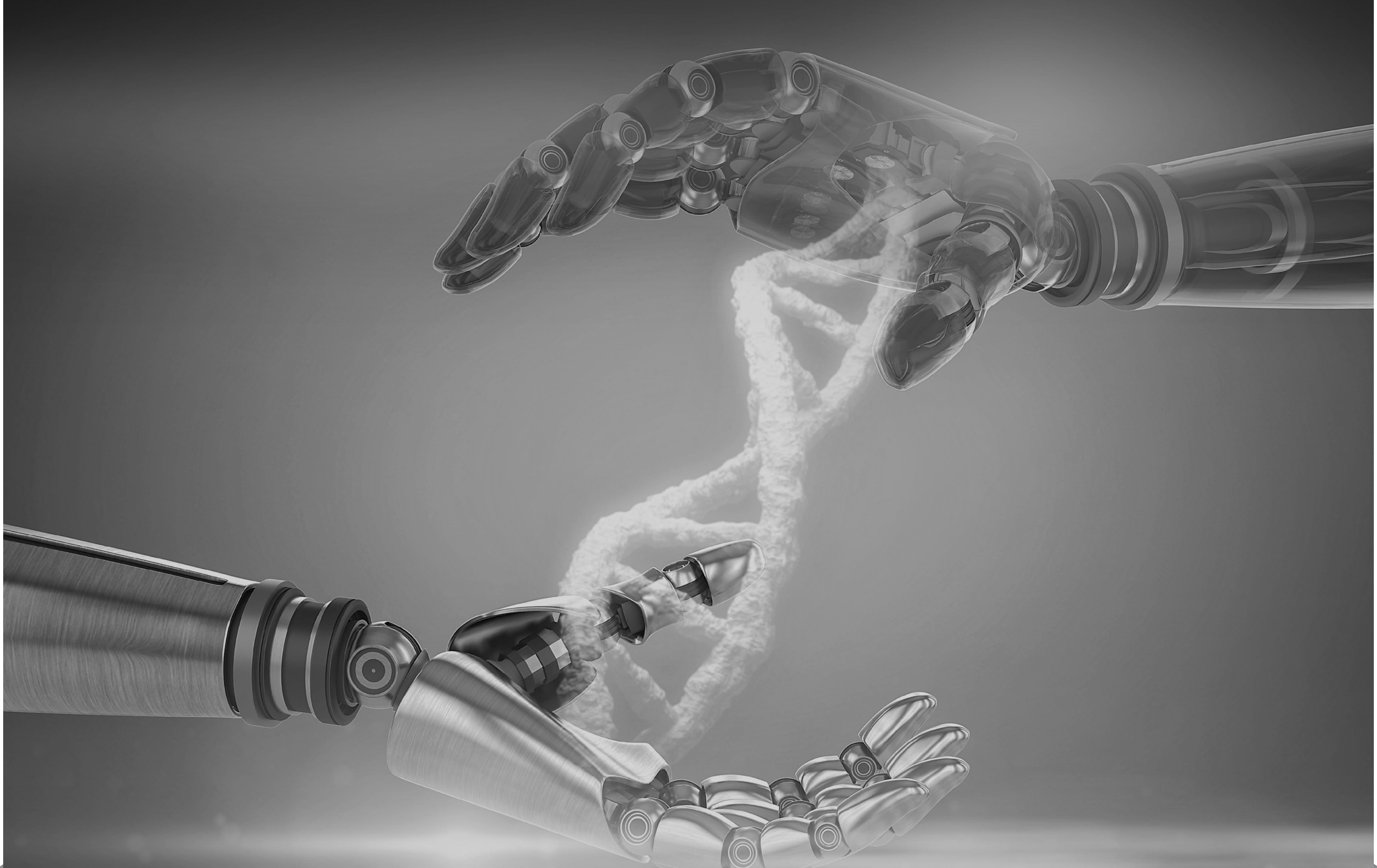
STOCKS DOWN UNDER

1 FEBRUARY 2022

Emerging Stocks Down Under

> *Love your enemies, for they tell you your faults.*
>
> - Benjamin Franklin (1706 - 1790), American Founding Father and inventor



LI-S ENERGY

Time for some fence-sitting

TOUCH VENTURES

Unicorn hunting

PROPHECY INTERNATIONAL

A prophecy of profits

LI-S ENERGY

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Stocks Down Under rating: ★★★

ASX: LIS
Market cap: A$685M

52-week range: A$0.965 / A$3.05
Share price: A$1.20

Brisbane-based lithium-sulphur battery technology developer Li-S Energy might have only listed on the ASX on 28 September 2021, but the team at Stocks Down Under knows the company quite well. In fact, just one month after the company listed, we published an interview with Li-S Energy's CEO, Dr Lee Finniear. As regular readers of Stocks Down Under will know, we cover many companies that develop new technologies to drive the current energy transition. Li-S Energy is no exception and its lithium-sulphur battery technology is nothing short of revolutionary, in our view. However, since listing at $0.85 per share, the stock price has exploded like a battery in a microwave. So, while we love Li-S Energy's management and technology, we need to take a hard look at the current valuation to see if this hot stock needs to cool off.

