EDISON

Avon Rubber

H117 results

New CEO marches on

Aerospace & defence

Avon Rubber's strong first half results allayed any concerns that the change in management team might have distracted this growth company from the task in hand. In fact, H117 numbers proved quite the opposite. Top-line growth has marched on apace and the CEO has shown ruthless focus in ensuring that R&D is concentrated on financially viable projects to stimulate further growth. A major new contract win announced yesterday should assuage any concerns about the M50 programme.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
09/15	134.3	19.8	56.1	7.3	19.9	0.7
09/16	142.9	21.6	74.2	9.5	15.1	0.8
09/17e	168.9	25.0	66.6	11.0	16.8	1.0
09/18e	178.7	26.9	71.4	13.0	15.7	1.2

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

Strong top-line growth and order intake

H117 results demonstrated that Avon Rubber is successfully delivering on its strategy of growing organically through good execution and strategic acquisitions. Revenue was up 7% organically, with flat margins despite slightly higher costs. EPS was flat year-on-year, but this is purely a function of an anomalously low tax charge in FY16 of 1%. The tax rate for FY17 is expected to normalise at 19%. Orders were up 9% y-o-y and we expect further contract wins in the second half.

Shift in mix at Protection & Defence as Dairy rebounds

There is a subtle shift in mix of customers and products in Protection & Defence. The sole-source M50 respirator contract with the US Department of Defense (DoD) is due to end in 2019 and volumes were lower this year, as expected. The proportion of the division's revenues from the DoD has therefore fallen from 56% in H116 to 50% in H117. Sales to EMEA and North America have increased, as, importantly, have sales of fire products following the acquisition of Argus. Avon is increasingly focused on more sophisticated mask systems, which have a higher selling price. In addition, the FY18 US defence budget, which was released yesterday, looks promising for Avon as it raises troop numbers. Dairy has benefited from a rebound in the milk price, which is leading to farmers investing in their facilities again. The Farm Services model is progressing well and the roll-out of the tag exchange has been brought forward to the second half of the year.

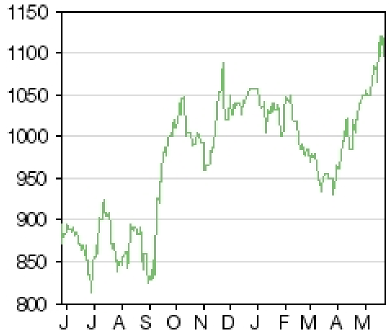
Valuation: At a justified premium to its peers

Avon Rubber is trading on 19.1x FY18e EPS compared to its aerospace and defence peers, which are trading on an average of 17.7x. However, we believe, this 8% premium is justified due to Avon's higher levels of growth (6% EPS CAGR over the next four years) and significant exposure to US defence and commercial markets. The M50 contract announcement yesterday is tangible evidence of future growth potential in new markets.

24 May 2017

Price	**1,118.00p**
Market cap	**£347m**
	$1.29/£
Net cash (£m) at 31 March 2017	12.6
Shares in issue	31.0m
Free float	96%
Code	AVON
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	9.6	14.6	23.5
Rel (local)	4.6	10.5	2.0
52-week high/low		1,119.0p	812.0p

Business description

Avon Rubber designs, develops and manufactures products in the respiratory protection, defence (71% of 2016 sales) and dairy (29%) sectors. Its major contracts are with national security and safety organisations such as the DoD. 86% of sales are from the US and 14% are from Europe.

Next events

FY17 results	5 December 2017

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Edison profile page

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Robust first half with strong order intake

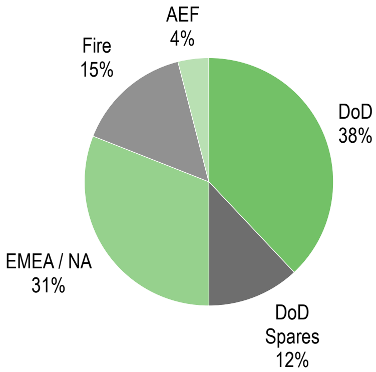
The interim results for FY17 showed that Avon Rubber has not suffered during this period of management transition, and that new CEO Paul McDonald has hit the ground running:

