PETRA CAPITAL

13 November 2020

Quickstep Holdings (QHL) BUY Share Price: A$0.08

Australia key to near-term Triton production continuity Target Price: A$0.17

We view the US Navy's decision to delay the purchase of its next batch of MQ-4C Triton to 2023 as an opportunity for the Australian Government to (i) bring forward delivery of its budgeted requirements at a lower unit price, and (ii) negotiate greater domestic supply chain participation. This could be beneficial for QHL, and by extension provides further tangible evidence of the company's potential tender pipeline and support for our current Buy rating and $0.17ps TP.

Taking a closer look at the MQ-4C Triton programme

- While Northrop Grumman's MQ-4C Triton programme, which is a cooperative between the RAAF and the US Navy, is currently in low-rate production, recent US budget deferrals could result in temporary closures.
- To mitigate this risk, Northrop Grumman is lobbying for the RAAF to bring forward the planned purchase of two of its six MQ-4C Triton. Doing so could be beneficial for various stakeholders, and potentially even QHL.
- While QHL is not part of the MQ-4C Triton supply chain, deferral of US Navy orders could strengthen Australia's bargaining position in terms of (i) the unit price it pays, and (ii) increasing domestic supply chain participation.

QHL's positive outlook remains intact

- QHL's strong 1Q21 sales growth is indicative of the company's positive operating track record and ability to secure incremental workflow, with the rolling 12-month run rate now at 13.5% on pcp (versus 12.3% in FY20).
- We expect the improvement in QHL's cash conversion evident in 1Q21 to continue for the foreseeable future, reflecting (i) supply chain normalisations, and (ii) lower incremental capex requirements for existing contracts.
- Our earnings forecasts imply a 5-year net profit CAGR of 10.4%, leveraging off a sales CAGR of 2.6% from existing defence programmes. Our estimated NPV from these forecasts is $0.08ps.

Reiterate Buy rating and $0.17ps target price

- While QHL's strategic imperative is to diversify revenue across defence and commercial aerospace, the current business mix is almost entirely defence-related. This is a positive in the current market context.
- We are confident that a continued focus on operational excellence will enable QHL to accelerate the recent growth in its order book, with the current strong tender pipeline reflecting recent growth in defence budgets.
- Given the potential upside to QHL's order book over both the near and longer-term, and with the company's shares currently trading at a ~50% discount to peers, we reiterate our Buy rating and $0.17ps target price.

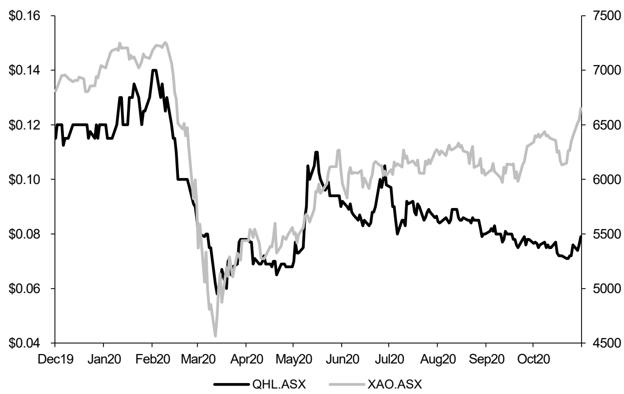
Company Data

Shares – ordinary (M)	714.6
Dilution (M)	16.5
Total (fully diluted) (M)	731.1
Market capitalisation ($M)	58.6
12 month low/high ($)	0.06 - 0.15
Average monthly turnover ($M)	2.2
GICS Industry	Aerospace & Defense

Financial Summary (fully diluted/normalised)

Year End June	2019A	2020A	2021F	2022F	2023F
Revenue (A$m)	73.3	82.3	88.2	93.4	93.4
Costs (A$m)	67.5	74.0	77.8	81.6	81.7
EBITDA (A$m)	5.8	8.2	10.4	11.8	11.7
NPAT (A$m)	2.7	3.9	4.8	6.4	6.5
EPS (¢)	0.4	0.5	0.7	0.9	0.9
EPS Growth (%)	100+	22.5	22.4	35.5	1.5
PER (x)	18.8	15.4	12.6	9.3	9.1
FCF (A$m)	-4.7	-5.8	3.1	7.0	7.7
FCF per share (cps)	-0.8	-0.8	0.4	1.0	1.1
Price to FCF (x)	NM	NM	19.5	8.5	7.7
EV (A$m)	60.8	67.1	65.2	59.3	51.5
EV/EBITDA	10.5	8.2	6.3	5.0	4.4
Payout ratio (%)	0.0	0.0	0.0	0.0	0.0
Dividend (¢)	0.0	0.0	0.0	0.0	0.0
Yield (%)	0.0	0.0	0.0	0.0	0.0
Franking (%)	0.0	0.0	0.0	0.0	0.0

QHL – performance over one year



Disclosure and Disclaimer
This report must be read with the disclosure and disclaimer on the final page of this document.

