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DroneShield Limited (DRO)

A game of two halves

Recommendation

Buy (unchanged)

Price

\$1.17

Target (12 months)

\$1.35 (previously \$1.25)

Sector

Capital Goods

Expected Return

Capital growth	15.4%
Dividend yield	0.0%
Total expected return	15.4%

Company Data & Ratios

Enterprise value	\$798.3m
Market cap	\$1,020.3m
Issued capital	872.1m
Free float	94%
Avg. daily val. (52wk)	\$11.3m
12 month price range	\$0.25 - \$2.72

Price Performance

	(1m)	(3m)	(12m)
Price (A\$)	1.48	0.90	0.31
Absolute (%)	-20.68	30.73	277.42
Rel market (%)	-21.99	28.07	264.80

Absolute Price



SOURCE: IRESS

Bottom-line earnings miss to BPe

DRO recorded revenue from customers of \$23.3m (+106% vs pcp) during the 1H24, -3% below BP estimates. Gross margin (71.6%) was largely in-line with BPe however opex (-\$22.7m) was materially greater than our estimates (-\$18.5m) and was the primary reason for the miss at the bottom line. This included share-based payment expenses of -\$2.7 million, an increase of 207% relative to 1H23 of -\$0.8m. DRO recorded EBITDA of -\$5.2m (vs BPe -\$1.1m) and a net loss after tax of -\$4.8m (vs BPe -\$1.6m), excluding the share-based payment expense the net loss after tax was \$2.1m. The company had a cash balance of \$230m as of 23-Aug-24, with no core debt or convertibles.

Focus remains on 2H

The company entered the 2H with a contracted backlog of \$32m and sales pipeline of \$1.1b, including 33 projects valued over \$5m each and the largest valued at \$213m. We remain confident the company will deliver a significantly improved 2H performance based on 1) the significant level of inventory on hand to facilitate rapid fulfilment, 2) the historical seasonality of the business with >80% of CY23 revenue recorded in the 2H and 3) numerous near-term sales opportunities, including recently announced military aid packages (see previous report 22-Jul-24).

Investment View: 8% increase in PT to \$1.35

We have made no changes to our revenue forecasts at this stage, whilst we have made minor changes to operating expenses, cash flows and working capital in-line with today's result. Our EPS changes are -6% and +2% in CY24 and CY25, respectively. We have reassessed our valuation assumptions and determined they are overly conservative considering the well capitalised balance sheet (we made no changes post the recent capital raise) and the recent re-rating of mid-cap defence peers. As such, we have increased the multiples we apply in our EV/EBITDA and PE valuations to 26x and 36x, respectively. The net result is an 8% increase in our PT to \$1.35, which is >15% premium to the share price so we retain our buy recomm.

Earnings Forecast

Year End 31 Dec	CY23	CY24e	CY25e	CY26e
Revenue (\$m)	54.1	97.4	129.2	162.9
EBITDA (\$m)	3.7	19.5	31.7	53.8
NPAT (underlying) (\$m)	9.2	18.6	27.3	46.1
NPAT (reported) (\$m)	9.2	18.6	27.3	46.1
EPS (cps)	1.7	2.3	3.0	5.0
EPS growth (%)	NM	0.4	26%	69%
PE (x)	68.7	50.0	39.6	23.4
FCF Yield (%)	NM	-6%	1%	1%
EV/EBITDA (x)	258.6	49.4	30.4	17.9
Dividend (eps)	0.0	0.0	0.0	0.0
Yield (%)	0.0	0.0	0.0	0.0
Franking (%)	0.0	0.0	0.0	0.0
ROE(%)	12%	6%	8%	12%

SOURCE: BELL POTTER SECURITIES ESTIMATES

1H24 Result

1H24 Result summary

A summary of the 1H24 result is show below.

Figure 1 - 1H24 result summary

Year end 31 Dec	Result vs PCP			Result vs Forecast		Comment
	1H CY23	1H CY24	Change	1H CY24e	Variance	
Revenue (A\$m)	11.3	23.3	107%	24.1	-3%	Pre-released. Miss based on "other income."
Cost of Goods Sold	-2.3	-6.6		-6.7		
Gross profit	8.9	16.7	87%	17.4	-4%	Gross margin (71.6%) was largely in-line with BPe
Total expenses	-12.5	-22.7	81%	-18.5	-23%	share-based payment expenses of -\$2.7 million
EBITDA	-2.5	-5.2	-108%	-1.1	-350%	Miss to Bpe based on increased opex.
Total Depreciation & Amortisation	-0.7	-0.7		-1.1		
EBIT	-3.2	-5.9	-83%	-2.3	-159%	
Net interest/(expense)	0.2	0.7		0.5		
Profit before tax	-3.0	-5.2	73%	-1.8	-189%	
Income tax benefit/(expense)	0.0	0.4		0.2		
NPAT	-3.0	-4.8	-59%	-1.6	-205%	Large miss to Bpe.
<i>Gross margin</i>	79.2%	71.6%	-758bps	72.0%	-38bps	
<i>EBITDA margin</i>	-22.0%	-22.2%	-16bps	-4.8%	-1742bps	
<i>NPAT margin</i>	-26.7%	-20.6%	614bps	-6.5%	-1408bps	
Diluted EPS	-0.6c	-0.8c	-26%	-0.2c	-291%	
Dividend	0.0c	0.0c	NM	0.0c	NM	No dividend expected.

SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

The key take-outs are:

- **Revenue pre-released:** DRO recorded revenue from customers of \$23.3m (+106% vs pcg) during the 1H24, -3% below BP estimates. The miss to our estimate was based on other income included in the pre-released revenue figure.
- **Gross margin:** Gross margin (71.6%) was largely in-line with BPe and we anticipate further margin expansion as SaaS revenues increase as a proportion of the overall figure.
- **Scale up drives higher opex:** Operating expenses (-\$22.7m) were materially greater than our estimates (-\$18.5m) and were the primary reason for the miss at the bottom line. This included share-based payment expenses of -\$2.7 million, an increase of 207% relative to 1H23 of -\$0.8m.
- **Miss at EBITDA and NPAT:** DRO recorded EBITDA of -\$5.2m (vs BPe \$1.1m) and a net loss after tax of -\$4.8m (vs BPe \$1.6m), excluding the share-based payment expense the net loss after tax was \$2.1m.
- **Cash:** The company had a cash balance of \$230m as of 23-Aug-24, with no core debt or convertibles.

Forecast and Valuation Changes

Changes to forecasts

We have made no changes to our revenue forecasts at this stage, whilst we have made minor changes to operating expenses, cash flows and working capital in-line with today's result.

We remain confident the company will deliver a significantly improved 2H performance based on 1) the significant level of inventory on hand to facilitate rapid fulfilment, 2) the historical seasonality of the business with >70% of CY23 revenue recorded in the 2H and 3) numerous near-term sales opportunities including recently

Our EPS changes are -6% and +2% in CY24 and CY25, respectively

A summary of the changes in our key forecasts is how below.

Figure 2 - Change in key forecasts

Year end 31 Dec	CY24e	Change	CY25e	Change	CY26e	Change
Total revenue (A\$m)	97.4	no change	129.2	no change	162.9	no change
EBITDA	19.5	-9%	31.7	9%	53.8	no change
Reported NPAT	18.6	-7%	27.3	3%	46.1	no change
Diluted EPS	2.3c	-6%	3.0c	2%	5.0c	-2%
DPS	0.0c	no change	0.0c	no change	0.0c	no change

SOURCE: BELL POTTER SECURITIES ESTIMATES

8% increase in PT to \$1.35

We have updated each valuation used in the determination of our price target for the earnings changes as well as market movements and time creep.

We have reassessed our valuation assumptions and determined they are overly conservative considering the well capitalised balance sheet (we made no changes post the recent capital raise) and the recent re-rating of mid-cap defence peers. As such, we have increased the multiples we apply in our EV/EBITDA and PE valuations to 26x and 36x, respectively.

There are no changes to our DCF assumptions, which are a 9.5% WACC and 4.5% TGR.

The change in each valuation and the impact on our PT calculation is shown below.

Figure 3 - Change in valuations and impact on PT

	Old (as at 08-Aug-24)			New (as at 27-Aug-24)		
	Valuation per share	% weighting	Price target	Valuation per share	% weighting	Price target
Methodology						
DCF	\$ 1.74	33%	\$ 0.57	DCF	\$ 1.72	33% \$ 0.57
EV/EBITDA	\$ 1.08	33.0%	\$ 0.36	EV/EBITDA	\$ 1.21	33% \$ 0.40
PE Ratio	\$ 0.99	33.0%	\$ 0.33	PE Ratio	\$ 1.13	33% \$ 0.37
Total			\$ 1.25			\$ 1.35

SOURCE: BELL POTTER SECURITIES ESTIMATES

DroneShield Limited (DRO)

Company Description

DroneShield Limited (DRO) is an Australian defence manufacturer specialising in counter-drone technology. DRO provides an end-to-end counter-drone solution that integrates proprietary artificial intelligence software with a suite of hardware products utilised to detect, identify and defeat aerial, ground and maritime threats. The company's products are largely in-house technology and include handheld, vehicular and fixed installations. DRO's customers primarily include military and intelligence, as well as law enforcement, critical infrastructure and commercial parties globally.