- **Revenue** increased 7% at constant currency year-on-year to £81.1m (2016: £66.3m), while adjusted **operating profit** increased 6% to £10.9m (2016: £9.0m) at an operating profit margin of 13.4% (2016: 13.6%). The 20bp decrease is attributable to the group absorbing £0.3m of additional amortisation, £0.3m of additional impairment charges and a £0.2m increase in corporate costs.
- **Adjusted PBT** increased 7% to £10.7m (2016: £8.8m). The **basic adjusted EPS** was flat year-on-year at 28.7p due to a **tax rate** of 19% compared to 1% last year. Last year's rate was anomalous due to a one-off tax credit and management has guided that 19% is a more normalised level.
- **Operating cash conversion** remained strong for the period at 103% of EBITDA (2016: 111%). **Net cash** was £12.6m, which is £10.6m higher than at the end of FY16 partly because capex has been slightly lower this half at £2.7m (H116: £3.8m). This is due to the new CEO taking a more focused approach to R&D spending, targeting opportunities with the highest returns and halting a number of programmes that he felt were too risky and/or commoditised, for example the tank pad.
- With the robust performance and sustained growth opportunities, the board increased the **interim dividend** by 30% again to 4.11p (2016: 3.16p), continuing the trend witnessed over the past four years. The payout ratio of 7.0x is more than comfortable, but the board is showing no inclination to increase it at this moment in time. This implies that the company wants to retain its firepower to make acquisitions.
- **Order intake** was strong, increasing 9% to £90.7m (2016: £73.4m) In Protection & Defence, 60% of the closing order book is for delivery in the second half of FY17, giving good visibility.

Protection & Defence: Diversification of the customer base

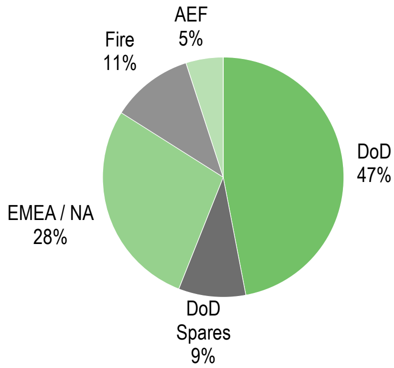
Revenue was 6% higher at £55.9m (2016: £45.7m) and underlying operating profit was £8.0m at an operating margin of 14.3% (2016: 14.3%). Interestingly, the shift in mix we saw last year continued, with only 50% of the division's sales going to the DoD compared to 56% in H116. This is partly due to lower DoD sales. However, it is mainly attributable to strong growth in Fire, where the acquisition of Argus appears to have been a success, and higher sales to EMEA and North American markets (see Exhibits 1 and 2).

Exhibit 1: Protection & Defence revenue split by market H117



Source: Avon Rubber H117 results presentation

Exhibit 2: Protection & Defence revenue split by market H116



Source: Avon Rubber H117 results presentation

- **M50 respirator:** sales of the JSMPG M50 were lower as expected at 93,000 mask systems (2016: 107,000). This long-term, sole-source contract continues to underpin the division and a further order for 131,000 units provides management with good visibility for the next 12 months. The contract states a total service requirement of between 2-3m mask systems. We estimate that Avon has supplied approximately 1.8m to date. However, this contract comes to an end in 2019, and the DoD has stated it could potentially look to dual-source its gas masks in the future. Management believes that in the future it will receive a contract to sustain stocks of the FM50 at the required levels, and while this will mean volumes will be lower, the price per unit is expected to be higher. President Trump's FY18 defence budget released yesterday proposed a 4% increase (38,000 troops) in the US Army's end strength to 1.018 million. This raises the possibility that Avon may also receive some additional orders as respirators are personal issue kit.
- **Move towards higher price products:** Avon is increasingly focusing on premium respirators. It sees significant opportunities materialising for the M53A1, which retails at $1,500-2,000 per mask, and the ST53, which retails at up to $7,000 per system. Management seems confident that these higher-end products will help offset the reduction in the M50 programme.
- **Export orders:** Avon Rubber has been involved in protracted discussions with Middle Eastern customers over the past couple of years and last week stated that it expected to receive orders from Middle Eastern customers in H217. Yesterday, the company announced a contract to supply 37,000 FM50 respirators and associated spares and accessories to an unnamed customer, which equates to c £8m of revenue expected in H118. This shows positive order momentum in defence export markets and the statement from last week suggests we can expect to see more contract wins in the second half of FY17. The company is also pursuing selling lower-tech masks to customers such as India where 'in-country' production and price are more important than cutting-edge technology. This could potentially lead to upselling opportunities to Special Forces.
- **Growth in Fire market sales:** the acquisition of Argus has been a success. Fire sales are now being led with the Thermal Imaging camera product range (Mi-TIC). There has also been organic growth in sales of the Deltair self-contained breathing apparatus.

