Mpac Group plc

Back on track

6th September 2018

Online shopping is not only sending shock waves across the retail industry, but also shaking up entire supply chains. Indeed the $39bn global packaging equipment sector is no different: undergoing seismic upheaval, as consumers seek to buy more personalised & environmentally friendly goods, at whatever time of day and in smaller batches. All expected for delivery within hours of purchase.

The big problem for manufacturers is that Amazon has ratcheted up the bar to elevated levels. Forcing premium brands (eg Unilever, Nestle, GSK, etc) to invest heavily in smart factory technology, incorporating **cutting edge systems**, such as **MPAC's ultra-fast packaging solutions**. However, as often with this kind of mega trend, there is an occasional bump along the way.

Pipeline is improving after recent quiet period

MPAC's occurred after experiencing a temporary lull in demand with H1 bookings being 20% below LY, primarily because of macro uncertainties and delayed customer decision making. **The good news is that since the July profit warning, orderflow has started to recover**, albeit pipeline conversion is still not fully back to normal.

More positively, the previously announced £1m of cost-overuns relating to two legacy contracts (one in Canada and the other UK) have been thoroughly investigated with remediation plans now in place. Here, the UK first-of-a-kind machinery project is being commissioned with final delivery set for H2'19. While the Canadian job should be concluded by December.

Improved quality of orderbook

What's more, management have combed-through all the other outstanding agreements, and reckon today's **backlog is of much "*higher quality and lower complexity*"** than before. In turn, underpinning this morning's **'in line' 1st half results and confident outlook**. Where H1'18 adjusted EBIT came in at £0.0m (£0.3m LY), impacted by the above one-off contract issues – on turnover up 11% to £28.2m (£25.4m) thanks to the strong opening orderbook. Accordingly, we make **no change to either our forecasts or 170p/share valuation**.

Cost saving initiatives implemented

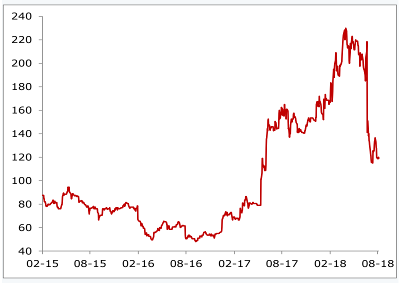
Plus, there is no shortage of financial muscle to execute strategic initiatives, with **net cash of £24.9m, equivalent to 123p/share**. Which together with the 253p/share of tangible net assets, should also in our view, **provide a solid floor under the 120p stockprice**.

Encouragingly too, there seems to be **little adverse effect from commodity price inflation (eg steel & aluminium) and/or the Trump trade tariffs**. Granted, there was a £2.4m increase in working capital due partly to the unwinding of customer deposits received in Q4'17. Yet even so, this should have largely reversed by y/e, and may **facilitate the re-introduction of a progressive dividend** "when the Board believes it is prudent to do so.''

Company Data

EPIC	**AIM:MPAC**
Price (last close)	120p
52 week Hi/Lo	230p/115p
Market cap	£24m
ED valuation/ share	170p
Avg. daily volume	70,000

Share Price, p



Source: Web Financial

Description

MPAC is a specialist provider of high speed packaging machines (76% of sales) and complementary services (24%, eg spares/maintenance) with c. 350 staff. The group was rebranded MPAC in Jan'18, encompassing the design / manufacture of cartoning equipment, case packers, end-of-line and robotic packaging solutions, as well as undertaking turnkey projects involving the design/integration of packaging systems. Here it has sites in Canada and the Netherlands, plus service engineers based throughout the world.

In Coventry (UK), the firm develops innovative technology and associated production / packaging machinery. Core verticals are Pharmaceutical (12% sales), Healthcare (30%) and Food/Beverage (58%), supporting the likes of Nestlé, GSK, AstraZeneca, Unilever, Kellogg's, Diageo, Ferrero, Hollister and CooperVision.

