

AUSTRALIAN

RESEARCH

INDEPENDENT INVESTMENT RESEARCH

Codan Limited (ASX: CDA)

1H18 Results

March 2018

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Share price (\$) as at 13 March 2018	2.44
Target price (\$) per share	2.72
Issued capital:	
Ordinary shares (M)	178.1
Options (M)	0.0
Performance Rights (M)	2.3
Fully Diluted (M)	180.4
Market capitalisation (\$M)	434.6
12-month Share Price Low/High (\$)	1.86/2.57

Board and Management

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

Major Shareholders

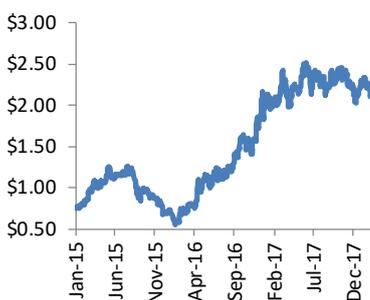
	%
Ian Wall	9.8
P. Wall	9.8
Starform Pty Ltd	6.4
David Uhrig	5.0
Brian Burns	5.5

Top 20 Shareholders

51.1

Source: IRESS

Share Price



NEW AGREEMENTS & PRODUCTS WILL ASSIST IN CONTINUING TO EXPAND SALES

CDA delivered a result for 1H18 that as expected was down on the pcp. There were a number of positive outcomes from the result including the sales for the Minelab division were better than expected and the news of Minetec entering an agreement with Caterpillar Inc., which will see the company realise a return on its investment in the Minetec technology. We expect the company to deliver above base level earnings in FY18 and the company is in a good position to deliver above base level earnings in FY19.

KEY POINTS

1H18 Result: CDA reported NPAT for 1H18 of \$15.8m down 29% on the pcp. We note that while the NPAT is down on 1H17 it is still above the NPAT for the full financial year for 2016 and we expect the company to deliver a result above its base level range for FY18. Revenue was down 9% on the pcp to \$94.7m. The decline in revenue was driven by weaker sales across all three divisions, with the Radio Communications division in particular delivering weaker sales than expected. The company declared an interim dividend of 4 cents per share, up 33.3% on the pcp. No special dividend was paid and the company has changed the policy regarding the payment of special dividends, whereby they will now only be paid with the final dividend, in the event they are paid.

Radio Communications Division Falls Short in 1H18: The Radio Communications division delivered weaker than expected sales in 1H18, down 17.2% on the pcp to \$29m. The decline was attributed to the long sales cycle of new products, the lumpy nature of contracts with the company not benefiting from any large contracts during the half in contrast to the pcp, and lower levels of demand from the US. While the company believes sales in the 2H18 will make up for the shortfall we have trimmed our sales expectations for this division for FY18.

New Products Diversify Minelab Earnings: Revenue of the Minelab division declined 2% on the pcp to \$63.5m. After a strong FY17, sales declined less than expected and the new products aimed at the entry levels of the market performed well. While this has an adverse impact on margins, a diversified product mix reduces the reliance on the sales of the GPZ 7000, which is one of the objectives of the company. We have revised upwards our expectations for the Minelab division on the back of the better than expected 1H result.

Minetec Signs Exclusive Development & Marketing Agreement with Caterpillar:

The weaker than expected result for the Tracking Solutions division was over shadowed by the announcement that Minetec, a wholly owned subsidiary of CDA, has entered into an exclusive global licensing, technology development and marketing agreement with Caterpillar Inc. The agreement will see the two companies collaborate to expand and develop Caterpillar's Minestar® technology solution for underground and surface mining operations. Minetec will integrate its proprietary products into Caterpillar's technology solution. The two businesses will share the profit from the sales of the integrated technology platform. Access to the Caterpillar customer base provides a significant opportunity for Minetec.

Valuation: We have revised our target price for CDA up to **\$2.72** from \$2.51 per share in our report published in September 2017. This represents an 11.5% premium to the share price at 13 March 2018. The Minelab division performed better than expected which has led us to revise our expectations for the division upwards, however, the Radio Communications and Tracking Solutions divisions underperformed expectations which has led us to revise downwards our expectations. The underperformance of the Tracking Solutions division was over shadowed by the announcement that the company has entered into an exclusive global licensing, technology development and marketing agreement with Caterpillar Inc. While this is not expected to deliver any earnings impact until FY19, the agreement recognises the value of the technology developed by CDA since 2012 and will see the company generate a return on their investment.

