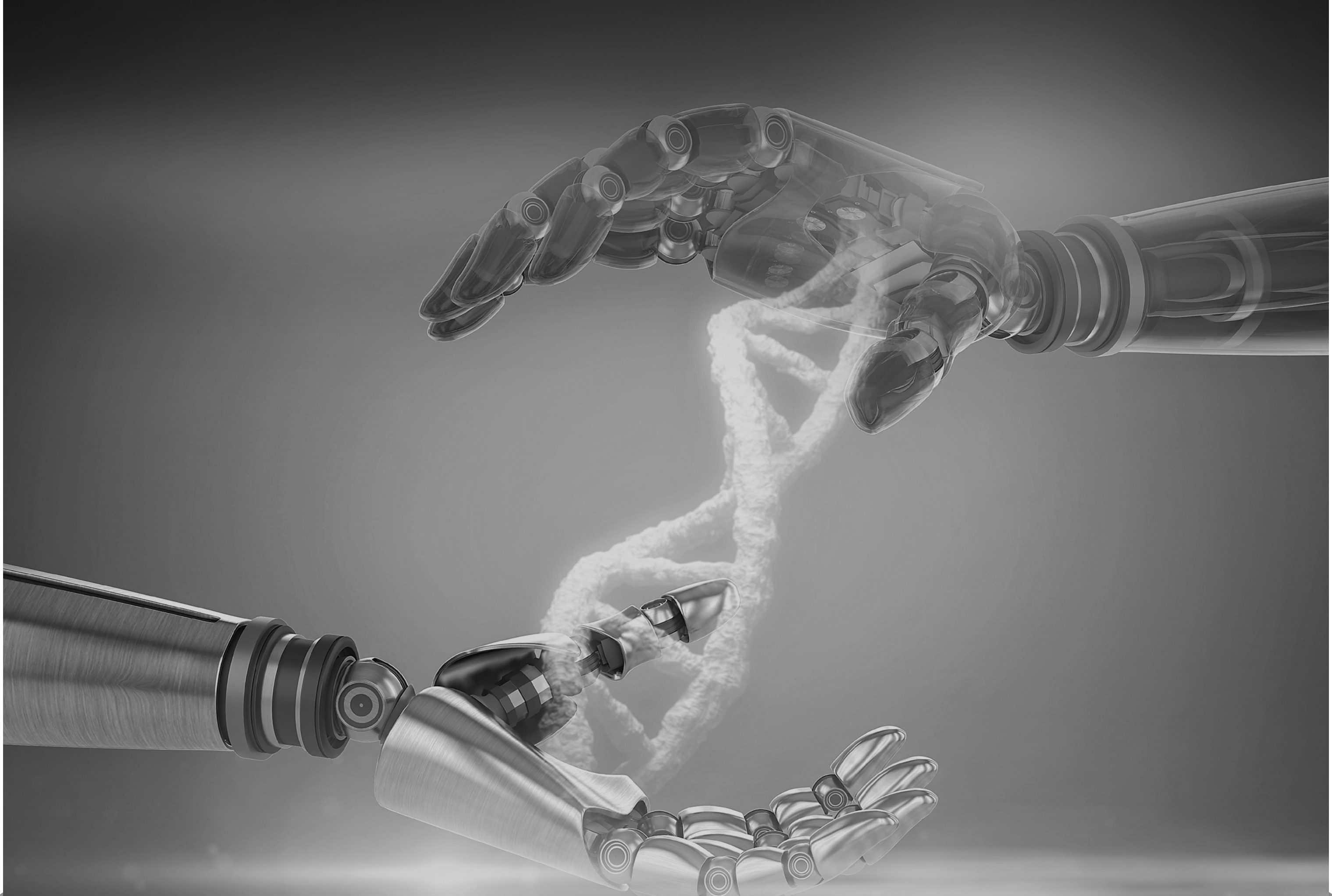
STOCKS DOWN UNDER

1 JUNE 2021

Emerging Stocks Down Under

"The optimist thinks this is the best of all possible worlds. The pessimist fears it is true."

