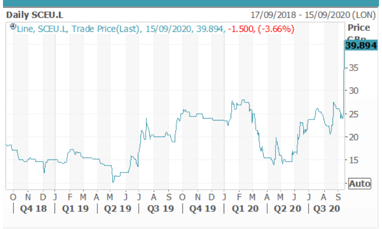
HARDMAN&CO.

Automotive components



Source: Refinitiv

Market data

EPIC/TKR	**SCE**
Price (p)	**41**
12m High (p)*	48
12m Low (p)	12
Shares (m)	154
Mkt Cap (£m)	63.0
EV (£m)	61.0
Free Float**	86%
Market	AIM

**Intraday **As defined by AIM Rule 26*

Description

Surface Transforms (SCE) is 100% focused on manufacture and sales of carbon ceramic brake discs. It has capacity in place for ca.£17.5m annual revenues, readily expandable to multiples of this.

Company information

Non-Exec. Chair.	David Bundred
CEO	Dr Kevin Johnson
Finance Director	Michael Cunningham

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Key shareholders

Directors	11.8%
Canaccord	14.8%
Unicorn	12.3%
Richard Gledhill esq. (director)	9.9%
Richard Sneller esq.	8.2%
Hargreaves Lansdown	4.5%

Diary

Late Sep'20	Interim results
May'20	Final results

Analyst

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SURFACE TRANSFORMS

A whole new level of contract winning

The most significant of several 2020 contract wins was announced on 14 September, from a new global customer, OEM 8. New order momentum is rising significantly. SCE's position as one of only two global manufacturers of a new automotive component – carbon ceramic brake discs – is bringing a series of major opportunities. As a consequence of OEM 8, our 2022 sales estimates double. To be winning such orders shows that these exacting clients embrace SCE's product, its robust supply chain and manufacturing. SCE also provides a £0.4m upgrade on recent sales revenue.

- **SCE is clearly endorsed as a major supplier:** With a superior product and OEMs keen to promote a credible newer supplier in SCE, it is well positioned to win a large share in the £200m, carbon ceramic brake disc market, which is set to grow by an order of magnitude. The OEM 8 order is a game changer.
- **Our estimates**: Our forward estimates reflect only existing contracts. Gross margins are steady, at either side of 70%, and new sales bring operationally geared returns. This new multi-year £27.5m order takes capacity utilisation to ca.60%. Investment is being made to support future growth.
- **SCE has arrived:** This is only just the beginning of top-line growth above market growth. 2019's success in winning its first OEM orders transformed SCE's industry-wide visibility. Lead times are over a year on the tests the OEMs undertake, giving good indications of pipeline opportunities.
- **Risks:** 2020 revenues have been affected by COVID-19 and, longer term, the macro-industry sales of cars globally may be affected by an economic slowdown or – at the luxury end, germane to SCE – by stock markets. A major revenue increase at SCE leads to a (definable) increase in working capital needs.
- **Investment case:** This large market is 99%-supplied by one, highly profitable player. Single supply was a most anomalous position for an auto OEM market; now SCE also supplies. Thus, the OEM 8 order, while a true "game changer", simply fits into the broader expansion of the market and of SCE in the market. This has been anticipated for some years. It is coming about on a broad front.

Financial summary and valuation

Year-end May*/ Dec**(£m)	FY18*	FY19*	*7-month 19E***	FY20E**	FY21E**	FY22E**
Sales	1.36	1.00	1.45	2.00	7.30	12.50
EBITDA	-2.01	-2.60	-1.41	-1.90	0.65	3.40
EBITA	-2.30	-2.94	-1.70	-2.55	-0.15	2.45
PBT	-2.30	-3.04	-1.76	-2.65	-0.40	2.20
PAT	-1.83	-2.12	-1.32	-2.10	0.15	2.75
EPS (adjusted, p)	-1.66	-1.68	-0.97	-1.44	0.10	1.78
Shareholders' funds	5.55	6.96	5.57	5.72	5.87	8.62
Net (debt)/cash	0.62	1.60	0.65	1.00	0.40	3.10
P/E (x)	loss	loss	loss	loss	n/a	23.0
EV/sales (x)	44.8	60.7	n/a	30.5	8.3	4.8
EV/EBITDA (x)	loss	loss	loss	loss	loss	17.9
DPS (p)	nil	nil	nil	nil	nil	nil

**May year-end, **Change of year-end to December*
Source: Surface Transforms, Hardman & Co Research estimates

Increasingly important advances

A new client – not the first this year – and sales estimates double

SCE has announced a major new client for tier one sole supply. Our 2022 sales estimates more than double, but the news is better than that. The OEM 8 order confirms that the global OEM industry recognises SCE's importance, and the major advances of 2019, and now 2020, are forming the base upon which much more seems likely to come.

