

Scales

1H20 Result – A Bite out of Horticulture

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NEUTRAL 

Scales (SCL) reported a soft 1H20 result in line, at a group level, with recently lowered expectations. Earnings mix shifted from historic levels with strong Food Ingredients growth effectively offsetting a weak period for the Mr Apple business. SCL reaffirmed its FY20 underlying NPAT guidance at the lower end of NZ\$30m to NZ\$36m (Forsyth Barr NZ\$30m). We view 1H20 Horticulture disruption as being largely one-off in nature and expect earnings to normalise, although rising labour cost pressures have muted our view of long term EBIT margins. Providing an earnings offset is a higher Food Ingredients earnings base following impressive volume growth. Our target price increases +NZ\$0.70 (+15%) to NZ\$5.30 on the back of cost of capital changes. SCL is trading broadly in line with our view of fair value. NEUTRAL.

NZX Code	SCL	Financials: Dec/	19A	20E	21E	22E	Valuation (x)	19A	20E	21E	22E
Share price	NZ\$4.88	NPAT* (NZ\$m)	48.6	30.0	33.9	37.2	EV/EBITDA	9.1	9.8	8.9	8.2
Target price	NZ\$5.30	EPS* (NZc)	34.6	21.3	24.1	26.4	EV/EBIT	10.6	14.0	12.4	11.3
Risk rating	Medium	EPS growth* (%)	69.5	-38.3	13.0	9.7	PE	14.1	22.9	20.3	18.5
Issued shares	140.6m	DPS (NZc)	19.0	19.0	21.0	22.0	Price / NTA	2.2	2.1	2.0	1.9
Market cap	NZ\$686m	Imputation (%)	100	100	100	100	Cash div yld (%)	3.9	3.9	4.3	4.5
Avg daily turnover	117.3k (NZ\$557k)	*Based on normalised profits					Gross div yld (%)	5.4	5.4	6.0	6.3

Earnings mix changes larger than expected

1H20 earnings mix change was larger than expected with weaker Horticulture earnings and a stronger Food Ingredients result. A combination of a large China domestic crop and the timing of lockdown restrictions in market negatively impacted price realisation for Mr Apple. Whilst harvest sizes vary from year to year, the delayed sales window due to COVID-19 restrictions significantly exacerbated any price impact, and as such we view the impact as largely one off in nature. Conversely, lockdown policies resulted in a level of consumer stock piling of pet food, leading to increased demand for SCL's raw ingredients products as its customers looked to shore up their supply chain. Although a degree of demand is likely to normalise, we suspect SCL has gained market share and therefore expect the earnings change to be more enduring on a go forward basis.

What's implied for the 2H – continuation of apple price trends

SCL maintained its FY20 guidance. 1H20 horticulture earnings are based on the assumption that apples not sold at balance date (49% of expected sales volume) achieve prices in line with suppressed levels experienced to date. As of today SCL has sold c. 80% of its expected volumes, and we, therefore, see limited further risk to FY20 earnings. Despite commentary suggesting trading at its Food Ingredients business has remained strong into 2H20, we estimate earnings guidance implies a marginal slow down in growth. We view this as prudent given what appears to be a level of pull forward demand captured in 1H20.

Cost pressures limit Horticulture margin expansion; Growth in Food Ingredients encouraging

SCL provided first time EBIT margin guidance for its Mr Apple business out to FY25, lower than our prior expectations. Guidance highlighted that despite investments into operational efficiencies and varietal mix improvements, rising cost pressures are expected to limit any margin expansion beyond a normalisation in FY21. Providing an earnings offset, Food Ingredients delivered impressive growth in 1H20, with an additional US factory contracted (currently using 9 factories) set to contribute from FY21. We make limited net changes to our earnings forecasts but recalibrate earnings mix, lifting Food Ingredients and lowering Horticulture.

