Low & Bonar

FY17 results

Mixed trading, change underway

Diversified Industrials

A period of stability following management change and delivery on some flagged FY18 group projects would see a good return of interest to the fundamental Low & Bonar investment case, in our view. There are clear markers for tracking progress and, in the near term, a 3.3% yield with the expected final dividend payment is a clear attraction.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
11/16	400.0	29.2	6.0	3.0	10.1	5.0
11/17	446.5	30.7	6.3	3.1	9.5	5.1
11/18e	417.0	30.1	6.4	3.3	9.3	5.5
11/19e	429.5	32.4	6.9	3.5	8.6	5.8

Note: *PBT and EPS (fully diluted) are normalised, excluding amortisation of acquired intangibles and exceptional items. Excludes disposed grass yarns business.

Some good performances, some distractions

FY17 results were in line with modestly reduced December guidance and showed good improvements in the contributions from Building & Industrial and Interiors & Transportation activities, a similar y-o-y outturn from Coated Technical Textiles (despite a soft end to the year) and ongoing underperformance at Civil Engineering. The latter is being addressed in a strategic review; material impairment charges were booked in the year and initial remedial steps have been announced. Significant investment was made in FY17 – notably in China – and, in combination with a weak sales pull-through/higher inventory position at the year-end, resulted in an increased net debt of £138m. The final dividend was held, giving a 1.7% increase in the full year dividend overall.

Prioritising a busy agenda

Having flagged potential estimate changes post FY17, we have reduced our FY18 and FY19 EBIT expectations by c 13% reflecting trading headwinds (of c £2.5m covering y-o-y input cost and FX effects) and a lower base for Coated Technical Textiles. The senior management team is in a transition period currently, but a number of clear group priorities have been set for the new financial year. These include completing the Civil Engineering review, lowering group net debt and improving efficiency in the internal supply chain. At some point, we might reasonably expect the new management team to provide an updated operational strategy also, and greater clarity on this may well come around July when the second phase of the Civil Engineering review is expected to become visible.

Valuation: Good near-term yield underpinning

After a sharp step down following December's trading update, Low & Bonar's share price responded favourably and regained some ground following the FY17 results announcement. Nevertheless, sitting on an FY18e P/E of 9.3x and EV/EBITDA (adjusted for pensions cash) of 6.4x suggests that investors still have to buy in fully to the prospect of improved earnings. The trailing 5.1% dividend yield (including c 3.3% from the final DPS to be paid in April), covered c 2x and with further growth potential, should provide a solid near term underpinning for the share price.

12 February 2018

Price	**60p**
Market cap	**£198m**
	€1.13/£
Net debt (£m) at end November 2017	138
Shares in issue	329.4m
Free float	99%
Code	LWB
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	15.3	(11.5)	(15.4)
Rel (local)	25.5	(6.8)	(14.8)
52-week high/low		89.8p	52.6p

Business description

Low & Bonar produces specialist performance materials for a variety of end-markets by combining polymers with specialty additives and pigments. It now reports as four global business units: Building & Industrial (19% of FY17 revenue), Civil Engineering (23%), Coated Technical Textiles (31%), and Interiors & Transportation (27%).

Next events

AGM	13 April 2018

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FY17 results overview

In FY17, in constant currency terms, Low & Bonar delivered y-o-y group revenue and operating profit changes of +4.5% and -4.6% respectively (with a reported EBIT margin reduction of -70bp to 8.0%). FX translation had a favourable effect on reported earnings across the global business units (GBUs), although polymer input costs were a headwind to progress. The year closed with a c £138m net debt position, with higher than normal inventory positions to be worked down in FY19. A number of initiatives are underway to improve the group's underlying profit potential including a strategic review of Civil Engineering activities and internal supply chain enhancements.

