We Turn Bullish on WiseTech After Reassessing Our Thesis
Fiscal 2021 result and outlook vindicate management's strategy.

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Contents

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Executive Summary

Narrow-moat-rated WiseTech Global has many attractive attributes including its switching cost-based economic moat, large global addressable market, relatively low ESG risk, strong balance sheet, an innovative culture, and a large recurring revenue base. However, we've held concerns about several aspects of the company, such as its global acquisition strategy, relatively high capitalisation of research and development costs, relatively poor disclosure, and slowing revenue growth. These concerns meant we adopted a relatively cautious approach to WiseTech's earnings outlook and fair value estimate.

WiseTech's fiscal 2021 result, fiscal 2022 earnings guidance, and improved disclosure have alleviated many of our concerns such that we now think our previous pessimism is unlikely to play out. Demand for WiseTech's CargoWise software is obviously strong and management's acquisition strategy looks likely vindicated. The company performed well during the pandemic, and recent customer wins, such as Fedex, the potential for new products like Neo, and the company's global expansion strategy have increased our confidence in the long-term earnings outlook.

Key Takeaways

- We now view WiseTech in a much more bullish light and have dramatically raised our earnings forecasts and fair value estimate, to AUD 60.00 from AUD 9.30 per share.
- We increase our forecast revenue CAGR over the next decade, to 19% from 12% and our terminal EBIT margin to 37% from 32%, both of which add around AUD 14 to the fair value, or 28% of the total fair value increase.
- We've also reduced WiseTech's cost of equity to 7.5% from 9.0% and increased the terminal growth rate to 4.9% from 2.2%, both of which add AUD 11 to our fair value or 22% of the total fair value increase.
- We've also improved WiseTech's capital allocation rating to Exemplary from Standard. At the current market price of AUD 48.94, we now consider WiseTech to be undervalued.

Companies Mentioned (Share Prices as of September 10, 2021)

Name/Ticker	Capital Allocation	Economic Moat	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Morningstar Rating	Market Cap (AUDb)
WiseTech Global (ASX:WTC)	Exemplary	Narrow	AUD	60.00	48.94	High	★★★★	16

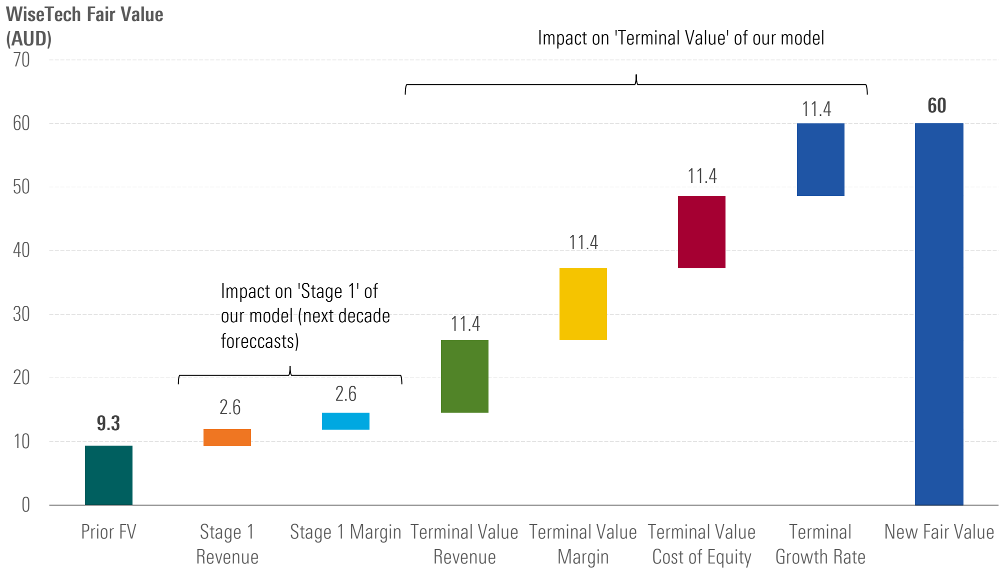
Summarising the Drivers of WiseTech's Fair Value Estimate Increase

We have illustrated the drivers of WiseTech's fair value estimate change in Exhibit 1. However, these are approximations as the impact of individual changes on the overall change depends on the order in which changes are applied and the impact of multiple changes differs from the sum of each change in isolation. The new model also includes a fiscal 2031 forecast year, following the fiscal 2021 result, which was not included in the prior model. Given this is a fast-growing company, it adds to the valuation.

WiseTech's fair value estimate increase is largely due to a higher terminal value, as 83% of our prior fair value was attributable to the terminal value. The terminal value increase is driven by the following four factors which have approximately equal impacts: First, our forecast revenue CAGR over the next decade has increased to 19% from 12% previously, resulting in an 81% increase in our terminal revenue forecast. This increase follows the strong fiscal 2021 result, improved disclosure, and better than expected fiscal 2022 outlook, which increase our confidence in WiseTech's global expansion strategy. Second, our terminal EBIT margin has increased to 37% from 32%, driving a doubling of our terminal NPAT forecast. Third, our cost of equity has decreased to 7.5% from 9.0%, as we now consider earnings cyclicality to be lower than previously expected. Finally, our implied terminal growth rate has increased to 4.9% from 2.2%, reflecting higher long-term earnings growth expectations but also implicitly incorporating other attractive attributes of the company which we expect the market to value via a valuation premium.

