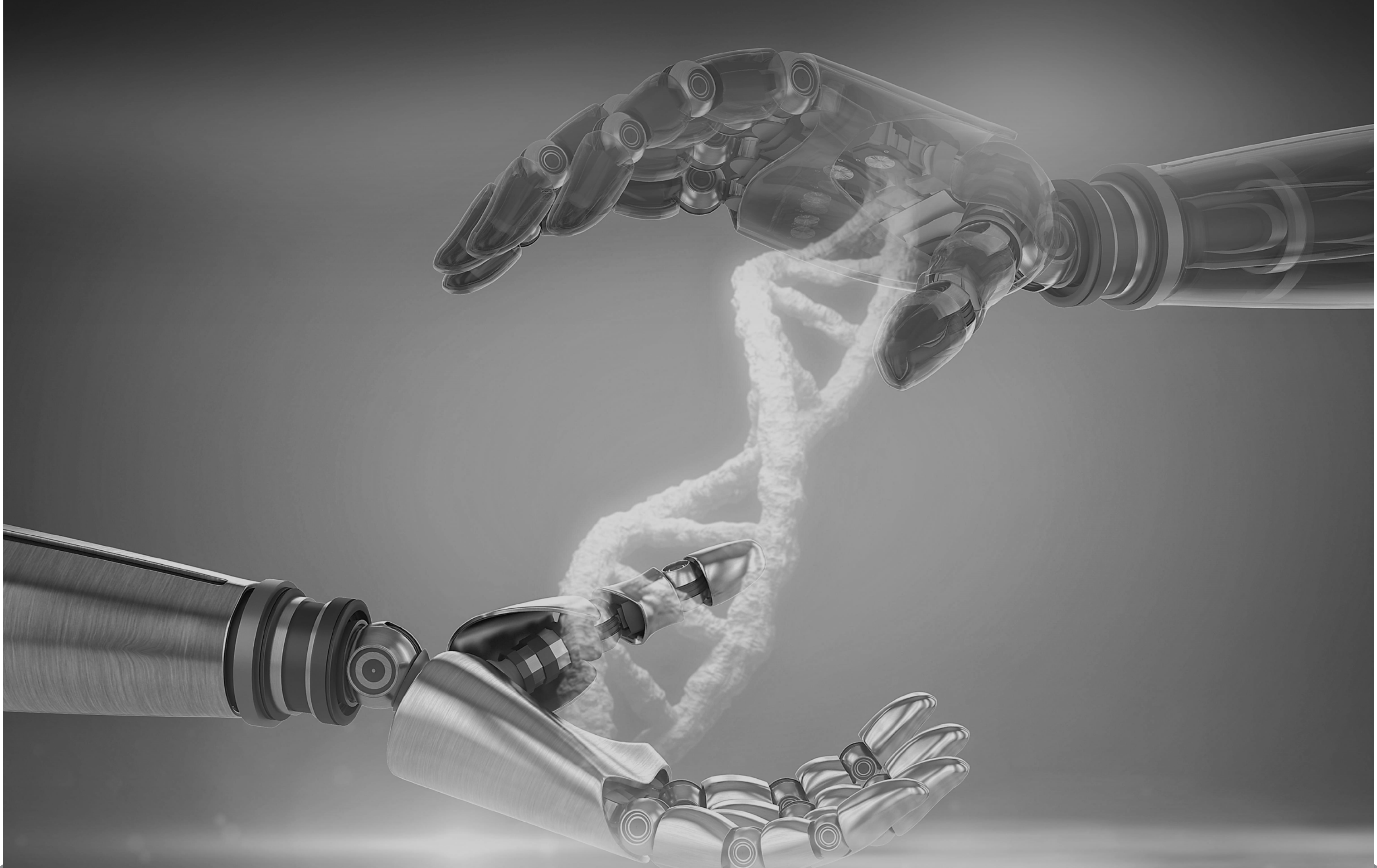
STOCKS DOWN UNDER

3 NOVEMBER 2020

# Emerging Stocks Down Under

*"Whenever you can, put a company in your mouth."*

**- Bobby Axelrod (Season 1 Episode 3), Billions (American TV Show)**



**AROA BIOSURGERY**

Valuable sheep guts

**ALCIDION GROUP**

Walking an unclear path

**ELSIGHT**

Starting to get traction

# AROA BIOSURGERY

## Valuable sheep guts

Stocks Down Under rating: ★★★★

**ASX: ARX**
**Market cap: A$ 396M**

**52-week range: A$1.225 / A$1.745**
**Share price: A$ 1.265**

The Auckland-based biotechnology company Aroa Biosurgery had a great start to its listed life on ASX in July 2020. The company offered 60 million shares at A$0.75 per share in its IPO, but the stock came on the boards at $1.40 and has yet to go below $1.25. Investors have liked Aroa because this company is now revenue-stage and because its products, designed to improve healing in complex wounds and soft tissue reconstruction, are demonstrably superior to the competition's.

