FORSYTH BARR

NEW ZEALAND EQUITY RESEARCH | TRANSPORT | COURIER & DOCUMENT STORAGE
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Freightways
FY20 — Pricing for Effort Lifts Target

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OUTPERFORM

We upgrade Freightways (FRE) to OUTPERFORM; the company has started FY21 on an above trend growth trajectory, which is supportive to earnings upgrades and a valuation re-rating. FRE is considered a GDP proxy stock, yet we believe has the potential to outgrow economic activity via strategic growth. Trading at a relatively attractive ~18x one year forward PE, FRE offers value for risk in an otherwise expensive market. The FY20 result is messy and difficult to analyse given the impact of (1) COVID-19, (2) first year of IFRS-16 (accounting for leases), and (3) the acquisition in April 2020 of Big Chill. However, cashflow was robust and improved management disclosure offers insight into the forward looking opportunity, particularly in the Express Package operations that are winning share and now generating better margins in the business-to-consumer (B2C) channel.

NZX Code	FRE
Share price	NZ$7.10
Target price	NZ$8.20
Risk rating	Medium
Issued shares	165.4m
Market cap	NZ$1,174m
Avg daily turnover	186.9k (NZ$1,331k)

Financials: Jun/	20A	21E	22E	23E
NPAT* (NZ$m)	56.0	64.6	74.3	81.0
EPS* (NZc)	35.5	39.1	44.9	49.0
EPS growth* (%)	-9.7	10.2	15.0	9.0
DPS (NZc)	15.0	29.3	33.7	36.7
Imputation (%)	100	100	100	100
*Based on normalised profits				

Valuation (x)	20A	21E	22E	23E
EV/EBITDA	9.3	8.2	7.5	7.1
EV/EBIT	15.9	12.2	10.9	10.1
PE	20.0	18.2	15.8	14.5
Price / NTA	n/a	n/a	n/a	n/a
Cash div yld (%)	2.1	4.1	4.7	5.2
Gross div yld (%)	2.9	5.7	6.6	7.2

What's changed?
- **Earnings:** FY21 NPAT lifted by +6%, FY22 +3%
- **Target price:** Raised to NZ$8.20 to reflect revised cost of capital assumptions and earnings upgrades

Express Package accelerating into FY21

FRE has enjoyed an impressive start to FY21 with year-to-date volume growth of +11% in its network courier operations. This reflects a combination of new and existing business, with both B2B (business-to-business) and B2C (business-to-consumer) contributing. With B2C's share of total volume growing to ~24% from ~20% in 1H20, we deduce that B2C is currently growing ~+30% against the prior year, implying solid market share gains on better margins (given 'pricing for effort' gains and better productivity).

Information Management key area of uncertainty

The impact of COVID-19 will likely be more enduring on Information Management given many of its activity based services benefit from office occupancy. FRE implemented a number of initiatives mid-year to counter the deterioration in profitability prior to COVID-19 and should be more adaptable to volume changes via cost base adjustments to protect margins through FY21. Once normal activity levels resume the division has scope for a step recovery in profitability.

Moral compass in favour of dividend

FRE's decision to not pay a final dividend is both prudent and sensible, in our opinion. It avoids the potential social consequences/fall-out of qualifying for, and claiming, wage subsidies, despite little (redundancy) threat to the workforce, and then paying shareholders a dividend out of subsidy supported earnings. We expect FRE to resume dividend payments in FY21 at an attractive, in light of its growth profile, ~6% gross yield.

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Freightways Ltd (FRE)

Priced as at 24 Aug 2020 (NZ$)	7.10

12-month target price (NZ$)*	**8.20**
Expected share price return	15.5%
Net dividend yield	4.2%
Estimated 12-month return	19.7%

Key WACC assumptions	
Risk free rate	1.30%
Equity beta	1.00
WACC	6.1%
Terminal growth	1.0%

