21 FEBRUARY 2020

Stocks Down Under

"Lawsuit: A machine which you go into as a pig and come out of as a sausage."

Ambrose Bierce (1842-1914), American writer

BREVILLE GROUP

A large premium for small appliances

IMF BENTHAM

A Beneficiary of Rising Global Demand for Litigation Funding

PALLA PHARMA LTD

Opiate manufacturer's painful past

BREVILLE GROUP

A large premium for small appliances

Stocks Down Under rating: ★★

ASX: BRG
Share price: A$ 22.32
Market cap: A$ 2.91bn

From Nespresso machines, to immersion blenders, to smart ovens and waffle makers, Breville claims there's more to luxury than meets the eye. The Sydney-based Breville manufactures a full line of elegant stainless-steel appliances that add functionality and sparkle to your kitchen. But don't let the shimmer fool you. While Breville's share price displays a clear uptrend – rallying by more than 54% over the last 12 months – beneath the surface, the company's foundation is starting to crack.

READ MORE

IMF BENTHAM

A Beneficiary of Rising Global Demand for Litigation Funding

Stocks Down Under rating: ★★★

ASX:IMF
Share price: A$ 4.81
Market cap: A$ 1.19B

It is not often that a stock has a high-flying IPO, lays low for 20 years, and comes back on the radar. Sydney-based litigation financer IMF Bentham, which also has operations in the United States, Canada, Asia and Europe, has done just that in recent months. The catalyst has been the recent buyout of Omni Bridgeway Holdings, and a strong industry outlook.

READ MORE

PALLA PHARMA LTD

Opiate manufacturer's painful past

Stocks Down Under rating: ★

ASX:PAL
Share price: A$ 0.85
Market cap: A$ 110.3M

Palla Pharma, the Melbourne based opioid pharmaceutical manufacturer, has suffered some setbacks in profitability in recent years. Over the last three years, Palla grew their revenue at an impressive 71% p.a. However, their share price dropped by 30% throughout this period, giving the indication that the market has an ongoing negative sentiment towards this company.

READ MORE

BREVILLE GROUP

A large premium for small appliances

Stocks Down Under rating: ★★

ASX: BRG
Share price: A$ 22.32
Market cap: A$ 2.91bn

From Nespresso machines, to immersion blenders, to smart ovens and waffle makers, Breville claims there's more to luxury than meets the eye. The Sydney-based Breville manufactures a full line of elegant stainless-steel appliances that add functionality and sparkle to your kitchen. But don't let the shimmer fool you. While Breville's share price displays a clear uptrend – rallying by more than 54% over the last 12 months – beneath the surface, the company's foundation is starting to crack.

Share price chart

Source: Tradingview

Breville's position in the marketplace

In FY19, Breville increased its R&D and marketing spending by 11% versus FY18. Reinvesting in the brand helped the company maintain its strong growth trajectory – with consolidated revenue increasing by 17.5% to $760m, EBITDA increasing by 13.7% and Breville's return-on-equity (ROE) increasing from 21.5% to 22.7%. The company also had several product launches in the first half of FY20 – including a new coffee machine called the Creatista Pro, which comes equipped with automatic milk texturing and sports a three second heat up time. In addition, Breville launched its Combi Wave 3 in 1 – a microwave oven that also has air fryer and convection oven capability in one product – and Sear & Press, an indoor grill that offers a pre-programmed one touch interface.

Those launches helped Breville to a strong result for the six months to December 2019, where revenue grew 25%. However, in that half, EBIT only rose 16%. We wonder if Breville is hitting the limits of margin growth.

Increasing competition within small kitchen appliances

Breville's basic challenge is that its products are secondary appliances that aren't essential for everyday use. Many consumers can't afford to shell out hundreds of dollars for products they may only use a few times per week. And given the discretionary nature of Breville's product line, value-oriented consumers are likely to pass on the new launches.

Without a doubt, Breville has an innovative line of products that combine technology with ease of use and enhance one's culinary experience in the kitchen. However, competition across the industry is fierce. Leading brands like Electrolux, a Swedish multinational home appliance manufacturer; Bosch, a German engineering and technology company; and KitchenAid, part of America's Whirlpool, are all bringing innovative products to market. And with the retail industry already engulfed in its own downward spiral, the household appliance market continues to suffer through declining sales, increased price competition and inventory build-ups. Furthermore, with generic competitors entering the market – mirroring Breville's products using their own house name – the company will see further margin erosion as consumers pivot toward lower priced alternatives.

Breville also outsources the majority of its manufacturing base, which exposes the company to supply chain risk, geopolitical risk and foreign exchange risk. And with tariffs becoming the newest government negotiating tool, any change in policy could disrupt Breville's operating performance, with supply-side inflation adding further pressure to the company's margins.

