EDISON

Coats Group

FY17 results

Building Industrial momentum

General industrials

FY17 results clearly demonstrate that Coats Group's industrial operations have good momentum and a transformation plan is to enhance this further over the next couple of years. Group earnings and free cash generation were both up by double-digit percentages in FY17. While partly anticipated in the current rating, we believe that Coats is focusing on faster-growing segments and, having clarified group pension requirements, has the financial capacity to achieve this in a number of ways.

Year end	Revenue (US$m)	PBT* (US$m)	EPS* (c)	DPS** (c)	P/E (x)	Yield (%)
12/16	1,457.3	140.7	5.8	0.8	20.3	0.7
12/17	1,510.3	161.4	6.9	1.4	17.0	1.2
12/18e	1,595.3	168.8	7.1	1.7	16.5	1.4
12/19e	1,644.8	181.5	7.8	2.0	15.1	1.7

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

Good progress, ahead of expectations

Coats' FY17 results exceeded our estimates at both the PBT (by c 4%) and EPS levels (c 7%), with DPS in line. As shown above, all three metrics were well ahead y-o-y. Industrial division revenue growth was well founded, with progress from both subsegments, and we believe that the performance in all three reporting regions was ahead of local GDP benchmarks. Margin improvement here drove a strong divisional profit uplift and, although this was partly offset by a disappointing Crafts outturn, the progress made was substantially retained. A much reduced pension deficit/normalised balance sheet and reset financing facilities reduce the distractions in this area, and underlying cash generation is coming more to the fore.

Tangible actions supporting higher estimates

Coats is the global leader in industrial threads, and management's view of dynamic customer-centric industry change (eg raised service capability and environmental standards) is guiding its growth strategy. The Connecting for Growth transformation programme is designed to reinforce existing business strengths and increase operational agility to align with market opportunities. This two-year plan (costing $30m, yielding $15m annualised net benefits by FY20) should result in higher EBIT margins by focusing resource on faster-growing segments and/or those with better returns. This action, together with underlying upgrades and acquisition effects, causes us to raise our earnings estimates by c 7% for FY18 and c 12% for FY19.

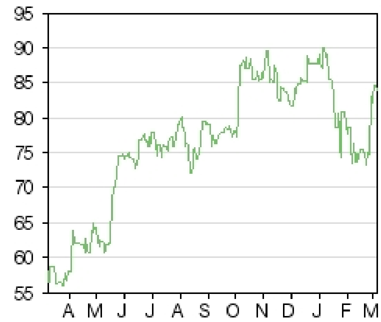
Valuation: Moving on to a growth footing

Having performed very well during 2017 (+64%), Coats' share price softened at the beginning of this year before reversing some of this decline with well-received FY17 results. On our increased estimates, the 17.0x historical P/E reduces to 13.9x by FY20, while EV/EBITDA (adjusted for pensions cash) moves from 10.4x to 7.7x over the comparable period. These multiples reflect an expectation of faster earnings growth, in our view. Management actions are geared towards increasing the rate of progress and the benefits of this are starting to be seen now.

6 March 2018

Price	**84.0p**
Market cap	**£1,187m**
	£/US$ 1.40
Net debt (US$m) at end December 2017	242
Shares in issue (includes Treasury shares)	1,413.3m
Free float	97%
Code	COA
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	11.0	(0.2)	43.6
Rel (local)	13.8	2.4	46.5
52-week high/low		90.0p	56.0p

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 (68%) and Performance Materials (18%); and Crafts (14%), based on FY17 revenue.

Next events

FY17 annual report publication	7 March 2018
AGM	May 2018 (TBC)
FY17 final dividend to be paid	29 May 2018

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Edison profile page

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FY17 results overview

Overall, Coats delivered a very solid group trading performance in FY17, showing consistent underlying revenue and EBIT progression over the year and double-digit growth in reported PBT, EPS and DPS. The group financial and pension positions are much clearer now and this allows increasing focus on the underlying cash flow characteristics of the business.

