

ALEXIUM INTERNATIONAL GROUP LTD

BUY
Records first cash flow positive QTR...cost base significantly reduced, gross margins growing

Materials / Diversified Chemicals

24 October 2017

COMPANY UPDATE

Ticker	AJX
Stock Price	\$0.410
Target Price	\$1.000
Forecast Capital Return	146.9%
Forecast Dividend Yield	0.0%
Estimated Total Return - 12 Mth Forward	146.9%

Company market data

Market Cap.	\$123.4m
Free Float (%)	69.0
Enterprise Value	\$126.2m
52 Week Range	\$0.38 - \$0.75
Shares Out.	304.6m
Avg. Daily Value	\$0.3m

Estimates changes	2017a	2018e	2019e	2020e
Core NPAT - <i>old</i>	(12.0)	0.2	7.0	12.3
Core NPAT - <i>new</i>	(12.0)	0.7	8.0	14.2
% Change	0.0	248.7	14.9	15.5
Core EPS dil. (€) - <i>old</i>	(4.0)	0.1	2.3	4.0
Core EPS dil. (€) - <i>new</i>	(4.0)	0.2	2.6	4.7
% Change	0.0	248.7	14.9	15.5
DPS (€) - <i>old</i>	0.0	0.0	0.0	2.0
DPS (€) - <i>new</i>	0.0	0.0	0.0	2.3
% Change	-	-	-	15.5

All figures are in AUD unless otherwise specified.

Share price performance

Alexium International Group Ltd vs. AS52 (rebased index)



Analyst

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EVENT

- 1Q FY18 quarterly activities report.

IMPACT

Key takeaways from AJX's Sep'17 4C include:

- First ever cash flow positive QTR** with +\$0.4m cash from operating activities recorded (vs. 4Q FY17 -\$2.9m).
- Annualised total costs reduced by 26% vs. FY17** led by a 20% reduction in staff costs from management & board remuneration changes.
- Gross margin increase to 23%** (+500bps QoQ) with low margin sales replaced by more profitable revenue streams (e.g. bedding).
- Cash on hand increased to \$9.5m** (vs. \$3.4m Jun'17) including \$5m drawdown from new debt facility.
- Sales revenue down 22% QoQ** with low margin business continuing to be phased out and a seasonal slowdown for some bedding customers.
- Favourable regulatory reform:** The U.S. CPSC has commenced a process drafting legislation to ban all non-polymeric halogen-based flame retardants (~65% of incumbent chemistry).

INVESTMENT VIEW

Key upcoming catalysts for AJX include:

- Financial Profitability.** We estimate profitability in 2H FY18, with gross margins moving closer towards management's run-rate target of 40%.
- Continued growth in high margin bedding and pillow sales** as AJX continues to expand its customers and end brands.
- Sales opportunities for Alexicool in underwear and active wear.**
- Commercialising FR chemistry** with near-term sales opportunities in outdoor tenting, apparel (including cotton), bedding FR, building construction materials, and healthcare nonwovens.
- Military Uniforms:** Finalising a prototype to be used in field trials for supply of the U.S. Army's FR combat uniforms.

AJX now operates a leaner structure with renewed focus on high margin sales. We expect profitability to be reached in FY18, following continued growth in sales of Alexicool into the bedding/pillow industry, combined with conversion of any of the material opportunities in the FR pipeline. With the business now at breakeven, any additional sales should largely drop through.

We retain our **BUY** rating and **\$1.00 target price**.

Y/E Jun 30	2017a	2018e	2019e	2020e
EBITDA	(11.0)	2.1	9.5	15.4
EV/EBITDA	nm	58.8x	13.3x	8.2x
Core NPAT	(12.0)	0.7	8.0	14.2
Core EPS (Diluted) (€)	(4.0)	0.2	2.6	4.7
P/E	nm	187.2x	15.4x	8.7x
EPS growth	(28.4%)	(105.4%)	1,112.5%	77.9%
DPS (€)	0.0	0.0	0.0	2.3
Yield	0.0%	0.0%	0.0%	5.8%
DPS growth	-	-	-	-
Dividend Payout Ratio	0.0%	0.0%	0.0%	50.0%

All figures are in AUD.

KEY TAKEAWAYS

Key takeaways from AJX's 1Q FY18 4C include:

First ever cash flow positive QTR

- +\$0.4m cash from operating activities vs. 4Q FY17 -\$2.9m.

