

Freightways

1H20 – A Slower Delivery

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NEUTRAL 

Freightways (FRE) reported a disappointing 1H20 result impacted by parcel volumes declines and further margin woes in Information Management. Revenue momentum is the slowest since the GFC (global financial crisis). While margins are stable to positive in Express Package, despite increased postal competition from NZ Post, the Information Management division has been dented by lower paper prices, further losses in its 'copy and print' business and a more subdued period for its digitisation operations. Some relief should come during 2H20 in the form of (1) recent restructuring moves to lower the cost base, and (2) the commencement of a major digitisation project in Australia. Moreover, FY21 earnings should recover further from the pricing for effort initiative and the cycling of a number of one offs in FY20, however, the risk to the earnings growth outlook is to the downside, in our opinion. The two years plus earnings downgrade cycle may not yet be over. FRE is trading at a one year forward PE of ~20x. After adjusting for the soon to be completed Big Chill acquisition, this should fall to ~18x. We believe this is fair risk/reward for FRE in light of its increasingly hazy earnings outlook. We retain a NEUTRAL rating.

NZX Code	FRE	Financials: Jun/	19A	20E	21E	22E	Valuation (x)	19A	20E	21E	22E
Share price	NZ\$8.05	NPAT* (NZ\$m)	61.0	57.2	63.3	69.6	EV/EBITDA	12.5	9.8	9.3	8.8
Target price	NZ\$8.00	EPS* (NZc)	39.4	37.0	40.9	45.0	EV/EBIT	14.4	14.4	13.4	12.5
Risk rating	Medium	EPS growth* (%)	2.4	-6.2	10.5	10.1	PE	20.4	21.8	19.7	17.9
Issued shares	154.8m	DPS (NZc)	30.5	30.5	30.7	33.7	Price / NTA	n/a	n/a	n/a	n/a
Market cap	NZ\$1,246m	Imputation (%)	100	100	100	100	Cash div yld (%)	3.8	3.8	3.8	4.2
Avg daily turnover	125.2k (NZ\$1,028k)	*Based on normalised profits					Gross div yld (%)	5.3	5.3	5.3	5.8

What's changed?

- **Earnings:** Underlying EBITDA forecast cut by -3% in FY20; our forecasts now incorporate IFRS 16 for the first time
- **Target price:** Reduced from NZ\$8.10 to NZ\$8.00

Revenue inflection

FRE has benefited over recent years from a supportive domestic economic backdrop and consistent market share gains. Group revenue growth has averaged ~+7% over the past 10 years (inclusive of ~+2% relating from M&A). The tables have turned on both fronts. A less supportive New Zealand economy has created a volume drag and the more commercial approach being taken by NZ Post is hampering FRE's competitive advantage in its core parcels business, in our opinion. While the former is cyclical, the latter is structural and will make it harder for FRE to generate the level of success it has historically enjoyed. Historic organic revenue growth may no longer be a good proxy for the future.

Key initiatives to drive margin enhancement; structural headwinds remain

Key management initiatives (including pricing for effort, route productivity, and medical waste) are being drowned out by a number of headwinds; some temporary, some structural. As the temporary ones subside (including one-off aircraft easing costs and restructuring costs) the margin opportunity should become more apparent in both Express Package and Information Management. However, the secular headwinds, including a more competitive playing field and lower paper prices (back in line with historic averages), will remain, in our opinion. The potential for major digitisation projects offer a boost to near term earnings but may not be sustainable over the longer term.

Outlook hazy; retain NEUTRAL

Freightways (FRE) reported a soft first half result impacted by lower volumes in Express Package and further margin degradation in Information Management. Underlying NPAT (prior to IFRS 16 adjustments) was down -6% to NZ\$30.3m on revenue growth of +1%. The result was impacted by a decline in volumes in Express Package, greater price competition by NZ Post for DX Mail, a decline in paper prices, losses incurred at 'print and copy' and the renegotiation of the Countdown delivery contract in the prior year.

