Sensera Limited

Realigned for growth

Share Price: A$0.018

ASX: SE1

Sector: Semiconductors & Semiconductor Equipment

6 May 2020

Early in February 2020, Sensera Limited (ASX:SE1) updated the market on its operational performance for 1H20 and FY20 outlook. The dual effect of lost customer opportunities and deferred demand caused a delay in break-even, along with capital erosion. Concurrently, SE1 proposed to raise A$3.5m via the issuance of convertible notes with a face value of A$0.03 and a 3-year maturity.

Restructured operations underpin mid-term growth

Realising the cost rationalisation requirements to drive operational break-even, SE1 restructured its operations. The company also partnered with a low-cost manufacturer in Thailand for its IOT Solutions (IOTS) segment to impact gross margins. The restructuring trimmed approximately US$3m from its Micro Devices (MEMS) segment, IOTS group and corporate overheads. In our view, this should fuel margin expansion in the short to medium term. Additionally, SE1 is changing its customer approach in the MEMS segment by targeting prospects with products currently on the market. We believe this should drive economies of scale for the MEMS segment through capacity utilisation as these opportunities move to production.

Revised valuation range of A$0.22–0.25 per share

Delay in orders from key customers and postponement in break-even, as announced by SE1's management, has led us to trim our November 2019 valuation for SE1 (A$0.40-0.42 per share) to A$0.22–0.25 per share using a DCF-based valuation. However, we believe that given the recent cuts in operating costs, margins can be sustainably improved over the short to medium term. Therefore, we continue to hold the view that the stock has substantial upside potential in the medium term.

Year to June (USD)	2018A	2019A	2020f	2021f	2022f
Sales (m)	6.4	10.2	11.5	12.3	14.6
EBITDA (m)	-6.6	-9.3	-2.7	1.2	1.1
Net Profit (m)	-6.8	-9.5	-3.5	0.6	0.3
EBITDA Margin	NM	-91.0%	-23.7%	9.8%	7.2%
Net Margin	NM	-93.7%	-30.2%	4.9%	1.9%
RoA	-69.6%	-66.2%	-24.6%	4.0%	1.5%
EPS	-4.51c	-4.03c	-1.08c	0.19c	0.09c
EV/Sales	2.7x	2.0x	0.6x	0.5x	0.3x
EV/EBITDA	-2.6x	-2.2x	-2.7x	5.0x	4.1x
P/E	-2.9x	-2.0x	-1.2x	7.2x	15.7x

Source: Company, Pitt Street Research

Market Cap. (A$ m)	5.8
# shares outstanding (m)	322.1
# shares fully diluted	368.0
Market Cap Ful. Dil. (A$ m)	6.6
Free Float	73.1%
52-week high/low (A$)	0.125 / 0.002
Avg. 12M daily volume ('1000)	2,014.4
Website	www.sensera.com

Source: Company, Pitt Street Research

Share price (A$) and avg. daily volume (k, r.h.s.)

Source: Thomson, Pitt Street Research

Valuation metrics	
Fair valuation (A$)	0.22-0.25
WACC	12.0%
Assumed terminal growth rate	2.0%

Source: Pitt Street Research

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Deferred demand by key customers impacts growth

Customer concentration made SE1 vulnerable to cyclical downturn in client industries

In each of its two business segments – Micro Devices (MD) and IOT Solutions (IOTS) – the company has been relying on a single large customer. While for the MD segment the key customer has been Abiomed (NASDAQ: ABMD), for IOTS, Zoetis (NYSE: ZTS) stands as the cornerstone buyer. This reliance makes SE1 vulnerable to cyclicality in customers' businesses and industries. For instance, a parallel delay in demand from both the keystone clients led to a downward revision of management's guidance for 2HY20, pushing the break-even out by six months to 2Q21.

