

Long Ideas

Tech

Canada



Photon Control: Best Supporting Actor In A New Economy Role

Jan. 24, 2021 2:44 PM ET | Photon Control Inc. (POCEF) | OPSSF, OPS:CA | 5 Comments | 4 Likes



Swich Research

371 Followers

About this article

Ticker	Author rating	Price at publication	Last price	Change since publication	S&P 500
POCEF	Strong Buy	\$1.82	\$2.85	56.79%	

Summary

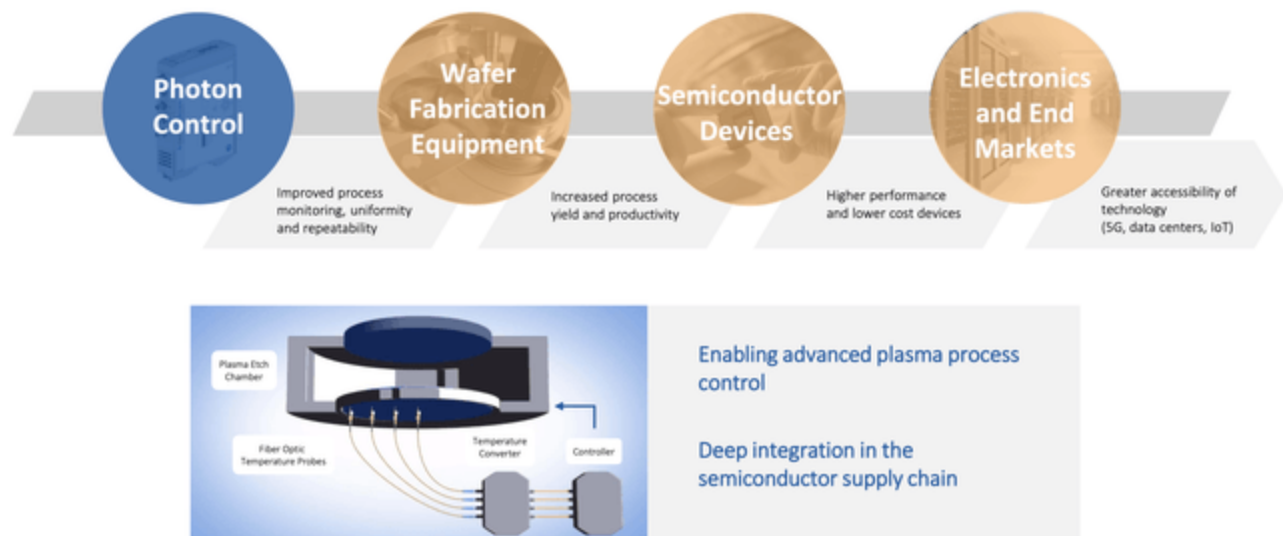
- Photon Control is a market leading provider of fiber optic measurement solutions in the semiconductor capital equipment sector and is undervalued when compared to industry benchmarks.
- Upstream in the value chain, Photon Control supplies the devices necessary for many red-hot hi-tech companies to provide their end-user products.
- Photon Control is profitable with growing revenues and ambitious initiatives to increase market share in their current industry while pursuing opportunities in other new economy sectors.

Over the years the Academy Awards have had a number of stand-out “[Best Supporting Actor](#)” winners where it felt like these secondary characters were actually the real stars of the film. Heath Ledger’s iconic “Joker” to Christian Bale’s Batman in 2009’s “The Dark Knight” comes to mind. There was also Javier Bardem’s unforgettable “Anton Chigurh” in 2007’s “No Country for Old Men”; Robin Williams’ career-defining performance in 1998’s “Good Will Hunting” is another, to name just a few. In every case, it would be hard to imagine those films enjoying the same level of success had they not had that stellar accompanying performance.

