

27 May 2021

Dropsuite Limited (DSE)**BUY****Share Price: A\$0.18****Ransomware attacks drive demand for backup software Target Price: A\$0.33**

We reiterate our forecasts following Dropsuite's recent AGM update and a deep-dive on the impact of ransomware as a structural tailwind for backup software providers. Ransomware incidents, a form of malicious software designed to threaten the data security are on the rise. However, it is the indirect costs like business downtime rather than direct costs, i.e. the actual ransom paid that is driving a seismic change in approach to data security amongst IT professionals. Recent industry data shows a step-change in the use of cloud based backup as a service software, with adoption of Office 365 third party back-up nearly doubling year on year. We reiterate our BUY recommendation and A\$0.33 target price, with DSE well positioned to benefit from a rising rate of adoption for dedicated third party cloud based backup software.

Key Points from our deep dive research

- The indirect costs of Ransomware (business downtime) increased by 98% in 2020 to US\$274k on average, 50x the average ransom requested of US\$5.6k.
- In response to rising frequency and costs, cloud backup software is rising in popularity given its effectiveness in reducing downtimes and relative low cost versus front line threat detection measures involving humans.
- The adoption of third party cloud backup software for Office 365 has almost doubled year on year to 46% of large enterprises, up from 26% in 2020.

Approaching profitability at low market penetration

- Consistent with our expectations, DSE reiterated their expectations to achieve profitability later year in AGM, a very positive sign given low market penetration to date.
- We assume 0.7m end users by 2021, implying <1% of the current Office 365 user base & low single digit share of dedicated cloud based office 365 backup users.
- We see upside risk to our base case user numbers given accelerated Office 365 backup adoption, DSE has the potential to hit 2m by FY23 vs our base case 1.3m, implying a target price of A\$0.70, >250% upside.

Financial Summary

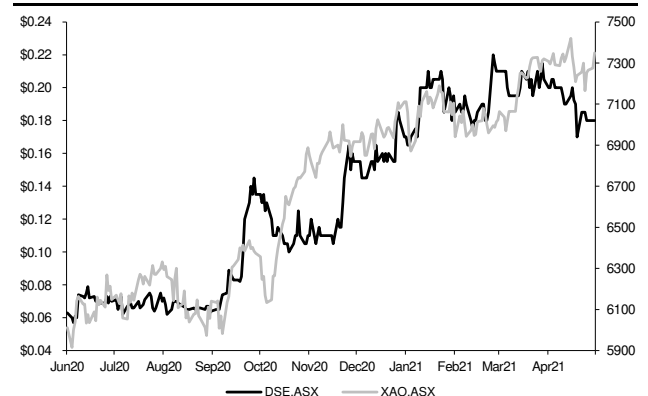
- We estimate revenue CAGR to FY22 of 63% driven by a robust +30% growth in backup software industry and mid to high teens growth in Office 365 users.
- We value the stock on a 50/50 FY22F 8.0x EV/Sales (A\$0.26) and DCF (A\$0.40) valuations.
- We reiterate our BUY recommendation, with ~80% upside to our unchanged A\$0.33 target price.

Company Data

Shares – ordinary (M)	579.9
Dilution (M)	3.0
Total (fully diluted) (M)	583.0
Market capitalisation (\$M)	104.4
12 month low/high (\$)	0.05/ 0.22
Average monthly turnover (\$M)	3.3
GICS Industry	Software

Financial Summary (fully diluted/normalised)

Year end 31 Dec	2019A	2020A	2021F	2022F	2023F
Revenue (\$M)	4.7	7.1	11.2	19.0	30.0
Costs (\$M)	(7.1)	(8.8)	(10.8)	(14.2)	(18.7)
EBITDA (\$M)	(2.4)	(1.7)	0.4	4.7	11.3
NPAT (\$M)	(3.2)	(2.2)	(0.1)	2.8	7.3
EPS (cps)	(0.6)	(0.4)	(0.0)	0.5	1.2
EPS Growth (%)	n/m	n/m	n/m	+100%	150%
PER (x)	n/m	n/m	n/m	36.9	14.7
Free cash flow (\$M)	(2.1)	(1.8)	(0.1)	2.8	7.5
FCFPS (cps)	(0.4)	(0.3)	(0.0)	0.5	1.3
PFCFPS (x)	n/m	n/m	n/m	35.1	13.6
Enterprise Value (\$M)	22.3	99.2	102.6	99.7	92.3
EV / Sales (x)	4.8	14.1	9.1	5.3	3.1
Payout ratio (%)	0%	0%	0%	0%	0%
Dividends (cps)	0.0	0.0	0.0	0.0	0.0
Yield (%)	0%	0%	0%	0%	0%
Franking (%)	n/m	n/m	n/m	n/m	n/m

DSE – performance over one year**Disclosure and Disclaimer**

This report must be read with the disclosure and disclaimer on the final page of this document.

