EDISON

Treatt

H1 results in detail

Zesty outlook

Food & beverages

Treatt continues its transformation from a trading house to a provider of value-added, technical flavour and fragrance solutions. Its core categories of citrus, tea and sugar reduction continue to drive profit growth. After several years of raw material price inflation, the company is experiencing some falling prices, particularly in citrus. Citrus is Treatt's historical area of strength and expertise: it represents c 50% of company revenues and the company has demonstrated longstanding skills in managing input prices over many decades. Raw material prices are cyclical, and whilst raw material price deflation tends to result in softer pricing, it does not necessarily cause a fall in profits. We leave our forecasts broadly unchanged and believe the current share price offers a good entry point considering our fair value of 517p (unchanged).

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
09/17	101.3	12.8	18.5	4.8	24.9	1.0
09/18	112.2	13.8	20.3	5.1	22.7	1.1
09/19e	113.8	14.1	18.3	5.1	25.2	1.1
09/20e	116.1	14.8	19.2	5.8	24.0	1.3

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

Operating in a niche

Treatt falls into a niche with no major direct competitors that cover all the same categories. It provides top-end innovation in beverages solutions, while also directly providing beverages ingredients. Many of its products can be classified as natural or clean label. Treatt's portfolio is well-suited to the current consumer trends of clean labels and more natural, better-for-you products. Its key categories continue to be important drivers of both revenue and margin growth. We forecast 2.5% revenue CAGR for FY18–21, with adjusted operating margins of 12.0% in FY21.

Moving up the value chain

Over time, Treatt has transformed itself by moving from trading commodities such as citrus oil, to partnering more deeply with its customers in order to deliver bespoke ingredients solutions, such as natural extracts in tonic waters. As Treatt moves up the value chain, it should deliver faster, less volatile growth, coupled with higher margins. To enable and aid the transformation, CEO Daemmon Reeve has fostered a culture of empowerment and championed a can-do attitude across the business, encouraging closer collaboration across categories and geographies, and deeper relationships with customers. This is set to continue, as the management delivers on its current strategic plan ending in FY22.

Valuation: Fair value 517p

Our DCF-derived fair value is 517p/share (unchanged), representing c 12% potential upside to the current share price. Our DCF is supported by Treatt's benchmark valuation, with the shares trading at 24.0x and 15.1x FY20 P/E and EV/EBITDA, c 6% and c 12% respective discounts to the ingredients peer group.

3 July 2019

Price	**461.0p**
Market cap	**£272m**

Net cash (£m) at 31 March 2019	9.4
Shares in issue	59.1m
Free float	100%
Code	TET
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	(3.6)	14.1	6.8
Rel (local)	1.1	16.6	6.0
52-week high/low		508.0p	388.0p

Business description

Treatt provides innovative ingredient solutions from its manufacturing bases in Europe, North America and Africa, principally for the flavours and fragrance industries and multinational consumer goods companies, with particular emphasis on the beverage sector.

Next events

FY19 results	26 November 2019

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Edison profile page

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Investment summary

Company description

Treatt provides ingredients and ingredient solutions both to the flavours and fragrance industries, and directly to global fast-moving consumer goods (FMCG) manufacturers. The beverages space has proved to be the fastest-growing segment for the company over the past few years, in particular sugar reduction, citrus, ready-to-drink tea flavours, and fruit and vegetable clean-label extracts. Treatt's in-depth knowledge of the commodities markets in which it operates (non-exchange-traded) and its long-term relationships with suppliers provide the group with an important competitive advantage. Treatt has more than 125 years of knowledge of sourcing and trading raw materials, which acts as a barrier to entry for potential new entrants.

Valuation: Attractive play

Over the last 12 months, the share price has risen 5% in absolute terms and 6% in relative (FTSE All-Share) terms, while over the last three months these figures are 19% and 17% respectively. The company trades at a discount to its larger peers based on benchmark valuation metrics. We value Treatt on a DCF basis and derive a fair value of 517p, or c 12% upside. As before, our DCF is predicated on a WACC of 6.9% (encompassing beta of 0.8, equity risk premium of 5.0% and borrowing spread of 5.0%) and a terminal growth rate of 2%.

Treatt trades at a discount to its larger ingredients peers on both P/E and EV/EBITDA multiples. Treatt trades at 24.0x and 15.1x FY20 P/E and EV/EBITDA, representing c 6% and 12% discounts to the peer group, respectively. While some discount is justified due to Treatt's size and part of its portfolio being relatively 'upstream', we believe the current share price offers a good entry point for the shares. While falling citrus prices are likely to be reflected in some price deflation in the segment, we do not believe profitability is at risk.

