Analyst
Tanushree Jain 612 8224 2849

Authorisation
TS Lim 612 8224 2810

Ellex Medical Lasers (ELX)

1H19- Strong Top-line growth, improved margins, cost step up affects NPAT

Recommendation
Buy (unchanged)
Price
$0.57
Target (12 months)
$1.41 (previously $1.47)

Expected Return	
Capital growth	**147.4%**
Dividend yield	**0%**
Total expected return	**147.4%**

Company Data & Ratios	
Enterprise value	**$77.5m**
Market cap	**$81.9m**
Issued capital	**143.6m**
Free float	**86%**
Avg. daily val. (52wk)	**$92,560**
12 month price range	**$0.50- $0.90**
GICS sector	**Healthcare Equipment and Services**

Disclosure: Bell Potter Securities acted as lead manager in the November 2017 placement and received fees for that service.

Price Performance

	(1m)	(3m)	(12m)
Price (A$)	0.60	0.68	0.86
Absolute (%)	-4.20	-15.56	-33.72
Rel market (%)	-9.82	-24.53	-37.65

Revenue in-line, EBITDA miss with step up in opex

Revenue of $41.6m was in-line with our forecast and up 9.3% on pcp, with Fx favourably impacting the result. Underlying EBITDA loss of $1.6m, increased over pcp and was higher than our forecast of $0.5m, with higher opex offsetting the marked improvement seen in gross margin for both the CLU business and the iTrack business. For iTrack, both US and China sales were up, while ROW sales declined due to temporary disruption at ELX's German distributor and increased competition. New account for iTrack in the US grew during the period, which should improve reorder sales in future. Inventory levels increased in 1HFY19, affecting cash flow and we expect it will reduce by end of FY19. ELX had a net cash position of $4.4m. We expect 2HFY19 result to be stronger than 1HFY19, with increased overall group sales driven by growth across all segments, with an improved EBITDA result (driven by strong EBITDA growth in CLU business, reduced EBITDA loss in the iTrack business and modest increase in EBITDA loss in 2RT). The EBITDA result would be driven by improved gross margin and better cost management.

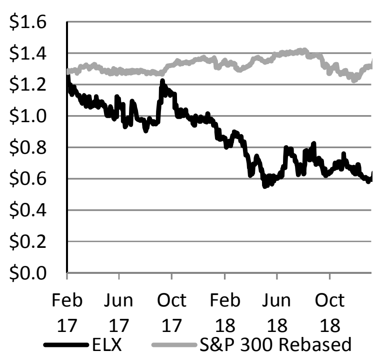
Modest Earning Revisions

Following revisions to our model, the net result is a $0.6m increase in our underlying EBITDA loss forecast for FY19, and increase in our EBITDA profit forecasts for FY20 and FY21 by 8% and 5% respectively, on the back of better forecast gross margins, partially offset by higher forecast opex. Changes to our overall group revenue forecasts were not material. Lower forecast amortisation expense has led to a decrease in our Net loss forecast for FY20 and increase in our NPAT forecast for FY21. Changes to our FY19 Net loss forecast was not material. We still, forecast ELX to achieve positive NPAT in FY21. We also still forecast positive EBITDA in 2HFY19.

PT reduced to $1.41, Retain Buy

The short term NPAT adjustments and recent market movements which have affected our relative valuations, has led to a modest reduction in our valuation for ELX. Our PT reduced to $1.41 (was $1.47). We retain Buy. The PT is generated using a blend of three valuation methodologies: DCF, EV/EBITDA and EV/Sales.

Absolute Price



SOURCE: IRESS

Earnings Forecast

Year end 30th June	2017A	2018A	2019E	2020E	2021E
Total Revenue (A$m)	71.6	79.1	87.5	95.9	108.6
Underlying EBITDA (A$m)	3.1	-2.1	-0.8	2.4	8.3
Reported EBITDA (A$m)	1.5	-1.4	-0.2	2.4	8.3
NPAT (normalised) (A$m)	-2.0	-5.3	-4.3	-2.0	2.7
EPS (normalised) (cps)	-1.7	-4.0	-3.0	-1.4	1.9
EPS -normalised growth (%)	-159.8%	-139.4%	24.8%	53.7%	NM
PER (normalised) (x)	N/A	N/A	N/A	N/A	30.1
EV/ underlying EBITDA (x)	24.8	-36.2	-95.2	32.8	9.3
Dividend (incl. spl div) (¢ps)	0.0	0.0	0.0	0.0	0.0
Yield (%)	0.0%	0.0%	0.0%	0.0%	0.0%
Franking (%)	0.0%	0.0%	0.0%	0.0%	0.0%
ROE (%)	-3.7%	-8.2%	-6.0%	-2.9%	3.9%

SOURCE: BELL POTTER SECURITIES ESTIMATES

1HFY19 - Results Summary

A summary of the reported 1HFY19 result is shown in the Table below:

