

23 May 2018

# Ellex Medical Lasers Limited (ELX) HOLD Share Price: \$0.66

**Slow ramp up for iTrack**

**Target Price: A\$0.71**

iTrack revenue growth on a quarterly basis has been slower than anticipated, despite a relatively superior product in terms of clinical data and reimbursement. As a result, we have reduced our forecasts and moved our recommendation to Hold. While we still see strong potential upside from iTrack over the medium term, execution risk is considerably larger than we anticipated. We will continue to monitor sales numbers and will revisit our assumptions once the business delivers consistent sequential growth.

## MIGS opportunity remains but execution risk is large

- The MIGS market remains a significant opportunity over the medium term.
- In term of Glaucoma treatment spend, MIGS is expected to increase from ~5% (US\$263) in 2017 to ~27% (US\$1.4bn) by 2022.
- Within this market, Ellex's iTrack product boasts the best clinical data and highest reimbursement rate, resulting in a product, which offers the best outcomes to both patients and doctors.
- However, despite these advantages, penetration of iTrack has been disappointing.

## iTrack performance disappointing

- iTrack sales have been consistently ~US\$2m on a quarterly basis since 4Q17, below our expectations.
- With new products entering the MIGS market in the US, competition for sales reps has been intense, which has negatively impacted growth.
- Between August 2017 and March 2018 the iTrack sales team only increased from 12 reps to 14 reps.

## Forecast Changes

- We have reduced our FY18F iTrack revenue forecast from A\$16.0m to A\$11.0m and our FY19F revenue forecast from A\$28.0m to A\$13.2m.
- In addition, we have reduced our long term assumed growth rate to 20% yoy, in-line with 3Q18.

## Valuation and Recommendation

- We have reduced our EBITDA estimates in FY18F to -A\$1.3m (A\$3.3m previously) and in FY19F to A\$2.8m (from A\$9.0m).
- Incorporating this downgrade into our DCF valuation generates a target price of A\$0.71.
- We reduce our recommendation to Hold from Buy.
- Once iTrack delivers consistently strong sequential sales growth, we will revisit our assumptions.

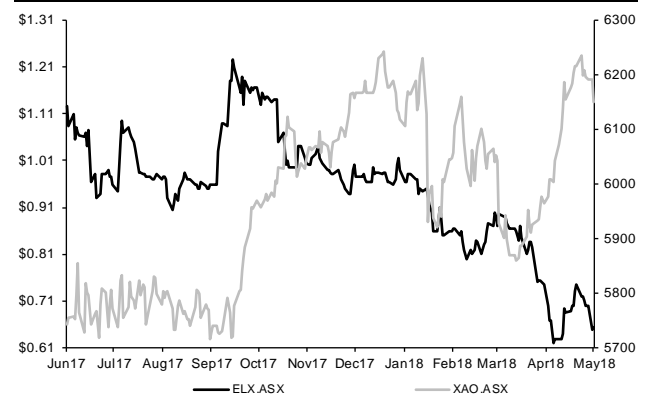
## Company Data

Shares – ordinary (M)	143.6
Dilution (M)	0.0
Total (fully diluted) (M)	143.6
Market capitalisation (\$M)	93.3
12 month low/high (\$)	0.61/ 1.25
Avg monthly turnover (\$M)	3.4
Index	All Ords
GICS Industry	Health Care Equipment & Supplies

## Financial Summary (fully diluted/normalised)

Year end June	2015A	2016A	2017A	2018F	2019F
Revenue (\$M)	62.7	72.9	71.6	76.9	81.3
Costs (\$M)	57.3	65.1	70.1	78.2	78.5
EBITDA (\$M)	5.4	7.8	1.6	-1.3	2.8
NPAT (\$M)	1.7	3.0	-0.9	-3.2	-0.3
EPS (¢ps)	1.6	2.8	-0.8	-2.4	-0.2
EPS Growth (%)	113%	78%	n/m	n/m	n/m
PER (x)	75.0	42.2	n/m	n/m	n/m
Free Cashflow (\$M)	2.1	0.9	-7.9	-8.4	-4.4
FCFPS (¢ps)	1.4	0.7	-5.5	-5.8	-3.1
PFCFPS (x)	45.3	100.4	-11.8	-11.2	-21.5
Enterprise Value (\$M)	96.2	94.9	100.4	86.4	90.8
EV / EBITDA (x)	17.9	12.1	63.6	-66.5	32.5
Payout ratio (%)	n/m	n/m	n/m	n/m	n/m
Dividends (¢ps)	n/m	n/m	n/m	n/m	n/m
Yield (%)	n/m	n/m	n/m	n/m	n/m
Franking (%)	n/a	n/a	n/a	n/a	n/a

## ELX – performance over one year



## Disclosure and Disclaimer

This report must be read with the disclosure and disclaimer on the final page of this document.

