Business Overview

Kraken Sonar Inc. is a marine technology company listed on TSX Venture Exchange, under the ticker “PNG.V”. With a market cap just shy of $17 million, it develops sonars and acoustic sensors for military and commercial applications. The company was incorporated in September of 2012 and began trading as Kraken Sonar Inc. on February 24, 2015 after the completion of a reverse takeover of Anergy Capital Inc.

Financial Highlights

As of 2014 year end, the company has yet to achieve profitability – posting a net loss of $110,734 in 2012, $136,926 in 2013, and $1,310,240 for fiscal 2014. In 2014, Kraken introduced a stock option plan resulting in $1,212,500 of share-based payments expense.¹

Other financial highlights for fiscal year 2014 include $2.4 million in revenues, up 300% from $576,049 in 2013. During 2014, Kraken also received proceeds of $2,109,509 from a private placement of an unsecured loan convertible into common shares.² The proceeds left the company with a cash balance of $1,343,167 and debt of $2,045,129. Subsequent to year end, conversion rights were exercised, eliminating the debt balance.

Business Fundamentals

Kraken Sonar’s primary product is Synthetic Aperture Sonar (SAS) for use in unmanned underwater vehicles (UUVs). Traditional sonar technology is used to navigate and communicate underwater, as well as for ocean floor imaging and mapping. Synthetic Aperture Sonar, originally developed by the military, improves upon traditional sonar technology. SAS is designed to provide high resolution imagery and superior area coverage rates, compared to the current industry standard - sidescan sonars.

SAS and Kraken’s other marine technology is primarily sold to the defence industry. Kraken also targets the offshore energy, seabed surveying, and ocean mining market segments. Kraken’s sonar technology can be integrated with a diverse set of unmanned underwater vehicles (UUVs) and be used for underwater mine countermeasures, offshore pipeline surveys, and for seabed imaging and mapping.

The company’s management believes its SAS technology is currently an industry leader, despite multiple larger competitors crowding the market. Kraken Sonar’s notable public competitors include Kongsberg Gruppen ASA (OTCMKTS/NSKFF), Thales SA (OTCMKTS/THLEF), Teledyne Technologies (NYSE/TDY), and Ultra Electronics Holdings. Several diversified defence contractors, such as L-3 Communications Holdings (NYSE/LLL) and Raytheon Company (NYSE/RTN) also offer comparable sonar systems.

Investment Thesis

In our view, Kraken Sonar is well positioned to benefit from the long term growth of the unmanned underwater vehicles (UUVs) market and its technically superior product.

The UUV market consists of autonomous and remotely operated underwater vehicles. Both types of underwater vehicles are experiencing stronger demand based on recent improvements in underlying technologies and versatile commercial applications. Greater processing capabilities, improvements in battery endurance, and a wide array of onboard systems will push UUVs to the forefront of maritime technology. Management and independent industry consultants believe that the UUV market will follow in the footsteps of the more developed unmanned aerial vehicles, commonly known as drones, market.

The global autonomous underwater vehicle (AUV) fleet is forecast to increase by 42% from 2014 to 2018. More than half of the demand in the AUV segment will come from the military. But, the area of highest growth will be the commercial sector. Commercial users, such as the offshore oil and gas industry, tasked with the challenge of exploiting deep water assets will benefit from multipurpose AUVs.

Kraken’s sonar technology enables many applications of unmanned underwater vehicles. Synthetic aperture sonar (SAS) combines multiple acoustic pings, targeted at a fixed object, and sophisticated processing of sonar data to develop high resolution images. In fact, image resolution, or quality, is believed to be 10 times greater than that provided by conventional sonar. SAS also improves upon a conventional sonar in regards to the amount of area that it can scan – improving data collection speeds and reducing costs.

SAS technology underpins Kraken’s primary product, the AquaPix. Technology, previously only available to the military for naval mine detection and classification, along with improvements in data collection and processing, has made the AquaPix possible. The high resolution imagery of the AquaPix makes it useful for continued military application, but also for wreck searches and for marine science. Vital offshore oil and gas industry uses include: surveys of the seabed for drilling rig moves, high resolution surveys for underwater pipeline and cable installation, and dredge monitoring.