Fundamentals are declining

Despite healthy top line growth, Breville is struggling across major markets. Consider FY19, where sales decelerated across Australia and New Zealand, while inventory purchases from a major Russian distributer also declined. In reality, FY19's sales growth can be attributed to strong demand in Germany (up 35.1%) – which controls 21% of Europe's market share for small kitchen appliances – and expansion into Benelux and Switzerland. However, these growth levels are unlikely to repeat in FY20. In the second half of FY20, the company plans to expand its operations into France, Portugal and Italy. However, these regions have demonstrated a much lower growth profile and are unlikely to provide the tailwinds investors are betting on. Recently, Breville also launched its products in Spain in September of 2019. However, the resultshave yet to be released.

As Breville searches for new avenues of growth, profitability is also coming under pressure. The company's EBIT margin declined from 14.2% to 13.0% in the December 2019 half, while inventory build-ups reduced the company's net cash position from $0.4m cash at December 2018 to $52.9m in net debt in December 2019. With Breville's stock trading at a P/E of 33x, shares are essentially priced for perfection. Given the challenging retail environment and growth premium already priced into the stock, we believe that two-star rated Breville is set to become a kitchen nightmare sooner rather than later.

IMF BENTHAM

A Beneficiary of Rising Global Demand for Litigation Funding

Stocks Down Under rating: ★★★

ASX:IMF
Share price: A$ 4.81
Market cap: A$ 1.19B

It is not often that a stock has a high-flying IPO, lays low for 20 years, and comes back on the radar. Sydney-based litigation financer IMF Bentham, which also has operations in the United States, Canada, Asia and Europe, has done just that in recent months. The catalyst has been the recent buyout of Omni Bridgeway Holdings, and a strong industry outlook.

Share price chart

Source: Tradingview

Omni Bridgeway buyout expands growth potential

In October 2019, IMF announced its plans to acquire Omni Bridgeway Holdings, a Netherlands-based financier of high-value legal claims. Omni Bridgeway is also prominent in cross-border enforcement against sovereign governments so this will further diversify IMF's portfolio. The $50.3m deal is expected to increase IMF's global footprint and expand its litigation funding capabilities for both common law and civil jurisdictions. This broadening of its case portfolio and associated growth may lead to IMF raising capital for investment. The company forecasts that the merger will generate income of approximately Euro 4.8m in fiscal 2020.

The Omni Bridgeway takeover is yet another step in the company's increasing global reach. It has a rising presence in the North American market through its well-established U.S. and Canadian subsidiaries. The company's U.S. segment has 32 investments that have produced a Return on Invested Capital (ROIC) of 47% while in Australia and other non-U.S. regions it has 65 investments that have delivered a much stronger ROIC of 133%.

Litigation funding industry poised for double-digit growth

The litigation funding industry is expected to grow at around 12% p.a. for the next four years potentially becoming a $242m market. Despite having been in business since 1994, consumers are still largely unaware of the litigation finance services offered by IMF Bentham and its peers. This appears to be changing, however, as a rising number of law firms are referring clients to these businesses. The clients are seeing the benefits and business is flowing in IMF's direction.

Litigation finance is a unique market that allows companies facing the uncertainty of legal matters to shift the financial aspect of litigation to a third party. A company has the choice to recognize the value of litigation at a more optimal time. This may occur, for instance, when EBITDA is expected to be lower. A firm like IMF Bentham steps in to provide funds against company assets to bridge the EBITDA gap.

Moreover, higher demand for IMF Bentham services is coming at a time when the legal industry is experiencing slower resolution rates. This stems from an increase in complex disputes and legal decision makers motivated to drag out the process to increase litigation spending by lengthening negotiations or going to trial. It is translating to increased risk for the companies and more interest in IMF Bentham's financial solutions.

A unique recession proof stock

Part of what makes IMF Bentham an interesting stock is that the business of litigation funding goes on regardless of the economic environment, changes in interest rates, or equity market performance. The uncorrelated nature of IMF means that should an economic downturn or stock market correction occur, its revenues would not be impacted by these events. In this way, the stock acts as a nice defensive addition to a diversified portfolio.

But that is not to say the company won't be able to produce significant growth. Revenue surged 87% in FY19 and although IMF posted a net loss of $25.4m, there may be a silver lining. The results were highly affected by delayed completions for several investments with only 9% of its portfolio completed. This means IMF has a huge backlog of cases that should drive strong financial performance over the next few years.

High valuation but with potential windfall upside

While the unpredictable nature of legal settlement dates makes for high variability in earnings, investors can take comfort in the company's rapidly increasing caseload, which should help smooth its bottom line. Among its 175 completed cases, IMF boasts an impressive 90% success rate.

Increasing attention towards litigation funding and attorney referrals should support growth at IMF for at least the next few years. A bulked-up case portfolio and the Omni Bridgeway acquisition also stand to extend its global reach and spur robust growth. The stock is trading at an EV/EBITDA of 8.7x. This seems about fair value to us right now. However, with potential upside from favourable settlements, our bias in the medium-term is for progressive share price improvements.

