Stock Focus

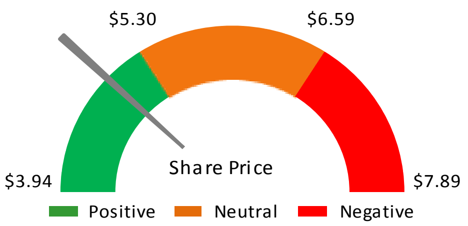
The Citadel Group (CGL)

EVANS & PARTNERS

Monday, 22 August 2016

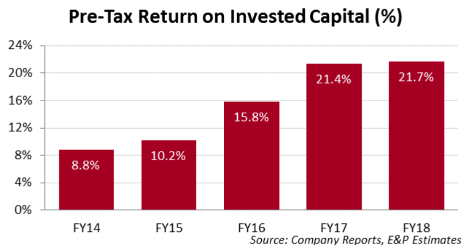
INFRASTRUCTURE IN PLACE, NOW TO DELIVER ON THE PIPELINE

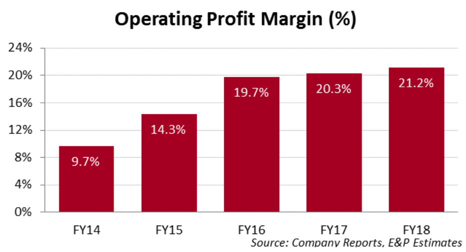
Recommendation: Positive

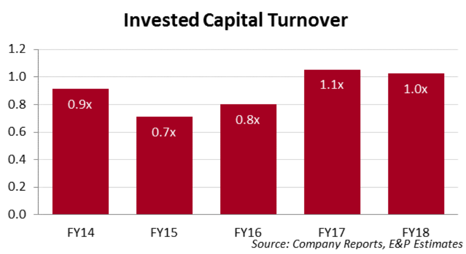


Trading Data

Last Price	$5.00
12 month range	$3.88 - $5.70
Market Cap	$234m
Free Float	$128m (55%)
12 month return (historical)	29.3%







KEY OBSERVATIONS

CGL reported FY16 earnings in line to slightly ahead of consensus expectations, however on lower than forecast revenues as operating leverage and cost control delivered stronger than expected margins. Group EBITDA rose +110% to $21.4m on revenue growth of +17%, with EBITDA margins rising to 25.9% from 14.1% in FY15.

Revenue growth takes precedence in our quality of earnings assessment, hence the 2H underperformance relative to our forecasts was disappointing. However we do note this can partly be attributed to i) c.$13m one-off payment in 1H relating to nRAH, ii) the negative impact of the Federal Election and iii) a lower initial contribution from Monash Uni, which is in the early stages of implementation.

Importantly, the pipeline of growth and market share prospects across existing and new verticals are enhanced heading into FY17 given:

i. Investments in Tech/eHealth product capabilities: Enterprise Data Management via Kapish acquisition and commercialisation of R&D within Citadel Health,
ii. Investments in proprietary infrastructure and new management/sales teams.
iii. New contract wins (Fed Govt agency) & high customer retention rates on larger managed service contracts that include the delivery of new capabilities.

Delivering industry high margins: CGL continues to derive benefits from higher margin service offerings, acquisition synergies relating to Citadel Health and a scalable cost base as CGL becomes established across new verticals. Across each of CGL's core capability sets, there are substantial scale benefits that we believe can sustain margins at current levels but in our view without material upside from here.

WHAT'S CHANGED?

Our FY17/18e EBITDA forecasts are largely unchanged (+1%), but a function of lower revenues (-9-11%) offset by higher margin services (FY17 EBITDA margin revised to 24.6% from 21.9% prior). Our blended valuation rises +3% to $5.93 due to higher market multiples and revised WACC (risk free rate to 5.0% from 5.5%).

OUR THINKING

We stay Positive. While FY17 earnings visibility is high across existing contracts and recent wins in place, we believe management execution across a strong pipeline of organic growth prospects (health, data & security) in conjunction with sustainable margins >20% is fundamental in ascribing a premium multiple relative to peers.

