Morgans IN ALLIANCE WITH CIMB

Coffey International

COF AU / COF.AX

FY14 RESULTS NOTE

Market Cap	Avg Daily Turnover	Free Float
US$61.71m	**US$0.05m**	**80.0%**
A$66.52m	A$0.05m	255.8 m shares

Current	A$0.26
Target	A$0.30
Prev. Target	A$0.28
Up/Downside	14.3%

STOCK RATING

ADD

HOLD

REDUCE

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Share price info

Share price perf. (%)	1M	3M	12M
Relative	3.4	19	66
Absolute	2	18.2	73.3

Major shareholders	% held
National Nominees Limited	9.6
Coffey International Employee Leveraged Share Plan Pty Ltd	3.9
ANZ Nominees Limited (Cash Income a/c)	3.9

Operationally in better shape

The key takeaway of the FY14 result was improved working capital management, resulting in a significant improvement in operating cashflow and net debt. Development Assistance remains the reliable performer, whereas difficult Australian operating conditions continues to challenge its Geoservices business. Post restructuring the business is operationally in better shape. However, its exposure to difficult Australian Geoservices markets may inhibit earnings growth. Hold.

Solid result considering conditions

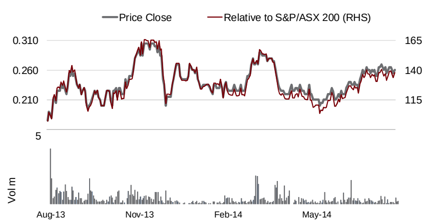
FY14 fee revenue of A$381m and underlying EBITDA of A$26.2m were in line with expectations but down 7.7% and 9.1% on pcp respectively. This result essentially reflects the difficult operating conditions faced by Australian focus Geoservices businesses. Improved working capital management led to a significant improvement in operating cashflow and 17.1% reduction in net debt. Sustained operational efficiency remains key.

Sustained operating efficiency remains key

We believe there is sufficient evidence in this result to suggest that restructuring of the COF business has and will improve operating performance. However, ongoing service demand and competition challenges, specifically in Australia, where its Geoservices business remains predominantly exposed, will continue. Continued focus on cost control and staff utilisation remains key whilst external operating conditions remain uncertain. There remains significant room for margin improvement from circa 6.2% to historic and industry peer levels in excess of 10% (fee revenue), which could accelerate further debt reduction and a share price re-rating.

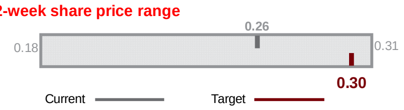
Leveraged to Australian development activity

We continue to seek evidence of the restructuring benefits through improved Geoservice margins. Given the uncertain Australian operating environment this may continue to take longer than expected. As such we again temper our forecasts to reflect ongoing operational uncertainty. Our 12 mth 4.5X EV/EBITDA valuation based target price is A$0.30 per share. In our view, business performance is improving but challenges remain. Strong operating leverage from cycling low margins are in its favour but this now looks to be a function of Australian operating conditions. We maintain our Hold rating.



Source: Bloomberg

52-week share price range



Financial Summary

	Jun-13A	Jun-14A	Jun-15F	Jun-16F	Jun-17F
Revenue (A$m)	686.6	624.9	624.9	640.6	640.6
Operating EBITDA (A$m)	28.80	23.69	27.57	30.44	34.94
Net Profit (A$m)	-0.87	4.37	7.83	9.81	13.49
Normalised EPS (A$)	0.037	0.017	0.031	0.038	0.053
Normalised EPS Growth	26.5%	(53.5%)	79.3%	25.2%	37.4%
FD Normalised P/E (x)	7.07	15.22	8.49	6.78	4.94
DPS (A$)	-	-	0.010	0.010	0.020
Dividend Yield	0.00%	0.00%	3.85%	3.85%	7.69%
EV/EBITDA (x)	4.35	4.87	4.04	3.49	2.81
P/FCFE (x)	NA	11.16	8.63	6.37	4.56
Net Gearing	42.3%	34.3%	30.1%	25.3%	18.8%
P/BV (x)	0.49	0.48	0.45	0.43	0.41
ROE	7.00%	3.16%	5.48%	6.55%	8.52%
% Change In Normalised EPS Estimates			(18.1%)	(14.7%)	(3.2%)
Normalised EPS/consensus EPS (x)			0.78	0.85	1.20

