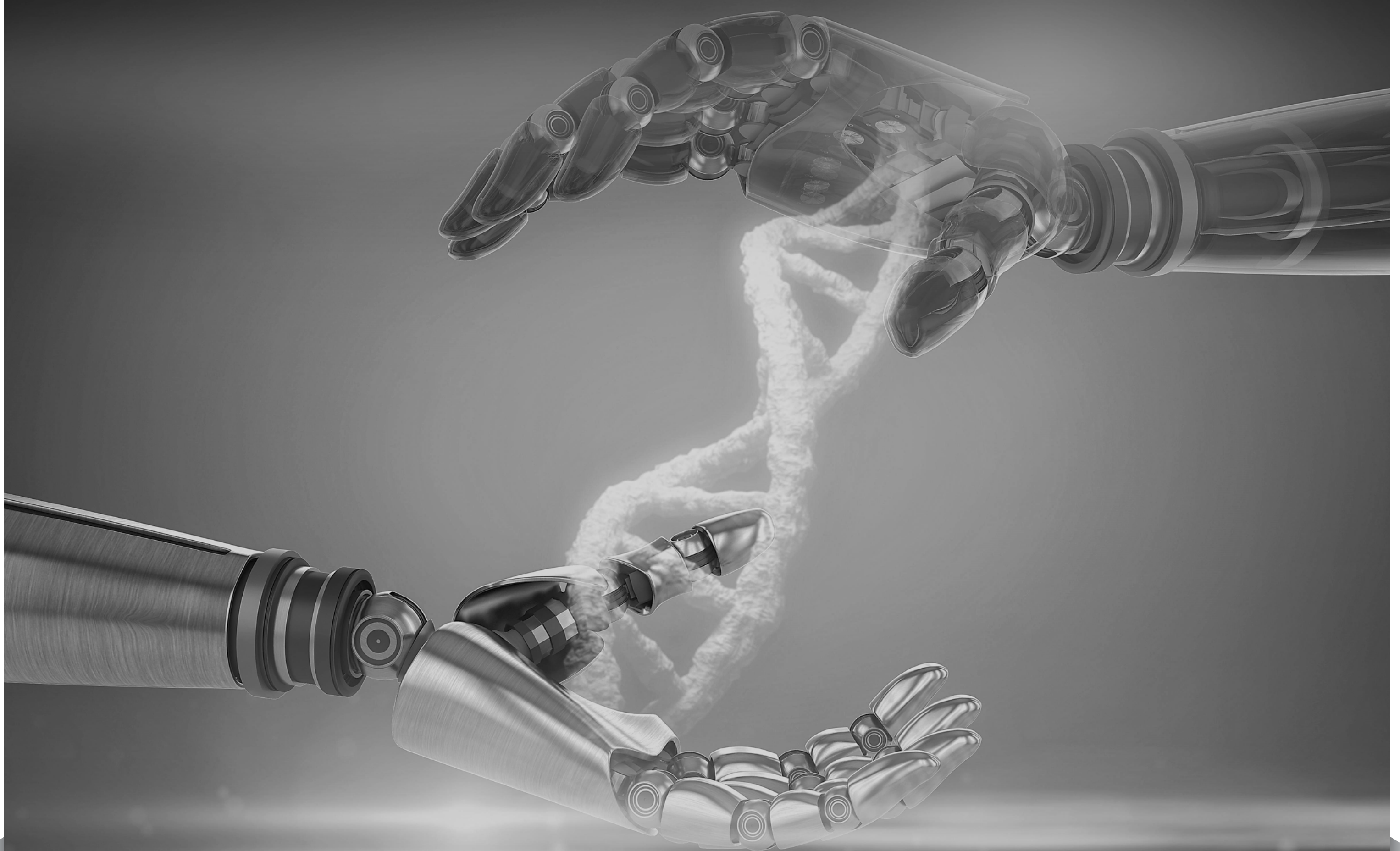
STOCKS DOWN UNDER

16 MARCH 2021

Emerging Stocks Down Under

“I’m not the smartest fellow in the world, but I can sure pick smart colleagues.”

- Franklin D. Roosevelt (1933 – 1941), 32nd president of the United States



CYCLOPHARM

USA bound

READYTECH

Ready, tech, go!

