

Freightways

NEUTRAL

Caught a Cold; Should Recover

Freightways' (FRE) first quarter trading update highlighted a business with a number of trading pressure points; some cyclical, some not. Weaker parcel demand and ongoing challenges in Information Management led to an -8% decline in 1Q20 NPAT year on year. While a concern, first quarter growth shouldn't be extrapolated. In particular, management's messaging around its pricing for effort initiative is unchanged, which should help lift NPAT into positive growth territory by year end. With FRE trading at a ~20% discount to the market on a one year forward PE basis, we retain a NEUTRAL rating but recognise upside potential should the volume environment stabilise. Price fuelled earnings growth and Big Chill acquisition benefits are positive medium term drivers, in our opinion.

What's changed?

- **Earnings:** EBITA cut by -5% in both FY20 and FY21
- **Target Price:** Lowered to NZ\$8.10 from NZ\$8.30; driven by earnings downgrades partially offset by positive market re-rating since last change

Express Package volume weak; pricing for effort helping to offset

Express Package volumes fell -1.5% in the quarter against the prior year, reflecting a continuation of the slowing theme over the past 12 months. However, margins were broadly flat year on year despite the impact of non-recurring aircraft costs and the Countdown contract reset, suggesting the pricing for effort initiative (raising prices for residential parcel deliveries) is having a meaningful impact.

Information Management in the dog box; utilisation opportunity remains

Another disappointing outcome reflecting margin pressure (again) and stalling revenue growth (flat year on year in 1Q20), despite a number of small acquisitions over the past 12 months. Management is targeting a +20% improvement in Australian utilisation over the next two years, which should assist margin recovery.

Valuation reasonable

FRE is trading at a one year forward PE of ~19x on our revised earnings estimates. This appears reasonable against a market PE of ~23x, particularly with pricing and Big Chill driven growth ahead. However, we remain wary about the current trading backdrop, which may prolong the current earnings downgrade cycle. Separately, the impact of IFRS 16 (admittedly non-cash) may not be as bad as previously feared given the impact on 1Q20 NPAT growth is only -1%. Therefore, the impact on FRE's prima facie PE may not be too penal.

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\$7.75
Target price	NZ\$8.10
Risk rating	Medium
Issued shares	154.8m
Market cap	NZ\$1,200m
Average daily turnover	173.3k (NZ\$1,332k)

Share Price Performance



Financials: June	19A	20E	21E	22E
NPAT* (NZ\$m)	61.0	62.9	69.5	75.1
EPS* (NZc)	39.4	40.6	44.9	48.5
EPS growth* (%)	2.4	3.0	10.6	7.9
DPS (NZc)	30.5	30.5	33.7	36.4
Imputation (%)	100	100	100	100

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	12.1	11.6	10.8	10.2
EV/EBIT	13.9	13.9	12.8	12.0
PE	19.7	19.1	17.3	16.0
Price / NTA	n/a	n/a	n/a	n/a
Cash dividend yield (%)	3.9	3.9	4.3	4.7
Gross dividend yield (%)	5.5	5.5	6.0	6.5

*Historic and forecast numbers based on underlying profits

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Forsyth Barr is acting as a financial adviser to Freightways in respect of its acquisition of Big Chill.

