

Dropsuite Ltd (DSE)

Rating: Buy | Risk: High | Price Target: \$0.35

19 July 2023

Update and outlook was strong and price reaction creates an opportunity. Reiterate Buy.

Key Information

Current Price (\$ps)	0.29
12m Target Price (\$ps)	0.35
52 Week Range (\$ps)	0.17 - 0.37
Target Price Upside (%)	20.7%
TSR (%)	20.7%
Reporting Currency	AUD
Market Cap (\$m)	206.6
Sector	Information Technology
Avg Daily Volume (m)	4.0
ASX 200 Weight (%)	0.01%

Fundamentals

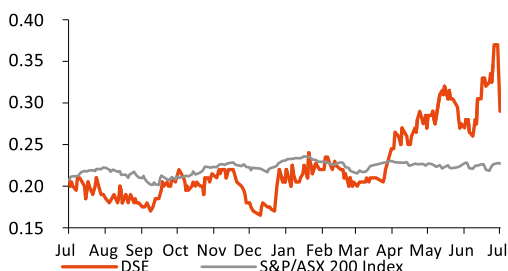
YE 30 Jun (AUD)	FY22A	FY23E	FY24E	FY25E
Sales (\$m)	20.7	29.3	37.6	44.7
NPAT (\$m)	1.5	2.2	2.9	3.8
EPS (cps)	0.2	0.3	0.4	0.5
EPS Growth (%)	638.7%	45.8%	31.9%	29.2%
DPS (cps) (AUD)	0.0	0.0	0.0	0.0
Franking (%)	0%	0%	0%	0%

Ratios

YE 30 Jun	FY22A	FY23E	FY24E	FY25E
P/E (x)	92.9	94.8	71.9	55.7
EV/EBITDA (x)	144.4	91.4	60.6	42.5
Div Yield (%)	0.0%	0.0%	0.0%	0.0%
Payout Ratio (%)	0.0%	0.0%	0.0%	0.0%

Price Performance

YE 30 Jun	1 Mth	2 Mth	3 Mth	1 Yr
Relative (%)	7.6%	1.7%	19.5%	30.3%
Absolute (%)	7.4%	1.8%	18.4%	39.8%
Benchmark (%)	(0.2%)	0.1%	(1.1%)	9.5%



Major Shareholders

Topline Capital Management LLC (Investme)	26.1%
Glory Wealth Group Ltd.	7.1%
FEARO TRACY ANNE	5.4%

Event

DSE has released its 2Q business update. The three things that stood out to us were: 1) 2Q ARR growth of +45% is running ahead of our FY23 forecast (+44%) and will benefit from S&M investment in the 2H; 2) gross margins delivered at 69% and expectations for FY23 were improved upon; and 3) the initial market reaction to Microsoft's Syntex updates creates a fantastic buying opportunity. DSE is a top pick. Reiterate Buy.

Highlights

- Key metrics** – 2Q ARR of \$30.4m grew +51% YoY and +8% sequentially. In US\$ terms, ARR grew +45% YoY and +9% seq (vs +10% seq in 1Q). Users grew +34% YoY and ARPU +6% in US\$. DSE added +35 direct partners and +250 Indirect, while partner revenue churn remained <3%. Gross margins delivered at 69% in-line with 1Q and ahead of initial FY23 expectations. DSE delivered another FCF positive quarter (+\$0.3m), with receipts of \$6.7m and payments of ~\$6.4m. Headcount was disclosed at ~100 implying only single-digit net adds in 2Q. DSE closed 2Q with \$23m cash and no debt.
- Highlights** – ARR growth is running ahead of our FY23 forecast, gross margins were ahead of initial expectations and the market reaction to Microsoft's Syntex update creates a fantastic buying opportunity. 1) 2Q ARR grew 45% YoY in US\$ and is running ahead of our +44% FY23 forecast (assuming AUDUSD 68c). DSE now requires ~+10% seq growth QoQ in the 2H to achieve our forecast. It delivered +10% in 1Q, +9% in 2Q and the 2H will benefit from S&M investment made during 1H (DSE added ~20 heads in 1H, with most joining in 1Q and on average sales rep taking 5-6mths to become productive). 2) DSE achieved a 69% gross margin in 2Q (in-line with 1Q). On the call, management highlighted that it now expects FY23 gross margins to be ahead of FY22. This was stronger language than what we have heard previously. 3) Despite a good result, DSE's stock price fell -21% today. This appears driven by an announcement that Microsoft will introduce M365 Back-up and Archive in Q4 of this year. Whilst on the surface this might appear a direct threat to DSE, we make the following observations: 1) it does not appear to target the MSP/SMB channel (ie majority of early partners are enterprise back-up vendors); 2) the indicated price point of "up to \$8/user" is well above DSE's end-user pricing (~\$3-4/user); 3) it is not a disaster recovery solution or satisfy "true" independence (in contrast, DSE takes data out of Microsoft's ecosystem, encrypts it and moves it to AWS; and 4) it doesn't suggest a change to Microsoft's shared responsibility model (which has been a key driver of third-party back-up adoption). Management summed up its position saying, "we've known about this for at least 18 months... and from where we sit today, we don't expect this to impact us in any way". We agree and think the "shoot first" market reaction today, presents a fantastic buying opportunity for investors, that are looking for a quality, high-growth ASX-listed software investment.
- Guidance/outlook/forecasts** – DSE reiterated its FY23 guidance including: 1) that it is well positioned to deliver strong ARR growth; 2) that gross margins in FY23 are now expected to be ahead of FY22; and 3) that it expects to deliver positive EBITDA and operating cashflow in a similar range to FY22. Post this update, we have slightly upticked our FY24/FY25 forecasts (return on recent S&M investment and contribution from new products etc) but left FY23 broadly unchanged.

