EDISON

Technicolor

Interim results

An improving picture for H2

Media

Technicolor's H1 results were in line with management expectations and we have made only minor adjustments to underlying forecasts (numbers now reflect implementation of IFRS 16). Work on *The Lion King* contributed to a very busy H1 for Production Services, which also has a good H2 pipeline. Connected Home has market leadership in broadband gateway access and has made good progress with its cost saving plan. We expect working capital to swing back to the group's advantage in H2 and operating margins to start to rebuild. The share price has recovered from recent weakness but remains well below peer based and DCF valuations.

Year end	Revenue (€m)	PBT* (€m)	EPS* (€)	DPS (€)	EV/EBIT (x)	P/E (x)	Yield (%)
12/17	4,253	7	0.02	0.06	8.5	39.3	N/A
12/18	3,988	(3)	(0.01)	0.00	18.3	N/A	N/A
12/19e	3,846	(44)	(0.15)	0.00	12.3	N/A	N/A
12/20e	3,836	15	0.02	0.00	7.4	N/A	N/A

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

Mix effects in margins

Production Services had a good H1, with constant currency revenues up 10%, offset by DVD Services dipping 6% over prior year. In Connected Home, revenues down 7% reflect declining US video sales, partially compensated by good broadband growth. As anticipated in our recent initiation, underlying H119 EBITDA margins experienced some pressure in both segments, 7.0% from 7.2% in H118 in Entertainment Services and to 2.1% from 2.5% in H118 in Connected Home. Within Entertainment Services, this reflects the mix between Production Services, which performed better than we had anticipated in both revenue and margin, and DVD Services, where a reduction in volumes and a greater proportion of standard DVDs in the mix more than countered cost reductions. As referenced in Q1, delays in the sales of new products in Connected Home led to an inventory build-up and prevented the benefit of lower commodity costs feeding through to the sales mix.

Working capital set to improve in H2

As anticipated, working capital performance in H1 was more markedly negative than usual, resulting in a free cash outflow of €262m, compared to €137m in H118. This figure was swollen by the €83m tied up in the Connected Home inventories and by the timing of Production Services milestone payments, which reduced cash flow by €23m compared to prior year. Project timing is weighted to H2 in FY19. With Connected Home now having worked through all of the higher-cost inventory, we expect a strong working capital performance in H2 and hence stronger FCF.

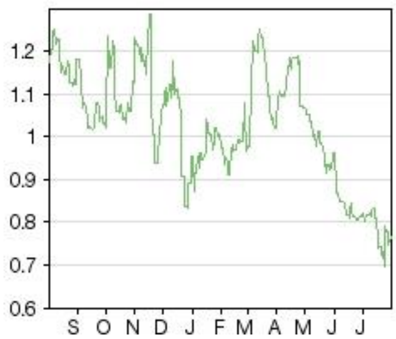
Valuation: Sum of the parts and DCF point to upside

On the same sum-of-the-parts basis as in our recent initiation, using averages of FY19e and FY20e EV/EBIT for Entertainment Services and EV/EBITDA for Connected Home, our base-level fair value of €1.42 is above the current price (up from €1.10, reflecting peer price rises and the positive impact of IFRS 16 on Connected Home). At a WACC of 8% and a terminal growth rate of 2%, our DCF indicates a value of €2.50 (vs €2.74).

1 August 2019

Price	**€0.76**
Market cap	**€314m**
	€0.90/US$
Net debt (€m) as at 30 June 2019	1,060
Shares in issue	413.4m
Free float	100%
Code	TCH
Primary exchange	Euronext
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	(5.7)	(28.1)	(35.9)
Rel (local)	(5.6)	(27.1)	(35.4)
52-week high/low		€1.29	€0.70

Business description

Technicolor is a worldwide technology leader operating in the media and entertainment industry. Its activities are organised in two business segments, Entertainment Services (the combined Production and DVD Services businesses) and Connected Home.

Next events

Q3 update	30 October 2019

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Better outlook for H2

The main changes to our forecast model relate to the implementation of IFRS 16. For H119, this increased the EBITDA (by €42m) and the depreciation (by €46m), decreasing the EBIT by €4m.

Exhibit 1: IFRS16 changes to EBITDA

	EBITDA Old (€m)	EBITDA New, pre IFRS16 (€m)	EBITDA New IFRS16 applied (€m)
FY19e	239	258	319
FY20e	295	301	363

Source: Edison Investment Research

The interest charge is also increased (more so in the short term, less as the leases mature) leaving us with a reduction in the adjusted PBT and earnings, as shown below.

