Norcros plc

Strategy refresh targets growth accelerators

16 May 2024

Market sentiment is rapidly re-focusing on earnings potential in an improving economic cycle. Norcros' CMD was well-timed with this increasing willingness to consider mid-cycle earnings scenarios. With an essentially unchanged business and financial model, Norcros is targeting accelerators to boost organic growth in core bathroom and kitchen product groups to be supplemented by M&A activity. We can see a pathway to a higher valuation, but for now raise our fair value for the company to 257p per share.

Platform set for realising group potential

Norcros' 1 May CMD reiterated the company's four strategic pillars and added financial targets including organic, above market revenue growth and margin expansion. Leading market positions and scale at both company and group levels are the platform and new product development, sales channel cross-referrals and operational excellence are the key enablers. The targets are a natural extension from the current position in our view, with greater emphasis on bringing the wider benefits of group to individual company performance. We saw a committed and confident management team at both Board and operating company levels.

Strategy in action - exit from UK tile manufacturing

On 25 April, Norcros announced the proposed disposal of Johnson Tiles UK to the existing management team for an expected £1m (plus potential deferred consideration) with a related exceptional impairment charge of £15m. We have adjusted revenue estimates accordingly with profitability unchanged. This disposal has the impact of **increasing** the pro forma group EBIT margin by c.100bp and group ROCE by c.50bp. Both of which are positive steps towards the newly announced financial targets under the updated strategy referred to above.

Valuation: Increase in fair value, with potential for more

Norcros' share price is approaching our existing 233p per share fair value (DCF based on current estimates). Applying wider peer group average earnings multiples would suggest a valuation of c.400p per share; we believe that this broadly equates to FY29 EBITDA consistent with the company's strategic targets. However, given we are at the early stage of strategic execution and cyclical recovery with unchanged estimates, we have applied an average P/E rating for other sub-Midcap sector peers only: this generates an equivalent 280p Norcros share price. Taking a simple average of this and our DCF valuation suggests **a fair value of 257p per share**. We will re-appraise medium term DCF inputs when FY24 results are announced in June.

Summary financials

Year to March (£m)	2022	2023	2024E	2025E	2026E
Revenue	396.3	441.0	392.0	378.2	388.7
EBITDA - ED*	46.5	51.7	46.5	47.3	49.2
Pre-Tax Profit - company norm	**39.3**	**41.8**	**36.1**	**37.1**	**39.0**
EPS FD - company norm (p)	**38.2**	**37.4**	**30.8**	**31.6**	**33.2**
DPS (p)	**10.0**	**10.2**	**10.3**	**10.4**	**10.6**
Net cash / (debt) pre-IFRS16 basis	8.6	(49.9)	(37.3)	(25.3)	(15.0)
P/E (x)	*5.6*	*5.7*	*7.0*	*6.8*	*6.5*
EV/EBITDA (x)*	*3.6*	*4.7*	*4.9*	*4.6*	*4.2*
Dividend yield (%)	*4.7%*	*4.7%*	*4.8%*	*4.8%*	*4.9%*

*Source: Company Annual Reports, Equity Development. *pre-IFRS16, before pensions cash*

Company Data

EPIC	NXR
Price (last close)	215p
52 weeks Hi/Lo	217p/134p
Market cap	£193m
ED Fair Value / share	257p
Net (debt) FY24E	(£37m)
Avg. daily volume	61k

Share Price, p

Source: ADVFN

Description

Norcros is a leading B2B producer of branded bathroom and kitchen products in its UK/Ireland, South African and selected export markets.

The portfolio of ten operating companies (6 UK, 4 South Africa) is characterised by strong individual brands, together providing product breadth and channel diversity from a strong supply chain base.

Toby Thorrington (Analyst)
0207 065 2690
toby@equitydevelopment.co.uk

Andy Edmond
0207 065 2691
andy@equitydevelopment.co.uk

Overview: Leveraging scale at company and group level

At the FY23 results presentation, CEO Thomas Willcocks introduced an updated strategy framework for Norcros' founded upon **four pillars**:

- **Organic growth**, **Operational excellence**, **Portfolio development** and **ESG**

None of the above elements are distinctly different from what Norcros has done in the past but this represented a first step to formally outlining the strategic priorities of the new executive team. At a company CMD at the beginning of May, further detail was added including new financial targets. These are mostly a step up from previous levels, acknowledging that the group has a strong base already which can be enhanced further. We have summarised the strategy, financial targets and some expected enabling activity that is expected to be seen in the diagram below:

Norcros: mapping strategic pillars to medium term targets

Strategic Pillars	Actions	Targeted outcomes
	4. ESG	**Organic:**
1. Organic growth	• New product development • Sales channel cross-collaboration	Revenue growth +2-3% above market Operating margin of 15%
2. Operational excellence	• Scale benefits from shared processes	ROCE of 20%+ Cash conversion of 90%+

3. Portfolio development	• M&A
	• Existing addressable markets (£6bn)
	• Potential markets (+£10bn)
	• Adjacent product categories
	  • Eg: bathroom furniture, sanitaryware
	• Geographic expansion
	  • Eg: DACH, Nordics, Middle East
		Inorganic: Target companies with similar business/financial models and market characteristics to existing group companies with synergistic benefits.
		ESG: SBTi targets for 2028
		• 33.6% lower Scope 1& 2 emissions,
		• 20% reduction in Scope 3 emissions
		(versus FY23 base year)

Source: Equity Development.

Compared to the company's stated strategy previously, we make the following observations:

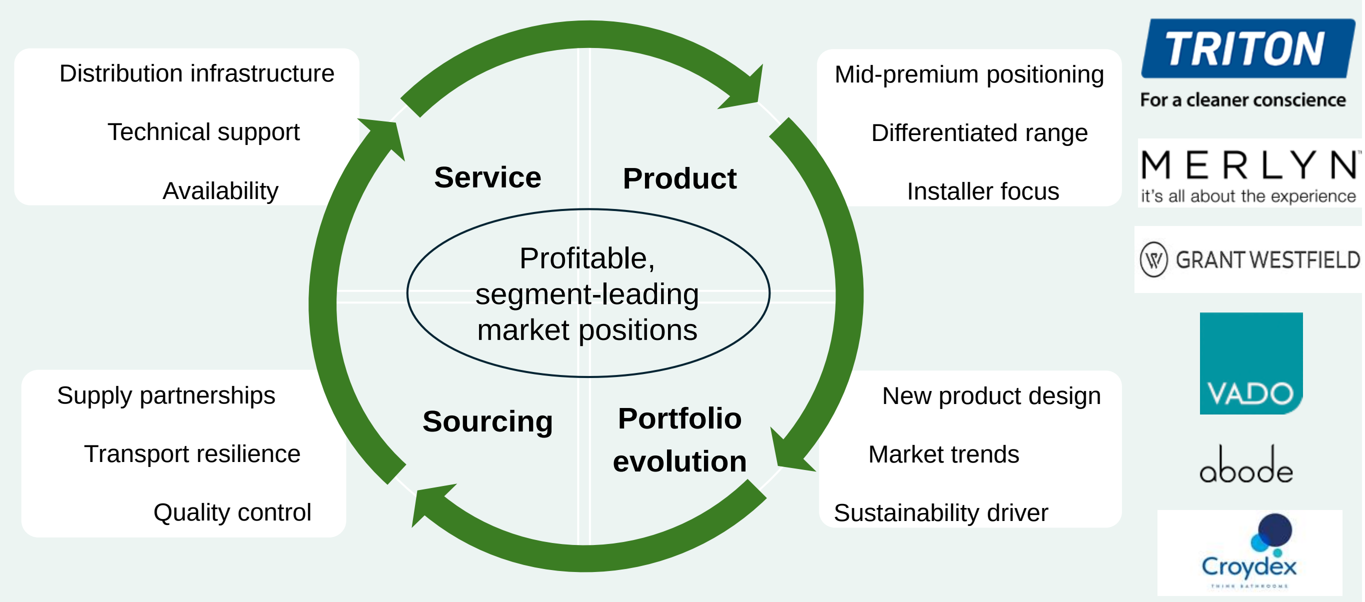
- **SBTi target set for first time**; Strategic and operational actions covering products and processes are to be viewed through an ESG lens as an input to decision-making (and, hence, is presented as a cross-discipline pillar as well as one with its own targets above)
- **Organic growth +2-3% above markets**; Norcros demonstrated business resilience around Covid19. Moving to market relative performance now is a sensible step away from specific revenue targets and clearly aims for market share growth.
- **Group EBIT margin 15%** (FY23 10.7%)
- **Sustainable Group ROCE >20%** (previously >15%)
- **Group cash conversion > 90%** (sustaining performance seen over most of last 10 years)

The following sections discuss each element of the strategy as outlined above and their potential implications for financial performance.

Organic opportunities: internal actions to drive profitability

We draw out some commonalities across Norcros group operating companies here to better understand a) the nature of business model strengths and b) how scale facilitates extending market positions. Norcros reports geographically as a two-divisional business each with an MD overseeing a number of operating companies (ie six in the UK and four in South Africa). The diagram below characterises the Norcros business model at individual company-level. This particularly applies to its UK companies and elements are also clearly present in South Africa though there are differences here referred to below.

Norcros: Company-level business model



Source: Equity Development.

Norcros group products are typically **mid-premium segment brands** and the important starting point in the diagram above is '**profitable, segment-leading market positions**.'

Profitability generates cash for reinvestment and a **scale presence in market channels** means that the potential volumes, revenues and returns on new product development are greater than for a smaller player. Hence, a successful active pipeline approach – and Norcros reported a **vitality index of 24%** in FY23 at group level (ie revenues generated from products introduced in the last three years as a proportion of the group total) – serves to reinforce and grow market positions, enrich product mix and profitability over time.

Scale economies also apply to costs and having a clear 'design for manufacture' focus permits group operating companies to leverage existing supply chain strengths, with scope to develop margins supporting our earlier returns point.

Sustainability and carbon footprint reduction are now everyday considerations in the wider building and construction industry. As associated auditing and reporting requirements become more onerous, having a very active new product development programme and strong supply chain partnerships is increasingly a source of competitive advantage.

South Africa – TAL Adhesives and Johnson Tiles SA (JTSA) are both fundamentally short supply chain local manufacturing operations and their strong market positions (number one and two respectively) share some of the above diagram characteristics. JTSA is also a significant sourcing/import business to supplement its in-house lines and therefore has similarities with Tile Africa (retail) and House of Plumbing (trade distribution). Ranges are curated and evolve through sourcing and supply chain partnerships - including other group companies. Having a network of stores and branches is a clear difference to UK operations.

Taking market share in fragmented markets

Although Norcros has leading positions in its segments and geographies, its aggregate shares in currently addressable UK and South African markets are understood to be c.15% and c.7% respectively. In results presentation material, management has stated that based on the existing product portfolio, **current addressable bathroom products markets** at manufacturer's selling prices are as follows:

- **UK: £1.9bn**
- **South Africa: £1.6bn**

The following table shows the absolute and relative market sizes for the product categories currently served as well as an indication of Norcros' UK operating companies' position within them.

Norcros: current addressable markets

Market segment	Value £m	FY23 rev Est. £m*	Norcros brand	Comments	
Existing - UK	**1900**	**247**			**1900**
Wall coverings	500	40	Multipanel (Grant Westfield)	Leading panel supplier (share c.20%)	500
Brassware	300	60	Vado, Abode	Very fragmented segment	300
Shower enclosures	300	58	Merlyn	Leading enclosure supplier (share <20%)	300
Showers	300	64	Triton	Leading shower supplier (electric: share c.50%)	300
Accessories	400	25	Croydex	Leading accessories supplier	400
Kitchen sinks	100	N/A	Vado		100
Existing - South Africa	**1640**	**145**			
Coverings	840	) 122	Johnson Tiles SA, Tile Africa	Second largest tile supplier	
Bathroom & plumbing	650	)	Tile Africa, House of Plumbing	Second largest retail & commercial supplier	
Fixing	150	23	TAL Adhesives	Leading supplier of adhesives, screeds (wall & floor)	

*Source: Company data *Equity Development estimates*

We do not have further detailed breakdowns so are unable to be more precise on sub-category splits between entry level/good, mid-market/better and premium/best. For example, the indicated Triton share appears to differ from that implied in the Value and Revenue columns above, but the comment is probably more reflective of the company's position in mid-premium electric showers as a sub-category. Also, Grant Westfield is a leading supplier of laminated panels which is now a smaller but faster growing product sub-group than tiles, which have historically dominated the bathroom wall coverings segment. Lastly, it should be noted that some Norcros company revenues and opportunities lie outside bathrooms. The most obvious example is Pronteau (Abode's multi-functioning hot water tap) which is a stated target growth segment and Multipanel designs (eg Naturepanel) are increasingly being used outside bathrooms.

The nature of competition varies in each of the above product categories; we believe that the shower category has a relatively more concentrated competitive profile, while brassware and accessories have fewer larger players. Nevertheless, **Norcros describes its market segments generally as fragmented** with opportunities to grow in each to varying degrees.

