Novanta Inc. (NOVT)

Baird Facts

Please refer to Appendix - Important Disclosures and Analyst Certification.

<table>
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<tr>
<th>Price ($) (5/13/20):</th>
<th>93.72</th>
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<td>52WK H-L ($)</td>
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<td>Market Cap (mil):</td>
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<td>Shares Out (mil):</td>
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<td>Float (mil):</td>
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<tr>
<td>Avg. Daily Vol (mil):</td>
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<tr>
<td>Dividend ($)</td>
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<td>Yield (%)</td>
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<td>Price Target ($)</td>
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<tr>
<td>L-Term Rev. Gr Rate Est:</td>
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<tr>
<td>L-Term EPS Gr Rate Est:</td>
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<td>Price Target ($)</td>
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<th>2021E</th>
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<td>1.45E</td>
<td>2.30E</td>
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| FY P/E   | 43.6x | 64.6x | 40.7x |

Company Description
Novanta is a manufacturer of highly engineered specialty components and sub-assembly technologies sold principally into medical device and advanced industrial equipment markets. Novanta designs/manufacturers/sells high-value, critical components and sub-assemblies to OEM’s. Core technological competencies in laser beam steering, laser sources, precision motion control, optical encoders, ID technologies (imagers/RFID) and medical visualization tools. Explicit in NOVT’s strategy is to maintain revenue balance between Medical and Industrial end markets.

Revenue by Market (1Q-20)

- Medical 58%
- Industrial 42%

Revenue by Geography (CY19A)

- U.S. 41%
- Europe 34%
- APAC 14%
- Other 4%
- ROW 2%

Company revenues are nearly evenly split between Medical and Industrial segments. NOVT’s Core Growth Vision is focused on medical markets, where it is currently 35% of the NOVT business and 13.3% year-over-year growth. NOVT’s Industrial Vision is focused on precision motion, which is 45% of the NOVT business and -13.8% growth.

NOVT Margin Trends (2015-2021E)

- Gross Margin *
- EBITDA% *
- EBITA% *

* reflects non-GAAP adjusted

Company Description

- Vision: 35% of CY20E Sales, -3.5% Core Growth
  - Key Products: Insufflators/Pumps (endoscopy), RFID, Machine vision engines
  - Key Competitors: Renishaw, Heidenham, Heidolph, HON

- Photonics: 45% of CY20E Sales, -13.5% Core Growth
  - Key Products: Laser beam steering, scanheads, galvanometers
  - Key Competitors: SCANLAB, RAYLASE, COHR/Rofin, Cobolt

- Precision Motion: 20% of CY20E Sales, -7.5% Core Growth
  - Key Products: Optical encoders, controllers, direct drives
  - Key Competitors: Renishaw, Heidenham, Physik Instr, Allied Motion Tech

Total 100% -8.3%

Source: Company reports, Baird research
Quick Summary

Neutral-rated. NOVT delivered 1Q results above plan. 2Q/3Q will degrade Q/Q but currently the "trough" appears shallower than we expected MODELED previously. Semi/electronics, diagnostics markets offering some stability near term until a recovery in surgical volumes to support better Medical growth (we expect by 4Qe). Advanced Industrial demand may recover more slowly. Nonetheless, we remain comfortable with NOVT’s generous valuation, as we see no reason to penalize NOVT’s share price as content/share gains should be nicely leveragable when post-COVID demand recovers. We impatiently await a more attractive entry point.

- Raised CY20E adjusted EPS to $1.45, -33% Y/Y, (from $1.31) as core sales (-8%) erosion less severe (prior -15%). CY21E EPS to $2.30, +59% Y/Y.
- 2Q sales guided above consensus, is 3Q the bottom? 2Q sales guided $130M-$142M (down -8-16%), above consensus $126M and well above Baird ($94M). NOVT indicated the 2Q guide upper end ($142M) captures incoming bookings/current demand, but ranges down ($130M) to account for potential supply chain/customer access limitations. While guide better than we expected, NOVT’s current view is its revenue lags its OE customers by 60-90 days, thus 3Q sales likely will be <2Q as the impact of paused 2Q demand (e.g., surgical procedures) is fully realized. NOVT cited pandemic driven uncertainty (duration/scope) in deferring from providing 2Q EPS or EBITDA guidance.
- Actions reducing discretionary expenses should aid EBITDA; however, COVID one-time/non-cash costs impact adjusted EPS. NOVT indicated SG&A could decline Q/Q as it implemented a range of cost actions, largely temporary, at 1Q-end (total amount not quantified). However, one-time COVID headwinds (e.g., logistics) could be $3M-$4M ($0.07-$0.09) impact on 2Q COGS. Additionally, FAS123 (non-cash) will increase ~$0.30 in CY20E as NOVT granted ~180k shares across the employee base (no Sr. executives involved) to help counter salary/wage measures and boost employee ownership mentality.
- Expect Medical sales recovery first. NOVT’s Medical businesses (~58% of NOVT) grew +6% in 1Q (Industrial -10%). While we expect pauses in surgical procedures (~70% of NOVT Medical tied to surgery) to be visible 2Q/3Q, this market appears best positioned to drive reacceleration in NOVT’s growth rate.
- 1Q results were above top end of guidance. 1Q adjusted EPS $0.51 beat RWB/consensus $0.39/$0.32 (guidance $0.34-$0.42) on sales $155.5M (RWB/consensus $149.5M/$143M; guide $144M-$154M), driving adjusted EBITDA $27.6M, -2% Y/Y (17.8% margin); guide $23M-$26M.
- 1Q core sales -4.3% (Baird -8.8%), better than expected. Reflected Precision Motion (-2% Y/Y, core -4%) above our forecast, while Vision (+5%, core +1%) and Photonics (-7%, core -12%) were at/just below our forecasts. NOVT suggested 1Q strength partly attributed to customers building component inventory buffers against pandemic supply risks. Overall bookings grew +6% Y/Y, book:bill was 1.06 (1Q seasonal is ~1.0). NOVT’s 2Q guide also assumes some 1Q "pull forward" activity impacting 2Q revenue.

