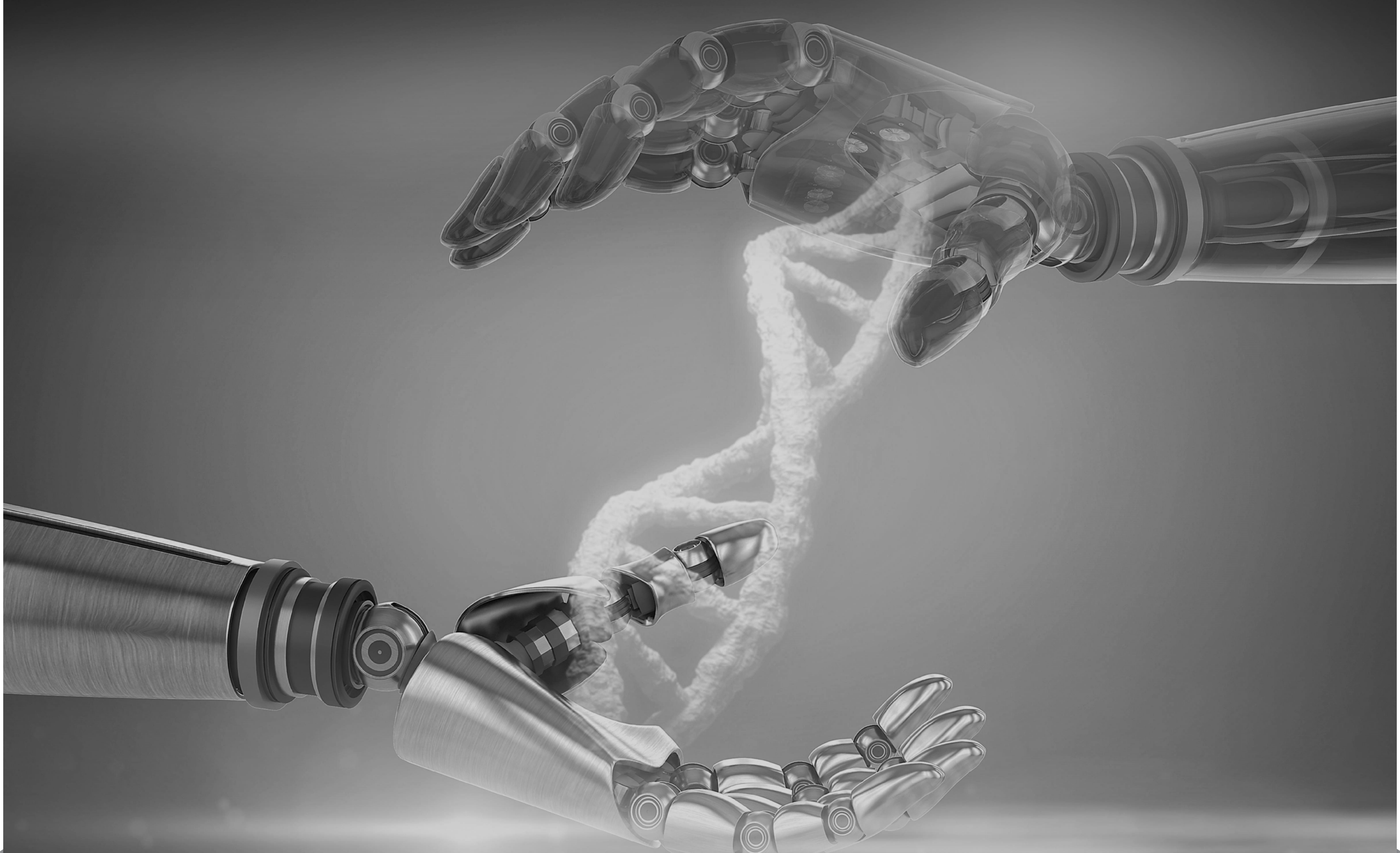
STOCKS DOWN UNDER

20 APRIL 2021

Emerging Stocks Down Under

"Great empires are not maintained by timidity."