- J. Robert Oppenheimer (1904 - 1967), American theoretical physicist



STRAKER TRANSLATIONS

Translating into profit

PLAYSIDE STUDIOS

Not all fun and games

FIRSTWAVE CLOUD TECHNOLOGY

A tough situation

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Stocks Down Under rating: ★★★★

ASX: STG
Market cap: A$ 119M

52-week range: A$0.80 / A$2.49
Share price: A$ 2.29

Headquartered in Auckland, New Zealand, is a company looking to translate its way into profit. Straker Translations uses Artificial Intelligence in its translation platform for businesses. This platform was far from simple to develop, with the company spending the last eight years attempting to perfect it. Despite revenue increasing 9% year-over-year to $14.8m, profits declined significantly to a loss of $2.5m during 1HY21. This might be why a few directors have been selling heavily recently.

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Firstwave Cloud Technology is an organisation dedicated to not only prevent cyber intrusion during the first wave of a cyber-attack, but any subsequent attempts as well. This Sydney-based organisation has created a whole new approach to cyber security product management using its proprietary, cloud-based platform. Despite all this the company has had a rough FY20 and 1HY21 as revenue declined. With the need for cyber security becoming painfully apparent over the last year, why has this company failed to capture new business in the last 18 months?

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Share price chart

Source: Tradingview

Translations for a global age

When you hear translation technology, you normally think of Google Translate or software that allows you to talk to people from other countries in real time. However, while there is increasing demand for this type of technology, there is an even larger market for long, complicated document translations. With such frequent, complicated and long reports that need to be translated, companies can quickly run into efficiency problem.

Straker's solution is best described as an Artificial Intelligence (AI)-powered translation tool. The company's platform enables large documents to be quickly translated by AI before a translator reviews the document for errors or misunderstandings. Unlike many other translation services, Straker allows its clients to pick and choose the translator they have to check the AI's work on a job-by-job basis.

Straker uses machine learning to continually train its AI engine, like all companies involved in this technology. What makes this AI-powered software different is the specific nature of each client's AI. Each client's system learns from the previous translations that were successfully accepted by the client. For example, some words can be difficult to translate because they mean different things in different contexts. Straker's AI creates a unique store of words and phrases whose translations have been previously accepted by a specific client, allowing for both the AI and human translators to finish a project more efficiently and accurately.

Revenues disappointed

During 1HY21, revenue grew 9% to NZ$14.8m on the back of a 32% increase in recurring revenue. However, there's more to these numbers as this growth seems due to the company's announced acquisition of NZTC on International 10 February 2020. When this acquisition was announced, NZTC was reported as generating NZ$4.3m in revenue over the last 12-months. Unfortunately, management has not broken out NZTC's results. Therefore, we estimate revenue declined approximately 7% organically year-over-year to NZ$12.7m. The company's EBITDA amounted to NZ$299,000 during 1HY21, due entirely to acquisition-fuelled revenue growth.

Straker's translation services are all based around its proprietary RAY platform and this provides the company with not only a value-add for clients, but also a value-add to margins. During management's 1HY21 commentary, the company reported that its acquisitions usually have gross margins of approximately 50%. As soon as the company has been fully absorbed into the RAY platform, these gross margins climb approximately 10%-points on average to 60%, a sizeable difference. Therefore, gross margins declining from 54.4% to 51.1% was mostly due to acquisitions not yet being fully implemented into RAY.

Overall, we believe 1HY21 was slightly disappointing. Of course the company came under pressure from the pandemic outside of Australia and was forced to cut costs. Despite these disappointing revenue numbers, there were some bright spots, like the rise in annualised recurring revenues and data volumes increasing 81% year-over-year. However, mixed results are not what investors want to see.

