

XP Power

FY18 results

Driving share gains with expanded product range

In FY18 XP reported strong organic growth and operating margins, generating EPS growth of 18%. After a series of acquisitions, it has a full portfolio of power solutions to meet all voltage and power requirements, and management is now focused on increasing its market share at key accounts. In our view, the stock is trading at close to trough multiples with a dividend yield above 4%.

Year end	Revenue (£m)	PBT* (£m)	Dil. EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/17	166.8	36.1	147.0	78.0	13.5	3.9
12/18	195.1	41.2	172.8	85.0	11.5	4.3
12/19e	210.3	43.9	184.2	88.0	10.8	4.4
12/20e	220.0	46.0	192.4	92.0	10.3	4.6

Note: *PBT and diluted EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

FY18: Organic growth boosted by acquisitions

XP reported the third record year of revenues and EPS. Double-digit organic growth was augmented by acquisitions that have broadened the product portfolio. The company is now positioned as one of a few providers of the complete range of power solutions across all voltage and power ranges. Even after adding headcount to support sales and engineering, XP expanded normalised operating margins by 36bp to 22.0% and reported normalised EPS growth of 17.6% y-o-y. As well as integrating acquisitions, the company is focused on expanding its Asian manufacturing capacity and putting in place a single ERP system to manage the business more efficiently.

Outlook: Cyclical headwinds but cross-selling potential could boost market share

As previously flagged, the semiconductor sector is seeing weaker demand. During this period, the company remains focused on product development and is working closely with customers on future designs to ensure it is well positioned for volume recovery. With its now expanded product range, XP is in a good position to grow its penetration of key accounts. We had already factored in weaker demand from the semis sector; minimal estimate changes reflect FY18 results and higher capex.

Valuation: Close to trough multiples

XP is trading at a material discount to peers on all metrics. In our view, concerns over the weakness of the semiconductor sector are weighing heavily on the share price, even though this makes up only a quarter of XP's revenues. With a broad product portfolio focused on structural growth markets, local customer support, control over the manufacturing process and strong cash generation, we view the company as well positioned to grow market share while maintaining high operating margins. Evidence of order growth in the semiconductor equipment sector is likely to be the key trigger for share price upside from this point.

Tech hardware & equipment

5 March 2019

Price **1,980p**

Market cap **£379m**

US\$1.32:£1

Net debt (£m) at end FY18 52.0

Shares in issue 19.1m

Free float 90%

Code XPP

Primary exchange LSE

Secondary exchange N/A

Share price performance



% 1m 3m 12m

Abs (3.4) (14.7) (39.8)

Rel (local) (4.9) (15.7) (39.2)

52-week high/low 3,710p 1,980p

Business description

XP Power is a developer and designer of power control solutions with production facilities in China, Vietnam and the US, and design, service and sales teams across Europe, the US and Asia.

Next events

Q119 trading update 15 April

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Investment summary

Company description: Power control solutions for industry

XP Power designs, manufactures and distributes power converter solutions to original equipment manufacturers (OEMs) in the healthcare, technology and industrial markets. The group has its headquarters in Singapore and, to remain close to its global customer base, has a sales, design and engineering presence in the US, Europe and Asia. Unlike many in the industry, XP is vertically integrated; its manufacturing facilities in Asia and the US allow the company to maintain quality control, improve flexibility, reduce product costs and minimise lead times.

Financials: Growth and margins maintained for another year

XP reported another record year for revenues and EPS, helped by recent acquisitions in the US, but also due to organic revenue growth of 11% y-o-y. Normalised operating margins expanded by 36bp and tax returned to more normal rates, resulting in normalised EPS growth of 17.6% y-o-y and full year dividend growth of 9.0%. Debt funding of acquisitions combined with higher working capital needs and expansion of manufacturing in Asia resulted in net debt increasing from £9.0m at end FY17 to £52.0m at end FY18. We forecast EPS growth of 4.8% in FY19e and 7.0% in FY20e.

Exhibit 1: Changes to forecasts									
	Normalised EPS (p)			PBT (£m)			EBITDA (£m)		
	Old	New	% chg.	Old	New	% chg.	Old	New	% chg.
2018	170.5	172.8	1.4	40.7	41.2	1.3	48.2	49.2	2.0
2019e	187.9	184.2	(2.0)	43.9	43.9	0.0	52.7	52.9	0.4
2020e	N/A	192.4	N/A	N/A	46.0	N/A	N/A	55.8	N/A

Source: XP Power, Edison Investment Research

Valuation: Discount reflects semiconductor weakness

On a P/E basis, XP is trading at a material discount to global power converter companies and UK electronics companies, with a dividend yield at the top end of the range, despite generating EBITDA and EBIT margins at the top end of the peer group. Outside of the impact of economic cycles in XP's end markets, we see scope for upgrades to earnings estimates from cross-selling and further market share gains in healthcare. Weak demand in the semiconductor production equipment (SPE) sector is weighing on the share price – we note this makes up roughly a quarter of revenues, with a further 22% generated from the less cyclical healthcare sector and another 43% from the industrial sector, where it is present in a diverse range of applications. Evidence that the semiconductor equipment sector is seeing the resumption of order growth is likely to be the key trigger for share price upside from this point.

Sensitivities: Cyclical, competition, currency

XP Power has cyclical exposure to global industrial, technology and healthcare markets and is therefore sensitive to end-demand and product development expenditure in these markets. Visibility of customer volumes is limited and, as such, individual customer orders can be volatile. With the majority of XP's revenues, manufacturing costs and opex US dollar-denominated, currency will continue to add volatility to XP Power's reported revenues, although it will have less impact at the net income level. XP competes with large global industrial companies as well as low-cost Asian manufacturers, XP also has more limited exposure to the euro/sterling exchange rate; to minimise this, the company enters into forward contracts. Recent acquisitions add integration risk.

Company description: Power control solutions

XP Power designs, manufactures and distributes power converter solutions to OEMs in the industrial, healthcare, semiconductor and technology markets. Power converters take the high-voltage alternating current output from the mains supply and convert it into various lower-voltage, stable direct current outputs that are required to drive most electronic equipment. The company has transitioned from being a distributor to designing and manufacturing the majority of its products. In 2015, XP made two acquisitions, EMCO and a South Korean distributor, for £9.1m. In 2017, it acquired Comdel for £18.8m and in 2018, acquired Glassman for £31.8m. XP has its headquarters in Singapore and has volume manufacturing facilities in China and Vietnam and specialist high-voltage, high power and radio frequency (RF) power product manufacturing in the US.

