EDISON

Avon Protection

FY21 results and earnings

Refocused Protection set to resume growth

Aerospace & defence

Avon Protection should be well positioned to recover strongly following the value destruction caused by the relatively small Armor activity, which now faces a managed closure over the next two years. Future growth rates are diminished by the exit but remain healthy in the further focused core of Respiratory and Head Protection. Management needs to restore investor confidence as it continues with its growth strategy, in order to regain the historical premium rating to its UK defence peers. In this note, we reset our forecasts and valuation to reflect the revised shape of the business.

Year end	Revenue ($m)	PBT* ($m)	EPS* (c)	DPS (c)	P/E (x)	Yield (%)
09/20	213.6	36.1	97.4	34.5	15.0	2.4
09/21	248.3	18.9	60.3	44.9	24.3	3.1
09/22e	278.4	33.2	85.1	47.1	17.2	3.2
09/23e	313.2	45.4	116.3	54.2	12.6	3.7

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

FY21 achievements masked by body armour issues

Despite COVID issues and excluding the Armor business, FY21 revenues grew by 21% to $241.8m (FY20: $199.9m). Excluding the initial 11-month consolidation of Team Wendy, which added $41.0m, core revenues rose modestly to $201.5m. Failures in first article testing (FAT) caused delays to product approvals for new body armour that ultimately led to a review of the entire Armor business and the decision to wind it down over the next two years. Although small (FY21 revenues of just $6.5m), these delays led to adjusted EBIT level losses of $10.5m and have damaged investor confidence more widely. Management must now focus on restoring sentiment and demonstrate that the value impact has been excessive.

Focus on growing respiratory and head protection

The core strategy for growth remains in place: focusing on organic growth, selective product development and value-enhancing M&A. In the near term, the focus is very much on growing the respiratory and head protection business as the process of winding down and closing the problematic Armor business is implemented over the next two years. Management expects growth of the non-US Military Respiratory segment to be the primary driver of revenue growth in FY22. In addition. Team Wendy enhances the head protection product portfolio and will make a full year contribution in FY22. The Armor business is expected to be a continuing activity in FY22 and FY23 and we expect it to eliminate the adjusted EBIT losses on higher revenues as it fulfils its outstanding contracts, significantly reducing the overall dilution to group margins.

Valuation: Premium to peers should be attainable

The FY23e P/E of 12.6x represents a c 13% discount to its UK aerospace and defence peer group. We feel that as the Armor issues should now recede, this is undeserved given exposure to the US defence market, strong core EBITDA margins, cash flow and growth expectations as the company addresses growing global chemical, biological, radiological and nuclear (CBRN) and other threats. Our reset capped DCF valuation returns a fair value of £16.75 or $22.78 per share.

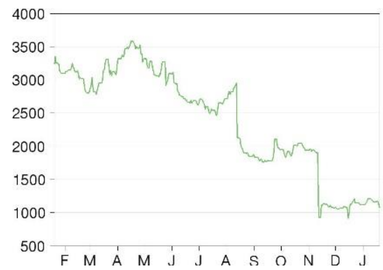
20 January 2022

Price	**1,076p**
Market cap	**£334m**

US$1.36/£1

Adjusted net debt ($m) at 30 Sept 2021 (excluding lease liabilities)	26.8
Shares in issue	31.0m
Free float	90.8%
Code	AVON
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	(4.4)	(46.2)	(68.5)
Rel (local)	(7.6)	(48.2)	(72.1)
52-week high/low		3582p	916p

Business description

Avon Protection designs, develops and manufactures personal protection products for Military and First Responder markets focusing on respiratory mask systems and helmets. Its main customers are national security agencies such as the US Department of Defense and c 90% of sales are from the United States.

Next events

AGM	28 January 2022

Analyst

Andy Chambers +44 (0)20 3681 2525

industrials@edisongroup.com

Edison profile page

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Investment summary

Core growth strategy remains

Avon Protection is recognised as a global leader in life-critical protection systems covering two main product areas: respiratory and head protection systems, serving customers in the global Military and First Responder markets. The smaller Armor operations proved problematic in FY21 and, following a review, are to be wound down and closed over the next two years. Armor accounted for just 2.6% of revenues in FY21, but its problems detracted from future growth prospects and the progress being made in the rest of the group, which accounts for the bulk of revenues, profitability and cash generation. In FY21, Respiratory systems and products accounted for 67.9% of group sales, while Head Protection products generated 29.5%. The group strategy remains focused on investing the strong cash flows to grow these core activities, with selective product development, while adding value-enhancing acquisitions when appropriate although no major M&A is planned for FY22.

FY21 results

Despite the pandemic which did increase operational challenges, the core of Avon Protection made reasonable progress in FY21, although this was masked by the problems that escalated at the Armor business during the year and led to the recent review of its future. Organic revenue growth of 8.1% and 1.3% was delivered by Military Respiratory and First Responder, respectively, augmented by the initial consolidation of Team Wendy. The now core activities (ex Armor) grew revenues by 21%. Negative operational gearing effects and the Armor losses depressed adjusted EBITDA margins, although these remained relatively high at 19%.

Financials: Reduced estimates but strong EPS growth

We have revised our estimates to reflect management caution for development of the ongoing core, with our FY21 revenue forecast towards the bottom end of the guided range of $260–290m. We expect overall margins to recover strongly in FY22 and FY23 as the group benefits from operational gearing, with volumes increasing and overheads reducing by around $15m. The losses of Armor should be eliminated as it executes its remaining contracts over the next two years as the business winds down to closure. Overall, we have reduced our FY22 revenue expectations by 4% to $278m ($260m core and $18m Armor) and expect growth to $313m in FY23. Our fully diluted FY22 EPS estimate falls 14% to 85.1 US cents, but still represents a strong recovery of 41%, with a further 37% progression forecast for FY23.

