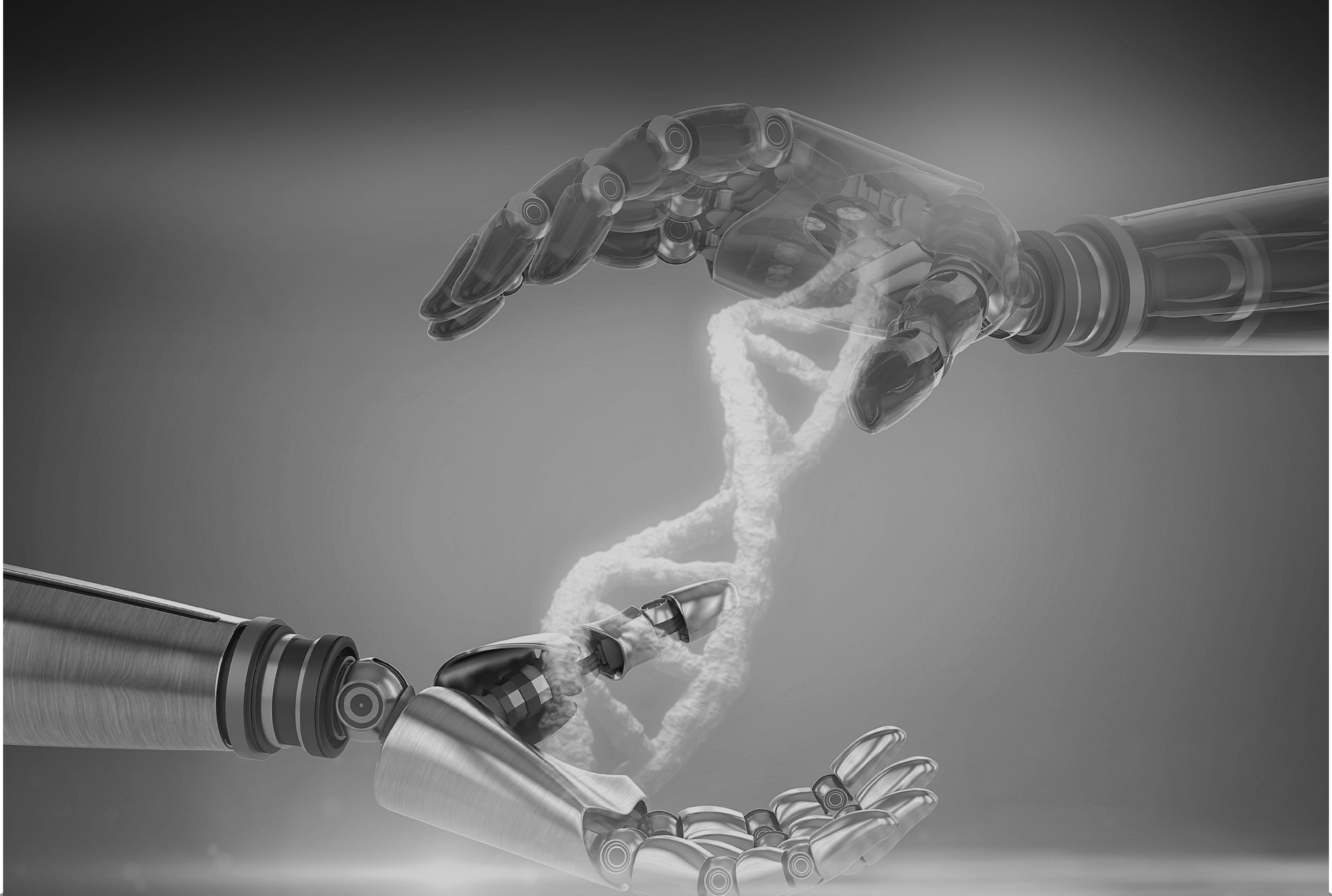
STOCKS DOWN UNDER

26 OCTOBER 2021

Emerging Stocks Down Under

"It isn't the mountains ahead to climb that wear you out; it's the pebble in your shoe."

- Muhammad Ali (1942-2016), American boxer



VITA LIFE SCIENCES

Viva la Vita

PAYGROUP

The correct way to expand

MEDLAB CLINICAL

Nano particles, Giga ambitions

VITA LIFE SCIENCES

Viva la Vita

Stocks Down Under rating: ★★★

ASX: VLS
Market cap: A$94.8M
Dividend yield: 3.1% (100% Franked)

52-week range: A$0.845 / A$1.99
Share price: A$1.88

Headquartered in the southern Sydney suburb of Kirrawee, Vita Life Sciences has been on a mission since its founding as a retail pharmacy in Singapore in 1947. A lot has changed since 1947 and Vita now focuses on creating and distributing vitamins and supplements across the Asia Pacific region. The company had an excellent 1HY21, fuelled by ecommerce sales across Australia. But the vitamin and supplements industry is extremely competitive, ruled by giants, like Blackmores. And yet, we say Viva la Vita!