Gross margins increased to 23%

- +500bps increase vs. 4Q FY17 (18%).
- Low margin business replaced by more profitable sales of Thermal Regulation chemistry (Alexicool) into the bedding industry.

Significant reduction in operating expenses (down 26% vs. FY17 annualised)

- Staff costs down 20% QoQ driven by structural changes made to management & board remuneration.
- Staff costs projected to fall another 12% in 2Q FY18.
- Investment was still able to be made into 2 new chemists, an additional sales person, and a customer service rep.
- R&D costs down 13% with efficiencies realised from newly completed HQ facility.

Sales Revenue down 22% QoQ

- Slowdown due to seasonal factors (including public holidays) and a strengthening AUD (+4% vs. 30 Jun'17).
- Shipments have returned to regular volumes in Oct'17.

\$9.5m cash on hand (vs. \$3.4m at Jun'17) with \$5m drawdown from new debt facility

Favourable regulatory reform

- The U.S. Consumer Product Safety Commission (U.S. CPSC) has commenced a process drafting legislation to ban all non-polymeric halogen-based flame retardants (~65% of incumbent chemistry).
- In the month following this decision by the U.S. CPSC, the states of Rhode Island and Washington DC banned the sale of products containing 20 difference halogen based flame retardands.

Figure 1: AJX Revenues and Margins



Source: Company, Moelis Analysis

INVESTMENT THESIS

Key drivers supporting our BUY rating include:

- **Strong momentum, with profitability estimated for 2H FY18** (vs. \$12m loss in FY17)
- **Cash flow positivity estimated for next quarter (2Q FY18).**
- **Renewed sales focus on high margin verticals**
 - Low margin verticals have been replaced with more profitable business.
- **Well-advanced sales pipeline opportunities**
 - Multiple opportunities for material supply agreements/licencing deals.
- **Incumbents under regulatory pressure due to toxic ingredients**
 - AJX estimate ~65% of incumbent chemistry may be affected by recent law changes (U.S. EPA and EU) banning of certain toxic chemicals inputs.
- **Stable operating cost base**
 - Capital light model with outsourcing of sales & manufacturing functions.
- **Large and growing end-user markets**
 - Identified addressable market opportunity of >US\$3bn.

EARNINGS ESTIMATES

Our revised earnings estimates for AJX are set out below:

Figure 2: AJX Earnings Estimates (\$m's, Moelis estimates)

	FY16	FY17	FY18e	FY19e	FY18 (previous)	Change (▲)	Moelis Comments
Revenue	3.4	24.0	32.8	51.3	34.8	-6%	Continuing phase out of low margin sales + seasonal slowdown in bedding sales 1Q/2Q FY18. Revenue expected to pick up in 2H FY18 with execution of FR opportunities.
Gross Profit	0.1	0.5	11.6	19.7	13.4	-13%	GM of 23% in 1Q FY18 expected to increase with scale and profitable new business through FY18.
<i>Gross Profit (%)</i>	1%	2%	35%	38%	38%	3%	
Operating Costs	(15.3)	(11.5)	(9.5)	(10.2)	(11.8)	-20%	Significant reduction of staff costs (-20% QoQ) due to lower management and board remuneration structure. Lower R&D costs due to establishment of new HQ facility in Greer.
EBITDA	(15.3)	(11.0)	2.1	9.5	1.6	34%	
NPAT	(15.4)	(12.0)	0.7	8.0	0.2	+0.5	FY18 profit increased primarily due to cost outs achieved. Carried forward tax losses to offset taxable income through FY21.
EPS			0.2cps	2.6cps	0.1cps		
EV/EBITDA			58x	13x			
P/E			na	16x			

Source: Company, Moelis Analysis

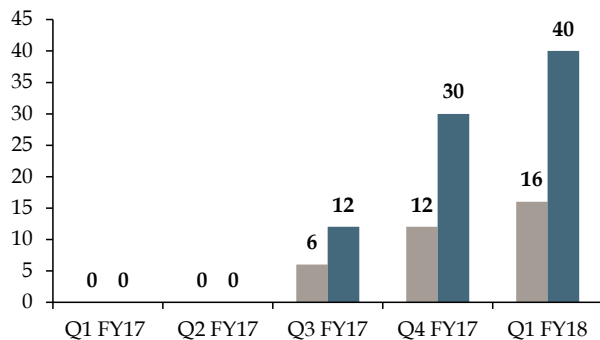
- We estimate AJX reaches profitability in FY18.
- 35%/65% weighting in revenues towards 2H FY18 as bedding/pillow sales ramp up and FR opportunities begin to contribute to earnings.
- We estimate AJX trades on an FY19 P/E of ~16x which appears undemanding given the Company's outlook for growth.

