Avon Rubber

Preliminary results

A new chapter with a bright future

Aerospace & defence

Avon Rubber has delivered a confident FY17 performance and has set out a clear threefold strategy to drive medium-term growth. The core business is buoyed by strong order activity in Protection while dairy market trends look set to stay positive into 2018. Cash performance has also been solid, which underpins selective future acquisitions.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
09/16	142.9	20.7	70.5	9.5	15.1	0.9
09/17	163.2	25.6	82.3	12.3	12.9	1.2
09/18e	163.2	26.5	69.4	16.0	15.3	1.5
09/19e	169.2	28.2	74.1	20.8	14.4	2.0

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

FY17 performance

Reported FY17 orders of £173.9m were 6.6% ahead of reported FY17 revenue of £163.2m (FY16: £142.9m). This equated to 4.5% revenue growth at constant currency and against consensus of £165.4m and Edison's estimate of £168.9m. Reported PBT of £25.6m (FY16: £20.7m), was marginally ahead of consensus of £25.0m and Edison's estimate of £25.0m. FY17 adjusted EPS was 82.8p (FY16: 71.9p) and the final dividend of 8.21p gave a total dividend per share for FY17 of 12.32p (FY16: 9.48p). Going forward, the Avon Protection division is bolstered by a building order book and ongoing proactive negotiations with the US Department of Defense (DoD) to drive business beyond FY18. Trends in the law enforcement market also remain supportive. Meanwhile, improved milk prices and low feed costs both build into a better dairy market for the milkrite | InterPuls division. Programme changes and a currency headwind prompt us to revise down our FY18 estimates. We now forecast the top line largely flat on FY17, with the improved product mix and operational leverage driving EBIT margin improvement. We forecast a return to top-line growth in FY19.

Strategy for growth

The significantly changed management team has developed a new, threefold growth strategy. The approach is to grow the core, add selective product development and make value-enhancing acquisitions to accelerate growth. While innovation is key to the business, the overall level of investment will be lower in total but more focused in nature. Avon is already leveraging acquisitions made in recent years, and future deals will become an increasing feature of future strategy.

Valuation: Medium-term upside opportunity

Our DCF valuation on a calculated WACC of 7.9% currently delivers a value of 1,226p on our revised forecasts. On 15.3x 2018e P/E, the stock is trading at a discount to its UK aerospace and defence peer group. However, the new growth strategy, higher than industry average profitability and building order book afford Avon Rubber the opportunity to deliver further medium-term upside earnings potential and hence justify a valuation premium.

15 November 2017

Price	**1065.00p**
Market cap	**£330m**
	$1.31/£
Net cash (£m) at 30 September 2017	24.7
Shares in issue	31.0m
Free float	96%
Code	AVON
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	12.1	6.6	5.3
Rel (local)	14.0	5.7	(4.9)
52-week high/low	1122.0p	909.0p	

Business description

Avon Rubber designs, develops and manufactures products in the respiratory protection, defence (70% of 2017 sales) and dairy (30%) sectors. Its major contracts are with national security and safety organisations such as the DoD. 75% of sales are from the US and 25% are from Europe.

Next events

AGM	8 February 2018

Analysts

Annabel Hewson +44 (0)20 3077 5700

Andy Chambers +44 (0)20 3681 2525

industrials@edisongroup.com

Edison profile page

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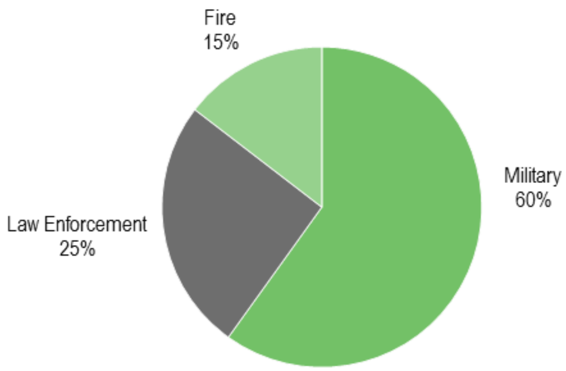
FY17 financial performance

Reported FY17 orders of £173.9m were 6.6% ahead of reported FY17 revenue of £163.2m (FY16: £142.9m). This equated to 4.5% revenue growth at constant currency and against consensus of £165.4m and Edison's estimate of £168.9m. Reported adjusted EDITDA was £36.0m (FY16: £29.9m), up 12.1% in constant currency and in line with consensus of £36.0m and Edison estimate of £35.7m. This resulted in FY17 PBT of £25.6m (FY16: £20.7m) compared to consensus of £25.0m and Edison's estimate of £25.0m. FY17 adjusted EPS was 82.8p (FY16: 71.9p) and the final dividend of 8.21p gave a total dividend per share for FY17 of 12.32p (FY16: 9.48p).

