EDISON

Norcros

Re-rating potential

FY17 results, AGM and acquisition activity review

Construction & materials

Norcros has continued to deliver against our expectations and AGM comments reinforce expectations of progress. The strategy of building a larger complementary business portfolio has been executed well to date and the company retains the financial flexibility to continue this process. Such activity may provide a catalyst for a re-rating but there is already scope for this to happen in our view.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
03/16	235.9	18.5	24.7	6.6	6.9	3.9
03/17	271.2	20.8	24.4	7.2	6.9	4.3
03/18e	289.1	22.1	25.8	7.5	6.6	4.4
03/19e	298.1	23.8	27.5	8.0	6.2	4.7

Note: *PBT and EPS FD are normalised, excluding intangible amortisation and exceptional items. EPS and DPS are adjusted for a one-to-10 share consolidation (30 September 2015).

Good trading momentum at the start of FY18

Following FY17 results marginally ahead of our model – and a modest increase to estimates - more recent AGM comments (27 July) pointed to positive momentum in both divisions in the first quarter of the FY18 trading year. Specifically, LFL revenue growth in the UK and South Africa (before positive FX translation) were +10.9% and +3.5% respectively. This reflects both FY17 exit rates and H117 comparative periods; we believe that these growth rates will converge or possibly cross over as the year progresses with UK progress tapering down while South Africa increases. This is consistent with our post results view and no further estimate changes were made after the AGM.

Successful acquisition strategy

Acquisition activity has been a feature of management's strategy since announcing growth targets in 2013. The three UK deals that have completed have all performed well individually and in a group context under Norcros's stewardship, and this has served to highlight and reinforce the company's portfolio business model. We review this activity in more detail in this note and, with our expected earnings and cash flow progression, show that there is plenty of headroom for further internally funded deals (eg end FY17 net debt stood at 0.7x EBITDA). There are no guarantees of course that additional M&A activity will complete, but we view it as a route in which management could boost the earnings growth outlook as a potential catalyst to achieving a market re-rating.

Valuation: Prospects better than rating suggests

Norcros's share price has largely traded within the 150-180p range over the last 18 months or so. It is currently c 11% below the level at the end of 2016 and has underperformed the FTSE All Share Index by almost 30% as a result. Our estimates have remained robust throughout and, consequently, the company's current year P/E and EV/EBITDA (adjusted for pensions cash) have compressed to 6.6x and 4.0x, respectively. Business prospects are somewhat better than the rating suggests in our view and a prospective 4.4% dividend yield enhances total return potential.

31 August 2017

Price	**169.25p**
Market cap	**£104m**
	ZAR17.0/£
Net debt (£m) at end March 2017	23.2
Shares in issue	61.3m
Free float	98.3%
Code	NXR
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	(3.8)	1.4	2.6
Rel (local)	(3.7)	3.4	(5.5)
52-week high/low		185.0p	138.0p

Business description

Norcros is a leading supplier of showers, tiles, taps and related fittings and accessories for bathrooms, kitchens, washrooms and other commercial environments. It has operations in the UK and South Africa, with some export activity from both countries.

Next events

Capital markets event	19 October
H118 results	November

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Edison profile page

Norcros is a research client of Edison Investment Research Limited

Investment summary

Company description: RMI market leader

Norcros is a leading supplier of showers, tiles, taps and related fittings and accessories for residential and commercial usage through multiple market channels. The UK and South Africa are Norcros's primary markets; as well as local manufacture, the company draws on international supply chain expertise and also exports into other European, African and Middle Eastern countries.

Valuation: Excessive discounts

Norcros is trading on a current year P/E of 6.6x with an EV/EBITDA (adjusted for annual pension scheme recovery cash) of 4.0x and a prospective 4.4% dividend yield. These metrics reduce further to 5.9x and 3.2x respectively with a yield of 5.0% in our third estimate year. We accept that our earnings growth expectations are not strong (with a three-year EPS CAGR of 5.5%), there is some macro-economic risk and that pension scheme liabilities are material. However, we view these counterpoints as either minor or manageable and current valuation multiples do not recognise progress made with the business and its ongoing fundamentals. Compared to peer companies exposed to similar UK markets, Norcros is trading on 40%+ discounts to the average earnings and cash multiples while paying a comparable dividend yield.

Financials: Flexibility to accelerate earnings growth

Norcros has delivered a strong increase in profitability since FY10 with company-defined earnings more than doubling (despite a normalising ie rising tax charge) while dividend payments have re-built over this period. We see steady revenue growth and modestly improving EBIT margins over our estimate horizon, which works through to a 5.5% fully diluted EPS CAGR (FY17 to FY20) and a similar rate of dividend progress. End FY17 net debt stood at 0.7x EBITDA; we anticipate that our earnings profile will generate sufficient cash – including pensions cash obligations - for the company to be in a broadly funds neutral position by the end of FY20. In the context of c £100m banking facilities (including a £30m accordion) in place, it is clear that the company retains significant financial flexibility to invest organically and through acquisitions in order to accelerate earnings growth above the levels that we currently expect.

Sensitivities: Market diversity and opportunity

Norcros is an international business with considerable exposure to suppliers and customers outside the UK. Sterling weakness affecting imported input and product costs has been a common challenge in the building materials space since the Brexit result in June last year. Norcros's policy is to take rolling forward transactional FX cover, broadly for a 12-month period; this provided an initial buffer to rising sterling prices and sufficient cover for Norcros to work them into its ongoing business model. Over the same period unhedged translational exposure to rand-generated earnings has benefited reported results. In its primary countries of operation, sustained GDP growth should be favourable for demand from both new and existing home sectors as well as commercial re-fit and newbuild activity. Sub-segment drivers are slightly different and sector diversity can be an advantage in variable markets, as we have seen, but also dilute the performance of stronger sectors. We expect Norcros to develop broadly across its current sector exposures in the medium and long term. Export markets potentially offer faster growth opportunities and represent further revenue diversity. Norcros has a material DB pension scheme, though we do not believe that this has restricted acquisition activity or dividend growth, and Norcros has headroom under existing facilities to make further acquisitions.

