FORSYTH BARR

NEW ZEALAND EQUITY RESEARCH | INDUSTRIALS | OEM PRODUCT/COMPONENT MANUFACTURER
26 JUNE 2020

Skellerup Holdings
Delivering Through Disruption

GUY HOOPER
guy.hooper@forsythbarr.co.nz
+64 4 495 5255

OUTPERFORM

Skellerup (SKL) has issued FY20 guidance ahead of our expectations, highlighting its agility to adjust to new operating conditions and the resilient nature of demand for a number of product lines. SKL's Agri business has been a highlight and although the Industrial division experienced a slow down, demand in recent months has rebounded stronger and faster than we would have expected. We lift our earnings forecasts in line with company guidance and increase our target price +NZ $0.05 to NZ$2.45. We reiterate our OUTPERFORM rating.

NZX Code	SKL
Share price	NZ$2.20
Target price	NZ$2.45
Risk rating	Medium
Issued shares	194.8m
Market cap	NZ$428m
Avg daily turnover	146.1k (NZ$318k)

Financials: Jun/	19A	20E	21E	22E
NPAT* (NZ$m)	29.1	28.2	28.2	29.1
EPS* (NZc)	14.9	14.5	14.5	14.9
EPS growth* (%)	5.5	-2.9	-0.2	3.2
DPS (NZc)	13.0	13.0	13.5	14.0
Imputation (%)	50	50	50	50
*Based on normalised profits				

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	9.4	8.9	8.8	8.6
EV/EBIT	11.1	11.2	11.0	10.7
PE	14.7	15.2	15.2	14.7
Price / NTA	3.3	3.3	3.2	3.1
Cash div yld (%)	5.9	5.9	6.1	6.4
Gross div yld (%)	7.1	7.1	7.3	7.6

Guidance update — Demand strong and recovery faster than expected

SKL has issued FY20 guidance of "NPAT in excess of NZ$28m", +7.5% ahead of our prior forecasts, with the impact on demand and from operating restrictions being lower than expected to date.

- **Agri —** SKL's Agri business is illustrating its resilience to the current economic disruption with demand for its products remaining strong. SKL's factories are considered essential and have therefore been able to operate through various lockdown policies, albeit with capacity constraints. Operational learnings have lifted productivity, and SKL is now operating at 90% of maximum capacity at its key Wigram factory.
- **Industrial —** The earnings profile in the Industrial division is more diverse, with the impact to date varied. Lockdown policies across markets and the slump in the oil and gas industry weighed on activity; however, SKL experienced strong demand for certain products and a faster than expected recovery in overall demand.

Outlook remains uncertain, however...

A high degree of uncertainty around COVID-19 and the ensuing economic fallout remains, with the key question being the impact to end customer demand.

... earnings exposure more resilient than it has been in the past

SKL's earnings exposure is more resilient to an uncertain economic environment than it has been in the past, in our view. Growth in the Industrial division has been driven by OEM (original equipment manufacturer) customers, whilst decreasing its business exposure to markets driven by commodity prices. SKL's operating model has improved, embedding itself into the OEM production process, supplying often critical products. We expect this to translate to a stickier customer relationship and more robust earnings streams. In its Agri division the bulk of its revenue is derived from the sale of quasi-consumable milking products such as liners and tubes, and as a result earnings tend to be more defensive. Although on farm capital spend remains a driver of sector earnings, we believe capital goods as a portion of total sales is lower than prior cycles, with less dairy conversion occurring.

