Elektron Technology plc

15th May 2019

Taking Checkit to the 'Next' level

Disruption may be the most over-hyped word in the Tech lexicon, yet it is reshaping almost every walk of life. Even routine tasks - from cleaning restaurants, hospitals, food factories and public toilets, to maintaining schools, shops and leisure facilities - have been transformed by the 'digital revolution'.

Checkit automates these processes, delivering unrivalled benefits in terms of efficiency, customer service, repeatability, transparency, safety and regulatory compliance. Moreover, **its innovative SaaS solutions are applicable across many different verticals** – with the **potential of eventually becoming a global 'category champion'**. The objective now is to exploit this **1st mover advantage**, and **rapidly scale the division**.

Transformational £8.8m acquisition

This morning, Elektron took a **major step forward** towards achieving this goal. Announcing the **£8.8m** (cash/debt free) **acquisition of [Next Control Systems Ltd]** (NCS, see below). **A leading UK** (98% sales) **remote monitoring, control, IoT and real time data analysis specialist** - based in Fleet (Hampshire) and employing 104 staff.

NCS primarily serves the energy, facilities management, retail, education, and healthcare sectors under its Next, Axon and Tutela (healthcare and life sciences) brands. Typically **saving clients up to 20% of their ongoing power, air-conditioning and refrigeration costs**, along with protecting their often valuable inventories (eg drugs) from unscheduled equipment failures.

Immediately EPS enhancing and value accretive

John Lewis / Waitrose is a long term Next customer

Source: Company

Here, **customer retention is high, with 57%** (£6.1m) **of turnover** (£10.7m 2018) **said to be recurring** - and the rest largely derived from implementation services, consultancy & associated hardware. What's more, the £8.8m consideration means the transaction is **immediately earnings enhancing** and **value accretive**.

Company Data

EPIC	**AIM: EKT**
Price (last close)	40p
52 week Hi/Lo	49p/31p
Market cap	£74m
ED SOTP valuation	83p/share
Net cash (Est Jan'20)	£3.2m
Share count	186.1m
Avg. daily volume	160k

Share Price, p

Source: Share Cast

Description

Elektron is a specialist niche product OEM and B2B operational service provider, enjoying a wide economic moat. It runs 3 separate divisions (see below), each targeting distinct markets, yet bound together by a single centre of engineering excellence located in Cambridge.

1) **Bulgin** designs and manufactures premium, fail-safe, hermetically sealed (ie air/water tight) circular connectors and electronic components.

2) **Checkit** is a high-growth real-time operational management platform, that digitises, streamlines, and vastly improves the management of routine tasks, providing top to bottom visibility.

3) **EET** – develops field vision and macular pigment screening devices to the ophthalmic industry.

Next News: Prelims 12th June 2019

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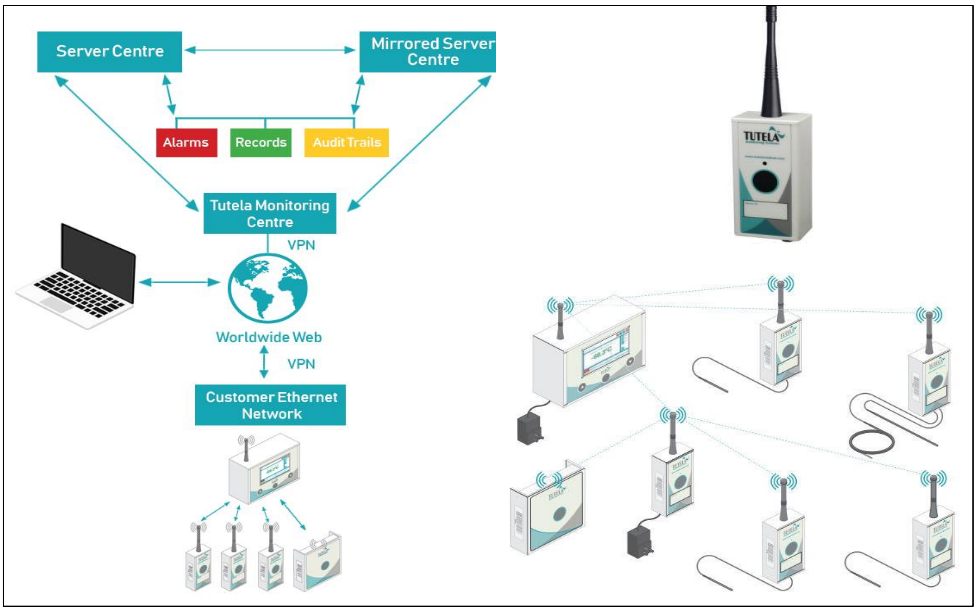
Modest price for high quality business

So what about the deal terms? Well for 2018, NCS clocked up turnover, EBITDA and EBIT of £10.7m (+9.8%), £1.3m & £1.2m respectively. Representing **modest EV/sales, EV/EBITDA and EV/EBIT multiples of 0.82x, 6.6x and 7.3x**, alongside **a 13.6% RoI**. The management accounts for the 4 months to 30 April 2019 show an operating profit of £0.5m YTD on sales of £3.7m (+12%) vs £0.4m & £3.3m LY.

