

Scales

NEUTRAL

1H19 Preview — A Growing Business

Scales (SCL) will report its 1H19 result on Wednesday, 28 August 2019. It has been a transformational past 12-months for SCL with ~NZ\$200m of assets sales and further M&A activity within its Food Ingredients business. Our key focus at the result will be 1) traction of new apple varieties, 2) an update on, and progression of, the evolving pet food strategy, and 3) additional clarity around possible transformational acquisitions. SCL's current FY19 guidance is for underlying NPAT of NZ\$32m to NZ\$37m which implies an underlying EBITDA guidance range of NZ\$49m to NZ\$55m.

Key issues to consider at SCL's 1H19 result

- Chinese apple prices:** Following a materially weaker Chinese apple harvest, prices of domestic produce soared in China. We expect SCL to have benefitted from positive pricing trends, although not to the same extent as local varieties given SCL's apples tend to sell at a material premium to Chinese produce.
- Traction of new apple varieties:** Mr Apple has launched commercial volumes of new varieties Dazzle™ and Posy™ in China. Orchard redevelopment is occurring in these varieties; therefore, market response and prices achieved will be critical for future success.
- Food ingredients outlook:** SCL has an EBITDA target for its Food Ingredients business of NZ\$25m by FY22, which we view as aspirational without further acquisitions or product development. Having purchased a business, partially sold another, and entered into a joint venture in the past 12 months, we look for more clarity in an updated strategy.
- Major acquisition possible:** Following recent divestments SCL has a net cash position of ~NZ\$107m, with additional balance sheet headroom for debt of ~NZ\$200m. SCL has indicated it is pursuing a potentially transformational acquisition, targeting vertically integrated agriculture companies with a China export focus. The broad spectrum of acquisition possibilities creates investment uncertainty, in our opinion.

Conference call details

SCL will host a 1H19 result conference call at 10am on 28 August 2019. Dial in details: New Zealand 0800 122 360, Conference ID: 10001515

Figure 1. 1H19 result expectations (NZ\$m)

	1H18	1H19	% chg	Consensus
Revenue	220.1	247.0	12%	n/a
EBITDA	46.7	48.3	3%	n/a
Reported NPAT	29.3	34.7	18%	n/a
EPS (cps)	21.0	24.8	18%	n/a
Dividend (cps)	9.5	9.5	0%	n/a

Source: Bloomberg, Forsyth Barr analysis

Investment View

SCL is an export focussed company offering investors broad exposure to New Zealand agriculture, with operations in horticulture and meat processing. Although pet food is a growing part of the business, annual apple harvest outcomes and global apple prices will remain key drivers of business performance in the near-term. NEUTRAL.

NZX Code	SCL
Share price	NZ\$4.80
Target price	NZ\$4.75
Risk rating	Medium
Issued shares	140.3m
Market cap	NZ\$674m
Average daily turnover	93.3k (NZ\$442k)

Share Price Performance



Financials: December	18A	19E	20E	21E
NPAT* (NZ\$m)	28.6	34.7	37.5	40.0
EPS* (NZc)	20.4	24.8	26.7	28.5
EPS growth* (%)	17.9	21.4	7.9	6.9
DPS (NZc)	19.0	19.0	19.0	20.0
Imputation (%)	100	100	100	100

Valuation (x)	18A	19E	20E	21E
EV/EBITDA	14.0	11.9	9.5	9.1
EV/EBIT	17.1	14.8	11.6	10.9
PE	23.5	19.4	18.0	16.8
Price / NTA	3.3	2.3	2.2	2.1
Cash dividend yield (%)	4.0	4.0	4.0	4.2
Gross dividend yield (%)	5.5	5.5	5.5	5.8

*Historic and forecast numbers based on underlying profits

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Scales Corporation (SCL)