Analysis

Dropsuite Limited						
Year end 31 Dec						
MARKET DATA						
Recommendation						Buy
Price	\$					0.18
Target Price (12-month)	\$					0.33
52 week high / low	\$					0.22/ 0.05
Market capitalisation (quoted)	\$m					104.4
Shares on issue (quoted)	no.					579.9
Options / Rights in the money	no.					3.0
Other equity	no.					0.0
Shares on issue (diluted)	no.					582.9
12-MONTH SHARE PRICE RELATIVE PERFORMANCE						
INVESTMENT FUNDAMENTALS						
		FY19A	FY20A	FY21F	FY22F	FY23F
Reported EPS (undiluted)	¢	(0.6)	(0.4)	(0.0)	0.5	1.3
EPS Underlying	¢	(0.6)	(0.4)	(0.0)	0.5	1.3
EPS Underlying (diluted)	¢	(0.6)	(0.4)	(0.0)	0.5	1.2
... Growth	%	n/m	n/m	n/m	+100%	150%
PER Underlying (diluted)	x	n/m	n/m	n/m	36.9	14.7
Operating cash flow per share	¢	(0.4)	(0.3)	(0.0)	0.5	1.3
Free cash flow per share	¢	(0.4)	(0.3)	(0.0)	0.5	1.3
Price to free cash flow	x	n/m	n/m	n/m	35.1	13.6
Free cash flow yield	%	n/m	n/m	n/m	3%	7%
Book value per share	¢	0.4	0.5	0.4	0.9	2.2
Price to book	x	2.7	6.7	7.2	3.4	1.4
Net tangible assets per share	¢	0.5	0.7	0.8	1.4	2.8
Price to NTA	x	9.8	24.1	23.5	13.1	6.3
Dividend	¢	0.0	0.0	0.0	0.0	0.0
Payout ratio	%	0%	0%	0%	0%	0%
Yield (Y/E/ spot)	%	0.0%	0.0%	0.0%	0.0%	0.0%
Franking	%	n/m	n/m	n/m	n/m	n/m
Gross Yield (Y/E/ spot)	%	0.0%	0.0%	0.0%	0.0%	0.0%
Net debt /(cash)	\$m	(1.4)	(2.5)	(2.4)	(5.2)	(12.7)
Enterprise value	\$m	22.3	99.2	102.6	99.7	92.3
EV/Sales	x	4.8	14.1	9.1	5.3	3.1
EV/EBITDA	x	(9.5)	(59.8)	246.5	21.0	8.2
KEY RATIOS						
		FY19A	FY20A	FY21F	FY22F	FY23F
EBITDA margin	%	(50%)	(23%)	4%	25%	38%
EBIT margin	%	(67%)	(30%)	(1%)	20%	33%
NPAT margin	%	(67%)	(30%)	(1%)	15%	24%
ROE (Average Equity)	%	(93%)	(97%)	(6%)	72%	81%
ROA (EBIT)	%	(18%)	(15%)	(1%)	15%	20%
Interest cover (EBIT / net interest)	x	n/m	n/m	n/m	n/m	n/m
Leverage (net debt / EBITDA)	x	n/m	n/m	n/m	n/m	n/m
Gearing (net debt / (net debt+equity))	x	n/m	n/m	n/m	n/m	n/m
DUPONT ANALYSIS						
		FY19A	FY20A	FY21F	FY22F	FY23F
Net Profit Margin	%	(66.8)	(30.3)	(1.3)	15.0	24.5
Asset Turnover	x	1.6x	1.7x	2.6x	2.4x	1.8x
Return on Assets (NPAT)	%	(110.1)	(52.5)	(3.3)	35.4	44.4
Financial Leverage	x	1.6	1.5	1.8	1.5	1.3
Return on Equity	%	(175)	(80.9)	(5.8)	53.2	57.8
INTERIM SUMMARY						
		1H19A	2H19A	1H20A	2H20A	
Total revenue	\$M	2.3	2.4	3.2	3.9	
Operating expenses	\$M	(3.4)	(3.7)	(4.1)	(4.6)	
EBITDA	\$M	(1.1)	(1.3)	(0.9)	(0.8)	
Depreciation & amortisation	\$M	(0.6)	(0.2)	(0.4)	(0.1)	
