Canaccord Genuity Capital Markets

1 September 2021

Lowering Target Price

DUG Technology Limited

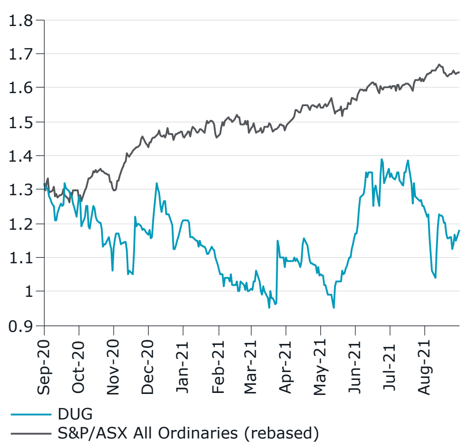
Services

Rating	Price Target
BUY *unchanged*	**A$1.71↓** *from A$1.76*
DUG-ASX	Price **A$1.07**

Market Data

52-Week Range (A$) :	0.95 - 1.39
Avg Daily Vol (M) :	0.1
Market Cap (A$M) :	106.4
Shares Out. (M) :	99.5
Dividend /Shr (A$) :	0.00
Dividend Yield (%) :	0.0
Enterprise Value (A$M) :	114

FYE Jun	2021A	2022E	2023E	2024E
Sales (US$M)	41.4	47.1↓	57.6↓	67.9↓
Previous	-	*53.0*	*64.8*	*78.6*
EBITDA (US$M)	(1.3)	9.2↓	14.3↓	20.6↓
Previous	-	*11.1*	*15.2*	*21.8*
EBIT (US$M)	(8.7)	0.8↓	5.1↑	10.9↑
Previous	-	*1.3*	*4.5*	*10.3*
EV/EBITDA (x)	(67.7)	9.6	6.5	4.8
EV/EBIT (x)	(9.9)	114.5	18.3	9.0
Net Debt (Cash) (US$M)	8	10↓	16	20↑
Previous	-	*14*	-	*19*



Source: FactSet

Priced as of close of business 31 August 2021

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Service interference

Investment Recommendation

A challenging 2H21 for the Services business had been alluded to in May 2021 and this eventuated, weighing on the group result. This combined with IPO-related costs and restatements led to a reasonable level of noise in the result, ultimately creating interference to the narrative management was seeking to convey – this being a mix shift towards compute-heavy workloads and related software and support, which is margin-accretive work relative to the historic base. Qualitative evidence of the strategy has been building over CY21 with multiple contract signings, proving out the diversity of use-cases for DUG's offerings.

Where fixed-cost leverage meaningfully impacted the 2H21 result, we are hopeful that the reverse plays out over FY22E. This requires a recovery in Services revenue, which has taken longer to bounce back than we, and the company, had originally envisaged. Delays to data capture and transfer, extended delivery and tendering processes and competitive pricing have been factors at play.

We have nonetheless seen enough evidence (listed market commentary, rig and seismic contract activity, sustained oil prices above US$65/barrel) to take the view that a recovery in Services revenue is coming. Combined with contributions from multiple recent contract signings, this suggests a stronger outlook for FY22E/23E than the market is giving DUG benefit for, in our view.

New contract signings, evidence of a recovery to more normal monthly Services revenue levels and progress on the Geraldton project are the notable potential catalysts we are looking for. We retain our BUY recommendation with a $1.71/sh price target (from $1.76 on lower near-term earnings, offset by a lower AUD/USD exchange rate and DCF rollover).

Result comment; headlines in line. DUG reported FY21 sales revenue US$41.4m (CGe, US$42.5m), EBITDA -$1.3m (CGe $0.1m) and underlying EBITDA $2.0m.

- **Services:** A $5.8m decrease in revenue (versus 1H21) led to a $5.1m fall in EBITDA for this division in 2H21, materially weighing on group earnings. Management reduced headcount during the period and we understand is seeking to be more selective on workloads (higher-priced and more compute-heavy contracts). A return to historic levels would materially benefit earnings, in our view, albeit we now assume this takes two years to play out fully.
- **HPCaaS:** New contract momentum building with increasing diversity of use-cases, most of which are burst compute and yet to contribute. New revenue types (e.g. HPC Support) aided step-up in 2H21 growth, albeit this was somewhat dampened by revenue recognition change and customer administration. We are forecasting strong growth for this business in FY22E.
- **Software:** Core revenue grew by 4% YoY (deferred revenue +9%). Revenue recognition changes and a new contract contribution (PXGEO) should underwrite double-digit revenue growth in FY22E.
- **Cash and cash flow:** DUG ended the period with US$10.0m of cash and net debt of $7.7m. Underlying operating net cash flow was broadly neutral.

