

# **Polypipe**

# Premium positioning

Polypipe's rating is currently slightly ahead of its sector, but this overlooks the company's positioning in long-term growth segments, in our view. The FY18 trading performance was noticeably stronger in H2, though margin progression was constrained by short-term production inefficiencies in certain areas. Management provide a clear and consistent message regarding business focus under a refreshed, growth-oriented strategy.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/17**	411.7	65.7	26.9	11.1	14.9	2.8
12/18**	433.2	67.1	28.1	11.6	14.1	2.9
12/19e	467.0	73.7	30.1	13.3	13.3	3.3
12/20e	479.2	76.7	31.3	13.7	12.8	3.4

Note: \*PBT and EPS are normalised, excluding amortisation of acquired intangibles and exceptional items. \*\*Continuing operations only.

# Busy year and strategic progress

The 2018 trading year was characterised by weather affected H1 trading and improved underlying y-o-y revenue performances in H2 in both divisions each of which also absorbed an acquisition towards the end of the period. Underlying profitability improved marginally though would have been stronger but for some production inefficiencies at higher volumes in certain lines. The Manthorpe and Permavoid acquisitions both appear to have settled quickly into the group. They were responsible for net debt increasing to c £164m at the year-end with good recurring underlying cash flow characteristics also in evidence. Exits from manufacturing operations in France and the Middle East were also completed during the year. We make no material changes to estimates following the results

# Refreshed growth strategy

Having presented a refreshed group strategy in Q2 2018, some portfolio evolution has since taken place, trimming non-core exposures and adding a complementary business in each division. The core underlying market out-performance objective is unchanged. Increased focus on building systems and solutions capability in faster growing subsegments and developing overseas markets are key features of the company's growth strategy. Current market positions and financial flexibility means that progress in these areas is likely to come from a combination of internal development activity and further M&A in due course.

# Valuation: Sector rating, premium positioning

After a weak close to 2018, Polypipe's share price has rebounded strongly (being up x15% ytd and also c 8% over the last 12 months) though is now off the 432.60p high seen just before the FY18 results announcement. We note that some but not all of the quoted UK housebuilders have also had a strong start to the year in share price terms and the long-term structural UK housing shortage theme is intact. Polypipe's modest P/E premium compared to UK listed peers does not reflect its leading market share positions and strategic positioning to develop further in our view.

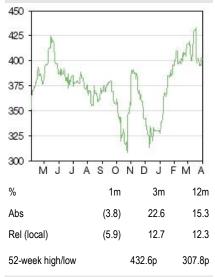
FY18 results and strategy refresh

Building & construction

#### 2 April 2019

Price	400.0p
Market cap	£800m
	£/€1.12
Net debt (£m) at end December 2018	164
Shares in issue	200m
Free float	93%
Code	PLP
Primary exchange	LSE
Secondary exchange	N/A

#### Share price performance



#### **Business description**

Polypipe is a leading supplier of largely plastic building products and systems. Operations in the UK (c 90% of revenue) address a broad range of sectors including residential, commercial and civil building demand and a number of subsectors within them. Overseas revenues are generated through exports particularly to the Middle East and a small Italy-based specialist fittings business.

#### **Next events**

2018 final DPS 7.9p XD	18 April 2019
AGM	23 May 2019
2018 final DPS to be paid	29 May 2019

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# **Investment summary**

#### Company description: Well positioned sector leader

Polypipe is an established and leading supplier of plastic building products and systems. UK operations account for c 90% of pro forma FY18 revenue and address a broad range of sectors including residential, commercial and civil building demand and a number of subsectors within them from an integrated design, manufacturing and distribution business platform. International revenues are generated through export sales and a small Italy-based specialist fittings operation.

#### Valuation: Favourable long-term trends

Favourable long-term trends include the undersupply of housing, an ageing housing stock and infrastructure spending driven by population growth and increasing urbanisation. While we are not currently in a high-growth economic environment, Polypipe's current P/E rating parity with UK-listed building materials peers does not reflect its leading market shares and strategic positioning to develop further, in our view. The company's P/E for FY19 is currently 13.3x and declines under our estimates to 12.2x by FY21. Its FY19 EV/EBITDA (including full year contributions from acquisitions) is 9.5x. Within its peer group, we note that Marshalls – which we consider to have a similar residential and commercial/infrastructure exposure – continues to trade on a significant sector premium with a 2019 P/E and EV/EBITDA of 21.7x and 14.3x respectively.

#### Financials: Growing ahead of the UK market

We made no material changes to estimates following the FY18 results announcement, with acquisitions balancing out our softer underlying expectations, especially in Commercial & Industrial. Polypipe's business model is characterised by a relatively low inventory, short supply chain and high service level offering in a comparatively short order visibility industry. A key strategic aim is to be able to outgrow the overall UK construction market by 2-4% pa. Over our forecast horizon, we expect an earnings growth CAGR of 5.3% and a DPS CAGR ahead of this at 6.5%. In the absence of any further acquisitions, our model currently shows net debt trending down from £164m at the end of FY18 to c £95m two years further out (or 0.9x EBITDA generated in that year).

#### Sensitivities: Business breadth and limited non-UK exposure

Polypipe is substantially a UK business in a UK market largely supplied by UK manufactured products so exchange rate fluctuations have a limited direct effect on performance. That said, international markets for virgin polymer materials are priced in US dollars; while Polypipe purchases in sterling, relative sterling strength/weakness clearly influences input prices affecting other UK-based manufacturers in a similar way. The rate at which input cost changes can be passed through to customers (relatively quickly through tenders, c three months lag overall through third-party distributors) can influence short-term profitability. Polypipe sells into RMI and newbuild subsectors to both residential and non-residential end markets and in private and public sectors which all have differences in underlying demand drivers. This product breadth and sector diversity brings resilience; Polypipe is able shift the focus of its development and manufacturing resources and this is a key business model strength.



