Polypipe

Initiation of coverage

Aligned with the times

Construction & materials

We expect forthcoming FY16 results (30 March) to highlight the strength of Polypipe's model with a strong y-o-y uplift in earnings and good cash generation. The company is well positioned and aligned with long-term UK government policy direction and we expect greater clarity to benefit this industry leader. Translating this to earnings growth above the peer average will be key to sustaining a premium rating.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/14	327.0	37.6	16.1	4.5	20.6	1.4
12/15	352.9	48.0	19.4	7.8	17.1	2.3
12/16e	428.0	61.3	24.6	10.0	13.5	3.0
12/17e	447.5	65.5	26.2	10.5	12.7	3.2

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

Strong business, well positioned

Polypipe's excellent market position has been constructed over an extended timeframe under a coherent and consistent strategy to build out a multi-sector, multi-channel provider of plastic building products. Further substitution by these products for other materials and the translation of favourable long-term UK government policies (in housing, water management and carbon efficiency) into practical and actionable industry level initiatives is expected to deliver above average top line growth to an already profitable and cash generative model.

Positive momentum into FY17 expected

FY16 results are scheduled to be reported on 30 March. Comments with the last trading update (15 November) pointed to UK LFL growth to the end of October of +8% (comprising +4.6% residential – slightly below H1, and +14.1% commercial/ infrastructure – slightly above H1) supplemented by annualised Nuaire effects. Trading across the smaller European operations has been less even but remains profitable. Since this update, we believe that industry commentary has remained supportive of positive momentum running into FY17. As well as the underlying trading performance at Polypipe, we will be looking at cash generation – which may be ahead of consensus – and for indications that the expanded ventilation offer is starting to generate additional product and system opportunities.

Valuation: Sustaining a premium rating

Since IPO, Polypipe's share price has risen by c 36% although the path has been somewhat more variable than the underlying trading performance. Sentiment was affected by the Brexit outcome in June last year but has recovered well from a share price low of 227p in July. On our initial estimates, the company is trading on FY16 13.5x P/E and 9.8x EV/EBITDA multiples, which compress to 11.7x and 8.2x respectively by FY18. Faster earnings growth rates sustaining the current premium rating and putting it in line with sector peer Marshalls would generate a share price towards or in excess of 400p. The expected FY16 dividend yield is 3.0%.

15 March 2017

Price	**332.2p**
Market cap	**£659m**
	€1.14/£
Net debt (£m) at end June 2016	191.3
Shares in issue	198.4m
Free float	93%
Code	PLP
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	(3.7)	10.1	2.4
Rel (local)	(4.8)	3.7	(13.4)
52-week high/low		351.9p	221.5p

Business description

Polypipe is a leading European supplier of plastic building products and ventilation systems. UK operations (c 86% of annualised FY15 revenue and c 96% of EBIT) address a broad range of sectors including residential, commercial and civil building demand and a number of sub-sectors within them. Overseas operations are located in France and Italy with a new manufacturing facility in the Middle East.

Next events

FY16 results announcement	30 March 2017
AGM	24 May 2017

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Edison profile page

Polypipe is a research client of Edison Investment Research Limited

Investment summary

Company description

Polypipe is a leading European supplier of plastic building products and ventilation systems. UK operations (c 86% of annualised FY15 revenue and c 96% of EBIT) address a broad range of sectors including residential, commercial and civil building demand and a number of sub-sectors within them from an integrated design, manufacturing and distribution business platform. Overseas operations include ducting manufacture in France and a newly established manufacturing facility in the Middle East to service local demand for water management solutions.

Valuation: Earnings growth to sustain premium rating

We expect Polypipe to report strong progress in its forthcoming FY16 results. This forms a material contribution to our 2015-2018 EPS CAGR c 14%. Including the annualised effects of Nuaire in FY16, on current estimates, our CAGR for 2016-2018 is a more modest c 7%. We believe that this is in line with our selected peer group average and that our EPS norm estimates are at or slightly below consensus. On FY16 multiples (not reported but effectively historic) the company is trading on a 13.5x P/E and 9.8x EV/EBITDA. This perhaps anticipates future progress ahead of our current estimates. Market indicators are favourable and Polypipe's sector positions are such that it should perform relatively well in these conditions with good, clean profit and cash generating attributes. However, we will wait for more up to date comments from the company prior to revisiting estimates. Against our selected peer group, Polypipe sits on a c 23% P/E premium and c 29% for EV/EBITDA for FY15 (last reported). On the same basis, these premia narrow to c 11% and c 20% respectively by FY18, largely due to the step up in FY16 earnings noted above. We expect Polypipe to re-establish its premium growth credentials through underlying market out-performance and possibly acquisition activity. If its historic earnings premium is applied to our FY18 earnings expectations, this would suggest a c 375p share price. In our view, Polypipe and Marshalls have similar business models and market positions but – with higher expected growth currently - the latter trades on a c 12% P/E premium. Closing the earnings growth gap and applying Marshalls FY18 P/E multiple would generate a Polypipe share price comfortably above 400p.

Financials: Profitable, cash generative model

Since its IPO in 2014, Polypipe has reinforced its profitable, cash generative credentials and made a material acquisition (Nuaire in 2015) to scale up in an adjacent market segment. Management aims to grow revenues by 2-4% ahead of underlying markets through a combination of higher penetration of its products and some longer-term supportive industry trends. We have modelled stable growth margins and a favourable impact on EBIT margins from increased volumes, offset in FY17 by input price effects. Allowing for declining net debt and bank interest (FY16e cover c 10x) and a stable tax regime, our FY15-FY18 EPS CAGR comes out at 13.7%, with a DPS CAGR not far behind at 12.2%. We expect free cash flow to continue to rise – with no DB pension scheme to service – reducing net debt from c £194m at the end of FY15 to c £115m by FY18. There is clear scope to increase the rate of investment, fund potential acquisitions and sustain dividend growth.

Sensitivities: Business model resilience

Polypipe has a diversified and relatively resilient business model. Overall activity levels are influenced by UK GDP growth, interest rates and cycles within individual construction sub-sectors. Underlying input price and FX movements can dampen/enhance short-term profitability affecting all industry suppliers. Additionally, FX movements have an effect on the reported results from Polypipe's European operations, though their profit contribution is modest currently.

