STOCKS DOWN UNDER

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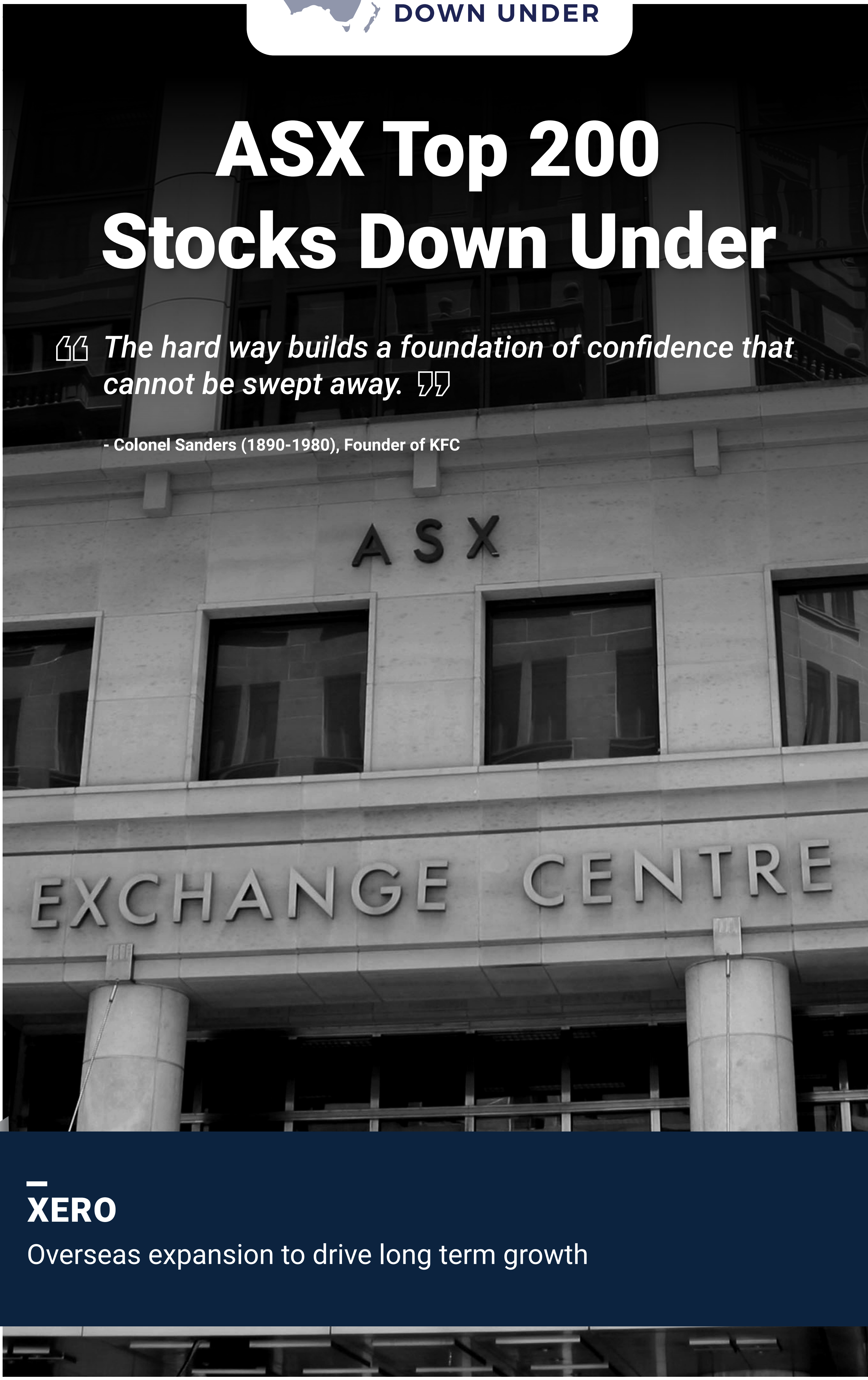
ASX Top 200 Stocks Down Under



"The hard way builds a foundation of confidence that cannot be swept away."

