discoverIE Group

FY18 results

Making good progress

Electronic & electrical equipment

discoverIE reported strong FY18 results: organic growth of 6% was boosted by acquisitions and currency to generate reported revenue growth of 14.7% and normalised EPS growth of 15.8%. The company is making good progress in its strategy to grow the Design & Manufacturing (D&M) business through a combination of organic growth and recent acquisitions. We expect further accretive acquisitions to move the company towards its target of generating 75% of revenues from the D&M business, and view progress towards this target as the key driver of share price performance.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
03/17	338.2	17.8	19.9	8.5	22.9	1.9
03/18	387.9	22.6	23.0	9.0	19.8	2.0
03/19e	422.5	25.3	25.0	9.5	18.2	2.1
03/20e	433.8	26.5	25.9	9.8	17.6	2.1

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

FY18: Strong trading and restructuring benefits

Strong order intake through the year resulted in group organic constant currency revenue growth of 6% in FY18, with 11% growth for D&M and flat revenues for Custom Supply (CS). Recent restructuring within CS enabled operating margin growth from 3.2% in FY17 to 4.5% in FY18 despite flat revenues. Normalised group operating margin expanded 0.4pp to 6.5%, and annualising the Santon acquisition would have been 6.9%. The group reported normalised EPS 6.5% ahead of our forecast, with net debt coming in 6.7% lower than our forecast.

Outlook: Solid backlog entering FY19

The order backlog at year-end was 7% higher than a year ago on an organic, constant currency basis, positioning the company well for growth in FY19. Recent PMI data suggests a slowing in growth expectations although this has not yet translated into any slowdown in order intake or design wins for discoverIE. We forecast 5% organic revenue growth for D&M and a conservative 1% for CS in FY19 and have revised our FY19 normalised EPS forecast up by 1.8%, mainly reflecting lower financing costs. We expect the company will make further D&M acquisitions to accelerate revenue growth and margin expansion.

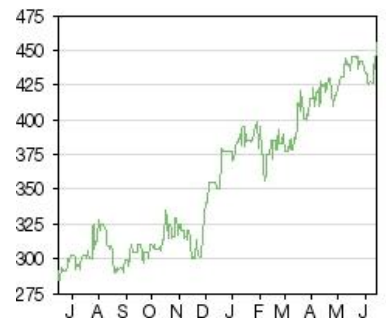
Valuation: Growing D&M business drives upside

The stock is trading on a P/E of 18.2x for FY19e, at a 7% discount to its peer group average. With better growth and higher margins, further progress in increasing the weighting of business towards D&M (including accretive acquisitions) combined with good control over the profitability of the CS business should help to close the gap further. The stock is also supported by a dividend yield of more than 2%.

14 June 2018

Price	**455p**
Market cap	**£334m**
	€1.13:NOK10.8:£1
Net debt (£m) at end FY18	52.4
Shares in issue	73.3m
Free float	96%
Code	DSCV
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	3.4	16.7	52.9
Rel (local)	3.3	8.4	47.7
52-week high/low		445.0p	285.0p

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

Q1 trading update	26 July 2018

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Edison profile page

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Investment summary

Supplier of customised electronics to industry

discoverIE is a leading international supplier of customised electronics to industry. Over the last nine years the company has broadened its product range, customer base and geographical presence via a series of acquisitions. The company offers design and manufacturing and value-added distribution services; the focus on differentiated products and expansion along the supply chain is helping the company to expand operating margins. The company intends to continue to grow organically and via acquisition while maintaining its focus on higher-margin business.

Financials: Revenue growth and margin expansion drive EPS growth

Reported revenue growth of 26.8% for D&M and 1.7% for CS resulted in group reported revenue growth of 14.7% for FY18. The normalised operating margin expanded from 6.1% in FY17 to 6.5% in FY18, and normalised EPS increased 15.8% y-o-y. The company managed its cash flow more efficiently than we had forecast, resulting in net debt of £52.4m at year-end. This equated to a net debt/EBITDA ratio of 1.5x, at the bottom end of the company's target range of 1.5–2.0x. We have revised our FY19 forecasts to reflect FY18 performance, resulting in a 1.8% increase in our normalised EPS forecast and a 16.7% reduction in FY19 forecast net debt (net debt/EBITDA 1.4x).

Exhibit 1: Changes to forecasts

	EPS (p)			PBT (£m)			EBITDA (£m)		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
FY18	21.6	23.0	6.5	21.6	22.6	4.5	29.0	29.3	1.1
FY19e	24.6	25.0	1.8	25.0	25.3	1.4	34.4	34.1	(0.9)
FY20e	N/A	25.9	N/A	N/A	26.5	N/A	N/A	35.2	N/A

Source: discoverIE, Edison Investment Research

Valuation: D&M growth strategy to drive upside

Over FY18, the stock gained 85% and over the last 12 months is up 54% as the company reported consistently strong order intake and made another accretive D&M acquisition. This has resulted in the discount to peers on an EV/EBITDA and P/E basis starting to reduce, now at 13% and 7% respectively for FY19e. Further progress in increasing the weighting of business towards D&M combined with good control over the profitability of the CS business should help to close the gap further. As discoverIE increases the proportion of revenues generated from D&M, we would expect to see meaningful increases in operating margins, which should flow through to the earnings level, and we expect the company to make further accretive D&M acquisitions to accelerate growth. The stock is supported by a dividend yield above 2%.

