

# Freightways

NEUTRAL

## FY19 — Margin Delivery Due; Upgrade to NEUTRAL

Freightways' (FRE) FY19 result was held back by slowing organic volume momentum, which is carrying on into FY20, but will be more than offset by pricing gains. After management provided early warning of a slowdown in its May 2019 trading update, there were few surprises in this result. Notwithstanding the emerging risks of a more sustained cyclical downturn, we believe underlying earnings growth will strengthen materially in FY20 given its 'pricing for effort' initiative. Having fallen to ~18x one year forward PE, we believe FRE's valuation now fairly reflects the balance between the near-term margin opportunity and a slower volume environment. We, therefore, upgrade our rating from UNDERPERFORM to NEUTRAL.

### What's changed?

- **Earnings:** Minor reductions over next several years
- **Target Price:** Lifted to NZ\$8.30 from NZ\$8.00 due to WACC change
- **Rating:** Upgrade to NEUTRAL from UNDERPERFORM

### Margin trough; near term step-up opportunity

Group EBITA margins declined in FY19 to a post-listing low, despite promising signs from Express Package that new initiatives (i.e. residential density, pricing for effort) are delivering. Despite the profit leverage risk of slowing/negative volume growth, we believe margins will expand from FY20 (principally from pricing for effort in the residential delivery channel) deriving an acceleration in earnings growth.

### Volume outlook has softened

Express Packages volume growth has deteriorated in recent months with year on year volumes declining in May and June. Parcel growth in most industry segments has decelerated, providing an early indicator that general economic headwinds are increasing.

### Information Management not fulfilling its potential

Improved disclosure provides greater visibility on Information Management's (IM) activities, highlighting the growth in destruction but structural challenges in storage. Divisional margins (and therefore return on capital) have come under pressure despite improving storage utilisation in Australia. IM is not fulfilling its potential, and given the longer term structural headwinds in several of its core businesses, the margin outlook will likely continue to be mixed.

### 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 a NEUTRAL rating on FRE.

NZX Code	FRE
Share price	NZ\$7.89
Target price	NZ\$8.30
Risk rating	Medium
Issued shares	154.8m
Market cap	NZ\$1,221m
Average daily turnover	169.8k (NZ\$1,294k)

### Share Price Performance



Financials: June	19A	20E	21E	22E
NPAT* (NZ\$m)	61.0	66.5	73.7	79.9
EPS* (NZc)	39.4	43.0	47.6	51.6
EPS growth* (%)	2.4	9.0	10.9	8.3
DPS (NZc)	30.5	32.2	35.7	38.7
Imputation (%)	100	100	100	100
Valuation (x)	19A	20E	21E	22E
EV/EBITDA	12.2	11.3	10.5	9.9
EV/EBIT	14.2	13.4	12.3	11.5
PE	20.0	18.4	16.6	15.3
Price / NTA	n/a	n/a	n/a	n/a
Cash dividend yield (%)	3.9	4.1	4.5	4.9
Gross dividend yield (%)	5.4	5.7	6.3	6.8

\*Historic and forecast numbers based on underlying profits

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## Result summary: prepping for FY20 lift

Freightways (FRE) reported an FY19 result marginally below market expectations. Underlying NPAT growth of +2% for the year meant a small decline in 2H19. While Express Package & Business Mail grew FY19 EBITA by +6%, Information Management suffered a -2% decline, with further margin deterioration evident. With no additional M&A, net debt is broadly on par with the prior year level and FRE has announced a small lift in the final dividend to 15.5cps (giving a full year pay-out of 30.5cps).