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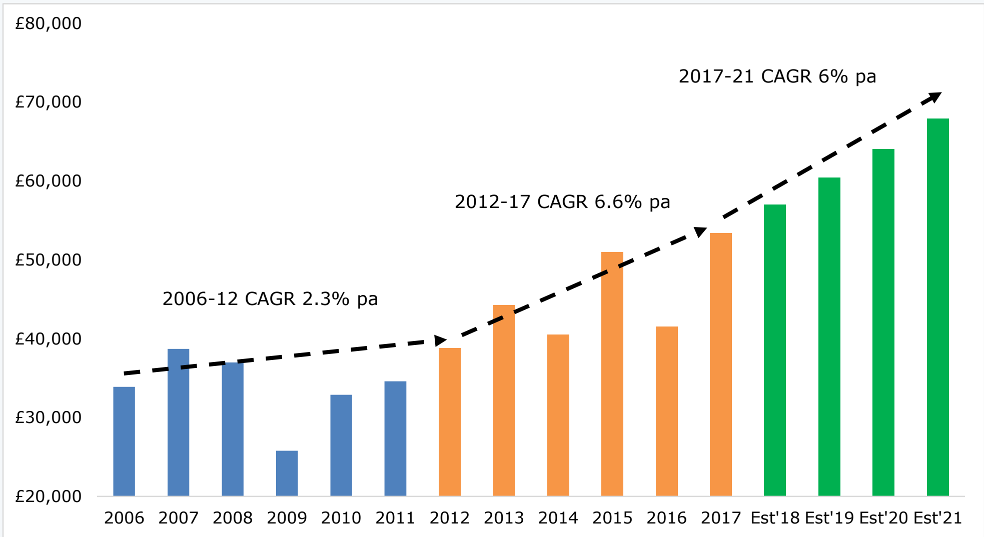
Excellent visibility for rest of the year

Importantly from a risk perspective, we estimate that there is **>90% cover to reach our 2018 sales and EBIT forecasts of £57.0m and £1.5m** respectively. Aided by the extra cost cutting measures (eg headcount reductions) that were implemented after the period end. Additionally, we believe there is scope to exceed our top (Est 6% pa) and bottom line projections – predicated on delivering enhanced service revenues, product innovation, x/up-selling, economies of scale and 'end-to-end' solutions.

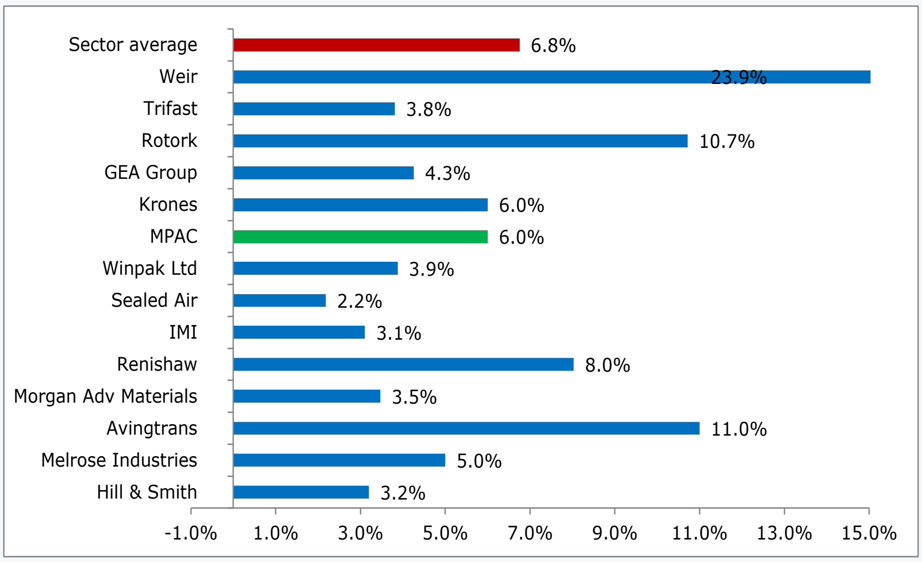
Historical & forecast top line growth rates



Source: Equity Development

In fact, if the Board's target of 10% LFL growth, alongside rising EBIT margins (Est 2.6% 2018) can be achieved, then we could see the shares rally above 250p.

Current year (CY) peer group turnover growth rates



Source: Equity Development

£35.1m accounting surplus for UK pension scheme

Moving to the balance sheet, the UK pension scheme (IAS 19: pre-tax) ended June in surplus at £35.1m (£11.1m LY), with the US deficit likewise improving to £5.8m (£6.6m). Both schemes benefitted from higher yields on AA corporate bonds (UK 2.6% vs 2.3% Dec'17; US $4.0% vs 3.5%), which helped lift discount rates used to calculate liabilities.

