

Drillcon AB (DRIL)

Sweden | Industry | MCAP SEK 306.8 mn

05 January 2021

Buy

Target price: SEK 9.2
 Current price: SEK 7.0
 Upside: 31.1%

A Hardcore Enterprise: Drillcon drilling deeper with old partners and penetrating lush Latin market

Drillcon is an established supplier of drilling solutions to companies in the mining industry and it has been building its track record since 1963. The company utilizes its excellent track record and good customer relationships to grow. It has proven its good relationship by being hired to perform drilling operations outside of its regions for the premium customer Boliden in Ireland. Through expansion in South America and increased prospecting trends in its European markets, Drillcon is estimated to achieve sales of 480 MSEK by 2022E. Compared with the sales of 2019A, that implies a CAGR of 6.9%. The company is expected to expand its net income margin from 9.4% in the year 2019 to 10.7% in year the 2022. The increase is attributable to automation and lower labour costs in South America, resulting in a net income of 51.6mn for the year 2022E. A target multiple in-line with the historical average of P/E 8.0x yields an upside of 31.1% and a buy recommendation.

Key takeaways

- An experienced company providing services for an industry facing growing demand.** The majority of Drillcon's customers are in the mining sector, which faces growing demand as countries of the world get richer and resource claims increase. The overall base metal mining market is expected to grow by a CAGR of 4.1% until 2025. As Drillcon is a company delivering drilling solutions and not mining, Drillcon can therefore profit from the increased mineral demand without experiencing the downside risk of low mineral counts. This creates a stable flow of revenues no matter the drilling result.
- Long term contracts create reliable revenue streams.** The primary revenue streams for Drillcon are long term contracts ranging from 6 months to 4 years, in core drilling and raise boring. Drillcon has established partnerships with Scandinavia's largest mining companies, which have been expanded in terms of length and volume over time. This creates a situation where the company's future cash flow is relatively secure and non-volatile.
- Expanding into the New World.** South America is one of the richest continents in untapped mineral reserves. Since expanding into Chile, Drillcon has managed to establish a relationship with the largest copper producer in the world, the Chilean state-owned company Codelco. Given the mining opportunities in South America, further expansion is expected to generate revenues of 30 MSEK by 2022E and, if well-executed, could drive the region to perform on par with Drillcon Nordics and Drillcon Iberia. Lundin Mining, one of Drillcon's long term partners, owns a copper mine in Chile, which accounts for almost half of Lundin Mining's net sales. This creates an interesting opportunity for future growth and expansion.

Analyst(s)

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Market Data, SEK

Exchange Nasdaq First North
 Shares (mn) 44.6
 MCAP (mn) 306.8
 EV (mn) 307.6

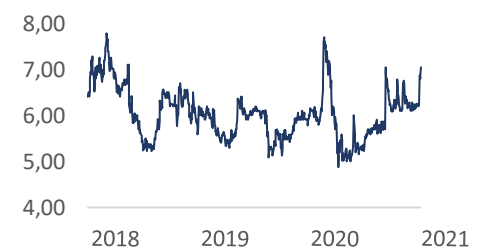
Metrics & Drivers	19A	20E	21E	22E
Curr. P/E	17.3x	39.1x	12.4x	6.28x
Curr. EV/EBIT	5.68x	21.82x	7.67x	3.88x

Forecast, SEKmn	19A	20E	21E	22E
Total revenue	393	311	396	480
Rev. growth y/y	2%	-20%	26%	21%
Gross Profit	355	279	358	436
Gross Margin	90%	89%	90%	91%
EBITDA	76	42	61	97
EBITDA Margin	19%	13%	16%	22%
EBIT	48	14	31	61
EBIT Margin	12%	4%	7%	14%

Major Shareholders

Traction	53.8%
Adriano Barros	3.0%
Total Institutional	6.4%
Total Insider	9.1%
Total	69.3%

Price Development, SEK



Investment thesis

A steady business with long-lasting partnerships expanding overtime and into new regions

