EDISON

# Polypipe

H117 results

## Performance at a premium

Construction & materials

**Polypipe has leading positions in the best performing UK building and construction segments and delivered robust financial performance in H117. The company is well set for this to extend in H2 and beyond and we retain our view that it should continue to attract a premium rating in its sector.**

| Year end | Revenue (£m) | PBT* (£m) | EPS* (p) | DPS (p) | P/E (x) | Yield (%) |
|---|---|---|---|---|---|---|
| 12/15 | 352.9 | 48.0 | 19.4 | 7.8 | 21.0 | 1.9 |
| 12/16 | 436.9 | 61.8 | 25.0 | 10.1 | 16.3 | 2.5 |
| 12/17e | 465.9 | 66.2 | 26.4 | 11.7 | 15.4 | 2.9 |
| 12/18e | 481.5 | 71.6 | 29.0 | 12.9 | 14.0 | 3.2 |

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles and exceptional items.

## Solid performance in H117

There was a solidity about Polypipe's H117 trading results, which is attractive to investors. Behind the input cost headwind and FX translation tailwind, Polypipe delivered good volume and profit growth even with variable market subsector demand. While the group EBIT margin was slightly below the previous year (down 80bp to 16.1% on a reported basis), we believe the underlying causes were transitory and pricing effects will wash through. The 16.1% H1 DPS increase provided a clear message regarding management's view of future prospects. Cash flow exhibited its usual seasonal pattern, with working capital movements exaggerated by market pricing behaviour. While net debt was higher than reported in December, the underlying trend remains firmly downward, in our view.

## Earnings estimates modestly up, dividends more so

We expect current UK subsector trends to remain intact, with positive outlooks for infrastructure and new housing demand partly tempered by caution in commercial and secondary housing markets. In the former areas, visible projects and build cycles respectively indicate that H2 trading conditions should continue to be favourable for Polypipe. In profit terms, we have raised our expected contribution from Commercial & Infrastructure Europe, while maintaining existing UK operation profitability in future periods. Together with lower group finance costs, our overall earnings estimates are now slightly higher. We have also incorporated a stronger dividend growth profile following the H117 DPS declaration.

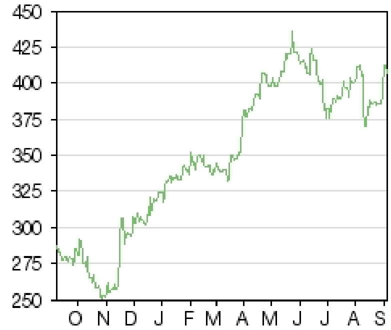
## Valuation: Premium rating

After a small dip, Polypipe's share price has more than recovered and sits just above pre-H117 results levels. It has modestly outperformed the FTSE All-Share index over this time, more so ytd (+22% relative). While our estimates have also risen a little, the company's P/E and EV/EBITDA for the current year now stand at 15.4x and 10.5x respectively, declining to 13.1x and 8.9x by FY19 on our estimates. We believe that a sector premium rating is well deserved and note that quality FTSE 250 peer, Marshalls, is currently rated materially higher.

**6 September 2017**

| | |
|---|---|
| **Price** | **407p** |
| **Market cap** | **£807m** |
| | £/€1.08 |
| Net debt (£m) at end June 2017 | 178.0 |
| Shares in issue | 198.3m |
| Free float | 93% |
| Code | PLP |
| Primary exchange | LSE |
| Secondary exchange | N/A |

### Share price performance




| % | 1m | 3m | 12m |
|---|---|---|---|
| Abs | (1.4) | (1.9) | 37.1 |
| Rel (local) | (0.1) | (0.3) | 26.8 |
| 52-week high/low | | 436.5p | 250.5p |

### Business description

Polypipe is a leading European supplier of plastic building products and ventilation systems. UK operations (c 87% of annualised FY16 net revenue and c 98% of EBIT) address a broad range of sectors including residential, commercial and civil building demand and a number of subsectors within them. Overseas operations are located in France and Italy with a new manufacturing facility in the Middle East.

### Next events

| | |
|---|---|
| H117 DPS 3.60p paid | 22 September 2017 |

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***Polypipe is a research client of Edison Investment Research Limited***

## H117 results overview

Polypipe delivered underlying volume and profit growth in H117 despite some market headwinds, most notably input price increases. Acknowledging seasonal effects, we consider that cash generation is set to remain strong with net debt maintaining a downward underlying trend.