FORSYTH BARR

Skellerup Holdings (SKL)

Priced as at 25 Jun 2020 (NZ$)	**2.20**

12-month target price (NZ$)*	**2.45**
Expected share price return	11.4%
Net dividend yield	6.1%
Estimated 12-month return	17.5%

Spot valuations (NZ$)	
1. DCF	2.26
2. Relative valuation	2.40
3. n/a	n/a

Key WACC assumptions	
Risk free rate	2.00%
Equity beta	1.10
WACC	8.7%
Terminal growth	1.5%

DCF valuation summary (NZ$m)	
Total firm value	440
(Net debt)/cash	(37)
Less: Capitalised operating leases	(61)
Value of equity	343

Profit and Loss Account (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Sales revenue	240.4	245.8	247.8	252.7	261.8
Normalised EBITDA	**47.2**	**48.9**	**51.9**	**52.2**	**53.4**
Depreciation and amortisation	(7.5)	(7.1)	(10.7)	(10.6)	(10.6)
Normalised EBIT	**39.8**	**41.8**	**41.2**	**41.6**	**42.8**
Net interest	(1.9)	(1.8)	(2.0)	(1.9)	(1.8)
Associate income	0	0.0	0	0	0
Tax	(10.6)	(11.0)	(11.0)	(11.5)	(11.9)
Minority interests	0	0	0	0	0
Normalised NPAT	**27.3**	**29.1**	**28.2**	**28.2**	**29.1**
Abnormals/other	0	0	0	0	0
Reported NPAT	**27.3**	**29.1**	**28.2**	**28.2**	**29.1**
Normalised EPS (cps)	14.1	14.9	14.5	14.5	14.9
DPS (cps)	11.0	13.0	13.0	13.5	14.0

Valuation Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EV/EBITDA (x)	9.8	9.4	8.9	8.8	8.6
EV/EBIT (x)	11.6	11.1	11.2	11.0	10.7
PE (x)	15.6	14.7	15.2	15.2	14.7
Price/NTA (x)	3.4	3.3	3.3	3.2	3.1
Free cash flow yield (%)	5.3	5.7	8.6	7.8	7.4
Net dividend yield (%)	5.0	5.9	5.9	6.1	6.4
Gross dividend yield (%)	6.7	7.1	7.1	7.3	7.6

Capital Structure	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Interest cover EBIT (x)	21.4	23.4	20.4	22.4	23.3
Interest cover EBITDA (x)	25.4	27.4	25.7	28.1	29.0
Net debt/ND+E (%)	15.1	17.0	13.6	11.6	11.2
Net debt/EBITDA (x)	0.7	0.7	0.5	0.5	0.4

Growth Rates	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Revenue (%)	14.3	2.2	0.8	2.0	3.6
EBITDA (%)	16.2	3.6	6.0	0.6	2.3
EBIT (%)	21.1	5.1	-1.4	0.9	3.0
Normalised NPAT (%)	23.2	6.5	-2.9	-0.2	3.2
Normalised EPS (%)	23.2	5.5	-2.9	-0.2	3.2
Ordinary DPS (%)	15.8	18.2	0.0	3.8	3.7

Key Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Return on assets (%)	15.8	16.3	15.0	15.1	15.4
Return on equity (%)	15.8	16.3	15.6	15.3	15.6
Return on funds employed (%)	14.4	14.5	14.0	14.1	14.6
EBITDA margin (%)	19.6	19.9	20.9	20.6	20.4
EBIT margin (%)	16.5	17.0	16.6	16.4	16.4
Capex to sales (%)	2.3	1.9	2.0	2.0	2.0
Capex to depreciation (%)	73	64	47	48	49
Imputation (%)	86	50	50	50	50
Pay-out ratio (%)	78	87	90	93	94

Cash Flow (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EBITDA	**47.2**	**48.9**	**51.9**	**52.2**	**53.4**
Working capital change	(3.8)	(8.5)	3.2	(0.4)	(2.6)
Interest & tax paid	(15.1)	(11.5)	(13.0)	(13.4)	(13.7)
Other	0	0	0	0	0
Operating cash flow	**28.3**	**28.9**	**42.0**	**38.4**	**37.0**
Capital expenditure	(5.4)	(4.6)	(5.0)	(5.1)	(5.2)
(Acquisitions)/divestments	0.9	(8.2)	0	0	0
Other	0	0	(3.6)	(3.7)	(3.8)
Funding available/(required)	**23.8**	**16.2**	**33.5**	**29.6**	**28.0**
Dividends paid	(19.3)	(24.3)	(25.3)	(25.3)	(27.3)
Equity raised/(returned)	0	2.4	0	0	0
(Increase)/decrease in net debt	**4.5**	**(5.7)**	**8.1**	**4.3**	**0.8**

