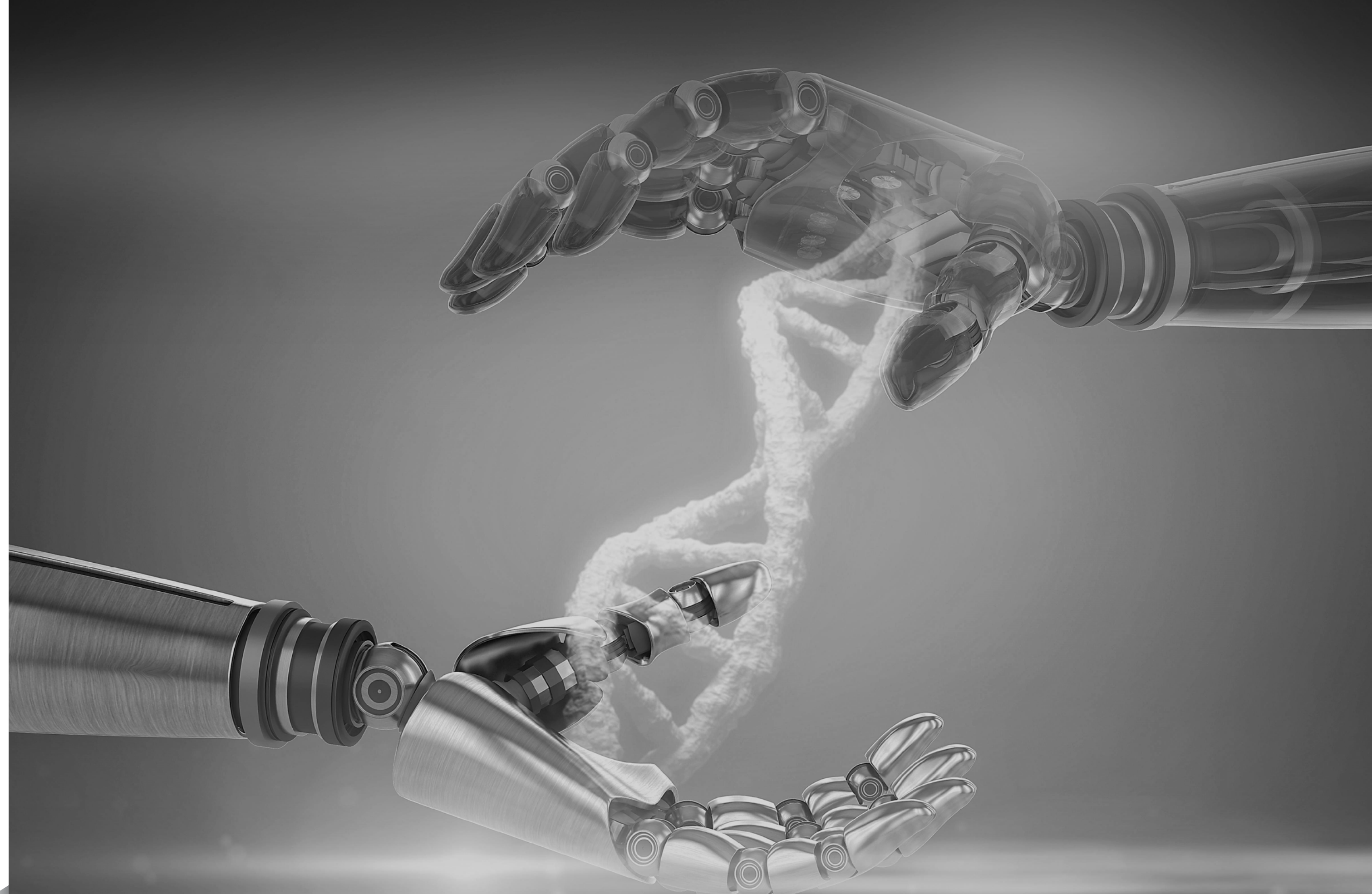
STOCKS DOWN UNDER

10 NOVEMBER 2020

Emerging Stocks Down Under

"Bull markets are born on pessimism, grow on skepticism, mature on optimism and die of euphoria."