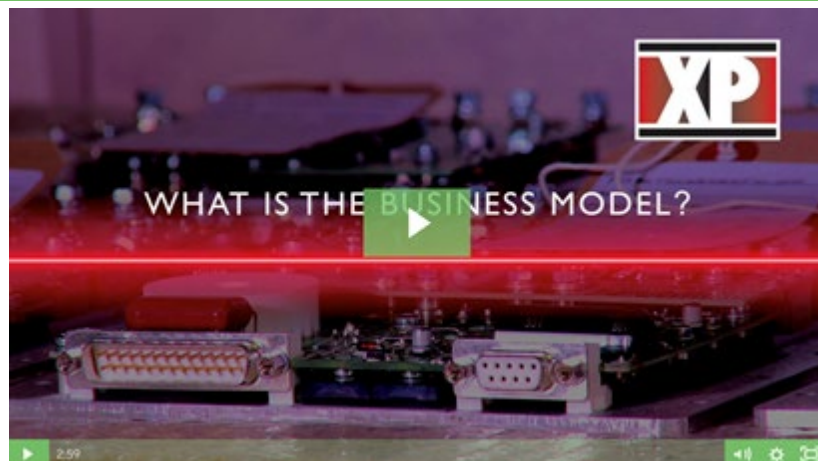
Background: Specialist designer and manufacturer

XP Power was formed as a specialist distributor of power converters in 1988 and listed on the LSE in 2000. In 2002, the board decided to begin developing its own IP and designs, and bought Switching Systems International (California, US), which designed its own configurable power converters with an outsourced manufacturing model. Since then XP has continued to develop its own products and brand, built out manufacturing capacity in China and Vietnam and completed the transition from distributor to designer and manufacturer. Recent acquisitions have expanded XP's product range from low power AC/DC and DC/DC converters to include high voltage, low power converters (EMCO), RF power products (Comdel) and high voltage, high power products (Glassman). XP sells through 27 sales offices and multiple distributors across Europe, Asia and North America and has engineering service functions in Northern California, Germany, Singapore and the UK. FY18 revenues were generated in North America (61%), Europe (31%) and Asia (8%).

Powering critical systems across diverse end markets

XP is focused on developing tailored products for applications with high reliability requirements in the technology, industrial, semiconductor and healthcare equipment markets. It avoids developing commodity products for high volume consumer electronics applications. Products in each end-market can have very different lifecycles. For example, a medical device could have a product life cycle of 10 years or more. Once a power converter is designed into this product, it is likely to remain in it for the full life of the product. On average, the product life cycle is five to seven years. XP's balanced mix of end-customers means it has a fairly high level of revenues that are recurring and exposure to multiple end-markets mitigates the risk of individual industry cyclicality.

Exhibit 2: XP Power business model video



Source: XP Power

XP's focus is on growing the proportion of own-IP, own-manufactured products. This provides control over the quality and cost of product and allows XP to provide customers with tailored solutions. The company operates across three business lines:

- **Own-manufactured product** (80% of FY18 revenues). Products designed by XP, ownership of 100% of the IP and manufactured in its Shanghai, Vietnam or US facilities. This includes engineered solutions where XP Power supplies are customised for specific customer end-product design requirements, namely designing and engineering additional casings, metalwork, circuitry, connectors.
- **Labelled products** (19%). Customer requirements identified and product design specified by XP, but products sourced from third-party manufacturers and labelled under the XP brand.
- **Distribution** (1%). Supply of third-party products.

In-house manufacturing well established

The company is vertically integrated; it manufactures power converters and magnetic components in two locations, China and Vietnam, with smaller US facilities acquired through the EMCO, Comdel and Glassman deals.

China: Main power converter facility

XP built a manufacturing facility in Kunshan, China (near Shanghai) and started production there in 2006. In addition to making power converters at this facility, XP also produces magnetic components for prototyping and short lead-time contracts.

Vietnam: Magnetics and less complex power converters

To reduce XP's exposure to rising Chinese labour costs and gain more control over the manufacturing process, XP expanded manufacturing into Vietnam, at a site near Ho Chi Minh City. The first phase (approximately the same size as the Chinese facility) was completed in 2011. The facility first started to produce magnetic components – these have a high labour component, hence the decision to manufacture them in a lower labour cost country. XP now manufactures virtually all of its magnetics requirements in house.

In 2014, the facility also started manufacturing power converters, starting with some of the less complex converters. The facility continues to qualify additional converter products and runs production in parallel with the Chinese facility until it achieves acceptable yields on those products. The company started building a second facility (Vietnam II – similar size to Vietnam I) on the same site in Q417 and completed construction in Q418. Production is expected to start in Q219.

Exhibit 3: Capacity and utilisation of facilities		
	Revenue capacity (\$m)	Utilisation
China	100	100%
Vietnam I	70	60%
Vietnam II	130	N/A

Source: XP Power

US: Specialist facilities

Through the three US acquisitions, XP has facilities in the US for the more complex high voltage, high power and RF products.

- **EMCO** has a facility in Nevada where it manufactures its high-voltage DC/DC converters. It also uses outsourcing partners for some manufacturing.
- **Comdel** has a 60,000 square feet manufacturing facility in Gloucester, Massachusetts. The component manufacturing for Comdel's products is outsourced within the US and final assembly and test is performed in the Comdel facility.

- **Glassman** has a manufacturing facility in New Jersey.

As EMCO, Comdel and Glassman products are typically more complex than XP's low power products (and therefore higher value), it makes sense to retain the specialist expertise of the US-based manufacturing facilities. We would expect, however, XP to consider shifting some component production for new designs to Asia to reduce the manufacturing cost and to enable the supply of higher volume programmes.

Geographic spread of facilities hedges political risk

Any product manufactured in China that is imported into the US has incurred 10% tariffs since September 2018. This accounts for only a small proportion of orders, as many US OEMs manufacture outside of the US for delivery to non-US based customers. In the event that tariffs are incurred, XP can in some cases pass the cost on to the customer. XP is also able to produce power converters in Vietnam, avoiding the tariffs entirely. The company is accelerating the rate at which it is qualifying more complex converters at the Vietnam facility to reduce the impact of the tariffs. The aim is to be able to produce all converters at both facilities. The company also notes that few of its competitors have Asian production outside of China, so XP's Vietnam facility represents a competitive advantage. For European customers, XP can ship finished product to warehouses in either the UK or Germany, so should be able to minimise the impact of Brexit.

Growth strategy

XP's strategy to drive revenue and profitability growth and to gain market share has been in place and evolved over a number of years. The current strategy aims to:

- develop a market-leading range of competitive products, organically and through selective acquisitions;
- target key customer accounts where XP can add value;
- increase vertical penetration of focus accounts;
- build a global supply chain that balances high efficiency with market-leading customer responsiveness;
- lead the industry on environmental matters; and
- make selective acquisitions in identified strategic markets or of complementary businesses to expand the product offering.

