ORD MINNETT RESEARCH

Dropsuite Limited

Growth > profitability makes sense to us

22 October 2024

DSE delivered a typically strong 3Q24 result, with few surprises. User growth continues to accelerate, as does net new ARR. From a strategic perspective, the company remains focused on growth > profitability, which is the correct choice in our view, given: (1) the enormous white space opportunity still available, (2) the best-in-class unit economics that DSE continues to demonstrate. Following the result, we raise our Price Target +8% to $4.09/sh and retain a BUY recommendation.

3Q24 Result: ARR in-line with OML, record quarter for net adds

- DSE's 3Q24 result was extremely strong, with **paid users** +135k (a new record), +300% YoY and ~50% ahead of OMLe. **ARR** growth of 33% YoY was an acceleration from ~30% seen in 1H (a clear sign demand is not waning), while **net new US ARR** of +$2.3m was also a record. **Partner growth** remains strong and is a lead indicator of future performance. **DSE is well funded** with ~$26m of cash on its Balance Sheet.
- The one disappointment in Q3's result was a slightly lower QoQ **ARPU** at $1.62 (we modelled an acceleration to $1.66). However, we believe this is simply due to mix (ie. BYOS), with margins unaffected.

Unit economics support continued re-investment

- On its result call, DSE once again fielded questions on the decision to prioritise growth over profitability. As we demonstrate on Pg. 2 of this note; DSE's marketing spend (CAC) is currently being repaid in just ~6 months, while with churn of <3%, an LTV:CAC of ~60:1 is implied.
- With unit economics like this, and a large global TAM to grow into, we believe any de-prioritisation of growth would be the wrong call.

Maintain BUY recommendation, PT lifts 8% to $4.09/sh

- Following today's result, we raise our Price Target +8% to $4.09/sh and retain a BUY recommendation.
- Our positive thesis is supported by (1) multiple structural tailwinds, (2) a best-in-class product and go-to-market strategy, (3) a demonstrable history of prudent and profitable growth, and (4) M&A optionality.

Key Financials

Year-end December ($)	FY22A	FY23A	FY24E	FY25E	FY26E
Revenue ($m)	20.7	30.6	40.6	53.2	66.8
EBITDA ($m)	1.3	1.1	1.9	5.4	8.8
EBIT ($m)	1.2	0.9	1.6	5.1	8.4
Reported NPAT ($m)	1.5	1.5	2.7	6.1	8.4
Reported EPS (c)	2.1	2.2	3.4	8.4	11.7
Normalised NPAT ($m)	1.5	1.6	2.4	6.1	8.4
Normalised EPS (c)	2.1	2.2	3.4	8.4	11.7
EPS Growth (%)	-	7.4	51.6	150.2	39.0
Dividend (c)	-	-	-	-	-
Net Yield (%)	-	-	-	-	-
EV/EBITDA (X)	-	-	-	42.2	25.4
Normalised P/E (x)	-	-	-	44.2	31.8
Normalised ROE (%)	6.3	6.1	8.3	17.9	20.5

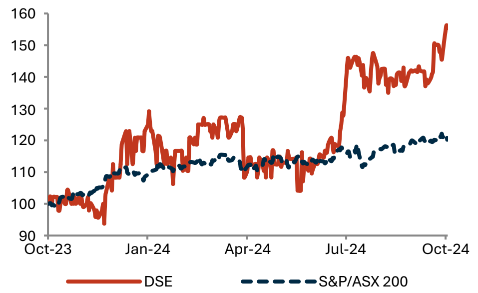
Source: OML, Iress, Dropsuite Limited

Last Price
A$3.73
Target Price
A$4.09 (Previously A$3.78)
Recommendation
Buy
Risk
Higher

IT Services

ASX Code	DSE
52 Week Range ($)	2.25 - 3.74
Market Cap ($m)	260.6
Shares Outstanding (m)	69.9
Av Daily Turnover ($m)	0.0
3 Month Total Return (%)	9.7
12 Month Total Return (%)	52.2
Benchmark 12 Month Return (%)	19.2
NTA FY24E (¢ per share)	51.9
Net Cash FY24E ($m)	26.4

