22 MAY 2020

Stocks Down Under

> *Relatives exist to eat your inner child.*

- Inspirobot (b. 2015), Artificial Intelligence system dedicated to creating quotes, created by Norwegian coder Peder Jørgensen

APPEN

Hey Google, is APX a good investment?

LYCOPODIUM

Risks in West African mining are increasing

MSL SOLUTIONS

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APPEN

Hey Google, is APX a good investment?

Stocks Down Under rating: ★★★★

ASX: APX
Share price: A$ 29.92
Market cap: A$ 3.6BN

Whenever you go online to shop, search and be Social on Media, chances are Sydney-based Appen had a big role to play in what you get served up on screen or by your Digital Assistant. Appen helps the world's largest technology companies, including Microsoft and Facebook, train their Artificial Intelligence systems. It has been doing this so successfully that the market is now projecting that Appen will achieve more than $700m in revenues this year, up from just $51m in 2014. You may have noticed that we at Stocks Down Under don't shy away from high valuations as long as the growth is there. With Appen trading at an EV/EBITDA of 27x, it'd better fit the high-growth bill!

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LYCOPODIUM

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Stocks Down Under rating: ★★

ASX: LYL
Share price: A$ 4.83
Market cap: A$ 193M

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Share price: A$ 0.073
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Share price chart

Source: Tradingview

How to train your dragon

We all know computers are dumb. They need an instruction for everything they do or else they just do nothing. The same is essentially true for Artificial Intelligence (AI) systems. Today's mainstream AI algorithms have been programmed by humans and by default are bound by the imagination of the programmers and the parameters they set. So once an AI algorithm is completed it can't be used straight away; it needs to be trained first, for instance to understand the difference between a traffic light and an oncoming truck .... quite important if you're the passenger in an autonomous vehicle.

In order to train an AI system, it needs to process a very large number of examples of a specific situation and be told what it is that it's seeing or hearing. For instance, AI for visual recognition may need 1,000 pictures of a bike in various scenarios to understand that there is a bike in every picture, albeit that one may be set in the woods and the other on the road. Similarly, a Digital Assistant may need to hear "Hey Alexa, what's the weather like today?" in 150 different accents before it can be let loose in the wild.

Technology companies compile large data sets with just this sort of information and feed that into their algorithms in what is known as supervised learning: the algorithm gets to see a picture or video or is played a sound and is told what it is. The more examples an algorithm is given, the better it will become at analysing unknown pictures or sounds where no information is given about what it is. This is where the term Machine Learning comes from.

Appen is very good at labelling data sets

Appen's customers are mostly large technology companies, such as Microsoft, Facebook, Amazon, IBM and Google, that are leaders in the field of AI. In order for them to train their algorithms they collect vast amounts of data that they plan to train these algorithms with. However, this data is unlabelled, i.e. there may be a thousand pictures of a horse in a data set, but nowhere does it say that it's horses in the pictures.

Appen has a platform that collects and labels images, text, speech, audio, video and sensor data to help customers build and train their AI systems. In addition to automated data labelling capabilities, Appen has an army of more than one million skilled annotators globally that it can source from to annotate and label large data sets. These are people with different geographic, cultural, racial and language backgrounds that go through these data sets to annotate and label them appropriately. Appen then sends back the data set to its customer who can use it to feed into the algorithm for supervised learning.

The global market for this sort of AI data labelling is expected to be around US$18bn in size by 2025, a very large market indeed.

AI systems need continuous education too

The nice thing about AI systems is that they need to be kept up-to-date. In fact, about a third of all AI models need to be refreshed monthly! So, in addition to revenues from new customers and new AI systems that need new data sets, Appen generates revenues from data sets that are used to train and update existing AI systems. Sort of double-dipping so to speak, which is a nice source of recurring revenues!