Financials

Following a stellar performance in FY17, with revenue growth of 25% and profit before tax up 46% on an adjusted basis, FY18 was always likely to witness a deceleration. This did indeed come to fruition, with revenues up 11% and profit before tax up 8% on an adjusted basis. Revenue growth in H119 slowed even further to 6%, although, crucially, adjusted PBT was up 7%. We expect H2 to witness a greater deflationary impact on selling prices in the citrus category stemming from falling raw material prices, but we note this should not result in a reduction in profits.

For the next three years we forecast a 2.5% revenue CAGR and 4.6% pre-exceptional PBT CAGR, translating to 0.4% pre-exceptional earnings CAGR FY18–21. Management's proven track record in meeting or beating consensus expectations, combined with the positive outlook for the natural ingredients industry, gives us confidence that consensus forecasts will be met. Management has been successful in navigating fluctuating raw material costs, and we expect this cycle to be no different, especially given that the citrus category is Treatt's historical area of expertise.

Sensitivities

Treatt has a couple of key sensitivities, which it seeks to mitigate through the in-depth knowledge and skills base of its buying team and by employing an active hedging policy where possible:

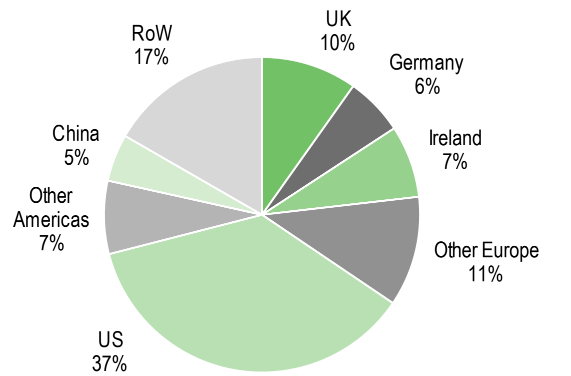
- **Commodity exposure:** namely citrus oils, which make up c 50% of revenues.
- **Foreign exchange:** translation risk on US dollar profits, which it manages through hedging, and transactional exposure as some raw materials are dollar-denominated.

Company description

Founded over 130 years ago, Treatt combines deep expertise in flavours and fragrance solutions and its close relationship with customers to help them create appealing and innovative products. Treatt's historical strength was in ingredient sourcing and risk management, but over time it has transformed itself into an innovative supplier of high-quality, value-added ingredient solutions. These solutions now account for over 65% of sales and 70% of group profits. Treatt's customers consist of flavour and fragrance companies (52% of sales) and FMCG and other manufacturers (48% of sales). Its products are used by the former and blended together to create highly value-added ingredients, which may be themselves sold to FMCG companies. In addition, some products are sold directly to FMCG and other players for use in their products. Sugar reduction and ready-to-drink (RTD) tea have proved to be growth segments for the company over recent years.

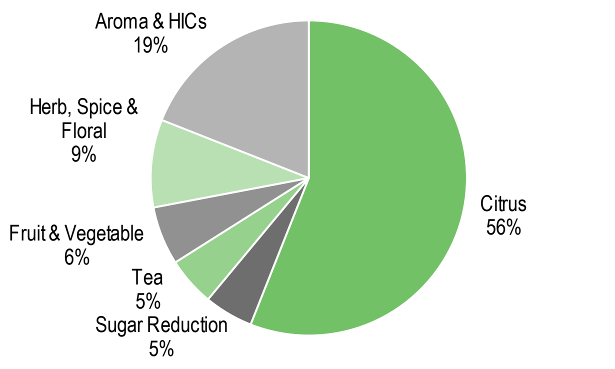
Treatt has a wide customer base in terms of size and geographic spread. While over the years the business has focused on its larger customers, the breadth of its customer base means the group is not overly dependent on any one relationship, with its largest customer representing c 10% of sales and the top 10 customers representing c 35% of sales. Approximately 80% of Treatt's product portfolio is flavour ingredients, which are mostly used in the beverages space. The remaining 20% of the portfolio encompasses fragrance ingredients. Typical end products that use Treatt ingredients range from soft drinks including mixers, alcoholic beverages (including craft beers) and confectionery, to soaps, shampoos and basic pharmaceutical products. Treatt has manufacturing sites in the UK and US, in which its two 100%-owned subsidiaries, RC Treatt and Treatt USA, are principally based. In addition to its manufacturing centres, Treatt has sales offices in China and India and a network of agents throughout the world, through which it exports to more than 90 countries worldwide.

Exhibit 1: Continuing revenue by geography (FY18)



Source: Treatt

Exhibit 2: Revenue by product category (FY18)



Source: Treatt

Treatt has three broad segments in which it operates: ingredient applications, flavour ingredients and fragrance ingredients. Ingredient applications are where Treatt collaborates closely with the customer to develop an ingredient solution for a particular problem or new product. Flavour and fragrance ingredients are part of an extensive range produced and supplied by Treatt for its customers. Treatt's specialists will still help their customers to find the ideal ingredient, and are constantly developing new ones.

