

# CODAN LIMITED

**BUY**
**Earnings expand through new product and markets**

Technology Hardware &amp; Equipment / Electronic Equipment &amp; Instruments

**20 February 2019**

## COMPANY UPDATE

Ticker	CDA
Stock Price	\$3.20
Target Price	\$3.68
Forecast Capital Return	15.0%
Forecast Dividend Yield	4.7%
Estimated Total Return - 12 Mth Forward	19.7%

### Company market data

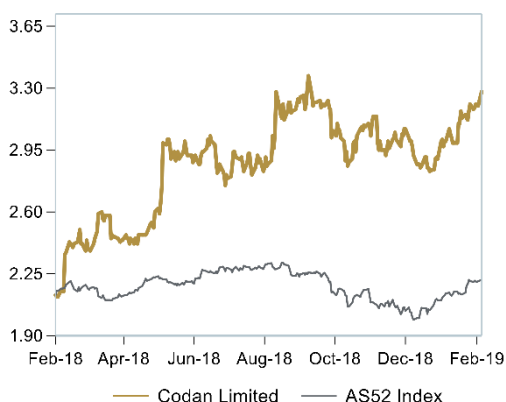
Market Cap.	\$570.2m
Free Float (%)	61.8
Enterprise Value	\$557.2m
52 Week Range	\$2.15 - \$3.37
Shares Out.	178.2m
Avg. Daily Value	\$0.5m

Estimates changes	2018a	2019e	2020e	2021e
Core NPAT - <i>old</i>	39.8	44.0	41.9	46.6
Core NPAT - <i>new</i>	39.8	44.1	43.2	47.2
% Change	0.0	0.1	3.0	1.1
Core EPS dil. (€) - <i>old</i>	22.1	24.4	23.3	25.9
Core EPS dil. (€) - <i>new</i>	22.1	24.5	24.0	26.2
% Change	0.0	0.1	3.0	1.1
DPS (€) - <i>old</i>	12.5	15.0	14.4	16.0
DPS (€) - <i>new</i>	12.5	13.9	14.8	16.2
% Change	0.0	(7.7)	2.8	0.9

All figures are in AUD unless otherwise specified.

### Share price performance

Codan Limited vs. AS52 (rebased index)



### Analyst

**Ronan Barratt**

+61 2 8288 5426

[ronan.barratt@moelisaustralia.com](mailto:ronan.barratt@moelisaustralia.com)

## EVENT

1H FY19 Result.

- **NPAT \$22.2m** (vs. guidance: "\$20-22m", in line vs. MOE \$22.2m).
- **Metal Detection:** 1H19 sales buoyed by GPZ demand from a new market (which has since normalised) and broadening sales of other gold and treasure detectors such as the Equinox device.
- **Radio Communications:** EBIT +21% vs. pcp. following large orders in 1Q19. New products in HF gaining traction with pipeline looking strong.
- **Mining Technology:** CAT & BHP works progressing well. Business "could double in size over the next few years".

## IMPACT

Our estimates remain largely unchanged, we expect the 2H NPAT to be similar to 1H across FY19, supported by continued strong sales in Communications and seasonal tailwinds in Metal.

## INVESTMENT VIEW

A key takeaway from this result is the diversifying of CDA's earnings base. All divisions are recording sales from new products to new customers.

This validates the large product development investments (~\$22m p.a.) that CDA has, and will continue to undertake. We note the Return on Incremental Capital since 2016 has been ~60%.

The broadening earnings base also makes the ~\$44m NPAT est. for this year of higher quality, providing a more reliable guide for future earnings.

We would point out that CDA's existing business trades on ~13x P/E, before Minetec has been monetised. Our CDA thesis comprises:

- **Growth present across all business divisions** with new product releases supporting the sales outlook for future periods.
- **Minetec division yet to be monetised** that could add material upside in to earnings in future periods.
- **High & growing returns on invested capital (~22% ROIC).**
- **Proven track record of re-investing capital at high rates of return: ~60%** Return on Incremental Capital across FY16-FY19e.
- **Net cash balance sheet** supports acquisitions or enlarged dividends.
- **Proven depth of product replacement cycle in Metal Detection** with CDA holding clear competitive advantages and barriers to entry.

