BAGGEDEM CAPITAL

Equity Research

Spectur – Equity Research [ASX : SP3]

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Overview

Spectur offer **security & CCTV type solutions** for a range of clients including governments, utilities, private companies, councils etc. They aim to differentiate from competitors by offering a **unique data & AI offering** as part of their security systems. Such data & analytics is **processed on-shore** for security reasons.

They have approx. 6 patents for the solutions they offer, & from the above they offer something no one else can achieve on a technology standpoint.

All competitors basically *"buy 3rd party {security systems} and bolt them together on a pole".* The security systems that SP3 offer is nothing that cannot be purchased elsewhere. They combine elements of the best security systems and bolt the AI/DATA component. "Sum of the parts" type argument.

They are **not currently cash flow positive** on a consistent basis.

SP3 share price since listing on late '17

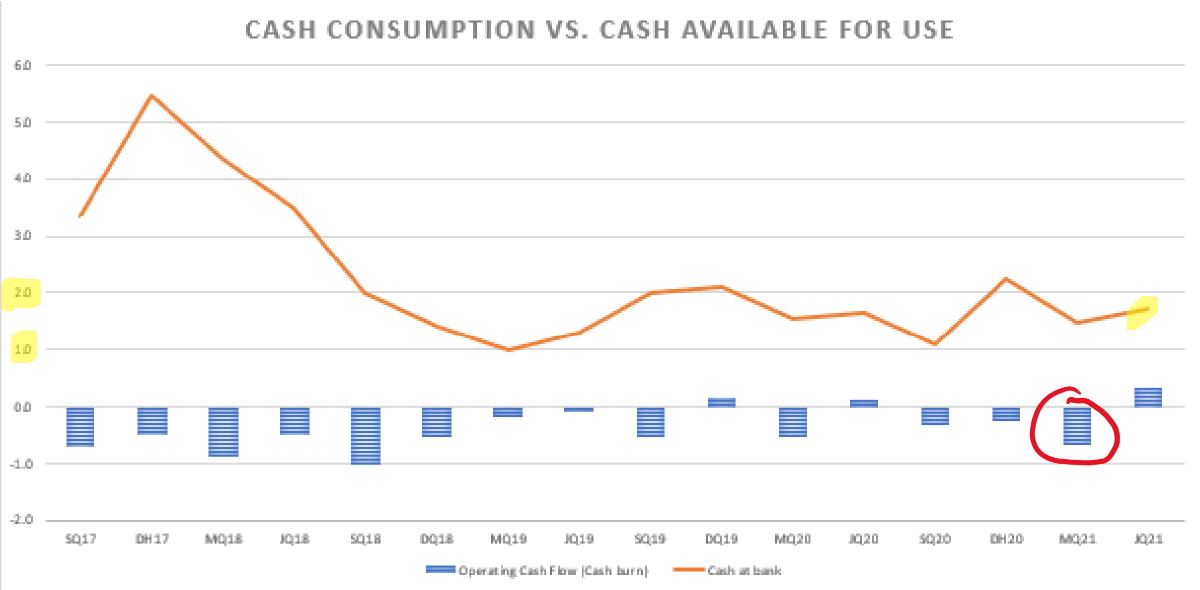
Capitalisation

With around ~106m shares outstanding, the current share prices corresponds a MC of ~$9.1m. Considering the $1.7m cash reserves, the **EV is a mere $7.4m**. We are talking down the very small end of the market now (Nano cap space, and **liquidity to match!**).

SP3 have raised capital once, back when covid hit in SQ20'. They have always been teetering on the edge of under-funded and are definitely still at this stage now. (Below shares a graph of the cash balance SP3 has managed since its inception).

This under-funding is a serious concern given the working capital nature of a business that produces a tangible product that requires assembling in a factory somewhere. This is continued later.

SP3 have access to a loan facility taken up with EGP Capital. Currently untouched but **paying a 3% facility fee.** The more sales, particularly rental sales **demands more upfront capital and a longer payback period.** This is ok in the long run but accentuates the lack of funding in the present day.



Capitalisation contd…

As highlighted in the above graph SP3 were only 1-2 quarters away from being broke, hence the need for the debt facility.

Management considered a further capital raise however “*Issuing furher equity at the current depressed valuation was deemed by the Board to not be in the best interests of shareholders”.*

Now shareholders are in a position where they are paying $45,000 just for having the facility readily available. It shows to me that **management are not demonstrating perfect capital management**. I will flesh this out further below.

Further to the debt facility, the debt holder also received 2.25m options, exercisable at $0.12, on/before Dec 23’. This represents ~2% of the companies listed equity.

Initial thoughts on valuation

When initially looking at the company given no context of the financials my first thoughts were that SP3 would one day be something of a **$50-100m EV company**, some 6-13x what it currently is valued at.