Avon Protection

Exhibit 1: FY17 revenue split for Avon Protection



Source: Avon Rubber accounts

Avon Protection reported FY17 revenue of £113.8m (FY16: £100.9m), up 3.6% at constant currency. Orders received of £123.9m resulted in a book to bill of 1.09x and order intake has continued strongly after the year end. The division reported FY17 adjusted EBITDA of £27.1m (FY16: £21.5m), representing growth in constant currency of 16.6% and a 250bp step up in margin. Margin uplift has been driven by product mix and long-term contract cost efficiencies.

Within the division, military revenues of £68.2m (FY16: £62.3m) were boosted 9.5% by currency but flat on a constant currency basis. The rest of the world business increased to £13.7m (FY16: £4.8m), supported by the delivery of 37,000 FM50 general-purpose masks.

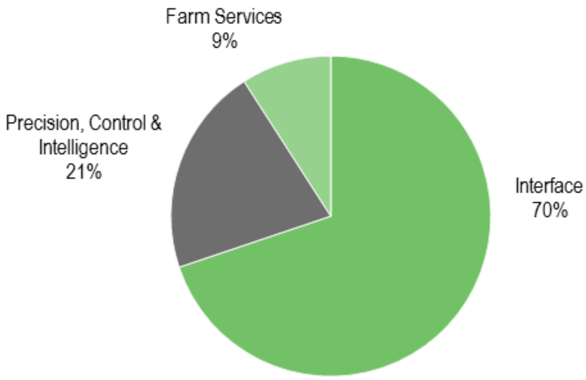
Going forward, the division is underpinned by an attractive order book. Within Military, encouraging negotiations with the US DoD continue as the M50 10-year sole-source contract ends in 2018. The US DoD is in active conversation with Avon Rubber to determine the shape and scale of the product replenishment phase. It is important to note that there will be a c £12m year-on-year impact to divisional revenues from a lower M50 delivery schedule in FY18. However, it is also important to understand that as the company moves through this transition into other programmes an improvement to operating margin is expected, given lower margins on the 10-year contract versus the portfolio average.

Orders for the M53A1 powered air respirator and the M69 aircrew respirator are expected in FY18 and should counter the M50 transition. Meanwhile, in Law Enforcement, FY18 growth will be supported by C50 mask system demand in the US and around the world. FY18 growth for the Fire business is expected to revert to more normal levels for the argus thermal imaging cameras. Closer to home, Avon has been selected by the UK MoD as preferred bidder for the resupply and in-service support of its General Service Respirator. This contract would in essence be a build to print of the current Scott Safety design on a multi-year medium-term basis. This contract is expected to be finalised in early 2018 and will require a build-up lead time, including tooling and approvals.

Overall, we see a year of transition for the division with modest top-line growth countered by a currency headwind. As detailed above, we expect a modest tick up in operating margin in FY18, progressing further with top-line growth in FY19. We expect the division to continue to leverage off its product portfolio and drive further order growth.

milkrite | InterPuls

Exhibit 2: FY17 revenue spilt for milkrite | InterPuls



Source: Avon Rubber accounts

milkrite | InterPuls reported FY17 revenue of £49.4m (FY16: £42.0m), up 6.6% at constant currency. Orders received of £50.0m resulted in a book to bill of 1.01x. The division reported FY17 adjusted EBITDA of £10.9m (FY16: £9.8m), representing growth at constant currency of 4.7% and a 120bps stepdown in margin. Margin decline has been a factor of increased investment in the global sales team to support future growth.

The Interface business grew at 4.3% on a constant currency basis, driven by Europe (15.6%) and Latin America (29.3%), although US growth was just 1.1% and Asia-Pacific was down 1%. Taking these in turn, Europe saw market share gains, manufacturing 76% of liners in FY17 (FY16: 72%) with success in both traditional and new products. In Latin America, Brazil represented a key market share gain. The US performance reflected a further decline in OEM revenues. However, the company made market share gains in the US market with milkrite | InterPuls manufacturing 64% of liners sold in FY17, up from 61% in FY16. Asia-Pacific weakness largely reflects difficult market conditions in China.