THERMAL REGULATION CHEMISTRY (THE BIGGEST GROWTH DRIVER RIGHT NOW)

Highlights

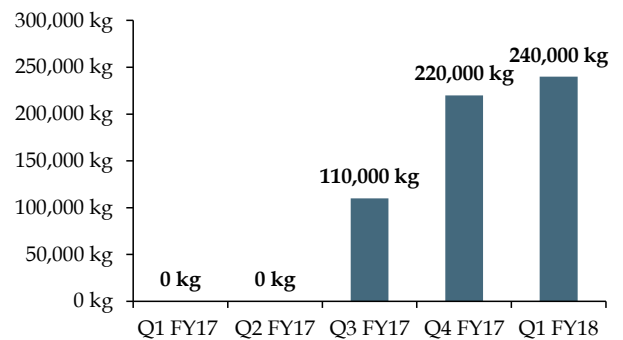
- In 2016 AJX launched its new 'Alexicool' thermal regulation product.
- The product has been well received within the bedding & pillow industries, with the number of brands using the Chemistry increasing rapidly since Jan'17.
- Alexicool sales have grown consistently QTR on QTR sine launch in Jan'17.

Figure 3: Bedding Customers & Brands



Source: AJX, Moelis Est.

Figure 4: Alexicool Shipments (kgs, Moelis est.)



Source: AJX, Moelis Est.

Why Alexicool?

Alexicool's core features and advantages:

- Thermal + FR - keeps mattresses cool whilst still providing fire protection.
- Durability - longer wash cycle (up to 100 washes) vs. competition (~20 washes).
- Cost effective - cheaper than competition of comparable quality.
- Less disruptive to original product characteristics (vs. competition).

Product Margins

- Alexicool is typically sold on high gross margin (>40%).
- Faster sales cycle vs. FR Chemistry which is subject to more stringent R&D testing.
- Gross Margins should expand as AJX achieved scale and sources raw ingredients more cost-effectively.

Pipeline Opportunities

- Expanding sales to new bedding customers
- Cross-selling into more brands of existing customers
- European Launch - Currently running 4 production trials at large mattress covering manufacturers in Belgium, Germany, Turkey & Canada.
- Pillow Sales to Pegasus Home Fashions: Opportunity to expand into more brands & products across Pegasus' production. Pegasus (AJX's first pillows customer) begun purchasing chemistry in 1Q FY18.
- New Verticals for Alexicool including Activeware and Underwear.

"The primary engine for growth has been AJX's rapid traction in the mattress industry"

Dirk Van Hying, CEO, Jun 2017

"Alexicool technology has proven to be the most efficient cooling technology on the market...at price points anyone can afford."

Lou Casali, Pegasus Head of Sales

FIRE RETARDANT CHEMISTRY (FR)

FR presents the largest end-market opportunity for AJX.

Commercialisation of FR chemistry is challenging given the stringent regulation it comes under, as well as the thorough product evaluation testing undertaken by customers.

We estimate AJX will begin to convert material FR sales opportunities in 2H FY18 & FY19.

Key opportunities include:

Outdoor Fabrics (Tenting)

- AJX has produced a customized, environmentally friendly chemical solution for natural fiber tent fabric that meets FR specifications and passes stringent durability tests
- Currently working with a large Chinese producer of tent fabric and a European producer of emergency tents.

Apparel (cotton & work wear)

- Negotiations & product evaluation being conducted with 3 global chemical suppliers to the Apparel industry for licencing of 'Alexiflam NF' (FR treatment of cotton).
- Alexiflam NF is non-toxic, cost-effective, highly durable chemistry that is minimally disruptive to original product characteristics.
- We anticipate one licencing agreement to be reached in 2H FY18.

Military

- After years of R&D (through funding from Natick), in 2016 AJX successfully developed an FR treatment for Nylon/Cotton (NyCo) fabric blends used in Military Uniforms.
- AJX is working with a fabric supplier to complete a prototype FR combat uniform (with required breathability & weight) for use in field trials
- AJX uniform is significantly cheaper & more durable vs. major incumbent (Tencate).
- **We estimate the potential size of a Military Uniform chemical supply agreement for AJX to be up to ~\$25m revenue p.a. with sales beginning to ramp up in FY20.**

Figure 5: Nylon/Cotton Military Uniforms



Source: Company Presentations

Figure 6: Polymers used in Electronics & Construction



Source: Google

Protective Coatings and Polymers (building construction)

- Coatings & polymers used in electronics and construction are vulnerable to fire and heat, with the use of toxic flame retardants commonplace.
- AJX's Alexiflam-SYN product is a non-toxic alternative.

