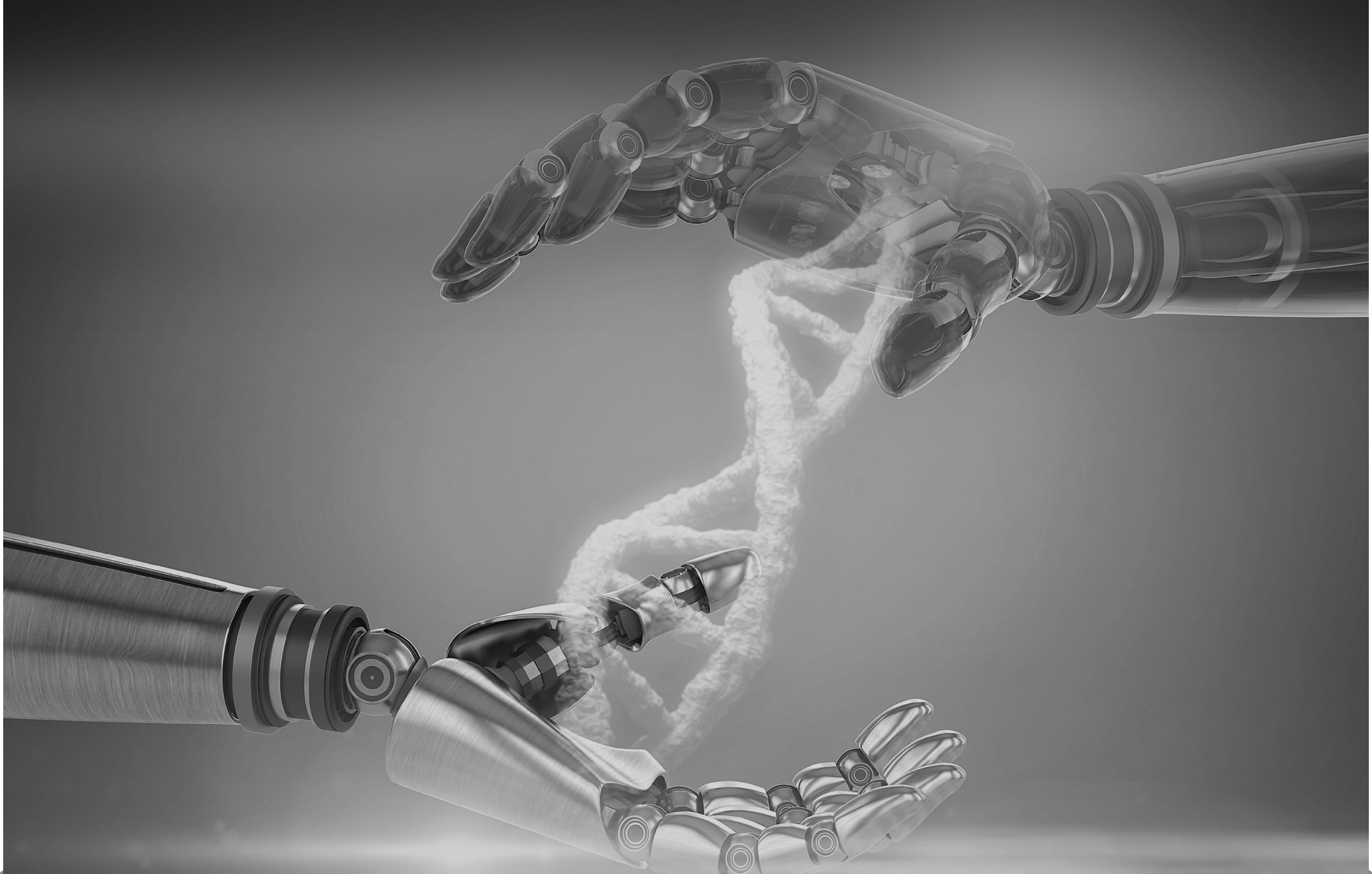
STOCKS DOWN UNDER

30 MARCH 2021

Emerging Stocks Down Under

"Without death, we'd be at a loss. It's the prospect of death that drives us to greatness."

