EDISON

Treatt

What crisis?

H120 results

Food & beverages

Treatt demonstrated its strength and resilience in H120, as so far the COVID-19 pandemic has not had any adverse impact on trading performance. Of course, this is in part due to the categories in which Treatt operates, with some of its products being used in household cleaners, which have witnessed a global spike in demand. Nevertheless, the steady performance is testament to the management and culture of the business, which have been able to withstand the unexpected and exogenous shock. H219 and H120 were affected by a global weakness in citrus raw material prices, which in turn affected revenue growth. Citrus prices have now started to firm and we expect growth in this category to return in H2. We leave our forecasts mostly unchanged but roll forward our DCF and hence our fair value rises to 560p (from 530p previously).

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
09/18	112.2	13.8	20.3	5.1	26.2	1.0
09/19	112.7	14.0	19.2	5.5	27.7	1.0
09/20e	115.0	14.8	18.9	5.8	28.1	1.1
09/21e	119.6	15.8	20.2	6.2	26.2	1.2

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

COVID-19 pandemic has had no adverse effect

Treatt's order intake has been strong, as its customers have responded to increased demand for cleaning products and beverages consumed at home. China witnessed some weakness earlier in the year but is already bouncing back. As flagged at the start of April, the relocation of the UK business will be delayed due to the pandemic and we estimate it could be pushed back by three to six months.

Treatt remains in the sweet spot

The company continues to successfully embrace the sweet spot in flavour ingredients. Its portfolio is well suited for the current consumer trends of clean labels and more natural, better-for-you products. The order book and current demand are looking healthy ahead of the peak seasonal period. While citrus prices continued to be lower than the prior year in H1, they have been recovering and in H2 will start to lap easier comparatives. We therefore continue to expect revenue growth during H2. We note that the non-citrus categories have continued to perform very well, with tea revenues up 47.5%, fruit and vegetables up 9.4% and health and wellness up 19.9% during H1 and we leave our estimates unchanged. This reflects the company's statement that demand so far has been robust and trading remains in line with the board's expectations.

Valuation: Fair value 560p

Our DCF-derived fair value is 560p/share (previously 530p; we have rolled forward our DCF to start in 2021), c 5% upside to the current share price. Our DCF is supported by Treatt's benchmark valuation, with the shares trading at 27.6x and 17.9x FY20 P/E and EV/EBITDA, representing a c 10% discount to the peer group, on both metrics.

26 May 2020

Price	**532p**
Market cap	**£315m**

Net cash (£m) at 31 March 2020	6.1
Shares in issue	60.2m
Free float	100%
Code	TET
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	7.9	1.5	32.2
Rel (local)	2.7	24.2	58.7
52-week high/low		548.0p	312.0p

Business description

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

Next events

Trading update	End September 2020
FY20 results	24 November 2020

Analysts

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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 health and wellness, citrus, ready-to-drink (RTD) 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 130 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 32% in absolute terms and 59% in relative (FTSE All-Share) terms, while over the last three months these figures are 2% and 24% 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 560p, or c 12% upside. As before, our DCF is predicated on a WACC of 7.0% (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. It trades at 27.6x and 17.9x FY20 P/E and EV/EBITDA, representing a c 10% discount to the peer group on both metrics. 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.

Financials

Treatt's revenues fell during H219 and H120 as global citrus prices were down sharply. During FY19, revenues were down 2% at constant currency despite the sharp fall in citrus, which accounted for 54% of group sales. Adjusted profit before tax was up 5.2%. During H120 revenue was down 5.8% at constant currency and adjusted PBT was down 2%. We expect H2 to witness a recovery as citrus prices have started to firm. Net cash stood at £6.1m at end H120.