Price performance



Source: FactSet

Consensus Earnings

	FY24E	FY25E
NPAT (C) ($m)	1.9	5.2
NPAT (OM) ($m)	2.4	6.1
EPS (C) (c)	2.6	7.2
EPS (OM) (c)	3.4	8.4

Source: OML, Iress, Dropsuite Limited

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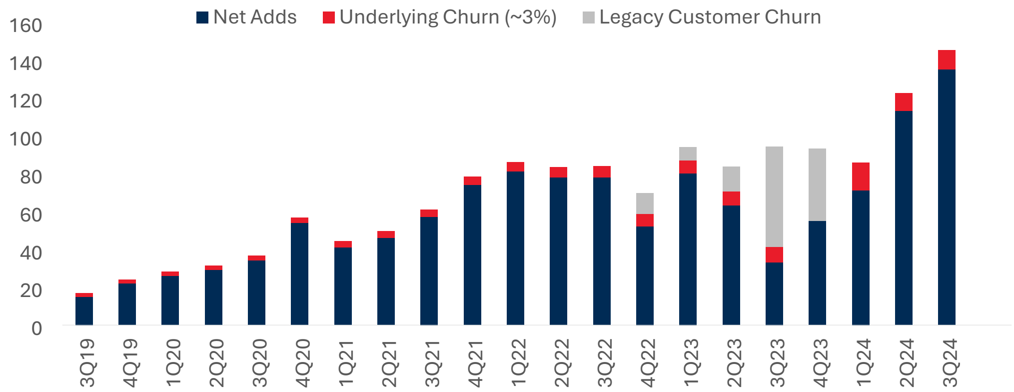
Three key takeaways from 3Q24

- **Takeaway #1: paid users continue to accelerate.** Net paid user adds continued to accelerate in Q3 (+135k QoQ). We believe this is being driven by PartnerSev (>10% tailwind to growth) and BYOS success.

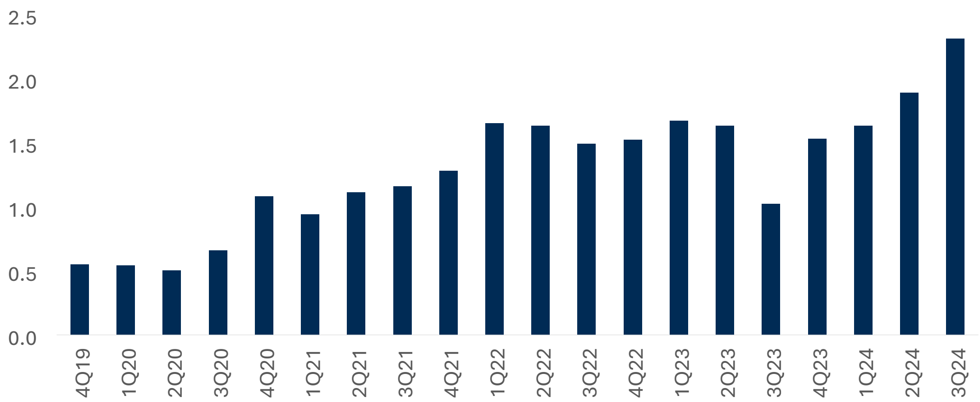
Figure 1: Paid user growth by quarter



Source: Company Reports, Ord Minnett Limited estimates

- **Takeaway #2: Net new ARR (DSE's key metric) is also accelerating.** USD ARR was +US$2.3m QoQ, up from +$1.9m in 2Q24, and +$1.6m in 1Q24.

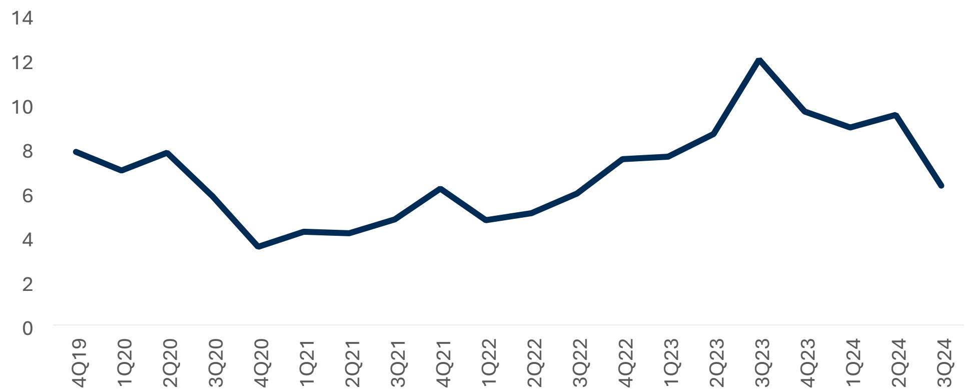
Figure 2: US ARR $ growth by quarter



Source: Company Reports, Ord Minnett Limited estimates

- **Takeaway #3: CAC payback returns to ~6 months.** We believe DSE's marketing spend is repaid within ~6m. And while we don't particularly like LTV:CAC as a metric, at ~3% churn, this is an implied LTV:CAC of ~60:1. **With unit economics like this, DSE's decision to focus on growth > profitability is the right one.**

