Investors' Chronicle | Alpha

**Alpha Editor:** James Norrington
**Alpha Production Editor:** Sameera Hai Baig

# Alpha small company research

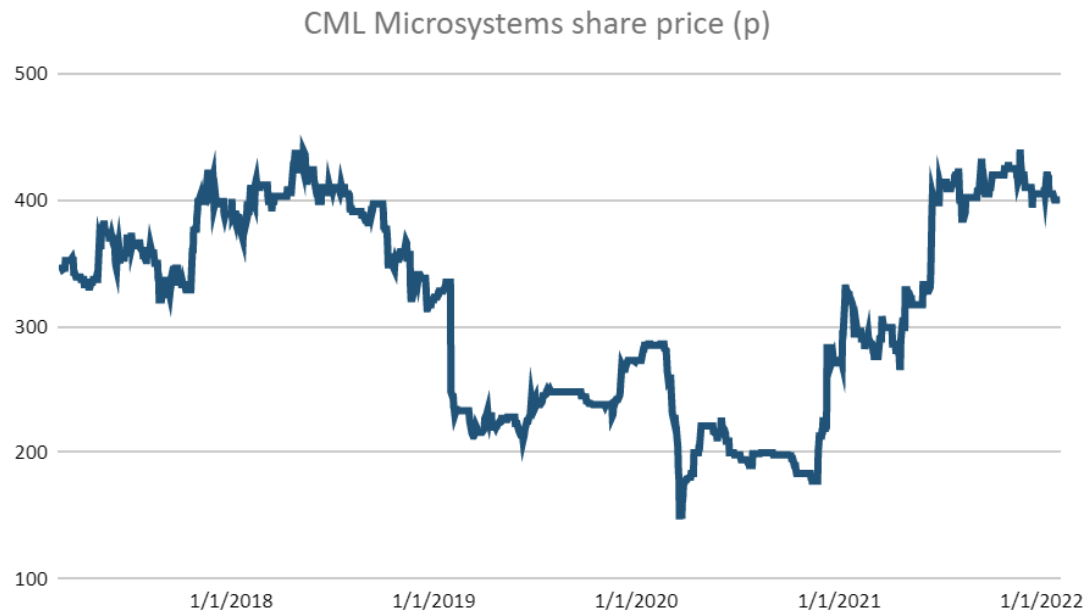
## 4 February 2022

## Profit from semiconductor market mega-trends

*An undervalued small-cap technology group boasts a record order book from its blue-chip client base.*

### Simon Thompson's view:

'The global semiconductor market is estimated to have increased 25 per cent to $500bn in 2021 even in the face of well documented supply chain issues. Industry experts expect another year of decent growth as global markets recover from the disruption caused by the Covid-19 pandemic. There are also secular growth drivers such as the roll-out of 5G infrastructure and the increased prevalence of networks for voice and data communications linked to the industrial internet of things. Maldon-based semiconductor chip designer and manufacturer CML Microsystems not only offers a pure-play on the high growth industrial communications market, but an attractive entry point for investors.'




Source: FactSet

## Bull points

1. Record order book and ongoing strong order intake
2. Double-digit earnings upgrades for 2022 and 2023 financial years
3. Secular tailwinds driving demand for compound semiconductors
4. Strong competitive position
5. Blue-chip diversified client base
6. Diverse product portfolio
7. Cash rich balance sheet
8. Hidden value in property assets
9. Significant director shareholdings
10. Potential for strategic bolt-on earnings enhancing acquisitions

## Bear points

1. Well documented industry wide supply chain issues
2. Higher inventory levels to minimise impact of supply chain delays
3. Extended lead times from third-party service providers
4. Group pension scheme deficit

## Key information

| **CML Microsystems (CML)** | |
|---|---|
| | |
| Ticker | CML |
| Current price | 400p |
| Target price | 550p |
| Market cap | £66.4mn |
| 52 week high | 460p |
| 52 week low | 264p |
| Net debt | £22.6mn (30 September 2021) |
| Shares in issue | 16.6mn |
| Financial year end | 31 March |
| Next event | annual results June 2022 |
| Website | cmlmicroplc.com |

Established in 1968, Maldon-based semiconductor chip designer and manufacturer CML Microsystems (CML) is now a pure play on the high growth industrial communications market following last year's $49mn (£36.5mn) strategic disposal of its solid-state storage division, Hyperstone.

Under CML's ownership, Hyperstone had become a major player in its market, supplying some of the world's largest original equipment manufacturers (OEMs). However, the business had relatively high product development costs and lacked the scale of its rivals. Also, there were few synergies with CML's core communications business which designs, develops and supplies low-power analogue, digital and mixed signal integrated circuits for voice and data-centric communication systems. Specifically, the communications business provides integrated circuits to distributors and system integrators (Cobra, Hytera, Icom, Kenwood, Orbcomm and Sepura are all clients).

| CML Microsystems (CML) | | | | |
|---|---|---|---|---|
| **Ord price:** | 400p | **Market value:** | £ 66.4mn | |
| **Touch:** | 390-410p | **12-mth high/low:** | 460p | 264p |
| **Dividend yield:** | 2.7% | **PE ratio:** | 27 | |
| | | **Cash-adjusted PE ratio:** | 18 | |
| **Net asset value*:** | 281p | **Net cash:** | £22.6mn | |
| Year to | **Revenue** | **Adjusted Pre-tax** | **Diluted adjusted earnings** | **Dividend** |
| **31 Mar** | **(£mn)** | **profit (£mn)** | **per share (p)** | **per share (p)** |
| 2019** | 28.1 | 2.98 | 15.8 | 7.8 |
| 2020 | 15.0 | 1.53 | 10.0 | 4.0 |
| 2021^ | 12.5 | 1.07 | 11.1 | 52.0 |
| 2022^ | 15.8 | 2.00 | 11.9 | 9.0 |
| 2023^ | 17.6 | 2.50 | 14.6 | 10.8 |
| **% change** | **11%** | **25%** | **23%** | **20%** |

Source: London Stock Exchange SETSqx

^ Shore Capital estimates for 2022 and 2023. Pre-tax profit and EPS for 2021 and 2020 adjusted by Shore Capital and stated pre-share based payments (£143,000 and £139,000), amortisation of goodwill (£212,000 both years), and impairment of development costs (£701,000 in 2020).

