Daily comment

Wednesday 5 November 2014

Rolls-Royce, Meggitt, Marshalls, Carmat, technology – LG and Samsung

Rolls-Royce RR:LN 842p Mkt cap £15.9bn Analyst: Sash Tusa

Our view

We see the key story in the two press releases issued by Rolls-Royce on 4 November as being the abrupt change of chief financial officer, not the restructuring announcement.

The restructuring had been expected, is by no means out of the ordinary in scale or nature for a company in the A&D sector, and the accounting (treating most of the costs as underlying, rather than 'exceptional') appears to us pretty conservative. By contrast we see the appointment of a new CFO as offering Rolls the opportunity to make a break from its tradition of a relatively defensive relationship with some of its financial stakeholders, and an approach to accounting that has often only varied between opaque and downright confusing. We accept that Rolls sits at a structural disadvantage in terms of simple scale and depth of financial backing compared to either General Electric or Pratt & Whitney. But we believe that, in the longer term, the upside in terms of investor sentiment and stock market rating from a simpler and more open approach to accounting and financial management could far outweigh any competitive downside from either greater disclosure or short-term volatility of financial results. Nearer term, however, we see some risk from the likely (and totally understandable) wish of a new CFO, and especially one lacking the long career of his predecessors inside Rolls-Royce, aggressively to re-base accounting and financial processes.

Restructuring: run of the mill, but conservatively accounted

Rolls had been clear in its 17 October trading statement that it would accelerate its restructuring to try to manage those elements of financial performance that are within its control; we see the c £300m cost (spread over 2014 and 2015) as reasonable, and the 2.5-year payback (based on Rolls' indications of annualised costs benefits of c £80m) as being worthwhile, but a second-order benefit for a group generating annual EBIT in excess of £1.5bn. We highlight, however, the large proportion of the charges (a total of £250m over the two years) that Rolls indicates it will take within EBIT; only £50m will be treated as 'exceptional'. This conservative approach compares very positively with, for example, Cobham, all of whose restructuring, both under the 'Excellence in Delivery' process and now the integration of Aeroflex, appears, highly conveniently, to be able to be treated as 'exceptional': This treatment has benefited Cobham EPS by c 10% annually, compared to the c 10% hit that Rolls will take for near-identical restructuring in 2015e.

A new CFO, a (very) new broom

David Smith, who joined Rolls as CFO for the Aerospace division earlier in 2014, is to replace Mark Morris as CFO of the group. It is hard to escape the conclusion that Mr Morris has carried the can for Rolls' two very negative trading statements this year (17 October and 13 February, 2013 results), plus the damaging restatement of accounts following the investigation by the Financial Reporting Council.

Our initial thoughts are that Mr Smith has the potential to rebase both Rolls' accounting, and its relationship with its financial stakeholders. He has what we believe is a significant advantage in being an 'outsider' (with a career at Ford, Jaguar Land Rover, and lately Edwards Group), who has not spent a majority of his career at Rolls, and hence may be able to reassess many of the company's often deeply complex financial structures and accounting principles. There are some, albeit over-simple, analogies with Tesco that Mr Smith could, in our view, very profitably address:

both are great British companies with strong international reputations and positions. But both can give the impression of having adopted increasingly complex (and ultimately counter-productive) accounting structures in order to meet stock market pressures for earnings and growth.

Rolls' October 2014 trading statement disappointed investors, in our view, in part because it included medium-term financial guidance that left many observers concerned that Rolls seems able to forecast the margins that it will make in 2018, but is unable (or unwilling) to even posit what level of revenues these margins might derive from. We see a clear priority for Mr Smith (and this should, in our view, be an exceptionally low-hanging fruit) as being to clarify Rolls' medium-term guidance. Simplifying the accounting that drives it (especially that relating to long-term service agreements for civil aero engines) could, we believe, be at least as positive for the longer-term multiples on which the Rolls-Royce share price could trade. But we feel it is essential that Rolls can forcefully and credibly address a concern emerging from the October trading statement that the company in any way makes the numbers up.

In the near term, Rolls-Royce's shares could remain volatile: underlying market conditions, especially in the non-aerospace businesses, are clearly tough and may drive additional restructuring, and Rolls needs to complete the sale of the industrial gas turbines business to Siemens by year-end on the terms agreed on 6 May 2014. We do not think it prudent to rule out a clarification of medium-term guidance with the preliminary results on 13 February 2015. And we think it possible that there could be a revision of some accounting items at that time. The key issue, therefore, with be the degree to which any such changes are perceived as increasing transparency, and hence the quality of earnings, as well as confidence in the medium-term civil aero engine growth story.

Next events:

- 13 November 2014: Interim management statement
- 13 February 2015: Preliminary results

Meggitt MGGT:LN 468p Mkt cap £3.8bn Analyst: Sash Tusa

Meggitt's IMS highlights a good Q3, with strong civil OE growth (+18%), the predicted recovery in the civil aftermarket (+4%) and a recovery in defence (+5%). However, at the group level this is largely eliminated by deferrals of contracts into 2015 and supplier problems in Brazil leaving Energy down 7%, plus a substantial hit from FX. Meggitt's forecast of low-single digit organic growth for FY14 looks little different from that given at the interims, implying a down year at the headline level after the effects of FX. Perhaps more significant is the forecast of similar low organic growth in FY15, implying that the pretty slow Q414 trading is likely to persist through 2015. This is not a BAE/Rolls-style "growth pause", but it is still a bit of a disappointment.

