STOCKS DOWN UNDER

17 JANUARY 2022

ASX Top 200 Stocks Down Under

> *Nobility never came from chivalry. It came from being tough and ruthless.*

- Orlando the Duke of Oxford (The King's Man), 2022 American movie

COCHLEAR

Deafeningly expensive

GQG PARTNERS

Smashing the prospectus forecasts

SITEMINDER

When VC's sell, why should you buy?

COCHLEAR

Deafeningly expensive

Stocks Down Under rating: ★★

ASX: COH
Market cap: A$14BN
Dividend yield: 1.2% (0% Franked)

52-week range: A$180.29 / A$257.76
Share price: A$201.10

We last reported on Sydney-based medical device manufacturer Cochlear on 17 July 2020. The company manufactures a variety of devices that help people with hearing problems. Most of the devices manufactured by the company are implantable and range from cochlear implant systems to bone conduction systems and device accessories. Cochlear's operations span the globe and the company has a robust Research and Development (R&D) division that releases new and improved versions of its existing products regularly.

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ASX: GQG
Market cap: A$5.5BN

52-week range: A$1.57 / A$2.13
Share price: A$1.87

Based in the United States state of Florida, GQG Partners is an asset management firm focused on equities. The company has numerous strategies that its clients can select, ranging from global, domestic (United States) and emerging market equities. GQG Partners' strategies are based around its domestic-based mutual funds, managed funds in Australia, funds regulated by the European Union and 'sub-advised' funds. The latter are funds that are managed by another firm than where the assets are held. Despite its short history, the company employs highly experienced with stellar track records. However, as the company itself states, past performance is not indicative of future results.

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Share price chart

Source: Tradingview

Sticking to what it knows

Cochlear was founded in 1981 and quickly became the world leader in hearing aid equipment with a 60% market share in cochlear implants globally. It provides its products throughout the world and uses a range of distributors and partners.

The company hasn't changed much over time and continues to innovate in the space. For example, the company launched the Nucleus Profile Plus Implant in April 2019. The main benefit that it offers over its predecessors is the ability for certain MRI scans to be performed without removing the internal magnet.

The major development that the company is currently focusing on is a fully implantable cochlear implant. This implant would be usable with or without external devices and would be capable of providing 24-hour hearing. The end goal, of course, is to eventually create a device that makes hearing as easy for the hearing impaired as it is for the average person.

This device is currently still in the feasibility study phase, with Cochlear testing its safety and market demand. Meanwhile, the company continuously improves upon existing designs and frequently releases updated iterations. For example, it received FDA clearance for the Osia 2 System in November 2019. The Osia 2 can bypass damaged areas of the natural hearing system and send sound vibrations directly to the cochlea.

The company is also diversifying its portfolio to a small extent. In November 2018, it invested $21m in Nyxoah, a Belgium-based company working on a nerve stimulation therapy for people with obstructive sleep apnea. Cochlear is currently Nyxoah's largest shareholder.

If you have hearing problems, you need Cochlear

Cochlear's products fall into four main categories. The company's most 'basic' product is the cochlear implant. Cochlear implants are effective for people with moderate to severe hearing loss and when we say basic, it's all relative. A cochlear implant is an incredibly complicated piece of technology. The implant works by stimulating the hearing nerve using electrical signals to ensure that the person's ear can register signals that would otherwise be lost. Cochlear also developed an implant that combines acoustic sound to enable 'hybrid hearing'. Hybrid hearing is when a patient can hear low frequency sounds, but uses an implant to facilitate hearing high frequency sounds.

Apart from cochlear implants, the company makes bone-anchored prosthetics that can reduce the cosmetic outcome of facial prosthetics. These prosthetics work by fusing titanium implants with the bone. Lastly, Cochlear sells a bone conduction implant. These implants use vibrations in a person's bones to allow them to hear clearer and overall better.

Apart from the three major products, the company also manufactures a lot of accessories and electronics to enable the hearing impaired to live a better and more normal life. These fall under the company's True Wireless range. The products include a mini microphone, a phone clip and a wireless TV streamer.

Lastly, the company provides various support groups and programs that allow people to seek help from others who are in a similar situation. Some of these programs can also be used to arrange consulting sessions to find the right product for each person.

