

# Severfield

Strength in diversity

Outlook

**Strong H118 results and positive order book development cause us to raise estimates, especially for the current year with better dividend prospects also. UK economic uncertainty will provide challenges but we believe that Severfield's sector diversity and some pipeline project opportunities should allow the company to continue to grow. Further order book gains and the application of surplus cash balances (via investment or distribution) can be catalysts for further share price recovery.**

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
03/16	239.4	13.7	3.8	1.5	19.3	2.0
03/17	262.2	20.3	5.7	2.3	13.0	3.1
03/18e	273.9	24.0	6.6	2.7	11.2	3.6
03/19e	279.2	24.6	6.7	2.8	11.0	3.8

Note: \*PBT and EPS are normalised, excluding pension net finance costs, intangible amortisation and exceptional items.

## Strong H118 performance

Management had previously flagged a stronger H1 weighting in the current year and H118 results (21 November) showed a good increase in revenue (+16%), around three-quarters of which was volume-driven. Underlying margin performance was very strong with good progress on ongoing and completed projects. The UK order book has increased versus last reported and there appear to be some reasonable pipeline opportunities also. JV and associate companies (JSW Severfield Structures, India and CMF, respectively) both made positive profit contributions in the period. The H1 dividend was increased by 29% y-o-y.

## Estimates raised, sector diversity to the fore

Management pointed to an FY18 outturn "comfortably ahead" of pre-results market expectations. We have increased our PBT estimate by c 8% for this year, with modest uplifts for FY19 and FY20, while at the same time raising our dividend expectations by 6% in all three years. While UK economic uncertainty could affect activity levels, we believe that Severfield's diverse sector exposure will be beneficial. We expect investor and occupier demand for prime office and retail assets to remain firm and for the importance of infrastructure and overseas projects to grow in importance. Linking these UK aspects together, major infrastructure work such as Crossrail and HS2 undoubtedly create demand for adjacent assets.

## Valuation: Identifying the catalysts

Our estimates have remained robust for some time now and the latest upgrade is an affirmation of the company's stated strategy. While reacting well to the H118 performance, Severfield's share price appears to be weighed down by broader economic and Brexit-related uncertainty. At this level, the current year P/E is 11.2x with an EV (projected cash)/EBITDA multiple of 6.4x and a prospective dividend yield of 3.6%. In our view, a general order book increase, securing some large, high-profile contracts and/or a sense that a special dividend distribution is likely to be sooner rather than later could all be catalysts for further share price recovery.

### Construction & materials

11 December 2017

**Price** 74p  
**Market cap** £221m

Net cash (£m) at end September 2017	31.4
Shares in issue	298.9m
Free float	100%
Code	SFR
Primary exchange	LSE
Secondary exchange	N/A

### Share price performance



%	1m	3m	12m
Abs	7.3	18.0	5.0
Rel (local)	9.2	17.4	(2.8)
52-week high/low	88.0p	59.8p	

### Business description

Severfield is a leading UK structural steelwork fabricator operating across a broad range of market sectors. An Indian facility currently undertakes structural steelwork projects for the local market and is fully operational.

### Next events

H118 DPS 0.9p ex dividend	16 December 2017
H118 DPS paid	12 January 2018

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## Investment summary

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### Company description

Severfield is a focused construction company that specialises in the design, fabrication and erection of structural steelwork. It is the largest in the UK and operates in a broad range of market sectors with varied building requirements. A JV in India undertakes similar activities and addresses the growing local market demand for steel-framed buildings.

### Valuation: Ongoing earnings growth and dividend attractions

Our earnings estimates have risen over the last 12 months, but Severfield's share price is towards the middle of its trading range over this period, even after a well-received H118 results announcement. At this level, its current year P/E is 11.2x with an EV (projected cash)/EBITDA multiple of 6.4x and, given earnings growth expectations, both are expected to taper down by FY20. An FY18 prospective yield of 3.6% is covered 2.4x by expected earnings and we expect further growth in the payout as earnings rise. Moreover, given a strong net cash position and outlook for positive cash generation, a special distribution at some point is a realistic expectation in our view.

### Financials: Growth in earnings, dividends and cash

We have raised our PBT estimate for the FY18 by c 8% following H118 results with minor uplifts for FY19 and FY20. (Corresponding earnings movements are dampened by updated tax and number of shares inputs.) We have raised our dividend expectations by c 6% for FY18 and c 1% thereafter. At this stage our estimates show strong progress in the current year (ie PBT, EPS and DPS growth of 18.2%, 15.7% and 15.2%, respectively) and more modest gains thereafter, yielding three-year CAGRs of c 9% for EPS and c 10% for DPS. The company has a stated goal of doubling FY16 PBT (reported as £13.2m) by FY20. H118 comments indicated that management considers that the company is on track to realise this and our model is consistent with this profit trajectory.

Severfield reported a c £31m headline net cash position at the end of September, slightly below the start year level with a healthy free cash inflow applied to a recapitalisation of term debt in the Indian JV and payment of the FY17 final dividend. We expect the cash position to be higher by the end of the current year followed by annual net cash inflow at or above £10m in the following two years.

Over and above a core £20m net cash position, Severfield is actively seeking investment opportunities to support growth, enhance efficiencies and/or add adjacent capabilities. Such activity will target positive impacts on earnings and cash flow in the medium term and beyond we assume. A special dividend distribution of cash is an increasing prospect in our view, the timing and scale of which will partly depend on the level of additional investment activity.