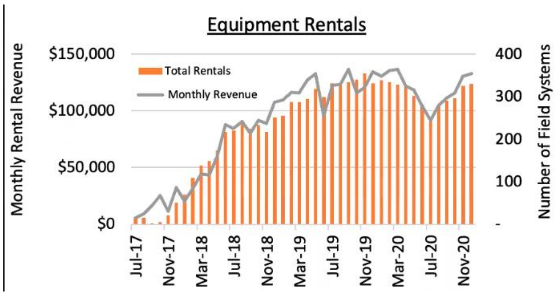
I like scenarios whereby **not a lot of success is priced into the stock** in the sense that it puts a hypothetical cap on my downside risk. I’m of the belief that SP3 sits in that basket, supported by the following metrics.

Considering ARR is now at $3.2m, the company trades on a relatively undemanding 2.8x ARR (to mc), 2.3x ARR (to EV), Price to Sales of 1.7x (MC) and 1.4x (EV).

For a little context, Codan (CDA) is a large technology hardware company, who trade on a Price to sales (MC) of 7.5x on annualised FY21 interim numbers. (Keep in mind CDA is a profitable, dividend paying firm).

For a company that has high growth aspects as SP3 do, they aren’t priced on achieving to much success. The MD had previously rambled about a **$20m revenue target**. I would expect, if reached, that the business would be worth several multiples of what it is today.

	H1 FY2020 Revenue / GM %	H1 FY2019 Revenue / GM %	Change
1. Hardware sales	$955k	$1,068k	-$113k
	56%	53%	3%
2. Rentals	$754k	$543k	$210k
	77%	77%	0%



Business Development

As previously mentioned, we can see that the rental model produces a much greater margin.

In some calculations made beforehand I had also calculated that the rental machines begin making incremental profits after being rented out for between 4-6 months in time.

The issue with the development of a rental fleet rather than a straight sales model is that it **requires more upfront capital.** This would be fine given SP3 is well capitalised…….the problem is they aren't. (Hence the capital raise back in the SQ).

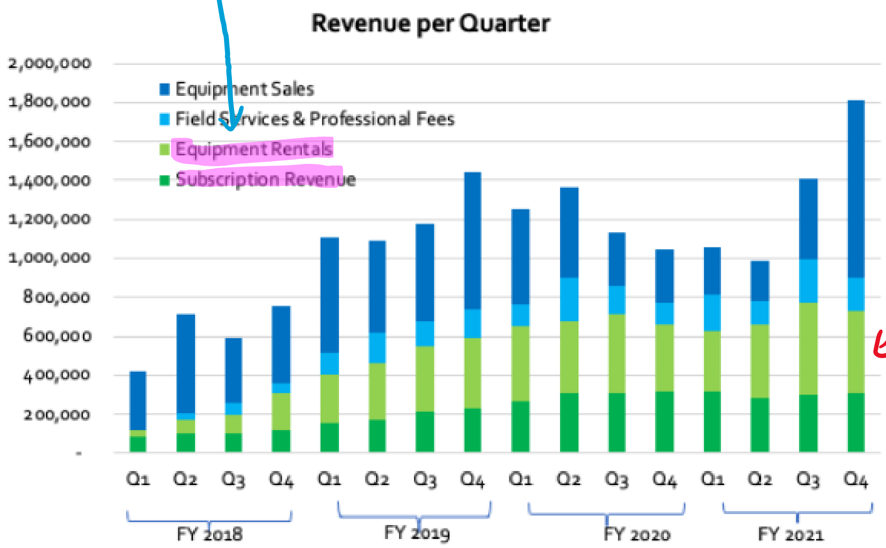
The debt facility that was recently acquired also helps to supplement this cause.

Problems begin to arise when the business reports a record quarter, yet **rental revenues have actually decreased.** The business is able to fund itself going forward if capital sales keep up the rate of the JQ, as seen by the $300k in OCF.

SP3 raised capital, and now a debt facility for what? If rental revenues are not going to be executed, then the debt facility becomes a sting on the wallet of shareholders rather than a pool of funding.

To put things into perspective, this was a decrease over a single quarter and alarm bells do not need to be ringing yet. If rental sales continued in a downward trend, or even went sideways then I would become concerned.

