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TZL Limited

Opening the door for a Q4 cash flow profit

ADD (no change)

Current price:	A$0.06
Target price:	A$0.08
Previous target:	A$0.11
Up/downside:	41%
Reuters:	TZL.AX
Bloomberg:	TZL AU
Market cap:	A$26.6m
Average daily turnover:	A$0.01m
Current shares o/s	252.0m
Free float:	65%

Key changes in this note

- FY16 EPS downgraded by 65%.
- FY17 EPS upgraded by 65%.

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- TZL delivered a good result that showed discipline given costs were up 6% in the face of 39% revenue growth. Good revenue momentum and cost management places TZL well for a positive operating cashflow in Q4 FY16.
- This result proved TZL's ability to have customers pre-pay to lighten TZL's working capital and equity requirements. With A$4-5m in net cash in January 2016, an operational partner in the USA, and an impressive pipeline of work, 2H16 could prove to be a milestone event for the TZL. Add retained.

Result snapshot

TLZ's 1H16 revenue was up 39% yoy and gross profit was up 41% yoy. Gross profit margins dipped lower temporarily ahead of the new manufacturing facilities moving to full production this half. Operating costs were higher than we had forecast. TZL ended the period with A$2.3m in cash but a A$2.75m inflow in January 2016 positions the company with net cash of A$4-5m. For us, the key highlight of 1H16 was TZL's tight working capital management, which proved customers' willingness to prepay. To fund its growth trajectory TZL will need to closely manage its working capital.

The good

TZL booked 39% year on year revenue growth from 1H15 to 1H16. Operating costs were up 5.6% illustrating a strong cost focus from the company. Debtors increased 158% yoy while creditors increased 72% over the same period – illustrating TZL's tight focus on working capital. Consequently, while operating cashflow was negative A$2.4m this was broadly flat year on year and a solid outcome considering the working capital implication on inventory in the face of a 39% increase in revenue. The key driver of the revenue uplift was the USA where revenue increased from A$2.5m in 1H15 to A$4.6m in 1H16. TZL has an agreement with a third party to roll out lockers in the USA, which should deliver scalability (without necessitating a large cost uplift for TZL). Revenue momentum was strong and the pipeline of work places TZL well, going forward.

The bad

TZL's funding position remains tight but the company looks set to achieve a cashflow positive position in Q416, which would be a key milestone. The Directors "maintain a positive outlook on achieving its first quarter of positive cash flow in the last half of the 2016 financial year." Working capital was tightly managed and if customers continue with prepayments, additional capital may not be required, although this risk cannot be ruled out entirely, in our view. TZL's path to commercialisation has progressed materially and reaching the all-important self-funding stage looks to be just around the corner.

Investment view – Add recommendation

TZL delivered solid earnings momentum in 1H16 and looks set to make a small, but meaningful, cash flow profit in Q4FY16. The higher cost base than our forecasts results in a ~65% downgrade to FY16 EPS while stronger revenue and gross profit margin assumptions in FY17 result in a ~65% upgrade. Our DCF based valuation declines from A$0.11 to A$0.08. Downside risk relates to TZL's ability to fund its rapid revenue growth profile while upside risk relates to the possibility of winning large scale contracts and potential corporate appeal. We think TZL is at a pivotal point in its maturity with the key milestone of becoming self-funding just around the corner. In the short term investors may wait for certainty on the capital position before taking a closer look at TZL; however, on a 12-month view we expect the company to be in a much stronger position and consequently we retain our Add recommendation.

