



# The Cut

Edition 10

## **EQUITY SHORT RECOMMENDATIONS**

19th May 2017

**IRF works with 96 Independent Research Providers covering multiple geographies, asset classes, industry sectors and methodologies.**

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### **Events associated with IRF**

- **[London Value Investor Conference](#), where IRF is a Media Partner, 25 May, Queen Elizabeth II Conference Centre, Westminster**

### **Researchers visiting London in the near future**

- **[Boyar Research](#)** - US Stocks, Jon Boyar, MD, **22-26 May**
- **[J Capital Research](#)** - China Macro, Asian Stocks & Global Shorts, Tim Murray, Managing Partner, available to discuss Harvey Norman, Snap On, Kone & China Steel/Iron Ore, **24-26 May**

- **Andrew Hunt Economics** - Global Macro, Andrew Hunt, Founder, **27-28 May**
- **Asianomics** - Global Macro with an emphasis on Asia, Sharmila Whelan, Deputy Chief Economist, **31 May**
- **Summit Redstone Partners** - US Semiconductors, Software & Hardware, Srin Nandury and Jagadish Iyer, Senior Analysts, **5-6 June**
- **Enodo Economics** - China Macro, Diana Choyleva, Founder & Chief Economist, and Seamus Keaveney, CEO, **8-9 June**
- **Gradient Analytics** - Global Shorts, Brent Miller, Head of Research, **26-28 June**
- **JL Warren Capital** - China Stocks & China Macro, Junheng Li, Founder, **10-12 July**

### Company Research

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## Company Research

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**1. Arete Research** - Sell **Liberty Global** (LBTYA US) on concerns regarding how ballooning capex coincides with odd "re-basing" adjustments, hard-to-explain OCF growth rates, and new peaks in the use of vendor financing

**IRF Note** - *Liberty Global looks very expensive (22x '17E and 21x '18E EV/opFCF) for meagre growth, and very limited organic deleverage capacity; Arete have cut their PT to \$26. Key points include:*

- Analysis suggests that the company only generated \$224m of underlying FCF in 2016 rather than the \$2bn in adjusted FCF reported. Liberty Global's opaquely-rebased OCF growth benefits from vast accrued capex, with FCF boosted via vendor-financing and "expenses paid by intermediaries", which is then used to retire equity, in a high leverage model.
- The Company focuses on 8% growth in UK OCF, but does not mention the 50% sequential rise in capex; accrued capex was a staggering 38% of sales in 4Q16. While Arete expected a step-up in Lightning build, normal cost/home assumptions do not come close to explaining the £160m sequential increase in accrued capex.
- One-off rebasing benefits seem to consistently outweigh the one-off drags – estimates that Liberty Global has effectively booked \$2.7bn in FCF early via its capex and opex financing efforts. This benefit must unwind at some point.
- Real leverage - if one simply takes 12-month OCF and adjust for Telenet minorities, net debt/OCF would actually be 5.2x – far higher than peers.
- Liberty Global supporters seem to look through the Project Lightning spend at multiples based around "normalised" capex. Arete think this approach is flawed given there is no compelling evidence that the incremental spend is yielding extra growth. Be careful when benchmarking Liberty Global against cable peers using EV/OCF multiple alone - EV/opFCF is preferred, which normalises for differing extents of opex capitalisation.
- The net result is that FY17E stand-alone valuation declines to \$24. But Arete continue to add \$2 to reflect a possible UK/Ire deal with Vodafone, meaning Liberty Global would still be trading at ~15x '19E EV/opFCF – a significant premium to both EU telcos and faster-growing US cable.
- Speculation continues to swirl around a possible VOD approach for Liberty Global. While Arete see the strategic case, they believe that Liberty's premium is too great, and the deal size too great given wide divergences in the company's ratings and different approaches to corporate governance and capital structure. Further Dutch-style tie-ups look more likely, with benefits flowing to both sides, but net net, the absence of a possible top-co premium still looks like a share price negative for Liberty.