Within flavours, Treatt has three key areas of focus: citrus, tea and sugar reduction. Citrus has been a historical area of strength and expertise for Treatt, while sugar reduction and tea have exhibited strong growth over the last few years as they are in the sweet spot of current consumer demand for healthy products that do not compromise on taste or convenience. Treatt has dedicated resources to these three leading product categories to increase their success, without leaving behind the rest of the business. Beverages remain Treatt's main area of expertise as liquid flavourings are most often used in beverages – and the company now derives around three-quarters of its revenues from the beverage industry (including ingredients that are sold on to the beverages industry via flavour houses). The high-impact flavours business continues to contribute to the group overall, but generally at a somewhat lower margin.

Industry overview

The food and beverage industry is constantly evolving. Over the last few years, one of the more significant trends has been for natural, clean-label, calorie-free and sustainable products. Consumers demand these product features, causing the market for natural and naturally derived products to accelerate in growth, and creating significant profit potential for both food and beverage manufacturers and ingredients suppliers. The products are highly desirable but also require a significant degree of complexity and know-how to formulate and utilise, thus giving rise to higher margins.

Consumers perceive natural ingredients as having a positive impact on general health, while synthetic ingredients are viewed less positively. As a result, food and beverage manufacturers have promptly responded to the situation by completely or partially replacing synthetic ingredients with their natural or clean-label counterparts. Clean eating has itself become a consumer trend, with consumers shying away from certain food groups and avoiding products that are viewed as being overly processed. Similarly within the personal care space, consumers are eschewing the larger brands in favour of more niche, sustainable and natural products. The larger FMCG manufacturers have sought to embrace this trend by both reformulating products with cleaner labels, and buying out smaller, niche brands with more organic/natural credentials.

A common problem in the wellness space is that the better-for-you variants often have a compromised taste. To keep taste as close as possible to the regular product, complex formulations take centre stage and may require an ongoing iterative process to optimise the taste. For example, stevia is an increasingly popular 100% natural sweetener; however, it is also renowned for a signature bitter liquorice aftertaste. Treattaromes are Treatt's trademark From the Named Food (FTNF) portfolio of clear aqueous distillates that naturally offset the aftertaste. They provide a natural sweet top-note flavour and are an exciting potential way for Treatt to participate in this fast-growing sector of the beverage market.

Another significant trend in the FMCG space has been the willingness of consumers to trade up in certain specific segments, where they perceive a benefit. For example, alcoholic drinks mixers used to be a low-value proposition, but over the last few years consumers have started to take more note, and hence are looking to trade up and want seasonal specialties, new profiles and high-quality blends that can also be consumed without alcohol. Treatt's expertise in sugar reduction and natural flavours can help its customers to reformulate an existing beverage to improve it, or to launch a new product, all without affecting taste.

We believe Treatt is in an excellent position to benefit from the constant need for FMCG manufacturers to produce a stream of new product formulations to keep consumers engaged, particularly given its focus on deep customer knowledge and relationships, thus enabling it to work closely with its clients. It is also well placed to capitalise on the natural and clean-label trends given its expertise in FTNF solutions.

Strategy

Treatt is in the advanced stages of transforming itself from a trading house to a provider of value-added, technical flavour and fragrance solutions. It seeks to build close, mutually beneficial relationships with its customers across as many touch points as possible.

Having achieved its previous goals three years ahead of schedule, Treatt updated its strategy in September 2018 with a new plan. The current strategy is entitled *Strategy 1.2 – the pathway to 2022* and, as the name suggests, it builds on the prior strategy. The focus has remained the delivery of long-term and consistent growth in profitability by focusing on customers and products that can bring Treatt long-term value. Treatt remains focused on putting its customers first, and developing close relationships with its clients, while remaining at the forefront of technical innovation and expertise. Its strategic priorities are to:

- drive innovation, particularly in its core categories;
- increase its focus on technical, value-added (and hence higher-margin) solutions; and
- invest for future growth with the physical relocation in the UK and the US expansion plan, which is now almost complete.

People and culture are viewed as important assets and the key to enabling and unlocking the priorities set out above, thus Treatt consistently invests in its culture by giving its staff a wide range of training opportunities and by actively engaging with its communities in the UK and US. It works to reduce its environmental impact and this helps to reduce cost and drive efficiencies.

Treatt has strong environmental, social and corporate governance (ESG) credentials, and has invested significantly in this space. It introduced free share awards for its staff in 2014 in order to improve employee ownership, and has recently appointed two new female Non-Executive Directors to its Board. Its use of citrus is highly sustainable, as it is largely a by-product of the juice industry.

