

Citadel bows out from the education game

We maintain a BUY rating with a revised price target of \$5.91 per share. Citadel has decided to exit the Vocational Education and Training (VET) sector in response to unfavourable regulatory changes that take effect from early 2017. The withdrawal only has minor implications at the earnings forecast level, reducing EPS by 2.5% in FY17. In the longer term, we see this as a positive for group valuation, given the sectoral directions in which Citadel is headed. Government, knowledge and healthcare integration offer far more scope for differentiation and margin development over time, in our view. We understand that Citadel has continued to pick up new contracts since the FY16 update in August.

Key points

Citadel pulling out of Vocational Education and Training (VET). Proposed regulatory reforms have prompted Citadel to withdraw from the VET sector at the end of the current academic period, in December. From January, the VET FEE-HELP scheme will move towards a loan scheme with reduced 'loan caps' which will place downward pressure on fees. Regulatory 'red tape' also looks likely to increase earnings pressure on all course providers.

Wilson's view. Citadel has flagged a potential exit from VET on previous occasions and we are not surprised. The narrowing of Citadel's focus towards health- and government-directed technology projects may assist group valuation multiples over the medium term. The market was probably applying a discount for Citadel's exposure to VET via its Education business segment.

Forecasts. Previously our forecast was for Education to 'break even' in FY17, with a small (~\$0.5m) 1H loss recovered in the 2H. Citadel will recognise a one-off restructuring charge of between \$1.1m and \$2.0m in relation to discontinuing its operations. Our normalised EPS forecast is 2.5% lower in FY17e; and approximately 4% lower in FY18e.

Price target revised to \$5.91 per share. BUY rating maintained. Changes to valuation reflect the withdrawal of Education from the model, which was discounting a return to modest profitability over the forecast period. Revised target price implies 21.5x FY17e EPS and 9.9x FY17e EV/EBITDA.

Risks and catalysts

Catalysts: a) reported revenue growth; b) evidence of margin expansion; c) new contract wins and/or renewals; d) accretive acquisitions.

Risks: a) loss of key contracts; b) loss of key management; c) technology obsolescence; e) competition.

Recommendation

BUY

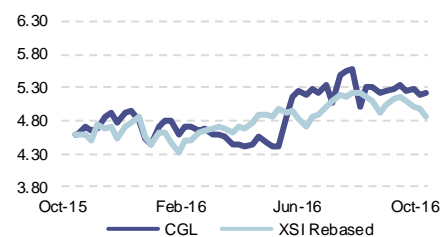
12-mth target price (AUD)	\$5.91
Share price @ 28-Oct-16 (AUD)	\$5.21
Forecast 12-mth capital return	13.5%
Forecast 12-mth dividend yield	2.6%
12-mth total shareholder return	16.1%

Market cap	\$248m
Enterprise value	\$234m
Shares on issue	48m
Sold short	0.0%
ASX 300 weight	n/a
Median turnover/day	\$0.1m

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12-mth price performance (\$)



	1-mth	6-mth	12-mth
Abs return (%)	-2.3	18.1	15.5
Rel return (%)	2.8	15.8	9.9

Key changes

		23-Aug	After	Var %
NPAT:	FY17F	13.4	13.1	-2.5%
norm	FY18F	16.7	16.1	-3.7%
	FY19F	16.7	16.5	-1.4%
EPS:	FY17F	28.1	27.4	-2.5%
norm	FY18F	35.0	33.7	-3.7%
	FY19F	35.0	34.5	-1.4%
DPS:	FY17F	13.0	13.0	0.0%
	FY18F	16.0	16.0	0.0%
	FY19F	19.0	19.0	0.0%
Price target:		6.09	5.91	-2.9%
Rating:		BUY	BUY	

Earnings forecasts

Year-end June (AUD)	FY15A	FY16A	FY17F	FY18F	FY19F
NPAT rep (\$m)	6.5	8.2	10.9	14.0	15.8
NPAT norm (\$m)	6.5	8.2	13.1	16.1	16.5
Consensus NPAT (\$m)			13.9	15.9	18.6
EPS norm (cps)	16.0	17.0	27.4	33.7	34.5
EPS growth (%)	29.1	6.1	61.5	22.9	2.3
P/E norm (x)	32.5	30.7	19.0	15.5	15.1
EV/EBITDA (x)	23.0	11.2	8.8	7.6	7.0
FCF yield (%)	2.5	3.0	5.9	7.9	9.0
DPS (cps)	5.8	9.6	13.0	16.0	19.0
Dividend yield (%)	1.1	1.8	2.5	3.1	3.6
Franking (%)	100	100	100	100	100

