Stock Focus

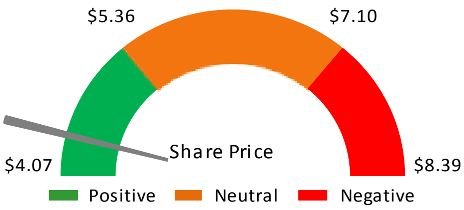
The Citadel Group (CGL)

EVANS & PARTNERS

Wednesday, 12 April 2017

NOT ALL TECH SERVICES ARE CREATED EQUAL

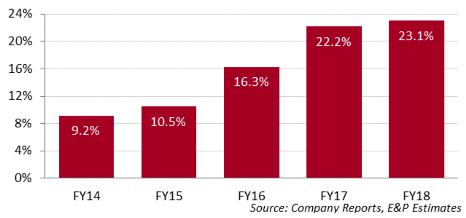
Recommendation: Positive



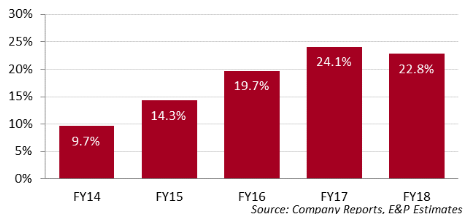
Trading Data

Last Price	$4.52
12 month range	$4.05 - $5.70
Market Cap	$216m
Free Float	$118m (55%)
12 month return (historical)	4.2%

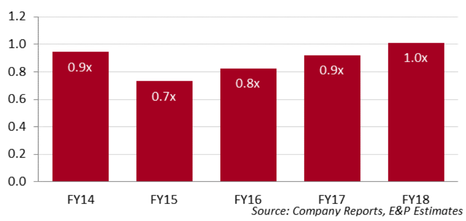
Pre-Tax Return on Invested Capital (%)



Operating Profit Margin (%)



Invested Capital Turnover



CGL VALUATION FRAMEWORK & RELATIVE DISCOUNT

We maintain a Positive recommendation on Citadel Group (CGL) with a $6.04/share valuation. In this report we define the key business attributes that we consider fundamental to ascribing premium valuation multiples for IT service providers.

Considering our valuation framework, CGL's strong growth outlook (3yr EPS CAGR +35%) & attractive margin profile, we think the current discount to listed peers is unjustified. The key attributes we identify are:

i. **Specialised high-growth end-markets:** Enterprise Content Management (ECM), Cyber Security & e-Health industry investment is supported by the increasing digitisation of information, communications and technological change.

ii. **Leveraging long-term & strategic client relationships into new markets:** CGL operates as trusted advisor guiding government/enterprise grade clients through increasingly complex & sensitive IT environments.

iii. **Managed Services** provide a high level of recurring revenues & earnings visibility. CGL's history of contract renewals reflect the successful delivery of client outcomes and provide additional upsell opportunities.

iv. **Attractive margins & scalable IP:** CGL's design & implementation of mission critical services with highly conservative risk premiums attached to contract pricing can sustain premium EBITDA margins >25%.

v. **Diversified vendor relationships:** CGL delivers best suited content management solutions and IT integrations across a range of applications.

WHAT'S CHANGED?

Our blended valuation remains steady at $6.04/share, with FY17/18 underlying EBITDA forecasts largely unchanged at $29.0m/$32.9m. The key adjustment to our forecasts is assuming Gross Margins (GM) normalise from the highs of 1H17.

We believe CGL is well positioned to continue growing its share of wallet managing sensitive and vulnerable data environments, including across smaller companies. Demand for Managed Service Providers that reduce IT complexity, improve cyber security and lower operational costs for corporations continues to grow.

Earnings Forecasts

Yr to June	14A	15A	16A	17E	18E	19E
EBITDA ($m)	5.6	11.6	21.4	29.0	32.9	37.7
Rep NPAT ($m)	3.7	6.5	8.2	11.5	17.2	20.9
Adj NPAT ($m)	3.7	8.0	8.2	12.9	17.2	20.9
EPS (¢)		16.0	17.0	27.0	35.9	43.7
EPS Gth (%)		92.7	6.2	58.7	32.9	21.8
PER (x)		**28.2**	**26.5**	**16.7**	**12.6**	**10.3**
PEG Ratio (x)		0.9	0.6	0.6	0.9	
DPS (¢)		5.8	9.6	12.0	16.0	22.0
Yield (%)		**1.3**	**2.1**	**2.7**	**3.5**	**4.9**
Franking (%)		100%	100%	100%	100%	100%
ROE (%)		**14%**	**13%**	**18%**	**20%**	**21%**
EV/EBITDA (x)		**15.6**	**8.5**	**7.0**	**6.4**	**5.2**
Net Debt/EBITDA (x)		(3.1)	(1.6)	(0.5)	(0.2)	(0.5)
Int. Cover (x)		(34.6)	(4.5)	(8.7)	(46.6)	(1,083.4)
Valuation (blended)						**$6.04**

