EDISON

Flowtech Fluidpower

First day of dealings

Quality growth business

Industrial support services

Flowtech Fluidpower is a distributor with a strong and unique position in a clearly defined growth sector within the engineering industry. Its outlook was transformed by management changes in 2009 and 2010, and it has a clear strategy for medium-term profits growth. At the placing price, the shares have strong attractions.

Year end	Revenue (£m)	PBT** (£m)	EPS** (p)	DPS (p)	P/E (x)	Yield (%)
12/12*	33.8	3.7	6.6	0.00	15.2	N/A
12/13*	34.3	4.5	8.2	0.00	12.2	N/A
12/14e*	33.0	5.7	10.8	5.00	9.3	5.0
12/15e	34.2	6.3	11.7	5.25	8.5	5.3

Note: *The figures above are pro forma and supplied by management, based on continuing businesses (2012-13), eliminating private equity financing costs (2012-14e), and based on post flotation issued capital. See Exhibit 4. **PBT and EPS are normalised and fully diluted, excluding intangible amortisation, exceptional items and share-based payments.

A unique position in a strong market

Flowtech has established a niche position in the fluid power market in the UK and Benelux. Acting as a super distributor, it is acknowledged across the industry as the only supplier of a comprehensive range of spare parts/components/accessories that is able to respond to urgent customer needs within 24 hours. Of necessity it has high inventory levels, but can secure above-average margins to finance the investment in working capital. Its product range includes branded equipment, generic support items and a growing range of high-quality own-brand goods; Flowtech's customer base largely comprises a wide range of distributors, including small independent operators and also the very large distribution chains.

A clear strategy

There is a clear strategy for growth, involving extending the product range in hydraulics, raising the share of business with its customers and strengthening its own-brand product portfolio. In addition there are medium-term ambitions to extend the geographical footprint and also to move into the on-site fluid power repair and maintenance business. There is a strong and motivated management team looking to build the group rapidly over the medium term.

Strengthened balance sheet

The elimination of private equity finance leaves the group with modest 14% pro forma gearing on the basis of December 2013 numbers. However, the balance sheet includes a high goodwill value. We anticipate a reduction in net borrowings on the basis of our estimates for 2014 and 2015.

Valuation: Attractively priced

On the basis of estimated pro forma 2013 figures and the issue price of 100p, the historic diluted P/E ratio of 12.2x represents a 29% discount to the 17.3x average of a selection of generally larger quoted industrial distributors. With EPS estimated to rise at a faster rate over the next two years, the flotation looks attractively priced.

21 May 2014

Price	**100p**
Market cap	**£40m**

Net debt at 31 December 2013, pro forma	£7.1m
Shares in issue	40.0m
Free float	99%
Code	FLO
Primary exchange	AIM
Secondary exchange	N/A

Business description

Flowtech Fluidpower is a specialist distributor of products used in the hydraulics and pneumatics industry. Operations cover the UK and Benelux.

Next event

Interim results	September 2014

Analysts

Nigel Harrison +44 (0)20 3077 5700

Roger Johnston +44 (0)20 3077 5722

industrials@edisongroup.com

This report has been commissioned by Zeus Capital Limited

Investment summary

Company description: Specialist distribution

Flowtech Fluidpower is a specialist distributor of fluid power components, operating from warehouses in Skelmersdale (Lancashire) and Deventer in north-west Holland. Over the past 20 years, it has developed a unique position in its chosen market; its catalogue, comprising some 47,000 products, including all the major global brands, is acknowledged as the industry standard. The group supplies almost entirely to other distributors, with its comprehensive inventory available at 24 hours' notice provides a strong position in the repair and service market, where appropriate margins can be earned. The business lost its way after being acquired by private equity investors, but has been revitalised by the present management team (introduced in 2009 and 2010). There is considerable organic potential from raising the share of existing customer business and developing the product base. We believe that acquisitions feature strongly in the management agenda.

Valuation: Higher rating to be earned over the medium term

On the basis of estimated pro forma (see Exhibit 4) earnings for 2013, the shares are valued at a 29% discount (12.2x vs 17.3x) to other UK-based industrial products distributors. On the basis of our estimates, we look for Flowtech's earnings to grow at a faster rate than the peer group, leading to a widening of the discount. A discount rating is understandable in the context of the relative size of the group against these other distributors, especially given the market's familiarity with them.

On the assumption that our profit estimates are delivered over 2013 and 2014, we would expect to see the rating of the shares move up towards those of the other industrial distribution groups.

