

11 August 2008

XP Power

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	PE (x)	Yield (%)
12/06	78.7	9.1	37.0	18.0	5.4	9.0
12/07	66.3	7.7	31.4	20.0	6.3	10.0
12/08e	66.7	8.1	31.7	22.0	6.3	11.1
12/09e	70.6	9.4	37.0	23.5	5.4	11.8

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

Investment summary: Business model benefits

H1 results highlighted the resilience of XP's end markets and IP-based business model. Own-branded revenues grew 7%, gross margins increased significantly H1-on-H1, driving sequential earnings growth of 30% and underpinning an 11% increase in the dividend. Management does have to focus on controlling input price increases, but the outlook statement and a book-to-bill of over 1x support our unchanged full-year forecasts. The shares look significantly undervalued in a sector where industry consolidation will continue to be a major feature.

Description: Mid-tier power-supply player

XP Power designs, manufactures and distributes power-supply solutions to the electronics, telecommunications and industrial markets. Management commented that the need for design and cost efficiencies and the legislative backdrop is supporting demand and the group is currently seeing underlying increases in pricing.

Business model: H1 highlights margin expansion

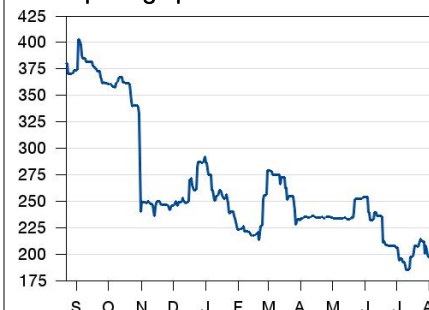
The shift in XP's business model towards own-designed products and Asian manufacturing will help XP to take market share, and support medium-term revenue growth. Management need to pass on current input price inflation but this shift delivered an increase in like-for-like gross margins to 42.8% in H1 (40.9% H107).

Forecasts and valuation: Undervalued on all measures

The economic backdrop is clearly uncertain but H1 financials and a book-to-bill of 1.09x support our unchanged forecasts – we conservatively assume H2 revenues down 8% sequentially on H1. We have raised our dividend forecast by 5%. By 2012, we forecast the business model can deliver margins of nearly 17%, supporting compound earnings growth of 12%. The shares are now trading on a PE of under 7x and offer a yield of over 11%. We continue to highlight the value in the higher margin, faster-growing 'own-product' sales, and we reach a group value of £74m.

Price 199p
Market Cap £38m

Share price graph



Share details

Code XPP
Listing Full/Overseas
Sector Electronics & Electronic Equipment
Shares in issue 19.24m

Price

52 week High 401p Low 178p

Balance Sheet as at 30 June 2008

Debt/Equity (%) 66.0
NAV per share (p) 160.5
Net borrowings (£m) 20.2

Business

XP Power is a mid-tier manufacturer and distributor of power supplies with a production facility in China and design, service and sales teams across Europe and the USA.

Valuation

	2007	2008e	2009e
P/E Relative	45%	57%	53%
P/CF	4.5	3.7	3.6
EV/Sales	0.9	0.8	0.8
ROE	21%	18%	19%