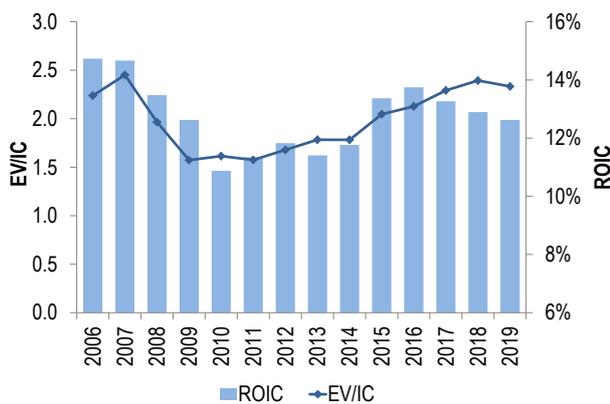
**Figure 1. Result summary (NZ\$m)**

	FY18	FY19	Change	Forsyth Barr
Sales revenue	580.9	615.7	6%	618.1
EBITDA	107.7	112.2	4%	111.6
EBITA	93.7	96.8	3%	95.5
Reported NPAT	62.2	63.4	2%	61.0
<b>Underlying NPAT</b>	<b>59.6</b>	<b>61.0</b>	<b>2%</b>	<b>61.9</b>
Underlying EPS (cents)	38.5	39.4	2%	40.0
Final DPS (cents)	15.25	15.50	2%	15.25

Source: Forsyth Barr analysis

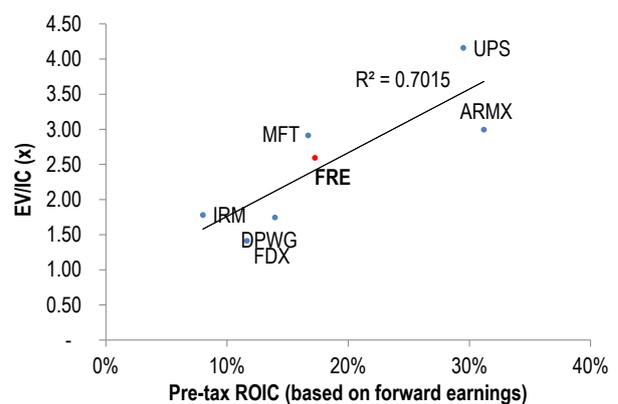
Our target price increases from NZ\$8.00 to NZ\$8.30 due principally to the reduction in our WACC estimate (7.8% from 8.2%). With earnings growth likely to accelerate in FY20, but with risk to the rate of growth to downside, we think FRE's current one year forward PE of ~18x is fair. We, therefore, upgrade from UNDERPERFORM to NEUTRAL.

**Figure 2. Investment in IM and adverse margin mix has dented ROIC**



Source: Eikon, Forsyth Barr analysis

**Figure 3. ROIC vs peers**



Source: Eikon, Forsyth Barr analysis

## Earnings revisions

Lower sales revenue growth but higher margin assumptions largely cancel each other out over the next several years. Our earnings forecasts are, therefore, largely unchanged as summarised in Figure 4. Our FY20 NPAT forecast implies growth of +9%, which may appear to be on the high side but reflective of FRE's B2C pricing initiatives, which will drive around half of the uplift.

**Figure 4. Earnings revisions (NZ\$m)**

	FY20E			FY21E			FY22E		
	Old	New	Chg	Old	New	Chg	Old	New	Chg
Sales revenue	659.3	645.8	-2.0%	694.1	676.5	-2.5%	n/a	714.4	n/a
EBITDA	120.1	120.8	0.6%	129.3	130.1	0.6%	n/a	138.0	n/a
EBITA	103.6	104.3	0.7%	112.3	113.1	0.7%	n/a	120.5	n/a
<b>Underlying NPAT</b>	<b>67.9</b>	<b>66.5</b>	<b>-2.1%</b>	<b>74.6</b>	<b>73.7</b>	<b>-1.2%</b>	<b>n/a</b>	<b>79.9</b>	<b>n/a</b>
Underlying EPS (cents)	43.9	43.0	-2.1%	48.2	47.6	-1.2%	n/a	51.6	n/a
Full year DPS (cents)	32.9	32.2	-2.1%	36.1	35.7	-1.2%	n/a	38.7	n/a

Source: Forsyth Barr analysis

## Key issues from the FY19 result

### (1) Pricing for effort to drive margin expansion in FY20

FRE commenced its 'pricing for effort' initiative in FY19 at a targeted customer level. Specific low margin customers were reviewed; in some cases the pricing was increased and in other cases FRE exited customer accounts. These initial pricing gains helped lift Express Package margins through 2H19.

