

Reiterate BUY, tranche 1 of federal contract announced, more to come

We maintain a BUY rating with a revised price target of \$6.00 per share. The first tranche of Citadel's new federal agency contract has been disclosed, which supports \$24.8m in revenue over the next two years. This contract is emblematic of what Citadel is setting out to achieve across key verticals including Defence, Health and Government. Our thesis remains one of valuation multiple uplift – that Citadel's IP and earnings quality can support multiples more akin to the larger international technology developers it so often beats for work. The development of Kapish post-acquisition also appears on track and is another potential source of upside to our FY17-19 forecasts.

Key points

First tranche of the Australian federal government agency contract announced. Citadel yesterday announced a contract win worth >\$24.8m over two years. We understand that this is the first of several pieces of new business expected to flow from the contract win flagged back in August. Ultimately, this project will see Citadel integrate more than 200 systems for the Agency, having won the work from a field comprising several large international competitors.

Positive update for Kapish. We sense potential upside from the Kapish acquisition, which settled in July. Guidance was set at ~\$4m (sustainable EBITDA) for FY17e; but management appears very satisfied with execution along all three growth dimensions (geographic, market penetration and Cloud).

Forecasts. We expect Agency revenue and earnings recognition to run consistently over the next 18-24 months. Our previous forecasts already allowed for a small FY17e Agency contribution plus a modest "envelope" of new contract business over FY18-19e, of which this project formed a part. As such, the incremental forecast contributions specific to this project are weighted towards FY18-19e, supporting EPS upgrades of 6.6% and 7.7%, respectively. At this stage we have included no explicit forecasts relating to the remaining, as yet undisclosed parts of this contract.

Valuation. Our 12-month price target is revised to \$6.00 per share and is based on DCF analysis. At 8.5x EV/EBITDA Citadel stock represents value compared to both domestic and international comps (some of which we understand were unsuccessful bidders for this Agency work).

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.

Earnings forecasts					
Year-end June (AUD)	FY15A	FY16A	FY17F	FY18F	FY19F
NPAT rep (\$m)	6.5	8.2	10.9	15.0	17.0
NPAT norm (\$m)	6.5	8.2	13.1	17.1	17.7
Consensus NPAT (\$m)			11.4	14.9	17.2
EPS norm (cps)	16.0	17.0	27.4	35.8	37.1
EPS growth (%)	29.1	6.1	61.5	30.6	3.6
P/E norm (x)	31.2	29.4	18.2	14.0	13.5
EV/EBITDA (x)	22.1	10.7	8.5	7.0	6.4
FCF yield (%)	2.6	3.1	6.1	8.2	9.9
DPS (cps)	5.8	9.6	13.0	16.0	19.0
Dividend yield (%)	1.2	1.9	2.6	3.2	3.8
Franking (%)	100	100	100	100	100

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

Wilsons Research

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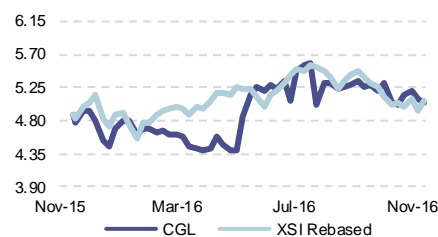
Recommendation	BUY
12-mth target price (AUD)	\$6.00
Share price @ 12-Dec-16 (AUD)	\$5.00
Forecast 12-mth capital return	20.0%
Forecast 12-mth dividend yield	2.7%
12-mth total shareholder return	22.7%

Market cap	\$239m
Enterprise value	\$225m
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 (%)	0.0	-1.4	5.3
Rel return (%)	-0.6	1.8	1.3

Key changes				
		01-Nov	After	Var %
NPAT:	FY17F	13.1	13.1	0.0%
norm	FY18F	16.1	17.1	6.3%
(\$m)	FY19F	16.5	17.7	7.7%
EPS:	FY17F	27.4	27.4	0.0%
norm	FY18F	33.7	35.8	6.3%
(cps)	FY19F	34.5	37.1	7.7%
DPS:	FY17F	13.0	13.0	0.0%
(cps)	FY18F	16.0	16.0	0.0%
	FY19F	19.0	19.0	0.0%
Price target:		5.91	6.00	1.5%
Rating:		BUY	BUY	

Price target		
	Valuation	Price target
WACC (%)	11.7	
Tg (%)	2.5	
NPV fcst FCF	100.5	
NPV perpetuity	172.1	
Net debt/(cash)	14.8	
Valuation (\$m)	287.3	
DCF (\$/share)		6.00

