Xref Limited

Lite the path

ORD MINNETT RESEARCH

Sales progress at Xref slowed over 1H20, with credit sales expanding in 2Q by just 2% on pcp. Combined with a cash EBITDA loss of ~$5m at the half, we need to see marked improvement in sales and rationalisation of costs in 2H to bolster confidence in the medium-term outlook. Management have shifted attention to driving client self-activation over enterprise sales, which should see cash burn shrink and sale re-grow into 2H. Our credit sales forecast is now $12.0m for FY20, with an expected FY cash EBTIDA loss of ~$6m. As we await early signs of regrowth in sales and tempering of expenses, we downgrade our recommendation to Hold. Our price target falls from 60c to 25c per share.

Net-cash burn profile leaves work to be done

Xref's slowing sales growth profile has seen management shift attention to self-activation via Xref Lite and Template builder, leading to a lower-cost sales function driven around marketing. We have yet to see material signs of this strategy, but welcome the 3Q and 4Q updates. In conjunction with the re-targeted sales effort, we expect to see rationalisation in expenses to drive a slimming cash burn. We expect this is underway, but prefer to see progress before becoming more optimistic on the medium-term financial outlook.

Xref offers some corporate appeal

Our Hold recommendation is in place until we see signs of strategic shifts taking hold. We still see value in Xref, with the platform fully built, producing attractive gross margins and solid revenues in ANZ. A lot of the hard work and expense to acquire large enterprise clients has already been completed and so we see strong strategic value underpinning the stock. We also have a favourable view towards the Xref lite platform which we believe will assist with reducing the cost of customer acquisition and proliferation of the brand.

Downgrade to Hold awaiting signs of re-growth

We have adjusted our forecasts in line with current progress, not factoring in complete success of the new strategic vision. Our forecasts were off by a fair margin and therefore so too was our valuation which falls from 60c per share to 25c. We welcome signs of progress to become more positive on the stock.

Key Financials

Year-end June ($)	FY18A	FY19A	FY20E	FY21E	FY22E
Revenue ($m)	4.8	8.0	9.6	11.6	14.2
EBITDA ($m)	(9.9)	(7.8)	(8.3)	(6.1)	(5.2)
EBIT ($m)	(10.0)	(7.9)	(8.9)	(6.8)	(5.9)
Reported NPAT ($m)	(8.9)	(8.1)	(8.9)	(6.8)	(5.9)
Reported EPS (c)	(5.7)	(4.6)	(4.8)	(3.3)	(2.5)
Normalised NPAT ($m)	(8.2)	(7.5)	(8.5)	(6.4)	(5.5)
Normalised EPS (c)	(5.2)	(4.3)	(4.6)	(3.1)	(2.4)
Dividend (c)	-	-	-	-	-
Net Yield (%)	-	-	-	-	-
Normalised ROE (%)	-	-	454.4	194.2	143.9

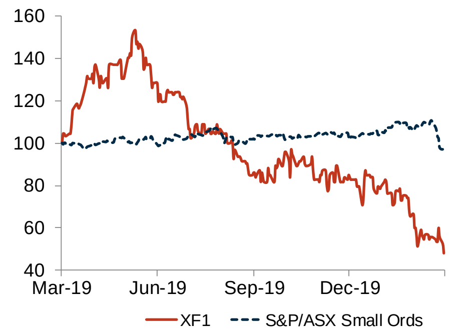
Source: OML, Iress, Xref Limited

Last Price
A$0.22
Target Price
A$0.25 *(Previously A$0.60)*
Recommendation
Hold (Previously Speculative Bu
Risk
Higher

Application Software

ASX Code	XF1
52 Week Range ($)	-
Market Cap ($m)	36.8
Shares Outstanding (m)	167.3
Av Daily Turnover ($m)	0.0
3 Month Total Return (%)	-43.6
12 Month Total Return (%)	-54.2
Benchmark 12 Month Return (%)	-0.2
NTA FY20E (¢ per share)	-1.5
Net Cash FY20E ($m)	2.8

