03 March 2022

Family Zone Cyber Security (FZO)

More confident than ever in our investment thesis

FZO released its 1H22 results earlier this week, alongside a Q3 update and announced acquisition of US K-12 filtering company, Cipafilter, for ~US$7.5m in cash/scrip. Following these releases, we move our PT to $0.84/Sh and strongly re-iterate our BUY recommendation.

1H22 result. Given quarterly reporting, FZO's 1H22 results were largely known ahead of its release this week, with new information including: (1) Revenues of $17.9m (below BW at $18.6m), (2) GP margins of 66%, which were materially up on 15%/41% in 1H22/2H22 respectively and also comfortably ahead of BW at 62%, (3) total cash/recurring expenses of $26m vs BW at $24.4m and (4) EBITDA loss of $14.2m vs BW at $11.3m.

Trading update. Accompanying its results, FZO also provided a trading update which included a swath of new (and almost exclusively positive) information, including: (1) a further improvement in margins, to >80% from the 66% in 1H22, (2) a UK NRR of 120%, which is above the recently disclosed figure of 110% and continues to demonstrate product market fit in that region, (3) a record pipeline of ~US$7m, (4) confirmation that Classwize will soon launch in the UK, (5) a long-overdue unified branding exercise, and (6) ongoing delays in the launch of US parental control – an unfortunate negative development.

Cipafilter acquisition. Cipafilter was established in 1999 and offers an on-premise filtering service to US K-12 students across the US Midwest. The company serves ~400k students, 580 schools, generates ~$3m in revenues via multi-year contracts and free cash flows of ~$1.5m.

Terms. FZO will pay ~US$7.5m for Cipafilter via a mix of cash (US$3m, paid in equal monthly instalments over 30 months) and scrip (US$4.5m at a 30-day VWAP, or ~13m shares). This purchase price implies ~A$26/child or ~3.5x revenues – comparing favourably with FZO at ~A$28 and ~5.5x, while the ~7x cash flows is extremely attractive in its own right.

Strategic rationale and metrics. (1) pro-forma ARR rises by $3m to $55m, (2) FZO accesses another 400k US students to cross-sell products to, (3) additional technical and sales expertise – in an otherwise tight tech labour market, (4) reduced cash burn, and (5) general benefits of scale – costs/marketing efficiencies/reputational advantages etc.

Investment thesis continues to play out. Our FZO investment thesis has always been predicated on a belief that once scale was obtained in its filtering business, FZO would shift focus to cross-selling new products into its student base at extremely high incremental margins… So, with GP margins now >80% (and likely to expand further), new business ARPUs coming on at ~2x the legacy figure of $5/student, NRRs >100%, and cash costs expected to remain ~flat throughout CY23 – we are witnessing this thesis play out in real-time. <u>Ultimately, with FZO rapidly approaching run-rate breakeven (we model late-CY23), and with all microcap tech names trading well off their recent highs (FZO by 52%), we have never been more confident with our BUY recommendation than we are now.</u>

Recommendation	**BUY**
Target Price (AUD)	0.84
Share Price (AUD)	0.41
Forecast Capital Return	105%
Forecast Dividend Yield	0%
Total Shareholder Return	**105%**
Market Cap	292,888
Net Cash (Debt)	16,729
Enterprise Value	276,159
Diluted Shares on Issue	714,360
Options on Issue	9,326

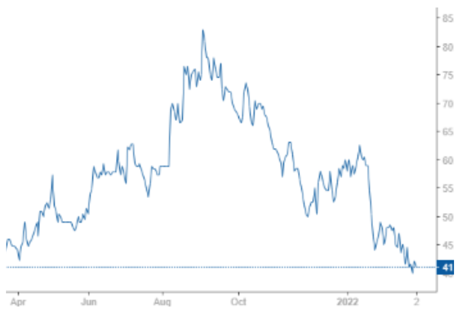
Lindsay Bettiol | Head of Research

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

Catalysts	
Key UK/US Sales Periods	3Q22/4Q22
ARPU improvements	Ongoing
Run-rate Breakeven	CY23
US Parental Controls Launch	3Q23

Substantial Shareholders	
McCusker Holdings	14.84%
Regal Funds Management	12.41%
Perennial Value	5.10%
Tim Levy	1.63%

