

Scales

NEUTRAL

Pruning Expectations

Scales (SCL) has provided first time earnings guidance for FY20E, implying a modest downgrade to market expectations. Consequently, we have trimmed our earnings forecasts, with the downgrades captured entirely within the Food Ingredients business on the back of challenging market supply dynamics. We now forecast largely flat earnings growth year on year across SCL's businesses, with orchard replanting also limiting near term growth in its Horticulture business. Trading on a ~20x forward PE, with limited near term earnings growth and a significant net cash position creating investment uncertainty, we expect the share price to be range bound. NEUTRAL.

What's changed?

- **Earnings:** We revise our underlying NPAT forecasts -5.5%/-4.5% in FY20E/FY21E
- **Target Price:** Lowered -NZ\$0.05 to NZ\$4.60
- **Rating:** NEUTRAL

Guidance update mixed

SCL has reiterated its FY19E underlying NPAT guidance range of NZ\$32m to NZ\$37m. We have left our FY19E forecast (NZ\$34m) unchanged, although note the wide guidance range given the proximity to the end of the financial year may imply some downside risk.

In addition, SCL released a first time FY20E underlying NPAT guidance range of NZ\$30m to NZ\$36m, implying a downgrade to previous market consensus forecasts. We have lowered our FY20E NPAT to NZ\$35m from NZ\$37m. We suspect a key driver of the downgrade has been the more challenging market conditions in SCL's pet food ingredients business, Meateor, driven by a combination of (1) changes in the raw ingredients supply dynamics, such as the increasing demand for use in human consumption, and (2) weaker venison prices. In addition to lower Food Ingredients earnings, we have lowered our interest income assumption with the low interest rate environment impacting SCL's significant net cash balance (FY19E NZ\$84m).

The wide FY20E guidance range appears conservative although prudent given the natural uncertainty associated with annual harvest outcomes. Heading into FY20, we remain comfortable with our Horticulture forecasts given (1) NIWA's seasonal outlook suggests favourable weather during the key growing period and (2) European apple stocks as of November 2019 are well below average, supportive of FY20 apple pricing in that market.

Signalling higher capex in FY20

SCL highlighted a 'material increase' in FY20E capex within its Horticulture division, targeted at creating cost efficiencies. We have lifted our Horticulture growth capex forecast +NZ\$6m to NZ\$14m. We understand capital projects include further investment into its Croptracker system as well as additional RSE (Recognised Seasonal Employers) worker accommodation. Seasonal labour supply has been tight in recent years, a lift in available RSE workers would be positive for SCL.

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\$4.90
Target price	NZ\$4.60
Risk rating	Medium
Issued shares	140.3m
Market cap	NZ\$688m
Average daily turnover	106.2k (NZ\$512k)

Share Price Performance



Financials: December	18A	19E	20E	21E
NPAT* (NZ\$m)	28.6	34.1	35.1	37.8
EPS* (NZc)	20.4	24.3	25.0	27.0
EPS growth* (%)	17.9	19.2	3.0	7.8
DPS (NZc)	19.0	20.0	20.0	21.0
Imputation (%)	100	100	100	100

Valuation (x)	18A	19E	20E	21E
EV/EBITDA	14.3	13.3	11.4	10.9
EV/EBIT	17.4	15.3	13.3	12.3
PE	24.0	20.2	19.6	18.2
Price / NTA	3.4	2.5	2.4	2.3
Cash dividend yield (%)	3.9	4.1	4.1	4.3
Gross dividend yield (%)	5.4	5.7	5.7	6.0

