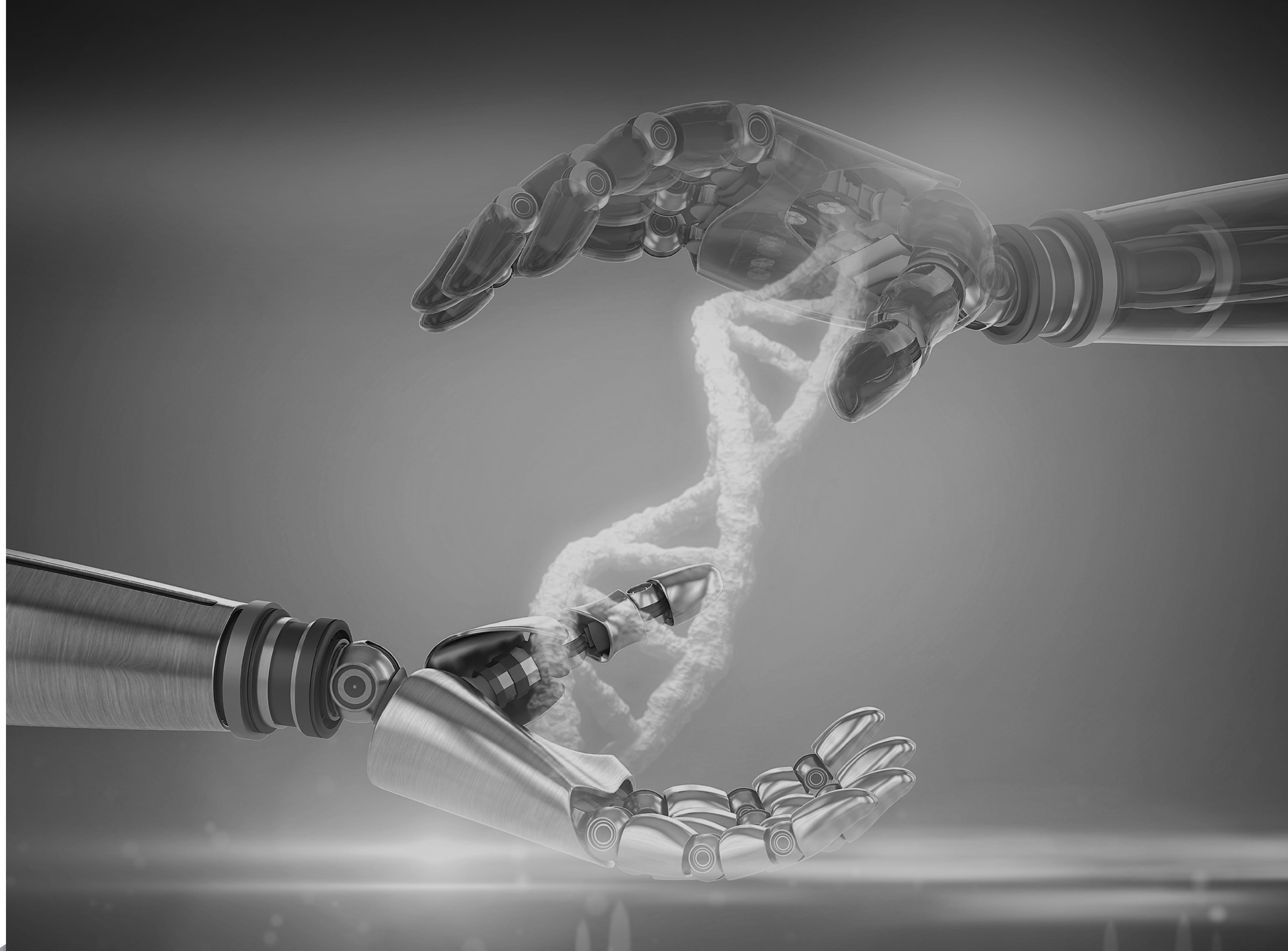
STOCKS DOWN UNDER

15 MARCH 2022

Emerging Stocks Down Under

"The stock market is like the weather. If you don't like the current conditions...wait a while."

- Louis Simpson (1937-2022), Berkshire Hathaway investment manager



PIVOTAL SYSTEMS

A severely undervalued chip stock

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Stocks Down Under rating: ★★★★

ASX: PVS
Market cap: A$85.9M

52-week range: A$0.47 / A$1.54
Share price: A$0.555

Long-time readers of Stocks Down Under would know we are big fans of the semiconductor industry. Semiconductors are responsible for most of the electronic devices we use in our everyday lives ranging from our phones to medical devices. While none of the companies on the ASX are global giants that directly supply semiconductors, many still play a vital part in the process and Pivotal Systems is one of them. Pivotal Systems is also one of the few players generating revenue, but it trades at a hefty discount to its peers – even some that are still in the R&D phase.

