EDISON

discoverIE Group

FY19 results

Growth strategy drives strong FY19 results

Electronic & electrical equipment

discoverIE generated another year of strong organic growth, which combined with recent design and manufacturing (D&M) acquisitions, helped expand operating margins and grow underlying EPS by 22%. The company entered FY20 with a strong order book and in line with its growth strategy we expect further higher margin D&M acquisitions which could boost EPS growth to the 15–20% rate it has seen in recent years.

Year end	Revenue (£m)	PBT* (£m)	Dil. EPS* (p)	DPS (p)	P/E (x)	Yield (%)
03/18	387.9	22.6	23.0	9.0	18.5	2.1
03/19	438.9	28.4	28.4	9.6	14.9	2.2
03/20e	465.8	32.1	29.1	10.0	14.6	2.4
03/21e	479.2	33.2	30.0	10.4	14.2	2.4

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

Strong progress against all KPIs in FY19

At constant exchange rates (CER) discoverIE reported strong organic revenue growth (+8%) in FY19 with a further 6% growth from acquisitions. Underlying operating profit and normalised EPS were both ahead of our forecasts, which we had upgraded in April to reflect strong trading. Underlying operating margin was 0.7pp higher at 7.0%, helped by Custom Supply hitting its 5% margin target, and underlying EPS grew 22% y-o-y. The full year dividend of 9.55p (+6% y-o-y) was ahead of our 9.50p forecast. Revenues from cross-selling hit target a year early and all other KPIs made good progress towards medium-term targets.

Market focus drives growth in value of design wins

The company started FY20 with a strong order book (+12% y-o-y on an organic basis) and saw a 40% increase in the lifetime value of design wins during FY19. Its focus on higher growth markets should help it to achieve organic revenue growth ahead of GDP growth and management continues to consolidate the fragmented custom electronics market. We have revised our estimates to reflect strong Custom Supply margins and lower finance costs with FY20 normalised EPS lifted by 4.5%. Our revenue forecasts already include a more cautious approach to growth in FY20/21, taking into account uncertainty in the global economy.

Valuation: D&M strategy key to earnings growth

While the share price is down marginally over the last 12 months, the discount to peers has widened; discoverIE now trades at a c 15% discount to its peer group on a P/E basis. Further progress in increasing the weighting of business towards D&M, combined with maintaining the profitability of the CS business should help to reduce the discount. As discoverIE increases the proportion of revenues generated from D&M we would expect to see meaningful increases in operating margins, which should flow through to the earnings level, and we expect it to make further accretive D&M acquisitions to accelerate revenue and earnings growth. The stock is supported by a dividend yield above 2%.

26 June 2019

Price	**425p**
Market cap	**£343m**
	€1.12:NOK11.0:£1
Net debt (£m) at end FY19	63.3
Shares in issue	80.7m
Free float	96%
Code	DSCV
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	(1.2)	6.0	(3.2)
Rel (local)	(2.8)	2.6	(0.9)
52-week high/low		462p	325p

Business description

discoverIE is a leading international designer and manufacturer of customised electronics to industry, supplying customer-specific electronic products and solutions to 25,000 industrial manufacturers.

Next events

AGM	25 July 2019

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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. The company intends to continue to grow organically and via acquisition while maintaining its focus on higher-margin business.

Financials: Strong organic growth

discoverIE reported revenue growth of 13% for FY19, with 8% growth on an organic, constant currency basis. Underlying operating profit grew 25% y-o-y with a 0.7pp increase in operating margin to 7.0% and underlying EPS increased 22% y-o-y. The company closed the year with a net debt position of £63.3m, 5% below our forecast due to better than expected working capital management. Our revenue forecasts are substantially unchanged but we increase our Custom Supply operating margins and reduce net finance costs, resulting in a 5.4% upgrade to FY20e normalised EPS. We forecast net debt/EBITDA of 1.2x by the end of FY20.

Exhibit 1: Changes to estimates

	EPS (p)			PBT (£m)			EBITDA (£m)		
	Old	New	% chg.	Old	New	% chg.	Old	New	% chg.
2019	26.9	28.4	5.8	27.0	28.4	5.0	35.8	37.0	3.4
2020e	27.6	29.1	5.4	30.6	32.1	4.7	39.7	41.2	3.8
2021e	N/A	30.0	N/A	N/A	33.2	N/A	N/A	42.4	N/A

Source: discoverIE, Edison Investment Research

Valuation: D&M strategy key to earnings growth

The stock declined from June 2018 until the end of November 2018, when the company reported strong interims. It has substantially recovered over the course of 2019 and is down c 3% over the last 12 months. The discount to peers has widened since we last wrote and discoverIE now trades at a c 15% discount to its peer group on a P/E basis. Further progress in increasing the weighting of business towards D&M, combined with maintaining the profitability of the CS business should help to close the discount. As discoverIE increases the proportion of revenues generated from D&M we would expect to see meaningful increases in operating margins, which should flow through to the earnings level, and we expect the company to make further accretive D&M acquisitions to accelerate revenue and earnings growth. The stock is supported by a dividend yield above 2%.