PROFIT & LOSS (\$M)				
Y/E June	2015A	2016A	2017A	2018F
Revenue	143.9	169.5	226.1	202.9
EBITDA	29.9	41.9	75.6	60.9
Depreciation & Amortisation	-10.6	-13.0	-15.3	-15.9
Finance Cost	-2.5	-1.7	-0.9	-0.9
Profit Before Tax	16.8	27.5	60.6	44.1
Tax Expense	-4.1	-6.4	-16.0	-11.7
Net Profit (Underlying)	12.7	21.1	44.6	32.4
One-off Items	-	-5.6	-1.2	0
Net Profit (Reported)	12.7	15.5	43.4	32.4

BALANCE SHEET (\$M)				
Y/E June	2015A	2016A	2017A	2018F
Cash and cash equivalent	7.2	14.3	21.4	16.0
Trade and other receivables	20.4	19.1	20.6	20.3
Inventories and work in progress	31.3	28.5	31.0	34.5
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	78.1
Property, plant and equipment	16.0	10.8	12.0	14.5
Intangible assets	89.3	87.6	86.2	83.2
Research and development	42.4	45.3	54.2	58.2
Total non-current assets	147.7	143.8	152.4	156.0
Total Assets	208.7	212.5	232.7	234.1
Trade and other payables	25.2	30.4	36.6	34.9
Borrowings	0.0	0.0	0.0	0.0
Current tax liabilities	0.1	2.2	16.1	5.8
Provisions	6.7	6.6	7.2	7.5
Total Current Liabilities	32.0	39.2	59.9	48.3
Trade and other payables	0.0	0	0	0
Borrowings	42.5	26.9	0.0	15.0
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	23.3
Net Assets	128.4	138.9	165.0	162.5

CASHFLOW (\$M)				
Y/E June	2015A	2016A	2017A	2018F
PAT	12.7	15.5	43.4	32.4
Adjustments for non-cash items	14.6	28.8	31.8	-3.7
Change in Working Capital	3.7	7.6	0.3	-5.1
Net Cash from Operation Activities	30.7	47.9	75.5	23.6
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	-4.1
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	-23.8
Proceeds from borrowings	0	0	0	15
Repayments of borrowings	-17.9	-15.5	-26.9	0.0
Dividends paid to ordinary shareholders	-5.3	-7.1	-17.7	-20.6
Proceeds from share issue	0	0	0	0
Net Cash from Financing	-23.2	-22.6	-44.7	-5.6
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	-5.7
Cash at End	7.2	14.3	21.3	16.0

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%	16.0%
ROA (%)	6.1%	7.4%	19.5%	13.9%
ROE (%)	9.9%	11.6%	28.6%	19.8%
Diluted EPS	7.1	11.8	24.9	18.0
DPS	3.5	6.0	13.0	9.0
Liquidity & Debt Ratios				
Net Debt to Equity (%)	27.5%	9.1%	-13.0%	-0.6%
Current Ratio (x)	1.9x	1.8x	1.3x	1.6x

1H18 RESULTS

- ◆ CDA reported NPAT for 1H18 of \$15.8m down 29% on the pcp. We note that while the NPAT is down on 1H17, it is still above the NPAT for the full financial year for 2016 and we expect the company to deliver a result above its base level range for FY18. Revenue was down 9% on the pcp to \$94.7m. The decline in revenue was driven by weaker sales across all three divisions, with the Radio Communications division in particular delivering weaker sales than expected.
- ◆ The company continues to deliver new products to market across its divisions, however, the Radio Communications division earnings continue to be lumpy as a result of the nature of the product sales cycle.
- ◆ Sales of the Minelab division have been driven by sales of the GPZ 7000 in recent times, however we saw a changing of the guard in some respects with a change in the sales product mix. New products that have been released to service the lower price point contributed to a greater extent than was expected. This is in line with the company's strategy to diversify earnings within the division and across the business as a whole.
- ◆ The company announced that Minetec, a wholly owned subsidiary of CDA, has signed an global marketing and development agreement with Caterpillar Inc. for the development and exclusive distribution of an integrated product that will be used in Caterpillar vehicles that services underground and surface mining. This is a major announcement for the company and recognises the product development the company has embarked on since 2012.
- ◆ The company had a negative operating cashflow in 1H18 largely as a result of the payment of a large tax liability.
- ◆ The company had \$15m in debt during the 1H18, with a net debt position of \$4.4m at 31 December 2017. The company has a \$55m debt facility in place, providing them with substantial capacity for additional capital expenditure if required.
- ◆ The company declared an interim dividend of 4 cents per share, up 33.3% on the previous interim dividend. The company has a policy of paying out ~50% of profits as dividends and has changed its policy to declaring any special dividends annually, along with the final dividend.

