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discoverIE Group

Capital Markets Day

Outlining the growth opportunity

Electronic & electrical equipment

At the recent Capital Markets Day, discoverIE management confirmed the company's strategy to grow the business through a combination of organic growth, and acquisition of design and manufacturing businesses. The integration process is designed to retain the entrepreneurial spirit of acquired businesses while taking advantage of the group balance sheet and central functions, to drive good organic growth post acquisition. Management aims to provide investors with a progressive dividend and a return of 15-20% pa.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
03/16	287.7	15.2	17.8	8.1	23.1	2.0
03/17	338.2	17.8	19.9	8.5	20.1	2.1
03/18e	391.0	21.6	21.6	9.0	19.1	2.2
03/19e	427.6	25.0	24.6	9.5	16.4	2.3

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

Consolidating a fragmented market

After making 11 acquisitions in the design and manufacturing space over seven years, management continues to find multiple acquisition opportunities in the fragmented custom electronics market. Management has strict criteria for targets and a well-defined integration process to maximise growth and operating efficiency, and the acquired business should generate an EBIT return on investment of at least 15% within two years of being acquired. Cross-selling is a key tool to drive organic revenue growth, and divisional heads were keen to emphasise the attractiveness of being part of a larger group with access to a wider customer base. Sales incentives have been structured to encourage this.

Shifting the profile to higher-margin D&M business

Organic growth from existing businesses, combined with the acquisition of D&M businesses, is gradually shifting the proportion of D&M revenues as a percentage of the total: from 3% in FY11 to our 56% estimate for FY18 (and 59% including Santon on a pro forma basis). D&M operating margin, before central costs, was 11.5% in FY17, versus 3.2% for Custom Supply. This mix shift has grown the underlying group operating margin from 2.8% in FY11 to 6.2% in FY18e. With the target of moving the proportion up to 75% of revenues in the medium term and 85% in the longer term, this provides a pathway to push the operating margin above 10% for the group.

Valuation: Still trading at a discount

The stock is trading on an FY19e P/E of 16.4x, at a c 14% discount to the peer group average. Continued growth in the proportion of revenue generated from design and manufacturing should support operating margin expansion, and should help to reduce the valuation discount. The stock is also supported by a dividend yield of more than 2%.

19 March 2018

Price	**412p**
Market cap	**£294m**

Net debt (£m) at end H118	37.6
Shares in issue	71.4m
Free float	96%
Code	DSCV
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	0.3	8.7	71.6
Rel (local)	0.8	12.7	74.1
52-week high/low		412p	217p

Business description

discoverIE (formerly Acal) is a leading international designer and manufacturer of customised electronics to industry, supplying customer-specific electronic products and solutions to 25,000 industrial manufacturers.

Next events

FY18 trading update	19 April 2018
FY18 results	June 2018

Analysts

Katherine Thompson +44 (0)20 3077 5730

Dan Ridsdale +44 (0)20 3077 5729

tech@edisongroup.com

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Design and manufacturing: Lifting the lid

At the recent Capital Markets Day, analysts had the opportunity to meet management from each of the 12 D&M businesses and see a variety of products from across those businesses.

D&M product criteria

D&M group commercial director, Paul Neville, outlined the characteristics of the products that the D&M business seeks to supply:

- Vital niche products in growing markets. Target growth markets include renewable energy, transportation, medical, and industrial connectivity.
- Customised products priced on value rather than on a "cost-plus" basis.
- Customers require local engineers and language.
- Products demand high performance and reliability and are optimised for each application.
- Product is a small proportion of overall equipment cost, but is essential to the end-device.

The businesses fit broadly into two categories:

1. Magnetics & power: Flux, Myrra, Noratel, Plitron and RSG
2. Components: Contour, Foss, Hectronic, MTC, Santon, Stortech and Variohm.

D&M growth path

The D&M division has grown from revenues of £6m in 2011 (all UK-based) to revenues of £176m in FY17, spread across the UK (14%), Europe (58%), North America (9%) and Asia/ROW (19%). This is from a combination of organic growth and 10 acquisitions (with one additional acquisition during FY18). Post-acquisition, on average businesses have shown organic revenue growth of 5% pa and organic EBIT growth of 7% pa.

