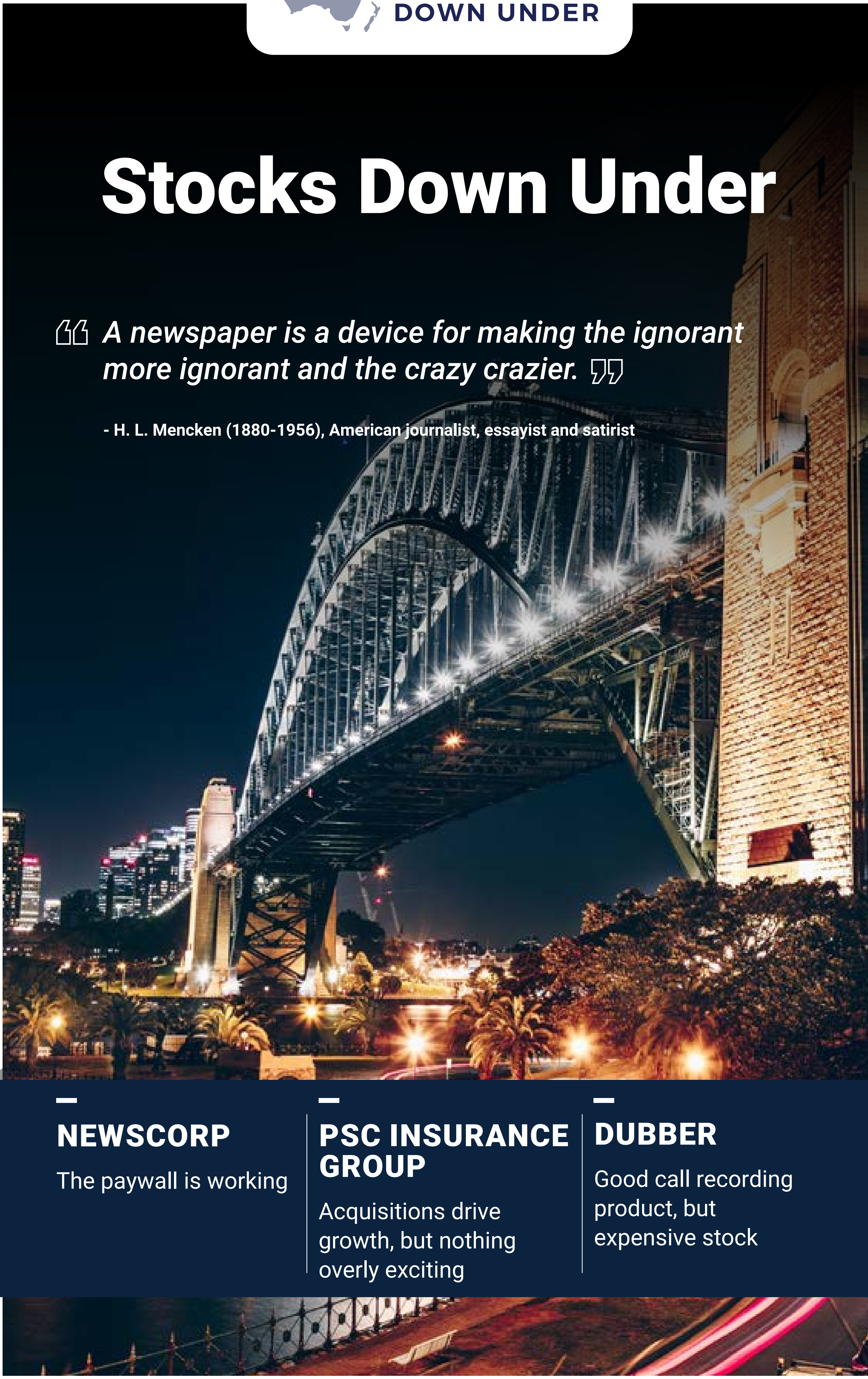
STOCKS DOWN UNDER

4 AUGUST 2020



Stocks Down Under

A newspaper is a device for making the ignorant more ignorant and the crazy crazier.

