

03 November 2021

Family Zone Cyber Security (FZO)

1Q22: Another strong qtr, with ARR @ \$46m and D&H costs down to \$1.06/student (from ~\$1.50 in 4Q21)

FZO released its 1Q22 quarterly update & 4C last week, which once again showed a business performing exceptionally well, with its ARR rising to \$46m (+\$2.5m QoQ) and data & hosting (D&H) costs reduced sharply, to \$1.06/child from \$1.50/child in the prior quarter. Unfortunately, we believe FZO did a reasonably poor job of explaining some one-off cash flow items, which took some of the shine off the result as OCF outflows at ~\$4m looked concerningly large. Following the release, we maintain a BUY recommendation with a \$1.16/Sh PT (down from \$1.26/Sh, with unfavourable FX being a ~\$0.07/Sh drag).

Note: As FZO pre-releases its results in early Oct, we focus only on key new information from last week's release below (ie. ARR, cash performance and operational updates).

ARR \$46m. This was up a very healthy \$2.5m QoQ, although below our estimate for ~\$47m (with ~\$600k of this being due to unfavourable FX). With ~600k POCs in the pipeline, we expect another ~\$3m in ARR to be added in 2Q22, taking FZO's ARR to ~\$49m at that time.

Cash burn overstated by ~\$2.5m. In 1Q22, FZO incurred ~\$1.5m in one-off cash expenses related to staff restructuring and bonus payments (as a condition of the SW acquisition), while due to the timing of payroll at SW, FZO also incurred ~2/3rds of the business' outgoings vs ~50% as implied by a 17th August closing date. All-in-all, we estimate these abnormal items overstated FZO's cash burn by ~\$2.5m in 1Q22.

Improvements in data & hosting costs the highlight. Over the course of 1Q22, FZO reduced its data & hosting (D&H) expense from ~\$1.50/student to \$1.06 – an incredible result, and one which was materially below our forecast for ~\$1.40/student. With a current contracted student base of 9.18m, these savings will amount to ~\$4m/year (which grows over time).

Cross-sell update. The other major highlight from FZO's release was the announcement of a ~\$1m US Monitoring pipeline – this comes just ~1 month post-launch in the US and sets the company up to comfortably hit our ~\$800k run-rate forecast by year-end FY22. Elsewhere, Classwize will launch in the UK from March (in-line with our model), while Community will launch in the UK at some stage next year (also in-line with us). As discussed (in our note dated 16/8), we expect cross-sell benefits from the Smoothwall (SW) acquisition to be worth ~\$30m by FY25 (Fig. 1, Pg. 3)

Breakeven @ 11.2m students. We believe FZO's fixed costs are running at ~\$12m/qtr or ~\$48m/year (and ~\$44m ex-R&D grants). Accordingly, given the huge improvement in GPs/student in 1Q22 (now ~\$4/child, from ~\$3.50/child), we believe FZO's business will breakeven at ~11.2m students – currently forecast for 1Q23. Obviously improvements in D&H costs or ARPU's will accelerate this timeline, while increases in spending will have the opposite effect (Fig. 2, Pg. 3).

Recommendation	BUY
Target Price (AUD)	1.16
Share Price (AUD)	0.62
Forecast Capital Return	87%
Forecast Dividend Yield	0%
Total Shareholder Return	87%
Market Cap	287,795
Net Cash (Debt)	35,594
Enterprise Value	252,201
Diluted Shares on Issue	464,185
Options on Issue	9,326

Lindsay Bettiol | Head of Research

Key Executives

Managing Director	Tim Levy
Executive Director - Sales	Crispin Swan
Non-Executive Chairman	Peter Pawlowitsch
Non-Executive Director	Matthew Stepka

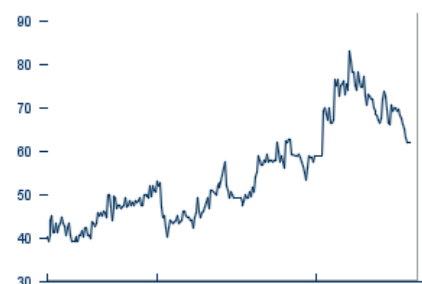
Catalysts

Key US Sales Period	4Q20/1Q21
US Schools Insights Launch	1Q21
US Schools Stimulus	Ongoing

Substantial Shareholders

Regal Funds Management	11.09%
McCusker Holdings	8.05%
Tim Levy	2.36%

Recent Performance



This report should be read in conjunction with the risks, disclaimer and disclosures sections which form part of this report and can be found at the end of this document.

