Elektron Technology plc

17th May 2018

Buy one, and get two for free

Have you ever had the pleasure of cleaning a canteen kitchen, fast-food outlet or public toilet? If so, then you'll know it's not for the squeamish. The restaurant, facilities management and medical industries are faced with this challenge millions of times each day. Balancing on the one hand, stringent health & safety, hygiene and clinical requirements with cost, employee & customer pressures on the other.

Improving operational and safety standards…

So what's the answer? Well there are no short-cuts. One has to implement a common set of standards, ensure they are meticulously followed and then continuously improve & update procedures. Granted not rocket-science, but nonetheless awfully tricky to achieve day-in, day-out. And worse still, acutely painful when things go wrong.

Indeed it has been estimated that **annually 48m Americans suffer from food poisoning, costing $55bn in treatment, lost productivity and premature death**. The usual failure-points being human error, non-compliance and lack of knowledge. Particularly where organisations employ large and geographically disperse workforces (incl temps & free-lancers), yet rely on traditional 'pen & paper' records.

whilst saving customers time, money & resource

Enter specialist engineer Elektron Technology (AIM:EKT) who, following a Google-esque moment of genius, created its proprietary SaaS based **Checkit** service. Recognising that by **digitising the entire process of performing routine tasks**, it could deliver substantial benefits in terms of efficiency, customer service, repeatability, transparency, operational management, safety and regulatory compliance. No wonder a **clutch of top-brands** (see below) **have already signed up**.

Household names benefiting from Checkit

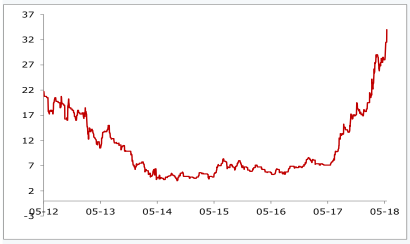
Source: Company

In fact 281 in all, who together run 378 sites, **taking 35m measurements per month,** and now generate **>£1m of annualised revenue** (vs £780k Jan'18 & £540k Jan'17).

Company Data

EPIC	**AIM: EKT**
Price (last close)	34p
52 week Hi/Lo	34p/7.5p
Market cap	£63m
ED SOTP valuation	60p/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 – is a leading supplier of field vision and macular pigment screening devices to the ophthalmic industry.

EKT employs 986 staff, of which 869 are in production and 117 sales/admin.

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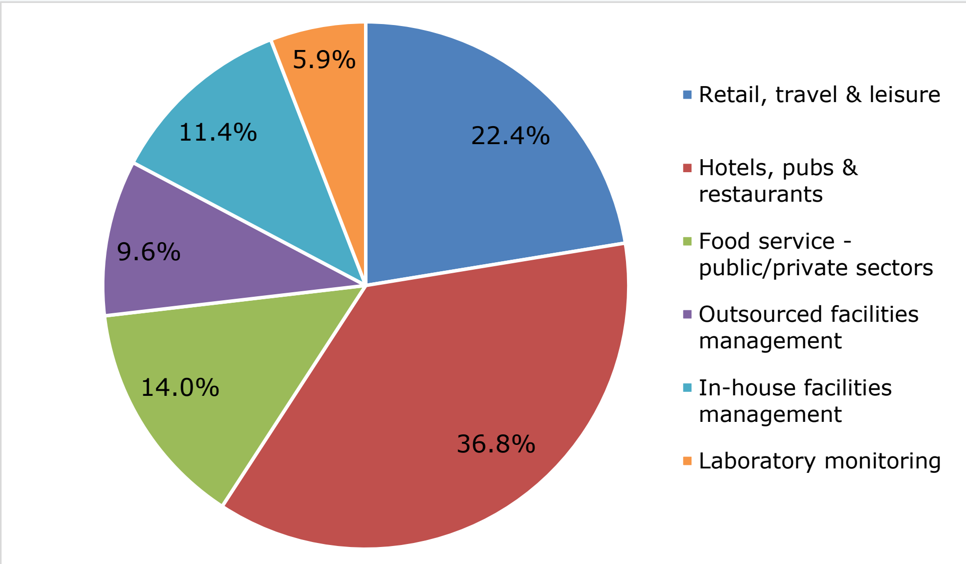
In turn, allowing **Checkit to move from startup to commercialisation mode** with a **US soft-launch slated for late 2018**, leveraging Los Angeles as an initial beach-head.

£3.5bn+ addressable market

This is not small beer either. The Board reckon **North American is worth >£1.3bn alone**, on top of the UK's £272m (see below), where ~95% of the food industry still uses pen & paper.

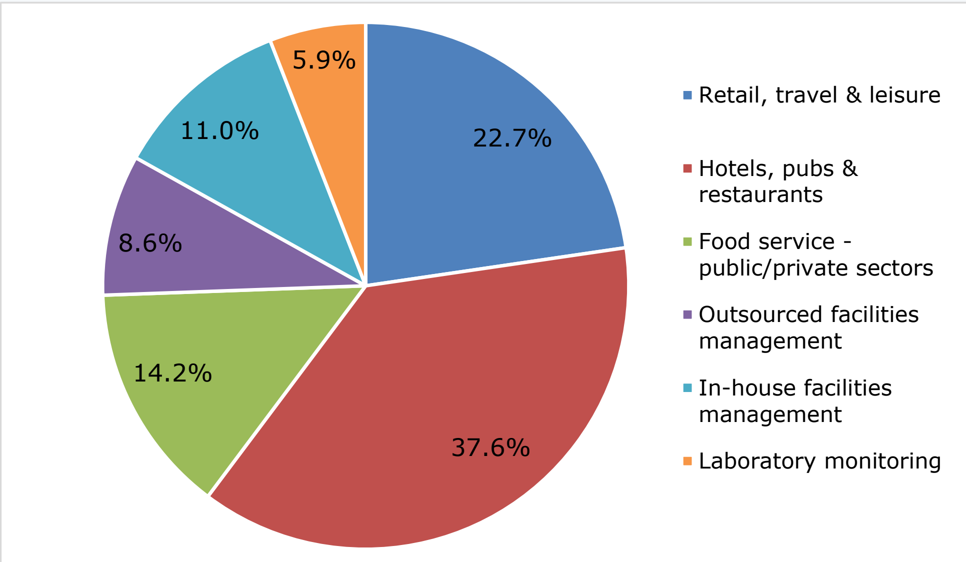
£272m UK addressable market



Source: Equity Development

Similarly, we estimate that continental Europe and the rest of the world (RoW) would add another £1bn a piece. **All told generating a >£3.5bn global addressable market** – albeit the latter two regions are longer term priorities. Elsewhere, there are thought to be numerous other verticals where Checkit could equally apply.

>£1.3bn North American opportunity



Source: Equity Development

Scalable business offering substantial upside

How much of this **untapped demand** Checkit can ultimately capture, and in what timeframe is anyone's guess. However, the early indications are promising. To date £13m has been invested developing the product, giving it a material head-start and 1st mover advantage over UK competitors like Crimson Tide (AIM:TIDE), Trail Ltd and Kelsius.

Better still, **existing users appear to like what they see** as evidenced by the **95% retention rates**. Plus new clients are coming on board thick & fast, and America is squarely in the cross-hairs. The trick of course to replicating the UK's success abroad, will be carefully selecting the right partners, supporting these launches with appropriate marketing campaigns and obtaining the necessary (customary) approvals.