- H. L. Mencken (1880-1956), American journalist, essayist and satirist

NEWSCORP

The paywall is working

PSC INSURANCE GROUP

Acquisitions drive growth, but nothing overly exciting

DUBBER

Good call recording product, but expensive stock

NEWSCORP

The paywall is working

Stocks Down Under rating: ★★★

ASX: NWS
Market cap: A$10.1BN
Dividend yield: 1.6%

52-week range: A$13.10 / A$22.74
Share price: A$17.93

Many people think that News Corp, as one of the world's leading newspaper publishers, is a stock in decline given the changing nature of the newspaper readership and advertising around the world. We think that view underestimates the ability of the talented people who run News Corp to move their mastheads into the 21st Century. That doesn't mean, however, you need to own the stocks of News Corp right now. We think it's more or less fairly valued.

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ASX: PSI
Market cap: A$ 720M
Dividend yield: 3.9%

52-week range: A$2.05 / A$3.36
Share price: A$2.50

Headquartered in Melbourne, PSC Insurance Group is an insurance company that operates in Australia, New Zealand, the United Kingdom and the United States. It recently entered the US market and has strengthened its position in the UK and Australia through acquisitions. PSC offers a range of insurance services in wholesale and direct broking as well as underwriting. The shares have been resilient this year and the long-term growth record is steady, but given the heightened expense level post-acquisitions in an uncertain economy, we prefer to take a flyer.

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Share price chart

Source: Tradingview

If you want to sum up News Corp's strategy since it was spun out of the pre-2013 News Corp, the transaction that created News Corp, ASX:NWS, and 21st Century Fox, Nasdaq:FOX, it's this: the company wants to own the best of the old print media that traditionally shaped public opinion in the US, the UK and Australia and move that media into the 21st century in terms of the way the products make money through subscriptions and advertising.

Going where the best writing is found

That strategy is why News Corp worked so hard to get hold of Dow Jones in 2007, because in New York in the year 2057 people will still likely be reading the Wall Street Journal, just as in London people will still be reading The Times and in Sydney they'll be reading The Australian. And all around the world folks are going to be reading books from HarperCollins. Why? Because that's where the best writing has always been found, and, dumb as people have become in the era of Facebook, there are still a lot of book and newspaper readers out there who will pay good money for the content that keeps them informed and give them a lot of background thinking.

They'll pay that money knowing full well that the 89-year old Rupert Murdoch and his equally conservative son Lachlan don't necessarily share their political views, but do believe in journalistic and artistic integrity. And they'll pay because if they haven't yet, they're likely getting sick and tired of all the interesting articles they'd like to read online but can't because the content is hidden behind that genius intellectual property moat called the 'paywall'.

By the year to June 2019 News Corp had gone a long way towards transitioning its readership to being fully online. During that year digital subscriptions to the Wall Street Journal rose 14% to the point where around seven in ten of all the paper's millions of subscribers were digital only. News Corp's Australian mastheads grew digital subscriptions by 24% in FY19, while in the UK The Times and The Sunday Times were up 19% in terms of digital subscriptions. That success didn't translate into higher revenues, because the advertising base was still moving away from old media, but it did mean that total revenue for News Corp's News and Information Services business was only down 3% through the year. News Corp believes that in the long run the advertising will come back as the digital-only subscriber model matures.

More time at home means more digital subscriptions

What interests us about News Corp right now is what the current crisis is doing to newspaper readership. One of the habit changes we're hearing many people have made as a result of having to isolate at home for a while is to consume more digital content. The result has likely been an explosion in subscriber numbers for many News Corp products.

We'll find out how much when News Corp release their full year numbers for FY20 later this month, but we wouldn't be surprised to see double digit growth. Sure, part of this growth has probably been 'forced' – the move to stop printing more than 100 regional newspapers in Australia in late May, for example, will have prompted some readers of those titles to subscribe digitally. However, a lot of the growth will have just been readers deciding to 'get with the times'. Ask yourself how many times in the past year a Facebook friend referred you to an article in The Australian or The Times only to find that the article is only accessible behind that pesky paywall.

We believe that perhaps three or four more years of this shift to digital-only will lead to a resurgence in overall revenue for News Corp as advertisers realise that digital marketing doesn't have to confine itself to Google adwords or to Facebook and Twitter any more. Complicating the picture at the moment is the fact that Covid-19 has thrown a monkey-wrench into advertising markets globally. However, we believe that revenue growth will be coming back to life by FY22.

