discoverIE Group

H121 trading update

Platform in place for recovery

Tech hardware & equipment

discoverIE reported resilient H121 results considering the expected drop in demand due to COVID-19. Having taken action at the start of the pandemic to reduce costs and conserve cash, the company was able to minimise the impact of the revenue shortfall on operating profit and pay down a substantial amount of debt. With order intake and design win activity now moving in the right direction, the company is well positioned to resume its growth path. While we have reduced our forecasts to reflect the risk from ongoing lockdowns, the reinstated dividend and resumption of M&A underline management's confidence in the outlook.

Year end	Revenue (£m)	PBT* (£m)	Dil. EPS* (p)	DPS (p)	P/E (x)	Yield (%)
03/19	438.9	28.4	28.4	9.6	21.2	1.6
03/20	466.4	34.6	31.8	3.0	19.0	0.5
03/21e	445.7	28.3	23.0	10.4	26.2	1.7
03/22e	486.5	32.4	26.4	10.7	22.9	1.8

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

Cash conservation puts company in strong position

Group revenue declined 6% y-o-y in H121 (8% lower on an organic constant currency basis). A high exposure to structural growth markets helped the Design & Manufacturing (D&M) division to keep the organic revenue decline to 7%, with a 4% boost from acquisitions. Custom Supply (CS) declined 11% on an organic basis. Group underlying operating profit declined only 11% y-o-y, as the company was able to cut operating costs by 4% y-o-y and 7% compared to the H220 run rate. Tight control of working capital, lower capex and no final dividend resulted in free cash flow of £20.1m in H121, bringing gearing down from 1.6x a year ago and 1.25x at the end of FY20 to 1.0x at the end of H121. Management has reinstated the dividend, announcing an interim dividend of 3.15p per share (+6% y-o-y).

Reflecting lingering COVID-19 disruption

We have revised our forecasts to reflect H121 results, the 18% decline in bookings and the acquisitions of Phoenix America and Limitor, as well as reflecting more caution in our revenue forecasts due to lingering COVID-19 restrictions. As demand improves, the company expects to resume more normal levels of spending. We have reduced our revenue forecasts by 3.2% in FY21 and 1.7% in FY22, with our underlying diluted EPS forecasts flat in FY21 and down 10.9% in FY22.

Valuation: Focused on recovery

The stock has bounced back by 60% from the low it reached in March and is up 6% year to date. The stock trades at a c 18% discount to its peer group on a FY21e P/E basis, down from 23% when we last wrote. Aside from continuing recovery in customer demand, we view the key trigger for earnings and share price upside to be progress in increasing the weighting of the business towards the higher-growth, higher-margin D&M business, which in turn should move the company closer to its 12.5% medium-term operating margin target. The stock is supported by a dividend yield approaching 2%.

10 December 2020

Price	**604p**
Market cap	**£540m**
	€1.1:$1.33:£1
Net debt (£m) at end H121	42.1
Shares in issue	89.5m
Free float	96%
Code	DSCV
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	(0.3)	3.8	12.7
Rel (local)	(6.1)	(5.8)	22.5
52-week high/low		678p	378p

Business description

discoverIE is a leading international designer, manufacturer and supplier of customised electronics to industry, supplying customer-specific electronic products and solutions to original equipment manufacturers.

Next events

Q321 trading update	January 2021

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Edison profile page

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Investment summary

Supplier of customised electronics to industry

discoverIE is a leading international supplier of customised electronics to industry. Over the last 10 years the company has broadened its product range, customer base and geographical presence via a series of acquisitions. It offers design and manufacturing and value-added distribution services; the focus on differentiated products and expansion along the supply chain is helping the company to expand operating margins. discoverIE intends to continue to grow organically and via acquisition while maintaining its focus on higher-margin business. To grow revenues ahead of GDP, it is focused on four structural growth markets: renewable energy, transportation, medical and industrial & connectivity. Its capital-light business model supports strong cash flow generation, with the aim of increasingly self-funding acquisitions.

Financials: Preparing for recovery in demand

We have revised our forecasts to take account of H121 results, the H121 bookings intake and the Phoenix America and Limitor GmbH (Limitor) acquisitions. Our forecasts were based on COVID restrictions diminishing from H221. However, ongoing sporadic lockdowns all over the world lead us to take a more cautious approach to H221 and FY22 revenues. At the same time, management has indicated that it is starting to increase the operating cost base in readiness for stronger demand and is likely to increase capex too, in part to meet new ESG targets. We have revised down our normalised diluted EPS forecasts by 2.9% in FY21 and 11.9% in FY22. Our underlying diluted EPS forecast (which includes share-based payments) is unchanged for FY21 and is 10.9% lower in FY22. We forecast net debt of £66.0m by the end of FY21 (net debt/EBITDA 1.6x) and £65.7m by the end of FY22 (net debt/EBITDA 1.5x).

Valuation: Focused on recovery

The stock has bounced back by 60% from the low it reached in March and is up 6% year to date. The discount to peers has reduced since we last wrote, from 23% to 18% based on FY21e P/E. Aside from continuing recovery in customer demand, we view the key trigger for earnings and share price upside to be progress in increasing the weighting of the business towards the higher-growth, higher-margin D&M business, which in turn should move the company closer to its 12.5% medium-term operating margin target. The stock is supported by a dividend yield approaching 2%.

Sensitivities: Economy, currency, pricing and acquisitions

Our estimates and discoverIE's share price will be sensitive to the following factors. **Customer demand:** demand will be influenced by the economic environment in Europe and increasingly in North America and Asia. **Currency:** with 87% of revenues generated in currencies other than sterling, discoverIE is exposed to the translation of euro, US dollar and Nordic-denominated subsidiary results into sterling, which had a small negative effect on sales and profits in FY20. **Pricing:** discoverIE's revenues and profitability are sensitive to its ability to include in price quotes engineering time spent on designing customer solutions. The company normally passes through supplier price increases and tariffs. **Acquisitions:** discoverIE expects to make further acquisitions, which could add integration risk and larger deals may require equity funding.