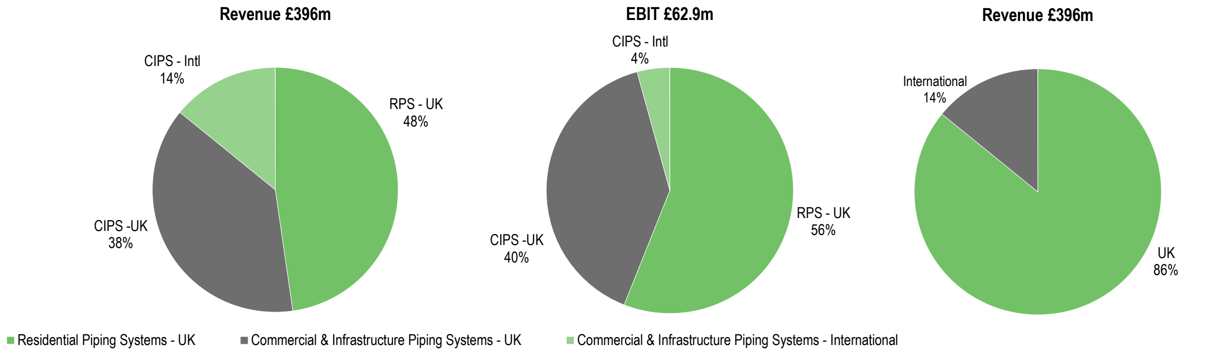
Company description: Building products leader

Polypipe is a leading European manufacturer of building products, chiefly pipework, ducting, fittings and ventilation systems that facilitate the provision of utility services in residential and commercial building and infrastructure applications. Its profitable business model is sustained by innovation and product development in segments with higher growth rates.

Managing manufacturing, customer and distribution complexity

Polypipe designs and manufactures a range of over 20,000 components for over 100 plumbing and drainage piping systems together with ventilation systems and ducting. It primarily processes basic polymers (including recycled) into high grade compounds which are extruded or moulded into finished parts. This is a flexible, modular process across several hundred machines and tools operating in conjunction with downstream assembly, fabrication and kitting processes all with a high degree of automation and in-line quality control Manufacturing sites tend to specialise by process and sector application and operate their own tailored logistics capability. The product range addresses multiple construction industry sub-sectors; the company reports residential and commercial/ infrastructure sector activity separately (splitting the latter into UK and Europe) and their relative importance is shown in Exhibit 1, implicitly showing that UK residential margins were ahead of those in UK commercial/infrastructure in FY15. European profitability is comparatively low.

Exhibit 1: Polypipe revenue and profit splits (FY15 pro forma, Nuaire annualised)



Source: Polypipe, Edison Investment Research estimates

In the UK, these largely trade end markets are addressed through a c 500 strong sales and technical support team. Customer types (including developers, contractors, specifiers, installers and housebuilders) vary by market segment and are served through multiple third-party channels as well as direct to site. Polypipe delivers with its own extensive transport fleet and limited strategic distribution space. French operations are focused on ducting and conduit for utility services.

Business portfolio developed over a number of cycles

A consistent management approach since 2005 has created the focused business of today through organic investment, acquisitions and exiting non-core activities.

Polypipe was **established as a residential plastic building products business in 1980** by a former Hepworth management team. It listed in 1986, moving into adjacent segments (including civils, ventilation and France) and others that were subsequently exited. **IMI acquired Polypipe in 1999** and added other complementary businesses (ie a UK/Italian industrial/commercial pressure systems company and a UK packager/distributor of plumbing products). A **2005 MBO** led by current CEO David Hall was the catalyst for more strategic focus. Polypipe invested further in its core areas and formally established a commercial building segment offering which was brought under the Terrain brand when that business was acquired in May 2007. By the time a new private equity (PE) partner refinanced the business in late 2007, substantially all non-core activities had been exited.

A similar pattern of investment in core operations and exiting the residual non-core ones occurred under the **second PE owners**, taking place initially during the industry down-cycle. Profitability troughed in 2009 (at £34.4m EBITDA) and early in the recovery phase the acquisitions of a small ventilation equipment manufacturer and another range of branded rainwater and drainage products (both in residential) took place. Site consolidation and investment was also undertaken in Civils manufacturing. By 2013, the last year of PE ownership, EBITDA had rebuilt to £54m, slightly ahead of the c £52m peak of 2007. At this point, the business had an even revenue split between residential and non-residential as it does today, though RMI and Civils accounted for a larger proportion of their respective segments then (partly due to sharper reductions in newbuild and UK commercial activity).

Since the **April 2014 IPO** (at 245p), Polypipe has added two small residential focused businesses (2014 Ferrob, ventilation, and 2015 Surestop, specialist pipe fittings), both of which expanded the product portfolio and enhanced distribution channel reach. The purchase of Nuaire (in August 2015 for £145m) brought in commercial ventilation systems capability for the first time, complementing a smaller position in residential. The transaction was funded internally through new banking facilities with the aim of product and system cross-collaboration to enhance the company's presence in both segments. Elsewhere, Polypipe has invested £3.6m spread over two years to build a Middle East facility for the manufacture of water management products (ie Polystorm cells). This was fully commissioned in Q316 and is designed to substitute for previously exported revenues as well as service expected future growth in local market demand.

While there has been some change in senior operational management in the last few years the team comprises very experienced personnel who have developed within the organisation. At board level, Martin Payne joined as CFO in May 2016 and the board is completed by four NEDs – all of whom were appointed at IPO – who bring a combination of industry, finance and legal experience.

Strategy: Above market growth

Polypipe has had a consistent strategy which has been maintained since the IPO in 2014. Management targets revenue growth of 2-4% ahead of the UK construction market average[1] by leveraging core market positions to address some faster growing opportunities with long-term structural industry drivers. These include:

- **Substitution of plastic building products** in place of other materials.
- **Water resource management** – environmental directives and legislation governing provisions for rain and stormwater collection and sewerage connections especially in new building.
- **Carbon efficiency** – tightening building regulations as part of wider government and industry targets to increase energy efficiency and reduce emissions gains.