Exhibit 1: Low & Bonar GBU and interim splits

£m	H1	H2	2016	H1	H2	2017	H1 (% change)			FY (% change)		
							Reported	CER	Volume	Reported	CER	Volume
Group revenue	**180.6**	**221.6**	**400.0**	**210.3**	**236.2**	**446.5**	**16.4%**	**4.6%**	**3%**	**11.6%**	**4.5%**	**3%**
Building & Industrial	31.8	41.6	**73.4**	40.9	45.0	**85.9**	28.6%	14.2%	13%	17.0%	9.6%	9%
Civil Engineering	39.5	51.3	**90.8**	45.8	56.2	**102.0**	15.9%	5.0%	9%	12.3%	4.9%	6%
Coated Technical Textiles	60.1	71.9	**129.8**	66.5	71.8	**138.3**	10.6%	-0.2%	-6%	6.6%	-0.7%	-5%
Interiors & Transportation	49.2	56.8	**106.0**	57.1	63.2	**120.3**	16.1%	3.8%	4%	13.5%	7.1%	6%
Group operating profit - reported	**13.3**	**21.4**	**34.7**	**15.5**	**20.0**	**35.5**	**16.5%**	**3.3%**		**2.3%**	**-4.6%**	
Building & Industrial	4.5	6.4	**10.9**	6.0	6.4	**12.4**	33.3%	17.6%		13.8%	6.0%	
Civil Engineering	1.0	3.2	**4.2**	0.0	0.1	**0.1**	N/M	N/M		N/M	N/M	
Coated Technical Textiles	3.5	5.2	**8.7**	4.9	4.4	**9.3**	40.0%	32.4%		6.9%	1.1%	
Interiors & Transportation	7.3	9.8	**17.1**	7.9	11.2	**19.1**	8.2%	-3.7%		11.7%	5.5%	
Unallocated central costs	-3.0	-3.2	**-6.2**	-3.3	-2.1	**-5.4**	N/M	N/M		N/M	N/M	

Source: Low & Bonar

Building & Industrial (B&I)

Technical textiles, mats, composites, systems and screens for a range of applications

Headline performance metrics were clearly positive, although implied y-o-y progress in the second half was below that achieved in the first, partly influenced by the agro textiles disposal, we suspect. Adjusting for part year effects,[1] we estimate that full year underlying GBU revenue progress was c 25% in sterling terms and +15-20% in local currency, most likely with some margin improvement. Therefore, the core building materials activities had a good year and management stated that this was well spread geographically and across a number of subsegments. New product development is considered to be a strong driver of top-line progress by driving core carrier fabric and membrane technologies into a wide variety of end-markets including roofing/green roofing, drainage, ventilation and filtration applications. Investment is being made to support this activity and to expand the accessible customer base. Air filtration in particular has seen good growth from a low base over the last couple of years and is becoming a more material contributor to GBU performance. As part of the review of the Civil Engineering product portfolio (see below), the Enka three-dimensional drainage plus matting lines are expected to be moved into this GBU to expand the offering to both existing and new customers during the course of this financial year. (Indicated annual revenue is c £20m; profitability will become apparent on GBU restatement.)

Civil Engineering (CE)

Geotextiles and construction fibres contributing to groundworks integrity in infrastructure projects

Underlying revenue progress was broadly similar at c 5% in both halves of the year. Management noted good interest in H1, which was expected to translate to orders and shipments in H2. In the event, higher specification product demand did not materialise as anticipated. H2 is typically a

[1] Part year effects were: agro textiles business (disposed 1 November, c 11-month contribution: c £18m revenue, break-even) and Walflor (acquired 17 January 2017; FY17 c 10.5-month contribution: £1.1m revenue, EBIT £0.5m).

seasonally stronger trading period and, while this pattern did repeat, mix effects and input cost pressures affected profitability, although the GBU did manage to achieve a modest profit in H2 and for the year as a whole. While EBITDA positive (adding back c £3m depreciation), inventory and probably debtor build will have more than offset this in cash terms. A previously flagged strategic review is underway and, in total, a c £32m impairment charge in relation to the carried goodwill and assets of this GBU was taken in FY17. The conclusion of the first phase is to exit the Ivanka site; this was originally a Texiplast facility (acquired in FY13) and had seen investment under Low & Bonar's ownership. We believe that its product focus was on higher-specification woven applications, where project demand and timing has been disappointing overall. Some of the loom capacity may be relocated, so at this stage the extent to which the GBU is withdrawing from this subsector is not clear. More positively, management expects that the Ivanka exit process will generate a positive net cash flow impact of £3-5m arising from an expected sale of the site and assets.

