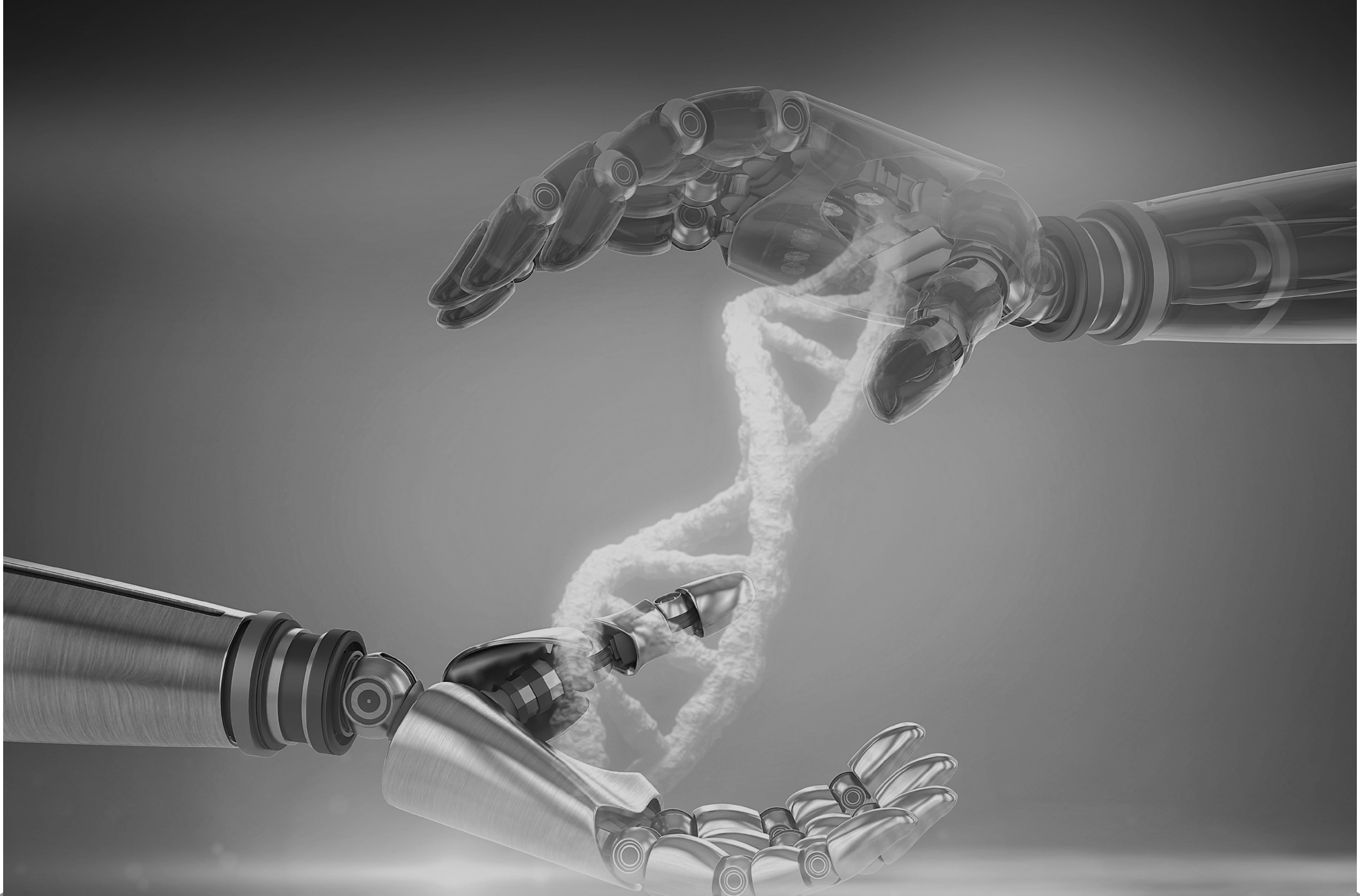
STOCKS DOWN UNDER

6 OCTOBER 2020

Emerging Stocks Down Under

I think the best way to find happiness is to stop looking so hard.

