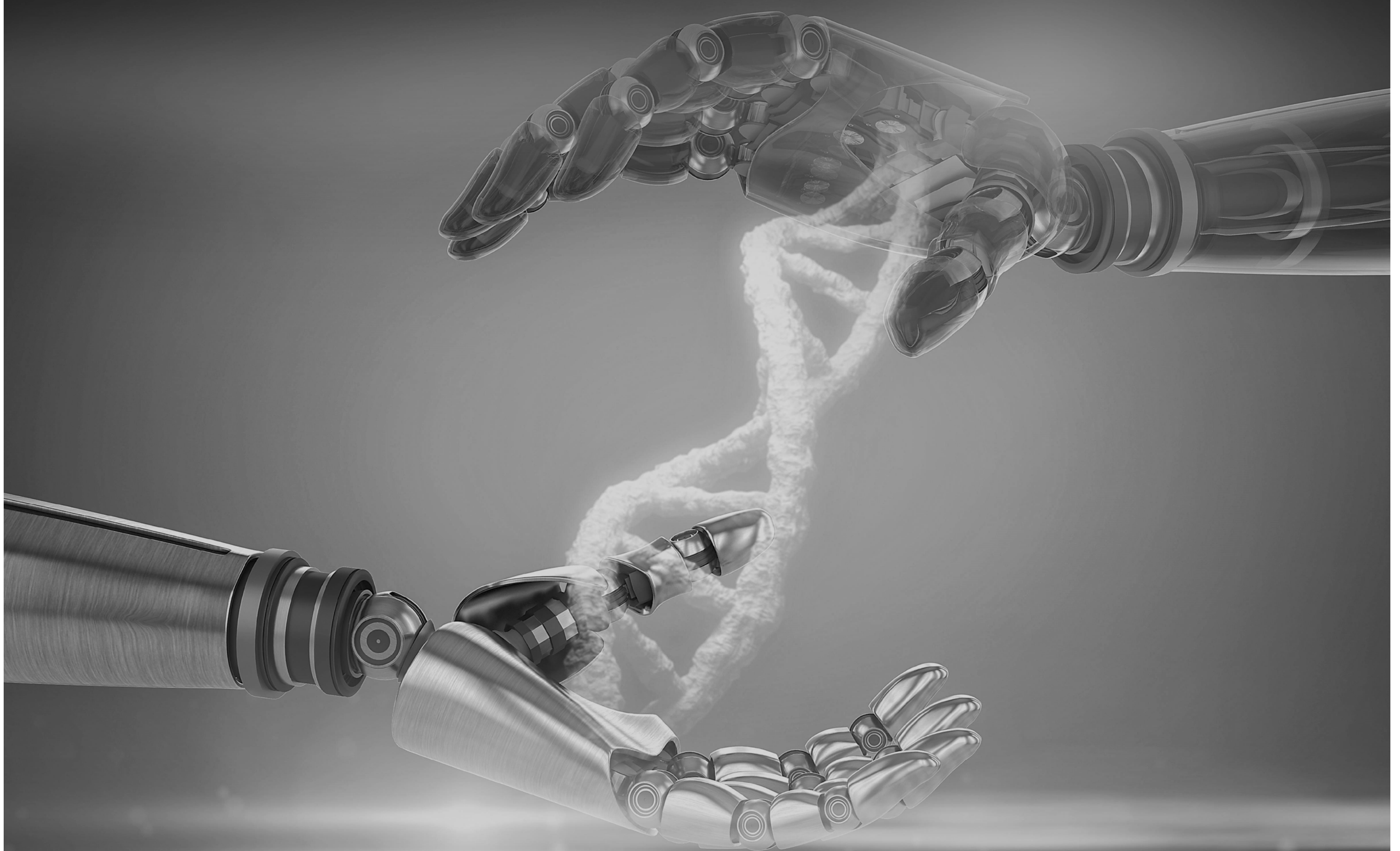
STOCKS DOWN UNDER

8 MARCH 2022

Emerging Stocks Down Under

> *While there are no shortcuts to getting rich, there are smart ways to go about it.*
>
> **- Phil Town (b. 1948), Investor and Author**



APPEN

Hey Google, where to now?

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Stocks Down Under rating: ★★★★

ASX: APX
Market cap: A$834.0M

52-week range: A$6.06 / A$18.66
Share price: A$6.76

Appen chose the worst possible day to release its FY21 results – the day Russia invaded Ukraine. The ASX crashed by 3% and Appen by over 25%. If you'd invested in Appen's IPO in 2015 and held up to now, you'd still have a very healthy gain given it was listed at 50 cents a share. But of course, you wouldn't be as happy if you'd bought in at over $40 a share in August 2020, especially because this isn't the first time it's crashed after results. So, where to now from here?

