Research as a Service

Structural Monitoring Systems

Initiation Report

Earnings at inflection point

Technology hardware & equipment

18 September 2024

Structural Monitoring Systems (ASX:SMN) is a vertically-integrated designer, developer, manufacturer and marketer of niche products and solutions for the aviation industry. The group has three distinct divisions: 1) AEM Avionics, manufacturing own-brand products for special mission aviation sectors such as firefighting and law enforcement, 2) AEM Contract Manufacturing for a select group of Original Equipment Manufacturers (OEMs) and 3) Comparative Vacuum Monitoring (CVM™), a smart structural monitoring system, initially targeted at the Aft Pressure Bulkhead on 737 aircraft. SMN delivered a maiden RaaS-adjusted $2.4m EBITDA in FY24, with momentum expected to continue into FY25 on the back of new radio product launches and final certification for CVM™. A likely decline in contract manufacturing revenues to make way for higher margin own brand products should have a positive impact on group gross margins going forward, adding to the earnings leverage from expected revenue growth (management have forecast 25% revenue growth in FY25). RaaS forecasts FY25 EBITDA of $8.6m, with further growth forecast into FY26. RaaS-selected domestic peer metrics provide little guide to relative valuation due to a wide range in key metrics. As a result, we revert to a DCF valuation methodology and arrive at a valuation of $0.82/share. We would note peers at the inflection of loss-to-profit can trade on very high near-term multiples.

Business model

SMN has three distinct business units that all have niche aviation applications at their core. AEM Avionics designs and manufactures products for special mission aviation industries. AEM Contract Manufacturing manufactures products for a select group of third-party aviation players. CVM™ Smart Sensors is in the process of commercialising a crack detection monitoring solution initially designed for use in Boeing 737 aircraft with wider applications medium term. We believe key to profitability for this business is the efficient utilisation of manufacturing capacity, new product development including securing key certifications and customer relationships.

FY24 momentum set to continue into FY25

SMN delivered a maiden profit at the EBITDA line in FY24 ($2.4m) and the June 2024 quarter ($1.2m). We expect this momentum to continue in FY25 as key new products are brought to market. In Avionics, the new Aerial Firefighting Radio aims to compete with legacy products and has an estimated total estimated addressable market (TAM) of $US45m. Final certification for the CVM™ crack detection solution is possible early CY2025, with an estimated initial TAM of US$45m before other applications are considered. As higher-margin own brands replace lower-margin contract manufacturing, we forecast revenue growth to be accompanied by an improved gross margin and lower inventory holdings, relative to revenue. Management forecasts 25% revenue growth in FY25 on the back of these drivers.

Valuation of $0.82/share or $112m market cap

There are a number of niche manufacturers listed on the ASX, but most are loss making and microcap in nature. The metrics of peers we have selected as somewhat comparable have limited application when valuing SMN due to a wide variation across key multiples. As a result, we use a DCF as our preferred valuation methodology and derive a valuation of $0.82/share. Key assumptions include first CVM sales in H2 FY25, medium-term penetration rates for new products and a medium-term growth rate of 10%.

Historical earnings and RaaS' estimates (in A$m unless otherwise stated)

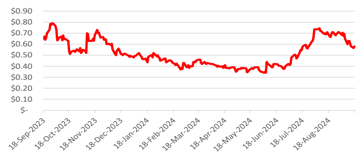
Year end	Revenue	Adj. EBITDA	Adj. NPAT	Adj. EPS	EV/EBITDA (x)	EV/Rev (x)	PER (x)
06/23a	22.4	(0.3)	(3.3)	(0.02)	n.m.	6.7	n.m.
06/24a	27.9	2.4	(0.6)	0.00	34.8	5.4	n.m.
06/25f	35.5	8.6	3.8	0.03	9.4	3.7	17.3
06/26f	39.2	10.7	5.3	0.044	7.2	3.3	12.9

Source: FY23 and FY24 actual, RaaS estimates FY25f and FY26f

Share Details

ASX code	SMN
Share price (17-Sept)	$0.57
Market capitalisation	$78.3M
Shares on issue	137.4M
Net Debt at 30 Jun-24	$8.3M
Free float	~68%

Share Performance (12 Months)



Upside Case

- Full CVM certification
- New product launches
- New industry use cases

Downside Case

- Further delays in CVM certification
- Increased competition
- Ability to fund growth

Catalysts

- CVM certification
- Demonstration of sustained earnings
- Access funding to accelerate growth

Board of Directors & Management

Ross Love	Executive Chair/CEO
Gary Elwell	CFO
Brian Wall	Non-Executive Director
Miroljub Miletic	Non-Executive Director
Sam Wright	Director & Co. Secretary
Heinrich Loechteken	Non-Executive Director

SMN Contact

Ross Love
ross.love@structuralmonitoring.systems

RaaS Contacts

John Burgess +61 410 439 723
john.burgess@raasgroup.com

Finola Burke +61 414 354 712
finola.burke@raasgroup.com

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Structural Monitoring Systems PLC

Structural Monitoring Systems (ASX:SMN) was listed in 2004 and has been developing its CVM™ technology since 2001. In November 2017, SMN completed the company-changing acquisition of Anodyne Electronics Manufacturing Corp (AEM). This added aerospace-certified contract manufacturing and the design & manufacture of a wide range of aerospace products to the SMN portfolio and provided a fully integrated R&D and manufacturing platform. It has been a long road to CVM™ commercialisation and company profitability, however, FY25 may well be the breakout year for both, with final CVM™ certification possible early CY25 and further EBITDA momentum likely off a maiden positive EBITDA result in FY24.

Investment Case

We detail our short- and medium-term investment case for SMN below:

- **Profitable at the EBITDA line**. SMN finished FY24 with a RaaS adjusted EBITDA profit of $2.4m, including first time profitability in a June quarter ($1.2m). The strong conclusion to FY24 is expected to continue in succeeding quarters as new AEM mission critical products are received by the market.

  RaaS estimates $8.6m in EBITDA in FY25, growing to $10.7m in FY26 as CVM should then be in production for a full 12 months.

