Strix Group plc

Signs of recovery now apparent

23rd July 2020

Today, Strix has published its H1 20 pre-close update (interims due in Sept). Against a backdrop of global disruption caused by COVID-19, Strix's H1 performance is said to be in line with expectations. Net sales down 21% YoY, with a much smaller impact on net profits on the back of strong cost management. Encouragingly, there are now signs of a bounce-back in H2 with a solid performance for June and a strong order book for July and August. FY profit expectations are largely intact, which the market should respond well to.

COVID-19 update. Both the supply and demand side were affected in H1, with a significant decline in Q1 in China in particular, and export demand temporarily affected. However, manufacturing in **China** is now again at very high capacity and every one of the top 20 OEM customers are back in production.

Still the leading player in the global kettle controls market. This is a resilient market, which historically has grown in low single digits p.a. The company today highlights a stable market share % in H1 2020 across territories, and in our view it has an enduring competitive advantage and unrivalled OEM relationships.

Diversification, growth in new markets and factory 'on track'. Elsewhere, Strix is seeing healthy growth in Water/Appliances, with plans for a launch programme of over 14 new products across all categories in 2021 in tandem with Global Brand partners. Strix also confirms that the new, enlarged group manufacturing facility is well on track, where full completion is still expected in August 2021.

H1 20 period end net debt, £36.9m. This is lower than originally budgeted for, and in part reflects the range of efficiency measures undertaken YTD, along with some deferral of capex to FY21. On our estimates, ND/EBITDA leverage is maintained at around 1x, which is a healthy position in current markets, underpinning Strix's resilient financial position.

FY profit expectations firming up. 'We have successfully implemented a range of efficiency measures and strategic initiatives to mitigate the impact of the pandemic on the full year profit forecast which we now expect to be in line with the previous financial year assuming no significant increase in further lockdown restrictions' CEO Mark Bartlett. As a reminder, FY 19 PAT/net income was £28.9m.

Robust investment case. The share price has now rallied by c. 60% from its March lows (a time of widespread market anxiety regarding the emerging pandemic). Strix has clearly reassured investors of its defensive qualities and remains a unique strategic asset on AIM, with industry leading margins and many organic growth initiatives underway.

Current share levels provide an attractively rated entry point. Valuation multiples are 12.9x PER 19, and 13.3x PER20. Strix has shown commitment to its dividend, and the yield at the current price is an attractive 4%. We estimate that fair value for the shares lies in the 220p-240p share price range.

Company Data

EPIC	KETL
Price (last close)	184p
52 weeks Hi/Lo	200p / 111p
Market cap	£350m

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.

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Strix: H1 20 pre close update

'Strix has delivered a resilient performance in the first half which is testament to the robustness of the business. It has now started to see signs of a marked recovery with a solid performance in June and visibility of a strong order book for July and August as lockdown conditions have begun to ease globally. This makes us cautiously optimistic about the demand for our products in the second half and is consistent with improving global macro-economic forecast trends.' CEO Mark Bartlett

The COVID-19 pandemic, since the lockdown in China in Q1, 2020, has posed unprecedented challenges on both industrial supply and demand side. We have already written at length about this, and COVID-19 remains a risk factor. In the case of Strix, however, with manufacturing capacity located in China these operating challenges have been tackled impressively to date, without erosion of competitive advantage or market share.

What emerges from the group's H1 trading update is a very resilient performance in the circumstances, and a tailwind from an improving order book and great stability at H1 period end. The tone of management commentary should be reassuring to investors, in our view. We highlight below H1 trading patterns, by Strix product type.

Kettle Safety Controls

In terms of the kettle supply chain, there was initially significant disruption in China, where more than 90% of kettles are manufactured. Factories had temporary closure, as they were faced with mandatory local lockdowns and an extended Chinese New Year holiday period.

By early March, the key factories were back in operation and those focused on production for the China domestic market have experienced a sharp bounce-back in demand. Following Q1 where output was more than 27% down YoY on 2019 levels, China's overall performance for H1 was down circa 9%. This implies a significant reversion after the Q1 'COVID shock'. According to the company, the accelerating trend of recovery is anticipated to continue in H2.

