27 November 2007

CustomVis

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	PE (x)	Yield (%)
06/06	0.0	(2.2)	(3.9)	0.0	N/A	N/A
06/07	0.9	(1.4)	(1.8)	0.0	N/A	N/A
06/08e	2.4	(0.3)	(0.3)	0.0	N/A	N/A
06/09e	3.8	0.0	0.1	0.0	70.6	N/A

Note: *PBT and EPS are normalised, excluding goodwill amortisation and exceptional items

Investment summary: Sales growth

CustomVis has announced its results for the year to 30 June. Last year, nine units were sold; since June this year there have been 10 sales (confirmed orders) with more likely to be signed this half. Management believes that up to 18 sales could be achieved in H2 matching current production capacity. An accounting restatement by auditors has caused a restatement of accounts but cash flows are unaltered.

Doubled sales rate since June

Sales have increased 2.5 fold over H1 2007 to 10 confirmed orders since June with six units installed; further orders in H1 2008 are possible. Management is confident of 18 sales in H2 2008. The company has production capacity of 36 units per year.

Higher market profile

CustomVis has assiduously worked the ophthalmic conference and exhibition circuit to raise its profile. Presentations from users have shown the advantages of solid state lasers with results well within FDA requirements. European sales did not occur in FY 2007.

Leased or deferred?

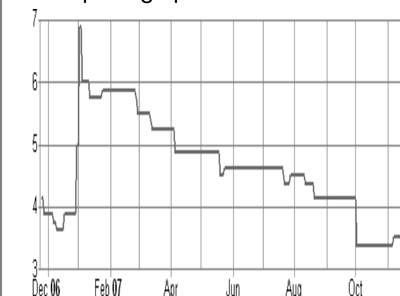
A small change in contract terms has caused a revision of accounting treatment defining all nine orders during 2006/2007 as sales rather than leases. This causes an apparent sudden rise in revenues but cashflows are unaltered with payments spread over two to three years. Hence a large debtor increase occurs with servicing costs treated as an accrual. Previous leased sales are unaffected.

Valuation: Cash lags profits

Sales are still at a low level and inevitably lumpy. Hence, we use a 15% discount rate. In addition, over £3.8m of cashflow from sales in the forecast period is delayed. Using a three times sales multiple and adding back the discounted cashflows post 2009, a value of 8.2p per share is indicated.

Price	3.5p
Market Cap	£3m

Share price graph



Share details

Code	CUS
Listing	AIM
Sector	Healthcare Equipment
Shares in issue	95.3m

Price

	High	Low
52 week	6.875p	3.375p

Balance Sheet as at 30 June 2007

Debt/Equity (%)	N/A
NAV per share (p)	2.5
Net cash (£m)	0.9

Business

Designs, builds and sells innovative lasers for high-end custom eye surgery. Based in Australia, sales are in Asia and emerging countries but the European market may develop from 2008.

Valuation

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

Geography based on revenues

UK	Europe	US	Other
0%	0%	0%	100%

Analyst

Dr John Savin 020 7190 1755

jsavin@edisoninvestmentresearch.co.uk

CustomVis is a research client of Edison Investment Research Limited

Investment summary: Sales growth

Company description: Solid technical leadership

CustomVis produces and sells the only solid-state laser surgical device, the Pulzar Z1, for correction of eyesight. Competitors use older technology which is less flexible and more costly. CustomVis is now establishing the clinical case and is slowly gaining medical acceptance with the sales rate since June, doubling compared to FY H1 2007. Sales are still biased to Asia and the Middle East and a breakthrough in Europe is not yet apparent. US sales will require FDA approval which requires a clinical trial, which will take two to three years and cost c.£3m to run. However, this should be relatively risk free as the Pulzar Z1 has exceeded the FDA criteria in user studies.

Valuation

On the current mixed, leasing and deferred payment business model, CustomVis will have a demanding cashflow profile that will need careful management due to the postponed revenues and relatively high cost of goods. Nonetheless, if the capacity of 36 units per year is fully utilised in FY to June 2009, CustomVis should break even and be approaching cash generation. With this business model, rapid growth is very cash demanding.

A potential market value based on a 3x sales multiple gives a c.£11m value. At the valuation point in June 2009, CustomVis will also have c.£3.5-4m of trade debtors and accruals which will generate cashflows over the subsequent two years. These have been taken into account with a 2009 NPV (at 5%) of £3.8m. Therefore, the projected June 2009 value is c.£14m. Taking cashflows into account, this gives an NPV (at 15%) of about £7.6m: 8.2p per share.