Exhibit 1: Coats Group divisional and interim splits

US$m	H1	H2	2016	H1	H2	2017	H1	FY	H1	FY	H1	FY
							Actual	Actual	CER	CER	L-f-l	L-f-l
Group revenue	**713**	**745**	**1,457**	**740**	**770**	**1,510**	**4%**	**4%**	**5%**	**4%**	**3%**	**3%**
Industrial Division	609	612	**1,221**	642	655	**1,297**	5%	**6%**	7%	**6%**	5%	**5%**
Apparel & Footwear	494	481	**975**	507	514	**1,021**	3%	**5%**	5%	**5%**	4%	**5%**
Performance Materials	115	131	**246**	135	141	**276**	17%	**12%**	18%	**12%**	9%	**7%**
Craft Division	104	133	**236**	98	115	**213**	-5%	**-10%**	-8%	**-11%**	-8%	**-11%**
Handknitting	49	72	**121**	47	61	**108**	-4%	**-11%**	-4%	**-10%**	-4%	**-10%**
Needlecraft	55	60	**115**	51	54	**105**	-7%	**-9%**	-11%	**-11%**	-11%	**-11%**
Group operating profit	**80**	**78**	**158**	**89**	**85**	**174**	**12%**	**10%**	**14%**	**11%**	**10%**	**9%**
Industrial Division	81	74	**155**	88	85	**173**	8%	**12%**	11%	**13%**	7%	**11%**
Craft Division	3	8	**11**	5	2	**7**	86%	**-35%**	79%	**-34%**	79%	**-34%**
UK pension admin costs	-4	-4	**-8**	-4	-2	**-6**						

Source: Company data

Industrial overview: a good all-round financial performance, with both subsegments growing underlying like-for-like revenue. Growth was strongest in the EMEA region, followed by Asia (the largest industrial sales territory), with below-average progress in the Americas. The divisional EBIT uplift included a 70bp margin improvement (to 13.3%) and there are plans for further gains here.

Industrial – Apparel & Footwear: this is the largest group revenue generator and we note that the acceleration of y-o-y growth in evidence in the early months of the year was sustained with faster progress in H2 (ie like-for-like H1 +4%, H2+6%, FY +5%). We understand that gains in market share have mainly come from smaller suppliers, which fits the narrative that global brand customers are raising supply chain requirements – with increased emphasis on CSR compliance – naturally leading to some supplier consolidation. New product introductions and a near doubling of the relatively small services income stream also contributed to above-market growth. In recent years, Apparel & Footwear (A&F) has been a clear beneficiary of the adoption of e-commerce and digital interfaces with customers; other related functionality is being launched and we believe that the insight gained in this space is a key driver of the company's growth strategy. A good exit rate at the end of FY17 should mean a positive start to FY18, notwithstanding generally challenging markets.

Industrial – Performance Materials: as reported in November, the rate of underlying progress slowed temporarily in Q3. This reflected reduced demand from more traditional consumer uses (around half of sales) as higher-specification product revenues grew by 18% for the year. Nevertheless, the overall H2 like-for-like increase was slightly ahead of that achieved in A&F. The expectation remains for faster relative growth in this subsegment and for this to be supported by innovation, new product development activity and globalisation of the acquired Gotex and Patrick Yarn Mill businesses. Management noted a slightly improved growth rate at the end of FY17.

Crafts: another mixed trading period with a number of unhelpful discrete factors (including a tornado in H1 and a partial customer loss starting in H2) in FY17. New management has been appointed to improve performance in the North American handknitting and needlecraft operations. Coats has flagged the disposal of the c $20m revenue lifestyle/fashion products business (expected completion during H118), while LatAm manufacturing activities will be reported in the Industrial division to drive cost synergy (as lines are co-located) going forward. We believe that the remaining North American business has broadly $130m revenue, with mid to low single-digit EBIT margins.

Strong and growing underlying free cash flow generation

Coats transformed its group financial position in FY17 following significant cash outflows relating to pension schemes in the period (see below). We split out the parent and operating cash movements to highlight Coats' underlying cash generation characteristics.

- **Parent company cash reduced from $343m to c $1m**:

  As reported in H1, a significant outflow of $348m upfront pension settlements into three UK DB schemes occurred during the year – successfully completing pensions regulatory investigations - with a modest offset arising from favourable FX translation in advance of this.

