

Stock Focus

ELECTRO OPTIC SYSTEMS HOLDING (EOS.ASX)

E&P

Friday, 31 July 2020

Deliveries set to re-start

Recommendation: Positive

Last price \$5.54
Valuation \$7.14

TSR	
Upside to valuation	28.9%
Dividend yield	0.0%
Expected total SH return	28.9%

EOS.ASX share price history v XJO.ASX

Source: EAP Research, IRESS



Trading Data

Last Price	\$5.54
Valuation	\$7.14
12 month range	\$2.98 - \$10.53
Market Cap	\$626m
Free Float	\$501m (80%)
12 month return (historical)	35.8%

Earnings revisions

	FY20	% chg	FY21	% chg
REVENUE (\$m)	230	0.0%	323	0.0%
EBITDA (\$m)	31	0.0%	50	0.0%
Adj. EPS (c)	17.5	0.0%	22.4	0.0%
DPS (c)	0.0	-	0.0	-
Val	\$7.14	0.0%		

Trading update

EOS has pre-announced the 1H'20 result and provided an update on deliveries and production. The loss is larger than expected at \$18.2m EBIT and \$12.7m after-tax, but entirely due to the timing of deliveries on the UAE contract. EOS had unrestricted cash of \$128m at the end of June.

Production of the 200 RWS units for the UAE is now complete (phase 1) and all product will be physically located in the customer's country by August 20th. The test firing range facilities will be open late-August (~20% of units are tested). These are in line with expectations stated in April and without any hiccups will see deliveries and invoicing resume in Q4 2020.

Full year guidance is now EBIT of \$20m-30m, compared to the previous number of \$27m. The wide range reflects the risk of slippage if there are any further coronavirus related delays. Hitting/exceeding the top-end depends on whether EOS wins an anti-drone contract in the Middle East (worth at least \$300m).

The risk-weighted tender pipeline remains strong at \$3bn with the order backlog unchanged (the gross value of the pipeline is more than \$10bn). According to EOS, the outlook for FY2021 is for strengthening growth as activity deferred from FY2020 is caught up, backlog is processed, and pipeline awards are made.

Earnings and Valuation Impact

No change to forecasts or valuation.

Our Thinking

EOS remains an exciting long-term story. Years of heavy investment in developing cutting edge IP is paying off, with the company in a unique position to win sizeable contracts in Australia and overseas. The opportunities span weapon systems (ballistic and laser), space tracking and satellite communications. We remain Positive and expect strong upside in the share price over the next two years.

Earnings Forecasts

Yr to December	17A	18A	19A	20E	21E	22E
EBITDA (\$m)	(9)	7	25	31	50	89
Rep NPAT (\$m)	(9)	15	18	23	32	59
Adj NPAT (\$m)	(9)	10	18	24	33	60
Adj. EPS (c)	(14.3)	11.4	19.7	17.5	22.4	40.6
Adj. EPS Gth (%)	519.5	(179.9)	72.0	(11.2)	28.3	80.9
PER (x)	NM	48.4	28.2	31.7	24.7	13.7
PEG Ratio (x)	NM	NM	0.4	NM	0.9	0.2
DPS (c)	0.0	0.0	0.0	0.0	0.0	0.0
Yield (%)	0.0	0.0	0.0	0.0	0.0	0.0
Franking (%)	0.0	0.0	0.0	0.0	0.0	0.0
ROE (%)	(37.8)	10.4	8.0	6.2	7.9	12.5
EV/EBITDA (x)	NM	77.9	21.3	14.8	8.4	4.8
Net Debt/EBITDA (x)	1.2	(6.7)	(3.4)	(5.7)	(4.1)	(2.2)
Int. Cover (x)	(253.2)	183.1	56.1	69.0	115.9	214.5
Valuation (blended)						\$7.14

Source: EAP Research

TRADING UPDATE AND CASH FLOW

EOS has provided a trading update and June Q cash flow. Operating cash flow was negative \$59m, and unrestricted cash totalled \$128m at the end of June.

The company expects to report a first half EBIT loss of negative \$18.2 million and a net loss after tax of \$12.7 million. While we expected a loss due to delays to delivery of the UAE contract delivery, suffice to say it was larger than anticipated.

Table 1. Cash flow

Source: Company reports

6mths to June - \$m	2020
Receipts	50.4
Payments	-109.6
Operating cash flow	-59.2
Interest	-0.1
Tax	-10.3
Capex	-6.6
Free cash flow	-76.2
Acquisitions	-11.0
	-87.2

We estimate that Revenue was \$75m. The revenue recognition policy is complex and depends on whether EOS is Prime or Subcontractor on a project. For the UAE contract EOS is Prime, so revenue is linked to delivery which as previously reported has been delayed (as subcontractor, ~75% of revenue is booked when the unit is built).