Valuation: Restoration of confidence paramount

The two FAT failures of new body armour products represent unanticipated factors in developing specific products and appear to primarily relate to material technology issues. In our view, the 75% of market value largely eliminated by the Armor failure is excessive, even if the stock was priced for perfection beforehand. While the company still faces technology and development product risk, we are less concerned about the positioning of the respiratory operations, which continue to grow leading positions with an expanding customer base. The helmets business acquired from 3M is developing the new-generation Integrated Head Protection System (IHPS) US military helmets, which are due for FAT during FY22. However, we believe the product development, engineering and construction of the products are distinct and separate from the body armour engineering efforts. Successful execution of the more cautious growth plan is paramount in restoring investor confidence and permitting full recovery of a premium rating against UK defence peers.

Global leader in respiratory and head protection

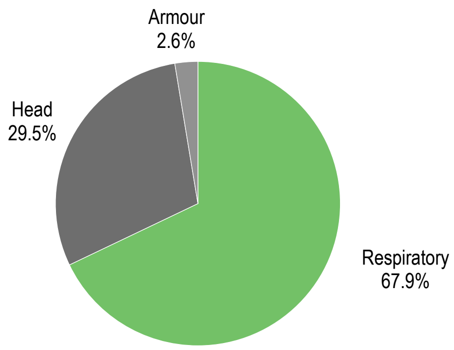
Following the acquisition of 3M's ballistic protection assets (known as Ceradyne) in January 2020 and the disposal of its dairy operations for $227.3m in September 2020, the group was focused on its life-critical protection solutions centred on respiratory systems, helmets and armour. The $132m acquisition of Team Wendy on 2 November 2020 further strengthened the helmet activity, both for military and civilian products as well as liner restraint systems. The group changed its name to Avon Protection (formerly Avon Rubber) in July 2020 to reflect the increased focus. As the majority of its sales and operations are now based in the United States, the group has adopted US dollar reporting from FY21, although it is listed on the LSE.

During FY21, the company's body armour business faced significant technical issues in developing new products that should have formed the core elements of future revenue streams for the armour activity. Following a review, it has been decided that further investment in the business is inappropriate and an orderly winding down of all the ballistic armour (body inserts and larger flat armour panels for helicopters) over the next two years is now underway. In FY21, the armour operations represented just $6.5m (FY20: $13.7m) or 2.6% (FY20: 6.4%) of group revenues, but have been the major reason for the significant value decline experienced since December 2020.

Moving forward, the core operations of the group are centred on two main product portfolios in respiratory systems and head protection.

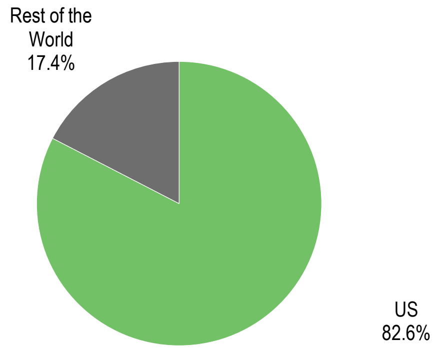
- Avon Protection has the global leading range of respiratory protection systems. Its product portfolio includes full face respirators, escape hoods, self-contained breathing apparatus (SCBA) systems, powered air purifying respirator (PAPR), modular units, thermal imaging cameras, underwater equipment, filters, spares and accessories.
- The head protection portfolio is focused on next-generation ballistic helmets and bump protection helmets, as well as helmet liner and retention systems.

Exhibit 1: Avon Protection FY21 revenues split by product area ($248.3m)



Source: Avon Protection

Exhibit 2: Avon Protection FY21 revenues split by geography ($248.3m)



Source: Avon Protection

In FY21, over two-thirds of group revenues were generated by respiratory product systems, accessories and spares, down from more than 75% in FY20 largely due to the initial 11-month consolidation of Team Wendy which generated $41.0m. Team Wendy added to head protection revenues, which meant that product area accounted for almost 30% of group revenues compared to 18% in FY20.

Looking at the revenues from end-market perspectives, Military sales accounted for 70% of core group sales (excluding Armor), split 37:33 between respiratory and ballistic products. First Responder sales accounted for 30% of the core group, split 75:23 between respiratory and ballistic.

FY21 results robust before Armor and pandemic disruptions

- Orders received up 35% to $282.7m (FY20: $209.6m).
- Order backlog $143.1m (FY20: $101.8m) up 41%.
- Revenues of $248.3mm (FY20: $213.6m) up 16%.
- Adjusted EBITDA $37.6m (FY20: $49.0m) down 23% and a margin of 15.1% (FY20: 22.9%).
- Adjusted operating profit down 43% to $22.0m (FY20: $38.5m).
- Adjusted PBT fell 52% to $18.9m (FY20: $36.1m).
- Adjusted FY21 EPS down 39% to 60.6 US cents (FY20: 98.6 US cents), 60.3 US cents fully diluted.
- FY21 DPS increased by 30.1% to 44.9 US cents (FY20: 34.5 US cents).
- Adjusted net debt (excluding lease liabilities) at FY21 $26.8m (FY20: net cash $147.7m).
- Cash conversion was 83.2% (81.6%).

