

# Rubicon

FY19 results

## Growth to come after FY19 challenges

FY19 represented Rubicon/ArborGen's first full year as a unified company under single parent ownership. Some restructuring activity and extreme weather events held back in-year sales performance and the latter also have implications for mix in the next couple of years. Nevertheless, ArborGen's market positions remain strong and we believe that this will translate to good earnings growth in each of our estimate years, albeit at a slower rate than we previously anticipated. Our core DCF is now NZ\$0.71 per share at the gross equity valuation level.

Year end	Revenue (US\$m)	EBITDA – US GAAP (US\$m)	PBT* (US\$m)	EPS* (c)	P/E (x)	EV/EBITDA (x)
03/19	49.1	4.6	4.7	1.1	12.3	18.3
03/20e	58.2	7.7	7.7	1.6	8.3	11.1
03/21e	64.4	9.5	9.6	1.9	6.7	8.7
03/22e	71.7	11.9	12.1	2.4	5.3	6.5

Note: \*PBT and EPS are group, normalised, excluding amortisation of acquired intangibles and exceptional items. No tax charge is anticipated in our estimates.

## Some market challenges but EBITDA in line

US seedling sales represented over 70% of Rubicon's FY19 sales and forestry customers' planting activities were affected by hurricane events and wet conditions in some areas. Sales volumes grew in Australasia while Brazilian sales were constrained by local market conditions. Overall, revenue and gross profit were slightly below our expectations but group EBITDA, PBT and EPS were in line. Net debt was modestly higher than anticipated at c US\$22m due to working capital investment and, as expected, no dividend was declared in the year.

## Near-term downgrades but long-term prospects intact

Hurricane damage at one ArborGen US seed orchard will restrict its ability to grow volumes of advanced seedlings in this region for FY20 and into FY21 pending some large seed orchards coming onstream. Our updated model takes this mix effect into account with a material impact on near-term earnings; we have reduced our FY20 and FY21 PBT and EPS estimates by between 20–25%. While this is disappointing, our three-year EPS CAGR (to FY23) is still over 30% and we believe that there are no negative medium- or longer-term business demand implications in the US. Growth prospects in Brazil and New Zealand also remain very much intact.

## Valuation: Modestly reduced, still strong upside

Rubicon's share price has remained between NZ\$0.18 and NZ\$0.23 in the year to date. It currently sits in the lower half of this range but has improved somewhat since the lows towards the end of May and is down c 7% since the end of December. Our core gross equity DCF valuation is NZ\$0.71 per share (previously NZ\$0.74) after taking into account lower near-term earnings, end FY19 net debt and a more favourable NZ\$/US\$ exchange rate. The current share price is at a significant discount to this valuation and also to the end-FY19 NAV per share (US\$0.30/NZ\$0.45). On our estimates, the current year P/E is now 8.3x with an EV/EBITDA of 11.1x, multiples which reduce rapidly over the following two years.

## Basic materials

27 June 2019

**Price** **NZ\$0.19**
**Market cap** **NZ\$96m**

US\$0.66/NZ\$

Net debt (US\$m) at 31 March 2019 21.8

Shares in issue 498.6m

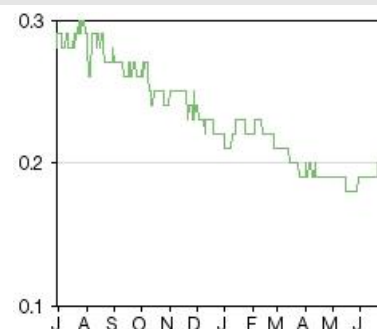
Free float 53%

Code RBC

Primary exchange NZX

Secondary exchange N/A

## Share price performance



% 1m 3m 12m

Abs 6.5 2.1 (27.4)

Rel (local) 5.0 (5.4) (35.1)

52-week high/low NZ\$0.30 NZ\$0.18

## Business description

Rubicon is an NZX-listed investment company whose ArborGen subsidiary is the world's largest integrated developer, commercial manufacturer and supplier of advanced forestry seedlings with operations in the US, Brazil and Australasia.

