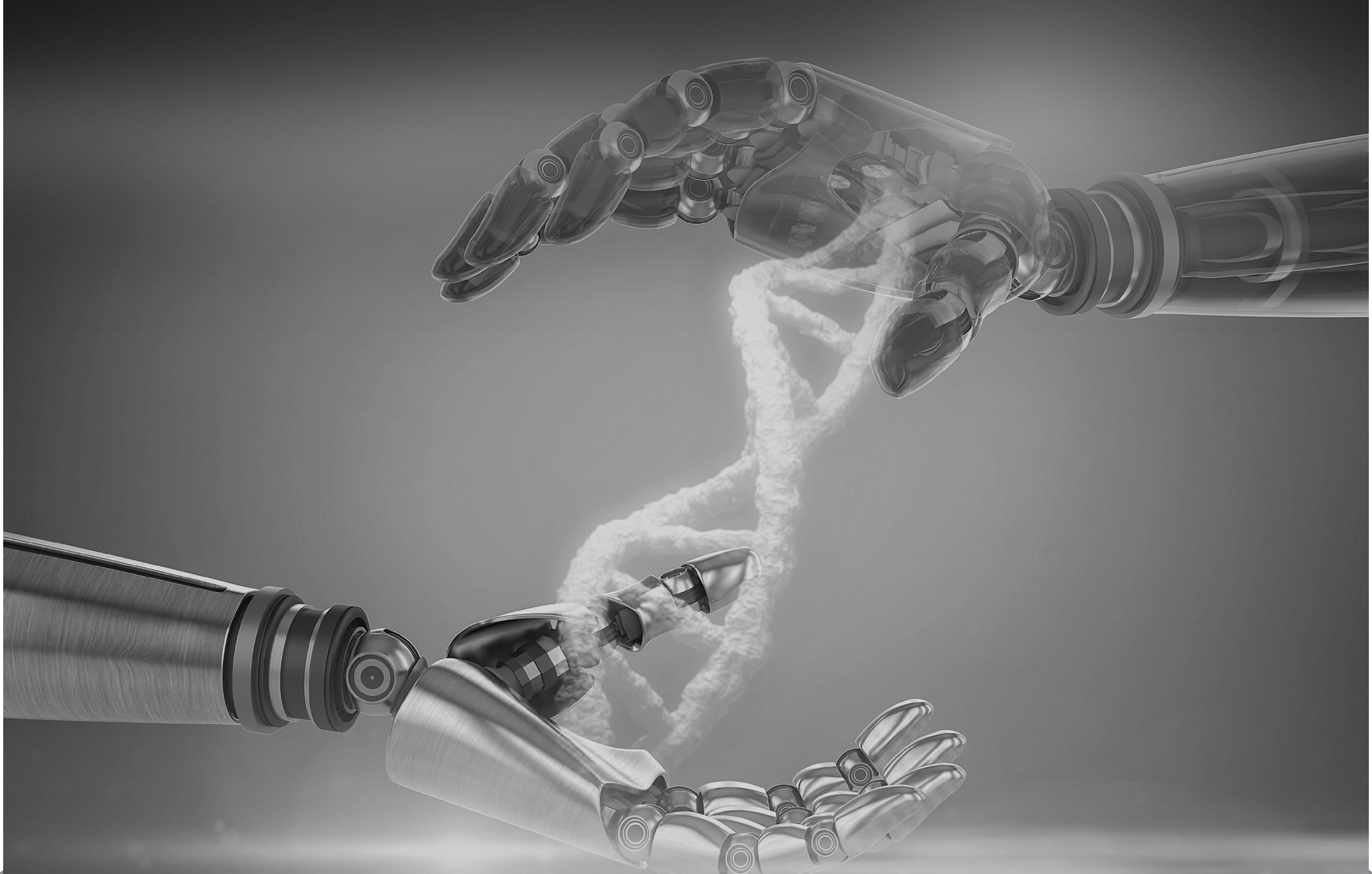
STOCKS DOWN UNDER

9 NOVEMBER 2021

# Emerging Stocks Down Under

> *But it's never wise to bet against any of the four horsemen long term. Their historical track record is horrifyingly good.*

