EDISON

Avon Rubber

FY19 results

Transformational year builds momentum

Aerospace & defence

Avon delivered FY19 modestly ahead of market expectations, as foreshadowed in the September trading update. New US mask systems contracts drove healthy organic growth for Avon Protection and, while milkrite | InterPuls sales were essentially flat, a progressive recovery in dairy markets allowed it to make up the shortfall experienced in Q119. Both divisions are expected to carry the positive momentum into FY20, with margins expected to improve in both divisions. The proposed record acquisition of 3M's ballistic protection assets should substantially enhance earnings, and this has driven the re-rating in recent months.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
09/18	165.5	27.2	76.6	16.0	26.8	0.8
09/19	179.3	31.4	90.9	20.8	22.7	1.0
09/20e	184.8	33.7	88.8	27.1	23.2	1.3
09/21e	194.3	36.4	95.9	35.2	21.5	1.7

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

FY19 trading

Avon Protection had a strong year in the Military segment, with new mask systems contracts for the US DOD commencing deliveries in H219 and a $16.6m Rest of the World (RoW) mask systems contract also delivered in H219. These more than compensated for forecast declines in M50 mask systems volumes, as well as the slow start to the year for the Law Enforcement and Fire segments, in part caused by the protracted US government shutdown. Following a weak Q119 performance, dairy markets improved as the year progressed, benefiting milkrite| InterPuls. Adjusted PBT rose by 15.4% to £31.4m and fully diluted adjusted EPS rose by 18.7% to 90.9p, benefiting from £3.4m of one-off tax settlements worth 11.1p/share.

Moderate growth expected with better margins

The company will face some headwinds in FY20, including expected M50 mask systems volume reductions for the US DOD, although at improved commercial pricing levels, as well as the decision to exit the subscale Fire SCBA market in the US, which will eliminate just under £7m of sales. A full year of new DOD mask systems deliveries at Avon Protection and a recovery in First Responders demand should drive moderate organic growth, with margins benefiting from better DOD contract pricing and the elimination of the lower-margin Fire SCBA sales. As dairy markets appear more supportive, entering FY20 with an improved opening order book, we expect a return to low single-digit organic growth and a recovery in margins towards historic levels. Our estimates have been increased modestly, but should be substantially enhanced once the acquisition completes.

Valuation: Discounting the acquisition benefit

A FY21 P/E of 21.5x reflects the anticipated financial enhancement from the $91m 3M ballistic protection acquisition. Once completed and consolidated, it should return the rating to a more normal premium to UK defence peers of c 17x.

20 November 2019

Price	**2060p**
Market cap	**£629m**
	US$1.29/£
Net cash (£m) at 30 September 2019	48.3
Shares in issue	30.5m
Free float	96%
Code	AVON
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	21.6	21.6	43.6
Rel (local)	18.9	18.3	36.1
52-week high/low		2060p	1180p

Business description

Avon Rubber designs, develops and manufactures products in the protection (72% of 2019 sales) and dairy (28%) sectors. Its major contracts are with national security organisations such as the US DOD. Over 70% of 2019 sales were from the US.

Next events

AGM	January 2020

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Edison profile page

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FY19 trading improves through the year

FY19 performance confirmed the growing momentum in H219. The commencement of deliveries of the recently won new mask systems orders in the US combined with improving dairy market conditions to provide a firm foundation for FY20, which should be further enhanced by the purchase of the 3M ballistic protection assets when it completes in H120. Management has also announced the withdrawal from the highly competitive and fragmented Fire SCBA (self-contained breathing apparatus) market in the US where it lacks critical mass. Avon has leveraged the SCBA technology for defence and law enforcement applications, where it can now focus its freed-up resources. The exit will be a headwind for Avon Protection, as £6.7m of below sector average margin revenues are eliminated, representing just under half of FY19 Fire segment revenues from Avon Protection.

Overall, Avon Protection (72% of group sales) experienced healthy growth of 11.0% (5.9% constant currency) to £128.4m with a strong EBITDA margin performance, rising 150bp to 24.5%. Higher Military segment sales growth, driven by the ramp-up in H219 of the new US DOD mask contracts and fulfilment of a major overseas mask systems order, more than compensated for reduced M50 mask systems volumes and lower Fire and Law Enforcement demand. As dairy market conditions improved following a weak Q119, milkrite | InterPuls (28% of group sales) recovered strongly, with FY19 revenues falling 0.3% in constant currency terms (up 2.2% reported) and EBITDA margins falling 130bp to 20.6%.

