11 MAY 2020

Stocks Down Under

> *Buy land, they're not making it anymore.*
>
> **- Mark Twain (1835-1910), American writer**

REA GROUP
The benefit of the doubt

INFOMEDIA
Auto software market on highway to growth

ZOONO
Ridiculous valuation for a generic product

REA GROUP

The benefit of the doubt

Stocks Down Under rating: ★★★★

ASX: REA
Share price: A$ 95.17
Market cap: A$ 12.5BN

Conceived in a garage in Melbourne in 1995, REA Group has grown into a company with 1,400 employees on three continents. REA calls itself a digital advertising company, which it is of course, but most people see just REA as a property search website. Looking for a house? Go to realestate.com.au. We like REA's business model, but the fallout from COVID-19 may be more severe than people think.

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INFOMEDIA

Auto software market on highway to growth

Stocks Down Under rating: ★★★★

ASX: IFM
Share price: A$ 1.57
Market cap: A$ 573M

Sydney-based Infomedia provides cloud-based parts and service software to the global automobile industry. Its value-added technology changes the way automakers and dealerships operate, make decisions and communicate with customers. Software-as-a-Service (SaaS) has become the dominant part of the business due to rising demand for technology and data insights that give market participants a competitive edge. It has become a leading software provider to the global auto industry with over 80% of revenue generated outside of Australia. As the modern auto industry evolves, we believe Infomedia has a great opportunity to access a broad, growing market and expand its global footprint.

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Share price: A$ 1.89
Market cap: A$ 309M

Headquartered in Auckland, Zoono is a supplier of antibacterial hand and surface sanitiser. The stock has come to the surface of the investment community amid the Coronavirus pandemic as the company has ramped production to help meet the high global demand for personal, household and business cleaning products. While the company is expanding its distribution worldwide and generating historically high revenues this year, it remains to be seen if the present success is sustainable. Prior to the COVID-19 crisis it was operating at a net loss and despite the current buzz around its products, scepticism remains as to their ability to protect against the novel coronavirus.

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Share price chart

Source: Tradingview

Prior to its listing on the ASX in 1999, REA received strong support from News Corp., which to this day still holds a stake of 61.6% in the company through various entities. Over the years, the company has expanded to Europe, the US and Asia with websites and services similar to its main gig, realestate.com.au in Australia. On the back of its strong long-term performance, REA share price has done really well over the years, rising from below $10 in 2012 to an all-time-high of $117.30 just three months ago.

Q3 was good, but COVID-19 impact will be visible from Q4 onwards

On 8 May, REA published its third quarter results and as was to be expected, the recovery after the 2018/2019 residential property downturn has been nipped in the bud by the Coronavirus Crisis. The third quarter revenues through March 2020 actually showed an improvement compared to the first half of the financial year with Q3 revenues growing 1% year-on-year to $199.8m while the first nine months of the year as a whole showed a 4% revenue decline to $640.2m.

However, REA indicated that new listings across Australia in April declined by 33% with Sydney and Melbourne down 18% and 27% respectively. So we expect the real impact on revenues will start to become visible when REA reports its Q4 numbers in July.

COVID-19 causes loss of appetite … for property

According to SimilarWeb, a website that monitors internet traffic, realestate.com.au had 32.6m total visitors in April on its website and mobile app combined versus just 14.3m for Domain.com.au. Clearly, realestate.com.au is the dominant platform, although yours truly prefers Domain's user experience, or UX, to realestate.com.au's.

Traffic in March and April of 32.5m on average was clearly lower compared to January and February, when realestate.com.au recorded 36.5m monthly visitors on average. Domain.com.au recorded comparable trends with a decline in website visits from 17.2m in January to the 14.3m we mentioned for April. Clearly, one of the symptoms of COVID-19 is loss of appetite for property.

We expect these numbers will bottom out once consumer confidence starts to turn, e.g. when lockdown restrictions are clearly easing and a start being made to revamp the economy. However, we remain concerned that unemployment and low consumer confidence will put the brakes on real estate transactions in the next 6 to 9 months, and consequently on ad spend. Additionally, less immigration in the near to medium term, caused by international travel restrictions and people's overall unwillingness to make big moves during times of uncertainty, will likely result in less demand for dwellings, both to buy and rent. In other words, we expect real estate related ad spend will remain under pressure for quite a while.