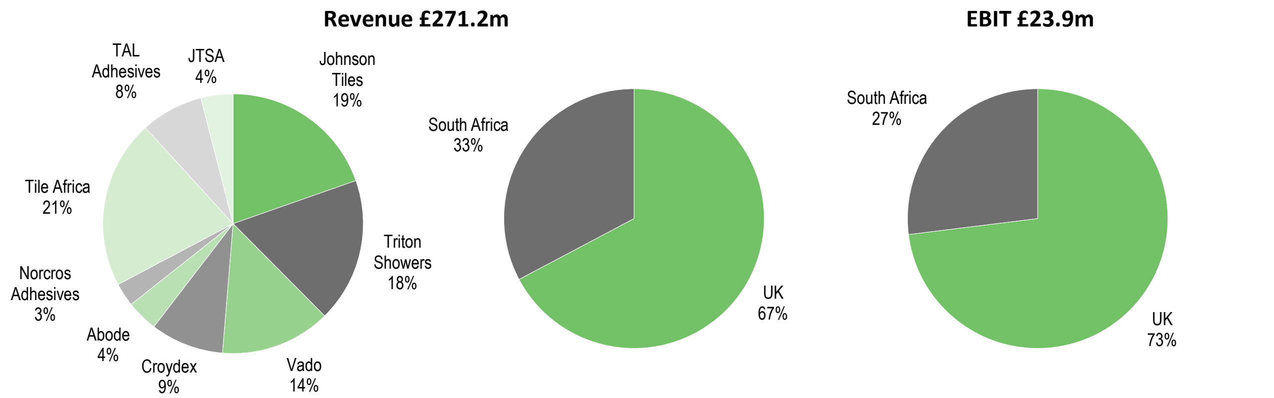
Company description: RMI market leader

Norcros is a leading supplier of showers, tiles, taps and related fittings and accessories for bathrooms, kitchens, washrooms and other commercial environments, with operations located in the UK and South Africa. The company is a B2B supplier with a segmented, multi-channel strategy into retail, trade and commercial customers and also has a direct retail presence in South Africa.

Collective focus, operational independence

We view Norcros as a portfolio of nine independently run but complementary businesses (six in the UK, three in South Africa) with a common focus on specific markets. Residential repair, maintain or improvement (RMI) spending is the primary end market driver with increasing exposure to newbuild as well as commercial (eg retail, hotel and leisure) uses. As Exhibit 1 shows, UK operations account for two-thirds of group revenue and almost three-quarters of FY17 EBIT.

Exhibit 1: Norcros revenue and EBIT splits FY17



Source: Norcros. Note: EBIT is reported (after SBP).

Ceramic tile and tile adhesive manufacturing is common to both regions and make up 23% and 11% of group revenues, respectively. In South Africa, sister company Tile Africa (a chain of bathroom products retail stores) is a vertically integrated customer for these lines and a broader range of other externally sourced ones. In the UK, the other four UK-based companies design, source and distribute proprietary products for use in similar environments, with local facilities engaging variously in assembly and finishing activities, providing technical support to customers. Norcros's brands are considered to have leading or significant positions in their markets, reached through multiple adjacent channels. Both regions export and these revenues represent c 15% of the group total. The addition of Vado, Croydex and Abode has resulted in increasing design, sourcing and distribution cross linkages creating both revenue and cost synergies.

Clear strategy, execution ongoing

Continuity has been a board hallmark since the company was first listed in 2007. Three of the five directors have been in post since 2012 (including Nick Kelsall as CEO from 2011, having been CFO prior to this). Current CFO Shaun Smith joined in April 2016. The stated group strategy is to double group revenue between FY13 and FY18 (representing a £420m target when set) through organic and acquisitive investment in existing and complementary market areas. Since the target was set, three UK acquisitions have been made and the underlying South African business performance has improved significantly. There is clear evidence of business synergies being generated between existing and new group companies and this sets a clear template for the future development of the group. Norcros remains conservatively financed and retains flexibility to both continue to execute its strategy and meet current and future pension fund obligations.

FY17 results overview

All-in-all, FY17 was a satisfying year for Norcros. Against the prior year, underlying PBT increased by c 12%, EPS was flat (due to a normalised tax charge) and DPS rose by c 9%. A strong H2 in the UK and solid positive contributions from acquisitions and South Africa contributed to this outturn. Good cash generation resulted in year-end net debt of £23.2m, representing 0.7x FY17 EBITDA. Notwithstanding some market caveats, management remains confident of achieving further progress in FY18.

Exhibit 2: Norcros divisional and interim splits

Year end 31 March, £m	H1	H2	2016	H1	H2	2017	Reported % change		Constant FX % change*		Constant FX, l-f-l % change*	
							H117	FY17	H117	FY17	H117	FY17
Group revenue	**118.8**	**117.3**	**235.9**	**128.8**	**142.5**	**271.2**	**8.4%**	**14.9%**	**9.2%**	**10.6%**	**-1%**	**4%**
UK	79.9	83.1	**163.0**	86.9	95.4	**182.3**	8.7%	**11.8%**	8.8%	**11.8%**	-7%	**2%**
South Africa	38.8	34.2	**72.9**	41.9	47.1	**88.9**	8.0%	**21.9%**	10.0%	**8.3%**	10%	**8%**
Group EBIT	**9.9**	**11.4**	**21.3**	**11.0**	**12.8**	**23.8**	**11.4%**	**11.9%**	**12.5%**	**7.6%**	**0%**	**-2%**
UK	8.0	9.2	**17.2**	8.0	9.4	**17.4**	0.1%	**1.3%**	0.1%	**1.3%**	-15%	**-10%**
South Africa	1.9	2.2	**4.1**	3.0	3.4	**6.4**	59.3%	**56.3%**	62.3%	**34.0%**	62%	**34%**
£/ZAR average rate	19.33		**20.50**	19.69		**18.31**						

Source: Norcross accounts, Edison Investment Research. Note: *All constant FX LFL and constant FX EBIT % change figures are Edison estimates.