# Company description: Well positioned sector leader

Polypipe is a leading UK-based manufacturer of building products, chiefly pipework, ducting, fittings and systems focused on water and climate management in residential and commercial building and infrastructure applications. Its profitable business model is sustained by innovation and product development in segments with higher growth rates.

# Focused and integrated manufacturing and distribution model

Polypipe designs and manufactures over 20,000 components for over 100 plumbing and drainage piping systems, ventilation systems/ducting and roofing and access products. Primarily, it processes basic (virgin and recycled) polymers into high grade compounds that are extruded or moulded into finished parts. This flexible, modular process uses several hundred machines and tools aligned with downstream assembly, fabrication and kitting processes all with a high degree of automation and in-line quality control. Manufacturing sites tend to specialise by process and sector application and operate their own tailored logistics capability. Divisional reporting is by primary customer type; the relative scale of the residential and commercial/infrastructure sectors is shown in Exhibit 1.

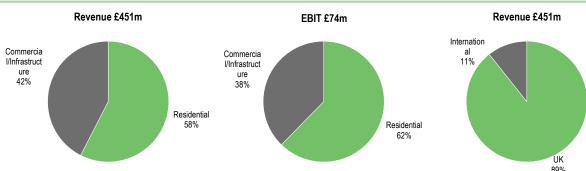


Exhibit 1: Polypipe revenue and profit splits (FY18 pro forma)\*

Source: Polypipe, Edison Investment Research estimates. Note: \*Continuing operations plus FY18 acquisitions annualised.

In the UK, these largely trade end markets are addressed through a c 500 strong sales and technical support team. Customer types (including developers, contractors, specifiers, installers and housebuilders) vary by market segment and are served through multiple third-party channels as well as direct to site. Polypipe delivers with its own extensive transport fleet and from limited strategic distribution space. Located outside the UK, a specialist Italian high-pressure fittings business is part of the Commercial and Infrastructure division.

#### Consistent strategy, recently refreshed

Polypipe's core business strategy has remained very consistent for a number of years, focusing on the sectors outlined above. Management targets above-average growth by investing in operational improvements, faster growing subsegments and selective acquisitions. Martin Payne became CEO in October 2017 (having joined as CFO in May 2016) and at the same time Glenn Sabin was appointed to the newly created role of COO (he had previously undertaken MD roles in the company for a number of years). Most recently, Paul James joined as CFO a year ago completing a renewal of the senior executive team since the April 2014 IPO. As covered in subsequent sections, a refreshed/updated strategy was presented at the May 2018 capital markets day (CMD). The most obvious manifestations of this to date are the exit from a non-core French business and withdrawal from Middle East manufacturing (though local sales and distribution presence is maintained) followed by two acquisitions during H2. In the near term, this reinforces an impression of greater UK focus. The Polypipe board composition is completed by four NEDs, including chairman Ron Marsh, who were all appointed around the time of the IPO and have a broad range of plc experience.



#### FY18 results overview

Both of Polypipe's reporting divisions generated improved y-o-y revenue performance in H2 partly, though not solely due to poor Q1 weather effects. Underlying profitability improved marginally in the year and acquisitions (Manthorpe and Permavoid) made small, part year contributions to the group result. Net debt increased to c £164m as a result of the acquisitions with good underlying cash flow characteristics that are expected to recur.

Exhibit 2: Polypipe divisional and interim splits										
£m	H1R	H2	2017	H1	H2	2018	Actual %	ch y-o-y	L-f-I %	ch y-o-y
							H1	2018	H1	2018
Group Revenue	210.0	201.7	411.7	210.2	223.0	433.2	0.1%	5.2%	0.1%	4.2%
Residential Systems	112.4	111.1	223.5	119.0	126.3	245.3	5.9%	9.8%	5.9%	8.5%
Commercial & Infrastructure Systems	97.6	90.6	188.2	91.2	96.7	187.9	-6.6%	-0.2%	-6.6%	-0.1%
Group Operating Profit - reported	37.9	34.7	72.6	36.3	37.7	74.0	-4.2%	1.9%	-4.2%	0.3%
Residential Systems	22.9	21.4	44.3	23.8	22.5	46.3	3.9%	4.5%	3.9%	2.5%
Commercial & Infrastructure Systems	15.0	13.3	28.3	12.5	15.2	27.7	-16.7%	-2.3%	-16.7%	-2.8%

Source: Company data. Note: \*H117R – French CI&S operations sold in March 2018 and treated as discontinued. LFL adjusts for acquisitions only – FX had a modest positive impact on revenue £0.2m and operating profit £0.1m

#### Residential (UK 97% revenue, overseas 3%)

Underlying newbuild subsector demand was firm throughout the year, slightly obscured around the end of Q1 by bad weather which affected H1 trading. In residential RMI (repair, maintain or improve) markets demand has been lacklustre. Construction Products Association (CPA) data estimates that spending in these segments was up 4.9% in the former category and flat in the latter, so Polypipe's underlying +8.5% revenue progress – with newbuild just over half of total sales – represents a clear outperformance of these measures. The underlying divisional EBIT margin declined by c 120bp to c 18.7% in 2018 due a combination of three elements; rising polymer prices (which although fully recovered is dilutive) over the course of the year, the short-term weather-related dip in H1 and production inefficiencies in certain lines at higher volumes in H2. We estimate that the latter effect represented a c £2m (or c 80bp) drag on profitability in the year. More positively, the acquisition of Manthorpe Building Products (see later section) contributed £2.8m revenue and £0.9m to EBIT to the divisional outturn during Polypipe's two months of ownership.

