Date
20 February 2018

Theme
Financial Results

WILSONS

Company
Citadel Group (CGL)

BUY: Maintaining EBITDA forecasts after verifying the strong 2H bias

We maintain a BUY rating with a revised price target of $7.38 per share. Optically, Citadel's interim NPAT of $4.9m was a miss, reminding the market of the strong 2H bias to earnings. We have left our full-year EBITDA forecasts unchanged and we see yesterday's 5% stock sell-off as a good opportunity to add to CGL holdings. Citadel is a recent addition to the Wilsons Conviction List. We like the company's renewed focus on centralised R&D, which looks to exploit new IP across multiple verticals and support earnings quality and re-investment. The stronger 2H18 result is expected to showcase several of these features well. As examples, we expect more business to be won in Health (Citadel having notched up its first organic wins outside pathology) and in Knowledge management (where the new Citadel-IX platform IP is key).

Key points

1H18 result snapshot. Citadel's 1H18 normalised EPS of 10.0cps reflected 29% growth on pcp and supported a 4.8cps interim dividend. The operating and profit results were both below our forecasts, which underplayed the 2H bias associated with large public sector clients. Management described a group-level 40:60 (1H:2H) split this year, implying ~$118m revenues for the full year. 1H18 revenue of $47.5m missed our forecast of $54.1m with most of the discrepancy expected to be recognised in the 2H. 1H18 EBITDA was $13.1m which was up 12% on pcp but 22% short of our forecast. Importantly, management indicated that it remains comfortable with full-year FY18e consensus expectations ($34.0m EBITDA versus our unchanged forecast of $33.5m). Management also indicated that EBITDA margins in the 2H would be similar to 1H, notwithstanding ongoing investment in people and new technology R&D.

Cash flow and balance sheet. The 2H bias is even stronger at the operating cash flow level, with 1H generating a weak $2m. Management expects that full-year operating cash flow growth will be similar to EBITDA growth, implying >100% EBITDA conversion in the 2H. Citadel also took a ~$11m increase in drawn debt for 1H18 but their net debt position remains very modest ($1.3m).

Takeaways from the conference call. Key themes: a) Contract growth: In January, management provided a contracts update, which clarified specific projects and revenue streams from health, national security, and cloud migration. There were $62m in renewals and/or new contracts signed since July 2017. The specific projects highlight the versatility of Citadel's IP and how it can be leveraged across multiple verticals. b) Health: While Citadel lost a major contract with Queensland Health (from 2022), we foresee continued growth across the broader health platform and with CHARM oncology. Citadel successfully secured its first Health Enterprise Services Management contract with Ballarat Health and has more high-value contracts in the pipeline both domestically (Ramsay) and internationally (UK providers). d) M&A: Management indicated its interest in pursuing M&A to generate higher levels of organic growth. The group is in a reasonably good position to pursue deals now that the payments for Charm and PJAS (deferred consideration) are settled. Recall that Citadel has drawdown capacity of up to $50m on facilities.

Forecasts and valuation. Our operational forecasts (revenue and EBITDA) are unchanged. Normalised NPAT changes of 2%-4% reflect increases in D&A and interest expense estimates. Our revised $7.38 price target is based on DCF and implies 10.3x EV/EBITDA and 25.0x FY18e EPS.

Risks and catalysts

Risks: a) loss of contracts; b) loss of key management; c) technology obsolescence. **Catalysts**: a) organic revenue growth; b) evidence of margin expansion; c) new contract wins and/or renewals; d) accretive acquisitions.

Recommendation	**BUY**
12-mth target price (AUD)	**$7.38**
Share price @ 19-Feb-18 (AUD)	$6.78
Forecast 12-mth capital return	8.8%
Forecast 12-mth dividend yield	2.2%
12-mth total shareholder return	**11.0%**

Market cap	$333m
Enterprise value	$315m
Shares on issue	49m
Sold short	0.0%
ASX 300 weight	n/a
Median turnover/day	$0.2m

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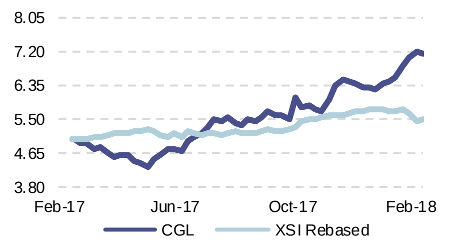
12-mth price performance ($)