For the next three years (FY19–22) we forecast a 3.3% revenue CAGR and a 6.1% pre-exceptional PBT CAGR, translating to 3.9% pre-exceptional earnings. The business is cash-generative, with a free cash flow yield of 4.7% in FY22 (once one-off project costs relating to the UK relocation cease). Given the current global environment, there is the risk that COVID-19 has a profound and ongoing impact on global demand. There may be a slowdown in new product development within the FMCG space, especially in the on-trade and out-of-home segments, which are temporarily closed in many geographies. This could affect Treatt's growth prospects, although there is no sign of this slowdown in the current order book, and hence current trading remains in line with the board's expectations.

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:

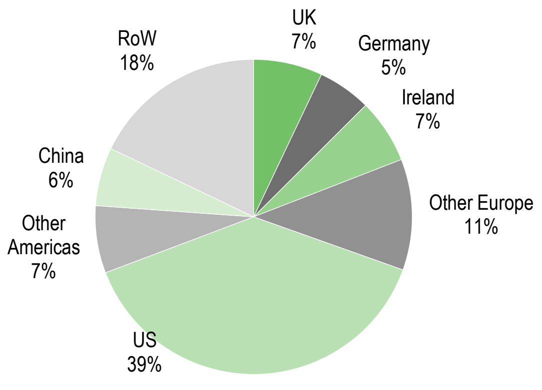
- **Commodity exposure:** namely citrus oils, which make up c 50% of revenues.
- **Foreign exchange:** translation risk on US dollar profits, which it manages through hedging and transactional exposure as some raw materials are dollar denominated.

Company description

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 it has transformed itself into a supplier of a diverse range of flavour and fragrance ingredients and ingredient solutions to its customers across the globe. Ingredients solutions now account for c 80% of sales and over 85% of group profits. These typically encompass more than one Treatt product, delivered as a 'solution' for a specific brief/purpose, and not a traded commodity. Treatt's customers consist of flavour and fragrance companies (50% of sales) and FMCG and other manufacturers (50% of sales), with the latter group expected to outgrow the former. That said, as flavour companies continue to move up their own value chains, they remain an important customer base for Treatt. Its products are used by flavour houses 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 (part of the Health & Wellness category) and RTD tea have proved to be growth segments for the company over recent years.

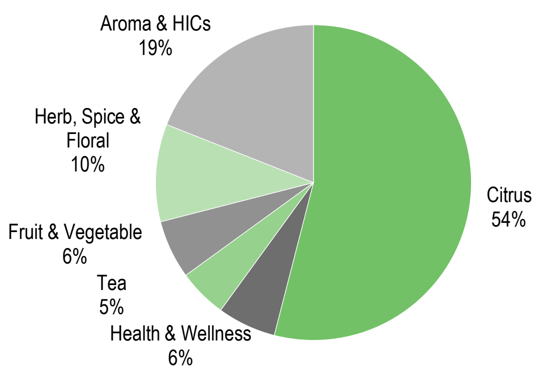
Treatt has a wide customer base in terms of size and geographic spread. While over the years the business has focused on its larger customers, the breadth of its customer base means the group is not overly dependent on any one relationship, with its largest customer representing c 10% of sales and the top 10 customers representing c 50% 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, household cleaning products 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 also exports to more than 90 countries worldwide.

Exhibit 1: Continuing revenue by geography (FY19)



Source: Treatt

Exhibit 2: Revenue by product category (FY19)



Source: Treatt

Treatt has six segments in which it operates: citrus, health & wellness, tea, fruit & vegetable, herb, spice & floral, and aroma & high-intensity chemicals, with coffee soon to be added as a standalone seventh segment. Treatt collaborates closely with its customers 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 four key areas of focus: citrus, tea, fruit and vegetables, and health and wellness. Citrus has been a historical area of strength and expertise for Treatt, while health and wellness (mainly sugar reduction), fruit and vegetables, 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 four 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 and aroma (synthetic) flavours business continues to contribute to the group overall (it accounts for c 20% of revenues), but generally at a somewhat lower margin.

