FORSYTH BARR

Freightways

UNDERPERFORM

FY19 Preview — Lower Gear Year

Freightways (FRE) will report its FY19 result on Monday 26 August; we expect the company to report subdued underlying profit given slower parcel volume growth and margin pressure. With cyclical pressures building we believe risk to FY20 earnings is to the downside, despite the benefits of FRE's 'pricing for effort' initiative.

Key issues to consider at FRE's FY19 result

- **B2B volumes:** FRE downgraded market earnings expectations in May 2019 with particular reference to business-to-business (B2B) parcel volume headwinds. FRE is an economic bellwether; an economic slowdown appears increasingly likely.
- **Express Package margins:** We expect margin contraction to remain a theme for Express Package in the FY19 result, reflecting (1) cost pressures, and (2) the adverse margin mix of higher growth of lower margin B2C.
- **Pricing for effort:** FRE's pricing for effort initiative has only just kicked off (with progressive B2C price increases from 1 July 2019); early management feedback will provide an indication of customer response to material price increases. This provides the key profit growth opportunity in FY20.
- **Information Management margins:** Information Management margins declined in both 1Q19 and 2Q19 year on year. Further investment in Shred-X's capabilities provides growth opportunities but will constrain any recovery in margins in 2H19. Lower waste paper prices add to the margin challenge.
- **M&A:** Management has suggested that it would like to be more aggressive in its acquisitive strategy, suggesting it has an appetite for larger deals. FRE acquired three small businesses in 1H19 and has a strong track record in business-building M&A.

Figure 1. Summary of earnings forecasts (NZ$m)

	FY18	FY19E	Change	Consensus
Sales revenue	580.9	618.1	6%	618.4
EBITDA	107.7	111.6	4%	112.0
EBITA	93.7	95.5	2%	n/a
Reported NPAT	62.2	61.0	-2%	n/a
Adjusted NPAT	**61.6**	**61.9**	**1%**	**61.9**
Underlying EPS (cents)	39.8	40.0	1%	40.0
Final DPS (cents)	15.25	15.25	0%	15.7

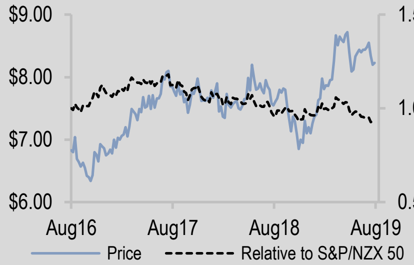
Source: Eikon, Forsyth Barr analysis

Investment View

FRE is a well-managed company with a leading position in the domestic courier market. It also has a material presence in the domestic and Australian information management markets. Historically, it has been able to achieve above average earnings growth through a combination of organic and acquisitive means; however, its exposure to a number of sunset industries will drag on long-term growth, in our opinion. We have an UNDERPERFORM rating on FRE.

NZX Code	FRE
Share price	NZ$8.23
Target price	NZ$8.00
Risk rating	Medium
Issued shares	154.8m
Market cap	NZ$1,274m
Average daily turnover	170.2k (NZ$1,296k)

Share Price Performance



Financials: June	18A	19E	20E	21E
NPAT* (NZ$m)	61.6	61.9	67.9	74.6
EPS* (NZc)	39.8	40.0	43.9	48.2
EPS growth* (%)	5.5	0.6	9.7	9.9
DPS (NZc)	29.8	30.3	32.9	36.1
Imputation (%)	100	100	100	100

Valuation (x)	18A	19E	20E	21E
EV/EBITDA	13.3	12.8	11.9	11.0
EV/EBIT	14.9	14.7	13.8	12.7
PE	20.7	20.6	18.8	17.1
Price / NTA	n/a	n/a	n/a	n/a
Cash dividend yield (%)	3.6	3.7	4.0	4.4
Gross dividend yield (%)	5.0	5.1	5.6	6.1

*Historic and forecast numbers based on underlying profits

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Freightways Ltd (FRE) Priced as at 19 Aug 2019: NZ$8.23 June year end

