



XTEK (XTE)

20 August 2020

Initiating coverage – call to action

Our View

We initiate coverage with an Outperform rating. XTEK has been assiduously building a series of new business lines over many years – with long lead times particularly within the body armour (XTclave) business and SUAS (small Unmanned Aerial Systems (drones)) that are now being monetized. One or two major wins within the body armour space would materially re-rate the business.

The valuation is reasonable, the business is set to be profitable and large new markets are set to be opened via past investment in body armour. Underlying demand remains solid, driven by defence spending, which is resilient to economic cycles and COVID-19 concerns.

In 2019, XTEK bought Highcom, a US-based body armour value-added reseller/manufacturer of security and defence related protection equipment. Highcom is profitable and was bought for a reasonable price. This acquisition was well-timed in that Australian developed armour can be sold via the US channel.

Key Points

XTEK continues to release strong news: -

Recent contract win(s), capital raising and trading update

- Raised fresh equity of \$9.2m with an SPP of up to \$2m. This provides timely capital to fund growth initiatives for XTEK.
- Provided FY20 earning update that showed a good rebound in EBITDA in the 2H20 and some further detail around FY21.
- Received first commercial order for XTclave plates from Australian law enforcement via Australian distributor TOTE Australia.
- Installed XTclave body armour plant in Adelaide in February 2020.
- First international order from the Finnish army for \$1m worth of XTclave plates via distributor/ballistic manufacturer CPE Production OY. CPE might be able to sell further XTE products into Europe countries. Since upsized to \$2m.
- We believe that the probability of winning new armour orders is high.
- Small unmanned aerial systems business continues to perform well underpinned by spare parts and maintenance work. XTEK recently received a fresh \$2.8m in contract value for further new units.

Balance sheet and valuation

- The balance sheet has \$3.6 m in cash as at 31st July 2020 before the recent capital raising, after gearing up the Adelaide plant and some working capital spending.
- We have a DCF derived valuation of 92 cents per share.

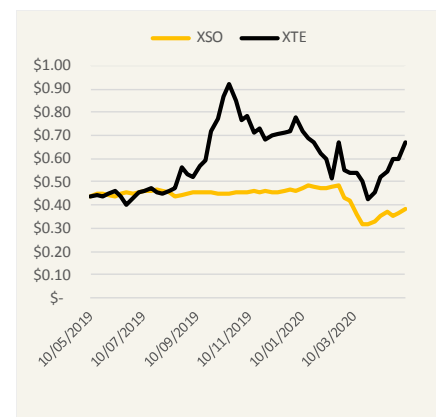
Risk factors

- Risks may include loss of material distributorships, technical problems with the body armour range, dependence of Australian Defence Department spending, and competition from major foreign players.

Recommendation: Outperform

Summary (AUD)

| | |
|-----------------------|---------|
| Market Capitalisation | \$47M |
| Share price | \$0.71 |
| 52 week low | \$0.385 |
| 52 week high | \$0.965 |



Key Financials (AUD)

| | FY19A | FY20E | FY21E |
|---------------|-------|---------|-------|
| Revenue (\$m) | 37.9 | 42.5 | 42.6 |
| EBIT (\$m) | 0.5 | 0.8 | 3.0 |
| NPAT Adj. | 0.2 | 0.0 | 1.9 |
| EPS Adj. (c) | 0.4 | - | 3.0 |
| Growth (pcp) | | -100.0% | high |
| PE Ratio (x) | 169.6 | n.m | 23.9 |
| DPS (c) | 0.0 | 0.0 | 0.0 |
| Div Yield | 0.0% | 0.0% | 0.0% |
| Franking | 0.0% | 0.0% | 0.0% |
| EV (\$M) | 26.5 | 32.3 | 31.9 |
| EV/EBITDA (x) | n.m | n.m | 10.8 |
| EV/EBIT (x) | n.m | n.m | 17.5 |

Reasons to buy

We initiate coverage with an Outperform recommendation for 4 reasons: -

1. **Ballistic solutions - Completion of the South Australian body armour plant** – with new orders starting to flow in. There is material upside if this plant can secure even more orders. Margins should be higher than the traditional XTEK distribution given that XTEK owns the plant, brand, customer relationships and all the IP.
2. **Expansion into the US via the acquisition of the profitable ballistic solution and security equipment manufacturing /distribution Highcom business.** This provides additional distribution expertise in the large US market and brings in relationships and on-the-ground relationships which are critical to secure sales. XTEK could manufacture the product in the US if required.
3. **Secured the SUAS (Small Unmanned Aerial Systems) long term support contracts to the ADF.** This provides ongoing maintenance and the possibility of further equipment sales into the future. The use of small unmanned aerial systems is set to grow over time. SUAS provide immediate and quantifiable battlefield intelligence at a fraction of the cost of fixed aircraft. XTEK have already sold a substantial quantity of AeroVironment (AVAV.US, \$75.29) small unmanned aerial systems to the Australian Army.
4. **Outlook for the distribution and agency business looks reasonable-** the business has a series of agencies and distribution arrangement that could secure solid sales into the future. Increasing demand for local content helps with securing further business. XTEK has greater business diversity, greater size and more capital than in the past. XTEK is in the market to secure higher margins via its proprietary products, better quality distribution, agencies and dealing more sternly with those that wish to push XTEK around. XTEK, for example, secured the Heckler and Koch VAR (Value added distributor) distribution in Australia. H and K supply high-quality arms to defence and police forces around the world.

Defence spending appears to not be correlated to GDP and the business has yet to be impacted by COVID-19. The most recent update (March quarter) reported: “strong demand” with both SUAS and XTclave reporting new orders.

1. Reasons to buy – improved sales trajectory of the ballistic plate business

XTEK has put considerable time (we estimate 10 years) and effort into developing ballistic plate technology (body armour) and then establishing a recently installed plant to produce these products. XTEK is now winning commercial orders for this technology. XTE in 2H20 received a grant of \$830k from Department of Defence (Australia) – providing technical validation of the technology that XTEK has developed. Other positives include displaying new range at a major US trade convention (before COVID-19) – helping to ignite US (Highcom customers’) interest in the product range.

