

Avon Rubber

Momentum builds behind new strategy

H118 report and outlook

Aerospace & defence

2 May 2018

Price **1,360p**
Market cap **£422m**

\$1.39/£1

Net cash (£m) at 31 March 2018 39.1

Shares in issue 31.0m

Free float 96%

Code AVON

Primary exchange LSE

Secondary exchange N/A

Share price performance



% 1m 3m 12m

Abs 7.1 7.5 29.7

Rel (local) 0.8 7.0 24.2

52-week high/low 1,375p 909p

Business description

Avon Rubber designs, develops and manufactures products in the protection (70% of 2017 sales) and dairy (30%) sectors. Its major contracts are with national security and safety organisations such as the DoD. 75% of sales are from the US and 25% are from Europe.

Next events

FY18 report November 2018

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Avon Rubber's H118 report demonstrates the strength of the group's new strategy in action. Success is evident in the enhanced product portfolio and order progression is building visibility and supporting medium-term growth. Given the group's exposure to the US, the FX headwind was visible in H118. Management maintained its guidance for FY18 underpinned by end market opportunities and new product deliveries.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
09/16	142.9	20.7	70.5	9.5	19.3	0.7
09/17	159.2	25.9	83.3	12.3	16.3	0.9
09/18e	159.3	26.5	74.3	16.0	18.3	1.2
09/19e	165.1	28.5	75.3	20.8	18.1	1.5

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

H118 results

H118 orders of £88.3m (H117 £90.8m) were 5% ahead on a constant currency basis while reported H118 revenue of £77.7m (H117 £78.9m) was 5.9% on the same basis. This gives a book to bill of 1.14x. Reported PBT was £9.4m (H117 £8.9m), while adjusted EPS of 32.8p (H117 28.6p) represented a 33.7% lift at constant currency. The interim dividend of 5.34p (H117 4.11p) indicated a 30% uplift. Cash generation remains good with 123.9% EBITDA conversion and, including the £6.6m proceeds from the Avon Engineered Fabrications (AEF) divestment, the net cash position increased to £39.1m (FY17 £24.7m).

Strategy

Avon introduced a threefold strategy in FY17 with the aim of delivering long-term, sustainable growth from the core business, product development and selective M&A. Further progress was visible in H118 especially with new product development and orders. The approach is to grow the core, add selective product development and make value-enhancing acquisitions to accelerate growth. While innovation is key to the business, the overall level of investment will be lower in total but more focused in nature. End market trends are supportive to both divisions and Avon has an attractive portfolio to leverage from this. The group has a successful acquisition history and will continue to be disciplined over future deals.

Valuation: Justified premium

Taking an average of our DCF and our sum-of-the-parts valuations gives a fair value price of 1,450p, which would imply a FY18e P/E of 19.5x. The stock is currently trading at a premium to its UK aerospace and defence peer group. We feel that this premium is justified given its exposure to the growing US defence budget environment and the heightened chemical, biological, radiological and nuclear (CBRN) threat in the UK and overseas. In addition, the stock should reflect the higher valuation of its dairy peers. Overall, the higher than average margin performance and future growth reflected in our forecasts support a valuation premium.

Investment summary

Company description: Structured for growth

Avon Rubber specialises in respiratory protection systems and milking point solutions to provide innovative solutions to a global customer base. The company is formed of two key divisions. Avon Protection (70% of FY17 group sales) is recognised as a global leader in CBRN respiratory protection systems supplying military, law enforcement and fire markets. milkrite I InterIPuls provides complete milking point solutions to dairy farms around the world. The group strategy today focuses on growing the core, selective product development while adding value-enhancing acquisitions.

Interim results and trading outlook

H118 for Avon Protection reflected the decline in Military revenues from the planned lower M50 mask systems to the US. However, growth in Law Enforcement has been encouraging, supported by initial sales of the Powered Air range. milkrite I InterIPuls was not without market challenges in H118, as tougher markets in North America affected the performance at Interface due to higher feed prices, and these challenges are expected to continue into H218. However, Farm Services growth was very strong. Group numbers were restated for the disposal of AEF. H118 has been a window into the development focus of the group, with the developing product suite. Overall, the company remains confident it can deliver FY18 expectations and medium-term growth prospects.

Valuation: Justified premium

Taking an average of our DCF and our sum-of-the-parts valuations gives a fair value of 1,450p per share, which would imply a FY18e P/E of 19.5x. The stock is trading at a premium to its UK aerospace and defence peer group. We feel this is deserved given its exposure to the growing US defence budget environment and the heightened CBRN threat in the UK and overseas. In addition, the stock should reflect the higher valuation of its dairy peers. Overall, the higher than average margin performance and future growth reflected in our forecasts support a valuation premium.

Financials: Modest changes to estimates

We have made modest adjustments to our forecasts largely to reflect the disposal of AEF, with an overall reduction in continuing revenues of c £4m and a cash contribution of c £6m. AEF was loss-making and hence a small uptick in profitability at Avon Protection is noted. While we expect FX to keep top-line progression muted in FY18, we see a return to growth in FY19e, with increased deliveries and service expansion, and we expect operating margin progression in both years.

Sensitivities: Global position

The M50 10-year sole-source contract ends in 2018 and the US Department of Defense (DoD) is in active conversation with Avon Rubber about the follow-on replenishment phase. The increased CBRN threat in the UK coincides with under-investment in this area, while the review launched by the UK MoD creates some uncertainty. Brexit is unlikely to affect Avon Protection, although the outcome is less certain for the UK dairy industry. milkrite I InterIPuls's customers remain sensitive to movements in milk and feed prices. The ability of management to identify and integrate acquisitions is important given the group strategy.