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## Analysis

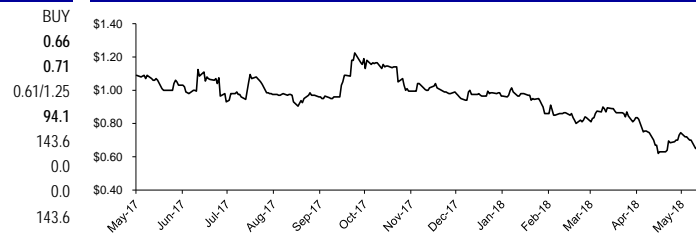
### Ellex Medical Lasers

Year end 30 June

#### MARKET DATA

Recommendation		BUY
Price	\$	0.66
Target price (12-month)	\$	0.71
52 week low / high	\$	0.61/1.25
Market capitalisation	\$m	94.1
Shares on issue (basic)	no.	143.6
Options / rights	no.	0.0
Other equity	no.	0.0
Shares on issue (diluted)	no.	143.6

#### 12-MONTH SHARE PRICE PERFORMANCE



#### INVESTMENT FUNDAMENTALS

	FY16A	FY17A	FY18F	FY19F	FY20F
Reported NPAT	\$m 3.0	(0.9)	(3.2)	(0.3)	1.5
NPAT normalised	\$m 3.0	(0.9)	(3.2)	(0.3)	1.5
Reported EPS (undiluted)	¢ 2.8	(0.8)	(2.4)	(0.2)	1.1
EPS normalised (undiluted)	¢ 2.8	(0.8)	(2.4)	(0.2)	1.1
... Growth	% 78%	(127%)	217%	-91%	-615%
PER normalised	x 23.6	(86.2)	(27.1)	(316.9)	61.5
Operating cash flow per share	¢ 3.6	(2.4)	(1.0)	2.0	3.2
Free cash flow per share	¢ 0.7	(5.5)	(5.8)	(3.1)	(1.1)
Price to free cash flow per share	x 100.4	(11.8)	(11.2)	(21.5)	(60.5)
FCF yield	% 1.0	(8.4)	(8.9)	(4.7)	(1.7)
Dividend	¢ 0.0	0.0	0.0	0.0	1.0
Payout	% 0.0	0.0	0.0	0.0	93.9
Yield	% 0.0	0.0	0.0	0.0	1.5
Franking	% n/a	n/a	n/a	n/a	n/a
Enterprise value	\$m 94.9	100.4	86.4	90.8	92.4
EV/EBITDA	x 12.1	63.6	(66.5)	32.5	17.1
EV/EBIT	x 20.2	(61.9)	(19.6)	(280.4)	40.4
Price to book (NAV)	x 1.9	2.3	1.6	1.6	1.6
Price to NTA	x 1.4	1.6	1.4	1.1	1.1

#### KEY RATIOS

	FY16A	FY17A	FY18F	FY19F	FY20F
EBITDA margin	% 10.7	2.2	(1.7)	3.4	6.3
EBIT margin	% 6.4	(2.3)	(5.7)	(0.4)	2.7
NPAT margin	% 4.2	(1.2)	(4.1)	(0.4)	1.8
ROE	% 6.3	(2.2)	(5.3)	(0.5)	2.5
ROA	% 4.3	(1.4)	(4.4)	(0.3)	1.7
Net debt / (cash)	\$m 0.9	6.4	(7.6)	(3.2)	(1.7)
Interest cover (EBIT / net interest)	x 23.5	(4.8)	(44.2)	(3.2)	22.9
Gearing (net debt / EBITDA)	x 0.1	4.0	n/m	n/m	n/m
Leverage (net debt / (net debt + equity))	x 0.0	0.1	n/m	n/m	n/m

