

23 February 2009

## CustomVis

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
06/07	0.9	(1.4)	(1.8)	0.0	N/A	N/A
06/08	1.2	(1.4)	(1.5)	0.0	N/A	N/A
06/09e	1.7	(1.0)	(0.6)	0.0	N/A	N/A
06/10e	3.2	0.3	0.2	0.0	2.2	N/A

Note: \*PBT and EPS are normalised, excluding goodwill amortisation and exceptional items. An FY08 currency gain of £2.4m is excluded, as it was a non-cash item.

### Investment summary: Currency adjustment

CustomVis published its delayed FY08 accounts in January. Sales progressed with 11 units installed in FY08 and a further seven units installed in the first half of FY09. A new retinal camera is in pre-launch phase and could be cash flow generative in FY10. The new auditors use a rigorous sales definition and have adjusted comprehensively for currency. This created a real £397k tax charge. There is a theoretical £2.4m currency gain on a £10m intercompany loan.

### Sales show steady increase

Sales definitions have changed with different auditors. Sales are now booked when the laser is installed. Eleven installation/sales were made in FY08, taking the installed base (including demo units) to 28. Seven lasers were installed in H109. The low running costs and high throughput of the Pulzar laser are distinct sales advantages in the current economic climate. Some sales were made in the EU.

### Cash, currency and tax

CustomVis raised £2.24m at 3.25p at the end of FY08. Year-end reported cash was £1.5m after a -£200k currency adjustment. Australian operations are funded by an intercompany loan, now c £10m. Currency movements created a nominal gain of £2.4m on the loan giving a real UK tax of £397. Most sales are in US\$; most costs are A\$. The A\$ weakness versus the US\$ has improved local cash flows.

### Corporate governance

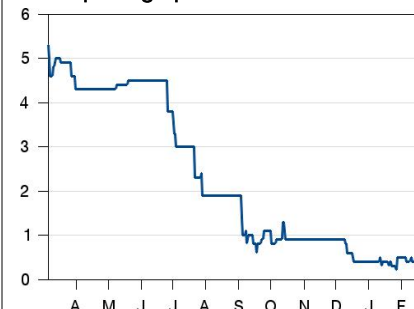
The departure of the COO in September and a re-structuring of board roles has led to Simon Carroll becoming chairman. The board now oversees operations and cash monthly. Sales are priced to be profitable with increased deposits. Unprofitable sales are declined. Debtors are better controlled; £30k of bad debt has been written off.

### Valuation: Cash lags profits

We assume sales of 13 installed units in FY09, which indicates reported sales on constant currency of £1.7m. As currencies have badly distorted cash flows, valuation on a straight DCF model is not reliable. On a prospective sales multiple of 2x, a value of £3-4m may be indicated.

Price 0.43p  
Market Cap £1m

#### Share price graph



#### Share details

Code CUS  
Listing AIM  
Sector Health Care Equipment & Services  
Shares in issue 169.2m

#### Price

52 week High 5.38p Low 0.29p

#### Balance Sheet as at 30 June 2008

Debt/Equity (%) N/A  
NAV per share (p) 2.0  
Net cash (£m) 1.5

#### Business

CustomVis designs, builds and sells innovative lasers for high-end custom eye surgery. Based in Australia, its sales are in Asia and emerging countries; EU sales are now developing.

#### Valuation

	2007	2008e	2009e
P/E Relative	N/A	N/A	22%
P/CF	N/A	N/A	3.1
EV/Sales	N/A	N/A	N/A
ROE	N/A	N/A	N/A

#### Geography based on revenues

UK	Europe	US	Other
0%	15%	0%	85%

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## Investment summary: Currency adjustment

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### Company description: Continued technical leadership

CustomVis produces and sells the only solid-state laser surgical device, the Pulzar Z1, for correction of eyesight. The business advantages of solid state, low running costs and faster throughput of patients, are appealing when ophthalmic surgeons need to attract more price sensitive customers and reduce their operational costs. Competitors use excimer gas technology that is less flexible, more costly and requires shipping of special, toxic gases – not easy in developing countries. The CustomVis Pulsar Z1 has been upgraded technically and retains its technical lead.

