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DG Innovate – Progress & Valuation Update

18th October 2022

Novel motor and energy storage business sets out roadmap towards volume production and commercialisation

DG Innovate (DGI) is an advanced research and development company focusing on sustainable & environmentally considerate improvements to electric mobility and energy storage solutions. Working with a range of partners, including major transport & energy companies, research bodies & the UK government, DGI is moving towards commercialisation, developing products with applications across a range of end uses.

Technology acceleration programme ongoing under new CEO

DGI listed on the Official List of the LSE on 8th April 2022 raising a total of £4.63 million. The proceeds are being used to fund an acceleration programme to advance commercial progress in the short to medium-term. In May, DGI announced Peter Tierney as its new CEO, an experienced executive with over 30 years' experience in operating and developing growth orientated service and manufacturing businesses.

October commercial update sets out roadmap towards volume production

In the drive technology business, DGI's advanced prototype 250kW/400kW e-drives are planned to be taken from advanced prototype stage to final product release & volume manufacturing over the next three years. After the final design prototype stage, a phase of pilot manufacturing and industrial engineering will take place, with the pilot facility expected to have a capacity of c.2,500 units per annum when completed early in 2024. Following this there will be a period of industrial engineering, a commercial scale design finalised, with a target of full commercial sales in volume by Q1 2025 from a new 10,000 unit per annum manufacturing facility. On the commercial side, DGI continues to explore a number of potential routes to market and progress discussions with its existing partners and other potential launch customers.

Licensing model being targeted for battery materials business

In battery materials, the initial formulation and testing of a hard carbon anode material from a sustainable bio waste product has advanced to the point of benchmark testing, with initial results said to be "good". Partners are being given small sample batches of material for further testing. A planned scale up of material production will involve an iteration of process engineering to maintain the desired performance and material characteristics in high volume, followed by integrating the material into commercial scale battery cell production. The commercial plan here is to mainly pursue a licensing model via licensing to sodium-ion battery manufacturers. DGI expects that moving from pilot manufacturing to "giga-scale" manufacturing will take around 42 months.

Valuation suggests significant upside as the business is de-risked

Our DCF model, based on revenues from the EDT business segment, suggests a value of £45 million and price per share of 0.446p, with significant upside as the business is de-risked. We update coverage with a stance of **Conviction Buy**.

CONVICTION BUY

Price target –0.446p



Key data

EPIC	DGI
Share price	0.165p
Listing	Official List - Standard
Shares in issue	8,842,715,107
Market Cap	£14.6m
Sector	Alternative Energy

Analyst details

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Background

We initiated coverage of DG Innovate (DGI) on 8th April 2022 following the completion of its reverse takeover of Path Investments and admission to the Official List of the LSE. On admission, the company raised £2.55 million at a price of 0.5p per share via an equity issue, with warrant exercises raising a further £2.077 million.

The net proceeds of the IPO fund raise, along with existing cash in the business, is being used to fund an acceleration programme to advance commercial progress in the short to medium-term. DGI's current strategy is to evolve from being an advanced R&D business into a Tier 2 supplier and/or technology licensor to the electric mobility and energy storage industries.

Shortly after listing, the company was awarded the Green Economy Mark by the London Stock Exchange. This is an accreditation which is only given to entities that derive more than 50% of revenues from products & services that contribute to the global green economy.

Key Product Areas

DGI is currently developing a range of sustainable and environmentally considerate products in collaboration with a number of partners including major transportation and energy companies, research institutions and the UK's Ministry of Defence. These products, which are nearing field trials and commercial deployment, span two divisions and include a range of novel electric motors, generators and advanced control systems, as well as materials for supercapacitor and battery systems. To date, ten patents have been granted for the company's technology, nine are pending, with three awaiting filing.

Enhanced Drive Technology (EDT)

In its EDT business, DGI is developing ultra-high efficiency, compact, high reliability, cost-effective electric motors and electronics which have applications across a range of markets. The electric drive technology platform, known as Pareta® (Parallel Eta [efficiency]), consists of a motor, high power inverter and control electronics, with a novel "multi motor/inverter" architecture and a number of fundamental and patent pending innovations. This technology has been developed over a number of years following ongoing work to build ultra-high performance and durable electric drives for the UK Ministry of Defence, with the resulting product family currently in its third iteration.

