# EDISON

# Avon Rubber

Proposed US acquisition

## Reinvesting milk money in head protection

Aerospace & defence

**When the disposal of Avon's dairy operations was announced, we assumed the proceeds would be reinvested in higher return businesses. The proposed $130m acquisition of the helmet systems activities of Team Wendy is a meaningful and strategically aligned deal, with higher returns and good organic growth prospects. Both deals should complete in Q1 FY21 and taken together should be EPS enhancing, improve value creation and leave net cash balances for further reinvestment.**

| Year end | Revenue (£m) | PBT* (£m) | EPS* (p) | DPS (p) | P/E (x) | Yield (%) |
|---|---|---|---|---|---|---|
| 09/18 | 165.5 | 27.2 | 76.6 | 16.0 | 51.6 | 0.4 |
| 09/19 | 179.3 | 31.4 | 90.9 | 20.8 | 43.5 | 0.5 |
| 09/20e | 233.0 | 35.4 | 93.1 | 27.1 | 42.4 | 0.7 |
| 09/21e | 288.4 | 49.2 | 129.5 | 35.2 | 30.5 | 0.9 |

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

## Proposed Team Wendy acquisition

Avon Rubber has announced the proposed acquisition of Team Wendy in the US for c $130m plus $8m of deal costs. Based in Cleveland, Ohio, it represents an expansion of Avon Protection's newest Helmets and Armor business. Team Wendy is a family owned business that manufactures and supplies military and first-responder helmets and head protection systems, and is a specialist in helmet liners and retention systems. The purchase represents a reinvestment of a large proportion of the net £140m proceeds (after tax and pension payments) from the divestment of its dairy operations milkrite | InterPuls. In the year to December 2019 Team Wendy had sales of $44.2m, generating an EBITDA of $13.4m, which represents an EBITDA margin of 30.3%. The deal implies a 9.7x EV/EBITDA multiple, below that for the disposal of dairy and Avon Rubber's own multiple.

## Deal should enhance returns

Team Wendy's operating profit of c $12m in 2019 replaces an expected dairy profit of c £8.5m in FY21 with a higher ROCE. The two deals should be modestly EPS enhancing with enhanced value creation and Avon retaining net cash for further reinvestment. Both deals are expected to complete in Q1 FY21, so Q420, with the disposal process said to be on track. If the Team Wendy deal completes before the dairy sale, the consideration will be financed by a new three-year $200m RCF facility. Following completion of the transaction, the new RCF should be available to support Avon Rubber's medium-term growth objectives, including potential further M&A in line with the growth strategy. There is no change to FY20 guidance or our estimates pending completion of both the dairy divestment and the Team Wendy purchase. From FY21 Avon Rubber will change its reporting currency to US dollars.

## Valuation: Rating reflects strategic development

Avon Rubber already achieves strong cash flows and is proving adept at recycling capital into businesses with higher returns and organic growth prospects. The market has responded positively to this as reflected in the FY21e P/E of 30.5x.

**10 September 2020**

| | |
|---|---|
| **Price** | **3,950p** |
| **Market cap** | **£1.21bn** |
| | US$1.30/£ |
| Net debt* (£m) at 31 March 2020<br>*Excluding leases | 45.8 |
| Shares in issue | 30.5m |
| Free float | 98.8% |
| Code | AVON |
| Primary exchange | LSE |
| Secondary exchange | N/A |

### Share price performance


| % | 1m | 3m | 12m |
|---|---|---|---|
| Abs | 14.2 | 32.8 | 134.3 |
| Rel (local) | 14.4 | 38.7 | 177.4 |
| 52-week high/low | | 3,950p | 1,620p |

### Business description

Avon Rubber designs, develops and manufactures products in the protection (77% of H120 sales) and dairy (23%) sectors. Its major contracts are with national security organisations such as the US DOD. Over 75% of H120 sales were from the US.

### Next events

| | |
|---|---|
| FY20 results | 18 November 2020 |

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# Strategically aligned reinvestment of dairy proceeds

## Team Wendy helmet systems

Team Wendy is a family owned business based in Cleveland, Ohio, employing 130 people and supplying head protection systems. It was founded in 1997 by Dan T Moore as a memorial to his daughter Wendy, who tragically died as a result of a traumatic brain injury sustained in a skiing accident. Producing its first helmet in 1998, its mission has been the pursuit of improving hea d protection for anyone wearing a helmet and risking their lives every day.

The business has grown over the last 20 years to become a global company, supplying military and first-responder customers in over 50 countries worldwide. The initial focus on skiing helmets has transitioned to the production of helmets systems for both ballistic and non-ballistic head protection systems. Its specialised helmet liner and retention products are specifically mandated on several US military helmets, some of which are Avon Protection products. Around 61% of 2019 sales came from US customers including the DOD, Department of Homeland Security, Department of Justice and National Industries for the Blind/AbilityOne Program.