Tutela healthcare monitoring systems



Source: Company

Material synergies to boot

This is just the start though. You see by combining NCS with Checkit, substantial benefits should flow through for customers, and the enlarged group alike. Namely:

- **Enhancing product quality** by **cross fertilising the best parts of each business** (eg software, sensors & technologies).
- **Up/x-selling services** throughout the entire client base.
- **Rapidly expanding Checkit into other verticals** (re Healthcare, facilities management).
- **Extending NCS' brands overseas**.
- **Industrialising / streamlining Checkit's operational processes**.

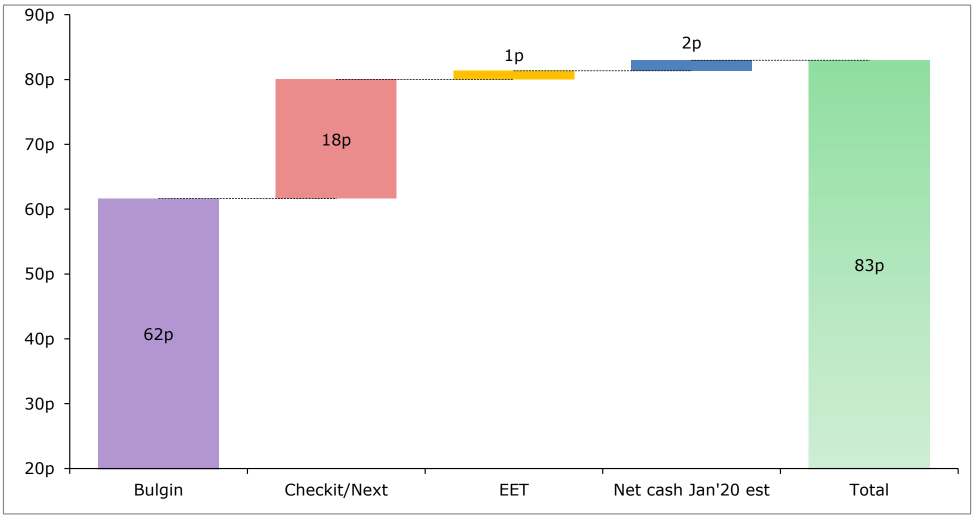
With regards to hard synergies, it is impossible to be too precise at this juncture, albeit we understand **management are targeting to (at least) double NCS' EBIT over the next 2-3 years**. A lot of which will be derived from self-help measures (re improved pricing, contract management, procurement, etc), with the remainder coming from scale advantages.

Equally though, we expect there to be some one-off integration costs (c. £400k-£500k), augmented by extra investment to 'round-out' the joint technology platform across verticals and geographies.

Attractive risk-reward balance

As such, we have **erred on the side of caution**, and modelled Checkit/Next revenues to climb by 25% LFL from FY22 onwards. On top, a £400k expense reclassification has been included from FY20 onwards (re switch from Bulgin to Checkit). Meaning that our **SOTP valuation remains unchanged at 83p/share** (see below), yet acknowledging there is a decent chance of upgrades in due course.

Sum of the parts valuation (pence/share)

