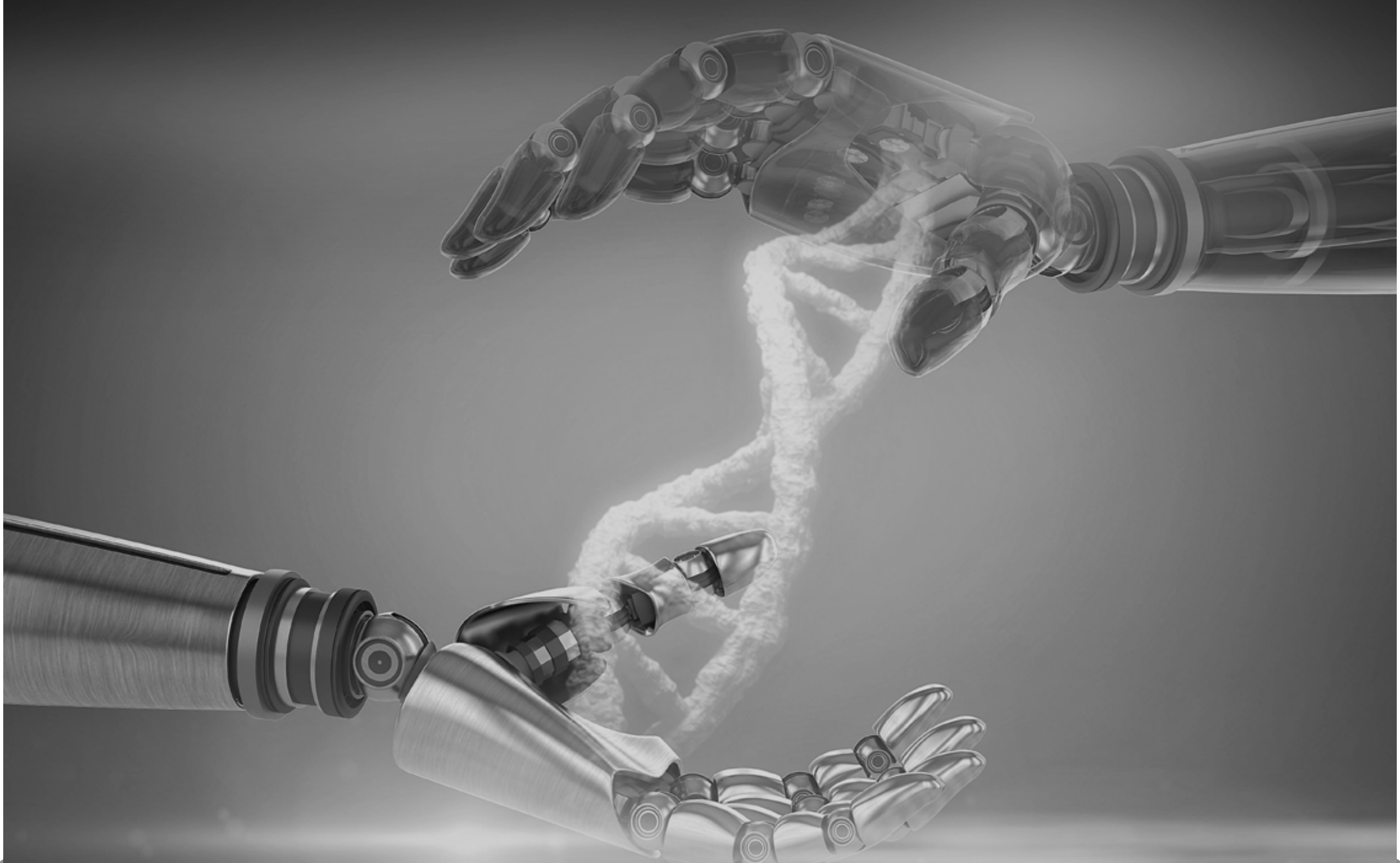
STOCKS DOWN UNDER

27 JULY 2021

Emerging Stocks Down Under

"If you cannot do great things, do small things in a great way."

