Investors' Chronicle | Alpha

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Alpha shares analysis

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GARP: always look beyond the headline numbers

This week we have an eclectic bunch: a fast reinventing green energy provider, a conglomerate and a thread manufacturer. Each offers better than average growth in the near-term, but all have something to give the investor a slight pause and ask if the value proposition looks and feels right. A change in stock perception, differing views of eco-friendliness, worries about reliance on constant acquisition to sustain growth and once crippling legacy issues make the investment case less straightforward but our three featured stocks this week all appear to offer at least some pockets of potential value.

- **SSE (SSE)** – this is the UK's leading green electricity provider, a great place to be as the war in Ukraine looks set to accelerate the race away from gas powered generation. Committed to a large increase in green investment and happy to sacrifice a large chunk of what was once seen as one of the UK's most reliable dividend streams, SSE is fast making the transition from almost a bond-proxy stock to one offering an attractive rate of growth. There has been a huge swing upwards in the quality of earnings here with the PE 50 per cent higher and the yield half the value of three years ago when the decision to reinvent the business was taken. The initial surge may be over but as now a growth stock, this is not expensive.

- **DCC (DCC)** – conglomerates were big in the 70s and 80s, but are rare today. DCC operates in four disparate industries, but with a common thread of acting as a distributor rather than principle. DCC has shown steady growth over 20+ years (and 27 years of rising dividends), but has substantially de-rated in the past five years. Today, the group's earnings rely on acquisitive rather than organic drivers, which can prove harder to sustain as a business grows. There is also a heavy skew towards fossil fuels, albeit largely at the 'greener' end of the spectrum. After five years the de-rating could/should be over and with high single-digit growth this stock is on a market average PE and could finally see the end of five years of negative total shareholder return (TSR).

- **Coats (COA)** – the world of thread manufacturing is hardly one to set the pulse racing, but Coats is a well-set and well-run business with a dominant market share and in an industry likely to grow faster than GDP. This business has had a number of setbacks born out of Covid amplifying the worst of the pandemic, but is now righting itself rapidly. In Coats, investors should see large market share gains, strong innovation, rapid growth from eco-products, large cost saving initiatives and a rating dogged by legacy issues related to the pension fund. Triple the market average rate of EPS growth on a marginally sub-market PE plus a discount for the pension issue creates a pocket of value here still intact even after a recent, steep share price jump.

Analyst: **Robin Hardy**

SSE – right place, right time, right strategy

Source: FactSet

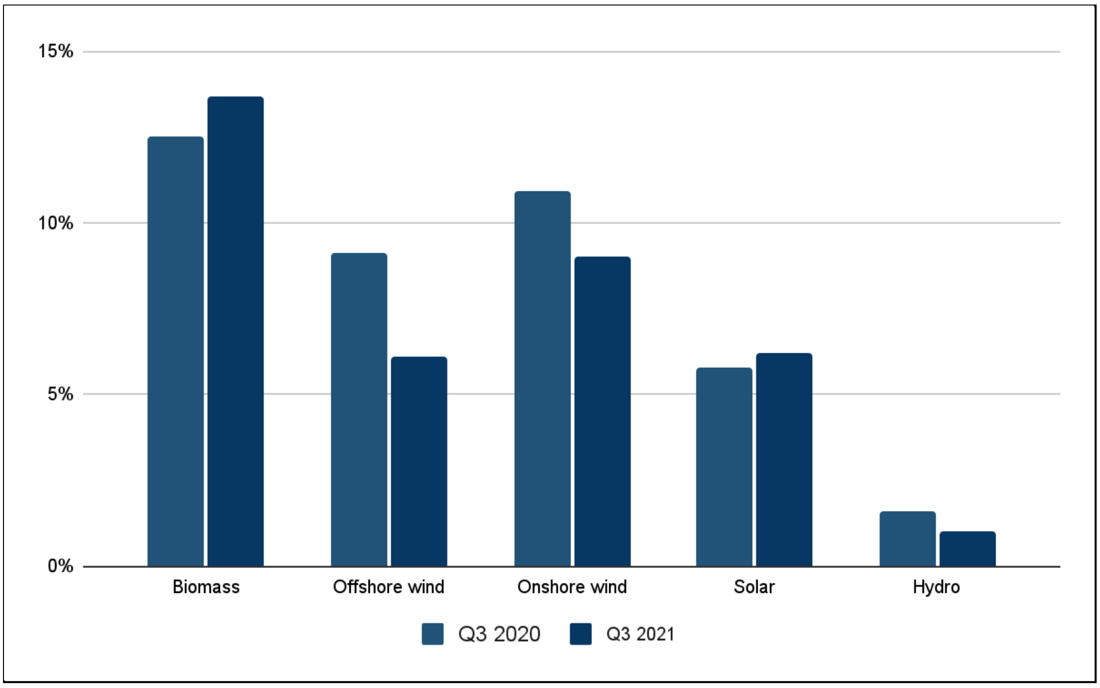
A rare winner from today's war

It can be hard to see that there could be winners arising from the dreadful war in Ukraine, but any business that looks to play a role in achieving 2030-2050 net zero targets or helping organisations to decarbonise are likely to see accelerated investment for several years to come. Europe has finally recognised that it needs to wean itself off gas more quickly and with both a wider-set reluctance and ultra-long timescales attached to nuclear, the much shorter delivery schedules from wind and solar should win out. SSE, therefore, looks well set as the UK's largest non-nuclear electricity generator and a rapidly evolving green energy provider (primarily wind).

