Jeremy Grime's Weekly Commentary

Exclusively for SharePad & ShareScope subscribers

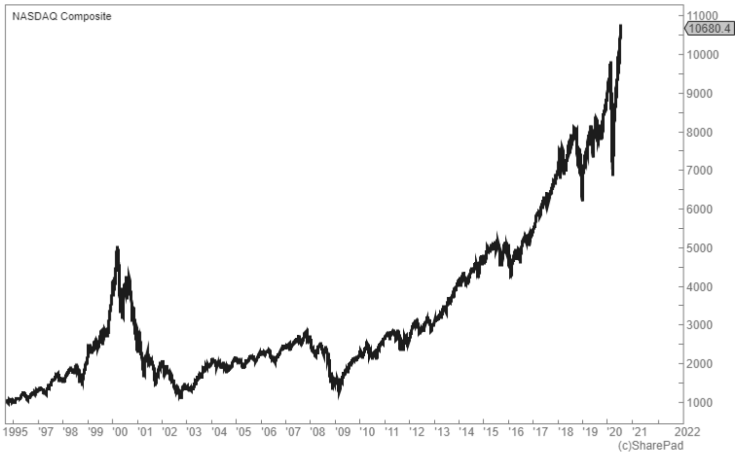
The Relative Value Trade

27 July 2020

The announcement of the EU recovery fund was a significant event last week. 27 countries jointly agreed to borrow €750bn to be dispersed through grants and loans on a scale not previously seen. The markets reactions was positive. The Euro rose against the dollar. The NASDAQ 100 was up 3% and has now increased 25% year to date. The market value of these stocks is now more than the entire Japanese stock market. While the NASDAQ 100 was up 3% the equal weighted version of the index was only up 1.6% indicating the polarity of the liquidity flows into the larger stocks. Value was ignored. And so, it seems this new burst of liquidity will perpetuate the dominance of the large liquid FANMAG stocks, as Facebook, Amazon, Netflix, Microsoft, Alphabet, Google have become known.

We shouldn't under-estimate the effect that €750bn can have. To put this in an investing context, if we were a high earner and so were capable of saving €100k per year it would still take us 7.5 million years to save that amount of money. So, we have to assume these sums will never get repaid and will just serve to devalue the buying power of the currency. What we call inflation.

This infusion of liquidity into the markets doesn't look likely to drop down to the small cap stocks in a hurry, rendering all but those stocks that can sell something to the FANMAG stocks pointless, which serves as a reminder that expensive stocks can get more expensive. But for those of us that remember the post dot com bubble years it may be worth remembering that it took 15 years for the NASDAQ composite to recover to its 2001 level. There wasn't much wrong with a lot of those dot com stocks, they were simply over valued, yet it took 15 years of profit growth for the NASDAQ index to recover its previous high, meaning an investor is wrong for 15 years. Today, the dot com bubble and its aftermath looks like a small aberration in a long-term trend.



Source: SharePad

Back in Blighty the FTSE 100 reached 7,000 back in the dotcom bubble while today it stands at 6,220. It can take a very long time for today's over valuation of the FANMAG stocks to correct. For those that can take a 20 year view it may well be OK to join the crowd who are investing today, but some of us may not want to wait 20 years.

Relative Valuation

A far more comfortable way of investing is to find the smaller and cheaper version of the FANMAG stocks, thus seeking some element of valuation protection while benefitting from the structural growth that is driving the sector. The example of Zoom, the video communication provider that many of us have become familiar with during lockdown trades on a PE of 202 while LoopUp, the smaller UK provider trades at 11.3X PE. This is a good example of the relative value trade. Or perhaps when we look at Robinhood, the high frequency trading app founded in 2013 and recently valued in a private fund raise at $8.6bn compared to the provider of high frequency trading infrastructure, Beeks Financial Cloud which is valued at £52m.
It is this very attraction to cheaper look-a-likes that leads imitators with inferior businesses to attempt to benefit from the valuation of the larger and better business. So we need to exercise caution when looking at such a relative value trade. We need to make sure that the company's product is not too far inferior to the larger competitor. If the company has a quality product and effective distribution the larger peer is ultimately likely to bid for the smaller peer, whereas if either the product or the distribution capability is inferior the larger competitor will simply compete it away. These two assessments can make the difference between a highly valued take over bid or a corporate failure.

