EDISON **Scale research report - Update**

Nanogate

Industrials

8 October 2019

Adapting to market conditions

Nanogate's order book of over €600m for delivery during FY19–21, we estimate a third of which relates to the industrial sector, shows the benefits of its long-term strategy of diversification from the European automotive sector. Moreover, while uncertainty in the European automotive sector has depressed H119 revenues and profits, Nanogate's technologies for manufacturing light-weight components that look like metal or glass put it in a good position, as the transportation sector globally seeks to reduce carbon emissions.

Uncertainty in automotive sector hits H119 profits

In H119 group revenues rose by 2% year-on-year to €122.2m, partly because the increasing uncertainty of customers in the automotive sector resulted in behaviour such as delays in commencing projects. However, indirect costs grew more quickly than sales because of a full six months of costs from FY19 acquisitions, additional staff engaged ahead of major new contract starts and the cost of the NXI programme intended to improve margins in the medium term. EBITDA declined by 37% to €8.0m and the group moved from €2.6m profit before tax in H118 to a €2.4m loss. Net debt increased by €5.4m during H119 to €97.0m at end June, maintaining gearing (net debt/equity) at 81%. Free cash outflow of €13.4m was partly offset by an oversubscribed placing raising €10.3m (gross) at €22.80/share.

Management reduces FY19 guidance

Management's response to the challenging market conditions is to intensify the NXI programme incurring additional costs during H219. Management has therefore revised FY19 guidance from €250m+ revenues generating c €24.2m EBITDA and a low single-digit negative consolidated result, to €245–250m revenues generating €14–17m EBITDA and a consolidated net loss in the high single-digit million range.

Valuation: Waiting on NXI delivering margin growth

Nanogate's share price has halved from a peak of €37.10 a year ago reflecting concerns about profitability and the automotive sector more generally. At current levels the shares are trading at a modest premium to our sample mean of year one EV/EBITDA multiples and a modest discount to the mean for year two EV/EBITDA multiples, which is when the benefit of the NXI programme on EBITDA margin starts to take effect. We note that the strong order book is expected to deliver revenue growth that is towards the top end of our sample. We see scope for share price appreciation as the NXI programme starts to deliver margin improvement.

Consensus estimates

Year end	Revenue (€m)	PBT (€m)	EPS (€)	DPS (€)	P/E (x)	Yield (%)
12/17	186.2	3.9	0.64	0.11	21.9	0.8
12/18	239.2	1.7	0.29	0.11	48.3	0.8
12/19e	246.6	(13.5)	(2.00)	0.11	N/A	0.8
12/20e	261.0	(3.6)	(0.71)	0.11	N/A	0.8

Source: Nanogate data, Refinitiv

Price	**€14.0m**
Market cap	**€76m**

Share price graph

Share details

Code	N7G
Listing	Deutsche Börse Scale
Shares in issue	5.4m
Last reported net debt at end June 2019	€97.0m

Business description

Nanogate is a leading global specialist for design-oriented, high-tech surfaces and components of very high optical quality. Nanogate develops and produces design-oriented surfaces and components and enhances them with additional properties, eg non-stick, scratch-proof, anti-corrosive.

Bull

- Diversity of applications gives access to emerging growth applications.
- Vertical integration aids customer retention.
- Increasingly global footprint.

Bear

- Short-term margin drag of NXI programme.
- Capital cost of succession of acquisitions.
- High concentration of customers in automotive industry, though this is reducing.

Analyst

Anne Margaret Crow +44 (0)20 3077 5700

industrials@edisongroup.com

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Financial performance

Profits depressed by uncertainty in European automotive sector

During H119 group revenues rose by 2% year-on-year to €122.2m. This was at the lower end of management's internal targets because of delayed production starts on new major projects associated with changes in specification. In addition, increasing uncertainty of customers in the automotive sector resulted in delays in commencing projects, reduced drawdowns and premature conclusion of late-phase projects, which are typically higher margin.

