PAC PARTNERS

Equity Research

Quickstep (QHL)

Australian Made Aerospace Approaching Scale

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Key Points

- QHL is on the verge of becoming profitable due to the significant growth in production of carbon fibre components for the F-35 Joint Strike Fighter program, despite a history of losses since listing in 2005.
- QHL is approaching the scale required to increase operating margins and generate long term profitability.
- We initiate coverage with a price target of $0.16, which is 39% above current share price on a DCF basis. Ability to control operating expenses is as important as the organic growth based on future contracted revenue.

Investment Thesis

- Quickstep has developed into a key manufacturer of composite carbon fibre components for the F-35 fighter, since contracts were signed in 2009. Production of components has been a long process with volume only developing in 2013. However, since then revenue is up 20x to $50m in FY16. We forecast $87m in FY19, enough to generate positive net profit, driven by growth in contracted levels of production. We anticipate gross profit margins to increase long term to 24% which is within the range of QHL's peers in the S&P500 Aerospace and Defence index. FY16 Gross profit margin was 20.8%. We see the margins increasing directly due to the economies of scale.
- Quickstep is still experiencing challenges though, as the automotive focussed New Technology Division is yet to secure large scale contracts. The niche level of production and losses incurred to date, indicates that their patented processes are yet to be adopted by the industry, and suggests that losses and R&D investment in this division are likely to continue in the near term.
- David Marino former COO of successful Australian based global automotive engineering solutions provider Futuris leads QHL, and provides investors with confidence in the expansion of the automotive focussed New Technology Division.
- Investment for the expansion of the Aerospace is complete with $10m invested to date in the Bankstown facility. Investment in R&D for the New Technology division extends the time horizon from immediate profitability, and we forecast significant net profits in FY19.
- QHL exhibits many of the risks associated with an Australian based aerospace/automotive manufacturer. Low gross profit margin, at times even negative GP margin (FY11-FY14). High operating expenses as a function of revenue, history of operating losses, and given the market cap an illiquid register. However, we believe that QHL has the scale required in its Aerospace Division to drive significant profitability in the medium term, and facilitate growth in the New Technology Division by leveraging their reputation in aerospace production to successfully win new large volume contracts.

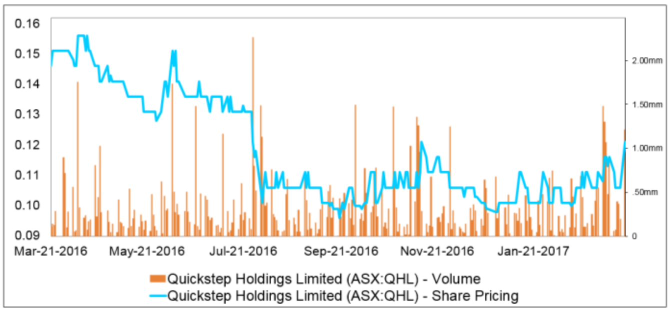
Recommendation	BUY
Previous Recommendation	Initiation
Risk Rating	High
Current Share Price	$0.115
12 Month Price Target	$0.16
Price Target Methodology	DCF
Total Return (Capital + Yield)	39%
DCF Valuation	$0.16
Market capitalisation ($m)	$64.68
Liquidity – Monthly Avg.	$1.4 m

Financial Forecasts & Valuation Metrics

Y/e ($m)	16 A	17 F	18 F	19 F
Revenue	50.13	53.40	67.05	87.11
EBITDA	-1.50	-1.37	1.23	6.15
NPAT underlying	-4.55	-3.13	-0.55	4.28
EV / EBITDA (x)	NMF	60.85	11.87	5.10

Source: PAC Partners estimates

QHL Share Price Performance



Source: CapitalIQ

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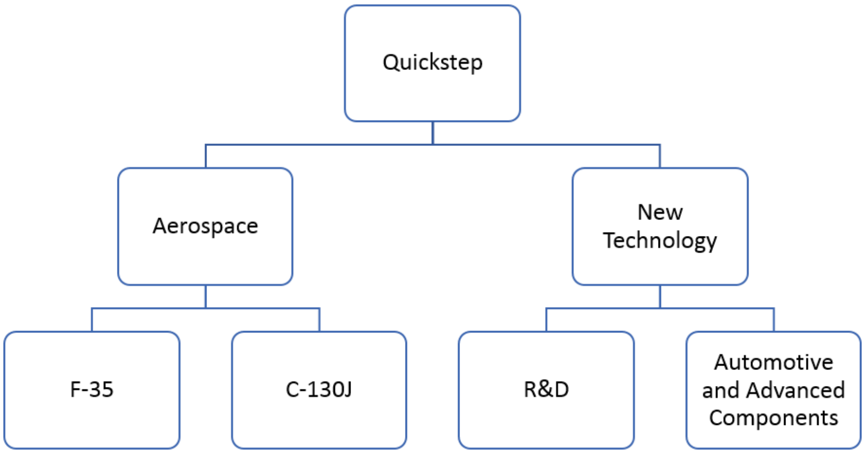
Organisational Structure and Operations

Quickstep has two divisions, Aerospace and New Technology as seen in Figure 1.