- **Two fundamental drivers of growth into FY25 and beyond**. The entry of AEM's modern Aerial Firefighting Radio solution for mission critical applications is estimated to have an addressable market of 3,000 aircraft or an estimated market opportunity of US$45m, with RaaS estimates calling for ~65% penetration by FY28.

  After ~15 years in development the Aft Pressure Bulkhead test solution CVM™ is nearing certification. The initial target of this product is Boeing 737 aircraft, of which management estimates there are 711 in the sky currently, this implies a near-term market opportunity for SMN of US$45m on RaaS estimates. We note further applications exist across other Boeing models, other OEM models and applications outside airlines that are not incorporated in our estimates.

- **The gross margin mix is set to improve,** with existing lower margin contract manufacturing capacity to be replaced over time by the higher margin internal IP products such as CVM and the Aerial Firefighting Radio. We forecast gross margin to grow from the 52.4% reported in FY24, to closer to 65% by FY28, which also feeds into improved working capital ratios, particularly inventory.

- **Many of SMN's products have a barrier to entry** given the certification process across a range of aviation authorities and special mission authorities. To aid this process a number of products are designed in conjunction with these authorities and users in mind.

- **Options to accelerate growth**. We believe SMN is somewhat constrained in the areas of manufacturing capacity and marketing given existing facilities and funding options respectively. A more aggressive rollout of products via expanding manufacturing capacity and investment into people could fast track growth over and above that forecast by RaaS currently.

- **Valuation**. There are a number of niche manufacturers listed on the ASX, but our selected comparables have limited application due to significant variation across key multiples. As a result, we defer to a DCF valuation and arrive at $0.82/share.

Divisional Overview

SMN has three distinct business units but all service niche applications and/or sectors in the aviation sector. We detail each division below.

AEM Avionics

SMN acquired Anodyne Electronics Manufacturing Corp (AEM) in November 2017 and added Eagle Digital Audio Systems to the portfolio when acquired in September 2021.

AEM Avionics is a leader in the design, development and manufacture of a range of special mission aviation products including:

- Aircraft communication systems;
- Loudspeaker systems, certified on almost every helicopter airframe and positioned on military programs;
- Mission radios using the latest digital technologies to ensure high performance in demanding environments;
- Avionics consoles which are customisable, easy to install and often used to replace OEM offerings; and
- Caution/warning panels.

AEM Avionics is an approved supplier of aircraft components to OEMs such as Boeing, Bell, Leonardo, Airbus Helicopters and Sikorsky. Key special mission applications include:

- Aerial firefighting;
- Law enforcement;
- Search and rescue; and
- Airbourne utility operators.

Some examples of product offerings appear in Exhibit 1 below.

Exhibit 1: Examples of Avionics products sold by AEM

Source: Company website

AEM Contract Manufacturing

The contract manufacturing business was part of the AEM acquisition by SMN in November 2017.

AEM provides contract manufacturing to a select group of aerospace customers in the industry's Special Mission sector including Canyon AeroConnect, SKYTRAC, Flyht and SEI Industries.

Growth in this division has been strong over the last 2 years, with revenue growing 28% in FY23 and 32% in FY24.

From FY25 we expect growth in SMN's own products across both AEM Avionics and CVM (see below) to substitute the capacity allotted for contract manufacturing, resulting in a revenue decline for this division.

However, high margin own brand products should more than offset the loss of lower margin contract manufacturing revenues at the gross profit and EBITDA line.

SMN secured better trading terms (receivables) for this division in return for a gross margin reduction in October 2023 as part of a working capital review, which has allowed this division to better switch on and off production when required.

AEM Comparative Vacuum Monitoring (CVM™)

The CVM™ Smart Sensor Solutions technology and test equipment has been under development for ~23 years, with Delta Airlines the latest collaboration partner.

The CVM™ solution is in the final stages of certification and is already the first Federal Aviation Administration (FAA) certified, non-destructive, failsafe 'at the gate' monitoring sensor solution for airline operators. The CVM requires an OEM sponsored Service Bulletin for commercial use, initially with 737 Boeing aircraft.

A Service Bulletin is the document used by manufacturers of aircraft, their engines or their components to communicate details of maintenance and manufacturing defect issues, and methods and mitigation. A government mandated Airworthiness Directive is used to regulate the Service Bulletin action to ensure continued safe operation of the aircraft.

The CVM™ solution works in the following way:

- The sensors are installed in hard to access airframe structures to detect early signs of metal fatigue;
- A handheld diagnostic connects to the sensors via an easy access point in the aircraft;
- The device applies vacuum pressure to the sensors, if vacuum is maintained than there are no cracks, if vacuum is not maintained there may be a crack.

Exhibit 2: The CVM solution

Source: SMN

Key benefits of the CVM™ sensors include:

- Eliminates the complexity and cost from heavy checks, which require the removal of structures such as seating to gain access to bulkheads;
- Improved maintenance planning with crack detection test results at the gate available in 20 minutes; and
- Improved quality control including the elimination of false positives (15%) and human error from current checks.

A study by collaboration partner Delta Airlines suggests fitted across their entire 71 B737 fleet, the CVM™ would restore 950 hours of commercial flying time, equivalent to 111 flight days, and save 426 labour hours.

The latest company update[1] suggests the Boeing Technical Design Review had confirmed all outstanding CVM™ tests had been successfully and the outstanding technical design issues arising from the initial review had been closed off. The next step is a compilation of the compliance summary report which is expected to be completed in October 2024 (according to Boeing) and an anticipated submission of the Boeing Service Bulletins and Compliance report to the FAA by November 2024.

Kelowna Manufacturing Facility

All divisions operate out of a purpose built 3,251sqm manufacturing facility in Kelowna, British Columbia. The facility was completed mid-2022 and was designed to improve operational efficiencies and added 929sqm of floor space, and also incorporated the addition of new manufacturing equipment.

The facility is vertically integrated with a metal shop, faceplate manufacturing, electronics, environmental lab testing and high-altitude lab testing all under the one roof.

Kelowna is known as an aerospace manufacturing hub with >30 aviation companies in the region.

The current facility has a manufacturing capacity of ~$35m in revenue (operating at 80% capacity based on FY24 revenue guidance of $28m) running one shift per day with current staffing and equipment.

