Strix Group PLC

Trading update / Completion of Billi acquisition

2 December 2022

Ongoing lockdowns in South China have impacted two of the Group's largest OEM customers during the busiest period of the year, delaying the shipment of products. Associated costs have increased as an additional warehouse has been retained to deal with future lockdowns. Uncertainty created by the war in Ukraine and its implications have also impacted wider demand across several key markets. Little improvement is anticipated ahead of H2 '23. The good news is that the completed acquisition of Billi strengthens the group's product portfolio, pushing it into new products, geographies, and commercial markets. We expect Billi to be modestly earnings accretive during FY23, with wide-ranging synergy benefits improving its impact further into FY24.

We have reduced our financial estimates across the board for FY22 and FY23, although we continue to feel that the shares remain modestly priced relative to both our cash flow expectations and its peers. The yield remains the highest of its listed peers, at 8.2% for FY22.

The trading update issued by Strix highlights the impact that Covid-19 related lockdowns in China are having on its key OEM customers. Two of the top five have witnessed major disruption, resulting in short-term factory closures, preventing Strix from shipping goods. In addition to the hit to revenues, costs increased as Strix has reinstated its secondary warehouse to secure future shipments. Timings of the lockdowns have been unfavourable, with little time to recover during the busiest period of the year. The uncertainty surrounding the challenging macroeconomic and political landscape in the Group's key markets continue to affect end demand, which we expect to continue into FY23.

Management continues to examine its cost base for efficiencies to ameliorate the pressure on the top-line. Costs have been at the forefront of management's thinking since mid-year, as employees leaving have not been replaced. Moving forward, the focus shifts in favour of a more selective marketing and investment spend on products deemed key to medium term growth prospects.

Strategic acquisition

Strix has completed the purchase of Billi on 1 December, following clearance of the Culligan/Waterlogic merger. The consideration amounted to £38m, which represents a proforma FY22 EBITDA multiple of just 4.6x and 0.95x FY22e revenues. The consideration was funded via a refunding of the existing RCF facility (£80m), a new acquisition-related term facility (£49m) and a share placing which raised £13m at 115p. We expect Billi initially to be modestly earnings accretive in FY23, then with a greater contribution anticipated as the benefits of Group-wide procurement, manufacturing efficiencies, a cross-fertilisation of the two product/customer bases emerge.

Even on new forecasts the shares appear too lowly rated

We have adjusted estimates to reflect the inclusion of Billi and the softer than anticipated trading within Kettle Controls, with revenues declining 5% in FY22 and adj. EPS -16.6%. Nevertheless, we anticipate that revenues and adj. EBITDA should increase by 19.9% and 9.7% on a three-year CAGR to FY24. We have also adjusted our dividend expectation, although at the current share price level this still implies a sector leading yield of 8.2% in the current year.

The share price currently stands at an all-time low. We have updated our DCF and various peer group comparison valuation models, which give a fair value of 188p/share. Our fair value represents a significant premium to the existing share price.

Company Data

EPIC	KETL
Price (last close)	80p
52 weeks Hi/Lo	315p/79p
Market cap	£173.9m
ED Fair Value / share	188p
Proforma net debt	£93.1m

Share Price, p

Source: *ADVFN*

Description

Strix Group PLC ("Strix") is a global leader in the design, manufacture and supply of kettle safety controls and other components and devices involving water heating and temperature control, steam management, and water filtration.

The Group has acquired Billi, comprising Billi Australia Pty Ltd, Billi New Zealand Ltd and Billi UK Ltd. Billi is a leading manufacturer and distributor of multifunctional taps.

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Chinese lockdowns and economic uncertainty

Trading update

The latest report highlights two factors driving the changes to estimates:

- Covid-19 related lockdowns in China
- Continued economic uncertainty created by the fallout from the Ukraine war

Q4 remains a key trading period for the Group, ahead of Christmas and the Chinese New Year holidays. Typically, there tends to be a strong improvement in activity levels between Q1 and the end of summer as customers ship product for those busy periods. Unfortunately, the lockdowns in China prevented the group from shipping to several customers (including two of the top five OEMs) as factories were temporarily closed. Such issues were worse in the south of China. The Group has reinstated a secondary warehouse to minimise any disruption, although this represents an additional cost.

