



## SCOTTY GROUP

**BUY\***

### H1 Results and initiation of coverage

**8p#**

Year-end December	2010A	2011E	2012E	2013E
Revenue (£000)	4,921	6,500	7,500	8,400
EBITDA (£000)	537	974	1,222	1,610
Adj. Pre-tax Profit (£000)	147	818	1,080	1,490
Adj. EPS (p)	1.3	3.0	3.9	5.0
DPS (p)	0.0	0.0	0.0	0.0
Net Cash/(Debt) (£000)	228	559	1,391	2,469
P/E (x)	6.1	2.6	2.0	1.6
Dividend yield (%)	0.0%	0.0%	0.0%	0.0%
EV/EBITDA (x)	-0.4	-0.6	-1.1	0.0

Key Data	
Rating (12 month)	Buy
Price Target	15p
Risk	High
Sentiment	Positive
Ticker	SCO.L
Shares in issue	27.7m
Market cap	£2.2m
12-mth price range	20 p-4.5p
Net cash	£0.6m
Next event	June Prelims

SOURCE: Northland Capital Partners Limited estimates

#Priced at market close, 27 Sept 2011

\*Northland Capital Partners Limited is the Broker to Scotty Group and therefore this information should be viewed as Marketing Material.

H1 results show marked improvement over last year; revenues up 24% to £2.1m (2010: £1.7m) and Loss before tax at £0.1m sharply improved from last year's £0.6m. Scotty will again see the bulk of revenues and earnings in H2 but is continuing to win new orders both for airborne and land based systems. Strong technical expertise, high barriers to entry for military communication systems and high margins means Scotty already ticks many boxes but a return to profits and cash flow again in H2 would reinforce its good value. On 2.6x FY11 forecast EPS and 2.0x FY12 Scotty's share price more than discounts limited visibility and fails to reflect its advantages and potential in an uncertain stock market. We initiate with a BUY and a 15p price target.

#### COMPANY DESCRIPTION

Scotty Group provides advanced encrypted video, voice and data communication systems including Beyond Line of Sight video surveillance systems for airborne, land and marine applications primarily to military and government end users.

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- Progress this year includes completion of the initial order from Diamond Aircraft for an Asian government, expected to be followed with a ground station order and continued work on the upgrade programme for Germany's CH53 helicopters and latterly a vehicle based system worth €1.4m.
- Scotty has steadily widened the range of aircraft its systems are qualified for and has broadened its customer base. This should allow it to secure new orders and increase both revenues and earnings although timing and visibility of such increases remains uncertain.
- Scotty also put in train cost saving measures to reduce costs by £0.25m, which will take effect fully in FY12 and include the relocation of the headquarters to Graz and the switch to being a European company.



## INVESTMENT APPRAISAL

**Investing in a defence business may seem counter intuitive in an era of cuts but Scotty is involved in programmes which should drive revenue growth. Scotty also ticks a lot of boxes; it has a high degree of technical expertise, high barriers to entry, it operates in niche markets uncontested by main contractors, margins are high and each contract generates regular, high margin service revenues. Contracts are admittedly lumpy and visibility sometimes limited; we have therefore been conservative with forecasts and any major contract win could lead to upgrades. On forecast PBT of £0.8m for FY11 and £1.1m FY12, Scotty trades on a PER of 2.6x FY11 EPS of 3p and 2.0x FY12 EPS of 3.9p, which discounts a great deal of uncertainty and takes virtually no account of future earnings potential.**

**Technical expertise, high barriers to entry and high margins**

H1 results show a big improvement over last year, with turnover up 24% to £2.1m (2010: £1.7m) and LBT reduced to £0.1m from £0.6m. Administrative costs were held below the level of last year but we expect further progress in H2 and the full impact of reducing corporate overheads to be felt in 2012, with a reduction in the region of £0.25m.

Scotty provides a highly specialised product, namely advanced encrypted audio, video and data communication systems as well as incorporating Beyond Line of Sight (BLOS) video surveillance. Scotty has built up considerable experience in customising off the shelf components to build military and government spec systems both in terms of ruggedness and compliance with NATO spec EMF shielding and secure encryption. The business is also readily scalable to meet any additional demand that may arise. The customer group is primarily military and homeland security, which also ensures that there are high barriers to entry both through the expertise required but also that Scotty's engineers require NATO clearance to work on many of the contracts.

