Daily comment

Tuesday 10 February 2015

Stock Spirits, MTU Aero, Morgan ADV Minerals, Carmat, technology – Baidu

Stock Spirits STCK:LN 197.5p Mkt cap £395m Analyst: Sohil Chotai

Stock Spirits' recent trading update has left investors nervous about the competitive environment in its key market of Poland. Given the persistence of supply and resurgence of competition we, cautiously trim our 2015 and 2016 estimates. However, we believe the underlying value creation story is still intact, with the possibility of an accretive transaction a key potential catalyst for positive momentum in our view. Additionally, management has committed to a focus on value share rather than engaging in aggressive discounting, a strategy that we think is appropriate. We adjust our valuation for earnings cuts and FX; we think less than 8x 2015e EV/EBITDA is compelling, offering 37% upside to our fair value.

Stock reported that supply chain disruption continued into Q4. Consumer volume trends deteriorated to -4.4% for January to November 2014 compared with a -3.6% decline at the H114 stage. As such, management reiterated guidance that FY14 EBITDA would be at the lower range of market expectations (c €67m). While we leave our FY14 estimate (€66m) unchanged, we note that competitors appear to be discounting more than previously anticipated to grow volume share (although according to Stock it is retaining value share). We believe market disruption will continue into this year and trim our estimates accordingly. Stock is continuing to focus on its value share and so investors will wish to evaluate the merits of this approach and to what extent management of the Polish business, now under the COO's direct control, can stem the volume declines in the shorter term. We anticipate clarity on these key issues at the FY14 results on 12 March.

We believe the consumer environment in Poland to be beneficial to Stock. Recent macroeconomic data have been positive, with the highest consumer confidence since July 2010. We elaborate further on this on page 3.

We think Stock Spirits is attractively valued against its spirits peers, as well as the broader beverages sector. Without confirmation that the corner has been turned with respect to the Polish business, the shares are unlikely to re-rate in the short term. **Valuing Stock at a 25% discount to the spirits sector multiple of 15x forward EBITDA and averaging this with our DCF approach yields our fair value target of 267p, offering 37% upside.**

MTU Aero Engines MTX:GY €82.57 Mkt cap €4.3bn Analyst: Sash Tusa

MTU: upgraded 2015e guidance benefits as much from the USD as underlying growth

MTU has beaten the guidance that it released in October 2014 by around 4% at the sales line (10% revenue growth y-o-y), 1% further down the P&L, and released guidance for 2015 that looks for 12% revenue growth and 10% EBIT growth. After what was clearly a slightly stronger Q414 for OE deliveries, MTU's guidance for 2015 looks for relatively consistent growth across all its commercial engine lines (OE, spares and maintenance, repair and overhaul) of between 5% and 9%. Only the (small) military engines business looks likely to hold MTU back, with a forecast c.5% decline in revenues.

The gap between what we estimate to be blended average volume growth of 6.5% in the commercial engines businesses and the 12% top line guidance we believe comes from the strength of the US Dollar against the Euro. A key focus on the conference call today is likely to be exactly what MTU's assumptions are, both for hedge rates (for the company's longer-term, largely OE sales) and spot (for spare parts and many MRO contracts).

The other focus is likely to be cash flow. MTU disappointed us at the November 2014 Investor Day by the very low forecasts for free cash flow over the coming years. We recognise and accept that rising OE deliveries, especially on new programmes such as the Pratt & Whitney Geared Turbo Fan family of engines, will absorb a lot of capital expenditure and working capital. However, we note that FCF of €43m in 2014 was only 11% of reported EBIT, highlighting the scale of the issue at this stage of MTU's growth cycle.

As with 2014, MTU has again left the question of the FY dividend hanging until the 3 March Supervisory Board meeting. The statement is more explicit that in 2014, referring to the "striving for continuity in its dividend policy... intends to offer investors an appropriate share of the good operating results achieved in 2014". Our forecast is a €1.45 dividend, up 7%, slightly above the 6€ actual increase in EBIT. **We think that anything below this would send a particularly negative message about the Board's view of its prospects, and especially near-term free cash flow.**.

