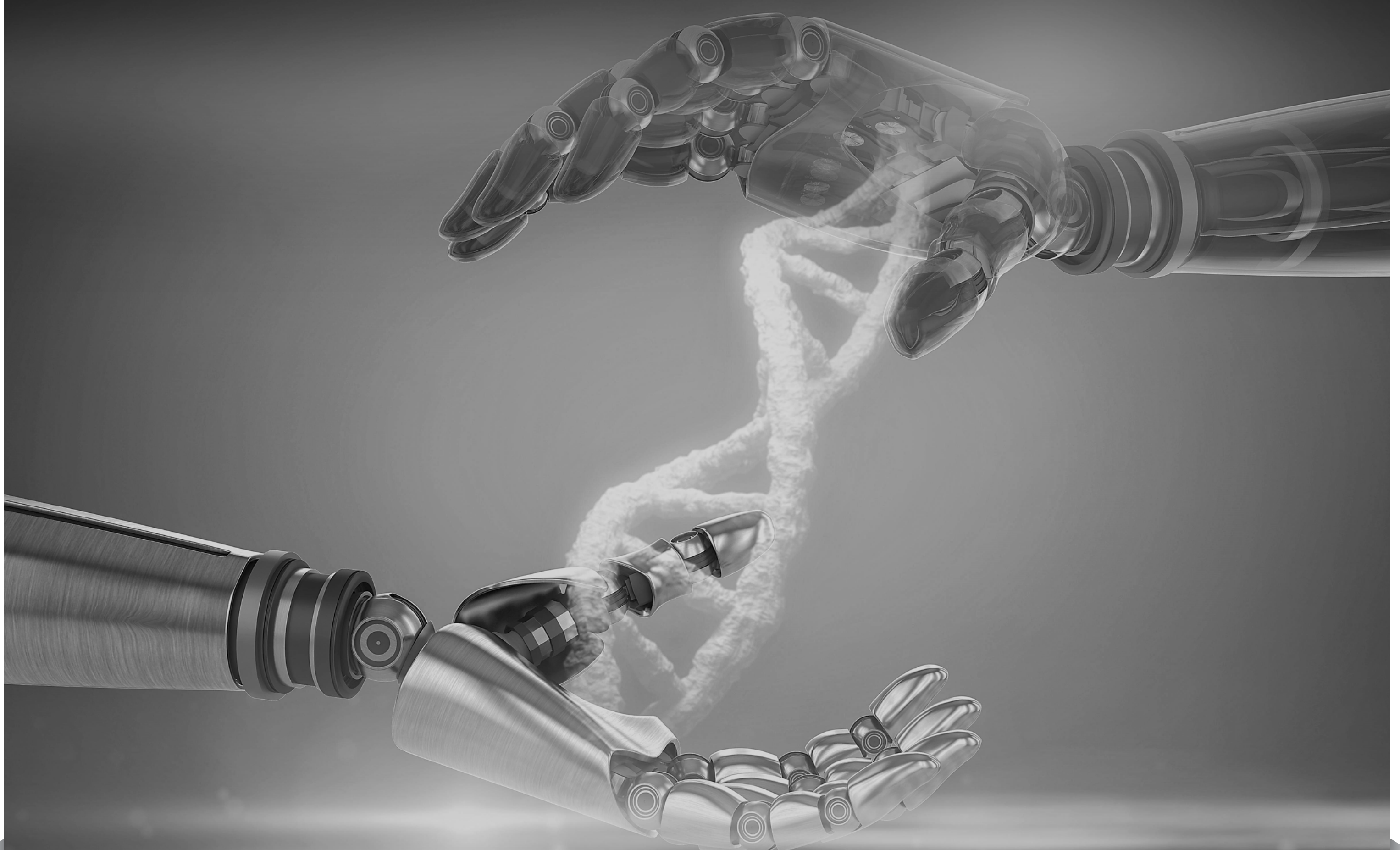
STOCKS DOWN UNDER

27 OCTOBER 2020

Emerging Stocks Down Under

"Man plans, and God laughs."

