For What It's Worth

A Montgomery White Paper
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NextDC

NextDC stores plenty of potential

But after recent gains, is the data centre operator beyond value territory?

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Kind regards

Roger Montgomery

A bit of good news goes a long way in a sharemarket correction. As one mining-service stock after another downgrades earnings, Clough defies the trend with an earnings upgrade in June. And as retailers bemoan weak trading conditions, Nick Scali this month lifts its profit guidance.

Investors could be forgiven for underestimating both companies and overlooking their good news, having become conditioned to a daily diet of profit downgrades, falling share prices, talk of potential recession, gloomy overseas news, and even a change of Prime Minister to top it off.

Another small-cap stock swimming against the tide of negativity is data-centre operator NextDC (ASX: NXT). As many speculative stocks tumble, NextDC has soared from about $2 in May to $2.60 – during a market correction, no less – as investors re-rate its growth prospects.

NextDC announced in June it had signed a minimum five-year $60 million contract with a "leading corporation". A trophy client and a big contract further reduce the risk of higher-than-expected vacancy rates for NextDC data centres.

The Brisbane-based company's June investor update had other good news: sharply higher contracted utilisation rates for its data centres; a big lift in recurring contracted revenue; an acceleration in the storage capacity – the best sign of NextDC's confidence; and plenty of cash on hand.

Underlying the good short-term news is the long-term trend of consumers using more data as they download videos and use mobile devices; governments and companies outsourcing more data storage to third-party providers such as NextDC; and an undersupply of modern data centre facilities.

NextDC has characteristics that can attract small-cap fund managers: exposure to a powerful long-term trend; a valuable first-mover position; management with good credentials who have a record of building fast-growing ventures; and early evidence that the strategy is being well executed.

The danger, of course, is overlooking value. NextDC may not report its first normalised full-year net profit after tax (NPAT) – after removing abnormal and non-recurring expenses – until FY15. The consensus view of six analysts suggests an NPAT of $14 million in FY15, for a 7 per cent return on equity (ROE).

With a $443 million capitalisation, the market has a huge price tag on a company yet to post normalised profits and a meaningful ROE.

NextDC's valuation is 2.8 times higher than that of Macquarie Telecom Group, which has a forecast normalised NPAT of $12.7 million for FY13 and ROE of 13.3 per cent, based on consensus estimates.

Macquarie Telecom is not a pure data centre operator – about 29 per cent of its FY12 revenue was in managed hosting, with the rest in telecommunication services. And as a hosting services provider, it has a different business model to NextDC, a pure infrastructure provider.

But the comparison is still instructive. As NextDC soars, Macquarie Telecom, also building state-of-the-art data centres, has slumped from $9 in May to $7.85 after an earnings downgrade and some operational disappointment from revenue delays in key projects.

So do investors chase NextDC higher and pay a big price for rapid profit growth that is still a few years away, or focus on Macquarie Telecom, the market darling in 2009 and 2010, but which has lost some favour in recent years as it transitions to higher-margin hosting services?

There is no easy answer. There's a lot to like about NextDC's market position, strategy, execution and balance sheet. It has done everything it said it would – and more – since listing in late 2010 through a $40 million float at $1 a share.

Like all good entrepreneurial ventures, NextDC is racing to cement a first-mover advantage as an independent data-centre operator with state-of-the-art facilities. It has built and opened data centres in Brisbane, Canberra and Melbourne. Sydney and Perth facilities are due to open in 2013.

There is scope for an Adelaide facility, a second data centre in Sydney and Melbourne, and expansion to New Zealand in coming years. A Trans-Tasman footprint would be a strong selling proposition for multi-national customers that seek one contract with one data centre provider.

NextDC also enjoys a stronger barrier to entry than the market realises. Some misguided commentary has suggested data centres are simply big industrial buildings with stacks of computer storage, and easily replicable by new entrants. That overlooks the technology involved, and the difficulty of securing inner-city locations that access large amounts of energy, and water for cooling.

The other barrier to entry is relationships. It is no easy sales task getting multi-national companies to entrust vital data to a third-party provider, rather than store it in-house. NextDC's ability to snare trophy clients such as Australia Post, Optus and possibly a software giant, is a huge asset.