A relatively small proportion of the overall fair value increase is attributable to the increase in "Stage 1' of our model, which incorporates the next decade of our earnings forecasts. This is due to WiseTech's very high earnings growth expectations, which means earnings increase significantly during Stage 1 and drives a relatively high terminal value. However, we attribute the Stage 1 increase roughly equally between higher revenue growth and margin forecasts.

Exhibit 1 WiseTech's Fair Value Increase is Largely due to a Higher Terminal Multiple



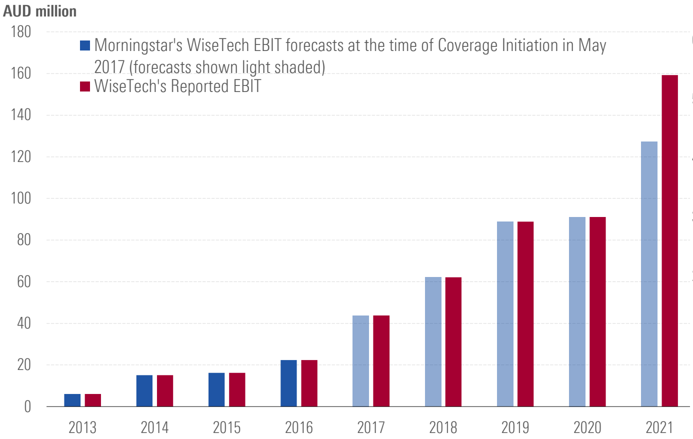
Source: Morningstar, Wisetech Global

Exploring Our Prior Bearish Thesis

Concerns Which Influenced Our Prior Investment Thesis Are Subsiding

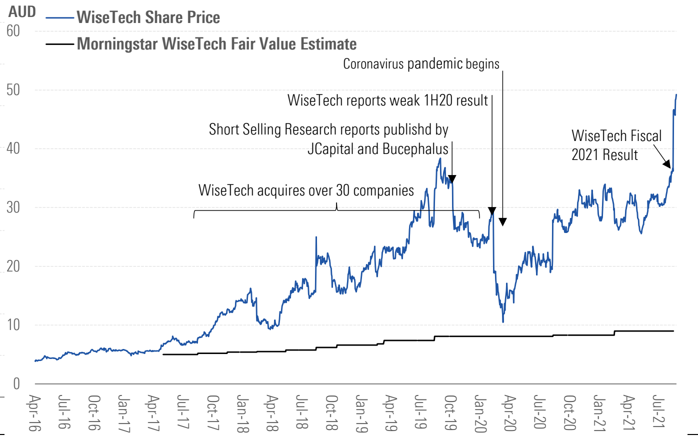
Prior to the fiscal 2021 financial result, WiseTech Global's earnings largely tracked the forecasts we made when we initiated research coverage of the company in May 2017, as shown in Exhibit 2A. However, the share price has performed much stronger, as shown in Exhibit 2B. We attribute the share price performance mainly to the market's expectations about WiseTech's long-term earnings outlook, which we estimate has been greater than our previous forecast underlying EPS CAGR of 17% over the next decade.

Exhibit 2A WiseTech's Earnings Have Tracked to Our Initial Forecasts



Source: WiseTech Global, Morningstar estimates

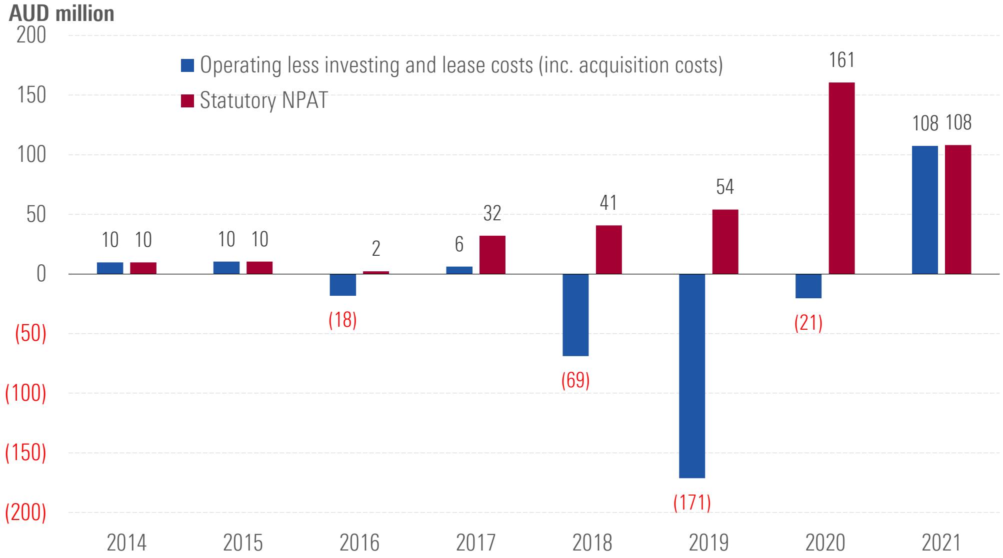
Exhibit 2B WiseTech's Share Price Has Been Volatile but Increased Significantly



