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Hot WAAAX

A value investor's look at the ASX Tech Sector

Ben Atkinson | 24 July 2019

'First-level thinking says, "It's a good company; let's buy the stock." Second-level thinking says, "It's a good company, but everyone thinks it's a great company, and it's not. So the stock's overrated and overpriced; let's sell." '

– Howard Marks

What's already in the price?

$33b valuation vs $0.1b in profits, a collective P/E of 330x. That is the remarkable market appraisal of the 'WAAAX' stocks – Wisetech, AfterpayTouch, Appen, Altium, and Xero. These stocks comprise a significant portion of the ASX's IT sector and have seen their values soar in the last two years.

There's no doubt these are innovative, high growth businesses. As such they can justify high multiples. The question is, how high? The typical valuation process estimates value from a single forecast path of growth and profitability. But for a fast-growing business, this can seem arbitrary because the range of potential outcomes is wide. In this note, we invert the process. If we simply extrapolate recent growth and margin trends, does that get us to the market's valuation of the business? If not, how much better does it have to get?

We discuss each business below, and the table on page 2 summarises the results. In the scenario analysis conducted, we assume growth in the market does not fade, and the company increases both market share and margin at the same pace as it has recently, or per management forecasts. This outputs a target EBITDA in a future year. We then assume a generous 70% of EBITDA equates to FCF (30% lost to tax and capex), and discount it to today's dollars. How does this cash flow compare to the market's valuation?

What we found

In conducting this exercise we found free cash flow yields in the low-to-mid single digits for four of the five WAAAX stocks, and the exception (Appen) needed a dramatic rate of earnings growth. These valuations assume growth, share gains and margin improvement continuing at rapid rates, which becomes increasingly difficult as these companies and their markets mature, and competition responds. Continuing to buy or hold the shares therefore demands even better outcomes to justify upside.

It is tempting to view a rising share price as confirmation of a buy thesis, but when prices accelerate beyond fundamentals, this in fact increases the risk profile. A rising share price pushes the growth requirement to further extreme levels, rendering the company more unlikely to achieve outcomes in line with expectations. This leads us to the conclusion that recent price increases are likely driven more by MOMO (momentum) and FOMO (fear of missing out), rather than business fundamentals.

We don't doubt the ability of the WAAAX businesses to continue growing – they almost certainly will – but operational returns and investor returns are distinct, and the latter is incomplete without consideration of the price being paid for growth.

Ultimately, this leads us back to the fundamental question; what's already in the price?

WAAAX vs FAANG

With the WAAAX group echoing even the naming convention of the FAANG collective, it is worth comparing the Aussie tech stocks to the US-based, global tech leaders (Facebook, Apple, Amazon, Netflix, and Google).

We use 5-10 year forecasts for the WAAAX stocks and assumed generous growth and margin inputs in estimating potential FCF. Below, we use consensus estimates of FCF for FAANG stocks on a 5 year, present value basis.

Figure 1: Relative FCF valuation – WAAAX vs FAANG

WAAAX	EV/FCF	FCF Yield	FAANG	EV/FCF	FCF Yield
WTC	34x	3.0%	FB	18x	5.5%
APT	26x	3.8%	AAPL	22x	4.5%
ALU	42x	2.4%	AMZN	16x	6.1%
APX	11x	9.1%	NFLX	56x	1.8%
XRO	17x	5.9%	GOOGL	16x	6.3%
Total	22x	4.5%	**Total**	19x	5.4%

Source: FactSet, Optar Capital | PV FCF for FY+5

We can see that even after giving full credit to the WAAAX stocks for ambitious growth rates being achieved, they still trade on a 20% premium to FAANG stocks. As the latter group contains proven, global-scale businesses possessing some of the world's most dominant competitive advantages, to justify paying a premium multiple requires conviction on extraordinary levels of growth.

What-ifs for the WAAAX: The following table demonstrates the level of free cash flow generated if we assume no slowdown in growth of markets, market share gains, and margin accretion.

