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Zacks Small-Cap Research

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Covalon Technologies Ltd (CVALF-OTC)

Updating Mid-East Revenue Forecast. Price Target Unchanged at $8.00/Share

We forecast Covalon to generate revenue and EPS of C$50.0M and C$0.02 in 2019 and C$68.9M and C$0.30 in 2020. We value Covalon using a combination of P/S and P/E methodologies. Based on analyst's revenue and EPS estimates of publicly traded companies in focused on wound care and medical supplies, infection control and vascular products, we calculate fair value of Covalon at ~C$10.6/share, or US$8.00 based on current exchange rates.

Current Price (07/25/19)	$2.24
Valuation (U.S.$)	**$8.00**

OUTLOOK

We are adjusting our forecasted Middle East revenue based on management's disclosure in this morning's Corporate Update. While our 2019 M-E revenue adjustments resulted in an 18% haircut from our prior estimate, it still implies 82% growth from fiscal 2018 and we still project the $100M worth of M-E contracts to be recognized by the end of fiscal 2021. Moreover, we continue to anticipate very strong growth of U.S. revenue as a result of the recent AquaGuard acquisition (closed on 10/1/18), which also provides the benefits of significant geographical and customer revenue diversification (over 60% of revenue in 1H'19 came from the U.S., compared to from 31% in the prior year) and higher margins. As such, we still look for very healthy total revenue growth in 2019 (87%) as well as in 2020 (38%) and 2021 (7%) and regular and significant improvement in profitability and EPS.

As we continue to value CVALF using a combination of price/sales (based on one-year forward sales) and price/earnings (based on two-years forward EPS) methodologies and combined with a slight favorable improvement in the US$/C$ exchange rate, the updates to our model do not meaningfully change our calculated fair value of the company.

SUMMARY DATA

52-Week High	**$7.12**
52-Week Low	**$2.24**
One-Year Return (%)	**N/A**
Beta	**N/A**
Average Daily Volume (sh)	**2,531**
Shares Outstanding (mil)	**22**
Market Capitalization ($mil)	**$50**
Short Interest Ratio (days)	**1**
Institutional Ownership (%)	**0**
Insider Ownership (%)	**N/A**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**42.5**
Earnings Per Share (%)	**N/A**
Dividend (%)	**N/A**
P/E using TTM EPS	**32.0**
P/E using 2019 Estimate	**112.0**
P/E using 2020 Estimate	**7.5**
Zacks Rank	**N/A**

Risk Level	**Above Avg.,**
Type of Stock	**Small-Growth**
Industry	**Med Products**

ZACKS ESTIMATES

Revenue
(in '000s of C$)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2018	6.4 A	5.7 A	7.9 A	6.7 A	26.7 A
2019	7.3 A	13.3 A	7.1 E	22.4 E	50.0 E
2020					68.9 E
2021					73.7 E

Earnings Per Share

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2018	$0.02 A	-$0.02 A	$0.09 A	-$0.03 A	$0.07 A
2019	-$0.09 A	-$0.01 A	-$0.02 E	$0.13 E	$0.02 E
2020					$0.30 E
2021					$0.38 E

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

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WHAT'S NEW…

Adjusting Model Based on Guidance in Corporate Update
We are adjusting our forecasted Middle East revenue based on management's disclosure in this morning's Corporate Update that "As previously disclosed, our contracted Saudi Arabian business will be more heavily weighted in our fourth quarter, which ends September 30, 2019. As a result, our Q3 results, which are due to be released at the end of August 2019, will not contain significant revenue from Saudi Arabia, and will therefore not result in a profit for the quarter."

As a reminder, Covalon announced in the latter part of 2018 that they had secured $100M worth of Middle East contracts which were expected to be recognized as revenue over the following three years (i.e. 2019 – 2021). And as of late-February (i.e. Q1'19 earnings announcement) they had anticipated that they would book approximately $30M of the $100M during fiscal 2019 (ending September 30th), including $7.8M which was recognized through 1H'19 (ending March 30th).

When Covalon reported Q2 results they did not specifically reiterate their previous guidance of generating approximately $30M of sales from the Middle East in 2019 but did note that they expected much of the deliveries in that territory to happen during Q4. As we explained in our Q2 update (May 31st), Middle East revenue was well ahead of our $3.9M estimate in Q2 and while we had updated our quarterly cadence, our total 2019 revenue estimate of approximately $29M from the Middle East remained largely unchanged. Our cadence update resulted in projected Middle East revenue of $7.0M in Q3 and $14.3M in Q4.

