

H2 demand surge anticipated as US reopens

Thankfully pandemics don't come around very often. The last one of such virulence as COVID-19 being the 'Spanish Flu' in 1918-20. So how is ClearStar faring?

Today's **2019 results** (see below) **were in line with our revised expectations** - reporting **adjusted EBITDA** (post SBPs) of **\$370k** (-\$108k LY) on **turnover up 14.1% LFL to £23.0m** (\$20.1m). Driven by **strong top line growth from Medical** (+21.4%, MIS) & **Direct** (+31.9%), **together climbing 26.2% to \$16.5m** (71.8% of group). Albeit partly offset by an 8.3% contraction at channel partners (non MIS), which reduced gross margins to 54.1% vs 56.4% LY, reflecting adverse divisional mix.

Consistent double digit organic revenue growth

\$'000s	Act 2018	Act H1'19	Act H2'19	Act 2019
Channel partners (non MIS)	7,056	3,237	3,231	6,468
Medical/drug testing - channel	7,055	4,150	4,417	8,567
Direct services (incl medical)	6,002	4,172	3,746	7,918
Turnover	20,113	11,559	11,394	22,953
<i>Channel partners (non MIS)</i>	-5.6%	-14.2%	-1.6%	-8.3%
<i>Medical/drug testing - channel</i>	25.8%	25.2%	18.1%	21.4%
<i>Direct services (incl medical)</i>	28.0%	49.0%	17.0%	31.9%
LFL % growth	13.1%	16.9%	11.4%	14.1%
Gross Profit	11,340	6,305	6,105	12,410
<i>% Margin</i>	56.4%	54.5%	53.6%	54.1%
Overheads (ex SBPs)	-11,183	-6,114	-5,915	-12,029
Adjusted EBITDA (pre SBPs)	157	191	190	381
Share based payments	-265	-4	-7	-11
Adjusted EBITDA (post SBPs)	-108	187	183	370
Depreciation & Amortisation	-1,226	-558	-497	-1,055
Adjusted EBIT	-1,334	-371	-314	-685
<i>Margin</i>	-6.6%	-3.2%	-2.8%	-3.0%
One-offs				
Executive severance		-268	-9	
Property related exit fees		-196	-50	
Reported EBIT	-1,334	-835	-373	-685
Net debt : EBITDA (post SBPs)				-0.94
Net cash / (debt)	923	-1,012	-346	-346

Source: Equity Development.

Albeit H1 sales set to decline "significantly"

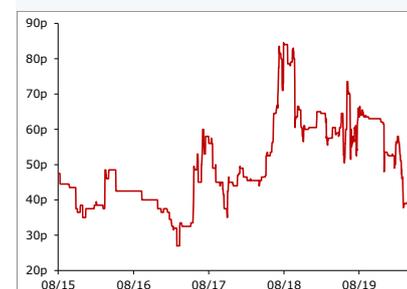
Similarly **ClearStar traded well up to February**, although from mid March onwards, US lockdowns were announced and corporates started to shed millions of staff. The latter leading to a loss of >30m jobs nationally (see overleaf) over the past 6 weeks.

Equally the big 3 diagnostic laboratories (ie Quest, Lab Corp & Abbott) have since prioritised resource on COVID-19 testing. Making it difficult for MIS to obtain capacity for its leading drug & alcohol services. Hardly surprising therefore that "**volumes have significantly reduced**", with sales down **-16% YTD & -50% in April** vs LY.

Company Data

EPIC	AIM: CLSU
Share price	39p
52 week Hi/Lo	73p/38p
Market cap	£14.2m
Sharecount	36.3m
Net debt 5 th May	\$1.0m
ED valuation / share	Withdrawn

Share Price, p



Source: Share Cast

Description

Floated at 54p/share in July'14, ClearStar is a tech-enabled Human Capital Integrity specialist serving the \$4bn global background & medical (MIS) screening market, which is growing at c. 4%-7% pa.

The firm is HQ'd in Georgia (99% US facing), and derives the majority of its revenues from high volume, low cost, 'everyday repeat' screens. Hence providing robust forward visibility and downside resilience.

