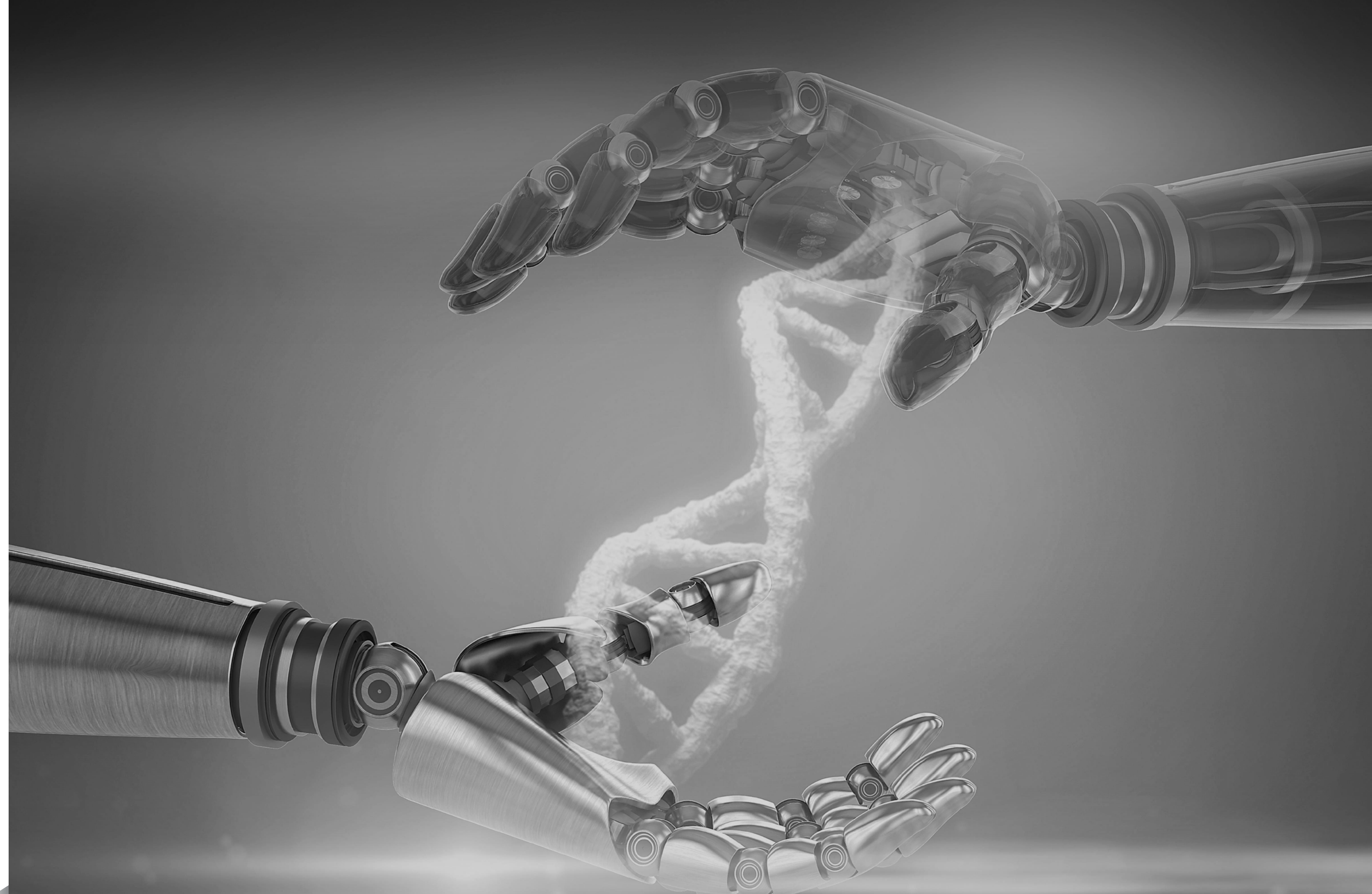
STOCKS DOWN UNDER

15 JUNE 2021

Emerging Stocks Down Under

"Not merely bear what is necessary, still less conceal it, but love it."

