

# Ultra Electronics

Interim results

Defence growth to resurface

Aerospace & defence

**It is appropriate to describe the H117 results from Ultra Electronics as flat. Revenues, operating profit, profit before tax and EPS growth (all on an underlying basis) varied by less than 0.5% when compared to the prior year. The company still anticipates a bigger skew in organic growth to H2 than in previous years. There is further fine-tuning to our EPS estimates, which we have lowered by 1%. The dilution from the placing in July depresses EPS until the reinvestment in Sparton completes, which is expected at the start of FY18. The subsequent uplift should coincide with higher organic growth following the improved momentum in H217.**

| Year end | Revenue (£m) | PBT* (£m) | EPS* (p) | DPS (p) | P/E (x) | Yield (%) |
|----------|--------------|-----------|----------|---------|---------|-----------|
| 12/15    | 726.3        | 112.4     | 123.9    | 46.1    | 16.7    | 2.2       |
| 12/16    | 785.8        | 120.1     | 134.6    | 47.8    | 15.4    | 2.3       |
| 12/17e   | 802.5        | 120.4     | 127.7    | 49.5    | 16.2    | 2.4       |
| 12/18e   | 840.0        | 130.1     | 130.6    | 52.0    | 15.8    | 2.5       |

Note: \*PBT and EPS are normalised, excluding amortisation of acquired intangibles and exceptional items.

## Stable first half performance, improving orders

The stable H117 outcome arose from a combination of organic revenue declines of 6.7% due to a higher level of engineering activity and contract award delays primarily caused by the Continuing Resolution (CR) in the US. The organic revenue decline was exacerbated by the impact of a 2.9% decline from the disposal of the ID business in August 2016, but these declines were largely offset by a favourable FX tailwind of 9.3%. Underlying operating margins were held at 15.7%, helped by net savings from the S3 shared services programme of £2.6m (H116 net charge: £0.5m). Encouragingly, the order book grew organically by 3.9% to £807.8m in H117 and order intake by 1.5% to £390.3m, a book to bill ratio of 1.07x. Cash flow was depressed by deferred working capital flows that should unwind in H2, but the modest £3.7m net debt increase maintained the strong balance sheet even ahead of the £133.9m placing. The interim dividend increased by 2.8% to 14.6p per share.

## Signs of improvement despite budget constraints

The CR, lifted in early May, has had a detrimental impact on H117 performance and order flow during H117. Although the pace of DOD spending improved in May and June, hopes of avoiding a new CR from October appear to be receding, despite a technically aligned administration. In comparative terms this should not affect H2 performance but could still constrain growth in Ultra's largest market. As well as order growth, increased customer-funded R&D implies a rise in future programme sales. Encouragingly export sales are gathering pace, boosted by the recent Indian order. The prospect of more dynamic organic growth in FY18 remains.

## Valuation: Rating premium justified

The dilution from the placing with reinvestment in Sparton targeted for early 2018 is distorting the current premium of Ultra to its UK peers. Given expectation of future growth and the uplift from Sparton we suggest Ultra's underlying quality merits the premium.

7 August 2017

|                               |             |
|-------------------------------|-------------|
| Price                         | 2070p       |
| Market cap                    | £1,609m     |
|                               | US\$1.315/£ |
| Net debt (£m) at 30 June 2017 | 260.4       |
| Shares in issue               | 77.7m       |
| Free float                    | 99%         |
| Code                          | ULE         |
| Primary exchange              | LSE         |
| Secondary exchange            | N/A         |

## Share price performance



## 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

|                   |                |
|-------------------|----------------|
| DSEI              | September 2017 |
| Q3 trading update | November 2017  |

## Analysts

|  |                     |
|--|---------------------|
| Andy Chambers  | +44 (0)20 3681 2525 |
| Roger Johnston   | +44 (0)20 3077 5722 |
| <a href="mailto:industrials@edisongroup.com">industrials@edisongroup.com</a> |                     |
| <a href="#">Edison profile page</a>  |                     |

