SPACETALK (ASX: SPA) – INVESTMENT RESEARCH
COMPILED BY: @DEALSMATE on Strawman
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Current share price: $0.145 (market cap, c.$24m)

About the company

Spacetalk manufactures connected smart watches for seniors and children. Currently, their biggest market is with kids, in a category they have created called kids connected devices (**KCDs**). Spacetalk has solved the problems of how to keep children aged 6-12 connected to their parents, and restricting them from dangers of the free internet and social media included on a smartphone. By creating and leading the growth in Australia of a new product market, this generates new/additional revenue for their distributors/retailers and does not compete disrupt revenues from existing products.

The watches use a data sim enabling calling and messaging to approved phone numbers through the Spacetalk app that parents install on their phones. The latest watch, the Adventurer (pictured below), features GPS tracking for safety, 4G connection, step counters, weather apps, a heart rate monitor, distraction free school mode, dust and water resistance, a 40 hour battery life and a camera.

Importantly, the product provides value to both parents and kids. Value is provided to parents through enabling connected guardianship and safety of their kids, whilst preventing kids from having mobile phones which have unfettered access to the open internet and social media earlier than they are ready for. At the same time, the fitness tracking, camera, the ability to call/message friends and other features provides value/entertainment to kids.

The key distribution channels are: (i) Mobile network operators (MNO) (currently Telstra and Vodafone) (ii) Bricks and mortar (JB Hi Fi, Harvey Norman, Office works, + more); and (iii) online (Spacetalk website, online websites of bricks and mortar stores plus Kogan.com).

The below product videos gives an overview/review of the Spacetalk products and there are many more online.

- https://www.youtube.com/watch?v=LpO8Ak62vSM
- https://www.youtube.com/watch?v=-f7T5uJ60U4

Network effects

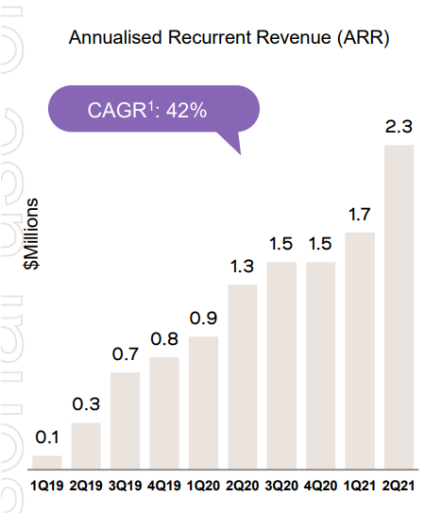
Within parenting and school communities, network effects can be extremely powerful for new products. When kids see other kids with a new kind of device at school, they ask and tell their own parents about them. Also, it is very topical amongst parents regarding what age children should have mobile phones in which KCDs provide a solution that will be shared as an idea amongst parents. This enables the company to grow and scale at a higher speed and with a lower CAC, increasing profitability. Further network effects exist in the Spacetalk app, refer below.

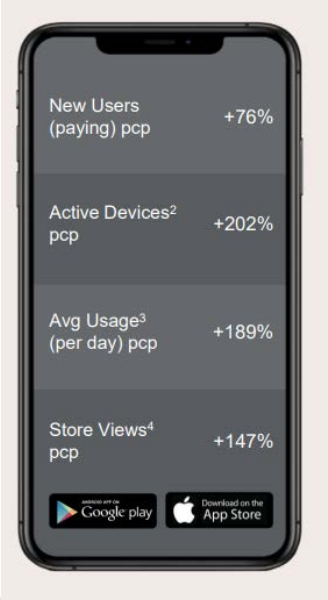
The app and recurring revenue model

Spacetalk devices connect to the Spacetalk app, charging $5.99 p/m to connect to two devices or $8.99 for up to five devices. The app provides instant messaging and calls, similar to WhatsApp, with the added benefit that Spacetalk communications are restricted to an ecosystem of "family and friends" contacts approved by the parent for their child. In doing so, Family Chat creates this unique secured "family" environment where every contact (and importantly only those parent-approved contacts) linked to the KCD can engage in wholesome fun ways, with Adventurer also allowing for recorded video and audio sharing.

Having more users on the app, creates a strong network effect and a stickiness to the platform as well as increasing awareness of the devices and driving further device sales. This is encouraged with the app fee charged only for the device's control-app (ie. the parent app which sets up the KCD), all other family/friend apps connected to the KCD are free and attract no monthly fee. And as the app works on both iOS and Android, it ensures parents, grandparents, extended family members and friends, regardless of whether they are iOS or Android phone or tablet users, can interact with linked Spacetalk device users.