Figure 1. Summary of 1H20 result pre-IFRS 16 (NZ\$m)

	1H19	1H20	Change	Forbar
Sales revenue	314.8	318.9	1%	323.0
EBITDA	58.2	56.2	-4%	59.1
EBITA	50.7	47.7	-6%	51.2
Adjusted NPAT	32.0	30.3	-5%	32.5
Underlying EPS (c)	20.7	19.5	-5%	21.0
Interim DPS (c)	15.0	15.0	0%	15.0

Source: FRE, Forsyth Barr analysis

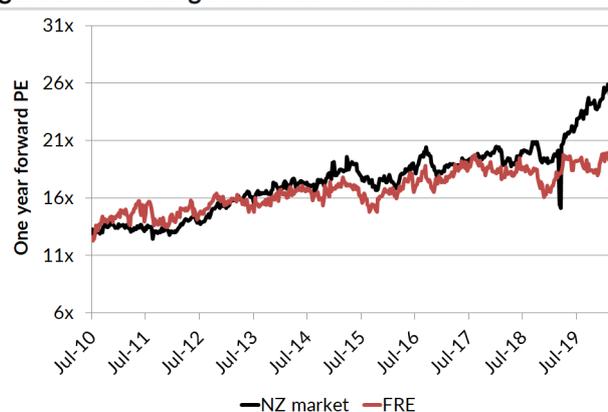
Figure 2. Segmental results pre-IFRS 16 (NZ\$m)

	1H19	1H20	Change
Express Package & Business Mail	232.6	236.6	2%
Information Management	82.2	82.3	0%
Total revenue	314.8	318.9	1%
Express Package & Business Mail	42.4	43.4	2%
Information Management	17.6	14.4	-9%
Total EBITDA*	58.2	56.2	-4%

Source: FRE, Forsyth Barr analysis *includes corporate and other

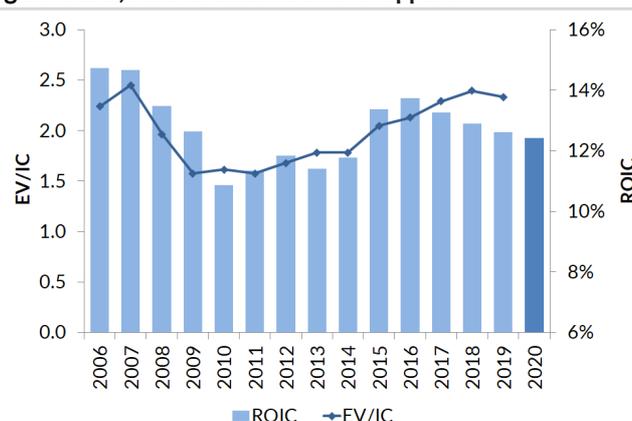
Our target price falls from NZ\$8.10 to NZ\$8.00 to reflect our underlying earnings changes in this report. There are plenty of things to like about FRE – its strong market leadership positions in a variety of growing industries and its still to be completed acquisition of Big Chill. However, it also has a number of less desirable businesses that are dragging on its earnings outlook (e.g. print and copy), or are lumpy and difficult to forecast (e.g. digitisation project work). While we expect a number of management initiatives to bear fruit in FY21 (in particular, the Pricing for Effort strategy and Big Chill earnings accretion), the earnings growth outlook is now more hazy than it ever has been. We think FRE's one year forward trading multiple at ~20x on our revised estimates (which will fall to ~18x when Big Chill is consolidated) is fair and therefore we retain a NEUTRAL rating.

Figure 3. FRE looking better value vs NZ market



Source: Datastream, Forsyth Barr analysis

Figure 4. But, returns diminution not supportive



Source: Eikon, Forsyth Barr analysis

Earnings revisions

Our earnings forecasts have been adjusted to incorporate IFRS 16 for the first time. Consequently, our EBITDA and EBITA estimates increase materially as shown in Figure 5. These apparent upgrades mask underlying downgrades at both lines. On an underlying basis EBITDA and EBITA decline -3% and -4% for FY20E respectively. Our FY20 underlying NPAT forecast falls -5%.

