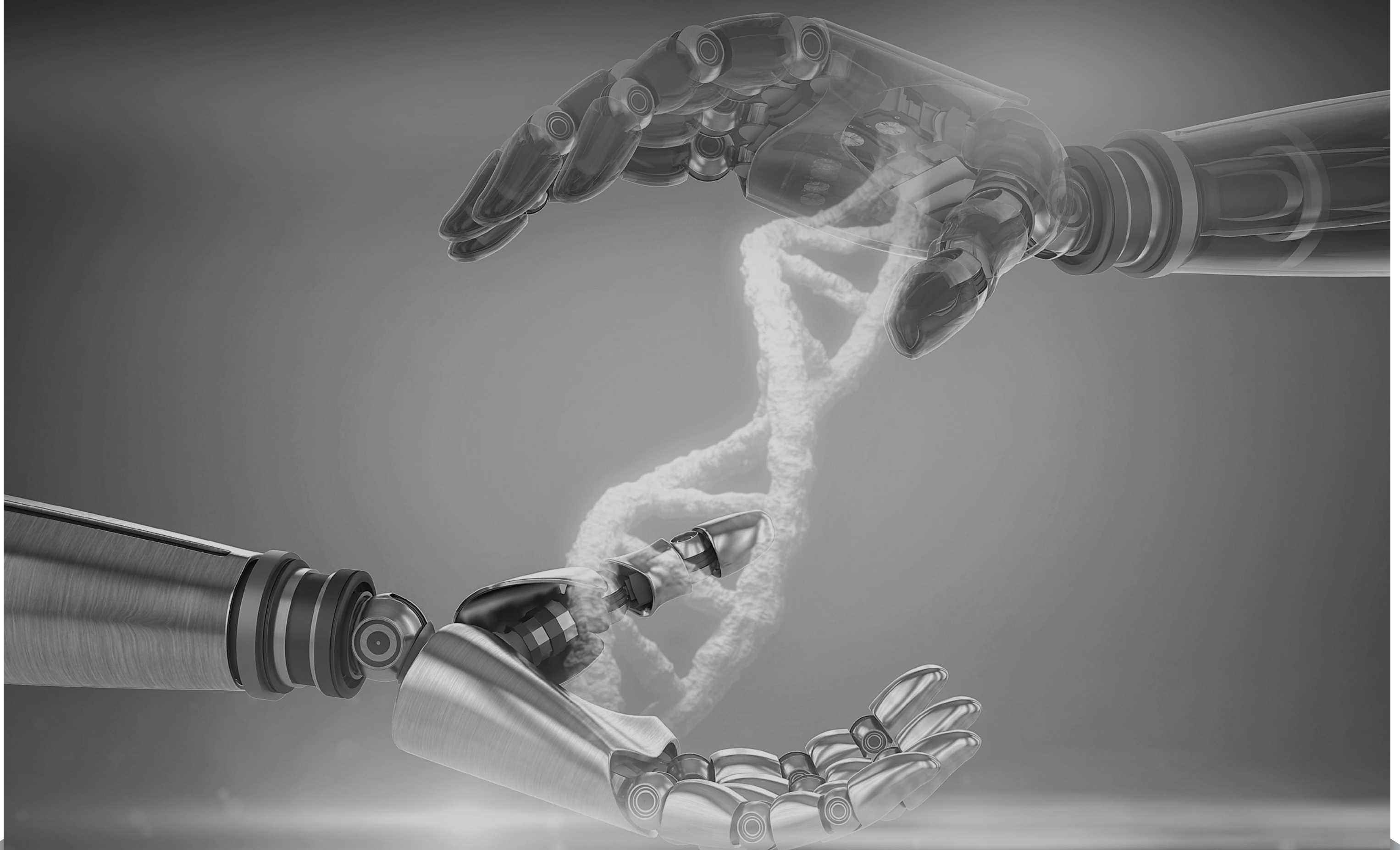
STOCKS DOWN UNDER

29 SEPTEMBER 2020

Emerging Stocks Down Under

> *It is the end of the road for antibiotics unless we act urgently.*

- Tom Frieden (b. 1960), former director of the U.S. Centers for Disease Control and Prevention (CDC)



RECCE PHARMACEUTICALS

Antibiotic resistance may have met its match

ENERGY ONE LIMITED

A shocking trade

9SPOKES

The wheels may not keep on turning

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Stocks Down Under rating: ★★★★

ASX: RCE
Market cap: A$ 196M

52-week range: A$0.210 / A$1.875
Share price: A$ 1.275

It's been a spectacular re-rating. The drug developer Recce Pharmaceuticals could be had for just 23 cents a share back on 24 March 2020. It's since gone up about sevenfold, thanks to a succession of favourable announcements related to Recce's lead compound, a fast acting, broad-spectrum antibiotic called Recce 327.