Source: EAP Research

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POSITIVE INVESTMENT CASE SUPPORTED BY VALUATION FRAMEWORK

CGL's specialist service, managing secure content collaboration for clients requiring the most robust data security systems is a clear point of differentiation to listed peers. We believe the current -10% PER discount to peers is unjustified.

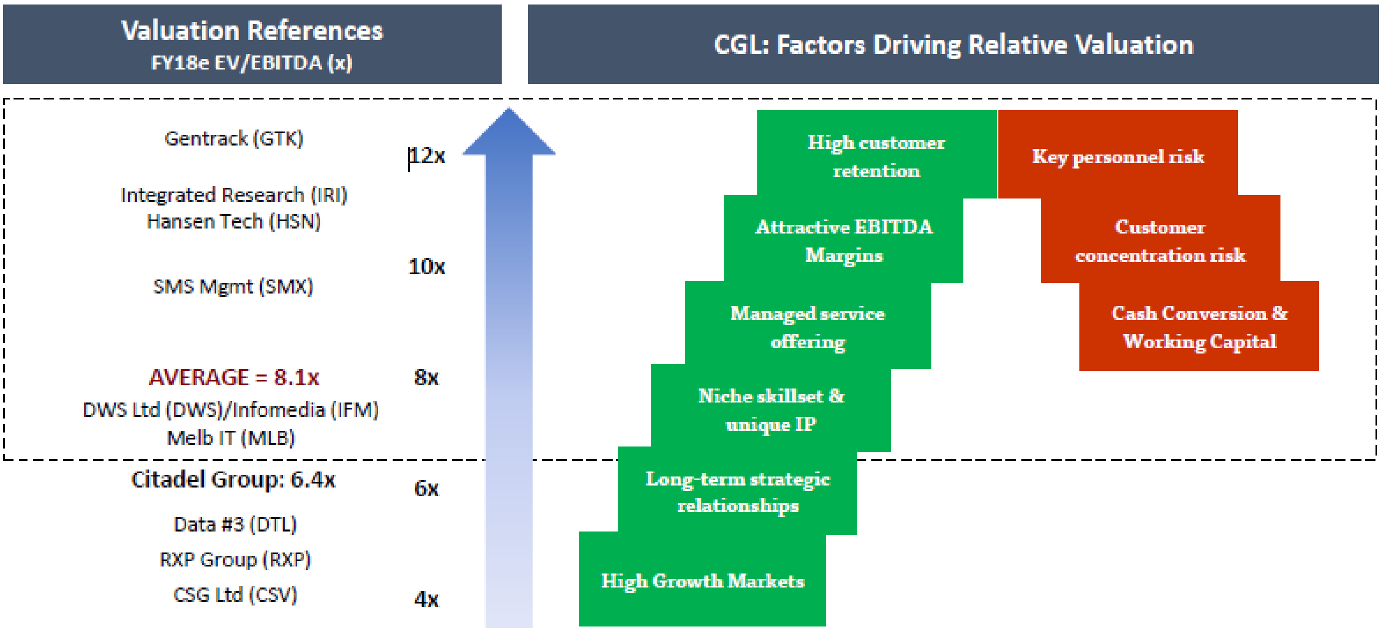
Our base case 'Capitalisation of Earnings' valuation of 8x FY18 EV/EBITDA ($5.62) incorporates a multiple in line with the listed peer average (8.1x) and represents +24% upside to the last closing price. Figure 1 below identifies the key factors that we believe drive relative value premiums in the sector.

CGL has proven its ability to leverage long-term client relationships to increase its share of IT spend. This includes scaling unique IP-based platform solutions to improve secure content collaboration, data analysis, automation and predictive analytics. As the strategic needs of clients become paramount to generating operational efficiencies, it's becoming purpose driven and tailored to specific user cases.

