Strix Group PLC

Diminishing headwinds

26 January 2023

The pre-close trading update for FY22 is evidence of a business determined to deliver. The focus is now on revenue generation and shorter investment payback periods. Two factors proved disruptive to activity levels in FY22; the war in Ukraine and lockdowns across China to prevent the spread of Covid-19. Although the former looks set to continue indefinitely, the re-opening of the Chinese economy represents a positive factor for FY23 onwards.

Cash levels will be boosted as the supply chain relaxes post-lockdowns, enabling the Group to reduce inventory levels, and marketing expenditure is likely to decline. Billi is integrating well into the Group following its acquisition in December, with new products launched and distributors appointed in Asia. We have left estimates unchanged for FY23 and FY24.

In view of the challenges caused by the Covid-19 related lockdowns in China during H2 '22, whereby two of the top five OEM customers witnessed major interruption and prevented Strix from shipping goods during the busiest time of year, the recent lifting of the policy and opening of the economy is a welcome relief. The duplication of warehouse costs is no longer necessary and with the supply chain re-opening, the requirement to hold higher stocks to maintain services levels should now be consigned to history, thereby enabling the freeing up of cash from Q2 '23.

The attention given to costs is set to continue, with a renewed emphasis on returns. The focus will now be in favour of a more selective marketing and, with investment spend on those products deemed crucial to medium term growth prospects and with shorter payback periods.

We commend the continued outperformance relative to ESG objectives, as the Group has delivered against its scope 1 & 2 net zero targets ahead of schedule.

Encouragingly, the integration of Billi is going to plan, with a strong pipeline of orders, distributors appointed in Asia and several new products due to launch during Q2 '23. In view of the bulk of the consideration increasing net debt/EBITDA levels to over 2x, the focus of the Group is to reduce indebtedness as rapidly as possible. With no large capex projects required, a focusing of investment spend, a reduction in working capital likely and no M&A on the horizon, we expect the Group to return to strong cash generation, with a net debt/EBITDA of c.1.7x expected by the FY23 year end.

Forecasts and valuation

We reduced our dividend estimates in early December, reflecting the level of indebtedness but this still suggests a highly attractive yield of 7% for FY22, rising to 7.6% in FY23. We have left those estimates unchanged, as well as the c.£23m guidance for PAT and consider it too early in the year to revisit FY23 and FY24 estimates. Our net debt estimates are higher than the recent £89m guidance, although c.80% of the difference reflects the payment of deferred consideration to LAICA switching to February '23.

Although the share price is off the lows recorded in late 2022, there remains a significant gap between the current share price and our fair value.

The combination of our DCF and peer group comparison models suggest a fair value / per share of 234p, materially above the current share price.

Company Data

EPIC	KETL
Price (last close)	93p
52 weeks Hi/Lo	283p/75p
Market cap	£202.4m
ED Fair Value / share	234p
Net debt (Dec '22)	£89m

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.

David O'Brien (Analyst)
0207 065 2690
david@equitydevelopment.co.uk

Hannah Crowe
0207 065 2692
hannah@equitydevelopment.co.uk

Estimates unchanged – outlook improving from H2?

The company's comments on financials suggests little need to change estimates at this stage. The key guidance from Strix included:

- PAT of approximately £23m, versus ED estimate of £23.5m
- Net debt of £89m, compared to ED's estimate of £93.1m, and
- A review of the level of the final dividend.

The guidance on PAT is little different to our forecast and therefore there is no immediate requirement to adjust, and it remains too early to gain an accurate measure of FY23 and FY24 PAT estimates. In terms of the net debt, we had included the payment of deferred consideration to LAICA, which will now be paid in February once the outturn for FY22 has been accurately recorded. The deferred payment accounts for approximately 80% of the difference between our estimate and guidance offered within the trading update. On this basis, we feel that the FY23 and FY24 net debt levels are broadly accurate and there is no need to make changes at this stage.

Management stated that it was expecting to reduce working capital and in particular inventory levels. Our expectations include such a reduction, amounting to £4.2m between the end of FY22 and FY23 in keeping with management's goals in this regard.

Part of the internal restructuring programme includes reducing the number of product launches, focusing on those which have the greatest chance of success in generating meaningful revenues and shortest payback on investment. As such, one should anticipate that marketing spend is likely to decline in the current year.