#### Commercial & Infrastructure (UK 81% revenue, Middle East 8%, Europe 7%, RoW 4%)

In broad terms, public and private sector commercial customers account for c 60% of UK revenue split roughly equally - UK newbuild (ie multi-occupancy residential) a further quarter and infrastructure the remaining c 15%. We consider that a flat underlying revenue performance after a 6.9% y-o-y revenue reduction in H1 to be a good outturn for 2018. Part of this pattern will have been attributable to the adverse Q1 weather referred to earlier but also to regaining some momentum in roadbuilding programmes in England and sales traction with newer product lines following investment in larger diameter sewer/drainage pipes and soil stack assemblies for tall buildings. For the year as a whole, UK sales were effectively flat (+0.2%), while international ones were slightly down (-1.6%). Lower Middle East sales contributed to the latter outturn; market conditions were soft and, as previously flagged, Polypipe transitioned to a local subcontractor model during the year here with some product sold during H2. We would expect higher input prices to have been recovered more quickly in this division, though the dilutive margin effect still applies, and the elimination of Middle East costs will have contributed to a reasonably robust underlying margin performance allowing for the poor Q1 weather effect. Permavoid (see later section) chipped in £1.3m revenue and £0.2m EBIT during the four months following its acquisition. Its water management product portfolio is already well known to Polypipe and brings international sales also.



## Good underlying cash flow expected to continue

Polypipe's year end net debt was £164.2m, a c £16m increase during the year. This movement was clearly driven by M&A transactions (two acquisitions and one disposal) which resulted in a net £43m cash outflow.

2018 EBITDA rose by c £2m y-o-y to c £91m. Operating cash inflow has a seasonal skew driven by UK site activity which typically requires working capital investment in H1 which substantially flows back in H2 (partly depending on year end activity and/or prospective price increases). In H118, an outflow of £21m reflected pricing trends and some weather disruption which more than reversed in H218 with a £26m inflow, boosted temporarily by higher trade creditor levels owing to purchasing ahead of price rises. After taking also into account non-recurring costs just above £4m (split broadly equally between Middle East restructuring and M&A transaction fees) operating cash flow was a very healthy £90m.

Cash interest and tax of c £17m was in line with underlying P&L charges while net capex of c £23m (the largest single item being £5m of new large diameter corrugated pipe equipment) was equivalent to 1.5x depreciation. Factoring in all of the above, free cash flow for 2018 was £50m. This was applied to cash dividends of £22m and, utilising some of the refinanced banking facility<sup>1</sup>, the £43m M&A referred to above. Note that timing differences were such that disposal proceeds for the non-core French business were received in H1, while net cash consideration for the acquisitions of Permavoid (August, c £4m) and Manthorpe (September c £52m) occurred in H2.

We expect Polypipe's net debt: annualised EBITDA to decline from 1.7x at the end of 2018 to 1.4x twelve months later – with further reductions beyond that, absent further acquisitions – even allowing for capex ahead of depreciation and dividend growth in each of our forecast years.

# Outperforming low single-digit growth markets

The latest CPA estimates for 2019 and 2020 point to low single-digit growth in new housebuilding (decelerating), road infrastructure (rising) and RMI spending (dipping but still positive in 2019, picking up slightly in 2020) and, in the commercial subsector, a high single-digit contraction followed by a much smaller one in 2020. These are useful background metrics for Polypipe, though of course, overall UK economic growth levels are likely to depend on the form that Brexit takes.

The commercial sector is an unwelcome headwind, but Polypipe has consistently delivered against its strategic aim to grow ahead of its markets and, as for the other segments, expects to perform relatively well. The company has taken steps to cope with capacity pinch points – by adding production equipment and adjacent land at its Broomhouse Lane site – and rebalancing some lines with Manthorpe is also an option. This acquisition along with Permavoid will provide some full year benefit to 2019 results and, prospectively, above average growth rates. Against our last published estimates, our group PBT expectations are now marginally higher for 2019 and 2020 respectively. This is the net result of c £5m annual PBT uplifts from the combined acquisitions of Permavoid and Manthorpe, being largely offset by more conservative underlying revenue growth and margin assumptions, especially in the Commercial & Infrastructure division.

Exhibit 3: Polypipe revised estimates											
	EPS, fully diluted, normalised (p) PBT, normalised (£m) EBITDA (£m)										
	Old	New	% chg.	Old	New	% chg.	Old	New	% chg.		
2018	28.7	28.1	-2.1	70.1	67.1	-4.3	92.9	90.6	-2.5		
2019e	30.1	30.1		73.6	73.7	+0.1	96.4	99.2	+2.9		
2020e	31.1	31.3	+0.6	75.9	76.7	+1.1	98.7	102.0	+3.3		
2021e	N/A	32.8	N/A	N/A	80.4	N/A	N/A	105.6	N/A		
Source: Edison Investment Research. 2018 Old = estimate, New = actual											

<sup>&</sup>lt;sup>1</sup> A £300m RCF to 2023 - with two one-year options to extend further - and a new £50m accordion facility.



# Manthorpe acquisition: Adjacent product lines added

The acquisition of Derbyshire-based Manthorpe Building Products brings a portfolio of adjacent residential building products using well-understood processes and materials and a self-contained freehold manufacturing site with scope for expansion. In terms of scale, Manthorpe operating profitability represents c 10% of Polypipe's ongoing divisional EBIT. The transaction was funded from existing cash and banking resources.

Organically developed business: established in 1986, Manthorpe has developed a portfolio offering from origins in roof and subfloor ventilation progressively into cavity wall closers/trays, loft doors and dry fix external roofing with a limited linear drainage range substantially all produced from polymer materials, especially polypropylene. It should be noted the company has had a presence in each of these segments for at least 10 years and the products have been subject to ongoing development and evolution backed by in-house R&D capability and some patent protection. Injection moulding and extrusion are the primary production processes employed. Manufacturing capacity – primarily injection moulding and extrusion machines – is understood to be well invested including in-process robotics to enhance operating efficiency. Manthorpe also has a modern warehouse and logistics facilities (50,000 square feet (sf)), which when completed in 2016 gave rise to a 30% or 30,000 sf uplift in manufacturing space. We understand that the freehold site acquired by Polypipe as part of the transaction has the potential for further development if the need to expand further arises. At the point of acquisition, Manthorpe employed c 100 staff.