XTCLAVE TECHNOLOGY – body armour /technology development

The XTclave™ is a composite curing and consolidation technology that was initially developed as a manufacturing process for ballistic protection laminates, specifically Small Arms Protective Inserts (SAPI). The XTclave provides cycles of ultra-high isostatic pressure (up to 300bar) at elevated temperatures (up to 180 deg C) to achieve composite curing and/or consolidation in thermoset and thermoplastic resin systems.

XTEK’s XTclave composite technology makes it possible to manufacture lighter, stronger and stiffer composite articles including ballistic plates, helmets and other armour. Importantly the armour can stop some common and powerful ammunition (AK47 bullets) that is a common form of threat to allied/western forces offering. The armour also offers reduced weight, some customization and increased buoyancy. Defence forces have a duty of care around providing adequate protection from known threats and this also drives demand. Soldiers/security forces are also more aware of their rights and available technology/armour. It has been known that the soldiers and security forces to directly buy their armour.

The initial testing is done, statistical validation is done, manufacturing quality validation done, the plant built - setting the business up to start to win material orders.

The practical lead time to market can be many years and gives the business a material competitive advantage.

Exhibit 1 – ballistic plate positioning and series of solutions - advantages

| | Soft armour | Hard armour plates | Helmets | Platform armour |
|--|-------------|---------------------------------------|---------------------------------------|---|
| FY19 sales ² | ✓ | ✓ | ✓ | ✓ |
| # products | Multiple | Multiple | Multiple | Customisable |
| Certification / compliant ³ | NIJ | NIJ | NIJ, MiL-Std, ASTM, CRASH | STANAG 4589 |
| XTclave™ potential | - | Up to 30% lighter; buoyancy potential | Stops AK-47 MSC bullets and fragments | Ground / air vehicles; shields and building |

(source – XTEK presentation) – this includes sales from Highcom

We have modelled some possible upside from the sale of high-end body armour.

- We have estimated the price per average unit is AUD\$1000 (this reflect the prices advertised in the Highcom website). Helmets may be more, and standard plates might be less.
- We assume the average person needs 3 pieces – a helmet, and plates on the back and chest. This could be higher if further plates are needed for the thighs and arms et al.
- We have assumed an EBITDA margin of 15% which is about the average for military equipment. There is also some degree of capping – where government cap the amount of margin to prevent the excessive cost. This 15% assumption reflects this as well.
- The business just won a \$2m armour order for the Finnish army – reinforcing our view that monetization is underway.

The possible upside from ballistic plates

Exhibit 2 – “what if” analysis – ballistic plates

| Item | Bear | Base | Bull |
|---------------------|----------|----------|----------|
| Sale price per unit | \$ 1,000 | \$ 1,000 | \$ 1,000 |
| Order size units | 1,000 | 5,000 | 10,000 |
| pieces per person | 3 | 3 | 3 |
| People | 333 | 1,667 | 3,333 |
| Contract value \$m | 1.0 | 5.0 | 10.0 |
| EBITDA margin | 15% | 15% | 15% |
| EBITDA \$m | 0.15 | 0.75 | 1.50 |

(source – Taylor Collison analysis) – margins could be higher than 15%.

Movement into this market and the additional profitability it brings is material for XTEK. It also does not harm the distribution business – and is likely to be helpful. It is a large market with over 120k Australian soldiers and security forces and over 1.4m US soldiers and 690k US security and police. Europe is also a large market.

XTEK just recently signed the Finnish army for an order worth more than \$1m via a European body armament distributor/VAR CPE Production. CPE might be able to secure other orders for the business with Europe. Finland had previously bought a small quantity for testing some time ago – so this is good news to receive the first commercial order from a foreign army. This order was recently increased to \$2m. We would expect further orders to follow. A smaller commercial quantity has also been received from law enforcement in Australia via an Australian based distributor of defence products TOTE Systems Australia (www.tote.com.au).

By combining HighCom Armor’s manufacturing team with the patented XTclave processing technology, XTEK can create the most comprehensive line of rifle armour protective solutions on the market today. Think thinner, lighter, and higher performance from the latest materials supplied by trusted and secure partners including DSM, Dupont, Barrday, Teijin, Honeywell, and others.

2. Highcom acquisition

XTEK bought Highcom in the middle of 2019. Highcom is already a profitable provider of body armour and personal protective equipment in the US. Highcom supplies law enforcement agencies which often have very short decision cycles and very short lead times. This was an astute purchase in that it gives XTEK an immediate US distribution presence, it secures all the relationships, authorisation and licensing all at once. It also provides a path to market for the output of the XTclave ballistic product that is being produced in Australia. Over time, if material US work is won – Highcom could form the nucleus of the US production requirements. Highcom already produces its products and can now provide advanced engineering and technical expertise to the Australian XTEK business and customers.

Exhibit 3 – high come metrics

| Highcom metrics | | |
|-----------------|-------|------|
| Item | FY18 | FY17 |
| Sales | 10.5 | 8.6 |
| EBITDA | 1.4 | 0.4 |
| Margin | 13.3% | 4.7% |
| Cost | 3.6 | |
| EV/EBITDA* | 2.6 | |

* pre- earnout

Highcom was established in 1997.

Highcom has an accredited testing capability

Supply some of the larger law enforcement operatives in the US

46,000 sq ft manufacturing and distribution facility in Ohio with a capacity to process 20k pieces per month. It can produce American made products.

Highcom has an extensive range of defence and law enforcement products.