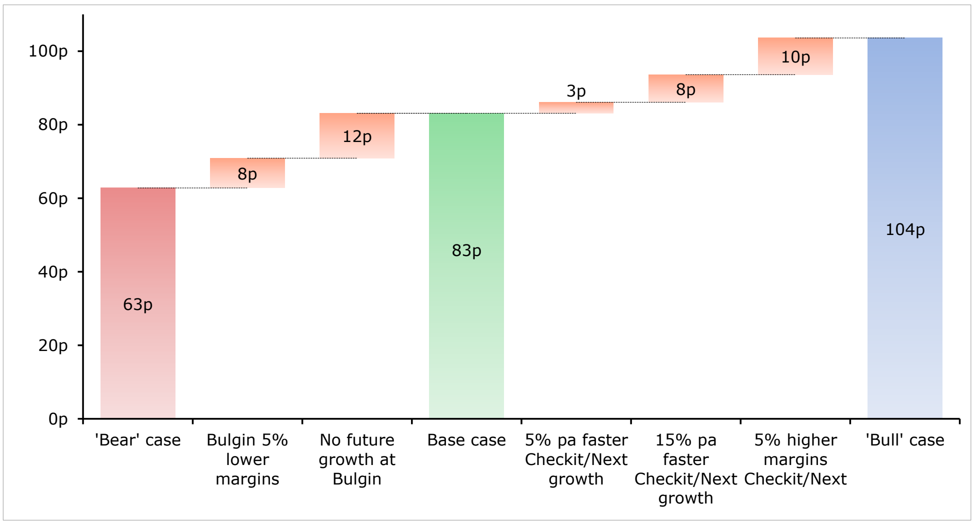


Source: Equity Development

Next opens healthcare/biotech door for Checkit

Additionally, we think the **diversity of Elektron's high quality assets provide a healthy cushion for investors**, even if events do not go quite to plan - as indicated by our **'Bear' and 'Bull' scenarios of 63p and 104p** (see below).

Sensitivity analysis (p/share)



Source: Equity Development

Management continuity to ensure smooth integration

From a risk perspective, **all of NCS' key employees have decided to stay on**, which should ensure a smooth handover and the strategic targets are attained. Plus, the deal appears to be relatively low risk, in light of the Board's prior knowledge of the business, alongside the **complementary skills, chemistry and cultures**.

Exec Chairman, Keith Daley and the Board commenting "***Next is an excellent strategic fit for Checkit****, providing technology and software that enables management teams to monitor, control and optimise business processes. This* ***transformational deal immediately adds scale*** *and* ***will significantly accelerate the path to profitability at Checkit****. We look forward to realising the many opportunities offered by the combination of Checkit and Next*"

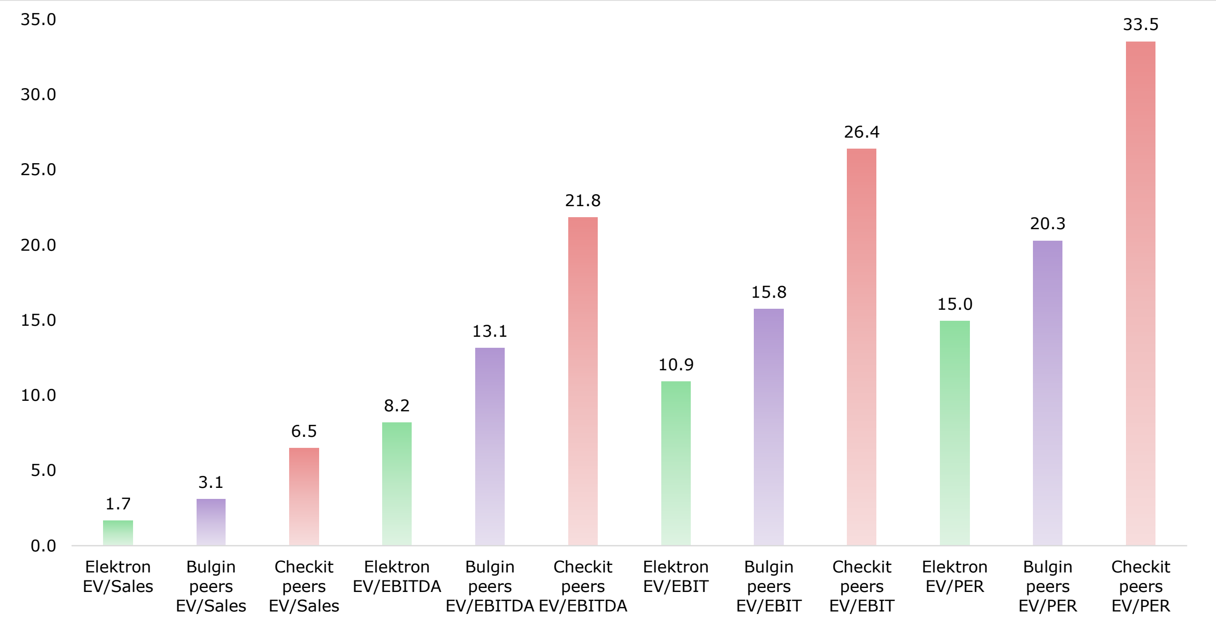
FY20 and FY21 upgrades

In terms of funding, the **£8.8m has come from Elektron's own cash resources** (£10.1m Jan'19), augmented by a new £3m bank overdraft, which combined with an existing £3m invoice discount facility should provide ample headroom for working capital purposes.

Similarly, **Q1'20 trading** (ie Feb-April) **has been strong with turnover up 17% to £8.9m** (LY £7.6m), driven primarily by **Bulgin** (+20%). Checkit on the other hand, experienced some 'air-turbulence' within the food service sector (eg High Street competition, restaurant closures, etc). Although still managing to post 49% LFL growth, and adding there was now "***an increasing number of enquiries from non-food clients***". Sales at Elektron Eye Technology (EET), which is considered non-core, fell 11% LFL, albeit against extremely tough comparatives.

