

KEYSTONE'S

Small-Cap Stock Report

Editor: Ryan Irvine, BBA (Finance)
Senior Analyst: Aaron Dunn, CFA

Independent Equity Advisors

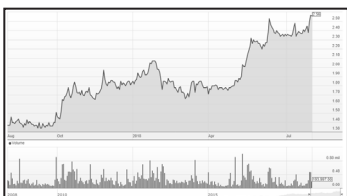
Photon Control Inc.

Current Price (August 2/2018): \$2.40

(PHO:TSX)

RECOMMENDATION: NEAR-TERM: SELL HALF/LONG-TERM: HOLD (HALF ORIGINAL POSITION)

CASH RICH UNIQUE TECH DRIVEN MICRO-CAP POSTS RECORD Q2 2018, LONG-TERM OUTLOOK REMAINS POSITIVE, NEAR-TERM SLIGHT WEAKNESS, STOCK REACHES NEAR-TERM FAIR VALUE –SHIFT RATING



Industry: Technology - Semiconductor Tech

Focus BUY Portfolio

Recommended: December 2014

Recommendation Price: \$0.46

Current Price: \$2.40

Market Cap: \$267,784,795

Shares Outstanding: 111,114,023

Fully Diluted: 114,892,553

SELECTED QUARTERLY DATA

Income Statement	Q2 2018	Q2 2017
Revenues:	\$14,565,000	\$8,877,000
Adjusted EBITDA:	\$5,124,000	\$2,467,000
Adjusted EBITDA Per Share:	\$0.05	\$0.02
Fully Diluted Ad. EBITDA/Share:	\$0.04	\$0.02

Headquartered in an ISO 9001:2008 manufacturing facility in Richmond, British Columbia, Photon Control Inc. designs, manufactures, and distributes a wide range of optical sensors and systems to measure temperature and position. These products are used by the world's largest Wafer Fabrication Equipment (WFE) manufacturers and end users in the semiconductor and related industries. Photon Control's high quality products provide industry leading accuracy, speed and quality in the most extreme conditions and are backed by a team of experts providing a variety of on-site and remote services including custom design, installation, training and support.

PRODUCTS, DISTRIBUTION AND INDUSTRIES

Semiconductor Industry: Temperature and Position Sensors

The semiconductor capital equipment industry offers several significant and growing applications for Photon Control's technology and has become the primary source of revenue and growth for business. The company designs and produces precision temperature and position sensors used by semiconductor WFE manufacturers. The manufacturing of silicon wafers for semiconductors involves a multitude of complex processes; monitoring and maintaining correct position and temperature is critical to this process and to optimize product yield. Fiber optic sensors are both electro-magnetic and radio frequency signal immune allowing them to provide highly accurate results especially in harsh environments, such as etch. Photon Control's fiber optic temperature and position sensors are manufactured according to "copy exact" standards in its ISO-certified facility.

The company's fiber optic sensor technology is uniquely qualified to measure temperature and position in semiconductor manufacturing environments such as wafer etching, atomic layer deposition (ALD), chemical vapour deposition (CVD) and physical vapour deposition (PVD). The need for increasing geometric granularity drives the number of measurement points required as well as the need for the highly accurate measurements provided by fiber optic sensors. In addition, as semiconductor capital equipment has gone from 28 nm to 10 nm linewidth for leading edge

RATINGS

VALUE	
EV/EBITDA (TTM):	13.05
P/S (TTM):	5.17
P/B:	4.91
Current Ratio:	6
D/E:	0.00

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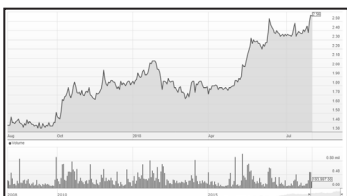
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applications over the last 10 years, the number of desirable measurement points has increased more than four-fold. Similarly, the proliferation of connected devices and 3D chip designs are becoming more and more mainstream taking significant market share in many applications. These factors have driven and are expected to continue to drive demand for Photon Control's products.

