PITT STREET RESEARCH

De.mem Ltd

Scaling up via acquisitions

In 1Q21, DEM announced its first acquisition of an Australian company, Capic, in an effort to further increase its presence and competitive position in the Australian market. Capic is a private Perth-based supplier of specialty chemicals used for water treatment purpose. It has a lucrative customer base that comprises some of the largest ASX-listed miners including BHP Billiton (ASX: BHP) and Pilbara Minerals (ASX: PLS). Capic earns ~$3.3M in revenue per year. On an upfront consideration of ~$4.4M, DEM effectively bought this established institutional customer base at <1.5x revenue multiple.

Group synergies

Due to the similar industry foci of both Capic and DEM, we see the acquisition as highly complementary to DEM and gives the merged group a strong foothold in the Australian market. We believe the acquisition will deliver multiple strategic benefits for DEM namely: (1) new growth opportunity to capitalise on the significant and lucrative WA mining sector; (2) potential to realise substantial synergies from cross-selling opportunities between entities; and (3) fortifying the merged group's moat in the WA mining space.

Valuation revised to $0.62 per share

We have arrived at a revised valuation range of $0.62 – $0.72 per share (previous: $0.64 – $0.74), which is equally weighted between EV/Sales and DCF of future cashflows. On the DCF side, the marginal increase is mainly a function of capturing the added cashflows and synergies from the Capic acquisition. This is however offset by our increased cost modelling and an expanded share base. Please refer to page 6 for more details on our DCF changes and page 7 for an elaborated discussion on the key risks associated with DEM.

Year to Dec (AUD)	2019A	2020A	2021F	2022F	2023F
Sales (mn)	10.1	14.2	26.2	35.5	42.9
EBITDA (mn)	(3.2)	(2.8)	(0.6)	1.8	4.2
Net Profit (mn)	(3.5)	(3.5)	(1.0)	1.3	3.5
EBITDA Margin (%)	nm	nm	nm	5.1%	9.7%
ROA (%)	nm	nm	nm	6.1%	14.1%
EPS	(2.6)	(2.0)	(0.5)	0.6	1.7
EV/Sales	2.8x	2.6x	1.9x	1.4x	1.1x
EV/EBITDA	nm	nm	nm	28.3x	11.8x
P/E	nm	nm	nm	44.8x	16.8x

Source: Pitt Street Research

Share Price: A$0.29

ASX: DEM

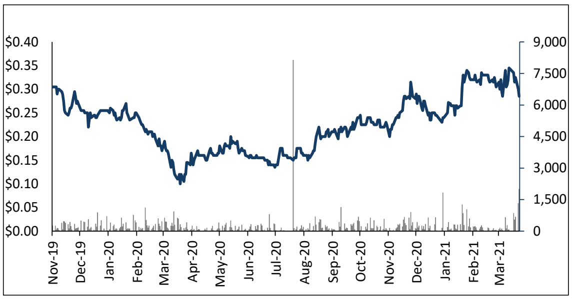
Sector: Utilities

24 March 2021

Market Cap. (A$ m)	59.2
# shares outstanding (m)	207.7
# shares fully diluted (m)	217.2
Market Cap Ful. Dil. (A$ m)	61.9
Free Float	61.6%
52-week high/low (A$)	0.35 / 0.10
Avg. 12M daily volume ('000)	247.3
Website	www.demembranes.com

Source: Company, Pitt Street Research

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



Source: Refinitiv Eikon, Pitt Street Research

Valuation metrics	
Blended valuation range (A$)	0.62 – 0.72
WACC	11.2%
Assumed terminal growth rate	2%

Source: Pitt Street Research

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Disclosure: Pitt Street Research directors own shares in De.mem Ltd.

