

Fundamental Research Corp.

Investment Analysis for Intelligent Investors

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Upco International Inc. (CSE: UPKO / OTC: UCCPF / Frankfurt: U06) – Legacy Business Continues to Deteriorate, Management Hints at Growth Plans

Sector/Industry: Technology

www.upcointernational.com

Market Data (as of May 21, 2019)

Current Price	\$0.07
Fair Value	\$0.29
Rating*	BUY
Risk*	4
52 Week Range	\$0.07 - \$0.23
Shares O/S	67,104,975
Market Cap	\$4.70 M
Current Yield	N/A
P/E (forward)	N/A
P/B	6.82x
YoY Return	-69.57%
YoY CSE	-10.92%

*see back of report for rating and risk definitions

**\$ denotes US\$ amounts unless otherwise specified.



Highlights

- Upco International Inc. (“Upco”, “company”) recently published their annual audited financial statements.
- **Deteriorating Legacy Business:** The company reported 2018 revenues of \$2.51 million, reflecting a YoY decline of 62.40% and missing our forecast of \$2.93 million. The revenue decline has been attributed to weakness in the company’s VoIP wholesale business.
- **Legacy Business Margins Dropping:** Topline troubles are further compounded by increased losses and sharply declining margins. The company missed our 2018 net loss forecast of \$1.34 million (EPS: -\$0.02), reporting an actual net loss that was significantly higher at \$2.53 million (EPS: -\$0.04).
- **Revised Forecasts** We have revised our 2019 revenue forecasts from \$5.48 million to \$3.13 million, and are introducing our 2020 revenue forecast of \$4.84 million. Our forecasts are now reliant on Upco Mobile for significant growth – the legacy business is assumed to exhibit sustained weakness moving forward.
- **Growth Prospects Dependent on Application Roll-Out:** Upco Mobile has been slow to roll-out, and with the legacy business’ continuous deterioration, Upco Mobile will be key to the company dragging themselves from their recent weak performance.
- **We are revising our fair value per share estimate from \$0.59 to \$0.29 per share.**

Key Financial Data (FYE - Dec 31)

(US\$)	2018	2019E	2020E
Cash	\$ 165,180	\$ 17,309	\$ 66,148
Working Capital	\$ 476,043	\$ 72,418	\$ -160,611
Debt	\$ -	\$ -	\$ -
Total Assets	\$ 977,583	\$ 1,076,250	\$ 1,466,414
Revenue	\$ 2,514,627	\$ 3,132,601	\$ 4,837,907
Net Income (Loss)	\$ -2,526,574	\$ -1,782,000	\$ -1,349,818
EPS	\$ -0.04	\$ -0.03	\$ -0.02

Financials

Upco reported revenues of \$2.51 million in 2018, versus revenue of \$6.69 million in 2017, reflecting topline decline of 62.40% YoY. As we noted in our previous update, the major decline in revenues was due to changes in wholesale voice call minute pricing in the European Union ("EU"). As noted previously, the trend in Europe's wholesale telecom industry is expected to continue downwards with respect to pricing, and margins, as a result of the EU's telecom pricing regulations.

STATEMENTS OF OPERATIONS			
(in US\$) - YE Dec 31st	2016	2017	2018
Revenue	12,068,708	6,688,138	2,514,627
Cost of Revenue	11,961,374	6,678,122	2,572,264
Gross Profit	107,334	10,016	(57,637)
EXPENSES			
SG&A	401,112	403,527	1,276,602
IT and Communication	269,732	264,156	196,649
Bad Debt Expense		125,399	311,055
Share-based Compensation		187,000	634,248
EBITDA	(563,510)	(970,066)	(2,476,191)
Depreciation			
Amortization			20,102
EBIT	(563,510)	(970,066)	(2,496,293)
Financing Costs	28,699	15,314	12,993
EBT	(592,209)	(985,380)	(2,509,286)
Non-Recurring Expenses	16,348	226,772	17,288
Taxes			
Net Profit (Loss)	(608,557)	(1,212,152)	(2,526,574)
FOREX Translation			-36,902
Net comprehensive Profit (Loss)	(608,557)	(1,212,152)	(2,563,476)
Weighted Average Shares	16,500,000	22,113,370	57,300,728
EPS	\$ -0.04	\$ -0.05	\$ -0.04

