

discoverIE Group

Focus on growth markets paying off

H120 results

discoverIE's H1 results confirm it is making continued good progress with its strategy to build its design and manufacturing (D&M) business. Underlying organic group revenue growth of 5% was boosted by higher margin acquisitions and the group is fast approaching its mid-term operating margin target. Targeting higher growth markets within D&M and focusing on efficiency in Custom Supply supports ongoing growth in revenues and profitability.

Year end	Revenue (£m)	PBT* (£m)	Diluted EPS* (p)	DPS (p)	P/E (x)	Yield (%)
03/18	387.9	22.6	23.0	9.0	23.4	1.7
03/19	438.9	28.4	28.4	9.6	18.9	1.8
03/20e	475.4	33.7	29.4	10.0	18.3	1.9
03/21e	498.5	37.6	31.1	10.4	17.3	1.9

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

Revenue and margin growth; strong cash generation

In H120 discoverIE generated 5% organic constant exchange rate (CER) revenue growth, with a 4% contribution from acquisitions and a further 1% boost from currency. The Design & Manufacturing (D&M) business was the driver of organic revenue growth (+7% CER) and this, combined with higher margin acquisitions, helped lift the group underlying operating margin by 0.8pp y-o-y. Despite flat underlying demand in Custom Supply (CS), the division managed to expand its operating margin by 0.2pp y-o-y. Cash generation was strong, with 101% cash conversion of underlying operating profit in H1 and free cash flow (after dividends) of £19m over the last 12 months. While our underlying estimates are substantially unchanged, we have revised our forecasts to reflect the application of IFRS 16.

Buy-and-build strategy drives strong performance

Since 2011, the company has made 15 D&M acquisitions and this division contributed 63% of revenues and 81% of operating profit in H120. The focus on higher growth target markets is helping the group to grow at rates ahead of GDP and the group is very close to hitting medium-term profitability targets. discoverIE has a well-established process for targeting and integrating higher margin custom electronics companies, enabling them to retain their entrepreneurial spirit while taking advantage of the group's central functions and balance sheet. We expect further D&M acquisitions, with a focus on expanding international reach.

Valuation: D&M focus supports upside

Since the placing at 415p per share in October, the stock has gained 30% and now trades at a small discount to the peer group average on a P/E and EV/EBIT basis. Further progress in increasing the weighting of business towards the higher growth and margin D&M business, combined with maintaining the profitability of the Custom Supply business, should help to further reduce the discount. The stock is supported by a dividend yield approaching 2%.

Electronic & electrical equipment

9 December 2019

Price **538p**

Market cap **£477m**

€1.17/NOK11.8/£

Net debt (£m) at end H120 55.4

Shares in issue 88.7m

Free float 96%

Code DSCV

Primary exchange LSE

Secondary exchange N/A

Share price performance



% 1m 3m 12m

Abs 3.5 22.3 49.0

Rel (local) 4.6 21.5 36.1

52-week high/low 554p 353p

Business description

discoverIE is a leading international designer and manufacturer of customised electronics to industry, supplying customer-specific electronic products and solutions to 25,000 industrial manufacturers.

Next events

Trading update January 2020

Analyst

Katherine Thompson +44 (0)20 3077 5730

tech@edisongroup.com

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Review of H120 results

Exhibit 1: H120 results highlights

£m	H120	H119	y-o-y
Revenues	232.0	211.7	9.6%
Custom supply	85.4	83.9	1.8%
Design & manufacturing	146.6	127.8	14.7%
Gross profit	77.4	69.9	10.7%
Gross margin	33.4%	33.0%	0.3%
Normalised operating profit			
Custom supply	4.1	3.9	5.1%
Design & manufacturing	17.6	14.2	23.9%
Central costs	(3.4)	(3.1)	9.7%
Total normalised operating profit	18.3	15.0	22.0%
Normalised operating margin (%)			
Custom supply	4.8%	4.6%	0.2%
Design & manufacturing	12.0%	11.1%	0.9%
Total normalised operating margin (%)	7.9%	7.1%	0.8%
discoverIE underlying* operating profit	17.7	14.5	22.1%
discoverIE underlying operating margin	7.6%	6.8%	0.8%
Reported operating profit	12.6	9.5	32.6%
Reported operating margin	5.4%	4.5%	0.9%
Normalised PBT	16.1	13.3	21.1%
Normalised net income	12.3	10.0	22.8%
Normalised diluted EPS (p)	14.8	13.4	10.9%
Underlying diluted EPS (p)	14.4	13.0	10.8%
Reported diluted EPS (p)	14.4	7.1	102.8%
Dividend (p)	2.97	2.80	6.1%
Net cash/(debt) excluding lease liabilities	(55.4)	(62.6)	(11.5%)

Source: discoverIE, Edison Investment Research. Note: *Underlying operating profit excludes amortisation of acquired intangibles and exceptional items.

discoverIE reported H120 revenue growth of 9.6% year-on-year, or 5% on an organic, constant exchange rate basis. Acquisitions contributed 4% to growth and currency 1%.