Figure 3: CAC payback in months



Source: Company Reports, Ord Minnett Limited estimates

3Q24 Result

Highlights

- **USD ARR** of $28.8m (+34% YoY) was ahead of OML at $28.7m (+US$2.3m vs +$2.1m QoQ). This represents a continued $ re-acceleration from +$1.9m in 2Q24 (and +$1.6m in 1Q24). AUD ARR of $42.6m (+27%) was below OMLe at $44.1m on FX differences.
- **Net paid user adds** remain the key metric to watch in our view; and DSE has once again delivered, +135k, ~50% ahead of OMLe (+89k). As with ARR, this represents a continuation of recent QoQ acceleration (Q4/Q1/Q2 +55k/+71k/+113k). Churn remains low at <3% and down from Q1 (one-off) levels of ~5%.
- **Direct partner growth** of +38 QoQ was solid (OMLe = +40). Total direct partners ended the quarter at 751, while indirect transacting partners rose by 270. Partner growth is a lead indicator of future growth and should not be overlooked.
- **Unit economics.** Measures of unit economics were mixed, with (1) **ARPUs** +1% YoY, yet down QoQ (we expected ARPU to rise), (2) **GP margins** held steady at 69%, (3) **ARR / partner** continuing to move higher, +6% YoY, and (4) **CAC payback** falling to an implied ~6m, as marketing costs fell sharply (and user growth, per above, was strong). On balance, these results were broadly in-line with OMLe.
- **Cash flows.** OCF of $0.78m represents the company's 10th consecutive positive OCF quarter. FCF was +$0.74m. DSE expects to continue investing for growth.
- **Balance sheet.** DSE is well-funded with $25.6m in cash at Sept 30. We continue to expect a portion of these funds will be allocated to M&A over time.

Figure 4: 3Q24 Result & KPI summary

							Actual	OMLe			
Quarterly Summary	Units	**2Q23**	**3Q23**	**4Q23**	**1Q24**	**2Q24**	**3Q24**	**3Q24**	**Diff.**	**YoY %**	**QoQ %**
Paid users	000s	1,078	1,111	1,166	1,237	1,350	1,485	1,439	3%	34%	10%
*Gross new**	000s	*76*	*86*	*93*	*86*	*122*	*144*	*99*	45%	67%	18%
Net new	000s	*63*	*33*	*55*	*71*	*113*	*135*	*89*	52%	309%	19%
ARPU	US$/m	1.58	1.65	1.65	1.66	1.64	1.62	1.66	-2%	-2%	-1%
ARR	US$m	**20.5**	**21.5**	**23.0**	**24.6**	**26.5**	**28.8**	**28.7**	**1%**	**34%**	**9%**
ARR	A$m	30.4	33.4	34.3	37.6	39.9	42.6	44.1	-3%	27%	7%
Partners	#	559	594	620	660	713	751	753	0%	26%	5%
New	#	*35*	*35*	*26*	*40*	*53*	*38*	*40*	-5%	9%	-28%
ARR / partner	US$000s	*36.6*	*36.1*	*37.1*	*37.3*	*37.2*	*38.4*	*38.1*	1%	6%	3%
OCF	A$m	**0.3**	**1.4**	**0.3**	**0.4**	**0.5**	**0.8**	**0.5**	**52%**	**-44%**	**44%**
Cash at hand	A$m	23.0	24.6	24.3	24.9	25.1	25.5	25.6	-1%	4%	1%
KPIs											
ARR	US$, YoY	45%	37%	34%	31%	30%	34%	33%			
ARR, US$	$, QoQ	1.6	1.0	1.5	3.2	3.5	2.3	2.1			
Paid users	YoY	33%	25%	25%	22%	25%	34%	30%			
ARPU	US$, YoY	9%	12%	8%	8%	4%	-2%	1%			
ARR / partner	YoY	17%	9%	6%	4%	2%	6%	5%			
GP margins	%	**69%**	**68%**	**70%**	**69%**	**69%**	**69%**	**69%**			
CAC payback	mnths	8.6	12.0	9.6	8.9	9.5	6.3	9.5			
Churn	%	3%	3%	3%	3%	5%	3%	3%			