Recommendation

We reiterate our Buy rating and increase our PT to 35c (was 34c). DSE is currently trading on an FY23 EV/Revenue multiple of 6.1x. Our PT implies 7.7x which we feel is justified given DSE's attractive combo of strong growth relative to peers (>40%) and profitability.

Jules Cooper | Senior Analyst

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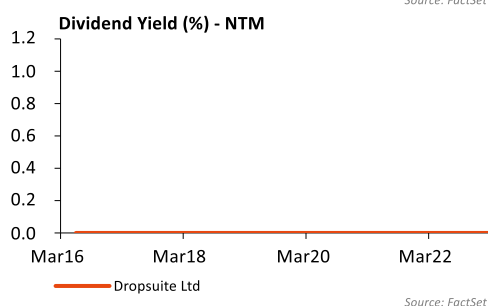
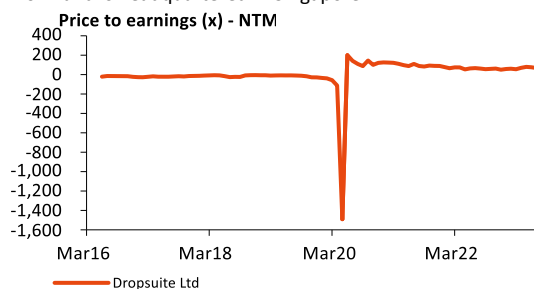
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Dropsuite Ltd Information Technology Software & Services FactSet: DSE-AU / Bloomberg: DSE AU

Key Items	Data
Recommendation	BUY
Risk	HIGH
Price (\$ps)	0.29
Target Price (\$ps)	0.35
52 Week Range (\$ps)	0.17 - 0.37
Shares on Issue (m)	712.6
Market Cap (\$m)	206.6
Enterprise Value (\$m)	182.8
TSR (%)	20.7%

Valuation NPV	Data
Beta	1.10
Cost of Equity (%)	9.1%
Cost of Debt (net) (%)	0.0%
Risk Free Rate (%)	3.0%
Terminal Growth (%)	3.5%
WACC (%)	9.1%
Valuation (\$m)	226.0
Valuation per share (cps) (AUD)	0.32

Dropsuite (DSE) is a leading partner-centric, data backup, archiving and compliance vendor for small and medium sized businesses globally. Its suite of backup solutions cover websites, email, servers and productivity suites including Microsoft 365 and Google Workplace. DSE was founded in 2011 and is headquartered in Singapore.