Scales Corporation (SCL)

Priced as at 26 Aug 2020 (NZ\$)

4.88
12-month target price (NZ\$)*
5.30

Expected share price return

8.6%

Net dividend yield

4.2%

Estimated 12-month return

12.8%

Spot valuations (NZ\$)

1. DCF

5.61

2. Comparative multiples

4.80

3. n/a

n/a

Key WACC assumptions

Risk free rate

1.30%

Equity beta

0.99

WACC

6.5%

Terminal growth

1.5%

DCF valuation summary (NZ\$m)

Total firm value

857

(Net debt)/cash

105

Less: Capitalised operating leases

(160)

Value of equity

802

Profit and Loss Account (NZ\$m)

	2018A	2019A	2020E	2021E	2022E
Sales revenue	402.5	484.6	478.8	495.0	528.4
Normalised EBITDA	51.7	72.0	58.1	64.1	69.7
Depreciation and amortisation	(9.2)	(18.1)	(17.7)	(17.9)	(18.8)
Normalised EBIT	42.5	61.8	40.4	46.2	50.9
Net interest	(2.4)	(3.8)	0.4	0.2	0.0
Associate income	0	0	0	0	0
Tax	11.0	9.4	10.8	12.5	13.7
Minority interests	0.4	3.6	3.5	3.8	4.0
Normalised NPAT	28.6	48.6	30.0	33.9	37.2
Abnormals/other	0	0	0	0	0
Reported NPAT	45.5	121.6	30.0	33.9	37.2
Normalised EPS (cps)	20.4	34.6	21.3	24.1	26.4
DPS (cps)	19.0	19.0	19.0	21.0	22.0

Growth Rates

	2018A	2019A	2020A	2021A	2022A
Revenue (%)	13.2	20.4	-1.2	3.4	6.7
EBITDA (%)	14.2	39.2	-19.4	10.4	8.8
EBIT (%)	15.7	45.4	-34.6	14.4	10.1
Normalised NPAT (%)	18.5	69.8	-38.3	13.0	9.7
Normalised EPS (%)	17.8	69.5	-38.3	13.0	9.7
Ordinary DPS (%)	0.0	0.0	0.0	10.5	4.8

Cash Flow (NZ\$m)

	2018A	2019A	2020E	2021E	2022E
EBITDA	51.7	72.0	58.1	64.1	69.7
Working capital change	(17.6)	13.9	0.3	(0.9)	(1.9)
Interest & tax paid	(13.5)	(13.2)	(13.5)	(15.5)	(16.9)
Other	15.9	(16.6)	7.6	7.8	7.9
Operating cash flow	36.6	56.1	52.5	55.5	58.8
Capital expenditure	(16.3)	(15.7)	(26.8)	(13.4)	(13.2)
(Acquisitions)/divestments	(15.9)	162.9	0	0	0
Other	0	0	(6.5)	(6.7)	(6.8)
Funding available/(required)	4.4	203.3	19.1	35.4	38.8
Dividends paid	(25.6)	(29.8)	(26.7)	(26.7)	(30.9)
Equity raised/(returned)	0.1	0	0	0	0
(Increase)/decrease in net debt	(21.1)	173.5	(7.6)	8.7	7.9

Balance Sheet (NZ\$m)

	2018A	2019A	2020E	2021E	2022E
Working capital	41.1	27.2	26.9	27.8	29.7
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	76.9	75.1	73.3
Other assets	145.5	62.7	64.3	64.7	67.0
Total funds employed	381.0	378.2	409.1	424.2	440.2
Net debt/(cash)	69.0	(104.9)	(91.8)	(96.3)	(100.6)
Lease liability	0	70.7	82.2	84.1	85.7
Other liabilities	62.1	53.4	44.7	47.5	47.5
Shareholder's funds	246.3	355.0	370.0	384.9	403.6
Minority interests	3.6	4.0	4.0	4.0	4.0
Total funding sources	381.0	378.2	409.1	424.2	440.2