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Analysis

Quickstep Holdings

Year End June

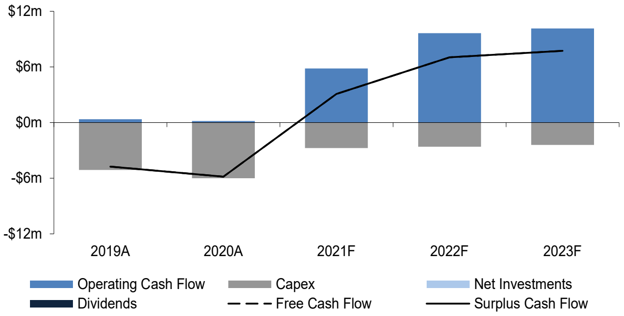
MARKET DATA		
Recommendation		Buy
Price	**$**	**0.08**
Price target (12-month)	**$**	**0.17**
52 week low / high	$	0.06 - 0.15
Market capitalisation	**$m**	**58.6**
Shares on issue (basic)	no.	714.6
Performance rights	no.	16.5
Other equity	no.	0.0
Shares on issue (diluted)	no.	731.1

INVESTMENT FUNDAMENTALS		2019A	2020A	2021F	2022F	2023F
Reported net profit	$m	2.7	3.9	4.8	6.4	6.5
Underlying net profit	$m	2.7	3.9	4.8	6.4	6.5
Underlying NPATA	**$m**	**2.7**	**3.9**	**4.8**	**6.4**	**6.5**
Reported EPS (diluted)	¢	0.4	0.5	0.7	0.9	0.9
Underlying EPS (diluted)	**¢**	**0.4**	**0.5**	**0.7**	**0.9**	**0.9**
….Growth	%	100+	22.5	22.4	35.5	1.5
Underlying PER (diluted)	**x**	**18.8**	**15.4**	**12.6**	**9.3**	**9.1**
Operating cash flow per share	¢	0.1	0.0	0.8	1.3	1.4
Free cash flow per share	¢	(0.8)	(0.8)	0.4	1.0	1.1
Price to free cash flow per share	**x**	**NM**	**NM**	**19.5**	**8.5**	**7.7**
Free cash flow yield	%	**(9.3)**	**(9.7)**	**5.1**	**11.8**	**13.0**
Dividend per share	**¢**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Payout ratio	%	0.0	0.0	0.0	0.0	0.0
Yield	%	0.0	0.0	0.0	0.0	0.0
Franking	%	0.0	0.0	0.0	0.0	0.0
Enterprise value	**$m**	**60.8**	**67.1**	**65.2**	**59.3**	**51.5**
EV/EBITDA	x	10.5	8.2	6.3	5.0	4.4
Price to book (NAV)	x	2.6	2.7	2.2	1.8	1.5
Price to NTA	x	2.6	2.7	2.2	1.8	1.5

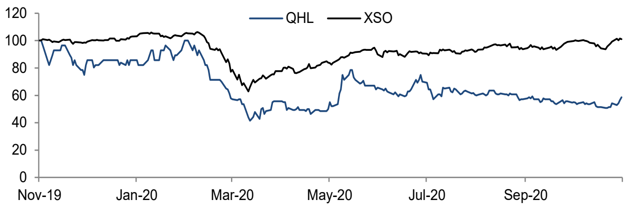
KEY RATIOS		2019A	2020A	2021F	2022F	2023F
EBITDA margin	%	7.9	10.0	11.8	12.7	12.5
EBIT margin	%	5.3	5.6	7.4	8.5	8.3
Underlying net profit margin	%	3.7	4.7	5.4	6.9	7.0
Return on average equity	%	19.4	17.8	19.8	21.7	18.0
Return on average assets	%	9.4	7.8	9.4	10.8	10.0
Net tangible assets per share	¢	3.1	3.0	3.7	4.6	5.4
Net debt /(cash)	$m	1.1	7.1	5.2	(0.7)	(8.4)
Interest cover (EBIT / net interest)	x	1.8	1.6	3.7	5.4	6.3
Leverage (net debt / EBITDA)	x	0.2	0.9	0.5	n/a	n/a
Gearing (net debt / net debt plus equity)	%	4.8	24.7	16.4	n/a	n/a

