17 April 2020

HARDMAN & CO.

SURFACE TRANSFORMS

High visibility for 2021 onwards; equity raise

ST's position as one of only two global manufacturers of a new automotive component – carbon ceramic brake discs – brings major opportunities for investors and the automotive industry. The OEM (original equipment manufacturer) order book is ca.£28m, generating gross profits equal to the market capitalisation. Timing here is set firm: 2021 will bring material revenues from the OEMs. This only scratches the surface of the market opportunity. COVID-19 has affected 2020 and – with an increase in equity limited to 10% – investors have put their shoulder to the wheel, so that ST has successfully countered the cashflow impact.

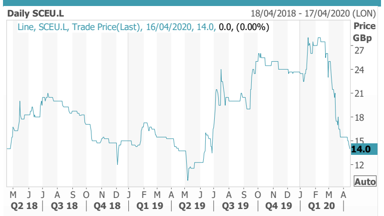
- **ST's potential is clear:** With a superior product and with OEMs keen to promote dual-sourcing from a credible new supplier, it is set to win a large share in the £150m, fast-growing carbon ceramic brake disc market. Sales to smaller customers are longstanding; ST has now expanded to a new league.
- **Our forward estimates only reflect existing contracts**: Pre-tests for additional prospective clients are progressing well. Start of production dates for OEMS are contractual and the models benefit from long forward pre-sales. COVID-19 hits 2020 sales, but there is no reason to change estimates for 2021 and beyond.
- **ST has arrived:** 2019's success in winning its first OEM orders transformed ST's industry-wide visibility. The lead times are over a year on the tests the OEMs undertake, giving good indications of pipeline opportunities. Only one competitor exists, and no others are envisaged for many years.
- **Risks:** COVID-19 has affected 2020 revenues, as this year is dependent on the shorter-order book of retrofit and race-track cars. The risks of longer-term sales shortfalls to existing OEM contracts are minimal. Even if the 2021 racing season were to be half that of 2019, which we do not expect, cashflow would be neutral.
- **Investment case:** This is a large, growing market, 99%-supplied by one, highly profitable player. A single supply is a most anomalous position, so now that ST also supplies, its opportunity is wide. Since the 2019 OEM contracts, the path is clear to ST discs being designed-in for many more models. Existing contracts make ST cashflow-positive from 2021.

Financial summary and valuation

Year-end May*/ Dec**(£m)	FY18*	FY19*	*7-month 19E***	FY20E**	FY21E**	FY22E**
Sales	1.36	1.00	1.45	1.60	4.00	5.70
EBITDA	-2.00	-2.60	-1.41	-1.55	-0.10	1.00
EBITA	-2.30	-2.94	-1.70	-1.25	-0.80	0.30
PBT	-2.30	-3.04	-1.76	-2.25	-0.80	0.30
PAT	-1.83	-2.12	-1.32	-1.75	-0.25	0.85
EPS (adjusted, p)	-1.66	-1.68	-0.97	-1.21	-0.17	0.57
Shareholders' funds	5.55	6.90	5.57	5.32	5.07	5.92
Net (debt)/cash	0.62	1.60	1.60	1.45	1.95	2.90
P/E (x)	loss	loss	n.a.	loss	loss	25.5
EV/sales (x)	14.7	23.8	n.a.	12.3	4.9	3.5
EV/EBITDA (x)	loss	loss	n.a.	loss	loss	19.7
DPS (p)	nil	nil	nil	nil	nil	nil

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

Automotive components



Source: Refinitiv

Market data

EPIC/TKR	**SCE**
Price (p)	14.5
12m High (p)	28
12m Low (p)	11
Shares (m) *	147
Mkt Cap (£m)	21.3
EV (£m)	19.7
Free Float	86%
Market	AIM

**Post placing, pre open offer*

Description

Surface Transforms (ST) is 100% focused on manufacture and sales of carbon ceramic brake discs. It has capacity in place for ca.£16.5m annual revenues, readily expanded 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	14.4%
Canaccord	13.4%
Unicorn	11.1%
Richard Gledhill esq. (director)	9.1%
Richard Sneller esq.	9.1%
Hargreaves Lansdown	4.1%

