

31 August 2018

Electro Optic Systems (EOS)

BUY**Share Price: A\$3.08****Strong 1H18 drives double digit upgrades****Target Price: A\$4.05**

With such a strong performance in 1H18, EOS has proven that it can successfully transition from an R&D company to a large scale manufacturer, delivering margins in-line with industry leaders. EOS offers investors exposure to a strong underlying Defence business with potential for additional large-scale contracts and a free option on its Space opportunity. We reiterate our Buy recommendation and A\$4.05 target price.

Underlying performance very strong

- EOS reported 1H18 NPAT of A\$5.3m versus our expectation of a break-even result.
- This significant outperformance was largely driven by FX movements following the correction in the AUD.
- Normalising for currency movements, NPAT would have been ~A\$1.3m, which is a very strong result.

Defence underlying margin improvement

- We estimate that the underlying PBT margin in 1H18 was ~11%, compared to our assumption of ~10%.
- This margin performance is even more impressive considering the Hume production plant was only operating at 50% capacity during the period.
- In addition to improving margins, EOS now expects RWS production for FY18 to be 264 units (240 previously). This should provide scope for further margin improvements in FY18.

Additional large-scale contract required for re-rating

- Defence – EOS has recently won a smaller scale contract with the Australian Government, which may add ~A\$8-26m in revenue p.a. over the next 8 years.
- Space – EOS is confident of securing a commercial arrangement in early 2019.
- Re-rating Catalyst – EOS has won large-scale tenders (~A\$400m), the conversion of these into contracts is the catalyst required in order to re-rate the stock in our view.

Forecasts and Valuation

- Following a strong 1H18, EOS we have upgraded our FY18 NPAT (Norm) by ~19% to A\$6.3m (A\$10.2m on a reported basis).
- This is driven by higher than anticipated Defence PBT margins (11% vs 10%), which we have applied to FY19F and FY20F, resulting in upgrades of 11.4% and 10.7%, respectively.
- We reiterate our Buy recommendation and A\$4.05 target price.

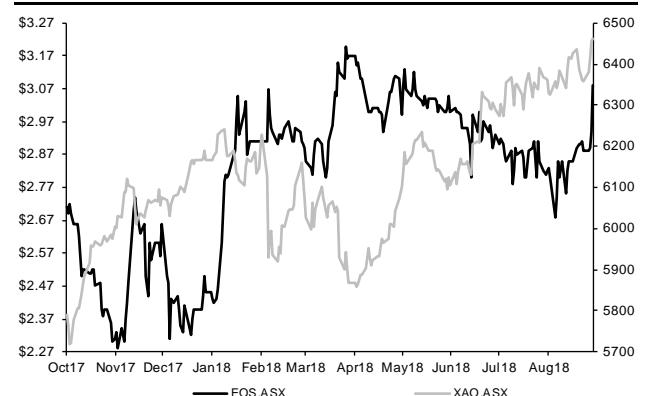
Company Data

Shares – ordinary (M)	96.1
Dilution (M)	0.0
Total (fully diluted) (M)	96.1
Market capitalisation (\$M)	282.5
12 month low/high (\$)	2.28/ 3.25
Average monthly turnover (\$M)	6.2
GICS Industry	Aerospace & Defense

Financial Summary (fully diluted/normalised)

Year end Dec	2016A	2017A	2018F	2019F	2020F
Revenue (\$M)	25.8	23.3	96.0	208.0	218.8
Costs (\$M)	-28.0	-35.2	-88.9	-187.6	-196.9
EBITDA (\$M)	-2.2	-11.9	7.1	20.4	21.9
NPAT (\$M)	-0.9	-9.4	6.2	19.5	14.7
EPS (¢ps)	-1.6	-15.1	12.7	21.2	16.0
EPS Growth (%)	n/m	n/m	n/m	67%	-24%
PER (x)	n/m	n/m	24.3	14.6	19.3
Free Cashflow (\$M)	-3.1	-27.1	-9.8	7.8	19.1
FCFPS (¢ps)	-3.2	-28.2	-10.2	8.1	19.9
PFCFPS (x)	n/m	n/m	-30.1	37.9	15.5
Enterprise Value (\$M)	287.1	286.0	235.8	228.0	208.9
EV / EBITDA (x)	n/m	n/m	n/m	11.2	9.5
Payout ratio (%)	n/m	n/m	n/m	n/m	n/m
Dividends (¢ps)	n/m	n/m	n/m	n/m	n/m
Yield (%)	n/m	n/m	n/m	n/m	n/m
Franking (%)	n/a	n/a	n/a	n/a	n/a

