EDISON

Carclo

Recovery postponed

Trading update

Tech hardware & equipment

Carclo has announced that the issues associated with initiating multiple low-volume lighting programmes in parallel that adversely affected H119 have continued throughout Q319. At the interim stage management believed that these issues would be resolved by the end of Q3, supporting a second half recovery, but now expects that second half profit levels will be similar to the first half. We revise our estimates, cutting EPS by 37% in both FY19 and FY20.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
03/17	138.3	11.0	12.1	0.0	4.0	N/A
03/18	146.2	9.1	9.8	0.0	4.9	N/A
03/19e	140.5	6.9	7.1	0.0	6.8	N/A
03/20e	150.1	7.6	7.9	0.0	6.1	N/A

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

LED inefficiencies continue into Q319

In H119 divisional profitability was hit by starting all of the new lighting production programmes for the year during the first half. This situation worsened during Q3 as production ramped up. Although action has been taken to bring additional machine capacity on stream and adopt more effective scheduling techniques, these improvements will take time to complete. Additionally, the delays in ramping up production have resulted in delays in the award of new programmes, affecting divisional revenues for H219 and FY20. We note, however, that progress on the key mid-volume programmes, which have dedicated design teams and production cells, has been unaffected, other than a key milestone payment slipping into FY20.

Technical Plastics recovery slower than planned

Following a 1.5pp year-on-year dip in margins in H119, initiatives to improve margins in Technical Plastics have started to deliver results but at a slower rate than management expected at the interims. Consequently, we now expect the second half recovery to result in FY19 divisional profit being similar to the FY18 result rather than generating 11% year-on-year EBIT growth. The smaller Aerospace division continues to perform ahead of management's expectations.

Valuation: Recovery to drive share price

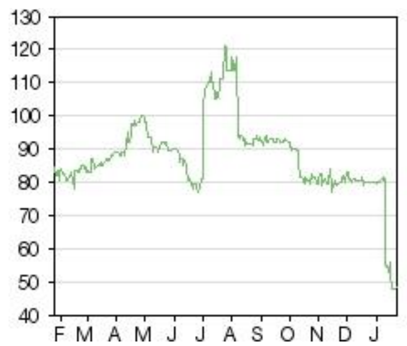
At group level Carclo, which has a diversified model, is trading on an FY19 P/E of 6.8x, substantially lower than the weighted mean of peers across the medical device manufacturing, automotive and aerospace sectors (12.3x). Newsflow demonstrating that management initiatives are driving margin improvement should help close this gap, with a range of 74–79p (a 10–15% discount to peers) looking justifiable on this basis, with scope for upside as the recovery beds down.

23 January 2019

Price	**48.45p**
Market cap	**£36m**

Net debt (£m) at 30 September 2018	35.9
Shares in issue	73.4m
Free float	91.8%
Code	CAR
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	(39.4)	(39.1)	(41.6)
Rel (local)	(41.4)	(37.9)	(34.9)
52-week high/low		121.0p	47.8p

Business description

Carclo is a specialist in high-precision plastic moulding, principally in healthcare, optical and automotive applications. Its two main end-markets are high-volume medical consumables and low-volume, very high-value automotive lighting, typically for supercars.

Next event

FY19 results	4 June 2019

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Edison profile page

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Changes to estimates

We revise our estimates to reflect:

- Efficiency issues in the LED division causing some customers to postpone placing new orders for low-volume programmes, thus reducing divisional revenues in H219 and FY20.
- Efficiency issues in the LED division adversely affecting margins in H219.
- A slower than expected improvement in CTP margins adversely affecting divisional profitability in H219.

Exhibit 1: Revisions to estimates

	FY18	FY19e			FY20e		
	Actual	Old	New	%change	Old	New	%change
CTP revenues (£m)	89.7	88.7	88.7	0.0%	95.6	95.6	0.0%
CTP EBIT (£m)	6.7	7.4	6.7	-9.1%	8.1	7.3	-10.8%
LED revenues (£m)	50.6	51.6	45.5	-11.8%	55.0	48.5	-11.8%
LED EBIT (£m)	6.4	7.8	4.4	-43.3%	8.3	4.7	-43.3%
Aerospace revenues (£m)	6.0	6.3	6.3	0.0%	6.0	6.0	0.0%
Aerospace EBIT (£m)	0.7	0.9	0.9	0.0%	0.7	0.7	0.0%
Group revenues (£m)	146.2	146.6	140.5	-4.1%	156.6	150.1	-4.1%
Group adjusted PBT (£m)	9.1	10.9	6.9	-37.0%	12.1	7.6	-37.1%
Group adjusted EPS (p)	9.8	11.3	7.1	-37.0%	12.5	7.9	-37.1%
Group DPS (p)	0.0	0.0	0.0	0.0%	3.9	0.0	N/A

