

25 July 2008

KleenAir Systems (KSI.L)

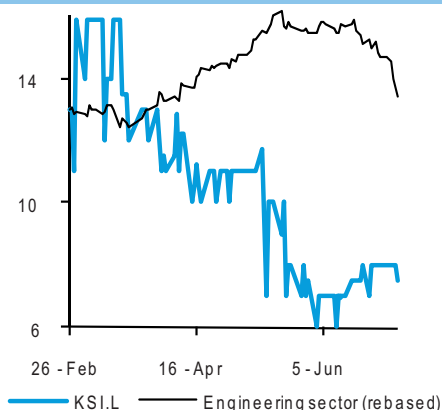
Price: 7.5p
Cleantech Sector

KleenAir has been hit by a combination of problems – not all of them of its own making. Prospects for the London LEZ were significantly reduced by the earlier actions of TfL. This, and the weakening UK economy, diminish also the prospects for other such schemes. Following KleenAir's other problems, notably in its supply chain and with key personnel, market sentiment now appears to await results rather than give the benefit of any doubt to KleenAir. We have materially lowered our forecasts and valuation.

KEY POINTS

- **The recent interim results quantified the extent of the profit warning** given with the AGM statement in May. Turnover of some £250k was materially below management and our own expectations.
- **Problems in the KleenAir supply chain and distribution channel** caused the company to miss a number of orders. Given that compliance deadlines are now passed, those orders are now lost rather than deferred. KleenAir has added a further supplier although, again, has no exclusivity.
- **Broader supply chain but another currency risk.** The existing supplier is Canadian and adverse currency movements were cited as contributing to the profit warning. The further supplier is based in Germany and we note the recent ECB decision to raise interest rates.
- **Key sales personnel and the technical Director left the company in March.** KleenAir has effected some replacement to date but clearly those departures will have hit sales in the critical closing weeks of the first half.
- **Changes to TfL requirements and a new Mayor.** The changes include a late exemption granted to HGVs over 12.5 tonnes which has materially lowered the potential total market size of the London LEZ. London's new cost-conscious Mayor may look closely at the LEZ's anticipated £10m pa operating costs.
- **We see little evidence yet that other cities are about to launch material LEZ schemes.** Instead we find several who are continuing to watch the London experience with apparently mounting indifference. The risk is that LEZs are seen as revenues (from penalty charges) foregone at a time of national budget restraint. We have not modelled any business outside the London LEZ.
- **The UK is already in a period of below-trend growth with a non-trivial risk of a full recession.** Budget squeezes are likely to hit not only city councils but also corporates and their CSR programmes.

Price chart (p)



Current fair value of equity

| | |
|------------------------|-------------|
| Expected Value | £1.8m |
| Value per share | 6.5p |

Company details

| | |
|------------------------|--|
| Quote | |
| Shares | |
| -London AIM | KSI.L |
| Hi-Lo last 12-mos. (p) | 25 - 6 |
| Shares issued (m) | 27.8 |
| Fully diluted (m) | 27.8 |
| Market Cap'n (£m) | 2.1 |
| Website: | www.kleenairsystems.co.uk |

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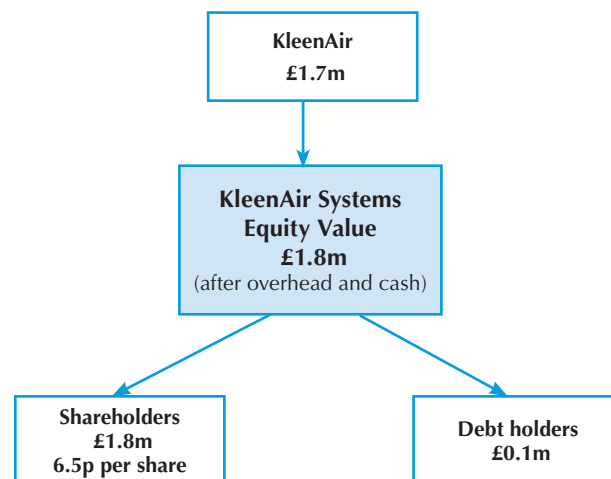
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Fair value summary (£m)