- As the MD business incurs a relatively large fixed cost for running the fab and assembly line, it runs the risk of capital erosion if revenue gets delayed. Additionally, SE1 lost a new volume customer with the cancellation of the Vectura nebuliser project. This loss is expected to result in a US$0.5m impact on the forecasted FY20 financials.
- On the IOTS side of the business, SE1 witnessed the completion of a high-volume, low-margin chip contract that had accounted for US$1.2m per quarter. The replacement contract (with the same client) for a new system infrastructure product generates only half of the revenue per quarter. However, the margin on this order is expected to be higher, which we believe will partly help offset operational margin erosion in the short term.

Restructured business to underpin operational optimisation

In order to tackle the issues SE1 encountered in 1HY20 and to ensure that history does not repeat itself, SE1 has taken the following steps to restructure its operations:

Substantial US$3m cost reduction via operational restructuring

1. **Cost rationalisation**: SE1 made major headway in reducing the cost for its IOTS and MD segments, by US$2m and US$1m respectively. For IOTS, this was driven by outsourcing production to a low-cost manufacturing partner in Thailand. Since this is a sustainable reduction in cost, we believe that it provides considerable potential for margin improvement in the short–medium term. In our view, this improvement has the potential to be further amplified as SE1 signs on new clients for IOTS.
2. **New approach to reach customers**: In line with its transition to becoming a systems supplier, rather than simply a component supplier, SE1 is also changing its customer targeting approach. The company is now looking for more production-based contracts for its MD business, as opposed to non-recurring design-based work. The idea is to increase utilisation of its fab facility, which forms a large fixed cost for SE1, by targeting clients with current products on the market.
3. **Management revamp**: SE1 introduced several changes at the management level, including financial personnel. To drive the transition in its IOTS business, SE1 also changed the operational leadership of the segment. The new GM – Brad Sherrard – is a veteran in the semiconductor and IoT industry, with approximately 28 years of experience in leadership roles at companies such as u-blox (SWX: UBXN), Roadpost, Stratos Global and Magellan Systems. We believe that by building on his expertise in business development and international

expansion, SE1 can boost the visibility of its IOTS segment and help ride the business' transition towards becoming a system supplier.

SE1 turns to market for help with depleting reserves

As a result of deferred demand from key clients, coupled with early ramping of production, SE1 experienced accelerated capital erosion. Even with the A$9.4m (US$6.3m[1]) funding programme completed in 2Q20, the cash balance as of 31 December 2019 stood at just US$2m.

Funding package in place

This led SE1 to propose another capital raise, this time via the issuance of 116.6m unsecured convertible notes to raise A$3.5m. The transaction will be underwritten by Altor Advisory Partners, which will underwrite up to A$2m of the subscription.

Notably, Altor also made significant contributions to the A$9.4m funding programme. Not only was Altor a cornerstone investor in the A$3m private placement, it was also a provider of the A$6.4m secured debt facility, along with PURE Asset Management. In our view, this is indicative of the value that Altor sees in SE1 as an investment. Additionally, SE1's choice to issue convertible notes rather than equity is indicative of management's intention to restrict and delay further share dilution.

The company has still not executed on this capital raise as they continue to evaluate options in regards to further restructuring and other less dilutive capital infusions.

Q3FY20 delivers lower cost base through further operational efficiency

As provided in its Q3FY20 result, SE1 has demonstrated its ability to deliver an improved total cash outflow of US$3.7M compared to US$6.3M over the previous quarter. This was mainly achieved through the restructuring activities undertaken by the firm, which included its partnership with a low-cost Thailand manufacturer for its IOT Solutions segment as well as cost cutting initiatives made in the MD segment.

Q3FY20 Gross Margins improved to 56%

Furthermore, the firm implemented additional operating expense reductions through streamlining of corporate positions, elimination of board fees and reduction of consulting services. Consequent to the cost base reduction, SE1 was able to expand its Q3FY20 gross margin by 1,000 bps QoQ to 56%.

