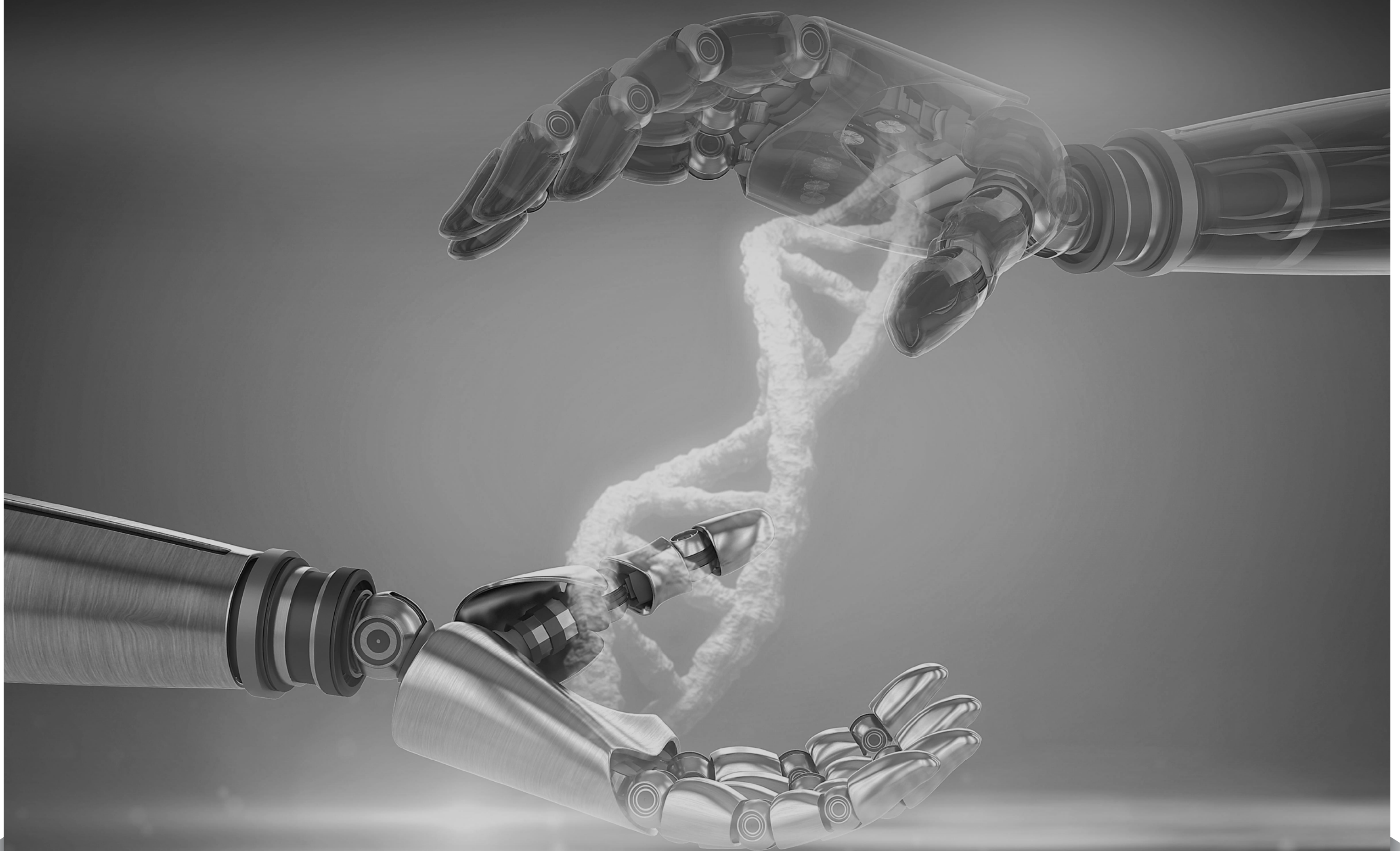
STOCKS DOWN UNDER

2 MARCH 2021

Emerging Stocks Down Under

"There is never a point in showing your hand before you have to; that is just a way to ensure giving the game away."

- Bruce Bueno De Mesquita (b. 1946), Political scientist and senior fellow at Stanford University's Hoover Institution



SILEX SYSTEMS

Combining lasers and uranium equals one hot stock

RECKON

No COVID-19 Reckoning

ADALTA

When the shark bites...

