This TSX Small Cap Is Music to Investors' Ears

Description

If the headline to this article read "The Best Stocks to Buy Under $10", **Stingray Digital Group** (TSX:RAY.A) would, in my opinion, be at the top of the list.

Here's why.

Investors misread acquisition

At the end of April, Stingray's stock hit an all-time high of $11.05, only to come crashing back to earth May 2 after announcing it would acquire Halifax-based radio station owner **Newfoundland Capital Corporation** for $618 million, including the assumption of debt.

Investors couldn't understand why Stingray, a company that specializes in providing recorded music to cable providers, would want anything to do with 72 old-time radio stations.

So, they walked.

However, if they had spent a little more time contemplating what the NewCap deal brought to the table, analysts believe they would have come to a far different conclusion.

"Stingray is one of the most underrated media successes in Canada, in my view," GMP Securities analyst Deepak Kaushal said in an e-mail to the *Globe and Mail* recently.

Currently, Kaushal has a "buy" rating on the company's stock, as do five out of the other six analysts who cover it.

Analysts are positive about the acquisition because of the free cash flow (FCF) it will generate once NewCap is integrated with Stingray, a move that will allow the company to continue to make additional acquisitions across all platforms, including old-school radio stations.

"There are many tuck-ins to do around the world. Our strategy is to mix the old school with the new school," CEO Eric Boyko said in a recent interview. "It's going to take a few quarters for us to prove our strategy."

The Caisse is onboard

As I'd stated in July, the Caisse de dépôt et placement du Québec, a big investor in Stingray, bought another $40 million in stock to help pay for the NewCap acquisition — a big thumbs-up from one of Canada's largest and most successful institutional investors.

Two years ago, I'd recommended investors consider Stingray's stock, in part because the Caisse was such a big believer in the company, but also because most of its revenue is recurring in nature (approximately 89%), providing a consistency of cash flow that's very rare among small-cap stocks.

"Businesses kill for this kind of consistent revenue generation. Investors seek out companies like this because they're a delight to own. That's why Caisse upped its stake," I wrote at the time. "However, most investors will probably shy away from Stingray because of its size."

The bottom line on Stingray's stock

Stingray expects to close the NewCap acquisition by the end of the year. Once done, it will generate FCF of approximately $70 million on an annual basis, considerably higher than the $33 million in fiscal 2018.

Based on its current market cap of $356 million, we're talking about an FCF yield (based on market cap) of 19.6%, providing a compelling value buy for anyone willing to put aside their feelings about small-cap stocks.

Assuming Stingray's enterprise value is $806 million (Market cap of $356 million plus $450 million in debt), its FCF yield becomes 8.7%, sufficiently above the 8% minimum value investors tend to look for when considering whether to buy a stock.

Either way, I can see Stingray becoming a $1 billion market cap by this time in 24 months, but a lot's got to go right between now and then.

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