#### DUPONT ANALYSIS

	FY16A	FY17A	FY18F	FY19F	FY20F
Net Profit Margin	% 4.2	(1.2)	(4.1)	(0.4)	1.8
Asset Turnover	x 1.0	1.1	1.1	0.9	0.9
Return on Assets	% 4.3	(1.4)	(4.4)	(0.3)	1.7
Financial Leverage	x 1.5	1.6	1.2	1.6	1.5
Return on Equity	% 6.3	(2.2)	(5.3)	(0.5)	2.5

#### GROWTH PROFILE

	FY16A	FY17A	FY18F	FY19F	FY20F
Operating revenue	% 16.3	(1.8)	7.3	5.7	5.6
EBITDA	% 46.0	(79.9)	(182.3)	(314.7)	93.5
EBIT	% 65.4	(134.6)	172.0	(92.7)	(805.3)
Operating NPAT	% 80.2	(129.5)	253.5	(90.6)	(615.4)
Normalised EPS	% 77.7	(127.4)	217.5	(91.4)	(615.4)

#### PROFIT AND LOSS (PRO FORMA)

	FY16A	FY17A	FY18F	FY19F	FY20F
Total revenue	\$m 72.9	71.6	76.9	81.3	85.9
EBITDA	\$m 7.8	1.6	(1.3)	2.8	5.4
Depreciation & amortisation	\$m (3.1)	(3.1)	(3.1)	(3.1)	(3.1)
EBIT	\$m 4.7	(1.6)	(4.4)	(0.3)	2.3
Net interest	\$m (0.2)	(0.3)	(0.1)	(0.1)	(0.1)
Non-operating income	\$m 0.0	0.0	0.0	1.0	2.0
Pretax Profit	\$m 4.2	(2.0)	(4.5)	(0.4)	2.2
Tax expense	\$m (1.2)	1.1	1.4	0.1	(0.7)
Minorities	\$m 0.0	0.0	0.0	1.0	2.0
Operating NPAT	\$m 3.0	(0.9)	(3.2)	(0.3)	1.5
Significant items	\$m 0.0	0.0	0.0	1.0	2.0
Reported NPAT	\$m 3.0	(0.9)	(3.2)	(0.3)	1.5

#### BALANCE SHEET

	FY16A	FY17A	FY18F	FY19F	FY20F
Cash	\$m 4.6	4.6	5.8	19.8	15.4
Receivables	\$m 15.7	15.4	12.3	13.0	13.7
Inventory	\$m 19.2	23.9	14.9	14.9	15.3
Other	\$m 1.5	0.9	1.0	1.0	1.0
Current	\$m 41.1	44.8	34.0	48.7	45.4
Prop, plant & equip	\$m 7.8	13.5	21.7	29.1	30.3
Intangibles	\$m 3.9	4.4	4.7	5.0	5.2
Other	\$m 18.2	2.4	11.8	9.3	10.5
Non current	\$m 29.9	20.2	38.1	43.3	46.0
Total assets	\$m 71.0	65.0	72.1	92.0	91.4
Accounts Payable	\$m 11.6	10.9	11.2	11.8	12.5
Borrowings	\$m 5.5	0.0	0.0	0.0	0.0
Other	\$m 4.0	0.0	4.9	8.8	8.8
Total liabilities	\$m 21.0	10.9	16.1	20.6	21.3
Shareholder's equity	\$m 48.3	40.1	59.3	59.0	60.5

