STOCKS DOWN UNDER

26 OCTOBER 2020

ASX Top 200 Stocks Down Under

Anything's possible if you've got enough nerve.

- J.K. Rowling, British Author

AFTERPAY

New price target now that $100 is reached

PRO MEDICUS

We're pro calming down

STEADFAST GROUP

Always look if its organic

AFTERPAY

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Stocks Down Under rating: ★★★★

ASX: APT
Market cap: A$ 28.7BN

52-week range: A$8.01 / A$105.80
Share price: A$ 102

As most readers will be aware, at Stocks Down Under we've been quite bullish on the Buy Now, Pay Later space, and AfterPay in particular. We first got excited about AfterPay in November 2019 in an episode of Friday Beers with Marc & Stuart, available on the website of our friends at Pitt Street Research. And we've written about AfterPay multiple times in Stocks Down Under, initially calling a $50 price target on 4 March 2020 followed by a new target of $100 per share when the initial target was reached in late May. Well, last week AfterPay hit $100 per share, $102 to be exact. So, where to from here?

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PRO MEDICUS

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Stocks Down Under rating: ★★

ASX: PME
Market cap: A$ 3.6BN
Dividend yield: 0.36%

52-week range: A$14.50 / A$34.81
Share price: A$ 33.64

Headquartered in Melbourne, Pro Medicus develops and sells imaging and radiology information system software in Europe, the United States and Australia. This company is on the cutting edge of its field and adoption rates in the medical industry have been steady and continual. However, COVID-19 has caused a wave of buying in the medical space and while we believe Pro Medicus has a strong future ahead of it, we find ourselves pro the calming down of the share price.

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STEADFAST GROUP

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ASX: SDF
Market cap: A$ 3BN
Dividend yield: 2.8%

52-week range: A$2.24 / A$4.10
Share price: A$ 3.37

Headquartered in Sydney, the Steadfast Group provides general insurance brokerage services across Australia, Asia and Europe. The issue with insurance brokerage services is that it's a declining industry because brokers have been increasingly squeezed out as the insurance industry has become significantly more transparent. This has led Steadfast to make continual, and significant, acquisitions in order to increase its EBITDA growth. However, we believe the market has valued Steadfast as though its growth is organic and not through acquisitions. In other words, we think the company's valuation is too high.

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Share price chart

Source: Tradingview

BNPL is just scratching the surface of its market potential

As we've argued before, we believe the Buy Now, Pay Later (BNPL) is just scratching the surface when it comes to monetising the massive market opportunities worldwide. Online payments made using a BNPL solution in the United States is only at 1%. Penetration of BNPL in online payments in Australia is 8%, which we believe is still low. But it indicates the opportunity for BNPL in the US, which has an online retailing market that is 28x (!) bigger than Australia's.

Expansion outside of core products

While AfterPay shares were already moving up towards $100 in the last few weeks, it went through the $100 barrier with a vengeance on Tuesday last week when it announced a partnership with WestPac (ASX: WBC). Starting in 2Q21 (June quarter) AfterPay will start offering savings accounts and cash flow tools to its customers, using WestPac's digital bank-as-a-service (BaaS) platform.

This BaaS platform, which is Cloud-based, allows WestPac to partner with FinTech's, like AfterPay, to rapidly bring new and existing financial services to market. In this case, the platform allows AfterPay to offer its customers savings accounts without having a banking license. That part is taken care of by WestPac, which is a major advantage for AfterPay as it doesn't have the compliance and balance sheet obligations that a banking license brings. The kicker for WestPac is getting access to a new, large, potential client base, mostly the Millenial cohort, that has proven to be elusive to traditional banks.

But getting back to AfterPay, all of a sudden the company can now start to think of creating financial products outside of its core BNPL products, and offer those to its 3.3m customers in Australia and New Zealand, and potentially to the ~43k ANZ merchants on its platform.

Furthermore, we expect WestPac's BaaS platform, which was developed by a company called 10x Future Technologies based in the United Kingdom, to be rolled out outside of Australia as well, either by WestPac or other banks. This should allow AfterPay to leverage its ~7m customer base outside of Australia and New Zealand as well.

Cleared by AUSTRAC

Another piece of news to benefitted AfterPay's share price was the conclusion of the AUSTRAC external audit into AfterPay's compliance with the Anti-money laundering and Counter-terrorism financing Act 2006. AUSTRAC stated that it will not take regulatory action against AfterPay, given that the company has remedied the shortcomings in its compliance framework. We'll call this a case of a start-up that was growing so fast in the initial years, its legal team couldn't keep up. Case closed.

Price target of $127 per share

In our BNPL sector report, published in August 2020, we calculated a potential value for AfterPay of $127 per share. Now that we've reached $100, we can say that new price target out loud: $127 per share.

That price target doesn't include any revenues from new services, like the ones now made possible through the WestPac collaboration. However, we believe that new services like this certainly add to the attractiveness of AfterPay longer term.

We happily reiterate our 4-star rating for AfterPay.

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Source: Tradingview

What's so special about Pro Medicus?

The medical imaging world has seen the amount of data it must process on an annual basis explode over the last decade as imaging has become more precise and the technology more readily available. For example, one optoacoustic breast ultrasound can take up over 10 GB of computer storage. This has created a problem when it comes to efficiently and consistently transferring, storing and searching patient files in the medical industry. This technological gap is where Pro Medicus has stepped in and its product suite has really shown its own during COVID-19 when doctors are forced to work from home.

Pro Medicus has a suite of products under the branding of Visage. These products allow for greater connectivity and faster results from Radiology Information Systems (RIS), Practice Management, Healthcare Imaging and e-health. Visage allows for greater connectivity and faster results by integrating into the networks of customers' facilities or by using the cloud to quickly transfer imaging data to a specific office or computer. Additionally, the Visage RIS' platform allows for easier sorting and searching of patient files by giving organisations the ability to customise it to their needs.

