

Erling Sorensen <erling@alignedcap.com>

Tuesday, 14 Sept 2021, 18.36

to [REDACTED]

Hi [Matt, Greg] and members of the Board

I never received a response to the email below where I laid out and stressed the importance of astute capital allocation when it comes to creating value for shareholders. Instead, I note with interest the recent announcement of the acquisition of Secure Data Centre.

It will come as no surprise to you that a core test of success for a business is whether one dollar invested in a company generates value of more than one dollar in the marketplace. Warren Buffett calls this the \$1 test.

Logically, a business passes the \$1 test only when it earns a return on investment in excess of the opportunity cost of capital.

Say a company invests \$1,000 in a new factory and estimates that the cost of capital is 10 percent. Were the factory to generate \$80 in after-tax earnings into perpetuity, the market value of the factory would be \$800 ($\$80/.10$) and the investment would fail the \$1 test.

Earnings of \$120, on the other hand, would create value of \$1,200 ($\$120/.10$), hence passing the \$1 test.

A company that generates a Return On Invested Capital (ROIC) in excess of the cost of capital generally indicates that management has been able to deploy resources intelligently. Subpar ROIC, on the other hand, can suggest poor capital allocation. The textbook definition for how ROIC is calculated is: NOPAT divided by Invested Capital = ROIC.

I note we are paying \$4.9 million for Secure Data Centre, which generated FY21 revenues of \$1.7m and EBITDA of \$0.7m. From the announcement I assume we are funding the acquisition with \$2.5m of debt from PURE and \$2.4m equity.

If I assume the revenue and earnings are able to be continued in the future, a low figure of \$50K depreciation p.a. and a 30% tax rate then that gets me to ~10% ROIC for Secure Data Centre.

I would be interested to understand how you believe the acquisition of Secure Data Centre passes the \$1 test, please? Using the above assumptions, a 14% cost of equity gets me to a value-neutral scenario, where the dollar invested adds no value, but also doesn't add value. Only now the company is carrying more leverage.

I think a more realistic cost of equity is closer to 20%. If that is true, then our cost of capital for this acquisition is ~13% and the acquisition is destroying value.

I would be grateful for your response and comments to the above.

Thank you very much in advance.

Kind regards,
Erling Sorensen
Mobile +61 457 730 175



On Fri, 18 Dec 2020 at 16:02, Erling Sorensen <erling@alignedcap.com> wrote:

Dear **Matt, Greg** and members of the Board

I am writing to you as a shareholder. We have owned shares in **DXN** since May 2019 and participated in the recent capital raise as well.

First, I would like to thank **Matt** and **Greg** for the ongoing positive dialogue and for taking time to discuss the suggestions I laid out during our meeting Thursday 3rd December. I understand that your time is valuable, and I look forward to continuing our discussions about how best to maximise shareholder value at **DXN**. I hope you have given considerable thought to what I believe we agreed is likely the most significant drag on **DXN**'s ability to excel and deliver value to its shareholders; the Sydney and Melbourne colocation facilities.

I recognise that we, in **[REDACTED]**, are ownership participants. We are a minority owner. Our style is to engage with the Board and management of companies in which we have an ownership participation, in an effort to ensure that their decisions are in the long-term interests of the company and in particular in relation to capital allocation and management remuneration, both of which I regard as vital.

Below I share some further detailed thoughts on matters I believe are of significant importance to **DXN**, views I know are shared by other shareholders too. The recommended course, as set out below, will enable **DXN** to trade cash flow positive, management to focus its attention and resources only on the segments of the business which are generating value and high returns on capital, **DXN** to be self-funding and the business to become significantly less capital intensive.

You would no doubt be familiar with the concepts of Anchoring Bias and Confirmation Bias, and the risks associated with not being aware of these and how they may be impacting on decision making. As I have previously mentioned to Matt, I believe a very apt analogy for these biases and for where **DXN** is finding itself at the moment, when it comes to the Sydney and Melbourne colocation facilities, can be found in the following quote by Warren Buffett ***"Should you find yourself in a chronically leaking boat, energy devoted to changing vessels is likely to be more productive than energy devoted to patching leaks"***.