Freightways Ltd (FRE)		Priced as at 31 Oct 2019: NZ\$7.75					June year end					
Forsyth Barr valuation							Valuation Ratios	2018A	2019A	2020E	2021E	2022E
Valuation methodology		DCF and sum-of-the-parts					EV/EBITDA (x)	12.6	12.1	11.6	10.8	10.2
12-month target price (NZ\$)*		8.10		Spot valuations (NZ\$)			EV/EBIT (x)	14.4	13.9	13.9	12.8	12.0
Expected share price return	4.5%	1. DCF		7.42		PE (x)	20.1	19.7	19.1	17.3	16.0	
Net dividend yield	4.1%	2. Sum-of-the-parts		7.93		Price/NTA (x)	n/a	n/a	n/a	n/a	n/a	
Estimated 12-month return	8.6%	3. n/a		n/a		Free cash flow yield (%)	4.8	4.4	4.5	5.0	5.4	
Key WACC assumptions		DCF valuation summary (NZ\$m)					Net dividend yield (%)	3.8	3.9	3.9	4.3	4.7
Risk free rate	2.00%	Total firm value		1,316		Gross dividend yield (%)	5.3	5.5	5.5	6.0	6.5	
Equity beta	0.97	(Net debt)/cash		(167)		Imputation (%)	100	100	100	100	100	
WACC	7.8%	Value of equity		1,149		Pay-out ratio (%)	77	77	75	75	75	
Terminal growth	1.5%	Shares (m)		155		Capital Structure		2018A	2019A	2020E	2021E	2022E
Profit and Loss Account (NZ\$m)		2018A	2019A	2020E	2021E	2022E	Interest cover EBIT (x)	9.8	10.1	10.9	13.6	17.0
Sales revenue	581	616	635	663	695	Interest cover EBITDA (x)	11.1	11.7	13.0	16.1	19.9	
Normalised EBITDA	108	112	116	124	131	Net debt/ND+E (%)	37.4	35.6	33.9	31.4	28.9	
Depreciation and amortisation	(16)	(18)	(19)	(19)	(20)	Net debt/EBITDA (x)	1.4	1.3	1.2	1.1	1.0	
Normalised EBIT	94	97	97	105	112	Key Ratios		2018A	2019A	2020E	2021E	2022E
Net interest	(10)	(10)	(9)	(8)	(7)	Return on assets (%)	16.8	16.6	16.4	17.5	18.2	
Associate income	-	-	-	-	-	Return on equity (%)	23.1	22.3	22.3	23.4	24.0	
Tax	(23)	(24)	(25)	(28)	(30)	Return on funds employed (%)	12.9	12.6	12.4	13.1	13.4	
Minority interests	-	-	-	-	-	EBITDA margin (%)	18.5	18.2	18.2	18.7	18.9	
Normalised NPAT	60	61	63	70	75	EBIT margin (%)	16.2	15.8	15.3	15.9	16.1	
Abnormals/other	3	2	-	-	-	Capex to sales (%)	3.2	3.8	3.5	3.5	3.5	
Reported NPAT	62	63	63	70	75	Capex to depreciation (%)	131	151	135	138	141	
Normalised EPS (cps)	38.5	39.4	40.6	44.9	48.5	Operating Performance		2018A	2019A	2020E	2021E	2022E
DPS (cps)	29.8	30.5	30.5	33.7	36.4	Revenue (NZ\$m)		2018A	2019A	2020E	2021E	2022E
Growth Rates		2018A	2019A	2020E	2021E	2022E	Express Package & Business Mail	427	451	465	483	505
Revenue (%)	6.5	6.0	3.1	4.3	4.9	Information Mgmt	154	164	170	179	190	
EBITDA (%)	6.7	4.2	3.1	7.3	5.6	Other/Inter company	-	-	-	-	-	
EBIT (%)	7.6	2.9	0.0	8.4	6.2	Total Sales	581	616	635	663	695	
Normalised NPAT (%)	5.4	2.4	3.0	10.6	7.9	Revenue growth (%)		2018A	2019A	2020E	2021E	2022E
Normalised EPS (%)	5.2	2.4	3.0	10.6	7.9	Express Package & Business Mail	6.5	5.7	3.0	4.0	4.5	
DPS (%)	7.2	2.5	-0.1	10.6	7.9	Information Mgmt	6.7	6.9	3.5	5.3	6.0	
Cash Flow (NZ\$m)		2018A	2019A	2020E	2021E	2022E	Total	6.5	6.0	3.1	4.3	4.9
EBITDA	108	112	116	124	131	EBITDA (NZ\$m)		2018A	2019A	2020E	2021E	2022E
Working capital change	0	-	-	-	(0)	Express Package & Business Mail	75	80	84	90	95	
Interest & tax paid	(32)	(34)	(34)	(36)	(37)	Information Mgmt	35	35	35	37	40	
Other	0	(3)	(5)	(5)	(5)	H/Office	(2)	(3)	(3)	(3)	(4)	
Operating cash flow	76	76	77	84	90	Total EBITDA	108	112	116	124	131	
Capital expenditure	(18)	(23)	(22)	(23)	(24)	EBITDA margin (%)		2018A	2019A	2020E	2021E	2022E
(Acquisitions)/divestments	(6)	(9)	-	-	-	Express Package & Business Mail	17.5	17.7	18.1	18.7	18.8	
Other	(0)	(1)	-	-	-	Information Mgmt	23.0	21.5	20.5	20.8	21.0	
Funding available/(required)	51	43	54	60	65	Group EBITDA margin	18.5	18.2	18.2	18.7	18.9	
Dividends paid	(45)	(47)	(47)	(52)	(56)	EBITA (NZ\$m)		2018A	2019A	2020E	2021E	2022E
Equity raised/(returned)	1	1	-	-	-	Express Package & Business Mail	68	72	75	82	86	
Increase/(decrease) in net debt	(6)	3	(7)	(8)	(9)	Information Mgmt	30	29	29	31	33	
Balance Sheet (NZ\$m)		2018A	2019A	2020E	2021E	2022E	H/Office	(4)	(5)	(5)	(5)	(5)
Working capital	20	24	18	19	20	Total EBITA	94	97	99	107	114	
Fixed assets	103	107	108	111	114	NZDAUD		0.92	0.93	0.93	0.93	0.91
Intangibles	358	365	369	373	377	Total funds employed		486	500	500	507	515
Other assets	5	4	4	4	4	Net debt/(cash)	154	151	144	136	127	
Total funds employed	486	500	500	507	515	Other non current liabilities	74	74	74	74	74	
Net debt/(cash)	154	151	144	136	127	Shareholder's funds	258	274	281	297	313	
Other non current liabilities	74	74	74	74	74	Minority interests	-	-	-	-	-	
Shareholder's funds	258	274	281	297	313	Total funding sources	486	500	500	507	515	
Minority interests	-	-	-	-	-	* Forsyth Barr target prices reflect valuation rolled forward at cost of equity less the next 12-months dividend						