September, new OEM 8 order

OEM 8 is a whole new category, taking utilisation to 60%

The contract is for SCE discs to be the standard fit, tier one sole supplier of the carbon ceramic brake disc on both axles of this car. As sole supplier, faith is being shown, not just in the superiority of the product, but also in the fully robust nature of the SCE supply chain. SCE has proven, established expertise. The order takes SCE capacity utilisation to ca.60%.

- The lifetime revenue on this specific car model contract is estimated to be approximately £27.5m. The initial contract runs through to 2024.
- In addition to this model news, the announcement anticipates that SCE "looks forward to further extending our relationship with this major new customer".

Cashflow implications

Working capital spend, plus capital expenditure

The impact on profitability is exciting (see page 3). There are three factors leading to a cash outflow:

Added operational capacity put in place

- an obvious and necessary need for investment into working capital;
- SCE has stated that it is undertaking modest capital expenditure; and
- with a series of orders won and high hopes for more, SCE is undertaking a significant increase in manufacturing support headcount, which will add £2.0m p.a. to the cost base between 2020 and 2022, with the bulk of the recruitment taking place in the next 12 months.

Sales and profit upgrade from current trading

We do note the useful allied announcement, on 14 September, that it is prudent to raise expectations of revenue in 2020 to ca.£2.0m. This increased revenue will mitigate the working capital impact of additional overhead this year, following the board's decision to invest in the company's headcount.

Rapidly rising sales momentum, with robust margins

2019 had seen major advances, with an order won earlier in 2020 too

In 2019, SCE secured a ca.£28m order book. OEM 8 is not the only good news regarding order wins this year – so far. In June, an additional contract to an existing client was announced, with a lifetime value of more than £5m and production due to start in mid-2022.

Financial implications of OEM 8: upgrade, operational and capital investment

New estimates – for example, we now estimate FY'22 EPS at 1.78p, vs. 0.55p previously

The top line increases materially. Previously, we estimated £5.7m revenue for FY22: now we estimate £12.50m. SCE has stated the OEM 8 run rate at £8m p.a. (by 2022).

See table overleaf.

Financial summary, previous and new (*) estimates				
Year-end Dec (£m)	*FY21E*	FY21E*	*FY22E*	FY22E*
Sales	*4.00*	7.30	*5.70*	12.50
EBITDA	*-0.10*	0.65	*1.00*	3.40
EBITA	*-0.80*	-0.15	*0.30*	2.45
PBT	*-0.80*	-0.40	*0.30*	2.20
PAT	*-0.25*	0.15	*0.85*	2.75
EPS (adjusted, p)	*-0.16*	0.10	*0.55*	1.78
Shareholders' funds	*6.27*	5.87	*7.12*	8.62
Net (debt)/cash	*2.65*	0.40	*3.60*	3.10
DPS (p)	*nil*	nil	*nil*	nil

Source: Hardman & Co Research

Cash implications – reinforcing SCE for growth

Note that the cash estimates in the table above refer to net cash. Gross cash is ca.£0.2m higher.

Cash initially reduces as a result of bringing forward £0.6m in 2020 and £0.9m in 2021 of new capital expenditure; also, there is a rise in working capital for the significantly enlarged sales revenue. It is important to note that the capital expenditure is to fully complete Production Cell One and to enhance efficiencies and cost savings (partially passed to the clients, to support new share gains), and that the capacity utilisation rises to 60% on full run-rate of all current contracts. The payback for a further capacity step-change should be within two years:

Large capacity in place

- £17.5m p.a. sales capacity is in place with current capital equipment;
- gross margins are robust: in the 65% to 75% range for some while, we estimate.

This is a highly cash-generative business model.