Sensitivities

- Laser prices vary; we assume an average of £110,000 in H2 2007. Getting higher margins sales in Europe from FY 2009 onwards will be crucial. Prices have firmed since June.
- Pricing is US$, costs are AU$ and results are in £. In FY 2007, the AU$ rose 13% against the US$ cutting revenues but offsetting this was a 5% rise in the AU$ against the £.
- Competition and Asian market focus appears to be limiting the ability to gain a premium price. The new presbyopia indication may help gain sales.
- Management is highly stretched: the board comprises just three directors.
- Production rates and quality — three lasers per month is challenging, and increasing this further by 2009 as planned adds further strain. The company has not yet installed three per month over several months.
- Production costs: the gross margin is assumed to be around 40%. Opportunities exist to cut costs and an R&D project is running to do so.
- Enforcing staged payments in developing countries like Syria and Azerbaijan may be interesting although a credit control strategy is in place.
- Gaining US regulatory approval will be costly and the timing is not guaranteed.

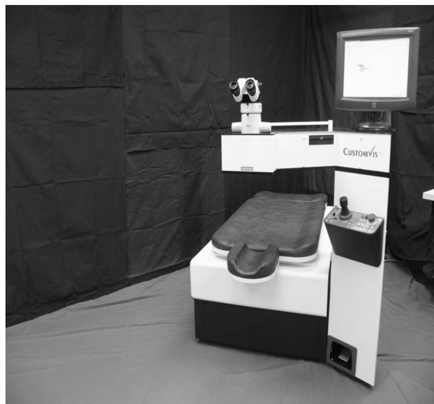
Company description: Solid market position

CustomVis was quoted on AIM based on technical advantages and these have been validated. No direct solid-state competitor has emerged and the company has an AU$2.3m grant contributing to its R&D programme to strengthen its lead and reduce production costs. The technical advantages are now resulting in strong growth. However, the leasing and deferred payment sales strategy generates a heavy working capital need.

Laser eye surgery: The CustomVis technical advantage

The CustomVis laser, the Pulzar Z1 uses solid-state technology to produce a high-energy, cool, ultraviolet beam of controlled laser light 0.6mm in diameter. Competing excimer lasers also produce high-energy light for eye surgery but these all work by exciting a mix of argon and (toxic) fluorine gases, require regular calibration and are noisy — like working next to a bus engine. The fluorine gas also corrodes the laser, requiring major spare parts every six to nine months. Gas supply outside Europe and the US can be problematic; fresh gas is required every day for operation.

By using solid state, CustomVis avoids the use of gases, the instrument is smaller, is easily maintained and has a fast start-up time. This offers a quiet working environment and lessens the need for technical support staff — a service every three months is recommended. It can also improve patient throughput for a busy surgical unit thereby generating more revenue per unit.



The surgical procedure undertaken is the ablation of tissue from the cornea – the transparent film and tissue at the front of the eye. The procedure is called laser *in situ* keratomileusis (LASIK).

The market

In the demanding US market, there are three FDA-approved custom LASIK systems: from VISX (AMO), Bausch & Lomb and Alcon. The precise range of conditions allowed for each varies. Current standards are set by the AMO Inc. (VISX) CustomVue system. The US market (best data) has plateaued in the number of procedures (1.4m), although gentle growth has resumed. The world market is estimated at c.3.7m procedures and may grow to 4.9m by 2010.

AMO owns the CustomVue system (via the acquisition of VISX Inc for US$1.3bn in 2005) and acquired Intralase, developer of a LASIK-related laser keratome technology, for US$808m. AMO claims 60% of the installed US base. There are technically strong German competitors, particularly Wavelight and Schwind. Wavelight was acquired in November 2007 by Alcon for €98m. Bausch & Lomb is a strong player in the eye care market, but lasers are a relatively small business unit for it, with falling sales. B&L is now private equity owned and may seek more aggressive future growth.

The overall global installed laser base is c.6,000 units with a nominal replacement cycle of five years: 1,000 per year plus new sales growth. Owing to the reactive gas used, current excimer lasers must be regularly replaced even if usage is low. Some 400 sales per year are in the US, with c.800 elsewhere. The market is estimated at c.$370m per year, 40% in the US.

CustomVis market development

CustomVis has focused on sales to Asia and the Middle East where there are fewer barriers to the adoption of new technology and the solid-state, low-maintenance laser is ideal.