**Maintain BUY rating. \$3.68 TP.**

Y/E Jun 30	2018a	2019e	2020e	2021e
EBITDA	70.6	78.8	81.5	87.4
EV/EBITDA	7.9x	7.1x	6.8x	6.4x
Core NPAT	39.8	44.1	43.2	47.2
Core EPS (Diluted) (€)	22.1	24.5	24.0	26.2
P/E	14.5x	13.1x	13.4x	12.2x
EPS growth	(12.3%)	10.5%	(2.0%)	9.2%
DPS (€)	12.5	13.9	14.8	16.2
Yield	3.9%	4.3%	4.6%	5.1%
DPS growth	(3.8%)	11.1%	6.3%	9.6%
Dividend Payout Ratio	56.4%	56.8%	61.6%	61.8%

All figures are in AUD.

## RESULT

- The 1H19 result was in line with MOE estimates, with strong growth shown vs. pcp.
- Differences included Radio Communication which was ahead of our estimates, however this was offset by larger corporate costs that related to accrued employee incentive payments as a result of the strong group performance in 1H.

**Figure 1: 1H19 Result vs. Estimates**

Profit and Loss	Actual	Moelis Estimates		vs. pcp
	1H19a	Moelis	Act v MOE	
<b>EBIT</b>				
Metal Detection	29.6	29.4	1%	29%
<i>Margin</i>	36%	39%	-3%	0%
Radio	10.3	8.5	21%	85%
<i>Margin</i>	25%	24%	2%	6%
Mining Technology	0.0	0.6	-99%	-101%
<i>Margin</i>	0%	10%	-10%	
Corporate	-9.5	-8.7	9%	33%
<i>% Group Sales</i>	-7%	-7%	0%	0%
<b>Group EBIT</b>	30	30	2%	43%
Group EBIT Margin	24%	25%	-2%	1%
<b>NPAT</b>	22.2	22.2	0%	40%
<b>EPS</b>	12.3	12.3	0%	38%

Source: Company, Moelis Analysis

Key takeaways from managements commentary included:

### Metal Detection

“Demand was strong across our full range of gold detectors, which includes the SDC 2300®, Gold Monster and GPZ 7000.”

“The recreational part of the Minelab business also showed strong growth...our new EQUINOX coin and treasure detector continues to sell well”

“While we are confident of continuing success in the second half of FY19, it is too early to determine the extent to which Minelab sales will exceed base level during this period.”

### Tactical Communications

“We are experiencing strong interest in our expanded tactical military offering and are confident that this strategy will broaden our addressable market in the mid to long term.”

“Assuming normalised sales over the second half, we expect full-year FY19 sales to fall within this range [\$65-75m].”

### Minetec

“In May 2018 Minetec won a \$9.5 million contract to supply its Fleet Management System to BHP’s Olympic Dam mine in South Australia....as an extension to this project, in December Minetec was awarded the contract to supply the underground communications and tracking infrastructure (Wi-Fi WASP) at Olympic Dam.”

## REVISED ESTIMATES

Our earnings remain largely unchanged, we expect similar NPAT across 2H vs. 1H FY19.

The main changes to our estimates include:

- ~\$2m increase in Metal Detection EBIT (reflecting stronger than expected 1H)
- ~\$1m increase in Radio EBIT (reflecting stronger than expected 1H)

Offset by:

- ~\$1m decrease in Mining Technology (reflecting investments in headcount ahead of BHP and CAT revenue expected in FY20+)
- ~\$1m increase in Corporate Overheads (reflecting accrued incentive payments from strong 1H).

