PITT STREET RESEARCH

99 Loyalty

99L Continues to Look Strong

Share Price: A$0.027

ASX: 99L

Sector: Technology

17 June 2022

99 Loyalty (ASX:99L) is a China-based and ASX-listed Platform as a Service (PaaS) provider offering customised Cloud-based solutions for loyalty management and customer engagement. We believe that 99L is well placed to benefit from strong revenue growth in the insurance brokerage services segment in the coming years. Although the company is witnessing pressure on its insurance brokerage segment in Q2 2022 due to stringent measures introduced by Chinese policymakers to control the spread of COVID-19 variants, downsizing of lockdown measures and government initiatives supporting production and consumption in June could result in a boost to the insurance related revenue from Q3 2022 onwards. A potential recovery in the currently subdued Loyalty and Marketing Services segment is also likely to support the strong growth outlook of the insurance brokerage segment.

Insurance brokerage segment seeing strong growth

The insurance brokerage division witnessed a strong performance in Q1 2022 owing to the company's solid expansion strategy and robust demand for virtual insurance goods. 99L added significantly high insurance institutions and agents and has demonstrated continued growth in its existing agents. Consumer awareness for risk protection and insurance products also increased due to lockdown measures stemming from COVID-19. This in turn promoted the usage of online platforms for the distribution of insurance products.

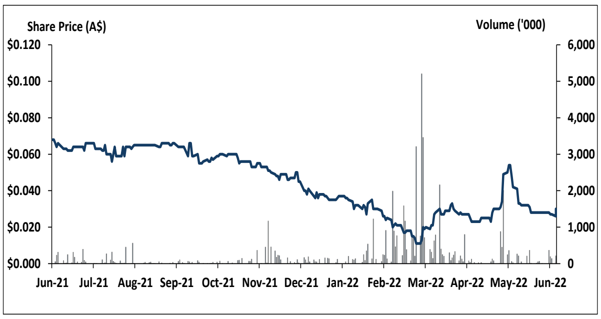
Valuation range remains A$0.10-0.22 per share

We reiterate our valuation at A$0.10 per share base case and A$0.22 per share optimistic case, using a composite of DCF and RV. Our assumptions are based on expansion of online insurance brokerage operations, and the company's contribution to the digitisation of China's economy. Execution and sudden change in regulations remain the biggest risks.

Market cap. (A$m)	34.8
# shares outstanding (m)	1,159.7
# shares fully diluted (m)	1,171.9
Market cap full. dil. (A$m)	35.2
Free float	40.4%
52-week high/low (A$)	0.068/0.009
Avg. 12M daily volume (m)	210.2
Website	www.99loyaltytech.com

Source: Company, Pitt Street Research

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



Valuation metrics	
DCF valuation range (A$)	0.12–0.22
Relative valuation range (A$)	0.08–0.21
Blended valuation range (A$)	0.10–0.22

Source: Pitt Street Research

Year to Dec (RMB)	2020A	2021A	2022F	2023F	2024F
Sales (m)	231.7	208.1	271.0	333.6	406.7
EBITDA (m)	74.0	(48.2)	31.7	56.0	86.1
Net Profit (m)	31.6	(74.2)	12.1	31.9	56.0
EBITDA Margin (%)	31.9%	NM	11.7%	16.8%	21.2%
ROA (%)	4.3%	NM	2.4%	6.1%	10.3%
Net Gearing (%)	74.0%	57.2%	53.1%	46.3%	38.1%
EPS	0.03	-0.06	0.01	0.03	0.05
DPS	NM	NM	NM	NM	NM
EV/Sales	0.4x	0.2x	0.1x	0.1x	0.1x
EV/EBITDA	1.4x	NM	1.1x	0.6x	0.4x
P/E	3.2x	NM	2.9x	1.1x	0.6x

Source: Company, Pitt Street Research

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A Glance at 99L's Recent results

In Q1 2022, 99L's revenue and gross profit declined by 5% on a year on year basis due to strict COVID-19 lockdown measures in Xi'an, Shenzhen, Shanghai and other key cities in China. The lockdowns negatively impacted the company's overall operating environment amid falling consumer spending and a decline in loyalty and marketing budgets by 99L's enterprise clients.

