

Scales

Horticulture Fails to Dazzle

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NEUTRAL 

Scales (SCL) has lowered market expectations, highlighting a tough apple pricing environment in Asia, with Underlying NPAT now expected to be at the bottom end of the NZ\$30m to NZ\$36m guidance range (Forsyth Barr NZ\$30.4m). The downgrade is entirely captured within the Horticulture business as COVID-19 related disruption resulted in weaker realised apple prices. Our target price increases slightly, up +NZ\$0.15 to NZ\$4.60 as peer multiples and time value of money offset an earnings downgrade. Looking forward, SCL's FY20 key risk period is behind it, and therefore we see limited further risk to FY20 earnings; however, with the stock trading on a 12 month forward PE of 21x we view risk/reward as fair. NEUTRAL

NZX Code	SCL	Financials: Dec/	19A	20E	21E	22E	Valuation (x)	19A	20E	21E	22E
Share price	NZ\$4.93	NPAT* (NZ\$m)	48.6	30.4	35.1	38.4	EV/EBITDA	9.2	9.9	9.0	8.3
Target price	NZ\$4.60	EPS* (NZc)	34.6	21.6	25.0	27.3	EV/EBIT	10.7	14.1	12.4	11.2
Risk rating	Medium	EPS growth* (%)	69.5	-37.4	15.6	9.4	PE	14.3	22.8	19.7	18.0
Issued shares	140.6m	DPS (NZc)	19.0	21.0	22.0	23.0	Price / NTA	2.2	2.1	2.0	1.9
Market cap	NZ\$693m	Imputation (%)	100	100	100	100	Cash div yld (%)	3.9	4.3	4.5	4.7
Avg daily turnover	115.2k (NZ\$545k)	*Based on normalised profits					Gross div yld (%)	5.4	5.9	6.2	6.5

Horticulture down on lower realised apple prices in Asia

The Horticulture division is the key driver of the earnings downgrade, with a weaker Asian market offsetting steady European growth. FY20 Horticulture earnings are expected to be materially lower than the prior year (FY19 NZ\$39.7m).

- Asian markets have been the primary source of disruption. The timing of COVID-19 restrictions in China meant that the domestic apple selling window was delayed and inventory couldn't clear the market, which, in combination with a large Chinese crop, led to pricing pressure on Southern Hemisphere apples.
 - Whilst crop sizes vary year to year, extensive COVID-19 restrictions are likely one-off. We, therefore, expect prices to recover to more normal levels in FY21.
- Europe/UK markets have held up well despite disruption, with prices having recovered from a slump in the prior year.

Food Ingredients up on additional pet food ingredients volume, led by US

Conversely, the Food Ingredients business is expected to materially outperform its prior year EBITDA result of NZ\$13.5m. Demand for pet food has been strong, with volumes lifting across all markets. We suspect there may be an element of pull through as consumers looked to stock up ahead of/during lock down restrictions. SCL's US business, Shelby, is the key standout, winning additional contracts amid COVID-19 disruption and introducing new product lines.

Forecasts updated, 1H20 result released 26 August

We have downgraded our FY20E forecast -NZ\$1.9m to NZ\$30.4m, in line with updated guidance, with minimal changes further out. FY20 headwinds are largely COVID-19 related and should reverse in the coming period. We understand guidance is predicated on adverse Horticulture condition continuing, and with the key selling period largely behind it (70% of expected export volumes sold), we see limited further downside risk to full year earnings.

SCL is set to report 1H20 earnings on Wednesday 26 August.

Scales Corporation (SCL)

Priced as at 03 Aug 2020 (NZ\$)

4.93

12-month target price (NZ\$)*

4.60

Expected share price return

-6.7%

Net dividend yield

4.4%

Estimated 12-month return

-2.3%

Spot valuations (NZ\$)

1. DCF

4.31

2. Comparative multiples

4.50

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

600

(Net debt)/cash

105

Less: Capitalised operating leases

(100)

