AUSTRALIAN

RESEARCH

INDEPENDENT INVESTMENT RESEARCH

# Codan Limited (ASX: CDA)

1H17 Results

March 2017

INDEPENDENT
INVESTMENT RESEARCH

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# Codan Limited (ASX: CDA)

1H17 Results

| Investment Profile | |
|---|---|
| Share price ($) as at 7 March 2017 | 2.37 |
| **Target price ($) per share** | **2.24** |
| Issued capital: | |
| Ordinary shares (M) | 177.3 |
| Options (M) | 0.0 |
| Performance Rights (M) | 2.6 |
| Fully Diluted (M) | 179.8 |
| Market capitalisation ($M) | 420.1 |
| 12-month Share Price Low/High ($) | 0.69/2.45 |

**Board and Management**

David Simmons: Chairman

Donald McGurk: Managing Director & Chief Executive Officer

Kathy Gramp: Independent Director

Lt-Gen Peter Leahy AC: Independent Director

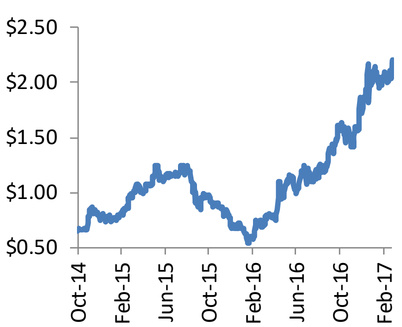
Jim McDowell: Independent Director

Graeme Barclay: Independent Director

| Major Shareholders | % |
|---|---|
| Ian Wall | 9.8 |
| P. Wall | 9.8 |
| Brian Burns | 7.0 |
| Starform Pty Ltd | 6.4 |
| David Uhrig | 5.0 |
| **Top 20 Shareholders** | **54.7** |

Source: IRESS

**Share Price**




## GPZ 7000 DELIVERS

CDA outperformed across all its business units in 1H17, with the Minelab division delivering returns above expectations on improved sales of the GPZ 7000. The company has continued to deliver earnings growth since the significant decline in earnings experienced in FY14 after the unprecedented increase in FY13 on the back of a 'gold rush' in Africa. With the company forecasting net profit of ~$35m for FY17, the company is in sight of FY13 earnings.

## KEY POINTS

**1H17 Result:** The company delivered revenue growth of 59.9% on the pcp to $103.9m and NPAT growth of 265% to $22.2m. Earnings was up across all three divisions with the Tracking Solutions division delivering its maiden profit. The sale of higher priced products saw the company deliver significantly improved margins for 1H17, with sales of the GPZ 7000 gold detector a key driver. On the back of the improved earnings, the company announced an interim dividend of 3 cents per share, a 50% increase on the previous interim dividend. In addition to the interim dividend, the company announced the payment of a special dividend of 3 cents per share, taking the total interim dividend payment to 6 cents per share.

**Radio Communications Division Beats Expectations:** The Radio Communications division delivered revenues of $35m for 1H17, a 20% increase on the pcp. Land Mobile Radio (LMR) products softened after the strong FY16, however High Frequency Radio (HFR) products made up for the softer demand in LMR. HFR revenue was boosted by the delivery of the US$7.9m military contract announced in March 2016, the majority of which was realised in the 1H17. Despite the strong 1H17, we remain cautious of the 2H17 given the lumpy nature of revenues for this division. With the release of upgraded LMR products in FY18, we expect demand to improve in the new financial year. The company is well placed to take advantage of the increasing unrest around the world.

**Minelab Division Growth Driven by GPZ 7000:** Minelab remains the largest division and was a key driver of earnings growth. After a sleepy start to the launch of the GP 7000 gold detector in Africa, sales improved significantly in 1H17. The improved volumes of the GPZ 7000 also resulted in improved margins. There has been no 'gold rush' driving sales as was the case in FY13. Improved volumes are attributed to consumers replacing their GPX metal detectors. The slow take up is attributed to the significant price difference between the GPX detectors and the GPZ 7000. Of significance is there are no counterfeit products on the market, which has been an issue for the company in the past.

**Tracking Solutions Division (previously Minetec division):** The Tracking Solutions division reached a significant milestone, posting its maiden profit in 1H17. The turnaround in the mining sector has generated interest in the product suite with the company securing a $1m contract during the period, adding to a number of operating mines in which the product suite is used. The goal for this division is to implement a sales strategy to scale up the business.

**Capital Position:** The company used the additional operating cash to pay down a significant portion of its debt over the period resulting in the company being in a net cash position at 31 December 2016. We expect the company to repay the remaining debt in the 2H17. Given the strong cashflow the company decided to reduce the debt facility from $85m to $55m. The debt facility remains undrawn and therefore available to fund growth opportunities.