Exhibit 2: Changes to forecasts

	EPS (€)			PBT (€m)			EBITA (€m)		
	Old	New	% chg.	Old	New	% chg.	Old	New	% chg.
2018	(0.01)	(0.01)	-	(3)	(3)	-	98	98	-
2019e	(0.05)	(0.14)	280	(30)	(44)	47	60	78	30
2020e	(0.01)	0.03	N/A	21	15	-29	111	116	5

Source: Company accounts, Edison Investment Research

The other significant impact is on the balance sheet, where net debt is inflated by the value of the operating leases, adding €75m to short-term debt and €239m to long-term debt. This visually obscures the improvement in free cash flow and net debt that we model for H219. Debt covenants are based on non-IFRS figures. Our model now shows year-end net debt of €1,060m. Less the operating lease element, this would be €746m, little changed from our previous estimate of €741m.

From negative free cash flow of €262m in H119, we anticipate an inflow in H219 as indicated by management, with the inventory position in Connected Home correcting and stage payments in Production Services being made. For the full year FY19, we now forecast a positive FCF of €13m, rising to €74m for FY20e.

As FY18 numbers have not been restated for IFRS 16, the segmental discussion below is based on non-IFRS numbers. This is more pertinent for Entertainment Services, where the bulk of the operating leases rest, lifting H119 adjusted EBITDA from €56m to €90m.

Connected Home (54% of H119 revenue)

H119 revenues were down 7.4% year-on-year at constant currency.

H119 adjusted EBITDA margin was down from 2.5% to 2.1% in H118 (on a non-IFRS basis).

The revenue decline was ‘in line with expectations’ and the mid-single-digit fall reported for Q1. Adjusted EBITDA fell to €20m, down €6m or 25% at constant currency, year-on-year. The trend described over the last year, namely declining video sales in the US (particularly Charter) partially compensated for by strong broadband growth, continued but in addition the company saw softness in the Latin American market (described as growing in Q1). As referenced in Q1, delays in the sales of new products saw a build-up in inventory and prevented the benefit of lower commodity costs feeding through to the sales mix.

The company remains confident about a strong recovery in profits and cash flow in H2. This is primarily due to the combination of falling commodity costs and the cost reduction plan (more than 70% of the €140m annual savings run-rate had been achieved by H1). With all excess inventory now burnt through, H2 sales will be higher gross margin and cash flow should improve. In addition, the headwind from declining US video sales should abate.

Our FY19 forecasts already factor in a modest abatement in the revenue decline and a strong recovery in profitability in H2, so our numbers are maintained. In the longer term, the company continues to make headway in securing market leading positions on growth platforms. It is now a clear market leader in broadband with a 21% share globally, it has a 40% market share on DOCSIS 3.1 and Android sales rose 33% year-on-year. As we referenced in our recent initiation, we see strength on these platforms as key to outperforming in a tough market over the long term.

Production Services (24% of H119 revenue)

H119 revenues were up 9.9% at constant currency.

Adjusted EBITDA ‘grew significantly’ (NB published segmental EBITDA is merged with DVD Services).

Recurring EBITA was down year-on-year, due to increased cloud rendering costs resulting from an exceptionally heavy delivery schedule. The business worked on visual special effects (VFX) for 25 film projects and 10 episodic streaming projects in the period, including Disney’s *The Lion King* (which we confirm is visually stunning).

The successful use of cloud-based rendering potentially gives the group options over managing the capacity constraints that would not necessitate capex on buildings and equipment. Additional technical people and artists are being recruited and trained and the costs of this are built into our forecasts.

The pipeline for film and episodic VFX is strong for H2. A new long-term production agreement with a major global streaming platform is also now in place, which supports the medium- to longer-term outlook. In animation, production on the new *SpongeBob* movie was delayed from H1 and a number of other projects will be coming through for features, episodic productions and games.

Technicolor is typically paid in staged payments, with down payments, then milestone payments through to a final payment on delivery. The timing of substantial projects can therefore make a considerable difference to the cash flow generated from the business. This was an issue for the group in H1, as flagged, which should correct in H2.

DVD Services (21% of H119 revenue)

H119 revenues were down 6.1% at constant currency.

By implication, adjusted EBITDA will have been well down, given that the combined EBITDA with Production Services was down 0.3%.

