

AUSTRALIAN

RESEARCH

INDEPENDENT INVESTMENT RESEARCH

Codan Limited (ASX: CDA)

FY17 Results

September 2017

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Share price (\$) as at 14 September 2017	2.32
Target price (\$) per share	2.51
Issued capital:	
Ordinary shares (M)	177.3
Options (M)	0.0
Performance Rights (M)	2.6
Fully Diluted (M)	179.9
Market capitalisation (\$M)	411.3
12-month Share Price Low/High (\$)	1.31/2.57

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Lt-Gen Peter Leahy AC: Independent Director
Jim McDowell: Independent Director
Graeme Barclay: Independent Director

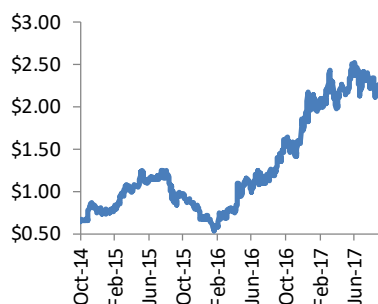
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	%
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P. Wall	9.8
Brian Burns	7.0
Starform Pty Ltd	6.4
David Uhrig	5.0

Top 20 Shareholders

Source: IRESS

Share Price



PRODUCT DEVELOPMENT PAYING DIVIDENDS

CDA delivered a strong result in FY17, with revenue increasing 33.4% on the pcp to \$226.1m and NPAT up 180.6% on the pcp to \$43.5m. The result exceeded our expectations on the back of a strong performance from the Radio Communications division, which delivered a 9.1% increase in revenue and the continued growth in the Minelab division. New product development across the business has delivered earnings growth in recent years and we expect this to continue moving forward.

KEY POINTS

FY17 Result: CDA delivered a better than expected result in FY17, with revenue up 33.4% to \$226.1m. Underlying EBITDA and reported NPAT were up 80.4% and 180.2%, respectively as a result of improved margins from the sale of higher priced and higher margin products. Sales and earnings were up for all three divisions. The improved earnings enabled the company to pay down its existing debt throughout the period and saw the company reduce its debt facility from \$85m to \$55m. The company increased its full year dividend 16.7% to 7 cents per share. The company paid an additional 6 cents per share in special dividends for FY17, resulting in a total increase of 116.7% in dividends paid in FY17 on the pcp. While the Radio Communications and Tracking Solutions division contributed to the earnings boost, the primary driver of the growth was the Minelab division, largely as a result of sales of the GPZ 7000 gold detector.

Radio Communications Division Beats Expectations Again: The Radio Communications division delivered better than expected results with sales growth of 9.1% on the pcp to \$70.9m and a segment contribution of \$19.9m. Margins for this division improved slightly from 26.8% in FY16 to 28.1% in FY17. Growth was driven by a strong 1H17 from HFR products and a recovery by LMR products in the 2H17. The company has released the Cascade™ platform for the LMR market and is moving from a product provider to a solutions provider for this market. This is expected to provide improvements for the LMR market in its area of focus, North America.

GPZ 7000 Continues to Drive Minelab Growth: The Minelab division, the largest division of the company by revenue, delivered another significant result in FY17, with revenue up 49.1% on the pcp to \$148.0m. The company significantly outperformed its base level range for this division of \$85m to \$95m on the back of strong GPZ 7000 sales, the company's premium gold detector. Sales strength comes from the upgrade of the GPX model to the GPZ 7000 throughout all its markets, coupled with a number of new markets opening in Africa. We view there to be some way to go in the replacement cycle. Given this in conjunction with potential new markets and new product launches we expect the division to deliver above base level sales in FY18, although are expecting a decline from FY17 sales.

Tracking Solutions Division in the Black: The Tracking Solutions division delivered its maiden profit in FY17, albeit small. This is a significant milestone for the division, which has had its challenges over the last few years. Revenue for the division was up 35.1% on the pcp to \$7.2m. We view the market opportunity for this division to be sizable and believe the company is in a position to scale up the business. We are expecting another sizable uplift in revenue in FY18, with earnings risk to the upside for this division.

Valuation: We have revised our target price for CDA up to **\$2.51** from \$2.24 per share in our report published in March 2017. This represents an 8.2% premium to the share price at 14 September 2017. The company continues to deliver product innovation and development which has resulted in sales and earnings growth in recent years. Earnings growth has resulted in a share price uplift of 70.6% over the 12-months to 14 September 2017. We expect the company to be able to continue to deliver new products to improve its market share across all three divisions. We have assumed sales for the Minelab division will be down 22% in FY18, but still above the base level earnings for this division. We expect revenue growth in the remaining two divisions, with meaningful growth in the Tracking Solutions division. However, we note there remains risks with the Tracking Solutions division with its success dependent on the ability of the sales and support team to educate the market about its products and partner with companies that will allow for the large scale rollout of its products across multiple mines.

