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Codan Limited (CDA)

Outperform

1H19 Result - 2H pipeline remains strong

\$3.20

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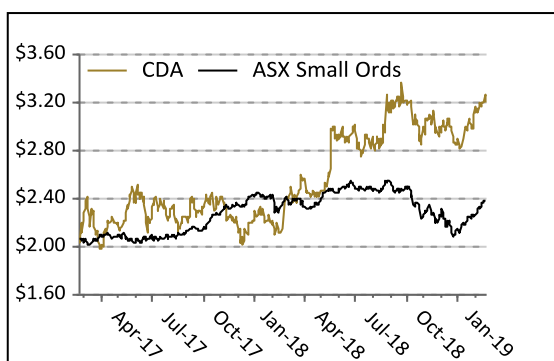
Summary (AUD)

Market Capitalisation	\$570.2
Share Price	\$3.20
52 week low	\$1.965
52 week high	\$3.115
Ave Monthly Vol (year rolling)	4.367M

Key Financials (AUD)

Year End (\$m)	1H19 Act.	FY19 Est.	FY20 Est.
Revenue	128.4	259.9	259.9
EBIT	30.7	60.6	51.7
NPAT Adj.	22.4	44.0	38.0
EPS (c)	12.6	24.7	21.3
PE Ratio (x)	n/a	13.0	15.0
DPS (c)	6.5	15.5	13.0
Div Yield	n/a	4.8%	4.1%
Franking	100.0%	100.0%	100.0%
EV	557.2	549.3	539.4
EV/EBITDA (x)	n/a	7.2	7.6
EV/EBIT (x)	n/a	9.1	10.4
ROE	n/a	22.3%	17.8%
EBIT Margin	23.9%	23.3%	19.9%
Payout Ratio.	51.7%	62.8%	60.9%

Share Price Graph (AUD)



Trading Update

Delivery of major tactical communications projects and a surge in GPZ 7000 sales from new market entries generated 40% growth in net profit during 1H19 (\$22.2m vs. \$15.8m). Strong demand across core metal detectors provided confidence for CDA to invest in select inventory positions ahead of the peak African winter season. This resulted in a significant drag to cashflows for the period. In line with historical trends, we would expect a material reduction in working capital during 2H. This should position the Group with \$20m cash as at FY19, even after a significant investment in product development through the period.

2H pipeline remains strong. The pipeline for 2H19 remains very strong across both Metal Detection and Tactical Communications. Reliance on the GPZ 7000 in the gold division is diminishing, and sales of both the SDC 2300 and Gold Monster remain firm. The Equinox (servicing coin and treasure market) continues to generate orders from dealers that historically stocked competitor products. Combined, this is improving the sustainability of the metal detection division sales. Despite this positive mix change, management is yet to increase its assessment of base level sales in this segment. Ongoing product delivery across Tactical Communications has provided for a good mixture of open projects across higher margin Africa and Central Asia, as well as lower margin APAC. As a consequence, margin and earnings from Tactical Communications should be much stronger than pcp during 2H19. Providing Tracking Solutions contracts fall in the next 4-mths (in line with management's guidance), we would expect 2H19 NPAT to be broadly in line with 1H19. To this end, we are forecasting FY19 NPAT of \$44m.

1H20 has a difficult comparison. For the reasons highlighted above, we expect 1H20 NPAT will revert back to typical 1H levels (TC est. \$15.3m). Our forecasts assume little cumulative benefits from growth projects until FY21. We do not expect commercialisation of the GPZ 2 until late FY21. On this basis, we are forecasting FY20 NPAT of \$38m (13.6% decline on FY19e). *The Gantt chart on p. 2 provides our est. timeframes of cumulative sales benefits from growth project & key updates.*

Valuation & Recommendation

CDA trades at 13x our FY19e EPS (on a reported basis) or 19x FY19e upper end 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; (6) Earnings growth opportunities ahead of the Group; and (7) is largely uncorrelated to Australian economy. In our view, CDA should trade in line with the S&P Small Ordinaries NTM EPS multiple of 16.6x, adjusting for surplus cash and the current value of future special dividends. On this basis we arrive at a valuation of \$3/ps on a FY19/FY20 basis. *Detailed workings provided on p 3.*

We acknowledge that 1H19 presents a difficult comparison during 1H20. Coupled with potential 2H weighting of CAT originated sales, this may disappoint some shareholders, and present a buying opportunity for those with a longer investment horizon. **In maintaining our OUTPERFORM recommendation,** we are looking through this potential short-term reported earnings reduction during FY20; focusing on the transformational opportunity ahead with CAT, and supportive growth projects across Radio Communications and Metal Detection.