McCloud signings more often and more diverse. DUG has been actively targeting non-O&G clients for around 18 months now and has signed over a dozen customers across education, health, industrial, meteorology and radioastronomy end markets.

HODL to improve Houston utilisation. The HoA with HODL Ranch will see DUG supply infrastructure and professional services in return for US$8.7m in revenue over a 36-month contract. It enables DUG to better use its Houston facility and related resources with a negligible capital outlay.

For important information, please see the Important Disclosures beginning on page 5 of this document.

Figure 1: DUG Technology (DUG-ASX); Canaccord Genuity forecasts

DUG Technology (DUG)		Share Price (A$)		$1.07	Share Price (US$)	$0.78		Year end 30 June	
Profit & Loss (US$m)	2021A	2022E	2023E	2024E	**Valuation Ratios**	2021A	2022E	2023E	2024E
Sales revenue	41.4	47.1	57.6	67.9	EV/EBITDA (x)	nmf	9.6	6.5	4.8
Total revenue	**41.4**	**47.1**	**57.6**	**67.9**	EV/EBIT (x)	nmf	114.5	18.3	9.0
EBITDA	**-1.3**	**9.2**	**14.3**	**20.6**	EPS (US$) (NPAT)	-0.16	-0.01	0.03	0.07
Depreciation	-7.2	-8.2	-9.0	-9.5	P/E (x) (NPAT)	nmf	-88.6	29.1	11.0
EBITA	**-8.5**	**1.0**	**5.3**	**11.1**	EV/EBITDA Rel - XAO		0.9	0.7	
Amortisation	-0.2	-0.2	-0.2	-0.2	EV/EBITDA Rel - XSO		0.9	0.6	
EBIT	**-8.7**	**0.8**	**5.1**	**10.9**	DPS (US$)	0.00	0.00	0.00	0.00
Net interest	-1.9	-1.6	-1.5	-1.5	Dividend yield (%)	0.0%	0.0%	0.0%	0.0%
Other	0.0	0.0	0.0	0.0	CFPS (US$)	-0.05	0.09	0.13	0.18
Pre-tax profit	**-10.6**	**-0.9**	**3.6**	**9.4**	Price / CFPS (x)	-15.9	8.3	5.9	4.3
Tax expense	-3.3	0.0	-0.9	-2.3	**Profitability Ratios**	2021A	2022E	2023E	2024E
NPAT (attributable)	**-13.9**	**-0.9**	**2.7**	**7.0**	EBITDA margin (%)	-3.1%	19.4%	24.9%	30.4%
NPAT (reported)	**-15.7**	**-0.9**	**2.7**	**7.0**	EBIT margin (%)	-20.9%	1.6%	8.9%	16.1%
Cash Flow (US$m)	2021A	2022E	2023E	2024E	ROE (%)	-532.2%	-7.5%	21.3%	40.4%
Operating EBITDA	**-1.3**	**9.2**	**14.3**	**20.6**	ROA (%)	-15.0%	1.5%	10.0%	19.5%
Interest and tax	-3.1	-1.6	-2.4	-3.9	ROIC (%)	-49.8%	-3.3%	11.1%	24.3%
Working capital/other	-0.6	1.8	1.3	1.2	**Capital Structure**	2021A	2022E	2023E	2024E
Operating cashflow	**-4.9**	**9.3**	**13.2**	**17.9**	Enterprise value (US$m)	85.4	88.1	93.3	98.1
Capex	-6.2	-9.5	-15.8	-20.3	Net Debt (cash) (US$m)	7.7	10.4	15.6	20.4
