Lupus Capital

Initiation of coverage

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Construction & materials

Lupus has been re-shaped and de-geared under new management. While its markets have yet to improve meaningfully, earnings are already moving forward again and this should be enhanced by broader recovery trends and complementary acquisitions in due course. The rating is now factoring in a recovery scenario with greater conviction, but we believe there is more to come.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/10	252.5	16.8	8.7	2.0	19.7	1.2
12/11	230.4	16.3	9.0	3.5	19.1	2.0
12/12e	239.5	21.2	9.8	4.3	17.5	2.5
12/13e	246.3	22.3	12.0	4.8	14.3	2.8

Note: Continuing operations: *PBT and EPS are normalised, as presented by Lupus, excluding intangible amortisation and exceptional items.

Gall Thomson exit provides a platform for expansion

The successful disposal of Gall Thomson (a standalone specialist coupling concern), leaves the group as a more focused building products business, with an international reach. The balance sheet has been substantially de-geared so that management can now have a more expansionary approach to developing its core business. Three acquisitions have already been made (Overland and Unique Balance Canada in North America and Fab & Fix in the UK) and have a clear fit with existing businesses in their respective territories.

Operational focus to magnify the upswing

Management deserves credit for achieving share gains in a shrunken volume environment – compounded by input cost pressures – without compromising margins. This outturn demonstrates a more strategic operational style rather than simply cost cutting. The effect has been to increase flexibility in product sourcing and the cost base. This strategy has paid dividends during a down phase and should also serve to magnify the upswing benefits. While housing markets remain generally sluggish, actions taken to re-shape the business should bear fruit as confidence returns to each region. North America (Lupus's largest market with the broadest product spread) is already starting to show more encouraging signs.

Valuation: Capable of more

At the underlying operating level, our estimates show little progress at this stage of the cycle and the rating (FY12 P/E ratio 17.5x falling to 14.3x, on Lupus's earnings definition) perhaps factors in a stronger near-term recovery expectation than we currently do. We believe that the mid-cycle earnings potential for the existing businesses has been raised and each of the regions is capable of exceeding previous highs under Lupus's ownership. Progress in North America is likely to be the chief catalyst for faster earnings growth and a further re-rating, and this region is looking more promising currently.

23 October 2012

Price	171.5p
Market cap	£223m

Shares in issue	129.7m
Free float	88%
Code	LUP
Primary exchange	AIM
Other exchanges	N/A

Share price performance

%	1m	3m	12m
Abs	9.9	28.4	57.4
Rel (local)	10.5	10.5	34.4
52-week high/low		175p	99p

Business description

Lupus Capital's product portfolio now solely addresses the residential RMI and building markets. It manufactures and sources window and door hardware and seals, largely for the US and European markets.

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FY results	March 2013

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Investment summary

Company description: Focused on building products

Lupus exited a significant non-core activity in March 2012 to focus on supplying products to the residential door and window supply chain in the UK and international markets, with North America as the leading sales territory. In subdued markets, this management team has quietly reshaped operations to enhance margins and market position. The disposal both increases business focus and gives the financial flexibility to further develop the continuing business.

Valuation: Little recovery factored in; more is achievable

Lupus is currently in a broadly stable underlying profit position, with earnings growth substantially coming from lower interest costs and acquisition contributions in FY12 and FY13. Valuation considerations must balance this profile under the near-term market outlook against achievable levels of profitability under better conditions. At 171.5p, Lupus is trading on an FY12 (to December) P/E multiple of 17.5x, falling to 14.3x in FY13. We believe that the FY08 building products' EBIT is now representative of mid cycle potential. On an ungeared basis, this would equate to a P/E ratio of c 11.1x. We also believe that acquisitions are likely to further raise this earnings base. The current share price is at a sizeable discount to our projected FY12 end NAV of 216p.

Sensitivities: Cycles, currency and margins

The residential housing market is clearly cyclical. Our current view is that markets will remain relatively subdued and below historic average levels in the near term. Volume and sales mix are important drivers of overall group margins. A faster volume pick up in core manufactured products – raising throughput and capacity utilisation – would feed in more quickly to improved profitability compared to, say, increased sales of externally sourced products. This is an important consideration in the market recovery phase. Overseas operations generate over 60% of revenues (predominantly but not solely in US dollars) so the relative strength of sterling can have a material impact on the translation of associated profits from these regions. Our current view is that North America offers both a relatively robust currency and the greatest opportunity for volume recovery in FY12/13. The ability of Lupus companies to adjust product pricing to variations in (polymer and metals) input pricing also influences reported margins.

Financials: Americas to lead near-term progress

H1 results (4 September) were consistent with our thoughts of flat to soft markets outside of North America where a gentle rate of pickup in activity levels in FY12 is to be supplemented by two bolt-on acquisitions (Overland Products and Unique Balance Canada) and the commissioning of a new extrusion line in Atlanta. Together with a sharp drop in other finance and net interest costs (following debt refinancing and the receipt of the Gall Thomson disposal proceeds respectively) this should contribute to a good uplift in profit from ongoing operations this year and next. Our estimates do not currently factor in a material rebound in any of Lupus's leading territories.

We expect FY12 year end net debt to be in the order of £36m, with underlying cash inflow (after funding an increase in both capex and dividends) supplementing the c £72m Gall Thomson cash receipts. Free cash flow in the order of £14m per year will either fund dividend growth and reduce gearing to low levels by the end of FY14 or provide additional funding to acquire good complementary bolt on businesses, subject to opportunity.