- Dan Carlin (b. 1965), American history podcaster



## DAMSTRA

Snapping back post-Covid

## STRUCTURAL MONITORING SYSTEMS

Structurally sound

## SECURITY MATTERS

Time for all that R&D to finally turn into Dollars

# DAMSTRA

## Snapping back post-Covid

Stocks Down Under rating: ★★★★

**ASX: DTC**
**Market cap: A$127M**

**52-week range: A$0.61 / A$1.98**
**Share price:  A$0.615**

Superficially, that four-star call on Damstra we made on 16 February 2021 at $1.44 doesn't look like it aged very well. The stock of this Melbourne-based developer of 'enterprise protection' software is now about half the level of early 2021, thanks to a disappointing FY21 result in August, followed by a disappointing 1Q21 quarterly result in October. Part of the slowdown in Damstra's business is, however, Covid-related. This means the company can snap back now that the lockdowns are more or less over.

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**52-week range: A$0.35 / A$1.05**
**Share price: A$0.715**

Based in Perth, Structural Monitoring Systems designs safety systems for the aviation industry. The company's systems usually monitor the structural health of the airplane through the use of Comparative Vacuum Monitoring (CVM) sensors. Currently, the company is making inroads into aviation communications with the key acquisition of Eagle Audio and aims to get Supplemental Type Certificates (STC) approval for the installation of CVM sensors on even more aircraft parts.

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Security Matters is a Tel Aviv-based chemical and technology company. It develops and commercialises a tracker that can chemically mark objects (including liquids and gasses) and trace them through supply chains to prevent theft, counterfeiting and to provide quality assurance. The company has developed an entire suite of solutions around its proprietary technology, allowing customers to use the tech for various applications. Despite little to no sales at the moment, we believe there is strong potential for the company's product and we expect Security Matters to be able to capitalise on this potential in the next few years.

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### Share price chart


***Source: Tradingview***

When Damstra went public on ASX in October 2019, the stock leaped out of the gate. The company, run by Christian Damstra, whose father had founded the company in 2002, not only raised $35m in new capital at $0.90, but the IPO also saw existing shareholders sell $14.3m worth of stock. Even with that overhang, Damstra still ended the first day at $1.23. And once we got through the February-March 2020 Corona Crash the stock was able to go all the way to $2.30 in October 2020.

### Back below the issue price

How did Damstra get there? Well, broadly speaking, workplace management solutions were either built internally by the users or implemented by global enterprise software providers whose software and knowledge wasn't necessarily suitable for smaller customers. Then Damstra got into the game and figured out the happy medium of a comprehensive suite of products that would work anywhere and everywhere, in the Cloud and for all sorts of organisations. Damstra had the data to show that its offering improved safety and compliance, and the word spread from there. No wonder, then, that revenue had grown from $8m in FY17 to $23.5m in FY20.

For investors, things seemed to go wrong after the merger with Vault Intelligence, which was effected via a scrip bid and brought capabilities in 'enterprise protection' where the people and assets are protected with Cloud-based software. The Vault merger was completed in October 2020 and the share price decline after that probably reflects Vault investors who had done well out of the merger moving on. The business itself remained in reasonably good shape, as evidenced by the result for the six months to December 2020, which showed gross margins 5% better at 75%.

The market, however, didn't like the fact that EBITDA was steady at $2.5m even though revenue was 30% higher. Damstra stock didn't show signs of life again until the June 2021 quarterly numbers showed that the synergies between the two merged entities were real. Before that quarterly, Damstra stock was back at $0.77.