Table 1 – 1HFY19 result summary

	Result vs PCP			Result vs Forecast		Comments
	1H18A	1H19A	% change	1H19E	Variance (%)	
Total Revenues	**38.1**	**41.6**	**9.3%**	**41.3**	**0.7%**	**Revenue in-line**
Cost of Goods Sold	16.9	15.7	-7.4%	17.8	-12.1%	COGS lower than expected
Gross Profit	21.2	26.0	22.6%	23.5	10.4%	
Operating Expenses	22.1	27.5	24.8%	24.0	14.6%	Opex higher than expected
Underlying EBITDA	**-0.9**	**-1.6**	**78.2%**	**-0.5**	**213.1%**	**Underlying EBITDA loss higher than our forecast driven by higher opex, partially offset by better gross margin**
Other income/gains and losses	-0.1	0.6	NM	0.0	NM	Includes other income and Fx gain
Reported EBITDA	**-1.0**	**-0.9**	**-6.7%**	**-0.5**	**86.3%**	**Reported EBITDA loss modestly higher than expected**
Depreciation & Amortisation	-1.7	-1.9	12.5%	-2.0	-2.3%	D&A modestly lower than our forecast
EBIT	**-2.7**	**-2.8**	**5.4%**	**-2.5**	**15.6%**	**EBIT loss higher with slightly lower D&A cost reducing variance at EBITDA line**
Net Interest and other Income/(expense)	-0.1	-0.2	39.9%	-0.1	**70.1%**	Net interest and other expense ahead of forecast due to impairment expense of $0.1m
Pretax Profit	-2.8	-3.0	7.1%	-2.6	18.1%	
Tax expense	0.0	0.0	NM	0.0	NM	
NPAT - normalised	**-2.8**	**-3.0**	**7.1%**	**-2.6**	**18.1%**	**Net loss higher than forecast**
Diluted EPS (cps)	**-2.3**	**-2.1**	**-6.5%**	**-1.8**	**18.1%**	
One-off items	*0.1*	*0.3*	*NM*	*0.0*	*NM*	*Deferred Tax benefit*
NPAT - reported	***-2.7***	***-2.7***	***-0.4%***	***-2.6***	***4.6%***	*Reported Net loss modestly ahead of forecast*
Diluted Reported EPS (cps)	***-2.2***	***-1.9***	***-13.1%***	***-1.8***	***4.6%***	
Effective Tax Rate	*0.0%*	*0.0%*	NM	*0.0%*	0bps	
Gross Margin	*55.6%*	*62.4%*	678bps	*56.9%*	546bps	Gross margin better than our forecast
Underlying EBITDA Margin	*-2.3%*	*-3.8%*	-146bps	*-1.2%*	-255bps	EBITDA margin lower than our forecast
EBIT Margin	*-7.1%*	*-6.8%*	25bps	*-6.0%*	-88bps	
Net Margin	*-7.5%*	*-7.3%*	14bps	*-6.2%*	-108bps	

SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

The key highlights from the result were:

- **Revenue in-line:** Total revenue of $41.6m (up 9.3% y/y) was in-line with our forecasts (BPe $41.3m). Growth over pcp in cc was +3% highlighting the favourable Fx impact on the Top-line. The increase over pcp was driven by ~4% growth in revenues in the Core Laser and Ultrasound (CLU) business, ~24% growth in iTrack revenues and strong growth in 2RT revenues of 535% (albeit off a low base). CLU business growth of 4% was driven by ~21% growth in sales of SLT lasers, 5% growth in sales of retinal lasers, partially offset by double digit decline in revenues in both the cataracts and vitreous opacities and ultrasound segments. Double digit growth in iTrack revenue over pcp was reported for US (39%), while Ex-US market sales were mostly flat. China sales grew strongly while, ROW sales declined. Growth in iTrack unit sales in US was 27% over pcp while EX-US growth in units was less than 1% (growth in China was offset by decline in ROW unit sales).
- **Underlying EBITDA loss higher than our forecast:** Underlying EBITDA loss of $1.6m (up 78.2% on pcp) was higher than our forecast of $0.5m, with higher than expected operating costs partially offset by lower COGS. Gross margin for both the CLU business (~59%% vs. ~53%) and iTrack improved significantly (~82% vs. ~73% pcp). iTrack opex was higher than our forecast. ELX had 17 sales reps for iTrack at the end of 1HFY19 (consistent with FY18). Reported EBITDA loss of $0.93m (down 6.7% on pcp) was higher than our forecast $0.5m. We note that as per ELX reported EBITDA loss is $0.85m (vs. the $0.93m as we have calculated), due to the company including interest income in its EBITDA calculation, while we have excluded that, in-line with prior year treatment and definition of EBITDA.

- **EBIT loss higher than our forecast:** EBIT loss of -$2.8m (up 5.4% on pcp), was higher than our forecasts (BPe -$2.5m), with lower depreciation and amortisation (D&A) cost reducing the variance at the reported EBITDA line. The decline in earnings in 1HFY19 was impacted by increased spending in all 3 business segments iTrack, CLU and 2RT business which increased operating costs, however was partially offset by strong improvement in gross margin for both the iTrack and CLU business.
- **Underlying Net loss higher and reported Net loss modestly higher:** Underlying Net loss of $3.0m (up 7.1% over pcp), was higher than our forecast of $2.6m. Reported Net loss of $2.7m (mostly flat over pcp), was modestly higher than our forecast (BPe $2.6m), impacted by a $0.3m tax benefit.
- **Net cash position:** ELX had a net cash position of $4.4m (close to in-line with BPe $4.3m) at the end of 1HFY19. Unfavourable change in working capital (-1.8m operating cash flow vs. -0.5m in pcp) due to higher than expected inventory was offset by both capex and capitalised development expenditure being less than our forecast and a modest bank overdraft of $0.5m in 1HFY19, which led to reported cash being close to in-line with our forecast. There was a breach of the EBITDA covenant due to which the company reclassified its ANZ bank facility as current debt. However, following December end they have obtained a waiver from ANZ and the facility is expected to be paid in normal course of business with renewal of the banking agreement expected within the next 12 months.

Key Highlights- 1HFY19 & Outlook for 2HFY19

The key highlights from Ellex's 1HFY19 results are enumerated below.

- Group sales increased by 9% to $41.6 million (3% in constant currency, which highlights the favourable Fx impact). Revenue increased over pcp across all 3 business segments, although as expected the mature CLU business saw low single digit growth (~4%), while both the high growth segments iTrack and 2RT saw significant increases in revenue over pcp.
- The growth in particular is driven by the company's products for glaucoma namely iTrack and the Tango and Tango Reflex SLT lasers.
- 2RT revenue saw a significant increase and is expected to be a material contributor to group revenue in the medium term.
- There was a significant step up in operating costs. The cost step up was in both CLU and iTrack business to drive glaucoma product growth and was also impacted negatively by Fx with majority of the spend in iTrack on field sales force, commission and marketing in USD. Expenses which grew materially over pcp were employee expenses, congress/marketing expenses and consulting expenses.
- Gross margin improved overall driven by strong improvement in CLU business and iTrack business.
- Inventory levels increased in 1HFY19, affecting cash flow due to sales in November/ December falling short of expectations, primarily in the CLU business. We expect inventory levels will reduce by end of FY19, from current levels.
- iTrack Stage 3 capex expansion has been delayed given the company is utilising less than 25% current capacity at current FY18 unit production volume. This is in-line with our expectations.

