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12 November 2018

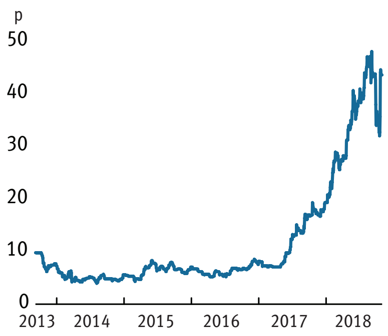
Elektron Technology: Playing a strong earnings upgrade cycle

The technology group is set to deliver a 75 per cent plus increase in pre-tax profits this year and could realistically lift EPS by another 50 per cent over the next two financial years, placing the shares on a cash-adjusted forward PE ratio of 10.7 for 2020

Elektron Technology (Aim: EKT)

Ticker	EKT
Current price (p)	44
Target price (p)	70
Market cap (£m)	81.9
52-week high (p)	49
52-week low (p)	16.6
Net cash (£m)	8.5
Shares in issue (m)	186.1
Financial year-end	31 Dec
Next event	2018 full-year pre-close trading update in February 2019
Company website	elektron-technology.com

EKT share price



Source: Bloomberg

Simon Thompson's view:

Elektron's shares were a casualty in the October stock market rout, but have recovered almost all the losses, following the release of an eye-catching third-quarter trading update that led to the fourth profit upgrade by analysts in as many months. Overall figures are buoyed by improving cash generation and sharply rising profitability from Elektron's design and manufacturing business. With the value of that business alone worth more than Elektron's market capitalisation, in effect you are getting the company's other two fledgling businesses thrown in for free. That's not only anomalous, it is likely to lead to another up-leg in the share price when investors cotton on to the undoubted value being created for shareholders when the company releases its full-year pre-close trading update in February 2019.

Bull points

- Strong earnings upgrade cycle.
- Record third-quarter performance and robust outlook.
- Highly cash-generative.
- High return on capital.
- Streamlined to focus on three high-growth business units.
- Manufacturing and design margins sustainable through cycle.
- Keen focus on costs and efficiencies.
- Deep discount to sum-of-the-parts valuations.
- Directors have significant skin in the game.

Bear points

- Short lead times on orders.
- Economic uncertainty.
- Foreign exchange risk.
- Shares volatile.
- Reliance on key individuals.
- Reliance on key suppliers.
- Ownership of relationship with customers sold to via distributors.

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It's not often that analysts are forced to upgrade their estimates for a company's performance four times in as many months, but that's exactly what's happened in the case of technology group **Elektron Technology (EKT)**, such is the strength of the ongoing earnings upgrade cycle.

Moreover, with the directors reporting a continuation of the robust trading performances across all three divisions in the third quarter to end October 2018, Elektron is well on course to deliver a 75 per cent organic increase in both its operating profits and pre-tax profits in the financial year to end January 2019. Importantly, the factors driving the impressive sales and profit momentum are showing no signs of waning, suggesting that the 50 per cent increase in EPS predicted by analysts over the next two financial years has substance too. Importantly, that potential is not being factored into Elektron's current share price which offers 59 per cent upside to my 70p target.

The transformation in Elektron's fortunes from a loss-making technology group less than two years ago, to a company in a strong earnings upgrade cycle, lies in the board's "shrink to grow" five-year streamlining programme which completed in April this year. Over this time, Elektron disposed or closed 12 businesses and reduced the number of its sites in the UK and overseas from twelve to four. Low margin business was rationalised and revenues have been reduced from £63m in the 2011/12

Elektron divisional structure

Division	Bulgin	Checkit	Elektron Eye Technology (EET)
Activity	Leading designer and maker of hermetically-sealed (air and water tight) connectors and critical electronic components.	Real-time operational software management platform that streamlines, digitises and improves the management of routine tasks across multiple sectors and industries.	Develops macular pigment screening devices for early detection and monitoring of age-related macular degeneration; and visual filed screeners for glaucoma screening.
Sales	2018: £27.3m 2017: £24.1m	2018: £0.5m 2017: £0.3m	2018: £2.0m 2017: £2.4m
Reported operating profit	2018: £7.2m 2017: £3.3m	2018: (£4.4m) 2017: (£3.5m)	2018: (£0.2m) 2017: (£0.4m)
Ebitda	2018: £7.9m 2017: £4.3m	2018: (£2.7m) 2017: (£2.8m)	2018: (£0.1m) 2017: (£0.2m)
Key facts	Operating margins almost doubled to 26.4 per cent in 12 months to end-Jan 2018, and have since risen to above 30 per cent by end-Oct 2018. Increased profitability enhanced by high-margin product growth strategy, in-house capacity improvements and operational gearing.	Elektron has invested over £13m in the business to date. Cash burn reduced by £0.8m to £3.4m last financial year. Business has exited start-up phase and entered scale-up phase, winning multiple new contracts. Annualised contracted recurring revenue now exceeds £1m.	Focus on increasing number of distributors globally. Record order book has underpinned 33 per cent rise in sales in the first three quarters of 2018/19 financial year and the unit is expected to turn profitable for full year to end-Jan 2019.

