

Spacetalk Limited

Getting Smartwatches for next to nothing

Spacetalk released a 3Q22 trading update on 26 April 2022. Revenue was below our estimate due to the lack of a major new customer. We are lowering our revenue forecasts by 11-35% due to greater caution on product uptake. New analysis on the \$10m estimated value of the School business suggests investors can get the core Smartwatch business for <1x normalised EBITDA. Our fair value moves to \$0.50 per share from \$0.63.

- **3Q22 trading below our forecasts:** Spacetalk reported 11% YoY group revenue growth in 3Q22 versus 44% YoY Veritas estimate and 50% YoY in 1H22 due to fewer infill orders than expected on there being no major new customer in the quarter as well as the launch of the Adventurer in Australia in the prior comparative period. International sales were in line with expectations with Europe growing by 367% YoY. Group revenue of \$4.3m was lower than our \$5.6m estimate due to Device revenue of \$2.6m versus \$4.3m estimate.
- **Product adoption takes time:** We are lowering our revenue forecasts by 11-35% (Figure 1) over the next three years due to the inflection in children's smartwatch adoption taking longer than we thought. Approximately half a million connected children's smartwatches should be sold globally in FY22, giving Spacetalk a c20% share of this emerging market and, we believe, the best consumer proposition. We estimate that children's smart watch penetration is currently less than 1% of the 70m five to ten year olds in the Western world. >50% is possible in time.
- **Operational progress:** Customer sell-through to end-users grew healthily at c40% YoY in the quarter despite COVID disruptions. Yesterday, Spacetalk announced it intends to launch a mobile virtual network operator (MVNO) in the US in June 2022. This should capture an additional revenue of US\$4-5 per user per month.
- **Getting the Smartwatch business for next to nothing:** Adjusting Spacetalk's valuation for \$6.7m net cash and \$10m estimated value of the Schools business (with c\$1.8m EBITDA contribution) implies that the core Smartwatch business is valued at less than \$5m (Figure 2). This is a business with forecast revenue of \$19m in FY22, optionality on higher revenue and estimated normalised EBITDA margins of 30% excluding growth costs.

Figure 1. Changes to Veritas forecasts for Spacetalk (\$m)

Year ended June 30 (\$m)	FY22E			FY23E			FY24E		
	Old	New	Chg.	Old	New	Chg.	Old	New	Chg.
Revenue	23.9	21.2	-2.7	45.1	29.2	-15.9	60.5	46.9	-13.7
Growth (% YoY)	58.3	40.2	-18.1	88.5	37.7	-50.7	34.2	60.6	26.4
EBITDA	-0.9	-1.7	-0.8	2.4	-2.7	-5.1	7.1	3.5	-3.6
Margin (%)	-3.7	-8.0	-4.3	5.2	-9.3	-14.5	11.8	7.4	-4.4
Profit before tax	-5.0	-5.9	-0.8	-2.3	-7.4	-5.1	2.2	-1.5	-3.6
Normalised dil. EPS (cps)	-2.3	-2.7	-0.4	-0.7	-2.3	-1.6	0.7	-0.5	-1.1
Free Cash Flow	-9.7	-9.8	0.0	-2.0	-3.5	-1.5	2.8	-0.6	-3.4

Source: Veritas estimates.

SPA.ASX

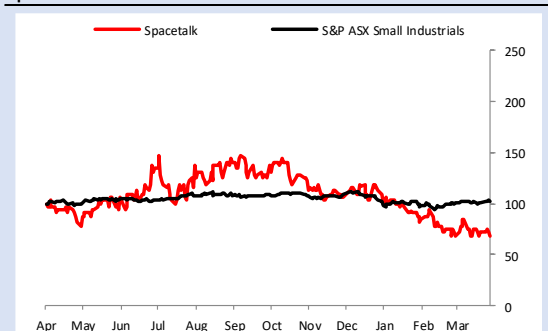
BUY

Friday 29 April 2022

Share Price	\$0.10
Price Target	\$0.50
Valuation Method	DCF
Market capitalisation	\$21.5m
Enterprise value	\$14.8m
GICS sector	Software and Services
12 month price range	\$0.10 - \$0.24
Shares in issue	215.5m
Top 20 holders	69.8m
Previous rating	Buy