EBIT	\$M	(1.7)	(1.5)	(1.3)	(0.9)	
Net interest	\$M	0.0	0.0	0.0	0.0	
Pretax profit	\$M	(1.7)	(1.5)	(1.3)	(0.9)	
Tax expense	\$M	0.0	0.0	0.0	0.0	
Underlying NPAT	\$M	(1.5)	(1.7)	(1.3)	(0.9)	
Dividend	¢	0.0	0.0	0.0	0.0	
PROFIT AND LOSS						
		FY19A	FY20A	FY21F	FY22F	FY23F
Sales Revenue	\$m	4.7	7.0	11.2	19.0	30.0
Other Income	\$m	0.0	0.1	0.0	0.0	0.0
Total Revenue	\$m	4.7	7.1	11.2	19.0	30.0
Operating costs	\$m	(7.0)	(8.8)	(10.8)	(14.2)	(18.7)
EBITDA	\$m	(2.4)	(1.7)	0.4	4.7	11.3
Depreciation & amortisation	\$m	(0.8)	(0.5)	(0.6)	(0.9)	(1.5)
EBIT	\$m	(3.2)	(2.2)	(0.1)	3.8	9.8
Net interest	\$m	0.0	0.0	0.0	0.0	0.0
Pretax Profit	\$m	(3.2)	(2.2)	(0.1)	3.8	9.8
Tax expense	\$m	0.0	0.0	0.0	(0.9)	(2.4)
Underlying NPAT	\$m	(3.2)	(2.2)	(0.1)	2.8	7.3
Adjustments	\$m	(0.0)	(0.1)	0.0	0.0	0.0
Reported NPAT	\$m	(3.2)	(2.3)	(0.1)	2.8	7.3
BALANCE SHEET						
		FY19A	FY20A	FY21F	FY22F	FY23F
Cash	\$m	1.4	2.5	2.4	5.2	12.7
Receivables	\$m	0.8	1.4	1.4	1.4	1.4
Other	\$m	0.1	0.1	0.1	0.1	0.1
Current	\$m	2.3	4.0	3.9	6.8	14.2
PPE	\$m	0.0	0.0	0.0	0.1	0.1
Intangibles	\$m	0.5	0.0	0.0	0.0	0.0
Other	\$m	0.1	0.1	0.4	1.2	2.2
Non current	\$m	0.6	0.1	0.5	1.3	2.3
Total Assets	\$m	2.9	4.1	4.4	8.0	16.5
Accounts Payable	\$m	0.7	0.7	1.2	2.0	3.1
Borrowings	\$m	0.0	0.0	0.0	0.0	0.0
Other	\$m	0.4	0.7	0.7	0.7	0.7
Current	\$m	1.0	1.4	1.8	2.6	3.8
Borrowings	\$m	0.0	0.0	0.0	0.0	0.0
Lease Liabilities	\$m	0.0	0.0	0.0	0.0	0.0
Other	\$m	0.1	0.1	0.1	0.1	0.1
Non current	\$m	0.1	0.1	0.1	0.1	0.1
Total Liabilities	\$m	1.1	1.4	1.9	2.7	3.8
Equity	\$m	21.1	24.0	24.0	24.0	24.0
Retained earnings	\$m	(19.4)	(21.6)	(21.7)	(18.9)	(11.6)
Reserves / Other	\$m	0.1	0.2	0.2	0.2	0.2
Shareholder's equity	\$m	1.8	2.7	2.5	5.4	12.7
CASH FLOW						
		FY19A	FY20A	FY21F	FY22F	FY23F
EBITDA	\$m	(2.4)	(1.7)	0.4	4.7	11.3
Change in working capital	\$m	(0.1)	(0.6)	(0.4)	(0.8)	(1.1)
Net interest	\$m	0.0	0.0	0.0	0.0	0.0
Tax paid	\$m	0.0	0.0	0.0	(0.9)	(2.4)
Other	\$m	0.4	0.5	0.0	0.0	0.0
Operating cash flow	\$m	(2.0)	(1.8)	(0.0)	3.0	7.7
Capex	\$m	(0.0)	(0.0)	(0.1)	(0.2)	(0.2)
Acquisitions	\$m	0.0	0.0	0.0	0.0	0.0
Other	\$m	0.0	0.0	0.0	0.0	0.0
Investing cash flow	\$m	(0.0)	(0.0)	(0.1)	(0.2)	(0.2)
Change in Equity	\$m	0.0	2.9	0.0	0.0	0.0
Increase / (decrease) in borrowings	\$m	0.0	0.0	0.0	0.0	0.0
Dividend / Other	\$m	0.0	0.0	0.0	0.0	0.0
Financing cash flow	\$m	0.0	2.9	0.0	0.0	0.0
Free cash flow	\$m	(2.1)	(1.8)	(0.1)	2.8	7.5

