Alfalah Securities

Technology & Communication

PSX: AVN | Bloomberg: AVN PA | Reuters: AVAN.KA

07-April-2017 | Perspective

Attractive multiples and upcoming contracts to keep stock in limelight

Avanceon Limited (AVN) held its analyst briefing yesterday in which the company elaborated on improved CY16 results and shed light on the future outlook of the company. We maintain our liking on the scrip mainly due to its 1) cheap trading multiples, 2) expected strong earnings growth due to upcoming Qatar projects and 3) focusing towards increasing share of recurring income (BTMI project). The technology sector is currently trading at weighted average P/E 21.3x. AVN is trading at cheap P/E multiple of 17.0x with discount of 20% to the industry which results in stock value of around ~PKR67/sh representing an upside of 25.2% from last closing.

In recent stock filling, AVN declared that its wholly owned subsidiary "Avanceon F.Z.E" landed the contract of a large project (worth USD13.7mn) in Qatar pertaining to safety systems for Qatar Rail project. While discussing the Qatar projects the company mentioned that the project is divided into 15 stages/portions and the aforementioned contract is just the base project. The company expects more similar projects, on back of FIFA world cup (to be held in Qatar) to come their way in the near future. The company has been operating almost debt free and further plans to finance future projects from its equity either through internally generated cash flows or by right issues.

Furthermore, the major focus of the company is to increase its share in "Build, Train, Maintain and Improve" (BTMI) service contracts, under which the company will build software for a client, train the client's employees, maintain the client's system and work on improving the system for the client. The monthly contracts will help the company in increasing its share (current share: 20-30%) in recurring revenue thereby stabilizing the earnings going forward.

- **AVN still trading at cheap multiple relative to its peers:** Even though the scrip has rallied by 46% CYTD, we believe the scrip offers further upside when compared to its peers. The technology sector is currently trading at weighted average P/E 21.3x while AVN is trading at a relatively cheap P/E multiple of 17.0x indicating a discount of 20% to the industry. As a result stock value comes out to be ~PKR67/sh representing an upside of 25.2% from last closing.

	Units	NETSOL	SYS	AVN	TRG	TPL
Current price	PKR	68.1	80.5	53.5	47.5	13.6
No. of shares outstanding	mn	89.5	110.7	105.7	545.4	217.2
Market capitalization	PKRmn	6,092	8,910	5,655	25,906	2,955
EPS	PKR	2.3	4.4	3.1	(4.8)	1.0
P/E	x	29.1	18.3	17.0	(9.9)	13.9
ROE	%	5.9	18.1	15.9	412.4	6.7
Industry weighted P/E	**21.3**					
Average P/E	**20.4**					
AVN discount to industry	**-20%**					
TP	**66.7**					

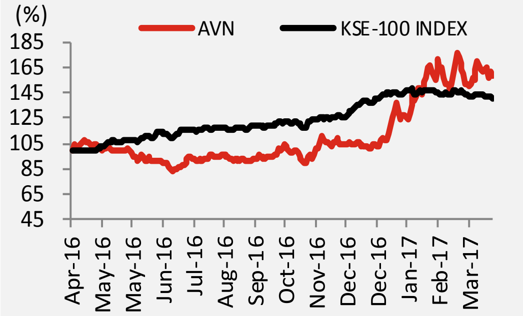
Source: Alfalah Research, Company Accounts

Avanceon Limited

Stock Details

Stock price	PKR	53.5
TP	PKR	67.0
Upside	%	25.2
Market cap	PKRbn	5.6
3-month avg turnover	USDm	0.3
Market cap	USDm	54.0
Free Float	%	24.5
Total shares	m	105.7

AVN vs KSE100 performance



Investment fundamentals

		CY14	CY15	CY16
Total revenue	bn	1.93	1.64	2.06
EBIT	bn	0.46	0.30	0.45
EBIT Growth	%	-1.5	-34.6	47.2
Recurring profit	bn	0.43	0.24	0.33
Reported profit	bn	0.43	0.24	0.33
EPS basic rep		4.09	2.29	3.14
EPS rep growth	%	5.1	-44.0	37.3
PE rep*	x	13.1	23.4	17.0
Price/book	x	2.8	2.7	2.6
ROA	%	17.1	8.9	10.8
ROE	%	21.2	11.7	15.1
BVPS		19.0	19.5	20.7

Source: Alfalah Research, PSX, Company Accounts

(all figures in PKR unless noted)

