

Rare 'hi-growth disrupter' at modest price

27th June 2019

Given the S&P500 is within a whisker of all-time highs, it is virtually impossible to find undervalued, high quality, growth stocks - especially those possessing 'disruptive' technology and addressing \$bn end-markets. However we think Kromek, a leading next generation radiation detection business, is one.

Today it posted **FY19 turnover up 22.6% LFL to £14.5m** (vs £11.8m LY), alongside a **4-fold increase in EBITDA** (pre SBPs) **to £2.0m** (£0.5m). Better still momentum accelerated throughout the period, with **H2'19 EBITDA coming in at £2.5m** (margin 23.3%) **on sales of £10.8m** (£7.0m LY).

Phenomenal 2nd half performance

In fact big picture, the company is not only **signing contracts hand over fist – almost \$80m in FY19** alone, representing a **Book:Bill of >4x**. But also building a treasure trove of patents, coveted IPR and customer relationships that provide **robust forward visibility** and **powerful barriers to entry**. We believe these embedded design wins, will generate high margin income for decades ahead, particularly where \$m+ scanners tend to be in use for years.

Momentum has continued into FY20

Other notable FY19 highlights include, landing a:

- **flagship \$58.1m 7-year medical imaging order** to provide CZT detectors and associated advanced electronics.
- **ground breaking \$2.0m contract with DARPA** to develop, a vehicle-mounted biological-threat detector.
- **5-year \$7.8m deal to supply baggage screening detectors**. On top KMK's bottle scanners are installed in 55 airports across 12 countries.
- **\$2.7m expansion order** under an existing 5 year security screening agreement (now worth a minimum of \$5.8m).

Treasure chest of intellectual property rights

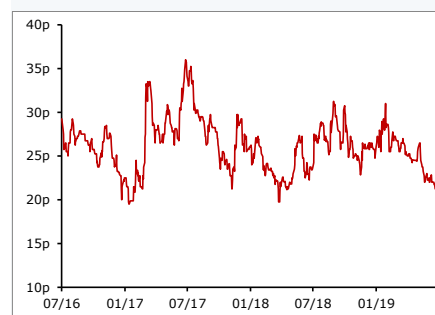
But that's not all. 11 patents were filed and a further 16 granted. Likewise **US manufacturing capacity has more than trebled**. Whilst the D3S family of handheld 'dirty bomb' detectors is being extended into additional application areas (eg US DoD), and is today deployed in c.18 countries across North America, Europe and Asia.

Ok, but how much is all this costing?

Company Data

EPIC	AIM:KMK
Price (last close)	22.0p
52 week Hi/Lo	31p/21p
Market cap	£75.8m
Share count	344.6m
Net cash Apr'19	£15.2m
Daily volume	300k
ED valuation / share	35p

Share Price, p



Source: Share Cast

Description

Kromek is a radiation detection company operating globally in three high-value markets – Medical Imaging (eg BMD, SPECT), Nuclear Detection (D3S), Security Screening (Airport baggage/bottles), primarily using cadmium zinc telluride (CZT) crystals.

Headquartered in Sedgefield (UK), Kromek has c.116 employees, of which approx. 95 are in R&D, with a 3 further sites in California, Pittsburgh and Germany. The firm has filed/registered >280 patents.

We estimate as at 27/06/19, the orderbook stands at >\$90m providing nearly 80% FY20 revenue cover - defined as orders, normal repeat business and preferred supplier positions.

Next news: AGM Sept'19

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Fortress balance sheet sporting £15.2m of net cash