H118 results

- Orders received of £88.3m (H117 £90.8m)
- Reported H118 revenues of £77.6m (H117 £78.8m)
- Adjusted H118 operating profit of £9.2m (H117 £8.0m)
- Adjusted H118 profit before tax of £11.6m (H117 £10.7m)
- Adjusted H118 EPS of 32.8p (H117 28.6p)
- Interim DPS of 5.34p (H117 4.11p)

Exhibit 1: H118 results

(£m)	H117	H118	% change	% at constant currency
Orders				
Avon Protection	65.8	64.2	-2.4%	6.6%
milkrite I InterPuls	25	24.1	-3.6%	1.0%
Total orders*	90.8	88.3	-2.8%	5.0%
Revenues				
Avon Protection	53.7	53.1	-1.1%	8.4%
Of which				
Military	32.9	27.3	-17.0%	(5.5)%
Law Enforcement	12.5	18.6	48.80%	42.0%
Fire	8.3	7.2	-13.3%	(6.3)%
milkrite I InterPuls	25.1	24.5	-2.4%	0.8%
Of which				
Interface	18.2	17.1	-6.0%	(1.1)%
Precision, Control & Intelligence	4.8	4.8	0.0%	5.3%
Farm Services	2.1	2.6	23.8%	28.7%
Total revenues*	78.8	77.6	-1.5%	5.9%
Operating profit				
Avon Protection	7.6	8.7	14.5%	21.0%
milkrite I InterPuls	3.3	2.6	-21.2%	1.2%
Other	-1.3	-1.4	7.7%	0.3%
Total operating profit*	9.6	9.9	3.1%	18.4%
Operating profit margin (%)				
Avon Protection	14.2%	16.4%	15.8%	
milkrite I InterPuls	13.1%	10.6%	-19.3%	
Total operating profit margin	12.2%	12.8%	4.7%	
EPS adjusted (p)	28.6	32.8	14.7%	33.7%
DPS (p)	4.11	5.34	29.9%	33.7%
Net cash	12.6	39.1		Up £14.4m

Source: Company reports. Note: *H117 numbers reflect the disposal of AEF including orders of £0.5m, revenues of £2.2m and an operating loss of £0.3m.

In Avon Protection, the decline in Military revenues reflected the planned lower number of M50 mask systems delivered to the US from 93,000 in H117 to 79,000 in H118. The business has a 70,000 order book to underpin H218 and has received a further 24,000 M50 mask system orders since 31 March. Meanwhile, the company remains in active dialogue with the US DOD for the M50 replenishment phase. Growth in Law Enforcement has been encouraging, supported by initial sales of the Powered Air range. Performance here is truly global, with hoods and masks growing well in Europe, Middle East and Asia, while North America saw strong growth in filters and spares. Fire revenues declined on tougher market conditions, however product upgrades in the Magnum SCBA (self-contained breathing apparatus) underpins the business looking forward.

milkrite I InterPuls was not without market challenges in H118, as tougher markets in North America affected the performance of Interface due to the effect of higher feed prices on farmers' operating margins. This is driving the company to focus on its costs in H218 as the tougher feed cost

environment continues. However, constant currency revenue growth of 8.6% was recorded across Europe, Middle East and Asia Pacific. Precision, Control and Intelligence (PCI) continued its growth trend while Farm Services experienced further success in Cluster Exchange with 23% growth in cluster points. The company is on track with the introduction of Pulsator Exchange and Tag Exchange.

Following the new strategy introduced in FY17, H118 has demonstrated the development focus of the group, with the developing product suite. The MCM100 underwater rebreather and the Magnum SCBA product ranges are significant examples of the development work and the success the group has had with end customers. Total H118 R&D spend was £4.4m, of which £1.4m was customer funded. Forecast R&D spend for FY18 is c £7m, half of which is customer funded. The company expects a similar level for FY19.

Management remains confident that it can deliver FY18 expectations and medium-term growth prospects.

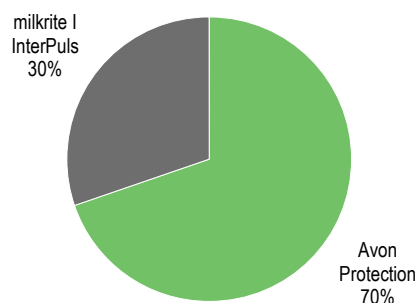
Company description: Building a brighter future

Avon Rubber specialises in respiratory protection systems and milking point solutions to provide innovative solutions to a global customer base. With headquarters in Melksham, Wiltshire in the UK, Avon has a broad global footprint, with sites in the US, China, Italy and Brazil. This equates to 11 sites with c 800 employees, supplying customers in 89 countries around the world.

While the company's origins date back to 1855, the current structure was created through portfolio rationalisation throughout the 1990s and a suite of acquisitions in the 2000s. From 2008, the company was winning contracts with larger values and longer terms, thus building visibility into the business. Today, Avon Rubber is formed of two key divisions. Avon Protection (70% of FY17 group sales) is recognised as a global leader in CBRN respiratory protection systems supplying the military, law enforcement and fire markets. milkrite I InterIPuls provides complete milking point solutions to dairy farms around the world.

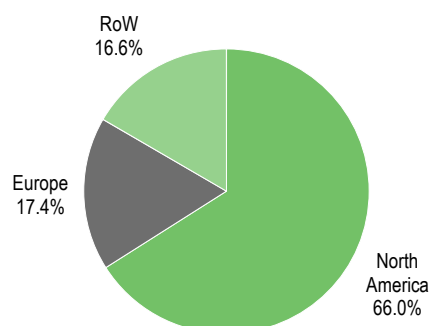
Both divisions have broadened their product portfolios and addressable markets through a series of successfully integrated acquisitions. The group strategy focuses on growing the core, selective product development and adding value-enhancing acquisitions. The recent disposal of AEF indicates the focus of the management team on the portfolio and its core markets.

Exhibit 2: FY17 group divisional split



Source: Company reports

Exhibit 3: FY17 group regional revenue split

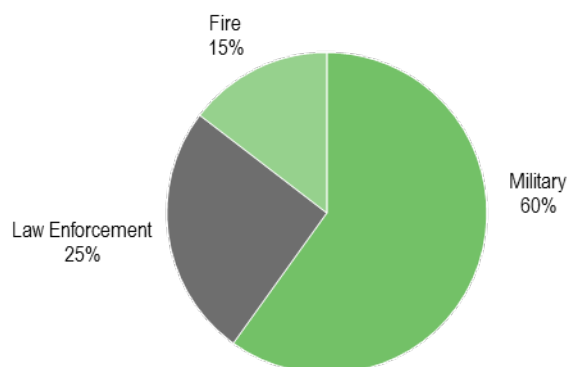


Source: Company reports

Avon Protection

Avon Protection is a global leader in CBRN respiratory protection systems. Military customers continue to make up over half of the division's revenues although there is significant and growing contribution from the law enforcement and fire markets.