## Covid is bad for business? Who knew?

However, the rally for Damstra was short-lived with the FY21 result, released on 26 August, not being well received. Revenue in FY21 was $27m and EBITDA was $6.6m, while gross margins for the full year were a juicy 79%. But what the market was concerned about was that Covid seemed to be hampering the business. Any time a Damstra client couldn't operate normally due to COVID-related restrictions, revenue was lower because some contracts had been priced on a per-use basis.

And COVID had led to client projects being delayed because those clients had bigger stuff than workplace management software to worry about. Covid was still causing problems for Damstra in October when the company reported its 1Q22 numbers. In that quarter, revenue increased by 20% year-on-year. However, management had previously guided for 32.5% to 40% revenue growth for the full FY22 year. It looked like Covid had taken a bite out of this guidance.

Part of the problem for Damstra was that construction is an important vertical for the company, with 95,000 users in the construction industry by the September 2021 quarter. So, when State governments deliberately slowed the construction industry in NSW and Victoria to deal with COVID, it looked like Damstra was in trouble.

The company recently made its second post-IPO acquisition. In late September 2021 the company announced that it was buying TIKS Solutions, a company that specialises in Cloud-based tools for workplace safety and compliance. The price was $18m, which Damstra was willing to pay because it should open up new verticals in facilities management, aviation and rail. Significantly, the TIKS vendor, founder Sam Marciano, took two thirds of his consideration in Damstra scrip at $1.00 per share and agreed to join the Damstra team as Chief Commercial Officer.

## A good year ahead

We think Damstra will end up having a pretty good FY22, justifying Marciano's decision to take scrip. In Australia we've now more or less seen the end of lockdowns. Damstra's products are in demand across a wide range of industries and the product range keeps growing thanks to a generous R&D budget. On top of that the company now gets more than 60% of its revenue from international markets where it is growing quickly, so the scope of the company's growth is larger than ever.

At the same time, we believe Damstra stock is undervalued based on reasonable growth expectations. Consensus estimates are currently suggesting that this company can grow EBITDA by 28% in FY22, to $8.5m. But you can get the stock for an EV/EBITDA multiple of just 14.7x. That may seem high, but it starts to look inexpensive when you take the expected EBITDA expansion out to FY24, when Damstra is expected to be doing around $18.8m in EBITDA. By that stage the EBITDA multiple is only 6.6x. That's low enough to suggest that our four-star call from February was valid. We're keeping this one at four stars.

# STRUCTURAL MONITORING SYSTEMS

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### If we can't increase profits, let's cut costs instead

When Richard Branson, the founder of the Virgin Group, stated that the quickest way to become a millionaire in the airline business is to start out as a billionaire, he was not wrong. Since the deregulation of airlines (1978 in the US and 1990 in Australia), cutthroat competition and high costs have led to the airline industry being a very obvious cautionary tale.

One of the major factors associated with the sector's low profit margins is the high cost required to maintain a fleet, averaging 25% of a commercial fleet's operating costs. So, not only do you need thousands of employees, but the aircraft maintenance alone can be enough to bankrupt the company. Airlines perform checks after a set interval, similar to car maintenance. More importantly, structural checks (checks that ensure that the integrity of a plane's body is not compromised) often require technicians to manually enter tight spaces in the plane, placing them at risk. Some of the checks need to be done on downright inaccessible components. Thus, technicians have to disassemble certain parts of the aircraft prior to accessing them. It goes without saying that this requires a unique set of skills and technology, enter Structural Monitoring Systems with its Comparative Vacuum Monitoring (CVM) technology.

CVM is based on the principle that a vacuum that is contained in a small volume is extremely sensitive to leakage. As such, the company can place CVM sensors on the structure and measure the differential air pressure between alternating channels (one where the air is at a partial vacuum pressure and one where it is at atmospheric pressure). Simply put, CVM can make structural integrity checks a lot easier.

