XAAR

TECHNOLOGY

28 March 2023

XAR.L

180p

Market Cap: £141.2m

SHARE PRICE (p)

12m high/low	273p/145p

Source: LSE Data (priced as at prior close)

KEY DATA

Net (Debt)/Cash	£7.5m *(at 31/12/22)*
Enterprise value	£133.7m
Index/market	LSE
Next news	AGM, May
Shares in Issue (m)	78.4
Chairman	Andrew Herbert
Chief Executive	John Mills
CFO	Ian Tichias

COMPANY DESCRIPTION

Xaar manufactures specialist industrial and commercial digital printheads, used in a variety of applications.

https://www.xaar.com

XAAR IS A RESEARCH CLIENT OF PROGRESSIVE

ANALYSTS

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Strong FY22 – solid footings for future growth

Xaar has delivered a strong FY22, in line with our expectations (or better) at all levels of profitability and with good cash generation. We make no changes to our FY23 revenue and profit estimates; a strong reopening of China could prompt upgrades but is likely to take time, and a general macro caution precludes our taking action at this point. We look forward to further positive developments as the year progresses, notably around the new Aquinox product, and hope to introduce FY24 estimates as global market conditions become more predictable in coming months.

- **FY22 delivered in-line.** The group has delivered FY22 performance in line with expectations. Revenue at £72.8m was materially in line our £73.3m estimate, but adjusted EBITDA of £6.2m was ahead of our £5.6m forecast, with adjusted PBT and EPS similarly strong. Cash of £8.5m at the year-end reflected investment in both inventory and infrastructure during the year.
- **Multiple drivers of performance.** The FY22 outcome, importantly, was the result of a number of different strands of the group's strategy, which combined to deliver a robust performance despite the market backdrop. Notably, Engineered Printing Solutions (EPS) saw a strong result following recent management action and with improved customer engagement. Recent acquisitions FFEI and Megnajet contributed well to the outcome, and both continue to deliver well within the group setting.
- **FY24 estimates.** Given the unusually high levels of macro uncertainty, we have chosen to await further news before publishing FY24 estimates. The reopening of China could deliver a strong boost (first to the later parts of FY23, but more materially to FY24), and the Aquinox product could begin to deliver revenue in that year. Set against this, we face the ongoing war in Ukraine and global macro uncertainty around inflation, interest rates and economic growth. We will therefore await further news on some or all of these factors, and set our FY24 estimates in due course.
- **Multiple positive signs for the future.** In the same way that FY22's result was based on a number of factors, we expect the group's medium-term performance to benefit from several different drivers. In particular, the outlook for the EPS division could continue to improve, the Printhead business could see further market sentiment progress, and the group should continue to benefit from recent and ongoing new product rollouts. We take comfort from today's FY22 result, and look forward to further news across the remainder of FY23.

FYE DEC (£M)	2019	2020	2021	2022	2023E
Revenue	49.4	48.0	59.3	72.8	79.6
Adj EBITDA	-4.9	0.1	3.2	6.2	6.9
Fully Adj PBT	-8.0	-3.9	-0.6	2.8	2.5
Fully Adj Dil EPS (p)	-15.1	-5.2	-0.1	5.0	3.2
EV/Sales (x)	2.7x	2.8x	2.3x	1.8x	1.7x
EV/EBITDA (x)	-27.5x	2156.3x	42.0x	21.6x	19.3x
PER (x)	N/A	N/A	N/A	36.3x	57.0x

Source: Company Information and Progressive Equity Research estimates.

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Please refer to important disclosures at the end of the document.

FY22 results

Divisional overview

Xaar has delivered a good FY22, with Printhead, EPS and the acquired units of FFEI and Megnajet all contributing in different ways to the overall outcome.

The Printhead business delivered a material improvement in gross margin, robust sales despite the macroeconomic headwinds, and planned investment in capacity and capability for future growth. Divisional revenues fell 3% as reported, although outside China the total rose by some 12%, demonstrating both the strength of the non-China business and the importance of that country to the division's performance and the overall group.

EPS has seen its fortunes transformed following a change in management team and a refreshed approach. Both revenue and margins are well ahead of the prior year, and the business returned an EBITDA profit.

