PITT STREET RESEARCH

Credit Intelligence Limited

Credit Intelligence enters Australia

On 1 June 2020, leading debt-restructuring provider Credit Intelligence (ASX: CI1) entered Australia by way of an acquisition of the private Sydney-based debt negotiation business Chapter Two Holdings Pty Ltd (CTH). The acquisition will enable CI1 to service the large and growing debt solutions segment of the broader Australian credit market. Given the Australian economy has just entered a recessionary phase, we see the timing of the acquisition as excellent as the counter-cyclical business model of CTH will allow the merged group to capitalise on the current state of the economy.

CTH may benefit from COVID-19 driven recession

After the release of the 2020 March quarter economic data revealing an economic contraction of 0.3%, the Federal Treasurer has confirmed that Australia is now in recession. Although the economy has started showing some signs of recovery as the country continues to unwind its lockdown restrictions, we think it will take some time before the economy can reach its pre-COVID-19 levels of activity. In fact, given the current dire macro conditions, our view is that many Australian individuals and businesses may enter into economic hardship once government support end in September 2020. If our theory proves right, CTH should be a significant beneficiary in the aftermath of COVID-19.

Valuation upgraded to A$0.07 – 0.10 per share

We upgrade our valuation for CI1 to A$0.07 – 0.10 per share (previously: A$0.06 – 0.08 per share) based on a blended methodology equally weighted between DCF and EV/Sales. Our changes are mainly made to capture the added earnings and assumed synergies from the CTH acquisition.

Year to June (A$)	2018A	2019A	2020F	2021F	2022F
Sales (M)	4.9	6.2	13.5	20.4	23.2
YoY growth	28.8%	27.3%	116.6%	51.3%	13.5%
EBITDA (M)	2.4	1.3	3.8	8.4	9.6
Net Profit (M)	2.0	0.9	2.6	6.0	6.9
EBITDA Margin (%)	48.8%	21.6%	27.8%	41.0%	41.3%
ROA (%)	40.6%	7.0%	6.9%	11.5%	11.8%
EPS	-0.03c	0.06c	0.26c	0.39c	0.45c
EV/Sales	1.5x	1.4x	2.0x	1.0x	0.7x
EV/EBITDA	34.0x	9.0x	7.0x	2.6x	1.7x
P/E	6.0x	13.9x	15.6x	7.7x	6.6x

Source: Company, Pitt Street Research

Share Price: A$0.03

Valuation range: A$0.07 – 0.10

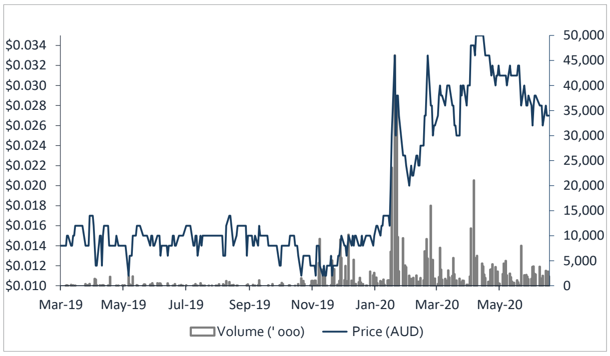
ASX: CI1

Sector: Commercial & Professional Services

22 June 2020

Market Cap. (A$ m)	34.2
# shares outstanding (m)	1,141.1
# share fully diluted	1,141.1
Market Cap Ful. Dil. (A$ m)	34.2
Free Float	23.0%
12 months high/low	0.04 / 0.01
Avg. 12M daily volume ('1000)	2,615
Website	www.ci1.com.au

Share price (A$) and avg. daily volume (k, r.h.s.)