| Scenario | Core | Pessimistic | Optimistic |
|--------------------------------|------|-------------|------------|
| Value of firm | 1.7 | 1.0 | 3.1 |
| Add: tax benefits | 0.2 | 0.1 | 0.2 |
| Add: starting cash + new funds | 0.0 | 0.0 | 0.0 |
| Total current value for firm | 1.9 | 1.1 | 3.3 |
| Less: starting & new debt | 0.1 | 0.1 | 0.1 |
| Total value to equity claims | 1.8 | 1.0 | 3.2 |
| Less: options & warrants | 0.0 | 0.0 | 0.0 |
| Ordinary equity holders | 1.8 | 1.0 | 3.2 |
| Value per share (p ps) | 6.5 | 3.8 | 11.8 |

Components of KleenAir's entity value



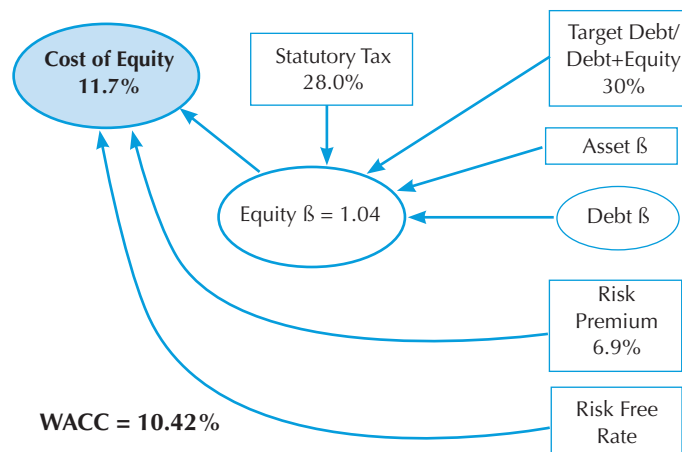
Scenarios

| | Pessimistic | | | | | Core | | | | | Optimistic | | | | |
|-----------------|-------------|-------|---------|---------|---------|-------|-------|---------|---------|---------|------------|---------|---------|---------|---------|
| | 2007 | 2008 | 2009 | 2010 | 2011 | 2007 | 2008 | 2009 | 2010 | 2011 | 2007 | 2008 | 2009 | 2010 | 2011 |
| Sales | 35 | 700 | 1,500 | 2,025 | 3,125 | 35 | 750 | 1,800 | 4,050 | 4,100 | 35 | 1,650 | 5,500 | 11,750 | 5,975 |
| COGS | (4) | (490) | (1,005) | (1,357) | (2,094) | (4) | (525) | (1,170) | (2,633) | (2,665) | (4) | (1,106) | (3,645) | (7,753) | (3,884) |
| Gross profit | 31 | 210 | 495 | 668 | 1,031 | 31 | 225 | 630 | 1,418 | 1,435 | 31 | 545 | 1,856 | 3,998 | 2,091 |
| Gross margin % | 89% | 30% | 33% | 33% | 33% | 89% | 30% | 35% | 35% | 35% | 89% | 33% | 34% | 34% | 35% |
| Selling costs | (133) | (105) | (225) | (243) | (344) | (133) | (113) | (270) | (446) | (451) | (133) | (215) | (660) | (1,293) | (657) |
| Admin costs | (684) | (105) | (225) | (243) | (344) | (684) | (113) | (270) | (446) | (451) | (684) | (215) | (660) | (1,293) | (657) |
| EBITDA | (786) | — | 45 | 182 | 344 | (786) | — | 90 | 527 | 533 | (786) | 116 | 536 | 1,413 | 777 |
| EBITDA margin % | n/a | 0.0% | 3.0% | 9.0% | 11.0% | n/a | 0.0% | 5.0% | 13.0% | 13.0% | n/a | 7.0% | 9.7% | 12.0% | 13.0% |