We believe CGL is well positioned to continue growing its share of wallet managing sensitive and vulnerable data environments (including across smaller companies) given technical skillsets and diverse relationships across all vendor applications. Corporate and Government demand for managed service providers to reduce complexity and IT/network operational costs continues to grow. For example, The Enterprise Content Management (ECM) market size is forecast to grow from US$25bn in 2015 to US$60bn by 2020 (CAGR +20%, Source. MarketsandMarkets).

FIGURE 1: KEY DRIVERS OF VALUATION MULITPLES - ASX LISTED IT & SOFTWARE SERVICE PROVIDERS

Source. EAP Research, Bloomberg Consensus



We see scope for CGL to command a premium rating over time. This can be justified by:

i. Stronger 3 year EPS growth profile (FY17-19e EPS CAGR +35% vs. peer average +12.9%)

ii. Premium yet sustainable EBITDA margins (>25%) due to CGL booking highly conservative risk premiums into new contract tenders and generating higher incremental margins on new contracts/projects.

iii. 100% customer retention and contract renewals across all key client contracts.

However, we believe ascribing value ahead of our base case is execution driven. This is on the basis management:

i. Continue building scale and diversification organically and/or via acquisition, and

ii. Build out a track record of delivering quality earnings results providing greater earnings conviction.

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EARNINGS & VALUATION

Our blended valuation remains steady at $6.04/share. Our FY17/18 underlying EBITDA forecasts remain largely unchanged at $29.0m/$32.9m. FY19e EBITDA rises +6% to $37.7m as we assume stronger organic growth in outer years. Further below we discuss the offset of lower EBITDA margins (from 31% to 27-28%) on stronger revenue growth (+15-20%) in FY18/19, as Gross Profit margins normalise towards 40-45%.

FY17/18e EPS forecasts are revised -4% primarily on higher D&A estimates. FY19e EPS rises +5% on stronger growth assumptions and unwind of deferred consideration payments (non-cash item sitting within interest expense).

KEY TAKEOUT: GROSS MARGIN REVERSION TO NORMALISED LEVELS OF 40-45%

The key adjustment to our forecasts is on Gross Margins (GM). We assume GM's revert back to the mid-point of a 40-45% target range, following a particularly strong 1H17 performance of 49.8%. This compares to 41.9% in FY16 & 30.0% in FY15.

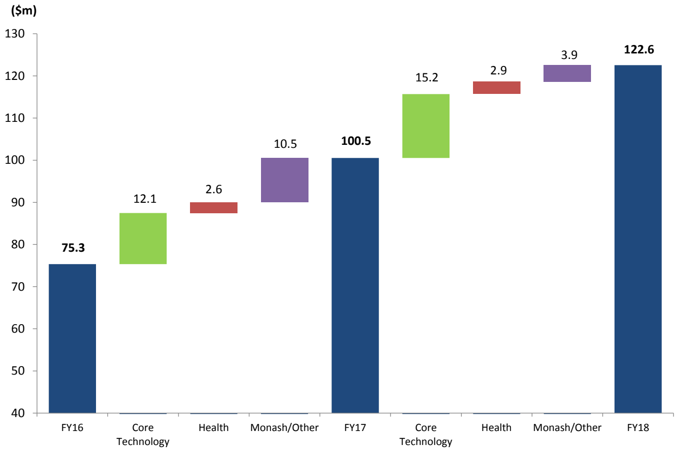
We forecast GM's normalise to 42.5% from FY18 & beyond, while the FY17 GM averages out at 46.5%.

The GM expansion is explained by CGL booking highly conservative risk premiums into the projected cost base of new contracts/projects. As contracts mature, the risk profile typically improves and hence a better than budgeted profit is booked assuming successful completion. Hence, while CGL's managed service contracts are set at a fixed price and invoiced to clients accordingly over a contract period, a larger portion of costs are assumed in the early stages of implementation.

The implication of this is that we believe CGL's EBITDA margins can be sustained at >25%. New contracts are expected to generate incremental margins materially higher on efficient and timely completion. Since IPO, CGL's earnings results have displayed the benefits of increased utilisation across a Knowledge Management skillset and workforce deployed across existing Government contracts. Other accretive benefits have been acquisition driven, including in e-Health (PJAS, now Citadel Health) & in Knowledge Management (Kapish, specialists in Electronic Document Records Mgmt. Services).