Revenues by geography

	UK	Europe	US	Other
0%	40%	60%	0%	0%

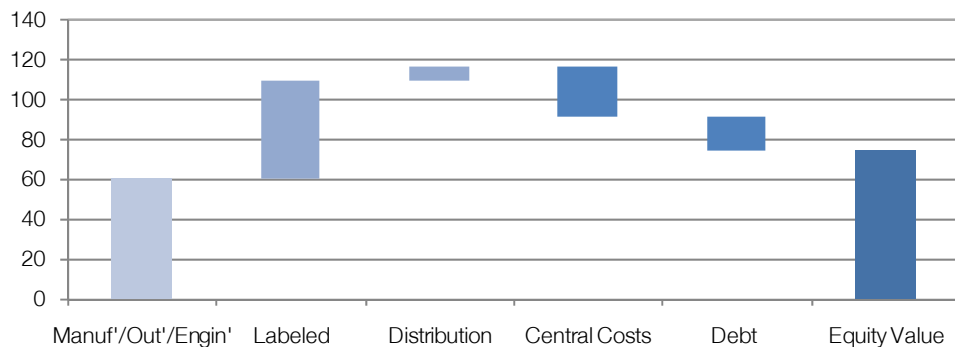
Analyst

Andrew Bryant 020 3077 5729
abryant@edisoninvestmentresearch.co.uk

Company Description: Power-supply designer

XP Power designs, manufactures and distributes power supply solutions to the electronics, telecommunications and industrial markets. Power supplies take the high-voltage alternating current output from the mains supply and convert it into various lower-voltage, stable direct current outputs that are required to drive most electronic equipment. The group structure has been built largely through acquisition and reflects the markets the company operates in, ie most of the customers, competitors and suppliers are based in Asia. Therefore, the group recently moved its headquarters to Singapore and is in the process of setting up a design engineering team there. It also has a manufacturing facility in China and runs design engineering teams in the US and the UK. In FY08, we estimate that XP-manufactured products (including outsourcing to other Asian manufacturers and custom-engineered solutions for specific customer requirements) will account for 37% of revenues, distribution of products labeled under XP's brand 35%, engineered solutions 11% and distribution 17%. We value each of these revenue streams in reaching a group value of £74m.

Exhibit 1: XP Power sum of the parts valuation (£m)



Source: Edison Investment Research

Interim results

In H1, underlying revenue growth was significantly stronger than the reported 1%, and an uplift in margins contributed to earnings growing 30% sequentially over the second half of 2007 (14.1p to 18.4p). The strategy and positive outlook were supported by a book-to-bill ratio of 1.09x.

- Revenue mix.** Overall revenues increased by 1%, but within the mix, own-IP product sales increased 7% and in line with the strategy, distribution of third-party products fell by 13%. North American revenues were \$33.6m (\$33.2m) with some encouraging recent design wins into new key customers in the medical and defence areas. European revenues were £16.7m (£16.4m). In H1, the mix of business between industry sectors has remained stable – 20% of revenues came from Communications, 49% from Industrial, 22% from Medical and 9% from Defence & Avionics.
- Gross margins.** Gross margins improved 190 Bpts from the comparable half last year, but sequentially they fell 80 Bpts from the second half of 2007. The power supply industry is almost totally supplied out of Asia, and component pricing, labour costs and

currency appreciation have all contributed to substantial increases in input costs across the industry. Industry unit selling prices are now increasing and XP will pass on price increases in Q4 this year – supporting higher gross margins for the full year.

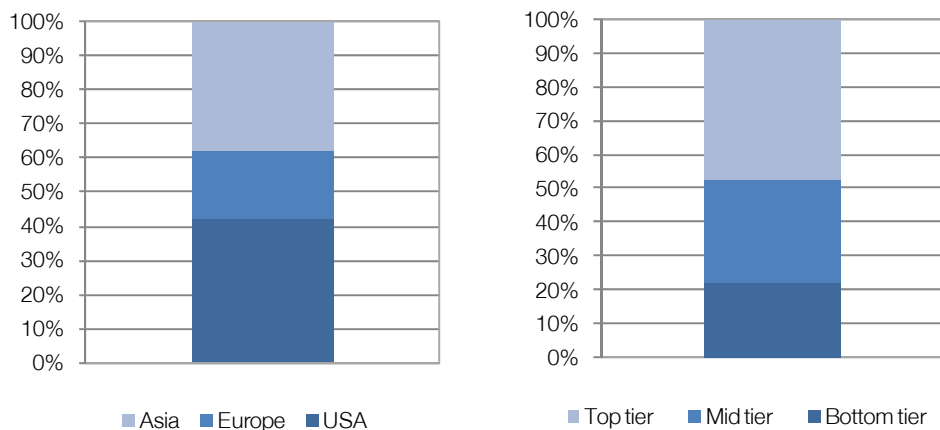
- **Balance sheet.** H1 net debt was c £20m, broadly in line with our forecast assumptions (we forecast year-end net debt of £18m). The board increased the H1 dividend by 11% (ninth successive increase), well ahead of our 5% forecast.
- **Manufacturing.** On 1 January 2008, XP purchased the remaining 50% of their Chinese manufacturing joint venture with Fortron Source for US\$2.5m and took control of this facility. The group also introduced a number of new products into the factory during the first half of the year. Management is now in the process of significantly increasing the capacity of this facility to meet demand. In June 2008, construction started on a new 6,300m² building on the existing site, located close to Shanghai in China. This expansion in manufacturing has enabled XP to become approved vendors to a number of new key customers, which should help drive revenue growth going forward.