US acquisition accelerates technology roadmap

In April last year, Appen acquired Figure Eight, a US-based machine learning company that had developed highly automated annotation tools for unstructured text, images, audio and video. Appen paid a total of $288m for Figure Eight, which represents 5.8x FY19 revenues. That money not only bought sophisticated technology, it also brought new clients on board, including the US government, Ebay, VMware, Groupon, Spotify, Mozilla, Twitter and American Express. It should address some of the criticism that Appen copped of being too dependent on just one or two very large customers.

Modestly priced given its growth prospects

Coming back to our opening comment about Appen needing to show high growth to justify its valuation, we note that the consensus forecasts calls for Appen to grow its revenues from $536m in FY19 to almost $1bn in FY22, so a doubling in three years. In that same time period, EBITDA is expected to grow from $101m to $214m, i.e. 32.2% in FY20, 29.8% in FY21 and 23.6% in FY22.

The company's EV/EBITDA multiple for those same years is 26.9x, 20.8x and 16.8x respectively. In other words, our favoured valuation method of EV/EBITDA-to-EBITDA growth stands at 0.84, 0.70 and 0.71 for those three years, i.e. well below 1x for the next three years. In our book that makes Appen an attractive investment right now, even after its very strong run post the Corona Crash. Four stars from us.

LYCOPODIUM

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COVID-19 crisis slows development plans

Around 90% of Lycopodium's business is in the Resources sector where it delivers engineering support for mining projects in gold, base metals, battery metals, specialty metals, diamonds and bulk minerals, like iron ore and bauxite. The strength in the price of gold has represented a significant tailwind as the company has seen an increase in gold mining development, especially in Africa.

The group is also is involved in the Infrastructure sector through various railway, road and port projects. Its third operating segment, Industrial Processes, covers a wide range of industries including pharmaceutical, biotechnology, chemical, energy, food & beverage and manufacturing.

The COVID-19 crisis has had a significant impact on the mining services sector. Government actions to contain the spread of the virus have had a profound impact on global economic activity and slowed Lycopodium's business development agenda. Activity in its project and study pipeline has slowed to a crawl. Due to the highly uncertain environment, Lycopodium withdrew its FY20 guidance for $220m in revenue and NPAT of $14.1m. It noted in a 25 March announcement that it expects business activity to be impacted "for an extended period".

Unrest in West Africa poses a major threat

While its roots are in the domestic market, the African region has grown into its main market representing approximately two-thirds of revenue. The increased dependence on West Africa has come with increased risks, particularly in countries like Burkina Faso, where it has participated in seven projects over the last five years. In October 2018 West African Resources awarded Lycopodium a contract to provide full Engineering and Procurement (EP) services for the Sanbrado Gold Project in Burkina Faso and in 1HY19 awarded the balance of the Construction Management (CM) business. The Sanbrado Project is expected to pour first gold in Q3 CY20 and while this is one of several promising projects in the region, there is a perpetual overhang of uncertainty here.

Burkina Faso, one of the poorest African nations, has been marred by political unrest and droughts that have resulted in widespread global concern over the state of its economy and human rights conditions. The 2018 attack on the French embassy in which 16 people were killed is just one example of a nation roiled by repeated military coups.

We believe the geopolitical risk in Western Africa is a big issue for Lycopodium. Terrorist or other violent events have the potential to disrupt operations at its project sites. In a worst-case scenario, the company may have to suspend some projects. If a conflict were to escalate into a major war, an exit from the key region entirely may become necessary. Although Lycopodium has opportunities to expand elsewhere around the world, making up for lost revenue sources could potentially take years.

Move into EPC business a source of uncertainty too

Back at home, Lycopodium recently formed a joint venture (JV) with Perth-based engineering group Monadelphous called Mondium to capitalise on growth opportunities in the mineral processing industry. It has a 40% interest in the JV. In January 2020, Mondium announced that it won a $400m contract from mining giant Rio Tinto to design and construct the Western Turner Syncline Phase 2 (WTS2) mine in the Pilbara region of Western Australia.

