

FLIR Systems, Inc.

NASDAQ:FLIR

Analyst: Pierre Riffard

Sector: Capital Goods

BUY

Price Target: \$36

Key Statistics as of 04/04/2016

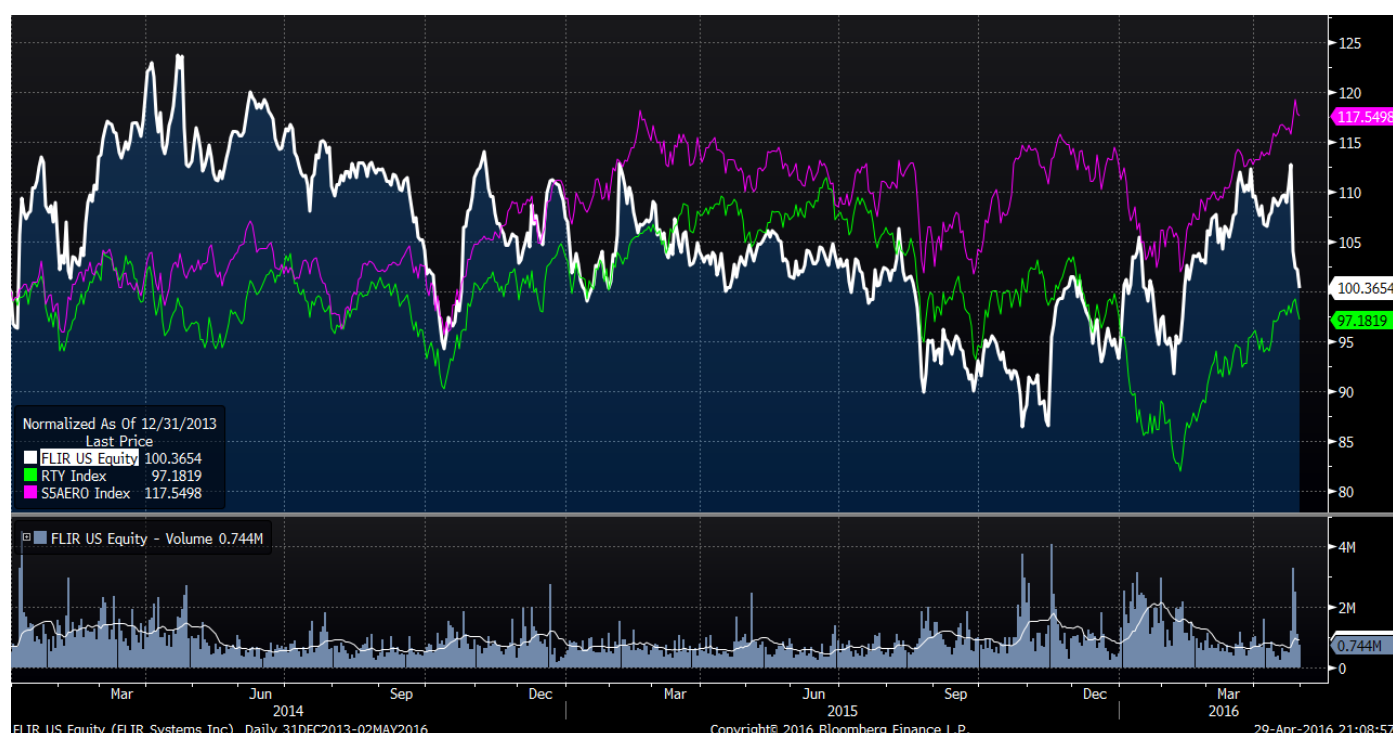
Market Price:	\$30.21
Industry:	Aerospace & Defense
Market Cap:	\$4.16B
52-Week Range:	\$25.12 - \$34.08
Beta:	0.94

Thesis Points:

- Market leader with better margins and sales growth than peers.
- Strong market outlook, record backlog, important R&D investments and a focus on cost reduction foresee improved performance.
- Recent drop in price after mixed Q1 2016 earnings made the stock attractive.

