Stock Focus

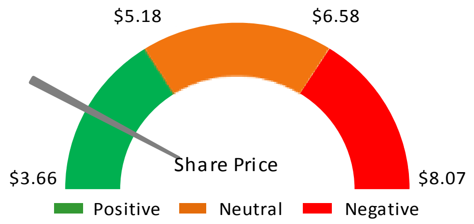
The Citadel Group (CGL)

EVANS & PARTNERS

Tuesday, 31 May 2016

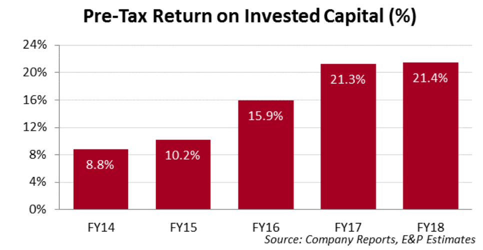
KAPISH EXPANDS CGL'S "KNOW-HOW" OF KNOWLEDGE MGMT

Recommendation: Positive

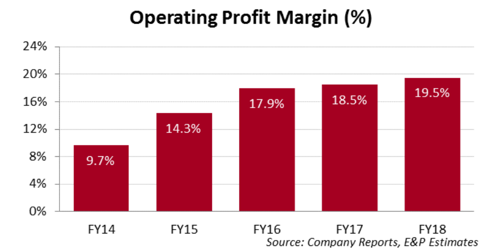


Trading Data

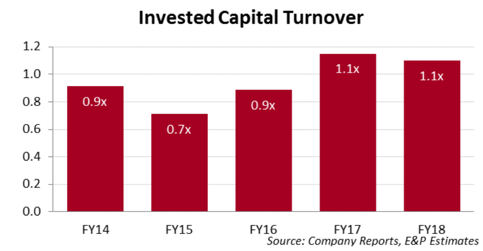
Last Price	$4.40
12 month range	$3.60 - $4.94
Market Cap	$206m
Free Float	$113m (55%)
12 month return (historical)	21.8%



The step up in ROIC is driven by i) increased skew towards higher margin managed service contracts and ii) the consolidation of PJAS.



Adding to the earnings profile is anticipated group operating margin expansion, in particular across Technology managed service contracts.



ACQUISITION & CONTRACT WINS

CGL provided an update on organic growth initiatives; along with complementary M&A across the group's core Technology segments. CGL announced:

i. The acquisition of 'Kapish', an Australian software and services company specialising in document and records management solutions. The deal is expected to be earnings accretive pre-synergies (4.4x FY17 EV/EBITDA) and a bolt on to CGL's current capabilities, deepening CGL's skillset and expanding market share.
ii. An increased stake in 'filosoph-e' to 50%. CGL aims to overlay its value-add security and assurance offering and further develop new "cloud first" offerings.
iii. Health contract renewal with Pathology North, including the delivery of new capabilities such as blood management (e-Blood). CGL Health continues to expand its presence within the sector, delivering mission critical services.
iv. New Technology contract wins with law enforcement agencies, while being shortlisted for a number of larger contracts.

WHAT'S CHANGED?

Incorporating Kapish and accounting for new contract wins/renewals, we revise FY17/18e EBITDA by +15-18% and EPS +20-22%. Our FY16 EBITDA/EPS forecasts are adjusted 3-4% lower on expected weakness within VET (Education earnings contribution drops to 7% in FY17). Our blended valuation rises +12% to $5.77/share.

BUILDING OUT FULLY INTEGRATED SERVICE OFFERING IN TECH & e-HEALTH

We view the 'Kapish' acquisition announcement as a complementary fit to CGL's core knowledge management offering - CGL will now have the ability to maintain and service a broader suite of offerings, while expanding market share prospects across Federal/State Governments, and other state agencies in a structural shift towards secured information environments. Positive developments in e-Health help mitigate concerns around contract renewals. The contract renewal with Pathology North in our view reflects a level of customer satisfaction in CGL investment and operational turnaround of PJA Solutions.

We stay Positive. With PJA Solutions tracking ahead of expectations and new contract wins building out CGL's recurring revenue profile, we have a greater level of confidence in management's ability to address growth opportunities over the medium term. We also maintain the view that high customer retention rates for a premium managed service offering justify a premium to listed ICT peers (c7.2x FY17 EV/EBITDA).

