Bruce Packard's Weekly Commentary

Exclusively for SharePad & ShareScope subscribers

Management Departures

5th July 2021

The FTSE 100 at 7,145 appears to be breaking out of the trading range that it has occupied since the beginning of May. The S&P +15% since the start of the year, is still ahead of the Nasdaq +13% although last week the latter was closing the gap, reporting a positive +1.5% gain. Amazon is +5% since the start of the year, lagging the likes of Moderna +125%, NVIDIA +55%, Alphabet (Google) +44% and Facebook +40%.

Last week was Jeff Bezos' last day in the office, as he's stepping down after almost 3 decades running Amazon. That leaves Facebook, now over $1 trillion market cap, as the largest (by far) of companies that is still led by its founder. If you haven't read Bezos' shareholder letters, I recommend them, his final one is here. The company has grown from a $300m market cap at IPO (when he raised $54m) in 1997 to a market cap of $1.7 trillion. The number of employees has grown from 158 mentioned in the first shareholder letter to 1.3m this year.

Critics will be sure to point out that despite the market cap of $1.7 trillion, Amazon paid just $2.9bn in corporate tax. Bezos is aware of the criticism, in his most recent letter he highlights that Amazon also pays $11bn in employee payroll taxes and other benefits. He also answers criticisms that he drives employees too hard and he says he takes Amazon's wider responsibilities to society seriously, so there's a section on climate change. Jeff is not leaving quietly, he plans to blast off into space in a couple of weeks.

Another departure this month is Andy Haldane, Chief Economist at the Bank of England famous for his "Dog and the Frisbee" speech. When public servants depart, that's often the time that they can say what would otherwise be left unsaid. His final speech is worth reading in full, but he gives us some interesting numbers: £200 billion of UK household excess savings from the pandemic that's likely to be spent in the economy in the coming months. UK companies accumulated a further £100 billion of bank deposits. Both those figures are likely to be underestimates of the economic impact, because each pound spent will have a multiplier effect.

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Haldane also makes some eye-catching comments about inflation: “by the end of this year, I expect UK inflation to be nearer 4% than 3%” and currently we are at the “most dangerous moment for inflation targeting so far”. He warns the policy response to financial crises may result in worries about UK debt service which “begin to contaminate perceptions of the future monetary stance”.

Translating into plain English: he means that the next crisis won’t be about commercial banks struggling to fund their balance sheet liabilities in the interbank markets, instead the next crisis will be about Governments and Central Banks. Or put another way, if inflation is going to approach 4%, who will buy UK Govt bonds currently yielding 0.82%? Seen in that context, perhaps it is not a coincidence that Andy Haldane has decided now is a good time to leave the Bank of England?

Below is the UK 10 year Governments bond yield chart from SharePad going back to 1995

This week I look at a couple of companies with departing Chief Executives: D4T4 (Peter Kear) and Argentex (co-CEO Carl Jani). A departing Chief Executive doesn’t always signal clouds on the horizon, but it can do. The example that springs to my mind is Accesso, the theme park queuing software company, when Steve Brown’s departure in April 2018 was followed by a 96% share price decline. I doubt we will see such a steep decline with Amazon, or with D4T4 or Argentex, but I do think senior departures carry some information value. The first company I look at though is Cambridge Cognition, which is reporting contract wins and positive momentum.