COVID-19 is as bad as hearing loss

COVID-19 was devastating for Cochlear due to a collapse in elective surgeries worldwide. In February 2020, the company reduced its Net Profit After Tax (NPAT) guidance from between $290m and $300m to between $270m and $290m. However, the company ended up posting a loss of almost $240m in FY20 as management's comments in February indicated it believed COVID-19 would mostly stay in China, rather than the rest of the world (compared it to SARS). Additionally, the company ended up eating a $416.3m patent litigation expense after an unexpected adverse judgement was handed down in its long-running AMF patent infringement case. The payment was made in June 2021 after the judgement became final on 26 May 2020 after multiple requests for an appeal were denied. In response, both the board and senior executives took a pay cut and the company had to raise its debt ceiling. In March 2020, Cochlear raised $880m at $140 per share through an institutional placement and a share purchase plan. In July 2020 one board member retired and in August 2020 the CFO resigned.

FY21 has seen a much-needed return to form for the company. In February 2021, it received approval from both the United States FDA (FDA) and from the European Union in the form of a CE Mark for the Baha 6 Max Sound Processor. Despite being the same size, it has a better hearing range than its predecessor and offers direct streaming from Apple and Android devices. Revenues went from $1.32bn to $1.5bn, with the company posting a NPAT of $326m.

However, the increase in FY21 was mainly attributable to the massive pick up in elective surgeries. Those unable to access hospitals to receive hearing aids went ahead and got them all at once, leading to a dramatic increase in Cochlear's revenues and profits.

According to consensus forecasts, the company's revenues should continue to grow, increasing to more than $2bn by FY24. However, the company's EBITDA is only expected to amount to $576.6m by that year. This means that the shares are trading at a 22.3x EV/EBITDA multiple for FY24, which we believe is not justifiable considering Cochlear's current EBITDA growth trajectory.

In FY23 and FY24, EBITDA growth is only forecasted to be 14% and 12.1%, respectively. And this is fairly far out. We hope to get a detailed outlook on 22 February 2022 when the company will release its 1HY22 results.

If Cochlear can achieve its goal of a totally implantable cochlear implant, maybe such a valuation could be justified. However, that is likely years away keeping in mind regulatory approval risk. Based on its current valuation, Cochlear is a two-star investment in our book. It is a great company with a strong competitive advantage, but it is simply too expensive at the moment.

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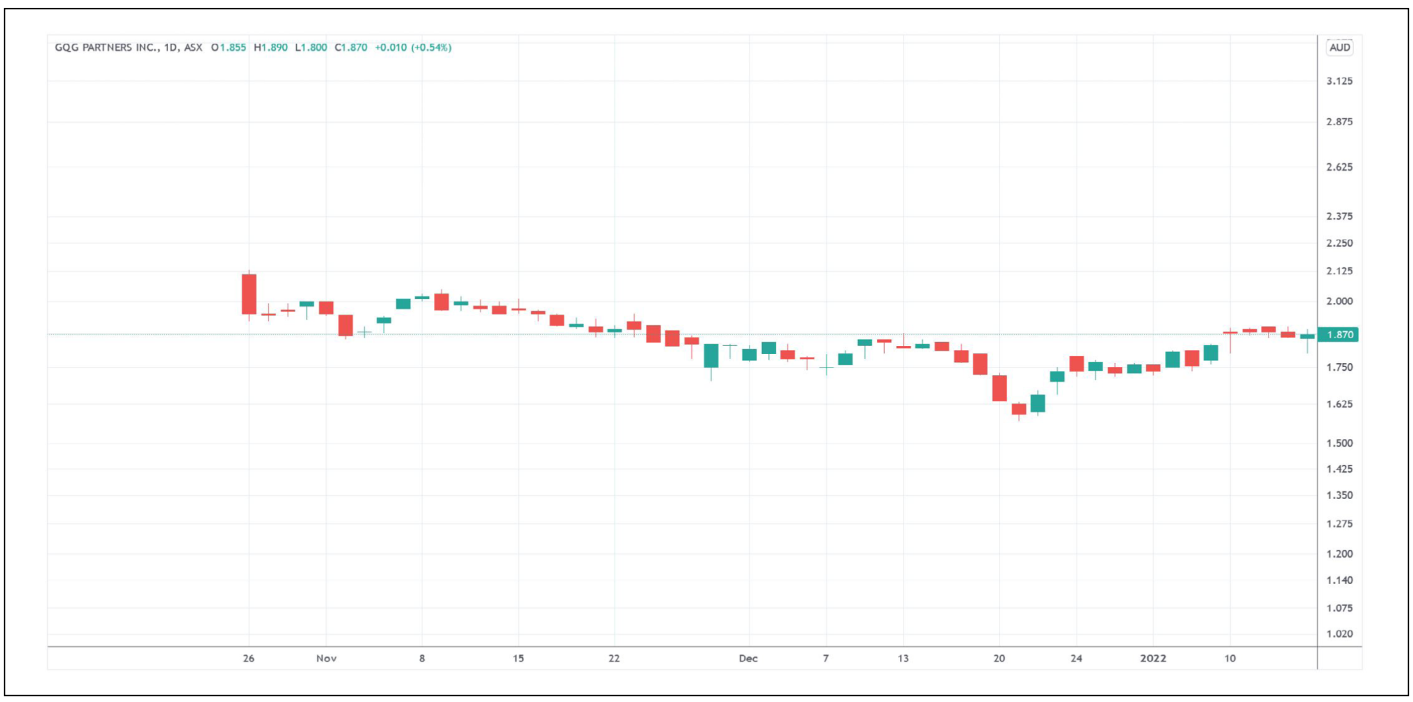
Share price chart