While the partnership makes perfect sense strategically, there are risks involved. First, Lycopodium owns a minority interest in the JV and therefore is not able to exert full control over important decisions. Secondly, the move into engineering, procurement and construction (EPC) service work is outside of its core competencies. As such it is unknown if the company can execute on the opportunity or if it will be distracted it from its core business. Lastly, a slowdown in Rio Tinto activity in recent months further adds to the uncertainty around this move.

Favourable cash position offsets risk

Meanwhile, the performance in the Americas region has been weak. Revenue in the Americas segment declined 71% to $1.6m in 1HY20. While this is a small part of the overall business, its struggles to achieve sustainable growth in the region continue to be a drag on financial performance.

Fortunately for Lycopodium, it has a strong balance sheet and a favourable cash balance that help offset some of these risks. As of 31 December 2019, it had $112.8m of cash and a minimal amount of borrowings. Lycopodium's financial strength should enable it to get through the current crisis and eventually address its other risk factors. Shares of the engineering consultancy offer a 4.6% dividend yield and trade at an EV/EBITDA multiple of 4.3x for FY21. We believe this modest valuation is warranted given the expected flat EBITDA growth in FY21 and mounting risks to the company's business.

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Share price chart

Source: Tradingview

Say you're running a local football club like, the Roosters in Sydney, which ranks one of our editors as a fan. You have a large membership base to keep track of. Multiple businesses running in the club's facilities. Playing fields to manage. A lot of business and event planning to undertake. And so on.

Traditionally you'd have multiple systems of varying ages to handle all of this and they wouldn't talk to each other easily. MSL Solutions, with its MPower platform, set out around 2007 to change all that by creating one integrated system. And clients liked it, particularly in recent years given the solutions were increasingly SaaS-based and therefore low-cost. By the time of the 2017 IPO, revenue was $24m and EBITDA $1.6m and in the year to June 2018 that grew to $33m revenue and $5.2m EBITDA.

In need of a down-sizing

By 2018 MSL was a big deal globally in data and software for stadia and hospitality venues, and it had also made a name for itself in the world of golf where it had software that would facilitate tournaments. There were 2,400 clients around the world being served by seven offices and a head count in the hundreds. And the potential to seriously shake up the game of golf through the World Handicap System it had developed. The company, had, however, grown too fast, and in 2019 it had to be downsized.

The problem for MSL Solutions was that not all of that $33m in revenue was recurring, which is really what you need if you want to scale globally with a SaaS model. Indeed, only $16m of FY18's revenue was recurring. The rest was basically the labour-intensive one-offs associated with getting Atlético de Madrid's stadium in Spain or the Wet N Wild theme park on the Gold Coast tooled up to use MPower. So, if new business growth was slow the company wouldn't make money. That's why in the six months to December 2018 the EBITDA line was $3m in the red.

Covid-19-proofed

In August 2019 new management set out to right-size MSL so that it could sustainably grow off the great products it had created or acquired. Tony Toohey, who in 2016 had sold the gaming technology services company Intecq (formerly eBet) to Tabcorp for $128m, came in as MSL's Executive Chairman, while Pat Howard, formerly in general management at a couple of Australian national sporting bodies, joined as CEO. It didn't take long for the new team to turn things around, although they did have to make a small placement at 7.5 cents a share to keep the doors open. In the six months to December 2019 the EBITDA loss was down to $1.6m and by the March 2020 quarter the company was cash positive.

MSL's annual revenue base is around $25m right now, were right now a normal year. However, as we all know, 2020 is not normal. Covid-19 should notionally have been bad for business at MSL given that pubs, clubs and restaurants everywhere have been shut and virtually no sport has been played. However, MSL is a SaaS-based business where the customers now need their products to, as it were, keep the lights on, if only to keep talking to their members and keep them loyal. As a consequence, there's been virtually no impact to MSL, which is why the stock has been re-rating since April. And why three directors - Earl Eddings, Richard Holzgrefe and David Usasz – have been recent on-market buyers of stock.

Ahead of the post-Covid resumption of the Toohey-Howard turnaround, we're with these on-market buyers in terms of liking the potential of MSL Solutions.

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