The COVID-19 pandemic has so far not had any adverse impact on trading performance. This is of course in part thanks to the categories in which Treatt operates: some of its products are used in household cleaners and personal care and hence have witnessed vastly increased demand as a result of the current global situation. Nevertheless, the fact performance has been remarkably steady is testament to the management and culture of the business, which have been able to withstand a severe exogenous shock.

Industry overview

One of the mega-trends in the food and beverage industry over the last few years has been for natural, clean-label and sustainable ingredients, as consumers seek wellbeing across all aspects of their lives. 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 use, thus giving rise to higher margins. In addition, a generation of challengers are fuelling innovation across consumer goods, as emerging trends gain traction and drive strong growth, with consumers eschewing the larger brands in favour of more niche, sustainable and natural products.

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. Brands are increasingly taking flavour off the label: over the last two years, 23% of new products launched globally included a natural label claim.

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 are required and may need 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, and they relate to the three fast-growing product categories of tea, health and wellness, and fruit and vegetables. They provide a natural sweet top-note flavour and are just one of the ways that allow 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. In a similar vein, alcohol-free beverages have also gained traction as health-conscious consumers look to reduce alcohol consumption without compromising enjoyment.

Over the last few years, Treatt has positioned itself to benefit from the latest consumer mega-trends. Its focus on deep customer knowledge and relationships enables it to work closely with its clients to develop new product formulations that keep consumers engaged. It is well placed to capitalise on the natural and clean-label trends given its deep knowledge and expertise in FTNF solutions.

Strategy

Treatt has transformed 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.

Treatt's strategy has evolved but its underlying aim is to create outstanding sustainable ingredients solutions, designed around its customers' needs. In turn, this should result in the delivery of long-term and consistent growth in profitability. Treatt's strategic priorities are to:

- drive innovation, particularly in its core categories, but also investing in new ones;
- increase its focus on technical, value-added (and hence higher-margin) solutions; and
- invest for future growth with the physical relocation in the UK, having completed the US expansion plan on time and on budget last year.

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 credentials and has invested significantly in this space. It introduced free share awards for its staff in 2014 to improve employee ownership and continuously strives to reduce its environmental impact. Its use of citrus is highly sustainable, as it is largely a by-product of the juice industry. During 2019 Treatt increased the proportion of its volumes transported by logistics groups that were part of the Sustainable Shipping Initiative.

Treatt has invested heavily in how it uses market insights across its business to become more agile. Its marketing department has increased its scope in data gathering and analysis and the company has improved how the information is shared around the business. The commercial functions are now closer together and work in partnership with category managers to unlock more effective and targeted marketing.

Product categories

Treatt has identified the categories of citrus, tea, health and wellness, and fruit and vegetables as key drivers of growth, given their size and Treatt's expertise. This is to better serve its customers and to concentrate on the higher-growth and higher-margin opportunities within the business. During H120, the fastest-growing category was tea, which was up 47.5% versus H119, and over the next few years it should benefit from the increased manufacturing capacity at Treatt's US facility. We set the seven main categories out in turn below. Treatt has formed dedicated, cross-functional teams to further develop these. Coffee has been added as a separate category this year, as Treatt has entered fast-growing beverage category, although it is not expected to become material for at least two to three years.

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, 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.

Health and wellness

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. It 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 and vegetables

Providing natural fruit and vegetable flavours 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, mango, cucumber and berry flavours have been particularly successful recently as they provide a fresh and authentic flavour.

Herbs, spices and florals

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, particularly at the premium end of the spectrum. Treatt sources, manufactures and supplies over 500 herb, spice and floral products. They are 100% natural ingredients, made 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. Treatt's ability to deliver a consistent and quality service in this space stands it apart from other players.

Coffee

Coffee is one of the quickest-growing beverage categories in the world and, like tea, it is the processing method (blending and roasting) that gives each coffee its distinctive properties. Coffee has grown consistently as a beverage over the last decade, with an ever-increasing choice of variants and formats. In its H1 results announcement, Treatt confirmed that it continues to build up its coffee platform, which it expects to make a meaningful contribution to profits in two to three years' time. Its experts can craft blended solutions that take account of taste profile, naming, regional requirements and desired caffeine levels, thus enabling Treatt to deliver stand-out products in this diverse yet crowded market.