Earnings Forecasts: *Source: EAP Research*

Yr to June	13A	14A	15A	16E	17E	18E
EBITDA ($m)	4.7	5.6	11.6	21.2	28.8	31.5
Reported NPAT ($m)	3.0	3.7	8.0	9.1	14.9	19.4
Reported EPS (¢)	13.5	8.3	18.0	19.5	31.9	41.6
EPS Gth (%)		(38.3)	116.9	7.9	63.7	30.5
PER (x)	**32.6**	**52.9**	**24.4**	**22.6**	**13.8**	**10.6**
PEG Ratio (x)	2.1	1.0	0.7	0.5	0.8	2.0
DPS (¢)	0.0	0.0	5.8	10.0	14.0	19.0
Yield (%)	**0.0**	**0.0**	**1.3**	**2.3**	**3.2**	**4.3**
Franking (%)	0%	100%	100%	100%	100%	100%
ROE (%)		**8%**	**14%**	**15%**	**21%**	**24%**
EV/EBITDA (x)	**43.7**	**29.9**	**14.7**	**7.6**	**6.2**	**5.8**
Int. Cover (x)	(19.5)	(48.0)	(34.6)	(5.3)	(12.9)	(201.0)
Valuation (blended)						**$5.77**

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1. INITIATIVES BUILDING OUT CGL'S INTEGRATED TECH & E-HEALTH OFFERING

We view CGL's 'Kapish' acquisition as a complementary fit to its core knowledge management offering, deepening expertise and capabilities in Electronic Document Records Management Services (EDRMS). Via the acquisition of Kapish, CGL will have access to IP and applications that enhance the engagement and usability of HP Trim. We note Kapish is one of only two Australian Gold Business Partners for the HPE TRIM/Records Manager suite of document and records management solutions.

CGL's current expertise is in 'Objective' (and to a lesser extent Microsoft SharePoint), hence Kapish is a complementary fit that may be viewed as part defensive, allowing CGL to maintain the service and support for both products. Combined capabilities (including that of 'filosoph-e') expand market share prospects across Federal/State Governments, local councils and non-security state agencies in a shift to a secure Document Records Management platform.

Contract renewals in CGL Health in our view reflect a level of customer satisfaction in CGL's investment and operational turnaround of PJA Solutions, and its core AUSLAB software. Commercialisation of new services such as e-Blood also goes some way to justifying the level of investment in internally generated IP, while opening up important integrations with key industry participants, further solidifying the AUSLAB software across the health sector.

With PJA Solutions tracking ahead of expectations and new Technology and e-Health contract wins further building out CGL's recurring revenue profile, we have a greater level of confidence in management's ability to execute and address organic growth opportunities over the medium term. Fundamentally our view hasn't changed - we believe CGL's high customer retention rates across a niche and premium managed service offering justify a premium to listed ICT peers (CGL is currently trading on 6.2x FY17e EV/EBITDA vs. peers at c.7.2x).

2. EARNINGS & VALUATION

Incorporating the earnings accretive acquisition of Kapish and accounting for new contract wins/renewals across CGL's Technology segment, we revise FY17/18e EBITDA by +15-18% and EPS +20-22%. Our FY16 EBITDA/EPS forecasts are adjusted 3-4% lower on expected weakness within VET enrolments – we note our Education group earnings contribution declines to 7% in FY17e. Underlying strength across Technology and e-Health underpins our earnings forecasts and we believe remains a driver of positive earnings surprise into the medium term. Our blended valuation rises +12% to $5.77/share (DCF: $6.07, 10% WACC; EV/EBITDA: $5.69, 8.8x FY17e):

We note reported EPS will be impacted in FY16/17 due to the higher effective tax rate of c.34% on the tax treatment associated with the PJAS acquisition (unwinding of a discount on deferred consideration payments non tax deductible).

