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Zacks Small-Cap Research

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Zecotek Photonics (V.ZMS)

V.ZMS: China-Based Production Gearing Up. Will Order Fulfillment and Revenue Finally Ramp?

We model revenue to grow from $440k in 2018 to about $38M in 2025. Our DCF model, which uses an 8% discount rate and 2% terminal growth rate, values the shares at approximately $0.75.

Current Price (07/18/2018)	$0.20
Valuation	**$0.75**

OUTLOOK

Hopefully the positive headlines are a harbinger to near-term revenue growth as Zecotek could certainly use a lot better news as it relates to their financial performance – which as of recently has been downright dismal. Through the six months ending April 30, 2018, which represents ZMS's two most recently reported fiscal quarters (i.e. Q2/Q3 '18), revenue was just $12k. That is the weakest topline of any consecutive two-quarter period since fiscal Q3/Q4 '12 ($6k revenue).

If lack of owned-manufacturing was indeed the hurdle that ZMS needed to clear before they could begin to fill the various multi-million dollar LFS crystals orders, then the news flow over the last several months has us hopeful that the company's historic inability to translate operational progress into revenue growth may soon be coming to an end. Proof will be on the income statement and, with fulfillment of substantive orders expected to have already begun and grow throughout the remainder of calendar 2018, we would expect to see meaningful revenue generation by the end of fiscal Q1 2019 (October 31, 2018) and for annualized revenue to reach a minimum of $2M by Q2 2019.

SUMMARY DATA

52-Week High	**$0.35**
52-Week Low	**$0.19**
One-Year Return (%)	**-35**
Beta	**1.51**
Average Daily Volume (sh)	**152,857**
Shares Outstanding (mil)	**165**
Market Capitalization ($mil)	**33**
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 2018 Estimate	**N/A**
P/E using 2019 Estimate	**N/A**
Zacks Rank	**N/A**

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

ZACKS ESTIMATES

Revenue
(in '000 of $)

	Q1 (Oct)	Q2 (Jan)	Q3 (Apr)	Q4 (Jul)	Year (Jul)
2017	208 A	6 A	212 A	42 A	467 A
2018	189 A	8 A	4 A	239 E	440 E
2019					4863 E
2020					11030 E

Earnings per Share

	Q1 (Oct)	Q2 (Jan)	Q3 (Apr)	Q4 (Jul)	Year (Jul)
2017	-$0.01 A	$0.00 A	-$0.01 A	-$0.01 A	-$0.02 E
2018	-$0.00 A	-$0.01 A	-$0.01 A	-$0.01 E	-$0.03 E
2019					-$0.03 E
2020					-$0.02 E

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

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China-Based Production Gearing Up. Will Order Fulfillment and Revenue Finally Ramp?

Zecotek has had several positive announcements over the last few months, many of which relate to their Chinese operations. Zecotek Imaging China, which is now anticipated to represent one of the most significant opportunities for growth of the company, has been the main subject of the recent headlines. Much of the content has surrounded the anticipated opening of a Zecotek-owned Shanghai-based crystals manufacturing operation and expectations of subsequent sales to EBO and PET scanner manufacturers.

Hopefully the positive headlines are a harbinger to near-term revenue growth as Zecotek could certainly use a lot better news as it relates to their financial performance – which as of recently has been downright dismal. Through the six months ending April 30, 2018, which represents ZMS's two most recently reported fiscal quarters (i.e. Q2/Q3 '18), revenue was just $12k. That is the weakest topline of any consecutive two-quarter period since fiscal Q3/Q4 '12 ($6k revenue).

"Orders" ≠ Revenue???
The recent financial performance is particularly disappointing as we had hoped to see initial revenue from the various LFS crystal orders that ZMS has alluded to over the recent past – that includes a $100k order related to "tier 1" PET OEMs (announced May 2017), $1.2M of orders (mostly) from EBO (announced July 2017), potential orders worth up to an estimated $10M from a (unnamed) European PET OEM (announced October 2017) and a $5M order ("single largest P.O.") through a distribution partner in China (announced June 2018). And that's in addition to an agreement to supply EBO with "over $21M worth of scintillation crystals over the next three years" (announced January 2017), the MUO related to supplying LFS crystals for up to 200 PET scanners to an OEM in China (initially announced March 2016) and the still-outstanding ($1.25M worth of) orders from Hamamatsu.

Exactly why the massive disconnect between what's been announced and what's shown up in the revenue line of the income statement? We don't know. Certainly, one of the suggestions is that there was a need for ZMS to own their own manufacturing – with potentially several reasons why that was required. Including that customers and prospective customers wanted assurance of quality control, capacity and chain-of-custody. Another is that owned-manufacturing would provide ZMS with greater control over processes, protection of IP and pricing.

