April 20th, 2016

**Research Update**

SMC Research
Small and Mid Cap Research

# artec technologies AG

## Growth leap in 2015 and good prospects for the future

Rating: **Buy** (unchanged) | Price: **5.91 Euro** | Price target: **6.60 Euro**


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# Recent business development


## Basic data

| | |
|---|---|
| **Based in:** | Diepholz |
| **Sector:** | Software |
| **Headcount:** | 25 |
| **Accounting:** | HGB |
| | |
| **ISIN:** | DE0005209589 |
| **Price:** | 5.91 Euro |
| **Market segment:** | Entry Standard |
| **Number of shares:** | 2.37 m |
| **Market Cap:** | 14.0 m Euro |
| **Enterprise Value:** | 13.7 m Euro |
| **Free float:** | approx. 29.0 % |
| **Price high/low (12 M):** | 9.04 / 1.601 Euro |
| **Ø turnover (12 M):** | 38,500 Euro |

For the second year in a row, artec has achieved a high growth and increased sales by more than 40 percent. As a result, the EBIT and the pre-tax result were nearly quintupled and operating cash flows jumped up as well. This result illustrates the great opportunities arising from the combination of artec's innovative technology and the development of the addressed markets. Based on its further improved foundation in terms of technology, balance sheet and liquidity artec should be able to continue this upward trend in the future as well. The successful recent capital increase is also important with regard to the further growth. artec plans to use the proceeds for an accelerated expansion of the scarce capacities. However, the recruitment and especially the training of additional employees will probably take several months, and we do not expect a perceptible capacity effect before 2017. Anticipating these higher capacities, we have revised our model towards a higher growth dynamic – from 2017 on – and ascertain now a new price target of EUR 6.60 per share. Our rating remains "buy".

| FY ends: 31.12. | 2013 | 2014 | 2015 | 2016e | 2017e | 2018e |
|---|---|---|---|---|---|---|
| Sales (m Euro) | 1.83 | 2.44 | 3.47 | 3.90 | 5.60 | 7.28 |
| EBIT (m Euro) | -0.42 | 0.11 | 0.64 | 0.39 | 0.92 | 1.38 |
| Net profit | -0.24 | 0.52 | 0.46 | 0.38 | 0.90 | 1.23 |
| EpS | -0.11 | 0.24 | 0.22 | 0.16 | 0.38 | 0.52 |
| Dividend per share | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Sales growth | -17.5% | 33.0% | 42.4% | 12.4% | 43.6% | 30.0% |
| Profit growth | - | - | -10.7% | -17.9% | 138.4% | 35.7% |
| PSR | 7.63 | 5.74 | 4.03 | 3.58 | 2.50 | 1.92 |
| PER | - | 27.0 | 30.2 | 36.8 | 15.5 | 11.4 |
| PCR | 51.59 | 61.71 | 14.38 | 21.49 | 11.85 | 9.30 |
| EV / EBIT | - | 127.2 | 21.6 | 34.8 | 15.0 | 10.0 |
| Dividend yield | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |

## High growth continues

After its sales had already improved by a third in 2014, artec was able to increase this high dynamic even further last year. Sales rose year-on-year by 42.4 percent to EUR 3.5m, with a particularly strong growth of more than 50 percent in the second half that was due to a low pre-year figure. Compared to the first half, however, the sales between July and December were slightly weaker (EUR 1.6 m after EUR 1.9 m). This was partly due to a defensive revenue recognition and partly to the lack of spare capacities.

## Result quintupled

The high utilization was caused by the high growth artec had mastered with an essentially unchanged workforce, which on the other side had a positive effect on the result. The EBITDA doubled to EUR 1.0 m, and while depreciation and amortization remained unchanged, the EBIT nearly quintupled to EUR 0.6 m. The pre-tax result increased to the same extent while the net profit that had hugely benefited from the rise of deferred taxes last year fell slightly to EUR 0.46 m. The EBITDA margin improved by 9.5 percentage points to 29.7 percent and the EBIT margin rose to 18.4 percent.