Source: Elektron Technology 2018 annual report and accounts financial year to just under £30m in 2017/18.

The multi-pronged strategy has not only simplified and optimised the structure of Elektron's business activities, but has enabled management to concentrate on scaling up the group's three remaining businesses: Bulgin, Checkit and Elektron Eye Technology (EET). The aim is to boost margins and generate organic growth, evidence of which was seen in the financial year to end January 2018. Elektron produced an operating profit of £2.6m from continuing operations (versus a loss of £600,000 the year before). This was on revenues that, at £29.8m, were up 11 per cent. The clear focus of the management team is on driving organic sales growth whilst maintaining class-leading margins and an eye-catching return on capital employed (ROCE) for a manufacturing business.

Key to this transformation has been the turnaround of Bulgin, a world-class designer and manufacturer of hermetically-sealed (air and watertight), fail-safe circular connectors used to supply electricity and other vital equipment, often in harsh environments.

Elektron Technology (Aim:EKT)

Ord Price: 44p
Touch: 43-44p
Dividend Yield: nil
Net Asset Value*: 7.5p
Market Value: £81.9m
12-Month High: 49p **Low:** 16.6p
PE Ratio: 14
Net Cash: £8.5m

Year to 31 Jan	Revenue (£m)	Pre-tax profit (£m)	Earnings per share (p)	Dividend per share (p)
2016	34.1	0.10	-0.10	nil
2017	26.8	0.20	0.30	nil
2018	29.8	2.60	1.00	nil
2019**	33.5	4.60	2.00	nil
2020**	36.0	5.80	2.40	nil
2021**	40.1	7.50	3.10	nil
% change	11%	29%	29%	–

Normal market size: 7,500 SETSqx
*Includes intangibles assets and capitalised development costs totalling £2.8m, or 1.5p a share
**Equity Developments forecasts. Pre-tax profits and fully diluted EPS stated before exceptional item
Source: Elektron Technology annual report, London Stock Exchange

Bulgin on a tear

Bulgin may be described as a designer and manufacturer of environmentally sealed waterproof connectors and electronic components, but its value proposition to customers and end users is significantly greater than this; as a net operating margin of over 26 per cent and ROCE above 100 per cent in the 2017/18 financial year highlights. Moreover, to illustrate the pricing power and the value Elektron's management have created around this business, Bulgin earned a gross margin of 50 per cent in its last financial year – that's seven percentage points higher than in 2016/17.

Bulgin earns such a high gross margin by providing

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technological expertise to improve the performance and energy efficiency of electronic and electrical equipment used in automotive, consumer electronics, automation, computer/peripherals, industrial, marine, telecom, oil/gas and lighting applications. Its products include a waterproof circular connector range (power, signal & data), mains connectors, battery holders, fuse holders, indicators, vandal resistant LED's, vandal resistant switches, and push button switches.

The impressive gross margins aside, Bulgin is also benefiting from a much higher level of profitability on its sales after the division increased operating profit (excluding non-recurring items) from £3.7m to £7.2m, on 13 per cent higher revenues of £27.3m. The much improved operating margin reflects a number of initiatives including:

- Rationalisation of thousands of low margin stock-keeping units. The benefit is to simplify the business structure, and reduce capital requirements.

- Reduction in the number of transacting distributors. Order values have increased by eliminating "back-to-back" distributor order entries.

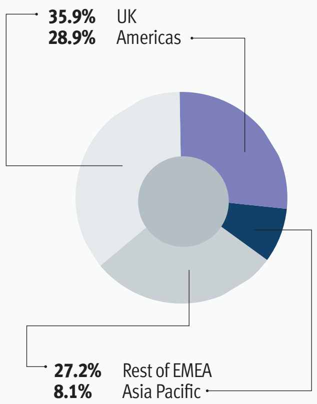
- Transitioning of a high proportion of direct accounts to distributor management. This initiative boosted order values, reduced the requirement for customer service contact, and reduced inventory holding in the sales channel. The move to significantly increase the proportion of revenue generated through distribution sales also means that Elektron can leverage these distribution partnerships to enhance the global reach of its sales too.

- Channel partners are now required to report real-time point of sale data and inventory levels. This enhances sales visibility, stock-turn and ROCE while at the same time reducing capital expenditure and shortening delivery times.

- Incentivisation of sales and distribution partners to lead with niche, higher margin products. The benefit is to reduce competition, shorten sales cycles, and boost margins.