SOURCE: MORGANS, COMPANY REPORTS

Figure 1: COF Financial Summary

Profit and loss	Jun-13A	Jun-14A	Jun-15E	Jun-16E	Jun-17E
Revenue	686.6	624.9	624.9	640.6	640.6
Gross Profit	28.8	23.7	27.6	30.4	34.9
Total Operating Costs	0.0	0.0	0.0	0.0	0.0
EBITDA	28.8	23.7	27.6	30.4	34.9
Depreciation	-7.3	-7.7	-7.7	-7.7	-7.7
Amortisation & impairments	-2.1	-1.5	-1.5	-1.4	-1.4
EBIT	19.4	14.5	18.4	21.3	25.8
Net Interest Income	-10.0	-8.1	-6.4	-6.4	-6.4
Pre-tax Profit	9.4	6.4	12.0	14.9	19.5
Tax	-0.1	-1.9	-4.1	-5.0	-5.9
Reported Profit	-0.9	4.4	7.8	9.8	13.5
Exceptional items	10.3	0.0	0.0	0.0	0.0
Normalised Profit	9.4	4.4	7.8	9.8	13.5

Cash flow statement	Jun-13A	Jun-14A	Jun-15E	Jun-16E	Jun-17E
EBITDA	28.8	23.7	27.6	30.4	34.9
Net interest	-10.0	-8.1	-6.4	-6.4	-6.4
Tax	-0.1	-1.9	-4.1	-5.0	-5.9
Changes in working capital	-0.6	7.3	-1.6	-0.9	-0.4
Operating cash flow	18.1	20.9	15.4	18.1	22.3
Capex	-7.8	-9.4	-7.7	-7.7	-7.7
Free Cash Flow	10.3	11.5	7.7	10.4	14.6
Acquisitions and divestments	0.2	1.4	0.0	0.0	0.0
Other Investing cash flow	-10.3	-7.7	-7.7	-10.4	-14.6
Investing cash flows	-7.5	-4.2	-7.7	-7.7	-7.7
Increase / decrease in Equity	0.0	0.0	0.0	0.0	0.0
Increase / decrease in Debt	-18.9	-10.8	0.0	0.0	0.0
Dividends paid	0.0	0.0	-1.2	-2.6	-3.7
Other financing cash flows	-3.3	-2.7	-2.7	-2.7	-2.7
Financing cash flows	-22.2	-13.5	-3.8	-5.2	-6.4

Balance Sheet	Jun-13A	Jun-14A	Jun-15E	Jun-16E	Jun-17E
Assets					
Cash And Deposits	30.7	28.9	32.8	38.0	46.2
Debtors	103.6	77.1	82.2	84.2	84.2
Inventory	0.0	0.0	0.0	0.0	0.0
Other current assets	35.6	39.2	39.2	39.2	39.2
Total Current Assets	169.9	145.2	154.2	161.5	169.7
Fixed Assets	25.5	32.7	32.7	32.7	32.7
Investments	0.0	0.0	0.0	0.0	0.0
Goodwill	0.0	0.0	0.0	0.0	0.0
Intangibles	111.2	110.7	109.3	107.8	106.4
Other non-current assets	18.7	22.0	22.0	22.0	22.0
Total Non-Current Assets	155.4	165.5	164.1	162.6	161.2
TOTAL ASSETS	325.3	310.7	318.2	324.1	330.8
Liabilities					
Short Term Debt	5.1	7.1	3.8	3.8	3.8
Creditors	59.6	50.5	54.0	55.2	54.8
Other current liabilities	33.2	29.7	27.2	24.6	22.0
Total Current Liabilities	97.9	87.4	85.0	83.6	80.6
Long Term Debt	83.6	69.9	73.1	73.1	73.1
Other Debt (inc hybrids)	0.0	0.0	0.0	0.0	0.0
Other Non curren liabilities	6.5	11.1	11.1	11.1	11.1
Total Non -Current liabilities	90.1	81.0	84.2	84.2	84.2
TOTAL LIABILITIES	188.0	170.4	171.3	169.9	166.9
Equity					
Issued capital	0.0	0.0	0.0	0.0	0.0
Retained earnings	0.3	19.7	19.7	19.7	19.7
Other reserves and FX	136.9	120.6	127.3	134.5	144.3
TOTAL EQUITY	137.2	140.3	146.9	154.2	164.0

