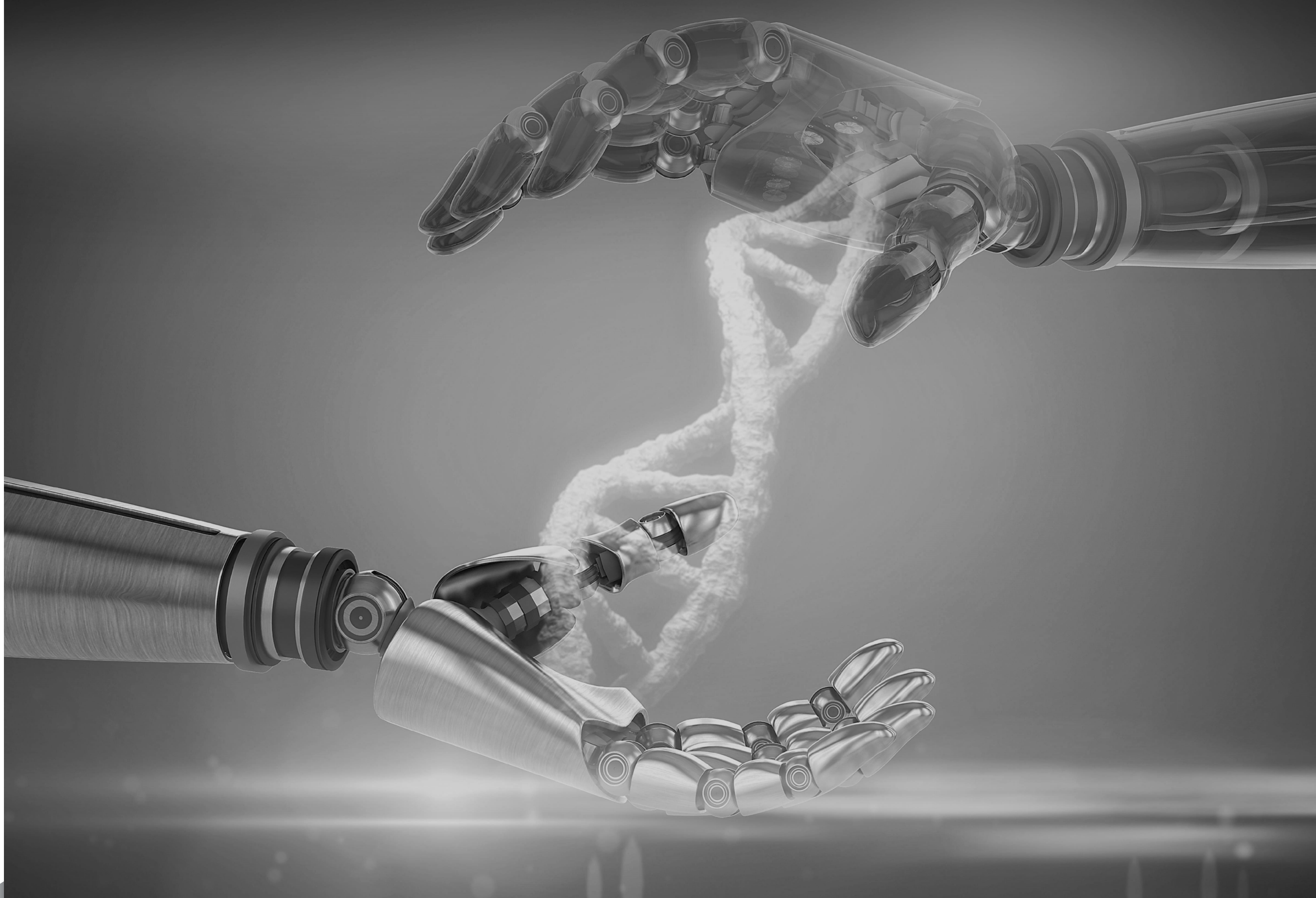
STOCKS DOWN UNDER

17 MAY 2022

Emerging Stocks Down Under

"When it comes to strategy, ponder less and do more."

- Jack Welch (1935-2020), CEO of General Electric



ELMO SOFTWARE

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Stocks Down Under rating: ★★

ASX: ELO
Market cap: A$281.2M

52-week range: A$2.90 / A$5.70
Share price: A$3.16

It's been a tough 6 months for the tech sector, but Elmo Software has been feeling the heat for longer, never reaching its pre-pandemic high of $8.39. We last covered the company in October 2020 concerned about its customer churn, which while not big, still big for a SaaS company. Arguably now the tech sell off is even a greater concern, but we see little cause for optimism in the months ahead.