DGI is focussing on developing electric drive systems which aim to deliver improved range over existing technology, based on the same battery capacity, by reducing energy losses and improving efficiency. The focus has been upon addressing one of the main challenges in electric mobility - the *range* that electric vehicles (EVs) can travel before the battery needs to be recharged. As well as battery capacity, range is determined by powertrain efficiency.

The strategic aim here is to progress from being motor designer to a supplier of choice for differentiated electric vehicle solutions. As a platform technology, DGI sees applications for EDT across a number of industries, with it offering multiple benefits across a range of sectors which use electric drive systems. These sectors include automotive, aerospace, marine and energy, in multiple vehicle types including passenger cars, buses, HGVs, pick-up trucks, helicopters, ships, submarines and wind turbines.

The company is currently working on a number of projects for the application of Pareta®, with a focus on the commercial and defence automotive sectors, where product orders and other pre-order enquiries have already been made. Along with the MoD, key partners include a major tier 1 supplier to commercial vehicle sector and a zero-emissions marine manufacturer.

The e-drive technology is being developed at favourable time, one which is seeing governments around the world legislate to reduce greenhouse emissions and improve energy efficiency. Market drivers are highly positive for the EDT side of the business given the move away from internal combustion engines and towards electric vehicles.

For example, the UK government's July 2021's *Transport Decarbonisation* plan set out the details of decarbonising the entire transport system in the UK, with initiatives including stopping the sale of new petrol and diesel cars and vans by 2030. Around the world, over 20 countries, along with a number of provincial and state governments, have set time frames for phasing out new internal combustion engine cars, or only allowing new sales to be electric.

Meanwhile, the UK government's recent *Net Zero Strategy: Build Back Greener* report highlighted that transport is one key area of focus for emissions reduction, with the domestic transport sector estimated to have the largest share of UK greenhouse gas emissions of any sector across the economy, at 23% in 2019. Demonstrating the size of the opportunity in the UK, the government estimates that to achieve the level of emissions reductions in the transport sector indicated by its delivery pathway to 2037, there will need to be additional public and private investment of around £220 billion.

Enhanced Battery Technology (EBT)

In the EBT business segment, DGI is developing fully-recyclable, sodium-ion (Na-ion) batteries using anode active materials as a key enabling technology. The intention is to offer comparable or greater energy density to incumbent battery technologies (such as lithium-ion) at a lower cost and reduced environmental impact. Sodium-ion batteries offer an attractive alternative to lithium-ion batteries, as they use materials that are more abundant, with lower carbon footprints, and which circumvent natural resource constraints involved in the production of lithium-ion batteries. The company is currently developing a safe and environmentally friendly storage cell using non-toxic and non-rare earth materials, with the target of the displacement of lithium batteries with a safe, non-toxic sustainable alternative.

In terms of initial target markets for EBT, sodium-ion is currently regarded as more suitable for stationary energy storage, for example from solar and wind energy production, given the increased weight of sodium over lithium – sodium's atomic weight is more than three times higher than lithium. Here, DGI PLC believes its technology can offer cost, safety and environmental benefits over lithium. The company also sees the potential for disrupting the electric vehicles market, which pretty much sees a 100% share of lithium-ion batteries.

DGI has already demonstrated commercially attractive performance characteristics of its carbon anode materials, particularly enabling significant energy densities, in line with the best performing sodium-ion batteries currently available, in battery cells manufactured at a small scale in the company's own facility in Wales. It continues to seek to increase the performance of its cells through its ongoing materials research and to that end completed the building of a pilot scale pouch cell production line in early 2021 to allow the manufacture of A5 size cells for testing.

Recent Developments

Over the past six months DGI has continued with its accelerated commercialisation programme for its suite of technologies. Below we cover the major developments and progress made by DGI since we published our initiation of coverage note.

Senior Management Changes

In mid-May DGI announced the appointment of Peter Tierney as its new CEO, effective from 1st July 2022. Previous CEO Christopher Theis, who guided the business through the IPO process, has resigned as a director of the company.

Peter Tierney is an experienced Chief Executive with over 30 years' experience in operating and developing growth orientated service and manufacturing businesses. He was recently the Chairman and CEO of Lewmar Marine, a private equity backed international marine manufacturing and distribution business. Peter was initially appointed to lead the turnaround of Lewmar Marine in 2008, returning the business to profit and implementing a successful growth strategy that led to sales doubling, before the business was sold to a US trade buyer in 2019. Prior to joining Lewmar Marine, Peter was CEO of Canada based Vector Aerospace, an aerospace maintenance and operating business, between 2003 and 2008. He has also held senior roles at a number of other engineering businesses in the UK and North America and has a degree in mechanical engineering, together with a master's degree in business.