Valuation details			
Share Price	$0.26	Market Cap	A$66.5m
Price Target	$0.30		
Total shareholder return	18.1%		

Key metrics/ multiples	Jun-14A	Jun-15E	Jun-16E	Jun-17E
P/E	15.2	8.5	6.8	4.9
Yield	0.0%	3.8%	3.8%	7.7%
PEG	0.0	0.1	0.3	0.1
EV/EBITDA	4.8	4.0	3.5	2.8
Price/ Book Value	0.5	0.5	0.4	0.4
Price/ Net Tangible Assets	2.3	1.8	1.5	1.2
Operating cash flow yield	31.5%	23.2%	27.2%	33.5%
Free cash flow yield	17.3%	11.6%	15.7%	21.9%

Per share data	Jun-14A	Jun-15E	Jun-16E	Jun-17E
Diluted shares on issue	255.8	255.8	256.0	256.1
Reported EPS (A$)	0.02	0.03	0.04	0.05
Normalised EPS (A$)	0.02	0.03	0.04	0.05
Dividends per share (A$)	0.00	0.01	0.01	0.02
Payout ratio	0.0%	32.7%	26.1%	38.0%

Result quality	Jun-14A	Jun-15E	Jun-16E	Jun-17E
Cash flow conversion	130.7%	94.1%	97.0%	98.8%
FCF vs. NPAT	263.4%	98.4%	106.5%	108.2%
Gross dividends vs FCF	0.0%	0.0%	0.0%	0.0%

Gearing	Jun-14A	Jun-15E	Jun-16E	Jun-17E
Net Debt	48.08	44.18	38.97	30.76
Net Debt / Equity	34.3%	30.1%	25.3%	18.8%
Net Debt / EBITDA (x)	2.03	1.60	1.28	0.88
EBIT interest cover (x)	-1.78	-2.88	-3.34	-4.06
Invested Capital	195.6	189.5	192.3	194.3
Enterprise Value	114.6	110.7	105.5	97.3

Growth ratios	Jun-14A	Jun-15E	Jun-16E	Jun-17E
Revenue	-9.0%	0.0%	2.5%	0.0%
EBITDA	-17.7%	16.4%	10.4%	14.8%
EBIT	*-25.4%*	*27.2%*	*15.6%*	*21.2%*
NPAT	-53.5%	79.3%	25.3%	37.4%
EPS growth	-599.9%	79.3%	25.2%	37.4%
DPS growth	na	#DIV/0!	0.0%	100.0%
Operating cash flow	15.7%	-26.2%	17.3%	22.9%

Margin analysis	Jun-14A	Jun-15E	Jun-16E	Jun-17E
EBITDA Margin	3.8%	4.4%	4.8%	5.5%
EBIT margin	2.3%	3.0%	3.3%	4.0%
NPAT margin	0.7%	1.3%	1.5%	2.1%
ROE	3.1%	5.3%	6.4%	8.2%
ROIC	7.4%	9.7%	11.1%	13.3%
ROE less WACC	3.1%	5.3%	6.4%	8.2%
ROIC less WACC	7.4%	9.7%	11.1%	13.3%

SOURCES: MORGANS, COMPANY REPORTS

1. FY14 result summary

- **Revenue:** FY14 fee revenue of A$381.0m was 7.3% down on the pcp, but in line with our forecast A$385.3m. Total revenue A$628m was similarly down 8.8% on the pcp but in line with our expectations. As expected COF was impacted by challenging Australian operating conditions, particularly with respect to demand for Geoservices. Around 70% of COF's Geoservice fee revenue is derived from Australia. Difficult operating conditions in Australia led to project cancellations and deferrals.