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Market cap: A$66.7M

52-week range: A$0.43 / A$0.81
Share price: A$0.56

Paygroup Limited is a Singapore-based Human Capital Management (HCM) solutions provider. The company provides everything from workforce management to payroll services, primarily operating in Australia, Asia and the Middle East. A total of five companies fall under the Paygroup brand, with each of them differentiated from the others through its feature set despite operating in the same niche. Through suitable acquisitions, we believe the company is in a prime position to grow strongly over the next few years.

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Share price chart

Source: Tradingview

A steady progression

Believe it or not, Vita Life has some very old roots and not originally in Australia. The company was founded as VitaHealth in 1947 in Singapore. While the company still operates this brand as one of its main vitamin and supplements lines, VitaHealth was originally a retail pharmacy. The company took another 26 years to get into the vitamin and supplements game, launching VitaHealth supplements in 1974 in Malaysia.

Everything changed in 2000, when Vita Life Sciences was founded with the purpose of acquiring VitaHealth's vitamin and supplement brand as well as Australian liquid herbal brand Herbs of Gold. The company spent the next seven years expanding its offering, launching brands VitaSciences in 2002 and VitaLife in 2007. With its fourth and final brand in place, management decided in 2007 it was time to enter the big league through a listing on the ASX.

Since listing, things have been a bit of a rollercoaster for shareholders, although if you bought shares before 2012 you would be sitting on a tidy profit of close to 400%. For a company as small as Vita we believe it is extremely impressive that, since dividend payouts were first raised above $0.015 on 17 March 2015, the company has never paid a dividend lower than $0.015 per share ever since. Even more impressive is that Vita has not missed a payment since dividend payments first began on 26 March 2012, even during the height of the pandemic. And no, this is not a story of debt and share issues to pay dividends. Over the last three years, dividend payments have been covered by operating cash flow. We believe a company in an industry as congested and highly competitive as Australian-produced vitamins and supplements, with a market share as small as Vita's, is inherently risky. But this dividend track record inspires a high degree of confidence in the business.

Nipping at the giant

Vita is far from alone in the Australian vitamin and supplement industry. In fact, there is a number of giants in this field with the potential to crush a small player like Vita before it grabs any real market share. Vita is growing at an excellent pace, but let's take a look at the company's main competitor, Blackmores (ASX: BKL | see 13 September 2021 report). Does an investment in a player with just a fraction of Blackmores market capitalisation make sense?

Before we really dive into the numbers, it's important to note that Blackmores operates on a financial year that runs from July through June, while Vita sticks to a calendar year. During FY21, Blackmores grew revenues by 1.3% and underlying Net Profit After Tax (NPAT) by 61.2%, although, this increase in NPAT was more due to the COVID-19 normalisation compared to FY20's 65% drop in NPAT than anything else. During the 1HY21, Vita was able to increase revenue by 16.8% to $25.7m and NPAT by 17.7% to $3.7m.

It is important to note that Vita is not heavily dependent on Chinese demand, like Blackmores. And the company has built up an impressive track record of year-over-year growth. COVID-19 seems to have offered the company the opportunity to continue to increase revenue, while drastically cutting costs and, therefore, increase its margins. During 2018, 2019 and 2020, Vita's SG&A costs (selling, general and administrative costs) accounted for 51.5%, 55.2% and 46% of sales, respectively. During 1HY21, this downtrend continued with SG&A costs dropping to 42.6% of sales. We expect the company will be able to keep these costs in the low-to-mid 40% range going forward.

Guidance implies a strong end to FY21

Before 4 October 2021, it was uncertain how the Delta variant was going to impact the remainder of Vita's financial year. Fortunately, management released guidance for the remainder of the year 4 October, placing full year revenue growth at approximately 15%, in a range of $51-$53m. Pre-tax profit growth is expected to amount to 20% resulting in approximately $10m pre-tax profit for FY21. While this pre-tax profit guidance is certainly not as 2020's 87.1% year-over-year growth, it is significantly better than 2019's 2.3% growth. Truthfully, we believe this sort of growth is what we can expect from Vita going forward as most of the cost savings seem to have been realised, judging by the fairly low SG&A percentage for 1HY21.