PROFIT & LOSS (\$M)				
Y/E June	2015A	2016A	2017A	2018F
Revenue	143.9	169.5	226.1	199.6
EBITDA	29.9	41.9	75.6	59.9
Depreciation & Amortisation	-10.6	-13.0	-15.3	-15.9
Finance Cost	-2.5	-1.7	-0.9	-0.1
Profit Before Tax	16.8	27.5	60.6	43.8
Tax Expense	-4.1	-6.4	-16.0	-12.3
Net Profit (Underlying)	12.7	21.1	44.6	31.6
One-off Items	-	-5.6	-1.2	0
Net Profit (Reported)	12.7	15.5	43.4	31.6

BALANCE SHEET (\$M)				
Y/E June	2015A	2016A	2017A	2018F
Cash and cash equivalent	7.2	14.3	21.4	25.0
Trade and other receivables	20.4	19.1	20.6	20.0
Inventories and work in progress	31.3	28.5	31.0	33.9
Current tax receivables	0.5	0.3	0.0	0.0
Other current assets	1.6	6.5	7.2	7.2
Total current assets	61.0	68.7	80.3	86.2
Property, plant and equipment	16.0	10.8	12.0	32.3
Intangible assets	89.3	87.6	86.2	56.9
Research and development	42.4	45.3	54.2	54.2
Total non-current assets	147.7	143.8	152.4	143.4
Total Assets	208.7	212.5	232.7	229.6
Trade and other payables	25.2	30.4	36.6	34.3
Borrowings	0.0	0.0	0.0	0.0
Current tax liabilities	0.1	2.2	16.1	6.1
Provisions	6.7	6.6	7.2	7.5
Total Current Liabilities	32.0	39.2	59.9	48.0
Trade and other payables	0.0	0	0	0
Borrowings	42.5	26.9	0.0	0.0
Deferred tax	5.2	6.8	7.2	7.2
Provisions	0.6	0.6	0.5	1.0
Total Non-Current Liabilities	48.3	34.3	7.8	8.3
Net Assets	128.4	138.9	165.0	173.4

CASHFLOW (\$M)				
Y/E June	2015A	2016A	2017A	2018F
PAT	12.7	15.5	43.4	31.6
Adjustments for non-cash items	14.6	28.8	31.8	13.6
Change in Working Capital	3.7	7.6	0.3	-5.4
Net Cash from Operation Activities	30.7	47.9	75.5	39.8
Payments for entities and businesses, net of cash acquired	0	-1.6	0.0	0.0
Payments for property, plant and equipment	-3.5	-4.7	-4.1	-4.0
Payments for intangible assets	-2.4	-0.2	-0.3	0.0
Payments for capitalised product development	-12.9	-12.0	-16.4	-19.7
Proceeds on disposal of businesses and property, plant and equipment	0.0	0.0	-2.9	0.0
Net Cash from Investing	-13.4	-18.1	-23.7	-23.7
Proceeds from borrowings	0	0	0	0
Repayments of borrowings	-17.9	-15.5	-26.9	0.0
Dividends paid to ordinary shareholders	-5.3	-7.1	-17.7	-12.4
Proceeds from share issue	0	0	0	0
Net Cash from Financing	-23.2	-22.6	-44.7	-12.4
Cash at Beginning of the Year	13.0	7.2	14.3	21.3
FX Effect	0.1	0.0	-0.2	0.0
Net Change in Cash	-6.0	7.1	7.2	3.6
Cash at End	7.2	14.3	21.3	25.0

Ratios				
	FY15A	FY16A	FY17A	FY18F
Profitability Ratios				
EBITDA margin (%)	20.8%	24.7%	33.4%	30.0%
Net profit margin (%)	8.9%	9.1%	19.2%	15.8%
ROA (%)	6.1%	7.4%	19.5%	13.7%
ROE (%)	9.9%	11.6%	28.6%	18.7%
Diluted EPS	7.1	11.8	24.9	17.5
DPS	3.5	6.0	13.0	8.9
Liquidity & Debt Ratios				
Net Debt to Equity (%)	27.5%	9.1%	-13.0%	-14.4%
Current Ratio (x)	1.9x	1.8x	1.3x	1.8x

