W5 Solutions: Progressing well towards 2025 targets

W5 Solutions **Research Update** 2023-05-11 07:41

Redeye updates on W5 Solutions after its Q1-results which saw somewhat higher revenue and EBITDA than expected. The company remains optimistic and comments that it is starting to see effects from increasing defence budgets and we believe the W5 is well on track towards its 2025 target of SEK500m in revenue.


Hjalmar Ahlberg


John Westborg

Solid Q1 report with strong topline growth

W5 saw strong growth in Q1 with total growth of 109% and organic growth of 40%. The results outcome was slightly better than we expected with revenue c7% above our estimate and EBITDA 3% above our forecast.

Growing defence budgets support positive outlook

Commenting on the outlook, W5 says it is seeing more funds flowing to its customers and that this is the beginning of many years of strong growth supported by growing defence budgets. With the acquisitions of ArcQor and Kongsberg Target Systems, the company has expanded its geographic reach and put it in a strong position to benefit from the increased budgets.

Limited changes to estimate and unchanged valuation range

With the Q1-results being close to our estimates and the outlook remaining positive, we make limited changes to our estimates and leave our valuation range unchanged. Our base case of SEK91 per share implies a valuation of c25x 2023E EV/EBITDA and c20x 2024E EV/EBITDA.

Key financials

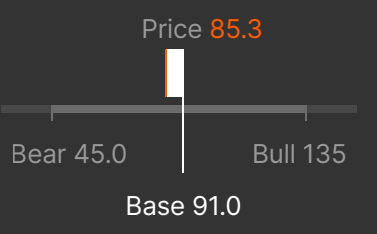
SEKm	2021	2022	2023E	2024E	2025E
Revenues	142	176	342	421	505
Revenue Growth	25%	24%	95%	23%	20%
EBITDA	25	24	53	66	81
EBIT	22	18	36	48	61
EBIT Margin	16%	10%	11%	11%	12%
Net Income	13	14	27	36	46
EV/EBITDA	19.1	28.1	20.9	15.3	12.0
EV/EBIT	21.3	39.1	30.5	21.1	16.0
P/E	26.2	55.3	41.7	30.8	24.4

REDEYE

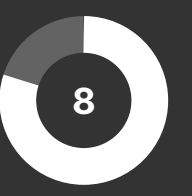
REDEYE QUALITY RATING



FAIR VALUE RANGE



TIMELINESS



KEY STATS

Market Cap	1.1 BSEK
Entprs. Value (EV)	1.1 BSEK
Net Debt (2023e)	-12.4 MSEK
30 Day Avg Vol	20 K
Shares Outstanding	13.6 M
Price / Earnings	78.6
PEG	N/A
Dividend Yield	N/A

Data from 2023-05-11 07:41

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 Q1 report with strong topline growth

W5 reported net sales of SEK71.0m in Q1 2023 which was c7% above our forecast of SEK66m. Organic growth was 40% which was largely in line with our forecast of 45% while the acquisition of ArcQor impacted somewhat higher than we estimated. The gross margin strengthened compared to Q4 2022 as component shortages improved although the company commented that it still cause some delays but at a smaller scale than before. Operating costs were in total close to our estimates, and EBITDA amounted to SEK11.8m which was just above our forecast of SEK11.4m. W5 saw strong cash flow from operations (cSEK26m) as working capital that was tied up in Q4 was released during Q1.

W5 Solutions results outcome

SEKm	Q1 22	Q2 22	Q3 22	Q4 22	Q1 23E	Q1 23A	Diff, %
Revenue	**34.0**	**38.7**	**25.2**	**78.1**	**66.2**	**71.0**	**7%**
Growth Y/Y (%)	49.8%	-5.3%	7.0%	42.4%	95.1%	109.2%	
COGS	*-13.5*	*-12.9*	*-7.1*	*-47.7*	*-26.5*	*-29.7*	
Staff costs	*-11.1*	*-13.0*	*-11.6*	*-15.5*	*-22.0*	*-19.1*	
Other costs	*-4.7*	*-6.5*	*-5.7*	*-6.0*	*-6.3*	*-11.1*	
EBITDA	**5.0**	**7.1**	**3.1**	**9.3**	**11.4**	**11.8**	**3%**
EBITDA (%)	14.7%	18.3%	12.3%	11.9%	17.3%	16.6%	
D&A	-1.0	-1.7	-2.0	-2.2	-3.2	-4.0	
EBIT	4.0	5.4	1.1	7.1	8.2	7.8	-5%
EBIT %	11.8%	14.0%	4.2%	9.1%	12.4%	11.0%	
Net income	3.1	4.0	1.3	5.3	6.2	5.5	-11%
EPS adj, SEK	0.27	0.31	0.11	0.42	0.47	0.42	-10%

