13 APRIL 2020

Stocks Down Under

There's no nobility in poverty.

- Jordan Belfort (b. 1962), The Wolf of Wall Street

ANGLOGOLD ASHANTI

Out with the high cost, in with the low cost

RHIPE

Microsoft's mini me

LIMEADE

A little-known high growth HR tech play

ANGLOGOLD ASHANTI

Out with the high cost, in with the low cost

Stocks Down Under rating: ★★★★

ASX: AGG
Share price: A$ 6.08
Market cap: A$ 12.6BN

There are not many stocks listed on the ASX that can claim to have held up during the Coronavirus Crisis. The Johannesburg-based gold major AngloGold Ashanti has been one of them. As at 3 April the S&P/ASX200 was down 29% compared to the 20 February 2020 all-time high. AngloGold stock was down just 6%. And no wonder. Gold is set to become pretty valuable as the long-term implications of this crisis become apparent, and AngloGold knows how to find a lot of it and mine it profitably.

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RHIPE

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Share price: A$ 1.79
Market cap: A$ 251M

Shares in the Sydney-based Cloud services provider rhipe (that's right, not capitalised) haven't really gone anywhere in the last 5 years. Sure, in 2019 we have seen a nice rally from around $1.25 at the start of the year up to above $3 in August, but a lot of that ground has been given up, even before the outbreak of the Coronavirus. At the current price, we're hovering just above the 2015 peak of $1.65, which technical analysts will say is a long-term support level. From a fundamental point of view, it seems rhipe has been struggling to take off and gain altitude. You could say, it's never really cleared the tarmac. Time for a closer look.

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Share price: A$ 1.41
Market cap: A$ 345M

Limeade, a United States software company based in Bellevue, Washington, offers employment engagement solutions. The enterprise software-as-a-service (SaaS) company seeks to "elevate the employee experience" through its comprehensive platform focused on communication and general employee well-being. It has achieved 30% annual revenue growth rate over the last five years due to increasing global demand for employee experience software. The stock debuted on the Australian Securities Exchange at $1.85 per share in a $100m IPO on 19 December 2019. While the timing relative to the Coronavirus outbreak couldn't have been worse, the long-term market opportunity remains.

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Share price chart

Source: Tradingview

When institutional investors in New York or London decide they need exposure to gold, they often buy just a few of the larger listed gold miners to make the job easy. They'll typically buy Newmont (NYSE:NEM) and Barrick (NYSE:GOLD), two companies built mainly on North American gold mines although they are global in focus. One company investors tend to look at less is the next one on the list of gold majors, the Johannesburg-based AngloGold Ashanti, whose stock trades in Johannesburg, New York and Australia. AngloGold isn't as big as the other gold companies, but it is still pretty sizeable. In 2019 Newmont's attributable output was 6.3 million ounces of gold. Barrick's was 5.5 million ounces and AngloGold's was 3.3 million ounces.

Who wants to buy a gold mine in South Africa?

Of these three, AngloGold doesn't look so good on cost. Newmont's All-In Sustaining Cost of production (AISC) in 2019 was US$966 an ounce, Barrick's was US$894 whereas AngloGold's was US$992. However, AngloGold's cost base is likely to improve over time because the company isn't averse to selling out of assets where the economics or the sovereign risk don't make sense. In December 2019 the company sold its share of the Sadiola Gold Mine in western Mali after the government of that major West African gold producer failed to provide attractive terms for a 'down deep extension' of the Sadiola main pit.

And, significantly, the company last month let go of its remaining South African assets for about US$300m, chief among them Mponeng, the world's deepest gold mine, located in the West Wits part of the Witwatersrand. When AngloGold flagged the potential for this sale in May 2019 it prompted a significant re-rating of its stock.

The transfer, to fellow South African miner Harmony Gold (JSE:HAR), was a true 'end of an era' moment. If you know your South African history you'll remember that AngloGold has its roots in Anglo American, the South African mining giant which the legendary Sir Ernest Oppenheimer started in 1917 and which dominated the South African mining scene, and therefore the world scene, for generations.

Obuasi more than makes up for Mponeng and Sadiola

What Sadiola and Mponeng represented was the high cost assets. AngloGold is now replacing them with lower-cost operations that are the fruits of its ability to find a lot of gold every year. On average for the last fifteen years it has found about 3.3 million ounces a year, much of it brownfields but some of it greenfields as well.