Operating Performance	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Revenue by segment					
Agri	89.0	88.8	92.3	94.1	96.0
Industrial	151.5	157.2	155.6	158.7	165.9
Total revenue (incl. eliminations)	**240.4**	**245.8**	**247.8**	**252.7**	**261.8**
EBIT by segment					
Agri	22.8	22.8	23.5	23.5	23.5
Industrial	20.8	22.9	21.4	21.8	23.2
Total EBIT (incl. overheads)	**39.8**	**41.8**	**41.2**	**41.6**	**42.8**
EBIT margin by segment					
Agri (%)	25.6	25.7	25.5	25.0	24.5
Industrial (%)	13.7	14.6	13.8	13.8	14.0
Total (%)	**16.5**	**17.0**	**16.6**	**16.4**	**16.4**

Balance Sheet (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Working capital	67.9	76.1	72.9	73.4	76.0
Fixed assets	93.4	91.3	89.4	87.7	86.3
Intangibles	46.0	49.5	49.5	49.5	49.5
Right of use asset	0	0	19.0	19.5	20.0
Other assets	6.4	7.6	7.6	7.6	7.6
Total funds employed	**213.6**	**224.4**	**238.4**	**237.6**	**239.3**
Net debt/(cash)	30.7	36.6	28.4	24.2	23.4
Lease liability	0	0	16.2	16.9	17.5
Other liabilities	10.6	9.5	12.4	12.4	12.4
Shareholder's funds	172.3	178.4	181.3	184.2	186.0
Minority interests	0	0	0	0	0
Total funding sources	**213.6**	**224.4**	**238.4**	**237.6**	**239.3**

Earnings changes and valuation

We have lifted our FY20E NPAT forecast +7.5% to NZ$28.2m, in line with updated guidance of "NPAT in excess of NZ$28m". The key drivers of our forecast changes are 1) stronger Agri sales, 2) a faster than expected rebound in Industrial demand, and 3) a lift to our near-term Industrial margin assumption. Our medium-term earnings assumptions lift on higher Agri revenue assumptions. Although demand through the past six months has been stronger than we expected, we maintain a level of caution over the near-term with our FY21E and FY22E forecasts remaining ~-5% below our pre COVID-19 levels.

Figure 1. Earnings changes (NZ$m)

	FY20E			FY21E			FY22E		
	old	new	% chg	old	new	% chg	old	new	% chg
Revenue	242.6	247.8	2.1%	249.0	252.7	1.5%	258.0	261.8	1.5%
EBIT	39.0	41.2	5.6%	40.3	41.6	3.1%	42.0	42.8	2.0%
Normalised NPAT	26.2	28.2	7.5%	27.3	28.2	3.3%	28.5	29.1	2.2%
EPS (cps)	13.5	14.5	7.5%	14.0	14.5	3.3%	14.6	14.9	2.2%
DPS (cps)	13.0	13.0	-	13.0	13.5	3.8%	13.5	14.0	3.7%

Source: Forsyth Barr analysis

Increase target price and reiterate OUTPERFORM

We lift our target price +NZ$0.05 to NZ$2.45, reflecting earnings changes. We reiterate our OUTPERFORM rating.