99L's strong expansion strategy, investments in capacity building and demand for virtual goods boosted insurance brokerage revenue during the quarter

However, the company demonstrated strong 30% growth in revenue from insurance brokerage. The robust revenue growth was mainly due to 99L's insurance expansion strategy, low penetration rates and the company's investment towards the expansion of its capabilities and partnership network in the insurance brokerage sector. Demand for virtual insurance goods also contributed to the robust insurance revenue growth. Increasing awareness for risk protection and insurance goods due to the COVID-19 induced lockdowns resulted in higher use of online platforms for the distribution of insurance products, in turn bolstering demand for virtual insurance goods provided by the company's Loyalty Technology segment.

The company continued to pursue a robust insurance expansion strategy through the addition of more insurance institutions on its insurance platform, an increase in number of new agents and growth in usage by existing agents. During Q1 2022, the company developed 43 new insurance institutions and agents. Looking at 99L's liquidity, the company's cash balance increased from A$6m (as of December 31, 2021) to A$7m (as of March 31, 2022) mainly due to improvements recorded in the process of collections for accounts receivables.

Insurance brokerage revenue to rebound after Q3 2022

The insurance brokerage segment is likely to exhibit a recovery, showing a return to strong revenue growth in Q3 2022, following the commencement of a scale back in COVID-19 lockdown measures and introduction of government measures to promote production and consumption in June 2022. These developments are likely to boost the company's potential for regrowth of its business (Figure 1). The company had previously shown a similar growth when the first lockdown was lifted in 2020. We note that during the period from April 1, 2022 and May 15, 2022, 99L developed 12 new insurance institutions and 4 new distributors. It has also signed 16 new contracts with insurance institutions and 4 new contracts with distributors.

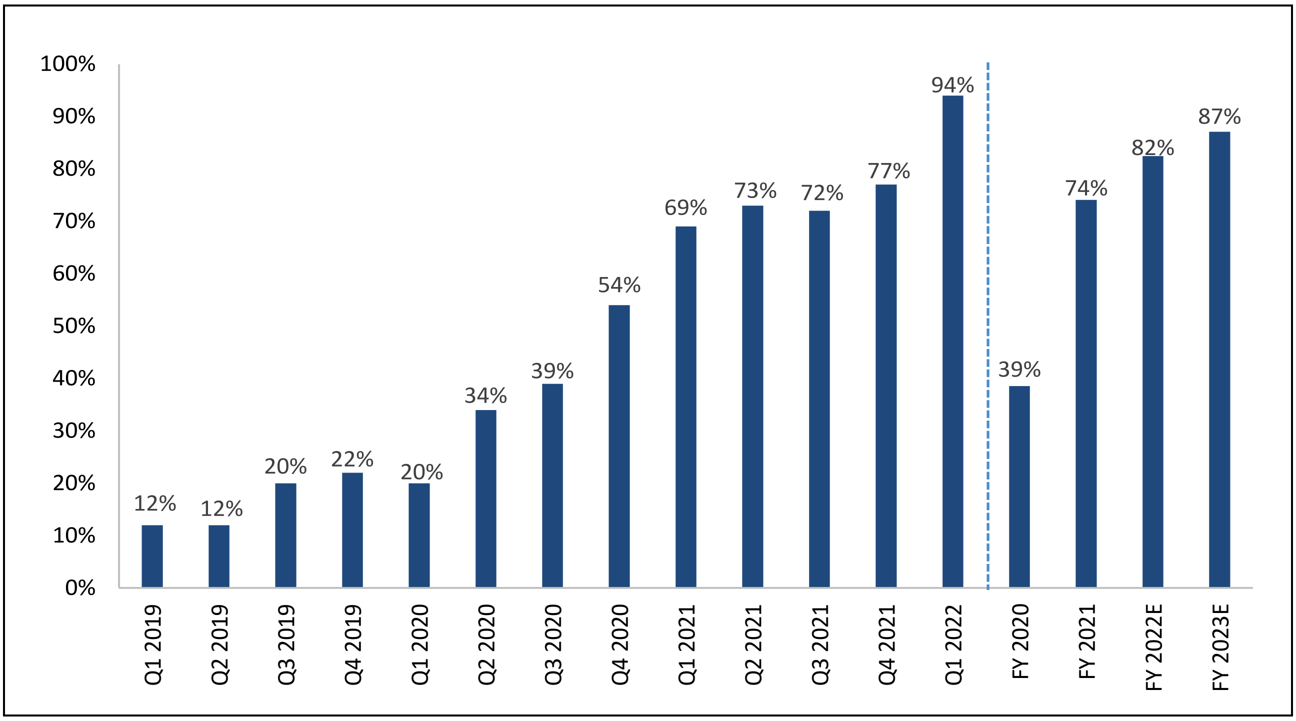
99L's Insurance Brokerage Services segment is in the early phases of long-term growth and is likely to underpin strong revenue growth in the coming years.