- Tacitus (56 AD - 120 AD), Ancient Roman historian and Senator



EMPIRED

An empire in the making

NETLINKZ

Risk without much reward

SENSEN NETWORKS

Fantastic idea, overridden by valuation

EMPIRED

An empire in the making

Stocks Down Under rating: ★★★★

ASX: EPD
Market cap: A$ 131M
Dividend yield: 1.8% (0% Franked)
52-week range: A$0.225 / A$0.885
Share price: A$ 0.81

Headquartered in Perth is an empire in the making. Empired serves businesses across Australia and New Zealand, offering clients the ability to bring their operations into the 21st century. The company has had some significant contract wins and things seem to be on the up-and-up, especially for shareholders. During 2020, shareholders ended the year with a tidy 89% profit and the stock has just kept on rising through 2021. We think this is a sign that the market has finally recognised the value of Empired.

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NETLINKZ

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ASX: NET
Market cap: A$ 98M
52-week range: A$0.035 / A$0.098
Share price: A$ 0.036

Today's companies require real-time data links through the internet, whether they are in New York or Timbuktu. Headquartered in Darlinghurst, New South Wales is a company whose name says it all. Netlinkz has created a business around providing companies with encrypted and protected Networks as a Service (NaaS) on a global scale. Unfortunately, the company is far from profitable and is effectively running on the issuance of new shares. Should shareholders overlook these issues, or is it time to sever the network links?

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Market cap: A$ 83M
52-week range: A$0.064 / A$0.25
Share price: A$ 0.155

The world is in the middle of a massive technological integration. Everything from business to our personal lives is being fitted with technology. Many of these integrations have to do with data and the need for greater efficiency in an ever-complex world. One company that is helping to drive this change is Melbourne-based SenSen Networks. The stock price saw a runup of more than 100% in just a few months, but has recently pulled back. We think this is just the beginning.

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Share price chart

Source: Tradingview

Beating the bubble

Empired was founded in Western Australia in 1999 with an initial focus on developing IT infrastructure and applications in Australia. In other words, Empired was created right at the end of the dot-com bubble that popped in 2000. Despite the harsh environment in which the company was created, it grew rapidly and eventually acquired its largest competition, Intergen.

Intergen was founded in Wellington, New Zealand, in 2001 and quickly grew to rival Empired for control of the New Zealand and Australian Microsoft-based application services market. To counter the threat posed by Intergen, Empired acquired the company in 2014 in a part cash, part stock deal totalling $17.4m. This acquisition was arguably the best $17.4m the company has ever spent as it created a wide-open playing field of which it fully took advantage. Today, New Zealand continues to be an important revenue generator for the company at 38% of total revenue during 1HY21. The remainder of Empired's current revenue is generated in Australia. Without the Intergen acquisition, it is improbable, in our view, that the company would be doing nearly as well as it is today.

Dissection, Stocks Down Under style

Empired's operation is currently divided into four main divisions: business applications, digital, data and AI, platforms and modern workplace. For 1HY21, the company generated total revenue and EBITDA of $90.3m and $16.2m, respectively. Revenue only saw a 7% increase year-over-year, but EBITDA, however, saw a 43% increase year-over-year, excluding JobKeeper payments. This was due to significantly reduced expenses leading to EBITDA margin growth to 13% pre-JobKeeper payments. During 1HY20, Empired's EBITDA margin was 9.2%. Unfortunately, we're not sure these higher margins are sustainable once COVID-19 is in the rear-view mirror, and therefore, we expect EBITDA growth will be lower during FY22.

Business applications represented the largest portion of revenue growth during 1HY21 at 15% year-over-year growth, to $30.1m. This division manages the offering of Microsoft software-based applications, helping companies use these applications and manage their transition from other products.

The digital, data and AI division grew revenues by 9% during 1HY21, to $28.1m. This division helps organisations in two ways: advisory services and software products. The company offers clients the ability to use software to help manage its data using both AI-enabled software and the cloud. Empired also services clients with more complicated systems that require consultancy services to help them determine the best way to transition and the best products to use. We believe this division will become more important to Empired going forward as companies continue to migrate away from legacy software.

The company's platform division is basically its cloud operation, which allows integration of Empired's products across organisations. During 1HY21, this division saw 1% year-over-year revenue growth to $14.4m, making it the smallest revenue contributor for Empired. Lastly, the Modern Workplace division sells Microsoft's Modern Workplace software product suite. This offering includes the entire Microsoft productivity application suite from Teams to SharePoint as well as Microsoft 365. During 1HY21, this division saw revenue decline 2% to $17.7m. The company currently expects growth to be flat during 2HY21 for this division.

