

Scales

FY19 – Horticulture Margins Less Dazzling

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NEUTRAL 

Scales (SCL) delivered a mixed end to FY19, with a strong performance in its Food Ingredients businesses offsetting misses by Horticulture and Logistics. Looking forward, we have trimmed our expectations on the back of wage inflation pressure and weaker than expected apple prices. Whilst we are attracted to SCL's long-term strategy, earnings growth remains muted over the near-term as orchards are redeveloped. In addition, SCL's large capital headroom for a potentially transformational acquisition creates investment uncertainty, in our opinion. **NEUTRAL**.

NZX Code	SCL	Financials: Dec/	19A	20E	21E	22E	Valuation (x)	19A	20E	21E	22E
Share price	NZ\$4.37	NPAT* (NZ\$m)	48.6	32.3	34.8	38.3	EV/EBITDA	8.1	8.1	7.8	7.2
Target price	NZ\$4.45	EPS* (NZc)	34.6	23.0	24.8	27.2	EV/EBIT	9.5	11.4	10.8	9.7
Risk rating	Medium	EPS growth* (%)	69.5	-33.5	7.9	9.9	PE	12.6	19.0	17.6	16.1
Issued shares	140.6m	DPS (NZc)	20.0	21.0	22.0	23.0	Price / NTA	2.0	1.9	1.8	1.7
Market cap	NZ\$614m	Imputation (%)	100	100	100	100	Cash div yld (%)	4.6	4.8	5.0	5.3
Avg daily turnover	114.5k (NZ\$555k)	*Based on normalised profits					Gross div yld (%)	6.4	6.7	7.0	7.3

FY19 result – divisional highlights

SCL reported Underlying EBITDA of NZ\$52.7m, slightly ahead of our expectations on the back of a strong contribution from its US pet food business, Shelby.

- **Horticulture** – FY19 saw weaker than expected apple prices, which in combination with wage inflation drove margin contraction and underperformed against our expectations. We expect margin pressure to remain in the near-term as the company invests in operational efficiencies and as orchards planted in premium apple varieties mature (margin improvement expected in FY22).
 - SCL has not experienced any impacts to date from coronavirus, having air freighted initial volumes of its Posy apple into China earlier this month. Its first sea shipment of apples is on route and not expected to land in China until mid-March.
- **Food Ingredients** – The segment was the highlight of the period, with recent partial acquisition, Shelby delivering a strong first period of earnings. SCL expects Food Ingredients to be the key driver of earnings growth in the near-term, enabled by opportunities in the US and China markets.
 - SCL is targeting EBITDA of NZ\$25m (pre-IFRS, FY19 NZ\$13.5m). We continue to this goal as ambitious and suspect further investment in the business will be required.
- **Logistics** – Reported a -32% drop in Underlying EBITDA, as it cycled a period of high air freight.

Outlook commentary implies broadly flat to declining earnings

SCL has reaffirmed its FY20E Underlying NPAT guidance of NZ\$30m to NZ\$36m, which implies Underlying EBITDA guidance of NZ\$49m to NZ\$55m (pre-IFRS 16). We have cut our EBITDA (pre-IFRS 16) forecasts -3.0% to NZ\$51.2m, reflecting lower margin assumptions in the Horticulture business, and a lower earnings base for Logistics.

Acquisition uncertainty remains

SCL reported a net cash position of NZ\$105m as at FY19, highlighting its significant capital headroom. Although still looking for potentially transformative acquisition opportunities, SCL has highlighted a number of organic growth opportunities, including further investment into its core competency of horticulture and possible value add options in Pet Food. Whilst we like SCL's disciplined approach to return targets, we note that the size of possible acquisitions creates significant investment uncertainty.

