Corero Network Security

Double digit growth

21st September 2023

Corero's cyber defence solutions delivered double digit growth in order intake, revenue and ARR in H1A. The Group also generated positive free cash flow leaving net cash on the balance sheet of $6.2m. Costs are relatively fixed from this point and Corero is now operationally leveraged into a growing cyber protection market. We are initiating forecasts targeting a conservative 10% revenue growth rate. Trading on 1.7x sales, we calculate a fair value of at least 14p which is 100% above the current share price.

Interim results. Interim revenues to June rose +19% YoY to $10.5m, with order intake increasing more rapidly at +19% YoY to $13.0m. New orders benefitted from some of the deferred customer orders from Q4A being booked in the new fiscal year. Corero's annualised recurring revenues (ARR), generated from its on-premise products and ongoing maintenance customers, grew +13% YoY to $15.3m.

Positive Adj. EBITDA. Adjusted EBITDA of $0.2m, stated before $0.4m of non-realised fx losses relating to an inter-company loan, remained in positive territory despite an increase in sales and marketing expenditure. Sales and marketing headcount has been strategically expanded and the cost base revised to reflect salary inflation necessary to retain key staff.

Net cash. Strong receivables collection relating to orders arising in Q4A contributed to a net working capital inflow of $3.1m. This assisted Corero to generate positive free cash flow of $0.7m net cash balances to grow sequentially to $6.2m (+9%). Notably, free cash flow is stated following the early retirement of all outstanding debt liabilities of $1.3m. In a market environment where financing needs weigh heavily on share prices, **the natural deleveraging of the balance sheet is a major milestone for the Group.**

Initiating forecasts. We are initiating forecasts with a 10% revenue growth rate in FY23E and FY24E. This is prudent in our view because it lies below both historical growth rates for the Group (CAGR 2019-2022A: +27%) and below market forecasts for compound growth out to 2027 of +13%. Nor do our expectations factor in any contribution from major new partnership agreements such as the one announced yesterday with Akamai which should have a material impact from FY24E onwards.

Operational leverage. With costs relatively fixed, we see incremental revenue growth rapidly recovering overheads and Corero beginning to generate a mature EBITDA margin profile of 6.0% in FY24E. In our view, the operating model should be able to generate a 15-20% return on sales.

US focus. With over 80% of Group revenues generated in the Americas, our comparables-based analysis sees the stock trading at a 70%+ discount to a peer group of US cyber stocks. We see fair value at a T+1 EV/sales ratio of 3.7x implying 90%+ upside on a rerating.

Forecasts & Ratios

Y/E Dec, $'m	2019A	2020A	2021A	2022A	2023E	2024E
Group revenue	9.7	16.9	20.9	20.1	22.1	24.3
EBITDA	-3.2	-1.4	3.3	2.6	1.0	1.5
PBT	-6.6	-4.0	1.4	0.4	-1.0	-0.5
Adjusted EPS (p)	-1.6	-0.8	0.3	0.1	-0.2	-0.1
EV/Sales (x)	4.1	2.4	1.9	2.0	1.8	1.6
EV/EBITDA (x)	nm	nm	11.9	15.2	40.0	27.2

Source: Company Accounts, Equity Development forecasts

Company Data

EPIC	CNS
Price (last close)	7.35p
52 weeks Hi/Lo	11.5p/5.75p
Market cap	£36m
ED Fair Value / share	14p

Share Price, p

Source: ADVFN

Description

Corero Network Security provides cyber defence solutions which help protect its global enterprise customers against DDoS attacks.