Source: Thomson Eikon, Pitt Street Research

Valuation metrics	
DCF (A$)	0.11 – 0.15
Relative Valuation (P/E) (A$)	0.03 – 0.04
Equal weighted average (A$) per share	0.07 – 0.10

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A pandemic induced recession

Australia in recession

On 3 June 2020, Australia has been confirmed by Treasurer Josh Frydenberg as a country in recession after official data showed the economy contracted 0.3% in the March quarter of 2020 due to the bushfires and COVID-19.

Australian economy contracted 0.3% for the March quarter of 2020

Although a recession is technically defined as two consecutive quarters of economic contraction, the Treasurer's view implies that expected economic data for the June quarter of 2020 will likely show a year-on-year contraction as well since the acceleration of slowdown in economic activity happened during April and May.

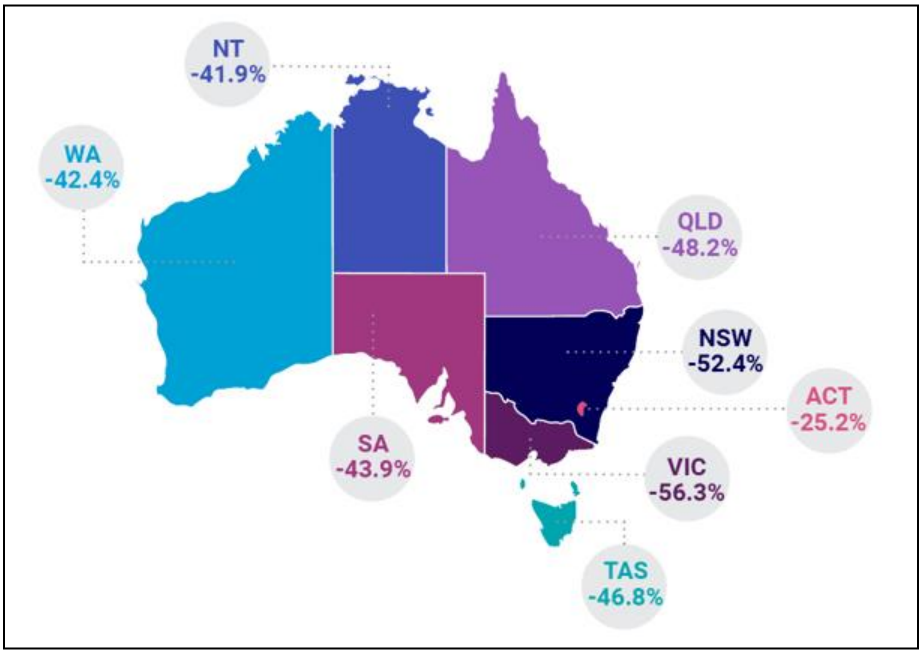
As the country unwinds restrictions post flattening of the COVID-19 curve, the economy has begun to show signs of a recovery. Many market participants tend to believe that the economic impact caused by COVID-19 is temporary and corporate activity, revenues and earnings will recover easily and quickly. This is evident in the recent performance of the Australian stock market, in which the ASX300 is currently trading on a 1-year forward PE of 18x even though its 1-year forward earnings is forecasted to decline approximately 27% from June 2019. Clearly, the market has written off FY20 and expects that recovery in corporate revenues and earnings will be strong in FY21 and beyond. Whilst the market is anticipating a V-shaped recovery, there is a chance that the recovery will be slow-paced.

Employment prospects remain bleak post COVID-19

A significant slowdown in business hiring post COVID-19

Figure 1 shows a material month-on-month decline in the number of job ads posted by employers across the Australian states and territories for April 2020. Implicit in these figures is the loss of business confidence in investment and hiring during COVID-19. Whether this loss of confidence is temporary or permanent is arguable. But what is clear is that job ads are a leading indicator of future employment. A significant reduction in job ads posted by employers implies weak employment prospects as fewer businesses are looking to hire.

