5 |
| Domain Holdings Australia | DHG | Communication Services | 4.05 | -28% | 35.2 | 18.2 | 24% | -1% | 2% | 2.4 |

Source: Refinitiv, Wilsons

## Comments

**Pinnacle Investment Management Group:** Listed fund manager is a high beta stock, with earnings significantly linked to equity markets. The market remains concerned about the performance fee outcome for FY22E.

**Healthco Healthcare and Wellness Reit:** higher bond yields have hit A-REITs, including higher growth REITs like HCW. Market looking for additional progress on balance sheet deployment.

**Judo Capital Holdings:** high growth business banking exposure, which has just gone through profit break-even. We see prospect guidance as being achievable.

**Silk Laser Australia:** SLA offers laser hair removal and other non-surgical aesthetic products and services. Shares held by private equity backer Advent International are now out of escrow post 1H22 results, creating a perceived overhang in the stock. Operational performance remains encouraging, leveraged to COVID reopening.

**Telix Pharmaceuticals:** high growth bio-tech which has just received FDA clearance. Large capital raising in 4Q21, with cash break-even still 12-24 months away. We look for news flow on sales and revenue success beginning later this half.

**Collins Foods:** KFC franchise owner has been impacted by macro related news flow QLD/NSW floods, EU exposure with Russia/Ukraine, and chicken shortages have weighed on the share price. Key peer RBD's poor margin performance has also weighed on the stock. We think this news is captured in the 40% fall in the share price.

**Ridley Corporation:** an animal feed business with self-help business improvement story with driving increased volumes and positive operating leverage. The market is underestimating both earnings leverage and ROE improvement.

**Readytech Holdings:** IT provider into education and employment industry. Easy 2H earnings guidance to achieve top-end of revenue guidance. Strong cash flow and undemanding valuation.

**City Chic Collective:** the stock price has fallen >50% since ATH, as high growth names have been sold off. Inventory and, therefore, balance sheet risk has increased. We believe the inventory will clear over an expected strong summer in the northern hemisphere.

**Accent Group:** footwear and apparel retailer has seen its share price fall 30% as momentum slowed over the summer given the Omicron outbreak Leveraged to consumer reopening, and brand expansion.

**Super Retail Group:** 30% share price pullback due to omicron's impact on January sales. We see an opportunity as COVID lockdowns dissipate. Our expectations around a strong Easter performance and potential benefit from next week's Federal Budget are not yet reflected in the share price.

**Temple & Webster Group:** the leading online hardgoods retailer, caught in rotation out of high growth stocks.

**Integral Diagnostics:** radiology operator was hit by COVID closures over the new year, stalling the reopening benefits. Recent $90m equity raising now leaves the stock digesting this additional capital.

**Netwealth Group:** high growth high multiple market-related stock, which reported a step up in costs at 1H22. At the margin, the strategic initiative in the sector looks to be with peer HUB24 (HUB) with the acquisition of Class vs the failure of the Praemium (PPL) acquisition for NWL.

**Home Consortium:** alternative asset manager is a high growth, high earnings multiple market-related stock. EPS upgrades have continued into 2022.

**Domain Holdings Australia:** DHG has fallen 30% largely on high growth rotation. In the HY22 result, management warned on higher costs and an easing property market in Sydney and Melbourne, which hit the share price.

# Disclaimer and Disclosures

Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

**Disclaimer**

All figures and data presented in this research are accurate at the date of the report, unless otherwise stated.

Wilsons Australian Equity Focus List (Focus List) is a weighted list of the Investment Strategy Group's (ISG) preferred companies. The Focus List can hold up to 25 companies, largely taken from the S&P/ASX 300. Stocks may be substituted at any time at the discretion of the ISG. Performance numbers around the Focus List are unaudited, and should be used only as a guide to indicate returns if investors were to follow the Focus List. For further information please contact your Wilsons Advisor.

This document has been prepared by Wilsons Advisory and Stockbroking Limited (AFSL 238375, ABN 68 010 529 665) ("Wilsons") and its authors without consultation with any third parties, nor is Wilsons authorised to provide any information or make any representation or warranty on behalf of such parties. Any opinions contained in this document are subject to change and do not necessarily reflect the views of Wilsons. This document has not been prepared or reviewed by Wilsons' Research Department and does not constitute investment research. Wilsons makes no representation or warranty, express or implied, as to the accuracy or completeness of the information and opinions contained therein, and no reliance should be placed on this document in making any investment decision Any projections contained in this communication are estimates only. Such projections are subject to market influences and contingent upon matters outside the control of Wilsons and therefore may not be realised in the future. Past performance is not an indication of future performance.

In preparing the information in this document Wilsons did not take into consideration the investment objectives, financial situation or particular needs of any particular investor. Any advice contained in this document is general advice only. Before making any investment decision, you should consider your own investment needs and objectives and should seek financial advice. You should consider the Product Disclosure Statement or prospectus in deciding whether to acquire a product. The Product Disclosure Statement or Prospectus is available through your financial adviser.

Wilsons Corporate Finance Limited ACN 057 547 323, AFSL 238 383 acted as:

- HealthCo Healthcare and Wellness REIT (HCW.ASX) - Co-Lead Manager in the September 2021 Initial Public Offering
- Judo Capital Holdings Ltd (JDO.ASX) - Co-Lead Manager in the October 2021 Initial Public Offering
- Pinnacle Investment Management Group Limited (PNI.ASX) - Joint Lead Manager and Underwriter to the November 2021 Institutional Placement.; Underwriter in the September 2021 and March 2021 Dividend Reinvestment Plans
- ReadyTech Holdings Limited (RDY.ASX) - Joint Lead Manager and Underwriter in the April 2019 IPO and Lead Manager and Underwriter in the November 2020 Placement of ReadyTech Holdings Limited
- SILK Laser Australia Limited (SLA.ASX) - Joint Lead Manager in the June 2021 Institutional placement; and Joint Lead Manager and Underwriter in the November 2020 initial public offering
- Telix Pharmaceuticals Limited (TLX.ASX - Joint Lead Manager to the Telix Pharmaceuticals Limited January 2022 Institutional Placement and SPP; Co-Manager to the Telix Pharmaceuticals Limited July 2019 Placement

for which it received fees or will receive fees for acting in this capacity. Wilsons Advisory and Stockbroking Limited may have a conflict of interest which investors should consider before making an investment decision. Wilsons Advisory and Stockbroking Limited, Wilsons Corporate Finance Limited and its related bodies corporate trades or may trade as principal in the securities that are subject of the research report.

Wilsons Corporate Finance Limited ACN 057 547 323, AFSL 238 383 may have participated in some capacity with regard to capital raisings for some of the companies mentioned in this article. To manage any conflicts of interest with Wilsons Research, full disclosure on any relevant corporate transaction may be found on our website.

**Wilsons contact**

john.lockton@wilsonsadvisory.com.au | +61 2 8247 3118

david.cassidy@wilsonsadvisory.com.au | +61 2 8247 3149

rob.crookston@wilsonsadvisory.com.au | +61 2 8247 3101

www.wilsonsadvisory.com.au