Avon Rubber

FY20 results

Focused on growth in critical personal protection

Aerospace & defence

FY20 has been a transformational year for Avon Rubber as it exited from dairy and recycled the proceeds into higher-return businesses with better growth prospects to further strengthen Avon Protection. The redeployment of capital to form a more focused group should enhance value creation for shareholders. The $91m acquisition of Helmets & Armor on 2 January 2020 was joined by Team Wendy from 2 November 2020. Overall, our FY21 EPS estimate falls by 2% in FY21, although this still represents strong growth. The reporting currency will switch to US$ in FY21 as more than 90% of revenues are of US origin.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
09/19	128.4	22.2	66.5	20.8	63.5	0.5
09/20	168.0	28.2	75.5	27.1	55.9	0.6
09/21e	262.7	48.8	127.2	35.2	33.2	0.8
09/22e	283.9	54.5	142.3	42.2	29.7	1.0

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles and exceptional items. FY19 restated for disposal of Dairy on 25 September 2020.

Strong US growth in FY20

The refocusing of the business onto Avon Protection delivered strong overall growth in the continuing activities largely due to the addition of the Helmets & Armor business following the asset purchase from 3M. The acquired activity delivered sales of £40.8m and an adjusted operating profit contribution of £5.1m as it started to benefit from the $5m of targeted synergies to be achieved by the end of FY21. Group organic growth was subdued at just 0.1% as overall sales rose 30.8% to £168m. Strong volume growth for US Military and First Responder customers, partly due to the pandemic, more than offset lower Rest of World Military sales and the £5m impact from exiting the Fire SCBA market. Adjusted EBITDA rose 35% to £38.4m (FY19: £28.4m), a margin increase of 80bp to 22.9%. Adjusted PBT rose by 27% and adjusted fully diluted EPS rose 14% to 75.5p. The dividend was increased 30% in line with the long-term policy targeting 2x cover.

Potential for acceleration in FY21

The group ended the year with net cash (excluding leases) of £116m, most of which has been deployed early in the current year to acquire Team Wendy. In addition to the initial 11-month consolidation of Team Wendy and a full-year contribution from Helmets & Armor, we expect underlying organic volume growth to be augmented by the ramp-up of volumes against long-term contracts. In particular, the Helmets & Armor business should see very strong incremental activity from body armour contracts signed in FY20. We expect the Military business to continue to grow as US contract volumes build and the international activity benefits from new long-term contracts. The opening order book has more than doubled to £79.8m.

Valuation: A premium rating for improving returns

Acquired growth is driving rapid EPS growth and the significant re-rating over the last two years. Strong cash flow needs to be invested for both organic growth and value-enhancing opportunities to maintain the premium to UK defence peers.

3 December 2020

Price	**4,220p**
Market cap	**£1,379m**

US$1.34/£1

Net cash* (£m) at 30 September 2020 *Excluding leases	116.0
Shares in issue	31.0m
Free float	98.8%
Code	AVON
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	6.3	9.8	112.7
Rel (local)	(7.3)	0.1	135.1
52-week high/low		4,625p	1,950p

Business description

Avon Rubber designs, develops and manufactures personal protection products for Military and First Responder markets including respiratory mask systems, helmets and body armour. Its main customers are national security agencies such as the US DOD and c 90% of sales are from the US.

Next events

AGM	29 January 2021
H121 results	18 May 2021

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Edison profile page

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US dollar reporting from FY21

We have chosen to present the note in sterling as we are reporting on FY20 and we feel that most expectations had been set in sterling terms.

However, as previously announced, Avon Rubber will report in US dollars from FY21. The vast majority of its activity originates in the US and is accounted for in US dollars, so this is a sensible presentational change and we have reflected the historic US$ performance of the business in the table below.

In the future consensus expectations will thus be set in US$ and, in order to transition our estimates for the new presentation currency, we adjust our sterling expectations to US$ in the table below alongside historical data provided by the company. We have assumed an exchange rate of $1.275/£ in line with the FY20 closing and average exchange rates in the financial statements.

Exhibit 1: Adjusted financial highlights in US$ and Edison estimates

Year to September ($m)	2019	2020	2021e	2022e
Revenues	**162.0**	**213.6**	**334.9**	**362.0**
EBITDA	**36.2**	**49.0**	**84.1**	**93.6**
Adjusted operating profit	28.8	38.5	65.3	73.6
Adjusted PBT	**28.3**	**36.0**	**62.2**	**69.5**
Adjusted net income	26.1	29.9	50.4	56.3
Adjusted EPS (US cents)	**85.6**	**97.6**	**164.4**	**183.9**
DPS (US cents)	26.6	34.5	44.9	53.9
Adjusted net cash (excluding leases)	**59.5**	**147.8**	**59.3**	**85.1**
Lease liabilities	-15.9	-29.0	-32.6	-29.8
Net financial assets/liabilities	43.6	118.7	26.7	55.2

