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Research update

SMC Research

Small and Mid Cap Research



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Daldrup & Söhne AG

Significant margin improvement in the first half of the year

Rating: Buy (unchanged) | **Price:** 7.06 € | **Price target:** 8.00 € (unchanged)

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Recent business development



Basic data

Based in:	Gruenwald
Sector:	Drilling services
Headcount:	127
Accounting:	HGB
Ticker:	4DS:GR
ISIN:	DE0007830572
Price:	7.06 Euro
Market segment:	Scale
Number of shares:	5.99 m
Market Cap:	42.3 m Euro
Enterprise Value:	48.6 m Euro
Free Float:	41.6 %
Price high/low (12 M):	8.90 / 4.20 Euro
Øturnover (12 M Xetra):	22,600 Euro

The Ukraine war has led to a strengthened focus on the use of geothermal energy, from which Daldrup & Söhne (D&S) is also benefiting. As a result, the company reports a significant increase in interest in this business field and was recently able to report another major order – up to two wells for Hamburger Energiewerke for the development of a heat storage facility. The total order backlog as of mid-September amounted to EUR 27.1 m, which already ensures utilisation of the drilling capacities well into next year. On this basis, the forecast for total output in 2022, envisaging a figure of approx. EUR 42 m, was confirmed. In the first half of the year, total output was still 22 percent below the previous year's figure at EUR 17.7 m, but in the second six months, final invoices for larger drilling projects and several new projects will lead to significant growth.

Encouragingly, EBIT doubled to EUR 1.2 m already in the first half of the year, corresponding to a margin increase from 2.7 to 7.0 percent. Since a special effect (amounting to EUR 400,000) was partly responsible for this, the margin target range of 4 to 6 percent for 2022 was confirmed.

FY ends: 31.12.	2019	2020	2021	2022e	2023e	2024e
Total output (m Euro)	41.8	47.5	44.9	43.0	44.5	46.5
EBIT (m Euro)	-9.7*	1.9*	1.6	2.1	2.5	3.5
Net profit	-11.9*	-5.2*	0.8	0.8	1.6	2.5
EpS	-1.99*	-0.87*	0.13	0.13	0.27	0.41
Dividend per share	0.00	0.00	0.00	0.00	0.00	0.00
Total output growth	19.7%	13.7%	-5.5%	-4.1%	3.5%	4.5%
Profit growth	-	-	-114.9%	2.2%	105.4%	51.1%
PSR	1.71	1.61	0.54	1.23	1.09	1.02
PER	-	-	54.3	53.1	25.8	17.1
PCR	10.4	26.2	-	35.3	12.0	10.9
EV / EBIT	-	25.7	30.7	22.8	19.4	13.9
Dividend yield	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%

* including special effects in connection with the sale of the power plant division

Total output still clearly declining

In the first half of the year, D&S' s total output of EUR 17.7 m was 22.4 percent below the previous year's figure. Both the reported sales (EUR 6.3 m, -20.9 percent) and the inventory build-up (EUR 11.5 m, -23.2 percent) were significantly lower than in the first half of 2021. However, this only shows the usual fluctuations in the project business, where the maintenance intervals of the large drilling rigs and their transport from one drilling site to the next can have a significant impact on the figures for individual quarters and half-years. Basically, D&S's capacities are currently well utilised, and the big rigs are being used in new projects. This will be reflected more strongly in total output and revenues in the second half of the year.

Group figures	6M 21	6M 22	Change
Sales	7.9	6.3	-20.9%
Total output	22.9	17.7	-22.4%
EBITDA	1.8	2.4	+37.2%
<i>EBITDA margin</i>	7.8%	13.8%	+6.0pp.
EBIT	0.6	1.2	+102.9%
<i>EBIT margin</i>	2.7%	7.0%	+4.3pp.
Period net result	0.4	0.4	-2.8%

In m Euro and percent, source: Company

Margin rises strongly

The temporarily declining business was converted into a strong reduction in material costs of 45.5 percent to EUR 6.7 m, also thanks to a significantly lower use of third-party services in the drilling, although the previous year's figure was biased upwards due to a lower-margin large project. As a result, the cost of materials ratio (in relation to total output excluding other operating income) fell from 53.8 to 37.8 percent. This compensated for the increase in personnel costs (+9.1 percent to EUR 4.9 m, ratio from 19.6 to 27.6 percent) as well as the disproportionately low decrease in other operating expenses (-12.4 percent to EUR 3.8 m, ratio from 18.9 to 21.3 percent). On balance, EBITDA increased by 37.2 percent to EUR 2.4 m, equivalent to a margin improvement of 7.8 percent to