Free cashflow	**-11.1**	**-0.2**	**-2.7**	**-2.3**	Net debt / equity (%)	64.0%	92.9%	112.0%	97.3%
Acquisitions	0.2	0.0	0.0	0.0	Net debt / EBITDA (x)	-6.1	1.1	1.1	1.0
Equity issued	17.4	0.0	0.0	0.0	NTA / share (US$)	0.12	0.11	0.14	0.21
Borrowings	-6.1	-6.2	0.0	0.0	Price / NTA (x)	6.7	7.1	5.7	0.0
Other	0.0	0.0	0.0	0.0	Shares on issue (m)	99.5	99.5	99.5	99.5
Net cashflow	**0.4**	**-6.4**	**-2.7**	**-2.3**	**Growth Ratios**	2021A	2022E	2023E	2024E
Opening cash	12.0	10.0	1.1	-4.0	Sales revenue (%)	-16.7%	14.0%	22.1%	17.9%
Closing cash	**10.0**	**1.1**	**-4.0**	**-8.8**	Gross profit (%)	-16.7%	14.0%	22.1%	17.9%
Balance Sheet (US$m)	2021A	2022E	2023E	2024E	EBITDA (%)	-112.6%	-826.0%	56.2%	44.0%
Cash	10.0	1.1	-4.0	-8.8	EBIT (%)	nmf	nmf	562.5%	114.2%
Receivables	6.0	7.1	8.7	10.2	NPATA (%)	nmf	nmf	-404.6%	163.5%
Inventories	0.0	0.0	0.0	0.0	EPS (NPATA) (%)	nmf	nmf	-404.6%	163.5%
PPE	23.1	24.2	30.8	41.4	DPS (%)	0.0%	0.0%	0.0%	0.0%
Intangibles	0.5	0.3	0.3	0.3	**Interim P&L (US$m)**	1H20A	2H20A	1H21A	2H21A
Other assets	16.6	16.6	16.6	16.6	Sales revenue	26.8	22.8	24.4	17.0
Total assets	**56.1**	**49.3**	**52.3**	**59.6**	Gross profit	26.8	22.8	24.4	17.0
Borrowings	17.8	11.6	11.6	11.6	**EBITDA**	**5.1**	**4.9**	**2.5**	**-3.7**
Payables	2.2	2.6	3.0	3.2	EBIT	0.3	0.5	-1.3	-7.4
Other liabilities	24.1	24.1	24.1	24.1	Pre-tax profit	-1.0	-5.1	-3.9	-8.5
Total liabilities	**44.0**	**38.2**	**38.6**	**38.9**	**NPAT (reported)**	**-2.5**	**-8.7**	**-4.5**	**-11.2**
Net assets	**12.1**	**11.1**	**13.7**	**20.8**	EPS (US$) (NPAT)	-0.04	-0.14	-0.04	-0.11
Board of Directors					DPS (US$)	0.00	0.00	0.00	0.00
Wayne Martin				Chairman	**Valuation**				
Matt Lamont				Founder & Managing Director	**DCF**				
Phil Schwan				CTO	Cost of equity	12.0%	Beta		1.5
Louise Bower				Director	Cost of debt	5.5%	WACC post tax		10.4%
Frank Sciarone				Independent NED	Terminal growth rate	2.5%	**DCF (A$/share)**		**$1.71**
Mark Puzey				Independent NED					
Shareholders		Shares		%	**Capitalisation of future earnings**			2023E	2024E
Matt Lamont		23.8		23.9%	EBITDA (US$m)			14.3	20.6
Perennial Value		14.8		14.9%	EV/ EBITDA multiple			10.0	10.0
Phil Schwan		7.2		7.3%	**Enterprise value (US$m)**			**143.2**	**206.2**
Regal Funds		5.9		5.9%	Net cash/ (debt) (US$m)			-15.6	-20.4
TIGA		5.1		5.1%	Equity value (US$m)			127.6	185.8
Top 20 shareholders		**70.6**		**71.0%**	**Equity value (A$/share)**			**$1.76**	**$2.56**