Sensitivities: Economy, currency, pricing, 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 80% of revenues generated in currencies other than sterling, discoverIE is exposed to the translation of euro and Nordic-denominated subsidiary results into sterling, which had a small negative effect on sales and profits in FY19. **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 may make further acquisitions, which could add integration risk and will require 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 product, resulting in higher profitability. The company intends to continue to grow organically and via acquisitions while maintaining the focus on higher-margin design & manufacturing 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, North America and South Africa. The company has made a series of acquisitions since 2009 – we provide further detail on page 6. discoverIE operates through two divisions: Design & Manufacturing (D&M: 61% of FY19 revenues) and Custom Supply (CS: 39% of FY19 revenues), with 4,400 employees across 23 countries.

Group strategy

Over the five years from FY13 to FY18, discoverIE more than doubled revenues and underlying EPS and increased underlying operating profit by more than four times. Over the same period, the share price saw a CAGR of 19% and the dividend a CAGR of 7.6%. Management is targeting a further doubling in underlying EPS from FY18 to FY23 (equivalent to a CAGR of 14.9%; the company grew FY19 EPS by 22%), along with a progressive dividend.

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 higher-margin D&M business.
- **Acquire businesses** with attractive growth prospects and strong operating margins.
- **Further internationalise the business** by developing sales in North America and Asia.

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. The company has also highlighted its priorities for the year ahead to generate earnings growth:

- drive organic revenue growth, including high quality design wins in target markets and continued emphasis on cross-selling;
- develop new and expanded production facilities;
- integrate the Hobart and Positek acquisitions, including driving organic growth, integrating into Noratel and Variohm respectively, and establishing cross-selling;
- improve underlying operating margins through further growth in the D&M contribution to the group, ongoing efficiency initiatives, operational gearing benefits and continued investment in commercial and manufacturing infrastructure; and
- make further value-enhancing acquisitions.

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 –

bio on page 14) and Simon Gibbins (CFO since 2010 – bio on page 14). The board is chaired by Malcolm Diamond, who is also non-executive chairman of Trifast (where he was CEO from 1984–2002) and Flowtech Fluidpower. Non-executive directors include Bruce Thompson (ex-Diploma CEO 1996–2018), Tracy Graham (also NED at Royal London, Ibstock and Link Scheme) and Clive Watson (ex-group FD of Spectris 2006–2019).

Technical expertise adds value to specialist product range

discoverIE specialises in supplying technically demanding, bespoke electronics for industrial applications and has c 25,000 customers over a wide range of end 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 multiple technology areas and expects to continue its active role in consolidating this fragmented market.

Mainly through acquisitions, discoverIE has built up its **D&M** capability in four of the company's five technology areas (see Exhibit 2). From this division, discoverIE supplies custom electronic products either designed uniquely or modified from an existing product. More than 80% of products are manufactured in house (with principal facilities in China, India, Mexico, the Netherlands, Poland, Slovakia, Sri Lanka and Thailand) with the remainder manufactured by third-party contractors. Increasingly, these products are also distributed through Acal BFi.

The main business in **CS** is Acal BFi, a specialist electronics supplier that 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. The products that the company supplies are often technically complex and therefore require more technical sales support, which discoverIE is able to provide (this is not always available from the product manufacturer or smaller local distributors). discoverIE solutions range from the recommendation and supply of a part, modification of an existing product, or full design and development of a custom solution. A significant proportion of sales comes from products that are either uniquely created for one customer and/or exclusively sourced.

Acal BFi supplies products from a selected group of manufacturers (including the D&M division), across five technology areas to more than 20,000 industrial customers (see Exhibit 2). It operates across Europe, with centralised warehousing, purchasing, finance, customer contact management and IT systems.

Exhibit 2: Product range by technology

Product area	Key products	Design and manufacture businesses
Power and magnetics	Standard and customisable power designs, magnetic components, electromagnetic and thermal interface.	Flux, Myrra, Noratel, Plitron, RSG, Santon, Hobart
Communication and sensors	RF components, fibre optic components, frequency control, wireless modules and systems, sensors and transducers, sensor assemblies, rotary signal transmitters.	Foss, Variohm, Positek
Electromechanical	Cabling and assemblies, human interface components, military connectors, gaskets, EMC connector seals, springs, shields.	Contour, MTC, Stortech, Cursor Controls
Microsystems and displays	Single board computers, server modules, system assemblies.	Hectronic
Imaging and photonics	Infrared thermal imaging, radar, visible cameras, modules and software, lasers and diodes, optical-mechanics, optics, test and measurement.	

Source: discoverIE

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.

Strategic progress update

Exhibit 3 summarises the steady progress discoverIE is making against its KSIs. We discuss below how the company is meeting its strategic objectives.

Exhibit 3: KSIs

	FY15	FY16	FY17	FY18	FY19	Mid-term target*	Long-term ambition
Increase D&M revenue	37%	48%	52%	57%	61%	75%	85%
Increase underlying operating margin	4.9%	5.7%	5.9%	6.3%	7.0%	8.5%	10%
Build sales beyond Europe	12%	17%	19%	19%	21%	30%	40%

Source: discoverIE. Note: *Three to five years from November 2016.

