

Skellerup Holdings

1H20 — Pipe Cracks, Milk Flows

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RESEARCH INSIGHTS

Skellerup (SKL) reported a slightly weaker than expected 1H20 result as trade tensions and a slowdown in key areas of its Industrial division weighed on the period. The Agri division maintained positive momentum, with a mixture of sales growth and operational efficiencies. However, growth is being driven in lower margin international markets, offsetting operational gains. Commentary suggests activity has picked up heading into the second half, with guidance implying a flat full year result. Consequently, we have lowered our forecasts, although remain cautious around ongoing macroeconomic risks.

NZX Code	SKL	Financials: Jun/	19A	20E	21E	22E	Valuation (x)	19A	20E	21E	22E
Share price	NZ\$2.27	NPAT* (NZ\$m)	29.1	28.7	30.0	30.7	EV/EBITDA	9.6	8.7	8.4	8.3
Issued shares	192.8m	EPS* (NZc)	14.9	14.7	15.4	15.7	EV/EBIT	11.3	11.1	10.6	10.4
Market cap	NZ\$438m	EPS growth* (%)	5.5	-1.3	4.6	2.3	PE	15.2	15.4	14.7	14.4
Avg daily turnover	158.0k (NZ\$361k)	DPS (NZc)	13.0	13.0	13.5	14.0	Price / NTA	3.4	3.3	3.2	3.1
		Imputation (%)	50	50	50	50	Cash div yld (%)	5.7	5.7	5.9	6.2
		*Based on normalised profits					Gross div yld (%)	6.8	6.8	7.1	7.4

1H20 result — key points

- **Industrial slow down** — The industrial division had a relatively disappointing 1H20E, reporting a headline -15% drop in EBIT, as multiple market segments experienced weakness. Weighing on the result was a slowdown in US infrastructure projects, oil exploration, and the European automotive market. Commentary suggests activity has subsequently picked up, with the second half expected to return to growth. We have tempered our expectations for the Industrial division.
- **Agri growing offshore** — On the positive side, the Agri division has delivered strong growth, driven by increased sales into the US market which was buoyed by lower feed costs and a higher milk price. Although international growth is generally lower margin (freight costs and lower level of own brand sales), operational gains at its Wigram facility helped reduce costs and maintain margins. We expect earnings growth in this business will be hard to replicate and continue to see headwinds for dairy production domestically, but are encouraged by traction in international markets and opportunities recent acquisition Silclear could unlock.

Outlook flat, small negative earnings revisions

SKL provided first time full year guidance of FY20E NPAT “consistent with the result achieved in the prior comparable period” or ~NZ \$29m, we have tempered our forecasts slightly, down -NZ\$1.1m to NZ\$28.7m. The company has indicated a strong start to the second half, with year to date NPAT ahead of the prior comparable period. However, we continue to see risk from ongoing trade tensions, headwinds for domestic dairy production, and possible coronavirus related impacts.

1H20 is the first earnings period following the adoption of IFRS 16 treatment of leases. With prior year numbers not having been restated, it makes direct comparisons difficult at the EBITDA line in particular. The impact of IFRS 16 on the half is not material, with a ~-NZ\$0.1m impact to reported NPAT. We expect the full year impact to be ~-NZ\$0.2m and have incorporated that in earnings estimates going forward.

Skellerup Holdings (SKL)

Priced as at 13 Feb 2020 (NZ\$)

2.27

Research Insights

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We do not provide valuation, target prices or investment ratings for companies in the Research Insights series. It is targeted at selected smaller cap stocks with typically higher risk attributes, or those under transitional coverage.

Our earnings and cashflow forecasts, together with key valuation and ratios provided on this page should assist investors in determining the relative valuation merits of the company.