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## **2. Bios Research** - Sees a unique short opportunity in the gene therapy space

**IRF Note** – According to Bios, over the past year the market has placed significant value on **Spark Therapeutics** (ONCE) and its gene therapy asset for Hemophilia B, despite growing safety issues, a limited market size, and poor economics related to the program. Bios notes this appreciation has occurred due to the market's fascination with Spark's molecular level FIX expression profile, which has indeed been impressive; however, Bios highlights some key issues below:

- Spark is currently valued at ~\$2B with no approved therapy on the market
- Spark only gets 13% royalty rights from Pfizer for the program. Additionally, Spark's program uses a vector that ~33% of the population has immunity against and therefore cannot be used. In short, ONCE has only 13% economics to 2/3 of the market.
- Spark's therapy has had significant safety issues in the form of immune reactions to its vector despite careful patient screening.
- Spark has significant competition from UniQure (QURE), who has also demonstrated clinically meaningful FIX expression levels, has a better safety profile, is farther ahead in development, and has superior manufacturing capabilities.
- Spark's lead compound in an ultra-orphan disorder of RPE65 will see approval in 2018. However, via clinical trials ONCE has already treated 30 of the 200-400 patient eligible and sell-side has drastically over estimated revenue potential.

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## **3. Customer Growth Partners** - The demise of U.S. teen apparel retailers?

**IRF Note** – CGP has assembled a predictive model for U.S. retailers that identifies traffic, conversion, sales and other trends on a real-time basis. According to this model, the once-vibrant teen sector has taken another leg down this spring, with rampant store overcapacity struggling to downsize to match the plunging demand. Key points include:

- Retail macro environment - retail traffic was anaemic the first half of Q1, slightly better ahead of Easter, then accelerated nicely in late April into May. Mall footfall was down by 8-10%, and even "A" malls saw flat traffic at best. Apparel and department stores were the hardest hit, and even off-price stores such as TJX are softening. The only robust sectors are home improvement, club stores and online.
- Teen sector overview - after many years of expansion, teen apparel has been perhaps the weakest of all apparel sectors over the past year. Bankruptcies have exploded and demand is down MSD from LY as buyer preferences rotate away from apparel and into tech and services.
- Fast fashion impact - retailers such as Forever-21 and H&M have sharply expanded their U.S. store fleets over the past decade, capturing market share from leading teen stores such as AEO and ANF, but are now decelerating as the fast fashion trend has peaked out since 2015.

- Performancewear - although it is still growing, with mainline stores from AEO to KSS all expanding "athleisure" assortments, the performancewear market is also beginning to peak out, and the sector may soon face the same declining productivity that F-21 has seen.
- AEO just had its second sub-par quarter, decelerating from a flat Q4. Beset by anaemic footfall and mostly commodity-type product, AEO saw Q1 conversion rates fall by two points, leading to about a 1% decline in transaction velocity and a similar drop in average ticket. AEO still leads a beleaguered sector, but it may be akin to the best-looking horse in the glue factory.
- ANF plunged again in Q1, continuing a long string of underperformance, only this time with brand Abercrombie's DD drop joined by an LSD decline at Hollister. ANF has been closing U.S. stores left and right, but is now putting the entire company on the block, seeking a rescuer.

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**4. Drewry Maritime Financial Research - Euronav** (EURN US) seen as Unattractive primarily on account of the reduced earnings potential of the fleet and depressed asset values

**IRF Note** – *Drewry believes the surge in newbuilding deliveries this year will be difficult to manage and is expected to take a toll on the earnings potential of tankers and hurt the profitability of ship-owners. Key points include:*

- Weaker earnings – key figures including operating revenue and adjusted EBITDA came in short of Drewry's estimates.
- Weaker outlook - although the demand for tankers is expected to grow (with rising crude consumption and trade) a surge in supply as a result of newbuild arrivals will adversely impact the earnings and profitability of ship-owners. Drewry expects ~80% y/y decline in the company's net income to \$34.3m in 2017 and negative earnings thereafter in 2018-19.
- The effect of the declining earning potential of vessels is reflected in the ~25% y/y fall in second-hand asset prices, as well as an average decline of 13% in newbuilding prices for tankers during the last 12 months indicates a short to medium term negative outlook for the tanker shipping market.
- Believes freight rates will slide further across all vessel categories on major trade routes, which will adversely impact revenue and profitability of ship-owners.
- Sale and leaseback of VLCCs – a defensive move to counter tough times, to ensure the required liquidity at a time when earnings are expected to shrink substantially and the company is likely to incur net losses in 2018-19, which will erode EURN's shareholders equity.
- Last October, the company successfully deferred the delivery of two vessels, Ardeche and Aquitaine, to January 2017 on account of weaker-than-expected 4Q16 and lack of funds to finance the delivery. While expanding the company's fleet capacity by ~5%, Drewry believes the new members of the fleet will only add ~\$16m to EURN's top line in 2017, which is ~55% lower than what two such vessels contributed in 2015
- Fair value estimate is \$6.30 per share.