Value of equity

605

Profit and Loss Account (NZ\$m)	2018A	2019A	2020E	2021E	2022E	Valuation Ratios	2018A	2019A	2020E	2021E	2022E
Sales revenue	402.5	484.6	464.7	483.7	516.2	EV/EBITDA (x)	14.4	9.2	9.9	9.0	8.3
Normalised EBITDA	51.7	72.0	58.1	64.4	70.1	EV/EBIT (x)	17.5	10.7	14.1	12.4	11.2
Depreciation and amortisation	(9.2)	(18.1)	(17.5)	(17.5)	(18.3)	PE (x)	24.2	14.3	22.8	19.7	18.0
Normalised EBIT	42.5	61.8	40.6	46.9	51.8	Price/NTA (x)	3.4	2.2	2.1	2.0	1.9
Net interest	(2.4)	(3.8)	1.6	1.9	1.6	Free cash flow yield (%)	2.9	5.8	3.8	6.1	6.6
Associate income	0	0	0	0	0	Net dividend yield (%)	3.9	3.9	4.3	4.5	4.7
Tax	11.0	9.4	11.8	13.7	14.9	Gross dividend yield (%)	5.4	5.4	5.9	6.2	6.5
Minority interests	0.4	3.6	0	0	0						
Normalised NPAT	28.6	48.6	30.4	35.1	38.4	Capital Structure	2018A	2019A	2020E	2021E	2022E
Abnormals/other	0	0	0	0	0	Interest cover EBIT (x)	17.5	16.3	n/a	n/a	n/a
Reported NPAT	45.5	121.6	30.4	35.1	38.4	Interest cover EBITDA (x)	21.3	19.0	n/a	n/a	n/a
Normalised EPS (cps)	20.4	34.6	21.6	25.0	27.3	Net debt/ND+E (%)	21.9	-41.9	-33.8	-32.5	-32.7
DPS (cps)	19.0	19.0	21.0	22.0	23.0	Net debt/EBITDA (x)	1.3	n/a	n/a	n/a	n/a
Growth Rates	2018A	2019A	2020A	2021A	2022A	Key Ratios	2018A	2019A	2020E	2021E	2022E
Revenue (%)	13.2	20.4	-4.1	4.1	6.7	Return on assets (%)	10.3	11.1	7.1	8.0	8.5
EBITDA (%)	14.2	39.2	-19.3	10.9	8.8	Return on equity (%)	11.6	13.7	8.3	9.2	9.6
EBIT (%)	15.7	45.4	-34.3	15.6	10.4	Return on funds employed (%)	12.6	12.2	7.7	8.6	9.2
Normalised NPAT (%)	18.5	69.8	-37.4	15.6	9.4	EBITDA margin (%)	12.9	14.9	12.5	13.3	13.6
Normalised EPS (%)	17.8	69.5	-37.4	15.6	9.4	EBIT margin (%)	10.6	12.7	8.7	9.7	10.0
Ordinary DPS (%)	0.0	0.0	10.5	4.8	4.5	Capex to sales (%)	4.0	3.2	5.8	2.8	2.6
						Capex to depreciation (%)	176	87	153	76	72
						Imputation (%)	100	100	100	100	100
						Pay-out ratio (%)	93	55	97	88	84
Cash Flow (NZ\$m)	2018A	2019A	2020E	2021E	2022E	Operating Performance	2018A	2019A	2020E	2021E	2022E
EBITDA	51.7	72.0	58.1	64.4	70.1	Revenue split (division)					
Working capital change	(17.6)	13.9	1.1	(1.1)	(1.8)	Horticulture	254.6	264.8	250.5	260.3	279.1
Interest & tax paid	(13.5)	(13.2)	(13.0)	(14.6)	(16.1)	Logistics	64.5	64.1	56.9	59.8	62.8
Other	15.9	(16.6)	7.1	7.1	7.0	Food Ingredients	83.1	155.1	157.3	163.6	174.4
Operating cash flow	36.6	56.1	53.3	55.9	59.2	Total	402.5	484.6	464.7	483.7	516.2
Capital expenditure	(16.3)	(15.7)	(26.8)	(13.4)	(13.2)						
(Acquisitions)/divestments	(15.9)	162.9	0	0	0	EBITDA split (division)					
Other	0	0	(6.4)	(6.4)	(6.3)	Horticulture	43.5	47.9	42.6	48.2	53.0
Funding available/(required)	4.4	203.3	20.1	36.1	39.7	Logistics	4.9	4.1	3.4	3.6	3.8
Dividends paid	(25.6)	(29.8)	(26.7)	(30.9)	(30.9)	Food Ingredients	11.9	13.5	16.9	17.6	18.3
Equity raised/(returned)	0.1	0	0	0	0	Overheads/other	(8.6)	(12.8)	(10.0)	(10.8)	(11.6)
(Increase)/decrease in net debt	(21.1)	173.5	(6.6)	5.2	8.8	Underlying EBITDA	51.7	52.7	52.9	58.5	63.5
Balance Sheet (NZ\$m)	2018A	2019A	2020E	2021E	2022E	EBITDA margin (%)					
Working capital	41.1	27.2	26.1	27.2	29.0	Horticulture	17.1	18.1	17.0	18.5	19.0
Fixed assets	150.6	165.7	197.3	212.8	226.5	Logistics	7.6	6.3	6.0	6.0	6.0
Intangibles	43.9	43.8	43.8	43.8	43.8	Food Ingredients	14.4	8.7	10.7	10.7	10.5
Right of use asset	0	78.8	74.6	70.7	67.0	Total	12.9	10.9	11.4	12.1	12.3
Other assets	145.5	62.7	63.7	64.8	67.2						
Total funds employed	381.0	378.2	405.5	419.3	433.5	Apple volumes ('000 TCE)					
Net debt/(cash)	69.0	(104.9)	(92.7)	(93.8)	(98.9)	Premium varieties	1,901	2,161	2,202	2,258	2,378
Lease liability	0	70.7	79.7	79.1	78.4	Traditional varieties	1,966	1,661	1,601	1,520	1,533
Other liabilities	62.1	53.4	47.5	47.5	48.9	Total	3,867	3,822	3,803	3,778	3,911
Shareholder's funds	246.3	355.0	367.0	382.5	401.2						
Minority interests	3.6	4.0	4.0	4.0	4.0						
Total funding sources	381.0	378.2	405.5	419.3	433.5						