Company description: Custom electronics supplier

discoverIE is a supplier of customised electronics to industry with operations throughout Europe and increasingly outside Europe. The last 10 years have seen the integration of a series of acquisitions and a focus on growing the percentage of higher-margin specialist products, resulting in higher profitability. The company intends to continue to grow organically and via acquisitions while maintaining the focus on its higher-margin D&M business.

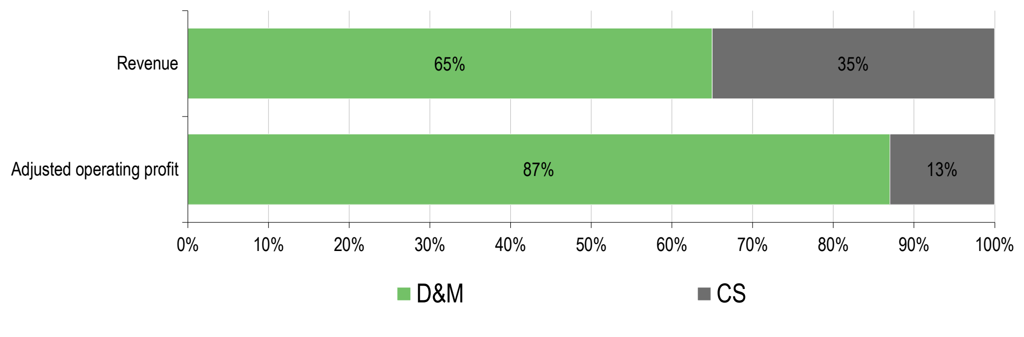
Company history

discoverIE was founded in 1986 and was admitted to the official list of the LSE in 1994 as a pure distributor of electronic components. After a change in management in 2009, through its strategy of specialisation the company has transitioned to become a provider of customised electronic solutions with operations in Europe, Asia and North America. The company has made a series of acquisitions since 2009 – we provide further detail on page 7. discoverIE operates through two divisions, Design & Manufacturing (D&M) and Custom Supply (CS), with 4,200 employees across 23 countries.

Business model

discoverIE specialises in supplying technically demanding, bespoke electronics for industrial applications and is focused on four target markets comprising 68% of group sales – renewables, electrification of transportation, medical and industrial & connectivity – all of which are long-term structural growth markets. The company estimates that the global niche electronic components market is worth £20bn annually. discoverIE mainly competes against small, privately owned, country-specific suppliers in one or two technology areas and expects to continue its active role in consolidating this fragmented market. The D&M business generates the majority of revenue and an even larger majority of operating profit. Future growth and investment plans are focused on this division.

Exhibit 1: Divisional split: H121 revenue and adjusted operating profit



Source: discoverIE

D&M: Diverse range of custom electronic products

Mainly through acquisition, discoverIE has built up its D&M capability in four areas of technology: power (40% of H121 divisional revenue), components (24%), systems (22%) and magnetics (14%). This division supplies custom electronic products either designed uniquely or modified from an existing product. More than 80% of products are manufactured at 27 sites across 17 countries (principal facilities in China, India, Mexico, the Netherlands, Poland, Sri Lanka, Thailand and the UK), with the remainder manufactured by third-party contractors. As well as direct sales, these products are also distributed through the CS business.

CS: Specialist electronics supplier

Acal BFi is the main business within this division and is a supplier of specialist electronics from a selected group of manufacturers (including the D&M division), to more than 20,000 industrial customers. It operates across Europe, with centralised warehousing, purchasing, finance, customer contact management and IT systems. Acal BFi differentiates itself from high-volume distributors such as Arrow or Avnet by supplying niche components from leading manufacturers (often on an exclusive basis) in a wide range of electronic component areas. discoverIE solutions range from the recommendation and supply of a part, modification of an existing product, to full design and development of a custom solution. Additionally, the division has a separate medical business, **Vertec**, which supplies exclusively sourced medical imaging and radiotherapy products into medical and healthcare markets in the UK and South Africa.

Industrial focus leads to longer product cycles

discoverIE's solutions are used in both the design and production phases of a customer's product. The company works with R&D engineers to help them develop new products; once these move into production, discoverIE supplies on a volume basis for the life of the product. We highlight that discoverIE is focused on industrial OEMs and does not service the consumer electronics market (which tends to be highly commoditised with short lifetime products and often highly cyclical sales). Across both businesses, a customer will typically take six to 24 months to move a product from design to production, at which point the company should earn revenues for the life of the product, typically five to seven years.

Group strategy

The group is focused on markets with sustainable growth prospects and increasing electronic content where there is an essential need for its products. It invests in initiatives and businesses that enhance design opportunities for customised products in targeted long-term structural growth markets.

Management's aim is to transform the company into a technology-led provider of customised electronics for industrial applications with design, manufacturing and distribution capabilities. To achieve this, the company has set the following strategic objectives:

- **Grow sales well ahead of GDP over the economic cycle** by focusing on structural growth markets.
- **Move up the value chain by continuing to build revenues in the D&M business** where operating margins are higher (typically >10% and increasingly >20%) while optimising performance in CS to achieve an operating margin of 5%.
- **Acquire high-quality businesses** with attractive growth prospects and strong operating margins.
- **Further internationalise the business** by developing sales in North America and Asia.
- **Generate strong cash flows from a capital-light model and long-term sustainable returns.**

To track progress with these objectives, the company has set key strategic indicators (KSIs) and key financial performance indicators (KPIs), which we discuss in more detail later in this report.

Experienced board supports growth ambitions

To support its growth ambitions, discoverIE has constructed a board with substantial experience in acquisitions and international growth. Executive directors include Nick Jefferies (CEO since 2009 – biography on page 14) and Simon Gibbins (CFO since 2010 – biography on page 14). The board is chaired by Malcolm Diamond (previously non-executive chairman of Trifast (2017–19) and CEO

(1984–2002)). Non-executive directors include Bruce Thompson (ex-Diploma CEO 1996–2018, non-executive chairman at Avon Rubber), Tracey Graham (also NED at Royal London, Ibstock and Link Scheme) and Clive Watson (ex-group FD of Spectris 2006–19, NED at Breedon Group, Kier Group and Trifast).

Tracking strategic progress

Exhibit 2 summarises the steady progress discoverIE is making against its KSIs. The company set the previous KSIs in November 2016, for a period of three to five years. With FY20 results, discoverIE announced new targets to run for the next five years. We discuss below how it is meeting its strategic objectives. While COVID-19 means that operating margins dipped in H121, the company has made good progress on all other targets during H121.