The app annual recurring revenue (ARR) is a terrific KPI to track users of devices (and proxy unit sales), as it includes all new users, less the unsubscribers (churn). Off a low base, the company has CAGR of 42% over the past 2 years, with impressive recent momentum relating to Christmas 2020 sales and the launch of the Spacetalk Adventurer. Below are extracts from the H121 presentation showing growth in App users.





Unit sales revenue recognition

Unit sales are recognised upon delivery to retailers/distributors. For this reason, when a new retailer or MNO are brought on board, we can expect to see a spike in revenue due to the distributor stocking up their bricks and mortar stores.

Future revenue will be driven by the distributor's sale of the devices and future purchase orders to replenish stock. Once Spacetalk build out their store network and it reaches a more steady state, the revenue is likely to be more stable, albeit, this won't be for some time.

Although they are not subscription based, unit sales should not be dismissed as non-recurring revenues. If customers are acquired at age 6, due to breakage and improvements in technology, Spacetalk should expect to make a number of unit sales over the next 6 years of a childs life until a smart phone is purchased.
Hence, the younger the customer acquired, the better the ratio of CAC to LTV. To Spacetalk's advantage, at the earliest adoption age of 5-6 years, kids are already in a school network which can increase awareness of the products at no cost to Spacetalk. Further, as one kid grows out of the Spacetalk another one grows into the customer age group. Hence, as long as Spacetalk can build out a market share the unit sales have a recurring nature.

Pricing

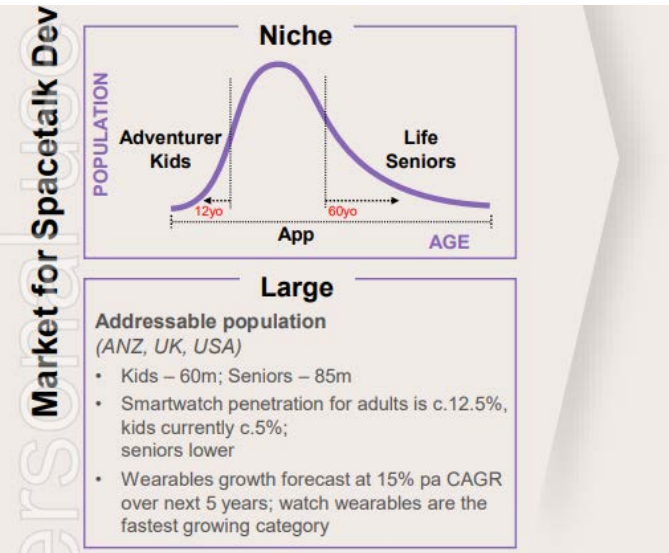
The kids Adventurer watch retails at A$349, whilst the Spacetalk kids is A$249. The Spacetalk kids is the superseded version with much less features (eg. is 3G not 4G) but offers an entry level option. The company heavily invests in R&D, and the watches will need to be continually upgraded and improved to remain competitive.

A market leader in a fast growing niche

The Spacetalk Adventurer is the #1 selling kids device the category in Australia. One of my favourite things about Spacetalk is that it is a market leader in a niche that it has created, and the niche is growing extremely fast. Thus, they have a first mover advantage.

Basically every extraordinary performing company in history, at one stage could be defined as a market leader in a fast growing niche. Think Facebook, Apple, Coca Cola (when introduced), Afterpay, Google, Microsoft, the list goes on. Slightly off topic, but Richard Koch wrote a terrific book called "The Star Principle" where he defined companies with these two characteristics as star companies and talked at length about the power of a star company. I would recommend this book to everyone.

The company notes an addressable population within kids of 60m with currently only 5% penetration (refer below). I expect this penetration to deepen as awareness of KCDs builds and parents begin to understand the significant value over and above other wearables without these features. For example, if penetration could deepen 20%, that would be 12m kids. If Spacetalk as a first mover was able to pick up just 10% of the market by 2025 that would be 1.2m unit sales, at say $250 each net to Spacetalk that would be $300m in revenue by 2025. Seniors are a larger addressable population 85m with much less current penetration and presents another significant opportunity for Spacetalk.