For Precision, Control & Intelligence, 20.2% growth on a constant currency basis was a reflection of improved confidence in the farming community and hence willingness to invest. Again, performance in Europe and Brazil was strong, with North America more modest.

Farm Services demonstrated exceptional growth at 18.9% on a constant currency basis, including 16.8% in North America and 22.7% in Europe. This is an exciting time for the business, with the Pulsator Exchange launch in North America in FY17 and the Tag Exchange launch planned for FY18. The Pulsator Exchange service has introduced 478 pulsators onto 11 farms serving 19,570 cows from a zero base.

Going forward, improved milk prices and low feed costs both build into a better dairy market for the business. Hence the growth momentum that has built in FY17 is anticipated to continue into FY18. However, within that Precision, Control & Intelligence (PCI) growth is likely to scale back closer to 10% (20.2% in FY17 at constant currency). We expect mid- to high-single-digit top-line growth in

FY18 with a currency headwind. We also expect operating margin improvement from improved operating leverage and new programmes.

Management

It is important to mention the change of management at Avon Rubber and the refocused strategy this has brought. Paul McDonald was appointed as chief executive officer in February 2017, with 14 years of experience at Avon Rubber, the last seven years of which he served as divisional managing director of Avon's Dairy division (now milkrite | InterPuls). Nick Keveth was appointed chief financial officer in June 2017, joining the company from Imperial Brands, where he worked for 12 years, latterly as director of finance, planning & reporting. In addition, there are new appointments at the head of each division, both internal promotions. Leon Klapwijk is the new divisional leader for Avon Protection, and Craig Sage is the new divisional leader for milkrite | InterPuls. The new management team has been swift to visit all Avon sites and work collaboratively to introduce its updated strategy, as detailed below.

Strategy

The senior management team change has driven the group to update its strategy. The goal is to deliver long-term, sustainable growth and there is a three-fold approach:

- grow the core;
- selective product development; and
- value-enhancing acquisitions.

Grow the core

Management has recognised clear growth opportunities within the Avon Protection division for both products and service across each of the end markets it addresses currently. Within Military, the strength of the relationship with the US DoD has developed a specialist product portfolio. Activity with the UK MoD is building and the group sees global opportunities. Meanwhile, in Law Enforcement, demand levels have risen in 2017 for chemical, biological, radiological and nuclear (CBRN) defence products and the company intends to continue to grow market share and introduce new products. Avon's work in the fire space will see enhanced products and upgraded systems to comply with new 2018 National Fire Protection Association (NFPA) standards, while the argus thermal camera business will add cross-selling opportunities. Underpinning this is the group's commitment to improving production processes, exploring local assembly options and optimising the production base for future growth.

In milkrite | InterPuls, the growth priority in Interface is to build the global dealer network and launch the next product generation. In turn, the Precision, Control and Intelligence (PCI) business can leverage off the Interface market position. For Farm Services, it is a question of marketing a service portfolio on both sides of the Atlantic, with Cluster Exchange Service (CES) at the core and introducing Pulsator Exchange Service (PES) and Tag Exchange Service (TES). In essence, the goal is to build on current success and become a key partner with farms on a lease hire arrangement.

Selective product development

Innovation is core to Avon Rubber, and new product introduction will continue but at a lower level of spend than seen in prior years. The focus for investment will be on projects that present an opportunity to add value and support the strategic goals of the company. In some instances, considerable investment has already taken place and it is now a question of fully leveraging off this. Overall, this approach ensures that the product portfolio is both enhanced and able to deliver future growth.

Partnerships are key to Avon Rubber, not least the long-term, multi-level relationship with the US DoD. As we have already discussed, the 10-year sole-source Joint Service General Purpose Mask (JSGPM) contract for the M50 mask system is moving to an end in 2018, and the company is in active dialogue to determine the size and shape of its future supplier role to the DoD in the replenishment phase, which should extend for another 15 years. Hence product development is already underway on some potentially significant platform programmes. This includes the Joint Services Aircrew Mask (M69) and the M53A1 combined tactical mask and powered air purifying respirator (PAPR) system.

Value-enhancing acquisitions

Avon Rubber has a strong track record in acquisitions and we detail the key recent deals below. Future targets are likely to be in the region of £30m to £50m EV, with guaranteed forward contracts and strong management teams. Important to note is that any targets would be within Avon's existing markets. The group has net cash of £24.7m and committed bank facilities of £29.9m, and cash performance continues to be strong.