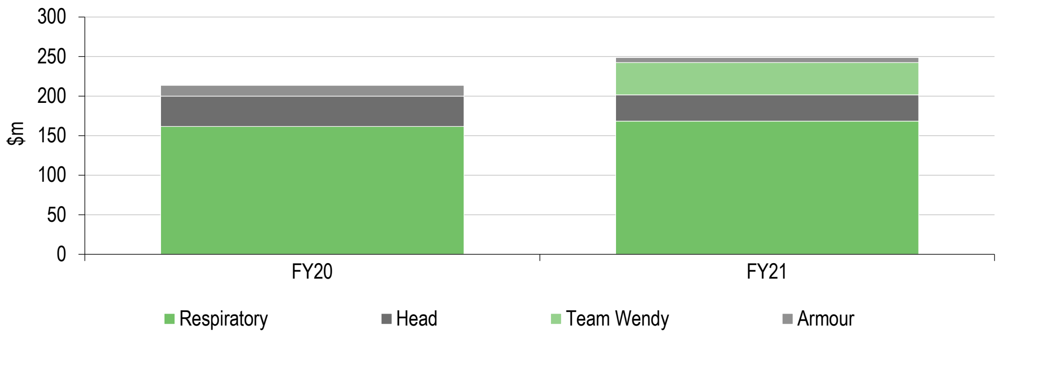
Exhibit 3: Avon Protection revenue analysis

Year to Sept ($m)	FY20	FY21	% change
Respiratory Military	104.9	113.5	8.2%
Respiratory First Responder	56.7	55.1	-2.8%
Total respiratory (A)	**161.6**	**168.6**	**4.3%**
Ballistic Military	35.3	27.5	-22.1%
Ballistic First Responder	3.0	5.4	80.0%
Total Ballistic (ex Armor) (B)	**38.3**	**32.9**	**-14.1%**
Protection (continuing) (A+B)	**199.9**	**201.5**	**0.8%**
Team Wendy		41.0	
Intra group		(0.7)	
Avon Protection (Core)	**199.9**	**241.8**	**21.0%**
Armor (non-core)	13.7	6.5	-52.6%
Avon Protection	**213.6**	**248.3**	**16.2%**

Source: Company reports

Group revenues grew 16.2% to $248.3m (FY20: $213.6m) in FY21. Excluding the armour activity, revenues rose 21.0% to $241.8m (FY20: $199.9m), largely due to the first contribution from Team Wendy. Within that, the ongoing activities (ie excluding Team Wendy and Armor) grew sales by 0.8% to $201.5m (FY20: $199.9m), with respiratory systems growth of 4.3% to $168.6m (FY20: $161.6m) more than offsetting a decline in sales of the ballistic helmets business acquired from 3M, which fell to $32.9m from $38.9m despite a full year contribution in FY21 (nine months in FY20), in part due to contract delays caused by the now resolved competitor protest of the IHPS award.

Exhibit 4: Avon Protection revenue development in FY21



Source: Company reports

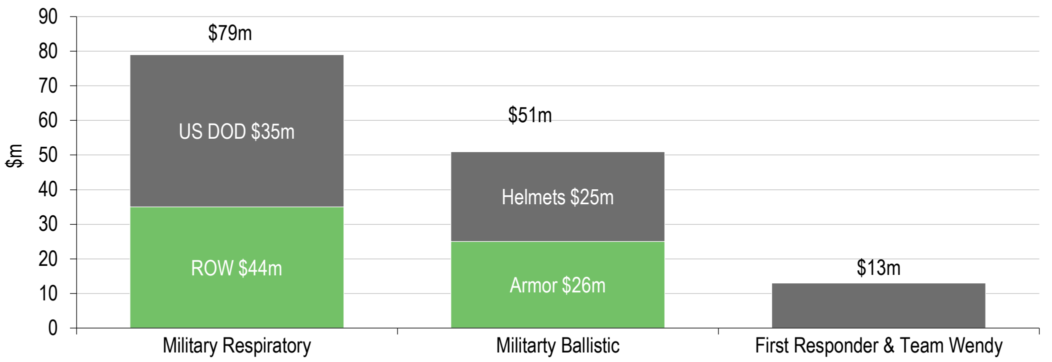
Organically, revenues fell by 2.9% due to the armour impact on Military Ballistic sales, although both Military Respiratory and First Responder grew by 8.1% and 1.3% respectively.

Strong core order intake and backlog growth

FY21 order intake was up 34.9% to $282.7m (FY20: $209.6m), reflecting strong momentum across the product portfolio for Military and First Responder markets. Excluding Team Wendy, orders received grew by 17.4%, Military by 24.6% and First Responder by 0.3%. Team Wendy contributed $36.6m of orders in its first 11 months of consolidation.

At the year end the company had an order backlog of $143.1m (FY20: $101.8m), $26.6m of which was in Armor and included Team Wendy's year-end order book of $3.2m (FY20: nil). The backlog can be further broken down as follows:

Exhibit 5: Composition of FY21 order backlog ($143m)



Source: Avon Protection

The Military Respiratory closing backlog was up 68% year-on-year, with First Responder excluding Team Wendy up 40% and Ballistic up 7% despite the Armor problems.

Excluding the Armor EBITDA loss of $8.4m, the core group performance was quite robust falling to $46m in FY21, a margin of 19% (FY20: 23%), with $1.0m of the $3.0m decline due to unfavourable FX movements reflecting adverse overhead recovery across the Ceradyne activity.

Non-recurring items totalled $54.5m (FY20: $33.9m) at the PBT level, including $31.1m of net impairments at the Armor business. In addition to amortisation of acquired intangible of $14.2m (FY20: $8.3m), Avon recognised acquisition costs of $2.6m (FY20: $10.7m), a previously disclosed inventory fair value acquisition accounting adjustment of $2.4m (FY20: nil), a write down of brought-forward capitalised cloud computing costs of $0.7m and $3.5m (FY20: $1.5m) of financial items.