A rare winner in Covid

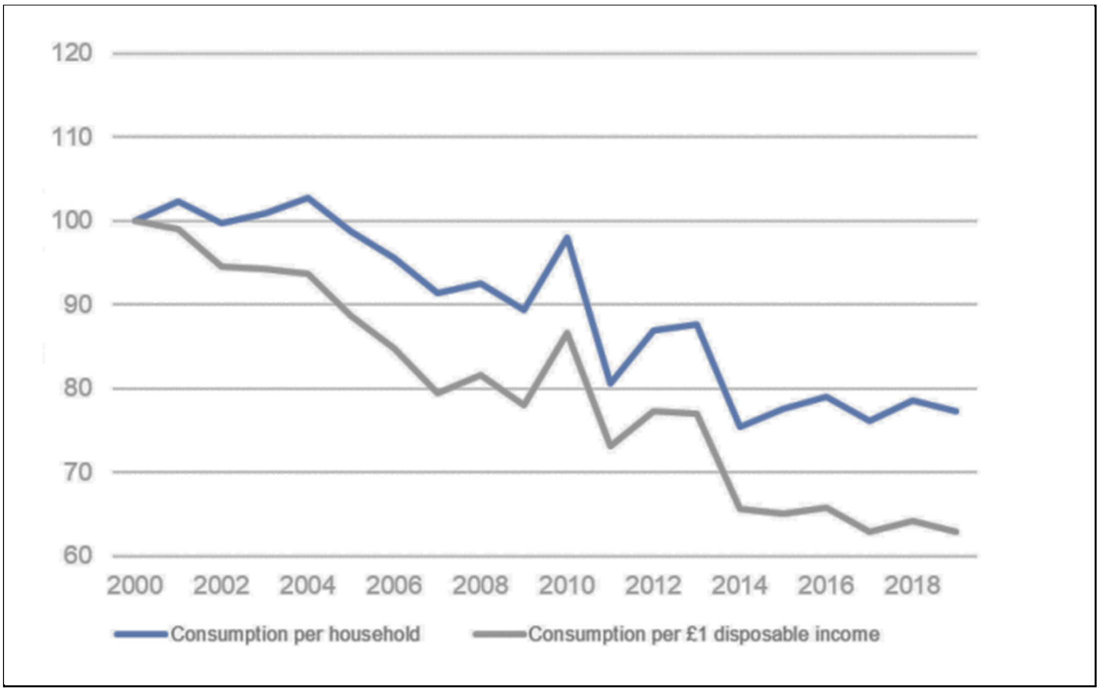
SSE is no longer a supplier to domestic customers (it sold its customer list to OVO in January 2020 for £500mn) and although domestic demand had increased with people working from homes, the surging wholesale price and the near impossibility of hedging enough to avoid crippling losses on domestic supply has to be seen as a bullet dodged. While there is still an arm to the group that supplies/bills business customers, there are no price caps in that space so the danger of having to swallow wholesale price rises on behalf of customers is not present. There is now a risk that businesses and households become even more conscious of energy use and trim their consumption, which is not likely to be that significant as there has already been a marked reduction in usage per household in the past 20 years and many older, energy inefficient appliances have already been replaced. Also domestic consumption is only c.33 per cent of total national consumption (see figure 3).

Figure 1: Renewables' share of electricity generation



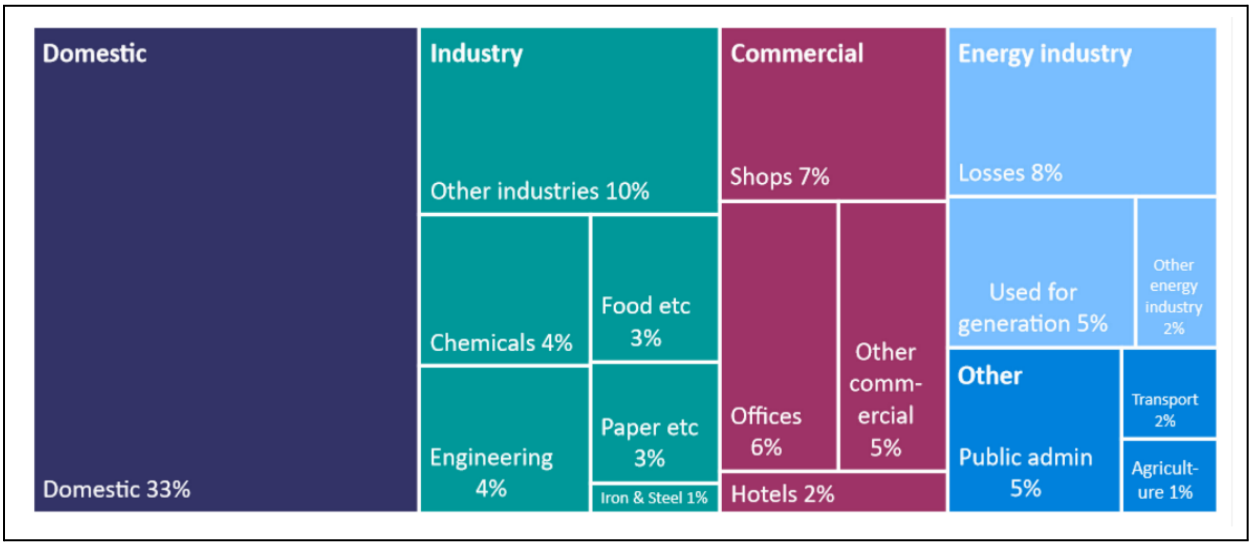
Source: Energy Trends - Department for Business, Energy & Industrial strategy

Figure 2: Change in energy intensity per household



Source: Energy Trends - Department for Business, Energy & Industrial strategy

Figure 3: End uses of UK generated electricity



Source: DUKES 2020 - Department for Business, Energy & Industrial strategy

Renewable sources of energy only hold 36 per cent share of UK generation, so there is still a vast amount of untapped potential for those businesses at the forefront of development of clean energy running for many years to come. Any near-term reductions in demand are likely to be more than offset by transition for older generating sources.

Upgrades even before the war began

In its February Q3 trading update, SSE pushed profit guidance up for the current year (to end-March 2022). The previous guidance from November was to expect EPS of 83p (which would have been a c.5 per cent decline); this was increased to 90p. The results will be published in late May (there is no Q4 or pre-close update typically here), but as this guidance was published two weeks before the hostilities began, it is possible that the trading/commercial pricing climate has further improved in the past six weeks of the year. Several forecasts in the consensus have stepped up to around 93p of EPS which would reflect growth of c.6 per cent. This has been achieved despite wind-generated power missing targets in the first nine months by 13 per cent (the well-publicised lack of wind), 135,000 homes in Scotland losing power due to Storm Arwen and SSE's own gas-powered generation dropping 14 per cent below the prior year which alone swung half year profits by £90mn. This augurs well for the FY2023 financials assuming these issues do not recur.

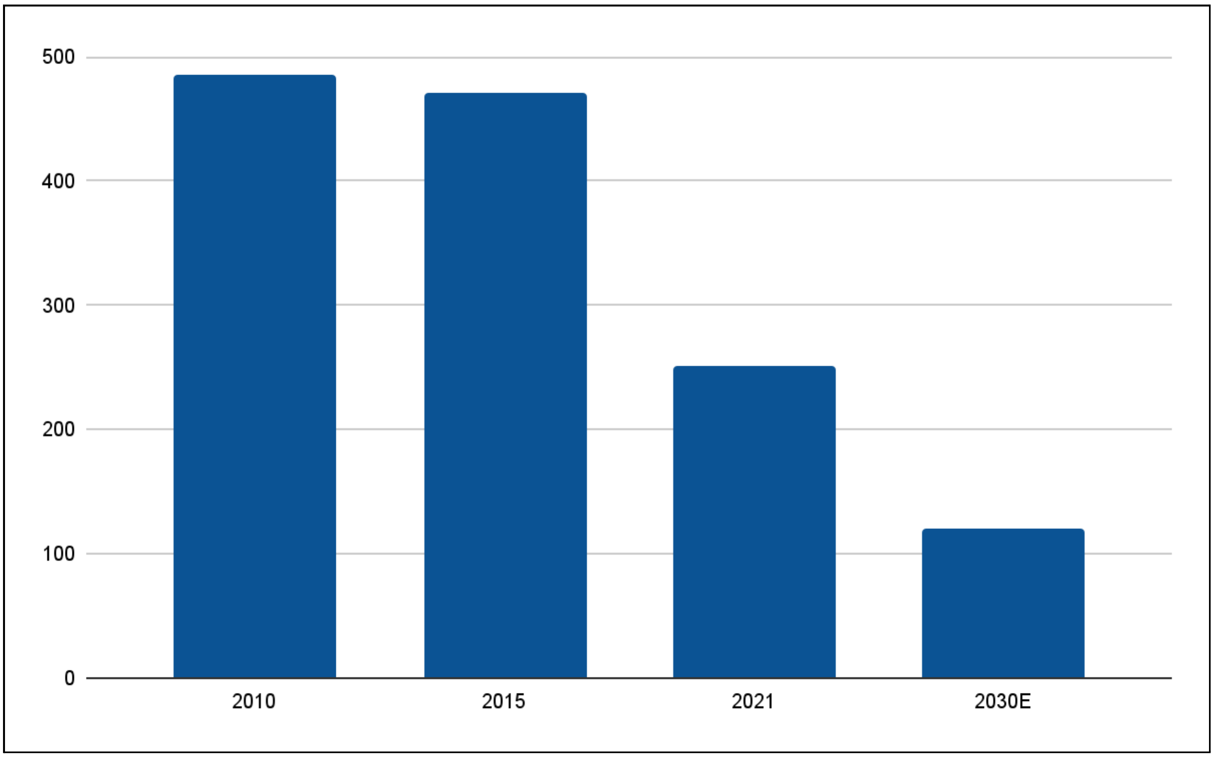
We look at the dividend prospects later, but there are further signs to support the view that SSE is capable of making the transition from a dull utility that was close to being a bond-proxy to something more capable of delivering growth close to, or above, market averages.