Dairy: Higher milk price drives higher sales

Trading conditions have markedly improved for the Dairy division in H117 following the improvement in the milk price. Revenue was up 7% at £25.2m (2016: £20.6m) and operating profit was £4.0m (2016: £3.4m) at an operating margin of 15.9% (2016: 16.5%). The 60bp decline in the margin is attributable to higher depreciation of the cluster equipment and some overhead growth as sales increase. Dairy farmers have increased their capital expenditure, which has led to further growth from the range of InterPuls products.

- **Less dependence on OEMs:** the acquisition of InterPuls has reduced Avon's reliance on OEMs. Own brand sales are higher margin and give the business strategic independence.
- **Accelerated expansion in Farm Services:** the Cluster Exchange Service business is growing well in North America and Europe. The Pulsator Exchange pilot was successful in North America in H117 and so the decision has been taken to accelerate its launch, which will now take place in the second half of the year. The Farm Services model should lead to a more robust and sustainable business model that is less susceptible to fluctuations in the milk price.
- **Potential remains in emerging markets:** the number of cows being milked using automated processes is growing in emerging markets. A portion of the higher central costs is attributable to the sales and marketing efforts in these areas, where business is relationship based and so having the best teams in place is crucial.

A strengthened management team

New CEO Paul McDonald has been busy during his first three months. He immediately appointed new divisional heads, with Leon Klapwijk assuming responsibility for Protection & Defence and Craig Sage heading up Dairy (Mr McDonald's previous role). These internal promotions left a void in the tier two management, which has now been strengthened by external hires from competitors. The new head of EMEA sales & marketing for Protection & Defence comes from Scott Safety, the sole-source provider of gas masks to the UK MoD. The new head of Farm Services comes from a competitor, which should help Avon plan how to best exploit its position in a competitive market. The newly appointed finance director, Nick Keveth, starts on 1 June and will have a two-month handover period with Paul Rayner, the interim FD.

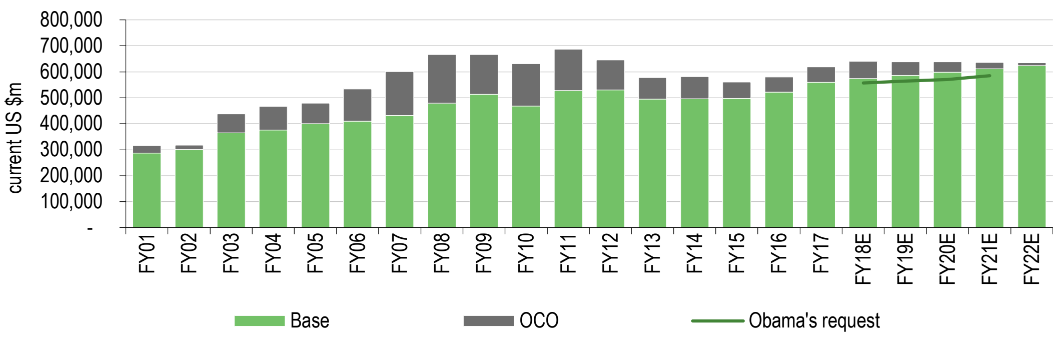
It is to Mr McDonald's and Mr Rayner's credit that they have managed to deliver such a strong set of results during this transition period for the company. While the CEO is new to the role, he has been at Avon Rubber for 15 years. He gave the impression at the results meeting that he is clear about where the company should be focusing and that he is relishing his new-found responsibilities.

