29 JUNE 2020

Stocks Down Under

> *Who wants to read a book when you can blow something up?*
>
> **- Rick Yancey, (b. 1962) American author**

ORICA

Growing with Alberto

PARADIGM BIOPHARMACEUTICALS

No bones about this one

LIFE360

Look through the lockdowns

ORICA

Growing with Alberto

Stocks Down Under rating: ★★★★

ASX: ORI
Share price: A$ 16.37
Market cap: A$ 6.6BN

Whenever the global mining industry is depressed, it's a good time to buy Orica stock because that Melbourne-based company is the world's largest provider of commercial explosives to the mining industry. If you bought Orica at the July 2016 low, then by November 2019 you would have almost doubled your money. The Coronavirus Crisis has provided another buying opportunity.

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PARADIGM BIOPHARMACEUTICALS

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Stocks Down Under rating: ★★★★

ASX: PAR
Share price: A$ 3.39
Market cap: A$ 757M

Since 19 March the stock of the Melbourne-based drug developer Paradigm Biopharmaceuticals has recovered 70% of the ground it lost during the Corona Crash. Investors are enthusiastic about this company's chances of successfully repurposing an old drug called Pentosan Polysulphate Sodium now that the drug is headed into Phase 3. We're with them.

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LIFE360

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Stocks Down Under rating: ★★★★

ASX: 360
Share price: A$ 1.95
Market cap: A$ 274M

Life360 listed on the ASX in the middle of 2019 at a price of $4.79 per CDI (CHESS Depositary Interest). The California headquartered company has had a rough time since that listing, though, with the share price falling to around $2 currently. Given that a large part of the functionality of the Life360 app for smartphones revolves around users' locations and movements, it's understandable that COVID-19 has recently hindered the company's expansion. But we believe things will improve when lockdown restrictions ease.

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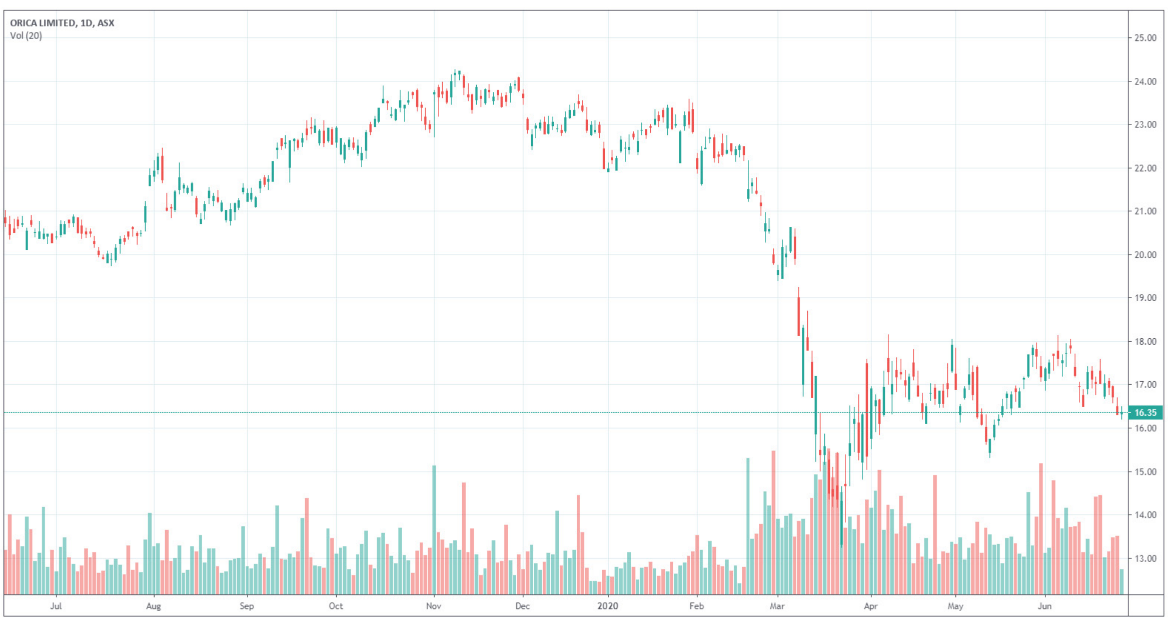
Share price chart



Source: Tradingview

If you want to understand Orica and its growth prospects over the next few years, a brief look at the career of Alberto Calderon, CEO since 2015, is a great place to start. This native of Colombia came to Melbourne in 2007 to be a senior executive at BHP Billiton and by 2013 he was in the running to be the CEO before the board of that company chose Andrew McKenzie instead. If Calderon had been named the CEO he proposed to expand the company considerably. Under McKenzie BHP did the opposite and effectively shrank through the South32 demerger of 2015. What Calderon foresaw at his BHP days was that mining remained an industry in expansion mode, thanks to the voracious demand of middle-income countries for commodities like copper. BHP, he argued, was well placed to expand with that demand even if the next few years would not be favourable in terms of commodity prices.