Exhibit 4: FY17 revenue split for Avon Protection



Source: Company reports

While Avon Protection addresses a broad end market spectrum, central to the investment thesis is delivering high-value products to key customers at attractive margins. There are clearly areas of opportunity in air, sea and technology integration, although the company wants to avoid mass market dynamics where it would face far larger competitors and less sophisticated products. This is demonstrated in Exhibit 5.

Exhibit 5: Avon Protection areas of operation

CBRN protection	Respiratory protection	Technology integration
Masks	Filters	Communications
Hoods	Powered air	Information display
PPE clothing	Self-contained breathing apparatus	Helmet/visor integration
Detection	Rebreathers	Sensors/detection
Decontamination	Land Air Sea	Thermal imaging cameras
Military	Law enforcement	Fire
		Industrial & civil

Source: Company reports, green shading indicates current exposure

The table below captures the breadth of the current Avon Protection military portfolio. The suite has developed considerably over the last decade ie in 2008 the company only offered the M50, FM53 and ST53 products whereas today's portfolio enables customers to be introduced via entry level products and in time move to more sophisticated options as appropriate. A visible benefit here is the step-up in unit value, where Avon may be selling the same number of units as before to a customer but the higher unit contribution has a positive multiplier effect. The company's decision to invest in selective product development is bearing fruit while addressing a significantly larger customer base. In addition, with 20- to 30-year product lifecycles, it is important to both understand customer requirements and ensure product economics from the outset.

Exhibit 6: Avon Protection military portfolio applications 2018

Applications	M50	FM53	ST53	M53A1	FM54	ST53SD	MCM100	MDC150	EZAIR	MP-PAPR	CS-PAPR	CS-ELITE
Military operations	X	X	X	X	X	X	X	X	X	X	X	X
Counter narcotics operations		X	X	X	X	X				X	X	X
Special operations		X	X	X	X	X	X	X		X	X	X
Law enforcement operations		X	X	X	X	X			X	X	X	
First responders		X	X	X		X	X	X	X	X	X	
Critical national infrastructure protection									X			
Other		X							X			

Source: Avon Rubber

Close to home, Avon was selected by the UK MoD as preferred bidder for the resupply and in-service support of its General Service Respirator on 3 November 2017. The contract announced in February 2018 is a build to print of the current UK MoD design over a five-year period. There is a required build-up lead time, including tooling and approvals, with production starting in H119. We are encouraged to see the contract win against a challenging procurement backdrop for the UK MoD. However, as we discuss later in this note, the current security backdrop is creating demand.

Overseas, Avon is in encouraging negotiations with the US DoD, as the M50 10-year sole-source contract ends in 2018. The company received an order for 53,000 M50 masks in early December. Combined with the order book of 49,000 M50 masks at the end of September, this fully underpins our FY18 M50 delivery forecasts. The order in January of 47,000 M50 masks will contribute towards building the FY19 order book and offers further visibility.

Partnerships are key to Avon Rubber, not least the long-term, multi-level relationship with the US DoD. The current active dialogue for the M50 replenishment phase should extend the programme for another 15 years. In addition, Avon continues to work with the DoD on some potentially significant platform programmes (see page 8-9). This is in line with the company's new, threefold growth strategy. The overall approach is to grow the core, add selective product development and make value-enhancing acquisitions to accelerate growth.

An exciting recent development is approval from the National Institute for Occupational Safety and Health in North America of the Powered Air Purifying Respirator (PAPR) range. The first US customer here is a large federal law enforcement agency, which itself was involved in the development of the technology. Avon anticipates further orders from US customers in the near future.

Other significant markets are first responders including the police and other emergency services, addressed either directly or through distribution channels. SCBA and thermal imaging equipment is targeted at the fire services and other industrial users, primarily through a US distribution network. All products are safety-critical and consequently markets are highly regulated, with approval standards creating significant barriers to entry with long product cycles.

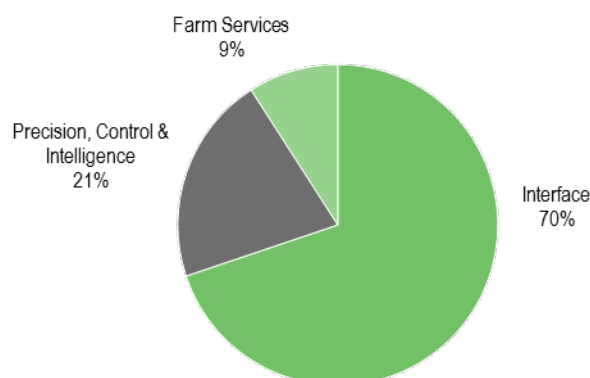
Exhibit 6 also suggests areas where further M&A could build out the portfolio in this division. Within Respiratory Protection, air and sea could prove attractive end markets if the right asset became available. We reiterate that Avon's M&A strategy is disciplined, bringing the right technology and market access to build upon the medium-term growth trajectory of the group.

milkrite | InterPuls

The milkrite I InterPuls business designs, manufactures and sells products and services used in the milking process. At the core of the business is rubber ware such as liners and tubing. These consumable products come into direct contact with the cow and the milk and are replaced regularly to ensure product hygiene and animal welfare and to maximise milk quality and yields. This division has also evolved organically and via significant acquisition. The €30m acquisition in 2015 of InterPuls, a milking equipment specialist in electromechanical components, has added significantly

to the product range. This includes pulsators, milk meters, automatic cluster removers, milking clusters, washing systems, vacuum pumps, bucket milkers and pipeline system components,

Exhibit 7: FY17 revenue split for milkrite | InterPuls



Source: Company reports

Today, Avon is a complete milking point solution provider, working through over 2,000 distributors worldwide. The global market is concentrated in high-consumption automated milking markets in North America and Western Europe, where Avon has significant market shares. Growth potential also exists beyond the traditional markets in South America, China, India and Russia.