Product Development

400kW e-drive for heavy vehicles

In early May, DGI announced an extension to its Pareta© range of high-performance electric vehicle drives (e-drives) to include a 400kW version, adding to existing 250kW and 100kW sizes. The scalable 250kW/400kW format drives are at an advanced prototype stage, currently undergoing extensive cycle testing at the company's laboratory in Wales. They are aimed at bus and HGV applications, industries where significant commercial opportunities are seen.

The 400kW drive is being developed in collaboration with a Tier 1 supplier to the commercial vehicle industry who has a significant global position in the heavy vehicle transmission sector. The two parties have a longstanding relationship, with the 400kW drive specification defined by the customer to target its growing E-drive needs.

With a compact integrated high power silicon carbide inverter, the 400kW Pareta© unit measures 400mm in diameter by 270mm in length, making the combination one of the most compact available. It is seen as a leading contender for use in the heavy truck, bus and delivery van markets; military land vehicles and sea vessel drives; along with having a suitability for safety critical aircraft drives. Performance and endurance verification testing is now underway.

Commercial update - EDT

A commercial update at the end of August revealed that testing of the 250kW Pareta© high-performance electric vehicle drive was underway. Initial performance results were said to be encouraging and in line with concept expectations. Cycle testing is expected to continue throughout September and October, with results to be reported in due course.

This development is important for the company's £0.89 million grant project - Pareta© High Efficiency Parallel Motor for Automotive Applications. The project being carried out by a consortium including DGI and a subsidiary of US-based global commercial vehicle components company, Meritor. Meritor is a strong partner to be working with, being a leading Tier 1 supplier of drivetrain systems and components, including axles, drivelines and braking and suspension systems, primarily for medium and heavy-duty trucks and other applications in North America. The company made revenues of \$3.83 billion in the year to September 2021.

The project is examining the benefits of compact, efficient design and the cost benefits of the Pareta™ construction system for the commercial bus and truck industry. Project deliverables include a technical feasibility study (design/prototyping/testing) of DGI's e-drive technology integrated into a drive system, optimised for city bus/delivery truck applications. The latest performance results mean that the project is progressing in line with its targeted key milestones for new product development. At the time it was also revealed that DGI continues to progress commercial discussions with its collaborative partners and potential launch customers.

New grant funding

In September, it was announced that subsidiary Deregallera had been awarded funding of c.£0.6 million by the UK Government's Advanced Propulsion Centre (APC) through their Scale-up Readiness Validation competition, part of the Automotive Transformation fund. The funding will cover 50% of the eligible costs of DGI's "Scale up Readiness Validation of Parallel Motor for Automotive Applications" (SUPAR) project. This is designed to optimise the Pareta® high performance electric vehicle drives to enable the most appropriate cost of production using lean manufacturing techniques, enabling substantial upscaling to commercial scale production.

The SUPAR project will involve the establishment of a pilot production facility, with attention being given to efficient manufacturing cell layout and the use of the latest lean manufacturing techniques. This pilot production will be validated by the company producing a quantity of its Pareta® units to provide scalable production viability, so that progressive upscaling to commercial scale production can be achieved.

Detailed plan to progress from prototype to manufacture

The most important recent announcement from DGI came in early October and provided updates on progress across a number of fronts. In EDT, it was announced that the advanced prototype 250kW/400kW e-drives are planned to be taken from the advanced prototype stage to final product release and volume manufacturing via a staged approach. Work is ongoing to produce a final design prototype, as is the current cycle testing programme for the 250kW Pareta® prototype drive which is expected to continue to the end of Q4 2022. Further cycle testing, including for the 400kW model, is then expected to be undertaken to establish and validate endurance requirements.

After the final design prototype stage, DGI then intends to complete a phase of pilot manufacturing and industrial engineering. First, further prototypes will be designed to optimise performance and costings before progressing to the pre-production stage. When fully developed the pilot facility is expected to have a capacity of c.2,500 Pareta® units per annum and be revenue generating. Planning for the facility is underway and DGI expects to start ordering longer lead time items and site preparations in Q4 2022 and into Q1 2023. The current target is for the facility to be completed early in 2024. Following this there will be a period of industrial engineering, a commercial scale Pareta® design finalised, with a target of full commercial sales in volume by Q1 2025.