iTrack Key Highlights

- US iTrack unit volumes grew 27% vs. pcp to 3,826 units, slightly below our 33% growth expectations (BPe 4,016 units). Sales for the half in AUD were in line with our forecasts due to Fx impact.
- EBITDA loss for the business of $4.0m for the half was ahead of our EBITDA loss forecast of $2.9m and was driven higher opex, partially offset by improved gross margin.
- Ex-US iTrack sales were slightly below our estimates, with Europe below and China mostly in-line. We continue to expect Europe overall sales will be impacted by both increased competition for MIGS devices in Europe and ongoing distraction at ELX's German distributor who is going through a take-over. For FY19 we now expect China to show good growth over pcp, while ROW is likely to be flat.
- Company noted that they saw an increase of 23% in new orders (suggesting growing penetration) and they also expect an improvement in reorders in 2HFY19 based on the 32% increase in 1HFY19 new accounts over pcp (62 new accounts vs. 47 new accounts in 1HFY18).
- **We note that there has been a change in the company's strategy in terms of being more focused in its targeting of physicians.** ELX is now focused on targeting the glaucoma specialists and the comprehensive doctors, vs. the earlier focus on cataract surgeons. **We view this as a positive** given ELX will face less competition

from well-funded and well entrenched competing devices in this target segment (competing MIGS devices need to be used in conjunction with a cataract operation and therefore cataract surgeons have been their primary marketing focus). **iTrack is not restricted to being used with a cataract operation and hence we believe this changed strategy is positive and is already bearing fruit in the improvement in new order accounts seen in 1HFY19 and we expect this trend to continue.**

- US iTrack sales continued their double digit growth over pcp and we expect 2HFY19 growth to be even stronger.
- We also expect opex for 2HFY19 would be below 1HFY19 levels, with company focusing on managing costs, while gross margin should potentially improve further in 2HFY19 (albeit expect it to be below FY18 levels). This should give a better EBITDA result in 2HFY19 for the iTrack business.
- We expect overall EBITDA loss for iTrack for FY19 to be slightly up over FY18 levels (which is a bit more conservative than the company guidance of EBITDA loss being at similar levels to FY18).
- ELX has 17 reps now vs. 12 at end of 1H18.
- Due to variability in orders from month to month, ELX will no longer provide quarterly sales update for iTrack. We expect the next update in August when the company reports its FY19 results.

CLU business key highlights

- CLU revenues for the half were in-line with our forecasts - $33.9m vs. BPe $33.8m. However, individually SLT lasers revenue were close to in-line with our forecasts, Retinal disease laser sales were much higher than expected, while both the cataracts and vitreous opacities and diagnostic ultrasound sales were much lower than expected.
- EBITDA for the business of $5.9m for the half was much ahead of our EBITDA forecast of $4.3m and pcp and was driven by materially improved margins (58.9% vs. 52.8%), with modest (~4%) growth in revenues, which is impressive.
- The improved margins were driven by Fx tailwind, focus on selling higher margin products (especially in US and Japan) and cost management.
- Diagnostic ultrasound continues to be disappointing and may improve in the 2HFY19 due to new product launch.
- Cataracts and Vitreous capacities segment fell much further which suggests some of the cannibalisation of sales from this segment due to the Tango reflex product in the SLT segment has continued. We expect this to continue for 2HFY19.
- SLT lasers grew as per our expectations and we expect continued double digit growth for 2HFY19.
- Surprisingly despite competition with pharmacotherapy, Retinal lasers saw a 5% growth over pcp which is pleasing. We expect 2HFY19 sales to be at similar levels to 1HFY19.
- We expect opex for 2HFY19 will be at similar levels to 1HFY19 and below pcp.
- Improved Top-line growth, with improved gross margins should see a significant increase in profitability for 2HFY19 and the full year.
- We expect gross margins for FY19 will be below the 1HFY19 level, however significantly up over FY18 levels.
- ELX has guided to continued FY19 growth in EBITDA on FY18 EBITDA. We expect higher revenues in FY19 from the CLU business, with opex at similar levels to FY18, with materially improved gross margins vs. FY18, with the net result of higher EBITDA in FY19.

2RT business key highlights

- 2RT is already approved in Europe, Australia and New Zealand for early AMD.
- Following the clinically meaningful results reported from the LEAD trial, in sub group of patients who made up the majority of the trial, Ellex has been focusing its efforts on generating support from KOL's (Key Opinion Leaders), training its staff on the trial data, driving awareness programs including recent symposium and booth at the key annual ophthalmic conference AAO (American Academy of Ophthalmology) held in the US.
- 2RT sales were modestly higher than our forecast ($1.3m vs. BPe $1m) and grew materially over pcp ~+535% (albeit off a small base), with company seeing increased interest (>80% sales in 2QFY19) after the LEAD trial results were released in september'18. Gross margins were down as initial sales have been skewed towards distributors vs. direct in Europe.
- **While we continue to expect the majority of the 2RT revenue growth will be skewed to 1HFY19, we have increased our FY19 revenue forecasts, based on the better than expected 1HFY19 result.**
- We now expect gross margin for FY19 for the 2RT business to be at similar levels to that seen in 1HFY19 and above pcp.
- In CY19, ELX will also get clarity from the US FDA on pathway to get that product approved for AMD in the US market. We note that 2RT is already approved in the US for another indication i.e. Clinically Significant Macular Edema (CSME), which may create a possibility of the product seeing some off label usage in AMD ahead of formal approval for AMD. ELX noted that they had a single US sales for 2RT in 1HFY19.

