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Codan Limited

Communications Equipment

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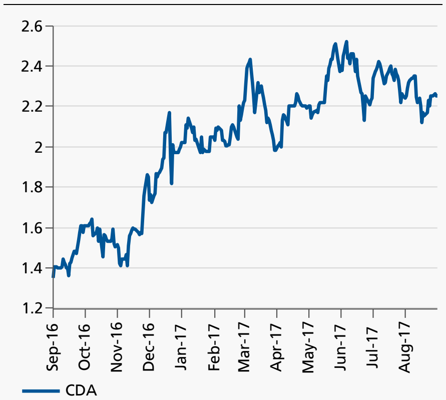
Australian Equity Research
31 August 2017

BUY↑
from HOLD

PRICE TARGET	A$2.60↑
from A$2.50	
Price (31-Aug)	A$2.25
Ticker	CDA-ASX

52-Week Range (A$):	1.27 - 2.56
Avg Daily Vol (000s) :	300.0
Market Cap (A$M):	417
Shares Out. (M) :	177.1
Net Debt (Cash) (A$M):	(20)
Enterprise Value (A$M):	379
Cash (A$M):	20.0
Long-Term Debt (A$M):	0.0

FYE Jun	**2016A**	**2017A**	**2018E**	**2019E**
Sales (A$M)	169.5	226.1	199.8↓	217.1↑
Previous	-	-	*200.5*	*217.0*
EBITDA (A$M)	41.9	75.6	56.4↑	61.0↑
Previous	-	-	*54.4*	*57.1*
Net Income Adj (A$M)	21.1	44.7	31.0↑	34.3↑
Previous	-	-	*30.0*	*32.7*
EPS Adj&Dil (AUc)	11.9	25.2	17.5↑	19.3↑
Previous	-	-	*16.9*	*18.5*
P/E (x)	18.9	8.9	12.9	11.6
EV/EBITDA (x)	9.8	5.0	6.4	5.6
DPS (AUc)	6.00	13.00	8.00	10.00↑
Previous	-	-	-	*9.00*
Div. Yield (%)	2.7	5.8	3.6	4.4



Source: FactSet

Priced as of close of business 31 August 2017

CDA designs and manufactures a range of electronic products including radio communication products, metal detection products and mining technology

Raising Recommendation

As good as gold

CDA delivered a strong result that was in line with guidance in a year where underlying NPAT more than doubled to $44.7m. We have made some minor adjustments to our FY18 forecast, lifting our NPAT estimate by 3.4% to $31m. The forecast decline in profitability reflects an expectation that demand for gold detectors will moderate. Still, our forecasts are ahead of the "base business", which we are more than comfortable with given we expect a certain level of demand for gold detectors to continue. We have raised our Target Price by 4% to $2.60 per share and upgrade our rating to a BUY.

Key points

Strong result. CDA's result was very solid and in line with guidance. The key highlights were (i) better than expected margins across Communications and Metal Detection; (ii) operating cashflow was strong at $76m; (iii) CDA has no debt, is in a net cash position and is well placed to pursue growth via acquisition; and (iv) a final dividend of 4c was declared together with a 3c special dividend.

What will happen in FY18? While CDA didn't provide guidance, management pointed to a base business of revenues in the range of $160-180m and NPAT of between $20-25m. Our estimates sit above this range, based on our expectation that demand for gold detectors will continue albeit at a lower level than FY17. This is based on there being a sizable replacement market for the GPX5000, distribution has been achieved into a broader number of African countries and no counterfeit product has emerged. This all bodes well for further demand in FY18 for the GPZ7000.

Changes to forecasts

We have made some minor revisions to our forecasts for FY18 and FY19 that mainly reflect the better than expected margins across Communications and Metal Detection. In FY18, our revenue forecast has remained more or less the same at $200m, while our NPAT forecasts increase by 3.4% to $31m.

