Zacks Small-Cap Research

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Zecotek Photonics (V.ZMS)

V.ZMS: Add'l Order Flow, Should Grow w/ Demand From PET OEMs

Current Recommendation	**Buy**
Prior Recommendation	N/A
Date of Last Change	10/02/2013
Current Price (11/24/2015)	$0.34
Target Price	**$1.80**

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. Major distributor recently signed and initial orders received. Crystals also to be used in high profile CERN experiments. Lawsuit whereby ZMS.V claimed patent infringement was just settled. We think the settlement now opens up significant opportunity for Zecotek, the benefits of which we think begin to be realized in the very near-term.

SUMMARY DATA

52-Week High	**$0.61**
52-Week Low	**$0.30**
One-Year Return (%)	**0**
Beta	**N/A**
Average Daily Volume (sh)	**115,274**
Shares Outstanding (mil)	**115**
Market Capitalization ($mil)	**39**
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 2015 Estimate	**N/A**
P/E using 2016 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)
2014	8 A	41 A	14 A	23 A	87 A
2015	98 A	76 A	70 A	210 E	454 E
2016					4498 E
2017					8882 E

Earnings per Share

	Q1 (Oct)	Q2 (Jan)	Q3 (Apr)	Q4 (Jul)	Year (Jul)
2014	-$0.01 A	-$0.02 A	-$0.02 A	-$0.04 A	-$0.09 A
2015	-$0.02 A	-$0.02 A	-$0.01 A	-$0.01 E	-$0.07 E
2016					-$0.02 E
2017					$0.01 E

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

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Productive Last Few Months with $750k in New Orders, Add'l Validation of Crystals and Manufacturing Upgrades: *Continue to Look for Order Sizes to Grow w/ Demand from PET OEMs….*

It has been a productive last few months for ZMS. The company continues to lay the groundwork for additional orders and greater demand for their LFS crystals which should culminate in much more substantive revenue and a greatly improved earnings picture.

In late August Zecotek preannounced expected Q4 revenue of $210k. And while that level is still immaterial from a financial perspective, it does imply sequential growth of over 200%, would be the highest in company history and, coupled with the subsequent announcements regarding increasing demand and additional orders, suggests this could be a harbinger for continued sequential growth and at greater amounts. With the Q4 revenue preannouncement management noted that "sales are gaining momentum and, so far, for fiscal 2016 we have confirmed orders for $2.9 million" – another $750k worth of orders were announced since they made that comment in mid-August.

Additional Order Flow…

There is little doubt at this point that interest in the LFS crystals continues to grow. And while it seemed that earlier orders had mostly related to evaluation of the crystals, the language in the press releases announcing the more recent orders suggests these are for use in to-be-commercialized medical PET scanners. In late October ZMS announced a $500k order from a PET OEM in China which will be used "for a new series of PET medical imaging devices and this is the first of a contemplated series of purchase orders".

Over the last few years certain OUS markets have become particularly attractive for PET component manufacturers – specifically India and China. Life sciences research firm, Visiongain, expects markets such as China and India to offer much more opportunity for growth than the U.S. or U.K. due to a relative lack of nuclear medicine facilities and increased healthcare spending in those parts of the world. Visiongain has noted that developed markets such as the U.S. and U.K. are already highly saturated and growth in these markets will mostly come from upgrading stand-alone PET and SPECT systems with hybrid units (i.e. – with adding CT or MRI) – but expects healthcare investment in emerging countries to double over the next seven years.

ZMS cites that there are approximately 2k PET medical scanners in the U.S., which equates to roughly 6.5 scanners per one million people. This compares to about 200 systems in China, or only ~0.14 scanners per one million people – which illustrates the potential growth opportunity in that country.

That $500k order was followed by a $250k LFS crystals order which ZMS announced just days later from a "strategic partner" – which likely means their commercialization partner Hamamatsu. And since Hamamatsu places orders after they already have an order on the other side – this $250k can also be expected to represent pull-through demand (i.e. - not stocking). The PR notes that this order will be used "for installation in the first positron emission tomography (PET) medical imaging scanner in a series of newly designed devices." To be clear, this is in addition to (and we think a different end-user customer) than the $500k order.

