

Narf Industries plc (NARF)

BUY

MARKET DATA

Bloomberg	Ticker	NARF
Share price	p/shr	0.75
Target	p/shr	2.12
TP upside	%	183%
Shares out	Million	1,697
Mkt cap	£m	12.7

ESTABLISHED US CYBERSECURITY SPECIALIST

Narf Industries is an established provider of high-end cybersecurity research, leading threat intelligence projects on behalf of a number of US Government agencies. Utilising a renowned team of government-vetted experts, the company works for customers such as Department of Defense, Defense Advanced Research Projects Agency (DARPA) and Department of Homeland Security. Narf secures involvement in projects at an early stage due to its track record of expertise and its extensive network of relationships within the US defence intelligence community. When successful projects result in a patented product with a substantial addressable market, Narf has the rights to commercially exploit the opportunity alongside development partners.

DESCRIPTION

Narf Industries is a UK-listed cybersecurity group specialising in high-end threat intelligence. Through its US-based operations, the group leads projects on behalf of several US government agencies and is commercialising a DARPA-backed solution designed to protect against cyberattacks on key infrastructure.

Record contract backlog paves way for positive EBITDA. Narf has started the current financial year with a record contract backlog of \$10.4 million, over 4 times its published 2022 revenues of \$2.6 million. These are revenues already contracted and due to be recognised over the next three years. On the basis of contracted backlog alone, and hence on the most conservative basis, the company is providing 2023 revenue guidance of \$5.9 million, over 130% higher than the previous year. Alongside a 40% expected cut in operating expenses, this allows us to forecast a positive EBITDA in 2023.

New Chairman at helm to steer leadership team. John Herring, co-founder of Corstone Capital and former CEO of an In-Q-Tel portfolio company (In-Q-Tel is the investment arm of the CIA) was appointed Executive Chair in April to oversee the wider strengthening of the leadership team as the company transitions from a private subsidiary of an investment company to a publicly quoted operating business. Together with Steve Bassi (CEO) and an interim CFO, the leadership secured the completion of the final 2022 audit in July after overcoming the difficulties of providing the auditors with access to politically sensitive contract information. The company agreed on the most conservative revenue recognition policy possible, and going forward, we expect this policy to become more aggressive.

Management targeting revenues of over \$20 million by 2027. We expect the company to generate substantial revenue growth in the next five years, supported by strong growth in Government work (driven by its privileged market position and some astute hiring of key researchers), together with incremental licensing income from a range of commercialisation opportunities arising from its R&D projects such as TIGR (critical infrastructure). With the shares trading on a 2024E EV/Sales multiple of just 2.1x, current levels present an attractive entry point for a business that offers investors a combination of a defensible & profitable core of Government work with the commercial upside from its R&D-based Intellectual Property. We maintain our **BUY** recommendation.

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Key Financials Forecast 2021A-25E

Y/E Dec (US\$M)	FY21A	FY22A	FY23E	FY24E	FY25E
Revenues	1.94	2.55	5.87	8.37	11.69
EBITDA	(0.60)	(2.36)	0.44	0.87	2.43
Headline Earnings	(0.84)	(3.07)	(0.31)	0.12	1.67
Earnings per share (p)	(0.10)	(0.17)	(0.01)	0.01	0.08
EV / Sales (x)	8.9	6.8	3.0	2.1	1.5
EV / EBITDA (x)	n/m	n/m	32.0	16.1	5.8

Source: Tennyson estimates

BUSINESS OVERVIEW

Narf Industries is an established provider of cybersecurity research solutions and services to US & other government entities, applying its expertise in addressing the evolving cyber threat framework faced by its clients. The company works with US government agencies such as Department of Defense, Defense Advanced Research Projects Agency (DARPA) and Department of Homeland Security (DHS), and often collaborates with other world-renowned private research companies in its work.

The group's core strategy is to leverage the regular government-funded R&D projects on which it works to develop company-owned IP which leads to the creation of innovative and disruptive products for multi-billion dollar commercial cybersecurity markets. This in turn is supported by the group's long-standing relationship with a major US Government agency from whom Narf continues to generate regular income for its cybersecurity work.