Figure 1: MoM decline in job ads posted by Australian employers for April 2020



Source: SEEK Employment Index

2.1 million Australians were unemployed on 5 June 2020

Based on estimates provided by research house Roy Morgan, there are approximately 2.1 million Australians unemployed as at 5 June 2020, representing approximately 8% of the Australian population. This means that if and when government support programs, including JobKeeper payments cease in September 2020, up to 3% of the unemployed people (i.e. 765,000 Australians) will need to be rehired in order for unemployment rate to revert back to the pre-COVID-19 level of around 5%. If this unemployment gap can be closed by September 2020, the economy could re-gain its pre-COVID-19 household consumption level. We think this may be difficult to accomplish given Australia's largest employment sectors, namely hospitality, retail and construction, have been severely impacted by the COVID-19 crisis. For instance, in the retail sector, many consumer services businesses, like Kikki K, Bardot, Flight Centre and EB Games, have closed a number of stores. Some have collapsed altogether. The re-opening of the economy post COVID-19 will not likely see a fast resurrection of lost jobs, in our view.

COVID-19 recession elevates household mortgage stress

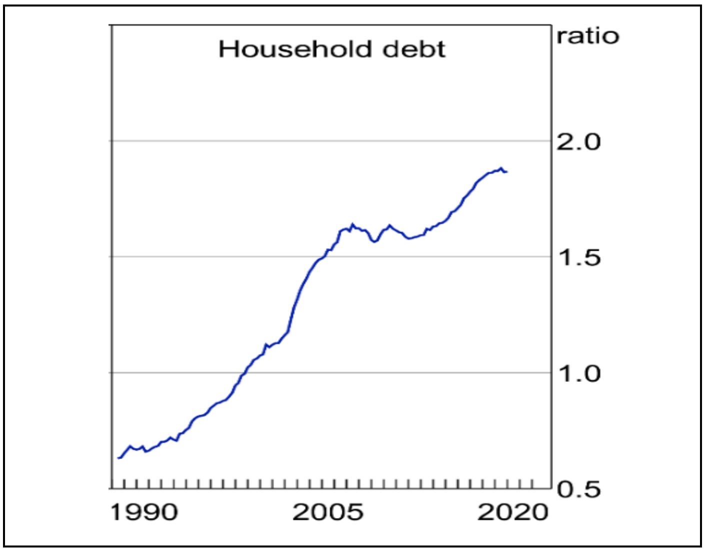
Australia has one of the highest private household debt levels in the world. Its household debt is almost double its household disposal income level (Figure 2), of which mortgage liabilities is the largest constituent.

As of 16 May 2020, the Australian Banking Association has revealed that 1-in-14 mortgages have been granted a bank repayment holiday due to the financial hardship caused by the COVID-19 pandemic.

Cessation of government support, such as JobKeeper wage subsidy and mortgage payment holidays, might elevate household mortgage stress

Moreover, Digital Finance Analytics showed that per the end of May 2020, the number of Australian households in mortgage stress sits at approximately 1.4 million.[1] The COVID-19 induced shutdown has made many cashflow stressed households dependent on government's JobKeeper wage subsidy.

Figure 2: Ratio of Australian household debt to disposal income



Source: RBA

However, once the JobKeeper subsidy ceases in September 2020 and the six-month mortgage repayment holidays expire, economists predict at least 100,000 mortgage stressed households could default on their loans. In our view, this scenario could be worsened if by September 2020 business confidence remains subdued and the job market remains tight. The resultant

[1] Digital Finance Analytics defines mortgage stress in terms of a household's actual cashflow — incomings and outgoings.

rise in unemployment could in turn drive a material uplift in mortgage arrears and defaults amongst the Australian households.

The pandemic tailwind for the debt management sector

Debt creates fragility and the effect is magnified in an environment where the macro conditions are poor

When the overall economy is healthy and growing, debt may be less of a concern to households and businesses. When the economy takes a hit and contracts, however, the piled-up debt would create fragility and exert a lot of pressure on households and corporates.