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- **Qatar railway project; a potential game changer:** In a recent stock filling, AVN declared that its wholly owned subsidiary "Avanceon F.Z.E" landed the contract of a large project (worth USD13.7mn) in Qatar pertaining to safety systems for Qatar Rail project. While discussing the Qatar projects the company mentioned that the project is divided into 15 stages/portions and the aforementioned contract is just the base project. Hence, the company expects more similar projects in the near future, on back of FIFA world cup being held in Qatar, to come their way of similar size in terms of revenue.
- Therefore, the management anticipates revenue growth of 30-40% in CY17 and a significant jump in earnings as well. Although the projects would span couple of years but as there are 15 stages, revenue would be recognized once a stage is completed. Therefore, the company expects revenues from the Qatar projects to be seen from 4QCY17 onwards. Shedding further light, the management expects margins to be as high as 40% for these projects. The company has been operating almost debt free and expects cash flows of around PKR900mn in next 12-18months. Moreover, the company plans to finance all future projects through equity. Hence, going forward right issue cannot be ruled out.
- **Oil and Gas sector projects to bolster local sales:** Numerous projects are being constructed in Oil and Gas sector and AVN is set to benefit by attaining significant number of these projects related to truck loading, radar system, storage & depots and the upcoming LNG plants. Furthermore, the company holds expertise in underground and tunnel operations (related to control and safety), which has helped them to land the project of Lowari tunnel in KPK. Moreover, AVN had a policy of not participating in government related projects. However, with the rise in development activities in the country, the management is now open to take part in upcoming public development projects which can further support the bottom-line in future.
- **Renewed focus on servicing business to enlarge recurring income:** Going forward, the major focus of the company is to increase its share in **"Build, Train, Maintain and Improve"** (BTMI) service contracts, under which the company will build software for a client, train the client's employees, maintain the client's system and work on improving the system for the client. The monthly contracts will help the company in increasing its share in recurring revenues (currently 20-30% of topline) thus stabilizing the earnings going forward.
- **Avanceon; the company explained:** Avanceon is the leading provider of automation, control systems integration, proprietary energy management solutions and support having presence in more than 8 Middle Eastern and African countries. The flagship project includes ventilations and relay upgradation of Dubai Metro, new Doha Port upward integration, Scada Systems for Lusail utility tunnels etc.
- The revenue generation in Pakistan stems from 3 sources 1) existing clients which includes multinationals such as Nestle, P&G, Unilever etc. for which company undertakes different projects from time to time and accounts for 40-50% of revenue, 2) one-off tenders offers based on opportunity e.g. tender from OGDCL which requires pre-qualify criteria which the company has to meet and accounts for 20-25% of revenue (company's plans to focus further on this segment) and 3) aftermarket support (service contracts) under which company performs maintenance and improvement of systems and this accounts for 20-30% of revenue with contribution margin of 40-50%. Currently company holds 35-40 service contracts in Pakistan while it holds 7 year contract for Dubai Metro. Revenue generation in Middle-East is 70-80% based on tenders and 20-30% service contracts. The company does 40% of the core work of any project in Lahore as result of having its home base and cost center in Pakistan allowing the company to exploit cheaper costs of doing business while having only client facing end in place globally to

bring in foreign contracts.

- The company's business model is as such that majority of the order completion falls in 3rd and 4th quarter with tentative delivery period ranging from 4 months to 18 months based on project's size resulting in backlog of revenue recognition (currently stands at USD25mn as of 28th Feb which is expected to be recognized in next 18 months). The company has the history of zero bad-debts which showcases their prudent policy on receivables and projects it undertakes enabling the company to pay stable dividends. Moreover, the company's run rate, which is time period a company can survive without getting any new order, currently stands at an all-time high of 20 months.
- Currently, the revenue generation comes from 50% local sales and 50% exports. On the tax front, the company expenses (primarily fixed cost) are pumped under Normal Tax Regime (NTR) which results in loses as a result company pays minimum tax of 2% on service (currently tax losses of PKR150mn) while the proceeds from outside Pakistan falls under export of software and services which are currently tax exempt under ITO which all in all helped maintain low effective tax rate of 16% for CY16. Furthermore, blue chip companies are major clientele of AVN which makes taxation of AVN quite transparent as the tax cut is mostly at source.
- **CY16 earnings clock in at PKR332mn, up 37% YoY:** The company declared CY16 results registering a consolidated NPAT of PKR332mn (↑37% YoY) translating into EPS of PKR3.14 (CY15 EPS: PKR2.29). The company also announced PKR1/share dividend for the year CY16 along with 25% bonus shares. The increase in company's profitability comes from clearance of revenue backlog which stood at USD18 by the end of CY15 (currently backlog is of USD25mn which is somewhat expected to materialize in CY17) supported by better sales. The gross margin increased by 328bps to clock at 36.16% as a result of better management salaries and wages cost as a percentage of total sale. The company's effective tax rate clocked in at 16% owing aforementioned reason.
- On sequential basis, the 4Q proved to be a buoyant quarter as company sales increased by 29% QoQ owing to higher revenue recognition as company's business cycle is as such. However, the increase in cost restricted the GPM to 33.7% against 39.4% recorded last quarter. Moreover, higher admin costs coupled with higher taxation kept the earnings restrained resulting in EPS of 0.85 in 4QFY17 vs. 1.19 in 3QFY17.

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