Sales remain biased towards Asia and the Middle East, but the company is now making sales in the EU and South America; the US market is still a number of years away. A new lower-cost, cash-sale product – a retinal camera suitable for high-street ophthalmologist use in glaucoma monitoring – could expand sales from FY10 onwards. A small pre-production run will occur soon and 10 units will be placed with ophthalmologists and surgeons to get feedback and opinion leader support.

### Valuation

The volatility of currencies means that DCF valuation is not currently reliable. A crude but robust value method is to use a sales multiple. CustomVis may sell 13-22 lasers in FY09, sales being installed units that generate revenues. The retinal camera is a novel product targeting an under-served market niche and should generate cash sales on perhaps over 100 units in in FY10. Accordingly, a sales multiple of up to 2x might be justified indicating a possible value of £3.4m on projected FY09 sales of £1.7m. There are 169m shares in issue, indicating a value of 2p per share.

### Sensitivities

- The accounts highlighted the diverse currency exposures of the company leading to an unnecessary tax charge at a time when cash remains critical. The corporate structure dating from IPO may need reorganisation. The major currency movements since June 2008 could require major adjustments to the FY09, accounts.
- The business model relies on CustomVis funding laser purchases over two-to-three years, although some sales are for cash. Additional working capital may be required.
- Management is stretched – the board comprises three directors two of whom are non-exec. There has been a high churn rate of finance personnel. The former COO's position was terminated in August and he resigned in September. However, the strong emphasis on corporate governance under the new chairman may now achieve consistency.
- The retinal camera appears to be a well-designed product fitting an unoccupied market niche. This could be a cash generative product for the company. The reaction to the placement of production prototypes may be critical.
- There is a nine-month sales cycle so the effect of the global recession on installations may not be fully seen. It is also possible that the business and technical advantages of the Pulzar laser could enable it to improve its market position.
- US market entry is not feasible for many years unless CustomVis partners with a major company that has a US sales force and cash for clinical trials.

## Company description: Retinal cameras – a new product line for FY10

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CustomVis is developing a new product line: Retinal cameras. This is a small device at a much lower price point, c \$12k. This is important, as it is a product with a potentially short sales cycle offering good margins and cash sales. It could be the key to profit and positive cash flow in FY10. Retinal cameras are used to record the state of a patient's retina. Current models take digital images that can be analysed. The main use is in detecting and monitoring glaucoma. Other clinical indications where the camera could be used include diabetic retinopathy, which affects late stage diabetic patients, hypertensive patients and potentially veterinary use.

### Glaucoma

Worldwide, there are 8.4m people with glaucoma; this number is predicted to rise to 11m by 2020. The prevalence of open-angle glaucoma (OAG) in the US population 40 years and older is estimated to be 1.86%. Extrapolating this to the US population as determined in the 2000 US census, it is estimated that OAG affects 2.22m US citizens.<sup>1</sup> Owing to the aging population, the proportion with OAG will increase by 50% to 3.6m in 2020. At least five times this number will be monitored for the condition.

Glaucoma is traditionally associated with high intra-ocular pressure (IOP) caused by poor drainage of the eye. However, in the 1990s, it was realised that loss of eyesight occurred irrespective of pressure, although pressure itself is certainly a contributory factor. The medical position now is that the underlying causes of glaucoma are unclear. It appears that the disease is due to death of the nerve cells (retinal ganglion cells [RGCs]) that transmit the visual image from the retina to the brain.<sup>2</sup>

Glaucoma is still treated with eye drops to reduce intra-ocular pressure. In some cases, pressure reduction appears to stabilise the disease. In other cases, the disease progresses despite reductions in pressure, and in 20-30% of cases, the glaucoma does not manifest itself with any increased intra-ocular pressure over normal levels. Even in pressure-stabilised patients, a progressive 9-10% deterioration is seen. Hence, imaging techniques to record retinal changes are required; eye pressure alone is inadequate as a diagnostic.