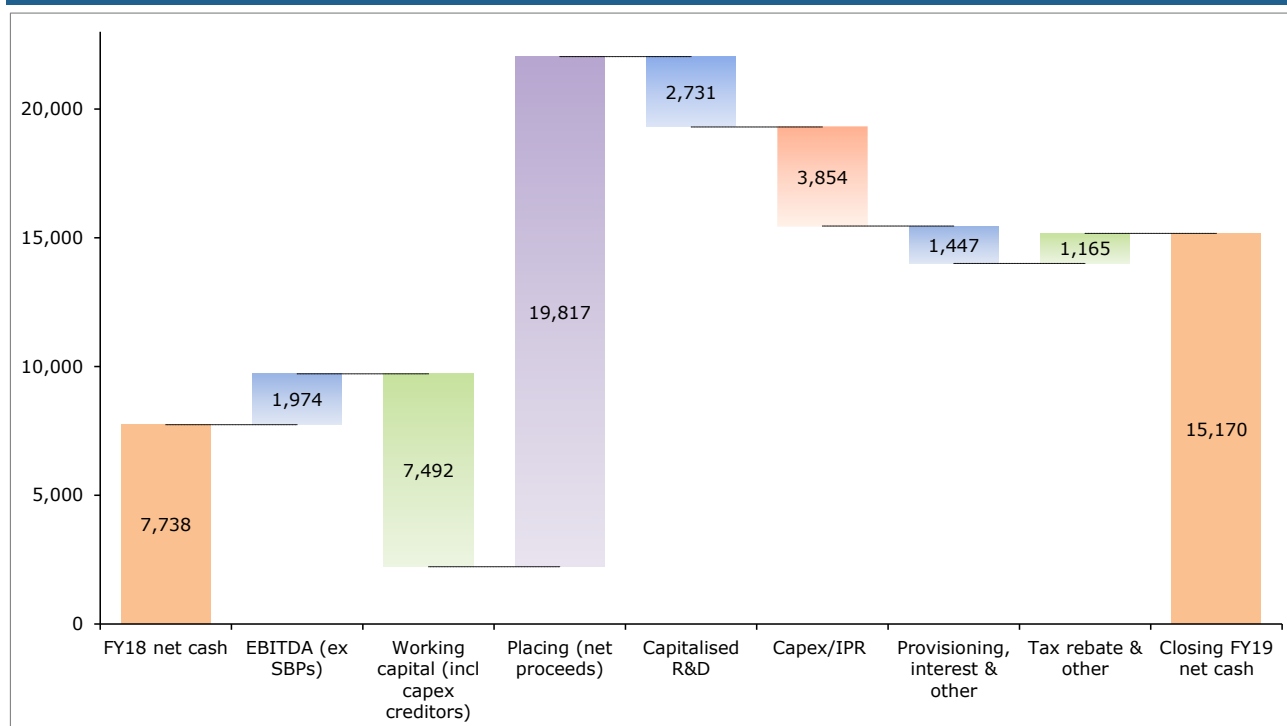
Well naturally, the **blow-out H2 results** contributed towards a temporary build-up of 'trade debtors & other receivables' at yearend – mostly attributable to 'Amounts Recoverable On Contracts' (or AROC: accounted for under IFRS15). Climbing to £20.0m as at Apr'19 vs £11.3m LY & £13.1m Oct'18.

Importantly though, **the Board anticipates these AROC products will be shipped, invoiced and converted into cash over the next 6 to 18 months**. Producing a rich source of future money for strategic expansion opportunities.

All told, **net funds closed April'19 at £15.2m** (vs £7.7m LY), after absorbing total outflows of £12.4m (excluding £19.8m of net proceeds from the Feb placing) as Kromek continues to invest in growth. The main movements being working capital (-£7.5m vs -£6.0m LY), £2.7m capitalised R&D (eg (re D3S and SPECT; -£3.5m LY), £3.9m capex/IPR (£0.9m) and provisioning/other (-£1.1m vs -£0.5m); partly offset by £1.2m (£0.9m) of tax rebates and £2.0m EBITDA (see waterfall chart below).

Encouragingly, **admin expenses and headcount rose only marginally** to £9.0m (vs £8.8m) and 116 (108) respectively, despite the 32% jump in LFL turnover and £1.8m of amortisation.

