6 JULY 2020

Stocks Down Under

"If I hadn't been able to study psychopaths in prison, I would have gone down to the Stock Exchange."

- Robert Hare (born 1934), Canadian psychologist

ASX LTD

Massively overvalued

AVITA THERAPEUTICS

Burn rate

SEZZLE INC.

Buy now, Pay later is sizzling

ASX LTD

Massively overvalued

Stocks Down Under rating: ★★

ASX: ASX
Share price: A$ 87.59
Market cap: $ 16.9BN

Sydney-based ASX Limited is Australia's main security listing and trading venue and one of the largest exchange groups in the world. It acts as a clearinghouse, market operator and payments facilitator in providing a wide set of bond, equity, futures, commodity and energy trading services. ASX also acts in a compliance capacity and offers data and technology services to banks, intermediaries and software companies. Trading near an all-time high, the shares only offer a 2.7% dividend yield and are valued at a massive 22x EV/EBITDA. Despite its leadership position, we're not sure ASX is worth that sort of valuation. Let's take a look.

READ MORE

AVITA THERAPEUTICS

Burn rate

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ASX: AVH
Share price: A$ 8.67
Market cap: A$ 927M

Back in 2005 when the Perth plastic surgeon Dr. Fiona Wood was named Australian of the Year, her 'spray-on skin' for the treatment of burns became widely known as an example of Australian medical ingenuity. Fifteen years later, spray-on skin, better known to medicine under the brand name 'Recell', is now working towards commercial success thanks to its owner, Avita Therapeutics. However, at a market capitalisation of close to A$1bn, Avita stock may have gotten a little ahead of itself.

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Market cap: A$ 752M

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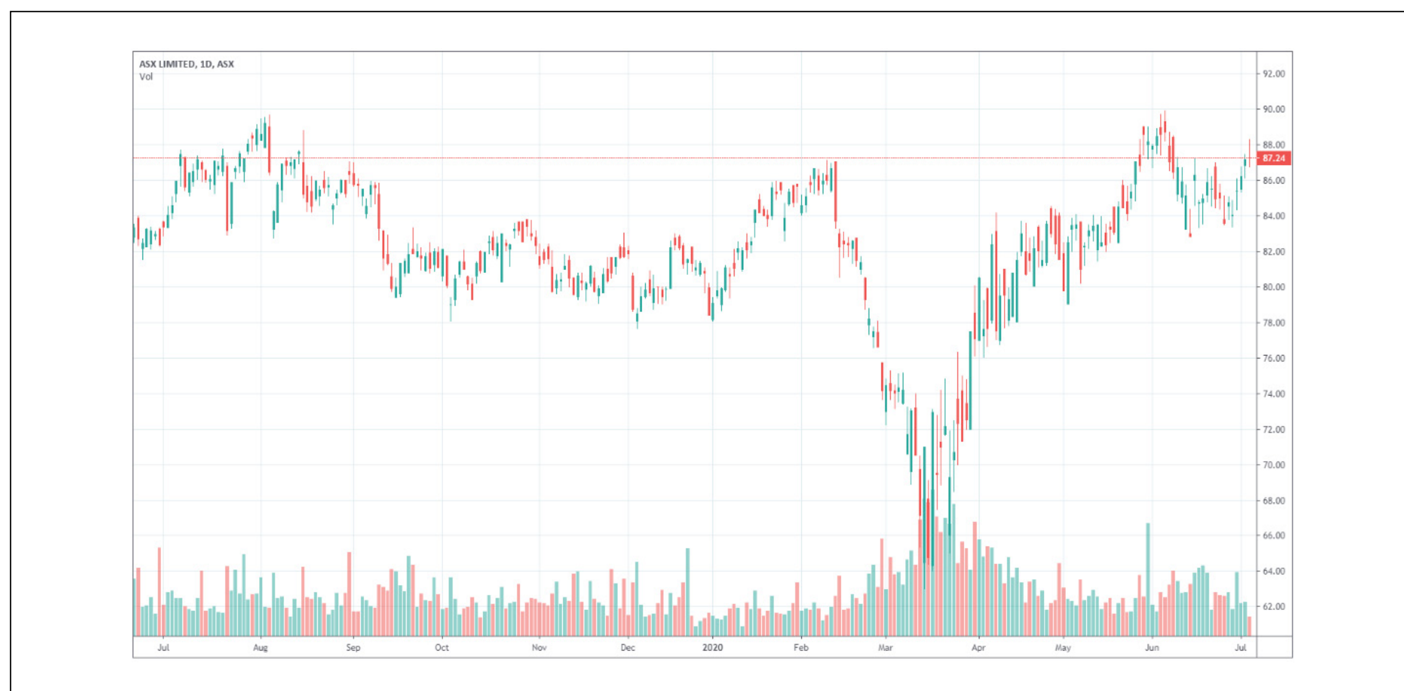
Share price chart



