Zacks Small-Cap Research

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Zecotek Photonics (V.ZMS)

V.ZMS: Another Upward Revision to Revenue Estimates Following Solid Q3 Numbers

We model revenue to grow from $452k in 2015 to almost $50M in 2025. Our DCF model, which uses an 8% discount rate and 2% terminal growth rate, values the shares at approximately $1.50.

Current Price (05/02/2016)	$0.27
Valuation	**$1.50**

OUTLOOK

Zecotek is the only company in the world to own all key elements for a high performance PET scanner. Technology is protected by large patent portfolio. ZMS.V is well positioned to capitalize on growth of PET market. Their LFS scintillation crystals look to be superior to any other crystals on the market and with PET scanner performance tied to performance of crystals, demand for LFS crystals could be substantial. Hamamatsu relationship holds significant potential but ZMS recently exploiting other opportunities as well. Recent relationship with Chinese PET OEM could be a home run, but we think too early to make any predictions. ZMS seeing interest from U.S. PET manufacturers and for applications in drug research as well. More recent opportunities in homeland and border security. Formal supply relationship with U.S. PET OEM 'major' Philips remains a possibility.

SUMMARY DATA

52-Week High	**$0.61**
52-Week Low	**$0.23**
One-Year Return (%)	**-25**
Beta	**0.55**
Average Daily Volume (sh)	**161,781**
Shares Outstanding (mil)	**119**
Market Capitalization ($mil)	**32**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**N/A**
Insider Ownership (%)	**N/A**
Annual Cash Dividend	**N/A**
Dividend Yield (%)	**N/A**
5-Yr. Historical Growth Rates	
Sales (%)	**N/A**
Earnings Per Share (%)	**N/A**
Dividend (%)	**N/A**
P/E using TTM EPS	**N/A**
P/E using 2016 Estimate	**N/A**
P/E using 2017 Estimate	**N/A**
Zacks Rank	**N/A**

Risk Level	**N/A**
Type of Stock	**Large-Growth**
Industry	**Med Products**

ZACKS ESTIMATES

Revenue
(in '000 of $)

	Q1 (Oct)	Q2 (Jan)	Q3 (Apr)	Q4 (Jul)	Year (Jul)
2015	98 A	76 A	70 A	208 A	452 A
2016	150 A	697 A	685 E	550 E	2082 E
2017					5483 E
2018					10144 E

Earnings per Share

	Q1 (Oct)	Q2 (Jan)	Q3 (Apr)	Q4 (Jul)	Year (Jul)
2015	-$0.02 A	-$0.02 A	-$0.01 A	-$0.01 A	-$0.07 A
2016	-$0.01 A	-$0.02 A	-$0.01 E	-$0.01 E	-$0.05 E
2017					-$0.05 E
2018					-$0.03 E

Zacks Projected EPS Growth Rate - Next 5 Years % **N/A**

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Q3 Revenue Preannouncement: Another solid quarter with LFS demand coming from several sectors…

Zecotek preannounced Q3 (ending April 2016) revenue of approximately $685k, which is up from just $70k in the comparable year-earlier period and roughly flat from the $697k posted in Q2. It's also ahead of our $550k estimate. This is the second consecutive quarter where revenue significantly outperformed our estimates. As such, we have since incrementally increased our subsequent period revenue estimates and now look for 2016 full-year sales of just about $2.1M, upwardly revised from $1.9M. And we note that our prior $1.9M estimate was previously increased from $1.3M.

As we first noted in our Q4 2015 update in August 2015, we expected some significant increases in order sizes going through fiscal 2016 which aligned with management's comments that sales were gaining momentum. With revenue in both Q2 and Q3 besting that of the full year 2015 by about 50%, that foresight seems to be accurate.

And importantly, sales are diversified among several customers including CERN for its PET medical device program, a Chinese PET OEM and an OEM which is using the LFS crystals in radiation monitoring and detection devices for homeland security applications.

ZMS still has $2M of orders that have yet to flow through the income statement and their China-based LFS manufacturer, BOET, continues to scale up production in anticipation of even greater demand. This should bode well for continued revenue growth.