** 2019 pre-tax profit and EPS stated on a reported basis and include Hyperstone business.

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CML is well funded to accelerate growth in a market that is exhibiting several secular growth mega trends as well as leveraging its standing as a key supplier to many of the world's Tier 1 equipment manufacturers. After returning almost £10mn of the Hyperstone proceeds back to shareholders through a 50p per share special dividend and £1.6mn of share buy-backs last year, CML has net cash of £22.6mn (136p a share) to help support organic growth (new product launches) and bolt-on acquisitions.

## Addressing mega growth markets

"Connected everything" is propelling exponential increases in data consumption – driving growth across wireless communications markets globally.

The key drivers are increasing demand for data to be transmitted faster and more securely, the upgrading of telecoms infrastructure and the growing prevalence of private commercial wireless networks for voice and data communications linked to the industrial internet of things (IIoT). In data-centric markets, increased data throughputs from terrestrial and satellite communications applications are required to meet the needs of the growing machine to machine (M2M) and IIoT market segments.

Prior to the disposal of the group's storage division, CML was addressing an annual serviceable market of $360mn, split 50/50 between communication and storage application areas. Post-disposal, the addressable market has expanded to $1bn and includes a number of key growth areas over the coming years: critical infrastructure (public utilities, smart grid, RF identification (RFID)); 5G (repeaters, small/pico cells, fixed wireless access, distributed antenna systems, smart meters); and satellite communications (terminals, broadband access).

| 01: 5G | 02: Private mobile radio | 03: Critical infrastructure |
|---|---|---|
| Small/pico cells, fixed-link broadband access<br>Radio Access Network (RAN) | Commercial, professional, mission critical | Public utilities, AMI, smart meter/grid, RFID, long-range data links |
| **Satellite communications**<br>Satellite terminals, global broadband networks | **Transportation**<br>Railways, vehicle tracking, marine | **Military** |

As one example, the 5G network is being rolled out in two phases. The first of them, operating on frequency bands below 6GHz, is already being deployed in several countries. In coming years, the roll-out will see the introduction of millimetre-wave frequencies that span 24-GHz to 40-GHz. These higher frequencies will offer much higher data rates, greater capacity, better quality and lower latency. Customer product designs for millimetre wave applications will also benefit from the use of compound semiconductor technologies, such as gallium nitride (GaN) or gallium arsenide (GaAs), rather than silicon. Independent market statistics estimate that the GaN radio frequency (RF) device market alone is expected to grow from $740mn to $2bn by 2025. While this represents a double-digit compound annual growth rate (CAGR) across the forecast period, the market is a new one for CML, thus highlighting the opportunity it represents.

Importantly, to address these multiple growth markets, CML has been expanding its semiconductor product portfolio for the past three years by adding narrowband applications operating at the lower end of the radio spectrum. As opposed to broadband, these applications use short-range fixed location wireless applications such as RFID, commercial vehicle remote keyless entry devices or narrowband-IoT ones focused on indoor coverage, low cost, long battery life and high connection density. The March 2020 acquisition of a third-party design house, PRFI, has been instrumental in the group's strategy to widen its product offering and addressable markets.

## PRFI acquisition enhances CML's market position and product offering

Located on the Essex-Cambridge borders, PRFI's expertise spans both front end integrated circuits for millimetre-wave 5G; broadband Monolithic Microwave integrated circuits (MMICs); receiver, transmitter and power amplifier (PA) integrated circuits for microwave links; and GaN power amplifiers for both commercial and defence applications.

The company is an approved third-party design house for several leading global semiconductor companies with an impressive client roster that includes BAE Systems, Huawei, Inmarsat, National Semiconductor, QinetiQ, Samsung, Sony Semiconductor and Thales. PRFI was acquired not only for its expertise in microwave and millimetre-wave frequencies (including wide band applications for high data rate applications) but to speed up the time-to-market for new products.

A good example was the launch in the first half of 2021 of CML's new SµRF range of high frequency, high bandwidth integrated circuits targeting RF and millimetre-wave frequencies in emerging markets such as 5G, satellite and IoT. By using PRFI's expertise in advanced integrated circuits design, CML has created a range of RF integrated circuits and MMICs that are high performance, simple to design with, and simple to use in mass-market applications.