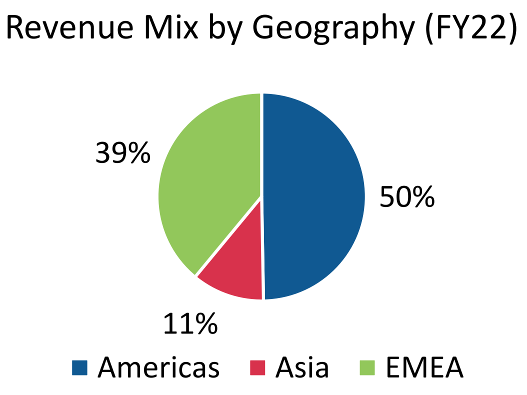
FFEI and Megnajet have both made strong starts to their lives within Xaar, with integration complete and the expanded product offerings delivering value and scale to the enlarged group.

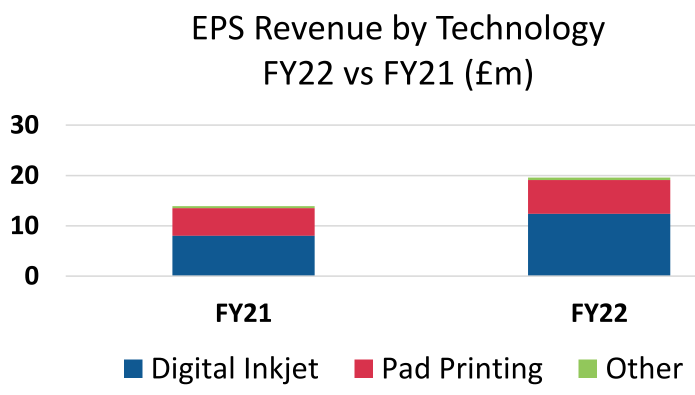
Financial summary

Overall revenue was fractionally below our estimate for FY22, with a reported total of £72.8m against our forecast of £73.3m. The figure represents growth of 23% over the prior year, with 15% being from acquisitions and 8% organic.

The charts below demonstrate the group's recent revenue performance, highlighting two key factors – the much-reduced contribution of Asia-Pacific (especially China) to the group's current performance, and the exceptional delivery being seen within EPS.

Revenue highlights – FY22 by geography and EPS divisional growth





Source: Company information, Progressive Equity Research estimates

Gross margin and EBITDA were both strong; gross margins in both Printhead and EPS moved materially ahead relative to the prior year, although we assume that some of this strong gross margin performance was due to the increase in investment in inventory resulting in absorption of overheads into stock at higher levels. As described below, as the group moved through a non-producing period as the Huntingdon facility was closed in late FY22/early Q1 23, we expect this to have had a negative impact on margins in early FY23 as this effect reverses.

Cash generation during FY22 was good at the operating level, with a £6.6m operating cash flow prior to the significant investment in inventory (some £8.8m), which, along with other items, saw an overall net cash outflow during the year. Nevertheless, the group remains in a strong cash-positive position, with gross cash of £8.5m at the year-end, and a net cash position (including the short-term portion of lease liabilities) of some £7.5m.

FY23 estimates

We leave revenue and profit estimates unchanged for FY23, reflecting the balance between optimism around market recovery, in particular in China, and the natural caution surrounding the overall macroeconomic outlook with the ongoing war in Ukraine and febrile financial markets.

While maintaining estimates, we adopt a more cautious approach to working capital across the course of the year, assuming an increased level of debtor days and higher inventories across the period than we had previously anticipated. This leads to our net cash forecast for end-FY23 (again on the basis of gross cash less short-term lease liabilities) remaining roughly unchanged on the end-2022 position at £7.2m. Hopefully this will prove cautious as FY23 is delivered, and the group potentially will not need to invest capital in debtors and inventory to this extent; but for now, once again, this feels like a sensibly prudent approach to adopt.

We would highlight that today's RNS has drawn attention to the near-term pressure expected as the Huntingdon closure caused a temporary halt to production. This is unlikely to have materially reduced sales (which were serviced from the previously expanded inventory holdings), but impacts the absorption of overheads into inventory as production for the period will be lower than normal levels.

FY24 estimates

As described above, we will publish FY24 forecasts at a later date. The group is currently re-establishing production routines following the planned temporary shutdown of its main manufacturing site, it is anticipating a recovery in the key China market, and it is watching world markets, which are themselves unsure of the path out of Covid-related slowdowns and mindful of both the Ukraine war and the current concerning state of the global financial sector. With all this in mind, we elect to defer the introduction of FY24 estimates until we have a slightly greater degree of clarity over at least some of these variables.

We would hope that FY24 performance could begin to show the fruits of the recent years' labours, with the strategic goals of customer centricity, expanded product ranges and addressable markets, and enhanced technology all beginning to deliver. Against that hope, there clearly remain a number of risks, mostly macroeconomic and outside the control of the group but some of them potentially significant. We therefore will look to introduce estimates at some point over coming months, at which time we hope it might be easier to balance these conflicting sentiments and pressures.