**Exhibit 1: Polypipe Group interim and divisional splits**

| £m | H116 | H216* | FY16* | H117 | Change (%) |
|---|---|---|---|---|---|
| **Group revenue - net** | **223.3** | **213.6** | **436.9** | **242.0** | **8.4** |
| Residential Systems | 105.4 | 102.2 | **207.6** | 115.0 | 9.1 |
| Commercial & Infrastructure Systems | 124.2 | 117.9 | **242.1** | 135.1 | 8.8 |
| CIPS – UK | 92.7 | 91.5 | **184.2** | 97.7 | 5.4 |
| CIPS - Europe | 31.5 | 26.4 | **57.9** | 37.4 | 18.7 |
| Inter company | -6.3 | -6.5 | **(12.8)** | (8.1) | |
| **Group operating profit - reported** | **37.7** | **31.7** | **69.4** | **38.9** | **3.2** |
| Residential Systems | 21.5 | 17.5 | **39.0** | 22.9 | 6.5 |
| Commercial & Infrastructure Systems | 16.2 | 14.2 | **30.4** | 16.0 | (1.2) |
| CIPS – UK** | 15.2 | 13.9 | **29.1** | 14.5 | (4.6) |
| CIPS - Europe | 1.0 | 0.3 | **1.3** | 1.5 | 50.0 |

Source: Company, Edison Investment Research. Notes: *We have excluded £0.3m H216 profit on asset disposal. **Includes £0.8m Middle East set-up costs, largely in H116.

**Residential Systems – good revenue growth and prospects**

A clear beneficiary of exposure to the newbuild segment which has, as widely reported by the quoted housebuilders, continued to show good levels of demand and activity. Management considers that the headline revenue growth reported was substantially volume driven, with the price increases (from higher polymer input costs) effectively compensating for demand pulled forward into FY16 ahead of price increases. The pull-through of underground product was referenced and, being indicative of early-stage installations, this augurs well for other above-ground and rainwater lines as the build cycle progresses. As other commentators have noted, weaker consumer confidence appears to have fed into the secondary housing market with lower transactions and demand for building products static at best. For the division as a whole, the small margin reduction (by 50bp to 19.9%) reflected polymer price recovery lags. This effect was anticipated and we consider the overall outcome a very creditable one.

**Commercial & Infrastructure UK – more mixed performance**

To some extent groundworks and preparation for newbuild housing also benefited this division, with water management/flood prevention products installed as new sites are developed. Commercial ventilation revenue growth is also understood to have been ahead of the divisional average as Polypipe continues to develop its market position following the acquisition of Nuaire in 2015. Conversely, road infrastructure project delays hampered divisional revenue growth, as did market conditions in the Middle East, including local restrictions in supplying Qatar. Consequently, the Dubai manufacturing facility was temporarily mothballed during H1 (exceptional cost £0.9m) pending greater clarity on demand in the region. Revenue mix, input price recovery lags (a greater impact here than in residential) and the Middle East performance will all have contributed to the modest EBIT and 150bp y-o-y margin reduction to 14.9%. We would expect all of these effects to be less pronounced (or more favourable) in H2.

**Commercial & Infrastructure Europe – a return to growth**

A return to GDP growth in Europe now appears to be well established and Polypipe's operations based in France experienced good volume growth (and delivered 8.6% like-for-like revenue growth) as well as favourable FX translation effects. Utility company demand across a number of segments was behind this performance. From a lower base compared to UK operations, EBIT margins improved by 50bp to 3.9%.

## Free cash flow neutral in H1, strong inflow expected in H2

At the end of June, Polypipe's net debt position stood at £178m, an increase of c £14m since the start of the year (but below the c £191m reported a year earlier). This outflow was equivalent to the FY16 final cash dividend payment as free cash flow was effectively neutral in H117 trading.

Higher first half operating profit came through in increased EBITDA and, as in previous years, this was partly offset by seasonal working capital build during Q2. The associated cash outflow was higher than normal owing primarily to price rises and their impact on demand patterns. Specifically, merchant customers made advanced purchases at the end of FY16. This required some inventory rebuild in H117 and the favourable trade creditor position at the beginning of the year also unwound during the period. The latter effect was the primary reason for the c £11m higher working capital investment in the period compared to H116, leaving trading cash flow c £9m lower y-o-y at c £21m.

Increased capex has been flagged previously and net spending in the first half was c £11m, up c £3m y-o-y, in comparison with an £8.1m depreciation charge. Good activity levels are driving a demand for incremental capex across the business and management specifically referenced new, large-diameter equipment at Polypipe Civils. Of the other line items we note the higher cash tax payment, was in line with the headline reported level on rising profit base and cash interest costs continued to trend down, together amounting to an outflow of almost £10m.