Sensitivities: Demand, currencies, acquisitions

Our estimates and discoverIE's share price will be sensitive to the following factors. **Customer demand:** demand will be influenced by the economic environment in Europe and increasingly in North America and Asia. **Currency:** with 80% of revenues outside the UK, discoverIE is exposed to the translation of euro and Nordic-denominated subsidiary results into sterling, which positively affected sales and profits in FY18. **Pricing:** discoverIE's revenues and profitability are sensitive to its ability to include in price quotes engineering time spent on designing customer solutions. The company normally passes through supplier price increases. **Acquisitions:** discoverIE may make further acquisitions, which could add integration risk and will require funding.

Company description: Custom electronics supplier

discoverIE is a supplier of customised electronics to industry with operations throughout Europe and increasingly outside Europe. The last nine years have seen the integration of a series of acquisitions and a focus on growing the percentage of higher-margin specialist product, resulting in higher profitability. The company intends to continue to grow organically and via acquisitions while maintaining the focus on higher-margin business.

Company history

discoverIE was founded in 1986 and was admitted to the official list of the LSE in 1994 as a pure distributor of electronic components. After a change in management in 2009, through its strategy of specialisation the company has transitioned to become a provider of customised electronic solutions with operations in Europe, Asia, North America and South Africa. Acquisitions include BFi Optilas in 2009, CompoTRON, Hectronic and MTC Micro Tech Components (MTC) in 2011, Myrra Group, Young Electronics Group and RSG in 2013, Noratel in 2014, Foss and Flux in 2015, Contour and Plitron in 2016, Variohm in 2017 and Santon in 2018. The company operates through two divisions: D&M (57% of FY18 revenues) and CS (43% of FY18 revenues), with 4,000 employees across 23 countries.

Group strategy

Management's aim is to transform the company into a technology-led provider of customised electronics for industrial applications with design, manufacturing and distribution capabilities. To achieve this, the company has set the following strategic objectives:

- **Grow sales organically and well ahead of GDP** by focusing on structural growth markets that have an essential need for discoverIE products.
- **Move up the electronics value chain** into higher-margin products. This includes growing revenues from the design and manufacture of own products, where operating margins tend to exceed 10%; optimising the performance of CS to achieve margins of 5%; and cross-selling D&M products.
- **Acquire high-quality businesses** with attractive growth prospects.
- **Develop sales internationally by further expansion into North America and Asia,** both by supporting existing customers' international needs and by developing local market sales.

To track progress with these objectives, the company has set key strategic indicators (KSIs) and key financial performance indicators (KPIs), which we discuss in more detail later in this report. The company has also highlighted its priorities for the year ahead to generate earnings growth:

- drive organic revenue growth, including continued growth in cross-selling;
- develop new and expanded production facilities;
- integrate the Santon acquisition, including driving organic growth, completing the automation project and establishing cross-selling; and
- make further value-enhancing acquisitions.

Technical expertise adds value to specialist product range

discoverIE specialises in supplying technically demanding, bespoke electronics for industrial applications and has c 25,000 customers over a wide range of end-markets. The company estimates that the global niche electronic components market is worth £20bn annually. discoverIE mainly competes against small, privately owned, country-specific suppliers in one or multiple technology areas and expects to continue its active role in consolidating this fragmented market.

Mainly through acquisitions, the company has built up its **D&M** capability in four of the company's five technology areas (see Exhibit 2). From this division, discoverIE supplies custom electronic products either designed uniquely or modified from an existing product. More than 80% of products are manufactured in house (with principal facilities in China, India, Poland, Sri Lanka and Thailand) with the remainder manufactured by third-party contractors. Increasingly, these products are also distributed through Acal BFi.

The main business in **CS** is Acal BFi, a specialist electronics supplier that differentiates itself from high-volume distributors such as Arrow or Avnet by supplying niche components from leading manufacturers (often on an exclusive basis) in a wide range of electronic component areas. The products that the company supplies are often technically complex and therefore require more technical sales support, which discoverIE is able to provide (this is not always available from the product manufacturer or smaller local distributors). discoverIE solutions range from the recommendation and supply of a part, modification of an existing product or full design and development of a custom solution. A significant proportion of sales come from products that are either uniquely created for one customer and/or exclusively sourced.

Acal BFi supplies products from a selected group of manufacturers (including the D&M division), across five technology areas to more than 20,000 industrial customers (see Exhibit 2). It operates across Europe, with centralised warehousing, purchasing, finance, customer contact management and IT systems.

Exhibit 2: Product range by technology

Product area	Key products	Design and manufacture businesses
Communication & sensors	RF components, fibre optic components, frequency control, wireless modules and systems, sensors and transducers, sensor assemblies, rotary signal transmitters.	Foss, Variohm
Electromechanical	Cabling and assemblies, human interface components, military connectors, gaskets, EMC connector seals, springs, shields.	Contour, MTC, Stortech
Microsystems & displays	Single board computers, server modules, system assemblies.	Hectronic
Imaging & photonics	Infrared thermal imaging, radar, visible cameras, modules and software, lasers and diodes, optical-mechanics, optics, test and measurement.	
Power & magnetics	Standard and customisable power designs, magnetic components, electromagnetic and thermal interface.	Flux, Myrra, Noratel, Plitron, RSG, Santon

Source: discoverIE

Additionally, the division has a separate medical business, Vertec, which supplies exclusively sourced medical imaging and radiotherapy products into medical and healthcare markets in the UK and South Africa.

