

QinetiQ Group

FY17 results

Momentum building

Aerospace & defence

QinetiQ is a business in transformation. It has a new management team, a new campaign based strategy and it is proactively adapting to meet the new defence environment in the UK and US. Solid FY17 numbers saw the first organic revenue growth since 2014, which is encouraging, and management has maintained its expectations for FY18. Underlying momentum is building at the company. Order intake, contract wins and continued organic revenue growth will demonstrate whether or not the new strategy can translate into higher returns.

5 June 2017

Price 310.0p
Market cap £1,750m

Net cash (£m) 31 March 2017	221.9
Shares in issue	564.3m
Free float	96%
Code	QQ
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	4.4	10.4	26.5
Rel (local)	0.9	7.3	4.4
52-week high/low	319.7p		217.5p

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
03/16	755.7	108.6	16.3	5.7	19.0	1.8
03/17	783.1	116.1	18.1	6.0	17.1	1.9
03/18e	831.4	110.3	16.9	6.4	18.4	2.1
03/19e	850.6	118.4	18.1	6.7	17.1	2.2

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

Growth potential but facing margin headwinds

QinetiQ's FY17 revenue grew organically by 1% to £783.1m (FY16: £755.7m). Underlying operating profit as reported by QinetiQ of £116.3m (FY16: £108.9m) was boosted by £7.4m of non-recurring trading items. Orders excluding the Long Term Partnering Agreement (LTPA) amendment were up 2% and book to bill improved to 1.3x (FY16: 1.2x). However, the EMEA Services division is facing margin headwinds from the lower baseline profit rate for single-source contracts with the UK Ministry of Defence (MOD). Management issued guidance for "steady progress" in FY18, although optically earnings will fall due to the £7.4m one-off boost to profits in FY17. Our FY18 numbers remain broadly unchanged and we introduce our FY19 forecasts for the first time.

Orders will be the metric to watch

With a number of interesting campaigns ongoing, including a robotics offering in the US, there is potential for upside to the company's restrained growth expectations. CEO Steve Wadey has stated that most of the campaigns will take three to five years to have a meaningful impact on revenue. Therefore, in the next two years we would hope to see a number of important contract wins, a growing order book and continued organic revenue growth.

Valuation: In line with its peer group

QinetiQ is currently trading on 17.1x FY19 EPS, which is in line with its aerospace and defence peers, which are trading on an average of 17.3x. QinetiQ has less US exposure than most defence and historically has been discounted accordingly. However, its recent strong share price performance implies that the market increasingly understands its strategy to become more international and believes the stock is well positioned to benefit from higher UK defence spending.

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 (78% of FY17 sales) and Global Products (22% of FY17 sales).

Next events

Paris Air Show	19-23 June 2017
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Return to organic growth as QinetiQ adapts

The FY17 results were the first opportunity for new CFO David Smith (ex Rolls-Royce) to present to the market. He and CEO Steve Wadey delivered a set of numbers that showed progress in the right direction and building underlying momentum.

- **Revenue** grew 1% on an organic basis to £783.1m (FY16: £755.7m) due primarily to a strong performance in QinetiQ North America in the Global Products division.
- **Underlying operating profit** as reported by the company of £116.3m (FY16: £108.9m) was boosted by £7.4m of non-recurring trading items. EMEA Services benefited from a £5.2m credit relating to the release of engine servicing obligations as QinetiQ invests in new aircraft for test aircrew training. Global Products benefited from £2.2m of credits related to historical overseas contractual disputes.
- **Underlying basic earnings per share** were 18.1p (FY16: 16.3p) benefiting from the higher underlying profit before tax and the reduced share count following the completion of the £50m share buyback on 31 March 2017.
- **QinetiQ's recent acquisitions**, Meggitt Target Systems and Rubikon, appear to be performing in line with expectations. Together they contributed £9.2m of revenue and £1.2m of operating profit.
- **The underlying tax rate** of 10.6% (FY16: 11.8%), remains below the UK statutory rate, primarily as a result of research and development expenditure credits in the UK.
- **Capital expenditure** of £32.9m in FY17 is expected to increase to £80-100m as investment is made as per the LTPA contract amendment announced in December 2016.
- As at 31 March 2017 QinetiQ had **net cash** of £221.9m (31 March 2016: £274.5m). The reduction was due to acquisitions, the share buyback and the progressive dividend policy.
- **The full year dividend** increased 5% to 6.0p (FY16: 5.7p).