Anecdotally, Chinese export data of small domestic appliances has declined by c.20% YTD, suggesting that Strix is at least maintaining its market share within the important kettle control market.

The Group has experienced a slowing within several export markets resulting from the continued economic uncertainty created by the war in the Ukraine. Higher energy, fuel, mortgage, and food costs across several key markets has resulted in falling demand.

From mid-year there has been a greater emphasis on the cost base and more recently the focus of marketing/promotional/investment spend has concentrated on the more profitable/key products.

Completion of Billi acquisition

The acquisition of Billi completes on 1 December, leading us to introduce estimates for the first time and reflecting the conditional nature of the deal (once clearance was approved for the larger Waterlogic/Culligan merger).

Products for the residential and commercial markets

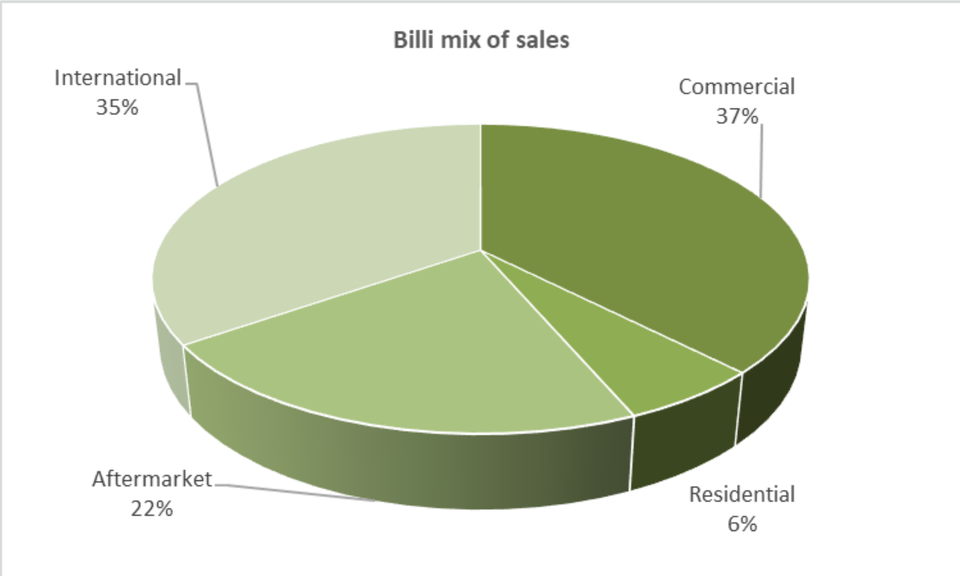
Source: Company

Billi is a manufacturer of **premium** filtered and unfiltered instant boiling, chilled and sparkling water systems for both commercial and residential use. The product fills a gap within the Strix portfolio, moving to under-the-worktop appliances. Billi is a leading supplier of the water systems across its markets, currently selling into Australia, New Zealand, the UK, Singapore, China, and Hong Kong, where it also operates service centres. The management of the division is based in Melbourne, where the business operates a manufacturing facility.

The markets in which Billi operates have similar drivers to the Group's Water category, not least, the move away from single use bottled water towards more sustainable alternatives and the move away from sugary beverages. The desire to filter out waterborne contaminations, such as pathogens, chemicals and microbes is a further long-term driver of the business. Commercial markets are driven by the replacement of office water coolers in favour of more environmentally friendly filtered water taps.

Products are sold into the commercial ('Billi for work') and residential sectors ('Billi for home'). Historically, sales were focused on the commercial sector, specified via architects, builders, and plumbers, with a rapidly growing base in residential emerging more recently. Expansion internationally has been through wholly owned distributors in the UK and New Zealand and, with third parties elsewhere.