Successful participation in these niches requires investment and innovation – facilitated by Polypipe's profitability, cash generation and scale - and this reinforces the company's position as a broad multi-product supplier. These development products account for around one third of UK revenue. To supplement UK organic growth prospects, management has also invested in:

- **Overseas manufacturing** – established, though smaller, operations exist in continental Europe and in 2016 a new Civils facility was commissioned in Dubai to serve the local infrastructure market (and manufacture stormwater cells that were previously exported to the region).
- **Acquisitions** – the purchase of Nuaire (in August 2015 for £145m) enabled Polypipe to expand its presence in the ventilation segment. In context, this business added c 30% to UK commercial/infrastructure revenue and c 10% to UK residential on an annualised basis. Historical margins were slightly ahead of those achieved in UK commercial/infrastructure.

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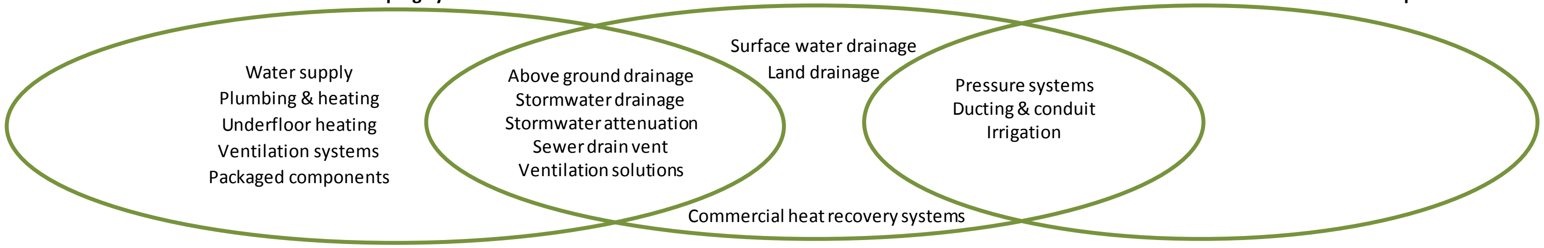
[1] Management uses a marginally adjusted ONS and CPA definition; overall construction output is considered a reasonably proxy due to the company's broad sector exposure.

Exhibit 2: Polypipe divisional structure

	Residential Piping Systems	Commercial & Infrastructure - UK	Commercial & Infrastructure - Europe

Primary product groups



FY15*		Residential Piping Systems	Margin	Commercial & Infrastructure - UK	Margin	Commercial & Infrastructure - Europe	Margin
	Revenue £m	**189**		**151**		**56**	
	EBITDA £m	**43.2**	22.9%	**31.5**	20.9%	**4.1**	7.3%
	EBIT £m	**35.2**	18.6%	**25.0**	16.6%	**2.7**	4.8%

	Residential Piping Systems	Commercial & Infrastructure - UK	Commercial & Infrastructure - Europe
Description	Manufacture of plastic pipe systems, fittings and ancilliary items (eg connectors, couplings, inspection chambers) for residential housing. Ventilation range includes mechanical extraction and ducting products.	Design & manufacture of internal & external thermoplastic drainage & water management systems, internal pressurised systems and ventilation solutions. Civil/infrastructure focuses on drainage & water management (especially roads/highways)	Manufacture & sale of plastic electrical and communications ducting, water & gas supply and conduit systems in France. Also, manufacture of pressure system fittings in Italy.
Routes to mkt	**Newbuild** - direct to site or pulled through national, regional or independent merchants. **RMI** - general merchants, plumbing & roofing stockists and also electrical stockists (ventilation) **DIY** - pre-packed components & kits	**Commercial** (developers, contractors and owners of private & public sector, high-rise, multi-occupancy & other tertiary buildings) - bias towards newbuild & direct to site or delivered via merchant network. **Civil/infrastructure** - newbuild for public agencies via spcialist engineers, contractors & merchants.	Delivery from stock from 3 manufacturing sites to merchants across France primarily for new installation projects.
Operations:	**Polypipe Building Products** Doncaster (BL) - rainwater & drainage systems Doncaster (NR) - fittings, plumbing & heating Doncaster (KS) - pre-packaged components Birmingham - Surestop, water mains switches Glasgow - northern distribution centre **Polypipe Ventilation** Doncaster (KS) - residential fans & ducting **Polypipe Ulster** Lurgan x3 - rainwater and drainage systems	**Polypipe Civils** Loughborough - Ridgistorm (larger diameter) Horncastle - Polystorm (cells) **Polypipe Terrain** Aylesford - above ground drainage (+export hub) **Polypipe Ventilation** Caerphilly - commercial & industrial systems **Polypipe Middle East** Dubai manufacturing (cells) & training, Doha sales	**Polypipe France** Janoplast (Seppois-le-Bas) - ducting, conduit Hydrotub (Castres) - large diameter pipes MdP (Aubagne) - ducting, conduit **Polypipe Italy** Genoa, Italy - Eiffast pressure systeme fittings
Competitors:	Wavin (Mexichem), Floplast, Epwin Group Aliaxis, McAlpine Plumbing John Guest, Kalsi Plastics *Ventilation - Volution, Envirovent, Greenwood, Airvac, Xpelair, Airflow, Vectaire*	Wavin (Mexichem), Naylor Drainage, JFC Asset International *Ventilation - Volution, Elta Fans, FlaktWoods, Soler & Palau*	Ducting: Arnoud, Courant Civils: Ryb, Pipelife (part of Wienerberger) Twin wall pipe: System Group, Polieco, Hegler

Source: Polypipe, Edison Investment Research. Note: *Estimated FY15 pro forma figures – annualised Nuaire contribution.

Sustaining growth ahead of the market

In this section we discuss the three key themes behind Polypipe's aspiration to exceed growth of its overall market by c 2-4% per annum, specifically, increasing penetration of plastic building products, water management solutions and carbon efficiency measures. Polypipe's so-called development products in these areas account for around one third of its UK revenue. We discuss the current position and expected direction of market developments, focusing on UK operations. We note the regulatory tailwinds, government intentions to build new homes at a faster rate but also policy inconsistencies. Our general sense is that progress in these areas will present opportunities that favour companies with strong market positions and who are able to invest and innovate.