Financial Year End: 30 June

Investment Summary (AUD)	FY21A	FY22A	FY23E	FY24E	FY25E
EPS (Reported) (cps)	(0.0)	0.2	0.3	0.4	0.5
EPS (Underlying) (cps)	0.0	0.2	0.3	0.4	0.5
EPS (Underlying) Growth (%)	107.8%	638.7%	45.8%	31.9%	29.2%
PE (Underlying) (x)	nm	92.9	94.8	71.9	55.7
EV / EBIT (x)	1,044.9	151.5	96.0	63.5	44.3
EV / EBITDA (x)	862.4	144.4	91.4	60.6	42.5
DPS (cps) (AUD)	0.0	0.0	0.0	0.0	0.0
Dividend Yield (%)	0.0%	0.0%	0.0%	0.0%	0.0%
Franking (%)	0%	0%	0%	0%	0%
Payout Ratio (%)	0.0%	0.0%	0.0%	0.0%	0.0%
Free Cash Flow Yield (%)	0.3%	0.6%	0.7%	1.6%	2.2%
Profit and Loss (AUD) (m)	FY21A	FY22A	FY23E	FY24E	FY25E
Sales	11.7	20.7	29.3	37.6	44.7
Sales Growth (%)	64.6%	76.8%	41.6%	28.3%	18.8%
EBITDA	0.2	1.3	2.0	3.0	4.1
EBITDA Margin (%)	1.8%	6.2%	6.8%	7.9%	9.2%
Depreciation & Amortisation	0.0	(0.1)	(0.1)	(0.1)	(0.2)
EBIT	0.2	1.2	1.9	2.8	3.9
EBIT Margin (%)	1.5%	5.9%	6.5%	7.5%	8.8%
Net Interest	0.0	0.3	1.0	1.0	1.1
Pretax Profit	0.2	1.5	2.9	3.8	5.0
Tax	0.0	0.0	(0.7)	(0.9)	(1.2)
Tax Rate (%)	0.0%	0.0%	(24.0%)	(24.0%)	(24.0%)
Minorities	0.0	0.0	0.0	0.0	0.0
NPAT Underlying	0.2	1.5	2.2	2.9	3.8
Significant Items	(0.2)	0.0	0.0	0.0	0.0
NPAT Reported	0.0	1.5	2.2	2.9	3.8
Cashflow (AUD) (m)	FY21A	FY22A	FY23E	FY24E	FY25E
EBIT	0.2	1.2	1.9	2.8	3.9
Tax Paid	0.0	0.0	(0.7)	(0.9)	(1.2)
Net Interest	0.0	0.2	1.0	1.0	1.1
Change in Working Capital	0.1	(1.5)	(1.8)	(0.9)	(0.8)
Depreciation & Amortisation	0.0	0.1	0.1	0.1	0.2
Other	0.0	0.9	1.2	1.5	1.7
Operating Cashflow	0.3	0.9	1.6	3.6	4.9
Capex	(0.1)	(0.1)	(0.1)	(0.2)	(0.2)
Acquisitions and Investments	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0
Investing Cashflow	(0.1)	(0.1)	(0.1)	(0.2)	(0.2)
Free Cashflow	0.4	0.9	1.5	3.4	4.7
Equity Raised / Bought Back	18.9	0.0	0.0	0.0	0.0
Dividends Paid	0.0	0.0	0.0	0.0	0.0
Change in Debt	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0
Financing Cashflow	18.9	0.0	0.0	0.0	0.0
Net Change in Cash	19.1	0.9	1.5	3.4	4.7
Balance Sheet (AUD) (m)	FY21A	FY22A	FY23E	FY24E	FY25E
Cash	21.6	22.3	23.8	27.3	32.0
Accounts Receivable	2.2	4.1	7.0	8.9	10.6
Other Current Assets	0.2	0.4	0.4	0.4	0.4
PPE	0.0	0.1	0.1	0.1	0.2
Goodwill & Intangibles	0.0	0.0	0.0	0.0	0.0
Investments	0.0	0.0	0.0	0.0	0.0
Other Non Current Assets	0.1	0.1	0.1	0.1	0.1
Total Assets	24.1	26.9	31.4	36.8	43.2
Accounts Payable	2.0	2.5	3.5	4.5	5.4
Short Term Debt	0.0	0.0	0.0	0.0	0.0
Long Term Debt	0.0	0.0	0.0	0.0	0.0
Income Taxes Payable	0.0	0.0	0.0	0.0	0.0
Other	0.2	0.2	0.3	0.3	0.4
Total Liabilities	2.2	2.7	3.8	4.8	5.7
Total Shareholder Equity	21.9	24.2	27.6	32.0	37.5
Ratios	FY21A	FY22A	FY23E	FY24E	FY25E
ROE (%)	1.5%	6.4%	8.4%	9.8%	11.0%
Gearing (%)	(7,309.8%)	(1,178.7%)	(639.8%)	(583.9%)	(584.2%)
Net Debt / EBITDA (x)	(100.7)	(17.5)	(11.9)	(9.2)	(7.8)