## Next events

ASM September - tbc

## Analyst

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## FY19 results overview

Reported FY19 results were broadly in line with our estimates on an IFRS basis and at the US GAAP EBITDA level. This was the first full year of reporting with a March year end and with this corporate structure. We are now able to clearly see the seasonal attributes of the business and, notwithstanding weather-related disruption in H2, a stronger year-on-year trading performance in the second half of the year. No dividend was declared as expected and Rubicon ended FY19 with US\$22m net debt.

### Performance influenced by weather events in largest market

At the headline level, revenue and gross profit (at US\$49.1m and US\$18.8m,<sup>1</sup> respectively) were both c US\$1m lower than our pre-results estimates, which we consider to be within a reasonable range of variation given the nature of weather effects in the year. Specifically, there were two significant hurricane events around the turn of the half year and the impact on forestry customers (ie initial damage incurred and subsequent ground condition evaluation) took time to be fully evaluated. Based on management comments, we believe that the majority of the group gross profit difference versus our expectations is attributable to unsold seedlings due to weather conditions written-off, taken above the line. Nevertheless, benchmarking H219 against the prior year, we note that revenue was c 10% above the H218 level with US\$0.8m higher gross profit (albeit with a 210bp lower margin y-o-y). Tree seedling planting seasons dictate that H2 is the dominant trading period for ArborGen particularly from a US perspective, so to make progress against the prior year despite weather challenges is a creditable performance we feel. In reported NZ IFRS terms, the profit shortfall against our expectations was effectively compensated for by tighter central cost control and a positive change in the fair value of biological assets – which we had assumed to be a neutral item – such that EBITDA, EBIT and PBT were all in line with our estimates.

**Exhibit 1: Rubicon FY19 regional revenue splits**

	Revenue (US\$m)	Seedlings (m)	Average selling price (US\$/seedling)
<b>Revenue</b>	<b>49.1</b>	<b>352</b>	<b>0.135</b>
North America*	34.8	280	0.124
Australasia	7.0	23	0.303
South America	6.1	50	0.120
Other income*	1.2		

Source: Rubicon. Note: \*Other income = logistics services related to seedling sales; we have assumed that this was all generated in North America and adjusted the reported revenue for this region accordingly.

**North America:** Against the company supplied pro forma FY18 seedling sales figure of c 270m, more seedlings were sold in FY19 at c 280m, a c 4% y-o-y increase. Moreover, a more favourable mix – including a higher proportion of MCP<sup>2</sup> and varietal seedlings – and, we believe, some general firmness in pricing, meant that revenue generated in this region was stronger than we had modelled. ArborGen has historically had stronger market positions with larger independent commercial forestry owners who have generally been more receptive to moving from traditional open pollinated to the latest generation mass control and varietal seedlings to increase yields. In FY19, the company noted more emphasis on private landowners and this may have been a contributory factor in average selling price progression. As noted earlier, gross margin was affected by seedling impairment charges taken above the line.

<sup>1</sup> Reported as US\$17.1m; we add back US\$1.7m of cost of goods sold depreciation here to be consistent with our financial summary presentation of EBITDA and EBIT.

<sup>2</sup> The seedling breeding development and value spectrum progresses from open control pollinated (OCP) to mass control pollinated (MCP) and onto varietals.

FY19 represented ArborGen's first year of operation of the Taylor Nursery, Trenton, on behalf of the South Carolina Forestry Commission. This 10-year agreement aspires to increase production capacity to 30m seedlings per annum in FY20 (from c 5m pre-agreement), achieving c 15m maiden production for ArborGen in FY19.

In November 2018, ArborGen also announced a five-year agreement with TexMark Timber Treasury (Triple T) to lease its seed orchards and nursery in the contiguous Jasper and Tyler counties, TX. This adds a further 30m seedling capacity, commencing FY20. During this lease period, ArborGen will be the exclusive supplier of Triple T's Texas loblolly pine seedling requirements; there is provision to extend the agreement and, at the end of the initial term, put and call options to transfer the ownership of the leased properties for US\$2.5m. ArborGen now has eight seedling nurseries in its US portfolio (six owned, two operated) with an estimated total capacity of c 400m seedlings per annum. This compares with the 280m sold during FY19.