Gross margin declined by 1.6pp to 52.9% reflecting costs associated with starting multiple new projects in parallel, the expiration of late-phase high-margin projects, and the growing proportion of revenues from the components segment, where materials account for a higher proportion of sales. Personnel costs grew more quickly than sales (ie by 15%), partly because of a full six months of costs associated with the sites in Austria and Slovakia and Design Studio heT design bureau, partly because of the addition of staff ahead of major new orders and, under the Nanogate Excellence Initiative (NXI) programme, in roles such as supply chain management, which will result in cost-savings in the longer term. Other operating costs reduced by €0.7m as a €2.6m decrease associated with the adoption of IFRS 16 was partly offset by one-off costs related to the NXI programme (see below for details). The costs associated with this programme totalled €1.6m, around one-third of which were attributable to personnel costs, and the remainder to 'other operating expenses'. EBITDA declined by 37% to €8.0m and the EBITDA margin declined by 4.1pp to 6.5%. The combination of reduced gross margin, higher personnel costs, the cost of the NXI programme and higher depreciation, some of which relates to prior year investment in production capacity and acquisitions, some the adoption of IFRS 16, resulted in the group moving from €2.6m profit before tax in H118 to a €2.4m loss.

Adverse impact of major new contracts on debt and gearing

Net debt increased by €5.4m during H119 to €97.0m at the end of June, maintaining gearing (net debt/equity) at 81%. Net bank liabilities/EBITDA increased from 3.8x at end FY18 to 5.0x at end H119. Although the group remained fully compliant with its banking covenants, management is focused on reducing this ratio. Free cash outflow totalled €13.4m. Key elements of this increase were an €8.8m increase in working capital, part of which was attributable to a build of inventories for new orders and the purchase of tooling for these new projects, €2.5m interest payments and €6.6m investment in capex. Most of this was for new machines at the Slovakian site to boost capacity and a new technology centre in the US. Both of these investments will support growth in FY20. The cash outflow was offset by a placing in June 2019, which was oversubscribed and raised €10.3m (gross) at €22.80 per share, ie without any placement discount.

Outlook: Guidance reduced

Management had always anticipated that FY19 profitability would be adversely affected by the start-up costs associated with major new orders commencing production, the costs of completing the integration of the sites in Austria and Slovakia and the initial implementation of the NXI programme and increased depreciation costs. Consequently, in April 2019 management guidance was for revenues to exceed €250m, ie a modest increase compared to €239.2m in FY18, with EBITDA remaining at FY18 levels (€24.2m) and a low single-digit negative consolidated result. Since management has intensified the NXI programme, particularly the site restructuring activity in response to the weak market environment in Europe, the costs of the programme will increase while sales are expected to be slightly lower because of project delays and similar customer behaviours caused by pessimism in the European automotive industry. Management has therefore revised FY19 guidance to €245–250m revenues generating €14–17m EBITDA and a consolidated net loss in the high single-digit million range. This includes expenses for the NXI programme and consulting costs in connection with restructuring measures, which are estimated to be over €3m.

With regards to the prevailing sentiment in the European automotive industry, Nanogate notes that market participants currently anticipate a decline in global car sales of 4–5%. This is causing its European automotive customers to delay new projects and call-off lower numbers of parts on active projects. Its US automotive customers appear less affected. This highlights the benefits of the strategic decision to diversify into the industrials sector and into North America. We note that some manufacturers of automotive components, for example those making parts for internal combustion engines, will be seriously affected by the decarbonisation of transport and shift to electric vehicles. We see this trend as positive for Nanogate, as its N-Glaze and N-metals technologies offer a route for light-weighting conventional vehicles, thus improving fuel efficiency and for electric vehicles, where the weight of batteries means that reducing the weight of other components is essential. Nanogate is producing plastic components for a new electric car from a German manufacturer that is scheduled for launch in 2020. Moreover, Nanogate's integrated smart surfaces offer supports the rapidly increasing numbers of sensors being deployed in vehicles as the industry moves towards fully autonomous vehicles with new models of ownership.