While a very strong second half is needed to make guidance, the delivery schedule looks to be on track to make it. Given that the 200 RWS units are already made, the costs have already been incurred and it's largely a case of receiving signoff by the customer. The contract is backed by a Letter of Credit with an Australian bank.

Australian Army contract – negotiations for 251 Remote Weapon Systems and related materiel expected to conclude and come under contract in Q3, with initial deliveries made in 2020. The estimated value is \$100m.

US facility – production has commenced at the Huntsville Alabama plant. The first complete units will begin shipping in Q3 for existing large and small contracts, including some orders from US customers (not materiel). The act of starting the plant completes qualification for upcoming tenders.

Counter drone weapons – EOS was recently selected as the preferred provider of counter drone weapons for a large international program (believed to be in the Middle East). Contract negotiations have been held up by the coronavirus pandemic, so it is unlikely the contract can be in effect in 2020. That said, EOS has moved its directed energy drone kill system to production, in anticipation of customer demand.

Tender pipeline – EOS has re-affirmed the \$3bn pipeline, which is split \$1bn for the T2000 turrets for the Australian Army (EOS is one of two consortiums bidding, trials next year, award mid-2022); \$1bn for US Army for RWS fitted to light reconnaissance vehicles (four potential bidders, award 2021); and \$1bn anti-drone in Middle East (EOS is one of two companies selected for trials).

This pipeline value is risk-weighted and based on probability of the contracts going ahead and chance of EOS winning. The gross figure is believed to be more than \$10bn.

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ELECTRO OPTIC SYSTEMS HOLDING (EOS.ASX), Positive, VALUATION \$7.14

EAP CORE DRIVERS

- Defence contracts – the weapons business has an order backlog of more than \$600m and it has tender submissions for more than \$2.5bn with existing customers. A large potential market is starting to develop in anti-drone defence systems, with EOS at the forefront.
- Space contracts – EOS performs more than 15,000 space tracks per week and will soon commence live testing of high-power lasers to manoeuvre space debris in orbit. The main revenue opportunity for EOS is military, with management estimating the potential market to be worth \$2bn over the next 10 years.
- Quantum Communications – this involves control of entangled photons. While the world is focused on developing ultra-secure communication networks, EOS is exploring options to commercialise its technology for long-range, ultra-wideband optical communications (i.e. 20THz).

INVESTMENT THESIS

- Electro Optic Systems (EOS) makes advanced weapon systems for the military and develops tracking systems for orbiting satellites and space debris. At the core of the company's IP is laser technology and the ability to tackle problems from a science-based perspective. Demand for the weapons business is growing strongly (contract wins and new tenders), and the market is finally opening for the space business, after decades of development.

EOS.ASX share price history v XJO.ASX

Source: EAP Research, IRESS



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ELECTRO OPTIC SYSTEMS HOLDING (EOS.ASX)

