Result Focus

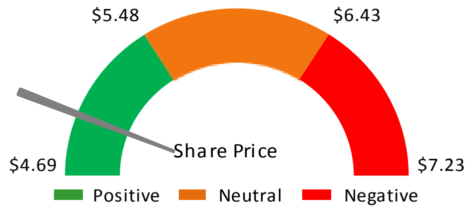
The Citadel Group (CGL)

EVANS & PARTNERS

Monday, 20 February 2017

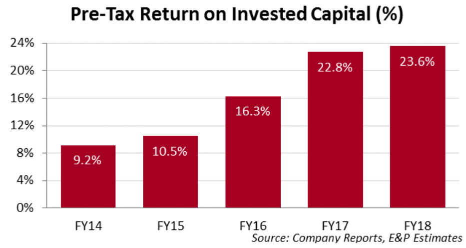
1H17 Result: Leveraging Skillsets, Delivering On Margins

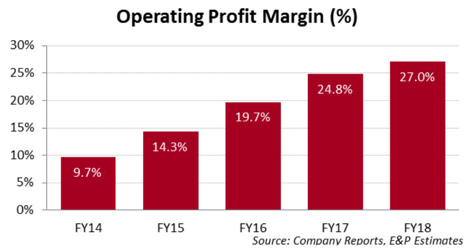
Recommendation: Positive

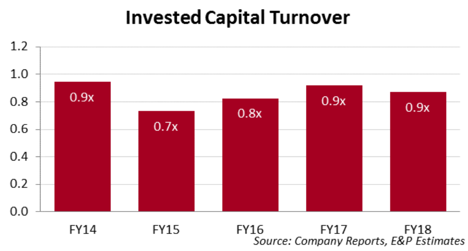


Trading Data

Last Price	$5.00
12 month range	$4.05 - $5.70
Market Cap	$239m
Free Float	$131m (55%)
12 month return (historical)	11.3%







KEY OBSERVATIONS

CGL reported 1H17 core EBITDA growth (+23.6% to $13.6m, ex Education) in line with our expectations and NPAT/EPS growth (+8-9%) 2-3% ahead. The key takeout was stronger EBITDA margins (expanding to 30.8% from 26.6%) on lower than forecast revenues (+6.3% to $44.1m). We attribute this to the Kapish integration (accretive operating margins on lower revenue contribution) and underlying scale benefits on incremental managed service contracts.

1H17 revenues were 12% below expectations but on margins that were well ahead of EAP estimates (30.8% vs. 26.1%). Revenue growth slowed in 1H17 as CGL cycled one-off project payments ($13m in 1H16) and minor delays in the commencement of new government projects. Despite the lower than expected revenues in 1H, our initial 43:57 forecast revenue split between halves is unchanged for FY17.

We expect 2H17 revenue growth to accelerate (to +55%) as new contracts scale up (incl. Fed Govt. Agency & Monash), the market opportunity across all sectors grows (including the new $20m pipeline in eHealth generated in 1H) and CGL expands customer reach (leveraging new targeted sales teams in new markets).

Rebasing margin expectations: New contract wins are not expected to be dilutive to margins in 2H17 and beyond. The margin outlook is supported by our estimate that underlying Technology margins (pre Corporate O/H) further expanded to 30% from 27% on cost control and increased utilisation of staff & infrastructure.

EARNINGS AND VALUATION IMPACT

Our FY17-19 revenue forecasts are revised -11-12% incorporating higher margin but lower revenue contribution from Kapish. The net effect to EBITDA is 0% in FY17 and +3% in FY18/19. Our blended valuation is steady at $6.04.

OUR THINKING

We stay Positive. We believe CGL is attractively priced at 13.4x FY18 PER as it delivers sustainable earnings growth & margin expansion, has a proven track record of customer renewals (incl. QLD Health) and efficient allocation of resources towards verticals in eHealth/Defence/state agencies that leverage its core competencies – managing secure content and collaboration in complex environments. We look for organic contract wins and revenue growth as the key catalyst for any positive re-rating in valuation multiples.