- Napoleon Hill (1883 - 1970), American author



AUSTRALIAN CLINICAL LABS

Failing the value test

XREF

A resume that doesn't lie

IMEXHS

Time for profit

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Failing the value test

Stocks Down Under rating: ★★

ASX: ACL
Market cap: A$755M

52-week range: A$3.18 / A$3.88
Share price: A$3.71

Headquartered in the Melbourne suburb of Clayton, Australian Clinical Labs provides clinical laboratory services using approximately 1,000 collection centres across Australia. The company offers all major tests, including immunology, drug and alcohol testing, routine and advanced pathology, and much more. Despite the demand for stocks in the testing industry, the company's 14 May 2021 IPO was a rather spectacular flop. Even at the lower price Australian Clinical Labs still doesn't pass our value test.

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Market cap: A$85.7M

52-week range: A$0.12 / A$0.54
Share price: A$0.46

Headquartered in Sydney, Xref is on a mission to make resume fraud a thing of the past. In today's increasingly specialised and technical world, employers need to be sure more than ever that the qualifications and experience an applicant claims they have, they do in fact have. With a turnaround time of approximately 24-hours for initial confirmation, Xref is clearly on the cutting edge of this increasingly important industry.

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Share price chart

Source: Tradingview

An IPO that failed the market's test

Australian Clinical Labs's IPO was motivated in part by investor demand for companies providing services directly related to COVID-19. At first glance, Australian Clinical fitted exactly what the market has been craving, given that this pathology services provider collected and analysed 8.3m samples during 2020.

What exactly is pathology? Well, it's a medical niche that focuses on analysing bodily fluids, organisms, and other forms of biological samples in order to determine the cause and nature of disease. In addition to providing pathology services, Australian Clinical also provides toxicology services, detecting and analysing poisons and other toxins like drugs and alcohol. This is a rather common mix of services, as the need for drug testing and testing for disease tend to overlap.

Unsurprisingly, pathology services have been in high demand since COVID-19 as testing became government demanded. As always, the best way to see a sharp increase in sales is to make your product or service a requirement by law. Unfortunately, the market has sent a very clear message that your long-run shareholder value muist still must be grounded in reality even if your company benefits from COVID-19. Australian Clinical priced its IPO at $4.00 per share but ended its first day of trading at $3.42. While the share price has recovered somewhat, that $4.00 is still a long way away. When we look at the financial situation of the company, we can see why.

Not much room from here

Australian Clinical is a profitable company. Between FY18 and FY20 pro-forma EBITDA rose from $95m to $116m, on the back of revenue that edged up about 2.8% p.a. over that period. Growth would have been larger in FY20 but other forms of testing were placed on the backburner.

So what's not to like about this company? Well, we believe Australian Clinical is likely going to see a decline in revenue and EBITDA starting in FY23. We find it difficult to believe anything will replace the massive amount of constant COVID-19 testing. FY21 saw such significant growth because demand for non-COVID-19 related testing rebounded as Australia normalised. This combination of non-COVID-19 testing and COVID-19 testing helped growth increase rapidly. But with worldwide vaccinations well underway, we believe testing demand in Australia will continue to decline towards the end of FY22 and likely drive significant declines in operating results during FY23.

Failing the value test

Even on a short-term basis, we believe Australian Clinical fails the value test. Despite trading well under its IPO price of $4.00 per share, the company is still trading at a trailing 12-month EV/EBITDA ratio of 6x. This valuation seems to be too rich when we factor in the likely decline in revenue and EBITDA during FY22 and FY23.

Australian Clinical has two main risks across the next two years. The first is the high level of competition in the Australian laboratory services industry. For example, Sonic Healthcare (ASX: SHL | latest report) is one of its largest competitors with a current market capitalisation of $19bn, and its fair to say that its various brands are much better known The second risk relates to just hwo strong the decline in EBITDA and revenue will be over the next two years. COVID-19 certainly has staying power and this could prolong the demand for testing well into FY23, but we believe the amount of testing required is unlikely to remain anywhere near FY21 and FY22 levels. We don't believe the current valuation has priced in the scenario where COVID-19 testing demand mostly dries up during FY23 at this time, and this is a risk investors must consider. Therefore, we believe Australian Clinical fails the value test. Two stars.