The fact that Bulgin reported record orders of £29.3m in its last financial year highlights just how well these initiatives have worked. Moreover, at the end of March 2018, Bulgin signed a distribution agreement with Arrow Electronics Inc., a global leader in providing products, services and solutions to both industrial and commercial users of electronic components and enterprise computing solutions. Initial stocking orders worth in excess of

Geographical revenue split for 2018 (£29.8m)



Source: Equity Development

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“Bulgin’s net operating margin will be in the region of 30 per cent for the full year to end-January 2019”

$700,000 (£540,000) were received from Arrow Electronics in the first half of the current financial year.

As Elektron’s chief executive John Wilson rightly points out, “this agreement, with one of the largest electronic component distributors in the world and the world’s largest customer base, further demonstrates the worldwide end-user demand for Bulgin’s continually evolving niche product portfolio. We look forward to exploiting the increasing growth opportunities that this relationship will deliver.”

Bulgin subsequently reported a 14 per cent hike in revenues in the first half to end July 2018, and has just reported record sales of £8.8m (representing a 13 per cent year-on-year increase) in the third quarter (end-October), news of which has prompted another wave of earnings upgrades from analysts. It’s understandable because the board also revealed that Bulgin’s net operating margin will be in the region of 30 per cent for the full-year to end January 2019. Based on divisional revenues of around £30m for the 12-month trading period, as forecast by analyst Paul Hill at Equity Development, this implies Bulgin is on course to report 25 per cent higher operating profit of £9m. This level of profitability more than justifies Elektron’s current market capitalisation of £82m – and that’s ignoring the value being created in its two other business units.

But are Bulgin’s margins sustainable?

I would suggest that Bulgin’s margins are sustainable for several reasons. For starters, there is very little competition for around 70 per cent of sales. Another moat around the business is the important role Bulgin’s ‘fail safe’ connectors have in powering much larger mission critical applications. For instance, Bulgin’s products facilitate secure power, signal and data connections in harsh industrial environments, such as locations for wind turbines and solar energy systems.

The business is also benefiting from the growth in other technologies such as the rise of big data, Internet of Things (IoT), data centres, and the race for superfast broadband, all of which are driving demand for electronic components.

There are now over 80,000 end users of Bulgin’s products, with the company having grown its customer base at a compounded annual rate of 5 per cent in the past three years. It has increased its addressable market fourfold, through expansion of the distribution channel, incentivisation of the distribution sales force and improved marketing.

In order to exploit the significant increase in its addressable markets, and tap into even more high margin growth opportunities, Bulgin has an aggressive rolling 24-month roadmap to target between 8 to 10 new product launches each year. For instance, its first rewireable fibre connector was launched in April. Other new products include a new fibre connector featuring a quick-turn coupling mechanism which is ideal for data application. It is scheduled for launch in the first half of 2019 as is a Cat 6 ethernet connector – the gold standard waterproof connector.

In terms of cost-control, Bulgin benefits from an offshore manufacturing facility in Tunisia where it has 650 staff and more than 100 temps. This operation is complemented by a smaller UK site in West Molesey, Surrey which has 30 staff.

Bearing in mind its manufacturing location, the currency matrix is working in Bulgin's favour. That's because although sterling (Elektron's reporting currency) has depreciated by 10 per cent against the US dollar since mid-April 2018, the Tunisian dinar has fallen even faster and is down 17 per cent against the US dollar in the same period. This means that overseas sales are not only worth more in sterling terms, but overseas manufacturing costs are cheaper too.

A point worth noting, given that international markets account for 64 per cent of group sales, is that thanks to much of its manufacturing being done in Tunisia, Elektron has minimal exposure to US-EU/China trade tariffs.

"Elektron has minimal exposure to US-EU/China trade tariffs"

Another reason to be confident about the sustainability of Bulgin's profitability is that its margins are not out of place compared with niche original equipment manufacturers (OEMs). For instance, safety kettle control group **Strix (KETL)** enjoys operating margins of around 32 per cent, and precision engineer **Renishaw (RSW)** has an operating margin of around 24 per cent.

There are multiple drivers of demand for Bulgin's products and, in the absence of a global economic downturn, this situation is not going to change anytime soon. This gives credibility to the sharp increase in earnings analysts are predicting for Elektron over the next three years.