### Sensitivities: UK economy, sector diversity and project control

Severfield's earnings are substantially generated from its UK-based operations, servicing domestic demand for new steel framed buildings. The UK government autumn statement contained annual GDP growth projections between 1.3% and 1.6% for 2018-22 and the fixed and business investment components of this run at or above 2% pa. Within this, different sectors will have different demand drivers and Severfield's sector diversity provides scope to allocate resource accordingly. Severfield's projects are substantially private sector funded and while we acknowledge that London commercial could slow public, or quasi-public, sector infrastructure projects (especially rail, road and airports) could become more prominent. The nature of the projects that Severfield undertakes means that a good control process is required throughout the contracting phases from tendering through to financial completion and is critical to achieving margin targets.

## H118 results overview

An AGM statement in September had implicitly flagged a stronger H1 trading period compared to previous years and, in the event, H118 results showed a strong revenue uplift and margin increase. JV and associate companies both made positive profit contributions in the period. The company retains a strong balance sheet with a net cash position in excess of £30m. Order books in both the UK and India have increased versus last reported and there appear to be some reasonable pipeline opportunities also. Severfield raised its H1 dividend by 29%.

### Exhibit 1: Severfield interim splits

Year end March, £m	H117	H217	FY17	H118	H118 v H117
Group revenue	118.2	144.1	262.2	137.1	+16.0%
Group operating profit – reported	8.2	11.4	19.6	12.7	+54.2%
Operating margin	7.0%	7.9%	7.5%	9.3%	+230bp
Group operating profit – adjusted*	9.2	12.9	22.1	13.5	+45.7%
Operating margin – adjusted*	7.8%	8.9%	8.4%	9.8%	+200bp

Source: Severfield, Edison Investment Research. Note: \*Reported operating profit is adjusted for share-based payments and pension net finance costs. Neither profit line includes any contribution from JV/associates.

### UK operations: Revenue, margin and order book all ahead

A rising order book from June 2016 drove a marked step up in activity levels in the second half of FY17 as some of the larger project work cycled through. H118 saw a continuation of this with headline revenue growth of 16%; three-quarters of this was volume-related and around one-quarter from higher pricing. Severfield does not take materials pricing risk in its contracts and, other things being equal, a pass-through of rising input costs has a dampening effect on reported margins. However, the combined effect of higher-volume throughput/operational efficiencies and a higher incidence of successful contract completions in the period with a favourable timing effect of financial close on some contracts each added c 100bp to the reported margin year-on-year. (In addition, operating profit included a c £0.7m asset disposal profit, equivalent to 0.5% of the reported operating margin.)

At any point in time, Severfield has around 80 live projects at varying stages of the contracting process. Severfield is the largest structural steel fabricator in the UK but its market position is not solely predicated on scale; design and erection complexity are key areas where it adds value to client projects contributing to whole build efficiencies in timing and cost.

During H118, some of the highlighted projects included:

- Major:
  - Tottenham Hotspur stadium (14,000 tonnes of steelwork, ongoing),
  - Wimbledon No. 1 court retractable roof (4,900 tonnes, ongoing), and
  - 22 Bishopsgate, London commercial office tower (16,000 tonnes, ongoing)
- Medium:
  - Ordsall Chord railway bridge (3,800 tonnes, completed),
  - London Bridge Station platform canopies (4,030 tonnes, ongoing), and
  - The Lexicon, Bracknell retail complex (4,200 tonnes completed).
- Smaller:
  - V&A Museum, Dundee (780 tonnes, completed),
  - Coal Drops Yard, Kings Cross retail regeneration (1,300 tonnes, completed), and
  - BBC Broadcasting House, Cardiff (2,100 tonnes, completed)

The recent order book movements (ie a £315m peak November 2016, retracing to £229m in June this year) substantially reflected the intake and execution of the major projects shown above. The

November £245m reading represents an uptick since June 2017 and given that H118 revenue was £137m – accepting that the trading period and order book end dates differ – this indicates a healthy intake of underlying new order activity.

Severfield has not really operated at the smaller end of the structural steelwork project market (ie below 500 tonnes) though it is now taking steps to develop a presence here. Its Sherburn facility has been mostly focused on portal frame design-and-build work, specialising in distribution sector clients. The intention is to consolidate much of this work onto the Dalton site, freeing up Sherburn to supply packages of processed steelwork and ancillary items into smaller contractor customers. The site's previously noted capacity was up to 25,000 tonnes; it is understood that no equipment is being relocated, directly affected members of the c 250 workforce will be offered alternative roles and no exceptional costs are anticipated. This should both support high utilisation rates at Dalton and allow Severfield to broaden its revenue base by accessing a hitherto unaddressed part of the market. It also retains an 'overflow' or 'subcontract' capacity option if the other three fabrication facilities are fully loaded. Elsewhere, Severfield continues to invest in its fabrication facilities, transportation and erection operations and, in support of them, more advanced and increasingly integrated IT capability. This has contributed to the positive UK margin development and will underpin future operational performance.

#### **Other operations: Indian JV and CMF both making positive contributions**

The combined contribution to PBT from Severfield's Indian JV (**JSW Severfield Structures**) and associate company (**Composite Metal Flooring**) was £0.283m and comprised the company's share of profit after tax from each of these entities.