Earnings Forecasts: *Source: EAP Research*

Yr to June	**14A**	**15A**	**16A**	**17E**	**18E**	**19E**
EBITDA ($m)	5.6	11.6	21.4	29.0	31.8	33.7
Rep NPAT ($m)	3.7	6.5	8.2	13.8	18.3	19.8
Adj NPAT ($m)	3.7	8.0	8.2	13.8	18.3	19.8
EPS (¢)	8.3	16.0	17.0	28.6	37.8	40.8
EPS Gth (%)	(38.3)	92.7	6.2	68.1	32.0	8.2
PER (x)	**60.1**	**31.2**	**29.4**	**17.5**	**13.2**	**12.2**
PEG Ratio (x)	1.4	0.9	0.6	0.9	1.9	
DPS (¢)	0.0	5.8	9.6	13.0	17.0	18.0
Yield (%)	**0.0**	**1.2**	**1.9**	**2.6**	**3.4**	**3.6**
Franking (%)	100%	100%	100%	100%	100%	100%
ROE (%)	**8%**	**14%**	**13%**	**19%**	**22%**	**21%**
EV/EBITDA (x)	**34.9**	**17.1**	**9.4**	**7.5**	**6.9**	**6.1**
Net Debt/EBITDA (x)	(6.8)	(3.1)	(1.6)	(0.5)	(0.4)	(0.8)
Valuation (blended)						**$5.93**

Peter Stamoulis pstamoulis@eandp.com.au +61 3 9631 9841

EARNINGS & VALUATION IMPACT

Our FY17/18e EBITDA forecasts are largely unchanged (+1%) - a function of lower revenue assumptions (-9-11%) and lower Education contribution (forecast to breakeven in FY17 on aggressive cost out), offset by higher margin services. Our prior estimates had forecast higher revenues at lower group EBITDA margins of 21.9% in FY17. Following stronger than expected operating leverage across Citadel Health and the core Technology segment, our revised FY17 EBITDA margin is 24.6%.

Our EPS forecasts are revised -9-10% lower, due to the non-cash implications of higher intangible amortisation relating to assets acquired through PJA Solutions and Kapish, the unwinding of a discount on deferred consideration payments sitting within the net interest expense line (totalling $3.6m in FY17, up from $1.9 previously) and increased share count. Our blended valuation rises +3% to $5.93 due to higher market multiples and revised WACC (risk free rate to 5.0% from 5.5%).

CGL EARNINGS REVISIONS

Metric	Sales ($m)			EBITDA ($m)			Adjusted EPS* (¢)			DPS (¢)		
Yr to June	Old	New	% Chg	Old	New	% Chg	Old	New	% Chg	Old	New	% Chg
2016A	95	83	(12%)	21.2	21.4	1%	19.5	**17.0**	**(13%)**	10.0	9.6	(4%)
2017E	132	118	(11%)	28.8	29.0	1%	31.9	**28.6**	**(10%)**	14.0	13.0	(7%)
2018E	138	125	(9%)	31.5	31.8	1%	41.6	**37.8**	**(9%)**	19.0	17.0	(11%)
Blended Valuation				**$5.77**	**$5.93**	**3%**						

**Adjusted EPS including the unwinding of a discount on deferred consideration payments for PJA/Kapish (non-cash and non-tax deductible).*

KEY ISSUES: EXECUTION ACROSS NEW PRODUCT CAPABILITIES & INFRASTRUCTURE

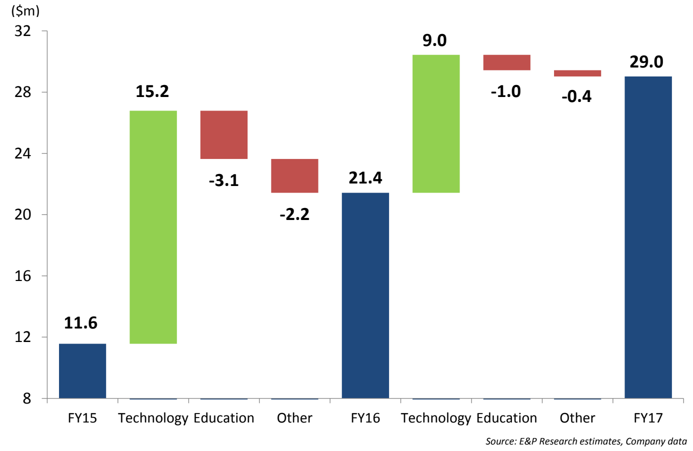
Execution across a strong pipeline of opportunities & acquisition in Knowledge Management: The Kapish acquisition (est. $4m EBITDA in FY17) is a complementary fit to CGL's core knowledge management offering, deepening expertise and capabilities in Electronic Document Records Management Services (EDRMS). Combining this with CGL's existing and proven capabilities in Knowledge Management, Kapish expands market share prospects across Federal/State Governments, local councils and non-security state agencies in a shift to a secure Document Records Management platform.

Detail from recent Federal Government agency contract win: On 1 August, CGL announced the successful tender of a new contract with a Fed Govt. agency as a part of a major ICT transformation program, to provide strategic integration and partnering services. The contract was won under a competitive tender, leveraging CGL's core skillset in delivering managed technology services for mission critical IT systems. This is a positive endorsement for the CGL brand, given the global competitors who are likely to have tendered for the contract. While details are yet to be disclosed, given the need for a market announcement it is expected to be material and potentially add upside to our medium term earnings forecasts.