FY19 Outlook

- Ellex reaffirmed its prior FY19 guidance released at the AGM to grow overall group sales with improved EBITDA result. However, the company revised its guidance on individual business segment performances based on 1H19 results.
- Revenue growth is continued to be expected for the CLU business driven by strong growth in SLT lasers for glaucoma. Company noted that sales had slowed down in Nov and Dec'18 in US and EMEA, hence growth rates at 1H19 vs. reported at the previous Trading update at 4 months were subdued. Diagnostic ultrasound is awaiting two new product launches, which could help to stem the decline in this segment. While Top-line growth is still likely to be single digits for the CLU business, the company expects to see strong growth in EBITDA for this segment vs. pcp, due to continued clinical adoption of high margin SLT lasers and cost leverage, which already saw a good improvement in gross margin in 1H19.
- 2RT sales materially increased in 1H19, although over a low base and the company expects this momentum to continue for FY19. ELX will also work on establishing US regulatory pathway in discussions with FDA for 2RT for AMD in CY19.
- iTrack is expected to continue on its growth trajectory in FY19, however ELX now expects EBITDA loss to be similar to FY18 levels (earlier Ellex had guided to a better EBITDA result expecting reduced opex at the AGM). In 2HFY19 ELX expects reorders to improve for iTrack, with the strong new account set up (62 new accounts) in 1HFY19 to deliver improved reorder revenue in future.

Earnings and Valuation Changes

We have reviewed our assumptions and forecasts for ELX based on the 1H19 results filed on the ASX and comments by management. This has impacted earnings and valuation.

Key changes to our assumptions

- Within the CLU business, we have reduced our sales forecasts for the diagnostic ultrasound and the photodisruption (YAG) lasers for secondary cataract and vitreous opacities and we have increased our sales forecasts for the SLT lasers for glaucoma and the Retinal lasers for primarily diabetes. **Overall there wasn't a material change in our revenue forecasts for the CLU business for FY19-FY21. FY19 revenue increased by ~1%, while increase in FY20-21 revenue was negligible.**
- **We have increased our FY19 revenue forecasts for the 2RT business by 20%** based on the higher than expected revenue reported in 1H19. There were no changes to our FY20-21 forecasts.
- For the iTrack business we have trimmed our forward unit sales forecast for the US, which was mostly offset by higher pricing in AUD terms given the Fx tailwind. We have also reduced our revenue forecasts for ROW (i.e. EX-US and China) modestly to account for increased competition and distraction at Ellex's German distributor. **The net impact was not material (less than 1% change in iTrack FY19-21 revenue forecasts).**
- **Overall there wasn't a material change in our group revenue forecasts for ELX for FY19-FY21. FY19 revenue increased by 1.5%, while changes to FY20-21 revenue forecasts were negligible (~0%).**
- We have increased our forward gross margin assumptions for the CLU business to ~56.5% (was 53.9%) and for iTrack to 82.5% (was ~80%), based on the significant improvement seen in 1HFY19. We have also increased our forward gross margin assumptions for the 2RT business, **Overall, our forward gross margin forecasts for Ellex has increased from FY19 onwards based on better margins across all the 3 business segments.**
- **We have increased our group opex forecasts for FY19-21 by ~4-8% based on the higher than expected opex reported in 1HFY19.** The FY19 opex increase was primarily driven by the iTrack business, while in FY20-21, it was driven by modest increase in the CLU business.
- We have moved the cumulative A$4.5m allocated expenditure on clinical trials for iTrack from FY19-FY21 to FY21-FY23, with the majority spend expected in FY23. Our capitalised development costs have shifted accordingly. We have also reduced our capitalised development expenditure for FY19 (assuming 2H expense is in-line with 1H19).
- Our D&A expense forecasts have also reduced due to lower amortisation of capitalised development costs.
- There was an accounting standard change in revenue recognition, which led to ELX restating some of its 1HFY18 or FY18 numbers. We have incorporated those in our model.

Following the above changes, the net result is a $0.6m increase in our underlying EBITDA loss forecast for FY19, and increase in our EBITDA profit forecasts for FY20 and FY21 by 8% and 5% respectively, on the back of better forecast gross margins, partially offset by higher forecast opex. Lower forecast amortisation expense has led to a decrease in our Net loss forecast for FY20 and increase in our NPAT forecast for FY21. Changes to our

FY19 Net loss forecast was not material. We still, however, forecast the company to achieve positive NPAT in FY21. We also still forecast positive EBITDA in 2HFY19.

Table 2 - Key Changes to our FY19-FY21 forecasts

	FY2019E			FY2020E			FY2021E		
	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)
Revenues ($m)	86.2	87.5	1%	95.9	95.9	0%	108.7	108.6	0%
Underlying EBITDA ($m)	-0.2	-0.8	366%	2.2	2.4	8%	7.9	8.3	5%
Underlying EBITDA margin (%)	-0.2%	-0.9%	359%	2.3%	2.5%	8%	7.2%	7.6%	5%
EBIT ($m)	-4.1	-4.0	-1%	-2.2	-1.8	-16%	3.2	3.9	21%
EBIT margin (%)	-4.7%	-4.6%	-3%	-2.3%	-1.9%	-16%	3.0%	3.6%	21%
NPAT -normalised ($m)	-4.2	-4.3	2%	-2.3	-2.0	-15%	2.2	2.7	23%
Diluted EPS -normalised (cents)	-2.9	-3.0	2%	-1.6	-1.4	-15%	1.5	1.9	23%

SOURCE: BELL POTTER SECURITIES ESTIMATES

Price Target reduced to $1.41

Our Price Target (PT) for ELX is generated using a blend of EV/EBITDA, EV/Sales and DCF valuation techniques. We apply a 60% weighting to the DCF valuation given we believe this is the most appropriate methodology for ELX with the strong revenue growth outlook and also the wide range between the two relative valuations of EV/EBITDA and EV/Sales. We apply equal weighting of 20% to the EV/EBITDA relative valuation and the EV/Sales relative valuation. Our EV/sales and EV/EBITDA multiples are based on FY20 forecasts. For the EV/Sales multiple we now apply a 55% discount (was 40%) to the median multiple given recent market movements and the much higher forecast revenue profiles for most US listed comps. The short term NPAT adjustments and recent market movements which have affected our relative valuations, has led to a modest reduction in our valuation for ELX.