Consequently overall, given the continued **robust Q1'19 results**, and today's earnings accretive acquisition, **we have upgraded our FY20 and FY21 EBIT forecasts to £6.6m** (vs £5.8m before) **& £8.4m** (£7.4m) **respectively**. It is also worth noting that at 40p, the stock trades at an unwarranted discount (see below) to peers.

Valuation benchmarks vs peers



Source: Equity Development

Potential beneficiary of Trump trade tariffs with China

But that's not all. Procedures have been put in place in the event of a 'no deal' Brexit – eg holding surplus inventory and ensuring channel partners have sufficient stock to service end users. Besides, Bulgin manufactures most of its products in Tunisia anyway, so it might even become a net beneficiary of the ongoing trade spat between China and America.

Elsewhere, there seems little danger either of an imminent US recession. Rather, there was another '**Goldilocks' jobs report in April** (3.6% unemployment), augmented by increasing wages (+3.2%) and above trend GDP (3.2% Q1'19).

Whilst if the current tensions (re tariffs) between Presidents Trump and Xi Jinping persist, then Federal Reserve Chairman Jerome Powell would probably cut interest rates, alongside China stepping up stimulus. In essence, **providing monetary & fiscal 'Puts' under the world's 2 largest economies**.

And with a forthcoming US Presidential election to boot (re November 2020), we suspect there is a chance of further fiscal loosening over the next 18 months. Perhaps even involving a new Infrastructure Bill, which both the Democrats and Republicans broadly support.