Exhibit 2: KSIs – updated targets

	FY14	FY15	FY16	FY17	FY18	FY19	FY20	H120	H121	Previous target	New target
Increase D&M revenue	18%	37%	48%	52%	57%	61%	64%	63%	65%	75%	>75%
Increase underlying operating margin	3.4%	4.9%	5.7%	5.9%	6.3%	7.0%	8.0%	7.6%	7.3%	8.5%	12.5%
Build sales beyond Europe	5%	12%	17%	19%	19%	21%	27%	24%	28%	30%	40%
Sales from target markets	N/A	N/A	N/A	56%	62%	66%	68%	66%	68%	New	85%

Source: discoverIE

Increasing D&M revenue; expanding operating margins

discoverIE started life as a pure distributor of electronic components, but through a strategy of specialisation and acquisition it has transitioned to become a provider of customised electronic solutions. Over the last nine years, the company has acquired 15 businesses with design and manufacturing capabilities – these are significantly more profitable than the CS business. Consequently, while the **D&M** division generated 65% of H121 revenues, it generated 87% of H121 profits. With D&M operating margins of 12.8% in FY20 compared to 4.3% for CS, as the company makes more D&M acquisitions group operating margins should continue to expand. In addition, pre-COVID D&M was growing at a faster organic rate than CS (D&M CAGR of 8.6% over three years versus 0.3% for CS) so absent any acquisitions, the margin should continue to expand.

In June 2020, with the group delivering an 8% operating margin the company raised its margin target to 12.5%. This also reflects the fact that more recent acquisitions have been higher margin (eg Sens-Tech underlying EBIT margin of 35%, Phoenix 20%). The company expects to deliver this target through a combination of organic and inorganic growth.

Targeting high-growth markets

As part of the group's goal to grow revenue ahead of GDP on an organic basis, discoverIE is targeting higher-growth markets. These are markets that are exhibiting structural growth and depend on technology for product development, resulting in increasing electronic content. discoverIE aims to supply essential products to OEMs in these markets. With the increasing focus on ESG by investors and consumers alike, the company is keen that its target markets also align with the UN's Sustainable Development Goals (SDGs).[1]

The table below describes the four target markets, the growth prospects of each market and examples of products that discoverIE supplies for each market. The group has focused on these markets for several years, but has only just added this to its KSIs. In FY20, the business generated

[1] UN SDGs: 17 goals adopted by all UN member states in 2015 as a universal call to action to end poverty, protect the planet and ensure that all people enjoy peace and prosperity by 2030.

68% its revenues from these four areas and is targeting this to grow to 85% over the next five years.

Exhibit 3: Growth areas targeted by discoverIE

	Renewable energy	Transportation	Medical	Industrial & connectivity
Growth drivers	Decarbonisation and diversification	Decarbonisation and automation driving electrification and autonomous vehicles	Proactive and preventative medicine using artificial intelligence, sensing & analytics	Connectivity, automation, industrial Internet of Things (IoT)
Market data	International Energy Agency sustainable development scenario calls for renewable energy to make up 50% by 2030, from 27% in 2019.	Electric cars now 1% of global stock, target 13% by 2030 (IEA). Autonomous driving system (HW and SW) market to be worth $57bn by 2030 (IDTechEx).	Medical electronics market to grow by 8% pa 2018–2024 (TechSci Research)	Industrial IoT market to reach $111bn by 2025, CAGR of 7.5% 2017–2025 (Statista).
discoverIE products	Power inductors, turbine blade pitch control, airflow measurement	Charging, sensing systems, power control, cabin monitoring and control	Embedded diagnostics, interface device and cabling, power systems	Wireless telematics, fibre-optic connectivity, wireless robotics control, communication technologies, power control
UN SDG	7 AFFORDABLE AND CLEAN ENERGY	11 SUSTAINABLE CITIES AND COMMUNITIES	3 GOOD HEALTH AND WELL-BEING	9 INDUSTRY, INNOVATION AND INFRASTRUCTURE

Source: discoverIE. Note: HW = hardware, SW = software.

The company has also looked more closely at the industrial & connectivity market and sees opportunities to meet three more of the UN SDGs (2 – zero hunger, 6 – clean water and sanitation and 12 – responsible consumption and production) by targeting products that support resource optimisation. Applications include smart agriculture, food manufacturing systems, efficient water use/management and water quality improvement.

During H121, D&M generated 73% of revenue from target markets (H120: 70%). Revenue generated from these markets declined by only 5% on an organic basis compared to an 11% organic decline in revenue from other markets. CS generates a lower proportion of revenue from target markets (59% in H121), which partially explains its larger organic revenue decline.

Acquisitions core to growth strategy

discoverIE started the transformation of the business in 2009 with the acquisition of BFi Optilas, the next largest European specialist distributor after discoverIE. This increased discoverIE's presence in Germany, the UK, France and the Nordic region. discoverIE then proceeded to make a series of acquisitions (see Exhibit 4 below), most with design and manufacturing capabilities. The company has a dedicated M&A team focused on developing and pursuing opportunities.

Criteria for acquisition targets

discoverIE's focus for future acquisitions is to target D&M companies with complementary product and/or geographical capability supplying common markets and customers. The preference is to buy businesses that are successful and profitable, with good growth prospects, good margins and similar long-term growth drivers to discoverIE's focus markets.

Integration strategy: Retain entrepreneurial approach

Many of the acquired businesses have been led by entrepreneurial managers and discoverIE is keen to retain this culture. To support this, acquired businesses typically continue to operate under their own brands and management, working towards agreed business plans. discoverIE has started to create technology clusters, where smaller businesses are taken under the wing of a larger business operating in the same product area. At the same time, they are able to take advantage of being part of the larger group, with access to the wider discoverIE customer base, support for product development and manufacturing, centralised finance and administrative support, and efficiency improvements through access to the group's purchasing scale, processes, warehousing and freight. Where appropriate, manufacturing is rationalised to make the most efficient use of the group's network of manufacturing facilities.

D&M acquisition track record

The table below summarises the acquisitions the group has made since FY10.

