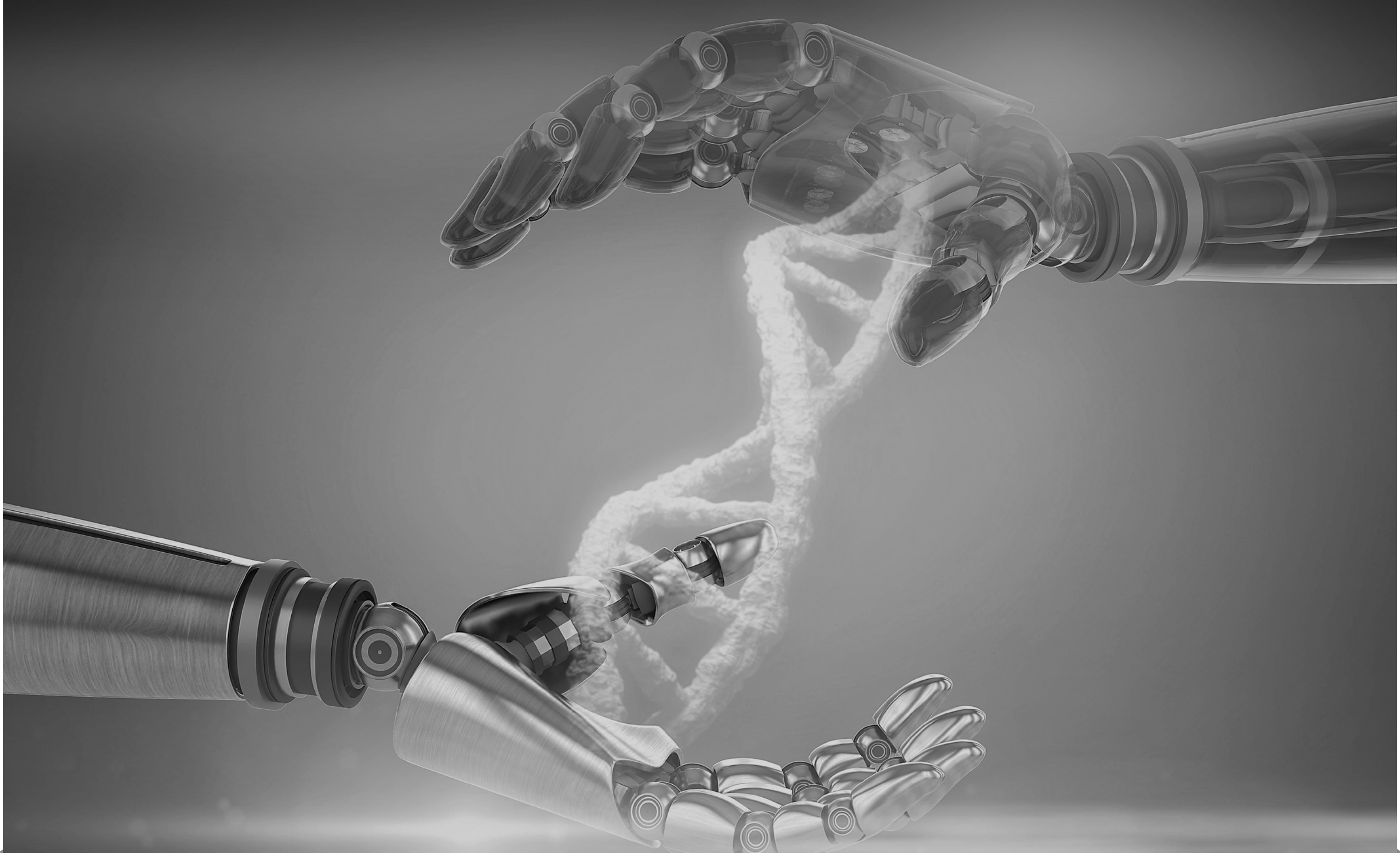
Emerging Stocks Down Under

> *If I had asked the public what they wanted, they would have said a faster horse.*
>
> - Henry Ford (1863 – 1947), Founder of Ford Motor Company



RHYTHM BIOSCIENCES

A Seriously Better Alternative

HAZER GROUP

The final test is here

SKYFII

I want to break free

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A Seriously Better Alternative

Stocks Down Under rating: ★ ★ ★ ★

ASX: RHY
Market cap: A$ 103M

52-week range: A$0.041 / A$0.58
Share price: A$ 0.52

The Melbourne-based Rhythm Biosciences, which is developing a next-generation diagnostic for colorectal cancer, has enjoyed a nice re-rating lately. Back on 6 August, you could buy this stock for just 7.8 cents. By 12 November it had made it to 42 cents. That's because the data for the diagnostic has looked very good so far, and there's likely more where that came from.