Moelis revised earnings are set out below:

**Figure 2: Moelis Earnings Estimates**

Profit and Loss	Actual	Estimates				Estimates Changes		
	1H19a	2H19e	FY19e	FY20e	FY21e	FY19e	FY20e	FY21e
<b>EBIT</b>								
Metal Detection	30	32	62	58	58	1	4	3
<i>Margin</i>	<i>36%</i>	<i>39%</i>	<i>37%</i>	<i>37%</i>	<i>36%</i>	<i>-1%</i>	<i>0%</i>	<i>0%</i>
Radio	10	8	19	20	25	2	1	2
<i>Margin</i>	<i>25%</i>	<i>24%</i>	<i>25%</i>	<i>24%</i>	<i>27%</i>	<i>1%</i>	<i>1%</i>	<i>1%</i>
Mining Technology	0	0	0	3	5	-1	-2	-2
Corporate	-9	-11	-21	-22	-24	-1	-2	-2
<b>Group EBIT</b>	<b>30</b>	<b>29</b>	<b>60</b>	<b>58</b>	<b>64</b>	<b>0</b>	<b>2</b>	<b>1</b>
Group EBIT Margin		23%	23%	22%	22%	-1%	0%	0%
Net Finance Expense		1	1	1	1	0	0	0
PBT		30	60	59	65	0	0	0
Tax		-8	-16	-16	-18	0	0	0
<b>NPAT</b>	<b>22.2</b>	<b>21.9</b>	<b>44.1</b>	<b>43.2</b>	<b>47.2</b>	<b>0%</b>	<b>3%</b>	<b>1%</b>
<b>EPS</b>	<b>12.3</b>	<b>12.2</b>	<b>24.5</b>	<b>24.0</b>	<b>26.2</b>	<b>0%</b>	<b>3%</b>	<b>1%</b>

Source: Company, Moelis Analysis

## METAL DETECTION

We remain confident in the medium-long term outlook for Metal Detection due to its:

- No. 1 market share in handheld Metal Detection (>\$400m p.a. market)
- Broadening product mix (gold, coin/treasure, countermine)
- High technological barriers to entry (world leading IP protected by patents)
- High barriers to distribution/global sales reach (danger factor/ political instability)
- Sophisticated counterfeit protection (military-grade software encryption)
- Growing geographical sales mix (reducing concentration risk)
- Supportive gold price (~\$1,300 USD/ounce).

**Figure 3: Gold Price (USD)**



Source: Factset

**Figure 4: Title**

- **NEW Multi-IQ technology**
  - Simultaneous multi-frequency
  - Adaptable for all target types and ground conditions
  - Obsoletes all single frequency VLF detectors
- **Mid-range coin & treasure detector**
  - Waterproof
  - Wireless audio
  - Lightweight
  - Easy set-up
  - RRP \$649 - \$899 USD
- **Strong order book**
- **First shipments February 2018**



Source: Company Presentations

We estimate that the GPZ7000 gold detector is ~65% through its replacement cycle, however we note this replacement cycle may be extended due to new markets penetrated since its release.

A new generation of the GPZ7000 is already under development, we expect this to be launched across FY21.

**Figure 5: GPZ7000 Replacement Cycle**

	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	1H19
Flagship Detector Model	GPX	GPX	GPX	GPX	GPX	GPX	GPX	GPX	GPZ	GPZ	GPZ	GPZ
Total Metal Detection Sales	\$42m	\$107m	\$107m	\$92m	\$99m	\$166m	\$70m	\$73m	\$99m	\$148m	\$164m	\$82m
Flagship detector sales	\$23m	\$59m	\$59m	\$51m	\$54m	\$91m	\$38m	\$40m	\$55m	\$81m	\$74m	\$37m
Cumulative GPX units sold	5,500	20,000	35,000	45,000	60,000	80,000	90,000	100,000				
Cumulative GPZ7000 units sold								1,000	9,000	20,000	30,000	35,000
Estimated GPZ addressable market (55% of GPX Sales)	55,000											
GPZ units sold to date (FY15-19)	35,000											
% through replacement cycle	64%											