Exhibit 4: Acquisition timeline

Company	Date	Product areas	Division	Operations	Sales	Cost (£m)
BFi Optilas	Dec 09	Speciality components, communication, photonic, imaging	CS	Germany, France, UK, Spain, Italy, Sweden, Netherlands	Europe	13.4
CompoTRON	Jan 11	Electronic communications and fibre-optic components	CS	Germany, UK, Denmark	Europe	7.1
Hectronic	Jun 11	Embedded computing	D&M	Sweden	Nordic region, US	1.2
MTC	Oct 11	Electro-magnetic shielding (own brand/manufacture)	D&M	Germany, South Korea	Europe and Asia	2.7
Myrra SAS	Apr 13	Transformers, coils, cores and inductors (own brand/manufacture)	D&M	France, Poland, China	Europe, Asia, North America, Africa	9.9
Young Electronics Group	Sep 13	Solid state lighting, electronic components, power supplies, power cords, custom cable assembly	CS	UK, Ireland	UK, Ireland	1.7
RSG	Nov 13	Custom power solutions	CS	Germany	Germany	2.7
Noratel	Jul 14	Low-, medium- and high-power transformers and inductors (own brand/manufacture)	D&M	Nordic region, China, US, India, Poland, Sri Lanka	Europe, Asia, North America	73.5
Foss	Jan 15	Customised fibre-optic solutions	D&M	Norway, Slovakia	Norway, Eastern Europe	12
Flux	Nov 15	Customised magnetic components	D&M	Denmark, Thailand	Denmark	4
Contour	Jan 16	Custom cable assemblies and connectors	D&M	UK	UK	17.5
Plitron	Feb 16	Custom toroidal transformers	D&M	Canada	North America	1.8
Variohm	Jan 17	Electronic sensors, switches and motion measurement systems	D&M	UK, Germany	UK, France, Germany, US	13.3
Santon	Feb 18	DC and AC switches and switchgear	D&M	Netherlands, UK	Europe, Asia, US	23.7
Cursor Controls Group	Oct 18	Human-to-machine interface technology	D&M	UK, Belgium	UK, Europe, N. America, Asia	19.0
Hobart	Apr 19	Customised transformers, inductors, magnetics	D&M	US, Mexico	N. America	11.7
Positek	Apr 19	Sensors	D&M	UK	UK, Europe, N. America, Asia Pacific	4.2
Sens-Tech	Oct 19	Specialist sensing and data acquisition modules for X-ray and optical detection applications	D&M	UK	US, Europe, Asia, UK	58.0
Phoenix	Oct-20	Magnetically actuated sensors, encoders and related products	D&M	US	US	8.5
Limitor	Dec-20*	Custom thermal safety components including temperature & current sensors, limiters and thermal switches	D&M	Germany, Hungary	Europe, US, Asia	13.2
Total						**299.1**

Source: discoverIE. Note: *Announced December 2020, completion dependent on regulatory approval (likely in Q421).

The company has analysed the 15 D&M acquisitions it has made over the last nine years, excluding those it has not owned for more than two years (ie Cursor Controls, Hobart, Phoenix, Positek and Sens-Tech). Of the 10 businesses, six have generated a return on investment (ROI)[2] well above discoverIE's target of 15% (range of 18–65%) and nine were above the company's WACC of 9%. On average, at 17% the whole group is generating an ROI above the target. Based on operating profit for FY20, the group generated an average ROI of 18.6%.

Further acquisitions expected

The company's target for more than 75% of revenues to be generated from the D&M business in our view assumes a combination of good organic growth and a material level of M&A in that division, with no further acquisitions in the CS division. While the company halted acquisition activity during the first COVID-19 lockdown, targets remained in the pipeline, and the company completed the acquisition of Phoenix America (Phoenix) in October 2020. discoverIE acquired the trade and assets of Phoenix, a US-based designer and manufacturer of magnetically actuated sensors, for $11.0m/£8.5m in cash with a three-year cash earn-out of up to $1.5m/£1.2m.

In December, the company announced a second acquisition, Limitor, a German-based manufacturer of custom thermal safety components for industrial applications with 85% of sales into the EU. discoverIE will pay an initial consideration of €14.5m with a further contingent consideration of up to €3.5m depending on hitting profit growth targets over three years. The Limitor acquisition, which is subject to regulatory approvals, is expected to complete in CY Q121.

Both Phoenix and Limitor will join the Variohm cluster while retaining their own brand identity.

Management considers two types of acquisition: 'platform' to create a new position in a technology and/or geography and 'bolt-on' to expand the position of an existing business. The company's M&A director is focused on sourcing new acquisition targets in discoverIE's key technological and geographical markets, namely companies with design and manufacturing capabilities in any of the group's technology areas, located in Europe, North America or Asia.

At the end of H121, the company had a net debt position of £42.1m, and gearing of 1.0x EBITDA was well below the target range of 1.5–2.0x. Post period end, the company acquired Phoenix for £8.5m in cash and will acquire Limitor for €14.5m/£13.2m. On a pro forma basis, this has increased gearing to 1.45x, just below the target range. The company has a £180m revolving credit facility (RCF) due in June 2024, and also has access to a £60m accordion facility. The RCF can be used for acquisitions and working capital. Based on the end-H121 position and the Phoenix acquisition, we estimate that c £93m of the RCF has been drawn down. Until there is better clarity on how COVID-19 will affect the general economy over the next year, we would not expect the company to borrow up to the top end of its target gearing range.

Increasing focus on ESG principles

At the start of 2020, the board and group executive committee initiated a review of the company's approach to ESG matters, with the aim of further improving the group's approach to sustainability. Group executive committee remuneration outcomes are dependent on ESG. Areas in which the company has undertaken initiatives include:

- **Alignment to UN SDGs** – as previously discussed in the section on market focus.
- **Tackling climate change** – externally: actively involved in designing and manufacturing products that reduce reliance on fossil fuels. This includes products directly involved in generating renewable energy as well as others that assist with the increasing electrification of transportation. The group has also announced a target to reduce carbon emissions by 50%

2 ROI: measured as average operating profit since acquisition divided by acquisition costs (upfront cost plus confirmed earnouts, expenses and integration costs).

within five years; this includes a target that within the first five years of ownership of new businesses, at least 50% of energy demand will be generated from renewable sources. It provides data on greenhouse gas emissions on an annual basis (independently assessed by Carbon Footprint) and has embedded environmental sustainability in business processes, eg increasing use of electric vehicles, recycling packaging materials, using renewable energy.