LoopUp

Share Price *190p*
Mkt Cap *£105m*

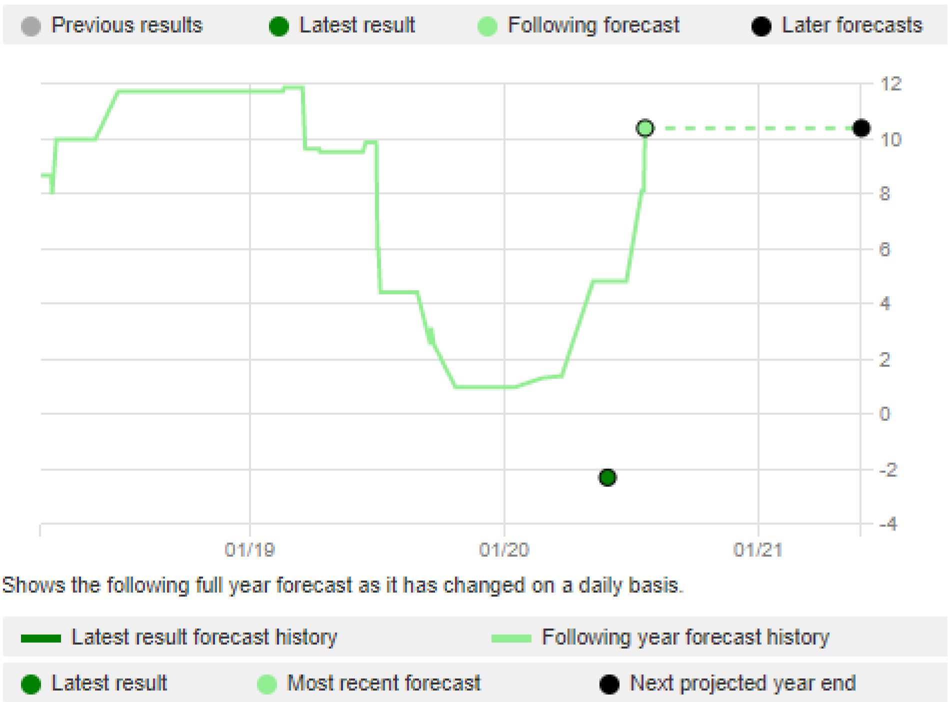
Product

Zoom can host meetings, webinars, conference rooms, phone calls and chat for up to 1,000 video participants and 10k viewers. It is easy to use and highly scalable, and is a cost effective solution for heavy users. Loop Up is also easy to use but it has a maximum of 20 guests who can share their video. It doesn't have as many tools such as voting management etc. but it is cheaper than zoom. Loopup also has a pay as you go capability as opposed to Zoom's subscription only model. It would seem that this market is rather like the early days of the mobile phone market where early adopters may use a pay as you go model which evolves over time into a full subscription model. Different providers initially owned different segments of the market until, as the market matures, they consolidate into a small number of large players, as we see now in the mobile network market.

A glance at the mobile phone industry in 2005 shows that the dominant providers of Nokia and Motorola has between them five times the market share of the next incumbent, Samsung. If this mobile conferencing market evolves in the same way it will be the pace of innovation that determines the ultimate winner, rather than the early dominant player. There is therefore a good case for backing the smaller company if it is more innovative. A glance at the tax credit in the report and accounts for LoopUp shows a £789k tax refund largely on account of the R&D expenditure, which is c 2% of the company's revenue. For Zoom, the research and development deferred tax carry forwards is $5.7m, which amounts to less than 1% of the revenue. It therefore appears that LoopUp is investing. LoopUp is growing its market share in professional services, growing its active users from 33.4k to 41.2k last year.

Estimates

Lockdown has clearly stimulated demand and the share price has responded to recent forecast upgrades.



Source: SharePad

The magnitude of the sensitivity is large. The company reported some intermittent service issues in November and December which led to downgrades at the start of this year. A google search of reviews confirms a number of issues with the service hanging. Then, following lockdown, the company reported a 40% increase in revenue in the first 4 months of the year to April 2020. 6 weeks later in June the company announced again that it expected to exceed market forecasts. The pre close update for H1 to the end of June, issued on 16 July, showed H1 revenue up 43% to £31.9m and EBITDA up 249% from £3.5m to £12.2m, underlining the operational gearing of small companies.