A move to $50m in revenue capacity would require an additional 15 production staff and modest equipment additions. The addition of an additional shift and some modest capital investment could handle $100m in revenues, but above this level the footprint would need to be expanded.

Market drivers

AEM Avionics

There are a number of demand drivers for special mission hardware across aerial firefighting, law enforcement and search & rescue, including:

- **Technological advancements in mission equipment**, with a good example being the replacement of analogue with digital, as digital systems provide more bandwidth across the spectrum and in some cases allowing for data transfer and providing an additional layer of security to analogue.

  AEM's new Arial Firefighting Radio is an example of technical advancements, it can operate in both analogue and digital radio networks but has a tier 1 digital system that can access a nationwide ground network in North America across a specific frequency range.

- **National and regional security and intelligence**.
- **A seeming rise in the frequency of natural disasters**, be they fire, storms and/or floods.
- **Ageing fleets being replaced by new aircraft**, requiring relationships and approved products with the OEMs.
- **Component obsolescence within existing aircraft** that is no longer supported by manufacturers.

  Many of AEM's products have been designed to be easily configurable and slot into existing consoles.

According to Cirium Aviation Analytics there are >3,000 aircraft (helicopter and fixed wing) in the USA and Canada designated as Firefighting/Utility aircraft. Our understanding is that each aircraft is required to have

[1] ASX announcement 30 August 2024

at least one compliant radio installed (two of three may be installed) to meet contractual requirements for firefighting operations, implying a market opportunity of at least US$45m by RaaS estimates.

Exhibit 3: Aerial firefighting aircraft in the US and Canada

Aircraft	USA	Canada	Total	Estimated market opportunity (US$)
Helicopters	1,883	1,038	2,921	44
Fixed Wing	87	87	174	1
Total	**1,970**	**1,125**	**3095**	**45**

Source: Cirium

CVM™

The Service Bulletin for the CVM™ solution (737-53A1248) is aimed at Boeing 737 (B737) aircraft only.

As for the B737 market opportunity, in a management presentation published on the SMN website[2] it is estimated there are 711 B737 aircraft in operation globally. 71 of these are operated by test partner Delta Airlines, leaving a further 640 as an addressable market upon certification.

Delta has already fitted out 35 B737 aircraft at June 2024 and has committed to fit its remaining fleet with the CVM™ solution post certification incorporating final contract payment. Given Delta is a test partner it is permitted to purchase CVM™ sensors at a discount to the global catalogue prices[3].

SMN has a target penetration rate of 75-80% of the relevant fleets to engage with the program over a period of five years, equating to ~500 installations at a rate of ~100 installations per year at full scale[4].

Further testing and certification will be required for use in other models and/or with other OEMs, with a number of engagements in recent years including:

- Airbus, with a study across the A320 family identifying 14 priority applications;
- A non-disclosure agreement with a major US airline to explore a range of additional applications for its A320 fleet; and
- Meetings with Japan Airlines and All Nippon Airways where the product was presented and demonstrated.

Opportunities also exist outside of aircraft in any sector that relies on metal structures, with meetings held with the likes of Kawasaki Heavy Industries and Subaru in Japan. Licencing opportunities are most likely in areas outside of airlines, in our view.

Key Compliance/Certifications

SMN own brand products are subject to various certifications and approval processes across both aviation regulators, OEMs and the bodies responsible for the procurement of special mission hardware.

This could be at any stage during the lifecycle of an aircraft, from original manufacture to a refit for a role change, a modernisation or replacement due to obsolescence.

Many products are designed in consultation with such bodies to ensure the product is fit for purpose in terms of user requirements and the environment it will operate in.

Key authorities that most AEM products will need to satisfy include:

- The Federal Aviation Administration (FAA) which regulates civil aviation in the US and surrounding waters.

[2] https://structuralmonitoring.systems/wp-content/uploads/2024/06/Investor-Presentation-Dec-2023.pdf
[3] 2017 Annual report
[4] FY23 4E Preliminary final report

- Transport Canada (TCCA) which is responsible for developing regulations, policy and services of road, rail, maritime and air transportation in Canada.
- European Union Aviation Safety Agency (EASA).
- Federal Communication Commission (FCC) in the US for Radio; and
- Innovation, Science and Economic Development Canada (ISED) for Radio.

Key procurement bodies that determine the level of management, contracting requirements and technical requirements needed for special missions include:

- The United States Forest Services (USFS).
- The US Department of the Interior.

Particularly difficult to obtain and providing more of a barrier to entry for products are:

- **A Supplemental Type Certificate (STC)**. A design approval processed and issued by an FAA for a modification to an aircraft in service or for replacement.

  AEM has recently received its first STC for installation of its new Forest Radio (MTP136D) on the AS350 helicopter, and with Transport Cananda (#SH24-21) for the installation for all aircraft in the Airbus H125 AS350) series[5].

- **A Service Bulletin (SB)** is the document used by manufacturers of aircraft, their engines or their components to communicate details of modifications which can be embodied in aircraft maintenance and manufacturing defect issues, at methods of mitigation. While not mandatory a service bulletin calls attention to improvements that should be made to improve safety. A government mandated Airworthiness Directive is used to regulate the Service Bulletin action to ensure continued safe operation of the aircraft.

  The CVM™ solution has a SB pending with Boeing 737 aircraft.

Key SMN Financials

Revenue

Management has forecast 25% revenue growth in FY25. We detail our divisional revenues assumptions with this guidance in mind below.

- **Contract Manufacturing**. Following revenue growth of 28% in FY23 and 32% in FY24, we forecast revenue declines of 10%-15% per annum over the forecast period (FY25-FY28) as contracting makes way for own brand manufacturing.

  Should there be a lull in Avionics and/or CVM™ manufacturing SMN has shown contract manufacturing can easily be switched back in a relative short timeframe.

- **AEM Avionics**. Revenue growth has accelerated in recent years, growing 62% in FY23 (including a first-time contribution from Eagle) and 19% in FY24.

  New product launches in radio and solid underlying demand in the existing portfolio range should see strong medium-term growth. We forecast 64% growth in FY25, slowing to 14% in FY26.

- **CVM™**. Revenue in this division to date has been modest and consists of sales to Delta Airlines at what we estimate to be at or near cost price given it is the development partner.

