Xref Limited

Xtracting costs

XF1 released a mixed 3QFY20 result, with costs reduced meaningfully but sales not regrowing as much as we would have liked. XF1's business model is dependent on market sentiment and employers hiring, making global uncertainty caused by COVID-19 a pertinent issue. Coming out of this crisis, XF1 is uniquely placed to play an important role in re-hiring, but in the meantime it will likely see a slowdown across all but its essential service clients. Having pared back credit sales in FY20, we expect an improvement in FY21 as the economy gets going again, and a more meaningful uplift in FY22 to follow. In order to see the business through to FY22, however, we anticipate additional capital being required. In addition, prolonged exposure to greater consumer and market uncertainty is likely to further deplete XF1's cash reserves in the short-term. We maintain our Hold recommendation and reduce our price target to $0.21.

Steps in the right direction

XF1 has continued to cut costs over the past quarter, with more anticipated in the fourth quarter. We view this favourably given XF1's current market capitalisation and likely need to raise capital in the next 12 months. In addition, management reaffirmed guidance that XF1 will reach cash flow break even in 4Q20. Given the cost base reduction of nearly $2m over the final two quarters, we feel this a more achievable that previously. XF1 also note that ~35% of its customers are considered essential services (e.g. health care) and have seen an uplift of ~55% over the last two weeks. This is a positive as it will help alleviate the strain of the remaining customers which have declined ~42%.

Capital raise coming

On our numbers, we still anticipate two capital raises are required for XF1 over the next two years. Whilst cost reductions are positive, they have not been sufficient to outweigh XF1's credit sales outlook in the short-term.

Changes to forecasts

We have reduced our credit sales forecasts for FY20 off the back of reduced breakeven guidance and increased our FY22 revenue (usage) growth to 45% as XF1 likely benefits from a recovery in the economy.

Key Financials

Year-end June ($)	FY18A	FY19A	FY20E	FY21E	FY22E
Revenue ($m)	4.8	8.0	7.8	9.9	14.3
EBITDA ($m)	(9.9)	(7.8)	(10.0)	(7.7)	(4.0)
EBIT ($m)	(10.0)	(7.9)	(10.7)	(8.3)	(4.6)
Reported NPAT ($m)	(8.9)	(8.1)	(10.7)	(8.4)	(4.7)
Reported EPS (c)	(5.7)	(4.6)	(5.8)	(3.7)	(1.7)
Normalised NPAT ($m)	(8.2)	(7.5)	(10.3)	(8.0)	(4.3)
Normalised EPS (c)	(5.2)	(4.3)	(5.6)	(3.5)	(1.5)
Dividend (c)	-	-	-	-	-
Net Yield (%)	-	-	-	-	-
Normalised ROE (%)	-	-	281.2	170.5	107.0

Source: OML, Iress, Xref Limited

Last Price
A$0.11

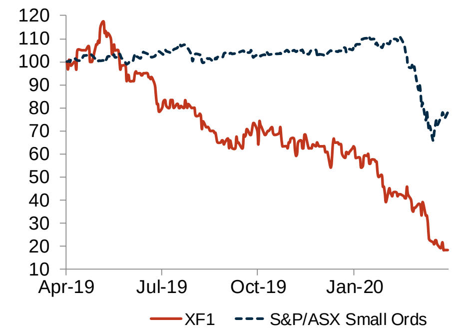
Target Price
A$0.21 *(Previously A$0.25)*

Recommendation
Hold

Risk
Higher

Application Software	
ASX Code	XF1
52 Week Range ($)	-
Market Cap ($m)	18.4
Shares Outstanding (m)	167.3
Av Daily Turnover ($m)	
3 Month Total Return (%)	-70.7
12 Month Total Return (%)	-82.5
Benchmark 12 Month Return (%)	-21.6
NTA FY20E (¢ per share)	-2.5
Net Cash FY20E ($m)	0.8

Relative Price Performance



Source: FactSet

Consensus Earnings	FY20E	FY21E
NPAT (C) ($m)	-	-
NPAT (OM) ($m)	(10.3)	(8.0)
EPS (C) (c)	-	-
EPS (OM) (c)	(5.6)	(3.5)