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ASX: TVL
Market cap: A$146M

52-week range: A$0.20 / A$0.74
Share price: A$0.205

Previously AP Ventures, Touch Ventures listed on the ASX at the end of September 2021. The company focuses on post-revenue start-ups with high-growth potential in the retail innovation, fintech and data sectors looking to scale and develop internationally. Through its partnership agreement with AfterPay, it hopes to invest between $10m and $25m in new ventures. After raising $100m through its IPO, the company currently has a portfolio of seven companies. As of 31 December 2021, Touch reported its Net Tangible Asset Value per share at $0.27 and with the goal to expand its portfolio to between eight and ten, we think this is just the beginning.

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Share price: A$1.09

Headquartered in Adelaide, South Australia is one of the boldest-named companies we have covered at Stocks Down Under. Unfortunately, for shareholders, Prophecy's results have been effectively flat over the last three years, a serious issue when you are operating at a loss. Accordingly, the stock has been trading more or less sideways as well for the last three years. That all changed on 1 October 2021 when it jumped 31.5%. What happened and could profitability finally be within reach?

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Share price chart

Source: Tradingview

Lithium-sulphur? That must be a mistake

No, our analyst did not have a stroke. We are indeed talking about lithium-sulphur batteries, a new type of battery that Li-S Energy is developing. But before we tell you more, let's explain why humanity needs a replacement for lithium-ion technology.

Lithium-ion batteries have been the backbone of electric powered technology since at least the 1990s, when it became a staple in consumer electronics. Since then, major advancements have drastically increased the efficiency and capacity of the technology, while simultaneously causing the price to crater. According to S&P Global Market Intelligence, lithium-ion battery packs cost US$1,183 per kilowatt hour (kWh) in 2010, only to decline to US$156 per kWh by 2019.

While production efficiencies have played a major role in driving down the price of lithium-ion batteries, the rapid emergence of renewable energy sources in the last fifteen years has played a vital role as well. Many have considered US$100 per kWh to be the tipping point for when electric cars reach cost parity with gas and diesel vehicles. According to BloombergNEF estimates, this will be achieved in 2024. The only issue is US$100 per kWh is also widely accepted to be right at the limit of lithium-ion battery technology's capabilities.

Associate Professor in the Department of Mechanical Engineering at Carnegie Mellon University Venkat Viswanathan has gone on record saying he forecasts lithium-ion battery prices could still decline by about 20% to 30%, but that it will not likely get much cheaper. While the exact point where the technology will hit a wall is up for debate, Professor Viswanathan's point is widely, if not universally, accepted. Lithium-ion battery technology will get us to the tipping point, but no further.

Did lithium make a deal with the devil?

The fact that we will hit the limits of lithium-ion technology sooner rather than later is nothing new and even a decade ago, research to find a replacement was underway. Research into finding a replacement technology for lithium-ion is unusual because of the number of actors attempting to solve the issue. While battery technology is often exclusively mentioned regarding renewable power storage or Electric Vehicles (EVs), batteries are in everything from the laptop we used to write this article to the cell phone many humans treat like an appendage.

The approaching limits of lithium-ion technology affect all these industries and more. For example, new smartphones often have a shorter battery capacity than the new version of the old model. A 2018 investigation by The Washington Post found that most iOS and Android-based smartphones have witnessed an enormous decline in battery life compared to older generations. Despite the advances in lithium-ion battery capacity, the power needs of new technology have far outstripped them, which brings us to Li-S Energy.

Promising technology, but it will take time to develop

Lithium-sulphur technology is nothing new and while it offers a theoretical energy capacity of approximately five times that of a lithium-ion battery, it tends to fail after only 30 cycles, making it completely uneconomical. This is where Li-S Energy has changed the game through Boron Nitride Nanotubes (BNNT) and a proprietary nanotechnology composite. The company claims that this not only increases the total number of potential cycles to over 1,100, but that it also increases electric energy capacity retention by 15% - batteries slowly lose their charge over time when not used.

Li-S Energy currently has a five-year agreement with BNNTTL for commercial quantities of BNNT and exclusive distribution rights to the global battery industry for lithium-sulphur batteries, effective July 2021 (automatic renewal for two years). BNNTTL is currently the largest and lowest-cost producer of BNNT globally, so this is a very important contract.