Export markets lagged the China domestic market by up to three months. Together with supply side disruption, this has resulted in H1 being down more than 15% on 2019 levels. However, signs of the anticipated bounce-back are now starting to come through with a solid performance in June and a strong order book in place for July and August.

In H1 Strix has held its market leading position in both the China domestic and export markets for kettle controls, using its latest U9 and Electronic platform ranges, and by remaining vigilant over its valuable IP.

Strix expresses cautious optimism about consumption and demand for products, with the key constraint being the global exit rate from lockdown restrictions. Strix's products have historically had limited correlation with short term consumer confidence since kettles are seen by many as a household essential and repeat purchase. The central expectation is that there will be no current noticeable effect on OEM or end-market demand.

In terms of global macro outlook, there are also signs of improvement, particularly in China where GDP grew 3.2% YoY in Q2. Mainland Chinese stockmarkets have also surged in early July, again reflecting improved confidence (in the first two weeks of this month, Shanghai +14%; Shenzhen + 17%).

Water Filtration and Appliances

In H1 20 the Water Category is reported to have grown 6% globally YoY. Aqua Optima remains in a strong position to capture further growth in H2 when market sentiment improves because of its share of the trade brand segment and increased distribution in both Europe and China.

HaloSource has now also been successfully integrated into the Group. The trading performance of the assets acquired is to date in line with the Group's expectations. Furthermore, the HaloPure technology has been utilised to create a disinfection facility at the Guangzhou factory, particularly valuable during the pandemic.

Furthermore, the potential for significant value creation here should not be underestimated:

- in the medium-term, entering into commercial agreements which will drive future profitability, with retail interest and distribution of the Astrea product line;
- new contracts secured for specific sterilization applications in both the farming and medical segments.

New product development is unaffected by COVID-19, with 14 new products due for release, mainly in H2. Key Strix projects include Duality, poultry drinking systems, Aurora, as well as various new Astrea vessels and filters. This could be a source of upside for forecasts, further down the line. There is secular growth potential in our view, in both Hot Water on Demand and Baby Care categories.

Factory

The relocation of Strix's existing manufacturing operations in China is in line with the project schedule and set to be fully operational by August 2021 as originally planned. There is some deferral of capex into FY21, from FY20.

The company has highlighted previously the security advantages of moving to 50 years, rather than 20 years, tenure for its new factory location (Zengcheng). This also underlines the support they receive from the regional Chinese government.

H1 20 pre-close update: Financials

In the RNS statement Strix makes the following comments in terms of full year expectations.

'Our confidence for adjusted profit after tax for the full year to be in line with the previous financial year assuming no significant increase in further lockdown restrictions being imposed or unforeseen macroeconomic shocks.'

For historical reference, we break out previous financial performance below. FY 19 Profit after tax was £28.9m.

Historic summary financials

£m	2019A	2018A	Growth
Revenue	96.9	93.8	3.3%
EBITDA	36.9	36.4	1.4%
Gross profit	39.6	38.9	1.8%
Op profit	31.5	30.9	1.9%
Op profit ex Halo Source	33.4	30.9	8.1%
PBT	30.2	29.2	3.4%
PAT	28.9	28.3	2.1%
Net debt	26.3	27.5	-4.4%
EPS, p	15.2	14.9	2.0%
DPS, p	7.7	7.0	10.0%

Source: Company Data

Strix also commented that H1 20 net sales (revenue) is down 21% YoY. For further reference, H1 '19 financial performance was as follows: Revenue, £43.9m; EBITDA, £14.9m; profit after tax, £10.9m. We would not, however, expect H1 profits to be down as much as the top-line, as a result of strong cost management. This in turn highlights the relatively low operational gearing in % terms.

Investors should be aware that Strix is usually H2-weighted in terms of contribution to FY outcome. In the light of COVID, however, Strix's profitability model was always going to strategically target H2 2020 for recovery. Management comments around recent order book progress suggest that H2 20 may end up showing mid single digits growth YoY, with the key constraint being a reintroduction of lockdown and unforeseen economic exposure, either on a regional or global basis.