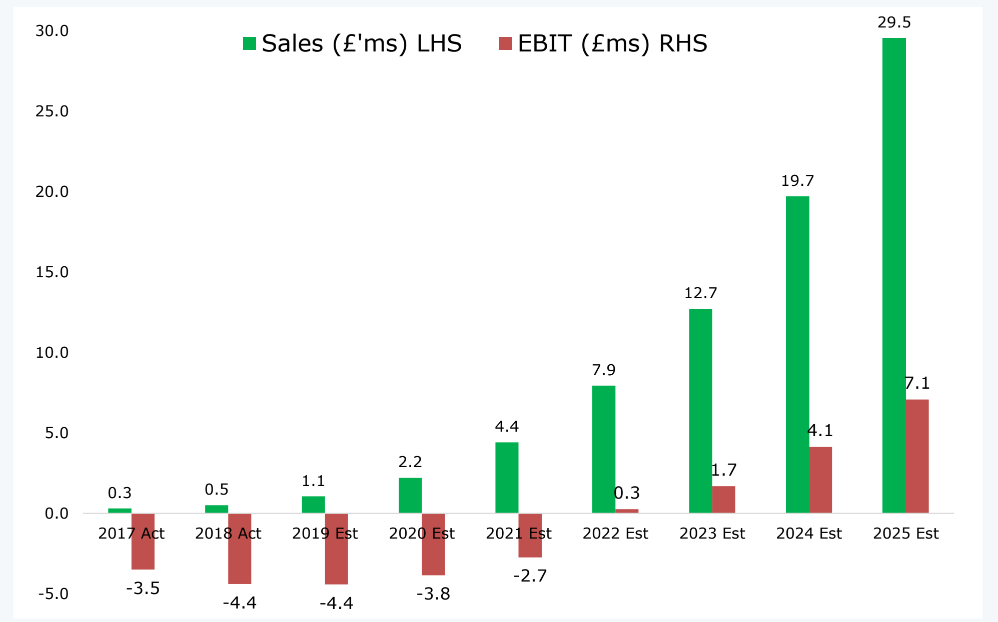
At the end of the day though, this is a **scalable business**, delivering **very high recurring revenues** and **EBITDA drop through rates** - allowing a large chunk of any incremental sales to fall directly to the bottom line. So how big could this become?

Well, it's impossible to be too precise. But based on our calculations, background research and management discussions, **Checkit should be able to achieve EBITDA and cashflow breakeven, somewhere around FY21-22** (January y/e) on turnover of circa £6m and £7m respectively.

Checkit could be worth >100p/share in 7 years' time

What's more in light of its exponential expansion, by FY25 the division could be churning out £7.1m of EBIT (24.0% margin) on sales of £29.5m (see below). And for investors, be **valued at >£200m** – equivalent to >£1/share, assuming a modest 1x PEG multiple in 7 years' time. So while acorns don't grow to the sky forever, there's nevertheless ample airspace left to more than flourish… for possibly decades ahead.

Checkit results built on SaaS



Source: Equity Development estimates, company historic data

But that's not all. Thanks to its ease-of-use, quick implementation periods and comparatively low cost vs 'value' derived, **John Lewis rolled-out the entire system across 80 of its sites in only 3 months**.

Interestingly too, the service is treated as a P&L expense, not a capital purchase. Once again allowing sales cycles to be 'relatively short', typically not >3 months from start-to-finish. Rather, the main barrier to adoption is usually internal resistance. Employees who don't want to 'rock the boat' and potentially impact jobs by computerising manual activities. That said as King Canute discovered, it's impossible to stop the tide coming in. In fact the decision might even be taken out of their hands, **since the authorities are cottoning on fast**.

UK Food Standard Authority gives thumbs up

In March 2018, after being put through its paces in Cambridge, Nina Purcell (Director of the Foods Standards Authority's (FSA) 2020 Regulating Our Future (ROF) programme) commented:

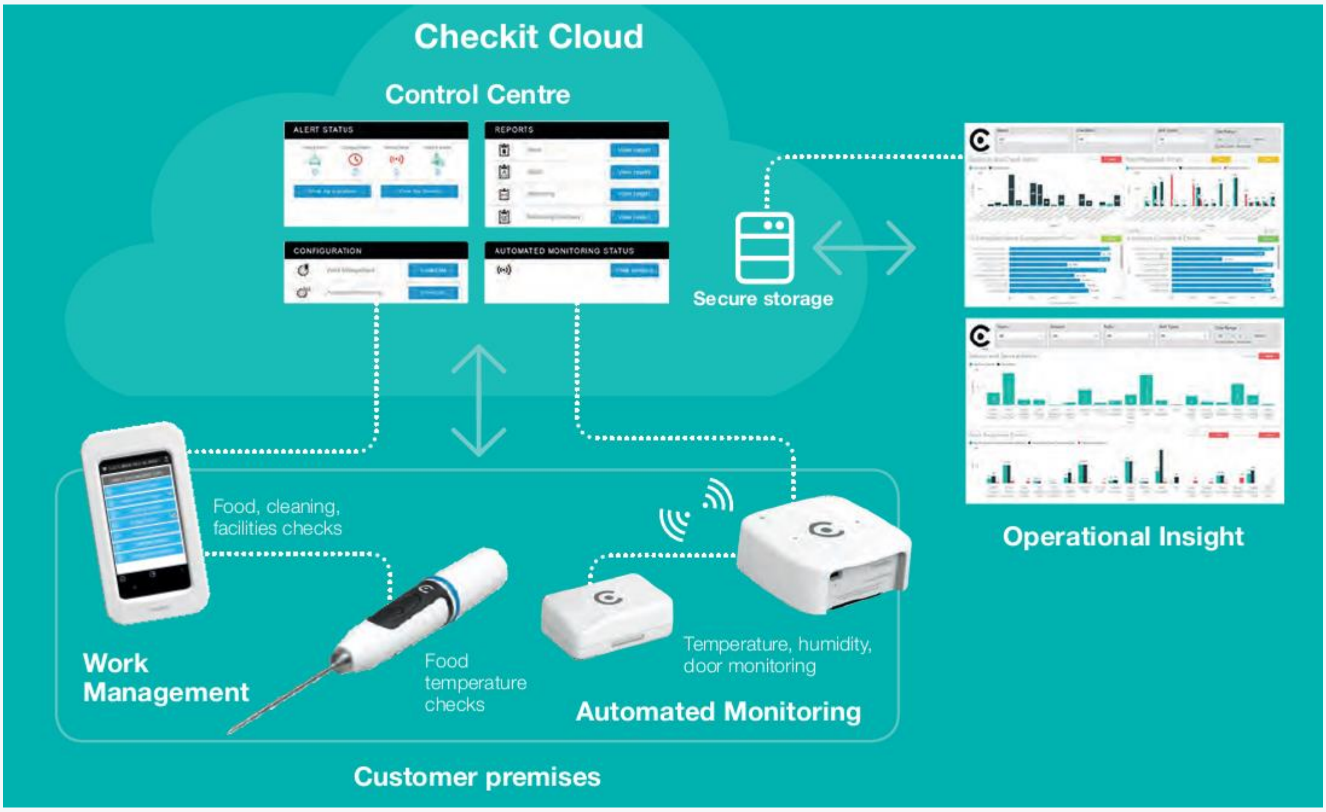
"*The **businesses involved liked this type of technology,** and **found it more efficient than the current paper-based system**. Our colleagues at Cambridge Council found that having the data was useful, as it helped them form a view of how well the company was managed and keep a better track between inspections. **We are currently redesigning the whole system for regulating food** [in the UK], **and envisage new technology as being integral to that***."