Source: Company data, Wilsons estimates, S&P Capital IQ

Wilson's Research

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Price target		
	Valuation	Price target
WACC (%)	11.9	
Tg (%)	3.0	
NPV Fcst FCF	94.6	
NPV perpetuity	166.8	
Net debt/(cash)	14.9	
Valuation (\$m)	276.3	
DCF (\$/share)		5.91

Price target (\$/share) 5.91

Interims (\$m)					
Half-year (AUD)	Dec 15	Jun 16	Dec 16	Jun 17	
	1HA	2HA	1HE	2HE	
Sales revenue	46.4	36.2	54.4	57.0	
EBITDA	12.3	8.7	12.9	13.6	
EBIT	10.1	5.8	10.0	10.7	
Net profit	5.6	2.7	5.6	7.5	
Norm EPS	11.5	5.5	11.7	15.7	
EBIT/sales (%)	21.9	15.9	18.4	18.8	
Dividend (c)	4.8	4.8	6.5	6.5	
Franking (%)	100.0	100.0	100.0	100.0	

Financial stability				
Year-end June (AUD)	FY16A	FY17F	FY18F	
Net debt	-33.3	-14.9	-10.2	
Net debt/equity (%)	<0	<0	<0	
Net debt/EV (%)	<0	<0	<0	
Current ratio (x)	3.5	3.8	4.3	
Interest cover (x)	5.1	6.5	12.1	
Adj cash int cover (x)	4.6	7.7	13.8	
Debt/cash flow (x)	0.1	0.1	0.5	
Net debt (cash)/share (\$)	<0	<0	<0	
NTA/share (\$)	1.3	1.4	1.6	
Book value/share (\$)	1.3	1.4	1.5	
Payout ratio (%)	57	47	48	
Adj payout ratio (%)	66	36	32	

EPS reconciliation (\$m)				
	FY16A		FY17F	
	Rep	Norm	Rep	Norm
Sales revenue	83	83	111	111
EBIT	15.9	15.9	22.7	22.9
Net profit	8.2	8.2	10.9	13.1
Notional earn	0.0	0.0	0.0	0.0
Pref/conv div	0.0	0.0	0.0	0.0
Profit for EPS	8.2	8.2	10.9	13.1
Diluted shrs (m)	48	48	48	48
Diluted EPS (c)	17.0	17.0	22.8	27.4

Returns				
	FY16A	FY17F	FY18F	FY19F
ROE (%)	14	20	23	21
ROIC (%)	42	34	29	30
Incremental ROE	9	89	58	5
Incremental ROIC	39	31	15	11

Key assumptions								
Year-end June (AUD)	FY13A	FY14A	FY15A	FY16A	FY17F	FY18F	FY19F	FY20F
Revenue growth (%)		-0.8	45.9	14.3	34.8	3.9	12.3	7.2
EBIT growth (%)		22.6	77.2	77.6	44.0	15.3	1.6	6.0
NPAT growth (%)		20.2	58.0	26.0	59.0	22.9	2.3	3.7
EPS growth (%)		22.5	29.1	6.1	61.5	22.9	2.3	3.7
EBIT/sales (%)	8.2	10.2	12.4	19.2	20.6	22.8	20.6	20.4
Tax rate (%)	20.3	22.0	22.5	30.4	37.9	27.9	27.0	27.0
ROA (%)	10.2	10.2	7.1	11.7	15.7	15.7	15.2	15.7
ROE (%)	15.9	16.4	11.5	12.8	19.6	21.1	19.7	19.4

Profit and loss (\$m)								
Year-end June (AUD)	FY13A	FY14A	FY15A	FY16A	FY17F	FY18F	FY19F	FY20F
Sales revenue	50.0	49.6	72.3	82.7	111.4	115.8	130.0	139.4
EBITDA	4.9	5.8	10.1	20.9	26.5	30.9	33.5	35.5
Depn & amort	0.8	0.7	1.2	5.0	5.8	6.5	6.9	7.1
EBIT	4.1	5.1	9.0	15.9	20.7	24.4	26.6	28.4
Net interest expense	-0.2	-0.2	-0.1	3.1	3.2	2.0	1.9	1.8
Tax	0.9	1.2	2.0	3.9	6.6	6.2	6.7	7.2
Minorities/pref divs	0.0	0.0	0.0	0.7	2.0	2.2	2.3	2.4
Equity accounted NPAT	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net profit (pre-sig items)	3.4	4.1	7.1	8.2	8.9	14.0	15.8	17.1
Abns/exts/signif	0.0	0.0	-0.5	0.0	2.0	0.0	0.0	0.0
Reported net profit	3.4	4.1	6.5	8.2	10.9	14.0	15.8	17.1

