

Paul Scott of QualitySmallCaps.co.uk interviews Mark Cambridge, CEO of Zytronic (ZYT)

17 Dec 2015

Key:

Paul Scott (“PS”)

Mark Cambridge (“MC”)

PS:

Hello. I am Paul Scott. Today I am talking to Mark Cambridge, CEO of Zytronic, ticker ZYT, the shares are listed on London’s AIM market. The shares are currently £4.19 which gives a market cap of about £56 million.

Quick disclaimers: I have *not* charged a fee to do this interview. I *do* hold shares personally and I am *not* giving advice or recommendations.

Okay. So welcome Mark.

MC:

Hi Paul. I hope you are okay?

PS:

Yes not too bad, not too bad. So let’s start by **asking you to give an introduction to Zytronic**, for people not familiar with the company.

MC:

Zytronic has been around since 2000. It was listed on the AIM market in June 2000. It has, over the 15 year period, been developing and concentrating on a unique touch-sensing product for the display markets. We have spent 15 years growing that product and technologies into various different market applications and uses, spread across a number of different global geographies, to a point now where we have turned over just shy of £18 million in touch revenues and just over £21 million of total product revenues, and exported roughly about 95% of the revenues.

PS:

Right okay. **Are you affected by Forex movements generally then, being a large exporter?**

MC:

Well not all of our exports are in currency. We do transact in three primary currencies, obviously the major one being sterling still. And roughly half of our exports are still in sterling. But we do have exposure to US dollars and Euros. From a hedging position we are generally naturally hedged more in Euros than we are in dollars. But we are exposed at both the sales line and the purchasing line to movements in both currencies.

The business tries to run at net net currency stability. So we are not looking to make profits based on currency and we are certainly not looking to see the business significantly lose profit

as a consequence of currency. So to mitigate part of that in 2014 the business did make a policy decision to put forward contracts in to handle our dollar and surplus Euros. At least 12 months out as a minimum and possibly as far as 18 months out, depending upon what the exact prevailing rate was on a month by month basis, as we were looking to extend the contracts.

So generally it was ability to get us to a net currency position.

PS:

By “net currency” presumably you mean sort of neutral to whatever exchange rates do?

MC:

Sorry I mean net neutral, yes you are quite right.

PS:

Yes.

MC:

What I would say is in the 2015 numbers we *didn't* achieve net neutrality. There is an overall £100K charge to profits. Now that is as a consequence of that at the margin level and direct cost level we were £180K gain on currency, but because of the month to month market movements and the forward contracts that we have in place, we actually had a £300,000 loss on that. So the net effect was a c.£100k charge.

PS:

Yes. Which I think in the context of £4.5 million profit is not material is it? So I think most people would be pretty relaxed about that.

MC:

I think we felt when we put the policy in to begin with, that we knew that there was either going to be a lot of pain or gain in that very first 12 month period. But once it was in and one is maintaining the policy then the smoothing really starts to transact out. And in a sense we saw that by the end of the year and it has continued along that vein.

PS:

Yes. Oh that is encouraging. I am just picking up one point you made at the beginning of this section. You said something quite interesting that **you export over 90% of your product but 50% of it is billed in sterling.**

MC:

Yes.

PS:

Did I get that right? That is really interesting. So you export, but you bill the overseas customers with a sterling invoice by the sounds of it?

MC:

Well I think in general terms for the business and protection of the business we try to do everything in sterling. But obviously from a commercial standpoint one can't prevail that all of the time. Therefore when we do have to move we will either move dollars or Euros. But we don't want to necessarily put ourselves exposed to those currencies.

PS:

Okay. That is great, that is very reassuring. So moving on to the results briefly then. I won't go through all the numbers because people can see those for themselves. The (results) [announcement was on 8 December](#). **Really good results, profit up 39% to £4.5 million for the year. Do you want to brief us on the main factors that caused that good performance and whether you -?**

MC:

- Yes. I think the drive is always improving revenues, but for Zytronic it is as much movement in revenues on the touch (product) is the primary driver, and the mix of those products that we could be manufacturing in touch.

One thing regarding the nicheness of the technologies that we manufacture is we can utilise that technology in producing products that are 5 inches in size, as readily as we can produce products which are 85 inches in size. They run through the same manufacturing conditions, using the same personnel, using exactly the same equipment, with a little bit of variability obviously in the material content - that is the one linear link between sizes.

