

Luna Innovations (Nasdaq/LUNA)

BUY

Current: \$3.67 / Target: \$5.55

Luna produces fiber optic sensing and test equipment for the comms and carbon fiber markets and operates an R&D division performing government contracts.

November 8, 2018

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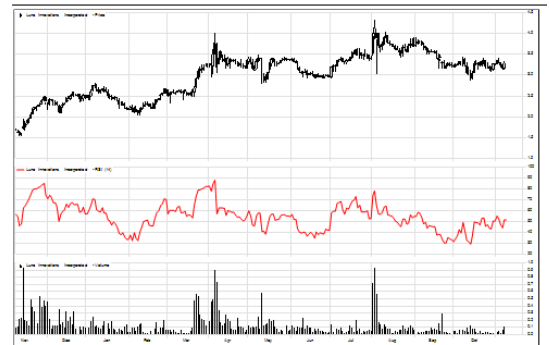
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Growth Accelerates and Margins Expand

- Luna reported strong third quarter results this morning with acceleration in revenue growth and expanding margins.
- Overall, revenue was up 28.7% with the technology development unit up 15.8% and the products and licensing segment up 44.7%.
- EBITDA was up 94% with the EBITDA margin expanding 290 basis points as the increased revenue better covers fixed costs.
- Management also issued strong guidance for 4Q and our new \$12.3 mm revenue estimate, implying 24.3% growth, reflects this.
- Luna is a niche manufacturer of test equipment which has few to no direct competitors for its products. It is poised to benefit as all of its end markets should see strong growth for several years:
 - In automotive and aerospace, manufacturers are making increased use of carbon composites which are stronger and lighter than metals. Luna's products test composite materials.
 - In technology, networks increasingly use fiber optic cable, in lieu of copper, and again Luna's products are used in testing and repair.
 - With Micron (which it acquired last month), its product line now addresses the oil and gas sector, which is seeing renewed activity now that oil prices have sharply rebounded.
 - Micron also addressed the civil engineering sector. If President Trump and the new Democrat House pass a massive new infrastructure bill, Luna would presumably benefit.
- We reiterate our Buy rating and \$5.55 price target.

Estimates	2018E	2019E	2020E
Revenue(\$000s)	\$41,641	\$46,807	\$52,849
1Q March	8,769 A	9,827	11,062
2Q June	9,923 A	11,088	12,445
3Q September	10,687 A	12,027	13,595
4Q December	12,262	13,865	15,747
EPS	\$0.04	\$0.02	\$0.03
1Q March	(0.01) A	0.00	0.00
2Q June	0.01 A	0.00	0.00
3Q September	0.04 A	0.01	0.01
4Q December	0.01	0.01	0.01
P/E (x)	NM	NM	NM
EBITDA	\$2,300	\$2,338	\$3,078
EV/EBITDA (x)	26.0X	25.6X	19.4X
Stock Data			
52-Week Range		\$1.53 -	\$4.32
Shares Outstanding (mil.)			27.3
Market Capitalization (mil.)			\$100.2
Enterprise Value (mil.)			\$59.8
Debt to Capital			3.0%
Book Value/Share			\$1.82
Price/Book			2.0X
Average Trading Volume (3-month) Mill			0.1
Insider Ownership			18.9%
Institutional Ownership			29.8%
Short interest			0.2%



Price target and ratings changes over the past 3 years:
Initiation - October 3, 2018 - Buy - Price Target \$5.55

Growth Accelerates and Margins Expand

This morning Luna reported third quarter results which were significantly better than expected and issued higher guidance for the remainder of the year. As we wrote in our initiation report on October 3, Luna's core technology utilizes fiber optics in both materials testing and testing of fiber optic hardware ranging from microprocessors to local networks to metro fiber networks. With results tracking better than expected, we reiterate our Buy rating on the shares.

Revenue totaled \$10.7 mm up 28.7%. Its technology development business posted revenue growth of 15.8%, although revenue was down 2.8% sequentially. This unit conducts contract research for federal government agencies on a cost-plus basis. Presumably, 2Q contracts essentially continued into 3Q, thus the flat sequential comparison. Since Luna gets to keep and monetize the commercial aspects of this work, the financial contribution is greater than just the quarterly contribution. For the quarter, this unit generated a gross margin of 26.3% or \$1.4 mm.