Overseas customers thus accounted for around 39% of revenues in 2019. It has a multiyear supply contract with the Australian Defence Force under the current programme of record, with over 40,000 ballistic helmets supplied to date. It also supplies military, first responder and search and rescue agencies in Europe, Asia, Latin America and the Middle East.

Revenue growth has been strong in recent years and has continued in the calendar year to date up until the end of July 2020. In the year to December 2019 Team Wendy had sales of $44.2m generating an EBITDA of $13.4m, an EBITDA margin of 30.3% with an operating profit of c $12m. The deal represents a 9.7x EV/EBITDA multiple below that for the disposal of dairy for a business with higher margins and sustainable, less cyclical growth prospects.

**Exhibit 1: Team Wendy historic financials**

| Year to December ($m) | 2017 | 2018 | 2019 | CAGR (%) |
|---|---|---|---|---|
| Revenue | 27.2 | 29.4 | 44.2 | 27.5% |
| EBITDA | 10.5 | 8.2 | 13.4 | 13.0% |
| Margin | 38.6% | 27.9% | 30.3% | |
| Operating profit | 9.6 | 7.4 | 12.1 | 12.3% |
| Net assets | 29.1 | 35.9 | 47.5 | |

Source: Avon Rubber

## Dairy disposal progressing on track

Management says the disposal process for milkrite | InterPuls is proceeding as planned, as it works through the regulatory approval processes. Completion of the £180m sale is also expected in Q1 FY21. Net proceeds from the deal available for reinvestment should be around £140m on completion, after equal payments of £20m for tax and deal costs as well as pension liabilities.

Both deals are expected to complete in Q1 FY21, that is, Q420. If the Team Wendy deal completes before the dairy sale, the consideration will be financed by a new three-year $200m RCF facility. Following completion of the transaction the new RCF should be available to support Avon Rubber's medium-term growth objectives, including potential further M&A in line with the growth strategy. The facility has two one-year extension options.

## Value creation and growth enhanced by reinvestment

As usual, we do not adjust our estimates until deals complete. With management guidance maintained for FY20 we are not adjusting our current estimates for FY20 or FY21.

The proposed acquisition will require shareholder approval as well as both HSR (Hart Scott Rodino) and CFIUS (Committee on Foreign Investment in the United States) regulatory approvals in the US. The deal is in line with the company's strategic growth goal of enhancing organic development through value creating M&A and adds new technology development programmes. The purchase further strengthens the product portfolio of Avon Protection's newest business, Helmets and Armor, which was formed following the acquisition of the Ceradyne ballistic protection systems activity from 3M for up to $116m in January 2020. Avon Protection will be the sole activity of Avon Rubber following the dairy disposal.

With a low finance cost, the deal will be immediately earnings enhancing and should more than offset the dairy disposal dilution in a full year, despite recycling just part of the proceeds.

Including deal costs, Team Wendy would need to generate a NOPAT of $10.5m to create value against our assumed group WACC for Avon Rubber of 7.5%. Assuming a 25% tax rate we would expect this to be achieved in its first full year after acquisition, so FY22.

For the $130m (c £100m) being reinvested from the disposal proceeds, the return on capital is higher than for the dairy business, with a further £35m still available for reinvestment after Team Wendy deal costs. We also anticipate higher earnings growth being delivered by Team Wendy than would be achieved by dairy, further supporting the business case for the sale and reinvestment.

Although a pipeline of opportunities remains, Avon's management has indicated that investors should expect a period of consolidation following 18 months of significant M&A activity.

## Trading update

Avon has also issued a trading update that we assume replaces the pre-close update expected later this month. Both Avon Protection and milkrite | InterPuls have continued to trade in line with management expectations and full-year expectations are maintained. There have been only modest disruptions due to the COVID-19 pandemic and demand has remained robust. FY20 cash conversion is expected to return to normal levels after receiving a delayed payment relating to the rest of world mask contract mentioned at the half year.

Avon is also going to report in US dollars from FY21 as around 90% of sales are dollar denominated, as is 100% of debt. It should better reflect the organic development of the group, less encumbered by significant translation effects. The dividend will be determined in dollars and paid in sterling using exchange rates immediately prior to payment.