But, as of result of today's disclosure that Saudi Arabia revenue is not expected to be significant in Q3, our related M-E Q3 revenue forecast has moved from $7.0M to just $0.5M. As we think this may also increase the risk that the prior FY'19 guidance of $30M in M-E revenue is less likely to be achieved, our Q4 M-E forecast has only increased moderately (with the assumption that only a portion of the prior Q3 estimate is delayed until Q4) and we now look for total M-E revenue of $23.8M. Our EPS estimates have moved from $0.07 and $0.09 in Q3 and FY'19, respectively, to ($0.02) and $0.02. However, our out-year EPS forecasts, benefitting from an assumed higher percentage of the M-E contract revenue now being recognized in 2020 and 2021, have moved from $0.27 (2020) and $0.35 (2021) to $0.30 and $0.38.

While our 2019 M-E revenue adjustments resulted in an 18% haircut from our prior estimate, it still implies 82% growth from fiscal 2018 and we still project the $100M worth of M-E contracts to be recognized by the end of fiscal 2021. Moreover, we continue to anticipate very strong growth of U.S. revenue as a result of the recent AquaGuard acquisition (closed on 10/1/18), which also provides the benefits of significant geographical and customer revenue diversification (over 60% of revenue in 1H'19 came from the U.S., compared to from 31% in the prior year) and higher margins. As such, we still look for very healthy total revenue growth in 2019 (87%) as well as in 2020 (38%) and 2021 (7%) and regular and significant improvement in profitability and EPS.

Valuation

As we continue to value CVALF using a combination of price/sales (based on one-year forward sales) and price/earnings (based on two-years forward EPS) methodologies and combined with a slight favorable improvement in the US$/C$ exchange rate, the updates to our model do not meaningfully change our calculated fair value of the company.

We value Covalon using a combination of price/sales (based one one-year forward sales) and price/earnings (based on two-years forward EPS) methodologies. We use two-years forward EPS as it more fully captures the anticipated operating leverage of the new-normal, higher revenue levels. Based on analyst's revenue and EPS estimates of publicly traded companies focused on wound care and medical supplies, infection control and vascular products (see table near end of report), we calculate fair value of Covalon at approximately $10.6/share in Canadian dollars and, based on the current exchange rate (i.e. US$1/C$1.31), approximately $8.10 in U.S. dollars (which we round to $8.00/share, unchanged from our prior update).

Valuation

We forecast Covalon to generate revenue and EPS of $50.0M and $0.02 in 2019. We forecast sales to grow another 38% in 2020 to $68.9M and, given expectations that operating leverage becomes more pronounced at these higher revenue levels, model EPS of $0.30 in that same year.

We value Covalon using a combination of price/sales (based one one-year forward sales) and price/earnings (based on two-years forward EPS) methodologies. We use two-years forward EPS as it more fully captures the anticipated operating leverage of the new-normal, higher revenue levels. Based on analyst's revenue and EPS estimates of publicly traded companies focused on wound care and medical supplies, infection control and vascular products, we calculate fair value of Covalon at approximately $10.6/share in Canadian dollars and, based on the current exchange rate (i.e. US$1/C$1.31), approximately $8.10 in U.S. dollars (which we round to $8.00/share).

	Wound care comps			**Medical sup/infection/vascular**	
	P/E	**P/S**		**P/E**	**P/S**
			ANGO	21.0	2.1
ANIK	30.0	5.3	**BSX**	21.1	5.0
MDWD	NA	11.3	**CSII**	NA	5.5
MDXG	NA	NA	**LMAT**	27.5	4.5
ORGO	NA	2.5	**MDT**	17.0	4.1
OSIR	37.6	3.9	**MLAB**	60.3	9.1
SNN	23.4	3.9	**PFN**	NA	9.7
SNWV	NA	5.8	**TFX**	22.5	5.2
Avg.	**30.3x**	**5.4x**		**28.2x**	**5.7x**

Implied CVALF current fair value based on:

P/S	C$12.44		
P/E	C$8.8		
Avg	**C$10.6**	**=**	**US$8.10**

Covalon Technologies Ltd

In Canadian dollars	2017 A	Q1A	Q2A	Q3A	Q4A	2018 A	Q1 A	Q2 A	Q3 E	Q4 E	2019 E	2020 E	2021 E
Product Revenue	24.7	6.0	5.1	3.1	5.9	20.0	6.4	12.1	5.8	21.0	45.3	60.7	62.9
YOY Growth	330.8%	8.2%	-9.7%	-23.7%	-38.3%	-19.0%	6.4%	138.4%	89.5%	259.0%	126.8%	33.8%	3.7%
% of total revenue	90.4%	93.3%	88.7%	38.8%	88.1%	74.8%	87.5%	91.0%	82.5%	94.0%	90.6%	88.1%	85.3%
Development & consulting fees	$0.9	$0.4	$0.3	$0.3	$0.8	$1.8	$0.8	$0.8	$0.9	$0.8	$3.3	$3.8	$4.6
YOY Growth	1655.5%	5305.7%	199.2%	-42.3%	218.8%	105.8%	107.6%	151.3%	188.0%	6.1%	85.6%	15.1%	22.0%
% of total revenue	3.2%	6.2%	5.7%	3.7%	11.4%	6.7%	11.4%	6.2%	12.0%	3.6%	6.6%	5.5%	6.3%
Licensing & royalty fees	$1.8	$0.0	$0.3	$4.6	$0.0	$5.0	$0.1	$0.4	$0.4	$0.5	$1.4	$4.4	$6.2
YOY Growth	119.5%	-61.5%	18.7%	235.8%	-36.4%	180.9%	152.1%	18.9%	-91.6%	1405.0%	-72.3%	222.0%	40.5%
% of total revenue	6.5%	0.5%	5.6%	57.5%	0.5%	18.5%	1.0%	2.9%	5.4%	2.4%	2.7%	6.4%	8.4%
Total Revenues	$27.3	$6.4	$5.7	$7.9	$6.7	$26.7	7.3	$13.3	$7.1	$22.4	$50.0	$68.9	$73.7
YOY Growth	315.0%	14.2%	-4.6%	34.4%	-32.0%	-2.1%	13.4%	132.4%	-11.0%	236.2%	87.2%	37.7%	7.0%
Cost of Goods Sold	$6.3	$1.9	$1.4	$1.4	$2.4	$7.1	$2.7	$4.1	$2.2	$7.3	$16.2	$21.8	$22.8
Gross Income	$21.0	$4.5	$4.3	$6.5	$4.3	$19.7	$4.6	$9.2	$4.9	$15.1	$33.8	$47.1	$50.9
Gross Margin	76.9%	70.9%	75.7%	82.0%	64.3%	73.6%	63.4%	69.4%	68.9%	67.5%	67.6%	68.4%	69.1%
Operations	$1.4	$0.4	$0.5	$0.6	$0.5	$2.0	$0.3	$0.6	$0.6	$0.9	$2.4	$2.8	$2.9
% Ops	5.3%	6.1%	9.0%	7.4%	7.5%	7.4%	4.3%	4.5%	8.7%	4.0%	4.8%	4.1%	3.9%
R&D	$1.1	$0.4	$0.4	$0.4	$0.3	$1.4	$0.4	$0.4	$0.4	$0.6	$1.8	$2.2	$2.4
% R&D	4.1%	5.6%	6.7%	4.6%	4.6%	5.3%	5.2%	3.0%	5.9%	2.8%	3.6%	3.2%	3.2%
Sales, Mktg & Agency fees	$11.5	$2.2	$2.5	$1.5	$2.0	$8.2	$3.3	$5.7	$1.8	$7.4	$18.1	$22.2	$23.2
% SM&A	42.1%	33.7%	43.5%	19.0%	30.5%	30.6%	44.9%	42.5%	26.2%	32.9%	36.3%	32.2%	31.5%
G&A	$5.2	$1.1	$1.4	$1.8	$2.1	$6.5	$2.2	$2.7	$2.2	$3.2	$10.3	$12.0	$12.6
% G&A	18.9%	17.4%	24.8%	23.3%	31.1%	24.1%	30.7%	20.3%	31.5%	14.1%	20.6%	17.4%	17.1%
Operating Income	$1.8	$0.5	($0.5)	$2.2	($0.6)	$1.6	($1.6)	($0.1)	($0.2)	$3.1	$1.1	$7.9	$9.9
Operating Margin	6.6%	8.1%	-8.4%	27.7%	-9.3%	6.1%	-21.6%	-0.9%	-3.4%	13.7%	2.3%	11.5%	13.4%
Total Other Income (Expense)	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	($0.3)	($0.1)	($0.2)	($0.1)	($0.7)	($0.8)	($0.7)
Pre-Tax Income	$1.8	$0.5	($0.5)	$2.2	($0.6)	$1.6	($1.9)	($0.2)	($0.4)	$3.0	$0.4	$7.1	$9.2
Tax expense (benefit)	$0.0	$0.0	$0.0	$0.0	$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%	0.0%	0.0%	0.0%	0.0%
Net Income	$1.8	$0.5	($0.5)	$2.2	($0.6)	$1.6	($1.9)	($0.2)	($0.4)	$3.0	$0.4	$7.1	$9.2
YOY Growth	-156.7%	-116.3%	-188.2%	364.3%	-214.8%	-10.7%	-467.4%	-51.5%	-120.0%	-582.1%	-74.4%	1618.0%	28.9%
Net Margin	-	-	-	-	-	-					0.8%	10.3%	12.5%
Diluted EPS	$0.09	$0.02	($0.02)	$0.09	($0.03)	$0.07	($0.09)	($0.01)	($0.02)	$0.13	$0.02	$0.30	$0.38
YOY Growth	-132.3%	-89.0%	-186.5%	784.5%	-43.4%	-20.2%	-480.9%	-53.1%	-120.8%	-562.8%	-73.3%	1535.1%	26.2%

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Diluted Shares O/S	20.8	23.0	21.5	23.2	21.5	23.2	22.2	22.2	22.3	22.4	22.3	23.4	23.9

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HISTORICAL STOCK PRICE



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