Relative Price Performance



Source: FactSet

Consensus Earnings

	FY20E	FY21E
NPAT (C) ($m)	-	-
NPAT (OM) ($m)	(8.5)	(6.4)
EPS (C) (c)	-	-
EPS (OM) (c)	(4.6)	(3.1)

Source: OML, Iress, Xref Limited

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Result overview

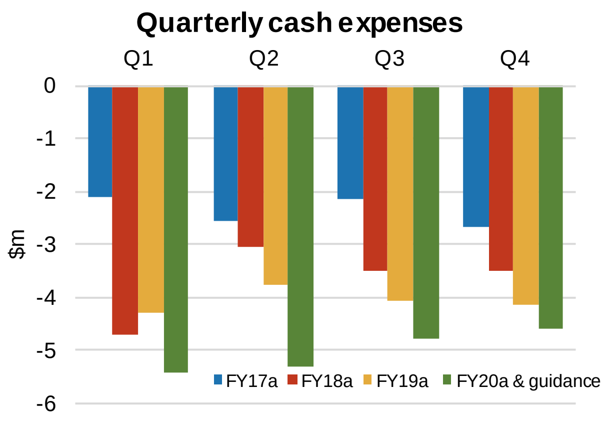
- XF1 produced underlying (exc share based payments) NLAT of -$6.5m in 1H20, which was backward by -24% on pcp. We note significant operating costs and reduced revenue growth as the drivers for the elevated loss.
- Credit sales, the key measure we rely upon, were below expectations in 1H20 with Xref reporting $4.6m of credit sales (+12% on pcp). Based on our previous FY20 credit sales forecast of $14.5m, XF1 would have required ~$9.8m of credit sales in the next two halves in order to achieve this target. **We have now revised our forecasts accordingly. See page 5 for further details.**
  - Whilst a traditionally weaker half, we also note that the Dec-19 quarter credit sales saw only 2% growth on pcp and was down -9% qoq. For reference Dec-18 grew 10% on pcp. This was despite 80 new clients coming on.
  - However, the implementation of Xref lite could increase the ease of selling credits through a self-service offering. This is showing early signs of success, with 235 added in the Dec-19 quarter.
- ANZ and North American credit sales were up 20% and 11% respectively on pcp. However, Europe was below previous periods with Norway slightly down and the UK worse, leading to an overall decline of 26% in Europe on pcp.
  - Xref has been largely impacted by economic uncertainty in the UK attributable to the Brexit vote
- Credit usage (recognised revenue) in 1H20 did see some growth with $4.4m 1H20 vs $3.4m in 1H19, which was positive to see.
- Cash cost growth (ex. one-offs) of ~16% on pcp in line with the 4Cs and largely driven by increased overheads and staff costs.

Figure 1: Result Overview

	1H19a	1H20a	%∆
Sales revenue	**2.8**	**3.4**	**12%**
Other revenue	0.0	0.0	na
Cash opex	-7.5	-10.0	-16%
EBITDA	**-4.7**	**-6.5**	**-19%**
D&A	0.0	-0.1	-113%
Normalised EBIT	**-4.7**	**-6.7**	**-20%**
Net interest	0.1	0.1	61%
PBT	**-4.7**	**-6.5**	**-19%**
Tax	0.1	0.0	-4%
Normalised NPAT	**-4.6**	**-6.5**	**-24%**
Share based payments	0.0	-0.1	-15%
Reported NPAT	**-4.6**	**-6.7**	**-23%**
Credit sales	4.2	4.6	6%
Credit usage	6.2	7.6	32%
Credit sales EBITDA	**-3.4**	**-4.8**	**-19%**
Year-end cash	11.1	5.7	-121%