Summary financial projections

Elektron Technology (January yearend)	2017 Act £ms	2018 Act £ms	2019 Est £ms	2020 Est £ms	2021 Est £ms	2022 Est £ms	2023 Est £ms	2024 Est £ms	2025 Est £ms	2026 Est £ms
Bulgin	24.1	27.3	30.1	31.1	32.7	34.3	36.0	37.8	39.7	41.7
Checkit/Next	0.3	0.5	1.0	8.7	14.3	17.8	22.3	27.9	34.8	43.5
EET	2.4	2.0	2.6	2.8	3.0	3.3	3.5	3.8	4.1	4.5
Turnover	**26.8**	**29.8**	**33.7**	**42.6**	**50.0**	**55.4**	**61.8**	**69.5**	**78.7**	**89.7**
Bulgin		*13.3%*	*10.3%*	*3.3%*	*5.0%*	*5.0%*	*5.0%*	*5.0%*	*5.0%*	*5.0%*
Checkit/Next		*66.7%*	*100.0%*	*766.9%*	*64.6%*	*25.0%*	*25.0%*	*25.0%*	*25.0%*	*25.0%*
EET		*-16.7%*	*30.0%*	*8.0%*	*8.0%*	*8.0%*	*8.0%*	*8.0%*	*8.0%*	*8.0%*
% growth		*11.2%*	*13.1%*	*26.3%*	*17.3%*	*10.9%*	*11.6%*	*12.4%*	*13.2%*	*14.0%*
Gross Profit	**11.2**	**14.8**	**17.1**	**23.0**	**27.5**	**30.9**	**34.9**	**39.8**	**45.6**	**52.7**
% margin	41.8%	49.7%	50.7%	54.0%	55.0%	55.8%	56.5%	57.3%	58.0%	58.8%
Bulgin	4.3	7.9	9.4	10.7	11.2	11.8	12.4	13.0	13.7	14.4
Checkit/Next	-2.8	-2.7	-3.1	-2.3	-1.0	0.2	2.0	4.3	7.3	11.1
EET	-0.2	-0.1	0.2	0.3	0.4	0.4	0.5	0.6	0.7	0.8
Adjusted EBITDA	**1.3**	**5.1**	**6.6**	**8.7**	**10.6**	**12.4**	**15.0**	**17.9**	**21.6**	**26.2**
Bulgin	*17.8%*	*28.9%*	*31.3%*	*34.4%*	*34.4%*	*34.4%*	*34.4%*	*34.4%*	*34.4%*	*34.4%*
Checkit/Next	*-933.3%*	*-540.0%*	*-310.0%*	*-26.3%*	*-6.8%*	*1.1%*	*9.2%*	*15.4%*	*20.9%*	*25.5%*
EET	*-8.3%*	*-5.0%*	*9.0%*	*10.4%*	*11.9%*	*13.2%*	*14.5%*	*15.6%*	*16.7%*	*17.7%*
% EBITDA margin	***4.9%***	***17.1%***	***19.5%***	***20.5%***	***21.3%***	***22.5%***	***24.2%***	***25.8%***	***27.5%***	***29.3%***
Bulgin	3.3	7.2	9.0	10.3	10.8	11.4	11.9	12.5	13.1	13.8
Checkit/Next	-3.5	-4.4	-4.6	-3.9	-2.7	-1.6	0.1	2.2	5.1	8.7
EET	-0.4	-0.3	0.1	0.2	0.2	0.3	0.3	0.4	0.5	0.6
Adjusted EBIT	**-0.6**	**2.5**	**4.6**	**6.6**	**8.4**	**10.0**	**12.4**	**15.2**	**18.7**	**23.1**
Bulgin	*13.7%*	*26.4%*	*30.0%*	*33.1%*	*33.1%*	*33.1%*	*33.1%*	*33.1%*	*33.1%*	*33.1%*
Checkit/Next	*-1166.7%*	*-880.0%*	*-455.0%*	*-45.0%*	*-18.7%*	*-9.0%*	*0.5%*	*8.0%*	*14.5%*	*20.0%*
EET	*-16.7%*	*-15.0%*	*3.8%*	*5.4%*	*6.9%*	*8.2%*	*9.5%*	*10.6%*	*11.7%*	*12.7%*
% EBIT margin	***-2.2%***	***8.4%***	***13.6%***	***15.4%***	***16.7%***	***18.1%***	***20.0%***	***21.8%***	***23.7%***	***25.7%***
Adjusted Profit before Tax	**-0.6**	**2.6**	**4.6**	**6.4**	**8.4**	**10.0**	**12.4**	**15.2**	**18.7**	**23.1**
Adjusted EPS (p)	**-0.1**	**1.1**	**1.9**	**2.7**	**3.5**	**4.2**	**5.1**	**6.3**	**7.7**	**9.5**
EPS growth rate		*-1939.1%*	*82.0%*	*38.0%*	*30.9%*	*19.3%*	*22.8%*	*21.9%*	*22.6%*	*22.9%*
Dividend (p)	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***
Yield	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*
Valuation benchmarks										
P/E ratio	*-688.8*	*37.5*	*20.6*	*14.9*	*11.4*	*9.5*	*7.8*	*6.4*	*5.2*	*4.2*
EV/Sales	*2.7*	*2.4*	*2.1*	*1.7*	*1.4*	*1.3*	*1.2*	*1.0*	*0.9*	*0.8*
EV/EBITDA	*54.8*	*14.0*	*10.9*	*8.2*	*6.7*	*5.7*	*4.8*	*4.0*	*3.3*	*2.7*
EV / EBITA	*-118.7*	*28.5*	*15.6*	*10.9*	*8.5*	*7.1*	*5.8*	*4.7*	*3.8*	*3.1*
Adjusted tax rate	*-83.3%*	*-26.9%*	*-21.0%*	*-21.0%*	*-21.0%*	*-21.0%*	*-21.0%*	*-21.0%*	*-21.0%*	*-21.0%*
EBITDA drop through rates		*126.7%*	*37.5%*	*24.4%*	*25.8%*	*33.3%*	*39.1%*	*38.7%*	*40.6%*	*41.8%*
PEG ratio		*-0.02*	*0.25*	*0.39*	*0.37*	*0.49*	*0.34*	*0.29*	*0.23*	*0.18*
Net cash/(debt)	**2.5**	**5.2**	**10.1**	**3.2**	**8.4**	**15.0**	**23.0**	**32.9**	**45.1**	**60.2**
Sharecount (Ks)	172.2	177.9	186.1	187.0	188.0	188.9	189.9	190.8	191.8	192.7
Shareprice (p)	**40.0**									

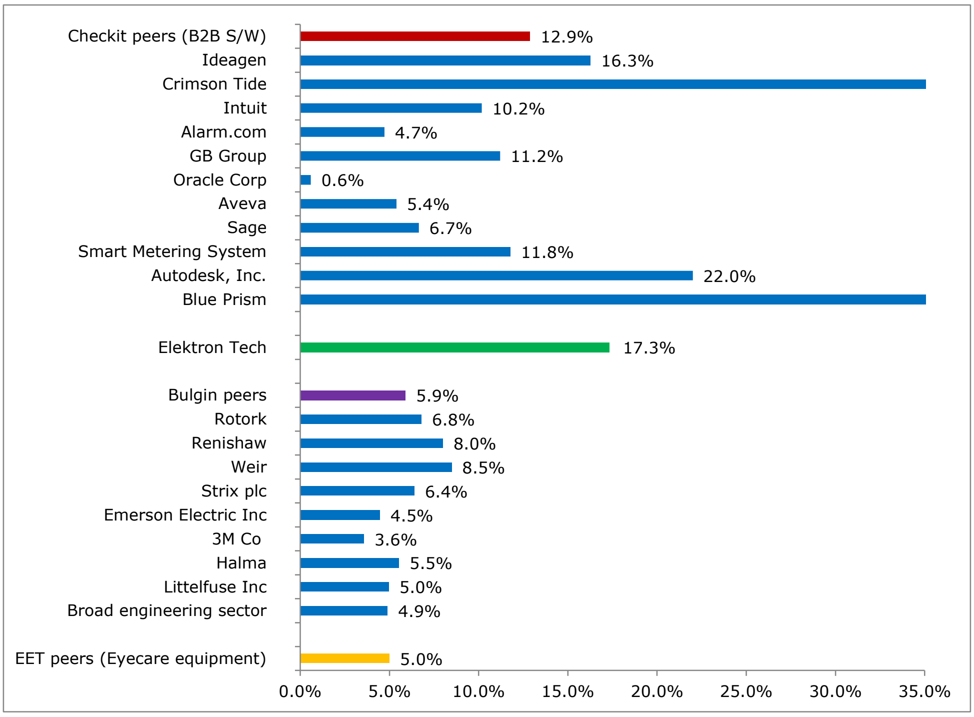
Source: Equity Development estimates, Company historic data. Note: Expense reclassification of £400k from Bulgin to Checkit from FY20 onwards

