W5 Solutions: Strong growth outlook for 2023

W5 Solutions **Research Update** 2023-03-02 07:30

Redeye updates on W5 following its Q4-results which saw solid growth but lower profitability than expected due to continued shortage of components. Looking into 2023, the outlook is strong where the company aims to achieve organic growth of 25% and including the acquisition of ArcQor, growth is expected to total 75%. On the back of the new target for 2023, we raise 2023-24E EBITDA with 19% while our new base case stands at SEK86 (SEK70).


Hjalmar Ahlberg


John Westborg

Solid growth in Q4, profitability hit by component shortages

W5 saw solid growth in Q4 with revenue coming in slightly above our forecast. However, EBITDA came in below our forecast as the company contiuned to be impacted by component shortages resulting in a lower gross margin than expected.

Strong outlook for 2023 with 75% growth target

The company is positive looking into 2023 where it forecasts growth of 75% in total. W5 expects to achieve 25% organic growth while the rest will come from the recently announced acquisition of ArcQor.

Raised estimates and valuation range

Overall, we have raised our 2023-24E revenue with c26% and EBITDA with c19% as we include ArcQor to our forecasts. We also increase our valuation range where our new base case stands at SEK86 (SEK70) while the bull case is SEK130 (SEK100) and the bear case is SEK44 (SEK36).

Key financials

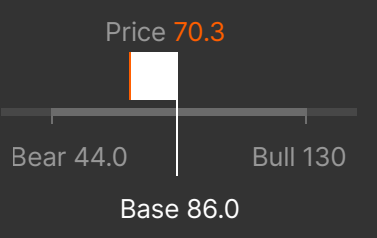
SEKm	2021	2022	2023E	2024E	2025E
Revenues	142	176	308	369	443
Revenue Growth	24.5%	23.9%	74.8%	20.0%	20.0%
EBITDA	25	24	52	63	76
EBITA	22	20	47	57	68
EBIT	22	18	39	49	60
Net Income	13	14	29	37	45
EV/EBITDA	19.1	28.1	16.4	12.4	9.7
EV/EBIT	21.3	39.1	21.7	16.0	12.2
P/E	26.2	55.3	31.8	25.4	20.5

REDEYE

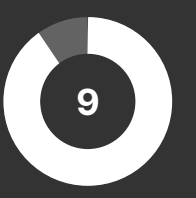
REDEYE QUALITY RATING



FAIR VALUE RANGE



TIMELINESS



KEY STATS

Market Cap	933.1 MSEK
Entprs. Value (EV)	850.0 MSEK
Net Debt (2023e)	-83.0 MSEK
30 Day Avg Vol	39 K
Shares Outstanding	13.3 M
Price / Earnings	64.8
PEG	N/A
Dividend Yield	N/A

Data from 2023-03-02 07:30

IMPORTANT INFORMATION

All information regarding limitation of liability and potential conflicts of interest can be found at the end of the report.

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Solid growth in Q4, profitability hit by component shortages

W5 reported revenue of SEK78m in Q4 2022 which represents growth of 42% and was stronger than our forecast of SEK75m. Despite the strong revenue growth, EBITDA came in below our forecast at SEK9.3m while we estimated SEK17.4. The main reason for the lower-than-expected outcome was a weaker gross margin than expected which came in at around 39% (we forecasted 56% and in Q4 2021 it was 43%). The company comments that it continues to be impacted by shortages of electronic components which has impacted costs and deliveries negatively.