- Yiddish adage ('Mann Tracht, Un Gott Lacht')



SUPERLOOP

Follow the money

NEUREN PHARMACEUTICALS

Orphan with a rich partner

REDFLEX

The bane of citizens but a goldmine for investors

SUPERLOOP

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Stocks Down Under rating: ★★★★

ASX: SLC
Market cap: A$ 342M

52-week range: A$0.44 / A$1.27
Share price: A$ 0.93

Superloop's IPO in June of 2015 looked very promising with the share price spiking 96% from its $1 IPO price on the first day of trading. In the 14 months that followed, the stock went up to an intra-day peak of $3.36 in September 2016. But it's been downhill ever since, literally if you look at the share price chart, and Superloop is now trading at $0.94. That's twice as high as during the 45-cent bottom at the height of the Corona Crash in March this year. Technical analysts might say Superloop has formed a reverse head-and-shoulder formation since June 2019, which would indicate upside from here. As fundamental analysts, we're wondering if the company's valuation and expected growth rates give us reason to turn bullish after four years of unrelenting share price declines.

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52-week range: A$0.97 / A$3.04
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Like most stocks listed on the ASX, Neuren Pharmaceuticals rebounded after the Corona Crash. However, the recovery for this Melbourne-based drug developer was brief, with the stock only making it to $1.80 on 1 June after the 97 cent Corona Crash low. Since June Neuren stock has been off the boil, investors shouldn't remove this one from their watch screen, however. Great Phase 3 data in Rett syndrome next year could change the picture markedly for Neuren.

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Share price chart

Source: Tradingview

Superloop 1.0: Disappointing growth

Telecom infrastructure provider Superloop is headquartered in Brisbane, but its activities span across Southeast Asia, including Singapore, Hong Kong and Australia. The company has built >1,000 km of metropolitan fibre networks in the major cities and fixed-wireless networks in Australia. Additionally, the company owns multiple subsea fibre cables. These assets combined enable Superloop to provide high-speed data connectivity between data centres and clients, including Enterprise and SME's and retail. In addition, Superloop sells its capacity to wholesale customers as well, i.e. to other service providers.

The thing about Telco infrastructure, though, is that it can quickly turn into a commodity. Just ask any mainstream Telco operator in any well-developed Telco market. Owning mobile networks, for instance, and offering plans that any other Telco can offer is not a winning strategy unless you have something that the other players don't have. We believe the same is true for data infrastructure. Additionally, offering NBN broadband plans to Australian retail and SME customers is not the goose with the golden eggs, especially at current NBN wholesale prices.

In the last few years, Superloop has disappointed on the execution of its strategy, with multiple downgrades of the company's own guidance, in part due to high costs, which has resulted in a gradually declining share price. The fact that Superloop acquired multiple companies that subsequently didn't work out and had to be written off hasn't helped.

The company received a take-over bid of its own in April last year at $1.95 per share, valuing it at $494m at the time. This take-over could have put shareholders out of their misery, but the talks collapsed in May, apparently because of disagreement on valuation. And in September 2019 Superloop fixed its balance sheet with a $90m recapitalisation. The restructuring of Superloop 1.0 is now essentially complete, and the question is if Superloop 2.0 is worth an investing.

Superloop 2.0: Transitioning to recurring revenues

Superloop has largely finished the build-out of its AsiaPac fibre network and should see limited annual CAPEX going forward, say around $30m to $40m annually instead of more than $70m or $80m each year. Furthermore, in the next several years, internet traffic in the region should continue to grow by more than 30% annually, driving demand for fibre capacity, enabling Superloop to fire up more of its dark fibre that can then start to generate revenue. Dark fibre is fibre optic cable that has been laid and paid for but is yet "unlit", or unused. Superloop can switch it on if demand so requires, which we expect will happen.

Summarising, we believe Superloop should be able to start benefitting from its high-leverage business model, i.e. high initial CAPEX that can now start to be leveraged as demand increases, without the need for much additional CAPEX. So, going forward, we expect to see substantial margin improvement from the FY20 EBITDA margin of 12.6%. We would be looking at a minimum of 25% in a few years, and potentially above 30%.

The founder is buying stock on market

Looking at Superloop's EV/Revenue valuation multiples of 3.1x and 2.5x for FY21 and FY22 respectively, we believe the company is not expensive given its expected average revenue growth of nearly 15% in the years 2021 through 2023.

On an EV/EBITDA basis, we believe Superloop is actually cheap with multiples of 17.8x and 14x for both years, i.e. consensus EBITDA growth for FY21 through FY23 is 59%, 27% and 21% respectively. This puts our preferred valuation metric, EV/EBITDA-to-EBITDA-growth at 0.3x and 0.51x respectively for FY21 and FY22, so yes, cheap in our book.

And it seems Superloop founder Bevin Slattery agrees with us. At the time of the IPO, he owned 60m Superloop shares, or 66.7% of the company, a holding which was diluted due to the recapitalisation last year. Last week, he bought an additional 308,385 shares at 89 cents per share. He now owns 64.3m Superloop shares or 17.6% of the company.