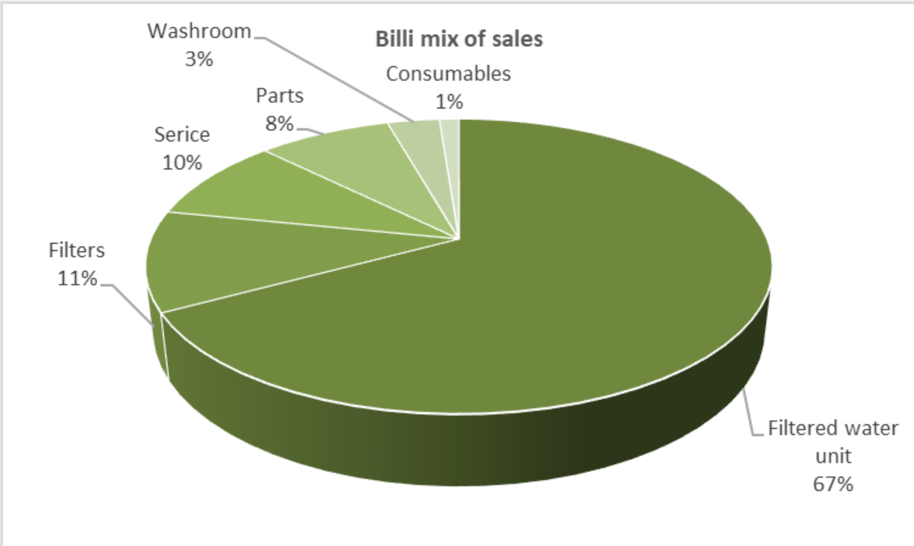
Billi – split of sales by end market



Source: Company

We highlight the historic sales by product/service in the chart below. One should bear in mind that washroom sales are solely into the commercial (office) environment and includes plumbed contactless sensor taps, as well as soap dispensers.

Revenue by product area, Billi



Source: Company

Billi will launch a five-in-one tap during Q2 '23, combining filtered, chilled, hot, sparkling and tap water in one unit and matching the market leader in Australia, Zip Industries. Significantly, the new product is a much smaller unit than that of its peers, comprising one-third of their size. The size differential should make the new 5-in-1 product more attractive for both residential and commercial markets, particularly where space is at a premium. Additionally, the tap can be retrofitted into existing systems of a similar nature. Energy consumption is also lower than competing systems, as the unit is water-cooled, rather than the traditional fan cooling. The waste heat energy produced during the chilling process is used to pre-heat boiling water via a heat exchanger, resulting in energy savings.

We consider it of note that several of the Directors of Strix purchased a combined £0.37m of shares in the placing in October to part-fund the acquisition of Billi. The participants in the placing included the Chairman, CEO, CFO and two of the NEDs.

Financials

Estimate changes

£m	Old FY22E	New FY22E	Change	Old FY23E	New FY23E	Change	Old FY24E	New FY24E	Yoy change
Revenue	116.1	110.3	-5.0%	131.6	157.1	19.4%	n/a	171.6	9.2%
Adj. EBITDA	38.3	33.8	-11.7%	44.2	50.7	14.8%	n/a	54.6	7.6%
Adj. PBT	28.3	23.6	-16.5%	33.2	30.5	-8.2%	n/a	35.8	17.4%
Adj. PAT	28.2	23.5	-16.6%	32.0	26.8	-16.2%	n/a	31.5	17.4%
Adj. EPS (p)	12.8	10.6	-16.6%	14.5	12.1	-16.2%	n/a	14.2	17.4%
DPS (p)	8.35	6.50	-22.2%	8.60	7.00	-18.6%	n/a	8.0	14.3%
Net debt	62.8	93.1	48.2%	59.3	83.8	41.4%	n/a	74.4	-11.2%

Source: Equity Development

The lion's share of the adjustment in financial estimates is down to the combination of Chinese covid policy impacting trading activity and the ongoing uncertainty resulting from the macroeconomic and political across several of the Group's key markets. Significantly, Chinese export data on small domestic appliances suggests that levels have declined c. 20% YTD and, on this basis, Strix has at least maintained its share of the global kettle controls market. We have reduced revenue estimates by 5% in FY22, with the pre-Billi top-line declining 10% in FY23 but rising 19% including Billi. Adj. EPS declines 16.6% in FY22, with only a modest contribution from Billi (£3m of revenues and £0.6m of EBIT). In FY23, adj. EBITDA rises 13%, although adj. EPS falls 16.2% on the inclusion of Billi reflecting the higher associated tax charge and the debt service costs.