The company's core products and licensing division was the main growth and profit driver. Revenue was up a strong 44.7% as each of the end markets its products address is experiencing strong growth. With trends such as greater usage of carbon composites in planes and cars, and 5G network development, we see this demand as sustainable. The gross margin for this unit was 61.3% with a contribution of \$3.3 mm. Its smaller Terahertz unit posted 55% revenue growth as a new general manager this year worked to reengineer the product to reduce costs allowing Luna to compete more effectively on price. While both business units were roughly equal revenue contributors in the quarter, products and licensing was by far the stronger earnings contributor.

Profitability also showed noticeable improvement in the quarter. In addition to the gross margin increasing by 370 basis points, the company also reported noticeable improvement in its operating and EBITDA margins. Despite the revenue growth, SG&A was essentially flat sequentially. R&D expenses consumed 8.2% of revenue, up from 7.7% last quarter and 8.0% a year ago. We would expect the company to modestly increase R&D spending with a flush balance sheet and surging revenues. Overall, the operating margin improved by 720 basis points going from negative 1.8% a year ago to 5.4% in 3Q. The EBITDA margin showed a 290-basis point improvement going to 8.8% with EBITDA up 94% year over year. EPS was \$0.04 on a continuing basis.

Luna has operated at the cusp of EPS breakeven for most of this year and last. With strong organic revenue growth, and the recent acquisition of Micron, we expect expanding margins and increased profitability. Our fourth quarter estimate calls for revenue of \$12.3 mm and EPS of a penny, in line with newly issued guidance to reflect the Micron acquisition which closed in mid-October. Management is not providing longer term guidance, but we expect revenue of \$46.8 mm next year, up 12% and EBITDA of \$2.3 mm, up 5%.

Luna is well positioned for growth with strong end market drivers. As noted, its technology development unit generates revenue from government contracts. With the Democrats taking over half of Congress in elections this week, we do not look for any move to cut government spending. On the products and licensing side, the end markets are composite materials manufacturing and optical communications. Aircraft and automotive manufacturers continue to incorporate more composites

into their new designs. For example, Boeing is expected to begin development on a new mid-range composite aircraft next year (797) while Northrup Grumman was just awarded an Air Force contract for the new B21 bomber. In communications, 5G networks just being deployed carry so much data that cell sites need to be connected with fiber, whereas with lower bandwidth 3G and 4G, copper sufficed. Also, on the cutting edge is the development of microprocessors that use light instead of electricity for faster computation. With the acquisition of Micron, Luna can now also address the oil and gas and civil engineering markets. While oil and gas is highly cyclical, we may be entering a new growth phase as oil prices have moved from a low of around \$27 per barrel, to over \$80. If the new Democrat House majority successfully passes an infrastructure bill and President Trump signs it, we ought to be entering a new boom in bridge and highway construction, creating demand for the Luna products acquired in the Micron acquisition.

The company ended the quarter with \$47.1 mm in cash on the books and spent \$5 mm on Micron just after the quarter ended. So it could easily fund several more acquisitions around the size of Micron, which we expect. It should also have ample cash once it completes its M&A process to embark on another share buyback program. If so, this would provide support for the stock in the event of any weakness.