The dairy farm of the future needs to address the multiple issues of milk quality, environmental impact, farm efficiency and profitability. milkrite | InterPuls believes that driving operating efficiency with technology is the answer. So, it is less the Internet of Things, and rather the Internet of Cows. We discuss this in more detail later in the report.

Exhibit 8: milkrite | InterPuls product range

Interface	Precision, control & intelligence	Farm services
Liners	Pulsators	Cluster
Tubing	Milk meters	Pulsator
Claws	Tag systems	Tag
Shells	Data management	
Wash systems		Unique leased ownership model
Market leader	Challenger	Low penetration

Source: Company reports

milkrite | InterPuls offers solutions with world-class products of its own in liners and pulsation equipment. The Interface business dominates the division sales split (70% in FY17) and the business is the clear market leader, manufacturing 64% of the liners sold in the US in FY17. Overall, Interface grew by 4.3% organically in FY17. Through its Interface business, milkrite | InterPuls has a strong installed base from which to leverage its other two business areas. The Precision, Control & Intelligence (PCI) and Farm Services businesses are demonstrating very strong growth (20.2% and 18.9% organically in FY17 respectively).

Farm Services is the company's leasing approach (Exchange), offering equipment on a lease hire basis with a fully incorporated service and warranty scheme. Today, the majority of the business is Cluster Exchange Service (CES), offered to farmers to reduce the time they have to change liners but also improve the regularity of changes. Typically, farmers will leave liners unchanged for longer

than is advised, increasing the chance of damage and subsequent infection. However, Pulsator Exchange Service (PES) was launched in North America in FY17 with 478 Pulsators introduced to 11 farms serving 19,570 cows in the year. Meanwhile, Tag Exchange Service (TES) is moving into its commercial launch phase following a successful pilot stage.

Overall, the market dynamic is changing in milkrite I InterPuls's favour. As little as 15 years ago, farmers had to be convinced of the benefits of technology, whereas today they are asking what solutions are on offer. Exchange schemes generate twice the revenue, with the addition of service to the product sale. They also add visibility and predictability to the business and mitigate the impact of variable milk or feed prices on investment decisions. The division is scheduled to spend £1.5m on product development this year to ensure it is at the forefront of this evolution.

Strategy: Threefold path

The senior management team change in FY17 drove the group to update its strategy. The goal is to deliver long-term, sustainable growth using a threefold approach:

- Grow the core
- Selective product development
- Value enhancing acquisitions

Grow the core

Management has recognised clear growth opportunities within the Avon Protection division for both products and service across each of the end markets it addresses currently. Within Military, the strength of the relationship with the US DoD has developed a specialist product portfolio. Domestic activity with the UK MoD has been encouraging with the success of the General Service Respirator (GSR) five-year contract and the group sees global opportunities. Meanwhile, in Law Enforcement, demand levels rose in 2017 for CBRN defence products and the company intends to continue to grow market share and introduce new products. Avon's work in the Fire space will see enhanced products and upgraded systems to comply with new 2018 National Fire Protection Association (NFPA) standards, while the argus thermal camera business will add cross-selling opportunities. Underpinning this is the group's commitment to improving production processes, exploring local assembly options and optimising the production base for future growth.

In milkrite I InterPuls the growth priority in Interface is to build the global dealer network and launch the next product generation. In turn, PCI can leverage off the Interface market position. For Farm Services, it is a question of marketing a service portfolio on both sides of the Atlantic, with Cluster Exchange at the core and introducing Pulsator Exchange and Tag Exchange. In essence, the goal is to build on current success and become a key partner with farms on a lease hire arrangement.

Selective product development

Innovation is core to Avon Rubber, and new product introduction will continue but at a lower level of spend than seen in prior years. Forecast R&D spend for FY18 is c £7m, half of which is customer funded. The company expects a similar level for FY19. The focus for investment for the core business will be on projects that present an opportunity to add value and fit within the strategic goals of the company. In some instances, considerable investment has already taken place and it is now a question of fully leveraging this. Overall, this approach ensures that the product portfolio is enhanced, meets the needs of the customer and is able to deliver future growth.

Partnerships are key to Avon Rubber, not least the long-term, multi-level relationship with the US DoD. As we have already discussed, the 10-year sole-source JSGPM contract for the M50 mask system is moving to an end in 2018 and the company is in active dialogue to determine the size

and shape of its future supplier role to the DoD in the replenishment phase that should extend for another 15 years. Hence, product development is already underway on some potentially significant platform programmes. This includes the Joint Services Aircrew Mask (M69) and the M53A1 combined tactical mask and PAPR system.

Value-enhancing acquisitions

Avon Rubber has a strong track record in acquisitions and we detail the key recent deals below. Future targets would ideally be in the region of £30 to £50m EV, with guaranteed forward contracts and strong management teams. Important to note is that any targets would be within Avon's existing markets. The group has net cash of £39.1m, committed bank facilities of £29.9m and cash generation continues to be strong.

As a reminder, recent acquisitions include:

- **VR Technology** – Avon acquired VR Technology in 2013 and it was originally focused on personal dive computers. VR subsequently developed rebreather designs of its own and the underlying technology for both products is a suite of control electronics, gas sensors and control valves that manage the diver's breathing air and maintain oxygen and carbon dioxide levels within the correct range. A key addition to the product portfolio from this acquisition has been the newly launched MCM100 rebreather, where initial customer orders were received in H118 for delivery in H218.
- **Hudstar Systems** – Hudstar Systems was purchased for \$5.1m in 2015. It designs and manufactures electronics hardware and software for the fire service industry. The acquisition reduced supply chain risk due to the vertical integration of a key supplier to the group's Deltair product and provided a route to insource other components purchased across the rest of the product range. Hudstar also provided electronics capability.
- **InterPuls** – In August 2015, Avon made the significant strategic acquisition of InterPuls for a total consideration of €29.75m. This made the Dairy division (now called milkrite | InterPuls) a leading international provider of milking point technology, providing complete teat-to-pipeline solutions for the sector. InterPuls added high-technology products, providing the farmer with a range of high-margin technical solutions including pulsators, milk meters, automatic cluster removers and vacuum pumps.
- **e2v's thermal imaging business** - In October 2015, Avon acquired argus, the thermal imaging camera business of e2v, for £3.3m. This further strengthened Avon's product range in the fire and first responder markets, bringing immediate access with a leading product, allowing increased penetration with Avon's current strategic law enforcement distributors/agents and installed customer base.