The next market will be Europe, where non–invasive medical devices already certified in Australia do not require new clinical studies. The company is attempting to achieve some breakthrough sales in Europe and has been active in attending key conferences and exhibitions. Sales may not be significant until after June 2008, putting them into FY09. CustomVis also uses distributors to boost sales. We note, however, that a higher price will be needed to make money (as margins are cut by at least 25% via distributors).

Data indicates that the Pulsar Z1 could easily gain FDA approval for the US market but a clinical trial will be needed, probably requiring 400 patients with a six-month follow-up; this will take two to three years to run and file for approval, and cost c.£3m. US entry is unlikely before 2012.

New Products

An R&D programme costing c.AU$5m is being backed by a AU$2.3m Australian government grant. This will enable an improved design and reduced manufacturing costs.

CustomVis is working on two new products. One is a new version of a retinal imaging device. These are widely purchased and used in high street opticians for routine eye examinations. The product would have a much lower price point than the current laser and so would be a cash sale.

The other “product” is a procedure for the Pulsar Z1 to correct presbyopia, the need for reading glasses in those over 40. Three small trials have been run and results are stated to be excellent. This application could be a niche where the Pulsar Z1 might have a clear advantage and if so, it could be positioned as an addition rather than replacement to existing excimer lasers in European and US clinics.

Prestigious export award

Customvis has recently been recognised by a prestigious export award from the Australian government. The relevance to shareholders is that this has generated a much higher profile in Australia for the company and this could open the way to additional financial support which in itself could be leverage with further Australian government export credit assistance. If the company can leverage this award, it could reduce the requirements of further equity funding.

Financials: Year to 30 June 2007

After an inspection by the auditors of contracts entered into during the 2006-2007 financial year, a decision was made that, due to a small change in the wording, the contracts were sales (with an associated payment schedule over two to three years) and not operating leases. The nine units

installed during 2006-2007 are all treated as sales. Whereas the effect of this sophistry on cash flows is zero, the accounting effect is major, although it does have the big advantage of making the accounts somewhat more transparent. In future, sales are accounted for when a confirm order (contract plus deposit) is received and not when the unit is shipped; there can be a two to three month delay before a laser is shipped and installed at customer premises.

The effects are seen in five ways:

- Reported sales revenues have increased markedly, partly due to new accounting treatment but also due to a rise in sales. However, sales do not reflect cash flows.
- Cost of goods reflects the actual materials per unit sold although labour costs are still recorded under Administration. Leased sales are recorded in the capital account. Lease sales now have a service charge added to the cost of goods. This service charge is treated subsequently as an accrual and release to the P&L.
- Depreciation and tangible assets have greatly reduced and will become less important over the next two years as the current leases start to expire.
- Debtors have increased 13 times with £401k , 43%, due after more than one year.
- Creditors have increased fourfold with 18% due in more than one year which reflects accrued service charges.

Sales

The assumed unit price of the laser (due to currency effects) is assumed to be approximately £113,000, although prices may have been stronger in H1 with more lower margin sales in India in H2. If all sales were on a straight cash basis, this indicates that the company has a turnover of just over £1m per year and is therefore valued on approximately a three times direct sales multiple.

From each contract defined as an outright sale by the auditors, approximately £29,000 is believed to be accrued to account for the service provisions. This is released to the P&L in a straight line over the service contract; typical periods are believed to be three to five years. At the end of each contract, servicing will be on a cash basis. The company had c.£25,000 of servicing revenues in 2007 and this figure should grow as pre-paid service contracts and warranties end. Consequently, c £85,000 per unit is reported as revenue. Of this we assumed that about £27,000, c.25%, on average is received as a cash deposit and that subsequent payments on a monthly or quarterly basis, depending on the contract terms, will then commence. The lease payments on two lasers from previous financial years continue to be made. This lease income ends in 2008. From the Edison model of the company, we have assumed the FY 2007 revenue breakdown is as follows:

Exhibit 1: Revenue breakdown (£'000s)

Cash sales value	1,021
Less service provision	(260)
Service revenues	62
Lease payments previous years	57
Total	880

}

Source: CustomVis

The company expects to make three or four cash sales in the 2008 financial year. These will clearly be very beneficial to cash flow.

Cost of goods

Over the course of the year, management has worked hard to reduce costs and it appears that cost of goods has fallen to around £40,000. This will have a major impact on potential profitability going forward and reduce the working capital demands of growth. Cost of goods includes the bought-in Tracy system for mapping the eye before laser ablation.