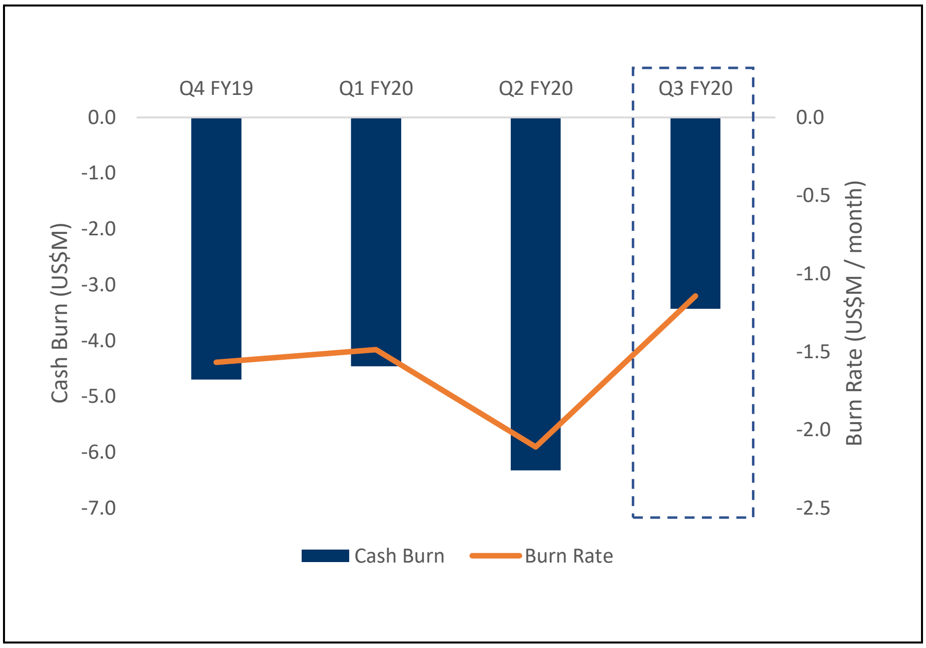
In addition to the cost reductions, SE1's cash position over Q3FY20 was partially strengthened through government rebates in the US and Germany. Cash sits at approximately US$1.4M as of 28 April 2020.

For Q4FY20, SE1 is implementing further operational efficiency to conserve cash whilst continuing to evaluate financing options to ensure viability through the COVID-19 challenges. This includes reduced staff costs and postponement of office rental and interest obligations.

Figure 1 compares SE1's cash burn quarter-on-quarter. Clearly, Q3FY20 cash burn was significantly lower compared to the previous three quarters, which is reflective of management's cost saving initiatives. Also, SE1's burn rates have been trending downwards.

[1] Conversion rate of 0.67354 as of 13 February 2020 |Source: Oanda currency converter.

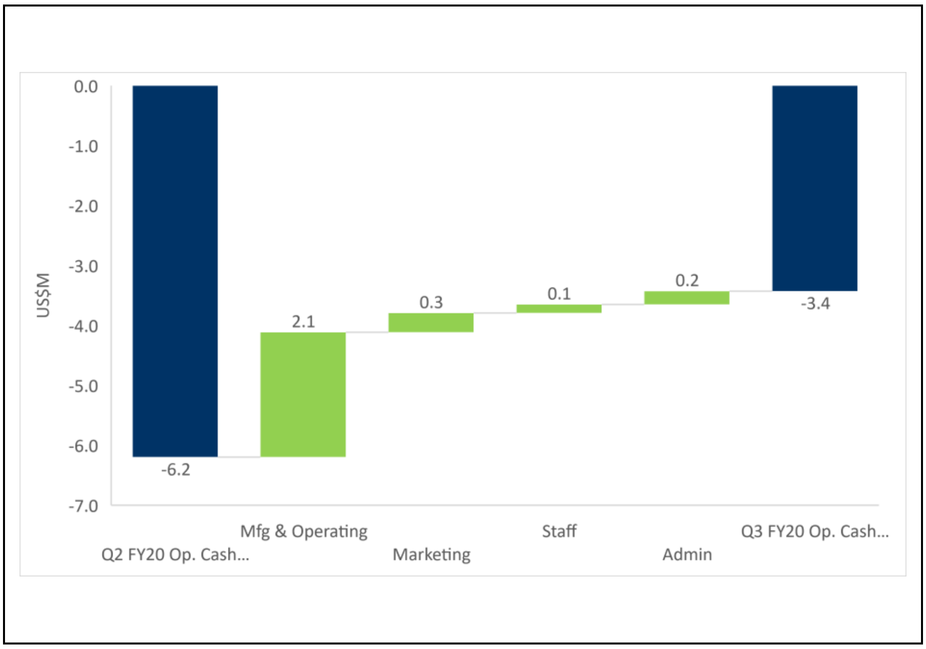
Figure 1: Quarterly cash burn & monthly burn rates