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Bulgin's improving margins

Financial year to 31 Jan	Revenues	Underlying operating profit	Margin
2013	£25.9m	£1.4m	5.4%
2014	£27.0m	£1.7m	6.3%
2015	£25.8m	£2.9m	11.2%
2016	£25.8m	£3.8m	14.7%
2017	£24.1m	£3.7m	15.4%
2018	£27.3m	£7.2m	26.4%
2019E	£29.9m	£9.0m	30.1%
2020E	£30.9m	£9.5m	30.7%
2021E	£32.4m	£10.0m	30.9%
2022E	£34.1m	£10.5m	30.8%

Source: Elektron Technology annual report and accounts, Equity Development forecasts (1 Nov 2018)

Bulgin driving cash generation

A major benefit of Bulgin's much stronger operational performance is it improves Elektron's overall cash flow generation, which can be recycled into growing its other two businesses – Chekit and EET – while also strengthening the balance sheet. Indeed, since the board commenced its "shrink to grow" streamlining programme five years ago, Elektron has moved from a net debt position of £8m in January 2014 to a bumper net cash position of £5.2m at the 2018 financial year-end.

Furthermore, in the third quarter trading update earlier this month, Elektron's directors revealed that net cash had risen to £8.5m by the end of October 2018. That is well ahead of the £8.2m closing year-end estimate analyst Paul Hill at Equity Development was previously predicting, prompting the equity research firm to upgrade their end January 2019 net cash estimates by £1.5m to £9.7m, a sum worth 5.2p a share based on a share count of 186m.

Bulgin's improving cash flow performance

Financial year to 31 Jan	Cash flow from operations	Net cash (debt)	Net asset value
2014	(£2.3m)	(£8.0m)	£7.4m
2015	£3.5m	(£2.7m)	£10.9m
2016	£3.8m	(£1.6m)	£11.6m
2017	£1.6m	£1.0m	£12.2m
2018	£4.1m	£5.2m	£12.9m

Source: Elektron Technology annual report and accounts, Equity Development forecasts (1 Nov 2018)

It is realistic to assume that, if Bulgin maintains its progress, Elektron's net cash per share is set to surge over the coming years given that both the group's other two other businesses – Chekit and EET – have now reached a stage, as they move closer to profitability, where their cash requirements are set to decline. To put this into perspective, Equity Development predicts that net cash could treble to £25.9m by January 2022, a significant sum in relation to Elektron's current market capitalisation of £82m.

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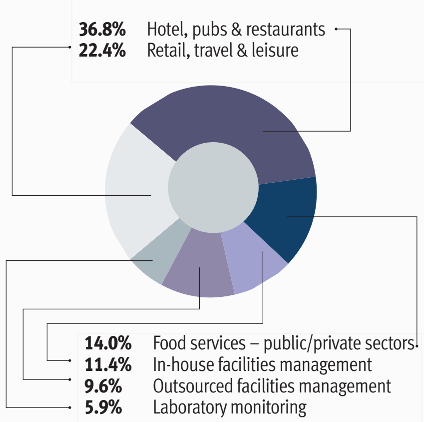
Bulgin's cash building strongly

Financial year to 31 Jan	Net cash (debt)	Net cash per share (p)
2014	(£8.0m)	na
2015	(£2.7m)	na
2016	(£1.6m)	na
2017	£1.0m	0.5p
2018	£5.2m	2.8p
2019E	£9.7m	5.2p
2020E	£14.3m	7.7p
2021E	£20.2m	10.9p
2022E	£25.9m	13.9p

Source: Elektron Technology annual report and accounts, Equity Development forecasts (1 Nov 2018)

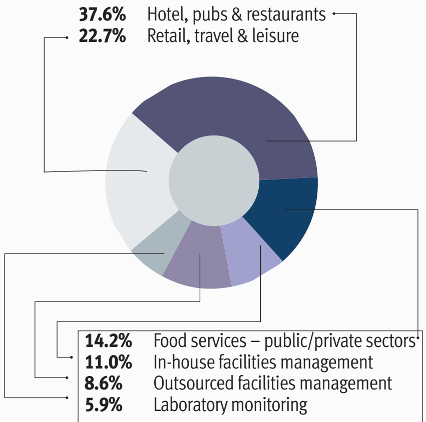
The cash build is not the only way Elektron is creating shareholder value as its other two business units have significant potential to deliver strong returns for investors in the coming years too.

Checkit's £272m addressable market in the UK



Source: Equity Development

Checkit's £1.3bn addressable market in the US



Source: Equity Development

Checkit

When you rely on people to carry out essential tasks and record them for compliance purposes, there is always uncertainty about what was done by whom and when. Elektron's proprietary work management 'software as a service' (Saas) product, Checkit, has been designed to solve this problem, replacing paper-based systems with a centralised, interactive cloud-based way of managing the multitude of tasks that staff are required to carry out on a daily basis.

It's not rocket science, but by implementing a set of standards that are followed to the letter Checkit enables every type of business to transform the way they manage food, hygiene and facilities tasks, ensuring staff carry them out the right way, and without fail. The addressable market is estimated to be worth around £272m in revenue in the UK alone with hotels, pubs and restaurants (36.8 per cent share), retail, travel and leisure (22.4 per cent), and food service (14 per cent) the key sectors, according to research from Equity Development.