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# ALCIDION GROUP

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**Market cap: A$ 129M**

**52-week range: A$0.097 / A$0.245**
**Share price: A$ 0.125**

Headquartered in Melbourne, the Alcidion Group is an emerging HealthTech company specialising in software and services that allow hospitals to better track their patients, bed count, communication and overall task management. Simply put, Alcidion's technology suite allows a hospital to have a clearer overhead view of its current operational situation. The company has been growing fast but COVID-19 has forced the health system to place its priorities elsewhere. Therefore, the company's profitability date has become less clear and until then, we think Alcidion needs to wait a little longer before it deserves a re-rate.

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**ASX: ELS**
**Market cap: A$ 61.5M**

**52-week range: A$0.21 / A$0.73**
**Share price: A$ 0.61**

Like many Israeli companies, Elsight has its origins in the Israeli Defense Force (IDF). The company has developed communications protocols and technologies that enable secure and reliable communications across different networks and for different applications. Not surprisingly, one of their major application areas is the Military and Homeland Security. The company has been running many Proof of Concepts and seems to be getting some good traction as of late. Time for a closer look.

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### Share price chart


*Source: Tradingview*

One of the gratifying things about the Life Sciences sector on ASX in 2020 has been the relative maturity of so many companies in this sector compared to just a few years ago. For a long time the typical publicly traded biotech or medical device company in Australian or New Zealand was conceptual in nature and had yet to run even one clinical trial of its lead product. Nowadays such companies are more likely to be in Phase 2 or beyond. Aroa Biosurgery goes one better than that. This company enjoyed in excess of US$14m in revenue from approved products in the year ended March 2020. It was EBITDA positive in that year too. And it is well placed to grow sales because its products work so well in the indications in which it is used. No wonder that Aroa is currently capitalised on ASX at around A$400m.

### 70% gross margins and rising

The secret to Aroa's success is a technology called 'Endoform', which is a kind of 'scaffold' that doctors can use to help their patients grow new tissue. You've seen scaffolding on the sides of new buildings that provide the supportive framework for the building as it is going up. Endoform is like that scaffolding, but for wound healing and soft tissue reconstruction. You see, more often than not, the body has the capacity to regrow tissue that has been lost through disease or injury, but needs a scaffold that will allow the regenerative cells to take root and grow in the right place. Endoform is one such scaffold, which Dr. Brian Ward, Aroa's founder, and his colleagues developed from the stomachs of sheep. That's right, sheep. Aroa is a New Zealand company, after all.

All jokes aside, the genius of Endoform is that this 'Extracellular Matrix' from the ovine forestomach does a better job at mimicking the microenvironment in which human cells can regrow human tissue than most regenerative medicine scaffolds that are out there. The data in about 16 peer-reviewed scientific publications is there to prove it and Aroa's salespeople are now actively marketing Endoform in the US and elsewhere in conditions such as complex wounds, hernia and breast reconstruction.

As we noted above, in FY20 Aroa rustled up NZ$22m in sales, which is US$14m or thereabouts, and there's arguably more where that came from because  the total addressable market for Endoform right now is about US$1.5bn. Throw in new indications currently being developed, and that addressable market opportunity grows by another billion or so, at the very least. Commercially Aroa is also well placed because the kind of pricing the company gets for its products allows a 70% gross margin and this margin is expected to get better as Aroa learns how to reduce its cost of goods over time.

### An overnight success story a decade in the making

Now, Aroa is far from an overnight success story. The company has been working on what became Endoform since 2008 and it took until 2013 before the first FDA approval came through. The difference between this company and most ASX-listed Life Sciences companies is that Aroa stayed private until it was through the hard clinical yards and on to the revenue stage of its growth. That meant the market was able to give Aroa a more generous valuation once it came to market, since the clinical and development risk was out of the way.

Another reason to put Aroa Biosurgery on your watch list is the 'stem cell' angle. Stem cells are simply those cells in the body with the power to regenerate new tissue. A company like Mesoblast (ASX: MSB), which we last wrote about on 14 August in Stocks Down Under, can routinely trade at a market capitalisation of more than a billion Australian dollars because its Mesenchymal Stem Cells have been working wonders in terms of clinical trial outcomes in conditions as diverse as Crohn's disease, heart disease and chronic low back pain. The way Endoform works, in part, is by recruiting Mesenchymal Stem Cells from the surrounding tissue. A paper in the journal PLOS ONE published on 13 July provided some supportive evidence of this, and given the rising level of research interest into Mesenchymal Stem Cells we think there'll be more papers yet.

