



## Adacel Ltd (ADA.ASX)

*Timing a drag but NASA opportunity is material*

### Event:

- Profit downgrade; contracts update.

### Investment Highlights:

- Adacel (ADA) announced a profit downgrade for FY17e, revising guidance down to a PBT of \$7.0-\$7.5M, or down 33% YoY, vs previous guidance of greater than 10% YoY growth, or >\$11.9M.** This was also below our forecast of \$11.8M. Chief reason for the downgrade were delays in Systems contracts – both those already awarded but not signed off, and those where the company is awaiting notification of whether successful or not.
- ADA states that \$11M of contracts have been awarded but not signed off.** Once contracts are finalised the company should be able to book all these revenues in FY18e.
- Additionally, there are \$19M of contracts on which ADA has bid and still awaiting notification.** We conservatively factor that 50% of these contracts - on a dollar value basis - will be awarded to ADA. We estimate all these will likely be booked in FY18e, with the exception of the French Territories, which we estimate to be over approximately three years.
- ADA stated Services revenue growth for FY17e will be around 10% YoY, in-line with our expectation.** The consistency highlights the annuity nature of the business.
- Overall, the company is confident of its backlog being higher at end FY17e vs FY16a.** As a sign of confidence in the outlook and that profit has been merely pushed back rather than not earned at all, ADA will maintain total FY17e dividend vs FY16. Furthermore, it has announced a share buyback.
- NASA contract success would have material 34% upside on earnings.** ADA has recently submitted a Services bid for the NASA SimLabs contract. This is worth US\$72M over five years, or A\$19M p.a. ADA expects notification of whether successful by August and contract would begin November. We estimate success would lift ADA's FY19e earnings (first full year of contribution) by 35%.

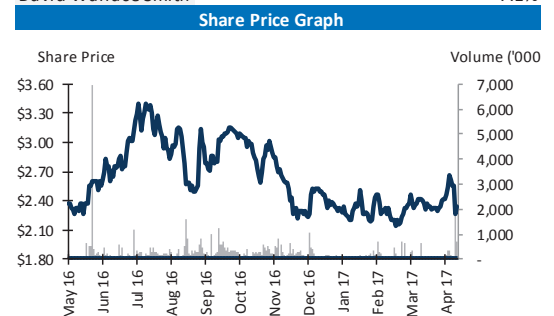
### Earnings and Valuation:

- We have revised our FY17e NPAT down 34% to \$5.8M (previously \$8.8M), due to the lower Systems sales, while our FY18e and FY19e forecast NPATs have declined 10% and 9% to \$7.9M (prior \$8.8M) and \$8.9M (prior \$9.8M) respectively.** We still forecast 11.7% CAGR in sales over 2016 to 2022. Our earnings forecast do not assume NASA SimLabs.
- Our valuation of ADA has increased to \$2.79/share from \$2.54/share, because of the NASA contract option for which we ascribe a 50% chance of success.** This has more than offset our earnings downgrade. If ADA were to win the NASA contract, our valuation would rise to \$3.15; if unsuccessful it would fall to \$2.43 – still above today's share price.

### Recommendation:

- We maintain our Buy recommendation on ADA and 12-month price target of \$2.79/share in-line with our valuation.** Catalysts for the share price include: 1) New contract wins; 2) Booking of awarded wins; and 3) NASA SimLabs contract success.

Recommendation		Buy		
Previous		Buy		
Price Target		\$2.79		
Previous		\$2.79		
Risk		Medium		
Share price		\$2.34		
ASX code		ADA		
52 Week Low-High		\$1.91-\$3.55		
Valuation		\$2.79/share		
Methodology		DCF		
Capital Structure				
Shares on Issue (M)		79		
Market Cap (A\$M)		186		
Net Cash/(Debt) (A\$M) Jun FY17e		19		
EV (A\$M)		166		
Diluted mkt cap (A\$M)		186		
12mth Av Daily Volume ('000)		272		
Y/e Jun	FY16a	FY17e	FY18e	FY19e
Sales \$M	47.9	44.2	51.9	58.8
EBITDA \$M	11.9	8.1	12.6	14.2
NPAT Adj. \$M	7.6	5.8	7.9	8.9
EPS adj c	9.6	7.3	9.9	11.3
DPS c	3.0	3.0	4.0	4.5
PER x	24.5	32.0	23.5	20.8
EV/EBITDA x	14.3	21.1	13.5	11.9
Yield	1.3%	1.3%	1.7%	1.9%
Board of Directors				
Peter Landos		Non-Executive Chairman		
Julian Beale		Non-Executive Director		
David Smith		Non-Executive Director		
Silvio Salom		Non-Executive Director		
Substantial Shareholders				
Thorney Holdings		32.4%		
Silvio Salom		9.9%		
David Wallace Smith		7.1%		