**Cash outlook:** in FY16, the H1 working capital investment unwound completely by year end, leaving a neutral position for the year as a whole. At this stage, we have modelled a substantial flow back to leave a small outflow for the year as a whole – essentially reflecting the earlier inventory point – although the actual outturn will of course be influenced by year-end activity levels. This, together with increased capex for the year (at c £25m) explains the expected dip in FY17 free cash flow (ie c £44m versus £51m in FY16). Implicitly, this entails strong FCF generation in H2 and, after rising dividend cash payments and a small element of treasury share purchases, leads to a £20m+ reduction in net debt by the year end to £143m. This represents 1.6x our projected FY17 EBITDA. Our estimates show further reductions in this multiple to 1.2x and 0.8x at the end of FY18 and FY19 respectively, in the absence of any major new capex programmes or acquisition activity.

## Playing into the relatively better industry sectors

**Market comment:** the Construction Products Association August forecasts pointed to an upwardly revised 1.6% industry growth expectation for 2017, to be followed by a downwardly revised 0.7% for 2018 and 1.8% in 2019 (previously 1.2% and 2.3% respectively). Behind these headline figures, infrastructure (major projects, water, road and rail) and private housebuilding are expected to be the positive drivers, partly offset by slower commercial and industrial. In the two years beyond 2017, private housing RMI activity is seen as being flat at best.

**Estimates:** regarding Polypipe, our underlying UK assumptions are essentially unchanged. We have nudged up revenue estimates in all years and in both divisions consistent with the current run rate of polymer prices. With unchanged UK EBIT expectations, this has a slightly dilutive impact on margins compared to our previous estimates. That said, the H1 performance of European operations causes us to now expect a better profit contribution, partly but not wholly, attributable to a stronger euro relative to sterling. Below this, we have modestly trimmed our group finance cost estimates, leaving the net overall changes shown in Exhibit 2.

**Exhibit 2: Polypipe estimate revisions**

| | Normalised EPS (p) | | | Normalised PBT (£m) | | | EBITDA (£m) | | |
|---|---|---|---|---|---|---|---|---|---|
| | Old | New | % chg. | Old | New | % chg. | Old | New | % chg. |
| 2017e | 26.4 | 26.4 | --- | 66.0 | 66.2 | +0.3 | 90.8 | 90.8 | --- |
| 2018e | 28.7 | 29.0 | +1.0 | 70.8 | 71.6 | +1.1 | 96.0 | 96.6 | +0.6 |
| 2019e | 30.7 | 30.9 | +0.7 | 74.9 | 75.5 | +0.8 | 100.2 | 100.8 | +0.6 |