Source: OML, Iress, Xref Limited

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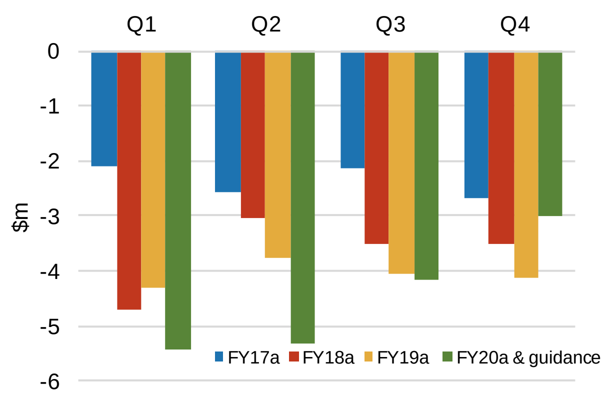
3QFY20 result overview

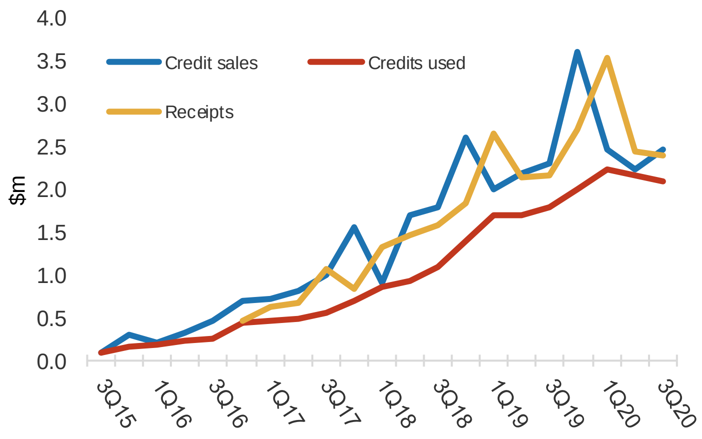
- XF1 has engaged in significant cost-outs throughout the third quarter recording $4.2m of cash costs (guided to $4.8m. This is a reduction of $1.1m from the previous quarter, with XF1 has also guiding to cash costs of $3.0m.
- XF1 has achieved the cost base improvements via reductions in headcount (now 67 vs 98 prior), travel costs and office leases.
- XF1's credit sales of $2.47m for the quarter were up 7% on pcp and 10% qoq. Whilst a step in the right direction given last quarter's performance, it was impacted by COVID-19 in late March. This puts XF1's credit sales for the year at $7.17m and requiring $4.83m to reach OMLe of $12m for FY20.
- **We have since modified our credit sales forecast to $9.8m (-2.4% pcp). This implies 4Q credit sales of $2.6m for 4QFY20.**
- XF1 has identified the impacts from COVID-19 as being significant. 35% of its clients are deemed to be essential services and XF1 has seen an uptick in revenue attributable to these clients by ~55% over the last two weeks. However, this also corresponded with the remainder seeing a decline of ~42% across the last two weeks of March.
- This impact was seen throughout the quarter with credit usage relatively flat qoq (-3%). We would anticipate that XF1 continues to see relatively flat credit sales in 4QFY20.
- We note that XF1 announced it has now integrated with LinkedIn Talent Hub, an ATS that leverages Linkedin's technology platform. We view this as positive as the integration route to customer is generally low cost from an acquisition perspective. In addition, tying up with LinkedIn is another positive method of raising awareness for the XF1 brand.
- XF1 management have not reiterated the goal of achieving cash flow break even in 4QFY20. Given the overall threat of COVID-19, the economic downturn associated with it and the significant number of firms that are reducing staff numbers, Management have elected not to provide formal guidance on cash flow break even. We view this as conservative given the nature of the current outbreak.