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**5. Gradient Analytics** - Sell **Straumann Holding AG** (STMN SW), as current valuation premium is unwarranted

**IRF Note** – *Gradient initiates coverage of Straumann Holding AG, a leading provider of tooth-replacement solutions, with a negative outlook and a 20-page report detailing fundamental weakness and several earnings quality concerns. Key points include:*

- Emerging value proposition could cannibalise premium product (90% of 2016 revenue) – value segment represents biggest near term growth opportunity, the concern is the impact it will have on overall margins. High competition in this value area will lead to additional margin compression.
- Inventory growth may portend gross margin pressure – inventory growth has significantly outpaced revenue growth over the last few years. Forward revenue estimates do not appear to indicate forward sales will be adequate to absorb current inventory levels. Additionally, concerning trends in inventory composition and procurement possibly indicates that this trend may not be fully explained by product expansion and growth, as suggested by the company.
- Trade-receivables-to-6M-revenue has climbed to the highest seasonal level in the last five years - growing faster than 6M revenue in seven of the last eight fiscal halves. This increase could have driven Straumann's top-line growth. While the composition of trade receivables has deteriorated, as trade receivables over 120 days past due increased 38% in 2016, causing the company to charge CHF17m to the allowance for doubtful accounts in 2016, more than triple 2015's charge.
- Earnings may come under pressure as a result of possibly larger than expected depreciation expense – a material divergence between depreciation expense, depreciable assets and capital expenditures may indicate that depreciation expense was unsustainably low in 2016.
- Straumann trades at an unwarranted premium to peers - forward P/E is 50.1% above peer median and PEG 21.1%; and historical valuations - current forward P/E is 32.4% above 5-yr average and PEG 69.4%.

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**6. Huber Research Partners** - Short **Sinclair Broadcast Group** (SBGI US) with the company having taken on too much debt leverage for a secularly declining traditional TV broadcasting company

**IRF Note** – *Short Sinclair following the announcement of the deal to acquire Tribune given that this is the large deal Sinclair investors have been hoping for and have been bidding the stock up in anticipation. FCC approval will take several months and likely will not close until 4Q17, and given all the debt taken on for this deal, it is unlikely Sinclair will be doing any more deals until after this one closes and is integrated. Huber's 12-month PT is \$28. Key points include:*

- Sinclair is attempting to get added scale to try to improve its prospects further in negotiations with cable/satellite companies for retransmission revenue and with the

broadcast networks, for network compensation (reverse retrans), extract revenue and cost synergies as well as enhance spectrum footprint for ATSC 3.0.

- The deal does nothing to fix ongoing pressure on TV ratings, pressure on TV advertising (which has gotten worse in H1 '17 - down 0-1% y/y for Sinclair, down for TEGNA, Meredith and E.W. Scripps, etc.), movement of eyeballs and ad dollars to digital, which Huber maintains is too powerful a trend to fix.
- With the 50% UHF discount being put back in place by the FCC, combining the two companies puts them at a 38% market reach vs. the current 39% ownership cap.
- Huber's EBITDA estimates for Tribune were \$433m, \$453.1m, and \$371.3m (2017-19) with 2019 hurt by Tribune starting to pay network compensation on eight FOX stations (vs. paying nothing now). Street consensus EBITDA for Tribune is too high at \$455m, \$528m and \$449m (2017-19).
- On a pro forma basis, Sinclair believes their net-debt-to-average-pro-forma-2016/17 (E) EBITDA ratio will be about 5x and can lower leverage to around 4.0x by the end of 2018. This is too much debt leverage for a secularly declining traditional TV broadcasting company especially when the economy weakens.
- \$28 PT is derived from the average of the following two methodologies: 1) 10-year DCF analysis places fair value at \$28.15 (using a WACC of 10.5%, a long-term FCF growth rate of 2.0% and a terminal FCF multiple of 11.7x, or an implied terminal EBITDA multiple of 7.2x); 2) a target multiple of 7.50x average estimated 2017/18 EBITDA (which works out to 12.7x estimated 2017/18 average EPS and 7.0x FCF).