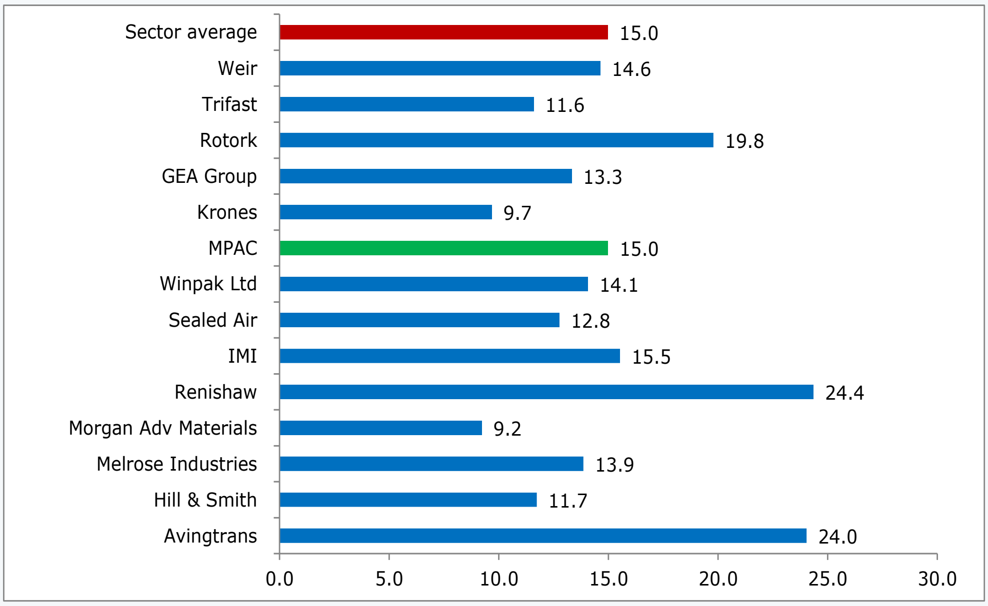
The key factor though, in determining future pension recovery payments (£1.9m UK: £1.3m US) will be the outcome of the June 2018 triennial review (£70m deficit in Jun'15) – which employs more conservative actuarial assumptions and lower gilt yields (1.5%). We do not think there should be a need to lift contributions, but a final decision could take until 2020.

That said, if there is a shortfall (say £25m), there may be a chance of filling some of this gap by injecting proceeds from the possible disposal of MPAC's 10 acres of spare land in Monks Risborough, Buckinghamshire (NBV £0.8m) - which is seeking planning permission after being rejected 2x before. Longer term, it might also be feasible to transfer some/part of these pension obligations to an insurance company in the event interest rates ever returned to historical norms.

So, what does this all mean for the valuation?

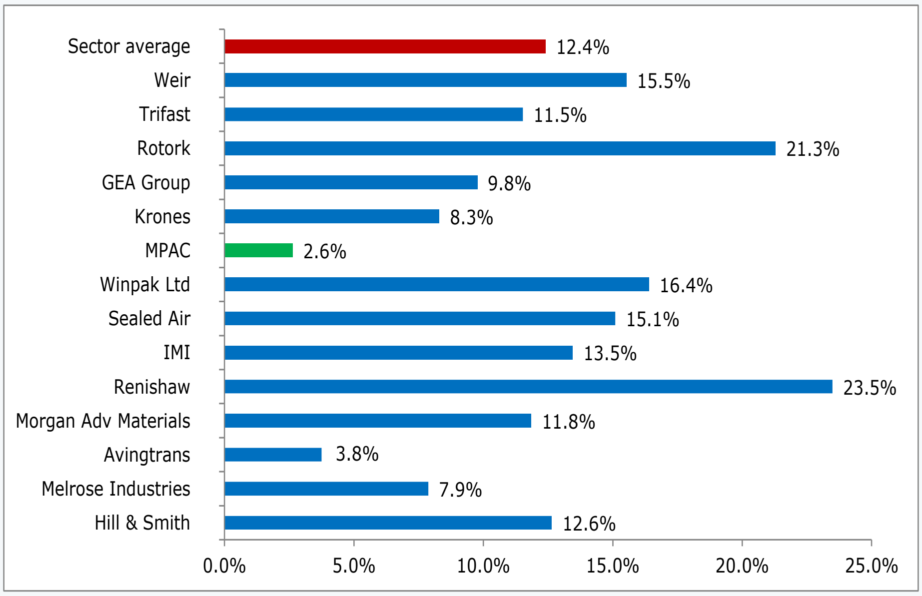
Well, based on a range of multiples and a 12% discount rate **we assess the stock to be worth a minimum of 170p**. True, on a current year EV/EBIT of 15x, it trades in line with the sector (see below), yet equally profits are artificially depressed and should rebound over time.