## Exhibit 2: Financial summary

| | £m | 2018 | 2019 | 2020e | 2021e |
|---|---|---|---|---|---|
| **Year end 30 September** | | **IFRS** | **IFRS** | **IFRS** | **IFRS** |
| **PROFIT & LOSS** | | | | | |
| Revenue | | 165.5 | 179.3 | 233.0 | 288.4 |
| Cost of Sales | | (99.9) | (106.8) | (138.8) | (171.8) |
| Gross Profit | | 65.6 | 72.5 | 94.2 | 116.6 |
| EBITDA | | 35.3 | 41.3 | 50.2 | 65.1 |
| Operating Profit (before amort. and except.) | | 30.4 | 35.9 | 41.7 | 55.4 |
| Intangible Amortisation | | (3.1) | (3.9) | (4.4) | (4.9) |
| Operating profit (company definition) | | 27.3 | 32.0 | 37.3 | 50.4 |
| Exceptionals | | (5.6) | (17.7) | (8.0) | (6.3) |
| Other | | (0.1) | (0.7) | (1.2) | (1.1) |
| Operating Profit | | 21.6 | 13.6 | 28.1 | 43.1 |
| Net Interest | | 0.0 | 0.1 | (0.7) | (0.2) |
| Profit Before Tax (norm) | | 27.2 | 31.4 | 35.4 | 49.2 |
| Profit Before Tax (FRS 3) | | 21.6 | 13.7 | 27.4 | 42.9 |
| Tax | | (1.8) | 0.6 | (5.2) | (8.2) |
| Profit After Tax (norm) | | 23.5 | 28.0 | 28.6 | 39.9 |
| Profit After Tax (FRS 3) | | 19.8 | 14.3 | 22.2 | 34.8 |
| Average Number of Shares Outstanding (m) | | 30.5 | 30.5 | 30.5 | 30.5 |
| EPS - normalised (p) | | 77.1 | 91.7 | 93.8 | 130.6 |
| EPS - normalised & fully diluted (p) | | 76.6 | 90.9 | 93.1 | 129.5 |
| EPS - (IFRS) (p) | | 64.9 | 46.9 | 72.6 | 113.9 |
| Dividend per share (p) | | 16.0 | 20.8 | 27.1 | 35.2 |
| Gross Margin (%) | | 39.6 | 40.4 | 40.4 | 40.4 |
| EBITDA Margin (%) | | 21.3 | 23.0 | 21.6 | 22.6 |
| Operating Margin (before GW and except.) (%) | | 18.4 | 20.0 | 17.9 | 19.2 |
| **BALANCE SHEET** | | | | | |
| Fixed Assets | | 64.1 | 64.4 | 148.6 | 144.2 |
| Intangible Assets | | 41.5 | 35.3 | 59.2 | 56.0 |
| Tangible Assets | | 22.6 | 21.4 | 72.8 | 73.9 |
| Right of Use Asset | | | 7.7 | 16.6 | 14.4 |
| Investments | | 0.0 | 0.0 | 0.0 | 0.0 |
| Current Assets | | 102.0 | 117.5 | 84.7 | 106.1 |
| Stocks | | 23.0 | 20.7 | 27.2 | 34.0 |
| Debtors | | 24.2 | 35.4 | 34.1 | 42.2 |
| Cash | | 46.6 | 48.4 | 10.4 | 17.0 |
| Other | | 8.2 | 13.0 | 13.0 | 13.0 |
| Current Liabilities | | (41.4) | (35.4) | (65.0) | (61.3) |
| Creditors | | (41.3) | (35.3) | (45.8) | (56.5) |
| Short term borrowings | | (0.1) | (0.1) | (19.2) | (4.8) |
| Long Term Liabilities | | (39.9) | (62.0) | (70.8) | (68.6) |
| Long term borrowings | | 0.0 | 0.0 | 0.0 | 0.0 |
| Lease Liabilities | | | (11.3) | (20.2) | (18.0) |
| Other long-term liabilities | | (39.9) | (50.7) | (50.6) | (50.6) |
| Net Assets | | 84.8 | 84.5 | 97.4 | 120.4 |
| **CASH FLOW** | | | | | |
| Operating Cash Flow | | 33.4 | 15.2 | 48.0 | 57.6 |
| Net Interest | | (0.2) | 0.0 | (0.7) | (0.2) |
| Tax | | (1.8) | 0.6 | (5.2) | (8.2) |
| Capex | | (8.9) | (7.9) | (18.7) | (15.8) |
| Acquisitions/disposals | | 5.1 | 0.0 | (72.4) | (2.4) |
| Financing | | (1.1) | (1.3) | (1.0) | (1.0) |
| Dividends | | (4.1) | (5.4) | (7.1) | (9.1) |
| Other | | (0.6) | 0.6 | 0.0 | 0.0 |
| Net Cash Flow | | 21.8 | 1.8 | (57.0) | 20.9 |
| Opening net debt/(cash) | | (24.7) | (46.5) | (48.3) | 8.7 |
| HP finance leases initiated | | 0.0 | 0.0 | 0.0 | 0.0 |
| Other | | 0.0 | 0.0 | 0.0 | 0.0 |
| Closing net debt/(cash) | | (46.5) | (48.3) | 8.7 | (12.1) |
| Total net financial liabilities | | (46.5) | (37.0) | 28.9 | 5.9 |

Source: Company reports, Edison Investment Research

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