- Hannibal Lecter (Hannibal), American TV series



SOMNOMED

Risk and low growth is not a good combination

5G NETWORKS

Not our kind of network

BUDDY TECHNOLOGIES

Not our buddy, yet

SOMNOMED

Risk and low growth is not a good combination

Stocks Down Under rating: ★★

ASX: SOM
Market cap: A$ 165M

52-week range: A$0.90 / A$2.58
Share price: A$ 2.02

Headquartered in Sydney, SomnoMed is an oral device manufacturer and developer with a stock chart that reminds us of a roller-coaster. This company has bounced between its 52-week low of $0.90 and a high of $2.58, mainly due to its extremely low average three-month daily volume of 30,000. The company's products focus on preventing teeth grinding and helping obstructive sleep apnoea, but the question remains, will owning this stock help you sleep better at night?

READ MORE

5G NETWORKS

Not our kind of network

Stocks Down Under rating: ★★

ASX: 5GN
Market cap: A$ 141M
Dividend yield: 0.8% (100% Franked)

52-week range: A$0.66 / A$2.44
Share price: A$ 1.20

For avid readers of Stocks Down Under, 5G Networks should be a recognisable name. We mentioned this company in our WebCentral article as 5G Networks is currently working to finalise a takeover of the company. 5G Networks' operations center around data facilities, cloud-based services, domain, website and email registration and management, and the operation of fibre and wireless infrastructure. The company's stock has had a rough go over the last six months, dropping approximately 27% to $1.24 per share. Is this an opportunity to buy or a time to duck and cover?

READ MORE

BUDDY TECHNOLOGIES

Not our buddy, yet

Stocks Down Under rating: ★★

ASX: BUD
Market cap: A$ 129M

52-week range: A$0.007 / A$0.10
Share price: A$ 0.04

Are you lonely? Do you need a buddy? Well, maybe you should move to Adelaide, where Buddy Technologies is headquartered. Buddy Technologies' business is cloud-based resource usage monitoring and consumption management equipment. The company's smart devices and its platform have two goals: reducing the world's carbon footprint and making the world's light bulbs smarter. A worthy goal, but with three billion existing shares outstanding, do you really need this kind of buddy?

READ MORE

SOMNOMED

Risk and low growth is not a good combination

Stocks Down Under rating: ★★

ASX: SOM
Market cap: A$ 165M

52-week range: A$0.90 / A$2.58
Share price: A$ 2.02

Headquartered in Sydney, SomnoMed is an oral device manufacturer and developer with a stock chart that reminds us of a roller-coaster. This company has bounced between its 52-week low of $0.90 and a high of $2.58, mainly due to its extremely low average three-month daily volume of 30,000. The company's products focus on preventing teeth grinding and helping obstructive sleep apnoea, but the question remains, will owning this stock help you sleep better at night?

Share price chart

Source: Tradingview

Sleep Apnoea is on the march

Sleep Apnoea is on the rise. In India alone, doctors have found that sleep-related disorders have increased 15-20% over the last year. This is according to a 13 March 2021 report published by the Indian Express. Sleep Apnoea is one of the main disorders reported in this rise and the pandemic has not made things any easier. You would think with people stuck at home they would be sleeping more, but it seems that it has either caused sleep issues or exposed pre-existing ones for many.

Obstructive Sleep Apnoea is one of the more common forms and occurs when the air passage becomes blocked. SomnoMed estimates that 9% of women and 25% of men suffer globally, with 400m people suffering from moderate and severe and 900m people from mild Obstructive Sleep Apnoea.

SomnoMed to the rescue!

SomnoMed believes they have found a way to help those suffering from Obstructive Sleep Apnoea and teeth grinding. The company has two main product types: SomnoBrux and SomnoDent.

SomnoBrux is a special mouthguard worn during sleep that, while not preventing teeth grinding, helps protect the teeth from damage. These products are only available in Australia currently through the company's network of specially trained dentists.