Key forecasts	Jun-14A	Jun-15A	Jun-16E	Jun-17E	Jun-18E
Revenue (A$m)	8.5	15.2	23.7	32.0	38.4
EBITDA (A$m)	-10.3	-4.4	-2.4	1.4	4.1
Reported NPAT	-12.1	-6.4	-4.2	-0.2	2.3
Cash NPAT	-7.7	-6.4	-4.2	-0.2	2.3
Net Profit Growth (%)	54.6	16.7	34.6	94.6	1102.2
Normalised Earnings Per Share (¢)	-0.04	-0.02	-0.01	0.00	0.00
EPS Growth (%)	n.m.	64%	40%	95%	1102%
EV/Revenue (x)	2.5	1.4	1.1	0.9	0.7
EV/EBITDA (x)	-2.0	-4.7	-11.3	19.9	6.6

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Figure 1: TZL Financial Summary

Profit and loss	Jun-14A	Jun-15A	Jun-16E	Jun-17E	Jun-18E
Revenue	8.5	15.2	23.7	32.0	38.4
Gross Profit	4.2	6.5	10.4	14.7	20.4
Cash operating costs (ex COGS)	**9.8**	**10.9**	**12.8**	**13.3**	**16.2**
Total Operating Costs	14.5	10.9	12.8	13.3	16.2
EBITDA	**-10.3**	**-4.4**	**-2.4**	**1.4**	**4.1**
Depreciation	-0.7	-0.6	-0.2	-0.3	-0.6
Amortisation & impairments	-0.5	-1.0	-1.7	-1.3	-1.3
EBIT	**-11.4**	**-6.0**	**-4.3**	**-0.2**	**2.3**
Net Interest Income	-2.1	0.1	0.0	0.0	0.0
Pre-tax Profit	-12.0	-6.5	-4.3	-0.2	2.3
Tax	-0.1	0.1	0.0	0.0	0.0
Reported Profit	**-12.1**	**-6.4**	**-4.2**	**-0.2**	**2.3**
Add back exceptional items	4.4	0.0	0.0	0.0	0.0
Normalised Profit	**-7.7**	**-6.4**	**-4.2**	**-0.2**	**2.3**

Cash flow statement	Jun-14A	Jun-15A	Jun-16E	Jun-17E	Jun-18E
EBITDA	-10.3	-4.4	-2.4	1.4	4.1
Net interest & tax	-0.1	-0.1	0.0	0.0	0.0
Changes in working capital	3.8	0.4	-0.3	0.4	-0.6
Operating cash flow	**-6.5**	**-4.1**	**-2.7**	**1.8**	**3.6**
Capex	-1.2	-0.2	-2.8	-1.2	-1.4
Free Cash Flow	**-7.8**	**-4.4**	**-5.5**	**0.6**	**2.1**
Acquisitions and divestments	0.0	0.0	0.0	0.0	0.0
Other inc capitalised R&D	-0.4	-1.6	-1.3	-1.3	-1.5
Investing cash flows	**-1.6**	**-1.9**	**-4.1**	**-2.5**	**-3.0**
Increase / decrease in Equity	6.5	8.7	0.0	0.0	0.0
Increase / decrease in Debt	-17.2	0.0	0.0	0.0	0.0
Other financing cash flows	0.0	0.0	0.0	0.0	0.0
Financing cash flows	**-10.7**	**8.7**	**0.0**	**0.0**	**0.0**

Balance Sheet	Jun-14A	Jun-15A	Jun-16E	Jun-17E	Jun-18E
Cash And Deposits	2.6	5.7	1.0	0.3	0.8
Debtors	2.9	5.0	3.2	4.3	5.3
Inventory & other	0.0	0.0	0.0	0.0	0.0
Total Current Assets	**5.5**	**10.7**	**4.2**	**4.5**	**6.1**
Fixed Assets	1.3	0.8	0.9	1.8	2.6
Intangibles	0.0	0.0	0.0	0.0	0.0
Other non-current assets	0.3	0.0	0.0	0.0	0.0
Total Non-Current Assets	**1.5**	**0.8**	**0.9**	**1.8**	**2.6**
TOTAL ASSETS	**7.0**	**11.5**	**5.1**	**6.3**	**8.7**
Short Term Debt	0.0	0.0	0.0	0.0	0.0
Creditors	2.0	4.2	2.2	3.6	4.0
Other current liabilities	0.3	0.3	0.2	0.2	0.2
Total Current Liabilities	**2.3**	**4.5**	**2.4**	**3.8**	**4.2**
Long Term & other debt	0.0	0.0	0.0	0.0	0.0
Other Non current liabilities	0.2	0.2	0.2	0.2	0.2
Total Non -Current liabilities	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**
TOTAL LIABILITIES	**2.5**	**4.6**	**2.6**	**4.0**	**4.4**
Issued capital	192.3	201.0	200.0	199.8	202.1
Retained earnings	-174.7	-180.6	-183.8	-183.8	-183.8
Other reserves and FX	-5.1	-3.5	-4.0	-4.0	-4.0
TOTAL EQUITY	**12.5**	**16.8**	**12.3**	**12.1**	**14.3**