99L's Insurance Brokerage Services segment is in the early phases of long-term growth and is likely to underpin strong revenue growth in the coming years. The segment's revenue prospects remain strong due to robust growth outlook of its insurance products and healthy capital efficiency. The company's Loyalty and Marketing Services business could also witness a recovery in the event of an end to the COVID-19 pandemic and normalisation in external conditions. The segment has remained under pressure since 2019 due to the recent introduction of financial regulations, impact of the pandemic and general economic conditions. The potential recovery in the segment is further likely to enhance the strong growth prospects of the insurance brokerage division.

Robust growth expectations for China's online insurance sector

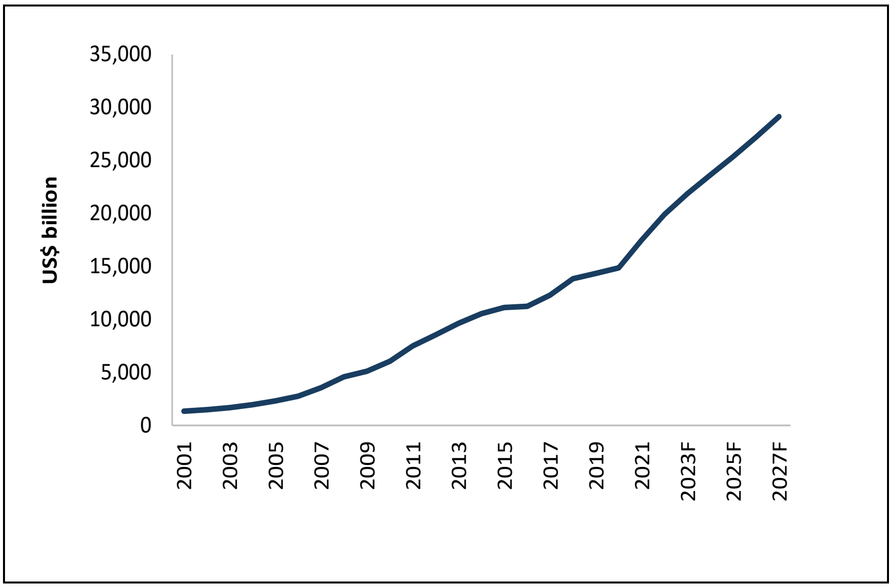
An upbeat tone has been cited for China's economic development in 2022 (Figure 2) in China's 14th Five Year Plan and the Central Economic Work Conference with dual targets for sustainable economic growth and economic stability. The Chinese government and related parties aim to achieve these objectives by encouraging the development of markets and enterprises using a wide range of policy tools.