Ok, but how does Checkit work?

In its purest form, **this real-time operations management platform** (see below) **can automate any routine task**. At the touch of a button, replacing traditional paper checklists - think A4 sheets stuck on walls - and manual collating, with smart apps, temperature readings, wireless sensors and data analytics. Tests are recorded using a mobile handset, and the results transferred to the cloud. Approved users are able access the information remotely, receive alerts on anomalies and interrogate dashboards to track performance.

Moreover at its core is a sophisticated workflow and Internet of Things (IoT) engine that in the future, when combined with Artificial Intelligence (AI) has the **potential to create an 'autonomous & self-learning' system** across a much wider industry base.

Widespread applicability to industries with large manual workforces



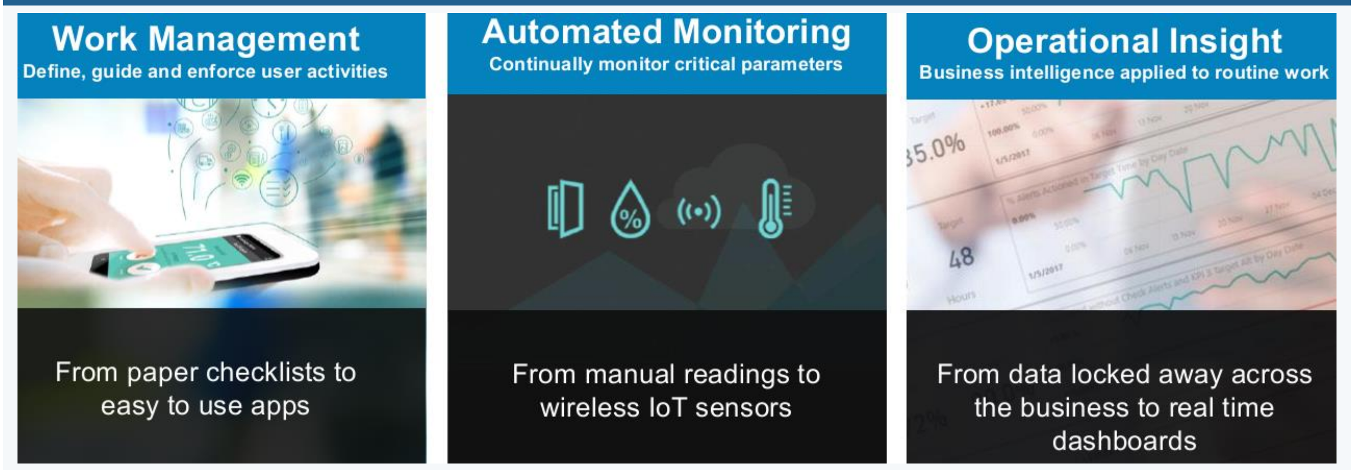
Source: Company

Greater data analytics, IoT and AI functionality coming

Looking ahead, its R&D roadmap includes many cutting-edge features, not least a new Android App, allied to more Internet of Things (IoT), big data and business intelligence functionality. Helping clients to enhance their processes, say by benchmarking sites against each other, sector best practise and/or adjacent markets.

As such, **management believe Checkit is presently the most advanced service of its kind, anywhere in the world**. Providing top-to-bottom transparency, ensuring regulatory compliance, improving productivity and freeing-up time for customer/revenue facing initiatives. Importantly too, **at a price point that delivers substantial value to the client**.

Checkit's three complementary modules

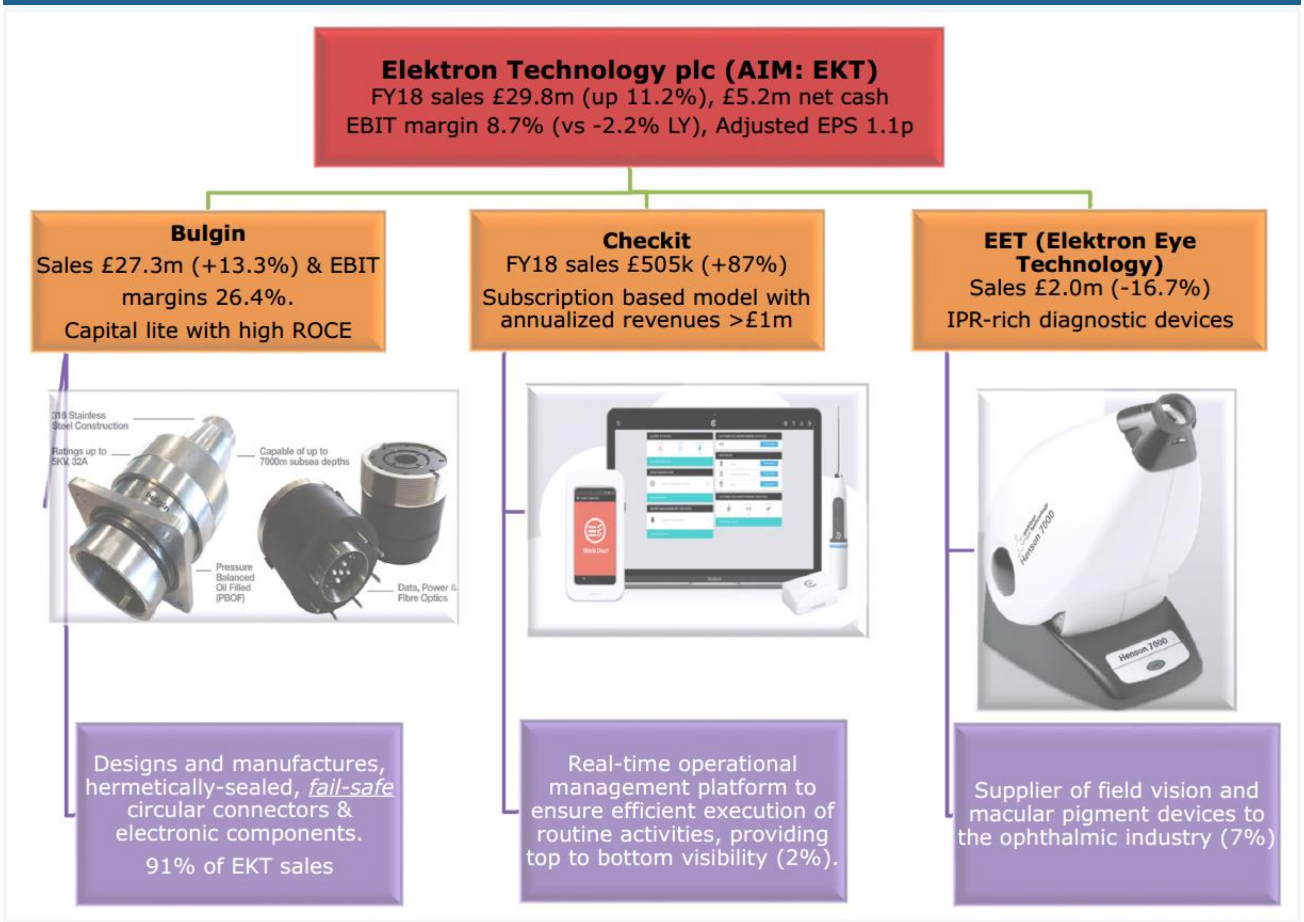


Source: Company

Three quality businesses for the price of one

The beauty for investors in terms of valuation, is that at 34p we think **Checkit is effectively given away in EKT's stock price 'for free'**. You see, the vast bulk (91% FY18) of group turnover and all the profits/cash, is generated by **Bulgin** (see below).