Consolidation and expansion of product portfolio: the clear and obvious common ground between Polypipe and Manthorpe is that they are both suppliers of predominantly polymer-based building products and use injection moulding and extrusion processes. As an engineering-led, innovative company in its own right, Manthorpe feels culturally very similar to Polypipe. As one would expect, Manthorpe has a narrower product offering and a SKU count of c 400. There is some functional commonality in cavity closer and loft hatch door applications - both are produced by Polypipe TDI – and in the latter area, management notes the acquired products have superior air tightness designs compared to Polypipe's existing offering. There appears to be core expertise in airflow management (ie ventilation and sealing products) and this may bring useful perspectives to Polypipe's existing residential ventilation activities within Domus Ventilation. Last, but by no means least, Polypipe is well known for its rainwater goods and connected drainage offering so the addition of dry fix roofing products and linear drainage enhances the package of adjacent products that the Polypipe group of companies can offer. Manthorpe has a bias towards specialist and merchant distributors serving the residential RMI sector with the remaining c 40% of revenues addressing the newbuild/contractor sector. We understand that there is some customer overlap, but we would expect that Polypipe's strong position with leading housebuilders and Manthorpe's additional distributor contacts should prove to be mutually beneficial in generating additional revenues over time.

**Financials/terms:** in the year to April 2018, Manthorpe generated revenue and underlying EBITDA of £16.4m and £6.3m (representing progress from £14.6m and £5.7m two years earlier). Its efficient, single-site operation has supported an EBITDA margin above 38% during this time (ahead of Polypipe's 21.4% in FY17) and operating cash flow conversion is understood to have been c 90% or better. A cash free/debt free consideration of £52m – including freehold land of £8m – funded from existing cash and debt facilities, was paid on completion and was equivalent to 8.3x pre-acquisition EBITDA. This deal structure (ie the absence of an earnout element) was vendor driven and allows Polypipe greater flexibility in aligning and integrating production. Manthorpe's senior operational management is staying with the acquired business.

No potential cost or revenue synergies were given but – subject to existing contractual commitments – we would expect improved purchasing of common polymer types given that



Polypipe is a significantly larger buyer. Thereafter, shared customer lists and manufacturing efficiencies could be additional sources of earnings enhancement.

After the two-month contribution to FY18 results, our modelling for FY19 onwards assumes c 3% annual revenue growth rates, which is more conservative than the 6% average in the previous two years, and profitability in line with historic patterns.

# Permavoid: Purchase of proprietary IP

On 3 September, Polypipe acquired Permavoid, a Netherlands-based specialist surface water management product designer and service provider, for an initial £4m cash consideration.

IP owner of geocellular product designs: Permavoid has developed and owns the design and some tooling IP for subsurface geocellular structures and ancillary products used in sustainable drainage systems to facilitate surface water infiltration and attenuation. Typical applications include hard and soft landscaped areas especially in urban environments and others include blue-green roofing and sports arenas. The structures are high strength, interlocking modular cells in relatively shallow (either 85mm or 150mm) depths used as a sub-base replacement to enhance above ground drainage. They are made from largely recycled polypropylene although Permavoid itself does not manufacture; revenue is primarily generated from licence income (derived from design and tooling) and related services (including materials support). Polypipe has been the sole licensee in the UK/Ireland since 2013 and we believe there is a licensee in the US also.

Complementary water management system: Polypipe supplies the Permavoid products to its customers as part of its civils and infrastructure water management portfolio. Among other things the portfolio includes large-diameter pipes and its proprietary Polystorm geocellular modular system. Polystorm is complementary and performs similar functions to Permavoid with a higher compressive strength specification used in deeper and also higher traffic applications. Acquiring the business and IP of Permavoid provides Polypipe control over its future product and commercial development, consolidated associated costs (versus a variable direct licence cost previously) and brought in licence revenue income from other geographies.

Consideration: at the point of acquisition, Permavoid expected to achieve revenue of £3.8m and adjusted EBITDA of £0.5m in the year to September 2018. Hence the initial £4m consideration represented just over 1x and 8x expected sales and EBITDA respectively. We believe the provision of other services and materials will have diluted the underlying EBITDA margin arising from licence income only. The year may also have included additional development costs although we are unable to verify this.

The other notable aspect of this transaction is a potential deferred consolidation element of up to £12.5m depending upon EBITDA performance to 30 September 2020. No further details were given on target thresholds required to achieve this level of pay out. Our working assumption is that any future deferred payment is derived by applying the initial entry multiple to any achieved uplift in EBITDA.

	Residential Systems	Commercial & Infrastructure Systems			
Primary product groups	Plumbing & heating Stormwate Underfloor heating Stormwate Ventilation products & systems Sewer d	Ind drainage Surface water drainage er drainage Land drainage rattenuation Pressure systems rain vent Commercial heat recovery systems			
FY18*	Revenue - net £m         260         Margin           EBITDA £m         60.0         23.1%           EBIT £m         50.5         19.4%	192 Margin 34.9 18.2% 28.0 14.6%			
Description	Manufacture of product groups for residential housing applications  > Plastic pipe systems, fittings and ancilliary items (eg connectors, couplings,inspection chambers)  > Ventilation systems including mechanical extraction & ducting products  > Other products -dry roofing systems, cavity management, access hatches	Design & manufacture of internal & external thermoplastic drainage and water management systems, pressurised building systems and ventilation solutions. Civil/infrastructure focuses on drainage & water management (especially roads/highways)			
Routes to mkt	Newbuild - direct to site or pulled through national, regional or independent merchants  RMI - general merchants, plumbing & roofing stockists & also electrical stockists (ventilation)  DIY - pre-packed components & kits	Commercial (developers, contractors and owners of private & public sector, high-rise, multi- occupancy & other tertiary buildings) - bias towards newbuild & direct to site or delivered via merchant network.  Civil/infrastructure - newbuild for public agencies via spcialist engineers, contractors and merchants.			
Operations:	Polypipe Building Products  Doncaster (BL) - rainwater & drainage systems  Doncaster (NR) - fittings, plumbing & heating  Doncaster (KS) - pre-packaged components  Birmingham - Surestop, water mains switches  Glasgow - northern distribution centre  Polypipe Ventilation	Polypipe Civils  Loughborough - Ridgistorm (larger diameter) Horncastle - Polystorm (cells)  Polypipe Terrain Aylesford - above ground drainage (+export hub)  Polypipe Ventilation Caerphilly - commercial & industrial systems			
	Doncaster (KS) - residential fans & ducting  Polypipe Ulster  Lurgan x3 - rainwater and drainage systems  Manthorpe Building Products  Ripley - ventilation, cavity, roofing & access products	Polypipe Middle East  Dubai distribution facility, Doha sales  Polypipe Italy  Genoa, Italy - Effast pressure system fittings			
Competitors:	Wavin (Mexichem) Floplast Epwin Group Aliaxis McAlpine Plumbing John Guest (now part of RWC) Kalsi Plastics	Wavin (Mexichem)  JFC  Aquaspira  Civils: Ryb (now Elydan Group), Pipelife (part of Wienerberger)  Twin wall pipe: System Group, Polieco, Hegler			
	Ventilation - Volution, Envirovent, Greenwood, Airvac, Xpelair, Airflow, Vectaire	Ventilation - Volution, Elta Fans, FlaktWoods, Soler & Palau			