## Outstanding cash flows development

The operating cash flows have seen particularly strong development and have quadrupled to nearly EUR 1.0 m and thus to almost 30 percent of sales. After disbursements for investment activities (above all, software development) there remained a free cash flow of EUR 0.5 m. artec used this to completely pay off the few remaining bank liabilities. Moreover, for the first time in several years the company reports a significantly positive cash position with EUR 0.2 m.

## Balance-sheet structure improved

Due to the high profit and the debt repayment, the equity ratio has seen a further increase from 84.0 to 92.0 percent of the balance sheet total. The structure of the assets side has improved as well because of the increased cash; at the same time, the deferred taxes have lost some of their relative weight.

| Business figures | FY 2014 | FY 2015 | *Change* |
|---|---|---|---|
| Sales | 2.44 | 3.47 | *+42.4%* |
| EBITDA | 0.49 | 1.03 | *+109.2%* |
| *EBITDA margin* | *20.2%* | *29.7%* | |
| EBIT | 0.11 | 0.64 | *+489.6%* |
| *EBIT margin* | *4.4%* | *18.4%* | |
| Pre-tax result | 0.11 | 0.64 | *+487.0%* |
| *Pre-tax margin* | *4.4%* | *18.3%* | |
| Net profit | 0.52 | 0.46 | *-10.7%* |
| *Net margin* | *21.3%* | *13.3%* | |

*In m Euro and percent; source: company*

## Capital increase placed

artec has further improved its balance sheet and its cash position with a ten-percent capital increase last March. 215,000 of new shares have been placed at a price of EUR 4.60 per share, generating gross proceeds of EUR 1.0 m.

## Capacity expansion planned

artec is planning to use the fresh funds to expand its capacity and thus to extend the growth of the last two years. In particular, the company wants to recruit new staff to resolve the current capacity bottlenecks. Due to the high utilization in the last quarters, the company was not always able to process all requests adequately, and according to its own statements, it was also lacking the resources for systematic sales activities. These bottlenecks might well be the reason that there have not yet been any announcements of sales success in the area of OTT streaming technology. Here, artec had recruited a top-class sales representative last year, but was not able to finalize the product development due to capacity constraints. In order to resolve such growth impediments, the company is planning to recruit new staff for software development and for technical sales, who shall also be able to carry out operative tasks for a customer in case of successful order acquisition. Since the training of new employees takes several months as a rule, artec has shunned a higher degree of investment in this area up until now. However, the financial buffer created by last year's result and the capital increase will be now used to attempt the next growth step. Upon the whole, artec plans to recruit up to ten new employees and reports a satisfactory situation in the recruitment market.

## Technological leadership

The artec figures for 2015 have been strong, but after the first half year not anymore surprisingly so. We had even expected slightly higher sales and accordingly a slightly higher profit, which we think could well have been achieved with a more offensive revenue recognition. Nevertheless, the profit is still considerably higher than the figures we had assumed at the beginning of 2015. Operating cash flows were also better than we expected. However, the second half shows – just as in 2014 – that profitable growth cannot be taken for granted and that the project driven business is not easily predictable. In spite of this, however, there is basically a positive trend, artec – as a technological leader – is moving in very promising markets and should well be able to propel its growth in future years as well – if the planned expansion of capacities is successful. The company's exceptional position with regard to technology has been confirmed by – amongst others – the renowned US trade journal CIO-Review Magazine. It numbers artec among 20 leading companies worldwide that influence the market for video surveillance technology in a lasting way and have the best prospects.

## Competitor taken over

Even more than video surveillance technology, the broadcasting area offers a considerable potential for the future. The Xentaurix platform and the new – or announced – products and features like the OTT streaming decoders, digital fingerprinting of video footage, and above all the possibility of a semantic search in video data – all these things move artec in the direction of a video search engine. The company is thus operating in an area for which there are worldwide great expectations. An indication for the future strategic importance that many market participants attach to handling video data is the recently announced takeover of an artec competitor, Volicon, by Verizon Digital Media Services, a subsidiary of the US media and telecommunication giant Verizon. According to press releases, the group that has taken over AOL last year and is also interested in acquiring Yahoo is emphasizing very strongly the connection of video services and online advertising within its growth strategy. Based on its leading role as a video specialist the company wants to catch up with internet giants like Facebook or Google in the online advertising market.