Source: Tradingview

A hybrid investment strategy

On the face of it, GQG Partners tries to keep its strategy as simple as possible by focusing almost solely on equities. However, the underlying thought process is much more complex. For one, the company takes advantage of diversification and opportunities by investing all over the globe. This allows it to protect its assets under challenging market conditions while simultaneously pursuing growth in emerging markets.

While GQG Partners does not reveal the exact details of its investment strategies, management does state that its approach is slightly different. It takes a hybrid approach between value and growth investing by pursuing companies that have the potential to make a massive impact in the long term, i.e. five years or longer. This implies a fairly long investment horizon.

ASX's largest IPO in 2021

GQG Partners was formed in 2016 on the back of a wealth of experience. CEO Tim Carver previously served as the CEO of Pacific Current Group (ASX: PAC | see 26 March 2021 report), as a General Partner in Orca Bay Partners and did a brief stint as an analyst at Morgan Stanley. The CIO Rajiv Jain served as a CIO, CEO and

Portfolio Manager of Vontobel Asset Management (SWX: VONN). With a combined experience of over 40 years in the investment management industry, the two co-founded GQG Partners.

GQG Partners listed on the ASX on 26 October 2021 at $2.00 per share, raising $1.2bn, making it the largest IPO on ASX in 2021. Despite the majority of GQG Partners' funds targeting its 'domestic' market (United States), it has a decent presence in Australia. CEO Tim Carver's familiarity with Australia (and its semi-annual reporting requirements) is what tipped the company towards an IPO on the ASX, rather than on a US exchange.

Despite an initial rally pushing the stock as high as $2.13, it closed its first day of trading down at $1.95. The founders are exceedingly optimistic, though, and have pledged to put at least 95% of their net (after fees and taxes) proceeds from the IPO into the fund for at least seven years.

The share price is stagnant for a reason

In FY18, GQG Partners reported revenues of $65m, generating a Net Profit After Tax (NPAT) of $32m. Fast forward to FY20 and revenue increased to $227.5m with a NPAT at $168m. Total Funds Under Management (FUM) has followed pace, growing from US$85.8bn to US$90.4bn in the month of October 2021 alone. While November 2021 saw FUM decline to US$87.3bn, by 31 December 2021 this had recovered to US$91.2bn. By ending 2021 at US$91.2bn, GQG Partners ended the period with net inflows of US$6.2bn, smashing the prospectus' forecasts of US$3.9bn for the six months following 7 October 2021.

All of this provides solid evidence that GQG Partners is on track to materially increase its profits once again. In 1HY21 (ending 30 June 2021), the company posted revenues of $183m and a NPAT at $146m. In other words, GQG Partners has made almost as much money in 1HY21 as it did in all of 2020. The prospectus forecasts had NPAT growing to US$227.6m (21.8% year-over-year growth) in 2021 and US$247.3m (8.7% growth) in 2022.

However, we would note those forecasts were based on closing FUM for the prior years of US$88.6bn and $92.5bn, respectively. As we already stated, GQG Partners smashed those forecasts making it clear that the prospectus likely underestimated 2022's potential.

In our view, the biggest risk when valuing GQG is its long investment horizon. Most of its profits have so far been generated through management fees as opposed to performance fees. While that can allude to the company's investment philosophy (its investments will take a while to mature), we only have management's experience to form the basis of our opinion at the moment.

As such, investing in GQG carries slightly higher risk compared to funds with a longer track record. Still, there is no doubt that management is more than competent. And the founders are confident enough to put their money where their mouths are.

The stock has taken a bit of beating since its IPO placing its current 2022 P/E multiple at 16.3x (based on the prospectus forecasts). All-in-all, we believe for those with a higher-than-average risk profile, GQG Partners is worth a punt. Four stars.