Financials

- The recent trading record has been influenced by the ownership of the group, involving very high borrowing costs, and by the restructuring programme, which has involved the exit from a number of non-core product lines and a major reorganisation of the Dutch operation. Following the IPO, the cleaner balance sheet gives management confidence to build the business. We look for strong earnings growth over the next two years.
- Net borrowings in the pro forma balance sheet at December 2013 of £7.1m represent 14% of shareholders' funds. However, there is a very high goodwill content to net assets, in excess of the market capitalisation of the group.
- Inventories are high at 30% of continuing revenues, with net working capital representing 40% of such revenues. These figures are justified, however, by the above-average gross margins.

Sensitivities

The obvious main sensitivity relates to shifts in the economic cycle; distributors tend to bear the brunt of destocking and restocking, which can accentuate changes in the overall level of demand. At Flowtech, a higher than average part of turnover relates to the aftermarket and it could well be that the group's distributor customers will destock and become more reliant upon 24-hour service across a wide range of components – the cost of a spare part is usually modest in relation to the plant or machine being idle.

A bigger concern could be maintaining relationships with the global OEMs; mergers could lead to changed distribution policies, although there is a perceived need to be in the group catalogue.

Directors and employees have very few shares. There are incentive schemes in place that will dilute the equity in the event of successful trading having a significantly positive impact on the share price.

Market leader in fluid power

Flowtech Fluidpower is a key player in the UK and Dutch fluid power markets, acting as a super distributor of a comprehensive range of products. The business was established in 1983, growing steadily over some 20 years. It was then acquired from the founding family in a management buy-out, with private equity support. The subsequent accelerated expansion into adjacent markets included a number of ventures with varied levels of success. The enlarged group then encountered difficulties, exacerbated by the onset of recession.

The present management team was introduced in 2009 and 2010 to restructure the business with the objective of re-establishing the group strengths and providing an exit for the outside investors.

The current IPO provides that exit, but more significantly, it frees up the capital structure to enable the management team to build a meaningful and focused business over the medium term.

Super distributor

Flowtech supplies some 3,000 customers across the UK and also Northern Europe, mostly in Holland. The focus is on fluid power products, procured either from the fluid power product OEMs or from specialist manufacturers, mostly in the Far East, which have been carefully selected to produce a range of generic and own-brand products to the highest specification.

Flowtech is recognised as the only feasible 'one-stop shop', offering unrivalled stock availability across a range of around 47,000 products, including all of the major global brands. The Flowtech catalogue is viewed as the definitive fluid power reference point in the UK, backed up by sophisticated and fully integrated software, which enables customers to order either directly online or by more traditional methods.

The business

- **Customers** – the group has around 3,000 customers, virtually all of which are distributors, rather than end-users. These customers range from the small independent distributor through to the large multi-branch and multi-product groups, such as Brammer. Many of the larger customers will have their own catalogue, mirroring the Flowtech catalogue, but with a customised front page, to give their customers the appearance of their ability to supply the comprehensive range of products, but without the need to hold large stocks of slower moving items in their warehouse.

Exhibit 1: Customer types

Customer type	Customer annual sales	Annual purchases from Flowtech	Description	Flowtech value add
Small independents	£1-3m	£5,000-20,000	Single site owner-managed business supplying fluid power products to a small number of local factories	Stockholding, relationships with the OEMs, customer service, catalogue, promotions and web trading
Medium-sized independents	£3-10m	£20,000-100,000	An owner-managed business with 2-4 sites serving up to 200 local customers and generally focusing on 1-2 local industries	Stockholding, relationships with the OEMs, customer service, customer-branded catalogues and online trading platform, bespoke marketing
Multi-brand nationals	£10m-£1bn	£100,000-£1m	Larger regional or national businesses, often selling fluid power products as part of a wider product range to a wide range of industries	Stockholding, fluid power expertise, customer branded catalogues and online trading platform
OEMs	£1-320m	£10,000-50,000	Manufacturers of products requiring fluid power components	Technical; fluid power knowledge and sourcing capability

Source: Flowtech Fluidpower presentation document

A majority of these customers will not use Flowtech to supply their entire requirement of fluid power products, citing price and a desire for greater independence as key factors and taking product direct from the manufacturer. On the other hand, the online platform enables Flowtech's customers to quote 24-hour delivery for urgent items that do not form part of their normal inventory. The group works hard on developing customer relationships, offering product training and technical support, where appropriate. The fragmented nature of the end market is indicated by the fact that the largest individual customer takes less than 3% of group turnover, with the top 10 customers accounting for well under 20% of sales.