Profit and Loss Account (NZ$m)	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Sales revenue	615.7	630.9	738.8	781.4	815.7
Normalised EBITDA	**112.2**	**144.7**	**165.6**	**176.6**	**186.1**
Depreciation and amortisation	(17.5)	(50.4)	(55.1)	(55.0)	(55.2)
Normalised EBIT	**97.1**	**84.7**	**110.5**	**121.5**	**130.9**
Net interest	(9.6)	(18.4)	(19.4)	(17.0)	(17.0)
Associate income	0	0	0	0	0
Tax	(24.1)	(18.0)	(26.5)	(30.3)	(32.9)
Minority interests	0	0	0	0	0
Normalised NPAT	**61.0**	**56.0**	**64.6**	**74.3**	**81.0**
Abnormals/other	2.4	(8.7)	0	0	0
Reported NPAT	**63.4**	**47.4**	**64.6**	**74.3**	**81.0**
Normalised EPS (cps)	39.3	35.5	39.1	44.9	49.0
DPS (cps)	30.5	15.0	29.3	33.7	36.7

Growth Rates	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Revenue (%)	6.0	2.5	17.1	5.8	4.4
EBITDA (%)	4.2	28.9	14.5	6.6	5.4
EBIT (%)	2.9	-12.7	30.5	10.0	7.7
Normalised NPAT (%)	2.4	-8.2	15.4	15.0	9.0
Normalised EPS (%)	2.2	-9.7	10.2	15.0	9.0
Ordinary DPS (%)	2.5	-50.8	95.4	15.0	9.0

Cash Flow (NZ$m)	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
EBITDA	**112.2**	**144.7**	**165.6**	**176.6**	**186.1**
Working capital change	0	0	0.0	0	0.0
Interest & tax paid	(33.7)	(28.6)	(36.6)	(37.9)	(40.5)
Other	(2.5)	11.1	(12.8)	(12.8)	(12.8)
Operating cash flow	**76.0**	**127.2**	**116.2**	**125.9**	**132.8**
Capital expenditure	(23.3)	(23.6)	(23.3)	(27.3)	(28.6)
(Acquisitions)/divestments	(8.7)	(101.6)	0	0	(38.4)
Other	1.9	(24.0)	(25.0)	(25.0)	(25.0)
Funding available/(required)	**46.0**	**(22.0)**	**68.0**	**73.6**	**40.9**
Dividends paid	(47.0)	(47.5)	(24.2)	(55.7)	(60.8)
Equity raised/(returned)	0.7	24.1	0	0	0
(Increase)/decrease in net debt	**(0.3)**	**(45.4)**	**43.7**	**17.8**	**(19.9)**

Balance Sheet (NZ$m)	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Working capital	23.8	18.7	21.5	22.4	23.1
Fixed assets	106.7	134.6	130.5	130.3	131.3
Intangibles	365.2	499.0	504.3	509.6	528.0
Right of use asset	0	278.1	278.1	278.1	278.1
Other assets	4.0	15.6	15.6	15.6	15.6
Total funds employed	**499.7**	**946.1**	**950.0**	**956.1**	**976.1**
Net debt/(cash)	151.4	205.0	161.3	143.4	163.4
Lease liability	0	311.1	311.1	311.1	311.1
Other liabilities	74.3	113.2	113.2	113.2	113.2
Shareholder's funds	273.9	316.7	364.3	388.2	388.3
Minority interests	0.1	0.1	0.1	0.1	0.1
Total funding sources	**499.7**	**946.1**	**950.0**	**956.1**	**976.1**

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

Spot valuations (NZ$)	
1. DCF	8.28
2. Sum-of-the-parts	7.34
3. n/a	n/a

DCF valuation summary (NZ$m)	
Total firm value	2,258
(Net debt)/cash	(153)
Less: Capitalised operating leases	(735)
Value of equity	1,370

Valuation Ratios	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
EV/EBITDA (x)	11.8	9.3	8.2	7.5	7.1
EV/EBIT (x)	13.7	15.9	12.2	10.9	10.1
PE (x)	18.1	20.0	18.2	15.8	14.5
Price/NTA (x)	n/a	n/a	n/a	n/a	n/a
Free cash flow yield (%)	4.5	8.8	7.9	8.4	8.9
Net dividend yield (%)	4.3	2.1	4.1	4.7	5.2
Gross dividend yield (%)	6.0	2.9	5.7	6.6	7.2