Narf's revenues can be broken down into three segments:

Government Solutions and Services

In its GS&S division, Narf develops cybersecurity solutions and provides related services to various US government agencies. Its software solutions typically address immediate cybersecurity mission needs, which continually evolve as the nature of cybersecurity threats change. The services component of the revenue provides on-going support for the operations of the delivered software solution.

In our forecasts, we expect \$2.26 million of revenues in this division in 2023, based entirely on already contracted work. Narf enjoys a unique competitive position with GS&S work through a recently renewed 5-year omnibus contract with a major Government agency (undisclosed). This streamlines government procurement cycles and gives multiple individual Government agencies access to the Group's solutions and services. Agencies execute these task orders, typically on a so-called "sole source" basis, meaning that Narf is pre-selected as the partner of choice and is not subject to competitive tendering. The timing from idea of task to award is 3 to 6 months, whilst the task itself typically takes 6 to 12 months to complete, at which time software is delivered and integrated into an operational system.

Management believes GS&S offers very high growth potential and its strategy is to scale and expand this segment. Narf's key researchers, including its Chief Executive Officer, Steve Bassi, are very experienced and connected within the relevant Government agencies and have been critical to the consistency and growth of this segment for Narf in recent years. Going forward, we expect the company to expand its team by recruiting similar highly experienced & sought-after cybersecurity specialists that can help the company win increased business in this segment.

Government Research and Development

In its GR&D division, we are forecasting \$3.61 million of revenues in 2023. Narf has a successful history of tendering for, and winning, government R&D contracts for groundbreaking technologies, predominantly from DARPA. The company's research work is focused on three key cybersecurity segments: critical infrastructure protection, open-source software (OSS) vulnerabilities; and threat intelligence. For each R&D contract, the government agency retains government purpose rights but Narf has the sole right to sell new solutions using the IP to the government as well as owning the IP rights for commercial exploitation in private markets.

The R&D contracting process can take longer than in GS&S, and may range from 9 to 15 months before being awarded a project that can then last up to 18 months or longer.

Management is targeting growth in this segment through developing new fields of research that complement its current rich IP portfolio (see the commercialization segment below).

The scale of Narf's work with DARPA and the closeness of the relationship should give investors confidence that Narf remains in an excellent position to win future R&D contracts, as DARPA further expands its government-funded work in high-end cybersecurity research. In 2022, Narf signed its largest R&D contract to date, winning a \$6.3M contract with DARPA. Work under the contract began immediately and falls under DARPA's HARDEN program (Hardening Development Toolchains Against Emergent Execution Engines), for which Narf has been commissioned to "develop practical tools to improve security outcomes in software for complex, integrated computing systems". The contract is evidence of Narf's deepening relationship with DARPA, for whom it has now begun work on three separate programmes in the last 18 months.

As with all of its R&D projects, Narf will own and have sole responsibility for commercialising the IP rights arising from HARDEN, whilst DARPA and the US Government will retain "right of use" access on normal commercial terms. Narf is one of several partners selected – others include Kudu Dynamics, River Loop Security and University of California, Santa Barbara – but the size of Narf's contract suggests it is one of the most important contributors to the program. According to DARPA's own announcement, the program will run for 48 months and is organised into three phases: Phases 1 and 2 will each be 18 months, followed by a 12-month Phase 3.

Commercialisation & Licensing

In this division, by collaborating closely with government agencies and tapping into their R&D resources, Narf gains access to cutting-edge technologies, methodologies, and insights. Through strategic partnerships, knowledge transfer and technology transfer programs, Narf aims to unlock the potential of these innovations for commercial markets.

Narf has said that two of its DARPA projects are "moving closer to commercialization" (**SAFEDOCS & RANGER**), but its most advanced commercialisation effort has been in the field of critical infrastructure protection, specifically vulnerabilities in Industrial Control Systems / Operational Technology (ICS/OT) systems. This effort leverages years of the group's work with DARPA's **RADICS** program ("Rapid Attack Detection and Incident Capability") and, more specifically, the critical subprogram, **TIGR** ("Threat Intelligent Grid Recovery").