We note incidents such as London's Grenfell Tower fire, in part caused by cladding that failed fire safety tests, highlights the importance of flame retardant building materials.

Profit and Loss (\$m)	2016a	2017a	2018e	2019e	2020e
Revenue	3.4	24.0	32.8	51.3	69.9
<i>Growth</i>	785.3%	604.0%	36.5%	56.2%	36.5%
EBITDA	(15.3)	(11.0)	2.1	9.5	15.4
<i>Growth</i>	140.4%	(28.0%)	(119.5%)	341.8%	62.8%
Dep'n & Amort	(0.2)	(0.4)	(0.4)	(0.5)	(0.6)
EBIT	(15.5)	(11.4)	1.7	9.0	14.8
<i>Growth</i>	138.5%	(26.6%)	(115.4%)	414.3%	64.7%
Net Interest Expense	0.0	(0.6)	(1.1)	(1.0)	(0.6)
Profit Before Tax	(15.4)	(12.0)	0.7	8.0	14.2
Tax	0.0	0.0	0.0	0.0	0.0
<i>Tax Rate (%)</i>	0.0%	0.0%	0.0%	0.0%	0.0%
Minorities	0.0	0.0	0.0	0.0	0.0
NPAT (Underlying)	(15.4)	(12.0)	0.7	8.0	14.2
<i>Growth</i>	125.0%	(22.5%)	(105.5%)	1,114.1%	77.9%
One-Off Items	0.0	0.2	0.0	0.0	0.0
NPAT (Reported)	(15.4)	(11.8)	0.7	8.0	14.2
EPS (Underlying) (€)	(5.5)	(4.0)	0.2	2.6	4.7
<i>Growth</i>	87.2%	(28.4%)	(105.4%)	1,112.5%	77.9%

Balance Sheet (\$m)	2016a	2017a	2018e	2019e	2020e
Cash	11.2	3.4	6.6	9.0	16.5
Inventory	0.0	2.1	4.2	5.5	7.7
Current Receivables	0.2	1.4	3.5	4.6	6.4
PPE	0.8	2.4	2.7	3.2	4.0
Intangibles	0.1	0.1	0.3	0.6	0.9
Other	1.8	0.1	0.1	0.1	0.1
Total Assets	14.2	9.7	17.4	22.9	35.7
Current Payables	2.8	1.8	2.8	3.6	5.1
ST Debt	0.0	5.9	5.9	5.9	5.9
LT Debt	0.0	0.4	3.3	0.0	0.0
Provisions	0.1	0.0	0.0	0.0	0.0
Other	0.0	1.4	1.4	1.4	1.4
Total Liabilities	2.9	9.4	13.3	10.9	12.3
Net Assets	11.3	0.2	4.1	12.1	23.4
Equity & Reserves	60.7	61.8	65.0	65.0	69.2
Retained Profits	(49.4)	(61.6)	(60.9)	(52.9)	(45.8)
Shareholders' Equity	11.3	0.2	4.1	12.1	23.4
Minorities	0.0	0.0	0.0	0.0	0.0
Total Equity	11.3	0.2	4.1	12.1	23.4

Cashflow (\$m)	2016a	2017a	2018e	2019e	2020e
EBITDA	(15.3)	(11.0)	2.1	9.5	15.4
Net Interest	0.0	(0.5)	(1.1)	(1.0)	(0.6)
Tax	0.1	0.0	0.0	0.0	0.0
Δ in Working Capital	(15.5)	(4.3)	(3.2)	(1.6)	(2.6)
Other	20.6	0.1	0.0	0.0	0.0
Operating Cash Flow	(10.1)	(15.7)	(2.1)	6.9	12.2
<i>Growth</i>	136.0%	55.4%	(86.7%)	(432.5%)	77.3%
Capex	(0.2)	(1.6)	(0.8)	(1.3)	(1.7)
Acquisitions	0.0	0.0	0.0	0.0	0.0
Divestments	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0
Investing Cash Flow	(0.2)	(1.6)	(0.8)	(1.3)	(1.7)
Equity Raised	9.5	0.7	0.0	0.0	0.0
Dividends Paid	0.0	0.0	0.0	0.0	(2.9)
Net Borrowings	0.0	6.7	6.1	(3.3)	0.0
Other	0.0	(0.3)	0.0	0.0	0.0
Financing Cash Flow	9.5	7.0	6.1	(3.3)	(2.9)
FX / Non Cash Items	0.4	(0.5)	0.0	0.0	0.0
Change in Cash	(0.4)	(10.7)	3.2	2.3	7.6
Free Cash Flow	(10.3)	(14.3)	(2.9)	5.6	10.5