The real pricing opportunity for FRE is in FY20 and FY21 as it targets an ~NZ\$1.50 per parcel increase for B2C (business to consumer; residential deliveries) relative to B2B. Management has suggested that it has thus far achieved 55–60c per parcel and 'hopes' to achieve 75c by the end of 1H20, having initially targeted 95c. Our modelling assumes it will achieve ~60c on average in FY20 as outlined in Figure 5. FRE has only lost one customer as a result of its pricing initiatives. Pricing for effort will impact ~20% of its parcel volume instead of the ~26% at the 1H19 result. In short, FRE's B2C exposure has fallen due to (1) refined geocoding of residential vs. commercial addresses, (2) customer behaviour in sending parcels to commercial rather than residential addresses, and (3) the loss of at least one B2C customer to NZ Post.

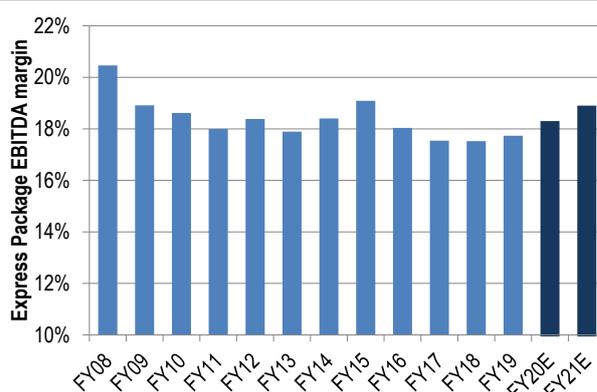
We see scope for FRE to sustainably lift its Express Package margins over FY20 and FY21, however, this may be to the detriment of volume growth as customers (which otherwise tend to be sticky) ultimately migrate to lower priced alternatives.

**Figure 5. Margin opportunity from 'pricing for effort' in FY20**

	Base case
Number of parcels (m) [a]	53
B2C split [b]	20%
Number of B2C parcels (m) [c = a x b]	11
Targeted price increase per parcel (NZ\$) [d]	0.95
Price realisation percentage [e]	75%
Collection of uplift given electronic ticketing phasing [f]	85%
Realised price increase [g = e x f]	0.61
Revenue uplift from B2C price increase (NZ\$m) [h = g x c]	6.5
Retention of B2C price increase (25c passed on to owner-drivers) [i = c x 25c]	(2.7)
EBIT uplift from B2C price increase (NZ\$m) [ = h - i]	3.8
<b>NPAT uplift from B2C price increase in FY20 (NZ\$m)</b>	<b>2.7</b>

Source: Forsyth Barr analysis \* FRE is targeting a general rate increase of +4.2% across both B2C and B2B.

**Figure 6. EBITDA margin history for Express Package**



Source: FRE, Forsyth Barr analysis

### (2) Volume growth weakening

Management outlined that Express Package volume growth has continued to slow in recent months. March and April volumes were flat year on year, while May and June volumes have declined, particularly at Post Haste. Growth has slowed across most key customer categories including manufacturing, wholesale, retail and healthcare, with the latter two both negative in recent months. Given underlying growth is still a feature in the ecommerce/B2C market, FRE's commentary suggests the B2B market is declining. We assume flat volumes for FRE in FY20.

### (3) Information Management's margins at a low point

Margin pressure was a constant theme in FY19 for Information Management. EBITDA margins are now the lowest they have been since divisional reporting began. This is reflective of (1) increased Shred-X investment (incl. NZ\$600k of one-off business merger costs in WA), (2) lower margin digitisation project work, and (3) lower spot paper prices.

We see scope for margins to improve in FY20 given (1) improving physical storage utilisation in Australia (currently 67%), and (2) cycling of WA business merger costs, but not dramatically. Longer term margins appear constrained by the sunset nature of some FRE businesses and the need to invest for growth.

## Result analysis

Figure 7. FY19 result analysis (NZ\$m)