Capital Structure	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Interest cover EBIT (x)	10.1	4.6	5.7	7.2	7.7
Interest cover EBITDA (x)	11.7	7.9	8.5	10.4	10.9
Net debt/ND+E (%)	35.6	39.3	30.7	27.0	29.6
Net debt/EBITDA (x)	1.3	1.4	1.0	0.8	0.9

Key Ratios	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Return on assets (%)	16.6	8.1	10.5	11.4	12.0
Return on equity (%)	22.3	17.7	17.7	19.1	20.9
Return on funds employed (%)	12.6	12.0	16.4	16.8	17.1
EBITDA margin (%)	18.2	22.9	22.4	22.6	22.8
EBIT margin (%)	15.8	13.4	15.0	15.6	16.0
Capex to sales (%)	3.8	3.7	3.2	3.5	3.5
Capex to depreciation (%)	151	50	45	53	55
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	78	42	75	75	75

Operating Performance	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Revenue (NZ$m)					
Express Package & Bus. Mail	451.3	472.2	571.3	599.9	626.9
Information Mgmt	164.4	158.8	167.5	181.5	188.9
Total Sales	**615.7**	**630.9**	**738.8**	**781.4**	**815.7**
EBITDA (NZ$m)					
Express Package & Bus. Mail	80.0	101.7	117.1	123.0	128.5
Information Mgmt	35.3	47.1	52.8	58.1	62.3
H/Office	(3.1)	(4.1)	(4.3)	(4.5)	(4.7)
Total EBITDA	**112.2**	**144.7**	**165.6**	**176.6**	**186.1**
EBITDA margin (%)					
Express Package & Business Mail	17.7	21.5	20.5	20.5	20.5
Information Mgmt	21.5	29.6	31.5	32.0	33.0
Group EBITDA margin	**18.2**	**22.9**	**22.4**	**22.6**	**22.8**
NZDAUD	0.91	0.95	0.91	0.90	0.89

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Upgrade to OUTPERFORM

We upgrade Freightways (FRE) to OUTPERFORM from NEUTRAL to reflect (1) market share gains in parcel operations driving sustainable parcel growth through FY21, (2) improving return on capital in the B2C channel as a result of its 'Pricing for Effort' initiative, implying scope for greater focus on new customer wins/share gains, (3) recovery opportunity in Information Management as office occupancy resumes and lifts activity based revenue, and (4) a more nimble approach to managing COVID-19 through FY21 with more dynamic cost management.

FRE has a number of attractive businesses. Express Package is a global leader in courier margins and return on capital. Big Chill is a market leader in the structurally growing temperature controlled freight sector. Destruction services, including Shred-X, is the market leader in Australasia and continues to seek new revenue streams. We also recognise FRE has several businesses within Information Management that have underperformed in recent periods or are already in their sunset years. These may continue to partially offset the progress made elsewhere across the group, though we expect capital allocation to increasingly be aligned with growth.

We lift our target price to NZ$8.20 to reflect (1) our revised WACC inputs (risk free rate 1.3%, market risk premium 6.0%) partly offset by a lower terminal growth rate assumption (1.0% from 1.5%), and (2) modest earnings upgrades as outlined below.

Result summary

FRE reported a softer COVID-19 impacted FY20 result with NPAT (before non-recurring items and IFRS-16 adjustments) down -4% against the prior year. With the introduction of IFRS 16 it was -8%. Moreover, after accounting for the ~NZ$16m of wage subsidies in NZ and Australia, the result was weaker than we anticipated by c.-7% at the underlying NPAT level. This is not a concern given the temporary and one-off nature of the profit hit in April and May given severe government restrictions. The result is complicated by introduction of IFRS-16, the impact of COVID-19 and the first time consolidation of Big Chill. FRE will not pay a final dividend. This is consistent with our view; we believe this is a very sensible Board decision in light of (1) its wage subsidy receipts, and (2) the heightened level of uncertainty that persists.