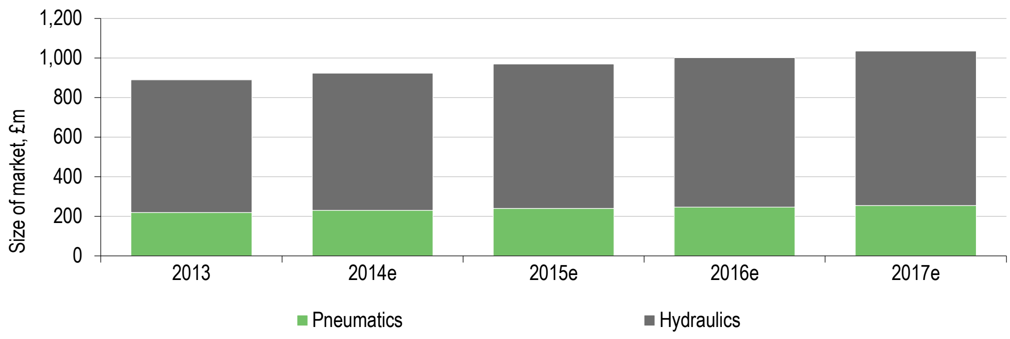
- **Suppliers** – the group has more than 400 suppliers, each of which sees Flowtech as an essential part of its access to the market. In particular they see the group as a key supplier for urgent requirements, an area where few OEMs are equipped to meet the needs of the ultimate end-user. All of the major US and European based global fluid power OEMs supply product to the market through Flowtech, acknowledging the group's unique position in the market place and also wishing to have their products featured in the catalogue. While branded products are fundamental to the group product offer (45% of group revenues), it also supplied generic product (27%) and own-brand products (28%). The generic products tend to be of reduced specification and tend to be bought in bulk form then broken down for sale – in this way, reasonable margins can be earned on commodity type products. The group has seven of its own brands, several of which have been in place for more than 10 years; management has invested in building a number of new own brands over the past two to three years, employing a small number of high-quality Far Eastern suppliers to produce high-specification product.
- **Product range** – we have already mentioned the extensive catalogue, encompassing some 47,000 products; management has indicated that this is by far the most comprehensive coverage of the fluid power industry in the UK and Benelux. The catalogue is spread across 18 different product sections to provide the customer with easy access to specific products. Flowtech produces 90,000 catalogues, sold to its customers, which in turn pass them on to their own major customers. The product range is constantly being extended as new products and applications come on to the market, with a revised edition of the catalogue being introduced each year, incorporating the new products, each of which will fit into one of 18 specific categories.
- **Logistics** – on the basis of a £100 typical order size, Flowtech processes around 250k invoices in the UK, ultimately reaching about 100,000 end users. Orders can be placed by telephone, fax, EDI or online; the latter has grown consistently as a percentage of the whole in recent years and is expected by management to be close to 60% in the current year. The quality of customer service is monitored through three key metrics: error rates; meeting delivery schedules; and stock availability. The error rate has been consistent at 0.2% over the past two years, while monthly stock availability on the 1,000 fastest movers was just under 99% during the second half of last year; over the whole product range, Flowtech has averaged over 95% over the past two years. The group does not own a delivery fleet. It has worked successfully with FedEx for the past 20 years, ensuring that orders placed by 10.00pm are collected overnight and delivered to group customers from the FedEx regional hubs the next day.
- **Facilities** – the group head office is part of a 91,000sqft leasehold warehouse complex, at Skelmersdale, Lancashire, just off the M58, with easy access to the UK motorway network. The group operates a sophisticated facility, handling an average 4,000 picks per day and fully integrated into the group software system. The group's Dutch operation, Flowtech Benelux, was acquired in 2007 and, following extensive rationalisation over the past two to three years, operates out of a 17,500sqft warehouse in Deventer, in north-west Holland. It now mirrors the UK operation, but with a smaller 25,000 product catalogue, supplying some 900 customers; while the majority of throughput is to other distributors, there is a larger direct involvement with end user customers. Its principal business is in Holland and Belgium, although there is a growing customer base in nearby parts of Germany and France. In addition, there is a procurement office in Shanghai, while the group has recently established a new logistics centre, based in a 22,000sqft facility in Guangzhou – much of the generic and own-brand product base is sourced in South-East Asia and is to be handled through these facilities.

- **Competition** – there is no company similar to Flowtech in the market. Ironically, its suppliers and customers are also its competitors. The other distributors will tend to acquire their inventory from the OEMs and other third parties – they see the group as a necessary part of their own supplier base, especially for urgent items that are not readily available to them, but they believe that they can acquire more cheaply, if they are prepared to accept longer lead times. Flowtech recognises this problem, but offers volumes discounts to its larger customers, while the increased quality of the own-brand range of products will be a major factor in raising the share of individual customer business.