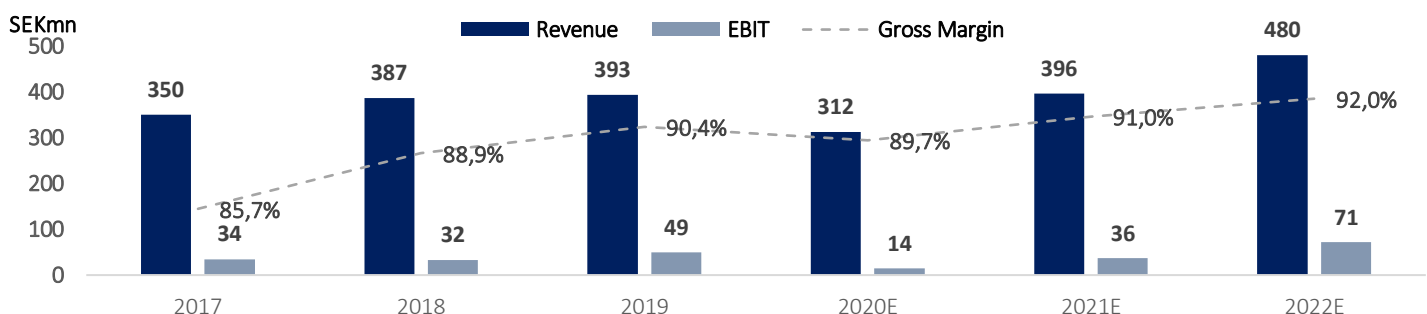
Drillcon's business model is based on acquiring long drilling contracts with its customers in the mining industry. It has been around in the Nordics since 1963 and has good relationships with its customers, shown by their customers renewing their contracts. This is evidence that Drillcon has a good track record delivering its services to large mining companies. The recent choice of Boliden to hire Drillcon in Ireland, instead of choosing a local mining company, implies that Boliden values the services of Drillcon highly. Some of Drillcon's customers are large mining corporations, including the Swedish state-owned LKAB and the Swedish company Boliden. Drillcon acquires contracts ranging from 1 to 5 years with its customers, implying long and steady revenues. In a fragmented and competitive industry. Global expansion into South America creates additional opportunities for organic growth of Drillcon's operations.

When Patrik Rylander became the CEO in 2016, a subsidiary in Chile was started to reach the South American market. By entering this market Drillcon has become a local player in the region housing the world's largest open-pit copper mine. Based on Drillcon's fantastic track record in the Nordics and Europe, the company is expected to become an important player in the world's most copper-rich region, Chile. Based on its performance in Europe and the fact that copper claims are increasing with the growth in technology hardware, it is fair to say that Drillcon Americas will be able to grow organically with a CAGR of 98% between the years 2019 and 2022E, though, from low levels due to COVID-19. By delivering a full-service drilling solution and upholding good relationships with customers, the South American market is expected to drive long term revenue growth for Drillcon even after the estimation period.

Improving margins as a result of cost-saving programs and lower wages in new regions.

In its expansion to Chile, Drillcon will face decreasing personnel costs compared to their historical counterparts since it has operated in the Nordics and Europe, where salaries are between 50-80% higher than those in South America. This provides an opportunity for decreasing personnel costs, resulting in an estimated personnel cost as a percentage of sales of 41.6% in 2022E compared with 44.2% in 2019A. The company has been increasing its efficiency through increased automation and is expected to reach a Gross Margin of 91% in 2022E. Through investments in automation of the drilling process as well as a cost-saving program, the company will be able to decrease its operating expenses and personnel costs, resulting in the increased EBIT margin of 14.8% in 2022E compared to 12.4% in 2019A.

Cost savings and automation combined with increased sales implies better margins



Source: Analyst estimates

A slow recovery with sluggish demand

The main risk for the valuation is a potentially slow COVID-19 recovery with sluggish demand for industrial metals. This is somewhat mitigated by government stimulus which tends to favor fundamental industries such as resource development. However, so far prices for industrial metals have recovered to levels higher than before COVID-19 hit the global economy, implying continuous growth in global demand.