FINANCIAL SUMMARY

ELECTRO OPTIC SYSTEMS HOLDING						EOS.ASX							
As at:	31/07/2020					Recommendation:	Positive					Share Price:	\$5.54
Year end	December	2019A	2020E	2021E	2022E	Year end	December	2019A	2020E	2021E	2022E		
INCOME STATEMENT						VALUATION METRICS							
Sales revenue	\$m	165	230	323	490	PER	x	28.2	31.7	24.7	13.7		
EBITDA	\$m	25	31	50	89	Dividend Yield	%	0.0	0.0	0.0	0.0		
Depreciation	\$m	(4)	(4)	(6)	(6)	EV/EBITDA	x	21.3	14.8	8.4	4.8		
EBIT (ex associates)	\$m	22	26	45	82	EV/EBIT	x	25.0	17.1	9.5	5.2		
Equity accounted profits	\$m	0	0	0	0	P/FCF	x	NM	NM	27.8	NM		
EBIT (incl associates)	\$m	22	26	45	82	P/BV	x	2.8	2.1	2.0	1.7		
Net interest	\$m	0	2	3	4	BLENDED VALUATION							
Pre-tax profit	\$m	22	28	48	86	Discounted Cash Flow	\$/sh	5.17	33.3%				
Tax expense	\$m	(4)	(4)	(14)	(26)	Capitalisation of Earnings	\$/sh	7.13	33.3%				
Net profit	\$m	18	24	33	60	PER	\$/sh	9.12	33.3%				
Oth./Outside equity interests	\$m	0	0	0	0	Blended Valuation	\$/sh	7.14	100.0%				
NPAT attributable to s'hers	\$m	18	24	33	60	EARNINGS							
Net abnormal items	\$m	0	(1)	(1)	(1)	Closing shares on issue	m	113	149	149	149		
Reported NPAT	\$m	18	23	32	59	EFPOWA	m	113	149	149	149		
BALANCE SHEET						Adj. EPS	c	19.7	17.5	22.4	40.6		
Assets						DPS	c	0.0	0.0	0.0	0.0		
Cash	\$m	87	174	205	197	Franking	%	0.0	0.0	0.0	0.0		
Working Capital	\$m	125	190	189	287	FINANCIAL RATIOS							
PP&E	\$m	8	14	17	20	Sales Growth	%	91.6	39.1	40.6	51.5		
Intangibles	\$m	17	16	14	13	EBITDA Growth	%	242.0	20.7	63.8	77.0		
Investments	\$m	-	-	-	-	EBIT Growth	%	218.1	22.9	68.0	85.1		
Other	\$m	69	96	122	131	Adj. EPS Growth	%	72.0	(11.2)	28.3	80.9		
Total Assets	\$m	306	490	547	648	Tax Rate	%	17.6	14.5	30.0	30.0		
Liabilities						EBITDA Margin	%	15.3	13.3	15.5	18.1		
Debt	\$m	0	0	0	0	EBIT Margin	%	13.0	11.5	13.8	16.8		
Working Capital	\$m	18	32	44	67	ROA	%	7.0	5.4	8.1	12.7		
Other	\$m	60	70	82	100	ROE	%	8.0	6.2	7.9	12.5		
Total Liabilities	\$m	79	101	126	167	ROCE	%	15.3	12.3	20.6	29.1		
Net Assets	\$m	228	389	421	480	Net Debt (cash)	\$m	(87)	(174)	(205)	(197)		
Ordinary Equity	\$m	228	389	422	481	Net Debt/Equity	%	(38.2)	(44.7)	(48.7)	(41.1)		
Minority Interests	\$m	(1)	(1)	(1)	(1)	Net Debt/Debt + Equity	%	(61.7)	(80.8)	(94.8)	(69.7)		
Total Shareholders' Funds	\$m	228	389	421	480	Net Debt/EBITDA	x	(3.4)	(5.7)	(4.1)	(2.2)		
Capital Employed	\$m	141	215	216	283	Working Capital/Sales	%	64.6	68.9	44.7	44.9		
CASH FLOW						D&A/PP&E	%	46.9	29.2	33.2	32.0		
EBITDA	\$m	25	31	50	89	EBIT Interest Cover	x	56.1	69.0	115.9	214.5		
Change in Working Capital	\$m	(57)	(64)	(6)	(75)	DIVISIONAL SUMMARY							
Other	\$m	(2)	(2)	(2)	(2)	Revenue							
Gross Operating Cash Flow	\$m	(34)	(36)	42	11	Space Systems	\$m	5	10	15	25		
Net interest paid	\$m	0	2	3	4	Defence Systems	\$m	158	198	283	437		
Tax paid	\$m	(2)	(4)	(13)	(24)	Communications	\$m	2	23	25	28		
Net Operating Cash Flow	\$m	(36)	(37)	32	(9)	EBITDA							
Maintenance capex	\$m	(1)	(2)	(3)	(3)	Space Systems	\$m	0	2	4	8		
Free Cash Flow	\$m	(37)	(39)	30	(12)	Defence Systems	\$m	26	26	43	77		
Dividends paid	\$m	0	0	0	0	Communications	\$m	0	3	4	4		
Net acquisitions/Growth capex	\$m	(5)	(17)	(4)	(4)	Corporate	\$m	0	(1)	(1)	(1)		
Equity raisings/Buybacks	\$m	81	139	0	0								
Net borrowings	\$m	0	0	0	0								
Other	\$m	(3)	4	5	9								
Net change in cash	\$m	37	87	31	(8)								
GOCF/EBITDA	%	(133.7)	(116.7)	83.0	12.3								
Total Capex/Sales	%	3.5	8.3	1.9	1.4								
Total Capex/Depreciation	x	1.5	4.6	1.1	1.1								

Source: Company data, E&P 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, e.g. Successful exploration, scientific breakthrough, high commodity prices, regulatory change, etc. Consequently, the stock is considered a high-risk investment which may be prone to high volatility in share price movements, have a greater risk of capital loss and/or the stock may have low liquidity.
Suspended	Stock is temporarily suspended due to compliance with applicable regulatory and/or E&P policies in circumstances where E&P 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.

For stocks where Evans & Partners does not generate its own forecasts, Bloomberg consensus data is used. Analysts can introduce other factors when determining their recommendation, with any material factors stated in the written research where appropriate.

