

Scales

FY19 Preview — Checking the Scales

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NEUTRAL 

Scales (SCL) reports its FY19 result on Wednesday, 26 February 2020 — we expect robust earnings from the key Horticulture business, weighed down by challenges in Food Ingredients. Our key focus at the result will be 1) apple harvest guidance for the coming season, 2) an update on, and progression of, the evolving pet food strategy, and 3) additional clarity around possible transformational acquisitions. SCL's FY19E guidance is for underlying NPAT of NZ\$32m to NZ\$37m (FB NZ\$34m).

NZX Code	SCL	Financials: Dec/	18A	19E	20E	21E	Valuation (x)	18A	19E	20E	21E
Share price	NZ\$4.37	NPAT* (NZ\$m)	28.6	34.1	35.1	37.8	EV/EBITDA	12.9	11.8	10.0	9.6
Target price	NZ\$4.60	EPS* (NZc)	20.4	24.3	25.0	27.0	EV/EBIT	15.7	13.6	11.7	10.8
Risk rating	Medium	EPS growth* (%)	17.9	19.2	3.0	7.8	PE	21.4	18.0	17.5	16.2
Issued shares	140.3m	DPS (NZc)	19.0	20.0	20.0	21.0	Price / NTA	3.0	2.3	2.2	2.1
Market cap	NZ\$613m	Imputation (%)	100	100	100	100	Cash div yld (%)	4.3	4.6	4.6	4.8
Avg daily turnover	113.3k (NZ\$550k)	*Based on normalised profits					Gross div yld (%)	6.0	6.4	6.4	6.7

Key issues to consider at SCL's FY19 result

- **Apple harvest guidance** — Apple yield and packout rate are key earnings drivers for SCL. The harvest period peaks through March and April. In light of recent dry conditions, commentary on harvest expectations for FY20 will be of interest.
- **Pet food progression** — We suspect Food Ingredients may be a key source of downside risk in FY19E, given the decline in venison prices and challenging supply dynamics. SCL has an EBITDA target for its Food Ingredients business of NZ\$25m by FY22 (FY18 NZ \$9.3m). With the business having undergone significant change we look for an update on its evolving pet food strategy. The path to achieving its growth target remains under-developed in our opinion.
- **Acquisition strategy** — SCL has a large net cash position of ~NZ\$84m, with significant additional balance sheet headroom. SCL has previously 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.
- **Apple pricing and coronavirus impacts** — A lower than average European harvest should be favourable for 2H19E and 1H20E apple prices. Prolonged effects from coronavirus on customer perceptions may be beneficial for SCL should consumer demand in China lift for imported produce.

Conference call details

SCL will host a FY19 result conference call at 10am on 26 February 2020. Dial in details: New Zealand 0800 122 136, Conference ID: 10003763.

Figure 1. FY19 result expectations (NZ\$m)

	FY18	FY19E	% change	Consensus	Guidance
Revenue	402.5	479.2	19.1%	467.0	-
EBITDA	51.7	51.1	-1.2%	54.9	~49.0 - 55.0
Reported NPAT	28.6	34.1	19.2%	34.4	32.0 - 37.0
EPS (cps)	20.4	24.3	19.1%	24.3	-
Final dividend (cps)	9.5	10.5	10.5%	9.3	-

Source: Bloomberg, Forsyth Barr analysis

Scales Corporation (SCL)

Priced as at 20 Feb 2020 (NZ\$) **4.37**

12-month target price (NZ\$)*	4.60
Expected share price return	5.3%
Net dividend yield	4.6%
Estimated 12-month return	9.9%

Key WACC assumptions	
Risk free rate	2.00%
Equity beta	0.99
WACC	8.7%
Terminal growth	1.5%

Spot valuations (NZ\$)	
1. DCF	4.40
2. Comparative multiples	4.40
3. n/a	n/a

DCF valuation summary (NZ\$m)	
Total firm value	546
(Net debt)/cash	84
Less: Capitalised operating leases	
Value of equity	631

