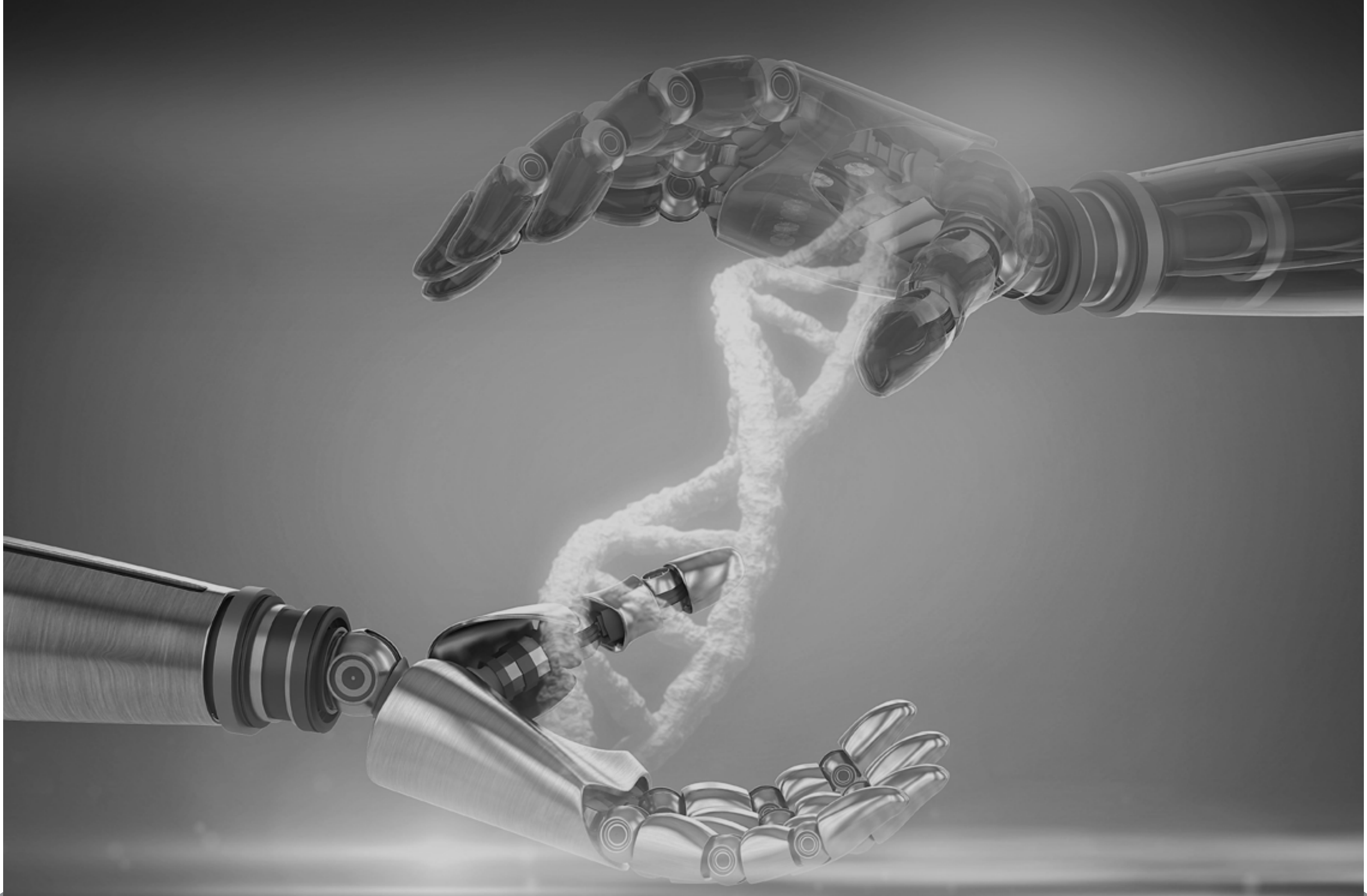
STOCKS DOWN UNDER

29 DECEMBER 2020

Emerging Stocks Down Under

> *"The irony of life is that those who wear masks often tell us more truths than those with open faces."*
>
> \- Marie Lu (b. 1984), American author



