

Big game hunting

28th January 2019

The healthcare industry has reached a seminal point. Faced with ageing populations, soaring demand and intense political pressure to improve patient outcomes, governments have realised that the only way to cope is to embrace 'revolutionary' new technologies. Not just those which deliver incremental improvements, but real 'step changes' that generate far superior results from much less resource. Focusing for instance on prevention rather than cure, where there is typically more bang for the buck.

To us, this strategic shift is a 'no-brainer', and next generation medical imaging equipment powered by CZT fits the bill. **Accelerating the diagnosis & treatment of some of the world's most common, yet serious conditions** - such as cancer, heart disease, dementia, diabetes & osteoporosis. Fine, but when will these machines become available in hospitals?

Pivotal moment for KMK & medical imaging sector

Well, hopefully pretty soon. This morning **Kromek announced that it had been awarded a 'ground-breaking' \$58.1m (minimum) 7 years contract** to supply its patented CZT detectors to a leading medical imaging device manufacturer (and existing client) with 1st revenues expected to commence in FY20.

This watershed agreement is significant on numerous counts. Firstly, along with its unique D3S 'dirty bomb detector', **KMK now has a 2nd monster 'home-run' to bolster its near-term pipeline.**

Next, given this OEM has decided to invest heavily CZT, then today's news removes any lingering doubt (if there was any) concerning the magnitude of the opportunity. In fact, this **secular upgrade cycle** is likely to drive KMK's growth over not just months & years, but probably decades too.

New 'normal' could trigger torrent of CZT orders

Better still, the RNS could potentially set the stage for a **mini 'gold rush'** across the industry. **In one fell swoop, shifting the technology goal-posts and positioning KMK as the front-runner** to sell its patented CZT detectors to other medical imaging OEMs. Organisations with whom we suspect discussions are already underway.

Moreover, Kromek is probably the only independent, end-to-end producer with the required design, engineering and technological skills to produce sufficient commercial grade quantities of CZT, in the desired timeframes and price levels. A key reason why the firm already sports a coveted roster of 11 healthcare clients - across SPECT (est. \$110m pa market), bone mineral densitometry (worth \$30m/p.a.) and gamma probes (used for radio-guided surgery). And where we think it is quickly becoming **the de facto standard.**

Company Data

| EPIC | AIM:KMK |
|--------------------|---------|
| Price (last close) | 28p |
| 52 week Hi/Lo | 31p/20p |
| Market cap | £73m |
| Share count | 290.5m |
| ED value / share | 50p |

Share Price, p



Source: WebFG

Description

Kromek is pioneering digital colour imaging for x- and gamma rays, using cadmium zinc telluride (CZT) crystals. Key markets include medical imaging, homeland/security screening and nuclear detection.

Headquartered in Sedgefield (UK), Kromek has c.109 employees, of which approx. 88 are in R&D, with a 3 further sites in California, Pittsburgh and Germany. The firm has filed/registered >270 patents.

Having invested in its facilities, the company is able to manufacture >30k D3S' per year (re dirty bomb detection).

Next news: Trading update May 2019

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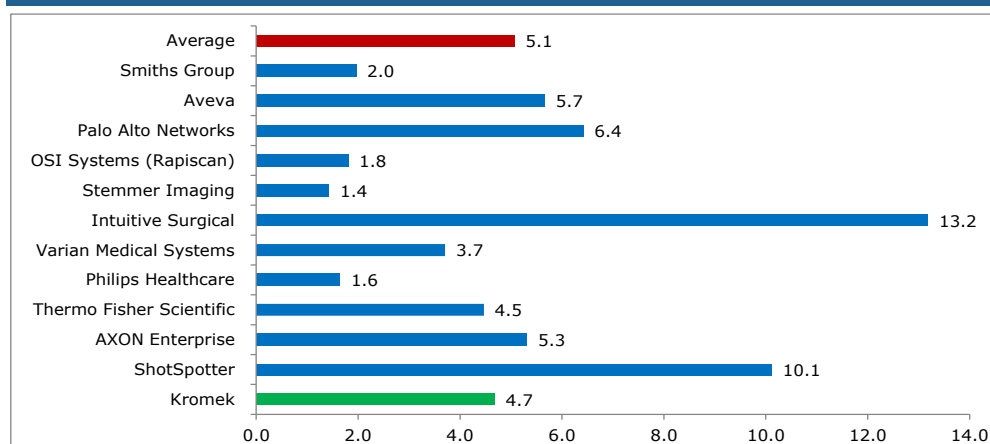
Excellent revenue cover