Figure 1. Organisational Structure of Quickstep.

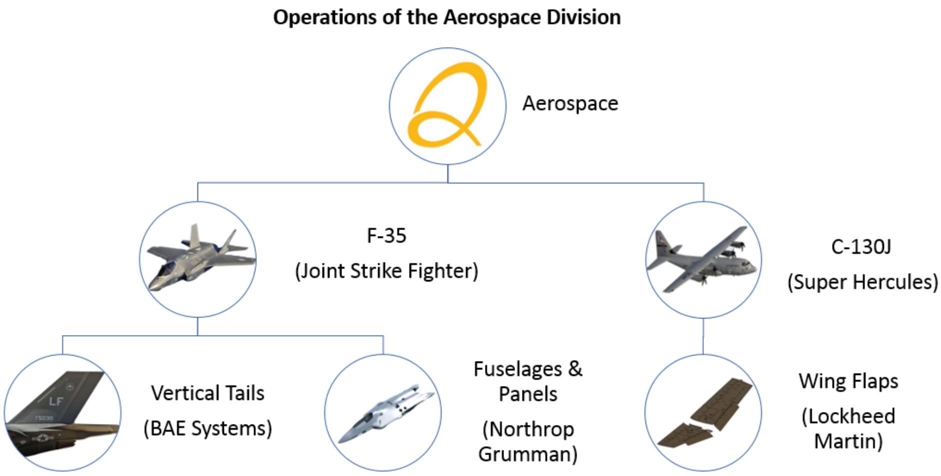


Aerospace

The Aerospace Division is the financial core of QHL. In FY15, FY16 and first half FY17 Aerospace accounted for 82%, 98% and 97% of revenue. The Aerospace Division is based in Bankstown, NSW, and employs 140 staff of varying technical skills. At full production of F-35 and C-130J components, the facility is estimated to be at 60% of total production capacity, offering opportunity for additional contracts, greater scale and increased operating leverage.

Presently Quickstep has 3 major operations to supply carbon fibre components for the F-35 (Vertical Tails, and Fuselages & Panels) as well as supplying Wing Flaps for the C-130J as seen in Figure 2. QHL's competitive advantage is their ability to create complex shaped composite materials.

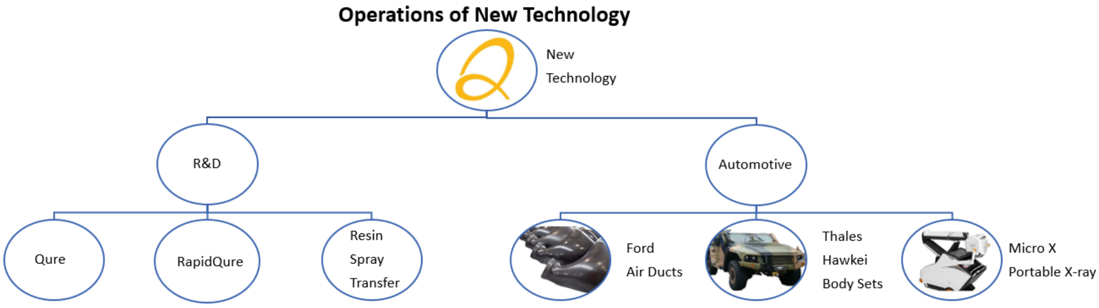
Figure 2. Operations of the Aerospace Division.



New Technology:

New Technology accounts for R&D and production of Automotive and Advanced Components as seen in Figure 3 below. R&D has generated patented technology such as Qure, Resin Spray Transfer (RST) and RapidQure, but is yet to be used in large-scale production. The Qure and RST processes have been used in niche volume projects such as production of Ford XR6 Sprint carbon fibre air ducts, Thales (EPA: HO) Hawkei body sets, and Micro-X (ASX: MX1) portable X-ray devices. The New Technology Division is based in Waurn Ponds, VIC, employs 30 staff and is expected to contribute strongly to revenue in the medium to long term.