- Friedrich Wilhelm Nietzsche (1844 - 1900), German philosopher and writer



SDI LTD

Making us smile

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An interesting idea, but high valuation

AVECHO BIOTECHNOLOGY

A biotech company reinvents itself in the medicinal cannabis space

SDI LTDC

Making us smile

Stocks Down Under rating: ★★★★

ASX: SDI
Market cap: A$ 112M
Dividend yield: 2.1% (100% Franked)
52-week range: A$0.665 / A$0.975
Share price: A$ 0.93

Headquartered in Victoria, SDI Ltd is a company that's been heavily involved in Australia's smile since it was founded in 1972. SDI listed on the ASX in 1985 and currently sells everything from dental cement to whitening stands in more than 100 countries. As the dental industry continues to recover, we believe SDI's revenue is set for a rebound. With the stock's current valuation far below where it should be when you price in the current recovery, this company has us smiling.

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An interesting idea, but high valuation

Stocks Down Under rating: ★★★

ASX: PYR
Market cap: A$ 48M
52-week range: A$0.415 / A$1.22
Share price: A$ 0.54

The Buy Now Pay Later space is one that has been a historic focus of Stocks Down Under. This still-emerging industry has spawned a plethora of new companies trying to take whatever market share they can get their hands on. One of the newer players to the game is Melbourne-based Payright. The company is rather new to the ASX after its shares listed on 23 December 2020.With the world beginning to recover from COVID-19, is there room for yet another Buy Now Pay Later player?

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ASX: AVE
Market cap: A$ 29.3M
52-week range: A$0.006 / A$0.045
Share price: A$ 0.016

Self-described as a 'pure biotech' company, Avecho Biotechnology is making a brave move into the medicinal cannabis industry after spending two decades in drug delivery and improved drug performance using its own patented technology. The company wants to develop more promising CBD products for the fragmented cannabis space that is in need of pharmaceutical products if it's to be taken seriously as mainstream medicine. This could provide long-term benefits to the Australian medicinal cannabis sector, its patients and the company itself.

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Share price chart

Source: Tradingview

2020: The year the dental industry stopped smiling

2020 was a tough year for dentists as lockdowns and restrictions around the world heavily restricted clients from coming in for a check-up. Unfortunately for SDI, its main markets are Europe (37%) and North America (25%), totalling 62% of 1HY21 sales. With Europe and the US still heavily in the grips of COVID-19, it would seem like the sector still has a choppy future ahead. However, when we dig into the numbers, the situation becomes a lot more optimistic.

The future of the world's regions

Unfortunately, we were not able to access a specific research report on Europe's complete dental industry. However, we were able to review a report by Inkwood Research published in April 2021 on Europe's dental sterilisation market. Since the overall dental market is directly correlated with the demand for dental sterilisation, we can extrapolate the dental industry from this report. Additionally, SDI's products do include sterilisation equipment and supplies.

The market is expected to grow at an average rate of 5.7% between 2021 and 2028, supported by an aging population and a skilled and accessible dental industry. Additionally, as we move further into the pandemic's second year, it is believed that demand will rebound as practices are forced to re-open or shut for good, and consumers are unable to delay their check-ups any longer. This is fortunate for SDI as the majority of its revenue was generated in Europe at $13.6m during 1HY21, although this still implied a year-over-year decline of 5.1%. IBISWorld estimates that the size of 2020's market in the US declined 10.4% year-over-year. This was largely due to shutdowns, restrictions and consumers opting to delay due to COVID-19 fears. However, now that many in the United States are either getting vaccinated, the US dental market is set to rebound 8.4% during 2021. Seeing as how North America's revenue is almost exclusively generated in the United States (20% of 1HY21's total revenue), we believe this growth is set to help SDI's 2HY21 and FY22 results, especially after rising 3.7% during 1HY21 to $9.2m.

The Asia Pacific region is mostly made up of Australia, but the company has seen some growth outside of the domestic market. Due to Australia's early success in containing COVID-19, the dental industry rebounded significantly faster than the rest of the world. Therefore, this region saw the largest increase in year-over-year growth during 1HY21 at 11.1%, resulting in $8.7m total revenue. Interestingly, this region is certainly one to watch in the future as the dental industry is expected to grow the most in the Asia Pacific region over the next few years, according to a February 2021 market research report by Grand View Research.

The company also sells its products in the Middle East, Africa and South America, generating $5.5m during 1HY21, a decline of 38% year-over-year. We believe the three main regions we mentioned above (US, EU, APAC) are where SDI will experience the most growth in the coming years. Therefore, we view these other regions as supplemental. However, we expect them to have rebounded in the last few months of 2HY21. We see further recovery to pre-COVID-19 levels in FY22.