Profit and Loss Account (NZ\$m)	2017A	2018A	2019E	2020E	2021E
Sales revenue	355.5	402.5	479.2	476.9	498.5
Normalised EBITDA	45.3	51.7	51.1	52.8	55.0
Depreciation and amortisation	(8.6)	(9.2)	(10.8)	(11.7)	(10.6)
Normalised EBIT	36.7	42.5	44.3	45.1	49.0
Net interest	(2.9)	(2.4)	6.4	3.6	3.5
Associate income	0	0	0	0	0
Tax	9.3	11.0	14.2	13.6	14.7
Minority interests	0.4	0.4	2.5	0	0
Normalised NPAT	24.1	28.6	34.1	35.1	37.8
Abnormals/other	0	0	20.2	0	0
Reported NPAT	31.2	45.1	127.3	35.1	37.8
Normalised EPS (cps)	17.3	20.4	24.3	25.0	27.0
DPS (cps)	19.0	19.0	20.0	20.0	21.0

Valuation Ratios	2017A	2018A	2019E	2020E	2021E
EV/EBITDA (x)	14.3	12.9	11.8	10.0	9.6
EV/EBIT (x)	17.6	15.7	13.6	11.7	10.8
PE (x)	25.3	21.4	18.0	17.5	16.2
Price/NTA (x)	3.0	3.0	2.3	2.2	2.1
Free cash flow yield (%)	3.1	3.3	5.6	4.3	5.5
Net dividend yield (%)	4.3	4.3	4.6	4.6	4.8
Gross dividend yield (%)	6.0	6.0	6.4	6.4	6.7

Capital Structure	2017A	2018A	2019E	2020E	2021E
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
Net debt/ND+E (%)	15.6	21.9	-36.7	-31.3	-30.8
Net debt/EBITDA (x)	0.9	1.3	n/a	n/a	n/a

Growth Rates	2017A	2018A	2019A	2020A	2021A
Revenue (%)	-4.9	13.2	19.0	-0.5	4.5
EBITDA (%)	-33.2	14.2	-1.3	3.4	4.1
EBIT (%)	-34.1	15.7	4.3	1.7	8.7
Normalised NPAT (%)	-37.0	18.6	19.1	3.0	7.8
Normalised EPS (%)	-37.3	17.9	19.2	3.0	7.8
Ordinary DPS (%)	5.6	0.0	5.3	0.0	5.0

Key Ratios	2017A	2018A	2019E	2020E	2021E
Return on assets (%)	10.7	10.3	10.2	10.1	10.6
Return on equity (%)	10.9	11.6	10.9	10.8	11.2
Return on funds employed (%)	12.5	12.6	11.6	11.5	12.1
EBITDA margin (%)	12.7	12.9	10.7	11.1	11.0
EBIT margin (%)	10.3	10.6	9.3	9.5	9.8
Capex to sales (%)	3.8	4.0	3.2	4.5	2.8
Capex to depreciation (%)	157	176	144	186	133
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	110	93	82	80	78

Cash Flow (NZ\$m)	2017A	2018A	2019E	2020E	2021E
EBITDA	45.3	51.7	51.1	52.8	55.0
Working capital change	(11.6)	(17.6)	1.7	0.2	(1.8)
Interest & tax paid	(12.2)	(13.5)	(7.8)	(10.0)	(11.2)
Other	10.8	15.9	5.0	4.9	5.6
Operating cash flow	32.4	36.6	50.0	48.0	47.7
Capital expenditure	(13.5)	(16.3)	(15.4)	(21.7)	(14.1)
(Acquisitions)/divestments	(0.8)	(15.9)	163.9	0	0
Other	0	0	0	0	0
Funding available/(required)	18.1	4.4	198.5	26.3	33.6
Dividends paid	(25.3)	(25.6)	(32.2)	(28.0)	(28.0)
Equity raised/(returned)	0.2	0.1	0	0	0
(Increase)/decrease in net debt	(7.0)	(21.1)	166.2	(1.7)	5.6