Insiders buying shares in their companies on market is usually a good sign. And in this case, it's an even better sign, in our view. Slattery seems to have a good instinct for value, judging by his involvement in NEXTDC (ASX: NXT), Megaport (ASX: MP1) over the years and the stakes he recently built in IntelliHR (ASX: IHR) and Pointerra (ASX: 3DP). As regular viewers of Friday Beers with Marc & Stuart will know, we have been big fans of Pointerra for a long time, although we believe anything above 40 cents per share is too high given Pointerra's current phase of development.

But back to Superloop. Compared to the NEXTDC and Megaport stories, which have been huge successes so far, the Superloop story hasn't panned out yet. However, at the company's current valuation level and with the transition towards more recurring, higher-margin revenues, we think Superloop 2.0 could work out well for investors. So, we're following the money and give Superloop a four-star rating.

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Share price chart

Source: Tradingview

You don't have to spend a long time looking for investment opportunities in the Life Sciences sector before you come across the strange term 'Orphan drug'. What's an Orphan drug? The best definition we can find comes from Lorenzo's Oil, the 1992 film based on a true story where a kid has a debilitating genetic condition called adrenoleukodystrophy and his parents research a potential cure.

In the film, you see a doctor played by Peter Ustinov explaining to the parents, played by Susan Sarandon and Nick Nolte, why there's been no cure so far: "Do you know how many children die every year from choking on French fries? Many more than from adrenoleukodystrophy. You see, ours is what is known as an orphan disease, too small to be noticed, too small to be funded, especially with the iron hand of Reaganomics".

Orphaned no more

The funny part about that quote was that it was US President Ronald Reagan, who in 1983 signed into law America's Orphan Drug Act, providing substantial incentives to drug developers working on Orphan drugs. Later on, other jurisdictions followed suit with comparable legislation. It wasn't long before the first Orphan drugs started coming to market, and they attracted, by pharma industry standards, very high prices. That,

in turn, allowed some of those drugs to become blockbusters. The effect of all this has been to virtually mainstream Orphan drugs, making them very popular with investors and pharma companies alike.

Neuren Pharmaceuticals believes it has one such future Orphan blockbuster in its pipeline. The drug is called Trofinetide, and it's currently in Phase 3 in a rare neurological condition called Rett syndrome. The beautiful part about Neuren right now is that the Phase 3 data will likely be available next year, but currently, you can get the company for less than A$150m. That's tiny by Orphan drug developer standards, where some companies on Nasdaq trade in the billions.

Getting rich by doing good

If Neuren and its partner, the American biotech company Acadia Pharmaceuticals (Nasdaq: ACAD), succeed clinically with Trofinetide they'll be doing a lot of good for some badly off patients. Rett syndrome is arguably the worst of the autism spectrum disorders. Fans of Manchester United may have heard of Rett syndrome because Wayne Rooney, formerly one of the club's star forwards, had a sister-in-law who died of Rett in early 2013. If a girl – and this condition is overwhelmingly female – has the causative mutations on the X chromosome in a gene called MECP2, her ability to speak, walk, eat and even breathe easily will be badly impacted. In this setting, any improvements are welcome and at Phase 2, Trofinetide performed well in treated patients when evaluated by both the caregivers and by the physicians. More importantly, the clinical improvements continued right through to the end of the short six-week trial.

Only around 10,000 people in the US are believed to be living with Rett right now, but even at modest pricing that suggests a blockbuster drug for Neuren and Acadia is in the works. The latter company, currently capitalised on Nasdaq at close to US$7bn, took the North American rights in mid-2018 and is on the hook with Neuren for both US$455m in potential clinical and commercial milestone payments and royalties after that. Neuren retains the rest-of-world rights. If you like companies that can both get rich and do some good at the same time, Neuren and Acadia are two of them.

The future for Neuren is purple

The US Phase 3 for Trofinetide comes in two parts. The first part, called 'Lavender', is a double-blind study designed to test Trofinetide's efficacy and safety in about 184 women and girls aged 5 to 20. It runs for 12 weeks, which is twice the length of Phase 2 so the potential for further improvements is increased. As the term 'double-blind' suggests, neither doctors nor caregivers know who gets the drug and who gets placebo in this part of the study. After the 12-weeks of Lavendar comes an extension study called 'Lilac' that will test trofinetide effectiveness over 40 weeks for all patients, regardless of who got drug or placebo in Lavender. The Acadia Phase 3 got started in October 2019 and, while it was interrupted by Covid-19 in March, the study was back up and running in June.