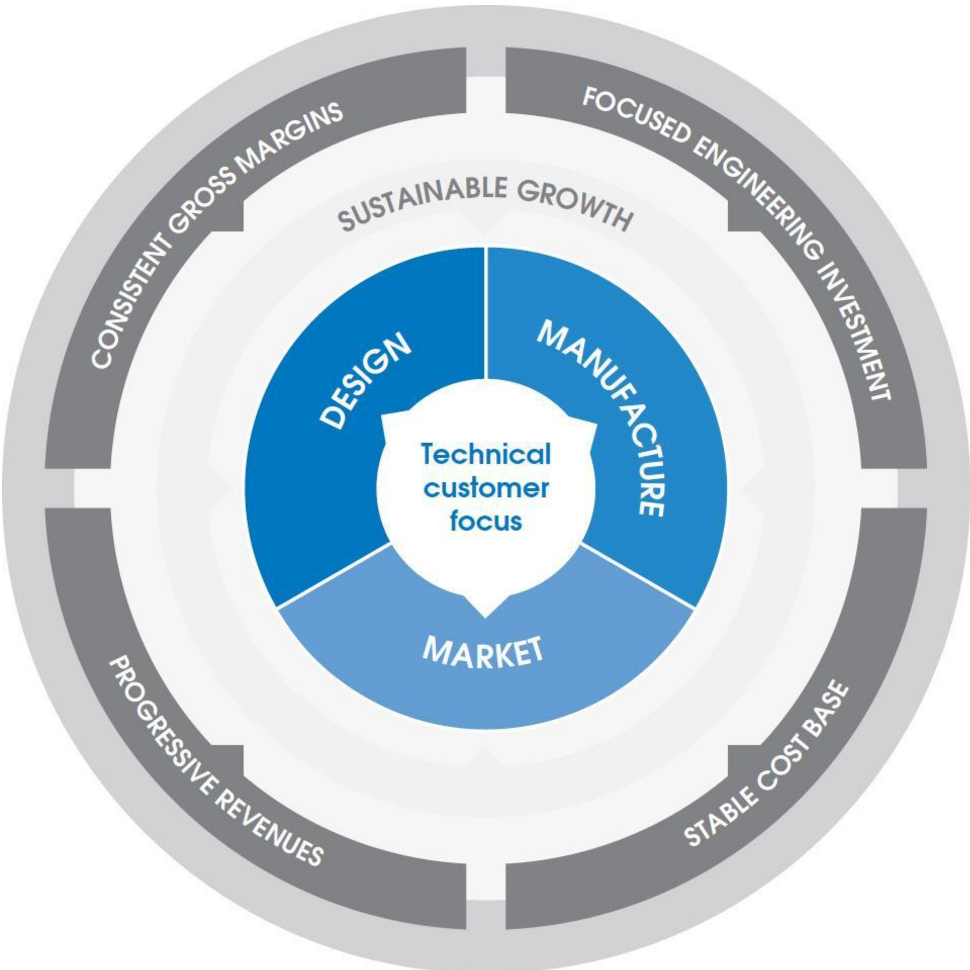
The technology is based on compound semiconductors that offer major performance advantages over legacy silicon-based chips such as higher switching speed, lower electrical current loss and higher power density. The feedback from customers has been positive, so much so that these new integrated circuits are beginning to achieve design-win status with new clients. First orders have already been received from early stage adopters within vehicle tracking and smart grid applications. End-customer shipments are scheduled to commence during the second half of the financial year to 31 March 2022.

In addition to the SµRF product range, CML is actively investing in new platform technology and differentiated wireless/baseband products to gain market share in a combination of existing and new end application areas under the communications umbrella. These new releases build upon prior year investments and product introductions that boosted the number of addressable market opportunities.

## Strong competitive position

CML utilises a combination of outsourced manufacturing and in-house testing, employing 147 staff (40 per cent are engineers) across operations in the UK, Asia and USA. It has secured a diverse, blue chip customer base, including some of the world's leading commercial and industrial product manufacturers. The spread of its customers and diversity of the product range help protect the business from the cyclicality usually associated with the semiconductor industry.

The combination of CML's proprietary IP, a reputation for quality and reliability, and single-source supplier status means that once CML's chips are designed in a client's product then it rarely loses the contract. That's because there would be a significant amount of product redesign required for the client to take its business elsewhere. Furthermore, CML leverages years of engineering hardware and software development, and works closely with clients through the product development cycle to reduce the time-to-market and de-risk the future sales cycle. Effectively, this 'one-stop shop' offering is an extension of the customer's own engineering team.




CML's customer centric business model appeals to clients

The main design centre is located at the group's headquarters in Langford Essex where customers can either select a standard system on the chip that is made on an 'off the shelf' basis, so reducing product design investment, costs and time-to-market; a custom application specific integrated circuit that is based on CML's vast design library; or CML's proprietary technology.

## End markets

Although CML doesn't segment revenue by activity, a high proportion of sales are derived from Professional Mobile Radios, followed by a range of data-centric wireless applications (critical infrastructure, public utilities, smart grid). 5G infrastructure (base stations, small cells, distributed antenna systems) and satellite communications are currently a smaller part of the mix, but these are the high growth sectors that are forecast to deliver a far larger contribution in the coming years.

### Professional Mobile Radios

This is the network of choice for the police, ambulance service, military and in other critical infrastructure markets, enabling voice, data and geolocation communication with high reliability. The major players in this market are Motorola Solutions, JVC-Kenwood, Harris, Thales and Hytera. They all use CML's products.

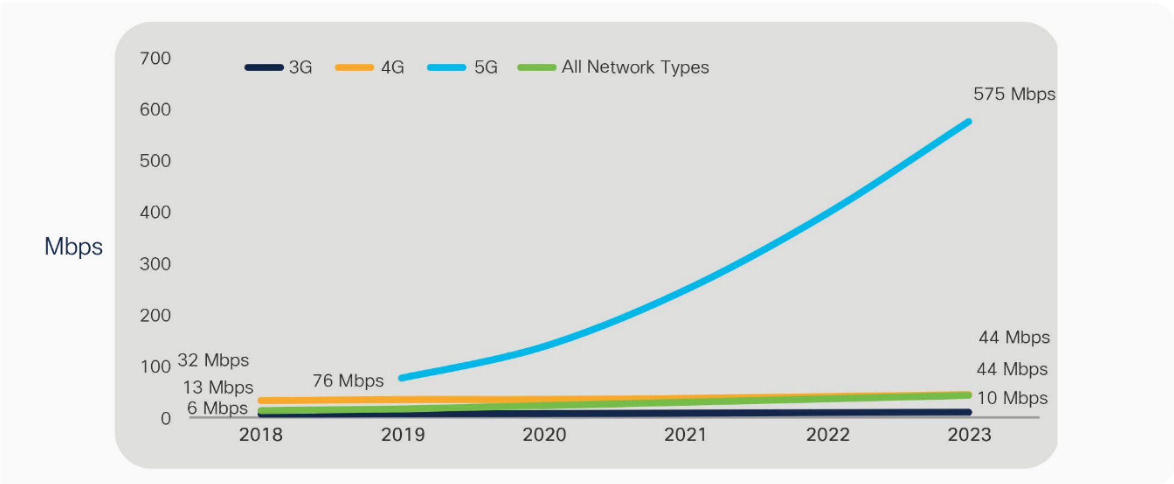
To simplify the design-in process and cut costs for the customer, each new product release also includes a shipset solution which can be used with CML's baseband or data modem integrated circuits. CML usually supplies between one and two chips per customer per device, but may ship four to five to any one customer, typically at an average selling price of \$3 to \$7 in a device that sells for \$150 to \$700.