Source: Pitt Street Research, Company Reports

Figure 2 below shows an operating cash outflow bridge from Q2FY20 to Q3FY20, excluding one-off restructuring costs. Notably, the majority of the cost saving initiatives came from an US$2.1M reduction of product manufacturing and operating costs.

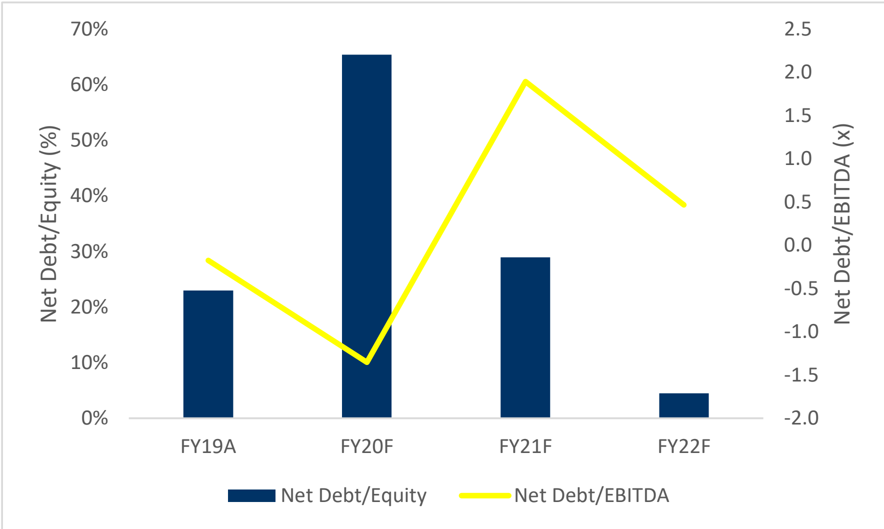
Figure 2: Operating Cash Outflow Bridge from Q2FY20 to Q3FY20



Source: Pitt Street Research, Company Reports

Figure 3 shows our forecasts on SE1's capital structure from FY20 to FY22. As the firm transitions from FY20 into FY21, we expect a de-leveraging to gradually occur as SE1 improves its cash reserves through increased sales and sustained cost reductions.

Figure 3: Solvency Analysis



Source: Pitt Street Research, Company Reports

Customer pipeline remains strong

Expanding the sales funnel

Even with the delay in demand and the loss of a client, we believe the company has a robust order pipeline (Figure 4). SE1 has been effectively building its inventory for potential clients (Figure 5) by increasing customer breadth and investing in its sales team.

In our view, the shift in customer scoping strategy to secure more production-based work, coupled with the sales expertise of new leadership at IOTS, should further drive the sales funnel. However, given the long lead cycles of approximately 24 months, we believe the results of these interactions with potential clients will be more noticeable in top-line growth in the medium-term rather than in the short term.