In terms of Billi, we note the confirmation that the integration into the Water and Appliance categories is going to plan, with the key features including:

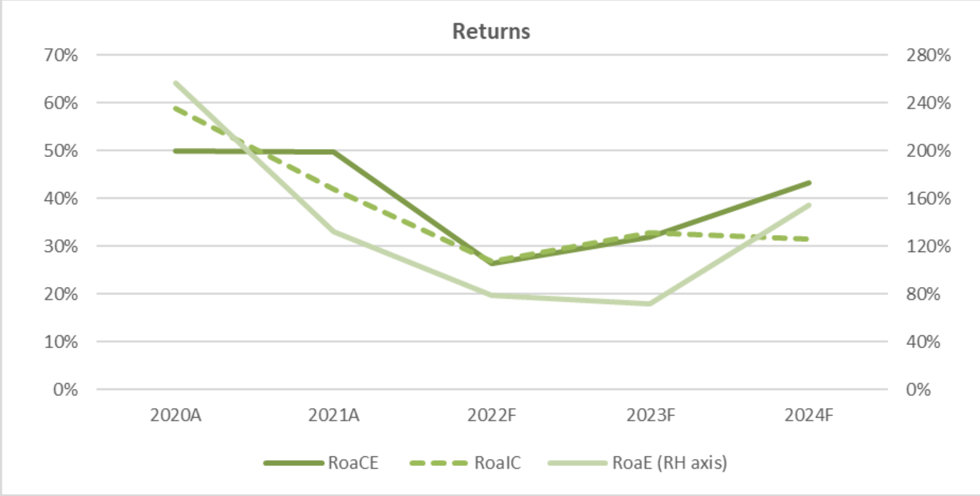
- New product launches
- A strong pipeline of orders, particularly as the Australian economy continues to progress, and
- Distribution agreements signed in Asia, expanding the reach of the business.

With the Chinese economy beginning to open following the lifting of lockdown restrictions approximately a month ago, any 'buffer' stock previously required to reflect the temporary closure of suppliers, is no longer necessary.

A semblance of normality is beginning to return as the Chinese economy re-opens, which should have implications with regard to trading. We think customer ordering is likely to stabilise at higher levels, following several months of 'stop/start' as lockdowns occurred. As the backlog in ports clear, exports should pick up and, on this basis, we expect Q2 to show an uptick in volumes.

As a result, we expect the beginning of the recovery should result in an improvement in returns, as highlighted in the chart below. The uptick is further fuelled by product launches across FY23, the initial FY contribution of Billi, which incidentally, has gross margins not dissimilar to the Kettle Controls category, and a re-focusing of investment within the business.

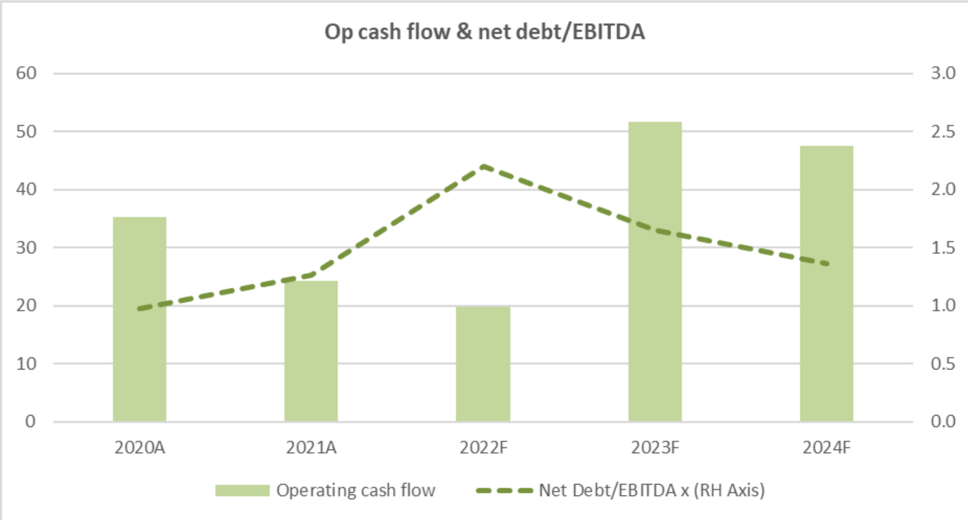
Measures of economic returns



Source: Company historics, ED estimates

Although the purchase of Billi pushed up the net debt/EBITDA level to c.2.2x by the end of FY22, we expect this to decline rapidly to a more comfortable level of 1.4x by the end of FY24. This reduction reflects the recovery in profitability, the contribution of Billi and the strong cash flow.