Share price chart

Source: Tradingview

How to train your...Siri?

Appen's business, in a nutshell, is sourcing and selling machine learning data to train AI algorithms. For AI algorithms to provide the best results, they need to be exposed to numerous examples of specific situations and be told what it is seeing or hearing. For example, Siri, Alexa or Google must hear the same query in dozens of different accents before they understand what's being said. This process is called machine learning and it is becoming a bigger and higher-margin business as AI is relied upon more and more.

The disruption to the economy from COVID-19 resulted in many businesses increasing their reliance on AI. For instance, eCommerce companies had to use more AI to cope with increased demand in their supply chains. This demand showed in Appen's share price until August 2020, when it hit an all-time high. But it slumped after its 1HY20 results and fell again after its full-year FY20 results in February 2021, its 1HY21 results in August 2021 and finally, its full-year FY21 results last month. Appen's market capitalisation is now less than a quarter of what it was in August 2020.

Why has it continued to fall?

We think there are four reasons. First, Appen's client base has historically been heavily concentrated around a handful of big tech companies and predominantly skewed towards algorithms for advertising purposes. The company is now diversifying its base into new clients and markets. Appen CEO Mark Bryan told the AFR in

February last year one example of these newer projects was training algorithms to combat misinformation. But investors are concerned that cash flows won't be as reliable and strong as before.

Second, the company's results in the last two years have disappointed and after missing FY21 guidance, it has given none for FY22. Although Appen has set the longer-term target of doubling its revenue by FY26, the decision to abandon short term guidance hasn't been perceived as a good sign for the short to medium term. Third, we believe investors have anticipated M&A activity because Appen's major rival Lionbridge was snapped up last year and investment bank Citi (which covers the company) declared last year that Appen could be a target. This has not happened – yet.

And finally, investors have been more bearish on high-growth tech stocks in anticipation of higher interest rates, which could impact the growth of Tech companies. Of course, unlike many Tech stocks that have suffered share price declines, Appen has a healthy cash balance and is EBITDA profitable.

Why we're sticking by it

As one of our Top Picks, we have been just as disappointed by Appen's share price performance. Its recent results weren't that bad, though. Its revenue was up 8% to US$447.3m and EBITDA was up 11.6% to US$78.9m. It paid a dividend of 10 cents a share and has a cash balance of US$47.9m. But it did miss previous EBITDA guidance (US$81-$88m EBITDA) by about US$2m and its growth rates were far slower than before – in 2018, it recorded revenue and EBITDA growth rates above 100%.

Consensus estimates have Appen recording US$505.1m in revenue and US$83.2m EBITDA in 2022, followed by US$543.3m revenue and US$94.1m EBITDA in 2023, which represent growth rates between 5% and 13%. Appen is trading at an FY22 EV/EBITDA ratio of 7.2x and a P/E of 15.6x. EV/EBITDA growth for FY22 is expected to amount to 7.3%, while this is set to accelerate to more than 11% in FY23. With lack of company guidance, we believe these growth rates illustrate the conservatism the market has built into its estimates for Appen following the disappointments in the last 18 months. The company's longer-term ambition through FY26 is to double its revenues, which implies and average growth rate of 15%.

It is also aspiring to rely more on its New Markets segment. This segment comprises of almost all its segments barring its big US tech customers. It includes product led businesses including its Government, China and Enterprise segments. In the past year, it has gone from 20% of Appen's revenue to 23% and grew 21% compared to Global Services (its big US tech customers) which only rose 5%.

We admit Appen's performance has been disappointing and think there could be more volatility in the short term. But we also think the stock has been punished too harshly in the current risk-off investment environment. Investors appear to have disregarded that Appen is still recording growth, is profitable, a dividend payer and has a significant market opportunity awaiting it, albeit different from what it was just a couple of years ago. While Appen did miss its EBITDA guidance, it was not a substantial miss – it recorded US$78.7m against the US$81-88m range previously forecast – and much of that can be attributed to Apple's iOS privacy changes. The company claimed the result was positively impacted in the second half, but investors took the yearly figure at face value.

Appen's share price will likely be volatile in the short term, but the growth in New Markets is boding well for the pivot away from too much dependence on the online advertising markets. So, we're again awarding four stars.

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