FY19 order intake was up 5.0% (1.4% at constant currency) to £181.9m (FY18: £173.3m) and marginally ahead of reported FY19 revenues, which were 8.3% higher (5.2% at constant currency) at £179.3m (FY18: £165.5m). The closing order book of £40.4m saw an increase of 6.9%, or a modest drop of 0.7% at constant currency. Revenues were also marginally ahead of our estimate of £178.6m. Adjusted EBITDA of £39.5m (FY18: £35.3m) was up 11.9% (7.7% constant currency), with the margin increased 70bp to 22.0%. Adjusted operating profit rose 14.7% to £31.3m (FY18: £27.3m), or by 10.4% at constant currency. FY19 adjusted EPS of 91.7p (FY18: 77.1p) was 18.9% higher, boosted by some favourable tax settlements. The company continued with its dividend policy aimed at reducing cover in the medium term. The final dividend of 13.89p was raised 30.0%, in line with the full year increase for a total dividend per share for FY19 of 20.83p (FY18: 16.02p).

The adjusted numbers excluded exceptional and one-off items totalling £16.9m (FY18: £4.5m), of which £6.9m were cash costs (FY18: £0.5m), as shown in Exhibit 1 below. Including these charges, reported operating profit thus fell to £14.4m from £22.8m in FY18.

Exhibit 1: Adjustments to operating profit

Adjustments	FY18	FY19
Write down of Fire SBCA assets	-	5.4
Restructuring costs	0.9	-
Pension equalisation charge	-	3.5
Amortisation of intangible assets	3.1	3.5
Cash costs related to acquisitions	-	2.9
Surplus property in Italy write down	-	1.1
Pension administration costs	0.5	0.5
Total adjustments	**4.5**	**16.9**

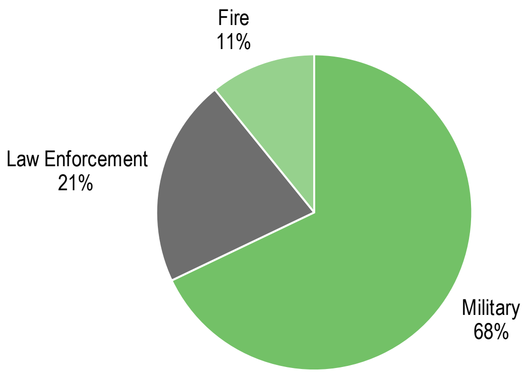
Source: Company reports

Cash generation was adversely affected by timing of the shipment of a $16.6m RoW military mask systems contract, where payment will be received in Q120. Operating cash flow fell to £23.2m from £37.9m in FY18. Cash conversion from adjusted EBITDA fell to 63.5% from 108.2% in FY18. As a result, net cash ended the year just £1.8m higher at £48.3m.

IFRS 16 will be adopted from the start of the current year (FY20) and will add a right-of-use asset of £6.5m and lease liabilities of approximately £10.2m on 1 October 2019, with a one-off adjustment to reserves accounting for the balance of £3.7m.

Avon Protection

Exhibit 2: FY19 revenue split of Avon Protection



Source: Avon Rubber

Avon Protection reported FY19 revenue of £128.4m (FY18: £115.7m), up 11.0% or 5.9% at constant currency. Orders received of £129.8m (FY18: £124.60m) represented a book-to-bill ratio close to parity. The closing order book of £36.7m was up 4.0% (down 1.1% at constant currency). The division generated an 18.0% increase in adjusted EBITDA to £31.4m (FY18: £26.6m), representing growth in constant currency of 13.4%. The adjusted EBITDA margin rose 150bp, more than recovering the previous year's decline reflecting a favourable product mix, increased operational leverage as new contract volumes build, together with commercial pricing application to ongoing M50 mask systems volumes.

The Military division reported FY19 revenues of £87.2m (FY18: £66.1m), up 26.1% at constant currency. US Department of Defense (DOD) revenues increased to £54.8m (FY18: £52.7m), reflecting lower M50 mask systems deliveries being more than offset by initial deliveries of the two major long-term awards received during the year of M53A1 mask and powered air system and M69 aircrew masks. Together with the M50 replenishment, RoW orders and escape hoods, Avon anticipates annual order intake for Military of between £85 and £120m pa in the medium term. Discussions continue with the DOD for the replacement M50 mask systems sustainment contract, with an award anticipated in H120, which we feel should lead to an increase in offtake from FY21. In addition, the UK contract for GSR masks for the UK MOD won in FY18 should start delivery in H120 and could lead to other domestic contracts. Global prospects for the MCM100 deep-water rebreather for military divers also remain strong following completion of the first large order for Norway, as well as sales of test units and an extensive schedule of dive trials for potential customers.