Diving into a pool of earnings

SDI is a profitable company and its EBITDA growth was significantly better than its revenue growth in 1HY21 as total sales declined 8% to $36.8m, while EBITDA increased 22.5% to $8.7m. Although we would never say anything negative in general about a 22.5% increase in EBITDA, this result was actually far more significant than it first appears. The increase in EBITDA was due almost exclusively to cutting selling and administration expenses, by 24% to $14.7m.

The company has not provided any guidance. However, after reviewing the company's products, industry, regional sales split and 1HY21's results, we are confident that SDI is on track to at least rebound to FY19's full-year EBITDA number of $14.2m. I If SDI can achieve the FY19 EBITDA number of $14.2m in FY21, this would imply a FY21 EV/EBITDA multiple of 7.2x. Compared to an anticipated 45% EBITDA growth rate this would mean the stock is currently trading at a very significant discount, in our opinion. Therefore, it's a four star rating for us.

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Share price chart

Source: Tradingview

How to Pay Right

We know what you're thinking, another Buy Now Pay Later company? Yes, that's what this is, but the company has a bit of a niche through its two plans: one for up to $10,000 and a plan for purchases between $10,001 and $20,000, specifically for the home improvement category. Basically, Payright's niche is large purchases and home improvements. The company needs a niche for more reasons than just the stiff competition. You see, its payment fee structure is a little on the high side and the fee structure is confusing.

The company breaks its fee structure into two categories: loans and home improvement. Each plan has set time periods. Up to 3 months ($0-$29 fee), 6 months ($39 fee), 12 months ($59 fee), 18-36 months ($59.90 fee). For the home improvement category, it's 48-60 months and $89.90 fee. The fee is spread across the lifetime of the plan like non-accruing interest. There is a standard monthly fee for active plans that reaches a maximum of $3.50 per month. The other fees are a repayment processing fee of $2.95 per repayment, a new plan fee of $19.95 and late fees of up to $12.95. This all sounds like a lot, but the total fees are, in fact, capped at $200 in the first 12-months and $125 during any future 12-month period. Late fees are separate and capped at whichever is lower, 10% of the approved credit limit, or $250.

Despite the complicated nature of its products, the company has found a customer base of over 40,000 customers and 3,000 merchants. This generated $5.8m in revenue in 1HY21, implying a 38% year-over-year growth rate. In the December quarter the company's total Gross Merchandise Value (GMV) grew 84% sequentially compared to the June quarter, resulting in $20.6m in GMV. Like most small, growing Buy Now Pay Later companies, Payright is not currently profitable, with a net loss of $4.8m in 1HY21.

Where is the Right competition?

Payright currently operates in Australia and New Zealand, although approximately 90% of the company's GMV is generated in Australia. When we focus on the large loan aspect of the company, Humm (ASX: HUM | see 3 September 2020 report), previously called FlexiGroup, could be considered a peer. Since we wrote about Humm, the company has clearly changed quite a bit. It tailors to two categories: little things and big things. Little things offer two plans for credit of up to $2,000. For five payments fortnightly, the only fee is a late payment fee of $6. For ten fortnightly payments, there is an $8 fee and a $6 late fee. The big things category allows for payment over six to sixty months with a monthly fee of $8, establishment fee between $35 and $90, a repeat purchase fee of $22 and a late payment fee of $6.

Clearly, Humm's fee structure is significantly more streamlined compared to Payright's. Humm is also currently profitable, generating $192.8m in EBITDA during FY20, although the market expects to see declining EBITDA in FY21 and FY22, especially since most of its current profits are not related to its BNPL business. Due to the fact that Humm is currently profitable, the two companies are not really comparable from a valuation standpoint. However, it is still important to see the different options customers have for large purchase Buy Now Pay Later transactions.

Growth is nothing to write home about

From an investment perspective we are not fully sold on Payright. When we compare the company's offerings to some of its closer competitors, we find its fee structure to be significantly more complicated and confusing. Additionally, after IPOing at $1.20 per share on 22 December 2020, the share price has fallen like a rock, to $0.54 as of Friday's close. While this could indicate a possible buying opportunity, we believe the stock likely still has some ways to go, downward that is.

Due to the lack of market projections or company forecasts, we have to rely on the company's historical performance, resulting in a trailing 12-month EV/Revenue ratio of 3x. What it comes down to is this, BNPL is a proven industry, but we don't believe Payright is there yet. With the lack of certainty surrounding Payright, its three stars for now.