Product categories

Treatt has identified the categories of citrus, tea and sugar-reduction as the key growth drivers for its current strategy. This is in order to better serve its customers and to concentrate on the higher-growth and higher-margin opportunities within the business. We note that in H119, the fastest-growing category was fruit and vegetable. We set the six main categories out in turn below. Treatt has formed dedicated, cross-functional teams to further develop these.

Citrus

Treatt has a long history of expertise in citrus, and it has been a core part of its business for many decades. The taste for citrus flavours remains a winner in the beverage industry and is often used to encourage consumers to try new or exotic flavours, as they can be paired with the more traditional orange, lemon or lime flavours. The natural citrus flavour can be touted by brands, together with its provenance. Citrus also has the advantage of working well in most beverage categories, from juices and flavoured waters, to sparkling drinks and teas. Treatt maintains long-term relationships with citrus growers and processors across more than 10 countries to provide a stable and sustainable supply and to smooth out some of the pricing volatility.

Tea

Tea is the second most widely consumed beverage worldwide, after water. All teas come from the same plant; it is the processing method that gives each tea its distinctive properties. It is popular in different forms depending on geography, but RTD tea in particular has increased in popularity globally, with the market growing by 40% between 2011 and 2016, far outpacing the growth of the carbonated soft drinks market. Current consumer interest in sugar reduction gives further opportunity for this market to grow, with companies providing healthier variants. Natural energy drinks, kombucha and cold brew teas are all outpacing market growth, driven by the trend of healthier consumption. Tea has a broad appeal and embraces the current consumer trends of low-sugar, natural products that have additional health benefits. Tea can be niche, premium or every day, hence giving Treatt a wide spectrum in which to operate. Treatt's expertise centres on authenticity of flavour, and it can provide solutions from a black tea flavour for an RTD tea beverage, to a delicate top note in a blended beverage.

Sugar reduction

Reducing sugar levels and calories in both food and drink is a global trend that is being driven by increasing consumer awareness of the detrimental effects of sugar on health. The food and drink industry as a whole is reformulating its product ranges as sugar reduction concerns become more prevalent and sugar taxes and levies are introduced. The key concern, however, is not to have a detrimental effect on taste. Sugar reduction is also technically complicated, which is where Treatt's expertise comes in. Sugar provides flavour, sweetness and mouth feel. Treatt operates principally in the niche of flavour, which is difficult to replicate. Treatt has a growing reputation here and is recognised for bringing the important technical sugar authenticity to the flavour profile of a beverage. Treatt's 100% natural, calorie-free sugar reduction range can deliver a sugar flavour that allows customers to bring an authentic sucrose or fructose profile to natural and artificial high-intensity sweeteners.

Fruit & vegetable

Providing natural fruit and vegetable flavour to food and beverages or fragrance to home and personal care items is another capability that taps into the current consumer trend for more natural products with clean labels. Treatt's fruit and vegetable flavour range is comprised of highly concentrated aqueous distillates. They are 100% natural and are distilled for shorter time periods at lower temperatures to maximise flavour. Their concentration results in them being extremely effective even at lower dosages. Watermelon, cucumber and berry flavours have been particularly successful recently as they provide a fresh and authentic flavour. The fruit and vegetable segment was the fastest-growing category for Treatt during H110, with sales up 64%.

Herb, spice & floral

Premium beverages come in a range of flavours, and floral, herbed and spiced flavours have gained in popularity as consumers experiment with new and exotic flavours. Treatt sources, manufactures and supplies over 500 herb, spice and floral products. They are 100% natural ingredients, made from the named food (FTNF). Treatt works closely with its customers to match specific requirements. Products include essential oils such as peppermint and lavender.

Aroma and High-Impact Chemicals

High-impact aroma chemicals (HICs) are ideal for creating powerful flavours and fragrances, and often offer a low-cost solution at low dosage. Treatt has an extensive range of speciality HICs and a long history in the space. The segment outperformed management's expectations during H119, up an impressive 18% vs the prior year.

Geographical split

Treatt primarily runs its business by geographical segment, as reflected in its segmental reporting. Of course, as part of its focus on culture and employee engagement, employees in each of the product categories are encouraged to share knowledge and best practices globally. The US is Treatt's largest and most dynamic market: it lends itself perfectly to Treatt's clean-label proposition, as consumers increasingly demand healthier and more natural products. The Asian market has witnessed extremely fast growth over the past few years. As discussed below, the well-known trends of increasing affluence and urbanisation have driven growth in the underlying ingredients space. In addition, Treatt has increased its focus on Asia over the past few years, thus being able to seize on a greater number of opportunities. The business remains small in the context of Treatt, however. North America and Europe (including the UK) have exhibited slower growth, but still represent 71% of overall sales.