Figure 1. Result summary (NZ$m)

	FY19	FY20	Change	Forbar
Sales revenue	615.7	630.9	2%	632.8
EBITDA	112.2	144.7	29%	134.5
EBITA	96.8	97.8	1%	90.5
Reported NPAT	63.4	47.4	-25%	60.3
Underlying NPAT	**61.0**	**56.0**	**-8%**	**49.5***
Underlying EPS (cents)	39.3	35.5	-10%	31.3
Final DPS (cents)	15.5	0.0	n/a	0.0

Source: FRE, Forsyth Barr analysis Note: Our forecast excludes the post-tax benefit of wage subsidy receipts of ~NZ$11m. Adjusting for this would lift our forecast to ~NZ$60m.

Figure 2. Divisional splits (NZ$m)

	FY19	FY20#	Change	FY20##
Express Package	451.3	472.2	5%	472.2
Information Management	164.4	158.8	-3%	158.8
Total revenue	**615.7**	**630.9**	**2%**	**630.9**
Express Package	80.0	85.6	7%	101.7
Information Management	35.3	29.6	-16%	47.1
Corporate & Other	(3.1)	(4.2)	35%	(4.1)
Total EBITDA	**112.2**	**111.0**	**-1%**	**144.7**

Source: FRE, Forsyth Barr analysis # pre-IFRS16, ## post-IFRS16

Earnings revisions

We lift our earnings forecasts in both FY21 and FY22, as summarised in Figure 3, to reflect (1) the strong volume revenue momentum achieved in FY21-to-date, and (2) higher margin assumptions in Information Management as its digitisation project work steps up, and FY20 cost base initiatives deliver.

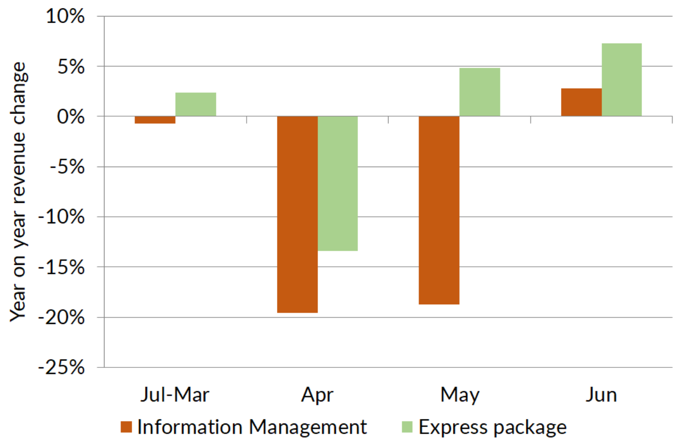
Figure 3. Earnings revisions (NZ$m)

	FY21E			FY22E			FY23E		
	Old	New	Chg	Old	New	Chg	Old	New	Chg
Sales revenue	720.0	738.8	2.6%	766.5	781.4	1.9%	n/a	815.7	n/a
EBITDA	153.7	165.6	7.7%	167.7	176.6	5.3%	n/a	186.1	n/a
EBITA	132.6	143.4	8.2%	146.4	154.4	5.5%	n/a	163.8	n/a
Underlying NPAT	**61.2**	**64.6**	**5.6%**	**72.2**	**74.3**	**2.9%**	**n/a**	**81.0**	**n/a**
Underlying EPS (cents)	37.0	39.1	5.6%	43.7	44.9	2.9%	n/a	49.0	n/a
Full year DPS (cents)	27.8	29.3	5.6%	32.7	33.7	2.9%	n/a	36.7	n/a

Source: Forsyth Barr analysis

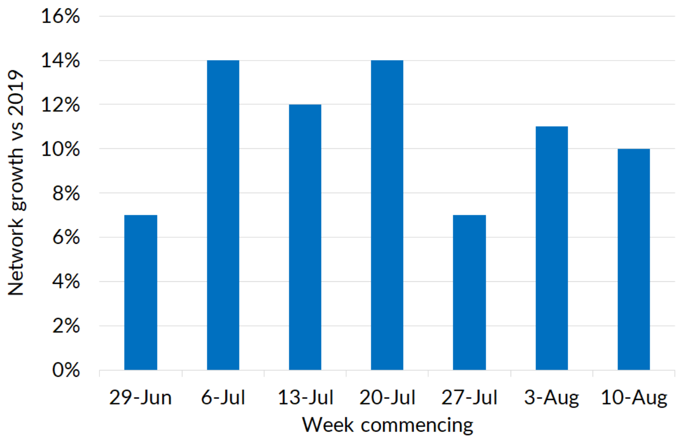
Key charts from FY20 result

Figure 4. COVID-19 significantly impacted revenue through April and May, though the business had recovered by June...