Source: Petra Capital

Ransomware: what is it and what are the costs?

Ransomware is a type of Malicious software threatening data security

Ransomware is shorthand for the words “ransom” and “malware” (malicious software), whereby malware installed on a device or IT infrastructure threatens the security of the victim’s data unless a monetary ransom is paid, with that payment usually requested in bitcoin or a digital currency given the anonymity and ease of transfer.

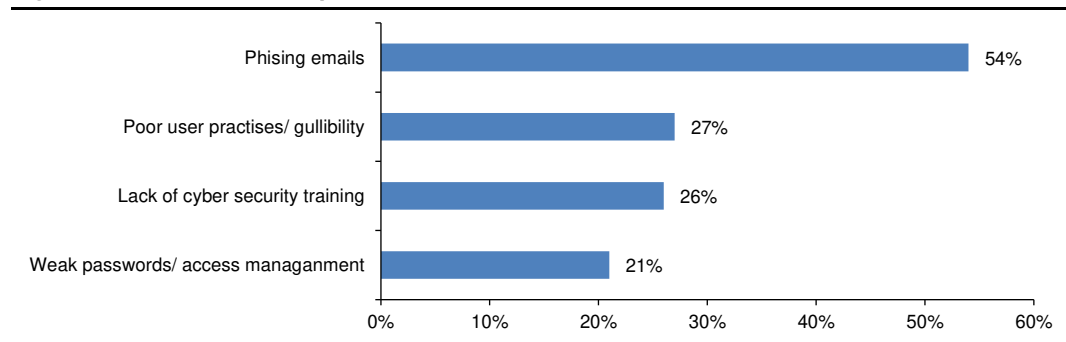
Ransomware threats include holding data prisoner under threat of deletion, public dissemination and having access blocked indefinitely, with the goal of extorting financial assets to secure its release.

How does malware access data?

Ransomware does not have a one-size fits all approach to gaining access to devices or IT infrastructure, and just like any criminal enterprise, those developing malware to extract ransoms are continually looking for new ways to infiltrate and lockdown organisations’ valuable data.

According to a survey of IT Managed Service Providers (MSPs), Phishing emails remain the top access point for control of data in ransomware attacks, with 58% of MSP’s recognising it as one of the three most common forms. As seen in Figure 1, the top four causes all involve a human element, with sophisticated deception and human error combining to provide easy access for cybercriminals.

Figure 1: Ransomware: Top causes

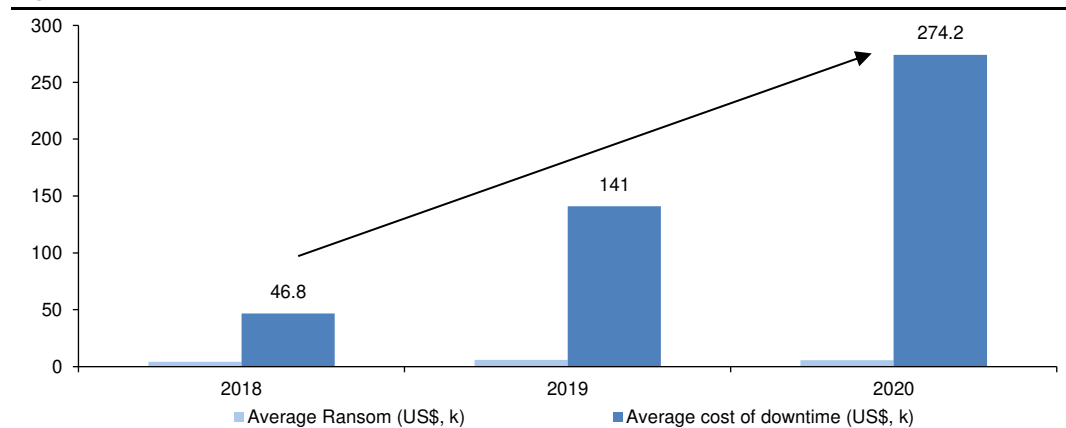


Source: 2021 Ransomware report (Datto Partner Survey of >1,000 MSP partners, Aug, 2020)