Current year EV / EBIT (pension adjusted) vs UK engineers



Source: Equity Development

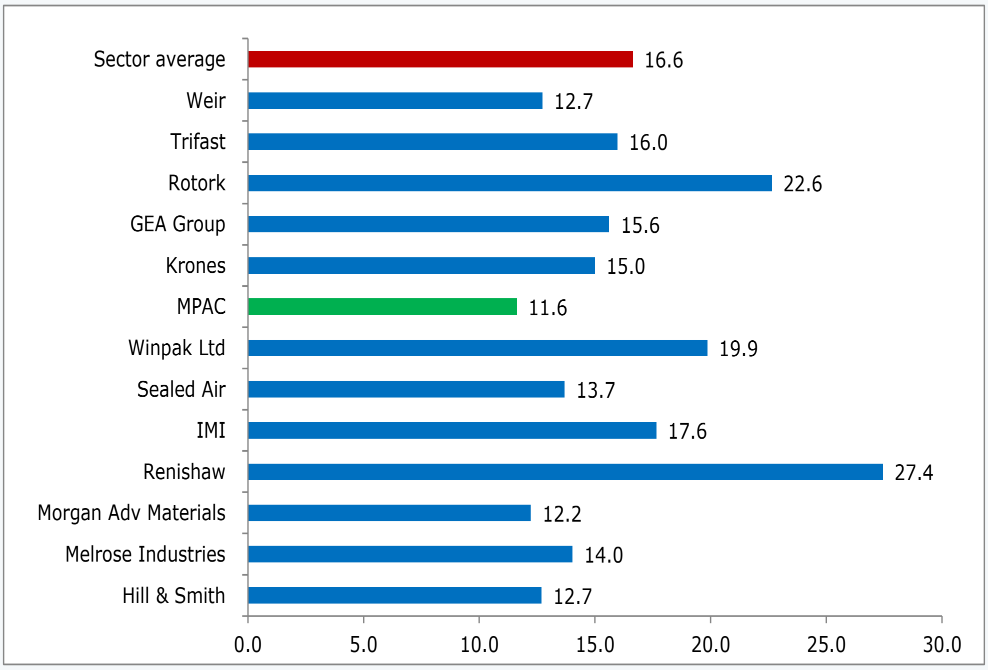
CY peer group EBIT margins



Source: Equity Development

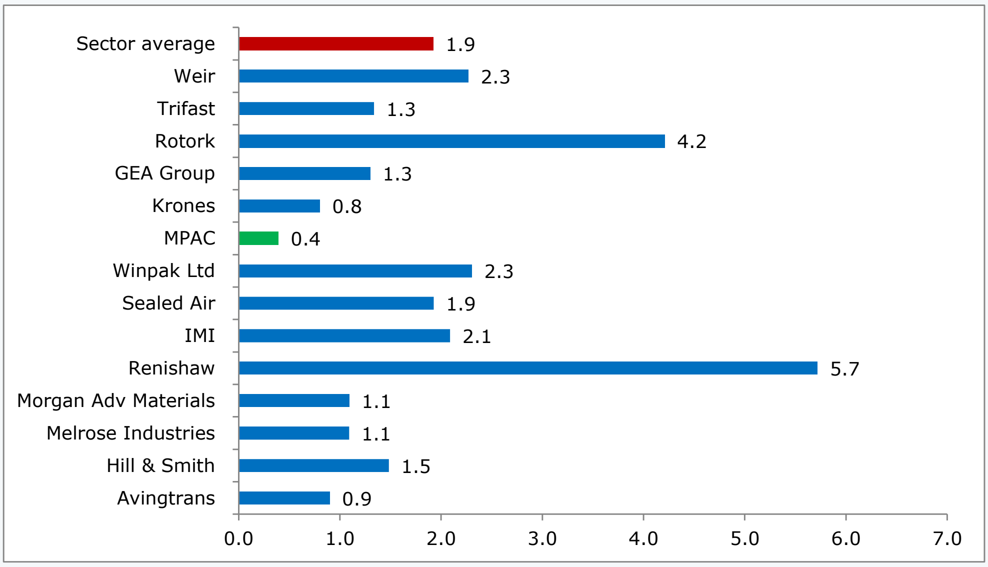
Interestingly too, peers are rated at between 1x-2x EV/sales and 12x-18x CY+1 PER (see below), which **hypothetically would imply a valuation of >300p for MPAC by 2022**.