Fluid power market

Fluid power is the use of fluids under pressure to generate, control and transmit power. Fluid power is subdivided into hydraulics using a liquid such as mineral oil or water, and pneumatics using a gas such as air or other gases. Compressed air and water pressure systems were once used to transmit power from a central source to industrial users over extended geographic areas; fluid power systems today are usually within a single building or mobile machine.

Exhibit 2: UK fluid power market



Source: BFPA economic forecast

While fluid power is a mature market, there is a constant search for new applications across the engineering industry. Because of the potential volatility of gases and fluid under pressure, the quality of equipment is fundamental, while there is a constant need to ensure that all aspects of a fluid power system are operating efficiently to avoid serious problems.

We consider fluid power to be a medium-term growth industry.

Group strategy

Market share

We understand from management that some 20% of the fluid power products market is available to Flowtech in the short to medium term, indicating a likely market share of around 12-13%. From our above comments, the group would appear undoubtedly to be the leader of a very fragmented market. Flowtech has outperformed consistently in recent years and should continue to do so. We see three specific areas of opportunity:

- **Spend per customer** – Flowtech currently supplies a relatively small part of an individual customer's requirements across the sector. The reasons for this are explained above, with the group often seen as a slightly more expensive supplier of urgently needed product, rather than normal basic supplies. Management has invested in developing considerable knowledge across the sector, enabling it to offer an advisory service and thus strengthen relationships with

EDISON

customers. With increasing discounts to catalogue prices negotiable as sales to a specific customer increase, the 'one-stop-shop' can have attractions to certain customers.

- **Own brand** – management has invested in raising the quality of its own-brand products. While certain brands have been in place for some time, the more recent developments, such as Kelm, Conah and Hiprho have become quickly recognised for their quality, securing mentions in the trade press. A number of end users have already started occasionally to specify these brands, pushing their supplier to the only source of the product.
- **Benelux expansion** – the group's Dutch operation has been restructured more recently than the UK business. Systems have been transferred from the UK, with a streamlined operating team; considerable revenues were sacrificed during the restructuring. Its market share in Holland and Belgium is half of that in the UK, underlining the potential for the next two to three years.

Margin potential

Product availability is often far more important than price, when an urgent machinery repair is being considered. The cost of a small component can be quite immaterial if a production line or a piece of earthmoving equipment is unavailable. To be acknowledged as the key last resort stockist of a comprehensive range of components Flowtech has high inventory levels and can command appropriate margins.

Current gross returns range from 41.7% on branded OEM products, to 44.6% on the generic range and 47.0% on the own-brand products. There is limited scope on the branded goods, where competition is the greatest, but we believe that there is scope to raise overall gross margins to reflect continued market penetration by the group's own brands. In addition, the new logistics centre in China ought to be able to secure improved purchasing terms, especially on the generic products.

New products

On the basis of last year's industry figures, the UK fluid power market is split between hydraulics and pneumatics on a 75:25 ratio. The Flowtech balance is the exact opposite; after stripping out industrial hose and fittings, the split is a 63:37 ratio in favour of pneumatics. This partially reflects the fact that pneumatics involves slightly higher specification product, but it also emphasises a considerable opportunity in terms of extending the group product range. Management has already started this process, introducing a new range of own-brand products to go alongside its portfolio of brands. In addition, management has indicated that there is an opportunity to expand the product range into a number of additional categories (there are currently 18) as part of its 'one-stop shop' strategy.

Geographical opportunities

Management is very aware of a similar business that supplies the German market, but elsewhere in Europe markets tend to be fragmented. The restructuring of Flowtech Benelux demonstrates the potential that can be tackled in overseas markets. The group already has sound relationships with virtually all of the global OEMs, a strong supply base for generic and own-brand products, plus a proven system for taking on new markets.

The timetable for such expansion may be some way into the future, but we would expect management to look for the next stage of geographical expansion to be into markets where there is, as yet, no Flowtech counterpart. More likely targets will be those, for example, in Eastern Europe, where there is already a strong manufacturing presence.

Acquisitions

Private equity ownership and the disappointing result of earlier expansion moves have almost certainly held back the current management team's acquisition plans. The IPO provides the group with a much stronger balance sheet and the scope to broaden its horizons. The above comments on new products and geographical expansion could, for example, be more quickly achieved by acquisition. We understand from management that there are several UK distributors of hydraulics products that could, if acquired, change the balance between the two segments of the fluid power market overnight. A major expansion in revenues would require extended warehouse facilities, but the introduction of Flowtech systems and the extension of its catalogue ought to ease the integration of such a business. Acquisition of an existing distributor would reduce the risk levels for the group when moving into new overseas markets.