**Ultra Electronics**  
*Ultra Electronics is a research client of Edison Investment Research Limited*

## Interim results

**Exhibit 1: Interim results and full year estimates summary**

| Consolidated income statement<br>Year to December (£m) | 2016  |       |       | 2017  |       |       | % change |       |       |
|--|-------|-------|-------|-------|-------|-------|----------|-------|-------|
|  | H1    | H2    | FY16  | H1    | H2e   | FY17e | H1       | H2e   | FY17e |
| Revenues   | 366.6 | 419.2 | 785.8 | 366.4 | 436.1 | 802.5 | -0.1%    | 4.0%  | 2.1%  |
| EBITDA   | 65.2  | 82.8  | 148.0 | 64.5  | 82.6  | 147.0 | -1.2%    | -0.3% | -0.7% |
| OPBIT  | 57.7  | 73.5  | 131.1 | 57.6  | 73.8  | 131.5 | -0.1%    | 0.5%  | 0.2%  |
| Pre-tax profit (underlying)                            | 52.4  | 67.7  | 120.1 | 52.4  | 68.1  | 120.4 | -0.1%    | 0.6%  | 0.3%  |
| Net income (ongoing underlying)                        | 40.9  | 53.8  | 94.7  | 41.1  | 52.8  | 93.9  | 0.6%     | -1.8% | -0.8% |
| EPS (p) – ongoing underlying                           | 58.1  |       | 134.6 | 58.3  |       | 127.7 | 0.3%     |       | -5.1% |
| DPS (p)  | 14.2  | 33.6  | 47.8  | 14.6  | 34.9  | 49.5  | 2.8%     | 3.9%  | 3.6%  |

Source: Ultra Electronics reports, Edison Investment Research estimates

Were it not for the moving parts, the interim results would resemble a repeat of H116 at the underlying level. However, the sale of the ID business, the deferral of US opportunities due to CR, higher company funded R&D and increased engineering activity were largely offset by the more favourable FX and at the operating level by the net savings now coming from the S3 shared services programme.

We take encouragement from an improving order book progression and rising book to bill ratio. The order book has grown organically by 1.8% to £807.8m over the last year, and by 3.9% since December 2016. All divisions saw higher backlogs at the end of the half year, including FX swings, albeit only modest in Aerospace & Infrastructure (up £0.4m at £255.8m). The Indian Defence Systems contract was not included in the half year so the situation has continued to improve in July. Orders on hand covered full year sales by 82% at the half year, similar to the 84% level a year ago.

A further positive for the medium-term growth potential is the increase in the level of customer-funded R&D. It increased by 13% or £6.9m to £60.0m. The investment generates lower development margins in the near term and generally leads to higher margins and expanded production revenues in the medium term.

Sales to the rest of the world increased 24% to £58.1m in H117 and now represent 16% of group sales. Given the increasing proportion of the group that total export sales represents, the rising demand for Ultra's products, notably in ASW, should further enhance organic growth and margins.