Three standalone divisions each underpinned by one centre of engineering excellence



Source : Equity Development, Company

Bulgin underpins EKT's shareprice on its own

This unit is **a world-class designer/manufacturer of hermetically-sealed** (ie air/water-tight), ***fail-safe*** **circular connectors** (see below), 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).

Focusing on higher value niche products (circa 70% of FY18 sales at £27.3m)

Source: Company

Here, along with separately shedding 9 non-core units since 2010, Bulgin has undergone a **dramatic transformation** involving copious amounts of elbow-grease over the past 5 years. Surgically streamlining the supply chain, eliminating waste, inefficiencies & duplication, concentrating on higher profit products, reducing the number of SKUs and aggressively incentivising the reseller base.

Hats off to management for exemplary turnaround

In aggregate **boosting EBIT margins from 5.4% in FY13 to 26.4% in FY18**, without unduly impacting the top line, since greater average selling prices and order sizes have more than compensated. Instead, turnover actually climbed 13% (11% constant currency) to £27.3m last year, boosted by record demand (1.07x Book:Bill) and £29.3m of bookings, as the benefit of distributor (87% of revenues vs 13% direct) incentives and new products kicked in.

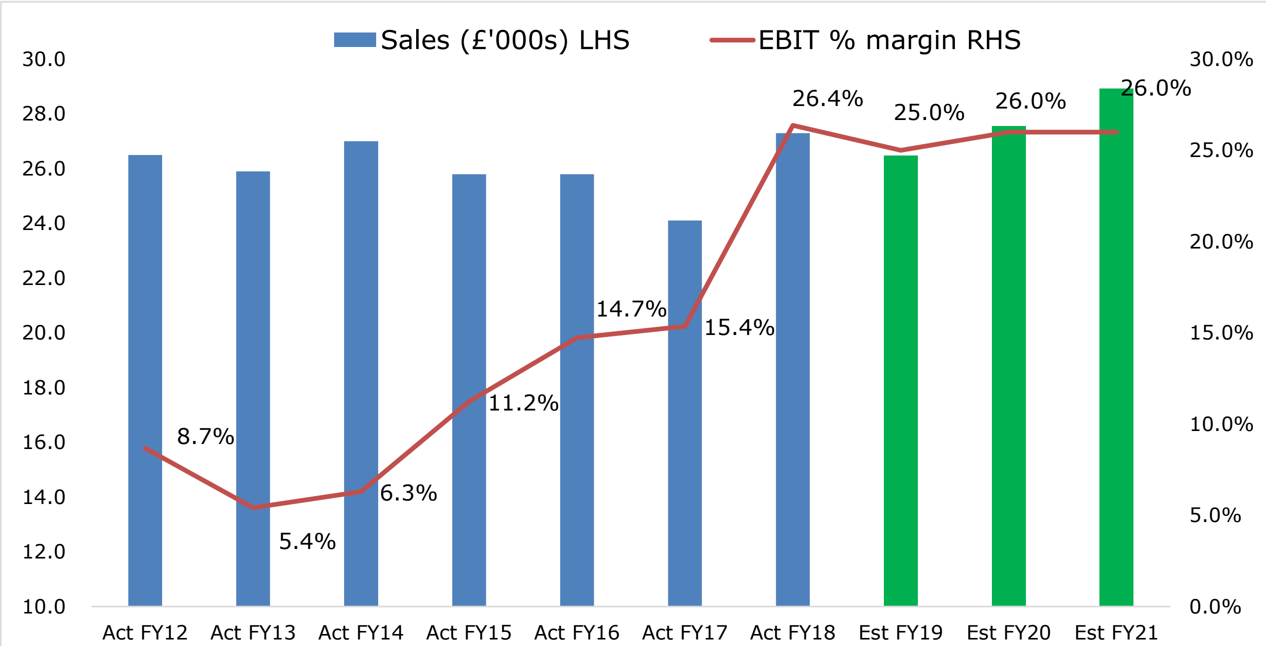
Channel partners are also required to report real-time point of sale (POS) data and inventory levels – not only enhancing visibility, stock-turns & ROCE, but also reducing capex and delivery times.

Orderbook at record levels

The recently announced contract with Arrow Electronics, the world's largest electronic component distributor, further reinforces this trend, which encouragingly continued in Q1'19. Albeit management did caution at the prelims on 3rd May, of a possibly softer H2 (Re 3 months' visibility), reflecting macro uncertainty and the impact of Trump's 'US 1st' trade policies.

Nonetheless, thereafter LFL growth should settle down into the mid-single digit range (circa 1.5x GDP), spurred on by increasing demand for ubiquitous power & data.

Bulgin EBIT margin and top line growth projections



Source: Company

Elsewhere, Bulgin possesses a low cost manufacturing facility in Tunisia (650 employees + >100 temps providing volume flexibility) complemented by a smaller UK site in West Molesey (30 staff). In April it launched its first rewireable fibre connector, with 10 new products slated for this year, expanding the division's already substantial £16bn addressable market.

How sustainable are the profit margins?

The key question being - can the 26% EBIT margins be maintained? For us, investors need to put themselves in the position of an end-customer, of which there are >80,000 worldwide.

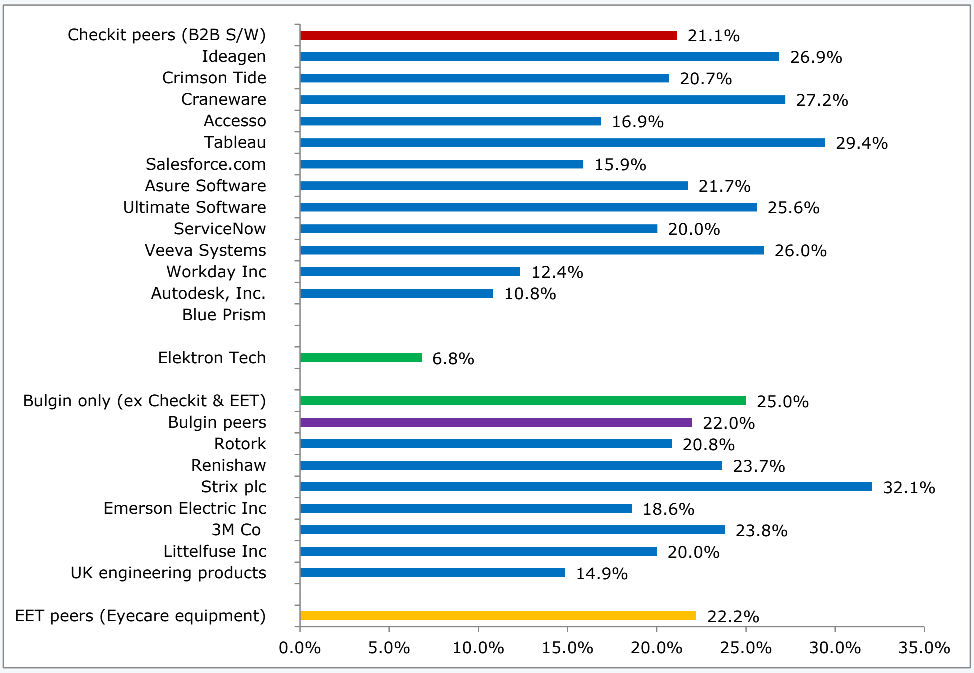
Typically Bulgin's premium 'fail-safe' connectors cost only a few dollars each, but are often a critical link in powering much bigger and perhaps mission-critical applications. If they were ever to fail, then it might cause untold disruption through a sudden loss of electricity or data traffic. In that 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, low grade alternatives. Besides for ~70% of its sales, there is little serious competition anyway.

