4 MARCH 2020

Stocks Down Under

"Anyone who lives within their means suffers from a lack of imagination."

- Oscar Wilde (1854-1900), Irish writer.

AFTERPAY TOUCH

Can it go to $50?

AF LEGAL

All rise

DATA#3

Cloudy skies ahead

AFTERPAY TOUCH

Can it go to $50?

Stocks Down Under rating: ★★★★

ASX: APT
Share price: A$ 33.19
Market cap: A$ 9.2BN

Melbourne-based AfterPay (part of the AfterPay Touch Group) is a Buy Now, Pay Later (BNPL) company and enables shoppers to pay for their purchases in four instalments rather than in one payment. Shoppers can sign up for the service online or in retailers' stores at the moment of purchase using their debit or credit card. At the moment of purchase, AfterPay draws 25% of the purchase amount from the shopper's card and then automatically takes 3 more payments of 25% fortnightly. The best part for shoppers is that these delayed payments are interest free…the retailer pays the fee. This payment model has enabled AfterPay to post very strong revenue growth in Australia and the United States in the last few years.

AF LEGAL

All rise

Stocks Down Under rating: ★★★★

ASX: AFL
Share price: A$ $0.135
Market cap: A$ 8.1M

From the kitchen table to the first family law firm listed on the ASX, the Melbourne-based AF Legal operates with a motto of under promise, over deliver. But since the stock commenced quotation on ASX after a backdoor listing in June 2019 investors have handed down a maximum sentence – with AF Legal's stock falling by more than a third from the 20-cent raising price. However, we believe the charges are baseless and won't hold up on appeal. We're bullish on the firm. And we believe its future earnings growth will prove our case beyond a reasonable doubt.

DATA#3

Cloudy skies ahead

Stocks Down Under rating: ★★

ASX: DTL
Share price: A$ $4.03
Market cap: A$ 617M

Cloud computing. Data analytics. IT lifecycle management. The buzzwords are everywhere. And with a focus on what's trending, Data#3 Ltd, the IT services company based in Brisbane, claims to provide innovative technology solutions that solve businesses' most complex challenges. But while the company's stock has mostly trended higher over the last twelve months – almost tripling to reach $4.89 on 13 February – we don't think Data#3's cloud provides investors with much of a cushion. Competition in the sector is increasing dramatically – and it's only a matter of time before the company's firewall breaks down. No wonder, then, the stock has fared poorly in the recent market rout.

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Share price chart

Source: Tradingview

Part of the strong growth that AfterPay has recorded is driven by its easy application process. As opposed to Zip Pay (ASX:ZIP), AfterPay doesn't perform a credit check on applicants. This is particularly attractive for younger people, including Millennials. Also, there is no payment fee for shoppers as the retailer adsorbs this fee, which is around 4% of the purchase price. Typical payments with credit card see these fees imposed on the shoppers, not the retailer.

The only way AfterPay makes money from shoppers is when they don't pay an instalment on time. AfterPay charges $10 if the required amount is not in the account 24 hours after it was due and another $7 if that money is still not there after 7 days. If shoppers are behind on there payments, they will not be able to use AfterPay for new purchases.

APT has gone ballistic, in a good way

If there is one thing the results announcement on 27 February demonstrated, it's APT's meteoric growth. In the first six months of FY20, through December, AfterPay's underlying sales grew by 109% year-on-year, to $4.8BN. This is the number used to calculate the merchant fees AfterPay can charge. So this is a very important metric.

In turn, underlying sales are driven by the number of shoppers that use the AfterPay service and by the number of retailers that offer AfterPay as a payment option to their customers. The number of active customers (shoppers) grew from 3.1 million in 1HY19 to 7.3 million in 1HY20, an increase of 134%. During the same period, the number of active merchants grew by 86% to 43,200.

The sum of all this is that AfterPay was able to grow its half yearly revenues by 105% to $212.2m.

Dance the Yankee Doodle

The key driver of this strong growth has been AfterPay's expansion into the United States. The number of active customers in the US went up from 700k to 3.6 million, spending $1.4BN through AfterPay in the last six months. The number of active merchants in the US went up from 1,400 to 7,400 in a year's time. And while the number of active merchants in Australia is about five times larger than in the US, underlying sales in Australia were only about twice those of the US: $3.1BN versus $1.4BN.