Operating Performance	2017A	2018A	2019E	2020E	2021E
Revenue split (division)					
Horticulture	228.0	254.6	267.9	266.2	271.6
Logistics	101.6	64.5	69.0	71.8	75.3
Food Ingredients	68.9	83.1	142.2	139.0	151.6
Total	399.1	402.5	479.2	476.9	498.5
EBITDA split (division)					
Horticulture	38.4	43.5	42.9	42.6	43.5
Logistics	3.3	4.9	5.2	5.4	5.7
Food Ingredients	8.2	11.0	12.0	13.5	15.3
Overheads	(4.5)	(7.6)	(9.0)	(8.6)	(9.4)
Total	45.3	51.7	51.1	52.8	55.0

Balance Sheet (NZ\$m)	2017A	2018A	2019E	2020E	2021E
Working capital	23.4	41.1	39.4	39.2	41.0
Fixed assets	228.9	150.6	148.3	166.6	176.8
Intangibles	18.2	43.9	43.9	43.9	43.9
Right of use asset	0	0	0	0	0
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)
Lease liability	0	0	0	0	0
Other 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

EBITDA margin (%)					
Horticulture	16.8	17.1	16.0	16.0	16.0
Logistics	3.2	7.6	7.5	7.5	7.5
Food Ingredients	11.9	13.3	8.4	9.7	10.1
Total	11.4	12.9	10.7	11.1	11.0
Apple volumes ('000 TCE)					
Premium varieties	1,616	1,901	2,095	1,987	2,058
Traditional varieties	1,929	1,966	1,727	1,611	1,532
Total	3,545	3,867	3,822	3,598	3,590

* 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 cashflow 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.

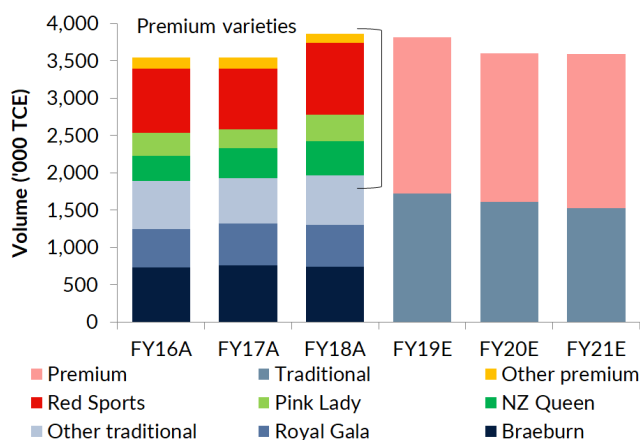
Financial structure

- **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

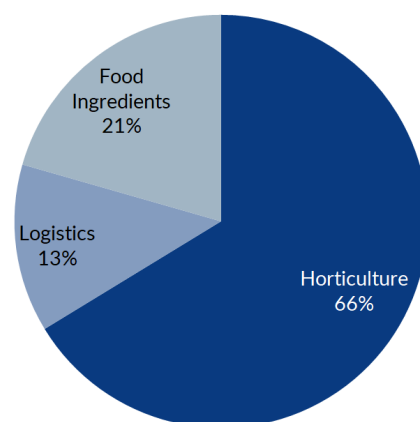
- **Climatic risks:** Extreme weather events, particularly during the key growing/harvest period, have the ability to negatively impact harvest volume and quality as well as herd cull numbers.
- **Bio-security risk:** As with any export focussed primary industry company, changes to the operating environment 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.

Figure 2. Mr Apple production by variety

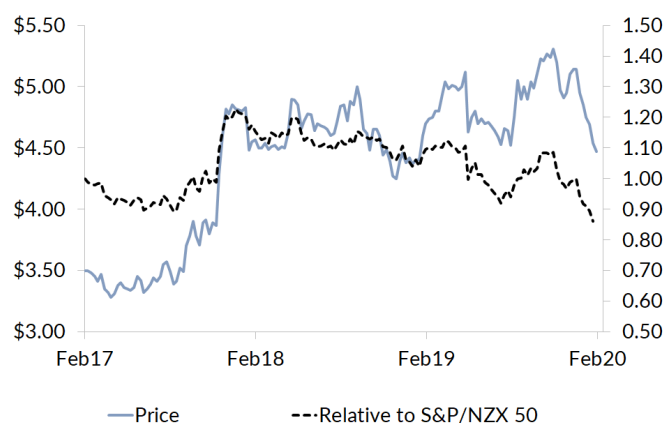


Source: Company reports, Forsyth Barr analysis

Figure 3. FY18 revenue by division (excl. disc. operations)