At a time when many UK corporates have withdrawn guidance, and investors are left searching for clues, Strix FY guidance and disclosure is very helpful, in our view. Although in the current climate, we would still caution all FY20 forecasts have above average risk.

Updated Forecasts

Following this trading update, we make some minor provisional tweaks to our own Strix forecast model. We will update more fully with the interims.

The net result is a modest downgrade to FY20, such that we now assume a very modest decline YoY in adjusted post tax profit. This is cautiously set below management expectations (see above). Prior to COVID-19 (at the outset of FY20), we were assuming c. 6% growth YoY.

The other key feature to highlight is the deferral of some FY20 capex, c. £4m, to FY 21 as the company moves towards completion of its new factory facility in China.

Financial Forecasts

	2017	2018	2019	2020E	2021E
Revenue (£000's)	91,263	93,769	96,876	93,970	96,090
y.o.y growth (%)	2.94%	2.75%	3.31%	-3.00%	2.26%
EBITDA (£000's)	35,117	36,351	36,904	36,206	36,811
EBIT. (£000's)	29,062	30,861	31,361	30,620	31,182
Adj. PBT (£000's)	28,304	29,206	30,199	29,355	30,032
Adj PAT (£000's)	27,517	28,259	28,863	28,034	28,681
EPS (p) basic adj.	14.48	14.87	15.19	14.75	14.14
EPS (p) ful dil. Adj	14.21	14.19	14.23	13.82	14.14
DPS (p)	2.90	7.00	7.70	7.90	8.10
Div yield (%)	1.58%	3.80%	4.18%	4.29%	4.40%
Div cover	0.00	2.03	1.85	1.75	1.75
Net debt/cash	45,889	27,479	26,342	35,462	33,071
P/E	12.94	12.96	12.93	13.31	13.01
EV/EBITDA	11.43	11.04	10.87	11.3	11.1

Source: ED estimates

Share price put in context

The Strix share price was 100p and its market cap £190m at the time of its IPO in August 2017. The share price grew steadily and in H2 19 up reached 199p. The current share price is 184p.

In 2020 YTD, the share price has shown notable recovery already from March (COVID) lows of 118p. Whereas the broader UK stock-market has fallen 25% YTD (and has been rangebound in recent weeks).

Valuation

There is no well-defined industry peer group for Strix, and hence traditional multiples-based analysis has clear limitations. At the same time, this underlines the company's own scarcity value.

Relative Valuation

	Share price	Market cap	Net debt	EV	EPS 2018	EPS 2019	P/E 2018	P/E 2019	Yld
	(p)	(£m)	(£m)	(£m)	(p)	(p)	(x)	(x)	(%)
Discover IE	390	286	30	316	21.9	25.8	17.8	15.1	2.2%
Halma	2265	8599	196	8795	42.3	46.7	53.5	48.5	0.6%
IMI	988	2691	265	2956	69.1	78.7	14.3	12.6	3.9%
Judges Scientific	5240	326	8	333	32.8	137.0	159.8	38.2	0.5%
Oxford Instruments	1400	801	109	910	59.0	58.0	23.7	24.1	0.9%
Renishaw	4750	3454	-52	3402	168.0	183.0	28.3	26.0	1.2%
Rotork	285	2478	13	2491	11.9	13.5	23.9	21.1	2.0%
Spirax-Sarco	10715	7890	373	8263	246.0	258.0	43.6	41.5	0.9%
Strix	184	373	28	401	14.2	14.2	13.0	12.9	4.2%
TT Electronics	171	279	-46	233	13.2	15.7	13.0	10.9	3.6%
Average							39.1	25.1	2.0%

*** Forecasts derived from Capital IQ, ED and other sources*

At Equity Development, we have nonetheless established a specialist engineering cohort for relative valuation (see above). This comprises well-known UK listed businesses, including for Halma and Spirax-Sarco. Note however, the median market value is in the £billions, whereas Strix is a small cap in comparison (even with an EV of £400m).

