

Analyst

Chris Savage 612 8224 2835

Authorisation

TS Lim 612 8224 2810

Adacel Technologies (ADA)

Bad, but not that bad

Recommendation
Buy (unchanged)
Price
\$0.88
Target (12 months)
\$1.50 (previously \$2.25)

GICS Sector
Software and Services

Expected Return

Capital growth	70.5%
Dividend yield	5.1%
Total expected return	75.6%

Company Data & Ratios

Enterprise value	\$56.1m
Market cap	\$68.6m
Issued capital	78.0m
Free float	54%
Avg. daily val. (52wk)	\$299,550
12 month price range	\$0.82 - \$3.18

Price Performance

	(1m)	(3m)	(12m)
Price (A\$)	1.75	1.65	2.83
Absolute (%)	-42.86	-39.21	-64.66
Rel market (%)	-39.57	-33.37	-63.86

Absolute Price



SOURCE: IRESS

Much weaker-than-expected guidance

Adacel provided 1HFY19 and FY19 guidance that was well below our expectations:

- 1HFY19 PBT to be 65-70% lower than pcg; and
- FY19 PBT to be 25-35% lower than pcg (we were forecasting a 1% decline).

The key drivers of the weaker-than-expected guidance were lower assumed revenues from the FAA in relation to simulator support (i.e. not the ATOP or controller training contracts), higher opex (due to increased R&D and S&M) and a negative forex impact. The company also said it had commenced legal proceedings against Adsync Technologies Inc. who last year were awarded the FAA simulator contract in place of Adacel. The proceedings relate to breach of contract and infringement of IP rights.

EPS downgrades of b/w 18-25%

We have downgraded our EPS forecasts in FY19, FY20 and FY21 by 25%, 21% and 18%. Our FY19 forecasts are consistent with the guidance – we forecast PBT to be 26% lower than pcg – and, while we recognise that Adacel has disappointed a number of times over the past couple of years, we believe the company has been quite conservative in the assumptions it has used in the setting of the guidance.

Investment view: PT down 33% to \$1.50, Maintain BUY

We have updated each valuation we use in the determination of our price target for the earnings changes as well as market movements and the time creep. We have also increased the discount we apply in the relative valuations from 5% to 25% and increased the WACC we apply in the DCF from 10.9% to 11.7% due to the disappointing update and guidance. The net result is a 33% decrease in our PT to \$1.50 which is a 70% premium to the current share price and so we maintain the BUY. We recognise there is a significant credibility issue with the company following a number of disappointments but we also believe the business is not broken and will continue to be profitable so can still be considered for investment.

Earnings Forecast

Year end 30 June	2018	2019e	2020e	2021e
Total revenue (A\$m)	54.6	59.2	62.1	65.1
EBITDA (A\$m)	10.9	8.3	10.5	12.2
NPAT (A\$m)	8.4	6.2	7.7	8.8
EPS (diluted) (cps)	10.6	8.0	10.0	11.6
EPS growth (%)	-9%	-25%	26%	15%
PER (x)	8.3	11.1	8.8	7.6
Price/CF (x)	8.0	7.0	7.1	6.0
EV/EBITDA (x)	5.1	6.8	5.1	4.0
Dividend (€ps)	9.5	4.5	5.5	7.0
Yield (%)	10.8%	5.1%	6.3%	8.0%
ROE (%)	35.6%	28.8%	30.7%	30.0%
Franking (%)	0%	0%	0%	0%

SOURCE: BELL POTTER SECURITIES ESTIMATES

Earnings and Valuation Changes

EPS Downgrades of b/w 18-25%

We have downgraded our EPS forecasts in FY19, FY20 and FY21 by 25%, 21% and 18%. Our FY19 forecasts are consistent with the guidance – we forecast PBT to be 26% lower than pcp – and, while we recognise that Adacel has disappointed a number of times over the past couple of years, we believe the company has been quite conservative in the assumptions it has used in the setting of the guidance.

A summary of the changes in our key forecasts is shown below. Note we have actually upgraded our revenue forecasts in each period and expect that revenue will grow in FY19 (but by less than the 10% the company is suggesting). The downgrades are largely being driven by reductions in our gross margin forecasts as well as increases in our opex forecasts.