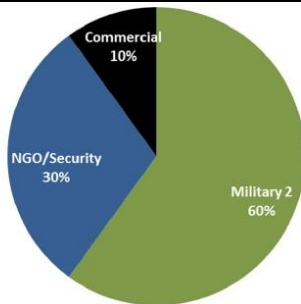
Source: Company, Moelis Analysis

## RADIO COMMUNICATIONS

We see medium-term growth in Radio Communications supported by two major investments:

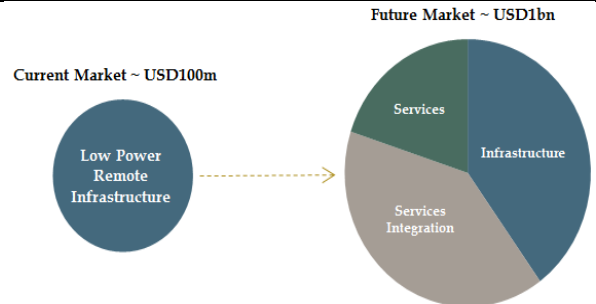
- High Frequency – entry into the Military 2 market (sales commencing 2H FY19)
  - Targets the global military market utilising the US government-funded Foreign Military Sales vehicle.
- Land Mobile Radio – launch of cascade radio in 2H FY20.
  - LMR’s new product ‘Cascade’, will target the ~\$1bn North American LMR market. Cascade will offer a lower-cost alternative to the dominant incumbent, Motorola (>80% market share).
  - The Cascade product expands CDA offering beyond just the radio, into systems integration and ongoing maintenance/support services, providing the opportunity to generate for recurring revenue.

**Figure 6: HF - Military 2 Market**



Source: Company Reports

**Figure 7: LMR - \$1bn Nth America Market**



Source: Company reports, Moelis Analysis

## MINING TECHNOLOGY

CDA expects Minetec could “double in size” over the next few years, implying revenues of ~\$30m by ~FY21. Our estimates fall broadly in line with this guidance, however we believe there is material upside to these estimates should CDA execute on its current opportunities with CAT and BHP.

Works on both CAT and BHP have de-risked over 1H19:

- CAT - first phase of this CDA/CAT product integration now complete and a trial of the combined technology underway at Newmont’s Tanami mine in Northern Territory.
- BHP – Scope of work extended beyond original \$9.5m ‘tracking’ contract to now include underground communications and tracking infrastructure (Wi-Fi WASP).

*We estimate first commercial sales with CAT 1H FY20*

We expect FY20 to be the breakout year of profitability for Minetec with commercial sales from works with CAT likely to begin in 1H FY20.

**Codan Limited (CDA)**

Market Cap: \$570m

Last Price: \$3.20

Target Price: \$3.68

**Buy**

Y/E Jun 30

Profit and Loss (\$m)	2017a	2018a	2019e	2020e	2021e
<b>Revenue</b>	<b>226.1</b>	<b>229.9</b>	<b>254.8</b>	<b>262.8</b>	<b>284.4</b>
<i>Growth</i>	33.4%	1.7%	10.8%	3.1%	8.2%
<b>EBITDA</b>	<b>75.7</b>	<b>70.6</b>	<b>78.8</b>	<b>81.5</b>	<b>87.4</b>
<i>Growth</i>	80.4%	(6.7%)	11.6%	3.4%	7.3%
Dep'n & Amort	(14.1)	(16.7)	(18.9)	(23.3)	(23.8)
<b>EBIT</b>	<b>61.6</b>	<b>53.9</b>	<b>59.8</b>	<b>58.1</b>	<b>63.5</b>
<i>Growth</i>	110.7%	(12.5%)	11.0%	(2.9%)	9.3%
Net Interest Expense	(0.9)	(0.7)	0.5	1.0	1.3
<b>Profit Before Tax</b>	<b>60.7</b>	<b>53.2</b>	<b>60.4</b>	<b>59.1</b>	<b>64.8</b>
Tax	(16.0)	(13.3)	(16.3)	(15.9)	(17.6)
<i>Tax Rate (%)</i>	26.3%	25.1%	27.0%	27.0%	27.2%
Minorities	0.0	0.0	0.0	0.0	0.0
<b>NPAT (Underlying)</b>	<b>44.7</b>	<b>39.8</b>	<b>44.1</b>	<b>43.2</b>	<b>47.2</b>
<i>Growth</i>	112.0%	(10.9%)	10.6%	(2.0%)	9.2%
One-Off Items	0.0	0.0	0.0	0.0	0.0
<b>NPAT (Reported)</b>	<b>44.7</b>	<b>39.8</b>	<b>44.1</b>	<b>43.2</b>	<b>47.2</b>
<b>EPS (Underlying) (¢)</b>	<b>25.2</b>	<b>22.1</b>	<b>24.5</b>	<b>24.0</b>	<b>26.2</b>
<i>Growth</i>	111.9%	(12.3%)	10.5%	(2.0%)	9.2%