Geographical split

Treatt primarily runs its business by geographical segment, as reflected in its segmental reporting, though over the years it has increasingly strived to bring its people together and share knowledge globally. As part of its focus on culture and employee engagement, employees in each of the product categories are encouraged to share information 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 69% 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 applied across multiple countries and consumers shifting their preferences towards 'better-for-you' products. New brands are establishing their credentials as natural, sugar free and ethical/sustainable and more established brands continue to reformulate to compete more effectively, 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. Again, Treatt's expertise in sugar reduction is creating opportunities. Over the last few years, the US market has experienced 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. In addition, the RTD coffee category has witnessed sharp growth, which plays into Treatt's emerging expertise in the area.

Asia

China is increasingly a focus as the rising affluence of the middle classes and urbanisation trends drive 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 employees. 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.

Treatt's focus on culture has really come to the fore in the current COVID-19 crisis, as it already had a truly flexible work culture. Treatt introduced social distancing and hand sanitiser stations across its sites before lockdowns began and has continued to operate throughout the crisis.

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. The US expansion was completed on time and on budget and became fully operational in the summer of 2019. The new capacity has begun to come on stream this year, in time for the peak beverage season in the Northern hemisphere. The expansion took into account future needs and there is c 40,000 sq ft additional space to further increase capacity in the longer term, if necessary (as a reminder, the expansion just completed was 60,000 sq ft).

UK

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 began during 2019, with a move-in date initially anticipated for summer 2020 and later shifted to early 2021. There will be a three- to six-month delay due to the COVID-19 pandemic, which has slowed down (but not stopped) construction. We forecast expansionary capex costs of £18m in FY20 and £10m in FY21 bringing the total to £44m over the lifetime of the project, with a further £5m of disposal proceeds in FY21–22 as the old site is divested. This brings our forecast total project cost to £39m, above the £36m guidance. Management expects ROI to be 10–15% three years after completion. (We note that our overall capex also includes maintenance capex, which is in addition to the project capex.)

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

Financial targets

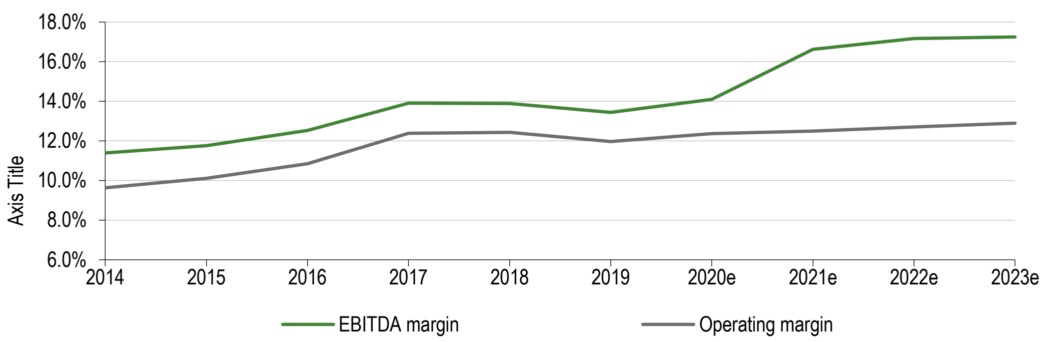
Treatt does not have any explicit financial targets for the medium term, other than to deliver consistent and sustainable growth in profits and increasing margins. In the shorter term, gross margins can fluctuate due to a number of factors, particularly cyclical changes in raw material costs.

Over the medium to long term, however, the evolution of the portfolio towards higher value-added technical ingredient solutions suggests gross margins should continue to rise. We forecast gross margin improvement of 40bp in FY20 as there is some benefit from the reduction in citrus prices, and then 20bp improvement 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 12.4% for FY20 and our unchanged DCF terminal EBIT margin assumption of 16.5%.

