NEW ZEALAND EQUITY RESEARCH | INDUSTRIALS | OEM PRODUCT/COMPONENT MANUFACTURER
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Skellerup Holdings
FY20 Result — Capturing US Milk Flow

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OUTPERFORM

Skellerup's (SKL) Agri division delivered a strong FY20 result, more than offsetting COVID-19 related weakness in its Industrial division. We are encouraged by Agri growth being ahead of expectations given both the high margin and consumable nature of its products. COVID-19 has created a high level of uncertainty, and whilst we acknowledge the weaker economic outlook we view SKL's earnings profile as more resilient than it has been in the past. A healthy balance sheet and low capex growth model provide some flexibility during periods of short-term turbulence or cash flow timing variability. We lift our target price +NZ$0.45 to NZ$2.90 (+18%) following cost of capital changes. With strong free cash flow, c. 5% gross dividend yield, and trading on a forward PE ratio of 18x (versus the market 22x) we continue to see value and reiterate our OUTPERFORM.

NZX Code	SKL
Share price	NZ$2.65
Target price	NZ$2.90
Risk rating	Medium
Issued shares	194.8m
Market cap	NZ$516m
Avg daily turnover	158.2k (NZ$344k)

Financials: Jun/	20A	21E	22E	23E
NPAT* (NZ$m)	29.1	28.8	29.7	30.8
EPS* (NZc)	14.9	14.8	15.3	15.8
EPS growth* (%)	0.0	-1.0	3.3	3.5
DPS (NZc)	13.0	13.5	14.0	14.5
Imputation (%)	50	50	50	50
*Based on normalised profits				

Valuation (x)	20A	21E	22E	23E
EV/EBITDA	9.9	9.9	9.6	9.4
EV/EBIT	12.9	12.7	12.3	11.9
PE	17.8	17.9	17.4	16.8
Price / NTA	4.0	3.9	3.8	3.7
Cash div yld (%)	4.9	5.1	5.3	5.5
Gross div yld (%)	5.9	6.1	6.3	6.5

Agri growth offset Industrial challenges

SKL reported FY20 NPAT (NZ$29.1m) flat on the prior year as its Agri division offset a softer Industrial result. Agri delivered 1) revenue growth as it lifted sales into the US, a market opportunity previously signalled by the company, and 2) margin expansion as it realised further operational efficiencies at its production facility. The Industrial division experienced earnings decline on flat revenue, with its infrastructure, automotive, and oil & gas exposed products the key drag. Earnings mix had a negative impact on margin. Outside of automotive, we view areas of weakness as largely COVID-19 related, with low oil demand weighing on activity and US infrastructure work suspended/delayed due to disruption, and therefore expect this to normalise over the coming two years.

Strong cash flow generation

SKL's operating cash flow increased +66% on the prior year driven by 1) robust earnings, 2) a working capital release, and 3) its low capex growth model. SKL has targeted growth through the OEM (original equipment manufacturer) channel, with customers paying upfront for product tooling. SKL reduced net debt -22% to NZ$29m. With the balance sheet conservatively geared, SKL has signalled the possibility of further bolt-on acquisitions, which the company has had recent success at executing. The company announced a final dividend of 7.5cps (FY20 13cps).

Trading well against an uncertain backdrop

Trading commentary was limited but suggests FY21 has started well. As SKL enter a period of heightened economic uncertainty the key question will be the impact on end customer demand for SKL's wide range of products, in particular, related to its Industrial division. Growth is expected to be driven by additional OEM (original equipment manufacturer) business, the nature of which means the timing of earnings contributions can be difficult to forecast, and a single project can be sizable, representing a step change in earnings. Although we suspect COVID-19 travel restrictions have likely added further delays, we see upside risk to our forecasts should SKL execute on growth opportunities.