Market sizes and shares – and Aquinox potential

The table below shows the various end markets for Xaar's products, the group's estimated market shares and the areas of opportunity or development needs of typical customers.

Markets addressed and market shares

Markets	Ceramics and Glass	C&M and DTS	3D and Adv Man	Packaging and Textiles	WFG and Labels
Market size for printheads	£100m	£100m	£100m	£100m	£500m
Estimated Xaar share	15%	15%	<5%	<1%	<5%
Development needs	Tuned Actuator and AcuChp	Long Throw Distance	High Viscosity High Laydown High Frequency (48kHz)	Aqueous compatibility High speed High resolution	Robust nozzle plate High speed High resolution
Market positions (management estimate)	Xaar 2002	Xaar Irix	Xaar Nitrox	Xaar Aquinox	TBA H1 2024
Xaar market share opportunity	★★	★★	★★★★	★★★	★★★★

Source: Company information, Progressive Equity Research estimates

We note in particular the potential in the Textiles market. As highlighted in our recent note (*Aquinox – a turning point in inkjet technology*, 18 November 2022), there is significant opportunity for Xaar's new product in this area. Previously, no combination of aqueous ink and compatible printhead has been able to provide both the colour performance and printing reliability that the market demands. Management believes that this new product could address the heavy pigment requirements and the reliability and longevity issues that appear to be holding back the digital textile printing market.

Digital printing on textiles – a potentially lucrative market for Aquinox

Source: Graphic Display World, IMIEurope

Revisiting Xaar's 'six reasons to invest'

In its 2021 Annual Report, Xaar highlighted six reasons to invest. We feel that the delivery of FY22 results is a good time to revisit these and consider whether they still hold as true as when the report was published.

1. **Market opportunity**

   The market clearly remains large in relation to Xaar's size. The group enjoys low double-digit market shares in both Ceramics and 'Coding & Marking and Direct-to-Shape', but penetration into other segments remains low, with material opportunity for improvement and growth. Notably, the recently launched aqueous printhead, Aquinox, opens significant new market potential in the Packaging & Textiles space.

2. **Proven technology and product roadmap with a strong value proposition**

   Products continue to address new markets. The ImagineX platform will form the basis of a number of new products, all focused on end-market and customer needs.

3. **Experienced and focused management team**

   Xaar has the same experienced team at group level, but has replaced the EPS management and seen significant performance improvement since this change.

4. **A clear strategic vision**

   Customer centricity remains key to Xaar's new strategy, with the removal of third-party distributors continuing to contribute to a recovery in group fortunes. This sits well alongside the preparedness to make major investments, with the acquisitions of FFEI and Megnajet propelling the group's standing in print engines and ink supply systems, respectively.

5. **Roadmap to deliver the opportunities**

   ImagineX is well established as a key platform for product introductions – Nitrox, Irix, and now Aquinox (for aqueous inks) as well as the Versatex print engine.

6. **Strong balance sheet position**

   Cash remained strong at the end of FY22, despite the planned investment into inventory during the back part of the year in advance of the planned factory shutdown. Xaar continues to benefit from its ability to invest in key strategic areas, and we see no sign of this changing in the near term.

Financial Summary: Xaar

Year end: December (£m unless shown)