W5 Solutions results outcome

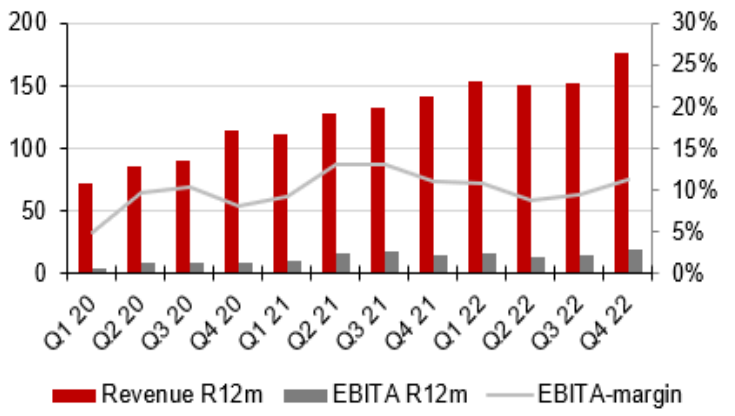
SEKm	Q4 21	Q4 22E	Q3 22A	Diff, %
Revenue	**54.9**	**75.0**	**78.1**	**4%**
Growth Y/Y (%)	19.7%	36.7%	42.4%	
COGS	*-31.3*	*-33.4*	*-47.7*	
Staff costs	*-11.9*	*-14.2*	*-15.5*	
Other costs	*-8.1*	*-10.0*	*-6.0*	
EBITDA	**9.9**	**17.4**	**9.3**	**-47%**
EBITDA (%)	18.1%	23.2%	11.9%	
Depreciation and amortisation	-1.0	-3.1	-2.2	
EBIT	8.9	14.3	7.1	-50%
EBIT %	16.2%	19.0%	9.1%	
Net income	9.4	10.7	5.3	-50%
EPS adj, SEK	0.82	0.85	0.42	-50%

Source: Redeye Research

Continued stable growth trend

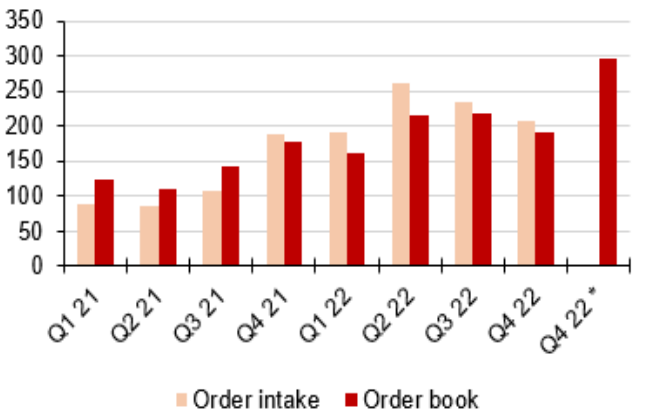
Looking at the full 2022, W5 ended the year strong where net sales increased 24% to SEK176m from SEK142m in 2021. As such, the company continues its growth trend towards the target to reach SEK500m by 2025E. While the EBITA-margin of 11% achieved during 2022 was lower than the target of 15% EBITA, we expect profitability to bounce back during 2023 as component shortages ease. The growth outlook is strong as well with an order book of SEK297m (including the orderbook from the recently acquired ArcQor) creating a good starting point for continued growth in 2023.

W5 Solutions: Revenue and EBITA R12m



Source: Redeye Research

W5 Solutions: Order book and order intake R12m



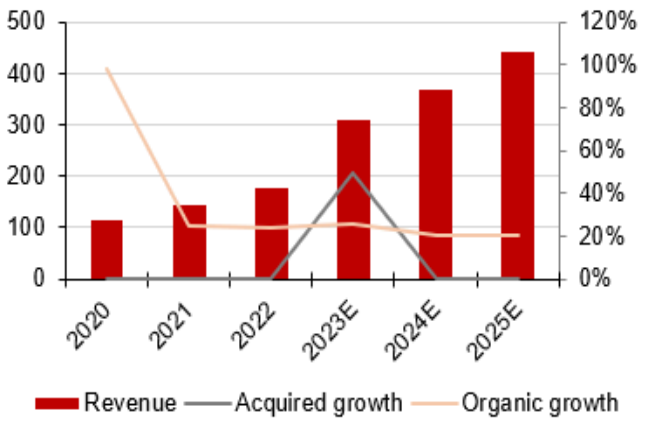
*Source: Redeye Research, * including ArcQor*