**Exhibit 2: Ultra Electronics half year divisional performance**

| Year to December (£m)         | H1            | H2           | 2016         | H1            | H2e          | 2017e        | % change     |             |             |
|-------------------------------|---------------|--------------|--------------|---------------|--------------|--------------|--------------|-------------|-------------|
|                               |               |              |              |               |              |              | H1           | H2e         | 2017e       |
| Aerospace & Infrastructure    | 93.0          | 111.7        | 204.7        | 96.0          | 116.9        | 207.9        | 3.2%         | 0.2%        | 1.6%        |
| Communications & Security     | 119.8         | 139.2        | 259.0        | 109.8         | 143.2        | 258.0        | -8.3%        | 6.5%        | -0.4%       |
| Maritime & Land               | 153.8         | 168.3        | 322.1        | 160.6         | 176.0        | 336.6        | 4.4%         | 4.6%        | 4.5%        |
| <b>Revenues</b>               | <b>366.6</b>  | <b>419.2</b> | <b>785.8</b> | <b>366.4</b>  | <b>436.1</b> | <b>802.5</b> | <b>-0.1%</b> | <b>4.0%</b> | <b>2.1%</b> |
| Aerospace & Infrastructure    | 15.2          | 17.2         | 32.4         | 16.1          | 16.9         | 32.2         | 6.1%         | -6.3%       | -0.5%       |
| Communications & Security     | 15.8          | 23.9         | 39.7         | 13.0          | 26.2         | 40.0         | -17.8%       | 13.0%       | 0.7%        |
| Maritime & Land               | 26.7          | 32.4         | 59.1         | 28.5          | 30.7         | 59.2         | 6.9%         | -5.1%       | 0.3%        |
| <b>Group operating profit</b> | <b>57.7</b>   | <b>73.5</b>  | <b>131.1</b> | <b>57.6</b>   | <b>73.8</b>  | <b>131.5</b> | <b>-0.1%</b> | <b>0.5%</b> | <b>0.2%</b> |
| Aerospace & Infrastructure    | 16.3%         | 15.4%        | 15.8%        | 16.8%         | 14.5%        | 15.5%        |              |             |             |
| Communications & Security     | 13.2%         | 17.2%        | 15.3%        | 11.8%         | 18.3%        | 15.5%        |              |             |             |
| Maritime & Land               | 17.4%         | 19.2%        | 18.3%        | 17.8%         | 17.4%        | 17.6%        |              |             |             |
| <b>EBIT margin</b>            | <b>15.73%</b> | <b>17.5%</b> | <b>16.7%</b> | <b>15.73%</b> | <b>16.9%</b> | <b>16.4%</b> |              |             |             |

Source: Ultra Electronics reports, Edison Investment Research estimates

Aerospace & Infrastructure benefited from an increase in the land vehicle segment, boosted by FX and supplemented by an improved performance from the contract manufacturing business. Revenues rose 3.2% to £96.0m generating operating profits of £16.1m. The operating margin increased by 50bps to 16.8%, which appears very supportive of our full year expectation.

Despite the deferral of some sales to H217 arising from the CR, sales of the Communications & Security division were flat after stripping out the contribution in H116 from the ID cards activity, which was a high-margin activity. In addition, the prior year period had benefited from now complete higher-margin production contracts. The division saw increased levels of engineering in support of future production programmes. These also served to reduce overall operating margins, which fell to 11.8% (FY16 c12.9% excluding the ID business).

The sale of ID took place a year ago and will therefore have less of an influence on second half performance. In addition, the 7.2% increase in the order book is an encouraging support for improved growth in the division.

Maritime & Land remains the largest activity, a position that should shortly be further extended by purchase of Sparton. In H117 sales rose 4.4% to £160.6m and profits rose by 6.9% to £28.5m, driven largely by increased demand for both US domestic and international sonobuoys. The CR did weigh on performance during the period and the benefit of the Fatahillah ship contract last year was absent. The 30bps increase in margin to 17.8% appears impressive in these circumstances. There was also an encouraging 1.9% improvement in orders on hand to £317.5m or almost two years' sales. The international demand for ASW products combined with the expansion of the sonobuoy business through the Sparton acquisition looks to be well timed.

## Reduced estimates reflect ongoing budget constraint

While the CR ended in May, we had hoped that the US administration might achieve an on time defence budget agreement and allow a full second half of uninterrupted contract flows. This now appears unlikely and although the issue may be resolved by the year end, it does seem likely to constrain H2 performance. Budgetary pressures are also apparent in the UK as evidenced by the first half decline in revenues. Affordability of the major procurement programmes has yet to be addressed and the snap general election has only served to delay the process and increase uncertainty. FX is also likely to provide a diminishing tailwind in the second half.

As a result we have found it necessary to reduce our revenue estimates by 1.3% this year and 1.5% next year, which leads to a c 2% decline in EBITDA in each year. However, the current FY18 earnings level is diluted by the cash held on account to part finance Sparton when it completes. The EPS growth when that happens should appear far more compelling.