Figure 1 - Summary of Price Target

Methodology	Valuation	% weighting	Price Target
DCF	1.72	60%	1.03
EV/EBITDA	0.43	20%	0.09
EV/Sales	1.46	20%	0.29
Total			**1.41**

SOURCE: BELL POTTER SECURITIES ESTIMATES

The figure above shows our price target for ELX is $1.41/sh. The price target is a significant premium to the current share price of $0.57/sh and therefore supports our Buy recommendation.

Upside Risk to our valuation

- **We are conservative on iTrack Ex-US opportunity:** We have only assumed a modest growth in iTrack Ex US revenues, with international iTrack revenues reducing as a total percentage of iTrack global revenues moving forward. We also believe we may be conservative here as ELX currently has the only MIGS device approved in China and its approval there was recently extended to 23rd May 2022, therefore China could be a much stronger growth market than we have currently assumed. ELX does not have direct sales force outside the US at this stage and margins on international distributor sales are also lower. If in future ELX decides to go direct in some of the Ex US markets it could improve the ex-US revenue opportunity for iTrack and represent an upside to our estimates. However at this stage we continue to assume Ex-US markets remain a distributor model and ELX's focus remains on the US market for the foreseeable future. Some of the markets where we believe it may be worthwhile for ELX to pursue a direct sales force model in future include Germany, Canada and Italy.

- **Results from confirmatory trials of 2RT will allow for increased probability of success:** We currently risk adjust our revenues for 2RT from FY21 by 80%. While the company already has CE Mark approval to market 2RT in Europe, and will use the results of the LEAD trial to drive adoption, we believe widespread adoption leading to increased sales from FY21 as per our forecasts would require confirmatory trials in the subgroup in which the LEAD trial showed significant benefit. As such, we envisage that ELX initiating and reporting results from confirmatory trials (potentially after clarifying US regulatory pathway for 2RT), will allow us to assign a higher probability of success from FY21 and therefore likely to lead to material upgrades in our numbers.
- **No value included for 2RT beyond Europe:** At this stage in our valuation, we do not include any value for 2RT in AMD beyond the European market from FY19 onwards. We note that the company is currently also selling 2RT to early adopters in Australia and New Zealand, however we do not model these markets separately. CE Mark approval could also assist ELX in accelerating its path to market for 2RT in some other markets (Middle East, South America and South East Asia) which recognise CE Mark. The Approval and subsequent launch of 2RT in additional markets (not included) in our forecasts will be an upside to our valuation. Clarification of path forward to get approval in the US market and the company pursuing that opportunity in the future could further extend the market for 2RT and represent an upside to our estimates. We do note that 2RT is already approved in the US for another indication namely, Clinically Significant Macular Edema (CSME). It is possible therefore that 2RT may see some off label usage in the US on the discretion of US physicians prior to receiving registration for the product for intermediate AMD in that market.

Ellex Medical Lasers (ELX)

COMPANY DESCRIPTION

Ellex is a specialist healthcare company with industry leading products in the area of ophthalmology (eye disease). The company operates in 3 segments – Core Lasers and Ultrasound (CLU), iTrack minimally invasive glaucoma surgery (MIGS) device and 2RT laser targeting early Age-Related Macular Degeneration (AMD). Over the last decade ELX has grown its CLU business and now has a strong brand and market leading position. CLU is a mature, relatively stable business and the company is now diversifying into high growth emerging segments with its iTrack and 2RT products. ELX's flagship product iTrack is poised to be a key player in the fast growing and vastly underpenetrated MIGS device market. We believe iTrack will be the key growth driver for ELX moving forward. ELX's 2RT product represents a potential breakthrough treatment for AMD. It is relatively early stage compared to the company's other two business segments, however the large market opportunity and first mover advantage could make this a highly lucrative product for ELX.

INVESTMENT STRATEGY

We have a Buy recommendation on Ellex Medical Lasers. Our investment thesis is based on:

$1.41 price target: Our 12 month price target on ELX is $1.41 based on a blend of three valuation methodologies: DCF, EV/EBITDA and EV/Sales. The price target is a significant premium to the current share price of $0.57/sh.

Forecast strong growth: Over the next 5 years we forecast the company's top line to grow at a 13.1% CAGR, reaching A$146.5m by 2023. We also forecast a return to positive NPAT in FY21 after a period of negative earnings from FY17 to FY20 due mainly to an increase in near term spending to expand the global sales and marketing efforts for iTrack, particularly expansion of the direct sales force in the US.

Diversified business: While the core lasers and ultrasound business is the main driver of revenue and profitability currently, we expect this business to be a minor contributor to the future growth of the company. However, we expect ELX to leverage the strong branding provided by this business to drive adoption and growth of its other two emerging high growth business segments (iTrack and 2RT), which are currently not profitable. We like the stability and foundation provided by the core business and now the improved margins resulting from a higher margin product mix, against the other two high growth emerging segments and believe this diversification de-risks ELX.

Flagship product iTrack has a long growth trajectory: ELX with its iTrack MIGS device is poised to be a key player in the fast growing MIGS (minimally invasive glaucoma surgery) device market. Revenues from ITrack grew ~24% over pcp in 1HFY19. We believe iTrack has a long growth trajectory ahead. We forecast revenues from this business to grow at a 35.0% CAGR from A$11.1m in FY18 to A$49.7m by 2023.This is driven mainly by adoption in the US market where the company is in the initial stages of commercialisation and is in the process of building a direct sales force. US adoption will also benefit from the 2017 increase in reimbursement for the procedure in the US.

MIGS device market in glaucoma represents significant commercial opportunity: The MIGS device market is expected to grow from ~US$177m to US$920m by 2021. Interest and competition has increased in the space driven by the highly successful launch of iStent MIGS device from the pioneer US based Glaukos' Corporation, which is boasting a >40% y/y growth in quarterly revenues since 2013. Several recent acquisitions in the space have been valued at US$500m-US$700. The market is poised for significant growth in the next few years and is vastly underpenetrated, which makes it a lucrative market for ELX's iTrack which we believe has the potential to be used as the first line MIGS therapy.