1. Increasing penetration of plastic building products

The combination of strong market position and increasing usage of plastic building products provides scope for Polypipe to take share and grow ahead of total demand in its categories. At the time of IPO, management stated that UK revenues were 1.5x larger than its next largest competitor (Wavin) and 4.5x greater than the next one (Aliaxis). We believe that Polypipe's underlying growth has exceeded its markets since IPO. The addition of Nuaire has added a significant presence in a new sector, commercial ventilation.

Exhibit 3: Penetration of plastic building products in selected applications

	Plastic %	Plastic £m	Other materials (% market share)	Products
Above ground drainage	80%	238	Aluminium (10%), Cast iron/steel/other (10%)	Guttering, downpipes, waste pipes, fittings, connections
Below ground piping systems	73%	602	Concrete (18%), Other (9%)	Sewerage, drains, inspection chambers, stormwater management
Plumbing & heating supply	36%	163	Copper (51%), Brass/alloy (11%), Cast iron/steel/other (2%)	Pipework, fittings
Underfloor heating	3%	N/A	Steel (97%)	Central heating radiators, room heaters

Source: Polypipe, 2012 data

Exhibit 3 shows a number of sub-sectors where plastic building products have increasingly been adopted, some more mature than others. Installation is the most commonly cited advantage from plastic products and, depending on sector, others include low maintenance, flexibility and bespoke characteristics. While polymer types vary, Polypipe has a cross-sector manufacturing capability with common technologies and distribution reach to service each of them.

Polypipe has clearly become a significant business through its participation in this alternative material trend, becoming an industry leader. Consequently, we believe it is well positioned to continue to benefit from ongoing substitution. In particular, its strong market positions are built on:

- **Scale** – as noted above, revenue generation and volume capability versus competitors.
- **Service** – integrated design, manufacturing and distribution model.
- **Distribution reach** – presence in multiple channels and a range of customer types accessed with a broad branded product portfolio.
- **Mix** –greater penetration of smaller independent merchants (c 49% vs 29% market average) and higher proportion of fittings and ancillary products (c 56% vs 76% market average) leads to the supply of product/project bundles and opportunities to increase achieved margin.

Together, these factors translate to higher levels of profitability and above industry average margins. Additionally, we believe that the benefits of innovation and investment are amplified through this market reach and scale in multiple channels and, with superior returns on offer, there is clear motivation for Polypipe to continue to do so.

2. Water management solutions – joined up thinking

The big picture drivers of demand for products and services in this space are:

- investment in and maintenance of network assets by water utilities (governed by Water Resource Management Plans, implemented under five-year AMP cycles); and
- the volume of new building construction activity (influenced by economic cycles, planning, environment). Building Regulations 2010, Part H governs drainage & waste disposal (requiring adequate systems to be in place to carry away roof rainwater and waste water).

In recent years, the point of connection between these physical assets has been subject to legislative and regulatory change.

Following the EU Floods directive 2007 and Pitt Review of 2008, the Flood & Water Management Act 2010[2] (FWMA) among other things made provision for the management of risks connected with flooding in England and Wales. It placed the onus on national and local authorities as well as water companies and highways agencies to develop coherent strategies to do so and then monitor and deliver against them. The elements most relevant to Polypipe are:

- **the adoption of existing sewer pipes** serving more than one home. (In 2011, OFWAT made provision for the transfer maintenance responsibility for existing private sewers and lateral drains to the water companies in England and Wales.)
- **potential end to the automatic right to connect new homes to existing sewage networks** in England and Wales. (Under policy review and may require prior agreement between developer and sewerage undertaker. Expected Mandatory Building Standards are still pending and may tie in with SuDS provision.)
- **provisions for the use of Sustainable Drainage Systems (SuDS)** to recognise the impact of new developments on surface water run-off. (Planning guidelines issued and non-statutory technical national standards published but yet to be fully implemented.)

The key implications of these measures are a) maintenance moving from private to quasi-public sector, b) developer drainage plans now subject to scrutiny and quality approval and c) raised profile of water management. We believe that this creates opportunities for Polypipe's residential housing (rainwater systems – above and below ground drainage) and civil/infrastructure systems (surface and stormwater management) activities. With greater emphasis on earlier stage engineering design involvement, the relative versatility of plastic systems – including offsite pre-fabrication – suggests that lower installation and lifecycle maintenance costs has appeal to both developers and the subsequent adopter.

Issues raised through industry consultation appear to centre on cost. In the case of developers, having longer project gestation periods in planning and approval processes potentially requires additional resource and delay. From the water companies' perspective, they clearly would not want to accept an open-ended liability to maintain low quality assets. This also applies to SuDS schemes where the post-construction phase management, which could potentially be a developer, asset owner, local authority, relevant agency or a combination thereof, is still to be clarified. The Housing and Planning Act (enacted May 2016) made provision for the Secretary of State to review SuDS policy. We understand that this review is underway and it is suggested that it will be delivered by June 2017. There are no guarantees on timing or ultimate outcome but we believe that the intent and direction of the FWMA legislation is such that increased and more diverse activity is inevitable once stakeholder interests are balanced out. Ahead of this, we should point out that a permitted new housing pipeline under already updated building regulations should support increased product and system demand. Polypipe is well placed to service current and expected future industry requirements.

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2 http://www.legislation.gov.uk/ukpga/2010/29/pdfs/ukpga_20100029_en.pdf

3. Carbon efficiency – devil in the detail

The UK government laid out its long-term carbon emissions objectives in the Climate Change Act 2008 which mandated an 80% economy wide reduction in UK CO_2 emissions by 2050. The roadmap to delivery is contained in five-year carbon budget frameworks – each with legally binding emissions limits – with three cycle visibility, giving a 15-year pathway. The 2011 Carbon Plan[3] updated the initial three cycle plan and introduced a fourth cycle which now takes us up to 2027.