- **Operating EBITDA:** FY14 underlying EBITDA of A$26.2m was down on FY13 (A$28.8m) and in line with our forecast A$26.8m. Ongoing market challenges and increased competition, particularly in Australia, has led to continued and slightly greater than expected margin pressures. COF reported a FY14 underlying EBITDA margin (to fee revenue) of 6.2%, lower than the FY13 EBITDA margin, and our FY14 forecast, of 7.0%. COF has previously stated that its target EBITDA / Fee revenue margin is 15% plus, based on historical margins and margins achieved by similar consultants. To achieve this target COF has restructured and resized the business, which it believes is now largely complete. Management indicated that continued management discipline and stabilising conditions should enable margins to return to historical levels. We believe Australian operating conditions will remain challenging in the near term. Hence, we continue to forecast margin management to be one of COF's greatest challenges going forward.

- **NPAT:** COF reported an NPAT of A$4.4m, an improvement on the A$1m loss in FY13. The NPAT was lower than our forecast A$7m reflecting the lower than forecast margins.

- **Dividend:** No dividend was declared. Given its return to profitability the lack of a dividend reflects the poor earnings visibility in our view. We forecast a 1cps FY15 dividend reflecting a pay-out ratio of 65%, but this will be dependent upon stabilisation and improvement in its operating outlook.

- **Balance sheet and operating cash flow:** Operating cash flow was A$20.9m, higher than FY13 (A$18.1m) and materially higher than our forecast A$5.2m. Operating cash flow to EBITDA was 88% a significant improvement from 42% reported for the 1H14 and 63% reported for FY13. The poorer conversion in the prior periods reflected the restructuring costs. However, 2H14 delivered a significant improvement in working capital management with working capital days down to 54 from 61 in FY13. Improved operating cashflow led to a material reduction in gearing (net debt/net debt plus equity) to 25.6% from 30% as at 1H14. Total debt reduced by A$3m on pcp. However, net debt decreased to A$48m from A$61.4m at 1H14 reflecting improved working capital management. The improvement in balance sheet gearing was a result highlight. Ongoing improvement in working capital management will be difficult and continued debt reduction will most likely be driven by improved operating activity. However, our forecasts expect management to remain diligent and maintain good working capital management performance going forward. We seek continued balance sheet improvement and would be more positive on COF at a net debt to EBITDA closer to 1x (currently 1.83x) and EBITDA to net interest cover in excess of 4x (currently 2.5x).

- **Outlook:** No specific guidance given. It was highlighted that 12 month net contracted fee revenue remained relatively stable to previous halves suggesting relatively stable revenue going forward. Although we do note a reduction in contracted Geoservices revenue highlights the difficult operating conditions, it was encouraging that staff numbers, particularly sales focussed services, had stabilised over the past 6 months indicating that the majority of COF's restructuring is complete. Following overhead reductions and business rightsizing we seek and would expect further evidence of the operating efficiency benefits via progressive margin improvement. COF note that it will provide ongoing quarterly updates.

