Orbital Corporation (OEC)

FY20 Result: Potential remains for a higher orbit

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KEY POINTS

- As OEC had pre-guided its result, it should have been as expected. Unfortunately, earlier EBIT guidance related to statutory results, which included a $3.3m abnormal gain (before tax). The wording in the guidance statement inferred EBIT guidance was underlying. As a result of further analysis of the result, we have lowered near term forecasts.
- The positive from the result is that 2H20 was the first half of solid sales, which has allowed us to analyse costs and margins. We have raised overheads (currently high as OEC is carrying a large engineering team working on three new engines due to come into production in either FY21 or FY22). High overheads mean OEC is more leveraged at the EBITDA than previously thought. Whilst short term EBITDA has been lowered, longer term EBITDA is higher than previously forecast.
- FY21 operating revenue guidance of $40-$50m was re-iterated. We have left revenue forecasts unchanged. The delta is the timing of when the 3rd engine with Insitu comes into production. We think risk is to the upside on our revenue forecast of $47.5m, though the 1H21 result should shed more light on the timing of the 3rd engine entering production.
- Peer comparison analysis of companies that sell into the drone market, indicates that they are trading at between a 50-60% premium to OEC on FY22 PER and EBITDA multiples. Even after discounting the premium for their larger size and higher liquidity, OEC could easily trade on higher multiples. Its strong technology lead in the TUAV engine market also makes it a takeover target, in our opinion.
- 2H20 Australian revenue (engine one and engineering revenue) came in at $17.7m, indicating that sales of its first engine are stronger than expected. 2H20 US revenue (Engine two) of $4.7m is slightly below expectations. Production started in February 2020 and is in ramp up, indicating potential for this to grow in FY21 above just annualising it.
- We have made material reductions to FY21/22/23 EBITDA forecasts of 53%/35%/22% respectively. This seems a lot, but it is off a low base and an investment in OEC is about the longer-term growth. The main negative is that FY21 EBITDA expectations may be too high if one were to use FY20 statutory EBITDA as the starting forecast base.

INVESTMENT VIEW

Due to near term downgrades, our DCF based price target moves to $1.60/share (from $1.82/share). The reduction is less than the downgrades would suggest due to the higher operating leverage lifting longer term forecasts. Our price target represents a TSR of 28% over the current share price. We retain our Buy recommendation.

With contracted long-term high growth and the potential for several near-term contract wins with other TUAV manufacturers in the near to medium term; OEC has: catalysts, re-rating potential and long-term high growth (all the key facets of a successful investment). It has to continue to deliver quality product to its customers and to date, it appears to have done that. We are bullish on the long-term upside at OEC, but caveat this due to FY21 EBITDA expectations that may be running a little high.

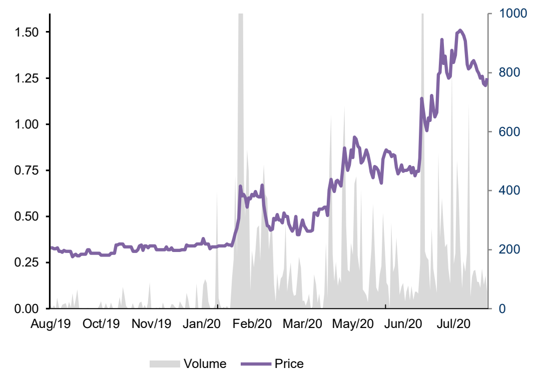
Recommendation	BUY
Previous Recommendation	Buy $1.82
Risk Rating	High
Current Share Price	$1.25
12 Month Price Target	$1.60/share
Price target Methodology	DCF
Total Return (Capital + Yield)	28%
FY22F ROIC	29%
Market Capitalisation	$97m
Liquidity	$300k/day

Financial Forecasts & Valuation Metrics

OEC Y/E Jun A$m	FY20A	FY21F	FY22F	FY23F
Revenue	33.8	47.5	63.5	81.4
EBITDA	1.0	4.9	10.1	16.1
EPS Adj (c)	-0.7	2.1	6.1	10.8
EPS Growth	87%	417%	189%	78%
DPS (c)	0.0	0.0	0.0	0.0
EV/EBITDA (x)	95.4	19.5	8.6	5.0
PE Underlying (x)	(188.2)	59.3	20.5	11.5
Gearing (%)	-1%	-9%	-61%	-98%
ROIC %	(3%)	11%	29%	50%

