1 MARCH 2021

Scales
FY20 Result — Growing Pains

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NEUTRAL

Scales (SCL) reported a soft FY20 result, as Horticulture weakness offset a surging Food Ingredients business. Pet food strength was a highlight in FY20, however, the key takeaway was the dampened outlook commentary and a downgrade to FY21 earnings guidance, cut -10% at the mid-point from its previous range. Weighing on earnings expectations are lower fruit production and Horticulture margin pressure. We lower our earnings forecasts and cut our target price -30cps to NZ$5.00. While SCL offers attractive medium-term earnings growth, it faces elevated near-term earnings risk (labour shortages) and a more opaque market outlook. We view risk reward as broadly fair. Reiterate our NEUTRAL rating.

NZX Code	SCL
Share price	NZ$4.60
Target price	NZ$5.00
Risk rating	Medium
Issued shares	140.9m
Market cap	NZ$648m
Avg daily turnover	116.7k (NZ$554k)

Financials: Dec/	20A	21E	22E	23E
NPAT* (NZ$m)	26.6	29.5	35.0	39.5
EPS* (NZc)	18.9	20.9	24.9	28.0
EPS growth* (%)	-45.4	10.9	18.8	12.8
DPS (NZc)	19.0	19.0	21.0	22.0
Imputation (%)	100	100	100	100
*Based on normalised profits				

Valuation (x)	20A	21E	22E	23E
PE	24.4	22.0	18.5	16.4
EV/EBIT	15.9	14.6	12.9	11.5
EV/EBITDA	10.5	10.3	9.4	8.6
Price / NTA	2.0	1.9	1.9	1.8
Cash div yld (%)	4.1	4.1	4.6	4.8
Gross div yld (%)	5.7	5.7	6.3	6.6

What's changed?

- **Earnings:** We cut our FY21E NPAT forecast -13% to NZ$29.5m. We also lower FY22 and FY23 NPAT forecasts -6% and -3% respectively, reflecting margin pressure through the Horticulture business.
- **Target price:** Our target price falls -30cps (-6%) to NZ$5.00 as a result of earnings changes and higher cost of capital assumptions.

Key take outs from SCL's FY20 result

- **Soft Horticulture with suppressed margin outlook** — SCL's soft Horticulture earnings were well signalled. Asian market price weakness weighed on revenue, while ongoing wage inflation impacted margin. Although the selling environment appears to have improved, we expect to see earnings weakness given 1) a lower expected crop, and 2) harvest risk and cost inflation due to low seasonal labour availability.
- **Food Ingredients growth the stand out but margin sustainability a question** — FY20 Food Ingredients EBITDA increased +71% on the prior year period to NZ$23m, supported by a structural demand tailwind for pet food and underpinned by margin expansion. EBITDA dollar/kg increased +64% on the prior year to NZ$0.20/kg (FY19 NZ$0.12/kg). We suspect margin growth was driven by supply demand dynamics, with meat works impacted by COVID-19 restrictions. However, margin reversion in FY21 is likely, and therefore we forecast a slight decline in Food Ingredients earnings.
- **NZ$98m cash balance for acquisitions** — Travel restrictions have weighed on SCL's ability to pursue bolt-on US pet food acquisitions, although expect pet food will be an area of incremental investment, with additional protein lines an opportunity to broaden its portfolio. SCL continues to pursue possible transformational acquisitions, with c. NZ$250m capacity on its balance sheet.

Guidance lowered with near-term headwinds signalled

SCL lowered its NPAT guidance range -10% at the mid-point to NZ$27.5m–NZ$32.5m (previously NZ$30m–NZ$36m). Although we expect earnings across the group to decline, the softer outlook is again primarily driven by the Horticulture business which is facing a number of headwinds in FY21 including: 1) lower third-party export volumes as a result of an adverse weather event in Tasman, 2) lowered own grown harvest expectations, 3) shipping congestion, and 4) labour shortage challenges.

