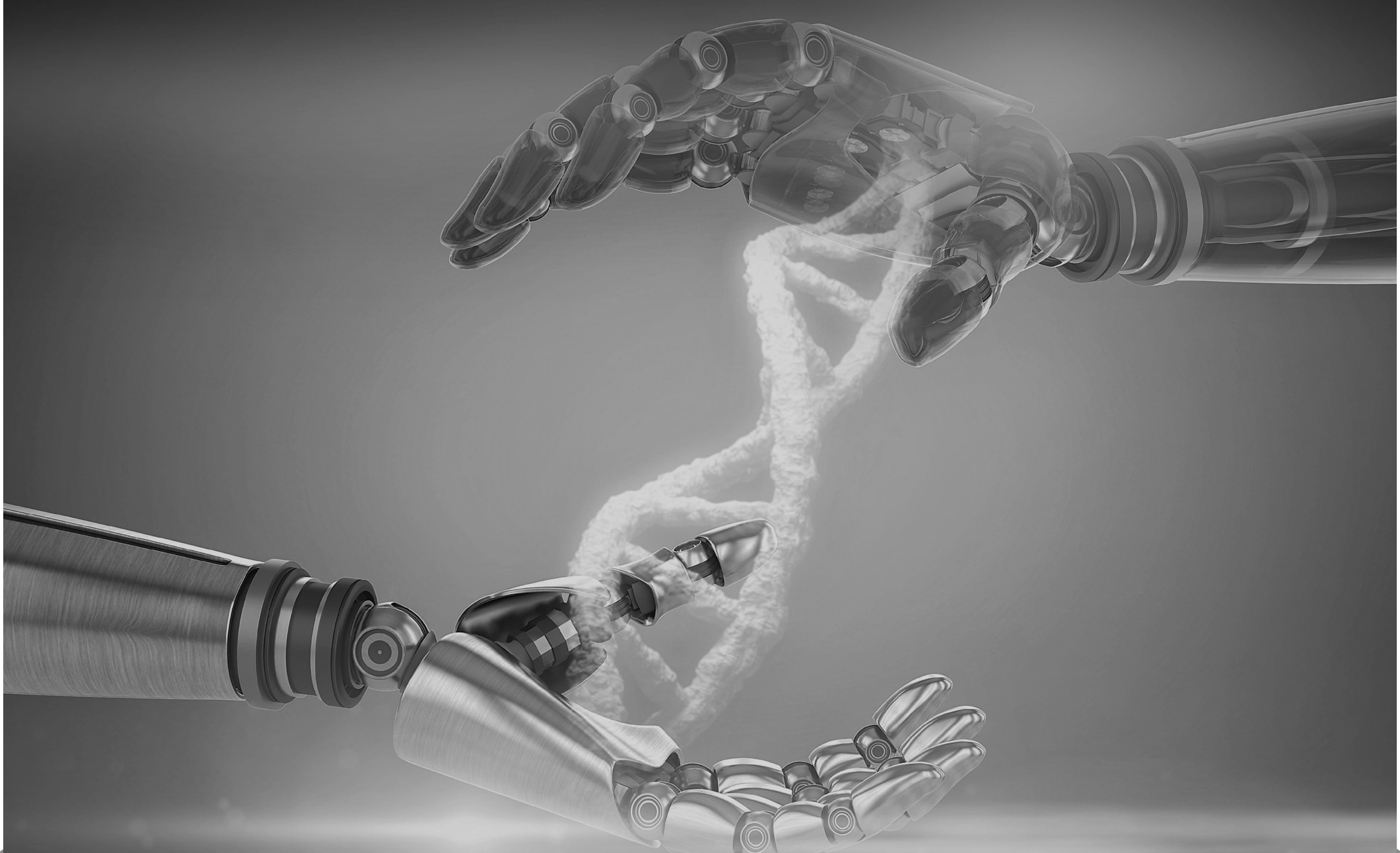
STOCKS DOWN UNDER

22 DECEMBER 2020

Emerging Stocks Down Under

I do not fear computers. I fear a lack of them.

- Isaac Asimov (1920 - 1992), Professor of biochemistry



CANN GROUP
Wait until 2022

PROTEOMICS INTERNATIONAL
J&J's new best friend

SENETAS CORPORATION
Encrypt your portfolio

CANN GROUP

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Stocks Down Under rating: ★★

ASX: CAN
Market cap: A$ 136M

52-week range: A$0.29 / A$1.835
Share price: A$ 0.495

2020 has not been kind to the shareholders of the medicinal cannabis company Cann Group. On 20 January this stock was changing hands at $1.68 a share, whereas by 2 November it was down to 30 cents. Medicinal cannabis has been out of favour and this company is taking a bit longer to execute on its business plan. Therefore, we feel it is a two star story for now.