Skellerup Holdings (SKL)

Priced as at 21 Aug 2020 (NZ$)	2.65

12-month target price (NZ$)*	2.90
Expected share price return	9.4%
Net dividend yield	5.1%
Estimated 12-month return	14.6%

Spot valuations (NZ$)	
1. DCF	2.73
2. Relative valuation	2.78
3. n/a	n/a

Key WACC assumptions	
Risk free rate	1.30%
Equity beta	1.10
WACC	7.4%
Terminal growth	1.5%

DCF valuation summary (NZ$m)	
Total firm value	531
(Net debt)/cash	(29)
Less: Capitalised operating leases	(81)
Value of equity	422

Profit and Loss Account (NZ$m)	2019A	2020A	2021E	2022E	2023E
Sales revenue	245.8	251.4	256.4	265.6	272.6
Normalised EBITDA	**48.9**	**55.3**	**55.0**	**56.1**	**57.4**
Depreciation and amortisation	(7.1)	(12.8)	(12.3)	(12.2)	(12.0)
Normalised EBIT	**41.8**	**42.5**	**42.7**	**43.9**	**45.4**
Net interest	(1.8)	(2.6)	(2.1)	(2.0)	(2.0)
Associate income	0.0	(0.1)	0	0	0
Tax	(11.0)	(10.8)	(11.8)	(12.2)	(12.6)
Minority interests	0	0	0	0	0
Normalised NPAT	**29.1**	**29.1**	**28.8**	**29.7**	**30.8**
Abnormals/other	0	0	0	0	0
Reported NPAT	**29.1**	**29.1**	**28.8**	**29.7**	**30.8**
Normalised EPS (cps)	14.9	14.9	14.8	15.3	15.8
DPS (cps)	13.0	13.0	13.5	14.0	14.5

Valuation Ratios	2019A	2020A	2021E	2022E	2023E
EV/EBITDA (x)	11.2	9.9	9.9	9.6	9.4
EV/EBIT (x)	13.2	12.9	12.7	12.3	11.9
PE (x)	17.8	17.8	17.9	17.4	16.8
Price/NTA (x)	4.0	4.0	3.9	3.8	3.7
Free cash flow yield (%)	4.7	8.5	6.9	6.6	6.9
Net dividend yield (%)	4.9	4.9	5.1	5.3	5.5
Gross dividend yield (%)	5.9	5.9	6.1	6.3	6.5

Capital Structure	2019A	2020A	2021E	2022E	2023E
Interest cover EBIT (x)	23.4	16.5	20.4	21.4	22.3
Interest cover EBITDA (x)	27.4	21.4	26.2	27.4	28.1
Net debt/ND+E (%)	17.0	13.4	10.9	9.9	8.3
Net debt/EBITDA (x)	0.7	0.5	0.4	0.4	0.3

Growth Rates	2019A	2020A	2021E	2022E	2023E
Revenue (%)	2.2	2.3	2.0	3.6	2.6
EBITDA (%)	3.6	12.9	-0.5	2.0	2.4
EBIT (%)	5.1	1.6	0.4	3.0	3.3
Normalised NPAT (%)	6.5	0.0	-1.0	3.3	3.5
Normalised EPS (%)	5.5	0.0	-1.0	3.3	3.5
Ordinary DPS (%)	18.2	0.0	3.8	3.7	3.6

Key Ratios	2019A	2020A	2021E	2022E	2023E
Return on assets (%)	16.3	15.0	15.0	15.3	15.7
Return on equity (%)	16.3	15.7	15.3	15.6	15.9
Return on funds employed (%)	14.5	14.5	14.3	14.8	15.2
EBITDA margin (%)	19.9	22.0	21.4	21.1	21.1
EBIT margin (%)	17.0	16.9	16.6	16.5	16.7
Capex to sales (%)	1.9	1.7	1.9	1.9	1.9
Capex to depreciation (%)	64	34	41	42	43
Imputation (%)	50	50	50	50	50
Pay-out ratio (%)	87	87	91	92	92

Cash Flow (NZ$m)	2019A	2020A	2021E	2022E	2023E
EBITDA	**48.9**	**55.3**	**55.0**	**56.1**	**57.4**
Working capital change	(8.5)	4.8	(0.6)	(2.7)	(2.0)
Interest & tax paid	(11.5)	(12.1)	(13.9)	(14.2)	(14.6)
Other	0	0	0	0	0
Operating cash flow	**28.9**	**48.0**	**40.5**	**39.2**	**40.8**
Capital expenditure	(4.6)	(4.4)	(5.0)	(5.1)	(5.2)
(Acquisitions)/divestments	(8.2)	(5.8)	0	0	0
Other	0	(4.7)	(4.7)	(4.8)	(4.9)
Funding available/(required)	**16.2**	**33.2**	**30.8**	**29.3**	**30.7**
Dividends paid	(24.3)	(25.3)	(25.3)	(27.3)	(27.3)
Equity raised/(returned)	2.4	0	0	0	0
(Increase)/decrease in net debt	**(5.7)**	**7.9**	**5.5**	**2.1**	**3.4**