DroneShield was founded in the U.S on the 10th January 2014. The company quickly shifted its operations to Australia with the goal of listing on the ASX, which occurred on the 4th November 2015.

Investment Thesis

We retain our BUY recommendation on DroneShield. Our investment thesis is based on:

- **Valuation:** Our 12-month price target on DroneShield is \$1.35. The price target is generated from a blend of three valuation methodologies we apply to the company: EV/EBITDA, PE ratio and DCF. The price target is a >15% premium to the current share price and the total expected return is the same given there is no forecast dividend yield so we retain our BUY recommendation.
- **Solid revenue momentum:** DRO has demonstrated strong earnings momentum in recent periods, with CY23 revenue (\$55.1m) increasing +228% YoY. We believe this momentum is likely to continue in CY24 based on a \$28m contracted order backlog and \$1.1b sales pipeline.
- **Structural growth in the market:** Increasing hostilities globally are broadly driving a significant increase in defence budgets with aggregate military expenditure exceeding \$2.4 trillion USD in 2023. Asymmetric warfare, including drones and counter-drone defence, is one of the fastest growing subsets within this growing military market - the core competency of DRO.
- **Opportunity for expansion into adjacent markets:** DRO's experience with AI/ML technologies in the counter-drone market has provided the opportunity to apply its capabilities to the broader field of Electronic Warfare, which has the potential to be an extremely lucrative opportunity for the company to expand outside its core business.

Key Risks

Key downside risks to our estimates and valuation include (but are not limited to):

- **Failure to retain existing clients or attract new customers:** Failure to retain existing customers or attract new customers will severely impact revenue growth and the overall financial performance of the company.
- **Research & Development Risk:** If the company lags the rest of the market in its product development it may have an adverse effect on the company's future operations.
- **Competition Risk:** DRO operates in a competitive market including large multi-national defence contractors who have extensive resources and scale.

