07 July 2016

THE CITADEL GROUP (CGL)

Wilson HTM EQUITIES RESEARCH

BUY HOLD SELL

Company update

Pencils down on the QLD Health LIS project – Citadel well positioned – BUY maintained

Queensland Health's re-tendering process for pathology laboratory information system (LIS) services will soon close. Citadel Health is the long-standing incumbent and our view is that it is likely to be returned, notwithstanding strong competition. The outcome is expected to be announced in early 2017. We expect Citadel to report 21% EPS growth when it release its FY16 results, on or about the 22nd of August. Strong forecast growth again in FY17e, benefiting from Citadel's pivot towards the healthcare vertical where more resources are being deployed. We maintain our BUY rating and $6.25 target price.

Key points

QLD Health LIS tender submission in the short term. We understand that submissions will soon close in relation to Queensland Health's market re-test for a public pathology laboratory information management system (LIS). Citadel Health is the long-standing incumbent but is likely to face competition from Cerner, Epic and others. LIS is a complex piece of infrastructure and as such we expect Queensland will spend at least six months reviewing proposals.

WHTM view and sensitivities. Our view is that the political and budgetary environment in Queensland is unlikely to support a change of this magnitude (costs, risks to patient safety), particularly within Health. Citadel has been returned on at least two previous occasions in its Queensland role and our model forecasts business as usual from FY17. Should Citadel not be returned, there are some protections around the near-term earnings impact, but the valuation effect could be as large as 10%, by our DCF-based assessments.

Earnings preview. We expect Citadel to report FY16 earnings on or about the 22nd of August. We are forecasting 21% EPS growth in FY16 and 52% growth in FY17, noting the recent acquisition of Kapish and potential upside from organic sources.

Valuation. Our 12-month price target of $6.25 per share (DCF). Our price target implies 21.2x FY17e EPS and 9.4x 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) reduced volume through changes to vocational education and training funding; c) loss of key management personnel; d) technological obsolescence; e) competition.

12-mth target price (AUD)	**$6.25**
Share price @ 04-Jul-16 (AUD)	$5.15
Forecast 12-mth capital return	21.4%
Forecast 12-mth dividend yield	2.5%
12-mth total shareholder return	**23.9%**
Market cap	$241m
Enterprise value	$216m
Shares on issue	47m
Sold short	
ASX 300 weight	n/a
Median turnover/day	$0.0m

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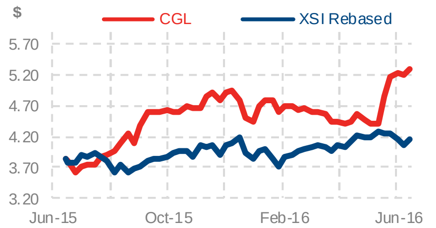
12-mth share price performance



	1-mth	6-mth	12-mth
Abs return (%)	12.3	11.8	41.1
Rel return (%)	15.0	12.5	33.4

Year-end June (AUD)	FY14A	FY15A	FY16F	FY17F	FY18F
NPAT rep ($m)	4.1	6.5	9.0	11.3	14.8
NPAT norm ($m)	4.1	6.5	9.0	13.8	17.0
Consensus NPAT ($m)			8.9	12.8	15.2
EPS norm (cps)	12.4	16.0	19.4	29.5	36.4
EPS growth (%)	22.5	29.1	20.9	52.5	23.2
P/E norm (x)	41.5	32.2	26.6	17.4	14.2
EV/EBITDA (x)	37.3	21.3	10.5	7.4	6.7
FCF yield (%)	2.2	2.5	5.4	6.4	7.9
DPS (cps)	20.0	5.8	10.0	13.5	16.5
Dividend yield (%)	3.9	1.1	1.9	2.6	3.2
Franking (%)	100	100	100	100	100

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

KEY CHANGES		14-Jun	After	Var %
NPAT:	**FY16F**	9.0	9.0	0.0%
norm	**FY17F**	13.8	13.8	0.0%
($m)	**FY18F**	17.0	17.0	0.0%
EPS:	**FY16F**	19.4	19.4	0.0%
norm	**FY17F**	29.5	29.5	0.0%
(cps)	**FY18F**	36.4	36.4	0.0%
DPS:	**FY16F**	10.0	10.0	0.0%
(cps)	**FY17F**	13.5	13.5	0.0%
	FY18F	16.5	16.5	0.0%
Price target:		6.25	6.25	0.0%
Rating:		**BUY**	**BUY**	

PRICE TARGET

	Valuation	Price target
WACC (%)	11.3	
Tg (%)	2.6	
NPV fcst FCF	56.9	
NPV perpetuity	218.3	
Net debt/(cash)	16.8	
Valuation ($m)	292.1	
DCF ($/share)		6.25
Price target ($/share)		**6.25**