Analyst: Mark Fichera +61 2 9993 8162  
[mark.fichera@fostock.com.au](mailto:mark.fichera@fostock.com.au)  
 The analyst owns 21,000 ADA shares.

This report was prepared by Foster Stockbroking.



## Adacel Ltd (ADA)

Full Year Ended 30 June

Profit and Loss A\$M	2016a	2017e	2018e	2019e
Sales revenue	47.9	44.2	51.9	58.8
Other revenue	1.3	1.2	1.4	1.6
Operating Costs	37.3	37.7	40.7	46.1
<b>EBITDA</b>	<b>11.9</b>	<b>8.1</b>	<b>12.6</b>	<b>14.2</b>
D&A	0.8	0.9	1.0	1.2
<b>EBIT</b>	<b>11.1</b>	<b>7.2</b>	<b>11.5</b>	<b>13.1</b>
Net Interest exp / (income)	0.3	0.0	-0.4	-0.5
<b>Profit before tax</b>	<b>10.8</b>	<b>7.2</b>	<b>11.9</b>	<b>13.5</b>
Tax exp / (benefit)	3.2	1.4	4.0	4.6
<b>NPAT before minorities</b>	<b>7.6</b>	<b>5.8</b>	<b>7.9</b>	<b>8.9</b>
Minority interest	0.0	0.0	0.0	0.0
<b>Rep. NPAT</b>	<b>7.6</b>	<b>5.8</b>	<b>7.9</b>	<b>8.9</b>
Significant items	0.0	0.0	0.0	0.0
<b>NPAT attributable reported</b>	<b>7.6</b>	<b>5.8</b>	<b>7.9</b>	<b>8.9</b>
<b>EPS diluted (c)</b>	<b>9.6</b>	<b>7.3</b>	<b>9.9</b>	<b>11.3</b>
<b>DPS diluted (c)</b>	<b>3.0</b>	<b>3.0</b>	<b>4.0</b>	<b>4.5</b>

Cashflow A\$M	2016a	2017e	2018e	2019e
EBITDA	11.9	8.1	12.6	14.2
Change in WC	2.7	0.1	-0.6	-0.3
Tax paid	-3.3	-1.0	-4.0	-4.6
Net interest	0.1	0.2	0.4	0.5
Other	0.0	0.1	0.0	0.0
<b>Operating Cashflow</b>	<b>11.3</b>	<b>7.4</b>	<b>8.3</b>	<b>9.8</b>
Capex	-0.5	-0.4	-1.2	-1.3
<b>Investing Cashflow</b>	<b>-0.5</b>	<b>-0.4</b>	<b>-1.2</b>	<b>-1.3</b>
Equity raising	0.0	0.0	0.0	0.0
Dividends paid	-2.0	-2.8	-2.8	-3.4
Other	-0.7	0.0	-0.8	0.0
<b>Financing Cashflow</b>	<b>-2.7</b>	<b>-3.5</b>	<b>-2.8</b>	<b>-3.4</b>
<b>Net Cashflow</b>	<b>8.2</b>	<b>3.5</b>	<b>4.3</b>	<b>5.1</b>