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

Valuation Ratios

	2018A	2019A	2020E	2021E	2022E
EV/EBITDA (x)	14.3	9.1	9.8	8.9	8.2
EV/EBIT (x)	17.4	10.6	14.0	12.4	11.3
PE (x)	23.9	14.1	22.9	20.3	18.5
Price/NTA (x)	3.4	2.2	2.1	2.0	1.9
Free cash flow yield (%)	3.0	5.9	3.7	6.1	6.7
Net dividend yield (%)	3.9	3.9	3.9	4.3	4.5
Gross dividend yield (%)	5.4	5.4	5.4	6.0	6.3

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	-33.0	-33.4	-33.2
Net debt/EBITDA (x)	1.3	n/a	n/a	n/a	n/a

Key Ratios

	2018A	2019A	2020E	2021E	2022E
Return on assets (%)	10.3	11.1	7.0	7.8	8.2
Return on equity (%)	11.6	13.7	8.1	8.8	9.2
Return on funds employed (%)	12.6	12.2	7.6	8.4	8.9
EBITDA margin (%)	12.9	14.9	12.1	12.9	13.2
EBIT margin (%)	10.6	12.7	8.4	9.3	9.6
Capex to sales (%)	4.0	3.2	5.6	2.7	2.5
Capex to depreciation (%)	176	87	152	75	70
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	93	55	89	87	83

Operating Performance

	2018A	2019A	2020E	2021E	2022E
Revenue split (division)					
Horticulture	254.6	264.8	254.0	259.0	276.9
Logistics	64.5	64.1	57.8	60.6	63.7
Food Ingredients	83.1	155.1	167.0	175.4	187.9
Total	402.5	484.6	478.8	495.0	528.4

EBITDA split (division)

	2018A	2019A	2020E	2021E	2022E
Horticulture	43.5	47.9	38.1	44.5	49.8
Logistics	4.9	4.1	3.5	3.6	3.8
Food Ingredients	11.9	13.5	21.3	20.8	21.0
Overheads/other	(8.6)	(12.8)	(10.0)	(10.5)	(11.0)
Underlying EBITDA	51.7	52.7	52.9	58.5	63.7

EBITDA margin (%)

	2018A	2019A	2020E	2021E	2022E
Horticulture	17.1	18.1	15.0	17.2	18.0
Logistics	7.6	6.3	6.0	6.0	6.0
Food Ingredients	14.4	8.7	12.7	11.9	11.2
Total	12.9	10.9	11.0	11.8	12.1

Apple volumes ('000 TCE)

	2018A	2019A	2020E	2021E	2022E
Premium varieties	1,887	2,095	2,211	2,258	2,378
Traditional varieties	1,980	1,727	1,694	1,520	1,533
Total	3,867	3,822	3,905	3,778	3,911

FY20 result summary

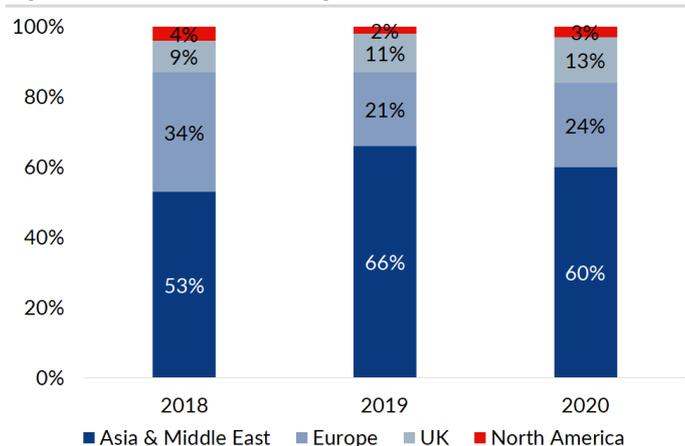
Scales (SCL) reported a soft 1H20 result as its Horticulture segment faced COVID-19 and apple price headwinds in its key Asia market, offsetting strong volume growth in its Food Ingredients business. 1H20 underlying NPAT of NZ\$29.2m was in line with recently lowered expectations.