**Exhibit 3: Ultra Electronics earnings estimates revisions**

| Year to December (£m)                  | 2017e        | 2017e        | % change     | 2018e        | 2018e        | % change     |
|--|--------------|--------------|--------------|--------------|--------------|--------------|
|  | Prior        | New          |              | Prior        | New          |              |
| Aerospace & Infrastructure             | 212.9        | 207.9        | -2.4%        | 223.5        | 218.3        | -2.4%        |
| Communications & Security              | 268.0        | 258.0        | -3.7%        | 284.1        | 268.3        | -5.5%        |
| Maritime & Land                        | 331.9        | 336.6        | 1.4%         | 345.2        | 353.4        | 2.4%         |
| <b>Sales</b>                           | <b>812.8</b> | <b>802.5</b> | <b>-1.3%</b> | <b>852.8</b> | <b>840.0</b> | <b>-1.5%</b> |
| <b>EBITDA</b>                          | <b>149.8</b> | <b>147.0</b> | <b>-1.9%</b> | <b>157.2</b> | <b>153.9</b> | <b>-2.1%</b> |
| Aerospace & Infrastructure             | 33.0         | 33.0         | 0.0%         | 34.9         | 34.0         | -2.4%        |
| Communications & Security              | 41.5         | 39.2         | -5.6%        | 44.6         | 42.1         | -5.5%        |
| Maritime & Land                        | 58.4         | 59.2         | 1.4%         | 60.7         | 62.2         | 2.4%         |
| <b>Underlying EBITA</b>                | <b>132.9</b> | <b>131.5</b> | <b>-1.1%</b> | <b>140.2</b> | <b>138.4</b> | <b>-1.3%</b> |
| <b>Underlying PBT</b>                  | <b>121.9</b> | <b>120.4</b> | <b>-1.2%</b> | <b>132.0</b> | <b>130.1</b> | <b>-1.5%</b> |
| <b>EPS – underlying continuing (p)</b> | <b>129.3</b> | <b>127.7</b> | <b>-1.2%</b> | <b>132.5</b> | <b>130.6</b> | <b>-1.5%</b> |
| DPS (p)                                | 49.5         | 49.5         | 0.0%         | 52.0         | 52.0         | 0.0%         |
| Net debt                               | 96.0         | 97.4         | 1.4%         | 44.6         | 48.2         | 8.0%         |