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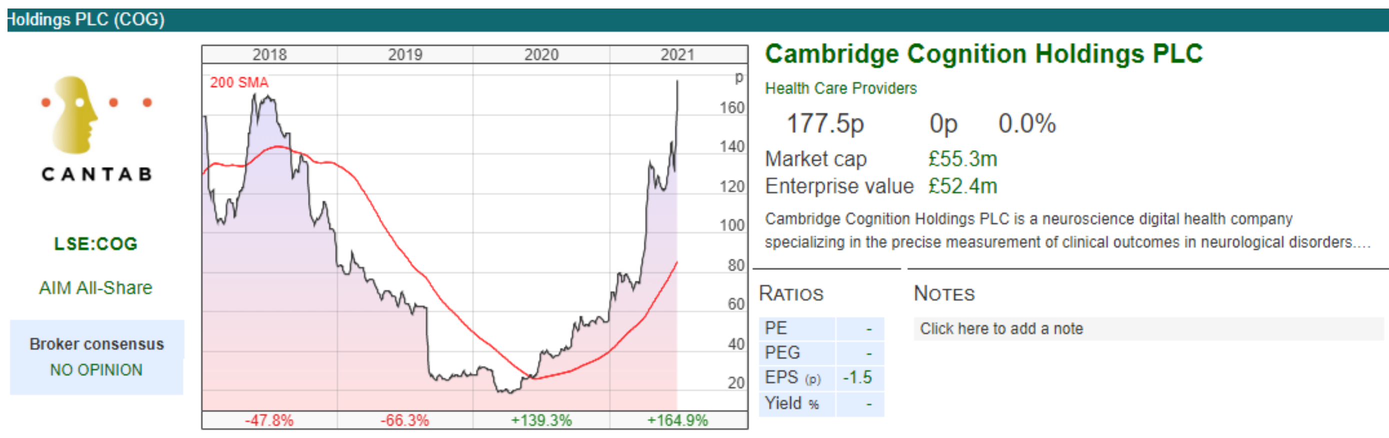
Cambridge Cognition



This software company focused on brain health and diagnostics announced a contract win valued at £2.2m, with revenues expected to be recognised over the next 3 years. The shares were up +22% following the RNS. Or put another way, the market cap has jumped by over £10m (to £55m), 4x higher than the increase in revenues (not profits) announced. Clearly some investors believe that the contract win, which is a cognitive home testing kit, shows acceptance of the company's technology.

History In 2013 Cambridge Cognition was listed on AIM, at 70p to commercialise digital health software originally developed at Cambridge University. They raised £5m valuing the company at £12m market cap. The funds were deployed to convert the company's existing CANTAB® software, a suite of 25 different cognitive tests well established at the time of the IPO, for use on smartphones and grow sales of CANTABmobile™, for early detection of dementia and other neurological problems.

Traditionally, cognitive tests have been carried out by pencil and paper and require a highly-trained examiner to follow a complex series of scoring and administrative steps. The advantages of computerised tests are i) standardisation ii) improved accuracy iii) automated comparison with an individual's performance as well as age-related norms and iv) more efficient from a staffing and cost perspective (that is, saves money).

Aside from initially diagnosing a cognitive problem, CANTAB® lets researchers (academic or in commercial clinical trial) continually test subjects/patients for cognitive status in a controlled, repeatable manner and so evaluate effects of intervention (ie do the drugs work) in conditions such as MCI, Alzheimer's, Parkinson's, schizophrenia and depression.

Financials The company has a December year end and reported results in March. Revenues were up +34% to £6.4m. Although the gross profit margin is attractive at 81%, there was a small loss for the year of £0.4m (an improvement on £2.9m in 2019). Cumulative losses stand at minus £17.4m in retained earnings on the balance sheet, so the group has had several capital raisings on its path to profitability. The most