Industrial focus leads to longer product cycles

discoverIE's solutions are used in both the design and production phases of a customer's product. The company works with R&D engineers to help them develop new products; once these move into production, discoverIE supplies on a volume basis for the life of the product. We highlight that discoverIE is focused on industrial OEMs and does not service the consumer electronics market (which tends to be highly commoditised with short lifetime products). Across both businesses, a customer will typically take six to 24 months to move a product from design to production, at which point the company should earn revenues for the life of the product, typically five to seven years.

Strategic progress update

Exhibit 3 summarises the steady progress discoverIE is making against its KSIs. We discuss below how the company is meeting its strategic objectives.

Exhibit 3: KSIs						
	FY14	FY15	FY16	FY17	FY18	Mid-term target*
Increase D&M revenue	18%	37%	48%	52%	59%	75%
Increase underlying operating margin	3.4%	4.9%	5.7%	5.9%	6.3%	8.5%
Build sales beyond Europe	5%	12%	17%	19%	23%	30%

Source: discoverIE. Note: *Three to five years from November 2016.

Moving up the electronics value chain

discoverIE started life as a pure distributor of electronic components, but through a strategy of specialisation and acquisition has transitioned to become a provider of customised electronic solutions. Over the last seven years, the company has acquired 11 businesses with design and manufacturing capabilities – these are significantly more profitable than the CS business. Consequently, while the **D&M** division generated more than half of FY18 revenues, it generated 76% of FY18 profits. In the **CS** division, discoverIE is focused on selling highly differentiated customised products. With D&M operating margins of 10.9% in FY18 compared to 4.5% for CS, as the company makes more D&M acquisitions, group operating margins should continue to expand.

Grow sales organically and well ahead of GDP

The company is taking a two-pronged approach to growing its revenues ahead of GDP on an organic basis by:

- targeting markets that are growing faster than GDP; and
- promoting cross-selling within Acal BFi and across the rest of the group.

Targeting high-growth markets

The World Bank is forecasting global GDP growth of 3.1% in 2018, 3.0% in 2019 and 2.9% in 2020 (2.2%, 1.9% and 1.7% respectively for advanced economies). To generate growth ahead of GDP, the company is targeting end-markets that look set to benefit from population growth and long-term technology trends. In FY18, the business generated 56% of its revenues from these four areas, up from 53% in FY17:

- **Transportation:** this includes road, rail and air travel. For example, the growth in electric vehicles is increasing demand for electronics – as a supplier to Tesla for its charging points, discoverIE is already benefiting from this trend. As automotive manufacturers work towards creating autonomous vehicles, the technology content of cars will increase even further.
- **Medical:** with an ageing population and growing levels of comorbidity, healthcare spending continues to rise, with increasing amounts of technology used in diagnosing, monitoring and controlling medical conditions.
- **Renewable energy:** the International Energy Authority forecasts that renewable energy will be the largest source of global power generation by 2030, mainly provided by solar, hydroelectric and wind technologies. Wind power is expected to account for 50% of the incremental power generated over this period. Through its Scandinavian acquisitions, discoverIE already has several wind turbine customers, and the recent Santon acquisition brings solar industry customers.
- **Industrial connectivity:** growth in device-to-device wireless connectivity (the internet of things) is driving demand for electronics for industrial applications such as smart meters, remote asset management and predictive maintenance.

Cross-selling strategy

Each of discoverIE's five technology groups has a team of specialist sales and support engineers and their role is to identify customer opportunities. The company has initiatives in place to increase the level of cross-selling to existing customers, with a particular focus on selling D&M products between group companies. When a new company joins the discoverIE group, it can take around three years for cross-selling to become established. Cross-selling generated sales worth £8.8m in FY18 (FY17: £4.6m), fast approaching the company's target of £10m by FY20.

Acquisitions core to growth strategy

discoverIE started the transformation of the business in 2009 with the acquisition of BFi Optilas, the next largest European specialist distributor after discoverIE. This increased discoverIE's presence in Germany, the UK, France and the Nordic region. discoverIE then proceeded to make a series of acquisitions (see Exhibit 4), the largest of which was Noratel for £73.5m in 2014, most with design and manufacturing capabilities.

Exhibit 4: Acquisition timeline

Company	Date	Product areas	Operations	Sales	Cost (£m)
BFi Optilas	Dec 09	Speciality components, communication, photonic, imaging	Germany, France, UK, Spain, Italy, Sweden, Netherlands	Europe	13.4
CompoTRON	Jan 11	Electronic communications and fibre-optic components	Germany, UK, Denmark	Europe	7.1
Hectronic	Jun 11	Embedded computing	Sweden	Nordic region	1.2
MTC	Oct 11	Electro-magnetic shielding (own brand/manufacture)	Germany, South Korea	Europe and Asia	2.7
Myrra SAS	Apr 13	Transformers, coils, cores and inductors (own brand/manufacture)	France, Poland, China	Europe, Asia, North America, Africa	9.9
Young Electronics Group	Sep 13	Solid state lighting, electronic components, power supplies, power cords, custom cable assembly	UK, Ireland	UK, Ireland	1.7
RSG	Nov 13	Custom power solutions	Germany	Germany	2.7
Noratel	Jul 14	Low-, medium- and high-power transformers and inductors (own brand/manufacture)	Nordic region, China, US, India, Poland, Sri Lanka	Europe, Asia, North America	73.5
Foss	Jan 15	Customised fibre-optic solutions	Norway, Slovakia	Norway, Eastern Europe	12
Flux	Nov 15	Customised magnetic components	Denmark, Thailand	Denmark	4
Contour	Jan 16	Custom cable assemblies and connectors	UK	UK	17.5
Plitron	Feb 16	Custom toroidal transformers	Canada	North America	1.8
Variohm	Jan 17	Electronic sensors, switches and motion measurement systems	UK	UK, France, Germany, US	13.3
Santon	Feb 18	DC and AC switches and switchgear	Netherlands, UK, Germany	Europe, Asia	25.8
Total					**186.6**

