EDISON

Coats Group

H117 results

Faster growth aspirations

General industrials

H117 results provided clear evidence of business momentum with a strategy to accelerate the influence of innovation on future growth rates. Following a series of announcements and the H1 cash flow presentation, the ongoing pension, and therefore group, funding positions are now fully visible. The combination of these points indicates an aspiration to achieve faster group progress, in our view.

Year end	Revenue (US$m)	PBT* (US$m)	EPS* (c)	DPS** (c)	P/E (x)	Yield (%)
12/15	1,472.5	127.3	5.0	0.0	20.1	N/A
12/16	1,457.3	140.7	5.8	0.8	17.1	0.8
12/17e	1,488.5	155.8	6.5	1.5	15.3	1.5
12/18e	1,548.6	157.9	6.7	1.7	14.9	1.7

Note: Continuing operations only. *PBT, EPS are Edison normalised, excluding intangible amortisation, exceptional items and share-based payments. **Pro forma FY16 1.25c/1.3%.

Encouraging H1 performance

Group revenue and EBIT grew by 4% and 12% respectively, primarily due to the encouraging performance from Industrial operations. Overall finance costs reduced such that adjusted EPS increased by 38% in the period and the payment of a maiden H1 dividend after a return to the dividend list with the FY16 final was another highlight. Pension cash payments dominated balance sheet funding movements in the period, but the underlying cash flow performance was positive and ahead of the previous year.

Clear focus

Management stated that its full year expectations are unchanged. Based on the H1 performance, we have nudged up our estimates for the second time this year. The group pension position is much clearer now; it includes a much-reduced deficit (to US$179m for the three UK DB schemes at the end of June), lower annual recovery payments and the cessation of all warning notices. Consequently, the group balance sheet position and cash flow prospects have also been clarified. Quite obviously, investors will focus more now on business performance and we believe that reasonable momentum is apparent currently. There is, perhaps, more to come from increasing capex and innovation initiatives on a medium-term view.

Valuation: Growing earnings, more expected

Notwithstanding a small post-results retracement, Coats' share price has performed well since the beginning of the year, rising by c 40% ytd. Our FY17 EPS estimates have risen by 6% over this time period; the current year P/E now stands at 15.3x with an EV/EBITDA (adjusted for pensions recovery cash) of 11.8x. By FY19, these metrics become 14.3x and 7.7x respectively. (Note that £/US$ movements affect valuation multiples.) We expect the dividend yield to rise from 1.5% to 2.0% over our estimate horizon. As previously noted, we believe the market is starting to price in faster earnings growth than the current consensus and, now that the pension position is clearer, this is likely to be the primary valuation driver in our view.

9 August 2017

Price	**76.40p**
Market cap	**£1,080m**
	£/US$1.30
Net debt (US$m) at end June 2017	261
Shares in issue (includes Treasury shares)	1,412.4m
Free float	97%
Code	COA
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	0.5	23.7	156.8
Rel (local)	(2.1)	20.2	130.3
52-week high/low		80.2p	29.5p

Business description

Coats Group is a leading producer of industrial thread and consumer craft textiles with over 70 manufacturing sites internationally. Its divisions are Industrial: Apparel & Footwear (67%) and Performance Materials (c 17%); and Crafts (16%), based on FY16 revenue.

Next events

Ex-dividend H117 interim 0.44c	26 October 2017
H117 dividend paid	17 November 2017

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H117 results overview

The robust H1 performance was most notable for increased underlying revenue growth rates in both Industrials subsegments, backed up by a small divisional margin improvement. The headline change in funding position was dominated by pension settlement payments from parent company cash leaving group net debt of c US$261m at the end of June. Underlying cash flow performance should become more visible and we expect Coats to end FY17 with net debt/EBITDA around 1x.