13.8 percent. However, this also includes a positive one-off effect of EUR 377,000 from the sale of power plant components – a residual item from the former activities in the power plant sector (yet there is an almost congruent offsetting entry in the financial result, see next paragraph). At the same time, D&S has made significantly higher provisions (partly subsequent to an issue from the sale of the power plant division), so that the improvement in results shows – at least essentially – operational progress.

Net result at previous year's level

With only a slight increase in scheduled depreciation (+2.9 percent to EUR 1.2 m), EBIT doubled from EUR 0.6 m to EUR 1.2 m, thus increasing the margin from 2.7 percent to 7.0 percent. The fact that the net result was nevertheless almost at the previous year's level of EUR 0.4 m is also largely due to the special effect from the sale of the power plant components, since in return the loans to the company J.D. Apparate- und Maschinenbau GmbH, which took over the sale of the components, had to be reduced by EUR 340,000 (the difference is the profit margin) with an effect on the income statement. In addition, following a recalculation, D&S wrote off EUR 151,000 of the receivables from IKAV, the buyer of the power plant division, which is why the financial result of EUR -0.8 m was significantly weaker than in the previous year (EUR -0.2 m).

Free cash flow negative

The positive trend in operating results has also not yet been adequately reflected in the cash flow development. An increase in inventories (+EUR 1.9 m) as well as in receivables and other assets (+EUR 0.9 m) combined with a simultaneous reduction in trade payables (EUR -0.4 m) were largely responsible for the fact that the cash outflow from operating activities more than doubled from EUR -0.4 m in the same period of the previous year to EUR -0.85 m. Together with the outflow from investing activities (EUR -0.3 m), resulting primarily from the acquisition of two smaller drilling rigs, the free cash flow for the first half of the year to-

talled EUR -1.1 m – in the previous year, a surplus of EUR 0.9 m had been reported due to inflows from the sale of the power plant division. Since loans were also repaid as planned (financing cash flow: EUR -1.2 m incl. interest payments), the liquidity reported in the balance sheet decreased from EUR 3.0 m to EUR 1.7 m in the first half of the year, while at the same time the utilisation of overdraft facilities increased from EUR 4.9 m to EUR 6.0 m.

Equity ratio: 49.5 percent

The total of liabilities and provisions remained stable at EUR 19.6 m in the first half of the year. As equity increased slightly from EUR 19.0 m to EUR 19.2 m thanks to the net profit for the period, the equity ratio rose from 49.3 to 49.5 percent and thus remains at a comfortable level. On the assets side, the balance sheet total is distributed fairly evenly among various items, the largest of which are other loans (EUR 9.2 m), other assets (EUR 8.7 m) and inventories (EUR 8.1 m).

Good order situation

The outlook for the second half of the year is positive; an order backlog of around EUR 27.1 m of mid-September already ensures capacity utilisation well into next year. The most recent addition is a contract from Hamburger Energiewerke GmbH to drill up to two wells for the development of an underground aquifer storage facility into which surplus waste heat from regional industrial and waste utilisation plants is to be introduced, which can then be fed back into the local district heating network as required. The maximum order volume is in the upper single-digit million range, and a first well is to be completed this year. Other major drilling projects currently being realised include a geothermal well in Switzerland, ten exploratory wells for Schweizer Salinen AG for salt production and an exploratory well for a city in the Rhine-Main region to survey the usable geothermal potential. Against this backdrop, the management has confirmed the annual forecast for total output, which amounts to around EUR 42 m – provided that, for example, the scheduled processing of orders is not unexpectedly hampered by the pandemic or supply bottlenecks. The annual forecast for the EBIT margin,

which is expected to be between 4 and 6 percent, was confirmed as well. Despite the high margin in the first half of the year, there was no increase because, according to the management, D&S will feel the generally rising costs (especially energy and personnel) somewhat more strongly in the second half of the year.