Bulgin is a well-oiled machine

Meaning that to us, **its margins appear realistic across the cycle**, and are neither out of kilter with other OEMs of similarly niche goods (see below). Sure one could quibble that ~2% of last year's 12.7% margin uplift came from the 20% devaluation in the Tunisian Dinar - yet equally management are confident of stripping out more overhead in line with future economies of scale.

In relation to competitors, this tends to come in the form of bigger organisations (eg TE Connectivity, Amphenol Corp, Esterline Connection, Samtec, Switchcraft, Molex, etc) who service large volume customers directly.

Current year (CY) EBIT margins vs divisional peers



Source: Equity Development, consensus, corporate websites

Last but not least, we arrive at **EET (Elektron Eye Technology)**, a leading supplier of field vision and macular pigment screeners to the ophthalmic industry.

EET (Elektron Eye Technology)

Like Checkit, **we think EET is today being effectively being valued at zero when compared to EKT's market cap**. Its two main therapeutic areas (see below) being the early detection of Glaucoma (Henson: central/right images) and 'age-related macular degeneration (AMD, MPSII on left) in patients. **It is estimated that by 2020 there will be 196m AMD and 80m glaucoma sufferers worldwide**.

Key products

Source: Company

The Henson brand (70% of EET) is the UK leader (~50% share), supplying the likes of Specsavers, Boots & Vision Express, with the aim to repeat this success overseas, where there is a £35m worldwide opportunity. Key competitors include German firm Carl Zeiss and Switzerland's Haag-Streit.

The MPS II on the other hand is less established, but has a >£100m runway ahead of it. Additionally it is the only commercially viable device of its type available, and can be used as a tool for the sale of lucrative vitamin supplements and blue light filtering lenses.

All the same, last year was a transitional period for EET, with sales dipping 16.7% to £2.0m as a major US MPS II distributor was swapped out, along with the appointment of new management.

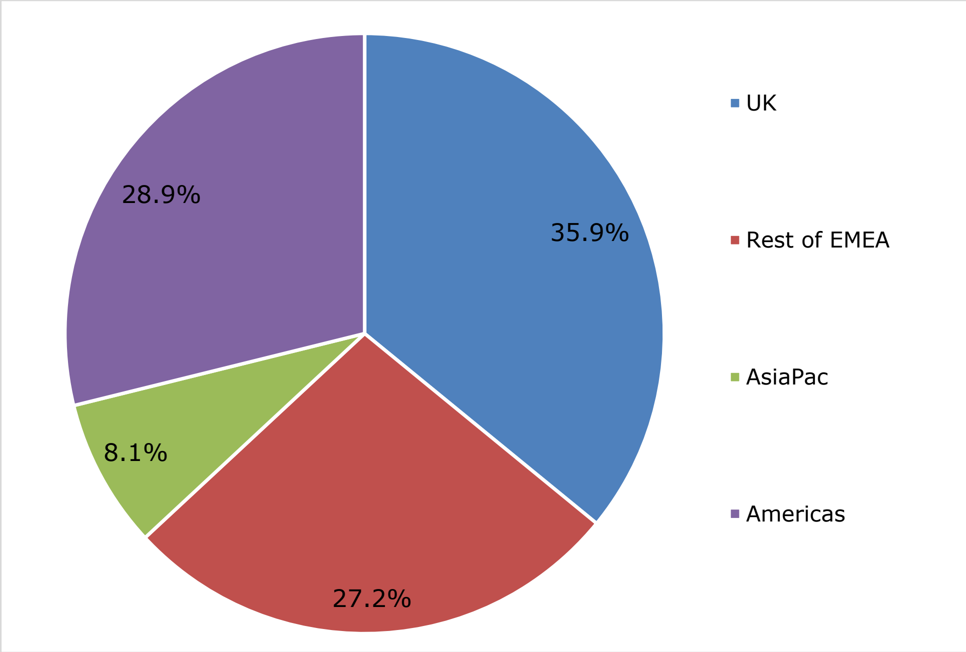
The good news is that the **turn-around is beginning to bear fruit**, with a "strong closing" orderbook (re Henson) at yearend, backed up by **Q1'19 being "significantly ahead" of last year**. There are also attractive opportunities to expand distribution internationally, particularly in the US and China, where registrations/approvals are already underway. Hence reinforcing EET's strategic worth to EKT, since regardless of being loss-making and sub-scale (<40% capacity utilised), this **fledgling division has the potential to grow at a 15% pa clip for the foreseeable future** without the need for significant capital investment.

So where does this all leave us?

In relation to our overall forecasts, **we're arguably being too conservative** in light of the record opening Bulgin orderbook, sharp rebound enjoyed at EET and the momentum building at Checkit.

Nevertheless, it is better to be safe than sorry, particularly as visibility at Bulgin & EET is only 3 months and 8 weeks respectively - and the EU/US economies experienced a slightly softer Q1 than anticipated, partly down to weather related issues. As a result for FY19 (see below), **we're prudently predicting flattish revenues of £29.6m, and a reduced PBT of £2.0m** (vs £2.6 LY) due to lower Bulgin volumes and ongoing investments at Checkit (eg North America).

Geographical turnover split for FY18 (£29.8m)



Source: Equity Development, Company

The group will still be profitable though, with Bulgin providing all the necessary capital to fund the other two divisions, and **FY19 net cash closing at a comfortable £8.2m** (vs £5.2m in January 2018). **Despite absorbing another period of heavy product development** (10% sales, or £3.2m vs £2.9m LY), of which ~1/3rd is anticipated to be capitalised (£1.1m LY vs £2.2m amortisation), mostly relating to Checkit (£0.7m LY). In addition as Checkit scales, its cash-burn (£3.4m LY) should eventually decline, mirroring positive operating leverage and high gross margins.