Scales Corporation (SCL)

Priced as at 26 Feb 2020 (NZ\$)

4.37
12-month target price (NZ\$)*
4.45

Expected share price return	1.8%
Net dividend yield	4.8%
Estimated 12-month return	6.7%

Spot valuations (NZ\$)

1. DCF	4.84
2. Comparative multiples	4.40
3. n/a	n/a

Key WACC assumptions

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

DCF valuation summary (NZ\$m)

Total firm value	575
(Net debt)/cash	105
Less: Capitalised operating leases	
Value of equity	680

Profit and Loss Account (NZ\$m)	2018A	2019A	2020E	2021E	2022E
Sales revenue	402.5	484.6	473.1	486.0	512.9
Normalised EBITDA	51.7	72.0	60.7	64.0	69.9
Depreciation and amortisation	(9.2)	(18.1)	(17.5)	(17.5)	(18.3)
Normalised EBIT	42.5	61.8	43.2	46.5	51.6
Net interest	(2.4)	(3.8)	1.6	1.9	1.6
Associate income	0	0	0	0	0
Tax	11.0	9.4	12.6	13.5	14.9
Minority interests	0.4	3.6	0	0	0
Normalised NPAT	28.6	48.6	32.3	34.8	38.3
Abnormals/other	0	0	0	0	0
Reported NPAT	45.5	121.6	32.3	34.8	38.3
Normalised EPS (cps)	20.4	34.6	23.0	24.8	27.2
DPS (cps)	19.0	20.0	21.0	22.0	23.0

Valuation Ratios	2018A	2019A	2020E	2021E	2022E
EV/EBITDA (x)	12.9	8.1	8.1	7.8	7.2
EV/EBIT (x)	15.7	9.5	11.4	10.8	9.7
PE (x)	21.4	12.6	19.0	17.6	16.1
Price/NTA (x)	3.0	2.0	1.9	1.8	1.7
Free cash flow yield (%)	3.3	6.6	4.5	6.9	7.5
Net dividend yield (%)	4.3	4.6	4.8	5.0	5.3
Gross dividend yield (%)	6.0	6.4	6.7	7.0	7.3

Growth Rates	2018A	2019A	2020A	2021A	2022A
Revenue (%)	13.2	20.4	-2.4	2.7	5.5
EBITDA (%)	14.2	39.2	-15.7	5.4	9.1
EBIT (%)	15.7	45.4	-30.1	7.6	10.9
Normalised NPAT (%)	18.5	69.8	-33.5	7.9	9.9
Normalised EPS (%)	17.8	69.5	-33.5	7.9	9.9
Ordinary DPS (%)	0.0	5.3	5.0	4.8	4.5

Capital Structure	2018A	2019A	2020E	2021E	2022E
Interest cover EBIT (x)	17.5	16.3	n/a	n/a	n/a
Interest cover EBITDA (x)	21.3	19.0	n/a	n/a	n/a
Net debt/ND+E (%)	21.9	-41.9	-33.6	-32.4	-32.8
Net debt/EBITDA (x)	1.3	n/a	n/a	n/a	n/a

Cash Flow (NZ\$m)	2018A	2019A	2020E	2021E	2022E
EBITDA	51.7	72.0	60.7	64.0	69.9
Working capital change	(17.6)	13.9	(2.2)	(3.5)	(4.3)
Interest & tax paid	(13.5)	(13.2)	(10.9)	(11.7)	(13.3)
Other	15.9	(16.6)	7.1	7.1	7.0
Operating cash flow	36.6	56.1	54.8	56.0	59.3
Capital expenditure	(16.3)	(15.7)	(26.8)	(13.4)	(13.2)
(Acquisitions)/divestments	(15.9)	162.9	0	0	0
Other	0	0	0	0	0
Funding available/(required)	4.4	203.3	27.9	42.6	46.2
Dividends paid	(25.6)	(29.8)	(28.1)	(30.9)	(30.9)
Equity raised/(returned)	0.1	0	0	0	0
(Increase)/decrease in net debt	(21.1)	173.5	(6.6)	5.3	8.9