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**7. J Capital Research** - Significantly lowers PT on electronics and furniture retailer, **Harvey Norman Holdings** (HVN AU) to reflect expectations the company will be forced to close persistently underperforming retail locations

**IRF Note** - *J Capital's initial Short thesis argued that Harvey Norman overstated revenue and manipulated their financial statements. Having recently updated their thesis, J Capital has now lowered their PT to AUD 2.11 (from AUD 2.91). Key points include:*

- J Capital previously demonstrated that HVN is overstating revenue by approx. AUD 150m each year and hiding it as growing receivables and overstated capex. This overstatement has been focused on keeping failed retail outlets alive that can be harvested for cash racking up debts to HVN they will never repay.
- Most of the 100 franchisees that close each year are concentrated in 40 retail outlets, predominantly operating in properties owned by HVN (the worst 10 locations with the greatest number of failed franchisees are all owned by HVN).
- Closing those outlets would halve the dividend - revenue would fall AUD 160m and cash flow would be AUD 117m less.
- Property write downs of over AUD 300m - the value of HVN properties at these 40 retail locations is approx. AUD 500m. Most are in regional Queensland and Western Australia and would struggle to find an anchor tenant to replace HVN.
- Unit trusts of failed franchisees harvested for tax losses and inventory - HVN takes control of the unit trusts associated with the failed franchisee in order to take possession of the inventory for resale and, most importantly, to utilise the tax losses of the franchisee. J Capital estimates that HVN can obtain a benefit of approx. AUD 200,000 per failed franchisee by utilising the tax loss and selling the inventory.

- Regulator investigation confirmed - it is now clear that ASIC has escalated its routine review of HVN accounts to an investigation.
- PT therefore lowered to reflect expectations of up to 40 retail locations being closed when HVN is forced into consolidating franchisee.

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**8. JL Warren Capital** - Short **BYD Auto** (1211 HK) on weakening fundamentals and questionable strategy

**IRF Note** – *The following is taken from JL Warren’s thesis on the Chinese automobile manufacturer, BYD Auto. They see considerable downside (~40%) from the current share price. Key points include:*

- 2017 net profit will slump 30% y/y and the decline is likely to continue in 2018 and beyond. The failure of BYD’s B2C (electric vehicle segment), and consequent B2B (electric business) forces the management to reinvent its business model as a B2G (business to government). However, the monorail is not nor will be profitable in the foreseeable future. Despite the market chatter of contract wins, JL Warren have only confirmed two contracts (Shenzhen and Shantou) that are revenue generating in 2017.
- Collapsing PNL - 1Q17 earnings declined 29% y/y. The company guided net profit down 15-30% in 2Q. This weakness is due to the EV sales margin collapse as government subsidies dropped.
- Rising debt, receivables and deepening negative cash flow – this is due to a ballooning Capex which is funded by debt and frequent equity offerings. Meanwhile, the outstanding number of days of receivables lengthened to all time high, due to rising revenues coming from government affiliated entities.
- Balance Sheet concerns - the sale/margin of electric buses will decline as the government has decided to cut subsidies gradually to zero by 2020 and the addressable market for electric buses is nearly saturated.
- Monorail – last year, the company decided to shift its focus towards building a “sky-rail” and selling it to local governments. But limited adoption proves that the disadvantages (e.g. high costs) thus far outweigh its advantages in commercial adoption. As such, the margins, both for construction and for maintenance, are in teens at best - much lower than BYD’s subsidised PV (25%) and buses (40%).
- Questionable strategy - as the company shifts its revenue sources, its business gets lumpy, unpredictable and less profitable. This increases dependence on the health and strength of the local governments’ balance sheet, which is extremely stressed by China’s ballooning debt.
- SOTP valuation methodology – Price/Share of the four segments below gives a PT of HKD 24.6 (0.3+14.3+5.3+4.7). Auto ICE - P/E: 50% discount to comps; Auto NEV – P/S: 50% discount to TSLA; Electronics - P/B: same as BYD Electronics (285 HK) and Battery – P/S: average of comps.