Company Description:

FLIR Systems, Inc. (NYSE:FLIR) is a global leader in designing and manufacturing thermal imaging and detection camera systems, and advanced sensors. The customer base of the company is very large and includes military, commercial, industrial, and consumer markets and governments from around the world. The company has been founded in 1978, and is headquartered in Wilsonville, OR. FLIR had approximately 1,726 employees in the United States and 1,277 employees abroad including Canada, Brazil, Belgium, Sweden, UK, Germany, Italy, Spain, Russia, UAE, Australia, New Zealand, China, India, Japan, and Korea. The mission statement of the company is to enable customers to benefit from the valuable information produced by advanced sensing technologies and to deliver sustained and superior financial performance for shareholders.



Thesis

FLIR Systems, a global leader in imaging systems reported mix results during its latest earnings call, and the stock went down 10.9% since 04/26/2016. Is that price sustainable? Is this correction in the stock price temporary? Did investors overreacted? Or is it a great opportunity to buy the stock?

The earnings were disappointing but the revenue were surprisingly high. The company expected to have a difficult quarter, but the full-year guidance remained unchanged and they expect improvement in margins during the second-half of the year. The fundamentals are solid, and the company is the most profitable among its peers. Its current earnings expectations are quite strong, with a positive market outlook. The company has very low risks given its R&D investments, and well-diversified and very large portfolio of products and patents. The company is selling worldwide to thousands of customers. Even if the actual earnings of the first quarter of the year disappointed, it was not enough to drag the price down by 10%.

Product Portfolio

The company is divided into six segments:

The biggest segment is *Surveillance*. It provides imaging and recognition solutions to military, law enforcement, public safety, and governments. It also manufactures hand-held and weapon-mounted thermal imaging systems. Products price ranges from below \$2,000 for hand-held systems to over \$1 million for the most advanced targeting systems. Revenue from that activity accounted for 32% of total sales, with a 29% operating margin for FY2015.

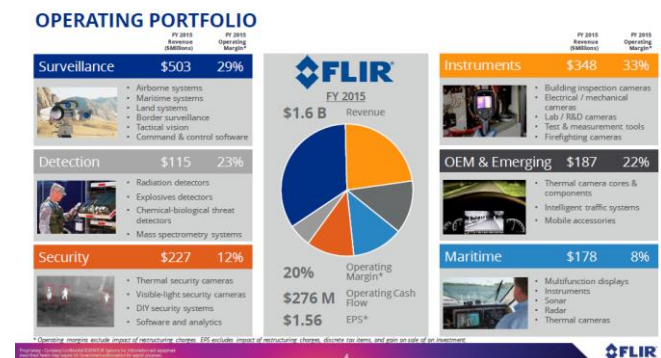
The second most important segment in terms of revenue is *Instruments*. It provides devices that image, measure, and assess thermal energy, gases, electricity, and other environmental elements. Such devices are used for commercial, industrial, and scientific applications and by the firefighting, and safety and health sectors. It accounted for 22% of total revenue, with a 33% operating margin in FY2015.

The third segment is *Security*. It develops a large range of camera and video recording systems for commercial, critical infrastructure, and home monitoring applications. It accounted for 15% of total revenue, with a 12% operating margin in FY2015.

The next segment is *OEM (Original Equipment Manufacturer) & Emerging Markets*. This segment manufactures thermal imaging camera components

used by third parties to manufacture imaging systems. It also develops emerging technologies like intelligent traffic systems, imaging solutions for the smartphone market, and thermal imaging solutions for commercial-use unmanned aerial systems. It accounted for 12% of total revenue with a 22% operating margin in FY2015. The least profitable segment is *Maritime*. It provides electronics (control systems and communications equipment) and imaging instruments for the recreational and maritime market. It accounted for 11% of total revenue, with an 8% operating margin in FY2015.

The smallest segment in terms of sales is *Detection*. It provides sensors, instruments, and integrated platform solutions for the detection, identification, and suppression of chemical, biological, radiological, nuclear, and explosives threat used for military, homeland security, first responders, and commercial applications. This segment had the best revenue growth, and accounted for 7% of total sales, with a 23% operating margin.