Figure 1: Quarterly cash expenses



Source: OML and company data

Figure 2: Quarterly metrics



Source: OML and company data

Changes to forecasts

Figure 3: Changes to forecasts

	FY20 old	FY20 new	%∆	FY21 old	FY21 new	%∆	FY22 old	FY22 new	%∆
Sales revenue	**9.6**	**7.8**	**-18.5%**	**11.6**	**9.9**	**-14.8%**	**14.2**	**14.3**	**1.3%**
Other revenue	0.0	0.0	na	0.0	0.0	na	0.0	0.0	na
Cash opex	-17.8	-17.8	0.0%	-17.7	-17.5	0.8%	-19.4	-18.3	5.4%
EBITDA	**-8.3**	**-10.0**	**-21.5%**	**-6.1**	**-7.7**	**-25.6%**	**-5.2**	**-4.0**	**23.5%**
D&A	-0.7	-0.7	0.0%	-0.7	-0.7	0.0%	-0.7	-0.7	0.0%
Normalised EBIT	**-8.9**	**-10.7**	**-19.9%**	**-6.8**	**-8.3**	**-23.1%**	**-5.9**	**-4.6**	**20.8%**
Net interest	0.1	0.1	na	0.1	0.0	na	0.1	0.1	na
PBT	**-8.8**	**-10.6**	**-20.4%**	**-6.7**	**-8.3**	**-24.1%**	**-5.8**	**-4.6**	**20.5%**
Tax	0.3	0.3	0.0%	0.3	0.3	0.0%	0.3	0.3	0.0%
Normalised NPAT	**-8.5**	**-10.3**	**-21.0%**	**-6.4**	**-8.0**	**-25.0%**	**-5.5**	**-4.3**	**21.4%**
Share based payments	-0.4	-0.4	na	-0.4	-0.4	na	-0.4	-0.4	na
Reported NPAT	**-8.9**	**-10.7**	**-20.1%**	**-6.8**	**-8.4**	**-23.5%**	**-5.9**	**-4.7**	**20.0%**
Credit sales	12.0	9.8	-18.5%	14.5	12.3	-14.8%	17.7	17.3	-2.3%
Credit sales EBITDA	**-5.9**	**-8.1**	**-37.9%**	**-3.2**	**-5.2**	**-62.1%**	**-1.7**	**-1.1**	**37.2%**
Year-end cash	2.8	0.8	-73.2%	2.5	0.6	-77.4%	3.2	1.9	-42.2%

Source: OML and company data

- We have revised our forecasts to better reflect XF1's current situation in light of COVID-19.
- We have reduced our FY20 credit sales target to better reflect the shift driven by COVID-19. We have applied a 28% discount to 4QFY19 to attain $2.6m of credit sales in 4Q20.
  - We believe this is conservative given it is traditionally XF1's strongest quarter with 4QFY19 growing 38% on pcp.
  - It also implies a -2.4% reduction in FY20 credit sales vs pcp.
- Given XF1 was willing and able to pull out costs, we have reduced our FY21 and FY22 Opex balance to show further reductions in the cost base.
- We have increased our FY22 revenue forecast to account for increased usage of the platform. We erred on the side of conservatism as to whether to include this in FY21, given the uncertainty surrounding COVID-19.
- The overall impact is an 21.5% increase in the EBTIDA loss in FY20. However, a significant improvement is forecast in FY22.
- XF1 is still likely to need two capital raises with $7.0m in FY21 (prev. $5.0m), $5.0m in FY22.

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 18c per share and a price target of 21c per share.
- COVID-19 has likely put a dampener on FY20, given the impacts on consumer and corporate sentiment.
- We hold the view that if XF1 can continue to reduce costs and weather this period of uncertainty, it is well placed for life post-COVID-19 when hiring and re-hiring commences. It will also potentially benefit from government stimulus too.

Figure 4: 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 ($m)	-5
Terminal value ($m)	54
Franking value	0
Enterprise value ($m)	**49**
Add net cash (4Q19) ($m)	-6
Equity value ($m)	**55**
Implied equity value (p.s.)	0.18
Price target derivation	
DCF valuation ($ ps)	0.18
Cost of equity (%)	14.0%
Rolled-forward valuations ($ ps)	**0.21**
Less dividend ($ ps)	0.00
One-year forward price target ($ ps)	**0.21**

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

COVID-19 and market sentiment

- A downturn in market sentiment and a reduction in hiring could have negative impacts on Xref's ability to sell credits
- We view this as a core possibility that would impact a large range of professional services

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 $12m 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.