Source: Redeye Research

Broadening product portfolio and geographic reach

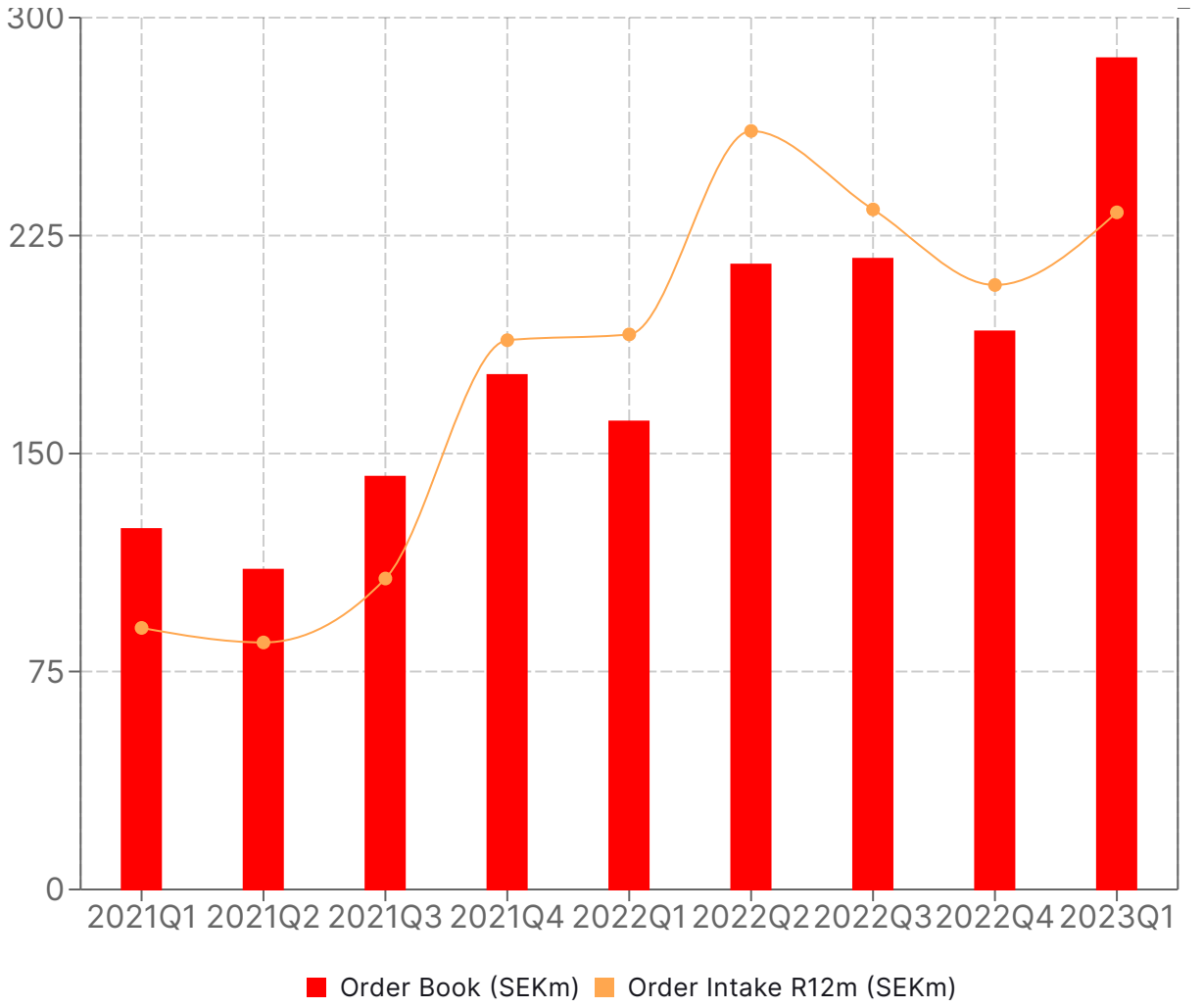
W5 has increased its M&A activity in 2023 with the acquisition of ArcQor in January (see our comment here: https://www.redeye.se/research/872778/w5-solutions-expands-product-offer-and-geographic-reach-with-acquisition-of-arcqor) which was followed by Kongsberg Target Systems in April (see our comment here: https://www.redeye.se/research/889609/w5-potential-acquisition-of-kongsberg-target-systems). In total, we estimate that the two acquisitions will add around SEK120m in revenue to W5 in 2023E, with potential for continued growth in the coming years.