The acquisition of Billi transforms the Water and Appliance categories in terms of top-line contribution. The revenue split between the two categories favours Appliances, with the remaining 40% in Water (servicing, parts, and filters). With a strong level of recurring revenues comprising unit rentals, servicing, and consumables (including filters and carbon dioxide canisters) this pushes the gross margin higher, with levels at Billi similar to the core Kettle Controls category.

The purchase of Billi is expected to result in the faster growing Water and Appliance categories accounting for **more than 50% of revenues by the end of FY23**, compared to less than 30% previously.

We consider Billi an excellent deal, notwithstanding the slowing of activity during Q4. With proforma revenues, EBITDA, and earnings (PAT) of £40m, £8m and £5.6m respectively, the FY22 multiple amounts to a 0.95x multiple of revenues, 4.75x EBITDA and 6.79x earnings. The £38m consideration was payable in cash on completion on a cash and debt free basis.

Our financial expectations suggest that the FY23 rating declines to a revenue multiple of 0.9x, 4.5x EBITDA and 6.4x earnings. The purchase of Billi increases the gross margin of the Group, with synergies improving the EBITDA margin by FY24.

We expect the acquisition of Billi to be EPS accretive in FY23 (a single digit uplift in its first full year), with the following providing a further uplift in FY24:

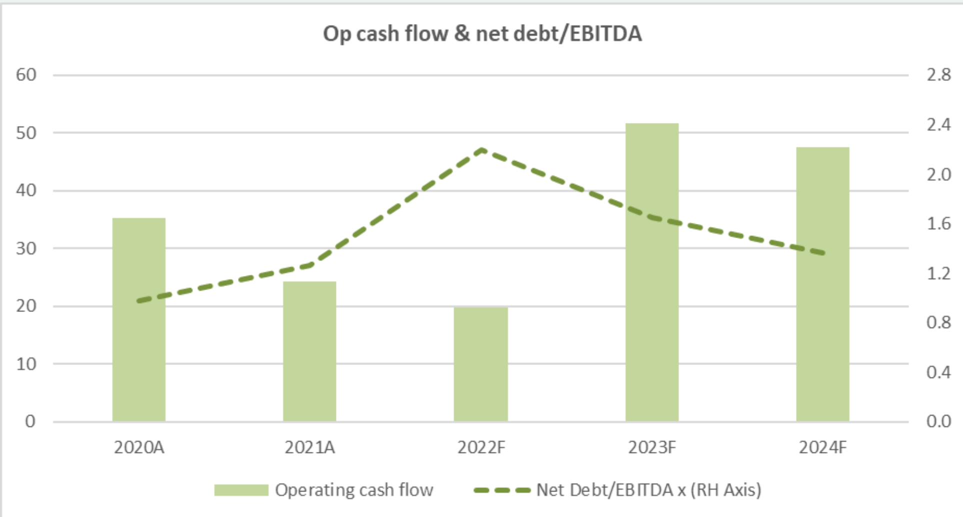
- New product launches, benefitting from Strix's technology and expertise in this area
- Increased residential sales
- Sales into a broader geographical area, using Strix's existing global footprint
- Introducing Strix's existing countertop appliances into commercial markets
- Sales of existing countertop appliances into Billi's regional markets
- Growth in the sale of consumables and servicing revenue streams
- Further integration benefits emerging, not least in procurement, marketing, distribution, retail outlets, and in manufacturing efficiency/capacity utilisation.

We expect Billi to be strongly cash generative, with free cash flow expected to equate to 70% of EBITDA, with only a modest capex requirement of £1m in FY23 and a further £1.6m in FY24. As such, we expect a significant portion of the net £26m of indebtedness associated with the acquisition, post costs and placing proceeds, to be paid down by the end of FY24.

The revolving credit facility of £80m was refinanced with a tenure of three years, with options to extend and, a new £49m amortising term loan over the same period. As bank debt falls, the interest rate paid declines, with the overall margin over base not dissimilar to current levels.

Net debt is likely to increase to £93.1m by the December 2022 year end. Net debt/EBITDA will rise to 2.2x (on a proforma basis) but reduce significantly to 1.4x by the end of FY24, in reflection of the recovery in profitability, the contribution of Billi and the strong cash flow.