But this is small fry compared with the global addressable market which could be worth £3.5bn with North America accounting for over a third of the total, according to Equity Development's research.

Given that the product helps businesses comply with health and safety standards, creates efficiency savings through improved productivity of employees, and offers operational insight through data analytics, it's not surprising that a number of leading global businesses have already signed up. It's quick to implement too; John Lewis rolled-out the entire system across 80 of its sites in only three months. John Lewis is not alone, as Checkit's clients

Quotes: From Chekit customers

"Checkit has had a hugely positive impact on daily operations at Inamo, making staff more efficient and giving managers the visibility they need whether they are on-site or not."
– Lee Skinner, Chief Executive, Inamo

"We quickly found out how much more you can do with Checkit, and we now use it to manage all our health and safety procedures and cleaning schedules, as well as temperature checks for cooked meat and hot water."
– Dominic Teague, Executive Chef, One Aldwych

"Compared to paper records, Checkit is a real time-saver. Staff don't need to spend time filling in paperwork, they have more time to focus on their core duties."
– Christopher Moore, HSE Director for B&I, Compass Group UK and Ireland

include food servicing groups Compass and Sodexho, as well as leisure groups Merlin and Center Parcs.

Chief executive John Wilson confirms that there are now 300 companies across 400 sites, taking 50m measurements per month and generating in excess of £1m annualised revenue for Checkit in the UK alone. Eye-catching retention rates of around 98 to 99 per cent highlight a very high level of customer satisfaction too. Moreover, Checkit is leveraging its proprietary technology and has just completed the development of its next generation Work Management capability which can be deployed on any Android device (phone, tablet etc.) and adds location-based work management. This offers significant benefits to customers and extends the target market outside of the food industry.

The opportunity to roll-out the product across other sectors is evidenced by the recent adoption of Checkit by the Blood Sciences Department of Leeds Teaching Hospitals NHS Trust. One of the largest in the UK, it now relies on Checkit to ensure that samples, reagents and equipment are kept under the correct conditions even while they are in transit. The initial roll out to almost 50 locations is nearing completion and there is potential to expand this contract to further departments and activities too. Checkit is going global too, having just launched into the US market ahead of schedule.

Admittedly, it's a nascent market, but it's also one where Checkit has potential to seize a first mover advantage and not just in food service. The business is targeting the adoption of the product by large and medium-sized organisations which have multiple sites such as hotel chains where Checkit can be used to support quality and operational assurance.

Also, there is a big opportunity for Checkit to gain traction through its data analytics capabilities. That's because the data can be used to help clients enhance their internal processes, ensure regulatory compliance in a more efficient manner, improve staff productivity (managers can see how different sites are performing in real-time), and ultimately free up employee time for redeployment in customer facing or sales initiatives. Ultimately, it delivers savings to clients, the key reason why the run rate of annualised revenues has more than doubled in excess of £1m since the start of last year.

Quantifying a value on Checkit

Elektron has invested £15m in Checkit to date and it's still making losses: analysts expect the business to report a flat operating loss of £4.5m in the 12 months to end January 2019. However, it's a very scalable proposition and one

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with high operational gearing. To put this into perspective, based on Checkit's revenues continuing to double over each of the next two financial years, the business is forecast to approach cash profitability (Ebitda) in the 2020/21 financial year. After this key inflexion point is reached, the operational gearing of the business really kicks in which means that an increasing amount of incremental revenues earned will drop down to the bottom line.

Checkit's move towards cash profitability

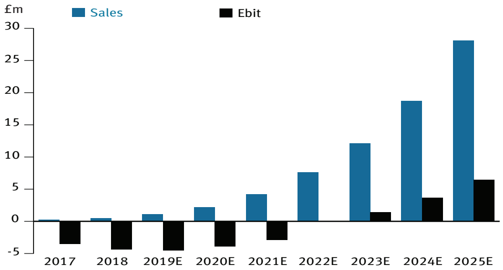
Financial year to 31 Jan	Revenues	Underlying Ebitda	Operating profit
2017	£0.3m	-£2.8m	-£3.5m
2018	£0.5m	-£2.7m	-£4.4m
2019E	£1.0m	-£2.7m	-£4.5m
2020E	£2.1m	-£1.7m	-£3.9m
2021E	£4.2m	-£0.3m	-£2.9m
2022E	£7.6m	£3.0m	£0.0m

Source: Elektron Technology annual report and accounts, Equity Development forecasts (1 Nov 2018)

If Checkit can deliver £3m of cash profits in the 2021/22 financial year as analysts forecast, and be cash flow positive too, then it's not difficult to see the SaaS business being valued on a multiple of 10 times those forecast profits, implying a value of £30m. That's equivalent to 36 per cent of Elektron's current market capitalisation. Checkit is certainly worth more than the £15m Elektron has invested to date, as it has exited the start up phase and is now commercialising the technology by creating a high margin recurring revenue stream with a high retention rate.

