EDISON

De La Rue

Keeping it real

Initiation of coverage

Support services

De La Rue continues to pursue a strategy that is transitioning the company to a less capital-intensive operation with a more diverse customer base and revenue streams, incorporating more embedded technology and IP. Underlying progress is apparent although masked by the disposals and the recent loss of the UK passport contract. The strengthening of the balance sheet enables appropriate M&A to augment what we expect to be a resumption of organic sales growth from FY21. The current rating implies scepticism but this should improve as growth prospects are recognised. In the meantime, the healthy dividend yield provides support for investors.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
03/17	461.7	58.7	47.0	25.0	9.1	5.8
03/18	493.9	53.4	42.9	25.0	10.0	5.8
03/19e	509.9	55.5	44.5	25.0	9.6	5.8
03/20e	506.5	55.5	44.3	25.0	9.7	5.8

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

Countering the counterfeiters

De La Rue is the largest commercial banknote printer globally and has designed 36% of all the banknote denominations in circulation. In a constant battle against increasingly sophisticated fraud and counterfeiting, it has developed a range of layered security features, services and software solutions that can prove authenticity. These can be applied to banknotes, revenue protection for consumer goods and excise authorities, as well as personal identification. Since 2015 the strategy has been to invest in growth areas such as polymer banknotes, security features and product authentication and tracking, while improving returns in the more mature banknote print operation. It has involved optimal exits from the non-core activities of cash processing machine and banknote paper. The strategy builds on De la Rue's core reputational strength as a design authority and security printer.

Underlying progress masked by contract loss

Success of the strategy is apparent in the expected doubling of sales of Product Authentication & Traceability over the next three years as major long-term tax stamp contracts begin and consumer brand protection share grows. It should largely offset the £40m sales decline in ID Solutions over 18 months from October 2019, resulting from the loss of the UK passport contract. We expect Currency to remain relatively stable now print capacity has been optimised, with polymer expanding rapidly and improving returns as it benefits from its rapid share gains. With strong demand for security features across the group, we expect a return to growth in FY21.

Valuation: Growth potential not rated

Our fair value DCF returns a value of 639p a share, a healthy 49% premium to the current share price. The implied P/E for FY20e of 13.9x is hardly demanding compared to the support services segment calendar 2019 P/E multiple of 14.8x. In our view, the current rating of 9.7x FY20 EPS with a yield of 5.8% does not reflect growth potential.

14 January 2019

Price	**428p**
Market cap	**£439m**

Net debt (£m) at 30 September 2018	94.3
Shares in issue	102.6m
Free float	99.6%
Code	DLAR
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	1.4	(8.7)	(32.0)
Rel (local)	(0.8)	(7.4)	(23.8)
52-week high/low		647p	407p

Business description

De La Rue is a world leader in anti-counterfeiting and security for currency, identity and brand protection. The company operates across 140 countries and is the number one commercial designer and producer of banknotes and passports.

Next events

FY19 results	May 2019

Analyst

Andy Chambers +44 (0)20 3681 2525

industrials@edisongroup.com

Edison profile page

De La Rue is a research client of Edison Investment Research Limited

Investment summary

A leading provider of authentication products and services

De La Rue is a leading provider of authentication and verification products and services centred on its core historic foundation of the secure design and printing of banknotes. In addition to currency, its products also protect against fraud and counterfeiting in the personal identification markets and in commercial products, including revenue enforcement and product verification. Founded in the early 19th century, the company is a globally leading player in many of its core activities and has been awarded more than 1,000 current patents, with an average of almost 30 patents granted each year. It operates through three divisions: Currency, Product Authentication & Traceability (PAT) and ID Solutions (IDS). As the world digitises, including in terms of payment options, so De La Rue has to evolve and continues to use its long-established trusted status to develop new protections and processes to support its governmental and commercial customers.

Since arriving in 2015, the current management team has been pursuing a strategy aimed at reinvigorating the group by optimising the portfolio and targeting investment to improve returns on capital and quality of earnings. While disposals of non-core businesses and the loss of the UK passport contract from later in 2019 are serving to obfuscate the successes to date, progress has been made. The revenue streams are diversifying, overcapacity has been eliminated and flexibility has improved. While the repositioning of ID solutions will mean a further offset of growth elsewhere over the next two years, we are of the view that underlying market growth should start to assert from FY21, underpinned by a much firmer financial foundation despite higher investment levels.

Markets are growing

The total amount of banknotes in circulation continues to grow at around 3% per year according to company estimates. We feel many investors may perceive that digital payment methods are likely to lead to a decline in banknote volumes. However, at present, evidence suggests continued growth with even the number banknotes in circulation of a mature currency such as the US dollar continuing to increase steadily. Certainly the requirement for increased fraud and counterfeiting defences is increasing, as is the market for longer-lasting polymer banknotes; the UK is a prime example with £5 and £10 notes shortly to be joined by a new polymer-based £20 note.

Financial foundation improving

Although portfolio changes and the loss of the UK passport contract may be constraining reported progress, we feel underlying growth is apparent for the continuing operations. In H119, adjusting for the exit from the banknote paper business, ongoing activities increased revenue by 9%. While adjusted operating profit fell 31% to £17.0m, this was largely due to contract mix in Currency with a sharp margin recovery expected in H219 supported by contract wins. As the UK passport contract loss is absorbed over the next two years, we expect reported profit growth to be relatively flat, again masking strengthening underlying performance; this should see growth resume from FY21.

Future growth resumption not rated

Trading on a single-digit prospective P/E multiple with a yield of 5.8% suggests the market perceives De La Rue to be value trap, presumably relating to the belief that banknote demand is in decline, which we feel is misplaced given growth of banknotes in circulation. Our fair value, an average of the implied value of placing De La Rue on a FY20 support services sector rating (640p) and our capped DCF valuation (638p), equates to 639p, a 49% premium to the current share price. The implied P/E for FY20e of 14.4x, is in line with the FY20 support services sector multiple.

Company description: Developing IP in secure printing

Founded in 1813, De La Rue is one of the world's largest independent security printers. It prints both paper and polymer banknotes and supplies ID documents, revenue and brand protection products. Importantly it develops and supplies the products and security features that assure the validity of the product or people with which they are associated, together with software products that support them. Headquartered in Basingstoke, Hampshire, the company has approximately 2,750 employees globally. It has three UK manufacturing sites and four overseas in Malta, Kenya, Sri Lanka and the US.