### 5G infrastructure

The roll-out of 5G infrastructure is creating demand for a range of millimetre-wave RF front-end architectures that need high performance semiconductor integrated circuits. The market is expanding, GaN and GaAs power amplifiers and integrated circuits are adopted in millimetre-wave 5G base stations at the expense of silicon technology, despite being more expensive. That's because silicon-based integrated circuits are unable to achieve the radio frequency power levels that GaN and GaAs technologies offer.

Bearing this in mind, CML's new range of compound semiconductor products means the group is well placed to exploit the growing 5G infrastructure market opportunity.

Global mobile average speeds by network type: 5G speeds will be 13 times higher than the average mobile connection by 2023

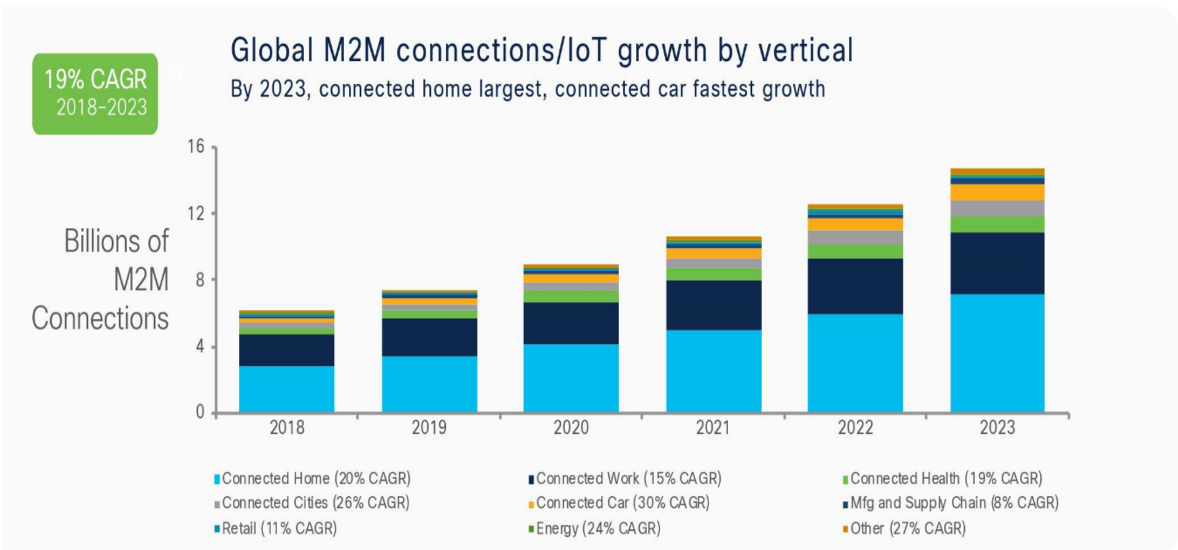



Source: Cisco Annual Internet Report, 2018-2023

## Industrial Internet of Things (IIoT)

Gartner Research defines the market for Industrial Internet of Things (IIoT) platforms as a set of integrated software capabilities which span efforts to improve asset management decision making, as well as operational control for plants, depots, infrastructure and equipment within asset-intensive industries. The platform software resides on smart devices (such as, controllers, routers, access points, gateways and edge computing systems), thus creating an ecosystem that communicates without the need for human involvement.

Global M2M connection growth by industries




Source: Cisco Annual Internet Report, 2018-2023

The fourth industrial revolution is well underway as smart devices already connect through 3G and 4G networks. However, it will be the capabilities offered by 5G infrastructure and networks that lead to far greater adoption of M2M and IIoT end-applications such as autonomous cars, and fibre-over-the-air. CML is well placed to exploit the business opportunity in these high-growth communications markets given its in-house compound semiconductor design capabilities and blue-chip client base.

## Satellite Communications

Satellite communications are being adopted by businesses and consumers for their broadband requirements, helped in part by government incentives to properties that are unable to connect to the internet through fast fibre networks.

CML already has a track record in this space having landed a design contract with Orbcomm, a privately-owned company that was acquired for $1.1bn by GI Partners last autumn. Orbcomm owns and operates a global network of 31 low-Earth orbit communications satellites and accompanying ground infrastructure, including 16 gateway Earth stations (GESs), around the world. It offers IIoT and M2M hardware, software and services that are designed to track, monitor, and control fixed and mobile assets in markets including transportation, heavy equipment, maritime, oil and gas, utilities and government.