FORSYTH BARR

Scales Corporation (SCL)

Priced as at 26 Feb 2021 (NZ$)	**4.60**

12-month target price (NZ$)*	**5.00**
Expected share price return	8.7%
Net dividend yield	4.2%
Estimated 12-month return	12.9%

Key WACC assumptions	
Risk free rate	2.30%
Equity beta	0.99
WACC	6.9%
Terminal growth	1.5%

Profit and Loss Account (NZ$m)	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Sales revenue	484.6	470.7	475.9	526.6	557.1
Normalised EBITDA	**72.0**	**56.7**	**59.2**	**65.8**	**72.0**
Depreciation and amortisation	(18.1)	(19.2)	(17.8)	(17.9)	(18.1)
Normalised EBIT	**61.8**	**37.6**	**41.5**	**47.9**	**53.8**
Net interest	(3.8)	(2.3)	(1.6)	(1.2)	(1.1)
Associate income	0	0	0	0	0
Tax	9.4	8.7	10.4	11.7	13.2
Minority interests	3.6	5.6	3.6	4.0	4.2
Normalised NPAT	**48.6**	**26.6**	**29.5**	**35.0**	**39.5**
Abnormals/other	0	0	0	0	0
Reported NPAT	**121.6**	**26.6**	**29.5**	**35.0**	**39.5**
Normalised EPS (cps)	34.6	18.9	20.9	24.9	28.0
DPS (cps)	19.0	19.0	19.0	21.0	22.0

Growth Rates	**2019A**	**2020A**	**2021A**	**2022A**	**2023A**
Revenue (%)	20.4	-2.9	1.1	10.6	5.8
EBITDA (%)	39.2	-21.2	4.4	11.1	9.3
EBIT (%)	45.4	-39.2	10.4	15.5	12.4
Normalised NPAT (%)	69.8	-45.3	10.9	18.8	12.8
Normalised EPS (%)	69.5	-45.4	10.9	18.8	12.8
Ordinary DPS (%)	0.0	0.0	0.0	10.5	4.8

Cash Flow (NZ$m)	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
EBITDA	**72.0**	**56.7**	**59.2**	**65.8**	**72.0**
Working capital change	13.9	4.1	(6.6)	(2.8)	(1.7)
Interest & tax paid	(13.2)	(11.0)	(15.0)	(16.0)	(17.5)
Other	(16.6)	3.4	7.6	7.7	7.9
Operating cash flow	**56.1**	**53.2**	**45.2**	**54.7**	**60.6**
Capital expenditure	(15.7)	(24.5)	(12.1)	(11.7)	(11.2)
(Acquisitions)/divestments	162.9	0.2	0	0	0
Other	0	0	(6.5)	(6.6)	(6.8)
Funding available/(required)	**203.3**	**28.9**	**26.6**	**36.4**	**42.7**
Dividends paid	(29.8)	(31.3)	(26.8)	(26.8)	(31.0)
Equity raised/(returned)	0	0	0	0	0
(Increase)/decrease in net debt	**173.5**	**(9.7)**	**(0.1)**	**9.6**	**11.7**

Balance Sheet (NZ$m)	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Working capital	27.2	20.1	26.7	29.6	31.3
Fixed assets	165.7	181.3	192.3	201.4	209.6
Intangibles	43.8	41.9	41.9	41.9	41.9
Right of use asset	78.8	77.9	75.7	73.5	71.4
Other assets	62.7	87.8	85.6	87.9	89.9
Total funds employed	**378.2**	**409.0**	**422.2**	**434.3**	**444.1**
Net debt/(cash)	(104.9)	(98.5)	(92.2)	(98.1)	(106.0)
Lease liability	70.7	70.2	82.2	84.0	85.5
Other liabilities	53.4	58.9	49.6	52.4	52.4
Shareholder's funds	355.0	373.8	377.9	391.3	407.5
Minority interests	4.0	4.6	4.6	4.6	4.6
Total funding sources	**378.2**	**409.0**	**422.2**	**434.3**	**444.1**

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

Spot valuations (NZ$)	
1. DCF	5.12
2. Comparative multiples	4.80
3. n/a	n/a

DCF valuation summary (NZ$m)	
Total firm value	796
(Net debt)/cash	98
Less: Capitalised operating leases	(160)
Value of equity	734

Valuation Ratios	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
EV/EBITDA (x)	8.6	9.3	9.0	8.1	7.4
EV/EBIT (x)	10.0	14.0	12.8	11.2	9.9
PE (x)	13.3	24.4	22.0	18.5	16.4
Price/NTA (x)	2.1	2.0	1.9	1.9	1.8
Free cash flow yield (%)	6.2	4.4	5.1	6.6	7.6
Net dividend yield (%)	4.1	4.1	4.1	4.6	4.8
Gross dividend yield (%)	5.7	5.7	5.7	6.3	6.6