What is known:

- ~\$11.8m has been invested in the Sydney colocation facility (this my estimation of is the depreciated value of the investment as at end June 2020). This represents ~79% of the net asset value of DXN as at end June 2020
- The ongoing cost associated with running the Sydney colocation facility is ~\$1.2m p.a. and ~\$1m p.a. for the Melbourne facility.
- Approx 90 racks are required to be leased out at ~ the list price to get the Sydney colocation facility to a cash break-even level. Obviously a significantly higher number of racks are to be leased out for a reasonable return, on the depreciated investment plus the annually incurred losses, to be achieved.

I, and I believe along with many other investors, use ROIC (Return On Invested Capital) as a measure of how well a company's Board and management is able to allocate capital profitably into its operations. It provides clear insight as to whether the Board and management indeed act as owners of a business, by having high regard for ensuring capital is allocated judiciously such that the return earned on that capital is greater than the cost of that capital. Therefore this measure is, in my opinion, one of the most important measures to investors.

My definition: $ROIC = NOPAT / Invested\ Capital$.

$NOPAT = Operating\ Profit\ (or\ EBIT) \times (1 - Tax\ rate)$. For simplification, and for the purposes of this email/discussion, the tax rate can be ignored.

$Invested\ Capital = (Plant\ \&\ Equipment + Intangibles\ \&\ Goodwill + Bank\ Guarantees + Non-current\ Borrowings) + ((Current\ Assets - Current\ Liabilities) - Cash)$

Using the above definition, and for further simplification - ignoring assets & liabilities associated with leases under AASB 16, the ROIC for **DXN** as at end June 2020 was (all in A\$ millions)

- $Invested\ Capital = (\$13.1 + \$1.7 + \$3.1 + \$2.5) + ((\$5.7 - \$3.6) - \$3.6) = \18.8
- $EBIT = -\$12.2$
- $ROIC = -65\%$

A clear demonstration of the devastating impact such poor capital allocation skills have, in respect of erosion of value to the owners of the business, is illustrated by a simple assessment of the value of the equity in the business relative to the cash injected into the business in the form of equity. What we find is

- as at end June 2018: Issued Capital was \$20.1m & Net Equity was \$14.7m. Net Equity as a percentage of Issued Capital was 73%
- as at end June 2019: Issued Capital was \$29.7m & Net Equity was \$16.9m. Net Equity as a percentage of Issued Capital was 57%
- as at end June 2020: Issued Capital was \$39.6m & Net Equity was \$14.9m. Net Equity as a percentage of Issued Capital was 38%

In other words, over the last two years \$19.5m of cash, accepted by **DXN** from investors in the form of equity, has been destroyed. The adage that time is the friend of a wonderful business, and the enemy of a mediocre indeed is proven true by **DXN**.

Clearly capital has been allocated incredibly poorly, at the expense of the owners of **DXN** - the shareholders. If **DXN** was a private business, owned by the Board and the management, one would assume such destruction of value would not be tolerated or afforded, and hence measures to address the issue(s) causing such value destruction would be addressed with vigour. The obligation on the Board and the management is now to be accountable and accept their fiduciary obligations to shareholders by accepting reality (keep in mind, you can't wipe out reality - but reality can wipe you out!) and addressing the issue(s) at hand vigorously. As is so frequently quoted "*Doing the same thing over and over again, expecting a different outcome, is the definition of insanity*" - with this in mind, a continuation of what has been attempted in the last few years appears unlikely to deliver results the owners of **DXN** will be satisfied with.