Positive US defence budget with troop uplift

President Trump released his FY18 defence budget yesterday. It confirmed that US defence spending is on an upward trajectory, which is positive for the defence industry as a whole, and of course for Avon Rubber; the DoD is Avon's key customer, providing 37% of FY17 revenue. President Trump has requested an FY18 base budget of $574bn, which is 3% higher than Obama's previous request, and he has requested $65bn of Overseas Contingency Operations (OCO) funding. The request for 38,000 additional Army personnel is positive for Avon because, as noted earlier, this may lead to the requirement for more FM50 respirators.

It is important to note though that for the president to set a defence budget at these levels, he needs to repeal the 2011 Budget Control Act, which enforces spending caps. The level of compromise shown by the House and Senate to pass the recent omnibus spending bill for 2017 suggests that Congress may be in a mindset that could see it finally reaching an end to sequestration.

Exhibit 3: US defence budget



Source: US FY18 budget and FY17 DoD Green Book

Small upgrades due to order momentum despite higher costs

Management does not give quantitative guidance, but said yesterday that it is confident in meeting its expectations for the full year. We have adjusted our FY17 revenue expectations to reflect better than expected growth in Protection & Defence, and tempered our expectations in Dairy slightly, resulting in a 0.8% increased at the group level. We have raised our FY18 revenue estimate by 1.3% to reflect the order momentum in Protection & Defence. In both years our margin expectations have remained broadly unchanged, although central costs are slightly higher as guided by management due to a higher spend on sales and marketing.

Our net cash figure is slightly lower due to the newly agreed payment scheme to service the pension following the triennial valuation. The group has agreed to increase its contributions to £1.5m per year from £0.7m, starting from 1 April 2017.

Exhibit 4: Estimate revisions

Year to September (£m)	2017e	2017e		2018e	2018e	
	Prior	New	% change	Prior	New	% change
Protection & Defence	113,027	118,073	4.5%	116,418	122,796	5.5%
Dairy	54,557	50,780	-6.9%	60,013	55,858	-6.9%
Total sales	**167,584**	**168,853**	**0.8%**	**176,431**	**178,654**	**1.3%**
Protection & Defence	17,632	18,656	5.8%	18,627	19,647	5.5%
Dairy	9,380	8,734	-6.9%	10,317	9,608	-6.9%
Other	(2,000)	(2,200)	-10.0%	(2,000)	(2,200)	-10.0%
Total operating profit	**25,012**	**25,190**	**0.7%**	**26,944**	**27,055**	**0.4%**
EPS normalised (p)	66.2	66.6	0.6%	71.1	71.4	0.4%
DPS (p)	11.0	11.0	0.0%	13.0	13.0	0.0%
Net cash/(debt)	19,529	19,080	-2.3%	36,564	35,216	-3.7%

Source: Edison Investment Research

Valuation

Trading at a justified premium to its peers

Avon Rubber is currently trading on 19.1x FY18e EPS, which places it at an 8% premium to its peers in the aerospace and defence sector, where the average is 17.1x. However, the company has higher than average growth due to its high levels of exposure to the US DoD and growing commercial markets. It also has excellent order momentum, as demonstrated by the defence contract announcement yesterday.