The current intention is to commence development of a volume manufacturing facility with the capacity to produce c.10,000 Pareta® units per annum. The estimated capital cost is c.£5 million, with the potential for this to be funded through loans, further grant funding and/or investment from a commercial partner. There is also the potential for commercial agreements in the form of licensed manufacture, joint-ventures or further direct supply agreements in order to increase the volume of units produced and sold.

On the commercial side, DGI continues to explore a number of potential routes to market and progress discussions with its existing partners and other potential launch customers. To date the focus has been on the military, heavy goods vehicle and bus markets, and these are expected to remain a priority given the inherent suitability of Pareta® units for these applications and the shorter expected timescales for these sectors to adopt new technology. However, additional applications in both electric vehicles and stationary applications are also being explored as Pareta® has been designed to be scalable to a range of vehicle sizes, from e-bike size to large marine drives.

Adding to the prospect of income from product sales, DGI is looking at the aftermarket as additional substantial opportunity. In this area, specific opportunities are expected from aftermarket electric vehicle conversions, especially from heavy vehicles and buses, long life vehicles which are facing an increasing number of emissions regulations. DGI would service this demand from in-house manufactured units and offer integration expertise and services. In order to increase its service offering, the company is currently considering appropriate acquisitions which are to be funded through a combination of equity and debt depending on the nature of the deal.

Commercial update - EBT

Meanwhile in EBT, the August commercial update revealed that the initial formulation and testing of a hard carbon anode material from a sustainable bio waste product has advanced to the point of benchmark testing, with initial results said to be “good”. The plan was then to supply small batch samples of material to key battery partners who consider this to be a potentially disruptive alternative to reduce dependency on hydrocarbon-derived anodes for both sodium and lithium-ion technologies.

The October update detailed further information on the product development and commercial plan for EBT. Further scale up of material production will involve an iteration of process engineering to maintain the desired performance and material characteristics in high volume. Then integrating the material into commercial scale battery cell production will require a parallel process of optimising cell design and large scale production engineering. The commercial plan here is to mainly pursue a licensing model via licensing to sodium-ion battery manufacturers, with the potential for in-house material production.

Notably, a number of large global battery manufacturers have recently announced plans to establish substantial sodium-ion battery manufacturing capabilities. Back in May for example, battery manufacturer Natron Energy, Inc. and Clarios International Inc., the low-voltage advanced battery technologies business, announced a strategic agreement to manufacture the world’s first mass-produced sodium-ion batteries. The facility in Michigan will become the world’s largest sodium-ion battery plant when mass production begins in 2023.

Elsewhere, we note the announcement in September that chemical materials producer Anshan HifiChem would be jointly investing c\$360 million with Malion New Materials to develop an industrial production technology for sodium-ion batteries raw materials. The pair will build a joint venture plant with an annual output of 180,000 tons of Prussian blue and Prussian white pigments.

As global sodium-ion battery production increases in the coming years, DGI believes there will be a substantial addressable market for its technology. On that front, we note a recent research report from BIS Research, titled Sodium-Ion Batteries Market – A Global and Regional Analysis, which is looking for the sodium-ion battery market to grow from a value of \$528 million in 2021 to reach \$4.36 billion by 2031. The analysts highlighted a number of factors driving the market including increased research & development activity in the industry, rising renewable energy generation and sodium’s higher availability, lower extraction and purification costs compared to lithium.

To take advantage of the market growth DGI working with a number of battery manufacturers. These parties will be supplied with small sample batches of material for further testing and to enable further cell manufacturing development to be carried out. DGI is also looking to increase the scale of its in-house material production capability. Given the industry’s stage of development and the complexities of cell manufacturing scale-up, DGI expects that moving from pilot manufacturing to ‘giga-scale’ manufacturing will take around 42 months – (to April 2026). However, there is the potential for earlier deployment both in existing lithium-ion battery manufacture and sodium-ion battery manufacturing should commercial scale be developed sooner.

Meanwhile, DGI recently won an Innovate UK grant of £170,000 to carry out a feasibility study for the evaluation of manufacturing its sodium-ion anode material at scale in the UK. In particular, this is to enable the company to refine its economic and technology model out to 10,000 tonnes-per-annum production of its hard anode material.

Financials

Since our last update, DGI has announced both full year results for 2021 and interims up to 30th June 2022.