Outlook and recommendation

We continue to retain a positive outlook for CDA. Each division is well positioned in their respective markets and with new products being developed and new markets being penetrated, there is growth potential in the base business. CDA is also well placed to grow via acquisition, being in a net cash position. Finally, we believe there is risk to the upside to our estimates should strong demand for gold detectors continue into FY18.

As a result of the minor changes to our estimates, we have raised our Target Price to $2.60 per share ($2.50 per share previously). We have arrived at our TP applying a 7.8x multiple (20% discount to Small Industrials average) to FY18e EBITDA of $56.4m. Based on the potential upside to our TP, we upgrade our rating to a BUY.

For important information, please see the Important Disclosures beginning on page 7 of this document.

Figure 1: Codan Limited (CDA); Canaccord Genuity forecasts

Profit & Loss ($m)	2016A	2017A	2018F	2019F
Sales Revenue	**169.5**	**226.1**	**199.8**	**217.1**
EBITDA	**41.9**	**75.6**	**56.4**	**61.0**
Depreciation	-2.3	-2.4	-1.7	-1.8
EBITA	**39.6**	**73.1**	**54.7**	**59.2**
Amortisation	-10.4	-11.6	-12.0	-12.1
EBIT	**29.2**	**61.5**	**42.6**	**47.1**
Net Interest Expense	-1.7	-0.8	-0.4	-0.4
NPBT	**27.5**	**60.7**	**42.2**	**46.7**
Tax expense	-6.4	-16.0	-11.2	-12.4
NPAT - underlying	**21.1**	**44.7**	**31.0**	**34.3**
Significant items	-5.6	-1.2	0.0	0.0
Reported NPAT	**15.5**	**43.5**	**31.0**	**34.3**
Cash Flow ($m)	**2016A**	**2017A**	**2018F**	**2019F**
Operating EBITDA	**41.9**	**75.6**	**56.4**	**61.0**
- Interest & Tax Paid	-5.8	-7.2	-16.4	-11.6
+/- change in Work. Cap.	9.4	2.2	1.7	-1.1
- other	2.4	5.0	2.6	0.1
Operating Cashflow	**47.9**	**75.6**	**44.3**	**48.4**
- Capex	-12.0	-16.4	-12.0	-12.0
- Aquisitions/divestments	-4.7	-4.1	0.0	0.0
- other	-1.5	-3.2	0.0	0.0
Free Cashflow	**29.8**	**51.9**	**32.3**	**36.4**
- Ord Dividends	-7.1	-17.7	-17.2	-14.7
- Equity /other	0.0	0.0	0.0	0.0
Net Cashflow	**22.7**	**34.2**	**15.1**	**21.7**
Cash at beginning of period	7.2	14.3	21.4	36.6
+/- borrowings / other	-15.5	-27.1	0.0	0.0
Cash at end of period	**14.3**	**21.4**	**36.6**	**58.2**
Balance Sheet	**2016A**	**2017A**	**2018F**	**2019F**
Cash	14.3	21.4	36.6	58.2
Inventories	28.5	31.0	27.4	29.8
Debtors	19.1	20.6	18.2	19.7
PPE	10.8	12.0	13.0	13.6
Intangibles	87.6	86.2	85.8	85.6
Other assets	52.1	61.5	56.3	56.4
Total Assets	**212.5**	**232.7**	**237.3**	**263.4**
Borrowings	26.9	0.0	0.0	0.0
Trade Creditors	30.4	36.6	32.4	35.2
Other Liabilities	16.2	31.1	31.1	31.1
Total Liabilities	**73.5**	**67.7**	**63.4**	**66.2**
NET ASSETS	**138.9**	**165.0**	**173.9**	**197.2**