Exhibit 1: Coats Group divisional and interim splits

US$m	H116	H216	FY16	H117	H117 % chg y-o-y		
					Reported	CER	L-f-l
Group revenue	**713**	**745**	**1,457**	**740**	**4%**	**5%**	**3%**
Industrial Division	609	612	**1,221**	642	5%	7%	5%
Apparel & Footwear	494	481	**975**	507	3%	5%	4%
Performance Materials	115	131	**246**	135	16%	18%	9%
Craft Division	104	133	**236**	98	-6%	-8%	-8%
Handknitting	49	72	**121**	47	-3%	-4%	-4%
Needlecrafts	55	60	**115**	51	-8%	-11%	-11%
Group operating profit	**80**	**78**	**158**	**89**	**12%**	**14%**	**10%**
Industrial Division	81	74	**155**	88	8%	11%	7%
Craft Division	3	8	**11**	5	79%	79%	79%
UK pension admin costs	-4	-4	**-8**	-4			

Source: Coats Group

Industrial – Apparel & Footwear: l-f-l revenue growth in H117 was around double that achieved in FY16 and, we note, slightly ahead of that for the four-month period ending April reported at AGM time. As the largest subdivision in the group, this is significant. A pricing environment described as “challenging” indicates that most, if not all, of the headline progress was volume driven and market share gains, together with some contribution from new products were the key drivers cited. “Winning with the winners” has been a phrase used by the company in the past and this very much appears to have been the case again as some of the leading brand owners and retailer customers have performed relatively well in their markets. Encouragingly, H117 saw growth in each of A&F’s identified product groups (including zips, trims and accessories) with favourable mix effects also.

Industrial – Performance Materials: as trailed with the AGM update in May, this sector has experienced a marked step-up in underlying revenue growth rates compared to the prior year (ie +9% in H117 versus +3% in FY16). This appears to be more than a rebound from a relatively weak start in US consumer durable demand in H116; Asia and EMEA revenues both grew above the underlying rate, partly attributable to the migration of existing products, as well as following opportunities with existing customers into other territories. No specific new products were highlighted as material contributors to revenue growth in the period, although Synergex (carbon fibre thread applications) was name-checked again as an area to watch. Our sense is that greater intensity is being brought to accelerating development in this segment with both innovation hubs (in the US and Turkey) and the establishment of a Global Innovation Forum indications of increasing focus here. Gotex (cable protection yarns, acquired in June 2016) made a material boost to headline growth rates in the period and this illustrates a further option for adding higher value-added products to the portfolio offering.

Crafts: the impact of previously flagged tornado disruption (affecting warehouse stock and shipments) was restricted to c US$10m of expected revenue. However, loss of profits insurance cover has optically improved the margin performance of this division. There will be a smaller tail of this in H2 and distribution has been substantially reinstated. North American markets have been more steady at lower levels but are considered to be weak, while Latin America has been somewhat better, underpinned by some actions to consolidate operations alongside Industrial ones.

Cash flow and balance sheet clarity

Pension cash flows dominated in H117 but, having agreed settlements with all three UK DB schemes and made the associated one-off payments, the end-June balance sheet is now representative of the financial position of the group going forward. Net debt stood at US$261m including a remaining c US$2m parent company cash, retained for pension settlement expenses.

- **Underlying FCF** – H1 EBITDA of c US$109m was c US$10m above the prior year with a more modest working capital outflow also (chiefly a H117 payables inflow versus a H116 outflow). Other normal cash flow items were, in aggregate, in line with H116; interest, tax and minority dividend payments were all modestly lower with capex c US$2m higher (including increasing IT platform spend) at US$19.7m, similar to the combined depreciation/amortisation charge. After accounting for all of these items, the underlying free cash inflow was c US$20m.
- **Acquisitions/dividends** – There was no acquisition spend in H117 compared to the c US$40m M&A spending made in the previous year (including the acquisitions of Gotex and Fast React and some residual EMEA Crafts disposal costs). Having returned to the dividend list by declaring an FY16 final, the associated c US$11m cash payment was made in May.
- **Pensions** – The DB scheme settlement agreements have been well documented. As previously noted, initial payments were made in FY16. A further US$340m payment was made in H117 concluding the standalone cash injections into all three schemes, including Staveley. As a result, parent company cash balances stood at US$2m at the end of June. It is anticipated that ongoing scheme recovery payments will total US$25m in FY17 before stepping down to US$22m pa (at £/US$1.27) thereafter or c 10 % of EBITDA.