Other commonly used and useful measures to help understanding the issues at hand would include

- Revenue / Total Assets (a basic measure of return on investment and capital efficiency); and
- Gross Profit / Total Assets (a basic measure of profitability)

Calculating these measures for **DXN** as at end June 2020, we find (all in A\$ millions):

- Revenue / Total Assets = $\$5.2 / \$31.8 = 16\%$
- Gross Profit / Total Assets = $\$1.4 / \$31.8 = 4\%$

Without having access to the required detailed information enabling an assessment of segment ROIC, I instead rely on the above two measures to provide a guide to the likely key driver of the value destruction outlined above. As an aside, I do not believe the segmentation chosen by **DXN**; Data Centre Operations & Modular Division, allows for sufficient insight to where capital is allocated and the profitability of the specific activities undertaken. Instead, I believe a more meaningful and transparent segmentation for **DXN** would be

- Modular
- Colocation
- Edge Data Centres

An assessment of each of the above suggested segments as at end June 2020, paints the following picture for us (all in A\$ millions):

- Modular
 - Revenue / Total Assets = $(\$5.2 - \$0.1 \text{ (est Hobart contribution)} - \$0.1 \text{ (est Sydney Colocation contribution)}) / (\text{current assets} - (0.5 \times \text{cash}) + \$0.1 \text{ (bank guarantee)} + \$0.3 \text{ (plant \& equipment)} + \$0.4 \text{ (lease right of use assets)}) = \$5.0 / (\$3.9 + \$0.1 + \$0.3 + \$0.4) = \mathbf{106\%}$
 - Gross Profit / Total Assets = $(\$1.4 - \$0.05 \text{ (est Hobart GP contribution)} - \$0.08 \text{ (est Sydney Colocation GP contribution)}) / \$4.7 = \$1.3 / \$4.7 = \mathbf{28\%}$
- Colocation

- Revenue / Total Assets = \$0.1 (est Sydney Colocation contribution) / (\$1.8 (50% of cash) + \$3.0 (bank guarantee) + \$11.8 (plant & equipment) + \$7.8 (lease right of use assets)) = \$0.1 / \$24.4 = **0.5%**
- Gross Profit / Total Assets = \$0.08 / \$24.4 = **0.3%**
- Edge Data Centres (Hobart ~1.5 months contribution)
 - Revenue / Total Assets = \$0.1 / \$2.7 = **4%** - or **32%** when annualised for full year contribution
 - Gross Profit / Total Assets = \$0.05 / \$2.7 = **2%** - or **16%** when annualised for full year contribution

Next, by making the following assumptions for FY21:

- Modular: revenue \$15m, 30% GP (which includes the cost of all staff involved in the manufacturing, assembling and dispatch of modules), WC 50% of revenue
- Colocation: revenue \$0.5m, 80% GP, no WC
- Edge Data Centres: revenue \$0.9m, 50% GP, no WC
- Cash held end June 2020 is consumed during the year

we arrive at the following estimations for the three suggested segments for FY21 (all in A\$ millions)

- Modular
 - Revenue / Total Assets = \$15 / \$7.5 + \$0.1 (bank guarantee) + \$0.3 (plant & equipment) + \$0.4 (lease right of use assets) = \$15 / \$8.2 = **183%**
 - Gross Profit / Total Assets = \$4.5 / \$8.2 = **55%**
- Colocation
 - Revenue / Total Assets = \$0.5 / \$3.0 (bank guarantee) + \$11.8 (plant & equipment) + \$7.8 (lease right of use assets) = \$0.5 / \$22.6 = **2%**
 - Gross Profit / Total Assets = \$0.4 / \$22.6 = **2%**
- Edge Data Centres
 - Revenue / Total Assets = \$0.9 / \$2.7 = **33%**
 - Gross Profit / Total Assets = \$0.5 / \$2.7 = **17%**

From the above analysis **it is clear the capital allocated to the Sydney Colocation facility along with the ongoing annual cost of ~\$2.2m to service the Sydney and Melbourne Colocation facilities are what is placing an unacceptable drag on DXN, and, not surprisingly, destructing enormous value for the owners of DXN.**