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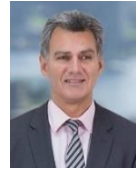
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MQG	E&P Corporate Advisory Pty Limited, a related entity of Evans and Partners Pty Ltd, has arranged, managed or co-managed an offering of securities of the company or its affiliates in the past 12 months, for which it received a fee.
MXT	E&P Corporate Advisory Pty Limited, a related entity of Evans and Partners Pty Ltd, has arranged, managed or co-managed an offering of the security in the past 12 months, for which it received a fee.
NBI	E&P Corporate Advisory Pty Limited, a related entity of Evans and Partners Pty Ltd, has arranged, managed or co-managed an offering of securities of the company or its affiliates in the past 12 months, for which it received a fee.
NEW	The Responsible Entity (RE) and the Investment Manager (IM) of New Energy Solar (NES), Evans and Partners Pty Ltd and E&P Corporate Advisory Pty Limited are wholly owned subsidiaries of Evans Dixon Ltd and related bodies corporate. The RE and IM will receive fees for acting as RE and IM of NES. Directors or employees of Evans Dixon and/or its related bodies corporate are directors of New Energy Solar Ltd, the RE and/or IM of NES. Each individual receives remuneration from Evans Dixon and/or its related entities.

Stock Focus

ELECTRO OPTIC SYSTEMS HOLDING (EOS.ASX)

PGG	E&P Corporate Advisory Pty Limited, a related entity of Evans and Partners Pty Ltd, has arranged, managed or co-managed an offering of securities and/or provided advisory services for the company or its affiliates in the past 12 months, for which it received a fee.
PMV	A director of Evans Dixon Limited, the ultimate holding company of Evans and Partners Pty Ltd, is a director of Premier Investments Limited.
QRI	E&P Corporate Advisory Pty Limited, a related entity of Evans and Partners Pty Ltd, has arranged, managed or co-managed an offering of securities of the company or its affiliates in the past 12 months, for which it received a fee.
SOHS.US	A director of Evans Dixon Limited, the ultimate holding company of Evans and Partners Pty Ltd, is a director of Sears Hometown & Outlet Stores Inc.
SUN	A director of Evans Dixon Limited, the ultimate holding company of Evans and Partners Pty Ltd, is a director of Suncorp Group Limited.
SWM	A director of Evans and Partners Pty Ltd is a director of Seven West Media Limited.
TGH	E&P Corporate Advisory Pty Limited, a related entity of Evans and Partners Pty Ltd, has arranged, managed or co-managed an offering of securities of the company or its affiliates in the past 12 months, for which it received a fee.
TLX	A director of Evans Dixon Limited, the ultimate holding company of Evans and Partners Pty Ltd, is a director of Telix Pharmaceuticals Limited.
TTT	E&P Corporate Advisory Pty Limited, a related entity of Evans and Partners Pty Ltd, has arranged, managed or co-managed an offering of securities of the company or its affiliates in the past 12 months, for which it received a fee.
URF	The Responsible Entity (RE) and Investment Manager (IM) of US Masters Residential Property Fund (URF), other entities that provide services to URF and Evans and Partners Pty Ltd are wholly owned subsidiaries of Evans Dixon Ltd and related bodies corporate. Each of the RE, IM and other related entities will receive fees for services provided to URF. Directors or employees of Evans Dixon and/or its related bodies corporate are directors of the RE, IM of URF and/or other related entities that provide services to URF. Each individual receives remuneration from Evans Dixon and/or its related entities. URF has appointed Evans and Partners Pty Ltd as Broker to an on-market buy-back. Evans and Partners Pty Ltd receives fees for acting in this capacity.
VCOF	The Responsible Entity (RE) of Venture Capital Opportunities Fund (VCOF) provide services to VCOF and Evans and Partners Pty Ltd which is a wholly owned subsidiary of Evans Dixon Ltd and related bodies corporate. The RE will receive fees for services provided to VCOF. Directors or employees of Evans Dixon and/or its related bodies corporate are directors of the RE of VCOF. Each individual receives remuneration from Evans Dixon and/or its related entities.

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I, Julian Mulcahy, hereby certify that all views expressed in this publication reflect my personal views about the subject theme and/or relevant company securities, and no attempt has been made by any other person to influence the views or themes contained within; and I am not in receipt of inside information and this publication does not contain any inside information. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this report.

I, Julian Mulcahy, received the following benefits from the company over the previous six (6) months: None.

I, Julian Mulcahy, and/or entities in which I have a pecuniary interest, have an exposure to the following securities and/or managed products: N/A.

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