EDISON

ArborGen Holdings

H221 update

US sales slow in H221, positive outlook remains

Basic materials

ArborGen's underlying H1 trading performance was robust, although the H2 US selling season has been slower than previously anticipated. Our headline FY21 PBT estimate is reduced by c 1% (or c 30% underlying before COVID-19 employment support monies) with no material change for FY22. An increase in supply of higher-value seedlings in the US remains on track and is expected to drive group earnings higher from FY22.

Year end	Revenue (US$m)	EBITDA** (US$m)	PBT* (US$m)	EPS* (c)	P/E (x)	EV/EBITDA** (x)
03/19	49.1	4.6	4.7	1.0	11.5	14.8
03/20	56.9	7.7	6.0	1.4	8.4	11.5
03/21e	54.7	7.1	9.4	2.0	6.1	12.2
03/22e	65.3	12.1	12.3	2.5	4.9	6.9

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles and exceptional items. No tax charge is anticipated in our estimates. **US GAAP after central (NZ plc) costs, before exceptional items.

Robust performance in seasonally smaller H1

ArborGen's NZ and Brazilian regional operations are the main revenue generators for the group in H1 and both faced local challenges in the period. The impact was limited to a US$0.3m (10%) y-o-y reduction in reported gross profit. After good control of opex and central costs, the US GAAP EBITDA loss actually reduced by US$0.7m to US$2.8m. This loss was almost offset by government funding grants (chiefly in the US) triggered by the coronavirus outbreak; after all items NZ IFRS PBT showed a good increase on H120. Net cash outflow was modest for the first six months, leaving core net bank debt at US$30m, broadly unchanged from FY20.

Near-term conditions constrain US sales in FY21

The key US selling season started well with c 90% of targeted sales confirmed with H121 results in November, including a strong position for higher-value seedlings. Since then, sales progress appears to have been sluggish partly due to reasons flagged at that time, but also constrained migrant planting labour availability from restricted travel conditions. Company US revenue guidance is now at 95% of its previous forecast levels. Factoring in weaker real translation effects also, our FY21 PBT estimate is lower by c 30% in underlying terms but only c 1% at the headline (normalised) level including COVID-19 related government grant income. With no material FY22 PBT changes and FY23 added, our estimates show a rising profile, driven chiefly by the increasing availability of higher-value seedlings in the US. We expect core net debt to trend down to c 0.8x EBITDA by end FY23.

Valuation: Large NAV discount, low earnings multiple

ArborGen's share price rallied from year lows following the H121 results and settled back a little after the company's latest update. The NZ$0.17 share price is a c 60% discount to the company's latest published NAV (US$0.30, NZ$0.41) and gives a P/E of just 4.9x for FY22. This rating does not appear to acknowledge ArborGen's well-established and leading position in its markets, which are sizeable in global terms, nor the expected increase in sales of higher-value seedlings in its main US market. Our updated DCF generates an equity value of c NZ$0.54 per share.

21 January 2021

Price	**NZ$0.17**
Market cap	**NZ$85m**

US$0.72/NZ$

Core net debt (US$m) at end September 2020	30.3
Shares in issue	499.6m
Free float	53%
Code	ARB
Primary exchange	NZX
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	15.9	21.7	(11.1)
Rel (local)	14.1	17.4	(16.7)
52-week high/low		NZ$0.2	NZ$0.1

Business description

ArborGen is an NZX-listed investment company and is the world's largest integrated developer, commercial manufacturer and supplier of advanced forestry seedlings with operations in the US, Brazil and Australasia.

Next events

FY21 year end	March 2021

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Edison profile page

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H121 results overview

In our view, the effects of lower revenue in H121 were very well managed with limited impact at the gross profit level and good underlying opex cost containment, which meant that the US GAAP loss actually reduced year-on-year. Similarly, ArborGen was cash flow neutral in H1 – its seasonally weaker trading period – partly aided by US COVID-19 support funding in the period.