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

Earnings changes and valuation

We lower our FY20 underlying NPAT forecasts -NZ\$1.9m to NZ\$30.4m, consistent with guidance of "bottom end" of NZ\$30m to NZ\$36m. Lower pricing assumption for premium apples varieties (Asia focussed) is the key driver of the downgrade. Providing some offset, we lift our volume assumptions through Shelby and Meateor.

We have made limited changes to earnings further out at this stage given 1) we do not expect the combination of a large China apple crop and lock down restrictions to reoccur, and 2) we suspect there is an element of demand pull forward for pet food volumes.

Figure 1. Earnings changes (NZ\$m)

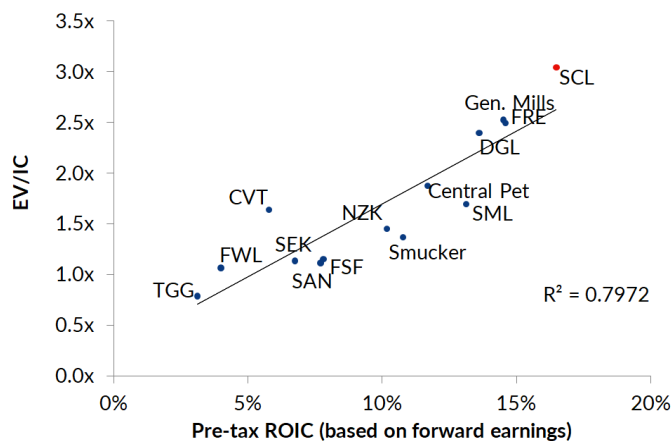
	FY20E			FY21E			FY22E		
	old	new	% chg	old	new	% chg	old	new	% chg
Sales	473.1	464.7	-1.8%	486.0	483.7	-0.5%	512.9	516.2	0.6%
EBITDA	60.7	58.1	-4.3%	64.0	64.4	0.6%	69.9	70.1	0.3%
NPAT	32.3	30.4	-5.9%	34.9	35.1	0.7%	38.3	38.4	0.2%
EPS (cps)	23.0	21.6	-5.9%	24.8	25.0	0.7%	27.3	27.3	0.2%
DPS (cps)	21.0	21.0	0.0%	22.0	22.0	0.0%	23.0	23.0	0.0%