The attraction of such contracts is their length. Signing up a big company for a five-year data-centre deal gives NextDC visible, recurring revenue – a vital asset in this market. Its annual recurring contracted revenue leapt from $13.6 million in February 2013 to $26.7 million in May 2013.

NextDC's capital-management strategy also impresses. It sold its properties into a trust, Asia Pacific Data Centre Group (APDC), which raised $88.5 million in a float in late 2012. NextDC owns 23 per cent of APDC and founder Bevan Slattery put his own money into the Australian Real Estate Investment Trust (A-REIT) – a good sign.

Selling its property assets to a specialist (A-REIT), and leasing them back, has freed up NextDC's balance sheet and given it a significant war chest to invest. Better still, it has maximised its prospects of a high ROE because it is not lumbered with lower-earning property assets that can weigh on ROE. "Travelling light", in this instance, is a smart move.

NextDC had almost $70 million in cash at May 2013 and no bank debt (it has begun proceedings for medium-term bank financing). The ability to grow rapidly out of surplus cash rather than load up debt or issue more shares is an excellent trait.

Interestingly, after a solid post-listing start, Asia Pacific's unit price has fallen in recent weeks despite NextDC's recent gains. APDC is leveraged to NextDC's success, with data centre contract wins reducing tenancy risk. APDC's price fall is perplexing, although somewhat expected given its low profile.

Tenancy risk has been a concern. The market needs to know NextDC's big data-centre investment is paying off, with a rapid up-take of new facilities and a fast path to profitability. Centre utilisation, based on initial capacity, is up from 25 per cent in February 2013 to 72 per cent in May 2013.

The key risk, perhaps, is what happens when more data centres inevitably open and competition intensifies? Will state-of-the-art data storage become yet another commodity with rapidly falling prices as companies push for better deals? Will giant overseas companies increasingly enter this market?

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Code		Change	Outperfomance
MPF	The Montgomery [Private] Fund	35.05%	-
XNAJI	ASX 200 Industrials Accumulation Index	4.65%	30.40%
XTOAI	ASX 100 Accumulation Index	14.89%	20.16%
XJOAI	ASX 200 Accumulation Index	12.18%	22.87%
XAOAI	All Ordinaries Accumulation Index	9.00%	26.05%
XKOAI	ASX 300 Accumulation Index	10.74%	24.31%
XTLAI	ASX 20 Accumulation Index	18.40%	16.65%
XMDAI	ASX Midcap 50 Accumulation Index	-3.39%	38.44%
XSOAI	ASX Small Ordinaries Accumulation Index	-26.75%	61.80%

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Will NextDC's model of being a pure infrastructure provider backfire if big customers want to store data with their telecommunication service providers? Will they want a one-stop shop, or prefer to use different telco providers and an independent data-centre operator, such as NextDC?

And we keep coming back to that other critical issue: valuation. As a loss-making company (after non-recurring gains), NextDC cannot be valued using traditional methods that rely on ROE. Using consensus analyst forecasts, NextDC is trading on a nose-bleeding Price-Earnings multiple of 31 times forecast FY15 earnings, although the PE metric, which relies on market input as a price, is a flawed way of valuing stocks.

International comparisons are useful in such situations. US data-centre owner and operator Digital Reality Trust is capitalised on the New York Stock Exchange at US$7.7 billion and trades on a trailing PE of 41 times.

Equinix Inc., capitalised at US$9.6 billion on the Nasdaq, has a business model closer to NextDC, and trades on a PE of 64 times. Granted, both companies are much larger and more established; Digital Reality, for instance, has 75 technology-related properties. Equinix operates in 15 countries.

This simple comparison, at least, shows the type of valuation multiples investors are prepared to pay for leading data centre companies, and why NextDC might be an attractive acquisition for a big global player one day, at the right price.

Nevertheless, conservative value investors should arguably refrain from buying NextDC and even Macquarie Telecom at current prices. NextDC's valuation, "priced for perfection", is based on tremendous growth in the next few years. The market may have got ahead a touch ahead of itself.

With so many other stocks approaching value territory after recent share-price falls, it is hard to justify chasing a loss-making company sharply higher, even one as impressive as NextDC.

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