Strong outlook for 2023 with 75% growth target

W5 are positive looking into 2023 where the company forecast organic growth of 25% and total growth of 75% including the recently announced acquisition of ArcQor. With the acquisition, W5 expands its products offer within power supply as well as increase its geographic reach where Finland and France becomes two new key markets and ArcQor will be a major growth driver during the year. The company comments that it sees good potential for growth in Finland where it has established a local subsidiary. Additionally, on top of complemeting W5's product offer in power suppy, ArcQor also manufactures electronics which can ease component shortages for W5.

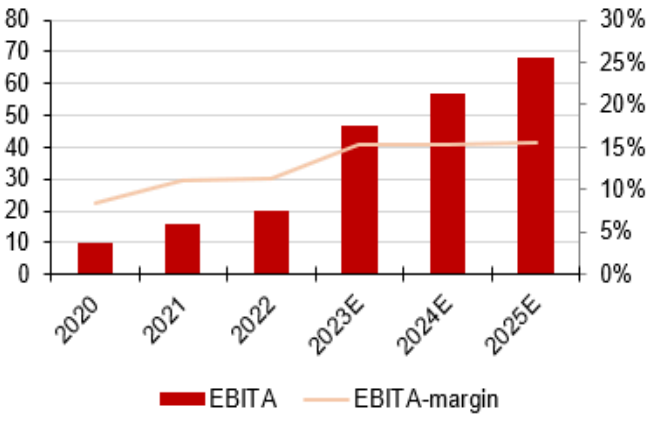
Overall, we believe W5's growth target for 2023E looks achievable and our new revenue estimate of SEK308m implies growth of 75% in line with the forecast. We also continue to forecast organic growth of 20% for 2024-25E resulting in revenues of SEK443m for 2025E putting the company close to its target of SEK500m by 2025.

W5 Solutions: Revenue and growth 2019-25E



Source: Redeye Research

W5 Solutions: EBITA and EBITA-margin 2019-25E



Source: Redeye Research

Key financials

Summarising our updated forecasts for 2023-24E we have raised our revenue with c26% while EBITDA is increased c19%. We believe W5 could see stronger than normal growth in Q1 as deliveries as it benefits from deliveries that was postponed during 2022. Still, the quarterly revenue continues to be difficult to forecast and the strong seasonality with a majority of revenue coming in Q4 will remain.