Priced as at 12 Jun 2019: NZ\$4.80

December year end

Forsyth Barr valuation		Valuation Ratios					2017A	2018A	2019E	2020E	2021E
Valuation methodology		DCF	EV/EBITDA (x)	15.6	14.0	11.9	9.5	9.1			
			EV/EBIT (x)	19.3	17.1	14.8	11.6	10.9			
12-month target price (NZ\$)*	4.75	Spot valuations (NZ\$)	PE (x)	27.8	23.5	19.4	18.0	16.8			
Expected share price return	-1.0%	1. DCF	4.25	Price/NTA (x)	3.3	3.3	2.3	2.2	2.1		
Net dividend yield	4.0%	2. Comparative multiples	4.80	Free cash flow yield (%)	2.8	3.0	5.6	5.4	5.9		
Estimated 12-month return	2.9%	3. n/a	n/a	Net dividend yield (%)	4.0	4.0	4.0	4.0	4.2		
				Gross dividend yield (%)	5.5	5.5	5.5	5.5	5.8		
Key WACC assumptions		DCF valuation summary (NZ\$m)		Imputation (%)	100	100	100	100	100		
Risk free rate	2.75%	Total firm value	504	Pay-out ratio (%)	110	93	77	71	70		
Equity beta	0.99	(Net debt)/cash	105								
WACC	9.2%	Value of equity	609	Capital Structure	2017A	2018A	2019E	2020E	2021E		
Terminal growth	1.5%	Shares (m)	140	Interest cover EBIT (x)	12.7	17.5	n/a	n/a	n/a		
				Interest cover EBITDA (x)	15.7	21.3	n/a	n/a	n/a		
Profit and Loss Account (NZ\$m)	2017A	2018A	2019E	2020E	2021E						
Sales revenue	355.5	402.5	454.1	470.0	487.5						
Normalised EBITDA	45.3	51.7	55.0	59.9	62.0						
Depreciation and amortisation	(8.6)	(9.2)	(10.7)	(11.1)	(10.1)						
Normalised EBIT	36.7	42.5	44.3	48.8	51.9	Key Ratios	2017A	2018A	2019E	2020E	2021E
Net interest	(2.9)	(2.4)	7.1	6.4	6.9	Return on assets (%)	10.7	10.3	10.8	11.4	11.6
Associate income	-	-	-	-	-	Return on equity (%)	10.9	11.6	10.5	10.7	10.9
Tax	9.3	11.0	14.4	15.5	16.5	Return on funds employed (%)	12.5	12.6	12.4	13.0	13.1
Minority interests	0.4	0.4	2.3	2.3	2.3	EBITDA margin (%)	12.7	12.9	12.1	12.8	12.7
Normalised NPAT	24.1	28.6	34.7	37.5	40.0	EBIT margin (%)	10.3	10.6	9.8	10.4	10.7
Abnormals/other	7.1	16.5	-	-	-	Capex to sales (%)	3.8	4.0	3.3	3.1	2.5
Reported NPAT	31.2	45.1	34.7	37.5	40.0	Capex to depreciation (%)	157	176	139	129	120
Normalised EPS (cps)	17.3	20.4	24.8	26.7	28.5						
DPS (cps)	19.0	19.0	19.0	19.0	20.0	Operating Performance	2017A	2018A	2019E	2020E	2021E
						Revenue split (division)					
Growth Rates	2017A	2018A	2019E	2020E	2021E	Horticulture	228.0	254.6	252.6	256.5	261.2
Revenue (%)	-4.9	13.2	12.8	3.5	3.7	Logistics	101.6	64.5	68.3	71.8	75.4
EBITDA (%)	-33.2	14.2	6.4	8.9	3.4	Food Ingredients	68.9	83.1	133.1	141.8	151.0
EBIT (%)	-34.1	15.7	4.3	10.1	6.4	Total	399.1	402.5	454.1	470.0	487.5
Normalised NPAT (%)	-37.0	18.6	21.4	7.9	6.9	EBITDA split (division)					
Normalised EPS (%)	-37.3	17.9	21.4	7.9	6.9	Horticulture	38.4	43.5	41.7	42.3	41.8
Ordinary DPS (%)	5.6	0.0	0.0	0.0	5.3	Logistics	3.3	4.9	5.1	5.4	5.7
						Food Ingredients	8.2	11.0	15.9	18.3	20.4
Cash Flow (NZ\$m)	2017A	2018A	2019E	2020E	2021E	Overheads	(4.5)	(7.6)	(7.6)	(6.1)	(5.8)
EBITDA	45.3	51.7	55.0	59.9	62.0	Total	45.3	51.7	55.0	59.9	62.0
Working capital change	(11.6)	(23.8)	(24.0)	(31.2)	(33.4)	EBITDA margin (%)					
Interest & tax paid	(12.2)	8.6	21.5	21.9	23.4	Horticulture	16.8	17.1	16.5	16.5	16.0
Other	10.8	-	-	-	-	Logistics	3.2	7.6	7.5	7.5	7.5
Operating cash flow	32.4	36.6	52.5	50.6	52.0	Food Ingredients	11.9	13.3	11.9	12.9	13.5
Capital expenditure	(13.5)	(16.3)	(14.9)	(14.4)	(12.0)	Total	11.4	12.9	12.1	12.8	12.7
(Acquisitions)/divestments	(0.8)	(15.9)	166.4	-	-	Apple volumes ('000 TCE)					
Other	-	-	-	-	-	Premium varieties	1,616	1,901	1,820	1,921	1,990
Funding available/(required)	18.1	4.4	204.0	36.3	40.0	Traditional varieties	1,929	1,966	1,796	1,666	1,584
Dividends paid	(25.3)	(25.6)	(32.3)	(26.7)	(26.7)	Total	3,545	3,867	3,616	3,587	3,574
Equity raised/(returned)	0.2	0.1	-	-	-	Food ingredients volumes					
Increase/(decrease) in net debt	7.0	21.1	(171.7)	(9.6)	(13.3)	Prof fruit volume ('000 L)	5,579	6,219	6,219	6,219	6,219
						Meateor ('000 mt)	27,663	29,028	29,028	33,440	37,714
						Shelby ('000 mt)	n/a	n/a	80,000	82,400	84,872
Balance Sheet (NZ\$m)	2017A	2018A	2019E	2020E	2021E						
Working capital	23.4	41.1	37.3	38.6	40.1						
Fixed assets	228.9	150.6	147.8	159.1	167.6						
Intangibles	18.2	43.9	43.9	43.9	43.9						
Other assets	44.1	145.5	44.6	44.9	45.4						
Total funds employed	314.6	381.0	273.6	286.5	297.0						
Net debt/(cash)	40.8	69.0	(105.1)	(109.9)	(119.8)						
Other non current liabilities	51.9	62.1	43.6	43.6	45.0						
Shareholder's funds	221.5	246.3	331.5	349.2	368.3						
Minority interests	0.4	3.6	3.6	3.6	3.6						
Total funding sources	314.6	381.0	273.6	286.5	297.0						