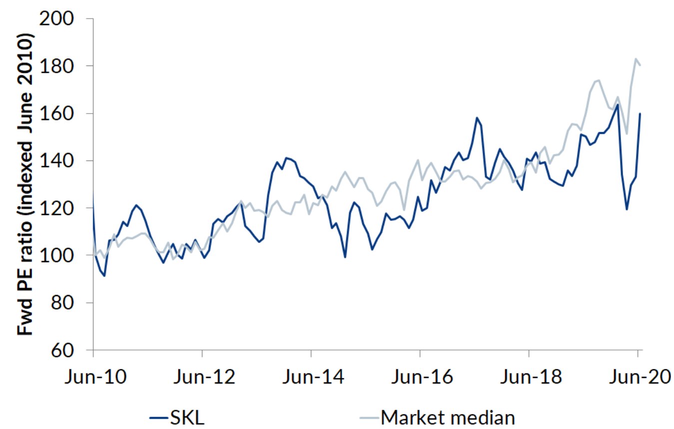
SKL is trading at a discount to the market (15x 12 month forward PE) and offers investors an attractive dividend yield backed by a strong balance sheet. Although we face a more uncertain economic outlook, we view improvements to SKL's operating model over recent years, targeting OEM (original equipment manufacturer) led growth, as making its earnings base more resilient than it has been in the past.

Attractive dividend

We lift our dividend forecasts on the back of earnings changes. SKL offers a 6.1% cash dividend yield. SKL's dividend yield premium relative to investment grade yield and defensive yield stocks has expanded over the last 12 months. Balance sheet headroom (net debt/EBITDA 1.2x), limited capex requirements (capex 2.0% of sales), and a solid, free cash flow yield provide some support against a short term downturn or timing issues with new business. Whilst earnings risk exists, we note that SKL's earnings exposure is more resilient to a recessionary environment than it has been in the past, and view growth avenues as improving industry exposure.

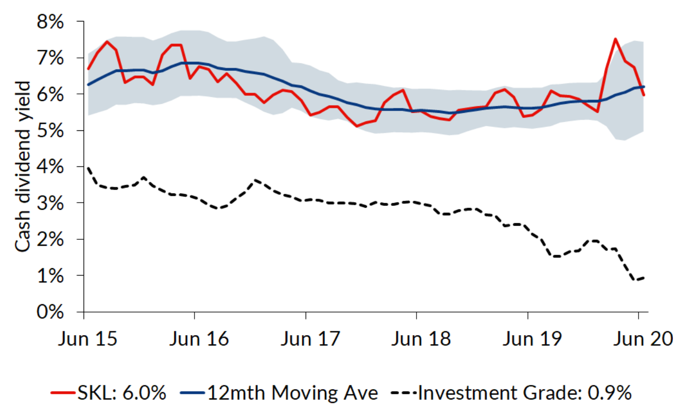
Key charts

Figure 2. SKL fwd PE ratio versus the market



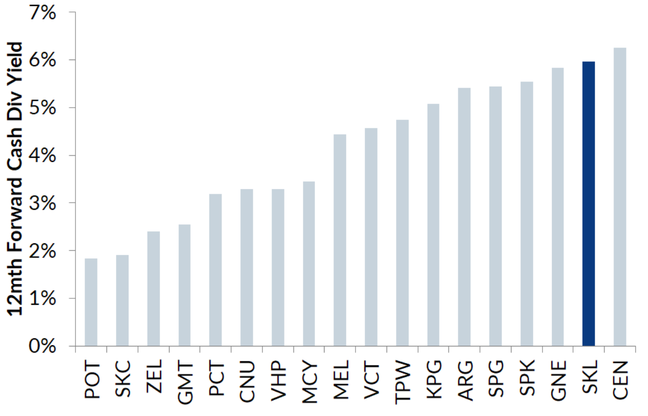
Source: Bloomberg, Forsyth Barr analysis

Figure 3. SKL cash yield vs investment grade yield



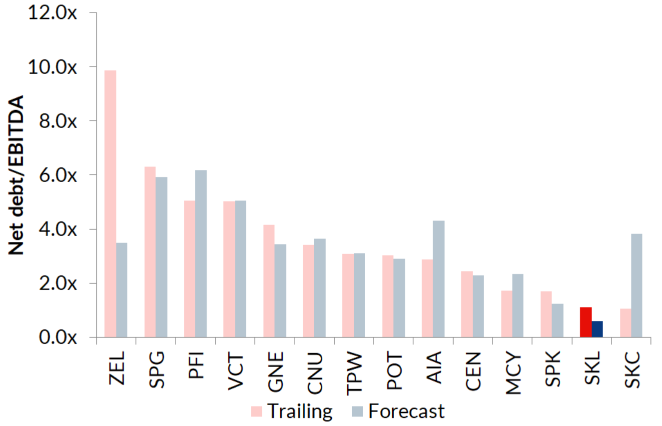
Source: Bloomberg, Forsyth Barr analysis