With the acquisition of ArcQor, W5 expands its product offerings within power supply as well as increases its geographic reach where Finland and France become two new key markets. The company has already seen strong progress in Finland where it will deliver orders of SEK40m. Additionally, ArcQor also manufactures electronics which can ease component shortages for W5. The acquisition of Kongsberg Target Systems, which is a global supplier of electronic target systems, will increase W5's product portfolio in live fire where it will ensure future digitalization while also expanding its international position. Kongsberg, which is based in Norway, will also build on the company's position within NATO member states.

Growing defence budgets supports positive outlook

Commenting on the outlook, W5 says it is seeing more funds flowing to its customers and that this is the beginning of many years of strong growth supported by growing defence budgets. The company saw an order intake of SEK42m during the quarter and the order book stood at SEK286m at the end of the quarter, where SEK215m is expected to be delivered during 2023. We expect the positive trend for the order intake to continue and support a growing order book.

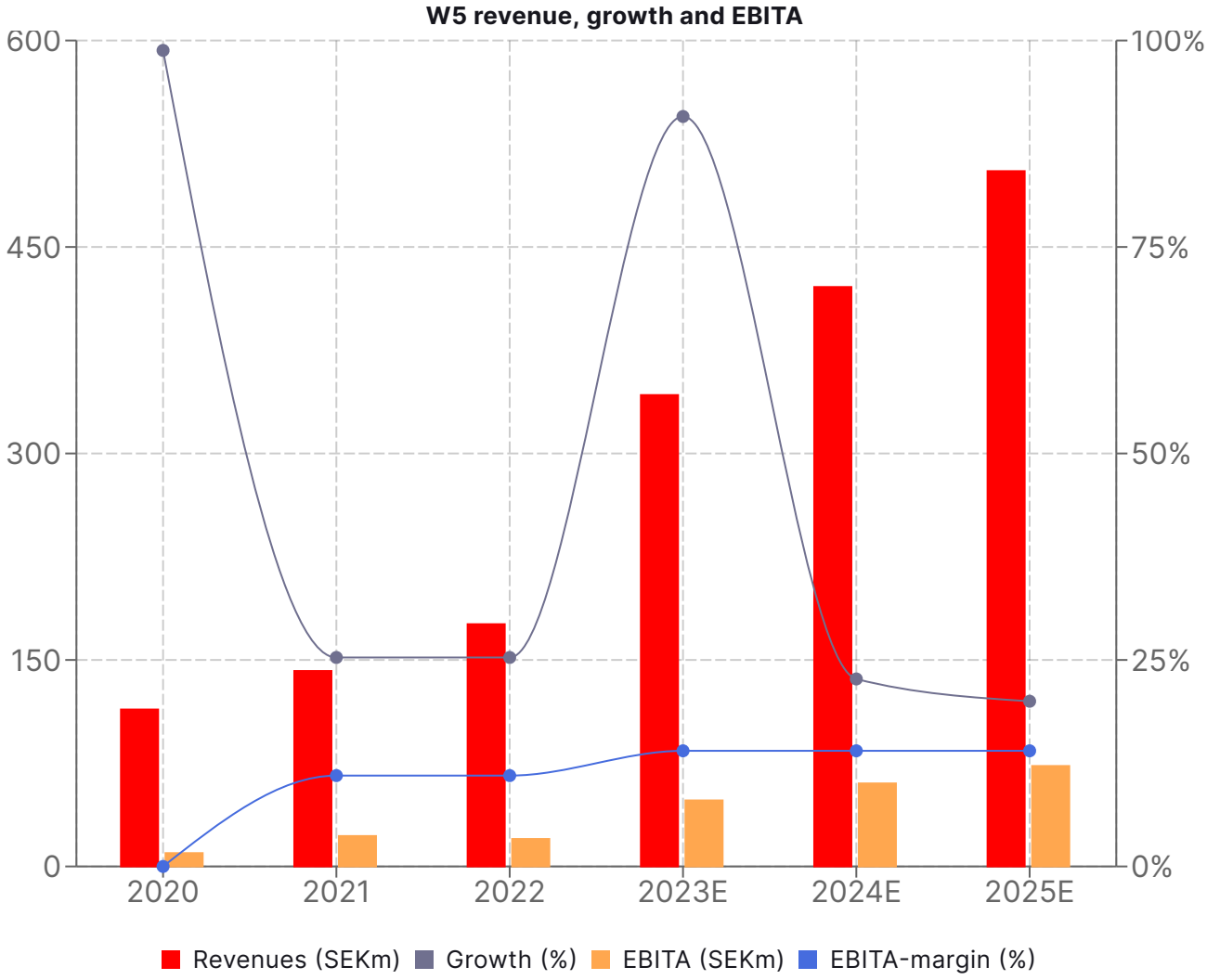
W5 order book and order intake R12m



Progressing well towards 2025 targets

W5 continues to see solid progress towards its target of SEK500m of revenue and SEK75m of EBITA by 2025E. In 2022, the company saw revenue growth of 25% and in 2023E we expect total growth of 95% of which c25% is organic and 70% is from the acquisitions of ArcQor and Kongsberg. This will yield SEK343m of total revenue in 2023E and with our forecast of 20% organic growth during 2024-25E we estimate revenue of SEK505m for 2025E. As such, we now expect the company to achieve its 2025 target organically while additional acquisitions