

# Freightways

## Feeling the Chill

**ANDY BOWLEY**

 andy.bowley@forsythbarr.co.nz  
 +64 4 495 8246

**SCOTT ANDERSON**

 scott.anderson@forsythbarr.co.nz  
 +64 4 914 2219

**NEUTRAL** 

Freightways' (FRE) revenue is falling dramatically during the domestic COVID-19 lock-down, but profitability is partially protected by a variable contractor base, wage subsidy support from the government, and a temporary reduction in employee wages. When the lock-down ends, the economic ramifications will likely suppress medium term demand, thereby spilling the earnings impact into FY21 and beyond. Earnings downgrades are partially mitigated by the accretion provided by the Big Chill deal, which has now completed. While originally intended to be debt funded, FRE has protected its balance sheet by a recent fully underwritten DRP (dividend reinvestment plan) and a cash for share switch on part of the purchase consideration. Following our earnings forecast downgrades, FRE trades at a one year forward PE of ~16x on depressed earnings. It's difficult to compare this against both domestic and international peers at this time given the very uncertain near term outlook and the lagged nature of consensus forecasts to current and future trading conditions. However, taking a historic view of FRE's relative valuation we believe this is fair and therefore retain a NEUTRAL rating.

NZX Code	FRE	Financials: Jun/	19A	20E	21E	22E	Valuation (x)	19A	20E	21E	22E
Share price	NZ\$5.62	NPAT* (NZ\$m)	61.0	49.0	60.1	71.2	EV/EBITDA	9.6	8.3	7.5	6.9
Target price	NZ\$6.40	EPS* (NZc)	39.3	31.0	36.3	43.0	EV/EBIT	11.2	12.7	11.1	9.8
Risk rating	Medium	EPS growth* (%)	2.2	-21.1	17.2	18.5	PE	14.3	18.1	15.5	13.1
Issued shares	165.4m	DPS (NZc)	30.5	23.0	27.3	32.3	Price / NTA	n/a	n/a	n/a	n/a
Market cap	NZ\$930m	Imputation (%)	100	100	100	100	Cash div yld (%)	5.4	4.1	4.8	5.7
Avg daily turnover	129.0k (NZ\$1,020k)	*Based on normalised profits					Gross div yld (%)	7.5	5.7	6.7	8.0

### Key changes

- **Earnings forecasts:** Material underlying reductions through outlook period partially mitigated by Big Chill earnings accretion
- **Target price:** Lowered from NZ\$8.00 to NZ\$6.40

### Trading activity hit by lock-down

FRE was navigating COVID-19 well until the Level 4 lock-down was imposed. Prior to lock-down parcel volumes in March were up +3% against the prior year, but hub and spoke volumes (ex messenger Services, which incorporates the Countdown contract) have since fallen by -65%. The re-opening of some ecommerce product lines will assist, but activity levels will remain depressed until the lock-down ends. Thereafter, the damper economic climate will weigh on activity levels. FRE has some cost levers available to mitigate the earnings impact, albeit profitability will fall materially through 2H20 and into FY21.

### Big Chill consolidated

FRE has completed the acquisition of Big Chill. We estimate the deal is immediately EPS accretive (by around +7%), albeit FRE still has to pay ~20% of the purchase price in FY23. As an essential service Big Chill is "trading well" through the lock-down, albeit the channel shift from foodservice to supermarket will mean more bulk deliveries and less higher margin local deliveries.

### Balance sheet protected

A cash for shares switch for part of the Big Chill purchase consideration and the fully underwritten interim DRP means FRE's balance sheet has ample capacity for an extended downturn. We estimate FY21 net debt/EBITDA of ~1.8x vs debt covenants at ~3.25x.