INTERIMS ($m)

Half-year (AUD)	Dec 14	Jun 15	Dec 15	Jun 16
	1HA	2HA	1HA	2HE
Sales revenue	29.4	42.9	46.4	47.3
EBITDA	3.3	6.8	12.3	8.4
EBIT	2.9	6.0	10.1	5.4
Net profit	**1.4**	**5.2**	**5.6**	**3.5**
Norm EPS	**3.7**	**11.5**	**11.5**	**7.7**
EBIT/sales (%)	9.9	14.1	21.9	11.4
Dividend (c)	0.0	5.8	4.8	5.2
Franking (%)	100.0	100.0	100.0	100.0

FINANCIAL STABILITY

Year-end June (AUD)	FY15A	FY16F	FY17F
Net debt	-35.8	-24.5	-16.8
Net debt/equity (%)	<0	<0	<0
Net debt/EV (%)	**<0**	**<0**	**<0**
Current ratio (x)	3.0	2.7	2.9
Interest cover (x)	<0	9.5	7.2
Adj cash int cover (x)	**<0**	**11.9**	**7.9**
Debt/cash flow (x)	0.0	0.1	0.1
Net debt (cash)/share ($)	<0	<0	<0
NTA/share ($)	1.4	1.1	0.9
Book value/share ($)	1.1	1.4	1.4
Payout ratio (%)	36	52	46
Adj payout ratio (%)	67	38	34

EPS RECONCILIATION ($m)

	FY15A		FY16F	
	Rep	Norm	Rep	Norm
Sales revenue	72	72	94	94
EBIT	8.4	9.0	15.5	15.5
Net profit	**6.5**	**6.5**	**9.0**	**9.0**
Notional earn	0.0	0.0	0.0	0.0
Pref/conv div	0.0	0.0	0.0	0.0
Profit for EPS	**6.5**	**6.5**	**9.0**	**9.0**
Diluted shrs (m)	41	41	47	47
Diluted EPS (c)	**16.0**	**16.0**	**19.4**	**19.4**

RETURNS

	FY15A	FY16F	FY17F	FY18F
ROE (%)	16	15	22	24
ROIC (%)	46	37	38	32
Incremental ROE	14	14	108	48
Incremental ROIC	45	30	51	10

KEY ASSUMPTIONS

Year-end June (AUD)	FY13A	FY14A	FY15A	FY16F	FY17F	FY18F	FY19F	FY20F
Revenue growth (%)		-0.8	45.9	29.6	30.6	4.7	8.4	8.6
EBIT growth (%)		22.6	77.2	73.6	65.3	7.4	5.8	9.8
NPAT growth (%)		20.2	58.0	38.5	52.5	23.2	4.8	11.4
EPS growth (%)		**22.5**	**29.1**	**20.9**	**52.5**	**23.2**	**4.8**	**11.4**
EBIT/sales (%)	8.2	10.2	12.4	16.6	21.0	21.5	21.0	21.3
Tax rate (%)	20.3	22.0	22.5	35.0	34.0	27.9	27.0	27.0
ROA (%)	**10.2**	**10.2**	**7.1**	**10.7**	**16.3**	**15.2**	**15.0**	**15.8**
ROE (%)	**15.9**	**16.4**	**11.5**	**13.7**	**20.0**	**20.9**	**19.7**	**20.7**

PROFIT AND LOSS ($m)

Year-end June (AUD)	FY13A	FY14A	FY15A	FY16F	FY17F	FY18F	FY19F	FY20F
Sales revenue	50.0	49.6	72.3	93.7	122.4	128.2	138.9	150.8
EBITDA	4.9	5.8	10.1	20.7	29.3	32.1	35.9	39.2
Depn & amort	0.8	0.7	1.2	5.1	6.1	6.7	6.9	7.1
EBIT	**4.1**	**5.1**	**9.0**	**15.5**	**23.2**	**25.4**	**29.0**	**32.1**
Net interest expense	-0.2	-0.2	-0.1	1.6	3.2	2.0	2.0	1.8
Tax	0.9	1.2	2.0	4.9	6.8	6.5	7.3	8.2
Minorities/pref divs	0.0	0.0	0.0	0.0	1.9	2.1	2.2	2.3
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**	**9.0**	**11.3**	**14.8**	**17.6**	**19.8**
Abns/exts/signif	0.0	0.0	-0.5	0.0	0.0	0.0	0.0	0.0
Reported net profit	**3.4**	**4.1**	**6.5**	**9.0**	**11.3**	**14.8**	**17.6**	**19.8**

