EDISON

Avon Rubber

Purchase of 3M's ballistic protection business

Acquisition and trading update

Aerospace & defence

In its largest acquisition to date, Avon Rubber is buying the ballistic protection assets of 3M, a market leader in the US. The purchase price of an initial $91m could increase by a further $25m depending on the outcome of tenders for legacy products. Subject to approvals, the deal should complete by fiscal Q220 and be immediately earnings enhancing, creating value in FY21, its first full year of ownership. Avon has also indicated that trading remains in line with management expectations, so our forecasts remain unchanged at present. We will update our forecasts for the acquisition when it completes in FY20.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
09/17	159.2	25.9**	83.3**	12.3	18.8	0.8
09/18	165.5	27.2	76.5	16.0	20.4	1.0
09/19e	176.3	29.8	78.6	20.8	19.9	1.3
09/20e	187.0	32.8	86.3	27.1	18.1	1.7

Note: *PBT and EPS are normalised, fully diluted and excluding amortisation of acquired intangibles, exceptional items and share-based payments. **Restated for AEF disposal.

US leader in helmets and body armour

Avon is buying the assets of 3M's ballistic protection business including the Ceradyne brand helmets and body armour activity. The acquisition is in line with one of the group's strategic goals of creating value through targeted acquisitions to complement the existing product portfolio and add growth opportunities. It has strong positions with the US Department of Defense (DOD) supported by excellent R&D capabilities. It has just started fielding the low rate initial production (LRIP) volumes of helmets and body armour for the US DOD Soldier Protection System (SPS) programme, which should provide growth as it moves into full production. Of its $85.4m of revenues in 2018, 93% are for US customers, so Avon Protection sees further potential from leveraging its international sales network.

Compelling financial case

Subject to approvals the deal should complete in Avon's Q220. The business generates EBIT margins of around 10% currently. Avon management believes it can generate $5m of annual cost synergies by FY21 for an upfront cost of $10m, which should leave ROIC in double digits and well ahead of WACC, creating shareholder value. The initial consideration is being funded from cash resources and an increased three-year revolving credit facility (RCF) of $85m. Group net debt to EBITDA is expected to not exceed 1.0x.

Valuation: Significant EPS enhancement expected

We maintain our estimates at present, in line with the trading comment, as we do not incorporate acquisitions into our estimates until a deal completes. However, we would expect an enhancement to earnings in the region of 20% in a full year post cost synergies. As the acquisition and business case is executed, we would expect Avon's valuation to respond accordingly.

9 August 2019

Price	**1,562p**
Market cap	**£484m**
	US$1.22/£
Net cash (£m) at 31 March 2019	46.8
Shares in issue	31.0m
Free float	96%
Code	AVON
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	15.7	10.9	9.2
Rel (local)	19.6	11.2	17.0
52-week high/low		1,572p	1,180p

Business description

Avon Rubber designs, develops and manufactures products in the protection (70% of 2018 sales) and dairy (30%) sectors. Its major contracts are with national security organisations such as the US DOD. Over 70% of 2018 sales were from the US.

Next events

Pre-close statement	16 September 2019
FY19 prelims	13 November 2019

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Edison profile page

Avon Rubber is a research client of Edison Investment Research Limited

Record acquisition progresses growth strategy

Avon has been exploring targeted M&A opportunities as an element of its three-pronged growth strategy. These are designed to augment organic growth from the existing product portfolio while maximising operational efficiency, enhanced by selective product development to maintain its cutting-edge technology and leadership in innovation. The business employs 280 people and operates from three well invested sites in the US; the main site is Irvine in California, with additional ceramic plate production in Lexington, Kentucky, and additional assembly and production capacity at Salem in New Hampshire, where the R&D centre for the business is located.

Rationale for the deal

The agreed purchase of 3M's ballistic protection assets maintains Avon's financial discipline in M&A deals. It has secure, organically growing and profitable revenue streams, expands the technology range of the group with leading market positions and brands and brings a strong management team with it. It should enhance earnings, create value and augment cash flows, allowing Avon to maintain a strong post-deal balance sheet.