Figure 1 - Change in key forecasts

Year end 30 June	FY19e			FY20e			FY21e		
	Old	New	Change	Old	New	Change	Old	New	Change
Total revenue (A\$m)	53.0	59.2	11.6%	57.4	62.1	8.2%	61.3	65.1	6.3%
EBITDA	10.8	8.3	-23.4%	13.2	10.5	-20.7%	15.0	12.2	-18.7%
NPAT	8.3	6.2	-25.6%	9.9	7.7	-22.6%	11.1	8.8	-20.5%
Diluted EPS	10.6c	8.0c	-25.1%	12.7c	10.0c	-21.2%	14.2c	11.6c	-18.4%
DPS	5.5c	4.5c	-18.2%	6.5c	5.5c	-15.4%	8.0c	7.0c	-12.5%

SOURCE: BELL POTTER SECURITIES ESTIMATES

33% Decrease in PT to \$1.50

We have updated each valuation we use in the determination of our price target for the earnings changes as well as market movements and the time creep. We have also increased the discount we apply in the relative valuations from 5% to 25% and increased the WACC we apply in the DCF from 10.9% to 11.7% due to the disappointing update and guidance. There is, however, no change in the terminal growth rate we apply in the DCF of 3.0%.

The change in each valuation and the impact on our PT calculation is shown below.

Figure 2 - Change in valuations and impact on PT

Methodology	Old (as at 18-Sep-18)			New (as at 9-Nov-18)		
	Valuation per share	% weighting	Price target	Valuation per share	% weighting	Price target
PE ratio	\$2.33	33%	\$0.78	\$1.37	33%	\$0.46
EV/EBITDA	\$1.99	33%	\$0.66	\$1.29	33%	\$0.43
DCF	\$2.43	33%	\$0.81	\$1.83	33%	\$0.61
Total			\$2.25			\$1.50

SOURCE: BELL POTTER SECURITIES ESTIMATES

The figure shows a double digit percentage decrease in each valuation ranging b/w 25-41%. The net result is a 33% decrease in our PT to \$1.50 which is a 70% premium to the current share price and so we maintain the BUY. We recognise there is a significant credibility issue with the company following a number of disappointments but we also believe the business is not broken and will continue to be profitable so can still be considered for investment.

Adacel Technologies

Company Description

Adacel Technologies (Adacel) is a leading global provider of simulation and control systems for the civil aviation and defence sectors. The core products of the company are air traffic control (ATC) simulation systems (where it is the leading global provider) and air traffic management (ATM) automation systems (where it is more of a niche provider). Adacel has also developed speech recognition technology which it uses in its ATC simulation systems as well as other products.

Investment Thesis

We maintain our BUY recommendation on Adacel. Our investment thesis is based on:

- **Valuation:** Our 12 month price target on Adacel is \$1.50. The price target is generated from a blend of three valuation methodologies we apply to the company: PE ratio, EV/EBITDA and DCF. The price target is a 70% premium to the current share price and the total expected return (which includes the forecast dividend yield) is 76%.
- **Diversified with a high level of recurring revenue:** Adacel has undergone a significant transformation over the past five years and today is a much more diversified company with less volatility in earnings and improved visibility. The company generates revenue from two key areas – systems and services – where the latter is recurring and underpinned by long term contracts. The current split between systems and services (i.e. non-recurring and recurring) is approximately 40%/60%.
- **High barriers to entry:** Adacel has a large installed base of both ATC simulation and ATM automation systems and, once installed, these systems tend to be in service for 10-15 years or more. Over this time the systems need maintenance and upgrades and, because Adacel owns the source code behind the systems, it is the only one that can provide these services. The large installed base of systems is therefore a barrier to entry for new entrants and also provides Adacel with long term recurring revenue.

Key Risks

Key downside risks to our estimates and valuation include (but are not limited to):

- **Lumpiness in revenue:** Adacel generates around a third of its revenue from systems sales which are non-recurring and can cause lumpiness in revenue. Adacel has attempted to reduce the lumpiness of revenue in the business by increasing the level of recurring services revenue but systems sales will always remain a key part of the business and so there will always be some level of non-recurring revenue.
- **Customer concentration risk:** Adacel generates more than 50% of its revenue from three key customers: FAA, the US Department of Defence and Leidos. All three have been long term customers of Adacel (i.e. >10 years) and all have recently signed new long term contracts with the company. There is still risk, however, given the contracts tend to have multiple one-year options and the customers or contracts are government funded and so there is risk of cuts or volatility in funding levels.
- **Key product risk:** Adacel has two key products – ATC simulation systems and ATM automation systems – and most of its services revenue is derived from the sale and support of these two products. There is risk, therefore, if the demand or outlook for one or both of these products changes.