TIGR is a hardware and software-based cybersecurity solution that allows utilities and cyber first responders to rapidly find & neutralise security compromises and restore power following a cyber-attack. TIGR was developed alongside DARPA and Stanford Research Institute (SRI), having originated in DARPA's RADICS program, on which DARPA spent US\$139 million over 4 years on projects to develop cybersecurity solutions for key utility infrastructure. For the commercialisation phase, Narf has secured an exclusive IP licence and is partnering with **SRI International**, which has a 4% stake in Narf as part of a licensing agreement that saw Narf obtain complementary IP from SRI that creates in combination a software & hardware solution for the Oil & Gas & Electric Utility sectors.

Until Narf's government business grows sufficiently to organically finance commercialisation initiatives, management strategy for now is to rely on paid development from prospects or investments by strategic partners. Ultimately, the expectation is that significant material licensing revenue opportunities will be created through the development of commercial products in the three key areas: Critical Infrastructure, Supply Chain Software & Threat Intelligence.

CURRENT OUTLOOK & LONG-TERM FORECASTS

As at the 2022 year-end, Narf had a record contracted backlog of \$10.4 million, representing contracts in progress but not yet fully recognised as revenues. The backlog is over 4 times the size of the company's 2022 revenue and provides a sustainable revenue stream for the group, with a high degree of visibility of future income. In our 2023 forecasts, all of our \$5.9 million forecast comes from the existing contracted backlog, so any new contracts recognised as revenues this year will allow us to upgrade our forecast numbers.

In addition, we expect a 40% decrease in G&A expenses this year, as the new leadership team bring to bear a much more effective cost discipline appropriate for a publicly quoted operating company.

This combination of growing revenues and operational efficiencies allow us to forecast a positive EBITDA of \$440K for the current year, compared to a \$2.4 million EBITDA loss in 2022. Our forecasts are achievable without the need for any further financing for the group in the forecast period.

Our 2023 forecasts in particular are based on two very conservative assumptions. Firstly, they are fully covered by the high degree of visibility provided by the record contracted order backlog. Secondly, we assume that the company continues to report its income on the most conservative recognition basis, in line with the 2022 audit. As discussed, the company is seeking to address this issue in the current quarter in a way that enables auditors to use a more generous method for recognition, whilst continuing to leave the name of one of its key contract partners and the nature of its work undisclosed.

In terms of our longer term forecasts, we are forecasting that Narf continues to deliver strong double-digit growth in income from its Government work. Over the next five years, we expect revenues from GS&S to grow from \$2.26 million to \$8.06 million and revenues from GR&D to grow from \$3.61 million to \$9.91 million, which represent compound annual growth rates of 37.4% and 28.7% respectively.

This growth is driven by a number of positive tailwinds such as ever more sophisticated cybersecurity threats, increasing breadth & scope of projects, and an increasing number of government agencies looking to tap Narf's expertise. They are also supported by our assumption that the company increases the size of its team of researchers, with overall headcount rising from 20 to 44 over the period, implying an increase in Government revenue per head from \$293K to \$408K.

We also project licensing income from commercialisation beginning in earnest in 2024 and rising to \$3 million per annum by the end of the period as the company finds new strategic partners to commercialise the range of IP that Narf has developed through its long track record of carrying out highly sophisticated and innovative Government-funded R&D. This is by nature a cautious preliminary forecast given the range of potential products and the large size of their addressable markets. As each opportunity comes closer into focus, we would expect to be able to provide more detailed and aggressive numbers well beyond the current forecasts.

Given the economies of scale in its Government business and the licensing income falling directly to the bottom line, we are able to forecast Narf growing its EBITDA over the period from \$440K in 2023E to \$7.9 million in 2027E. The company is best understood, in our opinion, as a business that offers a highly defensible and profitable core of sophisticated Government cybersecurity work (with a very high level of repeat business and a privileged market position), whilst also providing substantial potential commercial upside from the R&D-based Intellectual Property that has been developed through the same Government-funded R&D projects.