Board of Directors / Substantial Shareholders		
Board of Directors	**Shareholding**	**%**
David Simmonds - Chairman	0.0	0.0%
Donald McGurk - MD	0.8	0.5%
Peter Griffiths - N-E Director	0.1	0.1%
David Klingberg - N-E Director	0.1	0.0%
Brian Burns - N-E Director	0.0	0.0%
James McDowell - N-E Director	0.0	0.0%
Lt Gen Leahy - N-E Director	0.4	0.3%
Graeme Barclay - N-E Director	0.0	0.0%
Substantial Shareholders	**Shareholding**	**%**
IB Wall and PM Wall	34.8	19.7%
Starform Pty Ltd	11.4	6.4%
Griffina Pty Ltd	10.6	6.0%
Otterpaw Pty Ltd	10.6	6.0%
A.J Wood	10.6	6.0%
JP Morgan Trus Co (SJ Wood)	10.6	6.0%
Top 20 Shareholders	**109.6**	**66.8%**

Valuation ratios	2016A	2017A	2018F	2019F
EPS (cps)	11.9	25.2	17.5	19.3
P/E (x)	18.9	8.9	12.9	11.6
PER Rel - All Ind.	-10%	-56%	-33%	-34%
PER Rel - Small Ind.	3%	-54%	-28%	-31%
Enterprise Value ($m)	411.2	377.2	362.0	340.3
EV / EBITDA (x)	9.8	5.0	6.4	5.6
EV / EBIT (x)	14.1	6.1	8.5	7.2
DPS (cps)	6.0	13.0	8.0	10.0
Dividend Yield (%)	2.7%	5.8%	3.6%	4.4%
Franking (%)	100%	100%	100%	100%
CFPS (cps)	27.0	42.6	25.0	27.3
P / CFPS (x)	8.3	5.3	9.0	8.2
Profitability ratios	**2016A**	**2017A**	**2018F**	**2019F**
EBITDA Margin (%)	24.7	33.4	28.2	28.1
EBIT Margin (%)	17.2	27.2	21.3	21.7
ROE (%)	15.2	27.1	17.8	17.4
ROA (%)	14.7	29.1	21.2	23.0
ROIC (%)	16.4	31.8	22.9	25.0
Balance Sheet ratios	**2016A**	**2017A**	**2018F**	**2019F**
Net Debt (cash)	12.6	-21.4	-36.6	-58.2
Net Gearing (%)	9.1	-13.0	-21.0	-29.5
Interest Cover (x)	17.2	76.9	106.6	117.8
NTA per share ($)	0.29	0.44	0.51	0.64
Price / NTA (x)	7.8	5.1	4.4	3.5
EFPOWA (m)	177.1	177.3	177.3	177.3
Growth ratios	**2016A**	**2017A**	**2018F**	**2019F**
Sales revenue ($m)	17.8%	33.4%	-11.6%	8.6%
EBITDA ($m)	40.1%	80.3%	-25.4%	8.3%
EBIT ($m)	51.0%	110.6%	-30.7%	10.5%
NPAT ($m)	66.1%	111.8%	-30.6%	10.6%
EPS (cps)	66.1%	111.7%	-30.6%	10.6%
DPS (cps)	71.4%	116.7%	-38.5%	25.0%
Interim Analysis	**1H16A**	**2H16A**	**1H17A**	**2H17A**
Revenues	64.9	104.6	103.9	122.2
EBITDA	14.7	25.7	37.5	38.1
EBITDA margin (%)	22.7%	24.6%	36.1%	31.2%
EPS	3.9	8.0	12.5	12.7
DPS	2.0	4.0	6.0	7.0
Valuation				**2018**
EBITDA multiple (x)				
EBITDA ($m)				56.4
Target multiple (x)				7.8
Net Debt (cash) ($m)				-21.4
Implied Valuation				461.2
Per Share				**2.60**
Target PE Multiple				
EPS (c)				17.5
PE Target (x)				14.9
Per Share				**2.60**

Source: Company Reports, Canaccord Genuity estimates

FY17 Result Summary

Figure 2: FY17 results were in line with company guidance with profitability more than doubling on the pcp