Hurricane damage to the Bellamy, FL, seed orchard was flagged in October 2018. However, ArborGen has other orchards in the Atlantic Coast, Piedmont, Arkansas and South Texas regions in which there are extensive but relatively young trees of latest generation genetics that are expected to attain their mature seed production levels in two to three years' time. Consequently, near-term constraints in building higher-value MCP seedling volumes are expected to dissipate. So, while there should be some post-hurricane rebound in seedling demand, incremental FY20 sales (and therefore the overall mix) could potentially dilute the average selling price (ASP). This effect is expected to start to ease during FY21. For the record, our updated model contains annual seedling volume growth of 12% in FY20 and 6% in each of the following two years.

**Brazil:** We do not have year-on-year comparators, but, as shown in Exhibit 1, 50m seedlings were sold in FY19. Revenues were affected by demand weakness in the dominant eucalyptus forestry sector in FY19, exacerbated in the reporting currency by a c 14% depreciation of the real against the US dollar. In contrast, pine seedling sales were stated to have been better than management had anticipated. The Brazilian economy itself was seen to be decelerating in the second half of the year and this coincided with a general election process culminating in a new government coming into office on 1 January. Economic weakness was also seen in neighbouring South American countries, which could have had some effect on sentiment. That said, the weaker real may have had some positive effect on exports of downstream forestry products further afield (key sectors here being pulp in particular but also paper and wood panels), which would be supportive of replanting activity in due course. In trading terms, Brazilian operations generated a positive gross profit contribution (on US\$6.1m sales) but an operating loss of US\$1m, implicitly carrying an overhead base for a higher revenue stream. Looking ahead, the new Brazilian government was elected on a social reform ticket, aiming also to tackle public debt levels but it is too early in its term to assess progress, though higher GDP growth is expected in 2019 compared to 2018.

**Australasia:** Seedling sales grew by c 20% in FY19. This region enjoys the highest ASP in any of the areas served by ArborGen – reflecting the higher proportion of advanced seedlings sold – and pricing appears to have been firm year-on-year. The company's national nursery coverage in New Zealand has been advantageous in securing a 12-month seedling supply contract with Crown Forestry to support the NZ government's 10-year, One Billion Trees planting programme, getting underway in earnest in FY20. We assume that there are good prospects for follow-on agreements. Few additional details are given in the results release, but we understand that the expectation is that that the region (and both countries within it) will achieve record sales and profits in FY20.

**Exceptional items:** The year also included US\$4.1m of separately disclosed, non-underlying charges. Just over three-quarters related to the One Company restructuring programme (including severance in NZ and the US) and the remainder from transaction costs arising from Rubicon's acquisition of the ArborGen minority interests. After taking a US\$0.5m property disposal gain the net exceptional charge for the year was US\$3.6m.

## Net debt increases, underlying free cash flow neutral

It is worth commenting here on business seasonality and the working capital cycle as reflected through the cash flow statement. Reflecting the key US planting and therefore seedling selling season, ArborGen's profitability is strongly weighted towards its second half trading period.

Seed orchard harvesting takes place during H2 of the financial year so seed inventory rises during the period and peaks around the year end. Meanwhile, higher-value seedling inventory value in the US peaks early in Q4 (financial year) just prior to the US lifting season, thereafter moving in the opposite direction to the year end. The net profile at group level is inventory absorption in H1, release in H2. Receivables obviously follow the seedling sales cycle, so broadly peak at the year end, with a positive collections effect in H1 cash flow. The caveats to these observations are that they depend on local climate and weather conditions in each of the regions served and also noting that we only have one full year of reporting and that was affected by adverse weather conditions in the company's largest market. That said, we would expect the pattern to be broadly similar in most normal trading years.