FY19 cashflow movements (£'000s)

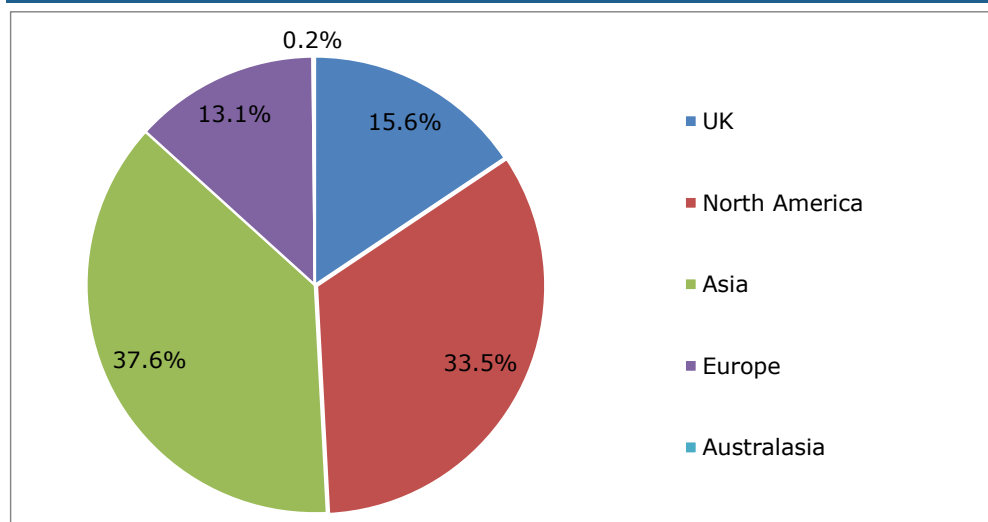


Source: Equity Development. Excludes IFRS 16 which would add a further £4.2m of operating lease obligations

84% of revenues reside outside of the UK

In terms of geography, 37.6% of revenues (see below) were derived from the rapidly expanding Asian region, with the rest generated by North America, Europe & UK. Hence providing **a natural hedge for investors against further sterling depreciation** (£:\$1.27), say in the event of a 'no-deal' Brexit.

Regional split of FY19 turnover (£14.5m)

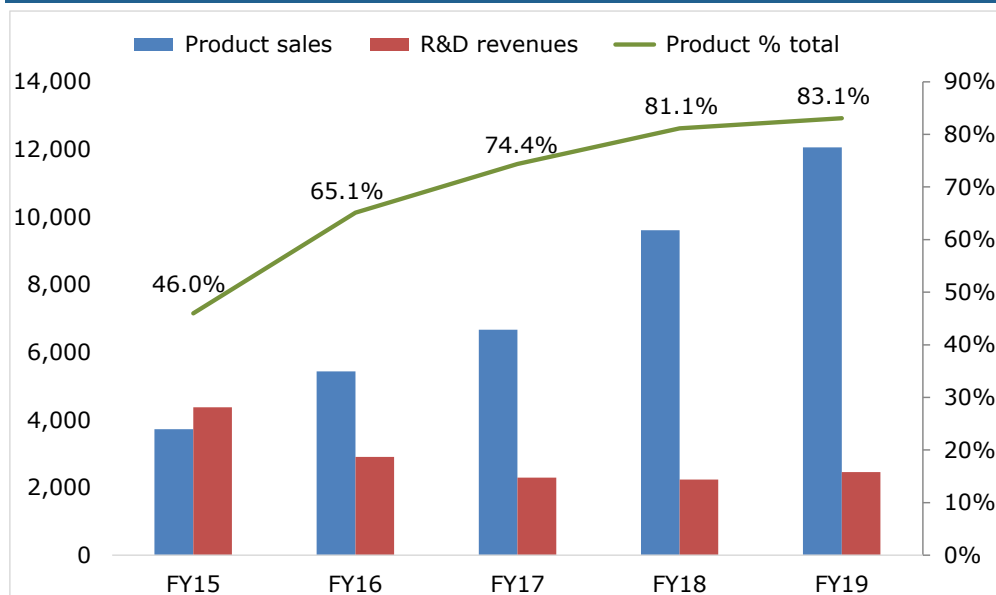


Source : Equity Development

CZT becoming mainstream

Similarly, **product sales climbed to 83%** of the group vs 81% LY (see below). Reinforcing that the CZT market as a whole is **rapidly transitioning away from lab development into everyday life**.