UK: FY17 was a variable year for many of the constituent companies in this division, but, after a subdued H1 performance, ended on a better note. **Vado** performed strongly domestically, with double-digit revenue progress across the year, and while a change in its Middle Eastern distributor disrupted H1 exports, this ground was regained in H2. **Johnson Tiles** (JT) and **Triton** both experienced weak H1 trading, but both achieved year-on-year revenue gains in H2, with trade and retail segments both developing positively for JT and a strong export performance from Triton. However, full year revenues were down marginally for both companies and this had an impact on underlying UK profitability. The group year-end trading update noted actions being taken to improve manufacturing flexibility at Johnson Tiles (including mothballing one of three kilns and the loss of c 90 jobs) and the staff reductions are now substantially complete. Revenue at the smaller **Norcros Adhesives** business was broadly flat over the year.

UK results benefited from two prior year acquisitions, with **Croydex** contributing an additional three months' trading results and **Abode** effectively a full 12 months. (In underlying terms, Croydex revenues were +10.8% ahead and Abode c 5% up y-o-y on a comparable full year basis.) Implicitly, their incremental EBIT contribution in FY17 was approaching £2m higher compared to FY16 and the combined margin was likely to have been ahead of the UK average. The benefits of being part of a larger group have been evident in both cases through a combination of improved channel access, increased customer penetration and enhanced service levels all helping to continue good business momentum seen at the point of acquisition.

Over shorter time periods it was, at times, difficult to pick an underlying trading pattern across the six UK companies, with channel categories exhibiting different demand characteristics. This serves to highlight the breadth of routes to market that have been developed across this portfolio of companies and the benefits of diversity when faced with short-term variability. That said, there was clearly a more positive performance from most of these companies in the second half of the year.

South Africa: The excellent underlying performance shown in Exhibit 1 was all organic, reflecting the three operating companies in the region, assisted in H2 by translation benefits arising from weaker sterling relative to the rand. **Tile Africa** (a tile and bathroom products retailer) made significant progress, with double-digit revenue growth in both halves and 12% for the full year.

A programme of upgrading store formats, displays and ranges with improved availability has been supported by enhanced sourcing using the group supply chain network. This extends to third-party suppliers but also includes lines from UK-based Vado and now Croydex too, as well as local in-house tile and adhesive manufacturing. **Johnson Tiles South Africa** (JTSA) has been busy and capacity constrained. Focusing on higher value-added lines and sourcing has continued to evolve the range offering, while plant improvements should have ensured that the benefits of sustained high-volume production are being retained. Direct third-party sales were slightly down year-on-year, though we consider it likely that JTSA contributed to the volume growth seen at Tile Africa. Management has outlined an intention to gradually increase capacity over the next two years, which seems to suggest that investment in an additional (ie third) kiln is unlikely in the near term. **TAL Adhesives** again saw positive revenue development (external sales +4.5% y-o-y), although this was below the strong double-digit rates of progress seen in recent years. Exports have continued to grow (now c 17% of external sales) and this may well lead to further adhesive plant/manufacturing investment elsewhere in sub-Saharan Africa. TAL is a good contributor to regional profitability and cash generation, with relatively low fixed capital requirements.

Over the last three years, the South African operations have increased revenue by over 40% and improved profitability almost fourfold in local currency terms. All three companies have contributed to this, with Tile Africa and TAL driving strong top line and profit growth, enhanced by a sustained turnaround at JTSA following improved manufacturing performance. Having an integrated local model has undoubtedly been beneficial and we feel that the benefits of being part of a wider group are also increasingly playing a part in this.

Good cash inflow and net debt set to reduce further

At the end of FY17, group net debt stood at £23.2m, a decrease of £9.3m compared to a year earlier. Of this movement, almost £8m was attributable to net cash inflow and the remainder substantially due to a more favourable translation of overseas cash balances.

EBITDA rose by 13% to £31.7m and good working capital management meant that underlying operating cash flow was almost £10m higher than the prior year at c £30m. Part of this uplift was absorbed by non-trading items, being £2.5m pension recovery cash and c £2m relating to acquisitions and exceptional items (versus a £2.1m outflow and a small net credit, respectively, in FY16). Nevertheless, a £7m increase in operating cash flow overall was a very creditable outturn in our view. Below this, other cash items were largely as we had anticipated, modestly better in some cases and in aggregate. The noteworthy items include a step up in capex to £8m (or 1.25x depreciation); this covered a wide spread of manufacturing projects in both the UK and South Africa (with a bias towards operational improvement and new product introductions) as well as ongoing investment in Tile Africa's store estate. FY17 cash outflow also included a £2.7m outflow relating to prior year acquisitions, chiefly the final Vado deferred payment. Lastly, the cash dividend payout was £0.6m above the prior year at £4.2m.

Cash outlook: We expect to see a similar underlying operating cash flow performance from Norcros in FY18 compared to FY17; we have factored in rising EBITDA being offset by slightly higher working capital outflow. Pension deficit recovery cash will be at similar levels and we estimate that there will be £2-3m of other non-trading items, chiefly the exceptional cash flow relating to the actions taken at Johnson Tiles. After taking into account rising cash tax payments, maintained capex spend, rising dividends and lower acquisition deferred payments, we expect a net cash inflow of c £7m in FY18. Further out, we have modelled a similar outturn in for FY19 (with a slightly different composition) and at or above £10m in FY20, which would take Norcros into a net funds position in this year, absent acquisitions. Management has made it clear that M&A has been and remains an important part of strategic growth intentions, and we will evaluate and incorporate any transactions as and when they are announced.

Confident of progress, earnings estimates unchanged

Management outlook comments reiterated confidence in its expectation of further progress in FY18. This is despite having some reservations about UK consumer spending and also political unrest in South Africa, citing increased business resilience. In the case of UK operations, acquisitions and actions by existing operating companies have diversified sector and channel exposure. Additionally, a much more robust tile manufacturing platform and momentum in retail operations in South Africa have helped performance relative to local conditions.