**FY19 cash flow performance:** Rubicon ended FY19 with c US\$22m net debt, an increase of c US\$12m over the course of the year (and c US\$3m above our estimate). Underlying free cash flow was neutral in the period so the outflow can be attributed to the exceptional items noted above and net corporate activity (ie US\$10m final deferred consideration paid to ArborGen minority shareholders less US\$2.4m received from prior year non-core disposals).

Adjusted EBITDA of US\$9m (NZ IFRS basis less the favourable fair value of biological assets effect) was substantially retained as the overall working capital outflow was only just over US\$1m. Within this, we note that seed investment (wip and finished goods) – most probably the net result of increased seed orchard capacity constrained partly by adverse weather – rose but cash absorption here was effectively matched by an uplift in payables. Net interest payments at just above US\$2m were in line with the P&L and no corporation tax was paid in the year.

Under NZ IFRS, R&D is capitalised and expenditure here approached US\$5m in the year overall. Other capex of US\$2.7m was in line with depreciation at the gross level, prior to the receipt of US\$0.8m disposal proceeds. There was a small bias towards higher capex (tangible and intangible) in H2.

**Cash flow outlook:** With a significant revenue uplift modelled for FY20 (part rebound from a weather-affected FY19, part new nursery and supply agreements), we have assumed that increased working capital investment is required to support it. In broad terms, this is financed by increased profitability and, before c US\$1m exceptional cash outflows (relating to final US retention payments), we again expect to see a neutral free cash flow outturn in FY20. Thereafter, we expect that higher levels of profitability will fund working capital and maintained capex spend and generate positive free cash flow, which will enable net debt to trend down to c US\$15m (or 0.9x EBITDA) by the end of FY22 versus c US\$22m (2.2x EBITDA) at the end of March 2019.

## Reduced estimates but strong growth still expected

In the four countries in which Rubicon operates, real GDP estimates are expected to exceed 2% in each of the next two years in all but one of them, the exception being Brazil (in 2019 only). The core industries that ArborGen serves (including housebuilding, pulp and paper) are considered to be cyclical, so we take this data to be broadly illustrative of macroeconomic growth.

**Exhibit 2: OECD GDP growth estimates**

(%)	Nominal GDP growth			Real GDP growth		
	2018	2019	2020	2018	2019	2020
US	5.2	4.5	4.4	2.9	2.8	2.3
Brazil	4.2	5.1	6.3	1.1	1.4	2.3
New Zealand	3.9	4.1	4.6	2.8	2.7	2.5
Australia	4.9	4.8	5.1	2.7	2.3	2.5

Source: OECD data

As mentioned above, the need for forestry owners to replace damaged treestocks and the new US nursery facilities feeding in during FY20 onwards underpin expectations of progress there. Additionally, in New Zealand, 2019 is the first year of the 10-year Crown Forestry tree planting programme and Rubicon has secured a supply contract that will have a material impact on local seedling sales volumes and profitability. The primary changes to our estimates relate to the mix in the US (lower proportion of MCP seedlings following seed orchard damage, on broadly unchanged volumes) and we have also lowered volume expectations in Brazil to reflect a lower base year and recent eucalyptus demand. As a result, our group revenue estimates have been trimmed modestly for the next two years, but a 400–500bp gross margin reduction flows through to materially lower PBT projections. Nevertheless, expected growth from FY19 is significant and this continues into FY22, which we publish for the first time. Over this three-year period, our EPS CAGR exceeds 30%.

**Exhibit 3: Rubicon estimate revisions**

	EPS fully diluted, normalised (c)			PBT norm (US\$m)			EBITDA* (US\$m)		
	Old	New	% chg.	Old	New	% chg.	Old	New	% chg.
FY19	1.1	1.1	---	5	4.7	-6%	5	4.6	-8%
FY20e	2.0	1.6	-25%	10	7.9	-21%	9	7.9	-12%
FY21e	2.5	1.9	-24%	12	9.4	-22%	12	9.3	-22%
FY22e	N/A	2.4	N/A	N/A	11.9	N/A	N/A	11.7	N/A

Source: Rubicon accounts, Edison Investment Research. Note: FY19 old = Edison estimate, new = actual. \*EBITDA US GAAP. Company reported numbers and Edison estimates previously published at the whole integer level; % changes shown against these bases and rounded.