Figure 4. 12-month forward cash dividend yield (FB)



Source: Bloomberg. Forsyth Barr analysis

Figure 5. Net debt/EBITDA (consensus)



Source: Bloomberg, 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.

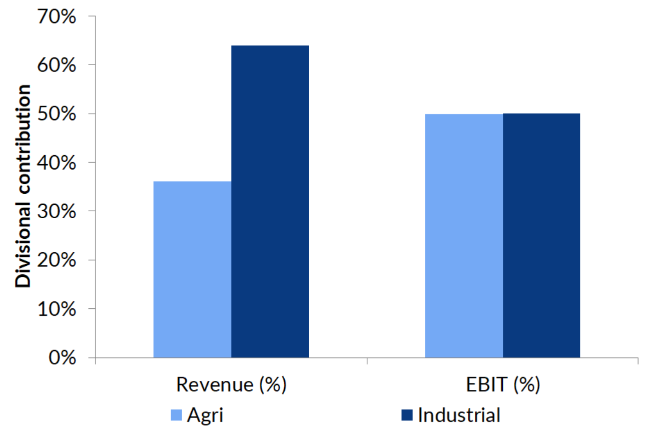
Financial structure

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

Risk factors

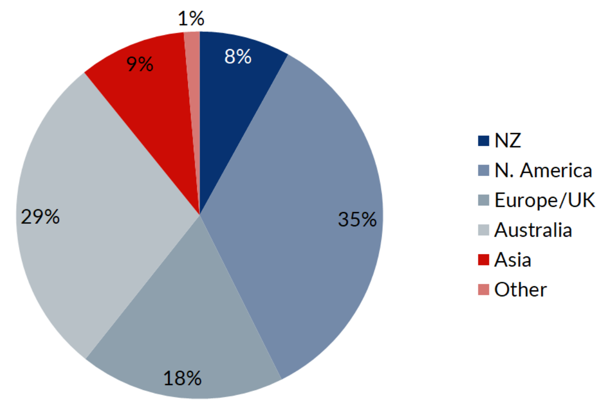
- **Commodity exposure:** Although SKL has been actively working to reduce commodity exposure, a reasonable portion of SKL's sales are tied to commodity markets. Swings in the price of commodities such as milk, iron ore, and oil & gas, can have an impact on product sales.
- **Trade risk:** SKL products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

Figure 6. revenue and EBIT by division (FY19)



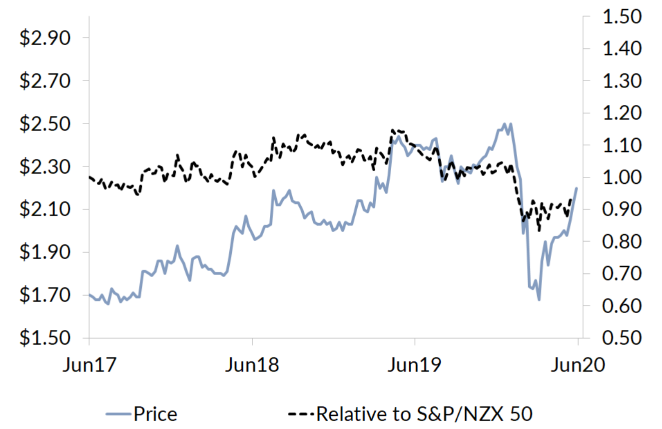
Source: Company reports, Forsyth Barr analysis