Kraken Sonar currently positions the AquaPix as low cost alternative, relative to other SAS systems, for two reasons. First, Kraken’s engineers were able to develop the AquaPix and SAS image processing software within a mere 18 months – lowering overhead expenses. Second, Kraken has yet to develop its own UUV vehicle; as a result, the company sells the AquaPix as a standalone sensor. Kraken markets the AquaPix for roughly $350,000, compared to the $1 million to $1.5 million price tag of competing SAS systems. An unmanned underwater vehicle equipped with SAS would cost from $3 million to $4 million.

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4 http://www.km.kongsberg.com/ks/web/nokbg0240.nsf/AllWeb/90CBC5D82A8F2A6CC125721F003360C2?OpenDocument
Recent Performance

Despite the challenge of servicing defence contractors and commercial users looking for a one-stop solution, Kraken offers a compelling product from a price-performance perspective. Recent sales point in the same direction.

In 2013, Kraken was awarded a contract to deliver the AquaPix to Australia’s Defence Science and Technology Organisation (DSTO). A year later, on May 7, 2014, Kraken delivered the AquaPix system, priced at $500,000, to Defence Research and Development Canada – an arm of Canada’s Department of National Defence. In both cases, the AquaPix was sold as a standalone system to be integrated with a third party autonomous underwater vehicle.

Strong performance continued into 2015, with Kraken Sonar generating revenue from several international customers. In March of 2015, the company announced delivery of its AquaPix sonar to Germany’s Fraunhofer Institute for Optronics, System Technology and Image Exploitation. A month later, Kraken Sonar delivered its SAS system to Brone Energy Group – a company focused on offshore and deepwater positioning, geophysical and geotechnical surveys. This is on top of Kraken’s recent order, totalling $1.2 million, from an undisclosed international defence contractor.

Competitive Landscape

Kraken Sonar, founded in 2012 and with only a few years of operating history under its belt, remains an early stage tech business. The company operates in a competitive industry with several players in the conventional sidescan sonar market, such as Edgetech, Sonardyne International Ltd. and L-3 Communications Holdings (NYSE/LLL). Sidescan sonars are a lower cost and lower performance technology that dominates the marketplace. Such conventional sonars take longer to scan the same amount of area, compared to SAS, and provide lower quality images of the seafloor.

Kraken has to also compete directly with other producers of modern synthetic aperture sonar systems such as Kongsberg Gruppen ASA (OTCMKTS/NSKFF), Thales SA (OTCMKTS/THLEF), Ultra Electronics (LON/ULE), and Teledyne Technologies (NYSE/TDY). In this segment, Kraken is at a disadvantage. At the moment, management has decided to sell its SAS system below the market price in an attempt to grab market share. In our view, it is a correct strategy to gain a foothold in the market. But Kraken’s product lineup and resulting value proposition, to end users, remain incomplete.

Competitors such as Kongsberg Gruppen offer SAS, along with multiple other underwater sensor systems. What separates this Norwegian rival from Kraken is that the company also produces AUVs to integrate the sensor systems with. Kongsberg’s underwater vehicles are tailored for applications, ranging from offshore oil and gas to environmental monitoring, hydrography, and search and recovery operations.

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Through the recent acquisition of Atlas Hydrographic, a German sonar systems maker, Teledyne Technologies has also entered the SAS market. Teledyne Technologies not only produces a complete lineup of AUVs, but also manufactures acoustic sensors that aid in underwater navigation — a market segment Kraken Sonar is planning to enter.

Another direct competitor is Thales Group, which generated $14.2 billion in sales for 2014. The French firm is a defence contractor with a position in airborne, naval and underwater combat systems. Other SAS competitors include: one of the world’s largest defence contractors, Raytheon Company; iXBlue Limited, a privately held firm with a range of navigation, positioning, and imaging products for maritime and airborne markets; and Ultra Electronics, based in London, England, and the former employer of Kraken’s Chief Sonar Engineer.

**Strategy and Outlook**

Despite the competitive challenges, Kraken has a solid track record to date. Moving beyond standalone sensor systems will drive future performance. The goal is to have unmanned underwater vehicles integrated with Kraken’s existing sonar systems and other sensors.

Management’s explicitly stated objectives are to develop a navigation system for UUVs and to probe opportunities to develop their own unmanned underwater vehicle. Implementation calls for several milestones to be reached in the remainder of 2015 and in the year after. Testing of the underwater navigation system is to be complete in the second quarter of 2015 and commercials sales to begin by the final quarter of the year. On the UUV front, Kraken aims to commence sales in the second quarter of 2016.