Source: discoverIE

discoverIE's focus for future acquisitions is to target companies with complementary product and/or geographical capability supplying common markets and customers. The preference is to buy businesses that are successful and profitable, with good growth prospects and similar long-term growth drivers to discoverIE's focus markets.

Integration strategy – retain entrepreneurial approach

Many of the acquired businesses have been led by entrepreneurial managers, and discoverIE is keen to retain this culture. To support this, acquired businesses typically continue to operate under their own brands and management, working towards agreed business plans. The benefits of being part of the larger discoverIE group include:

- access to the wider discoverIE customer base and cross-selling initiatives;
- support for management development and succession planning;
- capital investment in manufacturing capacity and infrastructure;
- discoverIE's strong balance sheet;
- support for product development;
- efficiency improvements through access to the group's purchasing scale, processes, warehousing and freight; and
- centralised finance and administrative support.

D&M acquisition track record

The company has analysed the 11 D&M acquisitions it has made over the last seven years. Excluding the recent Santon acquisition (February 2018), six are generating a return on investment (ROI[1]) above discoverIE's target of 15% and nine at above the company's WACC of 9%. On average, the whole group is generating an ROI above the target. Of the four companies not yet generating the target ROI, two are very close to achieving it, and changes have been made in the other two businesses that should result in improved returns in FY19.

Exhibit 5: discoverIE D&M acquisition track record

Measure	Result
Weighted average organic revenue growth	5% pa
Weighted average organic operating profit growth	7% pa
FY18 ROI	17%
Target ROI within two years of acquisition	15%
WACC	9%
Number generating above target ROI / WACC	6 / 9
Number generating below target ROI / WACC	4 / 1

Source: discoverIE

Further acquisitions likely

Acquisitions remain a key part of the group strategy, with management considering two types: 'platform' to create a new position in a technology and/or geography; and 'bolt-on' to expand the position of an existing business. The company's M&A director, Jeremy Marcom, is focused on sourcing new acquisition targets in discoverIE's key technological and geographical markets, ie companies with design and manufacturing capabilities in any of the group's five technology areas, located in Europe, North America or Asia.

The target for 75% of revenues to be generated from the D&M business in our view assumes a combination of good organic growth and a material level of M&A in that division, with no further acquisitions in the CS division.

At the end of FY18, the company had a net debt position of £52.4m. Its gearing of 1.5x EBITDA was well within the target range of 1.5–2.0x. The company has a £120m syndicated bank facility (with a term lasting until July 2021) as well as a £30m accordion facility. discoverIE can use the syndicated facility for acquisitions and working capital. We estimate that the company has debt headroom of c £19m, based on a maximum 2x our FY19 EBITDA forecast and the end-FY18 net debt position.

Develop sales internationally

In FY18, when annualising Santon's sales, 23% of revenues were generated outside of Europe (up from 19% in FY17). discoverIE's strategy is to support existing customers' businesses outside Western Europe and to make further acquisitions that expand the group's geographical coverage, such as the 2016 acquisition of Canadian-headquartered Plitron and this year's acquisition of Santon (mainly Asian customers).

1 ROI: measured as current year operating profit divided by acquisition costs (upfront cost plus confirmed earn-outs, expenses and integration costs).

Financials

Review of FY18 results

Exhibit 6: FY18 results highlights

£m	FY18e	FY18a	Difference	y-o-y
Revenues	391.0	387.9	(0.8%)	14.7%
Custom supply	*170.8*	*165.3*	*(3.2%)*	*1.7%*
Design & manufacturing	*220.1*	*222.6*	*1.1%*	*26.8%*
Gross margin	*32.2%*	*32.7%*	*0.4%*	*(0.2%)*
EBITDA	29.0	29.3	1.1%	20.6%
EBITDA margin	*7.4%*	*7.6%*	*0.1%*	*0.4%*
Underlying operating profit*	24.2	24.5	1.4%	22.5%
Underlying operating profit margin	*6.2%*	*6.3%*	*0.1%*	*0.4%*
Normalised operating profit**	24.8	25.2	1.8%	22.3%
Normalised operating margin	*6.3%*	*6.5%*	*0.2%*	*0.4%*
Normalised PBT**	21.6	22.6	4.5%	27.0%
Normalised net income**	16.2	17.1	5.8%	26.4%
Normalised EPS** (p)	21.6	23.0	6.5%	15.8%
Reported EPS (p)	12.1	16.7	37.4%	211.6%
Net (debt)/cash	(56.2)	(52.4)	(6.7%)	74.7%

Source: discoverIE, Edison Investment Research. Note: *Underlying operating profit excludes exceptional items and amortisation of acquired intangibles. ** Normalised profit measures also exclude share-based payments.