In the second phase, the intended shift of the Enka (drainage and matting) product lines into the Building & Industrial GBU will leave the large non-wovens segment as the dominant remaining product range, followed by construction fibres. The former are manufactured at multiple locations, the latter only one, although none are discrete sites, being shared sites with other GBUs. This adds to the complexity of the review in our view, but we are told that this will be entirely complete by July and the long-term future of operations within this GBU will become clearer at this time.

Coated Technical Textiles (CTT)

Specialist coated woven carrier fabrics for a range of primarily outdoor applications

Underlying revenue and volume performance appeared to have been stable across the two half years, although we know from a pre-close trading update that the year ended in a weaker than expected fashion. Specifically, a recurrence of manufacturing issues – which we believe is due to a higher proportion of shorter-run, more frequent changeover work – affected production quality and achievable margin in this period, as seen in FY16. Attention has refocused on this area, with the GBU director changing in January, which also appears to reflect a desire to rebuild customer confidence to historic levels. This GBU, located on three manufacturing sites, has historically generated EBIT margins in the high single-digit/low double-digit range over an extended period. However, patches of internal underperformance over the last couple of years have generated lower returns, also affected we feel by a reduced ability to pass through higher input costs as a consequence. This said, it had implicitly regained some momentum in Q3, in our view, and longer-run architectural textile volume may have contributed to this. Management's response is likely to be a simplification of business flows most discernibly through a lower number of stock items backed up by more robust manufacturing performance. This Europe-centric business should benefit from a positive EU growth outlook.

Interiors & Transportation (I&T)

Leading provider of technical non-woven carpet-backing materials, branded as Colback

This GBU showed excellent reported progress over FY17 with an acceleration in y-o-y revenue growth apparent in H2 in underlying terms. There was also margin improvement as the year progressed, although raw material cost increases were only partly passed through in the period, leaving EBIT margins slightly below the prior year overall. Within the mix, as seen at the interim stage, interior product applications saw relatively strong demand, while transportation (chiefly automotive) was comparatively slow versus the prior year. Excluding China, we estimate that underlying revenue growth was in the 4-5% range, amplified by favourable currency translation effects in reported numbers. We believe that revenue in China itself almost doubled versus the prior year (to 20% of the GBU total) and growth with carpet backing customers was supplemented by entry into the wallcoverings and decoration subsegments, all supported by the local production in Changzhou. Colback is regarded as a high-quality carrier/backing material and its versatility lends itself to the development of new market applications, which is benefiting revenue growth. A second Colback line in China is in the process of being commissioned and is expected to contribute to further volume growth from the second half of FY18. New product development supported by investment is expected to continue to be a driver of future growth.

Higher debt levels expected to decline in future periods

Low & Bonar ended FY17 with a £138m net debt position, an increase of c £27m over the year. This was largely a cash movement, save for c £3m adverse overseas debt translation. High investment levels in fixed and intangible assets were core and budgeted actions in the year, although a further working capital increase was more a reflection of some operational difficulties.

The company achieved a £3m y-o-y EBITDA increase to c £56m overall and, as in previous years, just over £4m additional pensions cash contributions were comfortably funded from this. Below this, almost £20m was absorbed into working capital, split more or less evenly between inventory and debtors, and we believe the primary drivers here were the Civil Engineering and CTT GBUs respectively. Cash interest and tax payments were both lower compared to the prior year but, including a higher minority dividend payment, the sum of these items was broadly similar at c £16m.

