Smart Company Analysis

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Net1UEPS Technologies Inc

Acquisitions create growth platform but Sassa contract issue increases risk

Equity Research

Hold

12-month target price	R175.36
Spot share price	R171.00
12-month implied total return	2.8%

Net1 share price

Source: I-Net BFA

Key statistics

Market cap: R9.0bn

Net debt-to-equity: net cash

Price:earnings ratio: 7.4

Forward PE ratio: 7.3

Dividend yield: none

Forward dividend yield: none

Risk: high

12-month high: R176.00

12-month low: R118.00

Ave monthly volume: 249,460

Financial year-end: 30 June

Latest event

Interim results to end-December

Date announced: 26 August

Share details

Company: Net1UEPS Technologies Inc

JSE Code: NT1

Sector: support services

Background

Net1 is a provider of alternative payment systems that leverage its Universal Electronic Payment System (UEPS) to facilitate biometrically secure, real-time electronic transaction processing to unbanked and under-banked populations in an online or offline environment. In addition to payments, UEPS can be used for banking, healthcare management, payroll, remittances, voting and identification. It provides payment solution platforms mainly in SA and South Korea. It also offers financial services and hardware and software sales. Net1 has its primary listing on the Nasdaq index in the US and therefore reports in US dollars. Its secondary listing on the JSE – it generates more than 70% of its business in SA – requires it to report headline earnings per share and it makes an effort to provide rand supplementary information.

Net1 generates its revenues from transaction fees to government agencies, merchants, financial service providers, utility providers, bill issuers, employers and healthcare providers. It also provides loans and insurance products and sells hardware, licensing software and related technology services.

During FY16 it launched a new product, the EasyPay Everywhere bank account (EPE). This is a sort of transactional bank account that gives clients access to other financial services such as microloans, life insurance and remittances as well as value-added services such as prepaid utilities and bill payments through mobile phones and a national network of ATMs and point-of-sale devices.

Our Thoughts

Net1 has been entangled in a legal wrangle since 2012 when it was awarded the SA Social Security Agency (Sassa) contract to distribute social grants to millions of welfare recipients including pensioners, to run until March 2017. Although the Constitutional Court set aside the contract in 2013, Net1 has continued to benefit from the contract *jus aequum* (it was for the greater good of the society to ensure continuity of monthly grant payments). In 2014, a new tender process – at the direction of the Constitutional Court – was cancelled after it was alleged that none of the bidders met the requirements, and this meant Net1 continued to benefit from the contract. There are indications that the contract may be extended for two more years because Sassa is not able to take over the payments when the contract lapses at the end of next month.

Given the legal form of the Sassa contract, and hence as a revenue stream for Net1, Intellidex has always been cautious when it comes to recommending the stock. Management's actions over the years, which suggest a lack of confidence in current operations, support our catious view. Although Net1's operations have been cash-generative, management has curtailed investment in current operations with capital expenditure consistently below the depreciation and amortisation charge. Instead, it has gone on an acquisition spree – investing in diversifying the business within and outside SA. We reckon it is not a bad move at all as it reduces concentration risk – in FY13 the Sassa contract contributed 42% to revenue and this has been reduced to 21%.

EPE, the major investment in current operations, is also clouded with uncertainty as it remains unclear to what extent it benefits from the Sassa contract database. The government is also reportedly looking to outlaw the direct deduction of payments from grant beneficiary accounts.

Sensitivity analysis				
	Terminal growth	1.0%	3.0%	5.0%
Wacc	13.0%	19 745	21 694	24 618
	14.0%	17 904	19 415	21 598
	15.0%	16 347	17 536	19 200
	17.0%	13 862	14 625	15 643
	18.0%	12 858	13 479	14 291

This reflects the sensitivity of our forecasts to assumptions of the terminal growth rate and the weighted average cost of capital. The highlighted cell shows our target price in cents.

Net1 reports in dollars but the bulk of its income is generated in rands and to a lesser extent South Korean won. The strengthening of the dollar against most emerging currencies in the past few years has limited the growth metrics of Net1. The rand has been strengthening since 2016 however and will boost translated earnings if it is sustained.

We are encouraged by the company's geographic and product expansion. Over time, this is likely to replace income from the Sassa contract and it has potential to grow significantly given the vast market opportunity presented by the unbanked developing world. We remain wary of the uncertainty presented by the Sassa contract however, and think the business has high operational and reputational risk. We have captured this by adding a risk premium when discounting its cash flows.

Its conservative earnings multiple shows that the counter is priced for its high risk, yet it has high growth prospects. Net1 would have been a buy but because of its elevated risk, which implies a high discount factor, we think it is one to hold.

Performance Review

RESULTS IN BRIEF	1H17	Change	1H16	FY16
Revenue($m)	307.1	0.8%	304.8	590.7
Operating profit ($m)	57.8	3.2%	56.0	114.4
Operating margin (%)	18.8%	2.4%	18.4%	19.4%
Attributable earnings ($m)	43.3	9.1%	39.7	82.5
HEPS (ZAR cents)	1136	0.3%	1133	2378

Results for the half-year to end-December were hit by a stronger dollar over the period. Other negative factors included regulatory changes in South Korea on card fees; lower prepaid sales due to improved security features on mobile products; and transaction costs related to various acquisition and investments. However, some positives came from growth in the lending and insurance businesses, the adoption of the EPE offering and the contribution from acquisitions.

Low valuation relative to growth prospects presents real upside potential – albeit with high risk

Although the company reports in dollars, it generates more than 70% of revenue in SA. In rand terms, revenue edged up 5% to R4.31bn while operating income rose 7% to R810m. Net1 has three reporting segments:

- The SA transaction processing division increased revenue 5.1% to $106.6m, primarily due to higher EPE transaction revenue. The operating margin rose to 25% from 24%.
- Its international transaction processing unit grew revenue 9.9% to $90.2m. This growth came from the inclusion of newly acquired businesses. However, it was partially offset by a lower contribution from South Korea due to the regulatory changes. Start-up costs saw the operating margin fall from 13% to 11%.
- The financial inclusion and applied technologies segment saw revenue fall 9.1% to $110.2m, primarily due to costs related to a new biometric linking feature for prepaid airtime and other value-added services. However, the operating margin improved to 24% (1H17: 23%) because low-margin prepaid sales were replaced by lending and insurance profits.

Bull Factors

- Potential for massive growth in the mobile and web-based applications space
- Low penetration levels in emerging markets provide scope for growth
- EPE business growing rapidly
- Low earnings multiple but underlying growth is impressive
- Strengthening rand boosts translated earnings

Bear Factors

- Sassa contract has to be terminated but it is unclear what will happen
- Court challenge by Sassa to stop company from processing debit orders on beneficiary bank accounts
- Customer concentration remains high
- Regulatory changes in South Korea has an adverse impact on its fee income
- Illiquid scrip

Extract of the DCF model	2016A	2017E	2018E	2019E
Operating profit ($'m)	114.4	120.1	133.3	154.6
Net opertaing profit after tax ($'m)	84.8	88.0	97.7	113.3
Working capital changes ($'m)	(10.2)	(34.7)	(17.8)	(25.9)
Capital expenditures ($'m)	(35.8)	(50.4)	(55.4)	(63.8)
Unlevered free cashflows ($'m)	76.8	42.5	67.9	73.6
Headline earnings per share ZAR cents)	2 308.9	2 356.1	2 615.3	3 033.7
PER (times)	7.4	7.3	6.5	5.6

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