Balance Sheet A\$M	2016a	2017e	2018e	2019e
Cash	15.8	19.3	23.6	28.7
Receivables	8.6	9.4	10.0	11.3
PPE	1.7	1.2	1.4	1.5
Intangibles	1.0	0.9	0.9	0.9
Inventories	0.2	1.0	1.2	1.4
Other	5.0	4.4	5.2	5.9
<b>Total Assets</b>	<b>32.3</b>	<b>36.4</b>	<b>42.3</b>	<b>49.8</b>
Accounts payable	4.9	7.1	6.9	7.8
Provisions	0.4	0.5	0.5	0.6
Tax liabilities	1.9	2.6	2.8	3.2
Borrowings	0.0	0.0	0.0	0.0
Advanced payments	2.3	1.6	1.9	2.2
Other	2.5	0.8	1.3	1.6
<b>Total Liabilities</b>	<b>12.0</b>	<b>12.6</b>	<b>13.5</b>	<b>15.4</b>
Reserves and capital	74.0	74.1	74.1	74.1
Retained earnings	-53.8	-50.4	-45.3	-39.7
<b>Total Equity</b>	<b>20.3</b>	<b>23.7</b>	<b>28.8</b>	<b>34.4</b>

Source: Company; Foster Stockbroking estimates

Financial Metrics	2016a	2017e	2018e	2019e
Sales growth %	14%	-8%	17%	13%
EPS growth %	93%	-23%	36%	13%
EBITDA margin	25%	18%	24%	24%
EBIT margin	23%	16%	22%	22%
Gearing (ND/ND+E)	nm	nm	nm	nm
Interest Cover (EBIT/net int)	nm	nm	nm	nm
Average ROE %	45%	26%	30%	28%
Average ROA %	66%	33%	44%	41%
Wtd ave shares (M)	79.3	79.3	79.3	79.3
Wtd ave share diluted (M)	79.3	79.3	79.3	79.3

Valuation multiples	2016a	2017e	2018e	2019e
P/E x	24.5	32.0	23.5	20.8
EV/EBITDA x	14.3	21.1	13.5	11.9
EV/EBIT x	15.3	23.6	14.7	13.0
EV/sales x	3.5	3.8	3.3	2.9
Dividend yield %	1.3%	1.3%	1.7%	1.9%

Equity Valuation - DCF		
Segment	A\$M	A\$/sh
Enterprise value	202.1	\$2.55
Net cash (debt)	19.3	\$0.24
<b>Equity (NPV<sub>10</sub>)</b>	<b>221.3</b>	<b>\$2.79</b>
2.5% terminal growth; WACC 10%		

Shares on issue		M
Ordinary shares		79.3

Major shareholders		Interest
Thorney Holdings		32.4%
Silvio Salom		9.9%
David Wallace Smith		7.1%

Board	
Peter Landos	Non-Executive Chairman
Julian Beale	Non Executive Director
David Smith	Non-Executive Director
Silvio Salom	Non-Executive Director
Natalya Jurchensin	Non-Executive Director

Segment \$M	2016a	2017e	2018e	2019e
Services	30.1	33.0	37.0	41.6
Systems	17.8	11.2	14.8	17.2
<b>Sales Revenue</b>	<b>47.9</b>	<b>44.2</b>	<b>51.9</b>	<b>58.8</b>



## TIMING OF SYSTEMS CONTRACT AWARDS TO IMPACT FY17e PROFIT

- Adacel (ADA) announced a profit downgrade for FY17e, revising its guidance down to an expected PBT of \$7.0-\$7.5M for FY17e, equivalent to down 33% YoY using the midpoint of guidance. This is in stark contrast to previous guidance, as most recent as February 2017, of greater than 10% YoY growth, equivalent to >\$11.9M PBT.
- The chief reasons for the downgrade was the delay in Systems contracts – both those that have already been awarded to ADA but not yet finalised or signed off, and those where the company had submitted a bid but were still awaiting notification of whether successful or not.

## DELAYS IN AWARDED CONTRACTS OF \$11M

### To be recognised in FY18e

- For the Systems contracts that ADA have been awarded but not yet recognised, administration processes surrounding finalisation of terms and documentation have contributed to the delay in ADA being able to recognize revenue. ADA stated it had been awarded \$11M of such contracts. While delays can range from a few days to a few months, the company expects most, if not all, of this revenue to be recognised in FY18e, with some to be booked in the 1H as well as 2H.
- We understand that the \$11M comprises eight systems, mostly MaxSims, with some sold to new as well as existing customers. These follow five MaxSims already sold in the US in this financial year.