Key metrics

Figure 1: Key quarterly metrics

	1Q20	2Q20	3Q20	4Q20	1Q21	2Q21	3Q21	4Q21	1Q22	2Q22	3Q22	4Q22	1Q23	2Q23
ARR	6.7	6.7	7.3	8.5	9.6	11.0	13.1	15.2	17.0	20.1	23.3	25.4	28.2	30.0
ARR (US\$)	4.1	4.7	5.3	6.4	7.3	8.4	9.6	10.9	12.5	14.1	15.6	17.2	18.8	20.0
Gross margin	63%	69%	66%	67%	67%	67%	64%	62%	63%	64%	64%	70%	69%	69%
Receipts	1.2	1.5	1.7	1.7	2.3	2.4	2.9	3.4	3.7	4.3	5.2	5.6	6.1	6.0
Payments	-1.9	-2.1	-1.8	-2.1	-2.3	-2.4	-2.8	-3.2	-4.0	-4.0	-4.6	-5.3	-6.0	-6.0
Cash generation	-0.6	-0.7	-0.1	-0.4	0.0	0.0	0.1	0.2	-0.3	0.4	0.5	0.3	0.1	0.0
Partners	249	272	297	318	335	354	395	409	421	453	473	491	524	550
Users	314000	343000	377000	431000	472000	518000	575000	649000	730000	808000	886000	935000	1020000	1080000
ARPU	1.76	1.64	1.62	1.64	1.68	1.77	1.9	1.95	1.95	2.07	2.2	2.26	2.31	2.3
ARPU (US\$)	1.09	1.13	1.17	1.23	1.29	1.35	1.39	1.40	1.43	1.45	1.47	1.53	1.54	1.6

Source: Company reports, Shaw and Partners analysis

Forecast changes

Figure 2: Forecast changes

Changes to Estimates	Old	New		Old	New		Old	New	
A\$m	2023	2023	Delta	2024	2024	Delta	2025	2025	Delta
Revenue	29.3	29.3	0%	37.2	37.6	1%	44.1	44.7	1%
Opex	-26.2	-26.1	0%	-32.8	-33.2	1%	-38.5	-38.9	1%
Op EBITDA	3.2	3.2	0%	4.4	4.4	2%	5.6	5.8	3%
SBP	-1.2	-1.2	-1%	-1.5	-1.5	-1%	-1.7	-1.7	-1%
EBITDA	2.0	2.0	0%	2.9	3.0	3%	3.9	4.1	5%
PBT	2.9	2.9	0%	3.8	3.8	2%	4.9	5.0	4%
NPAT	2.2	2.2	0%	2.9	2.9	2%	3.7	3.8	4%
Operating cashflow	1.6	1.6	0%	3.6	3.6	0%	4.8	4.9	2%
Capex	-0.1	-0.1	-1%	-0.2	-0.2	-1%	-0.2	-0.2	-1%
Free cashflow	1.5	1.5	0%	3.5	3.4	0%	4.6	4.7	2%
Net cash (debt)	23.9	23.8	0%	27.3	27.3	0%	31.9	32.0	0%
Total cash costs	-26.2	-26.1	0%	-32.8	-33.2	1%	-38.5	-38.9	1%
Cash EBITDA (ex SBP)	3.2	3.2	0%	4.4	4.4	2%	5.6	5.8	3%

Source: Shaw and Partners analysis

Risks to rating and price target

Top line growth does not deliver

We think our forecasts have been framed conservatively and that the risk lies to the upside through FY25. However, a tougher macro environment could impact demand for email backup and archiving solutions, sold to SMBs via MSPs. Further, our medium-term revenue growth relies on the successful launch of new products and modestly increasing ARPU. Lastly, DSE is growing fast and scaling rapidly, which brings its own unique set of challenges. Any of these factors could result in DSE not delivering the forecast growth we expect, which may impact operating leverage, efficiency optics and sentiment.