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	26.5	27.5	28.9	30.4	31.9	33.5	35.1
Checkit	0.3	0.5	1.1	2.2	4.4	7.9	12.7	19.7	29.5
EET	2.4	2.0	2.1	2.5	2.9	3.3	3.8	4.4	5.1
Turnover	**26.8**	**29.8**	**29.6**	**32.3**	**36.2**	**41.6**	**48.4**	**57.6**	**69.7**
Bulgin		*13.3%*	*-3.0%*	*4.0%*	*5.0%*	*5.0%*	*5.0%*	*5.0%*	*5.0%*
Checkit		*66.7%*	*110.0%*	*110.0%*	*100.0%*	*80.0%*	*60.0%*	*55.0%*	*50.0%*
EET		*-16.7%*	*5.0%*	*20.0%*	*15.0%*	*15.0%*	*15.0%*	*15.0%*	*15.0%*
% growth		*11.2%*	*-0.6%*	*8.9%*	*12.3%*	*14.9%*	*16.3%*	*18.9%*	*21.2%*
Gross Profit	**11.2**	**14.8**	**15.0**	**16.5**	**18.8**	**21.9**	**25.8**	**31.1**	**38.2**
% margin	41.8%	49.7%	50.7%	51.1%	51.8%	52.6%	53.3%	54.1%	54.8%
Bulgin	4.3	7.9	7.3	7.9	8.3	8.7	9.1	9.6	10.1
Checkit	-2.8	-2.7	-2.6	-1.8	-0.4	2.8	4.5	7.1	10.6
EET	-0.2	-0.1	-0.1	0.1	0.2	0.3	0.4	0.6	0.8
Adj. EBITDA	**1.3**	**5.1**	**4.6**	**6.1**	**8.0**	**11.7**	**14.1**	**17.3**	**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%*	*-250.0%*	*-83.8%*	*-10.1%*	*34.7%*	*35.3%*	*36.0%*	*36.0%*
EET	*-8.3%*	*-5.0%*	*-3.3%*	*2.2%*	*5.8%*	*9.0%*	*11.7%*	*14.1%*	*16.2%*
% EBITDA margin	***4.9%***	***17.1%***	***15.6%***	***18.9%***	***22.1%***	***28.2%***	***29.0%***	***30.0%***	***30.8%***
Bulgin	3.3	7.2	6.6	7.2	7.5	7.9	8.3	8.7	9.1
Checkit	-3.5	-4.4	-4.4	-3.8	-2.7	0.3	1.7	4.1	7.1
EET	-0.4	-0.2	-0.2	-0.1	0.0	0.1	0.3	0.4	0.6
Adj. EBIT	**-0.6**	**2.6**	**2.0**	**3.2**	**4.8**	**8.3**	**10.2**	**13.2**	**16.8**
Bulgin	*13.7%*	*26.4%*	*25.0%*	*26.0%*	*26.0%*	*26.0%*	*26.0%*	*26.0%*	*26.0%*
Checkit	*-1166.7%*	*-880.0%*	*-421.4%*	*-174.5%*	*-62.2%*	*3.2%*	*13.2%*	*21.0%*	*24.0%*
EET	*-16.7%*	*-10.0%*	*-8.3%*	*-2.8%*	*0.8%*	*4.0%*	*6.7%*	*9.1%*	*11.2%*
% EBIT margin	***-2.2%***	***8.7%***	***6.8%***	***10.1%***	***13.2%***	***19.9%***	***21.1%***	***23.0%***	***24.1%***
Adj. Profit before Tax	**-0.6**	**2.7**	**2.0**	**3.2**	**4.8**	**8.3**	**10.2**	**13.2**	**16.8**
Adjusted EPS (p)	**-0.1**	**1.1**	**0.9**	**1.4**	**2.0**	**3.4**	**4.2**	**5.5**	**6.9**
EPS growth rate		*-1939.1%*	*-20.1%*	*59.7%*	*47.2%*	*71.7%*	*22.9%*	*28.7%*	*26.2%*
Dividend (p)	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***1.1***	***1.4***	***1.8***	***2.3***
Yield	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*3.4%*	*4.2%*	*5.3%*	*6.7%*
Valuation benchmarks									
P/E ratio	*-585.5*	*31.8*	*39.8*	*24.9*	*16.9*	*9.9*	*8.0*	*6.2*	*4.9*
EV/Sales	*2.2*	*1.9*	*2.0*	*1.8*	*1.6*	*1.4*	*1.2*	*1.0*	*0.8*
EV/EBITDA	*44.7*	*11.4*	*12.6*	*9.5*	*7.3*	*4.9*	*4.1*	*3.4*	*2.7*
EV / EBITA	*-96.8*	*22.3*	*28.7*	*17.9*	*12.1*	*7.0*	*5.7*	*4.4*	*3.5*
Adjusted tax rate	*-83.3%*	*-29.6%*	*-21.0%*	*-21.0%*	*-21.0%*	*-21.0%*	*-21.0%*	*-21.0%*	*-21.0%*
EBITDA drop through rates		*126.7%*	*283.3%*	*55.9%*	*48.2%*	*69.2%*	*34.1%*	*35.2%*	*34.7%*
PEG ratio		*-0.02*	*-1.98*	*0.42*	*0.36*	*0.14*	*0.35*	*0.22*	*0.19*
Net cash/(debt)	**2.5**	**5.2**	**8.2**	**11.2**	**15.5**	**20.2**	**25.9**	**32.5**	**40.7**
Sharecount (Ks)	172.2	177.9	187.0	188.0	188.9	189.9	190.8	191.8	192.7
Shareprice (p)	**34.0**								

Source: Equity Development estimates, Company historic data

Strong start to FY19, but cautious about H2

CEO John Wilson commenting on 3rd May: "*Bulgin experienced record demand in FY18, more than doubling operating profit. **Checkit is building momentum with annualised recurring revenue recently exceeding £1m, and EET has been restructured with a distribution led focus, and early signs are encouraging**.*

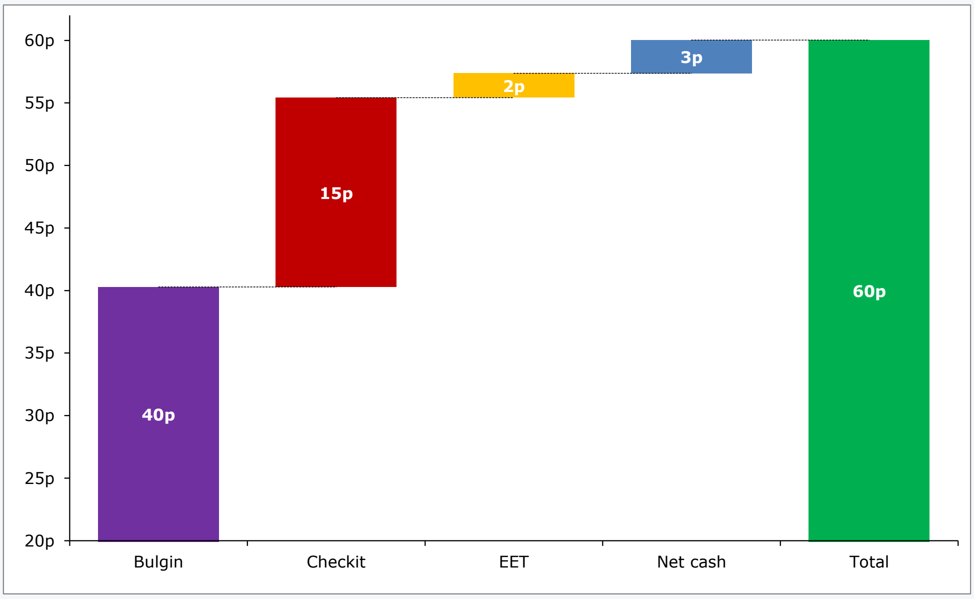
*Following record H2'18 sales, **Bulgin is expected to remain resilient as the current order book will translate to a strong H1**. However, the Board's visibility does not extend beyond H1 and is cautious around the potential global economic uncertainty in H2. Both Checkit and EET are currently showing encouraging increases in their business over prior year.*

The Board will continue to ensure that a proper balance is struck between the cash generated by Bulgin and that absorbed by the continuing investment in Checkit."