*Historic and forecast numbers based on underlying profits

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Scales Corporation (SCL)		Priced as at 05 Dec 2019: NZ\$4.90				December year end										
Forsyth Barr valuation						Valuation Ratios	2017A	2018A	2019E	2020E	2021E					
Valuation methodology						DCF	EV/EBITDA (x)	15.9	14.3	13.3	11.4	10.9				
12-month target price (NZ\$)* 4.60						Spot valuations (NZ\$)	EV/EBIT (x)	19.6	17.4	15.3	13.3	12.3				
Expected share price return						1. DCF	PE (x)	28.3	24.0	20.2	19.6	18.2				
Net dividend yield						2. Comparative multiples	Price/NTA (x)	3.4	3.4	2.5	2.4	2.3				
Estimated 12-month return						3. n/a	Free cash flow yield (%)	2.7	2.9	5.0	3.8	4.9				
Key WACC assumptions						DCF valuation summary (NZ\$m)	Net dividend yield (%)	3.9	3.9	4.1	4.1	4.3				
Risk free rate						Total firm value	Gross dividend yield (%)	5.4	5.4	5.7	5.7	6.0				
Equity beta						(Net debt)/cash	Imputation (%)	100	100	100	100	100				
WACC						Value of equity	Pay-out ratio (%)	110	93	82	80	78				
Terminal growth						Shares (m)	140	Capital Structure								
Profit and Loss Account (NZ\$m)						2017A	2018A	2019E	2020E	2021E						
Sales revenue						355.5	402.5	479.2	476.9	498.5	Interest cover EBIT (x)	12.7	17.5	n/a	n/a	n/a
Normalised EBITDA						45.3	51.7	51.1	52.8	55.0	Interest cover EBITDA (x)	15.7	21.3	n/a	n/a	n/a
Depreciation and amortisation						(8.6)	(9.2)	(10.8)	(11.7)	(10.6)	Net debt/ND+E (%)	15.6	21.9	-36.7	-31.3	-30.8
Normalised EBIT						36.7	42.5	44.3	45.1	49.0	Net debt/EBITDA (x)	0.9	1.3	n/a	n/a	n/a
Net interest						(2.9)	(2.4)	6.4	3.6	3.5	Key Ratios					
Associate income						-	-	-	-	-	Return on assets (%)	10.7	10.3	10.2	10.1	10.6
Tax						9.3	11.0	14.2	13.6	14.7	Return on equity (%)	10.9	11.6	10.9	10.8	11.2
Minority interests						0.4	0.4	2.5	-	-	Return on funds employed (%)	12.5	12.6	11.6	11.5	12.1
Normalised NPAT						24.1	28.6	34.1	35.1	37.8	EBITDA margin (%)	12.7	12.9	10.7	11.1	11.0
Abnormals/other						7.1	16.5	93.2	-	-	EBIT margin (%)	10.3	10.6	9.3	9.5	9.8
Reported NPAT						31.2	45.1	127.3	35.1	37.8	Capex to sales (%)	3.8	4.0	3.2	4.5	2.8
Normalised EPS (cps)						17.3	20.4	24.3	25.0	27.0	Capex to depreciation (%)	157	176	144	186	133
DPS (cps)						19.0	19.0	20.0	20.0	21.0	Operating Performance					
Growth Rates						2017A	2018A	2019E	2020E	2021E	Revenue split (division)					
