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WEBCENTRAL GROUP LIMITED (ASX:WCG)

Generating strong, free cash flow and primed for growth

Webcentral Group's (WCG) legacy and core business has survived the test of time, operating in Australia and New Zealand, servicing over 300,000 customers. Founded in 1996, Melbourne IT (now WCG) had a strong presence in the domain and hosting market, and grew to be the leading registry provider in Australia.

The company grew exponentially during the dot.com period, however, in the years to follow the company's highly profitable core division encountered headwinds and was not able to organically maintain previous growth rates. Management was under pressure to deliver, and as history illustrates, growth by acquisition did not favour the company, contributing to a gradual decline over many years. At the peak of the dot.com boom, the share price on the 31st of March 2000 reached $8.96 only to fall to 48 cents as of 31st December 2000. The company recovered over the following years to reach two further peaks of $2.59 30th June 2007, and $3.62 31st Dec 2017. In mid April 2020, the share price reached an all-time low of 7 cents, and currently trades at 45 cents. The company has changed its name several times throughout this period.

What is different this time?

WCG has since restructured by divesting all non-core assets, leaving their legacy domain and hosting business with A$60m+ of predominantly recurring, strong margin revenue generating A$10m+ free cash flow per annum.

The company has endured a confusing and complicated previous 12 months, as the subject of a bidding war between WCG's now largest shareholder (5G Networks 44%) and Web.com, funded by a New York private equity firm. With A$46m debt on WCG's balance sheet the initial bid of 10 cents (by Web.com) valued the company's equity at A$12m, with an enterprise value of A$58m. 5G Networks (5GN) made an all-scrip offer whilst at the same time secured a 10% position in WCG, blocking any competing bid (any shareholder that owns 90% or more of a company has the right to acquire the remainder). Web.com made two subsequent offers of 15.5 cents and 18 cents, to be rejected by WCG's previous board in favor of 5GN's all scrip deal given their blocking stake. The previous board's decision not only ensured the company stayed listed, it paved the way for existing shareholders to benefit from a possible turnaround (which has played out thus far given the current share price of 44 cents).

Despite board approval, a syndicate of existing shareholders voted down 5GN's all scrip offer as they believed it undervalued WCG's true worth. Subsequently through a series of transactions, 5GN has since grown to own 44.5% of the company.

The issue of outstanding debt

5GN did however acquire a controlling position, and paid WCG's A$46m debt facility to existing bankers, taking it on themselves. This is a great outcome as it shows alignment, and alleviates the risk of the debt being called in. Further, 5GN Managing Director Joe Demase owns 15% of 5GN, and 10% of WCG personally, and elected not to take a cash salary in WCG. Joe's WCG options vest on achieving A$10m EBITDA. Joe also bought A$100,000 worth of WCG stock at lower prices earlier this year. During 5GN's listed life having floated four years ago, Joe has displayed an ongoing alignment in the best interests of all shareholders.

The debt burden however is a drag on WCG given the amount of interest payable (estimated A$1.2m@3%-A$2.4m@6%) and opportunity cost to 5GN having working capital tied up in long term assets (despite having a yield), and not being able to invest back in the business or grow by acquisition. There are multiple ways in which both companies could look to address this issue.

1 Capital raise/external bank funding – WCG having consolidated operations, and as stated has a run rate of approximately A$10m EBITDA, the company is in a position to consider a modest capital raise and replace their 5GN debt obligation with bank funding under better terms.

2 5GN/WCG merger – The merged entity would become a mid-cap domain, telco, and data centre provider. An all scrip bid by 5GN would make sense as the consolidated business would generate A$25m+ EBITDA, and likely too attract larger capital flows.

3 Use free cash flow to pay down debt – The company has made it clear of their intention to reduce their debt. If any of the aforementioned scenarios fail to transpire, WCG remains in good position to pay their obligation under the current terms.

4 Debt to equity conversion - Would require shareholders approval and likely to pass only if the transaction was accretive to minority shareholders. It would result in 5GN's shareholding increasing, making an eventual bid/merger more likely.

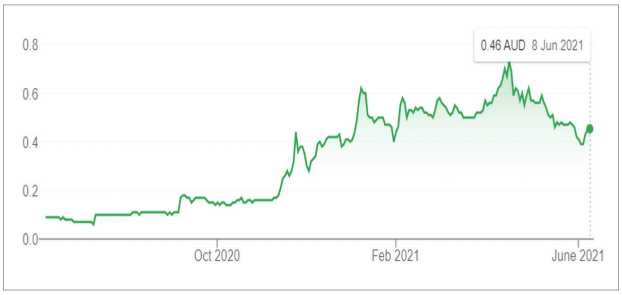
All of the above scenarios have the potential to improve shareholders return on equity, arguably some scenarios quicker than others. A combination of all could see the company better positioned to grow by acquisition if the opportunity presented.

Path to profitability

Organically
WCG has since restructured by divesting all non-core assets, The beginning of financial year 2022, Domain Administration (auDA) will release the ".au" extension. This means any business with a ".com" will be able to purchase the ".au". We anticipate many businesses will take the option to acquire the ".au" as it mitigates two scenarios. 1) The risk of someone else buying the domain name and confused customers sent to the wrong website. 2) The risk of someone after six months buying the rights to the business.com.au, and then selling it back at an inflated price (common practice). It's a small price to pay to avoid the above.

For comparison, in the UK when ".uk" was released, the industry grew revenues by 20-30%. Thus, WCG has been able to provide guidance of a similar uplift in ".au" sales. Not only is this a material once-off uplift in revenue, domain subscriptions require a yearly reoccurring fee. New domains typically encourage other services, i.e., when purchasing a domain, hosting, emails, security, online marketing are required, and thus have potential to drive incremental revenue.

By acquisition
WCG FY22 should have a run rate of A$12m+ free cash flow per annum. Pending this, the company will be well positioned to consolidate the domain and hosting businesses, in both Australia and New Zealand. Additionally, WCG are in a good position to make earnings accretive acquisitions of which they can cross sell their 300,000-customer base.



"The acquisition of WCG is exactly what we have been looking for. It will complement existing infrastructure by utilising our available capacity and as a result will drive increased EBITDA across the group. Additionally, the recurring revenue models of both organisations underpins stable and therefore very predictable revenue streams. We are excited by the growth potential we see in WCG and will leverage our experience and expertise to add significant value. The domain and hosting business are complementary to the 5GN product range, which unlocks significant opportunities to collaborate, package and integrate our solutions to improve the service experience for customers and drive product profitability. Accordingly, this acquisition delivers a compelling opportunity to leverage both 5GN's digital infrastructure and core operational capabilities to drive profitability across both 5GN and WCG."

Joe Demase
Managing Director, 5GN

Summary

The past 18 months has been transformational for WCG, having endured many preceding years of ongoing failure, which begs the question, why is this time different? WCG, as detailed above, has gone back to basics, sticking to what they know, divesting all non-core assets, and focusing on servicing their 300,000 SME clients. We like 5GN's involvement, both as management, and majority shareholder. We believe there is a great deal to look forward to given the market position of 5GN and WCG, with both business models being highly complementary to one another. With an Enterprise Value of A$110m, and the ability to achieve A$10m-12m EBITDA, WCG currently trades at an 9-11 x EBITDA multiple. It is our belief that over the medium term WCG is in a strong position to improve shareholder value based on being able to extract synergies, and cross sell each other's client base. Both 5GN & WCG operate in a highly fragmented industry, with significant tailwinds as SME's transition to digital. WCG, (as with most micro & small capitalisation companies) is considered as speculative, and it is advised to consult an advisor prior to making an investment.