We do not currently expect that Rubicon will make dividend payments over our estimate horizon.

Updating our **DCF analysis** following the latest set of results, using the same methodology as in our [September initiation note](#), the core assumption drivers are:<sup>3</sup>

- Group level CAGRs (10 years to FY29): seedling volumes +7.2%, average selling price +7.4% (which captures an improving mix effect, with a rising proportion of MCP/varietal seedlings). NB: By 2029, this translates to c 700m seedlings and a gross margin of 45.7%, enhanced by mix.
- As before for comparability, we have used an unchanged post tax WACC of 10% and 3% terminal value growth (company assumption) plus updated end FY19 net debt of US\$21.8m.

Using the above inputs generates a revised **gross equity value of US\$225m** compared with US\$240m previously. This variance is due to a slightly lower profit trajectory by 2029 and a higher net debt position. At the **per share level, this value equates to NZ\$0.71** with a small benefit here from a relatively firm US dollar translation effect. Investors should also be aware of the following adjustments to this headline valuation:

- **Warrants and options** if exercised account for c 10% of ArborGen's existing issued share capital, as before representing a c NZ\$0.06/share dilution.
- **Parent company central costs** (of c US\$1.0–1.5m pa) lower the DCF valuation by c NZ\$0.04/share compared to a standalone ArborGen.

<sup>3</sup> Previous comparable core assumptions: seedling volumes and ASP CAGRs of +6.7% and 8.6%, respectively, yielding a gross equity valuation of NZ\$0.74/share (and in FY29, c 730m seedlings and a gross margin of 42.7%).

Since we initiated coverage, the US risk-free rates and market risk premium have reduced. For illustration, if we used these inputs it would generate a company WACC of 7.4% and a gross equity value of NZ\$1.33 per share. Given that Rubicon has operations outside of the US, this WACC is probably too flattering, but it does serve to illustrate valuation upside in lower-risk/lower group cost of finance scenarios.

We have also updated our sensitivity table to demonstrate the effects of a range of US gross margin and average selling price (ASP) assumptions on the above valuation analysis, as shown in Exhibit 4. The range shown is slightly narrower than the previously presented version but broadly similar overall. (Note that our core analysis above generates ASP growth approaching 11% and a gross margin slightly over 51% (c 60bp and 200bp higher than before, respectively) on average for US operations beyond our explicit estimate years.)

<b>Exhibit 4: Rubicon's NZ\$/share value in different US revenue and gross margin scenarios</b>					
<b>ASP CAGR %*</b>	<b>8.0%</b>	<b>10.0%</b>	<b>12.0%</b>	<b>14.0%</b>	<b>16.0%</b>
<b>Gross margin*</b>					
<b>45%</b>	0.42	0.49	0.56	0.64	0.72
<b>50%</b>	0.52	0.59	0.68	0.77	0.87
<b>55%</b>	0.62	0.70	0.80	0.92	1.03
Source: Edison Investment Research. Note: *Flat gross margins and growth rates for 2023–29 inclusive (2020–22 uses published estimates).					