On the right side of the green line

SSE is the UK's largest generator of non-nuclear electricity with a rapidly expanding presence in the renewables market. Non-core disposals have continued and the group appears to be on target to hold only the assets it desires (wind, 'clean' gas, business supply, Ireland and moderate hydro positions) by the end of the current financial year. The last major disposal (the 33 per cent stake in Scotia Gas Networks Ltd or SGN) was agreed in August 2021 and has just completed for £1.286bn, helping bring debt down to the year-end target of c.£9bn.

There are ambitious investment plans to strengthen the base in renewables with a plan now to invest £12.5bn by 2030, a figure that was increased in November from the previous £7.5bn. Part of this was likely done in response to the pressure from activist investors (see later).

SSE carbon intensity of electricity generated – gCO_2e/kWh



Source: SSE

Interesting times for the dividend

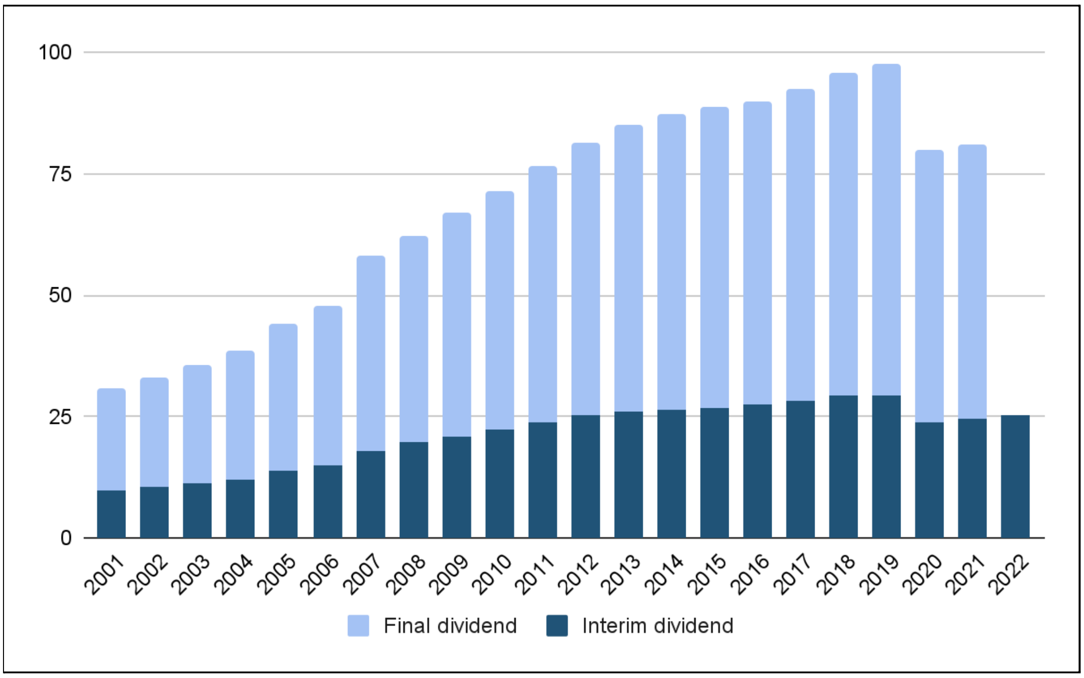
SSE was long viewed as one of the most steady and reliable dividend payers in the UK equity market. Since 1998 (the date of the Scottish Hydro Electric and Southern Electric merger) the dividend has increased by at least RPI (retail prices index inflation) every year. While very stable, this had turned the shares into something of a bond proxy and for many years all of the total return came from the dividend – the share price went, almost to the penny, nowhere in the 10 years to Q1 2019, when it bottomed out. As the business has (significantly) reshaped in the past three years, the dividend has been re-based (cut if you prefer) from 97.5p in FY2019 to 80p in FY2020. Along with the cut, however, came a promise to increase the dividend at the rate of RPI through March 2023. That was a promise made when inflation was still expected to remain close to the target 2 per cent – it could now peak at c.9 per cent and is likely to remain well above target for some time.

This would be good news for shareholders in the near term, but only until that FY2023 promise expires. The dividend baseline for FY2022 is 81p (same as paid in FY2021) plus RPI at the March year-end, so the payment is likely to exceed c.86p. While inflation could/should be heading back towards target rates (according to Capital Economic at least) by the end of 2023, they could still be at 4-6 per cent by March 2023 – that means the last of the old format dividends could be as high as 90-91p. Thereafter, the company set up another dividend reset, this time down to 60p per share with a promise of at least 5 per cent growth until 2026. As this is already programmed in, and because boosted free cash flows will be used to drive growth, the cut to 60p is unlikely to impact the share price.

We speculated back in July in Alpha that further dividend cuts were a possibility. It is not impossible that after 2026, the dividend sees another cut as the payment, even after four years of decent EPS growth, would still be expensive to fund: cover by EPS is likely to be only around 1.75x. Cover of 2.5x or even 3x might be desirable as the opportunities to invest in tech fields and new geographical markets, many away from the tough regulatory environment and proscribed margins in UK supply, are a better use of SSEs free cash flow. Every 10p cut from the dividend would free up £106mn of additional cash to invest.

That means that investors could see two years of payout at around 5¼ per cent yield before seeing that drop back to a market average of around 3.5 per cent from FY2024. While the dividend will be expensive for the next two years (likely to cost £8mn more than might have been expected), the savings from FY2024 is likely to be more than £33mn, so SSE has £100mn more to invest by 2026. Higher EPS and a better rating as a growing business should create a lot more value than the dividends foregone.