UK and Europe

These are diverse and evolving markets, which present a number of opportunities as several trends continue to gain traction. Reduction in sugar levels continues to be the most significant trend, with government initiatives, levies and taxes being implemented in multiple countries in order to incentivise consumers to reduce sugar consumption. New brands are establishing their credentials as sugar-free, and more established brands are reformulating in order to stay relevant and avoid sugar levies and taxes. Treatt's increasingly large portfolio of 100% natural sugar reduction solutions allows its customers to reduce sugar levels while maintaining a clean label, and not having a dramatic impact on taste.

North America

This is a mature and established market for Treatt, but there is an increased focus on innovation and new product development. Over the last decade, the US market has witnessed a marked consumer desire for healthier, more natural and more sustainable products across the food, beverage and personal care space. Brands across the FMCG spectrum are reformulating and repackaging in order to satisfy this consumer trend. Again, Treatt's expertise in sugar reduction is creating opportunities. In addition, the US market is witnessing a surge in demand for iced tea and RTD blended tea, which plays well into Treatt's expertise in tea, detailed above. These two trends are coming together as increasingly health-focused consumers are shifting their consumption towards tea thanks to its healthier connotations.

Asia

China and India are increasingly a focus as the rising affluence of the middle classes and urbanisation trends drives growth in the Asian beverages industry. Tastes are increasingly influenced by western culture and hence health and wellbeing are coming to the fore here too. Treatt is continuing to grow its footprint across Asia, as its core categories are in the sweet spot of consumer and customer demand.

Culture

Daemmon Reeve has driven significant cultural change at the company since becoming CEO in 2012. Treatt recognises that a well-motivated and experienced workforce will be more successful, and an important part of its strategy is to continuously enhance the engagement of its workforce. Internal structures are constantly improved to ensure collaboration across the business. The culture of openness, innovation and collaboration attracts and retains the brightest candidates and Treatt offers a tailored training and development programme to help individuals reach their full potential.

Engagement with local communities has resulted in Treatt being widely recognised as a desirable employer and a business committed to community responsibility. By fostering a culture of innovation, the company is seeing cross-departmental teams coming together and identifying new opportunities to grow and improve efficiency.

Relocation and expansion

The relocation and expansion in the UK and US, respectively, provide the platform for the new strategy to develop, and are key enablers of growth.

UK

For some time, Treatt has outgrown its current UK manufacturing facilities in Bury St Edmunds and it fully and carefully explored its options. In May 2015 the company announced its intention to fully relocate the UK business to another site near the existing one, and in November 2017 it announced an equity fund-raising through a placing to help meet the costs of the expansion project (the placing was for 10% of share capital, with shares placed at 410p and raising £21.6m before expenses, or £20.8m on a net basis).

Once completed, the new facility will be purpose-built, with upgraded machinery and the latest technology. The project is obviously complex, but the overall cash outflow over two to three years is forecast to be £35m, including spend of £6–8m on some capital projects that have been held back in view of the relocation (in effect delayed capex as management has sensibly reduced capital expenditure to the minimum possible over the past few years, in view of the imminent relocation). Construction should commence in mid 2019, with a move-in date anticipated for summer 2020 There was a six-month delay to the project, announced with the FY18 results, as the design phase took longer than expected. We currently forecast expansionary capex costs of £22m in FY19, £13m in FY20 and £3.5m in FY21 or £37.7m in total (including the £6.2m spent in FY18), with a further £5m of disposal proceeds in FY21–22 as the old site is divested, bringing the total project cost within the £30–35m range. Management expects ROI to be in the range of 10–15% three years after completion.

The new facility has been carefully planned. The buildings have been designed with the future in mind, in order to accommodate medium-term growth, combined with the option of modular expansion in the longer term.

US

The US site expansion in Florida was capacity-driven, as the business has grown at an impressive pace over the past few years. The 60,000 sq ft expansion will allow for growth in key areas such as Operations, Administration and Technical, and doubles capacity in in three fast-growing categories, namely tea, sugar reduction and fruit & vegetables. As with the UK relocation, the expansion has taken into account future needs and there is c 40,000 sq ft additional space to further increase capacity in the longer term, if necessary. This would come at a smaller cost – we estimate $4–5m – and would triple capacity from pre-expansion levels. The expansion was completed during Q219 on schedule and on budget (at a cost of $14m), and is due to become fully operational over the summer.

Financial targets

Treatt does not have any explicit financial targets for the medium term, other than to deliver consistent and sustainable growth in profits and increasing margins. In the shorter-term gross margins can fluctuate due to a number of factors, in particular cyclical changes in raw material costs. Treatt management flagged in its H119 results that citrus prices are falling and as a result we trimmed our revenue forecasts in our May update note. Our profit forecasts remained unchanged, leading to an increased margin forecast versus prior expectations (see details here). Over the long term, however, the evolution of the portfolio towards higher value-added technical ingredient solutions suggests gross margins should continue to rise over the medium term. We forecast a 30bp fall in gross margins in FY19; with the FY18 trading update, the company had flagged margins had fallen slightly due to pricing pressure on new business wins and some FX impact. We expect this to continue in FY19. We expect a bounce-back in FY20 as the effect of softening raw material prices continues and we forecast a 40bp increase in gross margins, followed by a more normal 20bp increase in FY21 and FY22.