The business also sells plastic face shields – which have likely performed well due to COVID-19)

www.highcomarmor.com

(source – Taylor Collison/ XTEK presentation)

Highcom, for example, has sold over 1m pieces of protective armour in the last 10 years and has contracts with hundreds of law enforcement agencies in the US. Highcom sells a range of plastic protective shields, face mask and helmets. Some of these products will have ancillary benefits in the protection of emergency and law enforcement personnel from COVID-19. The business does not appear to sell pure healthcare-related PP&E. Highcom might have such capabilities into the future. We believe the government budgets for this style of equipment will grow and Highcom may have had a spike in demand for this sort of equipment due to COVID-19 demand and increased riot activity. Highcom tends to sell to military, police, fire, ambulance and demand in these areas is strong but not the same as in healthcare (which they are less likely to supply

Exhibit 4 – samples of Highcom products



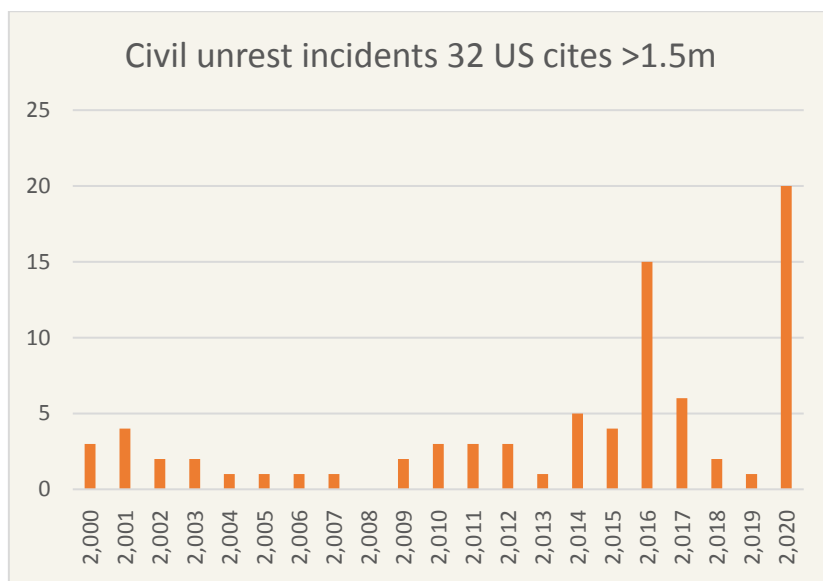
(source – Highcom website)

In the US, many emergency personnel (fire/ambulance/govt officials) like to carry/wear protection due to the greater degree of gun ownership, tough operating environment, economic inequality and the threat that these factors combined - create.

Highcom had a very good FY18 before acquisition– which may be hard to repeat. Under new XTEK ownership sales appear to have started well with 3 months leading to a \$3.7m sales contribution from exactly 3 months of trading). Highcom could also be very well positioned for plastic protective visors/face shields PPE within their product range used by US security and emergency personnel. Sales could be quite strong at present. Sadly increased rioting, protests and even issues around policing COVID-19 have likely helped underlie demand amongst law enforcement, medical and other emergency services in the US.

The chart below – shows increased civil unrest in the US. It is based on the 32 largest US cities with a population of 1.5m. It sadly has increased. These incidents span civil, police, economic and sports-related unrest.

Exhibit 5 – Civil unrest incidents in the 32 largest US cities.



(source – Wikipedia and Visualcapitalist.com)

3. Reasons to buy – sales of small unmanned aerial systems (SUAS) – small drones

XTEK for some years now has been able to secure material sales of small unmanned aerial systems (SUAS) to Australian defence forces. XTEK has secured service contracts for these systems. Also, the business is developing XTatlas (and other applications such as Skycraft) to add value to the SUAS fleet.

We note that unmanned aerial vehicles continue to provide highly effective and cost-effective solutions to the Australian military and are far cheaper than fixed-wing air forces. We think that UAV (unmanned aerial vehicles) will continue to take share from traditional large military technology such as manned warplanes, traditional manned reconnaissance aircraft/vehicles and human methods.

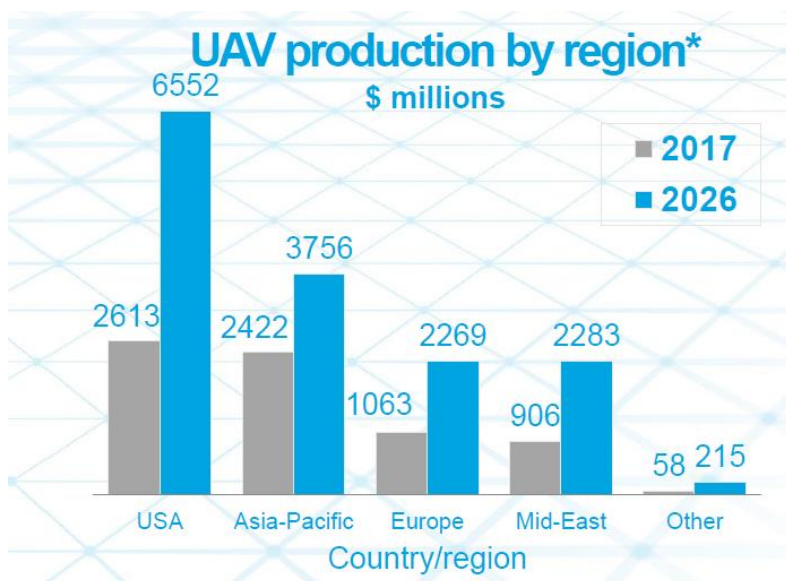
The initial capital SUAS sale was for \$42M over 3 years (July 2017) and then a further follow on maintenance/parts SUAS contracts \$10m were secured in September 2019. It is anticipated that this maintenance contract is worth up to \$5m possibly up to \$9m p.a. and could be worth \$35m during the life of the contract. The maintenance contracts appear to be to maintain 59 WASP (AeroVironment)¹ SUAS's. This maintenance contract flows on from the 2018 order for \$6.3m in parts and service and the prudent establishment of a repair facility at XTEK to carry out this work. There was a further sale of 20 WASP in FY2020/21 which would expand the serviced/parts requirements of the 79-vehicle fleet. The Australian Army uses the small unmanned aerial systems, they get broken, worn and need maintenance. XTEK have a Canberra based workshop that repairs these systems. XTEK has recently won an order for a further \$3.2m in parts for these systems. In July 2021 – XTEK received an order for an additional SUAS for \$2.8m (in contract value) – XTEK already performs maintenance work for the Army past SUAS sales.