Three-pillared strategy for growth maintained

The strategy initiated in FY17 remains in place, the main goal of which is to deliver long-term, sustainable growth using a three-pronged investment approach to:

- organically grow the core;
- invest in selective product development; and
- pursue appropriate value enhancing acquisitions.

The strategy aims to deliver organic growth of over 3%, augmented by M&A. It also targets adjusted EBITDA margins in excess of 20%, with cash conversion of more than 90%, delivering strong cash flows to support the capital allocation framework including adequate R&D spending and the progressive dividend policy.

Investing to grow the core organically

Management has already realised a significant refocusing and investment programme during the pandemic, exiting its dairy operations and reinvesting in the head protection and ballistic markets. Key to this is the strength of its relationships with both the US Department of Defense (DOD) and the Ministry of Defence (MOD) in the UK, which has allowed it to develop its specialist respiratory product portfolio and establish its leading market position so that it can pursue additional business in other Military markets, as highlighted by the recent success with the NATO contract framework.

Selective product development

Innovation is key for Avon Protection, and new product introductions should continue at a similar pace. R&D spend for FY21 was $19.1m or 7.7% of revenue (FY20: $11.8m, 5.5%), although this included $5.9m (FY20: $1.7m) rectification spend in Armor. We expect some decline in FY22 as a percentage of sales with the quantum ex Armor increasing. The focus for investment for the core business will be on projects that present an opportunity to add value and fit within the strategic goals of the company. In some instances, considerable investment has already taken place and it is now a question of fully leveraging this. Overall, this approach ensures that the product portfolio is enhanced, meets the needs of the customer and is able to deliver future growth. Partnerships remain core to Avon Protection, not least in the long-term, multi-level relationship with the US DOD, which provides the foundation for international product development.

Strategic value-enhancing acquisitions

Although management indicated in its capital allocation commentary accompanying the FY21 results that no near-term M&A activity was expected this financial year, Avon Protection retains the pursuit of appropriate targets, with financial discipline as the third element to drive growth and create value for shareholders. Despite the problems at Armor, both of the larger Ceradyne helmet assets and Team Wendy appear to be progressing well. The balance sheet remains relatively lowly geared, with net debt of $27m at the year end, an EV/EBITDA ratio of 1.0x and cash flow expected to remain strong. A consultation process on the potential for share buybacks is underway.

Withdrawal from body armour

Avon Protection's next-generation body armour product for the US Army, VTP ESAPI, failed FAT in November 2021. The single plate failure in the official FAT automatically disqualified the product from approval and followed successful pre-testing of more than 800 units. In isolation, the problem might have been resolved but followed a similar FAT failure on a legacy body armour plate (DLA ESAPI) for the Defense Logistics Agency (DLA) in the US in December 2020. The company re-engineered the DLA product and passed ballistic testing in August 2021. However, product approvals are further delayed and are now expected in Q222, with revenues commencing in H222.

Learning from the DLA plate failed to prevent the subsequent plate failure and, as a result, the board conducted an in-depth strategic review of the entire Armor business. The conclusion was that with engineering options largely exhausted and an unknown variable causing the failure, investing further funds and time in resolution was inappropriate given contract schedules with the VTP ESAPI contract expiring in March 2023. In addition, a disposal was unlikely to be the best option for stakeholders given the diminished prospects and small pool of potential buyers.

The review concluded that a managed wind down over the next two years before closure was the most appropriate course of action in collaboration with its main customers. That involves fulfilling existing DLA ESAPI contract obligations and offering a final lifetime purchase of flat armour plates used in helicopter programmes. These should generate revenues of up to $25m in both FY22 and FY23. The board believes the decision offers the best risk/reward for its stakeholders, maintaining a strong relationship with the US DOD and completing customer contracts, while avoiding the historical performance issues and clarifying the situation for employees.

Despite the market reaction to the demise of the body armour segments, the financial impact is quite limited even it does remove an element of what had been perceived as potential growth. The market value of Avon Protection fell by 65% or c £634m ($855m) during 2021 and by 39% or £231m ($312m) since the November 2021 trading update.

Around $7.5m of overhead reduction will be realised on closure, with the rightsizing of retained activities delivering a similar amount, an overall overhead saving of $15m. Net cash costs should be around $3–5m weighted towards FY23.

In addition, there are three outstanding leases with obligations, with a net present value of $11.8m spread over the next 10 years and a current annual cost of $1.7m. The company will seek to mitigate this cash cost by subletting the properties involved.

Avon has written down the majority of the assets but can recover some proceeds in the wind down process through inventory sales as well as plant & machinery. In addition, contingent consideration of $15.7m relating to the Armor business with respect to securing specific contracts is being avoided. The net $31.1m impact of the impairment and recoverable amounts is included in adjustments to group profits and summarised below.

Exhibit 6: Armor asset write downs

	Carrying value	Impairment	Recoverable amounts
	$m	$m	$m
Acquired intangibles	11.3	(11.3)	-
Development expenditure	8.1	(8.1)	-
Right of use assets	11.7	(11.7)	-
Plant and machinery	14.4	(13.9)	0.5
Leasehold improvements	0.1	(0.1)	-
Inventory	13.3	(1.7)	11.6
Total assets/(impairment)	**58.9**	**(46.8)**	**12.1**
Contingent cash consideration	(21.7)	15.7	(6.0)
Total net impact	**37.2**	**(31.1)**	**6.1**

Source: Avon Protection

Overall, the cash costs to exit would appear to be minimal and the loss of opportunity seems unlikely to warrant even the $834m value reduction since 1 January 2021 following the first Armor profit warning on 17 December 2021. At our calculated WACC for the group of 7.5%, it would imply the equivalent loss of an annual cash perpetuity of $62m from the Armor business. To be clear, that understates the overall value decline from the peak market value achieved immediately before the 17 December 2020 initial warning by over $500m.

