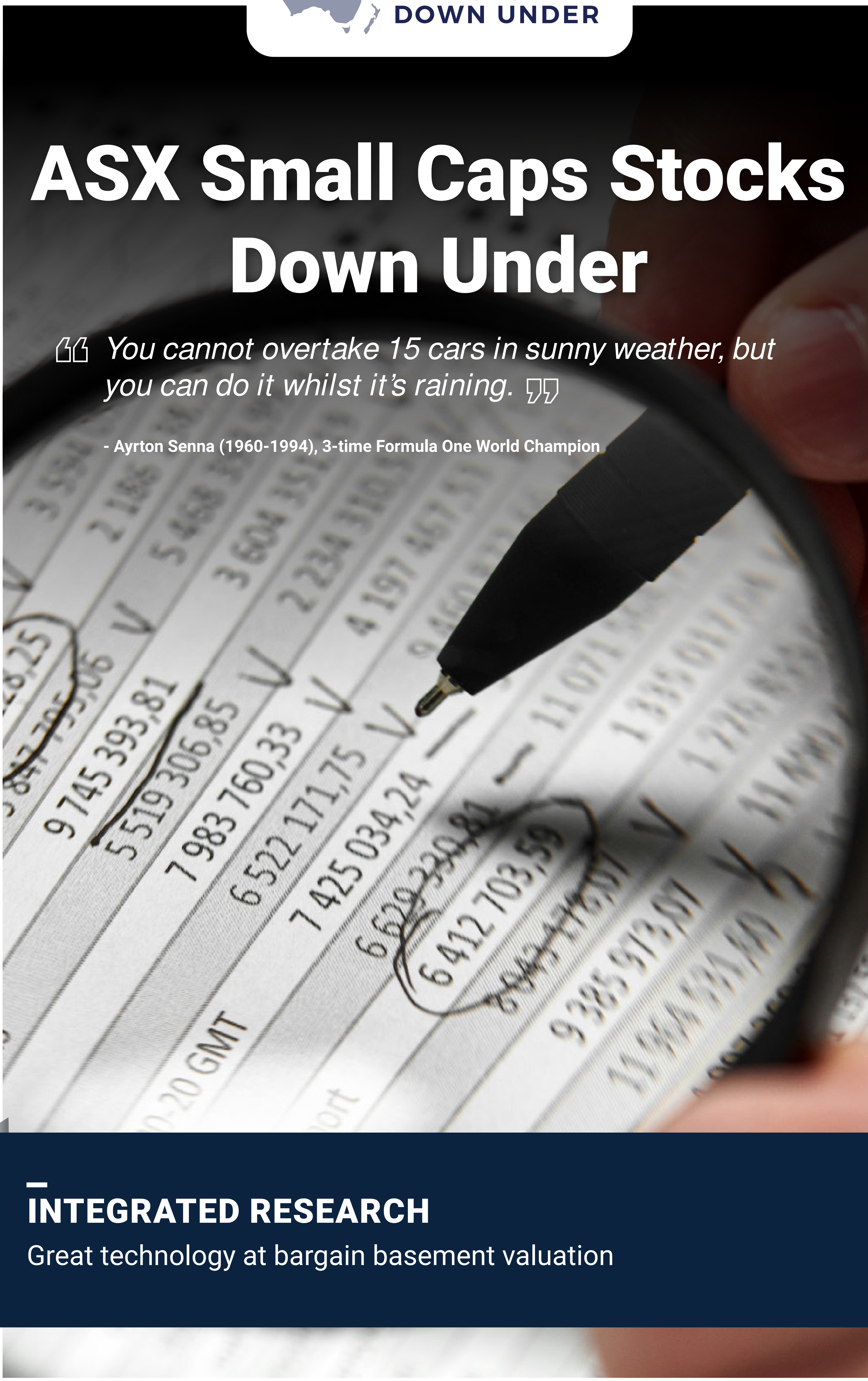
STOCKS DOWN UNDER

8 JULY 2022



ASX Small Caps Stocks Down Under

> *You cannot overtake 15 cars in sunny weather, but you can do it whilst it's raining.*

- Ayrton Senna (1960-1994), 3-time Formula One World Champion

INTEGRATED RESEARCH

Great technology at bargain basement valuation

INTEGRATED RESEARCH

Great technology at bargain basement valuation

Stocks Down Under rating: ★★★★

ASX: IRI
Market cap: A$81.4M

52-week range: A$0.36 / A$2.26
Share price: A$0.475

It's been more than two years since we last covered Integrated Research (ASX: IRI). We liked the company's product and revenue model, but couldn't bring ourselves to give it four stars, given the mediocre performance of the share price. We put it down to the large stake of its co-founder, which keeps many institutional investors away, and that its performance appeared to be deteriorating. We also observed that the stock was high-priced. Two years on, things have gone from bad to worse for shareholders, but things seem to be looking up for FY23. And following the recent Tech crunch, IRI's valuation is now too hard to resist.