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ASX: PIQ
Market cap: A$ 77.6M

52-week range: A$0.195 / A$0.835
Share price: A$ 0.82

Imagine a diagnostic that could predict the onset of disease four years in advance. That's what the Perth-based Life Sciences company Proteomics International has created with its PromarkerD test for diabetic kidney disease. That test is now being taken to the world and even has the mighty J&J interested, but there are other innovative diagnostics lined up behind Proteomics' foundation product. Proteomics stock has had a good 2020 thanks largely to PromarkerD, but we think there's more where that came from.

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52-week range: A$0.038 / A$0.079
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Share price chart

Source: Tradingview

When Cann Group went public on the ASX in 2017 the market liked what it saw. The IPO at 30 cents went off with a bang and by the start of 2018 the stock had made it to around the $4.00 level. Since then Cann Group has generally only moved downwards apart from an occasional rally like the one we saw a year ago.

Mildura is now funded

So what's gone wrong with Cann Group? Well, nothing much. The aim of the game for Cann has always been to build a vertically integrated business-to-business company supplying medicinal cannabis to domestic and global customers. There were some COVID-19 related disruptions – and what business hasn't been knocked around by this pandemic? – but by and large Cann has executed well on that strategy. In FY21 the company expects to enjoy A$15m in revenue and from there it wants to scale up as a quality supplier of GMP-certified cannabis medicine that can be sold in all major markets. However, $4.00 a share was just too high a price not to attract selling interest after such a rewarding market debut.

At the moment Cann Group is working hard on getting its cultivation facility at Mildura in northwestern Victoria up and running. The facility was granted the relevant Office of Drug Control licenses from Australia's Federal Department of Health last month. To fund the Mildura project, Cann raised $40m in a placement and SPP at 40 cents per share in July 2020 and has borrowed $50m from the National Australia Bank. However, things have moved slowly on that front. It took until late November before that bank actually said yes to the debt facility.

A scaled back vision

A big reason as to why Cann Group has been out of favour in 2020 has been the change in plans for Mildura. At the start of the year Cann looked at the global market for medicinal cannabis and decided the market was in oversupply. Cann's major shareholder, the Canadian cannabis pioneer Aurora Cannabis (TSX: ACB), felt the same way. It told Cann it wouldn't help fund the Mildura facility. Cann took the view that there's still an opportunity, but scaled back Mildura so that it would only produce 12,500kg of dry cannabis flower a year at the first stage. Stage 2 would see Mildura scale up to 25,000 kg. But that was still a long way from the 70,000 kg that had originally been on the table. Aurora had been Cann Group's largest shareholder, but it sold its stake in October.

One reason why Cann Group is well placed for the medium term, is that it already has global customers in places like the UK and Germany for the products it distributes. And the outlook for medicinal cannabis is good just about everywhere, because it has become legal in most places and the US is widely regarded as next should the incoming Biden Administration be able to obtain the necessary Federal legislation that would augment what's already in place in many states. In Australia there has been a rush of patients looking to access the Special Access Scheme in recent months, making for a robust domestic market. Out feedback is that the supply/demand balance for medicinal cannabis products is starting to rectify itself.

Wait a while on this one

Cann Group, however, probably won't be able to capitalise on the good times for the sector for another year or so. The construction teams won't be mobilised until early next year and the facility isn't expected to be commissioned until November 2021. That in turn means that it will be around March 2022 before the first product is on its way to customers.

We think 2021 will probably be a base-building year for Cann Group stock. 2022 could be a good time to come and take another look. We're reminded of Philip Fisher's old axiom from Common Stocks and Uncommon Profits regarding when to buy a growth stock: Wait until the plant is being commissioned but don't buy until the company has gotten through the 'teething problems'. There will probably be such teething problems for Cann in 2022, but we expect the company to ultimately work through them at which point the Mildura plant can go on to bigger and better things.

That, however, is for 2022. In late 2020 and moving into 2021, this story is a two star one because we think the market is still disappointed at how the earlier plans had seemed to vaporise like a puff of weed. Keep it on your watch list, though.

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Source: Tradingview

Back in 2000, when the Human Genome was finally sequenced, there was a lot of talk about how genomics, that is, the large-scale study of genes, would change the world. We would finally know where all the mutations in our DNA that caused diseases were located and could design drugs accordingly. A few wise heads in science and the biotech industry begged to differ, arguing that a new discipline called proteomics, that is, the large-scale study of proteins, was more important. The thing about genes is that they code for proteins, and it is proteins, not genes, that drugs interact with. This means the really big money would be made in proteomics.