[5] ASX announcement August 9

Our numbers assume full certification by December 2024, with a mix of sales to Delta and other airlines beginning H2 FY25. Given varying maintenance cycles and fleet ages our numbers assume 40% of the global B737 fleet is fitted out by FY28, below SMN's target of a 70-75% penetration.

We assume a sales price of A$40k for Delta Airlines and A$100k for other players.

Gross Margin

- **Contract Manufacturing** has delivered gross margins between 37% and 41% over the last 3 years, in-line with peers that manufacture and sell hardware-type products to OEMs (see Exhibit 9).

  We expect this range to continue over the forecast period (FY25-FY28 inclusive).

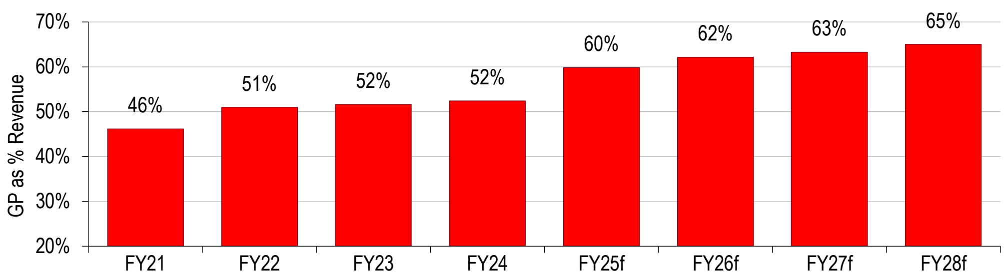
- **AEM Avionics** has delivered gross margins of between 62% and 68% over the last 3 years, higher than contract manufacturing due to their own brand/IP nature.

  We have forecast margins between 70%-72% over the forecast period (FY25-FY28 inclusive).

- **CVM™**. Given the own brand/IP nature of the CVM product we expect similar gross margins to the Avionics division at between 65%-70% over the forecast period (FY25-FY28 inclusive).

With our expectation of revenue growth from higher margin Avionics and CVM™ products, and a revenue decline from lower margin contract manufacturing, we forecast group gross margins to increase 1260bps over the forecast period FY24 to FY28. Strong Avionics revenue growth in H2 FY24 saw group gross margins increase 480bps on H2 FY23 to 59.5%, which is a good guide to FY25.

Exhibit 4: SMN gross margin history and RaaS forecast



Source: Company data, RaaS estimates

Operating costs

Key operating costs for the SMN business and our key assumptions for each line item are summarised below:

- **Employees** relates to the cost of existing and expected new employees as the business grows.

  Representing 71% of total operating costs in FY24, we have assumed stable employee costs in FY25, with costs thereafter increasing at 30% of the rate of revenue growth over the forecast period (FY25-FY28 inclusive), excluding share-based payments.

- **Sales and marketing** represented 8% of operating costs in FY24, and we have this cost increasing 10% per annum, over the forecast period (FY25-FY28 inclusive) as new products come to market.

- **General and administrative expenses** represented 14% of total operating costs in FY24 and we assumed a 10% per annum increase over the forecast period (FY25-FY28 inclusive).
- **Adjustments** include share-based payments, other income and foreign exchange gains/losses.

A full financial summary by division for SMN to FY27 is presented in Exhibit 5 below.

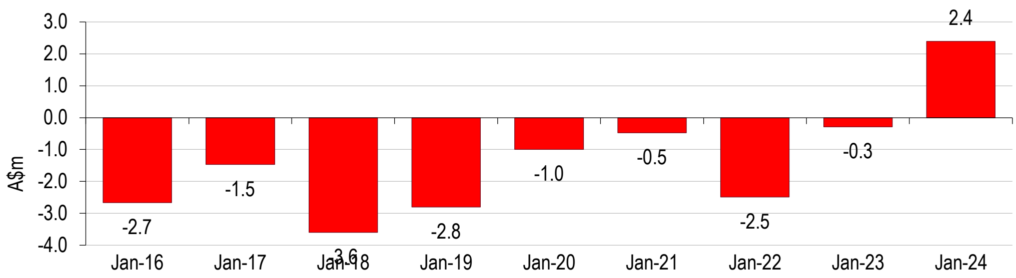
Exhibit 5: SMN P&L summary FY23-FY27f (A$m unless specified)

Year-ended June	2023	2024	2025f	2026f	2027f
Revenue	**22.39**	**27.92**	**35.45**	**39.21**	**41.01**
Avionics	9.33	11.10	18.27	20.90	23.53
Contract Manufacture	12.69	16.70	14.45	12.28	10.44
CVM™	0.37	0.13	2.73	6.03	7.05
Gross Profit	11.57	14.63	21.22	24.37	25.96
GP (%)	52	52	60%	62%	63%
Operating costs	11.86	12.24	12.63	13.66	14.34
EBITDA	**(0.29)**	**2.39**	**8.59**	**10.71**	**11.61**
Depn (PP&E)	0.38	0.38	0.40	0.40	0.40
Depn (RoU)	1.23	1.17	1.15	1.20	1.23
Amortisation	0.74	0.60	0.74	0.74	0.74
EBIT	**(2.65)**	**0.24**	**6.30**	**8.37**	**9.25**
Interest expense	0.70	0.75	0.85	0.80	0.70
Pre-tax profit	(3.35)	(0.65)	5.45	7.57	8.55
Tax expense	(0.02)	0.07	1.67	2.24	2.51
Adjusted NPAT	**(3.33)**	(0.72)	**3.78**	**5.33**	**6.04**
Adjustments	(0.22)	(0.32)	0.00	0.00	0.00
Reported NPAT	(3.55)	(1.04)	3.78	5.33	6.04

Source: Company data for actuals, RaaS estimates for FY25f-FY27f

FY24 delivered the first positive EBITDA since the acquisition of AEM in 2017, and as Exhibit 6 shows we are forecasting an acceleration of this growth into FY25.

Exhibit 6: SMN EBITDA history – FY16-FY24 (A$m)



Source: Company data

Other Financial Commentary

Cash flow

Working capital is currently high given the need to hold inventories in advance of revenue, with the inventory/revenue ratio sitting at 46% in FY24.