## Sales estimates raised

These developments show that artec's strategic orientation is on the right track and confirm the impression that there are only few restrictions on the demand side right now. However, the company is reaching capacity limits. As artec is still focusing strongly on customized solutions or at least on extensive, tailor-made adaptations of its products, the oftentimes spectacular projects require in part a considerable development or customizing efforts, which in turn slow down the pace of expansion at the moment. This will probably only change after the conclusion of the TRANSAS project, from which artec expects to generate a resalable product, and once the development of decoders for OTT streaming is completed. However, the next pilot contracts in the broadcasting area will probably require considerable development effort as well due to the high degree of innovation of the solutions at issue. We therefore expect a perceptible improvement of the capacity situation only after the announced workforce expansion. As the recruitment and especially the training of new staff is still taking several months, and will probably put additional strain on the available capacities for the time being, we do not expect a noticeable net effect on capacities before the next year. Consequently, we now think that our last estimate for the 2016 sales growth (based on the assumption of a much quicker workforce expansion) was far too optimistic. We have therefore reduced the estimation and are now calculating with only a slight rise to EUR 3.90

m. In return, due to further brisk demand and the fact that there are many new opportunities arising for artec from new fields of application and new markets, we have revised the hitherto anticipated subsequent flattening-out of the growth rates and have modelled a strong leap in sales especially for 2017 and 2018. For the subsequent years, we have raised the expected growth rates as well, and are now assuming sales of EUR 14.0 m for the end of the detailed forecast period in 2023 (compared to hitherto EUR 9.5 m for 2022).

## Investment phase

Additionally, and contrary to the principally assumed trend of a sinking personnel expenses ratio, we have assumed higher values for 2016 and 2017 and have thus incorporated artec's planned accelerated workforce expansion into our model. Together with the expenses for the capital increase, this leads in our model to a year-on-year considerably reduced EBIT margin, which is, however, still at a comfortable level at 10.1 percent. Subsequently, assuming growth-related economies of scale, we let the EBIT-margin increase again up to 21.4 percent in 2023.

## Outline data adjusted

The table on this page summarizes the most important figures of the detailed forecast period 2016-2023. For the basic model assumptions, we would like to refer to our extensive research report from June 10th, 2015. Detailed overviews of balance sheet, P&L and cash flows estimations are to be found in the Annex as well. Another change we made concerns the safety discount for the EBIT margin beyond the detailed forecast period, which we have lowered from 50 to 33 percent. In order to ascertain the terminal value, we calculate therefore with an EBIT margin of 16.1 percent and thus with a figure below last year's actual value in spite of the modification. The adjustment in our assumed target capital structure, which we have changed to an equity share of 85 percent due to high profitability, successful capital increase and the management's exceptional debt aversion, has an opposite effect. This results in a WACC increase to 9.6 percent.

| **million Euro** | **12 2016** | **12 2017** | **12 2018** | **12 2019** | **12 2020** | **12 2021** | **12 2022** | **12 2023** |
|---|---|---|---|---|---|---|---|---|
| Sales | 3.90 | 5.60 | 7.28 | 8.74 | 10.05 | 11.55 | 12.71 | 13.98 |
| Sales growth | | 43.6% | 30.0% | 20.0% | 15.0% | 15.0% | 10.0% | 10.0% |
| EBIT margin | 10.1% | 16.3% | 18.9% | 21.5% | 22.1% | 22.7% | 23.4% | 24.1% |
| **EBIT** | **0.39** | **0.92** | **1.38** | **1.87** | **2.22** | **2.63** | **2.97** | **3.36** |
| Tax rate | 5.0% | 5.0% | 15.0% | 30.0% | 30.0% | 30.0% | 30.0% | 30.0% |
| Adjusted tax payments | 0.02 | 0.05 | 0.21 | 0.56 | 0.67 | 0.79 | 0.89 | 1.01 |
| **NOPAT** | **0.37** | **0.87** | **1.17** | **1.31** | **1.55** | **1.84** | **2.08** | **2.35** |
| + Depreciation & Amortization | 0.30 | 0.32 | 0.34 | 0.36 | 0.37 | 0.38 | 0.39 | 0.41 |
| + Increase long-term accruals | 0.01 | 0.01 | 0.01 | 0.01 | 0.01 | 0.01 | 0.01 | 0.01 |
| + Others | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| **Gross operating cash flows** | 0.68 | 1.20 | 1.52 | 1.68 | 1.93 | 2.23 | 2.49 | 2.77 |
| - Increase Net Working Capital | -0.04 | -0.06 | -0.07 | -0.09 | -0.10 | -0.12 | -0.13 | -0.14 |
| - Investments in fixed assets | -0.39 | -0.40 | -0.41 | -0.42 | -0.43 | -0.44 | -0.44 | -0.45 |
| **Free cash flows** | **0.25** | **0.74** | **1.03** | **1.17** | **1.40** | **1.68** | **1.92** | **2.18** |