W5 Solutions: Financial forecasts														
SEKm	2020	2021	Q1 22	Q2 22	Q3 22	Q4 22	2022	Q1 23E	Q2 23E	Q3 23E	Q4 23E	2023E	2024E	2025E
Revenue	**114**	**142**	34	39	25	78	**176**	66	62	45	134	**308**	**369**	**443**
Growth Y/Y (%)	**98%**	**25%**	50%	-5%	7%	42%	**24%**	95%	61%	79%	71%	**75%**	**20%**	**20%**
COGS	*-60*	*-64*	*-13*	*-13*	*-7*	*-48*	*-81*	*-26*	*-23*	*-17*	*-67*	*-134*	*-159*	*-190*
Gross profit	54	78	20	26	18	30	95	40	39	28	67	174	210	252
Gross margin, %	47%	55%	60%	67%	72%	39%	54%	60%	63%	63%	50%	57%	57%	57%
Staff costs	*-30*	*-40*	*-11*	*-13*	*-12*	*-16*	*-51*	*-22*	*-23*	*-22*	*-26*	*-93*	*-114*	*-136*
Other costs	*-15*	*-22*	*-5*	*-7*	*-6*	*-6*	*-23*	*-6*	*-6*	*-4*	*-13*	*-29*	*-33*	*-40*
EBITDA adj	**10**	**25**	**5**	**7**	**3**	**9**	**24**	**11**	**10**	**2**	**28**	**52**	**63**	**76**
EBITDA adj (%)	9%	17%	15%	18%	12%	12%	14%	17%	16%	4%	21%	17%	17%	17%
Non-recurring	*0*	*-6*	*0*	*0*	*0*	*0*	*0*	*0*	*0*	*0*	*0*	*0*	*0*	*0*
EBITDA	10	18	5	7	3	9	24	11	10	2	28	52	63	76
EBITDA (%)	9%	13%	15%	18%	12%	12%	14%	17%	16%	4%	21%	17%	17%	17%
Depreciation and amortisation	*-1*	*-3*	*-1*	*-2*	*-2*	*-2*	*-7*	*-3*	*-3*	*-3*	*-3*	*-13*	*-14*	*-16*
OW amortisation	*0*	*0*	*0*	*-1*	*-1*	*-1*	*-2*	*-2*	*-2*	*-2*	*-2*	*-8*	*-8*	*-8*
EBITA	**10**	**16**	**4**	**6**	**2**	**8**	**20**	**10**	**9**	**1**	**27**	**47**	**57**	**68**
EBITA (%)	8%	11%	12%	16%	8%	10%	11%	15%	14%	2%	20%	15%	15%	15%
EBIT	10	16	4	5	1	7	18	8	7	-1	25	39	49	60
EBIT (%)	8%	11%	12%	14%	4%	9%	10%	12%	11%	-3%	19%	13%	13%	14%
Net income adj.	5	20	3	4	1	5	14	6	5	-1	19	29	37	45
Net income reported	5	13	3	4	1	5	14	6	5	-1	19	29	37	45
EPS adj, SEK	**0.5**	**1.7**	**0.3**	**0.3**	**0.1**	**0.4**	**1.1**	**0.5**	**0.4**	**-0.1**	**1.4**	**2.2**	**2.8**	**3.4**
EPS reported, SEK	0.5	1.2	0.3	0.3	0.1	0.4	1.1	0.5	0.4	-0.1	1.4	2.2	2.8	3.4

Source: Redeye Research

Valuation

We increase our valuation range on the back of the increased estimates coupled with a slighlty increased M&A upside potential. Our new base case stands at SEK86 (SEK70) while the bull case stands at SEK130 (SEK100) and the bear case at SEK44 (SEK36).

All our scenarios include upside from M&A with a range of SEK12-37 per share (previous SEK10-30 per share) depending on acquisition multiples of 5-10x EBIT and an assumed available capital of SEK200m (previous assumption SEK150) which includes 10% equity dilution. We use the average of SEK22 per share for our base case while we use the high-end of SEK37 per share for the bull case and low-end of SEK12 per share for the bear case.

The table below summarize the key assumptions for our three DCF-scenarios.

Bear case SEK44 (SEK36)	Base case SEK86 (SEK70)	Bull case SEK130 (SEK100)
Our bear case assumes organic growth of 8% in 2024-38E which assumes W5 sees limited success with its expansions and most revenue derived from Sweden. Terminal growth is 2% from 2038E.	Our base assumes organic growth of 12% in 2024-38E driven by mainly by successful expansion into new regions and partly by new segments and products. Terminal growth is 2% from 2038E.	Our bull assumes organic growth of 14% in 2024-38E driven by successful expansion of new regions as well as strong growth in new segments and successful new product additions. Terminal growth is 2% from 2038E.
We assume an EBITDA-margin of 14% over the forecast period and 13% for the terminal period.	We assume an EBITDA-margin of 17% over the forecast period and 15% for the terminal period.	We assume an EBITDA-margin of 19% over the forecast period and 18% for the terminal period.
The bear case includes M&A upside of SEK12 per share.	The base case includes M&A upside of SEK22 per share.	The bull case includes M&A upside of SEK38 per share.