Activity Outlook

The overall market outlook for companies like FLIR is very good. The company expects a 3% to 6% growth in activity. According to Bloomberg estimates, revenue are going to increase by 5.5%, 4.5%, and 5.9% in 2016, 2017, and 2018 respectively. Over Q1 2016, revenue from all segments, except *Instruments*, went up. The *Instruments* revenue actually went up by 5% but foreign exchange negatively impacted earnings by approximately \$2 million. The recent resurgence in national threats all over the world associated with the increase in military expenditures by non-ally countries are pushing governments (primarily United States, key European states, Asia, and Saudi Arabia) to increase their respective defense budgets with a primary focus on the detection of threats. The demand for detection and security high-end systems is booming following

recent bombing attacks in Paris and Brussels. The threat level is currently extremely high, governments are increasing security, and that situation is not going to stop over the next years. As the company is also acting as a supplier for competitors, the OEM segment is directly going to benefit from the rise in demand for thermal imaging, detection, and security systems. The company can also benefit from regulations. A recent American regulation imposes to any nuclear facilities to have a 24/7 video surveillance system. Due to the terrorist threats, governments and private companies are going to increase surveillance and detection systems. The products FLIR are selling respond to a need to detect what cannot be observed to enhance perception and awareness, and the current geopolitical situation is making that already essential need even more important.

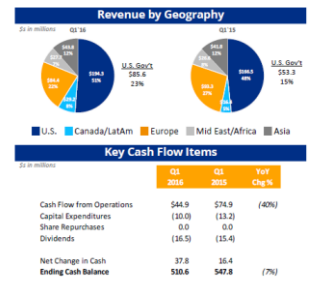
Q1 2016 Earnings Call

On 04/26/2016, the company reported mixed results: revenue was strong at \$379.472 vs estimate of \$360.75, and EPS was \$0.01 vs estimate of \$0.318. The EPS had been negatively impacted by a \$40 million charge to establish reserves booked in the quarter. As a result, the stock went down by 7.7% to \$31.31, and followed the market the next three days to finally reach \$30.21 at the closing bell on 04/29/2016. Here, I think there was an overreaction following the earnings call, and that based on fundamentals and expectations, the stock will go back to \$34. The adjusted EPS was \$0.30 vs estimate of \$0.32, but EBITDA was \$111.316 million vs estimate of \$75.967, that is a 46.5% positive surprise. The company recorded a \$613 million backlog, which is a 10% increase over the prior year and the highest since 2008. The total revenue went up by 10% compared to prior year. The main drivers of the revenue growth came from the *Detection*, *Security*, *OEM and Emerging* and *Surveillance* segments that went up by 61%, 21%, 20% and 10% respectively. Revenue to Canada and Latin America went up by 78%, and sales in the US increased by 17%. Operating profit went down by 13% compared to prior year. The company was expecting a decrease in margins for the first half of the FY2016. During the earnings conference, the management explained they forecast a strong second half of the year with better margins as programs within the *Surveillance* activity will be done, and they maintained their full-year guidance. The management of the company will also focus on

operating cost management. The company expects a revenue growth rate of 3-6%, and a 3-9% increase in adjusted EPS.

Q1 2016 Q1 Financials Review

(\$ in millions, except per share amounts)	Q1 2016	Q1 2015	YoY Chg %
Revenue	\$379.5	\$344.5	10%
Gross Profit	177.7	175.9	1%
Gross Margin %	47%	51%	-423 bps
Operating Income	\$57.4	\$65.8	(13%)
Operating Margin %	15%	19%	-387 bps
Net Income	\$1.1	\$47.9	(98%)
Tax Reserves Expense	40.0	0.0	
Adjusted Net Income	\$41.2	\$47.9	(14%)
Diluted Share Count	138.8	141.5	
EPS	\$0.01	\$0.34	(97%)
Adjusted EPS	\$0.30	\$0.34	(12%)
Cash Flow from Operations	\$44.9	\$74.9	(40%)