- **People** – ensuring diversity and inclusion; ensuring equal opportunity of recruitment, training and promotion; providing structured apprenticeship programmes for technical staff; supporting learning such as NVQs or similar; supporting professional accreditations.
- **Health &Safety** – tracking accidents and near-misses. Roll-out of new group health and safety (H&S) policy in late 2020, reinforcing emphasis on local management to ensure all relevant H&S issues are addressed.
- **Ethics** – whistleblowing, modern slavery and anti-bribery policies in place.

COVID-19 response

The company took action at the beginning of the pandemic to reduce costs and preserve cash. This included:

- deferral of non-essential capex and other discretionary spend;
- deferral of bonuses and pay rises and a hiring freeze;
- three-month salary reduction of 20% for the board and group executive committee:
- increased focus on working capital efficiency;
- deferral of all acquisitions, although pipeline development was continued; and
- no final dividend proposed for FY20.

Overall, this helped reduce H121 operating expenses by 4% y-o-y (£2.4m lower) and by 7% compared to the H220 run rate (£4.5m lower). Working capital was 9% lower than at the end of FY20 and capex was more than 50% lower leading to operating cash flow of £25.7m (+179% y-o-y).

The company established safe working practices for staff. Its 27 manufacturing facilities have been subject to various lockdown restrictions, but all sites are now open with capacity approaching normal levels.

The group has supported the development of more than 60 customer projects for virus-related medical products.

Financials

Making good progress versus KPIs

discoverIE last set KPIs three years ago, to run to March 2020. These KPIs remain relevant for future periods.

- The company has added an additional KPI, reflecting its desire to work towards self-funding future acquisitions – it is targeting **free cash flow** of at least 85% of underlying profit after tax. In FY20, free cash flow of £27.3m was 104% of underlying profit after tax. Benefiting from the work done to preserve cash during the pandemic, this increased to 174% in H121 with free cash flow of £20.1m.
- **Operating cash flow** generation has been above the target for the entire measurement period, rising to 159% of underlying operating profit in H121. Working capital reduced 9% h-o-h in

H121 – debtor days were down marginally versus end FY20 (51 vs 52), creditor days were marginally higher (65 vs 63), while stock turns reduced to 4.3x from 5.2x.

- Looking at **sales growth**, historically the D&M business has generated organic growth ahead of GDP. In FY20, weaker demand in the CS business resulted in overall group organic growth of 2%. In H121, the company estimates that organic revenue declined less than GDP over the same period.
- Until the pandemic, **EPS growth** was at or above the target across the entire measurement period.
- In May, the company announced that it would not be proposing a final **dividend** for FY20 to preserve cash during COVID-19 disruption. Management has since reinstated the dividend, with an interim dividend of 3.15p announced (+6% y-o-y).
- Despite a weakening in demand in Q420, the company managed to set a record **ROCE** of 16.0% in FY20, ahead of the 15% target. This dipped below the target in H121 due to the COVID-related reduction in operating profit but should recover in line with profitability growth as the economy recovers from the pandemic.
- As discussed in the ESG section, the company has set a new target to **reduce carbon emissions** by 50% from the level in 2019 over the next five years.

Exhibit 5: Key performance indicators

Key performance indicators	FY14	FY15	FY16	FY17	FY18	FY19	FY20	H120	H121	Three-year target (FY20)
Sales growth: CER*	17%	36%	14%	6%	11%	14%	8%	9%	(6%)	Well ahead of GDP
Sales growth: D&M organic	3%	9%	3%	-1%	11%	10%	5%	7%	(7%)	
Sales growth: organic	2%	3%	3%	-1%	6%	8%	2%	5%	(8%)	
Underlying EPS growth	20%	31%	10%	13%	16%	22%	11%	11%	(22%)	>10%
Dividend growth	10%	11%	6%	6%	6%	6%	N/A - only interim paid	6%	6%	Progressive
ROCE**	15.2%	12.0%	11.6%	13.0%	13.7%	15.4%	16.0%	15.8%	12.7%	>15%
Operating cash flow generation+	100%	104%	100%	136%	90%	93%	106%	101%	159%	>85% of underlying operating profit
Free cash flow generation+	24%	22%	64%	101%	58%	94%	104%	116%	174%	>85% of underlying profit after tax
Carbon emissions										50% reduction vs 2019

Source: discoverIE. Note: *Constant exchange rates. **Calculated as underlying operating profit (in FY20 annualised for the Sens-Tech acquisition) as a percentage of net assets plus net debt. +Half-year performance based on trailing 12 months.

Review of H121 results

Exhibit 6: H121 results highlights

Revenues (£m)	H121	H120	H120 CER	Reported y-o-y	CER y-o-y	Organic
Design & manufacturing	141.3	146.6	145.5	(4%)	(3%)	(7%)
Custom Supply	76.6	85.4	85.7	(10%)	(11%)	(11%)
Total revenues	**217.9**	**232.0**	**231.2**	**(6%)**	**(6%)**	**(8%)**
Underlying operating profit						
Design & manufacturing	17.2	17.6	17.4	(2%)	(1%)	
Custom Supply	2.5	4.1	4.1	(39%)	(39%)	
Unallocated	(3.9)	(4.0)	(4.0)	(3%)		
Total underlying operating profit	**15.8**	**17.7**	**17.7**	**(11%)**	**(10%)**	
Underlying operating margin						
Design & manufacturing	*12.2%*	*12.0%*	*12.0%*	*0.2%*		
Custom Supply	*3.3%*	*4.8%*	*4.8%*	*(1.5%)*		
Total underlying operating margin	***7.3%***	***7.6%***	***7.7%***	***(0.4%)***		
Reported operating profit	9.7	12.6		(23%)		
Underlying EPS (p)	11.3	14.4		(22%)		
Reported EPS (p)	5.8	9.1		(36%)		
Net debt	**42.1**	**55.4**		**(24%)**		