Summary Financials

P&L (A\$m)	FY20	FY21E	FY22E	FY23E	FY24E
Customer Revenue	5.1	10.0	47.3	78.0	112.9
COGS	2.2	7.0	14.8	17.6	21.4
Gross Profit	2.8	3.0	32.5	60.4	91.5
Other	3.4	3.0	4.0	4.0	4.0
Corporate	23.8	29.1	50.7	58.6	66.6
EBITDA	-13.2	-19.8	-11.2	8.8	31.9
D&A	4.2	3.3	3.0	3.0	3.0
EBIT	-17.4	-23.1	-14.2	5.8	28.9
Net interest	0.0	0.0	0.0	0.0	0.0
Pretax profit	-17.6	-23.2	-14.2	5.8	28.9
Tax	0.0	0.0	0.0	0.0	8.7
Minorities	0.0	0.0	0.0	0.0	0.0
NPAT (rep)	-17.6	-23.3	-14.2	5.8	20.2
Abnormal items	0.0	0.0	0.0	0.0	0.0
NPAT (adj)	-17.6	-23.3	-14.2	5.8	20.2
Ave shares (diluted)	251.4	395.4	599.0	735.7	739.3
EPS adj (A¢)	-7.0	-5.9	-2.4	0.8	2.7
DPS (A¢)	na	na	na	na	na

Balance sheet (A\$m)	FY20	FY21E	FY22E	FY23E	FY24E
Cash & equivalents	5.8	35.6	13.6	21.5	51.7
Receivables	4.7	4.7	7.5	7.5	7.5
Inventory	0.2	0.3	0.3	0.3	0.3
Other	0.2	0.3	0.3	0.3	0.3
Total current assets	11.0	40.9	21.7	29.6	59.8
Net PP&E	1.5	1.7	148.5	148.9	150.0
Intangibles	1.3	0.0	0.0	0.0	0.0
Total non-current assets	0.0	0.0	0.0	0.0	0.0
Total assets	14.2	43.2	170.8	179.1	210.5
Payables	3.1	5.0	5.0	5.0	5.0
Short term debt	0.0	0.0	0.0	0.0	0.0
Other	3.0	4.0	4.0	4.0	4.0
Total current liabilities	7.6	9.2	9.2	9.2	9.2
Long term debt	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0
Total long term liabilities	2.2	2.5	2.5	2.5	2.5
Total liabilities	9.8	11.8	11.8	11.8	11.8
Total common equity	4.4	30.1	157.8	166.0	197.4

Cash Flow (A\$m)	FY20	FY21E	FY22E	FY23E	FY24E
Net income	-17.6	-23.3	-14.2	5.8	20.2
D&A	4.2	3.3	3.0	3.0	3.0
Stock-based comp	2.9	2.6	2.5	2.5	2.5
Deferred taxes	0.0	0.0	0.0	0.0	0.0
Other	2.3	3.1	-2.8	0.0	8.7
Cash flow from operations	-8.3	-14.3	-11.5	11.3	34.4
Capital expenditures	-1.3	-2.1	-149.8	-3.4	-4.2
Acquisitions	0.0	0.0	0.0	0.0	0.0
Divestitures	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0
Cash flow from investment	-1.3	-2.1	-149.8	-3.4	-4.2
Dividends paid	0.0	0.0	0.0	0.0	0.0
Capital raised	10.3	46.2	139.3	0.0	0.0
Repaid debt/borrowed funds	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0
Cash flow from financing	10.3	46.2	139.3	0.0	0.0
Total cash flow	0.7	29.8	-21.9	7.9	30.2