EOS – performance over one year



Disclosure and Disclaimer

This report must be read with the disclosure and disclaimer on the final page of this document. Petra Capital was Sole Lead Manager for EOS's Placement to raise \$20.9M at \$2.30/sh on 19 September 2017 and \$65.0M at \$2.91/sh on 5 February 2018, for which a fee was received.

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Analysis

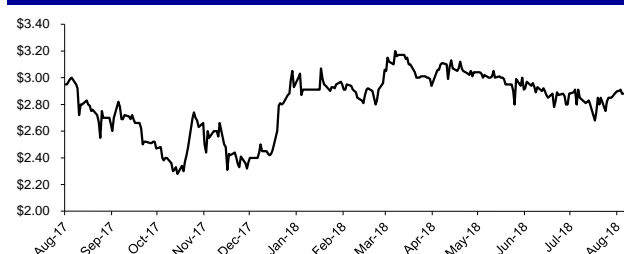
Electro Optic Systems

Year end 31 December

MARKET DATA

Recommendation		Buy
Price	\$	3.08
Target price (12-month)	\$	4.05
52 week low / high	\$	2.28/3.25
Market capitalisation	\$m	296.0
Shares on issue (basic)	no.	96.1
Options / rights	no.	0.0
Other equity	no.	0.0
Shares on issue (diluted)	no.	96.1

12-MONTH SHARE PRICE PERFORMANCE



INVESTMENT FUNDAMENTALS

	FY16A	FY17A	FY18F	FY19F	FY20F
Reported NPAT	\$m (0.9)	(9.4)	10.2	19.5	14.7
NPAT normalised	\$m (0.9)	(9.4)	6.2	19.5	14.7
Reported EPS (undiluted)	¢ (1.6)	(15.1)	11.3	21.2	16.0
EPS normalised (undiluted)	¢ (1.6)	(15.1)	12.7	21.2	16.0
...Growth	% n/m	n/m	n/m	67%	-24%
PER normalised	x n/m	n/m	24.3	14.6	19.3
Operating cash flow per share	¢ (2.8)	(27.0)	(9.2)	9.2	20.9
Free cash flow per share	¢ (3.2)	(28.2)	(10.2)	8.1	19.9
Price to free cash flow per share	x n/m	n/m	(30.1)	37.9	15.5
FCF yield	% (1.0)	(9.2)	(3.3)	2.6	6.5
Dividend	¢ 0.0	0.0	0.0	0.0	0.0
Payout	% 0.0	0.0	0.0	0.0	0.0
Yield	% 0.0	0.0	0.0	0.0	0.0
Franking	% n/a	n/a	n/a	n/a	n/a
Enterprise value	\$m 287.1	286.0	235.8	228.0	208.9
EV/EBITDA	x n/m	n/m	n/m	11.2	9.5
EV/EBIT	x n/m	n/m	n/m	n/m	9.6
Price to book (NAV)	x 73.1	12.6	3.9	3.1	2.6
Price to NTA	x 17.3	6.2	2.0	1.2	1.0

KEY RATIOS

	FY16A	FY17A	FY18F	FY19F	FY20F
EBITDA margin	% (8.7)	(51.3)	7.4	9.8	10.0
EBIT margin	% (9.1)	(52.2)	7.3	9.8	10.0
NPAT margin	% (3.4)	(40.4)	6.4	9.4	6.7
ROE	% (21.9)	(39.9)	8.2	20.6	12.7
ROA	% (5.2)	(19.7)	4.1	7.6	5.2
Net debt / (cash)	\$m (8.9)	(10.0)	(60.2)	(68.0)	(87.1)
Interest cover (EBIT / net interest)	x 4.0	(4.4)	8.7	25.4	27.3
Gearing (net debt / EBITDA)	x 4.0	0.8	(8.5)	(3.3)	(4.0)
Leverage (ND / (ND+E))	% 184%	n/m	n/m	n/m	n/m