- **Operating company net debt reduced from $265m to $242m**:

  There was a c $23m reduction in operating company net debt which, excluding favourable FX effects, was more like $18-20m, we believe. We now distinguish between normal business and a number of other discrete items to highlight the underlying cash flow performance of the business. (In the following analysis, the category totals may be slightly out due to rounding.)

Operational performance drove a strong EBITDA performance in FY17 at $216m, a y-o-y increase of $17m, substantially reflecting the EBIT improvement shown in Exhibit 1. Including a positive $15m company adjustment[1] and a $6m working capital outflow (reinforcing a stable 10% net working capital:sales ratio), **underlying group operating cash flow totalled $225m**. Cash interest and tax both rose (following reduced cash balances and higher profitability, respectively) and, although the minority dividend outflow was slightly lower y-o-y, the combined outflow from these items of $87m was modestly above the prior year. Coats has a global manufacturing footprint with a skew towards Asia and lower-cost European countries for its industrial factories. **Capital expenditure of $50m** (1.2x depreciation) was broadly spread and included growth (eg capacity expansion, new product equipment), environmental and safety items (eg effluent treatment plants), as well as underlying maintenance spend. We believe that ongoing development of digital and IT-based capability is also a growing feature. Taken together, these cash categories net down to **c $87m adjusted free cash flow** (FCF), +12% y-o-y.

Below the FCF line, Coats deployed **c $23m in investment spending** (largely initial Patrick Yarn Mills consideration) and paid out **c $18m in cash dividends** (being the declared FY16 final and H117 interim). Hence, we consider that FY17 saw **$46m underlying cash generated overall.**

We identify three further line items as non-underlying, being $3m proceeds from equity issuance and outflows of $6m on exceptional items, and $25m recurring pension payments (covering both scheme administration costs and deficit recovery cash). After taking them into account, we arrive at the c $18-20m reduction in operating company net debt highlighted above. One could argue that the (£17.5m/c $24m) pensions cash payment is an ongoing cash call that is not currently available for application elsewhere in the business – and therefore effectively lowers FCF – but it is worth splitting out in this way to demonstrate true underlying cash generation, in our view.

Refinanced: Coats' balance sheet presentation has normalised following the steps taken with the group pension schemes. At the end of FY17 new financing facilities were put in place, including $225m US private placement loan notes with 7-10-year maturities and a new five-year $350m bank facility. (Compared to the previous $680m facility, Coats has elected to reduce its overall debt financing arrangements by just over $100m.) Even allowing for a seasonal working capital increase during H1 from the $242m year-end net debt position (or 1.1x EBITDA, towards the bottom of management's 1-2x target), Coats clearly has scope to continue to make acquisitions of the scale of the last couple of years and potentially larger ones, subject to appropriate opportunities arising.

1 The company's definition of adjusted FCF consistently backs out pension administration costs ($6-7m pa, aggregating them with recovery payments – see above) and other, non-cash items.

Cash outlook: adopting the same approach as above, we see improving underlying FCF generation over the next three years rising above $90m in FY18 and to in excess of $100m by FY20. As well as continuing pension cash payments at a similar level, the Connecting for Growth business transformation programme (see later sections) is expected to give rise to $30m exceptional charges. We have assumed these will be cash costs and our model factors in $20m and $10m outflows for FY18 and FY19, respectively. This still allows for a healthily increasing dividend profile, in our view, and, after all of these effects, operating company net debt reduces significantly (to c $118m in our model) by the end of 2020.

Greater clarity on pensions

At the end of FY17, Coats' IAS19R deficit relating to its three UK DB schemes was $106m (versus c $2.3bn scheme liabilities). This much-reduced position from $576m a year earlier, following agreed one-off settlement and other recovery payments, has provided greater clarity and, we feel, less perceived risk, for investors. The next triennial funding valuation will be as at 31 March 2018 and the review work is expected to be completed during H119.