Acquired IBM's translation business

While we have made it clear that 1HY21's results were slightly disappointing, there was one announcement on 12 November 2020 that has the potential to be a complete game changer for Straker. The company acquired MSS in Spain in 2018 and in doing so it acquired IBM (NYSE: IBM) as a client. While MSS was only translating IBM's Spanish documents, after integrating MSS' services into the RAY platform, IBM became interested in expanding its relationship with Straker. As of January 2021, Straker is IBM's strategic translation provider, covering 55 different languages across IBM's technological infrastructure. This is a massive contract win and it is hard to underestimate the positive impact it will have on future earnings. Unfortunately, it's also difficult to estimate the impact it will have on the company's earnings in general as well other than to say they should be going up on the back of this client win.

Management has declined to provide guidance for 2HY21's revenue growth from this contract, apart from stating that it will be significant and will include a 30% increase in headcount, causing a significant increase in employment costs as well. Looking at consensus estimates for FY21 and FY22, we don't believe the market has properly taken this contract into account. Currently, the market consensus places FY21 and FY22 revenue growth at 18% and 65%, respectively. This seems low to us once we factor in the company's history of at least one acquisition per year and the scope of the IBM contract. With an EV/Revenue multiple of only 2.5x and 2.1x for both years, we believe Straker's future growth is underestimated. Four stars from us.

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Share price chart

Source: Tradingview

What do we play with PlaySide?

PlaySide Studios commenced trading on the ASX 17 December 2020 at $0.20 per share. The company has seen strong revenue growth over the last few years due to its three-spoke business plan: original IP, brands and licencing, and partnerships. The company generated $7m in revenue during FY20 after growing 63% year-over-year and this growth continued during 1HY21 at 61%, resulting in $5m for the period.

The company's original IP division creates games across mobile, virtual reality, augmented reality and PC platforms from concepts developed in-house. PlaySide contracts out its expert staff to companies that are looking to utilise its own IP to create a game as part of PlaySide's brands and licensing division.

The main avenue of growth the company has been focusing on is its partnership division. This division focuses on partnering with individuals and companies who own their own IP and for which PlaySide creates the game. However, unlike its brands and licensing division, the company retains partial ownership of the game. For example, on 17 February 2021, PlaySide announced a new partnership with Click Management (an entertainment company), LazarBeam (a YouTuber) and Fresh (a Twitch streamer). The partnership is set to develop a new PC title.

Despite the new partnership to develop a PC game, the company's main source of downloads is still the Apple App Store and Google's Play store. As per the company's 16 December 2020 prospectus, PlaySide's top ten downloaded games (35.2m total downloads) were all for mobile phone and tablet.

A power-up is needed to keep this game running

PlaySide recently listed on the ASX to be able to access fresh capital on an ongoing basis. During 1HY21, the company lost $2.1m, compared to a loss of $131,000 during 1HY20. The reason for the sharp increase in its loss was the company drastically increasing its costs to achieve its revenue growth. Employee expenses rose 71% while selling expenses rose 425%, leading to total operating expenses for 1HY21 increasing by 148% to $7.5m. Therefore, in order to grow the company's 1HY21 revenue, to $2m or 61% year-on-year, the company had to increase operating expenses by 148% to $4.5m. Administrative expenses increased by $910,000, in large part due to one-off IPO costs. But even after you correct for this, costs increased significantly more than revenue during 1HY21.

Companies in the application development industry are notorious for burning through cash and taking a long time to become profitable, if they ever do. PlaySide just raised $15m in its IPO, bringing its current cash and cash equivalents to $16.1m as of 31 December 2020. While the company has not announced any acquisitions, it did highlight them as one of its main growth pathways at the time of the IPO. Combine this with the company's mounting losses as it grows, and we believe it is highly likely that PlaySide will need to come back to the market for fresh capital repeatedly, diluting investors in the process.

It's all fun and games until you lose your shirt

Unfortunately, management has not provided any guidance since the company's listing and PlaySide is not currently covered by any analysts either. Our concern is that revenue will continue to grow, but that expenses will grow at a faster rate. Factoring this into PlaySide's trailing 12-month Price/Revenue ratio of 11.9x and it's safe to say we are not game.

Shareholders who purchased shares at the company's IPO price of $0.20 are currently looking at a 65% profit and we think it's time to take that money and run. Management still has a lot to prove and an industry reputation to beat. With all of the uncertainty around the company's future earnings potential, we believe PlaySide's shares are far from properly factoring in this risk. Therefore, PlaySide gets a two-star rating from us.