In other words, US retailers have a much wider reach, i.e. more stores per retailer and more customers. Case in point, AfterPay already has more active customers in the US than in Australia: 3.6 million versus 3.1 million in Australia and New Zealand. And while AfterPay is also expanding in the United Kingdom and Canada, we believe the US represents the company's biggest opportunity by far.

OK Boomer

In terms of risks to AfterPay's business model, the bears will argue there is regulatory risk, i.e. going forward there is a chance that the company may be regulated as a credit provider for the purposes of the National Consumer Credit Protection Act 2009. If that were to happen, AfterPay would need to perform credit checks on new customers and observe responsible lending obligations. The fear is that this would inhibit the company's ability to grow.

However, we would argue that AfterPay is already observing these obligations, given that consumers can't use AfterPay if they are behind on payments. Additionally, AfterPay doesn't charge a fee when a customer wants to pay an instalment, which is an important criterion, nor does the company charge interest.

Mandatory credit checks would most likely reduce the number of new consumers, and thus inhibit top line growth. However, we believe credit checks would also lower net transaction losses, i.e. losses from consumer defaults, as the quality of the customer portfolio would improve. In turn, this would mitigate the effects on the bottom line.

Valuation validated by EBITDA growth rate

AfterPay's valuation is another pain point for the bears. At an EV/EBITDA multiple of 103.7x for FY21 (starting in July) and 47.7x for FY22 the bears argue that AfterPay's valuation is out of this world. We would argue the opposite. Based on projections by 13 analysts covering the company, EBITDA growth in FY21 and FY22 is expected to amount to 295% and 117% respectively.

Based on these numbers, AfterPay's EV/EBITDA multiple for FY22 could double and the shares would still not be expensive, i.e. the EV/EBITDA-to-EBITDA growth ratio would still be smaller than 1. A ratio smaller than 1 indicates a stock is relatively cheap based on current EBITDA forecasts.

So, can AfterPay shares go to $50 within 12 months? We believe they can on the FY22 forecasts, and they don't need to double for that to happen. In other words, even at $50, we believe there will still be good value in AfterPay.

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A highly fragmented market

Lacking a dominant player in the Australian family law space, AF Legal is positioned for exponential growth. The firm currently holds 1% of Australia's market share, while it expects to increase that by 10x over the next three years. And with no single client accounting for more than 5% of its consolidated revenue, AF Legal is diversified across services and regions. Specializing in family and relationship law, the firm targets middle class Australians located in key capital cities and towns. And in just four years, AF Legal has achieved a level of scale that would require competitors decades to replicate.

According to the Australian Bureau of Statistics, there were 49,404 divorce settlements in 2018 – with nearly half of them involving children. The number of clients accessing family legal aid services also increased by 25% (compared to 2017), while the number of total cases hit a record 12,636. And not long ago, Australian courts were flooded with hearings as the justice system struggled to keep up with demand and reduce waiting periods.

Growth remains robust

Aiming to become the largest national family law firm in Australia, AF Legal is using a combination of organic growth and acquisitions to meet its target. Institutional and retail demand for the firm's services continues to skyrocket, with the firm addressing a market of $1.1bn in total. Executing its strategy, AF Legal acquired Walls Bridges Lawyers, a collaborative family law specialist from Mornington Vic, for $53.5k in February 2019 to increase its footprint across the region. And after the firm's reverse takeover IPO in April 2019 – in which private AF Legal bypassed the listing process by merging with Navigator Resources – the firm acquired Nita Stratton Funk & Associates, a family law firm from Brisbane, QLD for $400k. The addition will expand AF Legal's operations in Queensland, which has the highest divorce rate per capita. The transaction will also generate revenue and costs synergies – as the firm can integrate its front office operations within the Queensland region, while back office operations can be consolidated to reduce overhead costs.

On 28 January 2020, AF Legal also announced that its new Canberra office will be up and running in the third quarter of FY20. The region has a population of 430,000, and according to the Australian Bureau of Statistics, its residents earn the highest net weekly wages in Australia. In addition, AF Legal announced a new lateral operation in Brisbane. The project seeks to replicate the results achieved in Sydney and Melbourne – which generated roughly $1.5m and $2.5m during their first 18 months of trading.