Below we show our financial forecasts in more detail:

FINANCIAL FORECASTS

INCOME STATEMENT							
YE DEC (\$M)	2021A	2022A	2023E	2024E	2025E	2026E	2027E
Government Services & Solutions	-	-	2.26	3.28	4.59	6.20	8.06
Government R&D	-	-	3.61	4.69	6.10	7.93	9.91
Commercial Licensing Revenues	-	-	0.00	0.40	1.00	2.00	3.00
Total Revenues	1.94	2.55	5.87	8.37	11.69	16.13	20.97
% growth		31%	131%	43%	40%	38%	30%
Personnel Expenses	(1.39)	(2.74)	(4.29)	(6.07)	(7.47)	(8.87)	(10.28)
Headcount	11	17	20	26	32	38	44
Other G&A Expenses	(1.15)	(2.17)	(1.14)	(1.43)	(1.79)	(2.23)	(2.79)
EBITDA	(0.60)	(2.36)	0.44	0.87	2.43	5.02	7.90
% margin			7%	10%	21%	31%	38%
Depreciation & Amortisation	(0.32)	(0.56)	(0.54)	(0.54)	(0.55)	(0.58)	(0.61)
Share-based payments		(0.15)	(0.15)	(0.15)	(0.15)	(0.15)	(0.15)
Finance income/expense	0.15	0.00	(0.06)	(0.06)	(0.06)	(0.06)	(0.06)
Pre-Tax Loss	(0.77)	(3.06)	(0.31)	0.12	1.67	4.24	7.09
Taxation	(0.07)	(0.01)					
Headline Earnings	(0.84)	(3.07)	(0.31)	0.12	1.67	4.24	7.09
Exceptional items		(15.36)					
Reported Income	(0.84)	(18.43)	(0.31)	0.12	1.67	4.24	7.09

BALANCE SHEET							
YE DEC (\$M)	2021A	2022A	2023E	2024E	2025E	2026E	2027E
Intangible Assets	1.30	2.70	2.71	2.77	2.88	3.04	3.24
Tangible Fixed Assets	0.05	0.02	0.02	0.02	0.02	0.02	0.02
Receivables	0.05	0.76	0.98	1.28	1.66	2.16	2.81
Payables	(0.19)	(0.60)	(0.77)	(1.01)	(1.31)	(1.70)	(2.21)
Net Working Capital	(0.15)	0.16	0.21	0.27	0.35	0.46	0.60
Cash & Equivalents	0.45	0.44	0.22	0.36	1.99	6.11	13.01
Loans	(0.83)	(1.51)	(1.51)	(1.51)	(1.51)	(1.51)	(1.51)
Net Cash / (Debt)	(0.39)	(1.07)	(1.29)	(1.15)	0.47	4.59	11.49
Other	0.00	0.00	(0.15)	(0.30)	(0.44)	(0.59)	(0.74)
Shareholders Equity	0.82	1.80	1.49	1.61	3.28	7.52	14.60

CASH FLOW STATEMENT							
YE DEC (\$M)	2021A	2022A	2023E	2024E	2025E	2026E	2027E
EBITDA	(0.60)	(2.36)	0.44	0.87	2.43	5.02	7.90
Change in working capital	(0.08)	(0.31)	(0.05)	(0.06)	(0.08)	(0.11)	(0.14)
Taxes paid	(0.07)	(0.01)	0.00	0.00	0.00	0.00	0.00
Interest paid	(0.77)	0.18	(0.06)	(0.06)	(0.06)	(0.06)	(0.06)
Other	(0.58)	(0.16)	0.00	0.00	0.00	0.00	0.00
Operating Cash Flow	(1.26)	(2.82)	0.33	0.75	2.29	4.85	7.70
Capital Expenditure	0.00	(0.50)	(0.55)	(0.61)	(0.67)	(0.73)	(0.81)
Free Cash Flow	(1.26)	(3.32)	(0.22)	0.14	1.62	4.12	6.90
Acquisitions	0.00	(3.62)	0.00	0.00	0.00	0.00	0.00
Share issues (net)	0.00	6.51	0.00	0.00	0.00	0.00	0.00
Other	0.77	(0.25)	0.00	0.00	0.00	0.00	0.00
Net Cash Flow	(0.50)	(0.69)	(0.22)	0.14	1.62	4.12	6.90

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VALUATION

Looking at the peer group of global (mainly US) cybersecurity names, we can see that Narf Industries compares favourably in terms of expected top-line growth over the forecast period. Looking specifically at 2023E multiples, the peer group trades at 5.9 times revenues, and the lower-growth UK benchmark, Darktrace, trades at 5.2 times.