Operating Performance	2019A	2020A	2021E	2022E	2023E
Revenue by segment					
Agri	88.8	93.6	95.5	97.4	99.3
Industrial	157.2	157.9	161.1	168.3	173.4
Total revenue (incl. eliminations)	**245.8**	**251.4**	**256.4**	**265.6**	**272.6**
EBIT by segment					
Agri	22.8	25.4	24.3	24.3	24.3
Industrial	22.9	20.9	22.1	23.6	25.1
Total EBIT (incl. overheads)	**41.8**	**42.5**	**42.7**	**43.9**	**45.4**
EBIT margin by segment					
Agri (%)	25.7	27.1	25.5	25.0	24.5
Industrial (%)	14.6	13.2	13.8	14.0	14.5
Total (%)	**17.0**	**16.9**	**16.6**	**16.5**	**16.7**

Balance Sheet (NZ$m)	2019A	2020A	2021E	2022E	2023E
Working capital	76.1	73.7	74.3	77.0	79.0
Fixed assets	91.3	87.8	86.0	84.3	82.9
Intangibles	49.5	54.9	54.9	54.9	54.9
Right of use asset	0	21.8	21.8	21.8	21.8
Other assets	7.6	7.0	7.0	7.0	7.0
Total funds employed	**224.4**	**245.2**	**244.0**	**245.0**	**245.6**
Net debt/(cash)	36.6	28.5	23.0	21.0	17.5
Lease liability	0	17.8	20.2	20.8	21.3
Other liabilities	9.5	14.4	12.8	12.8	12.8
Shareholder's funds	178.4	184.6	188.0	190.5	194.0
Minority interests	0	0	0	0	0
Total funding sources	**224.4**	**245.2**	**244.0**	**245.0**	**245.6**

FY20 result summary

Skellerup (SKL) reported a solid result amid COVID-19 disruption, reporting FY20 NPAT of NZ$29.1m, slightly ahead of our expectations (Forsyth Barr NZ$28.2m).

SKL announced a final dividend of 7.5cps (50% imputed), flat on the prior period and in line with our expectations.

Key result takeouts

- **Agri uplift enabled by further US growth, more to come —** The Agri division reported +11% EBIT growth on the prior year as it increased its sales into the US market. In addition, further operational gains at its Wigram facility enabled EBIT margin growth (FY20 Agri EBIT margin 27% vs. FY19 25.7%). The Agri result is encouraging given 1) it shows execution on international growth, a market opportunity previously signalled by the company, and 2) the consumable nature of the product means it is typically more resilient to changes in the economic backdrop.
- **Industrial division experienced challenges —** Industrial EBIT fell -8% year on year, on flat revenue, negatively impacted by sales mix and COVID-19 related disruptions. SKL's vacuum systems sales fell, as US oil and gas activity declined (weak oil prices with global social distancing restrictions impacting demand).
- **Acquisitions performing well —** SKL made two bolt-on acquisitions in 2019 (Nexus and Silclear) with both performing well, and ahead of expectations.
  - Silclear produces silicon tubing for sale into international diary markets. Its sales to the European market are performing and have recently won new business, while in the US it is in trial phase for sale to a large OEM (original equipment manufacturer).
  - Nexus Foams produces high end performance foam, selling into both the health care and comfort (sofas etc.) foam market, both of which have experienced COVID tailwinds.
- **Healthy balance sheet and strong cash flows —** FY20 operating cash flow of NZ$48m, was +66% ahead of the prior comparable period and enabled further reduction of net debt (FY20 NZ$29m, 0.5x net debt/EBITDA). Operating cash flow was in part supported by a release in working capital expected to reverse in FY21. Due to COVID-19 related concern, there was strong demand for certain products in 3Q20, pulling forward sales from 4Q20 and artificially lowering receivables.