Investment case: Update

Markets: Mixed but market share supported by strategy

Management highlighted that trading conditions have been mixed in H1. There have been some signs of a slowdown in terms of order push-outs and cautiousness in some customers, while others continue to order strongly. Overall management described order levels as ‘robust’ – orders were 9% higher than sales in H1. The outlook for H2 orders looks encouraging, helped by more sales resources and new products and a growing legislative backdrop, which requires more efficient power usage in electronic devices.

Exhibit 2: Market by geography and tiering



Source: Edison Investment Research, company information

As OEMs focus on their own core design and manufacturing IP, the shift from captive (in-house) to merchant (outsourced to suppliers like XP Power) supply has continued to accelerate, underpinning growth faster than underlying end-market electronic product demand. XP Power’s target market is in the mid-tier higher-value merchant industrial and telecoms industries, which in total are estimated to be worth around \$2.5bn (estimated XP market share c 6%).

Target customers: Increasingly larger OEMs

XP's customers are original equipment manufacturers (OEMs), which are often designing niche or high-value products in the medical devices, communications and industrial automation markets. As typically mid-sized suppliers to their markets, these companies generally do not have in-house power-supply expertise and source the component either directly from manufacturers or through distributors. Major customers include OEMs ABB, Beckman Coulter, Siemens, Thales and distributors such as Premier Farnell.

Shift to own-designed products and Asian manufacturing

XP Power was formed as a specialist distributor of power suppliers in 1988. Subsequently, the business merged with Foresight (California, US) and IPS (New England, US) on flotation in 2000. Since then, the group has made a couple of further acquisitions to build out IP and a manufacturing capability, as well as shifted investment towards own-designed products – the company therefore remains a mid-sized distributor of third-party power supplies, but XP's strategy going forward is to design power supplies using its design engineering groups around the world and manufacture the power supply in Asia. Therefore, in forecasting and valuing the group, we identify five revenue streams:

- **Own-manufactured product.** Products designed by XP, ownership of 100% of the IP and manufactured in its Shanghai facility.
- **Sub-contract manufacture.** Products designed by XP, ownership of 100% of the IP but manufacture is outsourced to other Asian manufacturers.
- **Engineered solutions.** Customising of XP power supplies for specific customer end-product design requirements, ie designing and engineering additional casings, metalwork, circuitry, connectors, etc.
- **Labeled products.** Customer requirements identified and product design specified by XP, but products sourced from third-party manufacturers and labeled under the XP brand.
- **Distribution.** Supply of third-party power supplies.

In Exhibit 3, we highlight our estimate of the breakdown of FY08 revenues by each of these routes to market, as well as estimated annual growth rates (the low distribution growth rates reflect the strategy of XP to focus on delivering its own IP to customers and only focusing on higher-margin distribution opportunities) and margin structures. In H1, management reached its previous target of a mix of 75% higher-margin own-brand XP products, ie XP intellectual property.

Exhibit 3: XP Power revenue model

	Sales % FY08e	Growth rate pa	Gross Margin	Assumed medium-term EBITDA margin
XP manufactured product	13%	10 to 20%	45 to 50%	25%
XP sub-contract manufacture	16%	10 to 20%	40 to 50%	25%
Engineered solutions	12%	4 to 8%	30 to 40%	15%
Labeled product	35%	4 to 8%	30 to 40%	20%
Distribution	24%	0 to -5%	25 to 30%	10%

Source: Edison Investment research

Under a pure distribution model, a supplier learns little about its customer's product design and future roadmap, ie it essentially delivers a component at best price. However, the ability of

suppliers like XP to design and manufacture power supplies to an OEM's specification helps them become a value-added partner in their supply chain and typically opens up discussions about future, as well as, existing products. A typical power supply in XP's target markets has a lifecycle of upwards of five years and building a strong customer relationship is critical, ie for each new product, customers are likely to review their choice of component suppliers. The benefit of the shift in the customer proposition was reflected in the strong H1 design wins and book-to-bill.

Cost base: Shift to Asia key

The relocation of XP's headquarters to Singapore was completed during April 2007 and the group has been building a supply chain and engineering group at the location. Of XP Power's c 600 employees, over half are based in China and Singapore. However, we estimate these employees account for only 15% of the total payroll costs. The combination of the economies from manufacturing and the low-cost headcount has enabled XP to be more price-competitive, as well as push up gross margins.