We forecast this ratio to decline to 34% by FY28 as high margin own brand products require less inventory relative to revenue.

We forecast Capex to increase from $0.2m in FY24 to over $1.0m into FY25 as new equipment is added for manufacturing requirements.

Capitalised expenses relate to products under development but to be commercialised and can be considered a form of R&D expenditure. RaaS forecasts modest (5%-10%) growth in this expenditure over the forecast period (FY25-FY28 inclusive).

Balance sheet

Net debt as of June 2024 was $8.3m, comprising a cash balance of $1.3m and debt of $9.7m. Debt facilities were recently revised to include an additional CAD$1m in the revolving credit line and a new CAD$0.5m lease finance facility.

Goodwill of $1.6m relates to previous acquisitions.

Intangibles of ~$6.0m relates to capitalised development costs for new products yet to be commercialised as detailed previously.

FY24 Result Summary

A summary of the SMN FY24 result is tabled in exhibit 7 below. Following revenue growth of 31% at a gross profit margin of 45% delivering EBITDA of $0.7m in H1, SMN delivered revenue growth of 19% at a gross profit margin of 59% and EBITDA of $1.7m in H2, which included $1.2m in Q4 FY24.

Exhibit 7: SMN FY24 result summary (A$ unless specified)

Variable (A$000')	FY23	FY24	% CHG	Comments
Revenue	**22.39**	**27.92**	**25**	
Avionics	9.33	11.10	19	H2 +38%
Contract Manufacture	12.69	16.70	32	Utilising free capacity
CVM	0.37	0.13	-65	Not meaningful
Gross Profit	**11.57**	**14.63**		
GP%	0.52	0.52		H2 margin 59%
Operating Costs	11.86	12.24	3	Well controlled
Employee (ex SBP)	8.26	8.63	5	
Marketing	1.10	1.03	(6)	
IT and General				
EBITDA	**(0.29)**	**2.39**	**nm**	**Maiden profit**
Depreciation	1.61	1.55		
Amortisation	0.74	0.74		
EBIT	**(2.65)**	**0.10**	**(104)**	
Adj. NPAT	(3.33)	(0.58)	(78)	Excludes share-based payments and FX

Source: Company announcements, RaaS comments

Listed Peer Analysis

We see peers for SMN as niche manufacturing businesses supplying niche industries with high-tech products. Such manufacturers typically have high inventory requirements, have receivables greater than payables (combined with inventory high working capital requirements) and have manufacturing capacity considerations.

RaaS selected peers include:

Veem (ASX:VEE)

Veem is a designer and manufacturer of high-technology marine propulsion and stabilisation systems for the global luxury motor yacht, fast ferry commercial workboat and defence industries.

Veem exports most of its propellers to large premium boat brands in the US and Europe. The Gyrostabilisers are aimed at vessels over 24m in length and reduce the rolling motion of vessels in waves, increasing on-sea time and improving personal safety.

The group operates out of a 14,700sqm purpose-built facility in Perth and employs around 200 people.

Austin Engineering (ASX:ANG)

Austin Engineering designs and manufactures customised dump truck bodies, water tanks, tyre handlers and other ancillary products used in the mining industry.

Austin says it offers performance enhancements compared to OEM products, offering clients improved return on investment.

The group operates out of six sites across four continents comprising Australia, Asia, North America and South America.

In H1 FY24 84% of revenue was the sale of goods and the remaining 16% services to the mining industry such as maintenance.

Micro X (ASX:MX1)

Micro-X is in the process of developing and commercialising a range of high-tech products for global health and security markets, based on proprietary cold cathode, carbon nanotube emitter technology.

In the healthcare space MXI is developing a range of mobile x-ray machines which have a significant reduction in size, weight and power requirement than incumbent products, and are currently being sold for diagnostic imaging. The group also has an x-ray camera for security commercially available.

MX1 is working on the next generation airport security checkpoint with the US Department of Homeland Security and is also developing a miniature brain CT imager for pre-hospital stroke diagnosis in ambulances.

Beam Communications (ASX:BCC)

Beam specialises in the design, development, manufacture and distribution of satellite, cellular and dual-mode equipment applications and services. Customers include Iridium, Telstra, KDDI, Inmarsat and Thuraya.

Beam also has a joint venture interest in ZOLEO Inc with Roadpost Inc, which is developing a lower cost, consumer orientated global messaging solution including wireless devices and apps based on Iridium short burst data (SBD), cellular and Wi-Fi standards, and aimed at the fringe of cellular coverage, outdoor recreation and lone workers.

Beam is currently in arbitration with its ZOLEO JV partner, where BCC will either become the 100% shareholder or divest and crystalise in 50% share of the JV to Roadpost Inc. A ruling is expected 4-6 weeks from oral submissions due mid-June[6].

Droneshield (ASX:DRO)

Droneshield offers bespoke counterdrone and electronic warfare solutions and off-the-shelf products designed to suit a variety of terrestrial, maritime or airborne platforms. The group also provides Artificial Intelligence based platforms.

Customers include military, intelligence community, Government, law enforcement, critical infrastructure and airports.

In FY23 87% of DRO's revenue was hardware sales and the balance services. FY23 was the group's first positive Profit After Tax (PAT), with the share price up ~250% since the result release.

Fluence Corporation (ASX:FLU)

Fluence designs and manufactures pre-engineered, standardised Smart Products Solutions (SPS) to the Wastewater Treatment and Reuse, High Strength Wastewater Treatment, Wastewater-to Energy, Industrial and Drinking Water markets.

The group also provides ongoing operations and maintenance support Build Own Operate (BOO) and other recurring revenue solutions. For CY23 revenue was split 85% hardware and 15% services with a focus on the North America and Southeast Asian markets.

Fluence is a research client of RaaS Research.

Other

There are a number of other smaller, loss-making listed companies with little guidance and/or analyst coverage to provide meaningful comparables for SMN, but we believe are worth monitoring for future relevance, including:

Shekel Brainweigh (ASX:SBW), a manufacturer of weighing scales for OEMs across the self-checkout and healthcare sectors, while also developing new IP products in the vending and smart cart space.