Price target (\$/share) **6.00**

Interims (\$m)						
Half-year (AUD)	Dec 15		Jun 16		Dec 16	
	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	-14.8	-9.8	
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	12.8	
Adj cash int cover (x)	4.6	7.7	14.0	
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	45	
Adj payout ratio (%)	66	37	33	

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	24	22
ROIC (%)	42	34	31	32
Incremental ROE	9	90	80	8
Incremental ROIC	39	31	20	19

Key assumptions								
Year-end June (AUD)	FY13A	FY14A	FY15A	FY16A	FY17F	FY18F	FY19F	FY20F
Revenue growth (%)		-0.8	45.9	14.3	34.8	11.1	11.5	1.0
EBIT growth (%)		22.6	77.2	77.6	44.0	21.4	2.6	-0.4
NPAT growth (%)		20.2	58.0	26.0	59.0	30.6	3.6	-3.6
EPS growth (%)		22.5	29.1	6.1	61.5	30.6	3.6	-3.6
EBIT/sales (%)	8.2	10.2	12.4	19.2	20.6	22.5	20.7	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	15.6	16.4	16.0	15.5
ROE (%)	15.9	16.4	11.5	12.8	19.7	22.3	20.9	19.1

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	123.8	138.0	139.4
EBITDA	4.9	5.8	10.1	20.9	26.5	32.3	35.2	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	25.8	28.3	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	6.6	7.1	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	15.0	17.0	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	15.0	17.0	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	32.3	35.2	35.5
Interest & tax	-0.2	-1.1	-1.8	-4.3	-3.5	-4.6	-5.2	-5.4
Working cap/other	-1.5	1.9	-1.5	-6.2	-6.6	-6.1	-4.1	-1.8
Operating cash flow	3.3	6.6	6.9	10.4	16.4	21.6	26.0	28.3
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	23.6	25.6
Dividends paid	-1.3	-1.3	-4.1	-4.9	-5.4	-6.5	-8.6	-9.6
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	-18.6	-4.9	15.0	16.0
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	8.6	-10.1	-15.0	-16.0

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	26.0	36.1	51.1	67.1
Current receivables	11.2	12.1	21.3	12.5	13.9	15.5	17.2	17.4
Current inventories	0.4	1.5	1.8	1.1	1.7	1.9	2.1	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	133.6	159.0	171.3	183.1
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	46.1	48.7	49.7
Total liabilities	18.7	24.1	69.7	52.2	65.8	84.4	88.0	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	67.8	74.6	83.4	93.2
Total funds employed	22.2	25.4	58.4	65.8	79.1	100.9	109.6	119.4



Valuation

We value Citadel using a DCF model which has an eight-year explicit forecast period followed by a perpetuity growth assumption of 2.5%. Our primary valuation is consistent with 21.5x FY17e EPS and an EV of 10.0x FY17e EBITDA. Our investment view is that Citadel's operating outlook and earnings quality over the next 2-3 years is good enough to close the ~20% discount applied to its stock, vis-à-vis the group of domestic and international technology developers we look to as valuation reference points (EBITDA basis).

Table 1: DCF summary

Valuation		The Inputs	
PV of FCFF (\$M) =	100.5	Forecast period	FY17-27e
PV of Terminal Value (\$M) =	172.1	Risk-free rate	3.50%
Value of Operating Assets of the firm (\$M)=	272.5	Risk premium	7.00%
- Net cash (\$M)	14.8	Beta	1.2
Equity value (\$M) =	287.3	Target D/E	7%
Shares on issue	47.9	WACC	11.7%
New issuance and options	-	Tg	2.5%
Fully diluted shares	47.9		
Value of Equity per share =	\$6.00		