Source: Company Reports, Canaccord Genuity estimates

Result commentary

Figure 2: Divisional and operating cost commentary

US$m		FY20A	1H21A	2H21A	FY21A	Comment
Services	Revenue	37.9	18.2	12.4	30.6	Challenging 2H21 with ongoing COVID impacts
	EBITDA	3.6	-1.7	-6.8	-8.5	Right sizing of the business continues (lower headcount)
	margin	9%	-9%	-55%	-28%	US1.5m cost savings taken in 2H21
Software	Revenue	4.5	2.3	2.4	4.7	Excludes Polarcus contract roll-off and other income
	EBITDA	4.2	1.5	1.3	2.8	Deferred revenue growth of 9% over period
	margin	59%	52%	42%	47%	Incremental revenue should come on at strong margins
HPCaaS	Revenue	1.1	1.2	1.5	2.7	Momentum building, most new contracts yet to contribute
	EBITDA *	2.2	3.6	4.1	7.7	Margin opportunity from HPC becoming more evident
	margin *	18%	36%	39%	38%	* includes inter-segment HPCaaS revenue
Other	Revenue	6.1	1.7	1.7	3.4	Inter-segment elimination (revenue within Services, also with HPCaaS)
	EBITDA ^	-0.8	0.0	0.0	0.0	^ given underlying representation
Group	**Revenue**	**49.6**	**23.4**	**18.0**	**41.4**	Services impact outweighed all other impacts
Underlying	**EBITDA**	**9.2**	**3.4**	**-1.4**	**2.0**	Business reported a loss in 2H21
	margin	**19%**	**15%**	**-8%**	**5%**	
Add back other		0.8	-1.8	-1.5	-3.3	Redundancy costs, bad debts (Polarcus), other
Management	**EBITDA**	**10.0**	**1.6**	**-2.9**	**-1.3**	Management representation EBITDA
Employee		-30.6	-14.9	-14.7	-29.6	A broadly flat employee cost base
IT facilities		-2.5	-1.9	-1.8	-3.6	Growing with compute demand
S&M		-0.8	-0.3	-0.1	-0.4	Muted spend given lower activity levels, limited trade shows
Consulting		-1.2	-0.6	-0.6	-1.2	Comparable with prior periods
Other		-5.4	-2.4	-2.3	-4.6	
Operating Costs		**-40.5**	**-20.0**	**-19.4**	**-39.4**	A broadly flat cost base

Source: Company Reports, Canaccord Genuity

We adjust our revenue forecasts to incorporate a slower recovery in Services revenue. Our FY22E Services revenue is positioned 14% below FY19 levels and 9% below FY20 levels.

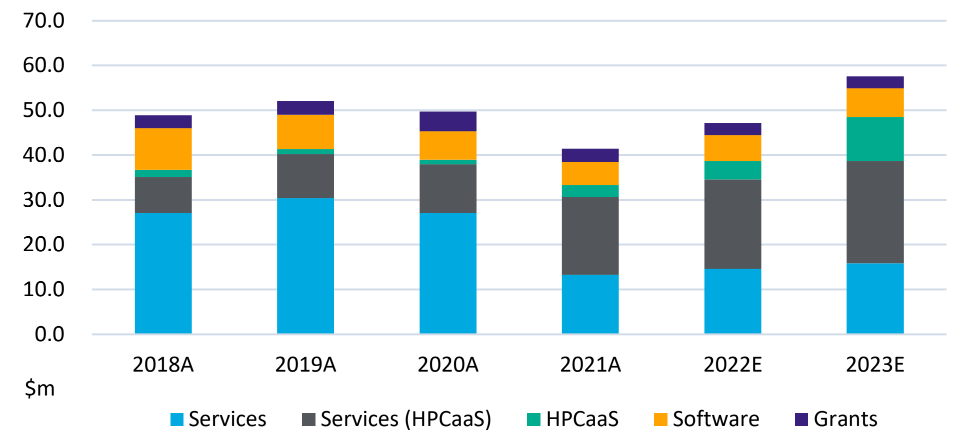
Given prioritisation of compute workloads and mix shift, we envisage strong operating leverage into FY23E.

Figure 3: Updated forecasts; incorporating a slower 1H21E ramp up in Services demand

		2022E			2023E	
US$m	Old	New	Change	Old	New	Change
Revenue	**53.0**	**47.1**	**-11.0%**	**64.8**	**57.6**	**-11.2%**
Growth		13.9%			22.1%	
Costs	-41.9	-38.0	-9.4%	-49.6	-43.2	-12.8%
EBITDA	**11.1**	**9.2**	**-17.4%**	**15.2**	**14.3**	**-5.8%**
Growth		nmf			56.2%	
Margin	20.9%	19.4%		23.5%	24.9%	
NPATA	**-0.3**	**-0.9**	**nmf**	**2.2**	**2.7**	**nmf**
Growth		nmf			nmf	
Net Debt	14.3	10.4		16.2	15.6	