Source: Tradingview

Strong trading and capital raising activity

Stock market operator ASX Ltd enjoys a near-monopoly position in Australia's exchange market. It earns commissions on share trades that are executed on the ASX. It also makes money when companies list and raise capital on the exchange as well from its derivatives market and annual recurring listing fees from listed companies. Since there is trading activity in both up and down markets, the group generates a reliable revenue stream from trading commissions. As such, it can be considered a defensive play that helps a portfolio withstand recessionary environments while still participating in market rallies. An increasing portfolio of complementary data and technology services provide additional growth opportunities.

In FY19 revenue increased 6.5% to $863.8m and underlying net profit rose 7.7% to $492m. This was the result of strong market activity and growth in the technical services business. The solid growth continued in 1HY20 as trading volumes stayed strong. Revenue was up 7.1% to $454.9m and net profit after tax (NPAT) increased 1.8%. The group's diversified business model helped it deliver its seventh consecutive interim dividend increase.

During the COVID-19 crisis, ASX experienced a surge in trading activity. The average daily number of trades neared doubled in March as investors jockeyed to rebalance portfolios. Although the number of trades slipped 2%, trading activity was higher by 33% year-over-year in May as measured by an average daily market value of $6.5bn. Year-to-date through May, the number of trades on the ASX reached 423.3m which was 29% above the amount recorded in the same period last year. This followed a 27% increase in the average daily number of trades in April and a 57% jump in average daily trade value.

Meanwhile, IPO activity has decreased significantly because companies looking to go public have opted to stay on the sidelines amid volatile market conditions. This, however, has been offset by an increase in companies issuing secondary capital to bolster their balance sheets. Secondary capital raisings soared 151% in May to approximately $7.5bn in value.

Blockchain technology improves functionality and security

The company's CHESS system is its 25-year old technology platform. It is the main engine behind trade clearing, settlement, asset registration and post-trade services. ASX is replacing CHESS with distributed ledger technology (DLT) to provide a broader range of benefits to a larger section of the market. DLT, commonly referred to as blockchain technology, will serve as a post-trade platform for the cash equity market. Both issuers and investors will benefit from greater control over market activities through simplified access to the register of holders and financial assets. The modern technology stands to enhance the credibility of ASX and should lead to new users and increased engagement from existing users.

Another area of upside potential is ASX Information Services. This segment provides a range of services that ensure clients receive the latest price and company information directly from the ASX. In 1HY20 ASX saw strong demand for connectivity, cabinets and data that helped drive increased operating income. This is because investors and data vendors benefit from reduced processing costs, fewer processing delays and the avoidance of data errors. We believe increasing demand from market professionals and distributors for fast, reliable news and data sources bodes well for the group's MarketSource, ComNews and ReferencePoint offerings.