JSSL's structural steelwork activities in India have been profitable in underlying terms (ie at the EBIT level) for some time now but its capital structure and relatively high local interest rates have meant that it has had minimal impact on group P&L. An uptick in revenue and EBIT margin supported a breakeven PAT contribution in H217 with a further improvement to a modest profit position in H118. We believe that this represents record first half revenue (at or slightly above £22m) and an EBIT margin comparable to that earned in the UK. The JV's term loan was repaid in June – through equal equity injections by its two partners – and this will benefit Severfield's share of PAT going forward (though we note that working capital and trade financing facilities will continue). The Indian order book stood at £79m in November – more than double the level a year earlier - split broadly equally between industrial project work which provides a healthy business baseload and higher margin commercial ones. We believe that this represents a record order level for the JV and, citing a number of large potential pipeline jobs, management appears confident that current activity levels can at least be sustained.

Severfield took a 50% stake in CMF – a design, manufacture and installation of structural metal decking and other cold rolled steel products – in November 2015. Since this time, it has made a small positive share of PAT contribution in each six month period reported subsequently. Based on a c £4m investment, the corresponding annual return on investment is in the 8-10% range but we note that Severfield now sources all of its metal decking requirements from CMF and, we would expect, secured more advantageous terms for doing so. No other financial information is provided on CMF but annual revenues are understood to be c £20m. We understand that the company has made investments in equipment to broaden the product offering to include purlins and rails (roof framing members) using similar processes and materials to those already employed. Hence, the potential value of work packages available to Severfield/CMF is expanded.

We do not factor in any further investment into either JSSL or CMF in our model, nor do we anticipate any cash returns to shareholders over our estimate horizon. They are both strategic investments and should continue to play a part in the long-term development of the group.

## Positive free cash flow funding investment and dividends

At the end of September, Severfield held a £31.4m net cash balance sheet position, with a negligible level of financial lease obligations and no bank borrowings. We estimate that customer advances represented c £4-5m of this cash balance, slightly lower than the end FY17 position. Overall, there was a £1.2m net cash outflow in the period, the net result of a healthy free cash inflow substantially funding discretionary investment and dividend payments.

EBITDA of £14.6m (excluding asset disposal profits) was well ahead of the £11.1m achieved the previous year, entirely driven by the stronger EBIT performance reported earlier. This was partly offset by a small working capital outflow (£0.6m) in H1 having previously seen inflows (between £1.7m and £6.2m) in the last three first half trading periods. Debtor and creditor flows in H118 were both higher than usual – reflecting activity levels – and the net outcome appears to be chiefly due to an adverse payables timing effect at the period end. Overall, operating cash flow rose by £1.2m y-o-y to 13.5m.

Below this, cash tax of £2.1m was in line with the H118 headline P&L charge. In the last three years, Severfield has consistently invested in capex ahead of its prevailing depreciation rate, contributing to improved operational efficiency and margins. This trend continued into H118 in a wide range of projects including production equipment, new in-house paint facilities at two sites as well as supporting construction site activity with new items. Ongoing investment is being made in upgrading and integrating IT systems across all sites and between project phases. In aggregate, gross capex totalled £3.3m and even after taking into account asset disposal proceeds, net capex of £2.4m was still ahead of the £1.8m depreciation charge in the period. Taking these items into account, free cash flow (FCF) of c £9m was slightly lower than H117 and was applied to:

- **JV investment: £5.3m** – as previously flagged both partners each injected this sum in new equity to recapitalise the JV's longer-term funding base
- **Dividends: £4.8m** – cash payment of the FY17 final (of 1.60p per share)

This left the period end cash position slightly lower than it was at the end of March.

**Cash outlook:** We have implicitly factored in a lower H218 EBIT contribution versus H1, which we believe is consistent with a lower expected incidence of project financial close positions on broadly similar revenue. Otherwise, we expect customer advance balances to substantially flow out by the year end, contributing to a H2 working capital outflow, and a similar level of capex in H2 to that seen in H1. So, while H2 FCF is set to be below H1, the one-off JV investment will not recur and the H118 cash dividend is smaller than the FY17 final. This leads to a c £3m expected net cash inflow in H2. Beyond this, we believe that Severfield is capable of generating £10m+ net cash pa; in the absence of higher rates of organic or acquisitive investment and/or dividend distribution, this would result in a net cash position in excess of £50m by the end of FY20 on our estimates.

## Activity levels expected to remain healthy

There is a mixed outlook across Severfield's sectors. This is not unusual although investor sentiment can be tested when London commercial prospects are questioned. In addition to the contracted order book, there is a broad spread of visible scale projects – including London commercial – within the pipeline that suggests that activity levels should remain healthy over our forecast horizon, in our view. We have increased our FY18 estimates, reflecting H1 activity levels resulting in both revenue and EBIT uplifts, with a H2 margin performance in line with that delivered in underlying terms in H1 (chiefly adjusted for a lower incidence of commercial completions).

Beyond this, our revenue expectations have risen by c 4% (in line with the steel-related pricing changes reported in H1) with a modest increase in EBIT. Overall, our estimates show a strong earnings increase for FY18 with more moderate progress thereafter (obviously reflecting small upgrades to future periods) and achieving management's stated doubling of FY16 PBT by FY20.