Given the top end of the anticipated order potential of $115m annually as a proxy for future Armor revenue, and applying an EBITDA margin of 23%, which we think is an optimistic assumption, we calculate the value sacrificed by the closure to be up to c $350m equivalent to an annual cash flow of c $26m on the same basis as above (compared to the implied value loss of over $62m above).

Addressable markets set to grow

The risk from the proliferation and evolution of CBRN threats shows no signs of abating and is compounded by easier access for those seeking to develop threats due to new technologies. Protection equipment needs to evolve more rapidly, preferably in advance of such threats, leading to an increasing requirement to integrate modular equipment for those responding to conflicts, emergencies and terrorist incidents. Key to this is weight relief for users. Avon Protection is well positioned to support the integration of personal CBRN, respiratory and head protection given its strong market positions, and continued product and materials development. It includes the aim to move into adjacencies for example in CBRN clothing. In addition, the threats are global and, with Avon's traditional US and UK markets still representing the bulk of revenues, it has the ability to penetrate new markets around the world to extend the customer base. A good example of this is the NATO 10-year framework contract awarded in August 2020.

The long-term in-service life of products, often between 20 and 30 years, also means that there is a significant revenue stream from spares, filters and accessories which grows as the installed base increases. These currently account for around 25% of respiratory revenues.

Avon Protection's management has historically indicated potential annual order intake by product lines. Over time, we would expect group revenue to trend towards intake levels, although these are dynamic as new product lines are introduced, existing products are retendered and new geographic markets are engaged. We summarise the latest information provided at the H121 results in the table below. Although the data were not updated in the year-end results, management did say the data were still valid, save for the elimination of the Armor prospect in the longer term.

Exhibit 7: Avon Protection potential annual order intake

Product segment (FY21 revenue)	Contact Type	Pricing	Potential annual order intake ($m)	
			Low end	High end
Military - Respiratory ($114m)				
US products				
M50 Mask System/M61 Filter	Sole Source	Commercial	30	45
M53A1 Mask and Powered Air System	Sole Source	Commercial	25	30
M69 Aircrew Mask*	Sole Source	Cost plus	15	20
Escape Hoods	Sole Source	Commercial	5	10
Rest of World Military	Competitive		30	45
Total Military - Respiratory			**105**	**150**
First Responder Respiratory ($55m)	Various		50	70
Total Respiratory ($169m)			**155**	**220**
Military - Ballistic ($68m)				
IHPS helmet	Sole Source		40	60
Rest of the World	Competitive		5	10
Team Wendy	Various		40	60
Total Military - Ballistic			**85**	**130**
First Responder Ballistic ($5m)			5	10
Total Ballistic ($73m)			**90**	**140**
Total Core Group ($242m)			**245**	**360**

Source: Company reports, *drops to maintenance level of c.$6m in FY23

At the upper end of the range, implied revenue growth potential would be up to c 50% for the continuing business, although we note that the lower end suggests limited potential. Indicated Armor order potential of $70–115m should have provided a significant additional impetus to group revenue growth in the medium term compared to its low level of sales in recent years. However, the wind down period means that this has now been constrained and it will be eliminated in the longer term. If we take the top end of all the core and Armor ranges, group growth potential has been reduced by around 50% by the closure. Another way of assessing the revenue potential is to look at the addressable market opportunities.

Exhibit 8: Avon Protection global addressable market for Military products (FY21: $595m*)

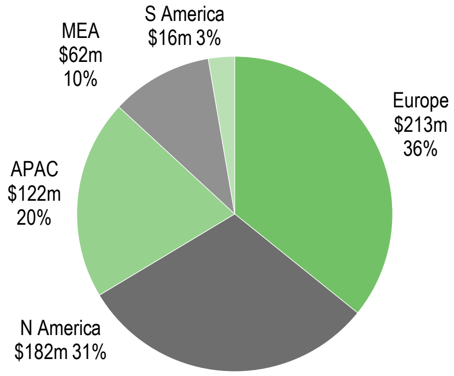
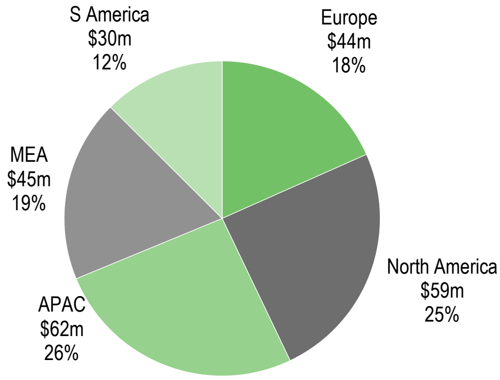


Exhibit 9: Avon Protection global addressable market for First Responder products (FY21: $240m*)



Source: Avon Protection. Note: *Excludes non-ballistic helmets, helmet accessories, armour, filters, accessories, underwater diving equipment and escape hoods.

In military markets, the United States remains the most sophisticated market which, alongside products developed for the UK, allows Avon to reference its market-leading positions to RoW customers. For example, the 10-year framework contract with the NATO Support and Procurement Agency (NSPA) enables other NATO countries and affiliates to purchase products based on the market-leading FM50 respiratory protection system, including accessories and filters. In FY21, the group was awarded orders worth up to $48m for six NATO members and was in talks with a further three NATO countries.