Figure 5. Earnings revisions summary (NZ\$m)

	FY20E			FY21E			FY22E		
	Old	New	Chg	Old	New	Chg	Old	New	Chg
Sales revenue	635.2	630.1	-0.8%	662.5	652.1	-1.6%	694.9	681.6	-1.9%
EBITDA	115.8	143.1	23.7%	124.2	152.7	23.0%	131.2	160.3	22.2%
EBITA	99.3	125.6	26.6%	107.3	133.4	24.3%	113.9	140.9	23.8%
Adjusted NPAT	62.9	57.2	-9.0%	69.5	63.3	-9.0%	75.0	69.6	-7.2%
Underlying EPS (cents)	40.6	37.0	-9.0%	44.9	40.9	-9.0%	48.5	45.0	-7.2%
Full year DPS (cents)	30.5	30.5	0.1%	33.7	30.7	-9.0%	36.4	33.7	-7.2%

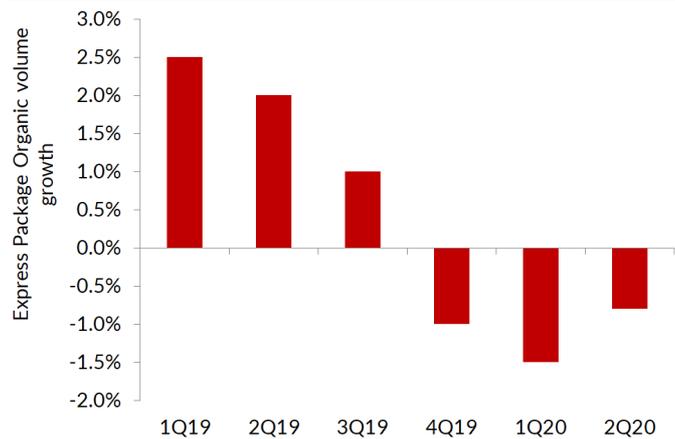
Source: Forsyth Barr analysis

Key issues from the result

(1) Express Package volumes getting 'less worse'

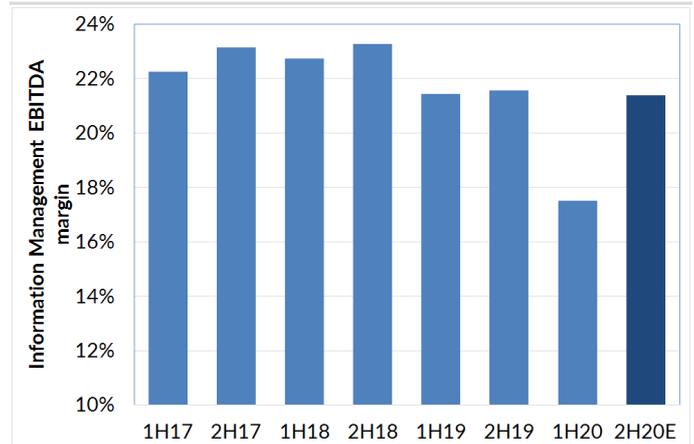
The direction of Express Package volume growth is improving, with volumes broadly flat in December and January, having declined c.-1% in 1H20. The domestic economic backdrop appears to have improved after a mid-2019 slowdown. However, the outlook is subdued rather than buoyant. FRE has yet to experience any impact from the coronavirus outbreak (it is 99% reliant on NZ Inc), as supply chain disruption for its customers potentially becomes a feature its level of activity could be impacted.

Figure 6. Volume growth backdrop getting "less worse"



Source: FRE, Forsyth Barr analysis

Figure 7. Margin decline at Information Management



Source: Forsyth Barr analysis

(2) Information Management to rebound from 2H20 but headwinds remain

FRE has been subject to a number of adverse drivers in its Information Management division in recent periods. Margins have declined materially. While we expect 1H20 to be the low point in FRE's margin profile at least over the next several periods, the division remains subject to a number of headwinds. Key divisional drivers include:

- Paper pricing:** Lower pricing impacted FRE's revenue and profits by ~NZ\$1.5m in 1H20. While the impact will be smaller in 2H20 as it laps lower spot prices in 2H19, we still expect the headwind to be material (>NZ\$1m).
- Print & copy:** The bureau part of Litsupport has recently cut its annualised labour costs by ~NZ\$2m; redundancies will have a cash cost of NZ\$0.25m. Therefore, the net benefit in 2H20 should be ~NZ\$0.7m.
- Digitisation:** FRE has commenced its major Royal Commission project in Australia, which it estimates could be worth NZ\$10m–NZ\$30m of revenue over the next 12 months, offering a typical project EBITDA margin of 25%–35%. We assume this adds ~NZ\$3m of revenue and ~NZ\$1m of EBITDA in 2H20, with a larger uplift in FY21. While FRE has a potential pipeline of these projects (there are a number of Australian Royal Commissions), we are wary of getting too excited about these low PE (price to earnings ratio) opportunities as they are one-off in nature and can be lumpy.
- AU records:** Continues to grow into empty capacity albeit management's utilisation target of ~75% in FY20 is unlikely to be met with the revenue uplift in 1H20 driven by services rather than storage.
- Destruction and medical:** Further acquisitions and organic growth will drive further gains in Shred-X and medical waste businesses.

(3) Balance Sheet assistance with DRP

FRE's opting for a full underwritten DRP (dividend reinvestment plan) helps de-stress the balance sheet as it completes the acquisition of Big Chill (due to complete subject to OIO (Overseas Investment Office) approval in April/May 2020). While we believe FRE did not need to raise equity capital, its ongoing M&A hunger will be constrained otherwise.

Management has also outlined its intention to seek buyers for the underperforming 'print and copy' part of Litsupport. This is a loss-making business that is not core to FRE's increasing digital focus in this area. We estimate book value is NZ\$5m–NZ\$10, which suggests the impact on the balance sheet will be marginal.

Investment Summary

Freightways (FRE) offers investors exposure to courier and records management businesses that enjoy high cashflow generation, scale benefits, barriers to entry and market leading positions. Notwithstanding some structural headwinds (sunset Information Management businesses, increased Express Package competition), FRE has a number of positive medium term drivers in place but several temporary factors are impacting near term growth. NEUTRAL.

Business quality

Earnings and cashflow 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.

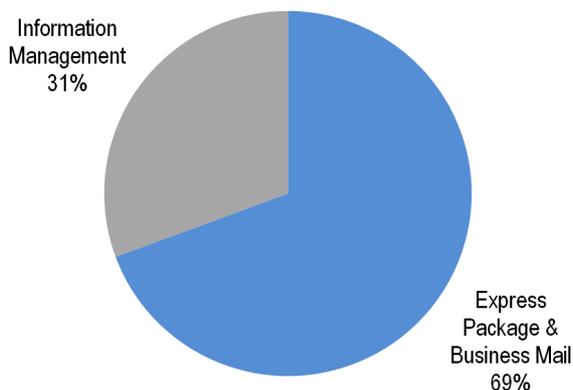
Financial structure

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

Risk factors

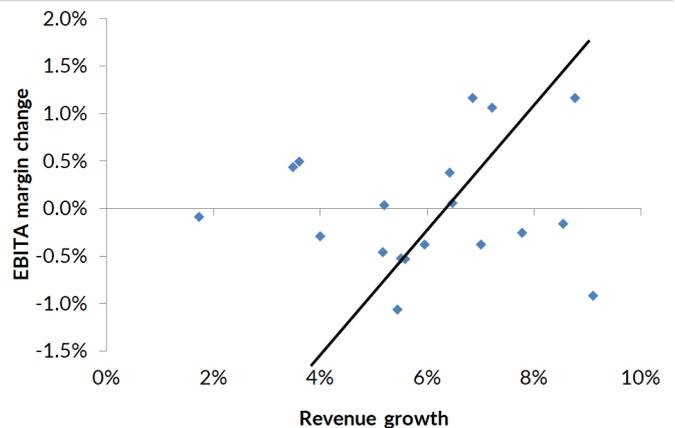
- **Cyclical environment:** FRE is exposed to the cyclical environment and therefore any sustained downturn will have an adverse impact on its performance.
- **Wage inflation:** The NZ courier industry largely uses a contractor model for its last mile deliveries. These owner drivers are outside minimum 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. EP division operating leverage (HY: FY10 to 1H20)