2RT represents a breakthrough treatment for early AMD: With the 2RT therapy, ELX is targeting the early AMD market which is much larger than the advanced AMD market, however much earlier in the disease state. ELX has a significant first mover advantage in the early AMD market for which there are currently no approved treatments. We believe this market would be a function of the current US$5-7bn spend on the advanced wet AMD pharmacotherapy market, which is where all the development in the industry been focused on. We forecast strong double digit percentage growth in the company's 2RT revenue from FY19 onwards. We expect revenues to grow from A$0.5m in FY18 to A$15.0m in FY23 (risk adjusted).

We believe ELX is undervalued and iTrack alone can support our Price Target: We believe ELX is undervalued when compared to the high growth small cap medtech companies in the US who are trading at a median 6.1x 2020 EV/sales vs. ELX trading at 0.8x 2020 EV/Sales. In our view, iTrack business alone can support our PT for ELX given the US$500m-US$700m recent acquisitions in the MIGS space.

Risks

The key risks specific to ELX include, but are not limited to, the following:

- **ELX will be competing with larger competitors:** For iTrack ELX will be competing with much larger competitors in the MIGS (minimally invasive glaucoma surgery) device market, who have more resources to market their products and also strong relationships with ophthalmologists. If ELX is unable to develop its own relationships with ophthalmologists and successfully market its product, it will adversely impact our market penetration forecasts. ELX will likely also face competition with these larger players in attracting and retaining productive sales reps.
- **Reliance on iTrack to drive value:** The key revenue driver in our model is iTrack. While the company is de-risked somewhat by virtue of its market leading laser and ultrasound business and could potentially have 2RT driving growth in a few years as well, we believe ELX is vulnerable to the success/failure in getting traction for iTrack in the US as we have forecasted. If iTrack's uptake into the marketplace turns out to be slower than we have anticipated, it will impact our forecasts.
- **US adoption of iTrack is reliant on expansion of US sales force:** One of our key assumptions underpinning our revenue forecasts for iTrack are the pace at which the company builds its US sales force and also the pace at which the productivity of its sales reps increase. We also believe that with the expected competition in MIGS devices in the next 1-2 years in the US, they may find it difficult to get quality people given that in some cases they will be competing with larger companies who may be able to provide a higher level of compensation and benefits to these reps.
- **Widespread adoption of 2RT may not happen without confirmatory trials:** We believe that results from the LEAD trial will generate sufficient interest to drive adoption among early adopters. However, given that the trial delivered clinically meaningful results in a subpopulation, widespread adoption is likely going to require confirmatory trials in that subgroup. We have assumed a 80% probability of success for our sales forecast from FY21. ELX not undertaking these trials or not reporting positive results from these trials would likely to impact our revenue forecasts for 2RT.
- **Repositioning of iTrack ABiC:** iTrack is used in a surgical procedure called "ab interno canaloplasty" (ABiC). Doctors use ABiC with iTrack device for the clearance and dilation of the ocular drainage systems compromised by glaucoma. ABiC is a simpler, faster, less invasive procedure than ab externo canaloplasty, commonly referred to as "canaloplasty". The usage of the iTrack for ab externo canaloplasty was first undertaken in the late 2000's and it was a complicated invasive operation. ELX relaunched iTrack and the ABiC procedure during 2016. ELX will have the task of re-educating physicians about the MIGS procedure who still associate the word canaloplasty with a time consuming, complicated procedure. We believe there is a lot of data for canaloplasty which iTrack will benefit from, however they may benefit from doing a head to head study to prove their superiority/equivalence against the other market leading MIGS device to drive further adoption.
- **Funding risk:** Growing the US sales force for iTrack has increased the near term spending needs for ELX. If the revenues from iTrack do not ramp up as we have forecasted, this business segment may take longer to become profitable than we have currently forecasted and will impact the groups' overall profitability. We note that the groups FY17 and FY18 results and FY19 and FY20 forecasts are already impacted by the increased investment in iTrack, however should iTrack not become profitable in FY21, it will likely impact the groups' overall profitability for longer than we have currently postulated, which in turn may require the company to take on more debt or raise capital.

Ellex Medical Lasers
as at 26 February 2019

Recommendation	Buy
Price	$0.57
Target (12 months)	$1.41

Table 3 - Financial summary

Ellex Medical Lasers (ELX)		Share price (A$)	$0.570
As at 26 February 2019		Market cap (A$m)	81.9

Profit and Loss

Y/e June 30 (A$m)	2017A	2018A	2019E	2020E	2021E
Total Revenue	**71.6**	**79.1**	**87.5**	**95.9**	**108.6**
Gross Profit	42.0	45.8	53.2	59.2	68.1
Underlying EBITDA	**3.1**	**-2.1**	**-0.8**	**2.4**	**8.3**
Other Revenue/gains & losses	-1.6	0.7	0.6	0.0	0.0
Reported EBITDA	**1.5**	**-1.4**	**-0.2**	**2.4**	**8.3**
Depreciation & Amortisation	-3.1	-3.7	-3.9	-4.2	-4.4
EBIT	**-1.7**	**-5.1**	**-4.0**	**-1.8**	**3.9**
Net interest & Other Income/(Expense)	-0.3	-0.3	-0.2	-0.2	-0.2
Pre-tax profit (loss)	**-2.0**	**-5.3**	**-4.3**	**-2.0**	**3.7**
Tax expense (benefit)	0.0	0.0	0.0	0.0	1.0
NPAT (normalised)	**-2.0**	**-5.3**	**-4.3**	**-2.0**	**2.7**
One off items	1.1	0.3	0.3	0.0	0.0
NPAT (Reported)	**-0.9**	**-5.0**	**-3.9**	**-2.0**	**2.7**