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Share price chart

Source: Tradingview

ColoSTAT is a better screening tool

Some of the best Life Sciences companies to invest in are what we call the 'SBA companies'. SBA stands for Seriously Better Alternative. The products of SBA companies will replace an old way of doing things that no one likes very much, but have to put up with because there's no viable alternative. For example, everyone hates surgery as a solution to chronic obesity. Imagine the billions to be made from safe and effective weight loss pills. Or consider something a little more prosaic: hands up if you like having to fast for eight hours before a standard blood test. Imagine the billions you could make from a non-fasting alternative.

The reason Rhythm Biosciences has recently re-rated has a lot to do with the fact that it's an SBA company. Its ColoSTAT product, currently in clinical development, is a blood test that can accurately determine if a patient has colorectal cancer. Currently one of the tools used to screen the population for colorectal cancer is the so-called faecal immunochemical test, known in the trade as the FIT. If the FIT indicates that a patient may have cancer, he or she can have a more expensive and invasive colonoscopy to confirm it. ColoSTAT is better than the FIT in terms of sensitivity and specificity and a heck of a lot more patient-friendly. It's a Seriously Better Alternative.

A tale of two diagnostics

What's the FIT? A giveaway for colorectal cancer is if there is blood in the stool of the patient. That blood is often not detectable with the naked eye, which is why a FIT is sometimes called a faecal occult test (we get the word occult from the Latin verb occulere, meaning 'to hide from view'). With the FIT the patient takes a sample of stool, places it in a special collection tube or on a special card, and sends it to the lab. Haemoglobin, an antibody that binds to a blood protein, is used to detect any blood.

What's ColoSTAT? It's an immunoassay, just like any other blood test, where antibodies are used to detect about five proteins of interest. The concentration of these proteins in the patient's blood will indicate whether not the patient has colorectal cancer.

The FIT versus ColoSTAT – which would you prefer

So why is ColoSTAT better? Well, try doing a FIT sometime and you'll quickly be asking if there's a Better Alternative. The stool needs to be collected on clean toilet paper and must not come into contact with water or urine. And then the sampling probe from the test kit has to be poked into six different areas of the stool sample!

And that's before having to properly seal and pack the test kit and fill out the relevant forms before the kit is mailed back. Seriously, folks, this is a sh*t test, and they wonder why only 40% of high-risk patients in Australia comply with it even when everyone over 50 is invited to get the test, which is provided free to those people by our government.

Now contrast that with ColoSTAT. You get to the collection centre, they draw your blood and five minutes later you're out the door. A few days later, they send the results to your doctor. And, hey, you don't even have to starve beforehand. Of course, the test has to work as well or better than the FIT, and all the data is showing that this is, in fact, the case.

On 12 November, Rhythm released the results of a study of 200 blood samples showing that ColoSTAT's sensitivity was 77% and specificity was 95%. Sensitivity is a test's ability to detect the substances being assayed for. Specificity is the ability of a diagnostic to detect only what is being assayed for. In Rhythm's study, ColoSTAT was comparable to the FIT on specificity, but much better on sensitivity.

Solving a serious health issue

Rhythm is currently working on getting the optimal ColoSTAT kit manufactured and once the final product is available, it will conduct an in-vitro study like the one we just described, called 'Study 6' to confirm that the test works as planned. Then comes 'Study 7', for which Rhythm is already recruiting, a prospective clinical study designed to show which works better – ColoSTAT, colonoscopy or the FIT.

Why compare to colonoscopy? The colonoscopy arm is there for a 'gold standard' control. ColoSTAT is, of course, competing only with the FIT and if the Study 7 numbers show a statistically significant difference between ColoSTAT and the FIT, then Rhythm can file for regulatory approval in various jurisdictions around the world, including Australia. That said, ColoSTAT would still be a very viable alternative to colonoscopy from an insurer's perspective and also for elderly folks less likely to handle the latter diagnostic.