*** Estimated post placing*

Diary

May'20	Final results for 2019
Jun'20	AGM
Oct'20	Interim results

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Investment case and fund raise

The order book profits exceed the market capitalisation

2019 was the year ST 'arrived'

In the past year, four global OEM clients have placed orders. This transformed the company and was the result of many years of smaller-scale sales to the retrofit and track car markets. The order backlog is ca.£28m, the longest contracts running through to 2029. Gross order book margins are in the 65% to 75% range.

What is more, the orders offer security of timing and of annual volume offtake

- Orders benefit from firm start dates, locked in to OEMs' broader considerations of important model-launch timelines.
- Vehicles of such high-end vehicles typically are pre-sold and on a waiting list.

Valuation

Almost nothing in the valuation for future order potential

The valuation of the company at the current share price almost totally discounts the potential for revenues to rise beyond the current orders held. The market capitalisation (EV is lower, given net cash on the balance sheet) closely matches the anticipated gross profits in the OEM orders (not time-discounted), which Hardman & Co estimates at ca.£19.0m. However, in addition, there is a run-rate of ca.£1.5m gross profits from the non-OEM revenues. Overheads (post R&D tax credit) run at ca.£2.5m. The future delivery of the order pipeline is not quite in the valuation for free, but not far off.

We conclude further OEM orders are not being priced in at the current valuation.

COVID-19 impacts

2019 COVID-19 setback covered off by fundraise of 10% new equity

There is a two-year lag, post the 2019 OEM order wins until cash generation: to 2021. 2021 remains a cash-generative year in our estimates. Notably, we are maintaining profit and cashflow estimates for 2021E and 2022E onwards; contracts have firm start dates.

Revenue estimate halved for 2020; no material impact on 2021 and thereafter

We have halved our 2020 revenue estimate to £1.6m. For 2020, pre the COVID-19 pandemic, however, we had anticipated a £0.7m loss after tax for 2020 on £3.2m revenue. Our estimate for 2020 is now a £1.75m loss on £1.6m revenue.

2020 reductions in track market, in retrofit and in OEM 6 with a start date delay

The 2020 track season will not take place. The retrofit market has been paused. Further, the OEM 6 (Aston Martin) scheduled to commence offtake in the coming weeks is likely to be pushed back to the last few weeks of 2020. This reduces OEM revenues by £0.5m in 2020, with 2021 unaffected. Although this is not entirely related to COVID-19, the decision to delay is understandable. All cars are pre-sold, however, so commencement will be prompt.

Cash outflow

We estimate a £1.65m cash outflow pre equity funding

We estimate a £1.65m cash outflow pre the new-equity funding. Depreciation of £0.7m is estimated and a £0.32m cash R&D tax credit is being received (£0.5m credit on full-year P&L). The large majority of this cash outflow is driven by the revenue reduction. Part of the cash is work-in-progress related. ST is continuing to manufacture – subject to guidelines and health resilience. There is scope for successful though modest management action to mitigate cash outflows.

Profits down, stock slightly up, slight benefit of management actions

New equity: £1.4m (gross) firm subscribed; up to £0.3m more to come (gross)

Placing and open offer at 13p

The firm placing of 10.8m shares has raised £1.4m gross and an open offer of 2.3m shares is under way, raising up to £0.3m. There is an over-allotment application mechanism and we have every anticipation that the open offer will secure further new capital.

Strong uptake by board and major shareholders

It is noteworthy that directors have subscribed for 1.5m new shares and existing major shareholders have made significant fresh investments.

Note that our model assumes £1.5m (net) equity raise. This is enough to give financial resilience but has been sparing of the use of expensive fresh equity, diluting by 10%.