CLEANSPACE HOLDINGS

Don't go cleaning your portfolio

AUSCANN GROUP

Phase 2 from 2021

VOLPARA HEALTH TECHNOLOGIES

Showing the importance of data in digital health

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Stocks Down Under rating: ★★

ASX: CSX
Market cap: A$ 505M

52-week range: A$5.41 / A$7.44
Share price: A$ 6.55

Headquartered in the Sydney suburb of Artarmon, CleanSpace Holdings designs, develops and sells masks and respirators for both healthcare and industrial purposes. The company took full advantage of the markets demand for COVID-19 related healthcare stocks and listed on the ASX on 23 October 2020 at $4.41 per share. The stock rallied hard on its first day ending up 69% higher at $7.44, but it has since declined to $6.55. Despite the continued advancement of COVID-19, we think this stock has gotten far ahead of itself.

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Stocks Down Under rating: ★★★★

ASX: AC8
Market cap: A$ 57.1M

52-week range: A$0.125 / A$0.385
Share price: A$ 0.18

Like every other listed stock on ASX, the Perth-based medicinal cannabis company AusCann was pummelled through the Corona Crash, falling from 28 cents on 21 February 2020 to 15 cents by 23 March. The general market recovered after late March. For AusCann you had to wait another eight months or so, until 3 December, for the recovery, but we think it will be a solid one.

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Share price chart

Source: Tradingview

The business of face coverings

CleanSpace designs, produces and sells masks and resperators to the healthcare and industrial industries. Unfortunately, the company does not breakout the sales difference between these two industries in either its prospectus or annual reports. The only indication of the sales split we have came from a 12 November 2020 market update stating that 1HY21 sales mix had so far been 77% healthcare and 23% industrial.

The company generated its first EBITDA profit during FY20, growing it from a $1m loss during FY19 to an EBITDA profit of $6.2m. In its prospectus the company projected a 1HY21 EBITDA profit of $13.4m. While we are optimistic about CleanSpace’s growth during 1HY21 and CY21, we are concerned that the company will see significant reversals once global COVID-19 masks and respirator demand drops. It seems likely to us that this will cause a glut in the healthcare sector’s respirator stockpiles and despite management’s projections that industrial sales will grow around 30% once the world economy is back on track, we doubt this will cover the drop in sales.

During FY20, CleanSpace had two other sources of income, $200,000 in COVID-19 related grants and a $776,893 research and development tax incentive from the Australian government. It is unclear if the COVID-19 related grants will occur again. However, we think it's unlikely. We believe we will see the research and development tax incentive again this year as the Australian government has doubled down on this program as part of its COVID-19 recovery plan with broad industry and political support.

How are those projections looking?

On 12 November 2020, management issued a trading update to the market increasing its 1HY21 revenue and EBITDA target to between $34m - $36m and $14m - $16m, respectively. This would result in an increase of around 7% in EBITDA margin to 44% versus the prospectus estimate of 37% for 1HY21. The company has also announced that it is on-track to increase its maximum production capacity to $100m per year by 31 December 2020. It certainly seems to us that the prospectus estimates were overly cautious.

What about the vaccine?

Unless you have been living under a rock this last month, it has been impossible not to hear about the multiple approvals around the world of vaccines and the subsequent rollouts. While this is a significant milestone, and we don't want to downplay this, we would advise investors to hold their horses. A full world-wide rollout will take a long time and it is still uncertain for exactly how long one vaccination will last. Overall, though, the vaccine rollouts are a significant step towards not needing a continual massive supply of respirators. However, we are nowhere near the finish line. We believe demand will continue throughout CY21.

Don't start making space just yet

We believe CleanSpace is a solid company and a welcome addition to the ASX. The company has, what we believe is, a pretty clean balance sheet with $6.7m in cash and only $4.8m in current and non-current borrowings as of 30 June 2020. However, we are concerned about the company's FY22 and FY23 revenue and EBITDA growth since we believe it is likely that this is when respirator and mask demand from the healthcare sector will really take a dive as COVID-19 comes under control globally.

The market is currently expecting FY21 to see $33m in EBITDA for CleanSpace, but then sees EBITDA decline during FY22 and FY23 to $24m and $21m, respectively. As we mentioned above, despite the likelihood of strong demand from the industrial sector once the world gets back on track, we believe that there will be a considerable overall demand lag once the bottom drops out of demand from the healthcare sector.