**Exhibit 5: Financial summary**

	US\$m	2017R	2018	2019	2020e	2021e	2022e
March (from 2018 onwards)		15m to Sep	6m to March				
<b>PROFIT &amp; LOSS</b>							
Revenue		6	35.4	49.1	58.2	64.4	71.7
Cost of Sales		(4)	(19.4)	(30.3)	(36.2)	(40.1)	(44.5)
Gross Profit		2	16.0	18.8	22.0	24.3	27.2
EBITDA - US GAAP		(6)	6.0	4.6	7.7	9.5	11.9
EBITDA - NZ IFRS		(1)	6.2	9.8	12.4	14.2	16.6
Operating Profit (before GW and except.)		(2)	5.0	6.9	9.5	11.3	13.7
Intangible Amortisation - internal		0	0	0	0	0	0
Exceptionals & Amortisation - external		(1)	(4.0)	(9.4)	(6.8)	(5.8)	(5.8)
Associate		3	0	0	0	0	0
Operating Profit		0	1.0	(2.5)	2.7	5.5	7.9
Net Interest		(2)	(1.4)	(2.2)	(1.8)	(1.7)	(1.6)
Profit Before Tax (norm)		(1)	3.6	4.7	7.7	9.6	12.1
Profit Before Tax (FRS 3)		(2)	(0.4)	(4.7)	0.9	3.8	6.3
Tax		0	2.6	0.5	0.0	0.0	0.0
Minorities		0	0	0	0	0	0
Discontinued		(4)	0	(0.1)	0.0	0.0	0.0
Profit After Tax (norm)		(1)	6	5.2	7.7	9.6	12.1
Profit After Tax (FRS 3)		(6)	2	(4.2)	0.9	3.8	6.3
Average Number of Shares Outstanding (m)		425.0	487.9	496.9	498.6	498.6	498.6
EPS - normalised (US c)		(0.2)	1.3	1.1	1.6	1.9	2.4
EPS - FRS 3 (US c)		(1.4)	0.5	(0.8)	0.2	0.8	1.3
Dividend per share (US c)		0.0	0.0	0.0	0.0	0.0	0.0
Gross Margin (%)		33.3	45.2	38.4	37.8	37.8	37.9
EBITDA Margin (%)		-16.7	17.5	20.0	21.4	22.1	23.2
Operating Margin (before GW and except.) (%)		-33.3	14.1	14.1	16.4	17.6	19.1
<b>BALANCE SHEET</b>							
Fixed Assets		187	156.0	152.3	149.3	146.3	143.3
Intangible Assets		125	106.7	105.6	104.5	103.4	102.3
Tangible Assets		62	43.3	42.7	40.8	38.9	37.0
Investments		0	6.0	4.0	4.0	4.0	4.0
Current Assets		81	57.8	41.7	45.6	53.3	63.6
Stocks		41	24.8	29.4	34.2	37.8	42.0
Debtors		9	10.0	9.1	10.5	11.5	12.6
Cash		31	23.0	3.2	0.9	4.0	8.9
Current Liabilities		(57)	(36.2)	(15.8)	(15.8)	(16.6)	(17.6)
Creditors		(38)	(20.4)	(14.5)	(15.8)	(16.6)	(17.6)
Short term borrowings		(19)	(15.8)	(1.3)	0.0	0.0	0.0
Long Term Liabilities		(51)	(26.2)	(30.6)	(30.6)	(30.6)	(30.6)
Long term borrowings		(45)	(22.8)	(27.7)	(27.7)	(27.7)	(27.7)
Other long term liabilities		(6)	(3.4)	(2.9)	(2.9)	(2.9)	(2.9)
Net Assets		160	151.4	147.6	148.5	152.4	158.7
<b>CASH FLOW</b>							
Operating Cash Flow		(3)	3.5	4.1	6.5	10.5	12.2
Net Interest		(4)	(1.4)	(2.1)	(1.8)	(1.7)	(1.6)
Tax		0	0	0	0	0	0
Capex		(5)	(3.0)	(6.6)	(5.7)	(5.7)	(5.7)
Acquisitions/disposals		66	0.9	(7.6)	0	0	0
Financing		12	0	0	0	0	0
Dividends		0	0	0	0	0	0
Net Cash Flow		66	0	(12.2)	(1.0)	3.1	4.9
Opening net debt/(cash)		65	33.0	9.6	21.8	22.8	19.7
HP finance leases initiated		0	0	0	0	0	0
Other		(34)	23.4	0	0	0	0
Closing net debt/(cash)		33	9.6	21.8	22.8	19.7	14.8

Source: Rubicon accounts, Edison Investment Research. Note: 2017R was restated to show discontinued operations separately. Significant other items in 2017R and 2018 cash flow relate to M&A activity associated with the disposed Tenon operations. Net debt includes restricted cash, shown as Investments.



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## New Zealand

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