Profit and Loss Account (NZ\$m)	2018A	2019A	2020E	2021E	2022E	Valuation Ratios	2018A	2019A	2020E	2021E	2022E
Sales revenue	240.4	245.8	255.3	261.1	265.4	EV/EBITDA (x)	10.0	9.6	8.7	8.4	8.3
Normalised EBITDA	47.2	48.9	54.1	55.6	56.3	EV/EBIT (x)	11.8	11.3	11.1	10.6	10.4
Depreciation and amortisation	(7.5)	(7.1)	(11.6)	(11.5)	(11.3)	PE (x)	16.0	15.2	15.4	14.7	14.4
Normalised EBIT	39.8	41.8	42.5	44.1	45.0	Price/NTA (x)	3.5	3.4	3.3	3.2	3.1
Net interest	(1.9)	(1.8)	(2.1)	(1.9)	(1.8)	Free cash flow yield (%)	5.2	5.6	7.5	6.8	7.1
Associate income	0	0.0	0	0	0	Net dividend yield (%)	4.8	5.7	5.7	5.9	6.2
Tax	(10.6)	(11.0)	(11.7)	(12.3)	(12.5)	Gross dividend yield (%)	6.5	6.8	6.8	7.1	7.4
Minority interests	0	0	0	0	0						
Normalised NPAT	27.3	29.1	28.7	30.0	30.7	Capital Structure	2018A	2019A	2020E	2021E	2022E
Abnormals/other	0	0	0	0	0	Interest cover EBIT (x)	21.4	23.4	20.7	23.5	25.6
Reported NPAT	27.3	29.1	28.7	30.0	30.7	Interest cover EBITDA (x)	25.4	27.4	26.3	29.6	32.0
Normalised EPS (cps)	14.1	14.9	14.7	15.4	15.7	Net debt/ND+E (%)	15.1	17.0	13.8	11.6	9.6
DPS (cps)	11.0	13.0	13.0	13.5	14.0	Net debt/EBITDA (x)	0.7	0.7	0.5	0.4	0.4
Growth Rates	2018A	2019A	2020A	2021A	2022A	Key Ratios	2018A	2019A	2020E	2021E	2022E
Revenue (%)	14.3	2.2	3.9	2.3	1.6	Return on assets (%)	15.8	16.3	15.3	15.8	16.1
EBITDA (%)	16.2	3.6	10.5	2.8	1.2	Return on equity (%)	15.8	16.3	15.8	16.1	16.1
EBIT (%)	21.1	5.1	1.6	3.9	1.9	Return on funds employed (%)	14.4	14.5	14.2	14.9	15.1
Normalised NPAT (%)	23.2	6.5	-1.3	4.6	2.3	EBITDA margin (%)	19.6	19.9	21.2	21.3	21.2
Normalised EPS (%)	23.2	5.5	-1.3	4.6	2.3	EBIT margin (%)	16.5	17.0	16.6	16.9	16.9
Ordinary DPS (%)	15.8	18.2	0.0	3.8	3.7	Capex to sales (%)	2.3	1.9	2.0	1.9	1.9
						Capex to depreciation (%)	73	64	43	44	44
Cash Flow (NZ\$m)	2018A	2019A	2020E	2021E	2022E	Imputation (%)	86	50	50	50	50
EBITDA	47.2	48.9	54.1	55.6	56.3	Pay-out ratio (%)	78	87	88	88	89
Working capital change	(3.8)	(8.5)	(2.5)	(6.6)	(6.0)						
Interest & tax paid	(15.1)	(11.5)	(13.8)	(14.1)	(14.3)	Operating Performance	2018A	2019A	2020E	2021E	2022E
Other	0	0	0	0	0						
Operating cash flow	28.3	28.9	37.8	34.9	36.0	Revenue by segment					
Capital expenditure	(5.4)	(4.6)	(5.0)	(5.0)	(5.0)	Agri	89.0	88.8	92.7	93.7	94.6
(Acquisitions)/divestments	0.9	0.2	0	0	0	Industrial	151.5	157.2	162.7	167.6	170.9
Other	0	0	0	0	0	Total revenue (incl. eliminations)	240.4	245.8	255.3	261.1	265.4
Funding available/(required)	23.8	24.5	32.8	29.9	31.0						
Dividends paid	(19.3)	(24.3)	(25.3)	(25.3)	(26.8)	EBIT by segment					
Equity raised/(returned)	0	2.4	0	0	0	Agri	22.8	22.8	23.9	23.4	23.7
(Increase)/decrease in net debt	4.5	2.6	7.5	4.6	4.2	Industrial	20.8	22.9	22.4	24.6	25.3
						Total EBIT (incl. overheads)	39.8	41.8	42.5	44.1	45.0
Balance Sheet (NZ\$m)	2018A	2019A	2020E	2021E	2022E						
Working capital	67.9	76.1	73.9	75.7	76.9	EBIT margin by segment					
Fixed assets	93.4	91.3	89.4	87.7	86.1	Agri (%)	25.6	25.7	25.8	25.0	25.0
Intangibles	46.0	49.5	49.5	49.5	49.5	Industrial (%)	13.7	14.6	13.8	14.7	14.8
Right of use asset	0	0	19.9	19.9	19.9	Total (%)	16.5	17.0	16.6	16.9	16.9
Other assets	6.4	7.6	7.6	7.6	7.6						
Total funds employed	213.6	224.4	240.2	240.3	239.9						
Net debt/(cash)	30.7	36.6	29.1	24.5	20.3						
Lease liability	0	0	17.0	17.0	17.0						
Other liabilities	10.6	9.5	29.3	29.3	29.3						
Shareholder's funds	172.3	178.4	181.7	186.4	190.3						
Minority interests	0	0	0	0	0						
Total funding sources	213.6	224.4	257.2	257.3	256.9						

