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Orbital Corporation (OEC)

Another US Defence Prime Contracted

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KEY POINTS

Textron Systems is one of the big two when it comes to the supply of TUAV's to defence forces and is the manufacturer of the Shadow and Aerosonde TUAV's. It is a major force in aeronautics, owning the Cessna brand.

OEC has historically only supplied parts to Textron. The signing of a new deal covers 12 months of design work (essentially taking an existing engine and configuring parts positioning so that it fits into an existing TUAV shape). This is followed by five years of supply of the engine, with options for a further 5 years supply. We estimate the contract is worth $10-15m pa.

Textron is also one of the leading candidates in the US armies FTUAS program (essentially assessing 4 products to replace the existing shadow TUAV). The engine OEC is supplying would most likely also be for the FTUAS program. Whilst some years away from being decided, this could be a very large contract (OEC is also contracted to the other lead candidate – Northrop Grumman).

The Textron contract win is expected to have a partial impact on FY22 revenue and a full impact in FY23, due to engineering being low revenue and the sales ramp up occurring in late Q4 FY22. The contract is strategically significant in that:

- It provides reinforcement that OEC has the best TUAV engine that meets defence force requirements of operating on heavy fuel. The two largest TUAV suppliers are now contracted to OEC;
- We expect other TUAV suppliers to also follow. Since OEC opened its US manufacturing operations, it has signed three additional defence primes as customers;
- Textron has multiple designs and overtime the contract could expand, presumably post Textron having more experience with OEC product;
- The contract win diversifies the customer base; and
- OEC had previously promised that it expected to secure new customers. There has been a steady stream of new customers, albeit they have long lead times before sales become meaningful, but this also means it is difficult for customers to leave.

Historically, the share price has had sharp increases on the back of positive announcements. The contract win underscores OEC strong position in a niche market, with increased market share as more engines start production.

As well as incorporating the new Textron contract into our forecasts, we have pushed back the timeframe on our risk weighted FTUAS contribution. The net effect is that near-term forecasts are relatively unchanged, though EBITDA is up $2.9m in FY23.

INVESTMENT VIEW

Due to long term contracted growth, we use DCF to value OEC. Pushing out the FTUAS contribution by two years lowers our terminal value earnings and our DCF valuation remains unchanged at $1.45/share. This provides an impressive TSR of 66%.

OEC has a market leading product that is hard for competitors to replicate. It is steadily growing the customer base and has several contracts that will generate high revenue growth as they convert to engine production. While FY21 is likely to be a year of finalising design works, high growth should return in FY22 and onwards.

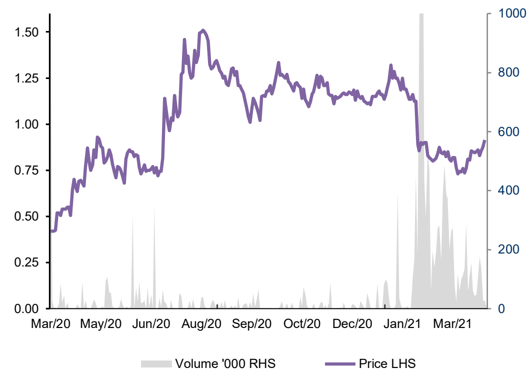
Recommendation	BUY
Previous Recommendation	Buy $1.45
Risk Rating	High
Current Share Price	$0.875
12 Month Price Target	$1.45/share
Price target Methodology	DCF
Total Return (Capital + Yield)	66%
FY23F ROIC	34%
Market Capitalisation	$68m
Liquidity	$100k/day

Financial Forecasts & Valuation Metrics

OEC Y/E Jun A$m	FY20A	FY21F	FY22F	FY23F
Revenue	33.8	35.7	52.5	76.9
EBITDA	1.0	0.0	5.8	14.5
EPS Adj (c)	-0.7	-1.8	2.7	9.2
EPS Growth	87%	-168%	251%	243%
DPS (c)	0.0	0.0	0.0	0.0
EV/EBITDA (x)	66.7	n/m	12.3	4.7
PE Underlying (x)	(131.7)	(49.1)	32.5	9.5
Gearing (%)	-1%	29%	17%	4%
ROIC %	(3%)	(5%)	13%	34%

Source: PAC Partners estimates

12-Month Share Price and Volume



Key Milestones

- Potential to be re-rated in line with global peer multiples, which would deliver >100% share price upside.
- Securing additional contracts with other TUAV manufacturers.
- An update on the progress of the 3rd Insitu engine to come into production, currently forecast late FY21.
- Production commencing for the Singapore defence contractor, currently in design.
- Northrop Grumman or Textron winning the FTUAS contract (though several years away).