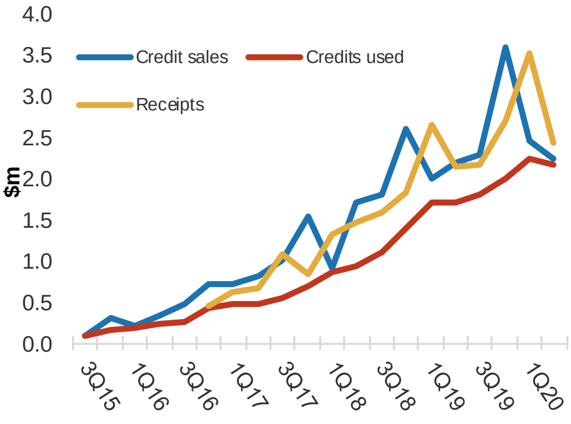
Source: OML and company data

Figure 2: Quarterly cash expenses



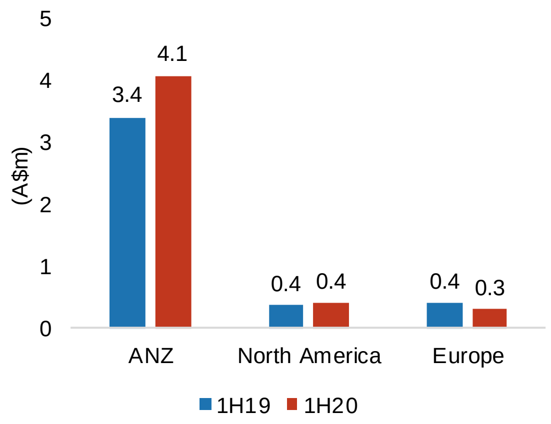
Source: OML and company data

Figure 3: Quarterly metrics



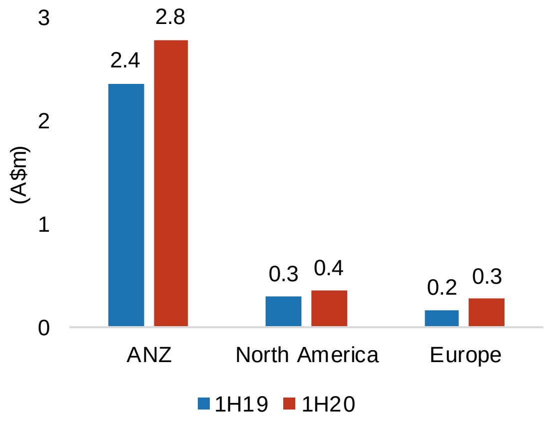
Source: OML and company data

Figure 4: Region breakdown – credit sales



Source: OML and company data

Figure 5: Region breakdown – revenue (usage)



Source: OML and company data

- As per figures 4 and 5 above, The EU and North American geographies saw weaker than anticipated performance in the 1H20.
- We would hope that this could be largely rectified via the continued introduction and roll-out of Xref lite enabling easier sales of credits to customers.