In a later section, discussing M&A targets, we outline what management believes to be the potential addressable market for Norcros – ie in product categories that its operating companies do not currently supply - subject of course to suitable opportunities to enter via acquisition arising.

Deepening customer relations through selling more product categories

Norcros' customer sales channel exposure has shifted over time and the UK/Ireland splits are currently:

- 64% Trade & specification
- 12% Export
- 14% Independent, specialist & online
- 10% Retail

Each UK group operating company has the potential to sell across channels as well as to multiple customers within them. The following chart from Norcros' CMD presentation shows the number of the UK division's top 20 customers supplied by each of its six operating companies:

Norcros: Matrix of organic cross-selling opportunities

	Customer 1	Customer 2	Customer 3	Customer 4	Customer 5	Customer 6	Customer 7	Customer 8	Customer 9	Customer 10	Customer 11	Customer 12	Customer 13	Customer 14	Customer 15	Customer 16	Customer 17	Customer 18	Customer 19	Customer 20
TRITON	●	●	●	●	●	●	●	●			●	●	●	●		●			●	
abode	●	●					●			●		●								
MERLYN	●	●	●		●			●										●	●	●
Croydex	●	●	●		●	●	●				●		●	●		●				
GRANT WESTFIELD			●		●		●	●	●		●									
VADO				●											●			●		

Source: Company

Picking out a few summary points:

- Triton has the highest penetration (supplying 14 of the top 20), while Vado has the lowest (at 3),
- A quarter of the top 20 customers source from four Norcros companies, three is the median number.

Simplistically, less than 40% of the spaces in that matrix are currently filled. We are unable to quantify the value of the vacant spaces and, realistically, all of them may not be filled over time. However, this still clearly demonstrates a scale opportunity to gain a bigger share of wallet with significant existing customers. It also indicates both diversity and positioning to 'win with the winners' supplying end customers who are themselves gaining market share. In context, management has stated that UK operations serve **over one thousand blue chip B2B customers**.

At the CMD, management gave examples of how UK companies had introduced others' product offer to their own customers with both Merlyn and Grant Westfield both highlighted for supported penetration of trade and retail customer accounts via introductions from other group companies. Merlyn is understood to have almost doubled revenues since acquisition by Norcros in 2017 partly as a result of these collaborations. Grant Westfield is newer to the Norcros portfolio (acquired in May 2022) but is already demonstrating a successful penetration of new accounts with existing group customers. This is particularly the case where new product launches have contributed to the process. While representing a significant opportunity, cross-selling to existing customers is not the only potential source of revenue growth. As customer channels evolve (eg emergence of online vendors), Norcros companies are well positioned to evolve their product and service offerings subject to appropriate customer market positioning and price points. Selectivity is a key discipline in growing revenues and margins in line with the group strategy.

Operational excellence: enhancing margins, improving service

The above section discusses, inter-company collaboration to generate revenue synergies from new product development and customer introductions. Norcros is keen to stress and retain the entrepreneurial nature of each of its operating companies as leading sector specialists best placed to address each of their respective product segments. While service is also a core market-facing discipline, supporting activities to achieve this – which we could crudely summarise as supply chain and administration – tend to be functions with more commonalities across businesses.

More explicitly, activities including transport, warehousing and distribution as well as HR, finance and IT all fall into our 'support service' categorisation.

Given that Norcros has acquired five of its six ongoing UK businesses (all since 2013) and recognising their product segment differences, it would not be surprising to learn of operational differences also. We are obviously aware of revenue collaborations and there have also been some purchasing synergies as well, but it is difficult to appraise how much additional integration has occurred under Norcros' ownership. By implication, there is more to go for under an operational excellence programme and we would expect geographic MDs to be leading this across their business clusters.

Operating company inventory requirements are essentially a function of supply chain length, manufacturing/assembly cycle and service proposition to end customers facilitated by fulfilment infrastructure in the form of warehousing and distribution strategies.

China has previously been identified as a significant sourcing region; Norcros has c.30 staff located there representing UK (ie Triton, Merlyn, Vado and Croydex) and South African operations, purchasing from over 120 local companies. Greater co-ordination between ordering cycles brings the opportunity to leverage scale and access better and potentially lower carbon freight rates as an important shipping customer. Any associated manufacturing/assembly benefits that could accrue from this would be generated at the operating company level, but subsequent finished product warehousing and distribution activities could potentially benefit from collaboration. As an example, having a distribution hub that holds inventory for more than one company could be an effective way to service customers who buy from more than one company which aligns with cross-selling referred to earlier.

The prize, then, is taking a holistic, collaborative view of each company's network in the context of others to yield supply chain and fulfilment efficiencies to both lower the cost to serve and improve service levels. While discrete steps can be taken here – witness Vado's consolidation of four warehouse facilities into one earlier this year – the greatest gains stand to be generated from a pathway to increased integration. Capital investment is available to facilitate such a programme with scale benefits and accelerated returns a benefit of being part of a larger group. This is not to say that the asset structure of, say, UK operations needs to change as a capital-light model has been flagged but rather that more effective ways to develop and manage assets are being sought.

On the tertiary side of the business, we would expect finance and budgeting cycles to be rapidly integrated into group reporting following acquisition. The extent to which they are part of fully end-to-end systems covering materials, production, distribution and customer information is likely to be more variable. The objective here over time would be to achieve this and generate faster and more detailed management and market information. Norcros has made clear that a group ERP system is not anticipated – again recognising operating company management autonomy – but, given other integration steps mentioned above, we would expect to see a degree of digital IT platform convergence. This is likely to take place within the natural lifecycle cadence of existing systems – meaning progression over time rather than a 'big' bang' evolution – but within a bigger picture template that facilitates operational integration over time.

Taking a step back, the actions outlined above (and the potential benefits thereof) are clearly going to be more available to Norcros as a group compared to single or narrower product range competitors. This is a further example of targeting scale economies with each operating company having access to organic growth capital to reinforce and extend already strong market positions. The same point applies to inorganic growth capital, and we now turn to M&A activity as a strategic pillar.

Portfolio development: accessing adjacent markets through M&A

Since its last CMD in April 2018, Norcros has added two further companies to its portfolio being House of Plumbing in South Africa (April 2019) and Grant Westfield in the UK (May 2022), following four others (ie Vado, Croydex, Abode and Merlyn) in the preceding five-year strategic period.

We believe that all of these companies have grown revenues since becoming part of the Norcros group, the best of these being Merlyn which is approaching twice its pre-acquisition size and we understand that this has not been at the expense of achieved margins.

We will return to low capital intensity, attractive returns and cash generation later, but all of these elements are visible within the Norcros group. The generation of capital for growth and access to a central M&A/business development resource process and template means that the company is well-positioned to identify and access acquisitions as opportunities arise to do so.