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ASX: EOL
Market cap: A$ 108M
Dividend yield: 0.83% (0% Franked)

52-week range: A$1.40 / A$4.84
Share price: A$ 4.24

Energy One Limited provides software solutions for the physical, contract and derivative energy trading and logistics markets. Headquartered in North Sydney on the Pacific Highway, Energy One's operational focus is in Australia, New Zealand, Singapore and Europe. The company is focusing its attention on growing its European market share while maintaining its dominant position in Australia. With plenty of runway left in Europe to grow, and the untapped potential of other markets, we believe Energy One has a bright future.

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ASX: 9SP
Market cap: A$ 44.2M

52-week range: A$0.008 / A$0.063
Share price: A$ 0.032

9Spokes, based in Auckland, New Zealand, enables its customers to buy different business applications all in one place, i.e. on the 9Spokes platform. The company aggregates and curates Apps that are relevant for SME's business processes and sells them in a revenue sharing model. The company also white-labels its platform to banks around the world that can offer the 9Spokes platform functionality to their SME banking customers. 9Spokes has been operating this business model for a number of years with varying degrees of success. It turns out Small and Medium-Sized Enterprises are pretty clever and don't really need someone to tell which apps they need. Let's take a closer look.

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Share price chart

Source: Tradingview

Around sixty years ago when people wanted to talk about the progress of humankind, they would talk about three things in particular: Jet planes, space travel and antibiotics. The reason people back then were so excited about antibiotics was that, within living memory, a whole lot of infectious diseases had been virtually incurable, but then Fleming, Florey and Chain changed all that between the 1920s and the 1940s with the invention of penicillin. People are less excited about antibiotics these days because of the rise of the so-called 'superbugs' – bacteria that no drug can kill easily. Indeed, there's a lot of talk out there these days suggesting that unless we get some drugs soon that can deal with the antibiotic resistance, the bad old days will come back again.

Superbugs may have met their match

Fear of superbugs would explain why Recce Pharmaceuticals is having such a good year. Recce was founded in 2008, and went public in 2016, in order to do just what the experts want – go to war with the superbugs. To show people they were serious, the founders gave their company a warlike name - Recce, pronounced 'wreck-key,' was chosen because it's the standard military shortening of the word 'reconnaissance'. The approach Recce took for its campaign was synthetic biology – invent drugs from scratch rather than wait for Mother Nature to supply the candidates, as Fleming and his successors had done.

By 2016 Recce had a lead candidate, a polymer called Recce 327 that could be made easily and cheaply through a one-step process and would kill all sorts of bacterial bad guys – both Gram-positive and Gram-negative - in the test tubes with lightning speed. Importantly, Recce 327 wouldn't lose potency through multiple uses because the secret to this drug's success was that it would bind to bacterial cell walls and weaken them until the cell ruptured. That way it wouldn't hit a part of the bacterium that it could evolve around. Recce 327 was named by the FDA in 2017 as a so-called 'Qualified Infectious Disease Product', meaning that it can get fast-tracked by the FDA once it gets done with clinical testing. Behind Recce 327 there's now a pipeline of powerful candidates building up, including Recce 435, which seems to work against the gut bacterium H. pylori.

A maiden clinical trial, coming soon

Recce 327 is expected to go into the clinic for the first time before the current year is out, and its developer wants to get this drug approved, in the first instance, as a treatment for sepsis. In sepsis the immune system stops responding to pathogens, leading to tissue damage, organ failure, lowered blood pressure and, finally, death. Sepsis is a big deal in modern healthcare systems – it is estimated that each year at least 1.7 million adults in America develop sepsis and nearly 270,000 die as a result. It's fair to say that less people would die if there were better antibiotics to deal with the infection.

Sepsis, however, isn't what prompted the dramatic re-rating of Recce this year. What has really got the market excited is Recce's long-standing contention that Recce 327 is not just anti-bacterial, it's anti-viral, something it established early on in experiments with influenza-infected rats. If there's one thing the world is really interested in 2020, it's drugs (and vaccines) that work against one virus in particular.