CY + 1 PERs



Source: Equity Development.

CY EV/sales (pension adjusted)



Source: Equity Development

"Business remains strong"

CEO Tony Steels adding, "***It's been a mixed start to the year, with good progress in a number of areas, counter-balanced by delays in two legacy contracts**. I am disappointed that the momentum built in the previous year has been slowed due to the current business environment with investment decisions taking longer to conclude, however since the end of June 2018 a significant value order was secured for delivery in 2019 which gives us further confidence that the strategic objectives will deliver long term revenue growth. **The fundamentals of our business remain strong, we are well capitalised, and fully focused on executing our strategic plan*** ".

Lastly, with regards to M&A we understand the company continues to actively look at opportunities - although after recently walking away from two acquisitions at the due diligence stage (cost £100k), nothing is presently imminent.

Key risks

- As demonstrated in past recessions, capital equipment volumes are typically exposed to the cyclical nature of the global economy.
- The large size of the UK (£375.3m of liabilities) & US (£21.8m of liabilities) defined benefit pension schemes compared to MPAC's market capitalisation.
- Currency exposure, trade tariffs, raw material price increases (eg steel, aluminium) and competition.
- MPAC is smaller than its rivals/clients (eg German and Italian) and could see margins squeezed.
- Slower than expected growth, higher costs and/or lower cash generation.

- Industry suffers occasionally from lumpy orders, protracted customer purchasing decisions and irregular cashflows over the period end.
- Long term trend towards clients outsourcing production to 'low cost' contract manufacturers.
- Continued industry consolidation could impact pricing and margins.