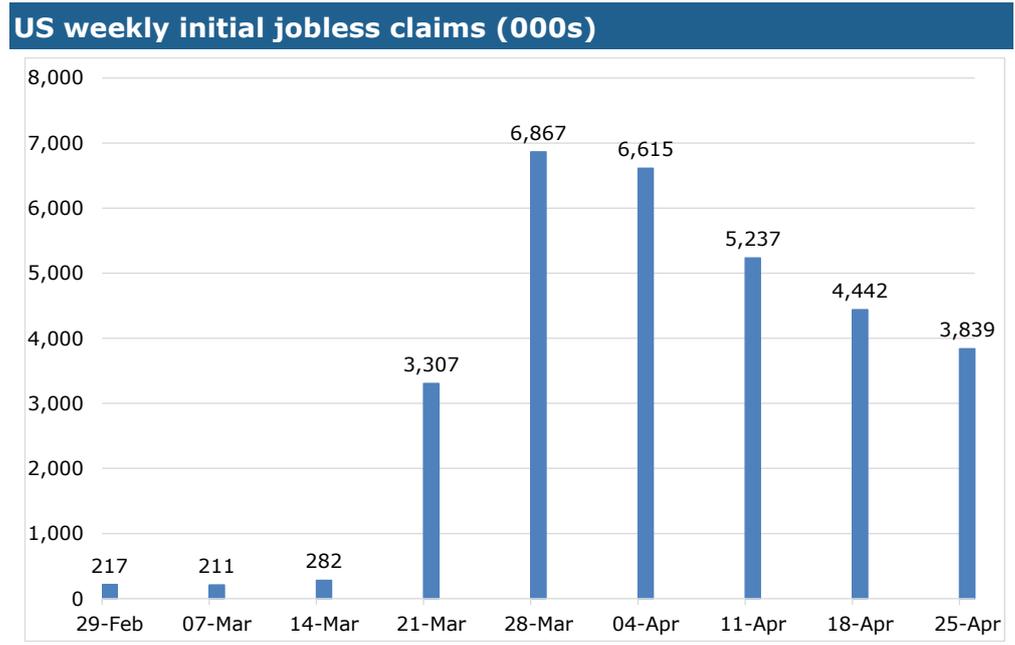
LFL growth is being driven by multiple factors, including the rise of the gig economy, government crackdowns on illegal workers, legalisation of cannabis for recreational use and 'MIS & Direct'.

Next News: AGM June 2020

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Source: Equity Development

2nd CV19 wave should not cause further lockdowns

The good news is that ClearStar ***hasn't lost any customers during this period, continued to win new business, and is well-positioned to benefit from the expected ramp up in recruitment when normal [conditions] resume.***

Additionally after last week's break-through clinical trial data relating to Gilead's Remdesivir antiviral – combined with greater ICU/ventilator availability, testing, track/trace & social distancing measures (re flattening the curve) – we think **America should now be able to get through the 2nd infection wave** when it arrives (probably) in the autumn.

So we plan neither 'to fight the Fed'...

Importantly **without reintroducing 'stay at home' orders either.**

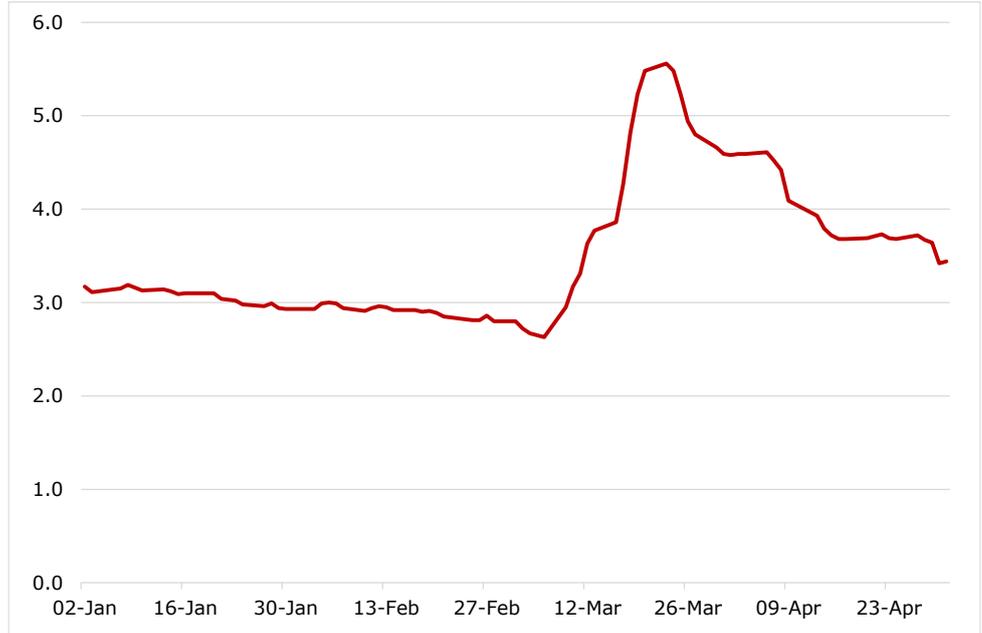
What's more, given massive central bank intervention and fiscal stimulus (re 'whatever it takes'), the eye of the corporate credit storm, which sent bond yields soaring in March (see below), appears to have passed too.