Figure 4: Committed pipeline value and expected start date[2]

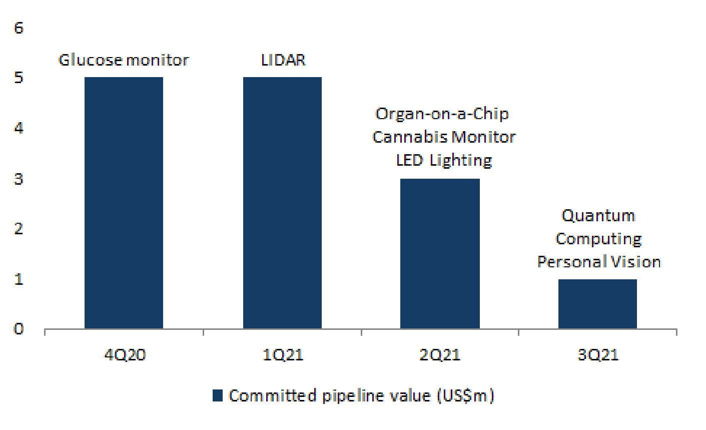
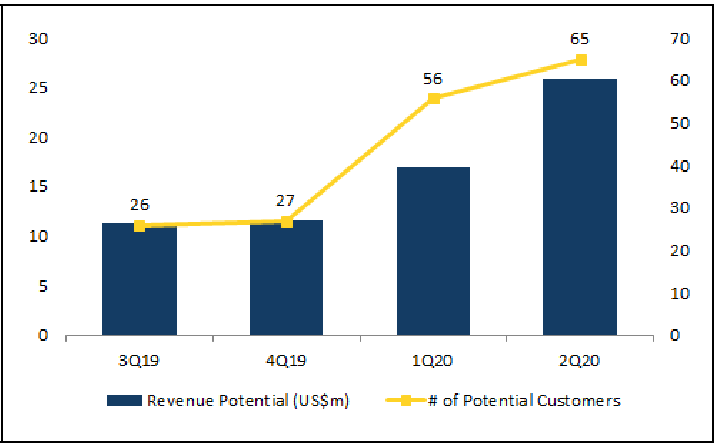


Figure 5: Opportunity potential and number of opportunities



Source: Company update presentation – February 2020

Partnership with a global distributor to underpin market expansion

Braemac distribution partnership to diversify client base

On March 3rd, 2020, SE1 announced a global distribution agreement with Sydney-based Braemac – a provider of electronic component distribution, design-to-manufacture and supply chain management solutions. Leveraging on Braemac's presence across all major continents, SE1 has the potential to substantially expand the geographic footprint for its solutions through this partnership. The agreement includes the entire range of SE1's IOT products — chips, modules, sensors and software. In our view, this agreement is in-line with SE1's strategy to diversify its customer base and should help offset the overreliance on a few key customers.

Revised valuation but medium-term scenario remains strong

In our November 2019 research note, we had highlighted the need for SE1 to rationalise its operating costs as excessive costs could delay break-even. Therefore, the recent operations update by SE1 does not come as a surprise, although the extent of the revenue impact from lost business was unexpected.

Consequent to SE1's restructuring activities, we have slightly increased near-term gross margins to factor in operational efficiency. Also, we have reduced near-term operating expenses to account for further cost base reductions as mentioned earlier. Overall, we expect SE1 to reach profitability in H2 FY21.

However, based on the revised short-term revenues, we trimmed our November 2019 valuation range (A$0.40-0.42) to A$0.22 base case/A$0.25 optimistic case (Figure 6 and Figure 7).

[2] Committed pipeline is not contracted but is indicative of customer guidance of total demand. The revenue will be booked over several periods or years from the expected start date.

Figure 6: Valuation for SE1

Base Case Valuation (USD)	
Present value of FCF	11,473,467
Present value of Terminal FCF	39,014,550
Enterprise Value	**50,488,017**
Net debt (cash)	3,190,255
Equity value	47,297,762
Share outstanding (for 2020, million)	322.1
Implied price (USD cents)	14.7
Implied price (AUD cents)	**22.0**
Current price (AUD cents)	2.00
Upside (%)	999.0%