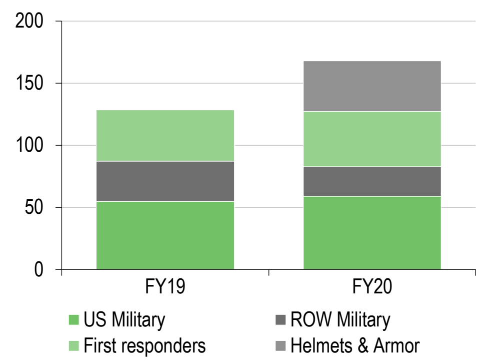
Source: Avon Rubber

FY20: A year of transformation and growth

FY20 was notable for the very successful exit from the Dairy business in late September, the proceeds from which largely covered the investment in the Helmets & Armor acquisition from 3M on 2 January 2020 and the $130m Team Wendy purchase on 2 November 2020.

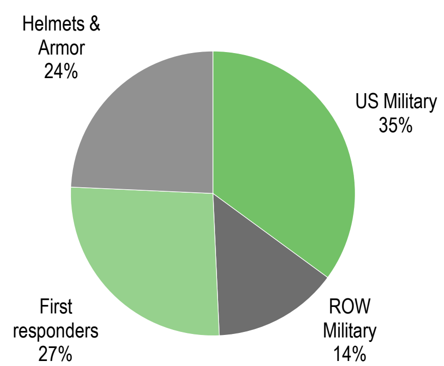
The trading performance for Avon Protection's activities during the year was strong in most areas, with clear momentum into the second half of the year for the continuing activities.

Exhibit 2: Avon Rubber FY20 revenue development by business area (£m)



Source: Company reports

Exhibit 3: FY20 revenue split of Avon Rubber by business area (FY20: £168m)



Source: Company reports

Group revenues rose 30.8% to £168.0m (FY19: £128.4m). Growth was primarily from the initial nine-month contribution from the Helmets & Armor acquisition (+31.7%), with a 1% FX headwind and organic growth of 0.1%. The organic development was below our expectation due to a sharp contraction in H220 Military mask systems sales to the rest of the world following strong deliveries in FY19 and before commencement of supply against new contracts. The larger US Military and First Responders revenue streams both exceeded our expectations with much stronger H220 momentum. The First Responders business grew 23%, adjusting for the exit from the Fire SCBA market, partially resulting from a favourable demand pull due to the COVID-19 pandemic in H220.

Other key highlights were:

- Orders received of £160.8m (FY19: £129.8m) rose 4.5% on an organic constant currency (OCC) basis and represented a book-to-bill ratio of 0.95x.
- The closing order book of £79.8m (FY19: £36.7m) more than doubled, reflecting the addition of Helmets & Armor backlog and +19.3% OCC growth.
- Adjusted EBITDA was 35% higher (+6.8% OCC) at £38.4m (FY19: £28.4m). The adjusted EBITDA margin rose once again, an 80bp increase to 22.9%, following a 150bp improvement in FY19. The improvement reflected a favourable product mix, from the new commercially priced M50 and M53A1 mask systems contracts for the DOD, as well as higher-margin First Responder sales.

Exhibit 4: Adjustments to operating profit

Adjustments	FY19	FY20
Amortisation of intangible assets	0.9	6.5
Cash costs related to acquisitions	2.9	11.9
Non-cash costs related to acquisitions		5.9
Pension equalisation charge	3.5	
Write down of Fire SBCA assets	5.4	
Total adjustments	**12.7**	**24.3**

Source: Company reports

- Adjusted operating profit increased by 33.6% (8.9% OCC) to £30.2m (FY19: £22.6m). The adjusted operating profit excluded exceptional and one-off items totalling £24.3m (FY19: £12.7m), of which £11.9m were cash costs (FY19: £6.4m), as shown in Exhibit 4. Including these charges, reported operating profit thus fell to £5.9m from £9.9m in FY19.
- Adjusted PBT was 27% higher at £28.2m (FY19: £22.2m), a 6.6% rise on an OCC basis
- The company continued with its dividend policy aimed at reducing cover in the medium term. The final dividend of 18.06p was again up 30.0%, in line with the full year increase for a total dividend per share for FY20 of 27.08p (FY19: 20.83p).
- Cash generation benefited from the timing of the shipment of the $16.6m RoW military mask systems contract, where payment was received in Q120. Operating cash flow for the continuing businesses before exceptional items rose to £32.6m from £18.4m in FY19. Cash conversion from adjusted EBITDA was 84.9% or 123.3% excluding Helmets & Armor. The company ended the year with adjusted net cash of £116.0m (FY19: £48.3m) excluding lease liabilities of £22.8m (FY19: £12.9m).
- The Dairy operation contributed a net trading profit of £5.4m, representing 17.7p of earnings per share, and the gain on disposal was £129.8m after tax or 424.5p per share. The operations contributed around £2.9m to cash flow prior to disposal and net proceeds from disposal of £165m.