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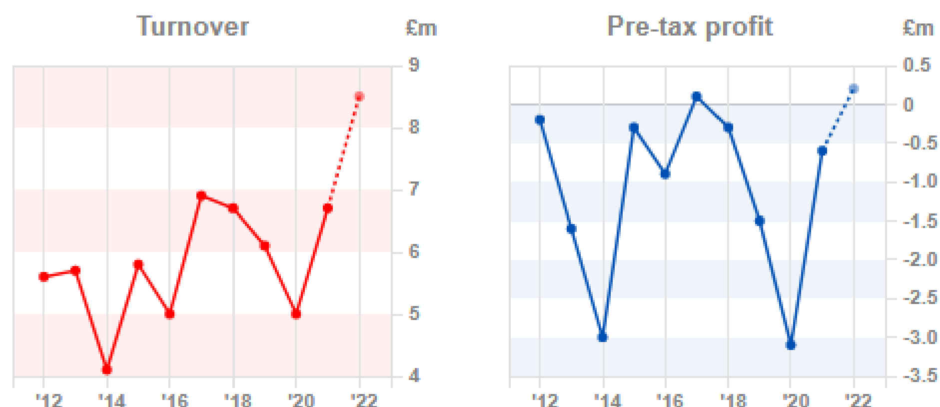
recent was £1.4m in March 2020, at 20p per share, so well done to those who supported the company at the low point last year.



The company had £3.0m of cash at 31st December. Management say that Covid-19 has accelerated interest in "virtual" clinical trials, which should create more opportunities this year and in the future. In the outlook statement they said that they were profitable in Q4 of last year, and would expect that to continue for 2021F. The Key Audit Matters section mentions revenue recognition, because the Group has multiple products that it provides as part of a single arrangement, so there's some management judgement in determining when performance obligations are satisfied and thus when revenue is recorded in the p&l. Payables on the balance sheet (that is future obligations) are £6.2m, almost 3x higher than receivables which were £2.6m at the end of December 2020.

Ownership The largest shareholder is Nigel Wray, with 15.6%. Given he's done very well out of Domino's Pizza UK and is involved in Franchise Brands, he qualifies as "smart money". That's no substitute for investors doing their own thinking though, rather than following recognisable names uncritically. AXA IM own 5%, Octopus 4.6% and Lombard Odier 4.5%.

Spin out A couple of days following the contract announcement the company also announced a spin out of its digital phenotyping business, called Monument Therapeutics. This was pre-revenue, so no change to forecast from the broker, and COG retain a 36.9% shareholding in Monument.

Valuation FinnCap, their broker, left their forecasts unchanged following last week's RNS. They are forecasting revenue growth of +27% to £8.5m, and a small £200K profit this year. They've raised their target price to 190p, +50% from 125p earlier this month. Theoretically there should be a link between EPS forecasts and target prices, but that's not how valuation models work in life sciences.

Opinion Looks really interesting. I'm put off by the high price to sales ratio, but this is an attractive gross margin business, which means if the company continues to win contracts, then profit should drop through to the bottom line. I wish that I'd looked at it this time last year, because the shares are up 9x since the 20p low in April last year.

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D4T4 FY to March 2021

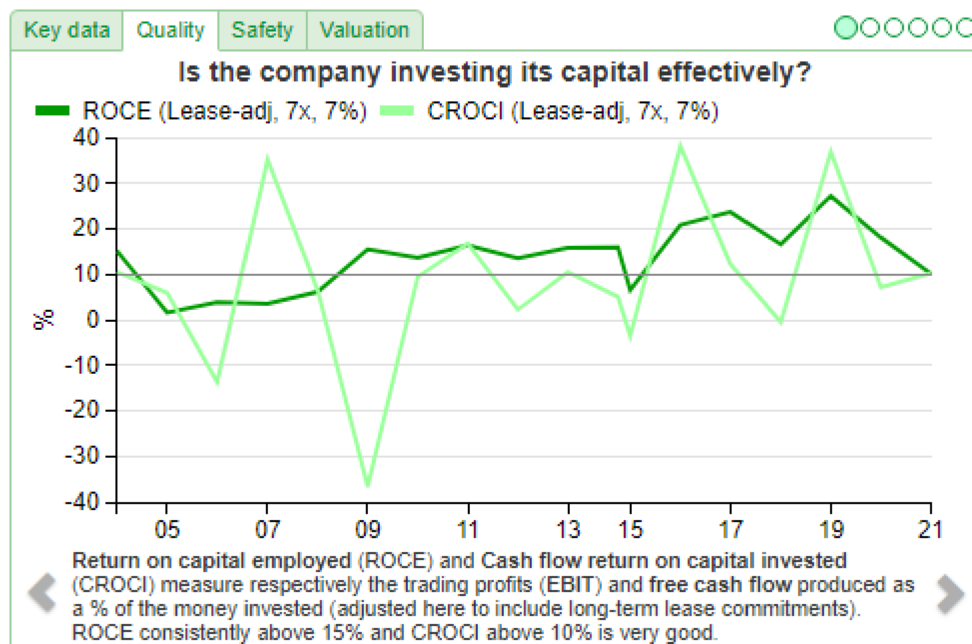
Last week D4T4, the enterprise software and fraud protection business I covered in April, disappointed with the share price falling -13%. Revenues were up +4.6% to £22.8m (in line with guidance given in April) and adj PBT was £4.45m (slightly ahead of guidance in April). Statutory PBT, where guidance hadn't previously been given, fell to £3m. The end of March cash position was £14.2m, again in in line with previous guidance.