Treatt's commitment to contain fixed costs remains clear and management views an EBIT margin in the mid-teens as achievable in the medium term, versus our forecast of 11.4% for FY19 and our unchanged DCF terminal EBIT margin assumption of 16.5%.

Sensitivities

Commodity exposure

Due to its background as a trader in raw material ingredients and the breadth of the product range it offers to customers, Treatt is exposed to a wide range of commodities. In general, this means that fluctuations in commodity prices tend to even out across the portfolio, as a 'natural hedge'. The exception, however, is the group's sizeable exposure to citrus oils, mainly orange and lemon. In the event of a price spike across all commodities, the ingredients space has generally shown some resilience and has demonstrated some pricing power, as flavours represent a tiny portion of raw material costs for its clients (the consumer companies), which have therefore been more accommodating with price increases. Again however, the value-added end of the spectrum has more pricing power.

Citrus oils

Citrus oils represent c 50–55% of Treatt's raw materials expenditure. Orange oil is a non-exchange-traded commodity, so its supply is managed by Treatt's highly skilled stock teams in the US and UK, with their deep market knowledge and expertise adding value to customers by consistently ensuring best prices and consistency of supply.

95% of Treatt's supply of orange oil comes from two key markets – Brazil and Florida. While both markets were negatively affected for several years by disease and adverse weather patterns that reduced both the quantities of oranges grown and the quality of the overall crop, 2019 is looking like a much better year. With more abundant crops in all major citrus markets, raw material prices have been in decline. Orange oil is a by-product of orange juice, extracted through the process of centrifugation. Despite being a by-product, there is no direct relationship between the price of orange oil and the publicly traded price of orange juice. This is because the key determinant of price is not simply the quantity of fruit grown in any one growing season, but rather the complex interaction of a number of influences, driven in the main by the amount of fruit that the processors need to buy to produce the quantities of juice they need to satisfy demand. The current influences on the price of orange oil are:

- Florida production is expected to bounce back following the devastation to the crop caused by Hurricane Irma last season, with an expected 70% increase in crop. California is also bouncing back (+25% crop expected) to more normal levels following the dip last year. Citrus greening (HLB, or yellow shoot disease), however, continues to have a significant impact and this affects the colour of the orange oil (turning it green).
- The Brazilian crop is forecast to rise 13% as favourable weather should result in a good bloom and fruit set. The 2019/20 crop is expected to improve further.

Prices are down significantly since the elevated levels of 2017 (when prices peaked at $12/kg vs the long-term average of $4-6/kg) and are around the $6/kg level. Management is expecting citrus oil prices to soften through FY19.

The lemon oil market is also witnessing some deflation: supply and demand of fresh lemons were in balance before tilting to a slight oversupply on a global basis. Management expects pricing to be slightly below that of last year.

The group's deep insight into the markets of both commodities has very clearly helped it navigate the worst of the volatility, and gives a significant value-added service to customers who may not have a similar level of insight. Increasingly, Treatt has secured longer-term contracts from both customers and suppliers to smooth out volatility in raw material procurement and revenues, with the aim of reducing volatility in group gross margin.

Foreign exchange

The principal foreign exchange risk is sterling/US dollar, which affects the company from both a transactional and a translational point of view:

- **Transactional:** raw materials (including orange oil) are mainly purchased in US dollars, thus affecting the cash values of sales and the gross margin if subsequently sold in a different currency. Movements in the US dollar can also affect the replacement cost of stock, which can and does have an impact on profitability as well as competitiveness.
- **Translational:** sales are made to more than 90 countries, thus fluctuation in the sterling exchange rate can affect reported revenues, gross profit and operating costs.

To try to mitigate the main sterling/US dollar exposure, the company takes out forward FX contracts to hedge the risk.

Valuation

We illustrate Treatt's relative valuation versus its ingredients peer group in Exhibit 3 below. Treatt trades at 24.0x and 15.1x FY20 P/E and EV/EBITDA, representing c 6% and c 12% discounts to the peer group, respectively. We believe some discount is justified to reflect its small size and because some of its products are relatively 'upstream' in the ingredients spectrum, particularly the bulk ingredients that are sold to other ingredients companies.