Source: WiseTech Global, Morningstar

Despite WiseTech's many appealing attributes, we had some concerns. First, we considered disclosure to be relatively poor. This detracted from long-term earnings visibility, vital for valuing high growth companies like WiseTech. Second, we were concerned about the relatively high capitalisation of research and development costs, which could inflate income statement profits. This concern was compounded by poor free cash flow, measured by operating less investing cash flow, as illustrated in Exhibit 3.

Exhibit 3 WiseTech's Cash Flow Has Finally Caught up With Statutory NPAT



Source: Morningstar, WiseTech Global

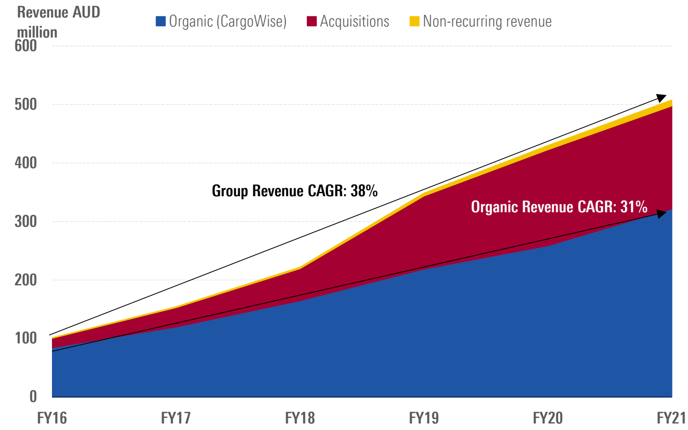
WiseTech's aggressive global acquisition strategy was also concerning. It saw over 30 small acquisitions between 2017 and 2020 of firms with relatively low profits and profit margins. This made it difficult to ascertain the proportion of revenue growth acquired versus the all important underlying organic revenue growth. The lack of organic revenue growth visibility made it possible to conclude underlying demand for WiseTech's core software could be weak and growth was being driven by acquisitions. WiseTech's writeback of contingent consideration in fiscal 2020 and slowing group revenue growth didn't help. Some short selling research providers heavily criticised WiseTech in late 2019, which drove a precipitous decline in the share price, as indicated in Exhibit 2B. Criticism was largely levelled at the acquisition strategy, but also accused the company of accounting irregularities and claimed WiseTech's customers were unhappy with its software and support services.

Fiscal 2021 Result Vindicates Management's Strategy

Exhibit 4A illustrates WiseTech's strong revenue growth in recent years, with a revenue CAGR of 38% in the five years ending in fiscal 2021. However, excluding the benefit of acquisitions, we estimate WiseTech's organic revenue growth CAGR was 31%, and fiscal 2021 organic revenue was around 40% lower than reported revenue including acquisitions.

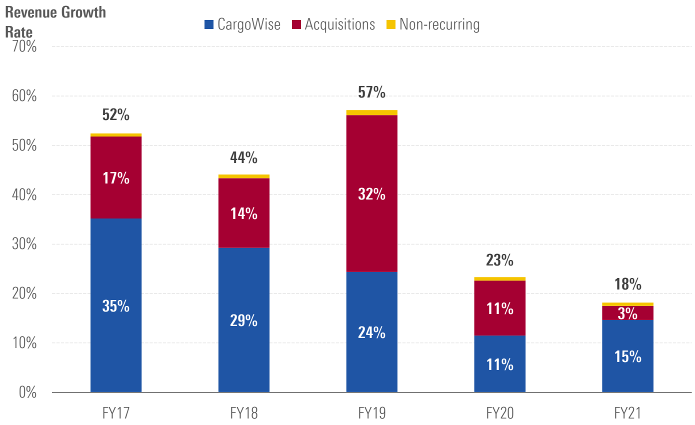
WiseTech's annual revenue growth has slowed in recent years and, including the contributions of prior acquisitions, fell to 18% in fiscal 2021 from 57% in fiscal 2019, as illustrated in Exhibit 4B. This slowing growth rate appeared to support the short seller's thesis that slowing organic revenue growth was being supported by acquisitions.