Outlook comments

- **Solid start to FY21 —** Outlook commentary suggests FY21 trading has started well in both divisions. Due to Level 3 and 4 production capacity restrictions, a level of FY20 international Agri sales were deferred into FY21.
- **Projects on the go, with growth expected to be driven by Industrial —** The Industrial division is expected to be the key driver of growth going forward, both through additional business wins and margin expansion. SKL highlighted a number of projects where customers have already committed capital towards the development of products. The nature of OEM (original equipment manufacturer) business means the timing of earnings contributions can be difficult to forecast and we suspect COVID-19 travel restrictions have likely added further delays, however, a single project can be sizable and represent a step change in earnings. We see upside risk to our forecasts from additional business wins.

Earnings changes and valuation

We have made modest changes to our earnings forecasts as we lift our Agri earnings base, reflecting international sales growth and operational efficiencies (higher margin assumptions).

Figure 1. Earnings changes (NZ$m)

	FY21E			FY22E			FY23E		
	old	new	% chg	old	new	% chg	old	new	% chg
Revenue	252.7	256.4	1.5%	261.8	265.6	1.5%	268.7	272.6	1.5%
EBIT	**41.6**	**42.7**	**2.6%**	**42.8**	**43.9**	**2.6%**	**44.3**	**45.4**	**2.6%**
Normalised NPAT	28.2	28.8	2.1%	29.1	29.7	2.2%	30.1	30.8	2.2%
EPS (cps)	14.5	14.8	2.1%	14.9	15.3	2.2%	15.4	15.8	2.2%
DPS (cps)	13.5	13.5	-	14.0	14.0	-	14.0	14.5	3.6%

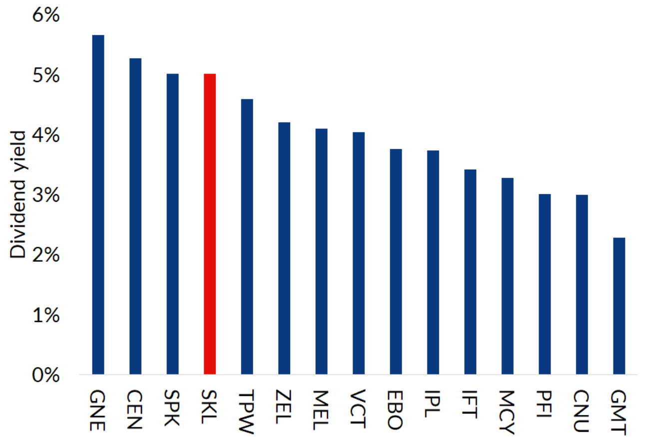
Source: Forsyth Barr analysis

+NZ$0.45 lift to target price, now NZ$2.90; OUTPERFORM rating reiterated

Our target price increases +NZ$0.45 to NZ$2.90 (+18%), driven by a combination of earnings changes and WACC impacts. Our WACC estimate has fallen from 8.7% to 7.4% 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.

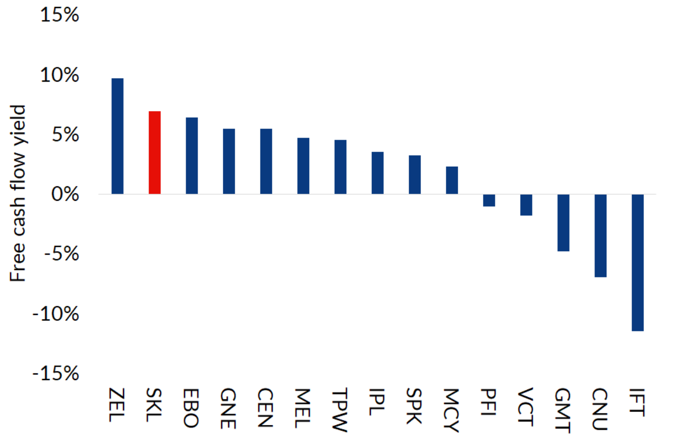
We reiterate our OUTPERFORM rating on SKL. FY20 illustrated the strength of its Agri division, with demand for consumable products used in the milking of cows remaining robust through disruption. Although its Industrial division experienced a slow down, a portion of that can be attributed to COVID-19 related headwinds, and therefore expected to normalise. We view SKL's earnings base as more resilient to changes in the economic backdrop than it has been in the past. SKL offers investors a c. 5% cash yield, backed by a healthy balance sheet (13% geared), and reasonable cash generation (free cash flow yield of c. 7%).