Peer Comparisons

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

PEER COMPARISONS

We have used global peers that operate in the Tactical Unmanned Aircraft Vehicle (TUAV) space, plus two ASX listed defence companies. As TUAV is seen as high growth, peers trade at high multiples.

Figure 1: Peer comparisons

Company	Share Price A$	Mkt Cap $m	Gearing ND/ND+E	EV/EBITDA (x) FY21F	EV/EBITDA (x) FY22F	PER (x) FY21F	PER (x) FY22F
Aerojet Rocketdyne	61.92	4,882	196%	10.4x	10.0x	23.9x	23.0x
AeroVironment, Inc.	155.76	3,812	-146%	44.1x	24.9x	64.2x	45.3x
Austal Limited	**2.32**	**834**	**-30%**	**3.8x**	**3.6x**	**9.4x**	**10.9x**
Elbit Systems Ltd.	177.85	7,907	29%	12.0x	10.8x	n/m	n/m
Electro Optic System	**5.26**	**793**	**-16%**	**12.4x**	**7.9x**	**25.0x**	**15.2x**
HEICO Corporation	161.86	20,939	11%	32.9x	27.3x	57.8x	45.8x
Kratos Defence	34.11	4,212	1%	37.2x	28.4x	74.3x	47.4x
Textron Inc.	71.71	16,273	31%	10.8x	9.4x	19.4x	15.9x
Average				**20.5x**	**15.3x**	**39.1x**	**29.1x**
Orbital Corporation	**0.88**	**68**	**29%**	**12.3x**	**4.7x**	**32.5x**	**9.5x**
Difference to Peers				**-40%**	**-69%**	**-17%**	**-67%**

Source: CapIQ

On FY22F EV/EBITDA multiples, OEC trades at a 69% discount to its peer group. Due to its smaller size, a discount is warranted, but not this large.

Signing large defence primes should help OEC to re-rate and as the expected earnings growth comes through over the next few years, this should further assist. We see OEC has having high re-rating potential and believe investors should enjoy solid share price appreciation over several years, rather than a one-off spike.

FORECAST CHANGES

Forecasts are relatively unchanged (see Figure 2), even though the new contract potentially adds >$10m of revenue in FY23, the pushing back of the time frame on the FTUAS contract award counteracts this change.

The other change is we have marginally increased our capex forecasts ($0.5m pa) to cater for the additional engine. New engines require testing equipment, hence the additional capex.

Figure 2: Forecast changes

$m	Old FY21F	Old FY22F	Old FY23F	New FY21F	New FY22F	New FY23F	Difference FY21F	Difference FY22F	Difference FY23F
Revenue									
Australia	20.5	36.5	39.4	20.7	37.5	39.4	0.2	1.0	0.0
US	15.0	15.0	30.0	15.0	15.0	37.5	0.0	0.0	7.5
Total Revenue	**35.5**	**51.5**	**69.4**	**35.7**	**52.5**	**76.9**	**0.2**	**1.0**	**7.5**
EBITDA	(0.0)	5.4	11.6	0.0	5.8	14.5	0.1	0.4	2.9
Depreciation & Amort	(1.9)	(2.1)	(2.4)	(1.9)	(2.1)	(2.8)	0.0	0.0	(0.5)
Total EBIT	**(2.0)**	**3.3**	**9.2**	**(1.9)**	**3.7**	**11.7**	**0.1**	**0.4**	**2.5**
Net Interest	(0.6)	(0.7)	(0.7)	(0.6)	(0.7)	(0.7)	0.0	0.0	0.0
Tax	0.8	(0.8)	(2.5)	0.7	(0.9)	(3.3)	(0.0)	(0.1)	(0.7)
Underlying NPAT	**(1.8)**	**1.8**	**5.9**	**(1.7)**	**2.1**	**7.7**	**0.1**	**0.3**	**1.7**
Abnormals	-3.165	0	0	(3.2)	0.0	0.0	0.0	0.0	0.0
Reported NPAT	**(5.0)**	**1.8**	**5.9**	**(4.9)**	**2.1**	**7.7**	**0.1**	**0.3**	**1.7**
Underlying EPS (cps)	**(1.8)**	**2.4**	**7.2**	**(1.8)**	**2.7**	**9.2**	**0.1**	**0.3**	**2.0**
EBITDA Margins	**-0.1%**	**10.5%**	**16.7%**	**0.1%**	**11.1%**	**18.9%**			

Source: PAC Partners

Investment view and valuation

We use DCF to value OEC. As OEC continues to diversify its customer base and grow the top line, it could get rated as a manufacturing tech company, and command a higher multiple.