Our group PBT estimates have risen modestly to reflect a lower net interest cost run rate than we had previously incorporated. Our EBIT estimates are maintained at the same level as before with a more favourable translation of overseas earnings (ie stronger rand, local currency estimates unchanged), offset by increased share-based payment expectations (we assume the FY17 level repeats in all years).

Exhibit 3: Norcros estimate revisions

	EPS FD norm (p)			PBT norm (£m)			EBITDA (£m)		
	Old	New	% chg.	Old	New	% chg.	Old	New	% chg.
FY17	24.0	24.4	+1.6%	20.2	20.7	+2.5%	31.4	31.6	+0.6%
FY18e	25.7	25.8	+0.3%	21.8	22.1	+1.4%	32.9	32.9	---
FY19e	27.4	27.5	+0.2%	23.5	23.8	+1.3%	34.5	34.5	---
FY20e	N/A	28.6	N/A	N/A	25.1	N/A	N/A	35.8	N/A

Source: Edison Investment Research. Note: FY17 old = Edison estimate, new = actual. Edison norm = company norm less IAS 19R administrative expenses and amortisation of finance costs

A slightly higher tax charge in line with FY17 – though this can be influenced by the regional mix of profits – brings our updated EPS expectations in line with previous estimates.

AGM update notes progress in both UK and South Africa

A Q118 update with the AGM pointed to 8.2% LFL group revenue growth for the period, comprising +10.9% for UK activities and +3.5% for South Africa. (After taking the relatively weaker sterling/strong rand into account, the group figure increases to +16.8%.)

UK momentum was much improved in H217 and this has carried over into the new financial year. This partly reflects a weaker trading period in H117 – including some de-stocking – but also the progressive influence of price rises following input cost increases. We understand that 20-25% of Q1 revenue progress was attributable to volume. Unsurprisingly, with the greatest exposure to new housebuilding, Vado has seen the strongest start to the year across the UK companies. Triton has also seen more robust channel performance than at times last year, although this pattern is less evident at Croydex. The flagged operational changes at Johnson Tiles are well advanced now; one of the three firing kilns has been mothballed while the second is in the process of being converted into smaller format tiles, to increase production flexibility. New product development is a central investment focus across all of Norcros's businesses and this has been apparent again in Abode as well as a joint shower development between Triton and Vado.

South Africa. At face value, headline growth rates have tapered down from the double-digit levels seen in H117. The local economic backdrop continues to be challenging but management remains confident that company growth rates will improve as the year progresses. Tile Africa (TAF) continues to be the driving force so far in FY18 with range extensions, additional space and, we believe, some market share gains all contributing. This will of course be pulling through product from other local group companies in tiles and adhesives, though their visible third party revenues are unlikely to be growing at the same rate.

The AGM statement made no specific comments on profitability in the Q118 trading period but did reiterate that ytd progress was in line with board expectations. We made no further estimate changes following this trading update.

UK case study: Building and buying

When formally initiating coverage in 2015, we described Norcros as a portfolio of specialist businesses. The residential bathroom and kitchen segments and other commercial environments are the common focus addressed across its product ranges. Norcros has a diverse, multi-channel B2B distribution perspective and this allows the company to broaden portfolio companies' channel presence over time through new product introductions where opportunities are identified. We start by showing the mix of markets and distribution channels across Norcros's UK operating companies and go on to look specifically at how the three UK acquisitions made since 2013 have developed individually and in the context of the wider group.

Exhibit 4: Norcros UK operating company sector focus

Source: Norcros, Edison Investment Research

Exhibit 4 shows a UK bias towards bathroom products, but diversity into other areas also and an overall balance between retail and trade distribution channels, with c 15% of revenue exported. The three most recent additions (Vado, Croydex and Abode) account for c 40% of UK divisional sales (and just over 25% of group).

Acquisitions have been a stated part of management's growth strategy since introducing a target of £420m revenue by FY18 (ie double the FY13 level). Since the base year, a small disposal and adverse £/ZAR exchange rate movements have impeded progress towards that target (providing a c £40m headwind). Even if we adjust for that, there is still some way to go to achieving £380m revenue versus the £271m reported for FY17. The timing of acquisitions of course is not entirely under the company's control though they remain on the agenda.

Norcros's three largest businesses (two in the UK, one in South Africa) form the cornerstones of its divisions with customer propositions based on brands backed by quality, innovation and service. They are leaders in their respective market segments:

- Johnson Tiles – one of just two scale UK tile manufacturers (privately owned British Ceramic Tiles, BCT, is the other). Sterling weakness has reinforced JT's market position.
- Triton – the leading branded UK electric shower supplier, which also has a significant presence in mixer showers.
- Tile Africa – mid to upper end retailer of tiles and associated bathroom and kitchen products sourced locally and internationally from group companies and third-party suppliers.

Fit with existing group operations has been and will continue to be a key acquisition consideration, covering both commonalities and complementarities in product offering, routes to market and/or supply chain. We now look at what the three UK deals brought to this division at the time of their acquisitions and how they have subsequently been integrated into the group.

Vado (March FY13) www.vado.com

Vado is a supplier of high-quality, chrome-finished bathroom brassware including taps, fittings, showers and accessories (including valves). Operating a design and source model, Vado has a developed Far East supply chain, which manufactures and facilitates new product development, shipping to Vado's facility in Somerset from where final orders are assembled, packed and despatched. At the point of acquisition, UK customers were primarily specialist retailers together with specification work and plumbers merchants in trade channels. Approaching 50% of revenue was outside the UK, in international specification, including projects in Asia and the Middle East. Norcros's ownership has enabled Vado to broaden its UK distribution channels and strengthen sales and marketing activities. As a consequence, pre-acquisition revenue of c £26m increased to £37.2m in FY17 (or compound growth approaching 10%); we believe that all of this increase was generated in the UK. Drawing on Triton's core specialism, Vado fairly quickly introduced its first electric showers as an extension to its mixer portfolio, enhancing access to the specification subsector. We note that Vado changed its distribution arrangements in the Middle East during FY17; this had some impact on sales in the region in H1 but the year ended with better momentum and this will provide a focal point for other Norcros companies. Also during FY17, Vado developed and introduced a number of new tap and shower ranges under the Evox and Vado brands for its sister operating company, the Tile Africa retail chain, and this will provide a further boost to non-UK revenues over time. We consider it likely that Vado's EBIT margin will have expanded in the last four years (from 7.8% pre-acquisition), though profitability is not reported separately.