The company has also made a recent disposal:

- **Avon Engineered Fabrications (AEF)** – In March 2018, sold for \$9.5m to Performance Inflatables Co, a Pinewell Capital portfolio company. AEF is a world-class supplier of coated fabrics to a broad range of end-markets, including hovercraft skirts and liquid storage tanks. Previously reported in the Avon Protection division, the FY17 revenue contribution was £4m (FY16: £4.8m). The company has stated that the group's acquisition strategy would result, in the medium term, in AEF losing its US small business regime benefits. Hence, although AEF had a strong Q417 and a healthy order book, the FY17 annual report mentioned that the group was "considering the strategic options for this business." We estimate that the cash contribution will be c £6m at current exchange rates, after adjustments, costs and tax.

Market opportunities

We outline here some of the key market trends supporting growth in both of Avon Rubber's operating divisions.

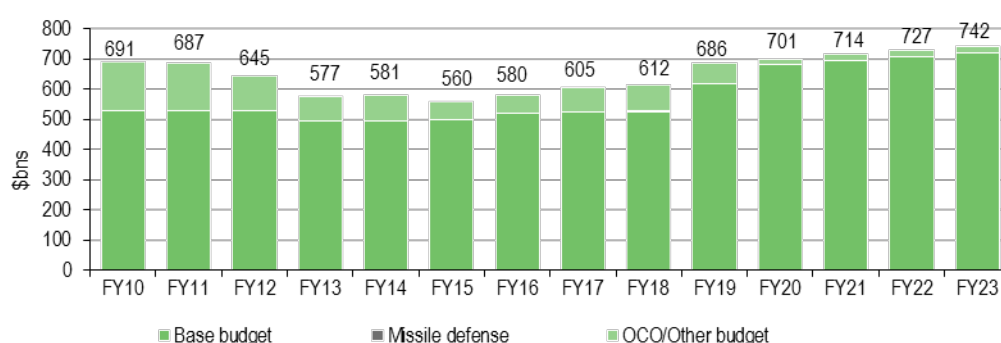
US protection market

While Avon Protection is building its global presence across multiple end markets, the US DoD has been a long-standing customer and continues to be an opportunity to drive further growth. Avon Protection FY17 revenues included £50.5m from DoD, the only customer to individually contribute more than 10% to group revenues. The FY19 defense budget is very much focused on addressing future threats from a position of strength. Hence the required uplift in defence spending is increasingly visible.

Avon Protection's current focus is on the US land forces, where again the budget trend is in step with the overall rhetoric. The FY19 budget request states that *"The (US) Army requires sufficient and predictable funding commensurate with its requirements to build readiness for the current fight and to prepare the Army for any future fight."* Important for a supplier of equipment used by individuals is that the declining trend in army personnel since FY11 has started to reverse. The FY19 budget request seeks a Regular Army end strength increase of 4,000 soldiers above the FY18 NDAA level to facilitate fully manned formations and growing specific capabilities in critical formations ie fires, air defence, cyberspace, and electronic warfare. The FY18 NDAA looked for an increase of 7,500 soldiers. In addition, as mentioned earlier, if Avon pursues the US military air and sea markets, these are exhibiting similarly increased manpower trends.

In addition, the current elevated threat from chemical weapons supports an increased demand for protective equipment. Overall, Avon Protection has the growth potential through a higher number of end users, increased value individual product contribution, as the company develops and delivers higher specification products, and the current elevated security threat.

Exhibit 9: US DoD funding from FY10 to FY23e (Discretionary Budget Authority)



Source: US Department of Defense FY19 PBR documentation

Exhibit 10: Department of the US Army overview

\$ms	FY18	FY19	%
Military personnel	57,966,897	63,746,449	10.0%
Operation and maintenance	67,849,660	77,491,536	14.2%
Procurement	22,148,297	27,820,028	25.6%
RDT&E	8,636,503	10,484,483	21.4%

Source: US Department of Defense

The recent Avon Rubber Capital Markets Day presentation included a discussion on 'future threats' by chemical weapons expert Hamish de Bretton-Gordon. Including recent events in Salisbury, UK, 2018 has already witnessed the most frequent use of chemical weapons since the First World War.

De Bretton-Gordon is the CBRN adviser to the UK MoD and he believes that the current events will affect the UK for the next 10 to 15 years. The increased threat coincides with under-investment in this area over recent years leaving military and first responders unprepared to respond. Both the London Fire Brigade Commissioner Dany Cotton and the UK security minister Ben Wallace have stated publicly that a chemical weapon attack on London and the UK, respectively, is a significant and real concern to them. With personnel protection paramount, it is clear that Avon has the optimal portfolio to address the current threat.

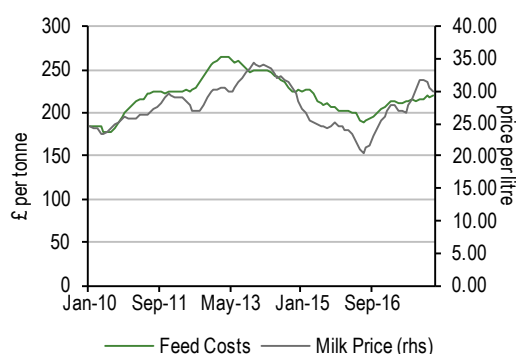
The growing CBRN requirements are also highlighted in the US DoD FY19 requirement noting *“Rogue regimes such as North Korea and Iran are destabilizing their regions by pursuing nuclear weapons or sponsoring terrorism. North Korea seeks to guarantee regime survival and increased leverage through a mixture of nuclear, biological, chemical, conventional, and unconventional weapons and a growing ballistic missile capability to gain coercive influence over South Korea, Japan, and the United States.”* In addition to growing number of boots on the ground, Avon Protection is in an attractive position in ensuring those troops are properly equipped.

Technical dairy

The general market backdrop is supportive for milkrite I InterPuls, with global consumption of dairy products expected to increase by 25% between 2015 and 2024 (OECD-FAO Agricultural Outlook, 2015). Milk production has been steadily growing at an average of 2.3% every year since 2000 and the industry employs around 750 million people globally.

