Ukraine conflict drives broader demand

We really like what CEO Scott Basham had done on refocusing the business, eliminating "moon-shot" projects and rightsizing the cost base. We also like the Board and their strong connections in the defence industry. While we had seen some direct ballistics order related to the Ukraine conflict prior to our initiation, we were unprepared for the size of the recent orders which were more than 3x the total FY21 Ballistics division revenue. The focus on operational issues has set the Company up to allowing it to quickly ramp up capacity and realise short delivery timeframes. Management are seeing increased procurement enquiries, and don't expect any reduction in demand while global tensions remain. This sees large upgrades to earnings, and a 28% increase in our valuation taking it to A$0.67 per share.

Contracts rolling in

Since Mar 2022, XTEK has announced six new orders totalling A$70m, A$64m of which is for ballistic products through its US subsidiary, HighCom. This compares with FY21 ballistics revenue of A$17m. A$55m of these orders are from undisclosed international customers, which we assume were catalysed by the conflict in Ukraine. The remaining orders comprise a A$9.5m ballistics order from the Asia-Pacific region and a A$4.9m order from the ADF for Small Unmanned Aerial Systems reflecting governments worldwide reacting to increased global tensions.

Strong margins

Different channels to market yield differing gross margins. In FY21, we estimate that 70% of HighCom orders were through private label partners at gross margins of c.30%. All the ballistic orders since March have been direct from customers which we assume have 50–60% gross margins. Given the scale of the orders and that these were for urgent delivery which likely required higher COGS, we assume margins were at 50% taking estimated gross profit from these five orders to A$32.2m (with A$18.2m recognized in FY22).

Outlook and forecasts

Company guidance for FY22e revenue is >A$60m (MST Access A$63m), with orders in hand for FY23 of A$38m. The Ballistics division has identified >$40m of new sales opportunities worldwide, and the Technology division is expecting the outcome of Land 154-4 tender shortly (likely value $25-50m over three years). We acknowledge the difficulty in forecasting revenue and earnings given the sharp uplift in recent months.

Valuation

By our estimates, closing net cash at 30 Jun-22 will be A$17.6m vs A$1.5m at year end FY21. While inorganic growth opportunities have been flagged, we anticipate the streamlined focus of the company to continue and any acquisition to be in adjacent categories with strong synergies. We value XTEK at 0.67 cps, 59% upside from the current price. Refer to page six for an analysis of the risks associated with this valuation.

XTEK provides front-line equipment for defence and law enforcement personnel. It manufactures body armour and helmets and has exclusive agency agreements for distribution of unmanned aerial and ground vehicles from which it has also built a service and support business. XTEK has also developed an innovative technology (XTclave) for use in body armour and helmets that it is now commercialising. It has operations in Australia and the US, but also has an international sales presence.

https://www.xtek.net/

Stock	XTE.ASX
Price	A$0.42
Market cap	A$42.3m
Valuation	A$0.67

Next News
Next 3 months: More order announcements
Next 3 months: LAND 154-4 Defence tender award
Aug-22: FY22 Result

XTE Share Price (A$)

Source: FactSet

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Figure 1: Financial summary

XTEK Limited (XTE-AU)

Year End 30 June		FY20A	FY21A	FY22E	FY23E	FY24E
Core PE	**x**	**71.8x**	**nm**	**4.0x**	**2.9x**	**7.1x**
EV/EBITA*	x	40.6x	nm	1.5x	1.4x	2.3x
EV/EBITDA	**x**	**15.9x**	**nm**	**1.4x**	**1.3x**	**2.0x**
Div yield	%	0.0%	0.0%	0.0%	6.9%	7.0%
FCF Yield	%	2.2%	nm	25.6%	35.0%	14.5%

Stock information	
Share Price ($)	$0.42
Market capitalisation (SOI) ($m)	42.3
Valuation ($)	**$0.67**
Shares on issue (Basic) (m)	100.6
Shares on issue (diluted) (m)	100.6