From startup to first approved product in just 18 years

20 years later the somewhat grandly named Proteomics International is now showing the importance of proteomics to modern medicine. Proteomics, the company, originated in 2001 as a protein analytics laboratory based in Perth and serviced mostly international drug makers. That kind of operation kept the lights on for this entrepreneurial company for a long time. The company still does proteomics services and the lab in Perth is ISO-accredited. However, Proteomics wasn't content to remain just a fee-for-service company.

The late Dr. Bill Parker and his co-founder and current CEO Dr. Richard Lipscombe had ideas about how to identify proteins that would be 'biomarkers' of disease, and those ideas evolved into a technology called 'Promarker'. By the time Proteomics International went public on ASX in 2015 the first product from Promarker was in development, a diagnostic for diabetic kidney disease, which Proteomics later started calling PromarkerD. That product gained its CE Mark, approving it for use in the EU in November 2019. The company is now rolling it out in Europe and other jurisdictions. Recently, for example, the company secured distributors for Italy (October 2020) and Israel (November 2020).

A novel diagnostic with high clinical utility

PromarkerD is an important step forward for doctors managing their diabetic patients because in about one-third of cases those patients will gradually lose kidney function. The patients themselves tend to be unaware they have kidney disease, but if the doctors become aware there are drugs they can prescribe, such as irbesartan, the old blood pressure drug which may slow or halt the decline somewhat, and a newer drug called Invokana.

If they don't, the result is the dreaded ESRD – end-stage renal disease – and expensive dialysis treatment. The usual conventional tests for assessing kidney function don't really work in predicting the progression of chronic kidney disease. PromarkerD does, however. Indeed, it can accurately predict it four years ahead of a conventional diagnosis.

Proteomics has the published papers to prove that assertion, including one important one in the Journal of Clinical Medicine that hit the streets in October 2020. We probably don't need to remind you that diabetes and its co-morbidities are a major, multi-billion dollar market opportunity with high prevalence just about everywhere. In the US alone over 10% of the population now has diabetes.

J&J is checking this one out

The Journal of Clinical Medicine paper, which reports data previously presented at the American Diabetes Association's Annual Meeting in June, is significant because it concerns a study conducted with the help of Janssen, a unit of the major American pharma company Johnson & Johnson. In April 2019 J&J had published data showing that its Invokana drug, FDA approved in diabetes since March 2013, could stall progression of chronic kidney disease and fend off cardiovascular problems as well. Invokana, generic name canagliflozin, is one of a relatively new class of diabetes drug called the SGLT2 inhibitors that work by pushing glucose into the urine. Its use in chronic kidney disease was FDA approved in September 2019.

In effect, PromarkerD could become a complementary diagnostic for drugs like Invokana/canagliflozin and Proteomics is now going after the relevant reimbursement code to allow doctors to easily use PromarkerD in the light of the fact that the drug is available for patients.

J&J logged US$735m in worldwide revenue for Invokana in calendar 2019. In March 2020 the Janssen collaboration with Proteomics moved to 'Stage 2' where the complementary diagnostic angle for Invokana will be explored. If the world's sixth largest pharmaceutical company, with US$40bn in prescription drug sales, likes PromarkerD, the upside for Proteomics International is likely to be significant.

Proteomics International's achievements with PromarkerD have been remarkable, but we believe there is more to come for this company in 2021. There are now Promarker diagnostics in early development for a range of conditions, including endometriosis and Covid-19, and the company believes it has one of the first good diagnostics for oxidative stress. The first revenues from PromarkerD should be coming soon as is a filing for FDA approval of PromarkerD.

Should PromarkerD make it through Stage 2 with Janssen, a lot of people from other pharma companies are likely to sit up and take notice of the Proteomics International story. This one gets four stars from us.

SENETAS CORPORATION

Encrypt your portfolio

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Source: Tradingview

Cyber security is now required

As the initial shock of COVID-19 cyberattacks wears off many governments are waking up to the vulnerable state of their most critical industries to cyber attacks. The Australian government has been one of the first to take significant action with the Australian Prudential Regulation Authority (APRA) announcing on 26 November 2020 that it has ordered priority one cyber security audits to be conducted and red hat hacker teams be utilised to test all banks, insurers and super funds' cyber protection protocols. Failure to meet the new standards will be met with harsh and strict enforcement action.