Ransomware downtime costs are material and rising

Ransomware attacks continue to be a consistent source of data loss and importantly these attacks result in material indirect costs to companies, with the average cost of downtime due to such attacks dwarfing the direct cost or average ransom paid in 2020 by as much as ~50x, Figure 2. Significantly, downtime costs have increased to 274k, +98% vs 2019 according to the same survey.

Figure 2: Ransomware costs US\$(k): cost of downtime



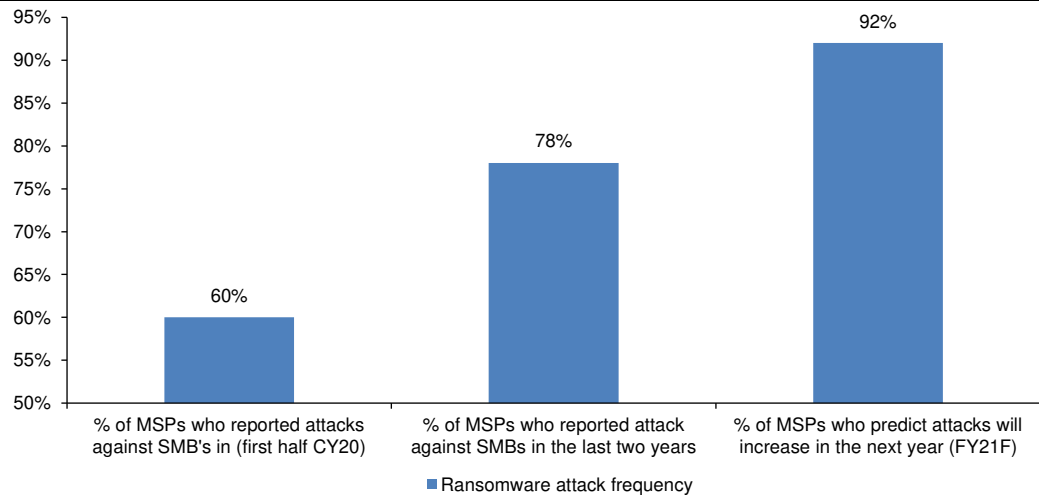
Source: 2021 Ransomware report (Datto Partner Survey of >1,000 MSP partners, Aug, 2020)

Frequency of ransomware attacks drive

Ransomware attacks are on the rise, as seen in Figure 3, industry data shows that as many as 78% of global managed service providers (MSP)'s reported a ransomware attack in the last two years within their SMB customers, while 92% of their MSPs partners expect an increase in attacks in 2021.

This was a prediction that would prove highly accurate given the high profile attacks on one of the largest global MSP's, Solarwinds (US\$6.6b) late last year and the recent attack on one of the U.S's largest oil pipeline, the Colonial, forcing disruption across multiple state lines in the U.S.

Figure 3: Ransomware attack frequency: % of MSPs reporting & prediction in FY21F



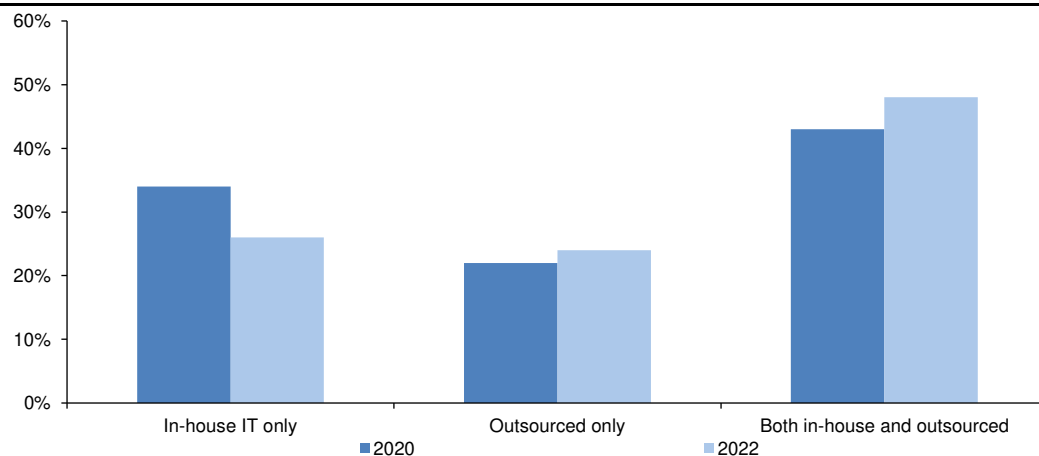
Source: 2021 Ransomware report (Datto Partner Survey of >1,000 MSP partners, Aug, 2020)

How are companies responding? Hand it over to the professionals...