Source: PAC Partners estimates

12 Month Share Price and Volume



Key Milestones

- Potential to be re-rated in line with peer multiples, which would deliver ~50% share price upside.
- Details around a potential new agreement with Textron, its 2nd largest customer.
- An update on the progress of the 3rd engine to come into production, currently forecast late FY21.
- Additional contract wins, with negotiations occurring with several potential new clients.
- Northrop Grumman consortium winning the FTUAS contract.

Disclosure: Entities associated with the author of this report own shares in OEC
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Operations Overview

It is possible that OEC may upgrade guidance in FY21, though as it is a large range, it depends on swing factors

FY21 GUIDANCE

OEC re-iterated previously provided FY21 operating revenue guidance of $40-$50m. We forecast for OEC to deliver towards the top end of its guidance based on our assumption of sales of the 3rd engine commencing in Q4 FY21.

Other outlook statements made in the presentation were that they are:

- Targeting additional new customer contracts; and
- Increased involvement in defence unmanned air vehicles (UAV) programs.

In our opinion, we believe it is likely that OEC secures additional supply contracts due to its market leading solution in a niche market. As seen from recent contract announcements, they tend to be material catalysts.

No new news was announced with the result and as guidance was already in the market, the result should not have a significant impact on the share price.

PEER COMPARISONS

Figure 1 includes close global peers, implying the sector trades on high multiples

Figure 1: Peer comparisons

	Share	Mkt	Gearing	EV/EBITDA (x)		PER (x)	
Company	**Price A$**	**Cap $m**	**ND/ND+E**	**FY21F**	**FY22F**	**FY21F**	**FY22F**
Aerojet Rocketdyne	57.57	4,457	-97%	8.4x	7.4x	21.1x	20.1x
AeroVironment, Inc.	105.16	2,514	-92%	22.3x	18.8x	41.1x	35.1x
Austal Limited	3.52	1,262	-42%	5.8x	5.4x	14.3x	14.8x
Elbit Systems Ltd.	187.19	8,273	28%	17.2x	15.6x	n/m	n/m
Electro Optic Systems	5.87	877	-39%	13.4x	7.6x	26.7x	14.3x
HEICO Corporation	149.62	17,889	14%	27.0x	21.9x	50.3x	42.0x
Orbital Corporation	27.10	3,326	-2%	24.0x	19.7x	36.7x	30.6x
Textron Inc.	54.35	12,393	34%	8.2x	6.5x	15.7x	11.6x
Average				**15.8x**	**12.9x**	**29.4x**	**24.1x**
Orbital Corporation	**1.25**	**97**	**-9%**	**8.6x**	**5.0x**	**20.5x**	**11.5x**
Difference to Peers				**-45%**	**-61%**	**-30%**	**-52%**

Source: CapIQ

A key investment thematic of OEC is that global peers in the UAV sector trade on very high multiples. Due to OEC's size, we would not expect to trade at these multiples; however, due to the large discount that OEC trades on relative to peers, multiple's upside exists.

FY20 Results Summary

The FY20 result was not as clear cut as we would of liked, but in the big scheme it is not that important

The result saw a large improvement in the 2H20; however, the result is difficult to interpret due to OEC not clearly defining the difference between underlying and statutory EBITDA and NPAT.

In March 2020, Orbital obtained a one-off legal settlement relating to a claim that commenced in 2014. We calculate from the annual report that the net benefit (after costs) from the claim to be $3.3m ($2.3m after tax). There was also a $0.2m positive reversal of an abnormal charge from FY19 that we treat as one off relating to impairment of receivables.

As a result of backing these Abnormals out of the result, we get different FY20 underlying EBITDA ($2.1m vs. $4.2m statutory) and UNPAT (-$0.6m vs. $1.9m statutory) compared to the headline numbers in the investor presentation. See Figure 2 for our calculation of underlying results, plus statutory NPAT.