The company is currently trading at 1.9x its FY21 projected revenues, while Blackmores is trading at 3.2x the revenue level projected by the market for calendar year 2021 (so not its financial year). Of course, in terms of revenues Blackmores is about twelve times larger than Vita, which makes Blackmores substantially less risky. Also, unlike Blackmores shares, most institutional investors are not allowed to own a small cap like Vita. So, this is all reflected in the valuation difference.

This ship has sailed

Since late September, Vita shares have shot up about 50% to more than $1.80, when they broke through the $1.20 resistance level that they had been bumping up against since March this year. While we like the stocks fundamentals, we believe this ship has sailed for now. If you own it, don't sell it. But if you're looking to get in, wait for a better entry price. We may see a retracement to at least $1.60. So for now, Vita is a three-star stock for us.

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Share price chart

Source: Tradingview

Pay it forward

Paygroup primarily uses a Software-with-a-Service (SwaS) model, providing services to companies to manage their human capital and payroll for a fee. While that is the company's main business, it also offers Software-as-a-Service (SaaS) solutions, where the clients themselves are responsible for payroll management without any services from Paygroup's subsidiaries.

PayAsia is the company's main business and enables organisations to make HR payments, pay salaries and perform complementary services. The software can also be combined with TalentOz or HROnline, two of the HCM suites provided by Paygroup.

TalentOz allows a company to organise its workforce, it assists in talent acquisition and integrates payroll with attendance and time. Another workforce management solution by the company is AstutePayroll. Astute allows integration with CRMs and accounting software to have one cohesive workforce management system.

The company also operates PayrollHQ, a managed payroll service that allows clients to outsource payroll management duties to Paygroup for a fee. Lastly, the company operates IWS Australia, which integrates payroll management and talent acquisition with real-time cloud-based data analytics and bookkeeping capabilities.

As you may have noticed, while these services are similar, there is enough differentiation between them for clients to decide which service they would rather use. Having an extensive product portfolio on offer for clients allows Paygroup to ensure that it can handle all payroll-related services, especially for multinational corporations requiring multiple software suites for effective management of their human capital.

The company also provides everything from a completely hands-on experience for clients to an end-to-end managed service that includes compliance, regulatory guidance and advisory. By casting a wide net on payroll management and human capital management, the company has managed to grow very quickly since its IPO in 2018.

Synergistic and accretive

Unlike most other companies, Paygroup's financial year ends in March. By the time the company listed on the ASX, it had offices in eight countries. Its services were used primarily in the Middle East, Asia and Australia (with a few clients in the US and other locations).

Initially, Paygroup listed on the ASX as the holding group for PayAsia and its proprietary HCM software, but with the intent to raise money to add complementary companies to the fold and expand its operations. By 31 March 2018, PayAsia had revenues of over $5.5m and had a slight loss of $0.75m after generating a profit of $0.3m the year prior.

The company had previously tried to IPO in late 2017. It attempted to raise $15m under the name PeoplesHR to acquire the tech start-up with the same name. However, market interest was lacklustre at the time and the IPO was called off.

The company eventually went public in 2018 at $0.50 per share. After going public, it made its first acquisition in November 2019, acquiring Astute One Limited for $11m in Paygroup shares. This was an accretive acquisition and would bolster the annual recurring revenues to over $15m. The company had to raise $3m at $0.7 per share to integrate Astute with other Paygroup businesses.

Recovering from COVID and recovering well

Even though Paygroup had a revenue target of over $16m for FY20, it only managed to hit $10m due to COVID and its devastating impact on Asia. However, the company acquired TalentOz in July 2020 for $1.2m, PayrollHQ in November of that year for $2.535m (in Paygroup shares) and IWS Australia in May 2021 for an initial consideration of $12.75m (part cash and part stock).

After raising $3.5m at $0.58 per share in September 2020, the company began to synergise its businesses to create a comprehensive ecosystem of products. This is starting to show results already, as total revenue for FY21 amounted to $15.6m with a positive EBITDA to the tune of $2.8m.

What makes Paygroup an excellent investment, in our view, is the expected increase in business now that many businesses are starting to recover from COVID. Consensus estimates show revenues climbing to $26.8m in FY22 and $31.6m in FY23, with FY22 being the first year the company generates a net profit since going public.

Making the most of its acquisition strategy using its shares has allowed the company to save cash and build up a net cash position of over $10m, ensuring that it has more than enough cash at hand to acquire other synergistic businesses and to fund growth.