Moving up the electronics value chain

discoverIE started life as a pure distributor of electronic components, but through a strategy of specialisation and acquisition has transitioned to become a provider of customised electronic solutions. Over the last eight years, the company has acquired 14 businesses with design and manufacturing capabilities – these are significantly more profitable than the CS business. Consequently, while the **D&M** division generated 61% of FY19 revenues, it generated 78% of FY19 profits. In the **CS** division, discoverIE is focused on selling highly differentiated customised products. With D&M operating margins of 11.2% in FY19 compared to 5.0% for CS, as the company makes more D&M acquisitions group operating margins should continue to expand.

Grow sales organically and well ahead of GDP

The company takes a two-pronged approach to growing its revenues ahead of GDP on an organic basis by:

- targeting markets that are growing faster than GDP; and
- promoting cross-selling within Acal BFi and across the rest of the group.

Targeting high-growth markets

The World Bank recently revised down is global GDP forecasts and is now expecting growth of 2.6% in 2019, 2.7% in 2020 and 2.8% in 2021 (1.7%, 1.5% and 1.5%, respectively for advanced economies). To generate growth ahead of GDP, the company is targeting end markets that look set to benefit from population growth and long-term technology and electronics trends. In FY19, the business generated 66% of its revenues from these four areas, up from 56% in FY18 and 53% in FY17:

- **Transportation:** this includes road, rail and air travel. For example, the growth in electric vehicles is increasing demand for electronics. As automotive manufacturers work towards creating autonomous vehicles, the technology and electronics content of cars will increase even further. Likewise the growth in public transport and associated safety requirements is giving rise to huge technological innovation.

- **Medical:** with an ageing population and growing levels of comorbidity, healthcare spending continues to rise, with increasing amounts of technology used in diagnosing, monitoring and controlling medical conditions.
- **Renewable energy:** the International Energy Agency forecasts that renewable energy will generate 40% of global power requirements by 2040, up from 25% now, and renewables will make up two-thirds of global capacity additions between now and then. Through its Scandinavian acquisitions, discoverIE already has several wind turbine customers and the Santon acquisition brought solar industry customers.
- **Industrial and connectivity:** growth in device-to-device wireless connectivity (the internet of things) is driving demand for electronics for industrial applications such as smart meters, remote asset management and predictive maintenance.

Cross-selling reached annual sales target a year early

Each of discoverIE's five technology groups has a team of specialist sales and support engineers and their role is to identify customer opportunities. The company has initiatives in place to increase the level of cross-selling to existing customers, with a particular focus on selling D&M products between group companies. When a new company joins the discoverIE group, it can take around three years for cross-selling to become established. Cross-selling generated sales worth £10.6m in FY19 (FY18: £8.8m), ahead of the company's target of £10m by FY20. The company has therefore increased the target for FY20 to £12m.

Acquisitions core to growth strategy

Exhibit 4: Acquisition timeline

Company	Date	Product areas	Operations	Sales	Cost (£m)
BFi Optilas	Dec 09	Speciality components, communication, photonic, imaging	Germany, France, UK, Spain, Italy, Sweden, Netherlands	Europe	13.4
CompoTRON	Jan 11	Electronic communications and fibre-optic components	Germany, UK, Denmark	Europe	7.1
Hectronic	Jun 11	Embedded computing	Sweden	Nordic region	1.2
MTC	Oct 11	Electro-magnetic shielding (own brand/manufacture)	Germany, South Korea	Europe and Asia	2.7
Myrra SAS	Apr 13	Transformers, coils, cores and inductors (own brand/manufacture)	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	UK, Ireland	UK, Ireland	1.7
RSG	Nov 13	Custom power solutions	Germany	Germany	2.7
Noratel	Jul 14	Low-, medium- and high-power transformers and inductors (own brand/manufacture)	Nordic region, China, US, India, Poland, Sri Lanka	Europe, Asia, North America	73.5
Foss	Jan 15	Customised fibre-optic solutions	Norway, Slovakia	Norway, Eastern Europe	12
Flux	Nov 15	Customised magnetic components	Denmark, Thailand	Denmark	4
Contour	Jan 16	Custom cable assemblies and connectors	UK	UK	17.5
Plitron	Feb 16	Custom toroidal transformers	Canada	North America	1.8
Variohm	Jan 17	Electronic sensors, switches and motion measurement systems	UK, Germany	UK, France, Germany, US	13.3
Santon	Feb 18	DC and AC switches and switchgear	Netherlands, UK	Europe, Asia	23.7
Cursor Controls Group	Oct 18	Human-to-machine interface technology	UK	UK, Europe, N. America, Asia	19.0
Hobart	Apr 19	Customised transformers, inductors, magnetics	US, Mexico	N. America	11.7
Positek	Apr 19	Sensors	UK	UK, Europe, N. America, Asia Pacific	4.2
Total					**219.5**

Source: discoverIE

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 above), the largest of which was Noratel for £73.5m in 2014, most with design and manufacturing capabilities.