The Plan is all-encompassing and clearly identified buildings as a primary source of carbon emissions by end user - split roughly two thirds domestic, one third non-domestic (commercial and industrial). Space heating is the most significant component of this in both building types, with hot water heating also material in domestic buildings. Consequently, buildings featured prominently in policy targets in the first four carbon budgets including:

- **2016** – new build dwellings to have zero in-use CO_2 emissions
- **2019** – new non-domestic buildings to have zero in-use CO_2 emissions
- **2020s** – mass deployment of low carbon heat technologies
- **2027** – Climate Change Act: 50% cut in total UK CO_2 emissions (vs 1990 baseline)

However, after initial gains, progress on buildings is considered to have stalled in the last three years and the above zero carbon timing targets effectively abandoned; potential cost to industry and, therefore, an obstacle to housing supply were cited as the reasons. In 2016, the Committee on Climate Change (CCC) reported on a policy gap[4] and most investors will be familiar with the mixed success of schemes such as Green Deal, ECO and feed-in-tariffs. Practical implementation issues in the context of wider governmental budget constraints do not send positive signals about opportunities to the building supply chain. However, the 2050 target is legislated and, put simply, the implication of a policy gap at this stage is that the rate of progress needs to intensify in order to get back onto the intended pathway. The CCC has published its recommendations for a stronger policy framework[5] ahead of an expected but delayed Emissions Reduction Plan from the Department for Business, Energy & Industrial Strategy. Directly or indirectly, HM Treasury is the facilitator for incentivising the building industry to adopt lower carbon methods –balancing short-term costs and long-term benefits - and we will continue to watch developments across the relevant departments.

Progress towards the 2050 targets is clearly not going to be linear. Forward visibility on the direction of travel is good but the elemental detail and prescribed timeframes lack clarity. Polypipe's existing residential and commercial product offering is aligned with likely areas of focus, such as:

- **Ventilation** – increased energy efficiency/reduced heat loss requires increasing air tightness and air quality management which needs to be factored in early in the design process.
- **Alternative heating** – underfloor heating is another portfolio product and, in due course, wider usage of ground and air source heat recovery will require systems and distribution, which may or may not be alongside conventional heating systems.

Looking at the wider picture, the lifecycle of plastic building materials is aligned with the theme of sustainability and sustainable development. Taking a whole supply chain perspective, the use of virgin and recycled polymers, lower energy processing costs (say versus concrete and copper products) and lighter weight leads to lower transportation and installation costs. Moreover, the materials can be recycled at the end of use. Much of the big picture benefits of such an approach taken across the whole economy are outside the scope of, and well beyond, our forecast horizons but the direction of travel is clear and the rate of progress should begin to gather momentum.

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3 www.gov.uk/government/uploads/system/uploads/attachment_data/file/47613/3702-the-carbon-plan-delivering-our-low-carbon-future.pdf

4 Meeting Carbon Budgets – 2016 Progress Report to Parliament (CCC, June 2016, p82-111)

5 Next steps for UK heat policy (CCC, October 2016)

Sensitivities

Polypipe operates a balanced manufacturing footprint and integrated distribution management to offer a broad product range across a varied customer base in a number of different sectors. This business model and scale is a significant competitive strength and provides resilience. Overall activity levels are influenced by UK GDP growth, interest rates and cycles within individual construction sub-sectors. Underlying input price and FX movements can dampen/enhance short-term profitability affecting all industry suppliers. In addition, FX movements affect reported results from Polypipe's European operations, though at present their profit contribution is modest.

Internal considerations: Close co-ordination and integration of UK manufacturing and distribution functions enables Polypipe to run a relatively low inventory (including limited warehousing), short supply chain, high service level customer proposition in a comparatively short order visibility industry. **Manufacturing:** The company has a multi-site manufacturing footprint. UK operations are considered to be well-invested and run efficiently. Facilities tend to specialise by process and/or market segment with operational flexibility for tooling/line changes. We believe that there is some scope for switching manufacturing between sites but site specialism is likely to be a constraint if a short-term need arose. European operations are subject to volume throughput variations which limit plant efficiency and profitability but also indicate latent capacity. A new Middle East facility was established in 2016 to produce surface water management (modular geocellular) products, substituting previously UK-manufactured exports. Subject to achieved volumes, this should enhance achieved margin but in the near term the non-UK facilities are likely to dilute group margin. **Distribution:** Service levels (including product breadth and availability) and distribution reach are key customer attractions. Polypipe maintains an in-house transport fleet and logistics capability. While this requires investment and P&L cost management, it reinforces market position and represents a significant competitive entry barrier. It also means that new investment can be rigorously benchmarked and offer accelerated pay-backs. We are unable to benchmark a substitute, third party cost to serve but consider distribution to be a core operational function.

External influences: Polypipe generates c 86% of revenue and almost all of its profit from UK operations and construction sector activity levels are key drivers. UK revenue is generated approximately 55:45 from residential:non-residential end markets. Each segment is further sub-divided; residential splits broadly equally between RMI/newbuild with non-residential extending across commercial (private), commercial (public) and infrastructure, again in broadly equal measure. These five sub-sectors have distinct demand drivers and are served through multiple distribution channels. All are affected by interest rates to some degree but we would argue that the range of customer types and funding are sensitive to different points on the yield curve. This diversity provides business model resilience and also guides the allocation of development resource into faster moving segments, enabling the company to gain share and management to target growth of 2-4% above the industry overall. Polypipe's markets are typically concentrated with a relatively small number of suppliers. This means that M&A can attract the attention of competition authorities who have investigated building materials segments periodically in the past.

Sterling movements impact the translation of overseas profits, though this is unlikely to be material to group results in the near term. FX also has indirect transactional effects as Polypipe purchases virgin polymer at a landed sterling cost although the underlying commodity currency is US dollar (sourced in Europe). So sterling weakness feeds into high UK polymer prices and other industry players are similarly affected. (We do not believe that imports are a significant portion of local finished product supply and so FX movements do not influence volume shifts.) For the record, polymer materials (both virgin and recycled) represent c 40% of Polypipe's revenue and other materials (eg pigments, packaging) a further 10%. We would expect Polypipe to recover input cost inflation through materials escalation clauses on specified/project-based contracts and through its trade price list in stockist/distributor channels, generally with a three to four month lag.