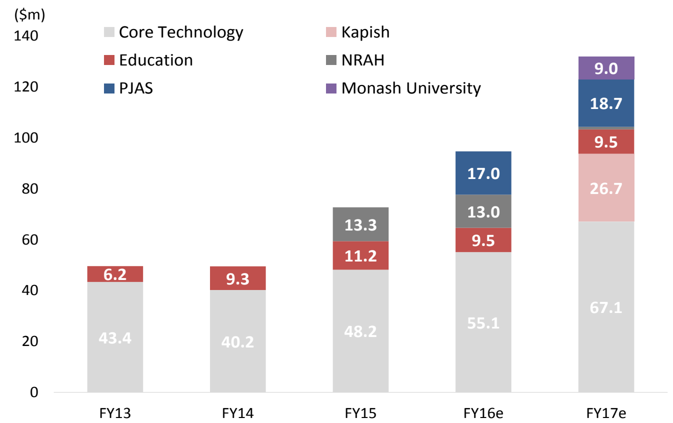
CGL **Earnings Revisions:** Source: Company data, Evans & Partners Research estimates

Metric	Sales ($m)			EBITDA ($m)			Adjusted EPS* (¢)			Reported EPS** (¢)			DPS (¢)		
Yr to June	Old	New	% Chg	Old	New	% Chg	Old	New	% Chg	Old	New	% Chg	Old	New	% Chg
2016E	95	95	(0%)	21.7	21.2	(3%)	22.1	**21.3**	**(4%)**	20.3	**19.5**	**(4%)**	10.0	10.0	0%
2017E	106	132	25%	25.2	28.8	15%	26.7	**31.9**	**20%**	26.7	**31.9**	**20%**	12.0	14.0	17%
2018E	110	138	25%	26.7	31.5	18%	34.0	**41.6**	**22%**	34.0	**41.6**	**22%**	15.0	19.0	27%
Blended Valuation				**$5.14**	**$5.77**	**12%**									

**Adjusted EPS pre the unwinding of a discount on deferred consideration payments for PJA (non-cash and non-tax deductible).*
***Reported EPS includes the unwinding of a discount on deferred consideration payments for PJA (non-cash and non-tax deductible).*

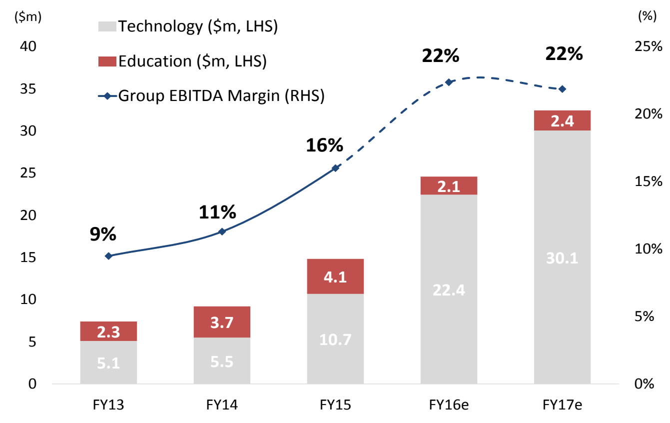
CGL Revenue by Segment and Contract ($m)

Source: EAP Research Estimates, CGL



CGL EBITDA by Segment ($m) before Corp O/H

Source: EAP Research Estimates, CGL



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3. CGL UPDATE: ACQUISITION & CONTRACT WINS

CGL today provided an update on organic growth initiatives, along with complementary M&A activities across the group's core Technology segments (secure knowledge management & e-Health). CGL announced the following:

i. The earnings accretive acquisition of 'Kapish', an Australian software and services company specialising in document and records management solutions for $17.5m and at 4.4x FY17e EBITDA.

ii. An increased its investment in 'filosoph-e', a business that focuses on secure enterprise content management, from 25% to 50%.

iii. A contract renewal in CGL's Health division, extending an agreement with Pathology North (Northern Sydney to Tweed Heads), including the delivery of new capabilities such as blood management (e-Blood). Health (PJA Solutions) is tracking ahead of expectations from the time of acquisition.

iv. CGL has been awarded new contracts with law enforcement agencies, while being shortlisted for a number of larger contracts that leverage CGL's unique IP that i) authenticates identities and ii) manages/distributes information across sensitive and secure environments.