Headline Result	1H17	1H18	% Change
Revenue (\$m)	103.8	94.7	-8.8%
Gross Profit (\$m)	63.9	54.6	-14.6%
Gross Profit Margin	61.6%	57.7%	-3.9%
Underlying EBITDA (\$m)	37.1	27.4	-26.1%
Underlying EBITDA Margin	35.7%	28.9%	-6.8%
Profit Before Tax (\$m)	29.8	20.7	-30.5%
Reported Net Profit (\$m)	22.2	15.8	-28.8%
EPS (cents)	12.4	8.8	-29.0%
Interim DPS (cents)	3.0	4.0	+33.3%
Special Dividend (cents)	3.0	0.0	na
Dividend Payout Ratio	24.2%	45.5%	+21.3%

DIVISIONAL PERFORMANCE

Radio Communications Division

Radio Communications Division	1H17	1H18	% Change
Revenue (\$m)	35.0	29.0	-17.2%
Segment Contribution (\$m)	9.8	5.6	-42.9%
Contribution Margin	28.0%	19.3%	-8.7%

- ◆ Revenue for the Radio Communications division was down 17.2% in 1H18 on the pcp to \$29m. While revenue for the half was down, it was only marginally below the five year average 1H revenue of \$31.7m. Sales were impacted by the company not securing a large contract in the half in contrast to the pcp and a slow down in US government spending, however the company expects purchasing levels to recover in 2H18.
- ◆ The company released the initial Cascade™ product platform during the 1H18 with further platforms to be released in 2H18 and FY19. The Cascade platform is expected to drive sales growth in FY19. These products typically have a long sales cycle which results in delayed results.
- ◆ In addition to lower sales, margins were significantly lower. Margins for the division are driven by revenue with the division having largely a fixed cost base.
- ◆ Sales in the division were below our expectations and while the company is expecting a stronger second half we have trimmed our expectations from the top end of the base level sales to be closer to the mid-base sales level.

Minelab Division

Minelab Division			
	1H17	1H18	% Change
Revenue (\$m)	64.8	63.5	-2.0%
Segment Contribution (\$m)	28.4	23.0	-19.0%
Contribution Margin	43.8%	36.2%	-7.6%

- ◆ The Minelab division delivered sales marginally below the pcp and continues to generate elevated sales when compared to the five year average. We are expecting earnings to decline in FY18 on the back of a strong FY17, however, sales declined by less than expected which has resulted in us reducing the expected decline in sales for FY18.
- ◆ Margins were lower on the back of a change in the product sales mix. Sales of the newly released lower priced products improved. This is in line with the company's strategy of diversifying the product mix and reducing its reliance on the sales of the GPZ 7000.
- ◆ Second half sales are typically stronger than the first half given seasonal conditions. We expect that trend to continue for 2H18.

Tracking Solutions Division

Tracking Solutions			
	1H17	1H18	% Change
Revenue (\$m)	4.1	2.3	-43.6%
Segment Contribution (\$m)	0.4	-0.3	-175%
Contribution Margin	9.8%	-13.0%	-22.8%

- ◆ Revenue for the Tracking Solutions division was down 43.6% for 1H18 on the pcp. The poor result was over shadowed by the announcement that Minetec, a wholly owned subsidiary of CDA, has entered into an exclusive global licensing, technology development and marketing agreement with Caterpillar Inc. The agreement will see the two companies collaborate to expand and develop Caterpillar's Minestar® technology solution for underground and surface mining operations.
- ◆ Minetec will integrate its proprietary products into Caterpillar's technology solution. The two businesses will share the profit from the sales of the integrated technology platform.
- ◆ The integrated solution will enable the Caterpillar trucks to be detected within a range of up to 1m and be able to pass data at a very fast pace. The solution will be superior to other products available on the market at present.
- ◆ Newmont Mining Corporation (ASX: NEM) intends to collaborate on the development and host the integrated technology solution at their Tanami Operations in the Northern Territory.

- ◆ While it will take some time to deliver material earnings to CDA, this is a significant agreement that will see the Minetec technology distributed throughout the extensive dealer network of Caterpillar globally. This agreement recognises the value of the technology that Minetec has been developing since 2012.

VALUATION

- ◆ We have revised our target price up to **\$2.72** per share from \$2.51 per share in our last report published in September 2017. This represents an 11.5% premium to the share price at 13 March 2018. We have revised up slightly our FY18 revenue on the back of a lower decline in sales for the Minelab division after the 1H18 sales declined less than anticipated. We have pared back our sales expectations for the Radio Communications and Minetec divisions.
- ◆ We are expecting a decline in earnings for FY18, however expect revenue and NPAT to be above the base level earnings range of the company. We are forecasting FY18 NPAT of \$32.4m, a 25.4% decline on FY17 and a dividend payout ratio of 50% which implies a dividend of 9 cents per share.
- ◆ There is upside for FY19 with sales expected to ramp up from the Cascade™ product and the commencement of sales from the agreement with Caterpillar Inc., which will provide a boost to the long-term earnings of the Tracking Solutions division with the company expected to realise a return on its investment from the agreement.

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