APRA has also extended its authority to cover third-party IT suppliers, fund managers and payment companies as it seeks to harden the Australian financial system against cyber attacks. APRA is not the only government body stepping up with the federal government proposing that the Australian Signals Directorate (ASD) be given the authority to take over a company's response to a cyber attack if they believe the company is unable to defend itself. Additionally, it was proposed to expand the definition of critical infrastructure to include food and grocery, healthcare and higher education.

Taking apart the technology

Senetas has five main product lines: CN Series, CV Series, SureDrop, Votiro Disarmer and the CM7 Network Encryption Manager. These products provide organisations with different solutions to better defend its data from being compromised or stolen by hostile, outside actors.

The CN Series has three different hardware variations that focus on encrypting an organisation's network and IT infrastructure directly through its interenet connection. These variations provide ethernet network encryption at rates of 100GBs, 1-10GBs, and 1GB per second.

The CV Series was created to offer organisations network and cloud encryption by funnelling its traffic through a guest virtual machine providing data protection and end-to-end encryption at up to 5GBs per second. A guest virtual machine operates as a separate operating system on top of an existing computer network. While there are many uses for this type of system, the CV Series utalises it to act as a barrier for data before it leaves the network and before it enteres it.

SureDrop provides organisations with AES256, end-to-end encrypted, cloud data storage. The application is fully compatible with Microsoft Outlook and Office 365. SureDrop is also fully compatible with the company's Votiro Disarmer product.

Votiro Disarmer is a patent protected content disarm and reconstruction technology. The technology forensically reviews each file by breaking it down into its individual components before rebuilding it and in the process removing any security risks.

Lastly, the CM7 Network Encryption Manager allows for real-time monitoring, configuration and certification of Senetas' CN Series. This device works on both Windows and Linux operating systems.

In a market announcement on 21 December 2020, Senetas reported that it had developed a "high assurance quantum resistant network encryption solution." Quantum computers are considered to be the greatest cyber security threat of the next few decades and if this product receives government certification it would be a massive win for the company. However, few specific details about this solution have been released by the company and due to the emerging nature of quantum encryption, and quantum computing for that matter, we remain a bit skeptical about the promise of this new product for now.

The revenue breakdown

Senetas earns revenue through its three main divisions: equipment and software, product maintenance and services. The company operates in the Asia Pacific (17% of revenues), the United Sates (56%) and Europe (27%).

The initial sale of Senetas' CN Series, CV Series, Votiro Disarmer and CM7 Network Encryption Manager is recorded under equipment and software revenue. Unsurprisingly, revenue from this division declined 22% during FY20 as companies reduced capital expenditures on the back of COVID-19 disruptions. However, three major windfalls for this division have already been announced during FY21. The first was a major supplier agreement being reached with Verizon Australia to distribute the company's encryptor products under its managed security offerings for government and business customers. The second was the Australian government added Senetas' products to its Evaluated Products List for cybersecurity. Lastly, it was announced that an undisclosed Middle Eastern government agency purchased US$2m worth of Sentas' CN9000 hardware.

The product maintenance division saw revenue grow 27% to $11m during FY20. We expect this division's growth to follow the equipment and software sales division on a delayed basis. Our reasoning here is simple, the greater number of products sold, the greater the demand for equipment maintenance. Additionally, during macro-based slowdowns like COVID-19, we believe this division would see minor revenue disruptions at worst. Systems will always require upkeep as shown by Senetas' one-year backlog in maintenance revenue from 30 June 2020 growing 35% to $8.4m.

Service revenue saw a sharp increase of 146% during FY20 to $1.8m after the company secured a partnership with AUCloud to use the company's SureDrop technology. With the increased focus on cyber security around the world we believe this division is likely to see a boost. However, the company has issued no outlook projections and, therefore, we are less clear as to how this division will perform during FY21 than Senetas' sales and maintenance divisions.

Encrypt your portfolio

Sentas is not profitable just yet, but we believe this company is primed to take full advantage of the renewed focus on cyber security following the rash of COVID-19 cyber attacks. The company and the market have not currently issued projections for FY21's revenue. However, we believe the company's inclusion in the Australian government's Evaluated Products, Verizon Australia partnership and the global focus on cyber security leads us to believe Senetas returning to its pre-COVID-19, FY19, revenue growth of 12.4% would be a high conservative estimation. Despite the conservative nature of this estimation, this would still present a FY21 EV/Revenue ratio of just 1.8x. Based on both the macro tailwinds for the cyber security sector and what we believe is a low FY21 EV/Revenue valuation, we are rating this stock four stars.

Pitt Street Research Pty Ltd

95 Pitt Street, Sydney, NSW 2000, Australia

Pitt Street Research Pty Ltd is founded on more than 40 years of combined experience researching companies in a range of different sectors.

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