Sensitivity to cost of capital assumptions

| | | | | | |
|----------------------------------|--------|--------------|-------|------------|--------|
| Change in interest rates (%) | -0.3% | +0.0% | +0.3% | +0.5% | +0.8% |
| Value (p/share) | 6.7 | 6.5 | 6.2 | 6.0 | 5.7 |
| % change | +4.2% | | -4.0% | -7.7% | -11.3% |
| Equity beta | 0.91 | 1.04 | 1.18 | 1.31 | 1.44 |
| Value (p/share) | 7.2 | 6.5 | 5.8 | 5.3 | 4.8 |
| % change | +11.0% | | -9.7% | -18.2% | -25.9% |
| Target gearing (debt/equity) (%) | 0% | 10% | 20% | 30% | 40% |
| Value (p/share) | 6.2 | 6.3 | 6.4 | 6.5 | 6.5 |
| % change | -4.3% | -2.9% | -1.5% | | +1.5% |

Weighted cost of capital



2008 has turned out to be an eventful year for KleenAir so far but unfortunately not in the way its shareholders might have hoped. In February the London Low Emission Zone commenced with confusion, uncertainty and a fair number of non compliant vehicles. Transport for London had already grand-fathered a large number of non Euro III engines at the last minute thus reducing the size of the over 12 tonnes compliance market and leading to delays in operators ordering equipment.

In February KleenAir issued a trading statement which contained little in the way of comment on actual trading but informed shareholders of a capital increase, a minority stake in unquoted company Nonox and that the company was targeting operators seeking London Low Emission Zone compliance. It stated "The retrofit market is expected to provide the Company with significant opportunities for at least 5 years."

KleenAir released its results for the year to 30 September 2007 on 31 March 2008. These were as expected, being prior to the launch of the LEZ and contained negligible revenues. The chairman's statement informed that shipments began in October, and although the first phase was smaller than originally estimated, stated that the company was ramping up shipments to complete the first phase and had begun shipments for the second phase. It added that the level of shipments equated to an 8% market share.

In May 2008 KleenAir issued a profits warning, alongside its AGM statement. And on 18 June issued interim results for the six months to 31 March 2008.

The interim results quantified the extent of the earlier profit warning. Turnover of some £250k was materially below both management and our own expectations. The damage was done principally through changes to the LEZ specification, reducing its potential size, and through problems in the KleenAir supply chain. Those were compounded by the abrupt and recent departure of KleenAir's sales team and technical Director, although some replacements have now been found.

Commentary

The problems besieging KleenAir are not entirely of its own making. The London LEZ is not a shining example of local government efficiency: it has been characterised by poor planning, delays, and confusion as to meaning. Most damaging for KleenAir and other players in the LEZ scheme, was an 11th hour exemption granted by TfL for many engines previously thought to be non-compliant, notably HGVs over 12.5 tonnes. There have also been delays caused by vehicle owners leaving it to the last minute to order abatement equipment and that has undoubtedly been damaging for KleenAir.

Several of the issues can and are being addressed by KleenAir management. We recognise that the interim statement describes “a record level of monthly orders in May” and that, at the time of the statement, the run rate for June was higher than that of May. Equally we recognise that management has changed supply arrangements and that other cities are considering the implementation of their own LEZ schemes.

However the reduction in the London LEZ potential market appears to be a structural rather than timing issue. The overall market size of the London LEZ is likely to be materially smaller than our original assumptions; the problem is not simply that orders have been delayed. The nature of the changes does not augur well either for the size of other city LEZs should they be implemented. As we noted in our January 15th Initiation note: “at this stage (any) possible extension to the market is non quantifiable because city councils are awaiting the outcome of the London LEZ”.

The supply chain is also problematic. In our January Initiation report we pointed out the key risks associated with the lack of KleenAir’s own IP and its dependence on a single supplier without an exclusivity agreement. That risk materialised over the course of the first half when KleenAir was hit by supply problems. That was compounded in February and March when key members of the sales team and the Technical Director left the company. We understand that some replacements have now been made.

A significant characteristic of the LEZ market is that it is time sensitive: once the compliance deadline is passed business dries up until the next phase. Orders lost are not likely to be regained. KleenAir’s problems in its supply chain have played directly to that weakness.

