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# Codan Limited (CDA)

Outperform

FY18 Result - First milestone of earnings quality thesis delivered

\$3.28

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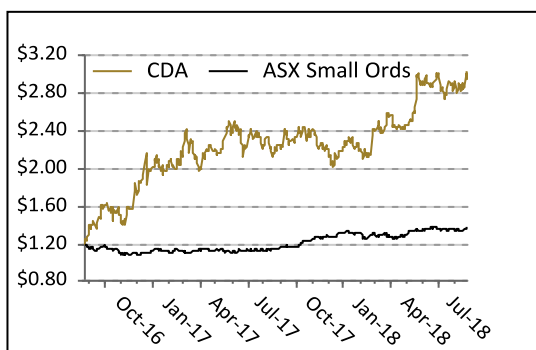
## Summary (AUD)

Market Capitalisation	\$584.5
Share Price	\$3.280
52 week low	\$1.965
52 week high	\$3.280
Ave Monthly Vol (year rolling)	4.367M

## Key Financials (AUD)

Year End (\$m)	FY18 Act.	FY19 Est.	FY20 Est.
Revenue	229.9	252.0	275.4
EBIT	53.7	57.3	58.3
NPAT Adj.	39.7	42.3	43.0
EPS (c)	22.3	23.7	24.1
PE Ratio (x)	14.7	13.8	13.6
DPS (c)	12.5	13.0	13.0
Div Yield	3.8%	4.0%	4.0%
Franking	100.0%	100.0%	100.0%
<b>EV</b>	<b>556.8</b>	<b>553.6</b>	<b>543.6</b>
EV/EBITDA (x)	7.9	7.3	6.7
EV/EBIT (x)	10.4	9.7	9.3
ROE	22.5%	21.4%	19.7%
EBIT Margin	23.3%	22.7%	21.2%
Payout Ratio.	56.0%	54.8%	53.9%

## Share Price Graph (AUD)



## Trading Update

Despite underlying NPAT reducing by 11% to \$39.7m, there were many positives to take from CDA's FY18 result. Broadening of the metal detection range (including an ongoing backlog of Equinox orders into FY19), continuing demand for the GPZ 7000, and endorsements of Minetec through (1) the BHP Olympic Dam contract; and (2) global licensing, technology development and marketing agreement with Caterpillar Inc., were obvious highlights. See p.2 for further analysis of the FY18 result.

## Investment Thesis

Importantly, CDA delivered the first milestone of what we believe will be a three year journey towards a ~80% growth in FY18 base level EPS. While reported earnings will remain relatively flat through this time, the quality will substantially improve. As a consequence, we believe this will provide multiple expansion of ~35-40%. The two key remaining milestones include:

- **Finalisation of an end-to-end solution in Land Mobile Radio ("LMR").** Today CDA confirmed that it should finalise the engineering development program for LMR by late FY19. We maintain our view that a small benefit will come from this project during FY20, building into FY21.
- **Material contract wins from the Caterpillar ("CAT") Minetec global distribution deal.** A working proof of concept at Newmont's Tanami mine is weeks away, while selected dealer training underway. Both need to be delivered before sales eventuate. Progress updates indicate both will be achieved during 1H19. Therefore we maintain that first contract wins could come by late FY19/early FY20.

## Valuation & Recommendation

CDA trades at 13.8x our FY19e EPS (on a reported basis) or 21.3x FY19e mid-point base level EPS. Despite being product driven, we believe CDA is underappreciated by the market considering: (1) Core intellectual property; (2) Balance sheet health; (3) Significant repeat customers; (4) Ongoing investment in R&D; (5) Market positioning across key verticals; and (6) The earnings growth opportunities ahead of the Group.

In saying this, we acknowledge the enhanced sovereign risk from operating in Africa. As discussed during our initiating report (dated 18 July 2018), we estimate that this will contribute 25-30% of CDA's base level sales by FY20-21. We cannot ignore this, nor should the market. Therefore, in our view, the base level business valuation should not exceed the S&P Small Ordinaries NTM market multiple of 18.5x EPS, adjusted for excess cash and estimated special dividends throughout the conversion period.