¹ AeroVironment (AVAV) market cap \$1.47bn. AVAV designs, develops, produces, supports, and operates a portfolio of products and services. The business turns over US\$300m and has an EBITDA of \$44m. It has \$270m in cash on the balance sheet. And employs 700 people. AVAV offers unmanned aircraft systems (UAS) and related services primarily to organizations within the U.S. Department of Defence and to international allied governments; and tactical missile systems and related services to organizations within the U.S. Government. It also provides small UAS products including WASP drones including spare equipment, alternative payload modules, batteries, chargers, repair services, and customer support. The company was founded in 1971 and is headquartered in Simi Valley, California.

We believe that the value of SUAS vs fixed-wing aeroplanes is massively superior and that these sorts of systems will continue to take share from other heavy armament systems/ fixed piloted aircraft. The advantage they deliver is also enormous and this remains an ongoing bright spot within defence and security expenditure. These systems are also finding greater uses due to better imaging, sound, size/weight, software, fuel efficiency – all of which continues to deliver useful value to the military. Unmanned Aerial System Plus (SUAS+) system capable of providing organic airborne surveillance and reconnaissance support to the Army Battlegroups, Special Forces, and Regional Force Surveillance Units. The capability will fill the gap between existing SUAS and Tactical Unmanned Aerial Systems (TUAS) currently in service with the ADF.

The chart below shows the dramatic growth of unmanned aerial vehicles into the future.

Exhibit 6 – substantial growth expected in unmanned aerial vehicles (UAV)



(source OEC/Teal estimates)

4. Distributor and Agency business – better strategy = scope to improve this

XTEK has historically had some major distributor, agency deals and value-added reseller (VAR) contracts and continues to do so. XTEK has been able to secure additional deals over time such as AeroVironment. There is increasing Australian interest in buying locally (refer to appendix and the 2016 Australian Defence white paper) and the requirement for local licensing, testing, security clearances and certification is also increasing. This along with greater access to capital and less dependency on any one provider is set to assist XTEK in securing more agency deals into the future. The relatively small nature of the Australian defence budget, security needs, population and some specialized needs is also helpful in driving these the use of agents /independent distributors in Australia (for offshore players).

Agency/distributor sales have been lumpy in the past for XTEK and at times the business has lost agency contracts or even after being successful - faced the threat that manufacturers who can go direct and can cut out XTEK. The nature of the sales – which can be for long-lasting capital equipment – also lends itself to the use of an agency. The key variable is to have a portfolio of these agencies to iron out the ups and downs and reduce dependency on any one manufacturer.

We expect that with the current trends identified in the White paper and much greater interest in local content (after COVID-19), military self-sufficiency and greater regulation are all helpful. Changes in the military threat and movement in technology are also helpful in driving military change.

XTEK also have pivoted the agency model to a VAR model to add value and crystalize more value of the contract.

We also note that other Australian based defence names such as Austal (ASB, not covered), Orbital (OEC, not rated) and Bisalloy (BIS, not covered). have reported little impact from COVID-19 and all appear likely to hit guidance and /or report reasonable trading conditions. Larger US-listed pure military has so far reported little impact in terms of earnings warnings from the COVID-19 environment.

Description of XTEK

The primary activities of XTEK in terms of the various business lines include: -

1. The supply of products and services to Defence and Law Enforcement agencies throughout Australasia.
2. The supply and servicing of small unmanned aerial systems (SUAS) systems to the Army.
3. The continued development and commercialization of XTclave isostatic composite consolidation technology – i.e. body armour.
4. The development of XTatlas contextual video and mosaic mapping technology to be used in SUAS to improve the image quality and situation awareness of SUAS.
5. Securing a range of new and enhanced products to assist governments in countering terrorism, border monitoring and security threats.

XTEK has three major business formats/ paths to market:-

1. XTEK is a **distributor** of military and security equipment, products and services -specifically the business buys the equipment and then resells it often with value-added services at the same time. In the past, XTEK has acted more as an **agent** for foreign armament suppliers that wish to sell and service products in the Australian market.

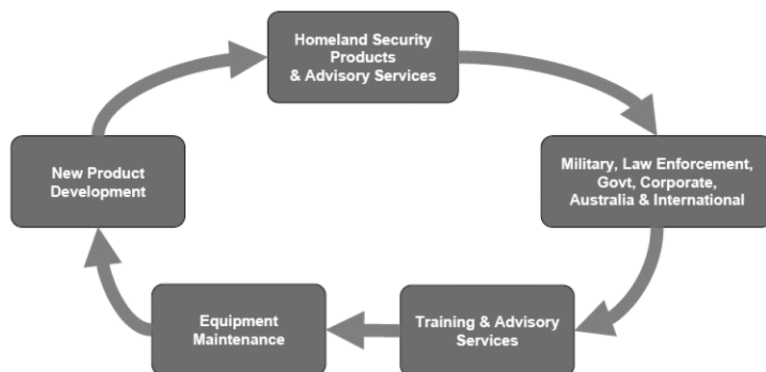
Australia is a small, geographically distant market and with the need for relationships, Australian content and some after-sales support – this has been a core part of the business for many years. XTEK also supplies small arms systems to the Army and security agencies – this enables them to test the physics of their armour on-site in a less formal way. The final armour's rating is however tested via an independent organization.
2. XTEK also act as a **value-added reseller**. In the SUAS market, they offer XTatlas software that enhances the performance of the products. They also carry out service and repairs and add much more value than an agent model. This value-added reseller business has been a positive development for the business.
3. Finally, XTEK now offers its **proprietary products/services** within the body armour segment including XTClave range. This offers the business much better margins (they keep the entire value), less lumpiness – they reduce the risk of the agent business that can be brought in-house or shopped around to other agents. The development of the body armour has been a costly and time-consuming investment (in terms of effort/Capex and sunk R &D). Body armour is also a smaller more, recurring sales than expensive capital items related to defence/security equipment. This business line development has been a long journey for XTEK. **We think the wait is almost over and the improvement in this business is undervalued by the market.**

Exhibit 7 – the top level of view of markets that XTEK operates in



(source – XTE presentation March 2020)

Exhibit 8 – simplified schematic of markets that XTEK operates in



(source – XTEK prospectus)

Body armour – XTEK over the last 10 years has been working on the development of XTClave composite consolidation technology applied to the manufacture of ballistic body armour systems. The use of hydrostatic pressure vessels can produce precision, void-free, structural carbon fibre laminates capable of withstanding extreme force. The plates have the advantage of being able to be customized to the soldier (women for example), having a degree of buoyancy (float which makes water crossing easier), lighter weight and more comfortable than some other alternatives.