Balance Sheet (\$m)	2017a	2018a	2019e	2020e	2021e
Cash	21.4	27.7	28.4	41.8	56.9
Inventory	31.0	31.6	37.9	40.4	43.9
Current Receivables	20.6	29.8	32.7	34.9	37.9
PPE	12.0	12.5	14.0	14.7	15.5
Intangibles	140.4	146.4	150.6	151.6	153.9
Other	0.0	0.0	0.0	0.0	0.0
<b>Total Assets</b>	<b>232.7</b>	<b>254.3</b>	<b>270.0</b>	<b>289.7</b>	<b>314.4</b>
Current Payables	36.6	46.3	45.5	48.5	52.7
ST Debt	0.0	0.0	0.0	0.0	0.0
LT Debt	0.0	0.0	0.7	0.0	0.0
Provisions	7.7	7.8	10.1	10.7	11.6
Other	52.8	52.4	51.6	54.6	58.8
<b>Total Liabilities</b>	<b>67.7</b>	<b>66.2</b>	<b>68.3</b>	<b>71.3</b>	<b>76.4</b>
<b>Net Assets</b>	<b>165.0</b>	<b>188.1</b>	<b>201.7</b>	<b>218.4</b>	<b>238.1</b>
Equity & Reserves	105.9	107.0	101.3	101.1	102.5
Retained Profits	59.1	81.0	100.4	117.2	135.6
<b>Shareholders' Equity</b>	<b>165.0</b>	<b>188.1</b>	<b>201.7</b>	<b>218.4</b>	<b>238.1</b>
Minorities	0.0	0.0	0.0	0.0	0.0
<b>Total Equity</b>	<b>165.0</b>	<b>188.1</b>	<b>201.7</b>	<b>218.4</b>	<b>238.1</b>

Cashflow (\$m)	2017a	2018a	2019e	2020e	2021e
EBITDA	75.7	70.6	78.8	81.5	87.4
Net Interest	(0.8)	(0.5)	0.5	1.0	1.3
Tax	(1.5)	(22.6)	(20.8)	(15.9)	(17.6)
Δ in Working Capital	2.2	(0.1)	(10.1)	(1.7)	(2.3)
Other	14.4	0.8	2.2	0.6	0.9
<b>Operating Cash Flow</b>	<b>89.9</b>	<b>48.2</b>	<b>50.6</b>	<b>65.5</b>	<b>69.6</b>
<i>Growth</i>	86.5%	(46.4%)	5.0%	29.3%	6.2%
Capex	(23.7)	(22.0)	(24.6)	(24.9)	(27.0)
Acquisitions	0.0	0.0	0.0	0.0	0.0
Divestments	0.0	0.0	0.0	0.0	0.0
Other	0.0	(0.5)	0.0	0.0	0.0
<b>Investing Cash Flow</b>	<b>(23.7)</b>	<b>(22.5)</b>	<b>(24.6)</b>	<b>(24.9)</b>	<b>(27.0)</b>
Equity Raised	0.0	0.0	0.0	0.0	0.0
Dividends Paid	(17.7)	(19.6)	(26.7)	(26.5)	(27.5)
Net Borrowings	(26.9)	0.0	1.4	(0.7)	0.0
Other	0.0	0.0	0.0	0.0	0.0
<b>Financing Cash Flow</b>	<b>(44.7)</b>	<b>(19.6)</b>	<b>(25.3)</b>	<b>(27.2)</b>	<b>(27.5)</b>
FX / Non Cash Items	0.0	0.1	0.0	0.0	0.0
<b>Change in Cash</b>	<b>21.6</b>	<b>6.3</b>	<b>0.7</b>	<b>13.4</b>	<b>15.1</b>
<b>Free Cash Flow</b>	<b>51.9</b>	<b>26.2</b>	<b>38.3</b>	<b>53.0</b>	<b>56.1</b>