As a reminder, recent acquisitions include:

- VR Technology – Avon acquired VR Technology in 2013 and it was originally focused on personal dive computers. VR subsequently developed rebreather designs of its own and the underlying technology for both products is a suite of control electronics, gas sensors and control valves that manage the diver's breathing air and maintain oxygen and carbon dioxide levels within the correct range.
- Hudstar Systems – Hudstar Systems was purchased for $5.1m in 2015. It designs and manufactures electronics hardware and software for the fire service industry. The acquisition reduced supply chain risk due to the vertical integration of a key supplier to the group's Deltair product and provided a route to insource other components purchased across the rest of the product range. Hudstar also provided electronics capability.
- InterPuls – In August 2015, Avon made the significant strategic acquisition of InterPuls for a total consideration of €29.75m. This made the Dairy division (now called milkrite | InterPuls) a leading international provider of milking point technology, providing complete teat-to-pipeline solutions for the sector. InterPuls added high-technology products, providing the farmer with a range of high-margin technical solutions including pulsators, milk meters, automatic cluster removers and vacuum pumps.
- e2v's thermal imaging business – In October 2015, Avon acquired argus, the thermal imaging camera business of e2v, for £3.3m. This further strengthened Avon's product range in the fire and first responder markets, bringing immediate access with a leading product, allowing increased penetration with Avon's current strategic law enforcement distributors/agents and installed customer base.

Financials

We have made changes to our FY18 estimates and introduce our FY19 forecasts. We lower our FY18 revenue estimate by 8.6% to £163.2m from £178.7m, following slightly lower than expected top-line performance versus our FY17 estimates, more modest growth in Protection plus a currency headwind. We introduce an FY19 revenue estimate of £169.2m, to reflect the implementation of the growth strategy. We lower our FY18 PBT estimate to £26.5m from £26.9m, in line with a lower top-line contribution and currency headwind. However, we introduce an FY19 PBT estimate of £28.2m, again to reflect the introduction of the growth strategy.

Our FY18 normalised EPS estimate moves down slightly to 69.8p from 71.4p previously, to reflect the reduced profitability, and introduce an FY19 normalised EPS estimate of 74.5p.

We have increased our FY18 DPS estimate to 16.0p from 13.0p, representing a 30% improvement over FY17. We introduce an FY19 DPS estimate of 20.8p, again representing 30% year-on-year growth over FY18 estimates. The company has stated that it will maintain a progressive dividend policy, and intends to grow dividends ahead of earnings over the medium term. FY17 dividend cover was 6.7x (FY16: 7.6x) and the company intends to keep cover above 2x. As dividend cover approaches 2x, the company intends to growth dividends in line with the growth in earnings per share. Full details of our revised forecasts can be seen in the table below and new FY19 estimates are shown in Exhibit 4.

Exhibit 3: Avon Rubber estimate revisions

Year to September (£000s)	2017			2018e		
	Estimate	Actual	% change	Prior	New	% change
Avon Protection	118,073	113,800	-3.6%	122,796	111,752	-9.0%
milkrite | InterPuls	50,780	49,400	-2.7%	55,858	51,475	-7.8%
Total sales	**168,853**	**163,200**	**-3.3%**	**178,654**	**163,226**	**-8.6%**
EBITDA	36,013	36,000	0.0%	38,246	36,095	1.8%
Avon Protection	18,656	19,800	6.1%	19,647	20,004	0.7%
milkrite | InterPuls	8,734	8,000	-8.4%	9,608	8,648	-10%
Unallocated	-2,000	-2.000		-2,000	-2,000	
Underlying EBITA	**25,390**	**25,800**	**1.5%**	**27,255**	**26,651**	**-2.2%**
Underlying PBT	25,040	25,565	2.1%	26,905	26,476	-1.6%
EPS – underlying continuing (p)	**63.0**	**82.8**	**30.7%**	**71.4**	**69.8**	**-2.2%**
DPS (p)	11.0	12.3	11.9%	13.0	16.0	23.2%
Net debt/(cash)	(19,080)	(24,700)	29.5%	(35,216)	(43,434)	23.3%

Source: Avon Rubber accounts, Edison Investment Research

Valuation

Our cash-based capped DCF valuation is, in our view, a conservative basis for estimating cash flow values as it does not assume any growth in the terminal value. While we do 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 7.9% currently delivers a value of 1,226p.

On our updated forecasts, Avon Rubber is currently trading on 15.3x FY18e P/E, the stock is trading at a discount to its UK aerospace and defence peer group. However, given its higher than average margin performance and future growth opportunities, we believe that Avon Rubber's modest valuation premium as suggested by our DCF valuation is justified.