Debtors

Debtors have increased from £71,382 to £923,481. Of this, £780k relates to staged payments related to 2007 sales; hence only £260k was received in cash on these sales during FY 2007. Of the £780k, c. £389k is due in FY 2008 and £401k in FY 2009.

Creditors and deferred income

The accrued amount for servicing has been added to creditors and is released to the P&L in equal monthly instalments over the lifetime of each contract. Creditors have risen from £187,992 to £618,951. Of this, £107k relates to accrued service revenues due in one year. A further £139k is due form FY 2009 onwards so total creditors is £758k.

Cash flow

On the current mixed, leasing and deferred payment business model, CustomVis will have a demanding cash flow profile that will need careful management due to the postponed revenues. The company has managed cash carefully but, despite a fund raising of £1.4m net in February and a big increase in creditors (excluding deferred income items), cash was £897,399.

Because of the deferred payments (75% of FY 2007 sales income due during FY 2008 and FY 2009), the company will continue to be cash negative in our view for at least the next two years. Given that CustomVis needs to continue to invest in products, expand its management team, and undertake clinical tests in United States, further equity funding is likely in our view. We have assumed a small fundraising of £1.75m to fund working capital growth in the next six to nine months. However, US clinical trials will require significantly in more than this. The auditors have noted the strained cash position in the notes to the accounts.

Profit outlook

On the new accounting basis which recognises sales immediately, even if cash is delayed, the company should move into breakeven in financial year to June 2009, assuming that at least 36 units can be sold and installed in that year. Sales of these large capital item products can be very lumpy but the order flow should even out as the pipeline of potential sales increases and the market profile of the Pulzar Z1 continues to grow. The new presbyopia indication and retinal imaging device could also add to sales. The complexity of the accounts with no one standard contract makes the consolidated P&L difficult to relate to underlying business performance. A better guide is the operating cashflow.

For a high-growth, export-led company, the management team is very thinly spread, particularly given that it is operating across a very wide geographic area from a relatively isolated base in Western Australia. A European partner could help business performance.

Sensitivities

- Laser prices vary; we assume an average of £110,000. Getting higher margins sales in Europe (from FY 2009 onwards) will be crucial.
- Pricing is in US$, costs are AU$ and results are in £. In FY 2007, the AU$ rose 13% against the US$ cutting revenues but there was a 5% rise in the AU$ against the £ so reducing the inpact on reported results.
- Competition appears to be limiting the ability to gain a premium price.
- Management is highly stretched: the board comprises three directors, of whom two are executive, with a UK-based chairman.
- Production rates and quality — three lasers per month is challenging, and increasing this further by 2009 as planned adds further strain.
- Production costs: the gross margin is assumed to have risen to over 60%. Opportunities exist to cut costs further and an R&D project is running to do so.
- Enforcing staged payments in developing countries like Syria and Azerbaijan may be interesting although a credit control strategy is in place.
- Gaining US regulatory approval will be costly and the timing is not guaranteed.

Valuation

A potential market value based on a 3x sales multiple gives a c.£11m value. In June 2009, CustomVis could have c.£3.5-4m of trade debtors with an NPV (at 5%) of £3.7m to generate subsequent cash flows. The projected June 2009 value is c.£14m. Taking cash flows into account, this gives an NPV (at 15%) of about £8m: 8.2p per share.

The acquisition of Intralase by AMO in January 2007 for US$808m provides a useful benchmark metric of 6x sales and 33x net earnings. Intralase sold 204 lasers in 2006 and generated revenues of US$131.9m with net earnings of US$24.3m. The Intralase deal shows that established novel technology coupled with a strong sales base and profits is very attractive to large medical device companies. However, Wavelight, with €75m sales, only commanded a 1.3 times sales multiple when targeted by Alcon, the deal completing in November. This reflects significant (€13m) recent losses

Strategic interest?

The company could become strategically interesting once US regulatory approval (FDA) is obtained. Sales success in Europe in 2008 could also trigger interest. However, valuing CustomVis as an acquisition target at this time is not easy.