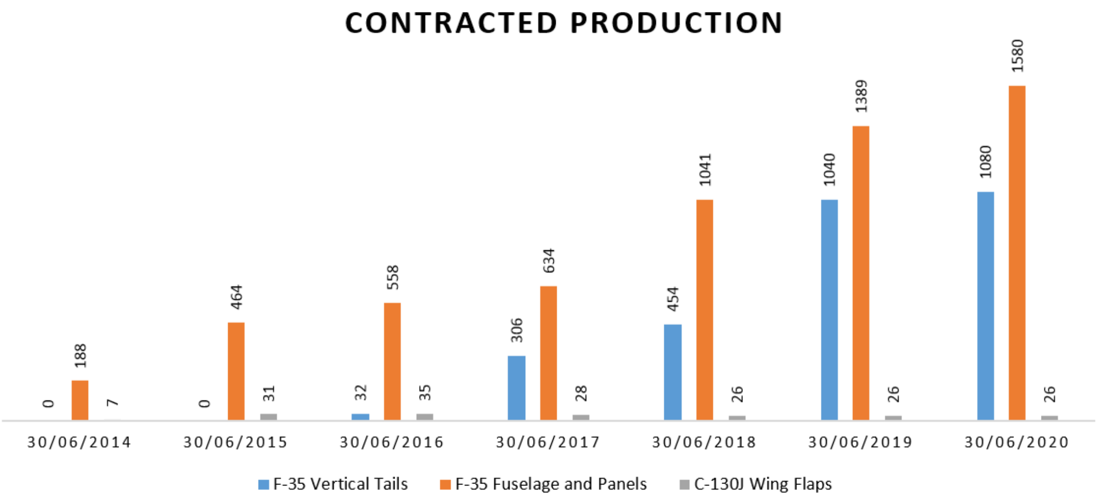
Figure 3. Operations of the New Technology Division and Competition.



Key Contracts and Competition

QHL has 3 major sub-contracts supplying to 3 different Aerospace and Defence manufactures which include Lockheed Martin (NYSE: NOC), Northrop Grumman (NYSE: LMT) and BAE Systems (LON: BA) / Marand. Presently we see much of the value of QHL related to these 3 contracts, due to the increased levels of contracted demand for the F-35 components as seen in Figure 4.

Figure 4. Contracted Production.



We anticipate combined F-35 parts to increase from 590 in FY16 to 2429 in FY19, whilst C-130J production remains at 26-28 wing flaps. The order book is valued at $115m as at Dec-16, but we see QHL deriving value from these contracts in the long-term (as seen in Figure 5 below), and realise that the full value of the order book is significantly higher, but only the short-term value is disclosed due to the nature of QHL's clients.

Figure 5. Nature of Contracts: Tenue, Value and Estimated Revenue per Unit.

Contract	Plane	Value and Tenure	Estimated Revenue per Unit
Production of Fuselage and Panels to Northrop Grumman (NYSE: NOC)	F-35 Joint Strike Fighter	$700M AUD over ~20 years. Production began 2012.	Between 20k and 30k AUD (depending on FX rate)
Production of Vertical Tails to BAE Systems (LON: BA) / Marand	F-35 Joint Strike Fighter	$139M AUD over 14 years. Production began 2016.	Between 10k and 15k AUD (depending on FX rate)
Production of Wing Flaps to Lockheed Martin (NYSE: LMT)	C-130J Super Hercules	$100M AUD over 6 years. Production began in 2014.	Between 700k and 800k AUD (depending on FX rate)

We see reduced risk around competition for the above contracts and renegotiation for several reasons. Firstly, there is a lengthy verification process to become a Qualified Supplier, which can take 3-10 years, and therefore creates a significant barrier to entry. Secondly, due to the complex shaped nature of the required components few manufacturers have the capabilities to produce the needed specifications, without significant capital expenditure. Finally, due to the importance of national security only countries participating in the JSF program can be awarded the F-35 contract, which reduces the number of lower operating cost manufactures able to compete. Therefore, we anticipate that QHL will maintain the F-35 and C-130J contracts going forward.

On the other hand, if QHL is to win additional commercial contracts and achieve full capacity at the Bankstown facility, QHL will have to compete with larger firms that are not subject to the specific limitations of national security and defence. This means that QHL will face competition from a wider view of countries and therefore firms with lower operating cost and greater economies of scale. Larger Australian competitors include Boeing Australia (Port Melbourne, VIC) and Marand Engineering (Moorabbin, VIC).

Contracts in the New Technology Division

QHL currently has no long-term manufacturing contracts within its New Technology Division, this is because QHL is establishing its automotive manufacturing capabilities, and as such contracts are often short term/one-off in nature and low in volume, which contrasts strongly with the Aerospace Division. For example, QHL produced 600 air ducts for the Ford Falcon XR6 Sprint in FY16, with total revenue from New Technology (including other one-off projects) of $1m for a net loss of $7m. QHL needs to win higher volume contracts, by leveraging its approved aerospace manufacturing capabilities to gain contracts with the required scale.