If proprietary manufacturing was indeed the reason (or the main reason) why these 'orders' didn't turn into actual orders then we are hopeful that the income statement will begin to show much closer correlation to the relative positivity of the news flow. That's because, over the last few months, ZMS's press releases have indicated that they have funded and opened their own manufacturing operation in Shanghai and that commercial production is on the cusp of commencement. So, with orders in-hand and manufacturing gearing up, we expect to see that translate into relatively very significant revenue in very near-term.

Status of the manufacturing operation…
Presumably part of the hold-up was lack of sufficient capital and part of it was administrative – specifically, regulatory approval for ZMS and their majority-owned subsidiary, Zecotek Imaging China (ZIC), to operate in Shanghai. That apparently was finalized in early April – which apparently was a prerequisite for the $5M invested in ZIC by the unnamed industrial business group based in China to be transferred to ZMS. In addition to almost $6M that ZMS raised through fiscal Q3 '18 from the sale of common stock, this $5M helped to fund the securing, building-out and opening of the Shanghai crystals production facility.

In early July ZMS announced production was initiated at their LFS crystals manufacturing facility, that they would host customers to inspect the operation and that they expected production to expand over the coming months. Then, last week, ZMS announced that they are working with EBO to "prepare for the resumption" of crystals delivery related to the previously-announced (January 2017) $21M order (over three years). Dr. CJ Yang, "President and CEO of Shanghai EBO Optoelectronics Technology Company", is quoted in the press release stating "We are very impressed by Zecotek's new crystal manufacturing facility in Shanghai, which will supply LFS scintillation crystals to a number of our clients developing positron emission tomography scanning devices" and "We look forward to working closely with Zecotek and resuming our supply agreement."

All of this suggests revenue should begin to ramp, but will it?…
In addition to the progress with the crystals production facility, ZMS appears to have also made headway with distribution. That includes in agreement (announced in mid-March 2018) with Shanghai Fortune Techgroup (website http://bit.ly/2JyI5LM) to provide distribution for their LFS crystals in China. This is an addition to distribution through EBO

All of this certainly seems to suggest that commercial production, sales and related revenue is about to ramp. That suggestion is particularly reinforced by two of the most recent press releases. On June 11th ZMS announced that the (unnamed) European PET OEM "made a larger scale order of arrays for final design" and "higher production volumes to commence later this year." Then on June 13th ZMS announced the new (and largest to-date) $5M crystals order, noting that the "first shipment of LFS crystals is expected to be completed in the next 30 days" and that the "remaining shipments will take place over the next 12 months."

But given the historic lack of correlation between seemingly significant operational progress, including the securing of several different multi-million dollar crystals orders, and what has shown up on the income statement, will all of this recent positive news flow actually translate into substantive commercial production, sales and related revenue? Given the very near-term timelines (i.e. by late-July, or sooner) implied in some of the recent press releases as to when substantive shipments should begin, we should know the answer to these questions fairly soon. We are giving ZMS the benefit of the doubt and have, again, made adjustments to our model which we think fairly represents what the company has communicated. We hope we will need to re-update our model in the very near future with upward revisions to our revenue.