Communication style Rather than the historic numbers, the disappointment seems to be driven by the outlook. That's despite management saying "trading during the new financial year has been in line with the Board's expectations". Yet FinnCap their broker cut this year's adj PBT by 31% to £3.8m. The reduction is caused by higher costs, mainly marketing spend to roll out the new FDP product. Reducing short term profits to invest in the business may well be the correct management decision. However I dislike management's communication style, saying that the current year is "in line" with the Board's expectations and yet suggesting to their broker that PBT is 30% too high.

Cheap words, expensive numbers It's a red flag to me when the company's narrative (what management say in the commentary) doesn't match what is happening with the numbers. As an example from my bank analyst days: HBOS proclaimed in H1 2008 that they had a "strong balance sheet", when in reality the bank was being supported by the Bank of England's Special Liquidity Scheme (SLS). By implication, HBOS management believed that they could say what they liked, because "strong balance sheet" is not clearly defined (investors would interpret the phrase as meaning no funding difficulties, but in reality the bank needed support). In most cases it is better to pay close attention to the story that the numbers tell, not the story that management say in the text, particularly when the two stories contradict each other.

VALUATION	MCap	fc PE	PEG	Price / NAV
	£138.8m	55.6	-	4.5
	EV £124.8m	3y avg 22.4	No forecast	3y avg 2.8

D4T4's historic PER ratio is 36x and forecast PER is 55x, which seems generous for a company where Returns on Capital Employed have fallen recently from 25% two years ago to 10% FY2021 (see chart below).



Co-founders leaving The other slight worry is that the Chief Exec, Peter Kear, who co-founded the business in 1985 is stepping down. Another co-founder and former Chief Exec is retiring as Non Exec Director, and the CFO is also leaving to pursue another role. These management departures could be signalling clouds on the horizon. Just a guess, but perhaps competition from well-funded US tech stocks, like Snowflake and Palantir could be intensifying?

Opinion Using FinnCap's new EPS forecasts for D4T4 of 5.7p FY 2022F and 9.8p FY 2023F puts the stock on 60x this year and 35x next year. I think what this shows is that valuations and expectations remain very high. We're in the type of market where companies are likely to be punished harshly for disappointing investors, so I'll avoid.