	FY18	FY19	Change	Comments
<b>Profit and loss account</b>				
Sales revenue	580.9	615.7	6.0%	Slower second half growth
Express Package & Business Mail	74.8	80.0	6.9%	Volume growth was solid in 1H19 before declining in the second half
Information Management	35.4	35.3	-0.1%	Strong growth in secure destruction business, particularly medical waste
Corporate & Other	(2.5)	(3.1)	26.4%	
<b>EBITDA</b>	<b>107.7</b>	<b>112.2</b>	<b>4.2%</b>	
Depreciation and amortisation	(14.0)	(15.4)	10.3%	Guidance for FY20 of NZ\$17m
Acquisition amortisation	(2.0)	(2.1)	6.0%	
One-time items	2.6	2.4	n/a	Largely consisting of gain on replacing earthquake damaged racking
Interest expense	(9.7)	(9.6)	-1.0%	
Profit before tax	84.7	87.5	3.3%	
Taxation	(22.5)	(24.1)	7.2%	Effective tax rate of ~28%
<b>Reported NPAT</b>	<b>62.2</b>	<b>63.4</b>	<b>2.0%</b>	
Abnormals (post tax)	(2.6)	(2.4)	-7.9%	
<b>Underlying NPAT</b>	<b>59.6</b>	<b>61.0</b>	<b>2.4%</b>	
Underlying EPS (cents)	38.5	39.4	2.4%	155m shares on issue
Final DPS (cents)	15.25	15.50	1.6%	Pay-out ratio of 77%.
<b>Cashflow and net debt</b>				
Operating cashflow	75.7	76.0	0%	Strong cash flow generation expected to continue in FY20
Maintenance capex = depreciation	(14.0)	(15.4)	10%	Guidance for FY20 of NZ\$22m-NZ\$24m
Disposals	1.2	2.5	111%	
<b>Free cash flow</b>	<b>62.9</b>	<b>63.0</b>	<b>0%</b>	
Acquisitions	(7.4)	(11.1)	50%	Acquisition of three small Australian businesses
Net debt	154.4	151.4	-2%	Slightly reduced gearing due to strong cash flow generation
<b>Margin analysis</b>				
Express Package & Business Mail	17.5%	17.7%	21 bps	Reviewed pricing for low margin customers, exiting low margin business
Information Management	23.0%	21.5%	-150 bps	Reflective of investment in new fleet capacity at Shred-X
Group EBITDA margin	18.5%	18.2%	-32 bps	
Group EBITA margin	16.1%	15.7%	-42 bps	
<b>Divisional sales growth</b>				
Express Package & Business Mail	6.5%	5.7%	-83 bps	DX Mail facing competitive pressures from NZ Post
Information Management	6.7%	6.9%	21 bps	Large data collection/transformation contract win

Source: FRE, 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. While parcel volume growth is slowing, FRE's pricing for effort initiative will deliver a material step-up in Express Package margins in FY20, which will drive an acceleration in group earnings growth. NEUTRAL.**

### Business quality

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

### 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.

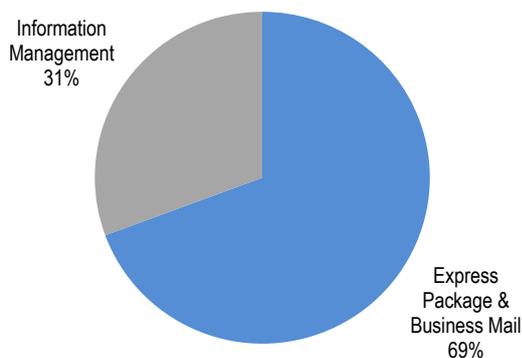
### Financial structure

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

### Risk factors

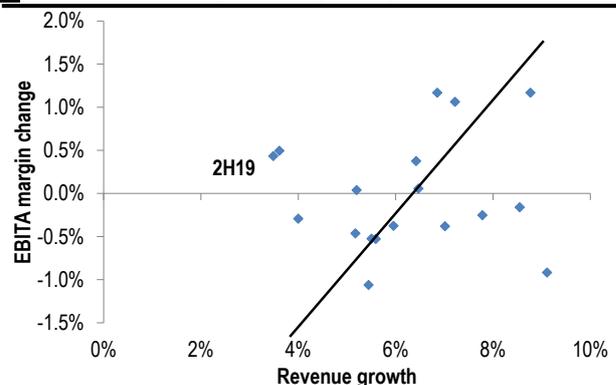
- **Cyclical environment:** FRE is exposed to the cyclical environment and therefore any sustained downturn will have an adverse impact on its performance.
- **Wage inflation:** The NZ courier industry largely uses a contractor model for its last mile deliveries. These owner drivers are outside minimum 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.