Q1 2016 Segments Summary

(\$ in millions)	Q1 2016	Q1 2015	YoY Chg %	YoY Chg %
Revenue				
Surveillance	\$124.2	\$112.9	10%	30%
Instruments	79.4	83.8	(5%)	(3%)
Security	47.1	38.8	21%	22%
OEM & Emerging	47.8	39.8	20%	23%
Maritime	51.7	51.0	1%	5%
Detection	29.3	18.2	62%	62%
Total Revenue	\$379.5	\$344.5	10%	10%
Operating Income				
Surveillance	\$30.2	\$30.2	17%	
Instruments	19.5	28.1	(31%)	
Security	(3.6)	3.8	(196%)	
OEM & Emerging	10.0	8.8	14%	
Maritime	5.0	4.8	4%	
Detection	7.9	2.7	194%	
Segment Operating Income	\$74.0	\$78.3	(5%)	
Segment Operating Margin %	20%	23%	-322 bps	
Corporate Expenses	(16.6)	(12.5)	33%	
Total Operating Income	\$57.4	\$65.8	(13%)	
Total Operating Margin %	15%	19%	-387 bps	



Q1 2016 Full Year 2016 Outlook

- Continue to expect revenue of \$1.60 – \$1.65 billion
 - An increase of approximately 3% to 6% over 2015
- Continue to expect EPS of \$1.60 – \$1.70
 - Excludes impact of discrete tax items
 - Range represents an increase of approximately 3% to 9% over 2015 (excluding 2015 restructuring, investment gain, and discrete tax items)
 - Gross margins expected to improve in second half of the year
 - Continued focus on operating cost control to absorb near-term gross margin softness
- Announced quarterly dividend of \$0.12 per share, payable on June 3rd to shareholders of record as of May 20th



Financials

The financials of FLIR are among the best of the industry. Over the last three years, revenue, EBITDA, and net income constantly went up. The company is following a vertical manufacturing integration, which has made FLIR the most profitable company among its peers. Key acquisitions, cost management policies, and growth in revenue will create more synergies in the following years. The 2015 EBITDA margin was 7% higher than competitors at 22.82%. The 2015 Profit margin was 5.5% higher at almost 14%. The \$518.5k sales per employees was much higher than any

competitors. The Free Cash Flow margin was also well better than the peers' average. Bloomberg estimates EBITDA to improve by 5%, 8.4%, and 10% in 2016, 2017, and 2018 respectively to reach \$447.5 million. The current level of cash and free cash flow will enable the company to increase its share repurchase program and its dividends to return more and more to shareholders. The Capital Expenditures are stable since 2012, and are not expected to increase over the next two years. As a result, free cash flow is expected to follow the operating cash flow positive growth.



manufacturing some of the components needed to manufacture its own imaging devices, but it is also selling such components to competitors. As a result, in addition to reducing costs and gaining sales, FLIR has some bargaining power over competitors and at the same time, it has less pressure from its suppliers. The company is currently a leader developer of highly reliable, accurate and effective advanced sensor systems. The company has achieved penetration into a very wide variety of customers (thousands of commercial and government customers) worldwide offering lots of potential for future sales. The product and patent portfolio is one of the largest currently available covering civil, military, detection, surveillance maritime, unmanned, scientific, firefighting, rescuing, law enforcers, and federal agencies operations.

Conclusion

FLIR has an exceptional market position with better-than-peers financial performance. With its portfolio diversification, its very wide base of customers, and its important R&D investments and expertise, the company is better prepared to improve both top- and bottom-lines than competitors. The missed earnings is partially offset by the strong expectations, and the surprisingly high revenue. Cost reductions will come with growth in sales. The future of this company is looking good, especially in the current and expected geopolitical situation. The 10% drop in price is not sustainable and may offer good returns over the next months. I would recommend a buy as the stock is below \$31.30 with a one-year target between \$35 and \$37.50.