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Interim revenue analysis

DPaaS is a rapidly growing service line

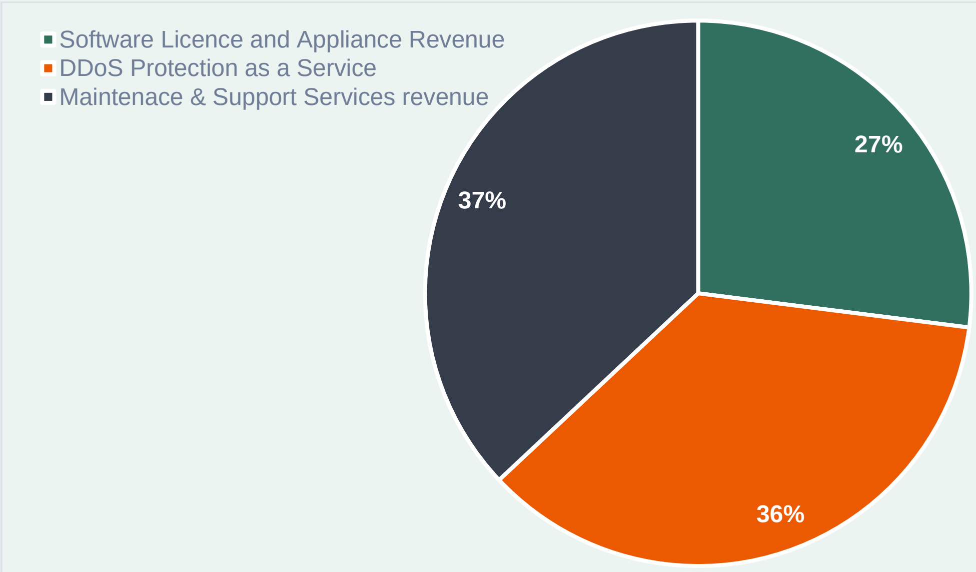
Corero segments its revenues between three service lines:

- Software licence and appliance revenues (37% of H1 FY23E sales): this service line reports the units that are physically shipped in hardware form to customers with the software-only term sales (typically three years) forming a small proportion of this income. Appliance units are sold typically on a term licence basis with revenues recognised on transfer of control to customers. Support and maintenance are charged as a percentage of contract value (typically 20% per annum). Despite some orders expected in Q4A falling into the FY23E, licence and appliance revenues rose 34% YoY in H1A.

- DDoS-Protection-as-a-Service (26% of H1 FY23E sales): DPaaS contracts are typically sold on a three years term with revenues recognised on a straight line basis through the contract period. DPaaS revenues increased 22% YoY in H1A.

- Maintenance and Support Services (37% of H1 FY23E sales): maintenance and support revenues are typically sold on a three-year basis too and recognised on a straight-line basis over the life of a contract. Maintenance and support revenues rose 6% YoY.

Interim revenue analysis (%)



Source: Company Data

Forecasts

Solid track record in line with a growing market

With the overall DDoS prevention market set to grow at a compound growth rate of 13%p.a., (Source: MarketsandMarkets) and Corero growing Group revenues at a compound rate of 27% between 2019-22A, we set our forecast assumptions as follows:

- a sub-market revenue growth rate of 10% in FY23E and FY24E,
- gross margin accretion to c.88% in FY23E and c.89% in FY24E to reflect a higher proportion of DPaaS in the mix
- continued investment in the business as guided which will see underlying operating margins remain above 4% in FY23E before recovering to 6.0% in FY24E,
- net interest expense in FY23E is expected to be limited to c$50k now all borrowings have been repaid, and we conservatively assume no interest income from net cash balances,
- given historical losses we assume no tax charge on earnings will be payable in our forecast horizon,
- very conservative assumptions around cash generation in H2E which provide for potential working capital or other outflows.

Revenue Analysis

Y/E Dec, $k	2018A	2019A	2020A	2021A	2022A	2023E	2024E
Software Licence and Appliance Revenue	4,866	3,821	8,446	10,337	8,107	8,918	9,809
DDoS Protection as a Service	819	1,287	2,876	4,025	4,854	5,339	5,873
Maintenance & Support Services revenue	4,266	4,606	5,555	6,533	7,160	7,876	8,664
Total revenue	**9,951**	**9,714**	**16,877**	**20,895**	**20,121**	**22,133**	**24,346**
Point in Time Delivery	4,866	3,821	8,446	10,337	8,107	8,918	9,809
Over Time	5,085	5,893	8,431	10,558	12,014	13,215	14,537
Total	**9,951**	**9,714**	**16,877**	**20,895**	**20,121**	**22,133**	**24,346**

