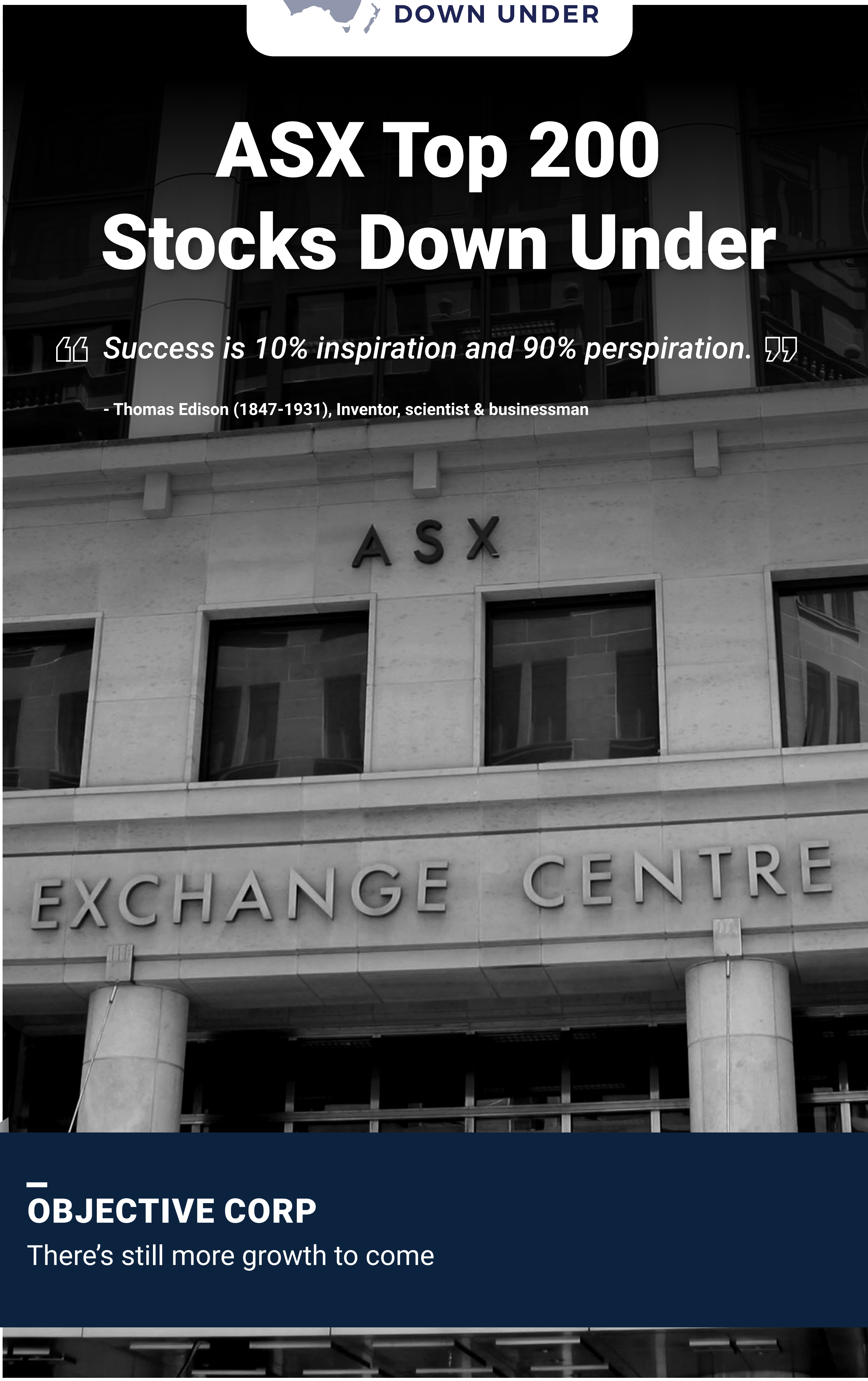
STOCKS DOWN UNDER

17 OCT 2022

ASX Top 200 Stocks Down Under

Success is 10% inspiration and 90% perspiration.

- Thomas Edison (1847-1931), Inventor, scientist & businessman



OBJECTIVE CORP

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Stocks Down Under rating: ★★★★

ASX: OCL
Market cap: A$1.3BN

52-week range: A$12.50 / A$22.10
Share price: A$13.20

There are few companies with a two-decade listed life that have never raised a cent of capital and even fewer that have been 65%-founder-owned all the while. Objective Corporation (ASX:OCL) is one such company. It may seem like it has had its run and can't get any bigger, particularly amidst the Tech Wreck of 2022, but we think Objective is solid enough with its existing clientele and still has plenty of growth potential.

Share price chart

Source: Tradingview

A two-decade evolution into SaaS

Objective Corporation has software products that can handle common problems or manually intensive tasks local governments and businesses in highly regulated sectors, such as law enforcement, undertake on a daily basis. This software increases the ease, security and efficiency with which such tasks can be accomplished.