An Empire in the making

Without being specific, Empired is expecting strong revenue growth during 2HY21, excluding its Modern Workplace division. We believe the company's lack of significant competition in the Microsoft-based product space will allow it to continue to expand over the next few years. We are especially optimistic about the company's business application and digital, data and AI divisions.

The market currently estimates EBITDA growth of 52% for FY21 and 9% for FY22. As we mentioned above, the company's EBITDA growth during FY21 is far from a repeatable event as it was almost entirely due to margin expansion from cost cuts. Therefore, the expected 9% growth during FY22 seems to be more in line with general operations, and this is why FY21 and FY22's EV/EBITDA ratios are as low as they are at 4.9x and 4.5x, respectively. However, we believe a multiple of 4.4x for FY22 doesn't do justice to the company's expected 9% EBITDA-growth next financial year and is far too low given the long-term value of the company. Therefore, its four stars from us.

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COVID-19, data and hackers. Oh my!

Cyber-attacks on corporations of all sizes have increased during the last 12 months as criminals and state actors continue to attempt to steal private and classified information, either for sale, blackmail, their own use, wanton destruction or all of the above. Just how unprepared we really are for these sorts of attacks became painfully apparent just recently with the hacking of Nine Entertainment (ASX: NEC).

Netlinkz aims to counter these sorts of threats with the Virtual Secure Network (VSN). A VSN enables employees to access their organisation's cloud-based infrastructure on public Wi-Fi without significant concerns that their data will be intercepted or their connection compromised This is done by automatically encrypting all traffic, making it hard for outside individuals to steal information in a useful form. Through its simplified platform, Netlinkz allows companies to easily manage who access their organisation's network, what else they access while using the VSN, and many other features designed to maximise efficiency and security.

Still a lot of work to do

Netlinkz is far from profitable. During 1HY21 alone, the company reported a net loss of $15.4m on $9.4m in revenue (including grants and interest). These results represented an increase in the company's net loss of 41% and growth in revenue of 508% year-over-year. The company's growth in revenue was due to VSN 2.0's launch in China, driving revenue growth in the country up 1,100% year-over-year to $7.7m during 1HY21 ($641,529 during 1HY20).

The company's principal activity is currently selling both physical and virtual secure networks for businesses of all sizes from its suite of proprietary technologies. Chief among its technology offerings is its cloud-based Virtual Secure Network (VSN). The company is currently focusing on expanding its roster of clients in the Asia Pacific region. The goal of management is to expand its operations mainly in six countries: Japan, Australia, New Zealand, India and Malaysia. Currently, only the company's Australia, New Zealand and Chinese operations are generating any revenue. To this end, during 1HY21 Netlinkz announced a partnership with LNS International to help secure company clients for its products, specifically its VSN.

The company is still pretty much in development mode as it creates both the infrastructure required to run its VSNs and the products it plans to sell. Unfortunately, this is proving to be rather expensive with no timetable for when the company expects to become profitable. We believe it is likely still years away.

A new understanding

On 10 March 2021, Netlinkz and Greece-based Uni Systems Information Technology signed a Memorandum of Understanding to create a beachhead in Europe to commercialise Netlinkz's intellectual property in the region. This partnership is slated to use Netlinkz's patented Virtual Secure Network (VSN) technology platform as the basis for an Internet of Things (IoT) laboratory at Uni Systems. This laboratory's focus will be on creating new products for the European market using the VSN platform. In effect, this new partnership is a research and development initiative that has the potential to create new sources of revenue in the future. The current Memorandum of Understanding lasts for one year.

You're going to be diluted

Netlinkz shareholders are likely to be massively diluted in the next couple of years. As of 1HY21, the company had 257.9m options on issue with an average strike price of $0.11. If exercised, this would bring in $23.6m in cash for the company. There's another 58.6m of options at a strike price of $0.06 or less.

We believe Netlinkz will likely be forced to continue diluting shareholders to stay afloat. As of 1HY21, the company had $5m in cash and $488,093 in net receivables. However, the company reported a net loss of $15.7m in 1HY21 alone.