On this basis we arrive at a 12-month price target of \$3.09/ps, which incorporates forward estimates with realistic timings around growth project customer take-up. We acknowledge in the short-term that CDA lacks catalysts. Despite this, our analysis suggests that CDA will be successful in achieving both LMR and Minetec sales targets by FY21. By this time our fair value (inclusive of excess cash) would approach \$4.50/ps. Combined with our est. 39.5cps FF div. over the same period, we believed the total shareholder return will be ~50%; with a free option over accretive acquisitions and/or product launch benefits from the GPZ 2. **Taking a medium term investment horizon, we maintain our OUTPERFORM recommendation.**

## Further analysis of FY18 result

### Radio Communications strongly positioned to recover during FY19

Margin erosion in Radio Communications was as spectacular as it was unexpected during 2H18. We calculated segment margin decline of 24% on pcp from 28.3% to 4.3%. CDA explained this as being largely customer driven; in that most of the HF Radio equipment was sold into lower margin regions such as APAC during this time in comparison to more traditional higher margin regions such as Afghanistan or Africa. Importantly, the forward pipeline in HF Radio is strong, with better customer mix. A number of larger contracts already shipped at the beginning of FY19 should provide sufficient earnings cushion for our estimated 15% decline in GPZ 7000 sales.

### Promising start to FY19 with strong GPZ 7000 sales to date

GPZ 7000 sales through the early stages of FY19 are run-rating similar volumes to the past six months. Further guidance will be provided at the October AGM. Included in TC's estimates are 15%, 25%, and 25% p.a. declines for this product during FY18, FY19 and FY20. The FY benefit of Equinox Coin & Treasure detector released during 2H18 should partially offset segment revenue and earnings declines if our forecasts eventuate.

### Minetec / MineStar trial remains on track

With approximately 80% of the integration works now completed at Newmont's Tanami mine, CDA is weeks away from a working "proof of concept" Minetec / MineStar solution. This working mine is a critical enabler to sales conversion, as is the training for selected CAT dealers (well underway). While \$30m in sales has been flagged as the FY20 milestone for Tracking Solutions, CDA's aspirational target is closer to \$60m further ahead. At a guaranteed gross margin of 50% (with little additional supportive costs), the earnings benefits could be transformational.

### Investing heavily in R&D

Over the past 5 years CDA has capitalised ~\$70m in product development costs, while over the same period amortising \$35m. Commitment to innovation through difficult trading years during FY13, FY14 and FY15 underpinned the earnings recovery through FY17 and FY18. Now possessing a more balanced product suite and medium term growth outlook, CDA has flagged an intention to accelerate its product development spend from \$16m p.a. to ~\$25m p.a. for the foreseeable future. Critical project deliveries in the next 12-24 months include final investments in Cascade, multiple product enhancement projects with MineStar, as well as commercialising the physics behind the GPZ 2. While supported investment is critical in product release driven businesses, investors should remember FCF to NPAT conversion will continue to be lackluster in the near term (TC estimates 60%, 77% and 80% during FY18, FY19 and FY20).

## Codan Ltd - Summary of Forecasts

Price

\$ 3.280

PROFIT & LOSS SUMMARY (A\$m)					
Period	FY17A	FY18A	FY19E	FY20E	FY21E
Revenue	226.1	229.9	252.0	275.4	294.0
EBITDA Adj.	75.6	70.3	76.1	80.8	84.7
Dep'n	(2.4)	(2.8)	(2.8)	(2.8)	(2.8)
Amort'n	(11.6)	(13.8)	(15.9)	(19.7)	(22.4)
<b>EBIT Adj.</b>	<b>61.5</b>	<b>53.7</b>	<b>57.3</b>	<b>58.3</b>	<b>59.4</b>
Net Interest	(0.8)	(0.5)	0.3	0.5	0.6
Pre-Tax Profit Adj.	60.7	53.1	57.3	58.3	59.4
Tax Expense	(16.0)	(13.4)	(15.0)	(15.3)	(15.6)
<b>NPAT Adj.</b>	<b>44.7</b>	<b>39.7</b>	<b>42.3</b>	<b>43.0</b>	<b>43.8</b>
Abnormals (net of tax)	(1.2)	1.7	0.0	0.0	0.0
<b>Reported Profit</b>	<b>43.5</b>	<b>41.5</b>	<b>42.3</b>	<b>43.0</b>	<b>43.8</b>
Change on pcp					
Total Revenue	33.4%	1.7%	9.6%	9.3%	6.7%
EBITDA Adj.	80.3%	-6.9%	8.2%	6.2%	4.8%
EBIT Adj.	110.6%	-12.8%	6.7%	1.7%	1.9%
NPAT Adj.	112.1%	-11.1%	6.4%	1.6%	1.9%