The company has taken steps to offset the reliance on a single supplier by concluding an agreement with a German supplier. However, KleenAir does not have an exclusive agreement covering the UK and it has added a further currency exposure to manage, this time to the euro. We note the recent decision of the ECB to increase interest rates.

Market sentiment clearly has been hit: since our Initiation note the FTSE AIM All-Share index has fallen by some 10%; KleenAir shares (recently at 8p) have fallen by almost 60% over the same period. Given the continuing febrile market conditions, changes to the London LEZ and its new, more cost-conscious Mayor, we believe that the market has moved to a demand for results rather than being prepared to give the benefit of any doubt to current management.

We have materially lowered our forecasts and our valuation. We now expect revenues of £0.75 and £1.8m in the current and 2008/9 financial years, down from £4m and £4.4m respectively. More damagingly for our valuation, we see peak revenues now of only £4.4m in 2012 as against £13m in 2010 at the time of our Initiation. Those numbers derive exclusively from the reduced London LEZ.

At present KleenAir has little in the way of tangible assets and continues to burn cash. Cash used in operations in the first six months was £625,000. It is not using its own IP and has no guarantee or exclusivity of supply. Nor as yet has it generated any meaningful revenues outside London LEZ business.

As a result of failure to capitalise on the first phase of the LEZ and the above shortcomings, it is difficult to see what the value proposition in KleenAir is other than as a quoted shell. Our revised central case values KleenAir at 6.5p per share on the increased number of shares following the capital increase. That valuation carries the implicit assumption that current management is able to effect necessary operational changes to address the weaknesses revealed in the first half.

Key Risks

We see the key risks as falling under a number of headings:

Funding

Although KleenAir raised fresh capital in January it committed to spending £300,000 of that on a 3.85% stake in an unquoted Italian business Nonox for which we cannot ascertain any sales or profitability figures. To date we understand that KleenAir has paid the first tranche of £150k. The total consideration valued Nonox at £7.79m, considerably more than KleenAir's recent market cap.

The interim statement showed that, at the end of March and net of the £1m January fund raise, KleenAir had a cash balance of only £297,202, receivables of £268,390 and inventories of £150,865, as well as trade payables of £226,342. If sales do not improve markedly from the first half, KleenAir may need to seek additional funding sooner rather than later.

Terminal value: is there life after London?

In our valuation we have assumed that KleenAir will continue to develop its business post our immediate forecasts and therein lies most of its value. For many businesses that is not a difficult concept.

However with KleenAir it is potentially a problem. To date KleenAir has been unable to generate any sustainable source of revenue outside the LEZ and as yet there are no published proposals to extend the requirements of the LEZ beyond January 2012.

We have highlighted before a lack of ongoing business outside the London LEZ with councils instead watching the London LEZ before committing. In view of the poor level of business in phase 1 of the London LEZ this becomes more of an issue and we have not modelled any revenues outside London over the forecast period. Several councils that we have spoken have no imminent material plans to introduce their own LEZ.

We further believe that if Boris Johnson remains Mayor in 2012 there is the real possibility that the London LEZ will not be extended and KleenAir revenues could dry up.

Unless KleenAir can build a material revenue stream outside the London LEZ, there may be no basis for ascribing any terminal value. KleenAir would become, in effect, little more than a quoted shell.

The London Low Emission Zone

The London LEZ championed by the previous Mayor, Ken Livingstone, began operation on 4 February 2008. It did not get off to a particularly smooth start, with VOSA having insufficient capacity to meet the surge in demand for smoke tests and suppliers underestimating the last minute surge in demand from hauliers.

These initial glitches have undoubtedly caused problems for both operators seeking to make their vehicles compliant and for the suppliers of abatement and compliance solutions. Some four months on there seems to be little evidence of further problems and implementation for the second phase is under way.

What concerns us is that the LEZ is costly to administer at some £10m pa. And, if it works properly, is likely to reduce the income from the existing stream of Penalty Charge Notices.

