FLINDERS Investment Partners

Warakirri ASSET MANAGEMENT

Two small companies positioned for above average returns

One of the attractive aspects of the emerging companies' space is the non-homogenous nature of the sector, which is often made up of little-known companies from a large range of industries. This makes for a variety of interesting investment ideas, and potentially lucrative ones. Some can be structural growers over a long period of time, while others are more cyclical in nature and their multiples can re-rate and de-rate over time. Here we consider one of each and why we feel these companies should deliver above average returns to investors in the coming years.

October 2023

This information has been prepared by Flinders Investment Partners, the underlying investment manager for the Flinders Emergi ng Companies Fund, distributed by Warakirri Asset Management.

Taking a deeper dive

One of the attractive aspects of the emerging companies' space is the non-homogenous nature of the sector, which is often made up of little-known companies from a large range of industries. This makes for a varied source of interesting investment ideas, and potentially lucrative ones. Some can be structural growers over a long period of time, while others are more cyclical in nature and their multiples can re-rate and de-rate over time.

In this article, we talk about one of each. Both are names that are not as well-known given their size, however, both are profitable and growing their earnings, and at a size which should start to capture more attention and we feel should deliver above average returns to investors over the coming years. The first is software company ReadyTech (RDY) and the second is essential infrastructure service provider Service Stream (SSM).

ReadyTech

ASX: RDY

Market Cap: $415m (as at 18/10/23)

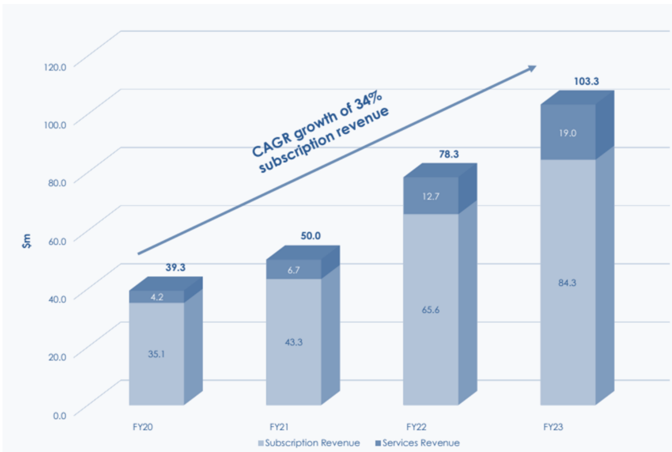
ReadyTech is an Australian Software as a Service (SaaS) provider of mission-critical technology that operates in the defensive markets of:

- Education & Work Pathways (student management software, learning management, etc.)
- Government & Justice (managing operations, collection of rates, etc.)
- Workforce Solutions (payroll, rostering, HR, recruitment, award interpretation, etc.)

Strong revenue growth

RDY's enterprise software products are mission critical solutions. A long history of R&D investment has allowed the company to consistently win new customers and grow its revenue base. The chart below (**Exhibit 1)** illustrates the growth in revenues of which >80% is recurring, with the balance being Services Revenue which captures implementation work for new customers and contracts.

Exhibit 1: Enterprise strategy delivering strong and sustainable SaaS revenue growth



(Source: Company Reports)

While revenue growth has been extremely strong at >30% CAGR over the last few years (a combination of organic and acquired growth), at the FY21 results the company made a significant projection by providing a 5-year outlook that would see revenue grow to over $125m by FY26 purely by organic means, a 20% CAGR on the $50m achieved in FY21. This demonstrated the company's confidence in the visibility of revenues and their pipeline of work.

On top of this, we expect a higher rate of profit growth given better margins as the company exits a period of heavy investment, as well as further inorganic and accretive opportunities to drive growth further.

Large addressable market

At its recent FY23 results, the company for the first time quantified each of its key markets through a bottom-up build of its Serviceable Addressable Market (SAM) – see **Exhibit 2** below – which captures revenues that RDY could win - as opposed to a top-down Total Addressable Market (TAM)) which can exaggerate addressability.

This near $1bn of SAM is substantial to RDY, relative to the ~$100m of Revenue in FY23, providing for many years of expected growth.