	WTC	APT	ALU	APX	XRO
Market Cap	$9.8b	$6.0b	$4.7b	$3.6b	$8.7b
Enterprise Value	$9.3b	$5.5b	$4.6b	$3.2b	$8.6b
Addressable Market: *What does the market look like if growth trends continue?*					
Market	*Logistics software*	*Online retail payment*	*PCB software*	*Data labelling*	*SME business software*
Current Market	$7.3b	ANZ: $30b	$900m	$3.1b	$13.8b
Trend CAGR	*10%*	*+US: $620b +UK: $130b*	*8%*	*35%*	*40m subs at $30/mth; inflation*
Forecast Year	FY28	FY22	FY25	FY25	FY29
Forecast Market	$18.8b	$780b	$1,430m	$25.0b	$18.6b
Market Share: *How much sales are generated if trend market share gains/growth continues?*					
Current Sales	$325m	$170m (Afterpay)	$200m	$365m	$550m
Current Share	4.5%	3.2m users $4.5b GMV	22%	12%	4%
Trend gains	*+65ppts mkt share gain/yr*	*Targeting $20b GMV by end FY22*	*18% CAGR, 2-3x industry growth*	*Holding share at a 35% CAGR*	*+600k subs/yr (+330% over 10yrs)*
Forecast Share	11.0%	14.2m users $20b GMV	55%	12%	20%
Forecast Sales	$2,068m	$800m	$790m	$2,970m	$3,774m
EBITDA Margin: *What will margins be if trend margin accretion continues?*					
Current margin	35%	2% GMV	32%	20%	13%
Trend gains	*+100ppts per yr*	*NTL already min. 50% EBTDA margin*	*Tgt 35% in 2020. Board and Systems 77% margin now.*	*+75ppts per yr. Scale offset by ↑ data collection cost*	*60% mature seg margins. Intuit 60% seg, 30% Group.*
Forecast margin	45%	2% GMV	35%	25%	50%
Free Cash Flow: *Assuming 30% of EBITDA is lost to reinvestment and tax, how much FCF is generated?*					
Forecast	$651m	$280m	$194m	$517m	$1,321m
Present Value	$276m	$210m	$109m	$292m	$509m
Discount Rate	*10% WACC*	*10% WACC*	*10% WACC*	*10% WACC*	*10% WACC*
Valuation on Free Cash Flow: *How much are you paying today for normalised future cash flows?*					
EV/FCF (x)	34x	26x	42x	11.0x	17x
FCF Yield (%)	3.0%	3.8%	2.4%	9.1%	5.9%

'If it don't make dollars, it don't make sense.'
– DJ Quik

As depicted above, most of the stocks are on fairly modest FCF yields, even after factoring in the high growth forecasts.

The implications are that either:

- The market expects even higher growth metrics to eventuate; or
- Investors are willing to accept low prospective returns; or
- The stocks are overvalued by the market.

It is worth highlighting that these implications say nothing of the highly innovative businesses or the entrepreneurial management teams in place. Rather, the takeaway is that even if these exceptional achievements are met, the market has already more than priced in these outcomes.

Note the outlier in APX, which is a result of by far the most lofty growth assumption. It may also be a reflection of the market placing a more apparent risk discount, given that its business model and artificial intelligence market exposures are perhaps the most difficult to forecast.

WiseTech Global (WTC)

How has the business grown?

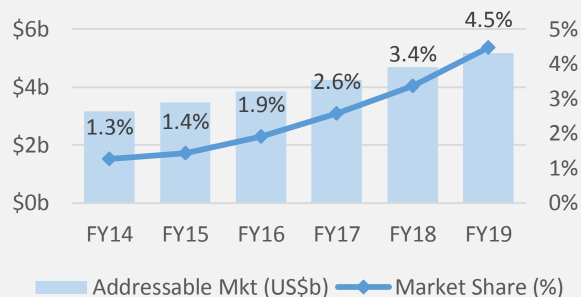
WTC licenses software to global logistics companies. The company's core solution is the CargoWise One platform, but a key part of its strategy has been buying smaller players in geographical or functional niches and bolting them onto the WTC ecosystem.

What if WTC maintains its current growth?

Extrapolating recent trends entails FY28 forecast of:

- Industry growth at a 10% CAGR, with addressable sales ~2.5x larger at $18.8b.
- WTC's market share continues to grow at 65ppts per year, reaching 11% and sales of $2.1b.
- If WTC can produce a 1% margin improvement per year, then in a decade EBITDA margins will be ~45%.

Figure 2: Addressable market and market share



Source: WTC Prospectus, WTC Financials

What does the current price imply about future growth?

Putting the above assumptions together, this produces present-value FCF of $276m. On today's enterprise value of $9.3b, this would give a 3% FCF yield (34x FCF). Based on returns that might materialise in a decade, this appears to inadequately compensate investors for the risks assumed.

If we want to justify the $9b market appraisal of WTC, we need even more aggressive assumptions. An *acceleration* of growth is required, including a combination of; a decade of industry growth above historical levels, market share gains well in excess of WTC's organic rate, and margins increasing by 50%.

The alternative is that the market price has overshot fundamentals. It is instead likely that market growth will *slow* as it matures. Growth via acquisition will continue, but any capital outlay naturally demands a return.