Product demos highlight the benefits of being part of discoverIE

Meeting the business heads, it was apparent they appreciated being part of the larger discoverIE group, citing benefits such as the strong balance sheet (which gives comfort to customers), access to resources to help with international expansion, and importantly, the benefits of introductions to potential customers by other group companies (and vice versa). The range of products being demonstrated highlighted the large number of applications that discoverIE products go into. Some business heads commented on the ability of their businesses to supply small and medium sized volumes of customised products to customers, which differentiates them from volume manufacturers using cheaper Asian facilities, who are not interested in such small production runs. Others highlighted the reliability of their products, which has allowed them to retain customers for many years. Talking to the different heads, it became apparent that the wide geographical spread of manufacturing facilities serve various purposes:

- the company can take advantage of **lower labour costs** – for example, magnetics produced at the Flux Thai facility;
- **meet domestic demand** - the soon to be opened Bangalore facility services the domestic Indian market; or
- **meet regulatory requirements** relating to the location of manufacturing - for example, US transport organisations buying technology for use in trains require at least 60% of the solution to be manufactured in the US. Noratel US is able to meet this requirement with its facility in California.

Approach to M&A

Jeremy Morcom, group head of Corporate Development, outlined the criteria used for selecting acquisition targets and the process undertaken to integrate businesses once acquired.

Well-defined criteria for acquisition targets

- Active in target growth markets.
- Already performing well – no problem companies that need fixing.
- Products that fit into the D&M product criteria listed above and that the group already understands.
- Strong value proposition, ie products require some element of customisation such that the product is not priced as a commodity.
- OEM customer base.
- Business has long-term growth potential.
- Management is ambitious.

The business should be capable of generating an EBIT return on investment[1] of at least 15% within two years of acquisition. Of the 10 acquisitions made up until the end of FY17, six companies have beaten that target and four have yet to hit it. On average, the return is 16%. The company expects the average to increase in FY18.

Future acquisitions could be bolt-ons that complement existing acquisitions or standalone deals. Target size (by enterprise value) is £10-80m, but a larger deal would be considered. Geographically, the company is keen to increase its presence in North America.

With net debt/EBITDA forecast at 1.7x at the end of FY18 and the company targeting gearing below 2x, it has some headroom to use debt. We expect that any larger deals would be part-equity funded.

Integration approach – retain entrepreneurial spirit

The company's approach to integration begins even before a deal is closed. It will develop a three-year business plan with the target, which is agreed with the target pre-acquisition. Typically, deals are structured with an earnout element to align incentives.

The acquired company typically retains its brand and identity. As discoverIE is keen to retain an entrepreneurial spirit within the group, it acquires companies with ambitious management teams and allows them a certain amount of autonomy. The newly acquired business will have access to the larger resources of the discoverIE group. This includes purchasing efficiencies, manufacturing, finance and back office functions, and international sales and marketing resources. Cross-selling is encouraged – incentives are offered to both parties to a cross-selling transaction to encourage growth in this area. This usually takes a few years to become evident at the revenue level, as the design process for many products is in the region of one to three years.

[1] Calculated as annualized operating profit divided by initial consideration, acquisition costs, earnouts (if paid) and integration costs.

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Exhibit 1: Financial summary