OPERATING SEGMENTS (A\$m)					
Period	FY17A	FY18A	FY19E	FY20E	FY21E
<b>Revenue</b>					
Communications	70.9	56.5	75.5	80.0	100.3
Metal Detection	148.0	164.0	161.0	158.9	149.2
Tracking Solutions	7.2	9.4	15.6	36.6	44.6
Other	0.0	0.0	0.0	0.0	0.0
<b>TOTAL</b>	<b>226.1</b>	<b>229.9</b>	<b>252.0</b>	<b>275.4</b>	<b>294.0</b>
<b>Segment Result</b>					
Communications	19.9	6.8	15.3	16.4	23.7
Metal Detection	61.5	64.1	58.2	52.7	44.4
Tracking Solutions	0.3	0.7	2.6	9.0	12.0
Other	0.0	0.0	0.0	0.0	0.0
D&A	14.1	16.7	18.8	22.5	25.3
Unallocated Corporate	(20.2)	(17.6)	(18.5)	(19.4)	(20.4)
Unallocated Other	(0.1)	(0.2)	(0.4)	(0.4)	(0.4)
<b>EBITDA</b>	<b>75.6</b>	<b>70.4</b>	<b>76.1</b>	<b>80.8</b>	<b>84.7</b>

PER SHARE DATA					
Period	FY17A	FY18A	FY19E	FY20E	FY21E
<b>EPS Adj. (c)</b>	<b>25.2</b>	<b>22.3</b>	<b>23.7</b>	<b>24.1</b>	<b>24.6</b>
Growth (pcp)	111.9%	-11.4%	6.3%	1.6%	1.9%
Ordinary Dividend (c)	7.0	8.5	9.0	11.0	13.5
Special Dividend (c)	6.0	4.0	4.0	2.0	0.0
Franking	100%	100%	100%	100%	100%
Book NTA per share (c)	14	23	28	34	42

VALUATION MULTIPLES					
Period	FY17A	FY18A	FY19E	FY20E	FY21E
<b>PER Adj. (x)</b>	<b>13.0</b>	<b>14.7</b>	<b>13.8</b>	<b>13.6</b>	<b>13.3</b>
<b>Dividend Yield (%)</b>	<b>2.1%</b>	<b>2.6%</b>	<b>2.7%</b>	<b>3.4%</b>	<b>4.1%</b>
Free CF Yield	8.9%	4.4%	4.4%	5.7%	6.0%
EV/EBITDA (x)	7.5	7.9	7.3	6.7	6.3
EV/EBIT (x)	9.2	10.4	9.7	9.3	9.0