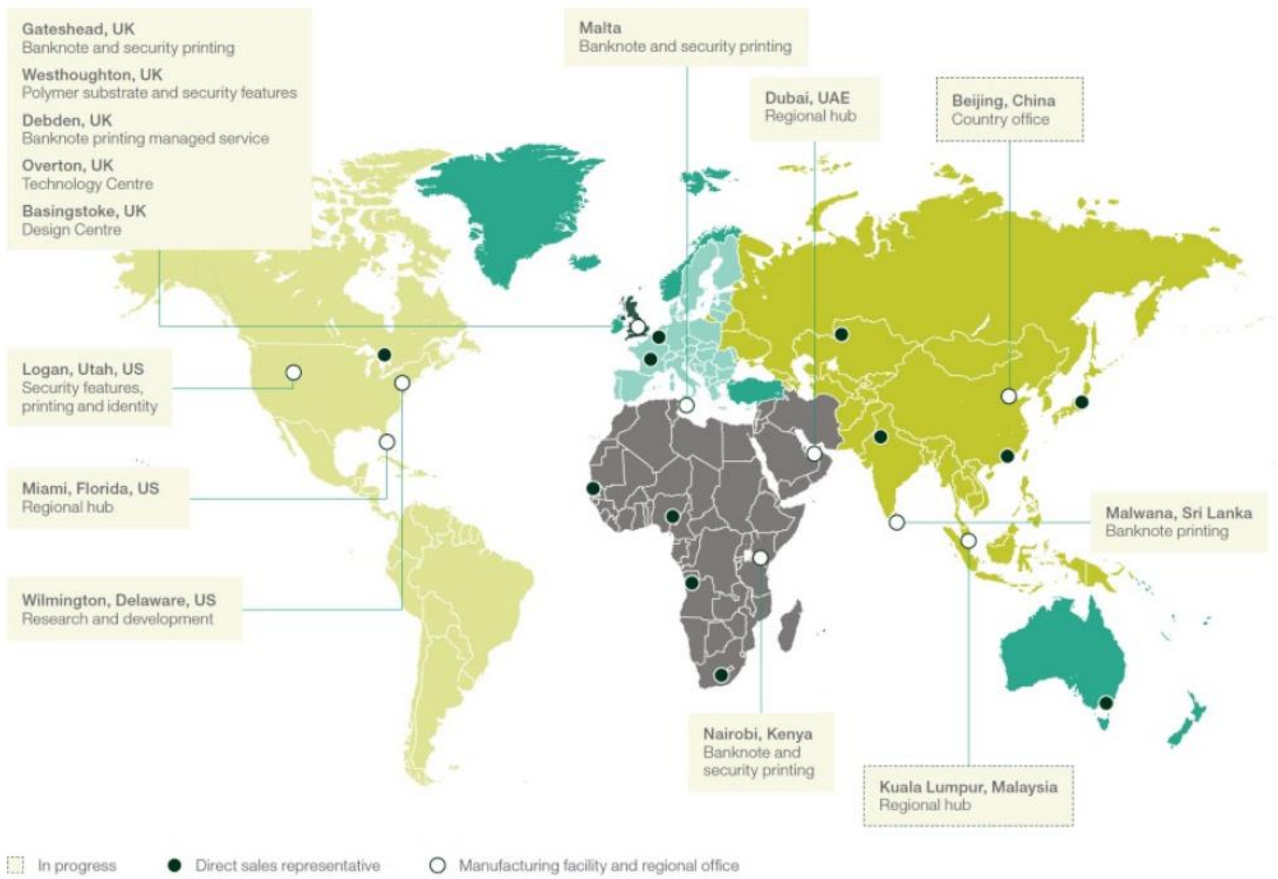
It has a technology centre in Overton near its HQ in Hampshire and a research and development centre in Wilmington, Delaware. The constant battle against fraud and counterfeiting makes the development of intellectual property extremely important to fulfil the companies stated ambitions:

Mission: To provide governments and commercial organisations with products and services that underpin the integrity of trade, personal identity and the movement of goods.

Purpose: To enable every citizen to participate securely in the global economy

In this regard De La Rue has over 1,000 current patents with a further 600 pending approval. In an ever more digitally sophisticated world, challenges can only be met by continuous improvement. In FY18 alone De La Rue filed 46 patents. By nature, the markets in which it operates have very high barriers to entry, with the strong brand and long-established reputation providing competitive advantage. In our view, the strength of the security features' development and application further bolsters this advantage and strengthens the brand recognition and trust among customers.

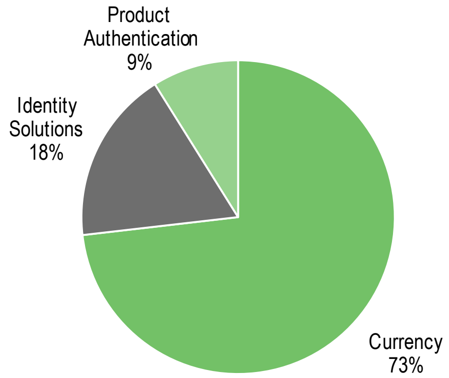
Exhibit 1: De La Rue global footprint



Source: Company reports

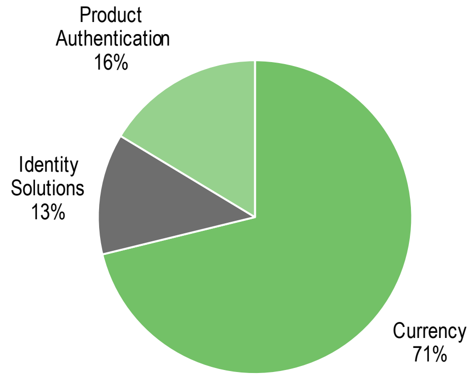
De La Rue operates through three separate divisions that have a common thread in security printing. Core competences include complete design solutions, data analytics and consultancy.

Exhibit 2: Revenue by division (FY18 – £426.4m excluding Paper)



Source: Company reports

Exhibit 3: Adjusted operating profit by division (FY18 – £62.8m excluding Paper)



Source: Company reports

Currency

- **Market size:** 171 billion banknotes issued in 2017 (11% of which available commercially, excluding overspill from State Print Works (SPW) of 2% to 4% per year).
- **Market growth rate:** De La Rue estimates 3% to 5% over the next four years.
- **De La Rue position:** global leader with 27% of commercial banknote print market volume (excluding overspill). Number two in polymer banknote substrate with rapid share gains.
- **Trends:** print on polymer; DLR Analytics and embedded features.

Product Authentication and Traceability

- **Market size:** £2.5bn to £3.0bn over the next three years.
- **Market growth rate:** 16% over the next three years.
- **De La Rue position:** Fragmented market, multiple product offerings. Global number two in tax stamp solutions.
- **Trends:** track and trace capability; digital and physical solutions.

Identity Solutions

- **Market size:** £3.9bn to £4.5bn over the next five years.
- **Market growth rate:** 8% passport and 5% National ID.
- **De La Rue position:** 32% commercial passport market volume.
- **Trends:** flexible financing; BOT (Build Operate Transfer); international funding.

Strategy

Following the arrival of Martin Sutherland as CEO in 2015, the company formulated a revised five-year strategy aimed at resetting the company and positioning it for growth. The goal was to develop a high-performance culture with more diverse revenue streams, a better business mix, a higher return on capital employed delivering a higher quality of earnings, and a stronger balance sheet. The businesses were divided into two categories, with differing strategies for each group.

Optimise and flex: in more mature businesses the strategy was designed to match core capacity more closely with base workloads, in often unpredictable demand environments, while improving efficiency and maintaining ability to flex production to meet peaks. Non-core activities were identified and divestment routes were developed. Banknote Print is the only operation that remains in this category following the disposal of the cash processing systems and paper businesses in the last two years.

Invest and build: in businesses with clearer growth dynamics, strategies were developed that included investment in sales, technology development (including software) and development of strategic partnerships. Targeted acquisitions to enhance the technology and capability of the portfolio are also part of the plan. The businesses included in this category were polymer and security features in Currency, as well as PAT and IDS. Goals for 2020 were to achieve a more balanced and diversified revenue stream by growing these activities at a mid-single-digit CAGR from 2015 to 2020, supported by doubled annual R&D spending by 2020.

While the loss of the UK passport contract is a blow to the invest and build ambitions, the security features and components elements of IDS will continue to be developed. However, with around £40m of profitable revenues from the total £86m divisional total being lost over the next couple of years from October 2019, the end-to-end passport solutions business will become subscale compared to the increasingly consolidated competitor landscape and it will be deemphasised. It is interesting to note the subsequent success in providing some security features for the Australian passport derived from those developed for the UK bid.

In addition to these operational priorities, management also focused on strengthening the balance sheet by targeting improved cash flow and reducing the large pension deficit.

Progress to date

Significant progress has been made so far in delivering the strategy.

In terms of the optimise and flex segment, Banknote Print has seen the removal of two print lines, which has reduced capacity from 8bn notes per year to 7bn. It is now more aligned with sustainable volumes given De La Rue's 27% share of the 20–25bn banknotes printed commercially each year. Outsourcing partners provide additional capacity if required. In addition, the company has invested in its production machinery and adopted more flexible working practices to increase efficiency.

In terms of dealing with non-core assets, the disposal of Cash Processing Systems in May 2016 for £3.6m to Privet Capital eliminated a lossmaking business (FY16 sales £34m, operating loss £8m).