Earnings Forecasts: *Source: EAP Research*

Yr to June	**14A**	**15A**	**16A**	**17E**	**18E**	**19E**
EBITDA ($m)	5.6	11.6	21.4	29.1	33.0	35.6
Rep NPAT ($m)	3.7	6.5	8.2	12.1	17.9	20.0
Adj NPAT ($m)	3.7	8.0	8.2	13.5	17.9	20.0
EPS (¢)	8.3	16.0	17.0	28.3	37.4	41.9
EPS Gth (%)	(38.3)	92.7	6.2	66.0	32.2	12.1
PER (x)	**60.1**	**31.2**	**29.4**	**17.7**	**13.4**	**11.9**
PEG Ratio (x)	1.4	1.0	0.6	0.8	1.5	
DPS (¢)	0.0	5.8	9.6	13.0	17.0	21.0
Yield (%)	**0.0**	**1.2**	**1.9**	**2.6**	**3.4**	**4.2**
Franking (%)	100%	100%	100%	100%	100%	100%
ROE (%)	**8%**	**14%**	**13%**	**18%**	**21%**	**20%**
EV/EBITDA (x)	**36.0**	**17.6**	**9.6**	**7.5**	**6.6**	**5.7**
Net Debt/EBITDA (x)	(6.8)	(3.1)	(1.6)	(0.8)	(0.6)	(1.0)
Valuation (blended)						**$6.04**

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EARNINGS & VALUATION

We revise our FY17-19 revenue forecasts by -11-12% to incorporate the higher margin Kapish business acquired in July 2016. We'd previously assumed margins were more closely aligned to that of CGL's core business, implying higher revenue contribution. The net effect of this and further improvement in underlying margins from 28.5% to 29% results in 0% change to FY17 EBITDA and +3% in FY18/19.

Our EPS revisions are c.1% lower due to share dilution relating to business consideration payments in scrip ($5m in 1H17), higher amortisation and the inclusion of minority interests (relating to the consolidation filosophe-e Pty Ltd after increasing ownership to 50% from 25% on 1 April 2016). Our blended valuation is steady at $6.04.

CGL EARNINGS REVISIONS

Metric	Sales ($m)			EBITDA ($m)			Adjusted EPS* (¢)		
Yr to June	Old	New	% Chg	Old	New	% Chg	Old	New	% Chg
2017E	113	100	(11%)	29.0	29.1	0%	28.6	**28.3**	**(1%)**
2018E	121	106	(12%)	32.1	33.0	3%	37.8	**37.4**	**(1%)**
2019E	128	113	(12%)	34.4	35.6	3%	41.9	**41.9**	**(0%)**
Blended Valuation				**$6.04**	**$6.04**	**(0%)**			

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

KEY ISSUES: DELIVERING ORGANIC GROWTH ACROSS ESTABLISHED VERTICALS

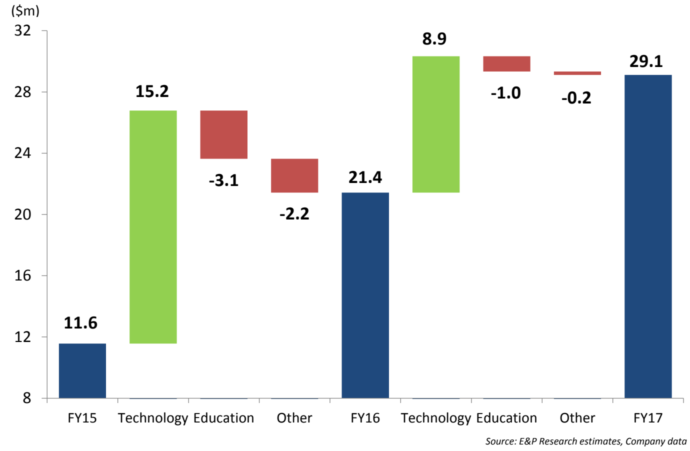
Knowledge Management capabilities expanding addressable market: With the Kapish acquisition complete, CGL needs to demonstrate its capabilities can be leveraged by new sales resources, enabling stronger organic growth. Product development in cloud-only based offerings will be key to scaling growth while sustaining premium margins. The risk to driving top line growth going forward will be competitive pricing tension, hence the importance of differentiating capabilities (as Kapish provides with Microsoft SharePoint).

Government endorsement and security spend tailwind: In 2H17, we expect revenues relating to CGL's recent customer win with a Federal Government Agency to begin flowing through ($24.8m over two years). We believe CGL is well placed to win its share of new business opportunities as the Government plans to further increase investment spend to build out national cyber security capabilities. Such contracts often deliver revenues beyond initial values outlined, with scope for additional work a factor of CGL exceeding client requirements, and at incrementally higher margins – a proven model for CGL to date.

QLD Health renewal and R&D monetisation: CGL last week signed a five year contract extension with Queensland Health for its state-wide laboratory information management system. This contract extension is a positive endorsement for CGL's investment and operational turnaround of PJAS after being successfully integrated into the CGL Health division. Furthermore, we expect additional new product modules to be taken up within the terms of the contract, monetising CGL's R&D focus on eHealth in remote monitoring, homecare and other cloud-enabled solutions.