**Freightways Ltd (FRE)**

Priced as at 01 Apr 2020 (NZ\$)

**5.62**
**12-month target price (NZ\$)\***
**6.40**

Expected share price return

13.9%

Net dividend yield

4.7%

Estimated 12-month return

18.6%

**Spot valuations (NZ\$)**

1. DCF

6.38

2. Sum-of-the-parts

5.69

3. n/a

n/a

**Key WACC assumptions**

Risk free rate

2.00%

Equity beta

0.97

WACC

7.7%

Terminal growth

1.5%

**DCF valuation summary (NZ\$m)**

Total firm value

1,602

(Net debt)/cash

(172)

Less: Capitalised operating leases

(375)

Value of equity

1,055

**Profit and Loss Account (NZ\$m)**

	2018A	2019A	2020E	2021E	2022E
Sales revenue	580.9	615.7	610.2	697.3	742.1
<b>Normalised EBITDA</b>	<b>107.7</b>	<b>112.2</b>	<b>134.5</b>	<b>153.4</b>	<b>167.3</b>
Depreciation and amortisation	(16.0)	(17.5)	(46.2)	(48.8)	(48.9)
<b>Normalised EBIT</b>	<b>94.3</b>	<b>97.1</b>	<b>88.3</b>	<b>104.6</b>	<b>118.5</b>
Net interest	(9.7)	(9.6)	(19.4)	(20.3)	(18.7)
Associate income	0	0	0	0	0
Tax	(22.5)	(24.1)	(19.9)	(24.2)	(28.5)
Minority interests	0	0	0	0	0
<b>Normalised NPAT</b>	<b>59.6</b>	<b>61.0</b>	<b>49.0</b>	<b>60.1</b>	<b>71.2</b>
Abnormals/other	2.6	2.4	0	0	0
<b>Reported NPAT</b>	<b>62.2</b>	<b>63.4</b>	<b>49.0</b>	<b>60.1</b>	<b>71.2</b>
Normalised EPS (cps)	38.4	39.3	31.0	36.3	43.0
DPS (cps)	29.8	30.5	23.0	27.3	32.3

**Growth Rates**

	2018A	2019A	2020A	2021A	2022A
Revenue (%)	6.5	6.0	-0.9	14.3	6.4
EBITDA (%)	6.7	4.2	19.8	14.1	9.1
EBIT (%)	7.6	2.9	-9.0	18.5	13.2
Normalised NPAT (%)	5.4	2.4	-19.7	22.7	18.5
Normalised EPS (%)	5.0	2.2	-21.1	17.2	18.5
Ordinary DPS (%)	7.2	2.5	-24.6	18.5	18.5

**Cash Flow (NZ\$m)**

	2018A	2019A	2020E	2021E	2022E
<b>EBITDA</b>	<b>107.7</b>	<b>112.2</b>	<b>134.5</b>	<b>153.4</b>	<b>167.3</b>
Working capital change	0.0	0	0	0	(0.0)
Interest & tax paid	(32.2)	(33.7)	(31.3)	(36.5)	(39.3)
Other	0.2	(2.5)	(38.5)	(38.5)	(38.5)
<b>Operating cash flow</b>	<b>75.7</b>	<b>76.0</b>	<b>64.7</b>	<b>78.4</b>	<b>89.6</b>
Capital expenditure	(18.4)	(23.3)	(26.0)	(24.4)	(26.0)
(Acquisitions)/divestments	(6.2)	(8.7)	(132.0)	0	0
Other	(0.3)	(0.6)	0	0	0
<b>Funding available/(required)</b>	<b>50.7</b>	<b>43.5</b>	<b>(93.3)</b>	<b>54.0</b>	<b>63.6</b>
Dividends paid	(45.4)	(47.0)	(13.3)	(45.1)	(53.4)
Equity raised/(returned)	0.7	0.7	30.0	0	0
<b>(Increase)/decrease in net debt</b>	<b>6.1</b>	<b>(2.8)</b>	<b>(76.6)</b>	<b>8.9</b>	<b>10.2</b>