Valuation Summary	
Current Mkt Capitalisation	570.2
Shares on Issue	178.2
Last Price	3.20
<b>12 Mth Target Price</b>	<b>3.68</b>
Total Estimated 12 Mth Return	19.7%
12 Mth Fwd Capital Return	15.0%
12 Mth Fwd Dividend Yield	4.7%

Valuation Ratios	2017a	2018a	2019e	2020e	2021e
<b>EPS (Underlying) (¢)</b>	<b>25.2</b>	<b>22.1</b>	<b>24.5</b>	<b>24.0</b>	<b>26.2</b>
<i>Growth</i>	111.9%	(12.3%)	10.5%	(2.0%)	9.2%
<b>P/E (x)</b>	<b>12.7x</b>	<b>14.5x</b>	<b>13.1x</b>	<b>13.4x</b>	<b>12.2x</b>
Small Industrials (ex Fin's)	16.5x	19.3x	17.2x	15.6x	19.3x
Premium / (Discount)	(23.2%)	(25.1%)	(24.2%)	(14.5%)	(36.6%)
<b>EV/EBITDA (x)</b>	<b>7.4x</b>	<b>7.9x</b>	<b>7.1x</b>	<b>6.8x</b>	<b>6.4x</b>
Small Industrials (ex Fin's)	11.0x	11.0x	11.8x	10.7x	9.9x
Premium / (Discount)	(33.0%)	(28.2%)	(40.0%)	(35.9%)	(35.8%)
<b>DPS (¢)</b>	<b>13.0</b>	<b>12.5</b>	<b>13.9</b>	<b>14.8</b>	<b>16.2</b>
<i>Growth</i>	116.7%	(3.8%)	11.1%	6.3%	9.6%
Yield (%)	4.1%	3.9%	4.3%	4.6%	5.1%
Payout Ratio (%)	51.5%	56.4%	56.8%	61.6%	61.8%
Franking (%)	100.0%	100.0%	100.0%	100.0%	100.0%
NTA	24.6	41.7	51.1	66.8	84.2
NTA/Share (\$)	0.14	0.23	0.28	0.37	0.47

Performance Ratios	2017a	2018a	2019e	2020e	2021e
ROA	19.2%	15.7%	16.3%	14.9%	15.0%
ROE	27.1%	21.2%	21.9%	19.8%	19.8%
ROIC	31.6%	25.2%	21.6%	24.0%	25.5%
Net Debt (Cash) (\$m)	(21.4)	(27.7)	(27.7)	(41.8)	(56.9)
Net Debt/EBITDA (x)	(0.3x)	(0.4x)	(0.4x)	(0.5x)	(0.7x)
ND/(ND + Equity) (%)	(14.9%)	(17.3%)	(15.9%)	(23.7%)	(31.4%)
Interest Cover (x)	84.6x	76.9x	134.0x	119.7x	86.3x
Working Capital	(1.0)	8.0	15.9	16.9	18.4
Working Capital/Sales (%)	(0.5%)	3.5%	6.2%	6.4%	6.5%