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Stocks Down Under rating: ★★★★

ASX: SLX
Market cap: A$ 207M

52-week range: A$0.17 / A$1.70
Share price: A$ 1.16

Headquartered in New South Wales' Lucas Heights Science and Technology Centre is a company working on commercialising an innovative laser enrichment technology. This technology works around the SILEX laser and is owned by the aptly named Silex Systems. While the company is looking to broaden its laser technology applications, the real story here is its ability to enrich uranium. With the uranium supply glut finally close to depleted, we think Silex's laser is prepared to enrich more than just uranium.

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Market cap: A$ 87M
Dividend yield: 3.9% (100% Franked)

52-week range: A$0.39 / A$0.91
Share price: A$0.75

In North Sydney, a reckoning is coming for investors' portfolios in the shape of business solutions and practice management software company Reckon. This company has a large suite of software products for accounting and legal practises. Despite the strength of the company's software portfolio, the market is estimating effectively flat growth for FY21. So, the question is, are the market's expectations in for a reckoning or does this company need a reckoning itself?

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Share price chart

Source: Tradingview

Uranium: Don't touch the glowing rocks

The atomic age first exploded onto the world with the drop of the Little Boy atomic bomb on the Japanese city of Hiroshima on 6 August 1945. This atomic weapon had a mass of 4,400 kg and a blast yield of 15 kilotons of TNT. Yet, despite, what we now consider to be, its lightweight destructive power, its blast set off a chain reaction that would lead to the rise and fall of countries, industries and world leaders in ways that nobody could have predicted.

One of the first obvious economic consequences of this blast was the founding of a worldwide uranium prospecting and mining industry. In 1954, the world's first nuclear power plant began generating electricity in Obninsk, a city in the former Soviet Union. Today, according to the International Energy Agency, nuclear energy accounts for 10.3% of the world's 25,606TWh of annual electricity generation. Unfortunately for the uranium mining industry, it acted just like the Little Boy, a quick, powerful flash followed by devastation.

Quite simply, the mining industry dug up far too much uranium far too quickly during the golden age of production, 1955 through 1980. Following the collapse of the Soviet Union, things worsened for the uranium industry as the world saw another massive source come on the market in the form of weapons-grade uranium. Basically, the world has been swimming in surplus uranium since the 1990s. However, the pool has

been shrinking over the last few decades and as recent as 2017, the World Nuclear Association estimated 85% of reactor fuel requirements came from direct mine output. With supply finally dwindling and the price on the rise, uranium mining seems to be on its way back.

Hold-up, where are my lasers?

“Silex is a laser company, not a uranium mining operation” we hear you say. Yes, that is true. But you can’t just dig uranium out of the ground and throw it in a nuclear reactor. This is where Silex’s laser technology comes in. The Separation of Isotopes by Laser Excitation (SILEX) technology was first developed in the 1990s by Dr. Goldsworthy and Dr. Struve in Sydney. To further develop the product towards full commercialisation, the SILEX laser technology was officially classified by the United States and Australian governments in 2001. Due to the nature of this technology, this is a normal and necessary step in nuclear technological development. However, this is also where things get a little complicated.

This technology was sold to General Electric (NYSE: GE) and Cameco who formed a joint venture, the Hitachi Global Laser Enrichment LLC, in 2006. Jumping forward to December 2019 and Silex signed an agreement between Cameco and GE-Hitachi to buyout GE from this technology to form a new joint venture. The new proposed split would be 51% owned by Silex and 49% by Cameco (increased from 29%). This acquisition was completed per 1 February 2021 following approval from the US Treasury Department and the US government’s Committee on Foreign Investment approval. So, Silex and its partners can finally get down to business.

Lasers are cool, but why use Silex?

Yes, we can probably all agree that lasers are cool, but why should we use them for uranium enrichment? While the exact process is obviously classified, we can tell you that it really comes down to efficiency. The process efficiency rating is a complicated name for what comes down to a rather simple concept, the amount of uranium enriched per unit of energy. The first generation of uranium enrichment technology was through gaseous diffusion, which had a high cost and a process efficiency rating of 1.004. The current technology in use is the centrifuge, which has an approximate process efficiency of 1.25. The Silex laser excitation process efficiency is currently classified, but the company has mentioned that the number is between 2 and 20. In other words, it operates at between 60% and 1,500% greater efficiency levels than the current centrifuge technology. Whether this technology operates at 60% or 1,500% greater efficiency is anybody’s guess, but we believe even 60% is a game-changer when it comes to costs.