SSE's dividend history - pence per share



Source: SSE, FactSet

Activism

SSE has been another victim of shareholder activism at the hands of US hedge fund Elliott, which had been pushing for the business to be broken up. Their thinking was likely to have been that the green energy side of the business could be worth more if cast free.

While spinning off the renewables arm might look like a good idea on paper it is less so in practice for shareholders. While the value of the pure renewables business might increase, it is likely that the value of the legacy, or 'thermal', or gas powered generating business would have fallen – that is before considering the greater impact that unstable wholesale gas prices might have had. Then there is the question of investment. While the gas powered end of SSE might be seen as a dinosaur, it is something of a cash cow and does not need especially high levels of investment. A pure renewables business would require substantial investment which could mean long-term dilutive equity issues and/or uncomfortable levels of relatively expensive debt if separated. While SSE (as is) attracts a BBB credit rating from S&P, the same would not be true for a spin-off.

Elliott's cajoling does seem to have accelerated what was already a positive move to reshape the business, so overall dragging the various issues on which it focused into the light has been a boon for shareholders. And that includes Elliott itself. Announcing that it had a stake that would rank it in the top five of SSEs register (meaning it would have had to hold c.90-100mn shares) in August, it is likely to have paid an average price of less than

1,500p per share: the price is now around 11 per cent higher making the hedge a profit of potentially £200mn.

Wrapping up

In the long run growth is the best focus for any business and if that involves cutting the dividend to part fund it, that is almost certainly for the best. The same is true for investors – wealth is never really going to accumulate significantly if the primary return is just a dividend yield, even if that is growing and stands comfortably above the market average.

SSE is moving to become more of a growth stock and that has been the main driver of the share price since the shift in focus was announced back in 2019. The total shareholder return (TSR) for investors between 2012 and 2019 was some 25 per cent or 2.8 per cent per annum but more than 100 per cent of this was dividend. The share price fell by 19 per cent, or 2.2 per cent per annum, in that time. Since starting to change its spots (i.e from May 2019) the TSR has been 92 per cent, of which capital appreciation of the shares accounts for 59 per cent.

Things to really admire here are a willingness to undertake massive change and to swing away from a dull but relatively safe/lowish risk market focus. That the board was not afraid to kill the sacred cow of the dividend not once but twice (and possibly will do so again after 2026) as a strategic rather than a desperate or other forced hand move is both impressive and rare.

Then there is the issue of the quality of earnings. This has been the real driver of the shares' re-rating and it has scope to continue to power the stock ahead. In May 2019, the stock was trading on a PE of 10.5x and yielding around 7.5 per cent. Today it trades on a forward PE of 15x and yields (on the 60p dividend outlook) 3.5 per cent. While a decent slice of any re-rating might already be behind us, compound EPS growth already in the forecast at c.12 per cent (against market average of 5-6 per cent at best) could still justify a bigger premium to the FTSE All share's average PE of approaching 12x.

Continued below

DCC – strength in diversity?

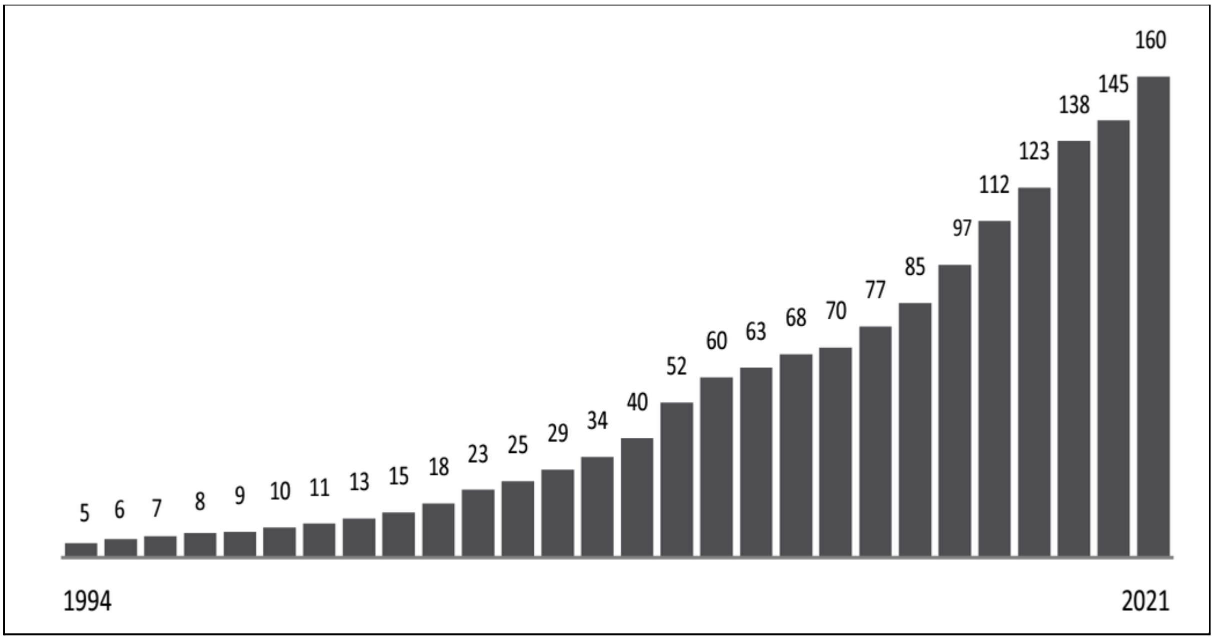
Source: FactSet

There are not many around these days, but DCC is a conglomerate, a business comprising several very different and diverse parts or industry groupings. Most of the world's largest conglomerates (such as Hanson PLC/Inc) broke themselves up in the 1990s as the 'sum-of-the-parts' always seem to suggest that investors saw the parts being worth much more than the whole, but never saw this borne out in the share price. Also too often good business units were raided to fund less good businesses or buy new ones rather than allowing those businesses to thrive.

Conglomerates are often an odd mix, and DDC is no exception. Founded over 40 years ago in Ireland as Development Capital Corporation, it operates through four divisions: LPG (liquified petroleum gas distribution), Retail & Oil (wholesale and retail distribution of fuels), Healthcare (own-brand health & beauty products + distribution of primary health care products) and Technology (distribution of consumer electronics, computers, audio/visual and communications equipment). The primary focus of the business is the distribution and supply of 3rd party products and it is typically not involved in downstream manufacturing or production (other than in some areas in health & beauty).

Conglomeration has its good sides, however. Diversification should lead to counter cyclicality and a well-set portfolio of industries can help create a very steady growth business. DCC must be doing something right as it has now managed to deliver an unbroken 27 years of dividend growth, a trend that it appears to have a very good chance of continuing based on a positive set of consensus forecasts.