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Share price chart

Source: Tradingview

The death of a saying

There’s a common saying that ‘everybody lies on their resume’. For those who have followed the ethically dubious implications of that saying, your days at your current job may be numbered. Over the last decade, employers have become increasingly vigilant and strict around the accuracy of an applicant’s resume. At a minimum, it is becoming common for potential employers to troll social media and Google, but it has even become commonplace for evidence of past salary to be requested. However, even if you manage to con your way into an organisation, don’t think you are safe for one second. For one thing, lying on your resume is actually a crime, since it is considered fraud. For another, a two-second Google search will reveal just how little sympathy organisations have for lying on your resume, even a decade later.

Two major examples of being caught after the fact are Veronica Theriault and Scott Thompson, the former a local case, the latter from the US. Veronica Theriault was Chief Information Officer for South Australia’s Department of Premier and Cabinet. In order to get the position, she lied about her previous experience and, upon discovery was not only sacked, but arrested and charged with deception, dishonestly dealing with documents and abuse of public office in September 2017. She ultimately pled guilty. Scott Thompson was the former CEO of Yahoo when, in 2012, it was discovered that he had he lied on his resume, claiming he had a computer science degree. Not only was he sacked, but five members of the Yahoo Board of Directors were given the boot with him.

The hand of justice

Xref was founded with the goal of making sure those who engage in recruitment fraud never spend a day in any position of potential authority. In order to do this, the company initially fixated on streamlining the process around checking an applicant's credentials, resume, and references. Today, Xref boasts a turnaround rate of only 24-hours for confirmation of an applicant's credentials.

Xref has been in business for over ten years now, and that has allowed the company to acquire some very high-profile clients. Think Qantas, Westpac, Macquarie Bank and Zoom. However, looking at this list, we can easily see that the bulk of Xref's business remains in Australia. According to Xref's 2021 shareholder presentation, 78.9% of its employees are based in Australia, servicing the company's 6,500 active users. The company has certainly grown over the last ten years, but it has yet to truly breakout into the growth area that is international sales.

Now is the time for employment

For regular readers of Stocks Down Under, you will know that we are highly bullish on the recruitment space in Australia. As we explained in our 1 June 2021 Insights article, our sealed borders have driven unfulfilled job listings to a 12-year high. On one hand, this might seem like a negative development for a company that relies on a robust stream of new hires. However, we believe this situation actually goes to the Xref's advantage as it will likely create a constant stream of businesses for the next couple of years until immigration to Australia returns to normal.

As of the Xref's latest operational update, the results seem to be backing up our industry thesis. Revenue increased 91% year-over-year to $1.2m, supported mostly by Xref's current client base. New clients only accounted for 8% of total sales during April. Despite operating for the last ten years, Xref remains unprofitable. Over the last 12-months, Xref's EBITDA loss was $6m. However, we are hopeful that this situation will improve significantly as the order pipeline continues to expand in the wake of the post-COVID-19 hiring boom. In fact, we believe it is likely that Xref will become EBITDA profitable if the revenue situation continues to improve as we expect over the next two years.

A valuation not yet recognising the growth

Before the latest Covid outbreak in Sydney the employment situation was starting to look good in Australia. Allow a few months for the current crisis to resolve itself as more and more people are immunised, and we believe the recruitment industry growth trajectory can continue. And yet, Xref has seen a rather significant run-up in price over the last month, pushing the trailing 12-month EV/Revenue ratio to 9x. Based on the growth we already see out of Xref, we don't believe this is a heavy overvaluation considering the company's growth prospects over the next two years.

However, the stock has shot-up from $0.25 in early June to its current price of $0.46 and since we believe 9x is around fair value, it seems likely the stock is due for a slight pull back. And yet, we remain confident in Xref's management and market trajectory making this stock certainly one to watch, three stars.

IMEXHS

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Share price chart

Source: Tradingview

2020, the year of change

ImExHs provides hospitals and clinics with a full-service radiology software application allowing for the compiling of everything that the clinicians need in one easy-to-access system. The ImExHs platform is split between two applications, one called 'HIRUKO' and another called 'Aquila in the Cloud'. Leave aside what these applications actually do. The important thing is that they can handle data. Lots of data.