($M)	1H16	2H16	FY16	1H17	2H17	FY17	% Change on pcp	CG Est	Beat/(miss)
REVENUE									
Communications products	29.0	36.0	65.0	35.0	35.9	70.9	9.1%	70.0	1%
Metal detection	33.6	65.6	99.2	64.8	83.2	148.0	49.2%	142.8	4%
Tracking solutions	2.3	3.0	5.3	4.1	3.1	7.2	35.8%	8.0	-10%
Total revenue	64.9	104.6	169.5	103.9	122.2	226.1	33.4%	220.5	3%
EBITDA	14.7	27.2	41.9	37.1	38.5	75.6	80.4%	74.3	2%
Depreciation and Amort	-5.7	-7.0	-12.7	-7.0	-7.1	-14.1	11.0%	-14.1	0%
EBIT	9.0	20.2	29.2	30.1	31.4	61.5	110.6%	60.3	2%
Interest Expense	-0.8	-0.9	-1.7	-0.3	-0.5	-0.8		-0.5	46%
PBT	8.2	19.3	27.5	29.8	30.9	60.7	120.7%	59.7	2%
Tax expense	-1.2	-5.2	-6.4	-7.6	-8.4	-16.0	150.0%	-15.2	5%
NPAT (Underlying)	7.0	14.1	21.1	22.2	22.5	44.7	111.8%	44.5	0%
NPAT (Reported)	6.1	9.4	15.5	22.2	21.3	43.5	180.6%	44.5	-2%
EPS (¢) – Underlying	3.9	8.0	11.9	12.5	12.4	24.9	109.2%	25.1	-1%
DPS (¢)	2.0	4.0	6.0	6.0	7.0	13.0	116.7%	10.0	30%
EBITDA Margin	22.7%	26.0%	24.7%	35.7%	31.5%	33.4%		33.7%	

Source: Company Reports, Canaccord Genuity estimates

Key Points

- **Strong result that was in line.** CDA reported a strong result that was in line with guidance, which was for NPAT to be "in the region of $44m". Underlying NPAT was $44.7m. It came after numerous upgrades throughout the year and hence was well flagged to the market.
- **Profitability benefited from margin improvement across all divisions.** Revenue increased 33% with improvements from both Communications (+9%) and Metal Detection (+49%). Profitability accelerated at a faster rate (EBITDA +80% and NPAT +112%) as margins improved. EBITDA margins improved from 24.7% in FY16 to 33.4% in FY17. One of the main drivers was the success of the GPZ7000, which commands a very high margin. This resulted in the segment margin from Metal Detection increased from 30% to 42%.
- **Operating cashflow was a standout.** Operating cashflow was $76m and cash conversion was strong at over 100%. After paying off the debt in 1H17, CDA ended the year with $21m cash. A lot of this is spoken for in the form of a tax bill and dividends; however, the company is well positioned to grow via acquisition should an opportunity arise. CDA has a $55m facility on standby.
- **The dividend was very special.** CDA declared a final dividend of 4c per share. Due to the significant increase in profitability, the company announced a special dividend of 3 cents, taking the total dividend to 7c per share.
- **Head office** costs for the period, having moderated in 1H17 to $8.5m, increased to $11.7m. The bulk of the increase related to performance payments to staff reflecting the break out year. On the assumption that profitability declines in FY18, then these costs should moderate back to 1H17 levels.

In Figure 3 and below, we discuss the performance of each division as well as the outlook.