Croydex (25 June 2015) www.croydex.com

Croydex is a leading and niche UK supplier of branded bathroom furnishings and accessories (including shower curtains, rods and rails, shelving, storage, mirrors, shower heads, panels and seats). Similar to Vado, its business model is design, source and distribute – again with a Far East supply chain – with some light assembly and despatch from its warehouse and office premises in Hampshire. It has a strong portfolio of proprietary innovative fixings developed by an in-house design team and which apply across the product range. Bathroom renewal spending is the primary demand driver and, prior to joining Norcros, retail (including the leading DIY sheds and some general retailers) was the slightly larger distribution channel compared to trade (via traditional merchants, plumbing/bathroom specialists and certain online B2C suppliers). Non UK sales have historically been modest. Norcros had not owned Croydex for two full years by the end of FY17 but revenue has risen by 24% against pre-acquisition levels. During this time, the growth has been generated by increasing retail listings and broadening the range carried by specific customers. Croydex has a common sub-sector focus to Triton where replacement/upgrades account for a significant proportion of the shower market. We would expect this to have been beneficial to the revenue progress achieved. Trade sales have been more stable while some momentum is visible in export markets from a comparatively low base. Within the Norcros group, Croydex has launched its fixings and accessories into both Vado and Tile Africa.

Abode Home Products (March 2016) www.abodedesigns.co.uk

Similar to Vado, Abode designs, sources and distributes high-quality home products including multi-functional kitchen taps bathroom taps, shower controls – with a particular strength in thermostatic controls – sinks and other showering accessories. This latest addition to the UK portfolio brought a narrower customer focus into specialist trade and retail outlets, supplied with both branded and own-label products. Exposure to DIY and general merchants is understood to have been limited. In the first 12 months of ownership by Norcros, revenue grew by 5% y-o-y with comparable margins to pre-acquisition levels (c 6%). Management noted progress with new listings, branded sales and new product introductions. We would expect this to translate to improved revenue and profitability as these effects gain momentum into FY18. They are run independently but Abode and Vado have clear alignment; Abode adds kitchen taps to the UK offering and extends the range in bathroom products. Moreover, it brings complementary distribution relationships and clear joint sourcing/common supply chain potential.

We now look at the financial benefit of these three companies to Norcros. Exhibit 5 shows that the c £40m total consideration (including deferred payments) to date is equivalent to 0.55x revenue and 4.8x EBITDA on our estimates after taking improved financial performance into account.

Exhibit 5: Norcros acquisition multiples

£m	Consideration			Pre-acquisition		FY17	
	Initial	Deferred – paid	Total	Revenue	EBITDA	Revenue	EBITDA*
Vado	11.6	3.6	**15.2**	25.6	2.5	37.2	4.0
Croydex	20.8	0	**20.8**	19.9	2.7	24.7	3.6
Abode	3.7	0	**3.7**	9.9	0.6	10.6	0.7
Aggregate	**36.1**	**3.6**	**39.7**	**55.4**	**5.8**	**72.5**	**8.3**
EV x				**0.64**	**6.1**	**0.55**	**4.8**

Source: Norcros, Edison Investment Research. Note: *Edison estimates. Aggregate deferred outstanding is c £2m, with a further possible c £1.4m payable under earnout arrangements.

As outlined previously, these businesses substantially design, source and distribute their product ranges. They require limited fixed asset investment though probably need to maintain meaningful working capital levels across their supply chain. Taking a conservative assumption that net cash flow has been neutral for these businesses overall, suggests a return on capital in the order of 11% versus consideration paid, which is clearly ahead of the company’s WACC of c 8.5%.

We estimate that the underlying performance of the three other UK businesses has, in aggregate, been broadly flat between FY13 and FY17, with Triton ahead (though below FY16) and Norcros Adhesives’ ongoing development offset by a weaker performance from Johnson Tiles. (The latter has been acknowledged through the third kiln mothballing to improve profitability.) This underplays the part that these group companies have played in the post-acquisition development of the acquired ones. Earlier commentary largely concentrated on distribution similarities including using Tile Africa as a new market channel. Without doubt, there are some clear supply chain commonalities between the existing and newer companies that are being progressively exploited:

- **Brassware** (taps, valves, accessories such as shower heads, rails) – Vado and Abode offer comparable products and largely source from the Far East. Tile Africa stands to benefit from these links and Triton also sources from the region in some complementary product areas.
- **Transport** – with a broader product offering, the group should be improving both purchasing and shipment costs – including co-ordinated consignments – into the UK and South Africa.

We should also point out supply chain overlap that exists elsewhere in the group:

- **Tiles** – Johnson Tiles and JTSA both import finished products (especially from Turkey and Italy) and can mutually benefit from shared supply chain knowledge.

Sensitivities

Norcros products primarily address demand in the residential bathroom and kitchen sectors as well as some commercial applications. Revenues are substantially generated in two countries (the UK and South Africa), with each having some export exposure also. Both regions manufacture locally and also have international supply chains. Exhibit 6 provides a summary of customer, installation and market positions by region and operating company.