Acquisitions fill out the product range

Historically, XP designed and manufactured low power AC/DC converters, supplying voltages up to 120V, with the majority of products sold supplying voltages up to 48V. As competition from low-cost Asian suppliers has increased, XP has started moving along the complexity scale. While it has invested in engineering resource to develop higher voltage products, it has made the majority of major product additions via acquisition as it is a much faster route.

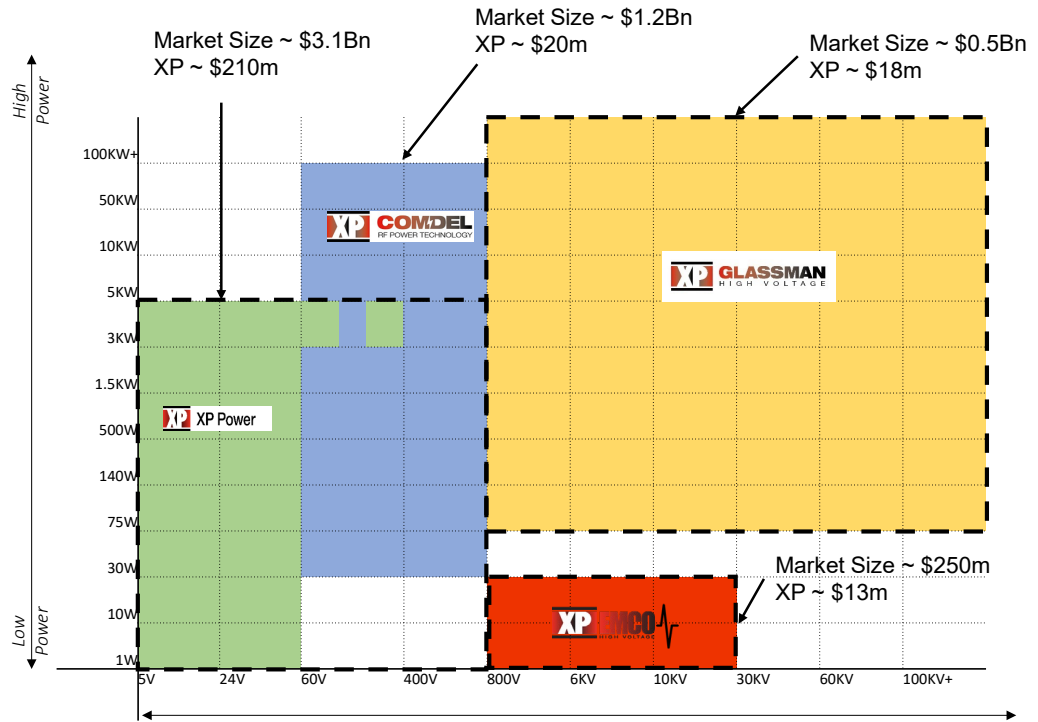
In 2015, XP bought **EMCO** to add high-voltage, low-power converters to its range. EMCO's DC/DC converters can supply voltages up to 40kV, with the majority of products in the 5–12kV range.

In 2017, XP acquired **Comdel** to add RF power solutions. Comdel designs RF power supplies, DC power supplies, impedance matching networks, multi-channel synthesisers and electrostatic chuck power supplies. It supplies standard, modified and custom products – due to the complexity of the products we understand there is a higher proportion of custom work compared to XP's product range. Its RF power supplies are sold to the SPE, thin film, photovoltaics and induction heating industries.

In 2018, XP acquired **Glassman**¹ to add high voltage, high power products. Typically, its products are used in equipment involved in the ionisation and acceleration of particles – applications include semiconductor production equipment, vacuum/plasma processing, analytical instrumentation, medical diagnostic and test equipment. Glassman has a very comprehensive standard product portfolio and can also provide custom solutions.

The chart below shows how the acquisitions have filled out the XP’s product range and highlights the addressable markets for the main product types. The three acquisitions have expanded XP’s total addressable market by nearly \$2bn.

Exhibit 4: Product map and addressable markets



Source: XP Power

We believe XP has made the major acquisitions required to build out its product portfolio. We expect management to focus on integrating the recent acquisitions and maximise the cross-selling potential of those deals. In terms of future M&A, we expect the company to take an opportunistic approach, making bolt-on acquisitions to add to its product or sector offerings.

Developing more custom capability; expanding engineering services

XP aims to have the most comprehensive and up-to-date product range in its target markets. The company introduced 27 new product families in 2018 (versus 27 in 2017). In 2018, XP spent £14.7m on R&D (pre-capitalisation and amortisation), up 28% from the £11.5m spent in 2017.

XP splits its R&D activities between developing new standard products and developing modifications to existing products to meet specific customer requirements. With competition tending to come from Asian manufacturers of low-complexity converters, the company is focused on serving customers with more complex requirements and undertakes custom design work for large customers. It is moving up the value chain by providing engineering solutions that make it easier for the customer to integrate power solutions into their critical systems. XP has built up its engineering services teams globally to provide this face-to-face support during the design process, and has engineering solutions teams in Europe, North America and Asia.

¹ "Rounding out the portfolio", May 2019

Targeting key accounts: New and existing

XP Power has more than 5,000 direct active customers, of which no customer makes up greater than 14% of revenues and no single project makes up more than 3% of revenues. In 2018, the top 30 customers made up 52% of revenues. XP Power supplies power converters to four key markets: industrial, healthcare, semiconductors and technology (see Exhibit 5).

Exhibit 5: End-market breakdown		
Sector	FY18 revenue split	Types of products
Industrial	43%	Factory automation, automated test equipment, industrial control, 3D printing, test and measurement, instrumentation, hazardous environments, defence, avionics.
Healthcare	22%	Medically approved power solutions for use in patient vicinity applications and in the lab environment, including homecare devices, highly efficient convection-cooled designs for low-noise patient area devices and defibrillator-proof DC/DC converters for applied part applications.
Semiconductors	24%	Semiconductor production equipment.
Technology	11%	Audio visual broadcast equipment, mobile and wireless communications, computing and data processing.

Source: XP Power

Leverage approved supplier status

XP's in-house manufacturing helps it sign up blue-chip customers, particularly in the medical equipment and semiconductor equipment markets. Stable and secure power supply is so crucial to the operation of these customers' products that they demand complete control over their supply chain and product manufacture to ensure quality. XP has achieved approved or preferred supplier status at a large number of customers, including all of the main healthcare equipment companies, and is now working to expand its share of business at each customer.

Cross-selling from acquisitions

The three recent acquisitions have increased the potential for cross-selling. As XP's AC/DC converters often provide the DC input for high-voltage DC/DC converters, there is good cross-selling potential for EMCO. Roughly 95% of Comdel's revenues and 70% of Glassman's revenues are generated from the semiconductor production equipment sector. In this market XP, Comdel and Glassman have some customers in common, but they do not overlap in terms of products sold. XP is keen to achieve wider vertical penetration at key accounts now it has the full range of power solutions.

