

AUSTRALIAN

# RESEARCH

INDEPENDENT INVESTMENT RESEARCH

## Codan Limited (ASX: CDA)

1H'16 Results - Revenue Down But Profit Up

February 2016

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Share price (\$) as at 11 February 2016	0.72
<b>Target Price (\$) per share</b>	<b>1.04</b>
Issued capital:	
Ordinary shares (M)	177.1
Options (M)	0.0
Performance Rights (M)	1.3
Fully Diluted (M)	178.4
Market capitalisation (\$M)	128.4
12-month Share Price Low/High (\$)	0.525/1.27

### Board and Management

David Simmons: Chairman
Donald McGurk: Managing Director & Chief Executive Officer
Peter Griffiths: Independent Director
Kathy Gramp: Independent Director
Lt-Gen Peter Leahy AC: Independent Director
Jim McDowell: Independent Director
Graeme Barclay: Independent Director

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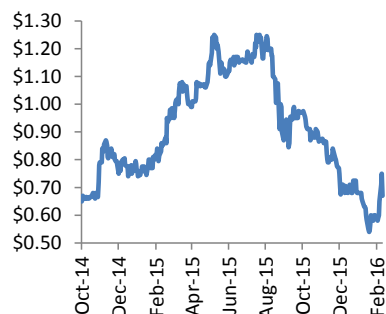
	%
Ian Wall	9.8
P. Wall	9.8
Brian Burns	7.0
Starform Pty Ltd	6.4
David Uhrig	5.0

### Top 20 Shareholders

55.3

Source: IRESS

### Share Price



## 1H'16 RESULTS - REVENUE DOWN BUT PROFIT UP

CDA reported a mixed result for the 1H'16, with revenue down 4.8% on the pcp, however EBITDA and net profit increased 7.3% and 8.9%, respectively. As expected, the Minelab division performed strongly, however we were expecting a better performance from the Radio Communications division so we have revised our forecasts for this division downwards and lowered our target price to reflect our revised expectations for FY'16. Despite the revised target price, we continue to view the company to be undervalued at current prices given our expectations of an improved FY'16.

## KEY POINTS

**Headline Result:** 1H'16 revenue was \$65m, down 4.8% on the pcp, primarily as a result of the decline in revenues from the Radio Communications division. Despite the decline in revenue, gross profit improved to 54.5% from 52.7% in the pcp. EBITDA and net profit also improved. EBITDA was up 7.3% to \$14.7m and net profit was up 8.9% to \$6.1m, year on year. EBITDA margins improved to 22.6% in 1H'16 from 20.1% in the pcp. This is a result of the improved margins realised from sales of the newly released GPZ 7000 metal detectors and the consolidation of the radio communications distribution network. The company announced an interim dividend of 2 cents per share, fully franked, a 33% increase on the previous interim dividend with the company maintaining their policy of a dividend payout ratio of around 50%.

**Radio Communications Division:** Results for the Radio Communications division came in below expectations, with revenue declining 20.7% on the pcp and profit before tax for the division down 27.5%. High frequency (HF) devices were a drag on the division during the 1H'16, with the Land Mobile Radio (LMR) segment performing to expectations but unable to offset the decline from HF devices. The company expects the division to deliver a result in line with FY'15.

**Minelab Division Prospers:** The Minelab division had a strong start to FY'16, with 1H'16 revenue up 23.9% on the pcp and the profit before tax for the division up 55.7% to \$8m. Sales of the new GPZ 7000 and the entry level GO-FIND metal detectors drove growth with the GPZ 7000 driving the improved profit margin for the division. The company also experienced demand for the GPX metal detectors in the African market which assisted with the sales improvement. We expect the division to deliver an improved 2H'16 on the pcp as well, although we expect the growth rate to be lower than that of the 1H'16 as the initial demand for the GPZ 7000 tapers off.