In Exhibit 3 we illustrate Treatt's EBITDA and operating margin over the decade FY14–FY23e, where we can see a broadly steady improvement despite the economic and raw materials cycles that occurred over the period.

Exhibit 3: EBITDA and operating margin progression (FY14 to FY23e)



Source: Edison Investment Research, Treatt data

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.

A total of 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, 2020 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 for the 2019/20 season is expected to drop slightly. Citrus greening (HLB, or yellow shoot disease) continues to have a significant impact, although growers are taking active steps to reduce spread of the disease and improve the health of their trees (HLB affects the colour of the orange oil, turning it green).
- The Brazilian crop for the 2020/21 season is expected to be down c 25% on the prior season.

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 $5/kg level. Having softened through FY19 and the start of H120, management is expecting citrus oil prices to continue their recovery.

The lemon oil market is also witnessing recovery as the Spanish crop is forecast to be down 22% and Italy also suffers higher prices due to COVID-19 related issues. Management expects pricing to continue to firm.

The group's deep insight into the markets of both commodities has very clearly helped it navigate the worst of the volatility over the last 12 to 18 months 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 27.6x and 17.9x FY20 P/E and EV/EBITDA, representing a c 10% discount to the peer group on both metrics. 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 4: Comparative valuation

	Market cap (m)	P/E (x)		EV/EBITDA (x)		Dividend yield (%)	
		2020e	2021e	2020e	2021e	2020e	2021e
Givaudan	CHF 31,906	37.4	38.2	27.9	25.4	5.7	5.5
IFF	$13,921	21.1	21.9	16.1	16.4	3.5	3.5
Symrise	CHF 13,921	44.8	35.6	21.5	19.1	4.4	4.0
Chr Hansen	DKK 83,963	44.5	42.4	29.4	27.9	10.4	9.9
Kerry	€ 18,171	26.2	27.8	18.6	19.7	2.8	2.9
Ingredion	$5,286	11.9	12.7	7.5	7.9	1.1	1.2
Peer group average		**31.0**	**29.8**	**20.2**	**19.4**	**4.6**	**4.5**
Treatt	314.6	27.6	25.9	17.9	15.0	1.1	1.2
Premium/(discount) to peer group (%)		**(10.9%)**	**(13.1%)**	**(11.2%)**	**(22.4%)**	**(76.2%)**	**(73.7%)**

Source: Refinitiv, Edison Investment Research. Note: Priced at 26 May 2019.

Our DCF-derived fair value is 560p (previously 530p). We have rolled over our DCF to commence in 2021, given we are more than halfway through 2020. Our longer-term sales growth forecast remains at 5.0% per year, falling to 2% growth in perpetuity. Our DCF is calculated based on a WACC of 7.0% (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 the current share price is implying a terminal EBIT margin of 16.5% and a terminal growth rate of 1.00%, versus our assumptions of 16.5% and 2%, respectively. We note that our FY20 EBIT margin forecast is 12.4%.

Exhibit 5: 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%	410	418	426	434	442
	0.0%	439	448	457	467	476
	1.0%	478	489	500	511	521
	2.0%	534	546	560	572	585
	3.0%	616	632	648	664	680
	4.0%	754	775	797	818	839

Source: Edison Investment Research

Financials

H120 results

H120 revenues were down 5.3% to £53.6m, in line with previous guidance and caused by the reduction in citrus prices. At constant currency, revenues were down 5.8%. Profit before tax was thus down 2% on an adjusted basis to £6.1m and adjusted EPS was down 3.2% to 8.08p.

The key product categories of fruit and vegetable, tea and health and wellness all performed strongly. The most notable feature of Treatt's H120 performance is that COVID-19 has had no adverse impact on trading performance so far. As expected, citrus, the largest category, was affected by the cyclical fall in raw material prices. The aroma and high impact flavour chemicals segment experienced revenues down 8.6% during H120, which was driven by the timing of some repeat business and some one-off business last year.

