FORSYTH BARR

NEW ZEALAND EQUITY RESEARCH | FOOD, BEVS, & AGRI | HORTICULTURE
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Scales
First Taste of Guidance

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NEUTRAL

Scales (SCL) provided first time FY21 earnings guidance, in line with expectations, signaling a normalisation of apple market conditions combined with labour cost pressures as a result of seasonal shortages. We view guidance as conservative albeit justified given the margin of error in providing guidance ahead of the key harvest period and the elevated seasonal labour risks. At 20x 12 month forward PE SCL is trading broadly in line with our view of fair value. NEUTRAL.

NZX Code	SCL
Share price	NZ$4.74
Target price	NZ$5.30
Risk rating	Medium
Issued shares	140.6m
Market cap	NZ$666m
Avg daily turnover	116.9k (NZ$551k)

Financials: Dec/	19A	20E	21E	22E
NPAT* (NZ$m)	48.6	30.0	33.9	37.2
EPS* (NZc)	34.6	21.3	24.1	26.4
EPS growth* (%)	69.5	-38.3	13.0	9.7
DPS (NZc)	19.0	19.0	21.0	22.0
Imputation (%)	100	100	100	100

*Based on normalised profits

Valuation (x)	19A	20E	21E	22E
PE	13.7	22.2	19.7	17.9
EV/EBIT	10.9	15.4	13.8	12.5
EV/EBITDA	9.3	10.7	9.9	9.1
Price / NTA	2.1	2.0	2.0	1.9
Cash div yld (%)	4.0	4.0	4.4	4.6
Gross div yld (%)	5.6	5.6	6.2	6.4

Earnings commentary

- **FY20 guidance:** Underlying NPAT guidance at the lower end of its previously announced range of NZ$30m to NZ$36m — Forsyth Barr NZ$30m
  - **Dividend:** SCL announced an interim dividend of 9.5cps and reiterated commitment to an annual dividend of no less than 19cps — in line with our prior assumptions
- **FY21 guidance:** Underlying NPAT guidance range of NZ$30m to NZ$36m — Forsyth Barr NZ$34m

What's implied in FY21 guidance — A normalisation of apple markets but higher operating costs

We view SCL's FY21 guidance range as conservative but justified given the timing, pre-harvest (highest risk period), and elevated labour shortage risk. Assumed within the guidance range is a normalisation of apple market conditions, with the prior year materially impacted by the timing of lockdowns in China. Northern Hemisphere production forecasts are for a year on year decline in apple crops across major producing areas, supportive of improved pricing conditions. Offsetting price improvements are higher operating cost assumptions driven by a combination of 1) labour cost inflation, 2) RSE (recognised seasonal employer) labour quarantine costs (c. NZ$11.5m across the sector), and 3) likely labour productivity losses from a higher portion of "first-time" workforce.

SCL's Mr Apple business has large seasonal labour requirements. Whilst the recent government announcement to allow a further 2,000 RSE workers into the country, alongside the c. 6,000 already in place, goes someway to alleviate labour shortage risks, there remains a significant shortfall which will need to be filled by domestic residents. The current RSE cap is 14,400 while the total number of RSE workers in New Zealand at any one time in 2020 was 10,500, which implies a shortfall of c. 20% to 40%. SCL retains a level of confidence that current initiatives should attract sufficient labour to meet harvest requirements, however, there remains both a risk of shortfall and elevated costs as a result of productivity losses associated with a new workforce.

Increasing Food Ingredients contribution

The standout performer in FY20 has been the Food Ingredients division, namely the pet food businesses, with travel bans and lockdown policies driving higher pet ownership. SCL is in the process of commissioning Shelby's new plant which should support further volume growth. Whilst there was no update on possible acquisitions, we expect pet food will be an area of incremental investment, with additional protein lines an opportunity to broaden its portfolio.

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Scales Corporation (SCL)

Priced as at 09 Dec 2020 (NZ$)					4.74

12-month target price (NZ$)*	**5.30**
Expected share price return	11.8%
Net dividend yield	4.4%
Estimated 12-month return	16.2%

Spot valuations (NZ$)	
1. DCF	5.71
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	873
(Net debt)/cash	105
Less: Capitalised operating leases	(160)
Value of equity	818

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

Valuation Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EV/EBITDA (x)	13.9	8.8	9.4	8.6	7.9
EV/EBIT (x)	16.9	10.3	13.5	12.0	10.9
PE (x)	23.2	13.7	22.2	19.7	17.9
Price/NTA (x)	3.3	2.1	2.0	2.0	1.9
Free cash flow yield (%)	3.0	6.1	3.8	6.3	6.8
Net dividend yield (%)	4.0	4.0	4.0	4.4	4.6
Gross dividend yield (%)	5.6	5.6	5.6	6.2	6.4

