

19 October 2023

Move to Ohio targets US contracts

NEED TO KNOW

- XTEK is targeting US Defence contracts with the moving of its XTclave manufacturing plant from Adelaide to the US, as well as cost savings.
- The Company has also recorded its third small Ballistics protection equipment order in FY24 – all building XTEK’s credibility for potentially larger contracts.
- Numbers for the full year starting to come together with revenue, working capital and cost savings

XTEK’s XTclave-based lightweight helmets and body armour is well positioned for a US Special Ops contract, but products needs to be manufactured in the US. Moving XTclave to the US will help as well as save \$2m pa.

XTEK now has nearly \$10m of Ballistics sales to international customers so far in FY24 following the recent \$1.6m order. Management is confident of further near-term orders which should help with winning some of the larger supply orders in its \$300m pipeline in Ballistics.

These announcements support our FY24 forecasts with the XTclave move to the US saving ~\$2m p.a. (costing \$0.8m in FY24), and the consistent international orders supporting our revenue and working capital forecasts as well as probability of winning larger international ballistics orders.

Investment Thesis

Geopolitical instability is driving strong growth in defence budgets
Countries are adding defence personnel and refreshing personal ballistics protection. High levels of gun violence in the US create ongoing demand from a wide range of enforcement agencies.

XTEK has proven capability in delivering quality products and service to Australian Defence, US agencies and more recently international customers.

XTclave is XTEK’s proprietary technology that provides lightweight armour and helmets. We expect it will be a significant contributor to value in coming years.

Valuation

Our earnings forecasts increase slightly with revenue growth offset by lower margins in the Technology segment. We estimate a 12-month forward value for XTEK based on capitalising FY25 EBITDA at a discounted market multiple. Our valuation is \$0.73 per share is unchanged with slightly higher earnings offset by a slightly lower market multiple.

Risks

Key risks include an inability to replicate the large international orders that it recorded in 2022, reduction in the contracts it wins with Australian Defence, failure to be able to ramp up cost-effective production of its XTclave based helmets and body armour, increased competition in the US law enforcement market and loss of share and being unable to shift the US sales channel away from white-label sales.

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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/>

Valuation	\$0.73 (unchanged)
Current price	\$0.48
Market cap	\$49m
Cash on hand	\$7m

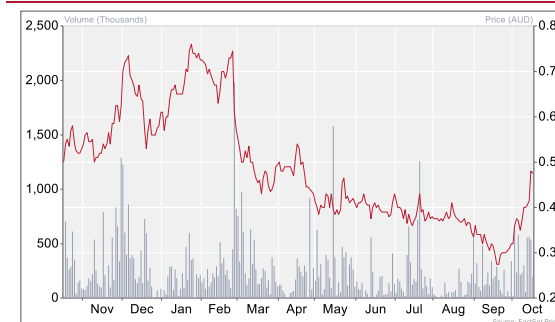
Additional resources

Video Link - Interview with CEO (13 October 2023)

Upcoming Catalysts and Newsflow

International orders Next 6 months
1H FY24 Result Feb 2024

Share Price (A\$)



Source: FactSet, MST Access

XTEK Limited (XTE-AU)

Year End 30 June		FY22A	FY23A	FY24E	FY25E	FY26E	Stock information
Core PE	x	6.1x	7.4x	5.3x	4.7x	4.1x	Share Price (\$)
EV/EBITA*	x	1.5x	4.8x	2.5x	1.9x	1.2x	Market capitalisation (SOI) (\$m)
EV/EBITDA	x	1.2x	4.0x	2.1x	1.6x	1.1x	Valuation (\$)
Div yield	%	0.0%	0.0%	3.9%	0.2%	4.4%	Shares on issue
FCF Yield	%	18.4%	13.9%	19.6%	21.9%	25.2%	Shares on issue (diluted) (m)