Source: Forsyth Barr analysis

Figure 10. Price performance


Source: Forsyth Barr analysis

Figure 11. Substantial shareholders

Shareholder	Latest Holding
ANZ NZ Investments	6.5%
Fisher Funds Management	5.8%
Investment Services Group	5.8%
Mawer Investment Mgmt	5.0%

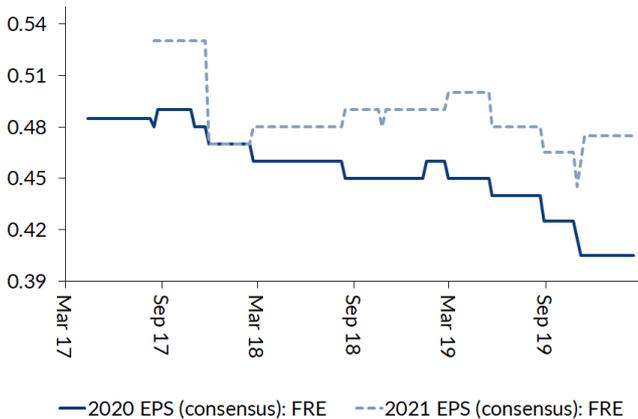
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 12. International valuation comparisons

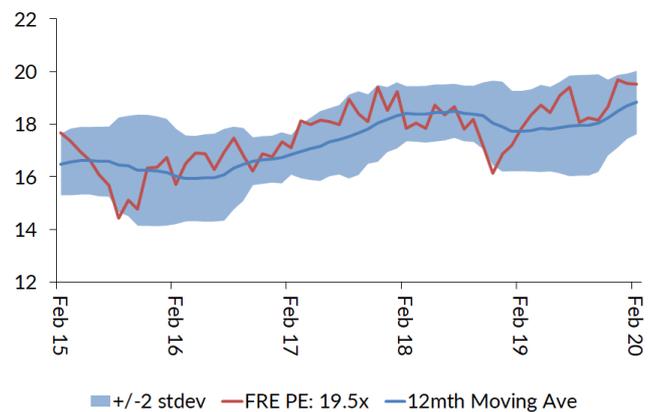
Company	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash Yld
				2020E	2021E	2020E	2021E	2020E	2021E	
<i>(metrics re-weighted to reflect FRE's balance date - June)</i>										
Freightways	FRE NZ	NZ\$8.05	NZ\$1,246	21.8x	19.7x	9.8x	9.2x	14.3x	13.2x	3.8%
Mainfreight *	MFT NZ	NZ\$41.70	NZ\$4,199	26.0x	23.6x	14.9x	13.6x	18.6x	16.9x	1.7%
FEDEX CORP	FDX US	US\$163.25	US\$42,628	14.9x	12.9x	10.2x	9.1x	20.0x	16.8x	1.7%
UNITED PARCEL SERVICE-CL B	UPS US	US\$102.94	US\$88,373	16.5x	12.6x	10.2x	9.8x	13.7x	12.8x	4.0%
DEUTSCHE POST AG-REG	DPW GR	€31.72	€39,216	13.8x	12.3x	6.7x	6.2x	12.1x	10.8x	4.3%
ARAMEX PJSC	ARMX UH	AED3.49	AED5,110	9.7x	8.8x	5.6x	4.9x	7.2x	6.9x	6.7%
IRON MOUNTAIN INC	IRM US	US\$34.45	US\$9,899	29.1x	23.6x	12.3x	12.9x	24.9x	n/a	7.2%
Compco Average:				18.3x	15.6x	10.0x	9.4x	16.1x	12.8x	4.3%
FRE Relative:				19%	26%	-2%	-3%	-11%	3%	-10%

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 13. Consensus EPS momentum (NZ\$)


Source: Forsyth Barr analysis

Figure 14. One year forward PE (x)


Source: Forsyth Barr analysis

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