It's important to note that Neuren is far from a one-trick Orphan drug pony. Acadia will also try out Trofinetide in another Orphan neurological condition called Fragile X syndrome and behind that opportunity, Neuren has a second drug called NNZ-2591 at the pre-clinical stage, but intended for three more Orphan indications with long names: Phelan-McDermid syndrome, Angelman syndrome and Pitt Hopkins syndrome.

Neuren's pipeline, and the pre-clinical and clinical work that supports it, suggests considerable upside beyond Rett for Neuren. Why has Neuren stock been quiet since June? Life Sciences stocks do that sometimes when the company is in the middle of a major clinical study. The stock won't stay asleep for too long, we suspect. Neuren and Acadia believe they can have their Lavender and Lilac data set ready by the second half of 2021. That's not far away. Ahead of the potential re-rating that event could prompt, this quality drug developer is four stars from us.

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Share price chart

Source: Tradingview

Traffic violations, the bane of citizens but the savour of investors

Redflex has three main bases of revenue: equipment and software sales, and ongoing operation and maintenance contracts. Equipment and software sales are classified under the same line item and have historically stayed between 19-20% of annual revenue. Equipment sales consist of five different products allowing for traffic violation monitoring, each with a different specialty.

The software developed and offered by Redflex consists of four different products. These products span land and speed enforcement, AI-enabled traffic analytics, real-time data matching and system monitoring, and a cloud based end-to-end back office photo enforcement platform.

Due to the emerging nature of Redflex's business, we believe the all-encompassing nature of its equipment and software offerings grant a significant edge. While equipment and software sales are not the majority of revenue, they function as the main basis for the acquisition of ongoing operation and maintenance contracts. We believe the more equipment and software sales the company can entice, the higher the chance the company will be chosen to operate and service the equipment going forward.

Ongoing operational and contract revenue makes up the recurring revenue generated by Redflex due to the long-term nature of these contracts. While the nature of these contracts can change, the company is usually responsible for the maintenance and operation of the equipment purchased by the government in question. The revenue generated from these contracts usually consists of a combination of a fee and a portion of the fines issued by the equipment in question.

The three corners of the world

Redflex has operations across three main geographical regions: APAC, EMEA and the Americas.

On a year-over-year basis, FY20's revenue from EMEA and APAC was effectively flat at $55.9m due to COVID-19 causing significant traffic reductions across the world. However, as Redflex continues to achieve efficiency improvements, the overall EBITDA margin for these regions increased from 13.1% during FY19 to 19.7% during FY20. About 70% of APAC and EMEA revenue consists of long-term, recurring, contracts, and these regions account for around 48% of the total sales pipeline.

The Americas saw a significantly larger drop in traffic due to COVID-19 than APAC and EMEA. Revenue and EBITDA in this region dropped to $44.8m ($61.8m FY19) and $8.4m ($10.9m FY19), respectively. We believe this decline is more or less a one-off as it was due solely to reduced revenue on the recurring contracts due to reduced traffic. However, on a positive note, the Americas EBITDA margin increased from 17.6% in FY19 to 18.8% during FY20 from gains in efficiency.

While these efficiency improvements are likely to be permanent, we're not sure how high these margins can go. However, prior to 2015, the company achieved overall EBITDA margins well in excess of 20%. So, maybe that would be a management target to shoot for.

A company for budget crunching and economic reopening

There are only a few analysts that cover Redflex and the current consensus estimate for FY21 EBITDA shows a decline in EBITDA of around $1m from FY20's $18.3m to $17.4m. On that basis, Redflex is currently valued at an FY21 EV/EBITDA ratio of around 4x. However, we don't believe the market is correct with its estimate for FY21 for two main reasons: it assumes a significant drop in EBITDA margin and declines in government fiscal health.

The total EBITDA margin for FY20 was 18.2% and the current consensus implies an EBITDA margin decline of 280 bps to 15.4%. Due to ongoing efficiency gains and the continued automation of the company's software systems in the last few years, we find it extremely unlikely that Redflex's EBITDA margins will decline in the current financial year, especially since revenues are expected to increase by 13%.

It is a well-known "secret" that governments who are in dire fiscal situations are likely to more strictly enforce ticketing and infraction laws in order to raise revenue. Therefore, we believe governments are more likely to look to install the systems and equipment produced by Redflex.

Overall, we believe Redflex is primed for significant growth over the next couple of years at quite an attractive valuation, even if we assume a higher EBITDA than what the market is assuming right now. Therefore, we are issuing a four-star rating at this time.

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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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