Source: FRC, Financial Statements

The company missed our 2018 revenue forecast of \$2.93 million by 14.09%. This highlights that the company's legacy business is deteriorating at a rate that surpasses even the sharp forecast cuts we introduced in our previous update. **We are lowering our previous 2019 revenue forecast of \$5.48 million to \$3.13 million, and introducing our 2020 revenue forecast of \$4.84 million.** We have adjusted our forecasts to reflect a deteriorating legacy business and a longer, delayed roll-out of Upco mobile.

STATEMENTS OF OPERATIONS		
(in US\$) - YE Dec 31st	2019E	2020E
Revenue	3,132,601	4,837,907
Cost of Revenue	2,968,545	3,967,183
Gross Profit	164,055	870,723
EXPENSES		
SG&A	1,404,262	1,693,267
IT and Communication	206,481	266,085
Bad Debt Expense		
Share-based Compensation	317,124	241,895
EBITDA	(1,763,812)	(1,330,524)
Depreciation		-
Amortization	18,188	19,294
EBIT	(1,782,000)	(1,349,818)
Financing Costs		
EBT	(1,782,000)	(1,349,818)
Non-Recurring Expenses		
Taxes		
Net Profit (Loss)	(1,782,000)	(1,349,818)
FOREX Translation		
Net comprehensive Profit (Loss)	(1,782,000)	(1,349,818)
Weighted Average Shares	67,104,975	67,104,975
EPS	- 0.03	- 0.02

Source: FRC, Financial Statements

Though we are significantly diminishing our outlook on the company, our discussions with management suggest the possibility of brighter times ahead. The following outlines general business initiatives aimed at returning the company to growth:

- Advancing their focus on countries where voice call termination commands higher margins (largely developing countries outside of Europe and North America).
- Joint ventures with partner wholesale VoIP companies. Specifically, the company wants to target a form of swap contract that has locked in volume traffic and margins for fixed periods.
- An undisclosed M&A plan targeted at wholesale VoIP telecom companies, with the goal of increasing revenue and cash flows.

Though the strategy and outlook alluded to through our discussions with management seem sound, we will wait for material news and guidance to be released to the public before adjusting our models to reflect management's outlook (if warranted).

Gross margins deteriorated in 2018 to -2.29%, compared to 0.15% in 2017. This was far below our expectations of modest, positive gross margin, based on the company's gross profit during the first nine months of 2018. This suggests that the financial viability of the company's legacy operations has deteriorated rapidly throughout 2018. The YoY decline in margins was reflected across the board as the company's legacy business not only shrinks, but grows less profitable as topline diminishes and expenses ramp up.

Margins	2016	2017	2018
Gross	0.89%	0.15%	-2.29%
EBITDA	-4.67%	-14.50%	-98.47%
EBIT	-4.67%	-14.50%	-99.27%
Net	-5.04%	-18.12%	-100.48%

Source: FRC, Financial Statements

SG&A expenses increased 216.36% YoY to \$1.28 million in 2018. This caused EBITDA to deteriorate on a YoY basis, from -\$0.97 million in 2017, to -\$2.48 million in 2018. The deterioration in EBITDA can be attributed to higher SG&A and share-based compensation. Normalized EBITDA was -\$1.84 million in 2018, versus -\$0.78 million in 2017, after adjusting for share-based compensation.