Recent Performance



BW EQUITIES

Level 30, 360 Collins Street
Melbourne, Victoria, 3000
+61 (0) 3 9601 4800

Summary Financials

P&L (A$m)	FY20	FY21E	FY22E	FY23E	FY24E
Customer Revenue	5.1	10.0	47.2	72.7	99.9
COGS	2.2	7.0	11.3	13.6	16.0
Gross Profit	**2.8**	**3.0**	**35.9**	**59.1**	**83.9**
Other	3.4	3.0	4.0	4.0	4.0
Corporate	23.8	29.1	64.7	68.0	75.5
EBITDA	**-13.2**	**-19.8**	**-21.8**	**-1.9**	**15.3**
D&A	4.2	3.3	3.0	3.0	3.0
EBIT	**-17.4**	**-23.1**	**-24.8**	**-4.9**	**12.3**
Net interest	0.0	0.0	0.0	0.0	0.0
Pretax profit	**-17.6**	**-23.2**	**-24.8**	**-4.9**	**12.3**
Tax	0.0	0.0	0.0	0.0	3.7
Minorities	0.0	0.0	0.0	0.0	0.0
NPAT (rep)	**-17.6**	**-23.3**	**-24.8**	**-4.9**	**8.6**
Abnormal items	0.0	0.0	0.0	0.0	0.0
NPAT (adj)	**-17.6**	**-23.3**	**-24.8**	**-4.9**	**8.6**
Ave shares (diluted)	**251.4**	**395.4**	**599.0**	**735.7**	**739.3**
EPS adj (A¢)	-7.0	-5.9	-4.1	-0.7	1.2
DPS (A¢)	**na**	**na**	**na**	**na**	**na**

Balance sheet (A$m)	FY20	FY21E	FY22E	FY23E	FY24E
Cash & equivalents	5.8	35.6	0.8	-1.4	12.8
Receivables	4.7	4.7	8.6	8.6	8.6
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**	**10.1**	**7.8**	**22.0**
Net PP&E	1.5	1.7	149.6	149.5	150.1
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**	**160.3**	**157.9**	**172.8**
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**	**147.3**	**144.8**	**159.7**

Cash Flow (A$m)	FY20	FY21E	FY22E	FY23E	FY24E
Net income	-17.6	-23.3	-24.8	-4.9	8.6
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	-3.9	0.0	3.7
Cash flow from operations	**-8.3**	**-14.3**	**-23.2**	**0.6**	**17.8**
Capital expenditures	-1.3	-2.1	-150.9	-2.8	-3.6
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**	**-150.9**	**-2.8**	**-3.6**
Dividends paid	0.0	0.0	0.0	0.0	0.0
Capital raised	10.3	46.2	139.4	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**	**139.4**	**0.0**	**0.0**
Total cash flow	**0.7**	**29.8**	**-34.7**	**-2.2**	**14.2**

Ratios & Valuations	FY20	FY21E	FY22E	FY23E	FY24E
Gross margin (%)	56%	30%	76%	81%	84%
EBITDA margin (%)	-260%	-198%	-46%	-3%	15%
EBIT margin (%)	na	-231%	-53%	-7%	12%
NPAT margin (%)	na	-233%	-53%	-7%	9%
Incrementals					
Gross margin (%)	76%	2%	89%	91%	91%
EBITDA margin (%)	-874%	-134%	-5%	78%	63%
EBIT margin (%)	-837%	-117%	-4%	78%	63%
NPAT margin (%)	-849%	-115%	-4%	78%	50%
P/E (x)	na	na	na	na	35.1
P/B (x)	23.4	5.4	1.7	2.1	1.9
EV/EBITDA (x)	na	na	na	na	18.9
Customer Rev growth (%)	22%	96%	372%	54%	37%
EBITDA growth (%)	na	na	na	na	na
EPS growth (%)	na	na	na	na	na

June year end

Ratios calculated using FZO share price of $ 0.41

Source: Company data, BW Equities Research estimates

BW EQUITIES

Level 30, 360 Collins Street
Melbourne, Victoria, 3000
+61 (0) 3 9601 4800

Market update highlights

Given FZO is a quarterly reporter, the company's 1H22 half-yearly results were largely a known quantity. Accordingly, we focus on the key takeaways from FZO's market update and its subsequent investor webinar below.

ARR forecasts for CY23

Following the acquisition of Cipafilter, FZO's pro-forma ARR was $55m at Dec 31st (ie. $52m + $3m). We expect this figure will rise to $64.5m by FY22-end and $74.5mm by CY22-end; comparing with our prior estimates of $62.4m and $72.3m respectively.

The ~$2.2m ARR uplift through to year-end is a combination of (1) a contribution from Cipafilter of ~$4.1m, and (2) a ~1.9m drag from the delayed rollout of parental controls – which we had previously expected to launch in 1Q23 and have now pushed this out to 3Q23.

Figure 1: Estimate changes

	4Q22		2Q23	
	Prior	Current	Prior	Current
ARR	**62,384**	**64,542**	**72,317**	**74,492**
Core Business	62,384	61,182	70,417	70,352
Cipafilter	-	3,360	-	4,140
Parental Controls	-	-	1,900	-

Gross profit margins running >80%

In our view, the single most-important piece of information from this weeks' release was the revelation that gross margins are now running >80% in January, across FZO's businesses – followed closely by confirmation that margins had improved from 15% to 66% YoY for the half.