2. Divisionals

- **Geoservices:** Fee revenue was down 19% on FY13 reflecting the continued slowdown in resource and infrastructure project activity, particularly in Australia. Notably fee revenue in its overseas businesses was up 25% on FY13. Allowing for restructuring costs, reported EBITDA margins improved from -1% in 2H13 to 4% in 2H14. The majority of COF's revenue continues to be sourced from Australia (70%). COF note that 17% of its revenue is derived from the mining sector, 35% from Infrastructure and 24% from Oil & Gas. The divisional EBITDA improvement looks primarily associated with previous restructuring of the division reflecting reduced activity. Margin performance remains well below historical levels of 12% plus. Staff utilisation remains key to continued margin growth and will need continued close monitoring with respect to activity levels to maintain margins and grow, in our view. We forecast flat revenue growth and improved EBITDA margin to 7% (on fee revenue) in FY15. However, in the current operating environment there is significant risk to our earnings forecasts.

- **International Development:** Revenue was in line with the previous half, which was a record half. Substantial year on year growth was driven by increases to the UK aid budget and additional revenue from its US operations. FY14 EBITDA margins remained stable at 6% of total revenue, in line with historical margins. COF did note some transition challenges with the Australian governments reorientation of aid funding towards diplomacy, trade and security. However, COF remains optimistic that continued focus on health and education projects aligns with key COF competencies. COF's 12 month contracted fee revenue at June 2014 A$230m and augurs well as it is higher than fee revenue contracted in previous halves. We forecast relatively stable revenue and margin growth going forward.

- **Project Management:** This division is leveraged to the commercial property market. A return to profitability was the key takeaway here. Although revenue of A$22.1m was down on FY13 (A$28.7m) the division reported a positive EBITDA contribution of A$0.8m. This was in line with our expectations but remains relatively small in scale and reliant on an improved commercial property market.

3. Changes to forecasts

Figure 2: Changes to forecasts

(A$m)	FY14F	FY14A	% chg	FY15F old	FY15F new	% chg	FY16F old	FY16F new	% ch
Fee revenue	385.3	381.0	-1.1%	396.8	381.0	-4.0%	406.8	390.5	-4.0
Underlying EBITDA	26.8	23.7	-11.6%	30.6	27.6	-9.8%	33.4	30.4	-8.9
EBITDA margin	7.0%	6.2%	-10.6%	7.7%	7.2%	-6.0%	8.2%	7.8%	-5.1
Underlying NPAT	7.0	4.4	-37.6%	9.5	7.8	-17.9%	11.5	9.8	-14.5
EPS (c)	2.8	1.7	-38.0%	3.7	3.1	-18.1%	4.5	3.8	-14.7
DPS (c)	1.0	0.0	-100.0%	2.0	1.0	-50.0%	2.0	1.0	-50.0
Gearing	30.6%	25.6%	-5.0%	30.2%	23.2%	-6.9%	28.8%	20.2%	-8.6

SOURCES: Morgans, COMPANY REPORTS

In the current Australian operating environment Geoservice forecasting remains difficult. We continue to seek evidence of the restructuring benefits through improved Geoservice margins. However, given the tough operating conditions this may continue to take longer than expected. As such we again temper our forecasts to reflect ongoing operational uncertainty. Business transparency and financial control has improved over the past few years as is evident from its relatively strong operational cashflow management performance. However challenging market conditions may continue to frustrate and delay a turnaround in profit performance.

4. Investment view

Improved working capital management and lower debt were the key result takeaways and a sign that the business is on a sound footing. However, before we become more positive we continue to seek further evidence (through improved margins) of sustained operational efficiency and productivity improvements. We believe this is of particular importance as we would like to see a continued improvement in COF's debt metrics. COF's exposure to difficult Australian Geoservice markets remains the key risk. As such we maintain our Hold rating on COF.

Given our view that earnings transparency is limited we continue to value the business on a EV/EBITDA basis (4.5x 12 month forward). This is our preferred methodology for COF given the turnaround nature of the business, its gearing level and lack of long term earnings visibility. Adjustments to our forecast and rolling forward our valuation means our price target is now A$0.30 per share (from A$0.28). Risks to our recommendation include further restructuring and a change in operating conditions resulting in a change to staff activity and utilization levels. Any significant reversal in operating cashflow would increase balance sheet pressure and increase market funding concerns.

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