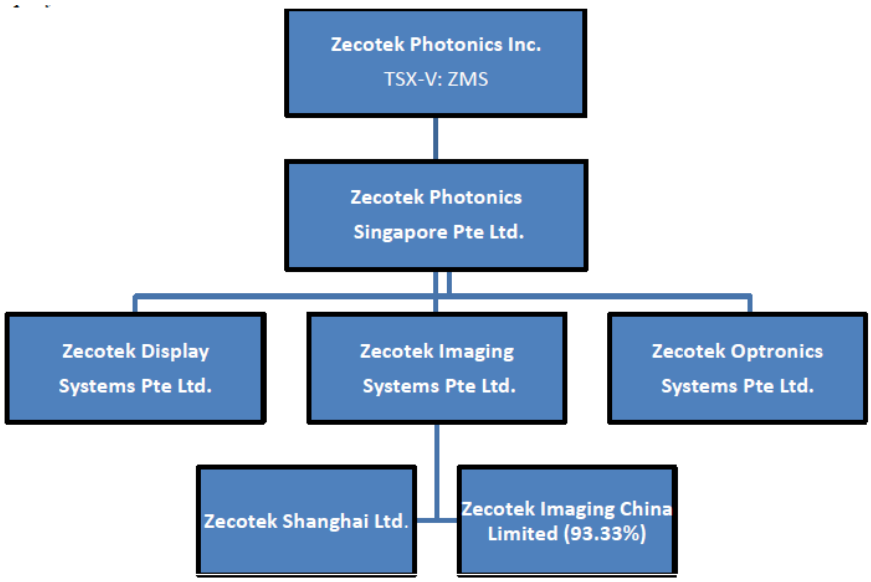
Healthy cash balance…

While ZMS has yet to be consistently successful in turning operational progress into revenue growth, they have been successful (particularly as of late) in raising badly-needed funds. Through the first nine months of fiscal 2018 (ending April 30th), ZMS raised nearly $11M which, in addition to the $5M from sale of 6.7% of ZIC, included $5.9M (net) from the sale of common stock. ZMS ended fiscal Q3 with $4.8M on their balance sheet. Some of these funds, as noted, were used to secure and build-out the production facility.

While ZMS has not provided cash-burn related guidance, we expect that their relatively sizable cash balance is sufficient-enough to fund initial working capital needs to begin commercial sales of their LFS crystals. And while we have no particular insight, we think it's also possible that they may have access to some form of trade credit or customer financing, if needed.

Subsequent to Q3, ZMS announced another equity investment from the same "industrial business group based in China" – but instead of sale of a portion of ZIC, this time it was $2M for a 2% stake in Zecotek Imaging Systems Pte. Ltd. As indicated in ZMS' press release, that ratio implicitly values Zecotek Imaging Systems (ZIS) at $100M (which also implies ZMS shares are significantly undervalued). As a reminder about the former transaction, ZMS sold 6.7% interest in ZIC for $5M – which implicitly valued ZIC at $75M. The graphic below, from ZMS' current MD&A, provides context of where ZIC and ZIS fit in Zecotek's corporate structure.

Based on this $2M investment for 2% interest in Imaging Systems, floor value Zecotek Photonics' equity is a minimum of $98M, or $0.59/share (which would conservatively assume the Optronics and Display segments are worthless). Our DCF methodology values ZMS at approximately $125M, or $75/share (see valuation section, below).



SOURCE: Zecotek Q3 2018 MD&A

Outlook

If lack of owned-manufacturing was indeed the hurdle that ZMS needed to clear before they could begin to fill the various multi-million dollar LFS crystals orders, then the news flow over the last several months has us hopeful that the company's historic inability to translate operational progress into revenue growth may soon be coming to an end. Proof will be on the income statement and, with fulfillment of substantive orders expected to have already begun and grow throughout the remainder of calendar 2018, we would expect to see meaningful revenue generation by the end of fiscal Q1 2019 (October 31, 2018) and for annualized revenue to reach a minimum of $2M by Q2 2019.

The recent news that a major European PET/CT OEM adopted the company's LFS crystals for a new line of scanners is particularly exciting for a couple of reasons. First, Europe is a more seamless market to work in as compared to China. Secondly, we think European PET OEM could be Philips – and if that is the case, the supply agreement could be related to the terms of the lawsuit settlement – which would suggest binding contract terms. And in addition, ZMS indicated (in Oct 2017) that they think this relationship could be worth in excess of $10M in revenue per year to the company. While our model includes assumed contribution from this relationship, we will not model anywhere near $10M annually unless and until there is more substantive information about the binding nature of the agreement or until there is a reasonable history of meaningful sales to this channel. This is one of the relationship which we are most eager to hear updates about.

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 MOU 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.

The recent $5M (6.7%) equity investment in ZIC and $2M (2%) equity investment in ZIS by an industrial business group based in China (which might be SCI, possibly, EBO) should provide a sizeable backstop in facilitating initial meaningful sales in China. But, benefits of this partnership could extend well-beyond the new operating capital. Partnering with a China-domiciled organization not only brings expertise and knowledge of the local business environment, it also presumably provides for greater efficiencies (as well as potentially addressing any legal mandates related to foreign companies doing business in China).

Despite the ongoing delays to order fulfillment and revenue generation, we view the establishment of Zecotek China and initial crystals orders as substantive progress towards entry into the Chinese market. The recent hiring of an experienced (and native) director of business development is also encouraging as it relates to the potential of this segment to gain traction. As such and given that we have yet to incorporate meaningful revenue related to these relationships, our model could prove highly conservative. We will be eagerly awaiting updates on progress of order fulfillment and capacity expansion of the production facility.