Operating cash flow (£m) and net debt/EBITDA



Source: ED

We do not anticipate further bolt-on acquisitions within the Water and Appliance categories until Billi is fully integrated and debt levels are more akin to FY21 levels.

Dividend

With regards to the dividend, the Group has two key considerations:

- A progressive policy, linked to underlying earnings growth, and
- Dividend growth of c.2% to prioritise the pay down of indebtedness.

With earnings expected to decline y-o-y in FY22, reflecting the combination of challenging markets and ongoing Covid-related lockdowns in China, the previous dividend expectation looks too high. Maintaining the level of dividend cover to the post-IPO average suggests a **FY22 DPS of 6.5p in FY22**. On the existing share price, this suggests a yield of 8.2%.

The above links into the allocation of capital and the requirement to reduce debt levels markedly over the medium term, which in turn will position the Group to continue its policy of strengthening its positions in each of its markets by means of organic growth and M&A.

Our new estimates suggest a CAGR in revenue, EBITDA, and PAT (earnings) of 19.9%, 9.7% and 4.3%, respectively in the three years to FY24.

Summary Profit & Loss

Year to Dec, £m	2020A	2021A	2022F	2023F	2024F
Kettle controls	79.8	85.1	70.0	71.0	74.0
Water products	11.7	21.4	24.0	43.7	50.2
Appliances	3.7	12.9	16.3	42.4	47.4
Revenue	95.31	119.41	110.34	157.08	171.58
CoGS	-55.9	-72.0	-66.8	-91.9	-101.1
Gross profit	39.4	47.4	43.6	65.2	70.5
Gross margin (%)	41.4%	39.7%	39.5%	41.5%	41.1%
Op costs	8.5	14.3	17.7	25.8	28.3
Other Op. income	1.1	0.6	0.9	0.8	0.8
Operating profit	32.0	33.7	26.8	40.1	43.0
Op margin (%)	33.6%	28.2%	24.3%	25.6%	25.1%
Net Interest	-1.2	-1.4	-3.2	-9.7	-7.3
Associates	0.1	-0.1	0.0	0.0	0.0
PBT (Adjusted)	30.9	32.2	23.6	30.5	35.8
Exceptionals	-5.5	-10.7	-7.5	0.0	0.0
PBT (Reported)	25.5	21.5	16.2	30.5	35.8
Tax	-1.4	-0.9	-0.1	-3.7	-4.3
Adj. PAT	29.5	31.4	23.5	26.8	31.5
Minority interests	0.0	0.0	0.0	0.0	0.0
Adj. Earnings	29.5	31.3	23.5	26.8	31.5
Reported PAT	24.0	20.6	16.1	26.8	31.5
Ordinary Dividends	-16.0	-17.3	-14.2	-15.3	-17.5
EPS (Adjusted) (p)	14.3	14.9	10.6	12.1	14.2
DPS (p)	7.9	8.4	6.5	7.0	8.0
Ave no of shares (FD) (m)	206.4	209.7	221.0	221.0	221.0

Source: Company historics, Equity Development estimates

Summary Cash Flow					
Year to Dec, £m	**2020A**	**2021A**	**2022F**	**2023F**	**2024F**
Operating profit	32.1	33.7	26.8	40.2	43.1
Depn. & Amortn.	6.0	6.9	7.0	10.5	11.5
Working capital movement	-1.6	-11.4	-10.5	4.2	-3.8
Other	-1.2	-4.9	-3.5	-3.3	-3.1
Operating cash flow	35.2	24.2	19.8	51.6	47.6
Net Interest	-3.4	-2.7	-3.2	-9.7	-7.3
Taxation	-0.9	-1.9	-2.0	-3.0	-3.0
Net capex	-17.4	-15.4	-8.8	-12.0	-11.9
Operating FCF	13.5	4.2	5.8	26.9	25.4
Net (Acquisitions)/Disposals	-6.7	-1.6	-43.5	-3.0	0.0
Dividends	-15.3	-16.5	-16.2	-14.6	-16.0
Share Issues	3.8	0.0	12.0	0.0	0.0
Minority payment	-0.1	-0.3	0.0	0.0	0.0
Other financial	-6.0	0.2	0.0	0.0	0.0
Increase Cash/(Debt)	-10.9	-14.0	-42.0	9.3	9.4
Opening Net Cash/(Debt)	-26.3	-37.2	-51.2	-93.1	-83.8
Closing Net Cash/(Debt)	-37.2	-51.2	-93.1	-83.8	-74.4