Figure 1: Insurance brokerage services will form the bulk of group revenueFigure 1



Source: Company and Pitt Street Research

Figure 2: Robust outlook for China's GDP growth

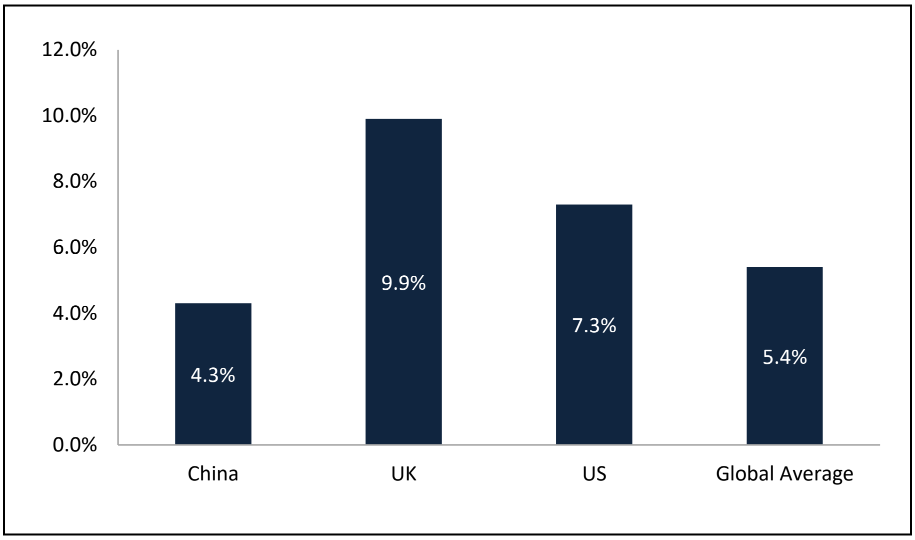


Source: Statista and Pit Street Research

99L to benefit from new favorable regulations and rising potential contribution to total premiums from online platforms in China

At the sectoral level, trends for growth in China's online insurance industry remain favourable. China is the most underpenetrated market compared to markets in advanced economies (Figure 3). The contribution of online platforms and sales channels to total premiums within China's broader insurance market is expected to increase in the recent future given increasing use of smartphones and expectations for interconnection with online financial services. Additionally, leading insurance service providers are being favoured by new financial regulations. China Banking and Insurance Regulatory Commission (CBIRC) have issued new regulations since 2021 in order to protect consumers and to ensure higher effectiveness in the sector's growth and development.

Figure 3: China's insurance penetration rate remains the lowest



Source: Company and Pit Street Research

99L well placed to reap benefits of digitalisation and regulation

99L is likely to be a beneficiary of the new regulatory environment amid expectations of rationalization in the industry structure.

99 Loyalty, being a licensed insurance brokerage services provider, is likely to be a beneficiary of the new regulatory environment amid expectations of rationalisation in the industry structure.

The company is expected to attract opportunities given its core competencies and is likely to contribute towards developing China's digital economy. The company's enterprise clients are likely to receive advantages from best-fit loyalty solutions and services coupled with technology, marketing and operations solutions offered by 99L. 99L is expected to capitalise on the success witnessed with the use of insurance products through diversification in its enterprise client base and further widening in the scope of virtual products.

99L announced two new executive appointments

On 31 May 2022, 99L appointed Mr. Scott Sheng and Mr Shujie Zhou as Executive Director and Leader of Technology respectively.

Mr. Scott Sheng, who was appointed as Chief Executive Officer in January 2022, succeeded Dr. Tao Wen as Executive Director from May 31, 2022. Dr. Tao Wen ceased his responsibilities as 99L's Executive Director and Chief Technology Officer on personal grounds. Mr. Sheng joined the management's team at the time of the company's establishment. 99L's business development has received a significant boost, attributable to Mr. Sheng's leadership of the company's sales and operations team.

Mr. Shujie Zhou, who is currently the Senior Research and Development (R&D) director, has been leading the technology team since May 2022. He has considerable experience in the setting up and management of the company's R&D team. Mr. Zhou has also been responsible for the development of 99L's technology and service platforms. He holds experience of over 10 years in R&D and has been instrumental in planning, designing and developing medium and large-scale Internet projects

Valuation: 99L is a "de-risked" story

We reiterate our valuation of A$0.10 per share in the base case and A$0.22 per share in the bull case.