Year ended June 30		FY21	FY22E	FY23E	FY24E
Revenue	\$m	15.1	21.2	29.2	46.9
Growth	%	44.2	40.2	37.7	60.6
EBITDA	\$m	0.7	(1.7)	(2.7)	3.5
Margin	%	4.8	(8.0)	(9.3)	7.4
NPAT	\$m	(1.8)	(5.9)	(5.3)	(1.1)
EPS	cps	(1.0)	(2.7)	(2.3)	(0.5)
CFPS	cps	(0.7)	(2.6)	0.2	1.0
PER	x	N/A	N/A	N/A	N/A
Price/Cash Flow	x	N/A	N/A	46.9	9.6
EV/Revenue	x	1.0	0.7	0.5	0.3
EV/EBITDA	x	20.3	N/A	N/A	4.3
EV/EBIT	x	N/A	N/A	N/A	N/A
EV/Capital	x	1.6	1.1	1.1	1.0
Gearing (net debt: capital)	%	1	8	36	40
Fixed charge cover	x	N/A	N/A	N/A	N/A
Return on capital	%	N/A	N/A	N/A	N/A

Spacetalk vs. Small Industrials Index



Source: FactSet, Veritas

Spacetalk is a provider of communications solutions for families. The company produce a range of smartwatches for children and seniors plus related software. Spacetalk is a leader in these emerging categories.

<https://www.spacetalk.com>

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EQUITY RESEARCH

Spacetalk

Share Price: \$0.10 ps

Valuation: \$0.50 ps

Financial Performance (A\$m)

	FY19	FY20	FY21	FY22E	FY23E	FY24E
Year ended June 30						
Revenue	7.1	10.5	15.1	21.2	29.2	46.9
Cost of sales	(1.9)	(3.0)	(5.8)	(8.8)	(14.0)	(23.9)
Gross profit	5.2	7.4	9.4	12.4	15.2	23.0
Operating costs	(5.5)	(7.6)	(8.3)	(13.6)	(16.9)	(18.5)
Share based payments	(3.4)	(2.5)	(0.4)	(0.5)	(1.0)	(1.0)
Normalised EBITDA	(3.6)	(2.7)	0.7	(1.7)	(2.7)	3.5
Depreciation and amortisation	(2.0)	(2.5)	(3.0)	(3.7)	(4.2)	(4.5)
Normalised EBIT	(5.6)	(5.1)	(2.3)	(5.4)	(6.9)	(1.0)
Associate income	0.0	0.0	0.0	0.0	0.0	0.0
Net interest	(0.0)	(0.1)	(0.2)	(0.5)	(0.5)	(0.5)
Normalised Pre-tax Profit	(5.6)	(5.3)	(2.4)	(5.9)	(7.4)	(1.5)
Normalised tax	1.0	1.0	0.7	0.0	2.0	0.4
Profit attributable to minorities	0.0	0.0	0.0	0.0	0.0	0.0
Normalised profit to holders	(4.7)	(4.3)	(1.8)	(5.9)	(5.3)	(1.1)
One off items (post-tax)	0.0	0.0	0.0	0.0	0.0	0.0
Reported profit to holders	(4.7)	(4.3)	(1.8)	(5.9)	(5.3)	(1.1)

Cash Flow Statement (A\$m)