Exhibit 1: ArborGen interim splits

Year end 31 March, US$m	H120	H220	FY20	H121	%change y-o-y
Group revenue	**14.2**	**42.7**	**56.9**	**11.9**	**-16.2%**
North America	0.9	37.8	**38.7**	0.1	-88.9%
Australasia	9.7	0.6	**10.3**	9.0	-7.2%
South America	3.6	4.3	**7.9**	2.8	-22.2%
Gross profit (Group/reported)	**3.0**	**16.7**	**19.7**	**2.7**	**-10.0%**
Group EBITDA – US GAAP (after central costs)	(3.5)	11.2	**7.7**	(2.8)	-18.6%
R&D – capitalised	1.9	2.2	**4.1**	1.8	
IFRS 16 adjustments	0.3	0.8	**1.1**	0.7	
Other*	(0.3)	(0.1)	**(0.4)**	2.4	
Chg in FV of biological assets	6.5	(7.1)	**(0.6)**	6.8	
Group EBITDA – NZ IFRS (after central costs)	4.9	7.0	**11.9**	8.9	80.7%
Depreciation – owned assets	(1.0)	(1.8)	**(2.8)**	(0.8)	
Depreciation IFRS 16	(0.4)	(0.4)	**(0.8)**	(0.5)	
Group Operating Profit**	**3.5**	**4.8**	**8.3**	**7.5**	**114.4%**
Gross margin %	21.1%	39.1%	**38.8%**	22.7%	
EBITDA margin % – US GAAP	-24.6%	26.2%	**13.5%**	-23.9%	
EBITDA margin % – NZ IFRS	-34.5%	16.4%	**20.9%**	74.4%	

Source: ArborGen Holdings. *H121 Other refers to net government receipts principally under the US Paycheck Protection Programme. **Before amortisation costs and FY20 exceptional items.

The importance of regional exposure and seasonality: The geographic splits shown in Exhibit 1 show that ArborGen's most important operating territory – the US – has a selling season that falls almost entirely in the second half of the company's financial year. For the other regions, Australasian sales are strongly H1 biased, while Brazil typically has a more even split across the year. Leading up to selling seasons, seed orchard and nursery operations are incurring operating costs without the associated revenues. As a consequence, this regional sales seasonality at a group level generates a US GAAP EBITDA loss in the first half, ie gross profit contributions generated in NZ and Brazil are exceeded by US seed sowing, nursery operations and opex costs. This is however more than made up in H2 as the stronger US profit generating (uplifting and selling) period feeds in.

The main differences compared to NZ IFRS EBITDA – which shows positive profitability in both half years – is the add back of R&D costs (expensed under US GAAP but capitalised under NZ IFRS) and the recognition of changes in the fair value of biological assets (attributing a value to the growth of US nursery seedlings in H1 prior to sale, reversing this when actual sales are realised in H2). Any mismatch between the H1 valuation and H2 reversal is usually attributed to selling price differences, ie proceeds versus expectations and/or adjustments to inventory on hand at the year end.

Australasia: ArborGen has had a significant presence in **New Zealand**'s North and South Islands for some time, a market with annual tree planting around the 50 million level (though not all of this is radiata pine). Harvesting and reforestation activities in NZ are the core driver of ArborGen's Australasian seedling sales. An NZ government programme with a broad aim of doubling annual planting rates over a 10-year period began in January 2019 and resulted in incremental sales in FY20. While the programme is ongoing a change in the funding mechanism during 2019 (switching from contracting directly with nursery suppliers for seedlings to a scheme whereby the tree planters receive subsidies) slowed the pull through at nursery level. This had some impact in H1 (effectively