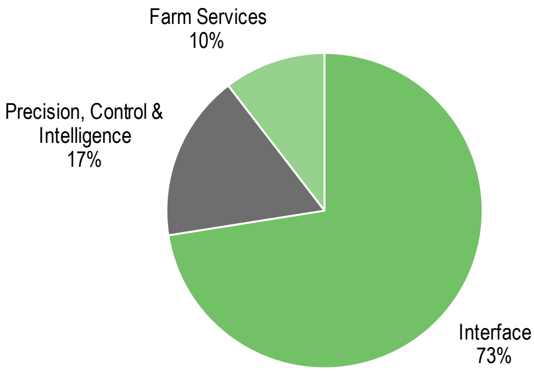
The Law Enforcement segment reported FY19 revenues of £27.3m (FY18: £35.4m), down 27.1% at constant currency, as the partial shutdown of the US government in H119 deferred spending and orders, with intake down 12.0% year-on-year. However, the deferral of orders has increased the opening order book to £4.3m (FY18: £3.5m) which, combined with identified prospects for respirators, hoods and powered air systems, should return the segment to growth this year.

Fire segment revenues of £13.9m (FY18: £14.2m), were down 5.3% at constant currency, despite order intake growing by 5.0% at constant currency. £6.3m of this was from Fire SCBA, from which the company has announced a strategic withdrawal, taking an exit charge of £5.4m in FY19. The US Fire SCBA market is seen as highly fragmented and competitive with below average returns.

The SCBA technology has also been successfully developed for use in both military and law enforcement applications, where Avon enjoys stronger market positions. The ongoing Fire business is focused on the Argus thermal imaging camera technology and will be combined with the Law Enforcement segment as a new First Responders segment from FY20. The ongoing Fire activities opening order book of £3.0m (FY18: £1.8m) provides an encouraging start to the year.

milkrite | InterPuls

Exhibit 3: FY19 revenue split of milkrite | InterPuls



Source: Avon Rubber

milkrite | InterPuls reported FY19 revenue of £50.9m (FY18: £49.8m), down 0.3% at constant currency following a weak start to the year. Encouragingly, order intake of £52.1m (FY18: £48.7m) was up 4.5% at constant currency and resulted in a positive book-to-bill ratio. The division reported FY19 adjusted EBITDA of £10.5m (FY18: £10.9m), a contraction of 3.7% or 6.6% at constant currency, with EBITDA margins dropping 130bp to 20.6%, reflecting negative operational leverage and the cost of consolidating the European operations onto one site in Italy.

Interface reported FY19 revenues of £36.9m (FY18: £35.6m), up 0.8% at constant currency. In challenging markets, sales in North America of £18.5m (FY18: £17.8m) declined by 1.5% at constant currency, offsetting strong growth in Europe and Asia, where sales grew 7.4% to £11.1m and 10.2% to £7.3m respectively in constant currency.

Precision, Control & Intelligence revenues fell 3.8% in constant currency to £8.7m (FY18: £9.0m), largely due to lack of customer confidence in dairy market conditions. As markets stabilised, confidence built and the FY19 order intake of £9.1m (FY18: £8.3m) was up 5.5% in constant currency, leaving a year-end backlog of £1.4m (FY18: £1.0m).

Farm Services sales of £5.3m (FY18: £5.2m) were down 1.6% at constant currency as a 5.3% fall in North America offset a 6.0% increase in Europe. The North American dairy market has been consolidating and Farm Services should be an attractive efficiency provider for the enlarged dairies.

Outlook and medium-term margin goals

Management has medium-term EBITDA margin targets of 25% for Avon Protection and 22% for milkrite | InterPuls. These are 50bp and 140bp higher than those achieved in FY19 but underpin the strong cash flows expected despite continued selective organic investment. Further value and proposition-enhancing acquisitions will also be sought to augment growth. The 3M business being acquired is a good example of that, extending the personal protection product offering with a compelling financial case that should enhance group annual EPS by around 20% as targeted cost synergies of $5m are achieved. These should lift 2018 EBITDA margins of 12.6% to c 20%, closer to the current group average.