Cash Flow Metrics	2017a	2018a	2019e	2020e	2021e
<b>FCF/Share (\$)</b>	<b>0.29</b>	<b>0.15</b>	<b>0.22</b>	<b>0.30</b>	<b>0.31</b>
Price/FCPS (x)	10.9x	21.7x	14.9x	10.8x	10.2x
Free Cash Flow Yield (%)	9.2%	4.6%	6.7%	9.3%	9.8%
Gross Cash Conversion	103.1%	101.2%	90.7%	99.8%	99.7%
Capex/Sales (%)	(10.5%)	(9.6%)	(9.7%)	(9.5%)	(9.5%)
Capex/Depreciation (x)	1.7x	1.3x	1.3x	1.1x	1.1x

Margins	2017a	2018a	2019e	2020e	2021e
EBITDA	33.5%	30.7%	30.9%	31.0%	30.7%
EBIT	27.2%	23.5%	23.5%	22.1%	22.3%
NPAT	19.8%	17.3%	17.3%	16.4%	16.6%

Valuation Methodology	2017a	2018a	2019e	2020e	2021e
WACC (%)					10.0%
Discounted Cash Flow Valuation					3.44
Sum-of-the-Parts Valuation					0.000
Average Valuation					3.44
<b>12 Mth Target Price</b>					<b>3.68</b>

**RESEARCH & SALES RESPONSIBILITIES**
**Equities**

Simon Scott	Head of Equities	+612 8288 5418
Elliot Leahey	Operations Manager	+612 8288 5402
Jack Dyson	Desk Assistant	+612 8288 5401
Jacqui Irons	Corporate Broking	+612 8288 5427

**Equities Sales & Trading**

Ian McKenzie		+612 8288 5404
Bryan Johnson		+612 8288 5412
Jason Bailey		+612 8288 5403
Andrew Harvey		+612 8288 5428
Sam Clark		+612 8288 5410
Mitchell Hewson - <i>Head of Execution</i>		+612 8288 5417
Aaron Payne - <i>Real Estate</i>		+612 8288 5405

**Equities Research**

<b>Real Estate</b>	
Hamish Perks	+612 8288 5419
Edward Day	+612 8288 5424
Ronan Barratt	+612 8288 5426
<b>Industrials</b>	
Sean Kiriwan	+618 6555 8602
Sarah Mann	+612 8288 5407
Brendon Kelly	+612 8288 5413
Tom Tweedie	+612 8288 5423

email: [firstname.lastname@moelisaustralia.com](mailto:firstname.lastname@moelisaustralia.com)

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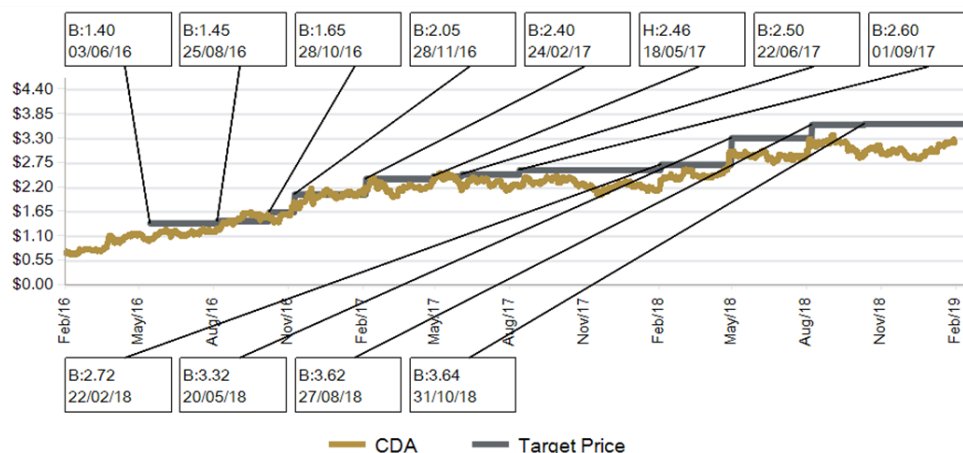
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**Distribution of Ratings as at 20 February 2019**

SELL	HOLD	BUY
6.8%	39.0%	52.5%

**Rating and Price Target History: Codan Limited (CDA) as of 19/02/2019**


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