

KEYSTONE'S

Small-Cap Stock Report

DECEMBER 2014

Independent Equity Advisors

Editor: Ryan Irvine, BBA (Finance)

Associate Analyst: Aaron Dunn, CFA

Initial Coverage: Photon Control Inc.

Price: \$0.46

Symbol: PHO: TSX

Near Term: **SPEC BUY (FOCUS BUY)**

Long Term: **SPEC BUY (FOCUS BUY)**

Summary

Headquartered in an ISO 9001:2008 manufacturing facility in Burnaby, British Columbia, Photon Control Inc. designs, manufactures and distributes a wide range of optical sensors and instruments to measure temperature, pressure, position, and flow. Optical sensors are immune to electro-magnetic interference and operate robustly in harsh environments. These products are used by original equipment manufacturers (OEM) as well as end-users in the Semiconductor (90% of current business), Oil and Gas, Power, Life Science, and Manufacturing industries. Photon Control's products provide high accuracy and reliability in extreme conditions and are supported by a team of experts that offer onsite installation, training, and support. Photon Control also provides engineering services for customized optical measurement systems.

While focusing on manufacturing and distribution of high-quality products, Photon Control has a strong partnership with Photon Control R&D Ltd., an engineering and research and development company, in order to enhance the effectiveness of its technical and customer support team, develop new technologies, and convert the company's intellectual property (consisting of 20 issued and 5 pending patents) into commercial products.

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Photon Control Inc.**Current Price (December 24/2014): \$0.46****PHO:TSX****RECOMMENDATION: SPEC BUY (FOCUS BUY)**

Shares Outstanding.....102,155,518

Fully Diluted Shares Outstanding.....112,369,518

SELECTED QUARTERLY DATA

Income Statement	Q3 2014	Q3 2013
Revenues	\$5,144,161	\$4,609,445
Net Earnings	\$1,410,310	\$1,121,950
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ROE	22%	25%

SUMMARY OF OPERATIONS

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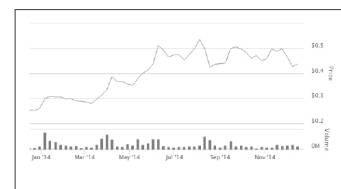
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MARKET/PRODUCT

Photon Control's custom engineered optical temperature and positioning sensors are integrated into the fabrication tools that are used in semiconductor manufacturing. The semiconductor manufacturing process involves multiple steps that need precise monitoring in order to maintain correct temperatures and positioning of the silicon wafers at all times.

Photon Control's approach to creating shareholder value has been to pursue OEM sales whether directly or through distributors and to investigate the market potential of products by working directly with customers in select industries to foresee their sectors' requirements. These collaborations often include commitments to conduct trials of the new products at industrial sites.

Photon Control's measurement and control instruments are intended for applications with high demand for precision, repeatable performance and reliability. The semiconductor manufacturers that are Photon Control customers set very high standards of supply chain management and Photon Control has satisfied these requirements. Photon Control supplies products to its 'Fortune 500' customer base through integrator contractors located in the USA, Europe, and Asia, and directly supplies products to three major capital equipment manufacturers located in Silicon Valley.

**RATINGS****VALUE (TRAILING)**

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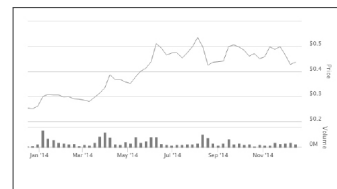
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FINANCIAL PERFORMANCE

During 2013, Photon Control continued to lay the foundation for creating long-term value and has demonstrated its commitment to corporate, operational and financial discipline. During the second half of 2013, Photon Control benefited from the more favourable economic and industry conditions. In the fiscal year 2013, Photon Control delivered a strong finish to a very good year achieving its best annual results on record reporting \$17.3 million in product sales and \$4.60 million profit before taxes. The significant increase in product sales was mainly due to accelerated levels of activity in the semiconductor market supported by the non-semiconductor product sales and the company's enhanced operational efficiency.

The significant progress achieved during fiscal 2013 made a positive impact on Photon Control's current fiscal year, securing profitability for the first three quarters of 2014. In the third quarter of 2014, Photon Control experienced an increase in all categories including sales, gross margins, profit results and sales order backlog compared to Q3 2013. In Q3 2014, Photon Control recorded product sales of \$5.1 million, approximately 11% higher than product sales in Q3 2013. Photon Control's profit before taxes for Q3 2014 was \$1.88 million, an increase of approximately 68% compared with \$1.12 million profit before taxes for the same period in 2013. Having said this, approximately \$670,000 of the pre-tax profit was due to favourable currency gains.