**Valuation:** We have revised our target price for CDA up to **$2.24** from $1.56 per share in our report published in August 2016. This represents a 5.5% discount to the share price at 7 March 2017. The revised target price comes on the back of the company surpassing expectations in the 1H17. We view the improved earnings to be reflected in the current share price, with the company surpassing our target price. We are expecting the momentum of GPZ 7000 sales to continue in the 2H, given this is typically the stronger half for Minelab sales. There is the risk that the rate of replacement slows, however with new markets in Africa opening up for the product, we view the risk to be to the upside for this division. We remain cautious with respect to the Radio Communications division, with the majority of the HFR contract realised in 1H17 and the upgraded LMR product suite not due to be released until FY18.

| PROFIT & LOSS ($M) | | | |
|---|---|---|---|
| **Y/E June** | **2015A** | **2016A** | **2017F** |
| Revenue | 143.9 | 169.5 | 215.4 |
| **EBITDA** | **29.9** | **41.9** | **60.3** |
| Depreciation & Amortisation | -10.6 | -13.0 | -14.1 |
| Finance Cost | -2.5 | -1.7 | 0.3 |
| **Profit Before Tax** | **16.8** | **27.5** | **46.5** |
| Tax Expense | -4.1 | -6.4 | -11.6 |
| **Net Profit (Underlying)** | **12.7** | **21.1** | **34.9** |
| One-off Items | - | -5.6 | 0 |
| **Net Profit (Reported)** | **12.7** | **15.5** | **34.9** |

| BALANCE SHEET ($M) | | | |
|---|---|---|---|
| **Y/E June** | **2015A** | **2016A** | **2017F** |
| Cash and cash equivalent | 7.2 | 14.3 | 13.9 |
| Trade and other receivables | 20.4 | 19.1 | 24.3 |
| Inventories and work in progress | 31.3 | 28.5 | 34.5 |
| Current tax receivables | 0.5 | 0.3 | 0.3 |
| Other current assets | 1.6 | 6.5 | 6.5 |
| **Total current assets** | **61.0** | **68.7** | **79.4** |
| Property, plant and equipment | 16.0 | 10.8 | 29.8 |
| Intangible assets | 89.3 | 87.6 | 78.6 |
| Research and development | 42.4 | 45.3 | 46.7 |
| **Total non-current assets** | **147.7** | **143.8** | **155.1** |
| **Total Assets** | **208.7** | **212.5** | **234.5** |
| Trade and other payables | 25.2 | 30.4 | 38.7 |
| Borrowings | 0.0 | 0.0 | 0.0 |
| Current tax liabilities | 0.1 | 2.2 | 11.6 |
| Provisions | 6.7 | 6.6 | 6.9 |
| **Total Current Liabilities** | **32.0** | **39.2** | **57.2** |
| Trade and other payables | 0.0 | 0 | 0 |
| Borrowings | 42.5 | 26.9 | 0.0 |
| Deferred tax | 5.2 | 6.8 | 6.8 |
| Provisions | 0.6 | 0.6 | 1.1 |
| **Total Non-Current Liabilities** | **48.3** | **34.3** | **7.9** |
| **Net Assets** | **128.4** | **138.9** | **169.4** |

| CASHFLOW ($M) | | | |
|---|---|---|---|
| **Y/E June** | **2015A** | **2016A** | **2017F** |
| PAT | 12.7 | 15.5 | 34.9 |
| Adjustments for non-cash items | 14.6 | 28.8 | 19.3 |
| Change in Working Capital | 3.7 | 7.6 | 7.7 |
| **Net Cash from Operation Activities** | **30.7** | **47.9** | **62.0** |
| Payments for entities and businesses, net of cash acquired | 0 | -1.6 | 0.9 |
| Payments for property, plant and equipment | -3.5 | -4.7 | -6.5 |
| Payments for intangible assets | -2.4 | -0.2 | 0.0 |
| Payments for capitalised product development | -12.9 | -12.0 | -12.0 |
| Proceeds on disposal of businesses and property, plant and equipment | 0.0 | 0.0 | 0.0 |
| **Net Cash from Investing** | **-13.4** | **-18.1** | **-17.5** |
| Proceeds from borrowings | 0 | 0 | 0 |
| Repayments of borrowings | -17.9 | -15.5 | -27.0 |
| Dividends paid to ordinary shareholders | -5.3 | -7.1 | -17.9 |
| Proceeds from share issue | 0 | 0 | 0 |
| **Net Cash from Financing** | **-23.2** | **-22.6** | **-44.9** |
| Cash at Beginning of the Year | 13.0 | 7.2 | 14.3 |
| FX Effect | 0.1 | 0.0 | 0.0 |
| Net Change in Cash | -6.0 | 7.1 | -0.5 |
| **Cash at End** | **7.2** | **14.3** | **13.9** |