PROFIT & LOSS	**2019**	**2020**	**2021**	**2022**	**2023E**
Revenue	49.4	48.0	59.3	72.8	79.6
Adj EBITDA	(4.9)	0.1	3.2	6.2	6.9
Adj EBIT	(7.9)	(3.7)	0.6	2.5	2.7
Reported PBT	(10.9)	(4.3)	1.0	0.8	2.0
Fully Adj PBT	(8.0)	(3.9)	(0.6)	2.8	2.5
NOPAT	(2.9)	(3.1)	0.0	2.6	2.0
Reported EPS (p)	(18.7)	(5.7)	0.9	2.3	2.5
Fully Adj Dil EPS (p)	(15.1)	(5.2)	(0.1)	5.0	3.2
Dividend per share (p)	0.0	0.0	0.0	0.0	0.0
CASH FLOW & BALANCE SHEET	**2019**	**2020**	**2021**	**2022**	**2023E**
Operating cash flow	(13.2)	(4.3)	(2.2)	(5.6)	2.6
Free Cash flow	(9.8)	(2.8)	(2.1)	(5.5)	2.6
FCF per share (p)	(12.5)	(3.6)	(2.6)	(7.0)	3.4
Acquisitions	(0.6)	(0.6)	(1.4)	(8.7)	(3.0)
Disposals	0.0	0.0	9.2	0.0	0.0
Shares issued	0.0	0.0	0.2	0.4	0.0
Net cash flow	0.3	(4.7)	5.1	(17.1)	(0.3)
Overdrafts / borrowings	(1.5)	(1.1)	(1.2)	(1.0)	(1.0)
Cash & equivalents	24.8	18.0	25.1	8.5	8.2
Net (Debt)/Cash	23.4	16.9	23.8	7.5	7.2
NAV AND RETURNS	**2019**	**2020**	**2021**	**2022**	**2023E**
Net asset value	70.3	56.2	68.8	71.8	73.6
NAV/share (p)	89.8	71.7	87.8	91.6	93.9
Net Tangible Asset Value	41.0	29.6	44.4	53.3	53.7
NTAV/share (p)	52.3	37.8	56.7	68.1	68.6
Average equity	101.1	63.2	62.5	70.3	72.7
Post-tax ROE (%)	(112.8%)	(28.0%)	17.8%	2.3%	2.7%
METRICS	**2019**	**2020**	**2021**	**2022**	**2023E**
Revenue growth		(2.8%)	23.5%	22.8%	9.4%
Adj EBITDA growth		(101.3%)	5033.9%	94.9%	11.7%
Adj EBIT growth		(52.7%)	(115.3%)	336.3%	9.7%
Adj PBT growth		(50.8%)	(85.4%)	(594.2%)	(12.3%)
Adj EPS growth		(65.3%)	(98.5%)	(6308.0%)	(36.3%)
Dividend growth		N/A	N/A	N/A	N/A
Adj EBIT margins		(7.8%)	1.0%	3.4%	3.4%
VALUATION	**2019**	**2020**	**2021**	**2022**	**2023E**
EV/Sales (x)	2.7	2.8	2.3	1.8	1.7
EV/EBITDA (x)	-27.5	2156.3	42.0	21.6	19.3
EV/NOPAT (x)	-45.8	-43.1	-4444.4	50.5	66.7
PER (x)	N/A	N/A	N/A	36.3	57.0
Dividend yield	N/A	N/A	N/A	N/A	N/A
FCF yield	(7.0%)	(2.0%)	(1.5%)	(3.9%)	1.9%

Source: Company information and Progressive Equity Research estimates

Progressive EQUITY RESEARCH

28 March 2023

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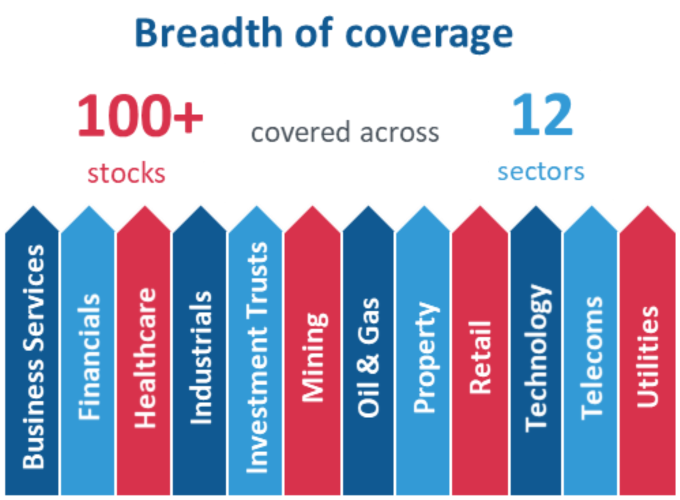

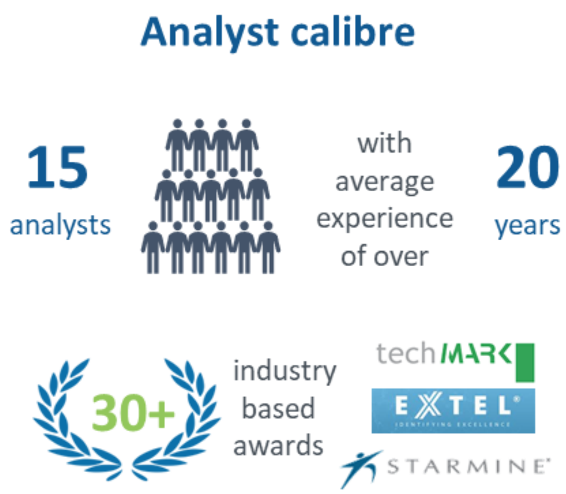

To arrange a meeting with the management team, or for further information about Progressive, please contact us at:
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