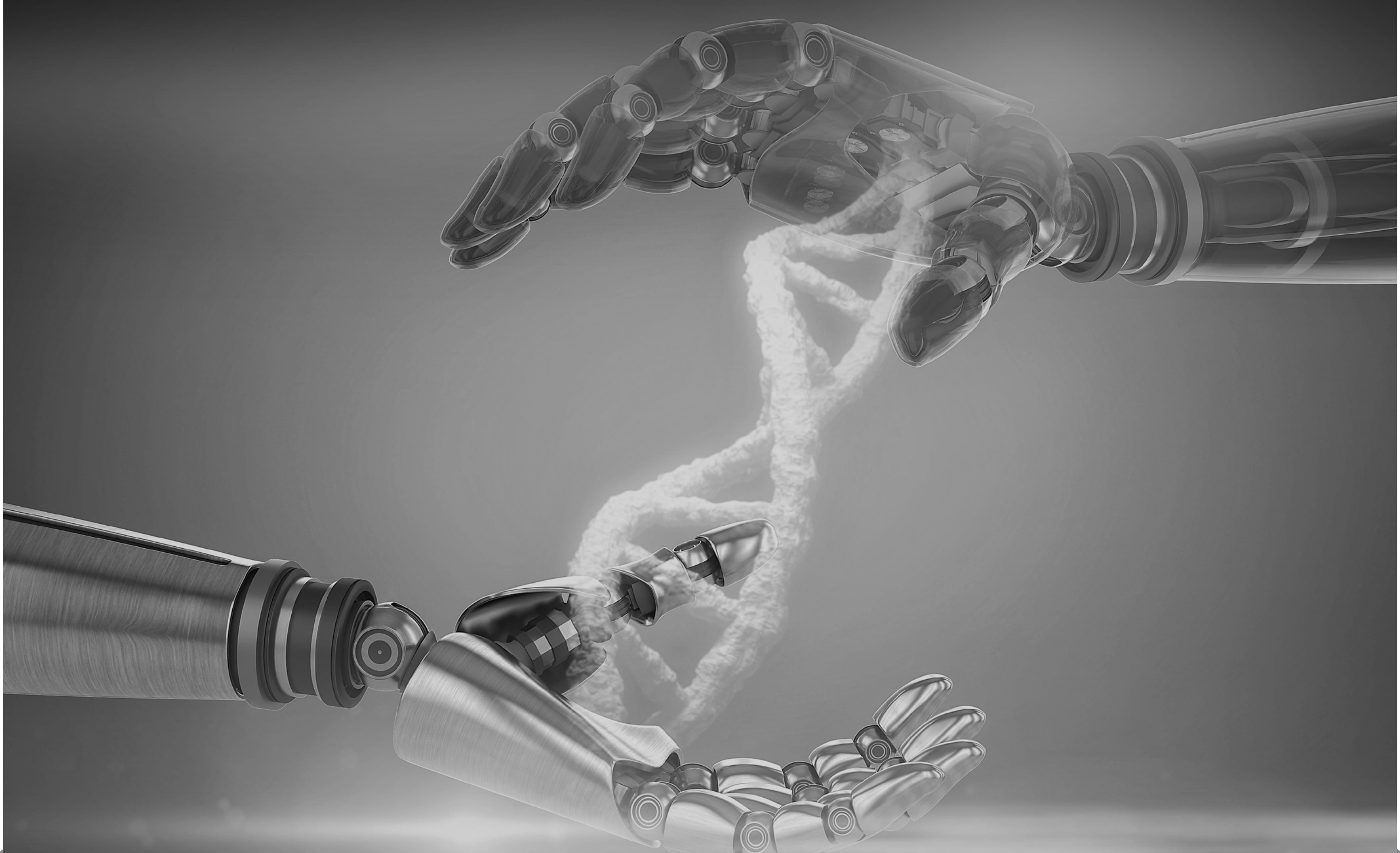
STOCKS DOWN UNDER

20 JULY 2021

Emerging Stocks Down Under

It's nice to finally get scripts offered to me that aren't the ones Tom Hanks wipes his butt with.