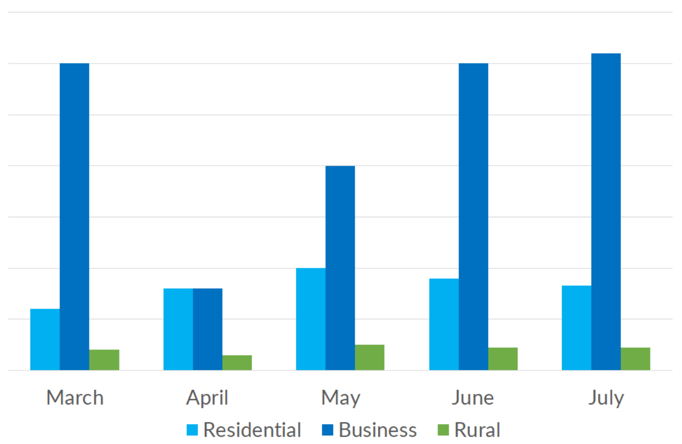
Source: FRE, Forsyth Barr analysis

Figure 5. ...and accelerated into July/August. Express Package network volumes are up +11% year to date in FY21



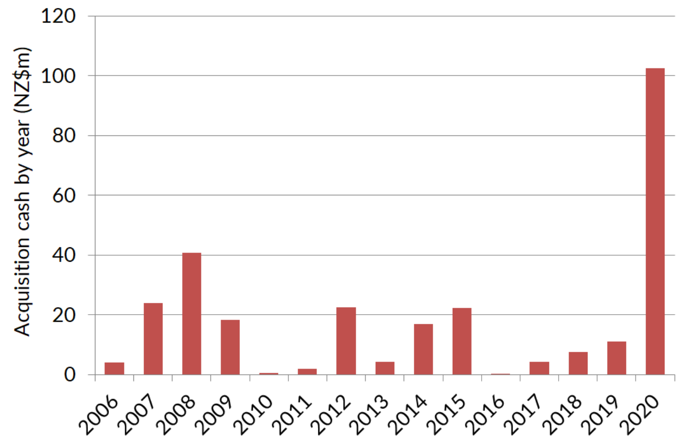
Source: FRE, Forsyth Barr analysis

Figure 6. Higher margin B2B Express Package have recovered fully. B2C growth has slowed since May but remains strong



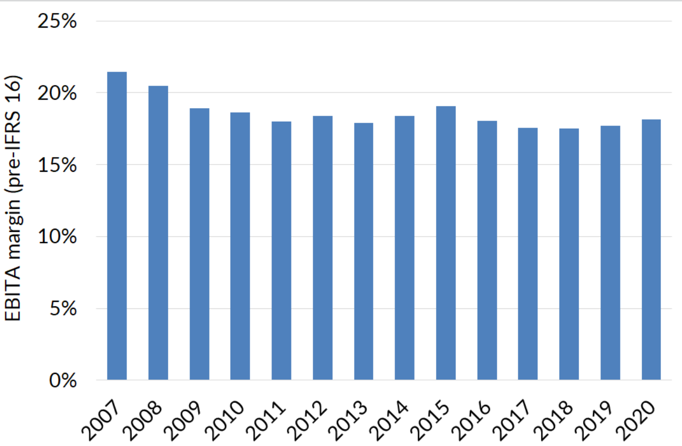
Source: FRE, Forsyth Barr analysis

Figure 7. Break-out acquisition in FY20 with Big Chill. Signals more aggressive approach and focus on structural growth sectors