Criteria for acquisition targets

discoverIE's focus for future acquisitions is to target 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 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. The acquisitions made post the year end are being managed in this way: Hobart reports into Noratel and Positek into Variohm.

The benefits of being part of the larger discoverIE group include:

- access to the wider discoverIE customer base and cross-selling initiatives;
- support for management development and succession planning;
- capital investment in manufacturing capacity and infrastructure;
- discoverIE's strong balance sheet;
- support for product development;
- efficiency improvements through access to the group's purchasing scale, processes, warehousing and freight; and
- centralised finance and administrative support.

D&M acquisition track record

The company has analysed the 14 D&M acquisitions it has made over the last eight years, excluding those it has not owned for more than two years (ie Santon, Cursor Controls, Hobart and Positek). Of the 10 businesses, seven have generated a return on investment (ROI[1]) well above discoverIE's target of 15% (range 24–115%) and nine were above the company's WACC of 9%. On average, the whole group is generating an ROI above the target: 20% versus 17% in FY18. The company is taking action to improve the performance of the small business that is generating returns below the company WACC.

Exhibit 5: discoverIE D&M acquisition track record

Measure	Result
FY19 ROI	20%
Target ROI within two years of acquisition	15%
WACC	9%
Number generating above target ROI/WACC	7/9
Number generating below target ROI/WACC	3/1

Source: discoverIE

Further acquisitions expected

Acquisitions remain a key part of the group strategy, with management considering two types: 'platform' to create a new position in a technology and/or geography; and 'bolt-on' to expand the

1 ROI: measured as current year operating profit divided by acquisition costs (upfront cost plus confirmed earn-outs, expenses and integration costs).

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 ie companies with design and manufacturing capabilities in any of the group's five technology areas, located in Europe, North America or Asia.

The company's target for 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.

At the end of FY19, the company had a net debt position of £63.3m. Its gearing of 1.7x EBITDA was well within the target range of 1.5–2.0x and helped by the £28m fundraising in April, we forecast it to fall to 1.2x by the end of FY20. In February, the company increased its syndicated banking facility from £120m to £180m and extended the remaining term by two years to the end of June 2023. It has an option to extend this by a further year. The facility can be used for acquisitions and working capital. We estimate that the company has debt headroom of £25–30m, based on a maximum of 2x our FY20 EBITDA forecast and the end-FY20e net debt position.

Develop sales internationally

In FY19, 21% of sales were generated outside of Europe, up from19% in FY18. discoverIE's strategy is to support existing customers' businesses outside Europe and to make further acquisitions that expand the group's geographical coverage. Recent acquisitions have targeted companies with sales in North America and Asia Pacific. The two acquisitions made post year-end add international revenues of c £10m on an annualised basis.

Financials

Review of FY19 results

Exhibit 6: FY19 results highlights

£m	FY18	FY19e	FY19	% diff	% y-o-y
Revenues	**387.9**	**438.5**	**438.9**	**0.1%**	**13.1%**
Custom supply	165.3	171.9	172.7	0.4%	4.5%
Design & manufacturing	222.6	266.5	266.2	(0.1%)	19.6%
Gross margin	32.7%	33.0%	33.0%	0.0%	0.4%
EBITDA	29.3	35.8	37.0	3.4%	26.3%
EBITDA margin	*7.6%*	*8.2%*	*8.4%*	*0.3%*	*0.9%*
Underlying* operating profit	**24.5**	**29.9**	**30.6**	**2.2%**	**24.9%**
Underlying operating profit margin	*6.3%*	*6.8%*	*7.0%*	*0.1%*	*0.7%*
Normalised operating profit**	**25.2**	**30.9**	**31.8**	**2.8%**	**26.2%**
Normalised operating margin	*6.5%*	*7.1%*	*7.2%*	*0.2%*	*0.7%*
Normalised PBT	22.6	27.0	28.4	5.0%	25.7%
Normalised net income	17.1	20.3	21.5	5.7%	25.2%
Underlying diluted EPS (p)	**22.3**	**N/A**	**27.2**	**N/A**	**22.0%**
Normalised diluted EPS (p)	**23.0**	**26.9**	**28.4**	**5.8%**	**23.7%**
Reported basic EPS (p)	15.0	15.6	20.0	28.4%	33.6%
Net (debt)/cash	**(52.4)**	**(66.7)**	**(63.3)**	**(5.1%)**	**20.8%**
Net debt/EBITDA (x)	1.5	1.8	1.7		

Source: discoverIE, Edison Investment Research. Note: *Excludes exceptional items and amortisation of acquired intangibles. **As for underlying and also excludes share-based payments.

