Cohort

Executing the strategy

H120 results & ELAC acquisition agreement

Aerospace & defence

Cohort has delivered a strong first half performance, with healthy like-for-like growth in revenues, and adjusted operating profit augmented by the initial first half contribution from Chess. With a record period-end order book of £207m, prospects remain bright and management expects to meet market expectations for FY20. The strong balance sheet supports the agile growth strategy and is facilitating the proposed €11.3m acquisition of ELAC Nautik from Wärtsilä Corporation which, we estimate, should enhance EPS by around 7% in a full year following completion. Even before the potential uplift from ELAC, the FY21e P/E of 15.8x does not look demanding against defence peers given the progression of the strategy.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
04/18	110.5	15.1	29.1	8.2	21.3	1.3
04/19	121.2	15.9	33.6	9.1	18.5	1.5
04/20e	145.7	18.6	35.7	10.1	17.4	1.6
04/21e	153.9	19.9	39.2	11.1	15.8	1.8

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

H120 delivers strong growth

Trading in H120 reflects the continued successful implementation of Cohort's growth strategy. Group revenues of £60.2m were up £20.7m, a combination of 17% like-for-like growth and an initial £13.9m first half contribution from Chess (acquired in December 2018). Adjusted operating profit rose fourfold to £4.0m, with the ongoing activities delivering 120% l-f-l growth to £2.2m (H119: £1.0m). Although SEA was modestly weaker, MASS, EID and MCL all made progress. An operating cash inflow translated into a modest increase in net debt during the period to £6.8m (excluding lease liabilities), and the interim dividend was again increased by 12%. The order backlog continued to expand to a period-end record of £207m and provides 83% cover for FY20 consensus sales estimates, well ahead of the same point last year. Management expects to achieve market estimates for FY20.

ELAC purchase to further extend the naval offering

The company has also announced an agreement to buy Wärtsilä ELAC Nautik (ELAC) for €11.25m from its parent. Subject to German government approval and other conditions being met, the deal should close by 30 June 2020. Based in Germany, ELAC is a market leader in the design and development of innovative hydroacoustic products and systems for the global maritime market. The proposed purchase is aligned with Cohort's agile strategy, extending regional reach with a complementary customer base and product offering. The deal is to be financed from Cohort's existing resources and should be immediately accretive.

Valuation: Re-rating warranted

While the shares have performed strongly again in 2019, the re-rating appears appropriate given the execution of the growth strategy. On a FY21e P/E of 15.8x, Cohort is now more closely aligned to its UK defence peers.

13 December 2019

Price	**620p**
Market cap	**£253m**
Net debt (£m) at 30 October 2019	6.8
Shares in issue	41.0m
Free float	72%
Code	CHRT
Primary exchange	AIM
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	12.7	33.3	51.2
Rel (local)	13.5	33.4	41.0
52-week high/low		620p	354p

Business description

Cohort is an AIM-listed defence and security company operating across five divisions: MASS (32% of FY19 sales), SEA (32%), MCL (18%), the 80%-owned Portuguese business EID (9%), and the 81%-owned Chess Technologies based in the UK (c five months 9%).

Next events

FY20 results	July 2020

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Agreement to acquire ELAC Nautik

Cohort has announced an agreement to purchase Germany-based Wärtsilä ELAC Nautik (ELAC) for €11.25m from its parent, the Finnish marine group Wärtsilä Corporation. The deal will be funded from Cohort's existing cash resources and credit facility. It is subject to German government approval and certain other conditions.

While €10.5m is payable on completion, which is expected on or before 30 June 2020, the final price will be adjusted for closing working capital and the funding of outstanding pension deficit obligations (€7.1m at 31 December 2018). As such and given the cash being acquired with the company, Cohort's management indicates an expectation to be in receipt of modest net cash on completion.

The deal should be directly enhancing to earnings, even allowing for some drawdown on the credit facility. For the year ended 31 December 2018, ELAC generated an EBIT of €1.4m on revenues of €20.7m, with growth expected for both in the year to 31 December 2019. The order book at 31 October 2019 stood at €26.4m, of which €20m is due for delivery in 2020, with a tail to 2025.

Founded in 1924, ELAC is based in Kiel in Germany and is a leader in sonar systems technology for both naval surface ships and submarines. It employs around 120 people and will become Cohort's sixth standalone division. ELAC is seen as complementary to the existing naval activities in SEA and will extend Cohort's maritime defence product offering to an expanded customer base. The international opportunity this presents is seen as sizeable with high growth potential. Cohort indicates that in Asia Pacific (excluding China) alone, spending over the next decade on new vessels in the naval export markets on which the expanded group is focused, is expected to reach US$150bn. There is also expected to be a strong refit and upgrade opportunity for both surface and submarine platforms, with local contractors and yard-independent subcontractors looking for sonars.