Source: Company, Edison Investment Research. Note: \*Pro forma based on Polypipe's reported FY18 results and annualised financials of Manthorpe (Residential) and Permavoid (Commercial & Infrastructure).



# Strategic evolution: Building from a sound platform

Polypipe's strategic mission statement is "to be the leading provider of sustainable and resilient water and climate management solutions for the built environment." A capital markets event in May 2018 showcased the wider Polypipe management team and reinforced the company's above market growth credentials. We now briefly review thematic drivers which have been outlined by the company previously and discuss some of the portfolio and operational drivers which are expected to feature in the next stage of strategic evolution. Fundamentally, we interpret this as a desire to grow faster than the market generally addressed by identifying and exploiting more dynamic subsectors by leveraging its strong existing market positions.

#### Well understood macro framework

At the macro level, primary legislation (eg Flood & Water Management Act 2010, Climate Change Act 2008) provides a fundamental long-term environmental underpin for the management of water and air quality in the UK. In this context, government regulatory planning and review cycles (eg water resource management plans, carbon budgets) maintain focus on making progress towards targets over time. The National Planning Policy Framework provides over-arching guidance and requirements concerning construction activity and its impact on the natural environment and these are applied for the most part in local policy measures and planning regulations. Clearly, in order to operate effectively, private builders and developers need to have a good understanding of the local planning environment and bring forward compliant projects to be successful. Infrastructure projects typically have longer gestation periods with central government funding and run by statutory planning agencies. In the Department for Transport for example, strategic business and delivery plans are in place for Highways England (under the Road Investment Strategy 2015-2020) and Network Rail (shortly to move into Control Period 6 or CP6, 2019-2024). Similarly, Ofwat regulates capital and operational spending programmes using Asset Management Plans (AMP6 2016-2020 is currently underway). Major infrastructure schemes may also require specific legislation, as with Crossrail and HS2. Taken as a whole, these processes provide some forward visibility to supply chain partners but also facilitate change through changing requirements over time. Together with the contractors' drive for more efficient building processes and techniques, this potentially creates faster growing subsegments and opportunities for innovative suppliers to benefit from this.

#### Well positioned with water and climate management portfolio

Population growth, increasing urbanisation, incidences of extreme weather events (both flood and drought) and carbon emissions reduction targets all, in some way, intensify water management challenges. The substitution of plastics for other heavier or more expensive building materials (eg copper, concrete, clay, cast iron) in piping systems and other applications is a well-established trend. This has enabled Polypipe to build a leading UK share position (26% of plastic piping systems) in a market – where plastic now accounts for c 63% of the total – management believes to have grown by 4.5% CAGR since 2010.

Building resilience into water resource management is a key policy objective nowhere more so than in new building considerations. Polypipe's external 'roof to river' portfolio now extends from green and dry roof products through conventional rainwater and above and below ground drainage and also attenuation systems. Within buildings, energy efficiency and air quality ratings are inter-related performance metrics and as well as conventional plumbing/heating pipes and fittings, Polypipe's portfolio includes residential under floor heating systems and ventilation systems for both residential and commercial buildings which play into the climate management theme.



As we have seen, Polypipe already has the twin strengths of a leading market position and a broad product portfolio that addresses some of the major drivers of growth in the sectors it addresses. We now go on to highlight how the company proposes to continue to capture above market growth.

#### Moving up the value chain

Portfolio evolution to date has been characterised by a progression – both organically and via acquisition – from discrete products into more complete systems and, in recent years, tailored engineered solutions. The latter include commercial and multi-occupancy residential ventilation systems and offsite, pre-fabricated drainage pipe stacks.

Increasing product breadth naturally creates the potential to be a system supplier depending on the proportion of the system supplied and the relative importance/value, availability and understanding of the remainder. One of Polypipe's stated strategic aims is to infill portfolio gaps – which may be product or IP-based – and add adjacent product categories to move deeper into the solutions spectrum and provide customers with a simplified supply chain or so-called 'one stop shop'. From Polypipe's perspective, this allows a closer customer/specifier relationship, permitting

- earlier engagement, design input, pre-sale service and value creation
- increase share of project wallet conversion of lead into higher value sale
- pull more volume through manufacturing base

Polypipe's CMD presentation<sup>2</sup> listed a number of candidate areas for portfolio infills in the context of a broader M&A strategy. We would observe that there appeared to be a bias towards commercial/industrial (eg high pressure water distribution, large warehouse rainwater capture) though not exclusively so and expanding the indoor/climate control and quality offering is also a clear feature. The adjacent nature of these product groups is logical and, as with Permavoid and Manthorpe, we will be able to assess any acquisitions – and the extent to which they add more than just another product group – as they are made. A further strategic aspiration is to move into 'smart solutions', effectively a closed loop involving data capture and feeding this back into an intelligent system response presumably relating to the management of flow rates and/or quality. This also brings into play the ownership of IP which can include product design and process knowledge as well as technology and sensor capability where Polypipe has not traditionally participated. IP ownership may also potentially broaden the company's geographic horizons. The disposal of its French operations and exit from direct Middle East manufacturing perhaps sent the opposite message but IP can be more exportable than products which typically contain significant void space. Permavoid, for example, has licensed its geocellular design and tooling to a US manufacturer.