The main product is SomnoDent, currently used by 500,000 patients worldwide. The product was established in 2004 and currently offers four variants: flex, classic, fusion and Avant. The SomnoDent has completed 17 peer-reviewed clinical trials and prevents blockage of the airway while sleeping at the same time, allowing for eating, normal speaking and even drinking.

The second-largest portion of the company's revenue is currently generated in North America at $9.5m. However, this represents a 23% decline on a year-over-year basis. Unfortunately, 2Q21 saw a more significant decline than 1Q21, increasing to negative 29% from negative 14%. As North America generates 31% of SomnoMed's total revenue, this continual decline is concerning to us.

Europe generates the majority of the company's revenue at $18.6m, and saw a 2% year-over-year increase. In a similar vein, the Asian Pacific region saw a 1% increase in revenue after generating $2.7m during 1HY21. In total, this led to a 7% decline in revenue and a 7% decline in gross margin to $30.8m and $18.1m, respectively.

However, due to a 17% drop in regional sales and marketing expenses, EBITDA actually increased 7% year-over-year to $3.2m during 1HY21. Unfortunately, we don't view this EBITDA increase as a positive thing. Since it was solely due to cutting the marketing and sales budgets when revenue declined, we view this as both a non-repeatable action and a concerning metric for the future. Yes, COVID-19 has certainly caused sales staff to be forced to go virtual, and this has cut travel expenses, but we are not convinced COVID-19 can completely explain this result away.

Slow and steady wins the race

Yes, there seems to be a lot of demand emerging during COVID-19 lockdowns. However, this does not seem to have been realised yet during 1HY21. Due to a lack of company guidance, we are unclear if demand is expected to move up going forward. The market seems to think that demand won't accelerate during 2HY21. Full-year FY21 EBITDA is expected to reach $5.7m, or $2.5m during 2HY21. This would represent EBITDA growth of 22% year-over-year. Based on this estimation, FY22 EV/EBITDA is currently at 24.8x.

SomnoMed also suffers from low trading liquidity that we believe will, unfortunately, only become worse. Currently, the average three-month average daily volume traded was only 30,000 shares. Using yesterday's last price, that represents $57,300 value traded each day. Making matters worse, on 12 March 2021, S&P announced that SomnoMed's stock was removed from the All-Ordinaries index fund. We are concerned that this will cause the company's already low liquidity to dry up further.

Demand for products that help people with Obstructive Sleep Apnoea is on the rise and SomnoMed is certainly in a position to benefit from this. Unfortunately, it is unclear when or if they will. However, even assuming that they do, we don't believe its current EV/EBITDA valuation of 24.8x is a fair one given that EBITDA growth. Combining the liquidity risk and what we consider to be a rich valuation, it's a two-star rating from us.

5G NETWORKS

Not our kind of network

Stocks Down Under rating: ★★

ASX: 5GN
Market cap: A$ 141M
Dividend yield: 0.8% (100% Franked)

52-week range: A$0.66 / A$2.44
Share price: A$ 1.20

For avid readers of Stocks Down Under, 5G Networks should be a recognisable name. We mentioned this company in our WebCentral article as 5G Networks is currently working to finalise a takeover of the company. 5G Networks' operations center around data facilities, cloud-based services, domain, website and email registration and management, and the operation of fibre and wireless infrastructure. The company's stock has had a rough go over the last six months, dropping approximately 27% to $1.24 per share. Is this an opportunity to buy or a time to duck and cover?

Share price chart

Source: Tradingview

The internet of things

5G Networks' operations truly look like the embodiment of the 'Internet of Things.' For those not familiar with the concept, the 'Internet of Things' refers to the billions of physical devices around the world that are connected to the internet. It also refers to the ability of any device to be easily connected to the internet. The company has many operations covering cloud-based managed services and network services, the operation of fibre and wireless infrastructure, operation of data centre facilities, the supply and management of domain name registration, website and email development and hosting, and Search Engine Optimisation (SEO).