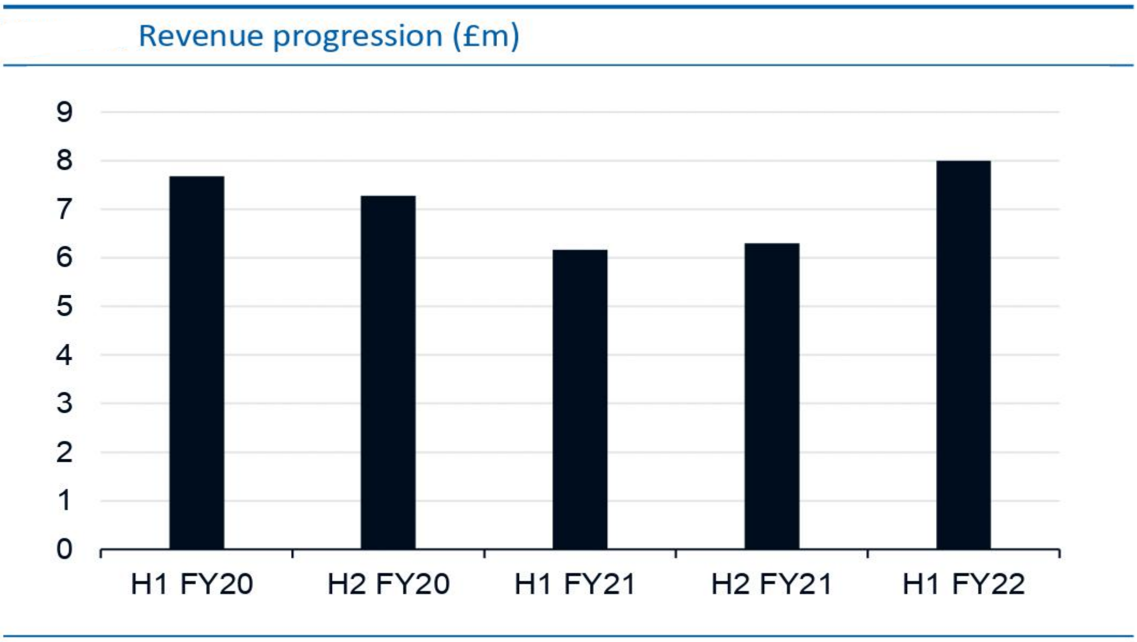
Other operators in this field include Viasat in the US, Eutelsat in Europe, Inmarsat's Global Express, OneWeb and Bharti Global, and Starlink (a satellite internet constellation operated by SpaceX). These operators have one thing in common – the links from their satellites to the ground stations use millimetre-wave links which in turn is boosting demand for 5G-ready satcom modem and RF chipsets.

## Impressive interim results highlight strong operational leverage and upgrade cycle

CML's business continues to recover strongly from the hit in the first half of the 2020/21 financial year when the Covid-19 pandemic impacted the voice centric radio manufacturers hard. As a component supplier into this market CML's revenues suffered accordingly, hence the profits declined that year.

Although this was always going to be a transient problem as traditional markets subsequently returned to growth trends, CML's first half results for the six months to 30 September 2021 were eye-catching even factoring in the improving backdrop for chip demand.

Buoyed by a record order book that stretches well into the 2022/23 financial year, and strong new order intake that has been assisted by demand from customers concerned about supply chain constraints within the semiconductor industry, CML's first half revenue surged 30 per cent to £8mn.




Source: Company Data; Shore Capital Markets

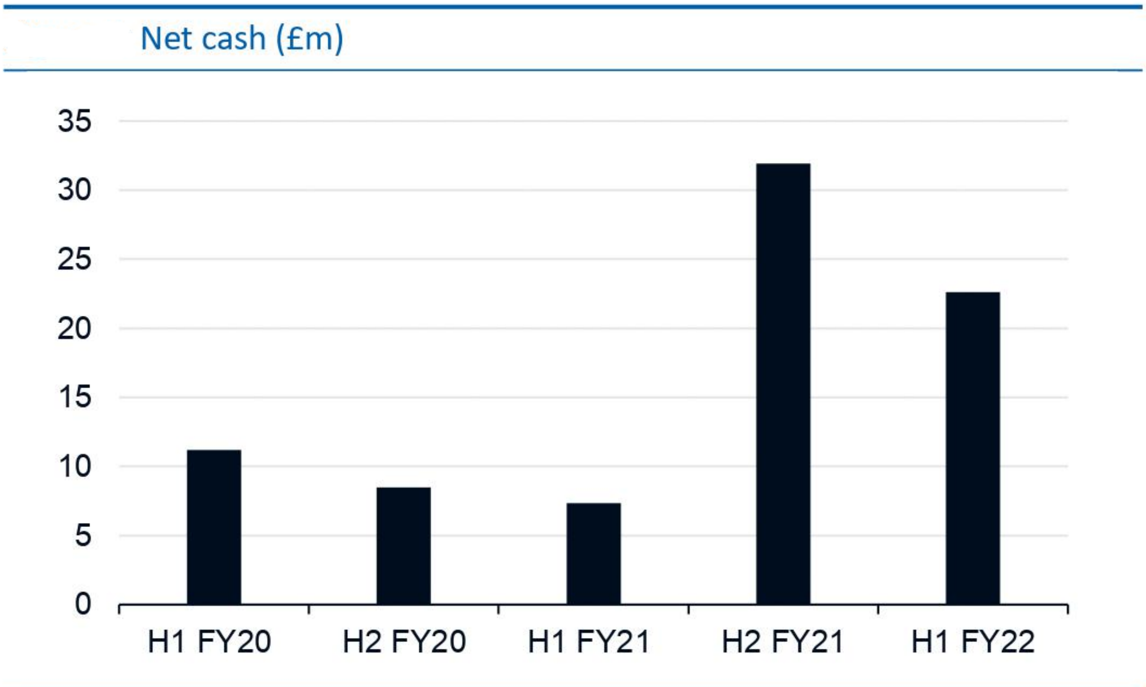
With gross margin stable at 76 per cent, and distribution and administration costs only modestly six per cent higher at £5.6mn, the group's earnings, before interest, taxation, depreciation and amortisation (Ebitda) soared by 43 per cent from £1.48mn to £2.12mn in the six-month period. This reflects the operational leverage of the business whereby a higher proportion of incremental gross profit earned is converted into cash profits in a positive sales cycle. To put the performance into perspective, CML reported Ebitda of £2.7mn in the 2020/21 financial year.