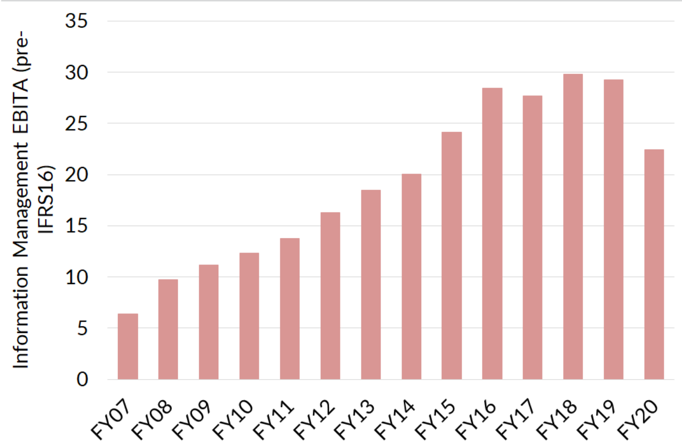
Source: FRE, Forsyth Barr analysis

Figure 8. Express Package margins enhanced in FY20 by (1) wage subsidies, (2) B2C productivity, and (3) 'Pricing for Effort' gains of 73c by year end, more than offsetting adverse mix of higher growth B2C parcels, and Big Chill initial contribution



Source: FRE, Forsyth Barr analysis

Figure 9. Information Management had a tough FY20. 1H20 deterioration led to a range of turnaround initiatives to improve performance but then COVID-19 hit. Lower B2B activity in Australia will remain an issue through 1H21



Source: FRE, Forsyth Barr analysis

Result analysis

Figure 10. FY20 result summary (NZ$m)

	FY19	FY20	Chg	Comments
Profit and loss account				
Sales revenue	615.7	630.9	2.5%	Includes NZ$22m from Big Chill
Express Package & Business Mail	80.0	101.7	27.1%	Pre-IFRS 16 increased +7%, though half of this reflects Big Chill acquisition
Information Management	35.3	47.1	33.1%	Boosted by IFRS 16. Like-for-like declined -16%
Corporate & Other	(3.1)	(4.1)	-29.6%	
EBITDA	**112.2**	**144.7**	**28.9%**	
Depreciation and amortisation	(15.4)	(18.5)	-19.6%	Guidance for FY21 is NZ$23m of depreciation
Lease depreciation	0.0	(28.4)	n/a	FY21 guidance for IFRS 16 lease depreciation of NZ$18m
Acquisition amortisation	(2.1)	(3.5)	-67.9%	
One-time items	2.4	(9.6)	n/a	Includes NZ$5.2m of goodwill impairment and NZ$2.7m of obsolete software
Interest expense	(9.6)	(9.7)	-1.1%	
Lease interest	0.0	(8.8)	n/a	Introduction of IFRS 16 — lease accounting
Profit before tax	87.5	66.3	-24.2%	
Taxation	(24.1)	(18.9)	21.5%	Effective tax rate of ~29%
Reported NPAT	**63.4**	**47.4**	**-25.2%**	
Abnormals (post tax)	(2.4)	8.7	467.5%	
Underlying NPAT	**61.0**	**56.0**	**-8.2%**	
Underlying EPS (cents)	39.3	35.5	-9.7%	Average shares on issue of 158m. Year end shares on issue of 165.4m
Final DPS (cents)	15.50	0.00	-100.0%	No final dividend citing near term uncertainty and wage subsidy receipts, expect to resume dividend in FY21
Cashflow and net debt				
Operating cashflow	76.0	127.2	67%	Boosted by IFRS 16
Maintenance capex = depreciation	(15.4)	(18.5)	-20%	Capex guidance of between NZ$20m–NZ$22m for FY21
Disposals	2.5	0.8	-65%	
Free cash flow	63.0	109.5	74%	
Acquisitions	(11.1)	(102.4)	-822%	Acquired Big Chill, including NZ$84.5m of cash paid during FY20
Net debt	(151.4)	(205.0)	-35%	Gearing of 38% excl IFRS 16 lease liabilities. Gearing of 62% incl lease liabilities
Margin analysis				
Express Package & Business Mail*	17.7%	18.1%	40 bps	Reduction in higher margin B2B volumes as a proportion of network volumes through April
Information Management*	21.5%	18.6%	-286 bps	1H20 challenges particulalry in LitSupport, lower paper prices, COVID-19 hit in 2H20
Group EBITDA margin	18.2%	22.9%	470 bps	Prima Facie margins boosted by IFRS 16
Group EBITA margin	15.7%	15.5%	-22 bps	
Divisional sales growth				
Express Package & Business Mail	5.7%	4.6%	-103 bps	Impacted to a large degree through April and May by COVID-19
Information Management	6.9%	-3.4%	-1033 bps	Delay to digitisation projects in Australia