Bull Case Valuation (USD)	
Present value of FCF	12,484,664
Present value of Terminal FCF	43,656,982
Enterprise Value	**56,141,646**
Net debt (cash)	3,190,255
Equity value	52,951,391
Share outstanding (for 2020, million)	322.1
Implied price (USD cents)	16.4
Implied price (AUD cents)	**24.6**
Current price (AUD cents)	2.0
Upside (%)	1130.3%

Source: Pitt Street Research

Figure 7: DCF in A$ using various WACCs

Sensitivity Analysis									
WACC	**12.05%**								
Terminal Growth Rate	**2.00%**	Change in WACC							
Implied Price (AUD cents)	**22**	*9.0%*	*10.0%*	*11.0%*	*12.0%*	*13.0%*	*14.0%*	*15.0%*	*16.0%*
Change in Terminal Growth Rate	*1.25%*	35.4	29.2	24.4	20.6	17.5	15.0	12.8	11.0
	1.50%	36.4	30.0	25.0	21.0	17.8	15.2	13.0	11.2
	1.75%	37.6	30.8	25.6	21.5	18.2	15.5	13.3	11.4
	2.00%	38.8	31.7	26.2	**22.0**	18.6	15.8	13.5	11.6
	3.00%	44.7	35.8	29.2	24.2	20.2	17.1	14.5	12.4
	3.50%	48.5	38.3	31.0	25.5	21.2	17.8	15.1	12.9
	4.00%	52.9	41.2	33.0	26.9	22.3	18.6	15.7	13.3

Source: Pitt Street Research

Conclusion

In our view, at present, the market is underestimating the potential of Sensera. The company is expected to break-even within the next 12 months and is expected to have a revenue of approximately US$12m in FY20, yet the market capitalization is just US$3.7m (A$5.8m).

Even though management has missed its earlier break-even guidance, they have now restructured the business for optimal efficiency, while the pipeline of customers continues to grow. With the added advantage of the new distribution partnership, higher margins on the IOTS side of the business, and the transition towards becoming a systems supplier, we believe the stock is well-positioned to see a substantial rerating in the medium term. In our view, the current share price level may present a great buying opportunity.

Risks

There are four main risks associated with SE1's investment thesis:

1. Execution risk: Even though SE1 has made a straight US$3m cut to operating expenses, in part by outsourcing, the overreliance on, and delay in, demand from key customers poses a threat to profitability. We believe that even with improved margins from IOTS, future growth will need to be underpinned by management's ability to secure more volume- and production-based work.
2. Future funding: Due to a delay in order placements, as well as higher operating and fixed costs, the company's margins have been impacted. In order to achieve economies of scale, SE1 will have to secure substantial funding. We believe the issuance of convertible notes should provide some relief to its working capital needs.
3. Risk of cannibalisation: Introduction of the Blink communication protocol, which can be applied to any DW1000-based tag, poses a threat of cannibalisation of sales of Nanotron's own anchors.
4. Shortening of supply chain: Sensera's current structure involves the company selling its products and technologies to OEMs, which in turn sell them to mainstream manufacturers. However, as these manufacturers are large enough to move these processes in-house there is a threat that the company might be left out of the market.

Please see www.pittstreetresearch.com for our initiating coverage on SE1.

Analyst certification

Marc Kennis, lead analyst on this report, has been covering the Semiconductor sector as an analyst since 1997.

- Marc obtained an MSc. in Economics from Tilburg University, The Netherlands, in 1996 and a Post Grad. in investment analysis in 2001.
- Since 1996, he has worked for a variety of brokers and banks in The Netherlands, including ING and Rabobank, where his main focus has been on the Technology sector, including the Semiconductor sector.
- After moving to Sydney in 2014, he worked for several Sydney-based brokers before setting up TMT Analytics Pty Ltd, an issuer-sponsored equities research firm.
- In July 2016, with Stuart Roberts, Marc co-founded Pitt Street Research Pty Ltd, which provides issuer-sponsored research on ASX-listed companies across the entire market, including Technology companies.

Cheng Ge is an equities research analyst at Pitt Street Research.

