

Avon Rubber

Equipped for growth

Capital markets day

Aerospace & defence

15 March 2018

Price 1,210p
Market cap £380m

Net cash (£m) at 30 September 2017 24.7
Shares in issue 31.0m
Free float 96%
Code AVON
Primary exchange LSE
Secondary exchange N/A

Share price performance



%	1m	3m	12m
Abs	0.0	(1.1)	28.5
Rel (local)	0.5	2.6	30.4
52-week high/low	1,325p		909p

Business description

Avon Rubber designs, develops and manufactures products in the respiratory protection, defence (70% of 2017 sales) and dairy (30%) sectors. Its major contracts are with national security and safety organisations such as the DoD. 75% of sales are from the US and 25% are from Europe.

Next events

H118 results 2 May 2018

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Avon Rubber's Capital Markets Day highlighted the strength and depth of its product portfolio. Investment in both divisions has ensured that the company is able to address strong growth trends in its end-markets with attractive solutions. Avon Protection has received US regulatory approval for its Powered Air Purifying Respirator range, which should see further orders. Meanwhile, milkrite I InterPuls is offering solutions for productivity improvements to a dairy market increasingly open to technology.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
09/16	142.9	20.7	70.5	9.5	17.1	0.8
09/17	163.2	25.6	82.3	12.3	14.7	1.0
09/18e	163.2	26.4	74.5	16.0	16.2	1.3
09/19e	169.2	28.1	74.7	20.8	16.1	1.7

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

Avon Protection addressing future threats

Avon Protection has developed its product range to not only significantly widen its addressable market but also to increase the sophistication and unit price point of its products. Avon may be selling the same number of units as before to a customer, but the higher unit contribution has a positive multiplier effect. Avon aims to introduce customers to its products and presents them with the opportunity to move up the product suite as demands arise. This also involves working closely with some customers to develop the best solution, which was the case with the Powered Air Purifying Respirator range. After recent regulatory approval, the first US customer for the range is a large federal law enforcement agency, which was involved in the development of the technology. Avon anticipates further orders from US customers in the near future.

milkrite I InterPuls driving productivity

milkrite I InterPuls provides solutions to farmers to address the multiple issues of milk quality, environmental impact, farm efficiency and profitability. The market backdrop is supportive, with rising global consumption of dairy products. As little as 15 years ago, farmers had to be convinced of the benefits of technology, whereas today they are asking what solutions are on offer. The division is scheduled to spend £1.5m on product development this year to ensure they are at the forefront of this evolution.

Valuation: Strategy still supports premium

Our DCF valuation on a calculated WACC of 8.0% currently delivers a value of 1,297p. On 16.2x 2018e P/E, the stock is trading at a discount to its UK aerospace and defence peer group. However, the company's growth strategy, higher-than-industry-average profitability and building order book afford Avon Rubber the opportunity to deliver further medium-term upside earnings potential and hence justify a valuation premium, in our view.

Capital Markets Day

The London-based event started with an introductory presentation from CEO Paul McDonald. The four key objectives for the event were:

- clearly illustrate the market drivers for Avon Protection and milkrite I InterPuls
- demonstrate the importance of innovation to meeting customer needs
- showcase the breadth and added value within the product range
- establish the importance of technology in delivering Avon's strategic objectives

A presentation and product demonstration for each division then followed in smaller groups.

Avon Protection

The table below captures the breadth of the current Avon Protection military portfolio. The suite has developed considerably over the last decade, such that in 2008 the company only offered the M50, FM53 and ST53 products. Today's portfolio enables customers to be introduced via entry level products and in time move to more sophisticated options as appropriate. A visible benefit here is the step up in unit value, where Avon may be selling the same number of units as before to a customer but the higher unit contribution has a positive multiplier effect. The company's decision to invest in selective product development is bearing fruit while now addressing a significantly larger market. In addition, with 20- to 30-year product lifecycles, it is important to ensure the product economics from the outset.

Exhibit 1: Avon Protection military portfolio applications 2018

Applications	M50	FM53	ST53	M53A1	FM54	ST53SD	MCM100	MDC150	EZAIR	MP-PAPR	CS-PAPR	CS-ELITE
Military operations	X	X	X	X	X	X	X	X	X	X	X	X
Counter narcotics operations		X	X	X	X	X				X	X	X
Special operations		X	X	X	X	X	X	X		X	X	X
Law enforcement operations		X	X	X	X	X			X	X	X	
First responders		X	X	X		X	X	X	X	X	X	
Critical national infrastructure protection									X			
Other		X							X			

Source: Avon Rubber

An exciting recent development is approval from the National Institute for Occupational Safety and Health in North America of the Powered Air Purifying Respirator range. The first US customer here is a large federal law enforcement agency, which itself was involved in the development of the technology. Avon anticipates further orders from US customers in the near future.