1Q20 trading update

FRE's 1Q20 trading update had little to cheer. Pricing for effort is the sole positive, which is helping to largely offset margin pressure in Express Package from operating deleverage (volume declines) and non-recurring costs.

As for the key negatives: (1) Organic volume decline of -1.5% in Express Package, albeit a casualty of the cyclical environment, which management suggest should improve in 2Q20. (2) Information Management has gone from bad to worse, even excluding the non-recurring items in the quarter.

The introduction of IFRS 16 (accounting for leases) lowers the NPAT by a further -NZ\$0.5m from than shown in Figure 1.

Figure 1. First quarter trading summary excluding IFRS 16 (NZ\$m)

	1Q19	1Q20	Change
Revenue	155.1	156.7	1.0%
EBITDA	27.6	26.3	-4.7%
EBITA	23.9	22.1	-7.5%
NPATA	15.6	14.5	-7.1%
NPAT	15.1	13.9	-7.9%

Source: FRE, Forsyth Barr analysis

Express Package & Business Mail — growth deceleration

Organic volume growth has softened consistently over the past 12 months (Figure 4), falling -1.5% in 1Q20. While more than offset by pricing gains, the benefits of the pricing for effort initiative are being hampered by the volume deleverage impact on margins. Management is optimistic that trading will improve in 2Q20 and through 2H20, suggesting that October has shown some recovery in growth rates.

The impact of aircraft disruption/maintenance costs (NZ\$0.75m; non-recurring) and the previously disclosed discount to retain Countdown as a customer (NZ\$0.35m; on-going) impacted EBITA by -NZ\$1.1m in the quarter.

Figure 2. Express Package and Business Mail division (NZ\$m)

	1Q19	1Q20	Change
Revenue	114	116	2%
EBITDA	19	20	1%
EBITA	18	18	0%
EBITA margin	15.4%	15.2%	-2%

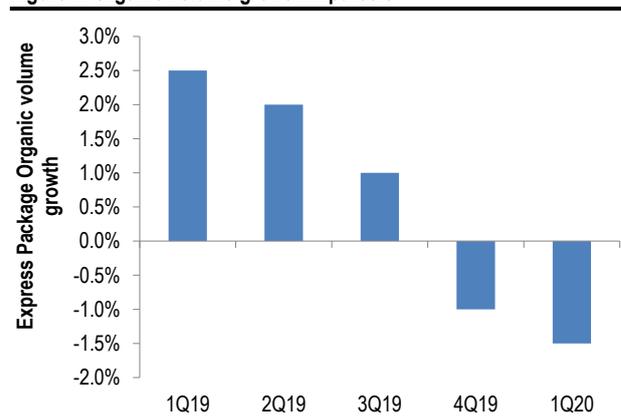
Source: Forsyth Barr analysis

Figure 3. Information Management division (NZ\$m)

	1Q19	1Q20	Change
Revenue	42	42	1%
EBITDA	9	8	-14%
EBITA	8	6	-23%
EBITA margin	18.7%	14.3%	-24%

Source: Forsyth Barr analysis

Figure 4. Organic volume growth in parcels



Source: FRE, Forsyth Barr analysis

Information Management — margin problems persist

Information Management margins continue to disappoint. First quarter margins have slipped by over -600bps in the past two years. While some of the slippage is non-recurring (Shred-X relocation in NSW — NZ\$0.4m) or cyclical (lower paper prices — NZ\$0.25m), a large chunk (NZ\$1.2m) relates to the print and copy services operations (i.e. Litsupport) where FRE now has a number of improvement initiatives underway.