The company reported a net loss of \$2.53 million (EPS: -\$0.04) in 2018. This compares to a net loss of \$1.21 million (EPS: -\$0.05) in 2017. The net loss was significantly higher than our forecasted 2018 net loss of \$1.34 million (EPS: -\$0.02). **As a result of our deteriorating outlook, we are reducing our 2019 net loss forecast from \$0.91 million (EPS: -\$0.01) to \$1.78 million (EPS: -\$0.03) and introducing our 2020 net loss forecast of \$1.35 million (EPS: -\$0.02).**

Free cash flows deteriorated YOY due to the larger net loss.

Summary of Cash Flows (US\$, mm)	2016	2017	2018
Operating	-\$0.47	\$0.11	-\$2.40
Investing	-\$0.26	\$0.00	-\$0.20
Financing	\$0.59	-\$0.10	\$2.75
Effects of Exchange Rate	\$0.00	\$0.00	-\$0.04
Net	-\$0.15	\$0.01	\$0.11
Free Cash Flows to Firm (FCF)	-\$0.73	\$0.11	-\$2.60

Source: FRC, Financial Statements

At the end of 2018, the company had a cash position of \$0.17 million, and working capital of \$0.48 million, as well as a current ratio of 2.65x. The company remains debt-free.

(in US\$) - YE Dec 31st

Liquidity & Capital Structure	2016	2017	2018
Cash	\$ 45,116	\$ 57,107	\$ 165,180
Working Capital	\$ 495,256	\$ -224,932	\$ 476,043
Current Ratio	2.34	0.70	2.65
LT Debt	\$ -	\$ -	\$ -
Total Debt	\$ 134,538.00	\$ -	\$ -
LT Debt / Capital	-	-	-
Total Debt / Capital	-	-	-
Total Invested Capital	\$ -533,283	\$ -210,243	\$ 523,209
Shareholders Equity	\$ -622,705	\$ -153,136	\$ 688,389

Source: FRC, Financial Statements

Stock Options and Warrants: We estimate that the company has 6.77 million stock options (weighted average exercise price of \$0.19) and 0.34 million warrants (weighted average exercise price of \$0.25) outstanding. 1.80 million options and none of the warrants are currently in the money. The company could raise up to \$0.11 million if all the in-the-money options are exercised.

Our updated DCF valuation on Upco's shares is \$0.29 per share versus our previous estimate of \$0.59 per share. The significant decrease in our valuation was due to diminished revenue forecasts as well as an increased diluted share count that has been updated to reflect future expected financings to fund cash shortfalls.

DCF Model	2019E	2020E	2021E	2022E	2023E	2024E	2025E	Terminal
EBIT(1-tax)	\$ -1,782,000	\$ -985,367	\$ -549,144	\$ 700,608	\$ 3,669,546	\$ 6,405,207	\$ 8,918,376	
Non-Cash Expenses	\$ 335,312	\$ 261,189	\$ 262,005	\$ 438,740	\$ 713,943	\$ 1,081,200	\$ 1,472,912	
Investment in WC	\$ 271,000	\$ 281,868	\$ -499,268	\$ -648,052	\$ -1,299,013	\$ -1,403,096	\$ -1,496,760	
CFO	\$ -1,175,688	\$ -442,310	\$ -786,408	\$ 491,297	\$ 3,084,476	\$ 6,083,311	\$ 8,894,527	
CAPEX	\$ -222,182	\$ -244,401	\$ -268,841	\$ -295,725	\$ -325,297	\$ -357,827	\$ -393,610	
FCF	\$ -1,397,871	\$ -686,711	\$ -1,055,249	\$ 195,572	\$ 2,759,179	\$ 5,725,484	\$ 8,500,917	\$ 8,755,945
PV	\$ -1,286,844	\$ -535,736	\$ -697,670	\$ 109,577	\$ 1,310,119	\$ 2,303,887	\$ 2,898,897	\$ 19,905,758
Discount Rate	18%							
Terminal Growth Rate	3%							
Total PV	\$ 24,007,988							
Cash - Debt	\$ 165,180							
Equity Value	\$ 24,173,168							
Shares O/S (dil)	92,719,261							
Fair Value	\$ 0.29							

Source: FRC

We are revising our previous fair value estimate of \$0.59 per share to \$0.29 per share and maintaining our BUY rating on Upco.