FY17 RESULTS

- ◆ The company delivered another strong year of revenue and earnings growth in FY17. Revenue for the group was up 33.4% on the pcp to \$226.1m and reported NPAT up 180.2% on the pcp to \$43.4m.
- ◆ Revenue growth was driven by the continued growth in Minelab sales (the largest division within the group) with the conversion to the GPZ 7000 gold detector remaining strong. The Minetec division delivered it's maiden profit in FY17, a significant milestone for this division.
- ◆ Margins improved across the board as a result of the sale of higher margin products, in particular the GPZ 7000 gold detector. The improved margins contributed to the significant boost to EBITDA and NPAT.
- ◆ The improved earnings saw the full year dividend payment increase 16.7% on FY16 to 7.0 cents per share. The company paid an additional 6.0 cents in special dividends for FY17, resulting in a total increase of 116.7% in dividends paid in FY17 on the pcp. The total dividends paid represented a payout ratio of 51.6%.
- ◆ The company's balance sheet is in a strong position with \$21.4m cash on hand and no debt. The company used the additional cashflow earned to pay down the outstanding debt during the period. Further to this, the company reduced the debt facility from \$85m to \$55m. This facility provides the capacity for any acquisition activity the company may seek to undertake.

Headline Result	FY16	FY17	% Change
Revenue (\$m)	169.5	226.1	+33.4%
Gross Profit (\$m)	94.9	136.2	+43.5%
Gross Profit Margin	56.0%	60.2%	+4.3%
Underlying EBITDA (\$m)	41.9	75.6	+80.4%
Underlying EBITDA Margin	24.7%	33.4%	+8.7%
Profit Before Tax (\$m)	27.5	60.6	+120.4%
Reported Net Profit (\$m)	15.5	43.4	+180.2%
EPS	11.9	25.2	+111.4%
DPS (cents)	6.0	13.0	+116.7%
Dividend Payout Ratio	50.4%	51.6%	+1.2%

DIVISIONAL PERFORMANCE

Radio Communications Division

Radio Communications Division	FY16	FY17	% Change
Revenue (\$m)	65.0	70.9	+9.1%
Segment Contribution (\$m)	17.4	19.9	14.5%
Contribution Margin	26.8%	28.1%	+1.3%

- ◆ The Radio Communications division delivered a better than expected result in FY17. Revenue increased 9.1% to \$70.9m compared to our expected 1.5% increase. Margins in this division also marginally increased over the period. The outperformance of the division came from an improved 2H17 from LMR products after a weak 1H17.
- ◆ In January, the company announced that it had entered into an agreement to acquire the IP and tooling for the 9300 range of military tactical antennas from Stealth Telecom FZC for US\$700,000. The acquisition is intended to support the latest product launches to the global military market.
- ◆ The company is focused on broadening the revenue base of the division by expanding the technology platforms into complementary markets and developing products to provide a complete solution to customers. During the year, the company released two new handheld tactical radios for use by the military market, in addition to the acquisition of the IP and tooling from Stealth Telecom.

- ◆ Post year-end, the company released the Cascade™ LMR platform, with additional features to be released throughout the year. The company sells the LMR solutions into the North American market and with the new Cascade platform expects to be able to grow its market presence.
- ◆ Post year-end, the company was awarded a US\$4.3m contract from RiverCom911, an emergency communications centre based in Washington State, USA. The contract is to supply a P25 Digital LMR solution. The solution will provide critical communications coverage while maintaining frequency, efficiency and allowing full control from RiverCom911's central facility, which services over 116,000 residents and 23 public safety agencies. The ability of the company to move to a solutions provider offers the potential for meaningful growth from the LMR business.

Minelab Division

Minelab Division			
	FY16	FY17	% Change
Revenue (\$m)	99.2	148.0	+49.1%
Segment Contribution (\$m)	29.8	61.5	+106.3%
Contribution Margin	30.1%	41.6%	+11.5%