Figure 2. Attractive dividend yield



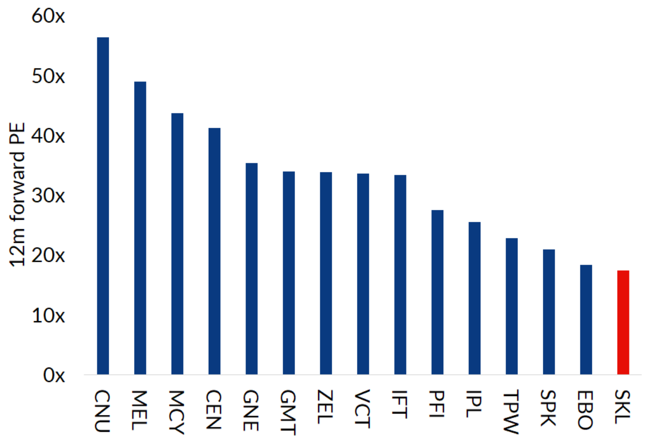
Source: Bloomberg, Forsyth Barr analysis

Figure 3. Strong cash generation



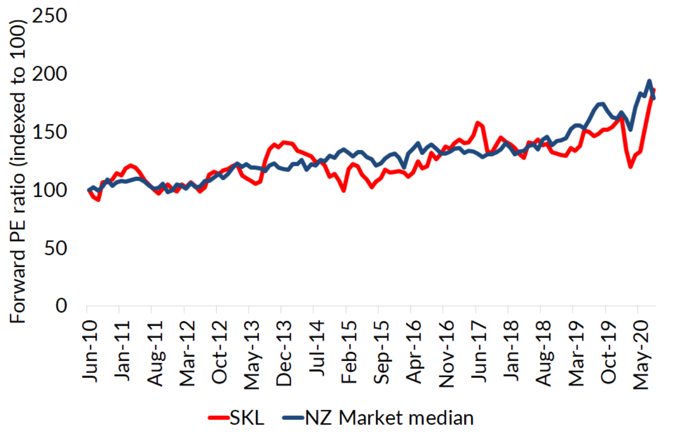
Source: Bloomberg, Forsyth Barr analysis

Figure 4. Valuation remains attractive



Source: Bloomberg, Forsyth Barr analysis

Figure 5. Historic against the market



Source: Bloomberg, Forsyth Barr analysis

FY20 result breakdown

Figure 6. FY20 result breakdown (NZ$m)

	FY19	FY20	Change	Comments
Agri	88.8	93.6	5%	International growth, namely US market
Industrial	157.2	157.9	0%	Slow down in oil exploration, infrastructure activity & automotive
Eliminations	(0.1)	(0.2)	4%	
Revenue	**245.8**	**251.4**	**2%**	
EBITDA	**48.9**	**55.3**	**13%**	
Depreciation & Amortisation	(7.1)	(12.8)	79%	IFRS-16 impact of NZ$5.0m
Agri	25.4	24.3	-4%	EBIT margin improvement enabled by operational efficiencies
Industrial	20.9	22.1	6%	Lower vacuum systems sales (high margin product)
Overheads	(4.5)	(4.0)	-10%	
EBIT	**41.8**	**42.5**	**2%**	**Led by Agri margin expansion**
Finance costs	(1.8)	(2.6)	45%	IFRS-16 impact of NZ$0.9
PBT	**40.0**	**39.9**	**0%**	
Tax expense	(11.0)	(10.8)	-2%	27% effective tax rate
Reported NPAT	**29.1**	**29.1**	**0%**	
Abnormals	-	-	n/a	
Underlying NPAT	**29.1**	**29.1**	**0%**	**IFRS 16 impact of -NZ$0.4m**
EPS (cps)	14.8	14.8	0%	
Final DPS (cps)	7.5	7.5	0%	50% imputed
Balance sheet & cashflow				
Operating cashflow	**28.9**	**48.0**	**66%**	**Strong operating cashflow, enabled by working capital release**
Free cash flow yield	6.9%	8.5%	160bps	Good cash generation
Capex	5.3	4.1	-24%	Low capex model, expected to remain around ~NZ$5m
Working capital	76.6	72.7	-5%	Receivables lower due in part to a COVID-19 shift in seasonal profile
Net debt (cash)	**36.6**	**28.5**	**-22%**	**Continues to explore acquisition opportunities**
Gearing	17%	13%	-4%	Healthy balance sheet