Adapting to changing market conditions

Other than intensifying the NXI initiative to improve efficiency across the group in response to the market environment, management is sticking with its stated market focus of preferentially growing business with industrial customers and with customers in North America and Asia. This strategy has already generated an order book of over €600m (see Exhibit 1) for delivery during FY19–21. Through adherence to the strategy management intends to generate over €500m annual revenues and €75m EBITDA by 2025. €200m of these revenues will be attributable to industrial applications, ie aviation, home appliances and medical devices.

Exhibit 1: Selected major new orders in FY18 and FY19

Announcement	Project	Volume	Start
2 July 2019	Components for interior and exterior of US SUV	Over US$10m over three years	July 2019
14 June 2019	N-metals chrome replacement components for premium coffee machines	Over €10m over five years	Q319
29 May 2019	N-Glaze components for kitchen appliances (second project for existing US customer)	US$50m over up to eight years	2020
4 April 2019	N-Glaze components (interior) for a new premium vehicle	C €50m over seven years	Summer 2019
19 Feb 2019	N-Glaze components for high-demand SUVs	C €50m over six to eight years	Summer 2020
14 Nov 2018	N-Metals in the US for SUV / pickup	C €15m over four years	Summer 2020
8 Nov 2018	Order for N-Mobility for components for new electric vehicle in Europe	€35m over seven years	Autumn2019
26 June 2018	N-Metals replacement for stainless steel components in kitchen appliances for US manufacturer	Up to US$100m over eight years	August 2019
19 April 2018	Several new orders in the US, including the first project of a German OEM in Ohio	Low double-digit million range over several years	-
15 March 2018	N-Glaze components for new mobility applications (eg sensors)	Multi-year projects with sales volumes in the millions range	-

Source: Nanogate data

NXI programme defines next phase of growth

Management launched the NXI programme in January 2019. The major difference between this and the preceding Phase 5 strategy is that now management has created a vertically integrated, international platform it intends to drive increased revenues and margins and to generate cash from this existing platform rather than seeking further expansion through acquisition. The NXI programme includes the following initiatives:

Simplified corporate structure: Where appropriate, subsidiaries will be merged or placed under a single management team to focus responsibilities and accelerate decision making. For example, in May 2019 Nanogate purchased the outstanding 25% stake in Nanogate Goletz Systems a year earlier than planned. (The consideration, for an undisclosed sum, was settled partly through the issue of shares in Q319, the remainder in cash in FY20.) This was in advance of the announcement in June 2019 that the group's sites in North Rhine-Westphalia, which include Nanogate Goletz Systems, would be combined operationally and strategically, focusing on more profitable orders, optimising existing production and purchasing processes, streamlining management and personnel structures and centralising and realigning engineering capacities. This action will potentially realise annual savings in the millions while incurring one-off restructuring costs in the low single-digit million range.

Optimisation of processes: Procurement and purchasing will be organised centrally. The finance and control functions will be expanded to manage the group more effectively.

Optimisation of capacity: Use of capacity across the group will be reviewed, relocating work and terminating low-margin activity where necessary so that recent major orders can be executed efficiently. For example, Nanogate is working closely with ERBIWA, a German specialist in the development of complex plastic components and sophisticated manufacturing processes. ERBIWA develops, constructs and procures key production resources and tools and manufactures small batches, prototypes and special parts for mass production. ERBIWA works with Nanogate heT Engineering, on the design and production of components during the product development stage to improve efficiency when parts enter volume production.

Marketing focus: The group will focus on two brands: N-Glaze and N-Metals; and on three growth areas: new mobility, metallisation and integrated smart surfaces. Exhibit 1 illustrates how previous investment in the N-Metals replacement for stainless steel launched in early 2018 has resulted in substantial orders. Management estimates that the global market for this technology is worth thousands of millions of euros. Market development will be independent of location. International marketing activities will be strengthened, although focused on key markets such as stainless steel applications for bathrooms and kitchens. The group will increasingly address potential customers in Asia as well as North America.