Loss of a material partner

As a partner-centric software vendor, DSE sells its solutions via hundreds of direct resellers and thousands of indirect MSPs. It is likely that within DSE's top 10 partners, some could be generating revenues in excess of a couple of million. The loss of any material partner, could result in DSE not delivering the forecast growth we expect, which may impact operating leverage, efficiency optics and sentiment.

Competition risks

DSE operates in a growing and attractive market. If other back-up vendors were to aggressively invest in or price their products, to gain market share, then this could result in DSE not delivering the forecast growth we expect, which may impact operating leverage, efficiency optics and sentiment.

Demand risks may impact sentiment

In 2022, small-cap software fell -26% lagging the ASX Small Ords (-21%) and the US peer group (-35%), as inflation, rising rates, geopolitical disruption and recession risks all impacted. Whilst valuations have corrected and software's fundamentals generally remain strong, there is potential for a macro slowdown to impact demand in the short-term. This may impact perceptions of software's relative growth and quality attributes, which could negatively impact sector sentiment and valuations.

Rating Classification

Buy	Expected to outperform the overall market
Hold	Expected to perform in line with the overall market
Sell	Expected to underperform the overall market
Not Rated	Shaw has issued a factual note on the company but does not have a recommendation

Risk Rating

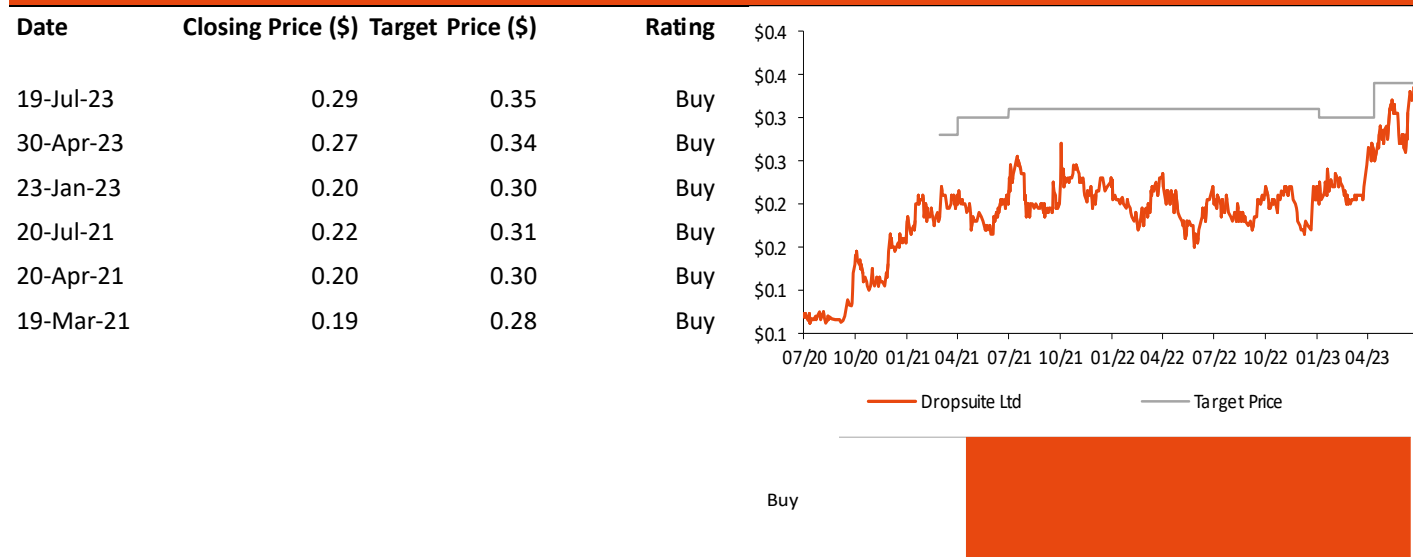
High	Higher risk than the overall market – investors should be aware this stock may be speculative
Medium	Risk broadly in line with the overall market
Low	Lower risk than the overall market

RISK STATEMENT: Where a company is designated as 'High' risk, this means that the analyst has determined that the risk profile for this company is significantly higher than for the market as a whole, and so may not suit all investors. Clients should make an assessment as to whether this stock and its potential price volatility is compatible with their financial objectives. Clients should discuss this stock with their Shaw adviser before making any investment decision.

Distribution of Investment Ratings

Rating	Count	Recommendation Universe
Buy	102	91%
Hold	10	9%
Sell	0	0%

History of Investment Rating and Target Price - Dropsuite Ltd



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