Figure 3: Revenue was similar to 2H16; however, profitability increased significantly

$M	1H16	2H16	FY16A	1H17	2H17E	FY17E	% Change on pcp	CG Est	Beat/(miss)
Revenue									
Communications	29.0	36.0	65.0	35.0	35.9	70.9	9%	70.0	1%
Metal Detection	33.6	65.6	99.2	64.8	83.2	148.0	49%	142.8	4%
Tracking solutions	2.3	3.0	5.3	4.1	3.1	7.2	35%	8.0	-10%
Total	64.9	104.6	169.5	103.9	122.2	226.1	33%	220.8	2%
Segment Profit									
Communications	7.9	9.5	17.4	9.8	10.2	19.9	14%	18.5	8%
Metal Detection	8.0	21.8	29.8	28.4	33.1	61.5	106%	58.1	6%
Tracking solutions	-1.3	0.1	-1.2	0.4	0.0	0.3	Nm	0.7	-54%
Total	14.6	31.4	46.0	38.6	43.2	81.8	78%	77.3	6%
Communications	27.2%	26.5%	26.8%	28.0%	28.3%	28.1%		26.5%	
Metal Detection	23.8%	33.3%	30.1%	43.9%	39.8%	41.6%		40.7%	
Mining Technology	n/a	n/a	n/a	9.0%	-1.3%	4.6%		9.0%	

Source: Company Reports, Canaccord Genuity estimates

Communications

Communications performed well in FY17 with revenue up 9% and segment profit up 14%. The 2H17 performance was driven by a recovery in Land Mobile Radio (LMR) products following the softness in demand in the lead up the US election.

The division is certainly well positioned for a similar result or perhaps better in FY18. There has been a lot of new product development across both High Frequency Radio (HFR) and Land Mobile Radio (LMR) divisions, which should deliver a return to growth in FY18 and FY19.

The release of the Sentry-H and Sentry-V in 1H17 is expected to deliver benefits in FY18, with the company entering into a significant new market worth an estimated $200-250m.

The LMR Cascade product was launched in July and is expected to be a strong contributor to growth in FY19 and beyond. Additional sales staff have been added to support the new products.

Radio Communications today is probably in the strongest position it’s been with a diversified product range across LMR and HFR that are addressing significantly larger markets than before. Management believe that the base line business is between $65-75m revenue. While this may be the case now, we suspect this will grow over time.

For FY18, we are expecting a slightly better performance with revenue of $72m and a segment profit of $20.2m. This is within the base line range outlined above.

Metal Detection

Revenue from Metal Detection was up 49% on the pcp and segment profit was up 106%. Many of the drivers in 1H17 were evident in 2H17. The GPZ7000 continued to perform well without any of the gold surges that were evident in previous years. In addition management noted that demand was coming from a broader range of countries in Africa.

Sales into other markets are increasing; however, it's coming off a low base and represents a small amount of the overall sales volume. Importantly, management noted that there was no evidence to date of any counterfeit product on the market.

Management refrained from commenting on YTD sales of the GPZ7000. We suspect there has been some softness relative to the volumes they had been doing previously, but this is not surprising given sales into Africa at this time of year are seasonally slower. Our estimates into FY18 assume GPZ7000 volumes decline by 40%.

Two new products should help support divisional sales into FY18. In May, CDA launched the Gold Monster, which is a single frequency, entry level product. It was designed for the African market to go up against some of the lower price point products in the market and retails for between ~US$800-1000. We understand initial demand has been strong. In addition, a new product is planned to be launched in FY18 for the coin and treasure market, which again will be a low priced, high volume product.

Management have noted that the base level of sales for Metal Detection is between $85-95m, with sales exceeding these levels when demand for gold detectors is strong. We are forecasting sales in Metal Detection of $119m, which is 20% lower than FY17. This is above the base level as we believe demand for gold detectors will remain driven by distribution into a broader number of countries, the significant replacement market for the GPX5000 and the fact that counterfeit product hasn't emerged. Sales of new products should also help.

Tracking Solutions

Revenue from Tracking Solutions increased in FY17 by 35% as Mintec deployed its solutions into several mines. The division was profitable during the period, which was positive although 2H17 was only breakeven. Management are looking at options to scale the business faster now that the product has been proven. This includes seeking strategic relationships with global players to fast track a roll out. We have reduced our revenue estimates in FY18 by 10% to $9.0m and are forecasting a small profit contribution.