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

Investment summary

Scales (SCL) is an export focussed company offering investors broad exposure to New Zealand agriculture, with operations in horticulture and meat processing. SCL aims to leverage exposure to a growing premium fruit market in Asia and a favourable macro backdrop for pet food. Following the settlement of its Polarcold business sale, SCL has a significant net cash balance and is pursuing potentially transformational acquisitions. We expect acquisition uncertainty will have an overhang on the share price. NEUTRAL.

Business quality

- **Competition:** The New Zealand apple industry primarily competes against other Southern Hemisphere producers such as Chile and South Africa.

Earnings and cash flow outlook

- **Horticulture drivers:** Apple prices are set in market with NZ grown apples typically achieving a price premium relative to competitors. A shift in focus to Asian markets and new varieties should lift group prices. Climatic outcomes typically drive tree yield, and harvest quantity and quality.
- **Food Ingredients drivers:** Both supply and customer contracts are typically negotiated annually, with earnings driven by availability of rendered meat and ultimately herd cull. Recent business transactions increase surety around supply volumes.

Financial structure

- **Balance sheet headroom, acquisitions on the cards:** SCL has significant headroom on its balance sheet following asset divestments. The company has indicated that it intends to pursue acquisitive growth, both through smaller bolt-on and potentially larger transformational acquisitions.

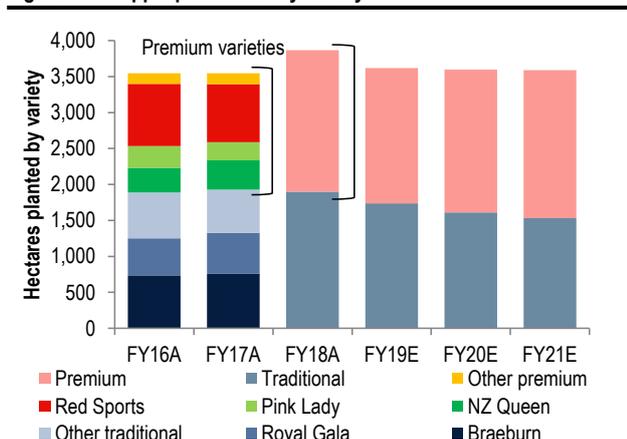
Risk factors

- **Climatic risks:** Extreme weather events, particularly during the key growing/harvest period, have the ability to negatively impact harvest volume and quality as well as herd cull numbers.
- **Bio-security risk:** As with any export focussed primary industry company, changes to the operating environment through the introduction of disease or pest could have a material impact on operating costs/market access.
- **Seasonal employment:** SCL has large seasonal employment requirements which can lead to labour shortages and create production bottlenecks. SCL's participation in the RSE scheme, which provides half of seasonal labour requirements, mitigates this risk to some extent.