Our overall conclusion is that Strix appears very inexpensive by the standards of this cohort / peer group, whilst we also flag that many of these names are mid/large caps which would ordinarily trade at a premium to smaller companies.

Earlier this year, the market was briefly pricing in material profit downgrades across the board. In the case of Strix, for example, this is clearly not reflected in subsequent forecast movements. It does however mean that sector investors need to look at historic numbers, and 'take a leap of faith' where company guidance has been withdrawn.

For Strix, both EV/EBITDA (10.9x) and P/E multiples (12.9x) are still comfortably beneath the cohort average (12.9x and 19.3x respectively) while EV/sales of 4.2x reflects the high margins generated.

Dividend cover on our FY 20 forecasts is a shade under 2x and appears secure. It was encouraging to see Strix reconfirm and pay its FY 19 total dividend per share of 7.7p

Investment case – a recap

In terms of Strix risk profile, we see the following as being most relevant to the investment case:

- High operating margins
- Dividend cover of 1.8x, implying a sustainable dividend (at a time of widespread dividend cuts in UK Plc). We would underline the income attractions, and we still forecast modest growth in FY20.
- ND/EBITDA leverage of c1x (on our forecasts), implying well below average financial risk. And well below bank covenant requirements of < 2.5x.
- As at 30 June 2020, net debt was £36.9 million, with ample headroom.
- Completion of a new £60 million revolving credit facility with RBS International Limited and Bank of China in May.
- In prior years, Strix has delivered strong shareholder returns despite Brexit and associated geopolitical concerns beyond the company control.
- Very experienced senior management, including Mark Bartlett (CEO) and Raudres Wong (CFO)

Having made these points about its risk profile, COVID-19 and the H1 market backdrop, we now attempt to put Strix PLC into more context.

Strix is an unusual strategic asset in our view, with well-assembled competitive advantage. This is reflected in its market share (in excess of 60% in regulated markets) and high 30%s group EBITDA margins. From these high margins, there is significant free cashflow that in turn funds, inter alia, an attractive dividend and growth capex where necessary.

Strix has world-class research & development and operates a lean and agile engineering business, which is a long-term competitive advantage. During 2019 for example, 521 million parts were manufactured at the factory in Ramsey, Isle of Man by a team of only 37 people. With its Isle of Man domicile, Strix also operates a very tax efficient model.

It is however a global service provider (across the value chain), operating in the IoM and China, providing components and value-added services to OEMs, brands and retailers. These components are used to produce water heating appliances (e.g. kettles), filtration technologies and appliances for consumers across the world. The engineering capability is backed up by a rigorous approach to IP protection and safety actions.

Strix has steadily built up market leading capability and know-how in this field since being founded in 1982. Specifically, in kettle controls the market dynamics remain attractive notwithstanding the turbulent geopolitical backdrop, of course beyond the company's control.

Kettles are replaced by households on average every 3 ½ years and remain a 'small ticket' in terms of consumer spending habits. However, with c. 196m appliances globally, penetration only stands at 35%, implying there is ongoing long-term growth potential.

Long term growth initiatives. The stock market has never seen Strix as a 'high growth' name. However, in total, 14 new product launches are planned for 2020. Across Kettles, Appliances and Water.

With the recent HaloSource deal, there is now clearly room for a new "high ground" to be established over time in purified water, and Strix has a strong track record of achieving global leadership based on what it has achieved in kettle safety devices. This also diversifies revenue.

The group remains well on-track near-term and is continuing to execute on initiatives which should build further value in the long term. We expect investors to focus once again on the strategic merits of the business, yield on the shares and the upside potential from long-term growth initiatives. And, of course, the lowly trading multiples.

ESG and SRI credentials

An important theme which we are now highlighting more clearly in our Strix equity research is that the Group is closely aligned to the vastly important ESG 'mega-trends' that are reshaping the global economy, business and society. This is reflected in Strix's evolving business model and the categories of water filtration/cleanliness; health and wellness; energy efficiency; as well as the reduction in use of plastics.

Investor Access

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