Share price chart

Source: Tradingview

Predicting the future

The quote "it is easier to create the future than to predict it", often used by Amazon founder Jeff Bezos, is the antithesis of this company. Integrated Research's key software platform is called Prognosis. It monitors and assesses computer and communications networks from end to end, for instance to pick up any current issues in a network. But it can also predict potential network issues before they occur, through predictive analytics.

IRI's key verticals are payments/financial services and telecom/IT. In respect of communications, a tool that provides an end-to-end overview of a network, and its potential performance issues, is valuable in an industry with such thankless consumers. As for payments, it improves stability across payments platforms, even allowing banks who use Prognosis to identify performance issues at other banks before they materialise, thereby providing the chance to prevent these issues materialising at their own end in the first place. IRI tends to secure multi-year contracts with customers, thereby ensuring future revenue streams and high retention rates.

A boom and a bust

The company has been listed for over 20 years. After a quiet first decade, it grew substantially between 2011 and 2018 as it expanded into overseas markets. But after hitting an all-time high of $4.80 in early August 2020, it has plunged over 90% to just over 40 cents, back where it was just over a decade ago. We think the decline is due to its deteriorating financial performance. The decline actually began prior to the pandemic, as we observed when we last covered IRI two years ago. After 100% revenue growth between 1HY16 and 1HY19, growth was just 6% in 1HY20. Also disappointing was a drop in EBITDA margin from 41% to 39% and the post-tax profit margin falling from 23% to 22%.

The company boasted record results in FY20, including a $24.1m net profit that was the seventh consecutive year of profit growth. Total revenue grew as well, by 10% to $110.9m. And it was able to pay a dividend of 7.25c per share across the year. But even then, some warning signs were present, including a cash balance of just $4.7m, a 2-percentage point drop in return on equity and high R&D expenditure of $22.5m, representing 20% of revenue. In return, it promised new products and enhancements to existing products.

At its AGM later in CY20 IRI admitted revenues were lagging due to COVID-19 and the upcoming election in the US, leading to lengthening sales cycles and a number of deferred purchase decisions. But the company promised that the release of new products would aid growth and it would be aided by the shift to remote working and digital payments. Ultimately, IRI's results in FY21 were a disappointment with a 29% drop in revenue, to $78.5m, and a 67% drop in its post-tax profit, to $7.9m. No dividend was declared.

The company blamed the same factors, but noted the result was dragged down by the first half. It cut back on marketing activities, but kept up its R&D spending, with hope new products would deliver revenue growth. It also made a shift to Total Contract Value (TCV), which investors would be forgiven for perceiving as a metric to hide poor performance in light of the timing of its introduction. Again, it did not provide forward guidance.

We admit seeing will be believing, but there is reason for optimism

IRI's latest update came on 16 May in which the company predicted it would not perform better in FY22, contrary to what it had anticipated. It expected an unquantified decline in Total Contract Value (TCV), a 3-7% decline in pro forma revenue and, despite expecting to be profitable at the NPAT level, to see an unquantified decline there too. The company's cash balance as of 30 April was $12.7m, while expecting R&D costs to exceed $10m for the year. The company said the combination of new solutions in its market verticals, anticipation of a stronger renewable cycle and a more favourable exchange rate environment would help. But, in this environment, it is difficult to make investors optimistic, especially when you have not been delivering for two years.

Consensus estimates for FY22 suggest $72.4m in revenue and $14.9m in EBITDA – down 8% and 32% from FY21. However, for FY23, which started a few days ago, analysts are expecting a bounce back. Estimates for FY23 forecast $79.1m in revenue and $21m in EBITDA, which would be 9% and an impressive 41% growth respectively.

You can get this for just 3.7x EV/EBITDA for FY23. And while the market is very volatile at the moment and Tech stocks are not in favour, we believe investors can make money off IRI in the next 12 months. So, whilst we can understand investor scepticism based on the past couple of years, we're giving this one four stars right now, because from a risk/reward standpoint, we believe the risk in the share price is to the upside.

Pitt Street Research Pty Ltd

3 Spring Street, Sydney, NSW 2000, Australia