PITT STREET RESEARCH

Hydrix Ltd.

Another strong quarter

Share Price: A$0.039

ASX: HYD

Sector: Life Sciences

26 April 2023

Hydrix (ASX:HYD) released its Appendix 4C for 3Q23 (the quarter ended 31 March 2023). Compared to the prior corresponding period, the company recorded a 40% increase in customer revenues to $3.5m, a 135% increase in the cash operating profit of Hydrix Services to $0.17m (from a $0.49m loss in the pcp) and a 54% improvement to net cash used in Group operating activities to $0.93m.

Hydrix Ventures companies delivering the goods

In our last report on Hydrix, published 29 March, we expressed the view that that investors have been disregarding other value-drivers of the company but for the Guardian device, particularly the Hydrix Ventures portfolio.

We think this time has turned as judging by the share price reaction from the news from Gyder Surgical Gyder's Hip Navigation System received TGA approval, just one day before the release of Hydrix's 4C. This achievement not only means that Gyder can commence commercial sales in Australia, but it triggers an equity-in-kind milestone payment, increasing Hydrix's investment by $0.33m to $1.76m.

Other portfolio companies of Hydrix Ventures have recorded achievements of their own increasing the Net Tangible Asset Value (NTA) of the portfolio year to date by $1.03m to $4.85m (an increase of 27%).

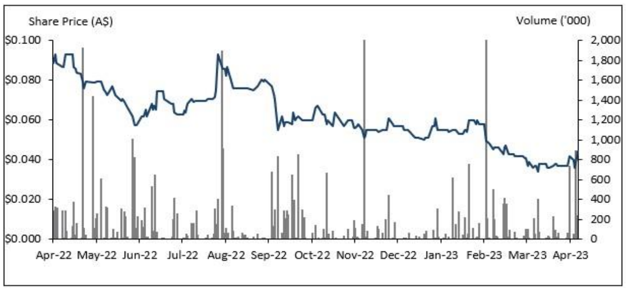
Valuation of $0.166-$0.224 per share reiterated

We last valued Hydrix at $0.166 per share base case and $0.224 per share bull case in our previous report dated 25 January and we reiterate our valuation. We are confident that the company can re-rate continued growth in the core Hydrix Services division, Hydrix Ventures companies achieving critical milestones and the Guardian device distributed by Hydrix Medical expanding into new territories and growing sales in existing jurisdictions.

Market Cap. (A$ m)	9.8
# Shares outstanding (m)	253.5
# Share fully diluted (m)	341.6
Market Cap Full. Dil. (A$m)	13.3
Free Float	85.0%
12-months high/low (A$)	0.093 / 0.034
Avg. daily volume ('1000)	185.6
Website	www.hydrix.com

Source: Company, Pitt Street Research

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



Source: Refinitiv Eikon, Pitt Street Research

Valuation metrics	
Fair valuation range (A$)	0.166-0.224
WACC	14.5%
Assumed terminal growth rate	2.0%

Estimates: Pitt Street Research

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Hydrix's 3Q23 Appendix 4C

For the benefit of new investors, we outline the company's three divisions. A core **Hydrix Services** business that provides outsourced design and engineering services to third-party product developer clients. **Hydrix Ventures,** an investment arm that has minority interest states in four early stage medtech companies – outlined later in this note. And a third division, **Hydrix Medical** that is business unit focused on the distribution of cardiovascular devices. Investors should view our initiation report published last November for a more comprehensive recap.

The company recorded a 40% improvement in revenues to $3.5m and a 135% improvement in the cash operating profit to $0.17m.

Turning to the 3Q23 4C, the company recorded a 40% improvement in revenues to $3.5m and a 135% improvement in the cash operating profit to $0.17m. The company's Core Services division is tracking a return to full-year profitability reflecting increases in billable utilisation and improved pricing structures during the past couple of years.

Hydrix has expanded its presence in the USA, hiring a second team member in January and advancing a new USA medtech client (remaining anonymous for now) to a second stage development contract in January. Amongst existing clients, work continued on products for Cyban which is also a Hydrix Ventures investee company.

To support growth in the Services business, the Company announced in April it entered into a $1.5m working capital facility, an efficient non-dilutive fit-for-purpose funding source.

Hydrix Ventures companies will keep hitting milestones

The day before the release of Hydrix's 4C, the company told shareholders that long-term client and venture investee company Gyder Surgical received TGA approval. Gyder Surgical has a non-invasive surgical navigation system to improve alignment in hip replacement surgeries. The Gyder system is able to non-invasively assist the surgeon to accurately position the acetabular cup, i.e., the socket where the replacement device needs to be implanted. The device is expected to markedly reduce the potential for revision surgery.

TGA approval means that Gyder can now sell commercially in Australia. The milestone triggered an equity-in-kind milestone payment, increasing the investment by $0.33m to $1.76m. This was on top of an $0.33m equity milestone payment paid just 2 months earlier after Hydrix completed the 1st generation product for Gyder.