Exhibit 6: Norcros companies – market sector exposures

	FY17 Revenue £m	Customer type		Installation type		Market focus	
		Retail	Trade*	RMI	Newbuild	Domestic	Export
UK	**182.3**	> 50%	10% - 50%	> 50%	10% - 50%	> 50%	10% - 50%
Triton Showers	48.7	10% - 50%	10% - 50%	> 50%	< 10%	> 50%	10% - 50%
Johnson Tiles	53.2	> 50%	10% - 50%	> 50%	10% - 50%	> 50%	10% - 50%
Norcros Adhesives	7.9	10% - 50%	> 50%	> 50%	10% - 50%	> 50%	
Vado	37.2	10% - 50%	> 50%	10% - 50%	> 50%	> 50%	10% - 50%
Croydex	24.7	> 50%	10% - 50%	> 50%	< 10%	> 50%	< 10%
Abode	10.6	> 50%	10% - 50%	> 50%	10% - 50%	> 50%	< 10%
South Africa	**88.9**	> 50%	10% - 50%	> 50%	10% - 50%	> 50%	10% - 50%
Tile Africa	57.0	> 50%	10% - 50%	> 50%	10% - 50%	> 50%	< 10%
JTSA	10.8	> 50%	10% - 50%	> 50%	10% - 50%	> 50%	< 10%
TAL Adhesives	21.1	10% - 50%	> 50%	10% - 50%	> 50%	> 50%	10% - 50%

Key: < 10% 10% - 50% > 50%

Source: Norcros, Edison Investment Research. Note: *Trade includes commercial.

Sustained GDP growth should be favourable for demand from both the new and existing home sectors though their primary drivers are slightly different. Population growth/household formation in the context of the existing housing stock are key newbuild drivers, while housing transactions prices and consumer confidence are the short- and medium-term drivers for repair, maintain and improvement spending. Norcros's biggest exposure is to UK RMI spending; this has been periodically patchy and flat overall for the last couple of years and sector diversity (including exports) has mitigated the impact on divisional performance. The penetration of tiles and bathroom products in South Africa is considered to be low by international standards.

Currency – translational and transactional exposure: Tiles and adhesives are manufactured in both the UK and South Africa substantially for their local markets. Tiles are also imported into both countries from Europe (mainly Italy and Turkey), while other finished and intermediate goods for the other UK operating companies and Tile Africa are largely sourced from the Far East. (Historically these countries have operated a US dollar peg system, though these linkages are now less strong than they were.) Sterling weakness since the Brexit result clearly increases the price of imported goods into the UK, though a policy of rolling 12-month FX cover insulated Norcros to a greater extent than its sector peers we believe. We understand that customer pricing has been gradually adjusted to account for these input cost pressures as the FX cover has rolled forward. More favourably, sterling weakness against the rand has had a beneficial impact on reported profitability through the translation of revenue and profit generated in South Africa.

Pension exposure – material but manageable: Cash recovery payments of £2.5m into the company's DB scheme represented c 8% of FY17 EBITDA under a 10-year plan agreed following the FY15 triennial valuation. (NB the payment will increase annually in line with the CPI.) For the record, scheme liabilities at the end of FY17 were c £467m with an IAS 19R deficit of £62.7m. Thus far, the deficit position has not restricted acquisition activity nor dividend growth and Norcros has headroom under existing facilities to make further acquisitions.

Valuation

In the last 18 months, Norcros's valuation has de-rated from already conventionally low multiples through a combination of improving earnings and a lower share price. We see scope for further growth from both UK and South African operations, though macro-economic conditions cause us to retain conservative estimates at this stage. Legacy issues have been tidied up with the exception of the pension fund; we believe that the associated cash requirements and long-term nature of the scheme are well within the service capability of the group. Overall, we think that the current valuation implicitly includes an unreasonable discount for identifiable risk factors.

Low valuation, risk mispriced

As we have seen, Norcros reports in a two division, country-based structure; with established and increasing linkages we consider the profit/cash flow profile and valuation position to be greater as a combined entity. On conventional metrics, Norcros is trading on a low valuation with a current year P/E of just 6.6x with an EV/EBITDA (adjusted for annual pension scheme recovery cash) of 4.0x and a prospective 4.4% dividend yield. These metrics reduce further to 6.0x and 3.2x respectively with a yield of 5.0% in our third estimate year.

One possible counter argument for a higher valuation is the relatively muted expected earnings growth, ie a three-year CAGR of 5.5%, which gives an indicative PEG ratio of 1.27x. Another might be an implied market expectation of lower earnings growth than our projections. We believe that our estimates are set conservatively (see the Financials section, below) and some of the larger operating companies in particular have medium-term potential above that currently assumed. One could also point to the presence of relatively large pension scheme liabilities and the associated net deficit as another valuation drag. Not a technique we subscribe to but, for illustration purposes, if we added the end FY17 deficit to the EV calculation, the FY18 EV/EBITDA would become 5.6x (and a notional interest cost adjustment would increase the P/E ratio to c 7.3x).

We think that the risk to the pension deficit is to the downside. Even on the current basis, recovery cash payments are well within the company's service capability (at 8% of EBITDA) and do not represent a restriction to future acquisition potential at the same rate as seen in the last two or three years. The balance sheet is conservatively geared (at 0.7x EBITDA), with interest costs well covered and plenty of headroom under existing borrowing facilities. Overall, we think that the current valuation discount is excessive and disproportionate to the realistic risk of the above factors.

Sizeable peer group discounts

This view is reinforced when comparing Norcros to a group of substantially UK-facing, residential RMI-oriented quoted peers. Exhibit 7 shows P/E ratio and EV/EBITDA discounts at or above 40%.

Exhibit 7: UK RMI peer group valuation table

	Price	Market cap	P/E ratio (x)			EV/EBITDA (x)			Div. yield %
	p	£m	2017e	2018e	2019e	2017e	2018e	2019e	2017e
Norcros	**169.3**	**104**	**6.6**	**5.9**	**5.6**	**4.3**	**3.8**	**3.8**	**4.4**
Epwin Group	67.0	96	5.2	5.1	4.8	3.6	3.5	3.4	10.0
Eurocell	241.0	241	11.0	10.3	9.5	7.7	7.3	6.8	3.8
Howden Joinery	414.9	2,589	14.5	13.5	12.5	9.3	8.8	8.3	2.7
Safestyle UK	225.5	187	11.6	10.8	10.3	8.2	7.7	7.3	5.2
Average (ex Norcros)			**10.6**	**9.9**	**9.3**	**7.2**	**6.8**	**6.5**	**5.4**

Source: Bloomberg. Note: All metrics based on Bloomberg data. Norcros is calendarised in line with peer year ends. Prices at 30/8/17.