Revenue (%)						-4.9	13.2	19.0	-0.5	4.5	Horticulture	228.0	254.6	267.9	266.2	271.6
EBITDA (%)						-33.2	14.2	-1.3	3.4	4.1	Logistics	101.6	64.5	69.0	71.8	75.3
EBIT (%)						-34.1	15.7	4.3	1.7	8.7	Food Ingredients	68.9	83.1	142.2	139.0	151.6
Normalised NPAT (%)						-37.0	18.6	19.1	3.0	7.8	Total	399.1	402.5	479.2	476.9	498.5
Normalised EPS (%)						-37.3	17.9	19.2	3.0	7.8	EBITDA split (division)					
Ordinary DPS (%)						5.6	0.0	5.3	0.0	5.0	Horticulture	38.4	43.5	42.9	42.6	43.5
Cash Flow (NZ\$m)						2017A	2018A	2019E	2020E	2021E	Logistics	3.3	4.9	5.2	5.4	5.7
EBITDA						45.3	51.7	51.1	52.8	55.0	Food Ingredients	8.2	11.0	12.0	13.5	15.3
Working capital change						(11.6)	(17.6)	1.7	0.2	(1.8)	Overheads	(4.5)	(7.6)	(5.0)	(4.7)	(4.8)
Interest & tax paid						(12.2)	(13.5)	(7.8)	(10.0)	(11.2)	Total	45.3	51.7	55.1	56.8	59.6
Other						10.8	15.9	5.0	4.9	5.6	EBITDA margin (%)					
Operating cash flow						32.4	36.6	50.0	48.0	47.7	Horticulture	16.8	17.1	16.0	16.0	16.0
Capital expenditure						(13.5)	(16.3)	(15.4)	(21.7)	(14.1)	Logistics	3.2	7.6	7.5	7.5	7.5
(Acquisitions)/divestments						(0.8)	(15.9)	163.9	-	-	Food Ingredients	11.9	13.3	8.4	9.7	10.1
Other						-	-	-	-	-	Total	11.4	12.9	11.5	11.9	12.0
Funding available/(required)						18.1	4.4	198.5	26.3	33.6	Apple volumes ('000 TCE)					
Dividends paid						(25.3)	(25.6)	(32.2)	(28.0)	(28.0)	Premium varieties	1,616	1,901	2,095	1,987	2,058
Equity raised/(returned)						0.2	0.1	-	-	-	Traditional varieties	1,929	1,966	1,727	1,611	1,532
Increase/(decrease) in net debt						7.0	21.1	(166.2)	1.7	(5.6)	Total	3,545	3,867	3,822	3,598	3,590
Balance Sheet (NZ\$m)						2017A	2018A	2019E	2020E	2021E	Food ingredients volumes					
Working capital						23.4	41.1	39.4	39.2	41.0	Profruit volume ('000 L)	5,579	6,219	6,219	6,219	6,219
Fixed assets						228.9	150.6	148.3	166.6	176.8	Meateor ('000 mt)	27,663	29,028	107,751	109,766	116,547
Intangibles						18.2	43.9	43.9	43.9	43.9						
Other assets						44.1	145.5	46.7	46.1	46.7						
Total funds employed						314.6	381.0	278.3	295.7	308.3						
Net debt/(cash)						40.8	69.0	(84.2)	(77.4)	(79.5)						
Other non current liabilities						51.9	62.1	45.0	45.0	46.4						
Shareholder's funds						221.5	246.3	313.9	324.6	337.8						
Minority interests						0.4	3.6	3.6	3.6	3.6						
Total funding sources						314.6	381.0	278.3	295.7	308.3						

