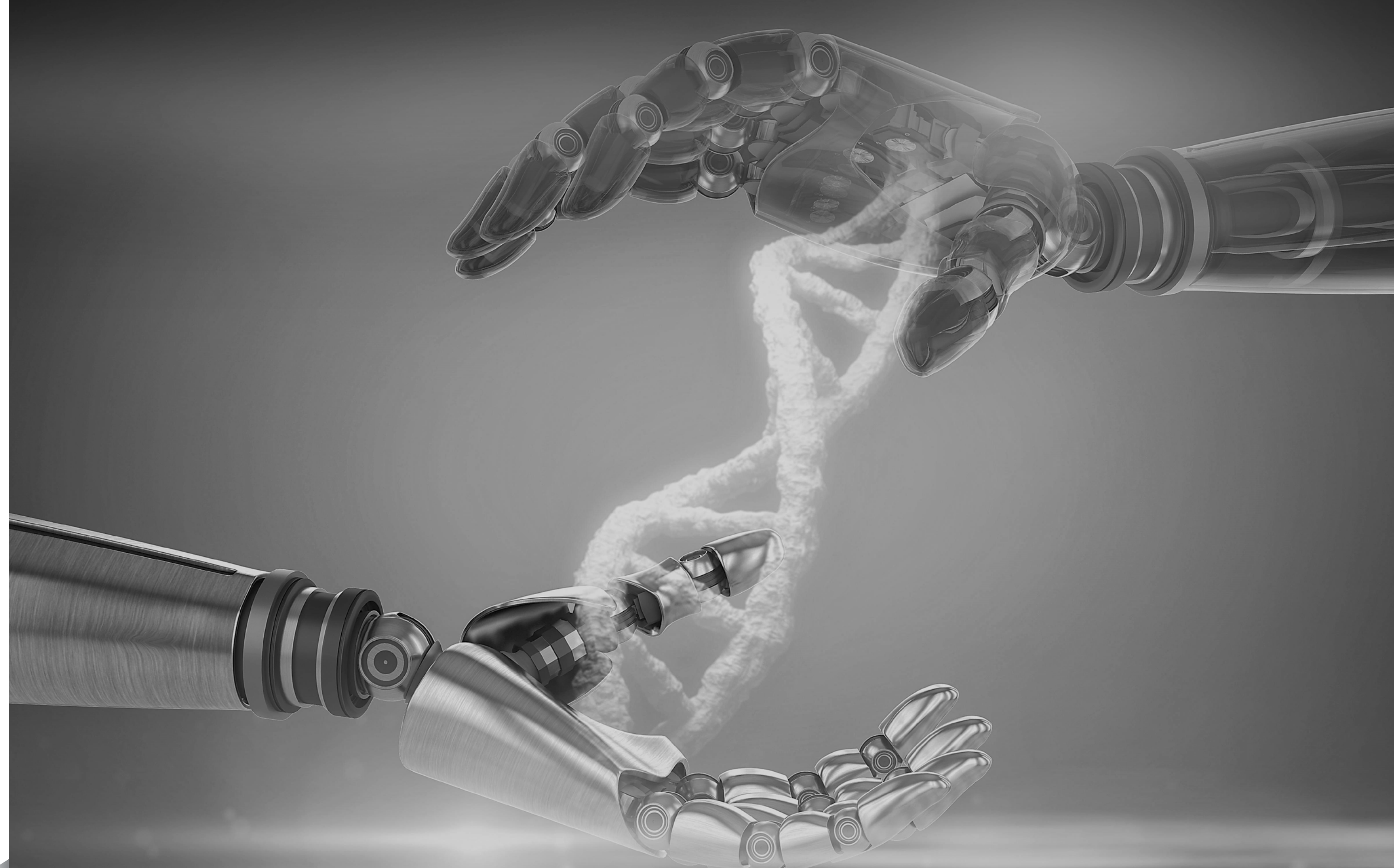
STOCKS DOWN UNDER

23 MARCH 2021

Emerging Stocks Down Under

> *My psychiatrist told me I was crazy and I said I want a second opinion. He said okay, you're ugly too.*