Where does this leave Li-S Energy? According to Li-S Energy's current development roadmap, it will take at least three years to move from development to production. In the meantime, basically every technology-based industry is throwing money at developing a replacement for lithium-ion technology. While we believe Li-S Energy is on the right track, there is a risk that it will be beaten to the punch, i.e. another technology may be developed in the next ten years that's better.

We'll sit this one out, for now

Li-S Energy does have plans in motion to generate some revenue in the near future through trial batteries produced at its pilot facility and if the company was valued under $100m, that might be relevant. However, with the company's market capitalisation currently around $685m, any revenue generated by these trial batteries is essentially irrelevant. That's not to say the trial batteries are irrelevant, far from it, but we care about how well they will perform, not about any potential revenues the batteries may generate.

There is significant potential for Li-S Energy's technology and, if successful, shareholders will likely be in for a grand slam level. Unfortunately, it will likely be a long three years and we expect Li-S Energy will need to return to the market a few times for additional capital.

So, in our view, an investment in Li-S Energy at this time would be prudent for investors looking to gain exposure to candidates likely to replace lithium-ion, but at this stage nothing is certain. The stock has been on an almost constant decline since the beginning of November and with the uncertainty in the financial markets, we think it's best to sit on the sidelines for now. Three stars.

Take a look at Pitt Street Research's 9 December 2021 report on Li-S Energy for more background on the company's technology.

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Share price chart

Source: Tradingview

More AfterPay?

Perhaps unsurprisingly, half of Touch Ventures' holdings are Buy Now Pay Later (BNPL) services operating across different markets. But despite its Aussie roots, Touch invests in start-ups worldwide. In 2021, the company acquired a 13.3% stake in Postpay for US$5m, it invested $5m in Till Payments Global and has the option to invest a further US$6.25m into Happay of which it already owns 20%.

Postpay and Happay are retail BNPL services offering consumers the option to pay in instalments as AfterPay does. Till Payments offers a single-source payment platform, based in Australia. Postpay and Happay are based in the United Arab Emirates (UAE) and China. China is particularly resistant to Western tech companies' expansion and the Chinese government has gone so far as to keep its population captive behind its 'Great Firewall'. With new restrictive regulations being passed by Chinese premier Xi Jinping every week in the name of 'Common Prosperity', it's possible AfterPay will be forced out of China despite its recent partnership with Tencent (SEHK: 700). Happay gives Touch a foothold in what could well become the world's largest BNPL market.

Touch has also increased its holding in Play Travel and that company's PlanPay service from 77.9% to 82.4% for $1.9m. In collaboration with AfterPay, Play Travel sells travel packages, basically acting as a travel agent. The partnership works by AfterPay handling trips costing $3,000 or less. If the trip costs more, customers can borrow up to $12,000 and pay it back through PlanPay. With ready-made holiday packages offered for destinations across Asia, the Pacific and within Australia, Play Travel is ready to capitalise on what we expect to be a post-COVID travel boom.

Unicorn hunting

Touch's listing on the ASX gives retail investors the ability to take part in Venture Capital (VC) funding. VC can be risky and 75% of VC-backed start-ups fail. As high as 90% of start-ups overall don't last, so maybe Touch VC investors are doing something right.

Of course, when you invest in a VC firm, you don't get to make the decisions, the VC firm does, so you need some trust. So, should you trust Touch Ventures? We think so. Both the CEO and CFOs Hein Vogel and Gerard Pais left Investec's emerging companies division to launch Touch Ventures in late 2019. Another key member of the team is Carl-Olav Scheibel, the former CEO of AfterPay subsidiary Clearpay. Combined, they have over 50 years of experience in VC and Fintech.

Fintech Future

In 2HY21 Touch generated a gain on its investments just shy of $15m and a Profit After Tax (PAT) of $14m. Earnings Per Share (EPS) in this period amounted to $0.03 for a P/E of 16.2x for FY21. While this is nothing too special, it is a considerable improvement on 2HY20, when the company generated a loss of $70,000. These figures are typical of a young VC firm and we expect the company will experience strong growth in the near future thanks to the A$100m it raised through its IPO.

The fintech market is expected to balloon to US$325bn by 2026, growing 23% per annum worldwide. It has already grown from $250m in 2015 to $4bn in Australia today, making Australia one of the top 10 countries for fintech start-ups. We believe Touch Ventures will give retail investors the opportunity to get the most out of that growth. Four stars.