SCL is yet to announce its interim dividend (paid in January) but has signalled no less than 9.5cps (“no less than 19cps” for the full year, with even interim/final split).

Key result take outs

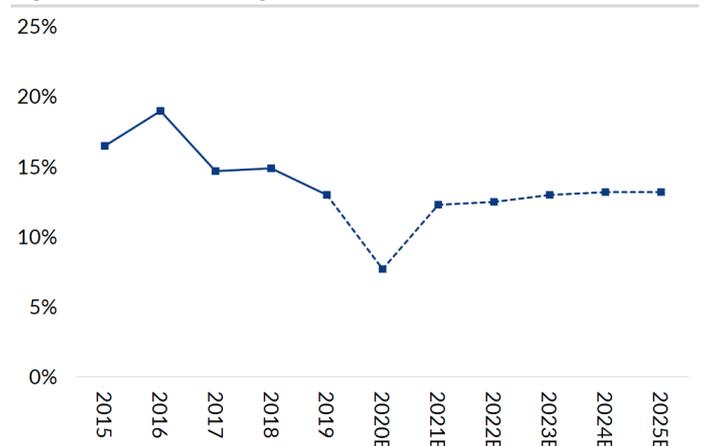
- Apple prices disappoint as China lockdown restrictions impact sales window** – The Horticulture division experienced a material step back in earnings, as weak apple prices and rising costs weighed on margin. The timing of COVID-19 restrictions in China meant that the domestic apple selling window was delayed and inventory couldn't clear the market, which, in combination with a large Chinese crop, led to pricing pressure on Southern Hemisphere apples.
 - We view price weakness as captured in FY20 and expect it to normalise. 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.
 - SCL has reiterated its long-term view of apple prices, implying price CAGR of +2.6% to FY23. Price growth is expected to be driven by mix change, as recently planted orchards mature and additional volume of premium apples is sold into Asian markets.
- Horticulture EBIT margins facing cost pressures** – SCL provided first time EBIT margin guidance for Mr Apple out to FY25, showing a normalisation of margins in FY21 then effectively remaining flat. Margin guidance was below our prior expectations.
 - SCL has experienced meaningful margin contraction as labour cost pressures build (-4% EBIT margin decline from FY15 to FY19). The company has implemented a number of strategies to provide an offset including improvements to coolstore/logistics, new planting techniques expected to deliver better yields and more efficient picking, and crop tracker technology.
- US pet food a standout performer** – Shelby, SCL's US pet food ingredients business, experienced impressive volume growth (up +14%) as it took market share amid COVID-19 disruption.
 - The pet food business is an area of investment focus for SCL and likely to benefit from favourable macro trends. Pet ownership accelerated into COVID-19 with reports of household pet adoption rates surging ahead of global lockdowns. We view growth in this business as attractive, particularly given the capital light model, however, note earnings are often derived as a marketer of product with limited competitive moat, in our view.
- What does full year guidance imply for the second half** – SCL reaffirmed FY20 underlying NPAT is expected to be towards the bottom of its NZ\$30m to NZ\$36m guidance range.
 - 1H20 Horticulture earnings imply prices as at June 2020 continue for the remainder of the period. As at today SCL has sold 80% of its expected apple export volume (compares to 82% at this time last year).
 - We estimate earnings guidance implies a marginal slow down in the Food Ingredients volume growth rate. An element of recent growth is likely to have been a pull forward of demand, as consumers stockpiled pet food ahead of lockdowns and SCL's customers looked to shore up their supply chain. Although commentary suggests trading has remained strong into 2H20, we assume some moderation in 2H20E growth.