The M&A model is to acquire companies in the core bathroom and kitchen space that have comparable market position characteristics with profitable, capital light business models and potential synergies to drive above market growth. Norcros has frequently used a strategic jigsaw graphic to identify those product groups in its core areas that could be of potential M&A interest. The latest CMD materials went a step further by attaching values to potential addressable markets as shown in the table below.

Norcros: Adjacent product and extended geographic addressable market opportunities

Adjacent product segment	**Value**	**Region - extended markets**	**Value**	
	£m		**£bn**	
	c.2499		**17.2**	
Sanitaryware	545	Western Europe*	5.3	France, Italy, Spain, Portugal
Plumbing products	490	DACH*	5.2	Germany, Austria, Switzerland
Furniture	454	Eastern Europe	2.1	
Ventilation	355	Sub-Saharan Africa*	1.7	
Underfloor heating	210	Middle East*	1.5	UAE, Saudi Arabia, Qatar
Lighting	70	Nordics	1.4	Norway, Denmark, Sweden
Shower trays	65			
Decorative radiators	60	**current export markets*		
Other (existing markets, ex UK)	c.250			

Source: Company

It should be noted that Norcros already has a presence in some of the above markets either through range extensions in product adjacencies or exports into extended markets. Examples of these include Vado offering sourced sanitaryware products and recently launching its Cameo range representing an initial step into the furniture category. Rather than being standalone products, co-ordinated finishes across the range with more traditional product areas (ie taps, showering, wastes, handles) is clearly targeting a bigger share of a project's value.

Geographically, Vado has exported to the Middle East for an extended period and Grant Westfield has Germany as a stated export market. South African operations (largely tiles and adhesives) have also regularly sold into other African countries.

Accumulating commercial knowledge in other markets first hand through exports enables the Norcros group of operating companies to build relationships. This should have the twin effects of identifying accelerated growth opportunities through M&A and reducing the associated risk when doing so. Clearly, we are not in a position to pre-judge which of the product segments and/or markets Norcros may choose to acquire in next and any deal will have to be judged on its merits.

In this regard, as well as initial entry metrics, investors should also factor in the fit with Norcros' new targeted medium-term outcomes and assess the scope for potential group synergies in any financial appraisal of future transactions.

Similarly, we are unable to provide an ex-ante scale of future M&A activity though we do provide an indication of capacity based on cash generation illustrations in later sections.

Portfolio development actions: pruning and re-shaping

As well as making two acquisitions since the last CMD in 2018, **Norcros has also withdrawn from its UK adhesives and wall tile manufacturing activities** (via the closure of Norcros Adhesives in FY23 and expected disposal of Johnson Tiles UK in May respectively). Our take on these actions is that there wasn't a leadership scale position in adhesives and the capital and energy intensity in tile manufacturing did not fit with the broader group strategy. Taken together, exiting these complementary product groups within a relatively short time span is an understandable move. While this could mean that some revenue synergy for other group companies may be foregone in the short term, the retained business portfolio clearly has breadth and extensive ongoing market positions.

Lastly, whilst tiles are a material product segment in their own right, **Norcros retains a presence in the more broadly defined wallcoverings segment** through the fast-growing Grant Westfield's range of panelling products.

The indicated financial metrics announced around the **Johnson Tiles UK sale** are as follows:

- **P&L:**
  - FY23 revenue £35.3m, EBIT £0.5m
  - Non-recurring item – non-cash impairment: £15m (of £25m gross assets)
- **Balance sheet**
  - See non-cash asset impairment above
  - Tunstall site freehold retained
- **Cash flow**
  - JTUK is understood to have absorbed cash in each of the last three years though a full breakdown by line item is not available. We understand that JTUK's annual depreciation charge was c.£0.5m. Cash costs associated with the disposal are expected to be less than £1m (FY25).
  - Proceeds of £1m plus a modest potential earnout based on future equity value (unspecified), both payable in April 2028 (ie FY29).

Estimates adjusted for lower revenue, profitability unchanged

Our existing Norcros estimates included FY24 revenue of £30m (followed by £25m in the two subsequent years) and effectively no contribution to group EBIT. Adjusting for this, the transaction details above and the FY24 pre-close update, we make the following simple changes to our estimates ahead of the FY24 results announcement.

- **FY24:** P&L revenue nudged down to align with the year-end update, otherwise unchanged (and includes JTUK full year contribution), provisional balance sheet adjustments made based on disclosed information.
- **FY25 & FY26**: revenues reduced by £30m, no change to EBIT in either year.

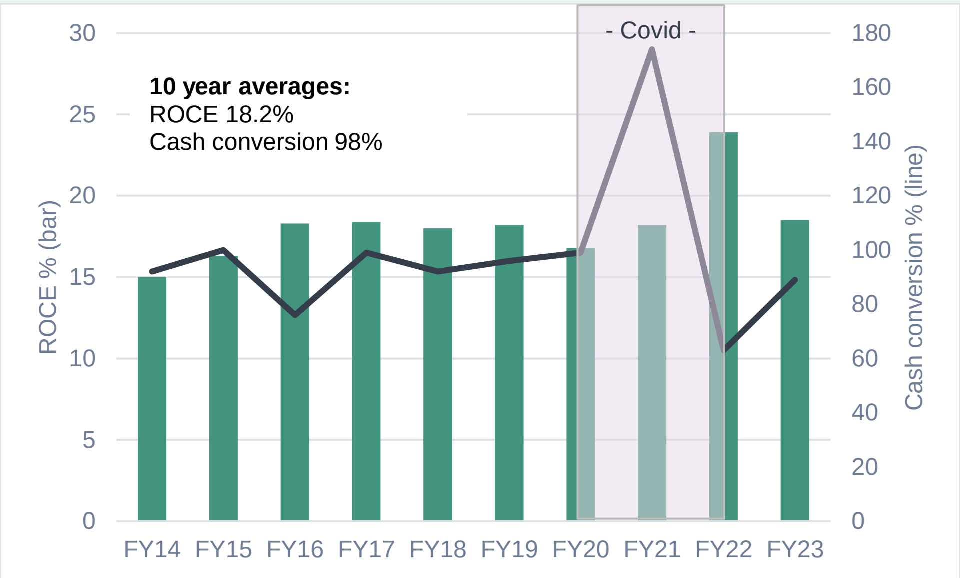
At this stage, as the disposal is to complete after the end of Norcros' financial year, it is unclear whether JTUK will be included within the FY24 results (as shown in our estimates) or treated as a discontinued business. Either way, we expect the full year trading contribution to be fully disclosed when FY24 preliminary results are reported on 13 June.