De.mem Limited

Profit & Loss (A$M)	2017a	2018a	2019a	2020a	2021e	2022e	2023e	2024e
Sales Revenue	**2.9**	**10.5**	**10.1**	**14.2**	**26.2**	**35.5**	**42.9**	**49.9**
Operating expenses	(9.2)	(12.3)	(13.4)	(17.9)	(26.9)	(33.7)	(38.8)	(43.5)
EBITDA	**(6.3)**	**(1.7)**	**(3.3)**	**(3.7)**	**(0.6)**	**1.8**	**4.2**	**6.4**
Depn & Amort	(0.1)	(0.2)	(0.3)	(0.6)	(0.4)	(0.5)	(0.7)	(0.8)
EBIT	**(6.4)**	**(1.9)**	**(3.6)**	**(4.4)**	**(1.0)**	**1.3**	**3.5**	**5.6**
Net Interest	(0.0)	(0.0)	(0.1)	(0.1)	(0.0)	0.0	0.0	0.0
Profit before tax	**(6.4)**	**(1.9)**	**(3.5)**	**(3.5)**	**(1.0)**	**1.3**	**3.5**	**5.6**
Tax expense	0.0	-	(0.0)	(0.0)	-	-	-	-
NPAT	**(6.3)**	**(1.9)**	**(3.5)**	**(3.5)**	**(1.0)**	**1.3**	**3.5**	**5.6**

Cash Flow (A$M)	2017a	2018a	2019a	2020a	2021e	2022e	2023e	2024e
Profit after tax	(6.3)	(1.9)	(3.5)	(3.5)	(1.0)	1.3	3.5	5.6
Depreciation	0.1	0.2	0.3	0.6	0.4	0.5	0.7	0.8
Change in working capital	(0.2)	0.1	1.3	1.2	0.8	(1.2)	(1.0)	(0.7)
Other operating activities	4.1	0.1	0.2	0.5	0.2	0.2	0.3	0.3
Operating cashflow	**(2.4)**	**(1.5)**	**(1.7)**	**(1.2)**	**0.3**	**0.8**	**3.5**	**6.0**
Capex	0.1	(0.5)	(0.2)	(0.8)	(0.8)	(1.1)	(1.3)	(1.5)
Other investing activities	(0.8)	(0.2)	(2.0)	(0.5)	(3.5)	(0.1)	(0.1)	(0.1)
Investing cashflow	**(0.6)**	**(0.7)**	**(2.2)**	**(1.3)**	**(4.3)**	**(1.2)**	**(1.4)**	**(1.6)**
Dividends	-	-	-	-	-	-	-	-
Equity raised	6.3	0.6	10.2	-	8.5	-	-	-
Debt drawdown (repaid)	(0.2)	0.1	(0.0)	(0.3)	-	-	-	-
Other financing activities	-	-	(0.2)	(0.3)	-	-	-	-
Financing cashflow	**6.1**	**0.7**	**10.0**	**(0.5)**	**8.5**	**-**	**-**	**-**
Net change in cash	**3.1**	**(1.5)**	**6.1**	**(3.1)**	**4.5**	**(0.3)**	**2.1**	**4.4**
Cash at End Period	3.3	1.8	7.9	4.6	9.1	8.8	10.9	15.3
Net Debt (Cash)	(2.8)	(1.2)	(6.3)	(4.1)	(8.6)	(8.2)	(10.3)	(14.7)

Balance Sheet (A$M)	2017a	2018a	2019a	2020a	2021e	2022e	2023e	2024e
Cash	3.3	1.7	7.8	4.6	9.1	8.8	10.9	15.3
Total Assets	6.3	5.3	14.6	11.2	20.5	21.6	25.0	30.8
Total Debt	0.5	0.5	1.4	0.6	0.6	0.6	0.6	0.6
Total Liabilities	3.1	3.4	5.1	4.5	6.2	5.7	5.3	5.2
Shareholders' Funds	3.2	1.9	9.5	6.7	14.3	15.9	19.6	25.5

Ratios	2017a	2018a	2019a	2020a	2021e	2022e	2023e	2024e
Net Debt/Equity (%)	-87.3%	-63.0%	-66.3%	-60.7%	-59.8%	-51.9%	-52.4%	-57.6%
Return on Equity (%)	nm	nm	nm	nm	nm	8.3%	17.9%	21.8%

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Fortifying its Australian market position

Background to the Capic strategic takeover

During 1Q21, DEM announced its first acquisition of an Australian company, Capic, in an effort to further build up its presence and competitive positioning in the Australian market.