| Ratios | | | |
|---|---|---|---|
| | **FY15A** | **FY16A** | **FY17F** |
| **Profitability Ratios** | | | |
| EBITDA margin (%) | 20.8% | 24.7% | 28.0% |
| Net profit margin (%) | 8.9% | 9.1% | 16.2% |
| ROA (%) | 6.1% | 7.4% | 15.6% |
| ROE (%) | 9.9% | 11.6% | 22.6% |
| Diluted EPS | 7.1 | 11.8 | 19.4 |
| DPS | 3.5 | 6.0 | 9.8 |
| **Liquidity & Debt Ratios** | | | |
| Net Debt to Equity (%) | 27.5% | 9.1% | -8.2% |
| Current Ratio (x) | 1.9x | 1.8x | 1.4x |

## 1H17 RESULTS

- The company delivered strong revenue and earnings growth in 1H17, above our expectations. Revenue improved 59.9% on the pcp to $103.9m and NPAT was up 264.6% to $22.2m.
- All segments improved on the 1H16, with the company reaching a significant milestone of reporting a profit for the Tracking Solutions division.
- The Gross Profit Margin improved 7.1% on the back of improved sales of higher priced products, in particular the GPZ 7000 gold detector. This flowed through to the EBITDA level, which saw a significant improvement in margins.
- The company's operating cashflow increased to $30.9m in 1H17, up from $4.3m in 1H16. The company took the opportunity to pay down a significant portion of debt. The company also reduced its debt facility from $85m to $55m. The facility is currently undrawn and therefore available to fund growth opportunities.
- As a result of the improved earnings, the company increased its interim dividend from 2 cents per share to 3 cents per share. In addition to the interim dividend the company will be paying a special dividend of 3 cents per share, taking the total interim dividend to 6 cents per share, a 200% increase on the 2016 interim dividend.

| Headline Result | | | |
|---|---|---|---|
| | 1H16 | 1H17 | % Change |
| Revenue ($m) | 65.0 | 103.9 | +59.9% |
| Gross Profit ($m) | 35.4 | 63.9 | +80.6% |
| Gross Profit Margin | 54.5% | 61.6% | +7.1% |
| EBITDA ($m) | 7.7 | 30.1 | +290.9% |
| EBITDA Margin | 11.8% | 29.0% | +17.2% |
| Profit Before Tax ($m) | 6.9 | 29.8 | +331.5% |
| Net Profit ($m) | 6.1 | 22.2 | +264.6% |
| EPS | 3.4 | 12.4 | +264.7% |
| DPS | 2.0 | 6.0 | +200.0% |
| Dividend Payout Ratio | 58.8% | 48.4% | -10.4% |

### DIVISIONAL PERFORMANCE

**Radio Communications Division**

| Radio Communications Division | | | |
|---|---|---|---|
| | 1H16 | 1H17 | % Change |
| Revenue | 29.0 | 35.0 | +20.4% |
| Segment Contribution | 7.9 | 9.8 | +23.8% |
| Contribution Margin | 28.0% | 27.2% | -0.8% |

- The Radio Communications division continued on from its strong FY16 in the 1H17, with revenue up 20.4% to $35m on the pcp. After a strong FY16 ,on the back of the release of new products, demand for Land Mobile Radio (LMR) products softened, however revenue for High Frequency Radio (HFR) products improved.
- HFR revenue was boosted by the delivery of HFR equipment to a military customer in the Middle East. This US$7.9m contract was announced by the company in March 2016 and the majority of the contract was realised in 1H17.
- LMR demand appears to have been impacted by the political instability in North America. However, the company sees the potential for significant upside given that President Trump has indicated that additional resources will be focused on security forces. The company previously indicated that it was to spend ~$5m in FY17 on the development of an upgraded LMR product suite. The development of these products is on track and will be launched in FY18.

- In January, the company announced that it had entered into an agreement to acquire the IP and tooling for the 9300 range of military tactical antennas from Stealth Telecom FZC for US$700,000. The acquisition is intended to support the latest product launches to the global military market.
- The company is well placed to take advantage of increasing tensions throughout the globe. While we recognise the division has had a strong 1H17, we are cautious about the 2H17. Revenue for the division can be lumpy with revenues contract dependent. The company will realise another portion of revenue from the military contract in 2H17 and then we expect the launch of the upgraded LMR products to stimulate demand in FY18.