Gross profit increased at a slightly higher rate, reflecting the increased proportion of higher margin D&M revenues. Normalised operating profit increased 22% y-o-y, mainly due to the 24% increase in D&M operating profit, again reflecting higher margin acquisitions. After taking account of share-based payments, underlying operating profit increased 22% y-o-y resulting in an underlying operating margin of 7.6%, up from 6.8% a year ago.

The company applied IFRS 16 for the first time from 1 April 2019. The removal of lease payments of £3.3m from operating expenses was offset by a £3.1m depreciation charge for right-of-use assets. Finance costs included £0.3m of interest charges relating to lease liabilities. This resulted in a £0.1m negative impact at the PBT level. At the end of H120, the company reported right-of-use assets with a net book value of £17.8m and lease liabilities of £17.9m.

The company incurred tax at a rate of 28% on reported PBT and 24% on underlying PBT. After taking into account shares issued in the placing to fund the Hobart and Positek acquisitions, normalised EPS was 10.9% higher year-on-year.

The company announced an interim dividend of 2.97p, +6% y-o-y.

At the period end, net debt had reduced to £55.4m from £62.6m a year ago and £63.3m at the end of FY19. The company delivered an increase in operating cash of 48% over the last 12 months, and in H120 converted 101% of underlying operating profit to operating cash, well ahead of its 85% target. This cash generation reduced gearing at the period end to 1.3x, with pro forma gearing of 1.6x including the recent Sens-Tech acquisition.

Exhibit 2: Divisional performance

(£m)	H120	H119	H119 CER	Reported y-o-y	CER y-o-y	Like-for-like
Revenues						
Design & manufacturing	146.6	127.8	128.2	15%	14%	7%
Custom Supply	85.4	83.9	83.9	2%	2%	0%
Total revenues	232.0	211.7	212.1	10%	9%	5%
Underlying operating profit						
Design & manufacturing	17.6	14.2	14.2	24%	24%	
Custom Supply	4.1	3.9	3.9	5%	5%	
Unallocated	(4.0)	(3.6)	(3.6)	11%	11%	
Total underlying operating profit	17.7	14.5	14.5	22%	22%	
Underlying operating margin (%)						
Design & manufacturing	12.0%	11.1%	11.1%	0.9%	0.9%	
Custom Supply	4.8%	4.6%	4.6%	0.2%	0.2%	
Total underlying operating margin	7.6%	6.8%	6.8%	0.8%	0.8%	

Source: discoverIE

Design & Manufacturing benefits from targeting key markets

D&M revenues were 14.7% higher year-on-year and 7% higher on an organic CER basis.

Acquisitions contributed growth of 7% and currency 1%. Underlying operating profit increased 24% y-o-y driving the operating margin up by 0.9pp over the year to 12.0%.

On a quarterly basis, Q1 revenues were 4% higher on an organic basis, jumping to +11% in Q2. In Q119 the company signed a large contract with Bombardier, creating a tough comparison for Q120.

On a geographic basis, performance was mixed. Germany and the Nordic region saw 9% growth and Asia 28% growth. The UK (-7% y-o-y) and US (+3%) felt the impact of inventory corrections – the UK from Q1 and the US from Q2.

The company noted that the majority (70%) of D&M H1 revenues were from target markets, generating organic growth at a rate of 9%, compared to non-target markets generating revenue growth of 3%. Target markets are renewable energy, transportation, medical and industrial and connectivity, all of which offer structural long-term growth.

The business completed the expansion of its China facility during H120 and is investing to expand the Bangalore facility. During H120, of the £22m of revenues generated in the US, £2.8m were subject to US tariffs on goods manufactured in China. The company managed to pass through the cost of the tariffs to customers, but also gave them the option to have their product manufactured in India rather than China. Around half of the volumes affected by tariffs are being shifted to the India facility.

The division is also investing in management development and succession as well as upgrading IT systems used by the various businesses.

Custom Supply focused on efficiency

Custom Supply revenues were 2% higher y-o-y on a reported and CER basis. During H120, the company shifted the RSG business from D&M to CS, reflecting the high level of distribution business. Excluding this transfer, CS revenues were flat year-on-year. Geographically, the division saw strong growth in Benelux and Italy while revenues in the UK and Germany declined.