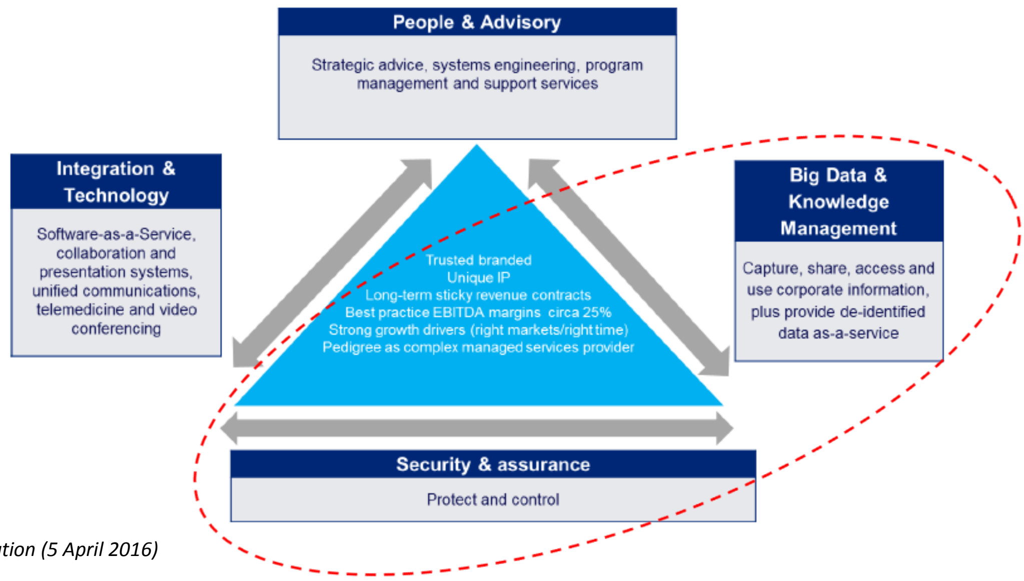
3.1 KAPISH EXPANDS CGL's EXPERTISE & MARKET SHARE OPPORTUNITY IN KNOWLEDGE MANAGEMENT

CGL's core capabilities in 'Knowledge & Information Management' have evolved through its specialisation in Electronic Document Records Management Services (EDRMS), most notably via its fully outsourced managed service offering to the Department of Defence. CGL's expertise in Knowledge Management is centred on the secure collection of large and complex data sets - including addressing the challenges for organisations to capture, manage, access, and secure documents and records from creation through to disposal.

As a direct bolt on to CGL's current capabilities, the acquisition of 'Kapish' deepens CGL's skillset and significantly expands market share opportunities across Federal and State governments, with minimal client overlap.

In Australia, the EDRMS market is dominated by 3 providers – Objective, HP Trim and Microsoft SharePoint. Kapish is one of only two Australian Gold Business Partners for the HPE TRIM/Records Manager suite of document and records management solutions, along with Optus. By way of background, CGL's current expertise is in 'Objective' (and to a lesser extend Microsoft SharePoint), hence a complementary fit that may be viewed as part defensive, allowing CGL to maintain the service and support for both products.

CGL's strategic initiatives with respect to M&A remain consistent with that outlined at IPO – leveraging complex/niche technology skillsets to consolidate and expand managed service contracts. The Kapish acquisition is a complementary fit to CGL's core Technology offering, as pictured below.



Source. Company Presentation (5 April 2016)

KAPISH OVERVIEW & STRATEGIC RATIONALE

Kapish currently has c.180 clients across local and state governments, with a high and growing proportion of annuity style revenue due to its internally developed IP that enhances the HP Trim offering.

Should HP Trim bid directly against Objective in the Department of Defence contract (which CGL currently services), CGL is well placed to deliver a fully outsourced managed service to both products.

As outlined above, in Australia, the EDRMS market is dominated by 3 providers – Objective, HP Trim and Microsoft SharePoint:

	CGL Existing In-House Offering		
	Objective	HP Trim	Microsoft SharePoint
Sales Capability	✓	●	✓
Design Capability	✓	✗	●
Implementation & Integration	✓	✗	●
Managed Service Capability	✓	●	●
Unique IP and Products	✓	✗	✗

Source. EAP Research

	CGL + Kapish		
	Objective	HP Trim	Microsoft SharePoint
Sales Capability	✓	✓	✓
Design Capability	✓	✓	●
Implementation & Integration	✓	✓	●
Managed Service Capability	✓	✓	●
Unique IP and Products	✓	✓	✗

Source. EAP Research

KAPISH ACQUISITION IS EXPECTED TO BE EPS ACCRETIVE PRE-SYNERGIES:

- Priced at 5x FY16 sustainable EBITDA, the total consideration payable is c.$17.5m.
- Consideration is payable over the next 25 months, with an initial payment of $12.25m funded from cash reserves, and two additional tranches over Year 2 & 3 totalling up to $5.25m.