XTEK has spent many years investing and developing this technology culminating in the opening of a new body armour plant in Adelaide in February 2020. Taylor Collison attended the opening of the plant and inspected the finished body armour plates and hardened helmets and other armament products. The plant now needs some large orders to cover fixed operating costs and monetise this considerable effort. It has capacity for \$40m worth of sales p.a. We estimate that the sunk R&D and capex to be several million dollars over the last decade. The CAPEX for the new plant has been done. This enables reference customers to visit it, see it and speak to other customers that might have bought the armour.

Competitive advantage

- Development and ownership of IP (intellectual property). Access to restricted/controlled IP and materials and inputs.
- Relationships – senior management, staff and line management often have deep relationships into the sales base – with many having an ex-law enforcement, government, defence or military background.
- Security clearances – the business and its staff are likely to have sufficient Australian based security clearances to enable them to sell to some highly secure customer bases.
- Canberra – the business is well located to major government customers located in Canberra. Australian owned, listed with access to capital.
- Products and business approved by Allied military forces (and the federal/state government) and security/police forces.
- Established plant and equipment for XTClave - that has been inspected and approved by the customers.
- Many of the products been extensively tested, developed, approved and ready for sale and use by approved military forces.
- There is a very long-time span to get new military products designed, tested and approved by the military. This can be a high-risk process as technology can obsolete the products as defence priorities may change and personnel move on.
- Massive lead times around development, testing, approval, decision-makers agreeing, then orders being placed (in size predicted) and then production (forward orders of components) are all major barriers to entry. The contracts are often able to be terminated with convenience and so it requires extremely disciplined and patient effort.
- Securing enough highly skilled staff at the right price, to produce the equipment economically.
- Increasing global presence which helps winning work with local content requirements and using staff with local security clearance to produce the systems.

Industry analysis – a synopsis

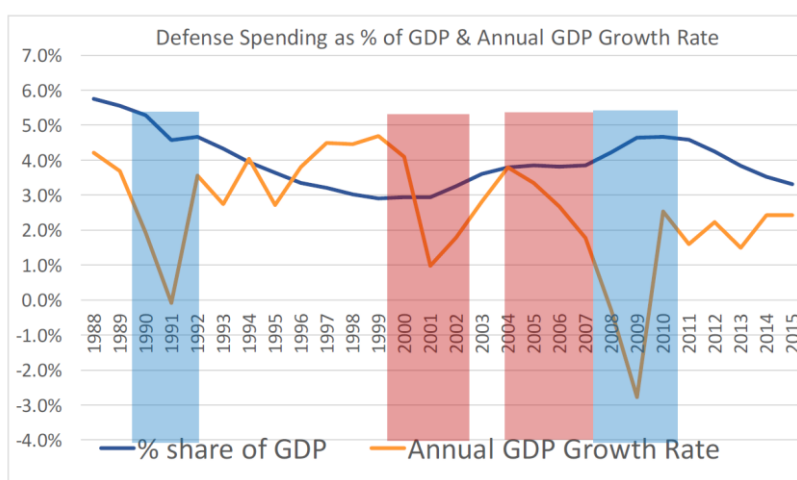
Western defence budgets sit between 1-2% of GDP. Some pressure exists to grow this as the US guarantee of support starts to be less clear. Spending is changing towards greater use of technology and less need for large standing armies.

In Australian/NZ total defence spending sits at A\$39bn pa. There is an increasing demand for a greater supply of domestic content and IP. It is estimated to be growing at 7% CAGR.

The US spends US\$891bn on defence – about 2/3 is spent on pure defence -with the rest of health/veterans/pensions.

Defence spending tends to resist economic downturns and be correlated to specific threats (wars) and problems (terrorism). This lack of correlation to GDP growth is strengthening the business in the current parsimonious economic environment. Australia is also continuing to grow its defence expenditure. (refer to appendix 2 – 2016 Defence White paper).

Exhibit 9 – Relationship between US defence expenditure and economic growth



(source – Colin Manchester – the relationship between defence expenditure and economic growth www.albany.edu)

The US spends US\$891bn on defence with about 2/3 of this on actual hardware and deployment of forces (the rest is pensions/veterans' healthcare et al).

To quote the Australian 2016 Defence White paper strategy; -

“To strengthen Defence’s long-term budget and planning certainty, the Government has decided that the 10-year funding model will not be subject to any further adjustments as a result of changes in Australia’s GDP growth estimates. This de-coupling from GDP forecasts will avoid the need to have to regularly adjust Defence’s force structure plans in response to fluctuations in Australia’s GDP” – page 108/109.

Management and board

The board and management are well-credentialed and have worked very carefully and patiently to develop the various divisions within the current business.

Mr Philippe Odouard – Managing Director – over 27 years in senior management roles in defence-related companies including ASX listed Quickstep (QHL). Quickstep grew to over \$50m in defence-related composite sales. Mr Odouard specialised in developing and commercialisation of defence technology.

Mr Uwe Boettcher – Chairman. Mr Boettcher has extensive experience in the legal field and general commercial businesses. Mr Boettcher has a special interest in commercialisation, investing in and developing innovative technologies. Mr Boettcher is a major shareholder owning 5.36m shares in XTEK.

Mr Robert Quodling – Executive Director – Mr Quodling has an extensive business background in the defence and aerospace sectors. Mr Quodling is a former Army Officer including with the SAS. Mr Quodling is the Chief Operating Officer of XTEK.

