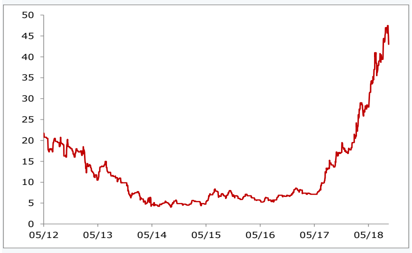
Elektron Technology plc

19 September 2018

Company Data

EPIC	**AIM: EKT**
Price (last close)	47p
52 week Hi/Lo	48p/14p
Market cap	£88m
ED SOTP valuation	69p/share
Avg. daily volume	250k

Share Price, p



Source: Web Financial

Description

Elektron (EKT) 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 hi-growth (>100%+ LFL) real-time operational management platform, that digitises, streamlines, and vastly improves the management of routine activities, providing top to bottom visibility.

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

Next News: Nov'18 trading update

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Doing all the right things consistently well

Professional investors tend to be a sceptical bunch. Nonetheless, even the most die-hard cynics occasionally have to 'tip their hats' when a company constantly out-performs. Sure there's always something to quibble about. Yet for Elektron - particularly in light of the difficult hand it was originally dealt – **this morning's 'strong' results** are the culmination of years of hard work, and **a reflection of the business' resilience and quality**.

Indeed, not only did the group have to undergo radical surgery, including complicated disposals, major restructuring and innovative growth initiatives. But also, despite the challenges and occasional setback, the Board never lost sight of its vision. **Namely to identify & turn-around those 'fallen stars'** which still possessed substantial upside (eg Bulgin), **retain unique IPR that could be scaled globally** (eg EET), and importantly **invest in new technology** to generate future returns.

It all sounds simple. However, in reality formulating such winning strategies, getting the timing right and then executing flawlessly, is no 'walk in the park'. What's more, for shareholders **we think there's plenty left in the tank**, given EKT's **healthy addressable markets**, **defendable USPs**, **attractive valuation** and **capable management**.

Cash piling up thanks to double digit LFL growth

In terms of the 1st half numbers, revenues and EBIT climbed to £15.9m (+17% LFL) and £1.4m (180%) respectively, thanks to a **standout performance from Bulgin**. Here ***"unprecedented demand***" (bookings +10%) propelled turnover up +14.4% to £14.3m (£12.5m LY), EBIT 20% higher (£3.6m vs £3.0m) and operating margins to 25% (24% LY). Similarly, **Checkit delivered impressive top line growth** of 146% to £0.4m, aided by July'18 annualised revenues running at a £1.1m clip (vs £1.0m April and £0.5m LY) – with losses broadly flat at £2.2m (-£2.3m LY) mirroring its ambitious expansion plans. Optometry equipment maker **EET made good progress** too, breaking-even (-£0.2m LY) on revenues up 33% to £1.2m.

Elsewhere, **net cash closed July at £6.8m** (vs £2.1m LY & £5.2m Jan'18) and is set to rise to £8.3m by Jan'19. ***Implying to us*** that there is headroom available for possible synergistic M&A, albeit nothing is thought to be imminent & **organic growth remains by far the #1 focus**.

Ok, great numbers but what comes next?

Well, this is where it gets really interesting. Because alongside the improving outlook, **the medium-long term prospects at each division are** in our mind **outstanding**. At **Bulgin, there is scope to acquire a much bigger slice of its multi £billion end-user verticals (TAM)**, facilitated by a slate of new product launches (eg hermetically sealed sensors, IoT, data coms, etc) and widening distribution (eg Arrow Electronics).