Given gross margins were just 65%/81%/41% across the ANZ/UK/USA business units in 1H22, a blended >80% margin in January implies enormous improvements across all business segments, particularly in the US – where ongoing costs savings, most notably the switch to GCS from AWS, are clearly having the desired effect.

FZO also highlighted that this >80% margin success arrived ~5 months ahead of schedule.

Figure 2: Margins by geography, as at 1H22

A$000s	ANZ	UK	USA
Income	1,883	9,943	6,102
Other Income	1	0	0
Direct Costs	662	1,841	3,630
Gross Profits	1,222	8,102	2,472
Margin %	64.9%	81.5%	40.5%

Run-rate breakeven by year-end

By inverting the abovementioned gross margins we can arrive at a breakeven ARR, which at current levels of profitability has fallen precipitously to just ~$75m (ie. the amount required to cover ~$60m in cash costs at ~80% margin), from ~$400m in 1H21 and ~$91m in 2H22. Importantly, if margins continue to improve (as both we and the company believe they will), this breakeven ARR figure will continue to trend lower over time.

BW EQUITIES

Level 30, 360 Collins Street
Melbourne, Victoria, 3000
+61 (0) 3 9601 4800

Given our CY22-end ARR estimate sits at ~$75m, we believe that FZO will achieve the important run-rate breakeven milestone this calendar year, under most likely scenarios.

Figure 3: The path to run-rate breakeven, BW estimates

	3Q22	4Q22	1Q23	2Q23
ARR	59,314	64,542	69,736	74,492
GP Margins	82%	82%	81%	83%
RR Gross Profits	48,428	52,997	56,812	61,757
RR Cash Costs	61,018	61,018	61,018	61,018
Run-Rate Cash Burn	-12,590	-8,021	-4,206	739

Cost productivity

Below the line, FZO also announced that it is aiming to achieve ~10% efficiency in operating costs over CY22 – which isn't to say the company will take ~$6m out of its cost base – but rather, that the company will find $6m in cost savings, which are subsequently re-filled with productive spending. These cost efficiencies are expected to see cash costs remain ~flat over CY22.

For reference, we model cash costs of ~$6m for CY23, being ~$15m per quarter (refer Figure 3 above).

Ability to double Cipafilter revenues

From our discussions with the company, we believe there is an opportunity to ~double Cipafilter revenues over the coming 2 years (we model $6.2m by 3Q24). We assume this revenue growth is delivered at ~80% incremental margins, which would see the Cipafilter business delivering ~$4m/year in cash flows at this time.

Parental controls delayed

FZO confirmed the release of its parental controls product is still a work in progress and could not provide a timeline for delivery. Accordingly, we have pushed back our estimates from a 1Q23 launch to a 3Q23 launch. Nevertheless, FZO's confidence in its B2B2C product remains high (as does ours), with the company opting to 'do it once and do it right' with regards to the eventual release.

M&A remains a focus

FZO confirmed that M&A will remain a focus for the company, stating there are "plenty more deals like this out there". FZO will look to acquire businesses that add strategic value and meet three key criteria, being (1) founders not looking to exit – ie. come on the journey, (2) allows FZO to acquire good talent, (3) allows FZO to acquire good tech.

Other takeaways from the trading update and call

- **US update.** 3QFY is a 'lead in quarter' for the US, ahead of the peak sales periods in 4QFY and 1QFY. With a material pipeline of ~$7m already at hand, we expect to see student growth accelerate from this quarter (ie. Q3 = 525k new students vs Q2 @ 220k).
- **Aus update.** The Australian business – while no longer the core focus – continues to strengthen with time. CACs have significantly fallen and the company is achieving a much lower gross churn rate of ~40% (or ~22% net). The company believes this is industry leading.
- **UK update.** 3QFY is traditionally the strongest quarter for UK sales, FZO will also launch its Classwize product into the UK this quarter, with live customers expected in the "next few weeks". With all of Smoothwall's customers already using a classroom product of some description (but not FZO's), this cross-selling opportunity makes a lot of sense. The opportunity is also forecast to be worth ~$30m/year (we model ~$4m by FY25).

BW EQUITIES

Level 30, 360 Collins Street
Melbourne, Victoria, 3000
+61 (0) 3 9601 4800

- **120% NRR in the UK.** FZO achieved 120% net retention in the UK (up from 110% at the last update). This has been achieved via (1) retaining all customers, (2) achieving higher pricing, (3) less discounting, and (4) cross-selling additional products into its student network.
- **Unified branding.** FZO will amalgamate its six brands (Linewize, Family Zone, Smoothwall, NetRef, Cipafilter) under a single brand. This is expected to be completed in 2H22.
- **Revenue growth.** The company feels comfortable in achieving ~40% top-line growth again this year (in line with its current run-rate). This aligns with our expectation for ARR to exit CY23 at $75m vs $55m coming in (ie. ~36% YoY growth).