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Share price chart

Source: Tradingview

Subscription-based business model

SiteMinder calls itself a worldwide hotel commerce platform. But this is just a fancy way of saying it's a single platform for hotels to manage everything from guest data, reservations, web design and analytics to managing third-party hotel listings. The all-encompassing nature of SiteMinder is why the company has over 32,000 hotels, 1,350 integrated partners and manages 105m hotel reservations annually in 150 countries.

The majority of SiteMinder's $100.8m in total revenue generated in FY21 was through the recurring subscription fees it charges for the use of its platform (83.3% of total revenue). The remainder of SiteMinder's total revenue is generated through a percentage or fixed fee (depending on the product) the company charges for using its hotel payments processor and other applications.

In FY21, the monthly Average Revenue Per User (ARPU) was $257, impressively flat compared to FY19 and FY20's $244 and $259, respectively. In fact, ARPU increased to $265 in 4Q21 after the company raised rates, but kept its monthly revenue churn rate low. In FY19, FY20 and FY21, the average revenue 'churn' (the percentage of clients who stopped using the platform) was 1%, 1.5% and 1.6%, respectively. So, while churn has been increasing, it is still extremely low overall and remains a strong indication of how valuable SiteMinder's platform is to its customers.

COVID-19 is not over yet

In late 2021, we all hoped the COVID-19 era was finally entering a more manageable phase, allowing travel and tourism to begin to return worldwide. While Omicron is not as dangerous as Delta, that's all relative (it can still be dangerous for some) and early evidence shows it's far more infectious. The 'R0' for the Omicron strain is not yet known, but Delta is estimated at between five and eight, according to a 26 July 2021 article by the University of New South Wales Sydney. For those not familiar with the term R0, it's the reproduction number. The higher the number, the more contagious the strain. For a point of reference, Ebola has an R0 of 2 and Measles is at 18.

SiteMinder does not own a hotel chain, but the company lives and dies by the growth of the global accommodation industry. So, while the company does not have the same asset risk as its clients, the company's success in expanding its relationships and gaining new clients is undoubtedly at risk because of COVID. We remain of the opinion that the current situation caused by Omicron is only temporary, but it is still a risk significant enough to warrant its own section in this report.

Looking past COVID-19

While SiteMinder's business is helping accommodation providers, there is a direct correlation between the success of the travel and accommodation industry. In our 10 January 2022 Air New Zealand (ASX: AIZ) report, we said we believed the market was looking at FY24 and beyond when valuing travel stocks at that time. In fact, the current market consensus doesn't see SiteMinder returning to an EBITDA profit until FY24, and then only $570,000.

The good news, though, is that after the IPO last November, SiteMinder seems to be fully funded until profitability. The company raised $19.8m in a pre-IPO capital raise, which covered all IPO costs, leaving the cash position at approximately $101.2m following the IPO. The total loss SiteMinder incurred in FY19, FY20 and FY21, before depreciation, amortisation, impairment and fair value movement on derivatives, was approximately $18.6m. Based on the company's 8 November 2021 cash holdings, SiteMinder can fund all three years more than 5 times over. In our view, this means the company's operations are not just fully funded, but SiteMinder has plenty of room to make a few strategic acquisitions as well.

When PE or VC is selling, watch your wallet

Here's the catch, though. SiteMinder's EV/Revenue valuation over the next few years is sky high. FY22, FY23 and FY24's annual revenue growth is forecasted to average 21.4%, implying EV/Revenue multiples of 15.1x, 12x and 9.4x, respectively. It seems the market is ignoring these loss-making years and is looking ahead to FY25 and FY26 already. Although FY25's EBITDA growth is meaningless given the low base in FY24, FY26 is expected to see an attractive 206.3% EBITDA growth. But that is still four years away! And the EV/EBITDA multiples for these years are 176.8x and 57.7x respectively.

In our view, SiteMinder is just too expensive right now. We are always very mindful when Private Equity or Venture Capital (VC) firms sell their portfolio companies, because they usually do so at valuations that are too high. SiteMinder is no exception, in our view, following the divestment by VC firm TCV that owned more than 56% prior to the IPO. Sure, there may be some upside potential to the stock if COVID miraculously disappears from the face of the earth. But SiteMinder's valuation leaves zero room for error…it's priced for perfection. And as we all know, we don't live in a perfect world.

We believe we should let the share price find some sort of equilibrium first, which we suspect will be lower than where we are today. In the meantime, it's two stars from us.

Pitt Street Research Pty Ltd

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