We expect a seasonally strong H2 operating cash performance to be sufficient to fund a step-up in capex in H2 (to c US$55m for the full year) and other normal cash flow items to leave group net debt in the US$210-215m range by the end of FY17. This is above our last published figure being the net product of including the Staveley settlement cash for the first time, partly offset by our improved underlying cash flow expectations. The indicated net debt level would be broadly in line with the EBITDA generated in the year on our estimates.

Edison estimates raised

Management's expectations for the full year are unchanged, with an emphasis more on internal initiatives rather than particularly supportive markets to achieve this.

Our group revenue estimates are barely changed overall, with increased Industrial expectations more or less offset by Crafts reductions. At the same time, we have nudged up our assumed Industrial margins modestly with a more positive effect on EBIT compared to lowered Crafts margins. Taken together with an associate contribution (where we had not previously expected one) and lower prevailing interest costs – even though our year-end net debt expectation is higher – the overall outcome is a c 4%+ uplift in our PBT forecast for the current year. At this stage, we have not amended the associate or interest lines in our model for subsequent years, so the PBT uplift is more modest. At the EPS level, we have factored in a 33% tax charge for FY17 (up 100bp) in line with the interim level, with FY18 and FY19 unchanged at 32%.

Exhibit 2: Coats Group revised estimates

	EPS – fully diluted, normalised (c)			PBT – normalised (US$m)			EBITDA (US$m)		
	Old	New	% chg.	Old	New	% chg.	Old	New	% chg.
2017e	6.4	6.5	+1.7%	149.3	155.8	+4.4%	203.0	212.1	+4.5%
2018e	6.6	6.7	+3.8%	155.4	157.9	+1.6%	207.6	214.9	+3.5%
2019e	6.9	7.0	+3.0%	162.0	164.5	+1.5%	215.2	222.5	+3.4%

Source: Edison Investment Research. Note: Edison normalised includes 'other' finance (including borrowing cost amortisation) and excludes 'other' (pension net finance costs). Edison norm and Company norm are both shown in Exhibit 3: Financial summary.