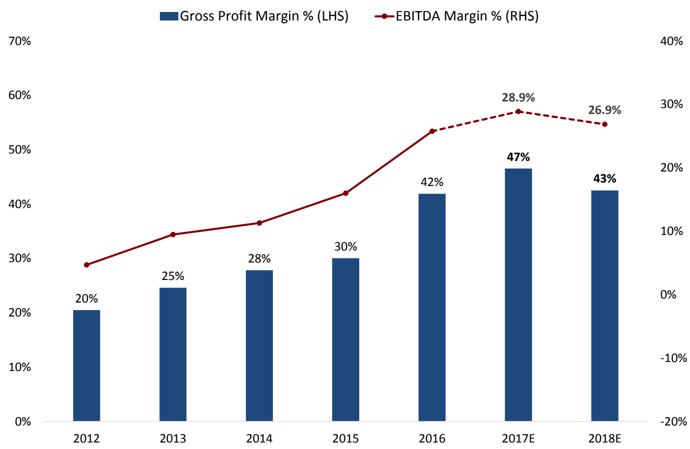
CGL: Revenue Bridge (FY16-18e)

Source: EAP Research Estimates, Company Data



CGL: Gross Margin & EBITDA Margin % (FY12-18e)

Source: EAP Research Estimates, Company Data



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
2017E	100	101	0%	29.1	29.0	(0%)	28.3	**27.0**	**(4%)**	13.0	12.0	(8%)
2018E	106	123	15%	33.0	32.9	(0%)	37.4	**35.9**	**(4%)**	17.0	16.0	(6%)
2019E	113	136	20%	35.6	37.7	6%	41.9	**43.7**	**4%**	21.0	22.0	5%
Blended Valuation				**$6.04**	**$6.04**	**(0%)**						

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

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RELATIVE VALUATION DISCOUNT UNJUSTIFIED

CGL's market opportunity continues to grow across Government, Enterprise and Healthcare clients, delivering premium and secure content management platforms. We believe CGL is attractively priced at 12.6x FY18 PER on the view the company can deliver above average earnings growth & EBITDA margins of +25%.

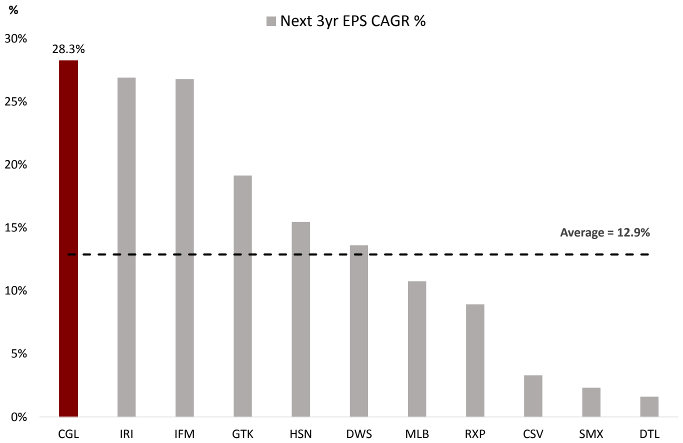
Organic contract wins are obvious catalysts for a positive re-rating, diversifying revenues and driving scale efficiencies across the group. We still forecast accelerating 2H17e revenue growth (to +56%), as new contracts scale up to full capacity (Fed Govt. Agency & Monash) and acquisitions contribute to growth.

With customer retention an important metric in any valuation framework, CGL's proven track record of customer renewals (incl. QLD Health, NSW Pathology North, Defence) and strategic partnerships with clients, acting as a trusted advisor, we believe adds upside to future organic growth prospects.

Complementing CGL's forecast revenue growth and 100% record of customer renewals, are i) 3 year forecast EPS growth and ii) EBITDA margins - both tracking well ahead of listed peer averages (as per charts below).