Furthermore, there are several other advanced aerospace and automotive manufactures such as Titomic, which uses 3-D printing to produce complex shaped components. Even though QHL has developed and patented its Qure, RST and RapidQure processes, it is unclear whether they are superior to competitors or more reliable and scalable than traditional autoclave methods. The low volume contracts completed to date suggests the industry is hesitant to adopt the technology, despite the advantages in rate of production and quality of finished product. This may be due to uncertainty of scalability and competition from other technologies. Therefore, senior management will have to leverage its existing relationships (e.g. David Marino former COO at Futuris), and history of production capabilities in the Aerospace Division, in order to secure the initial large-scale contracts over its competitors.

Share Ownership and Capital Raising

Ownership

QHL has 562m shares on issue. The largest 20 shareholders own 38% of issued capital. The largest institutional shareholder is Washington H. Soul Pattison with 15.9% ownership, they are a long-time supporter of QHL having taken a $3m placement in the most recent capital raising. Deakin University is the second largest with 5.9%, and is a strategic partner as the New Technology Division is located on the Deakin University campus in Waurn Ponds. The majority of shares are held by approximately 6,349 non-institutional shareholders.

Capital Raising

In October 2015 QHL completed an equity raising of $22m. $17m of which as a non-renounceable entitlement offer at $0.13 per share, and a $5m placement at $0.15 per share (discount 22% to VWAP).

As shown in Figure 6 $16m was used to expand current facilities in the Aerospace Division to meet future contracted demand as well as to fund further development of the RapidQure technology, all of which we view as a strong reasons for raising capital. However, $5m was used to repay debt, which is an unpleasant reason to raise equity as it shows weaknesses with appropriate debt structure. The Newmarket debt arrangement was developed prior to CEO David Marino (February 2015) and CFO Andrew Crane (September 2015), and shifts the responsibility of unsuitable debt structure to previous management.

Figure 6. Anticipated Expenditure from Equity Raising.

Automotive Capital Expenditure	$6m
Aerospace Capital Expenditure	$6m
Repayment of Newmarket Debt	$5m
RapidQure Commercialisation	$3m
C-130J and JSF Capital Expenditure	$1m
Equity Raising Costs	$1m
Total	$22m

Board and Key Management

Board

The board is comprised of seven directors, one of the latest additions is David Marino appointed February 2015 (current CEO and Managing Director) who replaced Mr. Philippe Odouard (former CEO and Managing Director of QHL). The board is compensated $576k in fees and has a combined share and rights value of $1.5m. We view the amount of compensation as reasonable.

Figure 7. Board Composition and Background.

Director	Position	Background	Ownership
Tony Quick	Chairman	Aerospace, Defence	Shares: 456k
David Marino	Managing Director	Automotive Manufacturing	Shares: 487k Rights: 3.3m
Bruce Griffiths OAM	Non-Executive Director	Automotive Manufacturing	Shares: 1.2m
Peter Cook	Non-Executive Director	Diversified emerging companies	Shares: 1.6m
Air Marshal Errol McCormack	Non-Executive Director	Air Force	Shares: 481k
Nigel Ampherlaw	Non-Executive Director	Accounting, Financial Services	Shares: 500k
James Douglas	Non-Executive Director	Investment Banking	Shares: 980k Rights: 8.3m

Senior Management

There have been significant changes to the composition of Senior Management. Since January 2015, 7 of 9 new members have been added including the appointment of David Marino (CEO), Andrew Crane (CFO) and Kevin Boyle (COO). New management reflects the increased strategic direction in automotive production, with many new members having a long history and significant experience in this field.

Key Risks

Aerospace Risk

The majority of QHL's future revenue is a result of 3 contracts with major suppliers Lockheed Martin, Northrop Grumman and BAE Systems/Marand. QHL therefore faces concentration risk, as a loss in contract would have a proportional impact on revenue.

Meeting JSF production obligations. Significant increase in JSF parts is expected over the next 3 years, increasing fourfold on FY16 parts delivered. We see risk around the contract and further purchase orders if the required demand is not achieved and/or quality decreases as volume increases.

Aerospace contracts are denominated in USD, and therefore an appreciation in the AUD or depreciation in the USD would materially affect revenue received. Likewise, some raw materials must be sourced internationally, creating exposure regardless of the change in AUD.

If new work is undertaken in addition to JSF and C-130J production, we forecast additional capital will be required for expansion at the Bankstown facility, adding financing risk through either a debt or equity raising.

New Technology Risk

New Technology Division is engaged in niche volume production which results in high operating costs, and as there is no commitment from existing clients for ongoing higher volume production, losses could therefore result for a sustained period.