All told hopefully allowing the economy to gradually reboot as the lockdowns are lifted.

'Nor bet against the American economy'

Indeed **over the next 1-2 years, there could be literally 20m+ people re-entering the workforce** (see below) - beginning perhaps as soon as this summer.

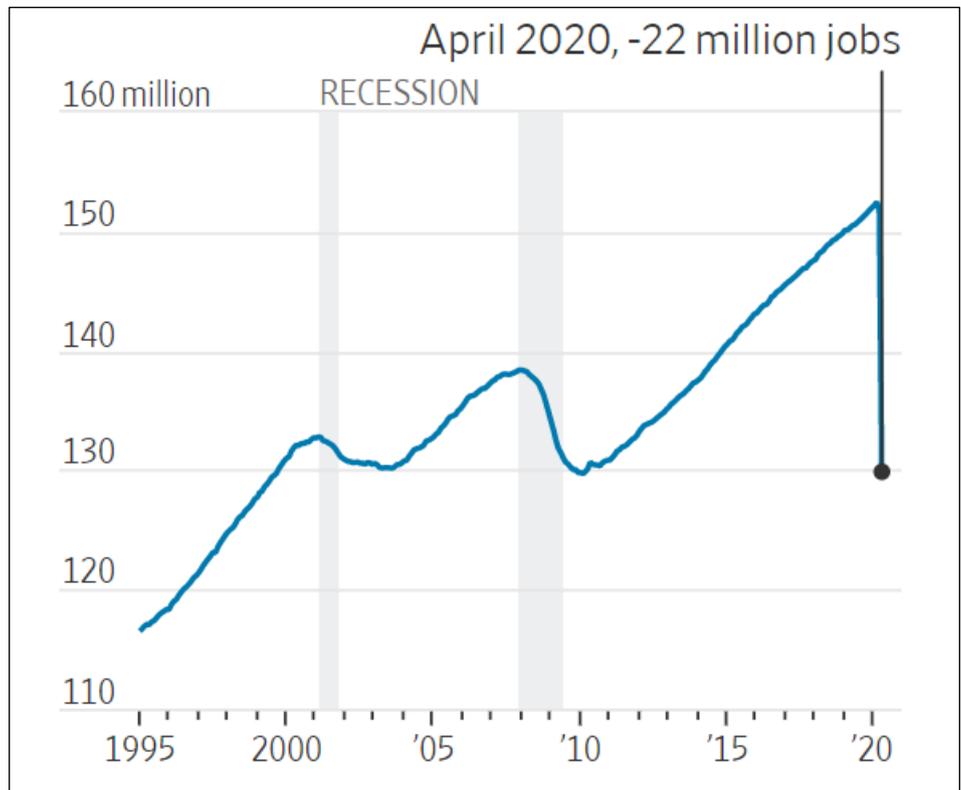
Bank of America BBB US corporate bond yields (%)



Source: Equity Development

Moreover involving **substantial job swapping** (re market dislocation) which could provide another catalyst for tech-rich, background screening providers like ClearStar to gain share during the re-absorption phase. Further accelerated by the **possible implementation of employer on-site & mobile coronavirus testing**.