**A highly specialised product**

The lead times for acceptance on military programmes are long but once a contractor is chosen, the contracts are invariably long duration, high value, high margin and in Scotty's case usually exclusive. The contracts are almost always followed by service and maintenance contracts, which carry equally high if not higher margins. Similarly when the programmes are extended, the incumbent usually secures the order.

Scotty's management has built up extensive relationships with the Bundeswehr, and Eurocopter which are its largest clients and provide a steady flow of long term business as well Diamond aircraft. These relationships tend to ensure that Scotty is first call for encrypted communication systems.

**Extensive relationships with key customers**

The recently announced order for €1.4m for three vehicular video-satcom workstations for military reconnaissance is building on Scotty's expertise and applying it for the first time to military land based vehicles. The first €0.5m will fall in FY11 with the remainder in FY12. Due to the way orders and deliveries have arisen in FY11 we expect H2 to show a larger proportion of FY11's revenues, with further Eurocopter, Diamond and maintenance adding to the vehicle contract to lift revenues to £6.5m and PBT to £0.8m.



## OVERVIEW

Scotty provides advanced encrypted video, audio and data communication systems, primarily to military and other government customers. The applications are for land, maritime or airborne operations. Although mostly for military use the systems can also be and are used for inter alia; border surveillance, fishery protection, pipeline security, marine communications and civil disaster coordination. Scotty has also continuously improved its systems, concentrating latterly on weight reduction of rack systems and components, opening up further potential in the UAV and drone arena.

Scotty's largest customer is Eurocopter, which has historically accounted for around 50% of revenue. Eurocopter is upgrading the German Army's fleet of CH53 Helicopters. The CH53 is the workhorse of the German Army's helicopter fleet and it operates them in various guises ( medium heavy transports, personnel recovery etc.), with the aim to have around 80 CH53G/GS variants. Eurocopter has orders for about 40 so far, with the contract due for completion in 2013. As part of this programme, Scotty has developed a communications system that enables in-flight satellite based video, voice and data communication. We believe Scotty has a further €6m or so worth of this order to be delivered between 2011 and 2013.

2010 saw revenue revive from Scotty's co-operation agreement with Diamond Aircraft Industries. Scotty received an order worth around €3m for BLOS and Line of Sight systems for an Asian Government. €2.1m was delivered in 2010 and the remaining €1m in March 2011. The systems have been developed for use in the Diamond DA42, a light, fuel efficient twin engine fixed wing aircraft that is relatively inexpensive. Diamond has supplied the plane to a number of governments as well as two to the MoD. Both Diamond and Scotty believe other orders will be received.

**Diamond Aircraft orders coming again**

Scotty's other large customer is the German Army, acting in its own right, which accounted for €1.2m revenue in 2010. Scotty supplies various systems to the Army including mobile conferencing systems and rollabout systems for field HQs.

In addition to its new systems business, Scotty is building up an increasing maintenance and upgrade business as its installed base increases. The CH53G systems are maintained under direct contract to the German Army. The contracts provide for annual maintenance at €15k per unit p.a. and €28k per unit for an upgrade and the contracts are renewable every three years. This provides a steady and reliable source of income, which is predictable and as it grows, will smooth out the more volatile contracting revenue. Maintenance revenue is currently about €800k p.a.

**Growing maintenance business**

Diamond operates differently and its customers prefer it to remain the point of contact, so the maintenance contracts are with Diamond. This has the advantage of keeping a regular dialogue with Diamond as a key customer.

By specialising in encrypted satellite communication systems, mostly for military applications, police, other security or monitoring applications, Scotty operates in a specialised niche market. The military systems need to be a NATO agreed spec with radiation shielded monitors to either zone 2, undetectable at 100m or zone one, at 20m spec, with rugged construction.



The company and its technicians need NATO clearance to work on the systems and customers prefer to deal with companies they know well and know are reliable. Furthermore, the size of the market is too small and fragmented to attract the large hardware suppliers and integrators. As a result, Scotty often has little competition and does not need to get involved in competitive tenders.

As a result of its technical expertise and particularly its EN9100 certification and status as a qualified supplier to both the Bundeswehr and Eurocopter, Scotty has recently been asked to a third party obtain certification for a landing gear related system. As well as generating additional revenue for the process, the equipment is certified as supplied by Scotty, earning it on-going revenues with each system. Ability to carry out this work for non-certified suppliers opens up a further potential revenue stream in the future.