Another potential area for the medium term would be the development of an on-site machinery maintenance business. We sense that broader management skills would be necessary, but any acquisition would have the benefit of unique inventory backing and plc disciplines to aid its future development.

Management

The executive management team offers considerable experience in industrial distribution, as can be seen in the comments on page 12 of this report. A major reorganisation was implemented following the appointment of Sean Fennon in late 2009, with the group exiting from non-core operations and investing in the resuscitation of the main distribution business. The warehouse and logistics functions were overhauled, with a new IT system introduced.

Key changes involve the building of a new ethos across the business, based on quality and maximising margins. This has involved concentration on building levels of relevant inventories to ensure consistent availability and raising the quality of own-brand products as part of the strategy to be seen as more than the distributor of last resort.

Staff numbers have been cut. Of the 160 current employees, 140 are in the UK, with the balance in Holland; some 60% are involved in administration, with the balance managing the receiving and distribution of product. We understand from management that since the reorganisation, there has been a fundamental shift in morale – staff turnover has been cut and motivation is high.

Sensitivities

- **Macro issues** – experience shows that distributors tend to see accentuated movements in economic cycles, because of the tendency to build and reduce stocks. Moreover, the last economic downturn was the final catalyst to prompt the change to the present management team. However, the super distributor often benefits from the perceived need for smaller distributors to respond to their own potential cash flow difficulties by relying on the 24 hour availability of parts from Flowtech. Moreover, the greater shifts in demand relate to OEM production, rather than urgent repairs/service for which the group has been equipped to respond.
- **OEM relationships** – the development of the range of own-brand products could undermine relationships with the OEMs, which will naturally be protective of their market positions. This is countered by the reputation of the Flowtech catalogue as the 'industry bible' – it would be a major step to withdraw product from the largest industry distributor, especially the one that has product available for urgent plant or machinery breakdowns.

- **OEM consolidation** – there has been a measure of consolidation of the OEM brands in recent years. If continued this could lead to reduced competition and squeeze the margins of distributors. As explained in the OEM relationships point, above, we believe that Flowtech's key position in the repairs and maintenance sector of the market reduces concerns in this respect.
- **Working capital demands** – the December 2013 balance sheet showed inventories representing 30% of revenues of continuing businesses, with debtors at 24% and creditors of just 14%; net working capital was, therefore, very high at 40% of continuing revenues. There will be obvious concerns about the demands of working capital investment in the event of rapid revenue growth. This is compensated by the high gross margins averaging 44% (the 33% gross margin calculable from the income statement is, in line with accounting standards, adjusted to absorb warehouse costs). The earn/turn ratio of 145 (3.3 × 44) is materially above danger levels of below 100.
- **Product liability** – there will always be a potential problem with product liability on equipment operating under high pressure. Management has arranged insurance cover to manage such concerns, so far as is possible.
- **Competition** – one of the major industrial distribution groups could be attracted by the high margins and decide to set up in competition with Flowtech. We sense that they would hesitate because of the working capital demands; moreover, it would probably make more sense to acquire Flowtech rather than set up in competition.
- **Operational risk** – Flowtech has established a reputation for product availability and 24-hour delivery. A computer breakdown or deterioration in the quality of service offered by FedEx could undermine this reputation.
- **Currencies** – the vast majority of own-brand and generic product is imported from the Far East, usually negotiated in US dollars. The catalogue is priced up annually, suggesting a potential risk related to shifts between sterling and the US dollar. Flowtech manages this risk by negotiating, where possible, long-term price agreements and placing forward currency transactions.
- **Acquisition risk** – acquisitions clearly appear in the management strategy for growth. While due diligence will obviously be undertaken, there are always risks associated with acquisitions, especially when there is a compact central management team.
- **Share options** – the Flowtech board came into the business as professional managers and will own just 0.8% of the group equity following the flotation. The Management And Employee Incentive Scheme, involving 155 employees including directors, would lead to 6.8% equity dilution on the assumption that the share price rises above 150p. There is also a Management Incentive Plan, based on the period to the publication of results for the year to December 2016; this plan will provide varying rewards based on share price performance, rising to 5.7% in the event of the share price trebling to 300p by that date.

Valuation

There are several industrial product distributors with which we can compare the rating of Flowtech. We have chosen a list of six companies, all distributing to the UK industrial sector and with varying degrees of international sales.

