EDISON

Treatt

H119 results

A good start to the year

Food & beverages

Treatt has delivered another period of strong revenue and profit growth, demonstrating its transformation from a trading house to a provider of value-added, technical flavour and fragrance solutions. Its key categories of citrus, tea and sugar-reduction continue to drive profit growth. After a few years of increasing raw material costs, Treatt is experiencing some falling prices, particularly in citrus. Citrus represents c 50% of company revenues – and Treatt's historical area of expertise – and falling raw material prices tend to result in selling price deflation. Crucially, they do not necessarily result in a fall in profits, as due to timing of contracts, the fall in raw material costs is not always fully passed onto customers. We trim our FY19 and FY20 sales forecasts in light of raw material deflation, but we leave our profit forecasts broadly unchanged. Our fair value moves to 517p (from 510p) as we roll forward our DCF to commence in 2020.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
09/17	101.3	12.8	18.5	4.8	21.9	1.2
09/18	112.2	13.8	20.3	5.1	20.0	1.3
09/19e	113.8	14.0	18.1	5.1	22.4	1.3
09/20e	116.1	14.7	19.0	5.8	21.4	1.4

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

US expansion complete, UK relocation continues

The $14m expansion of the existing US facility was completed on schedule in March and will be fully operational in June. It brings significant additional capacity in non-citrus. The UK project is more complex; planning consent has been obtained, and construction is due to commence in the summer, with occupancy to begin in Q420.

Sweet spot in a niche

The resilience of Treatt's profits despite input cost deflation demonstrates how far the business has moved from its commoditised origins. Its key categories continue to be important drivers of both the top line and margin, but its other categories continue to grow, as witnessed by the natural fruit and vegetables category during H119. The company falls into a niche as it provides top-end innovation in beverages solutions, while also directly providing beverages ingredients. The majority of its products can be classified as natural or clean-label. Treatt's portfolio is well-suited to the current consumer trends of clean labels and more natural, better-for-you products.

Valuation: Fair value 517p

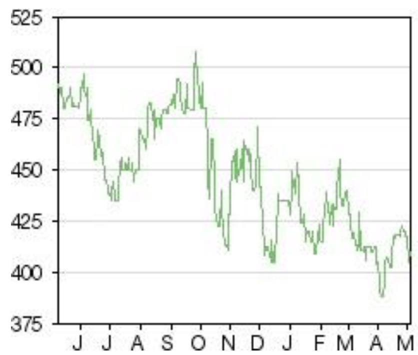
Our DCF-derived fair value is 517p/share (previously 510p; we have rolled forward our DCF to commence in 2020), c 27% upside to the current share price. Our DCF is supported by Treatt's benchmark valuation, with the shares trading at 22.4x FY19 P/E and 16.4x EV/EBITDA, representing a 21% and 12% discount to the ingredients peer group, respectively.

7 May 2019

Price	406.50p
Market cap	£239m

Net cash (£m) at 31 March 2019	9.4
Shares in issue	59.1m
Free float	100%
Code	TET
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	3.8	(6.2)	(11.8)
Rel (local)	5.3	(6.0)	(8.1)
52-week high/low		508.00p	388.00p

Business description

Treatt provides innovative ingredient solutions from its manufacturing bases in Europe, North America and Africa, principally for the flavours and fragrance industries and multinational consumer goods companies, with particular emphasis on the beverage sector.

Next events

FY19 results	26 November 2019

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Edison profile page

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H119 results

H119 revenues were up 6% to £56.6m, profit before tax was up 7% on an adjusted basis to £6.2m, and adjusted EPS was down 2.7% to 8.35p (the fall is due to the 10% placing in December 2017 and the absence of a one-off US tax credit in the prior year). The key product categories of sugar reduction and tea both posted impressive sales growth, at 38% and 20%, respectively. Citrus – the largest key category – was down 2% in revenue terms due to the above-mentioned cyclical price weakness in some raw materials; however, profits in the category increased by 6%, in part due to favourable product mix. All product categories performed well, including the range of natural, fruit and vegetable extracts, which are used to give a fresh, authentic flavour in premium beverages. Sales of high-impact flavour chemicals outperformed management's expectations during the period, and were up an impressive 18% vs the prior year.

During H119, the group continued to experience growth in key strategic markets, with US revenues up 3% at constant currency (the US now represents 38% of group revenue). China grew by 8% at constant currency as Treatt's strategy gains traction, and now accounts for 6% of group revenue.