### Watch out for a good second half

In the six months to September 2020, Aroa's revenue fell 10% to NZ$9m. That's not bad when you consider that the hospitals Aroa has been selling to were dealing with Covid-19 at the time and therefore had less interest in regenerative medicine products like Endoform.

Aroa's IPO set it up to make it through more than a few bad quarters and cash as at September 30 was NZ$38.7m. However Aroa doesn't think it will need to lean all that heavily on this buffer - once the full year to March 2021 is done, the company is forecasting similar revenue to FY20, with the second half recovery more than making up for the first half's difficulties. Ahead of that recovery, we're giving Aroa four stars.

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### Share price chart


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### Alcidion's three-pronged plan for global conquest

Alcidion is currently focusing its sales force in three specific geographical areas: Australia, New Zealand, and the United Kingdom.

The main market for Alcidion is Australia. The company's products are used in hospitals here accounting for around 27,500 beds, quite a large portion of Australia's approximately 63,000 hospital beds for a company that is not yet profitable. The company has significant existing relationships with the NSW, ACT, Vic and Northern Territory governments and we expect this to help it win new contracts and maintain its current market share going forward.

New Zealand is Alcidion's main market when it comes to market saturation. Out of the approximate 10,000 beds available in New Zealand, around 7,509 use an Alcidion product as of 30 June 2020. While the New Zealand government is conducting an all healthcare sector review, and we believe the company's products will come out favourably in the review, at 75% market saturation we believe it is safe to say that New Zealand will not be classified as a growth market for the company going forward.

The United Kingdom is where Alcidion is looking for its long-term growth and it plans on eventually using the country as a launchpad into the European Union. Despite our opinion that a hard Brexit is the most likely outcome, we still believe that, from a proof of product perspective, it is currently easiest to jump from Australia to the United Kingdom and then into Europe due to Europe's general lack of focus on Australia as a whole. We believe the largest issue with the company's United Kingdom growth plan is the country's renewed lockdown and out of control COVID-19 situation.

### Why is lack of profitability such an issue for us?

For regular readers of Stocks Down Under it might be a surprise to hear us issue a three-star rating largely because of a company's lack of profitability. However, unlike many of the other non-profitable companies we have looked at, Alcidion's revenue growth was only 10% during FY20 to $18.6m, and the time frame for when the company will reach profitability is unclear. Additionally, we are concerned with the company's United Kingdom business as the country has just gone back into a four-week lockdown due to the uncontrolled nature of the country's COVID-19 situation.

While many companies in the healthcare sector have benefited from drastic budget reallocations due to COVID-19, Alcidion's products, unfortunately, do not fall into that category. Despite the drastic increase in funding towards the healthcare sector, hospitals have had to prioritise where the funding goes, and overall efficiency upgrades to hospitals' operating, management and task management systems are certainly not the priority.

### What's the good news?

The company has one major and one potentially significant benefit going for it during FY21: recurring revenue and a relative return to normal in Australia and New Zealand.

Recurring revenue is a huge benefit to Alcidion as it creates more stability in the company's operating cash flow generation as well as being the driving force towards profitability. This is why FY20's 35% increase in recurring revenue year-over-year to $10.5m was welcome news, especially with overall revenue only increasing 10%. Additionally, FY21's recurring revenue is also looking strong as the company has already booked $9.7m in recurring revenue for FY21. While the date for profitability still remains uncertain, we do find it encouraging to see growth in recurring revenue as both a total sum and as a percentage of total revenue.

As the company made clear in its 1QF21 market update, COVID-19 has challenged healthcare providers and created an unstable operating environment that is not conductive to the sale of Alcidion's products. Australia and New Zealand, however, having seen significant normalisation in operating procedures as both countries are no longer dealing with out-of-control COVID-19 outbreaks. We are confident in the company's analysis that this normalisation will likely drive a significant increase in sales compared to FY20. How significantly the volumes grow remains to be seen, however.

### For now, the price is not right for a punt

With a market cap of around $130m, a three-month average daily volume of only around 1m shares (approximately $130,000 a day) and an unclear road to profitability, Alcidion falls squarely into the category of a punt. The company does not currently have any consensus estimates for FY21's results, but even if we assume revenue increases at 20% the stock is still trading at a FY21 EV/Revenue multiple of around 5.1x. While we believe this valuation is too high for a four-star recommendation, we do think a lot of things have the potential to go right for this company. However, until it is profitable, or has a clear road to profitability, we must rate Alcidion three stars.