Overview of the Company

As a private drilling contractor, Drillcon's customer base ranges from multinational corporations to government institutions, they primarily operate in Scandinavia and Iberia, with a growing presence in Latin America. In a high skilled business such as raise boring, where it can take up to six years to train a boring operator, Drillcon offers its clients fast and highly professional services. So that they can get the drilling done when and where they need it. Additionally, this allows the clients to outsource (to some degree) one of the main risks in mining operations which is worker safety. With highly skilled and specialised teams Drillcon helps minimize workplace accidents. Drillcon is a forward-looking company investing continuously in the development of employees and adapting modern, safe and proven technology. All with the purpose of having the best safety, occupational health, environmental, and quality (SHEQ) performance.

From North to South with long term contracts ranging from 6 months to 4 years in three regions

Drillcon offers core drilling and raise boring services, as well as infrastructure and geological services. The length of their contracts range from 6 months to 4 years, with many of their contracts getting successively upgraded overtime. This serves as a testament to the satisfaction of their clients. Additionally, clients have imported Drillcon's services for pilot programs in new regions, such as the world's largest zinc mine in Ireland. Drillcon divides its business into three regions, in order of revenue size; Nordics, Iberia, and the Americas, of which the Nordics and Iberia have been established for many decades. The expansion into the Americas started in 2016 at the initiative of CEO Patrik Rylander.

Margins pushed to new heights through automation and efficiency, Gross Margin from 86.9 to 90.4%

The main cost of services sold is the energy used by the machinery, which has become successively more efficient over the years. As a result, the gross margin of Drillcon has increased from 86.9% in 2015 to 90.4% in 2019. This trend is expected to continue with more automation and increased efficiency. The largest cost driver is personnel costs which has amounted to around 44% of revenue historically. This driver allows for great reduction opportunities, both through automation and the lower labour costs in Latin America, where the average wage is about a third of that in Sweden. The CEO is also optimistic that transportation costs will be lower in the future, at the moment they make up about 25% of other operating expenses.

South America – A New World of Opportunities

In 2016 Drillcon entered the Latin American market and now has contracts in place with Codelco, the worldwide largest copper mining company. Latin America offers many opportunities for mining and even Lundin Mining has gone in on the action and now operates one of the largest open-air pits in Chile. With pre-existing and expanding cooperation between Lundin and Drillcon in Scandinavia, Drillcon is a natural choice of contractor for Lundin in Chile.

Overview of the Market

The market for industrial metals has weathered the COVID-19 crisis relatively well compared to most other industries. According to the PwC global mining industry market report², the top 40 firms are forecasted to only lose about 6% of their EBITDA from 2019 in 2020, far less than expected in most other industries. It is believed that the mining industry will serve as a solid bedrock for the oncoming recovery. Production cuts of about 6% in copper and zinc have been estimated by the top 40 firms for this year. However, to get their economies back on track governments are expected to increase infrastructure spending. Specifically, China and India, the two main global consumers of industrial metals are forecasted to increase government spending and reach 9% respectively 7% GDP growth next year. The global demand for industrial metals is expected to grow steadily for the coming years, with the base metal mining market estimated to grow with a CAGR of 4.1% until 2025. The industry is characterized by a few trends such as reducing the frequency of accidents, improving sustainability, and lowering of emissions. These trends are driving the growth in automation, as it reduces the required man-hours needed in production and makes the whole process more efficient.

Financial Forecast Breakdown

Reliable revenue, with more to come 6.9% CAGR

The company utilizes long term contracts and good customer relationships to generate a reliable revenue streams. Added with increased prospecting by customers such as Boliden, Lundin Mining and LKAB in new regions, and the expansion into Latin America, Drillcon's revenue is expected to grow with a CAGR of 6.9% from 2019A to 2022E. Together with the long-term contracts with already existing clients, Drillcon is estimated to generate a revenue of SEK 480.0mn in 2022E.

Reaching New Records, Gross Margin up 0.6% to 91%

Drillcon is a service provider, hence the gross margin is relatively high compared to net sales making up 90.4% in 2019. The main cost of services sold is the energy used by the machinery and other necessities. Drillcon has become successively more efficient over the years. With more focus on automation, the trend is expected to continue, leading to further increased efficiency. As a result, the gross margin is expected to reach 91.0% in 2022E, an increase of 0.6% percentage points compared to 2019.