Source: Company reports, Forsyth Barr analysis

Investment Summary

Skellerup Holdings (SKL) contains a globally diversified range of businesses that manufacture highly technical products for the Agricultural and Industrial sectors. Growth is linked to long-run demand for key commodities (mainly dairy, iron ore, and oil/gas), civil construction, and utility spending. SKL's Agri division operates in a number of mature markets, with growth expected to come from market share gains offshore, namely the US. SKL's Industrial division is generating robust growth through OEM (original equipment manufacturer) business wins. We continue to rate management highly and like its longer-term growth prospects. A new customer or contract would likely result in a meaningful lift in earnings. OUTPERFORM.

Business quality

- **OEM lock in:** SKL often supplies small but essential products. OEMs have sizeable sales orders; additional OEM customers 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 represents an opportunity.

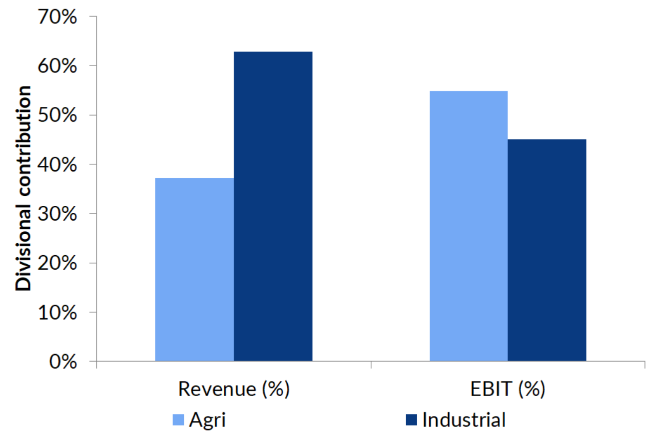
Financial structure

- **Balance sheet:** SKL has balance sheet headroom (17% geared) to pursue possible bolt-on acquisitions.

Risk factors

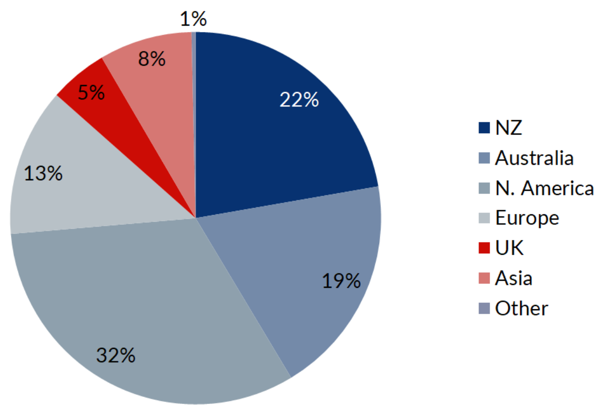
- **Commodity exposure:** Although SKL has been actively working to reduce commodity exposure, a reasonable portion of SKL's sales are tied to commodity markets. Swings in the price of commodities such as milk, iron ore, and oil & gas, can have an impact on product sales.
- **Trade risk:** SKL products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

Figure 7. Revenue and EBIT by division (FY20)



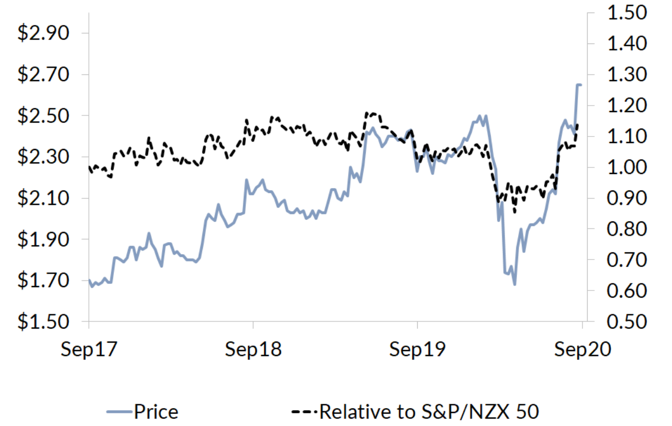
Source: Company reports, Forsyth Barr analysis