FIRSTWAVE CLOUD TECHNOLOGY

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Share price chart

Source: Tradingview

The wild, wild west of cyber security

As we have discussed repeatedly in Stocks Down Under, the cyber world is like Russia after the Soviet Union fell, i.e. huge profit potential, but you might get killed reaping those profits. Everything and everybody is fair game these days with no industry being safe from online criminals and hackers. The need for innovative ways of looking at cyber security has never been more apparent, so let's take a look at an Australian-born and breed idea: The Cloud Content Security Platform.

Move fast, but securely

The initial research that ended up becoming the Cloud Content Security Platform that makes up the backbone of Firstwave Cloud Technology's security offerings was started in 2002. This joint development project between Telstra Research Labs and FirstWave was spun off on the ASX as a separate company after its initial successes. Boosted by funding from investors, Firstwave quickly expanded abroad and into related products. The company now boasts four main products off of its Cloud Content Security Platform (platform): email, web, firewall and endpoint (products). These products are not directly sold by Firstwave. Instead, they are provided to third-party resellers, like Telstra, who then use the platform to pick and choose which products they want to provide to their customers.

If you follow cyber security companies, you may think this business model seems rather familiar. The truth is, Firstwave's business plan is far from unique and has a number of risks implied by its very nature. For starters, since Firstwave is relying on its partners to sell its products, the company does not have direct control over the sales staff responsible for communication with the end customer. These sales staff usually operate on commission and are, therefore, incentivised to sell certain products more frequently than others. Under Firstwave's business model, its products are not the only software for sale by its partners. So, just because Firstwave engages in a new partnership, it does not mean large volumes of sales will follow. While we are not privy to the details of Firstwave's partner agreements, we find it hard to believe an unprofitable company with $4.1m in revenue during 1HY21 would be able to provide the highest industry sales incentives.

Now that we have explained the difficulties inherent in Firstwave's business model, let's take a look at its products. FirstCloud Email Security focuses on preventing security breaches through inbound emails.

FirstCloud Web Security focuses on protecting a client's website from direct attacks. like Distributed Denial of Service (DDoS) or indirect attacks, like ransomware, malware, etc. A DDoS attack uses the constant flooding of requests to take down a website, preventing others from accessing it. This product uses Cisco's Talos and AMP systems as well as its own proprietary software to monitor, secure and protect a client's website.

FirstCloud Firewall Security inspects all traffic moving through a company's firewall for any threats and will attempt to block these. Firewalls are also used to limit outbound access to websites, like YouTube and Facebook. This product is focussed on Small and Medium-sized Enterprises (SME).

FirstCloud Endpoint Security is quite similar to a firewall, except it operates in the cloud. This type of product appeals more to micro/small businesses as the costs are lower, while these companies are not required to have any dedicated server. Basically, this product focuses more on protecting individual devices than entire systems.

Too risky for now

Firstwave is active in a highly competitive market and its 1HY21 revenues are testament to that. The company generated $4.1m, representing a decline of 2.4% year-over-year. Management has provided a February 2021 update and unfortunately the situation did not improve as the company moved into the new year. Firstwave saw its Australian recurring revenue decline 13% year-over-year to $536,000 after a contract with Cisco ended. However, international recurring revenue did show an extremely strong result generating $158,000 in February 2021. This represented 690% year-over-year growth, but this is from a low base as the international business only seriously starting to ramp up during FY21.

Unfortunately, management hasn't released any guidance and there's no broker coverage. So, we can only rely on backward-looking valuations. Despite the lacklustre revenue growth, the company is currently trading at a trailing 12-month Price/Revenue multiple of 8.1x, which we think is pretty steep given the circumstances.

Firstwave has a lot of growing to do before it can become profitable. Unfortunately, we believe it is far from certain that the company will ever turn a profit. The Australian situation is concerning and the international division is still way too small to carry the burden of being the major revenue driver. Therefore, its two stars from us.

Pitt Street Research Pty Ltd

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