**Minetec Division:** The Minetec division has been put into care and maintenance until the mining industry turns around. The division delivered a \$1.3m loss in 1H'16, however the company expects to breakeven in the 2H'16 and will continue to operate on a breakeven basis until there is an opportunity to generate sales, which is dependent on the mining companies starting to spend capital on mines again. We continue to believe that the Minetec division can be a valuable contributor to CDA in the future.

**Valuation:** We have revised our target price for CDA down to **\$1.04** per share (previously \$1.07) to reflect the lower expectations of the Radio Communications division. We use a relative value approach to determine the target price due to the non-recurring nature of revenue. We have applied a 12.6x multiple to FY16 EPS (adjusted for one-off costs) to arrive at the target price. The multiple reflects a 30% discount to the average PE multiple of the S&P/ASX Small Industrials Index. While there are risks associated with the business we view the 9.1x multiple that the company is currently trading at to be low compared to the index and given the expected upside to earnings in FY16.

PROFIT & LOSS (\$M)			
Y/E June	2015A	2016F	2017F
Revenue	143.9	152.8	161.9
Cost of Sales	-65.5	-70.3	-74.5
Gross Profit	78.3	82.5	87.4
<b>EBITDA</b>	<b>29.9</b>	<b>33.6</b>	<b>35.6</b>
Depreciation & Amortisation	-10.6	-12.5	14.1
Finance Cost	-2.5	-1.5	-0.8
<b>Profit Before Tax</b>	<b>16.8</b>	<b>19.6</b>	<b>20.7</b>
Tax Expense	-4.1	-4.9	-5.2
<b>Net Profit (Underlying)</b>	<b>12.7</b>	<b>14.7</b>	<b>15.5</b>
One-off Items	-	-2.0	-
<b>Net Profit (Reported)</b>	<b>12.7</b>	<b>12.7</b>	<b>15.5</b>

BALANCE SHEET (\$M)			
Y/E June	2015A	2016F	2017F
Cash and cash equivalent	7.2	13.9	17.9
Trade and other receivables	20.4	21.4	22.7
Inventories and work in progress	31.3	33.6	35.6
Current tax receivables	0.5	0.0	0.0
Other current assets	1.6	1.6	1.6
<b>Total current assets</b>	<b>61.0</b>	<b>70.5</b>	<b>77.8</b>
Property, plant and equipment	16.0	16.0	10.0
Intangible assets	89.3	89.3	89.3
Research and development	42.4	42.4	43.8
<b>Total non-current assets</b>	<b>147.7</b>	<b>147.7</b>	<b>143.1</b>
<b>Total Assets</b>	<b>208.7</b>	<b>218.2</b>	<b>220.9</b>
Trade and other payables	25.2	26.8	28.4
Borrowings	0.0	0.0	0.0
Current tax liabilities	0.1	0.1	0.1
Provisions	6.7	7.0	7.4
<b>Total Current Liabilities</b>	<b>32.0</b>	<b>33.9</b>	<b>35.8</b>
Trade and other payables	0.0	0.0	0.0
Borrowings	42.5	40.3	30.3
Deferred tax	5.2	5.2	5.2
Provisions	0.6	0.8	0.8
<b>Total Non-Current Liabilities</b>	<b>48.3</b>	<b>46.3</b>	<b>36.3</b>
<b>Net Assets</b>	<b>128.4</b>	<b>138.1</b>	<b>148.7</b>
Shareholders Equity	128.4	138.1	148.7