PALLA PHARMA LTD

Opiate manufacturer’s painful past

Stocks Down Under rating: ★

ASX:PAL
Share price: A$ 0.85
Market cap: A$ 110.3M

Palla Pharma, the Melbourne based opioid pharmaceutical manufacturer, has suffered some setbacks in profitability in recent years. Over the last three years, Palla grew their revenue at an impressive 71% p.a. However, their share price dropped by 30% throughout this period, giving the indication that the market has an ongoing negative sentiment towards this company.

Share price chart

Source: Tradingview

A run of bad luck

When Palla Pharma listed on the ASX back in 2015, bad weather conditions were rife in Tasmania, where the opium poppies are grown. At the same time, the Tasmanian Government imposed new laws against the importation of raw poppy ‘straw’ (the harvested poppy plant minus the seeds), causing Palla to establish their presence in Europe and NSW, as well as transfer their manufacturing operation to Victoria. Then, in 2017 Palla purchased a pharmaceutical manufacturing factory in Norway, where they hope to increase their capacity to produce codeine phosphate by an additional 20 tonnes p.a.

Another victim of the opioid crisis?

With 2.1 million Americans living with opioid use disorder, and around 48,000 people dying annually because of opioid misuse, prescriptions of these drugs have been on a global decline since 2012. Many believe that this crisis has been a distraction for Palla’s profitability. However, the company’s stance on opioid misuse is that there will always be people with diseases like cancer that rely on strong painkillers. They have also refused to comment on whether or not the opioid crisis is a problem in Australia, claiming to focus on manufacturing the ingredients used in morphine production as opposed to Oxycodone, the most widely abused prescription opiate.

Last year, the Australian federal government cracked down on prescription opioids in efforts to avoid an epidemic like the one crippling parts of the USA. They started to monitor the number of opiates being prescribed by over 5000 GPs and reduced the size of the opioid packs for patients to take home after treatment. They also made potent opiates such as Fentanyl exclusive to cancer and palliative care patients.

Interestingly, Palla has refused to enter the medical cannabis market, claiming that there is not enough research available on how cannabis effects the human body. This is despite the fact that cannabis has proven to be a lot more favourable than opioids for pain relief, and the medical cannabis industry is experiencing huge growth in many countries across the world.

Large losses and increased costs

PAL had revenue of $46.2m in calendar 2018 (up 113.1%) and a negative EBITDA of $2.6m (albeit a 78% improvement). In our opinion the company once again failed to deliver efficient cost management, for which they blamed expenses related to operational improvement initiatives, legal expenses and R&D expenses. These problems were mainly due to their quality control in Norway, and their EU serialization related disruption.

Palla expects a decrease in revenue in calendar 2020, predicting to reach the lower end of the $53-60m consensus range, with EBITDA to be roughly at breakeven. This is down to a Narcotic Raw Materials customer in France delaying their supply of product to PAL, combined with operating issues with PAL's UK based customers, resulting in a decrease of demand for their products.

On 10 February 2020 Palla disclosed that it was trying to acquire its largest UK customer, a manufacturer of finished dosage codeine phosphate. Palla believes that it can make the acquisition for a good price because the target company had its operating license suspended by the UK regulator in December. Palla's option on this acquisition runs out in March 2020. While this may result in upside for Palla in the medium term, it may be perceived as risky in the near-term.

Can Palla recover?

One advantage for Palla Pharma is the fact that they use exclusive patented water-based extraction technology, which allows them to manufacture their raw materials for opioid drugs without using wastewater treatment and toxic solvents. This gives them a competitive edge on the market as their technology has lower operating costs and is better for the environment as a whole.

Additionally, using the opioid crisis in to their advantage, Palla have started to make Naloxone, which is an opiate-derived antidote, that is used to temporarily reverse opioid overdoses. This offers a huge market opportunity for Palla and they are aiming to start supplying the US market with Naloxone by 2021.

That said, looking at recent trends from PAL, we recommend exercising extreme caution with this stock. If their track record over the past few years is anything to go by, then savvy investors should steer clear of investing their money into PAL stocks.

Pitt Street Research Pty Ltd

95 Pitt Street, Sydney, NSW 2000, Australia

Pitt Street Research Pty Ltd provides issuer-sponsored research for Small & Mid Cap companies and is founded on more than 40 years of combined experience researching companies in a range of different sectors.

You are receiving this email because you subscribed to our Stocks Down Under newsletter.

Stocks Down Under (Pitt Street Research AFSL 1265112) provides actionable investment ideas on ASX-listed stocks. The Content has been prepared for general information purposes only and is not (and cannot be construed or relied upon as) personal advice nor as an offer to buy/sell/subscribe to any of the financial products mentioned herein. No investment objectives, financial circumstances or needs of any individual have been taken into consideration in the preparation of the Content. Financial products are complex, entail risk of loss, may rise and fall, and are impacted by a range of market and economic factors, and you should always obtain professional advice to ensure trading or investing in such products is suitable for your circumstances, and ensure you obtain, read and understand any applicable offer document