An important point to note, is that the narrowing of Checkit's operating losses in the coming years will give a natural kicker to Elektron's overall operating profits. That's because shareholders will retain a greater share of Bulgin's profits which have been subsidising Checkit's losses as it scales up. The value being created in Checkit is simply not being priced into Elektron's share price, nor for that matter is the value in the much smaller Elektron Eye Technology (EET).

Checkit results built Saas (£m)



Source: Equity Development, Electron Technology annual report and accounts

EET eyes profitability

Effectively, this business is also in the price for free which seems harsh. Elektron's directors revealed in their third quarter trading update earlier this month that the performance of the business is running well ahead of their expectations, following a strong quarter of sales which saw revenue increase by a third year-on-year. This news led to analysts predicting the unit will deliver a cash profit of £200,000 and an operating profit of £100,000 on revenues up 30 per cent to £2.6m in the 12 months to end January 2019.

Around a third of EET sales are derived from its range of Henson glaucoma screening and management analysers that enable eye care professionals to detect and monitor glaucoma progression. Boots, Specsavers and Vision Express are all customers in the UK where EET has a market share of around 50 per cent. The plan is to try and replicate domestic success overseas, in a global market worth £35m, albeit EET is up against German rival Carl Zeiss and Switzerland-based Haag-Streit.

Perhaps, of more interest is EET's MPS II portable analysers that measure macular pigment optical density (MPOD) and are used to detect age-related macular degeneration. They provide results at speeds as fast as 90 seconds per eye, and currently are the only commercially viable device of their type on the market. The opportunity here is to expand the distribution network internationally, particularly in the US and China. Industry experts believe the addressable market could be worth north of £100m for this product. They also believe they have hit an inflexion point, from which EET can eventually make a useful contribution to Elektron's profits.

EET turns profitable

Financial year to 31 Jan	Revenues	Ebitda	Operating profit
2017	£2.4m	-£0.2m	-£0.4m
2018	£2.0m	-£0.1m	-£0.3m
2019E	£2.6m	£0.2m	£0.1m
2020E	£3.0m	£0.3m	£0.2m
2021E	£3.4m	£0.5m	£0.3m
2022E	£4.0m	£0.6m	£0.4m

Source: Elektron Technology annual report and accounts, Equity Development forecasts (1 Nov 2018)

Management and shareholder base

Bearing in mind management's streamlined focus on three core businesses, it's reassuring to know that the five main board directors have lengthy service with Elektron including executive chairman and 11.7 per cent shareholder Keith Daley who has held that position for a decade. He also chairs the Checkit and EET boards in an executive capacity.

Chief executive John Wilson joined the company as technical director in 2008 and was appointed to his current role in late 2010, so knows the business well. He chairs Bulgin in an executive capacity, and is chief executive of Checkit and EET. He also takes overall responsibility for quality, technology and product development. He owns a 1.4 per cent stake in the company.

Finance director Andrew Weatherstone, a KPMG trained accountant, was brought in almost five years ago. In addition to leading the finance function, he takes responsibility for IT and also the group's manufacturing operations.

Non-executive director Giovanni Ciuccio, another KPMG

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trained accountant and former investment banker at Barclays, has been on the board for three years and is a portfolio manager at D&A Income, a 24 per cent shareholder in the company.

The other non-executive director is 55-year old Peter Welch, one of the founders of N+1 Singer Capital Markets, a small-cap institutional stockbroking business which has a focus on a number of sectors including technology. Mr Welch holds 250,000 shares in Elektron.

In aggregate the five directors hold 13.2 per cent of the issued share capital, so have a significant financial interest. Excluding bonuses earned, their aggregate basic pay and pension and other benefits was £746,000 in the 2017/18 financial year, not excessive in relation to the profits of Elektron. Moreover, it means that the majority of any financial upside will come from their shareholdings and long-term options, thus aligning their interests with those of outside shareholders.

Elektron's major shareholders

Shareholder	Shareholding
D&A Income	24.13%
Mr K Daley (chairman)	11.67%
Ruffer	10.91%
Chelverton Asset Management	5.37%
Mr J Kinder	4.93%
Elektron Technology 2012 Employee Benefit Trust	4.35%
Total	61.36%

Source: Elektron Technology 2018 annual report; and London Stock Exchange RNS.

It's worth noting that 61.36 per cent of the share capital is held by only six shareholders so this impacts the free float (47.7 per cent of the shares are not held in public hands, according to the company), and means that the shares can be volatile. That's not an issue if the company delivers on forecasts, but it's worth bearing in mind. For instance, during the month of October the share price declined from a seven-year high of 48.5p to a low of 32p before the third quarter trading update sent the price soaring to recover almost all of the lost ground.