Luna Innovations Income Forecast

Dollars in thousands, except per share data

Fiscal years ended December 31

	2017					2018E					2019E				
	1Q	2Q	3Q	4Q	YEAR	1QA	2QA	3QA	4Q	YEAR	1Q	2Q	3Q	4Q	YEAR
Technology Development	4,236,102	4,602,272	4,590,054	5,147,954	18,576,382	4,636,776	5,466,281	5,315,861	5,662,749	21,081,667	4,868,615	5,739,595	5,581,654	5,945,887	22,135,751
YoY growth			11.5%	14.2%	14.1%	9.5%	18.8%	15.8%	10.0%	13.5%	5.0%	5.0%	5.0%	5.0%	5.0%
Seq growth	-6.0%	8.6%	-0.3%	12.2%		-9.9%	17.9%	-2.8%	6.5%	27.2.3%	-14.0%	17.9%	-2.8%	6.5%	27.2.3%
Products and licensing	2,398,000	3,680,000	3,713,000	4,714,000	14,505,000	4,132,000	4,457,000	5,371,165	6,599,600	20,559,765	4,958,400	5,348,400	6,445,398	7,919,520	24,671,718
YoY growth			-47.5%	-35.3%	-43.3%	72.3%	21.1%	44.7%	40.0%	41.7%	20.0%	20.0%	20.0%	20.0%	20.0%
Seq growth	-67.1%	53.5%	0.9%	27.0%	207.7%	-12.3%	7.9%	20.5%	22.9%	211.5%	-24.9%	7.9%	20.5%	22.9%	211.5%
Revenue	6,634,102	8,282,272	8,303,054	9,861,954	33,081,382	8,768,776	9,923,281	10,687,026	12,262,349	41,641,432	9,827,015	11,087,995	12,027,052	13,865,407	46,807,469
YoY growth						32.2%	19.8%	28.7%	24.3%	25.9%	12.1%	11.7%	12.5%	13.1%	12.4%
Seq growth	-43.7%	24.8%	0.3%	18.8%	335.4%	-11.1%	13.2%	7.7%	14.7%		-19.9%	12.8%	8.5%	15.3%	
Cost of Revenue															
Technology development	3,109,467	3,443,954	3,491,840	3,943,118	13,988,378	3,353,501	3,945,126	3,918,666	4,190,435	15,407,728	3,651,461	4,304,696	4,186,241	4,459,415	16,601,813
As a percent of revenue	73.4%	74.8%	76.1%	76.6%	75.3%	72.3%	72.2%	73.7%	74.0%	73.1%	75.0%	75.0%	75.0%	75.0%	75.0%
Products and licensing	995,000	1,529,000	1,470,000	1,732,000	5,726,000	1,575,000	1,748,000	2,079,749	2,639,840	8,042,589	1,983,360	2,139,360	2,578,159	3,167,808	9,868,687
As a percent of revenue	41.5%	41.5%	39.6%	36.7%	39.5%	38.1%	39.2%	38.7%	40.0%	39.1%	40.0%	40.0%	40.0%	40.0%	40.0%
Total COGS	4,104,467	4,972,954	4,961,840	5,675,118	19,714,378	4,928,501	5,693,126	5,998,415	6,830,275	23,450,317	5,634,821	6,444,056	6,764,400	7,627,223	26,470,500
Gross Margin	2,529,635	3,309,318	3,341,214	4,186,836	13,367,004	3,840,275	4,230,155	4,688,611	5,432,075	18,191,116	4,192,194	4,643,939	5,262,652	6,238,184	20,336,968
As a percent of revenue	38.1%	40.0%	40.2%	42.5%	40.4%	43.8%	42.6%	43.9%	44.3%	43.7%	42.7%	41.9%	43.8%	45.0%	43.4%
Selling, general and administrative	3,204,000	2,947,000	2,832,000	3,943,000	12,926,000	3,334,000	3,265,000	3,233,485	3,923,952	13,756,437	3,144,645	3,548,158	3,848,657	4,436,930	14,978,390
As a percent of revenue	48.3%	35.6%	34.1%	40.0%	39.1%	38.0%	32.9%	30.3%	32.0%	33.0%	32.0%	32.0%	32.0%	32.0%	32.0%
Research, development and engineering	700,000	600,000	662,000	692,000	2,654,000	880,000	760,000	873,629	1,226,235	3,739,864	982,701	1,108,800	1,202,705	1,386,541	4,680,747
As a percent of revenue	10.6%	7.2%	8.0%	7.0%	8.0%	10.0%	7.7%	8.2%	10.0%	9.0%	10.0%	10.0%	10.0%	10.0%	10.0%
Operating Income	(1,374,365)	(237,682)	(152,786)	(448,164)	(2,212,996)	(373,725)	205,155	581,497	281,888	694,815	64,847	(13,019)	211,290	414,713	677,832
Operating margin	-20.7%	-2.9%	-1.8%	-4.5%	-6.7%	-4.3%	2.1%	5.4%	2.3%	1.7%	0.7%	-0.1%	1.8%	3.0%	1.4%
Investment income	-	-	-	-	-	75,912	100,846	171,896	121,375	470,029	110,188	109,289	109,436	109,104	438,017
Other	351	(1,220)	(3,389)	175	(4,498)	(115)	1,187	8,319	-	9,391	-	-	-	-	-
Interest expense, net	(64,374)	(60,387)	(55,099)	(38,647)	218,506	(40,738)	(33,988)	(28,029)	(12,373)	(115,128)	(2,738)	(323)	(323)	(323)	(3,706)
Pretax Income	(1,438,388)	(299,289)	(211,274)	(486,636)	(1,998,988)	(338,666)	273,200	733,683	390,890	1,059,107	172,297	95,947	320,404	523,494	1,112,143
Taxes	26,690	40,937	(130,977)	(235,915)	295,753	1,396	(98,133)	(559,093)	97,722	(558,108)	43,074	23,987	80,101	130,874	278,036
Tax rate	-1.9%	-13.7%	62.0%	48.5%	-14.8%	0.2%	-12.9%	-76.2%	25.0%	-52.7%	25.0%	25.0%	25.0%	25.0%	25.0%
Net income - continuing ops	(1,465,078)	(340,226)	(80,297)	(250,721)	(2,294,741)	(340,062)	371,333	1,292,776	293,167	1,617,214	129,233	71,961	240,303	392,621	834,107
Net income margin	-22.1%	-4.1%	-1.0%	-2.5%	-6.9%	-3.9%	3.7%	12.1%	2.4%	3.9%	1.3%	0.6%	2.0%	2.8%	1.8%
Preferred dividends	34,096	29,536	33,699	49,558	146,889	64,425	63,235	63,235	65,000	255,895	65,000	65,000	65,000	65,000	260,000
Net Income Attributable to Common	(1,499,174)	(369,762)	(113,996)	(300,279)	(2,441,630)	(404,487)	308,098	1,229,541	228,167	1,361,319	64,223	6,961	175,303	327,621	574,107
Diluted shares outstanding	27,541,356	27,600,147	32,714,389	31,790,418	27,579,988	31,198,833	31,506,745	33,055,881	33,055,881	32,204,335	33,055,881	33,055,881	33,055,881	33,055,881	33,055,881
Seq change		58,791	5,114,242	(923,971)		(591,585)	307,912	1,549,136	-	(851,546)	-	-	-	-	-
EPS diluted - continuing	(\$0.05)	(\$0.01)	(\$0.00)	(\$0.01)	(\$0.09)	(\$0.01)	\$0.01	\$0.04	\$0.01	\$0.04	\$0.00	\$0.00	\$0.01	\$0.01	\$0.02
EBITDA															
Operating income	(1,374,365)	(237,682)	(152,786)	(448,164)	(2,212,996)	(373,725)	205,155	581,497	281,888	694,815	64,847	(13,019)	211,290	414,713	677,832
Other income	351	(1,220)	(3,389)	175	(4,498)	(115)	1,187	8,319	-	9,391	-	-	-	-	-
Addback: depreciation and amort.	956,687	285,253	488,119	284,742	2,014,801	307,852	314,725	238,002	310,000	1,170,579	315,000	315,000	315,000	315,000	1,260,000
Addback: stock-based comp.	170,084	151,672	154,672	238,666	715,094	94,606	117,823	117,823	95,000	425,252	100,000	100,000	100,000	100,000	400,000
EBITDA	(247,243)	198,023	486,616	75,419	512,401	28,618	638,890	945,641	686,888	2,300,037	479,847	401,981	626,290	829,713	2,337,832
EBITDA margin	-3.7%	2.4%	5.9%	0.8%	1.5%	0.3%	6.4%	8.8%	5.6%	5.5%	4.9%	3.6%	5.2%	6.0%	5.0%
YoY growth	-55.6%	18.9%	-41.2%	-95.3%	-120.6%	-111.6%	222.6%	94.3%	810.8%	348.9%	1576.7%	-37.1%	-33.8%	20.8%	1.6%