Cipafilter acquisition

Highlights

- **Background.** Cipafilter was established in 1999 and offers an on-premise filtering service to US K-12 students across the US Midwest.
- **Footprint.** Currently servicing ~400k students and 580 schools
- **Revenues.** Cipafilter currently generates $3m/year through multi-year contracts. This underpins an ARPU of ~A$7.5/child, which is slightly higher than FZOs ~A$5.5/child.
- **Cash flow generative.** The company currently generates underlying cash flows of ~$1.5m/year.
- **Strategic rationale**. (1) pro-forma ARR rises by $3m to $55m, (2) FZO accesses another 400k US students to cross-sell products into, (3) additional technical and sales expertise – in an otherwise tight tech labour market, (4) reduced cash burn, and (5) general benefits of scale – costs/marketing efficiencies/reputational advantages etc.
- **Terms.** FZO will pay ~US$7.5m for Cipafilter via a mix of cash (US$3m, paid in equal monthly instalments over 30 months) and scrip (US$4.5m at a 30-day VWAP, or ~13m shares).
- **Acquisition metrics.** The ~A$10.5m purchase price implies ~A$26/child or ~3.5x revenues – comparing favourably with FZO at ~A$28 and ~5.5x, while the purchase price also implies a multiple of ~7x cash flows – which is extremely attractive in its own right.

Our modelling

From our discussions with the company, we believe there is an opportunity to ~double Cipafilter revenues over the coming 2 years (we model $6.2m by 3Q24). We assume this revenue growth is delivered at ~80% incremental margins, which would see the Cipafilter business delivering ~$4m/year in cash flows at this time – if achieved, FZO will have purchased the business on an incredibly attractive multiple of ~2.5x 2-year forward cash flows.

BW EQUITIES

Level 30, 360 Collins Street
Melbourne, Victoria, 3000
+61 (0) 3 9601 4800

Disclaimer

This research was prepared for wholesale investors only as defined by sections 708 and 761 of the Corporations Act. This report was prepared as a private communication to clients and was not intended for public circulation or publication or for the use of any third party, without the approval of BW Equities Pty Ltd (BW Equities). While this report is based on information from sources which BW Equities considers reliable, its accuracy and completeness cannot be guaranteed. Any opinions expressed reflect BW Equities judgment at this date and are subject to change. BW Equities has no obligation to provide revised assessments in the event of changed circumstances.

BW Equities, its directors and employees do not accept any liability for the results of any actions taken or not taken on the basis of information in this report, or for any negligent misstatements, errors or omissions. This report is made without consideration of any specific client's investment objectives, financial situation or needs. Those acting upon such information do so entirely at their own risk. This report does not constitute an offer or invitation to purchase any securities and should not be relied upon in connection with any contract or commitment whatsoever.

DISCLOSURE OF INTEREST

BW Equities and/or its affiliated companies may make markets in the securities discussed. Further, BW Equities and/or its affiliated companies and/or their employees currently own shares and from time to time may hold shares, options, rights and/or warrants on any issue included in this report and may, as principal or agent, sell such securities. BW Equities has done business with the company covered in this report, more specifically has been involved in capital raising and has earned corporate advisory fees from the Company in the past.

The Directors of BW Equities advise that they and persons associated with them have an interest in the above securities and that they may earn brokerage, commissions, fees and other benefits and advantages, whether pecuniary or not and whether direct or indirect, in connection with the making of a recommendation or a dealing by a client in these securities, and which may reasonably be expected to be capable of having an influence in the making of any recommendation, and that some or all of our Authorised Representatives may be remunerated wholly or partly by way of commission.

ANALYST DISCLOSURE

I, Lindsay Bettiol, certify that the views expressed in this report accurately reflect my personal views about the company and no part of my compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this report.

The analyst(s) responsible for preparing this research report received compensation based on several factors including BW's total revenues, a portion of which are generated by corporate advisory activities.

BW Equities Pty Ltd ABN 66 146 642 462 AFS Licence No. 389353

BW Equities Contacts

Rory Luff
Executive Director, Corporate
+61 3 9601 4806
rluff@bwequities.com.au

Benjamin Kay
Executive Director, Equities
+61 3 9601 4801
bkay@bwequities.com.au

Lindsay Bettiol
Head of Research
+61 3 9601 4870
lbettiol@bwequities.com.au

Brendan Jesser
Equities
+61 3 9601 4805
bj@bwequties.com.au

Paul Pekish
Equities
+61 3 9601 4809
ppekish@bwequities.com.au

Tom Bleakley
Equities
+61 3 9601 4804
tbleakley@bwequities.com.au

Paul Bryan
Equities
+61 3 9601 4810
pbryan@bwequities.com.au