With rapidly moving forecasts, consensus numbers can become out of date. With £31.9m delivered in H1 analysts appear to be expecting £24.2m revenue in H2 and £1.4m EBITDA which looks an unlikely rate of decline from £12.2m EBITDA in H1. New users, I would imagine, tend to continue as users for some time, and it seems to me the professional market is certainly set to continue having remote meetings for the foreseeable future. I therefore suspect that over the course of H2 there could still be material upgrades to come.

FORECASTS £ millions unless stated

Year	2020		2021		2022	
Turnover	56.1	+31.8%	55.7	-0.7%	64.4	+15.7%
EBITDA	17.1	+166.8%	13.2	-22.9%	14.7	+11.4%
EBIT	13.1		8.7	-33.3%	-	
Pre-tax profit	10.4		6.0	-42.3%	7.4	+22.8%
Post-tax profit	7.0	+433.8%	4.7	-33.1%	-	
EPS (p)	16.4	+645.5%	9.3	-43.3%	10.5	+12.9%
Dividend (p)	-		-		-	
Capex	4.5	-28.9%	4.7	+4.5%	1.4	-69.9%
Free cash flow	9.6		5.1	-46.9%	-	
Net borrowing	0.4	-97.0%	-1.5		-7.0	
NAV	65.8	+13.3%	68.6	+4.2%	-	

Source: SharePad

Valuation

In my view the downward sloping forecasts for 2021 look too low, but perhaps that is what the market is valuing the shares from. The 43% decline in earnings would suggest that the era of video calls is drawing to an end, which it isn't. If we compare this to the markets' assumptions for **Zoom** in the US, those analysts make no such assumptions (below).

FORECASTS $ millions unless stated

Year	2021		2022		2023	
Turnover	1,804.4	+189.8%	2,263.6	+25.4%	2,901.2	+28.2%
EBITDA	475.0	+1529.6%	598.4	+26.0%	622.9	+4.1%
EBIT	376.8	+2868.0%	463.9	+23.1%	694.6	+49.7%
Pre-tax profit	393.3	+1392.1%	488.7	+24.2%	718.3	+47.0%
Post-tax profit	381.3	+1406.8%	468.3	+22.8%	679.7	+45.1%
EPS (¢)	128.7	+1330.0%	153.2	+19.0%	216.1	+41.1%
Dividend (¢)	-		-		-	
Capex	84.5	+120.9%	86.6	+2.6%	100.7	+16.3%
Free cash flow	502.7	+342.3%	594.5	+18.3%	881.4	+48.2%
Net borrowing	-988.8		-1,621.9		-2,385.8	

Zoom Video Communications Inc. *Source: Sharepad*

Thus, if LoopUp manages to grow its revenue in 2021 it could potentially turn out to be on a single figure PE, rather than the 20.6X shown in analyst forecasts.

RATIOS

Year	2020	2021	2022
PE	11.7	20.6	18.2
EV/EBIT	9.2	13.9	-
EV/EBITDA	7.1	9.2	8.2

Source: SharePad

Conclusion

This looks like one of those classic turn arounds when analysts typically take a long time to catch up. While there is a relative valuation play between Zoom and LoopUp, the upgrade cycle for LoopUp is significantly lagging that of Zoom. With the twin drivers of valuation and upgrades this looks like one for both the short and medium term, while in the long term the market is likely to start to mature and LoopUp could become a consolidation target.

Beeks Financial Cloud

***Share Price** 102p*
***Mkt Cap** £53m*

Product

Beeks provides what is termed "low latency" trading software (which in my view would be better described as "high speed"). It has 220 financial institution customers and 9,000 retail traders as clients across its 15 worldwide datacentres. There is little competition currently. While Cloud providers such as Microsoft Azure, and Google Cloud could compete they don't offer the connectivity and speed that is essential for high speed automated trading. When we see Robinhood, the US retail commission free trader, selling its volume of trades to market makers in order to generate its revenue, we can start to understand the value of high speed automated trading capability for financial institutions. Except the loss making Robinhood was valued at $8.3bn when it was refinanced in May this year while Beeks sits at a £53m market cap.

Estimates

Beeks is at an early stage and so “the law of small numbers” applies where incremental customer wins can make a very significant difference to numbers. 95% of revenues are recurring so the largest sensitivity in forecasts is the new client wins. The company has a June year end.