Will this one work for COVID-19?

If you've been watching the local efforts to beat COVID-19 in Australia you may have heard of the Melbourne-based Peter Doherty Institute for Infection and Immunity. Peter Doherty won the Nobel Prize in Physiology or Medicine in 1996 for his work on cell-mediated immune defence, so he knows a thing or two about how the body deals with viruses. The Institute of which he is Patron announced in July that it had selected Recce 327 as a 'Priority 1 candidate' for its programme to screen molecules for an anti-COVID-drug. The market really liked that.

We think there's more life left in Recce as a stock on the move. COVID-19 won't be over for a while and even when there's a vaccine, the market will still be interested in anti-virals to treat new infections. And there's still the clinical programme coming up in sepsis.

On Nasdaq companies that have new generation anti-microbials have been known to trade at levels even higher than those Recce is currently being afforded, so you might say this year's re-rating has been more a 'catch-up' story than anything else. Investors need to watch this one carefully given the speed of the 2020 re-rating, but we still think Recce is worth Four Stars.

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Share price chart

Source: Tradingview

A shocking suite of software

Energy One provides specialised software to power stations, gas pipelines, electricity transmission facilities and other related installations. This software helps the scheduling and trading of energy derivative contracts, carbon credits as well as electricity, gas and liquid commodities. To put it simply, this software specialises in helping utilities and other energy commodity suppliers to trade, deliver, track and sell energy products on the public markets as well as directly to other businesses. We believe it is worth reminding our readers that electricity itself is also a tradable energy commodity. In order to meet the individual needs of each client, Energy One offers nine different products with 203 customer-installs as of July 2020 on contracts that typically see renewal each year. FY20 saw an increase in total customer-installs of around 42% year-over-year.

Energy One did see a small increase in its customer churn from 3.8% during FY19 to 4.1% during FY2. However, we believe 4.1% is still extremely low.

Australasia, all about staying the course

Energy One's Australasia region consists of Australia, New Zealand and Singapore, and provides 56% of the company's total annual revenue. While this is a decline from FY19, it is entirely due to the growth of the

European segment. Australasia saw 4% revenue growth year-over-year and an increase in EBITDA margins from 26% to 29% during FY20.

Australasia consists mostly of Australia and is a highly mature market for Energy One. What we mean by this is the goal of Energy One in Australia is to maintain its total market share at the current 50% of the wholesale energy trade market and achieve steady, but small, yearly growth. This is further helped by the fact that 79% of annual revenue is recurring, made up of licence, support and hosting fees. Non-recurring revenue often consists of one-off system or software upgrades or other, related, projects.

We remain confident in Energy One's ability to maintain its market share in Australia going forward and while we don't see large growth opportunities here, we do believe this will be an important cash flow driver as Energy One expands into additional markets.

Europe, grow baby grow

The European business consists of two companies, eZ-nergy and Contigo Software Limited. eZ-nergy is a French company that supplies energy trading software and services to 45 customers across Europe and was acquired in June 2020. Contigo Software Limited is a UK-based Energy Trading and Risk Management vendor acquired by Energy One in November 2018.

The acquisitions allowed for Energy One to exploit established business connections and name recognition to ease the entrance into the European marketplace. Once the companies had been acquired, Energy One combined its software and services with the ones already provided.

This strategy has been highly successful so far with Contigo Software's EBITDA beating acquisition forecasts by 28% as the company has been able to increase efficiencies, broaden its potential client base, increase its competitive edge, all while remaining profitable. While the EBITDA margin is lower compared to the more established Australasia market at 18.4%, this can be attributed to the growth stage the company is in. For example, recurring revenue grew from 63% in FY19 to 75% during FY20, a strong indicator of future revenues.

eZ-nergy was acquired in June 2020 and Energy One's strategy of expanding its product and services base by integrating Energy One, Contigo and eZ-nergy's suite of products has already borne fruit as in August 2020 Contigo and eZ-nergy won its first major utility customer. Importantly, the three founders of eZ-nergy have announced they will be staying on with the company in an important vote of confidence in eZ-nergy's future.

Based on the acquisition of a new, major, client within a little over a month, and the track record with Contigo Software, we remain sceptical of Energy One's apparently low revenue and EBITDA estimates for eZ-nergy. It seems to us that these estimates are likely to be understated and that FY21 will see significantly better results than originally estimated.