Growth runways and optionality:

The company has the following optionality and growth runways

- **Telstra deal**, in March 2021 the company announced Telstra would retail the Spacetalk Adventurer and participate in joint marketing including influencer activity and other initiatives. This is a new distribution channel which I expect to drive significant growth for the company from the launch in April 2021. There is also a flow on effect as Telstra is the #1 MNO in Australia, and this can be leveraged to capture the attention of further MNO's globally.
- **Geographic expansion,** whilst they are the leading product in the category in Australia, Spacetalk is in early stages of the UK launch and yet to launch in the US. The company plans to make further inroads to the regions in 2021. Subject to success in those regions the company has the optionality of expanding into further geographies and unlocking further market opportunities.
- **Market penetration of KCDs,** the industry has a very low market penetration and a very large addressable population. The products are a new kind of technology and awareness/adoption takes time. Recent sales performance in ANZ indicates a wider adoption is starting to materialise. As the devices solve a highly relevant problem, I am very bullish that the devices can become widely adopted.
- **Vertical products**, Spacetalk also have a watch for seniors, Spacetalk life, currently accounting for just 5% of unit sales. With SOS functions, heart rate tracking and other features the idea is that seniors can stay at home longer and avoid nursing home care. The seniors watch was designed after feedback that a number of seniors were already using the kids watch, so the company decided to design one specifically for their requirements. Unit sales of the Life watch are in early stages but present a significant opportunity to Spacetalk. In their latest outlook, the company note they are in advanced conversations with aged care and home care providers regarding life.

COVID

In the US and UK, demand for Spacetalk devices is impacted by COVID, with the length and extent of lockdowns in the UK and the US, keeping parents connected to their children is a very low priority. This could likely shift to a structural tailwind when vaccines are fully rolled out, as parents have become used to being so close with children. Snapping out of lockdowns, parents may look for solutions to stay connected with their kids. This would leave Spacetalk in the right place at the right time to acquire new customers in these regions.

Humans are generally very adaptive in nature, and it will not take long for parents to get used to not being as connected, the same way that got used to being connected. As such, I would expect the tailwind to be short tailed in nature (perhaps 3-6 months), but nonetheless an important period for the company.

Key risks

1. *Competition*

Spacetalk has a strong first mover advantage, and building a product and undergoing extensive testing with retailers/MNO's creates a significant barrier to entry. However, competition still remains the primary risk for the company. The main competitor historically was Moochies, however reviews online suggest that Spacetalk is the leader and Spacetalk products are superior. This is evidenced by the price at JB Hi Fi which customers are willing to pay, where Moochies 4g watch is $249, less than the Spacetalk Adventurer $349. This is also evidenced at top tier MNO's such as Vodafone and soon Telstra, where Spacetalk is the only product retailed in the category.

In 2020, Apple launched "family set up" which allows connection of multiple apple watches to a smart phone, enabling kids to be set up off a parent's phone. However the Apple watch is targeted at adults as a fashionable, more luxurious product and is not built specifically built for kids and as durable as the Spacetalk watch. On a price front, the latest Apple watch series 6 (note the family set up is only available on series4+), retails at $579, significantly more than the Spacetalk Adventurer.

As KCDs is new and growing fast, a number of smaller less credible brands have started popping up. It remains to be seen how the competitive landscape will develop over the next 12-18 months. Of particular interest is how much Apple invest in growing their presence in the niche and whether other leaders in adjacent categories (eg. Garmin) can launch a competitive product.

On the positive, if Apple and other credible brands (eg.Garmin) launch targeted KCDs this will increase awareness of KCD's as a category. When parents are purchasing products, you can expect them to do some research and to discuss alternatives with retailers, this could drive further sales to Spacetalk. That is, market share may go down but the overall market penetration for KCD's gets traction and runs deeper. Spacetalk does not need to have monopoly in this market to do extremely well, it merely needs to be able to build and maintain slice of a growing pie.

2. *Monthly subscription revenue*

A key risk is the monthly subscription revenue for Spacetalk, eg. Apple do not require a monthly app subscription. If Apple were to launch a kids specific device, Spacetalk may not be able to continue to get away with charging fees as awareness builds and potentially further competitors enter.
This is a key risk, however should it materialise, the company can still get much larger than it is today on device sales alone.

On this, I would also like to see the company offer a premium subscription 12 month option up front at a discount. This is common in leading subscription based business (eg. WIX and Tinder + more many more). I noticed in product reviews some customers requested this option as they do not like monthly subscriptions. This would improve working capital and unlock a significant cash flow to fund growth. Referring below, I would like to see better cash flow conversion in future periods.

3. *Cash flow conversion and doubtful debtor provisions*

The company collected from customers only $4m on more than $8m in revenue in H121. Whilst most of this can be attributed to Christmas seasonality, I note the company holds a $0.6m provision for doubtful debts on a $4.3m gross trade receivable balance, or 14% of the balance is provided for. Given the company sells through tier 1 retailers with good credit ratings, this seems unusually high. I will further analyse cash flow conversion and provisioning in the FY21 year-end accounts, noting further disclosure is included at year end.