Capital Structure	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Interest cover EBIT (x)	16.3	16.2	25.6	39.4	47.3
Interest cover EBITDA (x)	19.0	24.5	36.6	54.2	63.2
Net debt/ND+E (%)	-41.9	-35.8	-32.3	-33.4	-35.2
Net debt/EBITDA (x)	n/a	n/a	n/a	n/a	n/a

Key Ratios	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Return on assets (%)	11.1	6.4	7.0	7.9	8.6
Return on equity (%)	13.7	7.1	7.8	8.9	9.7
Return on funds employed (%)	12.2	7.1	7.6	8.5	9.3
EBITDA margin (%)	14.9	12.1	12.4	12.5	12.9
EBIT margin (%)	12.7	8.0	8.7	9.1	9.7
Capex to sales (%)	3.2	5.2	2.5	2.2	2.0
Capex to depreciation (%)	87	128	68	65	62
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	55	101	91	84	78

Operating Performance	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Revenue split (division)					
Horticulture	264.8	246.0	233.3	260.0	273.8
Logistics	64.1	49.8	51.3	54.7	57.5
Food Ingredients	155.1	173.7	191.4	211.9	225.8
Total	**484.6**	**470.7**	**475.9**	**526.6**	**557.1**
EBITDA split (division)					
Horticulture	47.9	35.8	39.7	46.8	52.0
Logistics	4.9	4.2	3.3	3.8	4.0
Food Ingredients	13.5	23.1	21.5	20.5	21.4
Overheads/IFRS-16 impact	(13.6)	(9.2)	(16.0)	(15.9)	(15.9)
Underlying EBITDA	**52.7**	**53.9**	**48.5**	**55.3**	**61.5**
EBITDA margin (%)					
Horticulture	18.1	14.5	17.0	18.0	19.0
Logistics	7.6	8.5	6.5	7.0	7.0
Food Ingredients	8.7	13.3	11.2	9.7	9.5
Total	**10.9**	**11.5**	**10.2**	**10.5**	**11.0**
Apple volumes ('000 TCE)					
Premium varieties	2,095	2,238	2,170	2,325	2,478
Traditional varieties	1,727	1,677	1,633	1,609	1,619
Total	**3,822**	**3,915**	**3,803**	**3,934**	**4,097**

FY20 result summary

SCL reported a well signalled soft FY20 result, with Underlying NPAT of NZ$33.8m down -7% on the prior period, albeit ahead of our expectations of NZ$30m. A softer Horticulture result was the key driver of earnings weakness, with suppressed apple prices in Asia although largely offset by significant growth in the Food Ingredients business.

SCL announced a final dividend of 9.5cps.

Divisional breakdown

- **Horticulture (underlying EBITDA NZ$31m, down -21% on the prior year) —** Horticulture revenue fell -7% as weak apple prices in Asian markets weighed on performance (average premium apple prices fell -7% on the prior comparable period). Price weakness was largely driven by the timing of lockdowns, resulting in high stocks of domestic fruit in China during the New Zealand selling period.
  - We view Asian market pricing weakness as mostly a one-off impact, however, recent market anecdotes suggest pricing for imported fruit remains below pre COVID-19 levels. Conversely, the European market is exhibiting a robust pricing backdrop following weak domestic crops.
  - Margin is expected to be suppressed in FY21, with less seasonal workers available due to border closures and therefore more higher cost (less productive) domestic workforce. SCL signalled a higher need to invest in further mechanisation of the picking process in order to combat recent wage inflation.
- **Food Ingredients (NZ$23.1m, +70%) —** The result was underpinned by its Shelby pet food business, with pet food demand benefitting from a COVID-19 tailwind. Volume sold (+4%) and price achieved (+7%) were both up on the prior year, however, the significant earnings uplift came from margin expansion (FY20 EBITDA margin 13% vs FY19 of 9%).
  - Sourcing contracts are typically negotiated on a 12-month basis. We suspect meat processors will be more aggressive around pricing agreements given the well publicised strength in the pet food sector. We factor in some reversion of margin towards historical levels.
  - Top line growth in this business has been encouraging and we expect it to continue to benefit from the structural tailwind. However, management commentary suggests travel restrictions have limited new off-take agreements and possible bolt-acquisitions in the coming year.
- **Logistics (NZ$3.4m, +4%) —** Solid result amid COVID-19 disruption, up +3% on the prior year despite a decline in volumes shipped.
  - Outlook appears more challenging given exposure to New Zealand summer fruit which has been impacted by hail events.