Economists forecast a 22m drop for Friday’s US non-farm payrolls



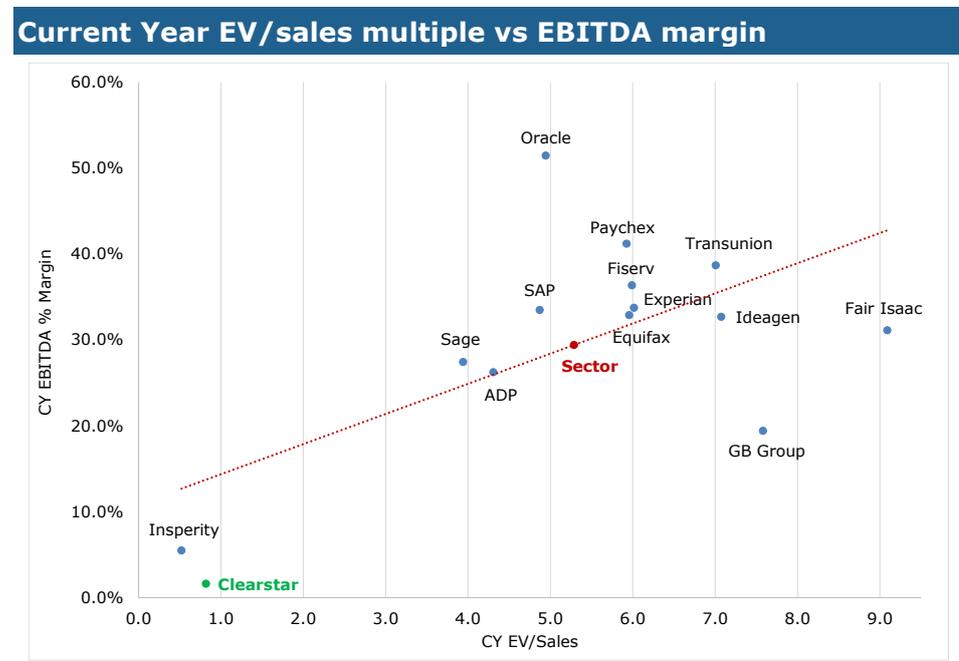
Source: Equity Development

Cost savings will enhance operational gearing

Besides, despite the awful macro backdrop, **US recruitment hasn't totally collapsed anyway**, especially for front-line healthcare, domiciliary care, online delivery, warehouse, grocery & pharmacy staff. In fact the Federal Reserve Bank of Atlanta, reckon there might have been up to 3 new positions created for every 10 layoffs.

And even if the waters remain choppy for longer than predicted, we estimate ClearStar has **sufficient liquidity to weather this transitory storm**. Supported by gross cash as at 5th May of \$3.8m (\$1m net debt), after receiving a 2 year \$1.1m loan (1% interest rate) under the Paycheck Protection Program (PPP).

On top, annualised savings of \$2.3m/year have been identified via reductions in travel, non-essential spend, rent & salaries (10%-25% reductions). These **initiatives should provide further upside and positive operational gearing**, once the tide begins to turn (hopefully) later this year.



Source: Equity Development. ClearStar & GB Group use 2019 numbers.

Bank facility waiver obtained until 30th June 2020

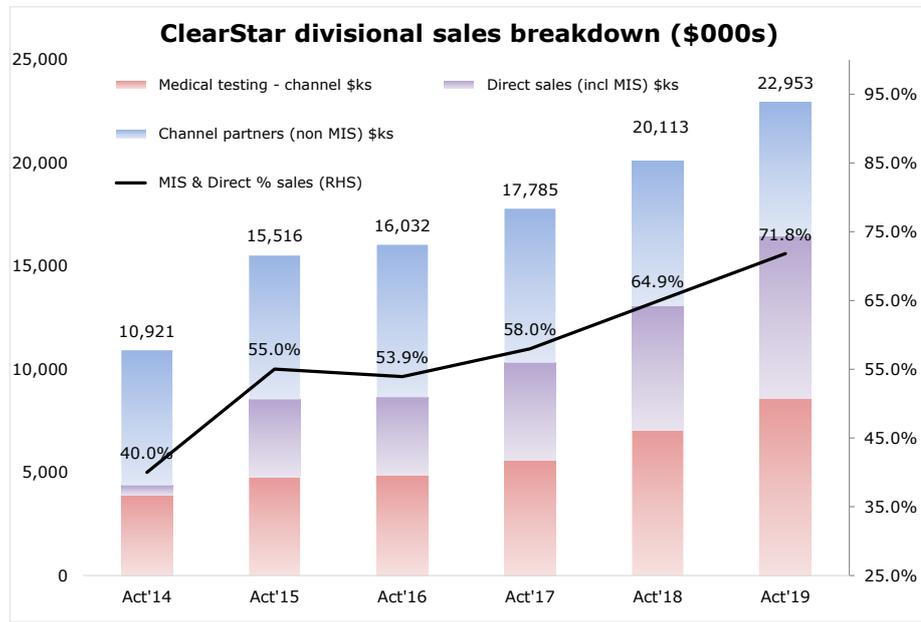
That said it isn't all plain sailing. The Board is engaged in discussions with Silicon Valley Bank to secure new temporary covenant terms from 1st July 2020, after already receiving waivers up to 30th June. We think this will be granted because even "based on current [artificially depressed] trading, the Company [should have] sufficient liquidity to remain viable until [December]".

Broadening of product-portfolio & sector exposure

Elsewhere the firm continues to upscale its direct client base with the **average spend per account increasing by 32%** in 2019. Alongside introducing new products (eg breath alcohol screening & criminal monitoring) and expanding its footprint across more industries including:

Financial, Transportation, Logistics, Healthcare, Environmental, Child education, student exchange programmes and facilities management.