Spending on plant and equipment spiked up to £29m, of which c £16m related to the second I&T Colback line in China. A further c £6m was applied to intangible assets and over half of this related to a new group-wide ERP system which is currently being rolled out. Net M&A activity was modestly cash positive, with the proceeds arising from the agro textiles business disposal at the beginning of November (£7.2m) exceeding the Walflor acquisition costs (£3.4m). Lastly, cash dividends of £10m were consistent with previously declared FY16 final and H117 DPS announcements.

Cash flow outlook: in the near term, net debt will increase by the end of H118, reflecting a working capital build ahead of the seasonally stronger H2 trading period. Over the course of the year as a whole, a step down in capex (though still above depreciation) and achieving a stated £10-15m reduction in working capital, should result in a much stronger underlying FCF performance in FY18. Notwithstanding c £6m flagged exceptional cash outflow (which will be partly offset by Ivanka site and asset net disposal proceeds), we project a c £125m group net debt position by the end of FY18 and further reductions thereafter. In context, this represents a move from 2.5x EBITDA in FY17 to 1.8x in FY20, on our estimates. The still to be decided outcome of the Phase 2 review of the Civils GBU could clearly have some impact on this profile during the current financial year.

External headwinds and more conservative margins

Low & Bonar is a portfolio of businesses and technologies; the key management challenge is to continue to drive forward the two GBUs, which have been consistently good performers in recent years, while also addressing underperformance in the other two to clearly establish a sustainable platform for growth. GBU drivers vary, although management has pointed to c £1m FX and c £1.5m materials costs as y-o-y headwinds that affect each to some degree. We have also factored in more moderate growth rates generally, more so in CTT. Supply chain and cost reduction actions may start to have a more positive impact from FY19 and we will monitor progress here.

Exhibit 2: Low & Bonar estimate revisions

	EPS FD normalised (p)			PBT normalised (£m)			EBITDA (£m)		
	Old	New	% chg.	Old	New	% chg.	Old	New	% chg.
2017	6.1	6.3	3.3	30.3	30.7	1.3	54.3	55.8	2.8
2018e	7.4	6.4	(13.5)	36.3	30.1	(17.1)	61.3	55.1	(10.1)
2019e	7.9	6.9	(12.7)	38.7	32.4	(16.3)	64.5	58.4	(9.5)
2020e	N/A	7.5	N/A	N/A	35.0	N/A	N/A	60.7	N/A

Source: Edison Investment Research. Note: 2017 old = estimate, new = actual.

Managing change

We have discussed trading performance in earlier sections, but also feel that there has been change at Low & Bonar in the last 18 months that is also worthy of comment. This includes a gradual reshaping of the group (including exiting non-core grass yarns in FY16 and agro textiles in FY17) and two executive board changes[2] during FY17.

The transition at board level is ongoing, pending the arrival of a new CFO. However, high-level messaging by prominent NEDs at the FY17 results presentation (ie chairman Martin Flower and current acting CEO Trudy Schoolenberg) reiterated existing group financial targets of 12% ROCE and a 10% return on sales. Profitability (before central costs) in the well-invested and better performing B&I and I&T business areas is likely to already be above these metrics on both counts. Coated Technical Textiles has probably also exceeded both metrics in the past, but has not done so in the last couple of years due to the operational problems referred to earlier and these are now being addressed under a new GBU director. Civil Engineering has underperformed for a while – and is unlikely to have achieved targeted returns to date – but is now under the strategic microscope. We have incorporated a profit recovery here in our estimates to previously achieved levels, but suggest there could be upside to earnings based on either a more successful turnaround or a reinvestment of cash into operations, generating better returns if the strategic decision to exit is made. In addition to specific GBU actions, the senior management team is set to focus on two key areas at group level to enhance the future profit potential of the group.