Exhibit 7: Divisional performance

£m	FY18	FY17	FY17 CER	Reported y-o-y	CER y-o-y	Like-for-like
Revenues						
Design & manufacturing	222.6	175.6	180.2	27%	24%	11%
Custom distribution	165.3	162.6	168.7	2%	(2%)	0%
Total revenues	**387.9**	**338.2**	**348.9**	**15%**	**11%**	**6%**
Normalised operating profit*						
Design & manufacturing	24.2	20.2	20.7	20%	17%	
Custom distribution	7.5	5.2	5.5	44%	36%	
Unallocated	(6.5)	(4.8)	(4.8)	35%	35%	
Total operating profit	**25.2**	**20.6**	**21.4**	**22%**	**18%**	
Normalised operating margin						
Design & manufacturing	10.9%	11.5%	11.5%	(0.6%)	(0.6%)	
Custom distribution	4.5%	3.2%	3.3%	1.3%	1.2%	
Total operating margin	**6.5%**	**6.1%**	**6.1%**	**0.4%**	**0.4%**	

Source: discoverIE. Note: *Underlying operating profit excludes exceptional items and amortisation of acquired intangibles.

discoverIE reported revenues slightly below our forecast, mainly due to lower than expected CS revenues (H1 +9.5%, H2 –5.0%). D&M revenues were 1.1% ahead of our forecast. The company had seen pressure on its UK import costs from the weaker pound, but through a combination of efficiency measures and price increases to customers, managed to increase the gross margin from 32.2% in H118 to 33.1% in H218.

Restructuring of CS in FY17/18, including closing the Spanish business, has resulted in improved gross and operating margins despite lower revenues. The division is now much closer to the target of 5%, and in fact achieved an operating margin of 5.0% in H218. Exhibit 7 shows the underlying growth rates of both divisions once the effects of acquisitions, disposals, and currency are excluded. D&M generated like-for-like growth of 11% in FY18, whereas CS revenues were flat on this basis.

Net finance costs came in £0.5m lower than our forecast, partly due to a lower level of debt than we expected. The effective tax rate of 24% was below our 25% forecast. Overall, this resulted in normalised EPS 6.5% ahead of our forecast.

discoverIE closed the year with net debt of £52.4m, better than our £56.2m forecast. Cash flows benefited from lower than forecast working capital consumption, interest, tax and acquisition-related pay-outs, partially offset by slightly higher capex and £1.5m paid in tax for options that were net settled on exercise.

Progress versus KPIs

The company made good progress against its KPIs in FY18. Sales growth, underlying EPS growth, dividend growth and ROCE all hit targets, and cross-selling is well on the way to meeting the FY20 target. Operating cash flow was lower than in previous years, just hitting the 85% cash conversion target, mainly due to an increase in working capital to support growth. We note that the D&M business requires more working capital than CS, so as the D&M side of the business grows faster, both organically and via acquisition, this puts pressure on the cash flow. Conversely, last year's working capital saw a cash inflow as the company locked in some working capital improvements in the acquired D&M businesses, coupled with lower organic growth.

Exhibit 8: KPIs

	FY14	FY15	FY16	FY17	FY18	Three-year target (FY20)
Sales growth: CER	17%	36%	14%	6%	11%	
Sales growth: organic	2%	3%	3%	(1%)	6%	Well ahead of GDP
Increase cross-selling	£0.3m	£0.9m	£3.0m	£4.6m	£8.8m	£10m pa
Underlying EPS growth	20%	31%	10%	13%	16%	>10%
Dividend growth	10%	11%	6%	6%	6%	Progressive
ROCE	15.2%	12.0%	11.6%	13.0%	15.5%*	>15%
Operating cash flow generation	100%	104%	100%	136%	85%	>85% of underlying profit

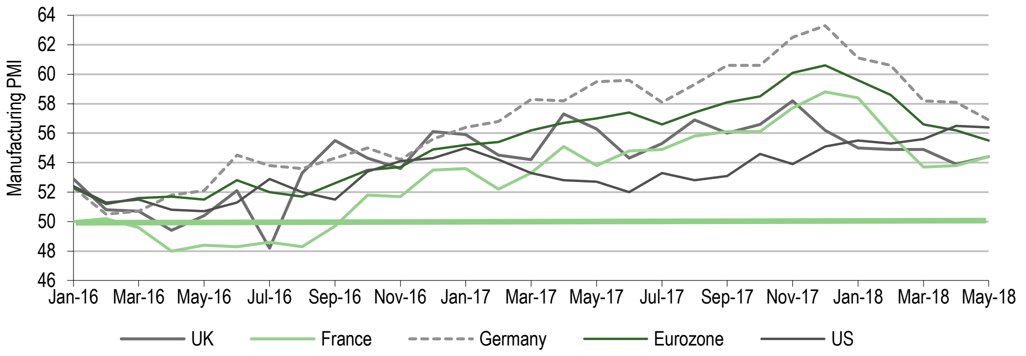
Source: discoverIE. Note: *Excludes Santon.

Outlook and changes to forecasts

The company ended FY18 with an order book of £122m, 12% higher than a year ago on a constant currency basis, and 6% higher on an organic basis. New project wins with an estimated lifetime value of £190m were signed in the year, compared to £127m in FY17, and 75% of these were in target markets. Book-to-bill for the year was 1.03x (H1: 1.02x, H2: 1.04x). On a divisional basis, D&M saw 10% organic order growth. The CS order growth rate was not disclosed, but the division reported a positive book-to-bill for the year.