BHP's loss, Orica's gain

Now fast forward to Calderon at Orica. What the new CEO could see was that mining was getting harder because the commodities the world needed were in more inaccessible locations. Which meant that all Orica needed to do was just improve its existing business, because it was already the world leader in the explosives and blasting systems and therefore well placed to develop products and services the miners would need as their job got harder. Project Breakaway, which was a series of business improvement plans, and Program 4S, which was an attempt to move various business systems into a single SAP environment, were launched on Calderon's watch. And the company's efforts to stay market-leading in terms of products and services continued. If you thought that explosives is an industry that doesn't need much R&D you'd be mistaken. Did you know that no wires are needed anymore to initiate a blast? Orica's WebGen product, which represented the first wireless initiation system ever, replaced those wires with low frequency magnetic waves.

Acquisitions weren't so important to Calderon, however in late 2017 the company did lay out A$205m to buy GroundProbe, a company that had developed advanced technologies to better allow geotechnical slope stability to be monitored. By 2019, under Orica's global aegis, GroudProbe was earning 70% more than Orica had previously expected. And in February of this year the company announced that it was acquiring Exsa, a Latin American explosives company based in Peru, for A$302m.

Alberto is delivering

By the year to September 2019 Orica under Calderon's leadership was humming. Revenue grew 9% to A$5.9bn and underlying EBITDA 6% to A$941m. Operating cash flow was up strongly and the balance sheet was in excellent shape with gearing of only 35%. In the March 2020 half the growth continued, but sales only rose 2%. EBITDA was up 10%, however, thanks to better margins as the product mix moved in the company's favour. This time around gearing was down to 34%. For Orica the COVID-19 impact was mixed because in some countries, such as Australia, mining operations continued unhindered while in others, such as Mexico and South Africa, there were restrictions. That said, for Orica it didn't matter too much because there was enough balance sheet strength for Orica to come through more or less unscathed.

Like every Top 200 stock on the ASX, Orica's stock took a hit during the Corona Crash, dropping 34% between 20 February and 23 March as against 37% for the S&P/ASX200, and while Orica has since recovered some of those losses we think there's more upside given the underlying strength of this business and Alberto Calderon's leadership.

Currently, investors can buy Orica for an EV/EBITDA multiple of just 8.2x FY21 earnings, declining to 7.6x for FY22. Looks reasonable to us given the forecast 10% per annum EBITDA growth out to then.

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Share price chart

Source: Tradingview

It's one of the best ways to create shareholder value in the Life Sciences sector: Take an old drug that is long off-patent, find new uses for that drug, reformulate the drug so that it works slightly better and then run the clinical studies to get the drug approved. It's called drug 'repurposing' and the principal advantage of this approach is that the drug's safety profile and parts of its mechanism of action are already well understood, so it's less risky than working with a completely new molecule. And you can create a lot of shareholder value because generally there's new patents that can be obtained around the drug.

Paradigm's drug takes the pain out of a common condition

Paradigm Biopharmaceuticals was founded to repurpose pentosan polysulphate sodium, or PPS for short. The drug had been around since the 1940s when it was introduced as a potential anticoagulant by a Munich-based pharma company called Bene Arzneimittel. PPS has never shot the lights out commercially. It turned out that there were better anticoagulants on the market, so the drug's only major use since then has been to treat an inflammatory condition of the bladder called interstitial cystitis. However, some years ago Paradigm founder Paul Rennie came to the view that PPS would make an excellent treatment for other conditions such as osteoarthritis of the knee and lesions in the subchondral bone. As an ASX-listed company Paradigm has been hustling away on new uses of PPS since 2015.

About March 2018 investors who knew the Life Sciences space started to give Paradigm a lot of attention. The catalyst was a study in which 45 patients with osteoarthritis (or OA) were injected with PPS. Osteoarthritis is what happens when the joints get inflamed after the cartilage, that ordinarily protects them, degenerates. It's pretty painful. In Paradigm's study the 45 patients registered, on average, a 50% reduction in pain scores, which was amazing given that the heavy-duty opioids these patients often get could only be expected to reduce the pain by 15%. Osteoarthritis is commonplace – knee osteoarthritis occurs in 10% of men and 13% in women aged 60 years or older in the US alone. And it's relatively harmless, unlike opioids. So, it looked like Paradigm had a shot at the big money. Over the next twelve months Paradigm stock went up nearly six-fold, to over $2.

A disease-modifying drug!

Then came the next leap forward for PPS. In late August 2019 Paradigm reported that its injectable PPS, which it now called Zilosul, wasn't just bringing down pain scores in knee osteoarthritis, it was actually protecting cartilage, if the Phase 2b data the company was seeing was real. So, this drug didn't just treat symptoms like Panadol would, but was disease-modifying. No wonder that over the next five months the stock it tripled before the Corona Crash brought the celebrations to a halt. It helped that the drug was being given to AFL players here in Australia as well as NFL players in the US under so-called 'special access' arrangements where patients can get not-yet-approved drugs on a case-by-case basis.