Valuation

We continue to use a sample of European companies involved in the manufacture of speciality chemicals for comparison, since Nanogate has no competitors offering the same range of capabilities. As Nanogate captures a higher proportion of the value chain than a typical speciality chemical company, has a more diverse skill set and is engaged in multiple markets, this is not entirely satisfactory, so we have extended our sample to include companies that use specialist chemical processes to provide a service, such as Bodycote.

Exhibit 2: Prospective multiples of listed peers

Name	Market cap (€m)	EV/sales 1FY (x)	EV/sales 2FY (x)	EV/EBITDA 1FY (x)	EV/EBITDA 2FY (x)	P/E 1FY (x)	P/E 2FY (x)	Revenue CAGR* (%)
Akzo Nobel	18,396	2.0	1.9	14.1	12.5	26.0	19.6	2.3%
Bodycote	1,508	1.9	1.9	6.9	6.6	13.0	12.3	2.9%
Croda International	7,018	4.8	4.6	16.6	15.5	25.3	23.4	3.2%
Elementis	975	1.8	1.7	8.4	8.0	11.6	10.9	5.8%
Johnson Matthey	6,554	1.5	1.5	8.6	8.0	12.6	11.7	-23.7%
Kemira Oyj	2,008	1.1	1.1	7.2	7.0	13.8	13.4	2.9%
Koninklijke DSM	19,245	2.2	2.1	11.7	11.0	21.3	18.8	3.2%
LANXESS	4,617	0.9	0.9	6.3	6.0	12.9	12.1	1.7%
Nabaltec	308	1.7	1.6	8.7	7.9	19.1	16.8	9.3%
Symrise	12,017	3.9	3.5	18.6	16.4	36.4	31.1	8.1%
Umicore	8,671	2.9	2.6	13.5	11.7	27.2	22.8	-32.2%
Victrex	2,100	6.1	5.8	14.6	13.6	19.6	18.5	-0.1%
Wacker Chemie	3,239	0.8	0.8	5.3	4.9	19.1	14.7	3.0%
Mean		**2.1**	**2.0**	**10.8**	**10.0**	**19.8**	**17.4**	
Nanogate	148	0.7	0.7	12.5	7.2	(7.8)	(22.1)	5.7%

Source: Refinitiv. Note: Prices at 26 September 2019. Grey shading indicates exclusion from mean. *Year 0–3.

Nanogate's share price has halved from a peak of €37.10 a year ago. reflecting company-specific concerns about the impact of the NXI programme on profitability and industry-specific concerns about the impact of the transition to electric vehicles on European manufacturers of automotive components. The current market cap is substantially below net asset value (€119.5m). At current levels the shares are trading at a large discount to the mean of our sample with respect to consensus EV/sales multiples. They are trading at a modest premium to our sample mean of year 1 EV/EBITDA multiples and a modest discount to the mean for year 2 EV/EBITDA multiples, which is when the benefit of the NXI programme on EBITDA margin starts to take effect. We note that the strong order book, which has been secured through earlier investment in technology development and capacity, is expected to result in revenue growth that is towards the top end of our sample. We see scope for share price appreciation as the NXI programme starts to deliver margin improvement. Consensus estimates show EBITDA margin falling from 10.0% in FY18 to 5.8% in FY19 before partly recovering to 9.5% in FY20 and reaching 11.5% in FY21, delivering a return to profit at pre-tax level in FY21 (PBT €5.9m).

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Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
1,185 Avenue of the Americas
3rd Floor, New York, NY 10036
United States of America

Sydney +61 (0)2 8249 8342
Level 4, Office 1205
95 Pitt Street, Sydney
NSW 2000, Australia