De La Rue

H120 results

Securing the future

Industrial support services

De La Rue remains challenged. New management has to navigate a difficult Currency market and consequent concern over its finances. The swift response in terms of a turnaround programme is a positive start, accelerating cost cutting initiatives and cash management measures, including suspension of the dividend. Restoring stability and rebuilding confidence in the investment case is likely to take some time.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
03/18**	461.4	47.5	38.2	25.0	3.6	18.1
03/19	516.6	54.1	42.9	25.0	3.3	18.1
03/20e	420.3	15.4	11.2	0.0	12.3	N/A
03/21e	369.6	24.2	18.1	0.0	7.6	N/A

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments. **Restated for the sale of Paper and IFRS 15.

Currency trading conditions deteriorated

As shown in the October trading update, H120 results saw a sharp drop in adjusted operating profit to £2.2m (H119 £17.0m). Product Authentication & Traceability made strong progress with revenues up 70% and adjusted operating profit more than doubling. However, Currency continued to face severe challenges as overspill volumes declined, with increased pressure on pricing and lower absorption of fixed costs. Adjusted Currency revenues (ex-paper) fell 30% to £128.7m (H119 £182.5m), generating an adjusted operating loss of £12.5m (H119 profit £6.5m). The group has revised its forecasts for FY20 and indicates a group adjusted operating profit of between £20m and £25m. We have cut our forecast accordingly.

Material risk of covenant breach

Net debt rose sharply to £170.7m in H120 due to the lower profitability and increased working capital. The net debt/EBITDA ratio was 2.72x, close to the limit of ≤3.0x. Having modelled potential downside risks, management believes it can continue to operate within its revolving credit facility covenant limits. However, it recognises there is material risk. The dividend has been suspended and the receipt of £42m of disposal proceeds from the International ID business in early October is helpful. However, the unwinding of working capital in H220 appears to be a key factor in avoiding a breach. A turnaround plan has been initiated by the new CEO and a strategic review should be completed by the year end. Previously announced cost reduction initiatives are underway and are being accelerated in H220.

Valuation: Rating reflects risk discounts

Management faces a major task of delivering the operational plan, restoring both internal and external confidence, as well as rebuilding an investment case. The material financial risk will weigh on valuations until the remedial cost actions and operational efficiencies start to bear fruit, and this is reflected in the single digit P/E multiple for the current year. Progressive improvement in operational performance and the financial constraints could provide opportunity, but there is no longer any yield support to compensate for the increased near-term risk.

6 December 2019

Price	**138p**
Market cap	**£143m**

Net debt (£m) at 30 September 2019	170.7
Shares in issue	103.8m
Free float	100%
Code	DLAR
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	(11.0)	(34.3)	(70.3)
Rel (local)	(8.8)	(33.9)	(71.6)
52-week high/low		458p	134p

Business description

De La Rue is a world leader in anti-counterfeiting and security for currency and brand protection. The company operates across 140 countries and is the number one commercial designer and producer of banknotes and security features on both paper and increasingly polymer substrates.

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Investment summary

In light of the trading update on 30 October 2019, which indicated a low single-digit adjusted operating profit for H120, down from £17.0m in H119, the performance for the period had been foreshadowed. However, the spike in net debt to £170.7m (FY19 107.5m) has further unpleasant ramifications.

The banking covenants on the group's revolving credit facility (RCF) are based on rolling 12-month measures of interest cover (EBIT/net interest) of ≥4.0x and a net debt/EBITDA ratio limit set at ≤3.0x. Both are based on adjusted earnings figures and are set using accounting principles in use at the time of agreeing the facility (which makes reconciliation more difficult).

H120 trading performance

The company adopted IFRS 16 from the start of FY20, and has not restated historicals, so there are some distortions to the comparative changes, although these are minimal at the adjusted PBT level.