Product sales expanding rapidly (£'000s)

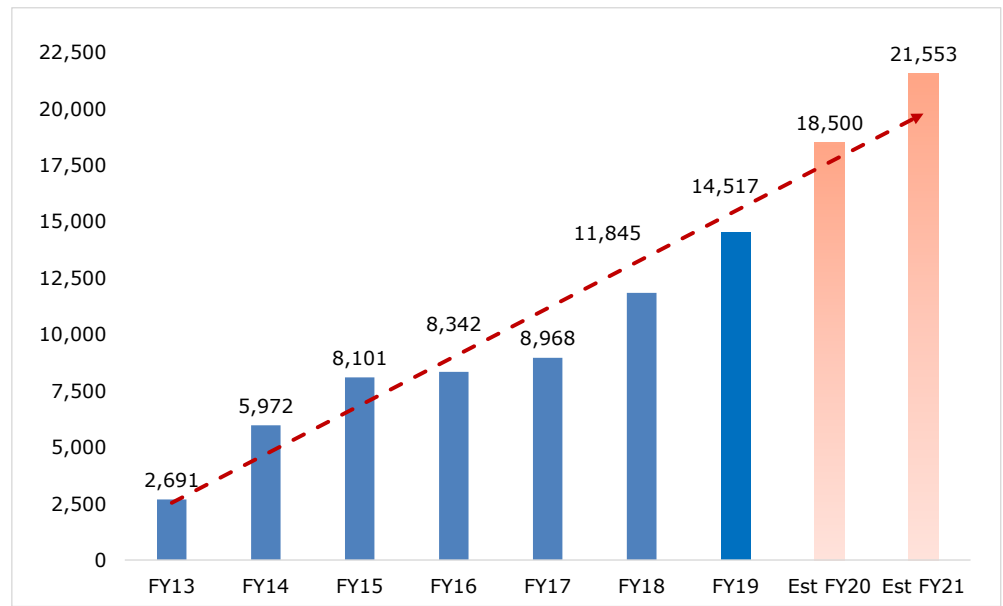


Source : Equity Development

Near 80% FY20 visibility, alongside >\$90m orderbook

Looking ahead we understand there is **approx. 80% visibility over our £18.5m FY20 sales target, underpinned by an approx \$90m orderbook** (ED estimate). What's more with attractive EBITDA drop through rates, a large chunk of this incremental revenue should fall straight to the bottom line. Suggesting there could be scope for EBITDA upgrades as the year progresses.

30% CAGR in sales between FY13 & FY21 (£'000s)