WEBCENTRAL GROUP

Web history, evolving

CYCLOPHARM

USA bound

Stocks Down Under rating: ★★★★

ASX: CYC
Market cap: A$ 223M

52-week range: A$0.70 / A$3.45
Share price: A$ 2.55

Headquartered in Kingsgrove, New South Wales, is a company on a mission to improve lung imaging safety. When imaging the lungs for, say, a pulmonary embolism, the patient inhales a gasified, radioactive compound that expands through the pathways of the lung, allowing a gamma camera to create an image of the lung. Cyclopharm's product Technegas is believed by management to offer not only a less damaging, but a more effective alternative radioactive compound. With all indications pointing to approval by the United States Food and Drug Administration during 2Q21, things are looking up for Cyclopharm.

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ASX: RDY
Market cap: A$ 164M

52-week range: A$0.96 / A$2.18
Share price: A$ 1.70

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Share price chart

Source: Tradingview

The current landscape

Cyclopharm generated total revenue of $14.7m during FY20, an increase of 4.2% year-over-year. However, this company is still well within the research, development and growth stage and is not yet profitable. The lack of profitability is where Cyclopharm's headquarters in Australia comes into play. Australia has a unique research and development policy called the R&D Tax Incentive. In FY20 alone, Cyclopharm received a cash payment of $3.1m from the Australian Government, subsidising its research. While it is impossible to make an accurate guess as to what the company's future R&D credit will be, it is important to note that the Australian Government has doubled down on the credit as part of COVID-19's recovery.

The company generates revenue through three main product offerings: Technegas, Tehcnegas Generators and service contracts. The vast majority of revenue, 73%, is generated through the sale of the Technegas compound. Technegas is heated until it reaches its gaseous form, whereas the patient proceeds to breathe it in. The gas then moves through the lungs, allowing for a gamma camera to pick up its radioactive signature. The main selling point for Technegas is it gives the patient a much lower dose of radiation than current products. At the same time, the patient needs to take fewer breaths and the process allows for a full

3D image. Competing products often require extended periods of breathing and do not offer 3D imaging. Technegas is already for sale in 60 countries, including China, Russia and the EU.

During FY20, generator sales accounted for 17% of revenue. The generators are the machines that heat up the Technegas and allow the patient to breathe in its gaseous form. Service contracts are related to the upkeep and repair of the generators.

I love the smell of Technegas in the morning

At least, management hopes the United States is going to say that during 2Q21. The good news is that publically available information presents some strong indicators that approval is coming soon. In June 2020, 77 US-based Nuclear Medicine physicians wrote to the United States Food and Drug Administration requesting an expedited review for Technegas. More recently, 102 frontline healthcare professionals wrote a letter stating, “We ask the FDA to finalise the approval of the Technegas application with utmost expediency to bring this ventilation agent with the least likelihood of the spreading the virus to healthcare professionals supervising the performance of ventilation scintigraphy.”

So, when do we expect to have the FDA’s final answer? According to a 12 March 2021 release, the FDA has stated that it plans to complete the full review by 26 June 2021. Afterwards, assuming approval, Cyclopharm plans on sales commencing in the United States market immediately during 2H21. Despite the vaccine rollout in the United States, we do not believe this timetable will cause the company to miss out on COVID-19 related sales. The United States is unlikely to start seeing significant improvements in its COVID-19 numbers until at least the end of the year. With the available evidence of Technegas’ low risk of COVID-19 transmission to healthcare workers, we believe the company will see plenty of demand.

Hold up, what about the lag time due to the generators? We hear you, and Cyclopharm has already considered this. For a hospital, purchasing a generator can be a large, singular expense. In order to make the most out of COVID-19 sales, the company has announced that as soon as it gets FDA approval, the generators will be temporarily offered not for sale in the United States, but use under a service contract. This contract will allow the company to keep ownership of the generators while the hospital pays a much smaller fee for each use. Seeing as how Technegas compound sales generated 73% of Cyclopharm’s revenue during FY20, we believe this is a smart strategy to maximise Technegas sales.

Towards the promised land of the USA

The likelihood of Technegas’ approval in the United States is a significant boon to the future value of Cyclopharm. This would complete the company’s Technegas authorisation in all major markets, especially since this product has plenty of large-scale applications outside of a COVID-19 focused world. Cyclopharm estimates that the United States offers an immediate US$90m market opportunity if it can capture 480,000 of the total 600,000 nuclear medicine ventilation procedures each year. While there is no certainty that the company will, they do provide a cheaper, easier to use, safer and more effective product than what is currently available in the United States. With pending authorisation for United States use, we believe this could be the push Cyclopharm needs to become profitable. Four stars.