Largely due to the continued decline of trading conditions at Currency, the group saw adjusted revenues (excluding pass through revenues from the former paper business) decline by almost 15% to £205.9m (H119 £242.0m). Adjusted operating profit fell by 87% to £2.2m (H119 £17.0m) as Currency fell into a significant loss at the adjusted operating profit level that was only partially mitigated by growth at Product Authentication & Traceability (PA&T) and a robust ID Solutions (IDS) performance.

Exhibit 1: H120 results summary

Six months to September (£m)	H119	H120*	% change
Currency	182.5	128.7	-29.5%
Product Authentication & Traceability	19.4	33.0	70.1%
ID Solutions	40.1	44.2	10.2%
Group adjusted revenue	**242.0**	**205.9**	**-14.9%**
EBITDA	**27.0**	**12.4**	**-54.1%**
Currency	6.5	(12.5)	N/M
Product Authentication & Traceability	3.6	7.7	113.9%
ID Solutions	6.9	7.0	1.4%
Adjusted operating profit	**17.0**	**2.2**	**-87.1%**
Adjusted PBT	**14.0**	**(1.1)**	**N/M**
EPS - underlying continuing (p)	**11.2**	**(1.5)**	**N/M**
DPS (p)	8.3	0.0	-100.0%
Net debt (excluding lease liabilities)	**107.5****	**170.7**	**58.8%**

Source: Company reports, adjusted basis pre-exceptional and acquired intangible amortisation. Note: *Using IFRS 16. **At FY19 (31 March 2019).

After a small increase in the finance charge, adjusted PBT recorded a loss of £1.1m (H119 profit £14.0m), which after tax and minorities represented an adjusted loss per share of 1.5p (H119 EPS 11.2p).

Exceptional items were up sharply to £11.0m (H119 £6.6m) largely due to an £8.2m (H119 nil) restructuring charge in the half year relating to the previously announced £20m cost reduction programme.

The Currency division continued to face severe challenges as overspill volumes declined, with increased pressure on pricing and lower absorption of fixed costs. Adjusted Currency revenues (ex-paper) fell 30% to £128.7m (H119 £182.5m), generating an adjusted operating loss of £12.5m (H119 profit £6.5m) for this division. Lower print volumes in the much more limited commercial print market also led to lower demand for higher margin security features. The Polymer bank note substrate business continues to grow and is now making a small profit. While the 12-month order book had risen from £202m at the start of the year to £238m (out of a total H120 Currency order book of £273m), there is little prospect of a dramatic recovery in sales in H220 and margins, while positive, are likely to be constrained.

PA&T made strong progress with revenues up 70% to £33.0m and adjusted operating profit more than doubling to £7.7m (H119 £3.6m), with margins rising to 23.3% (H119 18.6%). Growth in Government Revenues Services (GRS) volumes (primarily tax stamps and systems) continued to be partially offset by start-up costs against the major contracts that have been won, notably for the Kingdom of Saudi Arabia and the UAE.

ID Solutions traded robustly in the half year despite the anticipated cessation of trading at the end of FY20. The UK passport contract volumes remained strong and should deliver a similar H220 performance as it transitions to the new supplier. The international ID Solutions business also made a full contribution but has now been sold to Assa Abloy. The company will retain some security features activities that will be incorporated into the new Authentication division. In FY21 the vast majority of estimated divisional FY20 revenues of £64.5m and adjusted operating profits of £9.0m will have left the group.

Cash flow, liquidity and going concern

Net debt rose £170.7m at H120 from £107.5m at the start of the year already as a result of the lower profitability and adverse working capital movement of £35.1m. The pension deficit payment, capex and the FY19 final dividend were also significant H120 outflows but were little changed from H119.

The working capital movement reflected a £21.8m inventory build during the period primarily in Currency, partly due to changes in delivery schedules at customers but which should start to unwind in H220. There was also a £5.8m increase in receivables due to PA&T volume growth, and some outstanding invoice receipts at Currency which are thought to have been paid early in H220. Payables fell by £7.5m due to lower advance payments.