Using a weighted average valuation methodology, which assigns equal weight to our relative valuation and our DCF calculation, we reiterate the valuation of A$0.10 per share in the base case and A$0.22 per share in the bull case. Considering 99L's strong insurance brokerage revenue growth owing to its robust insurance expansion strategy and strong demand for virtual goods, we have an optimistic stance towards 99L. The company's role in supporting the development of China's digital economy given its core competencies will further provide the necessary support to our rationale.

Our relative valuation took the average FY22 EV/Sales of 99L's peers. Our base and bull cases took the sector average multiple of 1.5x, but differed in the discount given to 99L compared to its peers – our base case gave a 60% discount while our bull case gave a 35% discount. Our DCF used free cash flow projections through to FY31 using a terminal growth rate of 2.0% and a 10.3% WAAC (reflecting a 19.5% cost of equity and a 4.2% post-tax cost of debt). Our ultimate valuation assigned 50% weight to both our DCF and relative valuations. For further details on our valuation, see our initiation report published on 14 March 2022.

Re-rating of 99L

99L's stock is currently trading below our base case valuation. We see three factors helping to re-rate the company into our valuation range:

– Acceleration of digital transformation in the financial services industry (banks, insurance), leading to further increase in spending on loyalty and engagement programs.
– Swift expansion of channel penetration, leading to an increase in online insurance brokerage operations.
– Increased pace for adaption of virtual goods and services in China

Risks

The main risks that we see while investing in 99L:

– **Execution risk:** The majority of the future growth for 99L is expected to come from online insurance brokerage operations and entry into new end-industries. Any interruption in channel development, lack of further advancement in the platform features and delay in offering the new service of aggregate digital payment will jeopardise the investor sentiments.
– **Regulatory risk:** Any further increase in the stringent regulations related to economic and financial policies issued by the Chinese government to prevent systematic risk may impact the revenue profile of the company.
– **Economic downturn in the focussed industry:** 99L is expected to continue generating a significant portion of revenue from the financial service industry. Considering that the threat of COVID-19 is still looming, any uptrend in pandemic casualties will directly hamper banks and insurance, i.e. NPAs and claims. The resulting downturn could hamper 99L's growth potential.
– **Geographical concentration:** Operations of the company are fully concentrated in China, which restricts the global growth opportunities.
– **Competition:** As the Chinese PaaS market expands, larger (regional and foreigner) service providers will also increase their presence in the financial service industry. 99L will have to counter the financial and technological power of competitors to retain enterprise clients.

Appendix I – Analysts' Qualifications

Stuart Roberts has been an equities analyst since 2002.

- Stuart obtained a Master of Applied Finance and Investment from the Securities Institute of Australia in 2002. Previously, from the Securities Institute of Australia, he obtained a Certificate of Financial Markets (1994) and a Graduate Diploma in Finance and Investment (1999).
- Stuart joined Southern Cross Equities as an equities analyst in April 2001. From February 2002 to July 2013, his research speciality at Southern Cross Equities and its acquirer, Bell Potter Securities, was Healthcare and Biotechnology. During this time, he covered a variety of established healthcare companies, such as CSL, Cochlear and Resmed, as well as numerous emerging companies. Stuart was a Healthcare and Biotechnology analyst at Baillieu Holst from October 2013 to January 2015.
- After 15 months over 2015–2016 doing Investor Relations for two ASX-listed cancer drug developers, Stuart founded NDF Research in May 2016 to provide issuer-sponsored equity research on ASX-listed Life Sciences companies.
- In July 2016, with Marc Kennis, Stuart co-founded Pitt Street Research Pty Ltd, which provides issuer-sponsored research on ASX-listed companies across the entire market, including Life Sciences companies.
- Since 2018, Stuart has led Pitt Street Research's Resources Sector franchise, spearheading research on both mining and energy companies.

Nick Sundich is an equities research analyst at Pitt Street Research.

- Nick obtained a Bachelor of Commerce/Bachelor of Arts from the University of Sydney in 2018. He has also completed the CFA Investment Foundations program.
- He joined Pitt Street Research in January 2022. Previously he worked for over three years as a financial journalist at Stockhead.
- While at university, he worked for a handful of corporate advisory firms.

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