Exhibit 7: Divisional performance

£m	FY19	FY18	FY18 CER	Reported y-o-y	CER y-o-y	Organic CER y-o-y
Revenues						
Design & manufacturing	266.2	222.6	219.8	20%	21%	10%
Custom distribution	172.7	165.3	164.2	4%	5%	5%
Total revenues	**438.9**	**387.9**	**384.0**	**13%**	**14%**	**8%**
Underlying operating profit						
Design & manufacturing	29.8	24.2	23.9	23%	25%	
Custom distribution	8.6	7.5	7.5	15%	15%	
Unallocated	(7.8)	(7.2)	(7.2)	8%	8%	
Total operating profit	**30.6**	**24.5**	**24.2**	**25%**	**26%**	
Underlying operating margin (%)						
Design & manufacturing	11.2%	10.9%	10.9%	0.3%	0.3%	
Custom distribution	5.0%	4.5%	4.6%	0.4%	0.4%	
Total operating margin (%)	**7.0%**	**6.3%**	**6.3%**	**0.7%**	**0.7%**	

Source: discoverIE

discoverIE reported revenues in line with our forecast and underlying/normalised operating profit ahead of our forecast. The group underlying operating margin increased from 6.3% in FY18 to 7.0% in FY19, helped by strong organic growth and the contribution from higher-margin acquisitions. Net interest expense and tax was lower than forecast, resulting in normalised diluted EPS 5.8% ahead of our forecast. The company announced a full year dividend of 9.55p (+6% y-o-y), slightly ahead of our 9.50p forecast. It will review the level of future dividend growth with a view to achieving dividend cover of 3x underlying EPS in the long term (FY19 2.8x).

Exceptional costs totalled £2.0m for FY19, with £1.3m costs incurred for acquisitions, £0.9m to equalise benefits under Guaranteed Minimum Pensions, £0.5m in contingent consideration, £0.4m for IAS 19 pension charges and a credit of £1.1m relating to the insurance payout for the fraud previously disclosed at interims (£2.6m inflow from insurance offset by £1.5m fraud costs incurred in the year).

discoverIE closed the year with net debt of £63.3m, 5% below our forecast. Cash flows benefited from lower than forecast working capital consumption, interest and tax payments, in part offset by slightly higher capex.

Both divisions saw organic growth, with D&M exhibiting strong growth of 10% and CS also benefiting from strong demand in FY19 generating organic growth of 5%. D&M increased underlying operating margins by 0.3pp to 11.2% and CS by 0.4pp, hitting its mid-term target margin of 5%. The company noted that if Santon had not suffered from weak solar demand earlier in the year, the D&M margin would have been above 12% for the year (demand improved in H2). In particular, CS saw good demand from Germany, Italy and the Netherlands.

Making good progress versus KPIs

discoverIE's performance in FY19 was strong across all KPIs and the cross-selling target has now been increased after the company hit its original target a year early. Operating cash flow improved compared to FY18 – despite building inventory to cope with the possibility of Brexit, working capital consumed less cash than we forecast in FY19. We note that the D&M business requires more working capital than CS, so as the D&M side of the business grows faster, both organically and via acquisition, this puts pressure on the cash flow.

Exhibit 8: KPIs

	FY15	FY16	FY17	FY18	FY19	Mid-term target*
Underlying EPS growth	31%	10%	13%	16%	22%	>10%
Sales growth: CER	36%	14%	6%	11%	14%	
Sales growth: organic	3%	3%	(1%)	6%	8%	Well ahead of GDP
Increase cross-selling	£0.9m	£3.0m	£4.6m	£8.8m	£10.6m	£12m pa (target raised)
Dividend growth	11%	6%	6%	6%	6%	Progressive
ROCE	12.0%	11.6%	13.0%	13.7%	15.4%	>15%
Operating cash flow generation	104%	100%	136%	90%	93%	>85% of underlying profit

Source: discoverIE. Note: *Three to five years from November 2016.

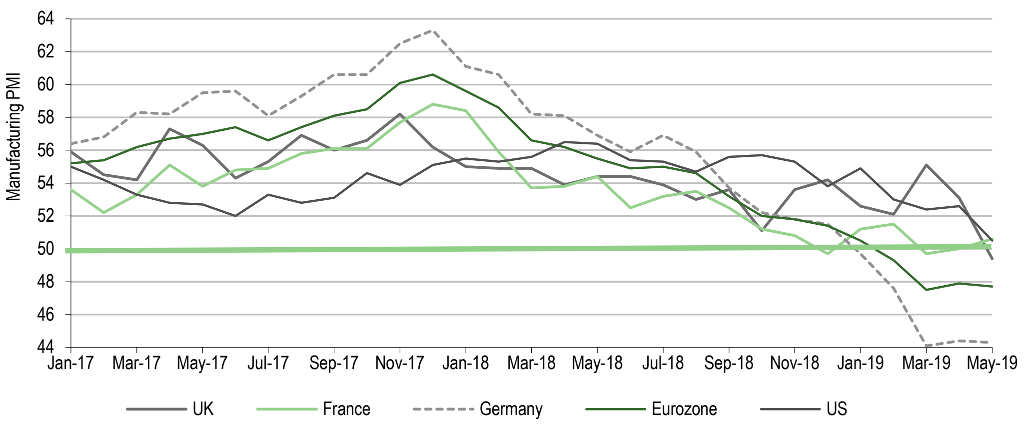
Outlook and changes to forecasts

The company ended FY19 with an order book of £139m – 15% higher than a year ago on a constant currency basis and 12% higher on an organic basis. New project wins with an estimated lifetime value of £266m were signed in the year (+40% y-o-y) and 75% of these were in target markets. Book-to-bill for the year was 1.03x, flat compared to FY18. Group orders increased 13% y-o-y (14% CER/8% organic). On a divisional basis, D&M saw 11% organic order growth.