DCF ANALYSIS

Our DCF valuation is unchanged, but still represents a lot of upside from the current share price

We leave our DCF assumptions unchanged. Whilst our forecasts have slightly higher medium-term forecasts, our longer-term forecasts are slightly lower and capex has increased by a small amount. The net effect is our DCF valuation has remained at $1.45/share, see Figure 3.

Figure 4: DCF valuation

Present value of cashflows FY21 to FY30	42
Present value of terminal year cashflow	78
Net Debt at 1H21A	(7)
Present value of equity	113
Diluted Shares on issue	78
Present value per share	**$1.45**

Source: PAC Partners

INVESTMENT VIEW

We forecast a 12-month TSR of 66% and retain a Buy recommendation.

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

The path to growth has taken longer than expected due to an issue at OEC main customer Insitu (refer to our previous research note). Increased customer diversification adds to the investment appeal and further customer additions should be a future catalyst for OEC.

We see OEC as a stock that should deliver good growth over the next 4-5 years from contracts already in place. The re-rating potential is also high. We like its long-term outlook and recommending accumulating now for what should be solid share price appreciation. The ASX does not have many pure play defence stocks and the closest peer (EOS) trades at 7.9x FY22 EV/EBITDA vs. OEC at 4.7x.

OEC has potential to be a $200m revenue company and if it were to get there by say FY25/26, it would carry a much larger market cap than its current $68m. It would also benefit from scale, which should help EBITDA margins expand.

Financial Model

Orbital Corporation Share Price ($) 0.88 Mkt Cap: ($m) 68 **Buy**

PROFIT & LOSS ($m)	FY19A	FY20A	FY21F	FY22F	FY23F
Operating Revenue	**15.0**	**33.8**	**35.7**	**52.5**	**76.9**
EBITDA	(3.2)	1.0	0.0	5.8	14.5
Depreciation	(0.9)	(1.6)	(1.6)	(1.8)	(2.5)
Amortisation	(0.0)	(0.2)	(0.3)	(0.3)	(0.3)
EBIT	**(4.2)**	**(0.9)**	**(1.9)**	**3.7**	**11.7**
Net Interest	(0.4)	(0.6)	(0.6)	(0.7)	(0.7)
Income tax expense	0.0	0.9	0.7	(0.9)	(3.3)
UNPAT pre abnormal	**(4.5)**	**(0.6)**	**(1.7)**	**2.1**	**7.7**
Abnormal Items	(1.4)	2.4	(3.2)	0.0	0.0
Reported NPAT	**(5.9)**	**1.9**	**(4.9)**	**2.1**	**7.7**
Normalised NPATA	**(4.5)**	**(0.6)**	**(1.5)**	**2.3**	**7.9**

BALANCE SHEET ($m)	FY19A	FY20A	FY21F	FY22F	FY23F
Cash	7.5	8.7	4.1	6.4	8.6
PP&E	4.5	4.2	4.8	5.3	9.1
Debtors & Inventory	13.8	14.7	14.7	17.3	22.6
Intangibles	0.9	0.9	0.8	0.7	0.6
Other assets	7.2	9.3	10.1	9.2	9.2
Total Assets	**33.8**	**37.8**	**34.5**	**38.9**	**50.1**
Borrowings	8.3	8.6	9.6	9.6	9.6
Trade Creditors	4.1	4.5	4.6	5.8	8.5
Other Liabilities	5.5	6.6	7.1	8.2	9.1
Total Liabilities	**17.9**	**19.7**	**21.3**	**23.6**	**27.2**
Shareholder Equity	**16.0**	**18.1**	**13.2**	**15.3**	**23.0**