Core estimates for 2022 unchanged

We had so far calculated a total output of EUR 43 m and an EBIT margin of 5 percent for D&S. A significantly higher level in the second half of the year is required to reach the figure for the total output. Given the comfortable order situation and numerous large drilling projects, this seems quite realistic, so we leave the estimate unchanged. Our EBIT margin estimate remains unchanged as well because of the company's references to cost developments in the second half of the year. However, due to the higher negative financial result, the net result we now estimate at €0.8 million is somewhat lower than our previous estimate.

Good basis for the estimation scenario

For the following years, we had so far assumed moderate growth in total output (CAGR by 2029: 5.5 percent p.a.) with significant improvements in margins. In our view, the current development supports this assessment. The framework conditions for geothermal energy development have improved significantly. The rupture of relations with Russia has made a strong expansion of renewable energies in the area of heat generation even more urgent. In the Netherlands and Switzerland, two important markets for D&S, the development of geothermal energy is already being systematically advanced with large government programmes. Germany is still lagging behind somewhat in this respect, but has recently implemented an important step towards improving the framework conditions with the "Guideline for the Federal Promotion of Efficient Heat Networks – BEW". Overall, interest and demand are increasing, which is also reflected in the relevant market volume published by Daldrup, which depicts the volume of orders in the negotiation stage weighted with the probability of occurrence and which has increased by 30 percent to EUR 136 m in the last six months. With a significant increase in demand, the drilling capacities and here especially the

m Euro	12 2022	12 2023	12 2024	12 2025	12 2026	12 2027	12 2028	12 2029
Total output	43.0	44.5	46.5	49.5	52.5	54.5	56.5	58.0
Total output growth	-4.1%	3.5%	4.5%	6.5%	6.1%	3.8%	3.7%	2.7%
EBIT margin	5.0%	5.6%	7.5%	8.7%	8.8%	8.8%	8.8%	8.8%
EBIT	2.1	2.5	3.5	4.3	4.6	4.8	5.0	5.1
Tax rate	1.0%	1.0%	5.0%	5.0%	5.0%	20.0%	30.0%	30.0%
Adjusted tax payments	0.0	0.0	0.2	0.2	0.2	1.0	1.5	1.5
NOPAT	2.1	2.5	3.3	4.1	4.4	3.8	3.5	3.6
+ Depreciation & Amortisation	2.4	2.3	1.5	0.5	0.6	0.8	0.9	1.0
+ Increase long-term accruals	0.6	0.3	0.3	0.3	0.3	0.3	0.3	0.3
+ Others	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross operating cash flows	5.1	5.1	5.2	4.9	5.4	5.0	4.7	5.0
- Increase Net Working Capital	-3.4	-1.5	-1.3	-0.8	-0.5	-0.4	-0.3	-0.3
- Investments in fixed assets	-0.7	-1.4	-1.5	-1.7	-1.9	-2.1	-2.3	-2.4
Free cash flow	1.0	2.2	2.4	2.5	2.9	2.5	2.1	2.2

SMC estimation model

skilled personnel are the limiting factor in the market. This limits the growth potential for D&S, but at the same time should offer potential for price increases and margin improvements. Although we have adjusted the cost estimates somewhat after the half-year figures, we have left the development path for the company largely unchanged. At the end of the detailed forecast period, we still see total output at EUR 58 m and continue to assume an improvement in the EBIT margin to 8.8 percent by then, the handling of the skills shortage likely being one of the key factors here. An overview of the development of the key cash flow indicators resulting from these assumptions until 2029 can be found in the table below; further details on the projected balance sheet, income statement and cash flow statement can also be found in the Annex.

Framework data remain the same

Subsequently, we continue to calculate the terminal value with a fifteen percent discount to the target margin of 2029 and a “perpetual” cash flow growth of 1

percent p.a. The discount rate (WACC) also remains unchanged at 6.0 percent. For this, we have assumed a cost of equity according to CAPM of 9.0 percent (with: safe interest rate of 1.5 percent, market risk premium of 5.8 percent and beta factor of 1.3), as well as a target capital structure of 55 percent debt, an interest rate on borrowed capital of 5.0 percent and a tax rate for the tax shield of 30 percent.

Price target: EUR 8.00

These assumptions result in a fair market value of equity of EUR 47.6 m or EUR 7.94 per share. From this we derive an unchanged price target of EUR 8.00 (a sensitivity analysis for the price target determination can be found in the Annex). We rate the forecast risk on a scale of 1 (very low) to 6 (very high) as slightly above average at four points due to the project nature of the business.