Valuation

Polypipe is an established, profitable and cash generative business which operates across a number of cyclical (primarily) UK construction segments. It seeks superior performance through investment in faster-growing niches to enhance returns generated from strong existing positions in its markets. Reflecting this profile, Polypipe is currently sitting on a premium rating to its peer group and if its historical earnings premium (c 23%) is mapped onto FY18 earnings expectations, this would suggest a c 375p share price. Obviously, a faster rate of earnings growth would raise the illustrated level further.

Integrated model, solid earnings foundation

We consider Polypipe to be a single entity with a fully integrated UK business model that provides technical and procurement support to its overseas operations. (Theoretically, non-UK operations could be separated but, at this stage, we do not believe the effect on group valuation would be material.) It has demonstrated an ability to outperform its markets and deliver respectable EBITDA margins even at low points in the cycle and we believe that reported earnings and cash flow are solid foundations for valuation metrics.

Attractive returns and cash

Based on our estimates, Polypipe is trading on FY16 multiples of **13.5x P/E and 9.8x EV/EBITDA**. This follows a significant step up in expected earnings in the year as a result of the annualised effects of the 2015 Nuaire acquisition supplemented by good underlying revenue growth and some margin improvement. Ahead of the FY16 results announcement, we currently expect compound EPS growth of c 8% pa for the two years to FY18. This gives an **indicative PEG of c1.7x** for this period. This is high by convention and suggests that Polypipe's rating includes a premium to the market and/or investors are anticipating a faster rate of growth. Indeed, consensus estimates – as shown in Exhibit 4 – factor in a c 9% CAGR for this period.

We consider that Polypipe has a very cash generative model. We currently model capex running at 1.2x depreciation and even after this we expect Polypipe to generate free cash flow (FCF) of c £43m in FY16, rising to c £53m in FY18. At the current valuation level, this is equivalent to **FCF yields of 6.4% and 7.9%** respectively. This is sufficient to fund a rising dividend payout and still produce surplus cash for additional investment (organic or acquisitive) or reducing net borrowings. For the record, Polypipe is expected to pay out c 40% of underlying earnings in each year and this suggests c 28% uplift in the expected FY16 DPS declaration. On this basis, the company is on a 3.0% dividend yield (covered 2.5x on both earnings and cash bases) with growth in line with earnings factored in thereafter.

Although this is not a key driver of valuation in our view, we expect group net assets to be in the region of £290m at the end of FY16, equivalent to an NAV per share of c 142p. The company's operating sites are largely freehold and the balance sheet is also backed by a significant element of goodwill; the pre-IPO businesses and Nuaire account for the majority of this and, as they are generating earnings above historical levels, we consider the reported level of intangibles to be robust. More important is the return that Polypipe is able to generate from its invested asset base. We calculate the company's expected pre-tax return on capital employed (ie Edison operating profit norm divided by net assets plus long-term liabilities) and weighted average cost of capital as:

- **Expected FY16 ROCE of 13.6%** (and slightly above this level in the following two years)
- **WACC of 7.4%**

This supports our assertion that Polypipe has a cash generative model. We expect to see net debt to EBITDA at or slightly below 2x for FY16 and, absent acquisition activity, trending down thereafter.

Premium rating for premium growth prospects

Against a peer group of other, quoted largely UK building materials companies, Polypipe sits on headline premiums of c 23% on a P/E basis and c 29% for EV/EBITDA for FY15 (last reported). On the same basis, these premia narrow to c 11% and c 20% respectively by FY18. Individual company multiples are shown in Exhibit 4.

Exhibit 4: Polypipe – peer group valuation analysis

	Year end	Price	Market cap	P/E x				EV/EBITDA x				Dividend yield %			
		p	£m	2015	2016	2017	2018	2015	2016	2017	2018	2015	2016	2017	2018
Polypipe Group	**Dec**	**335**	**665**	**20.4**	**13.7**	**12.6**	**11.5**	**13.2**	**10.0**	**9.4**	**8.9**	**2.2%**	**2.9%**	**3.2%**	**3.5%**
Marshalls	Dec	313	617	22.7	17.7	16.1	14.5	12.6	10.7	9.8	9.1	2.2%	2.8%	3.1%	3.5%
Volution Group	July	182	362	16.8	13.3	12.5	12.0	10.2	10.1	9.6	9.3	2.3%	2.3%	2.4%	2.5%
Epwin Group	Dec	110	157	11.6	7.9	7.4	7.1	8.0	5.6	5.3	5.1	4.8%	6.0%	6.2%	6.4%
Eurocell	Dec	210	210	9.5	9.5	8.8	8.3	7.1	7.1	6.7	6.4	4.4%	4.4%	4.9%	5.2%
Safestyle UK	Dec	300	248	14.2	15.2	14.2	13.2	10.0	10.5	9.8	9.2	4.0%	3.7%	4.1%	4.4%
Forterra	Dec	209	418	9.6	9.1	8.3	7.8	7.6	7.4	6.9	6.6	0.0%	2.8%	4.4%	4.9%
Ibstock	Dec	200	814	10.8	10.8	10.0	9.3	8.4	8.4	7.8	7.2	3.4%	3.4%	3.9%	4.3%
Travis Perkins	Dec	1,486	3,729	29.1	12.6	11.7	10.7	15.9	8.3	7.9	7.4	2.2%	3.1%	3.4%	3.5%
Grafton Group	Dec	659	1,557	17.8	13.9	12.8	11.4	11.5	9.0	8.3	7.6	1.7%	2.2%	2.4%	2.5%
SIG	Dec	115	680	23.5	12.0	10.8	9.2	11.0	8.0	7.4	6.5	3.2%	3.7%	3.9%	4.0%
Mean - exc PLP				**16.6**	**12.2**	**11.3**	**10.4**	**10.2**	**8.5**	**8.0**	**7.4**	**2.8%**	**3.5%**	**3.9%**	**4.1%**

Source: Bloomberg – consensus estimates. Note: *Volution's multiples and yield are calendarised. Priced at 14 March 2017.

We should point out that SIG, Volution, Ibstock and Grafton have more exposure to non-UK markets (chiefly Europe) compared to the other companies in the table.