- Jim Carrey (b. 1962), Canadian-American actor



BAILADOR TECHNOLOGY INVESTMENTS

An ever-growing star

PIVOTAL SYSTEMS

Booming times ahead…

IMPEDIMED

An impending rise

BAILADOR TECHNOLOGY INVESTMENTS

An ever-growing star

Stocks Down Under rating: ★★★★

ASX: BTI
Market cap: A$180M

52-week range: A$0.81 / A$1.61
Share price: A$1.28

Bailador Technology Investments is a Sydney-based VC fund that specializes in technology investments. Instead of investing in companies that are in the start-up phase, Bailador invests in companies that are looking to expand instead. While the potential returns of a strategy like this are lower compared to investing in start-ups, the risk is also much lower. On top of that, Bailador uses its experience and network to provide oversight and guidance to the companies it invests in.

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ASX: PVS
Market cap: A$169M

52-week range: A$0.71 / A$1.62
Share price: A$1.40

Pivotal Systems is a company that is unlike most others that we write about in Stocks Down Under. For one, it is headquartered in California, United States, and not Australia. Secondly, the company manufactures and sells a single product, Gas Flow Controllers (GFC). Sure, there are multiple models of the product available depending on the use case, but all of them essentially do the same thing: Help make semiconductors (or computer chips). After suffering through a cyclical downturn in the semiconductor industry two years ago, investors will be hoping for the company to bounce back based on increased semiconductor demand.

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Share price chart

Source: Tradingview

The stage is set

Bailador was founded in 2010 as a VC fund that would focus exclusively on tech companies. Compared to some of the giants of the VC industry, Bailador was (and is) a minor player. However, it has compensated for this by following a strategy that exposes the fund to a lot of upside, but without the extraordinary downside risk that is usual for VC funds.

Bailador only invests in companies that have a significant revenue stream. This means that any early-stage start-ups are a no-go for Bailador. The fund instead waits until a company has proven that its business model works and that it can grow its revenues. Once a company is at this stage, it usually needs additional capital to expand its operations and achieve critical mass. Achieving critical mass means that a company is self-sustainable and does not require any additional funding to operate. At or beyond critical mass many Tech companies usually go public and the investors (i.e. Bailador in this case) have the opportunity to cash out.

Of course, another possibility is that a company does not achieve critical mass under the wings of a VC firm and instead needs to go public to raise additional capital for further expansion. In this case, the investors may have to suffer through dilution, but the advantage is that the investment becomes a lot more liquid than before. A company going public, even if it is not at its full potential yet, would allow Bailador to sell down its shares in the IPO or at a later stage on the stock exchange if they wish to cash out.

Bailador's preference to only invest in companies with proven business models allows it to manage its risk without having to diversify excessively. While the fund still has a significant amount of diversification in terms of target markets of the companies in its portfolio, it only needs to invest in a handful of them.

An army of dancers

Prior to listing on the ASX, Bailador had made two investments, in SiteMinder, a SaaS company for hotel management, and Standard Media Index, a big data aggregator. Standard Media, along with Instaclustr (a Database-as-a-Service company), provides Bailador with exposure to the big data and data analytics space.

Bailador listed on the ASX in November 2014. In the second half of 2015, it acquired a stake in Straker Translations, Stackla and Rezdy. Stackla and Rezdy are both SaaS companies (Software-as-a-Service), which is an industry that forms the backbone of Bailador's holdings. Stackla is a social marketing platform and Rezdy is a suite of tools for the tourism industry.

According to the stake of ownership, Straker Translations is the fund's biggest investment. Straker uses machine learning and human input to translate languages at breakneck speeds. At the time of Straker's IPO in 2018, Bailador owned 8.2m shares accounting for 20.4% of the company. The fund sold 823,000 shares at $1.51 during the IPO for a total return from the investment of 276% at that time.

Lastly, to further diversify its portfolio, Bailador is invested in Brosa, an online furniture retailer. Brosa is fairly different from the fund's other investments and helps diversify its exposure to the SaaS and big data sectors.

In early 2021, Bailador exited from three of its investments. One was Viostream, a cloud-based video platform, for $1.1m, an investment that was not in line with Bailador's strategy. The other was DocsCorp, a productivity software tool that integrated with 30 document applications. DocsCorp was sold at a 55% valuation uplift for $17m. Lastly, Lendi (a mortgage company) was sold for $13m, a 21% uplift to its carrying value.