The above analysis also provides a framework to clearly understand what is required to be achieved before it is possible for DXN to earn a ROIC that sustainably exceeds its cost of capital associated with the Sydney and Melbourne colocation facilities, including the ongoing annual cash drain associated with each of these. **IF DXN is ever to be able to earn a ROIC that sustainably exceeds its cost of capital on the Sydney and Melbourne colocation facilities, then the sales of rack space would have to grow at exponential pace as well as scale.** Based on track-record demonstrated to-date, the required exponential growth and pace of rack space sales appears to be a highly unlikely proposition.

As custodians of DXXN's shareholders capital, I believe it is incumbent on the Board and management to address this issue now and I implore you to do so. Below I wish to outline a recommended solution for DXXN to be implemented immediately.

Dispose of both the Sydney and Melbourne Colocation facilities for a (worst-case) price of nil dollars, i.e. DXXN hands the keys to both facilities, along with all the assets installed in Sydney, to someone else in exchange for (worst-case) nothing, other than them taking over all obligations and liabilities associated with both facilities from that moment.

The remaining business would in my opinion be vastly superior. This is my recommendation. I urge the Board and management to consider this and to act on this with the vigour they logically would, was DXXN their own company and their own capital invested in it.

On execution of the recommendation, using the above FY21 assumptions, as well as an assumption that SG&A would be \$3m and Board costs \$0.2m, the company would generate the following metrics

- Revenue / Total Assets = \$15.9m / \$10.9m = **146%**
- Gross Profit / Total Assets = \$5m / \$10.9m = **46%**
- ROIC = EBIT (i.e. ignoring Tax) / Invested Capital (will use Total Assets as an approximation for Invested Capital). ROIC = \$5m (Gross Profit) - \$3m (SG&A) - \$0.2m (Board costs) - \$0.3m (est Depreciation & Amortisation) / \$10.9m = **14%**

Importantly, DXXN management would not be distracted by the current cash drain and continuous funding challenges. The erosion of shareholders capital would be addressed. The company would be profitable (excluding the write-off of the sunk capital into the Sydney and Melbourne Colocation facilities).

Management would be able to direct its undivided attention to growing the modular segment which presents a global opportunity set, and to cautiously expand the Edge Data Centre segment when undisputed value accretive expansion opportunities present. It will be far more transparent to determine what an appropriate price for DXXN to pay for an Edge Data Centre is, when there is no risk of there being a sense of a need to grow revenue to survive and disguise the ongoing costs and poor returns associated with the Sydney and Melbourne Colocation facilities.

Meanwhile, the attraction to growing modular sales should be self-evident. DXXN has latent capacity at its Perth facility as well as in its SG&A. Therefore, for every \$1m additional modular sales, over and above the above assumed \$15m

- Revenue / Total Assets increases by ~2%
- Gross Profit / Total Assets increases by ~0.8%
- ROIC increases by ~1.8%

Let's turn to how the market might value DXXN after having exited the Sydney and Melbourne Colocation for no consideration. I have pulled a number of ASX-listed companies, that I believe have some commonality to DXXN, and listed their Enterprise Value/Gross Profit and their Enterprise Value/Sales multiples (all based on the last twelve months). Adopting the average multiple for the group of companies assessed, the implied

Enterprise Value for **DXN** would be between \$33m and \$62m, based on the FY21 assumptions set out above. Should such re-rating occur, that would equal a x2 to x3 uplift from the current valuation of **DXN**. The fact that the sunk capital in the Sydney and Melbourne Colocation facilities have been written off to zero, would more than be made up, should such re-rating occur.

