STOCKS DOWN UNDER

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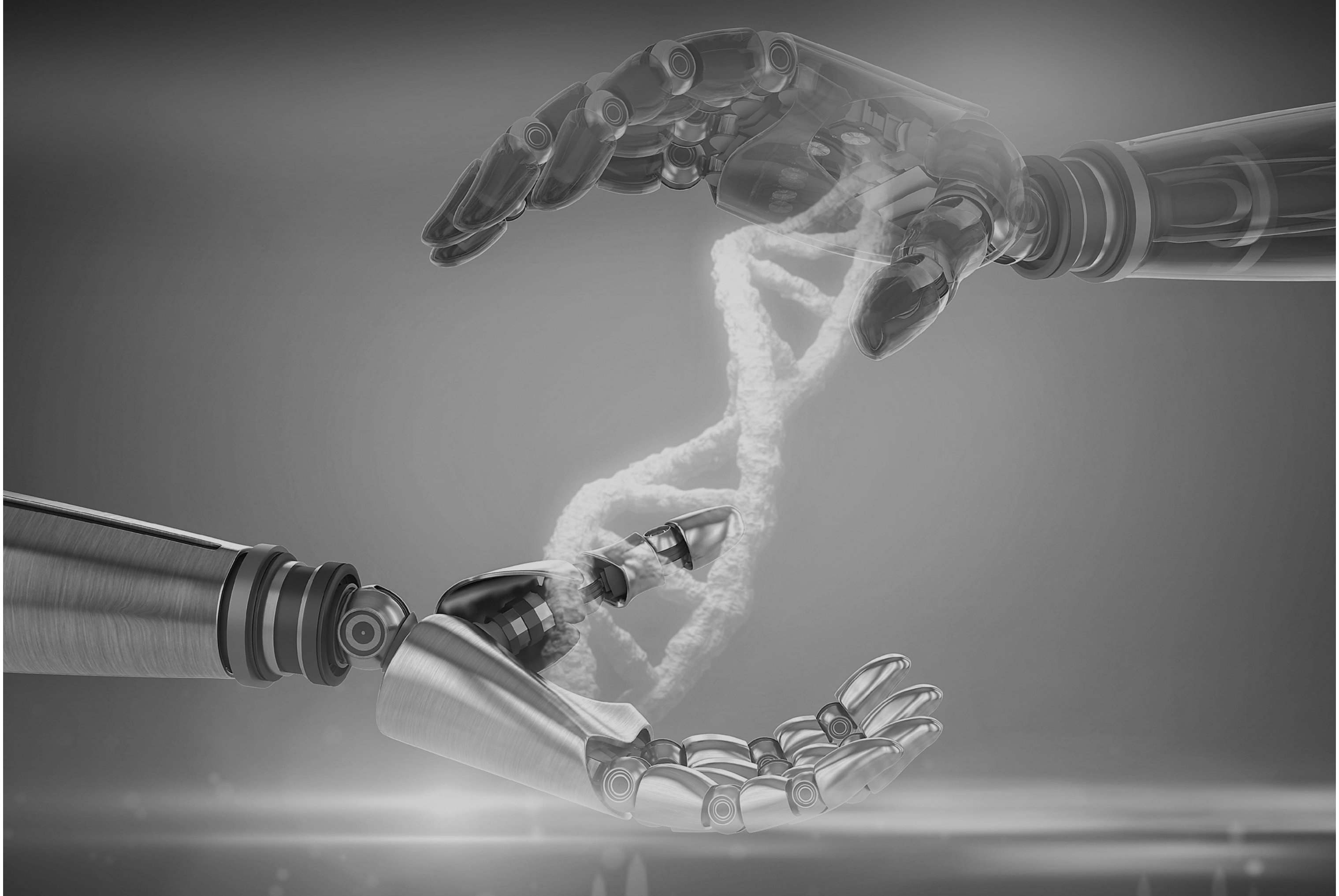
Emerging Stocks Down Under

"Anyone taken as an individual is sensible. As a member of a crowd, he becomes a blockhead."