Source: Company Accounts, Equity Development estimates

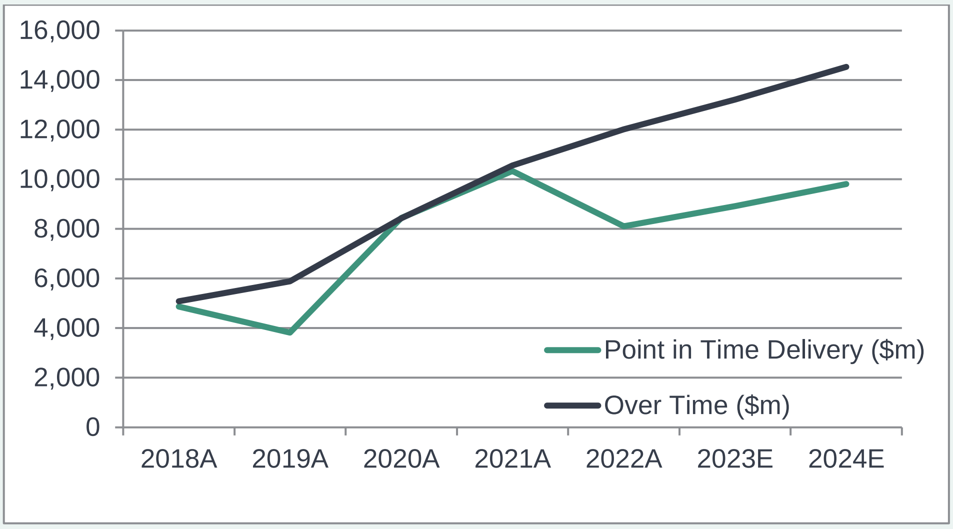
Building 'Over Time' revenues

Building ‘Over Time’ or ARR is a strategic priority for management. DPaaS, revenue share and Maintenance/support revenues are aggregated in the accounts to show the split between 'Point in Time' revenues (i.e. appliance and software sales) and recurring 'Over Time' revenues (i.e. DPaaS/support activities and multi-period term licences). This latter category of 'Over Time' revenues forms the basis of the stated Annualised Recurring Revenues (ARR) with 'Over Time' revenues being the product of twelve months of cumulative sales.

ARR in contrast is the value of all contracts as at a balance sheet date on an annualised basis. It is ARR which is the most valuable part of the revenue model in our opinion because of its predictability.

The predictability of these revenues is underlined with a stated contract renewals rate of 98% in FY22A, a level which we regard as high and very healthy. ARR revenues have grown quickly and have formed the majority of total income from FY21A onwards:

Revenue analysis by type ($k)



Profitable on an adjusted basis since 2021A

Corero Group revenues had fully recovered the Group's total cost base by FY21A such that the company has been able to report positive operating earnings from that time onward (FY21A: $1.1m, FY22A: $0.7m). There have been some notable one-off non-trading items which have impacted trading.

Firstly, the Group has been financing its subsidiaries with inter-company loans which are in sterling. The value of the inter-company loan in GBP changes with varying FX rates and can give rise to FX differences in the Income Statement.

Secondly, during COVID-19 Corero received a $0.6m loan from the US Government under its Paycheck Protection program. Following the US Government's subsequent decision to forgive these loans if certain conditions had been met, Corero recognised the loan proceeds as a credit in its Income Statement in FY21A.

These items were quite material in relation to earnings so, adjusting for them, we see underlying earnings and margins as follows:

Underlying margin analysis (2019-2024E)

Y/E Dec, $k	2019A	2020A	2021A	2022A	2023E	2024E
EBITDA	-3,160	-1,428	3,333	2,619	996	1,461
PPL foregiveness	0	0	-637	0	0	0
FX (gain)/loss on intercompany loan	313	263	-87	-961	400	0
Underlying EBITDA	**-2,847**	**-1,165**	**2,609**	**1,658**	**1,396**	**1,461**
Underlying EBITDA margin (%)	**-29.3**	**-6.9**	**12.5**	**8.2**	**6.3**	**6.0**

Source: Company Accounts, Equity Development estimates

Capitalised R&D table

Corero does capitalise some of its development expenditure as we show below. Accumulated balances are now amortised on a five-year straight-line basis. We can see that amortised development expenditure broadly offsets capitalised development expenditure with a net debit to the Income Statement of only c.$30k over the last couple of years.

The accounting treatment of capitalised research and development costs therefore does not distort the presentation of earnings in the Income Statement in any material way.