Orbital Corporation Limited (ASX:OEC), a manufacturer and supplier of integrated propulsion systems and flight critical components for tactical uncrewed aerial vehicles (UAVs)

Quickstep Holdings (ASX:QHL), a manufacturer of composite solutions for the defence and commercial aerospace and advanced industry sectors.

AML3D Limited (ASX:AL3), a metal parts manufacturer and supplier using the Company's patented Wire Additive Manufacturing process (WAM).

The following table summarises the key financial metrics of the selected peers for FY25 which we use to select the appropriate multiples for a Sum of The Parts (SoTP) valuation

[6] ASX announcement 21 May 2024

Exhibit 8: SMN peer group FY25f financial comparison (in A$m unless otherwise stated)

Company Name	Ticker	Share price (A$)	Mkt. cap.	Net debt (cash) @ Jun-24	Adj. EBITDA ^	Revenue	FY24 GP%	FY24 WC/Rev (%)	EV/ EBITDA (x)	R&D/ Revenue (%) #
Droneshield *	DRO	1.15	1,003	(134.2)	29.3	129.1	73	43	29.7	9
Austin Engineering	ANG	0.50	293	(5.1)	55.0	350.0	61	14	5.2	na
Veem	VEE	1.58	215	12.3	16.1	87.4	56	36	14.1	3
Fluence *	FLC	0.10	108	6.2	4.8	103.7	30	21	23.8	0
MicroX	MX1	0.05	31	(3.2)	(4.2)	29.1	61	27	(6.7)	20
Beam Communications	BCC	0.13	11	(3.1)	3.9	35.7	32	13	2.1	11
						AVERAGE	**52**	**25**	**n.m.**	**8**
Structural Monitoring	SMN	0.57	78	2.6	7.4	35.5	52	46	10.8	3

Sources: LSEG consensus, RaaS estimates (SMN); Prices as of 17 September 2024; *Dec Year-end # Excluding ANG and MX1
^Reported EBITDA less rent/leases (preAASB16)

Looking at SMN relative to the peer group using forecast FY25 multiples we would highlight the following:

- The same gross margin as the peer group average of (52%), with RaaS forecasting a margin closer to 60% in FY25;
- Higher than average working capital to revenue requirements at 46% against a peer average of 25%;
- Only two other peers (VEE and FLC) have net debt; and
- Has a market cap at the mid-range of the peer group.

Valuation

We believe the spread of peer metrics for FY25f provides little guide to where SMN should trade relative to peers from a multiple perspective.

Many of the peer group have yet to fully commercialise products (i.e. MX1) and/or are early in the shift from loss to profit (i.e. DRO). Others are relatively mature with strong industry positions (i.e. ANG).

SMN appears to sit somewhere in the middle, with CVM and radio relatively new while other avionics products and contract manufacturing is relatively mature.

DCF valuation

Given a lack of industry peer metrics we revert to a DCF as our primary valuation methodology. We have constructed a DCF valuation based on our earnings estimates out to FY28 and modest medium-term growth assumptions thereafter. The result is our valuation of $0.82/share.

We would highlight the following as being key drivers/assumptions of this valuation:

- 11.2% discount rate incorporating a beta of 1.1x, RFR 4.0% and equity risk premium of 6.5%;
- Medium-term growth beyond the forecast period of 10.0%;
- Perpetuity growth rate of 2.2%;
- 63% penetration of the aerial firefighting radio and 40% penetration of the B737 fleet by FY28, with no further applications assumed;
- Unchanged shares on issue; and
- No acquisitions.

Exhibit 9: SMN base-case DCF valuation (in A$m unless otherwise stated)	
Parameters	**Outcome**
Discount rate /WACC	11.2%
Beta	1.1x
Terminal growth rate assumption	2.2%
Sum of PV ($m)	37.1
PV of terminal value ($m)	80.0
PV of enterprise ($m)	117.1
Debt (cash) @ June 2024 ($m)	5.1
Net value – shareholder ($m)	112.0
No. of diluted shares on issue (m)	137
NPV ($/share)	**$0.82**

Source: RaaS estimates

SWOT Analysis

We see the strengths and opportunities for SMN outweighing weakness and threats.

Our Strengths, Weaknesses, Opportunities, Threats (SWOT) analysis is summarised below.

Exhibit 10: Strengths, Weaknesses, Opportunities, Threats	
Strengths	**Opportunities**
Highly regulated industry provides some barriers to entry	New product development
Highly experienced senior management team	Final certification and commercialisation of CVM
Vertically integrated and flexible manufacturing facility	Strengthen portfolio via acquisition
Established products and brands in market	Application of products outside of special aviation
Weaknesses	**Threats**
Small company in the context of customers and competitors	Further delays in CVM™ certification
Relatively small addressable markets	New products from competitors
Hardware only sales	
Ability to fund growth	

Source: RaaS analysis

Key Sensitivities And Risks

Following are the key sensitivities and risks:

CVM™ certification

RaaS forecasts first sales at full margin for the CVM™ Smart Sensor solution in H2 FY25, and ramping up in FY26 to represent 15% of group revenue and 20% of gross profit. Any slippage in this timeframe has the potential to reduce RaaS' estimates accordingly.

Gross margin assumptions

RaaS is forecasting AEM and CVM gross margins of between 70-72% and 65-70% respectively over the forecast period (FY25-FY28). By our estimates the 59.5% H2 FY24 group gross margin implied an AEM gross margin of 75%. The CVM gross margin is yet to be fully tested in the open market.

As mentioned throughout this document, the higher gross margin assumptions also have positive flow-on benefits for working capital assumptions, particularly inventory holdings.

Discount rate

RaaS uses a discount rate for our DCF valuation of 11.0% which incorporates a beta of 1.1. For every +/- 100bps move in this beta, the DCF valuation move by +/- $0.075/share or 9%, all else equal.

Board

Ross Love, Executive Chair and Chief Executive Officer. Appointed in July 2022, Mr Love is an experienced executive and consultant across a number of sectors and geographies, with a long-term concentration in airlines. Mr Love was most recently head of Boston Consulting Group's New York business and prior to that its global airline practice.

Mr Love has worked extensively in most aspects of airline commercial strategy and operations in Australia, the US, Europe, Asia and South America.