- Kermit the Frog (b. 1955), Actor best known for his roles in Sesame Street and The Muppet Show



ELMO SOFTWARE

No rush to get in

GENTRACK GROUP

This company needs to get back on track

FINTECH CHAIN

Uncertainty is not your friend

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Stocks Down Under rating: ★★

ASX: ELO
Market cap: A$ 429M

52-week range: A$3.66 / A$8.39
Share price: A$ 5.08

Sydney-based Elmo Software provides customers with a Cloud-based platform that lets them do anything related to Human Resources, ranging from payroll, recruitment and development to employee retention and engagement. What we like about Elmo is its very high recurring revenue rate. What we don't like is the company's high valuation, even after the 30% selloff in the last 2 months. We expect the share price will need to further adjust to the new reality of lower than previously expected revenue growth, at least in the next 12 months.

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ASX: GTK
Market cap: A$ 116M
Dividend yield: 2.4%

52-week range: A$0.77 / A$5.02
Share price: A$ 1.18

Headquartered in Auckland, New Zealand, the Gentrack Group is an ASX/NZX dual listed billing, customer management, revenue management, and market interaction software provider for utilities and airports. The focus for the company has been to increase its recurring revenue, however, airports provide the lowest portion of recurring revenue and COVID-19 has thrown a wrench into recurring revenue consolidation plans. Additionally, with a new CEO and interim CFO appointed within the last three months, we believe the Gentrack Group currently holds a lot of risks.

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Market cap: A$ 54M

52-week range: A$0.061 / A$0.190
Share price: A$ 0.079

With its registered headquarters based in Sydney, Fintech Chain is an investment holding company, which develops middleman payment and settlement software products for banks in the People's Republic of China. The company's product, T-Linx System, has been in development for nine-years and, since launching in 2016, is now used by around 1,000 banks and 6m merchants in China. However, in the FY20 report published on 30 June 2020, auditors reported that the company had a material uncertainty related to going concern.

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Share price chart

Source: Tradingview

High recurring revenue, but high churn as well

Elmo Software is active in Australia, New Zealand and the UK. And following a nearly $73m capital raise in May 2020, Elmo is very well funded with $139.9m in the bank per the end of June 2020.

The beauty of Software-as-a-Service (SaaS) companies is the high rate of recurring revenues. Customers typically pay a monthly fee for the service and most of the time don't need to install any new software or hardware because everything is Cloud-based. And with software applications as sticky as Human Resources solutions, it's not likely they'll swap suppliers regularly, because it's just too much of a hassle.

So churn is usually quite low for these sorts of companies, while the recurring revenue component is high. In Elmo's case, it generates more than 97% of revenues from subscriptions (which are recurring in nature). However, when it comes to churn, Elmo actually has a higher customer churn rate than is typical for SaaS companies. For FY20 the company reported a customer retention rate of 90.2%, down from 92.1%. Elmo attributes this to customer hardship due to COVID-19. Which brings us to one of the key reasons we're a bit cautious with Elmo at the moment.

Elmo only just made its own reistated guidance

On 9 June, Elmo reinstated its FY20 revenue and EBITDA guidance that had been withdrawn earlier in the year due to COVID-19. The reinstated revenue guidance for the full year was the same as before at $50m to $52m, while EBITDA guidance was tightened from a range of minus $4m to minus $6m before COVID-19 to minus $2.5m to minus $4.5m.

A few weeks later Elmo only just made its own guidance when it announced actual revenues for the full year of $50.05m and EBITDA of minus $4.2m. Despite the 24.7% y-o-y revenue growth, we believe the market was quite disappointed by that and proceeded to sell the stock down from around $7 on 6 August to around $5 today.

Our concern with Elmo right now is that the company will disproportionately suffer from lower demand for HR software in the next twelve months. SME's have had to make cutbacks and while the situation in Australia and New Zealand is not nearly as bad as elsewhere in the world, we believe lower than expected revenue growth is in the cards, at least in the next 12 months. And the market may not have fully discounted that, looking at Elmo's current valuation that we'll elaborate on below.

