

Analyst

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DroneShield Limited (DRO)

On the front foot

Recommendation

Buy (Hold)

Price

\$1.02

Target (12 months)

\$1.25 (previously \$1.60)

Sector

Capital Goods

Expected Return

Capital growth	23.6%
Dividend yield	0.0%
Total expected return	23.6%

Company Data & Ratios

Enterprise value	\$676.8m
Market cap	\$885.1m
Issued capital	872.1m
Free float	94%
Avg. daily val. (52wk)	\$10.4m
12 month price range	\$0.25 - \$2.72

Price Performance

	(1m)	(3m)	(12m)
Price (A\$)	1.95	0.83	0.33
Absolute (%)	-48.72	20.48	207.69
Rel market (%)	-46.76	20.13	203.12

Absolute Price



SOURCE: IRESS

Successful \$120m placement to fund R&D

DroneShield has successfully completed a \$120m fully underwritten placement, the purpose of which was to fund a significant R&D program into greater application of Artificial intelligence in next-generation DroneShield products. DRO has recognised the technological landscape is changing quickly and the company needs to expand its product offering to combat the rapid advancement of drones in order to maintain its market leading position. Specifically, the company intends to invest \$90m in R&D, \$20m in potential strategic bolt-on acquisitions, with the balance to cover the offer costs and further working capital.

Downgrades to forecasts

We have updated our financial model for the placement, including cash flows, working capital and the number of shares on issue. We have made no changes to our revenue forecasts at this stage, following the upgrades in our most recent note. We have increased the operating expenses throughout the forecast period based on the significant scaling of the software engineering team, which naturally places downward pressure on our EBITDA estimates and delays our forecast margin expansion until CY26. We now forecast EBITDA margins of 22%, 23% and 33% in CY24, CY25 and CY26, respectively. Our EPS changes are -23%/-36%/-19% in CY24/CY25/CY26 based on the dilutive effect of the equity raise and downgrades to our EBITDA forecasts.

Investment View: PT down 22% to \$1.25, Upgrade to BUY

DroneShield is now well positioned to not only capitalise on short-term market demand but also entrench itself as the long-term market leader. Based on a sales pipeline of >\$1.1b and a contracted order backlog of \$28m, we anticipate the company will have a significantly stronger 2H and we remain comfortable with our full-year revenue forecasts. Despite the reduction in our target price, the recent share price decline provides an attractive point of entry, so we upgrade our recommendation to BUY.

Earnings Forecast

Year End 31 Dec	CY23	CY24e	CY25e	CY26e
Revenue (\$m)	54.1	97.4	129.2	162.9
EBITDA (\$m)	3.7	21.4	29.1	53.8
NPAT (underlying) (\$m)	9.2	20.1	26.4	46.6
NPAT (reported) (\$m)	9.2	20.1	26.4	46.6
EPS (cps)	1.7	2.5	2.9	5.1
EPS growth (%)	NM	0.6	13%	77%
PE (x)	58.7	39.5	35.0	19.8
FCF Yield (%)	NM	-6%	1%	2%
EV/EBITDA (x)	218.8	38.0	28.0	15.2
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

R&D - Technology Development Plan

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R&D- Technology Development Plan

The primary focus of DroneShield’s R&D is to further develop its proprietary AI software engine and integrated hardware systems. To achieve this, the company intends to:

1. **Accelerate the Next-Generation of its existing products**, including the RfPatrol Mk3, DroneGun Mk5 and the new iteration of its DroneSentry C-2.
2. **Launch new products**, such as a C-UxS marine system and Multi-sensor C-UxS vehicle system.
3. **Evolve its AI capability by incorporating software**, and the corresponding SaaS revenue, across all of its products including the DroneGun.

The purpose of initiating this extensive R&D program now is to:

1. **Entrench DRO’s position as the market leader** in the rapidly expanding C-UxS market.
2. **Enable DRO to expand into new markets and products** as the drone and counter-drone warfare evolves.
3. **Expand gross profit margins** as the revenue mix shifts toward AI enabled software solutions supported by DRO’s market leading hardware solutions.
4. **Accelerate SaaS revenues** by deploying the company’s proprietary software across its entire product range.

Figure 1 -DRO Technology Development Plan



SOURCE: COMPANY DATA

Forecast and Valuation Changes

Downgrades to forecasts

We have updated our financial model for the placement, including cash flows, working capital and the number of shares on issue. We have made no changes to our revenue forecasts at this stage, following the upgrades in our most recent note.

As part of the technology development plan, DRO intends to significantly scale up its software engineering team over the next 18 months, which drives material increases in our operating expenses throughout the forecast period. This naturally places downward pressure on our EBITDA forecasts and delays our forecast margin expansion until CY26. We now forecast EBITDA margins of 22%, 23% and 33% in CY24, CY25 and CY26, respectively. Any upside to our current revenue forecasts will drive material margin expansion based on the operating leverage in the business.