Figure 7. SKL revenue by geography (FY19)



Source: Company reports, Forsyth Barr analysis

Figure 8. Price performance



Source: Forsyth Barr analysis

Figure 9. Substantial shareholders

Shareholder	Latest Holding
Sir Selwyn John Cushing	6.5%
ACC	5.0%

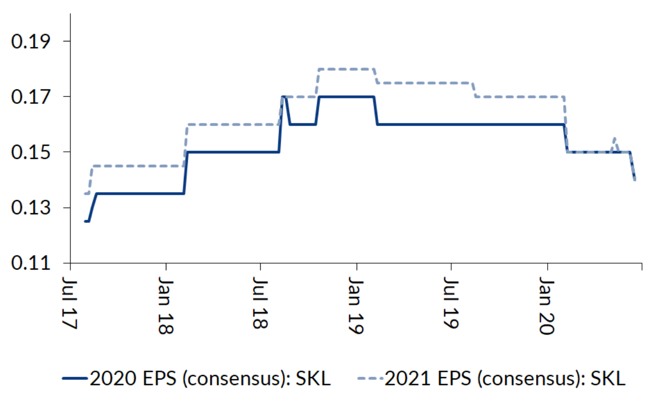
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 10. International valuation comparisons

Company (metrics re-weighted to reflect SKL's balance date - June)	Code	Price	Mkt Cap (m)	PE 2020E	PE 2021E	EV/EBITDA 2020E	EV/EBITDA 2021E	EV/EBIT 2020E	EV/EBIT 2021E	Cash Yld 2021E
Skellerup Holdings	**SKL NZ**	**NZ$2.20**	**NZ$428**	**15.2x**	**15.2x**	**9.0x**	**8.9x**	**11.3x**	**11.2x**	**6.1%**
AVON RUBBER PLC	AVON LN	£30.10	£934	39.2x	25.4x	24.3x	16.9x	36.3x	20.6x	1.1%
TRELLEBORG AB-B SHS	TRELB SS	kr128.70	kr34,887	<0x	12.7x	13.3x	8.7x	33.8x	13.3x	3.6%
PGG WRIGHTSON *	PGW NZ	NZ$2.71	NZ$205	14.3x	11.8x	<0x	<0x	<0x	<0x	6.6%
NUTRIEN	NTR CN	US$46.11	US$26,276	27.0x	23.7x	10.4x	9.8x	20.8x	19.1x	3.9%
METRO PERFORMANCE GLASS	MPG NZ	NZ$0.19	NZ$35	2.0x	13.0x	4.0x	5.3x	8.6x	14.9x	0.0%
STEEL & TUBE HOLDINGS *	STU NZ	NZ$0.64	NZ$106	24.5x	9.3x	3.5x	2.9x	8.6x	5.7x	9.4%
			Compco Average:	**21.4x**	**16.0x**	**11.1x**	**8.7x**	**21.6x**	**14.7x**	**4.1%**
EV = Current Market Cap + Actual Net Debt			**SKL Relative:**	**-29%**	**-5%**	**-19%**	**2%**	**-48%**	**-24%**	**50%**

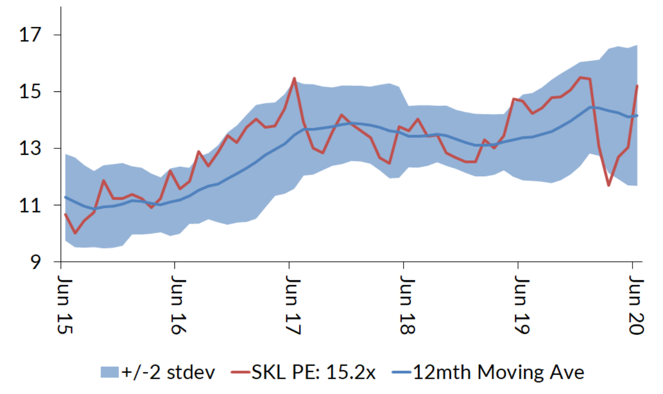
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (SKL) companies fiscal year end