**Balance Sheet (NZ\$m)**

	2018A	2019A	2020E	2021E	2022E
Working capital	20.1	23.8	17.8	19.7	20.6
Fixed assets	103.1	106.7	176.2	175.5	176.4
Intangibles	358.4	365.2	435.2	439.2	443.2
Right of use asset	0	0	195.0	195.0	195.0
Other assets	4.8	4.0	4.0	4.0	4.0
<b>Total funds employed</b>	<b>486.4</b>	<b>499.7</b>	<b>828.2</b>	<b>833.3</b>	<b>839.1</b>
Net debt/(cash)	154.4	151.4	228.1	219.2	209.0
Lease liability	0	0	220.0	220.0	220.0
Other liabilities	73.8	74.3	74.3	74.3	74.3
Shareholder's funds	258.2	273.9	305.8	319.9	335.8
Minority interests	0	0	0	0	0
<b>Total funding sources</b>	<b>486.4</b>	<b>499.6</b>	<b>828.2</b>	<b>833.3</b>	<b>839.1</b>

**Valuation Ratios**

	2018A	2019A	2020E	2021E	2022E
EV/EBITDA (x)	10.1	9.6	8.3	7.5	6.9
EV/EBIT (x)	11.5	11.2	12.7	11.1	9.8
PE (x)	14.6	14.3	18.1	15.5	13.1
Price/NTA (x)	n/a	n/a	n/a	n/a	n/a
Free cash flow yield (%)	6.2	5.7	4.2	5.8	6.8
Net dividend yield (%)	5.3	5.4	4.1	4.8	5.7
Gross dividend yield (%)	7.4	7.5	5.7	6.7	8.0

**Capital Structure**

	2018A	2019A	2020E	2021E	2022E
Interest cover EBIT (x)	9.8	10.1	4.6	5.2	6.3
Interest cover EBITDA (x)	11.1	11.7	6.9	7.6	8.9
Net debt/ND+E (%)	37.4	35.6	42.7	40.7	38.4
Net debt/EBITDA (x)	1.4	1.3	1.7	1.4	1.2

**Key Ratios**

	2018A	2019A	2020E	2021E	2022E
Return on assets (%)	16.8	16.6	9.6	11.2	12.6
Return on equity (%)	23.1	22.3	16.0	18.8	21.2
Return on funds employed (%)	12.9	12.6	10.1	15.0	15.7
EBITDA margin (%)	18.5	18.2	22.0	22.0	22.5
EBIT margin (%)	16.2	15.8	14.5	15.0	16.0
Capex to sales (%)	3.2	3.8	4.3	3.5	3.5
Capex to depreciation (%)	131	151	59	52	56
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	77	78	74	75	75

**Operating Performance**

	2018A	2019A	2020E	2021E	2022E
<b>Revenue (NZ\$m)</b>					
Express Package & Bus. Mail	427.1	451.3	428.7	433.0	463.3
Big Chill	0	0	23.7	99.9	105.9
Information Mgmt	153.8	164.4	157.8	164.4	172.9
<b>Total Sales</b>	<b>580.9</b>	<b>615.7</b>	<b>610.2</b>	<b>697.3</b>	<b>742.1</b>

**EBITDA (NZ\$m)**

	2018A	2019A	2020E	2021E	2022E
Express Package & Bus. Mail	74.8	80.0	88.3	92.2	99.1
Big Chill	0	0	3.9	17.0	18.2
Information Mgmt	35.4	35.3	45.6	47.7	53.6
H/Office	(2.5)	(3.1)	(3.3)	(3.5)	(3.6)
<b>Total EBITDA</b>	<b>107.7</b>	<b>112.2</b>	<b>134.5</b>	<b>153.4</b>	<b>167.3</b>