Outlook

The acquisition of Team Wendy completed on 2 November 2020 will make an 11-month contribution in FY21. We estimate that this should add around $42m of revenue with an adjusted operating margin of 25%, helping to drive an overall adjusted operating margin increase at the group level of around 150bp.

Helmets & Armor should make a full year contribution, adding c £14m to FY20 revenues before organic growth. Management still expects to achieve the targeted $5m pa of synergies by the end of FY21.

Following the excellent number of long-term contract awards achieved in FY19, momentum continued in FY20, with a number of new wins underpinning the medium-term revenue outlook. These included:

- Medium-term contracts worth up to $177m secured to supply the US DOD with the M50 mask system, M61 filters, spare parts and accessories.
- A 10-year NATO Support & Procurement Agency contract to supply FM50 mask systems, powered and supplied air systems, filters, spare parts and accessories.
- $93m next-generation Integrated Head Protection System (IHPS) ballistic helmet sole-source contract secured with the US DOD.
- Next-generation Vital Torso Protection X-Side Ballistic Insert (VTP XSBI) body armour four-year, $265m dual-source contract secured with the US DOD.
- Three-year legacy Enhanced Small Arms Protective Inserts (ESAPI) body armour sole-source contract with a value of up to $333m secured with the US DOD.

With ongoing supply orders expected against the M53A1 and M69 long-term contracts for the DOD, initial deliveries under the 10-year NATO Support & Procurement Agency framework contract for M50 mask systems and a ramp-up in orders and deliveries of the UK's General Service Respirator (GSR) mask contract expected, Military segment activity is expected to deliver healthy organic growth in FY21.

The First Responders segment should also benefit from further growth in demand for both mask systems and replacements filters, accessories and spares in response to the pandemic, augmenting the strong opening order book of £5.5m.

Estimate revisions

The table below reflects the somewhat complex nature of the discontinuation of the dairy activity of milkrite | InterPuls and the augmentation of growth at Avon Protection through the two businesses acquired in calendar 2020. In addition, pension finance costs (FY21) are no longer included in adjustments. The overall result is a modest reduction to our FY21 PBT and EPS estimates.

Exhibit 5: Avon Rubber earnings revisions

Year to September (£m)	2020			2021e			2022e
	Prior (est)	Actual	*% change*	Prior	New	*% change*	New
Avon Protection	179.8	168.0	*-6.6%*	233.6	229.7	*-1.7%*	246.9
Team Wendy					33.0		37.1
milkrite I InterPuls	53.2	0.0	*-100.0%*	54.8	0.0	*-100.0%*	0.0
Total Sales	**233.0**	**168.0**	***-27.9%***	**288.4**	**262.7**	***-8.9%***	**284.0**
EBITDA	**50.2**	**40.5**	***-19.4%***	**65.1**	**65.9**	***1.2%***	**73.4**
Avon Protection	31.8	30.2	*-5.1%*	44.6	43.0	*-3.7%*	48.5
Team Wendy					8.3		9.3
milkrite I InterPuls	8.4	0.0	*-100.0%*	8.8	0.0	*-100.0%*	0.0
Unallocated	(2.9)	0.0	*-100.0%*	(3.0)	0	*-100.0%*	0
Adjusted EBITA	**37.3**	**30.2**	***-19.0%***	**50.4**	**51.2**	***1.5%***	**57.7**
Adjusted PBT	**35.4**	**28.2**	***-20.2%***	**49.2**	**48.8**	***-0.9%***	**54.5**
EPS - adjusted fully diluted (p)	**93.1**	**75.5**	***-18.9%***	**129.5**	**127.2**	***-1.8%***	**142.3**
DPS (p)	27.1	27.1	*0.0%*	35.2	35.2	*0.0%*	42.2
Net debt/(cash)	8.7	(116.0)	*n.m.*	(12.1)	(46.5)	*282.9%*	(66.7)

Source: Edison Investment Research estimates

Valuation

As can be seen from the peer group table below, Avon is trading at a significant premium to its UK defence peers following the refocusing in FY20. The value-creating acquisitions are driving strong growth and improving returns, but FY21 is more likely to see a period of bedding these in before further deals are pursued. The second pillar of the strategy, to invest in new product development at around 5% of sales to enhance organic growth rates, is clearly important and extending the international product sales should be another potential driver of growth. The continued successful reinvestment of strong operational cash flow to enhance value is a clear expectation of the current premium rating.

