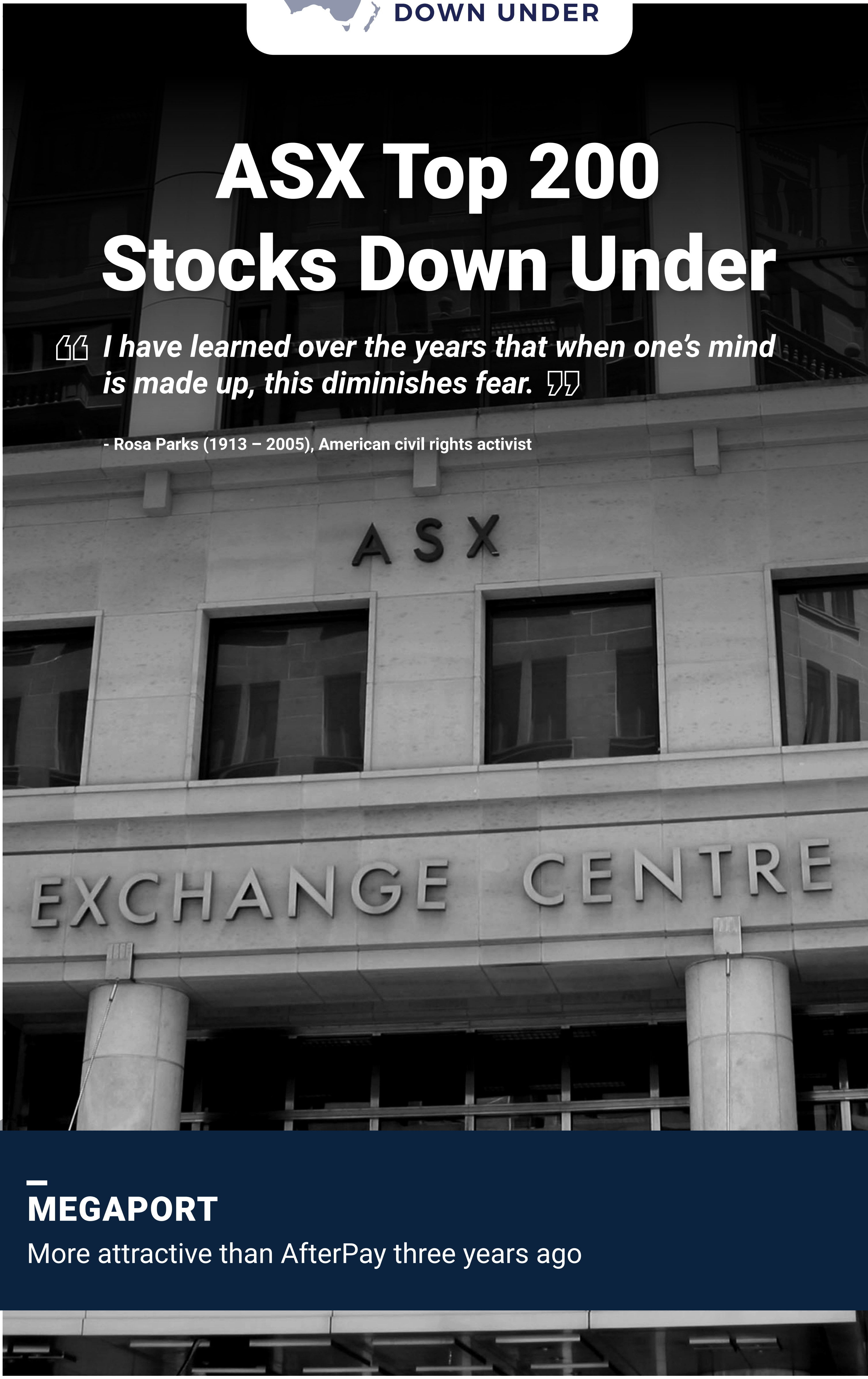


# ASX Top 200 Stocks Down Under

> *I have learned over the years that when one's mind is made up, this diminishes fear.*

**- Rosa Parks (1913 – 2005), American civil rights activist**

## MEGAPORT

More attractive than AfterPay three years ago

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**Stocks Down Under rating:** ★★★★

**ASX: MP1**
**Market cap: A$2BN**

**52-week range: A$10.67 / A$22.00**
**Share price: A$13.16**

On 8 February 2021 we deemed Brisbane-based Megaport overpriced despite an impressive FY20 result. The provider of enterprise Cloud connectivity solutions continued to catch a bid in 2021, but has dropped sharply in recent weeks amid broad market turbulence. With the share back at the same level of a year ago and solid growth prospects ahead, we have turned decidedly bullish on Megaport as a beneficiary of the digital transformation.