Changes to forecasts

- We have made some minor revisions to our forecasts for FY18 and FY19 to reflect the better than expected margins across Communications and Metal Detection and the outlook for each division as mentioned above.
- In FY18, our revenue forecasts have remained more or less the same at $200m, while our NPAT forecasts increase by 3.4% to $31m.
- We note that while CDA didn't provide guidance, management pointed to a base business of revenues in the range of $160-180m and NPAT of between $20-25m. While our estimates sit above this range, we believe demand for gold detectors will continue and, as noted above, our estimates assume a 40% decline in demand for the GPZ7000. We believe this assumption could prove to be conservative.

- We outline our changes in Figure 3 below.

Figure 3: Forecast changes

	FY18			FY19		
($M)	Old	New	% Change	Old	New	% Change
Communications	71.9	72.1	0.3%	74.1	74.3	0.3%
Metal Detection	118.7	118.9	0.2%	128.4	128.6	0.2%
Mine Technology	10.1	9.0	-11.0%	14.5	14.2	-2.2%
Total Revenue	200.5	199.8	-0.4%	217.0	217.1	0.0%
EBITDA ($m)	54.4	56.4	3.6%	57.1	61.0	6.8%
Underlying NPAT	30.0	31.0	3.4%	32.7	34.3	4.9%
EPS (¢) –normalised	16.9	17.5	3.3%	18.5	19.3	4.8%
DPS (¢)	8.0	8.0	0.0%	9.0	10.0	11.1%
EBITDA margin (%)	27.1%	28.2%		26.3%	28.1%	

Source: Canaccord Genuity estimates

Outlook and recommendation

- We continue to retain a positive outlook for CDA. We believe each division is well positioned in their respective markets and with new products being developed and new markets being penetrated there is growth potential in the base business. CDA is also well placed to grow via acquisition, being in a net cash position. Finally, we believe there is risk to the upside to our estimates should strong demand for gold detectors continue into FY18. We see catalysts as being; (i) new contracts in Communications, (ii) a positive trading update at the AGM in October and (iii) an accretive acquisition.

  As a result of the minor changes to our estimates, we have raised our Target Price to $2.60 per share ($2.50 per share previously). We have arrived at our TP applying a 7.8x multiple (20% discount to Small Industrials average) to FY18 EBITDA of $56.4m. Currently, CDA is trading on undemanding multiples – FY18e EV/EBITDA of 6.4x and PER of 12.9x. Given this, numerous catalysts, and the current price relative to our TP, we upgrade our rating to a BUY.

Appendix: Important Disclosures

Analyst Certification

Each authoring analyst of Canaccord Genuity whose name appears on the front page of this research hereby certifies that (i) the recommendations and opinions expressed in this research accurately reflect the authoring analyst's personal, independent and objective views about any and all of the designated investments or relevant issuers discussed herein that are within such authoring analyst's coverage universe and (ii) no part of the authoring analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by the authoring analyst in the research.

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Sector Coverage

Individuals identified as "Sector Coverage" cover a subject company's industry in the identified jurisdiction, but are not authoring analysts of the report.

Investment Recommendation

Date and time of first dissemination: August 31, 2017, 16:31 ET

Date and time of production: August 31, 2017, 12:43 ET

Target Price / Valuation Methodology:

Codan Limited - CDA

Our $2.60 Target Price is based on applying a 7.8x multiple (20% discount to Small Industrials average) to FY18 EBITDA of $56.4m.

Risks to achieving Target Price / Valuation:

Codan Limited - CDA

CDA is exposed to a number of risks including: Counterfeit product: CDA's metal detection products have been subject to counterfeit product. CDA has been countering this by applying a number of security initiatives unique to CDA's products. If CDA is not successful minimising counterfeit product is could impact on demand and margins. Gold price: Increases or decreases in the gold price could impact demand for CDA's gold detection products, a key driver of group profitability. Our view is that the gold price would need to move significantly lower for demand to be impacted. Competition: CDA's success is based around having market leading products in HF Radio Communications and Metal Detection. A superior product on the market by a competitor would have an impact on the demand for CDA's products. Acquisition risk: CDA acquired 2 small businesses in FY12 and further acquisitions are part of the company's strategy. If acquisitions are poorly integrated or the company overpays, then this would impact on the company's earnings.