Volumes were down 11% on the prior period, but the mix was unfavourable, with a greater proportion of standard definition DVDs as the studios pushed more catalogue product in the absence of blockbusters and a generally weak start to the year in theatrical box office. Blu-Ray had tough comparatives and also suffered from weak box office in Q1. H2 looks better in this respect, with a number of releases likely which will show particularly well on Blu-Ray.

The good news from this segment is that the first contract extension with a major customer has been completed and will take effect in H219. Renegotiation of these contracts to volume and activity-based pricing is the crux of the investment case for this division, as described in our initiation. The major studios still make a lot of cash from physical product and there are very limited alternative options given the amount of capacity that has been taken out of the global market. Timing on improving divisional operating margins will depend on when agreement is reached.

Exhibit 3: Financial summary

€'m	2017	2018	2019e	2020e
Year end 31 December	IFRS	IFRS	IFRS	IFRS
INCOME STATEMENT				
Revenue	4,253	3,988	3,846	3,836
Cost of Sales	(3,651)	(3,521)	(3,396)	(3,350)
Gross Profit	602	467	450	486
EBITDA	341	266	319	363
Normalised operating profit	103	48	71	118
Amortisation of acquired intangibles	(9)	(81)	(59)	(59)
Exceptionals	(54)	(86)	(32)	0
Share-based payments	0	0	0	0
Reported operating profit	40	(119)	(20)	59
Net Interest	(96)	(51)	(115)	(103)
Joint ventures & associates (post tax)	0	0	0	0
Exceptionals	0	0	0	0
Profit Before Tax (norm)	7	(3)	(44)	15
Profit Before Tax (reported)	(56)	(170)	(135)	(44)
Reported tax	(112)	(54)	43	14
Profit After Tax (norm)	7	(3)	(60)	8
Profit After Tax (reported)	(168)	(224)	(92)	(30)
Minority interests	1	(1)	0	0
Discontinued operations	(5)	157	0	0
Net income (normalised)	8	(4)	(60)	8
Net income (reported)	(172)	(68)	(92)	(30)
Basic average number of shares outstanding (m)	413	413	414	414
EPS - normalised (c)	1.9	(1.0)	(14.6)	2.0
EPS - normalised fully diluted (c)	1.9	(1.0)	(14.6)	2.0
Dividend (c)	.06	0.00	0.00	0.00
Revenue growth (%)	(8)	(6)	(4)	()
Gross Margin (%)	14.2	11.7	11.7	12.7
EBITDA Margin (%)	8.0	6.7	8.3	9.5
Normalised Operating Margin (%)	2.4	1.2	1.8	3.1
BALANCE SHEET				
Fixed Assets	2,161	2,101	2,529	2,385
Intangible Assets	1,567	1,591	1,743	1,606
Tangible Assets	243	233	509	502
Investments & other	351	277	277	277
Current Assets	1,551	1,659	1,524	1,454
Stocks	238	268	264	250
Debtors	684	677	640	606
Cash & cash equivalents	319	291	198	175
Other	310	423	423	423
Current Liabilities	(1,669)	(1,909)	(1,943)	(1,958)
Creditors	(947)	(1,135)	(1,094)	(1,109)
Tax and social security	(33)	(34)	(34)	(34)
Short term borrowings	(20)	(20)	(95)	(95)
Other	(669)	(720)	(720)	(720)
Long Term Liabilities	(1,707)	(1,578)	(1,817)	(1,817)
Long term borrowings	(1,077)	(1,004)	(1,243)	(1,243)
Other long term liabilities	(630)	(574)	(574)	(574)
Net Assets	336	273	293	64
Minority interests	3	1	1	1
Shareholders' equity	339	274	294	65
CASH FLOW				
Op Cash Flow before WC and tax	269	92	143	157
Working capital	34	(12)	(13)	62
Exceptional & other	9	91	0	0
Tax	(13)	(14)	43	14
Net operating cash flow	299	157	173	233
Capex	(145)	(162)	(160)	(160)
Acquisitions/disposals	(25)	1	0	0
Net interest	(44)	(39)	(97)	(103)
Equity financing	1	0	0	0
Dividends	(25)	0	0	0
Other	(13)	28	0	0
Net Cash Flow	48	(15)	(84)	(30)
Opening net debt/(cash)	679	778	733	1,060
FX	(39)	1	5	0
Discontinued	(88)	105		
Other non-cash movements	(20)	(46)	(248)	0
Closing net debt/(cash)	778	733	1,060	1,090

Source: Company accounts, Edison Investment Research. Note: Historical numbers have not been restated for IFRS 16.

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