Another element that suggests that Netlinkz will need to raise additional capital is the new partnership with Uni Systems. During 1HY21, the company didn't have any Research and Development expenses, but with this new partnership we expect this will become a new P&L line item going forward without any offsetting grants from the Australian government.

Too much risk

Netlinkz operates in an industry that we believe will benefit from significant corporate investment following the hacking bonanza that occurred during COVID-19 and continues to this day. The company certainly has an interesting product, but unfortunately, we believe there is too much risk of dilution and no clear timeline for the company to turn profitable. Combine this risk with the company's current trailing 12-month EV/Revenue ratio of 7.4x and we have no choice but to steer clear of this stock. Two stars from us.

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Share price chart

Source: Tradingview

Our cities need to get smarter

The world's cities have been seeing ever-increasing traffic congestion, which costs a lot more than just a few annoying minutes wasted. Before we dive in, we want to clarify that we will be intentionally ignoring 2020's statistics because COVID-19 lockdowns have skewed the statistics. The gold standard for global traffic reporting is called the TomTom Traffic Index, which covers 416 cities across 57 countries and all six settled continents. The index ranks the traffic level by how much extra time it takes to complete a trip due to congestion. For example, Bengaluru, India and Manila, Philippines were tied for first in 2019 with a congestion level of 71% each. If you were to take a trip that would typically take an hour, it would take, on average, one hour and 43 minutes in Manila during 2019. Out of the index's 416 cities, only 63 saw a decline in congestion during 2019 compared to 239 cities where the congestion got worse. In the increasingly complex world of logistics, these worsening congestion levels are costing the world economy a significant amount of money. The Australian Government estimated in 2019 that the cost of congestion to the Australian economy alone would reach $38.8bn a year by 2031.

The obvious solution to congestion is to build more roads, highways, freeways, etc. Unfortunately, this won't solve the problem all by itself. The fact is there is just not enough space for infrastructure alone to solve the problem. One of the main strategies is the implementation of so-called 'smart city investments.' By integrating data analytics and real-time, AI-enabled software into the world's traffic systems, we can drastically increase the efficiency of things like traffic lights and road closures. Another advantage is the ability to see and act when things break down significantly faster. Smart city investments are not just limited to tackling road congestion. Some other examples are gunshot detection technology, air quality sensors, and smart street lighting. We highly recommend the European Investment Bank's Smart City Fact Sheet report for more information.

A partnership between university and industry

SenSen Networks was founded in 2007 to commercialise the technology developed by the University of Technology Sydney. The technology in question is a combination of real-time video analytics and internet-connected devices that create an easily scalable platform that helps cities understand and improve their road conditions. The technology does this by identifying and analysing the patterns of a city's traffic, population and crowds to enable city planners and managers to create a significantly more efficient traffic strategy.

The company's technology has also been adapted for use by businesses to understand its operations better. For example, the Crown Casino in Melbourne uses the technology to better understand its table occupancy, hands per hour, bet type and the value of 'every bet placed on the gaming floor.' According to SenSen's website, the company currently has 18 clients from Las Vegas, NSW Road and Maritime Services to the Abu Dhabi Airports Company.

Despite all of these clients, the company is still not profitable after posting a net loss after tax of $449,098 during 1HY21 on $2.5m in revenue. This represented a 33% increase in revenue and a reduction in its net loss of $1.4m compared to 1HY20. Unfortunately, approximately 50% of this reduction in SenSen's net loss resulted from a decrease in research and development expenses. The other significant contributor to reducing the net loss for 1HY21 was a sharp increase in grants from the Australian Government of approximately $500,000. This indicates to us that the level of reduction in the company's net loss for this period might not be repeatable. Our reasoning for this is that it seems unlikely that management will continue reducing its research and development spending at this stage of its development.

Fantastic idea, but overridden by valuation

We believe SenSen's technology has a wide range of applications, so we are rather bullish about the company's future. However, SenSen's stock price has had a rather spectacular run over the last few months, helped in part by its renewed push into international markets. This has driven the company's valuation to a trailing 12-month EV/Revenue ratio of 18.9x. Comparing this to 1HY21's revenue growth of only 33% and no forward guidance, we believe SenSen's share price is due for a pullback. This is certainly a company to watch and we are a fan of management and its product. But at such a high valuation, we believe SenSen has gotten too far ahead of itself. Two stars for now.

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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.