## Inching toward global adoption

The primary benefit to the airlines of using CVM is not that it allows for a more straightforward assessment of structural damage. Instead, the benefit for airlines is that they can switch from a time-based, or cycle-based, maintenance approach to a condition-based one. Unless the structure is damaged, there is no reason to replace it. Potentially, this could have a massive impact on an airline's bottom line.

SMN's CVM sensors were ready for testing by the beginning of 2014. The company formally began conducting initial tests with US-based Delta Airlines in March 2014, testing the technology on Boeing 737-700 series aircraft. In December 2015, Boeing formally approved the CVM technology for use on its aircraft with Federal Aviation Authority approval also confirmed in the same month.

After receiving numerous regulatory approvals by early 2017, the company began to expand aggressively, targeting the Middle East and South America through partnerships and signing its first commercial supply and marketing agreement with Delta Airlines in August.

In January 2019, the company signed an MoU with Delta Engineering for the application of CVM technology for when WiFi systems are installed on aircraft. The goal of adding CVM technology when Delta Engineering's makes a plane WiFi capable is to help streamline the inspection process as installing a WiFi system can result in structural and surface cracks. A Supplemental Type Certificate (STC) is required for the two partners before they can approach prospects for this new use-case (An STC is a United States Federal Aviation Administration approval required for modifications to an airplane). To date, the two companies have submitted all data required for FAA approval and SMN is waiting for the results.

## Getting closer to profitability

Since its market entry, CVM has substantially improved the company's prospects. CVM brought in around $7.4m in revenue in FY18, $16.4m in FY19 and $19.1m in FY20. While the revenue dipped to $15.3m in FY21 due to COVID-19, SMN's net loss improved from negative $2.5m in FY20 to negative $1.9m in FY21.

If the Supplemental Type Certificate is granted, we believe SMN should be able to potentially generate a profit in FY22 or FY23, given the new use-cases for the sensor to many of its current clients. In any case, the company is still slowly reducing its costs, while increasing its presence in regions outside the US. Profitability should only be a matter of time.

In early September 2021, the company announced the acquisition of Eagle Audio from Eagle Copters for C$4.28m. The acquisition should generate valuation upside in the long term and provide diversification to the company's primary business (that relies on a single technology). Management specifically highlighted the Generation II Audio System as a key source of intellectual property. This is not just a bunch of speakers, but rather a complex control system for managing and facilitating all forms of communication on aircraft, helicopters, etc.

It is clear that CVM offers a tangible benefit to airlines and other uses for the sensors could yet be discovered. The technology is already used in aircraft and helicopters (with the Delta Engineering MoU another potential use-case for which approval is pending). We believe these markets are large enough in their own right to propel the company forward and achieve profitability.

In August 2021, SMN stock broke through a very long-term downtrend, started in 2016. The subsequent support level around $0.65 has subsequently been tested by the market throughout September and it looks like the market may test that level again in November. If it holds, that would be a very strong sign.

When we combine all this with the stock's current trailing 12-month EV/Revenue valuation of 5.8x, we believe this makes Structural Monitoring Systems a four-star investment.

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### Share price chart


***Source: Tradingview***

### Companies 1, Counterfeiters 0

This is what the score would be if Security Matters' proprietary technology were to achieve widespread use. The technology provides quality assurance and brand protection to producers of goods where the risk of counterfeiting is high.

The idea is simple. A hidden chemical barcode is attached to the product and can be read through a reader device. A blockchain record is kept to ensure the integrity and security of the data. This way, customers can ensure that the product received from a Security Matters customer is the product that was shipped and counterfeiting can be detected and traced.

Security Matters primarily deals with physical goods and then uses technology to ensure their authenticity. The barcode can be attached to solids, liquids and gasses, thereby providing a complete solution for all products to the company's clients.

The company also focuses on environmentally and socially responsible businesses by providing services such as food security and tracing of plastics for recycling. However, several other companies are doing similar things. Citizens Reserve, a California-based tech startup, has a SupplyChain-as-a-Service platform that allows clients to tag items and track them on the blockchain. While Security Matters has a crucial advantage because it works with any item, competitors still have solutions that would work for most use-cases.