And while ZMS still continues to carry almost significant customer deposits (i.e. deferred revenue) on their balance sheet related to previous orders which Hamamatsu has yet to take possession of (which we think relates mostly to dragging feet of Hamamatsu), there is more than just anecdotal evidence that ZMS is making a more determined effort to branch out to other customer channels. And while complete speculation on our part, the drawn-out delay with Hamamatsu and ZMS's additional sales and marketing efforts, to the likes of Chinese PET manufacturers, UC Davis, U.S.-based medical imaging manufacturers, U.S. homeland security and others, may be related. LFS crystals orders from non-Hamamatsu customers is what is driving the inflection in revenue and this is now where we think the majority of near-term growth will come from.

The most recent significant news came in late March when ZMS announced that "a major medical OEM based in China has selected Zecotek's patented LFS scintillation crystals for a new line of high resolution PET medical imaging devices". The parties entered into memorandum of understanding (MUO) which stipulates that upon delivery by ZMS of LFS crystals (end of April) and subsequent installation of the initial PET scanner incorporating the crystals in a hospital in Shanghai (early summer), that the MUO will convert into a contract. Under the contract, per the press release, "the OEM is projecting the installation of 200 LFS based PET scanners in hospitals and clinics across China over the next five years."

While we think it is much too early to start modeling 200 PET scanners worth LFS crystals sales, given that each scanner could need ~$400k - $500k in crystals, if ZMS were able to realize even a small fraction of this "minimum of 200 PET machines", it could be significant. Given the lack of reaction to ZMS's share price following announcement of the MUO, the market clearly is discounting any chance of significant orders resulting from this relationship. If the contract is consummated – which could be a summer event, it would at the very least provide greater confidence in continued and greater order flow from this customer. And it may also introduce greater potential that ZMS could be an acquisition candidate.

Additional recent operational developments includes the introduction of ZMS's next-gen photodetector, MAPT (micro-pixel avalanche photo transistors). MAPT follows in the footsteps of the legacy MAPD photo detector and will target Time-of-Flight scanners (i.e. - high-end, high resolution scanners). While ZMS's LFS crystals have been the headline-grabber given their superior performance to all other scintillation crystals as well as being the most near-term revenue source for the company, MAPT could eventually be a more significant product for the company. Zecotek's MAPT has shown to have much faster response time and higher resolution to alternative technologies. Zecotek's MAPD/MAPT have been developed to replace photo multiplier tubes, which remain the most commonly used photo detectors in PET scanners and gamma cameras. Photo multiplier tubes are very sensitive detectors of light with high gain, low noise and very fast response, which has made them ideal for applications such as in advanced medical imaging cameras. But they have some drawbacks, including being relatively large, expensive, and require very high voltage. As such PET manufacturers could be highly receptive to a more practical alternative and could offer the next wave of growth for ZMS.

Outlook

While the continued lack of recognition of orders from Hamamatsu remains disappointing, what we had previously viewed as more ancillary customer channels has recently come more to the forefront and is beginning to show up in the financials. We think this may have been a deliberate shift in focus and effort by ZMS to exploit opportunities via direct sales.

Revenue has been challenging to accurately forecast, missing our numbers on the low side the prior couple of quarters and then showing a big beat in the most recent period. While we think revenue may continue to be variable over the near-term, the recent customer engagements, continued broadening of the customer base and what we think is a more deliberate spreading of ZMS's wings towards opportunities outside of Hamamatsu has us encouraged that sales will trend towards more consistency. More importantly, however, will be if ZMS can steepen the revenue curve. As the customer base grows, so do the potential shots on goal and opportunities to grow revenue.

The Chinese PET OEM relationship could be home run but we think it is prudent to forego modeling any significant related contribution until, at least, the MUO turns into a formal contract (if it ever does). And if it reaches that point and with additional clarity on potential scheduling of follow-on orders, there may be an opportunity to make an informed estimate related to potential future sales through this channel.