Source: Company historics, Equity Development estimates

Abbreviated Balance Sheet					
Year to Dec, £m	**2020A**	**2021A**	**2022F**	**2023F**	**2024F**
Intangible Assets	29.6	27.3	25.7	23.3	20.8
Tangible Assets	37.2	49.8	52.6	56.1	58.7
Investments/other	0.1	0.1	0.1	0.1	0.1
Net Working Capital	4.4	15.9	26.3	22.1	26.0
Capital Employed	71.4	93.1	104.8	101.6	105.5
Other	-2.8	-2.1	-2.0	-1.9	-1.9
Net Cash/(Debt)	-37.2	-51.2	-93.1	-83.8	-74.4
Provisions Liabilities/Charges	-9.3	-9.3	-8.5	-8.0	-8.0
Net Assets	22.0	30.5	1.1	7.9	21.2

Source: Company historics, Equity Development estimates

Valuation

We think that Strix Group's strong market positioning is being undervalued by investors. We have updated our DCF model including the current expectations for cash flow. There are conservative assumptions used: a discount rate of 8.75%, a terminal growth rate of 2.25% and capex ahead of depreciation (underpinning our expectation of organic growth).

The model suggests a value / share of 221p.

Strix Group DCF calculation

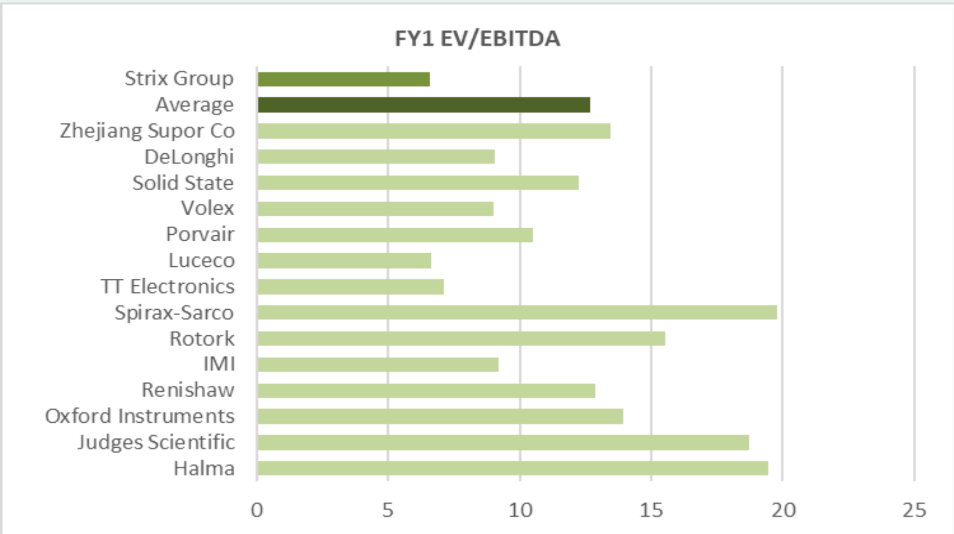
£m	2022F	2023F	2024F	2025F	2026F	2027F	2028F	2029F	2030F	2031F
Free cash flow	7.3	35.0	34.3	39.9	40.7	41.7	42.6	43.6	44.5	45.5
WACC (%)	8.25	8.25	8.25	8.25	8.25	8.25	8.25	8.25	8.25	8.25
Timing factor	0.92	1.92	2.92	3.92	4.92	5.92	6.92	7.92	8.92	9.92
Discount rate	0.93	0.86	0.79	0.73	0.68	0.63	0.58	0.53	0.49	0.46
Present value	6.8	30.1	27.2	29.2	27.6	26.1	24.6	23.3	22.0	20.7
Sum of discounted cash flows	237.6									
Terminal growth rate (%)	2.25									
Terminal value	345.8									
Net debt	-93.1									
Equity value	490.3									
No. of shares (m)	218.7									
Value per share, p	221.2									

Source: Equity Development

Not only is Strix Group trading at a material discount to the average of its peer group (based on FY1 estimates) but even following the reduction in our dividend expectation it is expected to deliver the highest yield across its sector.