The divestment of Paper on 29 March 2018 marked a further major step in optimising the portfolio. Epiris Fund II bought a 90% interest in Portals De La Rue for £60.3m in cash. The business was capital intensive, had been volatile and external sales were to a degree commoditised by oversupply in the market. Approximately half of its revenues were generated by internal sales to De La Rue banknote print operations and a 10-year supply agreement was secured as part of the deal. Revenues in 2018 were £67.5m, which generated £5.9m of adjusted operating profit.

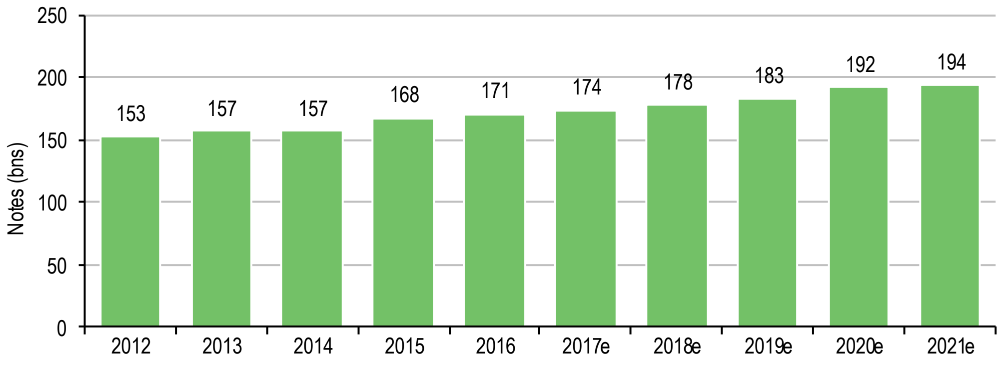
In terms of the invest and build ambitions there has also been significant progress. By FY18 R&D had risen by 74% from FY15, and the number of patents granted rose to 46. The $25m acquisition of Dupont Authentication on 5 January 2017 generated sales of £10.9m and EBIT of £1.2m in FY18 (its first full year after acquisition), and added a market-leading position in Lippmann holography to De La Rue's existing embossed hologram technologies. Excluding the loss of the UK passport contract, both IDS and PAT experienced a strong order intake in recent periods. PAT is now expected by management to double revenues over the next three years.

The balance sheet has been significantly strengthened. Net debt of £111.0m at the end of FY15 had fallen to £50m at FY18 and we estimate will end FY19 at around £71m. The pension accounting deficit had also reduced to at £79.3m at the end of H119. We expect the current triennial actuarial review should also reflect at least some of the improvement. This could have a positive effect on cash contributions, which are currently slated to rise to £23m annually through to 2028.

Market overview

Demand for cash remains strong with volume of notes in circulation growing by around 3–4% globally and exceeding GDP growth rates in most geographic regions. The rise of electronic and digital payment methods has yet to significantly disrupt this dynamic and De La Rue continues to estimate 3% growth in global banknote issuance through 2021, driven by increasing populations, GDP growth and availability through increasing installations of automatic telling machines (cash dispensers), currently growing at around 6% per year globally. Political uncertainty also acts as a support for cash retention and clean note policies provide an impetus to attrition and replacement rates, including the increasing adoption of harder-wearing polymer notes.

Exhibit 4: Global banknote issuance (volume)

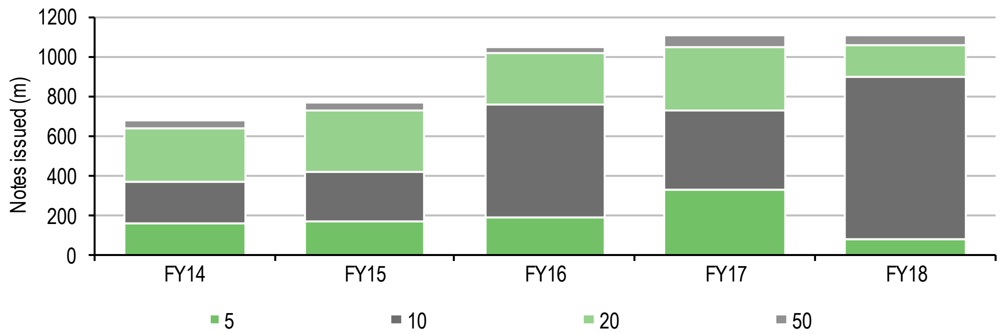


Source: De La Rue estimates

With the increasing demand for notes comes the increasing threat from counterfeiting and fraud, which drives the demand for security features. These also have applications across both the personal identity markets for IDS and commercial product authentication and revenue protection markets for PAT.

The Bank of England provides an example of the effects of the transition from paper to polymer notes. The polymer £5 note was introduced in September 2016 and the new polymer £10 a year later in September 2017. As issuance is driven by growth of cash in circulation plus replacement, the increased durability of new polymer £5 notes led to a temporary lull in issuance. The old paper notes were eventually withdrawn and destroyed and the new notes lasting 2.5x as long. As we progress towards the expected lifetime of the note, issuance levels should recover to reflect more normal replacement rates. A similar effect seems likely in the £10 note issuance rates in FY19 and again once the new polymer £20 note is introduced after FY21.

Exhibit 5: Bank of England note issuance volume by denomination

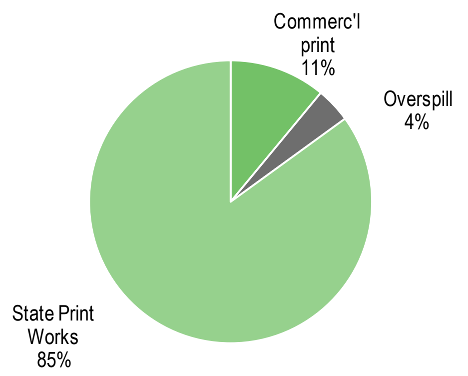


Source: Bank of England

Currency markets

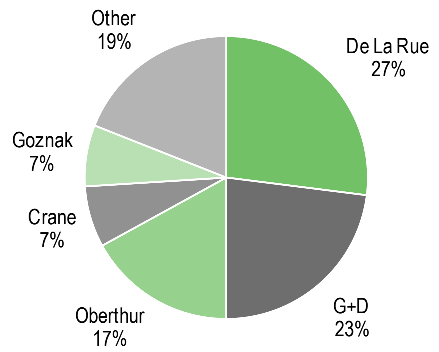
In the currency market the available share of banknote print is 11% excluding overspill demand from SPW, which adds another 4% to the commercial market. Outsourcing from SPW has been limited in recent periods so their excess demand represents a swing factor for the commercial print market and tends to fluctuate between 2% to 4% of the total market issuance. Currently, Venezuela and the Philippines both represent significant overspill volumes for the market. These exacerbate the already lumpy nature of order cycles for commercial printers.

Exhibit 6: Banknote print market by provider type (2016 171bn notes)



Source: De La Rue estimates

Exhibit 7: Commercial print market share (2016 by volume)

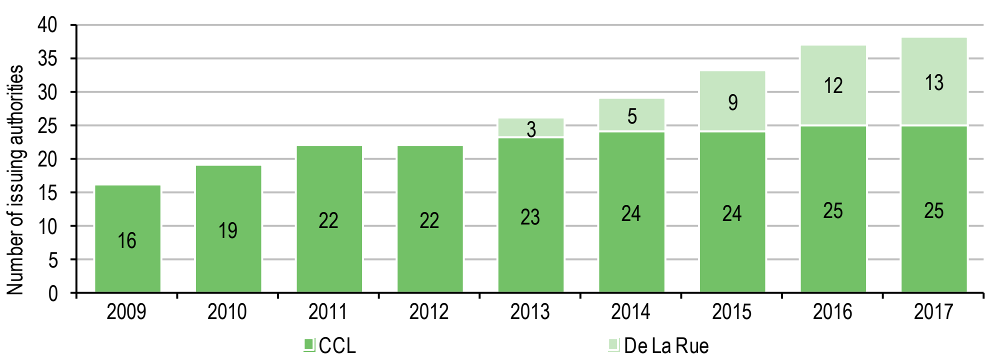


Source: De La Rue estimates

De La Rue has the leading market share in commercial printing with an estimated 27% in what is a fairly concentrated market. De La Rue's share combined with four other competitors Giesecke + Devriett (G+D, Germany), Oberthur Fiduciaire (France), Crane (US) and Goznak (Russia), which represents over 80% of the commercial bank print volumes. It should be noted that De La Rue does not print either US dollar or euro-denominated notes.