# Maintaining an innovation focus

Strategic development is not solely about M&A, however. With leading market shares already, Polypipe has an extended track record of delivering above market growth from its 'development product' portfolio. In the six years following 2011, these products have added £100m+ to group revenue and, in aggregate, accounted for c 44% of 2017 turnover. Behind and in support of this growth capital investment in equipment (eg co-extrusion, injection-moulding and large diameter pipe manufacture) and processes (eg automation, use of recycled material, offsite fabrication) has enabled Polypipe to differentiate its product offering and target faster-growing subsectors. In other words, ongoing application and development of process and materials knowledge enables the company to achieve faster growth and sustain or improve margins with differentiated products and increasingly systems to further enhance competitive position. The acquisition or in-licensing of external IP is a complementary approach to achieve the same end.

<sup>&</sup>lt;sup>2</sup> https://investors.polypipe.com/media/2016/capital-markets-day.pdf, p26



### **Sensitivities**

Polypipe is **substantially a UK business**, save for a small, Italy-based pressure fittings business (Eiffast), Permavoid (UK/Netherlands-based but international) and some export exposure, primarily to the Middle East. In Polypipe's product offering, we believe that the UK market is largely supplied by UK manufactured products and, taking these points together, consider that exchange rate moves have a limited direct transactional and translational effect on trading and financial performance.

**Pricing influenced by exchange rates.** The western European market for virgin polymer materials is priced in US dollars and based on the pricing of underlying feedstocks. While Polypipe purchases its input materials in sterling, pricing is clearly influenced by relative sterling strength/weakness and this applies to all other UK-based manufacturers also. UK-sourced recycled material (eg used in infrastructure and certain co-extruded products) accounted for 40% of FY18 polymer usage meaning that the above exchange rate point is less relevant although not completely so. We believe that raw material costs represent c 40% of revenue being largely polymer costs but also some other largely steel-based materials. Polypipe can reflect prevailing input costs more quickly through project tenders as they occur but, including third-party stockist/distribution channels, there is a c three-month timing lag in fully passing through underlying materials cost changes (in both directions).

End market balance brings business resilience. As shown in Exhibit 5, Polypipe sells into RMI and newbuild subsectors to both residential and non-residential end markets. In addition, non-residential includes private and public sector (including infrastructure) commercial projects. These subsectors have different underlying demand drivers and are serviced through multiple distribution channels. As a generality, a growing population and economy are favourable backdrops for all subsectors but the way this percolates through to budgets, priorities and spending patterns clearly depends on a number of other factors also depending on the relevant sector. Consequently, product breadth and sector diversity brings resilience; one could argue that the better-performing sectors are diluted, but we see the ability to shift the focus of resources as appropriate as a key strength of Polypipe's business model.

Integrated operations: scale, breadth and service levels are key customer attractions and Polypipe co-ordinates its UK manufacturing and in-house distribution activities. Balancing these functions improves operational efficiency at a given level of volume but is also required to be responsive to changes in volume. With a multi-site manufacturing footprint there is some flexibility to move production and, at factory level, change product tooling (in largely automated production processes) if required but some operational gearing to overall activity levels is unavoidable. Maintaining in-house transport fleet and logistics capability enables Polypipe to run a relatively low inventory, short supply chain, high service level business model in a comparatively short order visibility industry. The potential balance sheet impact of IFRS16 Leases remains to be seen, but we expect to see vehicles and associated funding to be more prominent once the accounting standard becomes applicable from 1 January 2019.

Investment underpins market outperformance objective. Polypipe's strategic aim is to outgrow the overall UK construction market by 2-4% pa from a position of already having significant market shares in most of its sectors. In our view, this is primarily achieved by allocating new product development resource and capital investment into faster-growing segments and/or where shares are smaller using existing manufacturing and distribution strengths. As we have seen, Polypipe management has flagged strategic interest in adding other complementary products where they can be incorporated into integrated customer solutions, capturing a greater share of project value. Hence, we see new product development and M&A activity as important influences on overall growth rates in the context of underlying markets. So, capex and acquisition spending levels are visible markers for investors regarding potential future market outperformance.



### **Valuation**

Polypipe operates in established construction markets largely in the UK as a manufacturer and distributor of its products and systems to B2B customers across and within a number of different subsectors. Individual subsectors have different drivers and are underpinned by some long-term trends including the undersupply of housing, an ageing housing stock and infrastructure spending from population growth and increasing urbanisation. While acknowledging that we are not currently in a high growth economic environment, in our view Polypipe's modest P/E premium compared to UK listed peers does not reflect its leading market share positions and strategic positioning to develop further in our view.

# Performing ahead of relatively flat underlying markets

The company has had a stable business model for an extended period and, in 2014 IPO documents and subsequently, it has demonstrated good profit growth and robust free cash flow generation together with a progressive dividend payout as a listed entity.