**Exhibit 2: Severfield revised estimates**

	EPS* (p)			PBT* (£m)			EBITDA (£m)		
	Old	New	% chg.	Old	New	% chg.	Old	New	% chg.
2018e	6.26	6.59	5.4%	22.2	24.0	8.1%	27.3	29.3	7.3%
2019e	6.87	6.74	(1.9%)	24.4	24.6	0.8%	29.6	30.0	1.4%
2020e	7.49	7.38	(1.5%)	26.6	26.9	1.1%	31.9	32.4	1.6%

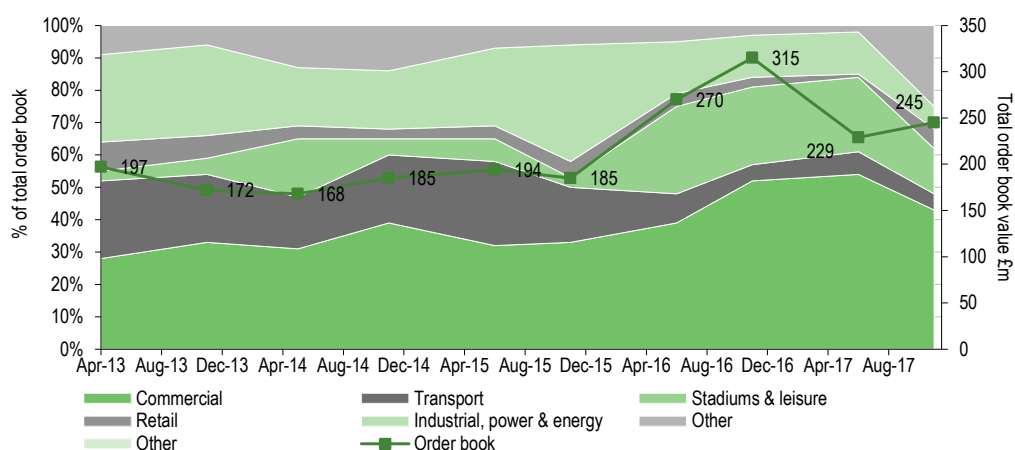
Source: Edison Investment Research. Note: \*We exclude pension net finance costs (c £0.5m pa).

Below the EBIT line, interest costs have been nudged up to reflect ongoing bank facility costs which will exceed likely interest receipts on cash balances. Additionally, we now assume a slightly higher tax charge (c 19% for all years, versus 17% previously). Not shown in Exhibit 2, but we have again increased our dividend expectations following the H118 results by c 6% for FY18 and by c 1% in the following two years.

## Selected sector outlook commentary

Recent downward revisions in UK GDP projections in the autumn budget and the first base rate rise (from admittedly historically low levels) for ten years at face value create an unhelpful economic backdrop for Severfield's core market. Moreover, in October the Construction Products Association pointed to an expectation of flat construction output in 2018 including growth in new housebuilding and infrastructure and the sharpest decline to come in commercial offices (-15% y-o-y) based on a sharp fall in contract awards. This (partly driven by Brexit uncertainty) is perhaps the biggest weight on investor sentiment for Severfield. We contend that the existing order book, some visible pipeline prospects, and the potential for economic infrastructure project spending are such that the company can continue to trade well as its sector diversity enables it to focus resources on the more active areas. We would also say that even in sectors which are expected to be weak, there should still be contract awards and some of this work could be sizeable.

We look first at Severfield's current order book position in its historic context, as shown in Exhibit 3.

**Exhibit 3: Severfield order book tracker**


Source: Company, Edison Investment Research. Based on published order book values and sector splits.

- **Commercial** – rose in the second half of 2016, driven by several large London office schemes (22 Bishopsgate, a Farringdon head office, 60 London Wall). Normally 30-40% of order book.
- **Stadia/leisure** – three large projects (ie new Tottenham Hotspur stadium, Anfield extension, Wimbledon's No1 court roof) boosted orders on hand during 2016.
- **Other** – this segment includes datacentres, health and education; Severfield has secured three ex UK projects (two in the Republic of Ireland, one in Belgium) in the former two sub-sectors.



Note that the UK order book value rose from £185m in November 2015 to a peak of £315m a year later as large project order intake ran ahead of operational throughput. This effect reversed in the first part of 2017 but the latest £245m reading (versus £229m in June) illustrates that sector diversity can still support healthy order book levels even when some of the larger/lumpier sectors experience variable intake. In essence, we feel that this is the key market challenge currently facing Severfield. We have previously focused on order book levels as an important business lead indicator and suggest that positive development in the scale and breadth of this metric from the November 2017 level would provide a strong underpin for investor sentiment. We now look at a number of the leading sectors addressed by Severfield, commenting on prospects as we see them.

**Commercial:** Anecdotal evidence points to a slowing London market, admittedly after a strong year for new space in 2017. Among the quoted property developers, Land Securities (14 November) reported some good City pre-let and sale activity but stated it was happy to not be delivering speculative buildings in the short term; Great Portland Estates (15 November) noted that pricing in the prime central London market remains robust although management expects some weakness in market rents and secondary yields during current business uncertainty; and British Land (16 November) suggested that occupiers are being 'more thoughtful about their future requirements'. Additionally, the Deloitte Winter 2017 Crane Survey<sup>1</sup> commented on a drop in the number of new schemes started. More positively, Deloitte also noted maintained demolition levels and resilient demand for new space (including reasonable pre-let activity) with Nine Elms, Midtown, Stratford and Kings Cross all appearing to be relatively tight markets. There is also a view that low City vacancy rates, limited new space availability (both current and speculative) and existing lease event activity between 2019 and 2023 should provide a firm underpin to this market. To us this suggests that while overall activity may be below recent levels, there will be strong pockets which provide new business opportunities. One example of this is a major new Kings Cross head office building ('KGX1', 92,000m sq, full planning approval, Lendlease appointed main contractor).

Outside the M25, Savills<sup>2</sup> has identified Cambridge, Birmingham, Manchester and Cardiff as having significant development pipelines to the end of 2019, though we do not have visibility regarding which projects fall into Severfield's target area.