Brian Wall, Non-Executive Director. Appointed June 2020, Mr Wall has held leadership roles in a >35-year career with organisations such as Cintas, Troika Ventures, The Pattison Group and most recently AEM.

Mr Wall joined AEM in August 2019 and held the position of Chief Executive until August 2022, successfully navigating the group through COVID-19 and the move to the new Kelowna facility.

Miroljub Miletic, Non-Executive Director. Appointed in November 2022, Mr Miletic is the Managing Director and founder of MEMKO Pty Ltd with a record of leadership and achievement in both the Australian and international aerospace industries.

Mr Miletic has worked on a range of large commercial and military aircraft projects and has held a number of senior leadership positions including Director Engineering & Quality Assurance and Manager of Business Development and Planning with the Boeing Company Australia.

Heinrich Loechteken, Non-Executive Director. Appointed in November 2022, Mr Loechteken has held a variety of executive roles in the aviation and corporate finance fields and has a deep understanding of aircraft leasing and a strong record of financial and operational restructuring of companies ahead of sale or IPO.

Mr Loechteken is currently CEO of JLPS Ireland Limited, which offers transportation leasing services encompassing aircraft, ships, maritime containers and solar power generation equipment.

Sam Wright, Non-Executive Director & Company Secretary. Appointed in October 2020, Mr Wright is experienced in the administration of ASX listed companies, corporate governance and corporate finance.

Mr Wright is Managing Director of corporate advisory firm, Straight Lines Consultancy, specialising in the provision of corporate services to public companies.

Shareholders

SMN has a relatively open share register with the top five shareholders accounting for ~24% of the register.

Exhibit 11: SMN top-five major shareholders June 2024

Holder	% total
Drake Private Investments LLC	15.3
Robert Looby	3.8
Sam Wright	1.4
Stephen Forman	1.4
Robert Wynne	1.3

Source: LSEG

Exhibit 12: SMN Financial Summary

Structural Monitoring Systems (SMN.ASX)					
Profit and Loss (A$m)					
Y/E 30 June	**FY22A**	**FY23A**	**FY24A**	**FY25F**	**FY26F**
Revenue	**15.7**	**22.4**	**27.9**	**35.5**	**39.2**
Gross Profit	8.0	11.6	14.6	21.2	24.4
Operating costs	10.5	11.9	12.2	12.6	13.7
Underlying EBITDA	**(2.5)**	**(0.3)**	**2.4**	**8.6**	**10.7**
Depn	(0.6)	(1.6)	(1.5)	(1.6)	(1.6)
Amort	(1.0)	(0.7)	(0.7)	(0.7)	(0.7)
EBIT	**(4.1)**	**(2.6)**	**0.1**	**6.3**	**8.4**
Interest	0.0	(0.7)	(0.7)	(0.9)	(0.8)
Tax	0.0	0.0	(0.1)	(1.7)	(2.2)
Adj. NPAT	**(4.1)**	**(3.3)**	**(0.7)**	**3.8**	**5.3**
Adjustments	0.4	(0.0)	(0.3)	0.0	0.0
Adjusted NPAT	**(3.6)**	**(3.3)**	**(1.0)**	**3.8**	**5.3**
Minorities	0.0	0.0	0.0	0.0	0.0
NPAT (reported)	**(3.6)**	**(3.3)**	**(1.0)**	**3.8**	**5.3**
Cash flow (A$m)					
Y/E 30 June	**FY22A**	**FY23A**	**FY24A**	**FY25F**	**FY26F**
EBITDA (inc cash rent)	(2.9)	(1.5)	1.2	7.4	9.5
Interest	0.0	(0.7)	(0.7)	(0.9)	(0.8)
Tax	0.7	0.2	0.2	(1.7)	(2.2)
Working capital/Other	(1.9)	0.0	(0.2)	(0.3)	(0.1)
Operating cash flow	**(4.1)**	**(2.0)**	**0.5**	**4.7**	**6.4**
Capitalised IT spend	(0.6)	(1.1)	(1.2)	(1.2)	(1.3)
Capex	(0.3)	(0.3)	(0.2)	(1.0)	(1.1)
Free cash flow	**(5.1)**	**(3.4)**	**(0.9)**	**2.4**	**4.0**
Acquisitions/Disposals	(4.4)	0.0	0.0	0.0	0.0
Other	(1.2)	1.2	0.0	0.0	0.0
Cash flow pre financing	**(10.6)**	**(2.3)**	**(0.9)**	**2.4**	**4.0**
Equity Issues	4.8	1.8	0.9	0.0	0.0
Debt	(5.5)	0.0	(0.2)	1.0	(2.0)
Net Dividends paid	0.0	0.0	0.0	0.0	0.0
Change in cash	**(11.2)**	**(0.4)**	**(0.2)**	**3.4**	**2.0**
Balance sheet (A$m)					
Y/E 30 June	**FY22A**	**FY23A**	**FY24A**	**FY25F**	**FY26F**
Cash	1.8	1.0	1.3	4.7	6.7
Accounts receivable	3.0	2.0	2.6	3.3	3.6
Inventory	11.3	13.5	14.0	15.0	15.6
Other current assets	1.7	0.6	0.6	0.6	0.6
Total current assets	*17.8*	*17.0*	*18.4*	*23.5*	*26.5*
Plant & Equipment	1.7	1.6	1.3	1.9	2.6
RoU assets	8.8	7.6	6.4	5.2	4.0
Intangibles	7.1	7.4	6.8	7.2	7.8
Other	0.0	0.0	0.0	0.8	1.6
Total non current assets	*17.7*	*16.6*	*14.4*	*15.2*	*16.0*
Total Assets	35.5	33.7	32.8	38.7	42.5
Accounts payable	3.7	3.9	3.8	4.8	5.3
Borrowings	5.5	4.2	5.3	6.3	4.3
Lease liabilities	1.2	1.2	1.3	1.3	1.3
Other	0.1	0.1	0.1	0.1	0.1
Total current liabilities	*10.5*	*9.4*	*10.6*	*12.6*	*11.1*
Borrowings	0.0	1.2	1.0	1.0	1.0
Lease liabilities	8.7	7.8	6.1	6.1	6.1
Other	0.3	0.4	0.5	0.5	0.5
Total long term liabilities	*9.0*	*9.4*	*7.6*	*7.6*	*7.6*
Total Liabilities	19.5	18.7	18.2	20.2	18.7
Net Assets	**16.0**	**14.9**	**14.6**	**18.4**	**23.8**
Share capital	32.0	32.0	32.0	32.0	32.0
Reserves	41.3	43.2	44.6	44.6	44.6
Retained Earnings	(57.3)	(60.3)	(62.0)	(58.2)	(52.8)
Minorities	0.0	0.0	0.0	0.0	0.0
Total Shareholder funds	**16.0**	**14.9**	**14.6**	**18.4**	**23.7**