CASH FLOW ($m)

Year-end June (AUD)	FY13A	FY14A	FY15A	FY16F	FY17F	FY18F	FY19F	FY20F
EBITDA	4.9	5.8	10.1	20.7	29.3	32.1	35.9	39.2
Interest & tax	-0.2	-1.1	-1.8	-4.1	-3.6	-4.5	-5.4	-6.4
Working cap/other	-1.5	1.9	-1.5	-2.1	-8.6	-6.6	-6.9	-6.9
Operating cash flow	**3.3**	**6.6**	**6.9**	**14.4**	**17.1**	**21.0**	**23.6**	**25.9**
Maintenance capex	-0.6	-1.4	-0.8	-1.5	-1.8	-2.1	-2.4	-2.7
Free cash flow	**2.7**	**5.3**	**6.1**	**13.0**	**15.3**	**18.9**	**21.3**	**23.2**
Dividends paid	-1.3	-1.3	-4.1	-4.9	-5.2	-7.0	-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	-20.0	-17.8	-18.0	0.0	0.0
Other inv flows	1.1	3.1	-1.9	2.8	0.0	0.0	0.0	0.0
Cash flow pre-financing	**2.6**	**7.1**	**-8.9**	**-9.1**	**-7.6**	**-6.1**	**12.8**	**13.8**
Funded by equity	0.0	0.0	25.0	0.0	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	11.0	-2.4	-8.9	-12.8	-13.8

BALANCE SHEET SUMMARY ($m)

Year-end June (AUD)	FY13A	FY14A	FY15A	FY16F	FY17F	FY18F	FY19F	FY20F
Cash	13.0	19.3	37.2	25.7	28.0	37.0	49.8	63.6
Current receivables	11.2	12.1	21.3	11.0	15.4	18.0	23.5	29.6
Current inventories	0.4	1.5	1.8	1.7	2.1	2.3	2.5	2.7
Net PPE	0.9	1.7	2.6	9.3	14.6	19.4	15.0	10.7
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	70.3	80.9	91.7	91.7	91.7
Other	1.1	1.2	3.8	4.2	4.2	4.2	4.2	4.2
Total assets	**40.3**	**49.4**	**126.7**	**122.1**	**145.2**	**172.5**	**186.7**	**202.5**
Current payables	14.5	14.4	21.9	14.2	18.3	19.5	21.2	22.9
Total debt	0.6	0.1	1.5	1.2	11.2	26.2	26.2	26.2
Other liabilities	3.6	9.5	46.4	45.4	50.0	52.2	54.8	57.4
Total liabilities	**18.7**	**24.1**	**69.7**	**60.7**	**79.4**	**97.9**	**102.1**	**106.5**
Minorities/convertibles	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Shareholder equity	**21.6**	**25.3**	**57.0**	**61.3**	**65.8**	**74.6**	**84.6**	**96.0**
Total funds employed	**22.2**	**25.4**	**58.4**	**62.5**	**77.0**	**100.8**	**110.8**	**122.2**

Citadel Group – notes following recent meetings

Reiterating our core thesis on Citadel

We are bullish on a "re-rating" for Citadel stock, heading into FY17. Citadel is pursuing a set of deeper, architectural plays, particularly in the Australian healthcare IT arena, involving "customer requested" combinations of hardware, software, managed services and recurring revenues. The corollaries of a successful managed service model are consistent, double-digit growth in revenue, featuring a growing proportion of recurring business, largely organic in nature, coupled with margin expansion. Earnings quality, therefore, ought to be the real driver of valuation gains for Citadel, as it seeks to differentiate itself from a crowded field of small cap, listed systems developers. Our $6.25 price target is set in line with our discounted cash flow (DCF) valuation of Citadel shares.

Earnings preview

We are expecting Citadel to release its FY16 results on or about the 22nd of August. Our expectations are unchanged from our coverage transition note of last month: WHTMe forecasting ~21% growth in underlying EPS, the uplift largely a reflection of the PJA Solutions (now part of Citadel Health) acquisition (closed Jun-15, contributing ~$9.5m in EBITDA).