the key NZ selling period) partly mitigated by seedling mix improvement (ie the volume decline was in relatively lower-value open pollination seedlings). Revenue for the period was down c 7% y-o-y. The H1 period also included some wider industry COVID-19 disruption with temporary closures at port facilities for timber exports (for which South-East Asia, and China in particular, is a very important shipping destination) and some initial interruption to tree nursery activities. In **Australia**, ArborGen's nursery in Colac, west of Melbourne, VA, is understood to have sold out its entire stock of 2020 eucalyptus seedlings, and is expected to be at capacity for the foreseeable future. For FY22, ArborGen has flagged an expected 15% uplift in NZ seedling demand benefitting from carbon planting initiatives and increased reforestation; the associated planting has already been completed across the company's seven nurseries there (for sales commencing in April 2021). For the remainder of FY21, increased revenues from horticultural and quarantine services are also expected in H2.

South America: The Brazilian real depreciated rapidly against the US dollar between January and May this year, with the H121 average rate more than 20% weaker year-on-year. We believe that this partly explained the year-on-year drop in revenue shown in Exhibit 1 and understand local market disruptions arising from COVID-19 effects also affected tree planting operating efficiencies and, hence, eucaplytus seedling sales in H1. With ArborGen Brazil having increased in-house control over seedling cultivation through the previously announced leases of two eucalyptus nursery facilities (in October 2019 and April 2020) the associated COGS should have reduced. As well as pine and eucalyptus variants developed internally, ArborGen Brazil now has access to in-licenced genetically improved eucalyptus clones from International Paper, Gerdau (since 2018) and Vallourec (announced in November), which it can develop and commercialise. Taken together these steps suggest a co-ordinated commercial strategy that is coming together to improve the market penetration of advanced genetics seedlings in the Brazilian eucalyptus forestry industry, an important supplier to the pulp, paper and steel producers located there. In the near term, ArborGen has flagged a significant increase in expected seedling shipments in H221, aiming to achieve 60m eucalyptus seedling sales in this financial year (in line with FY20).

North America: As described earlier, negligible sales are generated in the US in the first half of ArborGen's financial year, so the year-on-year revenue change in Exhibit 1 is not of concern. Operationally, the usual seed sowing and cultivation activities continued across ArborGen's eight nurseries across south-east US in H1; with some changes in working practices and to protect employment, the company participated in the US government's COVID-19 related Paycheck Protection Programme (PPP), receiving c US$2.4m of net support funding (shown as Other in Exhibit 1 for H121).

We estimate that around one-quarter of ArborGen's overall annual US seedling sales are currently from loblolly mass-controlled pollination (MCP) [1] produced seeds and varietal seedlings. These offer forestry owners superior growth, an increased proportion of higher value saw timber and other characteristics and are priced accordingly. ArborGen's core strategy is to increase the penetration of MCP sales across its customer base, while also noting that availability has been constrained by prior year extreme weather events including hurricane damage at one seed orchard in FY19. The latest cone harvest – producing seeds for sale as seedlings in FY22 – has seen a 'material increase' above the prior year, particularly in the coastal region. Furthermore, increasing maturity of extensive, younger orchards is expected to drive further annual MCP seed volume increases.

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[1] Seed orchards are established to produce seeds, which are subsequently sown in nursery conditions, cultivated into seedlings and then lifted and sold to forestry owners to coincide with their planting season. Achieving seed orchard tree maturity to the seed-bearing stage can take around seven years. Selection of the parent trees and the degree of control over the pollination process is critical to yielding seeds and seedlings with superior properties. Mass controlled pollination (MCP) selects parent trees with the best genetic characteristics and controls the fertilisation process by isolating tree flowers (through bagging) and introducing pollen from a known parent. This contrasts with open pollination, occurring naturally where the flowers are not isolated and the other pollen parent tree is not known.

Consequently, customer appetite for advanced seedlings together with this forthcoming increase in availability for sale is driving management confidence for strong growth in FY22 and an improving revenue profile in future years.