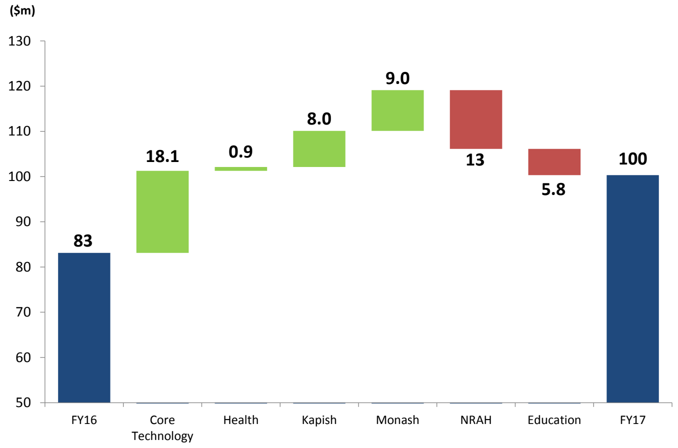
CGL: FY15-17e EBITDA Bridge By Segment

Source: EAP Research Estimates, CGL



CGL: FY16-17e Revenue Bridge By Segment

Source: EAP Research Estimates, CGL



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Result Focus – The Citadel Group (CGL)

EVANS & PARTNERS

FINANCIAL SUMMARY

The Citadel Group	**CGL**			
As at:	**20/02/2017**	**Recommendation: Positive**	**Share Price**	**$5.00**

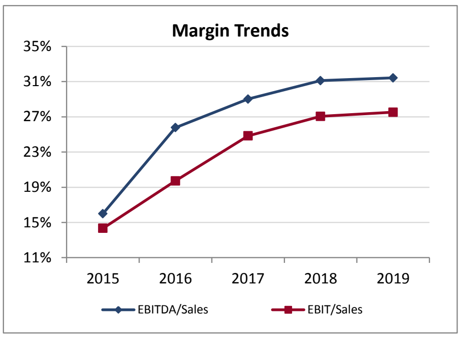
Year end	**June**	**2016A**	**2017E**	**2018E**	**2019E**
INCOME STATEMENT					
Sales Revenue	**$m**	**83**	**100**	**106**	**113**
Consolidated EBITDA	$m	21	29	33	36
D&A	$m	5	4	4	4
Consolidated EBIT	**$m**	**16**	**25**	**29**	**31**
Net Interest	$m	4	3	1	0
Tax Expense	$m	4	6	8	9
Associates/Minorities	$m	1	(3)	(3)	(3)
Adj NPAT	**$m**	**8**	**14**	**18**	**20**
NRIs	$m	0	(1)	0	0
Reported NPAT	$m	8	12	18	20
Shares on Issue (end period)	m	47	48	48	48
EFPOWA	m	48	48	48	48
EPS	**¢**	**17.0**	**28.3**	**37.4**	**41.9**
DPS	¢	9.6	13.0	17.0	21.0
Franking	%	100%	100%	100%	100%
GROWTH/PROFITABILITY RATIOS					
Sales Growth	%	15.0%	20.7%	5.8%	6.8%
EBITDA Growth	%	85.3%	35.9%	13.4%	7.8%
EBIT Growth	%	58.1%	52.0%	15.3%	8.6%
EPS Growth	**%**	**6.2%**	**66.0%**	**32.2%**	**12.1%**
EBITDA/Sales	%	25.8%	29.0%	31.1%	31.4%
EBIT/Sales	%	19.7%	24.8%	27.0%	27.5%
EBIT Interest Cover	x	(4.5)	(8.9)	(47.9)	(298.4)
Tax Rate	%	30.4%	27.5%	27.5%	27.5%
ROE	**%**	**12.7%**	**18.4%**	**20.9%**	**20.4%**
ROFE	**%**	**52.4%**	**48.6%**	**43.6%**	**49.5%**
CASH FLOW					
EBITDA	$m	21	29	33	36
Change in Working Capital	$m	(2)	(1)	0	0
Other	$m	(5)	0	0	0
Gross Operating Cash Flow	**$m**	**14**	**29**	**33**	**35**
Net Interest Paid	$m	0	(3)	(1)	0
Tax Paid	$m	(4)	(6)	(8)	(9)
Net Operating Cash Flow	**$m**	**10**	**20**	**24**	**27**
Maintenance Capex	$m	(4)	(1)	(1)	(1)
Free Cash Flow	**$m**	**6**	**18**	**23**	**25**
Dividends Paid	$m	(5)	(6)	(8)	(10)
Expansionary Capex	$m	0	0	0	0
Acquisitions	$m	(1)	(24)	(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	$m	(3)	0	0	(15)
Increase in Net Cash/(Debt)	**$m**	**(2)**	**(11)**	**(2)**	**0**
GOCF/EBITDA	%	66%	98%	99%	99%
Total Capex/Sales	%	5.3%	1.2%	1.2%	1.1%
Total Capex/Depreciation	x	(0.9)	(0.3)	(0.3)	(0.3)