Risks and mitigation

Cashflow

Cash burn in 2020 was in the models, even without the COVID-19 issue

The company is currently cashflow-negative and had been budgeted as such even prior to COVID-19. Importantly, 2021 onwards remains robust regarding profits and cashflow. Meaningful, positive cashflow from later in 2021 is delivered into the financial projections on current contracts, which run for several years.

Never net debt

The company has an interest-free loan related to public-sector funders and ca.£0.5m asset finance. The company has never been in a net debt position.

Guaranteed pricing

The OEM 5 and OEM 6 contracts have guaranteed pricing structures (in respective currencies of € and £).

Currently, inventories and work in progress are at levels which would cover higher run rates of sales. Revenue, set to rise, is not expected to lead to more than a modest working capital outflow in initial years. Similarly, capital expenditure has been undertaken well ahead of sales and further requirements will be relatively modest – until ST's revenue run rate moves towards outpacing the £16.5m installed capacity.

Resilience to COVID-19 recurrence

What if COVID-19 were to halve the 2021 racing season?

COVID-19 is responsible for the large majority of our recent sales downgrade for 2020E from £3.3m to £1.6m. 2021E and 2022E are unchanged. Were 2021's racing season to be halved – we expect it to be unchanged from previous estimates – the hit to 2021 profits might be up to £0.5m. This, by the way, would be likely to result in 2021E cashflow breakeven. As the OEM orders' start of production and pre-production development works are firmly cast as part of model sales profiles, £0.5m is a reasonable worst-case scenario, in our view.

Strong competitive position – and not needing to take volume from competitor

Competitive position

There is only one competitor, Brembo-SGL, and the substantial ownership of it by the Quandt family (the owners of BMW) makes other OEMs cautious, thereby offering a very significant opportunity for ST. We expect significant revenue growth for both participants.

IP and product superiority, far from simple to manufacture

Product and intellectual property (IP)

The product has been tested in use by customers for several years and by prospective customers in extreme-condition road tests. The product works. As volumes ramp up, we know that quality assurance is a high priority. Industry standards qualification has been secured, with imminent granting of the latest industry qualification confidently expected.

New factory successful commissioning, modular structure for easy expansion, cost cutting

Modern, cell-configured manufacturing facility

This mitigates i) the order fulfilment risk as seen by the potential customer, and ii) the risk faced by ST in expanding production. ST still has a multiplicity of opportunities to cut its manufacturing costs. Each programme to achieve cost cuts is clearly calibrated. As the manufacturing has a cell structure, this makes incremental scaling relatively pain-free.

Brexit

Whichever way the exit from the single EU market and possible trade barriers develops, the product is a high-gross-margin sale. Any supply-chain disruption could be covered by warehousing of the finished product in Germany.

Financial performance

Revenue account

COVID-19 outcome hits the race season hard and we also put back OEM 6 start by some weeks

For 2020 onwards, we estimate slightly higher gross margins than in previous years, as the mix is enriched by development revenues from OEMs. COVID-19 is responsible for close to three quarters of our recent downgrade for 2020E from £3.3m to £1.6m revenue. 2021E and 2022E are not changed. We have illustrated, were the 2021 racing season to be halved – we expect it to be unchanged from previous estimates – the hit to 2021 profits might be of the order of £0.5m. This 'aiming off', by the way, would be likely to result in 2021E cashflow breakeven, we estimate. As the OEM orders' start of production and pre-production development works are contractual, we think this £0.5m risk is a reasonable worst-case scenario.