The value is the technology

For all intents and purposes, Silex was re-launched on 1 February 2021 when the acquisition of the technology was completed. Our view is that over the next few years, uranium mining will become commercially viable again. All of this mined uranium will need enriching and from a cost and efficiency perspective, Silex’s technology has no current competition. The time is right and at $207m for 51% of this technology, we think it’s priced well within reason for the technology’s potential. It’s a nuclear four stars from us.

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Business, accountants and lawyers

Reckon's was started 30-years ago by its founder Greg Wilkinson in what is reminiscent of the 'classic' entrepreneur story, a maxed-out credit card and a loan against a car. Today, Reckon employs over 300 people with 600k businesses using its software while 14% of new Australian companies are registered using Reckon's software although this company only has a license to sell the software in New Zealand and Australia. The majority of this company's revenue (2020: 85%) is subscription-based revenue from its software products. The other 15% is split between other revenue (2020: 14.6%) and its business loans operation, Reckon Loans (2020: 0.4%). We won't be discussing Reckon Loans any further because even during 2019, this division only generated 1% of annual revenue.

Software, software and more software

Reckon's software portfolio can easily be broken down into two overarching divisions: business solutions and practice management. Business solutions has a broad range of offerings from small and large online accounting software, point of sale software, payroll and superannuation management software, and personal

finance software, to name a few. In total, business solutions offer clients a portfolio of eight software products to meet their needs.

The practice management software has four product offerings that allow accountants and lawyers to not only manage their firms, but complete their work more efficiently. To name a few of the things this software allows Reckon's clients to do: compile and lodge tax returns, register new companies and manage expense accounts. Reckon's practice management software offerings are fairly comprehensive and it does not surprise us how frequently it is used in Australia.

COVID who?

We finally did it! We found a company that was completely unaffected by COVID-19, either positively or negatively. Looking at Reckon's software portfolio, we have to admit we are quite surprised. The truth is, location is not truly an obstacle to use the majority of Reckon's products. Therefore, the transition to working from home was less of a transition than many people think.

Two areas did surprise and impress us. The first is the lack of a significant increase in doubtful debts during this period. Reckon generated revenue of $75.6m during FY20 and its business group division ($38.6m in revenues in FY20) focuses on small business. Despite this, provisions for doubtful debts were only increased by $600k. We believe this is a concrete example of the resilience of Reckon's business.

The other thing that surprised us was the location-based nature of Reckon's practice management software offerings. During the pandemic, many accounting and law firms in Australia, where the majority of the company's revenue is derived from, were forced to lay off a large number of employees and have only recently started to rehire them. Additionally, this software has access to a lot of confidential client information. Many firms wouldn't have even considered allowing employees to access it at home. The lack of serious confidentiality issues arising with these products indicates to us the versatility of Reckon's practise management software and the importance its customers place on it.

Not stagflation, stagnation

When we did our first scan of Reckon's 2020, 2019 and 2018 results, the first thing that came to mind was stagnation. Reckon's revenue has barely moved over the last three years, generating $75.6m during 2020, $75.4m for 2019 and $75.4m during 2018. On top of this, EBITDA has barely moved either during these same periods, with the company reporting $14.6m for 2020, $13.1m for 2019, and $14m for 2018. At Stocks Down Under, though, we don't just do a quick glance. We do a deep dive. Here's what is really going on.

It turns out that the business solutions division has been experiencing growth. During 2020 it saw revenue grow 6.5% year-over-year to $38.6m, while EBITDA grew 13% year-over-year to $19.8m. While the practice management division had revenue stay relatively flat at $37m for 2020, EBITDA dropped 5% to $15.6m. This decline can be traced back specifically to the legal side of the practice management software division. Law firms were reportedly hit harder than accounting firms, but now that both are rehiring, we expect this result to improve during 2021.

Reckon is not a widely covered company. With the Australian economy recovering quicker than many expected, we think the current 2021 EBITDA estimate of 0% year-over-year growth is likely to be too conservative. While we are not issuing a specific prediction, we believe the decline in the practice software side of the business is unlikely to reoccur during 2021. Therefore, we believe Reckon is likely to post positive EBITDA growth on a year-over-year basis. With FY21 and FY23's EV/EBITDA ratios under 4x (3.8x and 3.5x), we believe this company is being strongly underestimated by the market and therefore, it's a four-star rating for us.