Mr Ivan Slavich – Director. Mr Slavich has an extensive background in senior management in energy, banking, telco and business consulting. Mr Slavich was an officer in the Australian Army.

Mr Christopher Fullerton – Director – Extensive investment and accounting background. Mr Fullerton has held directorships in other ASX listed and unlisted businesses in the past in sectors such as property investment and agriculture sectors. Mr Fullerton is a director of ASX listed Paradigm Biopharmaceuticals (ASX.PAR).

The business has a series of ex-defence and security personnel on its staff. They have good relationships and domain knowledge of XTEK products and services and how these fit into government and security-related programs.

Risks

Loss of distribution agreements such as AeroVironment – who may decide to take in inhouse or use another party (or could be taken over for example).

Dependency on only a few major clients – the business depends on the Australian military for up-to 80% of sales. This has fallen after the recent acquisition of Highcom.

Subscale in term of R&D and inability to commercialise products and technology in a timely and cost-efficient manner

Capital nature of the sale – makes sales lumpy. Maintenance contract low % of the sale and interest to others

Extremely long sales lead times – with the risk that funding is cut and/or personnel may change during the project /sales cycle. Governments change and so can government priorities (from Terrorism to COVID19) for example.

Manufacturing risk – the business relies on high quality, high technology manufacturing capability that runs at high levels of capacity.

Supply chain – most of the production is outsourced to third parties. This includes components, assemblies and subsystems. The supply is global.

Acquisition and integration – the business has recently acquired Highcom Solutions.

International operations – XTEK has international supply chains and these supply chains may be subject to sovereign risks. These operations can be subject to foreign government regulations and controls and be changed unpredictably.

Licenses and authorization / Export controls – XTEK products are subject to export controls and these can be changed by governments for various changing political and strategic reasons.

Government contracts – contracts with governments can be subject to termination at their (the government's) convenience, modified, cancelled, having procurement (budget) suspended, subject to audit amongst a series of arbitrary changes.

Product liability – these products will need a manufacturer's warranty. Any failure would need to be rectified if still under warranty.

Competition – the business has some major competitors in the general defence, arms and related industry that could provide additional competition into the future for the business.

IP – the business can be subject to theft of IP by nefarious third parties. Cybersecurity – the product could be hacked, and software stolen. This would be highly problematic given the defensive nature of the products.

Margins for defence products can be capped. This margin capping can mean that plant capacity utilisation gains are given back to the customer via reduced costs for volume orders. We can only surmise that this may this apply to XTEK. The buyers are often highly sophisticated.

Financial model

We have modelled sales and EBITDA forecasts in exhibit 10 as below.

Exhibit 10 – Sales and EBITDA forecasts

| Divisional Forecast: | Jun 19 | 1H | 2H | Jun 20 | Jun 21 |
|-----------------------|-------------|-------------|-------------|-------------|-------------|
| | Final | Final | F'cast | F'cast | F'cast |
| Revenue | | | | | |
| Distribution | 31.3 | | | 23.8 | 17.8 |
| In house products | 1.6 | | | 1.8 | 1.9 |
| Logistics maintenance | 4.9 | | | 5.4 | 5.9 |
| Highcom | | 3.7 | 7.4 | 11.1 | 13.9 |
| Body armour | | | | 0.5 | 3.0 |
| Other | | | | | |
| Total revenue | 37.8 | 16.0 | 26.5 | 42.5 | 42.6 |
| EBITDA | | | | | |
| Distribution | | | | 0.7 | 0.5 |
| In house products | | | | 0.1 | 0.1 |
| Logistics maintenance | | | | 0.2 | 0.2 |
| Highcom | | | | 1.4 | 1.7 |
| Body armour | | | | -1.5 | 0.5 |
| Other | | | | | |
| Total EBITDA | 0.60 | -2.0 | 2.8 | 0.82 | 2.96 |

(source – Taylor Collison forecasts)

Distribution

Sales have been driven by the large SUAS fleet expansion to 79 plus units over the last few years. Another SUAS order was received in July 2020. This should help to expand the size of the maintenance work.

We have assumed reasonable medium-term trading in the distribution channel driven by continued growth in SUAS demand and other military product(s) demand. We are assuming further new unit SUAS demand into the next few years but at a reduced rate compared with the past. This could prove to be conservative given the ongoing use and demand for these SUAS products by military forces.

We do note that sales have fallen in the 2H20 – due to the lumpy nature of SUAS sales and the competition of the army 79 vehicle fleet. A new order was received in July for further SUAS units.

We believe that higher margins exist within maintenance/logistics compared to new unit SUAS sales.

The total business has guided to \$30m plus sales into FY21. There is a further \$25m on near term opportunity – we assume a 50% contribution from this near-term pipeline.

XTEK almost always has a seasonal sales swing into the 2H and profitability tends to occur in the 2H – which reflect government budgetary patterns and procedures.

Highcom

We expect Highcom to contribute materially into 2H20 and beyond. Highcom contributed \$3.7m in the first three months – so we have forecast 9 months of contribution at higher margins than other parts of the business. Highcom operated at EBITDA c10% upon acquisition. We assume a full 12-month contribution from Highcom into FY21 delivering AUD \$14m in revenue for the business at higher margins than other parts of the business.

Body Armour starts small but is also at 15% EBITDA margin because the IP and manufacturing are controlled and owned via XTEK. We have assumed more contract wins. The current plant has capacity up to \$40m worth of product per year. Recent contract wins help to underpin our conviction of more business for this division for example to a recent win of \$2m worth of product for the Finnish Army.

Maintenance/Logistics

This refers to the servicing of USAS – this is underpinned by a very large maintenance contract of \$35m (over 7 years) for the Australian army and the continued expansion of this fleet that helps to drive maintenance requirements.

Working capital - We would note this business in the past has been low margin and used working capital. As the business moves up the value chain and defence pays more promptly – this requirement may reduce.

Capex – the business has invested a few million in the development of the Adelaide XTclave plant. This plant is now installed running and we would expect to start-up capex related to it to decline.