Table 2: Domestic and international technology comps

Comparable Company Analysis													
Data as at:		12/12/2016											
Company Name	Ticker	Currency	Year-end	Mkt cap (m)	EV/EBITDA			P/E (norm.)			EBITDA margin		
					FY	FY+1	FY+2	FY	FY+1	FY+2	FY	FY+1	FY+2
Domestic developers													
Altium Limited	ASX:ALU	USD	30-Jun	1,026	34.1x	20.7x	17.0x	46.9x	25.9x	21.3x	31%	33%	35%
Hansen Technologies Ltd	ASX:HSN	AUD	30-Jun	710	17.5x	13.6x	12.5x	31.2x	23.0x	21.2x	26%	29%	29%
CSG Limited	ASX:CSV	AUD	30-Jun	246	9.9x	12.5x	10.8x	14.8x	10.5x	8.6x	20%	13%	13%
Integrated Research Limited	ASX:IRI	AUD	30-Jun	478	22.3x	12.7x	10.6x	38.3x	25.9x	20.9x	25%	39%	38%
Infomedia Ltd.	ASX:IFM	AUD	30-Jun	239	14.7x	9.1x	8.3x	30.4x	19.4x	17.5x	22%	33%	34%
Melbourne IT Limited	ASX:MLB	AUD	31-Dec	196	11.0x	7.6x	6.0x	28.8x	18.0x	11.5x	13%	15%	18%
Data#3 Limited	ASX:DTL	AUD	30-Jun	235	6.8x	5.2x	4.8x	20.1x	15.6x	14.2x	2%	3%	3%
Objective Corporation Limited	ASX:OCL	AUD	30-Jun	165	23.2x	NM	NM	43.8x	0.0x	0.0x	13%	NM	NM
DWS Limited	ASX:DWS	AUD	30-Jun	177	7.5x	7.2x	7.0x	11.8x	10.3x	9.9x	17%	17%	17%
SMS Management & Technology Ltd.	ASX:SMX	AUD	30-Jun	82	5.5x	8.8x	6.4x	9.2x	13.3x	9.4x	5%	3%	5%
Senetas Corp. Ltd.	ASX:SEN	AUD	30-Jun	119	18.6x	14.5x	10.3x	27.0x	20.4x	14.9x	27%	32%	38%
Group Average					15.5x	11.2x	9.4x	27.5x	16.6x	13.6x	18%	22%	23%
Group Median					14.7x	10.8x	9.3x	28.8x	18.0x	14.2x	20%	23%	23%
International developers													
athenahealth, Inc.	Nasdaq:ATHN	USD	31-Dec	3,796	65.0x	16.4x	13.7x	NM	53.6x	44.4x	7%	22%	22%
Allscripts Healthcare Solutions, Inc.	Nasdaq:MDRX	USD	31-Dec	2,056	32.3x	12.9x	10.9x	NM	19.7x	16.7x	8%	18%	20%
Computer Programs and Systems, Inc.	Nasdaq:CPSI	USD	31-Dec	344	14.9x	9.7x	9.3x	14.8x	14.7x	13.7x	18%	19%	20%
Quality Systems, Inc.	Nasdaq:QSII	USD	31-Mar	875	15.6x	9.8x	9.7x	32.7x	18.0x	17.0x	12%	18%	18%
Cerner Corporation	Nasdaq:CERN	USD	02-Jan	16,432	13.5x	10.4x	9.3x	31.1x	21.0x	18.8x	28%	33%	33%
Medidata Solutions, Inc.	Nasdaq:MDSO	USD	31-Dec	3,020	73.6x	27.8x	23.2x	NM	51.3x	42.8x	10%	23%	23%
Accenture plc	NYSE:ACN	USD	31-Aug	76,490	13.0x	12.2x	11.3x	30.1x	20.8x	19.0x	17%	17%	17%
Cap Gemini S.A.	ENXTPA:CAP	EUR	31-Dec	12,915	10.8x	9.2x	8.7x	19.8x	14.5x	13.3x	12%	13%	14%
PCI Holdings, Inc.	TSE:3918	JPY	30-Sep	8,664	10.2x	NM	NM	21.6x	0.0x	0.0x	7%	NM	NM
ULS Group, Inc.	JASDAQ:3798	JPY	31-Mar	7,077	5.6x	NM	NM	14.1x	11.8x	10.9x	17%	0%	0%
Fujitsu Limited	TSE:6702	JPY	31-Mar	1,460,781	6.7x	7.1x	6.1x	18.6x	16.6x	12.4x	7%	7%	9%
Lockheed Martin Corporation	NYSE:LMT	USD	31-Dec	76,037	13.9x	12.9x	12.4x	24.3x	21.2x	20.4x	14%	15%	14%
Group Average					23.0x	12.8x	11.5x	23.0x	21.9x	19.1x	13%	17%	17%
Group Median					13.7x	11.3x	10.3x	21.6x	18.9x	16.9x	12%	18%	18%
The Citadel Group Limited	ASX:CGL	AUD	30-Jun	239	10.7x	8.5x	7.0x	29.4x	18.2x	14.0x	22%	25%	26%

Source: CapitalIQ, Wilsons



The Citadel Group (CGL)

Business description

The business of The Citadel Group Limited (CGL) 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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