In the current market, a similar dynamic exists. Investors are inundated with stories about the titans of the new economy such as Tesla, Apple, Google, and regaled with tales about the “heroics” of their leaders and the life-changing potential of their products. Not to disparage these proven market darlings but too often what is overlooked are the “worker bees”, who toil in relative obscurity but contribute significantly to the success of their more iconic patrons. One of those companies, which could be a dark horse favorite for this year’s “Best Supporting Actor in the New Economy” category, is Photon Control Inc. (OTC: [POCEF](#)), a provider of fiber optic measurement solutions competing primarily in the semiconductor capital equipment sector.

From their [website](#), Photon Control provides a less melodramatic description of their role:

We are the market leader in temperature sensing in advanced semiconductor plasma processes, providing access to critical temperature readings required to control the extremely precise processes that manufacture new device architectures.”



Source: [Company Presentation](#)

That description may not be as tantalizing for day-trading investors accustomed to the hype and hyperbole associated with the high-flying tech stocks. The semiconductor industry customers Photon Control serves, however, understand that these items and suppliers are essential to creating the leading-edge integrated circuits (ICS) that power the development of our mobile phones, laptops, cloud computing, artificial intelligence, and autonomous driving. This brief but informative [video](#) provides an excellent explanation of Photon Control's competencies.

The History

Founded in 1988, Photon Control first made its name producing optical sensors for measuring temperature, position, and flow for the oil and gas sector during the Canadian boom years. More recently though they have focused their efforts on semiconductor equipment manufacturing, emphasizing innovation and customer collaboration to develop differentiated fiber optic sensing solutions. Currently, over 150,000 Photon Control fiber optic temperature sensors are deployed in semiconductor fabrications around the world. In 2020, the company benefitted from a huge increase in capital expenditures in the Wafer Fabrication Equipment (“WFE”) sector, which is expected to continue at last year’s record levels as companies and nations jockey for supremacy.

Although headquartered in British Columbia, Canada’s westernmost and arguably most picturesque province, Photon Control has established a global footprint with locations and distribution partnerships in the U.S., Switzerland, China, Japan, and, [announced](#) last summer, a new agreement with a leading Korean distributor, Woowon Technology Korea.

This agreement provides Photon Control with a proven partner in Korea, the second-largest semiconductor market in the world accounting for over 20% of the global market. The partnership furthers Photon Control’s market penetration strategy of strong local support in key markets.”

In many ways, 2020 was a pivotal year for Photon Control. Along with the new distribution partnership referenced above, the company also completed [the acquisition](#) of Micronor, which produces fiber optic kinetic sensors out of Camarillo, California. [Micronor](#) sensors leverage a patented technology to accurately measure rotary and linear position while offering immunity from lightning, radiation, and magnetic fields. Micronor serves industrial, medical, transportation, aerospace, and infrastructure clients, opening up a host of new markets for Photon Control, and adds accretive annual revenue of \$1.4 million.

Adding to the list of new and exciting opportunities, in July Photon Control [confirmed](#) a strategic partnership with Fisens GmbH (“[FiSens](#)”) through an exclusive worldwide license and distribution agreement for Fiber Bragg Grating (FBG) sensor solutions, which are used to accurately detect changes in physical properties such as strain and temperature. This unique technology is used in the utilities, industrial, automotive, aerospace, and renewable energy markets to provide accurate and reliable measurements that improve asset management and intelligent monitoring of critical systems.

The net result of all of this is a very aggressive expansion into more lucrative markets for Photon Control’s growing portfolio of products.

The Products

In simple terms, fiber optic sensors convert light energy into an electrical signal and are used to detect temperature, pressure, rotation, vibrations, and concentration of chemicals. Fiber optic sensors reduce electrical power and can also fit easily into small spaces. Other advantages of fiber optic sensors (versus conventional sensors) are their effectiveness for microwave products, their ruggedness to support deployment in harsh environments, and their ability to monitor a wide range of physical & chemical parameters. Photon Controls offers the following three key fiber optic sensor product categories:

Fiber Optic Temperature Sensors provide precise measurements for critical temperature monitoring, enabling advanced process control, higher throughput, and improved product performance in applications from advanced plasma processes in semiconductor manufacturing to patient monitoring during high RF cancer treatments.