So although revenues in totality for the business grew 13%, the underlying touch screen growth was 16%. And one of the main drivers in that was that we saw the greater products that we produce, over 30 inch size, we did 50% more in 2015 than we did in 2014.

PS:

And they are higher margin aren't they as well, the big screens?

MC:

They're better margin products, yes. I would often say that, for a business of our ilk, we don't do things which for any touch product which one would call poor margined product. Even the small-sized product is not a poor margin product. But there is a difference between the margins that we get from our touch screen products and the margins that we get from the products which are not touch screen. And the non touch screen products have a lower margin than the touch screen products and therefore they create a margin anchor, a margin drag a little bit, in the totality of the touch screen products, but they are very much stable cash generative business.

But I think ultimately for the business seeing the margin movement that we actually got up to, just shy of 42%, was obviously a great move for the business and one that if people had been listening to our story over a number of years, we always said that getting into the 40% for a business of our ilk was a driving goal.

PS:

I was just going to say that because I think the first time ... you and I chat about every six months don't we, after initially meeting two or three years ago at I think it was Buchanan's offices? And I remember you did say specifically 'This is about getting the margins up to about 40%'.

MC:

Yes. As a business of our nature being bespoke and variable, achieving those sort of margins ought to have been a goal for that business. But I think one should always bear in mind the relationship obviously between margins and then the profitability that consequently comes off it. And arguably there is no doubt that customers and suppliers look at your margins and also

look at your net profitability and question whether or not they can improve their pricing or improve their costings.

PS:

Yes, that is a good point yes.

MC:

One has always got to take a commercial view over what you are achieving (in terms of margins) and that is all in mind. I think with the mix of what we are seeing going on we ought to be ... the goal is obviously once attaining this level of margin is at least *maintaining* it. And we have been fairly successful as we have seen significant movements in the margins, of being able to maintain them once we had brought them in. But once we're into these low 40% (gross margin) it is going to become more and more difficult to look for additional significant margin growth that we have seen in the past.

PS:

Yes I see. So (summarising) it is more about sales, maintaining margins, but driving the sales growth from now on then is it? Would that be fair to say?

MC:

Yes. It is maintaining the margin and trying to get growth where we can in the margins and the variability will allow that, but it is also getting the *mix* of the products right, and I go back to talking about mix. Only 6% of our products were of our multi-touch types. It is not a great deal of our products which are of the high end margin generating side. Only 11% of our products were above 30 inches. It is not vast numbers, but significant. We don't need a big uplift in those volumes in the big sizes that we do to compensate for slight falls in the smaller sizes because of the margin benefits that we get.

PS:

Yes I see. One of the things and one of the reasons I like the shares is because I am starting to notice out and about in airports, in car showrooms and things, large touch screen advertising displays are starting to appear, and you have got other products liked the curved screen that you have developed for gaming and so on. So do you see us being at a nice stage of growth for these products, with more and more of them? Is your market going to be getting a lot bigger do you think for these products?

MC:

I think we have often said I don't think generally what we are doing is creating anything which is dramatically transformational. I think what we have got is the ability for good growth, ahead of expected market growth. And in our particular markets, expected market growth is really 10-12%-ish marks. And we have been certainly been tracking ahead of that.

Because the key really is not what is the market growing by, it is what is the *new* market growing by? Because it is all about being the person that is designed into these products. Once you are designed in and the design cycles in some instances are two years on average, and depending upon the complexity and newness of it, it could be three or four years before one actually starts seeing production values coming from it. But once you are designed in, the on costs of designing you *out* are fairly substantial. So it is all about being the person that is designed in. And I think we very much punch our weight in the new design in growth that is going on as a consequence of the broad breadth of offerings that we can do with the products.

PS:

Oh that is quite interesting. So although your order visibility has tended to be quite short in the past which did lead to a ... sorry go on?

MC:

Well as far as production orders to be built at the time, I would say visibility is short. But sitting behind all of that providing I would say levels of clarity, not necessarily levels of accuracy but certainly clarity, is what we call our opportunities log, our projects. And it is that which is constantly being refreshed, updated and monitored that basically provides the clarity of what *could* possibly be happening in six months, 12 months, 24 months.

PS:

I see, yes. So you have got short term variability but generally you can see where the trend is going for the orders I would imagine?

MC:

Yes.

PS:

Yes. Yes okay. Let's go over ... actually loads of questions from readers. So let's launch into these next if we may?

MC:

Yes.