Valuation details			
Share Price	$0.06	Market Cap	A$26.6m
Price Target	$0.08		
Total shareholder return	40.9%	WACC	14.9%

	Weighting	Valuation
DCF (fully diluted)	100.0%	$0.08
Premium / (discount)		0%
Price Target		$0.08

Key metrics/ multiples	Jun-15A	Jun-16E	Jun-17E	Jun-18E
P/E	-3.9	-6.5	-123.1	12.3
EV / Revenue	1.4	1.1	0.9	0.7
EV / EBITDA	-4.7	-11.3	19.9	6.6
Price/ Book Value	1.6	2.3	2.3	1.9
Price/ Net Tangible Assets	1.6	2.3	2.3	1.9
Operating cash flow yield	-15.4%	-10.2%	6.6%	13.3%
Free cash flow yield	-16.4%	-20.7%	2.1%	7.9%

Per share data	Jun-15A	Jun-16E	Jun-17E	Jun-18E
Diluted shares on issue	444.0	465.6	465.6	465.6
Earnings per share (A$)	-0.02	-0.01	0.00	0.00
Normalised EPS (A$)	-0.02	-0.01	0.00	0.00

Result quality	Jun-15A	Jun-16E	Jun-17E	Jun-18E
Cash flow conversion	91.4%	112.0%	126.7%	86.3%
FCF vs. NPAT	67.7%	131.2%	-246.0%	93.1%

Gearing	Jun-15A	Jun-16E	Jun-17E	Jun-18E
Net Debt	-5.69	-0.98	-0.27	-0.84
Net Debt / Equity	-33.8%	-8.0%	-2.2%	-5.9%
Net Debt / EBITDA (x)	n.m.	n.m.	n.m.	-0.20
EBIT interest cover (x)	n.m.	n.m.	n.m.	-444.23
Invested Capital	11.5	11.0	12.2	12.9
Enterprise Value	21.0	27.0	27.7	27.1

Growth ratios	Jun-15A	Jun-16E	Jun-17E	Jun-18E
Revenue	79.3%	56.2%	35.0%	19.8%
Gross profit	53.8%	59.7%	41.4%	38.1%
Cash operating costs	*11.3%*	*17.1%*	*4.1%*	*21.5%*
EBITDA	4441.0%	957.3%	432.5%	473.9%
EBIT	*-47.6%*	*-28.6%*	*-94.5%*	*-1075.6%*
NPAT	-46.7%	-34.6%	-94.6%	-1102.2%
EPS growth	-64.1%	-39.9%	-94.7%	-1102.2%
Operating cash flow	-37.2%	-33.9%	-164.7%	102.1%
Free cash flow	-43.8%	26.7%	-110.1%	279.2%

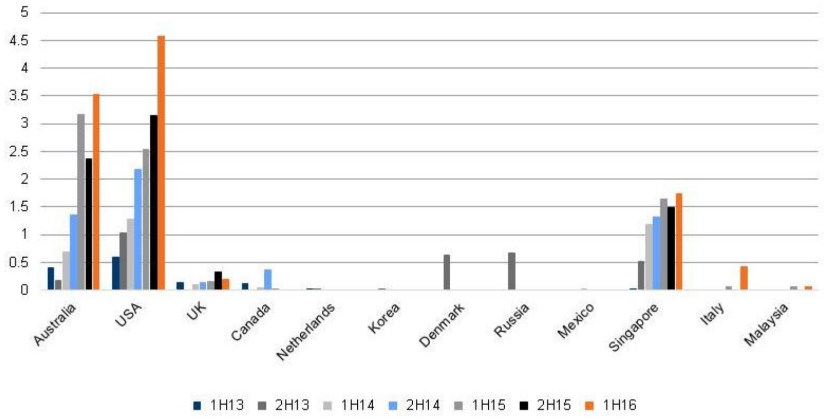
Margin analysis	Jun-15A	Jun-16E	Jun-17E	Jun-18E
Gross profit margin	43.0%	43.9%	46.0%	53.0%
EBITDA Margin	-29.1%	-10.1%	4.3%	10.8%
EBIT margin	-39.4%	-18.0%	-0.7%	6.0%
NPAT margin	-42.4%	-17.7%	-0.7%	5.9%
ROE	-38.2%	-34.2%	-1.9%	15.9%
ROIC	-51.9%	-38.7%	-1.9%	17.7%