Source: Edison Investment Research estimates

**Exhibit 4: Financial summary**

|  | £m      | 2015    | 2016    | 2017e   | 2018e |
|--|---------|---------|---------|---------|-------|
| Year end 31 December                         |         | IFRS    | IFRS    | IFRS    | IFRS  |
| <b>PROFIT &amp; LOSS</b>                     |         |         |         |         |       |
| Revenue                                      | 726.3   | 785.8   | 802.5   | 840.0   |       |
| Cost of Sales                                | (514.1) | (580.9) | (609.9) | (640.4) |       |
| Gross Profit                                 | 212.2   | 204.9   | 192.5   | 199.6   |       |
| EBITDA                                       | 134.8   | 148.0   | 147.0   | 153.9   |       |
| Operating Profit (before amort. and except.) | 120.0   | 131.1   | 131.5   | 138.4   |       |
| Intangible Amortisation                      | (3.8)   | (5.4)   | (5.1)   | (4.9)   |       |
| Exceptionals                                 | (81.7)  | (71.5)  | (31.8)  | (38.8)  |       |
| Other  | 0.0     | 0.0     | 0.0     | 0.0     |       |
| Operating Profit                             | 34.5    | 54.2    | 94.5    | 94.7    |       |
| Net Interest                                 | (7.5)   | (11.1)  | (11.0)  | (8.3)   |       |
| Profit Before Tax (norm)                     | 112.4   | 120.1   | 120.4   | 130.1   |       |
| Profit Before Tax (FRS 3)                    | 27.0    | 43.1    | 83.5    | 86.4    |       |
| Tax  | (9.8)   | (9.4)   | (17.3)  | (20.1)  |       |
| Profit After Tax (norm)                      | 86.8    | 94.7    | 93.9    | 101.5   |       |
| Profit After Tax (FRS 3)                     | 17.2    | 33.8    | 66.2    | 66.3    |       |
| Average Number of Shares Outstanding (m)     | 70.1    | 70.3    | 73.5    | 77.7    |       |
| EPS - normalised (p)                         | 123.9   | 134.6   | 127.7   | 130.6   |       |
| EPS - normalised and fully diluted (p)       | 123.8   | 134.5   | 127.6   | 130.4   |       |
| EPS - (IFRS) (p)                             | 24.5    | 48.0    | 90.0    | 85.4    |       |
| Dividend per share (p)                       | 46.1    | 47.8    | 49.5    | 52.0    |       |
| Gross Margin (%)                             | 29.2    | 26.1    | 24.0    | 23.8    |       |
| EBITDA Margin (%)                            | 18.6    | 18.8    | 18.3    | 18.3    |       |
| Operating Margin (before GW and except.) (%) | 16.5    | 16.7    | 16.4    | 16.5    |       |
| <b>BALANCE SHEET</b>                         |         |         |         |         |       |
| Fixed Assets                                 | 637.2   | 655.4   | 627.7   | 604.0   |       |
| Intangible Assets                            | 569.0   | 589.2   | 555.8   | 526.1   |       |
| Tangible Assets                              | 68.2    | 66.2    | 71.8    | 77.9    |       |
| Investments                                  | 0.0     | 0.0     | 0.0     | 0.0     |       |
| Current Assets                               | 308.5   | 364.9   | 522.5   | 537.2   |       |
| Stocks                                       | 81.8    | 78.2    | 82.2    | 88.7    |       |
| Debtors                                      | 117.0   | 142.5   | 160.5   | 167.2   |       |
| Cash   | 45.5    | 74.6    | 208.3   | 208.3   |       |
| Other  | 64.2    | 69.6    | 71.4    | 73.0    |       |
| Current Liabilities                          | (181.4) | (178.6) | (176.0) | (183.6) |       |
| Creditors                                    | (181.4) | (178.6) | (176.0) | (183.6) |       |
| Short term borrowings                        | 0.0     | 0.0     | 0.0     | 0.0     |       |
| Long Term Liabilities                        | (447.5) | (478.1) | (454.3) | (406.9) |       |
| Long term borrowings                         | (341.0) | (331.3) | (305.7) | (256.5) |       |
| Other long term liabilities                  | (106.5) | (146.8) | (148.6) | (150.5) |       |
| Net Assets                                   | 316.8   | 363.6   | 519.8   | 550.6   |       |
| <b>CASH FLOW</b>                             |         |         |         |         |       |
| Operating Cash Flow                          | 85.4    | 117.8   | 107.1   | 137.5   |       |
| Net Interest                                 | (6.0)   | (7.5)   | (11.1)  | (11.0)  |       |
| Tax  | (26.0)  | (17.3)  | (17.3)  | (20.1)  |       |
| Capex  | (6.4)   | (7.4)   | (18.8)  | (19.5)  |       |
| 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)  | (37.6)  |       |
| Other  | (13.9)  | (34.0)  | (0.0)   | 0.0     |       |
| Net Cash Flow                                | (165.2) | 38.9    | 159.3   | 49.2    |       |
| Opening net debt/(cash)                      | 129.5   | 295.6   | 256.7   | 97.4    |       |
| 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   | 97.4    | 48.2    |       |

Source: Ultra Electronics reports, Edison Investment Research estimates

Edison is an investment research and advisory company, with offices in North America, Europe, the Middle East and AsiaPac. The heart of Edison is our world-renowned equity research platform and deep multi-sector expertise. At Edison Investment Research, our research is widely read by international investors, advisers and stakeholders. Edison Advisors leverages our core research platform to provide differentiated services including investor relations and strategic consulting. Edison is authorised and regulated by the [Financial Conduct Authority](#). Edison Investment Research (NZ) Limited (Edison NZ) is the New Zealand subsidiary of Edison. Edison NZ is registered on the New Zealand Financial Service Providers Register (FSP number 247505) and is registered to provide wholesale and/or generic financial adviser services only. Edison Investment Research Inc (Edison US) is the US subsidiary of Edison and is regulated by the Securities and Exchange Commission. Edison Investment Research Limited (Edison Aus) [46085869] is the Australian subsidiary of Edison and is not regulated by the Australian Securities and Investment Commission. Edison Germany is a branch entity of Edison Investment Research Limited [4794244]. [www.edisongroup.com](#)