*SMC estimation model*

## New price target: EUR 6.60 per share

The modifications of our model combined with the rollover effect after the turn of the year have caused the assessed fair value of equity to increase to EUR 15.6 m. This corresponds with a fair value of EUR 6.58 per share, from which we derive a new price target of EUR 6.6; the number of shares that had increased to 2.37 m due to the last capital increase has already been taken into account. The estimation risk remains unchanged at 4 out of 6 possible points.

## Sensitivity analysis

For our sensitivity analysis, we have varied the input parameters WACC (between 8.6 and 10.6 percent) and perpetual cash-flows growth (between 0 and 2 percent). The fair value fluctuates between EUR 5.82 and EUR 7.80 per share.

| **Sensitivity analysis** | perpetual cash flows growth | | | | |
|---|---|---|---|---|---|
| WACC | **2.0%** | **1.5%** | **1.0%** | **0.5%** | **0.0%** |
| **8.6%** | 7.80 | 7.45 | 7.14 | 6.87 | 6.63 |
| **9.1%** | 7.42 | 7.11 | 6.84 | 6.61 | 6.39 |
| **9.6%** | 7.09 | 6.82 | **6.58** | 6.37 | 6.18 |
| **10.1%** | 6.80 | 6.56 | 6.35 | 6.16 | 5.99 |
| **10.6%** | 6.54 | 6.33 | 6.14 | 5.97 | 5.82 |

# Conclusion

In the last year, artec's performance was again convincing. With a growth clearly in the double digits, an EBIT margin of more than 18 percent and a sharp increase in cash flows the company has impressively shown the potential its innovative technology is offering in the addressed markets. This is all the more remarkable because in the course of the major project TRANSAS it has been necessary to break new technological ground at the interface of the two business areas video surveillance and broadcasting – a challenge that has been handled apparently without any problems so far.

However, the high degree of innovation of the projects had put such a strain on artec's capacities that the company had, for the time being, reached its growth limits in the second half of 2015. The conclusion of the extensive development work and especially the planned – and after the successful capital increase, possible – intensive workforce expansion are expected to remove this bottleneck from 2017 on and to lay a broader basis for growth.

If artec will be able to acquire the employees needed and to integrate them into the team, the dynamic development should well continue. According to announcements, there are currently hardly any restrictions on the demand side, and the company has many opportunities in various areas, which it should be able to seize a little more systematically as soon as the capacity increase is accomplished.

We have depicted this growth scenario in our model and have raised the average expansion dynamics compared to the previous approach. This results in a significantly higher (compared to our last update) price target of EUR 6.60 that indicates a further price potential of about 10 percent and thus still justifies a "buy" rating. Both the price target and the rating are based on fundamental considerations, but out of speculative considerations and especially against the backdrop of lively M&A-activities in the market, we think that even higher prices are possible – at least temporarily.