Figure 1: DCC's dividend record – pence per share paid



Source: DCC

Are investors becoming interested again in multi-disciplined businesses such as these? Not necessarily, as although DCC is less complex than the conglomerates of the 1970s, this is still a business with a huge number of moving parts that can be hard to track. As a key driver of the business is to continue making lots of acquisitions, that complexity is only likely to increase. Many professional investors find multi-line businesses too difficult to track, doubly so for private investors. There are plenty of simpler businesses that offer equally good prospects.

A complex and loosely connected basket

DCC has four operating divisions. While having very little apparent connection (not uncommon in conglomerate businesses), the common theme through all four is that they provide primarily distribution of third-party products with pockets of own-label and value-add to the products handled for their customers.

> **LPG** – liquified petroleum gas is a cleaner (but not clean) alternative to fuel oil, mainly used for heating, which is seen as a part solution to the decarbonising of businesses and 'off-grid' housing across Europe (90 per cent of deliveries). DCC is a pure distributor with no refining or stock holding interest which means that there is no direct benefit for investors from today's higher pricing. While there is now involvement in renewable energy (mainly solar), this is still a business

exposed to hydrocarbons. So, underlying growth here is more closely aligned with global GDP expansion but there is still room for expansion, especially in the USA, to bump up the pace. This arm accounts for around 45 per cent of earnings before interest and tax (EBIT).

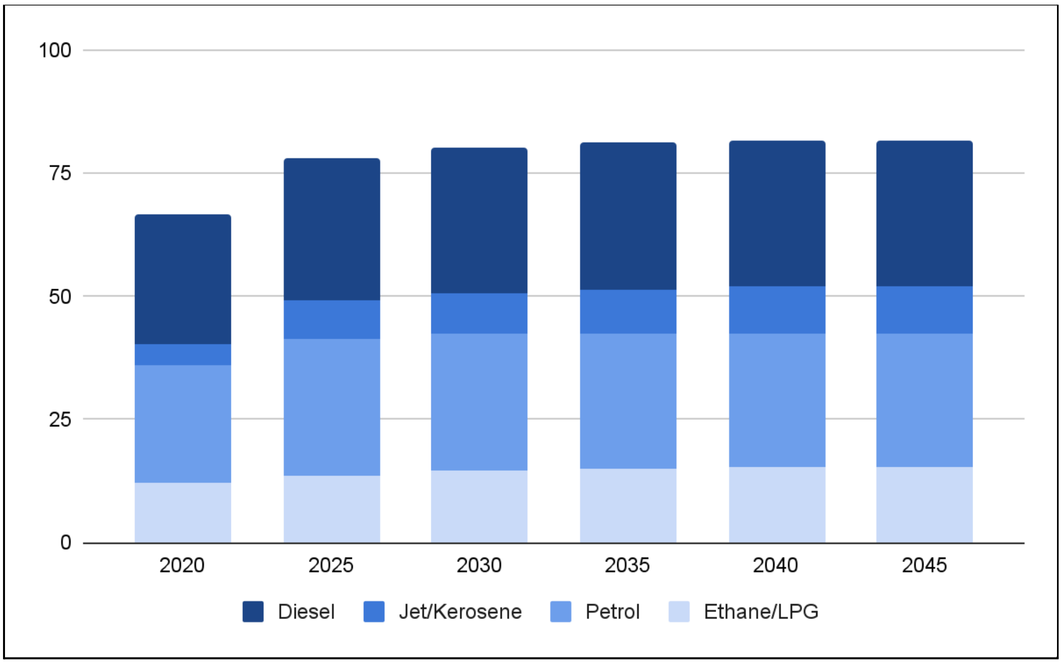
LPG is a greener fuel than those it looks to replace/supplant – lower carbon (15per cent less CO_2 than kerosene, 29 per cent less than diesel and 25 per cent less than heavy fuel oil/red diesel), low nitrous oxide NOx (half vs petrol and 95 per cent lower vs diesel), soot free, safe if spilled into the environment (it simply evaporates unlike oil or petrol), but it is not fully green and is not renewable like wind or solar. It is a better alternative and is viewed by many as a 'bridge' solution to reducing a carbon footprint rather than a truly green one.

There must also be some question marks over near-term demand rates for LPG as heating oil in the face of much higher pricing. LPG is a refinery by-product and as crude prices remain high and unstable, use could drop amongst domestic users. Lowering the thermostat by one degree saves around four per cent of energy use and a shortened heating cycle (assuming a seven hour, two cycle home heating profile) of 2.5 per cent for every 10 minutes cut from heating times. While heating is seen as being at the 'blunt' end of consumers' discretionary spending it cannot be seen as immune from lower demand in the near-term.

Retail & Oil – this is the distribution of liquid fuels (other than LPG) primarily petrol and diesel in bulk form and via a network of over 1,100 service stations. Around a quarter of profits arise here. Over 10 billion litres of increasingly lower emission fuels each year is split c.50/50 between the UK and Europe (mainly the Nordics and France). It feels as if this business will need to re-shape in the coming decade as electric vehicles (EV) become more dominant: in February 2022, over 17 per cent of new registrations were for EVs but they comprise only 3½ per cent of total cars on the road. DCC is looking more to electric vehicle refuelling but with an evolutionary rather than revolutionary pace.

While many countries will ban the sale of new internal combustion engines in less than 10 years, industry forecasts do not predict that sales of petrol or diesel (globally at least) will collapse. As Figure 2 shows, OPEC suggests that petrol and diesel demand will still grow at a compound rate of 1-1.5 per cent between 2020 and 2030 and then only then will the rate flatten. Inevitably it will begin to fall but perhaps not until after 2050. LPG demand has the same profile but OPEC suggests a fractionally higher compound annual growth rate (CAGR) of 1.8 per cent to 2030. Note that these are global figures and reflect the lower pace of change in larger nations such as India, China and the USA. The UK and Europe (and the Nordic states in particular) are likely to see declining demand sooner but still not a collapse, rather a slow fade.

Figure 2: Forecast sales of selected refined oil products (mln barrels/day)



Source: OPEC

Health & Beauty – two distinct arms here: 1) DCC Vital servicing largely single use consumables to primary health care providers (GPs and hospitals); 2) distribution of (primarily) supplements (but offers a full range of 'drugstore' style items) for third party, branded businesses (e.g Vitabiotics and Seven Seas). It also provides packaging solutions and some licensed manufacturing on non-pharma products. There is broadly an even split between the two arms in revenue terms and overall around 15 per cent of the group.

This looks to be the focus of group expansion, slowly steering the group away from the stagnating petroleum-related end markets. There are many opportunities here, especially in the USA and Germany where the markets are more fragmented and regionalised. DCC tends to purchase more acquisitive companies with an established M&A programme, which keeps up the expansive growth momentum after the initial large step up in investment. Global spending on healthcare (according to the OECD) is set to rise by 2.7 per cent per annum through to 2030, and the personal care, off-the-shelf health and beauty markets may grow almost twice as quickly. Expansion in this part of the business would improve the quality of earnings but is also necessary to inject more vitality into the group's organic growth which many observers believe to be too low.