Our observations on this are:

- **Sub-sector convergence** – there is a range of different business models across the peer group shown (as well as there being differences in focus); but the average earnings multiples for the producers (excluding brick makers, who trade at a discount) is similar to that for the distributors. The average merchant dividend yield is below that for the peer group as a whole.
- **Earnings growth expectations** – Marshalls and Polypipe have the strongest earnings growth prospects across the peer group with consensus CAGRs of c 14% (FY15-FY18) and approaching 10% (FY16-FY18). These companies have similar business models; Polypipe is priced on a c 13% P/E discount to Marshalls. While their PEGs are in excess of 1x their earnings growth profiles more than compensate for a below sector average yield, in our view.
- **EBITDA adjustments/pensions** – as previously noted, Polypipe does not have cash calls relating to pension deficit recovery plans. Of the selected peer group, Ibstock plus all three of the merchants make additional cash contributions into their respective DB schemes. In our models, we deduct this from EBITDA prior to calculating EV/EBITDA. If Bloomberg has not, this would have the effect of inflating the multiples seen in Exhibit 4 for these companies and narrow the apparent premium for Polypipe nearer to that for P/E-based ones. We are not necessarily suggesting that these payments are onerous, nor restrictive for the companies concerned although they clearly require more management attention compared to companies who are not operating such schemes.

Our last point on valuation is to note that the larger quoted housebuilders, which represent a significant customer group for the building materials suppliers, on average trade on forward P/E and EV/EBITDA discounts of c 15-20% versus our peer group and a dividend yield premium exceeding 30%. Valuations here are more driven by land banks on hand and NAV movement than are our chosen manufacturers and merchants.

Financials

Polypipe came to the market in April 2014 as a relatively streamlined, profitable, substantially UK-oriented focused building products concern with strong market positions. As a quoted entity, it has reinforced these aspects, made a material acquisition (Nuaire for £145m in 2015 increasing scale in the ventilation segment) and raising earnings by more than 50% (FY16e vs FY14). We expect net debt to have reduced to c £172m (c 2x EBITDA) by the end of FY16 and, ahead of FY16 results, our estimates show a three-year EPS CAGR of 13.7% and double-digit DPS growth also.

Robust earnings model delivering growth

Polypipe has a mature business model with earnings driven by volumes, manufacturing and distribution efficiency and pricing in an established customer base across the segments served.

- **Revenue** – we model by segment, substantially based on Construction Products Association (CPA) forecasts. Management aims for c 2-4% growth above its markets (including Nuaire's contribution) and our FY15-FY18 CAGR exceeds 10%. This includes lower, single digit rates in FY17 and FY18. There has been some conservatism regarding the residential outlook we believe, that is not currently being borne out by the larger quoted housebuilders.
- **Gross margin** has risen steadily; we model it at or slightly above the FY15 level (40.5%).
- **EBIT margin** - in the UK, residential margin exceeds commercial/infrastructure with Europe at the low single digit level. We believe that mix effects (including sterling weakness) and rising input prices will limit scope for near-term EBIT expansion (FY16e 16.5%, after SBP). In stable conditions we would expect revenue growth to drop through to incremental EBIT margin gain.

After allowing for declining net debt and bank interest (FY16e cover c 10x) and a stable tax regime, our FY15-FY18 EPS CAGR comes out at 13.7%, with a DPS CAGR not far behind at 12.2%.

Clean cash flow, healthy investment levels and debt reduction

Between 2012 and 2014, financial statements showed rising EBITDA, capex ahead of depreciation and increasing free cash flow. At IPO, the company was relatively lowly geared and raised no new money. Profitability stepped up following the Nuaire acquisition – funded from new debt facilities (a £300m RCF to August 2020) – and FY16 earnings and cash flow will reflect the annualised benefit of this. We expect pre-IPO cash characteristics to be a recurring feature of Polypipe's results; on current revenue estimates we see limited further working capital requirements and, even with capex at 1.2x depreciation, free cash flow should continue to rise. We note limited non-cash adjustments to reported EBIT. Additionally, Polypipe does not run a DB pension scheme so there is no deficit, deficit recovery plan or associated cash calls. We believe that there is scope for debt reduction ahead of the current consensus; our model shows net debt falling from c £194m in FY15 to £172m at the end of FY16 to c £115m by FY18. Potential increases in the rate of investment and/or acquisition opportunities are caveats to this profile. In either scenario we believe that DPS and cash dividends will continue to rise and a faster rate of investment could enhance this.

Long-term funding for long-term assets

The balance sheet structure is substantially comprised of fixed capital investment (goodwill and intangibles of c £375m spread across a number of cash generating units – c £234m relating to pre-IPO operations, the remainder largely Nuaire – and c £100m net tangible fixed assets) funded by long-term borrowings (£222m drawn down at the end of H116). Excluding cash, there is limited net current asset investment (modestly positive at the interim stage/negative at year end). Our model runs a sizeable cash on hand position; in practice this may be used to lower drawn borrowings but the company clearly has treasury management options.

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Exhibit 5: Financial summary