Fiber Optic Position Sensors are robust, immune to RF and electromagnetic fields, and easy to install, enabling smarter asset management, lower maintenance costs, and increased safety. These products are used in a variety of applications and industries including semiconductor, medical and industrial.

Photon Control also offers a range of “**Other**” **Fiber Optic Products**, such as signaling devices, designed using inherent safety principles, for simple deployment in all categories of explosive, gaseous and dusty atmospheres where electrical devices are not applicable.



TEMPERATURE SENSORS



POSITION SENSORS



OTHER FIBER OPTIC PRODUCTS

Source: [Company Website](#)

These products may not capture investors' imagination like the reports of the newest release of an electric vehicle or the latest mobile phone but without fiber optic sensors, those complex end-user products likely don't get built.

The Market

To get a sense of the current revenue opportunity and future prospects for Photon Control, we need to walk through the market layers, starting with semiconductor manufacturing equipment. In their [Semiconductor Equipment Consensus Forecast](#), industry association group SEMI predicts that global sales by original equipment manufacturers are expected to have increased 16% from 2019, for an industry record \$68.9 billion in 2020. That growth is expected to continue with the global market reaching \$71.9 billion in 2021, and \$76.1 billion in 2022.

SEMI® Mid-Year Total Equipment Forecast by Region



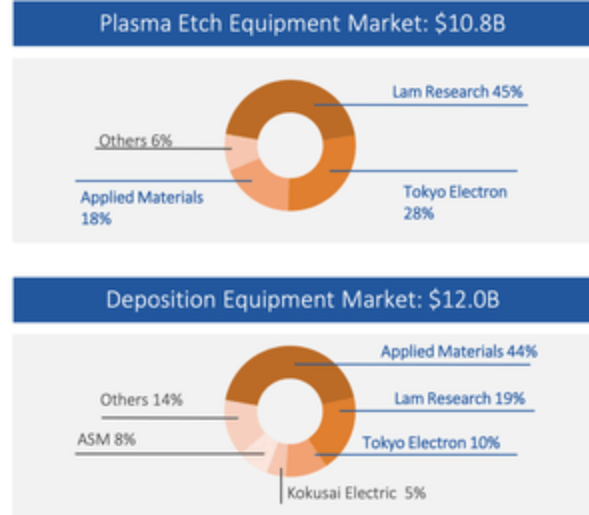
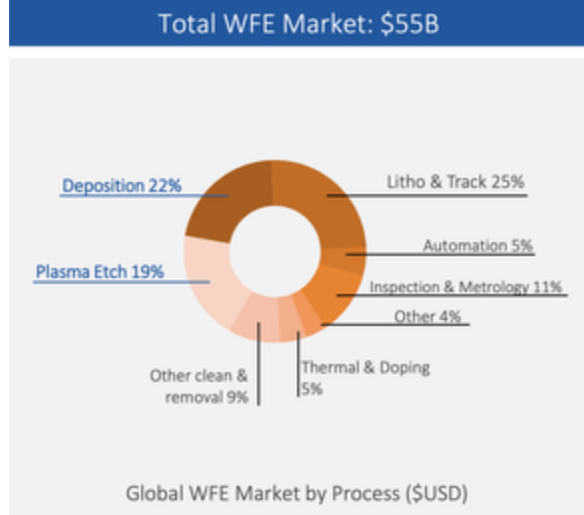
Source: [SEMI July 2020, Equipment Market Data Subscription](#)

Photon Control competes in the next layer, the \$55 billion WFE segment, and is a key supplier to its largest manufacturers. WFE accounted for about 15% of the semiconductor manufacturing equipment market share in 2019 and is forecasted to reach a total market size of US\$62 billion by 2023. SEMI, referenced earlier, projects record growth ahead for WFE, rising 15% to reach \$59.4 billion in 2020, followed by 4% and 6% growth in 2021 and 2022, respectively.