DUPONT ANALYSIS		2019A	2020A	2021F	2022F	2023F
Net Profit Margin	%	3.7	4.7	5.4	6.9	7.0
Asset Turnover	x	1.8	1.4	1.3	1.3	1.2
Return on Assets	%	6.6	6.7	6.9	8.8	8.4
Financial Leverage	x	2.9	2.7	2.9	2.5	2.1
Return on Equity	**%**	**19.4**	**17.8**	**19.8**	**21.7**	**18.0**

CASH FLOW SUMMARY



12-MONTH SHARE PRICE PERFORMANCE



PROFIT AND LOSS		2019A	2020A	2021F	2022F	2023F
Total revenue	$m	73.3	82.3	88.2	93.4	93.4
EBITDA	**$m**	**5.8**	**8.2**	**10.4**	**11.8**	**11.7**
Depreciation & amortisation	$m	2.0	3.6	3.9	3.9	3.9
EBIT	$m	3.9	4.6	6.6	7.9	7.7
Net interest	$m	2.2	2.9	1.8	1.5	1.2
Non-operating income	$m	0.0	0.0	0.0	0.0	0.0
Pretax Profit	$m	1.7	1.7	4.8	6.4	6.5
Tax expense	$m	(1.0)	(2.2)	0.0	0.0	0.0
Minorities	$m	0.0	0.0	0.0	0.0	0.0
Underlying NPAT	**$m**	**2.7**	**3.9**	**4.8**	**6.4**	**6.5**
Significant items	$m	0.0	0.0	0.0	0.0	0.0
Reported NPAT	$m	2.7	3.9	4.8	6.4	6.5

GROWTH PROFILE		2019A	2020A	2021F	2022F	2023F
Operating revenue	%	24.1	12.3	7.2	5.9	0.0
EBITDA	%	100+	41.3	26.8	13.5	(1.4)
EBIT	%	100+	18.5	43.2	20.9	(2.3)
Underlying NPAT	%	100+	44.5	22.6	35.1	1.1
Underlying EPS	%	100+	22.5	22.4	35.5	1.5
DPS	%	0.0	0.0	0.0	0.0	0.0

BALANCE SHEET		2019A	2020A	2021F	2022F	2023F
Cash	$m	7.3	1.7	0.2	0.6	8.4
Receivables	$m	6.9	7.7	8.4	8.9	8.9
Inventory	$m	8.5	10.1	17.6	18.7	18.7
Other	$m	11.3	11.1	9.1	9.2	7.9
Current	$m	34.0	30.6	35.3	37.4	43.8
Prop, plant & equip	$m	14.8	17.0	17.6	17.9	18.0
Goodwill	$m	0.0	0.0	0.0	0.0	0.0
Other	$m	1.0	19.2	19.1	19.0	19.0
Non current	$m	15.8	36.2	36.7	36.9	37.0
Total assets	**$m**	**49.8**	**66.8**	**71.9**	**74.3**	**80.8**
Accounts Payable	$m	14.3	12.2	15.4	16.3	16.3
Borrowings	$m	8.5	8.8	5.4	(0.0)	(0.0)
Other	$m	5.0	24.1	24.6	25.1	25.1
Total liabilities	**$m**	**27.8**	**45.1**	**45.4**	**41.4**	**41.4**
Net assets	$m	22.0	21.7	26.5	33.0	39.5
Equity	$m	22.0	21.7	26.5	33.0	39.5
Minorities	$m	0.0	0.0	0.0	0.0	0.0
Shareholder's equity	**$m**	**22.0**	**21.7**	**26.5**	**33.0**	**39.5**
Shares on issue	m	710.3	713.4	714.6	719.4	731.1