Kapish is expected to add $4m of EBITDA in FY17, implying a forward acquisition multiple of 4.4x FY17e EBITDA. The deal is expected to be completed by 30 June 2016, with the first payment due by 1 July 2016.

3.2 INCREASED INVESTMENT IN FILOSOPH-E

CGL also announced it has increased its investment in filosoph-e to 50% (from 25%). With a focus on delivering enterprise content management in secure environments, this increased investment goes hand in hand with the acquisition of Kapish, allowing CGL to overlay its value-add security and assurance offering and further developing a new "cloud first" and SaaS product offering to clients across new markets.

By broadening its skillset, CGL is well placed to capitalise on new opportunities where corporations or state agencies look to transition infrastructure to the cloud in a highly secure environment.

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3.3 HEALTH CONTRACT RENEWALS & COMMERCIALISATION OF INTERNALLY DEVELOPED IP

CGL announced it has signed a 3 year contract renewal (including two additional 1 year extension options) with 'Pathology North'. This is a positive endorsement for CGL and its investment in PJA Solutions. This contract is for the provision of complex laboratory information systems and database integration work, along with the delivery of new capabilities such as blood management (e-Blood). Pathology North provides pathology and laboratory medicine services from Northern Sydney to Tweed Heads at the Queensland border.

- E-Blood is a proprietary software developed by CGL, delivering blood supply chain management and governance that is aimed at reducing wastage and error rates relative to other product solutions in the market.

This contract renewal, which came ahead of any market tender process, highlights the level of trust in the CGL Health offering of mission-critical products to the sector. It also comes as CGL Health continues to expand its presence in the health sector, including:

i. QLD Health (electronic ordering of pathology tests and results),
ii. Eastern Health (enabling foreign specimen labels to be used for electronically ordered specimens),
iii. Integration between CGL's AUSLAB software and HealthRFID's ControlPoint Solution (used to track products through supply chains),
iv. The sharing of national blood product information between The National Blood Authority's BloodNet system and CGL's AUSLAB system.

PJA Solutions enables complex e-Health integrations. The opportunity for CGL and PJAS going forward will be:

i. Growing PJAS market share across the public market beyond 40%, with several public pathology tenders recently open for tender.
ii. Expanding presence across the private marketplace, with existing pathology providers currently reliant on maintaining legacy proprietary software, without allocating investment to product innovation.
iii. Adding new revenue streams, in particular the commercialisation and monetisation potential of e-health data.

CGL PRODUCT/INDUSTRY MATRIX

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EVANS & PARTNERS

FINANCIAL SUMMARY

The Citadel Group	**CGL**		
As at:	**31/05/2016**	**Recommendation: Positive**	**Share Price $4.40**