Debt covenant risk

As a result of the lower profitability and increased net debt, the H120 net debt/EBITDA of 2.72x is uncomfortably close to the limit and will deteriorate further as H220 will also deliver a lower EBITDA than in H219. Apart from the FY20 forecast, management has modelled downside risks and believes it can continue to operate within its revolving credit facility covenants. However, it recognises if more than one of the significant risk scenarios was to occur concurrently without mitigation, it may breach its net debt/EBITDA covenant. The company has suspended dividend payments to help manage cash flow and the receipt of £42m of disposal proceeds from the sale of the International ID business in early October is helpful. However, the unwinding of working capital in H220 appears to be a key factor in avoiding a breach.

Management changes

Both the chairman and the CEO have been replaced since the preliminary results in June, with the incoming CEO, Clive Vacher, bringing a track record of turning around businesses. While he only joined on 7 October2019, we expect the reviews and initiatives he has already undertaken to progressively augment the already initiated cost reduction programmes. A fully revised strategy will take time to formulate and we do not expect to hear substantial detail until Q420.

Outlook

Clive Vacher has initiated a turnaround plan aimed at setting 'a new vision for the Company and its divisions which reduces costs, improves cash management, accelerates the restructuring (specifically targeting company-wide overhead cost reduction) and repositions the company in its market places.' The details of the full strategic review being undertaken should be announced by the year end, but cost reduction initiatives are underway and the previously announced transition to a two-division structure of Currency and Authentication was implemented on 4 November.

Estimates revisions

Following H120 results, management is now guiding for a FY20 adjusted operated profit of between £20m and £25m. Having suspended our estimates following the 30 October 2019 profit warning, we have re-established our estimates and our adjusted operating profit estimate is in the middle of the management guidance range and represents a substantial downgrade on our previous estimates.

Exhibit 2: De La Rue earnings revisions

Year end 31 March (£m)	2020e			2021e		
	Prior	New	% change	Prior	New	% change
Currency	355.0	279.2	-21.3%	291.1	270.0	-7.3%
ID Solutions	61.3	64.5	5.1%	0.0	0.0	
PA&T	76.6	76.6	0.0%	99.6	99.6	0.0%
Sales	493.0	420.3	-14.7%	390.7	369.6	-5.4%
EBITDA	**69.8**	**43.5**	**-37.7%**	**67.9**	**52.8**	**-22.3%**
Currency	19.5	(5.6)	-128.6%	21.8	7.1	-67.4%
ID Solutions	9.8	9.0	-8.0%	0.0	0.0	#DIV/0!
PA&T	20.7	19.2	-7.4%	26.9	24.9	-7.4%
Adjusted EBITA	**50.0**	**22.6**	**-54.8%**	**48.7**	**32.0**	**-34.3%**
Adjusted PBT	**42.8**	**15.4**	**-64.0%**	**41.2**	**24.2**	**-41.4%**
EPS - adjusted (p)	**32.7**	**11.2**	**-65.7%**	**31.9**	**18.1**	**-43.3%**
DPS (p)	25.0	0.0	-100.0%	25.0	0.0	-100.0%
Net debt/(cash)	97.7	126.2	29.1%	113.3	133.2	17.6%

Source: Edison Investment Research estimates

Valuation

While we are forecasting a progressive recovery, the smaller group carries significantly increased risk. While we can see a path to higher cash flow-derived valuations, the market is likely to remain sceptical until the current risks are alleviated. Currently the market is assuming an implied WACC of around 12.9% if we reverse our capped DCF calculation, equating to a cost of equity approaching 20%. If risk is retired clearly, we would expect a lower premium to be applied.