Table 1 - Financial summary

Adacel Technologies (ADA)						Share price:	\$0.88	Target price:	\$1.50		
						No. of issued shares:	78.0m	Market cap:	\$68.6m		
Profit & Loss (A\$m)						Valuation data					
Year end 30 Jun	2017	2018	2019e	2020e	2021e	Year end 30 Jun	2017	2018	2019e	2020e	2021e
Sales revenue	42.4	53.1	57.6	60.5	63.5	NPAT (A\$m)	9.3	8.4	6.2	7.7	8.8
Other revenue (excl. int.)	2.0	1.5	1.6	1.6	1.6	Diluted EPS (cps)	11.7	10.6	8.0	10.0	11.6
Total revenue (excl. int.)	44.5	54.6	59.2	62.1	65.1	Change	1%	-9%	-25%	26%	15%
Change	-10%	23%	8%	5%	5%	P/E ratio (x)	7.5	8.3	11.1	8.8	7.6
Cost of sales	-24.5	-32.8	-37.3	-38.3	-39.6	CFPS (cps)	6.2	10.9	12.6	12.4	14.5
Gross profit	17.9	20.3	20.3	22.1	23.9	Price/CF (x)	14.2	8.0	7.0	7.1	6.0
Gross margin	42.1%	38.2%	35.2%	36.6%	37.7%	DPS (cps)	11.8	9.5	4.5	5.5	7.0
Forex gain/(loss)	-0.1	-0.1	0.0	0.0	0.0	Yield	13.4%	10.8%	5.1%	6.3%	8.0%
Expenses (excl. D&A, int.)	-11.0	-10.8	-13.5	-13.3	-13.3	Franking	0%	0%	0%	0%	0%
% of revenue	-25.9%	-20.3%	-23.5%	-22.0%	-21.0%	EV/EBITDA (x)	5.9	5.1	6.8	5.1	4.0
EBITDA	8.8	10.9	8.3	10.5	12.2	EV/EBIT (x)	6.5	5.5	7.4	5.5	4.2
Depreciation	-0.6	-0.4	-0.4	-0.4	-0.5	NTA per share (cps)	31.8	28.9	26.6	31.6	37.7
Amortisation	-0.2	-0.2	-0.3	-0.3	-0.4	Price/NTA (x)	2.8	3.0	3.3	2.8	2.3
EBIT	8.1	10.3	7.6	9.7	11.4	Performance ratios					
Net interest (expense)/revenue	-0.2	-0.1	-0.1	-0.1	0.0	Year end 30 Jun	2017	2018	2019e	2020e	2021e
Pre-tax profit	7.9	10.2	7.5	9.6	11.4	EBITDA margin	20.8%	20.5%	14.4%	17.3%	19.3%
Income tax expense	1.4	-1.8	-1.3	-1.9	-2.6	EBIT margin	19.0%	19.4%	13.2%	16.0%	18.0%
NPAT	9.3	8.4	6.2	7.7	8.8	Return on assets	24.5%	22.1%	17.1%	19.5%	20.1%
Change	1%	-10%	-26%	24%	15%	Return on equity	35.7%	35.6%	28.8%	30.7%	30.0%
Cash Flow (A\$m)						ROIC	>100%	>100%	>100%	>100%	>100%
Year end 30 Jun	2017	2018	2019e	2020e	2021e	Payout ratio	100.4%	89.3%	56.6%	55.0%	60.6%
EBITDA	8.8	10.9	8.3	10.5	12.2	Effective tax rate	18.2%	-17.6%	-17.5%	-20.0%	-22.5%
Change in working capital	-4.0	-4.5	0.7	-1.5	-1.5	Leverage ratios					
Gross cash flow	4.9	6.4	9.0	9.0	10.8	Year end 30 Jun	2017	2018	2019e	2020e	2021e
Interest received	0.0	0.1	0.1	0.1	0.2	Net debt/(cash) (A\$m)	-16.4	-12.5	-12.4	-15.7	-20.2
Tax paid	0.0	-1.7	-0.7	-1.0	-1.3	Net debt/equity	NM	NM	NM	NM	NM
Tax credits refunded	0.0	3.8	1.6	1.6	1.6	Gearing	NM	NM	NM	NM	NM
Interest paid	0.0	0.0	-0.2	-0.2	-0.2	Net debt/EBITDA (x)	NM	NM	NM	NM	NM
Operating cash flow	4.9	8.6	9.8	9.6	11.1	Net interest cover (x)	NM	NM	NM	NM	NM
Payments for PPE	-0.2	-0.3	-0.3	-0.4	-0.4	Segmentals (A\$m)					