Forsyth Barr valuation			
Valuation methodology			DCF and sum-of-the-parts
12-month target price (NZ$)*	**8.00**	**Spot valuations (NZ$)**	
Expected share price return	-2.8%	1. DCF	7.28
Net dividend yield	4.1%	2. Sum-of-the-parts	7.98
Estimated 12-month return	1.3%	3. n/a	n/a
Key WACC assumptions		**DCF valuation summary (NZ$m)**	
Risk free rate	2.75%	Total firm value	1,330
Equity beta	0.97	(Net debt)/cash	(203)
WACC	8.2%	Value of equity	1,127
Terminal growth	1.5%	Shares (m)	155

Profit and Loss Account (NZ$m)	**2017A**	**2018A**	**2019E**	**2020E**	**2021E**
Sales revenue	545	581	618	659	694
Normalised EBITDA	**101**	**108**	**112**	**120**	**129**
Depreciation and amortisation	(12)	(14)	(16)	(17)	(17)
Normalised EBIT	**89**	**96**	**97**	**104**	**112**
Net interest	(10)	(10)	(10)	(9)	(9)
Associate income	-	-	-	-	-
Tax	(20)	(23)	(24)	(26)	(29)
Minority interests	-	-	-	-	-
Normalised NPAT	**58**	**62**	**62**	**68**	**75**
Abnormals/other	3	1	(1)	(2)	(2)
Reported NPAT	**61**	**62**	**61**	**66**	**72**
Normalised EPS (cps)	37.7	39.8	40.0	43.9	48.2
DPS (cps)	27.8	29.8	30.3	32.9	36.1

Growth Rates	**2017A**	**2018A**	**2019E**	**2020E**	**2021E**
Revenue (%)	7.9	6.5	6.4	6.7	5.3
EBITDA (%)	2.6	6.7	3.6	7.6	7.7
EBIT (%)	1.9	7.8	0.6	6.9	8.5
Normalised NPAT (%)	4.0	5.7	0.6	9.7	9.9
Normalised EPS (%)	4.0	5.5	0.6	9.7	9.9
DPS (%)	1.8	7.2	1.7	8.8	9.9

Cash Flow (NZ$m)	**2017A**	**2018A**	**2019E**	**2020E**	**2021E**
EBITDA	**101**	**108**	**112**	**120**	**129**
Working capital change	-	0	-	0	-
Interest & tax paid	(30)	(32)	(34)	(36)	(38)
Other	(5)	0	(1)	(2)	(2)
Operating cash flow	**65**	**76**	**77**	**82**	**89**
Capital expenditure	(25)	(18)	(21)	(23)	(24)
(Acquisitions)/divestments	(3)	(6)	(8)	-	-
Other	(1)	(0)	-	-	-
Funding available/(required)	**36**	**51**	**48**	**59**	**65**
Dividends paid	(43)	(45)	(47)	(51)	(56)
Equity raised/(returned)	1	1	-	-	-
Increase/(decrease) in net debt	**6**	**(6)**	**(1)**	**(8)**	**(9)**

Balance Sheet (NZ$m)	**2017A**	**2018A**	**2019E**	**2020E**	**2021E**
Working capital	17	20	18	19	19
Fixed assets	102	103	108	111	114
Intangibles	344	358	366	370	374
Other assets	4	5	5	5	5
Total funds employed	**466**	**486**	**497**	**504**	**513**
Net debt/(cash)	158	154	153	145	136
Other non current liabilities	71	74	74	74	74
Shareholder's funds	237	258	270	286	303
Minority interests	-	-	-	-	-
Total funding sources	**466**	**486**	**497**	**504**	**513**

Valuation Ratios	**2017A**	**2018A**	**2019E**	**2020E**	**2021E**
EV/EBITDA (x)	14.1	13.3	12.8	11.9	11.0
EV/EBIT (x)	16.0	14.9	14.7	13.8	12.7
PE (x)	21.8	20.7	20.6	18.8	17.1
Price/NTA (x)	n/a	n/a	n/a	n/a	n/a
Free cash flow yield (%)	3.1	4.5	4.4	4.6	5.1
Net dividend yield (%)	3.4	3.6	3.7	4.0	4.4
Gross dividend yield (%)	4.7	5.0	5.1	5.6	6.1
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	74	75	76	75	75