Xref Limited

Hold

PROFIT & LOSS (A$m)	2018A	2019A	2020E	2021E	2022E
Revenue	4.8	8.0	7.8	9.9	14.3
Operating costs	(14.8)	(15.8)	(17.8)	(17.5)	(18.3)
Operating EBITDA	**(9.9)**	**(7.8)**	**(10.0)**	**(7.7)**	**(4.0)**
D&A	(0.1)	(0.1)	(0.7)	(0.7)	(0.7)
EBIT	**(10.0)**	**(7.9)**	**(10.7)**	**(8.3)**	**(4.6)**
Net interest	0.1	0.2	0.1	0.0	0.1
Pre-tax profit	**(9.9)**	**(7.7)**	**(10.6)**	**(8.3)**	**(4.6)**
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)**	**(10.3)**	**(8.0)**	**(4.3)**
Reported NPAT	**(8.9)**	**(8.1)**	**(10.7)**	**(8.4)**	**(4.7)**
Normalised dil. EPS (cps)	(5.2)	(4.3)	(5.6)	(3.5)	(1.5)
Reported EPS (cps)	(5.7)	(4.6)	(5.8)	(3.7)	(1.7)
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	226.8	287.1

CASH FLOW (A$m)	2018A	2019A	2020E	2021E	2022E
EBITDA incl. adjustments	(9.9)	(7.8)	(10.0)	(7.7)	(4.0)
Change in working capital	1.6	0.9	(0.3)	0.4	0.4
Net Interest (paid)/received	0.1	0.1	0.1	0.0	0.1
Income tax paid	-	-	-	-	-
Other operating items	1.7	1.7	0.2	0.3	-
Operating Cash Flow	**(6.5)**	**(5.0)**	**(10.0)**	**(7.0)**	**(3.5)**
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	7.0	5.0
Inc/(Dec) in borrowings	-	-	-	-	-
Dividends paid	-	-	-	-	-
Other financing items	(0.5)	1.3	-	-	-
Financing Cash Flow	**7.1**	**8.7**	**3.5**	**7.0**	**5.0**
FX adjustment	-	-	-	-	-
Net Inc/(Dec) in Cash	0.4	3.6	(7.3)	(0.2)	1.3

BALANCE SHEET (A$m)	2018A	2019A	2020E	2021E	2022E
Cash	4.5	8.0	0.8	0.6	1.9
Receivables	3.1	2.3	3.6	4.3	6.4
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**	**6.1**	**6.2**	**9.1**
Short term debt	-	-	-	-	-
Payables	1.6	1.8	2.7	3.4	4.7
Other current liabilities	4.7	6.8	6.9	7.5	8.3
Other non-current liabilities	-	-	-	-	-
Total Liabilities	**6.4**	**8.7**	**9.7**	**10.9**	**13.2**
Total Equity	**1.9**	**3.2**	**(3.7)**	**(4.7)**	**(4.1)**
Net debt (cash)	(4.5)	(8.0)	(0.8)	(0.6)	(1.9)

DIVISIONS	2018A	2019A	2020E	2021E	2022E

KEY METRICS (%)	2018A	2019A	2020E	2021E	2022E
Revenue growth	62.6	66.1	(2.9)	26.2	45.3
EBITDA margin	-	-	-	-	-
OCF /EBITDA	84.0	88.4	102.6	94.7	89.5
EBIT margin	-	-	-	-	-
Return on assets	-	-	-	-	-
Return on equity	-	-	281.2	170.5	107.0

VALUATION RATIOS (x)	2018A	2019A	2020E	2021E	2022E
Reported P/E	-	-	-	-	-
Price To Free Cash Flow	-	-	-	-	-
Price To NTA	8.0	5.9	-	-	-
EV / EBIT	-	-	-	-	-

LEVERAGE	2018A	2019A	2020E	2021E	2022E
ND / (ND + Equity) (%)	177.5	164.8	17.1	10.9	31.4
Net Debt / EBITDA (%)	45.0	103.2	7.5	7.5	46.6
EBIT Interest Cover (x)	85.0	43.0	98.8	230.8	90.6
EBITDA Interest Cover (x)	84.3	42.5	92.7	212.5	77.8

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 ($m)	(5.2)
Terminal value ($m)	54.2
Franking credit value ($m)	-
Enterprise Value ($m)	54.7
Less net debt / add net cash & investments ($m)	(5.7)
Equity NPV ($m)	**49.0**
Equity NPV Per Share ($)	**0.18**
Target Price Method	Rolled fwd DCF
Target Price ($)	0.21
Valuation disc. / (prem.) to share price (%)	90.9

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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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