- Cheng obtained a B.Com in Finance and LL.B from University of New South Wales in 2013, and has passed all three levels of the CFA Program.
- Prior to joining Pitt Street Research, he has worked for several financial services firms in Sydney, where his focus was on financial advice.
- He joined Pitt Street Research in January 2020.

Profit & Loss (US$m)	2017A	2018A	2019A	2020F	2021F	2022F	2023F
Sales Revenue	**1.2**	**6.4**	**10.2**	**11.5**	**12.3**	**14.6**	**17.9**
Operating expenses	-5.0	-9.9	-13.4	-8.4	-6.6	-8.3	-9.1
Adjusted EBITDA	**-5.3**	**-6.6**	**-9.3**	**-2.7**	**1.2**	**1.1**	**2.4**
Depn & Amort	-0.1	-0.3	-0.1	-0.6	-0.3	-0.4	-0.4
Adjusted EBIT	**-5.3**	**-6.9**	**-9.4**	**-3.3**	**1.0**	**0.6**	**2.0**
Net Interest	0.0	0.0	-0.1	-0.6	-0.4	-0.4	-0.4
Profit before tax (before exceptionals)	**-5.3**	**-6.8**	**-9.5**	**-3.5**	**0.6**	**0.3**	**2.9**
Tax expense	0.0	0.0	0.0	0.0	0.0	0.0	0.0
NPAT	**-5.3**	**-6.8**	**-9.5**	**-3.5**	**0.6**	**0.3**	**1.7**

Cash Flow (US$m)	2017A	2018A	2019A	2020F	2021F	2022F	2023F
Profit after tax	-5.3	-6.8	-9.5	-3.5	0.6	0.3	1.7
Depreciation	-0.1	-0.3	-0.1	-0.6	-0.3	-0.4	-0.4
Change in trade and other receivables	0.2	-0.9	-1.0	0.9	-0.5	-0.3	-0.2
Change in trade payables	0.1	-3.2	0.6	2.5	-0.2	-0.1	0.0
Other operating activities	0.6	5.0	2.0	-2.6	2.8	3.9	3.1
Operating cashflow	**-4.5**	**-6.1**	**-8.2**	**-3.3**	**2.5**	**3.3**	**4.1**
Capex (- asset sales)	-0.9	-1.3	-0.4	-0.5	-0.5	-1.0	-1.2
Other investing activities	0.0	-3.1	-2.8	0.0	0.0	0.0	0.0
Investing cashflow	**-0.9**	**-4.4**	**-3.2**	**-0.5**	**-0.5**	**-1.0**	**-1.2**
Equity raised (repurchased)	9.9	8.9	8.5	2.2	0.0	0.0	0.0
Other financing activities	-0.8	-0.6	1.9	2.0	-0.5	-0.5	-0.5
Net change in cash	3.7	-2.1	-1.0	0.3	1.4	1.8	2.4
Cash at End Period	4.0	2.0	0.8	1.2	2.6	4.4	6.9
Net Debt (Cash)	-4.0	-2.0	1.6	3.2	1.8	0.0	-2.4

Balance Sheet (US$m)	2017A	2018A	2019A	2020F	2021F	2022F	2023F
Cash	4.0	2.0	0.8	1.2	2.6	4.4	6.9
Total Assets	5.4	14.0	14.8	13.6	16.3	19.6	24.1
Total Debt	0.0	0.0	2.5	4.4	4.4	4.4	4.4
Total Liabilities	0.4	5.7	7.7	7.9	8.0	8.1	8.1
Shareholders' Funds	5.0	8.3	7.1	5.8	8.2	11.5	15.9

Ratios (US$m)	2017A	2018A	2019A	2020F	2021F	2022F	2023F
Net Debt/Equity (%)	-80.8%	-24.4%	23.0%	55.1%	21.5%	-0.2%	-15.4%
Interest Cover (x)	NM	607.4	82.8	-5.4	2.4	1.6	5.1
Return on Equity (%)	NM	NM	NM	NM	8.6%	2.8%	12.2%

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