The Capic takeover has improved DEM's competitive position by giving it a strong foothold in the WA mining sector

Capic is a private Perth-based supplier of specialty chemicals used for water treatment purpose. It has a diverse portfolio of high-margin products, ranging from scale and corrosion inhibitors to Reverse Osmosis membrane anticipants and cleaners. More significantly, it has a lucrative customer base that include some of the largest ASX-listed miners such as BHP Billiton (ASX: BHP), Northern Star (ASX: NST), Pilbara Minerals (ASX: PLS) and Iluka Resources (ASX: ILU).

DEM will buy Capic for a maximum consideration of $5.1M, comprising a base consideration ($3.4M in cash and $1.0M in shares) and a potential milestone payments component[1] of c.$0.8M (50:50 in cash and shares). Finalisation of the acquisition remains subject to commercial and due diligence completion.

Multiple strategic advantages to be delivered

Due to the similar industry foci of both Capic and DEM, we see the acquisition as highly complementary to DEM. Specifically, we believe this acquisition will deliver multiple strategic benefits for the merged group, namely:

- **New growth opportunity to capitalise on the large WA mining sector**. The acquisition will provide DEM with immediate scale in the Australian market. Pre-acquisition, DEM's Australian customers are predominantly based in QLD, VIC, SA and TAS. Post-acquisition, DEM will be able to leverage Capic's network of existing contacts (~50 WA clients), allowing it to tap into the vast and lucrative mining segment of the broader WA market. Given the significant size of the WA mining sector (~170 mines) and its reliance on water and waste water treatment applications, we see a long organic growth runway ahead for the merged group.
- **Potential to realise substantial synergies for the merged group**. There is the potential to bring cross-selling revenue synergies to the merged group as a result of: 1) DEM selling its containerised water treatment services to Capic's clients; and 2) Capic selling its chemicals services to DEM's clients. We estimate the potential revenue synergies will be substantial, mainly driven by the relative size of DEM's ACV, which was ~$0.9M for CY20 (contract values for CY20 ranged from ~$0.4M to ~$2.6M). If future contract pricings surprise on the upside, the revenue synergies for the merged group could be greater. See the following page for an elaborated analysis on group synergies.
- **Buying an institutional customer base at <1.5x revenue multiple.** Capic earns ~$3.3M in revenue pa from its pool of blue-chip customers. On an upfront consideration of $4.4M, DEM is effectively buying an institutional customer base at <1.5x revenue multiple. This will add an additional 50 customers including some high-quality blue-ship customers, which will then place the merged group at ~150 customers. Moreover, we highlight the importance of securing Capic's customers. This is because being able to establish and sustain a good relationship with some large institutional customers isn't something that competitors could easily imitate, in our view. Therefore, the barrier to compete will be high, which in turn fortifies the merged group's moat in the WA mining space.

The merged group's moat in the WA mining space has been fortified…

[1] The potential milestone payments are subject to the satisfaction of specific revenue milestones. Refer to company announcement dated 16 March 2021 for more detail.

Estimating potential revenue synergies

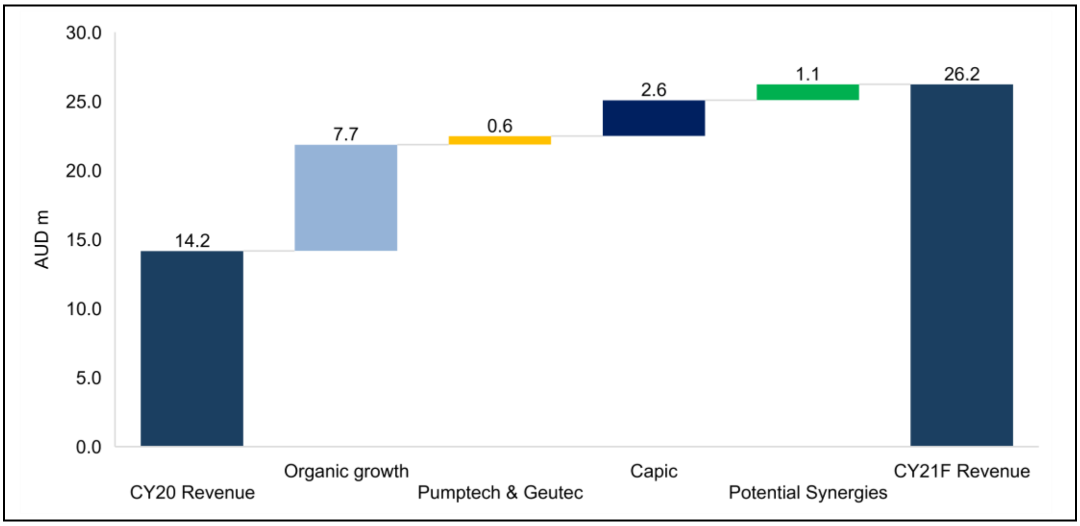
On incorporating the Capic acquisition into our DCF, we introduce and model two additional revenue streams, comprising Capic's future organic revenues and the potential cross-selling revenues between Capic and DEM.