- Sir John Templeton (1912 - 2008), American-born British Fund Manager



SMARTPAY

Australia bound

INCANNEX HEALTHCARE

Getting high

CIRRALTO

Better luck betting on a horse

SMARTPAY

Australia bound

Stocks Down Under rating: ★★★★

ASX: SMP
Market cap: A$ 130M

52-week range: A$0.19 / A$0.825
Share price: A$ 0.615

Headquartered in Auckland, New Zealand, SmartPay is the largest independent EFTPOS provider in both its home country and Australia. Like many companies in the payment facilitator industry, recurring revenue is the lifeblood of SmartPay. COVID-19 was not an operational disaster for the company, but it did cause its New Zealand asset sale to fall through. With COVID-19 accelerating the trend towards a cashless society, we believe SmartPay's FY20 growth positions the company to take full advantage of Australia's economic reopening.

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ASX: IHL
Market cap: A$ 85M

52-week range: A$0.03 / A$0.10
Share price: A$ 0.08

Sometime around 2014 investors woke up and realised that a plant with the scientific name Cannabis indica – what you and I used to call marijuana – was no longer 'weed' but, potentially, the source of some pretty powerful (and legitimate) medicines. Since 2014 investor enthusiasm regarding cannabis has waxed and waned, but many of the companies that have made it their mission to develop new cannabis-based therapeutics have enjoyed significant progress on the road to having prescription-only products on the market. The Melbourne-based Incannex Healthcare is one such company. We think its stock can get a lot higher.

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52-week range: A$0.002 / A$0.055
Share price: A$ 0.035

Headquartered in Sydney, Cirralto owns and operates technology assets that enable companies to invoice and pay other businesses easier. The company has seen significant hardship recently and was actually forced into a trading halt by the ASX between 1 October 2020 and 13 October 2020 due to its failure to lodge statutory audited accounts for FY20. Additionally, the company has recently experienced senior management turnover. All in all, we believe Cirralto is a troubled company we would not touch with a ten-foot pole. The reason we still gave it a three-star rating is because Cirralto is a punter's Valhalla.

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Share price chart

Source: Tradingview

EFTPOS, tailor-made for a pandemic

SmartPay has three main revenue streams: EFTPOS terminal service, transaction processing and other. SmartPay's financial year ends on 31 March, so when we discuss the FY21 results, we will be using the company's trading updates rather than full reports.

EFTPOS terminal service is the company's most significant revenue generator due to the recurring nature of its operations. This division provides a contract bundle of the hardware, software, and maintenance and repair services required to operate a SmartPay terminal. However, the actual sale of the terminal is not covered by this division, only the annual fees under the company's long-term service contracts.

During FY20 the NZ$16.9m provided by this division represented around 60% of the company's total revenue. However, this division declined 2.1% year-over-year and while the reasons behind the revenue decline are unclear, we believe it was solely on the New Zealand side of the business. Australia remains a significant region of growth for the company and the majority of New Zealand's revenue is allocated to this division.

The second business unit, Transaction processing, is a straightforward division that clips the ticket on each transaction. FY20 saw strong revenue growth of 204.5% as this unit bore the fruits of strong service adoption in Australia during the beginning of the year. FY20 revenues of NZ$10.3m represented 36.4% of SmartPay's total revenue, up from 16% during FY19.

Direct sales of hardware are accounted for under the Other revenue line and experienced strong growth in Australia during both FY20 and early FY21. Australian transacting terminals reached 4,611 units at the end of 2QY21 returning to the pre-COVID-19 record high during February. We fully expect the company to continue to see strong growth in the sale of Australian hardware as the economy returns to some semblance of normal and consumers continue to move away from cash.

Australia, land of vegemite, kangaroos and growth

During both FY20 and 1HY21, operations in New Zealand stayed relatively flat while transacting terminals in Australia saw growth at around 72% during 2QY21, returning to its pre-COVID-19 trend. Therefore, we believe it could be reasonably said that effectively all of SmartPay's future revenue growth is within Australia, not New Zealand.

So how can investors judge the performance of this important division? We believe the most important figure to watch is the number of transacting terminals at the end of the reporting period. Since the majority of revenue from Australia is generated by the transaction processing division, we believe the number of transacting terminals has historically been the clearest leading indicator of revenue growth in the subsequent quarter.

Strong set up indicates a solid hit

The market currently believes SmartPay is set up for around 22% EBITDA growth during FY21 while currently valuing the company's stock at a FY21 EV/EBITDA ratio of 18.3x. Since the majority of the company's growth is expected to come from Australia, we would have agreed that this rate of growth was reasonable to expect before Victoria came out of lockdown.