At the moment News Corp is trading on an EV/EBITDA multiple of 8x forecast earnings as against an expected 10% per annum EBITDA growth for the next two years. That suggests to us that News Corp is about fairly priced at the moment. We believe that any weakness in the stock that sees it trading below the S&P/ASX200 trend would change that view, since we're reasonably positive the business plan is a good one. However, at the moment this is a 3-star stock for us.

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Diversifying business through acquisition

PSC Insurance Group is primarily a commercial insurance business but offers much more. Its diversified insurance offerings include commercial, personal, casualty, professional liability, industrial, logistics, transport, pleasure craft, agri-risk, cyber and M&A insurance. Outside of its core commercial insurance broking, life insurance broking and workers compensations consult business, it also provides underwriting services for the construction, healthcare and hospitality industries.

In FY19 revenue was up a healthy 19% to $117.4m. Operational EBITDA also increased 19% to $41.7m and underlying EPS was up 11% to 11.3 cents. PSC paid an 8.3 cents per share dividend, which was above the 7.2 cents per share payout of FY18. It made a few acquisitions in 2019 including the broking business of Griffiths Goodall Insurance Brokers for $48m and the share capital of Paragon International Holdings Limited for $75m. Together the two assets are expected to add $10.5m to FY20 EBITDA. It also acquired Carroll

Insurance Group (CIG), a broking business that operates in the Lloyd's and London markets.

The half-year FY20 result included a 38.8% increase in underlying revenue to $74.6m. This growth was primarily driven by the recent acquisitions, which boosted revenue by $20.1m. Underlying core EBITDA increased 31.1% to $18.8m, $7.1m of which came from the acquisitions. NPAT grew 13.4% to $8.8m and underlying EPS increased 17% to 4.2 cents. Aside from the acquisitions, efforts to improve its platform contributed to the interim growth.

Unwavering EBITDA guidance during COVID-19

We believe PSC's balance sheet is of average quality. It had $79.7m in cash at the end of CY19 compared to borrowings of $135m. So, the net debt position needs some work, in our view. However, the gross debt to EBITDA ratio is healthy at less than 2.5x. The company executed a $35m equity capital raise in 1HY20 to finance the acquisitions. It also completed a UK debt facility, which gave it improved gearing flexibility and funding for additional inorganic growth opportunities.

Underlying costs were up 42% to $55.9m in 1HY20, largely due to the acquisition spree. The onset of COVID-19 caused management to take a close look at its cost structure. It has pared back on expenses where possible to brace for the unprecedented economic environment. It will likely take some time, though, before we see the impact of the recent cost reduction efforts on PSC's financial statements, likely not until FY21.

PSC's business is mostly focused on small to medium sized businesses that have directly felt the impact of COVID-19. PSC itself has felt the effects more indirectly and has not had issues related to COVID-19-specific insurance claims. Its cash collections have stayed on track. Year-to-date through the end of May 2020, underlying EBITDA was up 30% following a strong month of May when EBITDA doubled from the prior year. The company's performance has been in-line with pre-crisis expectations and it has maintained its FY20 EBITDA guidance of at least $57m throughout.

BP Marsh investment performing well

PSC's investment portfolio recorded some nice gains in FY19. By far, the largest contributor was its investment in UK-based private investment management company BP Marsh & Partners plc (BPM), which had a fair value gain of $6.3m. PSC acquired a 20% interest in the company during FY18 for approximately $33m to give it access to a growing early stage broking business. BPM recently concluded another strong year. For the 12-month period ended 31 January NAV (net of dividends) increased 8.5% compared to an 8.1% average since flotation. It made two new investments during the year -- Sydney-based Agri Services Company Pty Ltd and London-based Lilley Plummer Risks Limited.

PSC has become a well-diversified insurance business and has good growth opportunities in existing and new markets such as Hong Kong. But the timing of its string of acquisitions carries enhanced costs and integration risks in this recessionary environment. And at a P/E of 18.1x FY21 and a trailing P/B of 3.5x, PSC is not cheap. And the yield of 3.9% is nice but not great. In our view, there are better investment opportunities out there, but we don't see the shares going down much either. So we give PSC a neutral 3 stars.