If there's one thing about radiology today that's different from a generation ago, it's the shockingly large amount of data needed by radiologists to properly give a diagnosis. According to a study published in the Indian Journal of Radiology and Imaging in November 2008, computerised radiography is approximately 30MB per image. Imagine what Moore's Law has done to that in the meantime. When you factor in the need for a complete historical record, the multiple images taken each time a patient comes in, and the need for have these images available over the lifetime of the patients, you begin to understand the data problem. Remember, this only takes into account the images themselves, not the need to attach notes, sorting, searching, or all the other daily needs of a radiology operation. Unsurprisingly, ImExHs' cloud-based platform incorporates AI-based features to help with the management of all of this information.

ImExHs was founded in 2012 and listed on the ASX in 2018. However, it was not until last year that things really began to fall in place for the company after it took a series of important steps. It seems the driving actions that ImExHs took during 2020 was the reshuffling of its Board. During this process, the company appointed a new Chairman, a new independent non-executive director, and a new CFO and Company

Secretary. While all three of these people clearly had a positive impact, it seems the new independent non-executive director was the driving force behind some major changes. According to the Chairman's annual address, Damian Banks had extensive previous business experience and "has since made an important contribution to the Board's processes and decision-making." This is certainly not an understatement, during 2020, the Board established committees for Audit and Risk and for Remuneration and Nominations, co-chaired by Damian Banks. These are vital Board committees for transparency and good governance operations and it is fair to say these committees should have existed beforehand. A number of other major changes occurred, including the centralisation of the Australian operations in Sydney, a reverse split in the stock at a ratio of 1:50, and the exchange of a $1m loan for 16.67m shares.

Growth on the shoulders of recurring revenue

During 2020, the company's statistics grew to over 400m images stored, 6m new studies per year, 270 sites running on its platform across 2,000 specialists in 15 countries, and a highly impressive customer retention rate of 95%. We are most impressed by the customer retention rate, since ImExHs runs on an annual reporting schedule. This means that 2020's results include all of COVID-19's costs and troubles.

During 2020, revenue grew 42% to $11m, on the shoulders of strong expansion in the United States and in contracted recurring revenue. Most of ImExHs's revenue today is recurring in nature, and in 2020 this grew 29%, to $8.5m. FY21 might be a little less brisk since many of ImExHs' target countries have experienced second-wave COVID-19 outbreaks. That not only caused reductions in non-essential imaging, it, understandably, resulted in potential clients delaying their decision to onboard with ImExHs.

Unfortunately, the lack of high growth levels during this period is directly related to the new outbreaks in Latin America, causing delays in the company's office and application rollout. Despite this, ImExHs reported the strongest pipeline in its history as of the first quarter of 2021 as it continues to receive trail and sign-up requests. As major markets like the United States, Australia, and Mexico continue their vaccine rollout plans, we believe the pipeline is likely to see increased strength during 2022 as hospitals return to normal. One potential boon for ImExHs worth noting is the increasing evidence that those who recover from COVID-19 are unfortunately likely to experience severe complications in their lungs for the foreseeable future. Even after COVID-19 is quashed, we believe this is likely to cause the number of images taken to exceed projections across multiple healthcare systems.

ImExHs is not alone in the universe

Despite the first quarter of 2021's significant drop in growth, we believe the market's current consensus view of a 2022 EBITDA profit is still valid, given the ImExHs pipeline and our global COVID-19 outlook. Additionally, the increasing takeover of contracted recurring revenue as a percentage of total revenue increases our confidence that ImExHs's applications are ultimately achieving true adoption, rather than short-term trials or contracts. Therefore, a 2022 EBITDA number of 2.2m, followed by $7.3m in 2023, is entirely possible in our view. These numbers currently give EV/EBITDA ratios of 17x and 5.1x, respectively.

Now, don't get us wrong - there are still considerable risks over the next three years. The main risk is that ImExHs' field is far from competition-free. The need is great, but there is only so many hospitals and clinics to go around. Despite this, it seems that ImExHs has built two robust applications as the company continues to win a plethora of industry awards and sign-up additional clients. Therefore, for investors willing to tolerate a high amount of risk, we believe the likely reward at ImExHs' current valuation is more than worth it. Four stars.

Pitt Street Research Pty Ltd

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