Direct and MIS (71.8% sales) grew 26% LFL in 2019



Source: Equity Development

Forecasts & valuation temporarily withdrawn

Nonetheless these are uncertain times, and hence we’ve decided to withdraw our forecasts and valuation, until there’s greater clarity. Although in terms of the latter, the **stock is attractively priced for patient risk tolerant investors** - trading on a trailing EV/Sales multiple of 0.8x (see below), compared to typical industry multiples (pre COVID-19) of between 2.5x – 3.5x.

Admittedly the coronavirus will impact 2020 numbers, yet ultimately we believe the group will prosper. Enjoying high levels of repeat revenues, good retention rates, positive cash generation and a widening customer base.

Range of sector valuation benchmarks pre COVID-19 crisis

Valuation benchmarks	ClearStar 2019 Trailing	Typical HR screening multiples pre COVID-19 crisis	
		Low	High
EV/Revenues	0.8	2.5	3.5
EV/EBITDA		12.5	14.0
EV/EBIT		15.0	16.5
PER		18.8	20.6
EBITDA margins	1.6%	20.0%	25.0%

Source: Equity Development

Pandemic will be transitory

CEO Robert Vale concluding “In 2019, we continued to execute on our strategy to expand and increasingly upscale our direct client base as well as grow our market-leading medical screening solutions. Our success is reflected in our revenue growth for the year and our

contract wins, which included some high-calibre organisations. **We also entered 2020 with our highest ever order book.**

"Our business model has meant that we could adapt rapidly in response to the COVID-19 outbreak – with the procedures and technology in place to enable remote working and with the same strict level of security. **There has been no degradation in our quality standards and we have not lost any customers, however volumes have been significantly reduced**".

Summary financials

ClearStar (December yearend)	Act'14 \$'000s	Act'15 \$'000s	Act'16 \$'000s	Act'17 \$'000s	Act'18 \$'000s	Act'19 \$'000s
Channel partners (non MIS)	6,554	6,980	7,387	7,475	7,056	6,468
Medical/drug testing - channel	3,890	4,770	4,850	5,610	7,055	8,567
Direct services (incl 15% medical)	477	3,766	3,795	4,700	6,002	7,918
Turnover	10,921	15,516	16,032	17,785	20,113	22,953
MIS & Direct % of group	40.0%	55.0%	53.9%	58.0%	64.9%	71.8%
Channel partners (non MIS)	-13.4%	6.5%	5.8%	1.2%	-5.6%	-8.3%
Medical/drug testing - channel		22.6%	1.7%	15.7%	25.8%	21.4%
Direct services (incl 15% medical)	59.0%	689.5%	0.8%	23.8%	27.7%	31.9%
% total growth	37.0%	42.1%	3.3%	10.9%	13.1%	14.1%
Gross Profit	6,331	9,493	9,835	10,349	11,340	12,410
% margin	58.0%	61.2%	61.3%	58.2%	56.4%	54.1%
EBITDA (post SBPs)	-1,267	-956	-666	-462	-108	370
% Margin	-11.6%	-6.2%	-4.2%	-2.6%	-0.5%	1.6%
Adj. EBITDA (pre SBPs)	-1,267	-956	-542	-398	157	381
Opex	-8,071	-11,736	-11,930	-12,281	-12,674	-13,095
Opex growth			1.7%	2.9%	3.2%	3.3%
Adj. EBIT (post SBPs)	-1,740	-2,243	-2,095	-1,932	-1,334	-685
% Margin	-15.9%	-14.5%	-13.1%	-10.9%	-6.6%	-3.0%
Net interest	-17	-22	-16	-17	-68	-171
Adj. Profit before Tax	-1,757	-2,265	-2,111	-1,949	-1,402	-856
Adjusted EPS (cents)	-4.8	-6.1	-5.6	-5.4	-4.0	-2.4
EPS growth rate		-26.2%	7.3%	4.5%	25.1%	40.5%
Dividend (cents)						
Yield						
Valuation benchmarks						
P/E ratio						-20.1
EV/Sales	1.7	1.2	1.2	1.0	0.9	0.8
EV/EBITDA					-172.1	50.2
EV / adj EBIT					-13.9	-27.1
Implied EBITDA drop through rates		6.8%	56.2%	11.6%	15.2%	16.8%
Adjusted tax rate	-0.2%	-2.3%	-2.9%	0.0%	0.0%	0.0%
Cash conversion (ie (EBTDA - Cap R&D - W/Cap)/EBIT)						
PEG ratio						
Net cash/(debt)	6,124	3,630	2,253	1,240	923	-346
Net debt : EBITDA						0.94
Capitalised NPD	-803	-1,396	-886	-712	-665	-1,422
Depreciation & amortisation	-473	-1,287	-1,429	-1,470	-1,226	-1,055
R&D + capitalised NPD as % sales	-8.8%	-14.2%	-15.9%	-14.6%	-11.5%	-12.0%
Sharecount (Ks)	36,303	36,303	36,303	36,303	36,303	36,363
Shareprice (p)	39.0p					