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



Source: ED

Dividend

We reduced our expectation for dividend at the time of the previous trading update in early December to 6.5p per share for FY22. Our reasoning reflected an abnormally high yield on our previous estimate (10%+), falling levels of dividend cover and the increase in indebtedness associated with the acquisition of Billi. Management has suggested in the pre-close trading update that it is reviewing the level of the final dividend from levels of a year ago.

Given that the marketing and investment in product launches is becoming more focused, we think that a reduction in the dividend makes perfect sense strategically. Furthermore, even after our reduction in the final dividend, the yield at the prevailing share price still amounts to a very attractive 7.0% in FY22.

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

Our view is 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 259p.

Strix Group DCF calculation

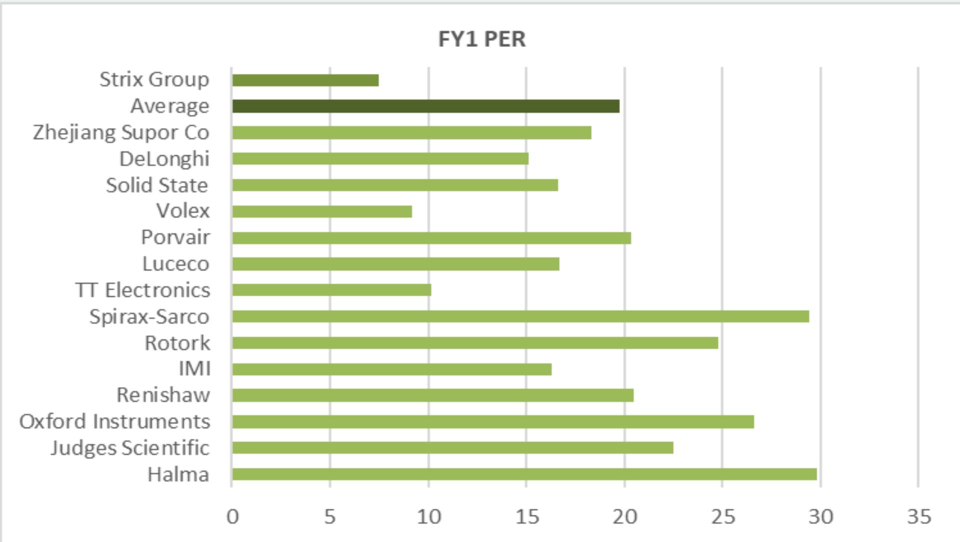
	2023F	2024F	2025F	2026F	2027F	2028F	2029F	2030F	2031F	2032F
Free cash flow	34.3	30.0	42.4	43.4	44.4	45.4	46.4	47.4	48.5	49.6
WACC (%)	8.75	8.75	8.75	8.75	8.75	8.75	8.75	8.75	8.75	8.75
Timing factor	0.08	1.08	2.08	3.08	4.08	5.08	6.08	7.08	8.08	9.08
Discount rate	0.99	0.91	0.84	0.77	0.71	0.65	0.60	0.55	0.51	0.47
Present value	34.0	27.4	35.6	33.5	31.5	29.6	27.8	26.2	24.6	23.1
Sum of discounted cash flows	293.4									
Terminal growth rate (%)	2.25									
Terminal value	356.0									
Net debt	-83.8									
Equity value	565.6									
No. of shares (m)	218.7									
Value per share	258.6									

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.

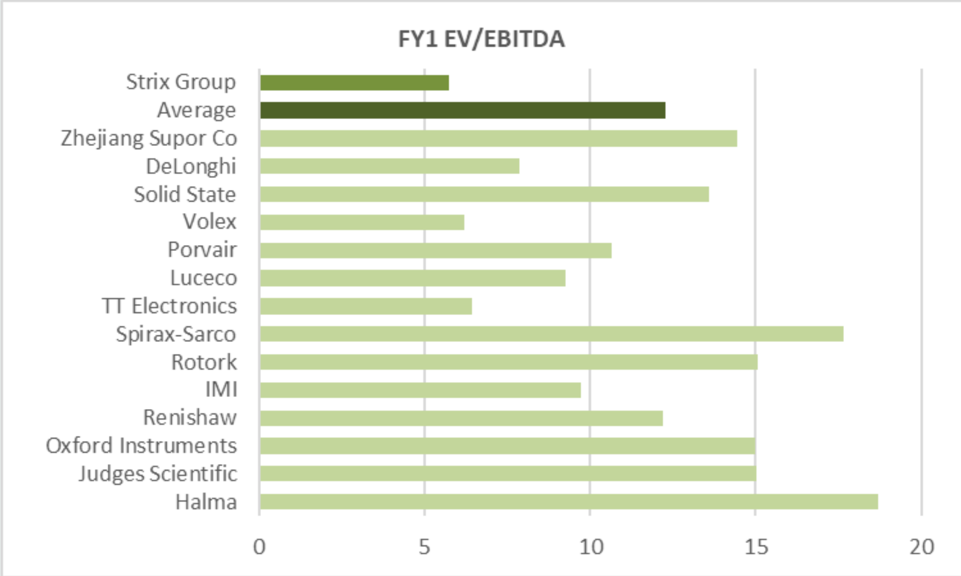
We highlight this in the FY1 & FY2 EV/EBITDA, PER and Yield charts below.