Distribution of Ratings:

Global Stock Ratings (as of 08/31/17)

Rating	Coverage Universe		IB Clients
	#	%	%
Buy	593	60.76%	39.63%
Hold	279	28.59%	23.66%
Sell	23	2.36%	8.70%
Speculative Buy	81	8.30%	72.84%
	976*	100.0%	

*Total includes stocks that are Under Review

Canaccord Genuity Ratings System

BUY: The stock is expected to generate risk-adjusted returns of over 10% during the next 12 months.

HOLD: The stock is expected to generate risk-adjusted returns of 0-10% during the next 12 months.

SELL: The stock is expected to generate negative risk-adjusted returns during the next 12 months.

NOT RATED: Canaccord Genuity does not provide research coverage of the relevant issuer.

"Risk-adjusted return" refers to the expected return in relation to the amount of risk associated with the designated investment or the relevant issuer.

Risk Qualifier

SPECULATIVE: Stocks bear significantly higher risk that typically cannot be valued by normal fundamental criteria. Investments in the stock may result in material loss.

12-Month Recommendation History (as of date same as the **Global Stock Ratings** table)

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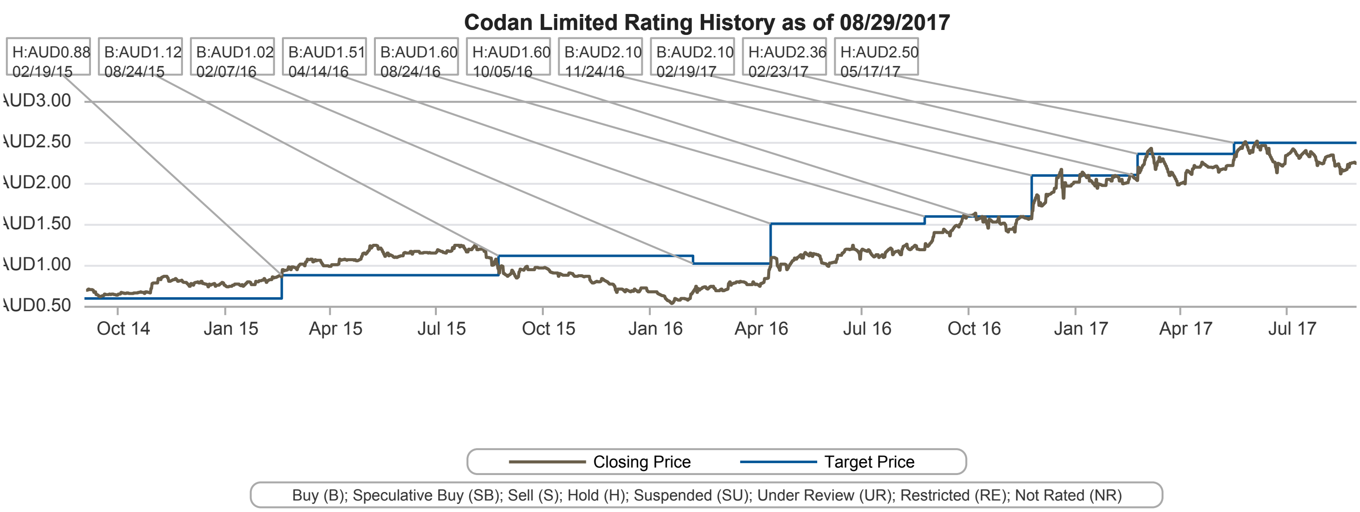

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