

## Equities

2 February 2012 | 7 pages

### QinetiQ (QQ.L)

#### Alert: Solid 3QFY12 IMS

QinetiQ's 3QFY12 IMS (for the quarter ending 31 Dec) was better than expected driven (again) by the Global Products business. QinetiQ commented that it would "at least" meet its previous guidance for Mar12E (Citi EPS 16.3p, Consensus 15.8p) but remains cautious on Mar13E due to limited visibility in core US and UK markets. In the medium-term, QQ believes that early cost cutting actions will leave it well positioned once budget defence budget visibility improves. We expect modest consensus upgrades for Mar12E following today's release.

Conditions remain challenging in the UK Services business (-9% in 1HFY12A), but cost cutting efforts appear to be paying off. In 1HFY12A, QQ achieved a 9.9% EBIT margin in UK Services, which looks as if it could be bettered slightly in 2HFY12E which is seasonally stronger than 1H.

QinetiQ's US Services business again suffering from delayed contract awards due to uncertainties surrounding US DoD budgets, in keeping with its defence peers. Like the UK business, QinetiQ's focus is on reducing the cost base. In 1HFY12, QQ reported -18% YoY Sales growth and an EBIT margin of 6.3% vs. 7.8% in 1HFY11.

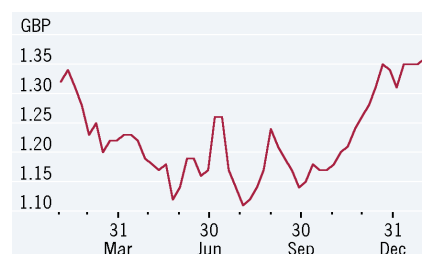
The main driver for the better quarter was Global Products. This has been the driver for stronger than expected results for the past 12 months, driven firstly by the large one-time Q-Nets order and then in 1HFY12A by stronger margins as a result of a favourable mix between OE and high margin aftermarket sales. Aftermarket sales were strong again in 3QFY12A, which suggest that 1HFY12A's EBIT margin of 20.5% could be repeatable in 2H. However, this does not necessarily extrapolate to Mar13E as the Q-Nets order will not be repeated and spares demand is hard to forecast.

QinetiQ did not report Net Debt at 31 December, as it has in previous quarterly statements. Alongside Global Products, cash conversion has positively surprised in previous periods (190% in 1HFY12A) as working capital has been taken out. We believe that this trend is coming to an end and expect more normal conversion of c90% from now on. Our Net Debt projection of £80.5m is slightly more optimistic than consensus and implies 0.4x ND/EBITDA – a much improved balance sheet for QQ vs. 2.7x in FY09A.

#### Company Update

<b>Neutral</b>	<b>2</b>
Price (01 Feb 12)	£1.36
Target price	-
Expected share price return	-
Expected dividend yield	-
<b>Expected total return</b>	<b>-</b>
Market Cap	£901M
	US\$1,426M

#### Price Performance (RIC: QQ.L, BB: QQ/ LN)



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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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## **QinetiQ**

### **Valuation**

This company has a Neutral rating. We have not assigned a target price and therefore no valuation methodology is applicable.

### **Risks**

The key risks to the QinetiQ share price are as follows:

Upside Risks: (1) The ongoing restructuring programme (which has been very successful in improving cash conversion & reducing net debt) could be extended to target margin improvements. (2) QQ could potentially find itself to be an acquisition target given the current trend towards consolidation in the defence industry. (3) QQ's order intake could surprise on the upside.

Downside Risks: (1) Defence budget cuts – QinetiQ's MOD research and consulting businesses could prove particularly vulnerable to UK defence budget cuts given the MOD's commitment to a number of large capital programmes. The US consulting business is also vulnerable to in-sourcing and the DoD's preference for smaller suppliers, (2) Restructuring – QQ needs to restructure its ailing UK business. Most employee negotiations are complete, but execution risk remains. QQ has already achieved its aim of reducing ND/EBITDA to >2x ahead of schedule, although raising margins may prove difficult, in our opinion, (3) Lumpy Demand – Orders in QinetiQ's Global Products segment tend to be lumpy which can make earnings volatile and difficult to predict and (4) Pension – QinetiQ's pension is large and could introduce volatility into earnings and impact future cashflows.

## **Appendix A-1**

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### QinetiQ (QQ.L)

#### Ratings and Target Price History Fundamental Research

Analyst: Jeremy Bragg

Covered since May 12 2009



	Date	Rating	Target Price	Closing Price
1	23-Mar-09	*1M	*1.75	1.36
2	25-Nov-09	*2M	*1.70	1.64
3	16-Feb-10	*1H	*1.55	1.22
4	27-May-10	*2H	*1.50	1.30

\* Indicates change

	Date	Rating	Target Price	Closing Price
5	11-Nov-10	2H	*1.10	0.97
6	24-Nov-10	2H	*1.30	1.13
7	3-Jun-11	2H	*1.20	1.17
8	16-Aug-11	*3H	*1.00	1.13

	Date	Rating	Target Price	Closing Price
9	7-Oct-11	Stock rating system changed		
10	7-Oct-11	*3	1.00	1.15
11	1-Dec-11	*2	-	1.27

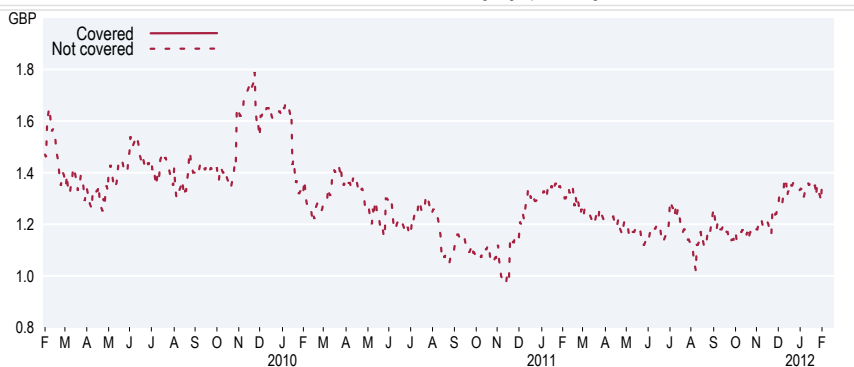
Rating/target price changes above reflect Eastern Standard Time

### QinetiQ (QQ.L)

#### Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Jeremy Bragg

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##### Data current as of 31 Dec 2011

	12 Month Rating			Relative Rating		
	Buy	Hold	Sell	Buy	Hold	Sell
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