We now expect that a further plant will be possibly commissioned into FY21 - back by further new orders of body armour. Capex could be higher than we have forecasts in our model.

R&D – continued investment matched to increased sales and demand is likely.

Finance costs – the business has minimal gearing and we would expect this to remain the case into the future.

Tax losses – the business has substantial tax losses

Cash flow conversion

The business tends to collect its cash flow towards the end of each financial year. We expect that cash flow should improve as material development costs scale down now that XTClave is commercialised. Highcom also brings a more normal cash flow profile into the future. The defence department has also moved to pay any approved invoice within 2 days, and this should result in a material improvement cash flow into 2H120. We are unsure if these trading terms are permanent.

Exhibit 11 – EBITDA to operating cashflow

| Item | 1H18 | 2H18 | FY2018A | 1H19 | 2H19 | FY2019A | 1H20 | average |
|----------------------|---------|-------|---------|---------|-------|---------|---------|---------|
| Cash from oper. Act | - 2,030 | 3,809 | 1,779 | 830 | - 286 | 544 | - 3,859 | 2,323 |
| EBITDA/reported | - 600 | 800 | 230 | - 1,700 | 2,300 | 600 | - 2,000 | 830 |
| % conv. cash /EBITDA | 338% | 476% | 773% | -49% | -12% | 91% | 193% | 280% |

(source – Taylor Collison)

Balance sheet analysis

Exhibit 12 – balance sheet

| Item | \$k | 31-Dec-19 | 30-Jun-19 | Comment |
|--------------------------------|-----|---------------|---------------|---|
| <u>Current assets</u> | | | | |
| Cash | | 4,127 | 5,349 | Helped by recent raising |
| Trade receivables | | 2,503 | 19,858 | Very large balance due to very large reseller deal /since cleared |
| Inventories | | 3,177 | 1,750 | Run down / since built up |
| Prepayments | | 3,596 | 989 | Mainly plant /right of use assets |
| Tot. current assets | | 13,403 | 27,946 | |
| <u>Non current assets</u> | | | | |
| Property/plant | | 3,516 | 2,308 | Capex spend due to Xclave plant |
| Intangibles | | 1,511 | 155 | Higher due to acquisition |
| Tot. non current ass | | 5,027 | 2,463 | |
| <u>Liabilities</u> | | | | |
| Trade/other payables | | 3,377 | 18,773 | High due to reseller deal/ since paid |
| Customer deposits | | 1,174 | 1,963 | recent payments balance being worked down /prepayment |
| <u>Lease liabilities</u> | | | | |
| Employee benefits | | 383 | 348 | |
| <u>Provisions</u> | | | | |
| Current liabilities | | 4,934 | 21,084 | |
| <u>Non current liabilities</u> | | | | |
| Trade payables | | 1,554 | 1,077 | Lease liabilities |
| <u>Deferred tax</u> | | | | |
| Other | | 113 | 553 | Deferred income - was govt grant |
| Tot. non current liab | | 1,667 | 1,630 | |
| Net assets | | 11,829 | 7,695 | |
| <u>Equity</u> | | | | |
| Issued capital | | 33,748 | 27,312 | Recently raised more capital |
| Reserves | | 8 | 8 | |
| Accumulated losses | - | 21,927 | - 19,625 | Large amount of losses |
| Total equity | | 11,829 | 7,695 | |

(source – Taylor Collison)

Valuation model

Given the high growth rates and improving margins – we have used a DCF model to value XTEK. We derive a valuation of 92 cents per share.

Exhibit 13 – DCF model

| <u>Free Cash Flow Valuation</u> | | <u>Cost of Equity</u> | |
|------------------------------------|----------------|-----------------------|--------------|
| Valuation year: | FY1 | Risk Free Rate | 6.0% |
| PV of FCF | 3.1 | Beta | 1.00 |
| PV of Terminal Value | 53.9 | Risk Premium | 4.0% |
| Add: Other assets not in cash flow | - | Cost of Equity | 10.0% |
| Enterprise Value | 57.0 | | |
| Less: Net debt | 5.4 | Cost of Debt | 6.0% |
| Less: Preference capital | - | Debt Weight | 0% |
| Less: Minority Interest | - | Equity Weight | 100% |
| Equity Value | 62.4 | | |
| Issued shares | 69.0 | | |
| Yr end adjustment | 1.014 | | |
| Value per share | \$ 0.92 | | |

Assumptions

| | |
|------------------|-------|
| LT Growth | 6.5% |
| WACC | 10.0% |
| RONIC after Yr 5 | 15.0% |

(source – Taylor Collison)

Summary

We rate the business as an outperform: -

1. Body armour is being monetized after many years of waiting.
2. Defence expenditure is resilient.
3. The distribution business has optionality via SUAS work and other military product demand.
4. The drive to increase Australian content and self-sufficiency is positive.
5. Highcom is a sound business and helps expand the US operations of XTEK.
6. The business is financially sound and has a strong competitive advantage.

Appendix 1 – company history

1976 – XTEK is established

2000 – a major supplier of products and services to the Sydney Olympics.

2005 – lists on ASX – the total offer was \$14m at 50c ps. Total market cap on the listing is c \$18m. The main product set is the homeland and security related products. XTEK had sales of \$14m just before listing. Buys ballistic business as part of the listing.

2006 – poor result after IPO – cost base too high for available business brought in

2007 – again did not win contracts as expected. Lumpy sales vs a cost base that did not adjust quickly enough

2008 – armour protection business starts to develop

2009 – New Chair Uwe Boettcher. Share price hits nadir of 0.7 cents. Series of new agencies announced including AeroVironment UAS. Trading improves

2010 - raises capital, further management changes

2010 – further develops the body armour business – including hydroclave technology

2011 – raises capital – notes the decline in agency business in heavy robots (bomb detection).

2012 – US department of Defence starts to look at armour solution, raises further capital

2013 – receives the US \$1.5m foreign comparative testing contract from the US Department of Defense

2014 – improved trading. Relocates to integrated office and workshop facility in Canberra.