Risk mitigation and valuation

Cashflow

Cashflow-negative, set to turn positive in 2H'21

The company is currently cashflow-negative, and had been budgeted as such, even prior to COVID-19. Meaningful, positive cashflow is built into the financial projections on current contracts, which run for several years.

Even before the OEM 8 success, 2021 calendar year would transition to cashflow-positive. Growth built in through existing contracts generates further cash. These existing contracts have firm volume offtakes, prices and timings.

Experienced in commissioning new capital expenditure

Capital expenditure is being undertaken. The capital plant is modern, and readily calibrated and commissioned. No commissioning is without risk but, to date, any disruptive effect has been minimal, and this is a far smaller operational move than opening a whole new factory, as was undertaken two years ago – to make SCE robust for exactly this growth.

Competitive position

An unusually strong competitive position

SCE has only one competitor, BremboSGL, and the substantial ownership of the latter by the Quandt family (the owners of BMW) makes other OEMs cautious, offering a very significant opportunity for SCE.

Brexit and COVID-19

Successful handling of Brexit and COVID-19 factors to date

Whichever way the exit from the single EU market and possible trade barriers develop, the product is a high-gross-margin sale. The contract with German OEM 5 includes the warehousing of the finished product in Germany.

A little more detail on COVID-19 indicates unlikelihood of sales downgrades exceeding 7% of 2021 estimates

COVID-19 led to significant downgrades for the retrofit and track cars segments for 2020. It is noteworthy that the guidance from SCE on this segment in very recent months has been positive. The extent of the initial downgrades to projections has been reduced. Nonetheless, this COVID-19 risk has not gone away. Were the 2021 racing season to be halved – we expect it to be unchanged from pre-COVID-19 estimates – the hit to FY'21 profits might be of the order of £0.5m. This would be a manageable eventuality. More significant for SCE is the possibility of a major global recession. This would, indeed, bring revenue risk to model sales. Once a new technology becomes accepted by the market, it invariably migrates to mid-range as a function of the OEM seeking up-to-date product to sell, and as a result of the ever-falling manufacturing cost being shared with the OEMs.

Valuation

Valuation not dissimilar to the confirmed order book's gross margins

At the current enterprise value, the market capitalisation of SCE is only some 50% higher than the (non-time-value discounted) gross margin in the current OEM order book. Hardman & Co estimates this at ca.£40.0m, which is a figure OEM 8 has just broadly doubled. Given the competitive position in the market and the evidenced rapid growth, this seems modest. The growth of SCE and the potential for more lead us to conclude that the shares appear to offer value.

Set against this, 2020 is still set for losses, but profits are visible beyond that, and operational gearing is high. Naturally, the volumes are not guaranteed, but these are multi-year orders with global players, which themselves benefit from more medium-term visibility of delivery volumes than normal in the automotive industry.

The EBITDA margin expands significantly due to operational gearing.

Financial performance

Revenue account

Revenue account

Year-end May*/Dec**(£m)	FY17*	FY18*	FY19*	7-month period FY19E**	FY20E**	FY21E**	FY22E**
Sales	0.70	1.36	1.00	1.45	2.00	7.30	12.50
Gross profit	0.43	0.92	0.62	0.87	1.42	4.96	8.38
Gross margin	61.43%	68.00%	61.70%	60.00%	71.00%	68.00%	67.00%
R&D & overheads***	-2.81	-2.93	-3.22	-2.28	-3.32	-4.31	-4.98
EBITDA	-2.38	-2.01	-2.60	-1.41	-1.90	0.65	3.40
EBITDA margin	loss	loss	loss	loss	loss	8.90%	27.20%
EBITA	-2.53	-2.30	-2.94	-1.70	-2.55	-0.15	2.45
EBITA margin	loss	loss	loss	loss	loss	loss	19.60%
Net finance income	0.00	0.00	-0.10	-0.06	-0.10	-0.25	-0.25
PBT (adjusted)	-2.53	-2.30	-3.04	-1.76	-2.65	-0.40	2.20
Exceptional items	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Tax	0.35	0.47	0.92	0.44	0.55	0.55	0.55
PAT	-2.18	-1.83	-2.12	-1.32	-2.10	0.15	2.75
EPS (diluted, adjusted, p)	-2.42	-1.66	-1.68	-0.97	-1.44	0.10	1.78
DPS (p)	0.00	0.00	0.00	0.00	0.00	0.00	0.00

May year-end, **December year-end, * includes £0.13m negative exceptional items in 2018*
Source: Surface Transforms accounts, Hardman & Co Research estimates

There are significant tax losses, which have been incurred to build the business market position.