Source: Company Reports, Ord Minnett Limited estimates

Estimate & Price Target Changes

Estimates

DSE's 3Q24 result was broadly in line with our estimates at ARR, although the mix of how we got there was different (ie. seat adds higher, ARPUs lower). Gross margins were in-line, and cash opex was lower than expected. **Ultimately, it is FX which plays the largest role**; noting our revenue estimates fall 2-3% through FY26, yet would have increased had our prior FX assumptions held. Ultimately, this all washes out at OCF.

- **FX changes**. We raise our FX assumption to 0.67c AUD / USD (in-line with current spot market pricing). This has the impact of reducing revenues and costs.
- **Paid users** rise ~4-12% across future periods (given a ~50% beat to our number in Q3). **ARPUs** are an offsetting factor however as BYOS and PartnerServ appear to be driving growth (lower ARPU) and the abovementioned FX changes weigh on US ARPU conversion.
- **Revenues** decline by a modest ~2-3% on account of the above changes.
- **GP down/GP% flat.** Gross profits fall in step with revenues with no change to our GP% margin.
- **EBITDA** falls $0.7m in FY25, before rising modestly (4-7%) in FY25-FY26. We expect DSE will continue to invest in its business over coming years. This may see lower EBITDA delivered, although we would expect faster-than-modelled growth to be an offsetting factor in this event.
- **Price Target rises 8% to $4.09/sh.** Following changes to our FX, user, ARPU and opex assumptions, and the roll forward of our model, our PT rises 8% to $4.09/sh.

Figure 5 provides an overview of these changes.

Figure 5: Estimate changes summary

			FY24			FY25			FY26	
Estimate Changes	**Units**	**Old**	**New**	**% chg**	**Old**	**New**	**% chg**	**Old**	**New**	**% chg**
Paid users	000s	1,529	1,589	4%	1,836	2,010	9%	2,098	2,343	12%
ARPU	A$/m	2.58	2.42	-6%	2.66	2.43	-9%	2.70	2.43	-10%
ARR	A$m	47.4	46.1	-3%	58.6	58.6	0%	68.1	68.3	0%
Revenue	**A$m**	**41.7**	**40.6**	**-3%**	**55.1**	**53.2**	**-3%**	**67.9**	**66.8**	**-2%**
Gross Profit	A$m	28.8	28.0	-3%	38.4	37.1	-3%	48.0	47.2	-2%
Margin	%	69.0%	69.0%	0%	69.8%	69.8%	0%	70.8%	70.8%	0%
Opex	A$m	-26.2	-26.2	0%	-33.3	-31.7	5%	-39.6	-38.5	3%
EBITDA	A$m	2.6	1.9	-28%	5.1	5.4	7%	8.5	8.8	4%
OCF	A$m	2.3	2.3	0%	4.7	5.0	6%	7.1	7.2	2%
FCF	A$m	2.1	2.1	0%	4.4	4.7	7%	6.7	6.9	2%
Price Target	**A$/Sh**	**3.78**	**4.09**	**8%**						

Source: Ord Minnett Limited estimates

Investment Thesis, Valuation, and Risks

Dropsuite Limited *(Buy; Price Target: $4.09)*

Company Overview

Founded in Singapore in 2011, Dropsuite is a cloud-based software platform offering backup, archiving, and recovery solutions for businesses. The company specialises in protecting critical data from Microsoft 365, Google Workspace, QuickBooks, and others. Its products are distributed via a network of ~4k IT reseller partners globally.

DSE has delivered rapid top-line growth since its founding, with ARR rising at a 7-year CAGR of >50%. The company now serves >1.48m users and we expect it will generate >$40m in revenue for FY24F.

A profitable grower at the intersection of three mega-trends

As a leading provider of cloud-based backup and archiving for businesses, DSE operates at the intersection of three mega-trends, being (1) the rise of cybercrime, (2) the migration of on-premise hosting to the cloud, and (3) MSP industry growth. These themes have long runways and will continue to act as positive tailwinds for growth.