Valuation Summary	
Current Mkt Capitalisation	123.4
Shares on Issue	304.6
Last Price	0.410
12 Mth Target Price	1.000
Total Estimated 12 Mth Return	146.9%
12 Mth Fwd Capital Return	146.9%
12 Mth Fwd Dividend Yield	0.0%

Valuation Ratios	2016a	2017a	2018e	2019e	2020e
EPS (Underlying) (€)	(5.5)	(4.0)	0.2	2.6	4.7
<i>Growth</i>	87.2%	(28.4%)	(105.4%)	1,112.5%	77.9%
P/E (x)	nm	nm	187.2x	15.4x	8.7x
Small Industrials (ex Fir's)	15.5x	14.0x	0.0x	0.0x	0.0x
Premium / (Discount)	nm	nm	nm	nm	nm
EV/EBITDA (x)	nm	nm	58.8x	13.3x	8.2x
Small Industrials (ex Fir's)	9.5x	8.8x	0.0x	0.0x	0.0x
Premium / (Discount)	nm	nm	nm	nm	nm
DPS (€)	0.0	0.0	0.0	0.0	2.3
<i>Growth</i>	-	-	-	-	-
Yield (%)	0.0%	0.0%	0.0%	0.0%	5.8%
Payout Ratio (%)	0.0%	0.0%	0.0%	0.0%	50.0%
Franking (%)	0.0%	0.0%	0.0%	0.0%	60.0%
NTA	11.1	0.1	3.8	11.5	22.4
NTA/Share (\$)	0.04	0.00	0.01	0.04	0.07

Performance Ratios	2016a	2017a	2018e	2019e	2020e
ROA	(109.1%)	(124.0%)	3.8%	34.8%	39.8%
ROE	(137.1%)	(5,452.0%)	16.1%	66.1%	60.8%
ROIC	(31,626.8%)	(371.8%)	26.5%	100.2%	116.7%
Net Debt (Cash) (\$m)	(11.2)	2.8	2.5	(3.1)	(10.7)
Net Debt/EBITDA (x)	0.7x	(0.3x)	1.2x	(0.3x)	(0.7x)
ND/(ND + Equity) (%)	(22,907.2%)	92.8%	38.1%	(34.6%)	(83.9%)
Interest Cover (x)	(351.8x)	(19.1x)	1.6x	9.2x	26.4x
Working Capital	(0.9)	1.5	4.7	6.2	8.8
Working Capital/Sales (%)	(27.4%)	6.2%	14.2%	12.1%	12.6%

Cash Flow Metrics	2016a	2017a	2018e	2019e	2020e
FCF/Share (\$)	(0.04)	(0.05)	(0.01)	0.02	0.03
Price/FCPS (x)	nm	nm	nm	21.9x	11.8x
Free Cash Flow Yield (%)	(9.1%)	(11.7%)	(2.4%)	4.6%	8.5%
Gross Cash Conversion	66.4%	110.9%	(46.4%)	83.4%	83.1%
Capex/Sales (%)	(6.1%)	(6.6%)	(2.5%)	(2.5%)	(2.5%)
Capex/Depreciation (x)	1.0x	4.4x	2.1x	2.7x	2.9x

Margins	2016a	2017a	2018e	2019e	2020e
EBITDA	(447.7%)	(45.8%)	6.5%	18.5%	22.1%
EBIT	(453.7%)	(47.3%)	5.3%	17.6%	21.2%
NPAT	(452.4%)	(49.8%)	2.0%	15.6%	20.3%

Valuation Methodology	
WACC (%)	9.2%
Discounted Cash Flow Valuation	0.899
Sum-of-the-Parts Valuation	0.000
Average Valuation	0.899
12 Mth Target Price	1.000

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RATINGS DISTRIBUTION TABLE

Distribution of Ratings as at 24 October 2017

SELL	HOLD	BUY
0.0%	34.0%	66.0%

Rating and Price Target History: Alexium International Group Ltd (AJX) as of 23/10/2017



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