Figure 1. Mr Apple sales by region (TCE)



Source: Company reports, Forsyth Barr analysis

Figure 2. Mr Apple margin outlook



Source: Company reports, Forsyth Barr analysis

Earnings changes and valuation

We have made minor net forecast changes. We increase our Food Ingredients earnings contribution assumptions, offsetting lower Horticulture forecasts, with the net impact being higher revenue and a lower group EBITDA margin. We also lower our interest rate assumption, lowering interest income from SCL's significant cash balance. Our dividend forecasts fall on lower earnings. SCL has committed to paying annual dividends of no less than 19cps while the company has a net cash balance.

Figure 3. Earnings changes (NZ\$m)

	old	FY20 new	% chg	old	FY21 new	% chg	old	FY22 new	% chg
Sales	464.7	478.8	3.0%	483.7	495.0	2.3%	516.2	528.4	2.4%
Normalised EBITDA	58.1	58.1	-0.1%	64.4	64.1	-0.5%	70.1	69.7	-0.5%
NPAT	30.4	30.0	-1.3%	35.1	33.9	-3.5%	38.4	37.2	-3.2%
EPS (cps)	21.6	21.3	-1.2%	25.0	24.1	-3.6%	27.3	26.4	-3.2%
DPS (cps)	21.0	19.0	-9.5%	22.0	21.0	-4.5%	23.0	22.0	-4.3%

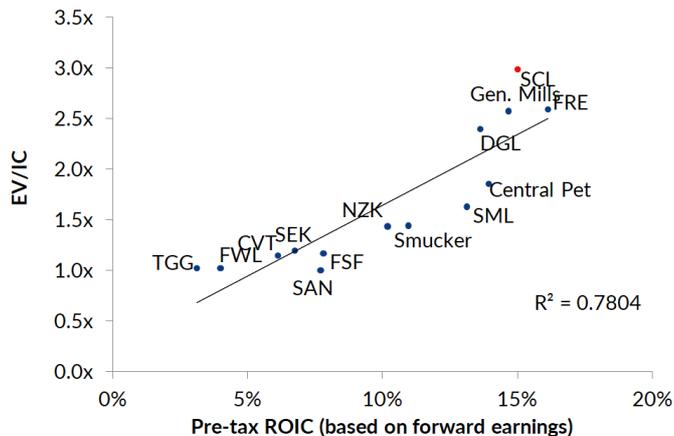
Source: Forsyth Barr analysis

Retain NEUTRAL; Target price lifts to NZ\$5.30 on cost of capital

Our target price increases +NZ\$0.70 to NZ\$5.30 (+15%), primarily driven by changes to our cost of capital. Our WACC estimate has fallen from 8.6% to 6.6% following changes to our risk free rate (from 2.0% to 1.3%) and market risk premium (from 7.5% to 6.0%), consistent with our strategy report, The Cost of Capital Conundrum – When TINA Came to Our Shores, published 7 August 2020.

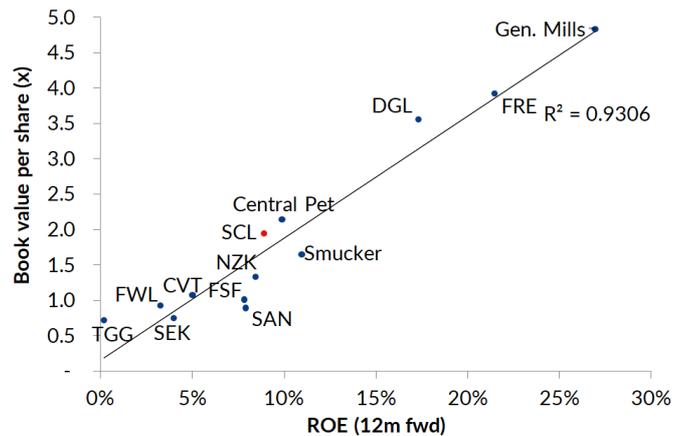
SCL is trading broadly in line with our view of fair value. SCL's key earnings driver, Mr Apple, has a track record of delivering attractive return on capital employed, and its Food Ingredients business has growth options available with low capital intensity, however at c. 23x 12 month forward PE we view this as reflected in the price and retain our NEUTRAL rating.