Investment thesis

Case

Attractive growth potential with M&A optionality

Redeye expects W5 to show continued growth over the coming years as it benefits from growing demand for defense training and simulation bolstered by expansion into new regions and customer segments, and new product development. We expect revenue growth of 20 percent organically in 2023-25E and believe the company will complement this growth with acquisitions. All in all, we believe W5 will achieve its revenue target of SEK500m by 2025 (it reported SEK176m in revenues in 2022). We also expect profitability to improve in line with the company's target to achieve a 15 percent EBITA margin (2022 EBIT-margin was 11 percent) as W5 is likely to see ongoing benefits of scale.

Evidence

Extensive history, high barriers to entry, and strong partnerships

W5 has an extensive history in the defense industry and its solid management team holds core expertise in simulation and training, growing niches with limited competition from the major defense contractors. The defense industry has high barriers of entry, which, together with long-term contracts, render high revenue visibility. W5 can also lever on its several major partnerships, including with Saab, L3Harris, Lockheed Martin, and KMW.

Challenge

Limited M&A experience, risk through geographical expansion, and production capacity

The main challenges we see for W5 are its geographical expansion into new markets and M&A. Breaking into new markets could be challenging, but W5's partnerships with larger players reduce this risk. While W5 has limited M&A experience, the merger of the companies to create W5 has been a success. Furthermore, a decentralized approach to acquisitions typically reduces the M&A risk. W5 could also face capacity challenges that could limit its growth if the company cannot produce to meet growing demand. Given a focus on complementary M&A, acquisitions could ease this challenge.

Valuation

Valuation based on DCF and upside optionality from M&A

On the back of a DCF-valuation we derive a fair value of SEK86 in our base case which implies a multiple of 25x EBIT 2024E. Our valuation also includes upside potential from M&A where we see an upside range of SEK12-38 per share depending on the valuation multiple for future acquisitions (we assume a range of 5-10x EBIT). The average for the range is SEK22 per share which we include as M&A upside our base case while we use the high-end of SEK38 per share for the bull case and low-end of SEK12 per share for the bear case.

Quality Rating

People: 4

Since the merger of W5 Systems, Teleanalys and MSE in 2018, the group has shown profitable growth whereas the individual companies struggled before the merger. The management and board of W5 Solutions consist mostly of the same people that led W5 Systems, Telenalys and MSE before the merger which we argue is good for W5 and brings insight on all different aspects of the company's businesses. With the solid profitable growth since 2019 and the focus on partnerships, M&A and a strong presence in W5's home markets we would say that the

management has proven itself. The management and board are also large investors in W5 through the holding companies Swedish Defense Group AB, DT2W Invest AB and MSE Holding AB.

Business: 4

The defense training and simulation market is bound by long contracts and high barriers of entry, giving W5 a strong market position in its home market Sweden. Through partnerships and a strategic M&A focus, W5 is in a good position for growth in both its home market and new geographic regions and market segments. One integral driver in the defense market is the uncertain geopolitical state of the world which requires increased spending on defense. With a ramp up of defense budgets, W5 is in a great position to expand its business.

Financials: 3

While W5 has seen strong financial performance since its foundation in 2018, the company's history is short which has a negative impact on the financial rating score. With long contracts the business model yields good visibility and solid cash flow with limited investment needs as product development is typically financed by customers. The company has a strong financial position which provides a good position to pursue its M&A ambitions.

Financials

Income statement

SEKm	2021	2022	2023E	2024E	2025E
Revenues	142	176	308	369	443
Cost of Revenue	64	81	134	159	190
Operating Expenses	54	70	122	148	176
Exchange Rate Differences	-	-	-	-	-
EBITDA	25	24	52	63	76
Depreciation	3	4	5	6	8
Amortizations	-	2	8	8	8
EBIT	22	18	39	49	60
Shares in Associates	-	-	-	-	-
Interest Expenses	1	1	-	-	-
Net Financial Items	(0)	(1)	-	-	-
Non Recurring Income Expense	(6)	-	-	-	-
EBT	15	17	39	49	60
Income Tax Expenses	2	3	10	12	15
Net Income	13	14	29	37	45