2015 - many improved results driven by strong agency sales

2016 – raised further capital. Starts to win work within the small unmanned aerial systems sector. XTatlas technology further enhanced. SUAS maintenance sales secured. Government policy around including Australian content in defence procurement appears to be starting to be enforced.

2017 – Again improved results. Greater government spending after the election.

2017 – July wins up to \$40m in SUAS sales to the Army and up to \$9m p.a in the maintenance of SUAS products. Raises further capital

2018 – Finland makes small order for body armour. Improved trading for the business.

Appendix 2 – Budget 2018/2019 and 2016 Defence Whitepaper

Defence Minister Payne – Budget Statement – extract - A safer Australia

Therefore, the 2018–19 Budget maintains the Government's commitment to provide Defence (inclusive of the Australian Signals Directorate (ASD)) with a stable and sustainable funding growth path, with the Defence budget growing to two per cent of GDP by 2020–21. The Government will provide Defence (inclusive of ASD) with \$36.4 billion in 2018–19 and \$160.7 billion over the Forward Estimates.

SUPPORTING DEFENCE INDUSTRY

A strong, sovereign Australian defence industry is vital to delivering Australia's defence capability. It is also front and centre of the Government's plan for jobs and growth in the Australian economy.

The last year has seen the Government make significant progress in establishing the initiatives and policy settings that will guide our defence industry to a sustainable and internationally competitive future.

In January 2018, the Government released the Defence Export Strategy which provides a systematic plan to grow Australian defence exports and support Australian industry to achieve export success. In March 2018, the Government released the expanded Australian Military Sales Catalogue showcasing a range of export ready Australian defence industry capabilities.

Complementing our major policy initiatives such as the Defence Industrial Capability Plan, the last year has seen the roll out of our strengthened Australian Industry Capability (AIC) Plan. **The strengthened AIC Plan is a requirement for major capital equipment projects of \$20 million and above and is driving greater Australian industry participation in meeting Defence's capability needs.**

In its first year of operation the Centre for Defence Industry Capability has established itself as the 'single point of entry' to Defence for small and medium enterprises. The Centre approved facilitation services for 352 small and medium enterprises, issued over \$1 million in Capability Improvement Grants and presented to an estimated 3,000 participants at industry briefings in support of the continuous naval shipbuilding public presentations alone.

Since its launch in December 2016, the Defence Innovation Hub has awarded 37 contracts totaling more than \$56 million and manages a portfolio of legacy innovation projects worth approximately \$62 million. The Defence Innovation Hub is expected to expand on this success as the program matures and builds towards a full portfolio of innovation investment.

Defence White paper 2016

The Government will invest in a program for continuously improving the personal equipment soldiers use, including their weapons and targeting equipment, digital communications systems, **body armour and self-protection equipment** (including for chemical, biological and radiological threats), and night fighting equipment. 4.52 Soldiers in the future Army will be supported by new vehicles and manned and **unmanned aircraft** with increased firepower, protection, mobility, situational awareness and logistics support.

The Government will introduce enhanced intelligence, surveillance and reconnaissance capabilities, including armed medium-altitude **unmanned aircraft in the early 2020s, with regular capability upgrades to follow.** The new armed medium-altitude unmanned aircraft will provide enhanced firepower and intelligence, surveillance and reconnaissance support to a range of missions including counter-terrorism missions overseas, while augmenting our surveillance capability for search and rescue, humanitarian assistance and disaster relief and other tasks.

(editors' comment – XTEK generally supplies the smaller unmanned vehicles – the direction and intent of the government is clear)

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The Government's approach to Australian defence industry and innovation policy aims to maximise the defence capability necessary to achieve the Government's defence strategy supported by an internationally competitive and innovative Australian industrial base. **The focus will be on the small to medium enterprises that are the incubators for advanced defence capability in Australia.**

4.100 The Government recognises that Australian defence industry has faced major challenges as a result of underinvestment in Defence, and the accompanying volatility in Defence funding. This Defence White Paper, the Defence Industry Policy Statement and the Integrated Investment Program provide Australian defence industry with a comprehensive policy framework to inform the contribution industry will need to make to Australia's long-term security, including the development of capability, infrastructure and skills for the future

4.102 Recognising that an **internationally competitive Australian defence industry** is a Fundamental Input to Capability means that it will be mandatory to consider Australian defence industry in the formal capability development process, helping to better match the development of new capabilities with Australian defence industry's ability to deliver them

4.105 The Centre for Defence Industry Capability, funded at about \$230 million across the decade to 2025–26, will connect Defence needs with the innovation and expertise of Australian defence industry, as well as help grow a competitive, sustainable Australian defence industry base. The Centre for Defence Industry Capability will be co-chaired by a senior private sector representative and a senior executive from Defence. The Centre for Defence Industry Capability will help build defence capability and promote Australian defence industry competitiveness by providing: ` advice and funding to help Australian defence industry build its skills and capabilities ` development support for small to medium enterprises, including assisting industry to access global supply chain markets ` information about Defence’s innovation requirements, to support the development of innovative capabilities by Australian defence industry

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8.10 To strengthen Defence’s long-term budget and planning certainty, the Government has decided that the 10-year funding model will be not be subject to any further adjustments as a result of changes in Australia’s GDP growth estimates. This de-coupling from GDP forecasts will avoid the need to have to regularly adjust Defence’s force structure plans in response to fluctuations in Australia’s GDP

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The Government has introduced a new 10-year funding model for Defence which gives Defence the long-term funding certainty it needs. The Government’s long-term funding commitment to Defence will see the Defence budget grow to \$42.4 billion in 2020–21, reaching two per cent of Australia’s GDP based on current projections.

8.6 Substantial progress has already been made towards meeting this long-term commitment to grow the Defence budget. In the 2014–15 Commonwealth Budget, the Government delivered on its promise to not cut the Defence budget. In 2015–16, the Defence budget grew with an increase of \$9.9 billion over the forward estimates. The Defence budget in 2015–16 is \$32.3 billion

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