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**9. Mithra Forensic Research** - Short **BTG** (BTG LN) as the company will be forced to record substantial impairments to a critical asset

**IRF Note** – *Melvin Glapion, founder of Mithra Forensic Research, believes BTG, a pharmaceutical company, specialising in antivenoms, oncology drugs and treatments for varicose veins, which just reported full year results that missed expectations, will have to record significant impairments to a key asset, Crofab, a treatment for snakebites. This follows a settlement and subsequent new licensing agreement with a competitor; the target price is 364p. Key points include:*

- Crofab accounts for 15% of BTG's total revenues and 28.5% of the company's total contribution.
- In 2013, Instituto Bioclon applied to launch its own snakebite antivenom in the US. Throughout 2013-14, BTG failed to disclose key facts or limited disclosure regarding the threat that Bioclon's drug, Anavip, would be approved; probably to prevent discussions around potential impairment charges to Crofab.
- Following a lawsuit filed by BTG alleging that Bioclon had infringed upon its US patent and were illegally importing and selling Anavip in the US, they agreed a settlement at the end of 2014.
- The licensing agreement between the two companies will lead to significant declines in BTG's revenues generated from Crofab. Anavip is significantly cheaper at \$5,500 per individual vs. \$23,700 for Crofab and many medical experts believe it is far more effective. Crofab recorded flat/declining revenue growth from 2013-15, suggesting Anavip was impacting sales.
- Since 2014, the Specialty segment to which Crofab belongs, has improved its contribution margin by 1,210 basis points. BTG claims that cost efficiencies and mix account for the improvement, but Mithra suspect that costs may have been reallocated in order to show higher cash flow margins, resulting in less likelihood of any impairment charges.
- BTG will need to begin recording impairments in either its FY2017 or FY 2018 results of at least ~£22m or 18% of FY2017e.

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**10. Off Wall Street Consulting** - Sell **Zoetis Inc.** (ZTS US), the world's largest producer of medicine and vaccinations for pets and livestock due to new generic competition, with revenue and margins set to miss analyst's expectations

**IRF Note** – *Zoetis beat consensus on both revenue and EPS in 1Q. However, core product sales declined, and Off Wall Street (OWS) expects the incremental revenue from Apoquel, Cytospor and Simparica will not be as significant in future quarters, thereby exposing this deterioration in core US companion animal sales. OWS also believes gross margin missing expectations, was due to selling of discontinued products at a discount (which would have inflated top line growth). Key points include:*

- Biggest difference between the "street" and OWS estimates is in companion segment – bulls expect growth of 11% y/y in 2017 and 12% in 2018, vs. OWS estimates of just 5% (2017) and 1% (2018).

- Revenue to be impacted as two important products see new generic competition and more patents are due to expire over the next couple of years.
- Sales of Apoquel to miss expectations – bulls had been hoping for \$400m in worldwide sales by 2018, but now Zoetis is guiding to a much slower ramp. OWS thinks the product is reaching peak sales in the US and the roll-out in other major markets is also nearly complete.
- OWS do not see new products adding the expected amount of sales due to more effective products already available.
- They also argue that Government efforts and consumer preference for reducing use of livestock antibiotics, will impact livestock revenue.
- Bulls argue that the significant improvement in margins seen over the last few years will continue. But OWS says this was due to an activist investor, who now no longer holds shares in Zoetis.
- OWS thinks the continued aggressive cuts to SG&A are unlikely, they slowed in previous quarters, and lower than expected growth of the high margin companion animal pharmaceuticals already mentioned will impact margins.
- Trading well above human pharmaceutical peers; OWS applies a multiple of 15x their 2018 EPS estimate and have a PT of \$35.