Morgan Adv. Materials MGAM:LN 307p Mkt cap £876m Analyst: Roger Johnston

Morgan has shown that even during a period of senior management change, focus has been maintained and progress had been achieved. While reported results were held back by currency, underlying growth was achieved across most parts of the group with the notable exception of Composites & Defence Systems which has been impacted by lower MoD spend. However this business now appears to have bottomed out at £30-£40m p.a. and now accounts for only 4% of group revenue. Regionally the strongest improvement was clearly in Asia with revenue up 13% (on a constant currency basis) delivering a 180 basis point margin improvement. North America remained strong across most business lines except for some weakness in ceramic cores, but still delivered 3.6% growth (cc) and a mid-term margin. Europe was down primarily because of the CD&S business with a flat performance elsewhere but even here, restructuring efforts allowed a small margin improvement to be achieved.

Overall, the group continues to refocus on global technology markets with premium products while constantly seeking to improve cost base and efficiency. This has shown through in further increases in R&D, investment in new facilities and acquisitions of complementary technologies such as the Porextherm business. With the recent appointment of Pete Raby as the new CEO announced, we expect the technology differentiation strategy to continue while his experience delivering Cobham's Excellence in Delivery (EiD) efficiency programme will ensure that no extra fat creeps back in during the process. With his arrival not until August however it remains key that the group maintains the focus demonstrated in H2 in the meantime

Carmat ALCAR:FP €69 Mkt cap € 295m Analyst: Emma Ulker

Carmat is making preparations for the c 20 patient pivotal stage of clinical testing of the bioprosthetic heart (a mechanical heart designed to function like the human heart), having recently established contingent equity funding of €50m to finance the CE mark development process, with filing planned in H216. These plans include deciding on clinical endpoints and recruiting European transplant centres (up to eight high volume centres targeted). The feasibility study is currently 50% recruited (2 patients remain to be transplanted with the heart) and the company expects that the remainder of the study will progress more quickly and should be completed by mid-2015. So far, in the two patients, implanted with the heart, in the very late stages of heart disease, the 30 day survival outcome measure was exceeded, the second having been discharged from hospital supported by a portable energy source.

Carmat is in discussions with FDA on the US regulatory route it will adopt at the outset, which will affect the size of the addressable market for the heart, depending whether it opts for humanitarian device exemption HDE a narrower addressable market but with an accelerated pathway or via the broader PMA route.

We value Carmat at €591m and if the company opts to develop the heart via PMA approval route in the US, this could lead to an increase in our valuation to €979m.

Technology –Baidu Q414 Mobility Pains - Analyst: Richard Windsor

Baidu pays the price for its mobile ambitions.

Baidu reported disappointing Q414 results, with the cost of building out mobile hurting the figures. Revenues / net profit were CNY14.05bn (US$2.23bn) / CNY3.23bn US$517m) which missed estimates of CNY14.08bn / CNY3.52bn. Mobile is causing Baidu two main problems.

First: Like Google, Baidu suffers from a revenue shift to mobile because mobile advertisements still carry lower prices than those on fixed devices. This is because the click through rates are lower and users are still less inclined to effect a transaction on a mobile device than they are on a computer. We continue to believe that this will change with time and in the long run mobile should actually end up being more valuable than fixed. This is because advertisements on mobile can be more relevant and more contextual to the user making them less intrusive and likely to be of greater interest. It will take time, but we believe that both Baidu and Google are likely to benefit long term as mobile matures. Yahoo! should benefit too, if it can execute on its mobile vision.

Second: Baidu is investing heavily in developing its own ecosystem of Digital Life services. Its coverage of Digital Life remains pretty weak and a lot of investment is needed to get a full suite of services up and running. There is no sign of these investments abating and 2015 is likely to suffer because of it. The fact that Q4 14 traffic acquisition costs (TAC) increased to 13.5% of revenues from 12.9% in Q3 14 also did not help matters.

Guidance for the coming quarter was also a bit soft as the late timing of Chinese New Year and a continued shift towards mobile is likely to keep a lid on growth. Q115E revenues are expected at CNY12.645bn – CNY13.065bn which represents growth of over 30% y-o-y but is meaningfully below consensus estimates of CNY13.5bn.

These results highlight that it is going to be only the biggest and the strongest that make it in the Chinese market. With smartphone users flattening out at around 900m, we now estimate that there is enough space in the market for three large players. This is where Xiaomi is at a disadvantage. It has plenty of revenues but lacks the profitability of Baidu, Tencent or Alibaba meaning that it does not have the resources to invest as heavily as its competitors.

Consequently, we are concerned that it will be left behind in the race to become an ecosystem in China unless it can do something very innovative and maintain its grip on the users' imagination. Hence, we continue to see Baidu, Tencent and Alibaba as the big three ecosystems in China.

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

View disclaimer