Source: Edison Investment Research

- The statement says that the group year-end net debt position is anticipated to be slightly above the level seen at the half year (£35.9m) due to a delay in receiving a substantial milestone for customer approval for tooling on a mid-volume contract. Hence we increase our year-end net debt to £37.8m from £28.5m previously. Management has stated that it expects group net debt to remain within banking covenants at the newly anticipated profit level, although margin for error has clearly reduced. We leave our capex estimates unchanged for the moment, as investment will be needed in the US ahead of the commencement of production in FY21.
- Management has previously noted that it would not reinstate the dividend until it was able to do this in a sustainable manner. We had previously assumed that this would be possible by FY20 but now adopt a more conservative position.

Management changes

CEO Chris Malley has been focused on resolving the production inefficiencies in the LED division for several weeks. On 11 January 2019, he stepped down from his CEO role in order to devote himself full-time to this task. Mark Rollins, who became non-executive chairman in July 2018, has switched to an executive capacity while a replacement full-time CEO is sought.

Valuation

At group level Carclo, which has a diversified model, is trading on an FY19 P/E of 6.8x, substantially lower than the multiples for medical device companies and below those for automotive and aerospace industries (see Exhibit 2).

Given the current issues and earnings momentum, this is understandable and was reflected in the negative share price response to the trading statement. However, in our view it prices in little prospect of a recovery. Action is being taken to rectify the situation in the LED division, while the recovery in Technical Plastics does appear to have started, albeit at a slower rate than previously anticipated.

We believe that newsflow with firm evidence that margin issues are being resolved should be a catalyst for the start of a share price recovery. A valuation of 74–79p (9.4–10.0x FY20 earnings, a 10–15% discount to an undiscounted sum of the parts peer valuation) looks justifiable on this basis. We still see potential for further share price appreciation beyond this as Carclo begins to deliver on the mid-volume automotive lighting programmes and investors can appreciate their impact on the bottom line.

Sum-of-the-parts methodology

We use a sum-of-the-parts approach to determine an indicative FY19e P/E multiple for Carclo, as this methodology acknowledges that around half of its divisional operating profit is attributable to the sale of products to the global healthcare industry. Where available, the P/E multiple applied to each division is the mean for each sector, as shown in Exhibit 3. There are a number of companies manufacturing high-volume medical products but the key one of relevance, which we use in the sum-of-the-parts calculation, is Gerresheimer, as its products are primarily for use in medical/pharmaceutical test facilities, rather than for patient care (Ambu, Coloplast and Straumann). As can be seen from Exhibit 2, the latter trade on much higher multiples and are excluded from our sum-of-the-parts calculations. As shown in Exhibit 3, the weighted average P/E multiple derived from the multiples for the three sectors is 12.3x.

Exhibit 2: Listed peers

Name	Market cap ($m)	EV/EBITDA 1FY (x)	EV/EBITDA 2FY (x)	P/E 1FY (x)	P/E 2FY (x)
Carclo @ 47p – current share price	45	4.6	4.2	6.6	6.0
Carclo @ 74p – 15% discount to undiscounted SOTP	70	5.9	5.5	10.4	9.4
Carclo @ 79p – 10% discount to undiscounted SOTP	74	6.1	5.7	11.0	10.0
Healthcare: patient implants and disposables					
Ambu A/S	5,235	39.7	29.9	77.6	53.8
Coloplast A/S	18,416	19.2	17.4	30.0	26.9
Straumann Holding AG	10,398	25.5	21.7	35.5	29.1
Healthcare: drug delivery and packaging					
Gerresheimer AG	2,151	10.1	10.0	13.0	15.3
Automotive					
American Axle & Manufacturing Holdings Inc	1,424	4.1	4.2	3.9	4.2
BorgWarner Inc	8,183	5.8	5.6	9.0	8.5
Freni Brembo SpA	3,962	7.4	7.1	13.0	12.3
Delphi Technologies PLC	1,509	3.9	4.3	4.1	5.1
Faurecia SA	5,590	2.8	2.7	6.7	6.2
Haldex AB	327	6.3	5.7	13.1	11.1
HELLA GmbH & Co KgaA	4,768	3.9	4.1	9.0	9.5
Leoni AG	1,184	4.9	4.7	8.0	7.8
Magna International Inc	16,751	4.8	4.7	5.6	5.3
paragon GmbH & Co KgaA	110	7.0	4.8	16.7	9.4
Valeo SA	7,511	4.3	3.8	9.8	8.1
Visteon Corp	1,897	6.0	6.1	11.7	11.5
Mean		**5.1**	**4.8**	**10.1**	**9.0**
Aerospace					
Facc AG	758	9.9	8.8	19.9	15.9
Latecoere SA	319	7.4	5.6	23.4	19.5
Senior PLC	1,140	7.7	7.1	13.7	12.5
TT electronics PLC	420	8.1	7.0	13.8	11.4
Mean		**8.3**	**7.1**	**17.7**	**14.8**

Source: Refinitiv, Edison Investment Research. Note: Prices at 14 January 2019. Grey shading indicates exclusion from mean.