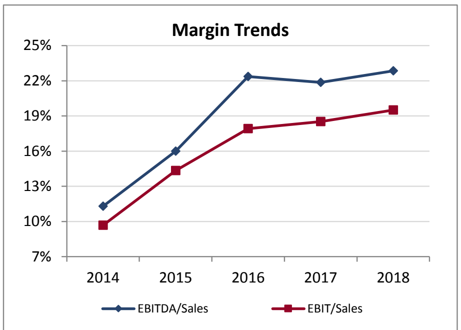
Year end	June	2015A	2016E	2017E	2018E
INCOME STATEMENT					
Sales Revenue	**$m**	**72**	**95**	**132**	**138**
Consolidated EBITDA	$m	12	21	29	32
D&A	$m	1	4	4	5
Consolidated EBIT	**$m**	**10**	**17**	**24**	**27**
Net Interest	$m	0	3	2	0
Tax Expense	$m	2	5	8	7
Associates/Minorities	$m	2	2	2	2
Adj NPAT	**$m**	**8**	**9**	**15**	**19**
NRIs	$m	(2)	0	0	0
Reported NPAT	$m	7	9	15	19
Shares on Issue (end period)	m	47	47	47	47
EFPOWA	m	44	47	47	47
EPS	**¢**	**18.0**	**19.5**	**31.9**	**41.6**
DPS	¢	5.8	10.0	14.0	19.0
Franking	%	100%	100%	100%	100%
GROWTH/PROFITABILITY RATIOS					
Sales Growth	%	45.8%	30.9%	39.4%	4.5%
EBITDA Growth	%	106.5%	83.0%	36.3%	9.3%
EBIT Growth	%	116.0%	63.6%	44.1%	10.1%
EPS Growth	**%**	**116.9%**	**7.9%**	**63.7%**	**30.5%**
EBITDA/Sales	%	16.0%	22.4%	21.9%	22.9%
EBIT/Sales	%	14.3%	17.9%	18.5%	19.5%
EBIT Interest Cover	x	(34.6)	(5.3)	(12.9)	(201.0)
Tax Rate	%	20.3%	34.0%	34.0%	27.5%
ROE	**%**	**14.1%**	**14.7%**	**21.2%**	**24.0%**
ROFE	**%**	**48.9%**	**95.6%**	**54.6%**	**45.6%**
CASH FLOW					
EBITDA	$m	12	21	29	32
Change in Working Capital	$m	(2)	1	0	0
Other	$m	(1)	0	0	0
Gross Operating Cash Flow	**$m**	**8**	**22**	**29**	**31**
Net Interest Paid	$m	1	(3)	(2)	0
Tax Paid	$m	(2)	(5)	(8)	(7)
Net Operating Cash Flow	**$m**	**7**	**14**	**19**	**24**
Maintenance Capex	$m	(2)	(1)	(1)	(1)
Free Cash Flow	**$m**	**5**	**13**	**18**	**23**
Dividends Paid	$m	(4)	(4)	(7)	(9)
Expansionary Capex	$m	0	0	0	0
Acquisitions	$m	(9)	0	(30)	(18)
Asset Sales	$m	0	0	0	0
Dividends Received	$m	2	0	0	0
Shares Issues/Buybacks	$m	22	0	0	0
Other	$m	(2)	(8)	0	0
Increase in Net Cash/(Debt)	**$m**	**14**	**0**	**(19)**	**(4)**
GOCF/EBITDA	%	70%	102%	99%	100%
Total Capex/Sales	%	2.3%	1.3%	0.9%	0.9%
Total Capex/Depreciation	x	(1.4)	(0.3)	(0.3)	(0.3)

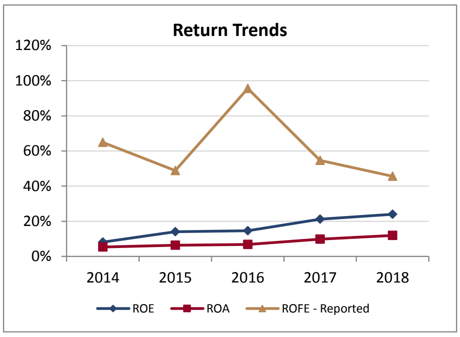
Source: Company data, E&P Research estimates