Hardened Through Hard Times, Other Operating Expenses down, while EBITDA up 2.9%

As a result of lower labor costs in South America, which, as a region, is estimated to become a larger contributor to the overall revenue, Drillcon's EBITDA margin is estimated to reach 22.3% in 2022E compared to 19.4% in 2019A. The company recently completed a cost savings program to counter the decreased sales of 2020, which included decreasing personal costs and leaning other operating expenses. This will, in the longer time frame also contribute to the EBITDA margin expansion to 22.3% in 2022E.

Investments for the future, Depreciation & Amortization up 0.5%

The increased automation will result in higher depreciation since Drillcon has been increasing investments in machinery. The depreciation is estimated to reach 36 MSEK in 2022E as a result of the automation investments by Drillcon. Depreciation as a percentage of sales will therefore grow from 7.0% in 2019A to 7.5% in 2022E. Resulting in an EBIT margin of 14.8% 2022E.

Haven is not found underground, Tax at a steady 26%

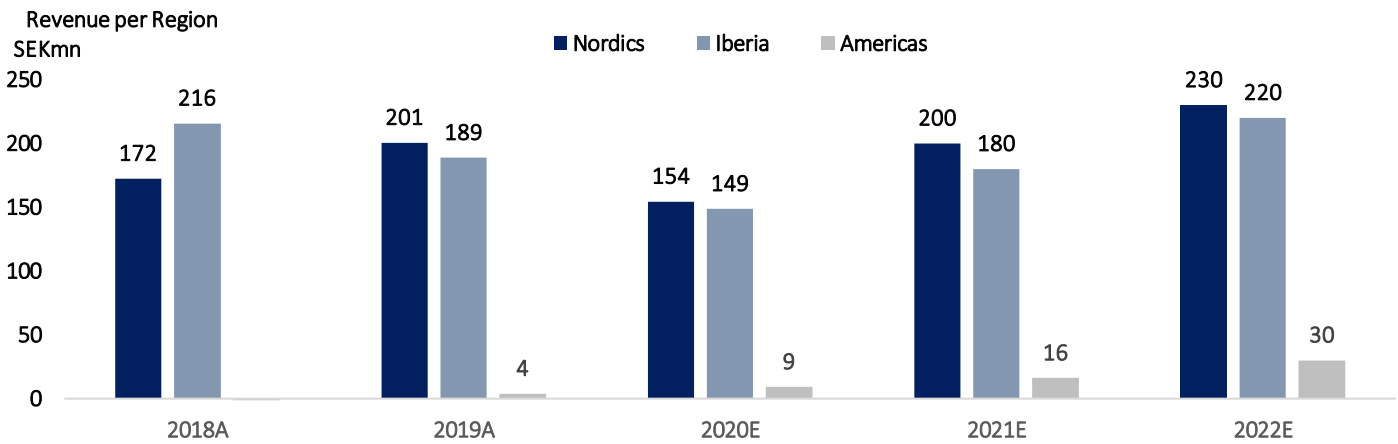
Due to that the company is situated in multiple countries, and that Latin America is expected to generate a larger part of revenues going forward, the tax rate 2022E is expected to be 26%, a slight decrease from the years 2016-2019. Finally, Drillcon is expected to reach an EBITDA margin of 22.3%, an EBIT margin of 14.8% and a net income margin of 10.7% in the year of 2022E.

TSEK	2018A	2019A	2020E	2021E	2022E
Net sales	386 582	392 995	311 989	396 000	480 000
Other income	0	0	0	0	0
Total revenue	386 582	392 995	311 989	396 000	480 000
COGS	42 897	37 678	32 278	37 620	43 200
Gross Profit	343 685	355 317	279 711	358 380	436 800
Gross Margin	88,9%	90,4%	89,7%	90,5%	91,0%
Other operating expenses	115 893	105 497	81 757	105 511	130 000
Personnel Costs	170 312	173 597	155 943	187 216	199 773
EBITDA	57 480	76 223	42 011	65 653	107 027
EBITDA Margin	14,9%	19,4%	13,5%	16,6%	22,3%
Depreciation & Amortization	25 389	27 672	27 915	29 700	36 000
EBIT	32 091	48 551	14 096	35 953	71 027
EBIT Margin	8,3%	12,4%	4,5%	9,1%	14,8%