Balance sheet

Assets

Non-current assets

SEKm	2021	2022	2023E	2024E	2025E
Property, Plant and Equipment (Net)	5	8	8	9	9
Goodwill	-	20	20	20	20
Intangible Assets	10	8	30	22	14
Right-of-Use Assets	-	-	-	-	-
Other Non-Current Assets	1	1	1	1	1
Total Non-Current Assets	15	36	59	51	44

Current assets

SEKm	2021	2022	2023E	2024E	2025E
Inventories	23	44	62	74	89
Accounts Receivable	45	97	77	74	89
Other Current Assets	8	14	15	18	22
Cash Equivalents	53	48	89	154	195
Total Current Assets	129	202	242	320	395
Total Assets	144	239	301	372	439

Equity and Liabilities

Equity

SEKm	2021	2022	2023E	2024E	2025E
Non Controlling Interest	-	-	-	-	-
Shareholder's Equity	65	143	172	209	254

Non-current liabilities

SEKm	2021	2022	2023E	2024E	2025E
Long Term Debt	4	4	4	4	4
Long Term Lease Liabilities	-	-	-	-	-
Other Non-Current Lease Liabilities	6	7	7	7	7
Total Non-Current Liabilities	10	11	11	11	11

Current liabilities

SEKm	2021	2022	2023E	2024E	2025E
Short Term Debt	1	2	2	2	2
Short Term Lease Liabilities	-	-	-	-	-
Accounts Payable	26	21	46	74	89
Other Current Liabilities	43	62	70	76	84
Total Current Liabilities	69	85	118	152	174
Total Liabilities and Equity	144	239	301	372	439

Cash flow

SEKm	2021	2022	2023E	2024E	2025E
Operating Cash Flow	18	(41)	76	72	50
Investing Cash Flow	(1)	(29)	(35)	(7)	(9)
Financing Cash Flow	29	65	-	-	-

Rating definitions

Company Quality

Company Quality is based on a set of quality checks across three categories; PEOPLE, BUSINESS, FINANCE. These are the building blocks that enable a company to deliver sustained operational outperformance and attractive longterm earnings growth.

Each category is grouped into multiple sub-categories assessed by five checks. These are based on widely accepted and tested investment criteria and used by demonstrably successful investors and investment firms. Each sub-category may also include a complementary check that provides additional information to assist with investment decision-making.

If a check is successful, it is assigned a score of one point; the total successful checks are added to give a score for each sub-category. The overall score for a category is the average of all sub-category scores, based on a scale that ranges from 0 to 5 rounded up to the nearest whole number. The overall score for each category is then used to generate the size of the bar in the Company Quality graphic.

People

At the end of the day, people drive profits. Not numbers. Understanding the motivations of people behind a business is a significant part of understanding the long-term drive of the company. It all comes down to doing business with people you trust, or at least avoiding dealing with people of questionable character.
The People rating is based on quantitative scores in seven categories:

- Passion, Execution, Capital Allocation, Communication, Compensation, Ownership, and Board.

Business

If you don’t understand the competitive environment and don’t have a clear sense of how the business will engage customers, create value and consistently deliver that value at a profit, you won’t succeed as an investor. Knowing the business model inside out will provide you some level of certainty and reduce the risk when you buy a stock.
The Business rating is based on quantitative scores grouped into five sub-categories:

- Business Scalability, Market Structure, Value Proposition, Economic Moat, and Operational Risks.

Financials

Investing is part art, part science. Financial ratios make up most of the science. Ratios are used to evaluate the financial soundness of a business. Also, these ratios are key factors that will impact a company’s financial performance and valuation. However, you only need a few to determine whether a company is financially strong or weak.
The Financial rating is based on quantitative scores that are grouped into five separate categories:

- Earnings Power, Profit Margin, Growth Rate, Financial Health, and Earnings Quality.

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