What about the valuation?

Bearing all this in mind, and employing a range of sector multiples, **our SOTP analysis (see below) indicates that Elektron is worth 60p/share** – split: 40p Bulgin, 15p Checkit, 2p EET and 3p net cash.

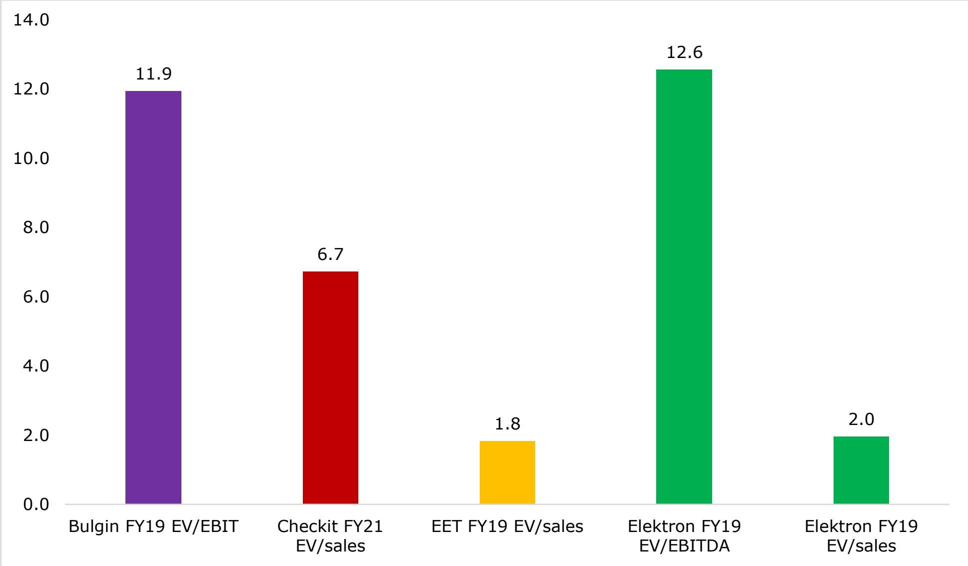
Sum of the parts valuation (pence)



Source: Equity Development

What's more if one assumes Checkit delivers anywhere near its true potential, EET engineers a turnaround, and Bulgin continues to expand at better than GDP rates, then even at 60p, the below implied multiples will, in our view, look extremely cheap in a couple of years.

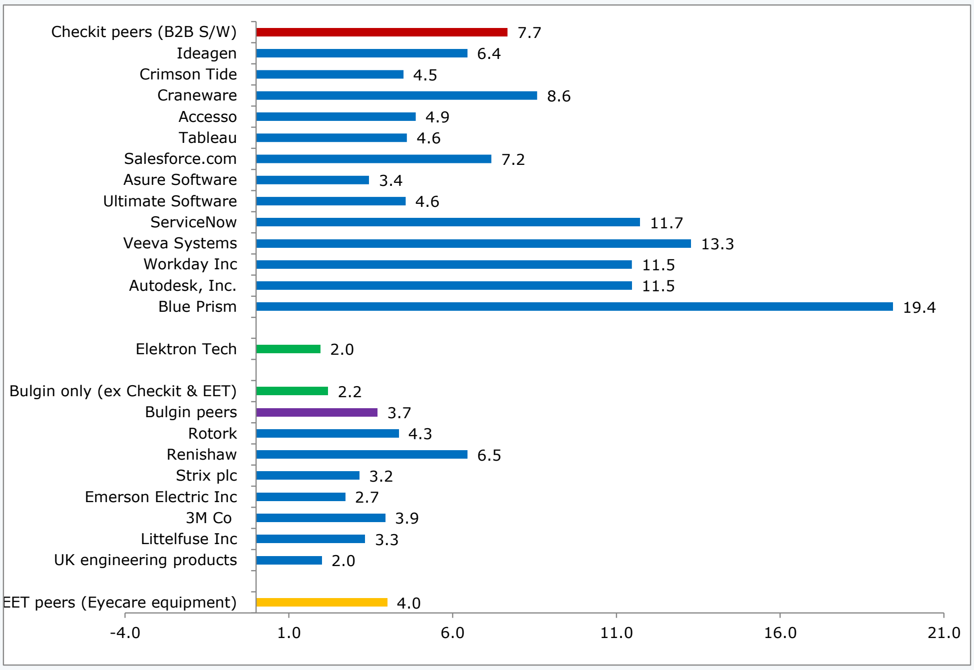
Implied divisional multiples at 60p/share SOTP valuation



Source: Equity Development

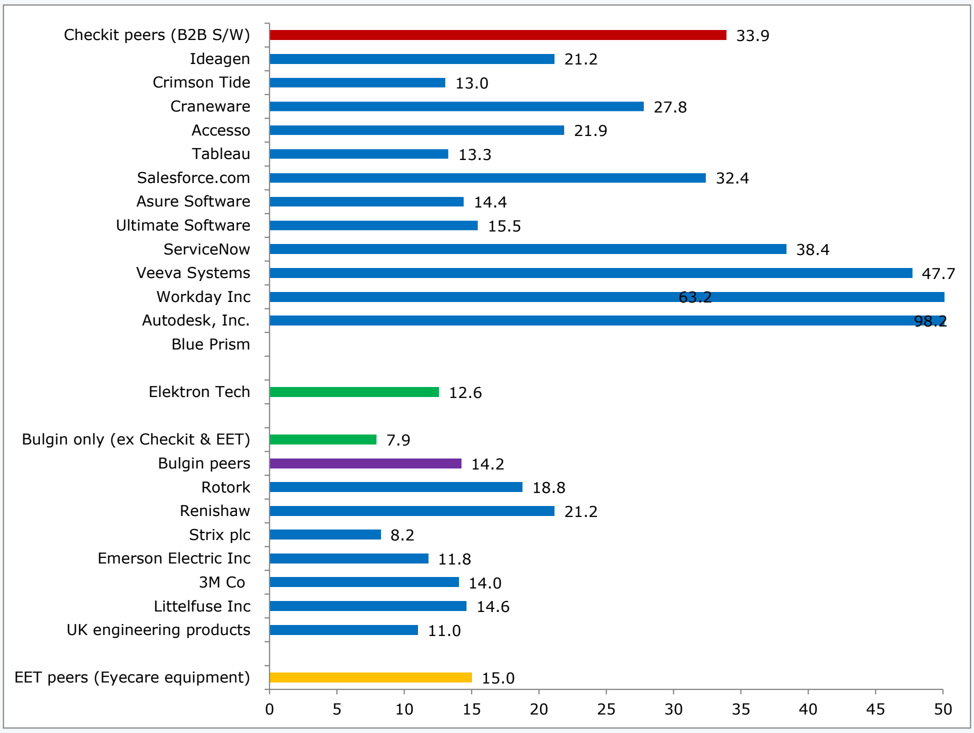
Especially when compared to today's 34p shareprice, representing a considerable discount to peers on most valuation metrics (see below).

