QinetiQ Group

Updated forecasts post-acquisition

Targeting acquisitions and contracts

Aerospace & defence

QinetiQ CEO Steve Wadey has now got the bit between his teeth and is on a mission to expand the company internationally while exploiting growth opportunities in the core UK business. The recent acquisition of Meggitt Target Systems (MTS) seems to make strategic sense, both industrially and financially. This note introduces our FY18 numbers for the first time. Our new FY17 forecasts reflect the purchases of MTS and Rubikon and the £1bn amendment to the Long Term Partnering Agreement (LTPA) with the UK Ministry of Defence (MOD).

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
03/15	763.8	108.5	15.3	5.4	18.4	1.9
03/16	755.7	108.6	16.3	5.7	17.2	2.0
03/17e	777.9	106.8	16.3	6.2	17.2	2.2
03/18e	826.0	111.1	16.9	6.6	16.6	2.3

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

LTPA affords some margin protection

The £1bn contract amendment to the Long Term Partnering Agreement (LTPA) with the UK Ministry of Defence (MOD) is significant for two reasons. First, it should provide some margin protection in the EMEA Services division, where the company has been guiding for a decline due to a declining baseline profit rate set by the MOD for single source contracts. Previously the MOD repriced the LTPA every five years meaning that QinetiQ never benefitted from long-term efficiencies, but this new agreement is for 11 years. Second, the MOD's long-term commitment has empowered QinetiQ to invest in the facilities which should stimulate additional longer-term growth, ideally from international customers.

Acquisition of MTS will be 5% EPS accretive in FY18

The acquisition of Meggitt Target Systems fills a gap in QinetiQ's existing Test & Evaluation offering. We expect the deal to be 5% accretive in FY18 because it brings c £30m of revenue into the Global Products division at a 19.8% margin which is higher than that of QinetiQ. QinetiQ paid 9x FY16 EBITDA, which is in line with its own rating and therefore looks to be a fair price for a high quality asset.

Valuation: Solid defence play with growth options

In our note of August last year we espoused that QinetiQ was a de-risked investment with potential catalysts to come from deploying the balance sheet. Since then, there have been a number of contract wins and the acquisition of MTS, CEO Steve Wadey's first major M&A deal, is reassuringly value creating. The stock is trading on 16.6x FY18e EPS, which is a c 10% premium to its peers in the Aerospace & Defence sector. Its forecast dividend yield of 2.3% in FY18e compares less favourably to some of its peers but QinetiQ has more growth opportunities given its nascent international business. Its net cash position (FY17e £193m) provides scope for more M&A activity now that the capital expenditure requirements of the LTPA are known.

22 March 2017

Price	**281.1p**
Market cap	**£1,599m**

Net cash (£m) 30 September 2016	271.2
Shares in issue	568.8m
Free float	96%
Code	QQ
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	2.1	8.3	20.6
Rel (local)	0.8	3.0	2.1
52-week high/low		283.2p	217.5p

Business description

QinetiQ provides technical support services to customers in the global aerospace, defence and security markets. The group operates through two divisions: EMEA Services (82% FY16 sales) and Global Products (18% FY16 sales).

Next events

FY17 results	25 May 2017

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Edison profile page

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Forecasts updated for acquisition and LTPA contract

We have updated our FY17 forecasts and publish our FY18 numbers for the first time. Our FY17 EPS is 3.9% higher than previously forecast due to £7m of additional revenue from MTS, a 10bps improvement in the EMEA Services margin due to the LTPA agreement and a lower tax rate as a result of R&D allowances. Our FY18 numbers incorporate £30m of revenue for MTS in Global Products and £10m of revenue for Rubikon in EMEA Services.

Exhibit 1: Forecast revisions table

	EPS, p			PBT, £m			EBITDA, £m		
	Old	New	% chg.	Old	New	% chg.	Old	New	% chg.
2017e	15.6	16.3	4.5	105.1	106.8	1.6	130.0	132.6	2.0
2018e	N/A	16.9		N/A	111.1		N/A	141.3	

Source: Edison Investment Research

LTPA contract should provide some margin protection

In December 2016 QinetiQ announced a £1bn contract amendment to its Long Term Partnering Agreement (LTPA) with the UK MOD. The agreement secured half of the core LTPA revenues at the 2016 Single Regulations Office (SSRO) baseline profit rate of 8.95% out to 2028. This is helpful to the EMEA Services margin for two reasons. First, it means that c £100m of revenue per year is no longer subject to repricing every five years. The SSRO profit rate is the starting point but companies can earn higher returns through good execution of contracts, and they keep the benefits of efficiency savings. However, historically, the repricing mechanism has meant QinetiQ had to give up these gains every five years when the MOD rebased the contract. It now has an 11-year window over which to plan how best to optimise its margins; longer-term efficiency programmes are now a viable business proposition.