Other Products

The company offers a comprehensive range of spectrometer accessories and software to make Original Equipment Manufacturer (OEM) integrations and complex experiments easier. They also provide stable ultraviolet (UV) and broadband light sources, reflectance probes, transmission stages, and collimating lenses.

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MARKET LANDSCAPE

Semiconductor Industry (Optical Sensors)

Semiconductors have revolutionized the way we work, communicate, travel, entertain, and live. As a building block of technology, semiconductors will continue to enable innovation and transform industries. With the accelerating pace of new chip capabilities and more applications, chip makers will need to increase production to meet this growing market. Simultaneously, semiconductor companies are regularly transitioning to new design and production technologies. Many of these technologies increase the number of process steps requiring more overall WFE production capacity. The combination of overall semiconductor growth and increased demand for equipment is expected to in turn drive growth for the company. Photon Control's primary vertical in this market is in etch, one of many manufacturing steps in the process of creating semiconductors. The company works in and is developing business plans to meet demand in several other process steps including expanding its revenues from the deposition step as well as extending its product reach into the processes involved in the manufacturing of Organic Light-Emitting Diode (OLED) panels and other sophisticated display panel technologies, the fabrication of which is similar to the process for semiconductors.

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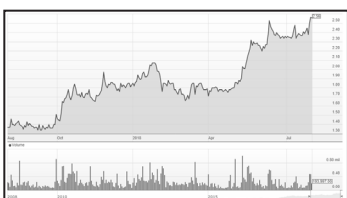
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REPORTED FINANCIAL HIGHLIGHTS

Photon Control was recommended in late December of 2014 with the company's shares trading at \$0.46. Heading into 2017, KeyStone re-recommended the stock in late December/early January with the stock trading in the \$0.80 range. In our May 2018 update with the stock in the \$2.00 range, we recommended a Near-Term BUY Half Position. Today, with the company shares trading at \$2.40 following record Q2 2018 financial results, we review the numbers and update our rating on the stock.

Q2 2018 increased 64% from \$8.9 million to a record \$14.6 million, and for the first half of 2018, revenue increased 37% from \$20.8 million to \$28.4 million. The increase year-over-year reflects a second quarter 2017 slowdown while the company relocated its manufacturing facility, as well as the company capturing an increased share of customers' spend of fiber optic sensors combined with strong overall market conditions in 2018.

Gross profit in 2018 reflects the benefits of the stronger revenue. Second quarter 2018 gross profit increased 78% to \$8.3 million versus the prior year quarter, and for the first half of 2018, gross profit increased 37% to \$16.2 million versus the prior year period. Gross margin increased to 57% for the quarter and year-to-date compared to 53% and 57% in the same year-ago periods. The increase was primarily due to sales mix and greater economies of scale realized from Photon Control's manufacturing facility.

Total comprehensive income for the quarter was \$3.8 million, or \$0.03 per share, compared to a loss of \$0.3 million or close to break-even per share for the comparable period of 2017 while for the first half of 2018, total comprehensive income was \$6.7 million, or \$0.06 per share, versus \$1.4 million, or \$0.01 per share, for the first half of 2017.

EBITDA for the quarter and first half of 2018 was \$5.1 million, or 35%, of revenue

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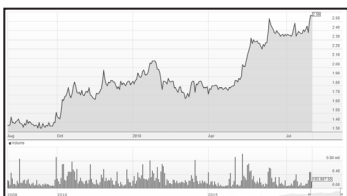
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and \$9.8 million, or 35%, of revenue compared to \$2.5 million, or 28%, of revenue and \$7.4 million, or 36%, of revenue in the same year-ago periods. For the comparative period, EBITDA was adjusted to remove the effect of non-recurring items.

As at June 30, 2018, cash on hand was \$40.8 million, or \$0.37 per share, an increase of \$6.5 million from \$34.3 million at December 31, 2017. The increase was attributable to Photon Control's strong operating results.