Organisations are increasingly looking to use the resources of an outsourced IT team, cybersecurity professionals and dedicated backup software rather than manage these risks in house.

As seen in Figure 4, IT professionals are expecting to outsource more of their IT security in 2022 than they do currently, with in-house only falling to 26% from 34% in 2020. We expect Managed Service Providers (MSP) and their software partners (the likes of Dropsuite) will benefit as the complexity of managing data security across multiple applications and cloud environments increases.

Figure 4: How do organisations deliver and plan IT security?



Source: Sophos, October, 2020 (Survey of >5,000 IT professionals)

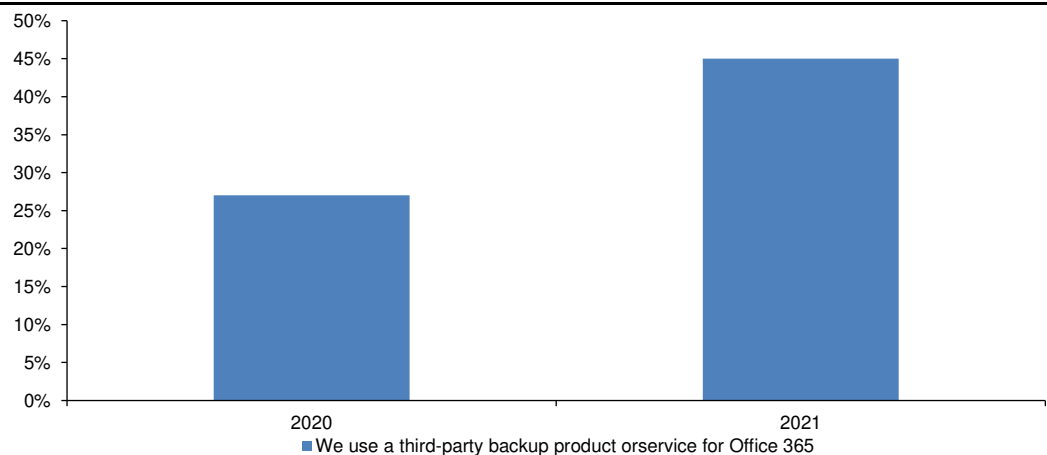
IT industry changing approach to data recovery

Traditionally, backup data security measures fell behind threat detection controls such as anti-virus software, multi-factor authentication and access control. However, whilst these front line measures are suited to preventing phishing emails and other causes of ransomware attacks at the source, they provide no security management purpose once a data breach has occurred and data needs recovery.

The under deployment is changing however, consistent with recently established Australian government guidelines known as “the essential eight” that contain specific recommendations to address data and application security via the use of robust dedicated backup systems & processes.

As seen in Figure 5, Office 365, being one of the most widespread cloud based applications (+300m users) is at the heart of this change, with organisations actively backing up Office 365 almost doubling year on year from 26% to 45%, according to a survey by global enterprises backup provider, Veeam.

Figure 5: Office 365 backup software adoption 2021 vs 2020



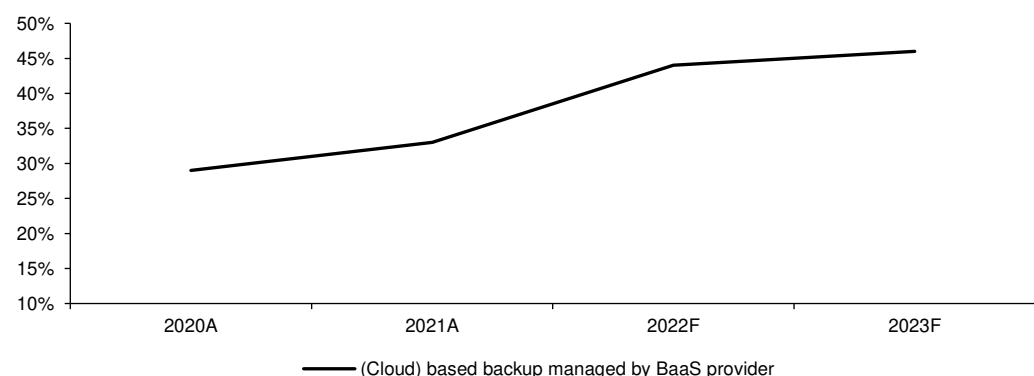
Source: Veeam, 2021 data protection survey (~3,000 IT Decision makers conducted in Sep & Oct 2020)