Second, it protects QinetiQ from feeling the full impact of the SSRO's declining single source baseline margin, which was announced last week as 7.46% for FY17/18, a 17% reduction on the FY16/17 figure of 8.95%. In FY16, 70% of EMEA Services revenues were from single source contracts (ie uncompeted) with the MOD. Removing the £100m of revenue per year for the LTPA amendment reduces that figure to 54%. The change to our published numbers is minimal (+10bp on the EMEA Services margin in FY17); however, over the life of the contract we expect QinetiQ to see additional margin benefits from the productivity savings it generates. Management has previously guided that the EMEA Services margin should decline; we now believe some of this decline may be mitigated by this amendment.

The new contract's 11-year timeframe out to 2028 has reassured QinetiQ of the MOD's long-term commitment. As a result, QinetiQ has now committed to an additional £60-70m of capital expenditure on the programme bringing the total to £180m, of which £120m will be spent in the next three years. Approximately £95m will be invested in modern tracking equipment, instrumentation and range infrastructure at MOD Aberporth and MOD Hebrides ranges. This will help reduce the overall operating costs of the ranges, ensuring they remain competitive with the latest capabilities. QinetiQ is targeting the repatriation of UK Defence money that defence primes spend on the MOD's behalf. The company estimates that approximately half the UK's test and evaluation money is currently spent overseas because the UK is not deemed to have the correct facilities. The Hebrides has the potential to provide 'best in class' facilities, unrivalled in size and interoperability of range which should attract defence primes to use it as one of their testing grounds. The investment should also make the UK ranges world class, thus attracting international customers. This is a win win situation. The MOD gets a higher return out of its fixed asset and it provides a platform for growth for QinetiQ.

£85m will be spent developing the future military test pilot programme. QinetiQ will replace the oldest aircraft in the current flying fleet with new systems-rich aircraft that can deliver the new syllabus whilst costing less to maintain, thus reducing the overall running costs of the RAF's Air Warfare Centre at Boscombe Down. A new commercial test pilot qualification will also be introduced, opening up the school to a wider range of students.

Acquisition of Meggitt Target Systems is 5% EPS accretive

On 21 December 2016 QinetiQ announced it had acquired Meggitt Target Systems for £57.5m on a cash free, debt free basis. The business generated approximately £28m of revenue and £5.5m of operating profit (19.6% margin) in the year to 31 December 2016. We therefore raise our FY17 forecasts for QinetiQ by £7m (1.1%) to account for one quarter of the additional revenue and we have added £30m to FY18e revenue, assuming slight growth in the business next year. Our analysis of the deal suggests it was a financially and strategically astute acquisition. As a cash buyer, QinetiQ paid a fair price at 9x EBITDA (which is in line with its overall rating) and we calculate the deal to be 5% EPS accretive in FY18e. The Meggitt Target Systems, now QinetiQ Target Systems, fills a gap in QinetiQ's existing Test & Evaluation offering as the business makes cost-effective unmanned aerial, naval and land-based target systems. Customers using any of QinetiQ's ranges need targets to test against so the company is now able to offer an end-to-end solution. QinetiQ Target Systems also generates 90% of its revenues from outside the UK so complements QinetiQ's desire to become a more international company.

The new strategy is evolving

CEO Steve Wadey is a man on a mission to internationalise QinetiQ. He appointed the first Managing Director responsible for International business last August and has developed a campaign style approach to winning new business. This is similar to his experience of partnering at the European missile manufacturer MBDA where he had to manage the complex relationship between a prime contractor and the MOD. He only spoke about this new approach in broad terms at the FY17 interim results (see Exhibit 2), but our understanding is that he is encouraging all the different parts of the business to be more joined up in order to offer strategic partnering to a broader range of customers, outside QinetiQ's traditional hunting ground of the UK Ministry of Defence (MOD).

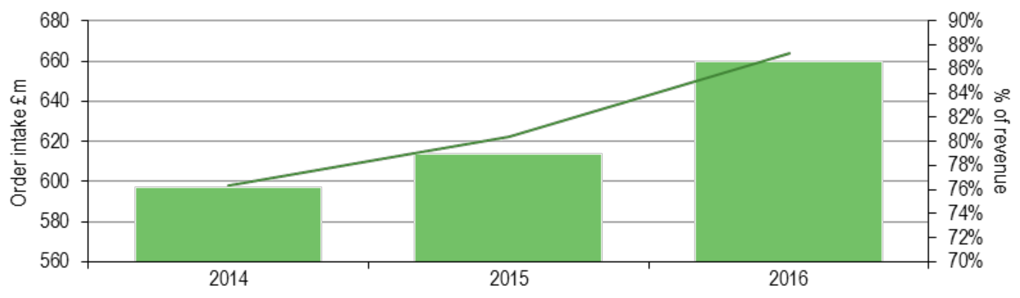
Exhibit 2: Slide 20 from 2017 interim results presentation

Source: Qinetiq

Management has identified 30 different campaigns where QinetiQ should be able to win new business, thus driving organic growth. We believe that the largest campaign is currently to grow the

Test and Evaluation business, where QinetiQ thinks it has the ability to double its market share in the UK alone. The most important metric to measure the success of this campaign led approach will be the level of order intake (see Exhibit 3), so we shall be watching it closely over the next year.