- Rodney Dangerfield (1921-2004) American stand-up comedian, actor



RACE ONCOLOGY

Racing up, but may get puffed soon

FAMILY ZONE CYBER SAFETY

Safe equals profit

STRATEGIC ELEMENTS

A pool of uncertain potential

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Stocks Down Under rating: ★★

ASX: RAC
Market cap: A$ 487M

52-week range: A$0.22 / A$4.23
Share price: $ 3.91

In June 2020 you could get the cancer drug developer Race Oncology for just over 30 cents a share. Suddenly it went over $1.00 and even though it was back at 75 cents on 8 October, the best was yet to come. By 11 March 2021 Race Oncology had raced all the way to $4.07. Investors clearly reckon Race Oncology has an approvable drug. They might, we fear, get tired of waiting though.

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ASX: FZO
Market cap: A$ 175M

52-week range: A$0.063 / A$0.64
Share price: A$ 0.45

Headquartered in West Perth is an organisation dedicated to creating a safe and secure cyber ecosystem for today's youth and the youth of tomorrow. This organisation, aptly named, is Family Zone Cyber Safety. One easy way to think of Family Zone's product is a more advanced and secure version of so-called 'parental controls.' The world has become a much more dangerous place over time and nowhere has this become more clear than in the ecosystem we call the internet. But does the need for parental controls of the internet equal a succesful venture?

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Share price chart

Source: Tradingview

Sometimes good drugs just get forgotten

When Race Oncology went public on ASX in 2016 at 20 cents a share, our sister company Pitt Street Research was commissioned to do some issuer-sponsored equity research. We liked what we saw, which was that Race was going to resurrect a cancer drug called Bistantrene. The drug had been around since the 1970s as a treatment for a blood cancer, called Acute Myeloid Leukemia (AML). It had gone through multiple clinical studies to establish safety and effectiveness. However, it had dropped off the market due to pharma company mergers and the emergence of other drug classes. Why not, Race argued, establish some fresh intellectual property around the drug and then take it back to the clinic?

Race felt that Bisantrene could still be useful in cancer care because it belongs to a class of drugs called the anthracyclines that is still used today. Bisantrene was one of the best of the anthracyclines because it came with much lower cardiac toxicity but still managed to bring about a Complete Response Rate (i.e. the cancer goes away) in about half of all the patients in which it was studied.

Finding the golden ticket

By 2016 Race Oncology had secured US Orphan Drug Designation for Bisantrene and was devising a clinical pathway. The market opportunity was certainly in the hundreds of millions and potentially in the billions, given the high prices these days for Orphan Drugs.

Over the next four years the company laid the groundwork for future success. It started getting granted patents and it was able to make Bisantrene under the industry-standard Good Manufacturing Practice. And, significantly, in July 2018, Race found, what we call, the 'golden ticket'. Which is to say, Bisantrene was granted 'Rare Paediatric Disease designation' by the FDA, so that if Race ever ran a clinical study of the drug in childhood AML, it would get a 'Priority Review Voucher', or PRV, that could be used by the holder to have their drug fast-tracked for FDA review. Since time is money in drug development, PRVs have been known to change hands for in excess of US$100m.

The first patient data is in. And it's good

So Race had done okay as a drug developer. However, the reason why no-one care much as 2020 rolled around was that there was no clinical data. That all changed on 16 June 2020 when the results of a Phase 2 study from Israel were read out. It was only in ten patients with relapsed or refractory AML, but the Objective Response Rate was a creditable 40%. One patient enjoyed a Complete Response and three a Partial Response (the cancer noticeably reduced in size). Given how difficult it is to treat relapsed or refractory AML – and these patients had failed, on average, an earlier three lines of therapy – this was a great outcome. Race stock, as we noted above, started to race up.

Now, the trouble for Race Oncology at the moment is the perception that the stock has jumped from 30 cents to over $4.00 solely because of that little proof of concept study. It's clear to us that Bisantrene has a bright future. In some ways that future is very bright. For example, we now know, thanks to recently published work by scientists at the City of Hope Medical Center in Los Angeles, that Bisantrene can knock out the 'cancer stem cells' that cancer uses to make a comeback after chemotherapy. The target that Bisantrene impacts, called 'FTO', also plays a role in helping cancer evade the immune system. So Bisantrene may turn out to be one of these hot new-generation immuno-oncology drugs and partly justify the present excitement.