PS:

Phil asks 'I would be interested to hear about the competition from the big electronic firms. What does Zytronic have that Panasonic or Sony or a Chinese firm would find difficult to replicate?'

MC:

Well I would say, yes it is a good question. And I would say Zytronic wouldn't classify itself in the world of the Panasonics and the Samsungs and the LGs. I think what you are seeing in the marketplace is a combination of these big people trying to drive new opportunities and volumes, where they are integrating at display level the touch and selling out as a complete unit which then spawns itself into ... I would class it as sort of the OEM third market which is people don't want to be buying the standard that is going to come from these companies and want the ability to build their own unique niche, bespoke solution. And in doing that you want to buy the monitor that you want to buy, and you want to buy the touch solution that you want to buy, in the configuration that you want them, and marry them up at the same time. And it is that marketplace where Zytronic is residing, rather than sitting there saying we have got to battle the Panasonic line that has been launched into the marketplace.

PS:

Yes. So it is more bespoke and lower volume, your market essentially then?

MC:

Yes. And certainly obviously on the face of it, better margins.

PS:

Yes. Yes okay. Actually there is another product question here from Gus. He says 'I read with interest that a Zytronic screen had recently been used by a UK optician, KITE GB, to allow customers to post in real time on social media pictures of them wearing new frames etc.' He says 'Do you see this as a one-off gimmick, or an idea with wider applications?'

MC:

Well I would say everything that Zytronic *initially* gets involved with, in a lot of forms, could be classed as a one-off gimmick. Until they get to the point where there is more expectation of these things being used more widely by the marketplace.

We are a component supplier, so we are enabling these things to happen at that sort of stage, with then the expectation that some of these things will then roll into bigger produced items.

You see touch screens all of the time now in doctors' surgeries for queuing systems for instance. Now obviously we do a lot of queuing based systems for companies, they are not necessarily doctors' surgeries, it is the marketplace that goes. We have done mirrored based systems for people that are looking at sort of retail environments where they are looking at themselves in clothes in the mirror and then taking a snapshot of it. So if you take that one example, it is the potential use of it that could be added into lots of different applications of the same type.

Do people want applications where in some instances it is a mirror, and then in other instances it is a visible display that you can interact with? And the opticians is one example of it.

PS:

So really you are driven by what your customers want essentially, I guess you are saying?

MC:

We are driven in combination by what our customers are wanting in some instances, and also what we are seeing as the market trends that may well be required in the size configurations that we can offer that some other people can't offer. And therefore we drive to bring in the big panels for instance, what people are used to seeing on a tablet, that the producers of the tablet screens couldn't make happen on a big screen.

PS:

So it sounds like there is genuine technological advantages with your system over other competing touch screen technologies, is that fair to say?

MC:

I would say yes. We fall under the umbrella of what everybody calls projected capacitance. Zytronic termed that phrase back in 2001, as a marketing tool to introduce everybody to our products. And it has been widely accepted in the marketplace as a coined phrase for technologies that you would find Apple using and Samsung using on tablets and Smartphones and things you now see going into all in ones (i.e. all in one computers). But they are very much driven off a technology that has come out of the mouse pads on laptops which in essence are just being made transparent and are driven by the same chips and entities, more advanced, but the same entities that you would find on those mouse pads.

Where the materials ... if you look at the various aspects of the materials, you have metallic coatings, which is what these guys are using. You can improve the performance and increase in sizes by going to what the market would class as sort of silver nanowires or looking at graphene or these micro fine metal mesh type of solutions is a sort of a resistance improvement which allows you to improve the sizes that you can do. To then move to a more pure copper electrode system which is what we have, we have by far the more stable and widely ranging material solution in the marketplace. But the processes to manufacture it do not lend themselves to any form of mass production. So although we technically are standing there we are with the solutions that we have are geared towards producing more bespoke niche solutions.

PS:

Well that sounds good because I suppose that helps maintain a competitive advantage then?

MC:

I think it maintains a competitive advantage and provides a sort of more of a clear clarity and the focus that is necessary in the markets that you operate.

PS:

I have had about three questions from Graham, somebody who has just called themselves NH, and Goldsmithy. And they have all basically asked about patents, so I am wondering if we could roll that into one? Probably if you just give us a brief overview on the third party elements of the patents and patents generally, hopefully we can cover all three questions in one go.

MC:

I know it is a question that is often being asked of Zytronic in various forms. But Zytronic has never hidden the fact going back to original documentation that the original touch technology that Zytronic was manufacturing products and still does to this day was a licence from a third party patent holder, a UK-based person, way back in 1999/2000 on patents that he had filed in 1995.