Capital Structure	**2017A**	**2018A**	**2019E**	**2020E**	**2021E**
Interest cover EBIT (x)	9.3	10.0	10.2	11.2	12.9
Interest cover EBITDA (x)	10.6	11.1	11.7	13.0	14.8
Net debt/ND+E (%)	40.0	37.4	36.2	33.7	31.0
Net debt/EBITDA (x)	1.6	1.4	1.4	1.2	1.1

Key Ratios	**2017A**	**2018A**	**2019E**	**2020E**	**2021E**
Return on assets (%)	16.5	17.2	16.7	17.4	18.5
Return on equity (%)	24.6	23.8	22.9	23.8	24.6
Return on funds employed (%)	13.9	14.5	0.0	0.0	0.0
EBITDA margin (%)	18.5	18.5	18.0	18.2	18.6
EBIT margin (%)	16.4	16.6	15.7	15.7	16.2
Capex to sales (%)	4.6	3.2	3.4	3.5	3.5
Capex to depreciation (%)	216	131	131	140	143

Operating Performance	**2017A**	**2018A**	**2019E**	**2020E**	**2021E**
Revenue (NZ$m)					
Express Package & Business Mail	401	427	453	480	504
Information Mgmt	144	154	165	179	190
Other/Inter company	-	-	-	-	-
Total Sales	**545**	**581**	**618**	**659**	**694**
Revenue growth (%)					
Express Package & Business Mail	8.8	6.5	6.0	6.0	5.0
Information Mgmt	5.4	6.7	7.5	8.4	6.0
Total	**7.9**	**6.5**	**6.4**	**6.7**	**5.3**
Volumes	n/a	n/a	n/a	n/a	n/a
Pricing	n/a	n/a	n/a	n/a	n/a
Acquisitions	n/a	n/a	n/a	n/a	n/a
Net new business	n/a	n/a	n/a	n/a	n/a
Total	**n/a**	**6.5**	**6.4**	**6.7**	**5.3**
EBITDA (NZ$m)					
Express Package & Business Mail	70	75	79	84	90
Information Mgmt	33	35	36	40	43
H/Office	(2)	(2)	(4)	(4)	(4)
Total EBITDA	**101**	**108**	**112**	**120**	**129**
EBITDA margin (%)					
Express Package & Business Mail	17.5	17.5	17.4	17.4	17.9
Information Mgmt	22.7	23.0	22.0	22.5	22.8
Group EBITDA margin	**18.5**	**18.5**	**18.0**	**18.2**	**18.6**
EBIT (NZ$m)					
Express Package & Business Mail	65	68	71	76	82
Information Mgmt	28	30	30	33	35
H/Office	(4)	(4)	(5)	(5)	(5)
Total EBIT	**89**	**94**	**96**	**104**	**112**
NZDAUD	0.93	0.92	0.93	0.90	0.90

* Forsyth Barr target prices reflect valuation rolled forward at cost of equity less the next 12-months dividend

FY19 preview

Figure 2. Forecast summary (NZ$m)

	FY18	FY19E	Change
Profit and loss account			
Sales revenue	580.9	618.1	6.4%
Express Package & Business Mail	74.8	78.8	5.3%
Information Management	35.4	36.4	2.9%
Corporate & Other	(2.5)	(3.6)	44.7%
EBITDA	**107.7**	**111.6**	**3.6%**
Depreciation and amortisation	(16.0)	(18.3)	14.9%
Acquisition amortisation	(2.0)	(2.3)	17.7%
One-time items	2.6	1.4	-46.2
Interest expense	(9.7)	(9.5)	-1.4%
Profit before tax	84.7	85.1	0.5%
Taxation	(22.5)	(24.1)	7.0%
Reported NPAT	**62.2**	**61.0**	**-1.9%**
Abnormals (post tax)	(0.6)	0.9	n/a
Underlying NPATA	**61.6**	**61.9**	**0.6%**
Underlying EPS (cents)	39.8	40.0	0.6%
Final DPS (cents)	15.25	15.25	0.0%
Cashflow and net debt			
Operating cashflow	75.7	77.0	2%
Maintenance capex = depreciation	(16.0)	(16.0)	1%
Disposals	1.2	0.0	-100%
Free cash flow	**60.9**	**61.0**	**0%**
Acquisitions	(7.4)	(8.0)	8%
Net debt	145.1	136.0	-6%
Margin analysis			
Express Package & Business Mail	17.5%	17.4%	-12 bps
Information Management	23.0%	22.0%	-100 bps
Group EBITDA margin	18.5%	18.0%	-50 bps
Group EBITA margin	16.1%	15.5%	-68 bps
Divisional sales growth			
Express Package & Business Mail	6.5%	6.0%	-49 bps
Information Management	6.7%	7.5%	86 bps