Exhibit 2: Financials

£'000 30-June	2006 IFRS	2007 IFRS	2008e IFRS	2009e IFRS
PROFIT & LOSS				
Revenue	89	881	2,402	3,769
Cost of Sales	(32)	(483)	(795)	(1,109)
Gross Profit	57	398	1,607	2,660
EBITDA	(2,330)	(1,628)	(483)	(77)
Operating Profit (before GW and except.)	(2,229)	(1,494)	(325)	2
Goodwill Amortisation	0	0	0	0
Exceptionals	0	0	0	0
Other	0	0	0	0
Operating Profit	(2,229)	(1,494)	(325)	2
Net Interest	73	55	31	49
Profit Before Tax (norm)	(2,156)	(1,438)	(294)	51
Profit Before Tax (FRS 3)	(2,156)	(1,438)	(294)	51
Tax	0.0	0.0	0.0	0.0
Profit After Tax (norm)	(2,156)	(1,438)	(294)	51
Profit After Tax (FRS 3)	(2,156)	(1,438)	(294)	51
Average Number of Shares Outstanding (m)	55.8	80.1	95.3	95.3
EPS - normalised (p)	(3.9)	(1.8)	(0.3)	0.1
EPS - FRS 3 (p)	(3.9)	(1.8)	(0.3)	0.1
Dividend per share (p)	0.0	0.0	0.0	0.0
Gross Margin (%)	63.7	45.2	66.9	70.6
EBITDA Margin (%)	N/A	N/A	N/A	N/A
Operating Margin (before GW and except.) (%)	N/A	N/A	N/A	N/A
BALANCE SHEET				
Fixed Assets	296	217	221	261
Intangible Assets	0	0	0	0
Tangible Assets	296	217	221	261
Investment in associates	0	0	0	0
Current Assets	2,255	2,939	5,012	5,725
Stocks	946	1,118	1,300	1,500
Debtors	71	923	2,422	4,078
Cash	1,238	897	1,290	147
Current Liabilities	(188)	(619)	(975)	(1,331)
Creditors	(188)	(619)	(975)	(1,331)
Short term borrowings	0	0	0	0
Long Term Liabilities	0	(140)	(282)	(571)
Long term borrowings	0	0	0	0
Other long term liabilities	0	(140)	(282)	(571)
Net Assets	2,363	2,397	3,977	4,083
CASH FLOW				
Operating Cash Flow	(2,287)	(1,707)	(1,228)	(1,002)
Net Interest	73	55	31	49
Tax	0	0	0	0
Capex	3	(72)	(160)	(190)
Acquisitions/disposals	0	0	0	0
Financing	1,484	1,384	1,750	0
Dividends	0	0	0	0
Net Cash Flow	(727)	(340)	393	(1,143)
Opening net debt/(cash)	(1,965)	(1,238)	(897)	(1,290)
HP finance leases initiated	0	0	0	0
Other	0	0	0	0
Closing net debt/(cash)	(1,238)	(897)	(1,290)	(147)

Source: Company accounts / Edison Investment Research

EDISON INVESTMENT RESEARCH LIMITED
Edison is Europe's leading independent investment research company. With a team of 44 including 29 analysts supported by a department of supervisory analysts, editors and assistants, Edison writes on more than 200 companies across every sector. Working directly with corporates, investment banks and fund managers, Edison's research is read by every major institutional investor in the UK, as well as by the private client broker and international investor communities. Edison was founded in 2003 and is authorised and regulated by the Financial Services Authority.

DISCLAIMER
Copyright 2007 Edison Investment Research Limited. All rights reserved. This report has been commissioned by CustomVis and prepared and issued by Edison Investment Research Limited for publication in the United Kingdom. All information used in the publication of this report, has been compiled from publicly available sources that are believed to be reliable, however we do not guarantee the accuracy or completeness of this report. Opinions contained in this report represent those of the research department of Edison Investment Research Limited at the time of publication. The research in this document is intended for professional advisors in the United Kingdom for use in their role as advisors. It is not intended for private individuals or investors. This is not a solicitation or inducement to buy, sell, subscribe, or underwrite securities or units. This document is provided for information purposes only and should not be construed as an offer or solicitation for investment. A marketing communication under FSA Rules, this document has not been prepared in accordance with the legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research. Edison Investment Research Limited has a restrictive policy relating to personal dealing. Edison Investment Research Limited is authorised and regulated by the Financial Services Authority (FSA) for the conduct of investment business. The company does not hold any positions in the securities mentioned in this report. However, its directors, officers, employees and contractors may have a position in any or related securities mentioned in this report. Edison Investment Research Limited or its affiliates may perform services or solicit business from any of the companies mentioned in this report. The value of securities mentioned in this report can fall as well as rise and are subject to large and sudden swings. In addition it may be difficult or not possible to buy, sell or obtain accurate information about the value of securities mentioned in this report. Past performance is not necessarily a guide to future performance.