Summary KPIs (£m – unless otherwise stated)

| | 1H21A | 2H21A | FY21A | 1H22A | 2H22F | FY22F | FY Chg |
|---|---|---|---|---|---|---|---|
| Revenue | 6.1 | 6.3 | 12.5 | 8.0 | 7.8 | 15.8 | 27% |
| Gross profit | 4.7 | 4.6 | 9.3 | 6.1 | 5.8 | 11.9 | 28% |
| Gross margin | 77% | 72% | 74% | 76% | 74% | 75% | 1% |
| Adj EBITDA | 1.5 | 1.3 | 2.7 | 2.1 | 1.7 | 3.8 | 39% |
| Rpt PBT | -0.3 | 0.3 | 0.0 | 1.0 | 0.6 | 1.6 | n/a |
| Net cash/(debt) | 9.0 | 31.9 | 31.9 | 22.6 | 20.7 | 20.7 | -35% |

Source: Company Data; Shore Capital Markets

Cash conversion was impressive, too. Despite maintaining a policy of holding higher inventory levels to mitigate the impact of the well documented supply chain issues in the chip sector, CML still delivered £1.37mn cash from operations, representing a 64 per cent conversion rate of Ebitda. This strong cash performance enabled the directors to spend £0.88mn on capital expenditure (expansion of product range and investment into final test and evaluation equipment that can handle higher radio frequencies), and a further £2.2mn in research & development costs for new products. This meant that closing net cash of £22.6mn (136p a share) at 30 September 2021 was only down £1mn compared to six months earlier after adding back the £8.3mn (50p a share) special dividend payment paid to shareholders. That's a very healthy cash position.




Source: Company Data; Shore Capital Markets

Analysts at house broker Shore Capital have taken note of the positive sales momentum, pushing through 9.7 per cent revenue upgrades (from £14.4mn to £15.8mn) for the financial year to 31 March 2022, and 4 per cent upgrades to their 2022/23 revenue estimates (from £16.9mn to £17.6mn). What this means is that even after factoring in slightly lower gross margins of 75 and 73 per cent, respectively, around three quarters of the additional £0.8mn to £0.9mn of gross profit added to Shore Capital's previous forecasts drops through to Ebitda, hence the broker's 19 per cent upgrades. CML's Ebitda of £2.7mn on revenue of £12.5mn in 2020/21 is now expected to surge to £3.8mn on revenue of £15.8mn in the current year to 31 March 2022, and £4.4mn on revenue of £17.6mn in 2022/23.

Summary forecast changes (£m – unless otherwise stated)

| | FY22F Old | FY22F New | Chng | FY23F Old | FY21F New | Chng |
|---|---|---|---|---|---|---|
| Revenue | 14.4 | 15.8 | 9.7% | 16.9 | 17.6 | 4.1% |
| Gross profit | 11.1 | 11.9 | 6.9% | 12.0 | 12.9 | 7.1% |
| Margin | 77% | 75% | -2 ppts | 71% | 73% | +2 ppts |
| Adj EBITDA | 3.2 | 3.8 | 18.8% | 3.7 | 4.4 | 18.9% |
| Margin | 22% | 24% | +2 ppts | 22% | 25% | +3 ppts |
| Adj Dil EPS (p) | 10.1 | 11.9 | 17.8% | 12.7 | 14.6 | 15.0% |
| Dividend (p) | 4.0 | 9.0 | 125% | 5.2 | 10.8 | 108% |
| Net cash/(debt) | 21.1 | 20.7 | -1.9% | 19.4 | 19.3 | -0.5% |

Source: Company Data; Shore Capital Markets

The broking house has also upgraded its adjusted earnings per share (EPS) estimates by 18 per cent to 11.8p (2021/22) and by 15 per cent to 14.6p (2022/23), implying 23 per cent earnings growth for the next 12-month forecast period. Net of £20.7mn (125p a share) of forecast cash at the financial year end, the shares are effectively priced on a cash-adjusted forward price/earnings (PE) ratio of around 18. That's hardly a punchy rating for a business that is in a strong earnings upgrade cycle and benefiting from new product launches and strong secular growth trends. World Semiconductor Trade Statistics estimate that world semiconductor markets rebounded 25 per cent last year, recovering strongly from the 2020 impact of the Covid-19 pandemic.

In addition, the directors have ample firepower to make bolt-on complementary earnings enhancing acquisitions, the effect of which should drive down the earnings multiple while at the same time rewarding shareholders with a progressive dividend policy. Shore Capital are pencilling in an annual pay-out of 9p a share in the current financial year, rising 20 per cent to 10.8p a share in 2022/23, implying a prospective dividend yield of 2.7 per cent.

It's also worth noting that CML has a rock-solid balance sheet with material hidden value.

## Hidden value in property and land holdings

At the half-year end CML had net assets of £46.6mn (281p a share), almost half of which was net cash of £22.6mn. The group also owns some valuable unencumbered investment property at Witham, near Chelmsford (the land and building the group traded from until 1999) as well as the old Microsense facility at Portsmouth which is let to a third party. These properties have a historic value of £2.46mn and were valued at £3.78mn at 31 March 2021, a valuation well underpinned by annual rental income of £344,000.

In addition, the unencumbered property and 29 acres of surplus land at the headquarters at Oval Park, Maldon, Essex has a £4.5mn carrying value in CML's accounts, or less than half its estimated open market value of £10mn. The land alone is likely to be worth many times its £4mn to £5mn open market valuation with residential planning consent, albeit CML has previously applied and failed to obtain consent in the past.

Even without redeveloping any of these three properties, they are still worth around £14mn (84p a share) which means that cash and property currently backup £36.6mn (221p a share), or more than half, of CML's market capitalisation of £66.4mn. Effectively, CML's operational business is in the price for £30mn, or a miserly 1.7 times annual sales based on forecast revenue of £17.6mn in the 2022/23 financial year.