Recurring

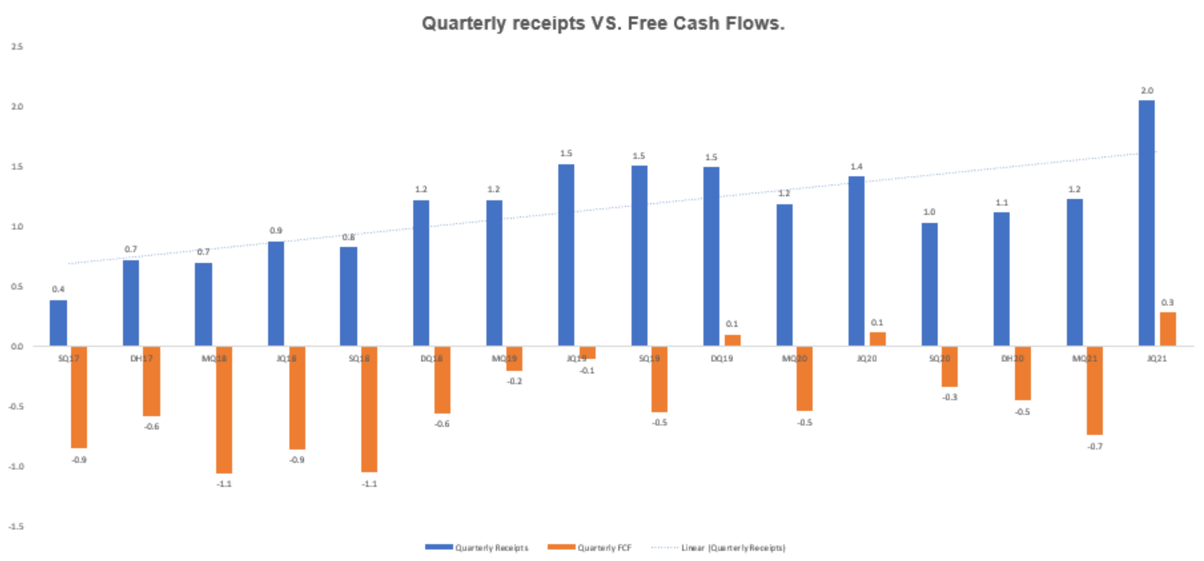


Detraction

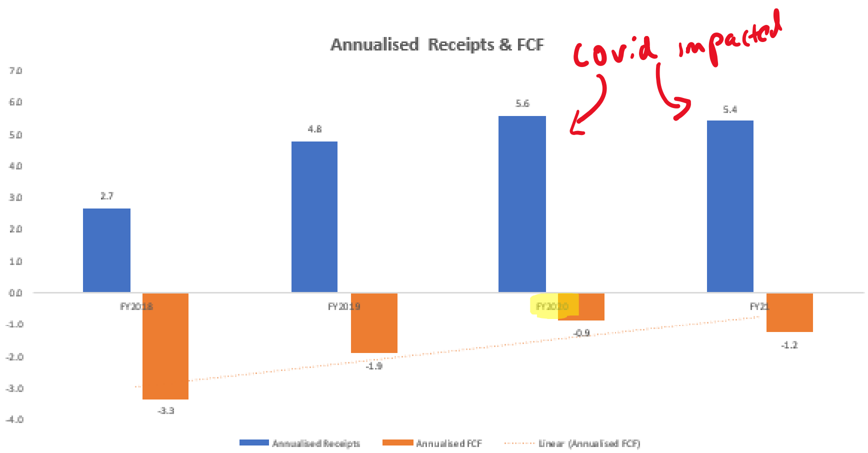
Investment Thesis

In believing the company can grow to become a $50m business, I would need to get a feel for some of the following.

1. How will the business aim to streamline revenue going forward? Will it be a pursuing rentals and recurring revenues, or capital sales, or both? I would like some clarity over which direction the MD will steer them.
2. To become OCF positive on a more consistent basis and understand if not, why this is. I need to understand the timeline for sustained profitability moving forwards.
3. Alternatively, to point #2, funding of future growth becomes more certain. (This could involve a capital raise, but hopefully at a much more attractive dilution rate).



History of quarterly cash flows for context



Historical annualised receipts and cash outflows

Note – These devices must be physically demonstrated and installed. COVID is an obvious overhang on growth.

Where is the value?

The renewed management led by Dr. Dyson (MD) and co have rejuvenated SP3 from the commiserations since its IPO back in 2017.

What are we getting for a $9m company? – Ideally, we want more than just a marketing front for a company that bolts on cameras and chucks in a bit of data analytics. The value-add comes from the **SaaS style, recurring revenue and higher margin** rental models as previously alluded to. This is particularly why I'm annoyed at the detraction in rental models for the previous 4C.

My hope (keeping in mind I don't hold SP3) is that management can steer through the under-funding issues and maintain a few periods of positive OCF enough to build up a meaningful cash balance and thus freely pursue growth in the rental market. This will allow them to produce and deploy the new 'STA-6' model more meaningfully.