Key Ratios	2018A	2019A	2020E	2021E	2022E
Return on assets (%)	10.3	11.1	7.5	7.9	8.5
Return on equity (%)	11.6	13.7	8.7	9.1	9.5
Return on funds employed (%)	12.6	12.2	8.1	8.5	9.2
EBITDA margin (%)	12.9	14.9	12.8	13.2	13.6
EBIT margin (%)	10.6	12.7	9.1	9.6	10.1
Capex to sales (%)	4.0	3.2	5.7	2.8	2.6
Capex to depreciation (%)	176	87	153	76	72
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	93	58	91	89	84

Balance Sheet (NZ\$m)	2018A	2019A	2020E	2021E	2022E
Working capital	41.1	27.2	26.6	27.3	28.8
Fixed assets	150.6	165.7	197.3	212.8	226.5
Intangibles	43.9	43.8	43.8	43.8	43.8
Right of use asset	0	78.8	74.6	70.7	67.0
Other assets	145.5	62.7	65.2	65.6	67.4
Total funds employed	381.0	378.2	407.5	420.3	433.5
Net debt/(cash)	69.0	(104.9)	(92.7)	(93.9)	(99.2)
Lease liability	0	70.7	79.7	79.1	78.4
Other liabilities	62.1	53.4	47.5	47.5	48.9
Shareholder's funds	246.3	355.0	369.0	383.5	401.4
Minority interests	3.6	4.0	4.0	4.0	4.0
Total funding sources	381.0	378.2	407.5	420.3	433.5

Operating Performance	2018A	2019A	2020E	2021E	2022E
Revenue split (division)					
Horticulture	254.6	264.8	263.3	267.3	280.8
Logistics	64.5	64.1	56.9	59.8	62.8
Food Ingredients	83.1	155.1	152.8	158.9	169.4
Total	402.5	484.6	473.1	486.0	512.9

EBITDA split (division)	2018A	2019A	2020E	2021E	2022E
Horticulture	43.5	47.9	47.4	49.4	53.3
Logistics	4.9	4.1	3.4	3.6	3.8
Food Ingredients	11.9	13.5	14.7	15.9	17.8
Overheads/other	(8.6)	(12.8)	(10.0)	(10.8)	(11.6)
Underlying EBITDA	51.7	52.7	55.6	58.1	63.3

EBITDA margin (%)	2018A	2019A	2020E	2021E	2022E
Horticulture	17.1	18.1	18.0	18.5	19.0
Logistics	7.6	6.3	6.0	6.0	6.0
Food Ingredients	14.4	8.7	9.6	10.0	10.5
Total	12.9	10.9	11.7	12.0	12.3

Apple volumes ('000 TCE)	2018A	2019A	2020E	2021E	2022E
Premium varieties	1,901	2,161	2,202	2,258	2,378
Traditional varieties	1,966	1,661	1,601	1,520	1,533
Total	3,867	3,822	3,803	3,778	3,911

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

FY19 result mixed

Scales (SCL) delivered a mixed end to FY19, with a strong performance in its Food Ingredients businesses offsetting misses in the Horticulture and Logistics divisions (relative to our forecasts). SCL reported Underlying NPAT towards the top end of its guidance range of NZ\$36.4m (FB NZ\$34.1m, guidance NZ\$32m to NZ\$37m).

Figure 1. Result summary (NZ\$m)

	FY18	FY19	% chg	Forsyth Barr
Revenue	402.5	484.6	20%	479.2
Underlying EBITDA	67.1	52.7	-21%	51.1
D&A	(14.8)	(10.2)	-31%	(10.8)
Underlying EBIT	52.3	42.5	-19%	40.3
Interest & tax	(16.5)	(6.1)	-63%	(6.3)
Underlying NPAT	35.8	36.4	2%	34.1

Source: Company reports, Forsyth Barr analysis

NEUTRAL rating retained; Target price lowered to NZ\$4.45

We have cut our target price by -3.3% to NZ\$4.45, reflecting lower earnings assumptions. Mr Apple is a quality horticulture business that achieves best in class yield, brand strength in target growth market China, and is repositioning into innovative apple varieties where it can receive a premium. However, we retain our NEUTRAL rating given 1) limited horticulture earnings growth as it undergoes a multi-year orchard redevelopment; 2) a still evolving strategy within its Food Ingredients business; and 3) the significant investment uncertainty given SCL's capital headroom to pursue a transformational acquisition and the broad range of possible outcomes.

