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Value opportunities

Simon Thompson

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It's a sad reflection on world we live in that terrorist attacks are all too common. It also means that government security agencies have little option but to adopt the latest counter-terrorism technology to prevent such atrocities occurring.

One company specialising in this niche area is Sedgefield-based **Kromek** (KMK:23.75p), a radiation detection technology company focusing on the medical, security and nuclear markets. Kromek has developed a 'dirty bomb' detector that is 10 times faster at detecting gamma and neutron radiation, and a tenth of the cost of conventional detectors. It's proving popular as European security agencies used them to protect US President Donald Trump during his visit to Brussels last summer, the New Jersey Port Authority in New York is now deploying them, and they have been field-tested by the US authorities in Washington DC.

The standalone radiation detectors have been “well received by these parties”, according to Kromek’s directors, who expect orders to materialise in due course. To quantify the potential market size, if the US government decides to roll out these detectors across up to 23 cities in the US, then each contract could be worth north of $10m (£7.4m). The company’s ability to fund such large contracts, assuming they are forthcoming later this year, is underpinned by its strong balance sheet boasting net funds of around £13.3m.

I would also flag up that following extensive due diligence by the US Department of Defence, the company has been named as a qualified contractor under the department’s US$8.2bn 10-year programme for the research, development, acquisition and production/procurement of a 'Man-portable Radiological Detector System (MRDS)', which is designed to 'provide the Army with a capability to detect and identify a Weapons of Mass Destruction threat'. True, it’s a blue-sky opportunity, but it’s also one that Kromek is well placed to profit from.

Moreover, the company is not a one-trick pony as its patented core cadmium zinc telluride (CZT)-based radiation detection technologies are proving popular in medical imaging. For instance, Kromek is delivering on a five-year contract valued at $12.6m, with a long-standing OEM customer. The company's detector modules, which are incorporated into the customers' systems, produce some of the most accurate imaging to diagnose the strength and health of bones. This allows clinicians to accurately detect, monitor and treat osteoporosis in patients. It’s not the only one as Kromek has recently been awarded a repeat contract by another OEM customer, worth US$5.38m, to supply its CZT-based detector modules into a new medical diagnostics product, and announced another US$1.5m contract win after its October half year end.

Importantly, the company is monetising its technology and is on track to break even on a cash profit basis for the 12 months to end April 2018. Analysts Paul Hill and Hannah Crowe at research firm Equity Development expect full-year revenues to rise by a third to £12.5m, a reasonable assumption following a 27 per cent increase to £4.8m in the first half. Kromek has a £6.2m order book of repeat business scheduled for delivery in the second half, implying it needs to book another £1.5m of new shipments to hit the full-year revenue estimate. Buoyed by a strong order book, which analysts believe is now worth US$45m across all three business units (the other being an airport security screening technology which is installed at over 50 airports in 11 countries), and with the company hitting an inflexion point, cash profits can be expected to ramp up sharply thereafter. Analysts are predicting a £3.5m rise in revenues to £16m in 2018/19 to deliver cash profits of £1.4m, highlighting the strong operating leverage of the business.

It’s fair to say that the directors are confident in the company’s future prospects as three insiders purchased shares at prices between 23.5p to 24.75p last autumn. I am too. So, having first advised buying Kromek shares at 25p ('**Follow the smart money', 27 Feb 2017**), after which they rallied to 37p before profit taking took hold, and subsequently rated them a buy at 26.5p last summer **(‘Repeat buying opportunities’, 29 Aug 2017**), I feel the risk:reward is very favourable. Trading on 1.5 times book value, and a modest three times forecast 2018/19 sales to enterprise value, I rate Kromek shares a buy and maintain my 34p target price. Buy.

Cohort undervalued

Last spring I suggested top slicing holdings in UK defence group **Cohort**(CHRT:385p) at 460p (**'Taking profits', 18 Apr 2017**), having first initiated coverage at 214p (**'Blue-sky buy', 6 Oct 2014**). It proved the right call as the shares drifted to 390p by last autumn when I upgraded my recommendation back to a buy (**'Seeking value', 4 Sep 2017**).

The reason for doing so was that Cohort has been winning a raft of contracts, supporting forecasts which point to the company increasing its pre-tax profit from £14.5m to £15.4m, according to analysts at Edison Investment Research. On this basis, expect adjusted EPS to rise from 26.6p to 29.1p to support a 15 per cent hike in the dividend per share to 8.2p. Importantly, the directors reiterated full-year guidance at the time of last month's half-year results, and Edison's profit and EPS forecasts remain unchanged, implying the shares are rated on 13 times earnings estimates, and offer a 2.1 per cent dividend yield.

However, Cohort's share price has yet to re-rate since I upgraded my recommendation in September, a reflection perhaps of investors being over cautious due to the second half weighting in the full-year forecasts. Bearing this in mind, nearly £55m of the company's £132m closing order book at the end of October is scheduled for delivery in the second half, accounting for over two thirds of the second-half revenue estimate embedded in Edison's estimates. In addition, post the half year end Cohort acquired a further 23 per cent stake in its majority-owned subsidiary EID, a Portugal-based designer and manufacturer of advanced communications systems for the defence and security markets. The increased contribution for EID will benefit the second half numbers too.