Design activity tends to be technology driven, whereas production activity is more geared to general economic conditions. The manufacturing PMI indices are useful indicators of the health of the industrial sector. Exhibit 8 shows the movement in the manufacturing PMI for the eurozone, France, Germany, the UK and the US since the start of 2016. All countries have come off their highs (mostly reached towards the end of 2017), although are still well above 50. The UK ticked up in May, but this masks the lower level of new orders. Despite this slowing in growth expectations, the company has not yet seen any slowdown in order activity. However, management noted that the company would ultimately be likely to track the market if growth slows on a sustained basis. We believe our revenue forecasts are conservative, assuming CS growth of 1% in FY19/20 and D&M underlying growth of 5.0% in FY19 and 3.8% in FY20.

Exhibit 9: Manufacturing PMI, January 2016 to May 2018



Source: Markit PMI

We have revised our forecasts to reflect results and added FY20 forecasts. We lift our FY19 normalised EPS forecast by 1.8% mainly due to lower interest costs.

Exhibit 10: Revised forecasts

£m	FY19e old	FY19e new	Change	y-o-y	FY20e new	y-o-y
Revenues	427.6	422.5	(1.2%)	8.9%	433.8	2.7%
Custom supply	*174.6*	*167.0*	*(4.4%)*	*1.0%*	*168.6*	*1.0%*
Design & manufacturing	*253.0*	*255.5*	*1.0%*	*14.8%*	*265.1*	*3.8%*
Gross margin	*32.4%*	*33.0%*	*0.6%*	*0.3%*	*33.0%*	*0.0%*
EBITDA	34.4	34.1	(0.9%)	16.3%	35.2	3.3%
EBITDA margin	*8.0%*	*8.1%*	*0.0%*	*0.5%*	*8.1%*	*0.1%*
Underlying operating profit	28.4	28.4	0.2%	16.0%	29.5	3.6%
Underlying operating profit margin	*6.6%*	*6.7%*	*0.1%*	*0.4%*	*6.8%*	*0.1%*
Normalised operating profit	29.2	29.2	0.2%	16.0%	30.4	3.9%
Normalised operating margin	*6.8%*	*6.9%*	*0.1%*	*0.4%*	*7.0%*	*0.1%*
Normalised PBT	25.0	25.3	1.4%	12.1%	26.5	4.5%
Normalised net income	18.7	19.0	1.6%	10.9%	19.9	4.5%
Normalised EPS (p)	24.6	25.0	1.8%	8.7%	25.9	3.4%
Reported EPS (p)	13.9	15.5	11.4%	(6.8%)	16.5	6.3%
Net (debt)/cash	(58.6)	(48.8)	(16.7%)	(6.9%)	(48.5)	(0.5%)
Net debt/EBITDA	1.7	1.4			1.4	

Source: Edison Investment Research

Valuation

Exhibit 11 shows valuation metrics for discoverIE's peer group and Exhibit 12 shows their financial performance. The stock has performed well recently, up 85% over FY18 and up 54% over the last 12 months, and this has resulted in a small reduction in the discount to the peer group average on EV/EBITDA and P/E multiples. Further progress in increasing the weighting of business towards D&M combined with good control over the profitability of the CS business should help to further close the gap.

D&M made up 57% of FY18 revenues; absent any acquisitions we forecast this will increase to 61% by FY20 and the company is targeting this to reach 75% over the next three to five years. We expect the company to make further accretive acquisitions in the D&M space, which should boost the revenue growth rate and accelerate the growth in operating margins.

Exhibit 11: Peer group valuation multiples

	EV/Sales (x)			EV/EBITDA (x)			P/E (x)			Dividend yield		
	Last yr	This yr	Next yr	Last yr	This yr	Next yr	Last yr	This yr	Next yr	Last yr	This yr	Next yr
discoverIE	**0.9**	**0.9**	**0.8**	**12.4**	**10.7**	**10.3**	**19.8**	**18.2**	**17.6**	**2.0%**	**2.1%**	**2.1%**
Design & manufacturing												
Gooch & Housego	2.8	2.7	2.6	15.0	14.3	13.3	25.3	23.9	22.8	0.8%	0.9%	0.9%
TT Electronics	1.0	0.9	0.8	8.9	7.8	7.1	21.0	17.5	15.1	2.4%	2.4%	2.6%
XP Power	4.0	3.4	3.2	16.0	13.7	12.5	23.2	19.2	17.6	2.3%	2.4%	2.5%
Specialist & high service distributors												
Diploma	2.9	2.8	2.7	16.0	15.3	14.5	22.9	21.7	20.6	2.1%	2.2%	2.3%
Solid State	0.6	0.6		7.2	8.3		10.3	12.5		3.8%	3.8%	
Electrocomponents	2.0	1.9	1.8	17.1	14.4	13.1	26.5	22.3	20.3	1.8%	1.9%	2.1%
Average	**2.2**	**2.1**	**2.2**	**13.4**	**12.3**	**12.1**	**21.5**	**19.5**	**19.3**	**2.2%**	**2.3%**	**2.1%**
Versus peer group					***(13%)***	***(15%)***		***(7%)***	***(9%)***			

Source: Edison Investment Research, Bloomberg. Note: Priced at 13 June.