Design activity tends to be technology driven, whereas production activity is more geared to general economic conditions. The manufacturing PMI indices are useful indicators of the health of the industrial sector. Exhibit 9 shows the movement in the manufacturing PMI for the eurozone, France, Germany, the UK and the US since the start of 2017.

After reaching peaks towards the end of 2017, all countries have contracted. Germany, the UK and the wider Eurozone have fallen below 50, with the combination of Brexit and trade tariffs creating significant uncertainty for the global economy. The UK saw a bounce up to 55.1 in March, but it is widely assumed that this was due to inventory building in advance of the original March Brexit date.

Exhibit 9: Manufacturing PMI, January 2017 to May 2019



Source: Markit PMI

The company has not yet seen any significant slowdown in order activity, although it has more modest expectations for FY20 after the strong organic growth of 8% achieved in FY19 and 6% in FY18. As the company is targeting the higher growth markets of renewable energy, transportation, medical and industrial connectivity, in the event of economic slowdown it would expect to be more resilient than the broader market. We believe our revenue forecasts are conservative, assuming CS growth of 1% in FY20/21 and D&M underlying growth of 3% in FY20 and 4% in FY21.We have revised our forecasts to reflect FY19 results and introduced FY21 forecasts. We have lifted our CS margins to 5% ongoing and have reduced our net interest payable forecasts to reflect lower than expected finance costs in FY19. On a reported basis, we have increased our share-based payment forecasts to more accurately reflect the costs and raised amortisation of acquired intangibles to factor in recent acquisitions.

Exhibit 10: Changes to forecasts

£m	FY20e old	FY20e new	Change	y-o-y	FY21e new	y-o-y
Revenues	465.4	465.8	0.1%	6.1%	479.2	2.9%
Custom supply	173.7	174.4	0.4%	1.0%	176.2	1.0%
Design & manufacturing	291.7	291.3	(0.1%)	9.4%	303.0	4.0%
Gross margin	33.0%	33.0%	(0.0%)	(0.0%)	33.0%	0.0%
EBITDA	39.7	41.2	3.8%	11.3%	42.4	2.9%
EBITDA margin	8.5%	8.8%	0.3%	0.4%	8.8%	0.0%
Underlying operating profit	33.8	34.5	2.1%	12.7%	35.5	2.9%
Underlying operating profit margin	7.3%	7.4%	0.1%	0.4%	7.4%	(0.0%)
Normalised operating profit	34.7	35.8	3.2%	12.6%	36.8	2.8%
Normalised operating margin	7.5%	7.7%	0.2%	0.4%	7.7%	(0.0%)
Normalised PBT	30.6	32.1	4.7%	13.0%	33.2	3.5%
Normalised net income	22.8	24.1	5.5%	12.2%	24.9	3.5%
Normalised diluted EPS (p)	27.6	29.1	5.4%	2.2%	30.0	3.1%
Reported basic EPS (p)	18.8	18.2	(3.6%)	(9.2%)	19.1	5.4%
Net (debt)/cash	(51.0)	(49.7)	(2.5%)	(21.4%)	(39.2)	(21.3%)
Net debt/EBITDA (x)	1.3	1.2			0.9	

Source: Edison Investment Research

Valuation

Exhibit 11 shows valuation metrics for discoverIE's peer group and Exhibit 12 shows their financial performance. The stock declined from April 2018 until the end of November 2018, when the company reported strong interims. It has substantially recovered over the course of CY19 and is down c 3% over the last 12 months. Since we last wrote in April, the discount to peers has widened, with discoverIE trading at a 17% discount this year and 12% discount next year on a P/E basis. Further progress in increasing the weighting of business towards D&M, combined with maintaining the profitability of the CS business should help to close this discount.

D&M made up 61% of FY19 revenues; absent any acquisitions, we forecast this will increase to 63% by FY21 and the company is targeting this to reach 75% over the next three to five years. We expect the company to make further accretive acquisitions in the D&M space, which should boost the revenue growth rate and accelerate the growth in operating margins and EPS.