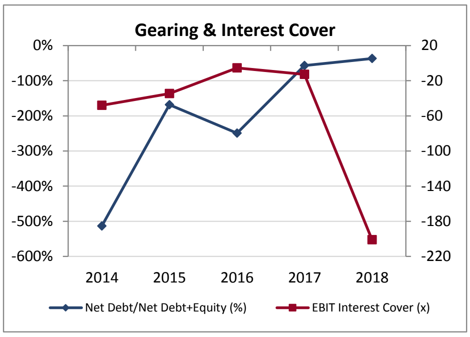
Year end	June	2015A	2016E	2017E	2018E
VALUATION METRICS					
PER	x	24.4	22.6	13.8	10.6
P/EG (2YR)	x	0.7	0.5	0.8	2.0
Dividend Yield	%	1.3%	2.3%	3.2%	4.3%
EV/EBITDA	x	14.7	7.6	6.2	5.8
EV/EBIT	x	16.4	9.5	7.4	6.8
P/FCF	x	39.2	16.4	11.6	9.0
P/BV	x	3.6	3.3	2.9	2.5
BALANCE SHEET					
Assets					
Cash	$m	37	45	26	23
Working Capital	$m	23	24	34	36
PP&E	$m	3	0	(3)	(7)
Intangibles	$m	60	60	90	107
Investments	$m	0	0	0	0
Other	$m	4	4	4	4
Total Assets	**$m**	**127**	**133**	**151**	**163**
Liabilities					
Debt (incl deferred payouts)	$m	1	33	16	13
Working Capital	$m	22	24	33	35
Other	$m	47	15	32	34
Total Liabilities	**$m**	**70**	**72**	**81**	**82**
Equity	**$m**	**57**	**62**	**70**	**80**
Capital Employed	**$m**	**21**	**18**	**45**	**59**
Net Debt incl deferred payout /(Cash)	$m	(36)	(12)	(10)	(10)
Net Debt/Equity	%	(63%)	(19%)	(14%)	(13%)
Net Debt/Debt+Equity	**%**	**(168.5)%**	**(24%)**	**(17%)**	**(14%)**
Net Debt/EBITDA	x	(3.1)	(2.1)	(0.9)	(0.7)
Working Capital/Sales	%	2%	1%	1%	1%
D&A/PP&E	%	(45.3%)	1,341.9%	127.0%	67.6%

DCF VALUATION			**$m**	**$/share**
Risk Free Rate	5.0%	Enterprise Value	261	$5.60
Market Risk Premium	6.0%	(Net Debt)/Cash	12	$0.26
Beta	1.20	Franking Credits		$0.49
WACC	**10.0%**	**DCF Valuation**		**$6.09**

DIVISIONAL SUMMARY					
Education	$m	11	10	10	10
Technology	$m	61	85	122	128
Corporate/Other	$m				
Group Revenue	**$m**	**72**	**95**	**132**	**138**
Education	$m	4	2	2	3
Technology	$m	11	22	30	33
Corporate/Other	$m	(3)	(3)	(4)	(4)
Group EBITDA	**$m**	**12**	**21**	**29**	**32**
Education	%	36.9%	22.5%	25.0%	27.5%
Technology	%	17.4%	26.4%	24.5%	25.4%
Corporate/Other	%				
Group EBITDA/Sales	**%**	**16.0%**	**22.4%**	**21.9%**	**22.9%**







Source: Company data, E&P Research estimates

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RESEARCH RECOMMENDATION DEFINITIONS

Positive	Stock is expected to outperform the S&P/ASX 200 over the coming 24 months
Neutral	Stock expected to perform in line with the S&P/ASX 200 over the coming 24 months
Negative	Stock is expected to underperform the S&P/ASX 200 over the coming 24 months
Speculative Buy	Stock has limited history from which to derive a fundamental investment view or its prospects are highly dependent on event risk, *eg.* Successful exploration, scientific breakthrough, high commodity prices, regulatory change, etc.
Suspended	Stock is temporarily suspended due to compliance with applicable regulatory and/or Evans & Partners policies in circumstances where Evans & Partners is acting in an advisory capacity.
Not Rated	Stock is not included in our investment research universe.

Research Criteria Definitions

Recommendations are primarily determined with reference to how a stock ranks relative to the S&P/ASX 200 on the following criteria:

Valuation	Rolling 12 month prospective multiples (composite of Price-to-Earnings Ratio, Dividend Yield and EV/EBITDA), or long-term NPV for resource stocks.
Earnings Outlook	Forecast 2 year EPS growth.
Earnings Momentum	Percentage change in the current consensus EPS estimate for the stock (rolling 1 year forward basis) over the consensus EPS estimate for the stock 3 months ago.
Shareholder Returns	Composite of forecast ROE (rolling 1 year forward basis) and the percentage change in ROE over 2 years.
Debt Servicing Capacity	Rolling 12 month EBIT Interest Cover ratio.
Cyclical Risk	Qualitative assessment of the 2 year outlook for a stock/industry's profit cycle.
Industry Quality	Qualitative assessment of an industry's growth/returns potential and company specific management capability.
Financial Transparency	If we don't understand it, we won't recommend it.

For stocks where Evans & Partners does not generate its own forecasts, Bloomberg consensus data is used. Analysts can introduce other factors when determining their recommendation, with any material factors stated in the written research where appropriate.

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