Strong balance sheet supports earnings growth

ASX has an excellent balance sheet that contains no debt and a robust $11.9bn in cash and other financial assets. It also contains investments of $99.2m in adjacent growth businesses. This includes a 49% stake in Symbali, a 45% stake in Yieldbroker and an 8% holding in DLT developer Digital Asset. ASX pays out approximately 90% of its earnings as dividends. Given its financial strength, this payout rate appears sustainable. With a dominant position in the exchange market and new growth potential areas, ASX looks as strong as ever.

And now for the bad news

We think there is much to like about ASX as a company. However, from an investment perspective we think the shares are highly overvalued at the moment. ASX is trading at an EV/EBITDA multiple of 22x for FY21 and 21.1x for FY22. Yet, the expected EBITDA growth for both years is only 2.6% and 4.6% respectively.

In other words, ASX is trading at a massive 8.5x EV/EBITDA-to-EBITDA-growth ratio, which makes it extremely overvalued in our book, quasi-monopoly or not. Which is why we put a 2-star rating on the company.

AVITA THERAPEUTICS

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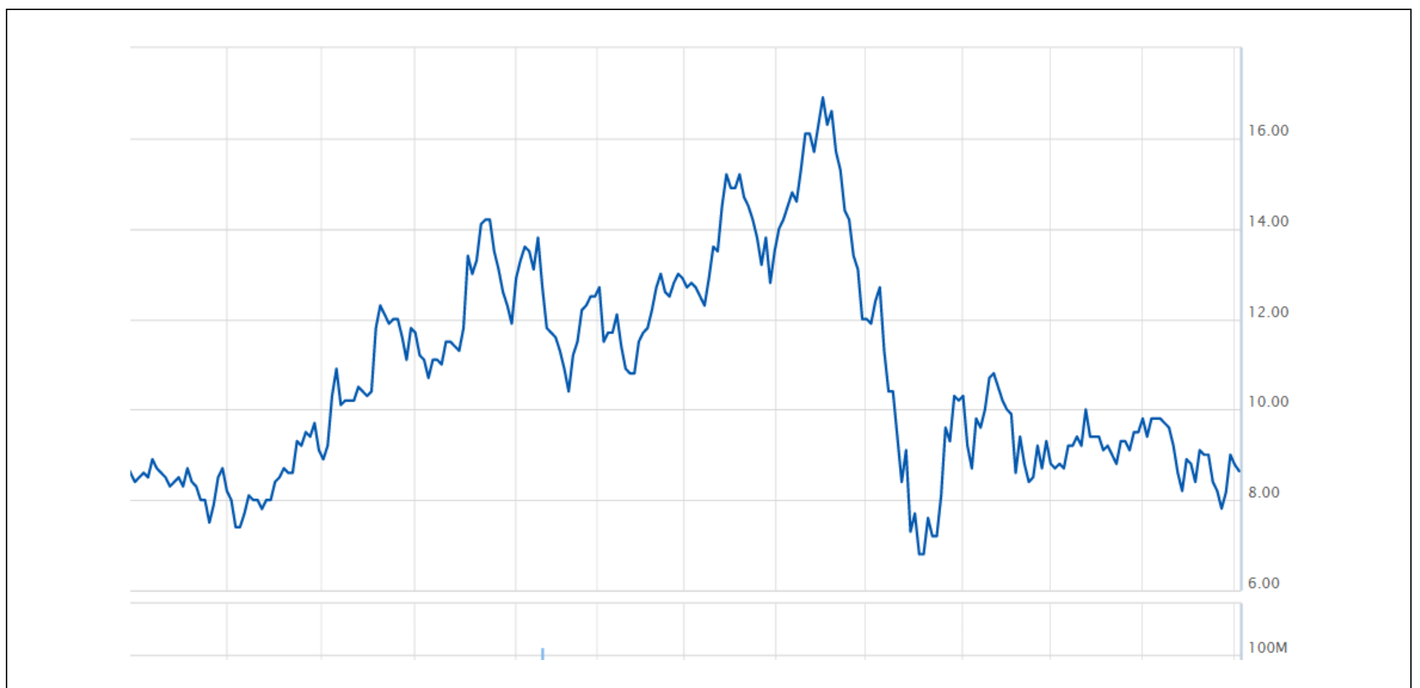