Capitalised R&D analysis

Y/E Dec, $'k	2019A	2020A	2021A	2022A	2023E	2024E
Total R&D	2,783	2,972	3,300	3,447	3,700	3,700
R&D Expensed	1,423	1,562	1,546	1,743	2,000	2,000
R&D Capitalised	1,360	1,410	1,754	1,704	1,700	1,700
R&D Amortised	2,638	1,933	1,872	1,732	1,732	1,732
Net P&L credit (debit)	**-1,278**	**-523**	**-118**	**-28**	**-32**	**-32**
% EBITDA	40	37	-4	-1	-3	-2

Source: Company Accounts, Equity Development estimates

Operating cash flow sharply improved

Operating cash flow has been variable even as the company reported positive earnings principally due to reported working capital volatility. The underlying working capital cycle of the company is actually much more stable than reported working capital movements might indicate. Debtor days on Point in Time revenues are reported as being generally around 30-45 days and Over Time revenues are billed quarterly in advance (excluding term licences which are billed annually in advance).

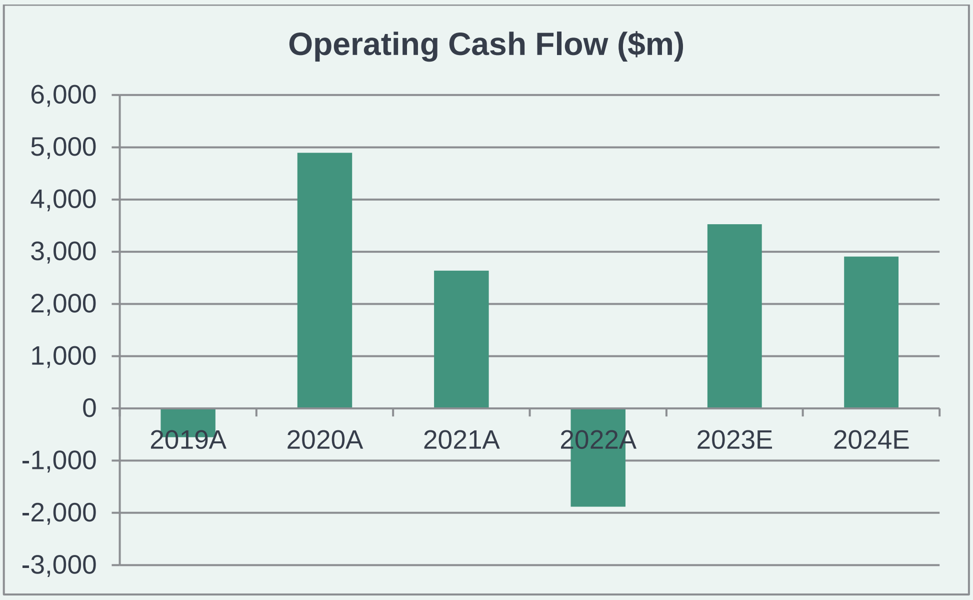
These factors suggest the underling working capital cycle of the business should be relatively neutral. The volatility we see below is, we believe, mostly attributable to quarterly loading when goods are invoiced towards the end of an accounting period.

Working capital

Y/E Dec, $k	2019A	2020A	2021A	2022A	2023E	2024E
Inventories	153	45	175	-26	-50	-50
Trade & other receivables	937	-1,187	223	-3,867	250	-1,000
Payables	1,129	6,852	-1,999	-1,361	1,595	1,740
Total	2,219	5,710	-1,601	-5,254	1,795	690

Source: Company Accounts, Equity Development estimates

Operating cash flow (2019-2024E)



Source: Company Data/ ED forecasts

Free cash flow

With positive free cash flow generation of $2.0m in H1A, partly driven by a material working capital inflow of $3.1m, we see some capacity for net working capital to unwind as the rest of the year progresses. We take a conservative stance on FY23E and see full year net cash balances reducing slightly from June levels to $5.7m. From FY24E we see a return to positive free cash generation and see net cash balances improving to $6.2m with any unanticipated movements in this figure likely to be attributable to order timing and/or working capital movements.

Valuation

Corero is only just beginning to develop its business into a mature operating state, by which we mean predictable, profitable, cash flow positive and self-sustaining. **The historical funding cycle of coming back to the market for additional equity financing is now over, in our opinion.** The solid track record of growing ARR is one that will be highly valued going forward.