Figure 8. EBITDA divisional split (FY19)



Source: Forsyth Barr analysis

Figure 9. Express Package operating leverage (HYs: FY10 to 2H19)



Source: Forsyth Barr analysis

**Figure 10. Substantial Shareholders**

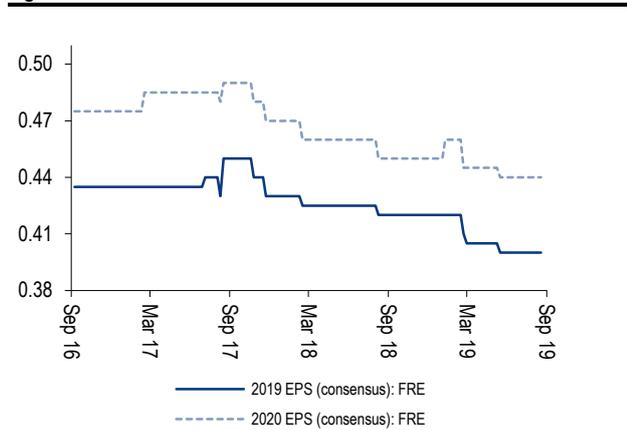
Shareholder	Latest Holding
Fisher Funds Management	8.0%
ANZ NZ Investments	6.5%
Mawer Investment Mgmt	5.0%

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

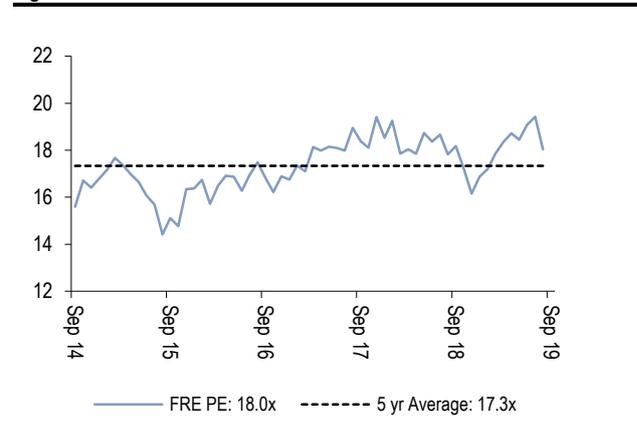
**Figure 11. International Compcos**

Company <i>(metrics re-weighted to reflect FRE's balance date - June)</i>	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash D/Yld 2021E
				2020E	2021E	2020E	2021E	2020E	2021E	
<b>Freightways</b>	<b>FRE NZ</b>	<b>NZ\$7.89</b>	<b>NZ\$1,221</b>	<b>18.4x</b>	<b>16.6x</b>	<b>11.4x</b>	<b>10.6x</b>	<b>13.5x</b>	<b>12.4x</b>	<b>4.5%</b>
Mainfreight *	MFT NZ	NZ\$40.50	NZ\$4,078	24.3x	21.6x	14.1x	12.6x	17.4x	15.5x	1.9%
FedEx Corp	FDX US	US\$151.97	US\$39,644	10.2x	9.2x	6.4x	6.0x	10.9x	9.9x	1.9%
United Parcel Service Inc	UPS US	US\$111.28	US\$95,557	14.3x	13.3x	10.7x	9.9x	13.5x	12.3x	3.7%
Deutsche Post AG	DPW GR	€28.70	€35,488	12.6x	11.4x	6.3x	5.9x	11.4x	10.3x	4.7%
Aramex PJSC	ARMX UH	AED4.10	AED6,003	10.2x	9.2x	7.1x	6.3x	9.6x	8.8x	5.5%
Iron Mountain Inc	IRM US	US\$31.14	US\$8,941	19.3x	21.7x	12.9x	12.0x	23.5x	21.2x	8.3%
<b>Compcos Average:</b>				<b>15.2x</b>	<b>14.4x</b>	<b>9.6x</b>	<b>8.8x</b>	<b>14.4x</b>	<b>13.0x</b>	<b>4.3%</b>
<b>EV = Current Market Cap + Actual Net Debt</b>				<b>FRE Relative:</b>	<b>+21%</b>	<b>+15%</b>	<b>+19%</b>	<b>+20%</b>	<b>-6%</b>	<b>-5%</b>

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

**Figure 12. Consensus EPS Momentum**


Source: Forsyth Barr analysis, Bloomberg

**Figure 13. 12 Month Forward PE**


Source: Forsyth Barr analysis

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