Conclusion

In the first half of the current business year, the total output of Daldrup & Söhne was still declining, but this was mainly due to the usual fluctuations in the project business. For the year as a whole, the expected total output of EUR 42 m is to be only slightly below the high figure of the previous year.

It is very satisfactory that D&S was nevertheless able to double its EBIT from EUR 0.6 m to EUR 1.2 m in the first six months. Even though this was helped by a positive one-off effect of just under EUR 400,000, this shows the upward trend in the margin. In the full year, the EBIT margin is expected to be 4 to 6 percent, after 3.4 percent in the 2021 financial period.

Overall, things are progressing at D&S, and the company is noticing a significant increase in interest in geothermal projects that is already reflected in the order intake. The framework conditions for using geothermal energy will continue to improve in the company's core markets, not least in response to the break with Russia, which should lead to a long-lasting upswing.

We have only reflected this very cautiously in our model and still see the fair value of Daldrup & Söhne at EUR 8.00 based on largely unchanged estimates. The share thus offers substantial upside potential, which is why our rating remains "Buy".

Annex I: SWOT analysis

Strengths

- Very experienced management team and staff with great expertise.
- The company has a strong market position in the drilling business in its core markets. A large equipment park enables a wide range of services.
- Longstanding track-record in the successful implementation of drilling projects, especially at depths of up to 6 thousand metres.
- D&S is strongly positioned in the field of geothermal energy, which is one of the most promising renewable energies, especially for the heating market.
- The need for investment is manageable for the foreseeable future because of the existing rig portfolio.
- With an equity ratio of almost 50 percent, the company has a very solid balance sheet structure.

Opportunities

- D&S is actively working to improve efficiency. The margin increase forecast for 2022 indicates the first successes of these efforts.
- At EUR 136 m, the volume of potential orders in the negotiation stage is currently very high and has increased by 30 percent since March.
- The envisaged accelerated expansion of renewable energies, also because of the Russian issue, could further stimulate investments in geothermal energy.
- The search for a final repository for radioactive waste offers great order potential for D&S, especially in Germany.
- In the future, D&S could participate in promising medium-sized geothermal power plants.

Weaknesses

- Due to a failed expansion in the field of geothermal power plant operation (with electricity production), D&S has recorded high losses in recent years. The business unit was sold in 2019/20.
- The margins in the drilling business are currently still relatively low. Across the group, an EBIT margin of 4 to 6 percent is targeted for 2022.
- D&S still needs to become more efficient, especially in the management of large drilling projects.
- Due to the strong influence of the power plant business on the figures of the last few years, it is still difficult to calculate the potential for generating free cash flows in the core business.
- Replacement or supplementary investments in large drilling rigs (for very deep wells) are associated with a high investment volume.

Threats

- Fixed-price contracts in the drilling business carry the risk of losses if there are delays for which the company is responsible.
- Rising material prices as well as energy and labour costs can put pressure on margins.
- The acquisition of qualified personnel is becoming increasingly difficult.
- Possible depreciation of residual items from the sold power plant business (at the end of 2021: approx. EUR 9 m).
- Electricity production with deep geothermal energy is still dependent on state subsidies; a reduction in subsidies would greatly reduce the project potential here.

Annex II: Balance sheet and P&L estimation

Balance sheet estimation

m Euro	2021 act.	2022e	2023e	2024e	2025e	2026e	2027e	2028e	2029e
ASSETS									
I. Total non-current	16.8	15.1	14.1	14.2	15.4	16.7	18.1	19.5	20.8
1. Intangible assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2. Tangible assets	7.2	5.9	5.0	5.0	6.2	7.5	8.9	10.3	11.7
II. Total current assets	21.8	25.2	29.7	34.6	39.4	44.6	47.1	49.3	51.9
LIABILITIES									
I. Equity	19.0	19.8	21.5	23.9	27.1	30.5	31.3	32.2	33.2
II. Accruals	1.2	1.8	2.1	2.5	2.8	3.2	3.5	3.9	4.2
III. Liabilities									
1. Long-term liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2. Short-term liabilities	18.4	18.7	20.3	22.4	24.9	27.7	30.3	32.8	35.4
TOTAL	38.6	40.4	43.9	48.8	54.8	61.3	65.2	68.9	72.8