Admittedly, at the 48.5p peak the shares were massively overbought which would have exacerbated the downwards move. Nonetheless this does highlight the above average volatility one should expect. That said, despite the lower than normal free float, the shares are readily tradable in bargain sizes well above the 7,500 electronic market size, and on a 1p a share bid-off spread, so building a decent holding should not be difficult. Importantly, last month's sell off means that the shares are no longer in overbought territory.

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Sum-of-the-parts valuation and target price

Based on Elektron delivering EPS of 2p in the 12 months to end January 2019, rising to 2.4p the year after and 3.1p in the 2020/21 financial year, the company is expected to lift EPS by north of 50 per cent over a two-year period. It's also expected to more than double net cash per share from 5.2p in January 2019 to almost 11p by January 2021.

On this basis, the cash-adjusted forward PE ratio of 20 falls to less than 11 in the 2020/21 financial year assuming both EPS and cash targets are hit. In my view, that modest forward rating fails to take into account the value being built up in all three businesses over the next 24-month trading period.

Elektron's cash-adjusted PE ratio falling

Financial year to 31 Jan	Net cash (debt)	Net cash per share (p)	Forecast EPS	Cash-adjusted PE ratio
2019E	£9.7m	5.2p	2.0p	19.4
2020E	£14.3m	7.7p	2.4p	15.1
2021E	£20.2m	10.9p	3.1p	10.7
2022E	£25.9m	13.9p	4.6p	6.5

Source: Elektron Technology annual report and accounts, Equity Development forecasts (1 Nov 2018)

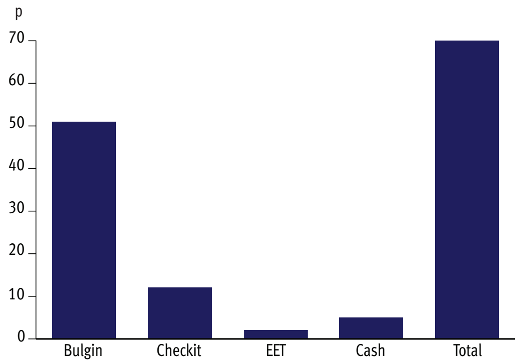
The shares are also being undervalued on a sum-of-the-parts basis. Indeed, it's not difficult to make the case that Bulgin should be valued on 13 times its post tax earnings for the current financial year to end January 2019. Based on a normalised tax charge, and the £9m operating profit projection for this business, the implied value for Bulgin alone is £95m, or 51p a share. Add to that sum the January 2019 forecast closing cash pile of 5.25p a share then in effect, at Elektron's current offer price of 44p, Checkit and EET are being attributed a negative value of 12.25p.

EET has to be worth around £4m, or 2p per Elektron share, now that it has reached profitability and is expected to be generating cash profits of around £500,000 within two years.

Valuing Checkit is more difficult as it is a blue sky opportunity. However, if it achieves the £3m of cash profits forecast in the 2021/22 financial year then valuing the business on a multiple of 10 times those forecast profits, implying a value of £30m, doesn't seem unreasonable. To give a 'margin of safety' I have discounted that £30m by 25 per cent to give an implied value of 12p per Elektron share.

This means on a sum-of-the-parts basis, I value the three business units and the cash pile at 70p, or 59 per cent above Elektron's current share price. This is my 12-month target price. I would point out that a chart break-out above the mid-September seven-year high of 49p would be a very bullish signal, adding weight to my belief that last month's share price correction was just that, and nothing more. The

Elektron sum-of-the-parts valuation



Source: Investors Chronicle

fact that the share price tested and strongly bounced off its 200-day moving average at the October low point also suggests that last month's share price draw down was only a correction within an ongoing bull market.

Moreover, given the robust operational progress being reported by all of Elektron's three divisions, and the strong likelihood of a positive full-year pre-close trading update being released in February 2019, then the operational performance is highly supportive of a valuation materially above the current level. Buy.

Risk assessment

Of course, there are risks with any investment and there are several to flag up for Elektron:

- **Sales risk:** Sales lead times for Bulgin and EET tend to be only 12 and 8 weeks, respectively, so sales visibility is low and there can be no assurance that the current level of strong sales growth will be maintained in the future. Sales may be affected by adverse market conditions or other factors. These might include pricing pressures from governments or other authorities; competition; the withdrawal of a product because of a regulatory or other reason; or the financial or commercial failure of a marketing partner. Elektron is operationally geared, which means that a relatively small reduction in sales can lead to a much larger percentage reduction in profits.