Exhibit 11: Peer group financial performance

(%)	Gross margin			EBITDA margin			EBIT margin			Revenue growth			EPS growth		
	LY	CY	NY	LY	CY	NY	LY	CY	NY	LY	CY	NY	LY	CY	NY
discoverIE	**33.0%**	**33.0%**	**33.0%**	**8.4%**	**8.8%**	**8.8%**	**7.2%**	**7.7%**	**7.7%**	**13.1%**	**6.1%**	**2.9%**	**23.7%**	**2.2%**	**3.1%**
Design & manufacturing															
Gooch & Housego	40.0%	37.5%	39.3%	16.3%	16.4%	17.6%	15.3%	10.7%	12.0%	11.5%	5.7%	4.4%	16.5%	(16.8%)	17.9%
TT Electronics	25.8%			10.9%	11.8%	12.3%	7.8%	8.4%	8.8%	19.3%	10.6%	4.4%	48.6%	12.8%	9.5%
XP Power	47.3%	45.8%	46.5%	25.2%	25.1%	25.8%	22.0%	20.9%	21.6%	17.0%	2.7%	4.4%	17.6%	(1.9%)	8.8%
Specialist distributors															
Diploma	35.6%	36.0%	36.0%	18.5%	18.6%	18.7%	17.5%	17.4%	17.6%	7.3%	9.6%	3.9%	13.3%	10.8%	4.6%
Solid State				7.9%	7.8%	7.2%	6.7%	6.3%	N/A	18.7%	15.8%	6.8%	13.2%	(1.0%)	1.8%
High service & commodity distributors															
Electrocomponents	44.5%	44.4%	44.5%	13.2%	13.7%	14.3%	11.7%	12.0%	12.4%	10.5%	4.9%	4.9%	30.3%	6.2%	10.0%
Average	**38.6%**	**40.9%**	**41.6%**	**15.3%**	**15.6%**	**16.0%**	**13.5%**	**12.6%**	**14.5%**	**14.1%**	**8.2%**	**4.8%**	**23.2%**	**1.7%**	**8.8%**

Source: Edison Investment Research, Refinitiv (as at 10 June). Note: LY = last year, CY = current year, NY = next year.

Exhibit 12: Peer group valuation multiples

(x)	EV/sales			EV/EBITDA			P/E			Dividend yield (%)		
	LY	CY	NY	LY	CY	NY	LY	CY	NY	LY	CY	NY
discoverIE	**1.0**	**0.9**	**0.9**	**13.9**	**11.0**	**9.9**	**14.9**	**14.6**	**14.2**	**2.2%**	**2.4%**	**2.4%**
Design & manufacturing												
Gooch & Housego	2.3	2.2	2.1	14.2	13.3	11.9	19.5	23.4	19.8	1.0%	1.0%	1.1%
TT Electronics	1.0	0.9	0.9	9.5	7.9	7.3	15.2	13.5	12.3	2.6%	2.9%	3.1%
XP Power	2.5	2.4	2.3	9.8	9.6	8.9	12.9	13.2	12.1	3.8%	3.9%	4.1%
Specialist distributors												
Diploma	3.7	3.4	3.2	20.0	18.1	17.4	28.4	25.6	24.5	1.6%	1.8%	1.9%
Solid State	0.7	0.6	0.6	9.3	8.0	8.2	14.0	14.2	13.9	2.5%	2.5%	2.4%
High service & commodity distributors												
Electrocomponents	1.5	1.5	1.4	11.6	10.7	9.7	16.8	15.8	14.4	2.4%	2.6%	2.8%
Average	**2.0**	**1.8**	**1.8**	**12.4**	**11.3**	**10.6**	**17.8**	**17.6**	**16.2**	**2.3%**	**2.4%**	**2.6%**
Versus peer group					**(3%)**	**(7%)**		**(17%)**	**(12%)**			

Source: Edison Investment Research, Refinitiv (as at 24 June)

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 FY19 no customer made up more than 4% of sales.
- **Currency:** translational – with 80% 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 and underlying operating profit by 1pp in FY19. Transactional – discoverIE sells mainly in euros, 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 will likely make further acquisitions, which could add integration risk and will require funding (we estimate discoverIE has £25–30m headroom in its debt facility). These could boost EPS by 15–20% over the next two to three years, compared to the c 15% added to EPS over the last two years from acquisitions.
- **Pension deficit**: the company has a £2.5m pension deficit and increased the level of contributions from FY13 by 3% a year (FY19: £1.7m contribution) as part of the plan agreed with trustees back in 2009 to try to eliminate it. The pension fund was closed to new entrants in 1999 and further service accruals in 2000.