Potential business  
qualifying 3<sup>rd</sup> party  
systems

Although for the time being Scotty's headquarters are in the UK, all design, R&D, manufacturing and virtually all of the sales take place are handled from Graz in Austria. There are 29 employees in Graz. The head office will be relocated from the UK to Graz, which will have the benefit of having the unit contributing the bulk of the revenue and the head office under one roof. There will also be associated cost savings on premises.

At the EGM on 27 September 2011, resolutions proposing conversion of Scotty to a Societas Europaea, issue of bonus shares, share consolidation and redenomination to Euro1 each were passed. Admission of the new Euro 1 ordinary shares is expected on 3 October 2011.

## Forecasts

### H1FY11 RESULTS HIGHLIGHTS

(£000)	H1FY11	H1FY10	% ch	FY10
Revenue	2,114	1,707	24%	4,921
Cost of Sales	(764)	(815)	-6%	(2,219)
Gross profit	1,350	892	51%	2,702
Administrative expense	(1,683)	(1,718)		(3,092)
Other operating income	284	266	6%	556
Operating profit/(loss)	(49)	(560)		166
Other				(2,561)
Finance costs	(18)	(8)		(19)
Loss before tax	(67)	(568)		(2,414)

SOURCE: Company reports

H1 results reflect a continued improvement in revenues and particularly gross margins, as well as the ability to rein in administrative costs. The figures are still impacted by the timing of orders and deliveries, with only four CH53 systems delivered against a budgeted fifteen for the full year. The budget suggests that FY11 will display the same H2 loading in terms of revenues as FY10 did.

Visibility remains limited due to the nature of Defence contracting at this level and we expect this to continue until Scotty's maintenance revenue line grows sufficiently to smooth out the more volatile contracting revenues. Scotty essentially has three large customers accounting for most its current business and while it continues to develop potential new revenue streams the lead times can be long and the visibility probably no different to existing defence contracts.



The Eurocopter contract remains Scotty's largest source of revenue and will almost certainly remain so in FY11. At the beginning of the year, approximately €6m of contract value remained to be delivered on the Eurocopter CH53 upgrade work and this is scheduled to be completed in 2013.

We estimate that this will be approximately €2.8m in FY11 with a similar amount in FY12 and the balance in FY13. The remainder of the Diamond Aircraft order was completed in H1FY11 with around €1m billed. Management is confident that the size of the order book will allow it to report a stronger H2 and we have forecast full FY11 revenues at £6.5m, with an anticipated gross margin of around 47% and tightly controlled administrative costs allowing it to report PBT of around £0.8m.

Looking further out to FY12, we expect continuation of the Eurocopter work, increased maintenance work, further rollabout systems and additional Diamond orders, to allow Scotty to generate around £7.5m of revenues and PBT of £1.1m. At these levels Scotty is cash generative.

Year-end December					
Key Profit & Loss Data (£000)	2009A	2010A	2011E	2012E	2013E
<b>Revenue</b>	<b>7,128</b>	<b>4,921</b>	<b>6,500</b>	<b>7,500</b>	<b>8,400</b>
Cost of sales	(2,902)	(2,219)	(3,380)	(3,900)	(4,368)
<b>Gross profit</b>	<b>4,226</b>	<b>2,702</b>	<b>3,120</b>	<b>3,600</b>	<b>4,032</b>
Administrative expenses	(4,202)	(2,721)	(2,686)	(2,508)	(2,422)
Other operating income	771	556	540	130	0
<b>EBITDA</b>	<b>795</b>	<b>537</b>	<b>974</b>	<b>1,222</b>	<b>1,610</b>
<i>EBITDA margin (%)</i>	<i>11.2%</i>	<i>10.9%</i>	<i>15.0%</i>	<i>16.3%</i>	<i>19.2%</i>
Depreciation	(163)	(98)	(24)	(21)	(19)
Amortisation	(142)	(273)	(140)	(140)	(140)
<b>EBIT</b>	<b>490</b>	<b>166</b>	<b>810</b>	<b>1,061</b>	<b>1,451</b>
<i>EBIT margin (%)</i>	<i>6.9%</i>	<i>3.4%</i>	<i>12.5%</i>	<i>14.1%</i>	<i>17.3%</i>
Other gains and losses	-	(2,561)	-	-	-
Interest	(18)	(19)	8	19	39
<b>PBT</b>	<b>472</b>	<b>(2,414)</b>	<b>818</b>	<b>1,080</b>	<b>1,490</b>
<b>PBT (adjusted)</b>	<b>472</b>	<b>147</b>	<b>818</b>	<b>1,080</b>	<b>1,490</b>
tax paid	272	113	0	0	(111)
Tax rate (%)	-57.6%	-76.9%	0.0%	0.0%	7.5%
PAT (adjusted)	744	260	818	1,080	1,378
<b>Adj. EPS (p)</b>	<b>3.7</b>	<b>1.3</b>	<b>3.0</b>	<b>3.9</b>	<b>5.0</b>