Exhibit 5: Financial summary

Year end 30 September	£000s	2013	2014	2015	2016	2017e	2018e
PROFIT & LOSS		**IFRS**	**IFRS**	**IFRS**	**IFRS**	**IFRS**	**IFRS**
Revenue		124,851	124,779	134,318	142,884	168,853	178,654
Cost of Sales		(91,140)	(83,264)	(88,618)	(90,159)	(106,545)	(112,730)
Gross Profit		33,711	41,515	45,700	52,725	62,308	65,924
EBITDA		20,440	23,164	26,586	30,808	35,718	36,873
Operating Profit (before amort. and except.)		14,223	17,003	20,215	21,763	25,190	27,055
Amortisation of Intangibles		(417)	(261)	(1,043)	(3,307)	(3,000)	(3,024)
Exceptionals		(383)	(2,017)	(604)	(506)	0	0
Other		(420)	(400)	318	(320)	(400)	(400)
Operating Profit		13,003	14,325	18,886	17,630	21,790	23,631
Net Interest		(347)	(274)	(147)	(154)	(150)	(150)
Other finance costs		(253)	(187)	(247)	(33)	0	0
Profit Before Tax (norm)		13,656	16,554	19,821	21,576	25,040	26,905
Profit Before Tax (FRS 3)		12,403	13,864	17,838	16,801	21,640	23,481
Tax		(3,566)	(3,053)	(2,672)	1,824	(4,869)	(5,283)
Tax adjustment		(122)	(450)	(253)	(924)	0	0
Profit After Tax (norm)		9,968	13,051	16,896	22,476	20,171	21,622
Profit After Tax (FRS 3)		8,837	10,811	15,166	18,625	16,771	18,198
Average Number of Shares Outstanding (m)		29.5	29.9	30.1	30.3	30.3	30.3
EPS - normalised (p)		33.8	43.7	56.1	74.2	66.6	71.4
EPS - continuing, FRS 3 (p)		30.0	36.2	50.4	61.5	55.4	60.1
DPS (p)		4.3	5.6	7.3	9.5	11.0	13.0
Gross Margin (%)		27%	33%	34%	37%	37%	37%
EBITDA Margin (%)		16%	19%	20%	22%	21%	21%
Operating Margin (before amort. and except.) (%)		11%	14%	15%	15%	15%	15%
BALANCE SHEET							
Fixed Assets		36,928	36,815	74,095	85,244	81,639	79,146
Intangible Assets		16,541	17,240	41,309	47,357	47,734	48,283
Tangible Assets		20,387	19,575	28,212	30,112	26,130	23,088
Other		0	0	4,574	7,775	7,775	7,775
Current Assets		34,449	34,971	34,481	45,111	59,828	78,330
Stocks		13,374	12,887	17,123	20,648	19,811	20,960
Debtors		20,891	19,159	17,026	19,968	20,938	22,153
Cash		184	2,925	332	4,495	19,080	35,216
Assets held for sale		0	0	0	0	0	0
Current Liabilities		(23,369)	(26,453)	(27,178)	(36,641)	(32,652)	(33,970)
Creditors		(17,296)	(19,601)	(18,005)	(24,185)	(22,695)	(24,013)
Short term borrowings		0	0	(2,350)	(2,499)	0	0
Tax		(6,073)	(6,852)	(6,823)	(9,212)	(9,212)	(9,212)
Other		0	0	0	(745)	(745)	(745)
Long Term Liabilities		(27,312)	(20,317)	(39,194)	(51,713)	(51,713)	(51,713)
Long term borrowings		(11,059)	0	(11,143)	0	0	0
Deferred Tax		(2,977)	(2,315)	(9,734)	(10,007)	(10,007)	(10,007)
Retirement benefit obligations		(11,279)	(16,029)	(16,605)	(39,951)	(39,951)	(39,951)
Provisions		(1,997)	(1,973)	(1,712)	(1,755)	(1,755)	(1,755)
Other		0	0	0	0	0	0
Net Assets		20,696	25,016	42,204	42,001	57,102	71,793
CASH FLOW							
Operating Cash Flow		14,708	25,004	20,446	31,680	32,896	34,225
Net Interest		(364)	(314)	(147)	(309)	(150)	(150)
Tax		(2,229)	(2,903)	(3,270)	(1,031)	(4,869)	(5,283)
Capex		(11,054)	(6,815)	(6,183)	(6,838)	(6,923)	(7,325)
Acquisitions/disposals		(437)	(31)	(21,228)	(3,250)	0	0
Equity financing		(1,765)	0	(1,152)	(1,812)	(1,000)	(2,000)
Dividends		(1,132)	(1,422)	(1,859)	(2,430)	(2,870)	(3,330)
Net Cash Flow		(2,273)	13,519	(13,393)	16,010	17,084	16,136
Opening net (debt)/cash		(8,725)	(15,937)	2,925	(13,161)	1,996	19,080
Cash FX effect		123	281	97	(853)	0	0
Discontinued operations / relocation		0	0	0	0	0	0
Debt FX and Other		(5,062)	5,062	(2,790)	0	0	0
Closing net (debt)/cash		(15,937)	2,925	(13,161)	1,996	19,080	35,216

Source: Edison, company accounts

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