Exhibit 12: Peer group financial metrics

	Gross margin (%)			EBITDA margin (%)			EBIT margin (%)			Revenue growth (%)			EPS growth (%)		
	Last yr	This yr	Next yr	Last yr	This yr	Next yr	Last yr	This yr	Next yr	Last yr	This yr	Next yr	Last yr	This yr	Next yr
discoverIE	32.7	33.0	33.0	7.6	8.1	8.1	6.5	6.9	7.0	14.7	8.9	2.7	15.8	8.7	3.4
Design & manufacturing															
Gooch & Housego	40.2	40.2		18.7	19.0	19.7	15.7	15.8	16.1	8.9	3.8	3.0	15.9	5.7	4.9
TT Electronics	28.4	27.3		10.7	11.3	11.5	7.0	7.6	8.0	(30.4)	8.7	6.9	2.5	20.3	15.5
XP Power	46.5	46.3	46.3	25.0	25.0	25.4	21.8	22.1	22.5	28.5	16.2	8.0	27.5	20.5	9.3
Specialist & high service distributors															
Diploma	36.0	36.0	36.0	18.4	18.6	18.8	17.4	17.7	18.0	5.5	3.5	4.0	9.8	5.1	5.4
Solid State	28.4	27.3		8.6	7.1		5.7			13.2	5.3		(4.1)	(17.6)	
Electrocomponents	44.0	30.4	30.9	11.6	13.0	13.6	10.4	11.3	11.8	12.8	6.6	5.0	35.2	18.7	10.1
Average	37.3	34.6	37.7	15.5	15.7	17.8	13.0	14.9	15.3	6.4	7.4	5.4	14.5	8.8	9.0

Source: Edison Investment Research, Bloomberg. Note: Priced at 13 June.

Sensitivities

Our estimates and the discoverIE share price will be sensitive to the following factors:

- **Customer demand:** demand for the company's products will be influenced by the economic environment in Europe. It will also be sensitive to the gain or loss of major customers, although in FY18 no customer made up more than 4% of sales.
- **Currency:** translational – with 80% of revenues outside the UK, discoverIE is exposed to the translation of euro and Nordic-denominated subsidiary results into sterling, which positively boosted sales growth by 3.6% and underlying operating profit growth by 4.7% in FY18. Transactional – discoverIE sells mainly in euros, sterling and Nordic currencies and purchases mainly in US dollars and euros. discoverIE hedges with forward contracts to the extent that the exposure cannot be passed to the customer.
- **Pricing:** discoverIE's revenues and profitability are sensitive to the company's ability to include within price quotes engineering time spent on designing customer solutions. The company tends to pass through supplier price increases, with very few fixed-price contracts.
- **Acquisitions:** the company may make further acquisitions, which could add integration risk and will require funding (we estimate discoverIE has c £19m headroom in its debt facility).
- **Pension deficit**: the company has a £3.0m pension deficit and increased the level of contributions from FY13 by 3% a year (FY18: £1.7m contribution) as part of the plan agreed with trustees back in 2009 to try to eliminate it. The pension fund was closed to new entrants in 1999 and further service accruals in 2000.

- **Supply chain:** any major disruption of the supply chain could make it difficult for the company to satisfy customer demand and therefore affect revenues.