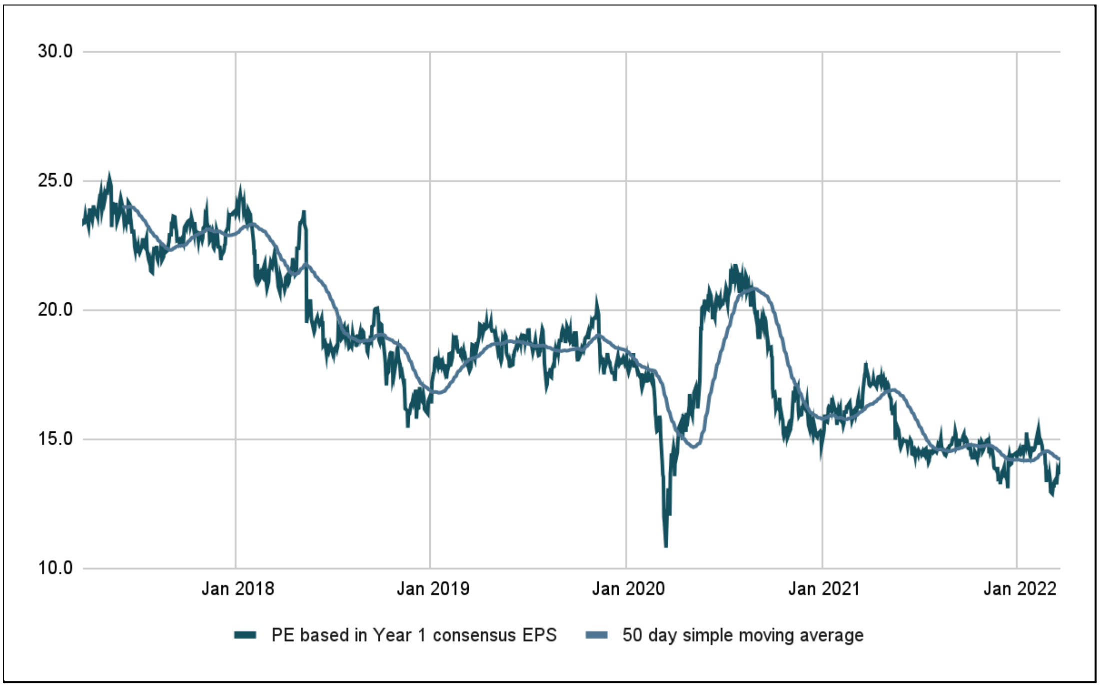
Technology – perhaps something of a misnomer as this is not a technology business *per se* but a distributor of third party electronics, IT devices and audio-visual equipment. There are large revenues here (about a quarter of group total) but half as much profit as margins are less than 1.5 per cent, but as a capital-light operation, a decent 12 per cent return on capital employed (ROCE) is made. The final 15 per cent or so of group profit comes from here.

Demand for electronic items is unlikely to diminish, but in the near term replacement cycles may extend as households feel the pinch financially. As DCC serves both store-based and online retail, any morphing in how customers make their purchases would have little impact on demand for the group's services.

A long-term de-rating

DCC has suffered a steady de-rating of its shares (i.e. the PE ratio has steadily fallen) since around 2016 - the point at which the share price ran out of momentum after a sustained positive performance. From 2012 to the end of 2016, DCC's share price rose 350 per cent, but has slowly fallen back since towards today's 5800p level with the PE ratio dropping from c.25x (on year 1 EPS) to stand today at just under 14x. Will the stock continue to de-rate?

Figure 3: DCC's PE ratio – simple and moving average



Source: FactSet

The rot really should have stopped as the shares have reached a point close to a market average rating and with EPS forecast to rise by an average 8.5 per cent to FY 2024 the rating should be slightly ahead of the market average. When the PE ratio was comfortably above 20x, that was simply too high even though EPS had been growing by around 15 per cent.

Could there be a positive re-rating? That feels unlikely with this lower rate of growth and because it now feels that the business will need to continue heavier investment in new businesses even to deliver the current growth in EPS - there does not seem to be a great deal of organic growth feeding through. The past six years have seen substantially higher rates of new business investment (averaging around £300mn per annum) representing half of all the acquisition spending made since the group's IPO 27 years ago. Getting the right targets and bringing out optimum value from them is always hard and becomes harder as the scale of expansion increases. As the four parts of the business are disparate and the operations within those four are also fairly diverse, it is not always easy to see that expansion drives greater operating efficiency or delivers operational gearing. There is plenty of resource to sustain investment and drive profits but organic and like-for-like growth is always likely to attract a better rating.

Is there value here?

While longer term investors will have seen a high total return from holding DCC – £100 invested 10 years ago is now worth £467 – any investment made more recently has fared less well. Other than anyone buying shares in the early days of the market-wide Covid slump in 2020, most purchases made in the last five years are likely to have seen a negative total return: over five years it is -7 per cent, four years - 3 per cent and over three years - 3 per cent. That could/should change going forward. If growth can be sustained at around 8 per cent and the de-rating stops, the share price has the scope to rise in line with earnings, and the dividend with it. The dividend is typically around twice covered by EPS, but does not appear likely to see an increasing share of free cash flows as the focus remains very much on expansion. The yield is around 2.75 per cent.

The high exposure to fossil fuels could be an issue for some investors plus the relatively slow pace that there appears to be to reposition from what has to be a long-term shrinking end market in both heating and transport fuels. This is so large a part of the business that making a rapid, wholesale shift to renewables would be tough and expensive in what is an increasingly competitive space. While DCC has very strong market positions in its existing markets, it is hard to see many other players want to buy DCC out of them or at least do so at a decent valuation.

That said, the timescales for energy transition are long with most global ambitions in this area looking to achieve zero carbon only by the second half of the 21st century, much longer than any realistic investment time horizon. All that can be asked of a business with a hand in the fossil fuels industry is to now be in transition and have an achievable 30-year objective: DCC is making change happen. Many nations have an even longer timeframe: China might be net zero by 2060 but India not until 2070 which means that products such as LPG and biodiesel are likely still to grow through most of the 2020s and even for investors with longer time frames.

All told, there could be some value for investors and the TSR swing here could move from negative to potentially double digit positive but only if the de-rating has run its course. There is something of a quality of earnings issue here and there would likely be scope for a higher rating if more organic growth was visible, if some more of the free-cash flow could fund a higher dividend (or the occasional share buy-back) and if there was faster growth in the non-petroleum disciplines.