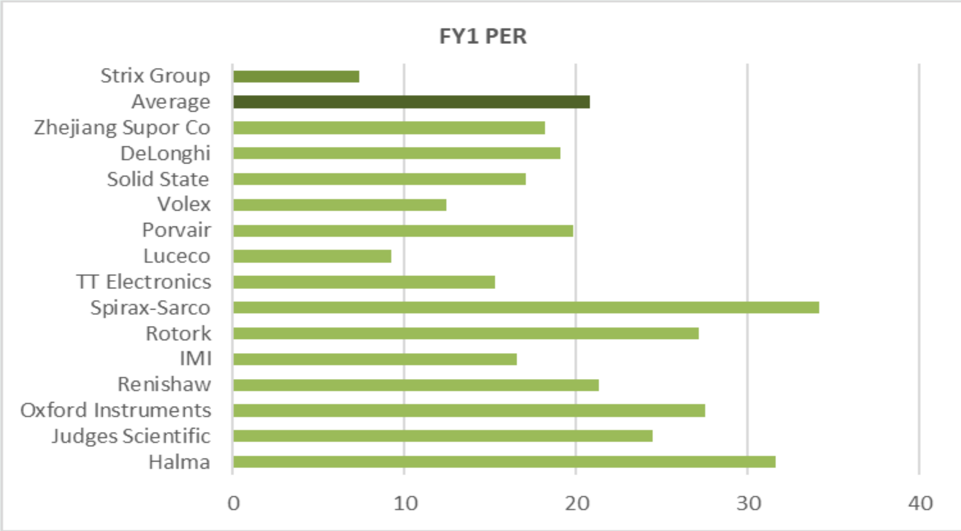
We highlight this in the FY1 EV/EBITDA, FY1 PER and FY1 Yield charts below.

Comparative valuation: FY1 EV/EBITDA



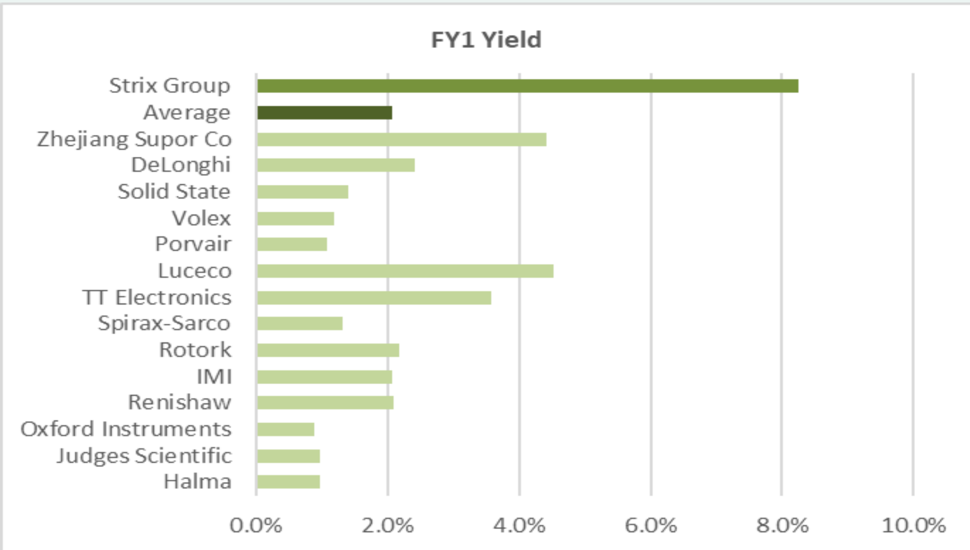
Source; MarketScreener

Comparative valuation: FY1 PER



Source; MarketScreener

Comparative valuation: FY1 Yield



Source: MarketScreener

In deriving fair value, we have conservatively incorporated a 15% size related discount for Strix into our peer group calculations (EV/EBITDA and PER). **Yet the average of the three valuations suggests a fair value / share of 188p. The current share price stands at a post-IPO low.**

Fair value

Methodology	Per share
DCF	221p
PER	188p
EV/EBITDA	155p
Average	**188.2p**

Source: ED

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