DUPONT ANALYSIS

	FY16A	FY17A	FY18F	FY19F	FY20F
Net Profit Margin	% (3.4)	(40.4)	6.4	9.4	6.7
Asset Turnover	x 1.5	0.5	0.6	0.8	0.8
Return on Assets	% (5.2)	(19.7)	4.1	7.6	5.2
Financial Leverage	x 4.2	2.0	2.0	2.7	2.5
Return on Equity	% (21.9)	(39.9)	8.2	20.6	12.7

PROFIT AND LOSS (PRO FORMA)

	FY16A	FY17A	FY18F	FY19F	FY20F
Total revenue	\$m 25.8	23.3	96.0	208.0	218.8
EBITDA	\$m (2.2)	(11.9)	7.1	20.4	21.9
Depreciation & amortisation	\$m 0.1	0.2	0.1	0.1	0.1
EBIT	\$m (2.3)	(12.1)	7.0	20.3	21.8
Net interest	\$m 0.6	(2.7)	(0.8)	(0.8)	(0.8)
Non-operating income	\$m 0.0	0.0	0.0	0.0	1.0
Pretax Profit	\$m (2.9)	(9.4)	6.2	19.5	21.0
Tax expense	\$m 2.0	0.0	0.0	0.0	(6.3)
Minorities	\$m 0.0	0.0	0.0	0.0	1.0
Operating NPAT	\$m (0.9)	(9.4)	6.2	19.5	14.7
Forex	\$m 0.0	0.0	4.0	0.0	0.0
Reported NPAT	\$m (0.9)	(9.4)	10.2	19.5	14.7

BALANCE SHEET

	FY16A	FY17A	FY18F	FY19F	FY20F
Cash	\$m 8.9	10.0	60.2	68.0	87.1
Receivables	\$m 3.8	11.7	50.6	109.7	115.4
Inventory	\$m 3.5	13.8	34.8	73.5	77.1
Other	\$m 0.5	2.4	2.5	2.6	2.8
Current	\$m 16.6	37.8	148.2	253.9	282.4
Prop, plant & equip	\$m 0.5	1.4	1.6	2.5	3.5
Intangibles	\$m 0.0	0.0	0.0	0.0	0.0
Other	\$m 0.0	8.4	0.0	0.0	0.0
Non current	\$m 0.5	9.8	1.6	2.5	3.5
Total assets	\$m 17.1	47.6	149.8	256.4	285.9
Accounts Payable	\$m 7.2	18.1	74.6	161.7	170.1
Borrowings	\$m 0.0	0.0	0.0	0.0	0.0
Other	\$m 5.9	6.0	0.0	0.0	0.0
Total liabilities	\$m 13.0	24.0	74.6	161.7	170.1
Shareholder's equity	\$m 4.0	23.6	75.1	94.7	115.8

CASH FLOW

	FY16A	FY17A	FY18F	FY19F	FY20F
EBITDA	\$m (2.2)	(11.9)	7.1	20.4	21.9
D&A	\$m (0.1)	(0.2)	(0.1)	(0.1)	(0.1)
Interest	\$m 0.6	(2.7)	(0.8)	(0.8)	(0.8)
Other	\$m (0.9)	(11.1)	(15.0)	(10.7)	(0.9)
Operating cash flow	\$m (2.7)	(25.9)	(8.8)	8.8	20.1
Capex	\$m (0.4)	(1.1)	(1.0)	(1.0)	(1.0)
Acquisitions	\$m 0.0	0.0	0.0	0.0	0.0
Disposals	\$m 0.0	0.0	0.0	0.0	0.0
Investing cash flow	\$m (0.4)	(1.1)	(1.0)	(1.0)	(1.0)
Equity	\$m 0.0	28.0	60.0	0.0	0.0
Increase / (decrease) in borrowings	\$m 0.0	0.0	0.0	0.0	0.0
Dividend/other	\$m 0.0	0.0	0.0	0.0	0.0
Financing cash flow	\$m 0.0	28.0	60.0	0.0	0.0
Free cash flow	\$m (3.1)	(27.1)	(9.8)	7.8	19.1

Source: Petra Capital



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