creates potential beat the target. Coming to profitability, we expect an EBITA-margin of 14% for 2023E which is slightly below the company's target owing to Kongsberg which initially will have lower margin then the group. We expect profitability to improve gradually towards the target of 15% EBITA during 2025-25E.

W5 revenue, growth and EBITA



Limited changes to estimates and valuation range

With the Q1-results coming in close to our forecasts and the outlook remaining positive, we make limited changes to our estimates. We also leave our valuation range unchanged where the base case stands at SEK91 while the bull case stands at SEK135 and the bear cast at SEK45 (see assumptions for our scenarios here: https://www.redeye.se/company/w5-solutions-2/fair-value-range). The tables below summarize annual key financials for 2020-25E and quarterly key financials for Q1 2022 to Q4 2023E.

W5 Solutions: Annual financials

SEKm	2020	2021	2022	2023E	2024E	2025E
Revenue	**114**	**142**	**176**	**342**	**421**	**505**
Growth Y/Y (%)	**98%**	**25%**	**24%**	**95%**	**23%**	**20%**
COGS	*-60*	*-64*	*-81*	*-147*	*-177*	*-212*
Gross profit	54	78	95	195	244	293
Gross margin, %	47%	55%	54%	57%	58%	58%
Staff costs	*-30*	*-40*	*-51*	*-105*	*-140*	*-167*
Other costs	*-15*	*-22*	*-23*	*-38*	*-38*	*-45*
EBITDA adj	**10**	**25**	**24**	**53**	**66**	**81**
EBITDA adj (%)	9%	17%	14%	15%	16%	16%
Non-recurring	*0*	*-6*	*0*	*0*	*0*	*0*
EBITDA	10	18	24	53	66	81
EBITDA (%)	9%	13%	14%	15%	16%	16%
D&A	*-1*	*-3*	*-7*	*-17*	*-18*	*-20*
OW amortisation	*0*	*0*	*-2*	*-12*	*-12*	*-12*
EBITA	**10**	**16**	**20**	**48**	**60**	**73**
EBITA (%)	8%	11%	11%	14%	14%	14%
EBIT	10	16	18	36	48	61
EBIT (%)	8%	11%	10%	11%	11%	12%
Net income adj.	5	20	14	27	36	46
Net income reported	5	13	14	27	36	46
EPS adj, SEK	**0.5**	**1.7**	**1.1**	**2.0**	**2.7**	**3.4**
EPS reported, SEK	0.5	1.2	1.1	2.0	2.7	3.4