Figure 2: FY20 result summary

($m)	1H19A	2H19A	1H20A	2H20A	1H20A 2H20A %	FY19A	FY20A	YoY Chg
Australia	2.2	12.3	10.6	17.7	67%	14.5	28.2	94%
US	0.0	0.5	0.8	4.7	460%	0.5	5.6	995%
Operating Revenue	**2.2**	**12.8**	**11.4**	**22.4**	97%	**15.0**	**33.8**	125%
Other (including abnormals)	1.4	0.8	0.8	4.3	450%	2.1	5.1	138%
Total Revenue	**3.6**	**13.6**	**12.2**	**26.7**	**119%**	**17.2**	**38.9**	**126%**
Est. COGS	(4.5)	(4.3)	(9.0)	(11.6)	30%	(8.8)	(20.6)	135%
Gross Profit	(0.9)	9.3	3.2	10.6	230%	8.4	13.9	65%
Overheads	(2.6)	(9.1)	(4.3)	(8.5)	96%	(11.6)	(12.9)	10%
Total EBITDA	**(3.5)**	**0.2**	**(1.1)**	**2.1**	**(292%)**	**(3.2)**	**1.0**	**(132%)**
Depreciation & Amortisation	(0.3)	(0.7)	(1.0)	(0.9)	(10%)	(1.0)	(1.9)	96%
Total EBIT	**(3.7)**	**(0.4)**	**(2.1)**	**1.2**	**(159%)**	**(4.2)**	**(0.9)**	**(79%)**
Interest	(0.3)	(0.2)	(0.4)	(0.2)	(52%)	(0.4)	(0.6)	52%
Profit before tax	(4.0)	(0.6)	(2.5)	1.0	(141%)	(4.6)	(1.5)	(68%)
Tax	0.0	0.0	0.9	0.0	(98%)	0.0	0.9	2388%
UNPAT	**(4.0)**	**(0.5)**	**(1.6)**	**1.1**	**(165%)**	**(4.5)**	**(0.6)**	**(88%)**
Abnormals	0.0	(1.4)	0.0	3.5	NM	(1.4)	3.5	(351%)
Tax on abnormals	0.0	0.0	0.0	(1.0)	NM	0.0	(1.0)	NM
Reported NPAT	**(4.0)**	**(1.9)**	**(1.6)**	**3.5**	**(315%)**	**(5.9)**	**1.9**	**(131%)**
Underlying EPS	**(5.2)**	**(0.6)**	**(2.1)**	**1.6**	**(176%)**	**(5.8)**	**(0.5)**	**(91%)**
DPS (cps)	0.0	0.0	0.0	0.0		0.0	0.0	
Operating Cashflow	2.7	(0.9)	(3.4)	7.1	(311%)	1.8	3.7	109%
Op. CF / EBITDA	-77%	-363%	304%	334%		-55%	367%	
Gearing (ND/ND+E)	5%	5%	27%	-1%		-1%	-1%	
Total EBITDA Margin	**-96.0%**	**1.8%**	**-9.1%**	**7.9%**		**-18.7%**	**2.6%**	

Source: OEC and PAC Partners

The main positive from the result is that the 2H20 gives us our first real half of solid sales to analyse costs and margins. Our main takeaway is that currently OEC has high fixed costs as it carries a large engineering team to design engines for multiple customers (i.e. Insitu, Northrop Grumman and a Singapore based defence contractor). As the revenue grows, this will get spread over a larger base and would materially decline if development work slowed.

KEY FEATURES OF THE 2H20 RESULT

We focus on the 2H20 result, as that gives a look through to 1H21, before high growth recommences in 2H21 with a 3rd engine coming into production.

2H20 was markedly stronger than the 1H20 and represented the period of when OEC moved from loss making to profitable. Onwards from here

2H20 operating revenue increased by 97% over 1H20, driven by much higher sales of engine one (Australia, well above expectations, though includes engineering revenue) and the commencement of sales of Engine 2 (US, below expectations, but in ramp up).