Therefore, we believe the FY21 EV/EBITDA ratio of 15.2x is too high. Despite the strong year we expect CleanSpace to have during FY21, the rocky road ahead leads us to believe an FY21 EV/EBITDA ratio of between 10x - 13x would be more within reason. This would equal a share price of around $3.55 - $4.60. Its two stars from us.

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Source: Tradingview

Time was when cannabis-based medicine was practised by shifty-looking guys in back alleys who hustled up the supposedly good stuff in a hurry and didn't need to know what they were 'prescribing' it for. In 2020, by sharp contrast, cannabis is rapidly growing in respectability. It's more-or-less legal for medical use in most jurisdictions around the world, albeit with some restrictions in many places. We know so much these days about the sort of conditions it helps. And now there's a multitude of public and private companies working on getting the best kinds of products onto the market for the benefit of patients. One of them is the Perth-based AusCann, ASX-listed since early 2017.

The regulators like cannabis

Companies like AusCann will never lack for potential indications to work on. For a long time now cannabis has been favoured for its pain-killing properties and for its ability to deal with the nausea and vomiting induced by chemotherapy. These are both huge market opportunities. No doubt you've seen stories on television of children with severe forms of epilepsy that have been helped by cannabis. Then there's a multitude of other conditions such as spasticity, anorexia and wasting associated with chronic illness, sleep apnea, Parkinson's and so on. The list is almost endless, and most of the therapeutic effect comes from 'cannabidiol' or CBD, which, unlike delta-9 tetrahydrocannabinol or THC, is not psychoactive. No wonder, then, that on 2 December the United Nations' Commission on Narcotic Drugs voted to reclassify cannabis, taking it off the strict Schedule IV list that includes dangerous and highly addictive drugs, such as heroin.

Not only are the market opportunities for cannabis significant, the Australian government has made it relatively easy for companies to bring products to market. Cannabis was rescheduled here in 2016 and through a Special Access Scheme doctors routinely make requests to the TGA – The Therapeutic Goods Administration, Australia's answer to the FDA – for patients to go on unapproved cannabis-based medicines. Back in September 2018 the TGA gave the tick to 237 such requests. By November 2020 the number had grown to 6,356.

In December 2020 the TGA has gone one step further, amending the classification of CBD from Schedule 4 to Schedule 3, allowing them to be obtained over-the-counter through pharmacies without the requirement of a prescription.

No need to inhale this product

Which brings us back to AusCann. Think of this company as a prescription drug developer, like many another Life Sciences company on ASX, Nasdaq, TSX etc., but where the products in the pipeline are based on cannabis. The company doesn't grow and harvest the plant and it doesn't even manufacture the medicines. Most of what it does is design the products and conduct clinical studies. Once it has approved products, it will then sell these to the clinics.

In December 2019 AusCann announced that it was ready for the clinic with its first product, a CBD-based hard-shell capsule. Doubtless you've swallowed a hard-shell capsule in your life at some point – they are the ones that look like a small thermos flask with rounded ends and the lower half of the flask inserted into the slight wider upper half. Medicines are often delivered in hard shell capsules because they're easy to formulate that way and therefore help get the right concentrations into the bloodstream.

Earlier this year AusCann ran a Phase 1 study of its hard-shell CBD capsule in healthy volunteers, which showed that the CBD showed up in the bloodstream at lower concentrations than a widely used comparator, but lasted longer. Around the middle of 2021 AusCann will move to a Phase 2a study in chronic neuropathic pain. The commercial opportunity for hard shell CBD is strong because there's a lot of neuropathic pain out there and tablets and capsules are the easiest ways to get the drugs to patients.

Now going into animal therapeutics as well

In early 2021 AusCann will extend its market reach into the veterinary area once a merger with CannPal Animal Therapeutics (ASX: CP1) closes. An all-scrip deal announced in November valued that company at only $17.5m. We think the upside here for AusCann is strong because before CannPal no company had really taken cannabis-based medicine for companion animals seriously. And CannPal now has some solid scientific evidence on the clinical utility of its products.