Connecting for growth – focus on strategic drivers and growth

November's trading update referred to focus areas for the next phase of growth and this has been encapsulated in management's Connecting for Growth initiative. The key objective is to become a more agile organisation, essentially enhancing customer service capability throughout the supply chain, including strong corporate sustainability and responsibility credentials. Developing the group's digital/data platform – both internal and commercial interfaces – and simplifying the organisational structure are the enablers to achieving this and we feel that increasing specialisation and innovation are likely to be the gathering themes. Pulling together the financial implications of this programme from earlier sections, it is to be substantially a two-year implementation period with $30m expected exceptional P&L costs to generate net $15m annualised gains (ie $25m gross adjusted for reinvestment in the areas indicated). More detail is likely to emerge in the coming year, which will more clearly identify the sources of these gains, but we expect them to arise from both central/infrastructure and wider operational portfolio change. For modelling purposes, we have factored in the following net cash effects; FY18 -$15m, FY19 neutral and FY20 +$15m. In our view, the foundations for this were laid when Rajiv Sharma moved into the CEO position at the beginning of 2017 and almost immediately merged the digital and technology development teams, and streamlined the global executive team. So we see this as a proactive management step driven by a dynamic view of the future evolution of its target customers and markets.

Good core momentum supplemented by other actions

Citing good momentum in Apparel & Footwear and innovation-driven Performance Materials subsegments – and some caution on Crafts – Coats modestly raised previous guidance. Including Patrick Yarn Mill (with a full-year contribution from FY18), progressive benefits from the Connecting for Growth programme (modelled in three +$5m increments in our estimate years) and low single-digit $m increases in underlying industrial profitability, our new estimates are shown in Exhibit 2.

Exhibit 2: Coats Group revised estimates

	EPS – fully diluted, normalised (c)			PBT – normalised (US$m)			EBITDA (US$m)		
	Old	New	% change	Old	New	% change	Old	New	% change
2017*	6.5	6.9	+6.8	155.8	161.4	+3.6	212.1	215.7	+1.7
2018e	6.7	7.1	+7.2	157.9	168.8	+6.9	214.9	229.2	+6.6
2019e	7.0	7.8	+12.1	164.5	181.5	+10.3	222.5	242.4	+8.9
2020e	N/A	8.5	N/A	N/A	194.4	N/A	N/A	255.8	N/A

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. 2017*: old = estimate, new = actual. % change figures rounded.