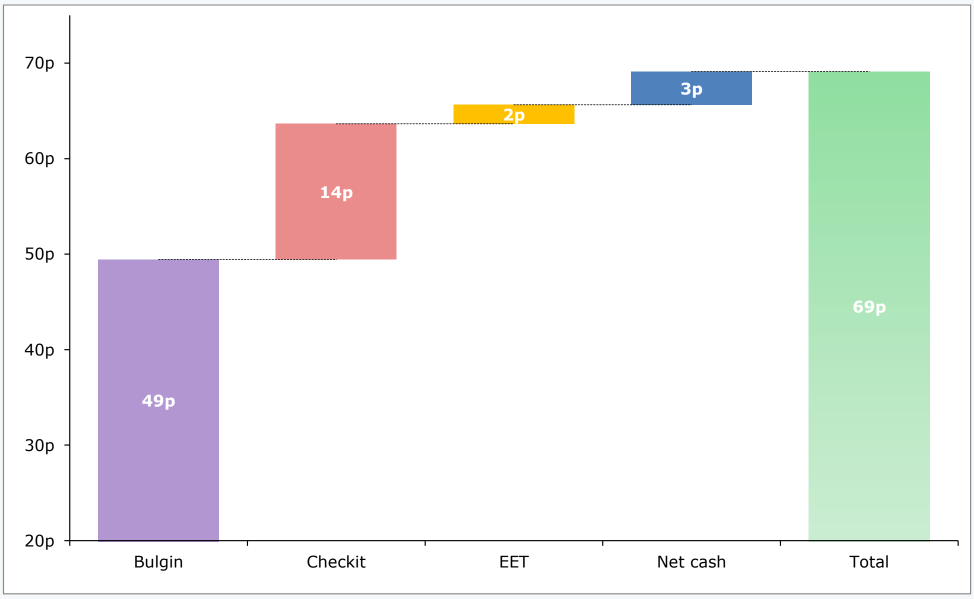
For **EET, the opportunity is to open new doors internationally** (eg Europe, China, South America) in order to leverage its **UK leadership position** and **mushrooming trove of clinical data.**

While **Checkit literally has the chance to transform the workplace**, both domestically and overseas (eg US, Europe). Simplifying daily tasks such as cleaning schools, monitoring food safety and testing patient blood samples – in the process delivering time/cost savings, improving customer service and helping to comply with stricter regulations.

Lifting SOTP valuation from 66p to 69p/share

For us, all of **these three scenarios are perfectly feasible and not factored into the current shareprice**. Consequently, although **our forecasts remain unchanged**, we think the broader risk/reward profile has improved, and accordingly have nudged up the **SOTP valuation from 66p to 69p/share** - split 49p Bulgin, 14p Checkit, 2p EET and 3p net funds (see below).

Sum of the parts valuation (pence/share)

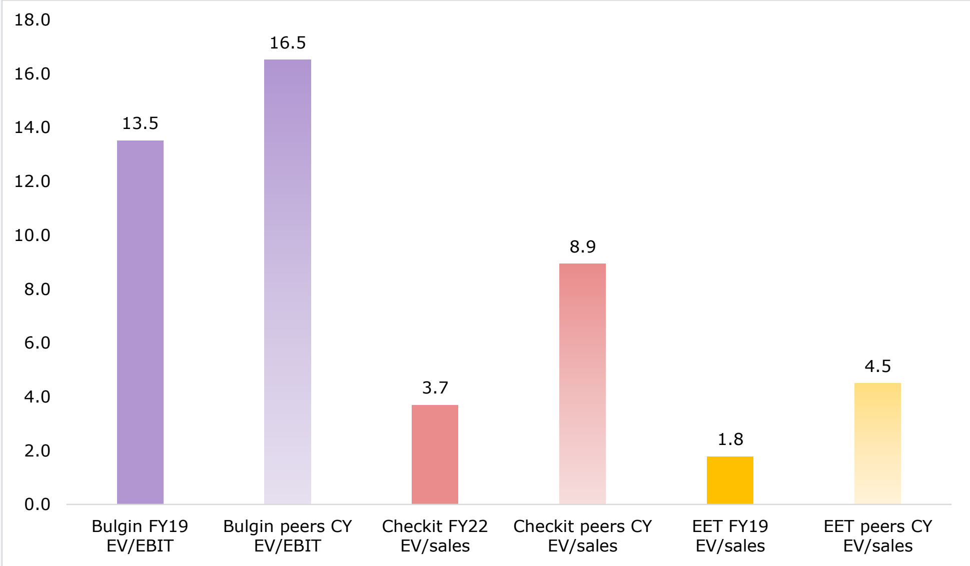


Source: Equity Development

Stock could more than triple by 2023

That said, even at 69p the shares still appear cheap, equivalent to the undemanding divisional multiples shown below. Plus, if **Bulgin** managed to gain a further 1% share of its TAM over say the next 5 years, then revenues and profits could more than double. So rather being worth 49p/share, **this unit alone might be valued at north of 120p by 2023**.