CASHFLOW (\$M)			
Y/E June	2015A	2016F	2017F
EBITDA	29.9	33.6	35.6
Interest & Tax Paid	-6.6	-6.4	-5.6
Change in Working Capital	3.7	0.9	-1.3
Other	3.7	0.0	0.0
<b>Net Cash from Operation Activities</b>	<b>30.7</b>	<b>28.1</b>	<b>28.7</b>
Payments for entities and businesses, net of cash acquired	0.0	0.0	0.0
Payments for property, plant and equipment	-3.5	0.0	0.0
Payments for intangible assets	-2.4	0.0	0.0
Payments for capitalised product development	-12.9	-12.9	-12.9
Proceeds on disposal of businesses and property, plant and equipment	5.4	0.0	6.0
<b>Net Cash from Investing</b>	<b>-13.4</b>	<b>-12.9</b>	<b>-6.9</b>
Proceeds from borrowings	0.0	7.8	0.0
Repayments of borrowings	-17.9	-10.0	-10.0
Dividends paid to ordinary shareholders	-5.3	-6.3	-7.2
Proceeds from share issue	0.0	0.0	0.0
<b>Net Cash from Financing</b>	<b>-23.2</b>	<b>-8.5</b>	<b>-17.2</b>
Cash at Beginning of the Year	13.0	7.2	13.9
FX Effect	0.1	0.0	0.0
Net Change in Cash	-6.0	6.8	4.0
<b>Cash at End</b>	<b>7.2</b>	<b>13.9</b>	<b>17.9</b>

## 1H'16 RESULTS

- ◆ CDA reported 1H'16 revenue down 4.8% to \$65m on the pcp, however improved margins saw the company report a 7.3% increase in EBITDA and an 8.9% increase in net profit.
- ◆ Lower revenue was largely a result of the underperformance of the Radio Communications division, which saw revenue decline 20.7% for 1H'16 on the pcp and profit before tax for the division declined 27.5% year on year. HF devices were the primary detractor for the division with the lumpy nature of the business evident in the 1H'16.
- ◆ The Minelab division performed strongly, with revenue for the division increasing 23.9% to \$33.6m in 1H'16 on the pcp. Margins for this division improved significantly as a result of sales of the newly released GPZ 7000 metal detectors with the profit before tax increasing 55.7% on the pcp to \$8m. The improved margins realised by the Minelab division flowed through to the headline results, in conjunction with the consolidation of the radio communications distribution network.
- ◆ The Minetec division has been put into care and maintenance with no end in sight to the issues facing the mining industry. The division reported a loss of \$1.3m in the 1H'16, however the company expects the division to breakeven in the 2H'16. While the current environment is not favourable for the division, we continue to believe that the division will be a valuable division for the company in the future.
- ◆ The company renewed its \$85m debt facility in December 2015 and during the first half drewdown \$7.8m from the facility, primarily for working capital purposes. Net debt to equity increased marginally on from June-end 2015 to 30.9% at 31 December 2015 (27.5% for FY'15) as a result the additional debt drawdown.
- ◆ The company is seeking to sell its vacant property in Newtown, South Australia. The property has a carrying value of \$6m. The company expects the property to be sold this year, however we do not expect the property to be sold until the 2H'CY16. Proceeds will be used to pay down debt.
- ◆ The company announced an interim dividend of 2 cents per share, fully franked, a 33% increase on the previous interim dividend with the company maintaining their policy of a dividend payout ratio of around 50%.

Headline Results			
	1H15	1H16	% Change
Revenue (\$m)	68.2	65.0	-4.7%
Gross Profit (\$m)	36.0	35.4	-1.7%
Gross Profit Margin	52.7%	54.5%	+1.8%
EBITDA (\$m)	13.7	14.7	+7.3%
EBITDA Margin	20.1%	22.6%	+2.5%
Profit Before Tax (\$m)	7.3	6.9	-5.5%
Net Profit (\$m)	5.6	6.1	+8.9%
EPS	3.2	3.4	+6.3%
DPS	1.5 cents	2.0 cents	+33.0%

### Radio Communications Division

- ◆ The Radio Communications division reported a disappointing result for the 1H'16, missing our expectations. Revenue for the division declined 20.7% on the pcp with margins also being impacted with the division reporting a profit before tax of \$7.9m, down 27.5% on the pcp.
- ◆ The HF devices were a drag on the division with the LMR devices not offsetting the declines from HF devices.
- ◆ The division streamlined its distribution network during the period which will assist with margins moving forward.

- ◆ Despite the underperformance of the division in the 1H'16, the company expects the division to perform in line with FY'15 for the full year. Given the LMR devices are expected to continue as per the first half, we are confident the divisions performance will be in line.
- ◆ We expect the HF sales to continue to be lumpy with the LMR devices to provide the growth for this division moving forward.