Source: discoverIE

Group revenue declined 6% y-o-y, with an 8% decline on an organic basis boosted by 2% growth from acquisitions. Gross margin increased by 0.3pp y-o-y to 33.7%, within which organic gross margin declined 0.3pp y-o-y, mainly due to mix. As previously mentioned, cost-cutting measures in response to COVID-19 allowed the company to keep the underlying operating profit decline to 11% (10% CER) and the margin decline to 0.4pp. D&M revenues declined by 7% on an organic basis and 3% on a CER basis, including acquisitions. The D&M margin expanded by 0.2pp y-o-y reflecting the inclusion of higher-margin Sens-Tech from October 2019. CS revenue declined 10% (11% on a CER basis), resulting in a 1.5pp decline in operating margin. Overall, the group saw underlying EPS decline by 22%, reflecting the increased share count from two capital raises (April 2019 and October 2019). Lower capex and working capital requirements combined with no final dividend for FY20 resulted in operating cash flow of £25.7m (+179% y-o-y) in H121, free cash flow of £20.1m (+367% y-o-y) and a reduction in net debt of 24% y-o-y.

Outlook and changes to forecasts

H121 orders reduced by 18% y-o-y on an organic basis, with a book-to-bill of 0.91x (Q121: 0.85x, Q221: 0.97x). Orders in September were up 6% y-o-y on an organic basis (monthly book-to-bill 1.04x) and orders in October and November have also shown year-on-year growth and a book-to-bill above 1x. The order book at end H121 of £140m was 10% lower y-o-y and 12% lower h-o-h. Design wins with an estimated lifetime value of £108m in H121 were 19% below the prior year. The company has seen customers continuing to place short-term orders at normal levels but more reluctant to place longer-term frame orders or work on new projects, typical behaviour in times of uncertainty. As visibility around COVID-19 recovery improves, the company is seeing customers returning to ordering on a longer-term basis and beginning to shift their focus to new projects.

We have revised our forecasts to reflect H121 performance and order intake, as well as to incorporate the recent Phoenix acquisition and the planned Limitor acquisition (we assume the deal completes towards the end of H221). We have brought down our underlying revenue and profit forecasts for FY21 and FY22, reflecting the longer duration of pandemic-related disruption and the expectation that the company will start to rebuild the operating cost base in anticipation of stronger demand and to support its growth plans.

Exhibit 7: Changes to forecasts

£m	FY21e old	FY21e new	Change	y-o-y	FY22e old	FY22e new	Change	y-o-y
Revenues	**460.5**	**445.7**	**(3.2%)**	**(4.4%)**	**494.8**	**486.5**	**(1.7%)**	**9.1%**
Design & manufacturing	296.8	291.0	(1.9%)	(2.3%)	322.8	323.3	0.2%	11.1%
Custom supply	163.8	154.7	(5.5%)	(8.2%)	172.0	163.2	(5.1%)	5.5%
Gross margin	**33.5%**	**33.7%**	**0.2%**	**0.1%**	**33.8%**	**33.8%**	**0.0%**	**0.1%**
EBITDA	46.0	45.3	(1.6%)	(11.0%)	53.6	49.7	(7.2%)	9.8%
EBITDA margin	10.0%	10.2%	0.2%	(0.8%)	10.8%	10.2%	(0.6%)	0.1%
Underlying operating profit	**31.4**	**31.3**	**(0.5%)**	**(15.7%)**	**38.8**	**35.5**	**(8.5%)**	**13.6%**
Underlying operating margin	**6.8%**	**7.0%**	**0.2%**	**(0.9%)**	**7.8%**	**7.3%**	**(0.5%)**	**0.3%**
Normalised operating profit	33.8	32.9	(2.8%)	(15.5%)	41.2	37.3	(9.4%)	13.6%
Normalised operating margin	7.3%	7.4%	0.0%	(1.0%)	8.3%	7.7%	(0.7%)	0.3%
Normalised PBT	28.8	28.3	(1.6%)	(18.1%)	36.2	32.4	(10.5%)	14.3%
Normalised net income	21.7	21.2	(2.2%)	(23.1%)	27.4	24.3	(11.3%)	14.4%
Normalised diluted EPS (p)	23.7	23.0	(2.9%)	(27.6%)	29.9	26.4	(11.9%)	14.4%
Underlying diluted EPS (p)	**21.7**	**21.7**	**(0.0%)**	**(28.0%)**	**27.9**	**24.9**	**(10.9%)**	**14.5%**
Reported basic EPS (p)	10.2	11.3	10.6%	(33.7%)	16.1	13.3	(17.2%)	18.0%
Dividend per share (p)	10.4	10.4	0.0%	250.2%	10.7	10.7	0.0%	2.9%
Net (debt)/cash	**(51.9)**	**(66.0)**	**27.4%**	**7.7%**	**(42.3)**	**(65.7)**	**55.2%**	**(0.5%)**
Net debt/EBITDA (x)	**1.3**	**1.6**			**0.9**	**1.5**		

Source: Edison Investment Research

Valuation

Exhibit 8 shows financial metrics for discoverIE's peer group and Exhibit 9 shows the valuation metrics. For the peer group, we use companies active in the electronics market and acquisitive industrial companies. The stock is trading at a discount to the peer group average on all valuation metrics. The company is growing revenue at a similar rate to peers but is below the average in terms of profitability. D&M made up 65% of H121 revenues; absent any acquisitions, we forecast this will increase to 66% by FY22 and the company is targeting this to exceed 75% over the next three to five years. To reach this target, we expect discoverIE to make further accretive D&M acquisitions, which would not only boost the revenue growth rate but would accelerate the growth in operating margins and EPS. Further progress in increasing the weighting of business towards D&M combined with a recovery in the profitability of the CS business should help to close the valuation discount.