To mitigate these risks, the investment focus is on developing products that are unique within markets that are growing or that are expected to grow. Elektron's sales force is focused on geographically diverse markets in order to reduce the risk of a downturn in a particular geography too. It's also worth flagging up that the group has approximately 3,500 customers (with no one customer amounting to more than 10 per cent of sales) and more than 80,000 end users worldwide across 125 countries, so the customer base is well diversified.

- **Relationship with end users:** Elektron sells a significant proportion of its sales through distributors and in many cases does not have direct contact with end users. The risk is that distributors may suggest the substitution of rivals' products for the group's products. To counter this risk, management has incorporated a requirement for point-of-sale (POS) data into many contracts with distributors. With POS data the group can monitor the account base being managed through distribution. This enables maintenance of existing customers and identification of new customers. Also, joint visits with distributors are arranged to key customers.

■ **Brexit/international sales:** The group sells globally and manufactures a proportion of its products outside the United Kingdom, which in turn exposes the business to the economic and political environments of those locations. The decision taken by the UK to leave the EU poses a potential risk if it leads to reduced availability of EU national resources and barriers to entry through implementation of tariffs. Elektron has already set up a committee to determine what action needs to be taken in respect of its relationships with customers and on its supply chain in advance of Brexit. The board also monitors conditions in each country in which it operates and ensures it has paid for goods in advance where appropriate.

■ **Price erosion:** Elektron experiences competition both from emerging suppliers based in low-cost countries and traditional European suppliers seeking to obtain market share by reducing prices. It manages this risk by continually monitoring competitive activity and by investing in the design of innovative products for niche applications. It operates a low-cost manufacturing facility in Tunisia and seeks to promote its offerings by focusing on customer service, product availability and quality rather than price.

■ **Checkit demand unpredictable:** Checkit's target market consists of around 500,000 businesses in the UK and substantially more in the US. If demand were to grow too quickly, Elektron may not be able to supply products, whether for operational or financial reasons. This could tarnish the brand. This risk is managed by controlling demand creation activities (for example, by phasing the launch of new offerings and introducing lead generation activities incrementally); by building an extremely flexible, scalable supply chain; and by automating key internal processes, such as account creation, to increase scalability.

■ **Market development and competition:** Checkit is an innovative product in the early stage of its life cycle offering several features that don't exist in the market. Its target market currently uses paper-based systems. It is therefore necessary to make assumptions as to how the market will develop until sufficient market feedback has been obtained. As the market grows it is possible that new entrants will be attracted and take market share from Checkit.

That said, Checkit is 'first to market' and its level of investment in product and marketing should ensure it retains its leading position. Moreover, the business case for Checkit is based on considerable feedback gained from the market and the achievement of £1m of contracted annualised recurring revenue. Elektron's approach and technology provide capabilities that mitigate some of the market development risk as Checkit is suitable for a wide variety of food business types and has applications beyond food hygiene in a number of large markets. This means that it is not reliant on one highly specific segment, which mitigates risk.

■ **Cloud services:** Elektron is reliant on cloud services provided by third parties in respect of its Checkit product. The failure or withdrawal of these services would mean that Checkit could not function. This risk is mitigated by selecting large, global providers with demonstrable scale and reliability to provide the Checkit cloud offerings and by designing the systems, where possible, to allow functionality to be moved between providers.

■ **Commodity and currency fluctuations:** A significant amount of Elektron's purchases are plastic moulding powders and metal parts. Consequently, exposure to movements in commodity prices can affect profitability. To offset this risk, product design is kept under review to ensure that Elektron's products use no more of such commodities than product offerings of its direct competitors.

Also, a significant percentage of Elektron's input and output transactions are denominated in currencies other than sterling, so there is currency translation and transactional risk to consider. To mitigate this, the board regularly review prices and currencies in order to ensure that an appropriate level of cost is passed on to customers. Elektron doesn't fix into long-term pricing contracts with customers, nor does it tie into long-term currency hedging contracts. Where ever possible both currency inflows and outflows are matched.

■ **Reliance on key suppliers:** Certain products are reliant on single-sourced items. If those suppliers were unable to supply then Elektron would be unable to sell some products to its customers. To mitigate this risk, management maintains an open dialogue with suppliers to ensure that an early warning system is in place. Where subcontracted items are single sourced, Elektron ensures that appropriate technical files and work instructions are maintained.

■ **Customer reliance on Elektron's products:** Many of the products the group supplies are essential to the running of its customers' businesses. Were those products to fail, Elektron could be liable for consequential losses. By

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ensuring that all products meet quality standards, and containing clauses limiting losses to the amount of the sale in the conditions of sale, then this risk is mitigated.

■ **Reliance on key individuals and retention of high quality staff:** The group is increasingly dependent on key individuals in commercial or management areas, including its technology team in Cambridge. This means that the profitability and reputation of the business could be adversely impacted if they were to depart without warning.

■ **Political risk:** As with any business with overseas manufacturing facilities, this needs to be considered.

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