### Detecting glaucoma

Whatever the reason for glaucoma, it is believed that high levels of retinal ganglion cell death occur for approximately 10 years before the glaucoma clinically manifests itself in a gradual loss of visual field. RGC death seems to occur throughout the eye, resulting in a general degradation of the visual field. The effect is to lose peripheral vision first, leading to tunnel vision. Up to 40% of RGCs may have died at the point of diagnosis. As nerve cells, RGCs do not regenerate.

As the number of ganglion cells reduces, gross morphological changes are seen in the cup of the optic (where the nerves are bundled together to leave the eye and connect to the brain). Although

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<sup>1</sup> Prevalence of Open-Angle Glaucoma. The Eye Diseases Prevalence Research Group. 2004, *Arch. Ophthalmol.*, Vol. 122, pp. 532-538

<sup>2</sup> Disease Progression and the Need for Neuroprotection in Glaucoma management. Varma, R. et al. 2008, *Am. J. Managed Care*, Vol. 14, pp. S15-S19.

correlations are claimed, various advanced optical techniques for determining the morphology of the cup or the depth of the ganglion layer do not appear to correlate with clinical indications.

Before visual field loss, the standard way of testing for glaucoma is to measure the pressure of the eye. This test is routine in many eyesight tests but as discussed above will miss a number of cases. If a retinal image is taken, gradual changes in the retina and the shape of the cup can be detected over some years; imaging is still the best method for detecting and monitoring the disease as changes to the shape of the cup over time appear to be the most accurate predictor of glaucoma. CustomVis is developing a high-quality portable camera for use by high-street ophthalmologists (and for taking quick images in eye clinics).

## Competitive positioning

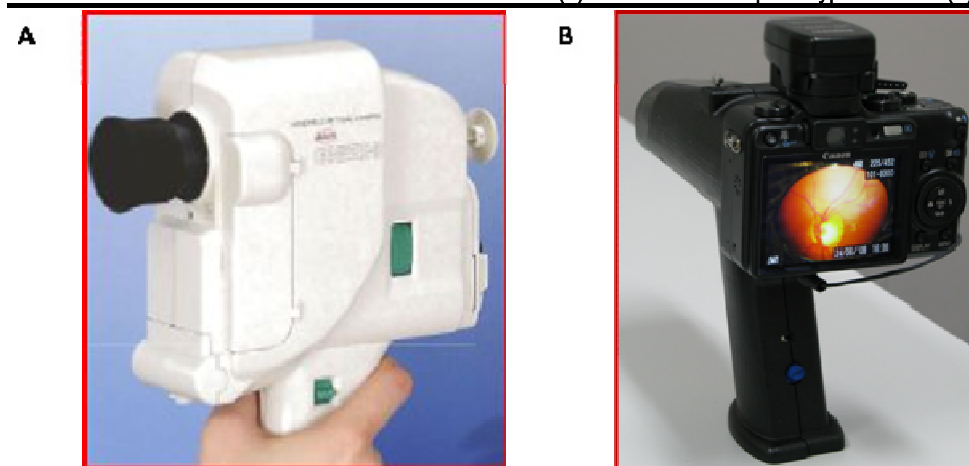
The CustomVis camera is currently at pre-production stage. CustomVis plans to manufacture 10 units soon and place these with opinion leaders at a low price to test the market and gather clinical data. If this goes well the unit would be made in volume, probably in H110.

The unit takes a simple, high-resolution picture but has no image processing. It is based on a high-end SLR camera with a coupled eye imaging and flash lens attachment. It appears to be easy to operate and the image can be seen immediately on the large LCD display on the camera back.

The two established competitors are Kowa (Japan) and Nidek (Japan). Clarity Medical Systems (US) also produces imaging systems. Competitors are tethered systems, that is the camera is attached by cable to a PC and power source. The CustomVis camera is fully independent.

Kowa makes a range of benchtop retinal cameras, such as the powerful and high-resolution VX-10 and Non-myd 7 products. It also has a handheld device, the Genesis-D with a 2-megapixel camera (Exhibit 1). This is sold for \$20,000-30,000. Note that Exhibit 1A does not show the cable attached to the Kowa unit or the required PC. In contrast, the CustomVis unit is as portable as an SLR camera.