Figure 4. EV/IC vs. ROIC (consensus)



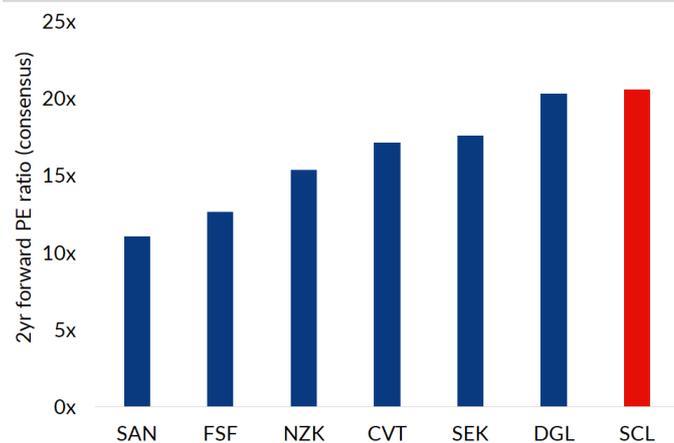
Source: Bloomberg, Forsyth Barr analysis

Figure 5. BV/share vs ROE



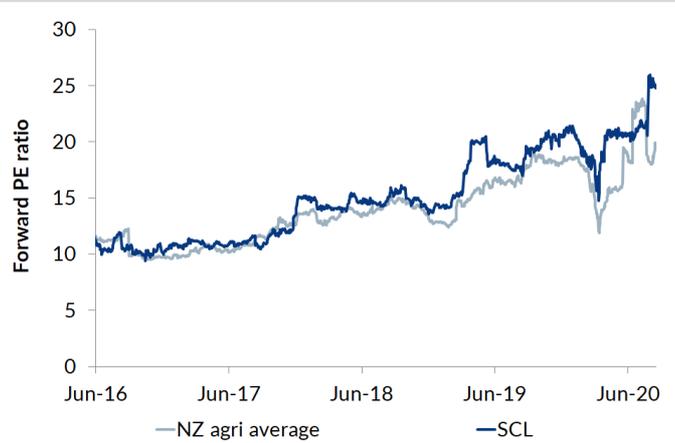
Source: Bloomberg, Forsyth Barr analysis

Figure 6. Two year forward PE ratio



Source: Bloomberg, Forsyth Barr analysis

Figure 7. Forward PE ratio vs NZ Agri peers



Source: Bloomberg, Forsyth Barr analysis

1H20 result breakdown

Figure 8. 1H20 result breakdown (NZ\$m)

	1H19	1H20	% chg	Comment
Revenue	278.0	253.3	-8.9%	Lower realised apple prices
COGS	(206.4)	(184.3)	-10.7%	
Gross profit	71.6	69.0	-3.6%	Gross profit margin 27%
Other income/expenses	(0.5)	(20.6)	n/a	
Reported EBITDA	71.1	48.4	n/a	Prior period includes fair value gains on sale
Horticulture	41.3	32.4	-21.5%	FY20 Mr Apple EBIT margin guidance c. 8% (FY19 12%)
Food Ingredients	5.1	11.0	115.7%	+14% lift in volume, with customers looking to secure supply lines
Storage & Logistics	3.1	3.2	3.2%	Consistent with expectations
Other	(2.2)	(2.2)	0.0%	
Underlying EBITDA	47.3	44.4	-6.1%	Implied FY20 guidance, low end of NZ\$49m to \$55m range
Depreciation & amortisation	(9.0)	(9.4)	4.3%	
Reported EBIT	62.1	39.0	-37.2%	
Interest expense	(3.1)	(1.1)	-63.3%	Net cash position
PBT	59.0	37.9	-35.8%	
Tax	(10.3)	(10.1)	-1.4%	
Reported NPAT (cont. ops)	48.8	27.8	-43.0%	
Adjustments	(18.7)	1.4	-108%	1H20 adjustments relate to IFRS treatments
Underlying NPAT	30.1	29.2	-3.0%	FY20 guidance, low end of NZ\$30m to NZ\$36m range
EPS (cont. ops, cps)	33.6	18.10	-46.1%	
Balance sheet & cashflow				
Inventory & ag produce	93.1	102.2	9.8%	At balance date only 51% of apples sold vs. 59% in the prior period
Working capital	100.0	96.1	-3.9%	
Net debt (cash)	(59.0)	(54.8)	-7.1%	Cash will be used for investment into Food Ingredients and possible M&A activity
Operating cashflow	(20.3)	(24.9)	22.4%	