EMEA Services: Modernising but facing margin headwinds

EMEA Services revenue was flat on an organic basis at £613.5m with performance across all business units described as “broadly consistent”. Underlying operating profit reduced to £92.7m (FY16: £93.8m) resulting in a margin of 15.1%. As previously mentioned it was boosted by a £5.2m credit. The company attributes 80bps of margin decline (£4.6m of operating profit) to the lower baseline rate for single-source contracts

Management reiterated its guidance that EMEA Services is facing margin headwinds because the baseline profit rate for new and renewed single-source contracts signed in FY18 will fall by 149bp from the 8.95% in FY16/17 to 7.46% in FY17/18. This rate is set by the Single Source Regulations Office (SSRO) and is applied to all MOD contracts that are uncompleted. It is important to note, though, that the rate is the starting point but companies can earn higher returns through adjustments for risk, capital requirements and good execution of contracts. 76% of EMEA Services revenue (FY16: 74%) is derived from single-source contracts. However, an increasing proportion of QinetiQ's revenue is contracted on a long-term basis, which provides some protection from falling rates. For example, the £1bn 11-year contract amendment to the Long Term Partnering Agreement (LTPA) was contracted at the 2017 profit rate. This is discussed further in our [update note](#) published in March 2017.

EMEA Services delivered 78% of group revenue in FY17 (FY16: 82%) so it is by far and away QinetiQ's most dominant division. However, it is the one facing structural challenges because the UK MOD, its primary customer, is changing the way it does business. The MOD is becoming more

commercial so the procurement regime is becoming tougher for industry. Historically, UK defence procurement has been chaotic, slow moving and unpredictable. QinetiQ and others therefore see the changes as positive in the long term, even if it means they suffer some near-term margin headwinds.

QinetiQ's EMEA Services is responding in two ways: innovating and internationalising. In the UK QinetiQ is aiming to become more reactive and responsive, which it believes will enable it to take on an even bigger role in supporting UK defence testing and evaluation. It is modernising facilities, for example aircrew training facilities, to enable growth opportunities, and it is bringing together the supply chain to offer a joined up solution. For example, it has entered into a teaming agreement with Thales and Textron to provide innovative, cost-effective and technologically advanced tri-service training using a Textron Scorpion jet equipped with Thales and QinetiQ sensors as part of the Air Support to the Defence Operational Training (ASDOT) programme.

Outside the UK, EMEA Services is constantly looking for growth opportunities. A new international business was established at the beginning of FY17, representing 6% of group revenue. Order intake in Australia grew, QinetiQ Canada achieved its first home win to provide advice to the Royal Canadian Coastguard and a new QinetiQ office is being established in Malaysia to support sales and marketing in South-East Asia.

EMEA Services orders, excluding the £1bn LTPA amendment, grew 5% to £520.9m (FY16: £495.4m). Management states that 79% of its forecast EMEA Services' FY18 revenue was under contract at the beginning of the year, compared with 77% at the beginning of the prior year. Its book to bill ratio improved from 1.2x in FY16 to 1.3x in FY17.

Global Products: Opportunities in OptaSense and robotics

Global Products has shorter order cycles than EMEA Services so can have a lumpier revenue profile. In FY17 revenue was up 8% due to higher product shipments for the new US aircraft carriers, robotics and growth in OptaSense.

In FY17, 8% of QinetiQ's group revenue came from the US Department of Defense (DoD). However, Global Products is showing encouraging signs that it is gaining increasing traction in the US. For example, it is currently bidding on a number of US robotics and autonomy competitions, two of which are likely to be awarded this year. QinetiQ's specialisation in unmanned systems plays well to the US DoD's focus on autonomy. The recent FY18 US defence budget requested 10% more for R&D than the Obama administration (as shown in Exhibit 1), much of which is expected to be spent on developing autonomous systems.

	FY18 Obama (\$m)	FY18 Trump (\$m)	Difference (%)	Difference (\$m)
Military Personnel	137,889	141,686	2.8%	3,797
Operations & Maintenance	219,039	223,277	1.9%	4,238
Procurement	115,270	114,983	-0.2%	-287
RDT&E	75,166	82,717	10.0%	7,551
Revolving & Management Funds	7,854	2,096	-73.3%	-5,758
Military Construction	1,353	8,375	519.0%	7,022
Family House	141	1,407	897.9%	1,266
Total Base Budget	556,712	574,541	3.2%	17,829

Source: US DoD Budget Materials, Edison Investment Research

The OptaSense business is also performing well and showing interesting potential in commercial markets. Growth last year was driven principally by continued strength in its pipeline sensing business and some recovery in the North American oil and gas market. It has recently signed an agreement with Siemens to pursue new opportunities in the rail sector.

Integration of the Target Systems business acquired from Meggitt in December 2016 is progressing well and is expected to start delivery good growth. CEO Steve Wade speaks with conviction about

how as a former customer, he knows that the end-to-end targeting solution that QinetiQ can now provide is in high demand.