### Exhibit 1: Kowa Genesis-D handheld fundus camera (A) and CustomVis prototype camera (B)



Source: Kowa product brochure, CustomVis

Clarity makes both fixed and semi-portable systems. The Retcam Shuttle is very sophisticated, transportable on a trolley (not handheld) and targeted at the paediatric and infant market. It costs over US\$100,000. The Nidek NM-200 is a desktop system using a small handheld, tethered camera. It fits with a range of benchtop camera systems.

## Market potential

This market is different from that for lasers, which are sold to ophthalmic surgeons; however, such surgeons increasingly need to make retinal records and offer a new market for a portable camera. The main market remains the high-street optometrists. These individuals carry out eyesight tests, including pressure tests for glaucoma, and prescribe vision correction, spectacles or contact lenses. An optician fits and dispenses the prescription. There were 33,000 optometrists in the US according to US government statistics. There were twice as many opticians. There are 10,000 optometrists registered in the UK.

We have assumed that 10 pre-production units are sold on an evaluation basis in the second half of 2009 with at least one hundred production units in FY10. The potential could be several hundred to units per year if appropriate distribution channels are established. The camera may also need appropriate image analysis and archiving software as a bundle. Pricing is not yet determined, but we have assumed \$12,000 (£6,500) as a list price before distributor discounts of c 25%.

## Financials: Final results to 30 June 2008

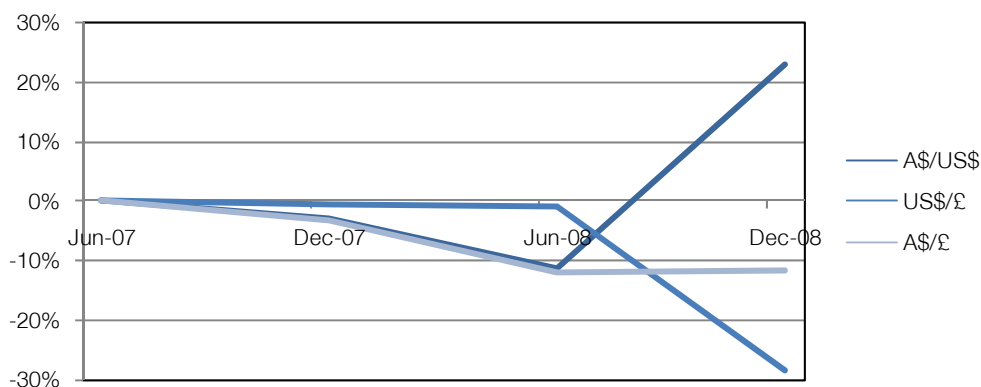
The company's policy on sales recognition and the accounting treatment of sales has altered under different auditors (see note dated 27 November 2007). The current policy is that the company records a sale once CustomVis installs the laser at the customer site. This means that reported figures from previous periods may not form a consistent series. The Board has changed the auditors and aims to retain the current finance personal to provide consistency.

## Currency effects

CustomVis has a high level of currency exposure. Sales are mostly in US dollars, costs are mostly in Australian dollars, and results are reported in pounds sterling. In addition, as most lasers are sold on deferred terms, the deferred payment value fluctuates with currency rates. This results in accounting adjustments that are non-cash and complicate the accounts.

Operations in Australia are funded in Australian dollars so the US\$/A\$ rate affects local cash flows. Since June 2008, the Australian dollar has dropped 23% against the US dollar, improving local cash flows. The A\$/£ rate has remained flat since June so reported costs in FY09 should be level. As the pound has fallen by 28% against the US dollar since June 2008, reported revenues should benefit. Exhibit 2 shows relative currency movements at interbank rates.

**Exhibit 2: Currency rates, June 2007-December 2008**



Source: Bloomberg

## Revenues

Revenues rose to £1.16m, a reported increase of 31.7% over FY07. Sales are 80% US dollars and 20% euros (all leasing revenues, some euro sales have been made the first half of FY09). Eleven lasers were sold against nine in the previous year. Revenues are broken down in Exhibit 2.