Exhibit 3: Industrial distributors

	Price	Cap (£m)	Revenue (£m)	P/E 2013 (x)	P/E 2014e (x)	P/E 2015e (x)
Acal	353	110	219	19.3	17.4	16.2
Brammer	482	623	652	20.4	18.9	17.3
Electrocomponents	284	1,248	1,236	17.4	16.2	14.6
HellermanTyton	288	620	538	12.6	13.2	12.0
Premier Farnell	216	803	968	15.2	14.1	12.4
Trifast	107	116	122	19.1	15.7	14.2
Average				**17.3**	**15.9**	**14.2**
Flowtech Fluidpower (pro-forma)	**100**	**40**	**33**	**12.2**	**9.3**	**8.5**

Source: Thomson Datastream, Edison Investment Research estimates. Note: Calendarised. Based on earnings before intangibles, amortisation and exceptional items. Flowtech P/E valuations based on management's pro forma adjusted numbers for 2013, 2014e; see Exhibit 4. Prices as at 19 May 2014.

The relative ratings show Flowtech to be valued at a significant discount to peers. On the basis of 2013 trading, the pro forma figure for the group is at a discount of 29% to the simple average of peers, a discount that increases as Flowtech earnings are forecast to grow at a faster rate over the next two years. A discount is understandable given the relative size of the various groups (although the discount is larger against the two smaller cap peers in the sample) and the fact that the market has yet to familiarise itself with Flowtech and its management. In particular the market will have to respect the high goodwill valuation and the need for heavy investment in working capital.

We believe that the shares ought to command a useful premium over the 100p issue price when dealing commences. If management can deliver in line with our estimates the share ought to prove a highly rewarding investment over the medium term, with the rating moving up to reflect the underlying performance.

Financials

Pro forma calculations

The financial structure of Flowtech while under private equity ownership was complex. The prospectus gives a pro forma statement of assets, effectively stripping out some £62m of debt (including £27.3m loan capitalisation), but does not provide sufficient information to adjust interest charges shown in the income statement.

From our discussions with management we show below estimates to demonstrate the underlying trading performance for the past two years:

Exhibit 4: Pro forma trading performance and adjustments from reported results

Year to December (£m)	2012	2013	2014e	2015e
Revenue	31.0	32.1	33.0	34.2
Operating profit (Edison normalised)	3.6	4.4	6.1	6.6
Adjustments:				
Discontinued operations	0.6	0.7		
Change in stock provision policy	0.3			
Reorganisation costs	0.4			
Aborted trade sale costs		0.2		
Other write-offs	0.3	0.2		
Operating profit (pro forma)	**5.2**	**5.5**	**6.1**	**6.6**
Operating margin (%)	16.7	17.1	18.5	19.3
Interest (Edison normalised)	(5.5)	(5.2)	(3.1)	(0.3)
Adjustment	4.0	4.2	2.7	-
Interest (pro forma)	(1.5)	(1.0)	(0.4)	(0.3)
Pre-tax profit (pro forma)	**3.7**	**4.5**	**5.7**	**6.3**
EPS (pro forma) (p)	**6.6**	**8.2**	**10.8**	**11.7**
P/E (x)	**15.2**	**12.2**	**9.3**	**8.5**

Source: Flowtech management (pro-forma historic results incl. H114), Edison Investment Research estimates

We have adjusted for the non-recurring interest charges and non-recurring operating items as detailed above; we have also reduced the revenue figure for 2012 and 2013 by £2.8m and £2.2m respectively, eliminating a discontinued business. In addition, historic figures were adjusted from UK GAAP to IFRS. For 2014e the only adjustment is for interest, to reflect an assumption that the post-flotation balance sheet would have been in place for the full year.

The relatively static revenue trend conceals the impact of the restructuring by the current management team. Several product lines and business ventures ceased trading over the period since 2010. This was particularly so at Flowtech Benelux, where management has retrenched the business as a prelude to moving forward.

Trading outlook

There are two fundamental factors behind the expected increase in profits. The action taken by management for the immediate and longer-term future of the group and the anticipated general recovery in the industrial trading climate both point to useful medium-term progress.

More significantly, the constraints of a heavily geared balance sheet will have been lifted, enabling management to begin a more positive phase of business development.

For the current year, management has given limited guidance, stating that the group has traded in line with management expectations since the December 2013 year end. We are looking for a relatively modest rise in underlying revenues. However, allowing for further reductions in the cost base and the expectations that the mix of business should support an increase rise in gross margins, we expect this to feed through to the bottom line, leading to a useful rise in underlying operating margins from 17.1% to 18.5%.

We look for underlying pro forma pre-tax profits of £5.7m in 2014, followed by £6.3m in 2015. The directors have indicated an initial dividend of 5.0p per share, which will be more than twice covered by pro forma earnings per share.