Current construction industry forecasts are for relatively flat activity levels this year overall and some improvement on this in 2020. Over time, Polypipe management expects to outperform the company's underlying markets by c 2-4% pa which implies low single-digit top line progress in the near term. In this context, a three-year EPS CAGR including acquisition effects of c 6% represents growth ahead of underlying markets

Looking at earnings-based multiples, the P/E for the current year (to December 2019) is 13.3x and declines under our estimates to 12.2x by FY21. In general, sentiment towards construction-related stocks has been affected by wider contractor newsflow to some extent but also investor views regarding an advanced stage UK cycle particularly in new housebuilding – one of Polypipe's stronger sectors currently – and general economic uncertainty in a post-Brexit economy. Alternatively, with a PEG of 2.6x it could be argued that this metric indicates an expectation that faster growth is achievable above currently anticipated expectations. As discussed elsewhere, Polypipe has financial headroom to be able to enhance growth through investment and M&A activity. The company's current year EV/EBITDA including full year acquisition effects is 9.5x and this becomes 8.5x in FY21. Importantly, Polypipe does not operate a defined benefit pension scheme and so there are no related valuation considerations to take into account.

# Comparable P/E to peer group, rating discount to Marshalls

We have reviewed a peer group of largely UK building materials companies and their indicative average ratings multiples are as follows:

P/E: 2019 11.7x, 2020 10.9x

EV/EBITDA: 2019 8.2x, 2019 7.4x

Dividend yield: 2019 4.5%

Against this peer group, Polypipe is trading on a small 2019e P/E premium, a comparable EV/EBITDA rating and a c 30% dividend yield discount. Within this peer group, we note that Marshalls – which we consider to have a similar exposure to residential and commercial/infrastructure segments to Polypipe – continues to trade on a significant sector premium with a consensus 2019e P/E and EV/EBITDA of 21.7x and 14.3x respectively.



### **Financials**

Residential has clearly been the stronger sector over the last year and our ongoing business mix reflects this, with both divisions to benefit from the annualised effects of 2018 acquisitions in 2019. As noted earlier, we have made no material changes to estimates following the FY18 results announcement, with acquisitions balancing out our softer underlying expectations, especially in Commercial & Industrial. Over our forecast horizon, we expect an earnings growth CAGR of 5.3% and a similar DPS CAGR. In the absence of any further acquisitions, our model currently shows net debt trending down to c £95m by the end of FY21 (or 0.9x EBITDA generated in that year). Note that we have not made any explicit IFRS16 adjustments to our estimates at this stage; once included, the impact on PBT is likely to be negligible but will inflate P&L depreciation and interest charges, while also bringing lease assets and future lease payments onto the balance sheet.

#### Growth in relatively flat overall UK construction market

Construction Products Association projections indicate flat to slightly lower overall sector activity in 2019 and growth between 1.0-2.0% in 2020. Growth in both years is expected from new housebuilding (decelerating), RMI and road infrastructure (accelerating) spending while commercial building is seen as being sharply lower y-o-y in 2019 but only marginally so in 2020.

Residential Systems is the largest group profit generator and Polypipe has grown its EBIT every year since 2011 (pre-IPO). Our estimates – prior to including Manthorpe – are for c 3.5% annual revenue growth and EBIT margins around 19%. In Commercial & Infrastructure Systems assuming normal weather conditions and momentum in road programmes continues, we project c 2.5% average annual growth and EBIT margins in the 14%-15% range. Permavoid is relatively modest in revenue terms and we have modelled at comparable EBIT margins for now. By the end of FY21, Residential is set to account for just over half of group revenue and c 60% of group EBIT in our model. As referred to earlier, our:

- three-year EPS CAGR (2018-2020) is 5.3%
- three-year DPS CAGR (2018-2020) is 6.5% (covered between 2.3x by earnings in each year)

#### Good underlying cash flows to fund investment and dividends

Notwithstanding seasonal fluctuations, Polypipe has not historically required significant working capital investment to grow sales (though there was higher than normal inventory build in FY17), but has consistently invested in capex ahead of depreciation to support growth in its development products. Acquisition consideration (for Manthorpe and Permavoid) pushed end FY18 net debt to £164m (c 1.7x EBITDA on an annualised earnings basis) with an associated increase in interest costs (covered over 10x by operating profit). We anticipate free cash flow (FCF) increasing from c £50m in FY18 to £57m by FY21. Prior to acquisitions this covers our expected cash dividend growth broadly two times and a material net debt reduction by the end of FY21. With pre-tax ROCE of c 14-15% ongoing reinvestment in the business is desirable subject to generating appropriate incremental returns and the same applies to M&A activity, subject to the right opportunities arising.

#### Renewed banking facilities

Polypipe recently renewed its committed RCF facility (£300m to 2023, with options to extend) and added an uncommitted £50m accordion facility. In the context of end FY18 net debt and our expected cash flow profile, this provides good headroom for further M&A activity. The company has a material tangible fixed asset manufacturing base, relatively limited net working capital in support of annualised revenues around £450m and significant intangible assets (including pre-IPO goodwill and subsequent acquisition effects). Note that Polypipe does not operate a defined benefit pension scheme and consequently has no liability exposure in this regard.