In the current times, when the global economy is severely battered by the COVID-19 pandemic and when unemployment is high, the accumulated debt levels in Australia could continue to see many more individuals experiencing economic hardship as they struggle to keep up with their financial obligations. As discussed above, we think this situation will become more amplified when the JobKeeper subsidy ends in September 2020 and when mortgage repayment deferrals are over.

Moreover, we believe the COVID-19 pandemic has caused a structural shift in consumers' behaviours, such as the accelerating trend of online shopping and remote working. If these changes become permanent in the post COVID-19 world, many job roles related to brick-and-mortar retailers, as an example, may become obsolete, which means a portion of the unemployed people will have to learn new skills and re-invent themselves in order to secure jobs that are more relevant in the post-COVID-19 economy. For this adaptation to happen, we think the broader economy will take some time.

A combination of rising household debt and high unemployment would see more individuals entering financial hardship

Accordingly, we believe the number of Australian households experiencing financial hardship will rise and remain elevated in the short to medium term. We believe this should bode well for the Australian debt management sector, including listed players such as FSA Limited (ASX: FSA), Collection House (ASX: CLH), Pioneer Credit (ASX: PNC) and Credit Corp Group (ASX: CCP).

CI1 enters Australia via acquisition of Chapter Two

On 1 June 2020, CI1 announced an acquisition expanding its debt solutions offering in Australia by buying a 60% interest in Chapter Two Holdings Pty Ltd (CTH).

CTH is a private Sydney-based debt negotiation business established in 2015 and provides informal debt negotiation and mortgage services to individuals who experience economic hardship.

CI1 will pay $400K in cash on completion, with an attached condition that CI1 will issue $320K worth of shares over three years contingent on CTH achieving a profit guarantee of $300K per year. Completion is expected to occur in July 2020 subject to due diligence and regulatory approvals.

The Chapter Two acquisition brings significant synergies

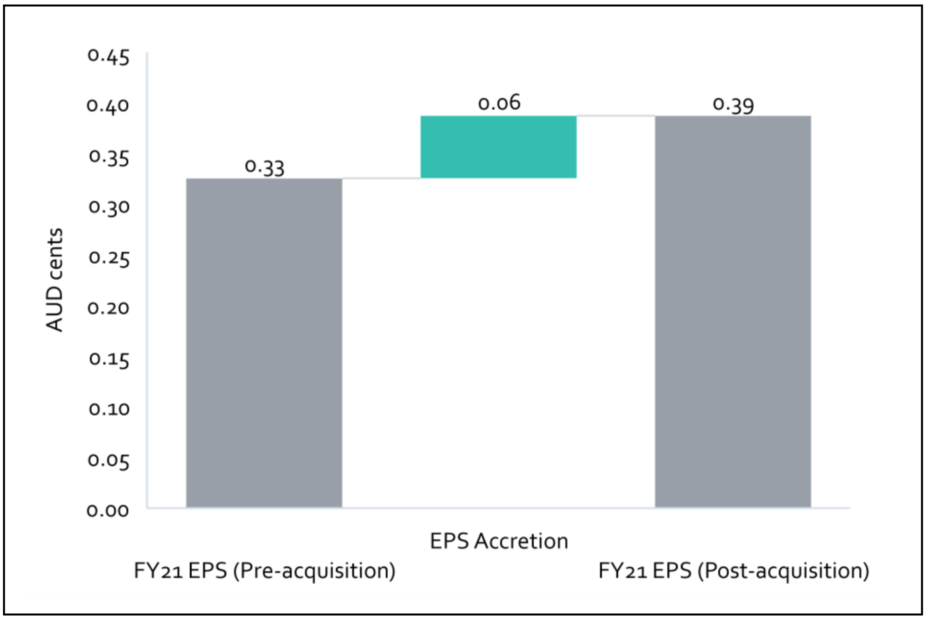
CI1 today provides debt restructuring and personal insolvency management services to individuals and corporates operating in the Asia Pacific region. The CTH acquisition will enable CI1 to service the large and growing debt solutions segment of the broader credit market in Australia. We believe the acquisition of CTH will deliver strategic advantages for CI1, including:

- Providing CI1 with immediate scale in the Australian market.
- Enabling CI1 to leverage its capital and fintech capability to expand the CTH business in Australia.
- Providing cross-selling opportunities such as CI1's debt restructuring / debt arrangement services to CTH clients.