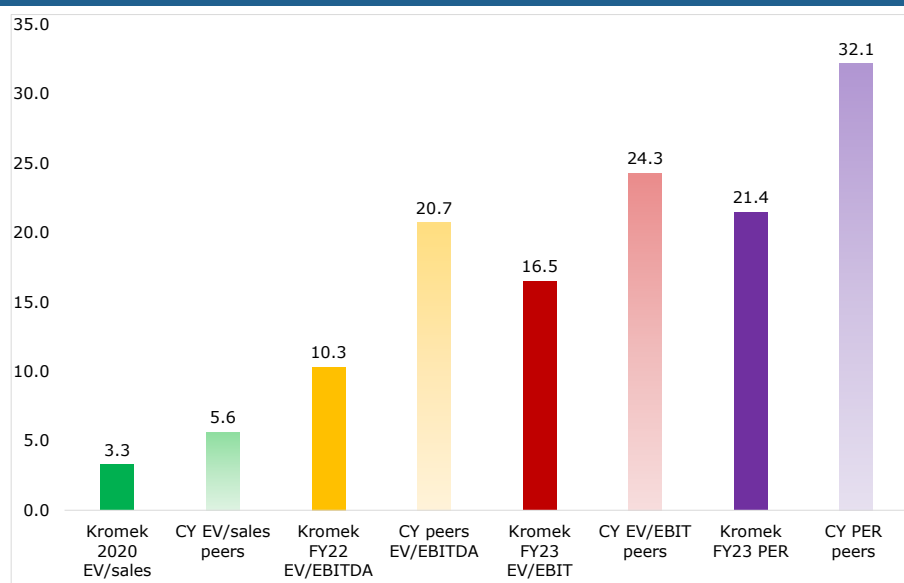
Source: Equity Development

Indeed ultimately, we see **the company delivering turnover of >£66m by 2026, growing organically at 20% pa and churning out EBIT margins of 20%**. On this basis we reckon the stock would justify a 4x EV/sales multiple, equivalent to >80p/share and delivering a 20% pa RoI from current levels. Moreover, irrespective of any future economic slowdown, Kromek should still be able to hit its numbers, since **the business is supported by numerous secular drivers** - namely improved patient outcomes, homeland security, regulatory requirements, etc. That said, let's not get ahead of ourselves just yet.

No change to forecasts or 35p/share valuation

For the next 2 years, **we make no change to our forecasts, and reiterate the 35p/share valuation**. Here we believe the stock trades at an unjustified discount to other 'hi-tech disruptive' peers (see below) across most metrics. Plus, if the company can secure any new major D3S deployments (say covering cities, military sites, border regions, etc), then this would materially enhance our numbers.

Valuation benchmarks vs comparable tech-disrupters

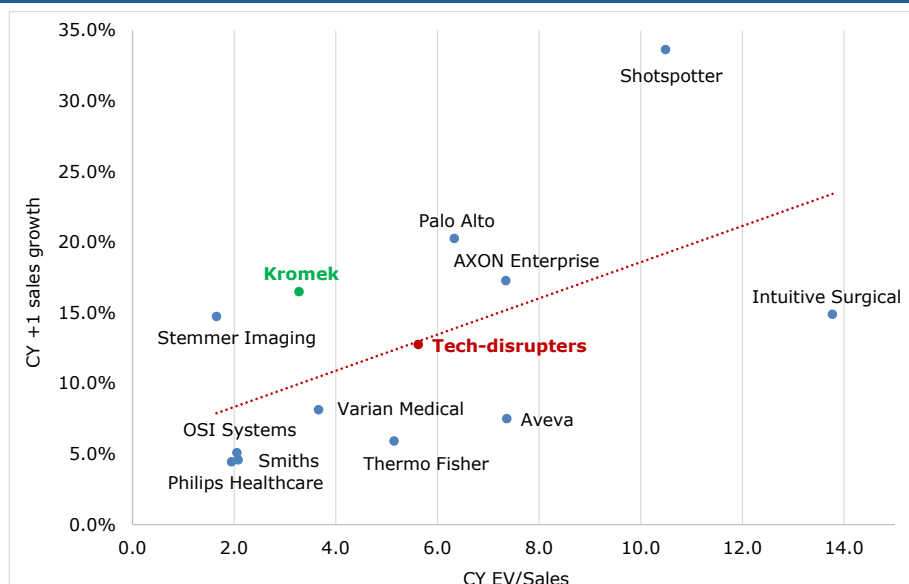


Source: Equity Development. CY = current year, or FY20. See appendices for details

Stock trading at a wide discount to peers

Lastly, as the firm generates more cash (eg working capital unwind), and maintains its impression double digit LFLs, we suspect there is every opportunity of a substantial re-rating (see below). Reflecting Kromek's **superior growth trajectory, world class technology, favourable long term dynamics** and **relatively modest EV/sales multiple**.

CY EV/sales multiple vs CY+1 revenue growth



Source: Equity Development

CEO Arnab Basu, concluding **"This was a milestone year for Kromek as we delivered on all of our objectives, including our key target of growing adjusted EBITDA**. We made progress across our business segments as we continued to execute on previously-signed agreements as well as win new, multi-year contracts from commercial and large government customers worldwide. We significantly strengthened the foundations of our business with the

successful relocation of our US operations to a new purpose-built facility, and raised £21m to enhance our UK and US manufacturing capabilities and to support expansion in our key growth areas of SPECT in medical imaging and our D3S products in nuclear detection.

"Looking ahead, we entered the 2019/20 fiscal year in a stronger position than ever before. With the increasing market adoption of customers' next-generation products that incorporate our radiation detection solutions, **we are receiving increasing demand from existing customers as well as interest from potential customers** – and we are well-placed to capitalise on these opportunities. The momentum of new contract wins has continued, providing us with greater visibility over revenue. As a result, **we are confident of delivering growth for full year 2019/20, in line with market expectations**, and continue to look to the future with confidence."