AusCann stock declined for a long time before a recent re-rating in early December. It was $1.85 in January 2018, back when cannabis stocks were in favour, but by November 2020 it was down to 12.5 cents. We think investors got tired of waiting for the big money to just roll in, forgetting that drug development is a time-consuming exercise. However, with AusCann's lead human therapeutic now developed and moving into Phase 2 and the company now set to grow a range of animal health products, we believe 2021 can be a better year.

AusCann is well funded for the next stage, holding $16.8m cash as at September 2020. And the market environment is even more favourable thanks to the recent UN pronouncement and our TGA's favourable regulatory changes. This stock is four stars in our book.

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Share price chart

Source: Tradingview

Prevention is key for Volpara

Volpara's most recent announcement is a major contract renewal with US Radiology Group for a five-year upgrade to the company's Volpara Breast Health Platform. The platform, which includes the company's own clinically validated breast density screening software, will deliver on-site testing and greater personalised information on breast density. The announcement is a blessing for the company in what has been a downer year, with Volpara's share price sliding even lower on the news to $1.31 – a clear difference from its pre-pandemic level of $1.90.

Using research originally developed at Oxford by the company's founder, Dr. Ralph Highnam, Volpara's platform technology uses data and artificial intelligence algorithms to improve the early detection and diagnosis of breast cancer, with a focus on measuring breast density. While mammograms are largely effective, a higher level of fatty tissue can make early detection more difficult as fat can obscure the tumour in conventional testing. Which is why Volpara has developed software that objectively measures and compares breast composition based on previous screenings.

While it sounds clinical on paper, Volpara highlights the fact that many patients have little understanding of density as a risk factor with many clinicians not obligated to inform women of their breast density levels, leading to higher risk of cases missed at first screening. As the company continues to develop software, which (through a mix of Artificial Intelligence and physics) can capture the nuance of each case by examining existing data, Volpara is aiming for quicker on-site density assessments and more informative personalised care.

Digital health diagnostics go beyond COVID-19

This new five-year deal in the US is more than good fortune, it's also a sign of Volpara's growth. The company has seen significant Q2 sales growth with Volpara's software now covering 27% of US screening services. But even with that growth, the pandemic has forced Volpara to change its medical marketing strategy to a more digital marketing strategy, which is designed to target more women online and drive use of the company's testing sites without the availability of face-to-face appointments. Volpara already has a certain digital advantage in that the majority of its software is subscription-based, so a more educational and direct approach seems to have been a good choice if the new US Radiology deal is anything to go by.

The Volpara Breast Health Platform in itself is a milestone for the company in that it marks a change in direction from single-use product sales to the integrated use of Volpara's full platform, which is designed to focus on tracking and personalised care beyond the initial screening. The company's takeover of MRS in 2019, which brought the company additional screening software, is part of Volpara's broader strategy to install testing sites in clinics and hospitals in the US and globally. And if the company's digital strategy pays off, investors might see further M&A activity and partnerships down the track. Volpara recently partnered with University of Sydney start-up Detect-ED to train clinicians in online breast density training, a move which could potentially propel Volpara's brand a lot further.

A busy future despite a hard year

Not surprisingly, the company announced a half-year loss of NZ$8.9 – on the back of marketing costs and a lower number of mammograms performed in the US – but conversely its revenue was up 38% to NZ$9.5m. The increase in revenue can be put down to the company's transition to SaaS subscription services over direct sales, with increased APRU (average revenue per user) accounting for greater platform sales instead of one product.

With its footprint growing in the US market, Volpara's merger with MRS Systems in 2019 gave the company another avenue in lung imaging. While lung cancer screening doesn't have the same commonality as breast cancer screening, the potential is there: lung cancer is still the leading cause of death making up 25% of all cancers. And although those cases are declining due to fewer people smoking, breast cancer remains commonplace with 13% of women diagnosed each year.

We believe Volpara is on the right track not just in terms of profit but also its health mission. Likely many medtechs, changing its digital strategy, while costly, makes more sense in a post-COVID-19 future. And as Volpara points out: COVID-19 will turn out be a blip where cancer is concerned. Four stars from the team at Stocks Down Under.

Pitt Street Research Pty Ltd

95 Pitt Street, Sydney, NSW 2000, Australia

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