### Share price chart


*Source: Tradingview*

### The middleman of Cloud connectivity

Megaport is the middleman that helps enterprises connect with partners between various data centres as well as within the same data center. Simply put, its software makes it easier and more secure for businesses to connect to critical Cloud-based systems, such as daily collaboration tools, payments systems and data back-ups. The Megaport labyrinth connects to more than 400 data centres throughout Australia, Asia, Europe and North America.

Let's say Macquarie Bank needs a direct, secure connection to CBA's network to handle payments (banks need many of these types of connections). Instead of installing a data cable directly from Macquarie's IT hub to CBA's, the two banks can simply connect their networks in a data centre where they are both present, e.g. in NEXTDC's Sydney S1 data centre. Megaport will help connect the two banks inside this datacentre. Depending on the country and the required network speed, Megaport will charge between $500 and $16,000 per month per connection. Furthermore, once a customer is connected through Megaport, it can connect to any party that is present in a datacentre where Megaport is also present. So, even if Macquarie and CBA are not present in the same data center, they can still connect through Megaport given MP1's presence in a large number of these centers. That is a big money saver for Megaport's customers!

### MP1 is data center agnostic

While Megaport is not unique in the services it provides, what we like is that the company is data center agnostic. Another provider of similar services is data center giant Equinex, which is the world's largest data center company. However, we believe its services are limited to its own data centers. In other words, you wouldn't find Equinex in too many of its competitors' centers. Additionally, through its services, MP1 brings together a lot of individual service providers in this industry, meaning that its customers don't have to source these providers individually, which is a big headache for most of them. Lastly, once a customer is connected, provisioning of additional connections and services through MP1 can be done in a matter of minutes rather than weeks or months.

### Supporting digital transformations worldwide

After posting 66% revenue growth in FY20, Megaport had a tough act to follow in FY21. Although top line growth slowed to 35%, it marked another record performance for the company. Demand for its services remained strong off an unusually potent year as its customer count climbed to 2,285 from 1,842. The net loss of $55m worsened from $47.7m in FY20, but this was expected and a result of investments in product development and marketing to capitalise on a hot market.

Megaport's FY21 coincided with an announcement about the acquisition of New York City-based InnovoEdge, an AI-powered cloud management start-up. Another step in improving Megaport's network, InnovoEdge will drive ease of use and increase functionality at a time when enterprises are seeking simple NaaS solutions that can do more. We think the US$15m purchase price was a small one to pay to bring in an innovative, complementary business with strong industry connections including US graphics chip leader Nvidia.

Earlier this month, Megaport provided its 2Q22 update that confirmed the underlying strength in the business. However, this mostly fell on deaf ears as global equity markets declined and the 8% quarter-on-quarter revenue growth prompted a further selloff. This was a near-sighted overreaction, in our view, given what's coming further down the road in terms of 43% FY22 revenue growth and positive EBITDA in FY23.

### More attractive valuation than AfterPay 3 years ago

As Megaport has yet to turn the corner on profitability, we have traditionally valued the share using an EV/Revenue approach. The EV/Revenue for FY22 is 17.2x, which compares favourably to the 43% projected revenue growth this year and 42% in FY23.

However, Megaport's main attraction, in our view, is its scalability and how that translates into EBITDA growth. The company is expected to generate positive EBITDA for the first time in FY23 ($22m compared to -/-$4.3m expected in FY22).

In FY24 and FY25, EBITDA growth is projected to soar by 170% and 87% respectively, while revenue is "only" expected to grow by 36% and 22% in those years. In other words, most of the additional revenue Megaport realises from FY23 and beyond will fall straight to the EBITDA line, and then to the bottom line, because the bulk of investments have already been done in the years up to FY22. This scalability is why we like Megaport so much.

If we then look at valuation, we see the shares are currently valued at EV/EBITDA multiples of 32.6x for FY24 and 17.4x for FY25. So, on our beloved EV/EBITDA-to-EBITDA-growth metric, Megaport is trading at a ridiculously low 0.19x and 0.20x for both years. When we first started liking AfterPay three years ago, it was trading at higher metrics than this! Following the recent Tech selloff, Megaport's valuation is no longer in the clouds, so we elevate our rating to four stars. We think this stock can easily more than double in the next 12 months, market sentiment permitting.

MP1 will be reporting its 1HY22 numbers on Wednesday 9 February. Given the current market sentiment, you may want to wait and see what the company has to say before you jump in.

**Pitt Street Research Pty Ltd**

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