Implied divisional multiples at SOTP of 69p/share



Source: Equity Development

CEO John Wilson adding "***H2'19 has started well in line with the Board's expectations**. **Bulgin maintains record levels of order intake**. **Checkit has a strong UK pipeline and has been launched in the US**. In addition, EET continues to outpace the prior year. **The Board retains its positive outlook** for H2 and **in delivering results in line with recently upgraded FY expectations**. The medium and long term prospects of the Group remain attractive* ".

Fine, but is there anything that could upset the apple-cart?

Bulgin's EBIT margins remain in line with peers

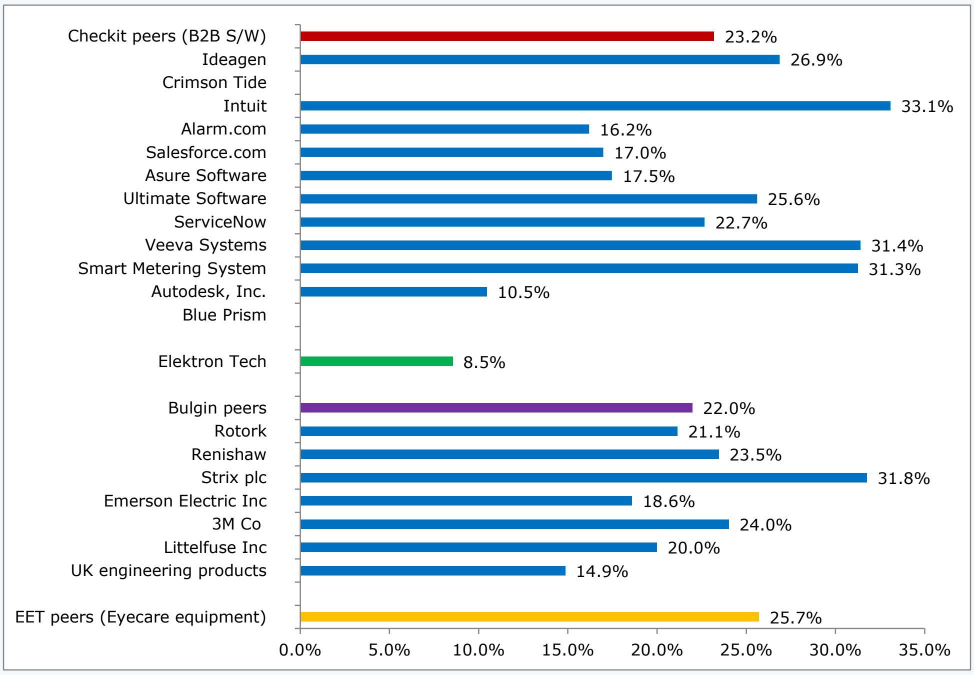
Well, apart from the normal macro risks of a deep/prolonged recession, destocking, BREXIT, escalating trade tensions (US vs China/EU), tougher competition, etc – **we see little on the horizon for investors be concerned about**.

However, if pushed then one might wish to consider the longevity of Bulgin's profit margins. Here though, the division is a **world-class designer/manufacturer of hermetically-sealed (ie air/water-tight), fail-safe circular connectors**, used to supply electricity/internet to machines and other vital equipment, often in harsh environments (eg outdoors, on ships, oil/gas, recreational, healthcare, sub-sea, agriculture, renewable energy, etc).

The items are sold to **>80,000 end-users worldwide** (5% CAGR), typically costing only a few dollars each, but are often a critical link in **powering much bigger and perhaps mission-critical applications.** If they were ever to fail, then it might cause major disruption through a sudden loss of electricity or data traffic. In that context it is hardly surprising customers tend to be far more concerned with performance/reliability, rather than wanting to save a few extra pennies on cheaper, lower grade alternatives. Besides for ~70% of its sales, there is little serious competition anyway.

Consequently, **we believe Bulgin's margins are sustainable across the cycle**, and note they are not out of sync with other niche product OEMs (see below) at c.22% (average).