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

1H20 result

SKL reported 1H20 NPAT of NZ\$12.1m, down ~-9% on the prior period on a like for like basis (adjusted for IFRS 16). We estimate IFRS 16 had a ~-NZ\$0.1m impact on reported NPAT in 1H20 (~-NZ\$0.2m impact on FY20E). Net debt rose marginally on the prior comparable period in 1H20 to NZ\$34.7m, largely reflecting the acquisition of Silclear (NZ\$5.0m). SKL will pay an interim dividend of 5.5cps (50% imputed), flat on the prior year and in line with our expectations.

Figure 1. 1H20 result summary (NZ\$m)

	1H19	1H20*	Change	Comments
Agri	42.3	44.2	5%	International growth, namely US market
Industrial	78.0	78.9	1%	Slow down in oil exploration and infrastructure activity
Eliminations	(0.1)	(0.1)	19%	
Revenue	120.2	123.0	2%	Currency impact negligible
EBITDA	23.0	24.1	5%	
D&A	(3.6)	(6.1)	70%	IFRS 16 impact, depreciation right of use asset NZ\$2.4m
Agri	9.6	10.1	5%	Operational efficiencies offset lower margin nature of US sales
Industrial	11.7	9.9	-15%	Combined slow down in sales with ongoing tariff impact
Overheads	(1.9)	(2.0)	5%	
EBIT	19.4	18.0	-7%	NZ\$17.6m excl. IFRS 16 impact, ~NZ\$0.8m contribution from recent acquisitions
Finance costs	(0.9)	(1.3)	48%	IFRS 16 impact
PBT	18.6	16.8	-10%	
Tax expense	(5.2)	(4.6)	-11%	
Reported NPAT	13.4	12.1	-9%	NZ\$12.2 excl. IFRS 16 impact
Abnormals	-	-	n/a	
Underlying NPAT	13.4	12.1	-9%	FY20E guidance "consistent" with pcg (FY19 NZ\$29.1m)
EPS (cps)	6.9	6.2	-10%	
Interim DPS (cps)	5.5	5.5	0%	50% imputed
Balance sheet & cashflow				
Operating cashflow	13.0	24.1	84%	Strong uplift enabled by working capital release
Capex	2.7	2.4	-10%	Capex expected to remain around the NZ\$5m mark for the full year
Working capital	72.4	69.5	-4%	Improved inventory management
Net debt	32.4	34.7	7%	Acquisition of Silclear (NZ\$5.0m)

Source: Company reports, Forsyth Barr analysis * includes impact of IFRS 16

Earnings revisions

We have lowered our FY20E NPAT to NZ\$28.7m, to reflect updated guidance of "consistent" with the prior period (FY19 NZ\$29.1m), which has driven a corresponding cut in our full year dividend forecasts. We have made negative revisions across our explicit forecast period reflecting 1) a lower FY20E earnings base, 2) more subdued outlook in the industrial division given a slowdown in activity, and 3) lower forecast EBIT margins in the Industrial division. We have incorporated IFRS 16 adjustments into our forecasts, this has a small lift to EBIT and no material impact on NPAT.