Valuation

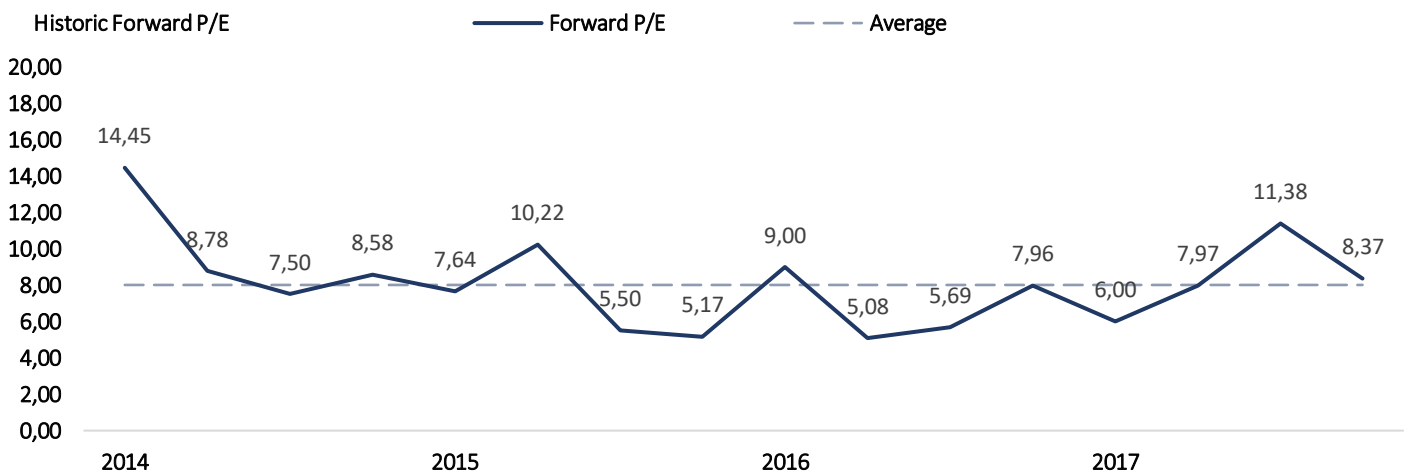
A valuation based on a historical forward P/E ratio implies a potential upside of 31.1%

Drillcon is likely an overlooked company, given its small market cap and boring/ drilling industry with very few analyst firms covering them. The company operates in a niche market with barely any similar competitors. Combined with the reliable long contract nature of the business makes a historic forward P/E valuation suitable. Historically, the median 2-year forward looking P/E ratio has been approximately 8.0x. Taking the estimated earnings per share of SEK 1.2 in year 2022E into account, this implies a share price of SEK 9.2, giving the stock an upside of 31.1% and a recommendation to buy. This is further justified by that the conditional outlook for Drillcon looks a lot better today than during previous years. Having weathered most of the COVID-19 crisis and supplying a mining industry facing record high industrial metal prices, means that Drillcon is well positioned to capitalize on the future.



The market seems to underestimate the potential of expansion in new regions and cost improvements

Drillcon has already established its Americas region and proven that it is able to sell its services there, as it generated sales of approximately 24 MSEK in 2017. Based on contracts between Drillcon and its largest customers in the Nordics and Iberia combined with the fact that Drillcon has started projects with mining companies in Chile, which holds the largest copper reserves in the world. The company is estimated to achieve sales of 30MSEK in 2022E in the region, with regional revenue continuing to grow even after the estimation period. Additionally, Drillcon has recently been contracted to do work in Ireland for Boliden, which is a new region for Drillcon. This combined with increasing operating margins will yield earnings growth of approximately 36% from 2019A to 2022E for the company, resulting in a net profit of SEK 51.6mn. It seems that the market underestimates the opportunity of these two new regions and the revenues that they will drive, yielding an opportunity for investors with a target price of SEK 9.2 and an upside of 31.1%.