Continued investment in sales and marketing will see operating margins trend sideways in our forecast horizon but ultimately once this phase is over, we see the natural operating leverage of Corero should begin to fully develop its financial performance. Corero's software-led business model should be able to generate operating margins of 15-20% upon maturity. We can take a couple of approaches to valuation:

Discounted ARR growth

Today's valuation metrics are arguably very constrained by a withdrawal of liquidity, which has been particularly acute in small and mid cap stocks. Given the market dynamics, ARR in our view could comfortably continue to grow at 10%+ per annum. We can generate notional forecasts beyond our formal horizon, into FY24E and FY25E, and apply three estimated though-the-cycle multiples for revenues, ARR and operating earnings (assuming a 15% operating margin) to arrive at a potential future value for the Group.

This provides for an estimate of future growth at a prospective time when there could be a market recovery in valuations. If we then discount those average valuations back into today's money at a conservative weighted average cost of capital (est. 12%), we can easily see a fair value for the stock around double the current share price.

Forward valuation model						
$k	**2022A**	**2023E**	**2024E**	**2025E**	**2026E**	**2027E**
ARR	14.4	15.8	17.4	19.2	21.1	23.2
Group revenue	20.1	22.1	24.3	27.3	30.5	34.2
Operating earnings (at 15%, a/s no tax)						5.1
Through the cycle sales multiples (x)						
ARR (range 5-7x)						6.0
Sales (range 3-5x)						4.0
NOPAT (range 15-20x)						17.5
Valuation - Sales ($m)						139.1
Valuation - ARR ($m)						136.8
Valuation - Earnings ($m)						89.8
Average valuation ($m)						121.9
Discount rate (%)						12.0
Present Value ($m)						73.1
Net cash (FY23E)						5.8
Total valuation ($m)						78.9
STG equivalent valuation (at USD 1.3)						**60.7**
Current enterprise valuation (£m)						**31.8**
Differential (%)						**91**

Company Data, ED estimates

Peer group comps

We can produce a set of comparator companies engaged in either cybersecurity or networking products to look at current valuations. We identify some close comparators in the US but, mainly because they are more mature businesses, we use these for reference purposes only.

The more immediate UK set of listed companies involved in some aspect of cybersecurity or networking markets (below) consciously excludes some of the nano/micro stocks below £25m market cap because the collapse of liquidity is not valuing these names on a rational basis, in our view.

US comps

Corero generated 82% of its revenues from the Americas in H1A and a comparable valuation with US comparators is therefore valid. We take a list of cyber related businesses in the table below:

US comparables (calendarized)

					EV/Sales (lc)			EV/EBITDA (lc)	
	Price ($)	**Mkt Cap ($m)**	**EV ($m)**	**T0**	**T+1**	**T+2**	**T0**	**T+1**	**T+2**
A10 Networks	14.76	1,090	940	3.4	3.4	3.0	12.5	12.6	10.4
Check Point	137.3	16,060	14,480	6.2	6.0	5.7	13.6	13.4	13.1
Cloudflare	60.17	20,110	19,980	20.5	15.5	11.9	nm	94.7	72.7
Crowdstrike	165.5	39,520	37,060	17.0	12.5	9.7	88.9	60.2	44.1
Cyberark	166.61	6,960	6,620	11.2	9.1	7.3	nm	nm	82.6
F5	161.27	9,560	9,120	3.5	3.3	3.2	9.8	10.0	9.3
Fortinet	60.44	47,470	45,140	10.2	3.5/.4	7.1	34.4	29.4	24.3
NetScout Systems	28.03	2,020	1,800	2.0	2.0	1.9	10.5	7.8	7.7
Palo Alto	236.17	72,880	72,370	15.2	11.9	9.6	61.7	46.3	34.9
Qualys	151.26	5,550	5,240	10.7	9.5	8.4	23.9	21.3	19.8
Radware	16.37	688	368	1.3	1.3	1.2	9.8	12.2	9.5
Rapid7	46.29	2,820	3,440	5.0	4.4	3.9	69.6	30.7	21.9
Splunk	119.27	20,000	21,620	6.1	5.6	5.0	32.2	27.4	23.3
Tenable	46.13	5,330	5,110	7.5	6.5	5.6	65.1	44.8	36.0
Varonis	31.4	3,440	2,990	6.3	6.0	5.4	71.7	93.1	63.5
Zscaler	155.05	22,820	21,930	25.9	16.9	12.3	nm	nm	66.9
Simple average				**9.5**	**7.6**	**6.3**	**38.8**	**36.0**	**33.7**