	FY19	FY20	FY21	FY22E	FY23E	FY24E
Year ended June 30						
Normalised EBITDA	(3.6)	(2.7)	0.7	(1.7)	(2.7)	3.5
Non cash items	3.4	2.5	0.4	0.5	1.0	1.0
Cash net interest	(0.0)	(0.1)	(0.3)	(0.5)	(0.5)	(0.5)
Cash tax (paid)/received	0.6	1.0	0.7	0.0	2.0	0.4
Working capital/other	(0.9)	0.3	(2.7)	(4.0)	0.7	(1.9)
Operating Cash Flow	(0.5)	0.9	(1.2)	(5.7)	0.5	2.4
Capex	(2.2)	(3.1)	(3.0)	(4.0)	(3.0)	(3.0)
Free Cash Flow	(2.8)	(2.2)	(4.2)	(9.8)	(3.5)	(0.6)
Disposals/Acquisitions	0.0	0.0	0.0	0.0	0.0	0.0
Dividends paid	0.0	0.0	0.0	0.0	0.0	0.0
Equity raised/buybacks	0.5	5.2	2.5	9.0	0.0	0.0
Borrowings/(debt repayment)	1.3	(1.3)	3.0	2.0	0.0	0.0
Other inc. finance leases	0.0	(0.2)	(0.2)	(0.2)	(0.2)	(0.2)
Net increase/(decrease) cash	(1.0)	1.5	1.0	1.0	(3.8)	(0.8)
Cash at beginning	2.6	1.6	3.2	4.2	5.2	1.4
Cash at end (including bank deposits)	1.6	3.2	4.2	5.2	1.4	0.6

Balance Sheet (A\$m)

	FY19	FY20	FY21	FY22E	FY23E	FY24E
Year ended June 30						
Cash and cash equivalents	1.6	3.2	4.2	5.2	1.4	0.6
Trade and other receivables	0.8	1.0	2.2	6.5	6.0	8.3
Inventories	1.2	1.0	1.7	2.4	3.4	5.4
Other current assets	1.0	1.1	2.8	2.8	2.8	2.8
Current assets	4.7	6.3	10.9	16.9	13.5	17.0
Plant and equipment	0.2	0.2	0.2	0.2	0.2	0.3
Intangible assets	2.8	3.7	3.9	4.5	4.6	3.4
Right of use	0.0	0.1	0.3	0.3	0.3	0.3
Deferred tax assets	0.0	0.5	0.7	0.7	0.7	0.7
Non current assets	3.0	4.5	5.1	5.7	5.8	4.7
Assets	7.7	10.7	16.0	22.6	19.4	21.7
Trade and other payables	1.3	2.1	1.9	2.9	4.0	6.4
Provisions	0.3	0.2	0.4	0.4	0.4	0.4
Borrowings & leases	0.0	0.1	0.2	0.2	0.2	0.2
Income tax liability	0.0	0.0	0.1	0.1	0.1	0.1
Current liabilities	1.6	2.4	2.6	3.6	4.7	7.1
Borrowings	1.3	0.0	4.1	6.1	6.1	6.1
Deferred tax liabilities	0.0	0.0	0.0	0.0	0.0	0.0
Non current liabilities	1.3	0.0	4.1	6.1	6.1	6.1
Total liabilities	2.9	2.4	6.7	9.6	10.7	13.1
Issued shares	10.8	16.1	18.7	28.2	29.2	30.2
Reserve options	3.7	6.2	6.4	6.4	6.4	6.4
Accumulated losses	(9.7)	(14.0)	(15.8)	(21.6)	(27.0)	(28.0)
Total equity	4.8	8.3	9.4	13.0	8.7	8.6

Directors and Key Management Personnel

	Shares	Holding
Mark Fortunatow	17.3m	8.0%
Martin Pretty	0.2m	0.1%
Brandon Gien	0.1m	0.1%
Saurabh Jain	0.0m	0.0%

Major Shareholders

	Shares	Holding
Regal	26.2m	11.9%
Thorney Investment Group	17.9m	8.1%
Mark Fortunatow	17.3m	7.9%
Top 20 shareholders	69.8m	31.7%

Source: Company data, Veritas Securities estimates.