Table 1 - Financial summary

Profit & Loss (A\$m)						Dronesield Limited					Year End 31 Dec	
	CY22	CY23	CY24e	CY25e	CY26e							
Year Ending 30 June						Share Price:	\$1.17	Target Price:		\$1.35		
Revenue	16.8	54.1	97.4	129.2	162.9	No. of issued shares (m):	872.1	Market cap:		\$1,020.3m		
<i>Change</i>	<i>59%</i>	<i>222%</i>	<i>80%</i>	<i>33%</i>	<i>26%</i>							
Cost of sales	(5.0)	(15.1)	(27.3)	(35.5)	(44.0)							
Gross profit	11.8	39.0	70.1	93.7	118.9							
<i>Gross margin</i>	<i>70.4%</i>	<i>72.0%</i>	<i>72.0%</i>	<i>72.5%</i>	<i>73.0%</i>							
Expenses (excl. D&A, int.)	(15.1)	(36.4)	(50.6)	(62.0)	(65.2)							
EBITDA	(2.0)	3.7	19.5	31.7	53.8							
Depreciation and amortisation	(0.9)	(1.5)	(2.2)	(4.3)	(4.7)							
EBIT	(2.9)	2.2	17.3	27.3	49.0							
Net interest (expense)/revenue	0.0	0.9	1.2	0.9	0.9							
Pre-tax profit	(2.9)	3.1	18.4	28.3	50.0							
Income tax benefit /(expense)	2.0	6.2	0.2	(1.0)	(3.9)							
Reported NPAT	(0.9)	9.2	18.6	27.3	46.1							
Cashflow (A\$m)						Valuation Ratios						
EBITDA	(2.0)	3.7	19.5	31.7	53.8	Basic EPS (cps)	(0.2)	1.7	2.5	3.1	5.3	
(-) Change in working capital	1.8	(7.5)	76.0	15.0	30.3	Diluted EPS (cps)	(0.2)	1.7	2.3	3.0	5.0	
Gross cash flow	(3.9)	11.2	(56.5)	16.7	23.4	<i>EPS growth (%)</i>	<i>NM</i>	<i>NM</i>	<i>45%</i>	<i>25%</i>	<i>69%</i>	
Income tax refunded/(paid)	2.1	(1.7)	0.2	(1.0)	(3.9)	PE(x)	NM	68.7	50.0	39.6	23.4	
Operating cash flow	(1.8)	9.5	(55.2)	16.6	20.5	EV/Sales (x)	57.3	17.8	9.9	7.5	5.9	
Payments for PPE	(0.8)	(1.7)	(3.1)	(5.4)	(5.9)	EV/EBITDA (x)	NM	258.6	49.4	30.4	17.9	
Payments for capitalised R&D	-	-	(14.4)	(36.0)	(21.6)	EV/EBIT (x)	NM	442.5	55.8	35.2	19.6	
Investing cash flow	(0.8)	(2.0)	(26.8)	(41.4)	(27.5)	FCF per share	NM	NM	(6.7)	1.3	1.7	
Net Proceeds from issue of shares	3.7	39.7	223.2	-	-	FCF yield %	NM	NM	-6%	1%	1%	
Proceeds/ (repayments) of borrowings	-	-	-	-	-	NTA per share (\$ps)	0.04	0.12	0.38	0.41	0.46	
Payment of lease liabilities	(0.6)	(0.6)	-	-	-	P/NTA (x)	27.8	9.6	3.1	2.9	2.5	
Other	0.0	(0.0)	7.8	-	-	Book value (\$ps)	0.04	0.12	0.38	0.41	0.46	
Financing cash flow	3.1	39.1	231.0	-	-	Price/Book (x)	27.8	9.6	3.1	2.9	2.5	
Net change in cash	0.5	46.6	149.0	(24.8)	(7.0)	DPS (cps)	0.0	0.0	0.0	0.0	0.0	
Cash at start of period	9.4	10.1	56.7	211.9	187.1	Payout ratio %	0.0%	0.0%	0.0%	0.0%	0.0%	
Exchange rate impact	0.2	(0.1)	6.2	-	-	Dividend Yield %	0.0%	0.0%	0.0%	0.0%	0.0%	
Cash at end of period	10.1	56.7	211.9	187.1	180.1	Performance Ratios						
Balance Sheet (A\$m)						EBITDA Margin (%)	NM	NM	20.0%	24.5%	33.0%	
Cash and cash equivalents	10.3	63.6	230.2	205.4	198.4	EBIT Margin (%)	NM	NM	17.7%	21.2%	30.1%	
Trade and other receivables	8.3	8.9	22.2	28.8	40.4	NPAT Margin (%)	NM	NM	19.1%	21.1%	28.3%	
Inventories	3.7	18.6	88.9	102.2	129.2	Net debt/(cash)	NM	NM	(222.0)	(197.2)	(190.2)	
PPE	2.4	4.0	7.7	8.8	10.0	ROE (%)	NM	NM	5.7%	7.7%	11.5%	
Capitalised R&D	-	-	14.4	50.4	72.0	Segmentals (A\$m)						
Right-of-use assets	0.5	1.9	4.7	4.7	4.7	Revenue						
Total assets	25.2	97.1	368.2	400.3	454.7	Hardware sales	14.5	47.3	90.0	117.0	140.4	
Trade and other payables	0.6	3.5	11.1	16.0	24.2	R&D Revenue	1.5	4.1	3.6	5.4	5.9	
Lease Liabilities	0.5	2.6	6.6	6.6	6.6	Subscription services	0.3	1.4	2.5	5.5	15.3	
Provisions	0.5	0.7	1.1	1.1	1.1	Other Revenue	0.5	1.3	1.3	1.3	1.3	
Borrowings	0.1	-	-	-	-	Total Revenue	16.8	54.1	97.4	129.2	162.9	
Other	4.6	15.7	22.1	22.1	22.1	<i>Revenue Breakdown</i>						
Total liabilities	6.2	22.5	40.9	45.8	54.0	<i>Hardware sales</i>	<i>86%</i>	<i>87%</i>	<i>92%</i>	<i>91%</i>	<i>86%</i>	
Net Assets	19.0	74.5	327.3	354.5	400.6	<i>R&D Revenue</i>	<i>9%</i>	<i>8%</i>	<i>4%</i>	<i>4%</i>	<i>4%</i>	
Share capital	40.5	80.4	311.4	311.4	311.4	<i>Subscription services</i>	<i>2%</i>	<i>3%</i>	<i>3%</i>	<i>4%</i>	<i>9%</i>	
Other reserves	5.1	5.5	7.2	7.2	7.2	<i>Other Revenue</i>	<i>3%</i>	<i>2%</i>	<i>1%</i>	<i>1%</i>	<i>1%</i>	
Accumulated losses	(26.6)	(11.3)	8.7	36.0	82.1							
Total shareholders' equity	19.0	74.5	327.3	354.5	400.6							

SOURCE: BELL POTTER SECURITIES ESTIMATES

Recommendation structure

Buy: Expect >15% total return on a 12 month view. For stocks regarded as 'Speculative' a return of >30% is expected.

Hold: Expect total return between -5% and 15% on a 12 month view

Sell: Expect <-5% total return on a 12 month view

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