The London LEZ is therefore simply a cost for hauliers and, in its operation, for London rate payers. For a new Mayor keen to establish his credentials in ensuring Londoners receive value for money and who has already started to cut back on unnecessary expenses, the LEZ could prove a juicy target. If the LEZ is found not to be delivering much value, the previous administration could be blamed for putting political capital ahead of Londoners' interests. The potential cost savings, in not extending the measures beyond those already scheduled (and modelled by us) are significant. They could be even greater if the enforcement structure were quietly abandoned once any management contracts are fulfilled.

There is also the risk that because the LEZ is not a revenue generating model in the way that congestion charging zones are, the latter may be given preference by city councils keen to raise additional revenue. It can also be argued that congestion charging may achieve much the same effect by improving traffic flow and reducing the time vehicles spend in the zone.

Against this background it is no surprise that there appears to be a gathering groundswell of opinion that suggests that any benefits from an LEZ are not large and could in any case be achieved by the vehicle replacement cycle. This is sure to be used by anti-LEZ lobbyists and a review of the LEZ by this new administration can by no means be ruled out.

Corporate Social Responsibility (CSR)

This could be a lucrative market albeit one that relies on peer pressure and pester power to generate revenues. The idea is that companies, in an effort to behave responsibly, upgrade their fleets and fit abatement equipment voluntarily to APUs and refrigeration units.

Additionally larger companies, for example Sainsbury or Waitrose, could make it a condition of trade that their suppliers also used vehicles fitted with abatement equipment – the pester power.

We have a number of concerns here. Haulage (fuel) costs have risen sharply again in the last few months and any further increase in costs, such as from abatement equipment, would add further to the burden. Consumers are already complaining about increased food costs and spending on CSR risks being passed straight through, adding further cost at the checkout. We remain sceptical that CSR will provide significant revenues over the forecast period.

Suppliers

This has been a recurring problem for KleenAir. Once TfL had taken the decision not to mandate a reduction in NOX emissions in the first stage of the LEZ, KleenAir needed a product, in this case a partial flow filter, a reliable supplier, and exclusivity for the UK.

In fact KleenAir was unable to secure exclusivity and ran into supply problems at a critical point during Phase 1. It has now added a further supplier, in Germany, to reduce single-point dependency. However it has not so far secured an exclusive agreement. The new supplier is based in Germany which introduces a further currency exposure to manage. We note the recent decision by the ECB to raise key interest rates. We note also that adverse (Canadian) currency movements were cited as contributing to the problems in the first half.

Sales channel

The KleenAir business model relies upon a combination of independent fitters and installers. A brief channel check of some of those listed on the KleenAir web site shows degrees of disenchantment. Several of the companies told us they had been let down by KleenAir; others that they did no business with KleenAir, although they had fitted systems from competitors.

In summary it appeared that levels of business *from* KleenAir were well below that anticipated, supply was unreliable and in at least two cases companies reported that their customers had decided to fit more expensive systems that would see them through the 2012 compliance requirement which the KleenAir system would not do.

Economic downturn

All of this is set against the background of the gathering problems for the UK economy generally. A period of below-trend growth is already upon us with the clear risk of a full-blown recession. Perversely the period is also one of massively increased fuel costs. The combination is set to hit hard the profits of road hauliers and other commercial vehicle operators.

We believe that the lobbyists representing these groups will be ever more active in opposing legislation that raises costs still further by seeking to impose retrospective compliance through abatement equipment. We also believe that Corporate Social Responsibility spending on such initiatives will be delayed by falling revenues and margins.