**EBITDA margin (%)**

	2018A	2019A	2020E	2021E	2022E
Express Package & Business Mail	17.5	17.7	20.6	21.3	21.4
Big Chill	n/a	n/a	16.6	17.0	17.2
Information Mgmt	23.0	21.5	28.9	29.0	31.0
<b>Group EBITDA margin</b>	<b>18.5</b>	<b>18.2</b>	<b>22.0</b>	<b>22.0</b>	<b>22.5</b>

NZDAUD

0.92

0.94

0.94

0.94

0.91

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

## COVID-19 pressures; Big Chill partially mitigates; NEUTRAL

The speed and severity of COVID-19 has significantly impacted the use of relative valuation measures given the heightened level of uncertainty for future earnings and less confidence in consensus earnings forecasts given their inherent lag. As a result, we no longer apply peer comparative multiples in our sum-of-the-parts valuation approach. Instead, we apply forward PE multiples for Express Package (18x), Big Chill (16x) and Information Management (14x), that we believe fairly reflects (1) the lower earnings outlook, (2) the level of uncertainty, and (3) historical valuation levels for FRE and its peers. Together with the negative earnings revision impact on our DCF (discounted cash flow valuation), we lower our target price to NZ\$6.40 and retain a NEUTRAL rating.

### Earnings revisions

We adjust our forecasts to reflect (1) an initial estimate on the impact on the COVID-19 lock downs in New Zealand and Australia, and the economic challenges thereafter - we assume four weeks in both markets, (2) consolidation of Big Chill, and (3) the dilution of the fully underwritten DRP (dividend reinvestment plan) and the NZ\$30m share issue to the Big Chill vendors as part of the purchase price.

Our earnings forecasts fall materially as summarised in Figure 1, however, **FRE remains profitable and continues to pay a dividend.**

**Figure 1. Earnings revisions summary (NZ\$m)**

	FY20E			FY21E			FY22E		
	Old	New	Chg	Old	New	Chg	Old	New	Chg
Sales revenue	630.1	610.2	-3.2%	652.1	697.3	6.9%	681.6	742.1	8.9%
EBITDA	143.1	134.5	-6.0%	152.7	153.4	0.5%	160.3	167.3	4.4%
EBITA	125.6	116.0	-7.7%	133.4	132.3	-0.8%	140.9	146.2	3.7%
Adjusted NPAT	57.2	49.0	-14.4%	63.3	60.1	-5.0%	69.6	71.2	2.2%
<b>Underlying EPS (cents)</b>	<b>37.0</b>	<b>31.0</b>	<b>-16.1%</b>	<b>40.9</b>	<b>36.3</b>	<b>-11.1%</b>	<b>45.0</b>	<b>43.0</b>	<b>-4.3%</b>
Full year DPS (cents)	30.5	23.0	-24.6%	30.7	27.3	-11.1%	33.7	32.3	-4.3%

Source: Forsyth Barr analysis

Our consolidation approach to Big Chill is not wholly consistent with our existing approach to lease accounting (IFRS 16) within our earnings estimates. The historic profit data provided by FRE for Big Chill is on old NZ GAAP basis and it has yet to determine the impact of IFRS 16 on Big Chill's earnings. We, therefore, include Big Chill within our estimates (which now incorporate IFRS 16) on a pre-IFRS 16 basis. This isn't optimal but we expect to refine our Big Chill forecasts when management provides more information concerning the impact of IFRS 16.

### Trading update and cost levers being pulled

FRE's trading update provides a number of insights into recent performance and ongoing activity. In particular it states:

- All FRE businesses in NZ are classed either as essential services or suppliers to an essential service
- In March, prior to Level 4 lock down, Express Package volume was up +3% year on year
- During the first few days of the lock down hub & spoke parcel volumes were down -65%
- Information Management's storage revenue (33% of the divisional revenue) will remain intact but other activity will fall away

Consequently, revenue through 2H20 will be materially impacted by the period of lock-down. However, FRE has a number of mitigating cost measures in place.

