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An Introduction to Cornerstone FS

One of my top picks for the next four months is ***Cornerstone FS (13.25p, £7.6m)***, a provider of payment solutions and foreign exchange services to small and medium-sized enterprises and to high net worth individuals. Although the shares are up 121% since the start of 2023 already, I think the Company is still flying under the radar of most investors. I consider fair value for the shares to be around the 25-30p mark, and I'm optimistic we see this range achieved before end January 2024.

Before I kick off: with a market capitalisation of only £7.6m, Cornerstone is what I consider a *nano-cap* stock (those LSE companies with a valuation of sub £10m). I intend to write on the subject at a later date on this channel; but for now, it's enough to say that investing in nano-caps is an exceptionally risky business for a whole host of reasons, regardless of sector. Do bear in mind, before reading on!

So: Cornerstone. Let's start at the beginning, and very briefly run through the corporate and operational history. This will enable readers to understand why the Company is positioned as it is; why its market capitalisation is a paltry £7m; and ultimately, why an appealing investment opportunity currently exists.

In late 2020, the then privately held Cornerstone ditched its legacy consumer products business, and made a fresh start in a new sector: payment solutions. Firstly, it acquired FXPress, a London-based provider of FX payment and currency risk management services. FXPRess had developed in-house a cloud-based multi-currency, customer account general ledger system, named FXPal. Cornerstone also acquired Avila, a company with a small electronic money institution licence focused on multi-currency e-wallets. This second acquisition enabled Cornerstone to allow clients to leave funds on deposit, effectively providing them with a multi-currency current account.

The enlarged Group then listed on AIM in April 2021, raising £2.2m cash at a share price of 61p, giving Cornerstone a market capitalisation of £12.4m. The strategy was to use the listing to supercharge growth via further acquisitions.

In August 2021, Cornerstone poached a team from a partner (/competitor!) company, Vorto Trading, to establish an Asia desk that would primarily focus on firms supporting Asia-based HNWs acquiring real estate in the UK. Performance-based shares was a component of the incentivisation package.

In September 2021, a second team from Vorto was hired, to open an office in Dubai and expand Cornerstone's operations into the APAC region and the Middle East. The team was led by Robert O'Brien, formerly Vorto's highest revenue generator. The incentivisation for O'Brien and his three senior team members was based on a two-year, performance-based earn-out. So impressive was the team's contribution in its first year that in August 2022, Cornerstone settled the earn-out early by issuing new shares to O'Brien, such that he is now the Company's largest shareholder with a 16.4% stake. O'Brien was also issued a £2m loan note, that is due to be repaid to him in H2 2026.

Cornerstone continued on its acquisition spree, buying Capital Currencies in January 2022 for up to £3.0m – with £0.6m cash paid upfront, and up to £2.4m to be paid out (depending on performance) in a possible combination of cash and shares across 2024 and 2025. To fund the acquisition, Cornerstone also raised £0.85m cash via a secondary placing at a price of 26.5p. Founded in 2004 and located in Tunbridge Wells, Capital Currencies focusses primarily on larger UK SMEs. As I explain below, it was a particularly good fit for Cornerstone's then midway pivot in operational strategy: over 90% of Capital Currencies' revenue is generated by clients that it services directly.

Cornerstone made its sixth acquisition / team hire with the purchase of Pangea FX in September 2022, for up to £200k (only £25k paid upfront; the remaining £175k subject to future performance over two years). Pangea FX is a specialist FX and treasury consultancy, founded by two Vorto Trading alumni.

With the Pangea acquisition completed, M&A has been put on hold over the past year. The Company has rationalised operations, by moving personnel and clients over to its main subsidiary, and selling surplus subsidiaries with valuable licences to recoup cash; and is focussing on driving organic growth from the foundations built between September 2020 and September 2022.

The Group now has a distinctive corporate identity and clear business strategy. At the core of its offering is the Cornerstone platform (previously FXPal), a proprietary cloud-based multi-currency payments platform. It provides customers with a multi-currency IBAN, which permits them to make and receive payments in – at last count – 58 currencies, in over 150 countries. Cornerstone doesn't try to compete with the mainstream players in the crowded and intensely competitive world of international payments. Rather, it focuses on offering premium services to SMEs and HNWs making high value transactions, such as property purchases or business acquisitions / investments.

At the time of IPO, it operated a B2B model, white labelling the Cornerstone platform to other FX providers who did not have their own trading platforms. White labelling (and introducer fees) accounted for 88% of Group revenue in 2020, with the balance of revenue coming from Cornerstone providing services to its own book of clients directly. The white labelling strategy enabled the Group to grow without significant investment in sales and direct marketing to SMEs and HNWs.

However, the gross margin wasn't particularly appealing: in 2020, it stood at 29.8%. In H2 2021, Cornerstone began focusing on servicing more customers directly (which yields a substantially higher margin) and building out that customer base, whilst simultaneously winding down contracts with white label partners. The efforts have yielded fantastic results: in H1 2023, revenues from direct clients accounted for 91% of total revenues, with white labelling / introducer fees accounting for the remaining 9%. Consequently, gross margin in H1 2023 came in 60.9%, where it has stabilised.