- ◆ The Minelab division delivered significant growth in FY17, with revenues increasing 49.1% on the pcp to \$148.0m. The GPZ 7000 gold detector continues to provide a significant boost to sales and to the bottom line as a result of the improved margins from this product.
- ◆ Security measures taken by management in developing the GPZ 7000 has reduced the risk of counterfeiting of the product. This should prevent an event like what happened in FY14 from happening again. The company has seen some new markets in Africa open up which has assisted with the sales growth for this division and we expect these new markets to assist with above average sales in FY18.
- ◆ The company released a large coil accessory for the GPZ 7000 during FY17, which is designed to increase the depth of the reading of the detector by 20%-25%. The coil sells for ~\$1500-\$2000. The company believes that it will take time for the market to get comfortable with the product before sales volumes become significant, in a similar fashion to the GPZ 7000 sales profile.
- ◆ The company released a new entry level product 'Gold Monster' in May that sells for under US\$1,000. The company has created the product to be superior to competing products in the entry level gold detector market. The Gold Monster detector is designed to fill a gap in Minelab's product range. Given the low price point, the product will not likely have a significant impact on revenue, however it will allow the company to increase its market share at this lower price point and has the advantage of users identifying with the Codan brand for potential future product upgrades.
- ◆ The Countermine business continues to develop new technology to assist military and humanitarian operations. The division was awarded a \$6.5m contract from the Australian Department of Defence for the development of a dual-sensor detector, which incorporates both metal detection and ground penetrating radar to assist with detecting and clearing land mines. This product will be delivered in FY19.

Tracking Solutions Division

Tracking Solutions			
	FY16	FY17	% Change
Revenue (\$m)	5.3	7.2	+35.1%
Segment Contribution (\$m)	-1.2	0.3	na
Contribution Margin	na	4.6%	+4.6%

- ◆ The Tracking Solutions division delivered its maiden profit in FY17, albeit small, which is a significant milestone for the business.

- ◆ The Tracking Solutions division provides the only single vendor solution for underground mine tracking and communications through its technology. The company provides tracking visualisation, task management and proximity detection capabilities. The company has the most accurate tracking solution in the market.
- ◆ Minetec focuses on hard rock underground mines globally. The company now has its product offering operating in a number of operating mines, which have shown productivity improvements.
- ◆ After a difficult period we believe the Tracking Solutions Division is now in a position to scale up the business and recognise some of the value that has been thwarted to date as a result of economic conditions. However, there remain challenges for the business. In addition to improving the sales pipeline, one of the greatest challenges for the business is the steep learning curve to understand the advantages of the product offering and utilise the technology to its full potential. The company recognises this and is increasing its support services to improve the performance of the product for customers.
- ◆ We expect a meaningful increase in revenue from the Tracking Solutions division in FY18. The global market opportunity for this division is significant, however the rate of growth for this division will be dependent on the ability of the company to identify meaningful partnerships with companies for the rollout of the product suite in multiple mines.

VALUATION

- ◆ We have revised our target price up to **\$2.51** per share from \$2.24 per share in our last report published in March 2017. This represents an 8.2% premium to the share price at 14 September 2017. The target price reflects a 22% reduction in Minelab division sales from FY17. Given FY18 has started in a similar fashion to FY17, the new markets that have opened up to the company and the introduction of new products, we believe the company will be able to deliver sales in above the base level in FY18. However, we note that there is always risks regarding the sales assumptions for this division given the low level of visibility.
- ◆ The target price is based on a PE ratio of 14.3x, a 15% discount to the S&P/ASX Small Industrials average PE. The discount represents the risks associated with future earnings. We have reduced the discount from 25% given the improved stability of earnings and the unlikely repeat of the counterfeit event that caused the sharp fall in revenues in FY14 given product development in the Minelab division.
- ◆ The uplift in the target price reflects the expected above base level sales in the Minelab division in FY18, in addition to growth in both the Radio Communications and Tracking Solutions divisions. We do expect a pull back in the EBITDA margin as a result of the introduction of lower margin products in the Minelab division as well as a low margin contribution from the Tracking Solutions business.
- ◆ We are forecasting FY18 NPAT of \$31.6m, a 27.3% decline on FY17 and a dividend payout ratio of 50% which implies a dividend of 8.9 cents per share.

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For further information, please contact IIR at: client.services@independentresearch.com.au



Independent Investment Research (Aust.) Pty Limited

SYDNEY OFFICE

Level 1, 350 George Street
Sydney NSW 2000
Phone: +61 2 8001 6693
Main Fax: +61 2 8072 2170
ABN 11 152 172 079

MELBOURNE OFFICE

Level 7, 20–22 Albert Road
South Melbourne VIC 3205
Phone: +61 3 8678 1766
Main Fax: +61 3 8678 1826

DENVER OFFICE

355 S Teller Street
Suite 200
Lakewood 80226
Denver Colorado USA
Phone: +1 161 412 444 724

MAILING ADDRESS

PO Box H297 Australia Square
NSW 1215