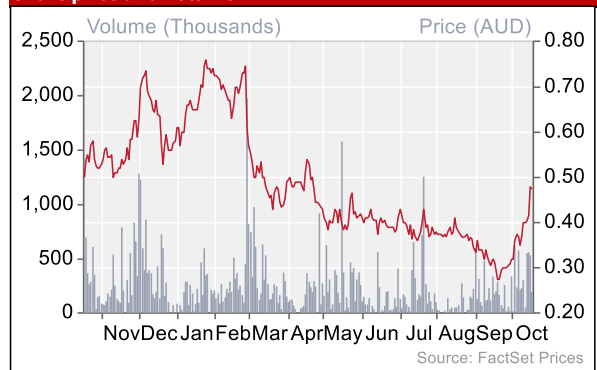
Profit & Loss Statement	\$m	FY22A	FY23A	FY24E	FY25E	FY26E	1H FY20	1H FY21	1H FY22	2H FY22	1H FY23	2H FY23E
Revenue		58.1	89.4	90.5	98.8	106.2	12.4	15.9	11.5	46.6	48.5	40.9
Change pcp	%	105.1%	53.9%	1.2%	9.2%	7.5%	-23%	-40%	-7%	192%	321%	-12%
Gross Profit		27.4	33.7	35.3	38.7	41.8	3.2	4.9	3.1	24.3	24.6	9.1
Gross margin	%	47.2%	37.7%	39.0%	39.1%	39.4%	26%	31%	27%	52%	51%	22%
Overheads		-18.4	-22.8	-20.6	-22.5	-23.6						
EBITDA		9.0	10.9	15.1	16.5	18.6						
EBITDA margin	%	15.5%	12.2%	16.7%	16.7%	17.5%						
D&A		-1.7	-1.9	-1.9	-1.9	-1.9						
Net interest expense		-0.2	-0.1	-0.2	-0.2	-0.2						
Tax and adjustments		1.1	-2.0	-3.4	-3.6	-4.0						
NPAT (underlying)		8.2	6.9	9.7	10.9	12.5						
Significant, discontinued et.al		-2.5	-0.8	-0.6	0.0	0.0						
NPAT (reported)		5.7	6.1	9.1	10.9	12.5						

Performance ratios		FY23A	FY24E	FY25E	FY26E
ROE (%)		14.5%	19.8%	19.1%	18.5%
ROIC (%)		19.4%	23.4%	24.1%	22.3%
Interest cover (EBITDA)		nm	nm	nm	nm
Capex/Depreciation		106%	164%	164%	100%
Days Working Capital		63	35	55	65

Per Share Data		FY22A	FY23A	FY24E	FY25E	FY26E	Segments	FY23A	FY24E	FY25E	FY26E
Ave. diluted shares outstanding	m	101	102	102	102	102	Revenue				
Underlying EPS	cps	8.2	6.8	9.5	10.6	12.3	Ballistics	52.7	65.8	70.8	76.2
growth pcp	%	-242%	-17%	40%	12%	15%	Technology	36.7	24.7	28.0	30.0
Reported EPS	cps	5.7	6.0	8.9	10.6	12.3	Group Revenue	89.4	90.5	98.8	106.2
growth pcp	%	-199%	5%	49%	19%	15%	Gross Profit #				
DPS	cps	0.0	0.0	0.0	2.1	2.5	Ballistics	26.4	29.6	31.9	34.3
Payout (on underlying)	%	0%	0%	0%	20%	20%	Technology	7.3	5.7	6.8	7.5
							Group Gross Profit	33.7	35.3	38.7	41.8
							Gross Margin #				
							Ballistics	50.0%	45.0%	45.0%	45.0%
							Technology	20.0%	23.1%	24.3%	25.0%
							Group Gross Margin	37.7%	39.0%	39.1%	39.4%

Balance sheet	\$m	FY22A	FY23A	FY24E	FY25E	FY26E
Cash & Deposits		36.2	6.9	17.9	23.3	30.7
Receivables		10.6	24.7	25.0	27.3	29.3
Inventory		16.4	25.7	21.2	26.4	30.0
PP&E (incl. ROUA)		12.2	11.2	12.2	13.2	13.2
Intangibles		1.7	3.2	3.2	3.2	3.2
Other Assets		1.3	4.5	0.0	0.0	0.0
Total Assets		78.5	76.1	79.4	93.3	106.4
Payables		7.0	31.4	31.1	34.0	36.4
Borrowings (incl. lease liabilities)		3.5	1.6	1.6	1.6	1.6
Provisions/ other (incl. lease liabilities)		33.2	1.0	0.9	0.9	0.9
Total Liabilities		43.7	34.0	33.6	36.4	38.8
Shareholders' Funds		34.8	42.1	45.8	56.9	67.6
Net Debt		-32.7	-5.3	-16.4	-21.8	-29.1