We believe the company is exposed to the following risks (list is non-exhaustive):

- The company's legacy business operates in an industry that is highly regulated and subject to material change from governmental intervention.
- No guarantee that Upco mobile will prove a commercial success. Despite its novelty and unique services, the VoIP application industry is dominated by popular apps. Penetration into the market may be difficult for entrants.
- The company requires licensing in order to process payments and transfer monies

Valuation

Risks

globally through Upco mobile. Failure to secure the necessary regulatory approval will significantly impact our valuation on the company's shares.

- The company has no protection for its intellectual property. If the company's app proves a commercial success, there may be potential for rivals to mimic Upco's technology in their own offerings.
- Access to capital and share dilution.
- Exchange rate risk.
- Liquidity risk

We are maintaining our risk rating of 4 (Speculative).

Appendix

STATEMENTS OF OPERATIONS				
(in US\$) - YE Dec 31st	2017	2018	2019E	2020E
Revenue	6,688,138	2,514,627	3,132,601	4,837,907
Cost of Revenue	6,678,122	2,572,264	2,968,545	3,967,183
Gross Profit	10,016	(57,637)	164,055	870,723
EXPENSES				
SG&A	403,527	1,276,602	1,404,262	1,693,267
IT and Communication	264,156	196,649	206,481	266,085
Bad Debt Expense	125,399	311,055		
Share-based Compensation	187,000	634,248	317,124	241,895
EBITDA	(970,066)	(2,476,191)	(1,763,812)	(1,330,524)
Depreciation				-
Amortization		20,102	18,188	19,294
EBIT	(970,066)	(2,496,293)	(1,782,000)	(1,349,818)
Financing Costs	15,314	12,993		
EBT	(985,380)	(2,509,286)	(1,782,000)	(1,349,818)
Non-Recurring Expenses	226,772	17,288		
Taxes				
Net Profit (Loss)	(1,212,152)	(2,526,574)	(1,782,000)	(1,349,818)
FOREX Translation		-36,902		
Net comprehensive Profit (Loss)	(1,212,152)	(2,563,476)	(1,782,000)	(1,349,818)
Weighted Average Shares	22,113,370	57,300,728	67,104,975	67,104,975
EPS	\$ -0.05	\$ -0.04	0.03	0.02

BALANCE SHEET				
(in US\$) - YE Dec 31st				
	2017	2018	2019E	2020E
ASSETS				
CURRENT				
Cash and Cash Equiv.	57,107	165,180	17,309	66,148
A/R	480,419	579,102	626,520	725,686
Marketable Securities			-	-
Prepaid Expenses		20,955	31,326	48,379
Total Current Assets	537,526	765,237	675,155	840,213
Related Parties				
Other Receivables	55,093	15,246		
Intangible Assets		181,882	385,876	610,983
PPE	639		-	-
Deposits	16,064	15,218	15,218	15,218
Total Assets	609,322	977,583	1,076,250	1,466,414
LIABILITIES				
CURRENT				
A/P	762,458	280,166	593,709	991,796
Other Payables		9,028	9,028	9,028
Deferred Revenue				
Loans Payable				
Total Current Liabilities	762,458	289,194	602,737	1,000,824
Advances Payable				
Total Liabilities	762,458	289,194	602,737	1,000,824
SHAREHOLDERS EQUITY				
Share Capital	1,480,756	4,289,069	5,539,069	6,639,069
Reserve	201,965	798,653	1,115,777	1,357,672
AOCI		-36,902	-36,902	-36,902
Accumulated Deficit	-1,835,857	-4,362,431	6,144,431	7,494,249
Total shareholders' equity (deficiency)	(153,136)	688,389	473,513	465,590
Total Liabilities and Shareholders Equity	609,322	977,583	1,076,250	1,466,414