Exhibit 8: Peer group financial metrics

	Y/e	Share price (p)	Market cap (£m)	Rev growth (%)		EBITDA margin (%)		EBIT margin (%)	
				CY	NY	CY	NY	CY	NY
DiscoverIE	**31-Mar**	**604**	**540**	**-4.4**	**9.1**	**10.2**	**10.2**	**7.4**	**7.7**
Diploma	30-Sep	2150	2681	28.7	7.1	19.5	19.8	17.1	17.6
Electrocomponents	31-Mar	823.5	3690	-4.3	6.7	12.1	13.9	9.6	11.6
Gooch & Housego	30-Sep	1280	321	1.3	3.5	15.6	17.2	10.4	12.6
TT electronics	31-Dec	208	363	-9.9	8.6	9.8	11.1	5.9	7.5
XP Power	31-Dec	4720	928	13.9	3.3	23.4	24.4	18.0	19.2
Avon Rubber	30-Sep	4105	1274	68.2	6.7	22.7	23.8	18.3	18.7
Halma	31-Mar	2263	8601	-1.4	7.3	24.1	24.9	20.2	21.3
Spectris	31-Dec	2843	3308	-17.5	5.0	16.6	18.5	11.6	13.8
Spirax-Sarco Engineering	31-Dec	10905	8050	-3.9	6.8	25.9	26.8	21.3	22.5
Average				**8.3**	**6.1**	**18.9**	**20.0**	**14.7**	**16.1**
Average excluding Avon Rubber & Diploma*				**-3.1**	**5.9**				

Source: Edison Investment Research, Refinitiv (as at 7 December). *To exclude effect of large acquisitions in current year

Exhibit 9: Peer group valuation metrics

	EV/Sales (x)		EV/EBITDA (x)		EV/EBIT (x)		P/E (x)		Div yield (%)	
	CY	NY	CY	NY	CY	NY	CY	NY	CY	NY
DiscoverIE	**1.3**	**1.2**	**13.3**	**12.1**	**18.3**	**16.1**	**26.2**	**22.9**	**1.7**	**1.8**
Diploma	3.6	3.4	18.5	17.1	21.2	19.2	29.9	27.2	1.5	1.7
Electrocomponents	2.0	1.9	16.8	13.7	21.3	16.5	28.0	21.7	2.2	2.0
Gooch & Housego	2.7	2.6	17.4	15.3	26.2	20.8	35.0	30.2	0.9	1.0
TT electronics	1.1	1.0	10.8	8.8	17.8	13.0	19.9	14.3	2.4	2.9
XP Power	4.3	4.1	18.2	16.9	23.6	21.4	28.1	25.7	1.4	2.0
Avon Rubber	4.2	3.9	18.4	16.4	22.9	20.9	30.9	28.2	0.9	1.1
Halma	6.8	6.3	28.0	25.3	33.4	29.5	42.0	37.1	0.8	0.8
Spectris	2.4	2.3	14.7	12.5	20.9	16.7	27.8	21.7	2.4	2.3
Spirax-Sarco Engineering	7.0	6.6	27.2	24.6	33.2	29.4	44.7	39.9	1.1	1.1
Average	3.8	3.6	18.9	16.7	24.5	20.8	31.8	27.3	1.5	1.7
Premium/(discount) to average	**(64.4)**	**(65.3)**	**(29.7)**	**(27.7)**	**(25.3)**	**(22.7)**	**(17.6)**	**(16.2)**	**13.6**	**6.6**

Source: Edison Investment Research, Refinitiv (as at 7 December).

Sensitivities

Our estimates and the discoverIE share price will be sensitive to the following factors:

- **Customer demand:** customer demand will be influenced by the economic environment in Europe and increasingly, the US and Asia Pacific. It will also be sensitive to the gain or loss of major customers, although in FY20 and H121 no customer made up more than 7% of sales.
- **Currency:** translational – with 87% of revenues in non-sterling currencies, discoverIE is exposed to the translation of euro, US dollar and Nordic-denominated subsidiary results into

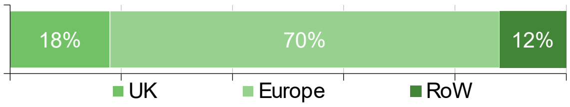
sterling, which reduced growth in sales by 2pp and underlying operating profit by 1.6pp in FY20. Transactional – discoverIE sells mainly in euros, US dollars, sterling and Nordic currencies, and purchases mainly in US dollars and euros. discoverIE hedges with forward contracts to the extent that the exposure cannot be passed to the customer.

- **Pricing:** discoverIE's revenues and profitability are sensitive to the company's ability to include within price quotes engineering time spent on designing customer solutions. The company aims to pass through supplier price increases and tariffs, with very few fixed-price contracts.
- **Acquisitions:** the company is likely to make further acquisitions, which could add integration risk and will require funding.
- **Defined benefit pension scheme**: the company has a pension deficit (£1.1m at the end of H121) relating to a defined benefit scheme that was closed to new entrants in 1999 and further service accruals in 2000. The company has increased the level of contributions since FY13 by 3% a year (FY20: £1.8m contribution) as part of the plan agreed with trustees to try to eliminate it.