The US and China continue to be key strategic markets for Treatt. In H120, however, China was affected by the earlier onset of COVID-19 and hence revenue was down 5.8% at constant currency. We expect growth to return in H2. The US witnessed growth of 0.5% at constant currency versus the prior period, whereas revenue in Europe (including the UK) fell 25.4% as this is the area with the highest proportion of citrus revenues. The decline in Europe was largely driven by the fall in citrus prices detailed above, but also due to the timing of contract deliveries to some major customers.

Net cash stood at £6.1m at the end of H120 and during H220 the business is likely to experience the usual seasonal cash inflow as working capital positions unwind. The cost of the UK relocation, however, will counter this somewhat. We forecast year-end net debt of £5.0m. Treatt holds a relatively high inventory position, but this helps it counter any sudden or seasonal fluctuations in its raw material costs. Its free cash flow yield stands at a healthy 5%.

We leave our forecasts broadly unchanged as current trading is in line with the board's expectations and citrus prices continue to firm, as the company initially highlighted in its April trading statement and reconfirmed at its H120 results. We illustrate our changes in Exhibit 6.

Exhibit 6: Old vs new key P&L forecasts

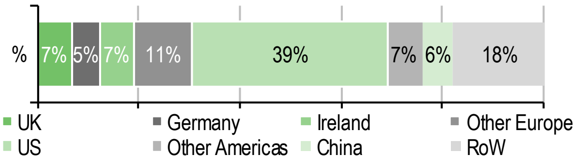
	EPS (p)*			PBT* (£000s)			Revenue (£000s)		
	Old	New	% change	Old	New	% change	Old	New	% change
FY2020e	17.7	16.9	-4.5%	14,029	14,029	0.0%	114,971	114,971	0.0%
FY2021e	18.9	18.9	-0.4%	15,042	14,981	-0.4%	119,570	119,570	0.0%
FY2022e	20.1	20.0	-0.5%	15,945	15,864	-0.5%	124,353	124,353	0.0%

Source: Edison Investment Research. Note: *Stated on company normalised basis, which is pre-exceptional but after amortisation of acquired intangibles and share-based payments.