Cash flow (\$m)								
Year-end June (AUD)	FY13A	FY14A	FY15A	FY16A	FY17F	FY18F	FY19F	FY20F
EBITDA	4.9	5.8	10.1	20.9	26.5	30.9	33.5	35.5
Interest & tax	-0.2	-1.1	-1.8	-4.3	-3.5	-4.2	-4.7	-5.4
Working cap/other	-1.5	1.9	-1.5	-6.2	-6.6	-5.0	-4.1	-2.9
Operating cash flow	3.3	6.6	6.9	10.4	16.4	21.7	24.7	27.2
Maintenance capex	-0.6	-1.4	-0.8	-2.9	-1.8	-2.1	-2.4	-2.7
Free cash flow	2.7	5.3	6.1	7.5	14.6	19.6	22.3	24.5
Dividends paid	-1.3	-1.3	-4.1	-4.9	-5.3	-6.3	-8.4	-9.3
Growth capex	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Invest/disposals	0.0	0.0	-9.1	-1.5	-27.8	-18.0	0.0	0.0
Other inv flows	1.1	3.1	-1.9	-1.1	0.0	0.0	0.0	0.0
Cash flow pre-financing	2.6	7.1	-8.9	0.0	-18.4	-4.7	13.9	15.1
Funded by equity	0.0	0.0	25.0	0.1	0.0	0.0	0.0	0.0
Funded by debt	-1.9	-0.6	1.4	-1.9	10.0	15.0	0.0	0.0
Funded by cash	-0.6	-6.5	-17.5	1.9	8.4	-10.3	-13.9	-15.1

Balance sheet summary (\$m)								
Year-end June (AUD)	FY13A	FY14A	FY15A	FY16A	FY17F	FY18F	FY19F	FY20F
Cash	13.0	19.3	37.2	34.6	26.2	36.5	50.4	65.5
Current receivables	11.2	12.1	21.3	12.5	13.9	14.6	16.2	17.4
Current inventories	0.4	1.5	1.8	1.1	1.7	1.8	2.0	2.1
Net PPE	0.9	1.7	2.6	6.0	15.3	20.0	15.7	11.4
Investments	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Intangibles/capitalised	13.8	13.7	59.9	59.3	73.4	82.0	81.8	81.8
Other	1.1	1.2	3.8	3.3	3.3	3.3	3.3	3.3
Total assets	40.3	49.4	126.7	116.7	133.7	158.2	169.5	181.5
Current payables	14.5	14.4	21.9	9.9	11.0	12.0	13.0	14.0
Total debt	0.6	0.1	1.5	1.3	11.3	26.3	26.3	26.3
Other liabilities	3.6	9.5	46.4	41.0	43.5	45.1	47.7	49.7
Total liabilities	18.7	24.1	69.7	52.2	65.8	83.4	87.0	89.9
Minorities/convertibles	0.0	0.0	0.0	3.6	3.6	3.6	3.6	3.6
Shareholder equity	21.6	25.3	57.0	64.6	67.9	74.9	82.6	91.6
Total funds employed	22.2	25.4	58.4	65.8	79.2	101.1	108.8	117.9



The Citadel Group (CGL)

Business description

The Citadel Group's business is the development, marketing, contracting, implementation and support of integrated knowledge management and business software. Citadel operates at the premium end of this market with respect to both its technology offering and clientele. Core clients are those that seek to capture and manage sensitive data in complex environments such as defence, immigration, health, education and government. These are a key verticals in which Citadel today demonstrates its national security and personal privacy credentials. Complexity takes many forms including logistics, geography, linguistic, technological and the challenge of integrating solutions with supporting infrastructure.

Investment thesis

Citadel differentiates itself from other enterprise systems/software developers by providing an end-to-end service which starts by helping clients define the desired application through to the development and implementation of the hardware and software. Many of Citadel's contracts translate into lengthy relationships with a high proportion of recurring revenue under a managed service model. Citadel's business model offers clients a complete solution managed by one company, with a premium applied to trusted incumbency.

Our core thesis is that Citadel's valuation multiples can re-rate over the next 12-18 months as the market recognises and values the link between these differentiation points and earnings quality.

Revenue drivers

- Technology – managed services contracts with an average ~4.6 year duration.

Margin drivers

- Cross-sales across the customer base and business units
- New contracts

Key issues/catalysts

- New contracts
- Divestment of education business
- Increased visibility into PJA Solutions driving a re-rating

Risk to view

- Contract losses
- Regulatory change in education segment

Balance sheet

- Strong balance sheet with net cash of \$34.6m as at end-FY16.

Board

- Kevin McCann, Independent Chairman
- Dr Miles Jakeman, Exec Director and Deputy Chair
- Mark McConnell, Executive Director
- Ms Deena Shiff, Non-Executive Director
- Lt General Peter Leahy, Non-Executive Director

Management

- Darren Stanley, CEO
- Mark McConnell
- Dr Miles Jakeman
- R. Andrew Burns, CFO

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