P&L estimation

m Euro	2021 act.	2022e	2023e	2024e	2025e	2026e	2027e	2028e	2029e
Sales	78.1	34.4	38.7	41.4	44.6	47.8	50.1	52.0	53.4
Total output	44.9	43.0	44.5	46.5	49.5	52.5	54.5	56.5	58.0
Gross profit	23.4	23.0	24.6	25.5	26.9	28.7	30.0	31.1	32.0
EBITDA	3.9	4.6	4.8	5.0	4.8	5.3	5.6	5.9	6.1
EBIT	1.6	2.1	2.5	3.5	4.3	4.6	4.8	5.0	5.1
EBT	0.8	0.9	1.8	2.7	3.4	3.7	3.8	3.8	3.9
EAT (before minorities)	0.8	0.8	1.6	2.5	3.1	3.4	2.9	2.6	2.6
EAT	0.8	0.8	1.6	2.5	3.1	3.4	2.9	2.6	2.6
EPS	0.13	0.13	0.27	0.41	0.53	0.56	0.48	0.43	0.43

Annex III: Cash flows estimation and key figures

Cash flows estimation

m Euro	2021 act.	2022e	2023e	2024e	2025e	2026e	2027e	2028e	2029e
CF operating	-0.4	1.2	3.5	3.9	4.2	4.9	4.8	4.8	5.0
CF from investments	1.3	-0.7	-1.4	-1.5	-1.7	-1.9	-2.1	-2.3	-2.4
CF financing	0.0	-0.8	-0.8	-0.4	0.0	0.1	-2.1	-2.0	-1.9
Liquidity beginning of year	3.0	3.0	2.7	4.1	6.1	8.5	11.6	12.2	12.7
Liquidity end of year	3.0	2.7	4.1	6.1	8.5	11.6	12.2	12.7	13.4

Key figures

percent	2021 act.	2022e	2023e	2024e	2025e	2026e	2027e	2028e	2029e
Total output growth	-5.5%	-4.1%	3.5%	4.5%	6.5%	6.1%	3.8%	3.7%	2.7%
Sales growth	198.1%	-55.9%	12.5%	6.9%	7.6%	7.2%	5.0%	3.7%	2.7%
Gross margin*	52.1%	53.6%	55.2%	54.9%	54.4%	54.7%	55.0%	55.1%	55.2%
EBITDA margin*	8.8%	10.6%	10.8%	10.7%	9.7%	10.0%	10.2%	10.4%	10.6%
EBIT margin*	3.5%	5.0%	5.6%	7.5%	8.7%	8.8%	8.8%	8.8%	8.8%
EBT margin*	1.8%	2.2%	4.0%	5.9%	6.9%	7.0%	6.9%	6.8%	6.6%
Net margin (after minorities)*	1.7%	1.9%	3.7%	5.3%	6.4%	6.4%	5.3%	4.5%	4.4%

*on total output

Annex IV: Sensitivity analysis

WACC	Perpetual cash flow growth				
	2.0%	1.5%	1.0%	0.5%	0.0%
5.0%	12.85	11.28	10.11	9.19	8.46
5.5%	10.92	9.78	8.90	8.20	7.62
6.0%	9.47	8.62	7.94	7.38	6.92
6.5%	8.35	7.69	7.15	6.70	6.32
7.0%	7.45	6.93	6.50	6.13	5.82

Disclaimer

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Charts

The charts were made with Tai-Pan (www.lp-software.de).

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II) Preparation and updating

The present financial analysis was prepared by: Dipl.-Kfm. Holger Steffen

Participants in the preparation of the present financial analysis: -

The present analysis was finished on 07.10.2022 at 8:10 and published on 07.10.2022 at 9:15.

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In the past 24 months, sc-consult GmbH has published the following financial analyses for the company:

Date	Investment recomm.	Target price	Conflict of interests
29.08.2022	Buy	8.00 Euro	1), 3), 4)
09.06.2022	Buy	6.70 Euro	1), 3), 4)
08.10.2022	Hold	5.60 Euro	1), 3), 4)
24.06.2021	Hold	5.60 Euro	1), 3), 4)
25.02.2021	Hold	5.60 Euro	1), 3), 4)
12.10.2020	Hold	4.90 Euro	1), 3), 4)

In the course of the next twelve months, sc-consult GmbH will presumably prepare the following financial analyses for the company: one update, one comment.

The publishing dates for the financial analyses are not yet fixed at the present moment.

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