### Labour cost levers

During the lock down and the immediate aftermath FRE's cost base will benefit from a number of labour related measures. (1) Its NZ businesses will likely qualify for the government's wage subsidy package, which will account for a substantial portion of wage and salary costs during the next few months. (2) During April, FRE will reduce its wage/salary bill to 80% of normal levels. This may be extended if the lock-down is prolonged. (3) FRE's owner driver model means that its contractor costs are predominantly variable. Contractors may apply for government assistance themselves.

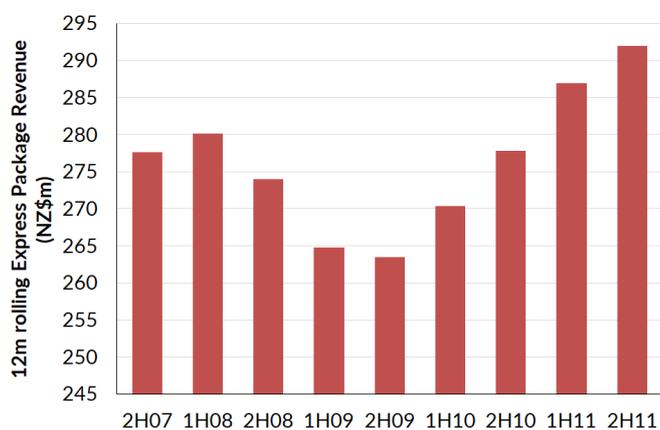
## GFC reminder

Once the lock-down ends the near term outlook will be dominated by the economic recovery, which may have a false start given the likelihood of pent up demand being released immediately before the reality of higher unemployment sets in. The last recession that FRE endured was the global financial crisis (GFC).

While the company's footprint has grown materially since then (revenue has more than doubled and it has grown through M&A), the GFC still provides a useful benchmark for FRE performance once the lock-down ends.

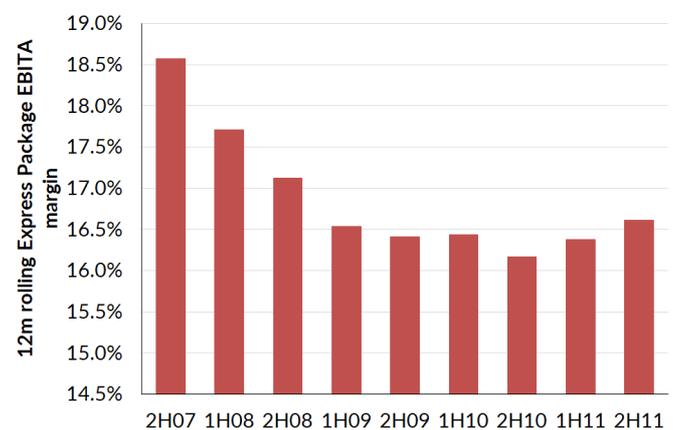
Our analysis in Figure 2 shows that FRE's express package revenue fell by -5% during FY09 at the height of the GFC. Divisional margins also declined and never recovered (Figure 3). We, therefore, believe it is prudent to assume that Express Package revenue will fall by at least -5% over the next 12 months (we assume ~-8% to reflect the negative impact of the fuel adjustment factor, given recent material oil price declines), despite the likely benefit to B2C (business to consumer) volumes from consumer behavioural changes, which may include more online shopping.