Key risks

- Slowdown in global GDP which could impact EKT’s end-markets. In particular Bulgin is early-cycle with revenues amplified by distributor de/restocking.
- Forward visibility at EET and Bulgin tends to be only 8 and 12 weeks’ respectively.
- Anticipated growth/profitability (eg Checkit/EET) may take longer than envisaged, cost more and/or not be fully realised.
- Successful integration of Next Control Systems, who have a high customer concentration relating to the John Lewis/Waitrose partnership.
- Foreign exchange. However this is primarily a translation risk with 64% of Elektron's FY18 turnover being generated outside the UK.
- Regulatory and tax changes. Competition may intensify as a function of new/existing players.
- Being relatively small, Elektron could get squeezed by larger rivals, partners and customers, particularly with regards to margins.
- Generic risks of retention/recruitment of key staff, etc.
- Potential future impact from BREXIT and/or US-China/EU trade tariffs/sanctions
- As with many smallcap AIM stocks, daily trading volumes can occasionally decline, particularly during seasonally quieter periods and/or between newsflow.

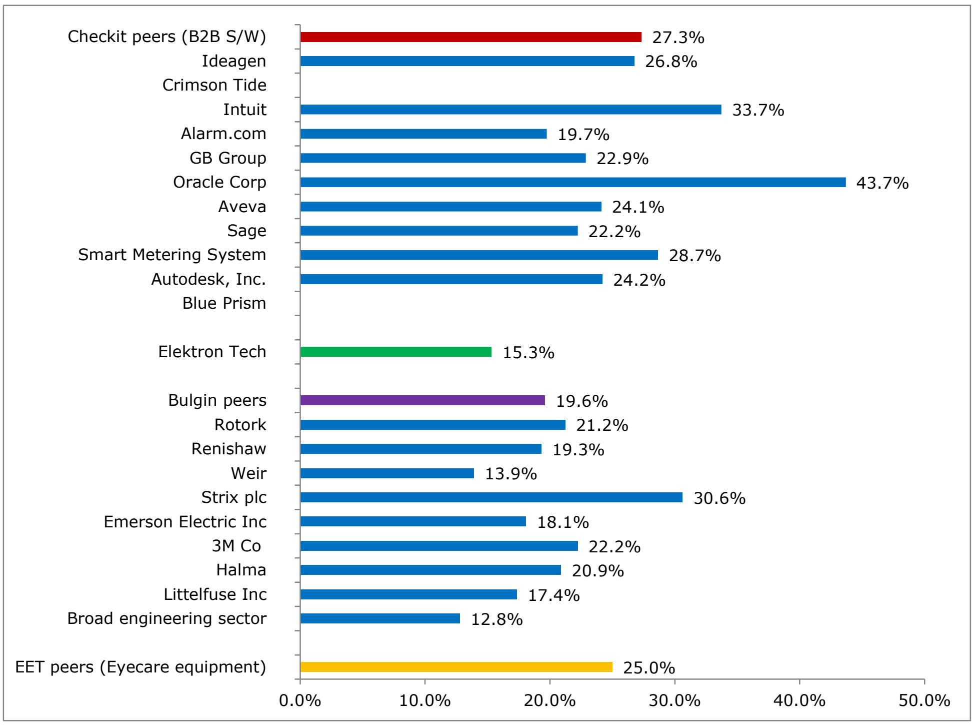
Appendix - Valuation benchmarks & industry KPIs