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Share price chart

Source: Tradingview

A leap into the somewhat unknown

For Avecho, medicinal cannabis is one more way to use its proprietary vitamin E-based Targeted Penetration Matrix (TPM) technology, a unique delivery system, which uses an enhanced form of vitamin E to reformulate drugs and improve their absorption by the body. As the TPM technology is designed to improve drug performance, the company is looking to create new formations of existing drugs to address unmet medical needs, particularly in the treatment of chronic pain.

Avecho has so far applied TPM to injectable products – including a long-lasting anaesthetic called propofol (the same drug Michael Jackson took before he died), which, when reformulated, has been shown to last longer than 24-hours. TPM also has several dermatological applications in the form of topicals and patches, with new products treatments (such as opioid patches) to target complex conditions like chronic pain.

The point of these TPM formulations is to increase absorption and decrease risk, and that's what Avecho hopes to achieve in its work with cannabinoids. The effectiveness of CBD-based medicines can be highly variable: CBD is an oil soluble molecule, meaning it has low solubility in water and low absorption rates. TPM is effective at trapping and dissolving oil-soluble molecules, leading to better absorption in a higher quality product. Although this is a new area for Avecho, the idea that TPM could offer pharmaceutical-grade CBD products has inspired investors, with the share price currently about twice what it was in October last year. The challenge for the company now is the development of oral and transdermal (through the skin) CBD-based products to address the disparity in the effectiveness of medicinal cannabis.

You need evidence if you want to be taken seriously

Since Avecho has been working on TPM for two decades, the company finds itself well-positioned to test the bioavailability of cannabinoids. That's especially important as the market for CBD continues to get larger, but the research and development lags behind. CBD-based pharmaceutical research is still fairly limited in that not enough is known about the therapeutic benefits and risks, and then there are questions about the most appropriate commercial formulations for CBD-based products. CBD has poor oral bioavailability – which basically means that medicinal CBD taken orally is highly variable in performance – so while the company has the avenue in topicals and patches, there is a window to provide tablet and capsule-based pharmaceuticals in a move away from the supplementary medicinal cannabis space. In late May, Avecho announced that it had completed developed of a cannabidiol soft-gel product.

Now that Avecho has tested the reformulated TPM-CBD concept in animal studies and found an increase in oral bioavailability in rats, it is now advancing to Phase 1 human clinical trials. Avecho's quick journey into testing has coincided with a profound change in attitudes toward CBD-based medicines – including the TGA's decision to allow CBD-products to be sold over the counter without prescription. That underscores the company's point that registered, evidence-based pharmaceutical products are key to further unlocking the medicinal cannabis market in Australia. As the space is largely unregulated, Avecho is part of the race to provide CBD products that practitioners and patients alike can actually have confidence in. And that should become clearer once the clinical trials are up and running and the company can closely consider other factors, such as best practice treatments or dosages for specific illnesses.

While a familiar oral-type CBD product would open many doors for Avecho, it would also be a win for patients trying to access more legitimate medication. The number of patients seeking cannabis subscriptions has risen, but the barriers remain high – as do the costs, with out-of-pocket expenses for non-regulated medicines as high as A$400 per month. Longer term, the integration of CBD pharmaceuticals into the industry means low costs and fewer barriers, and possibly a positive change in regulation to make the most of the market before cannabis is completely legal.

Endless opportunity

Funnily enough, the uptake of CBD research and development might be the making of Avecho. Even though the company had two decades of experience with TPM technology, the journey has been beset with many hits and disappointments, including that time when previous partner Terumo pulled out of the first 'failed' propofol trials. It's obvious that this company is not afraid to learn a few lessons from failure, as the positive development and offtake work for a product like propofol now shows. And while the board describes its move into cannabis as 'terrifying' and 'bizarre,' it's the certainty in cannabis' new age which makes the work all the more exciting.

Over the next year, the company intends to progress its Phase 1 clinical trials comparing TPM formulations against other brands in Q1 2021, which will then lead to disease-specific clinical trials, although this is some way off. With a cash balance of $1.8m Avecho is well-placed to deliver on time with the continued marketing of its most-promising products, such as its non-CBD pain-relief topical gel. A finished commercial CBD product could be introduced into a market, worth $25bn by 2025. Four stars for longevity.

Pitt Street Research Pty Ltd

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