In polymer substrate markets competition is limited to one other player, CCL of Canada, which was the first entrant. De La Rue has a growing market share with 11% of the total volume last year. Around 3% of bank notes printed in 2016 were on polymer substrate but the number of issuing authorities has been increasing and De La Rue has been growing its share. In 2017 it supplied 13 issuing authorities out of the 38 using polymer substrate for bank notes. The number that is using or will adopt De La Rue's substrate has subsequently increased to 26. De La Rue is growing share in a market that is expected to more than double to 10.3k tonnes in the next five years. Even then it would still only represent c 5% of the global banknote substrate market. We note that the Bank of England has recently announced a new polymer £50 note will be launched, completing the transition of its main circulation denominations from paper substrate.

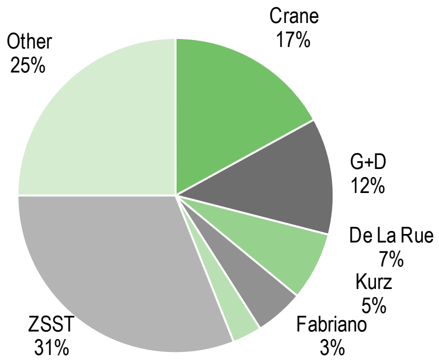
Exhibit 8: Polymer bank note issuing authorities by substrate supplier



De La Rue estimates

In comparison to banknote print and polymer substrate, the security features market is far more fragmented. Almost all countries incorporate value-added commercial security features in banknotes. De La Rue has about 7% market share, smaller than both G+D and Crane, which also compete in the segment as well as in print, and Chinese supplier ZSST, which has a 31% share (domestic market only). Leonhard Kurz Stiftung & Co (Germany) and Fabriano Security (Italy) also participate.

Exhibit 9: Security features market by volume



Source: De La Rue estimates

As counterfeiting is also becoming more technologically sophisticated, the security features market requires constant feature development including combinations of integrated multiple materials and IP to authenticate and protect currency, as well as personal ID, brand and revenue protection. De La Rue has invented over 100 security features for currency, which are embedded in 25% of the world's banknote denominations in circulation. It is the third-largest commercial supplier of security threads and the fourth largest of holographic features. Of the 171bn bank notes issued in 2017, 90% had security threads while only 13% had holograms. The prospect for continued penetration of more integrated features is thus significant.

Revenue, brand protection and authentication market

A rapidly growing market as a result of the counterfeiting of excisable goods such as cigarettes and alcohol, as well as consumer brands and pharmaceuticals, the market for brand protection is estimated to be growing at 16% per year to reach $4.2bn by 2020 from $2.7bn in 2017, and twice the size of the market in 2010. Both the tax stamp and brand protection markets are highly fragmented. The trend is towards more integrated security offerings that can uniquely identify, track and trace products throughout the supply chain. De La Rue estimates the overall market for PAT to be divided as follows:

Exhibit 10: PAT available markets by segment

	Size (£m)		Size (£m)
Government revenue protection	320	Security holograms	338
Serialisation & product coding	3,100	Other security devices	921
Enterprise track & trace	772	Brand enforcement foils	971
		IP & brand protection services	157
Total traceability	**4,192**	**Total brand protection**	**2,387**

Source: De La Rue estimates

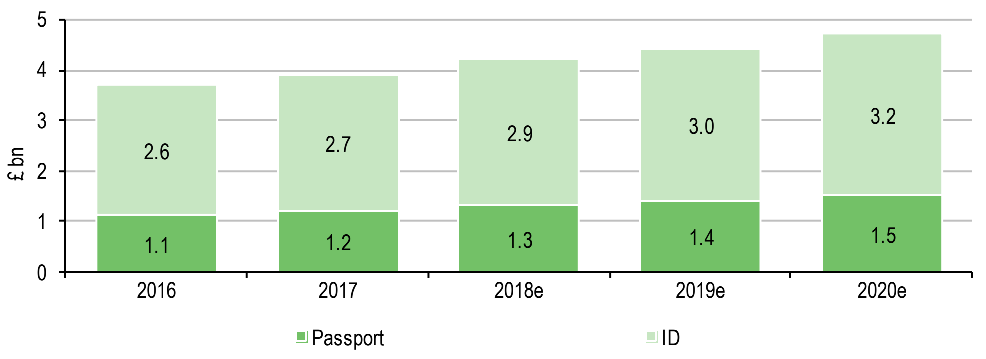
As most suppliers offer only partial solutions, the authentication, track and trace market is of growing significance for De La Rue as its seeks to diversify its revenue streams. Its long-established reputation and leading position in revenue protection stand De La Rue in very good stead to continue to develop strategic partnerships and attract new customers.

The increasing regulatory requirements and international accords in areas such as tobacco are also helping stimulate demand for tax stamp and track and trace solutions. The £25m five-year contract for the UAE entering production this quarter is a prime example of this trend.

Identity market

The identity market had been seen as an area for growth by De La Rue, but the loss of the contract to supply new passports to the UK passport office is expected to lead to deemphasising of the area. Worth around £3.9bn globally, the ID market incorporates passports, ID cards and associated digital solutions that validate unique trusted legal identities. Driven by rising populations, GDP growth and globalisation, the market was expected to grow at around 6% per year, with more than half available commercial printers.

Exhibit 11: Global passport and ID card market



Source: De La Rue estimates

Within this, the passport market grows at around 8%, with only 25% available to commercial printers with an increasing trend towards end-to-end digitalised solutions. However, the market has been consolidating with the creation of IDEMIA in France through the merger of Safran Morpho and Oberthur Technologies in late 2017 and the takeover of Holland-based Gemalto by Thales of France. Following its success in the UK, Gemalto will become the market leader, De La Rue is likely to be subscale to warrant its development of end-to-end solutions.

However, its security features remain highly attractive to passport issuers and we expect a continued focus on this element of the business, alongside the efforts in Currency and PAT.

Divisional overview

The table below shows the development of divisional performance for the ongoing activities of De La Rue excluding the Paper business that was divested in May 2018.

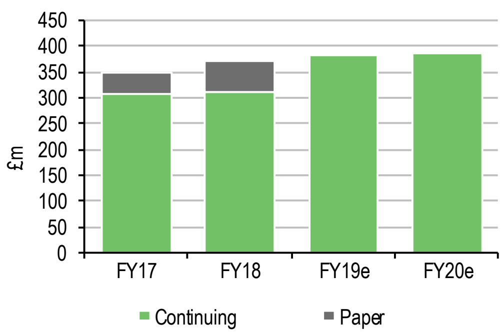
Exhibit 12: De La Rue divisional analysis

Year to March (£m)	2017	2018	2019E	2020E
Currency	349.5	371.8	380.4	384.2
ID Solutions	80.6	82.0	86.1	68.1
Product Authentication & Traceability	31.6	40.1	43.3	54.2
Group revenues	**461.7**	**493.9**	**509.9**	**506.5**
Currency	50.3	45.1	39.9	41.1
ID Solutions	11.4	8.3	9.7	7.1
Product Authentication & Traceability	9.0	9.4	11.3	13.5
Group adjusted EBIT, post internally generated intangible amortisation	**70.7**	**62.8**	**60.9**	**61.8**
Currency	*14.4%*	*12.1%*	*10.5%*	*10.7%*
ID Solutions	*14.1%*	*10.1%*	*11.3%*	*10.5%*
Product Authentication & Traceability	*28.5%*	*23.4%*	*26.0%*	*25.0%*
Adjusted EBIT margin	***15.3%***	***12.7%***	***12.0%***	***12.2%***

Source: De La Rue, Edison Investment Research estimates. Note: Continuing activities only.