Exhibit 13: Financial summary

£m	2015	2016	2017	2018	2019	2020e	2021e
Year end 31 March	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS							
Revenue	271.1	287.7	338.2	387.9	438.9	465.8	479.2
Cost of Sales	(186.7)	(195.1)	(227.2)	(261.2)	(293.9)	(312.1)	(321.0)
Gross Profit	84.4	92.6	111.0	126.7	145.0	153.7	158.1
EBITDA	16.6	19.8	24.3	29.3	37.0	41.2	42.4
Operating Profit (before am, SBP and except.)	14.0	17.0	20.6	25.2	31.8	35.8	36.8
Operating Profit (before am. and except.)	13.4	16.3	20.0	24.5	30.6	34.5	35.5
Amortisation of acquired intangibles	(2.1)	(2.8)	(3.9)	(4.9)	(5.9)	(8.0)	(8.0)
Exceptionals	(5.2)	(2.1)	(8.4)	(2.3)	(2.0)	(3.2)	(3.2)
Share-based payments	(0.6)	(0.7)	(0.6)	(0.7)	(1.2)	(1.3)	(1.3)
Operating Profit	6.1	11.4	7.7	17.3	22.7	23.3	24.3
Net Interest	(1.6)	(1.8)	(2.8)	(2.6)	(3.4)	(3.7)	(3.6)
Profit Before Tax (norm)	12.4	15.2	17.8	22.6	28.4	32.1	33.2
Profit Before Tax (FRS 3)	4.3	9.4	4.8	14.6	19.3	19.5	20.6
Tax	(1.4)	(2.2)	(1.3)	(4.0)	(4.7)	(4.9)	(5.1)
Profit After Tax (norm)	10.0	11.8	13.6	17.1	21.5	24.1	24.9
Profit After Tax (FRS 3)	2.9	7.2	3.5	10.6	14.6	14.6	15.4
Average Number of Shares Outstanding (m)	57.6	63.3	65.4	70.8	73.0	80.3	80.7
EPS - normalised & diluted (p)	16.4	17.8	19.9	23.0	28.4	29.1	30.0
EPS - IFRS basic (p)	5.0	11.4	5.3	15.0	20.0	18.2	19.1
EPS - IFRS diluted (p)	4.8	10.9	5.1	14.2	19.4	17.6	18.6
Dividend per share (p)	7.6	8.1	8.5	9.0	9.6	10.0	10.4
Gross Margin (%)	31.1	32.2	32.8	32.7	33.0	33.0	33.0
EBITDA Margin (%)	6.1	6.9	7.2	7.6	8.4	8.8	8.8
Operating Margin (before am, SBP and except.) (%)	5.2	5.9	6.1	6.5	7.2	7.7	7.7
BALANCE SHEET							
Fixed Assets	88.6	108.4	122.2	136.4	149.2	158.1	151.0
Intangible Assets	69.9	88.2	100.7	107.2	119.7	127.5	119.4
Tangible Assets	13.8	14.7	16.0	23.4	24.4	25.5	26.5
Deferred tax assets	4.9	5.5	5.5	5.8	5.1	5.1	5.1
Current Assets	127.3	128.3	147.1	165.9	179.1	205.0	215.6
Stocks	39.8	42.9	48.8	58.1	66.2	70.2	72.2
Debtors	60.2	65.5	77.3	84.6	88.7	102.1	105.0
Cash	26.7	19.9	21.0	21.9	22.9	31.5	37.0
Current Liabilities	(62.1)	(61.7)	(78.1)	(94.0)	(96.0)	(101.4)	(103.0)
Creditors	(61.9)	(60.9)	(77.1)	(87.6)	(94.3)	(99.7)	(101.3)
Short term borrowings	(0.2)	(0.8)	(1.0)	(6.4)	(1.7)	(1.7)	(1.7)
Long Term Liabilities	(61.1)	(73.1)	(68.7)	(81.5)	(97.6)	(92.1)	(86.6)
Long term borrowings	(45.5)	(57.2)	(50.0)	(67.9)	(84.5)	(79.5)	(74.5)
Other long term liabilities	(15.6)	(15.9)	(18.7)	(13.6)	(13.1)	(12.6)	(12.1)
Net Assets	92.7	101.9	122.5	126.8	134.7	169.6	177.0
CASH FLOW							
Operating Cash Flow	6.6	14.6	20.5	21.7	30.0	27.4	37.1
Net Interest	(1.6)	(1.8)	(2.8)	(2.6)	(3.4)	(3.7)	(3.6)
Tax	(3.3)	(4.3)	(3.0)	(3.7)	(3.8)	(8.0)	(8.3)
Capex	(2.5)	(2.3)	(3.4)	(4.3)	(5.4)	(6.4)	(6.5)
Acquisitions/disposals	(37.3)	(19.8)	(11.8)	(25.4)	(22.4)	(15.9)	0.0
Financing	52.7	0.0	13.6	(1.5)	0.1	28.0	0.0
Dividends	(3.6)	(4.9)	(5.2)	(6.2)	(6.7)	(7.8)	(8.2)
Net Cash Flow	11.0	(18.5)	7.9	(22.0)	(11.6)	13.6	10.6
Opening net cash/(debt)	1.8	(19.0)	(38.1)	(30.0)	(52.4)	(63.3)	(49.7)
HP finance leases initiated	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	0.0	0.0
Closing net cash/(debt)	(19.0)	(38.1)	(30.0)	(52.4)	(63.3)	(49.7)	(39.2)

Source: discoverIE, Edison Investment Research

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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 is also non-executive chairman of Trifast and Flowtech Fluidpower. Prior to being appointed chairman, Malcolm was chief executive of Trifast and, among other previous appointments, was senior non-executive director of Dechra Pharmaceuticals and a non-executive director of Unicorn AIM VCT	

Principal shareholders	(%)
Aberdeen Standard Investments	9.6
Canaccord Genuity	8.7
L&G Investment Management	5.9
Charles Stanley	5.2
BlackRock	4.0
Unicorn Asset Management	4.0
Chelverton Asset Management	3.8
Montanaro Asset Management	3.7
AXA SA	3.6
Franklin Resources	3.3

Companies named in this report
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