Net cash stood at £9.4m at the end of H119, and during H219 the business is likely to experience the usual seasonal cash inflow as working capital positions unwind. The cost of the UK relocation, however, will counter this. We currently forecast £22m of expenditure on these two projects in FY19, and we forecast year-end net debt of c £3m. Treatt holds a relatively high inventory position, but this helps it counter any sudden or seasonal fluctuations in its raw material costs. Its free cash flow yield stands at a healthy 5%.

Forecast revisions

We detail our key changes to P&L forecasts in Exhibit 1 below. Our sales forecasts move down by 2–4%, as we expect weakness in citrus pricing to weigh on Treatt's selling prices. We expect this to be more of a H2 phenomenon in FY19 and hence have a greater impact in FY20. This has also caused an increase in our gross and operating margin assumptions, as we expect Treatt to improve its profitability on some older contracts, while maintaining its margins on the newer contracts (effectively passing on the cost benefit). This is in contrast to a commoditised business, whereby a reduction in raw material costs would likely result in an immediate reduction in prices, and at a constant margin it would cause a reduction in absolute profits. During H119 Treatt also witnessed a positive impact due to product mix in citrus, which also helped improve margins. We expect this to continue.

We note that citrus is Treatt's historical area of expertise, and in its over 130-year history, the company has experienced many citrus pricing cycles, thus it should be well-placed to deal with the latest trends.

Our FY19EPS forecasts move as the remaining Kenyan assets are now loss-making following the Earthoil disposal. There has been a goodwill impairment to reflect this, and they are now being classified as assets held for sale as management has decided to dispose of them.

Exhibit 1: Old vs new key P&L forecasts

	EPS (p)*			PBT* (£000s)			Revenue (£000s)		
	Old	New	% change	Old	New	% change	Old	New	% change
2019e	17.0	15.1	-11.1%	13,088	13,064	-0.2%	116,089	113,845	-1.9%
2020e	17.7	17.2	-3.0%	13,667	13,614	-0.4%	120,732	116,122	-3.8%
2021e	18.7	18.3	-2.2%	14,410	14,477	0.5%	125,562	120,767	-3.8%

Source: Edison Investment Research. Note: *Stated on company normalised basis, which is pre-exceptional but after amortisation of acquired intangibles and share-based payments.

Valuation

We illustrate Treatt's relative valuation versus its ingredients peer group in Exhibit 2 below. Treatt trades at a discount to its peer group on both a P/E and an EV/EBITDA basis. We believe some discount is justified to reflect its small size and because some of its products are relatively 'upstream' in the ingredients spectrum, particularly the bulk ingredients that are sold to other ingredients companies.

Exhibit 2: Comparative valuation

	Market cap (m)	P/E (x)		EV/EBITDA (x)		Dividend yield (%)	
		2019e	2020e	2019e	2020e	2019e	2020e
Givaudan	CHF24,355	29.4	27.1	20.6	19.1	2.4	2.5
IFF	$14,696	21.7	19.5	16.3	14.8	2.0	2.1
Symrise	CHF11,575	33.9	29.7	18.0	16.3	1.2	1.3
Chr Hansen	DKK91,429	46.9	41.6	30.8	27.7	1.5	1.8
Kerry	€17,561	25.6	23.5	18.5	17.2	0.8	0.9
Ingredion	$6,147	13.1	12.2	7.9	7.6	2.6	2.8
Peer group average		**28.4**	**25.6**	**18.7**	**17.1**	**1.8**	**1.9**
Treatt	£230.7	22.4	21.4	16.4	13.9	1.3	1.4
Premium/(discount) to peer group (%)		**(21.1%)**	**(16.4%)**	**(12.3%)**	**(18.8%)**	**(28.5%)**	**(24.3%)**

Source: Refinitiv, Edison Investment Research. Note: Prices as of 3 May 2019.

Our DCF-derived fair value is 517p (previously 510p). We have rolled over our DCF to commence in 2020, given we are more than halfway through 2019. Our longer-term sales growth forecast remains at 5.0% pa, falling to 2% growth in perpetuity. Our DCF is calculated based on a WACC of 6.9% (encompassing a beta of 0.8, an equity risk premium of 5.0% and a borrowing spread of 5.0%) and a terminal growth rate of 2%.