Source: Company reports, Forsyth Barr analysis

Figure 4. Price performance


Source: Forsyth Barr analysis

Figure 5. Substantial shareholders

Shareholder	Latest Holding
China Resources	15.4%
Harbour Asset Management & Jarden Securities Limited	9.9%

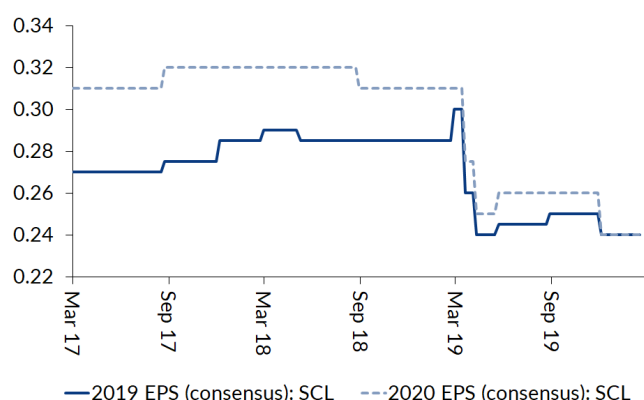
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 6. International valuation comparisons

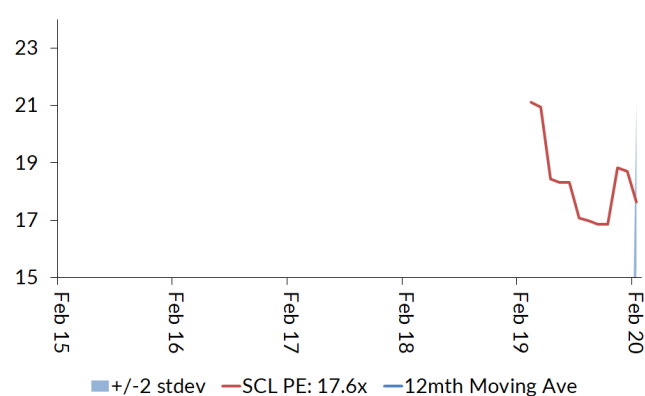
Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash Yld
(metrics re-weighted to reflect SCL's balance date - December)										
			(m)	2019E	2020E	2019E	2020E	2019E	2020E	2020E
Scales	SCL NZ	NZ\$4.37	NZ\$613	18.0x	17.5x	13.4x	12.9x	15.4x	15.1x	4.6%
Delegat Group *	DGL NZ	NZ\$10.50	NZ\$1,062	20.6x	19.1x	13.4x	12.5x	15.8x	14.8x	1.8%
Sanford *	SAN NZ	NZ\$7.80	NZ\$729	17.6x	14.2x	9.6x	7.9x	12.8x	10.9x	2.9%
New Zealand King Salmon *	NZK NZ	NZ\$2.24	NZ\$311	24.9x	20.2x	12.2x	10.6x	16.4x	14.3x	2.5%
Comvita *	CVT NZ	NZ\$2.72	NZ\$135	<0x	12.8x	<0x	9.9x	<0x	14.2x	1.2%
Fonterra *	FSF NZ	NZ\$3.94	NZ\$6,351	21.2x	15.8x	9.4x	9.6x	16.2x	16.2x	3.1%
T&G Global	TGG NZ	NZ\$2.85	NZ\$349	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Compco Average:				21.1x	16.4x	11.1x	10.1x	15.3x	14.1x	2.3%
SCL Relative:				-15%	6%	20%	28%	1%	8%	98%

EV = Current Market Cap + Actual Net Debt

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

Figure 7. Consensus EPS momentum (NZ\$)


Source: Forsyth Barr analysis

Figure 8. One year forward PE (x)


Source: Forsyth Barr analysis

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