- Freidrich Schiller (1759-1805), European playright, poet and philosopher



K2FLY

Helping top tier miners

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Stocks Down Under rating: ★★★★

ASX: K2F
Market cap: A$29.6M

52-week range: A$0.14 / A$0.31
Share price: A$0.175

How can mining companies meet their reporting requirements across all the different jurisdictions they operate in? This is where K2Fly comes in. K2Fly's RCubed software is a compliance program that improves efficiencies for mining companies to meet their reporting requirements across different jurisdictions. It counts several top tier clients, including BHP, Rio Tinto, Fortescue, and Newcrest. As useful as it sounds, investors haven't been very excited about this company in the past year.

Share price chart

Source: Tradingview

Gold and iron ore exposure hurts

We see three reasons why K2Fly has been sold down. Firstly, because even though K2Fly has diversified exposure, the big-name clients tend to be in the gold and iron ore space. Gold and iron ore prices have been in a bear market since reaching all-time highs during the first 12 months of the pandemic.

One might argue that these commodities have only been sold down because investors are more excited about lithium stocks. But the market for iron ore itself has been hindered by weakening steel production and economic growth in China, both of which have been dented by the Zero COVID policy and the souring property market.

The decline in gold is more difficult to explain. In a market with inflation at a 40-year high, high geopolitical tensions and significant uncertainty over whether or not we'll see a global recession, gold should be rising. Investors should remember that gold has grown in all seven of the last global recessions, on average by 20%. We think that gold has underperformed because the global economy has been growing since 1HY20 after the COVID-induced recession. But also because of investor and trader excitement over commodities, such as lithium. Where gold will go from here is anyone's guess, although we think it won't be until the economic or geopolitical environment shifts substantially. We think the most likely scenario that would cause a new bull market for gold would be a global recession, given the solid performance of gold in such an environment.

Transparency that investors struggle to see

The other two reasons why K2Fly has been sold down relate to the company's financial results. Firstly, the company is negative at the EBITDA and NPAT lines. It recorded $2.8m in EBITDA and a $4.6m net loss, both up ~40% from the previous year. Despite the bottom line being negative, revenues grew from $7m to $10m (likewise a 40% increase). Second, the broader tech crash that has impacted the entire sector, but particularly non-profitable companies.

Other metrics, namely Total Contract Value (TCV) and Annual Recurring Revenue (ARR), tell a different picture. As of 31 October 2022, K2Fly's ARR was $6.5m and TCV was $18.8m, and these figures have grown 59% and 34% in the last 12 months.

Looking cheap on FY24 numbers

Consensus estimates for FY23 expect $16.8m in revenue (up 68%), and positive EBITDA of $0.9m. Estimates call for continued improvement into FY24, specifically $22.4m in revenue (up 33%) and $4.6m in EBITDA (up 411%). K2Fly's multiples for FY23 are on the higher side, at 23.3x EV/EBITDA and 21.7x P/E, but look cheap for FY24, at 4.6x EV/EBITDA and a P/E of 9.9x. Beyond profitability, we think the other potential catalyst for the company's share price to grow in CY23 is if the company can win additional contracts, both from new clients and upgraded contracts from existing clients.

We don't think sovereign risk is a significant risk, given the company has heavy exposure to jurisdictions with low sovereign risk (60% of ARR comes from Australia).

A major tailwind will help

The main reason we are bullish on K2F is its major tailwind, i.e. rising demand for ESG services in the resources sector. There is increasing scrutiny on mining companies to disclose more information to regulators, shareholders, ratings agencies, and external stakeholders, to maintain their social license to operate. These include land access, heritage and tailings management, mine rehabilitation and anti-greenwashing laws. There are plenty of threats to the mining sector at the moment, such as supply chain issues, energy costs, inflation, a Chinese slowdown and resource nationalism. But ESG is perceived as the biggest threat – a survey by international law firm White & Case found ESG trumped all of those risks, being rated as the most important issue by 24% of respondents, more than any other.

K2Fly helps its clients prove that they are meeting their legal obligations and to shareholders that they are performing strongly on the ESG front. We expect demand for the company's services to grow in the years ahead as scrutiny on the mining sector increases. As a result, we think K2Fly deserves four stars.

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