Full Year Results

The annual results covered trading in the year to 31st December 2021. Given that they reflect a period before the reverse takeover was completed and given the company's current stage of development, they are largely irrelevant to the current investment case.

For the record, a loss of £3.9 million was made for the year on no revenues. Of the £3.9 million total expenses, £2.04 million were related to non-cash share based payments, with the net cash outflow from operations being £2.86 million. Fundraising highlights of the year included a £3.85 million equity raise in March, along with secured loans totalling £0.6 million agreed with Path Investments prior to the reverse takeover being completed. DGI ended the period with £0.68 million of cash.

Interim results

Numbers for the six months to 30th June 2022 covered the period when the reverse takeover was completed, including seven weeks' worth of operations as an enlarged entity.

Again the financial results are largely irrelevant at this stage, with the period seeing a pre-tax loss of £6.23 million, with £5.1 million of this being an exceptional charge relating to the reverse takeover, along with £1.17 million of administrative expenses. Grant income for the period amounted to £344,831, with other income of £5,307. More meaningful, cash at the period end stood at £1.65 million with loans outstanding of £0.23 million.

Valuation

DCF Analysis

In our initiation of coverage note we considered that, due to the early-stage nature of its operations, the most appropriate valuation method for DGI was an adequately risked discounted cash flow model. Given the developments made over the past six months, and considering the time scales given in the recent commercial update, we have revisited our model.

Working with management and considering wider industry sources we have put together a DCF model with a five year time horizon going out to 2027. We also add a terminal value in order to establish an appropriate value for the shares. We believe that adding a terminal value is appropriate given the current stage of development and significant long-term potential of the company's technologies. Our main assumptions and new numbers are presented below.

P&L

The EDT business segment is only revenue contributor to our financial model and, as previously, we are expecting no income from the EBT division given the earlier stage nature of the batteries business segment and higher risks involved in what is a rapidly developing market. Conservatively, we also assume that there is no additional grant income put through the income statement over the forecast period.

DGI's roadmap to commercialisation envisages the first significant volumes of e-drives being manufactured in 2025. Before then, in the years up to and including 2024, we expect modest initial sales from pilot production of the 250kW and 400kW e-drives along with smaller sales (but at a higher value) to the Ministry of Defence. We assume initial prices of c. £5,000 per unit for a 250kW unit £8,500 for a larger 400kW drive, declining over time due to competitive pressures. The MoD business is valued at £200,000 per sale, consisting of both the drive and integration work. Gross margins are expected to be around 40% for the 250kW and 400kW units and 50% for the MoD sales. Administration costs at the plc level are assumed start at £1.3 million per year, rising in line with inflation to the end of the forecast period.

We assume that no tax will be paid for the forecast period as the company has c.£6.1 million of accumulated losses to offset against tax. However, we assume a corporation tax rate of 25% in our terminal valuation, as per the government's current plan to increase the rate in 2023.

Our headline P&L forecasts are presented below.

Year to December (£)	2022	2023	2024	2025	2026	2027
REVENUES	0	240,400	2,275,000	9,575,000	34,350,000	66,166,000
COGS	0	-124,240	-1,285,000	-5,505,000	-20,010,000	-38,699,600
GROSS PROFIT	0	116,160	990,000	4,070,000	14,340,000	27,466,400
OPERATING COSTS	-2,800,000	-3,099,000	-3,822,420	-5,662,045	-11,106,661	-17,868,716
EBITDA	-2,800,000	-2,982,840	-2,832,420	-1,592,045	3,233,339	9,597,684
Depreciation & amortisation	-400,000	-430,000	-557,000	-1,081,300	-1,003,170	-875,321
PRE & POST TAX PROFIT (LOSS)	-3,200,000	-3,412,840	-3,389,420	-2,673,345	2,230,169	8,722,363

Source: Align Research

DCF calculation

To calculate the free cash flow to the firm we make various assumptions regarding capex, depreciation and amortisation and changes in working capital then factor them into the model. The main factors here include £5 million of capex alluded to in the October trading update, along with an additional £0.8 million to fund the pilot plant alongside the £0.6 million grant from the UK Government's Advanced Propulsion Centre. We use a discount rate of 16%, a figure which we consider to be appropriate given the company's current stage of development and progress made towards commercialisation.

After discounting the free cash flows for the five-year time period we also add in a terminal value. For this we use a terminal growth rate of 10%, which we believe is reasonable given the growth rates being predicted in the company's target markets and given the potential for significant growth from a small base. From this we add in the net cash position of £1.4 million. We value the company on a fully diluted basis, assuming that all current options are exercised.

