Ultra Electronics

Retaining core growth strategy

Trading update/ change of CEO

Aerospace & defence

While a trading update might have been anticipated the departure of the CEO is a major surprise. The return of the Chairman to the CEO role as an interim measure provides an element of reassurance and continuity, as does the commitment to an increased final dividend despite a cut of 9% to FY17 EPS. The UK declines are concerning, however it is not the largest regional contributor. We believe the larger US and export market contributions and recent order intake should provide a solid foundation for future growth, with the invest and grow strategy to remain in focus.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/15	726.3	112.4	123.9	46.1	9.5	3.9
12/16	785.8	120.1	134.6	47.8	8.8	4.1
12/17e	769.5	109.5	116.1	49.6	10.2	4.2
12/18e	786.3	116.0	116.4	52.0	10.1	4.4

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

MOD budget issues lead to estimates reduction

Ultra identifies two issues that impact H217 underlying profitability. The first is the deferral and cancellation of programmes by the MOD which, while diminishing part of group sales, has left FY17 revenues expectations at £770m or 5% below our previous assumptions. We assume the domestic defence budget constraints will persist next year and beyond due to the FX-induced affordability issues in the UK. To a degree, this offsets improving prospects for growth elsewhere, notably in the US, although a forecast 5% adverse FX movement is also unhelpful. In addition, Herley in the Communications & Security division requires increased investment in FY17 to support the additional SEWIP programme modules that it has won over and above the acquisition's business case. In combination management expects operating profit at c £120m for FY17 compared to our £131.5m previous forecast.

CEO change not strategic upheaval

The departure of Rakesh Sharma and his replacement on an interim basis by Douglas Caster does not, in our view, imply a strategic change of direction. We think the return of the former CEO in fact underpins a continuation of the invest and grow strategy that has been the hallmark of Ultra. A major initial task is to re-establish investor confidence that the model remains valid and intact. The final dividend indication appears to reflect that, being 0.1p more than we had forecast. With the balance sheet and cash flow also trending well we expect the Sparton deal to continue to a hoped for completion in Q118, which should be a positive catalyst.

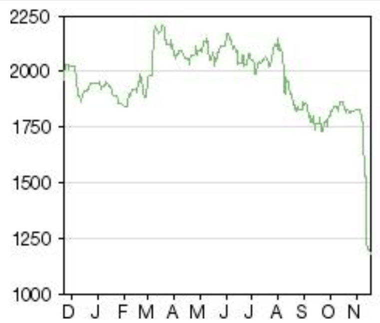
Valuation: Confidence restoration required

In our view, the sharp share price adjustment since the interims more than reflects the shortfalls announced. For our fair value, the DCF element has reduced to reflect lower growth expectations and we remove the premium to peers in our sum-of-the-parts for the time being. The current outcome is still 1,902p, 15% lower than our previous value of 2,257p, but implying significant potential from current levels.

20 November 2017

Price	**1179p**
Market cap	**£917m**
	US$1.32/£1
Net debt (£m) at 30 June 2017	260.4m
Shares in issue	77.7m
Free float	99%
Code	ULE
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	(36.1)	(37.8)	(40.1)
Rel (local)	(35.0)	(37.7)	(45.3)
52-week high/low		2204p	1179p

Business description

Ultra Electronics is a global aerospace and defence electronics company, with operations across three divisions: Aerospace & Infrastructure (26% of 2016 sales); Communications & Security (33%); and Maritime & Land (41%).

Next events

FY17 results	5 March 2018

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Edison profile page

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Management change

The parting of the ways with the now former CEO Rakesh Sharma certainly came as a surprise to us, and follows a "period of reflection" by the board. However, it is clear from a board perspective there may have been a variance on the future direction of the company. The latest disappointing trading update would appear to be the straw that broke the camel's back, but even then the timing and immediacy of the departure is a real surprise. Ultra is deep into the process surrounding the proposed acquisition of Sparton Corporation in the US and in our experience such a management change would not be expected to occur at such a time, and without a clear managed succession process in place.