The company's FY21 gyuidance is for revenues to come in between $57m-$61m, roughly implying 14% to 22% growth year-on-year. EBITDA is exected to be negative $4m-$7m, compared to minus $4.2m in FY20. So no improvement expected there.

The stock needs to adjust further

According to consensus estimates, revenue is roughly expected to grow between 20% and 30% per year from FY21 through FY24. While that growth rate is nothing to be sneezed at, it's not that high when seen in light of Elmo's EV/Revenue valuation of 5.5x and 4.5x for FY21 and FY22 respectively. At those valuation levels, we'd expect higher revenue growth, especially for a company that isn't expected to be EBITDA-positive until FY23.

Put differently, in the aftermath of COVID-19 we believe that either the market's growth projections for Elmo are too low or its valuation is still too high. We think it's the latter. In our view, Elmo's share price still needs to correct further to match the new reality of lower than previously expected revenue growth due to COVID-19.

In other words, we'll put a two-star rating on Elmo for now in anticipation of lower share price levels going forward.

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Share price chart

Source: Tradingview

Utility revenue provides the backbone of earnings

Given that Gentrack operates on a financial year ending 30 September, full-year FY20 results will be released on 26 November 2020.

The main goal of a company like Gentrack, aside from making money, is generating as large a percentage of its revenue as recurring. Total revenue for the utility division was 62.5% recurring as of 1HY20. Despite a year-over-year revenue decline due to customer losses in the UK and Australia, total recurring revenue increased from 54.4% during 1HY19.

The biggest concern for this division is that while operating expenses have been increasing, the number of customers in the UK and Australia have been declining. On the positive side, however, recurring revenue has been increasing both as a percentage of total revenue and in absolute terms.

Airport revenue could throw a wrench into revenue transition plans

Revenue from airports has seen the largest year-over-year increase in recurring revenue, although total revenue has also been declining. However, due to the complete shutdown of airports because of COVID-19, and the high exposure to the UK, we remain concerned around the ability of the airport division to continue acquiring contracts that allow for the increase in recurring revenue.

There is a significant amount of uncertainty surrounding this division's 2HY20 results due to COVID-19. Europe and the UK still have significant COVID-19 virus infections and with travel restrictions around the world, airports will struggle until things settle down. Therefore, we remain concerned about this division's performance going forward into FY21 and FY22.

Latest market update predicts better than initially feared results

Due to COVID-19, it was announced during the release of Gentrack's 1HY20 results, that revenue was going to be hit across the utilities and airport divisions.

On 25 September 2020, Gentrack announced that EBITDA for FY20 was going to be at the top end of forecasts around NZ$11m. This would present a decline in EBITDA of approximately 42% year-over-year. However, we believe a lot of this EBITDA result will be due to reductions in operating costs rather than a lack of revenue decline. Additionally, it was reiterated in Gentrack's updated outlook that a lot of these cost savings were due to cuts to employment costs. Investors should pay attention to the specific employment cuts made and that they don't hurt the company's ability to acquire new clients going forward. The company hasn't issued guidance yet for FY21.

Executive turnover hurts, no matter the reason

On 19 June 2020, Gentrack appointed Ros Bartlett as Interim Chief Financial Officer. This was due to the resignation of the Chief Executive Officer on 15 June 2020 due to health reasons forcing the CFO to step into the CEO position. However, it is important to remember that the CFO was only given the position on 9 March 2020. Despite the fact that the CEO's resignation was due to health reasons, we believe these executive turnover issues are a cause for concern surrounding the operating efficiency of the company during the difficult time of COVID-19.

The Gentrack Group is not one to take a punt on

Using Gentrack's guidance provided on 25 September 2020, we can estimate the FY20 EV/EBITDA ratio at around 12.3x. However, if the company meets its EBITDA guidance, this would present a year-over-year EBITDA decline of approximately 42%. Additionally, the decline would likely have been higher if not for significant cuts to employment expenses.