Given the large-scale untested nature of Qure, Resin Spray Transfer and RapidQure, the ability to meet the required production rate and quality is uncertain. Furthermore, there is scope for other technologies to displace the processes that QHL has developed.

Financial and Trading Risks

We forecast that working capital will increase from FY16 $6.3m to FY19 $10.6m to meet the increase in parts demanded for JSF. The significant increase in WC will be supported by an undrawn loan facility with EFIC of $3m. However, additional financing may be required, depending on management's minimal acceptable cash balance.

Liquidity Risk. Trading activity is low. The annual turnover of QHL shares is approximately 22% of all shares on issue. This is slightly below the minimum turnover for Industrial Capital Goods firms in the S&P Emerging Companies Index (^XEC) which has a minimum annual turnover of 24% of shares on issue and average of 66% annual turnover.

Valuation: Discounted Cash Flow Analysis

We believe that based on DCF analysis QHL's implied price is $0.16 per share, this is a 39% premium to the price of $0.115 on the 22nd March 2017. Our DCF is based on an explicit forecast till 2033 and a terminal value from 2034 onwards. The long explicit forecast period of 17 years, is due to the long-term nature of the Aerospace F-35 and C-130J contracts as highlighted in Figure 5. Nature of Contracts: Tenure, Value and Estimated Revenue per Unit.

As demonstrated in Figure 8 and Figure 9 we have modelled the revenue growth based on the growth in number of parts, estimated revenue per part and then extended this for the value and life of the contract. As seen in Figure 8, we expect revenue growth mainly in FY18, FY19 and FY20 due to increasing production from F-35 Joint Strike Fighter Vertical Tails and Fuselage & Panels. Total aerospace divisional revenue is composed of the long term contracted revenue, and other aerospace revenue.

In modelling the New Technology Division, we have assumed revenue generating capacity based on historical completed contracts.

Figure 8. Contract Specific Revenue.

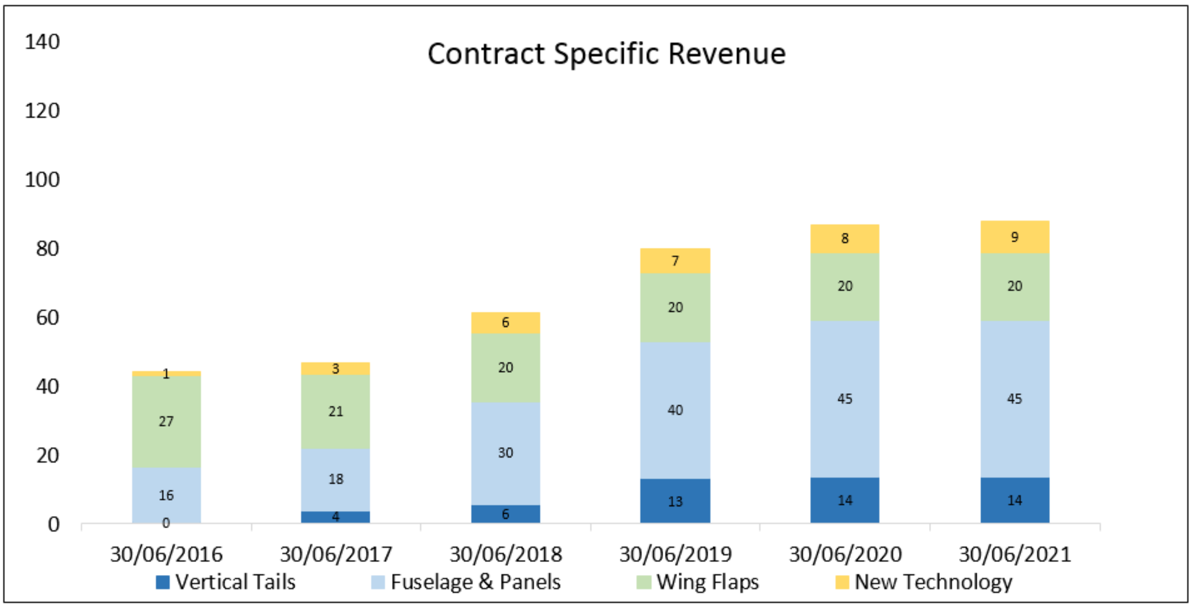
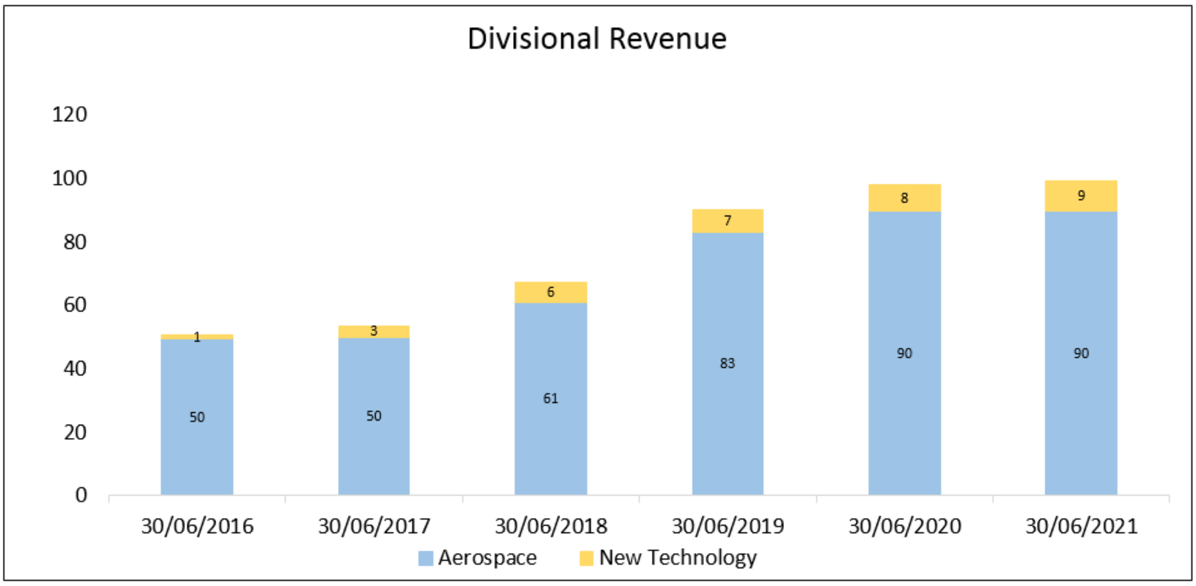