Current year (CY) EBIT margins vs divisional peers



Source: Equity Development

Granted, ardent critics could claim that margins have been bolstered by the weakness in the Tunisian Dinar. Equally, **management stripped out another £0.5m of corporate overhead** in H1 following the Queensgate sale for £0.8m (+ £0.8m earn-out). Whilst, capacity at the Tunis facility is being lifted, which should further reduce unit costs and enhance gross margins (47% vs 46% LY).

Checkit making great strides too

Likewise, although **client interest in Checkit** (H1'19 cash outflow -£1.8m) **is presently blossoming**, there is always a slim chance that ultimately it does not fulfil its true potential.

That said, the business has the financial resources to continue building on its '**first mover' advantage** in this nascent sector - where it is **aiming to become the *de facto* standard**, **competing against a host of smaller less well capitalised rivals**. Going forward, we reckon Checkit will sign a steady stream of new contracts, especially on the conclusion of several flagship pilots currently being undertaken by large national retail and fast food franchise organisations. At the other end of the scale, online meal deliverer **Just Eat will also soon begin promoting the service to its >20,000 UK partners**.

New services and territories coming thick & fast

Geographically, Checkit is encouragingly ahead of its original rollout schedule having just launched in America – a market worth a mouth-watering £1.0 billion pa vs £200k for the UK. Elsewhere there are possibilities in continental Europe (eg France & Germany), along with expansion into the UK/US hotel and facilities management verticals, valued at an estimated £400m and £300m respectively.

Scalable business offering enormous upside

Let's not forget too, that this service produces incredible amounts of useful data, which eventually can be mined to provide client benchmarking information (re continuous improvement), and 'anomalous' data sets to other 3rd parties, say for advertising purposes.

Based on our calculations, **Checkit should be able to achieve EBITDA and cashflow breakeven, somewhere around FY22** (January y/e) on turnover of circa £7m-£8m. And in light of its scalability and rapid growth trajectory, by FY25 the division could be churning out £6.5m of EBIT (23% margin) on sales of £28.1m (see below). In turn possibly **valuing it at c.100p/share**, assuming a 7-8x EV/sales multiple in 7 years' time.

Anything else from today's announcement?

Last but not least, **EET (Elektron Eye Technology) posted a 33% rise in revenues to £1.2m**, on the back of a re-energised distribution channel and the pull forward of orders by a large customer. Although H2 is not expected to be quite as strong, the division nonetheless should report FY LFL growth and lower overheads.