Historically, DRO has expensed all R&D costs as incurred, however, we now assume 80% of R&D costs will be capitalised. We anticipate capitalised R&D to be amortised over a 3- 5 year period.

We note \$20m from the equity raising was allocated towards potential bolt-on acquisitions, however, we have not yet accounted for this in our forecasts as we await further details from the company.

Our EPS changes are -23%/-36%/-19% in CY24/CY25/CY26 based on the dilutive effect of the equity raise and downgrades to our EBITDA forecasts.

A summary of the changes in our key forecasts is shown 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	21.4	-18%	29.1	-29%	53.8	-8%
Reported NPAT	20.1	-17%	26.4	-28%	46.6	-8%
Diluted EPS	2.5c	-23%	2.9c	-36%	5.1c	-19%
DPS	0.0c	no change	0.0c	no change	0.0c	no change

SOURCE: BELL POTTER SECURITIES ESTIMATES

PT down 22% to \$1.25

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.

There are no changes to the multiples we apply in our relative valuations, which include a 25.0x EV/EBITDA multiple and a 32.0x PE multiple. 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 22-Jul-24)			New (as at 08-Aug-24)		
	Valuation per share	% weighting	Price target	Valuation per share	% weighting	Price target
Methodology						
DCF	\$ 1.83	75%	\$ 1.37	\$ 1.74	33%	\$ 0.57
EV/EBITDA	\$ 1.49	12.5%	\$ 0.19	\$ 1.08	33%	\$ 0.36
PE Ratio	\$ 1.54	12.5%	\$ 0.19	\$ 0.99	33%	\$ 0.33
Total			\$ 1.00			\$ 1.25

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 upgrade our recommendation to BUY. Our investment thesis is based on:

- **Valuation:** Our 12-month price target on DroneShield is \$1.25. 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 upgrade our recommendation to BUY.
- **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)	CY22	CY23	CY24e	CY25e	CY26e	Dronesield Limited					
Year Ending 30 June						Year End 31 Dec					
Revenue	16.8	54.1	97.4	129.2	162.9	Share Price:	\$1.02	Target Price:	\$1.25		
<i>Change</i>	<i>59%</i>	<i>222%</i>	<i>80%</i>	<i>33%</i>	<i>26%</i>	No. of issued shares (m):	872.1	Market cap:	\$885.1m		
Cost of sales	(5.0)	(15.1)	(27.3)	(35.5)	(44.0)	Valuation Ratios					
Gross profit	11.8	39.0	70.1	93.7	118.9	Basic EPS (cps)	(0.2)	1.7	2.7	3.0	5.4
<i>Gross margin</i>	<i>70.4%</i>	<i>72.0%</i>	<i>72.0%</i>	<i>72.5%</i>	<i>73.0%</i>	Diluted EPS (cps)	(0.2)	1.7	2.5	2.9	5.1
Expenses (excl. D&A, int.)	(15.1)	(36.4)	(48.7)	(64.6)	(65.2)	<i>EPS growth (%)</i>	<i>NM</i>	<i>NM</i>	<i>57%</i>	<i>12%</i>	<i>77%</i>
EBITDA	(2.0)	3.7	21.4	29.1	53.8	PE(x)	NM	59.6	40.1	35.5	20.1
Depreciation and amortisation	(0.9)	(1.5)	(2.2)	(2.7)	(3.1)	EV/Sales (x)	49.3	15.3	8.5	6.4	5.1
EBIT	(2.9)	2.2	19.2	26.4	50.7	EV/EBITDA (x)	NM	222.3	38.6	28.5	15.4
Net interest (expense)/revenue	0.0	0.9	0.9	0.9	0.9	EV/EBIT (x)	NM	380.4	43.1	31.4	16.3
Pre-tax profit	(2.9)	3.1	20.2	27.3	51.6	FCF per share	NM	NM	(6.4)	0.8	1.8
Income tax benefit /(expense)	2.0	6.2	(0.0)	(0.9)	(5.0)	FCF yield %	NM	NM	-6%	1%	2%
Reported NPAT	(0.9)	9.2	20.1	26.4	46.6	NTA per share (\$ps)	0.04	0.12	0.36	0.39	0.45
						P/NTA (x)	24.1	8.3	2.8	2.6	2.3
						Book value (\$ps)	0.04	0.12	0.36	0.39	0.45
						Price/Book (x)	24.1	8.3	2.8	2.6	2.3
						DPS (cps)	0.0	0.0	0.0	0.0	0.0
						Payout ratio %	0.0%	0.0%	0.0%	0.0%	0.0%
						Dividend Yield %	0.0%	0.0%	0.0%	0.0%	0.0%
						Performance Ratios					
Cashflow (A\$m)	CY22	CY23	CY24e	CY25e	CY26e	EBITDA Margin (%)	NM	NM	22.0%	22.5%	33.0%
EBITDA	(2.0)	3.7	21.4	29.1	53.8	EBIT Margin (%)	NM	NM	19.7%	20.4%	31.1%
(-) Change in working capital	1.8	(7.5)	74.9	18.5	30.3	NPAT Margin (%)	NM	NM	20.7%	20.4%	28.6%
Gross cash flow	(3.9)	11.2	(53.5)	10.5	23.4	Net debt/(cash)	NM	NM	(208.4)	(179.5)	(173.5)
Income tax refunded/(paid)	2.1	(1.7)	(0.0)	(0.9)	(5.0)	ROE (%)	NM	NM	6.4%	7.7%	12.0%
Operating cash flow	(1.8)	9.5	(52.6)	10.6	19.4	Segmentals (A\$m)					
Payments for PPE	(0.8)	(1.7)	(3.1)	(3.4)	(3.9)	Revenue					
Investing cash flow	(0.8)	(2.0)	(17.5)	(39.4)	(25.5)	Hardware sales	14.5	47.3	90.0	117.0	140.4
Net Proceeds from issue of shares	3.7	39.7	221.3	-	-	R&D Revenue	1.5	4.1	3.6	5.4	5.9
Proceeds/ (repayments) of borrowings	-	-	-	-	-	Subscription services	0.3	1.4	2.5	5.5	15.3
Payment of lease liabilities	(0.6)	(0.6)	-	-	-	Other Revenue	0.5	1.3	1.3	1.3	1.3
Other	0.0	(0.0)	-	-	-	Total Revenue	16.8	54.1	97.4	129.2	162.9
Financing cash flow	3.1	39.1	221.3	-	-	Revenue Breakdown					
Net change in cash	0.5	46.6	151.2	(28.8)	(6.1)	Hardware sales	86%	87%	92%	91%	86%
Cash at start of period	9.4	10.1	56.7	207.9	179.1	R&D Revenue	9%	8%	4%	4%	4%
Exchange rate impact	0.2	(0.1)	-	-	-	Subscription services	2%	3%	3%	4%	9%
Cash at end of period	10.1	56.7	207.9	179.1	173.0	Other Revenue	3%	2%	1%	1%	1%
						Balance Sheet (A\$m)					
Cash and cash equivalents	10.3	63.6	214.8	186.0	179.9	Revenue					
Trade and other receivables	8.3	8.9	22.0	29.4	41.1	Hardware sales	14.5	47.3	90.0	117.0	140.4
Inventories	3.7	18.6	88.0	104.4	131.4	R&D Revenue	1.5	4.1	3.6	5.4	5.9
PPE	2.4	4.0	4.9	5.5	6.3	Subscription services	0.3	1.4	2.5	5.5	15.3
Intangibles	0.0	-	-	-	-	Other Revenue	0.5	1.3	1.3	1.3	1.3
Right-of-use assets	0.5	1.9	1.9	1.9	1.9	Total Revenue	16.8	54.1	97.4	129.2	162.9
Total assets	25.2	97.1	331.6	327.3	360.6	Revenue Breakdown					
Trade and other payables	0.6	3.5	11.0	16.3	24.6	Hardware sales	86%	87%	92%	91%	86%
Lease Liabilities	0.5	2.6	2.6	2.6	2.6	R&D Revenue	9%	8%	4%	4%	4%
Provisions	0.5	0.7	0.7	0.7	0.7	Subscription services	2%	3%	3%	4%	9%
Borrowings	0.1	-	-	-	-	Other Revenue	3%	2%	1%	1%	1%
Other	4.6	15.7	15.7	15.7	15.7						
Total liabilities	6.2	22.5	30.0	35.4	43.7						
Net Assets	19.0	74.5	301.5	291.9	317.0						
Share capital	40.5	80.4	301.6	301.6	301.6						
Other reserves	5.1	5.5	5.5	5.5	5.5						
Accumulated losses	(26.6)	(11.3)	8.8	35.2	81.8						
Total shareholders' equity	19.0	74.5	315.9	342.3	389.0						

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

Speculative Investments are either start-up enterprises with nil or only prospective operations or recently commenced operations with only forecast cash flows, or companies that have commenced operations or have been in operation for some time but have only forecast cash flows and/or a stressed balance sheet.

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Disclosure: Bell Potter Securities acted as Joint Lead Manager and Underwriter of DRO's \$100m capital raising in April 2024 and \$120m capital raising in August 2024 and received fees for that service.

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