**Minelab Division**

| Minelab Division | | | |
|---|---|---|---|
| | 1H16 | 1H17 | % Change |
| Revenue | 33.6 | 64.8 | +92.9% |
| Segment Contribution | 8.0 | 28.4 | +256.3% |
| Contribution Margin | 23.7% | 43.9% | +20.2% |

- The Minelab division delivered growth well above expectations with revenue growth of 93%in 1H17 to $64.8m and a segment contribution of $28.4m, up 256% on the pcp.
- Revenue growth was largely driven by sales of the GPZ 7000 in Africa. After a slow 12-months after the launch of the product in Africa, sales have gained momentum. The company attributes the improved sales due to the upgrade by those consumers who own GPX detectors. The GPZ 7000 gold detector is a significantly more expensive product and therefore consumers will take time with replacing existing products, however this replacement process seems to be gaining momentum. The company stated some new markets have opened up in Africa, which is also driving improved sales.
- The company has stated that there are currently no counterfeit products on the market which is also assisting sales. The company went to great lengths to reduce the ability of the GPZ 7000 to be replicated, given the company has been severely adversely impacted by counterfeit products historically.
- GPZ 7000 sales were also the primary contributor to the improved margins, with the product offering significantly greater margins than other product lines. Given the price of the GPZ 7000, the company is achieving improved earnings from significantly reduced volumes.
- There remains significant sales potential from the GPZ 7000 in the event consumers continue to upgrade their equipment, with the number of GPZ 7000's in the market believed to be less than 10% of the number of GPX detectors.
- The company released a large coil accessory for the GPZ 7000 during the period, which is designed to increase the depth of the reading of the detector by 20%-25%. The coil sells for ~$1500-$2000. The company believes that it will take time for the market to get comfortable with the product before sales volumes become significant, in a similar fashion to the GPZ 7000 sales profile.
- The company is looking to release a new entry level product 'Gold Monster' in the 2H17 that is expected to sell for under US$1,000. The company has created the product to be superior to competing products in the entry level gold detector market. While this will not likely have a significant impact on revenue, it will allow the company to increase its market share at this lower price point.
- The Countermine business continues to develop new technology to assist military and humanitarian operations. The division was awarded a $6.5m contract from the Australian Department of Defence for the development of a dual-sensor detector, which incorporates both metal detection and ground penetrating radar to assist with detecting and clearing land mines. This product will be delivered in FY19.
- With 2H sales typically stronger than 1H sales, we are expecting the Minelab division to generate greater than typical sales for FY17.

**Tracking Solutions Division (previously Minetec division)**

| Tracking Solutions | | | |
|---|---|---|---|
| | 1H16 | 1H17 | % Change |
| Revenue | 2.3 | 4.1 | 78.2% |
| Segment Contribution | -1.3 | 0.4 | 71.5% |
| Contribution Margin | na | 9.0% | 100% |

- The Tracking Solutions division posted its maiden profit in 1H17, which is a significant milestone for the business.
- The mining sector appears to have bottomed and is starting to recover which is giving companies confidence in pursuing capital spend. This is highlighted by the interest that has been shown in the Tracking Solutions division products.
- In out last update published in August 2016, the company had their products deployed in six operating mines. The company added another operating mine in the period.
- Minetec will be focusing on hard rock underground mines in Australia and South Africa. In October 2016, Minetec won a $1m contract with PYBAR Mining Services Pty Ltd for the delivery of high precision tracking, visualisation and task management for the Carrapateena copper/gold exploration project in South Australia, which is owned by OZ Minerals. PYBAR have been contracted to construct the 7.5km decline and associated ground infrastructure. This was in addition to the $1.8m contract secured in August 2016 for the underground tracking technology at a Western Australian mine.
- While the division has had its struggles on the back of the downturn in the mining industry, we continue to believe that this division will be a valuable contributor to the company in the future. It is difficult to forecast how quickly the growth will occur, as it is highly dependent on the successful implementation of the sales strategies.

## VALUATION

- We have revised our target price up to **$2.24** per share from $1.54 per share in our last report published in August 2016. With the company trading at $2.37 per share at 7 March 2017, we view the FY17 earnings improvement to be factored into the share price.
- The target price is based on a PE ratio of 11.6x, a 25% discount to the S&P/ASX Small Industrials average PE. Given the improved consistency in earnings we have reduced the discount we apply to the Small Industrial PE from 30% to 25%. The discount represents the risks associated with future earnings.
- The uplift in the target price largely reflects improved sales in the Minelab division on the back of strong sales in the 1H17. Given the improved GPZ 7000 sales we are also expecting the EBITDA margin to improve to 28% for FY17, compared to our previous forecast of 24%.
- We are forecasting FY17 NPAT of $34.9m, an improvement from the previous forecast of $22.2m and a dividend payout ratio of 50% which implies a final dividend of 3.8 cents per share.

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