Exhibit 4: Financial summary

£(1,000s)	2015	2016	2017	2018e	2019e
Year end 30 September	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue	134,318	142,884	163,200	163,226	169,153
Cost of Sales	(88,618)	(90,159)	(101,500)	(102,995)	(106,734)
Gross Profit	45,700	52,725	61,700	61,710	63,950
EBITDA	27,267	29,922	36,000	36,095	38,048
Operating Profit (before amort. and except.)	22,583	24,031	30,000	30,024	31,819
Intangible Amortisation	(2,368)	(3,154)	(4,200)	(3,372)	(3,300)
Exceptionals	(2,230)	(4,808)	(7,100)	(4,002)	(4,004)
Other	(247)	(33)	(35)	(36)	(38)
Operating Profit	17,738	16,036	18,665	22,613	24,476
Net Interest	(147)	(154)	(200)	(139)	(317)
Profit Before Tax (norm)	19,821	20,690	25,565	26,476	28,163
Profit Before Tax (FRS 3)	17,591	15,882	18,465	22,474	24,159
Tax	(2,672)	1,824	2,900	(4,502)	(4,840)
Profit After Tax (norm)	16,896	21,765	25,200	21,181	22,530
Profit After Tax (FRS 3)	14,919	17,706	21,365	17,972	19,320
Average Number of Shares Outstanding (m)	30.1	30.3	30.4	30.3	30.2
EPS - normalised (p)	56.1	71.9	82.8	69.8	74.5
EPS - normalised and fully diluted (p)	54.6	70.5	82.3	69.4	74.1
EPS - (IFRS) (p)	49.6	58.5	70.2	59.2	63.9
Dividend per share (p)	7.3	9.5	12.3	16.0	20.8
Gross Margin (%)	34.0	36.9	37.8	36.9	36.9
EBITDA Margin (%)	20.3	20.9	22.1	22.1	22.5
Operating Margin (before GW and except.) (%)	16.8	16.8	18.4	18.4	18.8
BALANCE SHEET					
Fixed Assets	69,521	77,469	66,700	59,758	52,928
Intangible Assets	41,309	47,357	40,400	36,928	33,634
Tangible Assets	28,212	30,112	26,300	22,829	19,294
Investments	0	0	0	0	0
Current Assets	39,055	52,886	80,500	100,015	123,007
Stocks	17,123	20,648	21,800	22,022	23,049
Debtors	17,023	19,968	23,800	23,804	24,668
Cash	332	4,495	26,500	45,990	67,090
Other	4,577	7,775	8,400	8,200	8,200
Current Liabilities	(27,178)	(36,641)	(39,000)	(39,460)	(43,616)
Creditors	(24,828)	(34,142)	(37,200)	(36,905)	(37,936)
Short term borrowings	(2,350)	(2,499)	(1,800)	(2,556)	(5,680)
Long Term Liabilities	(39,194)	(51,713)	(52,600)	(52,558)	(52,516)
Long term borrowings	(11,143)	0	0	0	0
Other long term liabilities	(28,051)	(51,713)	(52,600)	(52,558)	(52,516)
Net Assets	42,204	42,001	55,600	67,755	79,803
CASH FLOW					
Operating Cash Flow	17,115	30,504	29,754	34,055	34,994
Net Interest	0	(147)	(154)	(200)	(139)
Tax	0	(17)	2,900	(4,502)	(4,840)
Capex	(6,183)	(6,838)	(5,500)	(5,501)	(5,701)
Acquisitions/disposals	(21,249)	(3,300)	0	0	0
Financing	(1,152)	(1,812)	(1,000)	(1,000)	(1,000)
Dividends	(1,859)	(2,430)	(3,200)	(4,118)	(5,339)
Other	21	(803)	(96)	0	0
Net Cash Flow	(13,307)	15,157	22,704	18,734	17,976
Opening net debt/(cash)	0	13,307	(1,996)	(24,700)	(43,434)
HP finance leases initiated	0	0	0	0	0
Other	0	0	0	0	0
Closing net debt/(cash)	13,307	(1,996)	(24,700)	(43,434)	(61,410)

Source: Avon Rubber accounts, Edison Investment Research

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Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
295 Madison Avenue, 18th Floor
10017, New York
US

Sydney +61 (0)2 8249 8342
Level 12, Office 1205
95 Pitt Street, Sydney
NSW 2000, Australia