CASHFLOW ($m)	FY19A	FY20A	FY21F	FY22F	FY23F
Operating EBITDA	**(3.2)**	**1.0**	**0.0**	**5.8**	**14.5**
Interest & Tax Paid	0.2	(0.0)	(0.6)	(0.7)	(4.0)
Working Cap.	4.8	2.7	(2.6)	(0.3)	(1.8)
Operating CF	**1.8**	**3.7**	**(3.2)**	**4.8**	**8.7**
Maintenance Capex	(3.0)	(0.5)	(0.3)	(0.3)	(0.3)
Expansion Capex	(2.3)	(0.0)	(2.2)	(2.2)	(6.2)
Free Cashflow (FCF)	**(3.5)**	**3.2**	**(5.7)**	**2.3**	**2.2**
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**	**(5.7)**	**2.3**	**2.2**

DIVISIONAL P&L ($m)	FY19A	FY20A	FY21F	FY22F	FY23F
Australia	14.5	28.2	20.7	37.5	39.4
US	0.5	5.6	15.0	15.0	37.5
Other	2.1	5.1	0.0	0.0	0.0
Total Revenue	**17.2**	**38.9**	**35.7**	**52.5**	**76.9**

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

KEY RATIOS	FY19A	FY20A	FY21F	FY22F	FY23F
EBITDA Margin (%)	-21.4%	3.0%	0.1%	11.1%	18.9%
EBIT Margin (%)	-27.7%	-2.6%	-5.3%	7.1%	15.2%
NPAT Margin (%)	-39.4%	5.5%	-13.7%	4.0%	10.0%
ROE (%) y/e	-28.4%	-3.1%	-13.1%	13.7%	33.4%
ROA (%) y/e	-15.8%	-3.0%	-5.2%	12.4%	28.9%
ROIC (%) Av.	-15.9%	-3.3%	-5.4%	13.1%	34.3%
NTA per share ($)	0.19	0.22	0.16	0.19	0.29
Eff Tax Rate (%)	0.8%	61.9%	30.0%	30.0%	30.0%
EBIT Interest Cover (x)	(6.8)	(1.4)	(2.6)	5.5	16.3
Gearing ND/ND+E (%)	4.7%	(0.8%)	29.5%	17.3%	4.1%
OPCF / EBITDA (%)	(55%)	367%	######	83%	60%

VALUATION METRICS	FY19A	FY20A	FY21F	FY22F	FY23F
Dil. Normalised EPS (c)	-5.3	-0.7	-1.8	2.7	9.2
Dil. Reported EPS (c)	-7.0	2.2	-5.7	2.4	9.0
Dil. Normalised PE (x)	**-16.5**	**-131.7**	**-49.1**	**32.5**	**9.5**
Dil. Reported PE (x)	**-12.6**	**40.2**	**-15.2**	**35.7**	**9.7**
Enterprise Value ($m)	69	68	73	71	69
EV / EBITDA (x)	**-21.4**	**66.7**	**2048.6**	**12.3**	**4.7**
EV / EBITA (x)	**-16.6**	**-109.6**	**-46.3**	**17.7**	**5.7**
EV / EBIT (x)	**-16.5**	**-78.3**	**-38.9**	**19.2**	**5.9**
Price / NTA (x)	4.5	3.9	5.5	4.7	3.0
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	(6.6)	2.7	2.6
Price / FCF PS (x)	-21.3	23.6	(13.2)	32.1	33.6
Net Debt / EBITDA (x)	(0.2)	(0.1)	154.1	0.6	0.1

GROWTH PROFILE (YoY)	FY19A	FY20A	FY21F	FY22F	FY23F
Sales ($m)	-34%	125%	6%	47%	46%
EBITDA ($m)	-215%	-132%	96%	######	150%
EBIT ($m)	-284%	-79%	-118%	-297%	215%
Adj. NPAT ($m)	-360%	-87%	-169%	251%	243%
Adj. EPS (c)	-336%	-87%	-168%	251%	243%
DPS (c)	0%	0%	0%	0%	0%

DCF VALUATION			
PV of Cashflows FY20-29	42	Risk Free Rate	5.0%
PV of Term Year Cashflow	78	Equity Risk Premium	5.0%
Other	0	Equity Beta (x)	1.25
Net Debt at 1H21A	7	Cost of Equity	11.3%
PV of Equity	113	WACC	10.9%
PV of Equity per share	**$ 1.45**	Terminal Growth	3.0%

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

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RECOMMENDATION CRITERIA

Investment View

PAC Partners Investment View is based on an absolute 1-year total return equal to capital appreciation plus yield.

A Speculative recommendation is when a company has limited experience from which to derive a fundamental investment view.

Buy	Hold	Sell
>20%	20% – 5%	<5%

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