	Multiple	
	LTM	
	EV/GP	EV/Sales
VEE	3.8	2.4
DEM	8.0	2.7
ZEN	5.9	2.7
PEA	4.3	3.0
EWC	8.6	5.1
5GN	5.1	3.0
UWL	16.0	12.2
ST1	10.0	6.3
SLC	7.8	3.9
MNF	4.0	1.7
HFY	3.7	2.3
FRX	3.6	1.4
SPK	5.3	2.9
MAQ	6.8	4.6
Avg	6.6	3.9

DXN implied EV	\$ 33m	\$ 62m
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I understand that picking relevant multiples can be somewhat arbitrary and some might argue that multiples best suited to support an argument are often chosen. What is not arbitrary is the impact the return on capital that a business generates, has on the return a shareholder receives over time, largely irrespective of what multiple is paid for the business. Allow me to demonstrate this very important point: Assuming **DXN** grows its modular business to \$20m sales p.a., and that all else stays the same. On that basis the ROIC for **DXN** would be ~22%.

Now let's be conservative and round that down to 20% ROIC and compare that to another business that generates 10% ROIC. On entering an investment, which we assess over a 40 year time horizon, we pay double the multiple for **DXN** than what we pay for the comparative company and on exit we get a 50% lower multiple than what we get for the comparative company.

<i>Return over a 40 year investment horizon</i>				
	ROIC	Price multiple on entry	Price multiple on exit	CAGR
DXN	20%	x4 Book value	x2 Book value	18%
Comparative Company	10%	x2 Book value	x4 Book value	12%

Per the demonstration illustrated above, despite the unfavourable pricing for [DXN] mathematically the returns generated to an investor over the 40 year time horizon would have still been an attractive 18% CAGR. In other words, the benefits of a high ROIC significantly outweighs the perceived impact of a chosen multiple at a point in time. This point is important as it goes strongly to support why I believe the implementation of the recommendation above is vital to [DXN] in its ability to create value to its shareholders.

As mentioned at the outset of this email, our style is to engage with the Board and management of companies in which we have an ownership participation, in an effort to ensure that their decisions are in the long-term interests of the company, and in particular in relation to capital allocation and management remuneration.

In the first part of this email I have covered the things I believe are important to [DXN] to consider in respect of capital allocation. Next, I will briefly turn to remuneration of management.

I have on previous occasions given my input on the matter of remuneration directly to the chairman of [DXN]. I have yet to receive a response to any of my emails on this matter, and therefore repeat the key points again here.

Having read through [DXN]'s remuneration report I note that it appears, in my opinion, like many others, to be too complex, not specific and may result in cash payments to key executives without knowing if what was done to achieve the cash payment delivered the actual objective, which in most instances can only be truly measured over time.

Therefore, in my opinion, the incentive scheme appears not to be as effective, nor as aligned with []'s investors, as it could be. I trust you will agree that the objective of incentive schemes should always be for these to be completely aligned with the owners of the company? Perhaps especially for a company with the history and track record of [], now would appear to be an opportune and important time to ensure the best structure to ensure real alignment is put in place. It is with this in mind I offer my comments to you and your colleagues involved in Nom/Rem matters, for consideration:

- Of course I believe bonuses should be paid for services rendered. In my experience, for management teams in companies that are not listed, bonuses are nearly always the result of past performance. Unfortunately this is rarely the case for ASX-listed companies. Instead, complicated and opaque scorecards are used to determine both a short-term incentive and a long-term incentive. These are then 'paid' to management based on equally complex, and often flawed, vesting conditions.
- It is my belief that many management teams most likely place little value on the long-term portion of their remuneration, given the difficulty in understanding the structure of the reward and the risks associated with its vesting. This in itself is staggering given the cost of these schemes to shareholders. The cost in FY20 of >\$600K to the owners of [] serves as a pertinent example.
- It is, in my opinion, quite possible that high base salaries and short-term incentives – often with large cash components – are now used to compensate

executives for the risk that their long-term incentives do not vest. I believe this is a key matter that [REDACTED]'s board ought to consider / be mindful of.