Citadel Health contract renewal and R&D monetisation: Contract renewals in CGL Health (such as 'Pathology North') 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.

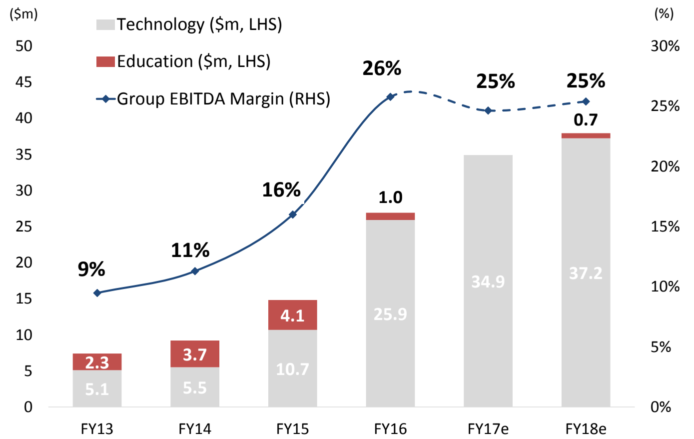
CGL: FY15-17e EBITDA Bridge By Segment

Source: EAP Research Estimates, CGL



CGL: FY13-18e EBITDA by Segment ($m) before Corp O/H

Source: EAP Research Estimates, CGL



Peter Stamoulis pstamoulis@eandp.com.au +61 3 9631 9841

EVANS & PARTNERS

FINANCIAL SUMMARY

The Citadel Group	**CGL**			
As at:	**22/08/2016**	**Recommendation: Positive**	**Share Price**	**$5.00**

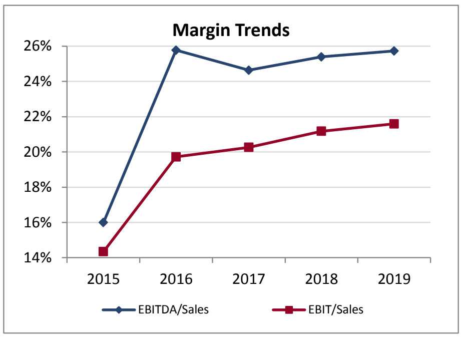
Year end	June	2016A	2017E	2018E	2019E
INCOME STATEMENT					
Sales Revenue	**$m**	**83**	**118**	**125**	**131**
Consolidated EBITDA	$m	21	29	32	34
D&A	$m	5	5	5	5
Consolidated EBIT	**$m**	**16**	**24**	**27**	**28**
Net Interest	$m	4	4	0	0
Tax Expense	$m	4	6	7	8
Associates/Minorities	$m	1	1	1	1
Adj NPAT	**$m**	**8**	**14**	**18**	**20**
NRIs	$m	0	0	0	0
Reported NPAT	$m	8	14	18	20
Shares on Issue (end period)	m	47	48	48	48
EFPOWA	m	48	48	48	48
EPS	**¢**	**17.0**	**28.6**	**37.8**	**40.8**
DPS	¢	9.6	13.0	17.0	18.0
Franking	%	100%	100%	100%	100%
GROWTH/PROFITABILITY RATIOS					
Sales Growth	%	15.0%	41.7%	6.5%	4.5%
EBITDA Growth	%	85.3%	35.5%	9.7%	5.9%
EBIT Growth	%	58.1%	45.6%	11.3%	6.6%
EPS Growth	**%**	**6.2%**	**68.1%**	**32.0%**	**8.2%**
EBITDA/Sales	%	25.8%	24.6%	25.4%	25.7%
EBIT/Sales	%	19.7%	20.3%	21.2%	21.6%
EBIT Interest Cover	x	(4.5)	(6.5)	(66.4)	(430.9)
Tax Rate	%	30.4%	28.0%	27.5%	27.5%
ROE	**%**	**12.7%**	**19.0%**	**21.9%**	**20.8%**
ROFE	**%**	**52.4%**	**41.6%**	**37.3%**	**42.1%**
CASH FLOW					
EBITDA	$m	21	29	32	34
Change in Working Capital	$m	(2)	(1)	0	0
Other	$m	(5)	0	0	0
Gross Operating Cash Flow	**$m**	**14**	**28**	**32**	**33**
Net Interest Paid	$m	0	(4)	0	0
Tax Paid	$m	(4)	(6)	(7)	(8)
Net Operating Cash Flow	**$m**	**10**	**18**	**24**	**26**
Maintenance Capex	$m	(4)	(1)	(1)	(1)
Free Cash Flow	**$m**	**6**	**17**	**23**	**24**
Dividends Paid	$m	(5)	(6)	(8)	(9)
Expansionary Capex	$m	0	0	0	0
Acquisitions	$m	(1)	(29)	(17)	0
Asset Sales	$m	0	0	0	0
Dividends Received	$m	2	0	0	0
Shares Issues/Buybacks	$m	0	0	0	0
Other	$m	(3)	0	0	(16)
Increase in Net Cash/(Debt)	**$m**	**(2)**	**(18)**	**(3)**	**0**
GOCF/EBITDA	%	66%	96%	99%	99%
Total Capex/Sales	%	5.3%	1.1%	1.0%	1.0%
Total Capex/Depreciation	x	(0.9)	(0.2)	(0.2)	(0.2)