£'ms	2011	2012	2013	2014	2015	2016e	2017e	2018e
December	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS								
Revenue	286.4	282.0	300.8	327.0	352.9	428.0	447.5	462.0
Cost of Sales	(190.1)	(176.8)	(188.3)	(202.4)	(210.0)	(250.3)	(261.7)	(268.0)
Gross Profit	96.3	105.2	112.5	124.6	142.9	177.7	185.8	194.0
EBITDA	39.6	49.0	53.6	60.8	69.3	86.2	90.8	96.0
Operating Profit (underlying)	26.6	36.1	39.7	46.3	54.2	70.2	74.5	79.5
SBP	0.0	0.0	0.0	0.0	0.0	(1.0)	(1.2)	(1.3)
Operating Profit (reported)	26.6	36.1	39.7	46.3	54.2	69.2	73.4	78.2
Net Interest	(14.4)	(14.5)	(14.1)	(7.7)	(5.3)	(7.0)	(7.0)	(6.8)
Other finance	(1.2)	(1.1)	(1.1)	(1.0)	(0.9)	(0.9)	(0.9)	(0.9)
Intangible Amortisation	0.0	0.0	0.0	0.0	(3.0)	(7.0)	(6.3)	(6.3)
Exceptionals	(0.3)	0.5	0.1	(20.7)	(3.5)	0.1	0.0	0.0
Profit Before Tax (norm)	11.0	20.5	24.5	37.6	48.0	61.3	65.5	70.6
Profit Before Tax (FRS 3)	10.7	21.0	24.6	16.9	41.5	54.4	59.2	64.3
Tax	(0.9)	(0.4)	(4.6)	(5.4)	(9.2)	(12.1)	(13.1)	(13.4)
Profit After Tax (norm)	10.1	20.1	19.9	32.2	38.8	49.2	52.4	57.1
Profit After Tax (FRS 3)	9.8	20.6	20.0	11.5	32.3	42.3	46.1	50.9
Average Number of Shares Outstanding (m)	200.0	200.0	200.0	199.9	199.3	198.4	198.4	198.4
EPS - normalised FD (p)	5.1	10.0	10.0	16.1	19.4	24.6	26.2	28.6
EPS - FRS 3 (p)	4.9	10.3	10.0	5.8	16.2	21.3	23.2	25.7
Dividend per share (p)	0.0	0.0	0.0	4.5	7.8	10.0	10.5	11.0
Gross Margin (%)	33.6	37.3	37.4	38.1	40.5	41.5	41.5	42.0
EBITDA Margin (%)	13.8	17.4	17.8	18.6	19.6	20.1	20.3	20.8
Operating Margin (underlying) (%)	9.3	12.8	13.2	14.2	15.4	16.4	16.6	17.2
BALANCE SHEET								
Fixed Assets	313.6	316.3	323.4	324.2	476.5	475.0	471.8	469.0
Intangible Assets	234.4	234.4	234.4	235.0	378.4	371.5	364.5	358.3
Tangible Assets	79.0	81.9	89.0	89.2	98.1	103.5	107.3	110.8
Investments	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Current Assets	90.3	107.9	126.6	103.9	99.6	137.9	170.1	202.8
Stocks	34.9	37.6	38.9	39.9	47.5	46.6	48.7	49.9
Debtors	15.7	20.9	19.2	20.2	29.3	38.8	40.4	42.0
Cash	37.8	47.0	65.9	43.1	21.6	49.5	76.5	105.9
Current Liabilities	(56.4)	(59.8)	(64.4)	(69.8)	(87.2)	(95.9)	(98.1)	(98.3)
Creditors	(56.4)	(59.7)	(64.4)	(69.8)	(87.2)	(95.9)	(98.1)	(98.3)
Short term borrowings	0.0	(0.1)	0.0	0.0	0.0	0.0	0.0	0.0
Long Term Liabilities	(156.9)	(153.3)	(154.2)	(120.6)	(227.9)	(233.0)	(234.3)	(235.4)
Long term borrowings	(148.6)	(149.6)	(150.6)	(118.0)	(215.9)	(221.6)	(221.6)	(221.6)
Other long term liabilities	(8.3)	(3.7)	(3.6)	(2.6)	(12.0)	(11.4)	(12.7)	(13.8)
Net Assets	190.6	211.1	231.4	237.7	261.0	284.0	309.4	338.1
CASH FLOW								
Operating Cash Flow	45.0	43.4	58.2	50.6	72.6	81.0	87.9	92.7
Net Interest	(14.6)	(14.4)	(14.3)	(10.4)	(5.7)	(7.3)	(7.0)	(6.8)
Tax	0.1	(3.8)	(4.9)	(3.7)	(5.2)	(11.3)	(12.1)	(13.1)
Capex	(10.1)	(15.5)	(20.3)	(14.9)	(18.9)	(19.8)	(20.0)	(20.0)
Acquisitions/disposals	(1.1)	(0.8)	0.3	(0.3)	(149.5)	0.0	0.0	0.0
Financing	0.0	0.3	0.0	(1.7)	0.0	(3.0)	(1.5)	(1.5)
Dividends	0.0	0.0	0.0	(3.0)	(10.6)	(17.2)	(20.4)	(21.9)
Net Cash Flow	19.3	9.2	19.0	16.6	(117.3)	22.4	26.9	29.5
Opening net debt/(cash)	129.3	110.8	102.7	84.7	74.9	194.3	172.1	145.1
HP finance leases initiated	(0.8)	0.0	0.0	(9.6)	(1.7)	0.0	0.0	0.0
Other	(0.0)	(1.1)	(1.0)	2.8	(0.4)	(0.2)	0.0	(0.0)
Closing net debt/(cash)	110.8	102.7	84.7	74.9	194.3	172.1	145.1	115.7

Source: Company accounts, Edison Investment Research.

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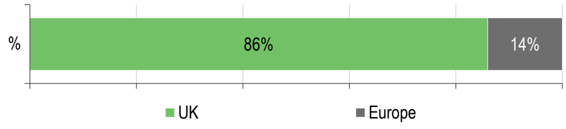
Revenue by geography (FY15 pro forma, Nuaire annualised)



Management team

CEO: David Hall

CEO since September 2005 having led an MBO in that year. Currently president of the British Plastics Federation and vice chairman of the Construction Products Association. Previously held MD positions at Marley UK and Glynwed International.

CFO: Martin Payne

Appointed May 2016. Previously group finance director at Norcros and held senior financial positions at JCB and IMI. Fellow of the Chartered Institute of Management Accountants.

Chairman: Ron Marsh

Appointed chairman in May 2015, having been the SID from March 2014. Currently NED at R Faerch Plast A/S and chairman of the UK Packaging Federation and Alliance for European Polymers. Previously NED at BPI and CEO of RPC.

Principal shareholders (28 February 2017)	(%)
Standard Life Investments	13.3
Schroder Investment Management	6.3
JP Morgan	4.3
Canaccord Genuity Wealth	4.3
Blackrock Investment Management	3.5
Vanguard Group	3.2

Companies named in this report

Mexichem (Wavin), Wienerberger, Hill & Smith (Asset International), Eurocell, Epwin Group, Forterra, Grafton Group, Ibstock, Marshalls, Safestyle UK, SIG, Travis Perkins, Volution Group