The question is: How much of that outlook is already discounted in today's share price? After bottoming at $62.05 on 23 March, REA's shares are now only 19% below February's all-time-high of $117.30.

Expensive near term, opportunity longer term

REA is currently valued at an EV/EBITDA of 23.9x for FY21, starting in July, and 19.9x for FY21. For the P/E fans out there, the company is trading at a P/E of 39.9x for FY21 and 31.4x for FY22.

When we relate these valuations to EBITDA growth in the next 2 years, we believe investors may have gotten ahead of themselves in the near term. Analyst consensus assumes EBITDA growth of 13.1% for FY21, while the stock is trading at nearly 24x EV/EBITDA. That represents an EV/EBITDA-to-EBITDA-growth ratio of 1.83, which is quite expensive.

For FY22 the picture is much more balanced. Consensus analyst projections assume 20% EBITDA growth for that year, while the current FY22 multiple is 19.9x, i.e. an EV/EBITDA-to-EBITDA-growth ratio of ~1x.

Although we believe REA stocks is expensive in the near term, we want to give the company the benefit of the doubt. Come 2021, we expect REA to be able to resume its multi-year growth path from before COVID-19, driven by a recovery in the domestic real estate market and further international expansion. So, four stars from us.

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Software drives dealer productivity and profits

Infomedia's Superservice software platform is designed to increase auto dealership sales and customer retention. Its SaaS parts platform, including the Microcat suite and Auto PartsBridge software, helps users quickly identify replacement parts to improve productivity and parts sales. The technology improves the profitability of auto service departments by providing accurate automobile information based on vehicle identification number (VIN).

Infomedia's integrated software offers service quoting, driveway check-in, vehicle health check, job management and real-time analytics modules. Customers like it because it allows them to stay informed and in control of decisions throughout the vehicle servicing process. This ultimately leads to higher parts and labour sales and better customer satisfaction.

The company's sales have climbed steadily since 1HY18. On the heels of a strong FY19 performance, Infomedia posted impressive 1HY20 financial results. Revenue advanced 19% to $47.9m and earnings per share grew 21% to $2.86. The growth was achieved across all product lines and regions. The parts division had a 10% increase in sales while service revenue grew 32%. Growth was particularly strong in the Asia Pacific region where revenue jumped 49% to become its largest geographic segment. It was able to maintain the recent growth pattern while staying committed to investing as disciplined cost control kept margins steady in 1HY20. Management expects revenue growth of 10% to 12% in FY20.

Expanding into data analytics through Nidasu acquisition

Infomedia's products are used by 180,000 users in 186 countries. We believe its high quality, defensive business model has enabled it to be resilient during the COVID-19 crisis with almost all revenue coming from recurring software subscriptions. As the economy normalizes and people return to auto dealerships, there is the potential for an acceleration in the business as Infomedia technology gets adopted by other areas of the auto ecosystem.

The global auto industry is experiencing disruption and trends are emerging on which Infomedia can continue to capitalize. It is a large, growing, and yet very fragmented market that is recognizing the value of modern software solutions and data analytics to maximize sales opportunities and solidify customer relationships.

The global auto software market is forecast to reach US$60bn by 2025. With annual revenue that equates to less than 1% of this forecast, Infomedia has a lot of room for growth, in our view. While there are several companies that offer parts, service, or data insights software platforms, few offer all three and do so on a global scale. Infomedia's SaaS offerings encompass the entire automaker and dealer spectrum, which combined with a broad global footprint give it a major competitive advantage.

The highly competitive auto industry has increasingly turned to data analytics to boost sales and gain a competitive edge. Infomedia recently acquired Australian auto software company Nidasu to bolster its data analytics capabilities and growth prospects. Nidasu provides data insights to automakers and dealerships that help them reduce operational costs and increase aftersales performance. Its products uncover hidden data relationships, provide insights into customer behaviour and forecast demand for parts and service. Nidasu made a good contribution to the company's APAC performance in 1HY20 and has room to grow in APAC and other regions because auto businesses around the world are in the early stages of data analytics adoption.

Strong balance sheet and competitive position

The SaaS-driven business represents a recurring revenue stream that is attractive from an investment standpoint. More than 95% of the business is revenue and is well diversified both globally and in terms of customer concentration. With few players that provide parts, service and data insights to the global auto industry and tremendous growth opportunities ahead, Infomedia is in the driver's seat.

