EDISON

De La Rue

FY19 results

Venezuela costs dearly

Industrial support services

Despite delivering close to our expectations for FY19, De La Rue has hit another problem which undermines prospects for FY20. The abrupt end of the overspill supply to Venezuela due to sanctions not only leaves the company £18m out of pocket, but also having to accelerate optimisation efforts to adjust to the new, lower but sustainable banknote print volumes by 2021. The result is a 22% reduction in our FY20 EPS estimates with declining revenues through FY21. Combined with the announced change of CEO, even the dividend yield support now falls into question, although we feel the prospects are bright enough for its maintenance.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
03/18**	461.4	47.5	38.2	25.0	8.1	8.2
03/19	516.6	54.1	42.9	25.0	7.1	8.2
03/20e	508.7	44.4	34.4	25.0	8.8	8.2
03/21e	450.1	44.0	34.6	25.0	8.8	8.2

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments. **Restated for the sale of Paper and IFRS 15.

Venezuela provision undermines FY19 delivery

Our FY19 expectations were almost met but through a different divisional mix and before the exceptional credit provision of £18m. Sales and profits for Currency beat our estimates following the sale of Paper at the end of FY18. ID Solutions (IDS) and Product Authentication & Traceability (PA&T) missed our revenue estimates by 9%, with the former exceeding our adjusted operating profit and the latter missing. The payment shortfall from the Venezuela supply is of greatest significance. The invoiced high margin sales receipts could not be remitted to De La Rue due to sanctions. The upheaval in the country shows no signs of being resolved, so an anticipated manageable decline in volumes through FY20 has been replaced by an abrupt termination of activity, with a loss in revenue of around £100m for Currency.

FY20e EPS reduced by 22%

The high profitability of Venezuelan supply means Currency margins will fall to c 5%, with lower return contract fill and despite increases at Polymer and Security Features. Proposed savings of c £20m should be front-end loaded, but are likely to only partly offset price pressure in Banknote Print as suppliers seek to fill freed up capacity. IDS was already compromised by the end of the UK passport contract in FY20, with the wind down agreed to start in November and a full impact in FY21. PA&T should grow strongly as the major Saudi Arabian and UAE contracts start full delivery. These factors reduce our FY20e EPS by 22% with a flat outlook for FY21.

Valuation: Rating reflects renewed uncertainty

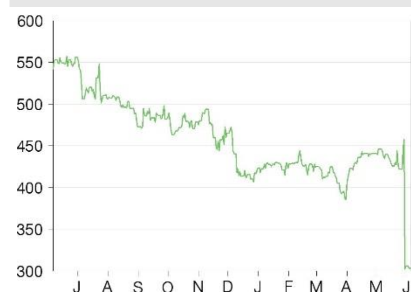
A single-digit P/E ratio for FY20e and historic yield of 8% should normally be quite appealing. However, with lower cash flows and a new CEO perhaps reorienting strategy, the yield support cannot be seen as a given for now. We still feel the medium term will see a return to growth driven by the IP-rich authentication and security activities of the group. Our DCF value drops from 663p to 568p.

6 June 2019

Price	**304p**
Market cap	**£313m**

Net debt (£m) at 31 March 2019	107.5
Shares in issue	103.0m
Free float	100%
Code	DLAR
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	(31.8)	(28.0)	(42.6)
Rel (local)	(30.2)	(28.1)	(38.6)
52-week high/low		557p	302p

Business description

De La Rue is a world leader in anti-counterfeiting and security for currency, identity and brand protection. The company operates across 140 countries and is the number one commercial designer and producer of banknotes and passports.

Next events

AGM	25 July 2019
Interim results	November 2019

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Edison profile page

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Outlook and forecast reductions

The implications of the FY19 results announcement are far reaching and lead to a sharp reduction in expectations for FY20e and beyond. Our assumption is no longer valid that a managed reduction of the bank note overspill supply to Venezuela is possible, mitigating pricing pressure as additional new contract volumes were brought in and costs progressively reduced. While volumes in FY20 are still expected to be around 7bn as lower-margin contracts already booked fill most of the shortfall. However, as De La Rue and its largest competitors try to alleviate the cessation of supply, the now spare capacity is likely to result in further significant pricing pressure in FY21 as available contracts are competed aggressively.

De La Rue will now complete the optimisation of Banknote Print lines that overspill activity had deferred, reducing capacity to around 6bn notes per annum from the current 7bn by FY21. However, the costs savings are likely to only mitigate pricing pressure on margins. As De La Rue has about 12 months' visibility on contracts, we expect greater selectivity of contracts pursued to lead to further revenue declines for Currency in FY21, despite growth in both the Polymer and Security Features subsegments. Our margin expectations for Currency now remain below 10% for even our long-term forecast period, compared to a previous expectation of double-digit margin maintenance.