Competitive Advantages

An important part of FLIR's business is its research & development. For FY2015, internally funded R&D was \$133 million. R&D are used to innovate and make available new technologies capable to bring additional revenues, or simply to maintain or increase the market share by constantly updating devices. It can also be used to reduce costs during the manufacturing process. That part is especially important for FLIR as another major competitive advantage is its vertical manufacturing integration. FLIR is not only

FLIR Systems, Inc. (FLIR)

CENTER FOR GLOBAL FINANCIAL STUDIES

NEUTRAL

Analysis by Pierre Riffard
4/30/2016

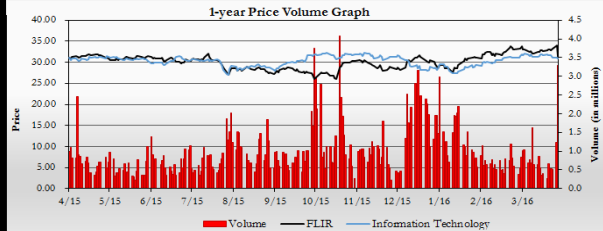
Current Price:
Divident Yield:

\$30.21
1.5%

Intrinsic Value
Target Price:

\$31.44
\$35.44

Target 1 year Return: 18.84%
Probability of Price Increase: 98.2%

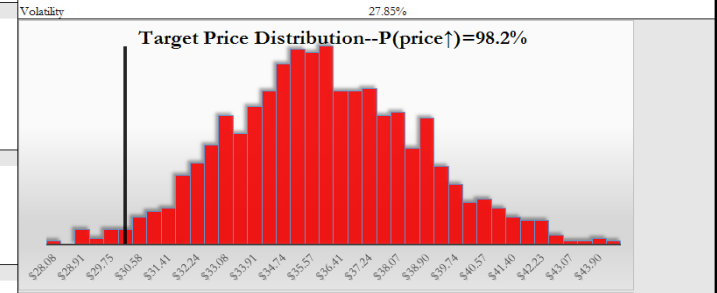


Description	
FLIR Systems, Inc. designs, develops, manufactures, and markets thermal imaging, visible-light imaging systems, locator systems, measurement and diagnostic systems, and threat-detection solutions worldwide.	
General Information	
Sector	Information Technology
Industry	Electronic Equipment, Instruments and Components
Last Guidance	November 3, 2015
Next earnings date	July 26, 2016
Estimated Country Risk Premium	7.04%
Effective Tax rate	26%
Effective Operating Tax rate	26%

Market Data	
Market Capitalization	\$4,155.66
Daily volume (mil)	0.74
Shares outstanding (mil)	137.56
Diluted shares outstanding (mil)	140.10
% shares held by institutions	94%
% shares held by investments Managers	84%
% shares held by hedge funds	4%
% shares held by insiders	0.96%
Short interest	2.25%
Days to cover short interest	3.27
52 week high	\$34.09
52-week low	\$25.12
Levered Beta	0.58
Volatility	27.85%

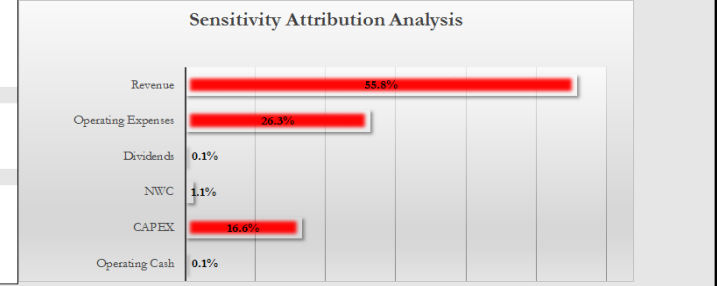
Past Earning Surprises	
Quarter ending	Revenue
3/31/2015	-6.82%
6/30/2015	2.32%
9/30/2015	-3.71%
12/31/2015	-0.87%
3/31/2016	2.01%
Mean	-1.42%
Standard error	1.7%

EBITDA		Peers	
		National Instruments Corporation	
		Rockwell Collins Inc.	
		AeroVironment, Inc.	
		FEI Company	
		Raytheon Company	
		MTS Systems Corporation	
		General Dynamics Corporation	