In their [Q3, 2020 market update](#), research firm Gartner predicted:

WFE revenue will increase by 4.5% in 2020 as foundries invest heavily in leading-edge logic and Chinese memory companies ramp up initial production. Major memory suppliers will return to investing in new capacity in 2021. Overall, the industry will grow by 3.8% in 2021.”

Within the WFE market, Photon Control targets the Etch segment, which is estimated at \$12 billion (see below) and is forecasted for the continued growth of 6% in 2021. Photon Control also believes a significant opportunity exists in the \$13 billion Deposition segment thanks to the increasing trend toward smart semiconductor manufacturing:



Source: [Gartner, Market Share: Semiconductor Wafer Fab Equipment, Worldwide, 2019](#)

Photon Control also believes additional growth opportunities exist outside of the semiconductor industry in other sectors requiring greater accuracy and precision in the provision of their products, such as flat panel displays, renewable energy, life sciences, and aerospace. Their recent strategic partnerships and acquisition position them well to pursue these markets and it is something to watch for progress reports on in upcoming company investor meetings.

The Financials

To be blunt, 2019 was a rough year for Photon Control, as it was for a lot of semiconductor industry suppliers, due in part to the overall decline in the sector. To address this slide, the company increased their efforts to develop new and existing markets through the initiatives announced this year. This is beginning to pay off as the high tolerance capacity of fiber optic sensors for extreme temperatures are leading to new uses in medical, industrial, military, energy, and power sectors, with deployment on the rise in “smart buildings”, “smart devices” and the new power grid infrastructure.

In the November [Q3 earnings](#), Photon Control announced revenue of \$16.3 million, almost double that of Q3, 2019, setting an YTD record of \$49.7 million. EBITDA was \$6.2 million, net income was \$3.6 million, and basic earnings per share was \$0.03 (\$0.12 YTD compared to \$0.02 for all of 2019). Gross margins were 62% (up from 55% in Q3, 2019) while cash and cash equivalents were a whopping \$46.6 million, an increase of \$13.2 million from December 2019. The pursuit of new markets and growth has resulted in higher costs compared with previous periods, but the earnings numbers show that the investment is providing strong returns.

Nigel Hunton, CEO of Photon Control, had this to say about the company's strong year-to-date results:

We have delivered a very strong performance through the first nine months of the year. The global pandemic has accelerated the digital transformation of the economy and Photon Control continued to benefit from the demand for high-performance computing and 5G infrastructure that positively impacts the semiconductor industry. We have exceeded our best-ever year in terms of both income and revenue, and we are only three-quarters of the way through the year.”

There remain storm clouds on the horizon with uncertainty in the market due to COVID-19, and this has contributed to a reduction in their order backlog to \$27 million in September compared to \$29.7 million at June 30, 2020. In terms of forward guidance, CEO Hunton expects Q4 2020 revenues of between \$12 and \$14 million, down from the first three quarters of 2020 still a record for Q4.

Leveraging the historical actual data and Mr. Hunton's guidance for Q4 revenue, which seems very conservative, we can project what the upcoming quarterly and full-year numbers might look like (in the table below). Other numbers were derived by calculating as a percentage of revenue averaged over the previous three quarters. Not a perfect algorithm but close enough for a “cocktail napkin” forecast.