Additionally at this stage, we understand there has been little impact caused by either the current trade tensions between the US & China and/or Brexit - albeit these will be watched closely going forward.

Summary financial projections

Kromek (April year end)	2014 Act £'000s	2015 Act £'000s	2016 Act £'000s	2017 Act £'000s	2018 Act £'000s	2019 Act £'000s	2020 Est £'000s	2021 Est £'000s
Product	4,746	3,726	5,432	6,671	9,611	12,060		
Other	1,226	4,375	2,910	2,297	2,234	2,457		
Turnover	5,972	8,101	8,342	8,968	11,845	14,517	18,500	21,553
% growth	121.9%	35.6%	3.0%	7.5%	32.1%	22.6%	27.4%	16.5%
Gross margin	3,871	5,626	4,429	5,117	6,684	8,309	10,630	12,500
% Margin	64.8%	69.4%	53.1%	57.1%	56.4%	57.2%	57.5%	58.0%
Adjusted EBITDA (pre SBP)	-3,007	-1,557	-2,376	-1,461	482	1,974	2,700	3,500
% Margin	-50.4%	-19.2%	-28.5%	-16.3%	4.1%	13.6%	14.6%	16.2%
Depreciation	-737	-673	-709	-762	-785	-879	-1,460	-1,504
Amortisation of capitalised R&D	-560	-711	-828	-1,417	-1,907	-1,806	-2,213	-2,279
Share based payments	-125	-181	-166	-99	-131	-195	-200	-245
Adjusted EBIT (post SBP)	-4,429	-3,122	-4,079	-3,754	-2,341	-906	-1,193	-528
% Margin	-74.2%	-38.5%	-48.9%	-41.9%	-19.8%	-6.2%	-6.4%	-2.5%
Underlying Interest charge	-515	-71	-83	-40	-192	-364	-50	-75
Adj. Profit before Tax (post SBPs)	-4,944	-3,135	-4,162	-3,794	-2,533	-1,270	-1,243	-603
Adj. Basic EPS (p)	-8.0	-2.9	-2.9	-1.8	-0.4	-0.1	-0.4	-0.2
EPS growth rate			-1.3%	40.0%	76.0%	75.8%	-248.9%	-51.7%
Valuation benchmarks								
P/E ratio								
EV/Sales	10.2	7.5	7.3	6.8	5.1	4.2	3.3	2.8
EV/EBITDA						30.7	22.5	17.3
EV/EBIT								
Effective tax rate				0.0%	0.0%	0.0%	0.0%	0.0%
PEG ratio							0.0	0.0
% EBITDA drop-through rate						67.5%	55.8%	26.2%
Dividend yield						0.0%	0.0%	0.0%
Net cash/(debt) - (ex IFRS16)	6,563	151	3,857	17,343	7,738	15,170	13,259	12,463
Reported sharecount	61,871	107,818	141,337	174,573	260,162	275,073	346,282	348,013
Sharecount diluted	66,951	114,042	147,586	178,137	262,768	277,655	348,863	350,594
Shareprice (p)	22.0							

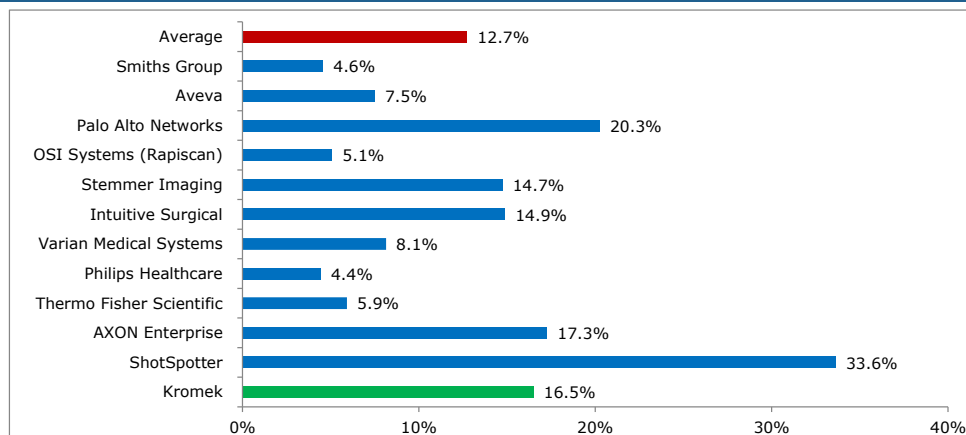
Source: Company historic data, Equity Development estimates.