**Retail:** Weakness in consumer confidence has been widely reported but there is still momentum to build high quality assets, taking a longer-term view. Two large retail/regeneration schemes in the south east are well advanced in planning terms, although they are still to receive final consent:

- **Brent Cross London** – Retail and leisure destination (90,000m sq new and refurbishment of existing 85,000m sq floorspace with enhanced public space and access). Detailed plans were submitted in May 2017 and a final planning decision from the London Borough of Barnet is expected by the end of 2017. The aim is for construction work to start in 2018 and complete in 2022 (owners: Hammerson/Standard Life Investments, preferred contractor Laing O'Rourke).
- **Croydon Partnership** – retail-led regeneration, replacing two schemes with one integrated development of 200,000m sq of up to three storeys. Planning consent for the retail redevelopment was granted in November (and also for a separate 68-storey double tower). Subject to detailed designs, land assembly and tenant agreements, the earliest construction commencement date would be 2019 (owners: Westfield/Hammerson).

We are also aware of an approved planning application for the redevelopment of the Whiteleys, Bayswater building (£1bn mixed use project with façade retention). Regional shopping centre development has also been active (eg Leeds, Southampton and Bracknell) and British Land has received outline planning approval for a £300m extension at its Meadowhall, Sheffield extension.

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<sup>1</sup> <https://www2.deloitte.com/uk/en/pages/real-estate/articles/crane-survey.html>

<sup>2</sup> [www.savills.co.uk/research\\_articles/173549/220073-0](http://www.savills.co.uk/research_articles/173549/220073-0)

**Infrastructure:** The December 2016 National Infrastructure Plan (NIP) identified c £88bn of largely publicly funded projects in the transportation sector between 2016/17 and 2020/21. This included roads (c £13bn), rail (c £46bn) and airports/ports (c £5bn). Clearly, a significant proportion of these sums are in areas other than structural steelwork but bridges and terminus hubs are very much established Severfield project areas. We would expect **HS2** and the **Heathrow expansion** plan (including a sixth terminal building) to begin within this time period and understand that HS2 tender activity is likely to step up in 2018. Outside of the UK, **Amsterdam Schipol airport** is planning to expand through the construction of a new pier (to be operational by December 2019) and a new terminal building (by 2023). Mace has been appointed as project and construction manager and this project is a pipeline opportunity for Severfield. In the energy sector, the NIP further identified c £117bn spending, to be substantially private sector funded. The **Hinckley Point** new nuclear power station is likely to form the largest single programme within this sector; while the first concrete pour has been approved structural steelwork packages have yet to be tendered. Clearly, some of the identified projects will extend beyond our estimate horizon but we highlight them as examples of larger potential opportunities for Severfield, especially pertinent if the UK economic growth and private sector outlook were to weaken further. We understand that the Infrastructure and Projects Authority is due to publish an updated National Infrastructure and Construction Pipeline in December 2017, with a 10-year projection of public and private investment in infrastructure.

**Stadia:** Work is well advanced on Tottenham Hotspur's new stadium and this significant project for Severfield is ongoing. Chelsea (60,000 capacity) and Everton (50,000+) have announced their intentions to build new grounds (a redevelopment, planning approved and a new site, design pending respectively), though neither are set to commence construction in the near term. On a smaller scale, Bournemouth has also flagged relocation to a new c 25,000 capacity stadium by 2020 though a site has not been finalised. Liverpool and Manchester City have both undertaken stand expansion projects in recent years – Severfield worked on both – and have advanced planning positions for further expansion with firm intentions still to be announced. Of the other 14 English Premier League stadia, five have a capacity below 30,000 and a further four between 30,000 and 40,000 so we see scope for further extension projects, obviously subject to the performance of the clubs concerned, particularly in the lower half of the league table. Severfield's stadium work has not been confined to football and the Wimbledon court No 1 retractable roof is also a significant project currently underway (and follows the centre court roof project in 2009). Other completed leisure sector projects include arenas, museums and exhibition centres and these examples have different demand drivers to the higher profile sports-based business models.

**Overseas:** Severfield has periodically undertaken project work in continental Europe in the form of datacentres (Microsoft, Amsterdam 2015) and arenas (Philharmonie de Paris 2014) and usually via main contractor relationships in the UK. The Republic of Ireland has made a significant contribution to group revenue in the past (ex UK £79m in 2008, immediately following Severfield's acquisition of Fisher Engineering in Northern Ireland). Sterling devaluation immediately following the Brexit referendum result has been sustained which has made Severfield more competitive in euro-based economies. The appointment of a European business development director in Holland earlier in the year reinforces the perception of improved market opportunities in the faster growing economies of northern Europe, though we should allow time for a pipeline to build. One post Brexit caveat to building an order book relates to trade terms; clearly this is a central topic of discussion and sector treatment may not necessarily be even. In the event of a 'no deal' scenario, construction steel imports from non EU members could possibly attract tariffs that influence supply.

Our final observation relates to market position. There are fewer competing contractors on large complex projects and this is unlikely to change. In the event of softer market volumes across the board – which we do not currently anticipate – an absence of larger projects can result in margin pressure on medium and smaller tonnage volume work. Hence, the pricing behaviour of the next tier of steelwork contractors could become more relevant under this scenario.



## Sensitivities

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Severfield's earnings are substantially generated from its UK-based operations, servicing domestic demand for new structural steel framed buildings with a bias towards larger complex projects. In the current order book of £245m, we estimate 10-15% is attributable to ex UK projects (in Belgium and the Republic of Ireland) to which net euro exposure is hedged. While the contribution from JSSL is set to rise, it will still be modest in the context of the group.