Even if we stripped out Howden, the discounts to the other peers would still be greater than 30%.

Financials

Since its post-recession low and an equity funding in FY10, Norcros has delivered a strong increase in profitability, with company-defined earnings more than doubling despite a normalising (ie rising) tax charge over this period. Dividends have also been rebuilt and were covered 3.9x by company-defined EPS in FY17. Reported net debt peaked at £32.5m at the end of FY16 following two internally-funded acquisitions in that year; this figure had reduced to £23.2m as at March 2017 and our model currently shows Norcros reaching a funds neutral position by FY20.

Steady earnings growth anticipated

Norcros operates in relatively mature UK markets and a developing South African market. GDP growth in both countries is expected to be positive albeit modestly (OECD 0% to 1.6% per annum range). Our estimates include three-year (FY17-20) **revenue CAGRs** of:

- **UK** +3.7% including slightly faster growth from newer companies; and
- **SA** +3.4% with faster Adhesives expansion in export markets and JTSA constrained.

We see a **pause in margin development in FY18** (reflecting the roll through of higher input costs and FX cover) before **modest incremental improvement thereafter**, including some recovery at Johnson Tiles). In aggregate, we see finance, pension administration and SBP costs as being stable across our estimate horizon. Together these effects translate to a normalised PBT CAGR on the same basis of 6.5% and slightly lower at the normalised EPS level (at 5.5%) taking into account a small rise in shares in issue. Expected dividend growth is in line with that for EPS, with cover remaining around 3.8x. There is scope for faster DPS growth in our view, though internally funded acquisitions are clearly a management aspiration and may restrict the short-term appetite for increased income distribution. Also, in all likelihood, pension fund requirements suggest that dividend cover would not reduce to the fairly conventional 2-2.5x 'norm'.

Positive underlying cash flow and net debt trending down

The reduced net debt position of £23.2m at the end of FY17 – down £9.3m y-o-y – represented 0.7x EBITDA generated in the year. It was also well within the company's existing borrowing facilities, being £70m revolving credit and £30m accordion facilities, both out to July 2019. For the group as currently constituted and based on the financial performance outlined above, we anticipate positive free cash and net cash inflows in each of our three estimate years such that Norcros will be in a broadly funds neutral position by the end of FY20. Looking at the path to this position, we expect the net cash inflow in the next couple of years to be slightly below the c £8m achieved in FY17 despite rising EBITDA. This is chiefly due to the effect of exceptional costs (c £2m arising from Johnson Tiles restructuring in FY18) and deferred consideration payments (£2m+ on Croydex and Abode in FY19). In FY20 itself, further growth and the absence of these non-trading items generates a net cash inflow of £10m+. Note that we have factored in rising dividends and associated cash payments in each of the three years under discussion. Apart from the deferred consideration mentioned, we have not assumed that any other acquisitions are made. Hence, further deals would need to be incorporated into the above framework if/when announced.

Asset backing and pension scheme deficit

The end FY17 NAV of £57m (92p per share) was primarily comprised of £43m tangible fixed assets, £56m net trade working capital investment (including accruals) and £45m intangibles offset by £23m net debt and an IAS 19R pension deficit of £63m (with scheme liabilities' present value of £467m). The DB scheme closed to new members in 2013 and is split 61% pensioners, 31% deferred and 8% active employees. Norcros makes a CPI-linked annual cash recovery payment into the scheme (FY17 base year £2.5m) and the next triennial review is due in April 2018.