H120 results summary

Cohort delivered a strong H120 performance with all its operations growing revenues and adjusted operating profit contributions, with the exception of SEA, which saw a modest reduction in both. The key highlights of the H120 results are as follows:

- Reported revenues were £60.2m (H119: £39.5m), including an initial first half contribution from Chess acquired in December 2018. On a like-for-like basis, revenues rose by 17%.
- Reported adjusted operating profit was £4.0m (H119: £1.0m), again including a full period contribution from Chess and an increase of 120% on a like-for-like basis
- Adjusted EPS was 6.94p (H119: 1.99p).
- Reported DPS was increased by 12% to 3.20p (H119: 2.85p), maintaining the group's progressive dividend policy.
- Net debt (excluding lease liabilities) of £6.8m (H119: net cash £4.7m), slightly above the FY19 level of £6.4m. Once again, the cash flow performance was better than we had expected.
- Order intake of £77.2m (H119: £45.6m).
- A record period-end closing order book of £206.7m (end October 2018: £108.8m), up from £190.9m at the start of the year, with £60m to be delivered in H220 providing strong order cover of 83% of FY20 consensus forecast revenue expectations.

The company has adopted IFRS 16 from the start of FY20. The impact of the new accounting standard for leases is to add a ‘right of use asset’ of £5.8m from 1 May 2019, with an offsetting lease liability of £6.1m, reducing opening FY20 net assets by £0.3m. In H120, there was a beneficial £0.5m increase in EBITDA as costs were moved from rental expenses to depreciation and financial charges. EBIT was increased marginally and PBT was essentially unchanged. Cash flow is unaffected, although presentation of relevant items has altered.

Divisional performance

MASS (H120 sales £19.9m; 33% of group sales, adjusted operating profit of £3.7m) experienced a sharp improvement in performance as new electronic warfare operational support (EWOS) projects for export customers commenced. Sales rose by 24% and the H120 adjusted operating margin rose to 19%, a level that management expects to be sustained for the full year. MASS is expected to maintain its backlog of £105.8m at the year-end following significant growth achieved in FY19, with several additional renewals already secured in H120. £22.4m of the backlog is due for delivery in H220, providing almost 98% sales cover for FY20 against our estimates.

Chess (H120 sales £13.9m; 23% of group sales, adjusted operating profit of £1.8m) was the second largest contributor to both revenues and profitability during H120. The period benefited from counter-drone systems supplied to the US and Norway and the completion of deliveries of naval systems to the Royal Navy. The order backlog of £16.0m extends over several years with £6.3m due for delivery in H220, providing sales cover of our FY20 revenue estimate of more than 90%.

SEA (H120 sales £13.4m; 22% of group sales, adjusted operating loss of £0.3m) experienced a further modest decline in revenues (-6%). Business mix was similar, although Transport revenues were down £1.1m at £2.8m in the absence of a major contract completion in the comparable period. Oil & gas revenues were again flat year-on-year at £0.9m, and submarine and other defence revenues rose modestly to £10.1m (H119: £9.5m). Profitability was depressed by new product development costs, including a sea trial of the Krait towed array sonar for the Portuguese navy, as well as higher bidding cost on export opportunities for naval products. The divisional order backlog of £34.6m contains £12.6m due for delivery in H220, or sales cover of 68% for our FY20 estimate. Management indicates that it expects further strong H220 order intake, and for FY20 performance to be profitable and similar to FY19.

EID (H120 sales £6.0m; 10% of group sales, adjusted operating profit of £0.1m) saw revenues rise 67% against a weak H119 comparator, mainly reflecting increased deliveries of vehicle intercoms to a Middle East customer by the Tactical (Land) division, with higher-margin naval systems still somewhat subdued. However, with a backlog of £37.1m containing £14.3m of revenues due for H220 delivery, our FY20 estimate is already covered. Margins are expected to return to the normal mid- to high-teens range for the year. Management sees significant H220 order opportunities for EID.

MCL (H120 sales £7.0m; 12% of group sales, adjusted operating profit of £0.5m) revenue and operating profits also showed good progress as activity in support of the UK MOD increased, specifically against the multi-year EW support contract for the Royal Navy won in FY19. MCL’s order book continued to grow and stood at £13.2m (H119: £10.0m) at the end of the half year, with £5.9m due to be delivered in H220. While this represents just 58% sales cover, MCL is by nature reliant on shorter order cycles. Management is confident of the strength of the pipeline and expects MCL’s full year performance to be similar to FY19.

Outlook

Following the strong H120 performance, management expects to meet market expectations for FY20. Our earnings estimates are unchanged for FY20 and FY21 and our anticipated divisional breakdown is shown in Exhibit 1 below. It should be noted that the adoption of IFRS 16 will lead to an increase in EBITDA of c £1m a year, although revenues, operating profits, PBT and cash flow are unchanged.