In summary, on our estimates the disposal of JTUK improves the UK margin by c.100bp and the group margin by c.70bp compared to reported FY23 results. Additionally, having exited the most fixed capital-intensive UK activity, we understand that the group ROCE be improvement will be c.50bp.

Improving returns on an evolving capital base

Norcros has reiterated its focus on 'capital light' businesses as part of its strategy. As regularly shown in the company's presentation materials, Norcros has been consistently cash generative[1] over an extended period with a group ROCE[2] typically at or above 15%. The following chart summarises the company's track record for these metrics over the last ten years.

Norcros: Cash conversion and ROCE – ten years track record



Source: Company data

Over the ten-year period shown above, group revenue increased by 2.01x, underlying operating profit[3] rose by 2.94x on an average underlying capital employed base that grew by 2.29x.

As reported at the time, the final quarter of FY20 was impacted by the initial Covid pandemic break out with a small negative impact on ROCE and cash conversion metrics. The bigger impacts were seen in the following two years, as the wider effects of lockdown became apparent, then superceded by an unprecedented demand for building materials products generally, requiring significant inventory build. While both years should be taken as exceptional, taken together the simple average ROCE of 21.1% and cash conversion of 119% reinforces the sense of overall **resilience in business performance and financial KPI metrics** over an extended period.

What is less apparent is the extent to which the company's balance sheet structure has also evolved over the same period of time. While acquisitions have changed the composition of capital employed other fixed and operational capital metrics can be seen to have been remarkably stable and consistent.

- **Low and reduced fixed capital intensity**
    - Gross capex has been in line with owned asset depreciation in aggregate over the ten-year period, although the value of owned fixed assets on the balance sheet has declined. Adjusting for the impairment of Johnson Tiles UK assets, we believe that Norcros has invested to maintain its capital base which – including acquisition effects – has effectively been held at or slightly above FY14 levels in underlying terms while revenues doubled by FY23.

[1] Company definition: cash conversion – Cash from operations (before exceptional and acquisition-related items and pension deficit recovery payments) as a percentage of underlying EBITDA (pre-IFRS16 basis).
[2] Company definition: ROCE – underlying operating profit on a pre-IFRS16 basis as a percentage of average capital employed at respective year ends.
[3] Company definition: underlying operating profit – EBIT before IAS 19R administrative expenses, acquisition-related costs and exceptional operating items.

- Fixed asset costs (defined here as owned asset depreciation and pre-IFRS16 basis principal plus interest lease costs) have declined from 4.4% of FY14 revenue to 2.6% by FY23. Hence, the absolute percentage is low in relation to activity levels and the direction of travel has been to reduce further.

Norcros' managed low fixed capital intensity in conjunction with rising profitability is a contributor to the strong ROCE metrics delivered. Note that Goodwill and Intangible assets in aggregate have risen from around a quarter of year end capital employed to just over half in the ten years to FY23. Taking this as a simple proxy for acquisitions made, it is clear that they have also contributed meaningfully to group ROCE averaging over 18% for this period overall compared to 15% when it began.

- **Operational capital requirements have moved broadly in line with revenues**
    - Trade working capital (defined as year-end inventory plus trade receivables less trade payables) as a percentage of revenue has been broadly stable at c.30% for the last seven or eight years. This indicates that during a period in which five acquisitions we made no major structural changes have occurred and working capital investment over time has been in line with revenue growth.
    - Inventory represents c.80% of trade working capital (the remainder being the net difference between trade receivables and trade payables) and finished goods represented 84% of end FY23 inventory, slightly above the long-term average.
    - Inventory turn (defined as year-end inventory compared to inventory costs expensed in that year) has been broadly stable since FY14, nudging up slightly to 2.2x by the end of FY23. (We recognise that acquisitions and seasonal effects will influence the true underlying calculation but take this as a reasonable proxy over time.)

Growing in line with revenue but slower than the increase in profitability means that operational capital control has also fed into improving group returns on capital.

On a pro forma basis, the 18.5% ROCE reported in FY23 would have been boosted by c.50bp by the disposal of Johnson Tiles UK as noted earlier. Organic revenue growth and margin expansion from new product development across the existing capital base are further sources of expected incremental ROCE improvement to take Norcros towards its 20%+ threshold as one of the company's medium-term targets.

It is expected that the Norcros capital light model will be sustained. In our view, attaining and maintaining ROCE above 20% will further depend further upon:

- **Operational excellence success** – we believe that marginal gains in fixed asset metrics are unlikely to make a material contribution to improved ROCE, though collaboration and co-investment (eg in warehousing) can be a facilitator. As noted above, inventory is the dominant trade working capital item; if actions taken can suppress cash absorption into inventory – or even release it – whilst at the same time improving customer service as revenue rises, this could be an important driver of a further uplift in ROCE.

- **Strong M&A performance** – maintaining M&A discipline, identifying complementary companies with similar business models and delivering synergistic growth post-acquisition is a formula that has worked well for Norcros.

  The scale required to meaningfully moved the ROCE dial has increased as the company has grown but the track record suggests that this can be achieved via multiple, individually digestible deals over time rather than transformational change deals. What is clear is that Norcros has the financial capacity to add to its business portfolio in this way subject to opportunities arising.

ESG: setting targets underpins other strategic actions

Having set a **Net Zero Carbon 2040 target and established new Science Based Targets initiative (SBTi) goals for 2028,** both have been validated in the first half of calendar 2024.

Our November initiation note highlighted that a significant proportion (ie 92%) of Norcros' attributed FY23 carbon emissions were derived from Scope 3 sources. This further breaks down as 30% from indirect upstream activities and 70% from the downstream value chain (dominated by purchased products/services and lifecycle use of sold products respectively).

While a relatively small contributor to calculated group figures overall, the **targeted c 34% reduction in Scope 1 and 2 emissions** can be derived from making further progress in process energy usage and fossil fuel reduction measures at local levels (including solar PV installations, low energy lighting and moving towards an electric vehicle fleet) as well as increasing the use of electricity from renewable sources. The disposal of Johnson Tiles UK will remove a significant energy consumer (with natural gas-fired tile kilns) from Norcros' calculations.

Product lifecycle usage is the largest contributor to group total and **Scope 3 emissions (where a 20% reduction by 2028 is targeted)**. Directly, we believe that this is likely to derive from Norcros' portfolio products concerned with water usage (ie Triton, Vado, Abode plus Tile Africa's retailing of similar products) and also energy usage (Triton again in electric showers and mini boiler units).