Outlook

With a full year of deliveries against the M53A1 and M69 long-term contracts, and initial orders and deliveries of the UK's GSR mask expected in H120, Avon Protection's Military segment activity is expected to show growth once again in FY20. This is despite the expected further c £10m sales reduction in M50 volumes (albeit with better pricing) and the absence of the $16.6m RoW mask systems contract delivered in H219. The Fire segment will be reduced due to the Fire SCBA withdrawal, but still has strong market positions in thermal imaging cameras and other products. Law Enforcement saw good momentum in H219 following the effects of the H119 US government shutdown and this should continue into FY20. The Fire and Law Enforcement segments are to be combined into a First Responders segment. We expect the mix and volumes to drive a further expansion of margins.

milkrite | InterPuls should also carry the momentum from H219 into the current year as it benefits from the stabilisation of the dairy markets and increasing farmer confidence as milk prices recovered. We see margins starting to return towards historic levels in FY20.

Cash conversion should return to more normal levels in FY20 as the invoice timing issue should have resolved in Q120. As a result, we expect much stronger operational cash flow to result in net cash of almost £75m at the end of FY20 (before the inclusion of c £10m of lease liabilities under IFRS 16). The strong balance sheet supports continued organic investment in line with the growth strategy, as well as the purchase of value-enhancing businesses.

Acquisition of 3M's ballistic protection business

In its largest acquisition to date, the company is seeking to buy 3M's ballistic protection business in the US, which manufactures helmets and body armour (see our update note published on 9 August 2019). Avon is paying an initial $91m subject to normal closing adjustments, for gross assets of $45.2m which generated FY18 revenues of $85.4m, EBITDA of $10.8m and PBT of $3.3m. Subject to the award of pending tenders for legacy products, a maximum further $25m would become payable, but we expect any awards to enhance the business case. The deal is subject to CFIUS and other US regulatory approvals, but given the complementary nature of the product ranges and Avon's existing US presence, we do not see these as potential obstacles to completion, which is expected in fiscal Q220. We do not include acquisitions in our estimates until their completion.

Avon has substantial cash resource, and has renewed and increased its three-year RCF to $85m. These resources will be used to pay for the deal, adding around $1.0–1.5m per year of interest, peaking in the year of acquisition. The deal is immediately EPS enhancing and adding $5m of cost savings will make it value creating in FY21, further enhanced by expected organic development.

Management expects the activity to have cash conversion consistent with the existing business, which is itself highly cash generative. Net debt to EBITDA is expected to be below 1.0x when the deal completes and, assuming all goes to plan, management expects to be in a net cash position by the end of FY21.

Estimates revisions

While the exit from Fire SCBA has led us to reduce FY20 revenues modestly, we expect margin recovery at milkrite | InterPuls and continued positive progression at Avon Protection as the new mask systems contract delivers for a full year and M50 replenishment moves to a commercial pricing basis, albeit with a further anticipated reduction in volumes. The result is a modest increase in our FY20 PBT and EPS estimates of just under 1%. We expect cash conversion to revert to more normal levels as the invoices from the Q419 RoW military mask systems contract are settled in H120.

Exhibit 4: Revision to earnings estimates

Year to September (£m)	2019e	2019a		2020e			2021e
	Prior	Actual	% change	Prior	New	% change	New
Avon Protection	127.8	128.4	0.4%	136.8	131.6	-3.8%	139.5
milkrite I InterPuls	50.7	50.9	0.4%	52.7	53.2	0.9%	54.8
Total Sales	**178.6**	**179.3**	**0.4%**	**189.5**	**184.8**	**-2.5%**	**194.3**
EBITDA	**39.5**	**39.5**	**-0.1%**	**43.1**	**42.5**	**-1.3%**	**45.5**
Avon Protection	24.5	26.2	6.7%	27.0	27.9	3.4%	30.2
milkrite I InterPuls	8.1	7.5	-7.1%	8.6	8.1	-5.0%	8.5
Unallocated	(2.2)	(2.4)	9.3%	(2.3)	(2.5)	9.8%	(2.5)
Adjusted EBITA	**30.4**	**31.3**	**2.9%**	**33.3**	**33.6**	**0.8%**	**36.2**
Adjusted PBT	**30.5**	**31.4**	**2.9%**	**33.5**	**33.7**	**0.8%**	**36.4**
EPS - adjusted (p)	**88.4**	**90.9**	**2.9%**	**88.2**	**88.8**	**0.7%**	**95.9**
DPS (p)	20.8	20.8	0.0%	27.1	27.1	0.0%	35.2
Net debt/(cash)	(49.1)	(48.3)	-1.6%	(77.0)	(74.7)	-3.0%	(91.3)