Where to next?

Along with the previous insight on RDY's addressable market, a key development and catalyst at the FY23 result in August was the company's guidance that capitalization of R&D as a percentage of revenue would progressively reduce over the next three years. There was evidence of this already in the 2H23 result.

The larger R&D investment historically has been critical for the company given their stated aim to win higher value enterprise customers, which has been happening. From here, the guidance suggests that cash margins and cash generation should improve; a key reason as to why the stock has recently re-rated higher.

We also see additional catalysts to look forward to including commencement of dividend payments and entry into the S&P/ASX300.

Exhibit 2: ReadyTech's Enterprise strategy to pursue large serviceable markets underpins long-term growth

(Source: Company Reports)

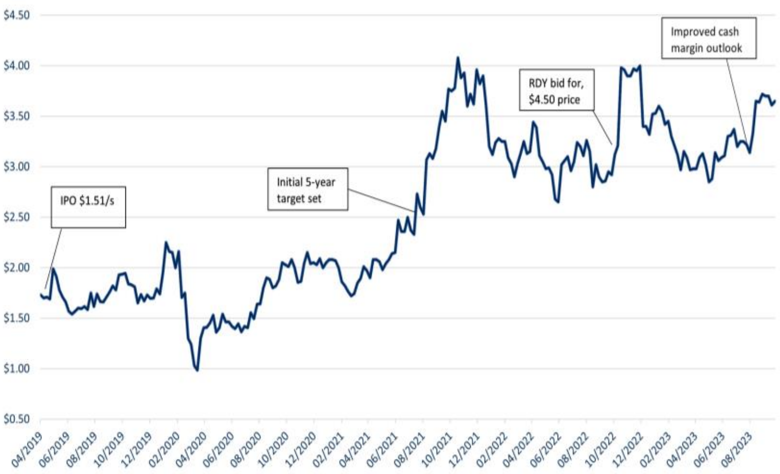
SaaS at a discount

Strongly growing SaaS companies with sticky customers, recurring revenues, high margins, and high returns, unsurprisingly trade at a premium valuation to the wider market. While RDY also trades at a small premium and has seen a recent re-rate to around 18x one year forward earnings, it continues to trade at a steep discount to other listed peers, and at less than half the multiple of Technology One (TNE: A $5bn S&P/ASX100 stock). In fact, RDY is often described as a 'mini Tech One' given similarities in their SaaS products and customers.

We believe that as RDY continues to demonstrate improved cash margins and cash generation, it should continue to re-rate to a level more in line with peers.

Incidentally, RDY received an unsolicited bid from Pacific Equity Partners (PEP) at $4.50/s, which was announced in November 2022, and at a 39% premium at the time. There were two significant RDY shareholders which ultimately made a binding transaction difficult, however the development did highlight the undervalued nature of the stock.

Exhibit 3: ReadyTech Share Price



(Source: IRESS)

Service Stream

ASX:SSM

Market Cap: $557m (as at 18/10/23)

Service Stream is a broad-based services company that provides construction, maintenance and other engineering services to telecommunication, gas, water and electricity utilities and transport infrastructure.

The company had its roots as a provider of:

- engineering, maintenance and connection services to both fixed and mobile telco operators; and
- a meter reading service to electricity and gas utilities.
- It has grown both organically and via acquisition to broaden its business activities with major customers.

A focus on lifting shareholder returns

In 2021 the company acquired Lend Lease Services that expanded its reach with existing clients and also added expertise in the electricity and transport (traffic and roads) sectors. The acquisition was earnings accretive and came with significant cost synergies that the company is still realising.

In 2022 the company struck cost and implementation issues with a design and construct project with a large water utility. This led to losses and a write-down of over $20m. This hit the company's share price hard and it de-rated significantly. This was not helped by persistent low margins in its utilities business.