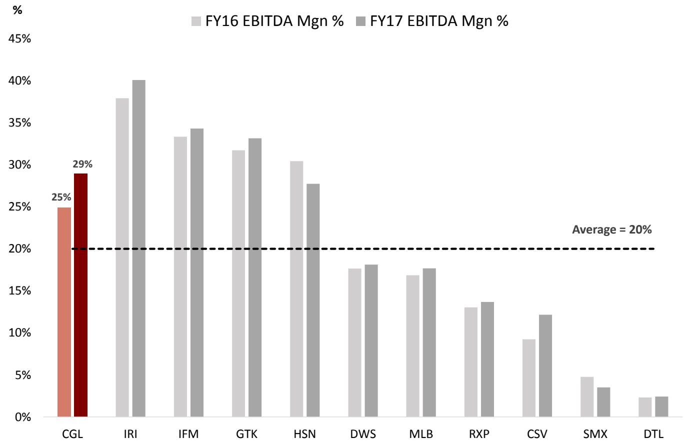
CGL vs. IT LISTED PEERS: Next 3yr EPS Gth %

Source: EAP Research Estimates, Company Data



CGL vs. IT LISTED PEERS: FY16/17e EBITDA Margin %

Source: EAP Research Estimates, Company Data

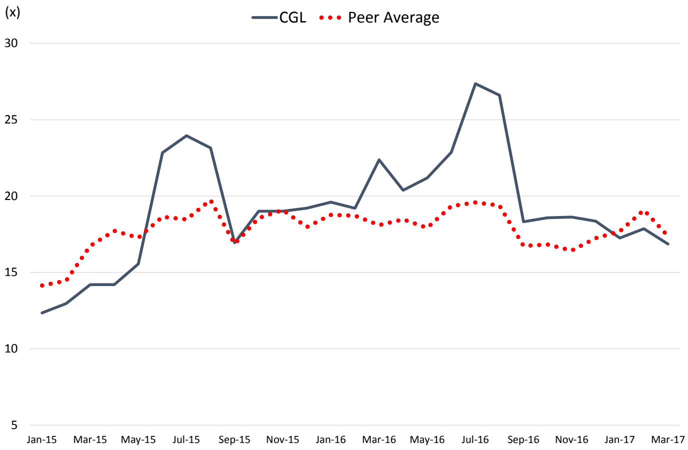


Whilst CGL has historically traded at a relative premium to peers (+7% since Jan-2015), it currently trades at a 10% discount to FY18e PER (x). CGL is trading on 12.6x FY18e PER vs. peers at 14.0x & 6.4x FY18e EV/EBITDA vs. peers at 8.1x.

As per the charts below, we highlight CGL is trading below the peer average on a FWD 12m PER basis for the first time since mid-2015. This is despite CGL's calculated withdrawal from the Vocational Education & Training (VET) sector where regulatory uncertainty impacted investor sentiment and CGL's ability to deliver its premium pathway education service.

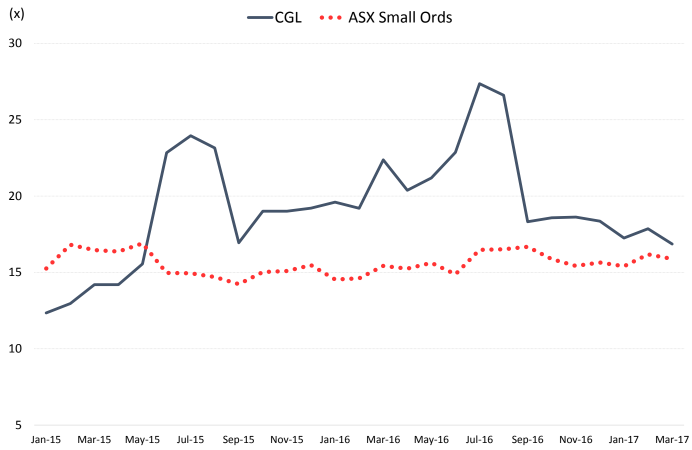
CGL vs. ASX LISTED PEER AVERAGE: Fwd 12m PER (x)

Source: EAP Research Estimates, Company Data



CGL vs. ASX Small Ords (XSO): Fwd 12m PER (x)

Source: EAP Research Estimates, Company Data



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PEER COMPARISON & VALUATION MULITPLES