Source: Edison Investment Research estimates

IFRS 16 will be adopted from the start of the current year (FY20) and will add a right-of-use asset of £6.5m and lease liabilities of approximately £10.2m on 1 October 2019, with a one-off adjustment to reserves accounting for the balance of £3.7m. The change to the recognition of associated costs from rental payments to amortisation and notional financial interest is expected to lead to a c £2m uplift in EBITDA, with a minimal impact on operating profit and EPS. For comparability purposes. we have not included these in our estimates yet but will reflect them in future analyses.

Exhibit 5: Financial summary

£000s	2018	2019	2020e	2021e
Year end 30 September	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS				
Revenue	165,500	179,300	184,801	194,293
Cost of Sales	(99,900)	(106,800)	(110,076)	(115,730)
Gross Profit	65,600	72,500	74,724	78,562
EBITDA	35,300	39,500	42,504	45,458
Operating Profit (before amort. and except.)	30,400	35,100	37,671	40,425
Intangible Amortisation	(3,100)	(3,800)	(4,104)	(4,255)
Operating profit (company definition)	27,300	31,300	33,567	36,171
Exceptionals	(5,600)	(17,700)	(4,300)	(4,300)
Other	(100)	(100)	(100)	(100)
Operating Profit	21,600	13,500	29,167	31,771
Net Interest	0	200	278	377
Profit Before Tax (norm)	27,200	31,400	33,746	36,448
Profit Before Tax (FRS 3)	21,600	13,700	29,446	32,148
Tax	(1,800)	600	(5,595)	(6,108)
Profit After Tax (norm)	23,500	28,000	27,334	29,523
Profit After Tax (FRS 3)	19,800	14,300	23,851	26,040
Average Number of Shares Outstanding (m)	30.5	30.5	30.5	30.5
EPS - normalised (p)	77.1	91.7	89.6	96.7
EPS - normalised & fully diluted (p)	76.6	90.9	88.8	95.9
EPS - (IFRS) (p)	64.9	46.9	78.2	85.3
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	22.0	23.0	23.4
Operating Margin (before GW and except.) (%)	18.4	19.6	20.4	20.8
BALANCE SHEET				
Fixed Assets	64,100	56,700	53,134	49,673
Intangible Assets	41,500	35,300	32,316	29,419
Tangible Assets	22,600	21,400	20,818	20,254
Investments	0	0	0	0
Current Assets	102,000	117,000	135,896	155,179
Stocks	23,000	20,700	21,548	22,882
Debtors	24,200	35,400	27,022	28,410
Cash	46,600	48,400	74,825	91,387
Other	8,200	12,500	12,500	12,500
Current Liabilities	(41,400)	(36,600)	(37,399)	(38,981)
Creditors	(41,300)	(36,500)	(37,299)	(38,881)
Short term borrowings	(100)	(100)	(100)	(100)
Long Term Liabilities	(39,900)	(50,700)	(50,643)	(50,586)
Long term borrowings	0	0	0	0
Other long-term liabilities	(39,900)	(50,700)	(50,643)	(50,586)
Net Assets	84,800	86,400	100,987	115,284
CASH FLOW				
Operating Cash Flow	33,400	15,200	48,744	41,808
Net Interest	(200)	0	200	278
Tax	(1,800)	600	(5,595)	(6,108)
Capex	(8,900)	(7,900)	(8,870)	(9,326)
Acquisitions/disposals	5,100	0	0	0
Financing	(1,100)	(1,300)	(1,000)	(1,000)
Dividends	(4,100)	(5,400)	(7,055)	(9,090)
Other	(600)	600	0	0
Net Cash Flow	21,800	1,800	26,425	16,563
Opening net debt/(cash)	(24,700)	(46,500)	(48,300)	(74,725)
HP finance leases initiated	0	0	0	0
Other	0	0	(0)	0
Closing net debt/(cash)	(46,500)	(48,300)	(74,725)	(91,287)

Source: Avon Rubber, Edison Investment Research

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