Exhibit 3: Comparative valuation

	Market cap (m)	P/E (x)		EV/EBITDA (x)		Dividend yield (%)	
		2019e	2020e	2019e	2020e	2019e	2020e
Givaudan	CHF 25,221	31.1	28.7	21.3	19.8	2.3	2.4
IFF	$15,233	22.5	20.3	17.0	15.6	2.0	2.1
Symrise	CHF 11,424	33.8	29.5	17.9	16.0	1.2	1.3
Chr Hansen	DKK 83,152	43.6	39.0	28.6	25.9	1.9	1.9
Kerry	€ 18,410	26.7	24.5	19.3	17.8	0.7	0.8
Ingredion	$5,505	11.9	11.1	7.6	7.3	2.9	3.1
Peer group average		**28.3**	**25.5**	**18.6**	**17.1**	**1.8**	**1.9**
Treatt	272.3	25.2	24.0	17.7	15.1	1.1	1.3
Premium/(discount) to peer group (%)		(10.8%)	(5.8%)	(4.7%)	(11.9%)	(39.9%)	(34.8%)

Source: Refinitiv, Edison Investment Research. Note: Prices as of 2 July 2019.

Our DCF-derived fair value is unchanged at 517p as we make no changes to our DCF forecasts. Our longer-term sales growth forecast remains at 5.0% pa, falling to 2% growth in perpetuity. Our DCF is calculated based on a WACC of 6.9% (encompassing a beta of 0.8, an equity risk premium of 5.0% and a borrowing spread of 5.0%) and a terminal growth rate of 2%.

Below, we show a sensitivity analysis to these assumptions and note that the current share price is implying a terminal EBIT margin of 16.7% and a terminal growth rate of 0%, versus our assumptions of 16.5% and 2%, respectively. We note that our FY19 EBIT margin forecast is 11.4%.

Exhibit 4: DCF sensitivity to terminal growth rate and EBIT margin (p/share)

		EBIT margin				
		15.5%	16.0%	16.5%	17.0%	17.5%
Terminal growth	-1.0%	367	375	383	391	399
	0.0%	396	405	414	423	432
	1.0%	435	446	456	467	478
	2.0%	490	503	517	528	541
	3.0%	573	589	605	621	637
	4.0%	712	733	755	776	797

Source: Edison Investment Research

Financials

For a review of the H119 results, please see our update note published on 7 May 2019. We have tweaked our assumptions for amortisation of intangibles, which leads to some minor changes to our forecasts.

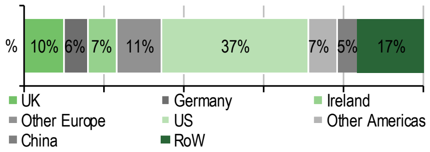
Earthoil update

Following the disposal of Earthoil Plantations during FY18, Treatt retained the former Earthoil operations based in Kenya. These operations are not considered core to the group's existing business, hence the company is looking to exit them. As a consequence, the assets are now classified as a disposal group held for sale. This resulted in a small non-cash impairment charge during H119 as the carrying value was reassessed prior to being reclassified.