2H20 EBITDA was positive ($2.1m) and FY20 underlying EBITDA came in at $1.0m based on our calculations. We calculate a -$3.2m difference between underlying and statutory EBITDA of $4.2m. The issue with highlighting the higher statutory EBITDA result is that it may raise some investors expectations for FY21 (our expectations were too high until we analysed the result in detail).

We expect that going forward OEC is likely to better distinguish between underlying operating earnings and statutory earnings.

2H20 Underlying NPAT came in at $1.1m (our estimate) and -$0.6m for FY20. Statutory NPAT after adding back $2.5m of tax adjusted Abnormals was $1.9m.

Net cash position of $0.1m (from -$0.8m). The net cash position was assisted by the one of cash inflow from the settlement.

Forecast Earnings Changes

Our forecast changes decrease EBITDA for FY21 to FY23 by 53%, 35% and 22% respectively, see Figure 3.

Figure 3: Forecast Changes

	Old			New			Difference		
$m	**FY21F**	**FY22F**	**FY23F**	**FY21F**	**FY22F**	**FY23F**	**FY21F**	**FY22F**	**FY23F**
Revenue									
Australia	25.5	25.5	36.4	25.5	25.5	36.4	0.0	0.0	0.0
US	22.0	38.0	45.0	22.0	38.0	45.0	0.0	0.0	0.0
Total Revenue	**47.5**	**63.5**	**81.4**	**47.5**	**63.5**	**81.4**	**0.0**	**0.0**	**0.0**
EBITDA	10.4	15.6	20.7	4.9	10.1	16.1	(5.5)	(5.4)	(4.6)
Depreciation & Amort	(2.1)	(2.3)	(2.5)	(1.8)	(2.0)	(2.3)	0.3	0.3	0.2
Total EBIT	**8.3**	**13.2**	**18.2**	**3.1**	**8.1**	**13.9**	**(5.2)**	**(5.2)**	**(4.4)**
Net Interest	(0.7)	(0.7)	(0.7)	(0.5)	(0.7)	(0.7)	0.2	0.0	0.0
Tax	(2.3)	(3.8)	(5.3)	(0.7)	(2.1)	(3.9)	1.6	1.6	1.4
Reported NPAT	5.3	8.8	12.3	1.9	5.3	9.3	(3.4)	(3.5)	(3.0)
Underlying NPAT	**5.3**	**8.8**	**0.0**	**1.8**	**5.2**	**9.2**	**(3.5)**	**(3.6)**	**9.2**
Underlying EPS (cps)	**6.2**	**10.3**	**0.0**	**2.1**	**6.1**	**10.8**	**(4.1)**	**(4.2)**	**10.8**
EBITDA Margins	**22.0%**	**24.5%**	**25.4%**	**10.3%**	**16.0%**	**19.8%**			

Source Pac Partners

Whilst large near term downgrades is not a good sign, they came about due to either poor communication or a misunderstanding, not because business conditions have deteriorated

Key assumption changes made include:

- We have changed the composition of our forecast direct and indirect labour costs. This increases overheads and lifts our gross profit assumptions. Whilst this materially lowers near term forecasts, it means OEC is more leveraged at the EBITDA line than previously forecast, which is a longer term positive.
- We have left revenue forecasts unchanged.
- We have incorporated a charge for amortisation of capitalised development costs (new in FY20), though is only small in value.
- We assume OEC commences paying tax in FY23 (tax holiday for two years factored in).

We had factored in FY20 EBIT guidance given in late July into our previous modelling as relating to underlying EBIT, as that is how it read. Our new forecasts are based off our calculated underlying FY20 earnings.

Investment view and valuation

Due to contracted high growth with a solid line of sight, we use DCF to value OEC.

DCF ANALYSIS

We roll forward our DCF and explicitly forecast FY21-FY26. We leave our DCF assumptions unchanged. Due to lower near-term forecasts, our DCF valuation reduces to $1.60/share (from $1.82), see Figure 5.

Our DCF valuation has declined due to lower near-term forecast reductions, but still represents high upside

Figure 5: DCF valuation

Present value of cashflows FY21 to FY30	53
Present value of terminal year cashflow	71
Net Debt at FY20A	(0)
Present value of equity	124
Diluted Shares on issue	78
Present value per share	**$1.60**

Source: PAC Partners

INVESTMENT VIEW

We forecast a 12-month TSR of 28%. We retain Buy recommendation.