CASH FLOW		2019A	2020A	2021F	2022F	2023F
EBITDA	$m	5.8	6.6	8.8	10.2	10.1
Change in working capital	$m	(5.3)	5.1	(4.9)	(0.6)	0.0
Net interest	$m	(0.7)	(2.0)	0.0	0.0	0.1
Tax paid	$m	0.0	0.0	1.9	0.0	0.0
Other	$m	0.6	(9.6)	0.0	0.0	0.0
Operating cash flow	**$m**	**0.4**	**0.2**	**5.8**	**9.6**	**10.1**
Capital expenditure	$m	(5.1)	(6.0)	(2.8)	(2.6)	(2.4)
Acquisitions/divestment/other	$m	2.9	0.5	0.0	0.0	0.0
Investing cash flow	**$m**	**(2.2)**	**(5.5)**	**(2.8)**	**(2.6)**	**(2.4)**
Free cash flow	**$m**	**-4.7**	**-5.8**	**3.1**	**7.0**	**7.7**
Equity	$m	11.7	0.0	0.0	0.0	0.0
Increase / (decrease) in borrowings	$m	(5.1)	0.7	(3.5)	(5.4)	0.0
Dividend/other	$m	(0.3)	(1.2)	(1.2)	(1.2)	0.0
Financing cash flow	**$m**	**6.2**	**(0.4)**	**(4.6)**	**(6.6)**	**0.0**
Net cash flow	**$m**	**4.4**	**(5.7)**	**(1.5)**	**0.5**	**7.7**

Source: Petra Capital

Northrop Grumman's MQ-4C Triton programme

The MQ-4C Triton, which is a variant of Northrop Grumman's fifth generation unmanned intelligence, surveillance and reconnaissance (ISR) RQ-4 Global Hawk, is a cooperative development programme between the Royal Australian Air Force (RAAF) and the US Navy. While the programme remains in a low-rate initial production phase, we note that:

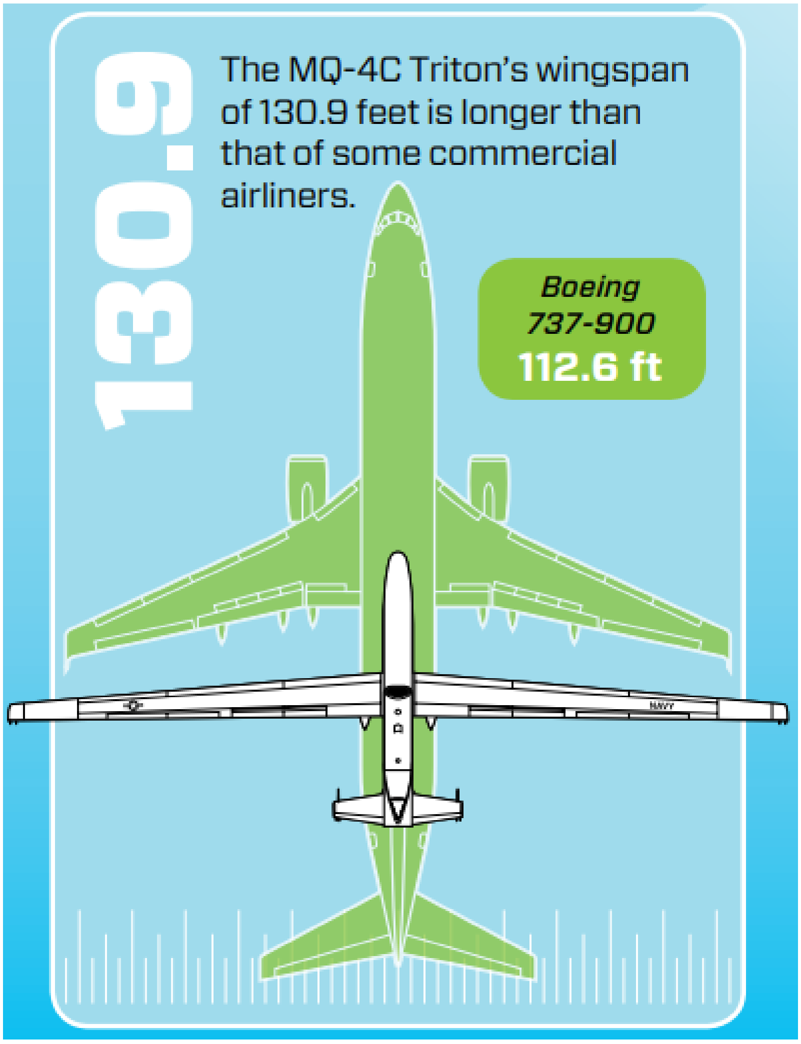
- The US Navy has ordered 14 of its indicative requirement for 65-68 MQ-4C Triton; and
- The RAAF has ordered three of its indicative requirement for six MQ-4C Triton.