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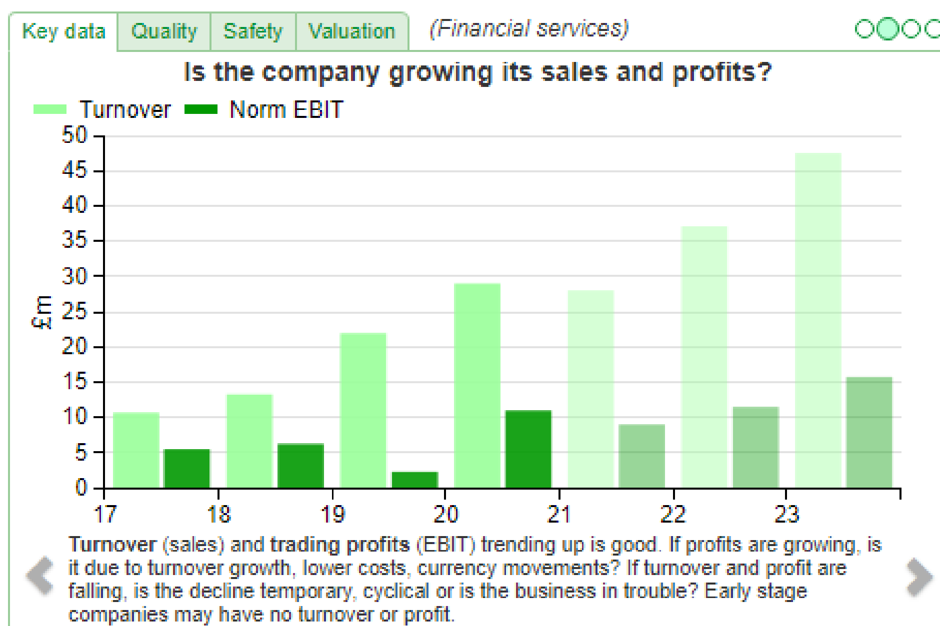
Argentex FY to March 2021

This foreign exchange broker reported FY to March revenue down -3% to £28.1m, statutory PBT was down -27% to £7.4m. I covered the company in April here, when they gave that revenue figure in a trading statement. The revenue split implies a considerable recovery in the recent second half +8% H2 vs H2 last year, compared to -14% for the H1 year on year split. Cash was down -22% versus the prior year to £38m, a number which wasn't given in the trading update in April. This company had an unusual co-CEO leadership, but in June Carl Jani announced he was resigning and Harry Adams became the sole CEO with immediate effect. The shares were off 7% following last week's RNS.

Outlook statement Says the business has started the year with "good momentum". But otherwise vaguely worded. Again, I'm troubled by positive sounding, but unspecific comments. I like that management have set themselves demanding expectations, but I do wonder if that does leave the possibility of a further downward revision to numbers?



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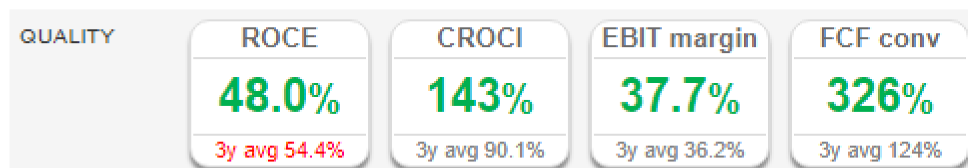
Broker forecasts Numis are their broker, so I don't have access to their forecasts. But I think we can safely assume that numbers are coming down. If we take the +8% growth achieved in H2 as the new underlying level, that would imply £30m of revenue for this year and £33m next year, I'd guess that the company will struggle to achieve 10p of EPS this year, though that's realistic for 2023F, which implies an attractive 11x PER, particularly given the level of cash and the other "quality" metrics that SharePad highlights.



Opinion I like the story, but I'm going to wait and see if there are further down revisions to earnings to come. One concern from a management presentation (I think investormeetscompany) Q&A an investor asked "Isn't it a problem that the banks have more leverage with your corporate customers? Often when banks agree credit with a corporate customer, they demand that the SME uses the bank for all their forex business, rather than a firm such as yourselves?"

The Chief Exec gulped and said that it was an astute question. He went on to answer, but I was more struck by the Chief Exec's body language than the content of the answer. So there is a risk that as corporates have relied on bank financing to get them through the pandemic, this has weakened Argentex's competitive position. Looking at the chart doesn't fill me with confidence either, particularly if the shares fall below the support level of 111p.

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