As this division has less exposure to target markets and has suffered from weakness in the German automotive market, management is focused on making the business as efficient as possible in the face of lacklustre demand. Underlying operating profit was 5% higher year-on-year lifting the operating margin by 0.2pp.

Performance against KPIs

Exhibit 3: Key strategic and performance indicators, FY14–H120

	FY14	FY15	FY16	FY17	FY18	FY19	H120	Mid-term target*	Long-term ambition
Key Strategic Indicator (KSI)									
Increase D&M revenue	18%	37%	48%	52%	57%	61%	63%	75%	85%
Increase underlying op. margin	3.4%	4.9%	5.7%	5.9%	6.3%	7.0%	7.6%	8.5%	10.0%
Build sales beyond Europe	5%	12%	17%	19%	23%	21%	24%	30%	40%
Key performance indicators (KPI)								Three-year target (FY20)	
Sales growth: CER	17%	36%	14%	6%	11%	14%	9%		
Sales growth: organic	2%	3%	3%	-1%	6%	8%	5%	Well ahead of GDP	
Increase cross-selling	£0.3m	£0.9m	£3.0m	£4.6m	£8.8m	£9.7m	£10.8m	£12m pa (up from £10m)	
Underlying EPS growth	20%	31%	10%	13%	16%	22%	11%	>10%	
Dividend growth	10%	11%	6%	6%	6%	6%	6%	Progressive	
ROCE	15.2%	12.0%	11.6%	13.0%	13.5%	15.4%	15.8%	>15%	
Operating cash flow generation	100%	104%	100%	136%	85%	93%	101%	>85% of underlying profit	

Source: discoverIE. Note: *Three to five years from November 2016.

The company continues to make progress against its KSIs and KPIs. Since the acquisition of Sens-Tech, the company is close to hitting its mid-term operating margin target. DiscoverIE estimates that it is generating a pro forma underlying operating margin of 8.4%, almost at the mid-term target. To meet the target of 75% of revenues generated by the D&M business by November 2021 will be more difficult, as each D&M business acquired also increases the size of the denominator. Even if the company misses this target, it is moving in the right direction and is likely to achieve the more important operating margin target on a lower proportion of D&M revenues.

Outlook and changes to forecasts

In the short term, order intake provides a good indicator of revenue performance – the company typically has roughly four months of sales in its backlog. In the longer term, design win activity is a lead indicator of future order wins. Management highlighted that it tasks each business with generating design wins worth 20% of current business, in order to develop a pipeline of business for future volume shipments. Even while the company is seeing an element of inventory destocking in various countries, it is keen to be included in customer plans for future product introductions so that when demand recovers, it is well positioned for volume orders.

- **Order intake:** group order intake was 9% higher than a year ago and 4% higher on an organic CER basis. D&M orders were 8% higher on an organic CER basis.
- **Order book:** at the end of H120, the order book was 15% higher than a year ago and was 11% higher on an organic basis.
- **Design win activity:** in H120, the company was designed into £134m of new projects (estimated lifetime value), +6% y-o-y. 80% of design wins were in target markets at a group level and 90% for D&M.

Management is confident that it will meet its expectations for FY20. We have made changes to our forecasts to reflect H1 performance and the application of IFRS 16 for the first time. The company continues to target gearing in the range 1.5–2.0x EBITDA (calculated on a pre-IFRS 16 basis).