Press reports suggest some investors have been unhappy with the M&A elements of the invest and grow strategy, citing Herley as an issue. It is important to note here, it appears that the additional investment Herley requires is a mark of its success in securing 11 modules in the SEWIP programme rather than the four the business case had anticipated. By implication, this would suggest a substantially larger future opportunity. In addition, the Sparton deal seems logical and, according to management, is financially compelling. Although there are some additional approval requirements by the US Department of Justice leading to a longer acquisition process, we assume it should continue to progress, which should in turn enhance earnings next year and create value in short order.

Trading statement

We have revised our forecasts to reflect the trading update as follows:

Exhibit 1: Ultra Electronics estimates revisions

Year to December (£m)	2017E Prior	2017E New	% change	2018E Prior	2018E New	% change
Aerospace & Infrastructure	207.9	202.6	-2.5%	218.3	206.7	-5.3%
Communications & Security	258.0	238.3	-7.6%	268.3	247.8	-7.6%
Maritime & Land	336.6	328.5	-2.4%	353.4	331.8	-6.1%
Sales	**802.5**	**769.5**	**-4.1%**	**840.0**	**786.3**	**-6.4%**
EBITDA	**147.0**	**135.0**	**-8.2%**	**153.9**	**139.1**	**-9.7%**
Aerospace & Infrastructure	32.2	31.4	-2.5%	34.0	32.2	-5.3%
Communications & Security	40.0	29.3	-26.7%	42.1	32.2	-23.5%
Maritime & Land	59.2	59.1	-0.2%	62.2	59.7	-4.0%
Underlying EBITA	**131.5**	**119.9**	**-8.8%**	**138.4**	**124.2**	**-10.3%**
Underlying PTP	**120.4**	**109.5**	**-9.1%**	**130.1**	**116.0**	**-10.8%**
EPS - underlying continuing (p)	**127.7**	**116.1**	**-9.1%**	**130.6**	**116.4**	**-10.8%**
DPS (p)	49.5	49.6	0.2%	52.0	52.0	0.0%
Net debt / (cash)	97.4	99.9	2.5%	48.2	58.5	21.5%

Source: Edison Investment Research estimates

This reflects the lower expectations for the UK in terms of revenue as well as the margin impact in Communications & Security arising at Herley. Management has yet to provide guidance for 2018 but we assume the persistence of those two factors should continue to depress H118 in particular. In addition, we now assume an average FX rate of US$1.35/£1 against our previous expectation of US$1.30/£1 which provides an additional profit headwind of around £4m.

However, we take encouragement from the improved order intake, mainly driven by demand in the US. At the end of October, the orders on hand for delivery in 2018 were 20% higher than at the same point last year in constant currency.

Further encouragement comes from the strength of the balance sheet. The year end cash conversion ratio is set to be around 80% and our year end net debt expectations is broadly unchanged. Going forward an 80-85% cash conversion ratio is targeted by management. As a measure of confidence in this prognosis, management has indicated that it is minded to pay a final dividend of 35.0p for 2017, 0.1p ahead of our forecast. The full year dividend will thus be up 3.7% at 49.6p, and covered 2.3x by our reduced EPS forecast.

Management has also refinanced its £300m revolving credit facility earlier this month at improved terms maturing in five years time.

Valuation

An assessment by the company of the impact of the introduction of IFRS15 had it been applied in 2016 shows little variance on the published revenue (would have been £1.6m higher) and operating profit (£0.2m lower). Updates should be provided as and when necessary, but we assume there is little likely effect, and as there is no cash impact we feel it changes little on our valuation perspective.

In terms of our fair value calculations, both the DCF and sum of the parts (SOP) elements have been reduced by the lower earnings expectations. In addition, in our SOP calculation we have for the time being removed the PE rating premium applied against peers following the setback. As margins remain healthy in all divisions this may prove to be conservative but we shall await further reports to assess progress in restoring confidence in the future. We believe Ultra's margins are more sustainable than some of its defence peers have displayed in recent periods when facing difficulties. Our sum-of-the-parts based on 2018 expectations now returns a value of 1,905p.