## AWAITING NOTIFICATION OF \$19M IN CONTRACTS

- ADA is also awaiting notification of \$19M of Systems awards, comprising seven systems, from both new and existing customers. The latter includes FAA, French Territories, US Navy, and RAAF.

### Notification of some contracts may be imminent

- Notification of some contracts – for example the US Navy, FAA, and French Territories – could be as soon as this month, but again, the vagaries of bureaucracy may still delay.
- The French Territories contracts ADA has bid for are ATM systems for Martinique and Guadeloupe (together Systems 2 and 3), and we understand there is only one other bidder. ADA has already successfully won the French Guiana contract (System 1) with French Territories. If successful, ADA would book revenue for System 2 over 18 months to 2 years, with that for System 3 to be recognized over 12 to 18 months. The total period is dependent on when the option for System 3 is exercised.
- We estimate the Systems 2 and 3 French Territories contract is worth about €5 to €7M, or \$7-\$10M over approximately three years. Other French Territories contracts are expected over the next few years for which ADA would likely bid for.
- We estimate the US Navy Systems contract that ADA is awaiting notification would be worth \$1M to ADA. The company is part of a contract vehicle as sub-contractor to two different parties out of a total of four bidders. Expects notification this month. Further US Navy contracts should arise in end CY2017 and mid CY2018, some of these which ADA could be prime and expect greater revenue.
- We believe the company is confident on success on these contracts, rating its chance of success at least 50%. Some of these bids are sole source as well as competitive.

## SERVICES GROWTH IN-LINE WITH EXPECTATION

- ADA stated that Services revenue growth for FY17e will be around 10% YoY, which is in-line with our forecast. This highlights the annuity nature of the segment and reflects the general growth in the air traffic industry.
- Besides growth in Services from new contracts and customers, existing contracts are also growing with positive contributions from upgrades and the like. Major annual Services contracts include Leidos which runs at US\$11M (\$14.7M), the FAA at US\$4M (\$5.3M), and the USAF.

## BACKLOG TO BE HIGHER AT END FY17e vs END FY16

- ADA expects with its new orders activity will result in total orders for FY17e being greater than that for the prior year for both Systems and Services, and its contracted backlog to be higher end June 2017 vs a year ago.

## EARNINGS FORECASTS CHANGES

### Downgrade to FY17e on contract delays

- We have downgraded our FY17e PBT for ADA to \$7.2M, in the middle of the company's \$7.0-\$7.5M guidance. The main reason is lowering our System sales forecast for the year to \$11.2M vs our previous expectation of \$14.9M, a decline of \$3.7M. We forecast NPAT of \$5.8M for the full year, down 34% on our prior forecast of \$8.8M.
- We have also slightly further lifted our FY17e operating costs on our prior assumption, to \$37.7M from \$37.1M, up \$0.6M. We estimate costs in the 2H to be \$21.1M vs the 1H of \$16.5M. The company indicated there had been an increase in expenses, including 5% uplift in research and development, 3% in sales and marketing, and 5% in overheads. Most of this was due to the French Territories contract work and preparation. This has had a net impact of crunching the EBIT margin in the 2H.

Figure 1: ADA Earnings Revision to FY17e

	1HFY17a	2HFY17e new	2HFY17e old	Chng	FY17e new	FY17e Old	Chng
Systems	3.8	7.4	11.1	-34%	11.2	14.9	-25%
Services	16.1	16.9	17.4	-3%	33.0	33.5	-2%
Total sales	19.9	24.2	28.5	-15%	44.2	48.4	-9%
Other income	0.0	0.0	0.3	-100%	0.0	1.3	-100%
Total Revenue	21.2	24.5	28.8	-15%	45.4	49.7	-9%
Operating costs	16.5	21.1	20.6	2%	37.7	37.1	1%
EBITDA	4.7	3.4	8.1	-58%	8.1	12.8	-37%
Depr & Amort	0.4	0.5	0.6	-15%	0.9	1.0	-9%
EBIT	4.3	2.9	7.6	-62%	7.2	11.9	-39%
Margin	21.5%	12.0%	26.6%	-55%	16.3%	24.5%	-34%
Net int exp/(inc)	0.1	-0.1	-0.1	0%	0.0	0.0	0%
PBT	4.2	3.1	7.7	-60%	7.2	11.9	-39%
Tax	0.4	1.0	2.6	-62%	1.4	3.1	-54%
NPAT	3.7	2.1	5.1	-60%	5.8	8.8	-34%

Source: Company; Foster Stockbroking estimates.