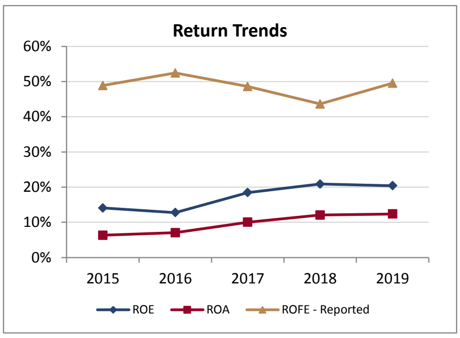
Source: Company data, E&P Research estimates

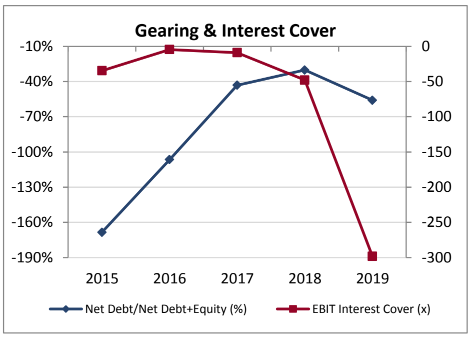
Year end	**June**	**2016A**	**2017E**	**2018E**	**2019E**
VALUATION METRICS					
PER	x	29.4	17.7	13.4	11.9
P/EG (2YR)	x	0.6	0.8	1.5	
Dividend Yield	%	1.9%	2.6%	3.4%	4.2%
EV/EBITDA	x	9.6	7.5	6.6	5.7
EV/EBIT	x	12.6	8.7	7.6	6.5
P/FCF	x	40.1	13.0	10.3	9.4
P/BV	x	3.6	3.3	2.8	2.4
BALANCE SHEET					
Assets					
Cash	$m	35	23	21	37
Working Capital	$m	14	23	25	26
PP&E	$m	6	3	0	(3)
Intangibles	$m	59	82	99	99
Investments	$m	0	0	0	0
Other	$m	3	3	3	3
Total Assets	**$m**	**117**	**135**	**148**	**162**
Liabilities					
Debt	$m	1	1	1	1
Working Capital	$m	13	22	23	25
Other	$m	38	38	38	38
Total Liabilities	**$m**	**52**	**61**	**63**	**64**
Equity	**$m**	**65**	**73**	**86**	**98**
Capital Employed	**$m**	**31**	**51**	**66**	**63**
Net Debt/(Cash)	$m	(33)	(22)	(20)	(35)
Net Debt/Equity	%	(52%)	(30%)	(23%)	(36%)
Net Debt/Debt+Equity	**%**	**(106.6)%**	**(43.2)%**	**(30.2)%**	**(56.0)%**
Net Debt/EBITDA	x	(1.6)	(0.8)	(0.6)	(1.0)
Working Capital/Sales	%	1%	1%	1%	2%
D&A/PP&E	%	(84.3%)	(139.1%)	11,958.3 %	138.0%

DCF VALUATION			**$m**	**$/share**
Risk Free Rate	5.0%	Enterprise Value	270	$5.64
Market Risk Premium	6.0%	(Net Debt)/Cash	12	$0.25
Beta	1.10	Franking Credits		$0.62
WACC	**10.9%**	**DCF Valuation**		**$6.26**

DIVISIONAL SUMMARY					
Education	$m	8	2	0	0
Technology	$m	75	98	106	113
Corporate/Other	$m				
Group Revenue	**$m**	**83**	**100**	**106**	**113**
Education	$m	1	0	0	0
Technology	$m	26	35	38	40
Corporate/Other	$m	(5)	(6)	(5)	(5)
Group EBITDA	**$m**	**21**	**29**	**33**	**36**
Education	%	12.8%	0.0%		
Technology	%	34.4%	35.4%	35.6%	35.6%
Corporate/Other	%				
Group EBITDA/Sales	**%**	**25.8%**	**29.0%**	**31.1%**	**31.4%**







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	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.

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