Imagine the shareholder value that Rhythm could potentially create with its Seriously Better Alternative, given that colorectal cancer, with nearly two million new cases and about a million deaths, is the third most deadly and fourth most commonly diagnosed cancer in the world? With this SBA company making serious progress, we rate it four stars.

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Share price chart

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Don't get all hazy, it's just the Hazer Process

The Hazer Process was originally developed by the University of Western Australia starting in 2007. Using products like biogas with an iron-ore catalyst, the process can produce 90-95% grade graphite and hydrogen gas. The company is currently building a commercial demonstration plant that will utilise the biogas produced by the Woodman Point Waste-Water Treatment Plant in Western Australia to produce around 100 tons of 'low-emission' hydrogen and 380 tons of graphite per annum. The estimated volume of biogas needed per year will be around two million normal cubic meters (nm3). In order to cut costs, the company is planning on installing a hydrogen cell-based battery to power a significant portion of the plant's electricity needs.

While this plant will produce income for the Hazer Group, the main purpose is to prove the scalability and economic viability of the Hazer Process. Hydrogen is currently expected to explode as a technology, no pun intended, and become worldwide economically viable within the next 10 to 15 years. If the Hazer Group can prove the economics of the Hazer Process, the company would have a foot in the door to a potentially massive industry.

Hydrogen, the three main types

There are two main types of environmentally friendly hydrogen: blue and green. Blue hydrogen is produced by separating the hydrogen content from fossil fuels, like biogas, natural gas and coal. The reason blue hydrogen is called ‘blue’ is the carbon dioxide produced through this process is prevented from being released through the utilisation of carbon capture technology.

Green hydrogen is produced through the utilisation of an electrolyser splitting water into hydrogen and oxygen. In this process, the electrolyser is powered using renewable energy generation, like solar or wind. We believe green hydrogen is bound to become the cheapest form of hydrogen production eventually, but this requires a large supply of renewable energy. Therefore, we believe blue hydrogen is likely to lead the worldwide transition.

Normal hydrogen production is simply hydrogen either produced with an electrolyser not using renewable energy or the blue hydrogen process without the carbon capture.

But hydrogen still has a long way to go right?

Yes, that is true, but when you look at the current investment and subsidy landscape worldwide, we believe hydrogen’s chances of advancing rapidly through the various phases of development and implementation by CY30 are quite strong.

A few of the more significant developments in government funding for hydrogen can be found in the European Union, Japan, China and Australia. Since 2017 the Japanese Government has been adamant that hydrogen will become commercially viable by 2030 and has spent a lot of time and money making sure this will happen.

Ideally, we would like to discuss international developments, funding, investments and projects that are going on around the world in relation to hydrogen, but this edition of Emerging Stocks Down Under would be 40 pages if we did. But if you buy us a beer, we’ll tell you all about it.

In a nutshell, the world is beginning to focus heavily on hydrogen for two primary uses: electricity production and long-haul trucking. We highly recommend readers take the time to read more into this quickly developing and fascinating industry.

Hydrogen, Australia’s ace in the hole

In December 2018 the Australian Government’s Chief Scientist wrote a proposal for a national hydrogen strategy after the COAG Energy Council requested it. The proposal found that if Australia did not become a major hydrogen exporter by 2030 the country’s future economic potential would be severely diminished. The report’s more conservative estimates predicted that demand for hydrogen for energy production alone would reach 8m tonnes annually by 2030 and 35m tonnes by 2040. For comparison’s sake, during FY20 Australia became the world’s largest Liquid Natural Gas (LNG) exporter in the world at 80m tonnes, but 35m tonnes of hydrogen has the energy equivalent of 84m tonnes of LNG.

To name a few of the funding initiatives produced by the Australian Government, on 4 May 2020, it announced $300m in funding to support hydrogen projects. Another example dates back to 2019, when the Australian Renewable Energy Agency announced $70m in funding to “help fast track the development of renewable hydrogen in Australia.