# Annex I: Balance sheet and P&L estimation

## Balance sheet estimation

| million Euro | 12 2015 | 12 2016 | 12 2017 | 12 2018 | 12 2019 | 12 2020 | 12 2021 | 12 2022 | 12 2023 |
|---|---|---|---|---|---|---|---|---|---|
| ASSETS | | | | | | | | | |
| I. Total non-current | 2.10 | 2.19 | 2.27 | 2.34 | 2.41 | 2.47 | 2.52 | 2.57 | 2.61 |
| 1. Intangible assets | 1.18 | 1.25 | 1.31 | 1.37 | 1.41 | 1.45 | 1.48 | 1.51 | 1.54 |
| 2. Tangible assets | 0.04 | 0.05 | 0.06 | 0.07 | 0.09 | 0.11 | 0.12 | 0.14 | 0.15 |
| II. Total current assets | 1.17 | 2.51 | 3.43 | 4.70 | 6.16 | 7.50 | 8.92 | 10.32 | 11.90 |
| **LIABILITIES** | | | | | | | | | |
| I. Equity | 3.03 | 4.40 | 5.30 | 6.53 | 7.91 | 9.15 | 10.44 | 11.69 | 13.10 |
| II. Accruals | 0.06 | 0.07 | 0.07 | 0.08 | 0.09 | 0.10 | 0.11 | 0.12 | 0.13 |
| III. Liabilities | | | | | | | | | |
| 1. Long-term liabilities | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| 2. Short-term liabilities | 0.20 | 0.26 | 0.34 | 0.45 | 0.59 | 0.74 | 0.91 | 1.10 | 1.31 |
| **TOTAL** | **3.29** | **4.72** | **5.72** | **7.07** | **8.59** | **9.98** | **11.46** | **12.91** | **14.53** |

## P&L estimation

| million Euro | 12 2015 | 12 2016 | 12 2017 | 12 2018 | 12 2019 | 12 2020 | 12 2021 | 12 2022 | 12 2023 |
|---|---|---|---|---|---|---|---|---|---|
| Sales | 3.47 | 3.90 | 5.60 | 7.28 | 8.74 | 10.05 | 11.55 | 12.71 | 13.98 |
| Overall performance | 3.96 | 4.27 | 5.97 | 7.66 | 9.12 | 10.44 | 11.95 | 13.11 | 14.38 |
| Gross profit | 2.80 | 2.98 | 4.13 | 5.33 | 6.41 | 7.32 | 8.37 | 9.17 | 10.05 |
| EBITDA | 1.03 | 0.70 | 1.24 | 1.72 | 2.23 | 2.59 | 3.01 | 3.37 | 3.77 |
| EBIT | 0.64 | 0.39 | 0.92 | 1.38 | 1.87 | 2.22 | 2.63 | 2.97 | 3.36 |
| EBT | 0.64 | 0.40 | 0.95 | 1.44 | 1.98 | 2.36 | 2.80 | 3.18 | 3.60 |
| EAT (before minorities) | 0.46 | 0.38 | 0.90 | 1.23 | 1.38 | 1.65 | 1.96 | 2.22 | 2.52 |
| EAT | 0.46 | 0.38 | 0.90 | 1.23 | 1.38 | 1.65 | 1.96 | 2.22 | 2.52 |
| EPS | 0.22 | 0.16 | 0.38 | 0.52 | 0.58 | 0.70 | 0.83 | 0.94 | 1.07 |

# Annex II: Cash flows estimation and key figures

## Cash flows estimation

| million Euro | 12 2015 | 12 2016 | 12 2017 | 12 2018 | 12 2019 | 12 2020 | 12 2021 | 12 2022 | 12 2023 |
|---|---|---|---|---|---|---|---|---|---|
| CF operating | 0.97 | 0.65 | 1.18 | 1.50 | 1.66 | 1.93 | 2.23 | 2.50 | 2.79 |
| CF from investments | -0.51 | -0.39 | -0.40 | -0.41 | -0.42 | -0.43 | -0.44 | -0.44 | -0.45 |
| CF financing | -0.22 | 0.99 | 0.00 | 0.00 | 0.00 | -0.41 | -0.66 | -0.98 | -1.11 |
| Liquidity beginning of year. | 0.00 | 0.24 | 1.49 | 2.26 | 3.35 | 4.59 | 5.68 | 6.82 | 7.90 |
| Liquidity end of year | 0.24 | 1.49 | 2.26 | 3.35 | 4.59 | 5.68 | 6.82 | 7.90 | 9.13 |