Exhibit 13: Financial summary

£m	2013	2014	2015	2016	2017	2018	2019e	2020e
Year end 31 March	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS								
Revenue	177.4	211.6	271.1	287.7	338.2	387.9	422.5	433.8
Cost of Sales	(123.0)	(148.6)	(186.7)	(195.1)	(227.2)	(261.2)	(283.1)	(290.6)
Gross Profit	54.4	63.0	84.4	92.6	111.0	126.7	139.4	143.1
EBITDA	7.4	9.1	16.6	19.8	24.3	29.3	34.1	35.2
Operating Profit (before am, SBP and except.)	6.1	7.7	14.0	17.0	20.6	25.2	29.2	30.4
Operating Profit (before am. and except.)	5.5	7.1	13.4	16.3	20.0	24.5	28.4	29.5
Amortisation of acquired intangibles	(0.7)	(1.0)	(2.1)	(2.8)	(3.9)	(4.9)	(6.0)	(6.0)
Exceptionals	(3.4)	(0.9)	(5.2)	(2.1)	(8.4)	(1.1)	(3.2)	(3.2)
Share-based payments	(0.6)	(0.6)	(0.6)	(0.7)	(0.6)	(0.7)	(0.8)	(0.9)
Operating Profit	1.4	5.2	6.1	11.4	7.7	18.5	19.2	20.2
Net Interest	(0.5)	(0.8)	(1.6)	(1.8)	(2.8)	(2.6)	(3.9)	(3.9)
Profit Before Tax (norm)	5.6	6.9	12.4	15.2	17.8	22.6	25.3	26.5
Profit Before Tax (FRS 3)	0.7	4.2	4.3	9.4	4.8	15.8	15.1	16.1
Tax	1.4	(0.5)	(1.4)	(2.2)	(1.3)	(4.0)	(3.8)	(4.0)
Profit After Tax (norm)	4.6	6.0	10.0	11.8	13.6	17.1	19.0	19.9
Profit After Tax (FRS 3)	2.1	3.7	2.9	7.2	3.5	11.8	11.3	12.1
Average Number of Shares Outstanding (m)	39.2	43.1	57.6	63.3	65.4	70.8	72.9	73.3
EPS - normalised & diluted (p)	11.3	13.1	16.4	17.8	19.9	23.0	25.0	25.9
EPS - IFRS basic (p)	(4.8)	3.0	5.0	11.4	5.3	16.7	15.5	16.5
EPS - IFRS diluted (p)	(4.7)	2.8	4.8	10.9	5.1	15.8	14.9	15.7
Dividend per share (p)	6.2	6.8	7.6	8.1	8.5	9.0	9.5	9.8
Gross Margin (%)	30.7	29.8	31.1	32.2	32.8	32.7	33.0	33.0
EBITDA Margin (%)	4.2	4.3	6.1	6.9	7.2	7.6	8.1	8.1
Operating Margin (before am, SBP and except.) (%)	3.4	3.6	5.2	5.9	6.1	6.5	6.9	7.0
BALANCE SHEET								
Fixed Assets	30.9	33.1	88.6	108.4	122.2	144.2	139.4	133.0
Intangible Assets	24.2	25.5	69.9	88.2	100.7	115.0	108.9	102.8
Tangible Assets	3.1	3.5	13.8	14.7	16.0	23.4	24.7	24.4
Deferred tax assets	3.6	4.1	4.9	5.5	5.5	5.8	5.8	5.8
Current Assets	81.8	92.7	127.3	128.3	148.4	166.2	176.9	178.7
Stocks	19.3	19.4	39.8	42.9	50.1	60.6	66.0	68.9
Debtors	44.7	48.3	60.2	65.5	77.3	82.4	89.1	92.7
Cash	17.8	18.1	26.7	19.9	21.0	21.9	20.5	15.8
Current Liabilities	(50.9)	(58.3)	(62.1)	(61.7)	(78.1)	(93.4)	(101.6)	(104.0)
Creditors	(46.6)	(51.5)	(61.9)	(60.9)	(77.1)	(87.0)	(95.2)	(97.6)
Short term borrowings	(4.3)	(6.8)	(0.2)	(0.8)	(1.0)	(6.4)	(6.4)	(6.4)
Long Term Liabilities	(10.3)	(19.0)	(61.1)	(73.1)	(68.7)	(87.7)	(82.8)	(69.8)
Long term borrowings	(1.7)	(9.5)	(45.5)	(57.2)	(50.0)	(67.9)	(62.9)	(57.9)
Other long term liabilities	(8.6)	(9.5)	(15.6)	(15.9)	(18.7)	(19.8)	(19.9)	(11.9)
Net Assets	51.5	48.5	92.7	101.9	123.8	129.3	131.9	137.8
CASH FLOW								
Operating Cash Flow	5.7	6.1	6.6	14.6	20.5	21.7	28.4	29.3
Net Interest	(0.6)	(0.8)	(1.6)	(1.8)	(2.8)	(2.6)	(3.9)	(3.9)
Tax	(1.4)	(0.9)	(3.3)	(4.3)	(3.0)	(3.7)	(5.3)	(5.6)
Capex	(1.3)	(1.4)	(2.5)	(2.3)	(3.4)	(4.3)	(6.0)	(4.5)
Acquisitions/disposals	(0.5)	(9.2)	(37.3)	(19.8)	(11.8)	(25.4)	(3.0)	(8.0)
Financing	5.7	0.1	52.7	0.0	13.6	(1.5)	0.0	(0.0)
Dividends	(2.3)	(2.7)	(3.6)	(4.9)	(5.2)	(6.2)	(6.6)	(7.0)
Net Cash Flow	5.3	(8.8)	11.0	(18.5)	7.9	(22.0)	3.6	0.3
Opening net cash/(debt)	6.3	11.8	1.8	(19.0)	(38.1)	(30.0)	(52.4)	(48.8)
HP finance leases initiated	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.2	(1.2)	(31.8)	(0.6)	0.2	(0.4)	0.0	0.0
Closing net cash/(debt)	11.8	1.8	(19.0)	(38.1)	(30.0)	(52.4)	(48.8)	(48.5)

Source: discoverIE, Edison Investment Research

Contact details	Revenue by geography
2 Chancellor Court, Occam Road, Surrey Research Park, Guildford GU2 7AH +44 (0)1483 544500 www.discoverieplc.co.uk	N/A

Management team	
CEO: Nick Jefferies	**CFO: Simon Gibbins**
Nick joined discoverIE as group chief executive in January 2009. He has held senior positions for over 15 years with leading international distributors of electronic components and computer products, such as Electrocomponents and Arrow Electronics. He originally trained as an electronics design engineer with Racal Defence (now part of Thales).	Simon was appointed as group finance director in July 2010. A chartered accountant, he was previously global head of finance and deputy CFO at Shire. Before joining Shire in 2000, he spent six years with ICI in various senior finance roles, both in the UK and overseas. His earlier career was spent with Coopers & Lybrand in London.
Chairman: Malcolm Diamond	
Malcolm was appointed as a non-executive director of discoverIE in November 2015 and became non-executive chairman in April 2017. He is also non-executive chairman of Trifast and Flowtech Fluidpower. Prior to being appointed chairman, Malcolm was chief executive of Trifast and, among other previous appointments, was senior non-executive director of Dechra Pharmaceuticals and a non-executive director of Unicorn AIM VCT.	

Principal shareholders	(%)
Canaccord Genuity Group Inc	9.6
Aberdeen Standard Investments	8.4
Unicorn Asset Management (UK)	7.2
Legal & General Investment Management (UK)	6.5
BlackRock Inc	4.4
Chelverton Asset Management	4.2
AXA SA	4.0
Franklin Resources	3.6
Montanaro Asset Management	3.3

Companies named in this report
Diploma (DPLM), Electrocomponents (ECM), Gooch & Housego (GHH), Solid State (SOLI), TT Electronics (TTG), XP Power (XPP)