Balance sheet

Balance sheet

@31 May*/Dec**(£m)	FY17*	FY18*	FY19*	7-month period FY19E**	FY20E**	FY21E**	FY22E**
Net current assets (including cash)	2.53	1.73	2.80	2.60	2.80	2.30	5.10
Shareholders' funds	3.90	5.55	6.90	5.57	5.72	5.87	8.62
Net (debt)/cash***	1.53	0.62	1.60	0.65	1.00	0.40	3.10
Avg. shares diluted (m)	90.00	110.30	125.20	136.00	145.40	154.60	154.60

**May year-end, **December year-end, ***includes modest current debt*
Source: Surface Transforms accounts, Hardman & Co Research estimates

Cashflow

Cashflow

Year-end May*/Dec** (£m)	FY17*	FY18*	FY19*	7-month period FY19E**	FY20E**	FY21E**	FY22E**
Cash from operations, net tax	-1.21	-2.17	-2.20	0.20	-1.25	0.30	3.50
Capex	-2.07	-2.00	-0.10	-0.20	-0.60	-0.90	-0.80
Interest	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Equity issuance	0.05	3.48	3.30	0.00	2.20	0.00	0.00
Net cashflow	-3.23	-0.69	1.00	0.00	0.35	-0.60	2.70
Depreciation	0.15	0.29	0.40	0.29	0.65	0.80	0.95

**May year-end, **December year-end*
Source: Surface Transforms accounts, Hardman & Co Research estimates

Further points of detail on the financial model

Clear quantified drivers to 2021 growth…

- In 2022E, the cash generation of the business comes to the fore. In the current year and 2021E, top-line growth is accompanied by incremental investment in the operations and in work in progress. In 2022, our estimates are for a generation of £2.70m net cash. Our estimate is based on the company entering that year with the full run-rate complement of work in progress for the enlarged sales rate in our model.

…and to 2022 as well

- Sales estimates comprise 2021E OEM 6 and OEM 8 rising significantly; 2022E OEM 5 and OEM 8 are rising significantly.

Note 1H'21E EBITDA losses

- Overheads and R&D are increasing as result of major new orders and the potential for more.

Investing on the back of strong order intake

- EBITDA: note that 1H'21E EBITDA losses are expected to reach just over £1.0m, on the increased cost base put in place for future growth.
- Our estimates for 2020 EBITDA profits have reduced, due to operational investment on expanded business. There is, indeed, a slight rise in sales estimates from retrofit and track cars versus estimates as of spring 2020. For OEM 8, *de minimis* revenue is modelled for 2020. Our model is for £3.0m, followed by, conservatively, less than £8.0m for 2021 and 2022.
- The finance charge in the accounts is non-cash.

Controlled investment into current assets

- Net current assets: there is tight control, but this item increases inevitably, given rising revenue. For 2020 and thereafter, the ratio of current assets to sales has fallen significantly compared with prior years. Cashflow's "cash from operations" typically broadly matches EBITDA in a steady-state revenue business, but growth here at SCE is significant. 2021 is the year during which we model significant rises in current assets, due to working capital. Nonetheless, this rise should be well below £1.0m. A modest amount of debtor finance is open to the company to take on.

Manufacturing capacity now in place; current capex is modest, but slightly rising

- Capex: note the rises, which are nonetheless modest. A future significant spend of ca.£8m would be needed for a step change investment to double capacity to more than £30m p.a.

Cash outflow bottoms out mid next year

- Note also that estimates for cash during the course of 2021 are expected to be below those at end-2020. Cashflow for 2H'21 is expected to be positive and remain positive thereafter.
- Shareholders' funds for 2021E rise *de minimis*, as a result of the investment in operations support; the significant positive impact from order wins is in 2022E. Cost base investments provide a robust platform for significantly greater future revenues.

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(Disclaimer Version 8 – Effective from August 2018)

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