#### CASH FLOW

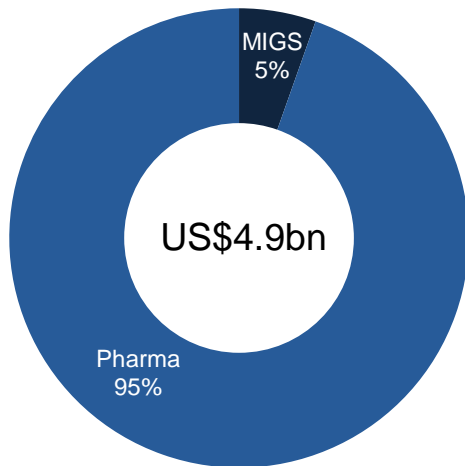
	FY16A	FY17A	FY18F	FY19F	FY20F
EBITDA	\$m 7.8	1.6	(1.3)	2.8	5.4
Change in provisions	\$m 0.0	0.0	0.0	1.0	2.0
Change in working capital	\$m 3.8	0.0	0.0	0.0	0.0
Net interest	\$m (0.2)	(0.3)	(0.1)	(0.1)	(0.1)
Tax paid	\$m (1.2)	(0.0)	0.0	0.1	(0.7)
Other	\$m 0.0	2.3	0.0	0.0	0.0
Operating cash flow	\$m 5.2	(3.5)	(1.4)	2.8	4.6
Capex	\$m (4.3)	(4.4)	(7.0)	(7.2)	(6.2)
Acquisitions	\$m (4.4)	(7.4)	0.0	0.0	0.0
Disposals	\$m 0.0	0.0	0.0	0.0	0.0
Investing cash flow	\$m (8.7)	(11.9)	(7.0)	(7.2)	(6.2)
Equity	\$m 4.7	9.8	22.4	0.0	0.0
Increase / (decrease) in borrowings	\$m 1.5	6.7	0.0	0.0	0.0
Dividend/other	\$m 0.0	0.0	0.0	0.0	0.0
Financing cash flow	\$m 6.2	16.6	22.4	0.0	0.0
Free cash flow	\$m 0.9	(7.9)	(8.4)	(4.4)	(1.6)

Source: Petra Capital

## Market opportunity is significant

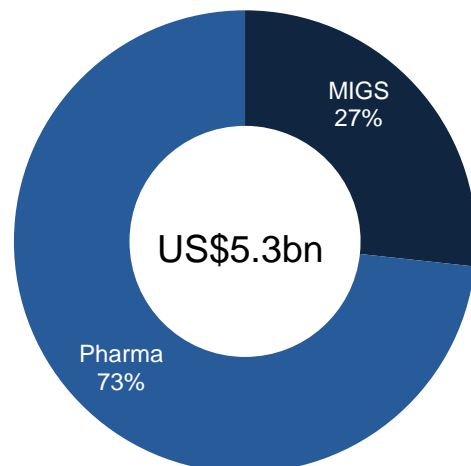
The market for Minimally Invasive Glaucoma Surgery (MIGS) remains, in our view, an extremely attractive market, as the device suite takes share from ineffective and expensive pharmaceutical treatments (eye drops). This structural shift in treatment options is expected to increase the MIGS market from ~5% of the total Glaucoma treatment market to 27% in 2022 (Figure 1 and Figure 2).

**Figure 1: Treatment for Glaucoma split 2017**



Source: Company Presentations and MarketScope

**Figure 2: Estimated treatment for Glaucoma split 2022**



Source: Presentations and MarketScope

### Drops are clinically sound but patient non-compliance is very high

Prescription Eye Drops, as a first line treatment for glaucoma, are taken one or more times a day in single or multiple medication regimes. This increases aqueous humor outflow and/or decreases its production, which can reduce IOP to baseline targets that can minimise vision loss.

The key short-coming of this treatment is poor patient compliance. Non-compliance is extremely high as the disease progresses slowly with few symptoms so patients do not adhere to the medication regime until there is significant vision loss, with some independent studies indicating that it may be as high as ~75% for single daily medication.

In addition, lifelong dosing requirements, diminishing effectiveness and potential complications with other medications leads to an ineffective course of treatment (15% of eye drop patients will progress to blindness within 20 years of diagnosis).

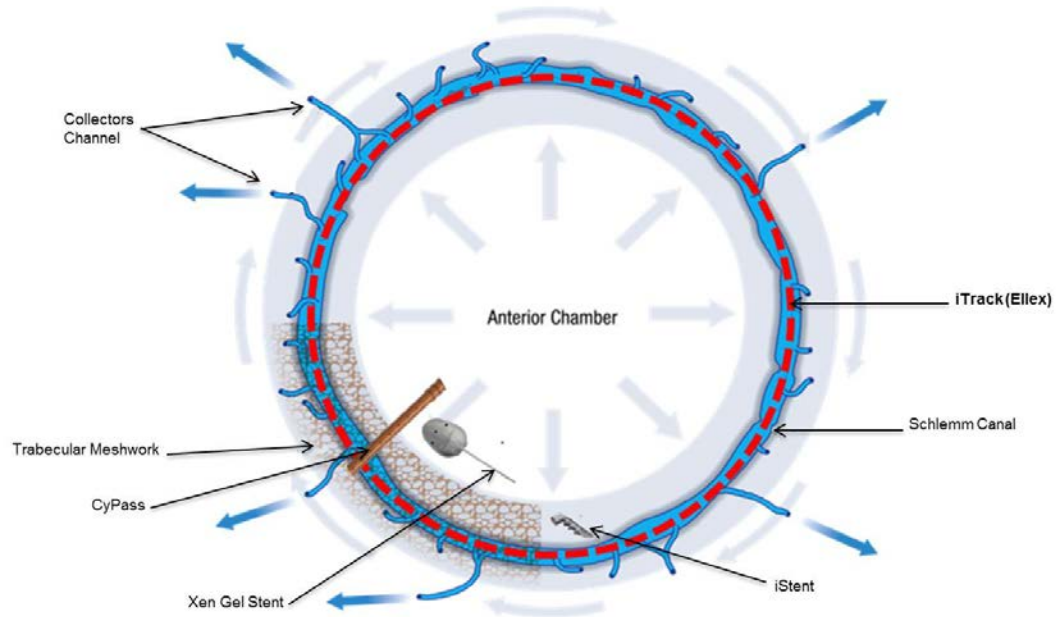
### iTrack appears superior...