Green hydrogen is the future, but blue is how we get there

The Hazer Process has great potential since it is currently considered a “low emission” form of hydrogen production and, with the introduction of carbon capture, would be considered “blue hydrogen.” Additionally, the added benefit of graphite production expands the income stream for companies that purchase and utilise this method. There is certainly a risk of the process failing in its final commercial test. We do believe, however, that the risks are certainly worth the reward. The Hazer Group has made it clear that a couple of companies have already expressed interest in the process, should the demonstration plant be successful.

While green hydrogen is certainly the future, governments are currently focusing heavily on the transition to a hydrogen-fuelled economy and realise this must be attained through blue and low emission hydrogen production. With a market cap of less than $120m, we believe this company is certainly worth four stars.

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Share price chart

Source: Tradingview

What the heck is venue analytics

Simply put, SkyFii collects all sorts of data on people visiting its customers' retail stores, schools, office buildings, malls, petrol stations, airports etc, using a range of different tools, like in-store WiFi, camera's, people counters, Point-Of-Sale data, Social Media and, believe it or not, the weather. Essentially, any data source that uses standard integration methods, like API's (Application Programming Interface), can be ingested.

SkyFii's platform, dubbed IO, ingests and analyses all that data to provide its customers insights into their visitors' behaviour, like dwell times in stores. Customers can then use that data to deliver content and marketing campaigns to their visitors when they are in the right place and at the right time. SkyFii's key markets are Australia and North America with activities in the UK and New Zealand as well.

Non-recurring revenues are a leading indicator

The company generates two types of revenues. Firstly, non-recurring revenues are essentially installation costs SkyFii charges to set up its systems for customers, like hardware for WiFi and people counters, and for the setup of the accompanying software. Most of this setup work is done by third-party installation companies and resellers, by the way. Non-recurring revenues are nice but are not SkyFii's main gig.

Recurring revenues are what the company is after and what we as investors should be keeping an eye on. You see, SkyFii sells its services in multi-year contracts, typically 3 to 5 years. And once you're in, you're in. When the contracts are up for renewal, it's much easier to renew if you're the incumbent then for a competitor to displace you. So recurring revenue growth is what we judge SkyFii on.

However, because provisioning always precedes the start of SkyFii's ongoing services to customers, we consider non-recurring revenues as a good leading indicator for future recurring revenue growth.

Non-recurring revenues took a hit in the April-June time frame as COVID-19 crippled economies worldwide, and many new installations and sales projects ground to a halt. Consequently, the 7% q-o-q recurring revenue growth in SkyFii's 1Q21 reflected the low level of new installations in the prior quarter. In recent years this q-o-q recurring revenue growth number has been in the double-digits.

So with this dynamic in mind, we believe the 21% sequential growth in non-recurring revenues in 1Q21 bodes very well for SkyFii's recurring revenue growth in Q2 and Q3 of its financial year.

Almost back to normal

SkyFii generated $13.5m in revenues in FY20, a 44% increase versus FY19, and $2.1m in EBITDA. Out of that $13.5m in revenues, recurring revenue accounted for $8.8m, an increase of 72% year-on-year. Annualised recurring revenue, i.e. all the contracted recurring revenues per the end of 4Q20, amounted to $10m.

Although recurring revenues in 1Q21 accounted to just $2.2m, i.e. roughly flat compared to the most recent two quarters, largely due to COVID-19, annualised recurring revenues grew to $11m, up 10% compared to the previous quarter.

The one analyst that covers SkyFii projects overall revenues will increase 30% in FY21, to $17.6m. We think that is a fairly conservative assumption, but for argument's sake let's go with it for now. At the current market cap, this revenue projection implies an EV/Revenue of 4.5x, which we think is quite reasonable for a fast-growing company like SkyFii.

Although COVID-19 continues to impact SkyFii's North American market in particular, we believe Australia and New Zealand should see business activity largely return to normal in FY21. On top of that, the world has started to adjust to COVID, so we believe business activity in North America will normalise as well.

All in all, we believe SkyFii shares are looking very interesting, having recently broken through the resistance level around 23 cents. Following the current base-building, the next step would be to break free from that level and set new highs helped by upbeat news around vaccines. The latter will help companies, such as SkyFii, that depend in part to the freedom of movement for consumers. It's four stars from us.

Pitt Street Research Pty Ltd

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