Consolidated Statements of Income	FY2018	FY2019	Q1/20	%	Q2/20	%	Q3/20	%	Q4/20	%	FY/2020
<i>(Unaudited, in thousands of CAD)</i>	Full Year to Dec.31	Full Year to Dec.31	to Mar. 31		to June 30		to Sept. 30		to Dec. 31		to Dec. 31
Revenue	46,704	32,730	17,312		16,098	-7.5%	16,330	1.4%	14,000	-16.6%	63,740
Cost of sales	21,057	15,165	6,724	39%	6,376	40%	6,125	38%	5,411	39%	24,636
Gross profit	25,647	17,565	10,588		9,722		10,205		8,589		39,104
Operating expenses											
General and administrative	7,035	6,516	2,155	12%	1,851	11%	1,918	12%	1,666	12%	7,590
Research and development (Engineering)	3,525	4,404	1,255	7%	1,154	7%	1,507	9%	1,103	8%	5,019
Sales and marketing	2,529	1,902	687	4%	920	6%	1,028	6%	746	5%	3,381
Total operating expenses	13,089	12,822	4,097		3,925		4,453		3,515		15,990
Operating income	12,558	4,743	6,491		5,797		5,752		5,074	-13.4%	23,114
Finance income, net	356	654	154	1%	27	0%	7	0%	51	0%	239
Accretion expense on contingent consideration	(748)	(520)	(122)	-1%	(106)	-1%	(84)	-1%	(88)	-1%	-400
Change in fair value of contingent consideration	(141)	(115)	(88)	-1%	(467)	-3%	(153)	-1%	(203)	-1%	-911
Gain on Sale of Assets	166	0	0		0		0		0		0
Foreign exchange (loss) gain	2,499	(1,264)	2,682	15%	(1,518)	-9%	(483)	-3%	145	1%	826
	2,132	(1,245)	2,626		(2,064)		(713)		(94)		(245)
Net income before taxes	14,690	3,498	9,117		3,733		5,039		4,980	-1.2%	22,869
Income taxes	4,007	1,127	2,478	14%	1,060	7%	1,432	9%	1,384	10%	6,354
Net income	10,683	2,371	6,639	38%	2,673	17%	3,607	22%	3,595	-0.3%	16,514
Other comprehensive income:											
Unrealized gain (loss) from Fx translation of sub	-125	4	16	0%	120	1%	11	0%	42	0%	189
Total comprehensive income	\$10,558	\$2,375	\$6,655		\$2,793		\$3,618		\$3,638	0.5%	\$16,704
Basic and diluted earnings per share											
Weighted average common shares, basic	110,814,812	106,238,776	104,513,571		104,565,672		104,592,218		104,592,218		104,592,218
Weighted average common shares, diluted	111,738,931	106,614,958	104,925,738		105,212,341		105,629,671		105,629,671		105,629,671
Basic earnings per share	\$0.10	\$0.02	\$0.06		\$0.03		\$0.03		\$0.03		\$0.16
Diluted earnings per share	\$0.09	\$0.02	\$0.06		\$0.03		\$0.03		\$0.03		\$0.16

Source: Author's Research

Although these are record performance results, with 2020 revenue likely coming in almost 50% higher than full-year 2019, there is a good chance the company will turn out an even better outcome than the CEO suggested. Analysts, who we'll review in more detail below, covering Photon Control have estimated 2021 revenue of \$72.9 million and EBITDA of \$28.6 million. For 2022, these analysts are predicting \$82.4 million in revenue and \$31.6 million in EBITDA, a growth rate of around 23% over 2020.

In any case, if 2020 full-year EPS hits an all-time high of \$0.16 and 2022 turns out as strong as expected, then that record just set in November may be quickly outdone.

The Metrics & Valuation

For a holistic view of a company's performance and prospects, it is best to consider a variety of metrics. The table below shows the company relative to the industry average and a Canadian peer providing fiber optic sensor products. It quickly becomes clear from this comparison that Photon Control's management is currently hitting it out of the park on all fronts. From the modest 15 x P/E to the very low 3.6 x P/S, and a +60% margin, you don't need to be a fiber-optic engineer to see that Photon Control is significantly undervalued.