Current year + 1 sales growth rates



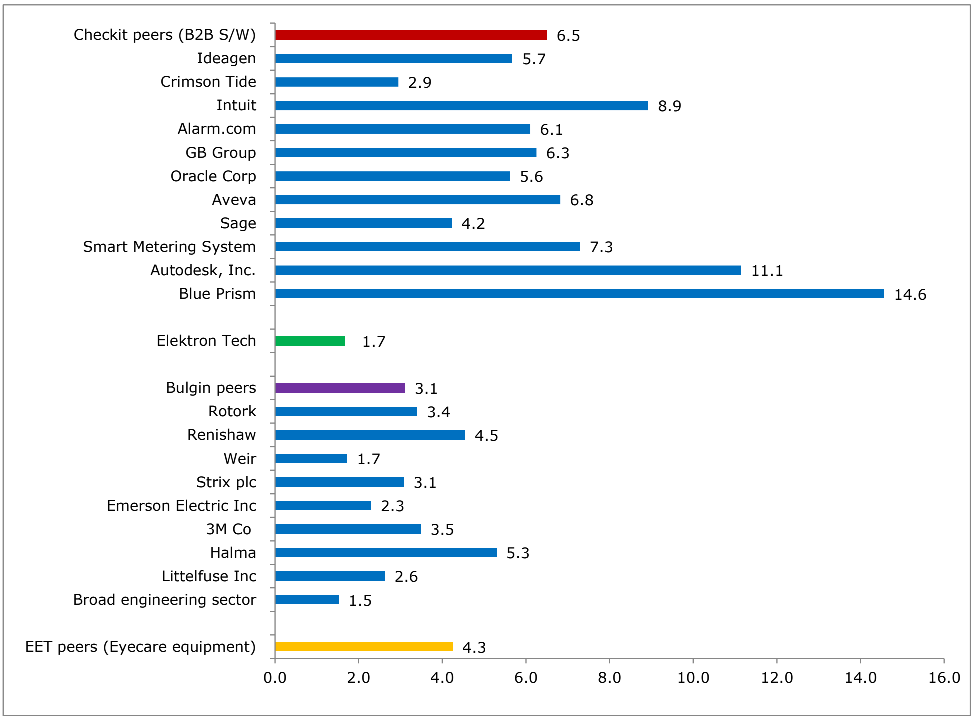
Source: Equity Development

Current year EBIT margins



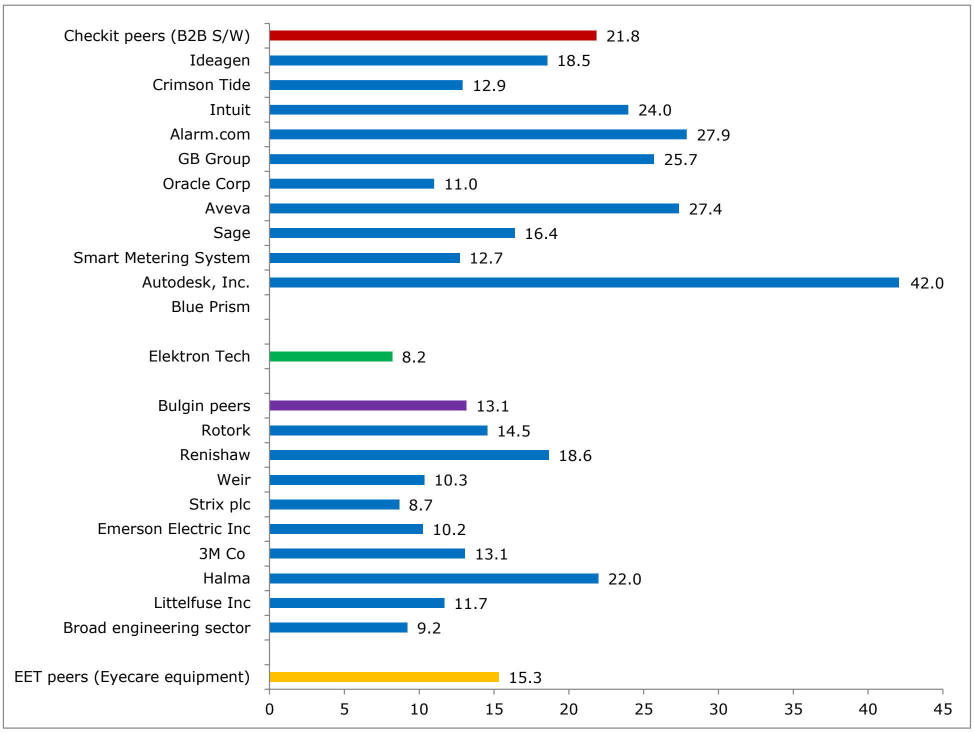
Source: Equity Development

Current year EV/sales



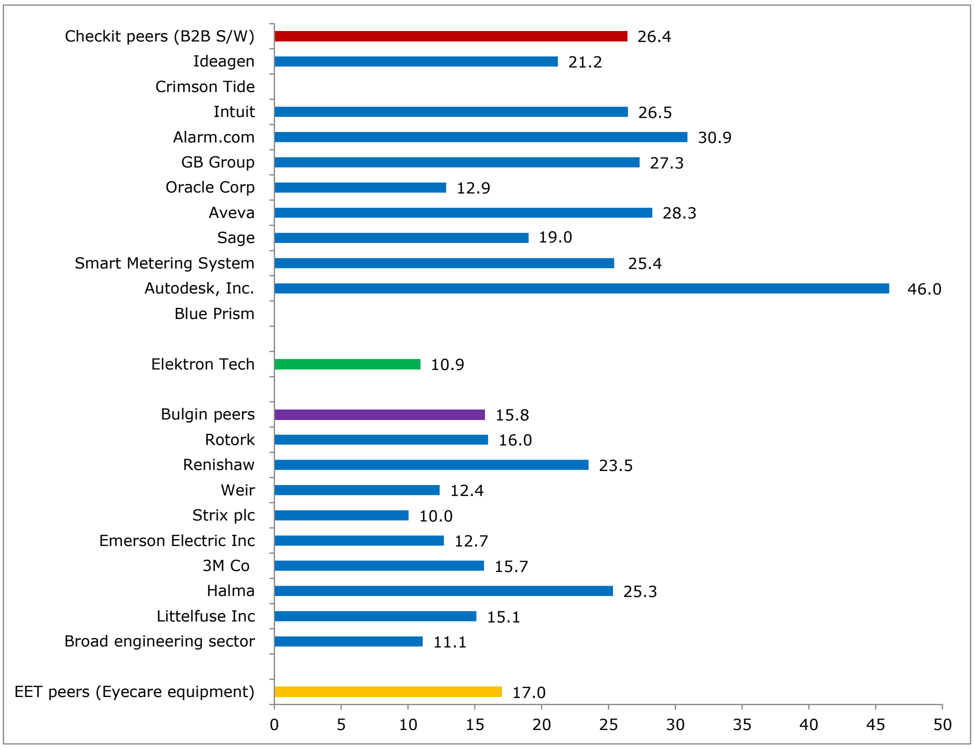