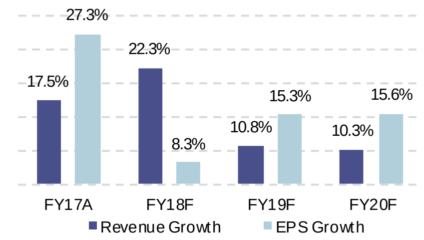


	1-mth	6-mth	12-mth
Abs return (%)	8.5	37.1	46.7
Rel return (%)	11.5	30.7	36.3

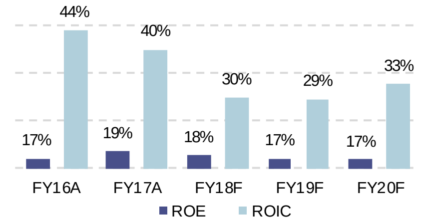
Key changes

		13-Dec	After	Var %
NPAT:	**FY18F**	15.1	14.5	-4.2%
norm	**FY19F**	17.0	16.6	-2.0%
($m)	**FY20F**	19.8	19.3	-2.5%
EPS:	**FY18F**	31.5	29.5	-6.1%
norm	**FY19F**	34.8	34.1	-2.0%
(cps)	**FY20F**	40.4	39.4	-2.5%
DPS:	**FY18F**	14.0	13.8	-1.4%
(cps)	**FY19F**	16.0	16.0	0.0%
	FY20F	18.0	18.0	0.0%
Price target:		7.50	7.38	-1.6%
Rating:		**BUY**	**BUY**	

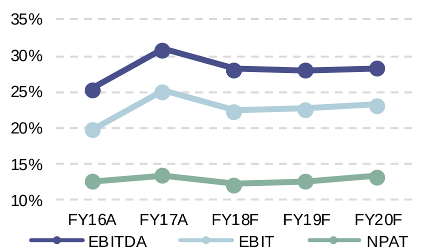
Growth rates



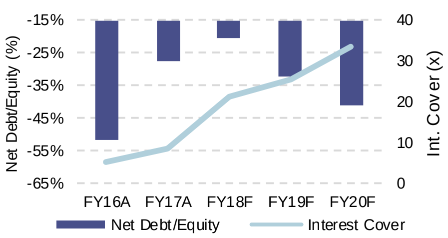
Returns



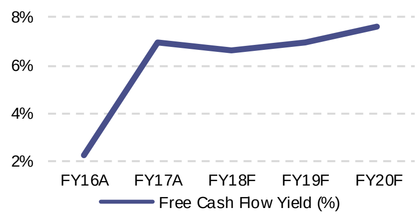
Margin trends



Solvency



Free cash flow yield



Interims ($m)

	1H17A	2H17A	1H18E	2H18E
Sales revenue	43.9	53.3	47.3	71.5
EBITDA	13.6	16.5	13.1	20.4
EBIT	10.6	13.8	9.8	16.8
Net profit	**4.5**	**8.5**	**4.9**	**9.6**
Norm EPS	**9.5**	**17.8**	**10.0**	**19.6**
EBIT/sales (%)	24.2	25.8	20.7	23.5
Dividend (c)	4.8	8.0	4.8	9.0
Franking (%)	100.0	100.0	100.0	100.0
Payout ratio (%)	50.8	44.9	48.2	46.2
Adj payout (%)	<0	23.4	>500	10.8

Key assumptions

	FY13A	FY14A	FY15A	FY16A	FY17A	FY18F	FY19F	FY20F
Revenue growth (%)		-0.8	45.9	14.3	17.5	22.3	10.8	10.3
EBIT growth (%)		30.0	72.6	77.3	48.7	9.0	12.1	13.0
NPAT growth (%)		20.2	61.9	55.1	25.3	11.3	14.7	16.4
EPS growth (%)		**22.5**	**32.3**	**30.6**	**27.3**	**8.3**	**15.3**	**15.6**
EBIT/sales (%)	8.2	10.8	12.8	19.8	25.1	22.4	22.6	23.2
Tax rate (%)	20.3	20.8	22.2	29.2	27.5	26.5	27.0	27.0
ROA (%)	**10.2**	**10.9**	**7.3**	**12.8**	**18.3**	**17.7**	**17.9**	**18.9**
ROE (%)	**15.9**	**16.4**	**11.7**	**14.8**	**17.2**	**15.1**	**14.9**	**15.9**

Financial ratios

	FY13A	FY14A	FY15A	FY16A	FY17A	FY18F	FY19F	FY20F
PE (x)	70.7	57.7	43.6	33.4	26.3	24.2	21.0	18.2
EV/EBITDA (x)	63.8	51.6	30.6	15.0	10.5	9.4	8.5	7.7
Dividend yield (%)	2.8	2.8	0.8	1.3	1.8	1.9	2.2	2.5
FCF yield (%)	0.8	1.6	1.8	2.2	6.9	6.6	7.0	7.6
Payout ratio (%)	197.6	161.3	35.3	44.8	46.9	46.8	47.0	45.7
Adj payout (%)	46.8	24.3	67.1	66.3	33.4	28.3	29.7	31.1

Profit and loss ($m)

	FY13A	FY14A	FY15A	FY16A	FY17A	FY18F	FY19F	FY20F
Sales revenue	50.0	49.6	72.3	82.7	97.1	118.8	131.7	145.2
EBITDA	4.9	6.1	10.3	21.0	30.1	33.5	37.0	41.0
Depn & amort	0.8	0.7	1.2	4.6	5.7	6.9	7.2	7.4
EBIT	**4.1**	**5.4**	**9.1**	**16.4**	**24.4**	**26.6**	**29.8**	**33.6**
Net interest expense	-0.2	-0.2	-0.1	3.1	2.9	1.2	1.2	1.0
Tax	0.9	1.2	2.0	3.9	5.9	6.7	7.7	8.8
Minorities/pref divs	0.0	0.0	0.0	0.7	4.0	4.0	4.3	4.5
Equity accounted NPAT	0.0	1.4	1.8	1.3	0.0	0.0	0.0	0.0
Net profit (pre-sig items)	**3.4**	**5.8**	**8.9**	**10.0**	**11.6**	**14.6**	**16.6**	**19.3**
Abns/exts/signif	0.0	-1.7	-2.4	-1.8	-0.2	-1.2	0.0	0.0
Reported net profit	**3.4**	**4.1**	**6.5**	**8.2**	**11.4**	**13.4**	**16.6**	**19.3**