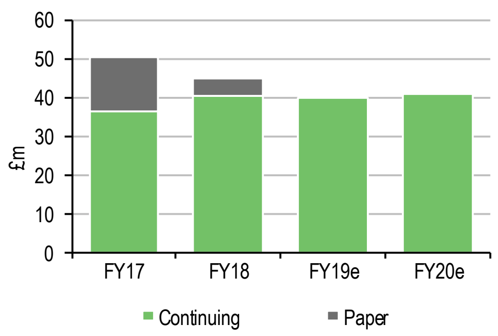
Currency

Exhibit 13: Currency revenues



Source: De La Rue, Edison Investment Research

Exhibit 14: Currency-adjusted operating profit



Source: De La Rue, Edison Investment Research

Following the exit from the banknote paper business in May 2018, Currency has three operating segments: Banknote Print, Polymer and Security Features. The operations provide customers with complete currency lifecycle support from R&D and design to the print of both paper and polymer notes with layered security features and data analytics of notes in circulation. De La Rue's strength of offer is reflected in its design of 36% of the banknote denominations in circulation. In polymer, De La Rue is substrate agnostic but is the only provider of a completely integrated polymer banknote capability when using its Safeguard substrate, which was launched in December 2012. Security features are available to both notes printed by SPW as well as the commercial market.

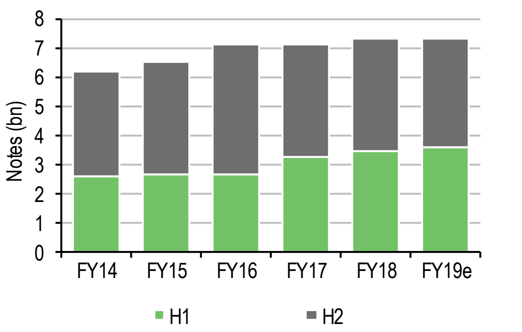
DLR Analytics was launched in 2017 and provides note-issuing authorities with the unique capability to assess note lifetimes and monitor trends, understand factors influencing note durability and help forecast future issuance requirement, including assessment of paper versus polymer solutions. Since launch it has been adopted by 70 issuing authorities, almost half of the total. Over a third of these are new customers for De La Rue.

In Banknote Print, the strategy has been to adjust footprint and increase efficiency. The removal of two lines and investment in the continuing plant has significantly reduced the age of the print lines.

Costs involved were around £8m of restructuring and £15m of capex, targeting £13m of cost savings by the current financial year.

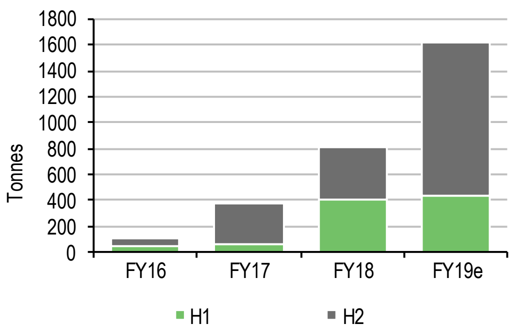
Current sales volumes are relatively stable at around 7.3bn notes. This compares to what management perceives to be optimum capacity of 6bn with the ability to flex up and down by approximately 1bn notes per year, through internal flexibility and use of external outsourcing partners. Volume was up 3% at H119 at 3.6bn notes, although management expects a relatively flat outturn for FY19 overall. Current global commercial demand is being boosted by overspill volumes from Venezuela and the Philippines, but these are expected to moderate over the next couple of years. While direct volume to De La Rue is thought to be limited, it could reintroduce swing capacity into the commercial banknote print market if it were to occur.

Exhibit 15: Banknote print volumes



Source: De La Rue, Edison Investment Research estimates

Exhibit 16: Polymer substrate volumes



Source: De La Rue, Edison Investment Research estimates

Polymer substrate volumes continue to grow sharply as more issuing authorities turn to De La Rue. Volumes more than doubled to 810 tonnes in FY18 and in H119 there was a year-on-year increase of 10% to 440 tonnes. As the number of note-issuing authorities adopting Safeguard continues to increase across more note denominations, further strong growth is expected. By H119 the number of authorities had increased to 26 across 60 denominations compared to 24 across 50 at the start of the year. Management expects substrate volume to double again this year implying an exceptional H219 increase as production for the Bank of England's initial 520 tonne two-year supply contract for its new polymer £20 note has begun in advance of its introduction later this year. As volumes continue to increase over the next two years, Polymer should move into profit with a beneficial impact on margins from FY21.

All of this is driving up demand for value-added, integrated and increasingly sophisticated digital as well as physical security features. In H119 revenues grew by 16% driven by both new contracts as well as higher demand from existing customers. A steady flow of new product introductions also serves to verify the technology investment programme. Four new features have been introduced in FY19 to date, Ignite and PureImage for banknotes in May 2018 and Photocolour UV later in the year. MyImage, developed in partnership with Opalux of Australia, is a polycarbonate security feature for ID documents.

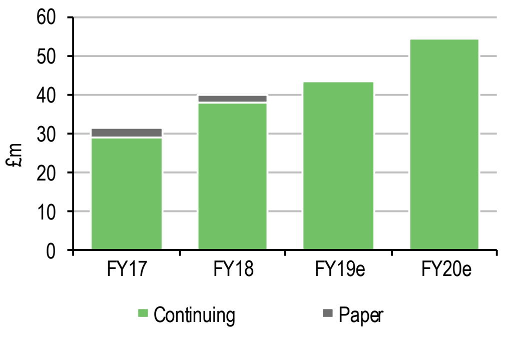
The 12-month forward order book had fallen to £231m for the division at H119, from £272m at the start of the year. Subsequent strong order intake including three-year contract for Kenya (c £85m) and Sweden (first production of SEK outside Sweden) have improved sales cover for H219 and improved longer term visibility. Sales excluding the paper business rose 11% to £182.1m in H119.

Adjusted H119 operating profit (excluding paper) fell sharply to £6.5m from £16.1m, a margin of 3.6% compared to 9.8% in the prior year due to weaker contract mix. A strong recovery is expected in H219 aided by the introduction of more profitable contracts and better overhead recovery.

As volumes appear to be relatively stable and new contracts come on stream, we expect the overall Currency performance to show modest improvement despite an expectation of limited growth in paper Banknote Print volumes. Both Polymer and Security Features should grow and improve profit contributions.

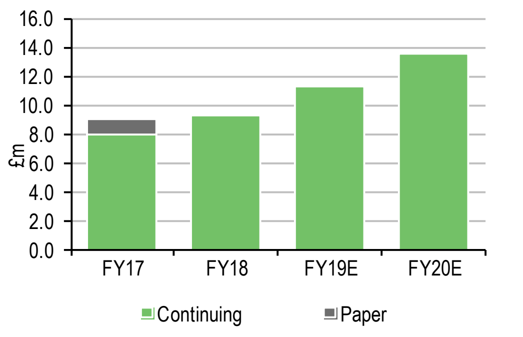
Product Authentication and Traceability

Exhibit 17: PAT revenues



Source: Company reports, Edison Investment Research

Exhibit 18: PAT adjusted operating profit



Source: Company reports, Edison Investment Research

PAT is essentially involved in two business activities, government revenue protection and consumer brand protection and authentication. The business can be split in two sub segments Government Revenue Services (GRS) for revenue protection and brand protection for consumer goods. It has provided GRS for over 150 years and provides excise protection services to more than 30 countries, underpinning its trusted partner reputation for customers globally. Customer relationships in commercial markets stretch back for over 40 years. Customers include the four leading tobacco companies, alcohol producers, tech companies including Microsoft and an increasing presence in pharmaceutical manufacturers. Almost all solutions are bespoke to meet the specific need and challenges faced by the customer.