Exhibit 8: Financial summary

£m	2011	2012	2013	2014	2015	2016	2017	2018e	2019e	2020e
Year end 31 March		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					**Cont.**	**Cont.**	**Cont.**	**Cont.**	**Cont.**	**Cont.**
Revenue	196.1	200.3	210.7	218.7	222.1	235.9	271.2	289.1	298.1	305.8
Cost of Sales	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Gross Profit	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
EBITDA	18.2	18.6	19.9	22.9	24.3	28.0	31.7	32.9	34.5	35.8
Operating Profit (before SBP)	11.6	12.3	13.7	17.0	18.3	22.5	25.3	26.5	28.1	29.4
Net Interest	(1.5)	(1.4)	(1.3)	(1.5)	(1.2)	(0.9)	(0.9)	(1.1)	(1.0)	(1.0)
Other financial - norm	(1.1)	(0.9)	(2.4)	(2.6)	(3.1)	(3.1)	(3.6)	(3.3)	(3.3)	(3.3)
Other financial	(0.4)	0.6	(0.2)	(5.2)	2.1	(0.2)	(4.2)	(2.0)	(2.0)	(2.0)
Intangible Amortisation	0.0	0.0	0.0	(0.4)	(0.3)	(0.9)	(1.2)	(1.2)	(1.2)	(1.2)
Exceptionals	(1.1)	(1.2)	(4.4)	(1.5)	(4.8)	(2.0)	(3.8)	(1.0)	(1.0)	(1.0)
Profit Before Tax (norm)	9.0	10.0	10.0	12.9	14.0	18.5	20.8	22.1	23.8	25.1
Profit Before Tax (company norm)	10.2	10.7	11.7	14.6	15.8	20.4	23.0	24.0	25.7	27.0
Profit Before Tax (FRS 3)	7.5	9.4	5.4	5.8	11.0	15.4	11.6	17.9	19.6	20.9
Tax	(0.8)	0.0	0.2	4.3	(3.0)	(2.4)	(3.1)	(5.0)	(5.5)	(5.8)
Other	0.0	0.0	0.0	(1.4)	0.1	0.0	0.0	0.0	0.0	0.0
Profit After Tax (norm)	8.2	10.4	9.3	13.9	11.1	16.1	17.7	17.1	18.4	19.3
Profit After Tax (FRS 3)	6.7	9.4	5.6	8.7	8.1	13.0	8.5	12.9	14.2	15.1
Average number of shares outstanding (m)	57.7	57.7	58.0	58.4	59.2	60.6	61.1	62.0	62.7	63.4
Average number of shares outstanding FD (m)	57.7	58.0	58.9	60.8	61.5	62.2	63.1	63.7	64.4	65.1
EPS FD - normalised (p)	14.1	17.9	15.8	22.8	18.0	24.7	24.4	25.8	27.5	28.6
EPS FD - company normalised (p)	16.3	19.2	18.7	27.9	21.1	27.7	27.9	28.7	30.4	31.5
EPS - FRS 3 (p)	11.6	16.2	9.5	14.3	13.2	19.7	9.8	19.2	20.9	22.2
Dividend per share (p)	3.6	4.2	4.6	5.1	5.6	6.6	7.2	7.5	8.0	8.4
Gross Margin (%)	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
EBITDA Margin (%)	9.3	9.3	9.4	10.5	10.9	11.9	11.7	11.4	11.6	11.7
Operating margin (before GW and except.) (%)	5.9	6.1	6.5	7.8	8.2	9.5	9.3	9.2	9.4	9.6
BALANCE SHEET										
Fixed Assets	80.7	80.0	86.7	80.0	78.3	93.4	98.8	99.6	103.0	103.4
Intangible Assets	23.9	23.4	27.6	27.1	26.9	44.7	44.8	44.0	45.8	44.6
Tangible Assets	49.1	44.8	43.5	36.9	37.6	38.2	43.0	44.6	46.2	47.8
Investments	7.7	11.8	15.6	16.0	13.8	10.5	11.0	11.0	11.0	11.0
Current Assets	94.4	89.7	104.6	102.2	100.4	119.4	165.3	147.4	158.6	173.1
Stocks	42.3	45.5	52.8	50.2	52.2	60.1	70.3	72.4	74.7	76.6
Debtors	36.4	34.5	36.3	35.5	37.5	47.3	53.5	57.0	58.8	60.3
Cash	7.7	2.9	6.8	3.9	5.6	5.9	37.5	13.6	20.5	31.2
Current Liabilities	(56.4)	(52.5)	(54.0)	(58.1)	(60.0)	(67.6)	(105.7)	(80.7)	(86.7)	(92.3)
Creditors	(53.3)	(52.1)	(53.5)	(57.3)	(58.6)	(64.8)	(74.8)	(80.7)	(86.7)	(92.3)
Short term borrowings	(3.1)	(0.4)	(0.5)	(0.8)	(1.4)	(2.8)	(30.9)	0.0	0.0	0.0
Long Term Liabilities	(39.3)	(46.1)	(75.7)	(58.6)	(67.4)	(97.6)	(101.8)	(101.3)	(100.6)	(100.0)
Long term borrowings	(15.2)	(20.3)	(37.0)	(30.5)	(18.4)	(35.6)	(29.8)	(29.8)	(29.8)	(29.8)
Other long term liabilities	(24.1)	(25.8)	(38.7)	(28.1)	(49.0)	(62.0)	(72.0)	(71.5)	(70.8)	(70.2)
Net Assets	79.4	71.1	61.6	65.5	51.3	47.6	56.6	65.0	74.3	84.1
CASH FLOW										
Operating Cash Flow	10.8	6.0	6.6	13.6	16.2	18.5	25.5	25.0	28.3	29.9
Net Interest	(1.0)	(1.6)	(1.3)	(1.6)	(1.3)	(0.9)	(0.9)	(1.1)	(1.0)	(1.0)
Tax	(0.6)	(0.6)	(1.0)	(1.7)	(0.5)	(1.0)	(1.9)	(4.0)	(4.5)	(5.0)
Capex	(6.3)	(6.7)	(4.2)	(2.8)	(1.4)	(6.6)	(8.0)	(8.0)	(8.0)	(8.0)
Acquisitions/disposals	4.4	0.0	(10.6)	0.1	3.3	(23.6)	(2.7)	(0.4)	(3.0)	0.0
Financing	0.0	0.2	0.3	0.4	0.2	0.1	0.0	0.0	0.0	0.0
Dividends	(0.7)	(2.2)	(2.5)	(2.8)	(3.1)	(3.6)	(4.2)	(4.6)	(4.9)	(5.3)
Net Cash Flow	6.6	(4.9)	(12.7)	5.2	13.4	(17.1)	7.8	7.0	6.9	10.7
Opening net debt/(cash)	15.9	10.6	17.8	30.7	27.4	14.2	32.5	23.2	16.2	9.3
HP finance leases initiated	0.0	(0.8)	(0.1)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	(1.3)	(1.5)	(0.1)	(1.9)	(0.2)	(1.2)	1.5	0.0	(0.0)	0.0
Closing net debt/(cash)	10.6	17.8	30.7	27.4	14.2	32.5	23.2	16.2	9.3	(1.4)

Source: Norcros accounts, Edison Investment Research

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Revenue by geography FY17

Management team

CEO: Nick Kelsall

Nick Kelsall became group CEO in April 2011, stepping up from FD, a role undertaken since 1996. He originally joined Norcros as Johnson Tiles' FD in 1993 from Waterford Wedgwood. Chartered accountant.

FD: Shaun Smith

Shaun Smith was appointed in April 2016. Currently he is NED at Air Partner. He was group finance director of AGA Rangemaster until 2015, having also undertaken finance roles with its previous parent company, Glynwed International and Marks & Spencer. Qualified corporate treasurer.

Chairman: Martin Towers

Martin Towers joined as an NED in 2011 and became chairman in November 2012. He is also NED chairman of Tyman and NED at RPC Group. Previously he was CEO at Spice plc and FD at Kelda Group, Spring Ram and McCarthy & Stone. Chartered accountant.

Principal shareholders (13 June 2017)	(%)
Hargreave Hale	13.9%
Miton Group	12.3%
FIL Ltd	10.1%
Artemis Fund Managers	9.8%
SVM Asset Management	3.8%
Standard life Investments	3.0%

Companies named in this report

Epwin Group, Eurocell, Howden Joinery, Safestyle UK