A show to remember

In FY20, Bailador offered its inaugural dividend. Fully franked at 2.5 cents a share, the dividend was paid due to the partial sales of the fund's stake in SiteMinder and Straker Translation, two investments of the fund that have significantly increased in value. However, the fund did label it as a special dividend, meaning that the company may not have any plans to continue dividends in FY21.

That said, the majority of investments made by Bailador have been profitable and we believe management will be able to find other companies of a similar nature in the future.

Bailador raised $20m through an institutional placement at $1.37 per share in April 2021. This, coupled with the sale of Lendi, gives the fund a lot of capital to invest in new companies that could have a huge payoff in a few years.

Bailador is trading very close to its Net Tangible Assets (NTA) after tax of $1.35 per share as calculated per the end of April 2021. This NTA has been predominantly driven by portfolio gains in the last two years. Given that we see a lot of upside potential for Bailador's current portfolio companies, we believe this is a four-star stock that offers attractive diversification for Tech-savvy investors.

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Share price chart

Source: Tradingview

A quintessential product

The GFCs produced by Pivotal are necessary to produce semiconductors. Essentially, semiconductor manufacturers use various gases that react with each other and with the material of the semiconductor wafer itself. Pivotal's GFCs allow semiconductor manufacturers to monitor and control the flow of the gasses that are introduced into the process.

Pivotal is the leader in its class, meaning that its products are considered to be better than most of its competitors. Its products and modules have been qualified by the world's leading equipment manufacturers, including Tokyo Electron, Lam Research and Applied Materials, so they can be used in their machines. However, as we mentioned when we wrote about the company in February 2020, the semiconductor industry is extremely cyclical. During good times, the demand rises exponentially, followed by sharp falls in demand during the bad times and suboptimal factory utilisation as a result.

On top of this, certain types of semiconductors have a very short lifespan, with new and improved ways of manufacturing them being invented regularly. This means that it is extremely difficult to move excess product if you do not manage to sell your inventory quickly. In other words, even companies with great products can still see strong revenue declines when the semiconductor cycle turns negative. Keep this in mind when investing in the semiconductor space.

When we last wrote about Pivotal, the semiconductor industry was just beginning to enter its upcycle. The Philadelphia Semiconductor Index (SOX), which monitors 30 of the largest semiconductor companies, was at around 1,850 points at the beginning of February 2020. Now, it is around 3,145, indicating that times for the semiconductor industry have definitely improved.

Pivotal, a company whose financial year ends in December, also profited off of this boom. Managing to retain most of its production capacity during COVID-19, having been deemed an essential business (Pivotal provided GFCs for semiconductors used in healthcare equipment), the company had a 553% increase in new orders and a 26% year-over-year increase in revenue in 1HY20.

For FY20 as a whole, the company saw an increase in revenue of 44% over FY19, a clear indication that the business was improving. Considering the current state of the semiconductor industry, it stands to reason that the results in FY21 will be even better.

A cycle like no other

The current upcycle of the semiconductor industry is different from all previous ones, because we've seen strong underinvestment by the semiconductor industry in 2020 due to COVID-19. On top of that, there is now an unprecedented demand for semiconductors as customers are scrambling with catch-up demand from end-users. This has occurred mainly due to the increase in the use of computer chips across a multitude of industries, at the head of which lie Electric Vehicles (EVs). There is no doubt that the global semiconductor industry is experiencing a shortage. Not only are vehicle manufacturers unable to secure semiconductors for their cars, but even companies with extremely reliable supply chains, such as Apple, have had to stagger product launches due to the semiconductor demand shock. The semiconductor industry experienced 6% growth in 2020 and that number is expected to rise to 12% in 2021.

In anticipation of this accelerating growth, Pivotal raised a total of $14m during FY20 in order to strengthen its manufacturing abilities and prepare for the increase in demand.

Also, the transistors in semiconductors are now more tightly packed than ever. Processors with a resolution, or linewidth, of less than 10 nanometres are becoming more common. As manufacturing of semiconductors becomes more complex and the need to control the manufacturing process more tightly, the need for high-quality GFCs will increase. This could grant industry leaders, such as Pivotal, a huge advantage over their competitors.

It only gets better

Based on Pivotal's progress in the last 18 months and the current state of the semiconductor industry, we believe that business can only get better for the company from here on out. With the number of EVs increasing by the day and more electronic devices being produced than ever before, we expect to see strong demand for semiconductors for at least 18 months, i.e. into 2023.