The decline compounds the already expected exit from the UK passport contract which will see a reduction in revenues for IDS of around £40m and a contraction in margin. The contract transition period has now been negotiated which is expected to lead to a slightly later than expected start to volume reductions in November 2019 providing a modest boost to expectations for FY20.

The new tax stamp contracts in PA&T for the UAE and Saudi Arabia will provide a major boost to the division in FY20m, adding significant high-margin revenues in excess of £20m. The FY20 profit increase should also benefit from the absence of £3.1m of non-recurring costs incurred against the contracts in FY19.

The changes to our estimates are summarised in Exhibit 1 below, which indicates that we have reduced our earnings expectations at the EPS level by 22.2% in FY20 to 34.4p and we expect them to remain flat in our newly introduced FY21 estimate.

Exhibit 1: Change in estimates

Year end 31 March (£m)	2019e	2019	%	2020e	2020e	%	2021e
	Prior	Actual	*change*	Prior	New	*change*	New
Currency	380.4	398.9	*4.9%*	384.2	355.0	*-7.6%*	291.1
ID Solutions	86.1	78.4	*-9.0%*	68.1	77.1	*13.2%*	59.4
PA&T	43.3	39.3	*-9.3%*	54.2	76.6	*41.5%*	99.6
Group revenues	**509.9**	**516.6**	***1.3%***	**506.5**	**508.7**	***0.4%***	**450.1**
EBITDA	**85.6**	**79.5**	***-7.1%***	**87.4**	**72.8**	***-16.7%***	**81.6**
Currency	39.9	41.7	*4.4%*	41.1	19.5	*-52.5%*	21.8
ID Solutions	9.7	12.7	*30.5%*	7.1	12.3	*72.5%*	4.7
PA&T	11.3	5.7	*-49.4%*	13.5	20.7		26.9
Adjusted EBITA	**60.9**	**60.1**	***-1.4%***	**61.8**	**52.5**	***-15.0%***	**53.5**
Underlying PBT	**55.5**	**54.1**	***-2.5%***	**55.5**	**44.4**	***-20.0%***	**44.0**
EPS - underlying continuing (p)	**44.5**	**42.9**	***-3.8%***	**44.3**	**34.4**	***-22.2%***	**34.6**
DPS (p)	25.0	25.0	*0.0%*	25.0	25.0	*0.0%*	25.0
Net debt/(cash)	71.1	107.5	*51.3%*	71.0	140.2	*99.8%*	155.3

Source: Edison Investment Research

We maintain our expectation that the dividend will be held at 25.0p but note that an incoming CEO may take a different view given the now reduced free cash flow expectation resulting from the adverse Currency market development.

Free cash flow in FY20 will continue to be burdened by pension deficit closure payments, capex and restructuring cash costs all of around £20–25m. The dividend would cost a similar amount, so even with a neutral working capital as guided by management, there will be another significant outflow in FY20. While net debt remains significantly higher than our previous expectations, the company remains well within its liquidity headroom and covenants with strong interest cover and net debt/EBITDA rising to 1.9x on our FY21 forecast, with the dividend support maintained.

FY19 results

FY19 results were presented after adopting IFRS 15, which added £12.2m to revenues and £6.9m to operating profit. Prior year numbers are not restated. Management came close to meeting our revenue and earnings expectations, although the divisional contributions were not what we had anticipated. Excluding Paper, which we classify as discontinued, the key highlights were as follows:

- Group revenues rose 12% to £516.6m (FY18 £461.4m), which beat our estimate of £509.9m by 1%. The FY19 number excludes the nil margin pass-through revenues of £48.2m relating to non-novated contracts at the Paper business. While Currency outperformed our expectations by 5%, both IDS and PA&T were each lower than we had expected by 9%.
- Adjusted EBITDA of £79.5m (FY18 £78.4m) was up 1.4%, but 7% shy of our estimate.
- Adjusted operating profit rose 5.6% to £60.1m (FY18 £56.9m), less than 1% below our estimate of £60.9m. Currency was 4% ahead of our expectations, with IDS 31% better, and PA&T 49% below our forecast although this was after £3.1m of non-recurring costs that we had not anticipated. Excluding these, PA&T was still 22% lower than our estimate.
- Net debt increased by £57.6m to £107.5m, significantly higher than we anticipated (£71.1m). The Venezuela uncollected receivable accounts for £18m of the difference, with higher than anticipated year-end receivables due to the phasing of contract revenues, the £16m adjustment as Paper moved from an internal to an external customer and £4.7m working capital build against the new PA&T contracts accounting for much of the rest.
- The dividend was maintained at 25.0p for the full year.