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What's in the tech?

ReadyTech generated $21.8m in revenue during 1HY21, resulting in $8.3m in EBITDA. So how exactly did the company generate 13.4% revenue growth and 0.5% EBITDA growth during 1HY21? ReadyTech earns revenue mainly through subscriptions from its three main software categories: education, workforce solutions and work pathways.

Education software is based around five separate product offerings covering digital credentials, student management, AI-based student analytics and AI-based student skill profiling and assortment. The education software products are currently used by 12 TAFE/universities, 1,300 private colleges, 10 private higher education organisations, 47 back-to-work organisations and one state government. With Australia's education system reopening during the 2HY21, we expect this division to start receiving much greater attention.

Workforce solutions provide employers with complete payroll, HR, recruitment and workforce analytics solutions. Work pathways' product offerings allow employers and recruiters to manage and analyse their employees and apprentice progress. Unfortunately, the workforce solutions and work pathways product offerings are not broken out into clients like the education products are. With the federal government currently placing a lot of focus on apprenticeships, we believe work pathways will likely see renewed interest in the coming years.

Entering the pit

The pit, in this case, is the world of local government, state government and justice department management. Many of these organisations worldwide and in Australia are looking to move over their databased and citizen-facing services to more sophisticated, cloud-based systems and ReadyTech wants a piece of the action. Management has determined that the best way to enter these markets is to acquire some readymade Intellectual Property by purchasing a company called Open Office.

We believe the Open Office acquisition can best be described as strategic. The company has been around for the last twenty years, so we are just going to focus on three of its most impressive aspects: current customer base, churn and Intellectual Property. As per ReadyTech's 1HY21 report, Open Office's software was used by 137 local governments in Australia and 16 courts and justice departments worldwide. While we have not used Open Office's software ourselves, it seems that it is more than adequate. How can we tell? Customer churn, or rather, the lack therof. Open Office's customer churn rate is shockingly low. The average length of its customer relationships is seven years and the current retention rate is 95%. With customer loyalty this strong, one can only surmise that its product is far greater than 'just adequate.'

This brings us to the third aspect: Intellectual Property. Open Office's cloud-based (and partially mobile) product suite covers asset and property management, licensing, compliance and environment, finance, HR, payroll, customer service management, 24/7 community engagement as well as court and justice system case management. Basically, Open Office is a one-stop shop for cloud-based software solutions for courts, justice departments and state and local government entities.

It's a director shopping spree!

ReadyTech's stock has not had a strong last couple of weeks. Since 15 February 2021, the share price has dropped from $2.05 to $1.70. The directors have been more than happy to take advantage of this price decline with a total of 572,312 shares being purchased (and none sold) between 18 February 2021 and 5 March 2021. This comes out to a daily average of 47,693 shares purchased by directors. When we compare this to the daily average volume across the last three months, we can see just how significant these purchases are. The daily average trading volume for the last three months has only been 80,000 shares. This is a rather significant portion of daily trading and confirms what we already believe, that this drop has offered a great buying opportunity and not just for ReadyTech's directors.

Ready, Tech, Invest!

The company currently expects FY21 revenue to grow in the mid-teens and EBITDA margins between 37% and 39%. However, this excludes the Open Office transaction. We believe the transaction is going to propel non-organic EBITDA growth significantly higher than this organic outlook projects. The market currently is expecting EBITDA, in total, to rise 19% during FY21 to $18.6m. This is based on an assumed EBITDA margin of 37% and revenue growth of 24% (including the acquisition). And this is exactly the reason directors have been buying the dip; the stock is currently valued at an FY21 EV/EBITDA ratio of only 8.2x, which represents an EV/EBITDA-to-EBITDA-growth ratio of only 0.44x, which is quite low.

ReadyTech has a strong product base and its acquisition of Open Office will only increase its potential client base. ReadyTech is still in its growth and development phase, but management has demonstrated that they can execute. With the current discount the stock is trading at, we believe it's a four star opportunity.