Changes to forecasts

Figure 6: Changes to forecasts

	FY20 old	FY20 new	%∆	FY21 old	FY21 new	%∆	FY22 old	FY22 new	%∆
Sales revenue	**10.9**	**9.6**	**-11.8%**	**14.6**	**11.6**	**-20.9%**	**18.7**	**14.2**	**-24.4%**
Other revenue	0.0	0.0	na	0.0	0.0	na	0.0	0.0	na
Cash opex	-17.9	-17.8	0.1%	-19.9	-17.7	10.9%	-21.7	-19.4	10.9%
EBITDA	**-7.0**	**-8.3**	**-18.1%**	**-5.2**	**-6.1**	**-16.9%**	**-3.0**	**-5.2**	**-74.0%**
D&A	-0.1	-0.7	-558.1%	-0.1	-0.7	-558.1%	-0.1	-0.7	-558.1%
Normalised EBIT	**-7.1**	**-8.9**	**-25.7%**	**-5.3**	**-6.8**	**-27.1%**	**-3.1**	**-5.9**	**-89.6%**
Net interest	0.1	0.1	na	0.1	0.1	na	0.1	0.1	na
PBT	**-7.0**	**-8.8**	**-26.0%**	**-5.3**	**-6.7**	**-26.9%**	**-3.0**	**-5.8**	**-90.3%**
Tax	0.3	0.3	0.0%	0.3	0.3	0.0%	0.3	0.3	0.0%
Normalised NPAT	**-6.7**	**-8.5**	**-26.9%**	**-5.0**	**-6.4**	**-28.3%**	**-2.8**	**-5.5**	**-98.4%**
Share based payments	-0.4	-0.4	na	-0.4	-0.4	na	-0.4	-0.4	na
Reported NPAT	**-7.1**	**-8.9**	**-25.4%**	**-5.4**	**-6.8**	**-26.2%**	**-3.2**	**-5.9**	**-86.0%**
Credit sales	14.5	12.0	-17.4%	19.5	14.5	-25.8%	25.0	17.7	-29.2%
Credit sales EBITDA	**-3.4**	**-5.9**	**-74.2%**	**-0.3**	**-3.2**	**-828.1%**	**3.2**	**-1.7**	**-151.5%**
Year-end cash	1.7	2.8	68.3%	1.7	2.5	49.6%	1.3	3.2	156.7%

Source: OML and company data

- We have revised our forecasts to better reflect XF1's current situation
- We have updated our FY20 credit sales target to better reflect an annualised 1H split in FY20 with some success for new paths to market
- We have also adjusted our Cash opex in FY20 to reduce overall costs as XF1 changes its sales strategy.
- The overall impact is an 18.1% increase in the EBTIDA loss
- On these numbers, we have forecast two $5m capital raises across FY21 and FY22 at a 15% discount to spot – we dilute for this in our valuation.

Valuation & Recommendation

- We continue to value to XF1 via a discounted cashflow method due to the long-dated nature of XF1's cash flow profile. We use a weighted average cost of capital of 14% and terminal growth rate of 3.5%. The result is a DCF of 22c per share and a price target of 25c per share.
- With sales growth slowing considerable since the time of our initiation and costs continuing to creep up, we prefer to downgrade our recommendation to Hold as we await signs that the new sales strategy has taken hold and credit sales are re-growing.
- We will review progress at the 3Q and 4Q updates, with the latter expected to be the maiden "cash flow break-even" quarter.

Figure 7: DCF inputs and outputs

DCF inputs	
Beta	1.50
Risk free rate	5.0%
Market risk premium	6.0%
Cost of equity	14.0%
Debt premium	4.0%
Cost of debt (after tax)	6.3%
D/E	0.0%
WACC	**14.0%**
Terminal growth rate	**3.5%**

DCF outputs	
Forecast cash flows ($m)	-6
Terminal value ($m)	51
Franking value	0
Enterprise value ($m)	**45**
Add net cash (4Q19) ($m)	-6
Equity value ($m)	**51**
Implied equity value (p.s.)	0.22

Price target derivation	
DCF valuation ($ ps)	0.22
Cost of equity (%)	14.0%
Rolled-forward valuations ($ ps)	**0.25**
Less dividend ($ ps)	0.00
One-year forward price target ($ ps)	**0.25**

Source: OML estimates

Risks

Operational risks

- Xref's reputation and client retention impacted due to incomplete references
- Low switching costs after credits have been fully spent
- We see these as relatively low risk given current high rates of retention and the strong management team

Technology and compliance risk

- Risk of technological obsolescence
- Downtime risk
- Large amounts of personal data leading to risk of privacy breaches
- We see these risks as having relatively low risk of eventuation due to Xref's strong technological control framework (ISO 27001 compliant) and utilisation of premium technological products and services (e.g. Amazon Web Services)

Competition

- Risk that the business model could be replicated. Our view that this risk is largely mitigated through the significant lead time, Xref's analytics and the customer base Xref already have

Break-even and external funding risk

- We expect Xref to achieve cash flow break-even in 4Q20. Our modelling suggests that a strong working capital position, government rebates for technology innovation, continued revenue growth and contained costs sees Xref fund itself through to break-even in that quarter, but dip back into burn thereafter. We expect the company to need external funding of $10m to reach sustainable cash flow positive.

