

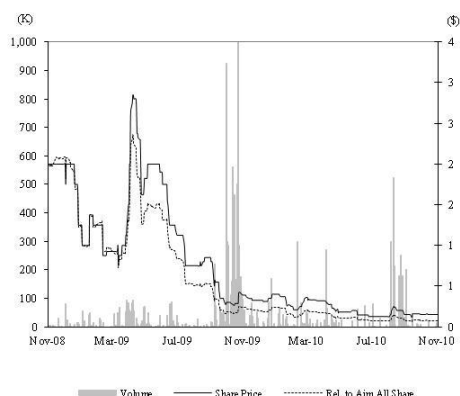
SPECULATIVE BUY

Summary Data

Price (\$)	0.15
Market Cap (\$m)	22.81
Shares in issue (m)	152.1
Sector	Technology

Source: Fidessa, Allenby Capital

Share price performance



Source: Fidessa, Allenby Capital

Key data (Y/E 31 December)

(\$m)	2006A	2007A	2008A	2009A
Revenue	0.00	0.25	16.35	10.65
Adj EBIT	-3.98	-6.21	7.71	-0.60
EBIT Margin			47%	
Adj PBT	-3.87	-4.95	8.25	-0.50
Adj EPS (c)	-2.25	-2.75	4.41	-0.26
Net debt / (cash)	(8.02)	(32.72)	(15.83)	(5.14)
P/E			3.4	
EV/EBITDA			2.6	10.6

Source: XGT.L, Allenby Capital

Key shareholders

MB Merchant Group, LLC	39.7%
Stormur Holding AB	14.7%
Treco International Limited	13.7%
Joe Bobier	3.3%

Source: XGT.L

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xG Technology, Inc. (XGT.L)

Significant progress in opening up US military market

xG has made significant progress in addressing the military opportunity for its xMax cognitive radio technology, aided by the appointment of military veteran John Coleman as COO. The company has secured a 6 month trial at a major US army base as well as signed an agreement with Western DataCom, which should open up further routes into the US military and related markets. The US military represents a substantial opportunity, given the requirement for both ground based communications systems in the US and tactical communications in combat conditions. Whilst an investment in xG remains speculative, a successful deployment by the US military would support a substantially greater valuation for xG than the current \$23m.

Fort Bliss Trial. xG has secured a six month trial to install xMax at the major US army Fort Bliss desert training camps in Texas and New Mexico, under which xMax will be evaluated as both a wide-area and tactical cellular system. xMax will concurrently be evaluated by CERDEC, the U.S. Army's Communications-Electronics Research, Development and Engineering Center. xG will receive \$0.15m to cover its costs of the trial.

Western DataCom agreement. xG has also secured a supply agreement with Western DataCom, a provider of specialist IP-based products. In addition, Western DataCom is introducing xMax technology to one of its partners, a major military smartphone manufacturer and systems integrator. All costs of product development will be met by Western DataCom, with xG retaining product IP for xMax enhancements, and xG will receive per-unit royalties. The agreement initially only covers mobile data modems, but strategically provides a route for xMax technology to become incorporated into a wide range of comms products being sold into the military and other markets (e.g. the first responder and homeland security markets).

US military represents substantial opportunity. According to Pentagon budget documents, total US military comms, electronics, telecommunications and intelligence (CET&I) technologies spending is of the order of \$17.4bn annually, of which \$1.1bn alone is on the ongoing, and heavily delayed, development of a new tactical radio system, JTRS. The army's interest in xMax reflects the fact that it is proven technologically, works in unlicensed spectrum (thus overcoming issues with using licensed spectrum overseas), is all-IP, and can be used on existing low cost xG handsets or adapted to work on conventional smartphones using an add on module. Equipping Army and National Guard bases could, we estimate, represent a c. \$1bn total market opportunity for xG over several years.