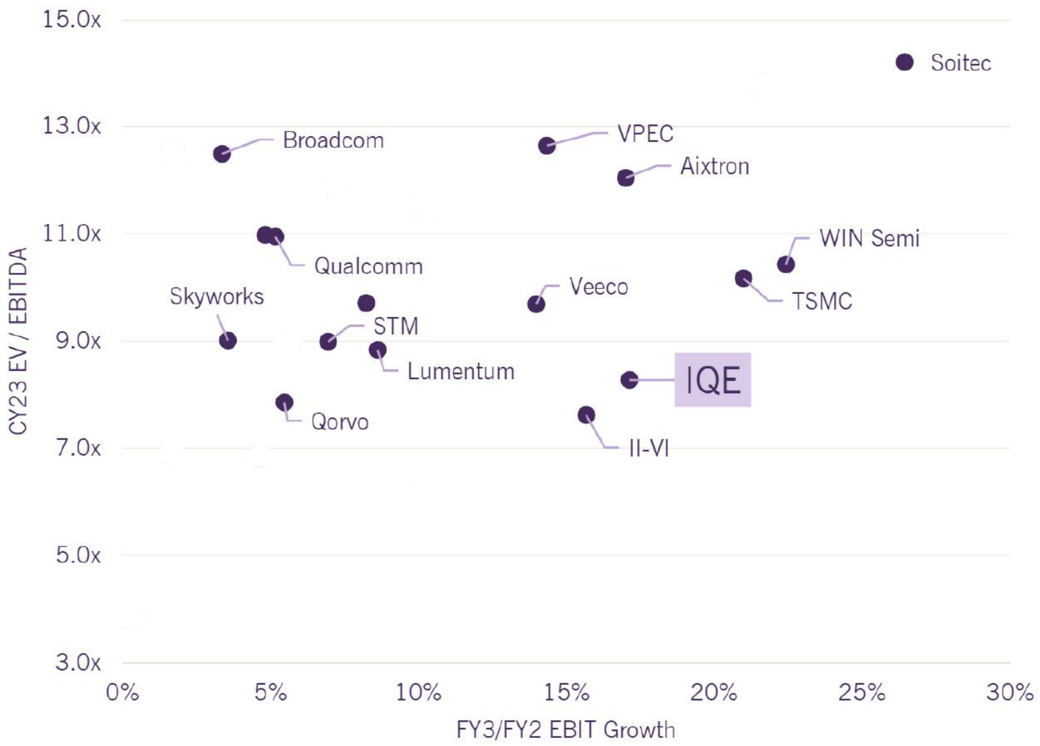
## Peer group comparison

To put CML's current modest valuation into perspective, the Philadelphia Semiconductor Index (a basket of the 30 largest global semiconductor stocks) trades on 6.4 times current annual sales, or almost four times the rating being attributed to CML's operational business.

CML has scarcity value in the UK, too. The only other UK-listed semiconductor company with earnings to benchmark it against is Cardiff-based **IQE** (IQE), a £266mn market capitalisation small-cap company.

IQE consensus valuation vs peers

*Source: Company accounts, Peel Hunt estimates*




Having seen its share price rally since issuing a trading update in late January, IQE is currently trading at 9.7 times enterprise valuation (EV) to Ebitda for the 2023 financial year when IQE's joint broker, Peel Hunt, predicted 12 per cent growth in Ebitda to £28.4mn. By comparison, CML is priced on an EV/Ebitda multiple of 10 times, which falls sharply to 8 times after stripping out £9mn worth of unencumbered surplus land holdings and its investment property.

CML is predicted to grow Ebitda by 16 per cent in its 2022/23 financial year, or four percentage points more than IQE. CML also has a 31 March 2023 year end whereas the forecasts for IQE are for the 12 months to 31 December 2023. On a calendar basis, CML's operational business could be making Ebitda of £5mn in 2023 after factoring in low double-digit profit growth, a highly realistic scenario.

On this basis, the cash profit multiple drops to only seven times enterprise valuation after stripping out the value of the surplus land, investment property and cash from the £66.4mn market capitalisation. There isn't a single company in Peel Hunt's peer group that is so lowly rated and CML's mid-teens earnings growth rate is mid to top quartile, too.

An expansion of CML's EV/Ebitda multiple to 10 times likely calendar 2023 Ebitda of £5mn would imply a market capitalisation of £83mn (500p a share), but the shares would still be inexpensive compared to larger rivals that trade on multiple of 11 to 14 times multiples. Fair value of the equity is closer to 550p a share, with the risk still weighted to the upside.

Management

The board's chairman is **Nigel Clark**, a chartered accountant. He was appointed Company Secretary in 1983, Group Financial Controller a year later and non-executive chairman six years ago.

**Chris Gurry** was appointed to the board in 2000 as Business Development Director and became Group Managing Director in October 2007. Prior to joining CML, he worked within the electronics design and manufacturing industry leading organisations primarily focused on applications within radio communications markets. Gurry holds a 5.48 per cent stake in the company.

CML's Microcircuits managing director **Mark McCabe** joined the group five years ago from Air Liquide, a global leader in the supply of gases to the nuclear, food and electronics markets. Previously, he gained experience in the electronic components industry as managing director of Semelab, part of TT Electronics, and executive vice president at SRC Devices and operational roles at Semitron. McCabe qualified as an electrical electronic engineer working at the Ministry of Defence.

**Mike Gurry** (brother to Chris) is Senior Vice President, group operations and logistics. Gurry has over 30 years' industry experience and has held roles as CML's manufacturing director (between 1997 and 2006) and subsequently UK Managing Director. He holds a 5.79 per cent equity stake.

**Nigel Wilson** is Senior Vice President, Technology, overseeing the group's technical activities with responsibility for strategic projects and technology programmes. He joined CML in 2002 to establish and build an RF Systems and Software capability, having previously held senior engineering roles at Securicor Wireless Technology, TTPCom (acquired by Motorola in 2006), and Plessey/GPT where he managed the development of a diverse range of communications products including GSM radios, cordless handsets and air traffic control equipment.