STATEMENTS OF CASH FLOWS									
(in US\$) - YE Dec 31st		2017		2018		2019E		2020E	
OPERATING ACTIVITIES									
Net Profit for the Year	-	1,212,152	-	2,526,574	-	1,782,000	-	1,349,818	
Adjusted for items not involving cash:									
Accrued Interest		4,764							
Finders Fee		94,656							
Gain on Settlements	-	797,300							
Impairment of Intangibles		351,850							
Amortization				20,102		18,188		19,294	
Depreciation						-		-	
Write-off of Equipment				639					
Stock-based Compensation		187,000		634,248		317,124		241,895	
Listing Expense		587,234							
Funds From Operations	-	783,948	-	1,871,585	-	1,446,688	-	1,088,629	
Change in working capital									
A/R		344,778	-	98,683	-	47,418	-	99,166	
Prepays			-	20,955	-	10,371	-	17,053	
Other Receivables		16,606		39,847		15,246		-	
Other Payables				9,028					
Related Parties		21,242				-		-	
A/P		571,715	-	459,187		313,543		398,087	
Deferred Revenue	-	62,546				-		-	
NET CASH USED IN OPERATING ACTIVITIES		107,847	-	2,401,535	-	1,175,688	-	806,761	
INVESTING ACTIVITIES									
Deposits	-	604		846					
PPE									
Marketable Securities									
Intangibles			-	201,984	-	222,182	-	244,401	
Net Cash acquired in RTO		4,943							
NET CASH USED IN INVESTING ACTIVITIES		4,339	-	201,138	-	222,182	-	244,401	
FINANCING ACTIVITIES									
Loans	-	139,302							
Advances Payable									
Exercise of Stock Options				130,931					
Net Proceeds from Share Issuance		39,107		2,616,717		1,250,000		1,100,000	
NET CASH FROM FINANCING ACTIVITIES	-	100,195		2,747,648		1,250,000		1,100,000	
Foreign Exchange / Others			-	36,902					
INCREASE IN CASH FOR THE PERIOD		11,991		108,073	-	147,871		48,838	
CASH, BEGINNING OF THE PERIOD		45,116		57,107		165,180		17,309	
CASH, END OF THE PERIOD		57,107		165,180		17,309		66,148	

Fundamental Research Corp. Equity Rating Scale:

Buy – Annual expected rate of return exceeds 12% or the expected return is commensurate with risk

Hold – Annual expected rate of return is between 5% and 12%

Sell – Annual expected rate of return is below 5% or the expected return is not commensurate with risk

Suspended or Rating N/A— Coverage and ratings suspended until more information can be obtained from the company regarding recent events.

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1 (Low Risk) - The company operates in an industry where it has a strong position (for example a monopoly, high market share etc.) or operates in a regulated industry. The future outlook is stable or positive for the industry. The company generates positive free cash flow and has a history of profitability. The capital structure is conservative with little or no debt.

2 (Below Average Risk) - The company operates in an industry where the fundamentals and outlook are positive. The industry and company are relatively less sensitive to systematic risk than companies with a Risk Rating of 3. The company has a history of profitability and has demonstrated its ability to generate positive free cash flows (though current free cash flow may be negative due to capital investment). The company's capital structure is conservative with little to modest use of debt.

3 (Average Risk) - The company operates in an industry that has average sensitivity to systematic risk. The industry may be cyclical. Profits and cash flow are sensitive to economic factors although the company has demonstrated its ability to generate positive earnings and cash flow. Debt use is in line with industry averages, and coverage ratios are sufficient.

4 (Speculative) - The company has little or no history of generating earnings or cash flow. Debt use is higher. These companies may be in start-up mode or in a turnaround situation. These companies should be considered speculative.

5 (Highly Speculative) - The company has no history of generating earnings or cash flow. They may operate in a new industry with new, and unproven products. Products may be at the development stage, testing, or seeking regulatory approval. These companies may run into liquidity issues, and may rely on external funding. These stocks are considered highly speculative.

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