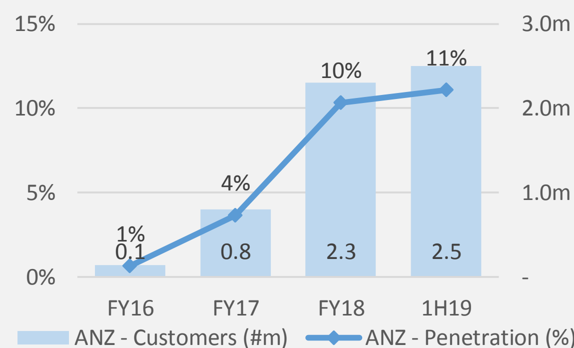
If the stock still appears overpriced under an already improbable set of assumptions, we question how realistic a scenario is in which this FCF forecast can be exceeded. This is to simply reach fair value – to have conviction on material upside being likely and a margin of safety being present in the purchase price, the bar is raised higher still.

AfterpayTouch (APT)

How has the business grown?

Since its IPO in 2016, Afterpay has achieved significant growth in Australia off the back of its instalment payment platform. With 2.5m customers in ANZ as at 1H19, APT has an 11% market penetration of the ANZ adult population. APT is yet to turn a profit at the NPAT level. The company has now entered the US and UK market – which are large, but face a different competitive environment to ANZ 5 years ago.

Figure 3: ANZ customers and market penetration



Source: APT financials, Optar

What if APT achieves targeted growth?

Our 'what-if' scenario assumes:

- Expanding operations to the US and UK increases the addressable market to $780b (26x ANZ).
- APT are targeting $20b in gross merchant value (GMV) by 2022. This is a 350% increase over the annualised GMV in 1H19, to be achieved in 3-4 yrs.
- Assuming stable per-customer spend, this implies a 4.5x increase in customers from 3.2m to 14.2m.
- Assuming no deterioration in the 2% of GMV margin, EBITDA will be $400m. (Note Pay Now and Corporate are ignored, but together produce a material loss).

What does the current price imply about future growth?

After deducting tax and reinvestment, and allowing for time value, the $400m in EBITDA becomes a present-value FCF of $210m. On today's $5.5b EV, that gives a 3.8% normalised FCF yield (26x FCF). Hence despite a quadrupling in customers over 3.5 years, with no deterioration in economics despite rising competition, and a 14x increase in EBITDA, the FCFs generated would be an inadequate return on today's market valuation.

What does the current price ignore?

- Untested in economic and credit cycle downturns?
- What portion of the increased basket size is simply consumption brought forward? Yet to normalise?
- Deteriorating retail margins pressures APT fees?
- Are APT fees at 2-10x interchange fees sustainable?
- Can the same market share and fees be achieved in new markets despite increasing competition?

Altium (ALU)

How has the business grown?

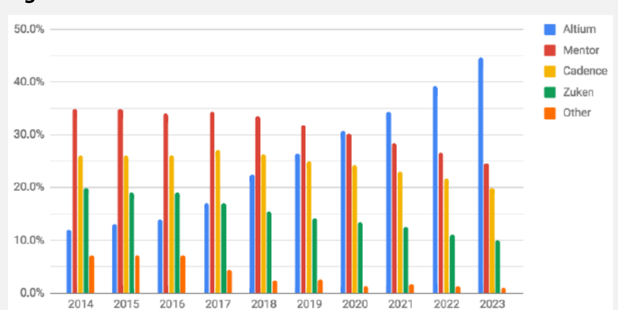
Through its core Printed Circuit Board (PCB) design software, ALU has experienced steady sales growth and market share gains. Sales grew at an 18% CAGR in the last 5 years as market share increased from 11% to 22%.

What if ALU achieves its targeted growth?

Altium have expressed with high confidence that they will "dominate the competition well before 2025". The company slide below forecasts an annual increase at *double the rate achieved over the last 5 years*. Our 'what-if' scenario gives ALU full credit for this hockey-stick growth, assuming that by FY25:

- The market grows at 8% p.a. to $1.4b.
- ALU grows at 2-3x market growth, increasing market share from 22% to 55% with $790m in sales.
- Group EBITDA margin increases to the 35% target.

Figure 4: Altium market share



Source: ALU 1H19 Presentation

What does the current price imply about future growth?

Putting the above assumptions together, this produces present-value FCF of $109m. Considering today's enterprise value of $4.6b, this would reflect a 2.4% normalised FCF yield (42x FCF). Again, this appears an inadequate return given the risks to already aggressive assumptions.

With PCB software margins now hitting 80% and market share already assumed to leap to over 50% in just 6 years, we struggle to identify what levers remain to pull in order to reach a valuation in line with the current market price.

What if Altium win it all?

Having almost a quarter of the global market share, ALU's FY18 NPAT was ~$50m. This suggests the total profit pool up for grabs is upwards of $220m. Even if ALU were to gain *100% market share* today (with no present value discount reflecting the time taken to achieve this share), its $4.7b market cap would reflect a P/E of 21x.