Working capital controls

The comprehensive product range lends itself to heavy investment in working capital. We have already mentioned inventory levels at December 2013 of £9.8m, indicating a stock turn of 3.3 times, while most sales are offered on 60-day terms – the net result is stocks and debtors running at a combined 54% of continuing turnover. Because of the high gross margins, trade creditors will be relatively small; the December figure of £4.6m was equivalent to 14% of continuing revenues.

Management is very conscious of the size of the investment in working capital, but is equally aware that attempts by the previous management to generate funds from working capital undermined the group's ability to deliver to customer expectations. In effect, this implies that Flowtech would need to invest £4m in working capital to add £10.0m to turnover.

We expect the stock turn to improve as the business grows, especially if a larger share of existing customer business can be secured; as the group adds new lines to the product range there will inevitably be a need to support these lines with appropriate levels of inventory. We believe that there is a fundamental link between stock turn and gross margins – a low stock turn can be financed if there are sufficient margins.

We remain firm believers in the earn/turn ratio (stock turn × gross margin). A figure in excess of 100 is deemed acceptable; based on 2013 numbers, the figure for Flowtech is a very comfortable 145.

Sound balance sheet

The prospectus shows a pro forma balance sheet at December 2013. It shows fixed assets of £44.3m of which £42.5m is goodwill. Net working capital amounts to £12.9m, with other net liabilities totalling £0.6m. The net total of £56.6m is financed by net borrowings of £7.1m and shareholders' funds of £49.4m.

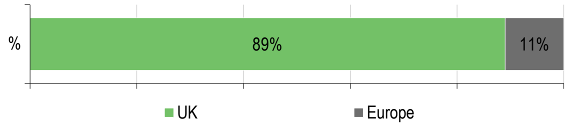
While the valuation applied to goodwill is fundamental to the strength of the balance sheet, management is better placed than for some time in terms of taking the group forward. On the basis of the IPO price of 100p, there is an implication that the goodwill may be overvalued, but we believe that as the business goes forward, the delivery of market estimates will justify the valuation.

Exhibit 5: Financial summary

		2011	2012	2013	2014e	2015e
Year end 31 December	£000s	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS						
Revenue		35,902	33,830	34,272	33,000	34,200
Cost of Sales		(24,531)	(23,342)	(22,857)	(21,800)	(22,500)
Gross Profit		11,371	10,488	11,415	11,200	11,700
EBITDA		4,568	4,034	4,882	6,600	7,000
Operating Profit (before amort. and except.)		4,114	3,610	4,434	6,100	6,600
Intangible Amortisation		(2,896)	0	(160)	0	0
Exceptionals		0	0	0	0	0
Other		(147)	0	0	0	0
Operating Profit		1,071	3,610	4,274	6,100	6,600
Net Interest		(5,774)	(5,461)	(5,197)	(3,100)	(300)
Profit Before Tax (norm)		(1,660)	(1,851)	(763)	3,000	6,300
Profit Before Tax (FRS 3)		(4,556)	(1,851)	(923)	3,000	6,300
Tax		35	(268)	(876)	(600)	(1,300)
Profit After Tax (norm)		(1,625)	(2,119)	(1,639)	2,400	5,000
Profit After Tax (FRS 3)		(4,521)	(2,119)	(1,799)	2,400	5,000
Average Number of Shares Outstanding (m)		1.3	1.3	1.3	40.0	40.0
EPS - normalised (p)		(136.3)	(163.0)	(126.1)	6.0	12.5
EPS - normalised and fully diluted (p)		(136.3)	(163.0)	(126.1)	5.6	11.7
EPS - (IFRS) (p)		(347.8)	(163.0)	(138.4)	6.0	12.5
Dividend per share (p)		0.0	0.0	0.0	5.0	5.3
Gross Margin (%)		31.7	31.0	33.3	33.9	34.2
EBITDA Margin (%)		12.7	11.9	14.2	20.0	20.5
Operating Margin (before GW and except.) (%)		11.5	10.7	12.9	18.5	19.3
BALANCE SHEET						
Fixed Assets		44,454	44,494	44,253	44,153	44,252
Intangible Assets		42,684	42,684	42,524	42,524	42,524
Tangible Assets		1,770	1,810	1,729	1,629	1,728
Investments		0	0	0	0	0
Current Assets		19,270	17,361	19,890	20,116	18,249
Stocks		9,811	9,197	9,804	10,078	10,444
Debtors		8,127	7,600	7,626	7,343	7,610
Cash		956	283	2,265	2,500	0
Other		376	281	195	195	195
Current Liabilities		(13,467)	(14,319)	(16,413)	(7,936)	(8,208)
Creditors		(5,847)	(5,297)	(5,146)	(4,908)	(5,242)
Short term borrowings		(7,620)	(9,022)	(11,267)	(3,028)	(2,966)
Long Term Liabilities		(59,484)	(58,952)	(60,918)	(5,158)	(158)
Long term borrowings		(59,209)	(58,780)	(60,760)	(5,000)	0
Other long term liabilities		(275)	(172)	(158)	(158)	(158)
Net Assets		(9,227)	(11,416)	(13,188)	51,175	54,135
CASH FLOW						
Operating Cash Flow		2,924	4,526	4,231	6,440	6,526
Net Interest		(5,459)	(5,406)	(5,165)	(3,100)	(300)
Tax		66	(170)	(883)	(669)	(1,125)
Capex		(567)	(445)	(374)	(400)	(499)
Acquisitions/disposals		(216)	(10)	0	0	0
Financing		0	0	0	62,623	0
Dividends		0	(141)	(52)	(660)	(2,040)
Net Cash Flow		(3,252)	(1,646)	(2,243)	64,234	2,562
Opening net debt/(cash)		62,621	65,873	67,519	69,762	5,528
HP finance leases initiated		0	0	0	0	0
Other		0	0	0	0	0
Closing net debt/(cash)		65,873	67,519	69,762	5,528	2,966