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
Bulgin	24.1	27.3	28.7	29.0	30.4	32.0	33.6	35.2	37.0
Checkit	0.3	0.5	1.0	2.1	4.2	7.6	12.1	18.7	28.1
EET	2.4	2.0	2.2	2.6	3.0	3.5	4.0	4.6	5.3
Turnover	**26.8**	**29.8**	**31.9**	**33.7**	**37.7**	**43.0**	**49.7**	**58.6**	**70.4**
Bulgin		*13.3%*	*5.1%*	*1.0%*	*5.0%*	*5.0%*	*5.0%*	*5.0%*	*5.0%*
Checkit		*66.7%*	*100.0%*	*110.0%*	*100.0%*	*80.0%*	*60.0%*	*55.0%*	*50.0%*
EET		*-16.7%*	*10.0%*	*20.0%*	*15.0%*	*15.0%*	*15.0%*	*15.0%*	*15.0%*
% growth		*11.2%*	*7.0%*	*5.7%*	*11.7%*	*14.2%*	*15.5%*	*18.0%*	*20.2%*
Gross Profit	**11.2**	**14.8**	**16.2**	**17.2**	**19.5**	**22.6**	**26.5**	**31.7**	**38.6**
% margin	41.8%	49.7%	50.7%	51.1%	51.8%	52.6%	53.3%	54.1%	54.8%
Bulgin	4.3	7.9	7.9	8.3	8.7	9.1	9.6	10.1	10.6
Checkit	-2.8	-2.7	-3.1	-2.1	-0.7	2.5	4.2	6.5	9.9
EET	-0.2	-0.1	0.1	0.2	0.4	0.5	0.7	0.8	1.0
Adj. EBITDA	**1.3**	**5.1**	**5.0**	**6.4**	**8.4**	**12.1**	**14.4**	**17.4**	**21.5**
Bulgin	*17.8%*	*28.9%*	*27.6%*	*28.6%*	*28.6%*	*28.6%*	*28.6%*	*28.6%*	*28.6%*
Checkit	*-933.3%*	*-540.0%*	*-305.0%*	*-100.0%*	*-15.5%*	*33.1%*	*34.4%*	*34.7%*	*35.1%*
EET	*-8.3%*	*-5.0%*	*5.0%*	*9.2%*	*11.9%*	*14.2%*	*16.3%*	*18.1%*	*19.6%*
% EBITDA margin	***4.9%***	***17.1%***	***15.6%***	***19.1%***	***22.3%***	***28.2%***	***29.0%***	***29.7%***	***30.5%***
Bulgin	3.3	7.2	7.2	7.5	7.9	8.3	8.7	9.2	9.6
Checkit	-3.5	-4.4	-4.5	-3.9	-2.9	0.0	1.4	3.7	6.5
EET	-0.4	-0.3	0.0	0.1	0.2	0.3	0.5	0.6	0.8
Adj. EBIT	**-0.6**	**2.5**	**2.7**	**3.7**	**5.3**	**8.6**	**10.5**	**13.5**	**16.9**
Bulgin	*13.7%*	*26.4%*	*25.0%*	*26.0%*	*26.0%*	*26.0%*	*26.0%*	*26.0%*	*26.0%*
Checkit	*-1166.7%*	*-880.0%*	*-445.0%*	*-185.7%*	*-67.9%*	*0.1%*	*11.3%*	*19.7%*	*23.1%*
EET	*-16.7%*	*-15.0%*	*0.0%*	*4.2%*	*6.9%*	*9.2%*	*11.3%*	*13.1%*	*14.6%*
% EBIT margin	***-2.2%***	***8.4%***	***8.5%***	***11.1%***	***14.0%***	***20.1%***	***21.2%***	***23.0%***	***24.0%***
Adj. Profit before Tax	**-0.6**	**2.6**	**2.7**	**3.7**	**5.3**	**8.6**	**10.5**	**13.5**	**16.9**
Adjusted EPS (p)	**-0.1**	**1.1**	**1.2**	**1.6**	**2.2**	**3.6**	**4.4**	**5.5**	**6.9**
EPS growth rate		*-1939.1%*	*7.8%*	*36.8%*	*40.0%*	*63.0%*	*21.5%*	*27.0%*	*25.0%*
Dividend (p)	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***1.2***	***1.5***	***1.8***	***2.3***
Yield	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*2.5%*	*3.1%*	*3.9%*	*4.9%*
Valuation benchmarks									
P/E ratio	*-809.3*	*44.0*	*40.8*	*29.8*	*21.3*	*13.1*	*10.8*	*8.5*	*6.8*
EV/Sales	*3.0*	*2.7*	*2.5*	*2.4*	*2.1*	*1.9*	*1.6*	*1.4*	*1.1*
EV/EBITDA	*62.1*	*15.8*	*16.2*	*12.5*	*9.6*	*6.6*	*5.6*	*4.6*	*3.8*
EV / EBITA	*-134.4*	*32.3*	*29.6*	*21.5*	*15.3*	*9.3*	*7.6*	*6.0*	*4.8*
Adjusted tax rate	*-83.3%*	*-26.9%*	*-21.0%*	*-21.0%*	*-21.0%*	*-21.0%*	*-21.0%*	*-21.0%*	*-21.0%*
EBITDA drop through rates		*126.7%*	*-5.5%*	*79.4%*	*50.3%*	*69.8%*	*34.2%*	*33.6%*	*34.5%*
PEG ratio		*-0.02*	*5.25*	*0.81*	*0.53*	*0.21*	*0.50*	*0.31*	*0.27*
Net cash/(debt)	**2.5**	**5.2**	**8.3**	**11.3**	**15.4**	**19.7**	**24.8**	**30.6**	**37.7**
Sharecount (Ks)	172.2	177.9	187.0	188.0	188.9	189.9	190.8	191.8	192.7
Shareprice (p)	**47.0**								

Source: Equity Development estimates, Company historic data

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.
- 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.

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