Finally from a risk perspective, the announcement should also decrease the notional 'discount rate' (ie equity premium) built into investor returns. Not only because **we estimate** Kromek's **backlog presently hovers at around \$100m**, but also because **future visibility has materially improved**.

Equally, despite (conservatively) not upgrading our projections for this year & next, we have **lifted the valuation to 50p/share**, reflecting the \$58.1m (minimum) contract, higher anticipated growth rates and lower risk profile. At 28p, we see **substantial upside available** for risk-tolerant investors, with the shares trading on a CY EV/turnover multiple of 4.7x (see below) - which is in line with peers, yet does not reflect **KMK's blossoming pipeline**.

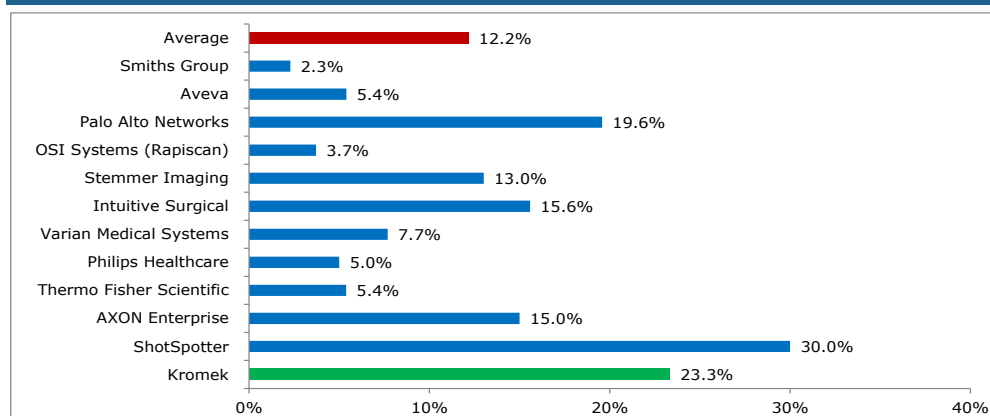
Valuation raised from 40p to 50p/share

Current year EV/sales multiple



Source: Companies. Prices as at 27th January 2019 – arithmetic average

CY + 1 sales growth %



Source: Companies. Arithmetic average

Raising the bar with regards to patient outcomes

CEO Dr Arnab Basu commenting: **"We are delighted to have been awarded this multi-year contract from an existing OEM customer, which is one of the most significant that we have secured both from a strategic and monetary perspective."**

It also the first major contract that will be delivered from our new facility in the US that has been purpose built as a world-class production site for medical imaging products.

"Building on the \$80m of contracts won over the last three fiscal years, this award strengthens and solidifies our revenue visibility and demonstrates the increasing commercial traction of our CZT detectors in our key target markets of medical imaging and nuclear detection."