The MIGS market is dominated by the Glaukos (NYSE: Market cap US\$1.2bn) iStent at present, with two other products attempting to win market share in addition to Ellex's iTrack (CyPass, owned by Alcon and Xen Gel Stent, owned by Allergan).

Ellex's iTrack is unique amongst the competing MIGS products in that they are all stents which are left behind in the eye. iTrack is an extremely fine (200-micron diameter) catheter that is worked into the eye's drainage canal, passed around 360 degrees of the canal and then withdrawn while at the same time visco-elastic (a bio compatible space enhancing fluid) is injected down the catheter and into the canal. This restores and refreshes the natural pathway of the eye through collector channels, the Trabecular Meshwork and Schlemm's Canal, while leaving nothing behind in the eye.

In Figure 3 the dotted line shows the pathway of the iTrack 360 degrees around the canal. By contrast the iStent, CyPass and Xen Gel Stent, impact on a single point in the drainage system. Neither are in the drainage system, they are peripheral in the space as a reservoir or man-made space to drain fluid from the eye into the neighbouring tissue, similar to a trabeculectomy (surgery).

**Figure 3: MIGS market competitive landscape**



Source: Ellex Medical Lasers

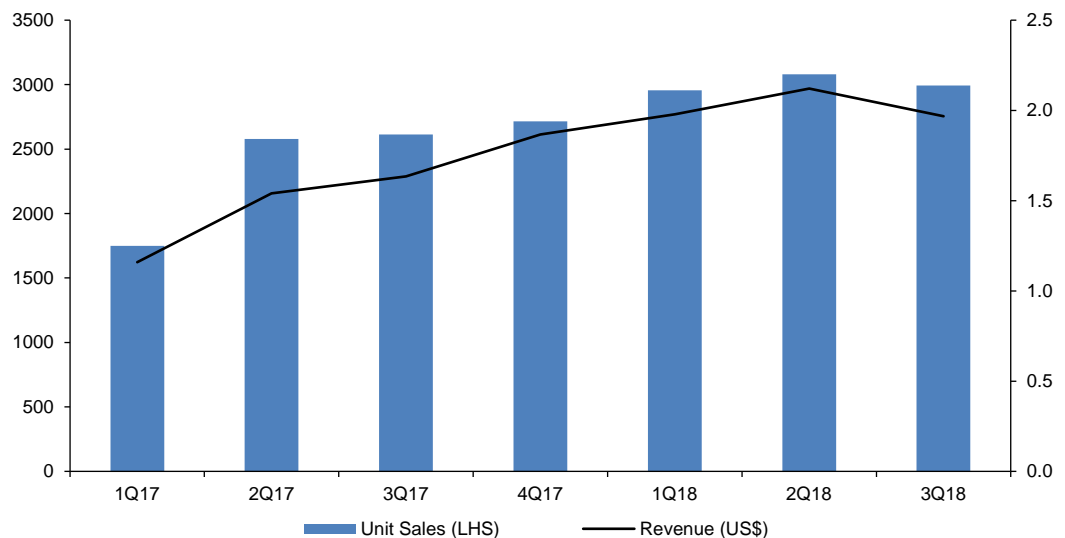
**...however, sales to date have been underwhelming**

There are a number of attractive attributes to the Ellex iTrack product, such as:

- Best clinical data for reduction of pressure within the eye (key measure of Glaucoma)
- Highest reimbursement relative to competing products
- iTrack does not leave anything behind in the eye

Despite the iTrack's more attractive characteristics to patients and doctors, sales performance in recent quarters has been disappointing, particularly on a qoq basis (Figure 4). We understand that this has been driven by intensifying competition in the US for sales reps. In the recent update to the market, Ellex highlighted that it had 14 reps in the US for iTrack, only a slight increase from 12 reps in August 2017.