Company description

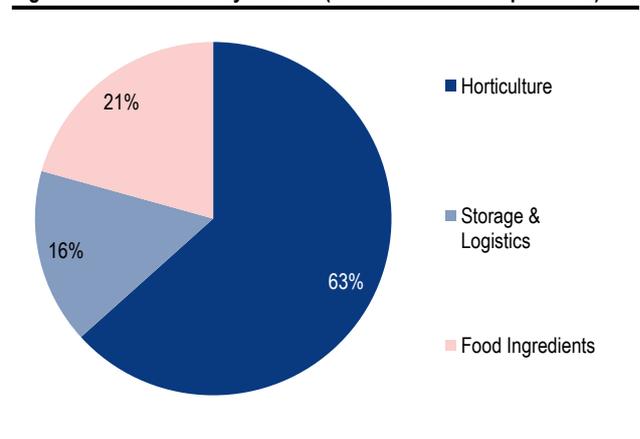
SCL is a diversified agricultural operator with business interests in horticulture and food ingredients. SCL's Mr Apple business is New Zealand's largest fully integrated grower, packer, and marketer of Apples, exporting ~5m TCE per annum. SCL's also operates Meateor, a meat processor for pet food ingredients and has a 50% interest in Profruit, a juice concentrate manufacturer.

Figure 1. Mr Apple production by variety



Source: Company reports, Forsyth Barr analysis

Figure 2. FY18 revenue by division (excl. discontinued operations)



Source: Company reports, Forsyth Barr analysis

Figure 2. Substantial Shareholders

Shareholder	Latest Holding
China Resources	15.4%
Harbour Asset Management & First NZ Capital Securities	8.4%

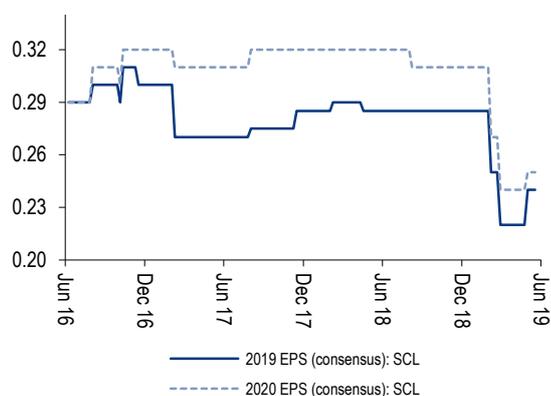
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 3. International Compcos

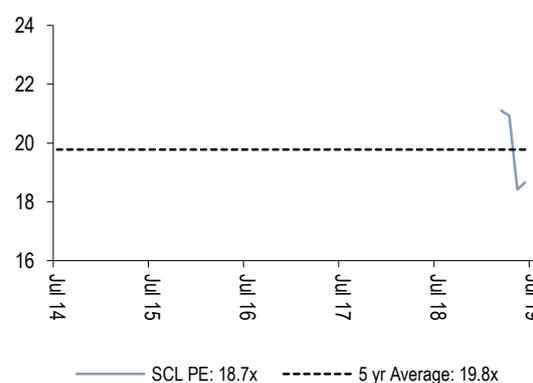
Company <i>(metrics re-weighted to reflect SCL's balance date - December)</i>	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash D/Yield
				2019E	2020E	2019E	2020E	2019E	2020E	2020E
Scales	SCL NZ	NZ\$4.80	NZ\$674	19.4x	18.0x	13.5x	12.4x	16.8x	15.2x	4.0%
Delegat Group *	DGL NZ	NZ\$11.00	NZ\$1,112	20.4x	17.9x	13.1x	11.9x	15.4x	13.8x	1.8%
Sanford *	SAN NZ	NZ\$6.86	NZ\$641	14.9x	12.6x	8.7x	7.4x	11.8x	10.1x	3.4%
New Zealand King Salmon *	NZK NZ	NZ\$2.20	NZ\$305	19.6x	16.5x	10.7x	9.1x	13.9x	11.7x	3.0%
Comvita *	CVT NZ	NZ\$3.73	NZ\$185	<0x	14.0x	>75x	11.5x	<0x	15.8x	1.7%
Fonterra *	FSF NZ	NZ\$3.95	NZ\$6,367	26.3x	13.6x	10.0x	8.5x	18.2x	13.8x	3.8%
T&G Global	TGG NZ	NZ\$2.75	NZ\$337	n/a						
Compcio Average:				20.3x	14.9x	10.7x	9.7x	14.8x	13.0x	2.7%
SCL Relative:				-4%	+20%	+27%	+28%	+13%	+17%	+46%

EV = Current Market Cap + Actual Net Debt

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

Figure 4. Consensus EPS Momentum


Source: Forsyth Barr analysis, Bloomberg

Figure 5. 12 Month Forward PE


Source: Forsyth Barr analysis

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