Peer group comparative model: FY23 PER (x)



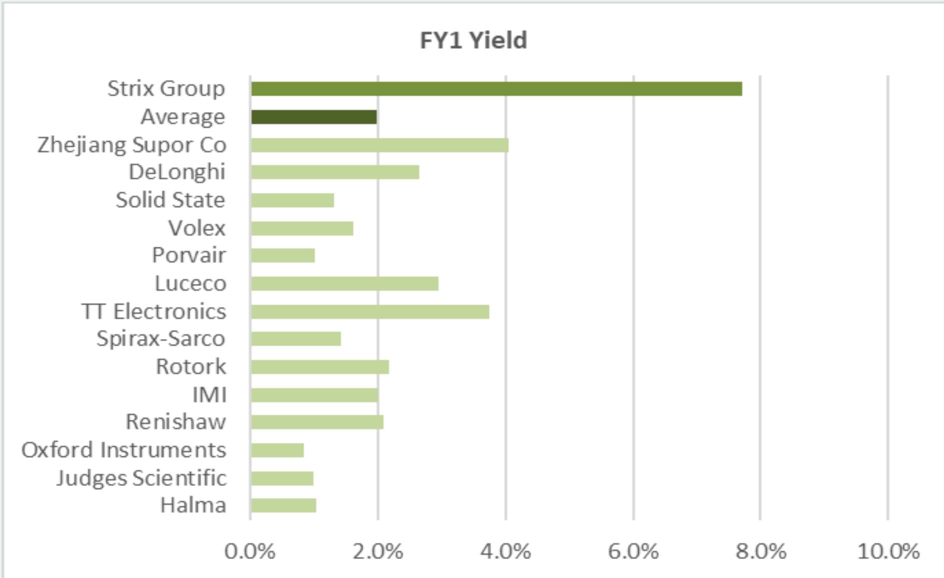
Source: Market Screener

Peer group comparative model: FY23 EV/EBITDA (x)



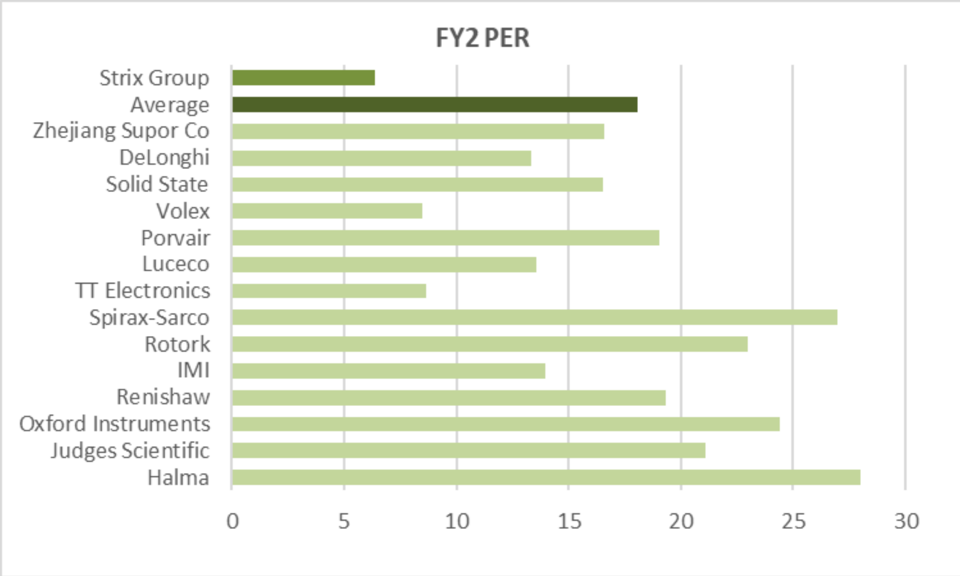
Source: Market Screener

Peer group comparative model: FY23 Yield (%)