- Capitalising on the current Australian macro conditions hampered by COVID-19

Figure 3 compares our FY21 EPS forecasts before and after the CTH acquisition. Due to the resulting revenue and cost synergies, we estimate the acquisition to be EPS accretive by approximately 19% on our FY21 forecast.

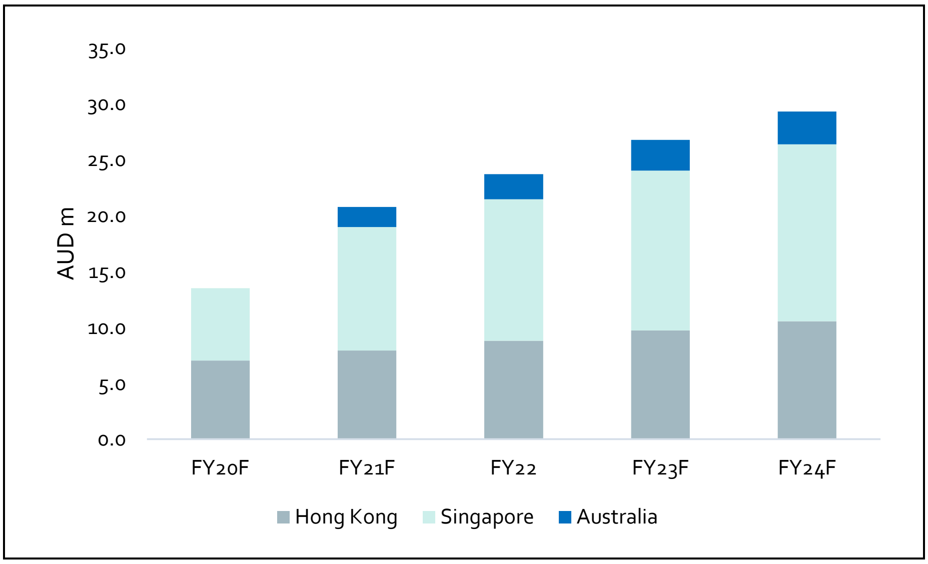
Figure 3: FY21 EPS comparison pre and post CTH acquisition



Source: Pitt Street Research

Figure 4 breaks up our operating revenue forecasts by geography, factoring in CI1's most recent Australian acquisition. The Australia segment, which we view as pivotal for CI1, should grow strongly on the back of the weak business trading conditions due to COVID-19.

Figure 4: CI1's revenue forecasts by geography



Source: Pitt Street Research

With cash sitting at approximately $2.7M post the CTH acquisition and new equity as a funding option, we see substantial upside to CI1's group revenues and earnings from continuing investment in further accretive acquisitions in the Asia Pacific region.

Forecast changes

We have made the following changes to our forecasts (Figure 5):

- On incorporating the CTH acquisition into our model, we assume that the completion of the acquisition will occur on 1 July 2020 as advised by CI1. Hence, we incorporate CTH into our revenue modelling for FY21 assuming a full year of contribution. Absent publicly available data as CTH is a private company, we gauge our earnings forecast for FY21 based on management expectations of $300K, however we apply an earnings risk factor of 20% in order to account for any potential M&A integration risk as well as a risk that the acquired business does not perform to management expectations. We then back-solve for revenue for FY21 by dividing our expected net profit of $240K over an assumed net margin of 19.5%.