Figure 11. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 12. One year forward PE (x)



Source: Forsyth Barr analysis

Analyst certification: The research analyst(s) primarily responsible for the preparation and content of this publication ("**Analysts**") are named on the first page of this publication. Each such Analyst certifies (other than in relation to content or views expressly attributed to another analyst) that (i) the views expressed in this publication accurately reflect their personal views about each issuer and financial product referenced and were prepared in an independent manner, including with respect to Forsyth Barr Limited and its related companies; and (ii) no part of the Analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that Analyst in this report.

Analyst holdings: The following Analyst(s) have a threshold interest in the financial products referred to in this publication: N/A. For these purposes, a threshold interest is defined as being a holder of more than $50,000 in value or 1% of the financial products on issue, whichever is the lesser.

Ratings distributions: As at 24 Jun 2020, Forsyth Barr's research ratings were distributed as follows:

OUTPERFORM	NEUTRAL	UNDERPERFORM
49.0%	35.3%	15.7%

Forsyth Barr's research ratings are OUTPERFORM, NEUTRAL, and UNDERPERFORM. The ratings are relative to our other equity security recommendations across our New Zealand market coverage and are based on risk-adjusted Estimated Total Returns for the securities in question. Risk-adjusted Estimated Total Returns are calculated from our assessment of the risk profile, expected dividends and target price for the relevant security.

Disclosure: Forsyth Barr Limited and its related companies (and their respective directors, officers, agents and employees) ("Forsyth Barr") may have long or short positions or otherwise have interests in the financial products referred to in this publication, and may be directors or officers of, and/or provide (or be intending to provide) investment banking or other services to, the issuer of those financial products (and may receive fees for so acting). Forsyth Barr is not a registered bank within the meaning of the Reserve Bank of New Zealand Act 1989. Forsyth Barr may buy or sell financial products as principal or agent, and in doing so may undertake transactions that are not consistent with any recommendations contained in this publication. Other Forsyth Barr business units may hold views different from those in this publication; any such views will generally not be brought to your attention. Forsyth Barr confirms no inducement has been accepted from the issuer(s) that are the subject of this publication, whether pecuniary or otherwise, in connection with making any recommendation contained in this publication. In preparing this publication, non-financial assistance (for example, access to staff or information) may have been provided by the issuer(s) being researched.

Investment banking engagements: Other than confidential engagements, Forsyth Barr has within the past 12 months been engaged to provide investment banking services to the following issuers that are the subject of this publication: FRE

Not personalised financial advice: The recommendations and opinions in this publication do not take into account your personal financial situation or investment goals. The financial products referred to in this publication may not be suitable for you. If you wish to receive personalised financial advice, please contact your Forsyth Barr Investment Adviser. The value of financial products may go up and down and investors may not get back the full (or any) amount invested. Past performance is not necessarily indicative of future performance. Disclosure statements for Forsyth Barr Investment Advisers are available on request and free of charge.

Disclaimer: This publication has been prepared in good faith based on information obtained from sources believed to be reliable and accurate. However, that information has not been independently verified or investigated by Forsyth Barr. Forsyth Barr does not make any representation or warranty (express or implied) that the information in this publication is accurate or complete, and, to the maximum extent permitted by law, excludes and disclaims any liability (including in negligence) for any loss which may be incurred by any person acting or relying upon any information, analysis, opinion or recommendation in this publication. Forsyth Barr does not undertake to keep current this publication; any opinions or recommendations may change without notice to you. Any analyses or valuations will typically be based on numerous assumptions; different assumptions may yield materially different results. Nothing in this publication should be construed as a solicitation to buy or sell any financial product, or to engage in or refrain from doing so, or to engage in any other transaction. This publication is not intended to be distributed or made available to any person in any jurisdiction where doing so would constitute a breach of any applicable laws or regulations or would subject Forsyth Barr to any registration or licensing requirement within such jurisdiction.