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.
- 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.

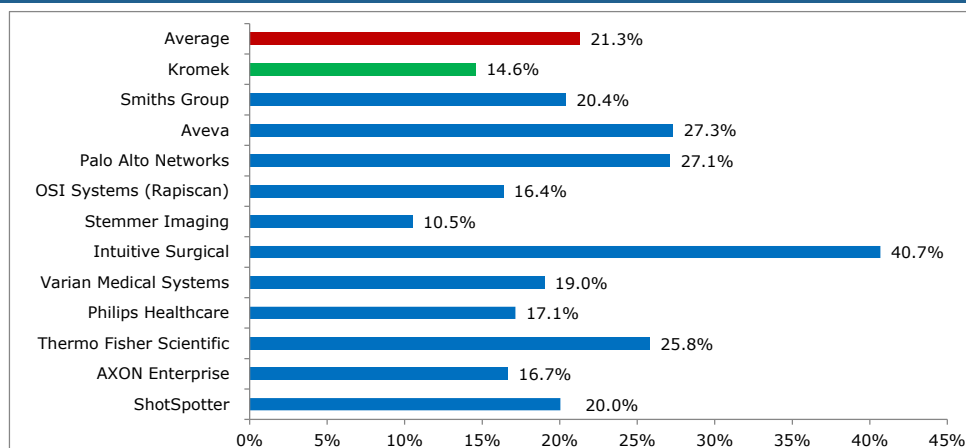
Appendix - Valuation benchmarks & industry KPIs