### FY18e and FY19e earnings also downgraded, but to lesser extent

- Figure 2 shows our earnings forecast changes from FY17e to FY19e. Following our downgrade to FY17e, we now assume that the \$11M already awarded in System sales will be booked as revenue in FY18e. Of the \$19M of contracts yet to be notified, we conservatively assume that ADA will be successful on 50% of the dollar value of these (\$9.5M), including the French Territories which we expect to be earned uniformly over approximately three years. We forecast total System sales of \$14.8M in FY18e. Conservatively, we assume no other Systems contracts to be booked in FY18e.
- The changes results in FY18e Systems sales being 33% higher than in FY17e, and Total sales (including Services) being up 17% YoY. We now forecast NPAT of \$7.9M for FY18e, down 10% on our prior forecast, but up 36% on FY17e.
- For FY19e we forecast higher sales vs FY18e but from a lower base, so that NPAT is now \$8.9M, down 9% on our prior forecast but up 13% on FY18e.
- Importantly, we retain our forecast CAGR in ADA sales over the period CY2016 to CY2022 remains 11.7%, in-line with our estimate for the industry.

Figure 2: ADA Forecast Annual Earnings FY17e to F19e – Changes

P&L \$M	FY17e	FY17e	Chng	FY18e	FY18e	Chng	FY19e	FY19e	Chng
	New	old		New	old		New	old	
Systems	11.2	14.9	-25%	14.8	16.6	-11%	17.2	18.6	-8%
Services	33.0	33.5	-2%	37.0	37.4	-1%	41.6	41.8	0%
Total sales	44.2	48.4	-9%	51.9	54.1	-4%	58.8	60.4	-3%
Other income	1.2	1.3	-9%	1.4	1.5	-7%	1.6	1.7	-6%
Total revenue	45.4	49.7	-9%	53.3	55.5	-4%	60.4	62.0	-3%
Operating costs	37.7	37.1	1%	40.7	41.6	-2%	46.1	46.5	-1%
EBITDA	8.1	12.8	-37%	12.6	13.9	-9%	14.2	15.6	-9%
Depr & Amort	0.9	1.0	-9%	1.0	1.1	-9%	1.2	1.2	5%
EBIT	7.2	11.9	-39%	11.5	12.9	-11%	13.1	14.4	-9%
Margin	16.3%	24.5%	-34%	22.2%	23.8%	-7%	22.2%	23.8%	-7%
Net int exp (inc)	0.0	0.0	0%	-0.4	-0.4	-7%	-0.5	-0.5	-8%
PBT	7.2	11.9	-39%	11.9	13.3	-11%	13.5	14.9	-9%
Tax	1.4	3.1	-54%	4.0	4.5	-11%	4.6	5.0	-8%
NPAT	5.8	8.8	-34%	7.9	8.8	-10%	8.9	9.8	-9%

Source: Foster Stockbroking estimates

### Maintenance of dividend and buyback signal confidence in outlook

- ADA stated that it will generate still generate cash for FY17e, albeit less than FY16a. We forecast \$7.4M operating cashflow vs the \$11.3M achieved last financial year. We estimate cash at end June FY17e will be \$19.3M.
- The company reiterated paying total dividends in FY17e at same level as in FY16a. ADA also announced it was implementing a share buyback as part of capital management, due to the growing cash position and as yet absent strategic acquisitions. However, the company continues to examine opportunities. The maintenance of dividend and buyback both signals the company's confidence in its outlook, including the pipeline of contracts both awarded and yet to be notified.

### NASA SIMLABS PRESENTS MATERIAL UPSIDE TO EARNINGS OF 34%

- One of the largest contracts in ADA's pipeline which is not included in the pool of \$19M of Systems contracts is NASA SimLabs. This contract is solely for Services and worth US\$72M cost-plus over five years, or \$19M p.a., for which ADA has submitted a bid as prime, not as a sub-contractor.
- The current NASA contract – held by the incumbent SAIC who is not qualified to bid - expires beginning November 2017. We would expect an announcement of the successful winner sometime between June and August.