Source: Equity Development estimates, Company historic data. NB. Singlesource was acquired in December 2014

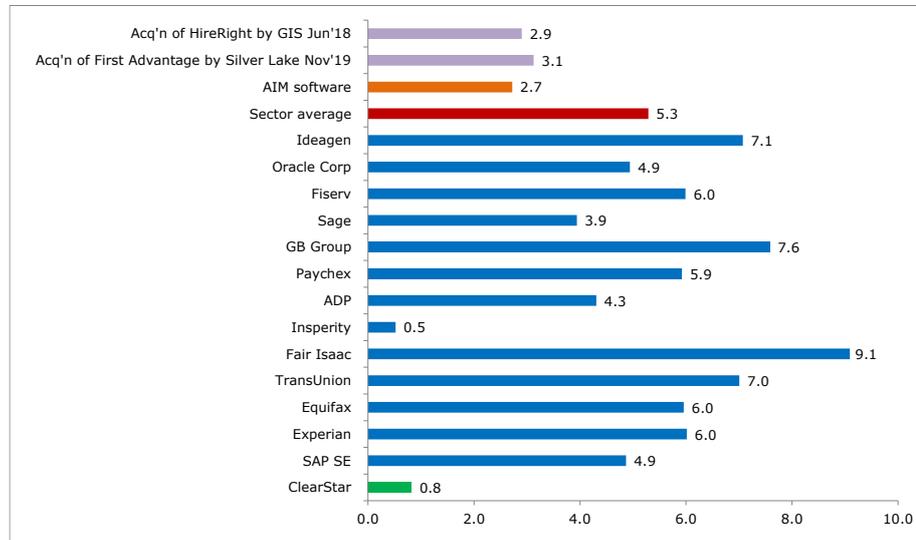
Note: As at 31st December 2019, CLSU had \$10,193k of unutilised tax losses, which can be utilised in future periods. These carry forwards however will begin to expire in 2023, but last until 2038.

Key risks

- Impact of a future recession on employment screening, although medical services should be far less affected by any economic downturn.
- Customer concentration, with the biggest account generating 11% of 2019 sales. This is a long term relationship with churn typically occurring only when a client is taken-over.
- Possible increase in bad debts due to COVID-19 induced downturn.
- Foreign exchange fluctuations for UK holders, given that >90% of turnover is derived from America.
- Being relatively small, ClearStar could get squeezed by its larger rivals, especially if there is further industry consolidation.
- The firm is presently loss making - hence it is important that sufficient resources continue to be made available. In the event more funding is required, then it is not certain that future capital would be available at commercial rates.
- Generic risks of greater competition, retention/recruitment of key staff, etc. Albeit this goes with the territory in the small-cap arena.
- Disruption caused to ClearStar's cloud based "Aurora & Sphere" platforms, such as from service outages, security breaches, etc.
- Supplier concentration. In 2019, CLSU bought \$5.7m of services from two vendors, representing 54% of group purchases.
- Possible adverse changes in employment law and local recruitment practises.
- ClearStar is registered in the Cayman Islands, and therefore does not fall under the UK Takeover Panel if it was ever approached by a third party.
- Protection of minorities, given that 49% of the shares are still held by directors/co-founders.

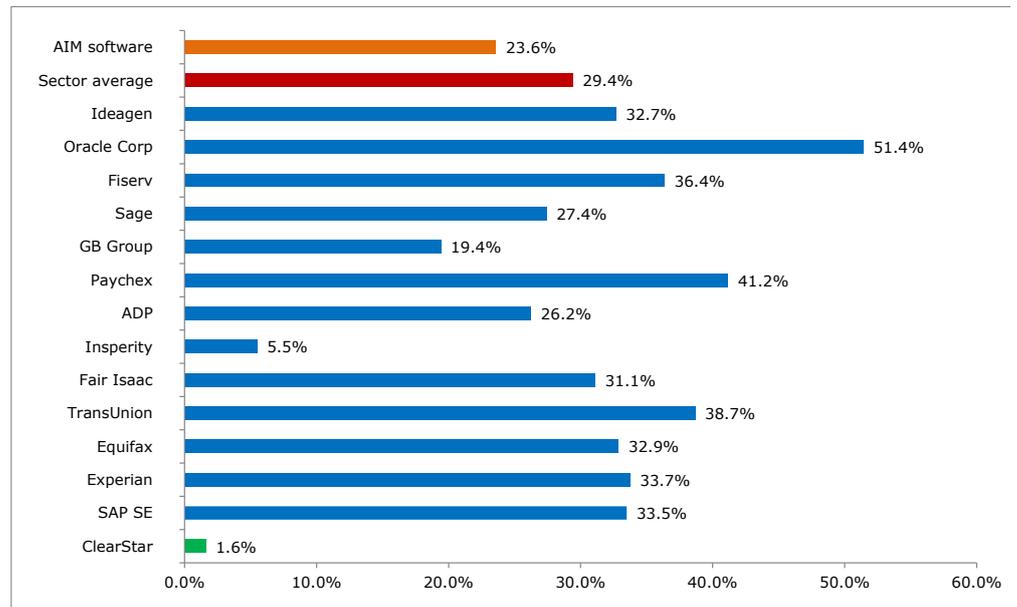
Appendices - Sector valuation metrics and KPIs