Earnings revisions

We downgrade our earnings forecasts for FRE as summarised in Figure 5. Our forecasts do not yet include IFRS 16 adjustments which FRE is introducing from FY20. FY20 EBITA growth of +3% compares to pre-update consensus of ~+7%.

An acceleration of earnings growth in FY21 reflects a modest improvement in revenue growth, margin benefits from pricing for effort (some from FY21 pricing moves but the full benefit of FY20 moves), and margin recovery in Information Management.

We do not incorporate the acquisition of Big Chill into our modelling at this stage, though recognise the earnings and value accretion that we believe will stem from the deal.

Figure 5. Earnings revisions (NZ\$m)

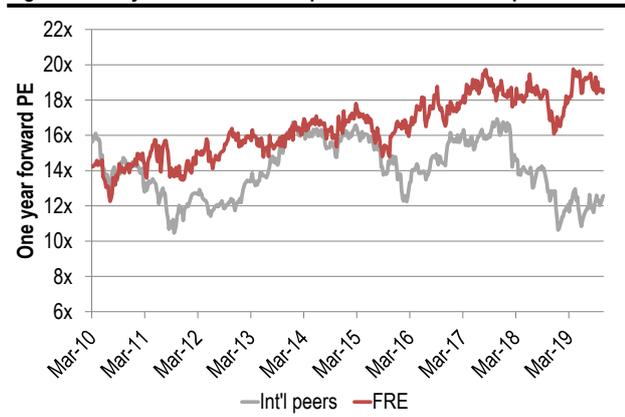
	FY20E			FY21E			FY22E		
	Old	New	Chg	Old	New	Chg	Old	New	Chg
Sales revenue	645.8	635.0	-1.7%	676.5	662.5	-2.1%	714.4	695.0	-2.7%
EBITDA	120.8	115.7	-4.2%	130.1	124.2	-4.5%	138.0	131.2	-4.9%
EBITA	104.3	99.2	-4.8%	113.1	107.3	-5.1%	120.5	113.9	-5.5%
Adjusted NPAT	66.5	62.9	-5.5%	73.7	69.5	-5.7%	79.9	75.1	-6.0%
Underlying EPS (cents)	43.0	40.6	-5.5%	47.6	44.9	-5.7%	51.6	48.5	-6.0%
Full year DPS (cents)	32.2	30.5	-5.5%	35.7	33.7	-5.7%	38.7	36.4	-6.0%

Source: Forsyth Barr analysis

Valuation implications

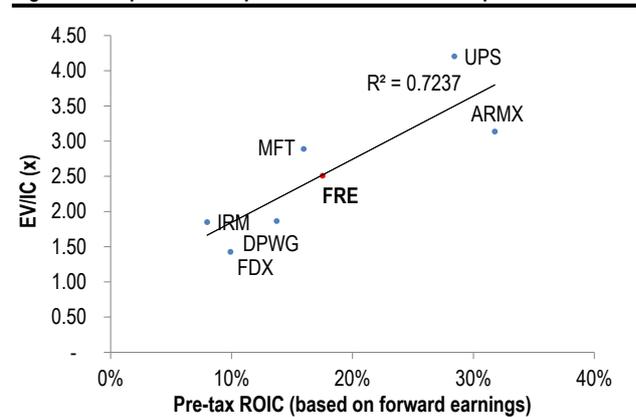
We lower our target price from NZ\$8.30 to NZ\$8.10 to reflect our earnings downgrades, partly offset by the market re-rating since our last target price change. FRE now trades at a one-year forward PE of ~19x, representing a ~20% discount to the market. While current trading conditions remain challenging and the impact of IFRS 16 (albeit entirely non-cash) will lift the PE multiple (given the adverse earnings impact) by 1x–2x, FRE's growth profile over the medium term has the potential to look increasingly attractive.

Figure 6. One year forward PE vs. peers — no relationship



Source: Eikon, Forsyth Barr analysis

Figure 7. Simple ROIC vs. peers — a clear relationship



Source: Eikon, 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.