The real surprise of the statement is the decision to start a share buy-back (amount to be confirmed) in the coming weeks. We have highlighted that Meggitt's balance sheet has become very ungeared, and thought there was an increasing risk that the company might undertake another large acquisition. We think the decision to do a buy-back suggests that Meggitt's board:

- accepts that the talk of a large deal that has persisted, since the FY13 results have actually acted as an overhang on the share price;
- cannot find a deal worth doing; and
- thinks that, if Meggitt can find a large acquisition, it can as easily be funded by equity. We think the response of the shares today (call at 9am) will largely be determined by the scale and pace of the buy-back vs disappointment at the likely weak 2015.

Marshalls MSLH:LN 201p Mkt cap £401m Analyst: Toby Thorrington

There is another positive update from Marshalls this morning ahead of a site visit (St Ives facility) later in the week. All three segments (Commercial, Domestic and International) are growing at double-digit percentages year-on-year but Domestic catches the eye. Revenue growth here has increased from c 4% at the H1/6m stage to +10% in the 10m to October. This partly reflects the installer order position previously reported but, even with increased capacity (ie more installers), this metric is higher again at 11.5 weeks. With fairly established pricing (+ 3-4%) at this stage in the year, this uplift in revenue performance is driven by genuine volume growth. Consequently, operational gearing effects should be positive too and we expect consensus estimates (FY14 revenue £340m, PBT £21m, EPS 9.0p, FY15 £368m, £29m, 11.8p) to increase by 5-10% for this year, with a more gentle nudge up for FY15. In other words, a more significant part of a rather steep rate of profit recovery is likely to be achieved in FY14 making FY15 a bit less of a leap of faith.

Generally speaking, the business is responding to the direction of a still fairly new management team, which appears confident in its direction of travel. MSLH is not cheap on headline estimates (FY14 P/E c 22x, FY15 c 17x, before upgrades) but the rate of earnings growth is impressive. The company has capacity to spare to accommodate further volume growth and – with Construction Products Association (CPA) estimates up again and further market share gains targeted – the operational gearing effect should remain positive.

Carmat ALCAR:FP €74.76 Mkt cap €320m Analyst: Emma Ulker

Carmat is preparing to recruit the third patient in the feasibility study of its bio-prosthetic heart. The pivotal study is due to start in H115 and could lead to CE mark certification in 2016. Meanwhile, the company is transitioning from project to industrial scale ahead of the clinical study and potential launch. Our valuation remains at €533m and as discussions progress on the likely US regulatory route, this could increase to €911m if Carmat pursues a full PMA approval accessing c 50,000 patients.

In H114, Carmat implanted the second patient in the feasibility study for the CE mark trial of its bio-prosthetic heart. Two out of four patients have now satisfied the 30-day survival success measure. The next clinical update is expected to be final results of the feasibility study, which could be in Q414. A pivotal trial (c 25 patients) is due to start in H115. A key endpoint is likely to be 180-day survival, but the protocol will be finalised depending on the outcome of the feasibility study.

Carmat is developing a 3kg portable energy supply providing patient autonomy for at least four hours. It is focusing on training surgeons, restructuring its industrial and production processes to meet the demands of the trial and commercialisation. The company is finalising its US strategy; the two non-exclusive options are a full PMA, a longer approval process with an addressable market of up to 50,000 patients, or a humanitarian device exemption (HDE), a faster development path for a narrower cross-section (c 4,000) of patients with a poorer prognosis.

Our forecasts indicate an increased funding requirement of €20m in FY15 after OSEO subsidies, an increase from the €15m estimate in our initiation. A €5.4m project milestone is expected in H214, c six months delayed, and H114 operating costs were €10.7m, vs our forecast €8.9m. End-June gross cash stood at €7.7m.

Technology – LG and Samsung – Analyst: Richard Windsor

Safety in low numbers – LG trades margin upside for safety

LG has struck a patent deal with Google that looks to be almost exactly the same as the deal struck with Samsung on 27 January 2014.

We continue to believe that this deal was a huge strategic blunder for Samsung (see here), but in LG's case there is little to lose. Although the headlines are all about patent cross-licensing, the substance of the agreement is all about the ecosystem.

In Samsung's case it agreed not to compete with the Google ecosystem on its devices and has since ceased all attempts at developing its own ecosystem. Samsung at the time enjoyed a 30% smartphone share and 18% EBIT margins and its only hope of preserving this profitability was to develop its own ecosystem. Success would have allowed it to differentiate its fast commoditising products, keep pricing high and thereby earn a high margin.

Unfortunately, strife inside Samsung and a lack of understanding of software prevented it understanding this reality, and it believed it had nothing to lose by ditching its own ecosystem.

The last two quarters have demonstrated how fragile Samsung's business is without something to differentiate it from the competition.

In LG's case, this is much less of an issue as it only has 5% smartphone market share and 3.9% EBIT margins. Over the last 10 years, LG has really struggled with handset software and has never come close to embracing the idea of an ecosystem. Consequently, ceding this possibility to Google represents no real loss, although it severely limits LG's margin upside.

It will now be forced to compete on hardware specification and price only, which means its margins are unlikely to rise above current levels unless it materially increases its share.

To make a decent return on smartphones, LG would need to more than double share from its position today and in that instance profitability would start to benefit from increasing scale. However, for the last 10 years, LG has been unable to get past where it is today and I see nothing to change that outlook.

Signing with Google gives LG the safety of being a preferred partner of Google, but also ensures that the real return from its handsets will be earned in Mountain View.

Best regards,
Jeremy Silewicz

For further information please contact:

Jeremy Silewicz +44 (0)20 3077 5704
Head of institutional team
jsilewicz@edisongroup.com

Sohil Chotai +44 (0)20 3077 5733
Institutional analyst
schotai@edisongroup.com

Sash Tusa +44 (0)20 3077 5757
Aerospace & defence analyst
stusa@edisongroup.com

Richard Windsor +44 (0)20 3239 9904
Tech, mobile & internet analyst
rwindsor@edisongroup.com