Exhibit 3: Financial summary

	£000's	2016	2017	2018	2019e	2020e	2021e
Year end September		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS							
Revenue		88,040	101,250	112,163	113,845	116,122	120,767
Cost of Sales		(67,639)	(75,985)	(84,407)	(86,015)	(87,270)	(90,520)
Gross Profit		20,401	25,265	27,756	27,831	28,852	30,248
EBITDA		11,604	15,049	16,627	15,654	18,429	19,366
Operating Profit (before amort., except and sbp.)		10,257	13,650	15,108	13,977	14,835	15,695
Intangible Amortisation		(142)	(137)	(124)	0	0	0
Share based payments		(566)	(966)	(1,040)	(962)	(1,095)	(1,165)
Other		0	0	0	0	0	0
Operating Profit		9,549	12,547	13,944	13,015	13,739	14,531
Net Interest		(703)	(851)	(1,302)	50	(125)	(54)
Exceptionals		(553)	0	(1,105)	(825)	0	0
Profit Before Tax (norm)		9,554	12,799	13,806	14,026	14,710	15,641
Profit Before Tax (FRS 3)		8,293	11,696	11,537	12,239	13,614	14,477
Profit Before Tax (company)		8,846	11,696	12,642	13,064	13,614	14,477
Tax		(2,144)	(3,129)	(2,284)	(3,331)	(3,472)	(3,692)
Profit After Tax (norm)		7,410	9,670	11,522	10,695	11,238	11,950
Profit After Tax (FRS 3)		6,149	8,567	9,253	8,908	10,143	10,785
Discontinued operations		0	978	2,976	(1,800)	0	0
Average Number of Shares Outstanding (m)		51.9	52.2	56.8	59.1	59.1	59.1
EPS - normalised (p)		14.3	18.5	20.3	18.1	19.0	20.2
EPS - normalised & fully diluted (p)		14.1	17.9	19.8	17.9	18.8	20.0
EPS - (IFRS) (p)		11.8	16.4	21.5	15.1	17.2	18.3
Dividend per share (p)		4.4	4.8	5.1	5.1	5.8	6.2
Gross Margin (%)		23.2	25.0	24.7	24.4	24.8	25.0
EBITDA Margin (%)		13.2	14.9	14.8	13.8	15.9	16.0
Operating Margin (before GW and except.) (%)		11.7	13.5	13.5	12.3	12.8	13.0
BALANCE SHEET							
Fixed Assets		16,161	19,532	21,863	42,888	54,036	48,677
Intangible Assets		3,364	3,331	752	752	752	752
Tangible Assets		11,361	14,821	20,038	41,063	52,211	46,852
Investments		1,436	1,380	1,073	1,073	1,073	1,073
Current Assets		54,435	68,230	102,401	101,782	102,262	104,577
Stocks		29,990	42,878	39,642	40,009	40,577	41,958
Debtors		17,853	19,973	28,828	29,033	29,381	30,315
Cash		6,588	4,748	32,304	32,304	32,304	32,304
Other		4	631	1,627	436	0	0
Current Liabilities		(16,388)	(27,003)	(35,781)	(39,897)	(42,504)	(34,941)
Creditors		(15,834)	(19,266)	(16,479)	(16,290)	(16,035)	(16,073)
Short term borrowings		(487)	(7,680)	(19,244)	(23,607)	(26,469)	(18,868)
Provisions		(67)	(57)	(58)	0	0	0
Long Term Liabilities		(17,021)	(14,281)	(6,858)	(16,460)	(17,691)	(13,691)
Long term borrowings		(7,755)	(7,293)	(3,001)	(11,803)	(13,234)	(9,434)
Other long term liabilities		(9,266)	(6,988)	(3,857)	(4,657)	(4,457)	(4,257)
Net Assets		37,187	46,478	81,625	88,312	96,102	104,622
CASH FLOW							
Operating Cash Flow		10,804	4,683	3,580	15,050	17,057	16,889
Net Interest		(703)	(913)	(609)	50	(125)	(54)
Tax		(2,022)	(2,822)	(2,978)	(3,331)	(3,472)	(3,692)
Capex		(679)	(5,111)	(6,190)	(23,138)	(14,742)	1,688
Acquisitions/disposals		(861)	(1,667)	8,357	1,100	0	0
Financing		280	270	21,090	0	0	0
Dividends		(2,095)	(3,025)	(2,876)	(2,895)	(3,012)	(3,430)
Net Cash Flow		4,724	(8,585)	20,374	(13,165)	(4,293)	11,402
Opening net debt/(cash)		6,155	1,654	10,225	(10,059)	3,106	7,399
HP finance leases initiated		0	0	0	0	0	0
Other		(223)	14	(90)	0	0	0
Closing net debt/(cash)		1,654	10,225	(10,059)	3,106	7,399	(4,003)

Source: Treatt accounts, Edison Investment Research

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