Dropsuite strategically positioned as cloud based BaaS to SMB’s

IT professionals overwhelmingly expect dedicated Cloud-based Backup as a service (BaaS) to take-over from traditional on premise and self-service models given the time critical nature of data recovery, its various downtime costs, integration complexity and data storage across multiple cloud servers, i.e. 68% of businesses use more than two cloud providers, Checkpoint 2020 cloud security.

As seen in Figure 6, 46% of IT professionals surveyed expect to use a dedicated cloud based Backup as a Service (Baas) by 2023, up from 33% in 2021 and 29% in 2020, a near 50% increase. Dropsuite is strategically placed with arguably faster uplifts in the SMB space where adoption of backup has lagged vs enterprise.

Figure 6: Cloud based BaaS (Backup as a Service) adoption



Source: Veeam, 2021 data protection survey (~3,000 IT Decision makers conducted in Sep & Oct 2020)

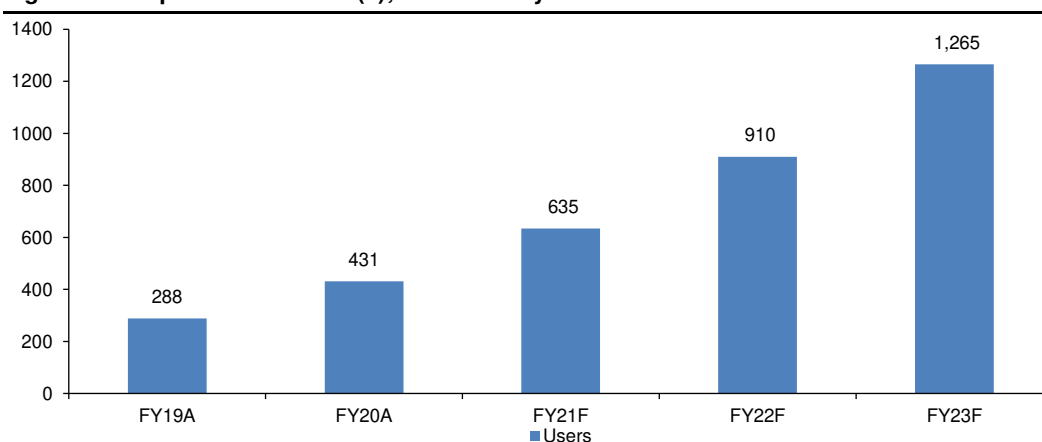
Operating & Revenue Model Assumptions

End users to grow to 1.3 million by FY23, but 0.3% share of potential market in FY23

We expect Dropsuite's end user customer base, i.e. the customers of their 300+ partner network will reach 1.3m in FY23, as seen in Figure 7. This drives a 46% CAGR in average users to FY23, Figure 8, benefitting from industry tailwinds, including rising demand for backup software currently expected to grow at a ~30% CAGR growth across cloud security and cloud based backup software markets.

Supporting the arguments above we note that c.29% of large organisations have a dedicated 3rd party cloud BaaS provider or 45% on Office 365 (which has nearly doubled from last year), where there are ~300m Office 365 growing share of an installed base of 1 billion+ Windows operating system. Importantly, our base case assumptions implies less than 1% of the total Office 365 user base is penetrated, which is already at 300m and expected to grow at a 20% CAGR over the next few years.

Figure 7: Dropsuite end users (k); at financial year end



Source: Company data, Petra Capital

Significantly, given the faster demand for Office 365 backup software across industry and DSE, we see upside potential to our base case user numbers such that a user base of 2m by FY23 is possible. This implies a >65% CAGR in users vs the 46% we assume and a target price of A\$0.70, even after factoring in a significantly higher cost base, i.e. 35% growth in SG&A vs mid-teens currently. This is in line with the significantly faster rate of adoption seen across backup for Office 365 at present.