**Figure 2. Express Package revenue through GFC**



Source: FRE, Forsyth Barr analysis

**Figure 3. Express Package margins through the GFC**



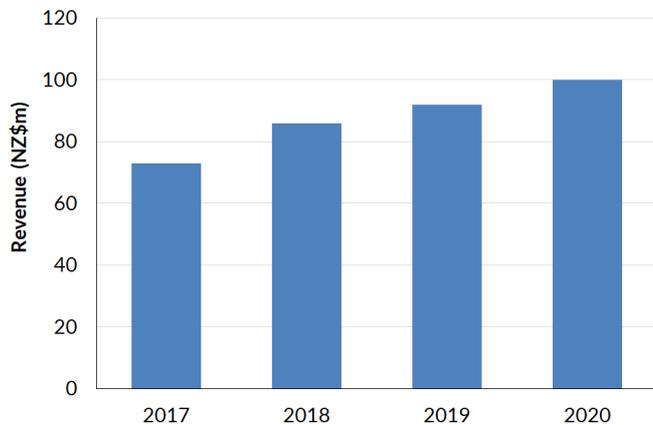
Source: FRE, Forsyth Barr analysis

Harder to gauge is the impact on margins over the next 12 months given the uncertainty around industry pricing measures in light of COVID-19 disruption. We expect the industry will continue to price up above historical trend levels, but the level of increase may be lower than it would have been if not for COVID-19. Moreover, FRE may adjust its approach to pricing for effort in light of the broader trading backdrop.

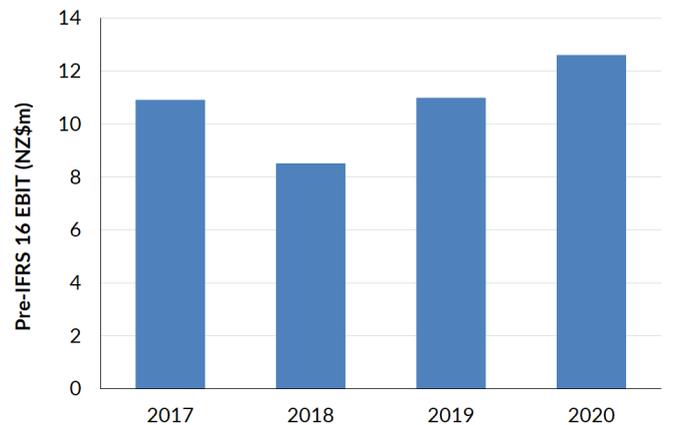
We assume margins contract across FRE's operations to reflect lower activity levels through the remainder of FY20 and into FY21.

## Consolidating Big Chill

We incorporate Big Chill into our earnings forecasts for the first time given the new profit and loss disclosures provided by FRE. Big Chill generated revenue of ~NZ\$100m and EBIT of ~NZ\$12.6m in the year to March 2020. Disclosed earnings exclude IFRS-16 adjustments, so are not fully compatible with our modelling approach but help provide a better reflection of FRE's earnings outlook given the accretion generated by the acquisition.

**Figure 4. Big Chill revenue in recent years (year to March)**


Source: FRE, Forsyth Barr analysis

**Figure 5. Big Chill EBIT in recent years (year to March)**


Source: FRE, Forsyth Barr analysis

### Deal structure altered to preserve balance sheet

Having already fully underwritten its dividend reinvestment plan (NZ\$23m), the company has also changed the structure of its payment to Big Chill's vendors by switching NZ\$30m of the initial payment from cash to shares. These actions provide ample headroom on existing banking facilities (~NZ\$50m). Our forecasts suggest that net debt to (pre-IFRS 16) EBITDA will be ~1.8x in FY21, very comfortably within FRE's banking covenants, which have historically been set at ~3.25x.

The initial cost of the deal remains NZ\$117m with a final payment payable in late 2022 based on 20% of the value of Big Chill as at 30 June 2022, calculated as FY22 EBIT multiplied by a multiple dictated by the level of EBIT growth in FY21.

### Earnings accretion swamped by macro challenges

We estimate the deal is ~+7% EPS accretive on an annualised basis from FY21 albeit given the likely earnings headwinds across the group over the next 12 months, this won't be overly noticeable. Once FRE pays the final ~20% of the purchase price in FY23, the level of accretion will reduce.

### Big Chill "trading well"

As an essential services provider Big Chill is operating on business as usual basis. While volumes will have been in excess of normal given the consumer inventory build in recent weeks, we expect overall business volumes to be largely immune to COVID-19 and the lock-down, given their very defensive nature. However, the channel switch from foodservice to supermarket (given the closure of restaurants and cafes) will have some impact on revenues given the lower margin nature of bulk compared to customised deliveries.