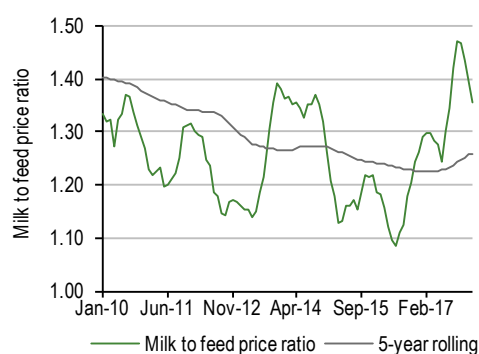
Variability of milk and feed prices can affect farmers' investment decisions and opportunities. As we discussed earlier, milkrite I InterPuls Exchange schemes can mitigate this, however there is a continual pressure to improve efficiency and quality while keeping costs down.

Exhibit 11: Farm gate milk price (ppl) and feed price (£/tonne)



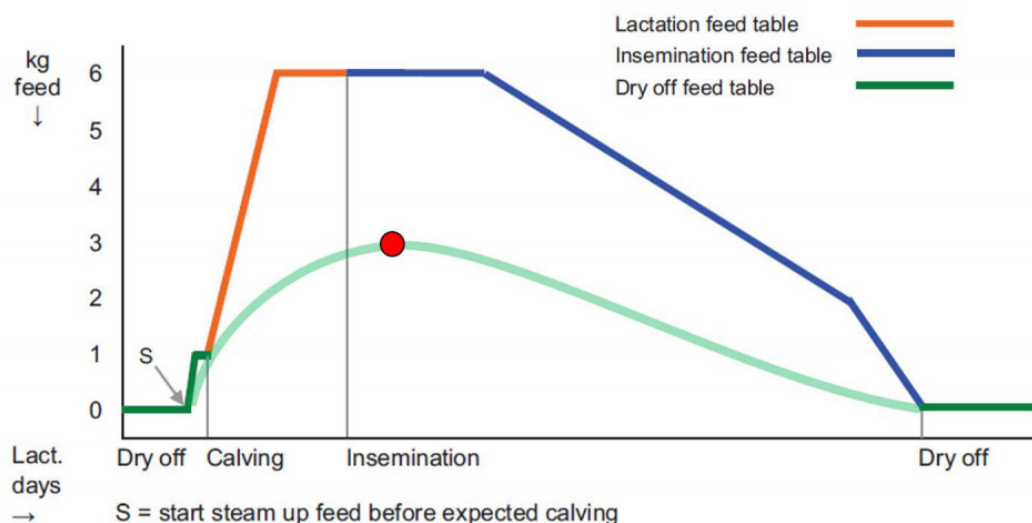
Source: Defra, Promar/Kingshay, AHDB Dairy

Exhibit 12: Milk to feed price ratio



Source: Defra, Promar/Kingshay, AHDB Dairy

milkrite I InterPuls believes that driving operating efficiency with technology is the answer, addressing the multiple issues of milk quality, environmental impact, farm efficiency and profitability. So, it is less the Internet of Things and rather the Internet of Cows. Essentially, the technology allows the farmer to monitor cow movement and behaviour. Milking cows within the most efficient time window is increasingly important, avoiding the estimated loss of £5 per day that occurs 300 days after calving, shown as “Dry off” in Exhibit 13. Tagging, tracking and monitoring cows permit a number of activities and actions to be monitored. Injured or ill cows can be quickly identified and separated for treatment. Feeding patterns can be analysed in addition to identifying the optimal time for insemination, which is central to milking efficiency and profitability.

Exhibit 13: Precision feeding chart


Source: Company reports

milkrite I InterPuls delivers solutions to farming customers, and its customers can be its best advertisement. At the Avon Rubber Capital Markets Day we were shown an example of a Russian farmer who visited a farm in Italy that was using a milkrite I InterPuls system. Adopting a similar system at his own farm drove production up by 25% in just 12 months.

Overall, the market dynamic is changing in milkrite I InterPuls's favour. As little as 15 years ago, farmers had to be convinced of the benefits of technology, whereas today they are asking what solutions are on offer. The division is scheduled to spend £1.5m on product development this year to ensure it is at the forefront of this evolution.

As we discussed earlier, the global market is concentrated in high-consumption automated milking markets in North America and Western Europe, where Avon has significant market shares. However, growth potential also exists beyond the traditional markets in South America, China, India and Russia, where milkrite I InterPuls's technology and services provide an attractive solution.

Management

The change of management at Avon Rubber brought a swift refocus of strategy in FY17. Paul McDonald was appointed chief executive officer in February 2017, with 14 years of experience at Avon Rubber, the last seven years of which he served as divisional managing director of Avon's Dairy division (now milkrite | InterPuls). Nick Keveth was appointed chief financial officer in June 2017, joining the company from Imperial Brands, where he worked for 12 years, latterly as director of finance, planning & reporting. In addition, there are new appointments at the head of each division, both internal promotions. Leon Klapwijk is the new divisional leader for Avon Protection and Craig Sage is the new divisional leader for milkrite | InterPuls. The new management team has been swift to visit all Avon sites and work collaboratively to introduce its updated strategy.

Sensitivities

- **M50 contract:** The M50 10-year sole-source contract ends in 2018. The US DoD is in active conversation with Avon Rubber to determine the shape and scale of product replenishment phase. It is important to note that there will be a c £12m y-o-y impact on divisional revenues from a lower M50 delivery schedule in FY18. However, it is also important to understand that as

the company moves through this transition into other programmes an improvement to operating margin is expected, given lower margins on the 10-year contract versus the portfolio average.