The US house construction market saw a significant increase in activity in 2020, especially in single family dwellings. This caused some lumber supply chain tightness and sharp price increases during the third quarter of the calendar year, but underlying log prices were more stable over this period. Nevertheless, as a longer-term indicator, we would expect sustained housing market growth over time to require increased forestry felling and an associated rise in replacement planting.

Stable net debt position at the end of H1

At the end of H121, ArborGen had c U$30m core net debt on hand, which was in line with the level at the beginning of the year. From a trading perspective, the government support receipts clearly benefited group EBIT/cash inflows in the period. There was also a small working capital inflow – similar to prior years with a larger inventory investment this year after a supply constrained H120 – while tangible fixed asset capex levels was in line with depreciation. ArborGen also had US$6.4m IFRS 16 leases on hand at the half year stage [increased due to nursery leases?], matched by right of use fixed assets on the balance sheet.

Cash flow outlook: We project a reduction in core net bank debt by the end of FY21 (to c US$27m) followed by further decreases in the subsequent two years. For the remainder of this year, the seasonal uplift in profitability driven by the US operations – albeit at lower levels than previously expected (see below) – is expected to more than fund a working capital outflow and other cash requirements. As a consequence, year-end core net debt:EBITDA should be below 2x on our estimates. In future periods, increased yields from the company's seed orchards should allow US operations to start to build some buffer inventory levels as an insurance against possible future weather disruption in order to maintain a steadily growing supply of higher-value seedlings into the local US markets. By the end of FY23 we project core net bank debt having fallen to around 0.8x the EBITDA generated in that year.

For the record, ArborGen recently announced (17 November) a renegotiated revolving credit facility with Synovus, extending its US$17m letter of credit facility by two years to August 2023 with some other favourable changes; the minimum annual borrowing cost is now 3.5%. Other banking facilities – being a head office mortgage, also with Synovus and a US$9.9m promissory note to May 2026 with AgSouth Farm Credit – are unchanged.

FY21e net PBT reduced, good growth thereafter

Our revised EBITDA estimate for the current year is now consistent with the company's January 2021 guidance (US GAAP basis US$10–11m before c US$1m central costs but including c US$2.4m government grants). In broad terms, our FY21 revision incorporates c US$10m lower revenue than before, with a c 30% drop-through effect at the underlying EBITDA level. FY22 changes made no material impact on expected PBT. We introduce FY23 estimates for the first time.

Exhibit 2: ArborGen estimate revisions

	EPS FD normalised (c)			PBT normalised (US$m)			EBITDA (US$m)*		
	Old	New	% chg.	Old	New	% chg.	Old	New	% chg.
FY21e	1.9	2.0	+5.2%	9.5	9.4	-1.1%	10.1	7.1	-29.7%
FY22e	2.4	2.5	+4.2%	12.2	12.3	+0.8%	12.5	12.1	-3.2%
FY23e	N/A	3.3	N/A	N/A	16.4	N/A	N/A	15.9	N/A

Source: Edison Investment Research. Note *US GAAP, after central costs (before FY21 government grants). Previous estimates were published in April 2020 and withdrawn in June 2020.

Note that the FY21 EBITDA reduction in Exhibit 2 is largely compensated for at the PBT level by the US government PPP payment referred to earlier and slightly lower expected interest costs. In FY22,

some marginal revenue reductions flowing through from a lower FY21 base in Brazil (partly activity levels, partly FX) are largely offset by a mix-driven better gross margin. Our FY23 estimates show a continuation of the progression achieved in the prior year, supported by an expectation of rising seed/seedling availability in the US. We do not currently factor in any dividend payments to our estimates nor has the company provided any guidance on this. With earnings expected to rise driving good cash generation and net debt reduction we would anticipate consideration of dividend payments during our estimate time horizon.