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**11. Summit Redstone Partners** - Sell **Nutanix** (NTNX US) due to increasing competition and expectations that growth will continue to slow

**IRF Note** – *The share price has already fallen over 50% since SRP initially recommended selling Nutanix. However, they continue to see further downside, due to increasing competition and expectations that growth will continue to slow. Additionally, despite the rumours, SRP do not see any natural buyers of Nutanix at this time. Following the lockup expiration in March, more shares are available making it easier to short. Key points include:*

- With Nutanix pushing AHV (Acropolis Hyper Visor) to displace VMware Hypervisor, it is just a matter of time before Dell stops selling their products through its channels.
- Increasing competition - Cisco is not happy with some of its channel partners selling Nutanix software on its UCS platform and SRP expects Cisco will use its leverage to effectively block its channel partners from selling Nutanix software over the next few quarters.
- Therefore Nutanix will be under increasing pressure to develop its own channels as well as its direct sales force to effectively compete against a large incumbent OEMs. This investment will take time, which will further impact margins.
- Following the acquisition of Simplivity by HPE, SRP believes the large server vendors no longer have a need for Nutanix. An acquisition from one of the big vendors (HPE, Cisco, Dell) is unlikely. If someone were to eventually acquire Nutanix, SRP expects the stock price would have to be much lower than current levels, possibly in single digits, before a 25-30% premium was applied (i.e. topping 2.5x EV/sales will be hard).
- Growth will continue to slow, driven by pricing pressure and bundling by large OEMs - disappointing guidance attributed the recent revenue guidance short fall to changes made to sales leadership. SRP believes there is more to it than this; the promoted leaders could still have closed the deals they were working on before transitioning to new roles.

- Nutanix is still trading at a premium to Pure Storage, and SRP expects the trading multiple to converge (NTNX is trading at 2.3x on EV/Sales versus PSTG of 1.8x). A 1.8x multiple translates to approx. \$14 (SRP's PT).
- In terms of the upcoming quarter results - expect Nutanix to put up a good quarter when it reports on 25th and the stock to pop given short covering. But this will likely prove temporary as the shares are then expected to fall.

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**12. Two Rivers Analytics** - Sell **DexCom Inc.** (DXCM US), the company is overvalued considering slowing growth, impending new competition and negative margins

**IRF Note** – *The stock has fallen over 20% (while the S&P has risen 11%) since Eric Fernandez, founder of Two Rivers Analytics, first recommended Shorting DexCom in an extensive 26-page report last year. They argued that the company, which develops, manufactures and sells continuous glucose monitoring (CGM) devices, was wildly expensive considering slowing growth, impending new competition and negative margins. With the company having recently missed expectations for the quarter, Two Rivers believes investors should continue selling the stock. Key points include:*

- Increasing competition - high market share in CGM leaves DexCom exposed to new product introductions by Medtronic, Abbott and Roche. They have been lowering prices in order to compete successfully, which highlights patients are both price sensitive and willing to switch.
- Type 2 diabetes (T2) isn't the opportunity DexCom bulls think it is – non-CGM remedies prevail in T2 (pills, exercise and weight loss). The discomfort and hassle of CGM and pumps are such that only 18% of T1s use CGM and only 30% use a pump. DexCom's model isn't scalable. Any T2 ramp would still require negative operating leverage and perhaps even a new sales and distribution model.
- Other technologies that could leapfrog DexCom's CGM - longer-lived sensors, very long lived implantable sensors, and non-invasive approaches, which do not require skin piercing, are also in development.
- As sensors get better (last longer) customers need to buy fewer of them - annual revenue per user will decline.
- Negative margins are troublesome - gross margins are too high (due to high market share) yet their EBITDA margins are negative even at a multi-hundred million sales run rate.
- They suffer from the widespread epidemic of high stock-based compensation - SBC is absorbing more than 100% of available pre-comp earnings. Insiders are selling and the shareholder base is all institutional and highly concentrated. A reassessment could cause a sudden exodus in the stock.
- Latest quarter - growth is still slowing sharply despite the company's CMS approval. Y/Y growth is now just 22%, down from over 50% last year. DexCom's hardware mix is shifting to the mobile transmitter, with negative gross profit effects.

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