Focus on operational excellence

XP has generated gross margins approaching 50% and operating margins above 20% since 2010, showing how efficiently the business has been run since shifting to the design and manufacture business model. The company continually looks at ways to maintain and improve this performance. This includes the focus on lean manufacturing as well as improvements to internal processes to enable the company to share information internally more effectively and provide better customer service. In 2018, XP started upgrading its SAP ERP software to SAP S/4 Hana, initially in existing operating regions, followed by the manufacturing facilities in Asia in FY19 before moving Comdel and Glassman onto the software in FY20.

High-efficiency products support 'green' credentials

XP is a full member of the Responsible Business Alliance. XP incorporated green technologies into the Vietnamese facility and received the Gold Plus rating by the Singapore Building and Construction Authority (BCA) for non-residential buildings in tropical climates. This is the first BCA Green Mark industrial facility in Vietnam and is the industry's most environmentally friendly building.

Having manufacturing facilities and products that meet high environmental standards helps XP to win approved supplier status with large OEMs, but its main ongoing contribution to sustainability is to design ever-more efficient power converters. For example, a 95% efficient product such as the CCM250 only wastes 5% of the input energy, thereby requiring a lower power input to achieve the same output as a device operating at a lower efficiency. The wasted power is often converted to heat, which in turn requires additional power or physical heat sinks to provide cooling, adding to the upfront and running costs of the product. Of the 27 new products introduced in the year, 20 were high-efficiency designs.

Market performance and outlook

Exhibit 6 shows the split of revenues by geography and end-market over the last two years and the video in Exhibit 7 describes in more detail the end markets that XP Power serves.

- Industrial sector:** this is the most fragmented market, with very few customers in XP's top 30. This sector grew 7% y-o-y in FY18 and saw 14% sequential growth in H218. Areas of strength in FY18 were distribution, analytical instrumentation, defence and industrial printing.
- Healthcare sector:** XP has corporate approvals from all of the major healthcare companies. Revenue growth in FY18 of 4% masks strength in Europe and North America offset by some products going end of life in Asia. Revenues grew 16% sequentially in H218. This is the least cyclical end market.
- Semiconductor sector:** the recent acquisitions in the US have increased XP's exposure to the semiconductor production equipment sector. The sector saw strong growth in 2017, which continued into H118. Cuts to capex budgets in H218, particularly from memory chip manufacturers, were reflected in weaker orders and shipments in this segment in H218. FY18 revenues grew 95% (mainly due to acquisitions) but H218 revenues declined 10% sequentially.
- Technology sector:** typical applications include broadcast, high-end communications including satellite and telecom base stations, and high-end computing. Programmes can be quite large but tend to have shorter lifetimes than the other sectors. Revenues from this sector grew 19% in FY18 and 27% sequentially in H218.

Exhibit 6: Geographic and end market revenue split (£m)							
Europe	FY18	FY17	y-o-y	Asia	FY18	FY17	y-o-y
Semiconductor manufacturing	0.5	0.3	66.7%	Semiconductor manufacturing	0.7	1.3	-46.2%
Technology	6.2	5.9	5.1%	Technology	1.2	2.7	-55.6%
Industrial	43.2	42.1	2.6%	Industrial	9.9	6.2	59.7%
Healthcare	11.2	9.2	21.7%	Healthcare	3.1	4.7	-34.0%
Total	61.1	57.5	6.3%	Total	14.9	14.9	0.0%
N. America				Group			
Semiconductor manufacturing	46.2	28.1	64.4%	Semiconductor manufacturing	47.4	29.7	59.6%
Technology	13.0	8.6	51.2%	Technology	20.4	17.2	18.6%
Industrial	30.6	29.8	2.7%	Industrial	83.7	78.1	7.2%
Healthcare	29.3	27.9	5.0%	Healthcare	43.6	41.8	4.3%
Total	119.1	94.4	26.2%	Total	195.1	166.8	17.0%

Source: XP Power

Exhibit 7: Video of markets served

Source: XP Power

Long-term growth drivers

Key drivers of market growth include:

- **Regulation:** legislation and consumer pressure are driving OEMs to reduce the power consumption of their products. Legislation also extends to the efficiency of power converters, driving demand for new products. XP's new products are designed to maximise efficiency.
- **Healthcare:** as the population ages while continuing to grow overall, people are living longer with chronic diseases, driving overall healthcare spending.
- **Technology:** several trends are driving demand for processing power and memory, including internet of things, artificial intelligence, big data, blockchain, augmented and virtual reality, and autonomous vehicles. It is possible that the growth of each of these technologies in parallel could reduce the cyclicity of the semiconductor industry.
- **Alternative energy:** technologies are evolving for lighting (eg LEDs) and power generation (eg solar, wind), which all have specific power conversion needs.
- **Innovation:** customers increasingly need to differentiate their products from the competition. XP's in-house design capabilities enable it to develop products for niche applications.

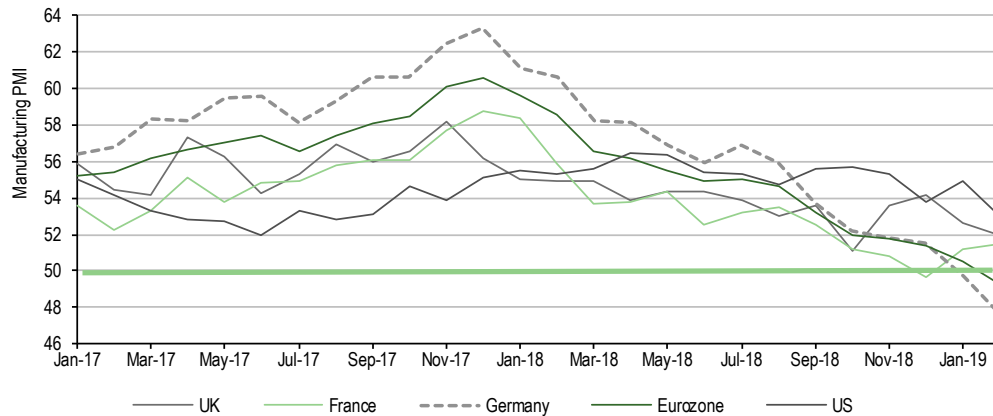
Exhibit 8: Video of market drivers

Source: XP Power

Short-term outlook

The strength of the industrial market depends on the health of the global economy. 2017 was a year of generally rising manufacturing Purchasing Managers' Index (PMI) data, closing the year at peak levels. The situation reversed in 2018, with data generally declining. So far this year, the eurozone has dipped below the 50 level (ie the level that implies expansion rather than contraction) pulled down by weaker data in Germany, Italy and Spain. Conversely, the UK and the US remain well above 50 despite Brexit and US trade tariffs.