Exhibit 7: Financial summary

£000's	2017	2018	2019	2020e	2021e	2022e	2023e
Year end September	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS							
Revenue	101,250	112,163	112,717	114,971	119,570	124,353	129,327
Cost of Sales	(75,985)	(84,407)	(84,060)	(85,281)	(88,453)	(91,743)	(95,154)
Gross Profit	25,265	27,756	28,657	29,690	31,117	32,610	34,173
EBITDA	15,049	16,627	15,785	16,865	20,613	22,114	23,125
Operating Profit (before amort., except and sbp.)	13,650	15,108	14,226	14,949	15,739	16,618	17,546
Intangible Amortisation	(137)	(124)	(90)	(77)	(65)	(55)	(47)
Share based payments	(966)	(1,040)	(637)	(644)	(720)	(763)	(808)
Other	0	0	0	0	0	0	0
Operating Profit	12,547	13,944	13,499	14,229	14,953	15,800	16,691
Net Interest	(851)	(1,302)	(199)	(200)	27	63	119
Exceptionals	0	(1,105)	(755)	(475)	0	0	0
Profit Before Tax (norm)	12,799	13,806	14,027	14,749	15,766	16,682	17,665
Profit Before Tax (FRS 3)	11,696	11,537	12,545	13,554	14,981	15,864	16,810
Profit Before Tax (company)	11,696	12,642	13,300	14,029	14,981	15,864	16,810
Tax	(3,129)	(2,284)	(2,673)	(3,577)	(3,820)	(4,045)	(4,287)
Profit After Tax (norm)	9,670	11,522	11,354	11,172	11,946	12,636	13,378
Profit After Tax (FRS 3)	8,567	9,253	9,872	9,977	11,161	11,818	12,523
Discontinued operations	978	2,976	(1,084)	0	0	0	0
Average Number of Shares Outstanding (m)	52.2	56.8	59.1	59.1	59.1	59.1	59.1
EPS - normalised (p)	18.5	20.3	19.2	18.9	20.2	21.4	22.6
EPS - normalised & fully diluted (p)	17.9	19.8	18.9	18.6	19.9	21.1	22.3
EPS - (IFRS) (p)	16.4	18.0	17.8	16.9	18.9	20.0	21.2
Dividend per share (p)	4.8	5.1	5.5	5.8	6.2	6.5	6.9
Gross Margin (%)	25.0	24.7	25.4	25.8	26.0	26.2	26.4
EBITDA Margin (%)	14.9	14.8	14.0	14.7	17.2	17.8	17.9
Operating Margin (before GW and except.) (%)	13.5	13.5	12.6	13.0	13.2	13.4	13.6
BALANCE SHEET							
Fixed Assets	19,532	21,863	31,730	49,462	52,816	47,630	43,944
Intangible Assets	3,331	752	845	769	703	648	601
Tangible Assets	14,821	20,038	29,485	47,293	50,712	45,582	41,942
Investments	1,380	1,073	1,400	1,400	1,400	1,400	1,400
Current Assets	68,230	102,401	98,158	97,317	99,244	101,353	103,532
Stocks	42,878	39,642	36,799	37,021	38,262	39,544	40,867
Debtors	19,973	28,828	23,020	23,109	23,794	24,622	25,477
Cash	4,748	32,304	37,187	37,187	37,187	37,187	37,187
Other	631	1,627	1,152	0	0	0	0
Current Liabilities	(27,003)	(35,781)	(28,905)	(32,713)	(30,674)	(22,741)	(15,487)
Creditors	(19,266)	(16,479)	(11,784)	(11,267)	(11,120)	(10,943)	(10,734)
Short term borrowings	(7,680)	(19,244)	(16,860)	(21,446)	(19,554)	(11,798)	(4,753)
Provisions	(57)	(58)	(261)	0	0	0	0
Long Term Liabilities	(14,281)	(6,858)	(13,876)	(21,030)	(19,884)	(15,806)	(12,083)
Long term borrowings	(7,293)	(3,001)	(4,369)	(10,723)	(9,777)	(5,899)	(2,376)
Other long term liabilities	(6,988)	(3,857)	(9,507)	(10,307)	(10,107)	(9,907)	(9,707)
Net Assets	46,478	81,625	87,107	93,036	101,502	110,436	119,905
CASH FLOW							
Operating Cash Flow	4,683	3,580	20,544	15,815	18,339	19,628	20,537
Net Interest	(913)	(609)	(199)	(200)	27	63	119
Tax	(2,822)	(2,978)	(2,208)	(3,577)	(3,820)	(4,045)	(4,287)
Capex	(5,111)	(6,190)	(10,392)	(19,725)	(8,294)	(365)	(1,940)
Acquisitions/disposals	(1,667)	8,357	855	0	0	0	0
Financing	270	21,090	622	0	0	0	0
Dividends	(3,025)	(2,876)	(3,080)	(3,253)	(3,415)	(3,647)	(3,862)
Net Cash Flow	(8,585)	20,374	6,142	(10,939)	2,837	11,634	10,568
Opening net debt/(cash)	1,654	10,225	(10,059)	(15,958)	(5,018)	(7,856)	(19,490)
HP finance leases initiated	0	0	0	0	0	0	0
Other	14	(90)	(243)	0	0	0	0
Closing net debt/(cash)	10,225	(10,059)	(15,958)	(5,018)	(7,856)	(19,490)	(30,058)

Source: Edison Investment Research, company data

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 (UK)	11.04
Discretionary Unit Fund Managers	5.90
Canaccord Genuity Wealth Management	5.38
Liontrust Asset Management	4.36
Hargreaves Lansdown Asset Management	4.11
Danske Capital	2.98
Schroder Investment Management	2.24

Companies named in this report

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