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Source: Tradingview

Prophecy's two drivers

Almost every religion has some form of prophecy. In fact, foretelling the future is arguably one of the oldest of human traditions. There have been many ways prophecies have come into existence. For example, many historians believe the Oracle at the Temple of Delphi in Greece used the hydrocarbon gases in the spring water. Ethylene, to be specific, a sweet-smelling gas that produces a disembodied euphoric, narcotic effect.

Fortunately for Prophecy International shareholders, the company does not rely on any narcotic to generate its revenues. Far from it, Prophecy is a business software developer with two main products: Snare and eMite. In FY21, the company generated $13m in revenue; $8m in licencing, $4.5m in maintenance and $375,297 in consulting fees.

Before we move on, let's take a quick look at Prophecy's two flagship software products. Firstly, Snare, a cyber security software product. Snare's specialty is a centralised log of all activities combined with data analytics. This combination allows customers to keep track of user access and to catch cyber-attacks in real-time.

eMite is a more comprehensive product that includes features like a real-time and historical analytics platform, KPI products, a contact centre for client's customers, etc.

A Prophetic letter to shareholders

A quick look at Phophecy's announcements would leave an investor rather confused. Why did the stock jump between 1 October and 4 October 2021 when the company only announced its contract with Humana (NYSE: HUM) on 7 October 2021 (we will come back to this later)? One easy assumption is that Prophecy has a leaky ship and insiders drove the rally, but as we said, that's the easy assumption and we don't think it holds up to scrutiny.

On 30 September 2021, Prophecy released its FY21 full year statutory accounts, and let's be clear, it was nothing special. In FY21, revenue declined 3.6% year-over-year and grew only 9.9% compared to FY19. Even worse, EBITDA had declined from a loss of $435,000 in FY19 and $535,000 in FY20, to $1.8m in FY21. What we believe caught the market's attention was CEO Bra Thomas' letter to shareholders that was included in the accounts stating: "With multi-year industry tailwinds ahead, strong market positions and diverse streams of recurring revenue flowing from our essential service segments of cybersecurity and cloud contact centres, we look forward to delivering scalable and increasingly profitable growth in the year ahead". It's one thing to be optimistic, but to say "increasingly profitable growth in the year ahead" is a very specific statement that borders on official guidance.

Fortunately for Prophecy's lawyers, the CEO was not playing with smoke and mirrors. On 7 October 2021, management announced the largest SaaS customer in the company's history, major US health insurer Humana. The agreement sees Humana using eMite for an initial term of three years. The minimum annual revenue from this contract is $1.8m, meaning eMite's Annual Recurring Revenue (ARR) exceeded $10m for the first time.

On 16 November 2021, management made a two-part announcement that led further credence to the CEO's bullish comments. First was the news that Verizon (NYSE: VZ) had extended its multi-year reselling deal. While this deal does not entail Verizon purchasing Snare's service, it does mean that Snare is available to Verizon customers. And it is reasonable to assume that Verizon would not have extended the resale agreement if they did not believe in the product. The second part of this announcement was regarding a change to Snare's sales strategy. The company announced that Snare is now also sold on a subscription basis with support via the Cloud or on-premise.

The last major announcement came on 26 November 2021, in the form of a general company update. In November alone, Prophecy announced it had added $1.8m in ARR (Annual Recurring Revenue), bringing the total to $15.4m. eMite has now firmly established itself as the main breadwinner of the company with $10.5m in ARR after a series of additional contract wins from three major companies: Farmlands Co-Operative Society, BPER Banca (BIT: BPE) and Providence St Joseph's Health.

Following Snare's change in revenue model, the company was able to grow subscription revenue to $600,000 and maintenance revenue now stands at $3.5m, totalling $4.1m in ARR. Clearly, the CEO knew what he was talking about in his FY21 letter to shareholders.

The prophecy of profitability

Prophecy is not yet profitable and prior to FY22, we would have had some serious doubts that it was ever going to be. However, the recent news out of the company is a major game-changer and on 20 October 2021, the company completed a $7.7m equity raising via a share placement at $0.81 per share. This brought the company's cash position to $11m per the end of December 2021.

Using FY21's net loss after tax of $2m, the capital raise alone gives the company more than five years of runway. This leads us to believe that additional shareholder dilution is unlikely, barring an acquisition over the next four years.

Since the November 2021 market update was still in the early stages of the FY22 financial year and we expect significant additional contract announcements in FY22, we believe taking the $15.4m in ARR as an estimate of FY22's revenue may be on the conservative side. Using this estimate, we get an FY22 EV/Revenue multiple of 4.6x on expected revenue growth of 20.3%. In our view this makes Prophecy a four-star investment, although we would caution that technology companies are currently taking the brunt of the market correction. So, before you jump in, maybe let the market pullback run its course. At the very least, wait for some consolidation in PRO's share price.

Pitt Street Research Pty Ltd

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