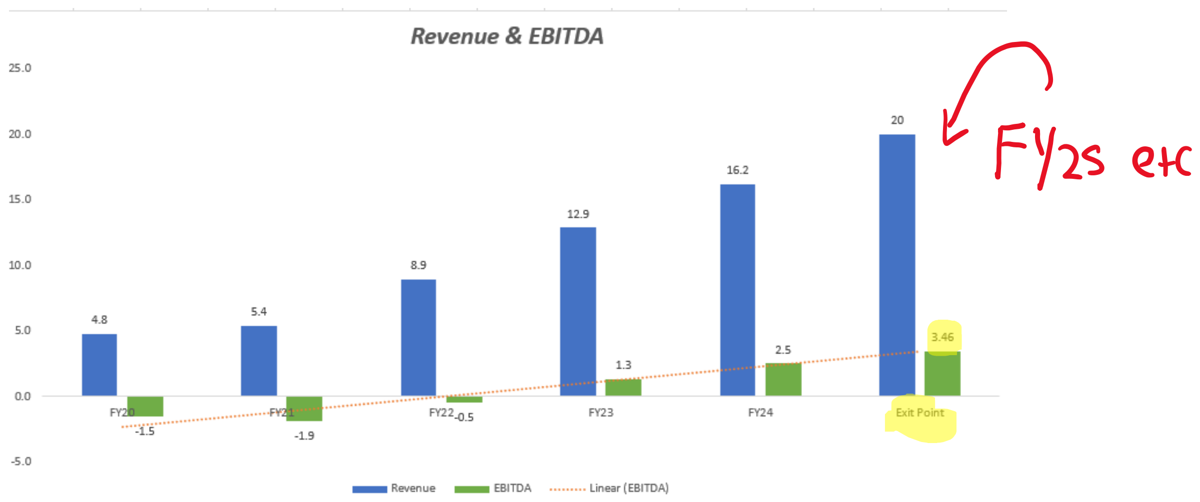
Reverse engineering valuation

As alluded to earlier, I wanted to engage valuation in a process that aligns with an overall 'feel' to what the company could be one-day be valued at, and back testing the inputs/outputs.

Firstly, the investment horizon to be considered is three to four years (due to technological innovation I usually do not expand much past this point).

Next, an applicable exit EV/EBITDA multiple is needed. I chose a 12x multiple on the basis of more attractive, annualised (SaaS) revenues under the rental model that I think the business can progress toward. (This really is the Centrepoint of the investment thesis).

Final step was selecting a company valuation. I stuck with $40m mc to start with. The results were as follows;



As we can see, the following assumptions are produced

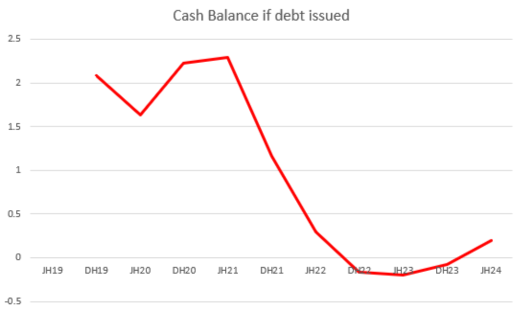
- 40% CAGR, with revenues growing to **$20m**
- Margins staying relatively flat, only minor uplift (conservative IMO given the higher margin rental model).
- CODB growing to $8m, ~$5m in FY21. (Note, I think this may be underestimating).
- D&A reaching $1.2m (again, possibly underestimating). ~$0.7m in FY20.

Reverse engineering valuation ….contd

In essence the end output is that SP3 needs to grow EBITDA from its current (~$1.8m) to $3.5m to justify the company being worth $40m. The assumptions infer that this is a relative stretch, especially when the underfunding argument pops back up.

Fiddling around with the numbers, a $30mc in FY24/FY25 seems a lot more within the ballpark and reason considering a conservative judgement. This means that only $2.5m of EBITDA is required for an exit.

For context, $30m represents a ~222% return on today's MC of $9.2m. (Assuming no dilution).



Funding

Unfortunately, a higher growth strategy infers that a capital raise is imminent if the debt facility is not taken up.

Alternatively, if the debt is issued than the funding perception is still touch and go.

SP3 can try and address the funding issues by sacrificing some short-term growth to ensure that the balance sheet remains in better shape. I'm not sure management want to do this as the growth pipeline looks healthy right now.

I think they would be happy to raise capital but at a point when the share price reflects a bit more optimism and thus shareholders get to experience less dilution.

Concluding thoughts

In summary I'm split over the end results. My guts tell me that this business is much more likely to be $40m in FY24 than the $9m (or less) today. Yet you need to stretch the maths far to get there. $30m mc makes me feel a lot better and still implies significant upside.

Because of my rather concentrated portfolio dynamic **I pass on owning shares at the time of writing**. If the share price subsided much for no reason, then it would become a BUY.

A think the business is a combination of HIGH RETURN and HIGH RISK before considering liquidity concerns. This will only accentuate the risk.

On the conclusion of all above, I would give the stock a **SPEC BUY, or HOLD** on the basis of **uncertainty surrounding revenue streams and funding concerns.**