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	1.60	4.00	5.70
Gross profit	0.43	0.92	0.62	0.87	1.20	2.88	3.99
Gross margin	61.43%	68.00%	61.70%	60.00%	75.00%	72.00%	70.00%
R&D & overheads***	-2.81	-2.93	-3.25	-2.28	-2.75	-2.98	-2.99
EBITDA	-2.38	-2.01	-2.63	-1.41	-1.55	-0.10	1.00
EBITDA margin	loss	loss	loss	loss	loss	loss	17.54%
EBITA	-2.53	-2.30	-2.94	-1.70	-2.25	-0.80	0.30
EBITA margin	loss	loss	Loss	loss	loss	loss	5.26%
Net finance income	0.00	0.00	-0.01	-0.06	0.00	0.00	0.00
PBT (adjusted)	-2.53	-2.30	-3.04	-1.76	-2.25	-0.80	0.30
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	0.50	0.55	0.55
PAT	-2.18	-1.83	-2.12	-1.32	-1.75	-0.25	0.85
EPS (diluted, adjusted, p)	-2.42	-1.66	-1.68	-0.97	-1.21	-0.17	0.57
DPS (p)	0.00	0.00	0.00	0.00	0.00	0.00	0.00

Note: On 15 August 2019, it was announced that there was to be a change in the year-end from May to December.
May year-end; **December year-end: * includes £0.13m negative exceptional items 2018*
Source: Surface Transforms accounts, Hardman & Co Research estimates

Some components of revenue forecasts

The first car from OEM 6 (Aston Martin) commences revenue from late this year and for the subsequent two years. Sales numbers comprise a few £000,000 in 2020 and 2022, with the full year run during 2021 being more, running at the annual run rate of £1.0m stated by ST. Other 2020E income is a very small amount of development revenues from OEMs. These derive from models announced for future start of production. The significant majority of current revenue is retrofit and (near-OEM) track cars. This is weighted to 1Q20 as a result of the COVID-19 situation.

Not changing our 2021 or 2022 estimates

We expect approximately half 2021 revenue to derive from these ongoing, regular non-OEM clients. 2021 sees OEM 5 revenues commence. It will also see the start of the smaller-sized Koenigsegg contract.

The scheduled start for the OEM 6 second car is in 2022; the full run rate on OEM 5 and on the smaller Koenigsegg. We estimate it is also set to comprise a broadly sideways trend in sales of the retrofit and (near-OEM) track cars.

Balance sheet

Pre the benefit of the OEM contracts, for which revenue streams are due to commence late this year, ST has been cash-consumptive. The most recent share issues include a 20 March 2019 placing of 12.30m new shares at 15.5p per share, which raised a gross £1.9m.

Subsequently, there was the 13p placing and open offer announced immediately prior to Easter. A firm placing of 10.8m shares raised £14.0m and there is an open offer of up to 2.3m shares, raising up to £0.3m. It is noteworthy that directors have subscribed for 1.5m new shares.

Shares in issue may vary very slightly from our estimates – dependent on the open offer outcome.

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	3.05	4.30
Shareholders' funds	3.90	5.55	6.90	5.57	5.32	5.07	5.92
Net cash (debt)	1.53	0.62	1.60	1.60	1.45	1.95	2.90
Avg. shares diluted (m)	90.00	110.30	125.20	136.00	145.20	149.20	149.20

**May year-end, **December year-end*

Source: Surface Transforms accounts, Hardman & Co Research estimates

Cashflow

A major positive change in 2021

We have outlined certain Hardman & Co assumptions above in the section covering the fundraise. In summary, we estimate changes in year-end trade net current assets to be small in 2020, 2021 and 2022. We expect the ratio of stock to coming-year revenues to reduce. We also model modest capital expenditure because the last major requirement to complete manufacturing cell 1 was paid in 2019. There are small items likely to be spent in order to add resilience and de-bottlenecking, but such items are modest. Effectively, they are relatively discretionary.

Capital expenditure will be required to add a further manufacturing cell as revenue rises significantly above levels estimated for 2022. Current total capacity of £16.5m fulfils all sales rates estimated in our forward estimates.

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	-1.05	0.65	1.45
Capex	-2.07	-2.00	-0.10	-0.20	-0.60	-0.15	-0.50
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	1.50	0.00	0.00
Net cashflow	-3.23	-0.69	1.00	0.00	-0.15	0.50	0.95
Depreciation	0.15	0.29	0.40	0.29	0.70	0.70	0.70

** May year-end ** December year-end*

Source: Surface Transforms accounts, Hardman & Co Research estimates

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