The first MQ-4C Triton is expected to be delivered to Australia in 2023, with delivery of the third unit scheduled for 2025. While the Australian government has committed A$1.4bn for the first aircraft (and associated infrastructure and operating capabilities) and A$350m for the second aircraft, funding for the third unit has not been disclosed, but is likely encapsulated in the A$1.8-2.7bn budget allocation.

The US Navy is planning to use its fleet of MQ-4C Triton to operate five ISR orbits around the globe, with the Australian fleet adding a sixth orbit. According to Northrop Grumman, the MQ-4C Triton is capable of covering >2 million square miles of ocean and littorals in a single flight, lasting >24 hours at a cruising altitude of 50,000 feet.

While it is unclear how much of the MQ-4C Triton's aerostructure is composites, we do know that one of the key differences compared to the RQ-4 Global Hawk is its composites wing (Figure 1), which enables the aircraft to descend and ascend through harsh maritime weather environments to gain a closer view of ships and other targets.

Figure 1: MQ-4C Triton's comparative wingspan



Source: Northrop Grumman

Northrop Grumman's current wing supplier for the MQ-4C/RQ-4B is Triumph Group (TGI), which is a US-based NYSE-listed aerospace business that derives ~20-25% of its annual sales from the defence sector. Its other key programmes include the F-35 Lightning II (metal fabrication) CH-47F Chinook (electronic/mechanical controls), and C-130J Hercules (metal fabrication and assembly).

In terms of Australian participation in the global MQ-4C Triton supply chain, we note that Northrop Grumman has to date awarded two contracts. These comprise (i) Ferra Engineering, which has been contracted for mechanical sub-assemblies, and (ii) Mincham Aviation, which has been contracted for structural metal components.

Both companies were procured through the Australian Department of Defence's Global Supply Chain programme. As at mid-2020, the programme comprised eight multinational defence companies, or prime defence contractors, that are able to assess domestic commercial capabilities in the requisite fields, and award contracts on a 'value-for-money' (i.e. competitive) basis.

MQ-4C Triton: A potential opportunity for QHL

While QHL is already Northrop Grumman's largest Australian supplier for the F-35 programme (21 fuselage composite components contract), it is not currently involved in the company's flagship air defence programme, the MQ-4C Triton. That said, we believe there are reasons to expect that QHL could secure a supply role in the programme. These include:

- The Australian Government being a strategic partner in the cooperative development programme, and by extension an active customer of Northrop Grumman, reflecting its current order for three MQ-4C Triton aircraft and indicative 'ultimate' order for six units;
- In line with the Australian Department of Defence's procurement policy, Northrop Grumman's stated intent to "continue to look to offer opportunities (particularly in cables, complex machine and composites assemblies) to Australian companies to be involved in the production of Triton";
- The Australian Government playing a vital role in limiting the potential for MQ-4C Triton production cost blowouts stemming from the US Navy's decision to defer its current purchase order to 2023, by bringing forward production of five of its indicative requirement for six aircraft.

In terms of the latter point, it is estimated that if Australia does commit to purchasing an additional two units (i.e. bringing its total order thus far to five units) then Northrop Grumman would be able to avoid incurring ~US$150m of additional costs associated with pausing production of the MQ-4C Triton for the two-year period to 2023. There are two potential benefits to Australia from doing so:

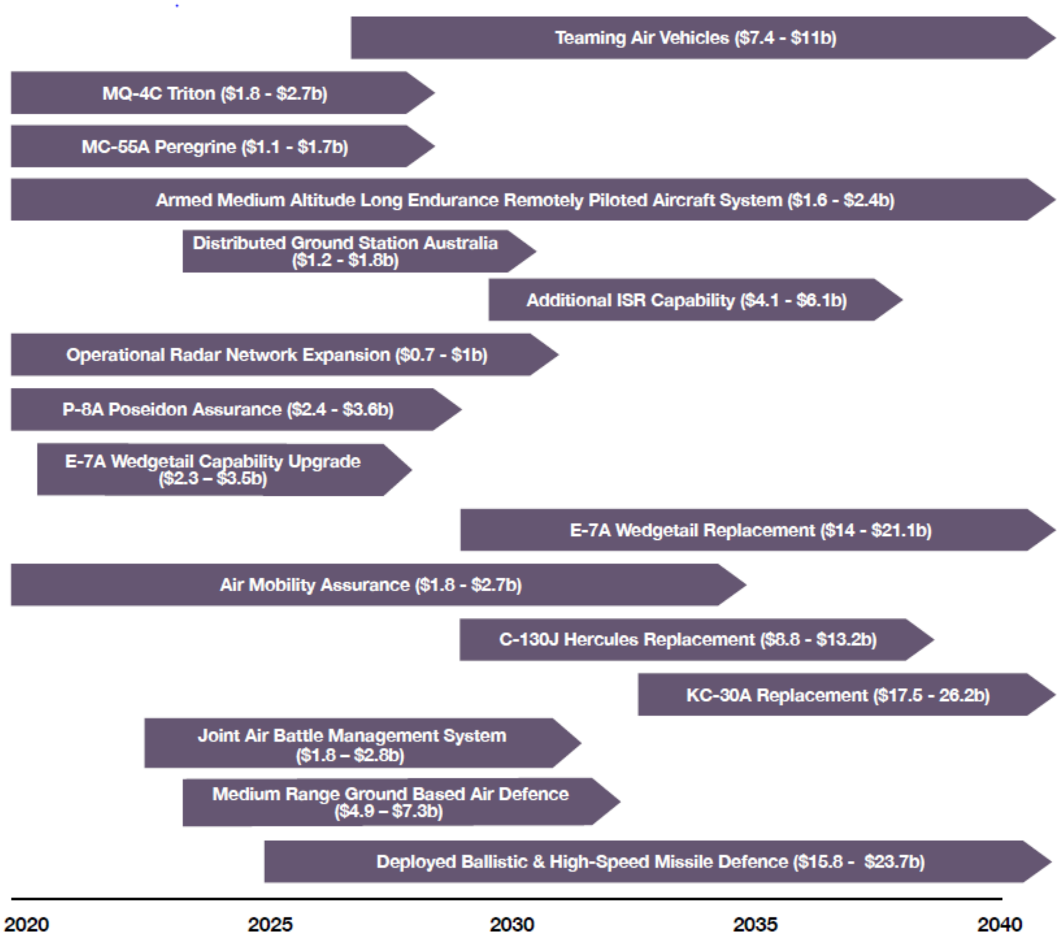
- Potential cost savings for the RAAF, with Northrop Grumman indicating that it is willing to transact at "the lowest price it has ever offered for an unmanned platform" to ensure the production line remains open;
- The potential for the Australian Government to extend this benefit to local industry by lobbying for greater domestic participation in the MQ-4C Triton supply chain, or any other global supply chain for current Northrop Grumman programmes;

In terms of the potential cost savings, it is worth noting that while overall unit numbers are relatively small, each MQ-4C Triton is estimated to cost more than a F-35 Lightning II combat aircraft, the latter of which costs ~US$80m per unit. The high cost per unit is likely to reflect (i) the payload of multi-intelligence capabilities, and (ii) current limited unit orders outside of the US and Australia.

MQ-4C Triton as part of Australia's budgeted ISR capability

As outlined in Figure 2, the Australian Government has allocated A$1.8-2.7bn for the purchase of a fleet (i.e. presumably a fleet of six) MQ-4C Triton aircraft. The planned purchase of these MQ-4C Triton will be (i) complemented by a concurrent investment in P-8A Poseidon and MC-55A Peregrine aircraft, and (ii) supplemented by a budget allocation for additional ISR capability in 2029.

Figure 2: Key Australian air domain ISR investments include the MQ-4C Triton



Source: Australian Department of Defence

Medium-term upside not factored into QHL's share price

Unlike other defence-related stocks under coverage, such as ASB, EOS, and OEC, we estimate that QHL's current share price is factoring in negligible upside for potential new contract wins. This is evident in Figure 3, with our earnings estimates indicating that QHL is trading at a FY21 PER of 12.6 (0.6x PEG), both of which are significantly below key peers.

Figure 3: QHL's company comparisons

Company	EV (A$m)	EV/EBITDA	PER	PEG +	EV/Order Book	Order Book (Years #)
ASB	732.0	4.5	11.7	9.3	0.2	4.0
EOS ^	826.2	21.2	35.1	6.5	1.2	3.0
OEC *	95.5	13.2	20.9	0.1	0.5	3.3
Average		**13.0**	**22.6**	**5.9**	**0.6**	**3.4**
QHL	65.2	6.3	12.6	0.6	0.1	14.1

*Source: Petra Capital, # Weighted average order book duration based on Petra Capital estimates, ^ June year-end adjusted, * Order book based on revenue forecasts, and compares to LTA range of $120-350m 2019-2023, + Based on average three-year EPS growth forecast*

13 November 2020

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Ratings

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