  Our net margin is based off industry comparables (FSA Limited (ASX: FSA), Collection House (ASX: CLH), Credit Corp Group (ASX: CCP)), with a 10% discount to account for lower economies of scale. Accordingly, we estimate CTH to contribute about $1.2M in revenue for FY21. Rolling forward, we expect CTH to grow its revenues at a CAGR of 6%, reaching up to $1.5M by FY24. As CI1 will own a 60% interest in CTH, we account for a minority interest of 40%.
- In addition to the expected revenues from CTH, we also expect revenue synergies such as cross-selling opportunities to accrue to the merged group. We derive this revenue enhancement by considering the revenue structure of CI1's debt restructuring service and the expected customer base of CTH. On our forecasts, CI1 should be able to cross-sell $235K worth of debt solutions service to CTH clients for FY21.
- We also increase our bankruptcy case growth for the Australia segment from 5% to 20% for FY21 to factor in the potential surge in the number of Australian households and businesses experiencing economic hardship due to the weak and still recovering macro conditions. As government support measures, including the JobKeeper wage subsidy, are expected to end in September 2020, coupled with cessation of mortgage repayment holidays, we expect the growth rate of bankruptcy cases to peak around mid-FY21. Accordingly, we believe there will be an uptick in demand for CTH's services near-term, which in turn should translate to higher revenues and earnings for the merged CI1 group.

Figure 5: Changes to forecast

CI1: Forecast changes		FY20			FY21	
Years ended Jun (A$m)	Old	New	Change	Old	New	Change
Group Revenue	13.8	13.5	-1.7%	19.5	20.4	4.9%
Hong Kong	7.0	7.0	0.0%	7.9	7.9	0.0%
Singapore	6.5	6.5	0.0%	11.1	11.1	0.0%
Australia	0.2	0.0	-100.0%	0.5	1.5	187.7%
Group Revenue Growth	120.4%	116.6%	-3.8%	41.7%	51.3%	9.6%
EBITDA	3.6	3.8	5.6%	7.7	8.4	9.4%
NPAT	2.3	2.6	10.6%	5.3	6.0	14.2%

Source: Pitt Street Research, Company Reports

Valuation upgraded to A$0.07 – A$0.10

Based on our forecast revisions, our DCF returned a base case valuation of 10.9 cents (previous: 9.4 cents) and an optimistic case valuation of 15.1 cents (previous: 13.1 cents), predominantly reflecting the added earnings and synergies from the CTH acquisition.

On a relative valuation, our base case and optimistic case FY21 P/E multiples remain largely intact at 9.3x and 11.2x, respectively.

Overall, our blended valuation range has increased to A$0.07 – 0.10 per share (previous: A$0.06 – 0.08 per share).

Please refer to www.pittstreetresearch.com for our initiating coverage on CI1, including an elaborate valuation and discussion of risk factors for CI1.

Analyst certification

Marc Kennis, lead analyst on this report, has been covering the semiconductor sector as an analyst since 1997.

- Marc obtained an MSc. in Economics from Tilburg University, Netherlands, in 1996, and a post graduate degree in investment analysis in 2001.
- Since 1996, he has worked for a variety of brokers and banks in the Netherlands, including ING and Rabobank, where his main focus was on the technology sector, including the semiconductor sector.
- After moving to Sydney in 2014, he worked for several Sydney-based brokers before setting up TMT Analytics Pty Ltd, an issuer-sponsored equities research firm.
- In July 2016, with Stuart Roberts, Marc co-founded Pitt Street Research Pty Ltd, which provides issuer-sponsored research on ASX-listed companies across the entire market, including technology companies.

Cheng Ge is an equities research analyst at Pitt Street Research.

- Cheng obtained a B.Com in Finance and LL.B from University of New South Wales, in 2013, and has passed all three levels of the CFA Program.
- Prior to joining Pitt Street Research, he has worked for several financial services firms in Sydney, where his focus was on financial advice.
- He joined Pitt Street Research in January 2020.

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