Current Year EV/revenue multiples



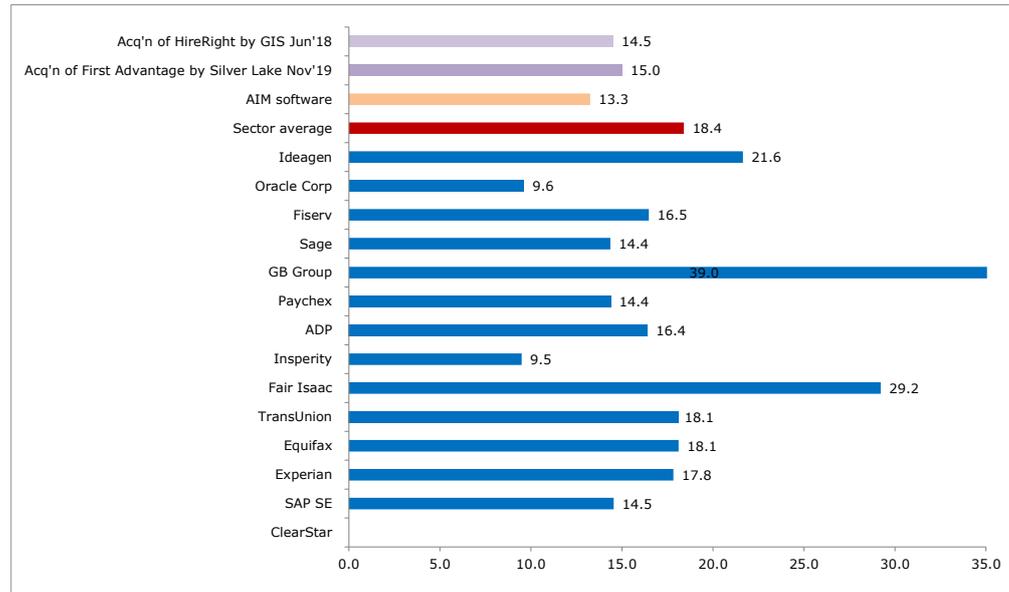
Source: Equity Development. ClearStar & GB Group use 2019 numbers

Current Year EBITDA margins (post SBPs)



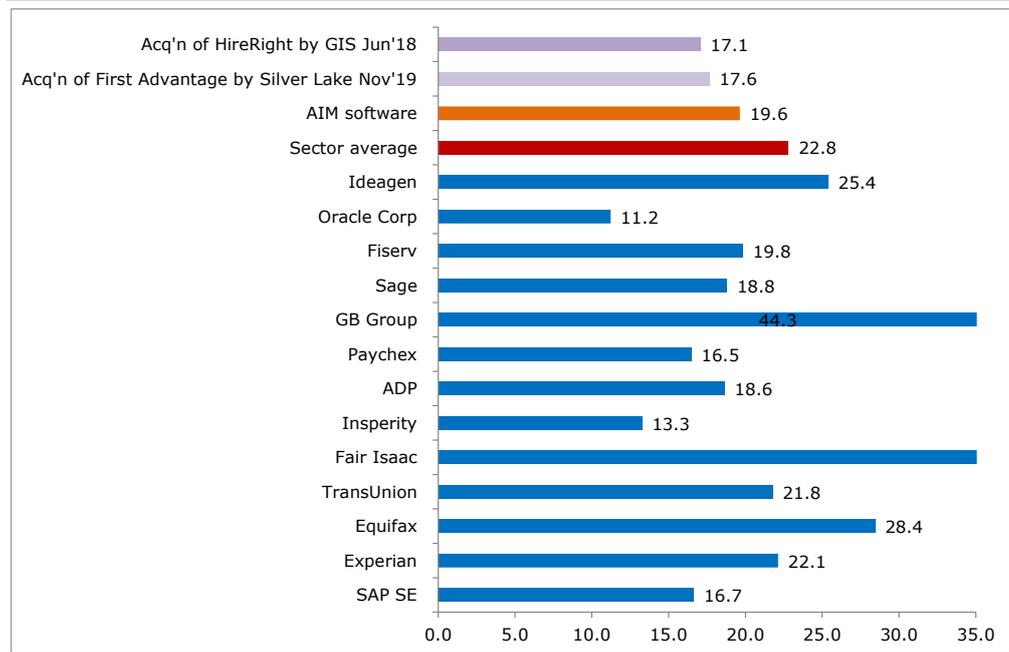
Source: Equity Development, arithmetic average for sector