Source: Company reports and Dawson James estimates

Important Disclosures:



Source: Factset Data Systems

Price target and ratings changes over the past 3 years:
Initiated – Buy – October 3, 2018 – Price Target \$5.55

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VALUATION

Our \$5.55 price target is based on a multiple of 2.4x our 2019 revenue estimate, plus \$0.55 per share in cash.

RISK FACTORS

1. Luna is a relatively small player selling to much larger corporate entities, so sales can be unpredictable and volatile.
2. While we believe that the company's technology is unique and innovative, a number of larger companies operate in the broader fiber optic industry and could challenge Luna with superior products.
3. LUNA shares are relatively illiquid and trading history has shown a range of volatility with the shares trading down even after fundamental events which appear positive. This could occur in the future.

Ratings Definitions:

- 1) **Buy:** the analyst believes the price of the stock will appreciate and produce a total return of at least 20% over the next 12-18 months;
- 2) **Neutral:** the analyst believes the price of the stock is fairly valued for the next 12-18 months;
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Ratings Distribution	Company Coverage		Investment Banking	
	# of Companies	% of Total	# of Companies	% of Totals
Market Outperform (Buy)	34	89%	10	29%
Market Perform (Neutral)	4	11%	0	0%
Market Underperform (Sell)	0	0%	0	0%
Total	38	100%	10	26%

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