Potentially significant valuation upside. These military developments represent the most significant progress made by xG in commercialising its technology since we initiated coverage on the company (please see our note of 24th August). The fact remains that xG is a speculative investment; however, success at selling to the US military would support a valuation significantly higher than the current \$23m.

Military opportunity

The US military represents a substantial opportunity for xG's cognitive radio technology, and one which has taken a major step forward with the Fort Bliss trial and Western DataCom agreement. It may sound surprising that there is a military requirement for a technology that works in unlicensed spectrum, given that the military tends to be a major owner of spectrum in most countries, but the US army faces a continuous spectrum challenge when deploying communications in overseas countries.

By supplying a technologically-proven, IP based voice and data system, xMax potentially fulfils a need for both low-cost domestic communications at US-based military locations as well as overseas in combat conditions. We understand that the army often has to use commercially available cellular services, which can be expensive to deploy. The US army has also been developing its own software defined radio Joint Tactical Radio System (JTRS) since 1997, which has been subject to cost and technical challenges, and which suffers from expensive handsets and not supporting IP-based services such as free or low cost VOIP calling. This is expected to attract spending of \$1bn this year. Whilst xMax is clearly not a substitute for such a wide-ranging program as the JTRS, there may be opportunities for xMax technologies to be deployed to meet portions of the program requirements. More broadly, xG believe that total US military spending on CET&I amounts to \$17bn annually. Equipping US Army and National Guard bases and personnel with a new wireless system could, we estimate, represent a c\$1bn total market opportunity for xG over several years.

The Fort Bliss trial

The Fort Bliss trial provides a strong endorsement from the US army as to xMax's potential role in military communications. Fort Bliss is the U.S. Army's largest training facility and a leading centre for the testing of new weapons and communications systems. xG will deploy a fully working network, including handsets, in multiple forward operating bases within Fort Bliss, offering full connectivity to existing army systems as well as the outside world, to 50 trial users. At the same time, xMax will be evaluated by CERDEC, the U.S. Army's Communications-Electronics Research, Development and Engineering Center. The trial is planned to last for 6 months, though could be extended.

The US army is paying \$0.15m to cover the costs to xG of the trial. A further sign of xMax's credibility was that the army was able to short cut the normal procurement cycles involved in selling technology to the US army by adding the field test to an existing approved contract.

The Western DataCom agreement

xG has secured an agreement under which Western DataCom will incorporate xMax technology into its ComCase product line. Western DataCom is a US private company, founded in 1982, which supplies specialised IP-based mobile datacomms products. Under the agreement, Western will pay for the costs of product development, with xG retaining product IP for xMax enhancements, and will pay xG a per unit royalty. The agreement initially covers mobile data modems, and will have limited financial impact in the near term, but is important strategically for xG.

First, the agreement raises xG's profile as Western DataCom is a well known supplier of components to the US military and first responder and homeland security markets, and therefore provides a quicker route to the military market than for xG to attempt to sell directly to OEMs. Secondly, and particularly importantly in this case, one of

Western's partners is a supplier of smartphones and systems integration services to the US military, and the agreement therefore provides an established route to the US military market, complementing xG's own efforts with the Fort Bliss trial.

Conclusions

Whilst xG's main addressable market remains the telecoms network operator community, the US military offers a potentially significant, and possibly earlier, opportunity given the real military requirement for radio technologies that work in unlicensed spectrum. Though the scale of the opportunity is uncertain, and will probably remain so for at least the next 6-9 months, any adoption of xG technology by the US military would represent a substantial revenue opportunity, and one which would support a valuation significantly above xG's current \$23m market capitalisation.

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This research note was produced by Philip Carse of IS Research on behalf of Allenby Capital. The recommendation has been made by Matt Butlin, Head of Research at Allenby Capital. This research recommendation has been approved and is disseminated by Allenby Capital. Matt is employed by Allenby Capital Limited as an Investment Research Analyst.

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There is no planned update to this research recommendation.

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