ZMS recently announced that they are in-process of expanding their manufacturing and production capabilities to meet the growing demand for their crystal arrays. This includes replacing manual processes with automation which will slash production time and lower costs.

And in terms of potential additional near-term demand, with ZMS's lawsuit against Philips and St. Gobain settled, this opens up the very real possibility that Philips and Zecotek enter into a supply agreement. Last year Philips suspended CT/PET scanner production at its Cleveland, OH facility after FDA raised concerns about manufacturing processes and controls. Philips did not provide specifics surrounding the issues cited by FDA although has publicly noted that production at Cleveland remains at a very low level and may not be back to full capacity until the current year-end due in part because "it took longer than anticipated to complete the necessary remediation at some of our suppliers…." While speculation, this could relate to suppliers for crystals.

And conclusion of the lawsuit also removed any possible hesitance by any of ZMS' other potential customers, including other PET OEM's, CERN and Hamamatsu-related customers to place orders until the patent issue was resolved. This, we think, has facilitated the recent increased order flow from PET OEMs and Hamamatsu.

Additional Validation…
Earlier this year CERN conducted an experiment which compared the LFS crystals to LYSO crystals which showed the LFS crystals produced a superior coincident time resolution. Results were presented in a poster session at the 2015 Institute of Electrical and Electronics Engineers (IEEE) Conference in Seattle. CERN's senior research scientist noted following results of the testing that, "Our team is impressed with the test results and with the competitive pricing of the LFS crystals. We are therefore proceeding to use Zecotek's LFS crystals for our PET-CERN projects." We viewed this as a meaningful "win" for ZMS as LYSO crystals are used in many of the OEM Time-of-Flight scanners (i.e. - high-end, high resolution scanners) and had been considered the highest performing crystals available. Higher performing crystals can be a tremendous competitive advantage as performance of crystals is a key factor in demand of PET scanners.

This validation by CERN could have very positive effects in terms of demand for the LFS crystals. In fact, just months after the experiment, a CERN team working at the University of Virginia on the Compact Muon Solenoid project placed orders for ZMS's thin LFS crystal plates.

Subsequent to the CERN experiment, researchers at the University of California at Davis, following testing of the LFS crystals for PET applications, noted that, "What we find most attractive about Zecotek's LFS crystals is the fast decay time…." UC Davis has multiple high-end projects ongoing using the LFS crystals which includes potentially incorporating them in high performance PET detector designs as well as possible collaboration with ZMS on crystal arrays. The UC Davis team is lead by Dr. Simon Cherry, who is extensively published in molecular imaging and a renowned expert in the field. So validation of the LFS crystals by Dr. Cherry and his team is a meaningful vote of confidence.

Additionally noteworthy is that in October of this year UC Davis was awarded a five-year, $15.5M grant by the National Institutes of Health/National Cancer Institute to fund their EXPLORER project. The goal of EXPLORER, being co-led by Dr. Cherry, is to (per the EXPLORER website….http://explorer.ucdavis.edu/) design, develop and construct the world's highest sensitivity PET scanner. This scanner is projected to have a sensitivity that is 40 times higher than current PET scanners and have the ability to scan the entire body at once.

And while we are not connecting any dots at this point between the LFS crystals and the EXPLORER project (although we are not ruling out a potential connection), at the very least we think the fact the Dr. Cherry is leading this project speaks to his credibility as an expert in the field. And the fact that an expert of his status is impressed with the performance of the LFS crystals is of significance.

Outlook

We continue to model approximately $4.5 million in total revenue in fiscal 2016 (ending July 31, 2016), driven mostly by pull through demand for crystals by PET OEMs. Given the more than $4.5 million in confirmed orders (which will need to ship to recognize as revenue) the company already has for 2016, it is quite possible our revenue estimate will prove low. As we have noted in the past, ZMS has seen burgeoning interest for their LFS crystals from manufacturers of small and next-gen Time-of-Flight PET scanners. In addition, validation of the LFS scintillation crystals for use in small PET scanners in applications such as pre-clinical pharmaceutical research for drug development is ongoing by certain international PET OEMs. ZMS's Chinese manufacturing partner, Beijing Opto-Electronics Technology (BOET), is scaling up its manufacturing capacity by ~300%.