A recent report from the Future Homes Hub[4] focuses on water as a scarce resource and recommends a graduated certification and labelling regime with a pathway for progressively tightening Part G (Sanitation, hot water safety and water efficiency) Building Regulations. Water heating is understood to be the third most important factor in household energy consumption (behind climate control and kitchen appliances). Consequently, those companies which develop products with improved water and energy efficiency over time stand to gain market share in our view. (Indirectly, a decarbonisation of electricity grids would be beneficial in the long term for Norcros's product in use emissions metrics though this is obviously beyond the company's control.)

New product development can also be a route to increase the use of recycled materials (in products and packaging) and reduce upstream sourcing emissions. Supply chain partnerships are crucial in achieving this, engaging with strong suppliers who are both able to invest in their own business and processes and also provide auditable emissions data. The **increasing importance of Environmental Product Declarations (EPDs) and other certification** raises the reporting bar for sector participants. Triton's Envi digital shower and Grant Westfield's evolving Multipanel range are two industry-recognised examples of ESG-leading products in the Norcros portfolio.

Environmental considerations should now be embedded in products and organisational processes at all stages and, again, economies of scale should prove to be a relative benefit for larger leading players. For Norcros, **collaboration across its new product development and operational excellence programmes** are the conduits for addressing these challenges and the route in which the strategic targets of above market growth and increasing operating margins can be achieved in a sustainable manner.

The appointment of a new **Chief People Officer** towards the end of calendar 2023 signifies that the third of Norcros's 3P approach to ESG progression (the others being Planet and Products, addressed above) has been elevated in importance. For the same reason that operating systems will have varied across acquired companies, a specific programme to harmonise common elements of HR policy, while still recognising local differences seems eminently sensible. A deliberate planned benefit of taking a group overview will be to identify and develop talent pathways across rather than solely within operating companies.

[4] Water Ready_A report to inform HM Government-s roadmap for water efficient new homes.pdf (cdn-website.com)

Valuation: peer discounts and strategic upside

Since our last note covering the FY24 year-end update on 11 April 2024, Norcros' share price has risen by 22% (with approaching 80% of this occurring post the company's 1 May CMD event) Over the same time period, other companies in the UK-listed building materials space have also seen rising share prices. Updating valuations for our selected peers[5], **Norcros is still trading on significant forward multiple discounts** (calendar year basis 2024 and 2025), as follows:

- **P/E ratio c.40-50%**, **EV/EBITDA c.35-50%** (Group 2 peers = lower bound, Group 1 = upper bound)

Average peer group multiples generate an equivalent Norcros share price of c.420p on a P/E basis and c 390p on an EV/EBITDA basis.

We note that there are notable ratings differences between larger and smaller companies in our selected peer group, with the Midcap names more typically attracting mid-teens P/E multiples and EV/EBITDA multiples approaching or above 10x.

Our previously outlined DCF approach based on existing estimates yielded a 233p per share fair value. In the first instance, the recent share price move towards this level suggests that general market sentiment regarding an earnings recovery is firming. (When we initiated coverage, we noted an expectation that FY24 would represent a trough earnings year for Norcros, though general sector expectations were still clouded by uncertain interest rate cycle signals at the time.)

Given that we have made no material changes to estimates following the JTUK disposal there is accordingly no material change to our previous DCF calculation at this stage. In the following section, we illustrate some DCF-based valuation scenarios using inputs from Norcros' new medium-term targets.

Strategy consistent with £85m EBITDA by FY29 and a 400p share price

Using a Norcros share price around 400p (as derived above from applying sector average earnings multiples) we assess what the DCF inputs are required to achieve this and view them in the context of the company's new medium-term targets.

Taking FY29 as a reasonable, five-year medium-term timeframe, we estimate that a **400p DCF fair value** is equivalent to an EBITDA profile incorporating our existing FY25 and FY26 estimates followed by a linear increase to **a long term stable and sustainable £85m from year five onwards**.

Cross-checking this with illustrative revenue and EBIT margin combinations, £85m EBITDA by FY29 is consistent with a revenue CAGR of 5.5% (driving a c.£110m underlying uplift to c.£480m) and an EBIT margin of 15.9%. In the former case, we consider that a 5.5% revenue CAGR is a realistic target given that Norcros is aiming to outperform its markets by 2-3% per annum through organic growth. A 15.9% EBIT margin is a more aggressive assumption compared to the stated 15% medium term target. We believe that this would require a bigger skew towards UK earnings in order to achieve it.

Other revenue/margin combinations can be used as inputs to generate the same outcome of course, the trade-off being a faster top line CAGR/lower margin assumption or vice versa.

Against the central assumptions outlined above, we overlay the following pension observation:

- **DB pension funding** - if we exclude all additional cash contributions, this adds c.50p per share of value; if a buyout agreement was reached for example, any required cash contribution below £45m that removed the need for future cash contributions ought to be seen as value accretive.

[5] Group 1 (nearest peers): Howden Joinery, Stelrad, Volution & Group 2 (other building products manufacturers): Alumasc, Epwin, Eurocell, Genuit, Marshalls, Tyman

Our model will be reviewed fully following the FY24 results announcement in June. In the very short term, our sense is that materially faster growth assumptions would be premature from an economic perspective, and we should allow for momentum arising from strategic actions to gather pace. Revenue and margin steps towards the scenario outlined above will be closely watched and used to reinforce expectations that strategic targets can be delivered. In other words, a material increase in fair value per share naturally follows where mid-cycle earnings are seen as robust and significantly ahead of near-term levels.

Strategy implications for cash generation: scaling M&A potential

We now continue with the illustrative assumptions supporting a 400p per share DCF valuation to see the broader implications for group cash generation and capacity for M&A activity.

On our illustration, attaining £85m EBITDA by FY29, would suggest cumulative EBITDA in the order of £320m over the five-year period, which we adjust for:

- 90% cash conversion rate,
- Less: DB pension cash
- Less: Lease costs[6]
- Less: Tax at 25%
- Less: Capex (in line with depreciation)

Taking all of the above into account nets down to approximately £155m free cash flow (undiscounted).

If we then assumed that this was fully reinvested in M&A with acquisition entry multiples in the 7-8x EBITDA range, this would generate a further c.£20m-22m EBITDA[7]. This would be in addition to the base FY29 EBITDA of £85m and prior to taking into account any post-acquisition growth under Norcros' ownership.

This example is meant to serve as a very broad illustration of what could be achieved by Norcros' delivering its medium-term financial targets where the cash generated is invested to further accelerate earnings growth. There is clearly execution risk in both elements and scenario timing could have a significant impact on calculations, though we have not undertaken any further sensitivity analysis at this stage.