£m	2013	2014	2015	2016	2017	2018e	2019e
Year end 31 March	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS							
Revenue	177.4	211.6	271.1	287.7	338.2	391.0	427.6
Cost of Sales	(123.0)	(148.6)	(186.7)	(195.1)	(227.2)	(264.9)	(289.1)
Gross Profit	54.4	63.0	84.4	92.6	111.0	126.1	138.6
EBITDA	7.4	9.1	16.6	19.8	24.3	29.0	34.4
Operating Profit (before am, SBP and except.)	6.1	7.7	14.0	17.0	20.6	24.8	29.2
Operating Profit (before am. and except.)	5.5	7.1	13.4	16.3	20.0	24.2	28.4
Amortisation of acquired intangibles	(0.7)	(1.0)	(2.1)	(2.8)	(3.9)	(4.9)	(7.4)
Exceptionals	(3.4)	(0.9)	(5.2)	(2.1)	(8.4)	(3.9)	(3.2)
Share-based payments	(0.6)	(0.6)	(0.6)	(0.7)	(0.6)	(0.6)	(0.8)
Operating Profit	1.4	5.2	6.1	11.4	7.7	15.4	17.7
Net Interest	(0.5)	(0.8)	(1.6)	(1.8)	(2.8)	(3.1)	(4.2)
Profit Before Tax (norm)	5.6	6.9	12.4	15.2	17.8	21.6	25.0
Profit Before Tax (FRS 3)	0.7	4.2	4.3	9.4	4.8	12.1	13.3
Tax	1.4	(0.5)	(1.4)	(2.2)	(1.3)	(3.5)	(3.5)
Profit After Tax (norm)	4.6	6.0	10.0	11.8	13.6	16.2	18.7
Profit After Tax (FRS 3)	2.1	3.7	2.9	7.2	3.5	8.6	9.9
Average Number of Shares Outstanding (m)	39.2	43.1	57.6	63.3	65.4	70.7	70.9
EPS - normalised & diluted (p)	11.3	13.1	16.4	17.8	19.9	21.6	24.6
EPS - IFRS basic (p)	(4.8)	3.0	5.0	11.4	5.3	12.1	13.9
EPS - IFRS diluted (p)	(4.7)	2.8	4.8	10.9	5.1	11.4	13.0
Dividend per share (p)	6.2	6.8	7.6	8.1	8.5	9.0	9.5
Gross Margin (%)	30.7	29.8	31.1	32.2	32.8	32.2	32.4
EBITDA Margin (%)	4.2	4.3	6.1	6.9	7.2	7.4	8.0
Operating Margin (before am, SBP and except.) (%)	3.4	3.6	5.2	5.9	6.1	6.3	6.8
BALANCE SHEET							
Fixed Assets	30.9	33.1	88.6	108.4	122.2	147.9	141.5
Intangible Assets	24.2	25.5	69.9	88.2	100.7	126.6	118.8
Tangible Assets	3.1	3.5	13.8	14.7	16.0	15.8	17.3
Deferred tax assets	3.6	4.1	4.9	5.5	5.5	5.5	5.5
Current Assets	81.8	92.7	127.3	128.3	149.6	164.6	170.7
Stocks	19.3	19.4	39.8	42.9	50.1	57.8	63.3
Debtors	44.7	48.3	60.2	65.5	77.3	86.8	94.9
Cash	17.8	18.1	26.7	19.9	22.2	20.0	12.6
Current Liabilities	(50.9)	(58.3)	(62.1)	(61.7)	(78.4)	(95.2)	(101.6)
Creditors	(46.6)	(51.5)	(61.9)	(60.9)	(77.1)	(89.9)	(96.3)
Short term borrowings	(4.3)	(6.8)	(0.2)	(0.8)	(1.3)	(5.3)	(5.3)
Long Term Liabilities	(10.3)	(19.0)	(61.1)	(73.1)	(69.6)	(93.3)	(86.5)
Long term borrowings	(1.7)	(9.5)	(45.5)	(57.2)	(50.9)	(70.9)	(65.9)
Other long term liabilities	(8.6)	(9.5)	(15.6)	(15.9)	(18.7)	(22.4)	(20.6)
Net Assets	51.5	48.5	92.7	101.9	123.8	124.1	124.2
CASH FLOW							
Operating Cash Flow	5.7	6.1	6.6	14.6	20.3	19.2	27.1
Net Interest	(0.6)	(0.8)	(1.6)	(1.8)	(2.8)	(3.1)	(4.2)
Tax	(1.4)	(0.9)	(3.3)	(4.3)	(3.0)	(5.4)	(6.3)
Capex	(1.3)	(1.4)	(2.5)	(2.3)	(3.4)	(3.7)	(6.2)
Acquisitions/disposals	(0.5)	(9.2)	(37.3)	(19.8)	(11.8)	(27.0)	(6.4)
Financing	5.7	0.1	52.7	0.0	13.6	0.0	0.0
Dividends	(2.3)	(2.7)	(3.6)	(4.9)	(5.2)	(6.2)	(6.5)
Net Cash Flow	5.3	(8.8)	11.0	(18.5)	7.7	(26.2)	(2.4)
Opening net cash/(debt)	6.3	11.8	1.8	(19.0)	(38.1)	(30.0)	(56.2)
HP finance leases initiated	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.2	(1.2)	(31.8)	(0.6)	0.4	0.0	0.0
Closing net cash/(debt)	11.8	1.8	(19.0)	(38.1)	(30.0)	(56.2)	(58.6)

Source: discoverIE, Edison Investment Research

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