Exhibit 10: Financial summary

£m	2015	2016	2017	2018	2019	2020	2021e	2022e
Year end 31 March	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS								
Revenue	271.1	287.7	338.2	387.9	438.9	466.4	445.7	486.5
Cost of Sales	(186.7)	(195.1)	(227.2)	(261.2)	(293.9)	(309.7)	(295.6)	(322.1)
Gross Profit	84.4	92.6	111.0	126.7	145.0	156.7	150.1	164.4
EBITDA	16.6	19.8	24.3	29.3	37.0	50.9	45.3	49.7
Operating Profit (before am, SBP and except.)	14.0	17.0	20.6	25.2	31.8	38.9	32.9	37.3
Operating Profit (before am. and except.)	13.4	16.3	20.0	24.5	30.6	37.1	31.3	35.5
Amortisation of acquired intangibles	(2.1)	(2.8)	(3.9)	(4.9)	(5.9)	(9.0)	(10.8)	(11.0)
Exceptionals	(5.2)	(2.1)	(8.4)	(2.3)	(2.0)	(4.3)	(2.4)	(3.6)
Share-based payments	(0.6)	(0.7)	(0.6)	(0.7)	(1.2)	(1.8)	(1.6)	(1.8)
Operating Profit	6.1	11.4	7.7	17.3	22.7	23.8	18.1	20.9
Net Interest	(1.6)	(1.8)	(2.8)	(2.6)	(3.4)	(4.3)	(4.6)	(5.0)
Profit Before Tax (norm)	12.4	15.2	17.8	22.6	28.4	34.6	28.3	32.4
Profit Before Tax (FRS 3)	4.3	9.4	4.8	14.6	19.3	19.5	13.4	15.9
Tax	(1.4)	(2.2)	(1.3)	(4.0)	(4.7)	(5.2)	(3.4)	(4.0)
Profit After Tax (norm)	10.0	11.8	13.6	17.1	21.5	27.6	21.2	24.3
Profit After Tax (FRS 3)	2.9	7.2	3.5	10.6	14.6	14.3	10.1	11.9
Ave. Number of Shares Outstanding (m)	57.6	63.3	65.4	70.8	73.0	84.0	89.1	89.5
EPS - normalised & diluted (p)	16.4	17.8	19.9	23.0	28.4	31.8	23.0	26.4
EPS - IFRS basic (p)	5.0	11.4	5.3	15.0	20.0	17.0	11.3	13.3
EPS - IFRS diluted (p)	4.8	10.9	5.1	14.2	19.4	16.5	10.9	12.9
Dividend per share (p)	7.6	8.1	8.5	9.0	9.6	3.0	10.4	10.7
Gross Margin (%)	31.1	32.2	32.8	32.7	33.0	33.6	33.7	33.8
EBITDA Margin (%)	6.1	6.9	7.2	7.6	8.4	10.9	10.2	10.2
Operating Margin (before am, SBP and except.) (%)	5.2	5.9	6.1	6.5	7.2	8.3	7.4	7.7
discoverIE adjusted operating margin (%)	4.9	5.7	5.9	6.3	7.0	8.0	7.0	7.3
BALANCE SHEET								
Fixed Assets	88.6	108.4	122.2	136.4	149.2	236.4	238.9	223.0
Intangible Assets	69.9	88.2	100.7	107.2	119.7	182.2	192.8	181.7
Tangible Assets	13.8	14.7	16.0	23.4	24.4	46.3	38.2	33.4
Deferred tax assets	4.9	5.5	5.5	5.8	5.1	7.9	7.9	7.9
Current Assets	127.3	128.3	147.1	165.9	179.1	197.4	189.1	198.8
Stocks	39.8	42.9	48.8	58.1	66.2	68.4	70.8	77.0
Debtors	60.2	65.5	77.3	84.6	88.7	90.1	89.1	97.3
Cash	26.7	19.9	21.0	21.9	22.9	36.8	27.1	22.4
Current Liabilities	(62.1)	(61.7)	(78.1)	(94.0)	(96.0)	(103.6)	(106.7)	(115.1)
Creditors	(61.9)	(60.9)	(77.1)	(87.6)	(94.3)	(94.0)	(97.1)	(105.5)
Lease liabilities	0.0	0.0	0.0	0.0	0.0	(5.3)	(5.3)	(5.3)
Short term borrowings	(0.2)	(0.8)	(1.0)	(6.4)	(1.7)	(4.3)	(4.3)	(4.3)
Long Term Liabilities	(61.1)	(73.1)	(68.7)	(81.5)	(97.6)	(129.7)	(114.4)	(95.7)
Long term borrowings	(45.5)	(57.2)	(50.0)	(67.9)	(84.5)	(93.8)	(88.8)	(83.8)
Lease liabilities	0.0	0.0	0.0	0.0	0.0	(14.7)	(8.1)	(1.5)
Other long term liabilities	(15.6)	(15.9)	(18.7)	(13.6)	(13.1)	(21.2)	(17.5)	(10.4)
Net Assets	92.7	101.9	122.5	126.8	134.7	200.5	206.9	211.1
CASH FLOW								
Operating Cash Flow	6.6	14.6	20.5	21.7	30.0	48.0	45.0	41.8
Net Interest	(1.6)	(1.8)	(2.8)	(2.6)	(3.4)	(3.7)	(4.6)	(5.0)
Tax	(3.3)	(4.3)	(3.0)	(3.7)	(3.8)	(6.4)	(7.1)	(8.1)
Capex	(2.5)	(2.3)	(3.4)	(4.3)	(5.4)	(6.3)	(4.0)	(7.5)
Acquisitions/disposals	(37.3)	(19.8)	(11.8)	(25.4)	(22.4)	(73.6)	(24.7)	(5.0)
Financing	52.7	0.0	13.6	(1.5)	0.1	53.9	(6.6)	(6.6)
Dividends	(3.6)	(4.9)	(5.2)	(6.2)	(6.7)	(8.1)	(2.8)	(9.3)
Net Cash Flow	11.0	(18.5)	7.9	(22.0)	(11.6)	3.8	(4.7)	0.3
Opening net cash/(debt)	1.8	(19.0)	(38.1)	(30.0)	(52.4)	(63.3)	(61.3)	(66.0)
HP finance leases initiated	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	(31.8)	(0.6)	0.2	(0.4)	0.7	(1.8)	(0.0)	(0.0)
Closing net cash/(debt)	(19.0)	(38.1)	(30.0)	(52.4)	(63.3)	(61.3)	(66.0)	(65.7)

Source: discoverIE, Edison Investment Research

Contact details	Revenue by geography
2 Chancellor Court, Occam Road, Surrey Research Park, Guildford GU2 7AH +44 (0)1483 544500 www.discoverieplc.co.uk	

Management team

CEO: Nick Jefferies	CFO: Simon Gibbins
Nick joined discoverIE as group chief executive in January 2009. He has held senior positions for over 15 years with leading international distributors of electronic components and computer products, such as Electrocomponents and Arrow Electronics. He originally trained as an electronics design engineer with Racal Defence (now part of Thales).	Simon was appointed as group finance director in July 2010. A chartered accountant, he was previously global head of finance and deputy CFO at Shire. Before joining Shire in 2000, he spent six years with ICI in various senior finance roles, both in the UK and overseas. His earlier career was spent with Coopers & Lybrand in London.
Chairman: Malcolm Diamond	
Malcolm was appointed as a non-executive director of discoverIE in November 2015 and became non-executive chairman in April 2017. He was previously non-executive chairman of Trifast and before that chief executive of Trifast. Other previous appointments include senior non-executive director of Dechra Pharmaceuticals and non-executive director of Unicorn AIM VCT.	

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