#### DISCLAIMER

Copyright 2017 Edison Investment Research Limited. All rights reserved. This report has been commissioned by Ultra Electronics and prepared and issued by Edison for publication globally. All information used in the publication of this report has been compiled from publicly available sources that are believed to be reliable, however we do not guarantee the accuracy or completeness of this report. Opinions contained in this report represent those of the research department of Edison at the time of publication. The securities described in the Investment Research may not be eligible for sale in all jurisdictions or to certain categories of investors. This research is issued in Australia by Edison Aus and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act. The Investment Research is distributed in the United States by Edison US to major US institutional investors only. Edison US is registered as an investment adviser with the Securities and Exchange Commission. Edison US relies upon the "publishers' exclusion" from the definition of investment adviser under Section 202(a)(11) of the Investment Advisers Act of 1940 and corresponding state securities laws. As such, Edison does not offer or provide personalised advice. We publish information about companies in which we believe our readers may be interested and this information reflects our sincere opinions. The information that we provide or that is derived from our website is not intended to be, and should not be construed in any manner whatsoever as, personalised advice. Also, our website and the information provided by us should not be construed by any subscriber or prospective subscriber as Edison's solicitation to effect, or attempt to effect, any transaction in a security. The research in this document is intended for New Zealand resident professional financial advisers or brokers (for use in their roles as financial advisers or brokers) and habitual investors who are "wholesale clients" for the purpose of the Financial Advisers Act 2008 (FAA) (as described in sections 5(c) (1)(a), (b) and (c) of the FAA). This is not a solicitation or inducement to buy, sell, subscribe, or underwrite any securities mentioned or in the topic of this document. This document is provided for information purposes only and should not be construed as an offer or solicitation for investment in any securities mentioned or in the topic of this document. A marketing communication under FCA Rules, this document has not been prepared in accordance with the legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research. Edison has a restrictive policy relating to personal dealing. Edison Group does not conduct any investment business and, accordingly, does not itself hold any positions in the securities mentioned in this report. However, the respective directors, officers, employees and contractors of Edison may have a position in any or related securities mentioned in this report. Edison or its affiliates may perform services or solicit business from any of the companies mentioned in this report. The value of securities mentioned in this report can fall as well as rise and are subject to large and sudden swings. In addition it may be difficult or not possible to buy, sell or obtain accurate information about the value of securities mentioned in this report. Past performance is not necessarily a guide to future performance. Forward-looking information or statements in this report contain information that is based on assumptions, forecasts of future results, estimates of amounts not yet determinable, and therefore involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of their subject matter to be materially different from current expectations. For the purpose of the FAA, the content of this report is of a general nature, is intended as a source of general information only and is not intended to constitute a recommendation or opinion in relation to acquiring or disposing (including refraining from acquiring or disposing) of securities. The distribution of this document is not a "personalised service" and, to the extent that it contains any financial advice, is intended only as a "class service" provided by Edison within the meaning of the FAA (ie without taking into account the particular financial situation or goals of any person). As such, it should not be relied upon in making an investment decision. To the maximum extent permitted by law, Edison, its affiliates and contractors, and their respective directors, officers and employees will not be liable for any loss or damage arising as a result of reliance being placed on any of the information contained in this report and do not guarantee the returns on investments in the products discussed in this publication. FTSE International Limited ("FTSE") © FTSE 2017. "FTSE®" is a trade mark of the London Stock Exchange Group companies and is used by FTSE International Limited under license. All rights in the FTSE indices and/or FTSE ratings vest in FTSE and/or its licensors. Neither FTSE nor its licensors accept any liability for any errors or omissions in the FTSE indices and/or FTSE ratings or underlying data. No further distribution of FTSE Data is permitted without FTSE's express written consent.