Share price (17 September 2024)						A$	0.570
Interim (A$m)		**H123**	**H223**	**H124**	**H224**	**H125F**	**H225F**
Revenue		10.1	12.3	13.3	14.6	16.8	18.6
EBITDA		(0.2)	(0.1)	0.7	1.7	4.0	4.6
EBIT		(1.5)	(1.2)	(0.5)	0.6	2.9	3.4
NPAT (adjusted)		(1.8)	(1.6)	(0.8)	0.1	1.7	2.1
Adjustments		0.5	(0.5)	(0.9)	0.5	0.0	0.0
NPAT (reported)		(1.3)	(2.0)	(1.7)	0.6	1.7	2.1
EPS (normalised)		(0.010)	(0.015)	(0.013)	0.005	0.013	0.015
EPS (reported)		(0.010)	(0.010)	0.005	0.005	0.013	0.015
Dividend (cps)		0.000	0.000	0.000	0.000	0.000	0.000
Operating cash flow		na	na	na	na	na	na
Divisionals		**H123**	**H223**	**H124**	**H224**	**H125F**	**H225F**
Revenue		**10.1**	**12.3**	**13.3**	**14.6**	**16.8**	**18.6**
Avionics		4.6	4.8	4.5	6.6	9.1	9.2
Contract Manufacturing		5.3	7.3	8.7	8.0	7.6	6.8
CVM		0.2	0.2	0.1	0.0	0.2	2.6
Operating Costs							
COGS		5.3	5.6	7.4	5.9	7.1	7.1
Employee (ex SBP)		3.7	4.6	3.5	5.2	3.6	5.0
Sales & Marketing		0.4	0.7	1.0	0.1	1.1	0.1
R&D		0.1	0.5	0.1	0.8	0.2	0.8
General & Admin		0.9	1.0	0.7	1.0	0.8	1.1
Total costs		**10.3**	**12.3**	**12.6**	**12.9**	**12.8**	**14.1**
EBITDA		**(0.2)**	**(0.1)**	**0.7**	**1.7**	**4.0**	**4.6**
EBITDA margin		(2.3%)	(0.5%)	5.1%	11.7%	24.0%	24.4%
D&A		-1.2	-1.1	-1.1	-1.2	-1.2	-1.1
EBIT		**-1.5**	**-1.2**	**-0.5**	**0.6**	**2.9**	**3.4**
Margins, Leverage, Returns			**FY22A**	**FY23A**	**FY24A**	**FY25F**	**FY26F**
EBITDA margin %			-15.8%	-1.3%	8.5%	24.2%	27.3%
EBIT margin %			-26.3%	-11.8%	0.4%	17.8%	21.3%
NPAT margin (pre significant items)			-23.2%	-15.0%	-3.7%	10.7%	13.6%
Net Debt (Cash)			3.7	4.5	5.1	2.6	-1.4
Net debt/EBITDA (x)	(x)		-1.5 x	-15.3 x	2.1 x	0.3 x	-0.1 x
ND/ND+Equity (%)	(%)		(29.6%)	(42.7%)	(53.1%)	(16.7%)	5.5%
EBIT interest cover (x)	(x)		n/a	n/a	7.3x	0.1x	0.1x
ROA			nm	nm	0.3%	17.6%	20.6%
ROE			nm	nm	(1.8%)	5.7%	6.3%
ROIC			nm	nm	nm	nm	nm
NTA (per share)			0.06	0.06	0.06	0.10	0.14
Working capital			10.7	11.6	12.8	13.4	13.9
WC/Sales (%)			**67.9%**	**51.6%**	**45.7%**	**37.9%**	**35.5%**
Revenue growth			2.4%	42.5%	24.7%	27.0%	10.6%
EBIT growth pa			n/a	n/a	(103.9%)	6075.8%	32.9%
Pricing			**FY22A**	**FY23A**	**FY24A**	**FY25F**	**FY26F**
No of shares (y/e)	(m)		123.7	132.8	136.8	137.4	137.4
Weighted Av Dil Shares	(m)		123.7	132.8	136.8	137.4	137.4
EPS Reported	cps		(0.029)	(0.025)	(0.008)	0.027	0.039
EPS Adjusted	**cps**		**(0.025)**	**(0.019)**	**0.000**	**0.033**	**0.044**
EPS growth (norm/dil)			n/a	n/a	-101%	21321%	34%
DPS	cps		0.000	0.000	0.000	0.000	0.000
DPS Growth			n/a	n/a	n/a	n/a	n/a
Dividend yield			0.0%	0.0%	0.0%	0.0%	0.0%
Dividend imputation			0	0	0	0	0
PE (x)			-22.9	-29.2	3713.1	17.3	12.9
PE market			18.0	18.0	18.0	18.0	18.0
Premium/(discount)			nm	nm	nm	(3.7%)	(28.3%)
EV/EBITDA			(29.8)	(275.5)	34.8	9.4	7.2
FCF/Share	cps		-4.10	-2.57	-0.66	1.78	2.92
Price/FCF share			-13.90	-22.19	-85.78	32.11	19.51
Free Cash flow Yield			(8.0%)	(2.9%)	(1.2%)	3.1%	5.1%

Source: Company data for actuals, RaaS estimates (FY25f-FY26f)

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Contact Details, BR and RaaS

BR Head Office: Level 1, 160 Edward Street, Brisbane, QLD, 4000 www.brsecuritiesaustralia.com.au

RaaS:. c/- Rhodes Docherty & Co Pty Ltd, Suite 1, Level 1, 828 Pacific Highway, Gordon, NSW, 2072.

P: +61 414 354712

E: finola.burke@raasgroup.com

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