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 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.

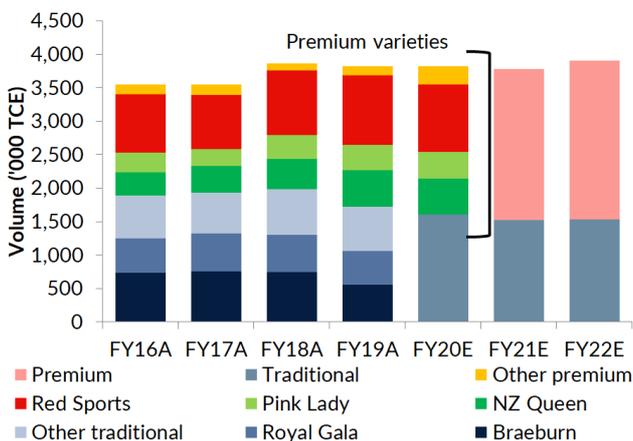
Financial structure

- **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

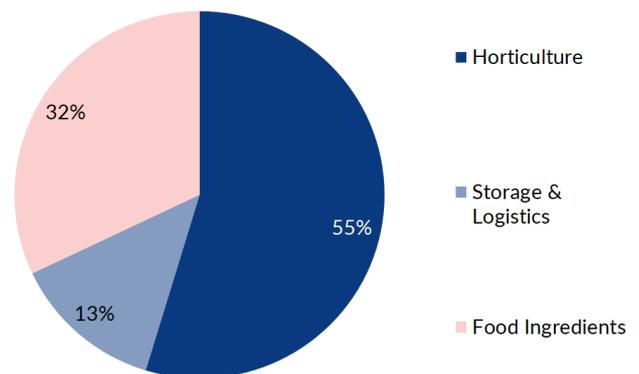
- **Climatic risks:** Extreme weather events, particularly during the key growing/harvest period, have the ability to negatively impact harvest volume and quality as well as herd cull numbers.
- **Bio-security risk:** As with any export focussed primary industry company, changes to the operating environment 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 9. Mr Apple production by variety

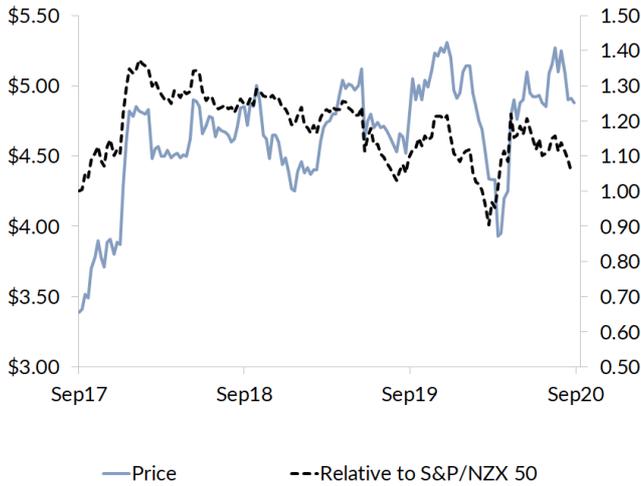


Source: Company reports, Forsyth Barr analysis

Figure 10. FY19 revenue by division



Source: Company reports, Forsyth Barr analysis

Figure 11. Price performance


Source: Forsyth Barr analysis

Figure 12. Substantial shareholders

Shareholder	Latest Holding
China Resources	15.4%
Harbour Asset Management & Jarden Securities Limited	10.0%
Salt Funds Management	5.0%