Exhibit 2: De La Rue FY19 results summary

Year to March (£m)	2018		2019	% change	
	Incl. Paper	Excl. Paper	Excl. Paper	Incl. Paper	Excl. Paper
Currency	371.8	344.1	398.9	7.3%	15.9%
ID Solutions	82.0	78.9	78.4	-4.4%	-0.7%
Product Authentication & Traceability	40.1	38.4	39.3	-2.0%	2.3%
Group revenue	**493.9**	**461.4**	**516.6**	**4.6%**	**12.0%**
Adjusted EBITDA	**87.3**	**78.4**	**79.5**	**-8.9%**	**1.4%**
Currency	45.1	40.5	41.7	-7.5%	3.0%
ID Solutions	8.3	7.0	12.7	53.0%	81.4%
Product Authentication & Traceability	9.4	9.4	5.7	-39.4%	-39.4%
Adjusted operating profit	**62.8**	**56.9**	**60.1**	**-4.3%**	**5.6%**
Adjusted PBT	**53.4**	**47.5**	**54.1**	**1.5%**	**13.9%**
EPS - underlying continuing (p)	**42.9**	**38.2**	**42.9**	**-0.1%**	**12.2%**
DPS (p)	25.0	25.0	25.0	0.0%	0.0%
Net debt	49.9	49.9	107.5	115.4%	115.4%

Source: Company reports

Currency

In Currency, revenues increased by a better than expected 16%, although this included £11.9m of revenues essentially pulled forward from delivery recognition in FY20 by IFRS15. Adjusting for the effect, growth was still 13% for the division. However, the adjusted operating margin fell by 140bp to10.4% due to more complex and lower margin contracts during the year as well as increasing competitive pressures. The operating profit IFRS benefited the division by £6.6m, so the 3% improvement in adjusted operating profit was a 13% decline before that adjustment.

The 12-month forward order book was down 26% to £202m (FY18 £272m), with a further £87m of orders on hand for future years, excluding future year orders against the Bank of England contract.

Banknote Print volumes increased 3% to 7.5bn largely due to increased overspill demand from Venezuela. Around 0.45bn of the total volume was satisfied through outsource partners. However, an exceptional bad debt provision of £18m has been taken against receivables for Venezuela following the tightening of sanctions that has prevented payment for work performed being transferred. Most of the FY19 payments had already been received.

Market share in Polymer was 20% (FY18 11%), with substrate volumes rising 23% to 998 tonnes (FY18 810 tonnes), of which 667 tonnes were direct sales to customers. The activity continues to move towards profitability.

Security Features volume rose 24% to 4.7m square metres, supporting a 38% increase in revenues.

IDS

Revenues for IDS were broadly flat year-on-year, with international ID volumes falling and a spike towards the year end of higher margin UK passport activity. The result was a 200bp rise in adjusted operating profit margin to 16.2% ignoring the prior year write-off of the UK passport contract bid costs, although profit also benefited from a £1.7m provision release following a customer settlement, which more than accounts for the remaining improvement.

An exit plan has been agreed from the UK Passport contract, with production ending by the end of FY20 and volumes expected to start declining from November as activity transfers to the new supplier.

PA&T

Revenues grew by 2% and adjusted operating profit fell by 39% to £5.7m. Management states that the division performed to its expectations, but adjusted operating profit was some way below our £11.3m estimate, even after adding back £3.1m of non-recurring costs. These consisted of £1.2m of upfront costs for the major new UAE and Saudi Arabian tax stamp contracts and £1.9m impact of transferring manufacture for the division from Gateshead to Malta.

The main development for PA&T for FY19 was the order flow driven by the World Health Organisation’s Framework Convention on Tobacco Control (FCTC) and the EU Tobacco Products Directive (EUTPD). The Digital Tax Stamp system for the UAE is now operational and the five-year tax stamp contract for Saudi Arabia starts delivery in FY20. In addition, PA&T has won contracts to supply more than 3.5bn tax stamps annually to various European countries.

Combined with continued growth in brand authentication markets, these government revenue solutions (GRS) contracts support the doubling of PA&T revenues over the next three years with very healthy margins attached.

Management and strategy

Martin Sutherland is to leave the company following the latest disappointment, but remain as CEO until a replacement is found, which will probably take at least three months. The strategy therefore continues to evolve from his existing plan and a new, two-division structure is being proposed (Currency and Authentication) to provide greater strategic focus with market-facing operations. Security Features will transfer into Authentication, which also includes PA&T and IDS operations. A reduction in overhead and greater efficiency should also result and the reorganisation is to be accompanied by a cost reduction programme aimed at saving a further £20m by FY22.

Guidance

Management is highlighting significant headwinds for Currency in the year ahead as Venezuela is abruptly curtailed, increasing competitive pressure across the oversupplied marketplace. However, PA&T is expected to see strong high margin revenue growth as the new contracts build volume and IDS will not see a major tail off from the UK passport business until H220.