Hydrix shares gained 16% on 19 April, the day this news came through. It is possible that shareholders were taking this news as consolation after Hydrix's decision to withdraw its application for TGA approval for the Guardian Device. But perhaps they are finally understanding that the existing and potential value in the Hydrix Ventures portfolio.

Other investee companies set to deliver the goods

Hydrix Ventures has minority investments in three other MedTech companies. One of these is AngelMed (the owner of the Guardian device which Hydrix Medical distributes). The other two are Memphasys and Cyban, and all 3 companies had achievements to boast of during 3Q23. Memphasys has a device that sorts sperm for the purposes of IVF while Cyban has developed next-generation brain oxygen monitoring device used in intensive care units and operating theatres where brain injuries are treated to prevent further damage.

In February, Cyban reported that one of its clinical trials demonstrated a major breakthrough in that its non-invasive brain monitor delivers equivalent results to invasive intracranial pressure (ICP) monitoring to offer a simple and safe alternative method to treat critical brain injuries. As for Memphasys, it announced its first commercial sale to the prestigious Kobe ART clinic in Japan and its first live birth using the Felix system. This news from Memphasys also bodes well for Hydrix Services business, given Memphasys is a client.

Figure 1 outlines our valuation of Hydrix Ventures companies, as per our initiation report.

Figure 1: Hydrix Ventures investee companies valuation

	HV investment stake post-dilution (%)	Company valuation (A$m)	HV share valuation (A$m)
Memphasys	1.00%	17.8	0.2
Cyban	3.70%	131.4	4.9
Gyder Surgical	7.50%	137.8	10.3
Angel Medical Systems	2.00%	681.5	13.6
TOTAL (A$m)			**29.0**
Diluted Shares ('000)			308.5
Per share price (A$)			**0.094**
Holding company discount (%)			-50%
Effective valuation per share (A$ cents)			**0.047**

Estimates: Pitt Street Research

There are further milestones to be achieved by all companies, all of which could re-rate Hydrix's stake in these companies. Gyder, having obtained TGA approval, is also applying for FDA approval in addition to the TGA and could potentially IPO in CY24. Cyban is targeting FDA approval too and will make its application in 2HY23. Angel Medical Systems completed an over-subscribed Series B round to accelerate its USA expansion. We expect Memphasys' product to make further commercial in roads, particularly in India and Australia. All of these products are targeting multi-billion-dollar market opportunities.

Hydrix Medical is set to make strides too

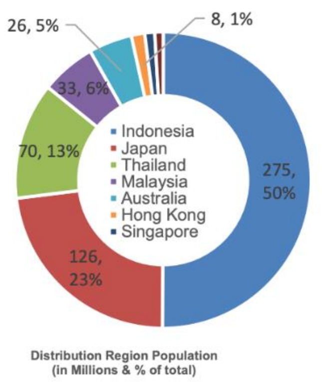
After being investors' favourite part of the business for several months, Hydrix Medical didn't escape this quarter unblemished.

It was a setback with the TGA, but not a fatal one

As outlined in our last report on Hydrix, the company opted to withdraw its application for TGA approval for the Guardian device having been advised the application was not going to be accepted. The re-action from investors implied that this was a setback big enough to impact on the revenue and earnings of the entire company. Indeed this is a setback for Australian patients and for commencing sales in Australia. But it does not impact on the company's current and near-term revenue or earnings prospects.

Australia's population represents just 5% of the eight countries in the Asia-Pacific where Hydrix has exclusive distribution rights (Figure 2). In Singapore and Malaysia, Hydrix already has access to a population of 41 million and that's before you consider countries where approval is still to come, namely Indonesia, Japan, Hong Kong and Thailand as well as New Zealand. All eight markets combined represent a population of 500m.

Figure 2: Hydrix's market opportunity



Country / Agency	Appl. Date	Status
USA / FDA	n/a	Approved
Singapore / HSA	16-Aug-21	Approved
Malaysia / MOH	27-Dec-21	Approved
Thailand / Thai FDA	12-Oct-21	In process
New Zealand / MMDSA	11-Aug-21	WAND notified
Hong Kong	-	In process
Japan	-	In process
Indonesia	-	In planning

Source: Company

Hydrix Medical's Achievements during the quarter

Despite the TGA setback, there were some achievements during the quarter. Hydrix engaged a Japanese Clinical Research Organisation to develop a regulatory and reimbursement pathway to market and distribute the Guardian in Japan and is in advanced commercial discussions to final stages with a prospective sub-distributor to commence sales into Malaysia.

Although Hydrix Medical only distributes the Guardian device for now, this could change in the near future. The company is engaged in ongoing discussions with several emerging cardiovascular technology companies to distribute their products in Australia and South-east Asia. Products being evaluated include medical software-as-a-service and other highly specialised products used to monitor and diagnose cardiovascular diseases.