Fundamentals continue to trend higher

In H1 FY20, AF Legal reported underlying revenue of $3.31m – up 32% versus H1 FY19. Underlying EBITDA also came in at $1.12m – up 41% – while the firm's underlying EBITDA margin expanded to 34%. On 26 February 2020, management also announced a share buy-back program to repurchase up to 10% of the company's fully paid ordinary shares. The program will begin on 16 March 2020 and extends for up to 12 months. Not only will the initiative increase the company's per share earnings, but it speaks to management's opinion of the underlying stock. Companies tend to repurchase shares when they believe their stock is undervalued. And with AF Legal taking this step, it only reaffirms our bullish outlook.

At the moment, you can buy this rapidly growing company at an EV/EBITDA multiple of only 3x. Not bad for a company that's executing well - management has already completed five of their six FY20 strategic priorities. They launched a new website in February 2020, which is already experiencing strong growth and generating new leads.

Similarly, they completed their regional expansion initiatives and integrated their acquisition targets, while also rolling out their Salesforce customer relationship manager (CRM) and recruit team. And with more than 80% of the boxes already checked, we believe AF Legal is poised to outperform in 2020 and beyond.

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2019 momentum will be hard to replicate

As new powerhouses enter the market, Data#3 will begin to experience margin pressure. As it tries to attract new customers, we believe the high-volume approach will also lead to heavy discounting. Operating in a labour-intensive industry, competition for highly skilled workers also remains fierce. And as cloud-computing companies battle to retain top talent, Data#3's cost structure could get out of control.

Data#3 is regarded as a top 20 managed service provider in Australia, offering solutions to a wide range of clients across the Asia-Pacific region. However, as niche cloud providers enter the market, they're offering specialized services that focus on governance, cost management and security. And with its bread and butter in hybrid IT, Data#3 is already losing market share to these specialist competitors, like First Focus, an IT service provider that targets medium-sized businesses, and Interactive, a leading cloud managed services provider.

A deteriorating business model

Data#3 has three main operating segments: software solutions, infrastructure solutions, and services & discovery technology (which operates independently). Leading the pack, software solutions was the main revenue driver in FY19. However, growth was generated by winning key licensing contracts with American technology firms like Microsoft, Adobe, VMware, Palo Alto Networks, Systematic and many others. But going forward, it will be extremely difficult for Data#3 to replicative this success. The company will be forced to branch out into other areas of the market – where it lacks expertise – to stimulate growth.

Data#3 generated $12.7m in NPBT in the year to December 2019, up 41%. That was a creditable result and the fruits of continued expansion across the Australian market, as well strong performance in its core business and public cloud offering. Data#3's stock is currently trading at a P/E of 30x and an EV/EBITDA multiple of 18x. Essentially, it's priced for perfection. Any slippage in full year earnings will lead to the stock getting crushed. We believe there is asymmetric risk to the downside, which is not something you want in a prospective investment.

The market continues to ignore important details

Let's look back at the FY19 result to see how this could happen. With all eyes fixated on the top line, Data#3 generated 19.8% revenue growth in the twelve months to June 2019. However, the company's services gross margin declined from 38.1% to 33.9%, as staffing costs increased by 6.5% and other operating expenses ticked up by 0.6%. The numbers highlight Data#3's growth at-all-costs strategy, which emphasizes the embedded risk in the stock.

Moreover, contract delays within Data#3's discovery technology business piggybacked the early termination of a five-year contract by a customer in FY18. The matter is currently being litigated – as Data#3 is seeking damages for the contract breach – but the issues were a major contributor to the services' margin decline in FY19.

In FY19, Data#3 also reported $1.2m in goodwill charges. Carried as an asset when the company pays more for an acquisition than the fair value of the target's net assets, accounting laws require the company to assess the value of goodwill each year to determine if it's maintained its value. And by recording the write down, it highlights Data#3's poor capital allocation practices and inability to successfully integrate its acquisitions. So, with nowhere left to turn – as acquisitions will be required to generate future earnings growth – we believe Data#3 investors should brace for cloudy skies ahead.

Pitt Street Research Pty Ltd

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