Share price chart

Source: Tradingview

A solid company at face value

Elmo was founded in 2002 and listed in 2017 with a $108m market capitalisation, representing $2 per share. The company aims to be a one stop shop for HR functions, such as recruitment, performance management and leave management. As a Software-as-a-Service (SaaS) company, it receives monthly fees for its services and its clients don't need to install any new software or hardware, because everything is Cloud-based. And because of the complexity of HR and the hassle of switching, it is unlikely that clients will swap suppliers too often. The downside is that software requires a big investment up front, but for Elmo, that was done years ago.

We last covered Elmo in October 2020 and raised concerns that this theory was not playing out in practice – at least to the extent of other companies. In FY20, it recorded a customer retention rate of 90.2%, which was down from 92.1% a year earlier. Elmo attributed this to increased customer hardship due to COVID-19. Having withdrawn its guidance due to the pandemic, only to reinstate it a few months later, it only just met its forecasts with $50m in revenue and an EBITDA loss of $4.2m in FY20.

For FY21 the company forecast $57m-$61m in revenue and a negative $4m-$7m EBITDA with the former figure representing 14-22% growth and the latter representing no improvement. The company actually achieved positive EBITDA of $0.4m and revenue of $69.1m. It's Annualised Recurring Revenue (ARR) was $83.8m, up 52.1% year-on-year. ARR is revenue a company expects to receive from all its current customers in the next 12 months. In the last year or so, Elmo has benefited from returning business confidence and the rise in remote working. It has also rolled out new software modules. One was "Experiences", which operates as a journey builder and tracker – journeys alluding to promotions, onboarding or office moves. Another was "COVIDsecure", which enables Elmo clients to record, monitor and report on their employees' COVID vaccination and test statuses.

Digging deeper generates a different story

But Elmo has continued to be sold off, down nearly 45% in the past year, which is nearly double the 24% the ASX All Technology Index has dropped in that time. Rising inflation and interest rates discount the value of the future streams of cash flows for tech companies. Arguably Elmo has suffered worse because of its focus on SMEs, which are more likely to be hit by these factors than larger corporates because they will find it more difficult to borrow money. Additionally, their profit margins get squeezed as suppliers hike prices and consumers reduce spending.

We also note that, even though Elmo is EBITDA profitable, it still isn't NPAT profitable. It lost $26.7m in FY21, up from $17.2m in FY20. If significant items are included the loss balloons to $37.6m. Looking to the company's cash flow statement, its net cash from operations is positive by $6.1m, although this was unchanged from last year and, ultimately, its cash balance fell by $58m, from $139.9m to $81.9m, mostly thanks to payments for intangibles and acquisitions. Although its Annualised Recurring Revenue (ARR) grew 35.7% to $74.7m, its Average ARR per customer fell ~$8,700 to $24,000 and the Lifetime Value (LTV) of its customer base fell $47m in a year to $555m.

Profitability is still some time away

In its 1HY22 results the company recognised that investors were digging deeper and boasted that it had reduced churn, although its cash balance fell further to $58.4m. For FY22, it forecast $107-$113m ARR, $91-$96m in actual revenues and $1.5m-$6.5m in EBITDA, which would all be higher than FY21. However, Elmo's 1HY22 net loss (including significant items) blew out from $12.4m in 1HY21 to $40.3m in the most recent half. The company is still well capitalised, but eventually companies have to become self-sustaining or raise capital and it will be more difficult to accomplish the latter in the current environment, in our view.

Consensus estimates are assuming Elmo's EBITDA for FY22 will come in just above the middle of the range at $4.1m, which means the company is currently trading at 70.4x EV/EBITDA for FY22. However, FY22 is almost over. Looking to FY23, consensus estimates are for $13.5m EBITDA, which represents a more reasonable multiple of 21.4x, especially considering the company promised shareholders at its 1HY22 results it would be cashflow break-even by then.

Still, the company's technical fundamentals do not make the case for buying the stock right now, with no lower support level established and the company in "cold" territory from a Relative Strength Index perspective. Considering all of these factors, we can't give Elmo any more than two stars for the time being and it is difficult to see further upside unless the company exceeds its guidance or becomes NPAT profitable.

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