Essentially, the offer of brand protection becomes a self-funded investment for customers as revenue lost to counterfeits, fake manufacturing and product diversion is eliminated and brand devaluation avoided.

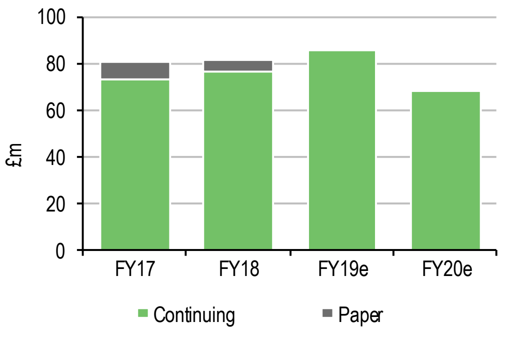
Products are becoming increasingly sophisticated as investment to drive innovation continues, including tax stamps where the company has a global number two position . Security features including tamper-evident technology such as seals, marking, foils and films, product traceability solutions through the supply chain and product authentication including holograms and UV inks, threads and RFID labels. PAT offers DLR Certify, a track-and-trace solution for government customers.

PAT is the fastest growing of De la Rue's activities and management expects it to double revenues over the next three years. Growth has been driven by strong order intake in recent years with major new contracts entering production. As it grows it should offset the decline at IDS to become De La Rue's second-largest division by FY21. Adjusted operating margins are the highest for the group and are expected to be maintained at around 25% despite the investment and growth from new contracts. In our view, PAT is a clear demonstration of the success of the invest and build strategy.

In H119 the rate of revenue growth was just 2% with sales of £19.4m but this is expected to accelerate as several contract come into production in H219. Adjusted operating profit fell 13% to £3.6m, a margin of 18.6% subdued by continued investment for growth, but with additional volumes in H219 providing good operational leverage, the full year outcome is expected to for mid-single digit percentage increase with strong FY19 margin performance. In the longer term, current orders and prospects have led management to say that it expects sales for the division to double over the next three years. We expect margins to remain at around 25% as products are high value add for customers, bespoke and IP protected.

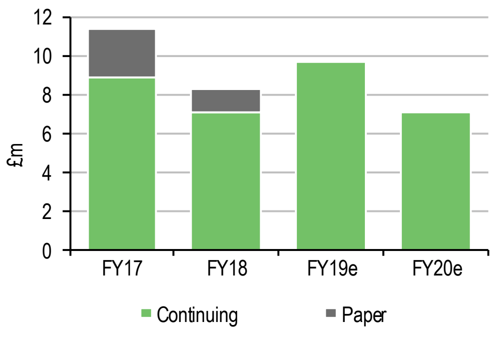
ID Solutions

Exhibit 19: IDS revenues



Source: Company reports, Edison Investment Research

Exhibit 20: IDS adjusted operating profit



Source: Company reports, Edison Investment Research

IDS provides identity documents such as passports and ID cards together with security features and services. Growth drivers of population authentication and cross-border security continue to stimulate demand, with increasing technology and security features adding impetus. Previously, De La Rue has been the world's largest commercial passport provider, supplying over 40 countries.

The loss of the UK passport contract to competitor Gemalto was announced in March 2018. De La Rue has been supplying under the existing 10-year contract and it represents around £40m of divisional revenue with margins above the divisional level. As was obvious at the time, the loss was a surprise to many. It appears the proposed technology solution was not necessarily the problem, as some features have subsequently been adopted in the next generation Australian passport. However, De La Rue was up against one of the consolidating players in the ID market. Gemalto is undergoing a merger with Thales of France and, following the creation of IDEMIA through the merger of Safran Morpho with Oberthur, two major and well-resourced European players are being created in the ID market.

The expectation is that the UK contract will start to wind down from October 2019 and all revenue will disappear by FY21. Although there is a great deal of uncertainty about how Brexit may affect the whole transition period, the timing would appear to represent the absolute downside.

As a result, the UK loss has led to a reappraisal of the direction of the strategy for the IDS activity. De La Rue has lost its flagship contract that provided the critical mass for the passport activity to pursue complete end-to-end solutions to other issuers. It seems likely the solutions activity will be exited including the related software product, DLR Identify.

The focus will shift to growing higher-margin security features for ID markets where De La Rue can use its materials science and other IP to provide differentiated components, such as the polycarbonate data page developed with Opalux.

In the absence of the £3.7m of UK passport contract bid costs borne by the division in FY18 and adjusting for the exit from Paper, we would expect moderate progress in revenues and adjusted operating profit in FY19. At H119 the division increased revenues (excluding paper) by 7% to £40.1m and profit by 57% to £6.9m, representing a very healthy adjusted operating margin of 17.2%. The performance was attributed to strong volumes in international ID markets, with margins benefiting from a more favourable contract mix. Order intake was perhaps surprisingly firm, with three new ID document contracts won in H119, ePassports for Qatar, ID cards for Malta and diplomatic passports for Libya, a new customer. However, as the UK passport contract progressively declines from the middle of FY20, we expect sharp divisional step down, although the remainder of the business should make progress.

Management

The main architect and driving force behind De La Rue's strategy is Martin Sutherland, who was appointed to the board as CEO in October 2014. While joining from BAE Systems, in our view this understates his credentials in high tech security markets as he was managing director of Applied Intelligence having joined BAE with its core, Detica the cyber security firm, acquired by BAE in 2008. He had been there since 1996 and was responsible for strategy as the company developed into the burgeoning cyber security market, becoming a leading international player. The very different challenge at De La Rue has been one of transition and transformation while retaining the long-established brand and reputation. Part of the strategy has been cultural change and, as part of this process, the executive team has largely been refreshed since his arrival. The appointment of Helen Willis as CFO in July 2018 is the latest part of the executive management jigsaw. She was previously CFO at Premier Farnell until its acquisition by Avnet. Oversight on the board is provided by non-executive chairman Philip Rogerson who was appointed in 2012, senior independent director Andy Stevens who was formerly CEO at Cobham, alongside three other independent directors. Sabri Challah was a partner at Deloittes until 2013, Maria da Cunha is still on the executive board at British Airways where she is director of people and legal, and Nick Bray is the CFO of Sophos Group.

Sensitivities

De La Rue is exposed to usual business trading risks such as site interruption, supply chain failures, quality control failures etc. In addition to these we would highlight following more specific risks arising from the company's activities and strategy:

- **Legal and regulatory requirements**: almost by definition De La Rue as a security printer with a reputation established on trust could suffer major reputational and financial damage if its employees or partners breached its requirements relating to bribery and corruption, anti-competitive behaviours or management of third-party partners. It has robust training enforcement and disciplinary procedures in place to help safeguard against this.
- **Confidentiality and product security**: alongside the above, the company is often in possession of sensitive customer information and has a strict control environment to ensure information security. Similarly, De La Rue has robust physical security and materials control operational procedures at production sites and through its handling of the movement of security materials and products between sites and onwards to customers.
- **IP protection and product innovation**: as part of the group strategy and a function of its security printing operations, the development of innovative technologies and features and the protection of the IP surrounding them is clearly important to maintain its standing. The ongoing increases seen in R&D in recent years and the evidence of increase grants of patents underpins this growth driver, as well as providing barriers to entry.
- **Materiality of contracts**: historically De La Rue has suffered from the lumpy and unpredictable nature of contract awards, especially in banknote printing. In addition the failure to renew or replace some sizeable contracts has exposed the lack of diversity of revenue streams in certain instances, with the UK passport contract loss perhaps being an example. Part of the strategy has been to diversify the customer base and revenue streams and increase the proportion of long-term contracts to deflect these risks. The growth of PAT and the higher proportion of revenues from long-term agreements indicate progress in this regard.
- **M&A execution risk**: as the balance sheet has strengthened and management seeks to augment growth through selected M&A, it could introduce an element of execution risk. We would expect robust due diligence to provide a protective framework.