Continued below

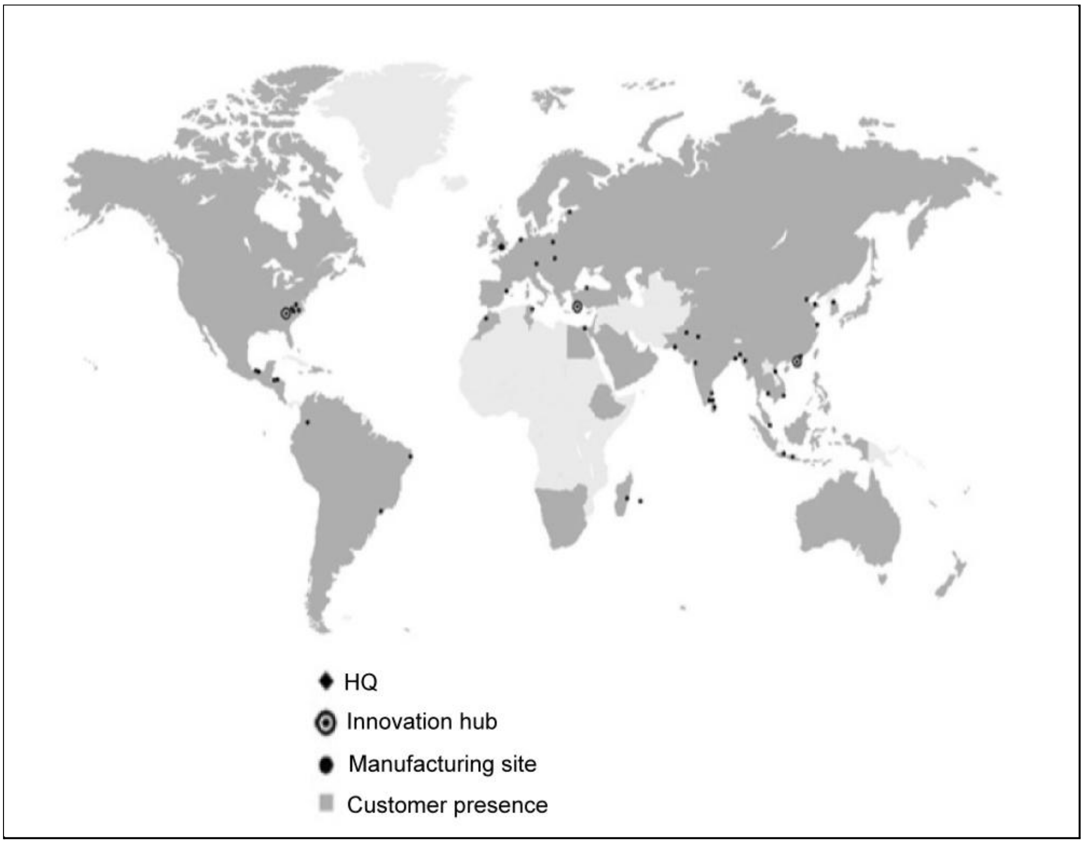
Coats – uncommon threads

Source: FactSet

Coats is the world's leading manufacturer of threads that are used to join together a wide range of materials in a vast array of end uses: it now controls 23 per cent of the global market. A very long-standing business, founded in 1755 and one of the original stocks in the FT-30 index back in 1935, today it sits bang in the middle of the FTSE 250 index with a market value of just over £1bn. Bought in 2003 (just after selling its loss-making garment manufacturing and fashion brands Jaeger & Viyella for £1) by Australian investment group Guinness Peat (GP) in a sort of reverse listing, it suffered a slightly chequered history with a €110mn fine in 2007 for cartel activity in zips and fasteners and a regulator enforced pension fund-top after GP neglected retirement funding: the pension is still something of an issue today (see later). The original group name reappeared in 2015 when GP changed the PLC's name back to Coats.

Today, Coats is focused wholly on the manufacture and development of synthetic threads for the apparel and footwear (A&F) industry (c.70 per cent of revenues) with the balance arising from the 'Performance Materials' operations (personal protection equipment, composite materials and specialised high performance threads). More than half the group's sales come from Asia as this is where the majority of its end products (there is a large bias towards fast fashion, sports and 'athleisure' wear) are manufactured. Its largest customers are the likes of Nike, Addias, GAP, H&M and Uniqlo. While the garment industry generally is seen as being capable of growing in line with underlying GDP, this customer profile exposes Coats to moderate, real, underlying growth markets.

Coats' global footprint



Source: Coats

Poor performance in Performance

A recent factor holding back profits has been the Performance Materials (PM) arm based primarily in the US. Here Coats has recently struggled to supply its customers due to a lack of labour with the plants mainly based in the Carolinas only able to operate at around 65 per cent capacity. Securing orders has not been a problem. Covid absences, lower immigration and rapid growth in Amazon warehouses have impacted Coats' core workforce. Also, the largely US customer base (armed forces, fire, ambulance, telco carriers, aeroplane manufacturers, car makers) often required that Coats' materials were made in the mainland USA, which prevented significant offshoring into the Asian plants servicing the A&F customers. Such flexibility is normally one of Coats' key strengths.

Agreements have now been reached to allow some manufacturing to move to Mexico and some processes to move further afield. This is expected to allow the PM division to return to full capacity, deliver around two-thirds of the overall $50mn cost saving drive and restore PM's margins to the low-to-mid teens levels achieved during the 2010s. In 2020, they dropped to c.4 per cent and partly restored to c.7 per cent in 2021. This alone would push up group profits by 10-12 per cent.

Good morning Vietnam

Vietnam is a key end market for Coats as many of its core manufacturing clients have their operations here. This country saw some of the harshest Covid restrictions during 2020 and 2021 with bans on immigrant workers, enforced factory closures and draconian restrictions of movement of workers within the country. This hit the 2020 results hard with all four quarters running negative versus 2019, and almost 50 per cent down in Q2 2020. Q1 of 2021 continued to struggle a little but overall FY2020 showed an average 5 per cent pick-up versus 2019 and a run rate above 10 per cent by Q4.

Strong legs for growth

Observers see four main legs to the positive development of Coats as a business.

Market share gains – Coats has been steadily growing its market share by around 50bps per annum, but last year it jumped by 200bps. Exposure to faster growth customers, some sizable wins in the PM division, strategic acquisitions also in PM and the various factors set out below could allow Coats to continue gaining market share above its longer-term average.

Sustainability – The A&F industry is a major polluter reckoned to be responsible for around 10 per cent of global carbon emissions and the industry is rapidly playing catch-up (largely from consumer pressure on leading brands), challenging all parts of its supply chain to play a part. Coats is able to use its much larger scale (its scale is a multiple of the industry's No.2 and 3 players) to innovate (see below) and deliver in this area. Synthetic threads have historically been an oil by-product but Coats is leading change here: its EcoVerde product made from recycled plastic bottles grew sales 159 per cent last year with another 60 per cent forecast in 2022: this brand new product is now one tenth of total revenues from a cold start. This could also help extend Coat's reach into more demanding eco-friendly brands such as Patagonia. Also many of the local markets to which Coats supplies are rapidly tightening their environmental requirements placed on manufacturers.

Innovation – while it may be hard to imagine innovation in threads, Coats is able to generate incremental revenues from new thread designs, especially in the higher performance arena. In FY2021, it brought 22 new threads to market and these alone generated $37mn of sales (3 per cent of sales growth), although part of that will have been replacements and/or cannibalisation. This plus the eco products show that further large market share gains can flow from innovation.

Coats' size is also a positive here as it is so much larger than its competitors: for example, A&E Gütterman having only c7.5 per cent of Coats' annual revenues or Unifi which has half Coat's $1.5bn revenues in total, but the bulk of its yarns are for fabric weaving rather than for joining.