- Colonel Sanders (1890-1980), Founder of KFC

XERO

Overseas expansion to drive long term growth

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Stocks Down Under rating: ★★★★

ASX: XRO
Market cap: A$11.3BN

52-week range: A$70.34 / A$156.65
Share price: A$74.63

Xero's (ASX:XRO) recent marketing campaign sums up what this company is all about. Specifically, helping businesses do business. The company, which has over 3 million subscribers, primarily sells accounting software that helps businesses keep books, pay bills and send invoices. But it has gradually developed features useful beyond book-keeping, such as storing files, converting currencies, keeping track of inventories and creating professional quotes. Xero has grown really fast in the last decade. To justify its current valuation, the company will need to keep up its recent growth rate. But can it achieve this growth and just how much does it have to grow to justify a higher share price?

Share price chart

Source: Tradingview

Overvalued for a long time

We last covered the company [18 months ago] when it was $133.75 a share and the share price decline had begun. We saw then, and now, that its customers like Xero because it makes complicated tasks easier. And there is just no incentive to shift to any competitors, such as MYOB or Reckon, as Xero releases more and more features due to innovation and M&A activity.

But we gave Xero two stars thinking it was significantly overvalued at 84x EV/EBITDA relative to EBITDA growth of just 11.6%. Back then, we described the valuation multiples as 'astronomical'. 18 months on, the shares are trading below $75 a share. Is now the time to jump into Xero?

Is it a buy now?

The question of Xero's valuation depends on whether or not it can maintain the significant growth rates it has achieved to date. If it can, then it certainly is an opportunity. But if growth moderates, then it is fairly valued now, but not undervalued.

In FY22, Xero achieved NZ$1.1bn in revenue (up 31%) and $212.7m in EBITDA (up 11%). We do note that although it reports EBITDA, it is an afterthought in its accounts with the company using 'operating surplus' as the primary bottom line. It grew subscribers to 3.3m globally, up 19% from the year before, but subscriber growth varied between different markets. The more mature New Zealand market only grew by 15%, but Australian subscribers grew by 21% while the UK and North America grew at 18% and 19% respectively. It also grew the average revenue per user by 29%.

For FY23 consensus estimates call for $1.4bn in revenue and $299.6m in EBITDA – up 27% and 41% respectively. For FY24, the market expects $1.7bn in revenue and $398.8m in EBITDA – up 21% and 33% respectively.

The stock is currently valued at an EV/EBITDA multiple of 43.2x for FY23 and 32.5x for FY24. When we then look at our beloved EV/EBITDA-to-EBITDA-growth metric, we see that that Xero is currently fairly valued at 1.06x for FY23 and 0.97x for FY24. But we believe a stock like Xero is driven by its longer term prospects and should actually command valuation premium.

If it continues its track record...

To capture Xero's longer-term potential, we have built a DCF model and tested certain scenarios over the next decade. Allow us to get a bit technical for a moment. If we assume Xero replicates the same growth in revenue per user and subscriber numbers that it did in FY22 for the next 10 years, that the company's expenses stay the same a percentage of sales, that NZ$1 buys A$0.90, a Weighted Average Cost of Capital (WACC) of 9.37% and terminal growth of 2%, we get an equity value of $54.7bn, which would be $366.23 per share, a share price upside of 377%.

Of course, it is unrealistic to assume that any company can keep growing at such a high pace forever, especially in Australia and New Zealand where Xero is relatively mature. However, Xero's future is overseas, the United States in particular. So, while historical growth rates should not simply be extrapolated, we do believe the company has ample opportunities ahead. If we assume subscriber growth in the mid-teens and average revenue per user growing by 15%, our model derives $100.99 per share. It would take 22% in revenue per user to surpass last year's high of $156.65.

Xero has a lot to deliver, but has a track record of growth

We understand investor skepticism about high growth Tech companies in the Tech Wreck of 2022. But Xero is a company with a proven track record of high organic growth. Yes, it has undertaken some M&A activity, but this has been to add new features to the platform for existing users rather than to buy new users.

We acknowledge that the software space tends to be ultra-competitive, but Xero has established a significant market position in Australasia, and increasingly in the US and the UK. And don't forget the potential for Xero to end up in the crosshairs of a strategic buyer or private equity firm. In summary, we believe there's a lot to like about Xero. Assuming it can continue its track record of growth, driven by overseas expansion, Xero is four stars for us.

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