Cashflow statement	\$m	FY22A	FY23A	FY24E	FY25E	FY26E
EBITDA		9.0	10.9	15.1	16.5	18.6
Net interest		-0.2	0.0	-0.2	-0.2	-0.2
Tax paid		1.1	-2.8	-3.4	-3.6	-4.0
Working capital movements		17.1	-34.3	4.0	-4.7	-3.3
Other/ Prepayments		-1.1	0.0	0.0	0.0	0.0
Operating CF		26.0	-26.3	15.5	8.1	11.1
Capital expenditure		-1.9	-1.7	-2.6	-2.6	-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		0.0	0.0	0.0	0.0	0.0
Investing CF		-1.9	-1.6	-2.6	-2.6	-1.6
Net borrow + princ. lease payments		-1.2	-2.0	0.0	0.0	0.0
Dividends paid		0.0	0.0	-2.0	-0.1	-2.2
New share issues		7.0	0.0	0.0	0.0	0.0
Financing CF		5.8	-2.0	-2.0	-0.1	-2.2
Effect of FX Rate Changes on Cash		0.4	0.6	0.0	0.0	0.0
Net change in cash		30.3	-29.3	11.0	5.4	7.4

Share price and volume

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.

Becoming a US manufacturer

XTclave off to the US

XTEK announced last week that it was shifting the manufacture of its proprietary XTclave helmet and body armour substrate, and its R&D function from Adelaide to Columbus, Ohio. There would appear to be two reasons for doing so:

- XTEK (through its subsidiary, HighCom) is bidding for part of the contract supply equipment to the US Special Ops forces under the project name SPEARS - Special Operations Forces Equipment Advanced Requirement). The ability to provide lightweight options with the same level of protection is seen as a critical competitive advantage. The US Department of Defence has stringent "Made in the USA" requirements requiring local production of the XTclave products.
- XTEK expects to save \$2m pa from co-locating the XTclave plant with the HighCom business. It expects that the cost of local redundancies and moving the plant to the US to cost \$0.8m and be completed by the end of 3Q FY24.

Of the total pipeline of \$300m, management estimate that the features offered with the use of XTclave technology will be an important characteristic in at least half of this pipeline.

Smallish international orders keep on rolling in

Since the start of FY24, XTEK has been awarded nearly \$10m of orders from international customers for its ballistics protection. Customers for each of the 4 orders are undisclosed but the \$1.6m order on 18 October was from the same customers as the 17 July order.

- 17 July - \$2.6m
- 23 Sep - \$3.2m
- 12 Oct - \$2.2m
- 18 Oct - \$1.6m
- TOTAL \$9.6m (since 30 June 2023)

Annualising sales in the first 3 months implies FY24e orders in the Ballistics segment of \$29m, against MSTe of FY24 revenue in the Ballistics segment of \$66m. We expect \$2 – 3m / month of regular sales from XTEK's HighCom business to US law enforcement agencies which would take FY24e Ballistics revenue to \$53 - 65m. Allowing for one or more large international orders in this segment would see XTEK achieve or exceed our forecast.

Name change and growth objectives

Consistent with where management see the future drivers of value within the Group, XTEK will be renamed to HighCom with the ASX code changing to HCL.AX. Almost all of the Ballistics segment revenue comes from XTEK's US subsidiary, HighCom. While the Technology segment is enjoying some medium term growth opportunities, management sees the longer growth opportunities linked to Ballistics protection. There is a large global market for these products as evidenced by the \$300m order pipeline which supports XTEK's goal to triple revenue over the next few years but which will require acquisition(s).

Nearly \$10m of international orders this fiscal year

XTEK to become HighCom

Forecasts, valuation and risks

Guidance

XTEK FY24 guidance is limited to, "... maintaining continued revenue growth and profitability in FY24." This compares with MSTe FY24 revenue and EBITDA growth of 5.5% and 53% respectively.

Forecast revenue

Ballistics

Annualising sales in the first 3 months implies FY24e orders in the Ballistics segment of \$29m, against MSTe of FY24 revenue in the Ballistics segment of \$66m. We expect \$2 – 3m / month of regular sales from XTEK's HighCom business to US law enforcement agencies which would take FY24e Ballistics revenue to \$53 - 65m. Allowing for one or more large international orders (that are delivered this year) in excess of \$13m this segment would see XTEK achieve or exceed our forecast.

Management continue to guide to a weighted pipeline of \$300m.

Technology

We are forecasting revenue of \$28.5m from this segment. Existing O&M contracts are expected to deliver ~\$10m in FY24 (\$7.5m for 9 months of the \$10m pa recent Drone support contract, and \$2.5m for maintenance of the WASP drone contract). We are expecting a further ~\$19m from additional hardware orders to be delivered this year. Given that it took more than 6 months to deliver \$26m of

drone orders last year, we expect that we would need to see a drone hardware order by early in 3Q FY24 for XTEK to achieve our forecast for this segment. This is against a \$75m pipeline consisting of drone hardware from the existing supplier (AeroVironment, Inc.) for Australian Defence. Note that we estimate that there could be an additional \$250m of support revenue for these drones over the 10 years following their supply to Australian Defence.