Management / Board

The company is founder led by tech entrepreneur, Mark Fortunatow. Mark is qualified in mathematics, computer science and economics and has decades of experience as an owner/operator. Mark founded MGM wireless in the early 2000's, which was initially a small company that provided SMS student absence and emergency notification for schools. In recent years, the company has pivoted into wearable smartwatches as the main line of business.

What impressed me most about Management was their recent ability to quickly listen to customer feedback and create the Spacetalk Life and unlock a new revenue stream. Going back, pivoting the original MGM business into kids smartwatches proves a unique ability to recognise, pivot, and launch into growing market areas.

From a capital allocation perspective, Management is supported at the board level by Martin Pretty, a highly experienced fund manager who formerly worked with Thorney investment group. Thorney investment group (Alex Waislitz' group) is also a substantial holder of Spacetalk. The wider Board appears to be very credible and offer a range of expertise useful to the company including sales, design, finance and marketing.

Revenue growth

Based on a terrific H121, the trading update for the first 5 weeks of 2021 and the Telstra deal, I forecast c.$15.0m in revenue for FY21. This implies a revenue growth rate of 43% from FY20.

I expect growth rates of at least this magnitude to continue for at least another 2 years, however with multiple long growth runways it could actually be higher and for much longer than 2 years. In any case, I have modelled this revenue growth out 2 years for illustrative purposes below.

	FY19A	FY20A	FY21F	FY22F	FY23F
Revenue	7.1m	10.9m	15.0m	21.4m	30.6m
Revenue growth rate		46%	43%	43%	43%

Valuation

The company currently trades on a little less than a 2 x FY21F revenue multiple, or a current market cap of $24m ($28.5m fully diluted).

In my view, the key question is whether I believe in growth of KCD's and whether I believe that Spacetalk can take a substantial position in the market. Based on Spacetalk's progress to date and trajectory, I find it easy to envisage a scenario in a few years, where Spacetalk is a $50-$100m revenue business. If it is, I expect it to be profitable at this scale and the upside from today's prices would be extraordinary.

As well as the opportunity for business growth, I believe there is also significant room for multiple expansion. Should the business be able to continue to grow at historic rates (eg. 42% CAGR for app ARR), I would expect it to re-rate on current revenue multiples. I seek to invest only when I have developed a view that there is ample room for both multiple expansion and business growth (otherwise known as the twin engines). All else being equal, the less room there is for multiple compression, the lower the risk of the investment. That is, price is an important factor in risk.

It is too early in the KCD journey for me to forecast cash flows with any precision. As such, I have adopted a group revenue multiple whilst the company continues to grow into a cash flow generative business and the KCD story continues to unfold. I have valued on a group revenue basis, however I found it useful to think about using separate multiples of app ARR, wearable revenue and school revenue.

On a fully diluted basis, I would find it difficult to sell at less than a 10x revenue multiple, and easy to buy up to a 5x revenue multiple. To add a little more thinking, if shareholders were presented with an acquisition proposal at a 5x revenue multiple, as a long term orientated investor I would vote no. At a 10x revenue multiple, I expect I would grapple with this decision and believe I may still vote no, in fear of selling myself far short of the opportunity. I have valued the business on this basis.

Valuation	Valuation method	Market capitalisation[1]	Number of shares (fully diluted)[2]	Share price
Low	5 x FY21F revenue	$75m	197m	$0.38
High	10 x FY21F revenue	$150m	197m	$0.76
			Mid-point	**$0.57**
			Current price	**$0.145**

[1] I have ignored the 5m of debt funding as the majority is likely to be converted with the remainder immaterial for the purposes of calculating enterprise value

[2] Includes dilution related to convertible debt and all options on issue: c.165m (current shares) + c.21m (options and incentives on issue) + 11m (Lender options) = 196m shares.

Closing comments

Spacetalk is front and centre in the very early stages of KCD's and have an exciting product for Seniors in a time that aged care technology is getting significant attention post the royal commission. Spacetalk have made the right foundations in ANZ, have proven their products are popular and high quality and have an impressive strategic direction. Whilst it remains to be seen how popular KCD's and the Senior devices will be, they solve relevant problems and I am particularly bullish that KCD's can become widely adopted globally, presenting an extraordinary opportunity for Spacetalk and the patient investor.

Important disclaimer