Exhibit 3: Financial summary

	US$m	2014	2015	2016	2017e	2018e	2019e
December		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS							
Revenue		1,561.4	1,489.5	1,457.3	1,488.5	1,548.6	1,601.0
Cost of Sales		(993.4)	(930.1)	(892.3)	(911.4)	(948.2)	(980.3)
Gross Profit		568.0	559.4	565.0	577.1	600.4	620.7
EBITDA		170.0	183.0	198.6	212.1	214.9	222.5
Operating Profit (before GW and except.)		123.4	139.4	157.9	170.3	174.9	181.5
Net Interest		(8.7)	(6.3)	(10.1)	(12.5)	(14.0)	(14.0)
Other finance		13.5	(6.3)	(7.1)	(2.0)	(3.0)	(3.0)
Intangible Amortisation - acquired		0.0	0.0	0.0	0.0	0.0	0.0
Pension Net Finance Costs		(11.3)	(17.1)	(13.6)	(10.2)	(10.2)	(10.2)
Exceptionals		(20.0)	(29.9)	(3.3)	(1.7)	0.0	0.0
Profit Before Tax (Edison norm)		128.2	126.8	140.7	155.8	157.9	164.5
Profit Before Tax (Company norm)		116.9	109.7	127.1	145.6	147.7	154.3
Profit Before Tax (FRS 3)		96.9	79.8	122.5	141.9	145.7	152.3
Tax		(45.1)	(43.7)	(46.8)	(50.8)	(49.9)	(52.0)
Discontinued		(27.2)	(75.5)	(4.5)	0.0	0.0	0.0
Profit After Tax (norm)		55.9	7.6	89.4	105.1	108.0	112.5
Profit After Tax (FRS 3)		24.6	(39.4)	71.2	91.2	95.8	100.3
Minorities		(9.6)	(11.2)	(11.9)	(12.2)	(12.5)	(12.8)
Profit Attributable to Shareholders		15.0	(-50.6)	59.3	79.0	83.4	87.6
Average Number of Shares Outstanding (m)		1,407.4	1,400.8	1,386.6	1,398.0	1,398.0	1,398.0
EPS FD - Edison norm (c)		5.2	5.0	5.8	6.5	6.7	7.0
EPS FD - Company norm (c)		3.1	4.0	4.8	5.8	5.9	6.2
EPS - FRS 3 (c)		1.1	(3.6)	4.3	5.7	6.0	6.3
Dividend per share (c)		0.0	0.0	0.8	1.5	1.7	2.0
Gross Margin (%)		36.4	37.6	38.8	38.8	38.8	38.8
EBITDA Margin (%)		10.9	12.3	13.6	14.3	13.9	13.9
Operating Margin (before GW and except.) (%)		7.9	9.4	10.8	11.4	11.3	11.3
BALANCE SHEET							
Fixed Assets		653.9	627.9	654.8	673.9	685.9	696.9
Intangible Assets		256.7	261.2	291.8	292.2	296.2	300.2
Tangible Assets		298.2	273.0	265.9	278.0	286.0	293.0
Pension Surplus		51.0	52.5	50.8	49.8	49.8	49.8
Other		48.0	41.2	46.3	53.9	53.9	53.9
Current Assets		1,308.4	1,122.6	937.8	623.2	671.9	721.5
Stocks		257.8	204.0	205.8	210.2	218.7	226.1
Debtors		311.6	268.7	255.5	259.7	267.9	275.0
Cash		739.0	649.9	476.5	153.3	185.3	220.4
Current Liabilities		(576.6)	(437.9)	(660.3)	(358.6)	(379.1)	(399.6)
Creditors		(463.1)	(417.7)	(652.6)	(358.6)	(379.1)	(399.6)
Short term borrowings		(113.5)	(20.2)	(7.7)	0.0	0.0	0.0
Long Term Liabilities		(985.1)	(958.6)	(841.3)	(712.0)	(690.0)	(668.0)
Long term borrowings		(304.6)	(389.1)	(390.6)	(366.9)	(366.9)	(366.9)
Other long term liabilities		(680.5)	(569.5)	(450.7)	(345.1)	(323.1)	(301.1)
Net Assets		400.6	354.0	91.0	226.5	288.7	350.8
CASH FLOW							
Operating Cash Flow		161.2	87.7	75.7	(147.6)	183.5	192.3
Net Interest		(13.5)	(5.3)	(10.0)	(12.5)	(14.0)	(14.0)
JV/Minorities		(5.2)	(10.1)	(13.4)	(12.2)	(12.5)	(12.8)
Tax		(55.7)	(49.3)	(57.9)	(55.8)	(53.9)	(55.0)
Capex		(40.8)	(31.4)	(35.3)	(55.0)	(50.0)	(50.0)
Acquisitions/disposals		0.4	(5.4)	(40.1)	0.0	0.0	0.0
Financing		0.2	(7.6)	(2.7)	2.5	0.0	0.0
Dividends		0.0	0.0	0.0	(18.1)	(21.2)	(25.4)
Net Cash Flow		46.6	(21.4)	(83.7)	(298.5)	32.0	35.2
Opening net debt/(cash)		(274.3)	(320.9)	(240.6)	(78.2)	213.6	181.6
HP finance leases initiated		0.0	0.0	0.0	3.8	0.0	0.0
Other		0.0	(58.9)	(78.7)	2.9	0.0	0.0
Closing net debt/(cash)		(320.9)	(240.6)	(78.2)	213.6	181.6	146.5

Source: Company accounts, Edison Investment Research

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