Exhibit 9: Manufacturing PMI data – January 2017 to February 2019



Source: IHS Markit

According to Gartner, the global IT market grew 3.9% in 2018 and is forecast to grow 3.2% in 2019. The semiconductor market is forecast to grow just 2.6% in 2019, after 15.9% growth in 2018 (source: WSTS). After a long run of growth for the semiconductor equipment market (2016 +8.7%, 2017 +35.6%, 2018 +9.6%), SEMI is forecasting a 7.8% decline in 2019 as chip manufacturers rein in their capex budgets. Based on recent results reported by SPE companies, on a half-yearly basis, H218 revenues declined versus H118 and are expected to remain depressed in H119 before starting to see improved demand in H219.

The healthcare technology market is expected to show steady growth in the low single-digit percentage range. Philips estimates that the healthcare technology market was worth c €145bn in 2015 and is likely to show a CAGR of 6–7% to 2019. Within that market, diagnostics and treatment technology (just over a third of the total market) is likely to grow at a CAGR of 4% over the same period. The shorter-term performance from the major healthcare equipment manufacturers mirrors this. In 2018, GE Healthcare saw a 2% increase in equipment orders and a 4% increase in organic revenues. Philips saw like-for-like revenue growth of 5% and order growth of 10% in 2018. Siemens' healthcare business saw like-for-like revenue growth of 3% and order growth of 5% in Q119 (calendar Q418) and expects revenue growth of 4–5% for FY19.

Competitive positioning

Referring back to Exhibit 4, XP sees the following addressable markets for its products:

- Low power, low voltage: \$3.1bn market of which XP has a c 6.8% share. The share looks relatively low as XP does not operate in the high-volume, low-value commodity power converter markets that supply products such as PCs, laptops and cell phone chargers, or in the market for inverters used for renewable energy;
- RF power: c \$1.2bn market of which XP has a c 2% share;
- High voltage, high power: c \$500m market of which XP has a close to 4% share; and
- Low power, high voltage: c \$250m of which XP has a c 5% share.

The low market shares that XP has in each area highlights the opportunity the company has to grow revenues by increasing vertical penetration with existing customers as well as signing up new customers. Exhibit 10 summarises the main competitors in each of the product areas that XP operates in. In the low power, low voltage market, XP competes most often with TDK-Lambda and Mean Well as well as with a number of local Asian suppliers.

Exhibit 10: Competition by product type		
Low voltage	High voltage	RF power
Artesyn (Platinum Equity)	Advanced Energy Industries	Advanced Energy Industries
Cosel	Crane Co	COMET Holding
Delta Electronics	Matsusada Precision	MKS Instruments
Mean Well	Spellman High Voltage Electronics	TRUMPF Huettinger
TDK Lambda (TDK Corporation)		
Source: Edison Investment Research		

Sensitivities

XP Power is a global electronics company supplying a broad range of end markets. The company is not immune to economic slowdown, but diversification and the low-cost structure afford XP some earnings resilience versus competitors.

- **Economic sensitivity:** the group has cyclical exposure to global industrial, technology and healthcare markets. Therefore, any slowdown in end-demand in these markets or cutbacks in product development expenditure will have an impact on XP's revenues.
- **Order book visibility:** the group has around four months of order book visibility at any one time. Therefore, visibility of customer volumes is limited and, as such, individual customer orders can be volatile.
- **Currency:** around 84% of XP's revenues, c 98% of cost of sales and c 70% of opex are US dollar-denominated. XP Power reports in sterling, exposing the company's results to fluctuations in the US\$/£ exchange rate. While moves in the exchange rate will have an effect on reported revenues, the overall impact of currency at the net income level is much less pronounced. To minimise the effect, the company enters into forward contracts.
- **Large competitors:** competition ranges from significantly larger players with big balance sheets through to smaller innovative companies. The deeper pockets of large competitors may make it more difficult for XP to keep pace with product development.
- **Acquisitions:** XP has recently made acquisitions, adding integration risk.

Financials

Review of FY18 results

Exhibit 11: FY18 results highlights						
£'m		FY17a	FY18e	FY18a	Diff (%)	% y-o-y
Revenues		166.8	194.8	195.1	0.2%	17.0%
Gross profit		77.6	89.6	92.3	3.1%	18.9%
Gross margin (%)		46.5%	46.0%	47.3%	1.3%	0.8%
EBITDA		41.7	48.2	49.2	2.0%	18.0%
EBITDA margin (%)		25.0%	24.8%	25.2%	0.5%	0.2%
Normalised operating profit		36.4	42.1	42.9	1.8%	17.9%
Normalised operating profit margin (%)		21.8%	21.6%	22.0%	0.4%	0.2%
Reported operating profit		32.5	39.7	39.3	(1.1%)	20.9%
Reported operating margin (%)		19.5%	20.4%	20.1%	(0.3%)	0.7%
Normalised PBT		36.1	40.7	41.2	1.3%	14.1%
Reported PBT		32.2	38.3	37.6	(1.8%)	16.8%
Normalised net income		28.5	33.3	33.7	1.2%	18.2%
Reported net income		28.3	31.1	30.2	(3.0%)	6.7%
Normalised basic EPS (p)		149.4	173.1	176.1	1.7%	17.9%
Normalised diluted EPS (p)		147.0	170.5	172.8	1.4%	17.6%
Reported basic EPS (p)		148.3	161.8	157.8	(2.5%)	6.4%
Dividend per share (p)		78.0	84.0	85.0	1.2%	9.0%
Net debt/(cash)		9.0	52.5	52.0	(0.9%)	477.8%

Source: XP Power, Edison Investment Research

XP reported revenue growth of 17% for FY18, with 21% growth on a constant currency basis and 11% on a like-for-like basis. The effect of a stronger pound versus the US dollar partly explains the higher gross margin (as the vast majority of revenues and costs of sale are US-dollar denominated). The gross margin also saw the benefit of product mix and better performance at Comdel, in part offset by the increased cost of components due to lengthening lead times (as already highlighted at the half year). Underlying operating expenses increased 20% y-o-y resulting in 18% growth in EBITDA. Excluding the impact of acquisitions and staffing the manufacturing facilities, headcount increased by 10% as the company added engineering and sales staff. XP incurred exceptional costs of £0.6m for acquisitions and £0.2m for the upgrade to SAP software.

XP announced a final quarterly dividend of 33p (vs 29p a year ago) payable on 23 April to shareholders as at 22 March. This resulted in a full year dividend of 85p, ahead of our 84p forecast.