Expected Timing of Growth Projects (TC estimates)

Growth Project Timing	1Q19	2Q19	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20	1Q21	2Q21	3Q21	4Q21	1Q22	2Q22	3Q22	4Q22	1Q23	2Q23	3Q23	4Q23
Radio Communications (LMR end-to-end solution)	Development				\$5m Sales p.a.		\$15m Sales p.a.		\$22.5m Sales p.a.				\$30m Sales p.a.							
Radio Communications (Expansion HF Radio Range) ¹	Sales Cycle		First Contracts		Ongoing Contract Wins				\$10m Sales p.a.				\$15m Sales p.a.							
Minetec/Tracking Solutions (CAT + existing business)	CAT Integration		First Contracts		\$20m Sales p.a.		\$30m Sales p.a.				\$40m Sales p.a.				\$50m Sales p.a.					
Minelab (Stage 1 Multi-Frequency Tech) ²	Development			\$10m Sales p.a.																

¹ Estimates remain conservative on the basis that legacy HF Radio business is becoming more competitive. On this basis, we have omitted incremental earnings from these sales.

² Only included estimates of announced extended Equinox product range. It is possible a refresh of one legacy recreational detector will occur yearly for the foreseeable future.

Key Growth Project Updates

Scaling Minetec through Caterpillar (“CAT”) partnership

- Completed first phase of software integration with CAR Minestar, and should soon be included as a standard product in the CAT catalogue. The products will then become visible to all CAT dealers’, allowing them to transact on system as opposed to using current workaround.
- Freeport Grassberg (Indonesia) - Order expected to be converted before end of FY19. *Included by CDA in FY19 Tracking Solution forecasts.*
- Newmont Tanami (NT) – Trials undertaken through 1H19 are proving that the equipment and capabilities work. This continues to be commissioned with a commitment from Newmont to buy the product when it is completed. *Included by CDA in FY19 Tracking Solution forecasts.* A possibility exists to expand services through other parts of the Tanami mine and other mines with the Group.
- BHP Olympic Dam (SA) – Direct contract independent of CAT. Secured more orders in the past few months on top of the original hardware deployment. Scope remains confident that further opportunities will present to expand capabilities across the rest of the mine.

Development of end-to-end solution in land mobile radio (“LMR”)

- Development continues, key capabilities/release remains 12-mths away.

Valuation & Recommendation

Commentary at the 1H19 result indicated that ongoing demand for the Gold Monster, SDC 2300 and Equinox has exceeded management's expectations. New markets have opened in respect of the gold detector business, albeit they remain immaterial in respect to West Africa. Combined with a strong Tactical Communications pipeline, expanding product range servicing more lucrative contracts and addressable market, we think base level NPAT assumptions of \$25-\$30m p.a. is too conservative. On this basis, for the purpose of our valuation (based on maintainable earnings) we have utilised the upper end of this guidance range.

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Base level NPAT	FY19E	FY20E	FY21E	FY22E	FY23E
Current (upper end)	30.0	30.0	30.0	30.0	30.0
<i>Growth Projects</i>					
- Minelab	-	-	2.5	2.5	2.5
- Radio Communications (LMR)	-	-	2.5	3.9	5.3
- Minetec	-	-	4.1	6.9	9.7
TOTAL	30.0	30.0	39.1	43.3	47.4
EPS (c)	16.8	16.8	22.0	24.3	26.6
EPS growth on FY19	0.0%	0.0%	30.4%	44.4%	58.1%
PE Ratio (x)	19.0	19.0	14.6	13.2	12.0
Valuation 16.6x EPS	2.79	2.79	3.64	4.04	4.42
Implied value of special div. FY18-FY20	0.09	0.02	-	-	-
Surplus cash on hand	0.12	0.17	0.25	0.30	0.35
Fair value on base level est.	3.00	2.99	3.89	4.33	4.77
CDA share price	3.20	3.20	3.20	3.20	3.20
Valuation Upside	-6.3%	-6.6%	21.7%	35.4%	49.0%

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