The presentation included a discussion on 'future threats' by chemical weapons expert Hamish de Bretton-Gordon. Including recent events in Salisbury, UK, 2018 has already witnessed the most frequent use of chemical weapons since the First World War. De Bretton-Gordon is the chemical, biological, radiological and nuclear adviser to the UK Ministry of Defence and he believes that the current events will affect the UK for the next 10 to 15 years. This increased threat coincides with underinvestment in this area over recent years, leaving military and first responders unprepared. Both the London Fire Brigade Commissioner Dany Cotton and the UK security minister Ben Wallace have stated publicly that a chemical weapon attack on London and the UK, respectively, is a significant and real concern to them. With personnel protection paramount, it is clear that Avon has the optimal portfolio to address the current threat.

milkrite I InterPuls

The milkrite I InterPuls presentation and product demonstration was focused on the dairy farm of the future, addressing the multiple issues of milk quality, environmental impact, farm efficiency and profitability. The market backdrop is supportive, with global consumption of dairy products expected to increase by 25% between 2015 and 2024. Milk production has been steadily growing at 2.3% on average every year since 2000 and the industry employs around 750 million people globally.

milkrite I InterPuls believes that driving operating efficiency with technology is the answer. So, it is less the Internet of Things, and rather the Internet of Cows. Milking cows within the most efficient time window is increasingly important, avoiding the estimated loss of £5 per day that occurs 300 days after calving. Tagging, tracking and monitoring cows permits a number of activities and actions to be monitored. Injured or ill cows can be quickly identified and separated for treatment. Feeding patterns can be analysed in addition to the optimal time for insemination, which is central to milking efficiency and profitability.

milkrite I InterPuls delivers solutions to farming customers, and its customers can be its best advertisement. We were shown an example of a Russian farmer who visited a farm in Italy that was using a milkrite I InterPuls system. Adopting a similar system at his own farm drove production up by 25% in just 12 months.

milkrite I InterPuls offers solutions with world-class products of its own in liners and pulsation equipment. This gives a strong installed base from which to leverage. In addition, we had greater detail on the leasing approach (Exchange) offered to farmers to reduce the time they have to change liners but also improve the regularity of changes. Typically, farmers will leave liners unchanged for longer than is advised, increasing the chance of damage and subsequent infection.

Overall, the market dynamic is changing in milkrite I InterPuls' favour. As little as 15 years ago, farmers had to be convinced of the benefits of technology, whereas today they are asking what solutions are on offer. The division is scheduled to spend £1.5m on product development this year to ensure they are at the forefront of this evolution.

Exhibit 2: Financial summary

	£000s	2016	2017	2018e	2019e
Year end 30 September		IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue		142,884	163,200	163,226	169,153
Cost of Sales		(90,159)	(101,500)	(101,516)	(105,202)
Gross Profit		52,725	61,700	61,710	63,950
EBITDA		29,922	36,000	36,270	38,064
Operating Profit (before amort. and except.)		24,031	30,000	30,024	31,819
Intangible Amortisation		(3,154)	(4,200)	(3,372)	(3,300)
Exceptionals		(4,808)	(7,100)	(4,002)	(4,004)
Other		(33)	(35)	(36)	(38)
Operating Profit		16,036	18,665	22,613	24,476
Net Interest		(154)	(200)	(171)	(406)
Profit Before Tax (norm)		20,690	25,565	26,444	28,073
Profit Before Tax (FRS 3)		15,882	18,465	22,443	24,070
Tax		1,824	2,900	(3,147)	(4,581)
Profit After Tax (norm)		21,765	25,200	22,742	22,739
Profit After Tax (FRS 3)		17,706	21,365	19,296	19,489
Average Number of Shares Outstanding (m)		30.3	30.4	30.3	30.2
EPS - normalised (p)		70.5	82.3	74.5	74.7
EPS - (IFRS) (p)		58.5	70.2	63.6	64.5
Dividend per share (p)		9.5	12.3	16.0	20.8
Gross Margin (%)		36.9	37.8	37.8	37.8
EBITDA Margin (%)		20.9	22.1	22.2	22.5
Operating Margin (before GW and except.) (%)		16.8	18.4	18.4	18.8
BALANCE SHEET					
Fixed Assets		77,469	66,700	63,087	56,557
Intangible Assets		47,357	40,400	36,928	33,634
Tangible Assets		30,112	26,300	26,158	22,924
Investments		0	0	0	0
Current Assets		52,886	80,500	97,015	120,907
Stocks		20,648	21,800	22,022	23,049
Debtors		19,968	23,800	23,804	24,668
Cash		4,495	26,500	42,990	64,990
Other		7,775	8,400	8,200	8,200
Current Liabilities		(36,641)	(39,000)	(38,466)	(43,652)
Creditors		(34,142)	(37,200)	(36,905)	(37,936)
Short term borrowings		(2,499)	(1,800)	(1,561)	(5,716)
Long Term Liabilities		(51,713)	(52,600)	(52,558)	(52,516)
Long term borrowings		0	0	0	0
Other long term liabilities		(51,713)	(52,600)	(52,558)	(52,516)
Net Assets		42,001	55,600	69,078	81,296
CASH FLOW					
Operating Cash Flow		30,504	29,754	34,199	34,952
Net Interest		(147)	(154)	(200)	(171)
Tax		(17)	2,900	(3,147)	(4,581)
Capex		(6,838)	(5,500)	(9,005)	(6,017)
Acquisitions/disposals		(3,300)	0	0	0
Financing		(1,812)	(1,000)	(1,000)	(1,000)
Dividends		(2,430)	(3,200)	(4,118)	(5,339)
Other		(803)	(96)	0	0
Net Cash Flow		15,157	22,704	16,729	17,845
Opening net debt/(cash)		13,161	(1,996)	(24,700)	(41,429)
HP finance leases initiated		0	0	0	0
Other		0	0	0	(0)
Closing net debt/(cash)		(1,996)	(24,700)	(41,429)	(59,274)

Source: Avon Rubber accounts, Edison Investment Research

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