- **CBRN investment:** Awareness of CBRN defence has been building due to ongoing chemical weapons usage in Syria and Iraq plus recent activity in the UK. Increased threat coincides with under investment in this area over recent years leaving military and first responders unprepared to respond.
- **UK defence budget:** While Avon Protection has been successful with the GSR contract, the UK MoD launched another review in January. Until the review's findings are made clear, there is some uncertainty over future funding levels and areas of focus. UK defence secretary Gavin Williamson said *"In order to secure competitive advantage over our potential adversaries we need to ensure we can move quickly to further strengthen our capabilities."* In addition, he said that the outcome would not be "fiscally neutral."
- **Brexit:** As defence policy has always remained sovereign under the EU, Brexit is not expected to dramatically alter Avon Protection's position. Meanwhile, for the UK Dairy industry the outcome is less certain for future exports and product development. However, while the UK is a small part of milkrite I InterPuls's geographic contribution, we believe that a focus on quality and efficiency will keep the offering relevant.
- **Milk and feed prices:** The customers for milkrite I InterPuls are sensitive to the variations in milk and feed prices, often affecting investment decisions. There can be a lag between milk price recovery and resumption of consumable spend of approximately three months and three to six months for larger capital equipment. It is important for the business to demonstrate how its products and services can drive efficiencies against potentially rising input costs or lower end product pricing.
- **Acquisition integration:** Recent portfolio activity has included the disposal of Avon Engineered Fabrications. However, with 'value-enhancing acquisitions' as the third leg of the company strategy, the ability of management to identify and integrate acquisitions is important.

Valuation

Our cash-based capped DCF valuation is, in our view, a conservative basis for estimating cash flow values as it does not assume any growth in the terminal value. While we do normalise working capital to zero and capex to equal depreciation, it still eliminates some element of the potential tail value. The DCF on a calculated WACC of 7.9% currently delivers a value of 1,325p, previously 1,297p.

As we used in our last Outlook report, our sum-of-the-parts valuation is shown in Exhibit 14. Taking an average of our DCF valuation and our sum-of-the-parts valuation gives a fair value price of 1,450p, which would imply a FY18e P/E of 19.5x.

Exhibit 14: Sum-of-the-parts valuation

(£m)	FY18e EBITA	Tax rate (%)	FY18e NOPAT (core)	P/E (x)	Value	Notes
Protection	20.4	20%	16.3	18.6	305	Average of MSA (19.6x), Honeywell (17.8x) and 3M (18.5x)
milkrite I Interpuls	8.2	20%	6.6	27.5	180	50% premium to Skellerup (13.8x), in line with Genus (34.2x)
Central costs	(2.0)	20%		13.0	(21)	
Net debt/(cash)					(25)	September 2017 year end
Equity value					489	
Shares in issue (m)					31.02	
Implied fair value per share (p)					1,575	

Source: Edison Investment Research, Bloomberg

On our updated forecasts, Avon Rubber is currently trading on 18.3x FY18e P/E. The stock is trading at a premium to its UK aerospace and defence peer group, which is deserved given its exposure to the growing US defence budget environment. In addition, the recent share price strength reflects the heightened CBRN threat in the UK and overseas and Avon's position to address that. Overall, this works to underpin the higher than average margin performance and future growth in our forecasts. Hence we believe the valuation premium is justified.

Financials

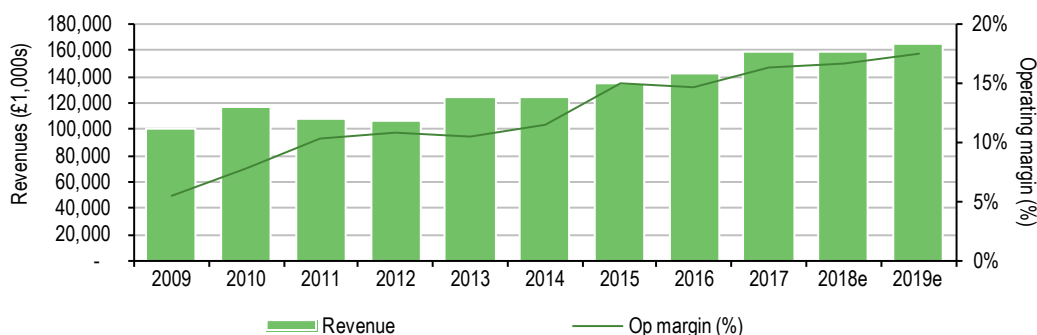
In FY18, Avon will deliver 60,000 fewer M50 mask systems to the US DoD versus FY17. It is important to note that our forecast reflects a c £12m y-o-y impact to divisional revenues from a lower M50 delivery schedule in FY18. The business has a 70,000 order book for the M50 to underpin H218 and has received a further 24,000 M50 mask system orders since 31 March, which we believe provides flexibility should any timing delays occur with delays in DOD new programmes. It is also important to understand that as the company moves through this transition into other programmes an improvement to operating margin is expected, given lower margins on the 10-year contract versus the portfolio average. For example, H218 revenue will also benefit from the contribution from both the M69 and M53A1 powered air respirator. Supporting revenue growth beyond FY18 are the wider opportunities from the enhanced product portfolio and the broad range of addressable end customers.

For milkrite I InterPuls, we have reduced our top-line growth assumptions slightly given the tougher H118 feed pricing and the effect on Interface. Looking forward, growth in Farm Services is encouraging and important for revenue growth as recorded on the original equipment and on the service element.

Given US exposure in both divisions, we expect FX to keep top-line progression muted for FY18 and see a return to growth in FY19. Improved product mix and operational leverage should support operating margin growth in both divisions in FY18 and FY19. The company has stated that it will maintain a progressive dividend policy and that it intends to grow dividends ahead of earnings over the medium term. We have made a small reduction in the number of treasury shares assumed for FY18 and FY19 which modestly reduces our EPS calculation.

We have made modest adjustments to our forecasts largely to reflect the disposal of AEF, with an overall reduction in continuing revenues of c £4m and a cash contribution of c £6m. AEF was loss-making and hence a small uptick in Avon Protection profitability is noted. While we expect FX to keep top-line progression muted in FY18, we see a return to growth in FY19e and operating margin progression in both years.