Exhibit 3: QinetiQ order intake £m (LHS) and as a % of revenue (RHS)



Source: Edison Investment Research, Qinetiq

QinetiQ's strategy of organic growth through exploiting international opportunities combined with M&A activity could result in a very different shape business in a few years' time. In FY16, 70% of revenue came from the UK government. We believe that Qinetiq is at the beginning of its international journey, as its defence peer Thales was three years ago.

Exhibit 4: Financial summary

£m	2015	2016	2017e	2018e
Year end 31 March	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS				
Revenue	763.8	755.7	777.9	826.0
Cost of Sales	0.0	0.0	0.0	0.0
Gross Profit	763.8	755.7	777.9	826.0
EBITDA	134.5	134.7	132.6	141.3
Operating Profit (before amort. and except.)	113.5	111.3	106.9	111.4
Intangible Amortisation	(1.5)	(2.5)	(1.1)	(0.9)
Exceptionals	(3.1)	(18.4)	(3.5)	(1.6)
Other	0.0	0.0	0.0	0.0
Operating Profit	108.9	90.4	102.3	109.0
Net Interest	(3.5)	(0.2)	1.0	0.5
Profit Before Tax (norm)	108.5	108.6	106.8	111.1
Profit Before Tax (FRS 3)	105.4	90.2	103.3	109.5
Tax	12.0	8.4	(12.9)	(15.3)
Profit After Tax (norm)	96.7	95.8	93.5	95.5
Profit After Tax (FRS 3)	117.4	98.6	90.4	94.2
Average Number of Shares Outstanding (m)	630.9	587.0	573.4	564.9
EPS - normalised (p)	15.3	16.3	16.3	16.9
EPS - normalised and fully diluted (p)	15.2	16.2	16.2	16.8
EPS - (IFRS) (p)	18.6	16.8	15.8	16.7
Dividend per share (p)	5.4	5.7	6.2	6.6
Gross Margin (%)	100.0	100.0	100.0	100.0
EBITDA Margin (%)	17.6	17.8	17.1	17.1
Operating Margin (before GW and except.) (%)	14.9	14.7	13.7	13.5
BALANCE SHEET				
Fixed Assets	354.8	317.4	386.6	453.4
Intangible Assets	122.5	81.4	125.4	124.1
Tangible Assets	229.6	233.4	258.1	325.7
Investments	2.7	2.6	3.1	3.6
Current Assets	386.1	453.8	386.6	443.0
Stocks	18.5	19.0	20.2	21.7
Debtors	143.4	129.9	143.9	152.8
Cash	195.5	274.5	191.3	235.6
Other	28.7	30.4	31.2	32.8
Current Liabilities	(370.6)	(383.9)	(380.1)	(403.3)
Creditors	(370.6)	(383.9)	(380.1)	(403.3)
Short term borrowings	0.0	0.0	0.0	0.0
Long Term Liabilities	(72.2)	(62.5)	(59.9)	(103.0)
Long term borrowings	0.0	0.0	2.2	(41.2)
Other long term liabilities	(72.2)	(62.5)	(62.2)	(61.8)
Net Assets	298.1	324.8	333.2	390.1
CASH FLOW				
Operating Cash Flow	112.5	182.4	111.1	148.4
Net Interest	0.0	(3.5)	(0.2)	1.0
Tax	0.0	(17.3)	(12.9)	(15.3)
Capex	(29.0)	(30.2)	(40.5)	(97.5)
Acquisitions/disposals	75.9	27.4	(57.5)	0.0
Financing	(106.8)	(48.6)	(47.0)	0.0
Dividends	(31.7)	(32.3)	(34.0)	(35.7)
Other	4.1	1.1	0.0	0.0
Net Cash Flow	25.0	79.0	(81.0)	0.9
Opening net debt/(cash)	(170.5)	(195.5)	(274.5)	(193.5)
HP finance leases initiated	0.0	0.0	0.0	0.0
Other	(0.0)	(0.0)	0.0	(0.0)
Closing net debt/(cash)	(195.5)	(274.5)	(193.5)	(194.4)

Source: Company accounts, Edison Investment Research

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