Exhibit 4A WiseTech Has Consistently Delivered Solid Revenue Growth



Source: WiseTech Global, Morningstar

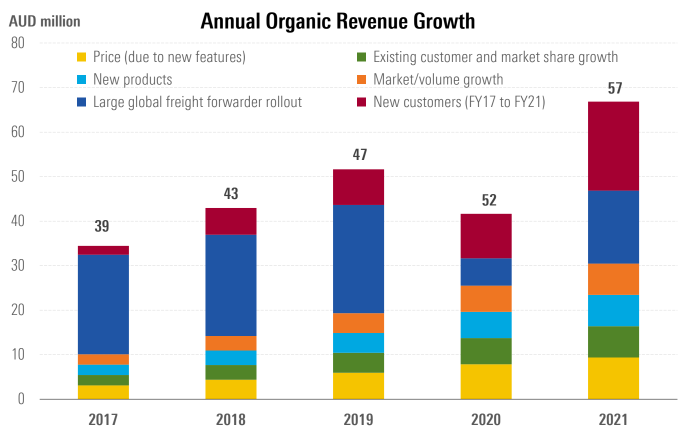
Exhibit 4B Acquisitions Have Been Important to Group Revenue Growth



Source: WiseTech Global, Morningstar

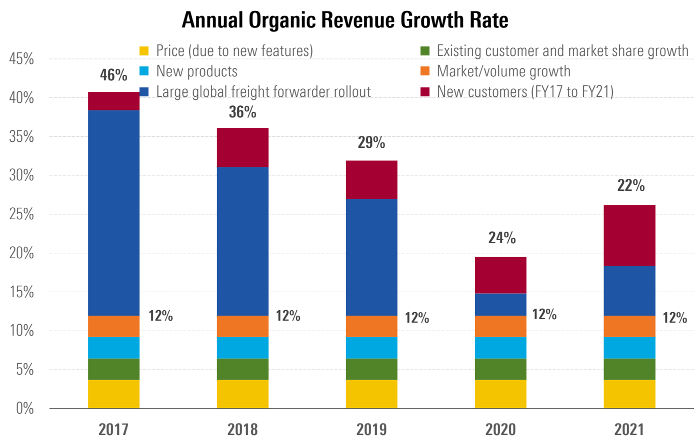
However, new disclosure with WiseTech's fiscal 2021 result has enabled us to better understand WiseTech's organic revenue growth. Exhibit 5A illustrates our estimate of the contribution to annual organic revenue growth from a range of sources, which we've used to estimate the contribution to the annual organic revenue growth rate from each source in Exhibit 5B.