Investment Thesis

- Emerging growth "compounder." We view NOVT as an emerging multi-Industry with a strong portfolio of component and sub-assembly technology. From late 2010 through 2015, NOVT undertook a transformational restructuring, refreshing and upgrade of its cost structure, management team and product portfolio. The current businesses reflect a balanced portfolio between Medical and Advanced Industrial markets expected to provide a lower beta revenue/profit profile.
- Attractive secular core growth orientation. The collective technology portfolio offers a core growth opportunity of +5-7% CAGR (NOVT’s target). End-market exposures slant toward areas growing GDP+ to 2X GDP, including: minimally invasive/robotic surgery, DNA sequencing, industrial robotics/warehouse automation, medical RFID/machine vision and laser-based material processing.
- Strong cash flow generation supports inorganic strategy. M&A is the priority use of FCF to subsidize core growth initiatives. Acquisitions assumed to contribute +8-10pp of the growth over the five-year (2020) planning period.
- Upward bias to margins. We estimate ~33% of NTM revenue (NDS, Celera Motion, WOM) contributes a below average EBITDA margin. Initiatives including operational improvements, supply chain leverage, new products, sub-assembly strategy are underway to nudge EBITDA margin higher in these businesses. G&A expenses are expected to be leveraged with sales growth. Management has boosted R&D investment (10% of sales) intentionally. Identifiable earnings power opportunities could represent as much as ~$0.20-$0.25 of EPS embedded in NDS, WOM, Celera Motion.
- $90 price target assumes 40X CY21E adjusted EPS, equivalent to NOVT’s average P/E range over the past two years as the NOVT story transitioned from turnaround to growth, in particular with an increasing sales mix favoring Medical. Also equates to 25X CY21E EV/EBITDA. We believe EBITDA holds upside from new platform "wins" in backlog. Timing of the ramp to commercial volumes of these "wins" has become less predictable as OE customers modulate new product introduction plans on COVID disruptions. A similar valuation profile for a comp group of advanced industrial & medical device component companies currently have average P/Ebs of 25X and 32X CY21E EPS, respectively. Moreover, we view NOVT’s exposure to secular growth drivers plus visibility from design wins as supporting our core growth recovery (no additional M&A assumed) forecast for CY21E.

Risks & Caveats

- OEM supplier role presents unique risks. The vast majority of NOVT products are sold to product OEMs, which entails competition for design wins (often several years in advance of revenue realization), subject to customer’s success rate, distance from the end user (diminishes visibility on end demand, market adoption rates.
- Reliance on capital budgets. Most of NOVT’s products/components ultimately reside within capital equipment, making NOVT exposed to the capital budgets/capital expenditures of the end users.
- Growth strategy reliant on acquisitions. NOVT’s growth strategy explicitly promotes the planned use of excess FCF to be used for acquisitions. Identifying synergistic acquisitions, target valuations and integration risks all accompany this strategy.
- Customer/application concentration. NOVT’s scale (revenue) leaves it subject to its own success. Customer (OE) concentration or concentration on a specific application can/does influence timing of quarterly or annual revenue. We believe NOVT has no 10% customers but SYK is ~7%. Timing (introduction OE new product, where NOVT has content), OE inventory levels, the conversion of NOVT “wins” versus commercialization of OE product, all add risk to forecasting NOVT quarterly revenue.
Appendix - Important Disclosures and Analyst Certification

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Rating and Price Target History for: Novanta Inc. (NOVT) as of 05-13-2020

1 Robert W. Baird & Co. Incorporated makes a market in the securities of NOVT.

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