Digitisation – garment manufacturing is something of a backwards industry (hence the high carbon footprint) so any move to automate the supply chain is likely to drive efficiency and market share gains. Coats is seen as being well ahead of its competition, as it has a flexible and widespread manufacturing base.

Pricing – Coats is able to use its large market share to exert good pricing power and has been able, to date, to pass through a substantial amount of higher input pricing. Other advantages it has here is a growing decoupling from the rising oil price (recycled plastics etc), the fact that threads are only a very small (c.2 per cent) proportion of the total cost of a garment and that it now has an extensive network of manufacturing plants that can allow shorter supply chains as manufacturers increasingly move their production to lowest net cost locations.

Coats' pension issues

When companies find themselves with large holes in their pension funds, there is typically a great deal of damage to the value held by external shareholders. Back in 2015 before owners Guinness Peat were forced by the Pensions Regulator, to agree to 'make whole' the pension fund, the deficit (the gap between the present value of all pension liabilities and the assets invested) in the pension scheme was £400mn against a market value of the company of only around £300mn.

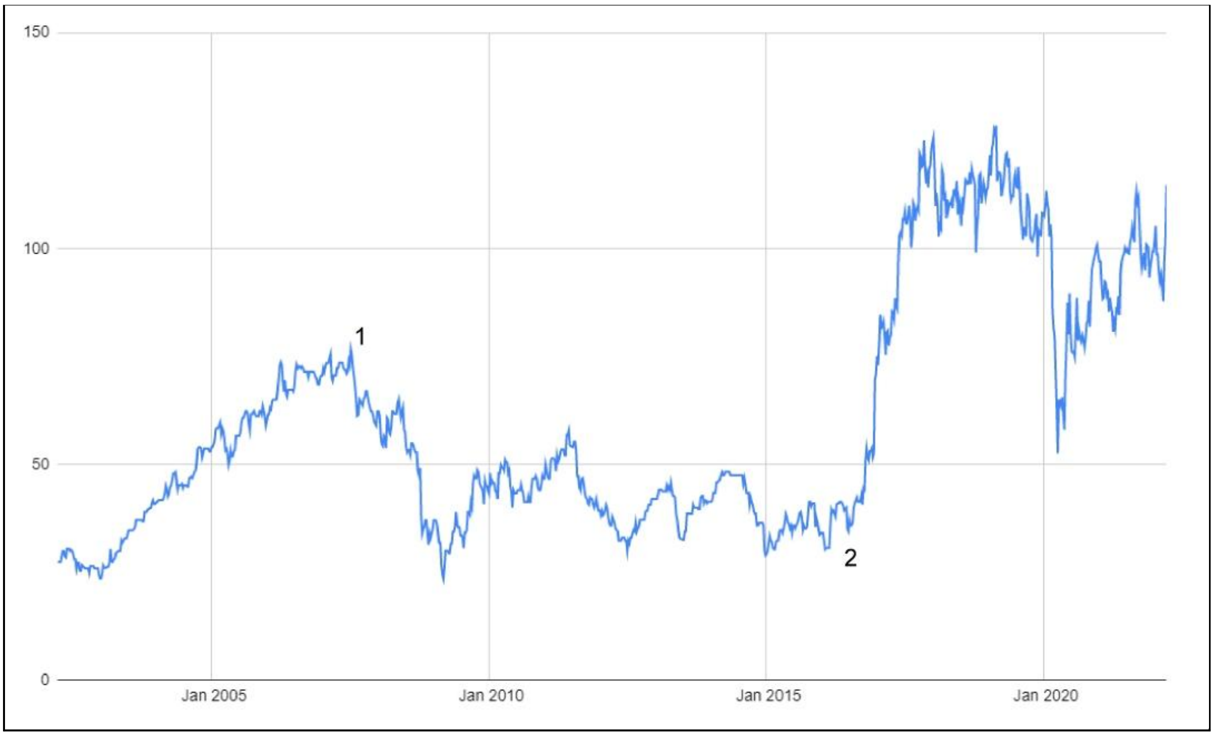
When a pension scheme (as in this case a final salary or defined benefit scheme) is this badly under-funded, the pension trustee gains an undue amount of power over the affairs of the business. They can prevent dividends being paid, block equity issues, prevent acquisitions and challenge larger items of capital expenditure all of which drag on business performance/opportunities and in turn drag on the share price. Once the pension issues at Coats began to be addressed (after 2015), there was a visible leap in the share price as the underlying value of the business was no longer eclipsed by the black hole in the pension fund.

Coats' pension scheme is now back in 'technical' surplus helped by good returns after the 2020 market slump and through rising discount rates shrinking the future value of the benefits payable. However, the trustees still have the PLC paying a total of £25mn into the fund until 2028, around 30 per cent of post-tax income.

This is still a drag on the group's valuation as the issues outlined above still act as something of a restriction on investment and on dividend payments. Charles Hall at Peel Hunt reckons that the share price is around 10-15 per cent below where it could or should be if the pension issue was not there.

However, this is increasingly a legacy issue and investors can begin to 'look through' the discount that remains in the share rating as there is at least now a possibility that at the next triennial review of the pension scheme (in Q1 2025) these corrective payments could cease. That would release £25mn for additional investment or distribution.

Long-term share price



Source & key: FactSet | 1 = EU Cartel fine   2 = Resolution of pension issues and renaming PLC as Coats

What is the journey from here?

The outlook for Coats is a pretty positive one and presents a good growth story on a still pretty low rating. Unfortunately, there has already been something of a jump following the FY2021 results which showed that the group's stars were really beginning to align. Since the end of February the share price has jumped by over 13 per cent and is finally beginning to come close to its pre-Covid highs. That said, estimates for FY2023 have increased by more than the share price: Peel Hunt has increased its EPS forecast by 20 per cent so, in fact, the shares have fractionally de-rated since the last results were published despite the price surge. Next year's PE ratio is still just 11x, which undervalues the compound EPS growth of over 17 per cent through to FY2024. If we adjust for this mismatch (there should be a premium to the market's c.12x PE as FTSE 350 average EPS growth is just 5.5 per cent). This could support a share price closer to 100p (77p at the time of writing).

Another issue here is that investors had simply lost faith that this was a business that could grow. The five-year compound growth in revenues up to FY2021 was just 0.2 per cent, enough to cause many investors to just walk away. While this might only be forecast to pick up to around 4 per cent per annum, the market share gains plus the rapid growth in eco-friendly products could see this rate beaten. Then considering the cost saving of $50mn plus the margin recovery in Performance Materials and a decent level of operational gearing as plant capacity utilisation rises, it becomes easier to argue that Coats is back in the growth club.

Even if that feels a little rich, there is still the issue of the diminishing drag from the pension issues that could alone allow the shares to push up by 10 per cent as the long saga of the retirement payments falls away. Either way, this is a stock that looks under-valued, not hugely but perhaps enough to give investors a total return by the end of 2024 of around 15 per cent (5 per cent coming from the dividend).

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