Improved capital discipline: net debt is higher than desirable at 2.5x historic EBITDA and a £10-15m reduction in working capital is a stated target for FY18 to benefit cash flow. We would add to this capital budget items; the track record has been mixed here in recent years ranging from a well-executed and successful Colback China greenfield facility and positive maiden Walflor contribution to disappointing outcomes for the Texiplast acquisition, Saudi JV and construction fibres investment. As mentioned earlier, there will be a natural step down in capex in FY18; the onus remains on effective capital deployment and the Civil Engineering strategic review forms part of this process. In due course, the appointment of a new CFO, in addition to Philip de Klerk moving into the CEO seat, will bring fresh perspective. We note that the process to refinance existing bank facilities has begun and the outcome of this may also provide some indications of the future capital requirements of the business. Lastly, we note that the UK DB pension scheme moved into an IAS19 surplus position at the year end and, while overseas DB schemes still show a deficit, the current triennial valuation could possibly result in a more favourable cash contribution outcome.

Right-sizing the supply chain: an internal project is underway to improve the operating efficiency and lower the cost of the group supply chain. The GBU/shared service model introduced in FY15 was designed to enhance commercial and business development presence with customers and, while this may have been achieved, it is felt that the support infrastructure had grown to become too unwieldy and bureaucratic for the company's size. Hence, the intention is to improve the agility and responsiveness of the internal supply chain, perhaps by more directly linking manufacturing and customer-facing operations. This programme is being led by interim CEO Trudy Schoolenberg and supported by an Integrated Supply Chain director (appointed in April 2017) and is expected to be complete by the end of April. The company has flagged a £4m restructuring charge in FY18, which is expected to yield c £3m annualised savings in due course. The roll-out of a new group ERP system may also facilitate this process and the benefits to accrue from it.

[2] In 2017, previous CFO Mike Holt stepped down from the board in May, being replaced by Philip de Klerk in October, while CEO Brett Simpson left in December ahead of taking up another post. Philip de Klerk is to become the new group CEO from 1 March 2018 and a search for a new CFO is underway.

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Exhibit 3: Financial summary