Order Backlog

Order backlog (defined as the value of sales orders scheduled to be shipped in the next 6 months) was \$19.5 million at June 30, 2018, a decrease from \$24.7 million at March 31, 2018, and an increase from \$18.3 million at December 31, 2017. The decrease in order backlog since March 31, 2018, reflects the record shipments in the quarter. Although not reflected in the order backlog, the company also has a strong pipeline of new products under development which contribute to revenue during the prototype and pre-production stages.

Quarterly Developments:

China Distribution Agreement

On July 30, 2018, Photon Control announced it entered into an exclusive distribution agreement with Crowntech Photonics for the company's fiber optic-based temperature and position sensors in China. Wafer fabrication equipment spending in China was approximately \$4 billion in 2014 and is expected to grow to \$11 billion by the end of 2018. The company's existing sales to China comprised 15% of overall revenue for the first half of 2018 and this new distribution agreement positions Photon Control to increase its presence in the region as China embarks on its "Made in China 2025" strategy. We see this as a long-term positive, but believe the agreement will take a number of quarters to years to see significant sales.

Tax Review

Earlier this year, the company announced it had commenced a review of its exist-

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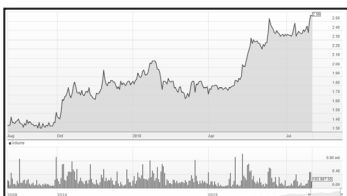
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ing tax structure with its third-party tax advisors to identify and take advantage of opportunities to achieve the most efficient and effective tax outcomes. In addition to identifying these opportunities, this process involved a review of historical filings and jurisdictional compliance. The review has identified a potential tax liability related to a foreign jurisdiction which could be in the range of \$1.4 to \$2.0 million plus penalties, if any. The actual liability amount may be influenced by available tax elections, application of historical losses and offsetting credits and deductions from both the taxing and other jurisdictions; and thus, cannot be more accurately estimated at this time. Photon Control and its advisors are working diligently to conclude this matter and we will update shareholders as it progresses. While the potential tax liability is not a positive (anytime a company has to pay out cash for unanticipated tax it is not), it is neither a crippling amount nor anything more than a one-time event, so we do not see a huge impact here.

CASH BALANCE – POTENTIAL DEPLOYMENT

Photon Control boasts a very strong balance sheet for a company of its size. As at the end of Q2 2018, the company held over \$40.8 million, or \$0.37 per share, an increase of \$6.5 million from \$34.3 million at December 31, 2017. At any given time, management believes it is prudent to hold from \$7 to \$10 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 from \$31 to \$34 million in cash on hand to invest in further product development or make a strategic acquisition. The company could look to use capital to add new technology in additional process steps in the arena of semiconductor “etch” as we alluded to above. Essentially, Photon would add content within the etch segment of the manufacturing of semiconductors and sell this as an add on to existing and new potential customers with little additional sales staff requirements. The company has also earmarked roughly \$3 million for a share buyback.

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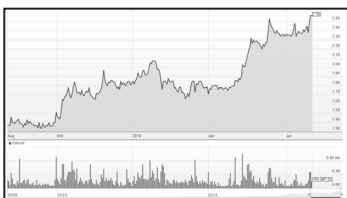
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Business Outlook for the Third Quarter of 2018

Management provided Q3 2018 guidance with its second quarter results stating they expect revenue to be in the range of \$10 to \$12 million. Management's expectation of a sequential decrease in quarterly revenue in the third quarter is the result of a slow-down in capital spending by the company's wafer fabrication equipment customers after a very strong first half of this year. Despite this slow-down, Photon Control continues to expect to generate year-over-year revenue growth exceeding overall industry growth. This is a result of the company's focus on etch, the fastest growing subsegment of the market, where adoption of fiber optic sensors is greatest as well as efforts to add new products to the portfolio. Management expects to maintain EBITDA and net income margins for the year at levels similar to or above those reported in the prior year.