SOURCE: Northland Capital Partners Limited estimates and company reports



Year-end December					
Key Cash Flow Data (£000)	2009A	2010A	2011E	2012E	2013E
Loss before tax	744	166	810	1,061	1,451
Depreciation	163	98	24	21	19
Amortisation	142	273	140	140	100
Goodwill impairment	-	2500	-	-	-
Change in working capital	(573)	136	(263)	(167)	(150)
P/L on disposal of fixed assets	20	0	0	0	0
<b>Cash generated from operations</b>	<b>496</b>	<b>3,173</b>	<b>711</b>	<b>1,055</b>	<b>1,420</b>
Taxation paid	0	0	0	0	0
<b>Net operating cash flow</b>	<b>496</b>	<b>3,173</b>	<b>711</b>	<b>1,055</b>	<b>1,420</b>
Capital expenditure	(256)	(8)	(12)	(22)	(20)
Investment in intangibles	(1,064)	(661)	(500)	(200)	(100)
<b>Free cash flow</b>	<b>(568)</b>	<b>2,512</b>	<b>211</b>	<b>855</b>	<b>1,320</b>
New equity	0	0	600	0	0
<b>Cash from financing</b>	<b>0</b>	<b>0</b>	<b>600</b>	<b>0</b>	<b>0</b>
<b>Net increase (decrease) in cash</b>	<b>(568)</b>	<b>2,512</b>	<b>811</b>	<b>855</b>	<b>1,320</b>

SOURCE: Northland Capital Partners Limited estimates and company reports

Year-end December					
Key Balance Sheet Data (£000)	2009A	2010A	2011E	2012E	2013E
Goodwill	6,000	3,500	3,520	3,540	3,560
Intangibles	997	1,299	1,639	1,679	1,659
PPE	255	159	137	128	119
Investments	188	188	188	188	188
<b>Non current assets</b>	<b>7,440</b>	<b>5,146</b>	<b>5,484</b>	<b>5,535</b>	<b>5,526</b>
Receivables	1,394	2,139	2,402	2,569	2,719
Inventory	710	701	895	981	1,059
Cash and equivalents	267	228	559	1,391	2,469
<b>Current Assets</b>	<b>2,371</b>	<b>3,068</b>	<b>3,855</b>	<b>4,941</b>	<b>6,247</b>
<b>Total Assets</b>	<b>9,811</b>	<b>8,214</b>	<b>9,339</b>	<b>10,476</b>	<b>11,773</b>
Payables	(1,829)	(2,902)	(2,453)	(2,539)	(2,642)
<b>Current liabilities</b>	<b>(1,829)</b>	<b>(2,902)</b>	<b>(2,453)</b>	<b>(2,539)</b>	<b>(2,642)</b>
<b>Net current assets</b>	<b>542</b>	<b>166</b>	<b>1,403</b>	<b>2,402</b>	<b>3,605</b>
Non Current liabilities	(308)	(116)	(273)	(273)	(248)
<b>Total Net Assets</b>	<b>7,674</b>	<b>5,196</b>	<b>6,614</b>	<b>7,664</b>	<b>8,883</b>
Called up share capital	10,106	10,106	10,481	10,481	10,481
Share premium account	37,385	37,385	37,610	37,610	37,610
Capital redemption reserve	183	183	183	183	183
Retained earnings	(40,100)	(42,578)	(41,760)	(40,710)	(39,491)
Other reserves	100	100	100	100	100
<b>Total Equity</b>	<b>7,674</b>	<b>5,196</b>	<b>6,614</b>	<b>7,664</b>	<b>8,883</b>

SOURCE: Northland Capital Partners Limited estimates and company reports



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