Near-term could see recognition of more of the outstanding Hamamatsu orders. And ZMS could see additional interest for their LFS crystals from manufacturers of small and next-gen Time-of-Flight PET scanners as well as in applications such as pre-clinical pharmaceutical research for drug development. And while a formal supply relationship with Philips has yet to be penned, that possibility remains open and, if it happens, could be a needle-mover for ZMS. And another, more recent, opportunity could be in homeland security applications. ZMS announced in early April that their crystals will be tested in devices used by homeland security and border patrol personnel – the Q3 2016 revenue preannouncement indicates that an OEM is now using the crystals in radiation monitoring and detection devices for homeland security applications..

We now look for 2016 revenue of $2.1M, which we have moved up from $1.9M prior to Q3 preannouncement. The revisions to our model have not impacted our DCF-generated price target, which remains at $1.50/share.

FINANCIAL MODEL

Zecotek Photonics Inc.

	2015 A	Q1A	Q2A	Q3E	Q4E	2016 E	2017 E	2018 E	2019 E
Total Revenues	$451.7	$149.6	$697.4	$685.5	$549.8	$2,082.2	$5,482.5	$10,143.9	$18,688.6
YOY Growth	*421.9%*	*52.8%*	*822.1%*	*877.2%*	*164.3%*	*360.9%*	*163.3%*	*85.0%*	*84.2%*
Cost of Goods Sold	$322.9	$94.5	$593.91	$418.1	$329.9	$1,436.4	$3,070.2	$4,970.5	$7,008.2
Gross Income	$128.8	$55.1	$103.5	$267.3	$219.9	$645.8	$2,412.3	$5,173.4	$11,680.4
Gross Margin	*28.5%*	*36.8%*	*14.8%*	*39.0%*	*40.0%*	*31.0%*	*44.0%*	*51.0%*	*62.5%*
SG&A	$5,825.1	$867.6	$1,483.8	$1,182.0	$1,066.0	$4,599.4	$6,962.8	$7,607.9	$8,223.0
% SG&A	*1289.5%*	*580.0%*	*212.8%*	*172.4%*	*193.9%*	*220.9%*	*127.0%*	*75.0%*	*44.0%*
R&D	$1,468.7	$356.3	$493.0	$465.0	$444.0	$1,758.3	$1,621.0	$1,657.0	$1,812.0
% R&D	*325.1%*	*238.2%*	*70.7%*	*67.8%*	*80.8%*	*84.4%*	*29.6%*	*16.3%*	*9.7%*
Operating Income	($7,165.0)	($1,168.9)	($1,873.4)	($1,379.7)	($1,290.1)	($5,712.0)	($6,171.5)	($4,091.5)	$1,645.4
Operating Margin	*-1586.1%*	*-781.4%*	*-268.6%*	*-201.3%*	*-234.7%*	*-274.3%*	*-112.6%*	*-40.3%*	*8.8%*
Total Other Income (Expense)	($290.8)	$124.8	($320.2)	$0.0	$0.0	($195.5)	$0.0	$0.0	$0.0
Pre-Tax Income	($7,455.8)	($1,044.1)	($2,193.6)	($1,379.7)	($1,290.1)	($5,907.4)	($6,171.5)	($4,091.5)	$1,645.4
Tax expense (benefit)	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
Tax Rate	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*
Net Income	($7,455.8)	($1,044.1)	($2,193.6)	($1,379.7)	($1,290.1)	($5,907.4)	($6,171.5)	($4,091.5)	$1,645.4
YOY Growth	*-13.9%*	*-54.9%*	*-9.2%*	*19.0%*	*-17.6%*	*-20.8%*	*4.5%*	*-33.7%*	*-140.2%*
Net Margin	*-1650.5%*	*-698.0%*	*-314.6%*	*-201.3%*	*-234.7%*	*-283.7%*	*-112.6%*	*-40.3%*	*8.8%*
EPS	($0.07)	($0.01)	($0.02)	($0.01)	($0.01)	($0.05)	($0.05)	($0.03)	$0.01
YOY Growth	*-26.6%*	*-60.2%*	*-14.0%*	*13.2%*	*-24.3%*	*-26.7%*	*-5.9%*	*-36.6%*	*-139.6%*
Diluted Shares O/S	108,340	112,275	116,211	118,000	122,000	117,122	130,000	136,000	138,000

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