Figure 9. Divisional Revenue.



We anticipate gross profit margins to increase long term to 24% which is within the range of QHL's peers in the S&P500 Aerospace and Defence index. FY16 Gross profit margin was 20.8%. We see the margins increasing directly due to the economies of scale from components manufactured.

Capital Expenditure related to JSF and C-130J is expected to be for maintenance purposes only, as the Capital Investment Program at the Bankstown facility has recently been completed with an overall investment of $30m.

We anticipate that investment in R&D will remain high at historical levels (FY15 and FY16) around 6% of revenue until 2020, at which point we assumed a more conservative 3% of revenue. This is in the anticipation that commercialisation and development of RapidQure will be complete.

We anticipate that days of sales and inventory outstanding will remain at historical levels, which are similar to peers and the industry average.

Although we anticipate QHL to be EBT positive in FY19 there is $64.3m of tax losses not brought forward, which we have used to deduct from taxable income when possible. Based on the tax losses not brought forward and a corporate tax rate of 30%, we do not anticipate cash outflows related to taxes until 2024.

At the beginning of FY17 QHL has $9.76m worth of outstanding long term debt which matures in 2021. We have assumed that repayments begin in FY17, peak in FY20 and are fully repaid by FY21. We have also assumed that the EFIC $3m loan facility to support working capital requirements is fully drawn down in FY18.

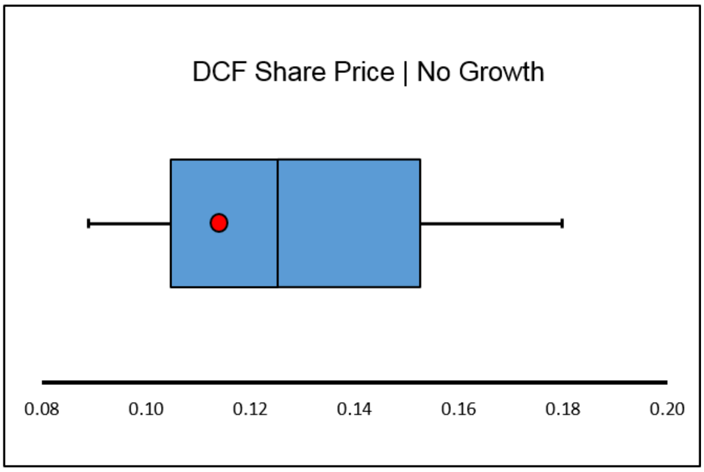
Our explicit forecast period has PV of 50.8m and terminal value of 38.2m. Total PV of cash flows to equity are 89.6m and with 562.5m shares outstanding we reach a DCF valuation of 0.16 per share.

Scenario Analysis

We have analysed 3 scenarios given QHL's growth position and have presented the implied per share price based on DCF analysis.