Source: FRE, Forsyth Barr analysis * pre-IFRS 16 margins

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), despite near term uncertainty, FRE has a number of positive medium term drivers in place. OUTPERFORM.

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 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.

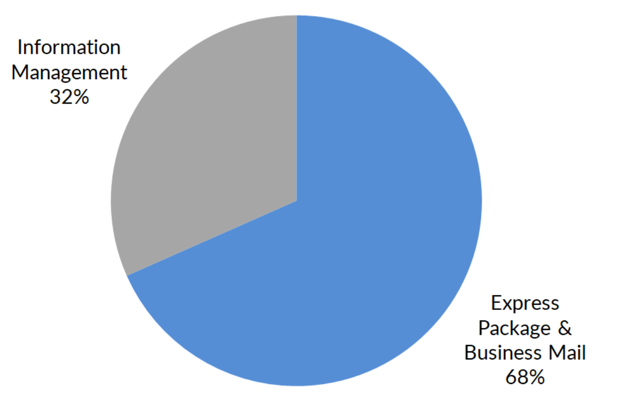
Financial structure

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

Risk factors

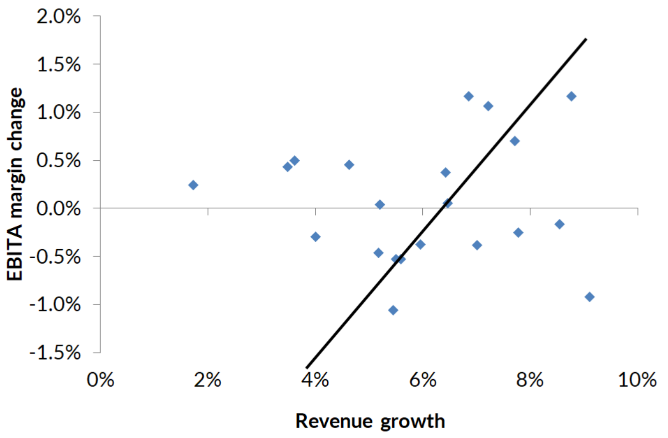
- **Cyclical environment**: FRE is exposed to the cyclical environment and therefore any sustained downturn will have an adverse impact on its performance.
- **Wage inflation**: The NZ courier industry largely uses a contractor model for its last mile deliveries. These owner drivers are outside minimum 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 11. EBITDA divisional split (FY20)



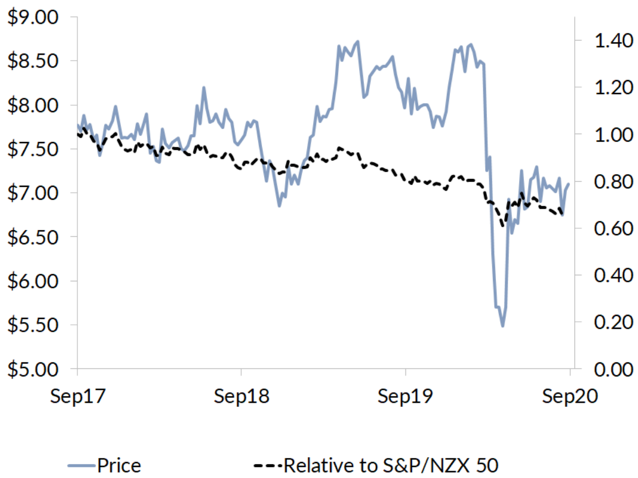
Source: FRE, Forsyth Barr analysis

Figure 12. Express Package op leverage (HYs: FY10 to FY20)