Source: Flowtech Fluidpower, Edison Investment Research

EDISON

Contact details	Revenue by geography
Pimbo Road Skelmersdale Lancashire WN8 9RB www.flowtechfluidpower.com	

CAGR metrics		Profitability metrics		Balance sheet metrics		Sensitivities evaluation	
EPS 2011-15e	N/A	ROCE 14e	8.6%	Gearing 14e	10.8%	Litigation/regulatory	○
EPS 2013-15e	N/A	Avg ROCE 2011-15e	N/A	Interest cover 14e	2.0x	Pensions	○
EBITDA 2011-15e	11.3%	ROE 14e	4.7%	CA/CL 14e	2.5x	Currency	◖
EBITDA 2013-15e	19.7%	Gross margin 14e	33.9%	Stock days 14e	111.5	Stock overhang	○
Sales 2011-15e	-1.2%	Operating margin 14e	18.5%	Debtor days 14e	81.2	Interest rates	○
Sales 2013-15e	-0.1%	Gr mgn / Op mgn 14e	1.8x	Creditor days 14e	48.5	Oil/commodity prices	○

Management team

Non-executive chairman: Malcolm Diamond

Malcolm Diamond spent 18 years as CEO of Trifast until retiring in 2002; he returned as executive chairman in 2009 to lead that company's strong subsequent recovery. He has served as a non-executive director of a number of successful public companies, offering extensive sales and marketing and strategic planning skills.

Chief executive: Sean Fennon

Sean Fennon joined Flowtech as CEO in November 2009 and has led the subsequent restructuring of the group and implementation of its new growth strategy. His 25-year career has required extensive design, manufacturing retail and industrial distribution skills. Prior to joining the group he was MD of Monks & Crane, the UK distribution subsidiary of Wurth Group

Chief financial officer: Bryce Brooks

Bryce Brooks is a qualified chartered accountant with a civil engineering degree. He joined Flowtech as CFO in March 2010, prior to which he spent 12 years as FD in two UK subsidiaries of Marlowe Holdings, an American owned industrial products distribution group.

Marketing director: Paul Watson

Paul Watson joined Flowtech as marketing director in January 2011. He brings 30 years' experience in industrial distribution, including working at Monks & Crane with the group CEO. More recently he ran his own industrial marketing consultancy practice, including work for Flowtech.

Principal shareholders	(%)
Hargreave Hale	13.1
Miton Asset Management	13.1
Cazenove Capital Management	7.5
Blackrock Investment Management	5.0
Henderson Global Investors	5.0
River and Mercantile Asset Management	5.0
Standard Life Investments	5.0

Companies named in this report

N/A

Frankfurt +49 (0)69 78 8076 960	London +44 (0)20 3077 5700	New York +1 646 653 7026	Sydney +61 (0)2 9258 1161	Wellington +64 (0)48 948 555
Schumannstrasse 34b	280 High Holborn	245 Park Avenue, 39th Floor	Level 25, Aurora Place	Level 15, 171 Featherston St
60325 Frankfurt	London, WC1V 7EE	10167, New York	88 Phillip St, Sydney	Wellington 6011
Germany	United Kingdom	US	NSW 2000, Australia	New Zealand