BALANCE SHEET SUMMARY					
Period	FY17A	FY18A	FY19E	FY20E	FY21E
Cash	21.4	27.7	30.9	40.9	52.8
Receivables	20.6	29.8	25.2	27.5	29.4
Inventory	31.0	31.6	35.3	38.6	41.2
Current Tax Asset	0.0	0.1	0.1	0.1	0.1
Assets Held for Sale	3.8	3.8	3.8	3.8	3.8
Other	3.5	2.5	2.5	2.5	2.5
<b>Total Current Assets</b>	<b>80.3</b>	<b>95.4</b>	<b>97.7</b>	<b>113.3</b>	<b>129.7</b>
Property Plant & Equipment	12.0	12.5	12.1	11.8	11.4
Product Development	54.2	59.8	71.5	79.4	86.5
Intangibles	86.2	86.6	87.0	87.4	87.8
<b>Total Non-Current Assets</b>	<b>152.4</b>	<b>158.9</b>	<b>170.6</b>	<b>178.6</b>	<b>185.8</b>
<b>TOTAL ASSETS</b>	<b>232.7</b>	<b>254.3</b>	<b>268.3</b>	<b>291.9</b>	<b>315.5</b>
Payables	36.6	46.3	40.3	44.1	47.0
Borrowings	0.0	0.0	0.0	0.0	0.0
Current Tax Payable	16.1	6.1	6.1	6.1	6.1
Provisions	7.2	7.3	7.3	7.3	7.3
<b>Total Current Liab</b>	<b>59.9</b>	<b>59.7</b>	<b>53.7</b>	<b>57.4</b>	<b>60.4</b>
Other Payables	0.0	0.0	0.0	0.0	0.0
Borrowings	0.0	0.0	0.0	0.0	0.0
Deferred Tax Liabilities	7.2	6.0	6.0	6.0	6.0
Provisions	0.5	0.5	0.5	0.5	0.5
<b>Total Non-Current Liab</b>	<b>7.8</b>	<b>6.5</b>	<b>6.5</b>	<b>6.5</b>	<b>6.5</b>
<b>TOTAL LIABILITIES</b>	<b>67.7</b>	<b>66.2</b>	<b>60.2</b>	<b>64.0</b>	<b>66.9</b>
<b>TOTAL EQUITY</b>	<b>165.0</b>	<b>188.1</b>	<b>208.1</b>	<b>227.9</b>	<b>248.6</b>

CASH FLOW SUMMARY					
Period	FY17A	FY18A	FY19E	FY20E	FY21E
<b>NPAT Adj.</b>	<b>43.5</b>	<b>41.5</b>	<b>42.3</b>	<b>43.0</b>	<b>43.8</b>
Add: Depreciation	2.4	2.8	2.8	2.8	2.8
Add: Amortisation	11.6	13.8	15.9	19.7	22.4
Abnormals, non cash, reclassification	18.0	(10.0)	(5.1)	(1.9)	(1.5)
<b>Gross Cashflows</b>	<b>75.6</b>	<b>48.2</b>	<b>55.9</b>	<b>63.7</b>	<b>67.6</b>
Net Capex	(4.1)	(3.4)	(2.5)	(2.5)	(2.5)
Investments in Intangibles	(3.2)	(2.5)	(3.0)	(3.0)	(3.0)
Capitalised product development	(16.4)	(16.5)	(25.0)	(25.0)	(27.0)
(Acquisitions)/Divestments	0.0	0.0	0.0	0.0	0.0
<b>Free Cashflows</b>	<b>51.9</b>	<b>25.8</b>	<b>25.4</b>	<b>33.2</b>	<b>35.1</b>
Dividends Paid	(17.7)	(19.6)	(22.3)	(23.2)	(23.2)
Debt Issued / (Repaid)	(26.9)	0.0	0.0	0.0	0.0
Equity issued / (Buyback)	0.0	0.0	0.0	0.0	0.0
<b>Net Cash Flow</b>	<b>7.2</b>	<b>6.2</b>	<b>3.2</b>	<b>10.0</b>	<b>11.9</b>

KEY RATIOS					
Period	FY17A	FY18A	FY19E	FY20E	FY21E
Net Debt / EBITDA Adj. (x)	(0.3)	(0.4)	(0.4)	(0.5)	(0.6)
Net Debt : Equity (%)	-13.0%	-14.7%	-14.8%	-17.9%	-21.2%
EBIT Interest cover (x)	70.1	89.1	n/a	n/a	n/a
Current ratio (x)	1.3	1.6	1.8	2.0	2.1
ROE Adj. (%)	29.4%	22.5%	21.4%	19.7%	18.4%
ROIC Adj. (%)	27.0%	22.5%	21.4%	19.7%	18.4%
Dividend Payout Ratio (%)	51.5%	56.0%	54.8%	53.9%	54.9%

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