In summary, I am of the opinion that most STI/LTI structures are complex with hard-to-understand hurdles and vesting conditions. They tend to be short-term weighted, asymmetrical and not aligned with shareholders given their high proportion of cash. I think there is an opportunity to improve on the structures in place in [REDACTED] and would like to put to you and your director colleagues the following five attributes that I believe should be included in the creation of an alternative incentive structure for consideration.

1. Simple and transparent
 - Replace short-term incentives and long-term incentives with a single bonus scheme, let's call it an Executive Incentive Plan (EIP).
 - The EIP is a payment in shares (after paying income tax on the bonus amount).
 - This eliminates short-term cash bonuses, makes the system easier for management to understand, and minimises the number of remuneration structures on which shareholders vote.
 - Structured well, by following the above suggestions, management is appropriately rewarded *only* for good *long-term* decisions.
2. Long-term focused
 - EIP shares purchased are to be placed in trust for at least three years, but preferably five years (even if that exceeds the executive's employment term).
 - Ideally, the term should align with [REDACTED]'s natural capital investment cycle.
 - The ills of poorly executed corporate strategy often only manifest themselves years later (as we have experienced in [REDACTED]) and then often only with the benefit of fresh eyes.
 - It is only fair that departing management share in the fruits (or problems) of their long-term decisions after they leave [REDACTED].
3. Symmetrical
 - The EIP awards are free of ALL vesting requirements.
 - Bonuses are paid for services rendered and are therefore already earned.
 - Future vesting hurdles, which are unnecessarily complex and less important when the awards are used to buy shares (see point 4 below), should be abolished.
4. Aligned with shareholders' interests
 - The after-tax bonus amount is invested in shares in [REDACTED], not paid in cash.
 - These shares are purchased on-market rather than being issued by [REDACTED].
 - These shares will rank equally with all paid-up shares in issue – they will carry votes, receive dividends and, importantly, their value will rise and fall with the market.
 - This way, great decisions, robust corporate strategy that is well executed and thoughtful allocation of capital will likely see [REDACTED]'s share price rise, and along with it the value of this award.

- Conversely, poor decisions, or badly executed corporate strategy, will likely see DXN's share price fall and along with it, the value of this award.
 - Consequently, despite the award being free of vesting hurdles, outcomes will still be aligned shareholders' interests.
 - The simplicity laid out above will save significant costs (tax consultants and accountants tasked with approving and monitoring complicated schemes, and the Board and management in discussing the outcomes). All costs currently borne by shareholders.
5. Quantum and fairness
- Addressing the structure of an EIP award of course remains the responsibility of DXN's Board.
 - Having the awards 'paid' in shares alleviates some of the risks around poorly constructed KPIs used to arrive at EIP award amounts, but it of course does not eliminate them.

I am gratified by the breadth of support that has generally been expressed by management to recommendations provided, and I share what I believe is growing to become the consensus view that DXN's management and Board should embrace this opportunity to implement and announce the recommendations set out above. I believe that these recommendations, if fully implemented, would likely result in a material and sustainable re-rating of DXN's share price. I believe the recommendations laid out are entirely achievable in a timely fashion and would result in not only a higher share price but also a more focused, productive, profitable and capital efficient business.

I very much appreciate the Board and management's time in considering these thoughts. I have great respect and admiration for DXN's high-quality modular business model, its technology, products and competitive position. However, I wish to reiterate that I believe shareholders are frustrated with the limited progress on profitability, the ongoing funding challenges and the continuous value destructive capital allocation.

I am firmly committed to DXN as an active shareholder with an investment to protect, and I look forward to continuing the dialogue with Matt, Greg and members of the Board as deemed appropriate. I hope that the Board and management believe, as I, and I am sure other shareholders do, that now is the time to take action.

As always, I welcome the opportunity to answer any questions you may have in respect of the above.

Kind regards,

Aligned Capital Partnership (ACN 618 424 016)

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