It's worth pointing out that CML's former finance director departed in February 2020 to pursue other opportunities. Chairman Nigel Clark then held the dual role of chairman and finance director on an interim basis, with the intention of securing a replacement finance director. However, following the Hyperstone disposal 12 months ago, which substantially reduced the scale of the group's operations, the board took the view that the strength in depth of its finance function, and the significant amount of financial expertise on the board, meant that there was no immediate need to appoint a new financial director. Clark retains overall responsibility for the finance function at board level.

CML has two non-executive directors: **Jim Lindop** and **Geoff Barnes**.

Lindop has extensive innovative leadership experience in the technology and engineering sectors, having spent over 30 years in the industry. He joined the group in 2013, having previously been founder and chief executive of Jennic, a privately held semiconductor company established in 1996 that was subsequently acquired by NXP Semiconductors in 2010. He has consulted companies in Cambridge, UK, including Symbionics, building and leading project teams in new wireless technologies. He has also held positions at Rolls-Royce designing electronic instrumentation for aero-engines.

Barnes is a former director of Baker Tilly having transitioned to the role in June 2016 after serving as its chief executive and president for 16 years. Previous roles include 18 years with Casson Beckman, culminating in the position of executive chairman, and six years with Deloitte Haskins & Sells in London where he qualified as a chartered accountant.

In the 2020/21 financial year, the main board directors were paid total salaries and benefits of £695,000 and received combined bonus payments of £249,000 relating to the sale of Hyperstone. In aggregate the Gurrys have interests in 20.7 per cent of the shares in issue, so upside in the share price and dividend income are by far the greatest financial incentive to them, thus aligning their interests with those of outside shareholders.

## Aim listing and major shareholders

CML moved its listing from the London Stock Exchange main market to Aim last summer. The rationale being that following completion of the sale of its storage division, CML is focussed on a much larger global opportunity within the wireless communications market. The directors consider that Aim provides a more appropriate regulatory environment for the company and its growth prospects.

The board also believes that, as an Aim company, certain shareholders may benefit from inheritance tax and stamp duty reserve tax exemptions in respect of their share interests, which are more attractive than those applicable to a company listed on the main market. In addition, given CML's anticipated earnings growth and income stream (from dividends), being admitted to trading on Aim will assist in diversifying the shareholder base and enable CML to be more flexible in relation to future corporate actions, complementing existing capital resources following the recent disposal.

Interestingly, some fund managers are backing the board including Premier Miton, Liontrust Asset Management, Otus Capital, Ruffer Investment Management, Herald Investment Management, and Schroders Investment Management. In total the top-10 shareholders hold 69 per cent of the 16.6mn shares in issue. The shares can still readily be traded between the bid-offer spread.

CML Microsystems major shareholder

| **Name** | **Percentage** |
|---|---|
| Premier Miton | 11.65% |
| Otus Capital Management | 9.48% |
| J. M. Gurry | 9.45% |
| Liontrust Asset Management | 6.62% |
| Herald Investment Management | 6.50% |
| Ruffer Investment Management | 6.03% |
| M. I. Gurry | 5.79% |
| C. A. Gurry (managing director) | 5.48% |
| T. M. R. Dean | 5.37% |
| Schroder Investment Management | 3.56% |
| **Total** | **69.93%** |

Source: CML Microsystems 2021 Annual Report, London Stock Exchange filings

## Target

On any basis, CML's shares are being undervalued. The group's market capitalisation of £66.4mn equates to a modest 1.4 times net assets even though property holdings are being conservatively valued and net cash backs up a third of the share price.

Moreover, with the group forecast to deliver 25 per cent growth in pre-tax profit (from £2mn to £2.5mn) in the 2022/23 financial year, CML's operational business is effectively only being priced on 12 times pre-tax profits, and a miserly eight times Ebitda. Add to that prospects for a 20 per cent hike in the pay-out which supports a 2.7 per cent prospective dividend yield, and CML's attractive income stream and high earnings growth potential underpin my 12-month target price of 550p**. Buy.**

## Risk assessment

**Currency risk.** In the 2021 financial year, CML's three largest regions by revenue were the Far East (56 per cent), Europe (24 per cent), and Americas (16 per cent). The majority of CML's earnings are linked to the US Dollar, so a decline in this currency will have a direct effect on revenue, although since the majority of the cost of sales are also linked to the US Dollar, this risk is reduced at the gross profit line. To put this into perspective, in the last financial year a 10 per cent movement in the sterling-US dollar and sterling-Renminbi exchange rates would have impacted profits by £0.48mn and £42,000, respectively.

**Customer risk.** Though the group has a diverse customer base in certain market sectors, key customers can still represent a significant amount of revenue. Customer relationships are closely monitored, but changes in buying patterns of a key customer could have an adverse effect on the group's financial performance. That said, only one customer is believed to account for more than 10 per cent of group revenue in the 2021/22 financial year, so the customer base is well diversified.

**Bad debt risk.** CML's blue-chip client base insulates the business from bad debts. The average credit period was 29 days in the 2020/21 financial year, and there were no impairment losses recognised on any financial assets. Of the £1mn trade receivables outstanding, the majority was classed as within 30-60 days.

**Pension scheme deficit.** CML had a £5.5mn group pension fund liability at 30 September 2021 when 57 per cent of the fund's £22mn assets was invested in equities. The pension scheme no longer invests in bonds, so has been insulated from the spike in bond yields, but is exposed to any stock market weakness.

**Economic downturn.** Given the nature of the markets CML operates within, the spread of its customers and diversity of the product range largely protects the business from the cyclicality usually associated with the semiconductor industry. Furthermore, its end markets are being driven by secular growth drivers which means that end customers are insulated from a consumer downturn to some extent, although the roll-out of some of the new products may be delayed, dampening demand for its semiconductors if the global economy weakens.

Alpha Editor: James Norrington
Alpha Production Editor: Sameera Hai Baig



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