In our view, Narf shares deserve a premium to the wider peer group for three principal reasons: 1) very strong projected growth based on its sizeable and growing order backlog; 2) privileged market position providing services and solutions to the US government, whose budget for high-end cybersecurity work is both substantial and likely to grow significantly over the longer term; 3) the value of Narf's Intellectual Property and the commercial opportunities it creates which offer substantial upside to our conservative forecasts

Applying a 10% premium to the average FY24E sector sales multiple (5.1x) and applying a 5.6x multiple to our 2024E revenue forecast of \$8.37 million would give an enterprise value for Narf Industries of £36.1 million, and allows us to set a 12-month target price of 2.12p per share, offering investors upside of 183% at current levels. **We maintain our BUY recommendation on the stock.**

CYBERSECURITY SECTOR CURRENT TRADING STATS				EV / SALES			EV / EBITDA			SALES GROWTH
Stock	Ticker	Price	Mkt Cap (US\$ M)	2022A	2023E	2024E	2022A	2023E	2024E	2022-26E
PALO ALTO NETWORKS	PANW	2.34	71,546	11.3	9.3	7.8	254.2	48.2	25.9	19%
FORTINET	FTNT	0.61	47,615	10.3	8.4	7.1	40.8	29.8	25.2	20%
CROWDSTRIKE	CRWD	147	32,880	14.2	10.4	8.1	n/m	72.7	36.8	29%
VERISIGN	VRSN	207	21,385	15.6	14.9	13.7	22.5	20.3	18.7	6%
ZSCALER	ZS	1.44	21,065	15.6	11.4	9.0	n/m	118.6	45.3	29%
SPLUNK	SPLK	118	19,859	6.1	5.4	4.9	n/m	51.1	20.2	14%
CHECKPOINT SOFTWARE	CHKP	1.35	15,760	5.3	5.1	4.9	13.2	11.5	11.1	4%
F5	FFIV	161	9,560	3.4	3.3	3.2	16.9	11.5	8.7	4%
JUNIPER NETWORKS	JNPR	28.5	9,162	1.8	1.7	1.7	12.3	8.4	8.1	2%
CYBERARK SOFTWARE	CYBR	160	6,679	10.2	8.2	6.6	n/m	260.3	74.4	n/a
QUALYS	QLYS	153.1	5,621	10.8	9.6	8.5	29.5	21.9	20.4	12%
TENABLE HOLDINGS	TENB	44.0	5,093	7.1	6.2	5.4	n/m	42.7	34.0	17%
VARONIS SYSTEMS	VRNS	0.32	3,470	6.4	6.1	5.5	n/m	97.8	72.9	10%
DARKTRACE	DARK	353	3,130	6.5	5.2	4.2	45.5	25.0	18.6	21%
RAPID7	RPD	47.9	2,921	5.2	4.6	4.1	n/m	29.7	20.9	13%
VERINT SYSTEMS	VRNT	32.8	2,108	2.6	2.5	2.3	19.7	10.4	8.1	n/a
A10 NETWORKS	ATEN	15.2	1,124	3.5	3.5	3.2	15.3	17.5	13.2	n/a
RADWARE	RDWR	17.0	743	1.2	1.4	1.3	23.8	20.2	11.6	n/a
MITEX SYSTEMS	MITK	0.11	509	3.7	3.3	3.1	18.7	11.5	9.0	10%
NCC GROUP	NCC	101	398	1.2	1.2	1.2	7.5	11.0	8.6	2%
BLANCCO TECHNOLOGY	BLTC	225	216	3.9	3.4	3.1	15.3	11.8	10.8	10%
NARF INDUSTRIES	NARF	0.78	17	6.8	3.0	2.1	n/m	32.0	16.1	59%
AVERAGE				7.0	5.9	5.1	38.7	44.6	24.0	13%

DISCLAIMER**RECOMMENDATIONS HISTORY****Market index : FTSE All-Share**

Date	Market Index level	Share Price (p)	Target Price (p)	Opinion
22/03/2022	4167.60	2.00	4.50	BUY
04/09/2023	4069.21	0.75	2.12	BUY

RATINGS, CERTIFICATION AND DISCLOSURE**RATINGS SYSTEM**

BUY: The stock is expected to generate absolute positive price performance of over 10% during the next 12 months.

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SELL: The stock is expected to generate absolute negative price performance of over 10% during the next 12 months.

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