As such, this space is a landgrab and it will be a global race to sign as many clients as possible. Luckily for Security Matters, it has a solid strategy.

## A three-step strategy

Since Security Matters listed on the ASX in 2018, the company has not generated any significant revenue as the technology has yet to achieve commercial success. However, management has presented shareholders with a three-stage roadmap for entry into the market and completed a $3.1m placement on 12 October 2021 to fund it.

The first step involves getting a market leader on board, which would provide two main benefits. You see, not only would the client generate significant revenue, but it would also act as a bellwether for the industry signalling that Security Matters is a company with which you can do business. By leveraging a market leader's authority, the company plans to become the de facto industry standard in that market leader's vertical with its proprietary technology before setting its sight on regulators and professional associations in each industry that it operates.

Since its launch on the ASX, Security Matters has been busy securing patents, mainly targeting the United States due to the large market opportunity. It has also signed a collaboration agreement with the Perth Mint to provide supply chain integrity and asset tracking solutions that ensure transparency and accountability from a precious metal mining site to the end-user.

In March 2019, the BASF and Security Matters commenced a feasibility study to determine if Security Matters' blockchain technology could be of use to BASF's Chemical Performance division. In August 2020, this was expanded to include twelve other companies and retailers to form a consortium known as reciChain. ReciChain's pilot program aims to use Security Matters' blockchain technology to increase the efficiency and accountability of the plastics value chain through better sorting, tracing and transparency. Security Matters was able to prove it could leverage its technology and demonstrated a functioning closed-loop value chain production during Phase II of the pilot program which ended in November 2020. Currently, reciChain is in Phase III, product scaling and, according to reciChain's BASF most recent timeline, is expected to reach commercial scaling in Phase V starting in 2023.

## The race is on

Security Matters is currently in a race to commercialise its technology and achieve global adoption. While the lack of revenues may be troubling to some, we believe that the company has all the underlying partnerships and patent applications to turn its technology into a profitable endeavour.

The company is also consistently working on improving its suite of solutions. It is doing this mainly by adding and testing new functionality to its existing products. For example, the company successfully tested its blockchain-enabled conveyor belt detector in June 2021. Companies can use the system to provide information about the products and materials moving through the belt, thereby allowing better sorting and recycling of all types of plastic.

In 1HY21, the company spent almost $900k on R&D, over $1.1m on administrative expenses and nearly $200,000 on marketing. The recent capital raise (October 2021) provides financial runway well into 2022. The 3Q21 results, released on 27 October 2021, revealed that Security Matters generated US$299,000 in revenue (12% increase versus 2Q21).Management is spending diligently decreased its general and administrative expenses by 11% to US$503,000.

With the vast majority of its technologies and solutions ready for market entry, we think 2022 could be a pivotal year for Security Matters. If it manages to sign enough clients, it could be set for years to come as it provides a service that its clients will need indefinitely. The company is off to a good start as Continental contracted Security Matters to help provide trackability along its technical rubber and tyre value chain.

Although we believe there is a very large addressable market for the type of advanced tracking & tracing technologies that Security Matters has developed, failure to commercialise it and kickstart revenues will leave the company vulnerable to competitors getting a head start.

Still, we believe that its obvious technical advantages and an expansive suite of solutions should allow the company to achieve significant market share in multiple industries, making it a four-star investment. The $0.24-$0.28 range is where the stock should technically find support after declining from $0.475 early in 2021.

However, make no mistake … this company is high-risk and it's not an investment for the faint of heart. When we first met management in Tel Aviv back in 2018, prior to the ASX listing, it was talking the exact same talk as it is today. But not a lot of commercial progress has been made since. So, if you're thinking of investing in SMX, keep in mind that this company still has to prove itself commercially.

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