Kraken’s solution to underwater navigation, launched in April of 2015, is the AquaTrak correlation velocity log. Once again, the company is poised to improve upon the industry standard – the Doppler Velocity Log (DVL), on the market since the 1980s. GPS and other radio signals are appropriate for above water navigation. But sea water blocks electromagnetic waves making radio signals unfeasible for underwater navigation. The Doppler Velocity Log, primarily used for oceanography, estimates the speed of water currents by measuring the speed of echoes reflected from the seafloor. Another important use for the DVL is to combine it with inertial sensors to correct underwater position estimates and improve navigation.

Kraken’s correlation velocity log, the AquaTrak, is marketed as providing superior price and performance characteristics over DVLs. According to Kraken, correlation velocity logs have yet to enter the market place as a viable alternative, due to the high level of signal processing required. Overcoming technological barriers has allowed Kraken to position the AquaTrak as a highly accurate long range navigation system capable of operating in deep waters. Sonardyne, a privately held company focused on acoustic positioning and inertial navigation systems, currently prices similar products at roughly $25,000.
Besides new sensors and in attempt to move up the value chain, Kraken is set to launch a Smart Towfish product in 2016. A Smart Towfish is an UUV tethered to a ship and towed below the water’s surface. With the launch of the Smart Towfish, Kraken will be able to provide an entire set of systems packaged in an underwater vehicle. The UUV can include Kraken’s synthetic aperture sonar, the AquaPix, and Kraken’s correlation velocity log, the AquaTrak. The company also sells SAS image processing software, which enables image analysis and 3D bathymetry.

The sensors to systems strategy can be viewed as a move from being a pure engine maker to a producer of complete automobiles with multiple onboard systems. In our view, the provision of a complete product can improve Kraken’s bargaining power with all clients. Users in the ocean science community, offshore oil and gas industry, and defence sector will be attracted to one supplier that meets all project needs. A successful effort to move up the value chain will serve to grow and diversify Kraken’s revenue stream. At the same time it will force the company to compete in the crowded underwater vehicles market.

Kraken Sonar’s ultimate position in the sonar systems and unmanned underwater vehicles market remains unclear, given the limited operating history of the company. The recent string of commercial and defence contracts will support revenues in 2015. Beyond 2015, the successful development of new products has the potential to increase earnings significantly.

Valuation

At current price levels the shares of Kraken Sonar are fairly valued; as a result, we have a HOLD recommendation. Our fair value estimate for Kraken Sonar Inc. is $CAD 0.24 per share. This implies a forward EV/EBITDA of 21 times and forward EV/Revenue multiple of 4.5 times. The fair value estimate assumes a weighted average cost of capital (WACC) of 12.90%, given the high risk nature of micro-cap technology stock.

Since incorporation, Kraken Sonar has grown revenues from $20,260 in 2012 to $2,353,982, in 2014. Sales are expected to continue their uptrend, growing at our base case assumption of 100% in 2015 and another 75% for 2016. Higher revenues are underpinned by the company’s 5 year plan, which focuses on the launch of a Smart Towfish product in 2016. The top line will also be supported by overall growth of the UUVs market as it follows in the footsteps of the more developed aerial drones’ marketplace. Revenue growth is expected to plateau by 2019 and eventually decline to the company’s long term top line growth rate of 5%.

Despite impressive revenue increase, Kraken Sonar has yet to achieve profitable operations. As of the first quarter of 2015, the company’s retained earnings are in a deficit position and are at negative $2,387,909. An overwhelming majority of the deficit is a result of several one-time charges related to the reverse takeover transaction completed in February of 2015. As part of the reverse takeover, which enabled Kraken to become publicly listed, 8 million options were granted, which cost the company $1.2 million in 2014. Kraken recognized another $751,695 of expenses related to the reverse acquisition in the first quarter of 2015.

As one-time charges dissipate, operating margins are expected to improve. Excluding share-based payments and investment tax credits, Kraken generated an operating margin of 21% in 2014. Looking ahead, we expect margins will move higher into the mid-to-high twenties. Another catalyst for Kraken’s share price will be the vesting of dilutive instruments related to a $2 million bridge loan. At the moment, share purchase warrants dilute the share count by 21%. In our view, as these dilutive instruments vest, option overhang is less likely to drag down the share price.
Risk

Investment in the shares of Kraken Sonar is highly speculative. The primary risks are a lack of visibility with regards to future revenues, absence of profits to date, and stiff competition.