Profit & Loss Statement	$m	FY20A	FY21A	FY22E	FY23E	FY24E
Revenue		**42.7**	**28.3**	**63.0**	**72.1**	**47.8**
Change pcp	%		-33.7%	122.2%	14.4%	-33.6%
Gross Profit		**8.6**	**8.1**	**26.1**	**29.3**	**17.7**
Gross margin	%	20.2%	28.7%	41.5%	40.6%	37.0%
EBITDA		**0.8**	**-3.0**	**15.5**	**20.9**	**9.3**
EBITDA margin	%	1.9%	-10.7%	24.7%	29.0%	19.5%
D&A		-0.8	-1.1	-1.2	-1.2	-1.2
Net interest expense		-0.2	-0.3	-0.4	-0.2	-0.2
Profit Before Tax		**-0.1**	**-4.4**	**14.0**	**19.5**	**7.9**
Tax and adjustments		0.4	0.5	-3.5	-4.9	-2.0
NPAT (underlying)		**0.3**	**-4.0**	**10.5**	**14.6**	**5.9**
Significant, discontinued et.al		0.0	0.0	-2.8	0.0	0.0
NPAT (reported)		0.3	-4.0	7.7	14.6	5.9

	Dec-19	Jun-20	Dec-20	Jun-21	Dec-21	Jun-22E
Revenue	**16.0**	**26.7**	**12.4**	**15.9**	**11.5**	**51.4**
Change pcp	91%	-9%	-23%	-40%	-7%	346%
Gross Profit	**-2.0**	**3.3**	**-3.1**	**0.6**	**-3.4**	**18.9**
Gross margin	-13%	12%	-25%	3%	-29%	37%

Performance ratios	FY21A	FY22E	FY23E	FY24E
ROE (%)	-18.6%	12.8%	33.2%	12.5%
ROIC (%)	-24.2%	46.4%	24.8%	14.0%
Interest cover (EBITDA)	nm	nm	nm	nm
Capex/Depreciation	1371%	267%	267%	267%
Days Working Capital	83	165	83	83

Per Share Data		FY20A	FY21A	FY22E	FY23E	FY24E
Ave. diluted shares outstanding	m	52	69	101	101	101
Underlying EPS	**cps**	**0.6**	**-5.8**	**10.4**	**14.5**	**5.9**
growth pcp	%	42%	-1083%	-281%	39%	-59%
Reported EPS	cps	0.6	-5.8	7.6	14.5	5.9
growth pcp	%	42%	-1083%	-232%	91%	-59%
DPS	cps	0.0	0.0	0.0	2.9	3.0
Payout (on underlying)	%	0%	0%	0%	20%	50%

Segments	FY21A	FY22E	FY23E	FY24E
Revenue				
Ballistics	16.9	52.7	55.6	29.5
Technology	11.5	10.3	16.4	18.3
Group	**28.3**	**63.0**	**72.1**	**47.8**
Gross Profit				
Ballistics		22.7	25.8	12.8
Technology		3.4	3.5	4.9
Group	**8.1**	**26.1**	**29.3**	**17.7**
Gross Margin				
Ballistics		43.1%	46.4%	43.5%
Technology		33.5%	21.0%	26.7%
Group	**28.7%**	**41.5%**	**40.6%**	**37.0%**

Balance sheet	$m	FY20A	FY21A	FY22E	FY23E	FY24E
Cash & Deposits		3.1	5.9	20.1	15.4	23.4
Receivables		15.4	1.9	4.1	4.7	3.1
Inventory		9.0	10.7	37.9	27.2	18.1
PP&E (incl. ROUA)		4.7	11.9	12.9	13.9	14.9
Intangibles		1.3	1.2	1.2	1.2	1.2
Other Assets		1.9	0.8	0.0	0.0	0.0
Total Assets		**35.3**	**32.4**	**76.2**	**62.4**	**60.7**
Payables		16.5	6.2	13.6	15.6	10.4
Borrowings (incl. lease liabilities)		3.6	4.4	2.5	2.5	2.5
Provisions/ other (incl. lease liabilities)		0.7	0.4	0.4	0.4	0.4
Total Liabilities		**20.9**	**11.0**	**16.4**	**18.4**	**13.2**
Shareholders' Funds		**14.5**	**21.4**	**59.8**	**44.0**	**47.5**
Net Debt		**0.6**	**-1.5**	**-17.6**	**-12.9**	**-21.0**