For FY20 the board expects revenues to be similar to FY19 and operating profit to be “somewhat lower”. We feel our revised estimates reflect these expectations.

Valuation

The reduction in our estimates severely curtails cash flow delivery for the group. Our capped DCF valuation for the group, rolled forward to the new FY20 basis, currently returns a value of 568p per share compared to 663p per share when we initiated despite a more favourable calculated WACC of 7.6% (previously 8.3%), reflecting the lower equity valuation and increased debt.

The sensitivity of our DCF value per share to terminal growth rates and WACC is shown in the table below, with our assumption highlighted in bold.

Exhibit 3: De La Rue capped DCF sensitivity to WACC and terminal growth rate (p)

WACC	7.0%	7.5%	7.6%	8.0%	8.5%	9.0%	9.5%	10.0%
Terminal growth rate								
0.0%	643	580	**568**	524	475	431	393	358
1.0%	761	678	663	608	547	494	447	406
2.0%	925	813	793	720	642	575	516	466
3.0%	1171	1008	979	877	771	682	607	543

Source: Edison Investment Research

Exhibit 4: Financial summary

£m	2018	2019	2020e	2021e
Year end 31 March	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS				
Revenue	461.4	516.6	508.7	450.1
Cost of Sales	0.0	0.0	0.0	0.0
Gross Profit	461.4	516.6	508.7	450.1
EBITDA	78.4	79.5	72.8	75.1
Operating Profit (before amort. and except.)	59.5	62.8	55.4	56.8
Intangible Amortisation	(2.6)	(2.7)	(2.9)	(3.3)
Exceptionals	74.6	(28.6)	(20.7)	(2.7)
Other	0.0	0.0	0.0	0.0
Operating Profit	131.5	31.5	31.8	50.8
Net Interest	(9.4)	(6.0)	(8.2)	(9.5)
Profit Before Tax (norm)	47.5	54.1	44.4	44.0
Profit Before Tax (FRS 3)	122.1	25.5	23.7	41.3
Tax	(18.9)	(4.8)	(3.8)	(6.6)
Profit After Tax (norm)	40.3	45.4	36.5	36.9
Profit After Tax (FRS 3)	103.2	20.7	19.9	34.7
Average Number of Shares Outstanding (m)	101.9	102.9	102.4	102.4
EPS - normalised (p)	38.2	42.9	34.4	34.6
EPS - normalised and fully diluted (p)	37.8	42.7	34.3	34.5
EPS - (IFRS) (p)	93.6	16.5	18.3	32.5
Dividend per share (p)	25.0	25.0	25.0	25.0
Gross Margin (%)	100.0	100.0	100.0	100.0
EBITDA Margin (%)	17.0	15.4	14.3	16.7
Operating Margin (before GW and except.) (%)	12.9	12.2	10.9	12.6
BALANCE SHEET				
Fixed Assets	149.0	155.6	160.0	162.6
Intangible Assets	29.5	33.3	36.2	38.7
Tangible Assets	112.8	115.0	116.4	116.6
Investments	6.7	7.3	7.3	7.3
Current Assets	179.9	219.7	218.1	208.2
Stocks	34.1	42.3	42.7	42.8
Debtors	102.3	139.3	137.4	128.3
Cash	15.5	12.2	12.2	12.2
Other	28.0	25.9	25.8	25.0
Current Liabilities	(252.7)	(321.6)	(351.0)	(356.7)
Creditors	(187.3)	(201.9)	(198.6)	(189.2)
Short term borrowings	(65.4)	(119.7)	(152.4)	(167.5)
Long Term Liabilities	(96.6)	(82.9)	(61.9)	(39.9)
Long term borrowings	0.0	0.0	0.0	0.0
Other long term liabilities	(96.6)	(82.9)	(61.9)	(39.9)
Net Assets	(20.4)	(29.2)	(34.9)	(25.8)
CASH FLOW				
Operating Cash Flow	93.2	(6.3)	21.8	47.6
Net Interest	(4.6)	(3.8)	(3.9)	(6.1)
Tax	(30.6)	(0.9)	0.3	(6.1)
Capex	(24.7)	(25.4)	(25.3)	(25.0)
Acquisitions/disposals	57.7	0.2	0.0	0.0
Financing	2.0	4.3	0.0	0.0
Dividends	(25.8)	(26.2)	(25.6)	(25.6)
Other	3.8	0.5	0.00	0.0
Net Cash Flow	71.0	(57.6)	(32.7)	(15.1)
Opening net debt/(cash)	120.9	49.9	107.5	140.2
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)	49.9	107.5	140.2	155.3

Source: Company reports, Edison Investment Research estimates

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