Valuation Metrics

	Valuation
Price Target (ps)	\$0.50 397%
Share Price (ps)	\$0.10
FY22E EV/Sales (x)	0.7
Implied FY22 EV/Sales (x)	4.7 577%
Implied FY23 EV/Sales (x)	3.4 392%
Market Capitalisation (A\$m)	21.5
Enterprise Value (A\$m)	14.8
Shares in issue (m)	215.5

Valuation Multiples

	FY19	FY20	FY21	FY22E	FY23E	FY24E
Year ended June						
P/E (x)	N/A	N/A	N/A	N/A	N/A	N/A
Price/Cash Flow (x)	N/A	15.0	N/A	N/A	46.9	9.6
EV/Revenue (x)	2.1	1.4	1.0	0.7	0.5	0.3
EV/EBITDA (x)	N/A	N/A	20.3	N/A	N/A	4.3
EV/EBIT (x)	N/A	N/A	N/A	N/A	N/A	N/A
Equity FCF yield (%)	-12.8	-10.2	-19.6	-45.3	-16.4	-2.8
Dividend yield (%)	0.0	0.0	0.0	0.0	0.0	0.0
EV/capital (x)	3.4	2.8	1.6	1.1	1.1	1.0
Price to book value (x)	2.6	1.7	1.9	1.7	2.7	2.7

Per Share Data

	FY19	FY20	FY21	FY22E	FY23E	FY24E
Year ended June 30						
EPS diluted - adjusted (cps)	(3.69)	(3.03)	(1.01)	(2.68)	(2.29)	(0.46)
EPS diluted (cps)	(3.69)	(3.03)	(1.01)	(2.68)	(2.29)	(0.46)
Cash flow per share (cps)	(0.4)	0.7	(0.7)	(2.6)	0.2	1.0
Free cash flow per share (cps)	(2.2)	(1.6)	(2.4)	(4.5)	(1.5)	(0.3)
Cash (cps)	1.3	2.2	2.4	2.4	0.6	0.2
Net assets (cps)	3.8	5.9	5.3	6.0	3.7	3.7
DPS (cps)	0.0	0.0	0.0	0.0	0.0	0.0
Franking (%)	0.0	0.0	0.0	0.0	0.0	0.0
Shares on issue - avg. basic (m)	121	138	164	200	215	215
Shares on issue - avg. diluted (m)	127	141	175	218	233	233

Segmental Revenue (A\$m)

	FY19	FY20	FY21	FY22E	FY23E	FY24E
Year ended June 30						
App ARR	0.8	1.5	2.8	4.0	6.0	9.6
App revenue	0.4	1.2	2.2	3.3	4.9	7.8
Device revenue	4.2	6.5	10.6	15.8	22.2	37.0
SpaceTalk revenue	4.6	7.7	12.8	19.1	27.1	44.8
MGM schools revenue	2.2	2.7	2.2	2.1	2.1	2.1
Trading revenue	6.8	10.4	15.0	21.2	29.2	46.9
Grants & other income	0.3	0.1	0.1	0.0	0.0	0.0
Revenue	7.1	10.5	15.1	21.2	29.2	46.9

Segmental Revenue Growth (% YoY)

	FY19	FY20	FY21	FY22E	FY23E	FY24E
Year ended June 30						
App ARR growth	N/A	87.5	86.7	44.5	47.1	61.3
App revenue growth	N/A	180.0	79.3	52.3	49.3	58.9
Device revenue growth	836.5	53.8	63.8	49.2	40.4	66.7
Spacetalk revenue growth	931.9	65.4	66.2	49.7	41.9	65.3
MGM schools revenue growth	(1.9)	25.1	(18.1)	(6.5)	0.0	0.0
Trading revenue growth	154.5	52.5	44.0	41.3	37.7	60.6
Revenue growth	160.3	46.8	44.2	40.2	37.7	60.6

Performance Ratios (%)