Financials: Forecasts look supported

Forecasts unchanged

As we have highlighted, given the H1 financial performance and the positive outlook statement, our full-year forecasts look well-supported. In reaching our forecasts we assume a broadly unchanged gross margin H2 and revenues down 8% sequentially over H1 (should be conservative given H1 end book-to-bill of 1.09).

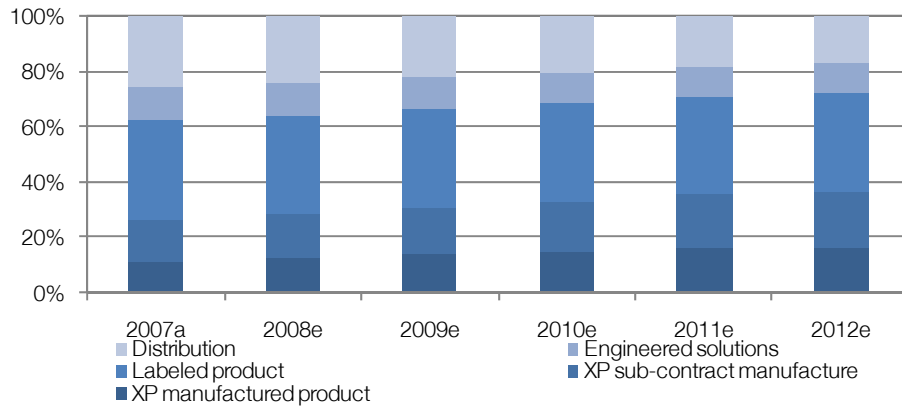
Exhibit 4: Forecast split £m

	H1	H2e	FY08
Revenue	34.8	31.9	66.7
Gross Profit	14.9	13.7	28.6
Margin	42.8%	43.0%	42.9%
EBITDA	5.6	4.7	10.3
Normalised EBIT	5.3	4.1	9.4
Normalised PBT	4.4	3.7	8.1

Source: Edison Investment Research

In our forecasts, we assume that the group's strategy to shift their business model contributes to significantly faster growth for its own IP products (for example, we assume annual growth over the next five years of 14% for own-manufactured products and 12% for outsourced products), and negative growth for the pure distribution operation (reflecting the strategy to move away from low-margin distribution customers). On a five-year view, this translates into the higher-margin manufacturing, outsourced engineering solutions and labeled products accounting for 83% of revenue (XP define these as XP 'own-brand' revenues).

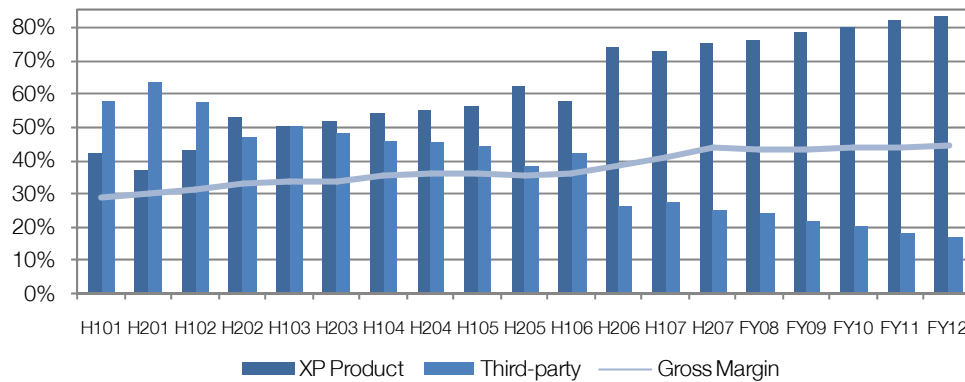
Exhibit 5: Shift in the business model



Source: Edison estimates

The shift in the revenue mix and our margin assumptions for each sales channel (highlighted in Exhibit 6) translate into a forecast of further improvement in the gross margin and we estimate a 300 Bpt improvement in EBIT margins to nearly 17% (15.2% in H1) by 2012.

Exhibit 6: Revenue mix and gross margin (management definition of “own” IP)



Source: Company reports, Edison estimates

We assume an operating cash flow in FY08 of £10.2m and £10.5m in FY09. After capital expenditure and the progressive dividend policy, we assume that net debt falls to £17.8m in FY08 (gearing of 51%) and to £16.9m in FY09 (46%). We now assume an increase in the dividend to 22p in FY08 (previously 21p) and 23.5p in FY09 (23p).