Exhibit 5A Global Rollouts Have Been the Main Source of Organic Growth



Source: WiseTech Global, Morningstar

Exhibit 5B Underlying Organic Revenue Growth Looks Strong and Sustainable

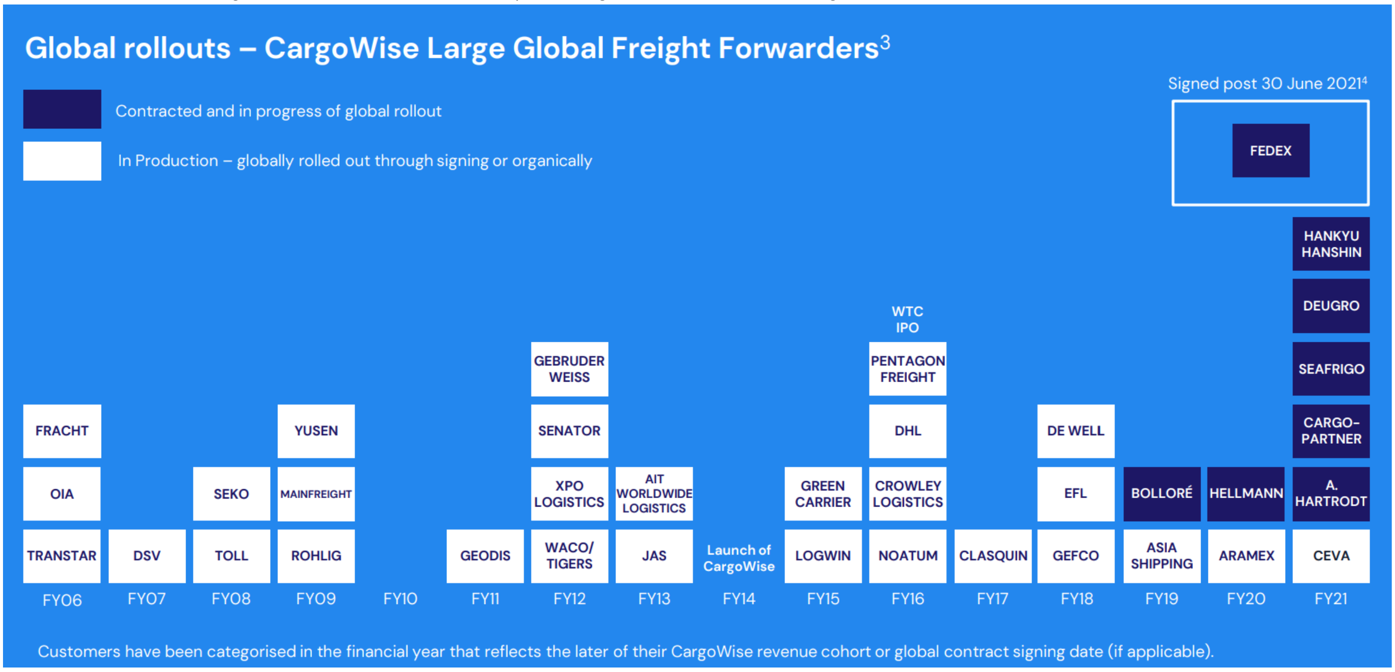


Source: WiseTech Global, Morningstar

These charts illustrate the importance of global rollouts of CargoWise software at existing customers to the organic revenue growth rate, which can take several years to complete. This is arguably a finite source of revenue growth which ends once the software is fully rolled out. However, recent customer wins indicate global rollouts will continue to be an important source of revenue growth as WiseTech wins new clients, such as Fedex. Seven global rollouts were in progress in fiscal 2021, as shown in Exhibit 6, but less than 10% of their expected users currently use CargoWise, indicating strong future growth from their rollouts as CargoWise replaces existing software solutions.

This newly available data vindicates management's global acquisition strategy because it demonstrates the strength of organic revenue growth, despite its gradually declining trend in recent years. This in turn implies WiseTech didn't need acquisitions to offset slowing organic revenue growth; rather, acquisitions were undertaken to create a global footprint from which to expand CargoWise software.

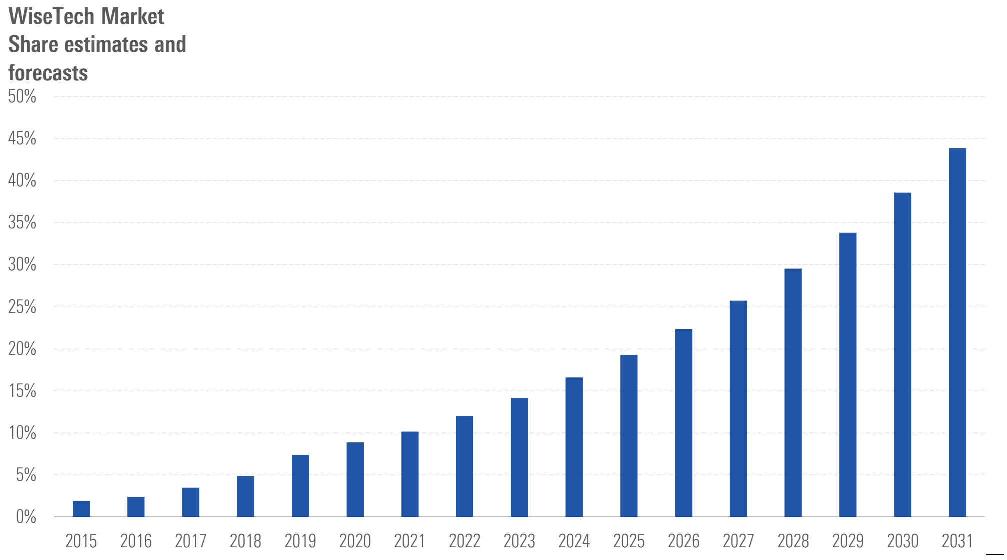
Exhibit 6 WiseTech has Signed New Global Clients Recently Including Fedex, Further Vindicating the Software



Source: WiseTech Global Fiscal 2021 Financial Result Presentation

New customers have also been an important source of organic revenue growth in recent years. In the long-run, this source of revenue growth will ultimately slow. However, the raft of recent wins infer that WiseTech's core software has a strong demand runway. WiseTech has a low share of its addressable market currently, which we estimate at around 10% as illustrated in Exhibit 7. However, the definition of the addressable market is rather nebulous and our market share figures are based on Gartner's 2019 USD 5 billion estimate of the supply chain execution segment. The broader supply chain software segment is valued at USD 15 billion and WiseTech will likely be able to access this market once its NEO product is fully developed.

Exhibit 7 We Expect WiseTech to Win a Substantial Share of its Existing Market



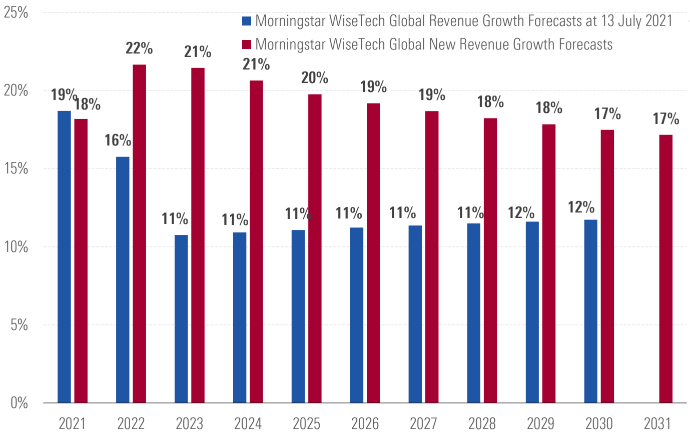
Source: Morningstar, WiseTech Global

We've Significantly Increased WiseTech's Revenue Forecasts

We now believe future customer wins can continue to be an important source of revenue growth for WiseTech but even without global rollouts and new customer wins, we estimate WiseTech can achieve a sustainable annual organic revenue growth rate of around 12%, as we expect the company has achieved in recent years as illustrated in Exhibit 5B.