Subsequent to Zytronic taking the licence, I would say what ultimately has happened in the 15 years that we have been doing them, is that Zytronic has put a lot of developing IP into the manufacturing processes, the electronics, the firmware, the linking software to the host PC which are Zytronic-owned IP that are *not* related to the original patents in any form. The original technology patents are around how you would run a projected capacitive system.

And I think the thing to bear in mind for everybody is that ... and as I tell a lot of people, is that patents are a novel idea at the point of them being taken out. And that novel idea is protected

for 20 years and 20 years only, you do not get it for forever and a day. And if your patent is still novel at the end of the 20 years, well life and technology still hasn't necessarily moved on very far, and I think in most instances it hasn't. But what you cannot do is you can't re-patent an original idea again. So it has always got to be moving forward.

So although Zytronic had the technology under licence and it was imparting a lot of IP into it, the IP it was generating needed to be self held. It wasn't information that we wanted to try and patent around things. And didn't want to overly reveal how we were doing certain things and improving things, to the world.

PS:

Yes I have heard that. Some companies have said that putting patents out just educates the competition in a way.

MC:

Well you don't have to do much to sort of say that you are doing something that is just outside the patent scope. A little tweak here, a little tweak there and basically you are not doing exactly the same but the output, the outcome could be the same.

PS:

So you have got a lot of internal knowhow and with the original patents at 1995 they must be expiring round about now are they?

MC:

They expired during 2015. And again we told everybody that that was what was happening when we put the interims out in 2015.

PS:

Sorry I must have missed that.

MC:

Obviously for us what it meant at that time was the licence agreement was tied to the life of the patent and therefore the licence agreement came to its natural conclusion. And as a consequence we continued to provide our product into the marketplace that arguably did not have patent protection, but was still Zytronic's products and owned by Zytronic.

Now I think what a lot of other people have then picked up on was that in 2012 as part and parcel of looking at developments within the business, we not only were imparting IP into that existing patented technology at the time, we also looked at different technical methodologies of actually doing things which were completely different from that original patent which are patents that Zytronic themselves took out in 2012. We put six in for filing in 2012 and four of them were granted in 2015. So the new product ... when Zytronic is referring to its multi touch technology or its MPCT product, that is patented technology which is owned by Zytronic.

PS:

I see. So overall it sounds like your position re patents is now probably better than it has been for a long time, is that a fair conclusion?

MC:

Yes. I think a lot of people were questioning. But from an internal perspective we were never nervous about the fact that the patent life was coming towards an end because we understood

the level of IP and development that we had ended up putting into the whole thing to commercially make this a viable item over the 15 year period.

PC:

I see okay. No that is brilliant. I can just mark off three questions on my list as having been answered, we have covered all of those so that is good. Moving on then, somebody has asked here three questions, first one on the patents so we have covered that, second one this is from Goldsmithy, he is saying 'Are you seeing any slowdown in sales in China as a result of the economic slowdown over in that area?'

MC:

I think it is always an interesting question regarding slowdown in sales for Zytronic because we didn't necessarily see recessionary effects when everybody else was seeing recessionary effects back in 2008 through to 2012. I think we are a little bit lagging on these type of things because of that project gestation period we were talking about being two to three years or two years on average. And a lot of what we sell into is OEM work, so we are selling to equipment builders at componentry level. But those pieces of equipment will be forming part of a much bigger capital spend programme or project that will either have already been funded and will go ahead or are getting to the stage where they will be delayed because funding can't be sought, which starts toward the end of sort of an economic slowdown cycle.

So at this very moment in time we did £1.9 million worth of sales in 2015 into China and we did £1.9 million worth of sales into 2014 and we are not necessarily expecting to see much of a significant change in that region as we are going forward at this moment in time. In fact from an investment point of view most people are probably aware that we have actually invested in a representative sales office based in Taiwan to basically better drive the sales proposition and business development proposition in the Greater China area going forward. So from a business perspective we are actually investing into the region rather than necessarily seeing, or at this moment in time, worrying about slowdown.

PS:

OK. Someone else asked ... this covers two questions actually 'I currently hold Zytronic shares in my grandchildren's JISAs, where do you see your company being in seven or eight times when the kids will have access to the JISAs?'