On 18 October, Paygroup actually increased its guidance for FY22 from a range of $35m to $37m in Annualised Recurring Revenues (which is not the same as actual revenues, mind you) to the top of that range at $37m. After the 10% share price jump following that guidance upgrade, Paygroup is now trading at an EV/EBITDA multiple of 14.2x for FY22 and around 10x for FY23. Given the anticipated 32% and 43% EBITDA growth this year and next, we believe Paygroup shares look pretty attractive, even after the recent 10% jump. And because the company will likely be looking for more accretive acquisitions, that EBITDA growth may turn out to be higher in the next few years. We believe this makes Paygroup a four-star investment.

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Share price chart

Source: Tradingview

Revolutionary? Or just a gimmick?

Medlab was formed in 2012 and listed on the ASX in 2015. It describes its business as the formulation and enhancement of therapeutic solutions. The company does this through several initiatives. Its main goal is to find a better solution for pain management when it comes to chronic conditions. Currently, opioids are extensively used in pain management during cancer. The company claims that little is known about the efficacy and side effects, though. As such, it looks to develop therapies that offer a better alternative.

Medlab's primary delivery system NanoCelle tries to optimise the delivery of medicines by breaking molecules down to nano-sized water-soluble particles. This is done through a buccal route, meaning the solution is placed against the cheek and absorbed into the bloodstream. These particles can easily bypass the first-pass metabolism, which degrades medicinal compounds and reduces their effects when they enter the bloodstream.

The company's two main products are NanaBis and NanoCBD. NanaBis is a cannabis oil extract, while NanoCBD is a hemp oil extract. Both are delivered through the NanoCelle process, with NanaBis being a late-stage drug and NanoCBD much more early stage. Late-stage refers to a drug that has passed Phase-II clinical trials (where a drug's efficacy is tested on a substantial number of patients).

Medlab also offers numerous supplements and nutraceutical products that are used to treat a wide variety of conditions. The company claims some help improve users mood, while others provide immune support, rehydration and probiotic support. Some of the products use NanoCelle to deliver vitamins and the company claims that these products with NanoCelle provide over 5x more absorption than equivalent tablets.

Apart from this, the company also offers a virtual clinic where prospective patients can schedule a free consultation (or an extended paid one) to determine if any of Medlab's products could help them.

Fast-tracked development

By the time Medlab went public, it had already completed Phase-I trials for NRGBiotic. This bacteria-based medicine can be used to treat treatment-resistant depression. The ethics approval for phase-IIA would be granted in March 2017, with the trial being completed in April 2020. By this time, the company had begun distributing the product through pharmacies and healthcare providers in Australia. That said, NRGBiotic is not the company's flagship product and it has played second-fiddle to cannabis-based products.

When it was granted its medical cannabis research license in July 2015, Medlab's focus shifted to cannabis-based therapies. After receiving the license to import Cannabis in November 2016, the company began preparing for clinical trials. In June 2017, after the ethics license was granted, the company announced that it planned to have NanaBis ready for commercialisation by February 2018. Medlab was granted the license to supply cannabis in Australia in January 2017 and the export license was granted in September later that year.

As for the trial, it commenced in May 2018 in the Royal North Shore Hospital in Sydney. NanaBis would be tested to combat pain from advanced cancers. Medlab also began a trial to test the safety of its nutraceutical product Multibiotic, a product that was already on the market, in August.

It all depends on Nana

Ethics approval for the NanaBis Phase-II trial was granted in June 2019, with the trial being completed by March 2020. On average, patients using NanaBis reported a 59.5% reduction in pain, allowing the company to push forward with plans for Phase-III.

The company had raised $5m at $0.28 per share in December 2019 and $5.4m at $0.15 per share in June 2020 to finance these trials. After raising a further $15m at $0.24 per share, the company was granted approval for Phase-III by the Australian government in August 2021. The trial, held in the UK, specifically focusses on bone cancer pain.

While the company has a wide product offering, it appears that NanaBis is expected to be Medlab's future. With highly positive results from the first two trials, it shouldn't be long before the company can bring the product to market. That is, assuming Phase 3 trials are completed successfully.

In FY21, the company increased its revenue, excluding R&D grants, by over 50% to $4.4m, while losses came down 8% to a still sizeable $12.3m net loss. With over $13m in cash at the end of FY21, the company should be able to cover its near-term Phase-III expenses. However, we believe Medlab will need additional rounds of financing to launch NanaBis and get to break even.

For now, we'd advice to hold off on Medlab, at least until after the next round of funding. In our view, there's plenty of time to get into the stock and this should depend on how the current NanaBis Phase-3 trials go. If you're a risk taker, you may want to get in before that news breaks.

The stock has been trading between $0.15 and $0.20 since May. So, the traders among you could have some fun with this one. But when it comes to our beloved star rating, we're sticking to three stars for now.

Pitt Street Research Pty Ltd

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