Earnings changes

We have incorporated IFRS 16 accounting for leases into our earnings forecasts which make comparisons difficult. On a like for like basis we have made modest negative revisions to our earnings forecasts, cutting FY20E EBITDA pre-IFRS 16 -3.0% to NZ \$51m, towards the bottom end of the guidance range (NZ\$49m to NZ\$50m). Changes reflect lower EBIT margin assumptions in the Horticulture business and a lower Logistics earnings base.

Figure 2. Earnings changes (NZ\$m)

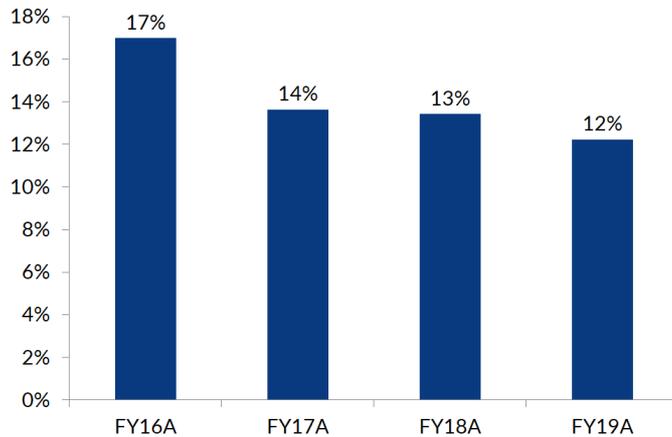
	FY20E			FY21E			FY22E		
	old	new	% chg	old	new	% chg	old	new	% chg
Sales	476.9	473.1	-0.8%	498.5	486.0	-2.5%	527.6	512.9	-2.8%
EBITDA	52.8	60.7	14.9%	55.0	64.0	16.5%	63.4	69.9	10.2%
EBITDA (pre-IFRS 16)	52.8	51.2	-3.0%	55.0	54.5	-0.8%	63.4	60.4	-4.8%
NPAT	35.1	32.3	-8.0%	37.8	34.8	-7.9%	40.3	38.3	-5.0%
EPS (cps)	25.0	23.0	-8.2%	27.0	24.8	-8.2%	28.7	27.2	-5.3%
DPS (cps)	20.0	21.0	5.0%	21.0	22.0	4.8%	23.0	23.0	0.0%

Source: Forsyth Barr analysis

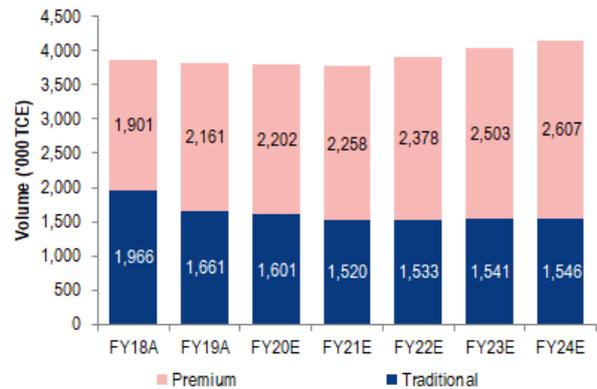
Horticulture margins

The Horticulture business had a disappointing end to FY19 relative to our expectations, with a combination of weaker prices for traditional apple varieties and wage inflation impacting margin. Underlying EBIT margin in the Horticulture business contracted to 11.7% in FY19 (FY18 13.4%) due to wage inflation. In addition, weakness in the price of traditional apples (down -10% in FY19), raises questions around medium-term price realisation in European markets. We have lowered our price assumptions to reflect the lower base but assume inflation type increases throughout our forecast period.