Source. Bloomberg Consensus

Code	Name	Market cap (m)	EV / EBITDA FY16	EV / EBITDA FY17	EV / EBITDA FY18	EBITDA Margin % FY16	EBITDA Margin % FY17	EBITDA Margin % FY18	P/E FY16	P/E FY17	P/E FY18	Dividend Yield % FY17	Dividend Yield % FY18	Dividend Yield % FY19	EPS Growth rate % Next 3 years
CGL	**The Citadel Group**	**216.4**	**9.7**	**7.0**	**6.1**	**25%**	**29%**	**30%**	**23.7**	**15.6**	**12.6**	**2.6%**	**3.3%**	**3.8%**	**28.3%**
HSN	Hansen Technologies	605.6	12.8	12.0	10.9	30%	28%	28%	22.7	20.8	18.9	1.9%	2.0%	2.2%	8.9%
IRI	Integrated Research	511.7	15.6	13.4	11.1	38%	40%	40%	31.9	27.8	22.4	2.2%	3.0%	3.8%	19.1%
GTK	Gentrack	364.1	21.3	16.5	12.9	32%	33%	34%	33.5	24.2	18.9	3.2%	3.8%	4.4%	26.8%
DTL	Data#3 Limited	264.8	7.2	6.3	5.4	2%	2%	3%	19.1	16.4	14.5	5.4%	6.2%	6.8%	13.6%
IFM	Infomedia Ltd.	225.3	9.3	8.4	7.5	33%	34%	36%	18.6	18.6	16.5	4.3%	4.7%	5.7%	10.8%
MLB	Melbourne IT Limited	221.3	9.3	8.1	7.0	17%	18%	18%	20.1	13.7	11.1	4.4%	5.7%	6.4%	26.9%
DWS	DWS Limited	195.8	8.1	7.7	7.5	18%	18%	19%	11.7	10.9	10.6	7.3%	7.5%	7.5%	3.3%
CSV	CSG Limited	142.8	8.9	5.3	4.2	9%	12%	14%	5.4	7.1	5.4	6.7%	8.3%	14.2%	1.6%
SMX	SMS Mgmt & Tech	111.7	7.7	11.4	9.5	5%	4%	4%	11.6	18.7	14.8	3.4%	4.0%	5.4%	2.3%
RXP	RXP Group	110.7	6.6	5.4	4.9	13%	14%	14%	10.4	8.3	7.2	4.8%	5.4%	5.7%	15.5%
Average			**10.7**	**9.4**	**8.1**	**20%**	**20%**	**21%**	**18.5**	**16.6**	**14.0**	**4.4%**	**5.1%**	**6.2%**	**12.9%**

CGL: FUNDAMENTAL DRIVERS FOR VALUATION MULTIPLE

Below we add further detail to CGL’s key drivers that underpin our valuation framework.

i. **CGL operate across high-growth, niche end-markets:** Enterprise Content Management (ECM), cyber security & e-Health investment is supported by the continual increase in digitisation of information, communications and technological change. As per Gartner’s industry report regarding ECM, application leaders responsible for content management should understand the following forces that are affecting the ECM market. We believe CGL is well placed to evolve as a market leader domestically and potentially offshore, following key clients into new markets:

- New business requirements, such as those introduced by the digital workplace.
- Technological evolution, as evidenced by the rise of cloud and hybrid content service architectures.
- Operational factors, such as new types of technology buyers and a focus on mobilized user experiences.
- A new organizational emphasis on creating and improving content-centric processes that boost productivity, foster digital business, and facilitate the use and sharing of information.
- Provide business intelligence (BI) and insight, and empower users as they work.

ii. **Leveraging long-standing strategic client relationships**: The power of incumbency improves on its growing reputation for delivering successful client outcomes**.** CGL enjoy high contract renewal rates and operate as trusted advisor guiding government/enterprise grade clients through increasingly complex & sensitive IT environments. Furthermore, CGL operate in a landscape where there are increased barriers to entry for non-panelled or foreign firms (where staff may not hold national security clearances).

iii. **Specialist ‘Knowledge Management’ service offering:** CGL has established multi-year recurring revenue streams under contracts with the Government, Defence and other Enterprise. CGL also processes c.40% of all data transactions associated in public laboratory pathology testing in Australia – i.e. mission critical data flow to the public health sector.

- This provides a high level of recurring revenues (>70% in any given year looking ahead 12 months) and earnings visibility. CGL’s history of contract renewals provide additional upsell opportunities at incrementally higher margins.

iv. **Sustainable margins (>25%) & scalable IP:** The design & implementation of mission critical niche services support sustainable EBITDA margins above the peer average of c.20%. On various managed service deals, an attached risk premium above expected margin premiums result in highly conservative cost allocation and much higher incremental margins on new contracts.

v. **Diversified vendor relationships** means CGL delivers best suited content management solutions and IT integrations across a range of applications.