Adjusted financial projections

MPAC plc - continuing (December year end)	**2016 Act £'000s**	**2017 Act £'000s**	**2018 Est £'000s**	**2019 Est £'000s**	**2020 Est £'000s**	**2021 Est £'000s**	**2022 Est £'000s**	**2023 Est £'000s**	**2024 Est £'000s**
Closing orderbook	**25,500**	**34,400**							
Equipment	28,800	40,400	46,000	48,760	51,686	54,787	58,074	61,558	65,252
Service	12,700	13,000	11,000	11,660	12,360	13,101	13,887	14,720	15,604
Turnover	**41,500**	**53,400**	**57,000**	**60,420**	**64,045**	**67,888**	**71,961**	**76,279**	**80,856**
Equipment		*40.3%*	*13.9%*	*6.0%*	*6.0%*	*6.0%*	*6.0%*	*6.0%*	*6.0%*
Service		*2.4%*	*-15.4%*	*6.0%*	*6.0%*	*6.0%*	*6.0%*	*6.0%*	*6.0%*
Total % YoY growth		*28.7%*	*6.7%*	*6.0%*	*6.0%*	*6.0%*	*6.0%*	*6.0%*	*6.0%*
Equipment	5,400	9,200	10,718	12,322	13,319	14,392	15,546	16,787	18,120
Service	5,600	5,300	4,400	4,664	4,944	5,240	5,555	5,888	6,241
Total gross margin	**11,000**	**14,500**	**15,118**	**16,986**	**18,263**	**19,633**	**21,101**	**22,675**	**24,362**
Equipment	*18.8%*	*22.8%*	*23.3%*	*25.3%*	*25.8%*	*26.3%*	*26.8%*	*27.3%*	*27.8%*
Service	*44.1%*	*40.8%*	*40.0%*	*40.0%*	*40.0%*	*40.0%*	*40.0%*	*40.0%*	*40.0%*
% Margin	*26.5%*	*27.2%*	*26.5%*	*28.1%*	*28.5%*	*28.9%*	*29.3%*	*29.7%*	*30.1%*
EBITDA	**450**	**2,200**	**2,500**	**4,007**	**4,915**	**5,905**	**6,984**	**8,159**	**9,436**
% Margin	*1.1%*	*4.1%*	*4.4%*	*6.6%*	*7.7%*	*8.7%*	*9.7%*	*10.7%*	*11.7%*
Distribution	-5,300	-5,400	-5,582	-5,749	-5,922	-6,100	-6,283	-6,471	-6,665
Administration	-6,600	-7,300	-7,546	-7,772	-8,006	-8,246	-8,493	-8,748	-9,010
Other	-300	-500	-490	-505	-520	-535	-551	-568	-585
Adjusted EBIT	**-1,200**	**1,300**	**1,500**	**2,959**	**3,816**	**4,752**	**5,774**	**6,888**	**8,101**
% Operating Margin	***-2.9%***	***2.4%***	***2.6%***	***4.9%***	***6.0%***	***7.0%***	***8.0%***	***9.0%***	***10.0%***
Underlying interest charge	-330	-170	-200	-200	-200	-200	-200	-200	-200
Adjusted Profit before Tax	**-1,530**	**1,130**	**1,300**	**2,759**	**3,616**	**4,552**	**5,574**	**6,688**	**7,901**
Adjusted EPS (p)	**-6.0**	**4.2**	**4.9**	**10.3**	**13.5**	**16.9**	**20.6**	**24.9**	**29.4**
EPS growth rate			*16.9%*	*111.2%*	*30.4%*	*25.6%*	*21.8%*	*20.6%*	*18.1%*
Dividend (pence)	***1.25***	***0.00***	***0.00***	***0.00***	***0.00***	***0.00***	***0.00***	***0.00***	***0.00***
Reported sharecount (Ks - incl Treasury)	20,172	20,172	20,172	20,172	20,172	20,172	20,172	20,172	20,172
Valuation benchmarks									
P/E ratio		*28.7*	*24.5*	*11.6*	*8.9*	*7.1*	*5.8*	*4.8*	*4.1*
PER (adjusted for pension recovery payments)					*193.2*	*25.8*	*13.4*	*8.7*	*6.4*
EV/Sales (pension adjusted)	*0.54*	*0.42*	*0.39*	*0.37*	*0.35*	*0.33*	*0.31*	*0.29*	*0.28*
EV/EBITDA (pension adjusted)		*10.2*	*9.0*	*5.6*	*4.6*	*3.8*	*3.2*	*2.8*	*2.4*
EV/EBIT (pension adjusted)		*17.3*	*15.0*	*7.6*	*5.9*	*4.7*	*3.9*	*3.3*	*2.8*
PEG ratio			*1.45*	*0.10*	*0.29*	*0.28*	*0.27*	*0.23*	*0.23*
EBITDA drop through rate			*8.3%*	*44.1%*	*25.0%*	*25.8%*	*26.5%*	*27.2%*	*27.9%*
Return on equity (%)		*1.9%*	*1.8%*	*3.8%*	*4.7%*	*5.6%*	*6.4%*	*7.1%*	*7.8%*
Net cash/(debt)	**800**	**29,400**	**23,637**	**20,936**	**19,018**	**17,945**	**17,781**	**18,597**	**20,468**
Estimated non-underlying Pension charges									
UK pension recovery payments		-1,847	-1,886	-1,925	-1,966	-2,007	-2,049	-2,092	-2,136
UK tax shield		369	358	366	374	381	389	398	406
US pension recovery payments			-1,300	-1,150	-1,000	-850	-700	-550	-400
Cashflow effect		**-1,478**	**-2,827**	**-2,710**	**-2,592**	**-2,476**	**-2,360**	**-2,245**	**-2,130**
Net cash/(debt) - pence per share		**146**	**117**	**104**	**94**	**89**	**88**	**92**	**101**
Net assets / diluted share (p)	175	216	263	273	287	304	324	349	379
Shareprice (p)	**120**								

Source: Equity Development estimates, Company for historic data

NB MPAC's EV has been adjusted for pension/spare land. The cost of UK PPF levy is included within EBIT.

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