Infomedia's balance sheet has $15.2m in cash and is free of debt. The company is highly cash generative and cash generation was up 11% in the six-month period ending 31 December to $17.2m. Its shares offer a growing dividend (2.6% right now) and trade at an EV/EBITDA of 10.9x for the next financial year, starting in July. Given its projected EBITDA growth of 12% and 15% in FY21 and FY22 respectively, that valuation looks pretty attractive to us. Four stars from us.

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Share price chart

Source: Tradingview

Strong COVID-19 demand, but does it work?

The COVID-19 crisis has put the spotlight on many companies involved with vaccine development, diagnostics and personal protective equipment (PPE). It has been the sole reason for the resurgence in investor interest in Zoono. The share price has already more than doubled in 2020 as the company continues to put out headline after headline to fuel the fear-based rally.

The selling point and apparent appeal of Zoono's main Z-71 Microbe Shield product is its patented antimicrobial technology. While current technologies lead to an intermittent hygienic state on surfaces, Zoono is designed for "persistent efficacy". It deposits a layer of molecular "pins" in a matrix formation that creates a defensive, antimicrobial layer in nano dimensions. The products offer an "elevated high-hygiene interval" that extends the duration of germ protection to 30 days on surfaces and up to 24 hours on hands. They are also marketed as environmentally friendly.

Australia's Therapeutic Goods Administration (TGA) recently gave Zoono the thumbs up to claim that its Z-71 Microbe Shield Surface Sanitiser is an effective hard surfaces disinfectant against COVID-19. Back in February the company claimed that an independent study found its sanitisers to be 99.99% effective against COVID-19. On 29 April, Zoono signed a distribution agreement with Australian buildings service company Johns Lyng Group.

Losing money before the pandemic

It's unknown, however, if Zoono's products are truly effective against the coronavirus. After all, didn't most sanitiser labels stake a similar 99.99% claim against other bacteria and germs before the COVID-19 outbreak? As such the surge in demand may be more of a psychologically driven purchase rather than one based on proven science. If it's eventually established that Zoono's products do not fully protect from the virus or that such sanitisers in general are not necessary, we believe sales could plummet immediately.

Zoono's business was operating at a loss heading into 2020. Although revenue increased 144% to NZ$1.7m in 1HY20, profit fell 47% to approximately -/-NZ$ 728k. While it did achieve a gross profit, the bottom line was hampered by a laundry list of high expenses which included employee costs of NZ$409k, professional and consulting fees of NZ$261k, selling and distribution costs of NZ$235k and marketing expenses of NZ$116k. The company had a moderate cash position of $2.7m as of 31 December that declined from the previous interim period. With NZ$1.3m in liabilities the balance sheet is in a rather tenuous position and management must exercise caution to avoid its already murky financial situation from becoming overextended.

Near-term hype versus long-term growth

Zoono will undoubtedly benefit from the near-term environment. High demand from online consumers forced the company to shut down web-based consumer sales for most of April and new orders are presently delayed for shipment until early May. Business-to-business (B2B) sales soared to $10.3m in the month of April alone. Zoono has been forming new distribution partnerships in Europe and the UK where its sanitisers are being used by the West Yorkshire Police Department and the London Underground rail system. It is also reportedly generating strong sales in China, Hong Kong and India with major airliners among its latest customers.

Despite the near-term success, we believe Zoono it is not a clear-cut winner because there are plenty of alternatives to its products. Many companies worldwide manufactured sanitiser products before the COVID-19 crisis, and countless more have pivoted their operations to get in on the fear-driven demand including businesses that previously had nothing to do with cleaning solutions.

Aside from the heavy competition, Zoono is one negative headline away from a downturn. While its contributions to fighting the global pandemic are commendable and the company may appear to be a clear winner on the surface, too many questions remain. At some point investors may recognize this as a short-term phenomenon rather than a sustainable long-term business model.

The current FY21 EV/EBITDA multiple of 18.3x and a P/E of 38.2x are ridiculously high for a company that basically sells a very generic product and essentially has no defendable market position. We'd wipe our hands clean of Zoono shares at these levels.

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Pitt Street Research Pty Ltd is founded on more than 40 years of combined experience researching companies in a range of different sectors.