Payments for IP	0.0	-0.3	-0.3	-0.3	-0.3	Year end 30 Jun	2017	2018	2019e	2020e	2021e
Investing cash flow	-0.2	-0.5	-0.6	-0.6	-0.7	Revenue					
Dividends paid	-2.8	-9.5	-7.4	-3.8	-4.8	Systems	9.7	21.9	24.1	25.3	26.6
Repayment of TPC loan	-0.7	-0.7	-0.5	-0.5	-0.3	Services	32.8	31.1	33.5	35.2	36.9
Shares repurchased	0.0	-2.0	-1.5	-1.3	-1.0	Sales revenue	42.4	53.1	57.6	60.5	63.5
Financing cash flows	-3.5	-12.2	-9.4	-5.6	-6.0	Interest income	0.0	0.1	0.1	0.1	0.2
Net change in cash	1.2	-4.1	-0.2	3.4	4.4	Other income (Rent and R&D Cr)	2.0	1.5	1.6	1.6	1.6
Cash at start of period	15.8	16.4	12.5	12.4	15.7	Total revenue	44.5	54.7	59.3	62.2	65.3
Exchange rate impact	-0.6	0.2	0.0	0.0	0.0	Gross profit					
Cash at end of period	16.4	12.5	12.4	15.7	20.2	Systems	3.4	6.1	6.0	6.3	7.3
Balance Sheet (A\$m)						Services	14.5	14.1	14.2	15.8	16.6
Year end 30 Jun	2017	2018	2019e	2020e	2021e	Gross profit	17.9	20.3	20.3	22.1	23.9
Cash	16.4	12.5	12.4	15.7	20.2	Gross margin					
Current receivables	12.6	11.0	13.0	12.8	12.7	Systems	34.8%	27.9%	25.0%	25.0%	27.5%
Accrued revenue	2.6	7.2	4.3	4.5	4.8	Services	44.3%	45.4%	42.5%	45.0%	45.0%
Other current assets	0.7	1.7	1.1	1.2	1.2	Sales revenue	42.1%	38.2%	35.2%	36.6%	37.7%
PPE	1.2	1.0	0.9	0.8	0.8	Interims (A\$m)					
Intangibles - Goodwill	0.0	0.0	0.0	0.0	0.0	Year end 30 Jun	1HFY17	2HFY17	1HFY18	2HFY18	
Intangibles - Other	0.8	0.9	0.9	0.8	0.7	Sales revenue	19.9	23.3	25.6	28.5	
Other non-current assets	3.5	3.5	3.5	3.5	3.5	Other revenue (excl. int)	1.3	0.8	0.5	1.0	
Total assets	37.8	37.9	36.1	39.4	43.8	Total revenue	21.2	24.1	26.1	29.6	
Payables	4.3	5.0	5.8	6.0	6.3	Change	-17%	-1%	23%	23%	
Advance payments	2.0	2.8	2.8	2.8	2.8	EBITDA		4.7	4.2	5.1	5.8
Current tax liabilities	2.5	2.6	2.6	2.6	2.6	Depreciation		-0.3	-0.3	-0.2	-0.2
Current provisions	1.1	2.5	2.5	2.5	2.5	Amortisation		-0.1	-0.1	-0.1	-0.1
Borrowings	0.0	0.0	0.0	0.0	0.0	EBIT		4.3	3.8	4.8	5.5
Non-current liabilities	1.9	1.4	0.9	0.4	0.1	Net interest (expense)/revenue		-0.1	-0.1	0.0	-0.1
Non-current provisions	0.0	0.0	0.0	0.0	0.0	Pre-tax profit		4.2	3.7	4.8	5.4
Total liabilities	11.8	14.3	14.6	14.4	14.4	Income tax expense		-0.4	1.8	-1.3	-0.5
Contributed equity	75.2	73.3	71.8	70.5	69.5	NPAT		3.7	5.5	3.5	4.9
Reserves	-2.0	-1.3	-0.7	0.3	1.6	Change		-34%	58%	-7%	-11%
Retained earnings/(losses)	-47.2	-48.4	-49.6	-45.7	-41.7						
Total shareholders' equity	26.0	23.6	21.5	25.1	29.4						

SOURCE: BELL POTTER SECURITIES ESTIMATES

Recommendation structure

Buy: Expect >15% total return on a 12 month view. For stocks regarded as 'Speculative' a return of >30% is expected.