Figure 2. Earnings changes (NZ\$m)

	old	FY20 new	% change	old	FY21 new	% change	old	FY22 new	% change
Revenue	255.4	255.3	-0.1%	261.3	261.1	-0.1%	265.6	265.4	-0.1%
EBIT	43.5	42.5	-2.4%	44.7	44.1	-1.3%	45.6	45.0	-1.3%
NPAT	29.8	28.7	-3.9%	30.8	30.0	-2.8%	31.5	30.7	-2.8%
EPS	15.3	14.7	-3.9%	15.8	15.4	-2.8%	16.2	15.7	-2.8%
DPS	13.5	13.0	-3.7%	14.0	13.5	-3.6%	14.5	14.0	-3.4%

Source: Forsyth Barr analysis

Investment Summary

Skellerup Holdings (SKL) contains a globally diversified range of businesses that manufacture technical rubber products for the Agricultural and Industrial sectors. GDP-type growth is driven by increased long-run demand for key commodities (mainly dairy, iron ore, and oil/gas), civil construction, and utility spending. SKL is primarily targeting growth opportunities in the US. While SKL's Agri division operates in a number of mature markets, SKL Industrial division is generating robust growth. We continue to rate management highly and like its longer-term growth prospects and sustainable margins. A new customer or contract would likely result in a meaningful lift in earnings.

Business quality

- **OEM lock in:** SKL often supplies small but essential products. OEMs have sizeable sales orders; additional OEM contracts materially increase sales and offer a more stable earnings flow.

Earnings and cashflow outlook

- **Global dairy volumes:** Best practice is for SKL's consumable rubber products to be replaced periodically by farmers. Replacement is based on the number of milkings.
- **Construction and water utility spending:** Sales in Gulf Rubber, the largest Industrial business unit, will be driven by increased construction and utility spending.
- **Regulatory changes:** Health and food safety concerns in some jurisdictions have resulted in regulated raw materials used in rubber manufacture. Increased health and food safety standards should benefit SKL given its strong reputation and chemist expertise.
- **EBIT margins:** SKL has been improving its EBIT margins, highlighting operating leverage with respect to fixed costs. Improving the Industrial division margins represent an opportunity and are showing the biggest improvement.

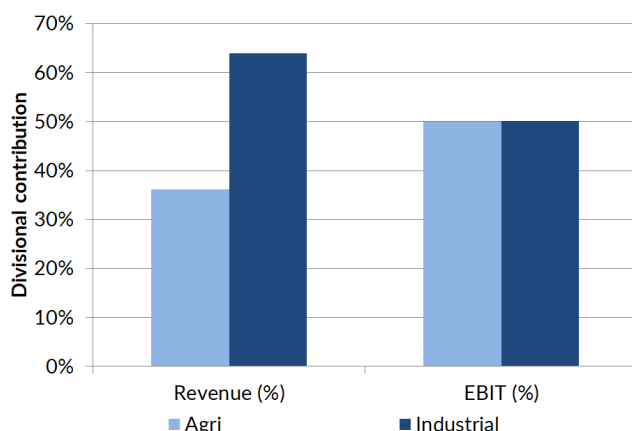
Financial structure

- **Balance sheet headroom:** SKL's undemanding debt levels (~14% geared) provide flexibility for opportunistic acquisitions. In recent history, SKL has pursued smaller bolt-on acquisitions that add technical expertise.

Risk factors

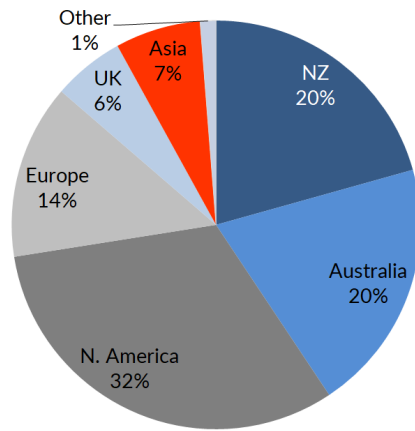
- **Commodity exposure:** Although SKL has been actively working to reduce commodity exposure, a reasonable portion of SKL's sales are tied to commodity markets. Swings in the price of commodities such as milk, iron ore, and oil & gas, can have an impact on product sales.
- **Trade risk:** SKL products are produced across the world (New Zealand, China, Vietnam, and Italy). SKL, therefore, relies on efficient trade routes when pricing for contracts.