Exhibit 4: Changes to forecasts

Year end 31 March (£m)	FY20e old	FY20e new	% change	% y-o-y	FY21e old	FY21e new	% change	% y-o-y
Revenues	472.8	475.4	0.6%	8.3%	495.7	498.5	0.6%	4.8%
Custom supply	174.4	173.3	(0.6%)	0.4%	176.2	175.0	(0.6%)	1.0%
Design & manufacturing	298.3	302.1	1.3%	13.5%	319.5	323.4	1.2%	7.1%
Gross margin	33.2%	33.3%	0.2%	0.3%	33.3%	33.3%	0.0%	(0.0%)
EBITDA	43.5	50.4	16.0%	36.3%	48.1	54.4	13.3%	8.0%
EBITDA margin	9.2%	10.6%	1.4%	2.2%	9.7%	10.9%	1.2%	0.3%
Underlying operating profit	36.8	37.2	1.2%	21.7%	41.2	41.4	0.7%	11.3%
Underlying operating profit margin	7.8%	7.8%	0.1%	0.9%	8.3%	8.3%	0.0%	0.5%
Normalised operating profit	38.1	38.4	0.9%	20.9%	42.5	42.6	0.4%	11.0%
Normalised operating margin	8.1%	8.1%	0.0%	0.8%	8.6%	8.6%	(0.0%)	0.5%
Normalised PBT	33.9	33.7	(0.4%)	18.7%	37.9	37.6	(0.8%)	11.4%
Normalised net income	25.5	25.4	(0.5%)	18.3%	28.6	28.3	(0.9%)	11.7%
Normalised diluted EPS (p)	29.5	29.4	(0.5%)	3.3%	31.4	31.1	(0.9%)	5.8%
Reported basic EPS (p)	19.1	19.5	2.2%	(2.6%)	21.5	21.3	(0.9%)	9.4%
Net (debt)/cash	(77.3)	(77.1)	(0.1%)	21.9%	(68.4)	(69.1)	1.0%	(10.4%)
Net debt/EBITDA (x)	1.7	1.8			1.4	1.4		

Source: Edison Investment Research

Valuation

Since the placing at 415p per share in October, the stock has gained 30% and now trades at a small discount to the peer group average on a P/E and EV/EBIT basis. Further progress in increasing the weighting of business towards the higher growth and margin D&M business, combined with maintaining the profitability of the Custom Supply business, should help to further reduce the discount. The stock is supported by a dividend yield approaching 2%.

Exhibit 5: Peer group valuation metrics

	EV/sales			EV/EBIT			P/E			Dividend yield		
	Last yr	This yr	Next yr	Last yr	This yr	Next yr	Last yr	This yr	Next yr	Last yr	This yr	Next yr
discoverIE	1.4	1.2	1.1	17.0	14.1	12.7	18.9	18.3	17.3	1.8%	1.9%	1.9%
Design & manufacturing												
Gooch & Housego	2.6	2.5	2.4	22.3	19.0	16.7	22.1	28.6	23.5	0.9%	0.9%	1.0%
TT Electronics	1.1	1.0	0.9	14.0	11.8	11.1	14.5	13.0	12.2	2.8%	2.9%	3.1%
XP Power	3.2	3.1	3.0	14.5	15.9	14.5	17.0	19.7	17.6	2.9%	2.9%	3.1%
Specialist distributors												
Diploma	4.3	3.5	3.4	20.4	19.9	18.6	32.7	26.1	24.9	1.4%	1.7%	1.8%
Solid State	0.7	0.6	0.6	11.4	9.2	8.6	13.1	11.2	10.7	2.6%	2.9%	3.1%
High service & commodity distributors												
Electrocomponents	1.7	1.6	1.5	14.3	13.7	12.7	17.7	17.1	15.9	2.3%	2.4%	2.6%
Average	2.3	2.0	2.0	16.1	14.9	13.7	19.5	19.3	17.5	2.1%	2.3%	2.4%
Versus peer group					(6%)	(7%)		(5%)	(1%)			

Source: Edison Investment Research, Refinitiv (as at 6 December 2019)