The findings of our updated DCF model are presented in the table below.

Year to December (£)	2023	2024	2025	2026	2027
Net income	-3,412,840	-3,389,420	-2,673,345	2,230,169	8,722,363
Capex	-1,500,000	-5,700,000	-700,000	-700,000	-700,000
Depreciation & amortisation	430,000	557,000	1,081,300	1,003,170	875,321
Change in working capital	0	-100,000	-300,000	-800,000	-400,000
FCFF	-4,482,840	-8,632,420	-2,592,045	1,733,339	8,497,684
Year	1	2	3	4	5
Discount factor	1.16	1.35	1.56	1.81	2.10
PV of cash flows	-3,864,517	-6,415,294	-1,660,614	957,307	4,045,858
5 YEAR NPV	-6,937,260				
NPV OF TERMINAL VALUE	50,573,223				
TOTAL	43,635,964				
Net cash	1,422,231				
VALUE TO EQUITY HOLDERS	45,058,195				
Fully diluted share capital	10,093,000,000				
Value per share (p)	0.446				

Valuation

Our DCF analysis shows that DGI PLC's business model looks to be potentially highly profitable once it reaches significant scale. While we note that the positive valuation is completely dependent on the terminal value NPV, this is understandable given the timeframes laid out in the October commercial update, long-term potential of the company's technologies and forecast growth in its target markets. As previously discussed, there is also the upside from the EBT side of the business, to which we have attributed no value.

It should be pointed out that our revenue forecasts assume that the projects with specific customers are successful and move onto their next phases in a timely manner. Any delays or unsuccessful conversions would materially affect our numbers. However, given the close working relationships DGI has with key partners Meritor and the MoD, along with the potential for sales to other commercial clients, we believe that this risk is adequately reflected in our chosen discount rate. We also flag that additional funding will be needed in order to finance both the pilot and volume manufacturing facilities.

With a total value to equity holders of £45.06 million, we calculate a fair value of 0.0446p per share, a figure which we choose to set as our base case target price.

Conclusion

The recent commercial update from DGI was highly encouraging, laying out a well thought out and what we consider to be a highly achievable timeframe towards commercialisation over the next three years and beyond. There are clear milestones to achieve along the way and this provides the opportunity for the company to deliver a steady stream of newsflow over coming months and years to keep investors updated with progress.

DGI has made significant progress to date on the development of its novel technologies. This has been reflected in the sizeable grant funding having been received, along with the company attracting a range of partners who are looking to apply its technologies to their own activities. Progress is being made in the context of a highly favourable political, social and financial environment for emissions reducing technologies, all of which set the scene nicely for growth in the coming years.

On the EDT side of the business, the relationships with the Ministry of Defence and Meritor strengthen the investment case and provide the opportunity for significant orders once final products are available. But given the large range of applications of the company's technologies, DGI is not solely reliant on these partners, so we expect further opportunities to reveal themselves over the coming months. Meanwhile, on the batteries side of the business, first commercial orders look to be slightly further away but we note that income here could be accelerated should the firm be able to use its materials in an existing cell that is closer to commercial release.

Noting the risks to the company's operations and our valuation model, we update coverage of DG Innovate with a target price of 0.446p and a stance of **Conviction Buy**.

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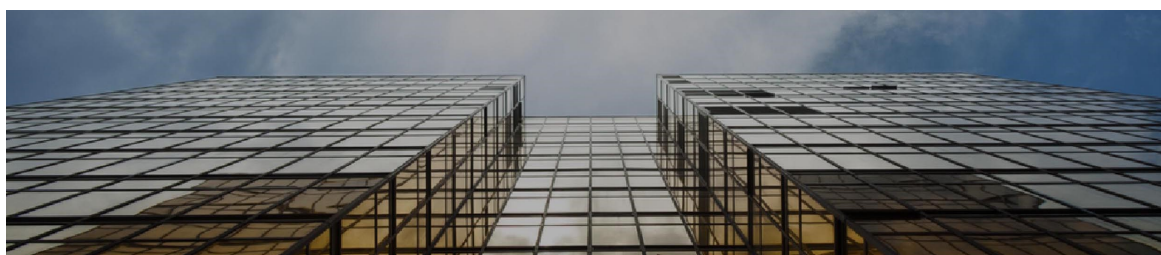
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