Avon continues to pursue new, replacement and upgrade multi-year programme opportunities around the globe for both respiratory and ballistic products.

FY22 guidance

Management has now provided guidance for FY22, which is for the ongoing core activities to grow revenues to $260–290m, an increase of between 8% and 20%. That will include a full year contribution from Team Wendy. The orderly wind down of the armour business should see the operation generate sales of up to $25m in both FY22 and FY23, as it completes existing contracts and orders it still expects to receive depending on the timing of product approvals by the US customer, the DLA.

Management expects a significant recovery in EBITDA margins in FY22 back towards historical levels (FY20: 22.9%), with the core operation making positive progress. Loss elimination at Armor is integral to that, but the operation will still dilute the margin performance as it is to be treated as a continuing operation in FY22 even if it is clearly non-core.

Capital allocation and dividend policy

The board is reviewing the capital allocation policy, with no major M&A activity expected in FY22. Given the healthy balance sheet and ongoing strong cash flow, the existing shareholder distribution is likely to be adjusted. Alongside the progressive dividend policy (see below), the board is considering the benefits of share buybacks.

The 30% increase in the dividend that has been delivered since the new strategy was adopted in 2018 is undermined by the short-term earnings shortfall, which has reduced cover to just 1.3x in FY21. We now expect a more modest growth in the payment of just 5% in FY22, which will allow cover to recover towards the 2.0x target. We then assume dividend growth of 20%, although management indicates that this will now be contingent on EPS progression while maintaining adequate cover.

Revisions to earnings estimates

We reflect the increased management caution in FY22 guidance with respect to the core respiratory and head protection business, largely due to supply chain issues. Our new forecast for the continuing core business is towards the low end of that range at $260.4m, with significant upside potential for the upper end of $290m. The difference relates to the supply chain uncertainties and administration process delays in the US DOD that are likely to persist for much of the current year.

However, having previously assumed just $10m of FY21 Armor revenue, we now increase the contribution to $18m and $25m including flat armour revenues in FY22 and FY23 respectively as the run-off of body armour contracts is implemented. Due to potential contract timing issues, we remain below guidance for a total of $50m revenues spread evenly over FY22 and FY23.

So, while our overall FY22 revenue estimate falls by only 4%, this largely reflects the caution around the core business, where our expectations have dropped by 10% to reflect management's understandable reduction in optimism given recent Armor events and the ongoing pandemic effects.

We also note that as well as positive operational gearing as volumes rise, the rightsizing measures to save a total of c $7.5m in overheads in FY22 and FY23 are also expected to benefit margins.

We also introduce our FY23 forecast, with Armor still being treated as a non-core but continuing activity until FY24.

Exhibit 10: Avon Protection earnings revisions

Year to September ($m)	2021e	2021		2022e			2023e
	Prior	Actual	% change	Prior	New	% change	New
Revenues							
Avon Protection ongoing	196.0	201.5	2.8%	241.3	212.6	-11.9%	235.4
Team Wendy	42.1	41.0	-2.6%	47.3	48.9	3.4%	53.8
Intragroup	(0.1)	(0.7)		0.0	(1.0)		(1.0)
Avon Protection (core) revenues	**238.0**	**241.8**	**1.6%**	**288.6**	**260.4**	**-9.8%**	**288.2**
Armor (non-core)	10.0	6.5	-35.0%	10.0	18.0	+80.0%	25.0
Total revenues	**248.0**	**248.3**	**0.1%**	**288.6**	**278.4**	**-3.5%**	**313.2**
Adjusted EBITDA	**43.5**	**37.6**	**-13.5%**	**59.4**	**55.1**	**-7.2%**	**68.4**
Adjusted operating profit	**29.1**	**22.0**	**-24.3%**	**42.0**	**36.4**	**-13.3%**	**48.5**
Adjusted PBT	**25.6**	**18.9**	**-26.1%**	**38.1**	**33.2**	**-12.9%**	**45.4**
EPS - adjusted fully diluted (US cents)	**66.7**	**60.3**	**-9.6%**	**99.4**	**85.1**	**-14.4%**	**116.3**
DPS (c)	44.9	44.9	0.0%	53.9	47.1	-12.5%	54.2
Adjusted net debt/(cash) (excluding leases)	27.0	26.8	-0.9%	20.1	27.1	34.7%	22.9

Source: Edison Investment Research estimates

Management

The executive management team remains in place at present, although the company has just confirmed the new CFO who will assume his position in March. Paul McDonald was appointed CEO in February 2017 and has 18 years of experience at the group. The current strategy was developed and implemented under his stewardship.

Bruce Thompson joined the Avon board in March 2020, having been CEO of Diploma for over 20 years. He was appointed chairman in December 2020. There are three other NEDs on the board: Chloe Ponsonby, who has over 20 years' experience in financial services, was appointed in March 2016 and is the senior independent director; Bindi Foyle, group finance director at Senior, was appointed in May 2020; and Victor Chavez CBE joined the board in December 2020, having retired as CEO of Thales UK, part of the Europe-based aerospace and defence group.

The company announced on 25 May 2021 that Nick Keveth, the group CFO since June 2017, would leave the group at the end of March 2022 for personal reasons. As part of normal succession planning, a search for his replacement commenced and identified Richard (Rich) Cashin for that role. Rich has both financial market and industrial experience gained at Rolls-Royce, UBS, Meggitt and Ultra Electronics, where he has been the president of strategy and corporate development since June 2019. He joins Avon on 7 March 2022 and will replace Nick when he leaves the group on 31 March 2022.