Exhibit 6: Financial summary

	£m	2015	2016	2017	2018	2019	2020e	2021e
Year end 31 March		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS								
Revenue		271.1	287.7	338.2	387.9	438.9	475.4	498.5
Cost of Sales		(186.7)	(195.1)	(227.2)	(261.2)	(293.9)	(317.0)	(332.5)
Gross Profit		84.4	92.6	111.0	126.7	145.0	158.5	166.0
EBITDA		16.6	19.8	24.3	29.3	37.0	50.4	54.4
Operating Profit (before am, SBP and except.)		14.0	17.0	20.6	25.2	31.8	38.4	42.6
Operating Profit (before am. and except.)		13.4	16.3	20.0	24.5	30.6	37.2	41.4
Amortisation of acquired intangibles		(2.1)	(2.8)	(3.9)	(4.9)	(5.9)	(7.6)	(8.0)
Exceptionals		(5.2)	(2.1)	(8.4)	(2.3)	(2.0)	(3.1)	(3.2)
Share-based payments		(0.6)	(0.7)	(0.6)	(0.7)	(1.2)	(1.2)	(1.2)
Operating Profit		6.1	11.4	7.7	17.3	22.7	26.5	30.2
Net Interest		(1.6)	(1.8)	(2.8)	(2.6)	(3.4)	(4.7)	(5.1)
Profit Before Tax (norm)		12.4	15.2	17.8	22.6	28.4	33.7	37.6
Profit Before Tax (FRS 3)		4.3	9.4	4.8	14.6	19.3	21.7	25.0
Tax		(1.4)	(2.2)	(1.3)	(4.0)	(4.7)	(5.4)	(6.1)
Profit After Tax (norm)		10.0	11.8	13.6	17.1	21.5	25.4	28.3
Profit After Tax (FRS 3)		2.9	7.2	3.5	10.6	14.6	16.3	18.9
Average Number of Shares Outstanding (m)		57.6	63.3	65.4	70.8	73.0	83.9	88.7
EPS - normalised & diluted (p)		16.4	17.8	19.9	23.0	28.4	29.4	31.1
EPS - IFRS basic (p)		5.0	11.4	5.3	15.0	20.0	19.5	21.3
EPS - IFRS diluted (p)		4.8	10.9	5.1	14.2	19.4	18.9	20.7
Dividend per share (p)		7.6	8.1	8.5	9.0	9.6	10.0	10.4
Gross Margin (%)		31.1	32.2	32.8	32.7	33.0	33.3	33.3
EBITDA Margin (%)		6.1	6.9	7.2	7.6	8.4	10.6	10.9
Operating Margin (before am, SBP and except.) (%)		5.2	5.9	6.1	6.5	7.2	8.1	8.6
BALANCE SHEET								
Fixed Assets		88.6	108.4	122.2	136.4	149.2	232.9	219.6
Intangible Assets		69.9	88.2	100.7	107.2	119.7	187.6	179.5
Tangible Assets		13.8	14.7	16.0	23.4	24.4	40.2	35.0
Deferred tax assets		4.9	5.5	5.5	5.8	5.1	5.1	5.1
Current Assets		127.3	128.3	147.1	165.9	179.1	181.2	192.7
Stocks		39.8	42.9	48.8	58.1	66.2	71.6	75.1
Debtors		60.2	65.5	77.3	84.6	88.7	104.2	109.3
Cash		26.7	19.9	21.0	21.9	22.9	4.1	7.1
Current Liabilities		(62.1)	(61.7)	(78.1)	(94.0)	(96.0)	(110.1)	(113.6)
Creditors		(61.9)	(60.9)	(77.1)	(87.6)	(94.3)	(101.7)	(105.2)
Lease liabilities		0.0	0.0	0.0	0.0	0.0	(6.7)	(6.7)
Short term borrowings		(0.2)	(0.8)	(1.0)	(6.4)	(1.7)	(1.7)	(1.7)
Long Term Liabilities		(61.1)	(73.1)	(68.7)	(81.5)	(97.6)	(100.2)	(85.4)
Long term borrowings		(45.5)	(57.2)	(50.0)	(67.9)	(84.5)	(79.5)	(74.5)
Lease liabilities		0.0	0.0	0.0	0.0	0.0	(7.9)	(1.2)
Other long term liabilities		(15.6)	(15.9)	(18.7)	(13.6)	(13.1)	(12.8)	(9.7)
Net Assets		92.7	101.9	122.5	126.8	134.7	203.9	213.4
CASH FLOW								
Operating Cash Flow		6.6	14.6	20.5	21.7	30.0	35.0	47.5
Net Interest		(1.6)	(1.8)	(2.8)	(2.6)	(3.4)	(4.7)	(5.1)
Tax		(3.3)	(4.3)	(3.0)	(3.7)	(3.8)	(8.3)	(9.2)
Capex		(2.5)	(2.3)	(3.4)	(4.3)	(5.4)	(6.4)	(6.5)
Acquisitions/disposals		(37.3)	(19.8)	(11.8)	(25.4)	(22.4)	(74.7)	(3.0)
Financing		52.7	0.0	13.6	(1.5)	0.1	53.9	(6.7)
Dividends		(3.6)	(4.9)	(5.2)	(6.2)	(6.7)	(8.6)	(9.0)
Net Cash Flow		11.0	(18.5)	7.9	(22.0)	(11.6)	(13.8)	8.0
Opening net cash/(debt)		1.8	(19.0)	(38.1)	(30.0)	(52.4)	(63.3)	(77.1)
HP finance leases initiated		0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other		(31.8)	(0.6)	0.2	(0.4)	0.7	0.0	0.0
Closing net cash/(debt)		(19.0)	(38.1)	(30.0)	(52.4)	(63.3)	(77.1)	(69.1)

Source: discoverIE, Edison Investment Research

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Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
1,185 Avenue of the Americas
3rd Floor, New York, NY 10036
United States of America

Sydney +61 (0)2 8249 8342
Level 4, Office 1205
95 Pitt Street, Sydney
NSW 2000, Australia