Sensitivities

- **Economic sensitivity.** The group has cyclical exposure to global industrial, telecoms and medical markets. Therefore, any slowdown in end demand in these markets or cutbacks in product development expenditure will impact XP’s revenues.
- **Orderbook visibility.** The group has around three months of order-book visibility at any one time. However, it is essentially a tier-2 supplier to the electronics industry and has a significant proportion of distributor revenues. Therefore, visibility of customer volumes is limited and, as such, individual customer orders can be volatile.

- **Dollar revenues.** The company operates in a largely dollar-based market. The group has an offsetting large proportion of costs in the US as well as low-cost Asian overheads. However, it does carry costs in Europe and the UK and of course reports in sterling. In addition, the manufacturing strategy is based upon low-cost Chinese input costs.
- **Competition.** As we have highlighted, competition ranges from significantly larger players with big balance sheets through to smaller innovative companies.

Valuation: Undervalued on all metrics

Cheap on multiples and valuation support

Shares in XP Power have more than halved over the last year, driven by economic uncertainty and the overall pull-back in investor appetite for UK small-cap technology stocks. At current levels, the shares are trading on 0.8x EV/Sales and only 6.3x forecast earnings. In addition, on our forecast 22p dividend this year (1.3x covered by earnings), the shares are yielding over 11%.

We believe that a major part of the apparent valuation anomaly is the perception of the company as a pure distributor of electronic components. As we have highlighted in this report, this was certainly the original conception of the group, but the transformation towards a business model with IP and manufacturing capability is happening rapidly. In Exhibit 8 we show a sum of the parts DCF approach where we have valued our forecast cash flows (EBITDA less working capital, capital expenditure and tax) for each of the channels to market and then adjusted for central costs (assumed to be c £2m in FY08) and our forecast net debt (£18m). This approach highlights a group market value of £74m (or 388p a share)

Exhibit 7: XP Power valuation

SOTP DCF valuation	% owned	£m	Per share	FY08 EV/EBITDA	Assumptions
Manufacture/Outsource/Engineerec	100.0%	60	315	11.4x	WACC: 12% No of shares 19.0m
XP Power Labelled	100.0%	49	259	10.8x	WACC: 12% Shr price 199.00p
Distribution	100.0%	7	35	4.1x	WACC: 12% Mkt cap £37.8m
Less: taxed central costs NPV		(24)	(128)		WACC: 12% Exch rate (US\$/£): 2.00
Group Enterprise Value		91	481		
Less: Adjusted net debt		(18)	(93)		
Group Equity Value £m		74	388		Up/(down)side from current price 95%

Ratio Analysis	2008f	2009f	Grp DCF Scenario's	Terminal growth rate
				3.00% 5.00%
EV/Sales	0.8	0.8		
EV/EBITDA	5.4	4.7	14.00%	292p 309p
EV/EBIT	5.9	5.1	13.00%	334p 359p
Price/Book	1.1	1.0	12.00%	387p 423p
Price/Earnings	6.3	5.4	11.00%	453p 509p
Price/Op Cash Flow	3.7	3.6	10.00%	538p 628p
ROE	18%	19%		
Gearing	51%	45%		
Interest Cover	7.2	8.8		
			Breakeven WACC	17.1%

Dividend Yield	FY08e	Revenue sensitivity
		Multiple 0.5x 1.0x 1.5x 2.0x
Dividend	22.0	Revenue Y2 £m 76 76 76 76
Dividend Cover	1.5	Implied EV £m 38 76 113 151
Yield	11.1%	Net (debt)/cash £m (18) (18) (18) (18)
UK Small Cap Yield	6.2%	Group equity value £m 20 58 95 133
Yield Relative	178%	Per share (p) 105 304 503 701