Exhibit 3: De La Rue capped DCF sensitivity to WACC and terminal growth (p/share)

WACC	8.0%	9.0%	10.0%	11.0%	12.0%	12.9%	13.0%	14.0%
Terminal growth rate								
0.0%	378	306	250	204	165	136	133	105
1.0%	444	356	288	234	189	156	153	122
2.0%	533	420	336	270	218	180	176	140
3.0%	657	506	397	316	254	208	204	163

Source: Edison Investment Research estimates

Exhibit 4: Financial summary

£m	2018	2019	2020e	2021e
Year end 31 March	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS				
Revenue	461.4	516.6	420.3	369.6
Cost of Sales	0.0	0.0	0.0	0.0
Gross Profit	461.4	516.6	420.3	369.6
EBITDA	78.4	79.5	43.2	54.1
Operating Profit (before amort. and except.)	59.5	62.8	25.5	35.1
Intangible Amortisation	(2.6)	(2.7)	(2.9)	(3.1)
Exceptionals	74.6	(28.6)	(2.4)	(2.8)
Other	0.0	0.0	0.0	0.0
Operating Profit	131.5	31.5	20.2	29.2
Net Interest	(9.4)	(6.0)	(7.2)	(7.9)
Profit Before Tax (norm)	47.5	54.1	15.4	24.2
Profit Before Tax (FRS 3)	122.1	25.5	13.0	21.4
Tax	(18.9)	(4.8)	(2.1)	(3.4)
Profit After Tax (norm)	40.3	45.4	12.9	20.2
Profit After Tax (FRS 3)	103.2	20.7	11.0	17.9
Average Number of Shares Outstanding (m)	101.9	102.9	103.8	103.8
EPS - normalised (p)	38.2	42.9	11.2	18.1
EPS - normalised and fully diluted (p)	37.8	42.7	11.2	18.1
EPS - (IFRS) (p)	93.6	16.5	9.4	15.9
Dividend per share (p)	25.0	25.0	0.0	0.0
Gross Margin (%)	100.0	100.0	100.0	100.0
EBITDA Margin (%)	17.0	15.4	10.3	14.6
Operating Margin (before GW and except.) (%)	12.9	12.2	6.1	9.5
BALANCE SHEET				
Fixed Assets	149.0	155.6	151.1	147.3
Intangible Assets	29.5	33.3	34.1	36.7
Tangible Assets	112.8	115.0	97.9	92.5
Right of Use Asset			11.8	10.8
Investments	6.7	7.3	7.3	7.3
Current Assets	179.9	219.7	201.3	197.7
Stocks	34.1	42.3	56.7	55.4
Debtors	102.3	139.3	100.9	99.8
Cash	15.5	12.2	12.2	12.2
Other	28.0	25.9	31.5	30.2
Current Liabilities	(252.7)	(321.6)	(307.8)	(305.5)
Creditors	(187.3)	(201.9)	(169.4)	(160.0)
Short term borrowings	(65.4)	(119.7)	(138.4)	(145.4)
Long Term Liabilities	(96.6)	(82.9)	(57.9)	(34.9)
Long term borrowings	0.0	0.0	0.0	0.0
Lease liabilities			(11.8)	(10.8)
Other long term liabilities	(96.6)	(82.9)	(46.1)	(24.1)
Net Assets	(20.4)	(29.2)	(13.2)	4.7
CASH FLOW				
Operating Cash Flow	93.2	(6.3)	(21.5)	18.4
Net Interest	(4.6)	(3.8)	(3.9)	(5.0)
Tax	(30.6)	(0.9)	(1.6)	(2.9)
Capex	(24.7)	(25.4)	(16.6)	(17.6)
Acquisitions/disposals	57.7	0.2	42.0	0.0
Financing	2.0	4.3	0.0	0.0
Dividends	(25.8)	(26.2)	(17.1)	0.0
Other	3.8	0.5	0.00	0.0
Net Cash Flow	71.0	(57.6)	(18.7)	(7.0)
Opening net debt/(cash)	120.9	49.9	107.5	126.2
HP finance leases initiated	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0
Closing net debt/(cash)	49.9	107.5	126.2	133.2

Source: Company accounts, Edison Investment Research

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