About Xref

Xref are a listed IT software-as-a-service (SaaS) provider that automates the candidate reference check process on behalf of employers. Xref's largest market is the Australian domestic market. However, recent expansion into Canada, United Kingdom and the Nordic region has been successful, winning new clients across the board. As at 30 June 2017, over 700 companies across seven countries have used the Xref product.

Xref Limited

Hold

PROFIT & LOSS (A$m)	2018A	2019A	2020E	2021E	2022E
Revenue	4.8	8.0	9.6	11.6	14.2
Operating costs	(14.8)	(15.8)	(17.8)	(17.7)	(19.4)
Operating EBITDA	**(9.9)**	**(7.8)**	**(8.3)**	**(6.1)**	**(5.2)**
D&A	(0.1)	(0.1)	(0.7)	(0.7)	(0.7)
EBIT	**(10.0)**	**(7.9)**	**(8.9)**	**(6.8)**	**(5.9)**
Net interest	0.1	0.2	0.1	0.1	0.1
Pre-tax profit	**(9.9)**	**(7.7)**	**(8.8)**	**(6.7)**	**(5.8)**
Net tax (expense) / benefit	1.7	0.2	0.3	0.3	0.3
Significant items/Adj.	-	-	-	-	-
Associate NPAT	-	-	-	-	-
Normalised NPAT	**(8.2)**	**(7.5)**	**(8.5)**	**(6.4)**	**(5.5)**
Reported NPAT	**(8.9)**	**(8.1)**	**(8.9)**	**(6.8)**	**(5.9)**
Normalised dil. EPS (cps)	(5.2)	(4.3)	(4.6)	(3.1)	(2.4)
Reported EPS (cps)	(5.7)	(4.6)	(4.8)	(3.3)	(2.5)
Effective tax rate (%)	-	30.0	30.0	30.0	30.0
DPS (cps)	-	-	-	-	-
Dividend yield (%)	-	-	-	-	-
Payout ratio (%)	-	-	-	-	-
Diluted # of shares (m)	155.8	175.9	185.3	205.6	233.4

CASH FLOW (A$m)	2018A	2019A	2020E	2021E	2022E
EBITDA incl. adjustments	(9.9)	(7.8)	(8.3)	(6.1)	(5.2)
Change in working capital	1.6	0.9	0.0	0.7	1.0
Net Interest (paid)/received	0.1	0.1	0.1	0.1	0.1
Income tax paid	-	-	-	-	-
Other operating items	1.7	1.7	0.2	0.3	-
Operating Cash Flow	**(6.5)**	**(5.0)**	**(7.9)**	**(5.1)**	**(4.1)**
Capex	(0.2)	(0.1)	(0.2)	(0.2)	(0.2)
Acquisitions	-	-	(0.6)	-	-
Other investing items	-	(0.0)	-	-	-
Investing Cash Flow	**(0.2)**	**(0.1)**	**(0.8)**	**(0.2)**	**(0.2)**
Inc/(Dec) in equity	7.5	7.5	3.5	5.0	5.0
Inc/(Dec) in borrowings	-	-	-	-	-
Dividends paid	-	-	-	-	-
Other financing items	(0.5)	1.3	-	-	-
Financing Cash Flow	**7.1**	**8.7**	**3.5**	**5.0**	**5.0**
FX adjustment	-	-	-	-	-
Net Inc/(Dec) in Cash	0.4	3.6	(5.2)	(0.3)	0.7