Current year + 1 sales growth rates



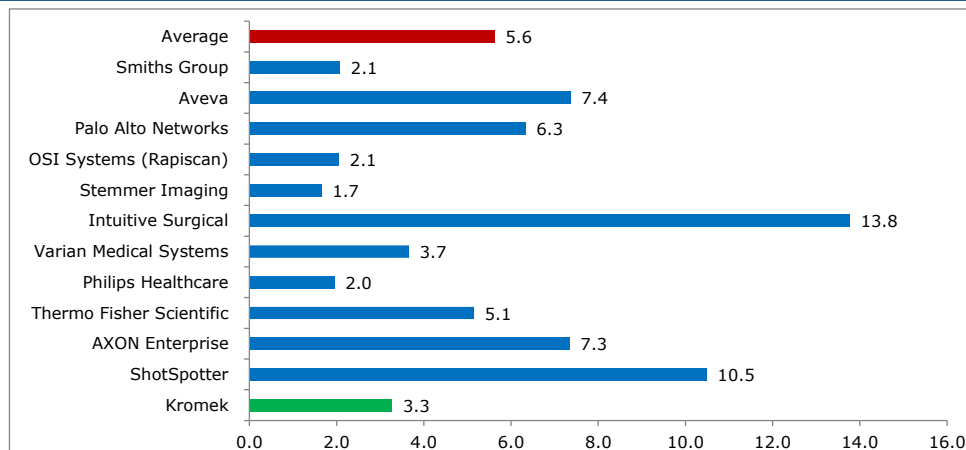
Source: Equity Development

Current year EBITDA margins



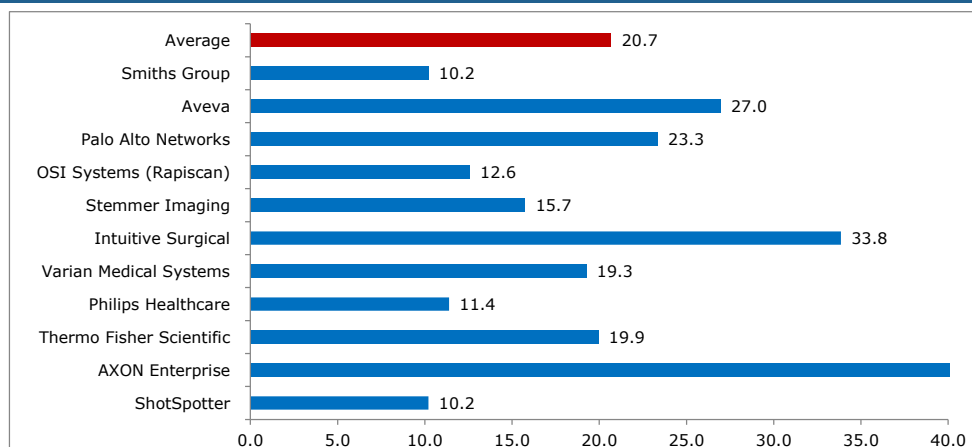
Source: Equity Development (ex SBPs Kromek)

Current year EV/sales



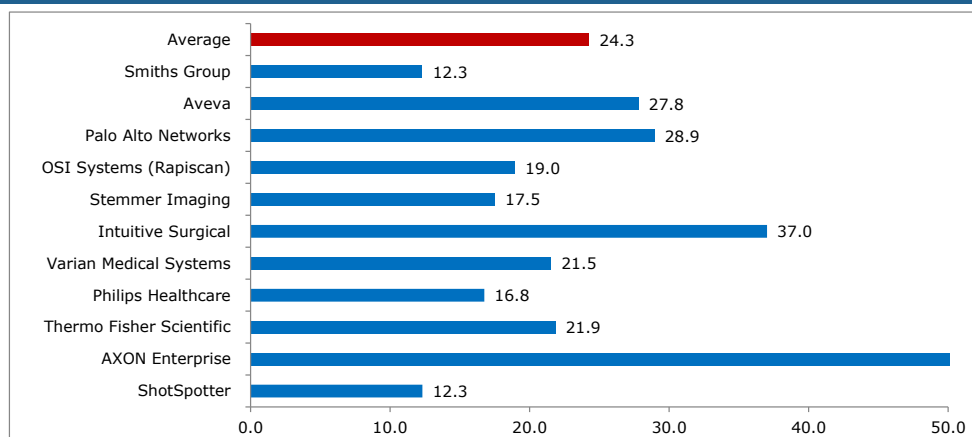
Source: Equity Development

Current year EV/EBITDA



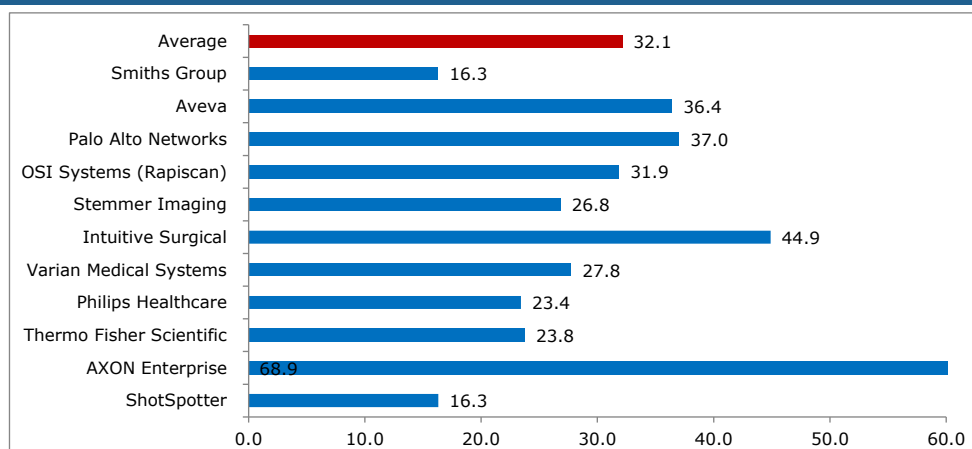
Source: Equity Development

Current year EV/EBIT



Source: Equity Development

Current year PER



Source: Equity Development



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