VALUATION AND FAIR VALUE ASSESSMENT

Photon Control has generated roughly \$0.10 in trailing earnings per share, giving it a current trailing PE of 23.8 which is now at a premium to the market average multiple. The company boasts a very strong balance sheet with zero debt and a cash balance of \$40.8 million, or \$0.37 per share. If we strip this out of the company and use an annual EPS figure of \$0.105, which is the consensus earnings estimate for the company over the next 12 months, its price-to-earnings based on the core business is around 19.14 – which is slightly higher than the market average PE. In our last report, we suggested that the company could support an EV/EBITDA multiple in the range of 14-15 or a PE of 18-19 which would put a fair value in the \$2.35 range near term. This is just below its current share price. As such, near term the stock has hit fair value.

CONCLUSION

The company's Q2 2018 results were strong and market records in terms of revenues and net income for Photon Control. The stock has continued to perform very well

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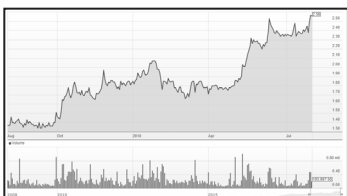
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and is now up 420% since our originally recommendation and over 190% since we re-iterated our buy on the stock a year and a half ago. Near term, Photon Control has hit our fair value estimated in the range of \$2.35. We continue to see the stock as one that can outperform long term and like the business long term, but from purely a fundamental perspective, the stock is at or slightly above our near-term fair value estimate and there is an opportunity to lighten positions with the strong gains by 25-50%. We continue to expect growth, but the semi-conductor industry is historically higher risk and profit taking in a historically cyclical industry is prudent. This is more a case of employing the old adage that “an investor never goes broke taking a profit” than a significant negative comment on the stock. In fact, we see value holding half the original position (which for many clients would now be a greater than full position given the gains) long term.

Long term (3-5 years forward), the growth profile is positive. Today, Photon Control serves just two verticals in the semi-conductor value chain - etch and deposition. The company provides just two types of process control measurements – temperature and position. Management believes the total addressable market for its products is currently \$200 million which it has far from fully penetrated. Photon Control is the single largest provider in this segment. The company sees its total addressable market growing from current \$200 million to approximately \$600 million by 2021. This growth which goes well beyond market size in increases in etch and deposition, anticipates more touch points and measurements in those core markets as well as extending to additional verticals in the semi-conductor and solid state industries. The company believes the total addressable market for fibre optic sensors will also increase as the larger share of the semiconductor logic and memory devices manufactured shrink to approach the atomic length scale and become even more 3D. These advanced devices require more precise temperature measurements at more points to achieve target yields in fabrication. Precise measurements like those provided by Photon Control’s products improve yields and fab yields equal profit in the company’s industry. The equation is simple; more measurement points equals more yield which leads to more profit for the WFE’s the company supplies and in the end

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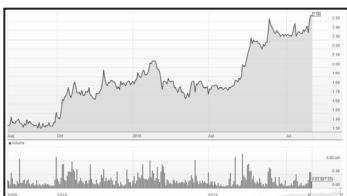
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for Photon Control. This is why the company is currently investing in engineering and sales. These investments have already started to pay-off but are truly designed to allow the company to expand organically with new product editions for its customers.

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, there will likely be another downturn at some stage. We do know business will pullback in Q3 from the record levels seen in Q2 2018 – this is not unexpected and the profitability in the quarter will likely improve over the prior year (Q3 2017) which is good to see. There are forecasts for a rebound in Q4 and into 2019, but the visibility is not great. Again, having said this, the company has experienced higher highs and lower lows in terms of sales and profitability overtime as it gains more customers. We expect the later to continue. With the push towards adding new products, the company is positioned well long term.

Again, we like the business and the long-term growth track, but the stock has reached fair value near term and it is prudent to take some of the excellent gains off the table. Near term we advise clients sell 25% to half their initial positions in Photon Control. The remaining positions we would continue to HOLD with a 2-5 year outlook where we expect the company to outperform long term.

Recommendation: Near-Term: SELL HALF, Long-Term: HOLD HALF Original Positions.

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 Control Inc.	YES	YES	NO	NO	NO

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