The business has a leading position in the US supplying helmets and body armour. Its products appear to be almost entirely complementary to Avon Protection's existing mask systems operations in the US. Both supply critical personal protection products to the US military and law enforcement agencies.

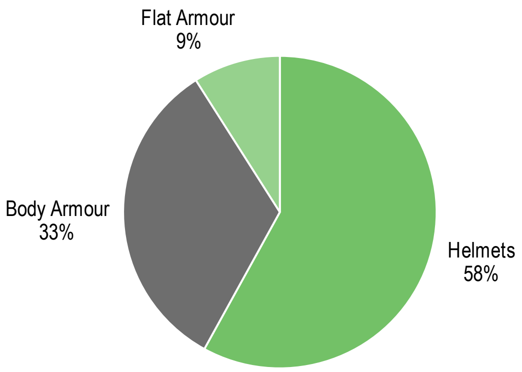
Extending the critical personal protection product range

The operations to be acquired are:

- Ballistic Helmets – lightweight and customisable for military and law enforcement customers
- Body Armour Plates – with both ceramic and composite solutions
- Flat Armour – helicopter and rotary wing protections systems for side and seat protection

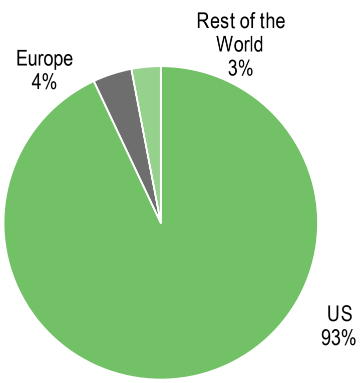
The company supplies the Advanced Combat Helmet (ACH) and Enhanced Combat Helmet (ECH) for the US Armed Forces. Its excellent product development has provided the next generation Integrated Head Protection System (IHPS) for the SPS programme, which has just commenced the sole sourced LRIP. The contracts for full rate production (FRP) are expected to be awarded by 2021, the transition to which should organically grow revenues,

Exhibit 1: Revenues split by product (2018 $85.4m)



Source: Avon Rubber

Exhibit 2: 2018 revenues split by customer location



Source: Avon Rubber

In body armour, the business is the sole source LRIP supplier of Vital Torso Protection (VTP) body armour under the SPS programme. Together with two other suppliers, an FRP contract worth a combined maximum of $704m over four years has been awarded. Deliveries are expected to commence in late 2020, further boosting organic growth in both 2020 and 2021.

Opportunity to generate both cost and revenue synergies

Management believes there are $5m of costs to be extracted as the back office and central head office operations of the new business are transitioned to and integrated with Avon's systems. The company is expecting one off costs of $10m to achieve these benefits by FY21.

In its business case value creation is not contingent on sales synergies, but there is clear potential for these to be achieved as well. At present most of the US sales go to the DOD, around 90% of the total, meaning only around 3% of sales go to law enforcement agencies. Avon Protection clearly believes it has the potential to extend penetration of the law enforcement and other domestic US markets. In addition, only 7% of sales went to overseas markets, and with Avon Protection's international sales network there is clearly potential for that to increase subject to any export licence restrictions.

The transformational increase in scale of Avon Protection should also further enhance its overall reputation and brand around the globe, hopefully providing additional leads in both domestic and export markets.

Financial metrics appear compelling

Avon is paying an initial $91m subject to normal closing adjustments, for gross assets of $45.2m that generated FY18 revenues of $85.4m, EBITDA of $10.8m and PBT of $3.3m. Subject to the award of pending tenders for legacy products, a maximum of a further $25m would become payable, but we expect any awards to enhance the business case. The deal is subject to CFIUS and other US regulatory approvals, but given the complementary nature of the product ranges and Avon's existing US presence, we do not see these as potential obstacles to completion, which is expected in fiscal Q220.