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FINANCIAL SUMMARY

The Citadel Group	**CGL**				
As at:	**13/04/2017**	**Recommendation: Positive**		**Share Price**	**$4.52**

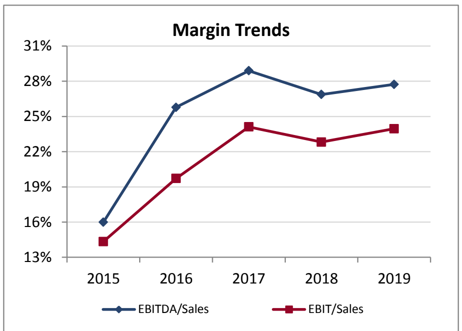
Year end	**June**	**2016A**	**2017E**	**2018E**	**2019E**
INCOME STATEMENT					
Sales Revenue	**$m**	**83**	**101**	**123**	**136**
Consolidated EBITDA	$m	21	29	33	38
D&A	$m	5	5	5	5
Consolidated EBIT	**$m**	**16**	**24**	**28**	**33**
Net Interest	$m	4	3	1	0
Tax Expense	$m	4	6	8	9
Associates/Minorities	$m	1	(3)	(3)	(3)
Adj NPAT	**$m**	**8**	**13**	**17**	**21**
NRIs	$m	0	(1)	0	0
Reported NPAT	$m	8	12	17	21
Shares on Issue (end period)	m	47	48	48	48
EFPOWA	m	48	48	48	48
EPS	**¢**	**17.0**	**27.0**	**35.9**	**43.7**
DPS	¢	9.6	12.0	16.0	22.0
Franking	%	100%	100%	100%	100%
GROWTH/PROFITABILITY RATIOS					
Sales Growth	%	15.0%	20.9%	21.9%	11.0%
EBITDA Growth	%	85.3%	35.5%	13.4%	14.6%
EBIT Growth	%	58.1%	47.9%	15.3%	16.6%
EPS Growth	**%**	**6.2%**	**58.7%**	**32.9%**	**21.8%**
EBITDA/Sales	%	25.8%	28.9%	26.9%	27.7%
EBIT/Sales	%	19.7%	24.1%	22.8%	24.0%
EBIT Interest Cover	x	(4.5)	(8.7)	(46.6)	(1,083.4)
Tax Rate	%	30.4%	28.0%	28.0%	28.0%
ROE	**%**	**12.7%**	**17.7%**	**20.2%**	**21.4%**
ROFE	**%**	**52.4%**	**40.6%**	**35.3%**	**41.2%**
CASH FLOW					
EBITDA	$m	21	29	33	38
Change in Working Capital	$m	(2)	(8)	(6)	(4)
Other	$m	(5)	(2)	0	0
Gross Operating Cash Flow	**$m**	**14**	**19**	**27**	**34**
Net Interest Paid	$m	0	(3)	(1)	0
Tax Paid	$m	(4)	(6)	(8)	(9)
Net Operating Cash Flow	**$m**	**10**	**11**	**19**	**25**
Maintenance Capex	$m	(4)	(1)	(1)	(1)
Free Cash Flow	**$m**	**6**	**9**	**18**	**24**
Dividends Paid	$m	(5)	(6)	(8)	(10)
Expansionary Capex	$m	0	0	0	0
Acquisitions	$m	(1)	(24)	(18)	0
Asset Sales	$m	0	0	0	0
Dividends Received	$m	2	0	0	0
Shares Issues/Buybacks	$m	0	0	0	0
Other	$m	(3)	0	0	(13)
Increase in Net Cash/(Debt)	**$m**	**(2)**	**(20)**	**(8)**	**0**
GOCF/EBITDA	%	66%	67%	82%	90%
Total Capex/Sales	%	5.3%	1.2%	1.0%	0.9%
Total Capex/Depreciation	x	(0.9)	(0.3)	(0.3)	(0.2)

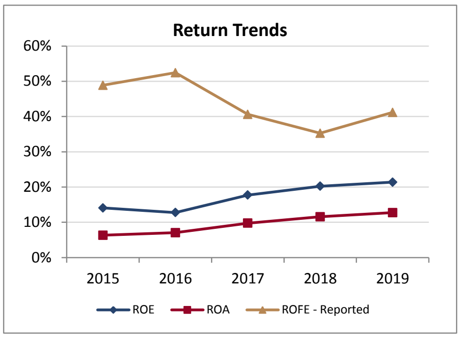
Source: Company data, E&P Research estimates