Valuation

We calculate a fair value by taking the average of the implied value of placing De La Rue on a support services sector FY20 rating and a capped DCF valuation, which equates to 639p per share. While this would represent a modest discount to the sector multiple, it should be noted it reflects a constrained level of earnings with a view that growth should start to appear from FY21.

Capped DCF

We use a capped DCF as a core valuation method for our coverage. We forecast six years of cash flow and then assume zero growth in the terminal value calculation. To reflect that steady status, we also normalise depreciation to capex and working capital usage to zero in that calculation. We use a calculated WACC of 8.3%, which assumes a cost of equity of 10%. Our model returns a value of 638p and sensitivity to various WACC and terminal growth rate assumptions is reflected in the table below. Our assumption is highlighted in bold.

Exhibit 21: Capped DCF sensitivity analysis to WACC and terminal growth rates (p)

WACC	7.0%	7.5%	8.0%	**8.3%**	8.5%	9.0%	9.5%	10.0%
Terminal growth rate								
0.0%	807	735	672	**638**	617	568	524	485
1.0%	945	852	772	729	703	642	589	542
2.0%	1139	1011	905	849	815	738	672	614
3.0%	1430	1242	1091	1015	969	867	780	707

Source: Edison Investment Research

Although we regard our methodology as inherently conservative it should be noted that we continue to expect De La Rue's capex to be in advance of depreciation and for working capital consumption throughout our forecast period. Normalising these thus boosts cash flow significantly. If we maintain assumptions for these items in the terminal value calculation, the returned DCF value would be 459p, but we feel this is inappropriate given the assumption of no growth.

Peer group comparison

As most direct peers are unquoted we compare to the support services sector in the FTSE classification, although De La Rue has a relatively unique business model in comparison to them. The sector trades on a calendar 2019 prospective P/E multiple of 14.8x falling to 13.4x in 2020. De La Rue's FY20e P/E multiple of 9.7x does not appear to be demanding, especially as growth should resume in FY21 once the loss of the UK passport contract has been absorbed. Placing De La Rue on a FY20 sector multiple of 14.5x to reflect our assumption of resumed profitable growth would imply a share price of c 640p.

In January 2018 Crane Co of the US acquired Crane Currency for 8.5x historic 2017 EV/EBITDA. It is the main competitor for the Currency division and has similar EBITDA margins to De La Rue overall. Applying that multiple to De La Rue would imply an equity value of 561p.

We could use Thales as a comparison but it is skewed towards other segments such as defence (pro forma ID represents c 20% of sales) and the acquisition of Gemalto has yet to complete.

The €4.8bn offer for Gemalto of €51 per share represented an adjusted EV/EBIT of 16.8x and 14.4x for calendar 2018 and 2019, a 48% premium to the three-month average share price. If we adjust the multiple to the level before the bid was made then the implied EV/EBIT multiples would have been 12.1x and 10.4x. Placing De La Rue on a FY20e 10.4x EV/EBIT it would imply a share price of 467p, significantly higher than the current value. If we were to assume that an arbitrary but more normal 30% control premium was included in the Gemalto offer price, the multiple would rise to c 11.6x implying share price for De La Rue of 536p.

Financials

H119 results for De La Rue are summarised below.

Exhibit 22: De La Rue interim results highlights

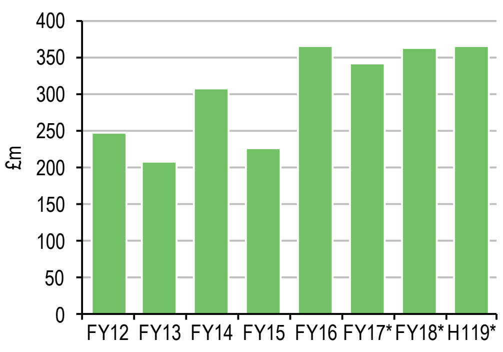
6 months to Sept (£m)	H118	H119	*% change*
Currency	165.1	182.5	*10.5*
IDS	37.5	40.1	*6.9*
PAT	19.1	19.4	*1.6*
Revenues	**221.7**	**242.0**	***9.2***
Currency	16.1	6.5	*-59.6*
IDS	4.4	6.9	*56.8*
PAT	4.2	3.6	*-14.3*
Group adjusted operating profit (continuing)	**24.7**	**17.0**	***-31.2***
Currency	*9.8%*	*3.6%*	
ID Solutions	*11.7%*	*17.2%*	
PAT	*22.0%*	*18.6%*	
Adjusted operating margin	***11.1%***	***7.0%***	
Pre-tax profit (adjusted continuing)	**19.0**	**14.0**	***-26.3***
EPS (p) – adjusted continuing	16.6	11.2	*-32.5*
DPS (p)	8.3	8.3	*0.0*
Net debt	135.7	94.3	

Source: Company reports

Adjusting for the paper business disposal, H119 group sales grew 9% to £242.0m (H118: £221.7m). Currency increased sales by 11% to £182.5m (H118: £165.1m), with banknote print volumes rising 3% to 3.6bn and polymer volumes rising 10% to 440 tonnes. IDS sales rose 7% to £40.1m (H118: £37.5m) and PAT sales grew 2% to £19.4m (H118: £19.1m). Adjusted group operating margin fell to 7.0% (H118: 11.1%) with adjusted operating profit down 31% to £17.0m (H118: £24.7m). The fall was mainly due to Currency, where contract mix and investment in R&D, sales and marketing reduced H119 margins. PAT saw profits fall modestly due to ongoing investment and following the end of a long-term contract in FY18. IDS profit was 57% higher at £6.9m

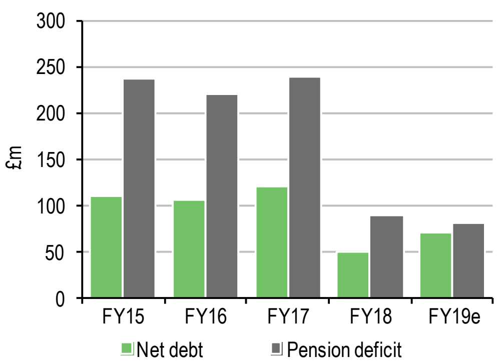
At the half year the 12-month forward order book excluding paper had risen to £365m from £363m at the start of the year. The strong order book position underpinned management confidence in a much improved H219, especially in Currency and PAT.

Exhibit 23: De La Rue 12m forward order book (* excludes Paper from FY17)



Source: Company reports

Exhibit 24: De La Rue year-end net debt and pension deficit



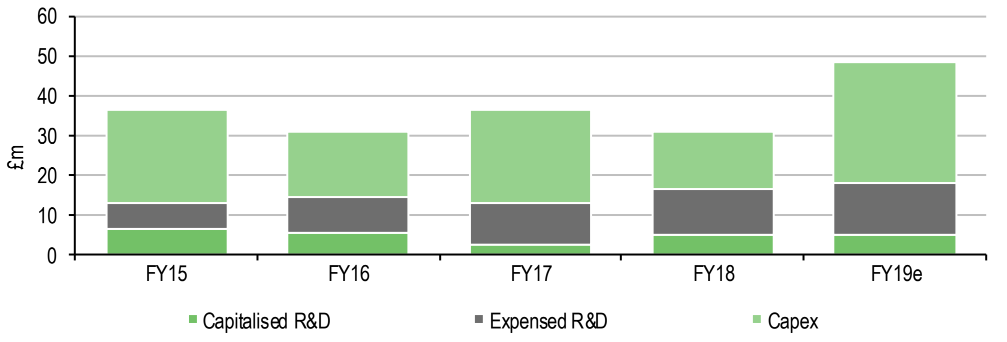
Source: Company reports, Edison Investment Research estimates

Net debt rose £44.4m in H119 to £94.3m from £49.9m at the year end. Working capital rose due to a one-off effect from the paper disposal, timing differences and inventory build to support higher H2 deliveries. It should partially unwind in H219, leaving year end net debt at c £71m.

The strategy also sought to reduce the burden from the pension deficit. The latest triennial review is in process and given the progress in the accounting deficit reduction, in large part due to the change to using CPI from RPI to measure liabilities, we would anticipate some relief from the currently expected rise to £23m in annual closure contributions from 2023 through 2028.