Source: marketscreener.com, stockanalysis.com

UK comps

Closer to home we take a list of cyber related businesses in the table below:

UK comparables (calendarized)

				EV/Sales (lc)			EV/EBITDA (lc)		
	Price (p)	**Mkt Cap (£m)**	**EV (£m)**	**T0**	**T+1**	**T+2**	**T0**	**T+1**	**T+2**
Corero Network Security	**7**	**34**	**30**	**2.0**	**1.8**	**1.6**	**15.2**	**40.0**	**27.2**
D4T4 Solutions	183	73	53	2.4	1.8	1.6	13.4	10.2	8.5
Darktrace	419	3,358	2,940	8.4	6.1	4.8	48.6	27.8	21.9
Eckoh	42	125	118	3.2	2.9	2.7	13.5	11.9	10.9
GRC	6	6	16	1.1	1.0	n/a	34.1	16.6	n/a
Intercede	50	30	22	1.9	1.7	1.5	19.5	20.2	16.7
NCC Group	106	330	380	1.3	1.2	1.1	6.7	7.9	9.0
Shearwater	44.5	11	7	0.2	0.2	0.2	6.9	3.6	2.2
Spirent	141.4	830	682	1.4	1.3	1.3	5.5	6.8	6.4
Simple average (excl. Corero)				**2.5**	**2.0**	**1.9**	**18.5**	**13.1**	**10.8**

Source: marketscreener.com, stockanalysis.com

Relative valuation

The relative underperformance and discounted valuation of UK technology stocks relative to the US is materially evident in these tables. Corero is trading at a 15% discount to the UK calendarised T+1 EV/.sales ratio of 2.0x, and a 73% discount to the comparable figure for the US peer group.

Investment summary

We see the ARR base (now 69% of FY23E revenues) as the most valuable part of Group revenue and further rises in this figure will improve revenue and earnings visibility. Based on a further $6.6m of forecast Over Time revenues being recognised in H2E in addition to what has been booked in H1A, Corero has visibility over $17m of FY23E revenues, or 77% of our forecast.

The outlook for FY24E has improved materially with the recently announced strategic partnership with Akamai, a leading US based international provider of content delivery network, cloud and security services. This partnership provides an accretive route to market for Corero. Akamai's process of validating Corero's technology is likely to have been as intensive as Juniper's. We believe that the structure of the deal will be comparable to Juniper's, where Akamai will be reselling Corero's products to its customer base as well as utilising Corero's SmartWall solutions internally.

With the Group's exposure to the Americas so meaningful in revenue terms and most likely rising, we believe our dual approach of taking a US predominantly recurring revenue peer group coupled with a discounted sales based approach to valuation is valid.

Our fair value calculation of 14p+, or 3.7x T+1 EV/Sales would still imply a material discount to the US peers of around 50%.

INCOME STATEMENT

Y/E Dec, $k	2019 A	2020A	2021A	2022A	2023E	2024E
Consolidated Revenue	9,714	16,877	20,895	20,121	22,133	24,346
Growth yoy	-	73.7%	23.8%	-3.7%	10.0%	10.0%
Cost of sales	-1,842	-3,832	-3,112	-2,576	-2,656	-2,678
Gross profit	7,872	13,045	17,783	17,545	19,477	21,668
Gross margin (%)	81.0	77.3	85.1	87.2	88.0	89.0
R&D	-1,423	-1,562	-1,546	-1,743	-2,000	-2,000
Operating expenses	-9,609	-12,911	-12,904	-13,183	-16,481	-18,208
EBITDA	-3,160	-1,428	3,333	2,619	996	1,461
EBITDA margin (%)	-32.5	-8.5	16.0	13.0	4.5	6.0
Depreciation (ex.DPaaS)	-515	-633	-697	-579	-575	-575
Amortisation of intangibles	-2,526	-1,684	-1,495	-1,364	-1,400	-1,400
EBIT	-6,201	-3,745	1,141	676	-979	-514
Other income	0	0	637	0	0	0
Net interest	-360	-285	-405	-272	-54	0
Profit before tax	-6,561	-4,030	1,373	404	-1,033	-514
Tax charge	0	246	149	150	0	0
Profit after tax	-6,561	-3,784	1,522	554	-1,033	-514
Basic EPS (p)	-1.6	-0.8	0.3	0.1	-0.2	-0.1
Average shares (m)	406.57	494.85	494.85	495.90	495.90	495.90