### 34% potential upside to earnings in first full year of contribution

- Should ADA be successful, we estimate its impact on FY19e earnings – the first full year of providing the services contract to NASA – would result in NPAT of \$11.9M vs \$8.9M in our base case, an uplift of 34%, while sales would be \$79.1M, up 35% on our base case of \$58.8M.

### VALUATION – INCREASES TO \$2.79 ON NASA OPTION

#### Risked NPV of \$2.79/share assumes 50% chance of NASA success

- Our NPV<sub>10</sub> valuation of ADA has increased to \$2.79, up from \$2.54 previously. While the downgrade to earnings has had a negative impact, we have factored in a probability factor of the NASA contract, which we had not included previously. This has had significantly more positive impact on valuation.
- Without NASA, our NPV<sub>10</sub> is \$2.43/share. Should ADA be successful, we estimate from our DCF model that this would increase NPV to \$3.15/share. We have decided to risk the NASA contract by 50% (i.e. 50% chance of success) to include some option value of this in ADA's valuation. As a result we value the company at \$2.80/share in our base case.

Figure 3: ADA Equity Valuation

Segment	Excluding NASA		Including NASA		NASA (Base Case)	
	A\$M	A\$/share	A\$M	A\$/share	Risked 50% A\$M	Risked 50% A\$/share
EV	175.8	\$2.19	230.2	\$2.90	<b>202.1</b>	<b>\$2.55</b>
Net cash (debt)	19.3	\$0.24	19.3	\$0.24	<b>19.3</b>	<b>\$0.24</b>
<b>Equity (NPV<sub>10</sub>)</b>	<b>195.1</b>	<b>\$2.43</b>	<b>249.5</b>	<b>\$3.15</b>	<b>221.3</b>	<b>\$2.79</b>

Source: Foster Stockbroking estimates.

- On a PE basis, ADA is trading at 20.7x FY19e earnings on our base case earnings. However, should the company be successful with the NASA contract, the stock at the current share price would be only on a PE of 12.7x.

### MAINTAIN BUY RECOMMENDATION - 12 MONTH PRICE TARGET \$2.79/SHARE

- We maintain our Buy recommendation on ADA with a 12-month price target of \$2.79/share, based on our risked valuation.
- Catalysts for the share price include: 1) New contract wins; 2) Booking of awarded wins; and 3) NASA SimLabs contract success.



## FOSTER STOCKBROKING DIRECTORY

Name	Role	Phone	Email
<b>Stuart Foster</b>	Chief Executive Officer	+61 2 9993 8131	stuart.foster@fostock.com.au
<b>Chris Francis</b>	Executive Director	+61 2 9998 8167	chris.francis@fostock.com.au
<b>Haris Khaliqi</b>	Executive Director	+61 2 9993 8152	haris.khaliqi@fostock.com.au
<b>Martin Carolan</b>	Executive Director	+61 2 9993 8168	martin.carolan@fostock.com.au
<b>Mark Fichera</b>	Executive Director	+61 2 9993 8162	mark.fichera@fostock.com.au
<b>Mark Hinsley</b>	Executive Director	+61 2 9993 8166	mark.hinsley@fostock.com.au
<b>Darren Odell</b>	Research	+61 2 9993 8121	darren.odell@fostock.com.au
<b>Matthew Chen</b>	Research	+61 2 9993 8130	matthew.chen@fostock.com.au
<b>Tolga Dokumcu</b>	Execution & Dealing	+61 2 9993 8144	tolga.dokumcu@fostock.com.au
<b>George Mourtzouhos</b>	Execution & Dealing	+61 2 9993 8136	george.mourtzouhos@fostock.com.au

Foster Stockbroking Pty Ltd  
A.B.N. 15 088 747 148 AFSL No. 223687  
Level 25, 52 Martin Place, Sydney, NSW 2000 Australia  
General: +612 9993 8111 Equities: +612 9993 8100 Fax: +612 9993 8181  
Email: [contact@fostock.com.au](mailto:contact@fostock.com.au)  
PARTICIPANT OF ASX GROUP

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