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. The recent LFS order from a U.S. neuroPET manufacturer is a clear positive, although time will tell if this relationship bears significant fruit. Israel, via ZMS's distribution agreement with RAM N.S. Technologies, adds another potential near-term shot on goal. 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 other recent revenue opportunities could be in homeland security, radiation detection and (as it relates to the Display segment) in 3D HUD. The agreements to develop a radiation detection unit with a radiation safety and homeland security OEM as well as the partnerships major European auto manufacturers in the development of a 3D HUD system sounds encouraging – although, as noted, the potential revenue opportunities related to both of these is currently unclear. Consummation of the outside equity investments in ZIC and ZIS may be a harbinger for a similar deal for Zecotek Display Systems – which would be used to complete integration of their 3D technology for automotive applications – and could result in another future revenue stream.

Revenue forecast…

Following the disappointing revenue in Q2 and Q3, we now model fiscal 2018 revenue of $440k, revised from $2.4M. Per recent PR's, we expect much more meaningful revenue from crystals shipments by early fiscal 2019 and for that to show consistent and meaningful qoq growth. We look for revenue to grow to $4.9M (revised down from $6.4M) in 2019 and to $11.0M (revised down from $14.8M) in 2020.

But, as noted, we have not incorporated contribution related to supplying crystals to the China PET OEM contract and are modeling only a fraction of the (indicated) $10M+ annual sales potential related to the European PET OEM. If the China contract is triggered and/or European PET OEM crystals sales ramp faster than our assumptions, our model will likely prove conservative and possibly highly conservative, particularly in the out-years. Consummation of an equity investment in Display Systems could also positively influence our outlook and related projections.

ZMS.V shares valued at $0.75…

Our model is subject to updating. Model revisions could also affect our price target. As it is now, our DCF methodology calculates fair value of Zecotek at approximately $125M, equal to about $0.75/share. Based on the recent $2M investment for 2% interest in Imaging Systems, floor value is a minimum of $98M, or $0.59/share (which would conservatively assume the Optronics and Display segments are worthless).

FINANCIAL MODEL

Zecotek Photonics Inc.

	2017 A	Q1 A	Q2 A	Q3 A	Q4 E	2018 E	2019 E	2020 E
Total Revenues	$466.9	$189.3	$8.3	$3.6	$238.7	$439.8	$4,862.7	$11,030.3
YOY Growth	-68.6%	-8.8%	37.0%	-98.3%	474.1%	-5.8%	#DIV/0!	126.8%
Cost of Goods Sold	$406.4	$230.0	$8.7	$4.0	$214.8	$457.6	$3,331.0	$6,110.8
Gross Income	$60.5	($40.7)	($0.5)	($0.5)	$23.9	($17.8)	$1,531.8	$4,919.5
Gross Margin	13.0%	-21.5%	-5.8%	-12.9%	10.0%	-4.0%	31.5%	44.6%
SG&A	$3,628.5	$886.1	$1,726.6	$1,812.0	$946.2	$5,370.9	$5,893.6	$6,805.7
% SG&A	777.2%	468.1%	20910.4%	50856.7%	396.4%	1221.2%	121.2%	61.7%
R&D	$1,283.9	$98.8	$144.1	$230.3	$217.2	$690.4	$1,444.0	$1,623.0
% R&D	275.0%	52.2%	1744.7%	6463.5%	91.0%	157.0%	29.7%	14.7%
Operating Income	($4,851.9)	($1,025.6)	($1,871.1)	($2,042.8)	($1,139.5)	($6,079.1)	($5,805.9)	($3,509.2)
Operating Margin	-1039.2%	-541.8%	-22661.0%	-57333.1%	-477.4%	-1382.2%	-119.4%	-31.8%
Total Other Income (Expense)	$1,828.5	$540.0	$1,137.5	$0.0	$0.0	$1,677.5	$0.0	$0.0
Pre-Tax Income	($3,023.4)	($485.6)	($733.7)	($2,042.8)	($1,139.5)	($4,401.6)	($5,805.9)	($3,509.2)
Tax expense (benefit)	$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%
Net Income	($3,023.4)	($485.6)	($733.7)	($2,042.8)	($1,139.5)	($4,401.6)	($5,805.9)	($3,509.2)
YOY Growth	-43.4%	-54.7%	-305.2%	43.1%	29.4%	-100.0%	#DIV/0!	-39.6%
Net Margin	-647.6%	-256.5%	-8885.2%	-57333.1%	-477.4%	-1000.8%	-119.4%	-31.8%
EPS	($0.02)	($0.00)	($0.01)	($0.01)	($0.01)	($0.03)	($0.03)	($0.02)
YOY Growth	-49.3%	-58.8%	-283.5%	18.7%	7.6%	25.8%	-99.7%	-43.1%
Diluted Shares O/S	131,092	139,748	143,555	159,669	164,000	151,743	175,000	186,000

Brian Marckx, CFA

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STOCK CHART



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