Wile-E-Coyote also knew how to Race

That doesn't change the fact that Race is still a long way off from having an approved drug. The company still has to run a properly constructed Phase 2 in AML, either paediatric or adult. And to get Bisantrene used widely in cancer there will have to be other studies as well. Race has plans to run clinical trials in breast and ovarian cancer. Race's higher share price will allow it to raise some large licks of capital with which to move its drug forward, making us confident that more clinical data is coming. However, it might take a while to get that data.

When Life Science stocks re-rate as hard and fast as Race Oncology has re-rated, we get nervous. In our experience there is a limit to the effectiveness of market releases with headlines like that from 23 February 2021: 'Positive early preclinical ovarian cancer results'. Stocks like Race circa February 2021 eventually seem to go the way of Wile-E-Coyote in those hilarious Road Runner cartoons, where the hapless Coyote runs over a cliff, but floats in mid-air until he realises what he's done. You know what happens next.

One of these days, we predict, Race's version of Bisantrene will be an approved drug. But not before the stock's Coyote moment. Two stars.

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The need for cyber safety

We are in an unusual time in history. To operate in today's world, a solid understanding of technology is a bare minimum requirement and kids have gained full access to the world of technology earlier than any generation before. A Melbourne-based study published in 2012 found that children between the ages of three and five years old spent an average of 113 minutes per day on screen-based entertainment. With the early exposure to technology, many children are quickly becoming far more proficient in using technology than their parents, teachers and administrators. But there's another issue, the vast majority of today's cyberattacks are not targeted. With today's level of automation and databases, hackers will often cast a wide net. This is where the danger lies.

Carving out a safe space

Family Zone's two products have been developed in an attempt to create the safe carveout many wish for their children. These products are divided into one for schools, called Linewize, and Family Zone for the home and everyday use. Linewize is split between school manager, classwize and community. The School Manager is an automated system that allows for content filtering and the creation of automated URL and data reports sent to school administrators and principles. Classwize allows teachers to see, manage and block the online content in their classroom in real time. The simple dashboard is designed to allow teachers to take control of their classroom's internet access without being forced to appeal to administrators constantly. On the other hand, Community was created to offer a way for schools to teach parents the proper ways of handling their children's use of their devices. Community provides guided communication, online education, app reviews, warnings of new cyber dangers and continual updates straight to parents.

Family Zone is an application that is placed on a minor's device, such as a mobile phone, tablet or computer, allowing a parent to manage their child's access from a master smartphone application. This master application allows parents to do various things, such as manage screen time, restrict device features like the camera or microphone, prevent in-app purchases and protect the device and network in question from attacks. Basically, it's a combination of parental control and firewall in one.

Family Zone generated $4.4m in revenue from the sale of hardware and subscription fees during 1HY21, a sharp increase of 85% year-over-year. The company also generated $2.5m in other revenue, the majority ($1.5m) was from its annual Research and Development grant. This totals $6.8m, an increase of 100% year-over-year.

Unfortunately, due to the sharp rise in employment costs, the company's 1HY21 loss after tax expanded from $8.3m during 1HY20 to $9.3m during 1HY21. Because this is not an expense line that is expected to see ongoing increases year-over-year, we don't think it is likely to drag down results significantly in the future.

It's all about the USA

As of 1HY21, 40% of total revenue was generated by the company's US operations, while 53% was generated in Australia and 7% in New Zealand. Neither Australia nor the New Zealand operations saw any significant growth during 1HY21 and this was not a huge surprise. Going by management's comments, the 1HY21's results and the company's historical trend, the company's future truly lies in the United States.

During 1HY21, operations in the United States saw revenue rise by $2.2m, representing a 430% increase year-over-year. We expect this trend to continue with the United States becoming the main source of future revenues.

Shaping up

We believe Family Zone's product is much needed in today's complicated world. However, future growth and profitability rely almost entirely on continued expansion into the United States. If this expansion fails or falters, we believe it would put the company on a completely different growth trajectory. However, we believe the product demand, especially after COVID-19, will help drive the company's United States' expansion.