| Profit & Loss | | | | | | |
|-------------------------------|--------------|-------------|--------------|--------------|--------------|--------------|
| Year ending September (£000s) | 2007A | 2008E | 2009E | 2010E | 2011E | 2012E |
| Revenues | 35 | 750 | 1,800 | 4,050 | 4,100 | 4,375 |
| COGS | (4) | (525) | (1,170) | (2,633) | (2,665) | (2,844) |
| Gross profits | 31 | 225 | 630 | 1,418 | 1,435 | 1,531 |
| Other op income | | | | | | |
| Selling costs | (133) | (113) | (270) | (446) | (451) | (481) |
| SG&A costs | (684) | (113) | (270) | (446) | (451) | (481) |
| EBITDA | (786) | — | 90 | 527 | 533 | 569 |
| Depreciation & amortisation | (45) | (60) | (61) | (63) | (65) | (66) |
| EBIT | (831) | (60) | 29 | 463 | 468 | 502 |
| Interest | 6 | 5 | 12 | 10 | 26 | 49 |
| EBT | (825) | (55) | 40 | 474 | 494 | 552 |
| Proforma tax | — | — | — | — | (51) | (154) |
| Earnings | (825) | (55) | 40 | 474 | 443 | 397 |
| Dividends | | | | | | |
| Retained earnings | (825) | (55) | 40 | 474 | 443 | 398 |

| Cashflow | | | | | | |
|--|--------------|--------------|--------------|-------------|-------------|--------------|
| Year ending September (£000s) | 2007A | 2008E | 2009E | 2010E | 2011E | 2012E |
| EBIT | (831) | (60) | 29 | 463 | 468 | 502 |
| Depreciation | 45 | 60 | 61 | 63 | 65 | 66 |
| (Increase) decrease in debtors | 23 | (119) | (175) | (375) | (8) | (46) |
| (Increase) decrease in inventory | (179) | (87) | (108) | (244) | (5) | (30) |
| Increase (decrease) in creditors | 163 | 87 | 108 | 244 | 5 | 30 |
| Net cash from Ops | (779) | (119) | (85) | 152 | 525 | 523 |
| Tax paid | — | — | — | — | (51) | (154) |
| Dividends | — | — | — | — | — | 1 |
| Interest recieved (paid) | 6 | 5 | 12 | 10 | 26 | 49 |
| New equity | 297 | 840 | — | — | — | — |
| New deposits (borrowings) | 100 | 75 | — | — | — | — |
| Capital expenditure | (38) | (366) | (68) | (69) | (71) | (73) |
| Net cash from financing | 365 | 554 | (56) | (59) | (96) | (177) |
| Net increase (decrease) in cash | (414) | 435 | (141) | 93 | 428 | 346 |

| Balance sheet | | | | | | |
|-------------------------------|-------------|--------------|--------------|--------------|--------------|--------------|
| Year ending September (£000s) | 2007A | 2008E | 2009E | 2010E | 2011E | 2012E |
| Net fixed assets | 234 | 540 | 546 | 552 | 559 | 565 |
| Cash | 9 | 444 | 303 | 396 | 824 | 1,170 |
| Debtors | 67 | 187 | 362 | 737 | 745 | 791 |
| Inventory | 179 | 266 | 373 | 617 | 622 | 652 |
| Current Assets | 255 | 896 | 1,038 | 1,749 | 2,191 | 2,613 |
| Total Assets | 489 | 1,436 | 1,584 | 2,302 | 2,750 | 3,178 |
| Trade creditors | (323) | (410) | (517) | (761) | (767) | (796) |
| Net Current Assets | (68) | 486 | 521 | 988 | 1,425 | 1,816 |
| Financial (creditors) debtors | (100) | (175) | (175) | (175) | (175) | (175) |
| Net Assets | 66 | 851 | 891 | 1,365 | 1,808 | 2,207 |
| Shares in Issue | 207 | 278 | 278 | 278 | 278 | 278 |
| Share premium | 1,985 | 2,754 | 2,754 | 2,754 | 2,754 | 2,754 |
| Retained earnings | | | | | | |
| Prior periods | (1,301) | (2,126) | (2,181) | (2,140) | (1,666) | (1,223) |
| This period | (825) | (55) | 40 | 474 | 443 | 398 |
| Capital Employed | 66 | 851 | 891 | 1,365 | 1,808 | 2,207 |

Source: Objective Capital

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Simon Miller

Simon Miller has over 25 years in finance. He was previous head of research for Bryan Garnier and managed funds for both Sagitta and Elysian. He is a former rated analyst.

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