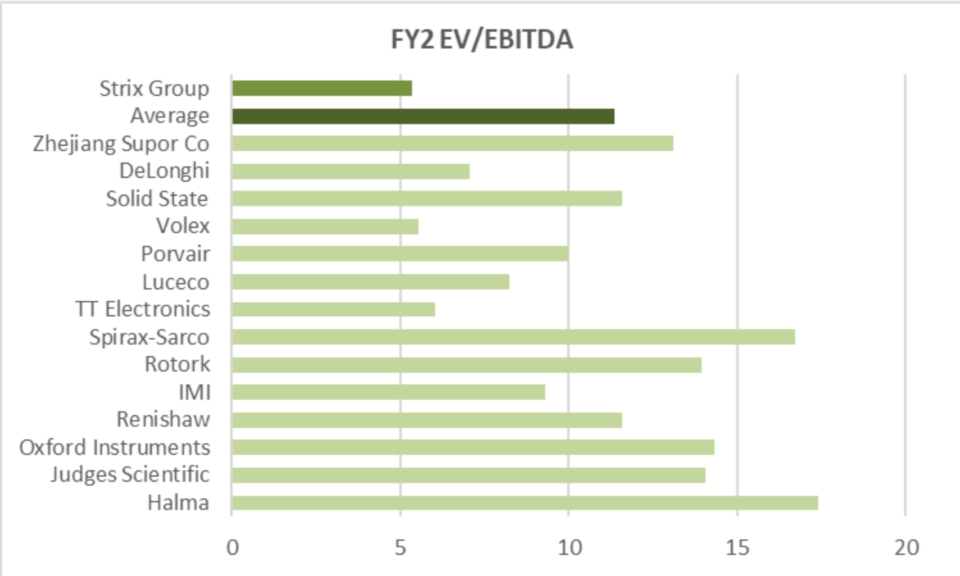
Source: Market Screener

Peer group comparative model: FY24 PER (x)



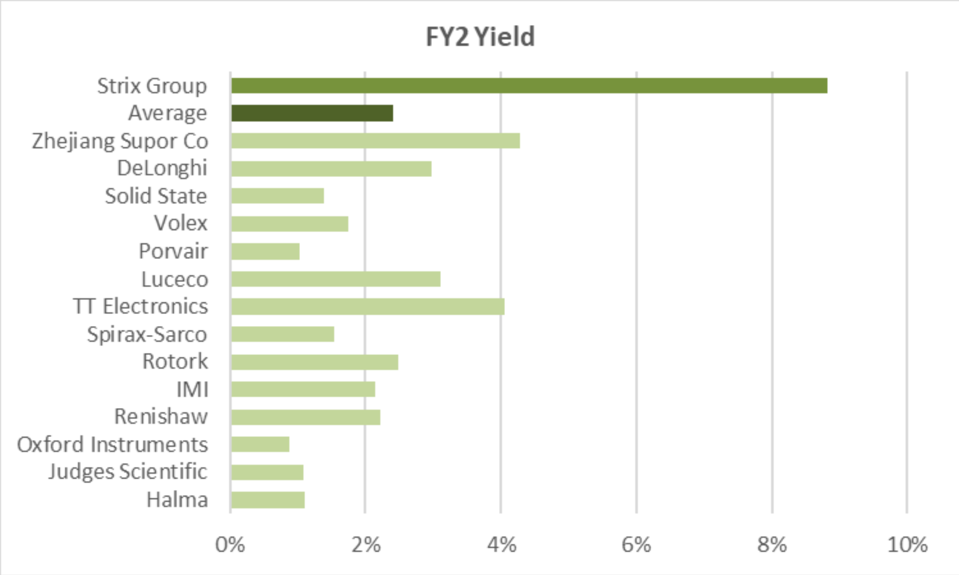
Source: Market Screener

Peer group comparative model: FY24 EV/EBITDA (x)



Source: Market Screener

Peer group comparative model: FY24 Yield (%)



Source: Market Screener

Fair value conclusion

In deriving fair value, we have conservatively incorporated a 10% size related discount for Strix into our peer group calculations (EV/EBITDA and PER). **Yet the average of the three valuations still suggests a fair value / share range of 231p to 237p.**

Fair value per share (p)

Metric	FY23 fair value	FY24 Fair value
DCF	259	259
PER	216	232
EV/EBITDA	218	220
Average	**230.6**	**236.9**

Source: ED

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