Current Year EV/EBITDA multiples



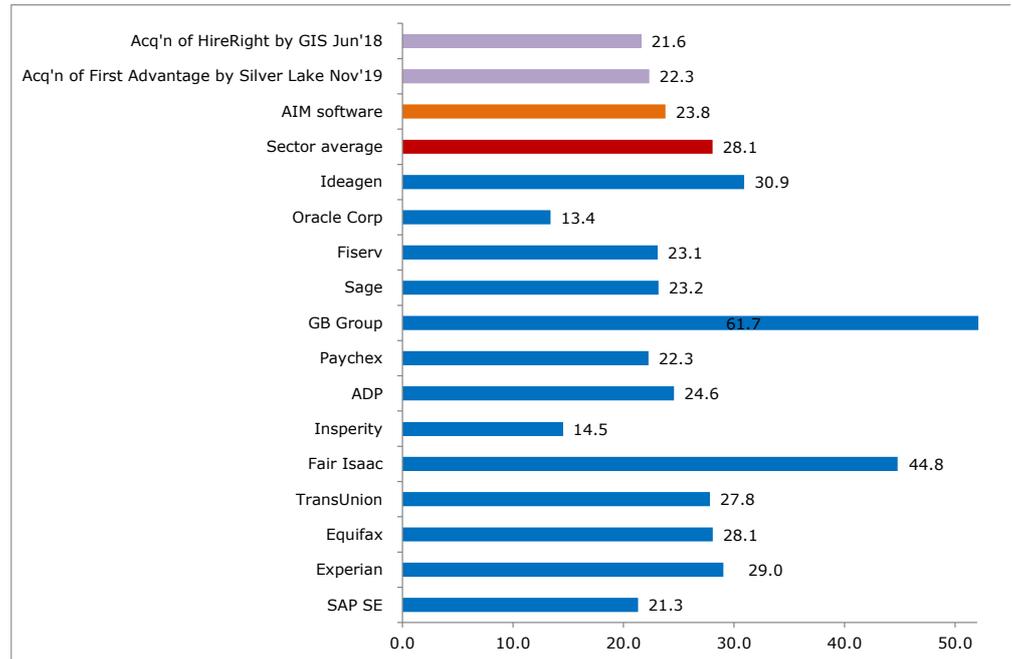
Source: Equity Development, arithmetic average for sector. 2019 numbers for GB Group

Current Year EV/EBIT multiples



Source: Equity Development, arithmetic average for sector. 2019 numbers for GB Group

Current Year PERs



Source: Equity Development, arithmetic average for sector. 2019 numbers for GB Group

Market capitalisation of peers

	Description	Shareprice	Mrk Cap (Millions)	CY Net cash / (debt) Millions	Enterprise Value (Millions)
ClearStar	Tech-enabled employment & medical screening services	39p	£14.2	-\$1.0	£15.2
SAP SE	ERP, accounting & HR software	€ 106	€ 126,140	-€ 10,586	€ 136,726
Experian	Credit checking & info services	\$30.19	\$27,477	-\$3,835	\$31,312
Equifax	Credit checking & info services	\$146	\$17,724	-\$2,980	\$20,704
TransUnion	Credit checking & info services	\$79	\$14,915	-\$3,383	\$18,298
Fair Isaac	Credit checking & info services	\$353	\$10,290	-\$781	\$11,071
Insperity	HR services	\$53	\$2,173	-\$161	\$2,334
ADP	Payroll services	\$145	\$62,640	-\$498	\$63,138
Paychex	Payroll services	\$67	\$24,120	-\$84	\$24,204
GB Group	ID verification	660p	£1,282	-£42	£1,323
Sage	ERP, accounting & HR software	628p	£6,845	-£394	£7,239
Fiserv	Financial services	\$103	\$70,555	-\$21,006	\$91,561
Oracle Corp	ERP, accounting & HR software	€ 52.00	€ 169,000	-€ 27,818	€ 196,818
Ideagen	Regulatory software	167p	£378.1	-£18.0	£396.1

Source: Equity Development



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