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

Earnings changes

We have lowered our FY20E underlying NPAT forecast by -NZ\$2m to NZ\$35m, to the top end of the guidance range (NZ\$30m to NZ\$36m). Earnings changes are captured within the Food Ingredients business which we now expect to achieve flat year on year earnings growth on the back of challenging market supply conditions.

We have also changed the basis of our underlying EBITDA, to be consistent with SCL's approach and disclosure.

Figure 1. Earnings changes (NZ\$m)

	FY19			FY20E			FY21E		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Sales	479.2	479.2	0.0%	483.1	476.9	-1.3%	505.2	498.5	-1.3%
Underlying EBITDA	51.1	51.1	0.0%	55.7	52.8	-5.2%	56.6	55.0	-2.8%
Underlying NPAT	34.1	34.1	0.0%	37.1	35.1	-5.5%	39.6	37.8	-4.5%
EPS (cps)	24.3	24.3	0.0%	26.5	25.0	-5.5%	28.2	26.9	-4.5%
DPS (cps)	20.0	20.0	0.0%	20.0	20.0	0.0%	21.0	21.0	0.0%

Source: Forsyth Barr analysis

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.

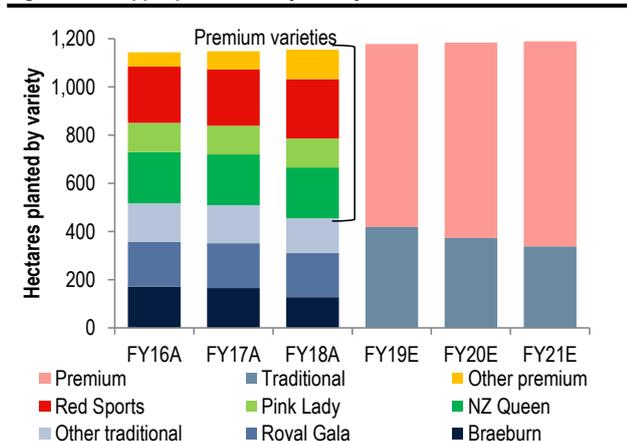
Risk factors

- **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

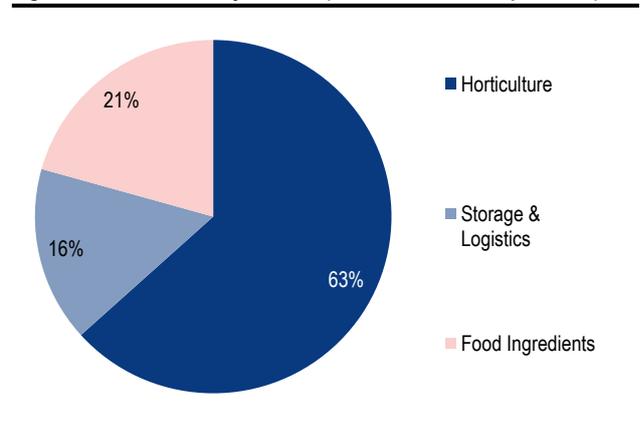
SCL is a diversified agricultural operator with business interests in horticulture and food ingredients. SCL's Mr Apple business is New Zealand's largest fully integrated grower, packer, and marketer of Apples, exporting ~5m TCE per annum. SCL's also operates Meateor, a meat processor for pet food ingredients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

Figure 1. Mr Apple production by variety



Source: SCL, Forsyth Barr analysis

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



Source: SCL, Forsyth Barr analysis

Figure 2. Substantial Shareholders

Shareholder	Latest Holding
China Resources	15.4%
Harbour Asset Management & Jarden Securities Limited	8.4%

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

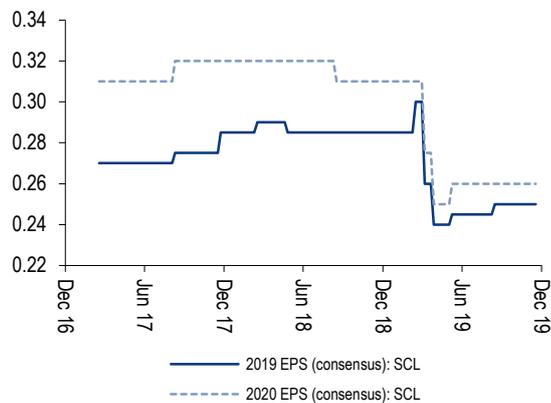
Figure 3. International Compcos

Company	Code	Price	Mkt Cap	PE	EV/EBITDA	EV/EBIT	Cash D/Yld
<i>(metrics re-weighted to reflect SCL's balance date - December)</i>							
			(m)	2019E	2020E	2019E	2020E
Scales	SCL NZ	NZ\$4.90	NZ\$688	20.2x	19.6x	14.8x	14.3x
Delegat Group *	DGL NZ	NZ\$11.30	NZ\$1,143	22.2x	20.6x	14.2x	13.3x
Sanford *	SAN NZ	NZ\$7.75	NZ\$725	17.5x	14.1x	9.5x	7.9x
New Zealand King Salmon *	NZK NZ	NZ\$2.20	NZ\$306	24.5x	19.8x	12.0x	10.4x
Comvita *	CVT NZ	NZ\$2.87	NZ\$143	<0x	13.6x	<0x	10.3x
Fonterra *	FSF NZ	NZ\$4.02	NZ\$6,476	21.6x	16.1x	9.5x	9.7x
T&G Global	TGG NZ	NZ\$2.76	NZ\$338	n/a	n/a	n/a	n/a
Compcos Average:				21.5x	16.8x	11.3x	10.3x
SCL Relative:				-6%	+16%	+31%	+10%
							+17%
							+80%

EV = Current Market Cap + Actual Net Debt

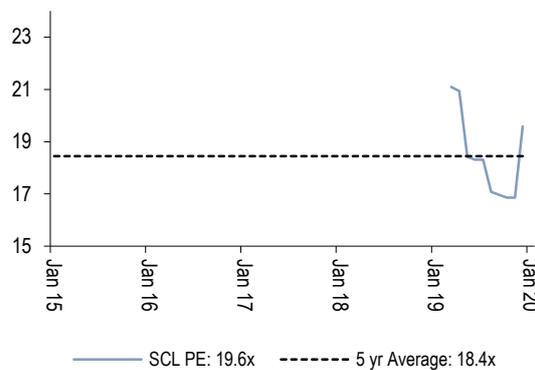
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compcos metrics re-weighted to reflect headline (SCL) companies fiscal year end

Figure 4. Consensus EPS Momentum



Source: Forsyth Barr analysis, Bloomberg

Figure 5. 12 Month Forward PE



Source: Forsyth Barr analysis

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