At an organic level, we assume Capic will grow 5-10% in revenue pa to reflect the long runway of growth in the WA mining sector. If we work off Capic's historical revenue of ~$3.3M and assume ~9 months of contribution for CY21, Capic would contribute ~$2.6M in organic revenue to the merged group.

At a synergistic level, we assume Capic and DEM will cross-sell to each other's clients their existing services. Our expected cross-sell revenues are derived as a function of the buyer's current customer base and the seller's recent ACV. For conservatism, we assume both Capic and DEM will initially capture only a small portion of each other's customer base, sequentially ramping up to their long-run targets (DEM: ~10%, Capic: ~50%). Based on our assumptions, we forecast DEM to cross-sell ~$0.6M to Capic's current customer base while Capic could potentially cross-sell ~$0.5M to DEM's existing customers. Adding together, we estimate revenue synergies due to cross-selling opportunities to amount to ~$1.1M for CY21.

Figure 1 shows our CY21 revenue bridge for the merged group, incorporating both the expected organic revenue contribution from the Capic business as well as the potential synergistic benefits due to the cross-selling opportunities between DEM and Capic.

Figure 1: CY21F Group Revenue Bridge



Source: Pitt Street Research

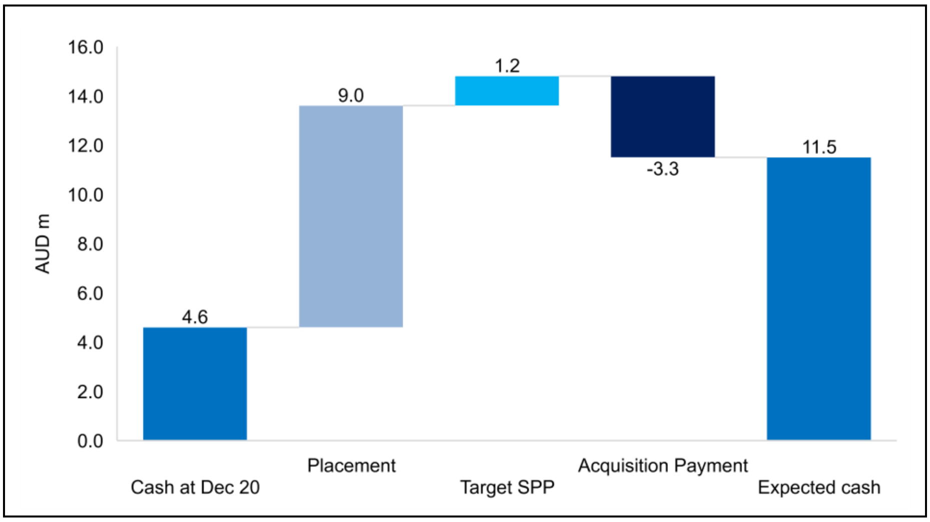
In our view, DEM has a proven track record in realising revenue synergies from well-executed bolt-on acquisitions. As evident in the CY20 financials, Pumptech, a Tasmania-based business which had been acquired by DEM in CY19, grew its CY20 revenue by ~60% YoY, a portion of which we believe were due to cross-sell and/or up-sell opportunities. Accordingly, we are reasonably confident that management will likely continue to efficiently and effectively integrate newly acquired businesses including Capic and realise the potential synergies of a merged group.

Cash expected to be ~17% of market cap (post-raising)

In 1Q21, DEM commenced an equity raising, comprising a ~$9.0M placement from institutional investors and a target SPP of ~$1.2M, with ~36.4M in new shares to be issued at $0.28. Post-equity raising and acquisition payment, DEM expects to have a cash reserves of ~$11.5M (Figure 2), which would represent ~17% of a ~$67.8M diluted market cap.