Ratios & Valuations	FY20	FY21E	FY22E	FY23E	FY24E
Gross margin (%)	56%	30%	69%	77%	81%
EBITDA margin (%)	-260%	-198%	-24%	11%	28%
EBIT margin (%)	na	-231%	-30%	7%	26%
NPAT margin (%)	na	-233%	-30%	7%	18%

Incrementals	FY20	FY21E	FY22E	FY23E	FY24E
Gross margin (%)	76%	2%	79%	91%	89%
EBITDA margin (%)	-874%	-134%	23%	65%	66%
EBIT margin (%)	-837%	-117%	24%	65%	66%
NPAT margin (%)	-849%	-115%	24%	65%	41%

P/E (x)	na	na	na	na	22.7
P/B (x)	35.4	8.1	2.4	2.7	2.3
EV/EBITDA (x)	na	na	na	na	12.8
Customer Rev growth (%)	22%	96%	373%	65%	45%
EBITDA growth (%)	na	na	na	na	na
EPS growth (%)	na	na	na	na	na

June year end

Ratios calculated using FZO share price of \$ 0.62

Source: Company data, BW Equities Research estimates

Cross-sell opportunities worth ~\$30m/year by FY25

FZO's sales of Monitor in the US have already outpaced our expectations, with ~\$200k in contracts secured within the initial weeks of its launch and a ~\$1m pipeline built inside the first ~ 1 month (for context, we have Monitor sales at only ~\$200k/qtr by 4Q22).

And while FZO's Monitor performance has already been impressive, the company also announced it will look to sell its Classwise (March 2022) and Parental Control (CY22) products into the UK market over the coming year – as Smoothwall currently does not offer either of these options.

As outlined in Figure 1, we believe the cross-sell opportunities available to FZO will prove extremely material over time, with the annual benefit rising to ~\$30m/year by FY25 (ie. within four years of integration). Much of this benefit comes from FZO being able to sell Parental Controls to a ~3x larger audience following the acquisition.

Figure 1: The FZO/Smoothwall cross-sell opportunity

Full-year revenue	FY21	FY22	FY23	FY24	FY25
Existing FZO revenues	10,159,003	19,263,114	33,239,827	52,020,446	74,209,095
Smoothwall, core business		32,003,720	37,598,890	43,595,669	50,017,445
Monitor into the US		472,917	1,828,000	4,085,583	5,150,583
Classroom into the UK		219,243	1,356,883	2,663,609	4,074,215
Parental Controls into the UK		402,230	5,793,925	12,895,275	20,563,759
Total revenues	10,159,003	52,361,224	79,817,524	115,260,582	154,015,098
Cross-sell benefits	0	1,094,389	8,978,807	19,644,467	29,788,558

1Q22 results imply a CF breakeven at ~11.2m students

We believe FZO's fixed costs are running at ~\$12m/qtr or ~\$48m/year (and ~\$44m ex-R&D grants). Accordingly, given the huge improvement in GPs/student in 1Q22 (~\$4/child, from ~\$3.50/child), we believe FZO's business will breakeven at ~11.2m students – currently forecast for 1Q23 (Figure 2).

Obviously improvements in D&H costs or ARPU's will accelerate this timeline, while increases in spending will have the opposite effect

Figure 2: FZO's path to cash flow breakeven

	1Q22	Comment
Total Cash Outgoings	14,578	Total cash outgoings for 1Q22
Add Pro-Rata Smoothwall	1,917	~1 additional month of ~\$23m/year in costs
Less Non-Recurring	-1,500	One-off staff bonuses and restructuring items
Less Variable Costs	-2,892	~\$1.26/student per year (avg. of \$1.50 and \$1.06) on 9.18m students
Total Fixed Cash Costs	12,103	
Annualised	48,412	
Less R&D	-4,000	BW est. for FY22
Total Costs to be Covered	44,412	
Current ARPU	5.01	= \$46m ARR / 9.18m students - we have this trending higher over time
Current D&H/Student	1.06	We model this trending lower over time
GP per Student	3.95	
Students Needed to Breakeven	11,244	We have FZO at 11.2m students in 1Q23

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