To cross-check our valuation, we compare EV/EBITDA multiples implied by our P/E-derived values with a blended sum-of-the-parts EV/EBITDA for the peer group. Our indicative valuation of 74–79p implies a year one EV/EBITDA range of 5.9–6.1x (see Exhibit 2), which is at a discount to the peer group blended year one EV/EBITDA multiple of 8.1x.

Exhibit 3: SOTP calculation

Division	P/E	% FY19e EBIT	EV/EBITDA
CTP	13.0x	56.0%	10.1x
LED	10.1x	36.7%	5.1x
Aerospace	17.7x	7.3%	8.3x
Blended value	12.3x		8.1x
FY19e EPS	7.1p		
Undiscounted indicative value	87.4p		
Indicative value applying 10% discount	78.7p		
Indicative value applying 15% discount	74.3p		

Source: Edison Investment Research

Exhibit 4: Financial summary

	£000s	2017	2018	2019e	2020e
Year end 31 March		IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue		138,282	146,214	140,537	150,100
EBITDA		17,033	15,543	14,483	15,599
Operating Profit (before amort. and except).		12,498	10,811	8,983	9,599
Intangible Amortisation		0	0	0	0
Exceptionals		(541)	(904)	(1,000)	0
Other		0	0	0	0
Operating Profit		11,957	9,907	7,983	9,599
Net Interest		(1,479)	(1,740)	(2,100)	(2,000)
Profit Before Tax (norm)		11,019	9,071	6,883	7,599
Profit Before Tax (FRS 3)		10,478	8,167	5,883	7,599
Tax		(2,496)	325	(1,652)	(1,824)
Profit After Tax (norm)		8,418	7,171	5,231	5,775
Profit After Tax (FRS 3)		7,982	8,492	4,231	5,775
Average Number of Shares Outstanding (m)		69.4	73.2	73.4	73.4
EPS – normalised (p)		12.1	9.8	7.1	7.9
EPS – normalised fully diluted (p)		12.1	9.8	7.1	7.9
EPS – (IFRS) (p)		11.5	11.6	5.8	7.9
Dividend per share (p)		0.0	0.0	0.0	0.0
EBITDA Margin (%)		12.3	10.6	10.3	10.4
Operating Margin (before GW and except.) (%)		9.0	7.4	6.4	6.4
BALANCE SHEET					
Fixed Assets		79,464	80,638	84,438	89,938
Intangible Assets		25,702	25,311	25,611	25,911
Tangible Assets		43,423	46,446	49,946	55,146
Investments		10,339	8,881	8,881	8,881
Current Assets		80,187	79,423	76,535	76,818
Stocks		19,250	19,812	20,792	21,384
Debtors		38,468	46,449	48,899	43,179
Cash		22,269	12,962	6,644	12,055
Other		200	200	200	200
Current Liabilities		(46,884)	(44,390)	(41,448)	(41,833)
Creditors		(27,996)	(29,205)	(26,263)	(26,648)
Short term borrowings		(18,888)	(15,185)	(15,185)	(15,185)
Long Term Liabilities		(68,504)	(63,652)	(63,652)	(63,652)
Long term borrowings		(29,406)	(29,253)	(29,253)	(29,253)
Other long term liabilities		(39,098)	(34,399)	(34,399)	(34,399)
Net Assets		44,263	52,019	55,873	61,271
CASH FLOW					
Operating Cash Flow		8,916	6,257	6,084	20,085
Net Interest		(762)	(917)	(1,000)	(900)
Tax		(2,086)	(1,693)	(1,652)	(1,824)
Capex		(7,683)	(9,075)	(9,500)	(11,700)
Acquisitions/disposals		(5,672)	0	(250)	(250)
Financing		7,616	(248)	0	0
Dividends		(596)	0	0	0
Net Cash Flow		(267)	(5,676)	(6,318)	5,411
Opening net debt/(cash)		24,750	26,025	31,476	37,794
HP finance leases initiated		0	0	0	0
Other		(1,008)	225	0	0
Closing net debt/(cash)		26,025	31,476	37,794	32,383

Source: Carclo accounts, Edison Investment Research

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