## 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

- **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 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.

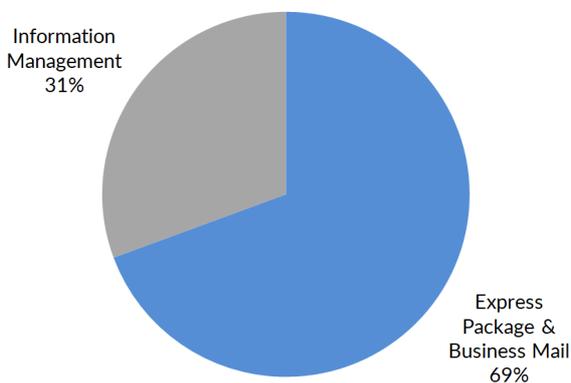
### Financial structure

- **Conservative gearing:** FRE has a conservative balance sheet, even after acquiring Big Chill, which provides scope for further M&A.

### Risk factors

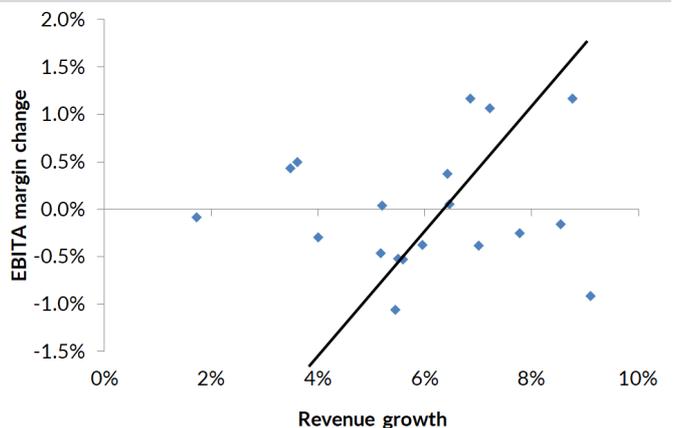
- **Cyclical environment:** FRE is exposed to the cyclical environment and therefore any sustained downturn will have an adverse impact on its performance.
- **Wage inflation:** The NZ courier industry largely uses a contractor model for its last mile deliveries. These owner drivers are outside minimum 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 6. EBITDA divisional split (FY19)

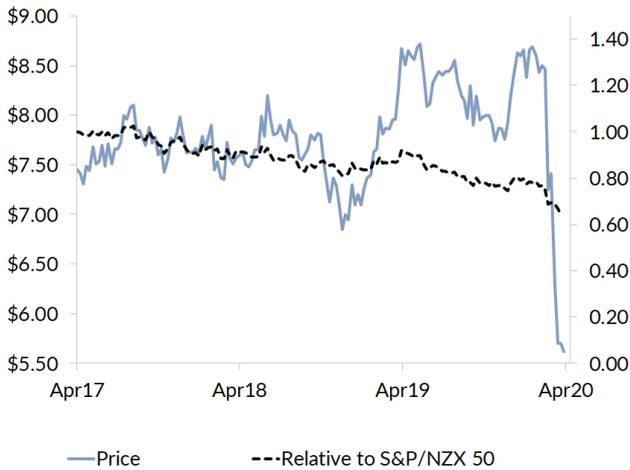


Source: Forsyth Barr analysis

Figure 7. Express Package operating leverage (HYs: FY10 to 1H20)



Source: Forsyth Barr analysis

**Figure 8. Price performance**


Source: Forsyth Barr analysis

**Figure 9. Substantial shareholders**

Shareholder	Latest Holding
Investment Services Group	6.8%
ANZ NZ Investments	6.5%
Fisher Funds Management	5.8%