The group counsel and company secretary is Miles Ingrey-Counter, who joined the company in 2007 and was appointed to the group executive management team in 2008.

Sensitivities

As was apparent in FY21, Avon Protection is subject to operational risk like all other companies. In our view, the unusual proximity of two similar testing failures was the result of engineering shortcomings rather than systemically poor senior management. The management responses appear appropriate in terms of trying to rectify the initial FAT failure and the subsequent conclusion that, given the lack of comprehension of the material technology issue, it should withdraw from the business in an orderly fashion. Risk remains in Avon's other business areas, but we understand that the engineering technologies are separate for helmets and armour. We are therefore hopeful that similar project failures can be avoided.

- **Pandemic disruption:** in common with its peers, Avon Protection continues to experience disruption in global supply chains, inflationary pressures and customer order processing that have arisen as a function of the pandemic and management actively seeks to mitigate these. Disruption is persisting in FY22 and has led management to guide for a relatively wide range of revenue outcomes for the core business.
- **Defence budgets:** in the longer term, while the CBRN threat remains significant, the spending allocation by governments may need to be reviewed due to pandemic spending. While current defence trends are generally favourable and Avon's products are mainly life critical, renewed budgetary constraints could moderate growth rates as force numbers come under pressure, although spending per user is increasing as kit becomes more sophisticated.
- **Customer concentration risk:** relationships with customers are very important to the group's reputation, referencing capabilities and thus growth potential. In essence, given the highly specialised nature of its products, the main customer base is essentially quite small and concentrated, with key customers such as the DOD and MOD often determining the ability to sell products to other global military and first responder markets.
- **M&A risks:** the problems at the Ceradyne ballistic armour business highlight the risks of an acquisition policy, The normal integration risks can be assessed and set, only for a technology issue affecting a relatively small part of the revenues of the business to undermine the total business proposition. Management needs to mitigate those risks through financial discipline, adopting a conservative approach to valuation with rigorous due diligence to fully understand what is being acquired. To a degree, contingent payments can be used to mitigate the financial impact on promised returns but are unlikely to protect sentiment. For example, Avon Protection currently has to restore confidence that the majority of the business cases remain on track for the Ceradyne helmet business and the more recent Team Wendy deal.

Valuation

We use our capped DCF valuation as what we consider to be a conservative basis for estimating value as it does not assume any growth in the terminal value. While we normalise working capital to zero and capex to equal depreciation, it still eliminates some element of the potential tail value. The DCF on a calculated WACC of 7.5% currently delivers a value of £16.75 or $22.78, rolled forward to our FY22 base and reflecting the structural loss of future Armor value.

Exhibit 11: Avon Protection capped DCF sensitivity analysis for WACC and growth (£/share)

WACC	6.0%	6.5%	7.0%	7.5%	8.0%	8.5%	9.0%
Terminal growth rate							
0.0%	22.29	20.15	18.33	**16.75**	15.37	14.16	13.09
1.0%	26.61	23.70	21.28	19.23	17.49	15.98	14.67
2.0%	33.08	28.81	25.40	22.62	20.31	18.36	16.69
3.0%	43.86	36.85	31.60	27.52	24.26	21.60	19.39

Source: Edison Investment Research estimates

Comparison to UK defence peer group

On our updated forecasts, Avon Protection is currently trading on a P/E of 12.6x in FY23e. The stock is trading at a discount to its UK aerospace and defence peer group, even adjusting for the inflated valuations of peers due to ongoing M&A activity in the sector. Given the exposure to the US defence market, the higher than average margin performance, with strong cash flows and future growth in our forecasts notwithstanding the Armor wind down (the impact of which should now recede), we believe the valuation now appears undemanding, with management needing to restore the positive investment sentiment it enjoyed before the Armor failure.

Exhibit 12: UK aerospace & defence peers

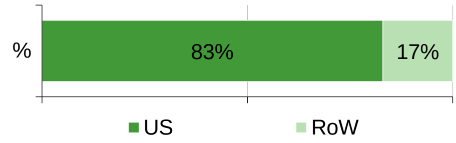
	Price	Market cap	Revenue (£m)		EV/EBITDA (x)		P/E (x)		Dividend yield (%)		Gross profit margin (%)	
Company	**p**	**(£m)**	**FY1e**	**FY2e**	**FY1e**	**FY2e**	**FY1e**	**FY2e**	**FY1e**	**FY2e**	**FY1e**	**FY2e**
Babcock	346	1,753	4,248	4,284	7.3	6.8	11.3	9.3	0.0	2.5	N/A	N/A
BAE Systems	572	18,097	21,278	22,117	8.1	7.6	12.4	11.5	4.3	4.5	39.7	40.3
Cohort	517	213	152	163	11.0	9.5	16.4	14.2	2.4	2.6	37.2	37.2
Ultra Electronics	3160	2,258	877	915	15.1	14.0	23.6	22.1	1.9	2.0	N/A	N/A
Rolls-Royce	128	10,690	11,615	12,673	11.0	8.1	137.5	26.3	0.0	0.0	13.2	16.0
Meggitt	749	5,858	1,589	1,798	22.4	17.8	46.3	31.8	1.1	1.4	35.4	36.6
QinetiQ	265	1,537	1,324	1,371	7.4	6.5	13.1	11.4	2.7	2.9	35.0	34.9
Senior	137	575	661	734	14.0	10.2	N/A	39.1	0.0	0.7	34.9	35.5
Average					**12.0**	**10.1**	**37.2**	**20.7**	**1.5**	**2.1**	**32.6**	**33.4**
Average adjusted					**9.0**	**7.7**	**38.1**	**14.5**	**1.9**	**2.5**	**31.3**	**32.1**
Avon Rubber*	1174	360.00	206.00	232.00	8.2	6.5	18.5	13.5	2.8	3.0	39.0	40.0