Source: Redeye Research

W5 Solutions: Quarterly financials

SEKm	Q1 22	Q2 22	Q3 22	Q4 22	Q1 23	Q2 23E	Q3 23E	Q4 23E
Revenue	**34**	**39**	**25**	**78**	**71**	**67**	**50**	**154**
Growth Y/Y (%)	50%	-5%	7%	42%	109%	74%	99%	97%
COGS	*-13*	*-13*	*-7*	*-48*	*-30*	*-25*	*-19*	*-74*
Gross profit	20	26	18	30	41	42	32	80
Gross margin, %	60%	67%	72%	39%	58%	63%	63%	52%
Staff costs	*-11*	*-13*	*-12*	*-16*	*-19*	*-28*	*-27*	*-31*
Other costs	*-5*	*-7*	*-6*	*-6*	*-11*	*-7*	*-5*	*-15*
EBITDA adj	**5**	**7**	**3**	**9**	**12**	**8**	**0**	**33**
EBITDA adj (%)	15%	18%	12%	12%	17%	12%	-1%	22%
Non-recurring	*0*	*0*	*0*	*0*	*0*	*0*	*0*	*0*
EBITDA	5	7	3	9	12	8	0	33
EBITDA (%)	15%	18%	12%	12%	17%	12%	-1%	22%
D&A	*-1*	*-2*	*-2*	*-2*	*-4*	*-4*	*-4*	*-4*
OW amortisation	*0*	*-1*	*-1*	*-1*	*-3*	*-3*	*-3*	*-3*
EBITA	**4**	**6**	**2**	**8**	**11**	**7**	**-2**	**32**
EBITA (%)	12%	16%	8%	10%	15%	10%	-3%	21%
EBIT	4	5	1	7	8	4	-5	29
EBIT (%)	12%	14%	4%	9%	11%	6%	-9%	19%
Net income adj.	3	4	1	5	6	3	-3	22
Net income reported	3	4	1	5	6	3	-3	22
EPS adj, SEK	**0.3**	**0.3**	**0.1**	**0.4**	**0.4**	**0.2**	**-0.3**	**1.6**
EPS reported, SEK	0.3	0.3	0.1	0.4	0.4	0.2	-0.3	1.6

Source: Redeye Research

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 SEK91 in our base case which implies a multiple of 20x EBITDA and 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	342	421	505
Cost of Revenue	64	81	147	177	212
Operating Expenses	54	70	143	178	212
EBITDA	25	24	53	66	81
Depreciation	3	4	5	6	8
Amortizations	-	2	12	12	12
EBIT	22	18	36	48	61
Shares in Associates	-	-	-	-	-
Interest Expenses	1	1	0.12	-	-
Net Financial Items	(0)	(1)	(0)	-	-
EBT	15	17	36	48	61
Income Tax Expenses	2	3	9	12	15
Net Income	13	14	27	36	46

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	107	96	84
Right-of-Use Assets	-	-	-	-	-
Other Non-Current Assets	1	1	1	1	1
Total Non-Current Assets	15	36	136	125	114

Current assets

SEKm	2021	2022	2023E	2024E	2025E
Inventories	23	44	86	84	101
Accounts Receivable	45	97	86	84	101
Other Current Assets	8	14	17	21	25
Cash Equivalents	53	48	18	105	149
Total Current Assets	129	202	206	294	376
Total Assets	144	239	342	419	490

Equity and Liabilities

Equity

SEKm	2021	2022	2023E	2024E	2025E
Non Controlling Interest	-	-	-	-	-
Shareholder's Equity	65	143	205	241	287

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	51	84	101
Other Current Liabilities	43	62	74	82	90
Total Current Liabilities	69	85	127	167	193
Total Liabilities and Equity	144	239	342	419	490

Cash flow

SEKm	2021	2022	2023E	2024E	2025E
Operating Cash Flow	18	(41)	51	94	53
Investing Cash Flow	(1)	(29)	(81)	(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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