OEC could be a bottom drawer stock that over several years could deliver material returns

OEC has recently softened a little, presenting a buying opportunity. In our opinion, OEC has world leading technology in its niche market of engines for TUAV's, that we expect will last for many years.

Most of the growth we factored in is contracted and likely to be renewed upon contract expiry. There are several other large contract opportunities in the market likely to come OEC's way. We risk weight one opportunity into our forecasts. New opportunities take several years to win and then ramp-up, hence we see OEC posting solid growth over a prolonged period.

The confusion of what is underlying earnings from the FY20 result probably didn't do OEC any favours, but on a longer-term perspective, we expect them to deliver sustained share price appreciation, with the potential for multiple contract wins in the near to medium term to act as material share price catalysts.

Financial Model

Orbital Corporation Share Price ($) 1.25 Mkt Cap: ($m) 97 **Buy**

PROFIT & LOSS ($m)	FY19A	FY20A	FY21F	FY22F	FY23F
Operating Revenue	**15.0**	**33.8**	**47.5**	**63.5**	**81.4**
EBITDA	(3.2)	1.0	4.9	10.1	16.1
Depreciation	(0.9)	(1.6)	(1.8)	(2.0)	(2.3)
Amortisation	(0.0)	(0.2)	(0.3)	(0.3)	(0.3)
EBIT	**(4.2)**	**(0.9)**	**2.8**	**7.8**	**13.6**
Net Interest	(0.4)	(0.6)	(0.5)	(0.7)	(0.7)
Income tax expense	0.0	0.9	(0.7)	(2.1)	(3.9)
UNPAT pre abnormal	**(4.5)**	**(0.6)**	**1.6**	**5.0**	**9.0**
Abnormal Items	(1.4)	2.4	0.0	0.0	0.0
Reported NPAT	**(5.9)**	**1.9**	**1.6**	**5.0**	**9.0**
Normalised NPATA	**(4.5)**	**(0.6)**	**1.8**	**5.2**	**9.2**

KEY RATIOS	FY19A	FY20A	FY21F	FY22F	FY23F
EBITDA Margin (%)	-21.4%	3.0%	10.3%	16.0%	19.8%
EBIT Margin (%)	-27.7%	-2.6%	5.9%	12.3%	16.7%
NPAT Margin (%)	-39.4%	5.5%	3.3%	7.9%	11.1%
ROE (%) y/e	-28.4%	-3.1%	8.1%	20.2%	26.8%
ROA (%) y/e	-15.8%	-3.0%	9.8%	25.3%	37.9%
ROIC (%) Av.	-15.9%	-3.3%	10.8%	29.1%	50.1%
NTA per share ($)	0.19	0.22	0.24	0.31	0.43
Eff Tax Rate (%)	0.8%	61.9%	30.0%	30.0%	30.0%
EBIT Interest Cover (x)	(6.8)	(1.4)	5.5	11.6	19.9
Gearing ND/ND+E (%)	4.7%	(0.8%)	(9.1%)	(60.6%)	(98.1%)
OPCF / EBITDA (%)	(55%)	367%	102%	100%	67%

BALANCE SHEET ($m)	FY19A	FY20A	FY21F	FY22F	FY23F
Cash	7.5	8.7	11.3	18.9	26.3
PP&E	4.5	4.2	5.7	5.9	7.0
Debtors & Inventory	13.8	14.7	16.5	18.9	22.5
Intangibles	0.9	0.9	0.8	0.7	0.6
Other assets	7.2	9.3	8.6	6.5	6.5
Total Assets	**33.8**	**37.8**	**42.9**	**51.0**	**62.9**
Borrowings	8.3	8.6	9.6	9.6	9.6
Trade Creditors	4.1	4.5	6.2	8.3	10.6
Other Liabilities	5.5	6.6	7.4	8.4	9.0
Total Liabilities	**17.9**	**19.7**	**23.2**	**26.3**	**29.2**
Shareholder Equity	**16.0**	**18.1**	**19.7**	**24.7**	**33.7**