Summary financial projections

| Kromek (April year end) | 2014 Act £'000s | 2015 Act £'000s | 2016 Act £'000s | 2017 Act £'000s | 2018 Act £'000s | 2019 Est £'000s | 2020 Est £'000s |
|---|----------------------------------|----------------------------------|----------------------------------|----------------------------------|----------------------------------|----------------------------------|----------------------------------|
| Product | 4,746 | 3,726 | 5,432 | 6,671 | 9,611 | | |
| Other | 1,226 | 4,375 | 2,910 | 2,297 | 2,234 | | |
| Turnover | 5,972 | 8,101 | 8,342 | 8,968 | 11,845 | 15,000 | 18,500 |
| % growth | 121.9% | 35.6% | 3.0% | 7.5% | 32.1% | 26.6% | 23.3% |
| Gross margin | 3,871 | 5,626 | 4,429 | 5,117 | 6,684 | 8,700 | 11,100 |
| % Margin | 64.8% | 69.4% | 53.1% | 57.1% | 56.4% | 58.0% | 60.0% |
| Adjusted EBITDA (pre SBP) | -3,007 | -1,557 | -2,376 | -1,461 | 482 | 1,649 | 3,014 |
| % Margin | -50.4% | -19.2% | -28.5% | -16.3% | 4.1% | 11.0% | 16.3% |
| Depreciation | -737 | -673 | -709 | -762 | -785 | -890 | -993 |
| Amortisation of capitalised R&D | -560 | -711 | -828 | -1,417 | -1,907 | -2,161 | -2,413 |
| Share based payments | -125 | -181 | -166 | -99 | -131 | -150 | -175 |
| Adjusted EBIT (post SBP) | -4,429 | -3,122 | -4,079 | -3,754 | -2,341 | -1,551 | -567 |
| % Margin | -74.2% | -38.5% | -48.9% | -41.9% | -19.8% | -10.3% | -3.1% |
| Underlying Interest charge | -515 | -71 | -83 | -40 | -192 | -200 | -200 |
| Adj. Profit before Tax | -4,944 | -3,135 | -4,162 | -3,794 | -2,533 | -1,751 | -767 |
| Adj. Basic EPS (p) | -8.0 | -2.9 | -2.9 | -1.8 | -0.4 | -0.7 | -0.3 |
| EPS growth rate | | | -1.3% | 40.0% | 76.0% | -58.1% | 56.4% |
| <u>Valuation benchmarks</u> | | | | | | | |
| P/E ratio | | | | | | | -95.8 |
| EV/Sales | 11.8 | 8.7 | 8.4 | 7.8 | 5.9 | 4.7 | 3.8 |
| EV/EBITDA | | | | | | 42.6 | 23.3 |
| EV/EBIT | | | | | | | -123.9 |
| Effective tax rate | | | | 0.0% | 0.0% | 0.0% | 0.0% |
| PEG ratio | | | | | | | -1.7 |
| % EBITDA drop-through rate | | | | | 67.5% | 37.0% | 39.0% |
| Dividend yield | | | | | 0.0% | 0.0% | 0.0% |
| Net cash/(debt) - excl IFRS16 leases | 6,563 | 151 | 3,857 | 17,343 | 7,738 | 2,691 | 2,738 |
| Reported sharecount | 61,871 | 107,818 | 141,337 | 174,573 | 260,162 | 261,000 | 262,305 |
| Sharecount diluted | 66,951 | 114,042 | 147,586 | 178,137 | 262,768 | 264,000 | 265,305 |
| Shareprice (p) | 28.0 | | | | | | |

Source: Company historic data, Equity Development estimates. NB FY18 net cash includes £1.25m of restricted funds

Key risks

- Kromek is at a relatively early stage of its commercial development, with no absolute certainty that anticipated revenues or growth can be achieved.
- Orders tend to be lumpy in nature, and therefore by their nature difficult to forecast.
- The adoption of new break-through technology can take longer and cost more than originally thought.
- The company is executing on many fronts, and therefore it is important there is sufficient management resource to facilitate the growth.
- Scaling up production and aftermarket support to satisfy substantially higher volumes could cause teething problems.
- Protection of intellectual property, especially from patent challenges.
- Competitive pressures - albeit given Kromek's leading position in CZT, then this looks a less immediate threat.
- Customer concentration, and regulatory changes which may impact the introduction of CZT based products.
- Foreign exchange fluctuations for UK holders, given that >90% of turnover is derived from America.
- The firm is presently loss making. In the event more funding is required, then it is not certain that future capital would be available at commercial rates.



Investor Access

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