SOURCE: MORGANS RESEARCH, COMPANY

Financials snapshot

TZL's result was in-line with our expectations at the revenue line but costs were higher than we had anticipated. Revenue and gross profit grew strongly while operating costs were well contained, albeit tracking higher. EBITDA was –A$2.3m for the half and this was pleasingly tracked by operating cashflow which we think is a commendable effort given the working capital implications of ~40% revenue growth. The United States was the star performer this half, overtaking Australia to become the largest revenue generating region and accounting for 46% of group revenue. This would no doubt be assisted by a weaker AUD, boosting USD higher on translation. Regardless, American revenue was up 81% yoy and this proves to us TZL's recent investment into establishing itself more substantially in America is paying dividends.

Figure 2: Geographic revenue trends



SOURCES: MORGANS, COMPANY REPORTS

Forecast and valuation changes

We have increased our cost assumptions in FY16 and beyond by ~A$1m which has resulted in NPAT declining 65% in FY16, albeit off a low base. Our assumptions of a higher gross profit margin in FY17 kick on from Q4 FY16 with the manufacturing facilities in place and this results in FY17 NPAT forecast being upgraded by 65%. The net impact of higher costs and margins is our DCF based valuation declines 23% from A$0.11 to A$0.08.

Figure 3: Forecast and valuation changes

	2016 old	2016 new	% change	2017 old	2017 new	% change
Revenue	23.6	23.7	1%	28.0	32.0	14%
EBITDA	-1.0	-2.4	-138%	1.1	1.4	30%
EBIT	-2.6	-4.3	-65%	-0.7	-0.2	67%
NPAT	-2.5	-4.2	-67%	-0.7	-0.2	66%
EPS	-0.6	-0.9	-67%	-0.1	0.0	66%
DCF	$0.11	$0.08	-23%			
Premium / (discount)	0%	0%	n.m.			
Price target	$0.11	$0.08	-23%			

SOURCES: MORGANS, COMPANY REPORTS

Risks and rewards

In our view, the key operational risk for TZL relates to funding the business' working capital and the implications this has for the share price until the capital position becomes clear. TZL is expecting to make an operating cashflow profit in Q42016 but given its tight cash position relative to cash burn (including investment capex) this is likely to create the perception TZL is cum capital raising. We have not assumed TZL raises capital but cannot rule this out. Should the company be successful in winning some larger contracts, it may require additional working capital. Should this not prove to be the case, then TZL may be able to manage sales (and customer prepayments) in a controlled manner. If this occurs TZL may move into a position whereby its positive operating cashflow is sufficient to fund the business going forward but this is likely to stall revenue growth.

On the upside risk side, TZL has, in our view, proven ability to take a smart technology product and convert it into a commercial business. Achieving positive operating cashflow in Q4 is a case in point. Achievement of this milestone and strong revenue growth / pipeline makes TZL, in our view, an attractive takeover target. Its undemanding trading multiple (~1.1x revenue) means there could be plenty of value creation from any suitor with an overlapping cost structure and the ability to extract costs. We also note that TZL has won a number of high quality contracts over the last 12-24 months and should some of these small deals convert into larger, more material contracts, we see plenty of upside (relative to current market pessimism) should TZL be able to convert and execute on these deals. Catalysts relate to the potential for TZL to convert its sales pipeline and/or win a number of larger contracts over the coming year.

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