When we last covered Pivotal, at the beginning of 2020, Pivotal was trading at $1.13. Consensus estimates show that EBITDA is expected to turn positive in FY21 to the tune of A$0.68m after a steep, COVID-induced EBITDA-loss of A$8.8m in FY20. Then in 2022, which is only 5 months away, EBITDA is expected to jump to A$6.2m and A$10.3m in 2023. Given this EBITDA-growth rate (65% in FY23) and looking at Pivotal's EV/EBITDA multiples for FY22 and FY23 of 26.5x and 16x respectively, we believe the shares offer good value at the current price and it's four stars from us.

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Share price chart

Source: Tradingview

Innovating a new technology

Impedimed was founded in 1999 and has been working on BIS devices ever since. The company has three major goals. Firstly, to constantly develop and update BIS devices and the relevant software (and provide support for the devices sold). Secondly, to help conduct research that shows the potential of these devices. And thirdly, to sell these devices to clinics and hospitals worldwide.

The first device made by the company was the DF50, which was discontinued in December 2016. However, it was with their second device, the L-Dex U400, that the company began to truly innovate in the BIS space. The U400 device incorporated the L-Dex technology in its software. L-Dex technology utilizes electrical signals to detect symptoms of Lymphedema in recovering cancer patients. Lymphedema is the swelling of limbs in the arms and legs as the result of the removal of lymph nodes (during cancer treatment). With the U400, Impedimed was able to generate an L-Dex score that measured how easily electrical signals moved through affected limbs compared to unaffected limbs.

If detected early, it is possible to impede the progression of Lymphedema by as much as 95% through standard compression therapy. The U400 was able to assign an L-Dex score between -12.0-20.0, with an increase of 6.5 or above 5 (compared to the L-Dex score of a healthy limb), being a sign of developing Lymphedema.

The L-Dex technology has been used by all of Impedimed's subsequent devices. The U400 was discontinued in November 2018 and was replaced by ImpediVET (for veterinary applications) and the SFB7. These devices can measure up to 256 discrete frequencies between 3 and 1000 kHz. However, while both devices are still available for purchase, Impedimed's main focus is now on its SOZO device.

Creating a sellable product

The SOZO is Impedimed's flagship device. With hand and footplates, the device can not only measure the patient's L-Dex score and cellular fluids, but also skeletal muscle mass, body mass index, basal metabolic rate and the level of protein and minerals. This is combined with a tablet with the SOZO app, that stores all patient data in SOZO's proprietary cloud.

SOZO and other Impedimed devices have been used in over 40 clinical studies and have shown effectiveness at their intended purpose in each. The Mayo Clinic and Scripps used both used SOZO in heart failure studies in 2016 and this was done after a high-profile clinical trial agreement with Institut Curie for the detection of lymphedema after breast cancer in 2013.

Shipments of SOZO commenced in the US in October 2017, after Impedimed obtained 510(k) clearances from the FDA regarding unilateral lymphedema. A 510(k) clearance means that a device is deemed safe and effective and can be sold for commercial applications. Further clearances were obtained for chronic heart failure monitoring in December 2017 and bilateral lymphedema in April 2018. Lastly, the company obtained an FDA clearance for the SOZO heart failure index in April 2021, which assigned a score that could be used to detect heart failure, just like the L-Dex for lymphedema.

It is clear that Impedimed has succeeded in its first two goals. It has efficient BIS devices capable of detecting and monitoring numerous conditions in patients, and it has enough clinical evidence to prove that its technology works. However, the company has had trouble in selling these devices, resulting in financial performance that leaves investors wanting.

Making ends meet

Impedimed has not managed to sell its SOZO device as well as it we had hoped. But with all the appropriate clearances now obtained, we believe the company is in a position to increase its sales over the next few years, which is reflected in consensus forecasts. The market is expecting revenue to grow from $5.7m in FY20 to $25.2m in FY23. However, Impedimed is still not expected to be EBITDA-profitable by then.

In November 2020, Impedimed sold its first SOZO to be used in monitoring heart failure. By March 2021, 200,000 patients had already been tested using SOZO. So, we think there's quite a bit of upside for the shares with EV/Revenue multiples of 7.4x and 5.5x for FY22 and FY23, making Impedimed a four-star investment, in our view.

Pitt Street Research Pty Ltd

95 Pitt Street, Sydney, NSW 2000, Australia

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