We expect Average Revenue Per User (ARPU) to increase to US\$1.88 by FY23, rising at a 15% CAGR as more customers take up the combined email backup, archiving and Office 365 applications, as seen in Figure 8. We estimate Dropsuite currently earns ~US\$2.00 per seat where the customer takes the full suite of products indicating that our estimates remain conservative versus expectations for continued capital light investment in new product development.

Figure 8: ARR and Sales Revenue Assumptions

Year to 31 December	Metric	FY19A	FY20A	FY21F	FY22F	FY23F	2yr to FY22F CAGR	3yr to FY23F CAGR
Users (Financial Year End)	k	288	431	635	910	1,265	45%	43%
ARPU (Financial Year End)	US\$	1.04	1.23	1.49	1.70	1.88	18.0%	15%
US\$ ARR	US\$m	3.6	6.4	11.3	18.6	28.5	71%	65%
FX	A\$/US\$	0.70	0.75	0.78	0.78	0.78	2%	1%
A\$ ARR	A\$m	5.0	8.5	14.6	23.8	36.6	68%	63%
Users (Average)	k	288	351	533	773	1,088	48%	46%
ARPU (Average)	US\$	1.00	1.14	1.36	1.59	1.79	19%	16%
Sales Revenue	US\$	3.3	5.3	8.7	14.8	23.4	67%	64%
SaaS Revenue	A\$	4.7	7.0	11.2	19.0	30.0	64%	62%
User (Average) Growth	% chg	n/m	22%	52%	45%	41%	48%	46%
SaaS Revenue (A\$)	% chg	-10%	49%	60%	69%	58%	64%	62%

Source: Company data, Petra Capital

Valuation

Our A\$0.33 target price values DSE on a combination of EV/Sales (50%) and DCF (50%) methodologies, adopting an 8x FY22F EV/Sales multiple, as seen in Figure 9.

Figure 9: Our blended EV/Sales & DCF based Target price is A\$0.33 per share

Valuation methodology	EV / Sales	DCF	A\$ Target Price
Price per share	0.26	0.40	0.33
Weighting	50%	50%	100%

Source: Petra Capital, target price rounded to 1 decimal place.

Peers trading on 6x delivering a median 3yr sales CAGR of 14%

Our 8x EV/Sales based valuation multiple is at a premium to the global backup peer median given its more attractive Sales growth profile and status as a native cloud leader in its field, Figure 10. The 8x compares to the 5.3x the stock currently trades on, but better reflects the 63% 2 year sales CAGR we expect DSE to deliver vs a peer median of 14%.

Dropsuite has one of the purest exposures to the fastest growing segments of the global data backup and archiving market (Cloud applications & security) vs. peers. DSE's customers recognised it as a leader in the industry, which means despite having a smaller market capitalisation, DSE should trade at a small premium to the median of its peers.

Figure 10: Global backup & archiving software, MSP peers trade on FY22 EV/Sales ~6.0x

Name	Share Price	Mkt Cap (A\$m)	P/E (FY22F)	EV/EBITDA FY2 (Dec y/e)	EV/Sales FY2 (Dec y/e)	FY20-22 yoy Sales CAGR
Varonis (VRNS)	47.6	6,482	268.9	108.3	10.1	24%
Rapid 7 (RPD)	82.0	5,802	300.4	96.0	8.1	21%
Fortinet (FTNT)	214.6	42,490	49.6	31.9	9.2	18%
Proofpoint (PFPT)	170.8	10,608	66.4	36.8	7.1	16%
Datto (MSP)	26.5	42,490	54.5	26.4	6.0	15%
Mimecast (MIME)	47.5	3,938	33.3	16.4	4.6	15%
Zix Corp (ZIXI)	6.9	505	10.0	11.1	2.5	14%
Qualys (QLYS)	98.7	4,956	33.7	19.4	7.9	11%
Fireeye (FEYE)	21.7	6,649	47.7	28.5	4.8	8%
CommVault (CLVT)	75.5	4,461	24.6	15.0	3.8	7%
Solarwinds (SWI)	16.5	6,677	15.9	13.2	6.0	6%
Checkpoint (CLVT)	118.2	20,520	16.4	11.2	5.4	3%
Median	n/m	6,412	40.7	22.9	6.0	14%
Dropsuite*	0.18	104.4	36.9	21.0	5.3	63%

Source: Bloomberg consensus (as at 26 May 2021), *Denotes based on Petra Capital estimates (26 May 2021).



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