Source: Forsyth Barr analysis

Target price increases +NZ\$0.15 to NZ\$4.60; NEUTRAL

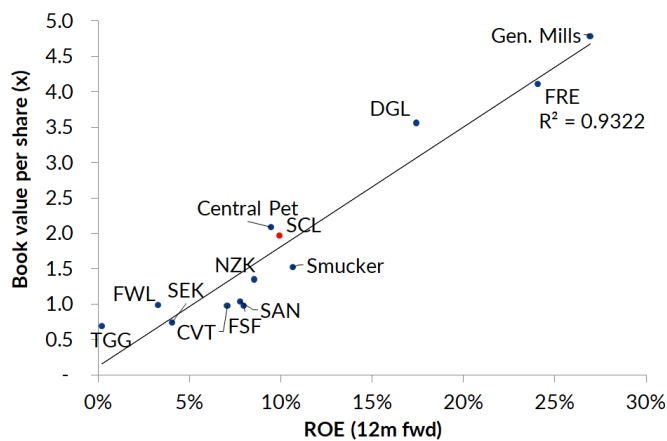
Our target price lifts slightly, up +NZ\$0.15 to NZ\$4.60 as 1) time value of money, and 2) higher peer multiples offset near-term earnings changes.

Figure 2. EV/IC vs. ROIC (consensus)



Source: Bloomberg, Forsyth Barr analysis

Figure 3. BV/share vs ROE



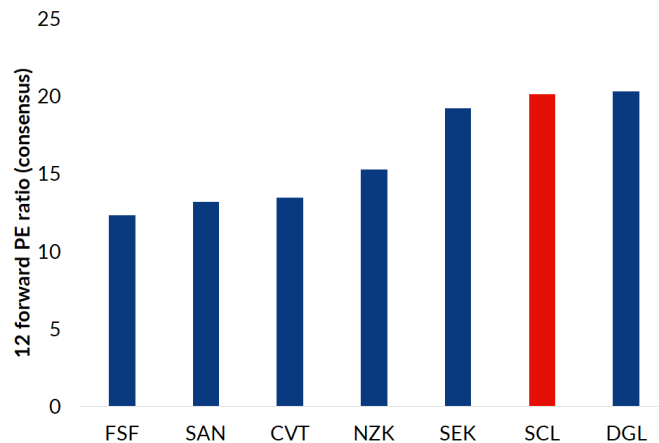
Source: Bloomberg, Forsyth Barr analysis

Figure 4. Forward PE ratio vs. NZ Agri peers



Source: Bloomberg, Forsyth Barr analysis

Figure 5. 12m forward PE ratio



Source: Bloomberg, 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.

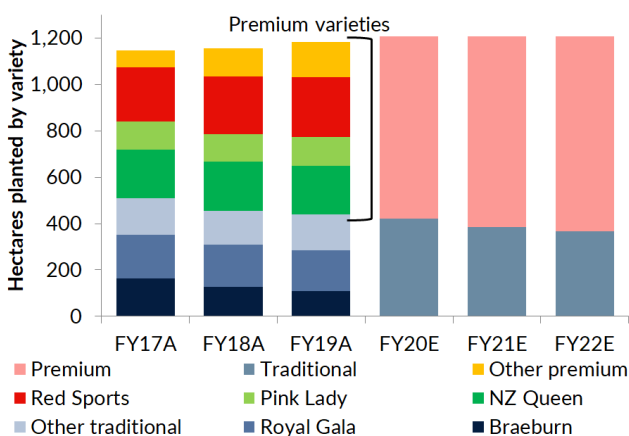
Financial structure

- **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

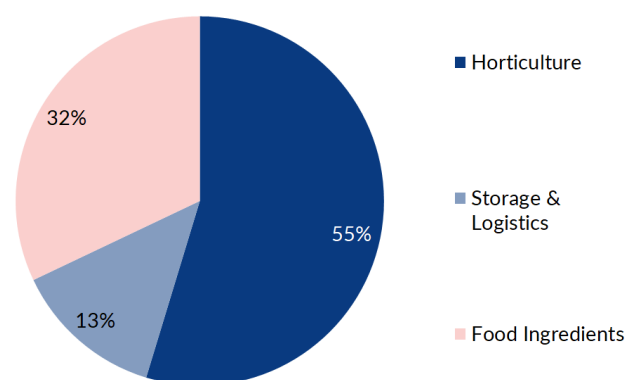
- **Climatic risks:** Extreme weather events, particularly during the key growing/harvest period, have the ability to negatively impact harvest volume and quality as well as herd cull numbers.
- **Bio-security risk:** As with any export focussed primary industry company, changes to the operating environment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