However, since it seems highly unlikely Australia is looking down the barrel of any new COVID-19 waves, we believe the quick return to the company's record high level of transacting terminals in the field per the end of 1HY21 indicates stronger than previously expected transaction processing revenue will be generated during 2HY21. However, there are is one macroeconomic factor that presents a major risk to our investment thesis; a potential depreciation of the Australian dollar.

One of the main reason analysts believe the Reserve Bank of Australia issued such a strong QE response during November's meeting was to counteract the rise in value of the Australian Dollar. Since SmartPay reports its earnings in New Zealand Dollars, the deprecation of the Australian Dollar that we are expecting would have a negative impact on revenue generated in Australia from a total earnings perspective. It remains to be seen to what extent the Australian Dollar does actually depreciate, though.

Despite this risk to our investment thesis, we believe SmartPay is set for a strong FY21 result. The company's Australian transacting terminal numbers reported during 2QY21 represent a strong leading indicator for 2HY21's transaction processing results, in our view. When all is said and done, we believe the company is currently undervalued by the market and therefore, we are issuing a four-star rating at this time.

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Back in March of this year the team that brings you Stocks Down Under released a Special Report on ASX-listed companies involved in the cannabis and hemp space. The report, which we commend to you, got a lot of attention, with orders of magnitude more 'likes' on social media platforms than we ordinarily receive. Why? Well, in the last five years or so, investors have figured out that a great boom is coming – the Cannabis Boom. It will be like the boom the drinks companies enjoyed following the end of Prohibition in America back in the 1930s, only it'll be a whole lot bigger. Not only will recreational cannabis, as it legalises, address a market it never had before, there is already a serious and legalised medicinal aspect to cannabis in place that alcohol never had.

The thing about the cannabis plant is that it is loaded with over a hundred compounds called 'cannabinoids' that have no psychoactive properties, but that seem to work across a range of disease conditions when sampled clinically. If you've heard of 'CBD' being administered to patients, you'll get what we're talking about. CBD is 'cannabidiol', the most important of the cannabinoids, and in the early stages of the Cannabis Boom a whole bunch of companies have started up aiming to develop and market CBD-based medicines. Incannex Healthcare, known as Impression Healthcare until July of this year, is one such company.

A serious prescription-only pipeline

Incannex is partly the brainchild of Dr. Sud Agarwal, an anaesthetist who several years ago realised there were vast opportunities waiting for physicians who could successfully link patients with cannabis medicines that had been studied in the clinic and approved by regulators just as if they were any other drug compound. Incannex already had a suite of CBD-based products that it sold on the Australian medicinal cannabis market, which now garners a few million a year in revenue. Agarwal and his colleagues proceeded to develop a pipeline of cannabis-based drug candidates that Incannex is now shepherding through the standard drug development process. There are currently four programmes being worked on, in Obstructive Sleep Apnoea (OSA), Traumatic Brain Injury, sepsis-associated Acute Respiratory Distress Syndrome and Temporomandibular Joint Disorder.

The OSA indication is particularly interesting. In OSA, a person's breathing either stops (apnea) or is severely restricted (hypopnea) multiple times during sleep, as a result of weakness in the upper airway. OSA will kill you if left untreated because of the damage from low blood oxygen levels. And there's a heck of a lot of OSA out there – maybe 30 million in the United States alone. Now you know why ResMed (NYSE: RMD), the CPAP equipment maker, did US$3bn in revenue in FY20 and is currently capitalised at US$31bn.

Incannex is a sleeper

Who would have thought that little Incannex has a cannabis-based product that may address the same market ResMed serves? Incannex's IHL-42X product is based on Dronabinol, a synthetic cannabis product. There is clinical evidence showing that Dronabinol can significantly reduce the level of apnea/hypopnea in OSA, including a Phase 2 study results of which were published in January 2018 in a journal called Sleep. Incannex is now getting set to run its own Phase 2 and recently received ethics approval. Science is still figuring out how cannabis-based medicine would work in OSA but the basic thinking is that the drug acts on pathways in the nervous system that control various cardio-respiratory functions. One thing we can be sure of is that compliance with a drug is likely to be a heck of a lot better than compliance with CPAP, which a lot of patients have decided is just too uncomfortable to be worth the trouble.