CY EV/sales vs peers



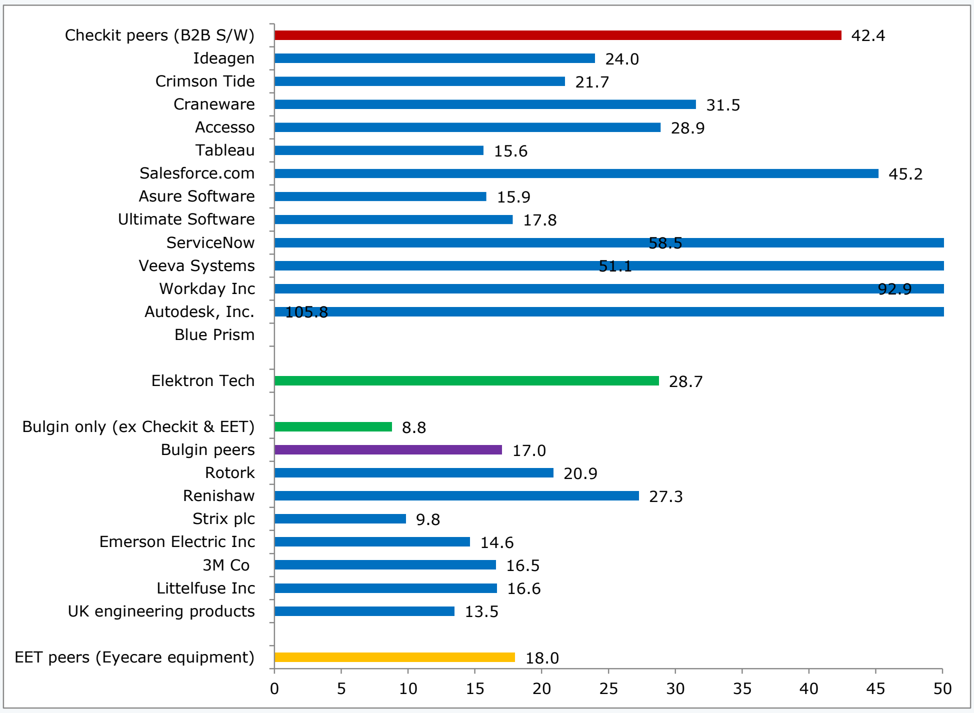
Source: Equity Development, corporate sites – closing prices as at 16th May 2018

CY EV/EBITDA vs peers



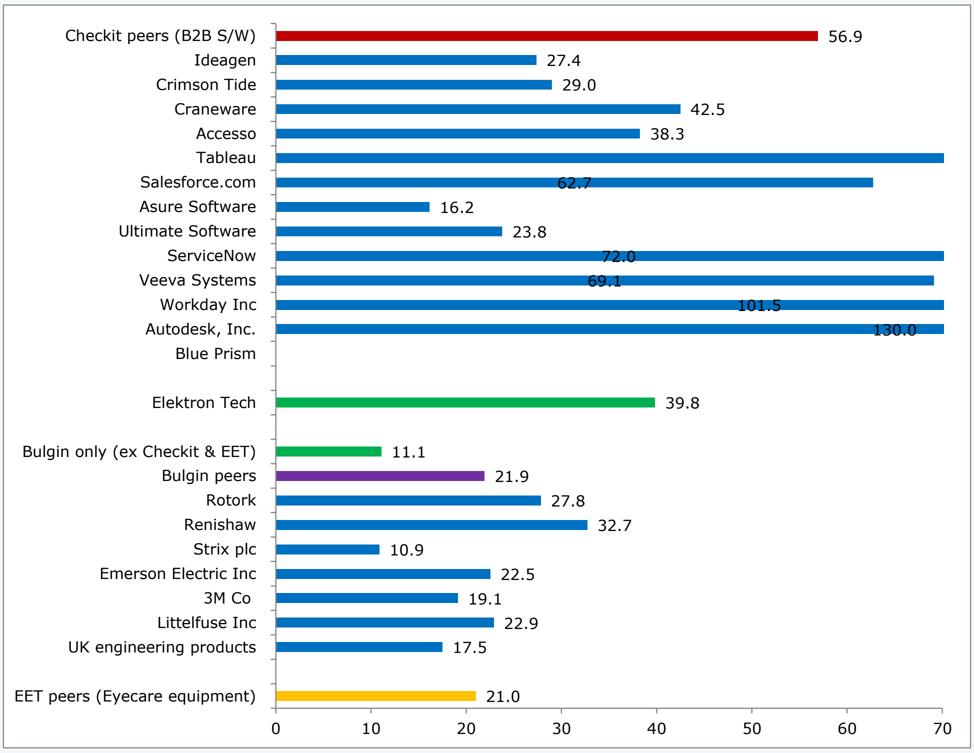
Source: Equity Development, corporate sites – closing prices as at 16th May 2018

CY EV/EBIT vs peers



Source: Equity Development – closing prices as at 16th May 2018

CY PERs vs peers



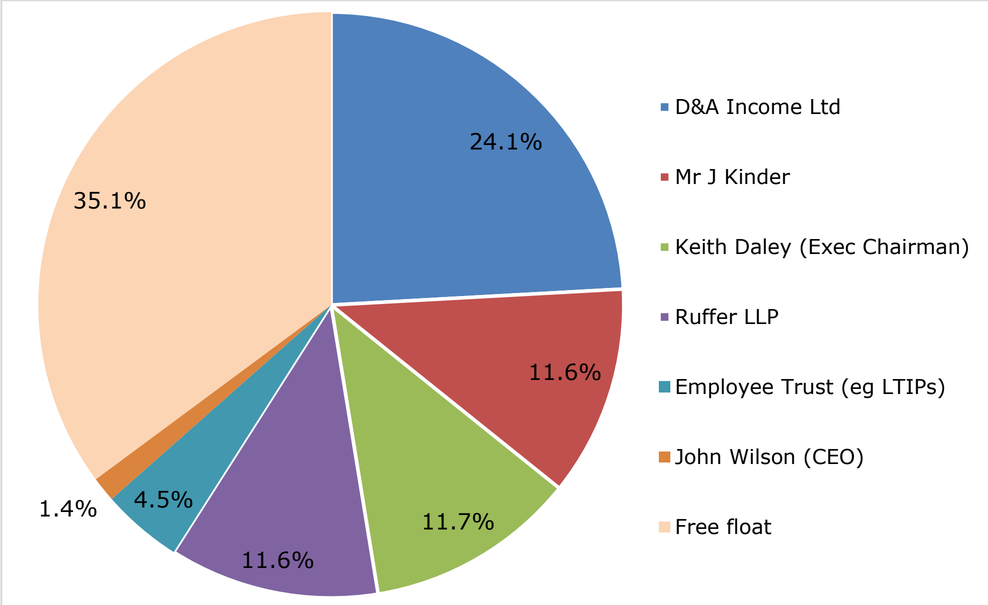
Source: Equity Development, corporate sites – closing prices as at 16th May 2018

Management have plenty of skin in the game

Finally, shifting gears to the ownership structure, investors should be able to infer a fair degree of reassurance from EKT's register, which is populated by insiders, augmented by a couple of respected fund managers (see below).

So, while the shares have undoubtedly moved a long way over the past 12 months, **we still believe there is material potential upside to our valuation level for risk-tolerant investors**. Moreover, while the Board's focus remains locked on organic growth, there are nonetheless M&A possibilities at Bulgin. For example, to acquire complementary products/IPR that can be leveraged within the division's finely-tuned distribution network.

Key stockholders (186.1m shares in issue)



Source : Company website

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.
- 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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