It is important to note, though, that the company's FY20 year ends on 30 September 2020 and it issued its guidance note on 25 September 2020. So, we believe it is highly unlikely that the company's results will not match extremely closely, if not exactly with guidance.

Unfortunately, the Gentrack Group has a difficult operating situation ahead of it. We remain concerned that it will take a few years before the company can achieve the EBITDA results it did in FY19, and we do not believe the company's valuation reflects the difficulties the company will be facing going forward. Therefore, we issue a of two out of five star rating at this time.

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Share price chart

Source: Tradingview

Breaking open operating revenue

As of Fintech Chain's Annual General Meeting on 18 September 2020, the company's product, T-Linx, is used by around 1,000 banks in mainland China and 6m merchants. Around 30% of these banks are a combination of state-owned national commercial and joint-stock national commercial banks. Joint-stock commercial banks are publicly traded Chinese banks whose shares are majority controlled by the Chinese government. Around 70% of these banks are rural credit cooperative unions that operate on a provincial basis and city commercial banks, which operate on a regional basis.

Annual transactions have increased 30% year-over-year to CNY 1TR during FY20. In order to generate revenue, the company receives an undisclosed basis point share of the transaction or an annual fixed service fee. These simple models of revenue generation have provided Fintech Chain with gross profit margins in excess of 50%. However, Fintech Chain has only generated a profit after tax during FY19 and FY20 due to extremely high general and administrative expenses. Despite the significant 28.9% year-over-year decline of these expenses in FY20, the situation has actually gotten worse, not better. Gross profit declined 32.1% between FY19 to FY20. Relatively speaking, general and administrative expenses for FY19 and FY20 made up 79% and 82.7% of gross profit, respectively.

While it has been noted that transaction numbers have recovered and actually increased on a year-over-year basis during June 2020, we remain concerned with Fintech Chain's ability to reduce its expenses and provide enough profit so large equity dilution is not required going forward.

Material uncertainty related to going concern, what does it mean?

Fintech Chain's annual report ending 31 March 2020, included a note by the auditor that the company had a risk of not being able to fund its liabilities. As of FY20, total liabilities were 1.47x greater than the company's total assets and non-controlling interests. This has created a situation where equity attributable to owners of the company has been negative since FY17.

At the end of FY20, net current liabilities were around RMB 5m negative due to the significantly higher rate of trade and other payables and convertible bonds versus current assets. Non-current assets are almost non-existent at RMB 1m. It is important to note that Fintech Chain has an additional RMB 10.7m worth of convertible bonds in non-current liabilities. It seems unlikely that the company will be able to pay off its liabilities with operating cash flow and, therefore, will likely be forced to issue more convertible notes or pure equity.

Massive equity dilution seems imminent

At the Annual General Meeting on 18 September 2020, Fintech Chain's shareholders voted to allow the company to issue an undetermined amount of convertible bonds and/or shares in the market. While there has been no announcement yet of any new issuance, or plans for new issuance, it seems highly unlikely to us that this would not take place. Combining the substantial likelihood of a new convertible notes and/or equity issue with the already large number of convertible notes on the balance sheet, leaves investors with a large risk of significant equity dilution before the year is out.

The answer is no

Using the RMB to AUD spot rate as of 5 October 2020, the last 12-months' EV/EBITDA ratio is currently 46x. While we typically prefer to use forward looking EV/EBITDA, the company has not issued any hard guidance for FY21 and the company is not well covered by analysts, so there's no consensus EBITDA estimate.

When a company is valued at such high earnings multiples, without any large dividends or other presiding factors, it indicates investors are expecting a high level of growth in the future. However, due to the way COVID-19 has damaged the Chinese economy in the near-term, we find it unlikely that EBITDA growth for FY21 will reach the amount indicated by Fintech Chain's current valuation. Additionally, the high number of convertible notes already on the balance sheet indicates a high likelihood of significant equity dilution over the next couple of years. Meanwhile, despite the current state of Fintech Chain's convertible notes, we believe the company will have no choice but to issue additional convertible notes, or regular equity, before the end of the year in order to finance its current operations. Therefore, we see no other rating than two out of five stars for Fintech Chain.

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