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Webcentral? More like web history

The internet. The modern world, seems inconceivable without it. However, the world wide web was only invented by Time Berners-Lee in 1990. Yes, node-to-node communication technology has existed since late 1969 when ARPAnet delivered the first message from one computer to another (UCLA to Stanford). The internet that we know today, featuring webpages, perfect up-time, etc., has only existed since 1990.

The Webcentral Group was one of the exalted few internet start-ups to survive the dot-com crash. The company came into being in 1996 with its original name, Melbourne IT. This start-up was one of the founding companies around the domains and hosting marketplace, with 300,000 Australian small businesses utilising its services since 1996. The company, like the internet, has seen significant evolution over the years. During the early 2000s, Melbourne IT acquired many of its Australian competitors: Netregistry, Domainz and WME.

Shortly after, Melbourne IT transformed into the Arq Group when it moved into the Enterprise Cloud business through its purchase of Infoready and Outware. The company's latest name change came in 2020 when the company divested its Enterprise BU, creating the organisation currently named Webcentral. Unfortunately, this company's evolution has not been without growing pains that have now led to a declining business situtation. What went wrong?

It’s always better to be aware of your issues

Before we dive in, let’s look at what Webcentral does exactly? The company’s operations can be broken out into five main divisions: domain, email, hosting, digital marketing and other income. The year 2018 was the last time Webcentral experienced revenue growth as it reached its revenue peak of $213m, growing 7.6% from 2017. Although the majority of the company’s 2019 drop in revenue to $83.6m was due to the sale of the enterprise business, trouble in the company had already reared its head. The company’s EBITDA, adjusted to exclude sold operations, declined 17% to $7.2m during the year and this loss accelerated with 2020 generating only $6.1m in EBITDA. What went so wrong? Yes, COVID-19 had an impact, of course, but the main reason was much worse: a poor customer experience.

A poor customer experience is just as harmful for a business as it sounds and in the case of Webcentral can be summarised in three main categories: support services, platform experience and technical stability. The company’s support services’ issues focus on the poor quality of its voice, chat and email support services, mainly around slow response times, forcing customers to call back repeatedly. Customers have been forced to deal with serious billing and job scheduling issues regarding the customer platform experience. The last issue is arguably the most significant. The technical stability of Webcentral’s network and cloud offerings has been far less than acceptable. In Webcentral’s business, reputation and reliability are everything as there is a large amount of competition for customers to transfer over to relatively easily. Management is confident that it can turn things around and has project 2021 EBITDA between $7m and $8m on the back of succesful cost and turnaround initiatives’. At least, that is the plan. However, the proof will be in the pudding and we remain sceptical of such a significant turnaround so quickly.

Some administrative matters (yay!)

Due to the declining, but still valuable nature of Webcentral’s operations, two companies have tried to acquire the organisation over the last year. The first to enter the fray was Web.com with an offer for $0.10 per share for 100% of outstanding shares. Management jumped on this offer. This deal seemed likely to close until Webcentral announced on 7 September 2020 that 5GN Networks had offered one 5GN share for every 12 Webcentral shares. On 12 September 2020, Webcentral’s board announced Web.com increased its offer to $0.155 per share. However, on 18 September 2020, Web.com retracted its offer after management decided to back 5GN.

After Web.com retracted its offer, 5GN was the de facto winner and, on 28 October 2020, acquired 50.7% of outstanding shares in Webcentral, meeting the 50.1% requirement for its takeover bid. However, there have been significant delays due to appeals to the Australian Government Takeovers Panel by Keybridge Capital to quash the takeover. The panel rejected the latest review on 26 February 2021, but unfortunately, Webcentral has not announced any time table or even confirmed that the acquisition of its remaining shares will commence. Based on 5GN’s current valuation of $1.23 per share, investors are looking at a value per Webcentral share of $0.103 if the acquisition goes through.

However, it seems some shareholders are expecting the takeover not to go through and the turnaround management has been discussing to be a foregone conclusion. The company is currently trading significantly above its current takeover price at $0.55 per share.

However, we would remind investors that even if they believe management and 2021 sees $8m in EBITDA, the company is still trading at a 2021 EV/EBITDA ratio of 15.6x. A lot is going on here and most of it is making us very warry. In summary, we do not believe the current value of Webcentral is warranted in any scenario and therefore, it’s a two star rating from us.

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