Product sales for the nine months ended September 30, 2014, totaled \$15.0 million, approximately 35% higher compared to the same period last year. The company's profit before taxes for the nine months ended September 30, 2014, was \$4.92 million, approximately 118% higher compared to the same period in 2013, surpassing the entire 2013 profit before taxes by approximately 7%. This increase in net earnings for the nine months ended September 30, 2014, was mainly due to an increase in sales of \$3.90 million which resulted in an increase in gross margin of \$2.74 million and an increase in other earnings (primarily foreign exchange) of \$457,211.

GROWTH STRATEGY

During 2014, Photon Control continued to identify and evaluate opportunities to enhance its operational results and to diversify its product range. The company continues to develop new sensor technologies and customized products for existing OEM customers, and is further expanding its product lines to pursue new customers in other sectors. As announced in the company's news release dated September 16, 2014, the company has received initial orders for Photon Control's customized optical measurement products from a new Original Equipment Manufacturer purchaser. The new

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OEM customer is active in the semiconductor industry outside of North America. While these relationships can take time to fully develop (often 1-3 years), if executed properly, they can grow into very profitable long-term (7-10 years or longer) relationships. The company continued to implement better communication procedures with existing distributors for increasing productivity and marketing initiatives.

Management also continues to revamp its geographic expansion for Photon Control's Focus® 2.0 optical gas flow meter (currently a very small percentage of sales – under 10%) and to build its distribution and support network in North America. In addition, further business development efforts for the Focus® 2.0 optical gas flow meter included sending representation to the American Gas Measurement School conference in Houston, Texas in September 2014. More recently in Q4 2014, the company co-exhibited with Japanese distributor KLV Co., Ltd. at Inter-optoExhibition in Yokohama, Japan presenting Spectroscopy and Fiber Optic Temperature Sensor product lines. Photon Control's Focus® 2.0 optical gas flow meter will be represented at the Bakken Flaring Alternatives & Gas Capture conference in Denver, Colorado in December 2014.

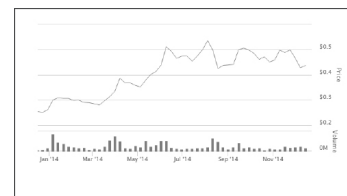
CASH BALANCE – POTENTIAL ACQUISITIONS

Photon Control boasts a very strong balance sheet for a company of its size. By the end of fiscal 2014 the company will have well in excess of \$12 million, or close to \$0.12 per share in cash. At any given time, management believes it is prudent to hold between \$2-\$5 million in cash on hand to give large customers the confidence that Photon Control can support their product needs long term. As such, the company has between \$7-\$10 million in cash on hand to invest in further product development or make a strategic acquisition. Management has stepped up its focus in this area and while we believe management will be prudent and consider only accretive acquisitions, we expect the company to be active on this front over the next 12-24 months.

CONCLUSION

Since 2009, Photon Control has made significant progress in implementing its five-year strategy and with its record Fiscal Year 2013, posted a fifth consecutive year of profits. With a \$4.2 million backlog, approximately 5% higher compared to the same period last year, heading into its Q4 and the company already posting record 9-month profitability, we expect a sixth consecutive year of profitability when the company reports 2014 results in late March or early April.

Photon Control is a solid success story that has largely flown under the radar in Canada. The company has grown revenues from just over \$1 million in 2004 to what is expected to be well over \$20 million in 2014 with excellent profitability.

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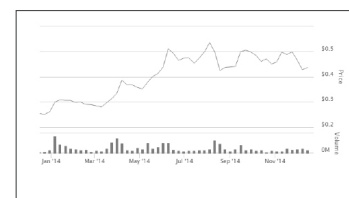
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Having said this, the growth has not exactly been in a straight line. Due to its high exposure to the semiconductor industry, business has historically been cyclical and while we expect this to smooth out as the base of OEMs grows and via product diversification, we inevitably expect another downturn at some stage. The good news is that the company has experienced higher highs and lower lows in terms of sales and profitability overtime as it gains more customers. We expect this to continue into the future.