Exhibit 5: Financial summary

£000s	2016	2017	2018	2019e	2020e	2021e	2022e
Year end September	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS							
Revenue	88,040	101,250	112,163	113,845	116,122	120,767	125,598
Cost of Sales	(67,639)	(75,985)	(84,407)	(86,015)	(87,270)	(90,520)	(93,889)
Gross Profit	20,401	25,265	27,756	27,831	28,852	30,248	31,709
EBITDA	11,604	15,049	16,627	15,760	18,518	19,443	20,428
Operating Profit (before amort., except. and share-based payments.)	10,257	13,650	15,108	14,082	14,925	15,772	16,677
Intangible Amortisation	(142)	(137)	(124)	(105)	(90)	(76)	(65)
Share based payments	(566)	(966)	(1,040)	(962)	(1,095)	(1,165)	(1,249)
Other	0	0	0	0	0	0	0
Operating Profit	9,549	12,547	13,944	13,015	13,739	14,531	15,363
Net Interest	(703)	(851)	(1,302)	50	(125)	(54)	160
Exceptionals	(553)	0	(1,105)	(825)	0	0	0
Profit Before Tax (norm)	9,554	12,799	13,806	14,132	14,800	15,718	16,836
Profit Before Tax (FRS 3)	8,293	11,696	11,537	12,239	13,614	14,477	15,523
Profit Before Tax (company)	8,846	11,696	12,642	13,064	13,614	14,477	15,523
Tax	(2,144)	(3,129)	(2,284)	(3,331)	(3,472)	(3,692)	(3,958)
Profit After Tax (norm)	7,410	9,670	11,522	10,800	11,328	12,026	12,878
Profit After Tax (FRS 3)	6,149	8,567	9,253	8,908	10,143	10,785	11,564
Discontinued operations	0	978	2,976	(1,800)	0	0	0
Average Number of Shares Outstanding (m)	51.9	52.2	56.8	59.1	59.1	59.1	59.1
EPS - normalised (p)	14.3	18.5	20.3	18.3	19.2	20.4	21.8
EPS - normalised & fully diluted (p)	14.1	17.9	19.8	18.1	18.9	20.1	21.5
EPS - (IFRS) (p)	11.8	16.4	21.5	15.1	17.2	18.3	19.6
Dividend per share (p)	4.4	4.8	5.1	5.1	5.8	6.2	6.6
Gross Margin (%)	23.2	25.0	24.7	24.4	24.8	25.0	25.2
EBITDA Margin (%)	13.2	14.9	14.8	13.8	15.9	16.1	16.3
Operating Margin (before GW and except.) (%)	11.7	13.5	13.5	12.4	12.9	13.1	13.3
BALANCE SHEET							
Fixed Assets	16,161	19,532	21,863	42,782	53,841	48,405	44,973
Intangible Assets	3,364	3,331	752	647	557	481	416
Tangible Assets	11,361	14,821	20,038	41,063	52,211	46,852	43,484
Investments	1,436	1,380	1,073	1,073	1,073	1,073	1,073
Current Assets	54,435	68,230	102,401	101,782	102,262	104,577	106,966
Stocks	29,990	42,878	39,642	40,009	40,577	41,958	43,386
Debtors	17,853	19,973	28,828	29,033	29,381	30,315	31,276
Cash	6,588	4,748	32,304	32,304	32,304	32,304	32,304
Other	4	631	1,627	436	0	0	0
Current Liabilities	(16,388)	(27,003)	(35,781)	(39,827)	(42,374)	(34,760)	(28,092)
Creditors	(15,834)	(19,266)	(16,479)	(16,290)	(16,035)	(16,073)	(16,088)
Short term borrowings	(487)	(7,680)	(19,244)	(23,536)	(26,339)	(18,687)	(12,004)
Provisions	(67)	(57)	(58)	0	0	0	0
Long Term Liabilities	(17,021)	(14,281)	(6,858)	(16,425)	(17,626)	(13,600)	(10,059)
Long term borrowings	(7,755)	(7,293)	(3,001)	(11,768)	(13,169)	(9,343)	(6,002)
Other long term liabilities	(9,266)	(6,988)	(3,857)	(4,657)	(4,457)	(4,257)	(4,057)
Net Assets	37,187	46,478	81,625	88,312	96,102	104,622	113,789
CASH FLOW							
Operating Cash Flow	10,804	4,683	3,580	15,155	17,147	16,965	17,855
Net Interest	(703)	(913)	(609)	50	(125)	(54)	160
Tax	(2,022)	(2,822)	(2,978)	(3,331)	(3,472)	(3,692)	(3,958)
Capex	(679)	(5,111)	(6,190)	(23,138)	(14,742)	1,688	(384)
Acquisitions/disposals	(861)	(1,667)	8,357	1,100	0	0	0
Financing	280	270	21,090	0	0	0	0
Dividends	(2,095)	(3,025)	(2,876)	(2,895)	(3,012)	(3,430)	(3,647)
Net Cash Flow	4,724	(8,585)	20,374	(13,060)	(4,204)	11,478	10,025
Opening net debt/(cash)	6,155	1,654	10,225	(10,059)	3,000	7,204	(4,274)
HP finance leases initiated	0	0	0	0	0	0	0
Other	(223)	14	(90)	0	0	0	0
Closing net debt/(cash)	1,654	10,225	(10,059)	3,000	7,204	(4,274)	(14,299)

Source: Company accounts, Edison Investment Research

Contact details	Revenue by geography
Northern Way Bury St Edmunds IP32 6NL UK +44 (0)1284 702500 www.treatt.com	

Management team

CEO: Daemmon Reeve	CFO: Richard Hope
Daemmon Reeve has extensive industry experience and knowledge, having worked at RC Treatt in the UK from 1991–2010, gaining widespread experience across technical, operational, and sales and purchasing disciplines. In July 2010, he was appointed CEO of Treatt USA and CEO of the group in July 2012, filling Hugo Bovill's position after he stepped down.	Richard Hope was appointed group finance director in May 2003, having been head of finance at Hampshire Cosmetics between 1996 and 2003. He is a qualified chartered accountant.

Principal shareholders	(%)
BlackRock Investment Management	10.50
Discretionary Unit Fund Managers	7.23
Cannacord Genuity	5.49
Hargreaves Lansdown	3.89
Schroder Investment Management	3.88
Liontrust Asset Management	3.36
BMO Global Asset Management	3.19
James Sharp	3.06
Barclays Wealth	2.82

Companies named in this report

IFF (IFF), Givaudan (GIVN:SW), Symrise (SY1:GR), Christian Hansen (CHR:DC), Kerry (KYGa.L), Frutarom (FRUT:IT), Ingredion (INGR)

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