Operating cashflow declined year-on-year reflecting the already flagged build-up of inventory to counter longer lead times for components. Capex increased by £5m y-o-y, reflecting the cost of constructing the Vietnamese facility, a 19% increase in capitalised development costs, and the start of the SAP upgrade programme.

Debt funded acquisitions

When XP acquired Glassman in May 2018, it extended its revolving credit facility (RCF) to \$85m with a \$20m accordion, repayable in full in 2021. In November, it exercised the accordion so that it now has access to a \$105m RCF. At year-end, it had used \$81m of this facility. The RCF incurs interest at LIBOR plus 1.2% for the used portion, and LIBOR plus 0.4–0.5% for the unused portion. The company closed the year with a net debt position of £52.0m and a year-end net debt/EBITDA ratio of 1.07x, well within banking covenants.

Outlook and changes to forecasts

The company received orders worth £198.4m in FY18 (+8% y-o-y, +12% constant currency, +5% organic). This resulted in a book-to-bill of 1.02x for FY18. As highlighted in the January trading

update, the company saw a slowdown in orders from the semiconductor sector in Q4, although all other end markets are trading well.

The company noted that it had seen an encouraging start to FY19 in terms of order intake and expects to be able to grow revenues in FY19 (this includes the benefit of a full year of Glassman). Growth is expected to be H2 weighted. We have assumed a c 10% decline in revenues from the semiconductor sector (before adding in the effect of a full year of Glassman) with mid-single digit growth from the remainder of the business.

As well as introducing FY20 forecasts, we have made the following changes:

- Capex: we have increased intangibles capex to reflect the cost of the SAP upgrade.
- EPS: after reflecting FY18 results and higher capex, we reduce our FY19e normalised EPS by 2% (6.6% growth y-o-y). We forecast 4.5% EPS growth in FY20.

Exhibit 12: Changes to estimates							
£'m	FY19e		%		FY20e		%
	Old	New	change	y-o-y	New	y-o-y	
Revenues	210.3	210.3	0.0%	7.8%	220.0	4.6%	
Gross profit	97.0	97.5	0.5%	5.6%	102.7	5.3%	
Gross margin (%)	46.1%	46.4%	0.2%	(0.9%)	46.7%	0.3%	
EBITDA	52.7	52.9	0.4%	7.5%	55.8	5.4%	
EBITDA margin (%)	25.1%	25.2%	0.1%	(0.1%)	25.3%	0.2%	
Normalised operating profit	45.7	45.7	0.0%	6.5%	47.8	4.5%	
Normalised operating profit margin (%)	21.7%	21.7%	0.0%	(0.3%)	21.7%	(0.0%)	
Reported operating profit	37.7	39.8	5.6%	1.3%	42.9	7.7%	
Reported operating margin (%)	17.9%	18.9%	1.0%	(1.2%)	19.5%	0.6%	
Normalised PBT	43.9	43.9	0.0%	6.6%	46.0	4.7%	
Reported PBT	35.9	38.0	5.9%	1.2%	41.1	8.0%	
Normalised net income	37.0	35.8	(3.2%)	6.3%	37.4	4.5%	
Reported net income	29.2	30.9	5.9%	2.4%	33.4	8.1%	
Normalised basic EPS (p)	190.8	187.7	(1.6%)	6.6%	196.1	4.5%	
Normalised diluted EPS (p)	187.9	184.2	(2.0%)	6.6%	192.4	4.5%	
Reported basic EPS (p)	150.6	162.1	7.6%	2.7%	175.2	8.1%	
Dividend per share (p)	87.0	88.0	1.1%	3.5%	92.0	4.5%	
Net debt/(cash)	45.0	43.3	(3.8%)	(16.8%)	31.8	(26.6%)	

Source: Edison Investment Research

Valuation

There is a limited number of listed power converter companies, as many businesses are part of larger industrial companies such as TDK or GE. We show below the financial performance of those listed peers as well as a group of UK-listed companies active in the electronics space. XP clearly generates EBITDA and EBIT margins at the top end of the peer group. On a P/E basis, the company is trading at a material discount to global power converter companies and UK electronics companies, with a dividend yield at the top end of the range. Outside of the impact of economic cycles in XP's end markets, we see scope for upgrades to earnings estimates from cross-selling and further market share gains in healthcare.

Exhibit 13: Peer group financial performance

	Rev growth			EBITDA margin			EBIT margin		
	LY	CY	NY	LY	CY	NY	LY	CY	NY
XP Power	17.0%	7.8%	4.6%	25.2%	25.2%	25.3%	22.0%	21.7%	21.7%
Cosel	18.3%	18.4%	-3.2%	20.9%	20.2%	19.1%	17.7%	N/A	N/A
Delta Electronics	4.3%	6.0%	7.8%	13.3%	12.2%	13.4%	8.8%	7.7%	8.9%
Advanced Energy Industries	7.1%	-11.2%	18.5%	26.3%	27.0%	30.1%	24.5%	21.8%	27.9%
Comet Holdings	-0.4%	-3.6%	8.1%		12.9%	15.3%		9.2%	11.7%
CML Microsystems	14.2%	-11.7%	11.8%	32.1%	31.8%	33.9%	15.3%	10.6%	14.6%
Diploma	7.3%	9.4%	3.9%	18.1%	18.6%	18.7%	15.2%	17.4%	17.5%
Electrocomponents	12.8%	10.2%	5.0%	12.0%	13.1%	13.6%	10.5%	11.6%	12.0%
Gooch & Housego	11.5%	11.1%	3.7%	18.2%	18.6%	19.3%	12.8%	13.9%	15.7%
TT Electronics	8.2%	17.6%	11.5%	13.7%	11.1%	11.5%	7.8%	7.9%	8.4%
Average power converter companies		2.4%	7.8%	20.2%	18.1%	19.5%	17.0%	12.9%	16.2%
Average UK electronics companies		7.3%	7.2%	18.8%	18.7%	19.4%	12.3%	12.3%	13.7%

Source: Edison Investment Research, Refinitiv (as at 4 March)