Figure 8. SKL revenue by geography (FY20)



Source: Company reports, Forsyth Barr analysis

Figure 9. Price performance



Source: Forsyth Barr analysis

Figure 10. Substantial shareholders

Shareholder	Latest Holding
Sir Selwyn John Cushing	6.5%
Forsyth Barr Investment Management	5.0%

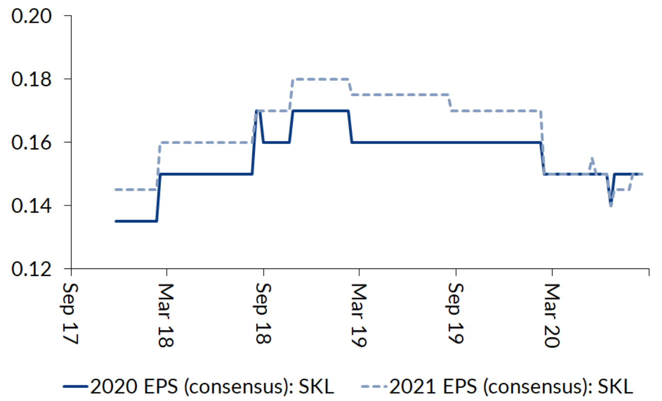
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 11. 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)	2021E	2022E	2021E	2022E	2021E	2022E	2022E
Skellerup Holdings	**SKL NZ**	**NZ$2.65**	**NZ$516**	**17.9x**	**17.4x**	**9.9x**	**9.7x**	**12.8x**	**12.4x**	**5.3%**
AVON RUBBER PLC	AVON LN	£36.75	£1,140	32.4x	29.0x	20.9x	19.4x	26.1x	23.2x	1.1%
TRELLEBORG AB-B SHS	TRELB SS	kr148.10	kr40,146	13.2x	11.3x	9.5x	8.5x	13.8x	11.5x	3.5%
PGG WRIGHTSON *	PGW NZ	NZ$2.60	NZ$196	12.4x	11.8x	4.0x	3.9x	8.3x	7.9x	6.9%
NUTRIEN	NTR CN	US$51.80	US$29,552	27.1x	22.1x	10.8x	10.0x	21.4x	18.4x	3.7%
METRO PERFORMANCE GLASS	MPG NZ	NZ$0.21	NZ$39	14.4x	21.4x	5.5x	6.1x	15.3x	18.1x	0.6%
STEEL & TUBE HOLDINGS *	STU NZ	NZ$0.55	NZ$91	21.0x	8.0x	3.1x	2.6x	7.5x	5.0x	10.9%
			Compco Average:	**20.1x**	**17.3x**	**9.0x**	**8.4x**	**15.4x**	**14.0x**	**4.5%**
EV = Current Market Cap + Actual Net Debt			**SKL Relative:**	**-11%**	**1%**	**11%**	**16%**	**-17%**	**-12%**	**19%**

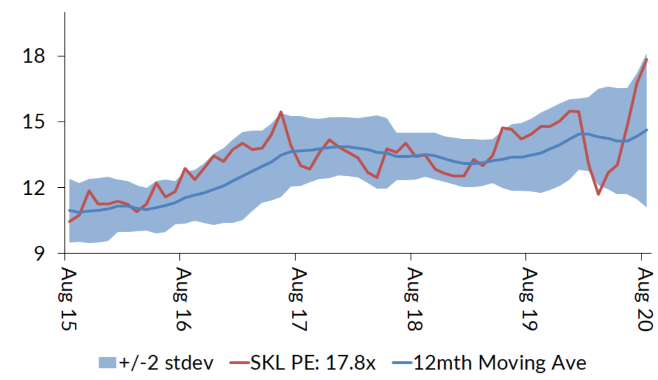
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (SKL) companies fiscal year end

Figure 12. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 13. One year forward PE (x)



Source: Forsyth Barr analysis

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