5G Networks' operations are broken down into two main divisions: data centres, networks, cloud and managed services. The majority of the company's $37.3m in 1HY21 revenue was generated by the data centre division, growing 22% year-over-year to account for 40.2% of total revenue. That all sounds great, but there's a catch. This 22% increase in revenue was driven by the division drastically expanded the number of servers it owns. This subsequently caused a 55% increase in the cost of goods sold. This is why we are worried about the company's revenue only growing 22%, especially since many employees were still working from home during 1HY21. In fact, this division's gross margin declined 3% year-over-year to $6.9m. We are concerned that if this division could not perform during COVID-19, it is unlikely to outperform in the future.

The managed services division is in a very similar boat as the data centre division. During 1HY21, revenue ($13m) and gross margins declined by $85,000 or 11.1% year-over-year, respectively. The strong decline in gross margins, compared to a relatively small decline in revenues, was due to the sharp increase in investment in this division by management during the year. Division assets increased 185% year-over-year to $44.2m through a combination of acquisitions and asset purchases. 1HY21 was really a transition period in Australia as offices began to slowly open up again. So, this division's poor performance during this period is a concern to us and we believe an indication of what we can expect going forward. Like the data centre division, we are bearish on this division's future performance.

The main attraction

As we mentioned before, we talked about 5G Networks in our article on the WebCentral Group as it has successfully 'acquired' the company. However, despite both WebCentral and 5G Networks agreeing that 5G Networks has control of the company, WebCentral Group is still trading on the ASX as it is unclear just when 5G Networks will finalise the acquisition of 100% of its shares.

This acquisition truly saved 5G Network's 1HY21 results. Without this acquisition, gross profit would have seen a decline of 7% year-over-year. However, now gross profit has increased 32% year-over-year to $19.4m during 1HY21. We strongly recommend you go to our vast archive for those interested in more information about the WebCentral Group and review our previous edition on this company.

However, in a nutshell, we are bearish on the WebCentral's prospects. The company has had some serious customer service and performance issues over the last couple of years, causing customer churn. 5G Networks clearly has its own operational problems and we are not sure that management will be able to fix WebCentral's problems. We view this acquisition as more of a patch for 5G Networks' faltering operations than a move to turnaround this failing business.

Valuation here is tricky

5G Networks' valuation seems highly attractive at a first brush glance because of the WebCentral acquisition. The market currently estimates FY21 year-over-year EBITDA growth at 140%. We must remember, however, that this growth is entirely due to this WebCentral acquisition. Without it, 5G Networks' EBITDA growth would be either slightly negative or flat for FY21. This is why the company is currently valued at an FY21 EV/EBITDA ratio of only 9x.

Our issue with 5GN stock is that we think the company's valuation itself is still too high given the uncertainty surrounding the timeline of the acquisition, the company's own performance issues and our bearish outlook on WebCentral's future performance. We remain bearish on 5G Networks' outlook and, therefore, its two stars from us.

BUDDY TECHNOLOGIES

Not our buddy, yet

Stocks Down Under rating: ★★

ASX: BUD
Market cap: A$ 129M

52-week range: A$0.007 / A$0.10
Share price: A$ 0.04

Are you lonely? Do you need a buddy? Well, maybe you should move to Adelaide, where Buddy Technologies is headquartered. Buddy Technologies' business is cloud-based resource usage monitoring and consumption management equipment. The company's smart devices and its platform have two goals: reducing the world's carbon footprint and making the world's light bulbs smarter. A worthy goal, but with three billion existing shares outstanding, do you really need this kind of buddy?

Share price chart

Source: Tradingview

The year of Buddy

The year 2020 saw a lot of changes for Buddy's of all kinds. The name Buddy shot up the rankings to become the most popular dog name of the year, according to mydogsname.com. A massive turnaround from previous years as the name's popularity had slipped. Buddy Technologies' 2020 saw just as much change. The company completely changed its retail presentation. It did a complete revamp of both its packaging and its retail displays. The hope is these more vibrant and eye-catching displays will increase sales and while we are not marketing experts, we must say that the new packaging and displays certainly do their job.