Exhibit 14: Peer group valuation metrics

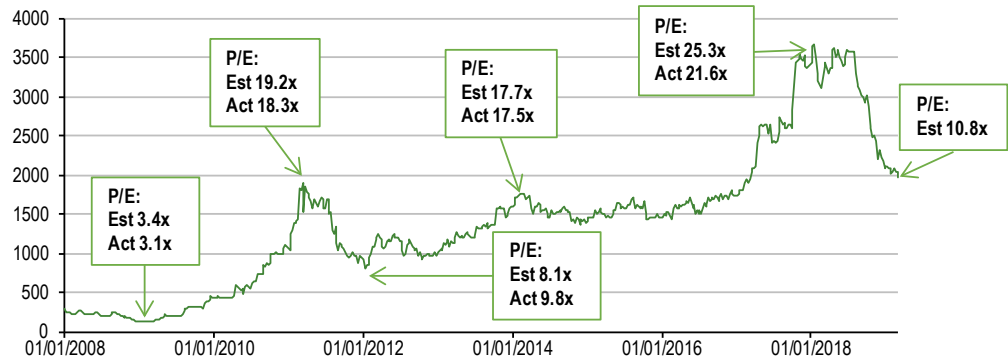
	Market	Share	Listing	P/E (x)			EV/EBITDA (x)			Div yield (%)		
	cap (m)	price	currency	LY	CY	NY	LY	CY	NY	LY	CY	NY
XP Power	378	1980	GBp	11.5	10.8	10.3	8.7	8.1	7.7	4.3%	4.4%	4.6%
Cosel	44,506	1196	JPY	13.2	12.5	14.0	6.7	5.8	6.3	2.7%	2.9%	2.7%
Delta Electronics	407,814	157	TWD	22.4	23.5	19.9	13.3	13.7	11.6	3.2%	3.1%	3.3%
Advanced Energy Industries	1,954	51.15	USD	11.7	17.8	11.1	8.5	9.3	7.0	0.0%	0.0%	0.0%
Comet Holdings	759	97.8	CHF		26.1	19.0		14.6	11.4	1.2%	1.5%	1.9%
CML Microsystems	52	301	GBp	11.7	19.5	12.6	3.7	4.3	3.6	2.6%	2.7%	2.9%
Diploma	1,564	1375	GBp	24.4	22.1	21.1	17.4	15.4	14.8	1.9%	2.1%	2.2%
Electrocomponents	2,556	576	GBp	20.3	16.1	14.7	13.2	10.9	10.0	2.3%	2.6%	2.8%
Gooch & Housego	291	1160	GBp	20.5	19.0	17.9	13.2	11.6	10.8	1.0%	1.0%	1.1%
TT Electronics	312	190.8	GBp	17.5	12.6	10.6	7.2	7.6	6.5	3.0%	3.3%	3.7%
Average power converter companies				15.8	20.0	16.0	9.5	10.9	9.1	1.8%	1.9%	2.0%
Average UK electronics companies				18.9	17.9	15.4	10.9	10.0	9.2	2.1%	2.3%	2.5%

Source: Edison Investment Research, Refinitiv (as at 4 March)

Close to trough valuation

In the chart below, we track the peaks and troughs in the XP share price and show the forward P/E based on EPS estimates at the time and based on the actual EPS subsequently reported for the forward period. The share price has shown a constant growth path, with cyclical peaks and troughs as the share price has over- or undershot earnings upgrades and downgrades. The most recent peak was in January 2018, at which point the stock was trading at 25.3x FY18e EPS. Based on the reported FY18 EPS of 172.8p, the peak multiple was 21.6x. By the beginning of March 2019, the share price had declined 47% to a trough of 1,980p. At this level, it is trading at 10.8x our revised FY19e EPS. Clearly, there is risk that the semiconductor downturn could be worse than we have factored in, or the general economy could show slower growth than expected. If we were to assume a lower rate of growth in FY19 (say 4% rather than our current 8%), reduce gross margins to reflect lower utilisation (from 46% to 44%) and assume a small cut to opex (only 2% reflecting the fact that the organisation is fairly lean already and would not want to reduce key headcount such as engineering or customer support), we estimate this could result in an EPS downgrade of 17%. This would put the company on a FY19e P/E of 12.9x, still a long way from peak multiple levels and still at a discount to peers. We expect that evidence that the semiconductor cycle has troughed will be the key trigger for share price upside from this point.

Exhibit 15: XP Power share price chart (p)