The Obuasi Gold Mine in the Ashanti region of southern Ghana, which AngloGold inherited in the 2004 merger with Ashanti Goldfiields, is a classic example of this Midas touch when it comes to brownfields. Obuasi restarted in December 2019 after a five-year hiatus. AngloGold's budget to rehabilitate this century-old mine was around half a billion US dollars but what it got was an AISC of only US$800 an ounce for 350,000 to 400,000 ounces a year over the next ten years. AngloGold expects similar or better upside for upcoming potential mines such as Gramalote and Quebradona in Colombia, and a gold project in the US state of Nevada oddly called Silicon.

Currently the market is pricing AngloGold at a P/E of just 10.7x calendar 2020 earnings. Newmont is 23.9x and Barrick 26.3x. Based on these valuation differences we see potential for AngloGold to re-rate to be more like its two larger peers so long as the Obuasi ramp-up is effected successfully through 2020. Gold is likely to help here. Since late March it's back to about US$1,600 an ounce.

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Source: Tradingview

Much more than a reseller

rhipe provides its customers with a range of tools and services to help them operate in the Cloud. Most of its products are sourced from large, well-known software companies, such as Microsoft, IBM, Red Hat, Citrix and VMware. Rhipe resells these services in a SaaS (Software-as-a-Service) model and clips the ticket. In turn, rhipe's customers, many of which are resellers of IT services themselves, can provide these services to their customers.

Now, rhipe doesn't just resell "products", like Office 365, but it also helps its customers to become better IT services providers to their own customers, i.e. rhipe provides them the tools and support to operate their own Cloud-based businesses.

Additionally, rhipe helps customers become resellers for certain software companies, like Microsoft and IBM. For instance, rhipe can help companies become resellers of IBM SoftLayer, which is a Data Center as a Service offering. This can by offered to companies, such as Managed Service Providers (MSPs) wanting their own datacentre capabilities without owning datacentre hardware. rhipe helps companies become certified resellers of SoftLayer by guiding them through the entire process and ensuring they meet all the criteria for resellers set by IBM.

Another example is Microsoft. rhipe can help companies become a Microsoft Cloud Solution Provider so they can manage their customers' product lifecycle, i.e. they can directly provision and manage subscriptions and billing of their customers in Azure, Microsoft's Cloud solution.

AsiaPac footprint is expanding

rhipe's customers are mostly located in Australia, New Zealand, South East Asia, the Philippines and South Korea. Australia accounts for about half of the company's net revenues ($20.5M in FY19 ending June), i.e. revenues net of money paid to vendors, such as Microsoft and IBM. Singapore is rhipe's second largest source of revenues ($6.5m in FY19).

Through a joint venture with Japan Business Systems (JBS), an IT services provider based in Tokyo, rhipe is planning to expand into the Japanese market by setting up rhipe Japan. rhipe will own 80% of the business and will be responsible for most of the operational aspects of the business. While Japan is a large potential market for rhipe, we don't expect a meaningful contribution to the company's numbers for at least the next several years.

Too dependent on Microsoft

Returning to our comment at the beginning - that rhipe's share price seems unable to sustainably gain altitude - we believe the company's extreme dependence on Microsoft is partly to blame. A stunning 74% of rhipe's licensing sales was derived from Microsoft products in FY19. And judging by the 1HY20 growth figures, released in February, that percentage is not likely to fall anytime soon.

Don't get us wrong…resellers of Microsoft products and services are in a good position following the renaissance of Microsoft in the last 10 years. The company has largely reinvented itself and offers some of the best collaboration and workflow tools on the market today. However, we believe it constitutes a serious, not entirely theoretical, continuity risk for any company to be so dependent on one single supplier.

Now, we believe the chance that Microsoft would actually terminate its business relationship with rhipe for whatever reason is very small. Our main concern is rhipe's dependence on the whims of Microsoft when it comes to pricing and promotions of its products, and the effects of that on rhipe's revenues. Microsoft has its own sales agenda and rhipe is along for the ride, in our view.