Cashflow

Y/e June 30 (A$m)	2017A	2018A	2019E	2020E	2021E
Reported NPAT	-0.9	-5.0	-3.9	-2.0	2.7
Non-cash items	3.7	4.2	3.9	4.1	4.3
Change in Working capital	-6.3	1.4	-1.9	-1.5	-1.4
Operating cashflow	**-3.5**	**0.5**	**-2.0**	**0.6**	**5.6**
Capex	-7.1	-2.6	-1.2	-1.2	-1.2
Investments in other intangible assets	-0.4	-0.4	-0.4	-0.4	-0.4
Acquisitions	-0.9	-1.9	0.0	0.0	0.0
Capitalised development costs	-3.1	-3.2	-2.6	-3.8	-4.8
Deferred consideration	-0.5	0.0	0.0	0.0	0.0
Other investing cash flow	0.1	0.2	0.2	0.1	0.1
Investing cashflow	**-11.8**	**-7.9**	**-4.0**	**-5.3**	**-6.4**
Change in borrowings	6.8	0.3	-0.3	-0.8	-0.8
Equity issued	9.7	21.8	0.0	0.0	0.0
Dividends paid	0.0	0.0	0.0	0.0	0.0
Other financing cash flow	0.0	-0.1	-0.1	0.0	0.0
Financing cashflow	**16.5**	**22.0**	**-0.4**	**-0.8**	**-0.8**
Net change in cash	**1.2**	**14.5**	**-6.4**	**-5.6**	**-1.6**
Cash at start of period	7.3	8.5	23.1	16.7	11.1
Exchange rate impact	0.0	0.1	0.1	0.0	0.0
Cash at end of period	**8.5**	**23.1**	**16.7**	**11.1**	**9.5**
Free cash flow (op. CF less capex, capitalised development costs, intangibles and acquisition)	**-14.9**	**-7.6**	**-6.2**	**-4.8**	**-0.9**

Balance sheet

Y/e June 30 (A$m)	2017A	2018A	2019E	2020E	2021E
Cash	9.2	23.1	16.7	11.1	9.5
Current receivables	15.1	14.7	15.2	16.1	17.1
Inventories	23.4	22.5	24.0	24.2	24.7
Other current assets	0.9	1.0	1.0	1.0	1.0
Current assets	**48.7**	**61.2**	**56.9**	**52.5**	**52.3**
PPE	13.5	14.6	14.1	13.6	13.0
Non-current receivables	0.2	0.3	0.3	0.3	0.3
Non-current inventories	0.5	0.3	0.0	0.0	0.0
Intangible assets - Goodwill	0.0	0.0	0.0	0.0	0.0
Intangible assets - Other	3.9	3.9	4.0	3.9	3.9
Capitalised development expenditure	13.4	14.9	15.7	17.6	20.3
Deferred Tax Assets	6.3	8.3	9.1	9.6	10.0
Non-current assets	**37.9**	**42.2**	**43.2**	**45.0**	**47.4**
Total assets	**86.5**	**103.5**	**100.1**	**97.5**	**99.7**
Payables	9.0	6.4	6.8	6.8	7.0
Current debt	15.5	9.1	8.8	8.8	9.8
Current Provisions	2.7	3.2	3.5	3.7	3.9
Current tax liability	0.1	0.1	0.2	0.2	0.2
Other current liabilities	0.9	3.7	3.7	3.7	3.7
Current liabilities	**28.3**	**22.6**	**23.0**	**23.1**	**24.5**
Non current Payables	0.0	0.0	0.0	0.0	0.0
Non-current debt	0.1	5.9	5.8	5.0	3.1
Non-current Provisions	0.5	0.4	0.5	0.5	0.5
Deferred tax liabilities	0.0	0.0	0.0	0.0	0.0
Other liabilities	0.7	1.3	1.2	1.2	1.2
Non-current liabilities	**1.3**	**7.7**	**7.5**	**6.7**	**4.8**
Total liabilities	**29.6**	**30.2**	**30.5**	**29.8**	**29.4**
Net Assets	**56.9**	**73.2**	**69.6**	**67.6**	**70.3**
Shareholders' equity	55.9	78.3	78.3	78.3	78.3
Reserves	-0.7	0.3	0.6	0.6	0.6
Retained earnings/ (losses)	1.7	-5.4	-9.3	-11.3	-8.6
Total shareholders equity	**56.9**	**73.2**	**69.6**	**67.6**	**70.3**

Earnings ratios at current price of $0.57

Y/e June 30	2017A	2018A	2019E	2020E	2021E
Diluted EPS - Reported (c)	-0.8	-3.7	-2.7	-1.4	1.9
EPS growth (%) -reported	***-127.3%***	***-394.9%***	***26.8%***	***49.6%***	***NM***
Diluted EPS - Normalised (c)	-1.7	-4.0	-3.0	-1.4	1.9
EPS growth (%) -normalised	***-159.8%***	***-139.4%***	***24.8%***	***53.7%***	***NM***
DPS - Ordinary (c)	0.0	0.0	0.0	0.0	0.0
DPS -Special (c)	0.0	0.0	0.0	0.0	0.0
DPS -Total (c)	0.0	0.0	0.0	0.0	0.0
Yield (%) (including special div)	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**
Franking (%)	0%	0%	0%	0%	0%

Valuation ratios at current price of $0.57

Y/e June 30	2017A	2018A	2019E	2020E	2021E
Net profit -normalised (A$m)	-2.0	-5.3	-4.3	-2.0	2.7
P/E ratio (on normalised EPS) (x)	N/A	N/A	N/A	N/A	30.1
FCF per share (c)	-12.3	-5.3	-4.3	-3.4	-0.6
Price/FCF per share (x)	-4.6	-10.8	-13.2	-16.9	-93.1
EV/ underlying EBITDA	24.8	-36.2	-95.2	32.8	9.3
EV/EBIT	NM	-15.3	NM	-42.3	20.0
NTA per share (c)	27.5	32.2	28.4	25.5	46.3
Price/NTA (x)	2.1	1.8	2.0	2.2	1.2

Performance ratios

Y/e June 30	2017A	2018A	2019E	2020E	2021E
Gross Profit Margin (%)	58.6%	58.0%	60.8%	61.7%	62.7%
Underlying EBITDA margin (%)	4.4%	N/A	N/A	2.5%	7.6%
Reported EBITDA margin (%)	2.1%	N/A	N/A	2.5%	7.6%
EBIT margin (%)	N/A	N/A	N/A	N/A	3.6%
NPAT - Normalised margin (%)	N/A	N/A	N/A	N/A	2.5%
Return on assets (%)	-2.5%	-5.6%	-4.2%	-2.0%	2.8%
Return on equity (%)	-3.7%	-8.2%	-6.0%	-2.9%	3.9%
ROIC (%)	-2.9%	-7.9%	-6.1%	-2.7%	3.9%
Payout Ratio -ordinary dividend (%)	0%	0%	0%	0%	0%
Effective tax rate (%)	0.0%	0.0%	0.0%	0.0%	26.8%