BALANCE SHEET (A$m)	2018A	2019A	2020E	2021E	2022E
Cash	4.5	8.0	2.8	2.5	3.2
Receivables	3.1	2.3	4.4	5.1	6.3
Other current assets	0.2	1.0	1.0	1.0	1.0
PP & E	0.3	0.3	(0.1)	(0.6)	(1.0)
Intangibles	0.1	0.1	0.7	0.7	0.7
Other non-current assets	0.1	0.1	0.1	0.1	0.1
Total Assets	**8.4**	**11.9**	**8.9**	**8.9**	**10.4**
Short term debt	-	-	-	-	-
Payables	1.6	1.8	3.4	3.9	4.7
Other current liabilities	4.7	6.8	7.4	8.2	9.5
Other non-current liabilities	-	-	0.4	-	-
Total Liabilities	**6.4**	**8.7**	**11.2**	**12.2**	**14.2**
Total Equity	**1.9**	**3.2**	**(1.9)**	**(3.3)**	**(3.8)**
Net debt (cash)	(4.5)	(8.0)	(2.8)	(2.5)	(3.2)

DIVISIONS	2018A	2019A	2020E	2021E	2022E

KEY METRICS (%)	2018A	2019A	2020E	2021E	2022E
Revenue growth	62.6	66.1	19.2	20.7	22.2
EBITDA margin	-	-	-	-	-
OCF /EBITDA	84.0	88.4	99.9	88.4	81.0
EBIT margin	-	-	-	-	-
Return on assets	-	-	-	-	-
Return on equity	-	-	454.4	194.2	143.9

VALUATION RATIOS (x)	2018A	2019A	2020E	2021E	2022E
Reported P/E	-	-	-	-	-
Price To Free Cash Flow	-	-	-	-	-
Price To NTA	16.0	11.8	-	-	-
EV / EBIT	-	-	-	-	-

LEVERAGE	2018A	2019A	2020E	2021E	2022E
ND / (ND + Equity) (%)	177.5	164.8	60.0	43.5	45.5
Net Debt / EBITDA (%)	45.0	103.2	34.1	41.7	61.7
EBIT Interest Cover (x)	85.0	43.0	69.2	85.1	65.5
EBITDA Interest Cover (x)	84.3	42.5	64.1	76.9	58.2

SUBSTANTIAL HOLDERS	m	%
Lee-Martin Seymour	30.9	18.4%
Tim Griffiths	30.9	18.4%
IFM	10.9	6.5%

VALUATION	
Cost of Equity (%)	14.0
Cost of debt (after tax) (%)	9.0
D / EV (%)	-
WACC (%)	**14.0**
Forecast cash flow ($m)	(5.7)
Terminal value ($m)	50.8
Franking credit value ($m)	-
Enterprise Value ($m)	51.0
Less net debt / add net cash & investments ($m)	(5.9)
Equity NPV ($m)	**45.1**
Equity NPV Per Share ($)	**0.22**
Target Price Method	Rolled fwd DCF
Target Price ($)	0.25
Valuation disc. / (prem.) to share price (%)	13.6

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Guide to Ord Minnett Recommendations

SPECULATIVE BUY	We expect the stock's total return (nominal yield plus capital appreciation) to exceed 20% over 12 months. The investment may have a strong capital appreciation but also has high degree of risk and there is a significant risk of capital loss.
BUY	The stock's total return (nominal dividend yield plus capital appreciation) is expected to exceed 15% over the next 12 months.
ACCUMULATE	We expect a total return of between 5% and 15%. Investors should consider adding to holdings or taking a position in the stock on share price weakness.
HOLD	We expect the stock to return between 0% and 5%, and believe the stock is fairly priced.
LIGHTEN	We expect the stock's return to be between 0% and negative 15%. Investors should consider decreasing their holdings.
SELL	We expect the total return to lose 15% or more.
RISK ASSESSMENT	Classified as Lower, Medium or Higher, the risk assessment denotes the relative assessment of an individual stock's risk based on an appraisal of its disclosed financial information, historic volatility of its share price, nature of its operations and other relevant quantitative and qualitative criteria. Risk is assessed by comparison with other Australian stocks, not across other asset classes such as Cash or Fixed Interest.

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