Limited room for margin expansion

IT Services is a very competitive industry where the ability to add more value for customers than your competitors is typically very limited. After all, Microsoft Office 365 will be the same product, no matter who you buy it from. And yes, if you can run a smooth deployment of O365 across your customer's 5,000 seats, that is valuable. But we argue that this will not structurally drive any IT service provider's margin significantly above the market average. Competitive pressures are simply too strong, in our view. So, while there may be scope to drive EBITDA margins towards 30%, following the 26.3% margin in 1HY20, we fail to see upside beyond that.

Where to from here?

Following the Corona Crash and, prior to that, the declines from the $3 peak in 2019, rhipe shares are now trading at an EV/EBITDA of 13.5x and a P/E of 26.4x, both for FY21 that starts in July. We believe this is still a fairly full valuation, given the current market circumstances in which demand for IT services maybe slow for a while. Combined with our more company-specific concerns, we're neutral on rhipe at the moment. Hence, three stars at this stage.

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What are 'employee experience solutions'?

Limeade is in the unique human resource business of offering "employee experience solutions". It is all about getting employees to feel like they matter, have healthy co-worker interactions and have opportunities to grow. When they do, it says individuals are twice as likely to be engaged in the workplace and 9-times more likely to remain at the company for at least three years.

The company's flagship Limeade One platform is built to support physical, emotional and financial employee well-being across entire organizations. Aside from promoting employee engagement and inclusion, it is also meant to prevent worker burnout, which is known to cost employers millions of dollars in lost productivity each year. The Limeade program teaches employers to identify burnout signs before people become less valuable or walk out the door.

Limeade's business model is designed to capitalize on the large and growing global employee experience software market opportunity. The company estimates that it is a US$18.2bn market, half of which resides in the United States. Industry analyst Bret Star estimates that the global market will grow by 20% this year and 25% annually from 2021-2023. This is because the employee experience industry is expected to see increasing mainstream adoption. Employers are placing greater value on attracting and retaining top talent to gain a competitive advantage.

In 2019, Limeade met or exceeded all its financial forecasts. Revenue increased 18% year-over-year to US$47.4m. EBITDA was up 40% on FY18 but remained negative, at -US$2.1m, and NPAT was -US$3.5m. The company continues to invest heavily in its science and data driven platform and various expansion opportunities. In FY19, research and development costs rose 36% to US$17.2m and sales and marketing expenses jumped 33% to US$15.7m. Limeade has poured more than US$77m in the business since its 2006 inception with an increased emphasis on higher value customers. Today, more than three-fourths of its customers have over 10k employees.

Diverse recurring revenue profile

Limeade caters to medium and large enterprises with 500-plus employees that operate in a diverse range of industries. Its customer base includes well-known companies and universities from around the world. Industrial and manufacturing companies are its largest customer segment at 23% of revenues followed by healthcare (19%) and the education, non-profit and government segment (16%). Its customers are loyal in nature as evidenced by its 97% customer revenue retention rate.

Like other SaaS companies, Limeade's revenues are predominantly subscription-based. Recurring revenue accounts for 96% of overall revenue. It added 30 new customers across seven industries in FY19 to bring its customer total to 173. The average contracted annual recurring revenue (CARR) per customer was US$330k. Its customer industry diversification serves to smooth the effects of sector-specific cyclicality and is one of the more compelling aspects of the company.

New solutions may speed profitability timeline

Unlike most companies, Limeade may benefit from the Coronavirus pandemic because of the spotlight that has been placed on the need for effective remote employee communication. It has provided several resources tailored to employee care including the Limeade Care in Crisis Edition mobile platform, which is free through 31 August.

The company serves over 2.6m users in 100 countries through its offices in the U.S., Canada, and Germany. It has growth opportunities in the form of domestic and international expansion (across APAC and Europe), platform innovation, and a broadened solutions portfolio. Given it has been able to post robust sales growth from a single software solution, there is the potential for new solutions to accelerate upside and make Limeade profitable.

Given the company's current customer base and high retention rates, and at an EV/Revenue multiple of 3.7x for FY20 (ending in December), we quite like Limeade. It could be one of those SaaS companies, like Altium and Appen, that keeps on growing nicely for many years, to one day find itself in the $1BN+ market cap category. It will need to start turning a profit, though, because unlike US and European investors, Australian investors don't have a lot of patience with EBITDA-negative companies, even if they're a high-growth Tech company.

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