Hold: Expect total return between -5% and 15% on a 12 month view

Sell: Expect <-5% total return on a 12 month view

Speculative Investments are either start-up enterprises with nil or only prospective operations or recently commenced operations with only forecast cash flows, or companies that have commenced operations or have been in operation for some time but have only forecast cash flows and/or a stressed balance sheet.

Such investments may carry an exceptionally high level of capital risk and volatility of returns.

Research Team

Staff Member	Title/Sector	Phone	@bellpotter.com.au
TS Lim	Head of Research	612 8224 2810	tslim
Industrials			
Sam Haddad	Industrials	612 8224 2819	shaddad
Chris Savage	Industrials	612 8224 2835	csavage
Jonathan Snape	Industrials	613 9235 1601	jsnape
Tim Piper	Industrials	612 8224 2825	tpiper
John Hester	Healthcare	612 8224 2871	jhester
Tanushree Jain	Healthcare/Biotech	612 8224 2849	tnjain
Financials			
TS Lim	Banks/Regionals	612 8224 2810	tslim
Lafitani Sotiriou	Diversified Financials/Fintech	613 9235 1668	lsotiriou
Resources			
Peter Arden	Resources	613 9235 1833	parden
David Coates	Resources	612 8224 2887	dcoates
Stuart Howe	Resources	613 9235 1856	showe
Analysts			
James Filius	Analyst	613 9235 1612	jfilius
Alexander McLean	Analyst	612 8224 2886	amclean
Damien Williamson	Analyst	613 9235 1958	dwilliamson

Bell Potter Securities Limited

ACN 25 006 390 7721

Level 38, Aurora Place
88 Phillip Street, Sydney 2000

Telephone +61 2 9255 7200

www.bellpotter.com.au

The following may affect your legal rights. Important Disclaimer:

This document is a private communication to clients and is not intended for public circulation or for the use of any third party, without the prior approval of Bell Potter Securities Limited. In the USA and the UK this research is only for institutional investors. It is not for release, publication or distribution in whole or in part to any persons in the two specified countries. In Hong Kong this research is being distributed by Bell Potter Securities (HK) Limited which is licensed and regulated by the Securities and Futures Commission, Hong Kong. This is general investment advice only and does not constitute personal advice to any person. Because this document has been prepared without consideration of any specific client's financial situation, particular needs and investment objectives ('relevant personal circumstances'), a Bell Potter Securities Limited investment adviser (or the financial services licensee, or the representative of such licensee, who has provided you with this report by arrangement with Bell Potter Securities Limited) should be made aware of your relevant personal circumstances and consulted before any investment decision is made on the basis of this document.

While this document is based on information from sources which are considered reliable, Bell Potter Securities Limited has not verified independently the information contained in the document and Bell Potter Securities Limited and its directors, employees and consultants do not represent, warrant or guarantee, expressly or impliedly, that the information contained in this document is complete or accurate. Nor does Bell Potter Securities Limited accept any responsibility for updating any advice, views opinions, or recommendations contained in this document or for correcting any error or omission which may become apparent after the document has been issued.

Except insofar as liability under any statute cannot be excluded, Bell Potter Securities Limited and its directors, employees and consultants do not accept any liability (whether arising in contract, in tort or negligence or otherwise) for any error or omission in this document or for any resulting loss or damage (whether direct, indirect, consequential or otherwise) suffered by the recipient of this document or any other person.

Disclosure of interest:

Bell Potter Securities Limited, its employees, consultants and its associates within the meaning of Chapter 7 of the Corporations Law may receive commissions, underwriting and management fees from transactions involving securities referred to in this document (which its representatives may directly share) and may from time to time hold interests in the securities referred to in this document.

ANALYST CERTIFICATION

Each research analyst primarily responsible for the content of this research report, in whole or in part, certifies that with respect to each security or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about those securities or issuers and were prepared in an independent manner and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that research analyst in the research report.