Share price and volume

Cashflow statement	$m	FY20A	FY21A	FY22E	FY23E	FY24E
EBITDA		0.8	-3.0	15.5	20.9	9.3
Net interest		0.0	0.0	-0.4	-0.2	-0.2
Tax paid		0.0	0.0	-3.5	-4.9	-2.0
Working capital movements		-5.4	3.9	-22.0	12.1	5.5
Other/ Prepayments		0.0	-1.1	28.1	-28.1	0.0
Operating CF		**-4.5**	**-0.3**	**17.7**	**-0.2**	**12.6**
Capital expenditure		-1.0	-8.4	-1.6	-1.6	-1.6
Asset sales		0.0	0.0	0.0	0.0	0.0
Acquisitions		0.0	0.0	0.0	0.0	0.0
Other		0.2	0.0	0.0	0.0	0.0
Investing CF		**-0.8**	**-8.4**	**-1.6**	**-1.6**	**-1.6**
Net borrow + princ. lease payments		-0.4	0.5	-2.0	0.0	0.0
Dividends paid		0.0	0.0	0.0	-2.9	-3.0
New share issues		3.4	11.2	0.0	0.0	0.0
Financing CF		**3.0**	**11.7**	**-2.0**	**-2.9**	**-3.0**
Effect of FX Rate Changes on Cash		0.0	-0.2	0.0	0.0	0.0
Net change in cash		**-2.3**	**2.8**	**14.2**	**-4.7**	**8.1**

Company description

XTEK provides front-line equipment for defence and law enforcement personnel. It manufactures body armour and helmets and has exclusive agency agreements for distribution of unmanned aerial and ground vehicles from which it has also built a service and support business. XTEK has also developed an innovative technology (XTclave) for use in body armour and helmets that it is now commercialising. It has operations in Australia and the US, but also has an international sales presence.

Source: Company, MST Access

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Contracts rolling in

Since 1 March 2022, XTEK has announced A$69.5m of combined orders that are c.2.5x higher than FY21 revenue, dramatically resetting the Company which has previously suffered a long history of stagnant growth and weak/negative operating cash flows.

The recent orders have been direct from the customer to XTEK's Ballistics subsidiary in the US – HighCom. We have previously estimated that direct orders attract margins of 50% - 60%. Given that these orders had to be delivered with short delivery timeframes, we have assumed that the gross margin on all these orders was 50%.

Figure 2: Announced Orders since 1 March 2022

BALLISTICS DIVISION ORDERS

Date	Amount (A$m)	Delivery	Channel	Assumed Gross Margin	Gross Profit
07 Mar-22	2.8	Urgent	Direct	50%	1.4
24 Mar-22	3.2	Urgent	Direct	50%	1.6
04 Apr-22	2.2	Urgent	Direct	50%	1.1
26 May-22	9.5	Coming Weeks	Direct	50%	4.8
27 May-22	46.8	c.40% FY22, c.60% 1QFY23	Direct	50%	23.4
TOTAL	**64.4**				**32.2**

TECHNOLOGY DIVISION ORDERS

Date	Amount (A$m)	Item	Channel	Assumed Gross Margin	Gross Profit
09 Mar-22	4.9	SUAS	Direct	20%	0.99
04 Apr-22	0.2	Hardware & Software	Direct	20%	0.04
TOTAL	**5.1**				**1.03**
FY22 Total	**41.5**				**19.2**
FY23 Total	**28.1**				**14.0**
Overall Total (since 1 Mar-22)	**69.5**				**33.2**

Source: Company, MST Access.

All ballistics orders are being manufactured by XTEK's Highcom subsidiary at the Columbus Manufacturing Centre. This facility's capacity is sufficient to deliver the current orders with the in the specified timeframe, with supply chain logistics and equipment for this expanded capacity having been put in place in recent months. Additional labour has been acquired to support extended operating hours of the plant.

The most recent A$46.8m order cannot be fully delivered in FY22, with c.60% expected to flow into 1QFY23. We note that this A$46.8m order was fully prepaid, which will lead to a strong cash outcome in FY22 (Figure 4) albeit we assume that all the raw materials for this order are procured in FY22. We have also estimated adjusted cash flows for the forecast years to better adjust for the pre-payment of the $46.8m order and therefore better reflect the underlying cash flows.