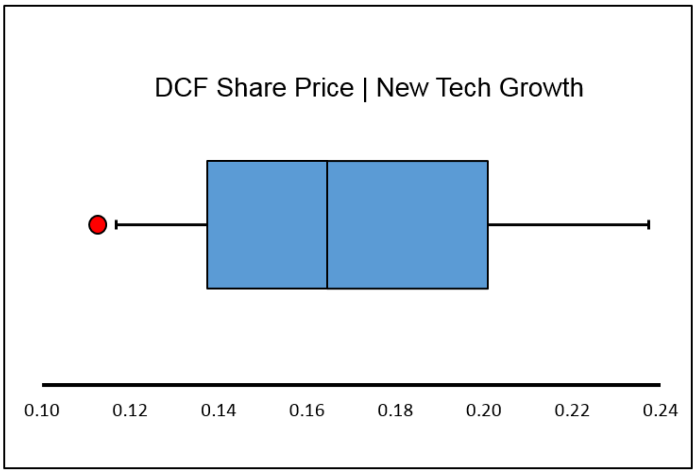
Scenario 1: DCF based only on contracted revenue in the Aerospace Division, with no Aerospace or New Technology growth. We view this as an extreme scenario, as we anticipate growth in the New Technology Division and Aerospace Division, by winning contracts and leveraging their production capabilities. Even in this scenario QHL appears to be trading at slightly below the implied fair value, this may be due to the illiquidity of QHL.

Figure 10. DCF Share Price, with no growth in Aerospace or New Technology Division.



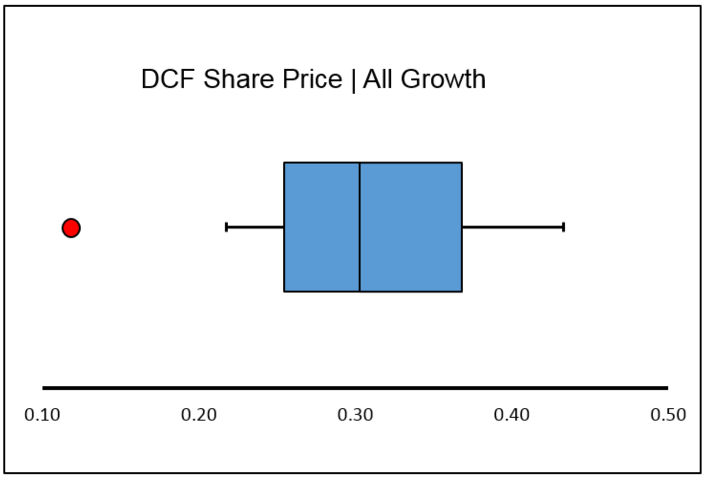
Scenario 2: DCF based on contracted revenue in Aerospace Division, and growth in New Technology Division. This scenario we see as most likely to occur in the medium term, with a DCF value of $0.16 per share, our reported results are presented using this scenario.

Figure 11. DCF with growth in New Technology.



Scenario 3: DCF based on contracted aerospace revenue, expansion of Aerospace Division to full capacity, and growth in the New Technology Division at the same rate as scenario 1 and 2. We see this scenario as possible, but less likely based on current focus in the New Technology Division. QHL would need to win a significant contract in the Aerospace Division, whilst simultaneously growing the New Technology Division for this scenario to unfold.

Figure 12. DCF with growth in Aerospace and New Technology Division.



Results: 3 Statement Operating Model

INCOME STATEMENT ($m)

Y/e Jun	FY15A	FY16A	FY17F	FY18F	FY19F	FY20F
Revenue	**39.51**	**50.13**	**53.40**	**67.05**	**87.11**	**94.74**
EBITDA	-0.65	-1.50	-1.37	1.23	6.15	12.63
Depreciation & Amortisation	0.00	0.00	-1.15	-1.15	-1.15	-1.16
EBIT	**-0.65**	**-1.50**	**-2.53**	**0.08**	**5.00**	**11.47**
Interest Expense	-1.85	-3.14	-0.71	-0.67	-0.75	-0.67
Income tax	0.00	0.00	0.00	0.00	0.00	0.00
Adj. NPAT underlying	**-2.47**	**-4.55**	**-3.13**	**-0.55**	**4.28**	**10.84**
Less non-controlling Interest	0.00	0.00	0.00	0.00	0.00	0.00
Abnormal items	-1.47	-1.22	1.80	0.00	0.00	0.00
NPAT Reported.	**-3.94**	**-5.78**	**-1.33**	**-0.55**	**4.28**	**10.84**

BALANCE SHEET ($m)