## Key figures

| percent | 12 2015 | 12 2016 | 12 2017 | 12 2018 | 12 2019 | 12 2020 | 12 2021 | 12 2022 | 12 2023 |
|---|---|---|---|---|---|---|---|---|---|
| Sales growth | 42.4% | 12.4% | 43.6% | 30.0% | 20.0% | 15.0% | 15.0% | 10.0% | 10.0% |
| Gross margin | 80.8% | 76.5% | 73.7% | 73.2% | 73.4% | 72.9% | 72.4% | 72.1% | 71.9% |
| EBITDA margin | 29.7% | 17.9% | 22.1% | 23.6% | 25.5% | 25.8% | 26.0% | 26.5% | 27.0% |
| EBIT margin | 18.4% | 10.1% | 16.3% | 18.9% | 21.5% | 22.1% | 22.7% | 23.4% | 24.1% |
| EBT margin | 18.3% | 10.2% | 17.0% | 19.8% | 22.6% | 23.5% | 24.2% | 25.0% | 25.8% |
| Net margin (after minorities) | 13.3% | 9.7% | 16.2% | 16.9% | 15.8% | 16.4% | 16.9% | 17.5% | 18.0% |

# Disclaimer

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**Charts**

The charts were made with Tai-Pan (www.lp-software.de).

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**II) Preparation and updating**

The present financial analysis was prepared by: Dr. Adam Jakubowski

For the preparation of its financial analyses the sc-consult GmbH uses a five-tier rating scheme with regard to price expectation in the next twelve months. Additionally, estimation risk is quantified on a scale from 1 (low) to 6 (high). The ratings are as follows:

| | |
|---|---|
| Strong Buy | We expect an increase in price for the analyzed financial instrument by at least 10 percent. We assess the estimation risk as below average (1 to 2 points). |
| Buy | We expect an increase in price for the analyzed financial instrument by at least 10 percent. We assess the estimation risk as average (3 to 4 points). |
| Speculative Buy | We expect an increase in price for the analyzed financial instrument by at least 10 percent. We assess the estimation risk as above average (5 to 6 points). |
| Hold | We expect that the price of the analyzed financial instrument will remain stable (between -10 and +10 percent). The forecast risk (1 to 6 points) has no further impact on the rating. |
| Sell | We expect that the price of the analyzed financial instrument will drop by at least 10 percent. The forecast risk (1 to 6 points) has no further impact on the rating. |

The expected change in price refers to the current share price of the analyzed company. This price and any other share prices used in this analysis are XETRA closing prices as of the last trading day before publication. If the share is not traded on XETRA, the closing price of another public stock exchange is used with a separate note to that effect.

The price targets published within the assessment are calculated with common methods of financial mathematics, especially with the DCF (discounted cash flow) method, the sum of the parts valuation and a peer group analysis. The valuation methods are affected by economic framework conditions, especially by the development of the interest rates.
The rating resulting from these methods reflects current expectations and can change anytime subject to company-specific or economic changes.

In the past 24 months, sc-consult GmbH has published the following financial analyses for the company:

| Date | Rating | Target price | Conflict of interest |
|---|---|---|---|
| 09-08-2015 | Buy | EUR 4.90 | 1), 3), 4), 5) |
| 06-10-2015 | Buy | EUR 3.00 | 1), 3), 4), 5) |
| 03-12-2015 | Buy | EUR 2.80 | 1), 3), 4), 5) |
| 09-09-2014 | Buy | EUR 2.50 | 1), 5) |
| 07-01-2014 | Buy | EUR 2.10 | 1), 3) |
| 03-12-2014 | Buy | EUR 2.10 | 1), 3), 4) |

In the course of the next twelve months, sc-consult GmbH will presumably prepare the following financial analyses for the company: one Report, two Research-Comments

The publishing dates for the financial analyses are not yet fixed at the present moment.

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