Source: Edison Investment research

Exhibit 8: Financials

Year end 31 December	£m	2005 UK GAAP	2006 UK GAAP	2007 UK GAAP	2008e UK GAAP	2009e UK GAAP
PROFIT & LOSS						
Revenue		69.5	78.7	66.3	66.7	70.6
Cost of Sales		(44.7)	(49.5)	(38.3)	(38.1)	(40.1)
Gross Profit		24.8	29.2	28.0	28.6	30.5
EBITDA		9.0	11.0	10.2	10.3	11.6
Operating Profit (before GW and except.)		8.4	10.3	9.4	9.4	10.6
Goodwill Amortisation		0.0	0.0	(0.3)	(0.3)	(0.3)
Exceptionals		0.0	(1.0)	(2.4)	0.0	0.0
Other		0.3	0.1	0.1	2.1	0.0
Operating Profit		8.7	9.4	6.7	11.2	10.3
Net Interest		(0.8)	(1.3)	(1.7)	(1.3)	(1.2)
Profit Before Tax (norm)		7.9	9.1	7.7	8.1	9.4
Profit Before Tax (FRS 3)		7.9	8.1	5.0	9.9	9.1
Tax		(1.7)	(2.0)	(1.4)	(2.0)	(2.3)
Profit After Tax (norm)		5.9	7.0	6.3	6.1	7.1
Profit After Tax (FRS 3)		6.2	6.1	3.6	7.9	6.8
Average Number of Shares Outstanding (m)		19.6	18.9	17.8	19.0	19.0
EPS - normalised (p)		30.1	37.0	31.6	32.0	37.3
EPS - normalised fully diluted (p)		30.1	37.0	31.4	31.7	37.0
EPS - FRS 3 (p)		31.6	32.3	19.1	41.5	35.7
Dividend per share (p)		16.0	18.0	20.0	22.0	23.5
Gross Margin (%)		35.7	37.1	42.3	42.9	43.2
EBITDA Margin (%)		12.9	14.0	15.4	15.5	16.4
Operating Margin (before GW and except.) (%)		12.1	13.1	14.2	14.1	14.9
BALANCE SHEET						
Fixed Assets		33.6	36.6	36.7	36.1	36.0
Intangible Assets		30.2	32.7	32.8	32.3	31.8
Tangible Assets		3.0	3.2	3.4	3.8	4.2
Investment in associates		0.4	0.7	0.5	0.0	0.0
Current Assets		30.1	32.6	30.3	30.1	31.0
Stocks		8.1	11.1	10.5	10.6	11.2
Debtors		17.2	17.2	16.2	16.3	17.2
Cash		4.8	4.2	3.6	3.2	2.5
Current Liabilities		(32.0)	(21.5)	(13.2)	(12.2)	(11.7)
Creditors		(12.1)	(13.9)	(10.5)	(10.5)	(11.0)
Short term borrowings		(19.9)	(7.6)	(2.7)	(1.7)	(0.7)
Long Term Liabilities		(4.5)	(18.3)	(24.0)	(19.3)	(18.3)
Long term borrowings		0.0	(14.4)	(20.3)	(19.3)	(18.3)
Other long term liabilities		(4.5)	(3.9)	(3.7)	0.0	0.0
Net Assets		27.2	29.4	29.8	34.6	36.9
CASH FLOW						
Operating Cash Flow		8.0	7.8	8.3	10.2	10.5
Net Interest		(0.8)	(1.3)	(1.7)	(1.3)	(1.2)
Tax		(0.7)	(2.5)	(1.4)	(2.0)	(2.3)
Capex		(0.8)	(1.2)	(1.9)	(1.3)	(1.4)
Acquisitions/disposals		(4.2)	(1.8)	(1.4)	0.0	0.0
Financing		(3.7)	(.5)	0.4	0.0	0.0
Dividends		(2.8)	(3.2)	(3.8)	(4.0)	(4.3)
Net Cash Flow		(5.0)	(2.7)	(1.5)	1.6	1.3
Opening net debt/(cash)		10.1	15.1	17.8	19.4	17.8
HP finance leases initiated		0.0	0.0	0.0	0.0	0.0
Other		0.0	(0.0)	(0.1)	0.0	(0.0)
Closing net debt/(cash)		15.1	17.8	19.4	17.8	16.5

Source: Company accounts/Edison Investment Research

EDISON INVESTMENT RESEARCH LIMITED

Edison is Europe's leading independent investment research company. With a team of 50 including over 30 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 2008 Edison Investment Research Limited. All rights reserved. This report has been commissioned by XP Power 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 advisers in the United Kingdom for use in their roles as advisers. It is not intended for retail 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 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.

Edison Investment Research

Lincoln House, 296-302 High Holborn, London, WC1V 7JH ■ tel: +44 (0)20 3077 5700 ■ fax: +44 (0)20 3077 5750 ■ www.edisoninvestmentresearch.co.uk
Registered in England, number 4794244. Edison Investment Research is authorised and regulated by the Financial Services Authority.