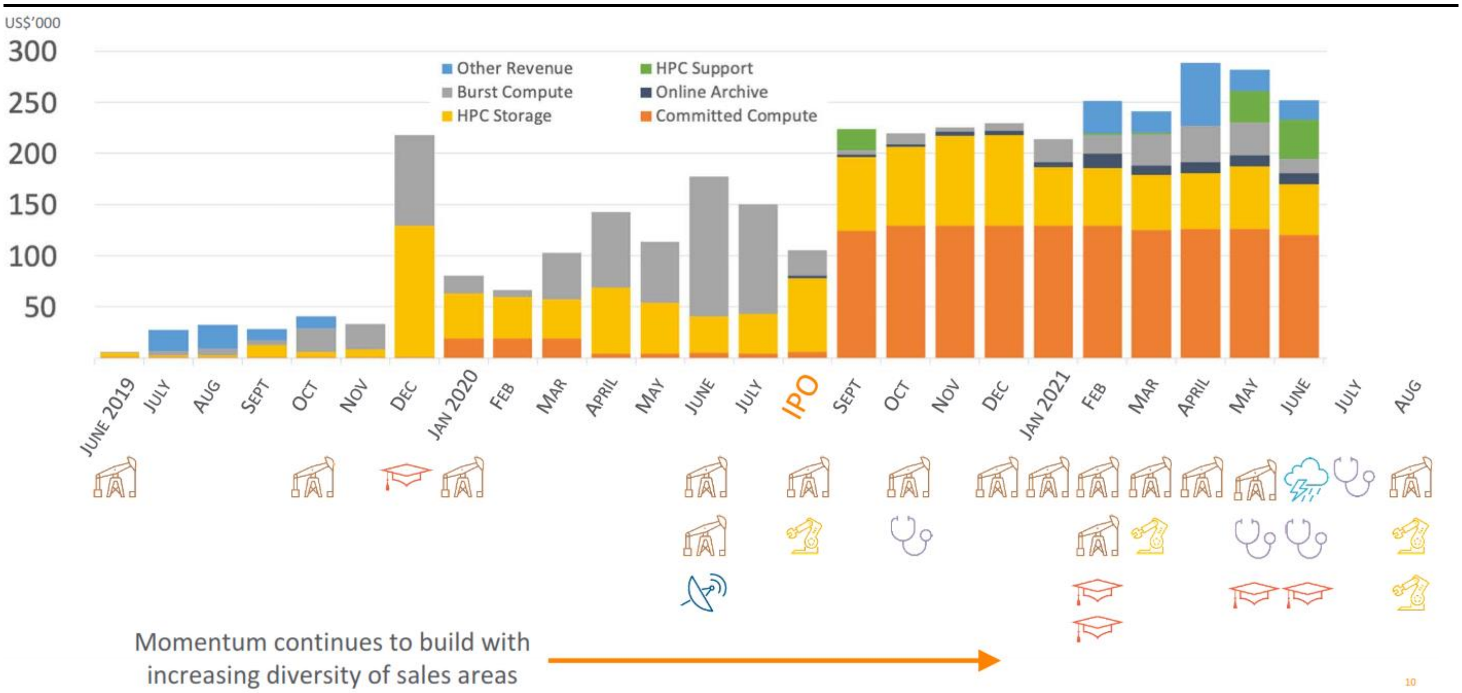
Source: Canaccord Genuity estimates

Figure 4: Revenue mix; the business mix is shifting towards compute and storage (HPCaaS)



Source: Company Reports, Canaccord Genuity estimates

Figure 5: HPCaaS revenue and signings; graphics below chart indicate growing momentum and breadth of client wins. Many of these are yet to contribute to revenue. A revenue recognition change and a client loss impacted 4Q21 committed compute and HPC Storage momentum respectively.



Source: Company Reports

Valuation

Our 12-month price target for DUG is A$1.71/share (from A$1.76/share on lower near-term earnings, offset by a lower AUDUSD exchange rate and DCF rollover). The valuation is DCF based and assumes a WACC of 10.4% (12.0% cost of equity, 20.0% debt to equity and terminal growth of 2.5%).