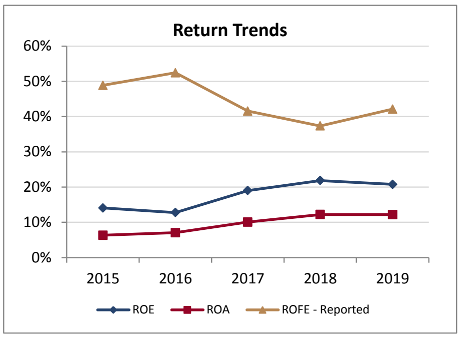
Source: Company data, E&P Research estimates

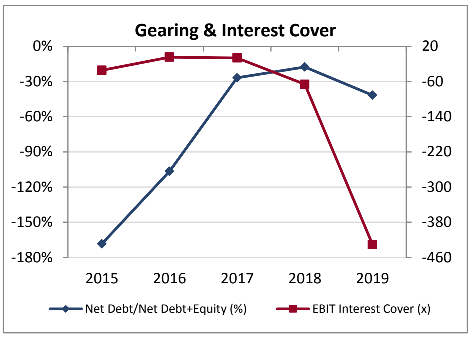
Year end	June	2016A	2017E	2018E	2019E
VALUATION METRICS					
PER	x	29.4	17.5	13.2	12.2
P/EG (2YR)	x	0.6	0.9	1.9	
Dividend Yield	%	1.9%	2.6%	3.4%	3.6%
EV/EBITDA	x	9.4	7.5	6.9	6.1
EV/EBIT	x	12.2	9.1	8.3	7.3
P/FCF	x	39.2	13.6	10.3	9.6
P/BV	x	3.6	3.3	2.9	2.5
BALANCE SHEET					
Assets					
Cash	$m	35	17	14	29
Working Capital	$m	14	27	29	31
PP&E	$m	6	2	(2)	(6)
Intangibles	$m	59	88	105	105
Investments	$m	0	0	0	0
Other	$m	3	3	3	3
Total Assets	**$m**	**117**	**138**	**150**	**163**
Liabilities					
Debt	$m	1	1	1	1
Working Capital	$m	10	23	24	25
Other	$m	38	38	38	38
Total Liabilities	**$m**	**52**	**65**	**66**	**67**
Equity	**$m**	**65**	**73**	**84**	**95**
Capital Employed	**$m**	**31**	**57**	**71**	**67**
Net Debt/(Cash)	$m	(33)	(15)	(12)	(28)
Net Debt/Equity	%	(52%)	(21%)	(15%)	(29%)
Net Debt/Debt+Equity	**%**	**(106.6)%**	**(26.9)%**	**(17.5)%**	**(41.7)%**
Net Debt/EBITDA	x	(1.6)	(0.5)	(0.4)	(0.8)
Working Capital/Sales	%	4%	4%	4%	4%
D&A/PP&E	%	(84.3%)	(250.4%)	267.4%	88.2%

DCF VALUATION			**$m**	**$/share**
Risk Free Rate	5.0%	Enterprise Value	270	$5.57
Market Risk Premium	6.0%	(Net Debt)/Cash	12	$0.25
Beta	1.20	Franking Credits		$0.49
WACC	**10.0%**	**DCF Valuation**		**$6.07**

DIVISIONAL SUMMARY					
Education	$m	8	7	7	7
Technology	$m	75	111	118	124
Corporate/Other	$m				
Group Revenue	**$m**	**83**	**118**	**125**	**131**
Education	$m	1	0	1	1
Technology	$m	26	35	37	39
Corporate/Other	$m	(5)	(6)	(6)	(6)
Group EBITDA	**$m**	**21**	**29**	**32**	**34**
Education	%	12.8%	0.0%	10.0%	15.0%
Technology	%	34.4%	31.4%	31.4%	31.5%
Corporate/Other	%				
Group EBITDA/Sales	**%**	**25.8%**	**24.6%**	**25.4%**	**25.7%**







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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	Composite of Rolling 12 month prospective multiples and discounted cash flow (DCF), or DCF 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.

Peter Stamoulis pstamoulis@eandp.com.au +61 3 9631 9841

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Peter Stamoulis pstamoulis@eandp.com.au +61 3 9631 9841