Importantly, Cohort continues to win new orders including a £10m contract extension announced last month with the UK Ministry of Defence to provide training and exercise support to Joint Forces Command. Internationally, business has been building and now accounts for a third of the company's revenues with higher-margin export activity expected to increase with the benefit of EID being part of the group. There is ample scope for further selective earnings accretive bolt-on acquisitions to add earnings momentum too. Cohort's net funds are expected to rise from £5.7m to £10m in the second half, a sum worth 25p a share, and the company has access to £25m of credit facilities.

In the circumstances, I feel that investors are being too cautious on Cohort's prospects with the shares priced on a near 20 per cent discount to the UK defence sector average earnings multiple for 2019. Buy.

Ramsdens upgrades again

Middlesbrough-based **Ramsdens Holdings** (RFX:184p), a diversified and fast-growing financial services company that joined London's junior market early last year, reported a bumper set of results in late November while I was on sabbatical. Pre-tax profit surged by almost two thirds to £5.2m on revenues up 18 per cent to £21.8m in the six months to end September 2017, an outcome that supported a maiden interim payout of 2.2p.

A key driver has been Ramsdens' highly competitive foreign currency arm, which exchanged £324m-worth of currency with more than 511,000 retail customers. This underpinned a £2m increase in the division's gross profit to £7.5m, accounting for almost half of the company's gross profits of £16.1m, up from £13.2m in the same period last year.

There was a decent contribution from the company's small pawnbroking operation which benefited from the higher sterling gold price for scrap proceeds on forfeited pledges, improved retail activity and an 18 per cent hike in the loan book to £6m, all of which contributed to interest income increasing by £600,000 to £3.5m. Scaling up the company's jewellery retail operations by cross selling to its enlarged customer base through its 127 store estate and increasing its online presence is paying dividends too. Revenues from this part of the business shot up by 40 per cent to £3.5m to deliver a £400,000 rise in gross profits to £1.9m.

Not surprisingly for a cash-based business, Ramsdens is converting a high percentage of its profits into cash flow: net funds increased by £3.7m to £13.4m in the six months to end September 2017. The growing cash pile is now worth 43p a share, providing the directors ample capital to finance a planned store roll-out programme.

Reflecting the momentum in the foreign currency and jewellery segments, analyst Justin Bates at house broker Liberum Capital has upgraded his full-year EPS estimates once again, this time by 6 per cent to 16.2p, implying 60 per cent year-on-year growth. Admittedly, investors are now cottoning onto the growth prospects. Having first suggested buying the shares at 132p ('**A jewel in the north', 12 Jun 2017**), and subsequently at 169p (**'Riding earnings momentum', 6 Sep 2017**), my 190p to 200p target range was achieved in late November.

However, on nine times earnings estimates after stripping out cash, and offering a prospective dividend yield of 3.5 per cent based on a full-year pay-out of 6.5p a share, I feel a valuation of 210p a share is warranted in light of the latest earnings upgrades. Buy.

Stadium recovery potential

It's incredibly frustrating when my target price is hit and I opt to run profits only for the price to slide back. In the case of **Stadium** (SDM:84p), a niche electronics company specialising in wireless, power and human machine interface products, it was more than a slide as the share price has lost a third of its value since I suggested running profits at 123p in the autumn (**'Riding earnings momentum', 6 Sep 2017**). I first advised buying at 75p ('**Switch on to the Stadium of light', 30 Jul 2014**), so a chunk of those long-term gains have been wiped out, albeit the company has paid out dividends of 7.7p a share too.

A 15 per cent profit downgrade is the reason for the share price reversal, reflecting contract delays in some higher-margin technology products which had been expected to ship before the December year-end, a situation compounded by a global shortage of certain electronic components – memory chips, circuitry and passive components, in particular – which has further contributed to cost pressures. The delays and pricing pressures are likely to impact the company in 2018 which is why analyst Jon Lienard at brokerage N+1 Singer has reined in this year's numbers by a similar percentage. Mr Lienard now expects Stadium to report a modest 7 per cent rise in pre-tax profits of £4.5m on 15 per cent higher revenues of £63m in 2017, rising to pre-tax profits of £5.4m on revenues of £70m this year. On this basis, expect EPS of 9.1p last year, and 10.8p in 2018.

The positive news is that the company's order book now exceeds £32m, a new record, having risen from £25.8m at the end of 2016, so at least providing sales visibility. A £40m-plus design-led pipeline of business in its high-margin technology products division augurs well too. This segment has been growing organically, and by acquisition, and now accounts for 61 per cent of Stadium's revenue, up from only 21 per cent in 2013, reflecting its transition from an electronic manufacturer to a design-led technology company.

Of course, execution risk is clearly an issue as the profit warning illustrates. However, this is more than factored into with the shares trading on 9 times downgraded earnings estimates for the 2017 financial year, and offering a near 4 per cent prospective dividend yield. The implication being that the business has gone ex-growth even though the record order book points to improved sales and profits growth this year.

So, ahead of the full-year results on Tuesday, 13 March, I rate Stadium's shares a recovery buy and have a new target price of 105p. Buy.

■ Simon Thompson's book **Stock Picking for Profit** can be purchased online at **www.ypdbooks.com** for £14.99, plus £2.95 postage and packaging, or by telephoning YPDBooks on 01904 431 213 to place an order. It is being sold through no other source. Simon has published an article outlining the content: **Secrets to successful stock picking**