Source: FRE, Forsyth Barr analysis

Figure 13. Price performance



Source: Forsyth Barr analysis

Figure 14. Substantial shareholders

Shareholder	Latest Holding
ANZ NZ Investments	6.5%
Investment Services Group	5.7%

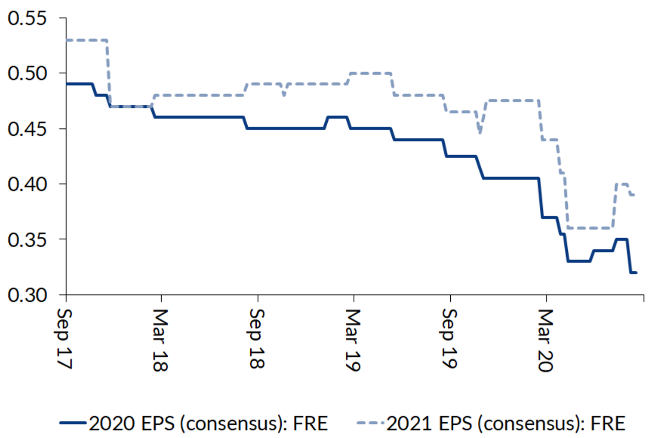
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 15. International valuation comparisons

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash Yld
(metrics re-weighted to reflect FRE's balance date - June)			(m)	2021E	2022E	2021E	2022E	2021E	2022E	2022E
Freightways	**FRE NZ**	**NZ$7.10**	**NZ$1,174**	**18.2x**	**15.8x**	**8.3x**	**7.8x**	**12.5x**	**11.4x**	**4.7%**
MAINFREIGHT *	MFT NZ	NZ$46.25	NZ$4,657	26.7x	22.6x	10.8x	9.8x	18.0x	15.5x	1.8%
FEDEX CORP	FDX US	US$216.74	US$56,796	20.3x	17.0x	11.6x	10.3x	22.9x	18.9x	1.3%
UNITED PARCEL SERVICE-CL B	UPS US	US$159.64	US$137,829	21.4x	19.1x	15.4x	13.7x	20.2x	17.7x	2.6%
DEUTSCHE POST AG-REG	DPW GR	€38.76	€47,927	17.5x	15.2x	7.7x	7.0x	14.4x	12.4x	3.5%
ARAMEX PJSC	ARMX UH	AED3.64	AED5,329	15.1x	12.0x	6.7x	6.0x	10.0x	8.9x	4.5%
IRON MOUNTAIN INC	IRM US	US$30.16	US$8,692	24.6x	22.5x	13.2x	12.3x	26.5x	22.7x	8.2%
			Compco Average:	**20.9x**	**18.1x**	**10.9x**	**9.9x**	**18.7x**	**16.0x**	**3.7%**
EV = Current Market Cap + Actual Net Debt			**FRE Relative:**	**-13%**	**-13%**	**-24%**	**-21%**	**-33%**	**-29%**	**30%**

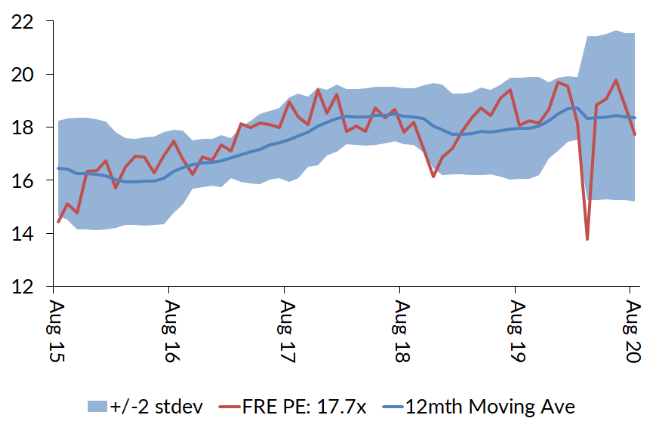
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (FRE) companies fiscal year end

Figure 16. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 17. One year forward PE (x)



Source: Forsyth Barr analysis

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