### Minelab Division

- ◆ The Minelab division was the shining light for the company in the 1H'16, with revenue increasing 23.9% on the pcp to \$33.6m. Improved revenue was driven by sales of the newly released GPZ 7000 and GO-FIND metal detectors as well as renewed interest in the GPX series of metal detectors in Africa. Sales of the GPZ 7000 were the primary driver of the improved profit margin for the division, with profit before tax up 55.7% on the pcp to \$8m.
- ◆ We expect sales of the GPZ 7000 and GO-FIND metal detectors to moderate in the 2H'16 yet still delivering strong results.
- ◆ During the period, the company was awarded a US\$1.35m contract by the US Army to develop a dual sensing detector that incorporates ground penetrating radar for mine detectors. This means that the development of the technology is being funded by the US Army. Development is expected to take two years. While this does not secure any contracts in the future, the company will at least be in contention for a contract should one arise.
- ◆ Long-term growth for the division will depend on the company continuing to develop new technology and releasing improved products that metal detector users would like to upgrade to, as well as expanding the user base of its products. In the short-term, growth will be dependent on the company's ability to penetrate the African market with its new product range. This will likely be somewhat dependent on a significant gold find.

Divisional Performance				
	1H14	1H15	1H16	% Change
<b>Revenue</b>				
Radio Communications	23.6m	36.6m	29.0m	-20.7%
Minelab	32.9m	27.1m	33.6m	23.9%
Minetec	2.4m	2.5m	2.3m	-8.0%
Other	2.2m	2.0m	0.0	na
Total	61.1m	68.2m	65.0m	-4.8%
<b>Profit Before Tax</b>				
Radio Communications	5.4m	10.9m	7.9m	-27.5%
Minelab	9.2m	5.1m	8.0m	+55.7%
Minetec	-0.2m	-1.4m	-1.3m	na
<b>Profit Margin</b>				
Radio Communications	22.7%	29.8%	27.2%	na
Minelab	28.0%	18.8%	23.8%	na
Minetec	-8.3%	-56.0%	-56.5%	na
Total	23.2%	20.8%	22.5%	na

## VALUATION CHANGES

- ◆ We have revised our valuation assumptions based on the results released. The Minelab division is performing as expected, however the Radio Communications division performed below expectations and is expected to perform in line with FY'15. We were originally expecting some growth in this division. As such, we have revised our expectations downwards for this division.
- ◆ The decline in the Radio Communications division has been offset to some extent by the improved margin expectation for FY'16. We have revised our EBITDA margin expectations from 21% to 22% for FY'16.

- ◆ We have also updated the PE multiple we have applied to reach the valuation to account for the changing market conditions. This has declined from 13.7x to 12.6x. We have also reduced the discount applied to the S&P/ASX Small Ordinaries Index PE multiple from 35% to 30%. This is a result of the risk of the company generating an improved earnings for FY'16 declining.
- ◆ The revisions to our forecasts have resulted in the target price being revised down to \$1.04 per share (previously \$1.07 per share) based on an adjusted FY'16 EPS of 8.24 cents per share.

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## INVESTMENT CASE

- ◆ Despite the revised target price we still view the company to be undervalued at current prices. The company is still on track to deliver earnings upside in FY'16 through its Minelab division.
- ◆ We expect Minelab to continue with the sales growth in the 2H'16, although we expect sales to taper in the 2H'16.
- ◆ While the Radio Communications division is not expected to deliver any growth in sales in FY'16, there are new LMR products being developed that will be released in FY'17 that will hopefully drive some growth, although we do not expect growth levels to be high.
- ◆ The Minetec division offers risk given the current environment in the mining sector, however also offers upside value if the sector turns in a favourable direction. With the pilot programs successfully completed, Minetec products are ready for use. The automation of vehicles used in mining and safety concerns provide a niche but potentially significant market for the Minetec division. If other countries follow South Africa from a regulatory standpoint, the company will have the opportunity to gain a meaningful foothold in the market.



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