First, Kraken’s revenue stream is volatile in nature. Since the first quarter of 2014, Kraken has consistently booked on average $600,000 in revenues; however, future sales depend on securing government contracts and coming out on top in competitive bidding processes. As a result, the revenue stream will lumpy in nature. Earnings will also be highly concentrated, with revenues from the top 3 customers accounting for 92% of 2015’s first quarter revenues.

Second, the company has limited operating history and is yet to post a profit for a full fiscal year. Continued losses may require additional financing, which can prove difficult in adverse market conditions. Potential future challenges are kept at bay by the company’s prudent liquidity management. As of March 31, 2015, Kraken had a working capital balance of $1,927,387, a cash balance of $1,144,106, and zero debt outstanding.

Third, the use of UUVs carries a smaller logistics burden and enables many uses where high resolution imagery of the seabed is required. A growing UUV market supports the demand for advanced sonar and acoustic sensor systems, but also attracts more competitors. Kraken Sonar, as a micro-cap company, faces formidable competition from diversified technology companies and major defence contractors. A major challenge for Kraken Sonar will be to establish an industry presence and to successfully meet new product development targets.
Management

Kraken Sonar Inc. is at the hands of Karl Kenny, President and CEO. Mr. Kenny founded Kraken Sonar after stepping aside from his role as President and CEO of Marport Deep Sea Technologies Inc. in December of 2011. After his departure, Mr. Kenny acquired all the intellectual property rights for synthetic aperture sonar technology from Marport, which is presently used in Kraken’s products.

Subsequently, Marport entered receivership in October of 2013. Marport specialized in deep sea technologies including echo sounders, current profilers, and sonars for the fishing industry. Prior to Marport, during October of 1999, Mr. Kenny successfully sold Telepix Imaging Inc., a developer of internet imaging solutions, to a European photo equipment manufacturer.18

Mr. Kenny is supported by an experienced management team led by Sean Chapman, Chief Sonar Engineer, and Greg Reid, Chief Financial Officer.

Sean Chapman was responsible for commercializing the synthetic aperture sonar technology for Kraken within the record time of 18 months. Prior to joining Kraken, Mr. Chapman had served as Chief Sonar Engineer for Ultra Electronics Holdings (LON/ULE) for over six years. The financial direction of the company is guided by Greg Reid, serving as CFO. Mr. Reid brings management and capital market experience from his prior roles as President of GasGen Canada and Director of Research at Wellington West Capital Markets.

In our view, given managements’ collective experience, the Kraken Sonar team commands the technical expertise and managerial experience to create shareholder value in the long term. To date, management has taken the necessary steps to develop and commercialize its sonar technology, as well as transition from private ownership to a publicly traded corporation.

The current capital structure also ensures that managerial incentives are aligned with Kraken Sonar’s success. Mr. Kenny did not receive compensation in 2012 or 2013; however, in 2014 the $1.2 million share-based payment expense was the result of a one-time share issuance to key management figures. As a result, Karl Kenny and Elizabeth Kenny approximately control 63.6% of the shares outstanding.19 It is expected that Mr. Kenny will receive a $150,000 salary in 2015, along with another $60,000 attributable to the CFO.

One concern for investors is the option overhang. On an undiluted basis there are 71 million shares outstanding, but on a fully diluted basis the share count sits at 86 million. A large portion of the overhang rests with the 14 million units of warrant outstanding. The warrants have a February 2018 expiry date and are exercisable when Kraken shares trade at a weighted price of $0.45 per common share for 20 consecutive trading days.20 The warrants are in connection with the $2 million in bridge financing Kraken received prior to the reverse takeover agreement of Anergy Capital.

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18 http://do.bsc.bc.ca/Securities_Law/Exemption_Orders/Historical_Exemption_Orders/GRETAG_IMAGING_HOLDING_AG__et__al__MRRS_/  
19 http://www.sedar.com/GetFile.do?lang=EN&docClass=10&issuerNo=00027082&fileName=/csfsprod/data151/filings/02359607/0000001/]%C3A5CSEDAR%5C_docs%5CkrakenSonarInc%5C150624MPM%5C150624krakenSonarINFOCIRC_cwm.pdf  