Buddy's consumer-facing lighting product is under the Lifx brand. The Lifx brand has a number of bulb offerings, but is mainly known for its 'smart' bulbs that allow users to change their colour and turn them on and off using a smartphone application. The brand launched seven new bulbs during FY21 so far, most notably Lifx Clean and Lifx Lightstrip. Lifx Clean operates as a fully-featured Lifx colour smart light, but its light also can kill bacteria on nearby surfaces and in the surrounding air. The product is currently only available in the United States. The Lifx Lightstrip is simply a smart light switch that can be programmed via the Lifx application to interact with its smart lights. The light switch's buttons can be changed via the application as well.

While all these products may be really cool and interesting, we'd like to point out that Philips Lighting, the world's largest lightbulb manufacturer, has been selling products like this for almost 10 years at a massive scale. We seriously doubt Buddy has a future in this market.

Buddy's B2B operations, i.e. managed services and licensing operations, trade under the Buddy Ohm name. Buddy Ohm operates mostly in Latin America and Europe where it helps commercial properties and factories easily audit, manage and report its electricity, gas and water use via the cloud. This is provided as a service and therefore has recurring revenue with two-to-three-year contracts. The company also licenses this technology to third parties, which it charges royalty fees.

Revenue but no profits

Comparing 1HY21 to 1HY20 paints a bleak picture. During 1HY21, revenue declined 10% to $19.4m, even after accounting for the $1.1m in government grants and subsidies during 1HY21 that the company did not receive during 1HY20. The company's operating revenue is split between the sale of its products, generating $16.7m, and service revenues at $571,750. The other revenue comes from government grants and rebates.

During 1HY21, the company managed to lower its net loss to $5.6m from $14.8m the year before. However, we do not view this as a reason to celebrate. The main reason for the decline of the company's loss was the combination of foreign exchange gains of $2.9m versus a loss of $476,223 the year before, cutting marketing costs to $1.2m from $3.1m, and a decline in refinancing and acquisition costs from $1.9m during 1HY20 to $403,536 during 1HY21. Therefore, we believe the decline in the net loss was not necessarily a positive sign. However, despite this myriad of negativity, there is hope. The company has completely transformed its product line and bought itself some time with its debt restructuring. But for now, we have to wait and see.

Warrants issued, but not for an arrest

During 1HY21, Buddy reorganised its finances through a debt deferment agreement and US$20m loan facility with Partners for Growth (PFG). This agreement has a lot of parts, but the most important ones are as follows. PFG was issued 50m warrants for one share each, expiring in five-years. These warrants can be exercised at any time prior to the expiry date for $0.058 per share. The US$20m loan facility has an interest rate of 12.5%, a fairly high rate, even for a company like Buddy. This facility is important for more than just its interest rate, the company has a strong history of equity dilution.

As of 1HY21, total shares outstanding was slightly under 3bn. To put this in perspective, the 50m of warrants issued to PFG, if executed today, would only dilute shareholders by approximately 2%. Buddy's PFG loan agreement stipulates repayments in two US$10m tranches. The first is paid in equal instalments over 40 months starting 1 April 2021. The second is due in a lump sum after 36 months. Please remember that US$10m is the principle of the loan, and it does not include interest.

Here's the issue for shareholders, if Buddy is unable to execute over the next 36 to 40 months, it will be forced to pay off at least a chunk of its loan by issuing new shares. With the short-term nature of the loan facility and the lack of profitability, we believe this creates serious dilution risk for shareholders.

The company is currently trading at an EV/Revenue ratio of 5.1x, and this is, unfortunately, the best we can look at right now due to a lack of market projections. We believe this is far too high when you look at the company's execution and dilution risk.

All-in-all, the transformation is interesting, but the valuation is currently far too high, in our view, given the company's risk profile. Two stars.

Pitt Street Research Pty Ltd

95 Pitt Street, Sydney, NSW 2000, Australia

Pitt Street Research Pty Ltd is founded on more than 40 years of combined experience researching companies in a range of different sectors.