VALUATION METRICS	FY19A	FY20A	FY21F	FY22F	FY23F
Dil. Normalised EPS (c)	-5.3	-0.7	2.1	6.1	10.8
Dil. Reported EPS (c)	-7.0	2.2	1.9	5.8	10.6
Dil. Normalised PE (x)	**-23.6**	**-188.2**	**59.3**	**20.5**	**11.5**
Dil. Reported PE (x)	**-18.0**	**57.4**	**67.1**	**21.4**	**11.8**
Enterprise Value ($m)	98	97	95	88	80
EV / EBITDA (x)	**-30.4**	**95.4**	**19.5**	**8.6**	**5.0**
EV / EBITA (x)	**-23.7**	**-156.7**	**30.6**	**10.8**	**5.8**
EV / EBIT (x)	**-23.4**	**-112.0**	**33.9**	**11.3**	**5.9**
Price / NTA (x)	6.4	5.6	5.1	4.0	2.9
DPS (c)	0.0	0.0	0.0	0.0	0.0
Dividend Yield (%)	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**
Franking (%)	0%	0%	0%	0%	0%
Payout Ratio (%)	0%	0%	0%	0%	0%
Free Cash / Share (cps)	-4.1	3.7	1.8	9.0	8.7
Price / FCF PS (x)	-30.4	33.7	70.6	13.9	14.4
Net Debt / EBITDA (x)	(0.2)	(0.1)	(0.3)	(0.9)	(1.0)

CASHFLOW ($m)	FY19A	FY20A	FY21F	FY22F	FY23F
Operating EBITDA	**(3.2)**	**1.0**	**4.9**	**10.1**	**16.1**
Interest & Tax Paid	0.2	(0.0)	(0.5)	(0.7)	(4.5)
Working Cap.	4.8	2.7	0.7	0.7	(0.7)
Operating CF	**1.8**	**3.7**	**5.0**	**10.2**	**10.9**
Maintenance Capex	(3.0)	(0.5)	(0.3)	(0.3)	(0.3)
Expansion Capex	(2.3)	(0.0)	(3.2)	(2.2)	(3.2)
Free Cashflow (FCF)	**(3.5)**	**3.2**	**1.5**	**7.7**	**7.4**
Ord & Pref Dividends	0.0	0.0	0.0	0.0	0.0
Net Other	(0.1)	(1.3)	0.0	0.0	0.0
Net Cashflow	**(3.6)**	**1.8**	**1.5**	**7.7**	**7.4**

GROWTH PROFILE (YoY)	FY19A	FY20A	FY21F	FY22F	FY23F
Sales ($m)	-34%	125%	40%	34%	28%
EBITDA ($m)	-215%	-132%	-382%	107%	59%
EBIT ($m)	-284%	-79%	425%	177%	74%
Adj. NPAT ($m)	-360%	-87%	418%	189%	78%
Adj. EPS (c)	-336%	-87%	417%	189%	78%
DPS (c)	0%	0%	0%	0%	0%

DIVISIONAL P&L ($m)	FY19A	FY20A	FY21F	FY22F	FY23F
Australia	14.5	28.2	25.5	25.5	36.4
US	0.5	5.6	22.0	38.0	45.0
Other	2.1	5.1	0.0	0.0	0.1
Total Revenue	**17.2**	**38.9**	**47.5**	**63.5**	**81.5**

DCF VALUATION			
PV of Cashflows FY20-29	53	Risk Free Rate	5.0%
PV of Term Year Cashflow	71	Equity Risk Premium	5.0%
Other	0	Equity Beta (x)	1.25
Net Debt at FY20A	0	Cost of Equity	11.3%
PV of Equity	124	WACC	10.9%
PV of Equity per share	**$ 1.60**	Terminal Growth	3.0%

DIRECTORS	%		%
John Wellborn	1.1%	Kyle Abbott	0.0%
Todd Adler	0.5%	Steve Gallagher	0.1%
		Total	**1.7%**

SUBSTANTIAL HOLDERS	%		%
ICM Limited	29.9%	First Sentier Investors	10.3%

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