The market seems to agree with us and current earnings projections have Family Zone earning a profit during FY23 after seeing revenue climb from $5.1m during FY20 to $51.3m during FY23. Based on these projections, the FY21 EV/EBITDA ratio is 10.1x. This might seem high until you look at FY22 and FY23, with ratios of 4.5x and 2.9x respectively.

We believe this company certainly has strong potential and at its current valuation, we believe investors can take advantage of that potential. However, it is important to remember that this relies almost entirely on Family Zone's expansion in the United States going according to plan. Four stars from us.

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Source: Tradingview

PDF...like Adobe?

No, a PDF does not refer to the Adobe software product, but rather a Pooled Development Fund. This type of organisation was first created by the Australian Government with the passage of the Pooled Development Funds Act of 1992. The act grants these types of funds a very special place in the Australian tax code, which has significant benefits. For example, Pooled Development Funds are taxed with income tax rates of 15% on any income and gains from investments in Small and Medium-sized Enterprises (SMEs), less any specific deductions. These funds must all be registered with the Australian Government and all have one specific mandate in mind to back Australian innovation.

Let's get researching

Strategic Elements is still developing, what it hopes will be, a series of technological innovations that will lead to successful Australian companies. These technologies are being developed through collaboration with some of Australia's largest Universities and research organisations, like UNSW, CSIRO and UWA. Despite these collaboration, the technologies in question are all 100%-owned by Strategic Elements and are being held in subsidiary companies.

Strategic Elements' research focuses on four main 'megatrends.' Robotics and automation, data and analytics, renewable energy, and computer memory and storage. However, since none of these technologies have reached the commercialisation stage yet, not only is Strategic Elements not profitable, it is not even earning revenues.

The divisions

The robotics and automation division currently focuses on developing an Autonomous Robotics Vehicle Platform for applications in security, defence, transport, resources and agriculture. However, while the technology will eventually be able to be utilised across these sectors, the current focus is on developing an Autonomous Robotic Security Vehicle (ASV) for perimeter security. The robot would be able to constantly check a perimeter and autonomously determine if somebody is authorised to be there or not. Additionally, incorporated into the robot is proprietary stealth hardware and software that would allow the robot not to be easily detected while on patrol. The project was started in 2019 and continues to be under development.

The computer and memory and storage division is currently working on creating printable computer memory and self-charging battery technology. The printable electronics project would allow electronics to be easily printed on more flexible plastic and glass platforms rather than on the current silicon. To make this idea come to life, the company is developing what it calls the Nanocube Memory Ink cartridge. This transparent ink would contain billions of nanometre-scale particles that would allow for glass or plastic surfaces to be assembled with electrodes into computer memory. This technology is being developed with support from the University of New South Wales and while originally licensed, it is now 100% owned by the company.

The renewable energy division is looking to create small batteries based on graphene oxide technology that would allow for certain self-charging properties. The initial results from tests are due during 1Q21 and toxicity tests are expected in 2Q21.

You may be wondering about the data and analytics division, but there are no projects being developed here as of yet. However, management has stated that they will be developing a product within this segment in the near future.

Risks abound

This company has three main risks that we can see. The first is dilution risk. It is unclear when Strategic Elements' divisions will launch their first product and, therefore, the company will need ongoing funding through the issuance of new shares for the foreseeable future. In 1HY21 alone, the company issued $5.1m in new shares.

The second risk is execution risk. Due to the lack of a product being commercially available, we have not yet experienced management's ability to bring a product to market successfully. While we believe this is not the largest risk, it can't be ignored.

The third and largest risk, in our view, is the scenario where most or all development projects fail, i.e. none of them can be commercialised. A lot of these projects sound like they have significant potential, but potential can always be squandered or squashed. Until the projects reach commercialisation, it is unclear whether they are commercially viable.

A lot of what Strategic Elements is involved in sounds like it could be highly lucrative, but only in the future. We believe the uncertainty surrounding the technologies' potential for future commercialisation means now is not a good time to invest, especially given Strategic Elements' fairly high market capitalisation of $172m. We prefer to wait on the sidelines until the commercial potential of all these technologies becomes more evident. Three stars from us.

Pitt Street Research Pty Ltd

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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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