Source: Tradingview

It was a big step forward for burns patients. From around 1993 Fiona Wood and her scientific collaborator Marie Stoner evolved a method of skin repair, mainly for use in burns victims, that saw new skin cells being sprayed on the skin of the patient. The technology involved taking a sample of the patient's skin from elsewhere in the body, splitting the sample apart with a certain commercially available enzyme, then taking the cells from a layer of skin in the middle that have a habit of growing and dividing faster. Once those cells were cultured into a big enough dose they could be applied to the site of a burn using aerosol technology, after which the cells would regrow into new skin.

Better burns healing, less scars

The Wood/Stoner spray-on approach proved to be an effective skin repair technique because the level of scarring at the site of a burn is in large measure a function of time. If it only starts to heal after around ten days, the result is permanent scarring. With the Wood/Stoner method, the new skin cells could be cultured in adequate quantities and sprayed on to the site of the burn within a week, making for much a much more aesthetic skin graft.

The use of spray-on skin to treat victims of the October 2002 Bali bombings provided a graphic illustration of the technology's power in a burns unit environment and attracted the interest of investors as well, because around that time an ASX-listed company, based in Perth and newly renamed Clinical Cell Culture, was working on commercialising the technology. At that time you could buy the whole company for just under A$20m, but that valuation was expected to be a lot higher once the regulatory approvals could be obtained to take this product to the world. Indeed, many were hoping that one day Fiona Wood's invention would create a billion dollar company.

The billion dollar FDA approval

Well, they got there eventually. Like any early stage biotechnology company, Clinical Cell, which became Avita Medical in 2008 and Avita Therapeutics just recently, had its ups and downs through the years. In March 2005 the first generation device gained its CE Mark, for marketing in Europe, with other jurisdictions following. However, this product didn't really sell very well because it only worked for small burns. So Avita developed a second generation device that could treat up to a 1,920 sq cm, as against the 320 sq km of the original ReCell, and this device gained its CE Mark in October 2015 and FDA approval in September 2018.

It was that 2018 FDA approval that caused Avita stock to shoot off into the stratosphere – jumping from under $2 in late 2018 to around $15 by February 2020. Burns are a big market opportunity in the US, worth perhaps US$5-6bn, and the standard of care treatment of 'split thickness skin grafts' was clearly inadequate compared to ReCell, with the clinical data from two major studies now in to prove it. Moreover, burns treatments tend to reimburse at very high prices and Avita had the capital to build a sales force to address the market. Importantly, by 2018 Avita was able to show that at the price it was charging for the product, it was very cost effective in terms of healthcare economics.

Too far, too fast

And then there were opportunities beyond burns in wound care, scars and a rare disease of the skin called vitiligo. The American popular musician Michael Jackson (1958-2009) would have been pleased about the vitiligo opportunity, had he lived today, because that was the condition he is now known to have had and the reason he lost skin pigmentation.

To return to Avita, we can all agree that there's been a lot to like about this company. However, we fear the stock may have overstretched itself a little in 2019.

Remember, in the last six months of that calendar year it only had A$9.7m in sales and its loss for the period was $21m. Avita is expected to have A$60m in revenue by FY22, but is not expected to be profitable at even the EBITDA line at that time. As at March 2020 there was $130m in cash but that won't last forever.

Despite the selloff during the Corona Crash, Avita stock is currently still trading at 21x forecast FY21 revenue. That's too high, in our view. It's also worth remembering that even with good data a new drug or medical device sometimes has to wait years before gaining a market following, so the revenue projections may end up being too high. We think these concerns are a big reason why the stock only re-rated for a short time after the Corona Crash and has been trending down again since mid-April. Avita is a good company and it's addressing a great opportunity while doing good for a lot of people, but based on its valuation the stock is only Two Stars from us right now.