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Attractive recurring revenue SaaS model

Dubber provides a 100% Cloud-based service that enables customers to securely record all their calls with unlimited storage capacity through various monthly plans, ranging from $1 to $30. Recording calls for compliance purposes around MiFID II, FCA, Dodd-Frank and GDPR is only one major market opportunity for Dubber. Healthcare providers and call centers need secure and scalable call recording solutions as well. And in this age of Covid-19, with most people working from home, Webex and Zoom meetings also need to be securely recorded.

The benefit of the Cloud is that call recording can be provisioned very quickly and that customers don't need to invest in any equipment. And when requirements change, the service level can change with them, e.g. more storage, more connections etc. Furthermore, because of its Cloud-based servicing model, Dubber can offer its services in an attractive SaaS model that generates recurring revenues.

The company also offers Dubber AI (Artificial Intelligence), which automatically transcribes each call to make it searchable for keywords and sentiment analysis, very helpful in improving customer experiences.

Channel partners to expedite growth

A key element of Dubber's strategy has been to roll out its services through channel partners, such as Telecom providers and IT companies. For instance, just recently the company's service has become part of Cisco Webex Calling, whereby Webex users, as part of the Cisco platform, can opt to have their calls automatically recorded.

Another example is Telstra. Dubber has recently become available on Telstra's network, which enables enterprises to record their calls straight from the network. Again, compliance is a major driver here with two Australian financial institutions having signed on for pilot projects that should become broader engagements if all goes well.

Dubber is also working with an unnamed US telco carrier to provide call recording specifically to enable data capture with Dubber AI, while agreements with Verizon and AT&T are also in place. In total, the company has signed agreements with 138 service providers of which 83 are currently revenue generating.

COVID tailwind

The number of users amounted to 192,500 at the end of June, up strongly from around 152,500 at the end of March. Part of that growth is related to the recent acquisition of CallN, an Australian call recording company that has about $1m in Annualised Recurring Revenues. Dubber will be looking to migrate those customers and relationships to its own platform.

Apart from this acquisition, Covid-19 has been a strong driver of demand for call recording. Business Continuity Planning and many people working from home have required companies to have a good look at their compliance and business continuity from a communications angle. Dubber has seen a lot of activity in this regard from call centres, financial institutions and health care providers over the last few months. We'd expect this to remain a key driver for the foreseeable future.

Slow sales growth for a SaaS company

For a young SaaS company, Dubber's revenue growth hasn't shot the lights out in the last few years. In the recently closed 4Q20 the company generated $2.56m in revenues, which was down 2% quarter-on-quarter. Excluding adverse currency movements it would have been up 7.6% Q-o-Q, to $2.81m, but this includes revenues from recently acquired CallN.

We believe the relatively slow revenue growth is partly attributable to Dubber's chosen strategy, i.e. to partner with large Telco and IT services providers. For a small company like Dubber, it is notoriously hard to get traction with these sorts of companies, because the incremental revenue you can bring them as a small SaaS company is typically very small.

Even if you clear the first hurdle of getting in the door of their Product teams and are able to deliver a working product ready to roll, getting traction with their enterprise sales people is yet another. Telstra's sales people may not be jumping at the opportunity to introduce a product like Dubber's to a big client like, say, CBA as it introduces risk into a relationship that would typically generate tens of millions of dollars per year. The marginal revenue contribution that Dubber's product would deliver is just not worth it in many cases. Just ask the people at Cipherpoint (ASX:CPT), formerly know as Covata, how hard it is to get Telco's and the likes of Cisco to back a product, even after they have signed a distribution agreement with you.

So it's good that Dubber is native on the Webex platform enabling users to sign up for the service without the need for Cisco sales people to push it. We're not sure how the sales model is going to work with Telstra, but the company may run into these sorts of typical sales issues.

Very rich valuation

Relating Dubber's Annualised Recurring Revenues of $16.1m per 30 June to its market cap of roughly $273m generates a proxy for a Price/Sales multiple of 17x, which we believe is very rich. Mind you, ARR is not actual sales. Even if we assumed these "not actual sales" to double in FY21, Dubber would still be trading at more than 8x its revenues for FY21, which is very high for a SaaS company that has not shown very strong sales growth recently.

Taking all the above into consideration, we believe investors currently have better opportunities elsewhere in the ASX-listed Tech space. Two stars from us.

Pitt Street Research Pty Ltd

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