Exhibit 15: Revenue and operating margin development (2009 to 2019e)



Source: Edison Investment Research

Exhibit 16: Revised forecasts

Year to September (£000s)	FY18E			FY19E		
	Prior	New	% change	Prior	New	% change
Avon Protection	111,752	108,702	-2.7%	115,104	111,963	-2.7%
milkrite I InterPuls	51,475	50,635	-1.6%	59,589	53,167	-10.8%
Total sales	163,226	159,337	-2.4%	174,693	165,130	-5.5%
EBITDA	36,095	36,254	0.4%	38,048	38,372.8	0.9%
Avon Protection	20,004	20,436	2.2%	21,222	21,681	2.2%
milkrite I InterPuls	8,648	8,203	-5.1%	9,296	9,145	-1.6%
Unallocated	-2,000	-2,000		-2,000	-2,000	
Underlying EBITA	26,651	26,639	0.0%	28,518	28,825	1.1%
Underlying PBT	26,476	26,464	0.0%	28,163	28,479	1.1%
EPS - underlying continuing (p)	74.5	74.3	-0.3%	74.7	75.3	0.8%
DPS (p)	16.0	16.0	0.0%	20.8	20.8	0.1%
Net debt/(cash)	-44,785	-49,703	11.0%	-63,003	-67,995	7.9%

Source: Edison Investment Research

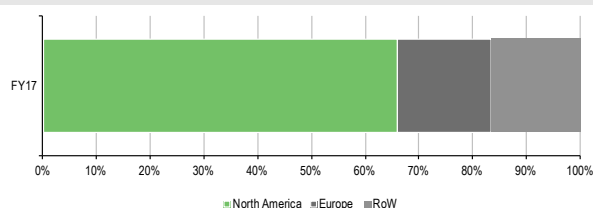
Exhibit 17: Financial summary

	£000s	2016	2017	2018e	2019e
Year end 30 September		IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue		142,884	159,200	159,337	165,130
Cost of Sales		(90,159)	(101,500)	(101,587)	(105,281)
Gross Profit		52,725	57,700	57,750	59,849
EBITDA		29,922	36,300	36,254	38,373
Operating Profit (before amort. and except.)		24,031	30,300	30,011	32,126
Intangible Amortisation		(3,154)	(4,200)	(3,373)	(3,301)
Exceptionals		(4,808)	(7,000)	(4,002)	(4,004)
Other		(33)	(35)	(36)	(38)
Operating Profit		16,036	19,065	22,601	24,783
Net Interest		(154)	(200)	(138)	(308)
Profit Before Tax (norm)		20,690	25,865	26,465	28,480
Profit Before Tax (FRS 3)		15,882	18,865	22,463	24,476
Tax		1,824	2,900	(3,150)	(4,658)
Profit After Tax (norm)		21,765	25,500	22,759	23,068
Profit After Tax (FRS 3)		17,706	21,765	19,313	19,818
Average Number of Shares Outstanding (m)		30.3	30.4	30.5	3052
EPS - normalised (p)		70.5	83.3	74.3	75.3
EPS - (IFRS) (p)		58.5	71.5	63.4	65.1
Dividend per share (p)		9.5	12.3	16.0	20.8
Gross Margin (%)		36.9	36.2	36.2	36.2
EBITDA Margin (%)		20.9	22.8	22.8	23.2
Operating Margin (before GW and except.) (%)		16.8	19.0	18.8	19.5
BALANCE SHEET					
Fixed Assets		77,469	66,700	60,446	53,846
Intangible Assets		47,357	40,400	36,830	33,537
Tangible Assets		30,112	26,300	23,616	20,309
Investments		0	0	0	0
Current Assets		52,886	80,500	103,745	127,587
Stocks		20,648	21,800	21,829	22,849
Debtors		19,968	23,800	22,626	23,448
Cash		4,495	26,500	51,090	73,090
Other		7,775	8,400	8,200	8,200
Current Liabilities		(36,641)	(39,000)	(39,564)	(44,338)
Creditors		(34,142)	(37,200)	(38,177)	(39,243)
Short term borrowings		(2,499)	(1,800)	(1,387)	(5,095)
Long Term Liabilities		(51,713)	(52,600)	(52,558)	(52,516)
Long term borrowings		0	0	0	0
Other long term liabilities		(51,713)	(52,600)	(52,558)	(52,516)
Net Assets		42,001	55,600	72,070	84,580
CASH FLOW					
Operating Cash Flow		30,504	29,754	35,840	35,402
Net Interest		(147)	(154)	(200)	(139)
Tax		(17)	2,900	(3,150)	(4,657)
Capex		(6,838)	(5,500)	(8,862)	(5,947)
Acquisitions/disposals		(3,300)	0	6,500	0
Financing		(1,812)	(1,000)	(1,000)	(1,000)
Dividends		(2,430)	(3,200)	(4,126)	(5,366)
Other		(803)	(96)	0	0
Net Cash Flow		15,157	22,704	25,029	18,329
Opening net debt/(cash)		13,161	(1,996)	(24,700)	(49,703)
HP finance leases initiated		0	0	0	0
Other		0	0	0	(0)
Closing net debt/(cash)		(1,996)	(24,700)	(49,703)	(67,995)

Source: Company reports, Edison Investment Research

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Revenue by geography FY17

Management team
CEO: Paul McDonald

Paul was appointed CEO on 15 February 2017. Prior to this he was divisional managing director of Avon's Dairy division and a key member of the group executive management team. Paul joined the company in 2003 and spent the early part of his career at Avon in commercial and operational roles which included responsibility for all UK operations and the European Protection & Defence and Dairy business units.

CFO: Nick Keveth

Nick Keveth was appointed CFO in June 2017. Prior to joining Avon, he was director of finance, planning & reporting at Imperial Brands, the FTSE250 tobacco group. He was with Imperial for 12 years and held a variety of senior finance roles during this period. He also served as a non-executive director of the Spanish listed group Compania de Distribucion Integral Logista Holdings, a leading distributor of products and services to convenience retailers in Southern Europe, from 2014 until 2017. Prior to joining Imperial Nick worked for PricewaterhouseCoopers for 14 years in both audit and advisory roles.

Chairman: David Evans

David Evans took over as chairman in February 2012, having joined the board in 2007. He has over 30 years' experience in the UK and US defence market, having spent 17 years with GEC-Marconi before joining Chemring Group in 1987 and being appointed CEO in 1999. He remained as an NED following his retirement in April 2005 and was previously an NED of Whitman.

Principal shareholders

	(%)
Blackrock	8.9%
Schroders	6.8%
JP Morgan Chase	6.1%
Van Lanschot	5.5%
Ameriprise Financial Group	5.3%
River & Mercantile AM	4.5%
Canaccord Genuity	3.8%

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