The focus is key

Energy One is not a growth-through-acquisitions story. From the time of listing in November 2006, the company has only done one follow-on equity raising in April 2020 for 825,000 shares, or around 0.8% dilution. The company has provided EBITDA guidance of $6.5m for FY21. However, current market consensus puts it at around $7.0m.

Truthfully, we believe both of these estimates are likely to be understatements as the acquisition of eZ-nergy alone is supposed to bring EBITDA to $6.02m. As we mentioned above, we believe the estimates for eZ-nergy's EBITDA are understated and therefore, we are slightly more bullish than even the current consensus EBITDA FY21 estimates. In order to stay on the conservative side of valuation, however, we believe it would be best to use the current FY21 consensus EBITDA estimates to calculate the EV/EBITDA ratio. This gives us an EV/EBITDA valuation of 15.2x. Given the anticipated 48% EBITDA growth this year, we believe the only rating possible is four out of five stars.

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Share price chart

Source: Tradingview

Not an IPO we wanted to invest in

Yours truly remembers meeting 9Spokes management during their IPO roadshow more than four years ago when they explained the business model and the types of Apps the company was selling to SME's through the 9Spokes platform. In that meeting, management also explained how it would try to white-label the platform to banks that could make it available to their SME clients. We came away from that meeting thinking that we probably shouldn't participate in that IPO. Our concerns were fourfold.

Offering is not compelling enough

Firstly, why would companies need someone else to tell them which Apps they need to run their business. It's pretty self-explanatory. Companies need accounting software, HR and payrolling, some form of ERP (Enterprise Resource Planning) if you're a manufacturing company, digital marketing tools, like email distribution, etc etc. It's not rocket science and SME's are usually staffed with pretty clever and entrepreneurial people who can figure stuff out on their own and don't need a third party platform for this.

Secondly, App development is never-ending. For instance, accounting platform Xero expands its functionality all the time and these days probably does all the the work that a company would have needed three different Apps for five years ago. Similarly, software for Customer Relationship Management (CRM) and email distribution have pretty much been integrated, so companies no longer need to pay for two different applications. In other words, over time certain Apps become obsolete as competitors expand functionality of their Apps to include functionality of competing Apps. As a result, demand for a certain proportion of Apps that 9Spokes sells on its platform will disappear, and the revenue opportunity will disappear with it.

Thirdly, although banks are notoriously slow in developing proprietary, client-facing, technology, they are probably even slower in adopting third-party solutions that need to integrate with existing banking platforms. Compliance and security concerns are the main reason for this slow pace of adoption. We believe many banks are not keen in taking on extra compliance customer care risk by exposing their clients to third-party products through their banking platforms.

Lastly, 9Spokes proudly claims that its platform curates business Apps. When we hear the word "curates", we actually hear "restricts", i.e. 9Spokes decides which Apps are available on its platform. So, as a company you don't have an overview of the full spectrum of available Apps to address a certain functionality. You are restricted to what 9Spokes wants you to see, which is not ideal, in our view, because companies may have specific requirements that are not addressed by the Apps available on the 9Spokes platform.

To sum up, we believe 9Spokes will continue to struggle with the commercial rollout of its platform.

Likely to be operating cash flow negative for a little while yet

Revenues in the last financial year, ending March 2020, fell 17% to $6.8m from $8.3m the year before. 9Spokes euphemistically attributes most of this drop to a "change in banking partners". In other words, it lost clients. With Bank of America coming on board last year, it also won a new client through a channel partnership with Microsoft announced in 2019. More recently, 9Spokes signed a deal with Visa USA to make the platform available to Visa's SME clients.

The company cut back its expenses significantly in the last financial year. This resulted in a substantial improvement in its net loss before taxes, which improved from -$9m to -$5m year-on-year. However, we expect the company will continue to struggle with its commercialisation, so we don't see an end to these losses for at least another few years. In turn, this means that the company will likely need to keep tapping the market for funding, like the $10m capital raise it did recently.

If we assume 9Spokes can steady the ship and generate around $7m in revenues in the current financial year, the shares would be trading at 6.5x revenues for FY20, which we believe is very steep. We typically don't have a problem with high valuation multiples if they are warranted by the company's growth rates. In the case of 9Spokes, however, there is no growth! So, at the current market capitalisation of $45m, we believe the company is grossly overvalued. Hence, a 2-star rating from us.

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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