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

%	1m	3m	12m
Abs	2.3	(0.9)	21.1
Rel (local)	0.0	(4.0)	7.7
52-week high/low		2204.0p	1677.0p

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

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Interim results

Exhibit 1: Interim results and full year estimates summary									
Consolidated income statement	2016			2017			*% change*		
Year to December (£m)	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%*
Revenues	**366.6**	**419.2**	**785.8**	**366.4**	**436.1**	**802.5**	***-0.1%***	***4.0%***	***2.1%***
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%*
Group operating profit	**57.7**	**73.5**	**131.1**	**57.6**	**73.8**	**131.5**	***-0.1%***	***0.5%***	***0.2%***
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%*			
EBIT margin	***15.73%***	***17.5%***	***16.7%***	***15.73%***	***16.9%***	***16.4%***			

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 Prior	2017e New	% change	2018e Prior	2018e New	% change
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%*
Sales	**812.8**	**802.5**	***-1.3%***	**852.8**	**840.0**	***-1.5%***
EBITDA	**149.8**	**147.0**	***-1.9%***	**157.2**	**153.9**	***-2.1%***
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%*
Underlying EBITA	**132.9**	**131.5**	***-1.1%***	**140.2**	**138.4**	***-1.3%***
Underlying PBT	**121.9**	**120.4**	***-1.2%***	**132.0**	**130.1**	***-1.5%***
EPS – underlying continuing (p)	**129.3**	**127.7**	***-1.2%***	**132.5**	**130.6**	***-1.5%***
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
PROFIT & LOSS					
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
BALANCE SHEET					
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
CASH FLOW					
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

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