Exhibit 1: Cohort divisional analysis

Year to April (£m)	2018	2019	2020e	2021e
MASS	37.6	38.9	43.4	46.5
SEA	37.3	38.3	38.5	40.5
MCL	17.4	21.7	22.2	23.3
EID	18.3	11.5	19.6	20.2
Chess		10.7	22.0	23.5
Group revenues	**110.5**	**121.2**	**145.7**	**153.9**
Adjusted operating profit				
MASS	7.1	8.2	8.5	9.1
SEA	4.4	5.5	5.4	5.6
MCL	2.1	2.3	2.1	2.2
EID	4.3	1.4	3.5	3.6
Chess		1.7	3.2	3.3
HQ Other and intersegment	(2.7)	(2.8)	(3.0)	(3.0)
Adjusted operating profit	**15.2**	**16.2**	**19.7**	**20.8**
Adjusted operating margin				
MASS	*18.9%*	*21.0%*	*19.5%*	*19.5%*
SEA	*11.8%*	*14.3%*	*13.9%*	*13.9%*
MCL	*11.9%*	*10.5%*	*9.6%*	*9.6%*
EID	*23.6%*	*11.8%*	*18.0%*	*18.0%*
Chess		*15.8%*	*14.5%*	*14.0%*
Group EBIT margin	***13.8%***	***13.3%***	***13.5%***	***13.5%***

Source: Company reports, Edison Investment Research estimates

The acquisition of ELAC is not expected to complete until the next financial year and, as is our normal practice, we will not include it in our estimates until then. We note that it should enhance EPS by around 7% in a full year.

Exhibit 2: Financial summary

£m	2018	2019	2020e	2021e
Year end 30 April	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS				
Revenue	110.5	121.2	145.7	153.9
Cost of Sales	(70.9)	(78.1)	(93.9)	(99.2)
Gross Profit	39.7	43.0	51.7	54.7
EBITDA	16.3	17.3	22.0	23.3
Operating Profit (before amort. and except.)	15.2	16.2	19.7	20.8
Intangible Amortisation	(5.3)	(9.5)	(8.0)	(7.5)
Exceptionals	0.3	(0.7)	0.0	0.0
Other	0.0	0.0	0.0	0.0
Operating Profit	10.3	5.9	11.7	13.3
Net Interest	(0.1)	(0.3)	(1.1)	(0.9)
Profit Before Tax (norm)	15.1	15.9	18.6	19.9
Profit Before Tax (FRS 3)	10.2	5.7	10.6	12.4
Tax	(2.1)	(0.6)	(1.8)	(2.5)
Profit After Tax (norm)	12.2	13.3	15.5	16.6
Profit After Tax (FRS 3)	8.1	5.1	8.8	9.9
Average Number of Shares Outstanding (m)	40.7	40.7	40.8	40.8
EPS - fully diluted (p)	28.7	33.4	35.5	38.9
EPS - normalised (p)	29.1	33.6	35.7	39.2
EPS - (IFRS) (p)	19.0	13.4	19.8	23.1
Dividend per share (p)	8.2	9.1	10.1	11.1
Gross Margin (%)	35.9	35.5	35.5	35.5
EBITDA Margin (%)	14.8	14.3	15.1	15.1
Operating Margin (before GW and except.) (%)	13.8	13.3	13.5	13.5
BALANCE SHEET				
Fixed Assets	54.9	72.9	65.0	57.5
Intangible Assets	45.3	61.9	54.0	46.4
Tangible Assets	9.6	11.0	11.0	11.1
Investments	0.0	0.0	0.0	0.0
Current Assets	61.5	75.6	87.0	91.5
Stocks	5.9	13.5	16.2	16.6
Debtors	34.7	43.0	51.7	50.8
Cash	20.5	18.8	18.8	23.8
Other	0.5	0.4	0.4	0.4
Current Liabilities	(39.6)	(36.2)	(38.6)	(40.6)
Creditors	(30.4)	(36.1)	(38.6)	(40.6)
Short term borrowings	(9.2)	(0.1)	0.0	0.0
Long Term Liabilities	(1.9)	(35.3)	(31.7)	(21.4)
Long term borrowings	0.0	(25.1)	(25.6)	(18.8)
Other long-term liabilities	(1.9)	(10.1)	(6.1)	(2.6)
Net Assets	75.0	77.0	81.6	87.0
CASH FLOW				
Operating Cash Flow	16.2	11.5	9.1	27.3
Net Interest	(0.1)	(0.3)	(1.1)	(0.9)
Tax	(2.9)	(2.6)	(3.1)	(3.3)
Capex	(0.7)	(2.1)	(1.5)	(1.5)
Acquisitions/disposals	(6.0)	(21.0)	0.0	(5.5)
Financing	(0.8)	0.1	0.0	0.0
Dividends	(3.0)	(3.5)	(3.8)	(4.3)
Other	0.0	0.0	0.0	0.0
Net Cash Flow	2.6	(17.8)	(0.4)	11.8
Opening net debt/(cash)	(8.5)	(11.3)	6.4	6.8
HP finance leases initiated	0.0	0.0	0.0	0.0
Other	0.2	0.0	0.0	0.0
Closing net debt/(cash)	(11.3)	6.4	6.8	(5.0)

Source: Company reports, Edison Investment Research estimates

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