	£'ms	2014	2015	2016	2016*	2017*	2018	2019e	2020e	2021
December	2	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFR
PROFIT & LOSS										
Revenue		327.0	352.9	436.9	387.2	411.7	433.2	467.0	479.2	494
Cost of Sales		(202.4)	(210.0)	(256.8)	(219.1)	(236.0)	(251.9)	(270.3)	(277.4)	(286.
Gross Profit		124.6	142.9	180.1	168.1	175.7	181.4	196.6	201.8	208
EBITDA		60.8	69.3	86.4	84.5	88.3	90.6	99.2	102.0	105
Operating Profit (underlying)		46.3	54.2	70.4	69.5	73.4	75.0	82.6	85.2	88
SBP		0.0	0.0	(1.0)	(1.0)	(0.8)	(1.0)	(1.0)	(1.0)	(1.
Operating Profit (reported)		46.3	54.2	69.4	68.5	72.6	74.0	81.6	84.2	87
Net Interest		(7.7)	(5.3)	(6.6)	(6.6)	(5.8)	(5.8)	(7.5)	(7.1)	(6
Other finance		(1.0)	(0.9)	(1.0)	(1.0)	(1.1)	(1.1)	(0.3)	(0.3)	(0
ntangible Amortisation		0.0	(3.0)	(6.8)	(6.8)	(5.5)	(5.9)	(7.5)	(7.5)	(7
Exceptionals		(20.7)	(3.5)	(0.6)	(0.6)	(4.6)	(2.7)	(0.5)	(2.8)	(,
Profit Before Tax (norm)		37.6	48.0	61.8	60.9	65.7	67.1	73.7	76.7	80
Profit Before Tax (FRS 3)		16.9	41.5	54.4	53.5	55.6	58.5	65.7	66.4	72
Tax		(5.4)	(9.2)	(11.8)	(10.1)	(11.8)	(10.5)	(13.3)	(13.8)	(14.
Profit After Tax (norm)		32.2	38.8	50.0	49.2	53.9	56.5	60.4	62.9	65
Profit After Tax (FRS 3)		11.5	32.3	42.6	43.4	43.8	49.1	53.8	53.9	59
,										
Average Number of Shares  Outstanding (m)		199.9	199.3	198.9	198.9	198.4	199.0	199.0	199.0	199
EPS - normalised (p)		16.1	19.4	25.0	24.6	26.9	28.1	30.1	31.3	32
EPS - FRS 3 (p)		5.8	16.2	21.4	22.2	22.1	24.7	27.0	27.1	30
Dividend per share (p)		4.5	7.8	10.1	10.1	11.1	11.6	13.3	13.7	14
Gross Margin (%)		38.1	40.5	41.2	43.4	42.7	41.9	42.1	42.1	42
EBITDA Margin (%)		18.6	19.6	19.8	21.8	21.4	20.9	21.2	21.3	2
Operating Margin (underlying) (%)		14.2	15.4	16.1	17.9	17.8	17.3	17.7	17.8	17
BALANCE SHEET										
Fixed Assets		324.2	476.5	472.6		455.1	520.3	521.8	525.4	525
Intangible Assets		235.0	378.4	371.6		356.5	401.9	394.9	390.2	382
Tangible Assets		89.2	98.1	101.0		98.6	118.4	126.9	135.2	143
Investments		0.0	0.0	0.0		0.0	0.0	0.0	0.0	(
Current Assets		103.9	99.6	119.5		147.7	141.7	169.3	196.1	228
Stocks		39.9	47.5	52.2		53.5	58.1	62.4	64.0	66
Debtors		20.2	29.3	38.9		32.6	35.0	37.6	38.5	39
Cash		43.1	21.6	26.5		35.7	46.2	66.4	89.1	117
Current Liabilities		(69.8)	(87.2)	(104.5)		(108.8)	(108.7)	(109.3)	(112.9)	(114
Creditors		(69.8)	(87.2)	(104.5)		(108.8)	(108.7)	(109.3)	(112.9)	(114
Short term borrowings		0.0	0.0	0.0		0.0	0.0	0.0	0.0	
ong Term Liabilities		(120.6)	(227.9)	(200.2)		(192.0)	(222.1)	(223.5)	(224.8)	(226
ong term borrowings		(118.0)	(215.9)	(190.8)		(184.1)	(210.4)	(210.4)	(210.4)	(210
Other long term liabilities		(2.6)	(12.0)	(9.4)		(7.9)	(11.7)	(13.1)	(14.4)	(15
Net Assets		237.7	261.0	287.4		302.0	331.2	358.3	383.8	414
CASH FLOW										
Operating Cash Flow		50.6	72.6	86.5		79.2	90.0	92.0	99.4	102
Net Interest		(10.4)	(5.7)	(7.3)		(6.6)	(6.1)	(7.5)	(7.1)	(6
Гах		(3.7)	(5.2)	(10.1)		(12.6)	(11.2)	(11.9)	(13.3)	(13
Capex		(14.9)	(18.9)	(18.7)		(22.0)	(23.2)	(25.1)	(25.1)	(25
Acquisitions/disposals		(0.3)	(149.5)	0.0		0.0	(42.5)	(0.5)	(2.8)	(
toquiotto, to, alopoodio		(1.7)	0.0	(2.9)		(0.7)	0.3	(1.5)	(1.5)	(1
Financing		(3.0)	(10.6)	(17.1)		(21.0)	(22.3)	(25.2)	(26.9)	(27
Financing Dividends		(0.0)				_ , _ ,	(15.1)	20.2	22.7	2
Financing Dividends		16.6	(117.3)	30.5		16.3	(15.1)	20.2	22.1	
Financing Dividends Net Cash Flow		16.6								
Financing Dividends Net Cash Flow Opening net debt/(cash)		16.6 84.7	74.9	194.3		164.3	148.4	164.2	144.0	12
Financing Dividends Net Cash Flow		16.6								12



Chairman: Ron Marsh

# Contact details Broomhouse Lane Edlington Doncaster. DN12 1ES UK +44 (0) 1709 770 000 www.polypipe.com FY18 Revenue by geography 89% 5% 6% EWK Rest of Europe Rest of world

# Management team CEO: Martin Payne CEO since October 2017, having joined as group CFO in May 2016. Previously Appointed CFO in March 2018. Previously group financial controller at Carphone

group finance October 2017, having joined as group CFO in May 2016. Previously group finance director at Norcros and held senior financial positions at JCB and IMI. Fellow of the Chartered Institute of Management Accountants.

COO: Glenn Sabin

of Chartered Accounts in England & Wales.

Appointed chairman in May 2015, having been the SID from March 2014. Currently NED at R Faerch Plast A/S, SID at Walstead Group and chairman of the UK Packaging Federation and Alliance for European Polymers. Previously NED at BPI and CEO of RPC.

Appointed to the newly created COO role in October 2017, having joined the group as MD UK Civils (2004) before becoming MD Building Products (2013) including responsibility for Civils and Terrain. Extensive construction industry experience including George Wimpey, Redland and Marshalls.

Dixons and Inchcape, where he was also treasury director. Fellow of the Institute

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