With a strengthened balance sheet, the company is well-positioned to drive conversion of its strong BOO pipeline, which should in turn drive its recurring organic revenue growth.

Figure 2: Cash position post-equity funding and acquisition payment



Source: Pitt Street Research, Company

Valuation

DCF changes

Given the new Capic acquisition and the full year CY20 results, we re-work our DCF to incorporate the following key changes:

- We revise our revenue and cashflows modelling to incorporate the recent Capic acquisition. Our approach in estimating Capic's expected revenues and group synergies is discussed earlier in the report. Further, given the group's increased liquidity position, we are convinced that management will efficiently deploy capital to help drive conversion of its robust BOO pipeline, the outcome of which should organically drive a material uplift in the group's recurring revenues.
- We also update our CY20 financials to be in line with DEM's actual results. Revenue fell short of our expectations by ~13% whilst net losses of ~$3.5M were greater than our forecast of ~$1.7M. We believe the difference in net losses is largely due to our cost underestimation of the merged group (post-Pumptech and Geutec acquisitions). Upon updating, our cost modelling on a group basis is now higher than previous.
- In 1Q21, DEM executed a ~$0.6M contract with an Australian energy company for the delivery of a water treatment equipment. We therefore incorporate this deal into our near-term equipment sales forecast.
- We expand our share base by an additional ~32.1M due to DEM's recent placement to institutional investors. At this stage, we haven't accounted

for any SPP shares that are expected to be issued as the SPP is still ongoing with completion expected by 2Q21.

- We roll forward our cashflows modelling by an additional year to CY31F in order to maintain an 11-year forecast horizon as DEM is still relatively young in its lifecycle.

Valuation revised to $0.62 per share

Our blended valuation range (50:50 DCF & RV) has been revised to $0.62 – $0.72 per share (previous: $0.64 – $0.74) (Figure 3).

On a DCF level, our valuation range has been marginally increased to $0.61 – $0.74 (previous: $0.59 – $0.72) as a result of incorporating the above changes which include the added cashflows from Capic. This is however offset by our increased cost modelling following the release of the group's CY20 results, of which net losses came in above our expectations. Additionally, an expanded share base due to the recent capital raising also weighed on our valuation on a per share basis.

On our forecasts, DEM is currently trading on EV/Revenue of 1.9x for CY21, falling to 1.4x for CY22.

We see the catalysts for a re-rating of the stock include successful integration of the Capic business, new customer wins, customer renewals, more accretive acquisitions and continued expansion in recurring revenue base.

Figure 3: Blended valuation summary

Base Case	Weights (%)	Share price (AUD)
DCF	50.0%	0.61
Relative valuation	50.0%	0.64
Composite Value (AUD)		**0.62**
Current Price (AUD)		0.29
Upside/Downside (%)		**118.5%**

Bull Case	Weights (%)	Share price (AUD)
DCF	50.0%	0.74
Relative valuation	50.0%	0.70
Composite Value (AUD)		**0.72**
Current Price (AUD)		0.29
Upside/Downside (%)		**151.7%**

Source: Pitt Street Research

Please refer to www.pittstreetresearch.com for our initiating coverage report on DEM.

Key risks

We see five major risks for DEM as a company and as a listed stock:

- **Integration risk**. There is a risk that the acquired Capic business will not perform to management expectations and as such, the amount of the expected synergies, as per our modelling, may not be realised
- **Competition risk.** There is a risk that competitors will bring superior or cheaper products.
- **Operational risk**. There is a risk that the company will not be able to scale the business profitably and as such, positive cashflows and earnings may be delayed than our model forecasts.
- **Commercial risk**. There is a risk that the company will not be able to renewal its existing clients and/or have difficulty in converting its customer pipeline.
- **Execution risk**. There is a risk that the company will run into execution issues in product innovation and implementation.

Appendix – Analyst Qualifications

Cheng Ge, lead analyst on this report, 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.
- Before 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.

Marc Kennis has been covering a range of sectors as an analyst since 1997.

- Marc obtained an MSc in Economics from Tilburg University, Netherlands, in 1996 and a post graduate degree 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 and Industrials sectors, 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.
- In 2020 Pitt Street Research launched Stocks Down Under, a subscription-based investment publication.

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