Offsetting negative revisions slightly, SCL updated its five year harvest outlook, increasing yield assumptions ~+3% to +6%. We have incorporated the increase but note that this is an agri business and remains subject to year to year climatic risks.

Figure 3. Horticulture underlying EBIT margins


Source: Company reports, Forsyth Barr analysis

Figure 4. Mr Apple sales volume forecasts


Source: Company reports, Forsyth Barr analysis

NZ\$25m of capex in FY20E

SCL has signalled higher FY20E Horticulture capex of NZ\$25m (prior FY20E expectations ~NZ\$18m) as the company invests into employee accommodation and a new coolstore in order to drive operating efficiencies and offset rising labour costs. The new coolstore will include additional automation and is expected to be in operation during FY21.

Result summary

Figure 5. FY19 result summary (NZ\$m)

	FY18	FY19	% chg	Comment
Horticulture	254.6	264.8	4%	Price of traditional apples fell -10%
Food Ingredients	83.1	155.1	87%	Shelby contribution, volumes by ~+4x
Logistics	64.5	64.1	-1%	Sea freight gain offset air freight loss
Revenue	402.5	484.6	20%	
COGS	(312.2)	(383.1)	23%	
Gross profit	90.3	101.5	12%	
Horticulture	42.6	39.7	-7%	EBIT margin contraction to 11.7% (FY18 13.4%)
Food Ingredients	10.2	13.5	32%	Includes ~NZ\$3m writedown to inventory
Logistics	4.9	3.3	-33%	Lower portion air freight
Other	9.4	(3.8)	-140%	
Underlying EBITDA	67.1	52.7	-21%	
D&A	(14.8)	(10.2)	-31%	FY20E capex >NZ\$25m
Underlying EBIT	52.3	42.5	-19%	
Tax & interest	(16.5)	(6.1)	-63%	
Underlying NPAT	35.8	36.4	2%	
Abnormals	9.7	85.2	778%	Gain on sale of Polarcold & 50% of Meateor NZ
Reported NPAT	45.5	121.6	167%	

Source: Company reports, 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 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.

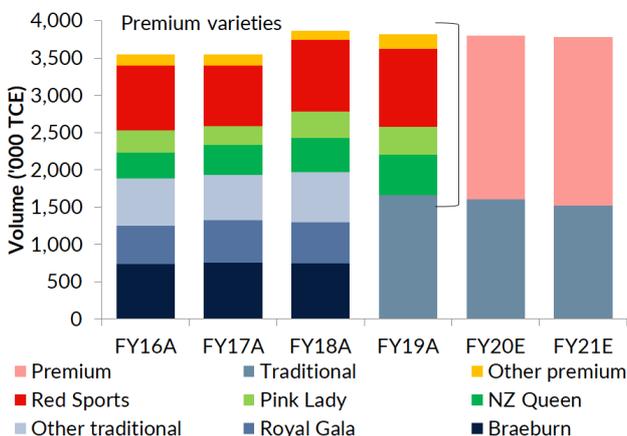
Financial structure

- **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

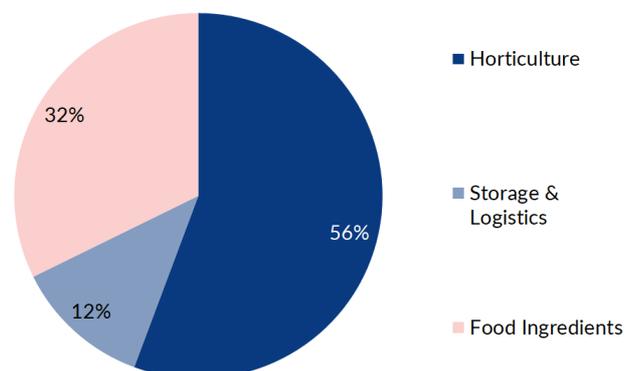
- **Climatic risks:** Extreme weather events, particularly during the key growing/harvest period, have the ability to negatively impact harvest volume and quality as well as herd cull numbers.
- **Bio-security risk:** As with any export focussed primary industry company, changes to the operating environment 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 6. Mr Apple production by variety