Source: Forsyth Barr analysis

Investment summary

Freightways (FRE) offers investors exposure to courier and records management businesses that enjoy high cashflow generation, scale benefits, barriers to entry and leading market positions. With parcel volume growth slowing and a number of factors adding to margin pressure, the company's near term earnings outlook looks less secure, despite the likely benefits of an enhanced industry pricing backdrop and FRE's 'pricing for effort initiative'. UNDERPERFORM.

Business quality

- **Management track record:** Impressive longer term organic growth coupled with value accretive business-building in its Information Management division through M&A.
- **Competitive advantage:** FRE's dominant share of the NZ courier market's profit pool and its high ROIC generation are a function of its market leadership in the B2B (business to business) channel.

Earnings and cash flow outlook

- **Correlation to economic growth:** FRE's Express Package volume growth is correlated to New Zealand's GDP growth. Organic growth of existing customers is typically a more important driver than customer wins.
- **E-commerce:** E-commerce is providing additional volumes for the courier industry with rising B2C (business to consumer) activity. FRE's business is, however, more exposed to higher margin B2B.
- **Strong cashflow generation:** FRE offers investors exposure to courier and record management businesses which offer strong cashflow generation.

Financial structure

- **Conservative gearing:** FRE has a conservative balance sheet which provides scope for internally funded M&A.

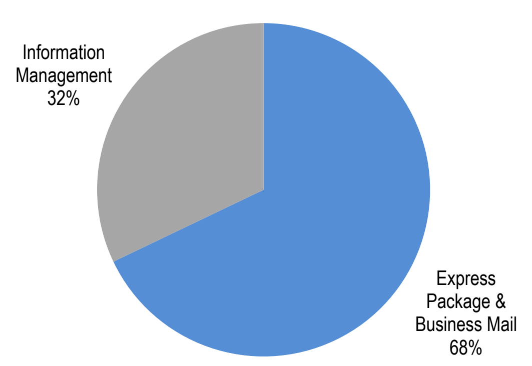
Risk factors

- **Competitive pricing:** Key competitor Courier Post has posted lower price increases than FRE's express package operations in recent years, albeit the industry pricing environment now appears more rational.
- **Wage inflation:** The NZ courier industry largely uses a contractor model for its last mile deliveries. These owner drivers are outside minimum wage legislation, though competition for labour will create cost inflation.
- **Paperless offices:** FRE is exposed to the structural threat of less paper usage in its records management and document destruction businesses.

Company description

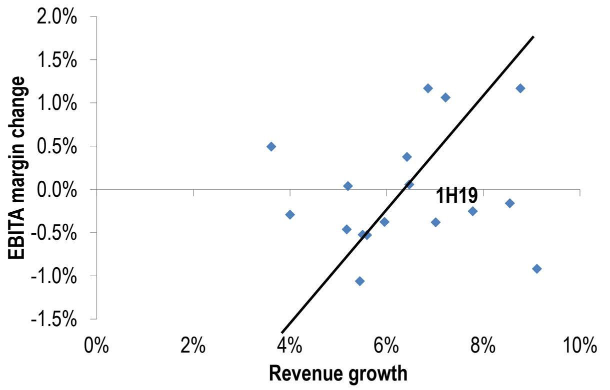
FRE was formed in 1964 and operates in the New Zealand courier market and Australasian records management industry. The company operates a multi-brand strategy, but has recently consolidated its Information Management brands (except Shred-X) into TIMG. Each brand services a different segment/geography of its targeted markets. Brands include NZ Couriers, Post Haste, Castle Parcels, Sub 60, NOW Couriers, DX Mail, TIMG and Shred-X. FRE's major courier competitor is NZ Post's Courier Post business, but it also competes against smaller players including PBT Couriers and Fastway Couriers.