(Clarification note: I meant to say seven or eight *years*' time)

MC:

I think that is a difficult question to answer if I am being honest. I have got no idea how regulations may or may not change. Obviously the business is intending to continue to grow, we will add and bolt on as needed to maintain that level of growth. We will internally develop to maintain that -.

PS:

- By bolt on Mark, do you mean acquisitions of other companies?

MC:

Well no not necessarily acquisitions but different *applications* if necessary. From a development perspective, a business development perspective, it is very much business as usual going forward. I think we hide our light under the bushel a little bit because under the bonnet there is always a lot of things going on, the curved screen, encrypted, looking at having the technology do a bit more than it does at this moment in time, which on the face of it may look as if it might be transformational, but it is very much business growth as usual for us. It is to ensure that we have got product offerings that the marketplace will be needing and necessarily wanting going forward.

I am *not* talking about acquisitions. We are often tasked with are we looking actively at acquisitions? We have never said that we wouldn't look at an acquisition, and I have never said that there hasn't been things that on the face of it have come across our path every now and then. But as a business we have very much driven hard to get the business where it is, to be developing the level of profitability that it is producing under its own steam, and to look at risking that as a cash injection or a cash purchase of something in the vain hope that we will be able to turn it into something, is not something that we would want to expose the cash or the risk of the business to. So it would have to be pretty much an investment if anything was to happen, in something that was additive immediately, rather than sort of would be sucking things out. But those acquisitions just haven't come across the pipeline at this moment in time.

PS:

So never say never, I suppose you are saying?

MC:

I would say never say never, because obviously we are a very good cash generative business. And therefore we have cash to enable ourselves to go and do various things if the opportunity was to raise. And that opportunity may be that at some point we have got volume of economies of scale to look to manufacture in a different territory for instance and it supported territorial growth. And having the cash there to enable us to just go and invest in that obviously is a cold comfort.

PS:

Yes okay. Yes because another ... Aaron asks about the cash pile as well. And he is saying obviously that is rising every year and now up to £9.8 million, so he asks again about acquisitions, which we have covered. But the other obvious use of the cash is a special dividend isn't it, or share buybacks?

MC:

There are special dividends, there are share buybacks, there are those sort of things. And the Board is reviewing those situations all of the time under the basis of what we are expecting our cash flows to be. We have been very cash generative this year even though most of our costs have actually gone up. We have paid more in dividends, we have paid more to the taxman, we have paid more capex out in the underlying development of the business. But yes the cash has been converted very well into profits and has converted into reserves.

But I think everybody ... people need to look at the numbers a little bit closer and the cash number although increasing is not matching the distributable reserves in the business. So there

is a reasonable chunk of undistributable reserves in the reserves that necessarily would not facilitate as handing all of the cash out as dividends.

PS:

I see. That can be dealt with through the Court can't it? You can reclassify reserves as distributable...

MC:

There are various forms on the face of it but it is not something at this moment in time with what we are looking to do because we are progressively moving the dividend policy on. And I am fairly certain that your readership and listeners are probably fairly thankful that we have moved the dividends on substantially, 20% up this year.

PS:

Yes. And I think it is worth pointing out as well that in the one year where you *did* have a bad year, you maintained the dividend fully didn't you? So that is the benefit of having a cash pile isn't it?

MC:

Yes. And that is the benefit of having the cash and the reserves that we have actually got that we are able to do that, because I think you have mentioned previously in some of the notes that I have seen from you, there is obviously always a risk element in a low visibility business that is project-driven in our form. But I think those type of things, even when they materialise, 2013 was a prime example of it, they are usually fairly spiky but short lived. Because it is not a nature shift in the business when things like that happen it is just ... it is a couple of one off events.

PS:

Yes. Yes that makes sense okay. I think that has probably covered nearly everything people have asked because we have probably overrun our time a bit. Have you got any closing remarks that you want to make, Mark?

MC:

I think thanks for the opportunity to speak to you.

PS:

No not at all you are welcome.

MC:

I think everybody is ... it is business as usual and 2016 has started off at a pace that is ahead of what 2015 started off at.

PS:

Good, good. So you are feeling reasonably relaxed, well not relaxed, but comfortable about the outlook?

MC:

Yes. I am hoping to have a good Christmas and New Year.

PS:

Excellent. Okay Mark. Well thanks ever so much for your time, I really appreciate it. And we will probably catch up after the interim results then?

MC:

Yes we will do most certainly.

PS:

Righto, thanks Mark.

MC:

Okay Paul, thanks very much.