**UK growth slowing, diverse sector exposure:** The chancellor's autumn budget statement included downward revisions to GDP projections (mainly due to slower national productivity growth forecasts) and for modest progress of between 1.3% to 1.6% per annum for 2018-2022 inclusive. We note that the fixed and business investment components of GDP are projected to run at or above 2% for this period (with consumption bringing down the overall figure). These figures obviously cover the Brexit period, although the assumed impact is not clear. London commercial is being seen as a litmus test for both inward overseas investors and for financial services firms – traditionally leading occupiers of new space – who may need to move resource around if cross-border transactions are governed under a different regulatory regime. We believe that the demand for infrastructure and stadia are unlikely to be affected. Over time, retail, distribution and industrial building demand will of course be affected by economic growth but each also have other drivers (such as visible planning outcomes, internet fulfilment and automotive investment respectively). Regional office demand and city centre regeneration can also be driven by other agendas as indeed are public and private sector budgets.

**Managing project level risk:** Severfield's practice is to effectively fix substantially all anticipated project costs when entering a contract. Attributed overhead and specific labour costs (both fabrication and on-site erection) are estimated based on expected volume and process hours. External costs – chiefly materials but also sub-contractors – are agreed with suppliers, factored into contract pricing and fixed back-to-back in successful tenders. Some variability can occur in transport costs (ie fuel surcharges) which are otherwise executed by in-house fleet or under sub-contractor arrangements, as above. Clearly project risk can arise from inaccurate tender processes and/or poor onsite execution and these points can be related. Achieved contract margin essentially reflects performance against tender and the extent to which additional costs compared to contingency risk are priced in. (Variations to the original contract need to be similarly agreed and managed.) The nature of the projects that Severfield undertakes – typically large scale, complex and one-off in nature – mean that a good control process is required throughout the contracting phases from tendering through to financial completion.

**Cash management:** Severfield has adopted a financial framework that includes retaining a c £20m underlying cash position, split broadly equally to fund working capital requirements and provide a buffer against unforeseen adverse project outcomes. Currently, the net c £32m on hand includes c £5m client advances – even adjusting for this, the company sits comfortably above its desired core position. At the end of FY17, client retentions stood at just over £5m (being part of reported trade receivables). Only c £0.6m of this was noted as overdue and, based on H118 results, we anticipate that a significant portion of the c £5m has already been paid. Note that Severfield takes out adequate credit insurance on all customer contracts (forming part of operating costs) and, hence, does not carry bad debt provisioning. Over and above the £20m underlying cash balance, management has expressed an intention to pursue ongoing growth/efficiency capex and possibly strategic investment both obviously subject to identifying appropriate opportunities. In the absence of this, management will not allow the net cash position to build indefinitely which opens the door to the possibility of a special dividend distribution at some point. Our model currently shows a projected c £53m net cash position at the end of FY20. While we have not factored in a special dividend payment into our estimates, we consider this to be highly likely under this scenario.

## Valuation

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Severfield's share price is currently sitting around the mid-point of its 12-month trading range (of 59p to 88p) having recovered from a c 60p low in September and reacted favourably to the H118 results announcement. Our earnings estimates have remained robust during this period, with a significant increase for FY18 and more modest uplifts in the other two years. Based on these estimates, the current year P/E is 11.2x with an EV(projected cash)/EBITDA multiple of 6.4x and both are expected to taper down by FY20. At the same time, the prospective FY18 dividend yield is 3.6% and further growth is anticipated in the payout even before a possible special distribution.

### Cash position influences valuation and dividend outlook

On our revised estimates, Severfield's earnings show a strong progression in FY18 followed by more moderate progress in the following two years, equating to a three-year **EPS CAGR (to FY20) of 9%** overall. With an historic FY17 P/E of 13.0x, the **implied PEG of 1.4x** is perhaps factoring in faster growth. We are comfortable with our current FY20 projections which are in line with stated management targets for this year. The **FY20 P/E** on our estimates is **10.0x**.

The company's current net cash position and prospective cash generation in future periods is material in the context of its current £225m market cap. Calculating EV on a projected net cash (or debt) basis yields a current year **EV/EBITDA ratio of 6.4x reducing to 5.1x by FY20**. (Recognising that others use a last reported net cash/debt calculation, the equivalent multiples are 6.5x and 5.9x respectively.)

Lastly, an extended period of good earnings growth has facilitated a rebuilding of dividend returns since FY15 to a current year **prospective yield of 3.6%**, covered 2.4x by earnings. Further growth is anticipated and a special distribution at some point is a realistic expectation (see below).

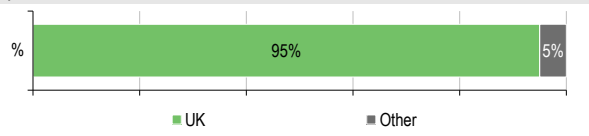
### Mid-cycle earnings revisited; visible support for further gains

Previously, we have pointed to £25-30m as a reasonable expectation for mid cycle earnings and note that our FY20 estimates are at the lower end of this range. This is consistent with management's own stated target. The question is whether this cycle's shape has been affected by Brexit and whether, for example, our illustrative mid-point is actually the high for this particular cycle. We understand this viewpoint but based on recent order intake, the current order book, some high profile pipeline opportunities and the prospect of some larger infrastructure work commencing, we believe that there is a good possibility of further earnings accretion in the years beyond our current estimate horizon. At this stage, it would seem appropriate to anticipate mid to low single digit growth ie at or slightly above GDP growth for revenue with margins at least maintained, until the scale of some of the larger infrastructure work and Severfield's competitive position become more apparent. It is fair to say that the company's cash position also provides financial flexibility for non-organic investment which could bolster or enhance earnings growth prospects, although we have not factored in such spending into our model. Failing this, a special dividend distribution is a realistic possibility which could meaningfully enhance shareholder returns on a one-off basis. For example, our expected FY18 full year dividend of 2.65p – yielding 3.6% - has an £8m cash cost. In context, our projections show a £10m+ pa net cash inflow in FY19 and FY20, so the FY18 cash illustration could be funded comfortably as a special dividend, in our view. We would suggest that the consideration and timing of any such special distribution is more likely to be towards the end of the next financial year.