For reference, at our target price, DUG would trade on a FY23E EV/EBITDA of 10.1x.

Appendix: Important Disclosures

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Investment Recommendation

Date and time of first dissemination: August 31, 2021, 16:31 ET

Date and time of production: August 31, 2021, 10:41 ET

Target Price / Valuation Methodology:

DUG Technology Limited - DUG

Our 12-month price target for DUG is A$1.71/share. This is based on a DCF valuation that assumes a WACC of 10.4% (12.0% cost of equity, 20.0% debt to equity and terminal growth of 2.5%).

Risks to achieving Target Price / Valuation:

DUG Technology Limited - DUG

Brand damage from technology-related issues: With technology operating services across multiple end-user touch points, service levels and uptime performance are critically important. Similarly, data security breaches as a result of cyberattacks, data theft or human error could impact brand reputation and client demand.

Commodity price volatility: The business has been impacted in recent months by oil price volatility, and continuing uncertainty may lead to long-term changes in end-market demand for services.

Foreign exchange movements: DUG's functional currency is US dollars. Shares are listed in Australian dollars and with no hedging in place against movements in exchange rates, translation risk is present.

Increasing competition or technology advancements: The business operates in competitive and fast changing markets. The relevance of products and services, product pricing, customer relationships and brand reputation should be monitored.

IP protection and patent rights: Patent applications may be challenged or not granted, and with this, DUG may not be able to adequately protect its IP from competing products.

The company is currently a co-respondent in litigation alleging patent infringement. The outcome of this litigation may require damages to be paid and/or alteration of operations.

Reliance on key personnel: DUG is a founder-led business with a track record of long tenures and a consistent strategy. Changes to this dynamic, especially relating to Matt Lamont, Phil Schwan and Troy Thompson would warrant caution. Failure to attract, train and/or retain adequately skilled employees could have an adverse impact on the business going forward.

Slower-than-expected uptake of HPCaaS services and DUG McCloud platform, especially in FY21: Adoption of these offerings and expansion to use cases outside the resources sector may take longer than expected, impacting operating performance and investor sentiment.

Distribution of Ratings:

Global Stock Ratings (as of 08/31/21)

Rating	Coverage Universe		IB Clients
	#	%	%
Buy	636	66.25%	44.97%
Hold	161	16.77%	27.33%
Sell	9	0.94%	33.33%
Speculative Buy	145	15.10%	60.69%
	960*	100.0%	

*Total includes stocks that are Under Review

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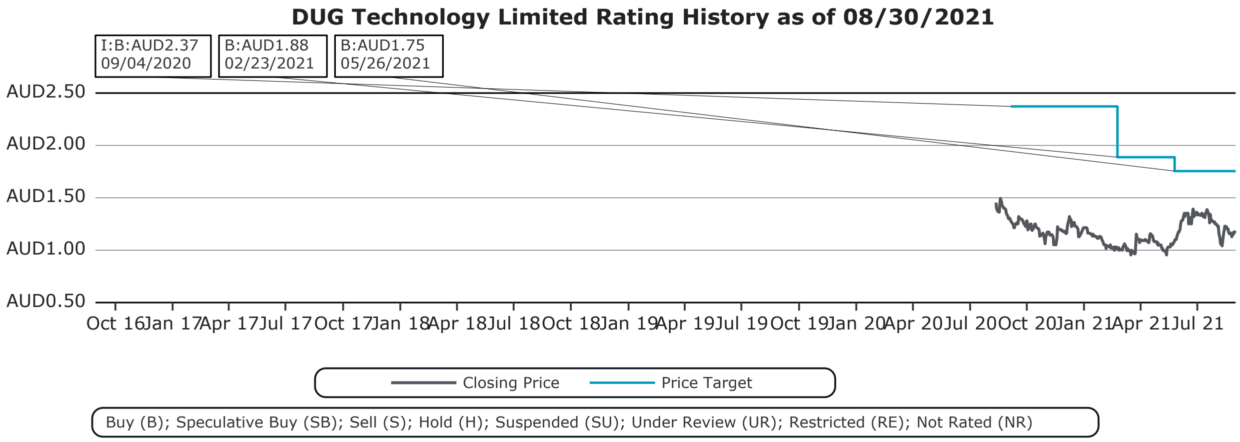

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