Based on current fundamentals which include a trailing PE cash out of under 8 and a price-to-cash flow cash out of 4.5, Photon Control appears quite cheap. The company also boasts a strong balance sheet with zero debt and a cash balance of close to \$12 million, or \$0.12 per share. The near-term outlook remains solid for the semi-conductor space, but we expect a contraction at some point in the next 12-24 months which would likely translate into a pullback in revenues and profitability. During a pullback on an annual basis, we would expect Photon Control to remain profitable (with quarterly fluctuations), but at a lesser rate. Following the pullback, we would expect the company to gain traction once again and begin climbing the growth ladder.

As such, we are initiating coverage on Photon Control with a BUY rating and placing the company on our Focus BUY list. At present we recommend purchasing a HALF POSITION and would not chase the stock beyond the \$0.50 range. Given its high share count, investors should not expect any large near-term gains. We expect to hold Photon Control through a 2-5 year time horizon which will see an inevitable semi-conductor downturn where we may elect to add more shares, potential acquisitions, strong cash generation and a new growth cycle.

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BV (BV/Share): Book value (book value per share)

Book value per common share calculated as total shareholder's equity less preferred equity, and divided by the number of common shares outstanding. Should the company decide to dissolve, the book value per common share indicates the dollar value remaining for common shareholders after all assets are liquidated and all creditors are paid.

D/E: Debt-to-equity ratio

A measure of a company's financial leverage calculated by dividing long term debt by shareholders equity. It indicates what proportion of equity and debt the company is using to finance its assets.

Current ratio

One of many ratios designed to evaluate short-term liquidity of a company. Calculated as current assets divided by current liabilities, this ratio gauges the level of cash resources relative to current liabilities as a measure of cash obligations.

EBITDA

Earnings before interest, taxes, depreciation, and amortization. EBITDA is calculated as revenue minus expenses (excluding tax, interest, depreciation, and amortization).

EPS: Earnings per share

A company's earnings available to common shareholders, also known as net income or net profit, divided by the number of shares outstanding.

EV: Enterprise value

Enterprise value is calculated as market capitalization less cash and equivalents, plus debt. Evaluation of EV relative to the company's trailing EBITDA is used in identifying potential takeover targets.

FCF: Free cash flow

Capital expenditures are subtracted from cash flow from operating activities to arrive at free cash flow, which intends to measure the cash available to a company after making all cash outlays necessary to maintain existing productive capacity (as measured by capital expenditures on a company's cash flow statement).

Net working capital

A measure of the company's ability to carry on its normal business comfortably and without financial stringency, to expand its operations without the need of new financing, and to meet emergencies and losses. Calculated by deducting current liabilities from the current assets.

P/B: Price-to-book ratio

Calculated as a stock's market value (current closing price) divided by its latest quarter's book value. While a lower P/B ratio could mean that the stock is undervalued, it could also serve as a sign of weak fundamentals, and as with most ratios, this varies a fair amount by industry.

PEG ratio

The price/earnings to growth, or PEG ratio is calculated as P/E ratio divided by a company's annual EPS growth. The PEG ratio is used to determine a stock's value while taking into account earnings growth.

P/FCF: Price-to-free cash flow ratio

Calculated as a company's current share price divided by its free cash flow per share (i.e., free cash flow divided by the number of company's shares outstanding) over the last four quarters (called "TTM," or "trailing 12 months" calculation). It is a measure of the market's expectations regarding a firm's future financial health.

P/S: Price-to-sales ratio

It is calculated as a stock's current market price divided by its sales (revenue) per share. When calculating this ratio, we use the company's revenue from its latest four quarters, or on a TTM basis.

ROE: Return on equity

A measure of a corporation's profitability, calculated as net income divided by shareholder's equity. ROE is often useful in comparing the profitability of a company to other firms in the same industry.

Featured companies in KeyStone's Small-Cap Stock Report are evaluated on a scale of 1 to 5 on each of the following criteria:

Value: 1 - poor investment value
5 - excellent investment value

Risk/Liquidity: 1 - high exposure to liquidity concerns
5 - low exposure to liquidity concerns

Growth: 1 - poor growth potential
5 - excellent growth potential

Overall: 1 - poor fundamental characteristics
5 - excellent fundamental characteristics

Disclosure					
Stock Holding				Other	
Companies	KeyStone	KeyStone Employees	Related Companies	Investment Banking Client	Related Company Business Relationship
Photon Controls Inc	YES	NO	NO	NO	NO

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