Outlook maintained for FY18 and we introduce FY19 forecasts

This is the first time management has issued guidance for FY18, and it is maintaining expectations for “steady progress excluding the non-recurring benefits in FY17”. EMEA Services is expected to deliver modest revenue growth with a continued headwind to operating margins due to the lower baseline profit rate for single-source contracts. The Global Products division is expected to continue growing in FY18. Cash flow in FY18 will reflect increasing investment in the LTPA with £80-100m of capital expenditure.

Our forecasts for FY18 remain broadly unchanged. The only notable change in Exhibit 2 is our dividend forecast. We had previously forecast a 10% rate of growth, which was unnecessarily ahead of management’s guidance for a progressive dividend policy. We now forecast 6% growth in FY18. Exhibit 3 introduces our FY19 forecasts for the first time.

Exhibit 2: FY17 forecasts vs actuals and FY18 new forecasts						
Year to March (£m)	2017			2018e		
	Estimate	Actual	% change	Prior	New	% change
EMEA Services	622.6	613.5	-1.5%	638.8	638.8	0.0%
Global Products	155.4	169.6	9.2%	187.3	192.6	2.9%
Sales	777.9	783.1	0.7%	826.0	831.4	0.7%
EBITDA	132.6	145.3	9.5%	141.3	143.1	1.3%
EMEA Services	87.2	92.7	6.4%	86.2	86.2	0.0%
Global Products	18.6	23.6	26.6%	24.3	24.3	-0.3%
Underlying EBITA	105.8	116.3	9.9%	110.6	110.5	-0.1%
Underlying PTP	106.8	116.1	8.7%	111.1	110.3	-0.7%
EPS - underlying continuing (p)	16.3	18.1	11.0%	16.9	16.9	-0.1%
DPS (p)	6.2	6.0	-3.1%	6.6	6.4	-3.6%
Net debt / (cash)	-193.5	-221.9	14.6%	-194.4	-198.6	2.2%

Source: QinetiQ accounts, Edison Investment Research

QinetiQ is meeting “challenges and opportunities” head on

QinetiQ is a business in transformation. CEO Steve Wadey said that he believes defence companies have two options in the changing defence environment: either sit back and try to defend the status quo of the past, or adapt and be part of shaping the future. He is choosing to meet the “challenges and opportunities head on”. QinetiQ has always been seen as technologically innovative, but management identifies a crucial nuance in that not only is it applying its innovative expertise to the technology but also to creating original and experimental customer-focused solutions and delivery. In QinetiQ’s own words, “turning creativity and innovation into tangible value for our customers increasingly requires innovative thinking across the broader range of activities.”

Initial evidence of this new way of operating was given in the recent agreement with Rockwell Collins to collaborate on the next generation of Navigation Satellite System (GNSS) receivers. Rockwell Collins is the global leader in secure military GPS receivers and QinetiQ has critical satellite navigation technologies that enable the development of multi constellation solutions. It is very significant that Rockwell Collins, one of the defence industry giants in the US, has chosen to partner with QinetiQ.

For the past year QinetiQ has been operating a campaign strategy with the aim of maximising opportunities for products across customers. There are reported to be more than 30 growth campaigns, all of which are worth tens of millions of pounds, and some are reported to be worth

hundreds of millions of pounds. We expect that it will be three to five years before this strategy delivers meaningful revenue growth; however, if it is successful there should be an increase in order intake, notable contract wins and continued organic growth.

Financials and valuation

Cash focused on higher capex for the LTPA

QinetiQ started FY17 with net cash of £274.5m. Operating cash flow of £117.7m covered capex of £32.9m and acquisition outlays of £65.7m (on Meggitt Target Systems and Rubikon). Share buybacks of £48.1m and dividend payments of £33.4m led to end-March 2017 year net cash of £221.9m. Management has guided that capex will rise to between £80-100m in FY18 in order to invest in facilities for the LTPA (for further details see our [March note](#) – we are modelling £100m). It also expects a partial unwinding of net working capital. Company cash contributions to the pension plan are £13m per year until 31 March 2018. We therefore forecast £198.6m of cash at end FY18, leaving QinetiQ with a strong balance sheet. Its stated capital allocation priorities are:

- Investing in organic capabilities, complemented by bolt-on acquisitions where there is a strong strategic fit.
- Maintain the necessary balance sheet strength.
- Provide a progressive dividend to shareholders.
- Return excess cash to shareholders.