DSE has delivered extraordinary growth over the past 7-years (a CAGR of >50%) and has managed to do so profitably – delivering positive FCF in each of the past nine quarters, while cumulative cash flows are now positive back to 2Q19. Additionally, management are prudent capital allocators, having built a ~$260m business on just ~$42m of outside capital (of which only ~$18m has been spent). <u>We expect this performance to continue.</u>

Microsoft concerns appear overblown

At its Inspire Conference 2023, Microsoft provided a first look at its 365 Backup and Archive solution (B&A) – DSE's price fell 22% on the day. However, based on our work, and discussions with industry participants, we conclude that fears of existential risks to DSE's business are overblown. <u>Accordingly, we believe the market's scepticism is providing an opportunity.</u>

Valuation and Recommendation

We derive our 12-month forward $4.09/Share Price Target via a 10-year DCF, which implies a FTM EV/revenue multiple of 4.3x. We believe this is appropriate given the considerable revenue growth we expect DSE to deliver in the medium-term (3-year CAGR = >25%), its solid gross margin (~70%) and strong FCF profile (FY26F = $6.9m).

Our Price Target implies a 10% TSR, which underpins our BUY recommendation.

Risks to Rating and Price Target

Key risks to our core thesis, include:

- Point solution: M365 backup presents a concentration risk. Additional product launches and/or growth in secondary products moderates this risk.
- Increased competition from others within the cloud backup industry.
- Technology risk: new technologies / competitors enter the market and usurp DSE's products.
- Key person risk: DSE is run by a long-time CEO, Charif Elansari. His departure is a risk.
- Security breaches: A malicious attack on DSE's systems could result in client data loss and reputational damage.

Dropsuite Limited

Buy

PROFIT & LOSS (A$m)	2022A	2023A	2024E	2025E	2026E
Revenue	20.7	30.6	40.6	53.2	66.8
Other income	0.0	0.0	0.0	-	-
Operating costs	(12.4)	(19.8)	(26.2)	(31.7)	(38.5)
Operating EBITDA	**1.3**	**1.1**	**1.9**	**5.4**	**8.8**
D&A	(0.1)	(0.2)	(0.3)	(0.3)	(0.3)
EBIT	**1.2**	**0.9**	**1.6**	**5.1**	**8.4**
Net interest	0.3	0.7	0.8	0.9	1.1
Pre-tax profit	**1.5**	**1.6**	**2.4**	**6.1**	**9.5**
Net tax (expense) / benefit	-	-	-	-	(1.1)
Signfiicant items/Adj.	-	-	-	-	-
Associate NPAT	1.5	1.5	2.7	6.1	8.4
Normalised NPAT	**1.5**	**1.6**	**2.4**	**6.1**	**8.4**
Reported NPAT	**1.5**	**1.5**	**2.7**	**6.1**	**8.4**
Normalised dil. EPS (cps)	2.1	2.2	3.4	8.4	11.7
Reported EPS (cps)	2.1	2.2	3.4	8.4	11.7
Effective tax rate (%)	-	-	-	-	11.4
DPS (cps)	-	-	-	-	-
DPS (cps)	-	-	-	-	-
Dividend yield (%)	-	-	-	-	-
Payout ratio (%)	-	-	-	-	-
Diluted # of shares (m)	70.0	71.1	71.9	71.9	71.9

CASH FLOW (A$m)	2022A	2023A	2024E	2025E	2026E
Net Interest (paid)/received	0.2	0.7	0.8	0.9	1.1
Income tax paid	-	-	-	-	(1.1)
Other operating items	-	-	-	-	-
Operating Cash Flow	**0.9**	**2.3**	**2.3**	**5.0**	**7.2**
Capex	(0.1)	(0.1)	(0.2)	(0.3)	(0.4)
Other investing items	-	-	-	-	-
Investing Cash Flow	**(0.1)**	**(0.1)**	**(0.2)**	**(0.3)**	**(0.4)**
Inc/(Dec) in borrowings	-	-	-	-	-
Financing Cash Flow	**-**	**-**	**-**	**-**	**-**
FX adjustment	(0.1)	(0.2)	0.0	-	-
Net Inc/(Dec) in Cash	0.9	2.1	2.1	4.7	6.9