Technology segment
focussed on SUAS product

Management has sharpened the strategy in the Technology division which is focussed on the delivery of small unmanned aerial systems (SUAS) from AeroVironment, Inc (AVAV-US) to Australian Defence. The most recent SUAS order included two different sized drones.

Figure 1: Puma



Source: AeroVironment, Inc

Figure 2: Puma LE



Source: AeroVironment, Inc

Gross margins

XTEK does not break out margins for each of its operating segments. We estimate that Ballistics will have 45% gross margins in FY24 but that international sales have 10% sales commission which is recorded in the Overheads. We estimate that the Technology segment will generate 23% gross margins in FY23 with hardware sales generating 15% gross margins, and support (and parts) generating 35% gross margins (slightly lower than previously forecast).

Overheads

Our overheads include 1 quarter of lower overheads arising from moving the XTclave manufacturing (and R&D) to Columbus, Ohio. We assume that ~\$1.5m of the stated \$2.0m cost savings are retained in FY25 with other cost increases subsuming part of the savings. The estimated \$0.8m cost of this move is treated as a one-off.

Overhead saving from
shifting XTclave to Ohio

Figure 1: Changes to forecasts

A\$m	Previous			Current			Change		
	FY24e	FY25e	FY26e	FY24e	FY25e	FY26e	FY24e	FY25e	FY26e
Revenue	90.5	94.1	101.5	90.5	98.8	106.2	0%	5%	5%
Ballistics	65.8	70.8		65.8	70.8	76.2	0%	0%	nm
Technology	24.7	23.3		24.7	28.0	30.0	0%	20%	nm
Gross Profit	37.8	39.6	40.0	35.3	38.7	41.8	-7%	-2%	4%
EBITDA	15.4	16.2	18.2	15.1	16.5	18.6	-2%	2%	2%
Underlying NPAT	10.4	10.8	12.4	9.7	10.9	12.5	-7%	0%	1%
EPS	10.2	10.6	12.1	9.5	10.6	12.3	-7%	0%	1%

Source: MST Access

Valuation

We estimate a 12-month forward valuation based on capitalising forward earnings (EBITDA) using a discounted S&P ASX Small Ords multiple. For simplicity, we use FY25 forecasts and market multiple.

Our valuation remains unchanged at \$0.73 per share; the slight uplift in earnings is offset by a slight decline the market multiple. In determining the valuation, we have used the cash on the balance sheet at 30 June 2023. If management are able to sustainably reduce working capital by \$10m (inventory), then our valuation would increase by \$0.10.

Valuation unchanged at
\$0.73

Figure 4: Valuation summary

Market Multiple FY25 EV/EBITDA	x	8.5	Net Debt (cash) at 30 Jun-23	A\$m	-5.3
Discount	%	50%	Equity Value	A\$m	74.1
Multiple applicable to XTEK	x	4.3	Diluted Shares on Issue	m	101.9
Weighted FY24 / FY25 EBITDA	A\$m	16.2	Equity Value per share	A\$	0.73
Enterprise Value at 30 Jun-23	A\$m	68.8	<i>... premium to current share price</i>		<i>143%</i>

Source: MST Access, FactSet

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 in other countries. The war in Ukraine created short-term demand for these products that has allowed XTEK the opportunity to build global delivery credibility. Additionally, revenue growth will also come from the sale of third-party unmanned aerial vehicles to Australian Defence from its exclusive supply agreement with AeroVironment, Inc.

Longer term underlying margin growth in the Ballistics division 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 supported through the provision of higher volumes of products based on the proprietary XTclave technology.

Additional drivers of value for the Group are the restructure and strategic refocus undertaken by the current CEO, and the growth in the Ballistics division (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 unmanned ground and aerial vehicles and their on-going maintenance through its Technology division. XTEK's strong history as a value-added reseller and support provider to Defence will underpin the growth in this division.

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+.

Longer term, XTEK is targeting revenue of \$300m within the next few years to be achieved through acquisition, as well as organic growth of both Ballistics and Technology businesses. Longer term growth is expected to be in the Ballistics segment.

Risks

- Revenues have grown rapidly on the back of large orders. There is a risk that the company is unable to continue to leverage the credibility that delivery of these orders has given them, and revenue declines.
- 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.
- A 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.

Benefits of XTclave in future years

Geopolitical instability drives global demand for ballistics protection

Growth through acquisition over the next few years

- 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 ultra-high-molecular-weight polyethylene (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.

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