	FY19	FY20	FY21	FY22E	FY23E	FY24E
Year ended June 30						
Gross margin	73.1	70.9	61.9	58.5	52.0	49.0
EBITDA margin	(51.0)	(25.6)	4.8	(8.0)	(9.3)	7.4
Gross debt inc. leases (\$ m)	1.3	0.1	4.2	6.2	6.2	6.2
Net cash/(debt) (\$ m)	0.4	3.0	(0.1)	(1.1)	(4.8)	(5.7)
Gearing (net debt/(cash): capital)	(8.7)	(57.3)	0.6	7.5	35.9	39.8
Fixed charge cover	N/A	N/A	N/A	N/A	N/A	N/A
Return on capital	N/A	N/A	N/A	N/A	N/A	N/A

Getting the core Smartwatch business for next to nothing

Spacetalk began its life as a company that provided a messaging service for schools which informs parents via a chat-bot if their children do not turn up or are sick. As pricing pressure increased in the School Messaging Services (SMS) market the company launched a children's smartwatch business in October 2017. Smartwatches is forecast to generate \$19m revenue in FY22, 90% of our group revenue forecast. School Messaging Services remains highly profitable and provides unappreciated asset backing to an investment in Spacetalk.

We forecast the School Messaging Services will generate \$2.1m of revenue, \$2.0m of gross profit and \$1.8m of EBITDA in FY22 on a realistic allocation of costs to the respective segments noting that the business has just two staff. Note that Spacetalk statutory accounts allocate most of the group corporate and central costs to the SMS segment as it provided the foundation of the company.

We estimate the School Messaging Services is worth \$10m (5.5x EBITDA FY22E) and could be realistically sold to private equity or a competitor for its annuity like cash flows and dominant position in its niche market.

Adjusting Spacetalk's current valuation for its \$6.7m net cash position and the \$10m estimated value of School Messaging Services implies that the market is valuing the core Smartwatch business at less than \$5m or 2c per share (Figure 2). This is a business with forecast revenue of \$19m in FY22 and with estimated normalised EBITDA margins of 30% i.e. excluding growth costs. Note that the company is currently investing substantially in the business to expand distribution globally and develop future models.

Figure 2: Estimated stub value of Spacetalk's Smartwatch business

Item	\$m	\$ per share
SPA market capitalisation	21.5	0.10
Cash at 1H22	-9.7	-0.04
Financial debt and leases at 1H22	2.9	0.01
SPA Enterprise Value	14.8	0.07
School Messaging Services (SMS) EV at 5.5x FY22E EBITDA	10.0	0.05
Smartwatch implied Enterprise Value	4.8	0.02
Smartwatch revenue FY22E	19.1	0.09
Smartwatch normalised EBITDA margin (ex. growth costs)	30%	
Smartwatch normalised EBITDA in FY22E	5.7	0.03
Smartwatch EV/Revenue FY22E (x)	0.3	
Smartwatch EV/normalised EBITDA FY22E (x)	0.8	

Source: Company data, Veritas. Note: We exclude \$1.9m of warrants issued by SPA from debt in 1H22 as they are out of the money.

A new major customer could triple group sales

Spacetalk is currently operating at a sales run rate of approximately 100,000 smartwatch units annually. We estimate that a single substantial new customer like AT&T, Verizon or Walmart US could each sell >200,000 units annually. Note that Walmart has >4,000 stores in the US which at a sales rate of 1 unit per store per week would give more than 200,000 unit sales per year. Spacetalk has numerous top-tier reference customers including O2 (Telefonica), Sky UK, Telstra, Telenor and Elisa.

We see limited downside to the shares from here given the low implied value of the smartwatch business and the substantial optionality provided by existing and new distribution agreements.

RATING

- BUY – anticipated stock return is greater than 10%
- SELL – anticipated stock return is less than -10%
- HOLD – anticipated stock return is between -10% and +10%
- SPECULATIVE – high risk with stock price likely to fluctuate by 50% or more

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