### Exhibit 2: Revenues

Item	Value
Installed lasers	£1,143k
Minus service costs (accrued) of	£275k
Plus service fees (released from accruals)	£131k
Leased income under the old sales contract	£161k

Source: Edison Investment Research

The deduction for service is because lasers are sold with a one-to-three year service element or guarantee; this can be longer in some cases. To reflect this liability in the accounts, an average £25k per installed system is deducted from revenues and accrued. This is then released to the P&L at monthly intervals over the service contract period; this differs for each laser. These are balance sheet not cash items. However, the Australian operation does incur similar costs in servicing the units. Leases will expire during 2009.

## Costs

Cost of goods was £533k giving a gross profit of £629k. Costs of operations were £1.4m, a change of -1%. Within costs, staff costs fell by 29% and marketing by 40%, but administration rose by 225%; this may reflect cost-reallocations. The company had other income of £438k. This is a mixture of rent for subletting part of the premises, Australian grants and interest of £23k.

## The effect of corporate structure

CustomVis's Australian operations are funded by an intercompany loan from the UK listed company. The loan has a theoretical interest rate, which is unpaid. At the year end, the loan was about £10m. As the Australian dollar declined against the pound over the period, a nominal gain of £2.4m has been recorded. This amount will be adjusted to market rates on each reporting date that will lead to an unpredictable P&L item. A gain of £20k is possible in the interim figures.

The effect is to cause a real corporation tax charge of £90k for FY08. In addition, the theoretical interest on the intercompany loan, which was written off in previous years' accounts, was wrongly used in tax calculations, causing a further tax charge of £302k. This makes a maximum tax of £397k; the company is attempting to minimise this.

## Balance sheet

A number of currency adjustments have been made, so the inter-relationship of the balance sheet and cash flow statement is not always clear.

## Inventories

Inventories increased by £392k on the balance sheet but decreased by £3k cash after currency effects. The balance sheet inventory of £1.5m includes £563k of finished lasers, about 11 lasers. There is £723k of raw materials. One of our key cash management assumptions is that inventories decrease by at least £500k to release capital.

## Debtors

Trade debtors rose to £880k up £364k of which £112k has been due more than 120 days. The currency-corrected increase was £600k. Deferred payments due in more than a year rose to £664k. A steady rise in the debtor position is inevitable without external financing of laser sales. It is also critical that cash payments on installed lasers are received promptly.

## Creditors

Trade creditors remained at 30 days. We assume these remain level. Accrued service costs now stand at £438k. This is a significant liability but is a worst-case as actual costs may be less than this. CustomVis has moved to a marketing strategy where distributors place and service lasers. This may lower accrual rates. In addition, as the installed base increases, service engineers are used more efficiently and as guarantee periods start to expire over the next few years, servicing becomes a revenue generating activity.

## Cash flow and cash

Following the £2.24m financing in 2008, year-end cash was £1.4m. With the increased deposit level, CustomVis is now covering the direct cost of each sale. Cash is also coming in from previous installations and the retinal camera may contribute cash next year. We have assumed that debtors are controlled and inventories are decreased to fund growth. If this is not achieved the company would need additional finance.

## Outlook

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The company forecast that sales for FY09 may be 13 units, up from 11 in FY07. The board has set a target of selling 15 in the second half of FY09; 22 for the year. This seems ambitious especially if the pricing level is maintained. The retinal camera could add a further £625k of sales in FY10. However, this is currently difficult to assess and may be an underestimate. New laser distributors may become available in 2009 if Alcon switches sales to its own distribution network. The presbyopia application (a treatment that removes the need for reading glasses) could also add to sales. The presbyopia method has been further improved and a second trial will be run.

## Valuation

Currency volatility and the lumpy nature of the sales mean that DCF valuation is not currently reliable. A crude but robust alternative valuation method is to use a sales multiple. Accordingly, a sales multiple of up to 2x might be justified suggesting an indicative value of £3.4m on projected FY09 sales of £1.7m. There are 169m shares in issue, indicating a value of 2p per share.