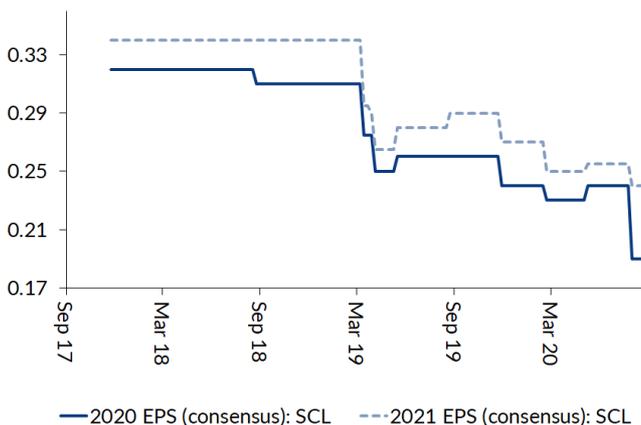
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 13. International valuation comparisons

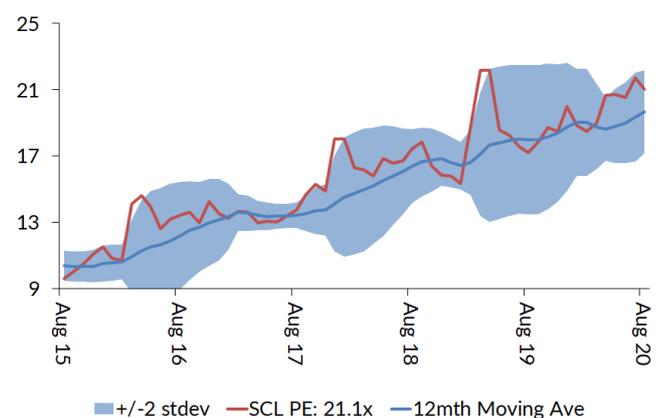
Company (metrics re-weighted to reflect SCL's balance date - December)	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash Yld 2021E
				2020E	2021E	2020E	2021E	2020E	2021E	
Scales	SCL NZ	NZ\$4.88	NZ\$686	22.9x	20.3x	10.0x	9.1x	14.4x	12.6x	4.3%
DELEGAT GROUP *	DGL NZ	NZ\$13.19	NZ\$1,334	21.6x	19.4x	14.1x	12.9x	16.4x	14.9x	1.4%
COMVITA *	CVT NZ	NZ\$3.12	NZ\$222	39.6x	18.4x	11.8x	10.7x	23.8x	18.5x	1.4%
FONTERRA *	FSF NZ	NZ\$3.92	NZ\$6,319	15.7x	11.8x	9.6x	9.1x	16.2x	14.6x	4.7%
SANFORD *	SAN NZ	NZ\$5.61	NZ\$525	13.5x	9.9x	7.5x	5.8x	10.6x	8.1x	4.1%
NEW ZEALAND KING SALMON *	NZK NZ	NZ\$1.80	NZ\$250	16.1x	11.9x	8.7x	6.7x	11.6x	8.7x	3.9%
	Compco Average:			21.3x	14.3x	10.3x	9.0x	15.7x	13.0x	3.1%
	SCL Relative:			7%	42%	-3%	0%	-8%	-3%	39%

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 14. Consensus EPS momentum (NZ\$)


Source: Forsyth Barr analysis

Figure 15. One year forward PE (x)


Source: Forsyth Barr analysis

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