Valuation

QinetiQ is trading on 17.1x FY19e EPS, placing it in line with its aerospace and defence peers, which are trading on an average of 17.3x. It is also trading in line on an FY19e EV/EBITDA of 9.2x compared to a sector average of 9.7x. QinetiQ has less US exposure than most defence stocks so has not benefited from the wave of optimism surrounding US defence; however, the growth in FY17 came from North America so this perception of the stock may be outdated.

Exhibit 3: Financial summary

	£m	2015	2016	2017	2018e	2019e
Year end 31 March		IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS						
Revenue		763.8	755.7	783.1	831.4	850.6
Cost of Sales		0.0	0.0	0.0	0.0	0.0
Gross Profit		763.8	755.7	783.1	831.4	850.6
EBITDA		134.5	134.7	145.3	143.1	150.1
Operating Profit (before amort. and except.)		113.5	111.3	118.9	113.1	120.0
Intangible Amortisation		(1.5)	(2.5)	(2.6)	(2.6)	(2.5)
Exceptionals		(3.1)	(18.4)	15.4	(5.2)	(4.6)
Other		0.0	0.0	0.0	0.0	0.0
Operating Profit		108.9	90.4	131.7	105.3	113.0
Net Interest		(3.5)	(0.2)	(0.2)	(0.2)	0.8
Profit Before Tax (norm)		108.5	108.6	116.1	110.3	118.4
Profit Before Tax (FRS 3)		105.4	90.2	131.5	105.1	113.8
Tax		12.0	8.4	(8.2)	(14.2)	(15.4)
Profit After Tax (norm)		96.7	95.8	103.8	95.4	102.4
Profit After Tax (FRS 3)		117.4	98.6	123.3	90.9	98.4
Average Number of Shares Outstanding (m)		630.9	587.0	573.9	564.9	564.9
EPS - normalised (p)		15.3	16.3	18.1	16.9	18.1
EPS - normalised and fully diluted (p)		15.2	16.2	17.9	16.7	18.0
EPS - (IFRS) (p)		18.6	16.8	21.5	16.1	17.4
Dividend per share (p)		5.4	5.7	6.0	6.4	6.7
Gross Margin (%)		100.0	100.0	100.0	100.0	100.0
EBITDA Margin (%)		17.6	17.8	18.6	17.2	17.6
Operating Margin (before GW and except.) (%)		14.9	14.7	15.2	13.6	14.1
BALANCE SHEET						
Fixed Assets		354.8	317.4	384.1	447.6	507.2
Intangible Assets		122.5	81.4	142.5	137.9	134.1
Tangible Assets		229.6	233.4	238.8	306.9	370.3
Investments		2.7	2.6	2.8	2.8	2.8
Current Assets		386.1	453.8	587.8	577.8	586.3
Stocks		18.5	19.0	28.9	29.4	30.4
Debtors		143.4	129.9	144.9	153.8	157.4
Cash		195.5	274.5	221.9	198.6	189.1
Other		28.7	30.4	192.1	196.0	209.5
Current Liabilities		(370.6)	(383.9)	(372.0)	(371.0)	(379.2)
Creditors		(370.6)	(383.9)	(372.0)	(371.0)	(379.2)
Short term borrowings		0.0	0.0	0.0	0.0	0.0
Long Term Liabilities		(72.2)	(62.5)	(67.3)	(66.8)	(66.4)
Long term borrowings		0.0	0.0	0.0	0.0	0.0
Other long term liabilities		(72.2)	(62.5)	(67.3)	(66.9)	(66.4)
Net Assets		298.1	324.8	532.6	587.6	648.0
CASH FLOW						
Operating Cash Flow		112.5	182.4	117.7	126.0	138.4
Net Interest		0.0	(3.5)	(0.2)	(0.2)	(0.2)
Tax		0.0	(17.3)	(8.2)	(14.2)	(15.4)
Capex		(29.0)	(30.2)	(32.9)	(100.3)	(95.8)
Acquisitions/disposals		75.9	27.4	(65.7)	0.0	0.0
Financing		(106.8)	(48.6)	(48.1)	0.0	0.0
Dividends		(31.7)	(32.3)	(33.4)	(34.6)	(36.6)
Other		4.1	1.1	18.2	0.0	0.0
Net Cash Flow		25.0	79.0	(52.6)	(23.3)	(9.5)
Opening net debt/(cash)		(170.5)	(195.5)	(274.5)	(221.9)	(198.6)
HP finance leases initiated		0.0	0.0	0.0	0.0	0.0
Other		(0.0)	(0.0)	0.0	0.0	(0.0)
Closing net debt/(cash)		(195.5)	(274.5)	(221.9)	(198.6)	(189.1)

Source: QinetiQ accounts, Edison Investment Research

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