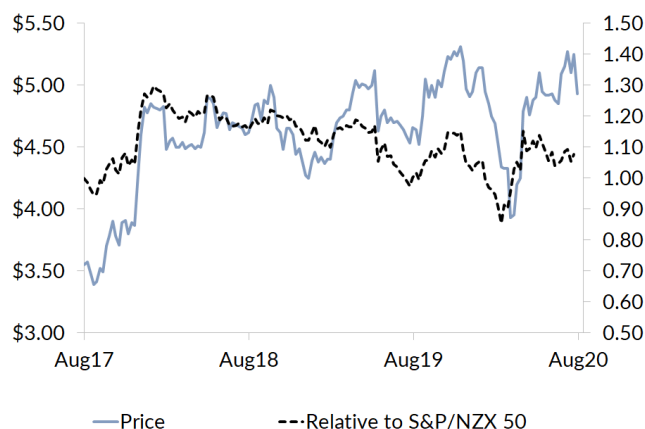


Source: Company reports, Forsyth Barr analysis

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	10.8%
Salt Funds Management	5.0%

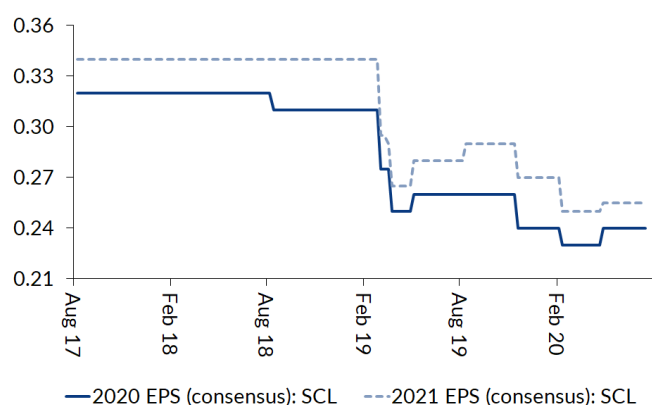
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 10. International valuation comparisons

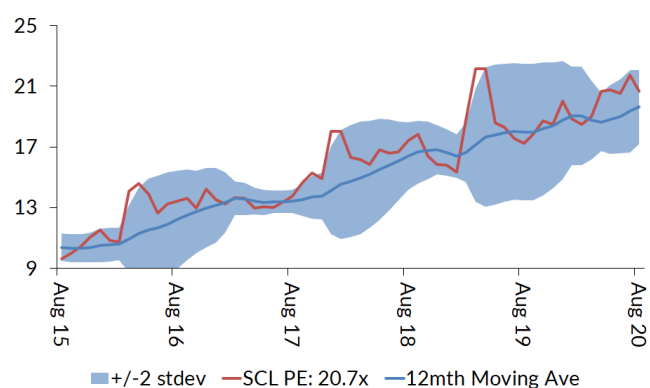
Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash Yld
(metrics re-weighted to reflect SCL's balance date - December)										
			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E
Scales	SCL NZ	NZ\$4.93	NZ\$693	22.8x	19.7x	10.1x	9.1x	14.5x	12.5x	4.5%
DELEGAT GROUP *	DGL NZ	NZ\$13.10	NZ\$1,325	21.5x	19.3x	14.0x	12.8x	16.3x	14.8x	1.4%
COMVITA *	CVT NZ	NZ\$2.97	NZ\$210	n/a	n/a	n/a	n/a	n/a	n/a	n/a
FONTERRA *	FSF NZ	NZ\$3.82	NZ\$6,167	15.3x	11.5x	9.5x	9.0x	16.0x	14.5x	4.8%
SANFORD *	SAN NZ	NZ\$6.45	NZ\$603	15.5x	11.4x	8.4x	6.5x	11.8x	9.0x	3.6%
NEW ZEALAND KING SALMON *	NZK NZ	NZ\$1.84	NZ\$256	16.4x	12.2x	8.8x	6.9x	11.8x	8.9x	3.8%
Compco Average:				17.2x	13.6x	10.2x	8.8x	14.0x	11.8x	3.4%
SCL Relative:				33%	45%	-0%	4%	4%	6%	32%
EV = Current Market Cap + Actual Net Debt										

EV = Current Market Cap + Actual Net Debt

Source: *Forsyth Barr analysis, Bloomberg Consensus, Compc 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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