Avon has substantial cash resource and has renewed and increased its three-year RCF to $85m. These resources will be used to pay for the deal, adding around $1.0–1.5m per year of interest, peaking in the year of acquisition. The deal is immediately EPS enhancing and adding $5m of cost savings will make it value creating in FY21, further enhanced by organic development from the SPS programme.

Management expects the activity to have cash conversion consistent with the existing business, which is itself highly cash generative. Net debt to EBITDA is expected to be below 1.0x when the deal completes and, assuming all goes to plan, management expects to be in a net cash position by the end of FY21.

Exhibit 3: Financial summary

£000s	2017	2018	2019e	2020e
Year end 30 September	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS				
Revenue	159,200	165,500	176,250	187,049
Cost of Sales	(97,600)	(99,900)	(106,389)	(112,907)
Gross Profit	61,600	65,600	69,861	74,141
EBITDA	36,300	35,300	38,772	42,203
Operating Profit (before amort. and except.)	30,300	30,400	33,449	36,609
Intangible Amortisation	(4,200)	(3,100)	(3,718)	(4,075)
Operating profit (company definition)	26,100	27,300	29,732	32,534
Exceptionals	(7,000)	(5,700)	(4,300)	(4,300)
Other	(33)	(100)	(100)	(99)
Operating Profit	19,067	21,500	25,332	28,135
Net Interest	(200)	0	200	321
Profit Before Tax (norm)	25,867	27,200	29,832	32,756
Profit Before Tax (FRS 3)	18,867	21,500	25,532	28,456
Tax	2,900	(1,800)	(4,870)	(5,426)
Profit After Tax (norm)	25,502	23,500	24,164	26,532
Profit After Tax (FRS 3)	21,767	19,700	20,662	23,031
Average Number of Shares Outstanding (m)	30.4	30.5	30.5	30.5
EPS - normalised (p)	83.3	76.5	78.6	86.3
EPS - (IFRS) (p)	71.5	64.6	67.7	75.5
Dividend per share (p)	12.3	16.0	20.8	27.1
Gross Margin (%)	38.7	39.6	39.6	39.6
EBITDA Margin (%)	22.8	21.3	22.0	22.6
Operating Margin (before GW and except.) (%)	19.0	18.4	19.0	19.6
BALANCE SHEET				
Fixed Assets	66,700	64,100	61,060	57,950
Intangible Assets	40,400	41,500	40,646	39,800
Tangible Assets	26,300	22,600	20,414	18,149
Investments	0	0	0	0
Current Assets	80,500	102,000	120,597	139,791
Stocks	21,800	23,000	24,739	26,517
Debtors	23,800	24,200	25,772	27,351
Cash	26,500	46,600	61,886	77,723
Other	8,400	8,200	8,200	8,200
Current Liabilities	(39,000)	(41,400)	(43,615)	(45,894)
Creditors	(37,200)	(41,300)	(43,615)	(45,901)
Short term borrowings	(1,800)	(100)	(0)	7
Long Term Liabilities	(52,600)	(39,900)	(39,838)	(39,777)
Long term borrowings	0	0	0	0
Other long term liabilities	(52,600)	(39,900)	(39,838)	(39,777)
Net Assets	55,600	84,800	98,205	112,071
CASH FLOW				
Operating Cash Flow	29,754	33,400	35,776	38,721
Net Interest	(154)	(200)	0	200
Tax	2,900	(1,800)	(4,870)	(5,426)
Capex	(5,500)	(8,900)	(9,101)	(9,659)
Acquisitions/disposals	0	5,100	0	0
Financing	(1,000)	(1,100)	(1,000)	(1,000)
Dividends	(3,200)	(4,100)	(5,419)	(6,992)
Other	(96)	(600)	0	0
Net Cash Flow	22,704	21,800	15,386	15,844
Opening net debt/(cash)	(1,996)	(24,700)	(46,500)	(61,886)
HP finance leases initiated	0	0	0	0
Other	0	0	(0)	0
Closing net debt/(cash)	(24,700)	(46,500)	(61,886)	(77,731)

Source: Company reports, Edison Investment Research estimates

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