Source: Company reports, Forsyth Barr analysis

Figure 7. FY19 revenue by division



Source: Company reports, Forsyth Barr analysis

Figure 8. Price performance



Source: Forsyth Barr analysis

Figure 9. 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

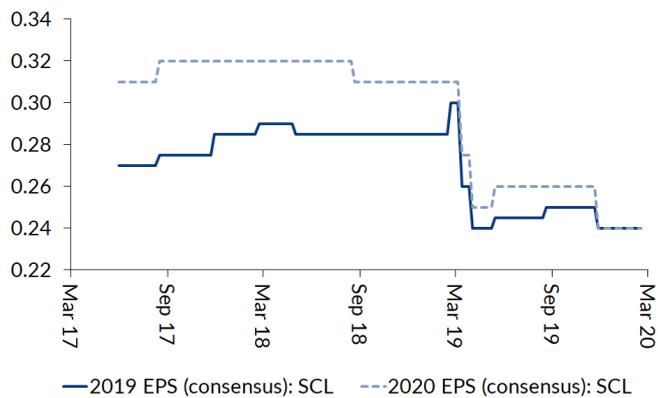
Figure 10. International valuation comparisons

Company	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash Yld 2021E
				2020E	2021E	2020E	2021E	2020E	2021E	
Scales	SCL NZ	NZ\$4.37	NZ\$614	19.0x	17.6x	8.4x	8.0x	11.8x	11.0x	5.0%
Delegat Group *	DGL NZ	NZ\$10.70	NZ\$1,082	19.0x	16.4x	12.5x	11.1x	14.7x	12.8x	1.7%
Sanford *	SAN NZ	NZ\$7.26	NZ\$679	13.2x	11.4x	7.4x	6.5x	10.2x	8.9x	3.2%
New Zealand King Salmon *	NZK NZ	NZ\$2.10	NZ\$292	18.9x	14.6x	10.0x	8.1x	13.4x	10.5x	3.1%
Comvita *	CVT NZ	NZ\$2.64	NZ\$131	12.5x	9.0x	9.7x	8.1x	13.9x	10.8x	2.7%
Fonterra *	FSF NZ	NZ\$3.97	NZ\$6,399	15.9x	12.0x	9.6x	9.1x	16.3x	14.7x	4.6%
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:				15.9x	12.7x	9.9x	8.6x	13.7x	11.5x	3.1%
SCL Relative:				20%	39%	-15%	-7%	-14%	-5%	64%

EV = Current Market Cap + Actual Net Debt

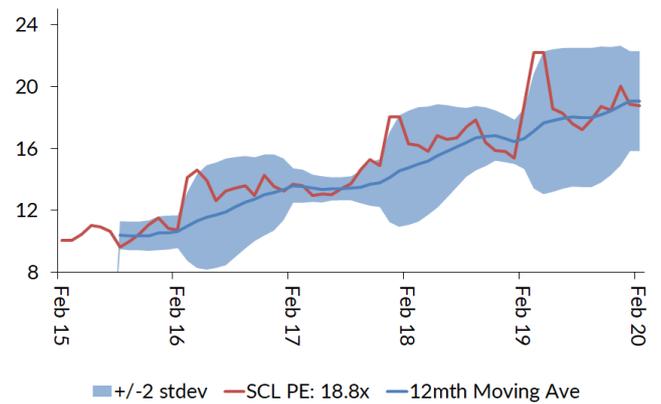
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (SCL) companies fiscal year end

Figure 11. Consensus EPS momentum (NZ\$)



Source: Forsyth Barr analysis

Figure 12. One year forward PE (x)



Source: Forsyth Barr analysis

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