Y/e Jun	FY15A	FY16A	FY17F	FY18F	FY19F	FY20F
Cash	1.91	8.57	2.94	2.58	2.93	9.04
PP&E	12.05	13.05	16.17	16.15	16.13	16.21
Receivables	5.13	5.32	6.30	7.91	10.28	11.18
Inventories	5.98	11.91	10.75	13.09	16.48	17.48
Prepaid Expenses	0.50	0.40	0.45	0.54	0.68	0.72
Total Assets	**25.57**	**39.25**	**36.61**	**40.28**	**46.51**	**54.64**
Accounts Payable	5.31	8.15	8.19	9.97	12.55	13.32
Deferred Revenue	5.63	4.75	4.24	4.92	5.92	4.88
Other	0.11	0.20	0.20	0.20	0.20	0.20
Debt	15.74	11.92	11.08	12.84	11.20	8.76
Total Liabilities	**26.80**	**25.02**	**23.70**	**27.93**	**29.87**	**27.16**
NET ASSETS	**-1.23**	**14.23**	**12.90**	**12.35**	**16.64**	**27.48**

Cash Flow ($m)

Y/e Jun	FY17F	FY18F	FY19F	FY20F
Operating EBITDA	(1.37)	1.23	6.15	12.63
Interest & Tax	(0.44)	(0.47)	(0.55)	(0.47)
Change in Working Cap	(0.34)	(1.58)	(2.31)	(2.22)
Others	1.80	0.00	0.00	0.00
Operating Cash Flow	**(0.36)**	**(0.82)**	**3.28**	**9.94**
Capex	(4.27)	(1.14)	(1.13)	(1.23)
Free Cashflow (FCF)	**(4.63)**	**(1.96)**	**2.15**	**8.71**
Asset Sales (purchases)	0.00	0.00	0.00	0.00
Ord Dividends	0.00	0.00	0.00	0.00
Debt Drawdown, (Debt Paydown)	(1.00)	1.60	(1.80)	(2.60)
Net Cashflow	**(5.63)**	**(0.36)**	**0.35**	**6.11**

KEY RATIOS

Y/e Jun	FY15A	FY16A	FY17F	FY18F	FY19F	FY20F
EBITDA Margin	-1.65%	-2.99%	-2.57%	1.84%	7.06%	13.33%
NPAT Margin	-9.96%	-11.52%	-2.49%	-0.82%	4.92%	11.44%
ROA (%) y/e	-9.66%	-11.60%	-8.55%	-1.37%	9.21%	19.84%
ROE (%) y/e	NMF	-40.58%	-10.32%	-4.47%	25.75%	39.46%
TA per share (cps)	0.05	0.07	0.07	0.07	0.08	0.10
Eff Tax Rate	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Interest Cover	NMF	NMF	NMF	0.12	667.73	1704.26

VALUATION PARAMETERS

Y/e Jun	FY16A	FY17F	FY18F	FY19F	FY20F
EPS (cps)	-1.03	-0.24	-0.10	0.76	1.93
PE Adj (x)	-0.11	-0.49	-1.17	0.15	0.06
Enterprise Value ($m)	68.03	72.83	74.95	72.95	64.41
EV / EBITDA (x)	-45.39	-53.04	60.85	11.87	5.10
EV / EBIT (x)	-45.39	-28.81	964.09	14.60	5.61
Price / TA	1.65	1.77	1.61	1.39	1.18
DPS (¢ps)	0.00	0.00	0.00	0.00	0.00
Dividend Yield (%)	0.00	0.00	0.00	0.00	0.00
FCFE / Share		-0.01	0.00	0.00	0.02
Price / FCFE PS (x)		-13.97	-33.00	30.07	7.43

VALUATION

PV of Cashflows FY16 to FY33	51.37	15 Year Australian Govt. Bond	3.18%
PV of TV	38.23	Australian Equity Risk Premium	6.10%
PV of Equity	89.59	Small Cap Equity Risk Premium	2.40%
Shares on Issue	562.47	Levered Beta	0.71
		CAPM Cost of Equity	9.93%
PV of Equity per share	0.16	Cost of Equity	9.93%

GROWTH PROFILE (YoY)

Y/e Jun	FY15A	FY16A	FY17F	FY18F	FY19F	FY20F
Sales Revenue		27%	7%	26%	30%	9%
EBITDA		NMF	NMF	NMF	399%	105%
EBIT		131%	69%	NMF	6327%	130%
NPAT		47%	NMF	NMF	NMF	153%

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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.

Buy	Hold	Sell
>20%	20% – 5%	<5%

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

Risk Rating

PAC Partners has a four tier Risk Rating System consisting of: Very High, High, Medium and Low. The Risk Rating is a subjective rating based on: Management Track Record, Forecasting Risk, Industry Risk and Financial Risk including cash flow analysis.

Disclosure of Economic Interests

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