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Share price chart

Source: Tradingview

If you've been around the Life Sciences scene for a while you will doubtless have heard of 'monoclonal antibodies'. These are a drug class pioneered in the late 1990s and today worth more than US$100bn annually. Antibodies are powerful in a therapeutic sense because of the exquisite way in which they can hit the target they are designed to reach. The development of the antibody as a drug resulted in Nobel Prizes in the 1980s and in commercial fortunes for the early start-ups in the 1990s and 2000s. However, monoclonal antibodies are getting a bit old-hat these days. The race is now on to find antibody-like drugs that are a lot smaller and therefore even better at hitting targets of interest. A Melbourne-based company called AdAlta believes that it is a contender.

Sharking in on a hot i-body

AdAlta's version of the small, targeted protein drug is called the 'i-body'. The original idea came from sharks. Those fearsome sea creatures are famous in the biology world for having antibodies with really long arms. AdAlta's i-bodies take the long loops from shark antibodies and combine them with a small human protein 'scaffold'. The result is a drug that is a fraction of the size of a conventional monoclonal antibody (like, 90% smaller), but with much better targeting ability because the loops can reach where a conventional antibody's can't. They are also likely to be cheaper to make and easier to administer.

How is AdAlta going to join in the gold rush that is forming around next-generation antibodies? Well, that brings us to a little bit more science and then we can get on with the fun money-making stuff. Next time you talk to a medicinal chemist, ask what kind of target he or she would really like to drug. The answer will likely be 'G-Protein Coupled Receptors', known in the trade as 'GPCRs'. A lot of drugs on the market today act on GPCRs, but those kind of receptors are notoriously difficult to work with. A few years ago, AdAlta realised that their i-bodies were good at drugging GPCRs. The company set out to build a pipeline of i-body drugs that worked that way, with a view to mimicking a company like Receptos, which ultimately got bought by Celgene in 2015 for a cool US$7.2bn.

Replacing a good drug with a better one

AdAlta's lead candidate in that effort, at the beginning of its listed life in 2016, was AD-114, targeting a GPCR called CXCR4. With AD-114 AdAlta reckoned it had the Next Big Thing in a rare lung condition called Idiopathic Pulmonary Fibrosis. There were drugs out there to treat IPF and a multi-billion dollar market was developing, but those drugs weren't great. AdAlta reckoned that AD-114, by choking off the flow of fibrotic cells to the lung, would not only provide a better alternative, but also prove that i-bodies were great drugs. There was, however, a minor problem if you could call it that. In 2018 AdAlta replaced AD-114 with AD-214. The latter candidate had much longer half-life and enhanced activity in the animal models, but the change meant that AdAlta wasn't in the clinic until July 2020.

That milestone has renewed investor interest in AdAlta. Sure, AdAlta's initial Phase 1 study has only recruited healthy volunteers so far, but the drug has yielded an interesting surprise. On 14 December AdAlta was able to announce that not only was its drug safe, but that 'receptor occupancy' was higher than expected. Which is to say, AD-214 was hitting CXCR4 better and longer than the animal data had initially suggested. That means that, potentially, less dosing of the drug may be required in the future, which could give it a competitive advantage.

To explore this further, the healthy volunteer part of Phase 1 is being extended. Later this year AD-114 will be administered to patients with IPF and a related condition called Interstitial Lung Disease (ILD), in 'single ascending' (SAD) and 'multiple ascending' (MAD) studies. In a MAD study, patients receive multiple doses of the drug, whereas subjects in a SAD study receive only one dose of the study drug.

Caring for an Orphan

AD-214 was recently granted Orphan Drug status by the US FDA for the treatment of IPF. An 'Orphan' drug is one that treats only a small patient population and Orphan Drug status compensates for this by providing certain regulatory benefits to the drug developer. It also enhances the prestige of the developer with investors because these days a lot of Orphan drugs ultimately sell for very high prices.

We think 2021 will be a good year for AdAlta. The company can now confidently say that i-bodies are viable drug candidates and that it has a good one in the Orphan drug space and in the clinic. With data from IPD and ILD patients coming soon and a pipeline of i-body drug candidates emerging, mainly targeted at fibrotic diseases, we think this stock is worth looking at. If you want to learn more, there's some great issuer-sponsored research available on the web site of our sister company Pitt Street Research. AdAlta is a four-star stock in our book.

Pitt Street Research Pty Ltd

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