FUNDAMENTAL ANALYSIS	Photon Control	Opsens Inc	Electrical Components
	Inc		& Equipment
	(to Sept/20)	(to Sept/20)	(to Sept/20)
PER SHARE DATA			
Earnings (TTM)	\$0.13	\$0.00	(\$0.01)
Book Value	\$0.47	\$0.17	\$0.16
Cash Flow (TTM)	\$0.15	\$0.02	\$0.01
VALUATION			
Price/Earnings	15.0x	-	117.0x
Price/Sales (TTM)	3.6x	6.1x	54.1x
Price/Book (MRQ)	3.3x	11.8x	36.2x
Price/Cash Flow (TTM)	13.1x	124.6x	82.7x
PROFITABILITY			
Gross Margin	60.02%	53.19%	48.28%
Operating Margin	34.28%	-0.58%	-346.81%
Profit Margin	23.25%	-0.58%	-489.52%
MANAGEMENT EFFECTIVENESS (TTM)			
Return on Assets	20.32%	-0.54%	-48.98%
Return on Equity	24.45%	-1.12%	-67.74%
Return on Investment	23.51%	-0.65%	-65.48%
FINANCIAL STRENGTH (MRQ)			
Debt to Capital	2.05%	45.17%	63.99%
Current Ratio	5.0x	3.6x	6.4x
Quick Ratio	4.2x	2.6x	6.0x
SIZE			
Market Cap	\$210.2M	\$188.9M	\$259.7M
Revenue	\$58.6M	\$30.8M	\$15.0M
Shares Outstanding	104.6M	90.4M	143.5M
Employees	103	171	64

Source: Author's Research

This bullish recommendation is backed up by the analysts covering the company. In November, Paradigm Capital analyst Daniel Rosenberg maintained his “Buy” rating on Photon Control, increasing his price target from \$2.75 to \$3.00, thanks in part to the strong Q3 numbers that beat his projections and on rosy future expectations for the company. Rosenberg had this to say about Photon Control’s success:

The company has made efforts to diversify its line of offerings, supplementing products developed through in-house R&D with accretive transactions such as its recent in-licensing agreement, enabling the company to increase its portion of revenue outside of the highly cyclical semi industry. The agreement provides [PHO] with an innovative technology that has new-use cases within the semi space as well as applications in several other verticals, such as railway, automotive and medical, to name a few.”

This January, Echelon Capital Markets analyst Amr Ezzat also re-confirmed a “[Buy](#)” rating for Photon Control, raising his price target from \$3.00 to \$3.50. Ezzat provided this reasoning:

We believe Photon’s balance sheet strength together with its leverage to an economic upcycle constitute attractive risk-reward characteristics. Despite the strong stock performance since our late 2015 initiation, valuation remains exceptionally attractive with earnings growth keeping pace with stock performance.”

The Risks and Conclusion

The incoming presidential administration in the U.S. has signaled that it plans to focus on supporting local supply chains, especially for high tech products. This could further fuel Photon Control’s North American operations given their recent acquisition of a California facility. The bullish trends expected in Photon Control’s new market pursuits, such as cloud computing, 5G deployment, and gaming should also translate into future strength.

As with any “penny stock”, there is always caution urged when considering your investment. For Photon Control, a big risk is the volatility and cyclicity in the semiconductor industry. Any downturn is typically amplified for equipment suppliers. An economic recession or further fall-out from the pandemic could turn this risk into reality. The mitigation though is Photon Control’s push into different markets outside of their primary WFE and their expanding global reach.

Something the company might soon want to pursue is a direct listing on a U.S. exchange to increase exposure to American investors and mitigate the challenge of trading over-the-counter stocks. What the company should avoid is any further dilution. At 104 million shares outstanding, it might make sense to use some excess cash or even leverage to buy back shares and reduce the float, assuming there are no immediate strategic investments available with a better ROI.

Photon Control is in a very strong financial position to weather any interim downturn. The CAD\$60 million cash-on-hand is a terrific safeguard and their solid fundamentals should give investors peace of mind. Management just needs to continue to demonstrate strong operational execution through this pandemic crisis and beyond to fuel an ongoing upward trend in shareholder value and hopefully win themselves the equivalent of a new economy “Oscar” for their efforts.

This article was written by



Swich Research

371 Followers

Employing innovative fundamental practices featuring thorough quantitative and qualitative analysis to identify high-value investments.

Disclosure: I am/we are long POCEF. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.