Share price chart

Source: Tradingview

GFCs – but not the bad kind

Pivotal Systems was founded in 2003 and listed on the ASX in mid-2018 at $1.86 a share. The company's two products – Gas Flow Controllers (GFCs) and Flow Ratio Controllers (FRCs) help stabilise and control the delivery of gases required in the semiconductor manufacturing process. Gases create the chemical reactions needed to shape a semiconductor's electrical properties, but only if done correctly. You need to control how much gas is used, the location where gases enter the reaction chamber, the speed at which gases enter and the mix ratio of gasses in case a mix is used.

These devices need to operate with extreme precision. For example, the opening and closing of valves is measured in milliseconds. The faster this response time, the better the production process can be controlled, leading to more working chips per wafer, or yield.

Pivotal's GFCs and FRCs are the fastest and most accurate flow controllers globally. They can monitor and maintain flow accuracy to a National Institute of Science and Technology (NIST) primary standard. Consequently, it is little surprise that its client list includes the three biggest industry production equipment suppliers: Applied Materials, Tokyo Electron and Lam Research.

The market for GFCs is over US$1bn and roughly 70% of this relates to semiconductor manufacturing. More generally, global semiconductor fabrication equipment sales are expected to reach US$98bn in 2022, up 10% from 2021.

So why is the share price down?

This said, we can understand investor scepticism about Pivotal Systems given its lack of performance relative to peers such as Weebit Nano (ASX: WBT) and BrainChip (ASX: BRN). While we are not withdrawing our support of BrainChip and Weebit Nano, we would note that Pivotal has been a revenue-generating company for some years. Meanwhile, Weebit Nano is not generating revenues yet, although Weebit's inaugural revenues are expected this year. On the back of its first commercial deal, BrainChip started to generate revenues in 2021.

We think there are four reasons why Pivotal Systems is down. Firstly, it conducted multiple capital raises at discounts to its listing price. While theoretically, discounts are supposed to attract institutional investors with the perception they are underpaying, retail investors take it as a management concession that a company was overvalued. Second, PVS isn't yet profitable and even though the company cut its full year loss from US$9.1m in FY20 to US$1.4m in FY21, investors have developed high scepticism towards non-profitable Tech companies. The company withdrew its guidance in the middle of the year due to component supply constraints on GFC manufacturing, spooking investors although it ultimately overcame these bottlenecks to record revenues roughly in line with that original guidance. Third, Pivotal is a foreign domiciled company, and many such companies have underperformed the market compared to their local peers. Pivotal is seeking a dual listing on the NASDAQ in order to bring global institutional investors into the stock.

Finally, the semiconductor and semiconductor equipment markets are expected to continue to grow, but at a reduced rate in 2022 vs 2021. In 2021, the Wafer Fabrication Equipment (WFE) market is expected to have grown 44%, but only 12% is expected for 2022. The reality is that the semiconductor market is notoriously cyclical and, consequently, not for faint-hearted investors. However, the long-term trajectory for semiconductor capital equipment remains strong, with a significant increase in new fabrication (fab) plants under construction in 2021 and 2022, alongside new government initiatives to secure and grow domestic semiconductor chip manufacturing in the US, Europe, South Korea, Japan and China.

With the share price where it is now, it's good to remember that smart semiconductor investors make their moves, and thus their money, well before the industry turns, i.e. when it hits the bottom or top of a cycle. Where the broader market typically moves about 6 months ahead of turn in an economic cycle, the Philadelphia Semiconductor Index (SOX), the industry's leading index, often moves 9 months or more ahead of a turn in the semiconductor cycle. In other words, investors in this industry need to look further ahead than they do in other sectors. For PVS it means we need to look ahead to the remainder of 2022 and we like what we're seeing with expected revenues between US$34m and US$40m in FY22 (PVS financial year is to 31 December).

PVS is substantially undervalued

We think the closest comparable company to Pivotal Systems (ASX: PVS) on ASX is Revasum (ASX: RVS), which is also based in the US and also provides equipment for the semiconductor manufacturing process. Revasum generated US$13.7m in revenue in FY21 and is forecasting US$25-$35m in FY22. Revasum's trailing EV/Sales ratio (allowing for currency conversions) is 4.1x, and its forward EV/Sales is 2.3x (based on the lower end of Revasum's guidance).

Pivotal meanwhile is trading at a trailing EV/Sales ratio of 2.4x and a forward EV/Sales ratio of 1.7x. One significant upside for Pivotal is that its flow controllers are at the leading edge in terms of performance. New USD$7-14bn semiconductor fabs are always built with leading edge technology.

We think Pivotal should be trading at least at par with Revasum and maybe even deserves a premium because it has higher trailing and forecast revenues. The company has some work ahead of it to reduce its cash burn and recently raised another ~$10m in capital. But we are encouraged by its increased order book (US$30.7m), backlog (US$3.9m) and increased gross margin (31.3%) - all of which have grown in the past year. Four stars from us.

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