Even more impressive is Cornerstone's revenue growth since its late 2020 rebirth. The four acquisitions in 2021-22, focussed on building out the Group's direct sales capabilities, have more than paid off. In FY 2020, the year before its IPO, revenues were £1.7m; by FY 2022, revenues had increased by 190%, to £4.8m. Transacted payments for clients totalled £584m last year, up 61% year-on-year.

Sales growth has not let up this year: H1 2023 revenues came in at £3.6m (and that *excludes* £184k of income generated from interest on client cash balances, which clients are unable to collect under the terms of the Group's Electronic Money Licence, and thus becomes a revenue stream for Cornerstone). Since H1 2021 (the period in which the Company listed on AIM and recorded sales of £0.84m), revenues have surged at a compound *six-monthly* growth rate of 55%.

H1 2023 proved a tipping point for Cornerstone. It was the Company's first period of generating a positive EBITDA, a positive net profit and a positive operating cash flow. Whilst all very modest figures (£191k, £35k and £114k respectively), they signify that Cornerstone has now become self-sustainable, and will not require the support of any further external funding.

With what evidently appears to be incredibly positive progress – both operationally and financially – in its first 30 months since listing at 61p, I think many would expect Cornerstone's share price to be sitting near to all-time highs. On the contrary, at the beginning of July last year, the share price hit a low of around 6p – a drop of 90% since its IPO only 15 months previously. The share price remained in a relatively tight range from 6p to 8p for 11 months, until end of May this year. Why?!

On 30 June last year, the Company published its annual results for 2021. It revealed cash outflows of £1.4m, and an admittance by management that Cornerstone required external funding to remain afloat. Sure enough, in August 2022, the Company raised £1.1m cash via a share placing at 6.5p. Bear in mind that investors at IPO had put in cash at a price of 61p, only a year previously; and investors had stumped up a further £0.85m at 26.5p, as recently as January 2022… And one can understand why the investment community lost all faith in the business, despite the excellent operational progress. Unsurprisingly, in a six-month period between May and October last year, 5 out of the 7 person board of directors, who led Cornerstone at the time of the IPO, resigned – including the CEO and Chairman.

Now, this brings me to reasons for *why* I consider Cornerstone to represent excellent value today. In tandem with the 6.5p rescue fundraise last August, the Company appointed a new CEO, James Hickman, who has extensive experience within the payments industry, notably five years as Chief Commercial Officer at Cornerstone's much larger and more established AIM-listed peer, ***Equals Group (EQLS.L, 118p, £219m).*** Two new impressive non-executive directors were also hired in the subsequent few months. The team quickly raised a further £0.35m at 8p to strengthen the balance sheet; supplemented by a further £0.45m through disposals of two non-core subsidiaries this year.

Moreover, the new team has been able to actually slightly *reduce* operating costs, whilst still increasing revenues. In H2 2022 – the financial half-year in which the new CEO and Chairman were appointed – operating costs were £2.1m; in H1 2023, they had decreased by 4%, to £2.0m. Sales, meanwhile, increased by 23% over the same period.

And here we land at the crux of the trade. The Company's turnaround and speed of revenue growth have been *much* faster than the forecasts of analysts covering the stock predict. If we see at least 20% revenue growth in the current H2 over H1, Cornerstone will be booking total sales for FY 2023 of around £8m. Assuming gross margin and operating costs remain stable in H2 at 60% and £2m respectively, that would result in a full-year EBITDA of circa £0.8m.

But for *next* year, if we assume just a 35% increase in sales, coupled with a 15% increase in operating costs, we could see EBITDA jump to around £1.9m. Against Cornerstone's current enterprise value of £9.0m, that would put the Company on a very modest EV/EBITDA ratio of 4.7x. My belief is that this is *far too cheap*. I think fair value currently sits around 25p to 30p – taking into account the valuation of its peer group, notably Equals Group, coupled with Cornerstone's superior topline growth rate.

Whilst the single analyst that has put forecasts out into the market, has stated that 2023 full-year numbers will come in *significantly ahead* of her forecasts (as has Cornerstone itself!), she has chosen not to upgrade her numbers on the back of the interim results. She has EBITDA of only £0.1m for 2023, increasing to £1.1m next year. Whilst this may seem bizarre to readers, I imagine that having already enjoyed a forecast upgrade in April 2023, the Company is content to now simply obliterate those once-upgraded numbers in the market, rather than matching a twice-upgraded set of forecasts. Understand: it'll look better, at year end, to those who haven't been following the story closely (i.e. the vast majority)! Optics are key in the world of nano- and micro-caps.

So there you have it. The short-term trade opportunity at Cornerstone is primarily based on analysts' guidance falling well short of reality, coupled with a hangover in the market following an abysmal share price performance in the first two years after IPO. In my opening line, I specifically mentioned *four* months as the trade opportunity. In mid-January, we get a full year trading update for 2023, which will prove or disprove my trade rationale. In the meantime, we should have the new broker, Shore Capital, publishing its initiation note (my hope is the analyst there puts out more realistic 2023 and 2024 forecasts); the launch of a (debit?) card for Cornerstone's customers; and hopefully a Q3 trading update next month, confirming rapid topline growth has been maintained.

Disclosure

The author of this paper, Myles McNulty, is a private investor. He and his family hold ordinary shares in Cornerstone FS.

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