INDUSTRIALS

THE SHORT CUT

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The introduction of the Goods and Services Tax and Business Activity Statements from July 2000 transformed the business module of MYOB and Reckon (ASX: RKN).

Both businesses had been focused on bookkeepers and accountants. Suddenly, small businesses, of which there are over one million in Australia, could transform their accounts from the shoebox to the computer and talk directly to their bookkeepers or accountants.

The software would arrive in a box to be installed on the user's desktop, and MYOB and RKN's recurring revenue climbed from "servicing the client" rather than simply selling the software.

Changes of ownership, particularly at MYOB, saw founder Craig Winkler throw his lot in with the New Zealand based Xero Limited (ASX: XRO).

Xero has launched a cloud-based accounting package that is specifically tailored to small business owners. The software provides daily bank feeds and a user-friendly interface that can be used by clients with limited financial acumen. Add-ons can be purchased at an additional cost to tailor the package to specific user needs.

Xero has been well received, and the company's customer base has just surpassed 200,000 users, up from 78,000 in March 2012. This has translated to strong revenue growth, which has ramped up from NZ$19 million in 2012 to NZ$39 million in 2013. The company is currently investing in a platform that will support over one million customers, and management believes that the addressable global market is 500 million small businesses.

Despite the incumbents' slow transition to the cloud, their market shares have been resilient. In 2012, MYOB and Reckon generated revenues of AU$218 million and AU$96.8 million respectively.

For Xero to achieve scale, management has been spending considerably on employees, advertising and infrastructure in recent years. This has resulted in multi-million dollar losses, and it is likely that these losses will not prevail for the short-term.

Even though Xero has strong growth, there are still many risks, and unlike MYOB and Reckon, it does not have a sizeable recurring revenue base to fall back on. Growth companies of this nature tend to trade at high multiples to reflect this potential, but the higher this premium, the lower the margin of safety that is provided to the investor.

So how much should a company like this be worth? To put things into perspective, Bain Capital acquired MYOB for AU$1.2 billion in 2011, and Reckon has a market cap of AU$272 million. Xero has a market cap of AU$2 billion, which is significantly greater than the value of the two companies combined — and a considerable premium for a company that has a fraction of the revenue and is yet to reach profitability.

While Xero may very well have the potential to eclipse these incumbents, there is one important thing to keep in mind — the opportunity cost of your capital. It may be years before Xero becomes highly profitable, and yet its shares are already pricing in considerable growth. At Montgomery Investment Management, we are attracted to companies with bright prospects, and while Xero satisfies this criterion, we will defer judgment until the company's earnings are well proven before making an investment.

Roger Montgomery is founder of Montgomery Investment Management

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