Scale research report - Update

Diskus Werke

Mechanical engineering

05 October 2017

Potential recovery in profitability

Diskus Werke is well on track to achieve the improvement in profitability from the depressed levels of 2016 that it projected a few months ago in the annual report and accounts. It has now revised up its forecasts, but there appears to be a degree of prudence in the new figures, notably in terms of profitability and order inflow, perhaps reflecting the small drop in the book/bill ratio to 0.95x from 1.00x.

Sharp improvement in first half figures

On two of the measures projected by the management, the outcome in the first half of 2017 was well above the company forecast level. H117 turnover rose 19% to €120.5m, 13% above company expectations, and PBT was up 128% at €7.1m, 32% above company expectations. The improvement in profitability, with EBIT margin rising to 6.6% from 4.0%, appears to be essentially driven by the top line, leading to a sharp improvement in overhead recovery. Turnaround has progressed well at the three subsidiaries that were deep in the red in 2016, with losses reduced to €1.2m in the first half of 2017 from €3.0m in the comparable period.

Cash outflow, but financing ratios still comfortable

The surge in working capital needs driven by the rise in turnover more than offset the drop in capital spending, now that the new plant at Dietzenbach has been completed. As a result, net debt rose to €66.3m from €56.6m in the previous year. The debt/equity ratio now stands at a still comfortable level of 53% and the equity ratio is at a very solid 50%.

Valuation: Illiquidity is the main consideration

The vast majority of the company's equity is tightly held and likely to remain so. With a free float of some 0.4%, Diskus Werke is unlikely to feature in most institutional investors' universes. This means that peer group valuation is unlikely to play much of a part in setting the share price. Such activity as there is, is therefore likely to be driven by private investors, to whom share price momentum and dividend yield (1.0%) will probably be more important. We note the share price has risen sharply since the summer.

Historical data

Year end	Revenue (€m)	Net profit (€m)	EPS (€)	DPS (€)	P/E (x)	Yield (%)
12/13	169.5	5.94	0.61	0.10	31.0	0.5
12/14	160.5	3.48	0.36	0.10	52.5	0.5
12/15	199.2	7.58	0.78	0.21	24.2	1.1
12/16	218.4	5.08	0.52	0.20	36.3	1.1

Source: Diskus Werke data

Price	**€18.89**
Market cap	**€183m**

Share price graph

Share details

Code	DIS
Listing	Deutsche Börse Scale
Shares in issue	9.68m
Last reported net debt and equity ratio at 30 June 2017	€66m and 50%

Business description

Diskus Werke is an archetypal Mittelstand systems provider with extremely strong market positions in the sub-segments within which it operates. The company is organised around three business units: Machine Tools & Automation, Tools & Components, and Production.

Bull

- Strong market position.
- Few strategic threats.
- Potential high-margin growth in contract manufacturing.

Bear

- Very low free float.
- Loss-making subsidiaries in 2016.
- Core client industries are mature.

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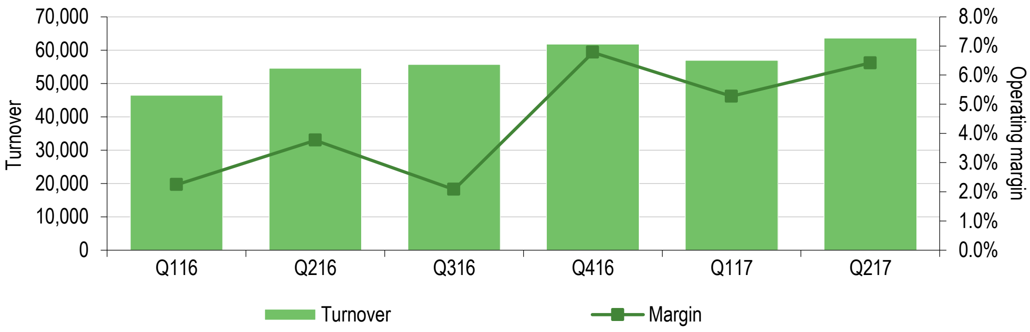
Improvement in results persists

The interim results showed that the trend in profit restoration of the second half of 2016 continued in H117. The improvements in earnings and profitability are driven by the top line. The results are significantly above budget levels and management has revised up its guidance for the full year.