Source: Edison Investment Research

## Exhibit 3: Financial summary

| £m | 2014 | 2015 | 2016 | 2017e | 2018e | 2019e |
|---|---|---|---|---|---|---|
| December | IFRS | IFRS | IFRS | IFRS | IFRS | IFRS |
| **PROFIT & LOSS** | | | | | | |
| Revenue | 327.0 | 352.9 | 436.9 | 465.9 | 481.5 | 495.0 |
| Cost of Sales | (202.4) | (210.0) | (256.8) | (277.0) | (283.6) | (290.1) |
| Gross Profit | 124.6 | 142.9 | 180.1 | 188.9 | 197.9 | 204.9 |
| EBITDA | 60.8 | 69.3 | 86.4 | 90.8 | 96.6 | 100.8 |
| Operating Profit (underlying) | 46.3 | 54.2 | 70.4 | 74.5 | 80.1 | 84.0 |
| SBP | 0.0 | 0.0 | (1.0) | (1.2) | (1.3) | (1.3) |
| Operating Profit (reported) | 46.3 | 54.2 | 69.4 | 73.4 | 78.8 | 82.7 |
| Net Interest | (7.7) | (5.3) | (6.6) | (6.0) | (6.0) | (6.0) |
| Other finance | (1.0) | (0.9) | (1.0) | (1.2) | (1.2) | (1.2) |
| Intangible Amortisation | 0.0 | (3.0) | (6.8) | (5.6) | (5.6) | (5.6) |
| Exceptionals | (20.7) | (3.5) | (0.6) | (1.2) | 0.0 | 0.0 |
| Profit Before Tax (norm) | 37.6 | 48.0 | 61.8 | 66.2 | 71.6 | 75.5 |
| Profit Before Tax (FRS 3) | 16.9 | 41.5 | 54.4 | 59.4 | 66.0 | 69.9 |
| Tax | (5.4) | (9.2) | (11.8) | (13.2) | (13.6) | (13.6) |
| Profit After Tax (norm) | 32.2 | 38.8 | 50.0 | 52.9 | 58.0 | 61.9 |
| Profit After Tax (FRS 3) | 11.5 | 32.3 | 42.6 | 46.1 | 52.4 | 56.3 |
| | | | | | | |
| Average Number of Shares Outstanding (m) | 199.9 | 199.3 | 198.9 | 199.3 | 199.3 | 199.3 |
| EPS - normalised (p) | 16.1 | 19.4 | 25.0 | 26.4 | 29.0 | 30.9 |
| EPS - FRS 3 (p) | 5.8 | 16.2 | 21.4 | 23.1 | 26.3 | 28.3 |
| Dividend per share (p) | 4.5 | 7.8 | 10.1 | 11.7 | 12.9 | 14.2 |
| | | | | | | |
| Gross Margin (%) | 38.1 | 40.5 | 41.2 | 40.6 | 41.1 | 41.4 |
| EBITDA Margin (%) | 18.6 | 19.6 | 19.8 | 19.5 | 20.1 | 20.4 |
| Operating Margin (underlying) (%) | 14.2 | 15.4 | 16.1 | 16.0 | 16.6 | 17.0 |
| | | | | | | |
| **BALANCE SHEET** | | | | | | |
| Fixed Assets | 324.2 | 476.5 | 472.6 | 475.8 | 473.7 | 471.3 |
| Intangible Assets | 235.0 | 378.4 | 371.6 | 366.0 | 360.4 | 354.8 |
| Tangible Assets | 89.2 | 98.1 | 101.0 | 109.8 | 113.3 | 116.5 |
| Investments | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Current Assets | 103.9 | 99.6 | 119.5 | 162.5 | 194.3 | 228.2 |
| Stocks | 39.9 | 47.5 | 52.2 | 56.3 | 57.6 | 59.0 |
| Debtors | 20.2 | 29.3 | 38.9 | 40.6 | 42.4 | 43.7 |
| Cash | 43.1 | 21.6 | 26.5 | 63.7 | 91.9 | 122.7 |
| Current Liabilities | (69.8) | (87.2) | (104.5) | (107.6) | (108.5) | (109.0) |
| Creditors | (69.8) | (87.2) | (104.5) | (107.6) | (108.5) | (109.0) |
| Short term borrowings | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Long Term Liabilities | (120.6) | (227.9) | (200.2) | (216.6) | (217.7) | (218.7) |
| Long term borrowings | (118.0) | (215.9) | (190.8) | (207.0) | (207.0) | (207.0) |
| Other long term liabilities | (2.6) | (12.0) | (9.4) | (9.6) | (10.7) | (11.7) |
| Net Assets | 237.7 | 261.0 | 287.4 | 314.0 | 341.8 | 371.8 |
| | | | | | | |
| **CASH FLOW** | | | | | | |
| Operating Cash Flow | 50.6 | 72.6 | 86.5 | 87.6 | 93.2 | 97.7 |
| Net Interest | (10.4) | (5.7) | (7.3) | (6.0) | (6.0) | (6.0) |
| Tax | (3.7) | (5.2) | (10.1) | (12.5) | (13.2) | (13.6) |
| Capex | (14.9) | (18.9) | (18.7) | (24.8) | (20.0) | (20.0) |
| Acquisitions/disposals | (0.3) | (149.5) | 0.0 | 0.0 | 0.0 | 0.0 |
| Financing | (1.7) | 0.0 | (2.9) | (1.5) | (1.5) | (1.5) |
| Dividends | (3.0) | (10.6) | (17.1) | (21.1) | (24.2) | (25.8) |
| Net Cash Flow | 16.6 | (117.3) | 30.5 | 21.7 | 28.3 | 30.8 |
| Opening net debt/(cash) | 84.7 | 74.9 | 194.3 | 164.3 | 143.3 | 115.1 |
| HP finance leases initiated | (9.6) | (1.7) | 0.0 | 0.0 | 0.0 | 0.0 |
| Other | 2.8 | (0.4) | (0.5) | (0.7) | 0.0 | 0.0 |
| Closing net debt/(cash) | 74.9 | 194.3 | 164.3 | 143.3 | 115.1 | 84.3 |

Source: Company accounts, Edison Investment Research

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