Growth (%)

Y/e June 30	2017A	2018A	2019E	2020E	2021E
Gross Profit Growth	0.3%	9.2%	15.9%	11.3%	15.2%
Underlying EBITDA Growth	-60.6%	-168.7%	62.0%	NM	251.4%
Reported EBITDA Growth	-81.6%	-194.2%	87.1%	NM	251.4%
EBIT Growth	-133.5%	-206.7%	20.1%	54.6%	NM
PBT Growth	-146.8%	-172.6%	19.7%	53.7%	NM
NPAT - normalised Growth	-164.7%	-172.6%	19.7%	53.7%	NM

Leverage ratios

Y/e June 30	2017A	2018A	2019E	2020E	2021E
Net debt/(cash) (A$m)	6.4	-8.1	-2.1	2.6	3.4
Net debt/equity (%)	11.2%	NA	-3.0%	3.8%	4.8%
Net debt/EBITDA (x)	2.0	NA	2.6	1.1	0.4
Net Interest cover (x)	6.8	net cash	32.7	12.0	23.7
Gearing (net debt/net debt + equity) (%)	10.1%	NA	-3.1%	3.7%	4.6%

Segmentals

Y/e June 30	2017A	2018A	2019E	2020E	2021E
Revenue					
Core laser and Ultrasound	62.5	67.5	71.0	73.9	77.9
iTrack MIGS device	8.2	11.1	14.4	19.0	25.9
2RT (early AMD)	0.9	0.5	2.1	3.0	4.8
Total Revenues	**71.6**	**79.1**	**87.5**	**95.9**	**108.6**
Revenue Growth (%)					
Core laser and Ultrasound	*-4.0%*	*8.0%*	*5.2%*	*4.1%*	*5.5%*
iTrack MIGS device	*29.1%*	*34.9%*	*29.5%*	*32.6%*	*36.1%*
2RT (early AMD)	*-38.1%*	*-44.8%*	*331.8%*	*42.0%*	*56.5%*
Total Revenues	***-1.8%***	***10.4%***	***10.6%***	***9.7%***	***13.2%***
EBITDA					
Core laser and Ultrasound	7.2	8.3	12.0	13.1	14.9
iTrack MIGS device	-1.3	-5.1	-5.6	-2.1	2.1
2RT (early AMD)	-0.4	-1.0	-0.7	-2.1	-2.3
Unallocated	-4.0	-3.6	-5.9	-6.5	-6.5
Total Reported EBITDA	**1.5**	**-1.4**	**-0.2**	**2.4**	**8.3**
EBITDA Margin (%)					
Core laser and Ultrasound	*11.6%*	*12.3%*	*16.9%*	*17.7%*	*19.1%*
iTrack MIGS device	*-15.9%*	*-45.7%*	*-39.1%*	*-11.3%*	*8.2%*
2RT (early AMD)	*-45.4%*	*-200.4%*	*-31.9%*	*-67.6%*	*-47.3%*
Total Reported EBITDA margin	***2.1%***	***-1.8%***	***-0.2%***	***2.5%***	***7.6%***

Interims

Y/e June 30 (A$m)	2H17A	1H18A	2H18A	1H19A	2H19E
Total Revenue	37.4	38.1	41.0	41.6	45.9
Underlying EBITDA	0.8	-0.9	-1.3	-1.6	0.8
...Underlying EBITDA margin (%)	2%	-2%	-3%	-4%	2%
Reported EBITDA	-1.6	-1.0	-0.4	-0.9	0.8
...Reported EBITDA margin (%)	-4%	-3%	-1%	-2%	2%
EBIT	-3.4	-2.7	-2.4	-2.8	-1.2
Pre-tax profit	-3.5	-2.8	-2.5	-3.0	-1.2
NPAT (normalised)	-3.0	-2.8	-2.5	-3.0	-1.2

SOURCE: BELL POTTER SECURITIES ESTIMATES

Recommendation structure

Buy: Expect >15% total return on a 12 month view. For stocks regarded as 'Speculative' a return of >30% is expected.

Hold: Expect total return between -5% and 15% on a 12 month view

Sell: Expect <-5% total return on a 12 month view

Speculative Investments are either start-up enterprises with nil or only prospective operations or recently commenced operations with only forecast cash flows, or companies that have commenced operations or have been in operation for some time but have only forecast cash flows and/or a stressed balance sheet.

Such investments may carry an exceptionally high level of capital risk and volatility of returns.

Research Team

Staff Member	Title/Sector	Phone	@bellpotter.com.au
TS Lim	Head of Research	612 8224 2810	tslim
Industrials			
Sam Haddad	Industrials	612 8224 2819	shaddad
Chris Savage	Industrials	612 8224 2835	csavage
Jonathan Snape	Industrials	613 9235 1601	jsnape
John Hester	Healthcare	612 8224 2871	jhester
Tanushree Jain	Healthcare/Biotech	612 8224 2849	tnjain
Financials			
TS Lim	Banks/Regionals	612 8224 2810	tslim
Lafitani Sotiriou	Diversified Financials/Fintech	613 9235 1668	lsotiriou
Resources			
Peter Arden	Resources	613 9235 1833	parden
David Coates	Resources	612 8224 2887	dcoates
Stuart Howe	Resources	613 9235 1856	showe
Analysts			
James Filius	Analyst	613 9235 1612	jfilius
Alexander McLean	Analyst	612 8224 2886	amclean
Damien Williamson	Analyst	613 9235 1958	dwilliamson

Bell Potter Securities Limited
ABN 25 006 390 7721
Level 38, Aurora Place
88 Phillip Street, Sydney 2000
Telephone +61 2 9255 7200
www.bellpotter.com.au