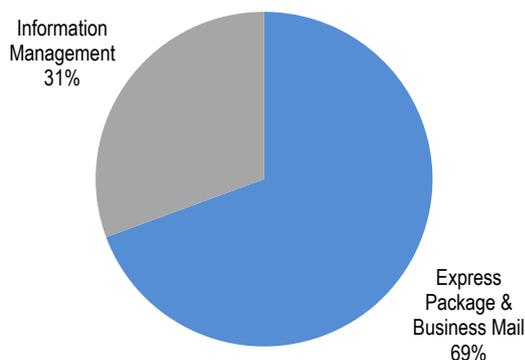
Financial structure

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

Risk factors

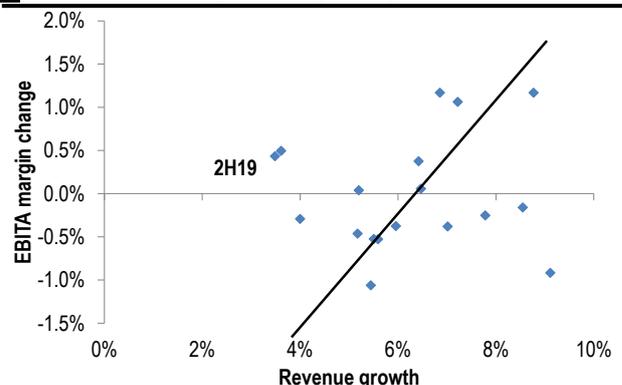
- **Cyclical environment:** FRE is exposed to the cyclical environment and therefore any sustained downturn will have an adverse impact on its performance.
- **Wage inflation:** The NZ courier industry largely uses a contractor model for its last mile deliveries. These owner drivers are outside minimum 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	6.9%
ANZ NZ Investments	6.5%
Investment Services Group	5.8%
Mawer Investment Mgmt	5.0%

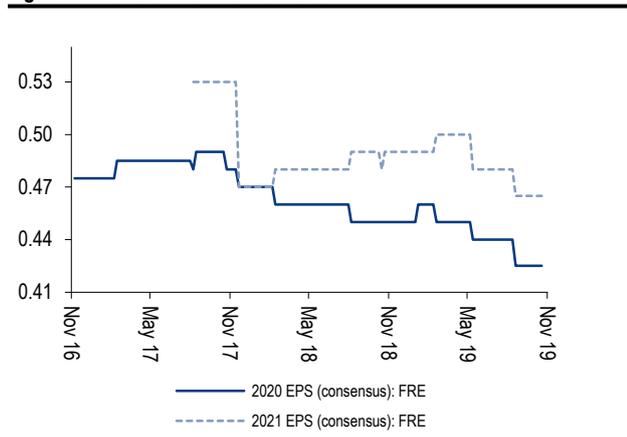
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 11. International Compocos

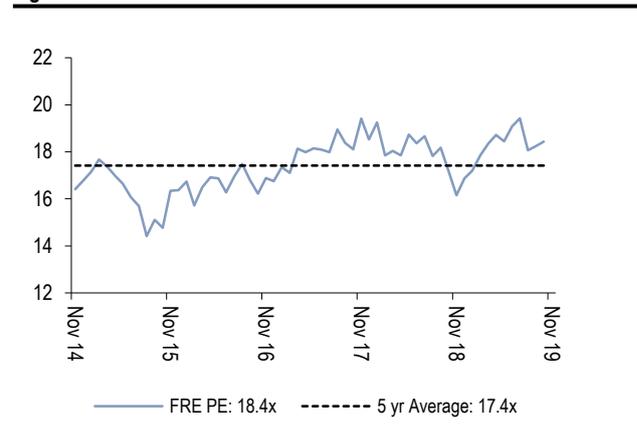
Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash D/Yld
<i>(metrics re-weighted to reflect FRE's balance date - June)</i>										
			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E
Freightways	FRE NZ	NZ\$7.75	NZ\$1,200	19.1x	17.3x	11.7x	10.9x	13.9x	12.8x	4.3%
Mainfreight *	MFT NZ	NZ\$40.20	NZ\$4,048	25.5x	23.4x	14.5x	13.4x	18.2x	16.7x	1.7%
FedEx Corp	FDX US	US\$154.85	US\$40,393	12.6x	11.0x	9.0x	8.2x	16.8x	14.7x	1.8%
United Parcel Service Inc	UPS US	US\$116.10	US\$99,640	14.9x	13.8x	11.2x	10.4x	14.2x	13.1x	3.6%
Deutsche Post AG	DPW GR	€31.83	€39,358	13.9x	12.6x	6.8x	6.3x	12.2x	11.0x	4.2%
Aramex PJSC	ARMX UH	AED4.00	AED5,856	10.4x	9.6x	6.3x	5.9x	9.2x	8.5x	5.6%
Iron Mountain Inc	IRM US	US\$32.89	US\$9,445	22.2x	23.1x	13.3x	12.4x	24.2x	21.8x	7.9%
			Compco Average:	16.6x	15.6x	10.2x	9.4x	15.8x	14.3x	4.1%
			FRE Relative:	+15%	+11%	+15%	+15%	-12%	-10%	+5%

EV = Current Market Cap + Actual Net Debt

Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco 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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