# ELSIGHT

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### It's been a bumpy ride since the IPO

Your Stocks Down Under editors visited Elsight in Israel on multiple occasions in the last few years. Located just to the northwest of Ben Gurion airport, the company is based in the outer ring of the Tel Aviv agglomeration. Elsight listed on the ASX in June 2017 at $0.20 per share. After an initial spike to around $1.60 late 2017 and early 2018, the stock trended down for two years, mostly because commercialisation has been much slower than anticipated. It bottomed around its IPO price in March and April this year.

Helped by some good announcements in July and August around the commercialisation of its products, the stock has jumped to more than 60 cents, giving it a market capitalisation of more than $65m. The question is, could that be too high for a company that only recorded US$352k in revenues in its 1HY20 through June? And this number was down from $864k the year before too. Or are the recent announcements around commercial deals the prelude to a very rosy 2021?

### Reliable and secure communications for critical services

Elsight's technology is focused on providing reliable and secure communications for a range of application areas, the most prominent ones being Military, law enforcement, Homeland Security (HLS), medical and transportation. At the heart of each product is a system that can split up a communication stream into multiple streams that will be sent across multiple channels, typically four.

For instance, the data, video and audio feeds from an autonomous or remotely operated border patrol vehicle, armoured truck or drone can be split up into four separate streams that get sent back to headquarters through four separate cellular connections, preferably from different mobile operators, or through private lines of communications. The reason to break up a communication stream in this way is to make sure that if one of the substreams gets intercepted by the bad guys, it will be useless given that the other three are needed to make any sense out of it. Additionally, each stream will be encrypted before it's being sent. The four streams are reassembled and decrypted at the end-point.

Elsights latest version of the technology, released in November 2019, has been dubbed HALO and has been integrated into the company's various product lines. HALO received all the relevant certifications, including FCC certification in the US, and can be marketed in most of Elsights relevant markets, including the US, Europe and a number of Asian countries.

## Large orders starting to come in

While Military and HLS are obvious markets for this type of technology, the medical market is very interesting for Elsight as well. The company has been working with French company Alrena for a few years to develop medical backpacks to deliver medical assistance in remote locations. This Telehealth solution has just been adopted by the French government, which translated into an initial order for Elsight of US$300k back in August.

In July, Elsight secured an order worth US$1.6m for delivery of HALO to be used in direct-to-consumer Telehealth services to rural areas in the United States through Kinetex Prime. This order came about after substantial testing through a Proof of Concept (POC) with rural health clinics. The company expects multiple repeat orders from Kinetx Prime in the next three years.

Given the number of POC's the company has conducted in the last few years, we would expect a steady stream of orders to start coming in.

## Elsight 2.0 seems to be a hit

There are no financial estimates available for Elsight. And to be honest, we'd need to take any estimate for a company like this with a few grains of salt, because it's just very hard to predict revenue ramp ups for emerging companies. In the last three years, Elsight generated US$1.3m, $2.4m and US$1.8m in revenues respectively.

So, when it comes to deciding whether or not Elsight is worthy of your investment dollars, we need to look at the market opportunity and the specific solution Elsight has come up with to solve the problem it has come across.

The first one is very easy. We believe the market opportunity for secure and reliable communications is massive. When it comes to law enforcement, HLS and military applications alone, we're looking at a market worth billions of dollars globally. Add to that Medical, Automotive and armoured vehicles and we think there is plenty of market to address for Elsight.

With respect to Elsight's technological solution, though, we've been slightly sceptical previously given that revenues haven't really taken off in the last few years, despite the company putting in a lot of effort when it comes to POC's. For the Military, HLS and law enforcement verticals in particular it seemed that Elsight's solution was interesting, but not interesting enough to fit (or retrofit) Elsight's products into existing vehicles and assets. At least, that's what the lack of revenues seemed to indicate.

However, as evidenced by the recent commercial successes, it seems that HALO is now really starting to convert prospects into customers, specifically in the medical vertical. Maybe Elsight has been chasing down the wrong type of client in the past four years. Could that be the reason that the founding CEO, who's got an extensive background in the Isreali military, stepped down recently?

In any case, we believe the Elsight share price is starting to show signs of live. Revenues could start to tick up quickly if (repeat) orders from companies like Kinetx start to come in. Hence, we're willing to give Elsight four stars. Keep in mind, though, that we believe the company will likely have to do at least one more capital raise before it reaches cash breakeven.

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