Exhibit 1: Diskus quarterly turnover (€000s) and operating profit margin



Source: Diskus Werke, Edison Investment Research calculation

The first half of 2017 enjoyed a significant improvement in turnover with a 19.4% increase compared to H116 to a total of €120.5m. At the half-year stage the company does not provide an analysis of turnover, so it is hard to identify the underlying drivers of this achievement. Diskus appears to have performed visibly better than the German machine tool industry as a whole. Additions to internally sourced inventory and work in progress recognised in the P&L were in line with the 2016 level of some €5m.

Order inflow was also healthy albeit not quite as dramatically so, as turnover and the book/bill ratio actually declined to 0.95x in H117 from almost exactly 1.0x in the comparable period. The total order inflow rose 4.2% to €114.1m taking the order book to €119.3m, compared to a notably strong €131.3m at end June 2016 and €125.7m at end December 2016.

Costs remained under good control, most notably payroll, which was up only 9.1% at €35.5m. The cost of bought-in services dropped marginally to €8.2m. Raw material costs rose slightly more than turnover with a 24% increase to €50.3m. The improvement in absolute gross profit was still more than adequate to boost operating profit from the depressed levels of the first half of 2016 via greatly improved overhead recovery. EBIT almost doubled to €8.3m. Despite the rise in net debt discussed below, finance charges were up only 5% so PBT rose 128% to €7.1m.

There has been substantial progress in turning around the three subsidiaries that burdened 2016 results, with losses cut to €1.2m in the first half of 2017 from €3.0m in the comparable period. As a result, Pittler returned to the black, Diskus Werke Schleiftechnik improved somewhat but healthy order inflow in the first half of 2017 will make for a strong second half, while Fröhlich saw a significant improvement due to cost measures and better capacity utilisation.

The surge in business in the first half of 2017 entailed a sharp increase in working capital requirements, with a €22.2m increase in current assets only very partially offset by a €2m increase in trade receivables. Set against this, capital expenditure fell very sharply to €2.8m from €11.6m in the comparable period, reflecting the completion of the move to the new manufacturing site at Dietzenbach. All told, net debt rose to €66.3m from €56.6m at end June 2016. This represents a manageable 53% of equity with an equity ratio of 50%.

The most encouraging part of the statement was the upward revision in full year expectations, especially as the 2017 figures guided in the annual report released in May 2017 were described as ambitious (albeit achievable). This suggests that business has shown a material improvement in the last three to four months and management reported that the results in the first half were well above budget: 13% in terms of turnover and 34% in terms of profits. The actual compare with the original budget of €106.6m for turnover, €5.4m for PBT and a margin of only 5.0%, compared to actual results of €120.5m, €7.08m and 5.9%, respectively.

At the annual report stage, management was forecasting order inflow of €225m in the full year 2017, turnover of €220m and a pre-tax profit of €13m or so. These have all been increased in the half yearly report, albeit not to an extent that would fully embody the overshoot in the first half.

The revised €230m in order inflow is based on a quarterly rate of €55-60m, which translates to a potential €5m variation positive or negative on the full year figure. At the lower end of the range, this would merely be the level forecast in the annual report, but the potential variation gives a flavour of the moderate extent of uncertainty that will carry forward into 2018.

Even the low end of the range of the new turnover forecast of €230-240m is above the level of the annual report figure, doubtless reflecting the better visibility available at the top line given the length of the order book. It does, however, imply a half-year on half-year decline or flat performance, perhaps driven by some softening in the order book.

The new forecast of €13-14m in PBT looks similarly conservative, given the scale of the overshoot in the first half, and implies a possible absolute decline in second half PBT to €6-7m. It is not clear whether this might reflect persistence of structural issues at the three problematic subsidiaries.

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