Table 1: Earnings summary for Citadel Group (CGL)

Earnings summary				
Y/E 30 Jun		FY15a	FY16a	%chg
Sales revenue	**$m**	**72.3**	**93.7**	**30%**
Technology		61.1	83.1	36%
Education		11.2	10.6	-5%
Gross Profit	$m	22.5	38.5	71%
Margin	*%*	*31.1%*	*41.1%*	
Operating Expenses	$m	12.3	17.8	45%
EBITDA	**$m**	**10.1**	**20.7**	**104%**
Margin	*%*	*14.0%*	*22.1%*	
D&A	$m	1.2	5.1	329%
EBIT	$m	9.0	15.5	74%
Margin	*%*	*12.4%*	*16.6%*	
Net interest expense (benefit)	$m	(0.1)	1.6	nm
Tax expense (benefit)	$m	2.0	4.9	138%
NPAT (normalised)	**$m**	**6.5**	**9.0**	**38%**
NPAT (reported)	$m	5.6	9.0	62%
EPS (normalised)	**cps**	**16.0**	**19.4**	**21%**
DPS	**cps**	**5.8**	**10.0**	**72%**

Source: WHTM Research

FY17 outlook

We are forecasting 40% EBITDA growth in FY17, with the recently completed acquisition of Kapish contributing at least ~$4m and Citadel's increased equity interest in filosoph-e as another key component. Kapish's FY17 earnings may benefit incrementally from geographical expansion and by leveraging complementary technology from elsewhere within the Citadel group. Turning to Health in FY17, there are two obvious sources of upside to our forecasts: a) an opportunity to take on managed service responsibilities at the new Royal Adelaide Hospital (NRAH) facility; and b) further extensions in pathology (geographical and product-level enhancements). Winning new work at NRAH does depend on other parties – notably Spotless, as the prospective facility manager. We view NRAH as a 2HFY17 opportunity, given that the hospital is likely to open late 2016 or early 2017. We also see the potential for Technology gross and operating margins to improve over the course of specific contracts. As new projects are added, incremental revenue growth will lap the upfront expenditure at project start-up, giving margin expansion. The operating margin expansion in Technology should be an important driver of our ~13-15% medium-term EPS CAGR forecast.

Thoughts on QLD Health contract, currently under review

QLD Health LIS contract action date in early 2017. Citadel Health is the incumbent provider of the laboratory information system (LIS) that is used across pubic pathology in Queensland. Queensland Health is obliged to periodically re-test the provider market by competitive tender. Last month, Queensland Health did retender for this project, and we understand that proposals are due very shortly, starting a review phase of ~6 months. We would expect rival bids to come from traditional competitors including Cerner, Epic and Omnilab.

WHTM view. Our forecasts and valuation both work on the basis of Citadel being returned in Queensland on similar commercial terms to what they have now. We form that view on the basis that the prevailing political and budgetary environment in Queensland, to our mind, does not appear conducive to a change of this magnitude, particularly one involving the Health portfolio. The level of cost and risk associated with changing the Queensland public pathology LIS is reported to be very high because the state's dependence on the data crosses into multiple portfolios. Citadel has been returned on at least two previous occasions. In this episode, the technology offering from Citadel may also be enhanced by the prospect of rolling out significant upgrades (looking to Victorian public hospital reference sites which are operating with updated versions), integration with the National Blood Authority's centralised blood inventory management system and other interoperability features.

Potential earnings and valuation impact attached to QLD contract. We understand that if the Queensland decision does go against Citadel in early 2017, revenue remains contracted over a transitional period, measured in years. That surety, coupled with likely cost-out options, may limit the near-term earnings impact, relative to our forecasts. The Queensland contract is more material to our valuation. In pure DCF valuation terms, we assess the share price downside impact at ~8% to 10%, having explored a range of DCF scenarios. It is difficult to determine the effect with accuracy, but the earnings short-fall would be offset in a small way by the non-payment of specific earn-out liabilities and even some potential claw-backs for underperformance.

Valuation

DCF valuation

Our 12-month price target of $6.25 per share is derived from our DCF valuation. The price target implies 21.2x FY17e EPS and 9.4x FY17e EV/EBITDA which are higher multiples than have been applied to the stock during its relatively short trading history.

Table 7: Discounted cash flow valuation framework for Citadel

Valuation		The Inputs	
PV of FCFF ($M) =	56.9	Forecast period	FY20
PV of Terminal Value ($M) =	218.3	Risk-free rate	3.50%
Value of Operating Assets of the firm ($M)=	275.2	Risk premium	7.00%
- Net cash ($M)	16.8	Beta	1.2
Equity value ($M) =	**292.1**	Targe D/E	7%
Shares on issue	46.7		
New issuance and options	-		
Fully diluted shares	46.7	WACC	11.3%
Value of Equity per share =	**$6.25**	Tg	2.6%
CGL Target Price	**$6.25**		

Source: WHTM Research

Figure 1: Citadel valuation data since IPO in 2014

Source: Bloomberg, WHTM Research

The Citadel Group Limited (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 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, software and systems. 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

- Education segment – number of students and revenue per student
- 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 forecasting net cash of ~$25m as at FY16e

BOARD

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

MANAGEMENT

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

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Recommendation structure and other definitions

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