Growth is consistent

We believe Pro Medicus provides a superior product and the adoption rate of the Visage product line has been very consistent. Since the end of FY20 (June), the company has signed agreements with NYU Langone Health in New York and Ludwig-Maximilians University in Germany. The NYU Langone Health contract has a seven-year term with total revenue of $25m paid across the duration of the contract and will span six hospitals. Meanwhile, the Ludwig- Maximilians contract will also last for seven-years and earn $10m in revenue.

Pro Medicus' Visage product line is specifically aimed at imaging and radiology services. Therefore, COVD-19 saw a decrease in demand for its products as the priority of hospitals and doctors shifted towards containing the virus. Despite this setback, Pro Medicus reported an after-tax profit of $23.1m, an increase of 20.7% year-over-year. However, this year-over-year increase was subdued by Europe reporting a decrease in revenue of 37.7% year-over-year. This decline was expected, though, because the company made a one-off $3.1m sale to the German government during FY19. In other words, the comparison base was very hard. So we don't think the revenue decline is cause for concern.

While the number of examinations performed using Pro Medicus' technology declined heavily during COVID-19, the company did manage to adapt by using its existing products' inherent connectivity to allow doctors to work from home with very low loss of efficiency. We believe this successful, real-time demonstration of Visage's adaptability and performance will only help to more rapidly boost global adoption of the technology.

Hype can go too far

We believe Pro Medicus is a fantastic company with an even more impressive product. Therefore, the company certainly deserves to be trading at a sizable premium. However, the COVID-19 market rebound has driven almost all medical companies to new heights, and we believe Pro Medicus is a prime example of this market bubble. Using the daily forward market consensus EV/EBITDA numbers over the last three years, we found Pro Medicus has historically traded at a median ratio of 49.6x. With annual growth historically being in the range of 20-30%, we believe 49.6x is significant, but warranted premium.

However, Pro Medicus is currently trading at an estimated FY21 EV/EBITDA ratio of 70.1x. We believe this premium is far too significant considering FY21's EBITDA growth is estimated to be well within the historical range at 27.4%. Additionally, the average annual EBITDA growth for FY20 through FY25 is expected to amount to 26.4%, so the market does not expect Pro Medicus to see a step change in its growth rate in the next few years.

The company is certainly experiencing a period of rapid growth as institutions realise the standard set by its Visage product line. However, we believe the market has put the cart well before the horse in its rush to purchase anything medical. Therefore, we are issuing a two-star rating at this time.

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Source: Tradingview

It's not insurance, its brokerage

Steadfast is the largest general insurance broker network in Australasia and is expanding its operations in Asia and Europe. The company operates across three main business divisions: broker network, underwriting agencies and its complementary businesses. Unfortunately, we are not given a detailed breakdown of the profits derived from each of these divisions.

The broker network, as of 30 June 2020, has 458 general insurance brokerages across Australasia with access to 160 products and services. During FY20, the company generated approximately $8.3bn gross written premium.

The underwriting division has 25 agencies and around 100 products. The main operations of this division are the design, development and provision of specialised insurance products for brokers who operate within Steadfast's broker network, as well as for third-party brokers.

The third, complementary division is comprised of eight different companies providing legal services, asset management, life insurance, reinsurance and wholesale insurance, health consultancy, risk servicing, back office support and technology development for its broker network.

Cash flow remains a concern

Steadfast is a company whose growth is almost entirely funded by acquisitions and while we are going to discuss this further below, we first want to discuss the issue of operating cash flow. During FY19 and FY20, the company generated net cash of $152.1m and $119.7m, respectively, mostly from the issuance of debt and new shares.

Net debt/EBITDA increased from 1.1x during FY19 to 2.1x during FY20. While Steadfast is nowhere near insolvency and is able to take on more debt, we believe the company will only be able to grow by acquiring more companies, funded through more debt and equity.

COVID-19 has certainly not helped the industry causing only more strife through insurance cancellations and insurance agencies squeezing broker fees as they look to cut costs. While we believe Steadfast's dividend remains safe for now, investors should remember that it is being entirely funded by shareholder dilution and the issuance of new debt.

A declining industry and growth by acquisition

Investors may be thinking, Stocks Down Under keeps saying the insurance brokerage industry is in decline but Steadfast produced 15.5% EBITDA growth during FY20. While that is true, Steadfast's organic EBITDA growth was only 1.3%. Organic growth in this context is important because it indicates the company's ability to expand its business without being forced to absorb another company. Therefore, excluding the profits gained from the acquisition of other businesses, Steadfast's EBITDA was effectively flat. Flat autonomous EBITDA growth suggests that the company is one of the more successful and efficient insurance brokers given the industry as a whole has been seeing shrinking profits. However, this also means that flat organic EBITDA growth is the best we can expect from Steadfast in the future.

Steadfast should be valued on organic growth not total growth

The market currently estimates that Steadfast will produce total EBITDA growth of only 1.4% during FY21. However, the current FY21 EV/EBITDA multiple is 14.7x, i.e. well above the expected EBITDA growth rate.

With the overall insurance industry in turmoil over the new COVID-19 economic realities, including persistent rock bottom interest rates, we don't think there is any magic bullet that can pull this industry out of its overall decline.

If Steadfast were valued at around 5x EV/EBITDA, we believe its organic growth and dividend yield would warrant it as a reasonable investment. However, the company is currently valued at a forward EV/EBITDA ratio of 14.7x, significantly higher than we believe is reasonable. Therefore, we are only issuing a two-star rating at this time.

Pitt Street Research Pty Ltd

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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.

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