Figure 3. EBITDA divisional split (FY18)



Source: Forsyth Barr analysis

Figure 4. Express Package operating leverage (HYs: FY10 to 1H19)



Source: Forsyth Barr analysis

Figure 5. Substantial Shareholders

Shareholder	Latest Holding
Fisher Funds Management	8.0%
ANZ NZ Investments	6.5%
Mawer Investment Mgmt	5.0%

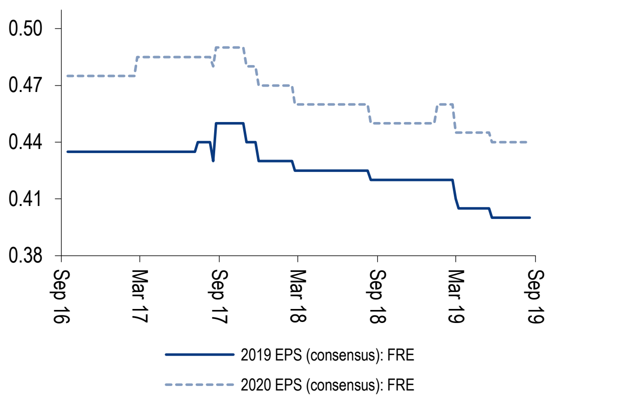
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 6. International Compcos

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash D/Yld
(metrics re-weighted to reflect FRE's balance date - June)			(m)	2019E	2020E	2019E	2020E	2019E	2020E	2020E
Freightways	**FRE NZ**	**NZ$8.23**	**NZ$1,274**	**20.6x**	**18.8x**	**12.8x**	**11.9x**	**14.7x**	**13.8x**	**4.0%**
Mainfreight *	MFT NZ	NZ$39.92	NZ$4,020	27.5x	24.0x	15.7x	13.9x	19.6x	17.2x	1.7%
FedEx Corp	FDX US	US$156.00	US$40,695	>50x	10.5x	7.1x	6.6x	12.4x	11.2x	1.7%
United Parcel Service Inc	UPS US	US$115.30	US$99,009	18.1x	14.8x	12.2x	10.9x	15.7x	13.8x	3.4%
Deutsche Post AG	DPW GR	€28.61	€35,370	15.2x	12.6x	7.2x	6.3x	14.0x	11.4x	4.4%
Aramex PJSC	ARMX UH	AED4.13	AED6,047	11.5x	10.2x	8.1x	7.2x	10.1x	9.6x	4.9%
Iron Mountain Inc	IRM US	US$31.49	US$9,041	22.1x	19.6x	13.5x	12.9x	25.1x	23.6x	7.9%
			Compco Average:	**18.9x**	**15.3x**	**10.6x**	**9.6x**	**16.2x**	**14.5x**	**4.0%**
EV = Current Market Cap + Actual Net Debt			**FRE Relative:**	**+9%**	**+23%**	**+21%**	**+23%**	**-9%**	**-5%**	**-0%**

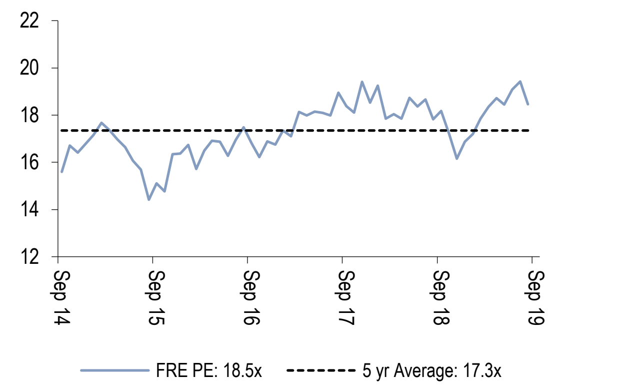
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (FRE) companies fiscal year end

Figure 7. Consensus EPS Momentum



Source: Forsyth Barr analysis, Bloomberg

Figure 8. 12 Month Forward PE



Source: Forsyth Barr analysis