Exhibit 6: Peer comparison

	Price	Market cap	EV/EBITDA (x)		P/E (x)		Dividend yield (%)	
Company		**(local CCY m)**	**FY1e**	**FY2e**	**FY1e**	**FY2e**	**FY1e**	**FY2e**
Avon Rubber	4,625.0	1,424.8	22.2	20.7	36.9	33.7	0.8	1.0
BAE Systems	509.2	16,271.8	7.2	6.6	11.7	10.4	4.6	4.9
Chemring	255.0	714.5	11.0	10.4	18.1	17.3	1.5	1.7
Cohort	610.0	248.2	12.2	11.3	17.7	16.1	1.8	2.0
QinetiQ	299.2	1,706.1	9.0	8.6	15.2	14.4	2.9	2.4
Ultra Electronics	2,130.0	1,503.6	10.9	10.4	16.6	15.9	3.0	2.8
Average			**12.1**	**11.3**	**19.4**	**18.0**	**2.4**	**2.5**

Source: Refinitiv data as of 2 December 2020

Exhibit 7: Financial summary

£m	2019	2020e	2021e	2022e
Year end 30 September	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS				
Revenue	128.4	168.0	262.7	284.0
Cost of Sales	(78.6)	(100.2)	(160.8)	(173.8)
Gross Profit	49.8	67.8	101.9	110.1
EBITDA	28.4	38.4	65.9	73.4
Operating Profit (before amort. and except.)	25.9	33.3	56.8	63.9
Intangible Amortisation	(3.3)	(3.1)	(5.6)	(6.1)
Operating profit (company definition)	22.6	30.2	51.2	57.7
Exceptionals	(13.5)	(27.7)	(7.0)	(7.0)
Other	(0.5)	(0.1)	(1.8)	(1.8)
Operating Profit	8.6	2.4	42.5	49.0
Net Interest	0.1	(1.9)	(0.7)	(1.4)
Profit Before Tax (norm)	22.2	28.2	48.8	54.5
Profit Before Tax (FRS 3)	8.7	0.5	41.8	47.5
Tax	1.5	1.1	(7.9)	(9.0)
Profit After Tax (norm)	20.5	23.4	39.5	44.2
Profit After Tax (FRS 3)	10.2	1.6	33.8	38.5
Average Number of Shares Outstanding (m)	30.5	30.6	30.6	30.6
EPS - normalised (p)	67.1	76.5	129.0	144.3
EPS - normalised & fully diluted (p)	66.5	75.5	127.2	142.3
EPS - (IFRS) (p)	33.4	5.2	110.5	125.8
Dividend per share (p)	20.8	27.1	35.2	42.2
Gross Margin (%)	38.8	40.4	38.8	38.8
EBITDA Margin (%)	22.1	22.9	25.1	25.8
Operating Margin (before GW and except.) (%)	20.2	19.8	21.6	22.5
BALANCE SHEET				
Fixed Assets	65.9	121.9	200.2	198.4
Intangible Assets	35.3	70.2	124.6	125.7
Tangible Assets	22.9	31.5	52.6	51.9
Right of Use Asset	7.7	20.2	23.0	20.8
Investments	0.0	0.0	0.0	0.0
Current Assets	119.4	234.9	278.3	315.0
Stocks	20.7	28.5	45.0	49.1
Debtors	35.4	36.1	56.4	61.0
Cash	48.4	147.0	46.5	66.7
Other	14.9	23.3	23.3	23.3
Current Liabilities	(35.4)	(77.1)	(174.2)	(187.0)
Creditors	(35.3)	(46.1)	(67.2)	(72.1)
Short term borrowings	(0.1)	(31.0)	0.0	0.0
Long Term Liabilities	(74.7)	(99.6)	(102.2)	(99.7)
Long term borrowings	0.0	0.0	0.0	0.0
Lease Liabilities	(12.9)	(22.8)	(25.6)	(23.4)
Other long term liabilities	(61.8)	(76.8)	(76.6)	(76.3)
Net Assets	75.2	180.1	202.1	226.7
CASH FLOW				
Operating Cash Flow	6.9	(2.7)	69.3	64.0
Net Interest	0.0	(1.9)	(0.7)	(1.4)
Tax	1.5	1.1	(7.9)	(9.0)
Capex	(5.7)	(15.6)	(14.6)	(13.6)
Acquisitions/disposals	0.0	93.2	(105.4)	(7.2)
Financing	(1.3)	0.0	(1.0)	(1.0)
Dividends	(5.4)	(7.0)	(9.1)	(11.5)
Other	5.8	0.6	0.0	0.0
Net Cash Flow	1.8	67.7	(69.5)	20.2
Opening net debt/(cash)	(46.5)	(48.3)	(116.0)	(46.5)
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)	(48.3)	(116.0)	(46.5)	(66.7)
Total net financial liabilities/(assets)	(35.4)	(93.2)	(20.9)	(43.3)

Source: Company reports, Edison Investment Research estimates

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