Figure 1. FY20 result summary (NZ$m)

	FY19	FY20	% chg	Comments
Revenue	**484.6**	**470.7**	**-2.9%**	**Lower Horticulture revenue (-7%) offset by Food Ingredients growth (+12%)**
Horticulture	39.7	31.4	-20.9%	Soft apple prices in Asia. Average realised price for premium apples -7.3% vs. pcp
Food Ingredients	13.5	23.1	71.1%	Strong demand, sales up +12%, with material EBITDA margin expansion - FY20 13% vs. FY19 9%
Logistics	3.3	3.4	3.0%	Freight volumes down -10% vs. pcp, offset by margin expansion
Corporate	(3.8)	(4.0)	5.3%	
Underlying EBITDA	**52.7**	**53.9**	**2.3%**	**Post-IFRS 16 Underlying EBITDA NZ$64.2m**
D&A	(10.2)	(10.9)	6.9%	
Underlying EBIT	**42.5**	**43.0**	**1.2%**	
Interest & tax	(6.1)	(9.2)	50.8%	Net interest revenue of NZ$0.7m (pre-IFRS 16)
Underlying NPAT	**36.4**	**33.8**	**-7.1%**	
Reported NPAT	**121.6**	**26.6**	**n/a**	**Adjustments include impairment of some orchards (NZ$4.3m)**
EPS (cps)	25.9	24.0	-7.1%	
Final DPS (cps)	9.5	9.5	n/a	Full year dividend of 19cps (flat on prior year), payout ratio 127%
Balance sheet & cashflow				
Working capital	24.3	18.5	-23.8%	NZ$19.5 growth capex. Orchard redevelopment and Whakatu coldstore
Net debt / (cash)	**(104.9)**	**(98.5)**	**-6.1%**	**Material net cash balance. International bolt-on strategy slowed by COVID**
Capex	15.7	24.5	56.1%	Orchard redevelopment and whakatu coldstore. FY21 capex likely to be at a maintenance level
Operating cashflow	56.1	53.2	-5.1%	

Source: SCL, Forsyth Barr analysis

Earnings changes and investment view

We lower our FY21E NPAT forecast -13% to NZ$29.5m, slightly below the mid-point of the guidance range (NZ$27.5m to NZ$33.5m). Earnings changes reflect lower Horticulture margin and a drop in Logistics contribution. We assume lower earnings contributions from all three divisions in FY21. We also lower our FY22E NPAT as we factor in a higher labour cost assumption. Earnings changes are more limited in FY22E and beyond, as higher average realised apple prices (mix driven) offset the rising cost base.

Figure 2. Earnings changes (NZ$m)

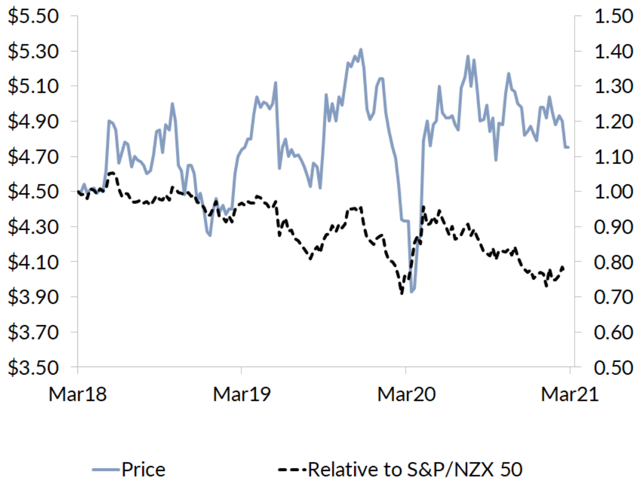
		FY21			FY22			FY23	
	old	**new**	**% chg**	**old**	**new**	**% chg**	**old**	**new**	**% chg**
Sales	495.0	475.9	-3.9%	528.4	526.6	-0.3%	557.0	557.1	0.0%
EBITDA	64.1	59.2	-7.6%	69.7	65.8	-5.6%	75.2	72.0	-4.3%
EBITDA (pre-IFRS 16)	52.9	48.5	-8.3%	59.2	55.3	-6.6%	63.7	61.5	-3.4%
NPAT	33.9	29.5	-13.0%	37.2	35.0	-5.8%	40.5	39.5	-2.5%
EPS (cps)	24.1	20.9	-13.1%	26.4	24.9	-6.0%	28.8	28.0	-2.7%
DPS (cps)	21.0	19.0	-9.5%	22.0	21.0	-4.5%	23.0	22.0	-4.3%