Source: Refinitiv, Edison Investment Research

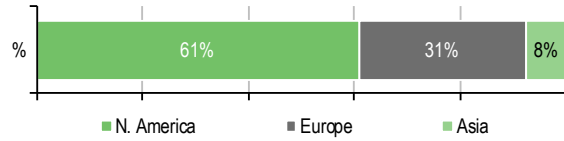
Exhibit 16: Financial summary

	£'m	2012	2013	2014	2015	2016	2017	2018	2019e	2020e
31-December		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
INCOME STATEMENT										
Revenue		93.9	101.1	101.1	109.7	129.8	166.8	195.1	210.3	220.0
Cost of Sales		(49.0)	(51.5)	(51.0)	(55.1)	(67.8)	(89.2)	(102.8)	(112.8)	(117.3)
Gross Profit		44.9	49.6	50.1	54.6	62.0	77.6	92.3	97.5	102.7
EBITDA		23.3	26.0	27.6	29.7	33.0	41.7	49.2	52.9	55.8
Normalised operating profit		21.0	23.3	24.5	25.9	28.8	36.4	42.9	45.7	47.8
Amortisation of acquired intangibles		0.0	0.0	0.0	0.0	(0.4)	(0.6)	(2.8)	(4.4)	(4.4)
Exceptionals		0.0	0.0	0.0	(0.3)	(0.4)	(3.3)	(0.8)	(1.0)	0.0
Share-based payments		0.0	0.0	0.0	0.0	0.0	0.0	0.0	(0.5)	(0.5)
Reported operating profit		21.0	23.3	24.5	25.6	28.0	32.5	39.3	39.8	42.9
Net Interest		(0.8)	(0.4)	(0.2)	(0.2)	(0.2)	(0.3)	(1.7)	(1.8)	(1.8)
Joint ventures & associates (post tax)		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Exceptional & other financial		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Profit Before Tax (norm)		20.2	22.9	24.3	25.7	28.6	36.1	41.2	43.9	46.0
Profit Before Tax (reported)		20.2	22.9	24.3	25.4	27.8	32.2	37.6	38.0	41.1
Reported tax		(4.5)	(4.5)	(4.8)	(5.5)	(6.3)	(3.6)	(7.2)	(6.8)	(7.4)
Profit After Tax (norm)		15.7	18.4	19.5	20.2	22.3	28.8	33.9	36.1	37.7
Profit After Tax (reported)		15.7	18.4	19.5	19.9	21.5	28.6	30.4	31.2	33.7
Minority interests		(0.2)	(0.2)	(0.1)	(0.2)	(0.2)	(0.3)	(0.2)	(0.3)	(0.3)
Discontinued operations		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net income (normalised)		15.5	18.2	19.4	20.0	22.1	28.5	33.7	35.8	37.4
Net income (reported)		15.5	18.2	19.4	19.7	21.3	28.3	30.2	30.9	33.4
Basic ave. number of shares outstanding (m)		19	19	19	19	19	19	19	19	19
EPS - basic normalised (p)		81.7	95.8	102.1	105.3	116.2	149.4	176.1	187.7	196.1
EPS - diluted normalised (p)		81.3	95.1	101.1	104.3	115.3	147.0	172.8	184.2	192.4
EPS - basic reported (p)		81.7	95.8	102.1	103.7	112.0	148.3	157.8	162.1	175.2
Dividend (p)		50	55	61	66	71	78	85	88	92
Revenue growth (%)		(9.4)	7.7	0.0	8.5	18.3	28.5	17.0	7.8	4.6
Gross Margin (%)		47.8	49.1	49.6	49.8	47.8	46.5	47.3	46.4	46.7
EBITDA Margin (%)		24.8	25.7	27.3	27.0	25.4	25.0	25.2	25.2	25.3
Normalised Operating Margin		22.4	23.0	24.2	23.6	22.2	21.8	22.0	21.7	21.7
BALANCE SHEET										
Fixed Assets		52.8	53.3	56.1	65.4	73.2	88.1	129.2	138.1	140.7
Intangible Assets		38.1	39.1	40.5	48.2	53.0	63.9	97.7	100.4	100.0
Tangible Assets		13.2	12.7	14.4	16.1	19.1	22.5	30.7	36.9	39.9
Investments & other		1.5	1.5	1.2	1.1	1.1	1.7	0.8	0.8	0.8
Current Assets		39.3	42.2	47.0	53.5	65.7	83.5	105.1	109.5	119.9
Stocks		19.8	20.4	25.2	28.7	32.2	37.8	56.5	55.6	57.9
Debtors		14.2	15.4	16.0	17.5	21.5	23.8	33.0	34.6	36.2
Cash & cash equivalents		4.1	5.0	3.8	4.9	9.2	15.0	11.5	15.2	21.7
Other		1.2	1.4	2.0	2.4	2.8	6.9	4.1	4.1	4.1
Current Liabilities		(20.2)	(22.4)	(18.6)	(19.8)	(25.8)	(25.1)	(26.8)	(30.3)	(31.4)
Creditors		(11.1)	(12.7)	(14.4)	(14.6)	(16.1)	(21.4)	(22.4)	(25.9)	(27.0)
Tax and social security		(1.6)	(1.1)	(1.7)	(1.2)	(3.3)	(3.5)	(4.2)	(4.2)	(4.2)
Short term borrowings		(7.3)	(8.5)	(2.5)	(4.0)	(5.5)	0.0	0.0	0.0	0.0
Other		(0.2)	(0.1)	0.0	0.0	(0.9)	(0.2)	(0.2)	(0.2)	(0.2)
Long Term Liabilities		(10.6)	(3.7)	(4.2)	(10.0)	(6.2)	(29.6)	(70.1)	(65.1)	(60.1)
Long term borrowings		(7.4)	0.0	0.0	(4.6)	0.0	(24.0)	(63.5)	(58.5)	(53.5)
Other long term liabilities		(3.2)	(3.7)	(4.2)	(5.4)	(6.2)	(5.6)	(6.6)	(6.6)	(6.6)
Net Assets		61.3	69.4	80.3	89.1	106.9	116.9	137.4	152.2	169.0
Minority interests		(0.2)	(0.2)	(0.1)	(0.8)	(0.8)	(0.9)	(1.0)	(1.1)	(1.1)
Shareholders' equity		61.1	69.2	80.2	88.3	106.1	116.0	136.4	151.1	167.9
CASH FLOW										
Op Cash Flow before WC and tax		23.3	26.0	27.6	29.7	33.0	41.7	49.2	52.9	55.8
Working capital		4.2	(0.3)	(4.1)	(4.6)	(6.1)	0.4	(21.6)	2.8	(2.7)
Exceptional & other		0.4	(0.5)	1.9	0.6	5.1	(6.3)	3.2	(1.0)	0.0
Tax		(4.3)	(5.0)	(3.6)	(4.7)	(4.1)	(6.1)	(4.1)	(6.8)	(7.4)
Net operating cash flow		23.6	20.2	21.8	21.0	27.9	29.7	26.7	47.8	45.7
Capex		(4.7)	(3.2)	(5.8)	(5.4)	(6.8)	(10.1)	(15.0)	(20.5)	(15.0)
Acquisitions/disposals		(1.6)	0.1	0.1	(8.3)	0.1	(18.3)	(35.4)	0.0	0.0
Net interest		(0.5)	(0.3)	(0.1)	(0.1)	(0.2)	(0.2)	(1.5)	(1.8)	(1.8)
Equity financing		(0.5)	0.1	(0.2)	0.0	0.2	(0.2)	0.6	0.0	0.0
Dividends		(9.1)	(10.1)	(11.0)	(12.2)	(13.1)	(14.2)	(15.6)	(16.8)	(17.4)
Other		0.5	0.2	0.1	0.2	0.0	0.0	0.0	0.0	0.0
Net Cash Flow		7.7	7.0	4.9	(4.8)	8.1	(13.3)	(40.2)	8.7	11.5
Opening net debt/(cash)		18.6	10.6	3.5	(1.3)	3.7	(3.7)	9.0	52.0	43.3
FX		0.3	0.1	(0.1)	(0.2)	(0.5)	0.6	(2.7)	0.0	0.0
Other non-cash movements		0.0	0.0	0.0	0.1	(0.2)	0.0	(0.1)	0.0	0.0
Closing net debt/(cash)		10.6	3.5	(1.3)	3.7	(3.7)	9.0	52.0	43.3	31.8

Source: XP Power, Edison Investment Research

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Revenue by geography

Management team
CEO: Duncan Penny

Duncan qualified as an accountant with Coopers & Lybrand and from 1980 to 1990 held a senior financial management position with LSI Logic and Dell Computer. He joined XP in 2000 as group FD. In February 2003, he was appointed as CEO.

CFO: Gavin Griggs

Prior to joining the group in October 2017, Gavin was CFO of Alternative Networks, a listed Telecoms and IT services business until December 2016 when it was acquired by Daisy, whereupon he became FD of the larger group. Gavin has worked in various senior international finance positions including roles at Logica, SABMiller, PepsiCo and Sodexo.

Chairman: James Peters

James has over 25 years' experience in the industry with Marconi and Coutant Lambda, before joining Powerline in 1980. In 1988, he founded XP Power. In 2000, he was appointed as European MD. In 2003, he was appointed deputy chairman and in 2014 became chairman.

Principal shareholders

	(%)
Standard Life Aberdeen	14.6
James Peters	8.0
Mawer Investment Management	7.9
Canaccord Genuity	6.2
Capital Group Companies	6.1
Janus Henderson	5.3
BlackRock	3.1
Montanaro Asset Management	3.1

Companies named in this report

Advanced Energy Industries, COMET Holding, Cosel, Delta Electronics, TDK Corporation

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