**Exhibit 4: Financial summary**

	£m	2010	2011	2012	2013	2014	2015	2016	2017	2018e	2019e	2020e
Year end 31 March		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
		12m to Dec	12m to Dec	12m to Dec	15m to Mar	12m to Mar	12m to Mar	12m to Mar	12m to Mar	12m to Mar	12m to Mar	12m to Mar
<b>PROFIT &amp; LOSS</b>												
Revenue		266.7	267.8	256.6	318.3	231.3	201.5	239.4	262.2	273.9	279.2	285.9
Cost of Sales		(242.6)	(246.9)	(268.8)	(330.9)	(217.8)	(186.7)	(219.6)	(236.3)	(244.5)	(249.1)	(253.4)
Gross Profit		24.1	20.9	(12.2)	(12.7)	13.5	14.9	19.8	25.9	29.4	30.1	32.5
EBITDA		21.6	19.5	(13.6)	(13.6)	12.0	13.6	18.9	25.7	29.3	30.2	32.9
Operating Profit - Edison		17.1	15.0	(17.7)	(18.6)	8.4	10.0	15.2	22.1	25.4	25.9	28.1
Net Interest		(0.9)	(1.6)	(1.6)	(2.0)	(0.6)	(0.5)	(0.2)	(0.2)	(0.2)	(0.2)	(0.2)
Associates		(0.4)	(2.5)	0.2	(0.3)	(3.0)	(0.2)	(0.2)	0.5	0.8	0.9	1.0
SBP		(0.0)	(0.3)	(0.0)	(0.1)	(0.2)	(0.5)	(1.1)	(2.0)	(2.0)	(2.0)	(2.0)
Intangible Amortisation		(2.7)	(2.7)	(2.7)	(3.5)	(2.7)	(2.6)	(2.6)	(2.6)	(1.5)	0.0	0.0
Pension Net Finance Costs		(0.5)	(0.5)	(0.5)	(0.6)	(0.5)	(0.5)	(0.5)	(0.5)	(0.5)	(0.5)	(0.5)
Exceptionals		(1.4)	(0.6)	(1.0)	(3.8)	(5.3)	(5.9)	(0.9)	0.8	0.0	0.0	0.0
Profit Before Tax (norm) – Edison		15.8	10.6	(19.1)	(20.9)	4.5	8.8	13.7	20.3	24.0	24.6	26.9
Profit Before Tax (norm)		15.3	10.1	(19.6)	(21.5)	4.0	8.3	13.2	19.8	23.5	24.1	26.4
Profit Before Tax (FRS 3)		11.1	6.8	(23.3)	(28.9)	(4.1)	(0.2)	9.6	18.1	22.0	24.1	26.4
Tax		(3.5)	(0.9)	3.9	5.7	1.4	0.3	(1.0)	(2.7)	(4.3)	(4.4)	(4.8)
Profit After Tax (norm)		11.7	7.7	(16.2)	(17.9)	3.1	7.4	11.4	17.0	19.7	20.2	22.1
Profit After Tax (FRS 3)		7.6	5.8	(19.4)	(23.1)	(2.6)	0.1	8.6	15.3	17.7	19.7	21.6
Average Number of Shares Outstanding (m)		89.0	89.3	89.3	89.3	295.8	297.5	297.5	298.9	299.4	300.0	300.0
EPS - normalised (p) - Edison		6.82	4.51	(9.42)	(10.42)	1.05	2.47	3.84	5.70	6.59	6.74	7.38
EPS - normalised (p)		6.51	4.21	(9.72)	(9.45)	0.88	2.31	3.67	5.53	6.43	6.58	7.21
EPS - FRS 3 (p)		4.47	3.41	(11.33)	(13.49)	(0.89)	0.05	2.89	5.13	5.92	6.58	7.21
Dividend per share (p)		7.5	5.0	1.5	0.8	0.0	0.5	1.5	2.3	2.7	2.8	3.0
Gross Margin (%)		9.0	7.8	-4.8	-4.0	5.8	7.4	8.3	9.9	10.7	10.8	11.4
EBITDA Margin (%)		8.1	7.3	-5.3	-4.3	5.2	6.7	7.9	9.8	10.7	10.8	11.5
Operating Margin - Edison (%)		6.4	5.6	-6.9	-5.8	3.6	4.9	6.4	8.4	9.3	9.3	9.8
<b>BALANCE SHEET</b>												
Fixed Assets		165.0	156.9	155.6	154.9	147.7	145.1	149.3	148.3	155.4	159.5	163.1
Intangible Assets		75.2	72.9	70.4	69.8	64.6	61.8	59.2	56.3	54.7	54.7	54.7
Tangible Assets		82.9	79.6	76.2	76.1	74.1	76.6	77.4	78.9	81.8	84.5	86.6
Investments		6.9	4.4	8.9	8.9	9.0	6.7	12.7	13.1	18.9	20.3	21.8
Current Assets		88.1	100.5	69.8	80.5	72.2	76.3	75.1	107.1	115.3	126.2	139.0
Stocks		12.6	9.1	7.1	8.2	5.8	4.8	5.3	7.8	8.0	8.2	8.3
Debtors		71.9	89.2	61.2	71.6	60.8	64.6	50.7	66.5	72.6	74.6	76.8
Cash		3.6	2.3	1.4	0.7	5.5	6.9	19.0	32.8	34.7	43.5	53.9
Current Liabilities		(99.8)	(103.6)	(97.0)	(112.5)	(57.9)	(59.7)	(58.2)	(78.7)	(84.1)	(85.3)	(86.9)
Creditors		(81.2)	(70.3)	(66.1)	(70.9)	(52.7)	(59.5)	(58.1)	(78.5)	(83.9)	(85.2)	(86.7)
Short term borrowings		(18.6)	(33.3)	(30.9)	(41.7)	(5.2)	(0.2)	(0.2)	(0.2)	(0.2)	(0.2)	(0.2)
Long Term Liabilities		(22.3)	(21.6)	(21.7)	(20.4)	(18.5)	(21.1)	(17.9)	(22.5)	(21.1)	(21.1)	(21.1)
Long term borrowings		0.0	(0.3)	(0.3)	(0.2)	(0.0)	(0.6)	(0.4)	(0.2)	(0.1)	(0.1)	(0.1)
Other long term liabilities		(22.3)	(21.3)	(21.4)	(20.2)	(18.5)	(20.5)	(17.5)	(22.3)	(21.0)	(21.0)	(21.0)
Net Assets		130.9	132.3	106.6	102.4	143.4	140.6	148.2	154.2	165.6	179.2	194.2
<b>CASH FLOW</b>												
Operating Cash Flow		(5.8)	(5.4)	12.9	3.1	2.1	11.4	24.8	27.4	23.7	28.7	31.1
Net Interest		(0.8)	(2.0)	(1.3)	(1.7)	(0.8)	(0.8)	(0.2)	(0.1)	(0.2)	(0.1)	(0.1)
Tax		(5.4)	(3.7)	(2.7)	(2.3)	0.4	(1.0)	(0.9)	(2.4)	(2.9)	(4.3)	(4.4)
Capex		(2.8)	(1.5)	(0.2)	(1.4)	(1.5)	(1.3)	(4.3)	(5.3)	(6.1)	(7.0)	(7.0)
Acquisitions/disposals		(2.9)	(0)	(2)	(3.0)	(3.5)	(1.7)	(4.1)	(0.4)	(5.3)	(0.5)	(0.5)
Financing		0	0	0	0.0	44.8	0	0	0	0	0	0
Dividends		(8.9)	(3.6)	(4.5)	(4.5)	0.0	0.0	(3.0)	(5.1)	(7.5)	(8.0)	(8.6)
Net Cash Flow		(26.6)	(16.3)	1.7	(9.7)	41.5	6.7	12.4	14.0	1.8	8.8	10.5
Opening net debt/(cash)		(11.5)	15.0	31.3	31.3	41.2	(0.3)	(6.1)	(18.4)	(32.4)	(34.4)	(43.2)
HP finance leases initiated		0	0.0	0.1	0.0	(0.2)	(0.3)	(0.2)	(0.2)	(0.1)	0.0	0.0
Other		0	(0)	(0)	(0)	0.2	(0.6)	0.2	0	0	0	0
Closing net debt/(cash)		15.0	31.3	29.7	41.2	(0.3)	(6.1)	(18.4)	(32.4)	(34.4)	(43.2)	(53.6)