Source: Company Accounts, Equity Development estimates

CASH FLOW						
Y/E Dec, $k	**2019A**	**2020A**	**2021A**	**2022A**	**2023E**	**2024E**
EBIT	-6,201	-3,745	1,141	676	-979	-514
Depreciation	515	633	697	579	575	575
Amortisation of acquired intangibles	13	6	5	2	2	0
Amortisation of capitalised development	2,638	1,933	1,872	1,732	1,732	1,732
Working capital	2,219	5,710	-1,601	-5,254	1,795	690
Share based payments	265	359	522	386	400	425
Other including exceptional costs	0	0	0	0	0	0
Operating Cash Flow	-551	4,896	2,636	-1,879	3,525	2,908
Net Interest	-281	-190	-237	-151	-54	0
Tax	0	246	149	150	0	0
Cash flow pre-capex and investment	-832	4,952	2,548	-1,880	3,471	2,908
Investment in intangible assets	-6	-8	0	0	0	0
Capitalised development expenditure	-1,360	-1,410	-1,754	-1,704	-1,700	-1,700
Net capex	-579	-1,015	-421	-420	-450	-500
Acquisitions/disposals	0	0	0	0	0	0
Financing/other	3,028	-686	842	-1,240	-1,208	-237
Dividends	0	0	0	0	0	0
FX & other	44	-14	-154	-311	0	0
Net Cash Flow	295	1,819	1,061	-5,555	113	471
Closing Net Cash/(Debt) pre-IFRS 16	5,384	7,662	8,424	4,438	5,759	6,230

Source: Company Accounts, Equity Development estimates

BALANCE SHEET						
Y/E Dec, $k	**2019A**	**2020A**	**2021A**	**2022A**	**2023E**	**2024E**
Fixed Assets						
Goodwill	8,991	8,991	8,991	8,991	8,991	8,991
Acquired intangible assets	7	9	4	2	0	0
Capitalised development expenditure	5,169	4,646	4,528	4,500	4,800	5,100
Tangible assets	652	1,099	796	604	479	404
Leased right of use assets	357	237	145	62	50	50
Trade & other receivables	307	694	859	1,571	1,571	1,571
Total Fixed Assets	15,483	15,676	15,323	15,730	15,891	16,116
Current assets						
Inventories	63	98	57	164	214	264
Trade and other receivables	2,572	3,714	3,206	5,294	5,044	6,044
Cash	8,321	10,140	11,201	5,646	5,759	6,230
Total Current Assets	10,956	13,952	14,464	11,104	11,017	12,538
Current liabilities						
Trade payables	-2,008	-6,461	-4,068	-3,956	-5,551	-7,291
Lease liabilities	-112	-86	-94	-78	-78	-78
Deferred income	-2,800	-3,444	-4,677	-3,323	-4,000	-4,500
Borrowings	-1,149	-2,073	-1,421	-971	0	0
Total Current Liabilities	-6,069	-12,064	-10,260	-8,328	-9,629	-11,869
Net Current assets	4,887	1,888	4,204	2,776	1,388	669
Long term liabilities						
Trade & other payables	-139	-402	-143	-100	-100	-100
Lease liabilities	-257	-171	-78	0	0	0
Deferred income	-1,096	-2,705	-2,147	-2,285	-2,500	-2,750
Borrowing facility	-1,788	-405	-1,356	-237	0	0
Total Long Term Liabilities	-3,280	-3,683	-3,724	-2,622	-2,600	-2,850
Net Assets	17,090	13,881	15,803	15,884	14,679	13,935

Source: Company Accounts, Equity Development estimates

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