Gross R&D spending and tangible capex reflect the strategic aim of increasing investment for organic growth. It includes developing new security features and other technologies, and investing in efficiency through modernising plant as well as manufacturing footprint optimisation. Capex combined with overall R&D expenditure (including capitalised software and development costs) is expected to reach almost £50m this year. R&D is expected to continue to rise in FY20, although tangible capex should stabilise around the £30m level this year and next, slightly above the perceived normal run rate of £25m.

Exhibit 25: De La Rue R&D spending and capex investment



Source: Company reports

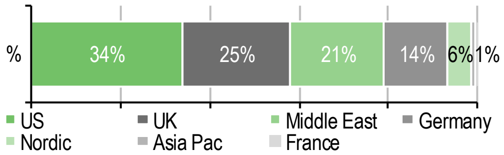
The group has a £275m revolving credit facility available until December 2021 and is well within covenant limits with interest cover of 13.6x (covenant 4x) and a net debt/EBITDA ratio of 1.37x (covenant <3x). As growth returns, we expect strengthening cash flows to support the strong balance sheet. In turn following disposals and despite the passport contract loss, De La Rue looks positioned to make selective bolt-on acquisitions if appropriate financials can be achieved.

The capital allocation priorities in descending order remain investing for growth, pension support and maintaining the strong dividend support, with enhancing M&A as appropriate.

Exhibit 26: Financial summary

£m	2016	2017	2018	2019e	2020e
Year end 31 March	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue	454.5	461.7	493.9	509.9	506.5
EBITDA	96.6	97.3	87.3	85.6	87.4
Operating Profit (before amort. and except.)	73.6	73.0	65.4	63.7	64.9
Intangible Amortisation	(3.2)	(2.3)	(2.6)	(2.7)	(3.1)
Exceptionals	(3.6)	(0.5)	60.2	(9.3)	(2.6)
Other	0.0	0.0	0.0	0.0	0.0
Operating Profit	66.8	70.2	123.0	51.6	59.2
Net Interest	(11.9)	(12.0)	(9.4)	(5.5)	(6.3)
Profit Before Tax (norm)	58.5	58.7	53.4	55.5	55.5
Profit Before Tax (FRS 3)	54.9	58.2	113.6	46.2	52.9
Tax	(6.3)	(8.7)	(16.8)	(7.4)	(8.5)
Profit After Tax (norm)	49.9	49.4	45.1	46.6	46.5
Profit After Tax (FRS 3)	48.6	49.5	96.8	38.8	44.4
Average Number of Shares Outstanding (m)	101.3	101.6	101.9	102.4	102.4
EPS - normalised (p)	48.1	47.0	42.9	44.5	44.3
EPS - normalised and fully diluted (p)	47.5	46.5	42.5	44.1	43.9
EPS - (IFRS) (p)	16.2	39.3	91.9	36.9	42.2
Dividend per share (p)	25.0	25.0	25.0	25.0	25.0
EBITDA Margin (%)	21.3	21.1	17.7	16.8	17.3
Operating Margin (before GW and except.) (%)	16.2	15.8	13.2	12.5	12.8
BALANCE SHEET					
Fixed Assets	180.5	198.6	149.0	159.0	167.4
Intangible Assets	13.4	31.3	29.5	31.1	32.4
Tangible Assets	167.0	167.2	112.8	121.2	128.3
Investments	0.1	0.1	6.7	6.7	6.7
Current Assets	272.1	252.5	179.9	214.2	215.5
Stocks	67.1	67.8	34.1	40.8	40.5
Debtors	93.5	109.7	102.3	130.0	131.7
Cash	40.5	15.4	15.5	15.5	15.5
Other	71.0	59.6	28.0	27.9	27.9
Current Liabilities	(367.2)	(345.3)	(252.7)	(286.9)	(280.4)
Creditors	(220.6)	(209.0)	(188.8)	(200.3)	(193.9)
Short term borrowings	(146.6)	(136.3)	(63.9)	(86.6)	(86.5)
Long Term Liabilities	(231.0)	(248.6)	(96.6)	(88.2)	(85.6)
Long term borrowings	0.0	0.0	0.0	0.0	0.0
Other long term liabilities	(231.0)	(248.6)	(96.6)	(88.2)	(85.6)
Net Assets	(145.6)	(142.8)	(20.4)	(1.9)	16.9
CASH FLOW					
Operating Cash Flow	72.0	67.3	87.9	45.9	71.3
Net Interest	(4.6)	(4.8)	(4.6)	(3.8)	(3.0)
Tax	(17.3)	(8.1)	(25.3)	(5.9)	(7.9)
Capex	(28.0)	(26.3)	(24.7)	(35.3)	(34.6)
Acquisitions/disposals	0.0	(15.8)	57.7	0.0	0.0
Financing	0.3	1.2	2.0	2.0	0.0
Dividends	(25.6)	(25.7)	(25.8)	(25.5)	(25.6)
Other	8.1	(2.6)	3.8	1.5	(0.0)
Net Cash Flow	4.9	(14.8)	71.0	(21.2)	0.1
Opening net debt/(cash)	111.0	106.1	120.9	49.9	71.1
HP finance leases initiated	0.0	0.0	0.0	0.0	0.0
Other	(0.0)	0.0	0.0	0.0	0.0
Closing net debt/(cash)	106.1	120.9	49.9	71.1	71.0

Source: Company reports; Edison Investment Research

Contact details	Revenue by geography
Jays Close Viables Basingstoke Hampshire. RG22 4BS United Kingdom Phone 01256 605000 www.delarue.com	

Management team

Chairman: Philip Rogerson	Chief executive officer: Martin Sutherland
Philip was formerly chairman of Aggreko and Carillion. He was an executive director of BG (formerly British Gas) from 1992 to 1998, latterly as deputy chairman. Today he is also chairman of Bunzl. He is a non-executive director at Blancco Technology Group and chairman of the advisory board of the North and East London Commissioning Support Unit of the NHS.	Martin joined De La Rue from BAE Systems Applied Intelligence, where he was managing director since its acquisition by BAE Systems in 2008. At BAE Systems Applied Intelligence (formerly Detica), Martin was responsible for the strategic expansion of the business internationally through both organic growth and acquisitions. Prior to joining Detica in 1996, Martin worked for Andersen Consulting (now Accenture) and British Telecom.
Chief financial officer: Helen Willis	**General counsel and company secretary: Edward Peppiatt**
Helen joined De La Rue as interim chief financial officer on 16 April 2018. Helen was appointed as chief financial officer on 19 July 2018 and became a member of the board on 26 July 2018. Helen is a qualified accountant and has a wealth of finance experience, most recently with Premier Farnell, where she held the positions of chief financial officer and director of financial operations between 2014 and 2017, until its acquisition by US parts distributor Avnet in 2017. Her previous experience spans a number of senior finance roles in international manufacturing environments including, among others, AZ Electronic Materials.	Edward has many years of experience as a general counsel and company secretary in publicly quoted businesses and his past roles have included responsibility for risk, security, insurance, HSE and HR. He was previously general counsel and corporate secretary of Christian Salvesen and prior to that practised as a corporate lawyer at Stephenson Harwood. He is a qualified solicitor and holds an MBA from Cranfield School of Management.

Principal shareholders	(%)
Brandes Investment Partners	9.49
Aberforth Partners LLP	6.64
Crystal Amber	5.43
Majedie Asset Management	5.41
Royal London Asset Mangement	5.10
Neptune Investment Management	5.06

Companies named in this report

Safran (SAF FP), Thales (HO FP), Crane Co (CR US)

EDISON

General disclaimer and copyright

Australia

New Zealand

United Kingdom

United States

Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
295 Madison Avenue, 18th Floor
10017, New York
US

Sydney +61 (0)2 8249 8342
Level 4, Office 1205
95 Pitt Street, Sydney
NSW 2000, Australia