Conservatively rebased DCF generates per share value more than double current share price

Our DCF model (over 10 years – including the three years of estimates in this report - with 3% terminal value growth rate) has been updated and now aligned with the US volumes inferred in the FY20 Annual Report. The chief change is to a stable market share position rather than a growing one; this reduces our US volume projection by c 20% in year 10, but also with an improved mix. No other material changes have been made. Our modelled 10-year period generates a **c 11% revenue CAGR** (c 70% from rising average seedling selling prices due to mix effects and nominal inflation, c 30% from increased seedling volumes) with an **improving gross margin** (also due to mix). We have previously used a **10% WACC** and do so again here for comparability purposes (also noting that current market data produces an NZ WACC of c 8.5% and a US WACC of 7.2%).

On the above basis, our DCF produces a **gross[2] equity value of c US$200m** (or **US$0.39/ NZ$0.54 per share**). We note that this is c US$60m below the company's own illustration[3] (which used a WACC of 11% at that time) and we presume that this is due to us having lower margin inputs (feeding into lower profitability and cash generation). For completeness, investors should also be aware of two potential adjustments to this gross equity value. If one excluded public company central costs from the model – for example to appraise the operating entities alone – this would add c US$12m (or c US$0.03 per share) to the valuation. Also, outstanding warrants relating to ArborGen Inc if converted would result in the parent company's interest in its US subsidiary reducing to 95%.

We should point out that our new DCF valuation (our last published one was NZ$0.72 per share) is not directly a change of view on the company's prospects, rather a realignment with some high-level assumptions used and published by the company itself as part of a conservative review of the carrying value of goodwill, in line with best practice. With a leading proprietary position in advanced seedling development backed by seed orchard and nursery capacity, together with extensive market presence, it would be very surprising indeed if ArborGen was not able to gain market share over the next 10 years. Hence, we consider that investors should view the revised valuation as a conservative base level.

Even with the above assumptions, our DCF continues to indicate a group valuation well in excess of ArborGen's current share price (c NZ$0.17 or c US$0.12). With strong management confidence in the outlook for increasing yields of higher value US seeds and seedlings coupled with net debt at manageable levels and on a downward trajectory, ArborGen's share price is taking an unduly pessimistic view of the future in our view.

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[2] Whole company as currently constituted, after central costs but before warrant/share option dilution.

[3] FY20 Annual Report; p27 note 16 table.