Figure 3. Revenue and EBIT by division — FY19

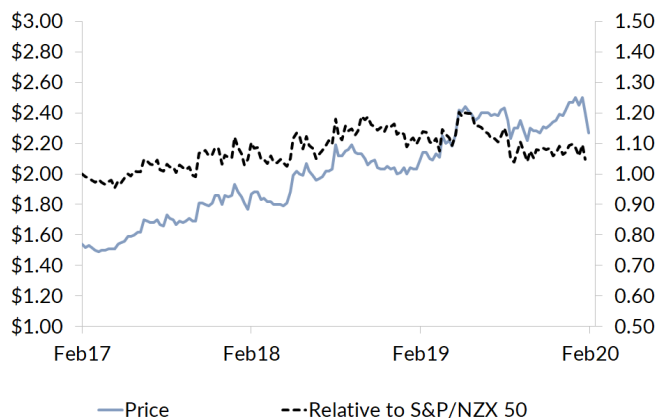


Source: Company reports, Forsyth Barr analysis

Figure 4. SKL revenue by geography — FY19



Source: Company reports, Forsyth Barr analysis

Figure 5. Price performance


Source: IRESS, Forsyth Barr analysis

Figure 6. Substantial shareholders

Shareholder	Latest Holding
Sir Selwyn John Cushing	6.5%

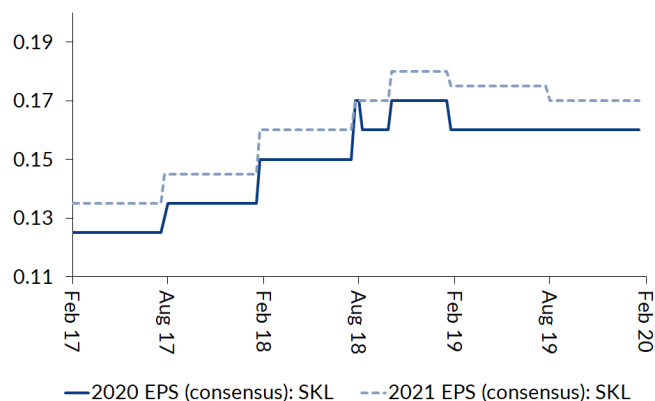
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 7. International valuation comparisons

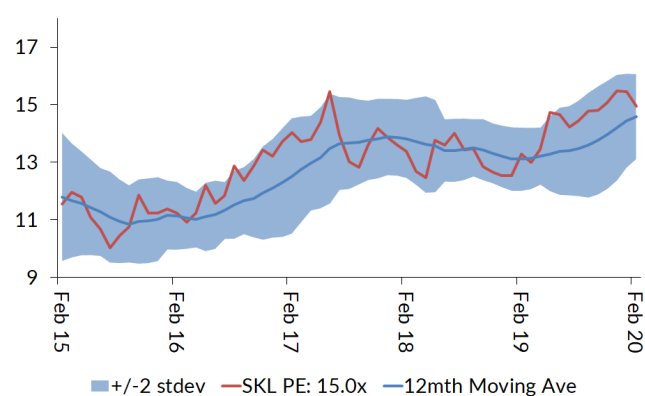
Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash Yld	
(metrics re-weighted to reflect SKL's balance date - June)											
			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E	
Skellerup Holdings	SKL NZ	NZ\$2.27	NZ\$438	15.4x	14.7x	8.8x	8.5x	11.2x	10.7x	5.9%	
Avon Rubber PLC	AVON LN	£27.50	£853	37.2x	27.4x	20.6x	15.9x	31.7x	21.4x	1.2%	
Trelleborg AB	TRELB SS	kr178.75	kr48,454	<0x	n/a	15.7x	n/a	39.5x	n/a	n/a	
PGG Wrightson *	PGW NZ	NZ\$2.32	NZ\$175	11.5x	10.0x	<0x	<0x	<0x	<0x	7.8%	
Ruralco Holdings	RHL AT	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	
Metro Performance Glass *	MPG NZ	NZ\$0.25	NZ\$46	3.9x	3.4x	2.9x	3.0x	5.2x	5.2x	16.3%	
Steel & Tube Holdings *	STU NZ	NZ\$0.80	NZ\$133	25.0x	11.2x	4.1x	3.4x	9.2x	6.3x	6.2%	
Compco Average:				19.4x	13.0x	10.8x	7.5x	21.4x	11.0x	7.9%	
EV = Current Market Cap + Actual Net Debt				SKL Relative:	-21%	13%	-19%	14%	-48%	-2%	-24%

EV = Current Market Cap + Actual Net Debt

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

Figure 8. Consensus EPS momentum (NZ\$)


Source: IRESS, Forsyth Barr analysis

Figure 9. One year forward PE (x)


Source: IRESS, Forsyth Barr analysis

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