The balance sheet starting point for investors is end FY24 pre-IFRS16 net debt of c.£37m, equivalent to c.0.9x EBITDA. Norcros' existing funding arrangements include a committed £130m bank facility (and an uncommitted accordion of £70m) to October 2027. This provides funding visibility, potentially to the mid-point of the five-year horizon in the above example. It also gives management flexibility to make acquisitions during this period ahead of the full benefits of the medium-term strategy accruing backed by sound prospective cash metrics to pay down acquisition debt subsequently.

Cash generation provides Norcros with capital allocation flexibility. While we have focused on scaling the scope for M&A activity, investors may also wish to receive dividend growth. This is a reasonable expectation though the rate is likely to depend on which acquisition opportunities arise and when.

Management's clear objective is to generate and redeploy cash where it can produce attractive returns in line with the company's medium-term targets and perpetuate this cycle. Where the opportunities to invest are present in scale, a more moderate rate of dividend increase is a fair trade-off for building a bigger and stronger entity over time in our opinion.

[6] We factor in no bank interest costs in aggregate at this point as Norcros would effectively de-gear mid-way through the period.
[7] On a discounted basis, using the same M&A multiples, the incremental acquired EBITDA would be more like £10m-12m at current prices; this represents a similar percentage uplift compared to our FY24 estimates as in the undiscounted example shown above.

Financial Summary

Norcros: Income Statement											
Year end: March	**£m**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024E**	**2025E**	**2026E**
					IFRS16	IFRS16	IFRS16	IFRS16	IFRS16	IFRS16	IFRS16
Revenue		**271.2**	**300.1**	**331.0**	**342.0**	**324.2**	**396.3**	**441.0**	**392.0**	**378.2**	**388.7**
Gross Profit		99.5	109.7	124.2	124.5	118.4	140.8	169.3	150.5	145.2	149.2
EBITDA - pre IFRS16 & SBP		31.6	34.7	42.5	39.0	40.1	48.1	53.5	48.4	49.2	51.1
EBITDA - company		30.2	33.8	41.3	38.6	37.9	45.4	50.5	45.3	46.1	48.0
EBIT - company norm		**23.8**	**27.4**	**34.4**	**32.3**	**33.7**	**41.8**	**47.3**	**42.9**	**43.9**	**45.6**
Net Bank Interest		(0.9)	(1.1)	(1.8)	(1.6)	(1.5)	(0.8)	(3.7)	(5.0)	(5.0)	(4.8)
IFRS16 Interest		0.0	0.0	0.0	(1.9)	(1.7)	(1.7)	(1.8)	(1.8)	(1.8)	(1.8)
Other financial		(2.2)	(1.9)	(1.7)	(1.7)	(1.6)	(1.9)	(2.5)	(1.9)	(1.9)	(1.9)
Profit Before Tax (ED norm)*		**20.7**	**24.4**	**30.9**	**27.1**	**29.0**	**37.4**	**39.3**	**34.2**	**35.2**	**37.1**
Profit Before Tax (company norm)		**22.9**	**26.3**	**32.6**	**28.8**	**30.6**	**39.3**	**41.8**	**36.1**	**37.1**	**39.0**
Intangible Amortisation		(1.2)	(2.2)	(3.5)	(3.7)	(3.7)	(3.7)	(6.2)	(6.6)	(6.6)	(6.6)
Other Non-Underlying Items		(3.8)	(4.2)	(4.3)	(9.3)	(3.8)	(0.2)	(12.0)	(19.3)	(1.9)	(1.9)
Profit Before Tax (reported)		11.5	13.5	25.4	15.0	18.5	33.0	21.7	10.2	28.6	30.5
Tax		(3.0)	(3.6)	(6.0)	(4.1)	(3.5)	(7.3)	(4.9)	(8.2)	(8.5)	(8.9)
Other		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Profit After Tax (reported)		**8.5**	**9.9**	**19.4**	**10.9**	**15.0**	**25.7**	**16.8**	**2.0**	**20.2**	**21.6**
EPS FD - ED norm (p)		**24.4**	**26.8**	**29.6**	**26.1**	**29.6**	**35.9**	**34.6**	**28.7**	**29.5**	**31.1**
EPS FD - company norm (p)		**27.8**	**29.5**	**31.7**	**28.2**	**31.1**	**38.2**	**37.4**	**30.8**	**31.6**	**33.2**
EPS FD - reported (p)		**13.4**	**14.1**	**23.9**	**13.5**	**18.6**	**31.2**	**18.8**	**2.2**	**22.3**	**23.9**
Dividend per share (p)		**7.2**	**7.8**	**8.4**	**3.1**	**8.2**	**10.0**	**10.2**	**10.3**	**10.4**	**10.6**
Shares - Avge (m)		61.1	68.0	80.2	80.3	80.6	80.9	88.1	89.3	89.3	89.3
Shares - Period End (m)		61.7	80.2	80.9	80.6	80.8	81.0	89.3	89.3	89.3	89.3
Margins (%)											
Gross Profit		***36.7***	***36.5***	***37.5***	***36.4***	***36.5***	***35.5***	***38.4***	***38.4***	***38.4***	***38.4***
EBITDA - pre IFRS16 & SBP		*11.7*	*11.6*	*12.8*	*11.4*	*12.4*	*12.1*	*12.1*	*12.3*	*13.0*	*13.2*
EBITDA - company		*11.1*	*11.3*	*12.5*	*11.3*	*11.7*	*11.5*	*11.5*	*11.6*	*12.2*	*12.4*
EBIT company norm		***8.8***	***9.1***	***10.4***	***9.4***	***10.4***	***10.6***	***10.7***	***10.9***	***11.6***	***11.7***

Source: Company, Equity Development (ED). ED norm includes IAS19R administration & other financial costs