Our capped DCF returns a value of 1,899p for 2018. Our fair value calculated as an average of the two is thus down 15% on our prior value of 2,257p at 1,902p per share.

The company is scheduled to report preliminary FY17 results on 5 March 2018.

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Exhibit 2: Financial summary

£m	2015	2016	2017e	2018e
Year end 31 December	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS				
Revenue	726.3	785.8	769.5	786.3
Cost of Sales	(514.1)	(580.9)	(609.9)	(640.4)
Gross Profit	212.2	204.9	159.5	145.9
EBITDA	134.8	148.0	135.0	139.1
Operating Profit (before amort. and except.)	120.0	131.1	119.9	124.2
Intangible Amortisation	(3.8)	(5.4)	(5.1)	(4.9)
Exceptionals	(81.7)	(71.5)	(39.8)	(38.8)
Other	0.0	0.0	0.0	0.0
Operating Profit	34.5	54.2	74.9	80.5
Net Interest	(7.5)	(11.1)	(10.3)	(8.2)
Profit Before Tax (norm)	112.4	120.1	109.5	116.0
Profit Before Tax (FRS 3)	27.0	43.1	64.6	72.3
Tax	(9.8)	(9.4)	(13.1)	(17.0)
Profit After Tax (norm)	86.8	94.7	85.4	90.5
Profit After Tax (FRS 3)	17.2	33.8	51.4	55.3
Average Number of Shares Outstanding (m)	70.1	70.3	73.5	77.7
EPS - normalised (p)	123.9	134.6	116.1	116.4
EPS - normalised and fully diluted (p)	123.8	134.5	116.0	116.3
EPS - (IFRS) (p)	24.5	48.0	69.9	71.2
Dividend per share (p)	46.1	47.8	49.6	52.0
Gross Margin (%)	29.2	26.1	20.7	18.6
EBITDA Margin (%)	18.6	18.8	17.5	17.7
Operating Margin (before GW and except.) (%)	16.5	16.7	15.6	15.8
BALANCE SHEET				
Fixed Assets	637.2	655.4	627.4	603.4
Intangible Assets	569.0	589.2	555.8	526.1
Tangible Assets	68.2	66.2	71.6	77.3
Investments	0.0	0.0	0.0	0.0
Current Assets	308.5	364.9	533.4	581.9
Stocks	81.8	78.2	78.9	83.0
Debtors	117.0	142.5	153.9	156.5
Cash	45.5	74.6	230.6	271.6
Other	64.2	69.6	70.0	70.8
Current Liabilities	(181.4)	(178.6)	(168.8)	(171.9)
Creditors	(181.4)	(178.6)	(168.8)	(171.9)
Short term borrowings	0.0	0.0	0.0	0.0
Long Term Liabilities	(447.5)	(478.1)	(479.1)	(480.6)
Long term borrowings	(341.0)	(331.3)	(330.5)	(330.2)
Other long term liabilities	(106.5)	(146.8)	(148.6)	(150.5)
Net Assets	316.8	363.6	513.0	532.8
CASH FLOW				
Operating Cash Flow	85.4	117.8	99.8	124.8
Net Interest	(6.0)	(7.5)	(11.1)	(10.3)
Tax	(26.0)	(17.3)	(13.1)	(17.0)
Capex	(6.4)	(7.4)	(18.1)	(18.5)
Acquisitions/disposals	(171.8)	16.8	0.0	0.0
Financing	4.9	3.0	133.7	0.0
Dividends	(31.3)	(32.6)	(34.3)	(37.7)
Other	(13.9)	(34.0)	0.0	0.0
Net Cash Flow	(165.2)	38.9	156.8	41.3
Opening net debt/(cash)	129.5	295.6	256.7	99.9
HP finance leases initiated	0.0	0.0	0.0	0.0
Other	(0.9)	0.0	0.0	0.0
Closing net debt/(cash)	295.6	256.7	99.9	58.5

Source: Company reports, Edison Investment Research estimates

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