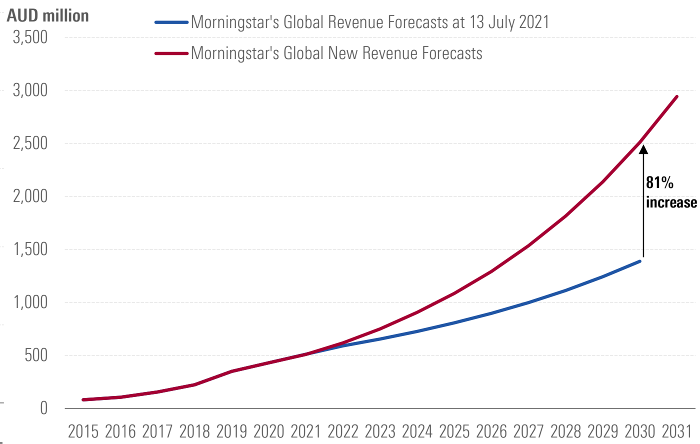
Our increased confidence in management's strategy and the likelihood of the creation of a dominant global logistics software platform has driven a significantly higher forecast revenue CAGR over the next decade which we've illustrated in Exhibits 8A and 8B. We previously assumed WiseTech's revenue would fall to an annual growth rate of around 12% whereas we now consider this to be a base growth rate, on top of which the company can add customers and global roll outs. Importantly, WiseTech's revenue is extremely "sticky" and it's possible that network effect-like forces will encourage new customers to adopt CargoWise as the software is increasingly used by numerous large logistics providers. This is partly because industry professionals may become experienced in using CargoWise, thereby encouraging employers to purchase the software to attract employees.

Exhibit 8A We've Significantly Increased our Forecast Revenue CAGR



Source: WiseTech Global, Morningstar

Exhibit 8B The Higher Forecast Revenue CAGR has a Large Impact on Earnings



Source: WiseTech Global, Morningstar

The Fiscal 2021 Result Alleviated Our Margin Concerns

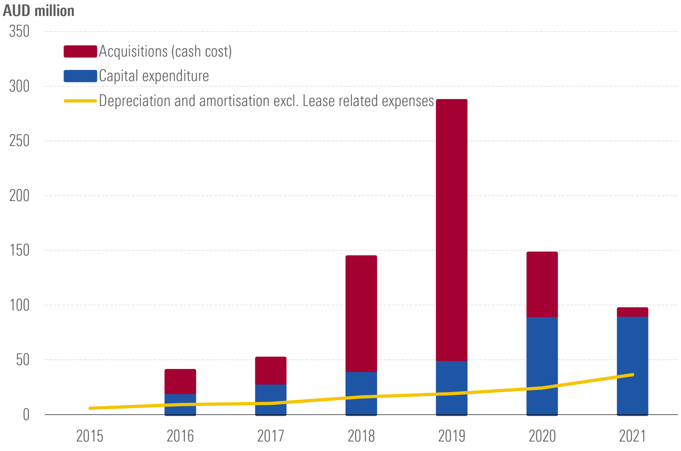
We Expect Wisetech to Achieve a Long-Term EBIT Margin of Around 40%

The improvement in both the group as well as the underlying EBITDA margins in fiscal 2021 provides tangible evidence of strong demand for CargoWise software and that the global acquisition strategy provides a solid foundation for a global logistics software platform. Cash flow conversion also greatly improved, as illustrated in Exhibit 3. This also supports robust underlying business economics.

We've been somewhat concerned about cash flow generation given the relatively high degree of capitalisation of research and development costs. Also, acquisition costs largely avoid the income statement. This has resulted in a significant difference between investing cash flow and depreciation and amortisation, as shown in Exhibit 9A, which arguably overstates profit margins.

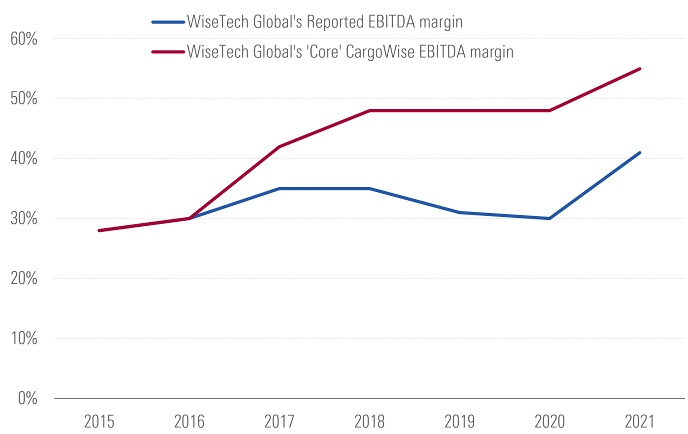
In addition, the numerous acquisitions depressed group profit margins due to the relatively low profit margins of the acquisitions. Although management said the group underlying profit margin was much stronger than the reported figure, as illustrated in Exhibit 9B, the declining group margin between fiscal 2017 and 2020 was a concern.