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

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

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

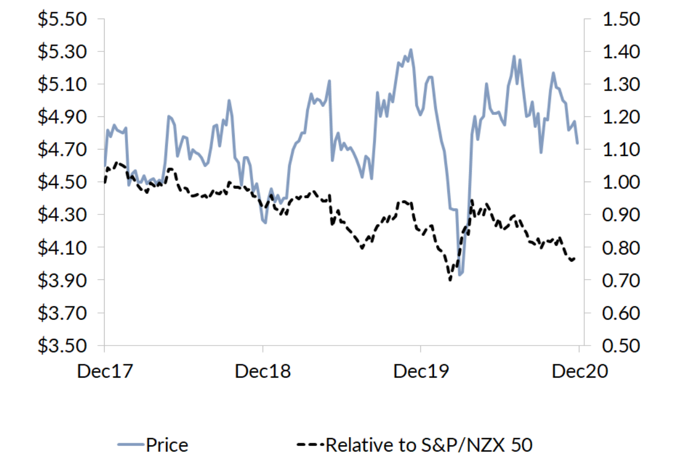
Cash Flow (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EBITDA	**51.7**	**72.0**	**58.1**	**64.1**	**69.7**
Working capital change	(17.6)	13.9	0.3	(0.9)	(1.9)
Interest & tax paid	(13.5)	(13.2)	(13.5)	(15.5)	(16.9)
Other	15.9	(16.6)	7.6	7.8	7.9
Operating cash flow	**36.6**	**56.1**	**52.5**	**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**

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)					
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 (%)					
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)					
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**

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

Figure 1. Price performance



Source: Forsyth Barr analysis

Figure 2. Substantial shareholders

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

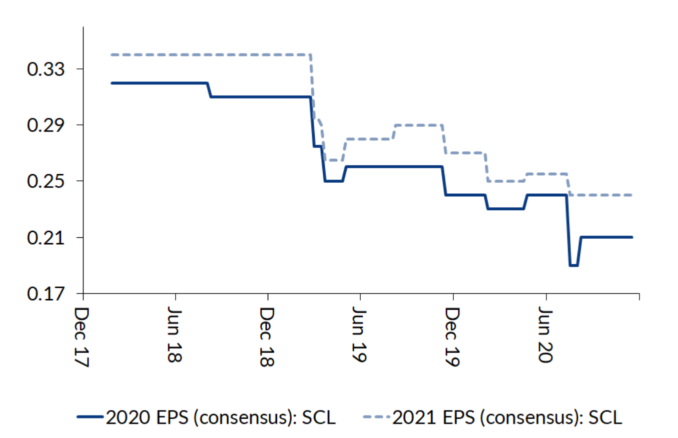
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 3. 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$4.74**	**NZ$666**	**22.2x**	**19.7x**	**9.7x**	**8.8x**	**13.9x**	**12.1x**	**4.4%**
DELEGAT GROUP *	DGL NZ	NZ$15.75	NZ$1,593	24.7x	23.0x	16.0x	14.8x	18.7x	17.2x	1.2%
COMVITA *	CVT NZ	NZ$3.27	NZ$228	41.5x	19.3x	12.2x	11.0x	24.5x	19.0x	1.4%
FONTERRA *	FSF NZ	NZ$4.37	NZ$7,050	17.0x	14.4x	7.9x	7.9x	13.7x	13.8x	3.3%
SANFORD *	SAN NZ	NZ$5.10	NZ$477	19.7x	16.1x	9.8x	8.6x	16.7x	13.7x	2.9%
NEW ZEALAND KING SALMON *	NZK NZ	NZ$1.62	NZ$225	21.4x	22.3x	10.7x	9.6x	17.6x	15.5x	2.5%
			Compco Average:	**24.9x**	**19.0x**	**11.3x**	**10.4x**	**18.3x**	**15.8x**	**2.2%**
EV = Current Market Cap + Actual Net Debt			**SCL Relative:**	**-11%**	**3%**	**-14%**	**-16%**	**-24%**	**-23%**	**98%**

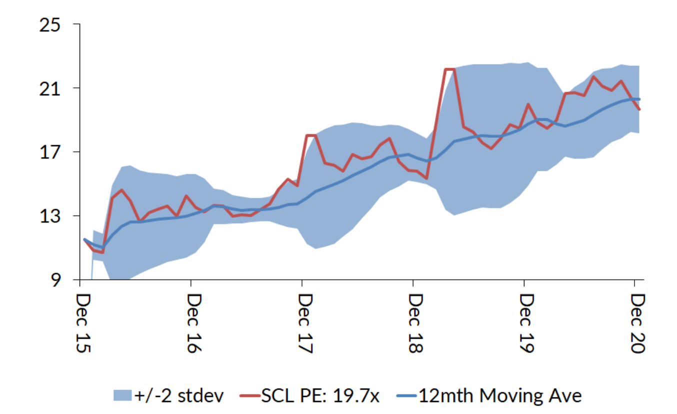
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (SCL) companies fiscal year end

Figure 4. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 5. One year forward PE (x)



Source: Forsyth Barr analysis

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