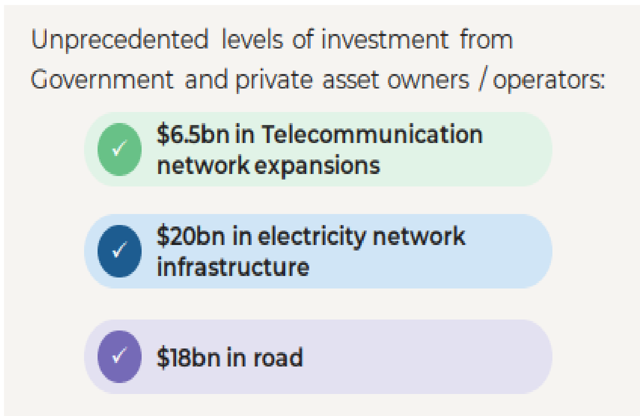
Since then, the company has met profit expectations, has growth opportunities and is seeing margins recover. The management team is experienced and very focussed on lifting shareholder returns.

Growth opportunities

Service Stream's addressable markets are very large, and importantly, undergoing high levels of investment. For instance, in electricity, the move to renewables will demand a significant overhaul of the transmission and distribution infrastructure over the next 20 years.

Technology is seeing constant upgrading of telecommunications systems (both fixed and mobile) and road infrastructure is always in need of increased maintenance and upgrading with a growing population.
Large utilities need service providers with scale, workforce, systems, regulatory compliance, and the skills to take on contracts. The barriers to entry are increasing and service providers decreasing. Service Stream is growing in this environment.

Exhibit 4: Core Markets



(Source: Company Reports)

Why now?

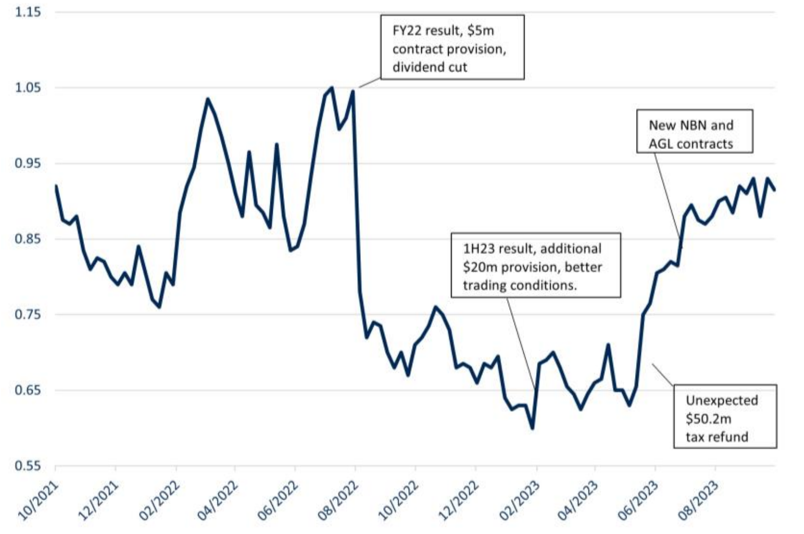
A number of factors are falling into place that will improve the company's profitability profile over the next few years.

We suggest these have not been recognised by the market:

- The NBN fibre to the home (FTTH) upgrade is in an expansion phase with the around 4m homes to be upgraded and eventually connected. SSM is heavily involved in this process.
- The utilities division will see improving margins off an unusually low base. A number of low value contracts have rolled off and the company has stopped bidding on fixed price design and construct contracts.
- After road repair work was interrupted due to floods in 2022, workflow is now more consistent, and the roads are in even greater need of repair.

- Opportunities exist in defence department asset maintenance – a new area for the company but using existing skills and services.
- The company continues to trade at a steep discount to the market and with very little debt, good cashflow and low capital employed, we expect both capital and dividend growth over the next few years.

Exhibit 5: Service Stream Share Price



(Source: IRESS)

Conclusion

For smaller companies, the consensus is that the higher rates, rising costs and an iffy consumer means there is no reason to consider them, but we believe the market is wrong to take a blanket approach to the sector. Money has come out of small-caps and with less liquidity it has meant that there have been many companies with good growth prospects such as the two companies highlighted above that have been over-sold and provide compelling investment opportunities.

For more information, please contact us on 1300 927 254 or visit warakirri.com.au