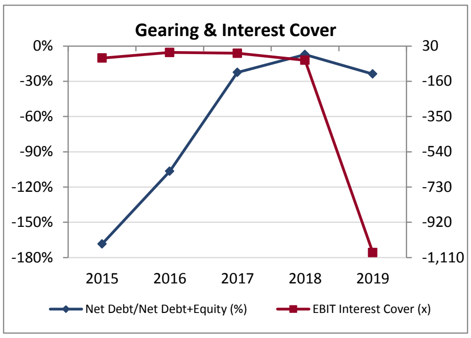
Year end	**June**	**2016A**	**2017E**	**2018E**	**2019E**
VALUATION METRICS					
PER	x	26.5	16.7	12.6	10.3
P/EG (2YR)	x	0.6	0.6	0.9	
Dividend Yield	%	2.1%	2.7%	3.5%	4.9%
EV/EBITDA	x	8.5	7.0	6.4	5.2
EV/EBIT	x	11.2	8.4	7.5	6.1
P/FCF	x	36.3	23.0	12.3	9.2
P/BV	x	3.3	3.0	2.5	2.2
BALANCE SHEET					
Assets					
Cash	$m	35	15	7	20
Working Capital	$m	14	31	41	47
PP&E	$m	6	2	4	5
Intangibles	$m	59	82	99	99
Investments	$m	0	0	0	0
Other	$m	3	3	3	3
Total Assets	**$m**	**117**	**133**	**149**	**164**
Liabilities					
Debt	$m	1	1	1	1
Working Capital	$m	13	20	24	27
Other	$m	38	38	38	38
Total Liabilities	**$m**	**52**	**60**	**64**	**66**
Equity	**$m**	**65**	**73**	**85**	**98**
Capital Employed	**$m**	**31**	**60**	**79**	**79**
Net Debt/(Cash)	$m	(33)	(13)	(6)	(19)
Net Debt/Equity	%	(52%)	(18%)	(7%)	(19%)
Net Debt/Debt+Equity	**%**	**(106.6)%**	**(22.4)%**	**(7.2)%**	**(23.8)%**
Net Debt/EBITDA	x	(1.6)	(0.5)	(0.2)	(0.5)
Working Capital/Sales	%	1%	10%	13%	15%
D&A/PP&E	%	(84.3%)	(198.4%)	382.4%	99.1%

DCF VALUATION			**$m**	**$/share**
Risk Free Rate	5.0%	Enterprise Value	279	$5.83
Market Risk Premium	6.0%	(Net Debt)/Cash	6	$0.12
Beta	1.18	Franking Credits		$0.63
WACC	**11.4%**	**DCF Valuation**		**$6.45**

DIVISIONAL SUMMARY					
Education	$m	8	2	0	0
Technology	$m	75	101	123	136
Corporate/Other	$m				
Group Revenue	**$m**	**83**	**101**	**123**	**136**
Education	$m	1	0	0	0
Technology	$m	26	35	39	44
Corporate/Other	$m	(5)	(6)	(6)	(7)
Group EBITDA	**$m**	**21**	**29**	**33**	**38**
Education	%	12.8%	0.0%		
Technology	%	34.4%	34.9%	31.8%	32.5%
Corporate/Other	%				
Group EBITDA/Sales	**%**	**25.8%**	**28.9%**	**26.9%**	**27.7%**







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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AYJ	A director of Evans and Partners Pty Ltd is a director of Australian Masters Yield Fund No 3 Limited
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IGL	Evans and Partners has arranged, managed or co-managed an offering of securities of the company or its affiliates in the past 12 months.
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NAB	Evans and Partners has arranged, managed or co-managed an offering of securities of the company or its affiliates in the past 12 months.
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SWM	A director of Evans and Partners Pty Ltd is a director of Seven West Media Limited.
TOX	Evans and Partners arranged, managed or co-managed a public offering of the company or its affiliates in the past 12 months
URF	A director of Evans and Partners Pty Ltd is a director of URF's primary underlying investment, US Masters Residential Property (USA) Fund (US REIT), and a director of other related entities that provide services to URF.
USF	A Director of Evans and Partners Pty Ltd is a director of the Investment Manager of the Limited Partnership, the investment vehicle through which USF invests.
USG	A Director of Evans and Partners Pty Ltd is a director of the Investment Manager who provides investment management services to the General Partner for the Limited Partnership, the investment vehicle through which USG invests.
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