FORECASTS — £ millions unless stated

Year	2020		2021		2022	
Turnover	9.6	+30.1%	12.9	+35.3%	16.4	+26.7%
EBITDA	3.4	+37.8%	4.4	+27.7%	6.0	+37.6%
EBIT	1.5	+25.9%	2.1	+37.2%	2.8	+35.6%
Pre-tax profit	1.3	+27.0%	1.9	+46.4%	2.8	+44.3%
Post-tax profit	1.3	-0.3%	1.8	+38.5%	2.3	+27.8%
EPS (p)	2.2	-12.0%	3.3	+50.0%	4.6	+39.4%
Dividend (p)	0.4	+14.3%	0.5	+25.0%	0.5	0.0%
Capex	1.9	+11.5%	2.2	+18.9%	2.1	-4.5%
Free cash flow	-0.8		0.1		-	
Net borrowing	-0.1		-0.3		-1.0	

Source: SharePad

In April 2020 the company announced the acquisition of Velocimetrics, which offers real time network monitoring and trade analytics software to a global list of financial institutions, expanding Beeks’ service offering, as well as its customer base. The price was £1.3m which was a little above the £1.2m revenue reported. Therefore the 35% revenue growth expected in 2021 is closer to 20% on an underlying basis. On results in March the company reported a strong pipeline of new business, but it would appear that some new business may be factored into the above forecasts.

Valuation

In traditional PE terms the company is not cheap at 41X. However with only c.£10m of revenue the sensitivity of earnings to new client wins is significant, so perhaps this is a play on the potential of the company rather than today’s earnings, much as the loss making RobinHood is valued according to its potential profitability rather than today’s earnings.

VALUATION RATIOS

PE	41.0	46.6	31.1	22.3
Debt-adjusted PE	42.4	-	-	-
CAPE	-	-	-	52.4
EV/EBIT	43.1	34.2	24.9	18.4
EV/EBITDA	20.8	15.1	11.8	8.6
EPS growth	13.6	(12.0)	50.0	39.4
PEG	-	0.9	0.8	-
PEGY	-	0.9	0.8	-
Neff TRR	(0.3)	1.1	1.3	-
Graham number (£)	0.2	-	-	-
Graham ratio	4.1	-	-	-
Price to turnover	7.1	5.5	4.0	3.2

Source: SharePad

Conclusion

I have always had a soft spot for Beeks as the company is named after the analyst Laurence Beeks who starred in the film Trading Places and was the author of the vital crop report in the film. But emotional attachment is a dangerous trait for investment decisions. I suspect over the long term the company will do well but it is hard to know when the new business will arrive. Forecasts are assuming some new business. The outlook statement at the H1 results said “current trading is positive” which is not as strong as I might have hoped given the forecasts anticipate perhaps 20% underlying growth. Perhaps this is one for the longer term investor rather than the short term investor.

Summary

The tech bubble looks set to continue for a while as unprecedented liquidity is pumped into markets by governments. This will end badly, but in the meantime the relative valuations are becoming extreme between the large liquid US tech giants and UK small companies. LoopUp vs Zoom and Beeks Financial Cloud vs Robin Hood are good examples of this. While Beeks has a name I am fond of, recent updates seem less confident than I might hope. LoopUp on the other hand, looks to have a pessimistic analyst following who may benefit from counselling to help them see that the numbers could be a lot better than they are forecasting. With the twin drivers of potential forecast upgrades and valuation improvement that could be of interest to both the short and medium term investor, while in the long term LoopUp could become a consolidation target.

Personal Note

I shall be taking up an opportunity to work in the rated financial services team at Canaccord Genuity in a few weeks’ time which means I will be unable to continue writing for SharePad. I have enjoyed writing for SharePad and the team and hope that these ramblings have been fruitful or enjoyable for readers. I have learned a lot of the great features on SharePad that rival the expensive systems I have used in the professional market and suspect that it is systems such as SharePad that are contributing to the increasing influence of retail investors in the stock market that is set to continue to grow for many years. In the coming weeks I shall review some of my truly dreadful views and some of the better ones. Thankyou for reading and I wish all SharePad users successful investing.

Future Events

Company	Date	Event
	10-Aug-20	My last Weekly Commentary
LoopUP	17-Sept-20	H1 Results
Beeks Financial Cloud	4-Sept-20	FY Results

Source: Me, Sharepad, RNS