Which brings us to Paradigm's post-Crash rapid recovery. With the Phase 2b study having successfully met all its endpoints, Paradigm, with some chutzpah, asked America's FDA if it would approve the drug based on a single Phase 3. The Agency said no, but did say two Phase 3's would be fine, which is what most drug candidates are expected to do anyway. That guidance came in early April 2020. Paradigm expects to have its Phase 3's done by late 2022, putting it on track to have an FDA approved drug by 2023 or 2024 if all goes well. The company has the capital to run its studies because an April raising at $1.30 per share boosted Paradigm's cash balance to more than $100m.

We think Paradigm will be capitalised at well over US$1bn, which is A$1.46bn at the current exchange rate, once the company is well into those Phase 3's. That kind of valuation for a late stage US biotech company on Nasdaq is commonplace, and the data on Zilosul is good enough to warrant it, particularly given the high level of unmet medical need. And, let's face it, if ancient products like Voltaren Gel (diclofenac) and Panadol (paracetamol) are still getting a lot of use in osteoarthritis, there's going to be blockbuster opportunity for something as powerful as Zilosul. The stock may be well north of the raising price, but for this one we think there's more where that came from.

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Share price chart

Source: Tradingview

Keeping an eye on your family

The basic premise of Life360 is that users should be closely connected to, and be up to speed on the whereabouts of the people they care about most, like family members and close friends. The Life360 App for smartphones enables users to form Circles that can include the members of a household and/or close friends.

Using the Family Locator function with a phone's GPS chip, Circle members can subsequently monitor other members' whereabouts and movements on a map, like their kids walking home from school, or their better half driving home from work. Life360 charges A$67 per year for the basic functionality that enables someone to set up Circles on the phone and invite family members and friends.

A key feature of the Life360 app is Crash Detection. Crash detection can detect major traffic collisions at speeds over 40k per hour. If a collision is detected, Life360 will call the driver and can dispatch emergency responders if necessary. It will also notify everyone in the driver's Circle. While Crash Detection itself is a free service on the App, Life360 generates revenues from a premium version of the service, called Driver Protect. In addition to Crash Detection, this includes place notifications about Circle members, member driving reports, neighbourhood crime reports and extended roadside assistance. The latter covers towing, flat tires, lockouts, jump starting in case of a dead battery and running out of gas.

Growing ARPPC x more Paying Circles = Strong growth

In the last financial year, which ended in December 2019, Life360 grew its revenues by a whopping 84%, to US$58.9m, which is about A$86m. Unfortunately, the EBITDA loss also rose, from US$20.1m to US$28.7m, mostly due to higher marketing expenses and more people working in R&D.

Life360 generates direct and indirect revenues. Direct revenues, which account for 75% of revenues, are generated mainly from the Paying Circles, in the US and internationally. In FY19 these direct revenues amounted to just over US$40m, with Average Revenue Per Paying Circle (ARPPC, yes, that's a new one for us too) at more than US$70 per the end of 2019. That number has been growing quite nicely, from just US$39 three years ago. It is an indication of how well the company has been able to expand and cross sell once new Paying Circles are onboarded. The total number of Paying Circles grew by 43% in FY19, to 827,000.

Indirect revenues are generated from sales of data, from Life360's lead generation deal with US insurance company Allstate and from a partnership with ADT, which is being wound down. In total, Life360 generated nearly US$15m in revenues in FY19, which is about 25% of the total.

COVID-19 setbacks in the US will inhibit growth this year

The key functionality of the Life360 App revolves around location and movement of Circle members. So, if people are unable to freely move around, say during a lockdown caused by a global pandemic, the need for, and use of the App is likely to be lower. While Life360 saw little to no impact from COVID-19 in the early part of Q1 2020, the company did see a decrease in new user registration in March as the utility of the App obviously diminished. As a consequence, FY20 revenue guidance, which stood at US$90m, was abandoned at the end of March and new user acquisition was scaled back to save costs.

The recent flare ups of COVID-19 infections across the US are likely to lead to continued lockdown restrictions in the next few months, and hence ongoing weakness in new user registrations. However, looking through this near to medium term weakness to a period where new infections in the US are under control, we believe the utility of the Life360 App remains very compelling, especially for families with young children.

The valuation reflects the current COVID-19 risks

Considering that Life360 isn't profitable yet and is also in the red at the EBITDA level, the only thing we can really judge the company's valuation by is EV/Revenues, a tried and tested metric for high growth Tech companies. Tech companies that are still loss-making, but with proven business models, like Uber, typically trade at an EV/Revenue multiple anywhere between 3x to 6x forward looking sales. In the case of Uber it's 4.1x for FY20 (ending December) and 3x for FY21.

Life360 is currently trading at an EV/Revenue of 1.6x for the current financial year and 1x for FY21. Given its projected revenue level of more than A$100m for FY20, you could argue that its business model has proven itself, i.e. there are enough paying users of the App to say that the company has a viable business model. When you add to that the expectation that EBITDA will turn positive in 2022, it would appear that Life360 shares have become quite attractive at current levels.

Yes, there is the risk of COVID-19 dampening revenue growth this year and next, pushing out breakeven, but we think this has been largely discounted in the share price. Hence, four stars from us.

Pitt Street Research Pty Ltd

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