The market appears to price in an extraordinary growth requirement. If the stock still appears expensive after winning 100% market share overnight, we question the probability of a scenario in which a satisfactory level of free cash flow is generated to justify the current price.

Appen (APX)

How has the business grown?

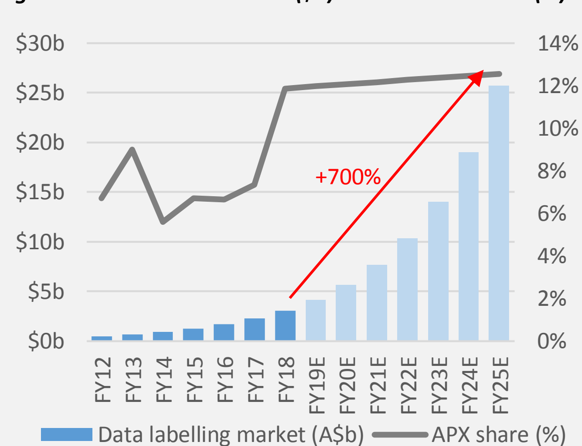
With continuous technological evolution in web search, language integration, and online media, Appen's annotated databases have been increasingly in demand by tech companies and governments. In the last 5 years, sales have increased 6x to $365m, aided by ~$100m in acquisitions.

What if APX maintains its current growth?

Determining the potential size of the artificial intelligence and machine learning market is challenging. APX in their FY18 presentation depict an AI market growing to US$180b by 2025 (35% CAGR):

- APX assume that 'data' represents 10% of the AI investment, entailing an addressable 'data labelling' market of $25b (US$18b).
- If APX maintain share through 2025, this entails a 35% CAGR and a 700% increase in sales over 7 yrs.
- Data collection is the primary cost for APX, rising from 42% to 62% of sales since FY14. This reflects the labour intensive, limited scale benefits of the human annotation model. EBITDA margins can likely only rise from 20% now to perhaps ~25%.

Figure 5: Addressable market ($b) and APX mkt share (%)



Source: APX, MarketsandMarkets, OC

What does the current price imply about future growth?

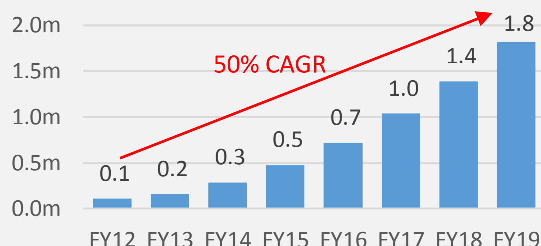
Putting the above assumptions together, this produces present-value FCF of $292m. Considering today's enterprise value of $3.2b, this would reflect a 9.1% normalised FCF yield (11x FCF). While this represents a more attractive level of return, it is based on a DCF with 100% certainty of a 1000% increase in EBITDA over 7 years.

By utilising global labour networks, APX exploits wage arbitrage to label its data sets. Therein lies both the opportunity and threat to Appen. An AI program that could replicate the annotation process would remove wage costs, deliver a run-away advantage, and result in a winner-takes-all market. What is the probability that APX discovers this technology? At the current price, the market does not appear to account for this binary outcome.

Xero (XRO)

How has the business grown?
In the last 10 years, Xero has grown to become a major global player in the business and accounting software market. XRO generated sales of NZ$550m in FY19 from its 1.8 million subscribers.

Figure 6: Subscribers (# million)



Source: XRO financials

What market share can XRO capture?
XRO already has dominant market share in its home regions, with >90% in NZ and >50% in Australia. XRO is growing internationally off a smaller base, with market shares of ~10% in the UK and ~1.5% in North America. Its 1.8m subscribers represents ~5% global market share.

Over the last 5 years, XRO added subs at an average rate of +300k per year (with annual sub growth slowing from 80% to 30%). Consensus appears to estimate a doubling of this rate, with new sub additions at +600k/yr. At this pace, by FY29:

- XRO will reach 7.8m subs and a 20% market share. This equates to sales of $3.8b (+600% on FY19).
- It would be an exceptional result if further scale can increase XRO's *Group* level EBITDA margins from 13% currently to 50%.

What does XRO's current price imply about growth?
Putting the above assumptions together, this produces present-value FCF of $509m. Considering today's enterprise value of $8.6b, this would reflect a 5.9% normalised FCF yield (17x FCF). This is generated under bullish assumptions of XRO quadrupling market share to 20%, despite incumbents Intuit (Quickbooks) and Sage together already holding ~75% of the addressable market.

Xero has done exceptionally well to have established itself as one of the leading global players in the market, but a willingness to buy or hold XRO at the current $8.6b market appraisal must come with conviction that XRO will gain dominant global market share over the next 10 years.

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