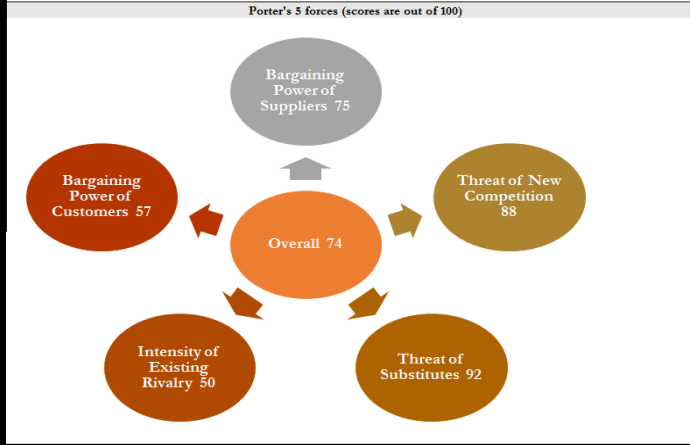
Management	
Teich, Andrew	Chief Executive Officer, Pre
Singhi, Amit	Chief Financial Officer and
Sutran, Thomas	Chief Operating Officer and
Muesile, David	Chief Accounting Officer and
DuChene, Todd	Chief Ethics & Compliance Of
Frank, Jeffrey	Senior Vice President of Glo

Total compensations growth		Total return to shareholders	
	38.47% per annum over 5y		-3.22% per annum over 5y
	N/A		0% per annum over 0y
	31.01% per annum over 2y		-2.08% per annum over 2y
	N/A		0% per annum over 0y
	23.13% per annum over 1y		-11.76% per annum over 1y
	29.12% per annum over 1y		-11.76% per annum over 1y



Profitability		FLIR (LTM)		FLIR (5 years historical average)		Industry (LTM)	
ROIC	12.2%		17.01%		10.19%		10.19%
NOPAT Margin	19%		22.82%		13.1%		13.1%
Revenue/Invested Capital	0.64		0.75		0.78		0.78
ROE	11.9%		16.19%		11.43%		11.43%
Adjusted net margin	18%		22.12%		12.1%		12.1%
Revenue/Adjusted Book Value	0.65		0.73		0.94		0.94

Invested Funds		FLIR (LTM)		FLIR (5 years historical average)		Industry (LTM)	
Total Cash/Total Capital	17.2%		17.4%		16%		16%
Estimated Operating Cash/Total Capital	2.1%		2.2%		N/A		N/A
Non-cash working Capital/Total Capital	17.1%		18.9%		16%		16%
Invested Capital/Total Capital	85.0%		84.7%		82%		82%



Capital Structure		FLIR (LTM)		FLIR (5 years historical average)		Industry (LTM)	
Total Debt/Common Equity (LTM)	0.10		0.11		0.16		0.16
Cost of Existing Debt	3.64%		4.13%		3.49%		3.49%
Estimated Cost of new Borrowing	2.85%		2.68%		3.49%		3.49%
CGFS Risk Rating	A		A		BBB		BBB
Unlevered Beta (LTM)	0.54		0.73		1.02		1.02
WACC	7.52%		8.94%		10.68%		10.68%

Valuation	
Revenue growth	NO PAT margin
Base Year	19.0%
3/31/2017	19.3%
3/31/2018	19.7%
3/31/2019	19.7%
3/31/2020	19.6%
3/31/2021	19.6%
3/31/2022	20.1%
3/31/2023	20.5%
3/31/2024	20.9%
3/31/2025	21.4%
3/31/2026	21.7%
Continuing Period	22.1%

Invested Capital		Net Claims		ROIC/WACC	
Base Year	\$1,728.06		1.62		1.62
3/31/2017	\$2,048.22		1.59		1.54
3/31/2018	\$2,193.12		1.54		1.50
3/31/2019	\$2,336.66		1.47		1.48
3/31/2020	\$2,486.82		1.48		1.49
3/31/2021	\$2,528.40		1.49		1.49
3/31/2022	\$2,654.25		1.49		1.49
3/31/2023	\$2,744.67		1.49		1.49
3/31/2024	\$2,830.35		1.49		1.49
3/31/2025	\$2,907.15		1.50		1.50
3/31/2026	\$2,974.05				
Continuing Period					

Price per share	
Base Year	\$31.36
3/31/2017	\$35.37
3/31/2018	\$39.36
3/31/2019	\$43.40
3/31/2020	\$47.48
3/31/2021	\$51.60
3/31/2022	\$55.86
3/31/2023	\$60.24
3/31/2024	\$64.74
3/31/2025	\$69.35
3/31/2026	\$74.05
Continuing Period	