Exhibit 9A Income Statement Margins Have Benefited From Capitalisation



Source: WiseTech Global, Morningstar

Exhibit 9B Profit Margins Were Impacted by Acquisitions

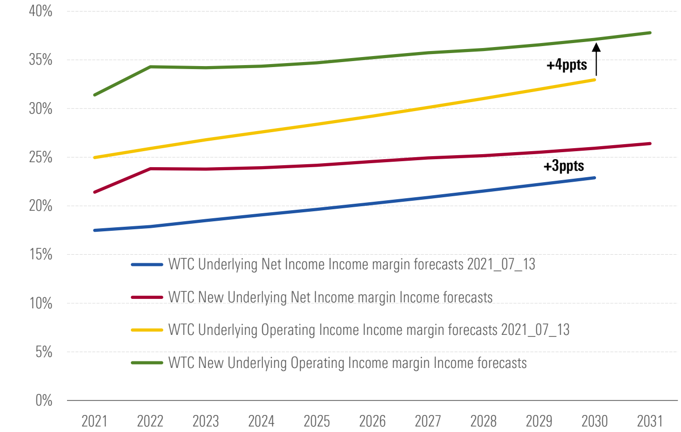


Source: WiseTech Global, Morningstar

Comparable Companies Imply a Long-Term EBIT Margin of Around 40%

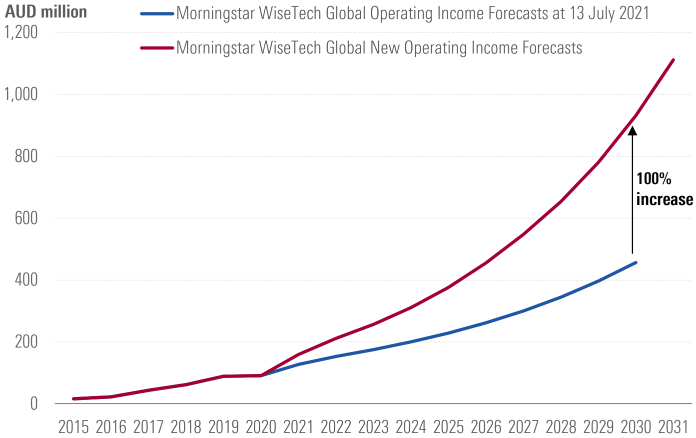
We have illustrated the impact of our stronger revenue forecasts on profit margins in Exhibit 10A and operating profit in Exhibit 10B. The increase to our revenue forecasts has a leveraged impact on our long-term operating income forecasts due to the operating leverage within the business. This is mainly because additional revenue doesn't require an equal increase in general and administration costs nor research and development costs.

Exhibit 10A Higher Revenue Forecasts Have Boosted Profit Margins



Source: WiseTech Global, Morningstar

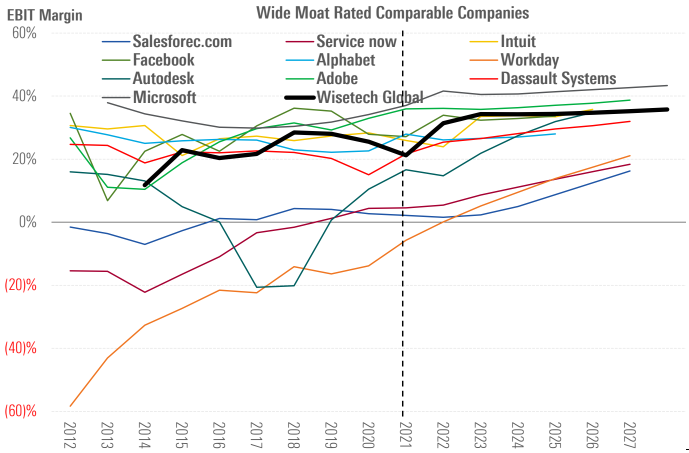
Exhibit 10B Operating Leverage Enhances the Impact of Higher Revenue



Source: WiseTech Global, Morningstar

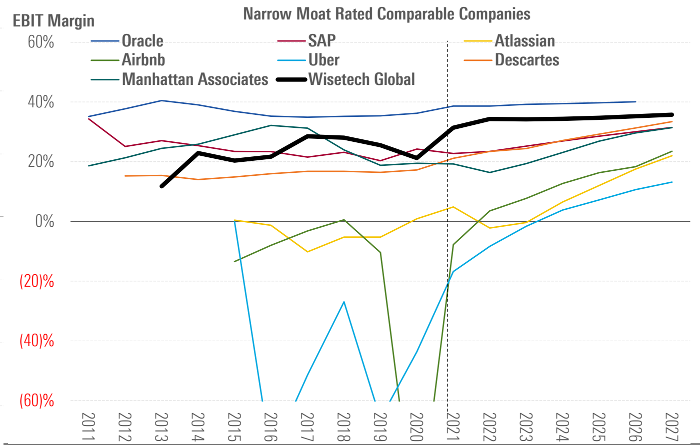
We have compared our new long-term EBIT margin forecasts for WiseTech with other leading global software companies. Exhibit 11A illustrates the EBIT margins for a selection of wide-moat companies, based on Morningstar analysts' earnings forecasts. WiseTech's margins are already at the higher end relative to this peer group and our new forecasts imply this will continue. Similarly, WiseTech's margins look relatively strong in comparison to the narrow moat selection in Exhibit 11B.