Figure 3: XTEK Revenue and EBITDA Profile (A$m)

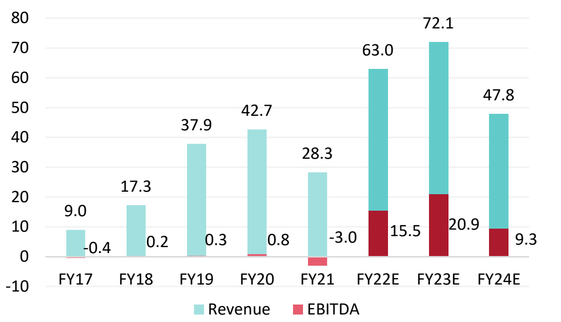
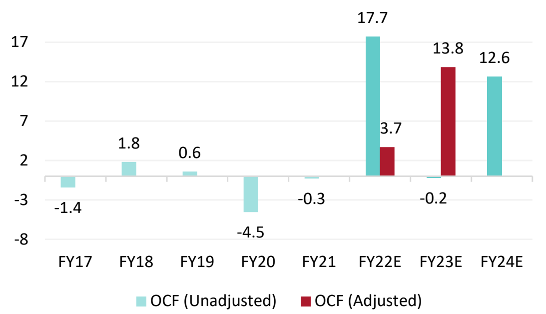


Figure 4: XTEK Operating Cash Flow Profile (A$m)



Source: Company, MST Access

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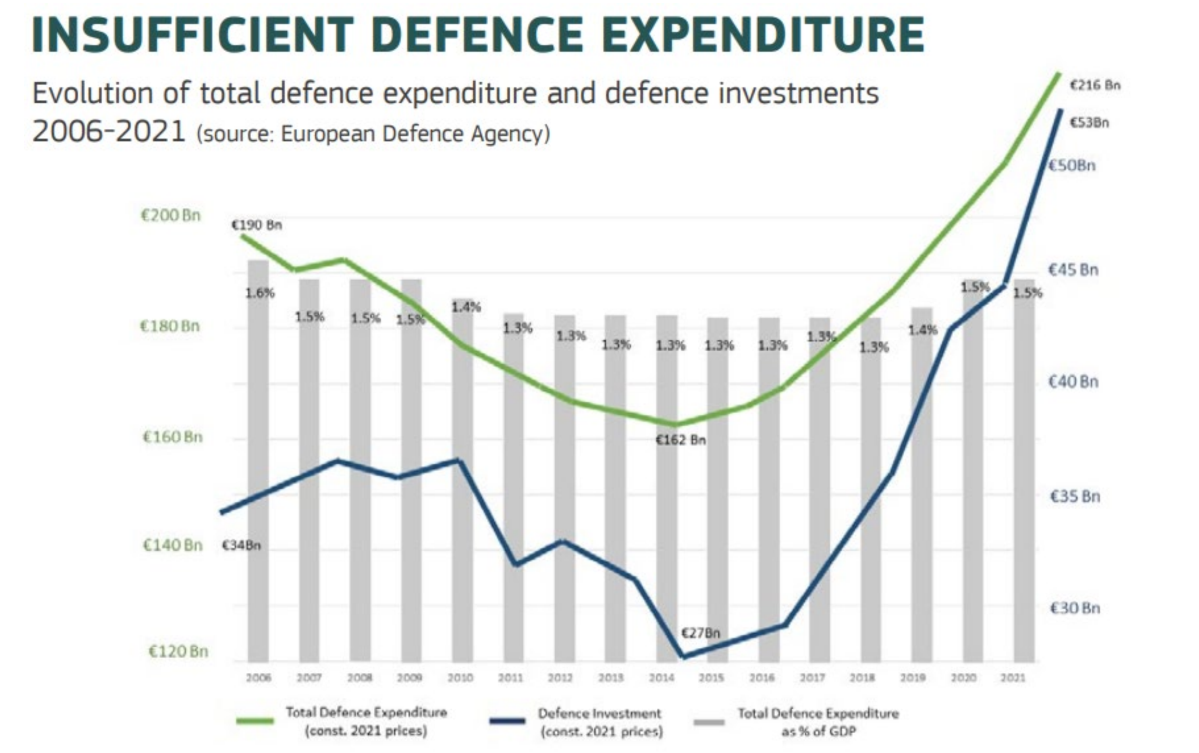
Demand longevity

XTEK continues to pursue >A40m of ballistic sales opportunities worldwide with a large volume directly related to the Ukraine conflict. XTEK continues to field enquiries from the countries in Europe who are responding to the increased threats in the region by increasing capability.

Data from the European Defence Agency indicates a gap in EU defence expenditure in the last 10 years which has only recently recovered (Figure 5).