Management and board

Carl Östring – Chairman of the Board

Has been a chairman of the board since 2016 and director since 2014. Previous business experience as General Counsel and Investment Manager at Traction since 2011. Lawyer and Managing Partner of Magnusson's law firm and trustee administrator at law firm Fylgia. He also holds a few more Board assignments at Mönsterås Metall AB, Duroc AB, Recco AB and Institute Fakultetskurser.

Carl Östring currently holds 40 000 (0.9%) of the total numbers of shares outstanding



Patrik Rylander – President and CEO

President and CEO for Drillcon AB since 2016. Has previous business experience Managing Director Dynasafe Protection System and Managing Director Atlas Copco Nigeria and Regional Business Manager North- and South America. Current Board assignments Chairman in Drillcon Scandinavia, Drillcon Norway, Drillcon Drilling Equipment, Drillcon Iberia and Drillcon Americas. Board member in Svemin, Gruvornas Arbetsgivarförbund, Swedish Mining & Tunneling Group and Chamber of commerce Mälardalen.

Patrik Rylander currently holds 10 000 (0.2%) of the total number of shares outstanding



Adriano Barros – Managing Director Iberia

Managing Director Drillcon Iberia. Has previously held various positions within Drillcon Iberia since 1995.

Adriano Barros currently holds 1 315 000 (29.5%) of the total number of shares outstanding



Julio Portocarrero – Managing Director Americas

Regional Managing Director Drillcon Americas since 2017. Previous experience, acting Managing Director for Resemin and Atlas Copco Product Line Manager and Business Line Manager Aftermarket in Mexico.

Julio Portocarrero currently holds an unknown number of shares



Appendix

Company: Drillcon AB		Historical					Estimates		
TSEK	2015	2016	2017	2018	2019	2020E	2021E	2022E	
Net sales	278,975	257,689	349,813	386,582	392,995	311,989	396,000	480,000	
Other operating income	898	2,039	0	0	0	0	0	0	
Revenue	279,873	259,728	349,813	386,582	392,995	311,989	396,000	480,000	
COGS: Råvaror och förnödenheter	36,569	32,243	49,876	42,897	37,678	32,278	37,620	43,200	
Gross Profit	243,304	227,485	299,937	343,685	355,317	279,711	358,380	436,800	
<i>Gross Margin</i>	86.9%	87.6%	85.7%	88.9%	90.4%	89.7%	90.5%	91.0%	
Personnel Costs	123,819	107,667	153,681	170,312	173,597	155,943	187,216	199,773	
Other operating expenses	94,516	81,133	89,514	115,893	105,497	81,757	105,511	130,000	
EBITDA	24,969	38,685	56,742	57,480	76,223	42,011	65,653	107,027	
<i>EBITDA Margin</i>	8.9%	14.9%	16.2%	14.9%	19.4%	13.5%	16.6%	22.3%	
Depreciation & Amortization	21,942	18,721	22,817	25,389	27,672	27,915	29,700	36,000	
EBIT	3,027	19,964	33,925	32,091	48,551	14,096	35,953	71,027	
<i>EBIT Margin</i>	1.1%	7.7%	9.7%	8.3%	12.4%	4.5%	9.1%	14.8%	
Net interest	1709	-293	-736	491	208	3,728	1,022	1,013	
EBT	1,318	20,257	34,661	31,600	48,343	10,368	34,930	70,014	
<i>EBT Margin</i>	0.5%	7.8%	9.9%	8.2%	12.3%	3.3%	8.8%	14.6%	
Taxes	6,548	5,391	8,919	9,273	11,477	2,530	9,207	18,454	
Net Income	-5,230	14,866	25,742	22,327	36,866	7,838	25,723	51,560	
<i>Net Income Margin</i>	-1.9%	5.7%	7.4%	5.8%	9.4%	2.5%	6.5%	10.7%	

End notes:

1. Market Analysis by Grand View Research
2. Mine 2020 Resilient and resourceful – PwC

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Other

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