Exhibit 11A Wide-Moat Companies Tend to Have High Margins



Source: Morningstar estimates

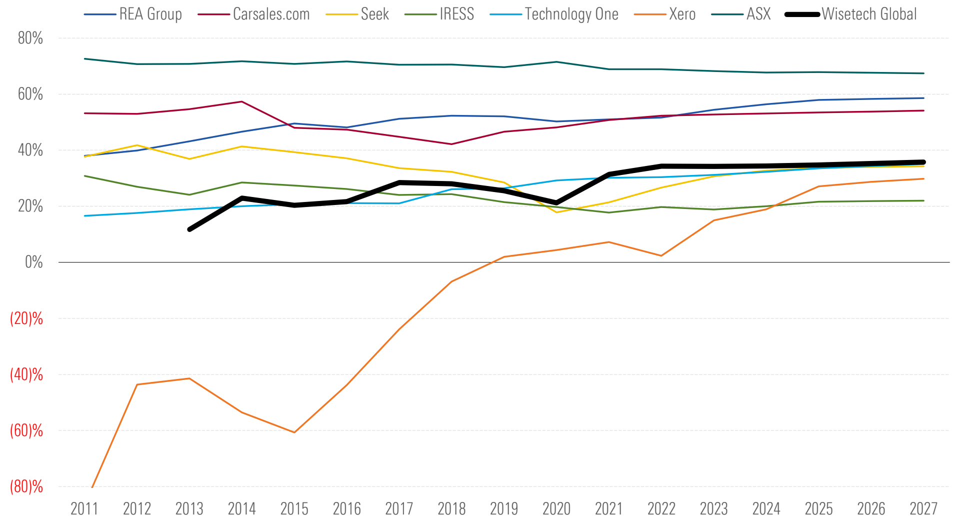
Exhibit 11B Narrow-Moat Comparables Are Rapidly Growing Margins



Source: Morningstar estimates

We've also compared WiseTech margins with a selection of Australian software-based companies, as shown in Exhibit 12. The Australian comparable companies include ASX Limited, REA Group, and Carsales.com, all of which have very high margins versus the international comparable companies discussed earlier. However, these three companies benefit from the network effect, which is often a stronger source of economic moat than the switching cost source which applies to most application software firms, including WiseTech. Also, these three companies are heavily Australia-centric and arguably benefit from relatively low competition within the Australian economy. This means we think it's unlikely WiseTech will be able to achieve these kinds of margins as a global business.

Exhibit 12 Australian Comparables Have Relatively Strong Margins



Source: Morningstar estimates

We've Lowered WiseTech's Cost of Equity and Increased its Terminal Multiple

We've Lowered the Cost of Equity to 7.5% from 9.0%, Adding AUD 6 to the FVE

We previously used a 9% cost of equity for WiseTech, assuming the company was likely to experience market-, or economy-like earnings cyclicality due to its exposure to international trade. However, we now believe WiseTech has lower than average earnings risk due to the likely resilience of the demand for its software and revenue reliance. Our increased confidence in the resilience of organic revenue and its outlook means we now think a lower discount rate is appropriate. Organic revenue has a very high recurring revenue rate of around 99% and does not appear to fluctuate materially with trade cycles. WiseTech has demonstrated its ability to retain customers and the strong switching costs inherent in its software. We've therefore lowered the cost of equity to 7.5%, which is the lowest we apply. This boosts our fair value by around AUD 6 per share.

Our Terminal Price/Earnings Multiple Increases to 38 from 15, Adds Around AUD 6 to the FVE

We've also increased our terminal price/earnings multiple to 38 from 15, which adds around AUD 6 to our fair value estimate. The market historically traded on a P/E ratio of around 15. However, the reduction in interest rates in recent years has increased this to around 20. Interest rates appear unlikely to move higher soon, suggesting the market is likely to trade on a P/E of closer to the 20 we now expect in the future, rather than the historical average of around 15. We think WiseTech is also likely to trade on a premium P/E ratio to the market. Even if it had market-like earnings growth, positives such as an ungeared balance sheet, resilient earnings, and the potential to accelerate earnings growth via innovation mean a premium multiple is likely warranted. This is something we've observed in other software companies, such as IRESS, which has delivered virtually no earnings growth over the past decade but nevertheless trades on a premium to the market's P/E ratio. Our new terminal P/E ratio for WiseTech also assumes it continues to generate above market earnings growth beyond the explicit earnings forecast period of the next decade.

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