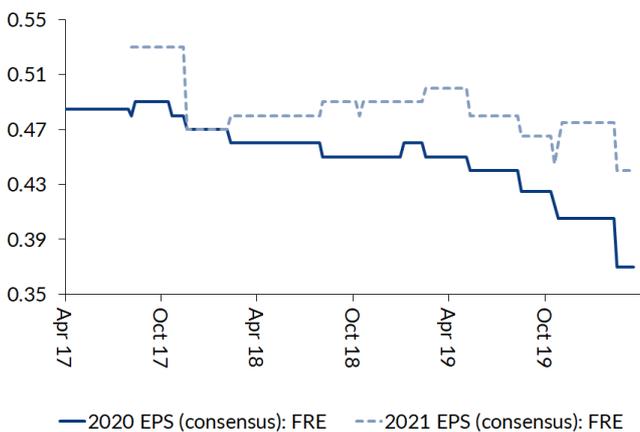
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

**Figure 10. International valuation comparisons**

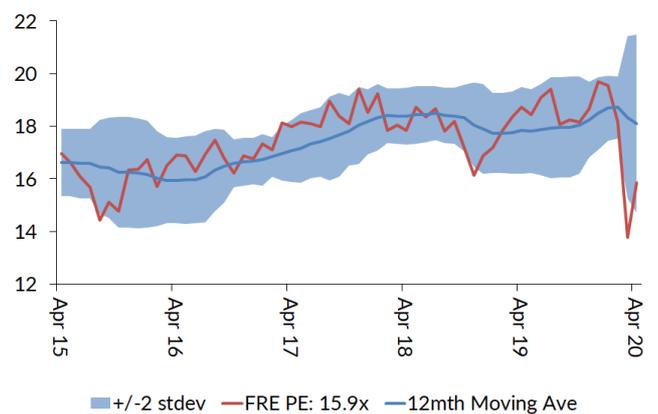
Company	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash Yld 2021E
				2020E	2021E	2020E	2021E	2020E	2021E	
<b>Freightways</b>	<b>FRE NZ</b>	<b>NZ\$5.62</b>	<b>NZ\$930</b>	<b>18.1x</b>	<b>15.5x</b>	<b>8.0x</b>	<b>7.0x</b>	<b>12.2x</b>	<b>10.3x</b>	<b>4.8%</b>
Mainfreight *	MFT NZ	NZ\$31.05	NZ\$3,127	19.4x	17.6x	11.2x	10.3x	14.0x	12.7x	2.3%
FEDEX CORP	FDX US	US\$116.94	US\$30,577	11.9x	10.5x	9.1x	8.1x	19.0x	15.9x	2.3%
UNITED PARCEL SERVICE-CL B	UPS US	US\$93.58	US\$79,312	15.1x	11.6x	9.5x	9.2x	12.7x	12.0x	4.4%
DEUTSCHE POST AG-REG	DPW GR	€23.16	€28,557	10.4x	9.5x	5.3x	4.9x	9.7x	8.8x	5.7%
ARAMEX PJSC	ARMX UH	AED2.13	AED3,119	6.3x	6.2x	4.1x	4.2x	6.3x	6.6x	10.1%
IRON MOUNTAIN INC	IRM US	US\$23.40	US\$6,721	19.8x	16.0x	10.3x	10.8x	21.1x	n/a	10.7%
<b>Compco Average:</b>				<b>13.8x</b>	<b>11.9x</b>	<b>8.2x</b>	<b>7.9x</b>	<b>13.8x</b>	<b>11.2x</b>	<b>5.9%</b>
<b>FRE Relative:</b>				<b>31%</b>	<b>30%</b>	<b>-3%</b>	<b>-11%</b>	<b>-11%</b>	<b>-8%</b>	<b>-18%</b>

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 11. Consensus EPS momentum (NZ\$)**


Source: Forsyth Barr analysis

**Figure 12. One year forward PE (x)**


Source: Forsyth Barr analysis

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