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Share price chart

Source: Tradingview

The same, only different

With an expected revenue in FY20 (to December) of around A$66m, Sezzle is substantially smaller than AfterPay with its projected revenue of more than A$600m in calender 2020. But Sezzle is twice the size of OpenPay, which is expected to generate A$29m in revenues in calendar 2020.

While its basic product is similar to other BNPL providers, i.e. breaking up the payment of a purchase into multiple pieces, Sezzle allows its users to change the repayment schedule after the original purchase transaction has been completed. Like AfterPay, Sezzle will take payment of the first 25% in a transaction at the moment of purchase by a consumer. It then takes payment of the rest of the money in three fortnightly instalments. But users can tweak the timing of these repayments one time and for whatever reason. Any change to the repayment schedule after that incurs a US$5 fee. Also, if customers are late with a payment, they will incur a late payment fee if that payment hasn't been made within 48 hours of the original due date.

When it comes to target markets and expansion areas, the key consumer areas Sezzle is focused on include Beauty & Cosmetics, Home & Electronics, Health & Fitness, Apparel & Accessories and Leisure & Hobbies in the United States. And like most other BNPL players, its key target demographic is Millenials. So far, these have generally been the early adoptors of BNPL services, with older generations now also slowly getting familiar with the service.

Exponential growth

Sezzle doesn't charge consumers for its service, but instead takes a fee from merchants that offer Sezzle to their customers. Merchant fees have been steadily growing in the last two years, from an average of just under 4% of the transaction value to nearly 6% in the first quarter of 2020. The basis for these fees are the so-called Underlying Merchant Sales (UMS), i.e. the total value of all sales generated by merchants through Sezzle's platform. In the 2019 financial year. Sezzle grew this UMS to US$244m, from just US$31m the year before. As a result of this strong growth, the company's own income grew almost tenfold, from just US$1.6m in FY18 to US$16.1m in FY19. And in the first quarter of 2020 alone, UMS grew to more than US$119m, which is roughly half of UMS recorded during the whole of 2019.

The key to this sort of growth is expansion of the number of merchants offering Sezzle to their customers and the growth of the number of active customers. Sezzle has done really well in both areas and currently has more than 1m active customers, up from just 155,000 at the end of December 2018, and is adding well over 100,000 new users per month.

Take a VC approach to investing in BNPL

When it comes to valuation, EV/Revenue is all we have to go by considering that Sezzle won't be EBITDA positive until some time in FY23. On that metric the company is trading at 9x EV/Revenue for the current financial year that, for purposes of this comparison, we have brought in line with AfterPay, OpenPay and Zip, i.e. July to June. For the year after that, it drops to 6.2x. This is well below the 24x and 16x that AfterPay is trading at for those same years. But it's well ahead of the 6.1x and 3.7x for OpenPay. And it's roughly in line with Zip's valuation.

So it seems that the higher the revenues, the higher the revenue multiple investors are willing to pay for BNPL players at the moment. The idea behind that is that the largest players in this space are expected to become the dominant players longer term in a market where there may likely only be a handful of winners. We don't expect consumers will want to use more than 2 or 3 BNPL services and the ones with the smoothest user experience will likely be the winners. This means ease of use, lowest friction, highest flexibility etc.

At this stage it is way too early to tell which companies are going to win in the BNPL space longer term, but size does matter. Seen in that light Sezzle is at a disadvantage to AfterPay, but ahead of several other companies, including OpenPay. Therefore, it might make sense to take a VC (venture capital) approach when it comes to investing in BNPL companies: i.e. build small positions in a number of companies in this sector. The profits made from the winner should far exceed the losses incurred from the losers.

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