BALANCE SHEET (A$m)	2022A	2023A	2024E	2025E	2026E
Cash	22.3	24.3	26.4	31.1	38.0
Receivables	4.1	5.9	8.8	11.5	14.3
Inventory	-	-	-	-	-
Other current assets	0.4	0.7	0.8	0.8	0.8
PP & E	0.1	0.1	0.1	0.0	0.1
Investments	0.0	0.0	0.0	0.0	0.0
Intangibles	-	-	0.2	0.2	0.2
Other non-current assets	0.1	0.2	0.1	0.1	0.1
Total Assets	**26.9**	**31.2**	**36.3**	**43.7**	**53.4**
Short term debt	-	-	-	-	-
Payables	2.5	3.2	4.9	6.2	7.4
Other current liabilities	-	0.3	0.4	0.4	0.4
Other non-current liabilities	0.1	0.1	0.1	0.1	0.1
Total Liabilities	**2.7**	**3.8**	**5.5**	**6.8**	**8.1**
Total Equity	**24.2**	**27.4**	**30.8**	**36.9**	**45.3**
Net debt (cash)	(22.3)	(24.3)	(26.4)	(31.1)	(38.0)

DIVISIONS	2022A	2023A	2024E	2025E	2026E

KEY METRICS (%)	2022A	2023A	2024E	2025E	2026E
Revenue growth	77.0	48.1	32.5	31.1	25.4
EBITDA growth	49,740.6	(11.7)	69.5	189.8	61.3
EBIT growth	-	(26.2)	80.4	224.2	63.6
Normalised EPS growth	-	7.4	51.6	150.2	39.0
EBITDA margin	6.0	3.6	4.6	10.2	13.1
OCF /EBITDA	55.6	142.4	78.7	75.3	82.0
EBIT margin	5.8	2.9	3.9	9.7	12.6
Return on assets	4.7	3.0	4.7	12.8	15.3
Return on equity	6.3	6.1	8.3	17.9	20.5

VALUATION RATIOS (x)	2022A	2023A	2024E	2025E	2026E
Reported P/E	179.9	167.5	110.5	44.2	31.8
Normalised P/E	-	-	-	44.2	31.8
Price To Free Cash Flow	299.8	121.0	124.4	54.9	37.9
Price To NTA	9.5	8.3	7.2	6.0	4.9
EV / EBITDA	-	-	-	42.2	25.4
EV / EBIT	195.5	266.1	147.3	44.5	26.4

LEVERAGE	2022A	2023A	2024E	2025E	2026E
ND / (ND + Equity) (%)	(1,178.7)	(784.5)	(594.4)	(539.0)	(516.2)
Net Debt / EBITDA (%)	(1,785.5)	(2,198.1)	(1,408.9)	(573.3)	(433.9)
EBIT Interest Cover (x)	-	-	-	-	-
EBITDA Interest Cover (x)	-	-	-	-	-

SUBSTANTIAL HOLDERS	m	%
Topline Capital Management LLC	21.6	31.0%
John Fearon	3.5	5.0%
Charif El-Ansari	3.5	5.0%

VALUATION	
Cost of Equity (%)	10.5
Cost of debt (after tax) (%)	7.5
WACC (%)	**9.8**
Enterprise Value ($m)	194.3
Target Price Method	DCF
Target Price ($)	4.09
Valuation disc. / (prem.) to share price (%)	9.6

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Guide to Ord Minnett Recommendations

Our recommendations are based on the total return of a stock – nominal dividend yield plus capital appreciation – and have a 12-month time horizon.	
SPECULATIVE BUY	We expect the stock's total return (nominal yield plus capital appreciation) to exceed 20% over 12 months. The investment may have a strong capital appreciation but also has high degree of risk and there is a significant risk of capital loss.
BUY	The stock's total return (nominal dividend yield plus capital appreciation) is expected to exceed 15% over the next 12 months.
ACCUMULATE	We expect a total return of between 5% and 15%. Investors should consider adding to holdings or taking a position in the stock on share price weakness.
HOLD	We expect the stock to return between 0% and 5%, and believe the stock is fairly priced.
LIGHTEN	We expect the stock's return to be between 0% and negative 15%. Investors should consider decreasing their holdings.
SELL	We expect the total return to lose 15% or more.
RISK ASSESSMENT	Classified as Lower, Medium or Higher, the risk assessment denotes the relative assessment of an individual stock's risk based on an appraisal of its disclosed financial information, historical volatility of its share price, nature of its operations and other relevant quantitative and qualitative criteria. Risk is assessed by comparison with other Australian stocks, not across other asset classes such as Cash or Fixed Interest.