Source: Refinitiv, *Edison Investment Research estimates

Exhibit 13: Financial summary

$m	2020	2021	2022e	2023e
Year end 30 September	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS				
Revenue	213.6	248.3	278.4	313.2
Cost of Sales	(130.1)	(0.2)	(0.2)	(0.2)
Gross Profit	83.5	248.1	278.3	313.0
EBITDA	49.0	37.6	55.1	68.4
Operating Profit (before amort. and except.)	42.5	27.2	43.2	55.6
Intangible Amortisation	(4.0)	(5.2)	(6.8)	(7.1)
Operating profit (company definition)	38.5	22.0	36.4	48.5
Exceptionals	(29.6)	(51.0)	(7.0)	(7.0)
Other	(4.3)	(3.5)	(1.3)	(1.3)
Operating Profit	4.6	(32.5)	28.1	40.2
Net Interest	(2.4)	(3.1)	(3.2)	(3.1)
Profit Before Tax (norm)	36.1	18.9	33.2	45.4
Profit Before Tax (FRS 3)	2.2	(35.6)	24.9	37.1
Tax	1.6	11.1	(5.2)	(7.8)
Profit After Tax (norm)	30.2	18.6	26.2	35.8
Profit After Tax (FRS 3 continuing)	3.8	(24.5)	19.7	29.3
Average Number of Shares Outstanding (m)	30.6	30.7	30.6	30.6
EPS - normalised (c)	98.8	60.6	85.6	117.1
EPS - normalised & fully diluted (c)	97.4	60.3	85.1	116.3
EPS - (IFRS) (c)	12.4	(79.9)	64.2	95.6
Dividend per share (c)	34.5	44.9	47.1	54.2
Gross Margin (%)	39.1	99.9	99.9	99.9
EBITDA Margin (%)	22.9	15.1	19.8	21.8
Operating Margin (before GW and except.) (%)	19.9	11.0	15.5	17.7
BALANCE SHEET				
Fixed Assets	155.3	229.6	230.0	230.2
Intangible Assets	89.4	181.0	180.3	179.2
Tangible Assets	40.2	33.6	37.3	40.9
Right of Use Asset	25.7	15.0	12.5	10.2
Investments	0.0	0.0	0.0	0.0
Current Assets	299.2	169.1	164.4	173.6
Stocks	36.3	62.3	58.5	62.6
Debtors	46.0	44.7	47.3	50.1
Cash	187.2	14.1	11.4	12.8
Other	29.7	48.0	47.2	48.0
Current Liabilities	(98.2)	(84.4)	(85.9)	(88.6)
Creditors	(58.7)	(43.5)	(47.4)	(53.0)
Short term borrowings	(39.5)	(40.9)	(38.5)	(35.7)
Long Term Liabilities	(126.8)	(108.9)	(98.9)	(93.9)
Long term borrowings	0.0	0.0	0.0	0.0
Lease Liabilities	(29.0)	(29.1)	(24.6)	(20.1)
Other long-term liabilities	(97.8)	(79.8)	(74.3)	(73.8)
Net Assets	229.5	205.4	209.6	221.3
CASH FLOW				
Operating Cash Flow	7.6	(0.6)	49.5	58.4
Net Interest	(2.4)	(3.1)	(3.2)	(3.1)
Tax	1.6	11.1	(5.2)	(7.8)
Capex	(19.9)	(31.6)	(26.1)	(27.1)
Acquisitions/disposals	116.0	(128.1)	0.0	0.0
Financing	0.0	(4.3)	(1.0)	(1.0)
Dividends	(8.9)	(12.1)	(14.2)	(15.2)
Other	(5.8)	(5.8)	0.0	0.0
Net Cash Flow	88.2	(174.5)	(0.3)	4.2
Opening net debt/(cash)	(59.5)	(147.7)	26.8	27.1
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)	(147.7)	26.8	27.1	22.9
Total net financial liabilities/(assets)	(118.7)	55.9	51.7	43.0

Source: Company reports, Edison Investment Research estimates

Contact details	Revenue by geography
Hampton Park West Melksham Wiltshire, SN12 6NB UK 01225 896899 www.avon-protection-plc.com	

Management team

CEO: Paul McDonald	CFO: Nick Keveth
Paul was appointed CEO on 15 February 2017. Prior to this he was divisional managing director of Avon's Dairy division and a key member of the group executive management team. Paul joined the company in 2003 and spent the early part of his career at Avon in commercial and operational roles, which included responsibility for all UK operations including the European Protection & Defence business unit.	Nick Keveth has been CFO since June 2017, helping to oversee the implementation of the growth strategy and refocusing of the group. It was announced in July 2021 that he had chosen to leave for personal reasons and will leave the company on 31 March 2022.
Chairman: Bruce Thompson	**CFO designate: Richard (Rich) Cashin**
Bruce joined the board in March 2020 and was appointed chairman in December 2020. He was previously CEO of Diploma, the FTSE 250 specialised technical products and services business, for over 20 years. Prior to joining Diploma, he was a director with the technology and management consulting firm Arthur D Little, both in the UK and the US. He is also currently the senior independent non-executive director of discoverIE Group.	A chartered management accountant, Rich has both financial market and industrial experience gained at Rolls-Royce, UBS, Meggitt and Ultra Electronics, where he has been the president of strategy and corporate development since June 2019. He joins Avon on 7 March 2022 and replaces Nick when he leaves the group.

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