Norcros: Cash Flow Statement											
Year end: March	**£m**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024E**	**2025E**	**2026E**
					IFRS16	IFRS16	IFRS16	IFRS16	IFRS16	IFRS16	IFRS16
EBITDA pre IFRS16 & SBP		31.6	34.7	42.5	39.0	40.1	48.1	53.5	48.4	49.2	51.1
Change in working capital		(1.8)	(2.8)	(2.1)	(4.8)	21.8	(23.6)	(13.3)	3.2	0.6	(3.6)
Other		(4.3)	(8.4)	(5.1)	0.6	(1.9)	(1.2)	(2.5)	(2.9)	(0.7)	0.1
Operating Cash Flow		**25.5**	**23.5**	**35.3**	**34.8**	**60.0**	**23.3**	**37.7**	**48.7**	**49.1**	**47.6**
Tax paid		**(1.9)**	**(4.9)**	**(4.6)**	**(5.3)**	**(3.5)**	**(6.5)**	**(7.7)**	**(6.0)**	**(7.6)**	**(8.0)**
Investing Activities		**(10.7)**	**(66.8)**	**(7.6)**	**(14.0)**	**(2.8)**	**(5.4)**	**(84.3)**	**(7.8)**	**(8.0)**	**(8.0)**
Income from associates & JVs		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Tangible Fixed Assets purchased		(8.0)	(7.7)	(5.6)	(4.8)	(2.8)	(5.4)	(6.0)	(7.8)	(8.0)	(8.0)
Tangible Fixed Assets disposed		0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Intangibles		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Acquisition consideration		(2.7)	(59.1)	(2.1)	(9.2)	0.0	0.0	(78.3)	0.0	0.0	0.0
Disposal proceeds		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other business investments		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing Activities		**(5.1)**	**23.4**	**(9.3)**	**(15.1)**	**(7.2)**	**(16.2)**	**(1.2)**	**(21.3)**	**(21.4)**	**(21.3)**
Net finance income (cost)		(0.9)	(1.1)	(1.8)	(1.7)	(1.4)	(0.8)	(3.7)	(5.0)	(5.0)	(4.8)
IFRS16 interest		0.0	0.0	0.0	(1.8)	(1.8)	(1.7)	(1.8)	(1.8)	(1.8)	(1.8)
IFRS16 lease capital repayments		0.0	0.0	0.0	(3.8)	(4.3)	(4.7)	(4.6)	(4.6)	(4.6)	(4.6)
Equity Issued		0.0	30.1	(0.9)	(0.8)	0.3	0.1	18.1	(0.8)	(0.8)	(0.8)
Dividends paid		(4.2)	(5.0)	(6.4)	(7.0)	0.0	(9.1)	(9.2)	(9.1)	(9.2)	(9.3)
Other		0.0	(0.6)	(0.2)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Cash Flow		**7.9**	**(24.8)**	**13.8**	**0.4**	**46.5**	**(4.8)**	**(55.5)**	**13.6**	**12.1**	**10.3**
Opening cash/(net debt) pre IFRS16		**(32.5)**	**(23.2)**	**(47.1)**	**(35.0)**	**(36.4)**	**10.5**	**8.6**	**(49.9)**	**(37.3)**	**(25.3)**
Change in Net Cash		7.9	(24.8)	13.8	0.4	46.5	(4.8)	(55.5)	13.6	12.1	10.3
Other		1.4	0.9	(1.7)	(1.8)	0.4	2.9	(3.0)	(1.0)	0.0	0.0
Closing cash/(net debt) pre IFRS16		**(23.2)**	**(47.1)**	**(35.0)**	**(36.4)**	**10.5**	**8.6**	**(49.9)**	**(37.3)**	**(25.3)**	**(15.0)**
IFRS16 lease liabilities					**(25.1)**	**(24.2)**	**(24.0)**	**(24.7)**	**(22.3)**	**(22.3)**	**(22.3)**

Source: Company Equity Development

Norcros: Balance Sheet											
Year end: March	**£m**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024E**	**2025E**	**2026E**
					IFRS16	IFRS16	IFRS16	IFRS16	IFRS16	IFRS16	IFRS16
Non-Current Assets		**98.8**	**147.9**	**138.0**	**150.8**	**141.2**	**158.8**	**226.8**	**192.1**	**193.5**	**194.9**
Intangible Assets		44.8	98.9	94.9	96.5	93.6	90.3	167.1	145.8	139.2	132.6
Tangible Assets - Owned		43.0	45.0	42.3	29.0	28.0	29.0	24.8	10.7	14.8	18.6
Tangible Assets - RoU		0.0	0.0	0.0	20.6	19.6	19.9	20.0	17.9	17.9	17.9
Other Fixed Assets		11.0	4.0	0.8	4.7	0.0	19.6	14.9	17.7	21.7	25.9
Current Assets		**165.3**	**165.1**	**169.5**	**188.7**	**171.0**	**200.7**	**216.2**	**220.6**	**232.7**	**247.7**
Inventory		70.3	74.9	79.5	78.9	78.1	100.6	103.9	96.8	95.5	98.1
Trade Receivables		53.5	58.5	57.8	56.1	60.4	66.9	78.7	73.0	74.4	76.5
Other Debtors		74.3	5.9	5.0	6.4	4.2	5.8	4.6	8.9	8.9	8.9
Cash		37.5	25.8	27.2	47.3	28.3	27.4	29.0	41.9	53.9	64.2
Current Liabilities		**(105.7)**	**(89.8)**	**(85.1)**	**(79.2)**	**(104.1)**	**(110.8)**	**(112.7)**	**(94.0)**	**(98.2)**	**(104.0)**
Trade Payables		(42.6)	(41.1)	(44.6)	(41.2)	(49.5)	(56.6)	(50.8)	(38.2)	(38.8)	(39.9)
Other Creditors		(32.2)	(40.2)	(36.7)	(32.7)	(49.2)	(48.5)	(55.8)	(49.5)	(53.1)	(57.8)
IFRS16 Lease Liabilities					(5.2)	(5.4)	(5.7)	(6.1)	(6.3)	(6.3)	(6.3)
Short-term Debt		(30.9)	(8.5)	(3.8)	(0.1)	0.0	0.0	0.0	0.0	0.0	0.0
Non-Current Liabilities		**(101.8)**	**(118.6)**	**(96.7)**	**(155.9)**	**(59.7)**	**(48.4)**	**(119.9)**	**(117.5)**	**(116.6)**	**(115.8)**
Long-term Debt		(29.8)	(64.4)	(58.4)	(83.6)	(17.8)	(18.8)	(78.9)	(79.2)	(79.2)	(79.2)
IFRS16 Lease Liabilities					(19.9)	(18.8)	(18.3)	(18.6)	(16.0)	(16.0)	(16.0)
Other Long-term Liabilities		(72.0)	(54.2)	(38.3)	(52.4)	(23.1)	(11.3)	(22.4)	(22.3)	(21.4)	(20.6)
Net Assets		**56.6**	**104.6**	**125.7**	**104.4**	**148.4**	**200.3**	**210.4**	**201.2**	**211.4**	**222.9**

Source: Company Equity Development

Contacts

Andy Edmond
Direct: 020 7065 2691
Tel: 020 7065 2690
andy@equitydevelopment.co.uk

Hannah Crowe
Direct: 0207 065 2692
Tel: 0207 065 2690
hannah@equitydevelopment.co.uk

Equity Development Limited is regulated by the Financial Conduct Authority

Disclaimer

More information is available on our website www.equitydevelopment.co.uk

Equity Development, 2nd Floor, Park House,16-18 Finsbury Circus, London, EC2M 7EB

Contact: info@equitydevelopment.co.uk | 020 7065 2690