Source: Company accounts, Edison Investment Research

<b>Contact details</b>	<b>Revenue by geography (FY17 – wholly owned operations, excludes India JV)</b>
<p>Severs House Dalton Airfield Industrial Estate, Dalton Thirsk, North Yorkshire. YO7 3JN United Kingdom +44 (0)1845 577896 <a href="http://www.severfield.com/">http://www.severfield.com/</a></p>	 <p>■ UK ■ Other</p>
<b>Management team</b>	
<b>CEO: Ian Lawson</b>	<b>FD: Alan Dunsmore</b>
<p>Appointed group CEO in November 2013 from Kier Group where he had been a main board director since 2005 (with responsibility for Services and Property divisions). Prior to this he held other senior management positions within Kier and had been MD at Bickerton Group. Fellow of the Royal Institute of Chartered Surveyors and the Chartered Institute of Building.</p>	<p>Appointed group FD in 2010, joining from Smiths Group where he had been Director of Finance for Smiths Detection since 2004. Chartered Accountant. Currently Acting CEO pending the return of Ian Lawson from illness. Adam Sample (Group Financial Controller) is Acting CFO during this period.</p>
<b>COO: Ian Cochrane</b>	<b>Chairman: John Dodds</b>
<p>Appointed group COO in 2013. Joined Severfield in 2007 following the acquisition of Fisher Engineering where he was MD. Previously held a number of roles here including Project Director.</p>	<p>Joined as NED in 2010 before becoming Chairman in September 2011. Previously with Kier Group including CEO role for seven years up until 2010. Currently NED Chairman at Lagan Construction Holdings and NED at Newbury Racecourse.</p>
<b>Principal shareholders (1 December 2017)</b>	<b>(%)</b>
JO Hambro Capital Management	15.0
M&G Investments	13.9
Threadneedle Investments	8.7
Legal & General Investment Management	6.0
Artemis Investment Management	5.5
Invesco	5.2
Hargreave Hale	4.3
Polar Capital Partners	3.3
<b>Companies named in this report</b>	
British Land, Great Portland Estates, Hammerson, Land Securities	

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