Meanwhile there's also potential for another Incannex product called IHL-675A to be useful in Acute Respiratory Distress Syndrome (ARDS), the immune system storm that happens in, among other conditions, Covid-19 infections. Incannex announced in April 2020 that it had combined CBD and hydroxychloroquine – the drug everyone has been talking about - as a potential treatment for sepsis-related ARDS. This move was driven in part by early evidence that the combination may have utility in the respiratory distress associated with Covid-19 infections. Last week Incannex reported in vitro data showing that the combination was particularly powerful and in vivo work to confirm this is planned.

Cannabis is back in favour

Incannex stock has done well since the Corona Crash low of 2.9 cents, more than tripling between then and the 9.5 cent high of mid-October. Part of the recovery has just been the return to favour of cannabis in Canada and elsewhere, after an 18-month bear patch, as investors recognise that cannabis medicine is mainstreaming.

But part of Incannex's recovery has also been acknowledgement of the fact that this drug developer has some serious science behind it and the market opportunities are in the billions. With plenty of pre-clinical and clinical data still to come, we see further upside from here. Four stars.

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Share price chart

Source: Tradingview

Cleaning up the B2B mess

Cirralto offers a suite of Software as a Service (SaaS) products that focus on increasing efficiency, accuracy, and clarity for businesses' data sharing and business-to-business (B2B) transactions. The company currently operates six different software products covering areas like group and batch payments, Point of Sale systems, business overview platforms, and cloud-based data management.

Operations took a sizable hit during FY20, declining 49% to $341,332. However, the company did launch its new payment platform during April 2020 and therefore, the platforms results were only partially incorporated into FY20's results.

There's a lot wrong with this company

The company boasted 396% average revenue per user (ARPU) growth between April 2020 and August 2020 following the launch of its payment platform. Keep in mind that this 396% increase was from a low base of around $17 to about $52. Additionally, total gross processed customer payments remained under $4m in total through the end of September 2020, which is still very low.

The company has no significant intellectual property of its own and with revenues of $341,332 and around $7.3m in losses during FY20 that are showing no signs of any significant turnaround, we believe the long-term value of the company might be close to $0. While the company does not currently have negative equity from a balance sheet perspective, this is because management has created a cycle of issuing debt and then paying it off later with equity issuance.

We also believe it is important to note that Cirralto paid $1.3m and $1.4m in employee and directors' benefit expense during FY20 and FY19 respectively despite the company's continually worsening financial results. We have not seen any realist road map to profitably from management and we believe this is because there truly is none.

Insolvency risk dead ahead!

In addition to Cirralto's 7.4m in net losses during FY20, the company ended the period with a balance sheet that is in serious trouble, in our view. In order to keep operating, the company had to issue both additional shares and $3m in convertible debt during FY20. It is important to note this is a change from FY19's strategy of just issuing pure equity to stay afloat. The company currently has $1.9m in cash and while this may seem positive, the company was forced to issue $5.2m in additional capital to pay off maturing debt and to continue operations. We don't see any clear path out of the company's current cycle of issuing debt and equity, unless it can somehow, magically start generating substantially higher revenues and drive down its losses.

You are the weakest link

For those not familiar with the reference, the Weakest Link was a popular game show in the United States whose catchphrase was 'you are the weakest link, goodbye.' Unfortunately, we are reminded of this phrase when we look at Cirralto.

In our opinion the company has almost no chance of removing itself from its current cycle of equity funded operations until it fully calls it quits and declares bankruptcy. Unfortunately for shareholders, we do not believe the company has any significant assets that can be liquidated, certainly not in the $57m range. We believe purchasing this company will achieve shareholders nothing but further funding the company's executive payouts of over $1m a year.

So why a 3-star rating?

However, despite all of this we have opted for a three-star rating for Cirralto. While we are of the strong opinion that this company has a true value close to $0, it has an extremely high number of shares on issue and is priced at a level that attracts speculators in droves. Both have led to very high liquidity in the stock, which has made it a punter's Valhalla. In other words, there's no saying what the stock will do in the short term although fundamentally we wouldn't touch it with a ten-foot pole.

Therefore, we have opted for a three-star rating at this time with a strong "avoid" notice attached.

Pitt Street Research Pty Ltd

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