Exhibit 3: Financial summary

US$m	2014	2015	2016	2017	2018e	2019e	2020e
December	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS							
Revenue	1,561.4	1,489.5	1,457.3	1,510.3	1,595.3	1,644.8	1,703.9
Cost of Sales	(993.4)	(930.1)	(892.3)	(932.7)	(985.2)	(1,015.8)	(1,052.3)
Gross Profit	568.0	559.4	565.0	577.6	610.1	629.0	651.6
EBITDA	170.0	183.0	198.6	215.7	229.2	242.4	255.8
Operating Profit (before GW and except.)	123.4	139.4	157.9	173.7	186.8	199.0	211.4
Net Interest	(8.7)	(6.3)	(10.1)	(12.4)	(15.0)	(14.5)	(14.0)
Other finance	13.5	(6.3)	(7.1)	0.1	(3.0)	(3.0)	(3.0)
Intangible Amortisation - acquired	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Pension Net Finance Costs	(11.3)	(17.1)	(13.6)	(9.4)	(6.0)	(6.0)	(6.0)
Exceptionals	(20.0)	(29.9)	(3.3)	(7.0)	(20.0)	(10.0)	0.0
Profit Before Tax (Edison norm)	128.2	126.8	140.7	161.4	168.8	181.5	194.4
Profit Before Tax (Company norm)	116.9	109.7	127.1	152.0	162.8	175.5	188.4
Profit Before Tax (FRS 3)	96.9	79.8	122.5	142.9	139.8	162.5	185.4
Tax	(45.1)	(43.7)	(46.8)	(47.8)	(51.4)	(54.4)	(57.4)
Discontinued	(27.2)	(75.5)	(4.5)	0.0	0.0	0.0	0.0
Profit After Tax (norm)	55.9	7.6	89.4	113.6	117.4	127.1	137.0
Profit After Tax (FRS 3)	24.6	(39.4)	71.2	95.1	88.4	108.1	128.0
Minorities	(9.6)	(11.2)	(11.9)	(14.3)	(14.6)	(14.9)	(15.2)
Profit Attributable to Shareholders	15.0	(-50.6)	59.3	80.8	73.8	93.2	112.8
Average Number of Shares Outstanding (m)	1,407.4	1,400.8	1,386.6	1,399.2	1,399.2	1,399.2	1,399.2
EPS FD - Edison norm (c)	5.2	5.0	5.8	6.9	7.1	7.8	8.5
EPS FD - Company norm (c)	3.1	4.0	4.8	6.3	6.7	7.4	8.1
EPS - FRS 3 (c)	1.1	(3.6)	4.3	5.8	5.3	6.7	8.1
Dividend per share (c)	0.0	0.0	0.8	1.4	1.7	2.0	2.3
Gross Margin (%)	36.4	37.6	38.8	38.2	38.2	38.2	38.2
EBITDA Margin (%)	10.9	12.3	13.6	14.3	14.4	14.7	15.0
Operating Margin (before GW and except.) (%)	7.9	9.4	10.8	11.5	11.7	12.1	12.4
BALANCE SHEET							
Fixed Assets	653.9	627.9	654.8	703.8	715.2	723.8	731.4
Intangible Assets	256.7	261.2	291.8	293.9	292.2	288.7	285.2
Tangible Assets	298.2	273.0	265.9	292.7	305.8	317.9	329.0
Pension Surplus	51.0	52.5	50.8	57.9	57.9	57.9	57.9
Other	48.0	41.2	46.3	59.3	59.3	59.3	59.3
Current Assets	1,308.4	1,122.6	937.8	626.9	649.6	702.9	774.9
Stocks	257.8	204.0	205.8	232.2	231.3	238.4	247.0
Debtors	311.6	268.7	255.5	276.3	273.4	280.0	287.9
Cash	739.0	649.9	476.5	118.4	144.9	184.5	240.0
Current Liabilities	(576.6)	(437.9)	(660.3)	(383.4)	(394.9)	(419.1)	(445.5)
Creditors	(463.1)	(417.7)	(652.6)	(381.7)	(394.9)	(419.1)	(445.5)
Short term borrowings	(113.5)	(20.2)	(7.7)	(1.7)	0.0	0.0	0.0
Long Term Liabilities	(985.1)	(958.6)	(841.3)	(637.0)	(607.0)	(577.0)	(547.1)
Long term borrowings	(304.6)	(389.1)	(390.6)	(358.2)	(358.2)	(358.2)	(358.2)
Other long term liabilities	(680.5)	(569.5)	(450.7)	(278.8)	(248.8)	(218.8)	(188.9)
Net Assets	400.6	354.0	91.0	310.3	362.9	430.6	513.7
CASH FLOW							
Operating Cash Flow	161.2	87.7	75.7	(157.4)	191.2	206.8	228.8
Net Interest	(13.5)	(5.3)	(10.0)	(12.4)	(15.0)	(14.5)	(14.0)
JV/Minorities	(5.2)	(10.1)	(13.4)	(12.3)	(14.6)	(14.9)	(15.2)
Tax	(55.7)	(49.3)	(57.9)	(60.5)	(55.4)	(57.4)	(59.4)
Capex	(40.8)	(31.4)	(35.3)	(49.7)	(55.0)	(55.0)	(55.0)
Acquisitions/disposals	0.4	(5.4)	(40.1)	(23.1)	(1.8)	0.0	0.0
Financing	0.2	(7.6)	(2.7)	3.0	0.0	0.0	0.0
Dividends	0.0	0.0	0.0	(17.6)	(21.2)	(25.4)	(29.7)
Net Cash Flow	46.6	(21.4)	(83.7)	(330.0)	28.2	39.5	55.5
Opening net debt/(cash)	(274.3)	(320.9)	(240.6)	(78.2)	241.5	213.3	173.7
HP finance leases initiated	0.0	0.0	0.0	(41.1)	0.0	0.0	0.0
Other	0.0	(58.9)	(78.7)	51.4	0.0	0.0	0.0
Closing net debt/(cash)	(320.9)	(240.6)	(78.2)	241.5	213.3	173.7	118.2

Source: Company accounts, Edison Investment Research

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