It is possible that if over 20 units per year can be installed plus at least 100 retinal cameras sold, CustomVis could, with careful cash and cost management, become cash positive and profitable. This could happen in FY10, and would allow a sustainable valuation revision

**Exhibit 3: Financials**

Year end 30 June	£'000	2007 IFRS	2008 IFRS	2009e IFRS	2010e IFRS
<b>PROFIT &amp; LOSS</b>					
<b>Revenue</b>		<b>881</b>	<b>1,161</b>	<b>1,734</b>	<b>3,212</b>
Cost of Sales		(483)	(533)	(580)	(784)
Gross Profit		398	629	1,154	2,427
<b>EBITDA</b>		<b>(1,628)</b>	<b>(1,563)</b>	<b>(1,079)</b>	<b>152</b>
<b>Operating Profit (before GW and except.)</b>		<b>(1,494)</b>	<b>(1,448)</b>	<b>(964)</b>	<b>267</b>
Goodwill Amortisation		0	0	0	0
Exceptionals		0	2,481	0	0
Other		0	0	0	0
<b>Operating Profit</b>		<b>(1,494)</b>	<b>1,033</b>	<b>(964)</b>	<b>267</b>
Net Interest		55	23	10	5
<b>Profit Before Tax (norm)</b>		<b>(1,438)</b>	<b>(1,425)</b>	<b>(954)</b>	<b>272</b>
<b>Profit Before Tax (FRS 3)</b>		<b>(1,438)</b>	<b>1,056</b>	<b>(954)</b>	<b>272</b>
Tax		0.0	(397.6)	0.0	1.0
<b>Profit After Tax (norm)</b>		<b>(1,438)</b>	<b>(1,823)</b>	<b>(954)</b>	<b>274</b>
<b>Profit After Tax (FRS 3)</b>		<b>(1,438)</b>	<b>659</b>	<b>(954)</b>	<b>273</b>
Average Number of Shares Outstanding (m)		80.1	117.9	169.2	169.1
EPS - normalised (p)		(1.8)	(1.5)	(0.6)	0.2
EPS - FRS 3 (p)		(1.8)	0.6	(0.6)	0.2
Dividend per share (p)		0.0	0.0	0.0	0.0
Gross Margin (%)		45.2	54.1	66.5	75.6
EBITDA Margin (%)		N/A	N/A	N/A	N/A
Operating Margin (before GW and except.) (%)		N/A	N/A	N/A	N/A
<b>BALANCE SHEET</b>					
<b>Fixed Assets</b>		<b>217</b>	<b>145</b>	<b>95</b>	<b>95</b>
Intangible Assets		0	0	0	0
Tangible Assets		217	145	95	95
Investment in associates		0	0	0	0
<b>Current Assets</b>		<b>2,939</b>	<b>4,547</b>	<b>3,425</b>	<b>4,624</b>
Stocks		1,118	1,510	1,200	1,100
Debtors		923	1,464	1,855	2,962
Cash		897	1,493	291	483
<b>Current Liabilities</b>		<b>(619)</b>	<b>(1,336)</b>	<b>(1,119)</b>	<b>(2,046)</b>
Creditors		(619)	(1,336)	(1,119)	(2,046)
Short term borrowings		0	0	0	0
<b>Long Term Liabilities</b>		<b>(140)</b>	<b>0</b>	<b>0</b>	<b>0</b>
Long term borrowings		0	0	0	0
Other long term liabilities		(140)	0	0	0
<b>Net Assets</b>		<b>2,397</b>	<b>3,356</b>	<b>2,402</b>	<b>2,674</b>
<b>CASH FLOW</b>					
<b>Operating Cash Flow</b>		<b>(1,707)</b>	<b>(1,891)</b>	<b>(1,188)</b>	<b>237</b>
Net Interest		55	23	10	5
Tax		0	0	0	0
Capex		(72)	(5)	(25)	(50)
Acquisitions/disposals		0	0	0	0
Financing		1,384	2,470	0	0
Dividends		0	0	0	0
Net Cash Flow		(340)	596	(1,203)	192
<b>Opening net debt/(cash)</b>		<b>(1,238)</b>	<b>(897)</b>	<b>(1,493)</b>	<b>(291)</b>
HP finance leases initiated		0	0	0	0
Other		0	(0)	0	0
<b>Closing net debt/(cash)</b>		<b>(897)</b>	<b>(1,493)</b>	<b>(291)</b>	<b>(483)</b>

Source: Company accounts/Edison Investment Research

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