Reiterated valuation of $0.166-$0.225 per share

We reiterate our valuation of Hydrix at $0.166 per share base case and $0.225 per share bull case.

We reiterate our valuation of Hydrix at A$0.166 per share base case and A$0.225 per share bull case. Investors interested in a more detailed outline our model should view our initiation report from last November and our update note from last January – available here.

To briefly re-cap, we used a blended DCF and peer group valuation for the Hydrix Services and Hydrix Medical businesses and Hydrix Ventures at $0.047 per share, using a SOTP valuation, taking into account all four companies in the portfolio. We used a 14.5% WAAC reflecting a 16.5% cost of equity and a 7.5% post-tax cost of debt (10% pre-debt).

There were three differences between our base and bull cases: First, slightly stronger growth in the Hydrix Services Division; Second, higher Guardian sales in the Hydrix Medical Division; and Third, a halved discount attributed to the company to account for the premium companies on overseas exchanges trade at relative to ASX companies.

In January, we updated our DCF valuation in January on account of its strong 1HY23 results, thereby increasing our valuation to $0.166 per share base case and $0.225 per share bull case. We increased our FY23 results and while retaining the same growth rates for future years, this improved the company's results from FY24 onwards as they were based on year-to-year growth. We reiterate our valuation (Figures 3, 4 and 5).

Figure 3: Weighted average valuation for Hydrix (base)

Valuation	Weighting (%)	Share price (A$)
DCF	50.0%	0.087
Relative valuation	50.0%	0.151
Business Value		**0.119**
Hydrix Ventures		0.047
Composite Value		**0.166**
Current Price		0.039
Upside/Downside (%)		325.6%

Estimates: Pitt Street Research

Figure 4: Weighted average valuation for Hydrix (bull)

Valuation	Weighting (%)	Share price (A$)
DCF	50.0%	0.155
Relative valuation	50.0%	0.201
Business Value		**0.178**
Hydrix Ventures		0.047
Composite Value		**0.224**
Current Price		0.039
Upside/Downside (%)		474.4%

Estimates: Pitt Street Research

Figure 5: DCF value in A$ cents using various WACCs (base case)

Sensitivity						
WACC	**14.5%**					
Terminal Growth	**2.00%**					
Implied Price	**0.087**	*10.5%*	*12.5%*	*14.5%*	*16.5%*	*18.5%*
Change in Terminal Growth Rate	*0.50%*	13.7	10.3	8.0	6.2	4.9
	1.00%	14.3	10.7	8.2	6.4	5.1
	1.50%	15.1	11.1	8.5	6.6	5.2
	2.00%	15.7	11.5	**8.7**	6.8	5.3
	2.50%	16.6	12.0	9.1	7.0	5.4
	3.00%	17.6	12.6	9.4	7.2	5.6
	3.50%	18.7	13.2	9.8	7.4	5.8

Factors supporting a re-rating of Hydrix

The Hydrix stock is currently trading below our valuation. We see four factors supporting a re-rating:

– Strong progression across venture companies as they reach key commercial inflection stages. We see FDA approval for Gyder as one milestone with significant potential to cause a re-rating as evidenced by investor reaction to Gyder's TGA approval.
– Increase in traction for the Hydrix Services business;
– Regulatory approval and a rolling out of the Guardian device in other target markets, particularly Thailand;

Risks

We see the following key risks associated with Hydrix:

– **Regulatory risk:** Hydrix requires approval from respective regulators across countries to be able to market and distribute Guardian cardiovascular devices. There exists a risk of either being denied the approval or unexpected delay in receiving. Either of those cases may impact the revenue growth prospects, particularly if it were important markets for the company from a revenue perspective. The investor reaction to the TGA outcome, even though Australia was one of the smaller targets for the company, depicts that investors are playing close attention to this risk.
– **Execution risk**: There exists a risk that the Guardian device may not attract the kind of reimbursement it is looking for. This could be due to increased competition from companies offering alternative solutions. This will necessitate higher capex into research, sales and marketing. Consequently, this may impact the expected profitability trajectory for Hydrix.
– **Capital risk**: Considering that a lot of companies in the medtech space are chasing private capital, there exists a risk of higher cost of capital for Hydrix. With inflationary pressure continuing across globe, higher cost of capital will reduce the fundamental return for Hydrix's investors.
– **Market risk**: There is the risk that the investee companies in Hydrix Ventures suffer a delay in reaching their commercial inflection stage (difficulty in raising enough capital, delay in product trials, regulatory hurdle etc.). This would impact the valuation proposition for Hydrix.
– **Macroeconomic risk**: A downturn in macroeconomic conditions could cause existing and would-be Hydrix Services clients to cut back expenditure on R&D projects. This will cause a decrease in Hydrix's revenue and thus impact our expected trajectory for the company.

Appendix I – Analyst certification

Stuart Roberts, lead analyst on this report, 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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