Cash flow ($m)

	FY13A	FY14A	FY15A	FY16A	FY17A	FY18F	FY19F	FY20F
EBITDA	4.9	6.1	10.3	21.0	30.1	33.5	37.0	41.0
Interest & tax	-0.2	-1.1	-1.8	-4.3	-6.1	-10.2	-8.9	-9.8
Working cap/other	-1.5	1.6	-1.6	-6.3	1.0	1.7	-2.5	-3.2
Operating cash flow	**3.3**	**6.6**	**6.9**	**10.4**	**24.9**	**25.0**	**25.6**	**28.0**
Maintenance capex	-0.6	-1.4	-0.8	-2.9	-1.9	-3.0	-2.4	-2.7
Free cash flow	**2.7**	**5.3**	**6.1**	**7.5**	**23.0**	**22.0**	**23.2**	**25.3**
Dividends paid	-1.3	-1.3	-4.1	-4.9	-7.7	-6.2	-6.9	-7.9
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	-23.2	-17.3	0.0	0.0
Oth investing/finance flows	1.1	3.1	-1.9	-1.1	-0.1	-1.6	0.0	0.0
Cash flow pre-financing	**2.6**	**7.1**	**-8.9**	**0.0**	**-8.0**	**-3.2**	**16.3**	**17.4**
Funded by equity	0.0	0.0	25.0	0.1	0.3	1.4	0.0	0.0
Funded by debt	-1.9	-0.6	1.4	-1.9	7.9	10.5	0.0	0.0
Funded by cash	-0.6	-6.5	-17.5	1.9	-0.2	-8.6	-16.3	-17.4

Balance sheet summary ($m)

	FY13A	FY14A	FY15A	FY16A	FY17A	FY18F	FY19F	FY20F
Cash	13.0	19.3	37.2	34.6	29.8	32.9	49.2	66.7
Current receivables	11.2	12.1	21.3	12.5	17.1	5.0	9.0	12.0
Current inventories	0.4	1.5	1.8	1.1	2.0	2.0	4.2	9.0
Net PPE	0.9	1.7	2.6	6.0	6.2	7.2	6.3	5.5
Intangibles/capitalised	13.8	13.7	59.9	59.3	68.4	72.2	68.3	64.4
Total assets	**40.3**	**49.4**	**126.7**	**116.7**	**130.8**	**139.4**	**157.1**	**177.7**
Current payables	14.5	14.4	21.9	9.9	16.8	17.0	17.4	18.5
Total debt	0.6	0.1	1.5	1.3	8.9	14.8	14.8	14.8
Total liabilities	**18.7**	**24.1**	**69.7**	**52.2**	**55.3**	**50.9**	**51.3**	**52.4**
Shareholder equity	**21.6**	**25.3**	**57.0**	**64.6**	**75.5**	**88.5**	**105.8**	**125.3**
Total funds employed	**22.2**	**25.4**	**58.4**	**65.8**	**84.3**	**103.3**	**120.6**	**140.1**

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 enterprise 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. 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.

Investment thesis

We maintain a BUY rating with a revised price target of $7.38 per share. Optically, Citadel's interim NPAT of $4.9m was a miss, reminding the market of the strong 2H bias to earnings. We have left our operating earnings forecasts unchanged and we see yesterday's 5% stock sell-off as a good opportunity to add to CGL holdings. Citadel is a recent addition to the Wilsons Conviction List. We like the company's renewed focus on centralised IP generation which can be exploited across multiple verticals and support earnings quality. The stronger 2H18 result is expected to showcase several of these features. As examples we expect more business to be won in Health (Citadel having notched up its first organic wins outside pathology) and in Knowledge (where the Citadel-IX platform is key).

Revenue drivers

- Technology – managed services contracts with an average ~4.6-year duration
- New contract wins

Margin drivers

- Cross-sales across the customer base and business units
- New contracts
- Level of R&D investment

Key issues/catalysts

- New contracts
- Contracts moving from start-up to mature phase often provides margin leverage
- Increased visibility into PJA Solutions driving a re-rating

Risk to view

- Contract losses
- Execution problems reducing the profitability of core contracts

Balance sheet

- Forecasting net cash of $15.1m at end FY18

Board

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

Management

- Darren Stanley, CEO
- R. Andrew Burns, CFO
- Cindy Schwartz, GM Advisory, People and Knowledge
- Stephen Lynch, GM Health
- Mike Ricketts, GM Technology & Integration
- Brent Kuhl, GM Solutions

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Definitions at wilsonsadvisory.com.au/Disclosures.

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