Source: Forsyth Barr analysis

We lower our target price -30cps to NZ$5.00; NEUTRAL

We lower our target price 30cps (-6%) to NZ$5.00, reflecting a lower margin backdrop for Horticulture and changes to our cost of capital assumptions. Our WACC estimate has increased from 6.5% to 6.9% following changes to our risk free rate (from 1.3% to 2.3%) and market risk premium (from 6.0% to 5.5%), consistent with our strategy report, *Still a One Way Bet? — Updated WACC Assumptions*, published 12 February 2021.

Figure 3. Price performance



Source: Forsyth Barr analysis

Figure 4. Substantial shareholders

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

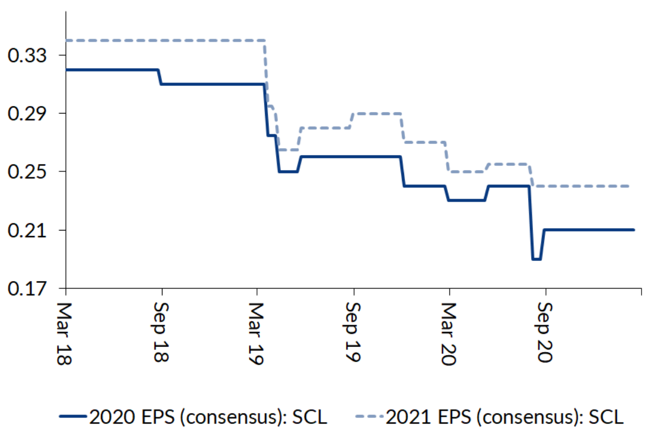
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 5. 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)	2021E	2022E	2021E	2022E	2021E	2022E	2022E
Scales	**SCL NZ**	**NZ$4.60**	**NZ$648**	**22.0x**	**18.5x**	**9.3x**	**8.3x**	**13.3x**	**11.5x**	**4.6%**
DELEGAT GROUP *	DGL NZ	NZ$15.00	NZ$1,517	21.0x	19.3x	13.8x	12.9x	15.8x	14.7x	1.3%
COMVITA *	CVT NZ	NZ$3.20	NZ$224	18.9x	15.1x	10.8x	9.7x	18.7x	15.4x	1.7%
FONTERRA *	FSF NZ	NZ$5.03	NZ$8,115	16.6x	15.0x	8.7x	8.4x	15.0x	14.3x	3.3%
SANFORD *	SAN NZ	NZ$4.45	NZ$416	14.1x	9.1x	7.8x	6.0x	12.4x	8.7x	5.2%
NEW ZEALAND KING SALMON *	NZK NZ	NZ$1.47	NZ$204	31.3x	12.8x	10.4x	6.8x	19.7x	9.8x	3.4%
			Compco Average:	**20.4x**	**14.3x**	**10.3x**	**8.7x**	**16.3x**	**12.6x**	**3.0%**
EV = Current Market Cap + Actual Net Debt			**SCL Relative:**	**8%**	**30%**	**-10%**	**-4%**	**-19%**	**-9%**	**52%**

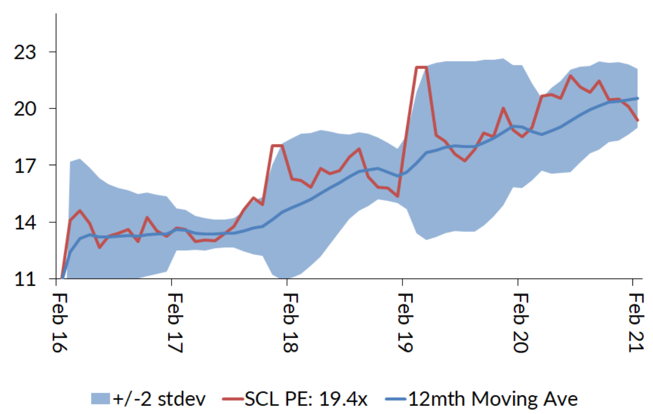
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (SCL) companies fiscal year end

Figure 6. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 7. One year forward PE (x)



Source: Forsyth Barr analysis

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