For example, one of Objective's recently won clients was the New Zealand Police Force, which chose Objective to manage the registration and licensing of all firearms in New Zealand, an outcome of the Christchurch mosque attack in 2019. This was a competitive tender process that Objective won, obtaining a 5-year contract worth ~$13m.

When it was founded, Objective was an on-premise license business, but it has since transitioned towards a Cloud-based subscription model (Software-as-a-Service, or SaaS). It makes 77% of its revenue from Australia, but also has a significant presence in New Zealand and the UK where Objective is very-well entrenched with local councils (90% of councils in New Zealand, 70% in the UK versus only 40% in Australia). Objective is also targeting expansion into the US over time.

The Cloud transition has only just gotten started

Since the pandemic, it is easy to think that the transition to the Cloud is virtually complete and that the 'Big Tech' stocks cannot get any bigger (at least in the current environment). But we note two observations by Goldman Sachs that put to bed these theories.

The first is that the transition of organisations from on-premise software to Cloud SaaS is only 20% completed. And second, SaaS could be a US$800bn Total Addressable Market (TAM) globally within an overall Cloud software TAM of US$1tn. Today, global revenues are US$235bn, but enterprise IT revenues are much larger (at US$1.4tn). Goldman thinks that the Cloud could easily grab most of that enterprise IT spend and even more from non-digital spending.

Now, this is all well and good, but worthless to a company if it cannot take grab market share. But we think Objective stands out because of its market position, underpinned by its long-term track record. It has undertaken M&A, but has primarily grown organically and innovated internally. And government spending only goes in one direction, in Australia up 4% on a CAGR basis since 1960 without ever declining in nominal terms.

Overcoming market challenges

In FY22, Objective generated $106.5m in revenue (up 12%), $85.5m in Annualized recurring revenue (ARR) (up 15%), $30.7m (up 20%) in EBITDA and $21m in NPAT (up 31%). It has $63.8m in cash (without a cent of external debt) and paid a dividend of 11c per share, up 22% from the year before, but representing a yield of less than 1% and an EPS payout ratio of only 50%.

Consensus estimates for FY23 are $123.6m in revenue and $38.2m in EBITDA, representing growth of 16% and 24% from FY22 respectively. For FY24, the market expects $144.2m in revenue and $47.7m in EBITDA, which would represent near-identical growth compared to the year before (17% and 24%) respectively. The stock is trading at 31.8x EV/EBITDA, 48.3x P/E for FY23 and 2.2x PEG (assuming long term growth of 22%).

If you want to judge a business simply on its multiples, this one would easily be two stars. This is particularly so in the Tech Wreck of 2022. However, as we have noted above, we think the company can continue to grow revenues from governments, even without winning customers. We also think it can gain market share in the private sector where it has lower penetration. And finally, we think it can expand into the US, which is a much larger market opportunity (a US$191bn TAM for government IT alone, compared to just US$10bn in Australia and US$17bn in the UK). Granted, it is only early days for Objective in the USA, but it acquired Atlanta-based data governance business Simflofy back in March. Simflofy has technology that tames data sprawl, allowing users to easily find information, particularly in the government, financial services and insurance bases. And although consensus estimates can be wrong, the company's transition to recurring subscription means revenue growth should be more consistent.

Not a company for everyone, but we're backing it

What are the risks with this one? Most obviously the risk of rising interest rates and inflation, particularly relevant for a tech stock seeking expansion in the US. Ironically, software has proven its ability to grow throughout economic cycles, yet investors will mark down the company because higher interest rates decrease the value of future cash flows.

Another one is the risk of cyber-attacks. Even though one of Objective's selling points is military-approved levels of security, the Optus cyber breach illustrates that there is always a risk in this regard. Other risks include talent shortages, wage inflation, competition from larger peers and the risk of higher churn. You also have to bear in mind that the company has invested over 20% of its revenue in R&D for the past couple of years. But we think investors shouldn't worry too much about this given two reasons. First, R&D spend is below many of its peers (Xero's R&D for instance is 43% of sales). And secondly, these expenditures are 100% expensed when incurred (so they are reflected in the bottom line and not in the company's balance sheet).

Objective isn't a company for dividend investors, given its yield is low and unlikely to grow given future acquisitions. ESG investors may also not like the risk of cyberattacks, even if some of its projects are ESG friendly – earlier this year it was hired by the Victorian government to help it enforce anti-wage theft regulation.

But investors looking for a profitable tech stock with high-recurring revenues, growth potential, a sticky client base and relatively lower R&D expenditure relative to its software industry peers, have their company right here. Four stars.

Pitt Street Research Pty Ltd

3 Spring Street, Sydney, NSW 2000, Australia

Stocks Down Under gives you an information advantage to better invest and trade in ASX-listed stocks!