Figure 5: Total Defence Expenditure and Investment by Member States of the European Defence Agency



Source: European Defence Agency

More broadly, Russia's assault on Ukraine has provided a wakeup call for countries worldwide, which will drive reassessments of defence capabilities and subsequent investments in defence equipment. In Australia, the Labor government has reiterated the $270bn defence spending target over the next decade, which includes a focus on building sovereign capability. We expect XTEK to benefit from this focus, supported by its relationships that senior management and board members have in the ADF. Across the board and management there are four army veterans and a former defence minister, Christopher Pyne. The new Chairman Mark Stevens was in the same Duntroon class as Angus Campbell – Chief of Defence since 2018, and CEO Scott Basham was a Duntroon graduate of 1992 with strong on-going connections in Defence.

Earnings Changes

We have revised our earnings forecasts to incorporate the announced orders since we last published. Our FY23 revenue forecast of A$72m is based on contracted revenue of A$37m leaving A$35m of sales to be realised. XTEK is already pursuing more than A$40m of potential sales. It is obviously difficult to forecast revenue given that in the last three months, XTEK has generated sales of A$70m and it is difficult to assess the sustainability of sales of that magnitude.

Given the magnitude of these new orders, our earnings changes are large with revenue increases of between 38 and 136%. With stronger forecast margins in FY22 and FY23, and only small increases in our overhead assumptions, EBITDA for FY22 is ~8x our previous forecast – mostly the result of the most recent ballistics order for A$46.8m.

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Figure 6: Earnings Changes

	Revenue (A$m)			Gross Profit (A$m)			EBITDA (A$m)			Underlying NPAT (A$m)			EPS (cps)			DPS (cps)		
	Current	Previous	% Chg	Current	Previous	% Chg	Current	Previous	% Chg	Current	Previous	% Chg	Current	Previous	% Chg	Current	Previous	% Chg
FY22E	63	27	136.3%	26	13	103.7%	16	2	598.0%	10	1	1772.6%	10	1	1772.6%	0.0	0.0	nm
FY23E	72	31	128.9%	29	16	85.3%	21	8	157.8%	15	5	190.2%	15	5	190.2%	2.9	2.0	45.1%
FY24E	48	35	37.6%	18	17	4.5%	9	9	6.4%	6	6	7.4%	6	5	7.4%	3.0	2.2	34.2%
PRICE TARGET	0.67	0.52	27.7%															

Source: MST Access

For the Technology division, we have also updated our tender tracker slightly to reflect our current assumptions around likelihood of award.

Figure 7: Tenders Tracker Summary

Future Tenders	Assumed Delivery	Opportunity (A$m)	Status/ Notes	Award Probability	Expected Value
UAVs					
NZDF - long-range small UAVs	FY23	5-10	Sole source tenderer	80%	**6.0**
ADF - long-range small UAVs	FY23	5-10	Shortlisted	50%	**3.8**
UGVS					
ADF - replacement of EOD UGVs	FY23	25-50	Shortlisted	50%	**18.8**
ADF - Combined ballistics + UGVs	FY24	20+		15%	**3.0**

Source: MST Access

Valuation Summary

Given the strength of earnings now expected in FY22 and FY23, we have changed our valuation methodology to not overweight the earnings in these years. The cash contribution as a result of these orders is captured in forecast cash on the balance sheet at 30 June 2024.

We now value the company as at 30 June 2023 using a NTM EV/EBITDA multiple based off FY24 EBITDA, and then discount back at a 12% WACC to determine the current valuation (30 June 2022). This earnings capitalisation multiple is based off the median NTM EV/EBITDA multiple of the ASX 300, discounted at 30% to account for XTEK's scale and the inherent risks to our forecasts. This gives us a valuation of A$0.67 per share, 59% upside to the current share price.

Figure 8: Valuation Summary

XTEK valuation					
Market Multiple NTM EV/EBITDA	x	8.9	Net Debt (cash) at 30 Jun-23	A$m	-12.9
Discount	%	30%	Equity Value	A$m	64.3
Multiple applicable to XTEK	**x**	**6.2**	Diluted Shares on Issue	m	100.6
FY24 EBITDA	A$m	9.3	Dividends Paid	cps	2.9
Enterprise Value at 30 Jun-23	**A$m**	**58.1**	**Equity Value per share**	**A$**	**0.67**
WACC	%	12%	Current share price	A$	0.42
Current Enterprise Value	**A$m**	**51.4**	Valuation Premium	%	59%

Source: MST Access

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Investment thesis

Key revenue drivers for XTEK come from the sale of body armour and helmets to defence and law enforcement - primarily in the US and Australia - with the war in Ukraine creating short-term demand. Additionally, revenue growth will also come from the sale of third-party unmanned ground and aerial vehicles to Australian Defence.