**Figure 4: iTrack quarterly sales performance**



Source: Company Presentations and Petra Estimates

## Forecasts and Valuation

We have adjusted our forecasts and valuation for Ellex to incorporate recent results and a more cautious outlook for iTrack following four quarters of a broadly flat performance (Figure 5).

The key driver of the downgrade is the reduction in our iTrack sales estimates from A\$16.0m to A\$11.0m in FY18F and from A\$28.0m to A\$13.2m in FY19F. As a result, we have reduced our EBITDA estimates in FY18F to -A\$1.3m (A\$3.3m previously) and in FY19F to A\$2.8m (from A\$9.0m).

**Figure 5: Ellex divisional forecasts (A\$m's)**

	FY18	FY18	FY19	FY19
	OLD	NEW	OLD	NEW
<b>Revenue</b>	<b>81.9</b>	<b>76.9</b>	<b>98.5</b>	<b>81.3</b>
- Core Lasers & Ultrasound	64.9	64.9	67.5	66.2
- iTrack	16.0	11.0	28.0	13.2
- 2RT	1.0	1.0	3.0	1.9
<b>EBITDA</b>	<b>3.3</b>	<b>-1.3</b>	<b>9.0</b>	<b>2.8</b>
- Core Lasers & Ultrasound	9.8	9.8	10.8	10.6
- iTrack	-2.5	-7.1	0.0	-5.0
- 2RT	0.2	0.2	2.5	1.5
- Corporate	-4.2	-4.2	-4.3	-4.3

Source: Petra Estimates

## Reducing recommendation to Hold

Incorporating our revised forecasts into our DCF valuation using a 12% WACC, which we feel is appropriate given the execution risk surrounding iTrack and limited visibility within the core business generates our new target price of A\$0.71 per share. We reduce our recommendation to Hold.

**Figure 6: Ellex DCF Valuation**

Year to June (A\$m)		FY18E	FY19E	FY20E	FY21E	FY22E	FY23E	FY24E	FY25E	FY26E	FY27E
EBIT	[A\$m]	-4.4	-0.3	2.3	5.0	4.9	6.1	8.5	10.8	16.0	21.7
Less Tax on EBIT	[A\$m]	30%	30%	30%	30%	30%	30%	30%	30%	30%	30%
NOPAT	[A\$m]	-4.4	-0.3	1.6	3.5	3.4	4.3	5.9	7.5	11.2	15.2
Plus: D&A	[A\$m]	3.1	3.1	3.1	3.1	3.1	5.5	8.0	12.0	15.0	19.0
Gross Cashflow	[A\$m]	-1.3	2.8	4.7	6.6	6.5	9.8	13.9	19.5	26.2	34.2
Less: Capex	[A\$m]	-7.0	-7.2	-6.2	-7.4	-6.1	-7.0	-8.0	-9.2	-10.6	-12.2
Free Cashflow to Firm	[A\$m]	-8.3	-4.4	-1.5	-0.8	0.4	2.8	5.9	10.3	15.6	22.0
PV of Free Cashflow	[A\$m]	-8.7	-4.1	-1.2	-0.6	0.3	1.7	3.1	4.9	6.6	8.3
Terminal Value	[A\$m]										219.8
NPV of Cashflows	[A\$m]	10.2									
PV of Terminal Value	[A\$m]	82.8									
Enterprise Value	[A\$m]	93.0									
Less: Net debt	[A\$m]	-7.6									
Equity Value	[A\$m]	100.6									
<b>Per Share</b>	<b>[A\$m]</b>	<b>0.71</b>									

Source: Petra Estimates

## Catalysts to increase our optimism

Despite this downgrade, we still see significant upside potential for iTrack over the medium term as it offers both doctors and patients the best clinical and financial outcome in a disruptive high growth segment of an established market.

We will incorporate this potential into our forecasts and valuation once the business delivers consistent, strong sequential growth supported by an expanding distribution team.

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