Source: Equity Development

Current year EV/EBITDA



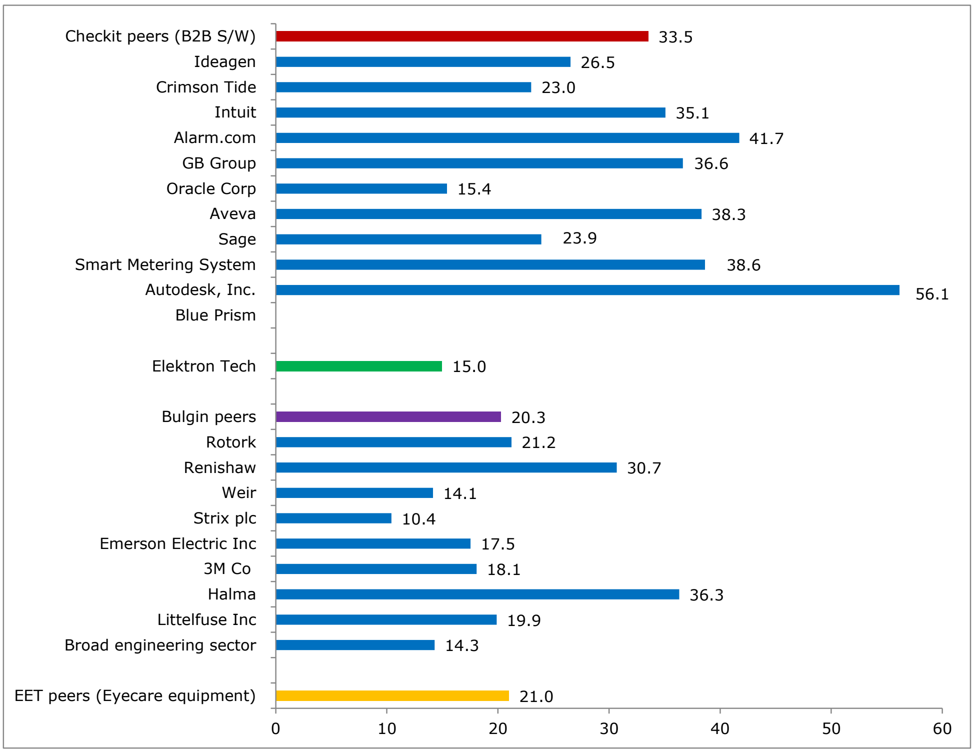
Source: Equity Development

Current year EV/EBIT



Source: Equity Development

Current year PER



Source: Equity Development

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