Additional drivers of value for the Group are the restructure and strategic refocus undertaken by the current CEO, and the growth in HighCom sales and margins from leveraging its channel to deliver XTclave based products. XTclave characteristics provide competitively priced lighter weight body armour and more complex shapes give it particularly important advantages in female body armour and helmets.

Global geopolitical trends in the Asia-Pacific and in Europe have given cause for reassessment of defence spending in XTEK's key markets of the US and Australia. The war in Ukraine has likely catalysed the decisions to increase long term spending on defence. As recent sales have shown, this war has created demand for high quality personal protective equipment allowing HighCom to deliver to customers outside its usual sales geographies.

Over the last five years we have seen a steady and consistent shift in Australian Defence attitudes about procurement. This will increase the support for Australian manufacturing and services in the delivery of Defence contracts. We expect that will support demand for XTEK's supply of unmanned ground and aerial vehicles and their on-going maintenance. XTEK's strong history as a value-added reseller and support provider to Defence will underpin its growth.

XTEK completed the commissioning of its XTclave manufacturing plant in Adelaide in April 2021. Using the pilot plant, XTEK completed its first major order of $2m to Finland in 2020. While able to offer competitively priced lightweight body armour, its ability to deliver high strength complex profile products make it ideal for female body armour and helmets. Particular configurations allow it to meet the US based standard, III++, with product development underway targeting Level IV protection, as well as other configurations at Level III+.

Near term orders slated for urgent delivery from customers outside its usual US and Australian geographies have supported strong FY22 growth.

Even without the benefit of the additional direct orders, we expected recovery in HighCom gross margins from the COVID-19 affected 25% in FY20 to a closing run rate of 33% in FY22 and a similar margin for all of FY23. The strong margins from these direct urgent orders over the past three months has mean that forecast margins for FY22 and FY23 are 43% and 46% respectively. Longer term margin growth in HighCom is likely to come as a result of an increase in direct and reseller sales with private label sales showing much more limited growth. We expect that this will be enabled through the provision of higher volumes of products based on the proprietary XTclave technology.

Local sales of unmanned vehicles in Australia to Defence will arise as XTEK wins supply contracts. It is currently bidding on c.$50m of contracts expected to be awarded over the next 2 years.

Key to the Group's improved profitability has been the new CEO's implementation of a strategic plan that has delivered much sharper focus on business segments and a reduction in overheads of an estimated $3m pa with 2H FY22 seeing much of that benefit.

Risks

- The very large orders achieved by XTEK in recent weeks makes forecasting revenue in coming years particularly difficult. There is a risk that a cessation of the conflict in Ukraine results in sharper falls to revenue that what we have forecast.
- The key risk to our forecasts is that the characteristics of the XTclave product (strength, weight, thickness, cost) are insufficient to provide the level of competitive advantage that make it meaningfully attractive to customers.
- New iterations of XTclave products are required to meet NIJ certification to ensure acceptance of the products by large parts of the market. Failure to do so will significantly reduce its potential market, and may result in sales being too low to justify the current share price.

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- A key risk to our forecasts is that the characteristics of XTclave proposed products are matched by competing products. Development of lightweight products based on UHMWPE is forecast to be the fastest growing segment of body armour with significant funds being invested in the development of products lighter, thinner products that can be delivered at lower price points. There is also significant investment in other technologies, including new materials which, if successful, may also affect the relative attractiveness of XTclave products.
- The Technology division relies primarily on winning of tenders with Defence (in Australia). While XTEK has a strong track record of supply and maintenance contracts with Defence, there is no guarantee that it will continue to win tenders or win them at the rate it has in the past.
- While we forecast that XTEK will not need additional capital to reach break-even, the history of the business is that the Company has needed to raise additional capital on a regular basis. Should the company need to raise additional capital, there is a risk that due to market conditions or company specific issues, it may not be able to do so. Should this happen, there is significant risk to the value of shareholders investment in this Company.
- There is a risk that the substantial surplus cash on the balance sheet is applied to value destructive acquisition or organic growth based expenditure. This would result in a reduction in our valuation (given we include the value of that cash in our valuation) and a marking down of the market's perception of board and management.

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