£m	2014	2015	2015	2016	2017e	2018e	2019e	2020e
Year end 30 November	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS	**IAS19R**	**IAS19R**	**Restated IAS19R**	**IAS19R**	**IAS19R**	**IAS19R**	**IAS19R**	**IAS19R**
Revenue	410.6	395.8	362.1	400.0	446.5	417.0	429.5	440.2
Cost of Sales	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Gross Profit	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
EBITDA	45.6	46.9	46.0	52.8	55.8	55.1	58.4	60.7
Operating Profit (ex SBP)	32.3	33.4	32.5	35.6	36.2	36.0	38.3	40.6
Net Interest	(5.0)	(4.2)	(4.3)	(5.4)	(4.6)	(5.0)	(5.0)	(4.8)
SBP	(0.6)	(0.6)	(0.6)	(0.9)	(0.7)	(0.7)	(0.7)	(0.7)
Saudi JV	(1.1)	(1.8)	0.0	0.0	0.0	0.0	0.0	0.0
PNFC	(0.4)	(0.2)	(0.2)	(0.1)	(0.2)	(0.2)	(0.2)	(0.2)
Profit Before Tax (company norm)	25.2	26.5	27.4	29.2	30.7	30.1	32.4	35.0
Intangible Amortisation	(5.2)	(4.1)	(4.1)	(4.0)	(3.7)	(3.7)	(3.7)	(3.7)
Exceptionals	(3.3)	(10.1)	(1.9)	0.7	(47)	(5)	0	0
Profit Before Tax (FRS 3)	16.7	12.4	21.4	25.9	(19.7)	21.4	28.7	31.3
Tax	(4.9)	(6.3)	(6.2)	(8.2)	2.1	(7.9)	(8.5)	(9.2)
Minorities	(0.3)	(0.5)	(0.5)	(0.6)	(0.6)	(0.6)	(0.6)	(0.6)
Other			(9.0)	(3.2)				
Profit After Tax (norm)	18.3	18.6	19.0	19.9	21.4	21.8	23.5	25.4
Profit After Tax (FRS 3)	11.8	6.1	5.7	13.9	(18.2)	12.9	19.6	21.5
Average Number of Shares Outstanding (m)	327.0	328.1	328.1	329.0	329.4	329.7	329.7	329.7
EPS FD- normalised (p)	5.4	5.5	5.8	6.0	6.3	6.4	6.9	7.5
EPS - FRS 3 (p)	3.5	1.7	1.7	5.2	(5.5)	3.9	5.9	6.5
Dividend per share (p)	2.7	2.8	2.8	3.0	3.1	3.3	3.5	3.6
Gross Margin (%)								
EBITDA Margin (%)	11.1	11.8	11.8	13.2	12.5	13.2	13.6	13.8
Operating Margin (before amort. and except) (%)	7.9	8.4	8.4	8.9	8.1	8.6	8.9	9.2
BALANCE SHEET								
Fixed Assets	230.2	232.0		261.2	257.0	260.8	261.6	262.4
Intangible Assets	105.8	89.9		104.8	91.7	91.0	88.3	85.6
Tangible Assets	119.3	132.0		150.3	144.5	149.0	152.5	156.0
Investments	5.1	10.1		6.1	20.8	20.8	20.8	20.8
Current Assets	192.0	187.6		202.9	222.8	219.0	227.6	237.5
Stocks	90.9	82.6		97.5	97.3	88.9	89.5	89.8
Debtors	62.8	62.9		63.4	71.8	66.0	67.0	67.7
Other	12.5	8.2		15.7	15.5	15.5	15.5	15.5
Cash	25.8	33.9		26.3	38.2	48.6	55.6	64.5
Current Liabilities	(87.7)	(114.4)		(88.9)	(93.7)	(96.3)	(100.8)	(105.0)
Creditors	(87.7)	(82.9)		(88.8)	(91.0)	(96.3)	(100.8)	(105.0)
Short term borrowings	0.0	(31.5)		(0.1)	(2.7)	0.0	0.0	0.0
Long Term Liabilities	(147.6)	(133.3)		(171.5)	(204.4)	(200.2)	(196.0)	(191.8)
Long term borrowings	(113.8)	(104.5)		(137.2)	(173.9)	(173.9)	(173.9)	(173.9)
Other long term liabilities	(33.8)	(28.7)		(34.3)	(30.5)	(26.3)	(22.1)	(17.9)
Net Assets	186.9	171.9		203.7	181.7	183.3	192.5	203.1
CASH FLOW								
Operating Cash Flow	34.1	35.3		33.9	32.2	59.0	55.0	57.9
Net Interest	(4.5)	(4.5)		(4.9)	(4.4)	(5.0)	(5.0)	(4.8)
Tax	(7.7)	(7.5)		(10.8)	(10.3)	(7.9)	(8.5)	(9.2)
Capex	(20.2)	(33.7)		(22.2)	(34.4)	(25.5)	(23.5)	(23.5)
Acquisitions/disposals	3.0	0.0		21.7	3.8	3.0	0.0	0.0
Financing	0	(1)		(0)	(1)	0	0	0
Dividends	(8.8)	(9.0)		(9.2)	(10.0)	(10.6)	(11.0)	(11.5)
Net Cash Flow	(4.0)	(20.2)		8.4	(23.9)	13.1	7.0	8.9
Opening net debt/(cash)	86.8	88.0		102.1	111.0	138.4	125.3	118.3
HP finance leases initiated	0.0	0.0		0.0	0.0	0.0	0.0	0.0
Other	2.8	6.1		-17.3	-3.5	0.0	0.0	0.0
Closing net debt/(cash)	88.0	102.1		111.0	138.4	125.3	118.3	109.4

Source: Company, Edison Investment Research

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