And ZMS has recently made additional and substantive headway in the Display segment - which the company believes will have initial sales of their 3D display monitors in Q1 2016. In early July they announced that the deal with Aquarius, which was announced about 12 months ago whereby this Russian conglomerate would purchase 20% of Zecotek Display Systems for $7 million, fell through. But, shortly afterwards (8/12), the company announced that they signed agreements with the Engineering Centre of the National Research Nuclear Center MEPhi (ECM) and its affiliate Novilab Mobile to commercialize the 3D display monitors in Russia. ECM and Novilab are responsible for manufacturing the 3D using ZMS technology and for commercialization and, in return, these partners have exclusive rights to the Russian market. Zecotek expects to announce additional commercialization partnerships in other areas of the world.

We are maintaining our $1.80/share price target and Buy recommendation.

FINANCIAL MODEL

Zecotek Photonics Inc.

	2014 A	Q1A	Q2A	Q3A	Q4E	2015 E	2016 E	2017 E	2018 E
Total Revenues	$86.6	$97.9	$75.6	$70.1	$210.1	$453.8	$4,498.2	$8,881.7	$15,752.9
YOY Growth	*118.5%*	*1100.5%*	*82.8%*	*391.1%*	*824.0%*	*424.3%*	*891.3%*	*97.4%*	*77.4%*
SG&A	$6,857.3	$2,018.9	$1,838.6	$928.0	$1,198.0	$5,983.6	$5,277.0	$6,128.3	$7,561.4
% SG&A	*7922.7%*	*2062.2%*	*2431.1%*	*1323.0%*	*570.2%*	*1318.6%*	*117.3%*	*69.0%*	*48.0%*
R&D	$1,682.4	$397.2	$472.0	$378.2	$401.0	$1,648.4	$1,388.0	$1,344.0	$1,657.0
% R&D	*1943.8%*	*405.8%*	*624.1%*	*539.2%*	*190.9%*	*363.3%*	*30.9%*	*15.1%*	*10.5%*
Collaboration costs	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
Operating Income	($8,453.1)	($2,318.2)	($2,235.0)	($1,236.1)	($1,388.9)	($7,178.2)	($2,166.8)	$1,409.3	$6,534.5
Operating Margin		*-*	*-*	*-*	*-*	*-1581.8%*	*-48.2%*	*15.9%*	*41.5%*
Total Other Income (Expense)	($203.0)	$2.1	($180.4)	$76.7	$0.0	($101.6)	$0.0	$0.0	$0.0
Pre-Tax Income	($8,656.2)	($2,316.2)	($2,415.4)	($1,159.4)	($1,388.9)	($7,279.8)	($2,166.8)	$1,409.3	$6,534.5
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	($8,656.2)	($2,316.2)	($2,415.4)	($1,159.4)	($1,388.9)	($7,279.8)	($2,166.8)	$1,409.3	$6,534.5
YOY Growth	*23.0%*	*121.4%*	*44.7%*	*-41.2%*	*-65.0%*	*-15.9%*	*-70.2%*	*-165.0%*	*363.7%*
Net Margin		*-*	*-*	*-*	*-*	*-1604.2%*	*-48.2%*	*15.9%*	*41.5%*
EPS	($0.09)	($0.02)	($0.02)	($0.01)	($0.01)	($0.07)	($0.02)	$0.01	$0.05
YOY Growth	*-0.8%*	*93.9%*	*20.5%*	*-49.4%*	*-70.6%*	*-28.4%*	*-73.1%*	*-162.9%*	*356.3%*
Diluted Shares O/S	92,331	99,134	110,002	112,259	112,275	108,417	120,000	124,000	126,000

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