Exhibit 3: Financial summary

	US$'ms	2017R	2018	2019	2020	2021e	2022e	2023e
March (from 2018 onwards)		15m to Sep	6m to March		IFRS16	IFRS16	IFRS16	IFRS16
PROFIT & LOSS								
Revenue		6	35.4	49.1	56.9	54.7	65.3	74.3
Cost of Sales		(4)	(19.4)	(30.3)	(34.8)	(32.0)	(37.2)	(41.9)
Gross Profit		2	16.0	18.8	22.1	22.7	28.2	32.4
EBITDA - US GAAP		(6)	6.0	4.6	7.7	7.1	12.1	15.9
EBITDA - NZ IFRS		(1)	6.2	9.8	11.1	14.2	17.0	21.0
Operating Profit (before GW and except.)		(2)	5.0	6.9	8.3	11.4	14.2	18.2
Intangible Amortisation - acquired		(-1)	(2.6)	(5.8)	(5.9)	(5.9)	(5.9)	(5.9)
Exceptionals		0	(1.4)	(3.6)	(3.9)	0.0	0.0	0.0
Associate		3	0	0	0	0	0	0
Operating Profit		0	1.0	(2.5)	(1.5)	5.5	8.3	12.3
Net Interest		(2)	(1.4)	(2.2)	(2.3)	(2.0)	(1.9)	(1.8)
Profit Before Tax (norm)		(1)	3.6	4.7	6.0	9.4	12.3	16.4
Profit Before Tax (statutory)		(2)	(0.4)	(4.7)	(3.8)	3.5	6.4	10.5
Tax		0	2.6	0.5	1.1	0.4	0.0	0.0
Minorities		0	0	0	(0)	(0)	0	0
Discontinued		(4)	0	(0.1)	0.0	0.0	0.0	0.0
Profit After Tax (norm)		(1)	6	5.2	7.1	9.8	12.3	16.4
Profit After Tax (statutory)		(6)	2	(4.2)	(2.7)	3.9	6.4	10.5
Average Number of Shares Outstanding (m)		425.0	487.9	496.9	497.8	499.5	499.6	499.6
EPS - normalised (US c)		(0.2)	1.3	1.0	1.4	2.0	2.5	3.3
EPS - statutory (US c)		(1.4)	0.5	(0.8)	(0.5)	0.8	1.3	2.1
Dividend per share (US c)		0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross Margin (%)		33.3	45.2	38.3	38.8	41.4	43.1	43.6
EBITDA Margin (%)		-16.7	17.5	20.0	19.5	25.9	26.1	28.3
Operating Margin (before GW and except.) (%)		-33.3	14.1	14.1	14.6	20.8	21.8	24.5
BALANCE SHEET								
Fixed Assets		187	156.0	152.3	155.0	151.7	149.5	147.6
Intangible Assets		125	106.7	105.6	103.8	102.0	100.6	99.5
Tangible Assets		62	43.3	42.7	49.2	49.7	48.9	48.1
Investments		0	6.0	4.0	2.0	0.0	0.0	0.0
Current Assets		81	57.8	41.7	45.7	48.9	59.5	73.9
Stocks		41	24.8	29.4	29.3	31.5	36.5	41.2
Debtors		9	10.0	9.1	10.5	12.1	14.9	17.5
Cash		31	23.0	3.2	5.9	5.4	8.1	15.2
Current Liabilities		(57)	(36.2)	(15.8)	(20.6)	(13.2)	(15.2)	(17.1)
Creditors		(38)	(20.4)	(15.0)	(14.3)	(13.2)	(15.2)	(17.1)
Short term borrowings		(19)	(15.8)	(0.8)	(6.3)	0.0	0.0	0.0
Long Term Liabilities		(51)	(26.2)	(30.6)	(38.2)	(40.1)	(40.1)	(40.1)
Long term borrowings		(45)	(22.8)	(16.5)	(31.2)	(32.8)	(32.8)	(32.8)
Other long term liabilities		(6)	(3.4)	(14.1)	(7.0)	(7.3)	(7.3)	(7.3)
Net Assets		160	151.4	147.6	141.9	147.3	153.7	164.2
CASH FLOW								
Operating Cash Flow		(3)	3.5	4.1	4.8	11.3	12.1	16.7
Net Interest		(4)	(1.4)	(2.1)	(2.5)	(2.0)	(1.9)	(1.8)
Tax		0	0	0	0	0	0	0
Capex		(5)	(3.0)	(6.6)	(9.3)	(6.3)	(6.5)	(6.7)
Acquisitions/disposals		66	0.9	(7.6)	0	0	0	0
Financing		12	0	0	0	0	0	0
Dividends		0	0	0	0	0	0	0
Net Cash Flow		66	0	(12.2)	(7.0)	3.0	3.7	8.2
Opening net debt/(cash)		65	33.0	9.6	9.8	29.6	27.4	24.7
HP finance leases initiated		0	0	0	(12.6)	(1.0)	(1.0)	(1.0)
Other		(34)	23.4	0	(0.2)	0	0	0
Closing net debt/(cash)		33	9.6	21.8	29.6	27.4	24.7	17.6
IFRS16 leases					5.7	6.4	6.4	6.4

Source: ArborGen Holdings, Edison Investment Research. Note: 2017R was restated to show discontinued operations separately. Significant other items in 2017R and 2018 cash flow relate to M&A activity associated with the disposed Tenon operations. *FY20 opening net debt has been restated to exclude IFRS 16 leases (which are now shown at projected year ends); the group's purchase of its US head office property in August 2019 moved this from a leased asset to an owned one.

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