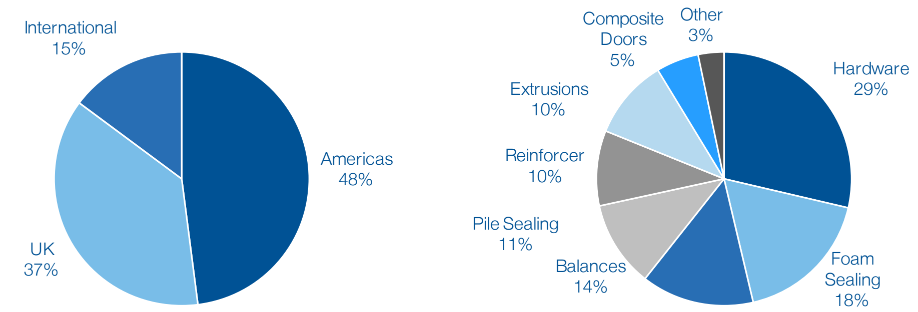
Company description: Focused on building products

Lupus Capital's sale of Gall Thomson leaves a broad international business supplying a range of products into the residential door and window industries. The business is founded on two acquired seals and hardware operations (in 2006 and 2007) and primarily addresses the repair, maintenance and improvement segment, rather than new-build markets.

Servicing the door and window supply chain

Continuing operations comprise an international grouping of businesses supplying a range of products and components to the residential door and window markets. The principal product groups are fittings (eg security hardware, locks, handles, balances) and seals, with the Americas (trading as 'Amesbury') and the UK ('grouphomesafe') as the dominant sales territories.

Exhibit 1: Lupus product and geographical product split, FY11



Source: Edison Investment Research, company

Lupus has a hybrid model, incorporating manufacturing, sourcing and distribution. Virtually all seal products are made in house, as are window balances, extrusions and composite doors. Fittings, including security hardware, are variously assembled, sourced to Lupus designs or otherwise bought in, depending upon region. Typically, manufactured product is made for the local market, reflecting both regional variance in specification and a focus on short supply lines to achieve industry-leading service levels. Regionally, UK activity is more hardware oriented (with a 90:10 split between RMI sectors and newbuild), while the Americas have a broader sales spread across product categories. Other international markets are less well developed and largely seals focused, and addressed from four manufacturing facilities (three in Europe, one in Australia). Product quality, breadth, availability and service are the cornerstones of the business.

New management enhances supply chain and service focus

A board overhaul at the end of 2009 brought in the current three NEDs (including Chairman Jamie Pike) followed by Louis Eperjesi (CEO) and James Brotherton (CFO) in February and May 2010 respectively. Overall, the board brings a balance between financial expertise and building products experience substantially gained in European markets.

Operating in depressed markets in its key regions, this team has focused on developing a robust supply chain, striking a balance between manufacturing and sourcing (own design) products with which to service end customers. A rolling programme of incremental improvement is now adopted practice. Recovery in core markets is likely to be supplemented by expansion into adjacent product lines with common distribution channels and/or end markets, either organically or by acquisition.

Exhibit 2: Lupus Capital operations

Lupus Capital Building Products		FY11 £m	Hardware	Balances	Foam seals	Pile seals	Reinforcer	Extrusions	Other	
Revenue		230.4	26%	18%	20%	11%	8%	11%	7%	
Operating profit		22.4								
		9.7%								
groupshomesafe		89.0	41%	4%	4%	5%	26%	1%	19%	
		7.7								
		8.7%								
ERA Security Hardware	Falkirk		x							Distributor of hardware products for the fenestration industry in Scotland
ERA Products	Willenhall		x							Supplier of quality cylinder and multipoint security locks
Balance UK	Somerset		x	x						Supplier of quality spiral sash balances, window hardware and other accessories
Schlegel	Henlow		x		x	x				Manufacturer of Foam weatherstrip; distributor of pile weatherstrip and window hardware
Linear	Newton Aycliffe					x		x		Manufacturer of pile weatherstripping & extrusions
Fab & Fix *	Coventry		x							Designer & distributor of high quality suited hardware products (* from 7/8/12)
Telford Pressure Castings	Telford		x							Specialist manufacturer of zinc die-cast components for a variety of industrial sectors
EWS Manufacuring	Wolverhampton						x			Manufacture and supply of reinforcement sections and aluminium and steel spacer tube for PVCu window and insulated glass
Ventrolla	Harrogate								x	High quality timber sash and casement window renovation
Amesbury Group		105.4	22%	29%	27%	8%	0%	15%	0%	
		11.3								
		10.7%								
Fastek Products	Canton, SD		x							Manufacturer of Zinc Die Cast and Plastic Injection molded components for the fenestration industry
Overland Products *	Fremont, Nebraska		x							Stampings, mainly for window market (*from Q1 FY12)
Door Hardware / BSI-Balance Systems	Sioux Falls, SD		x	x						Distributor of hardware for a range of door and window hardware & Manufacturer of several block & tackle/hybrid balances
BSI-Balance Systems	Statesville, NC			x						Manufacturer of Block & Tackle and Constant Force Balances for Single and Double-hung Windows
Amesbury Mexico	Chihuahua			x						Manufacturer of block & tackle balances for single and double-hung windows
Unique Balance *	Montreal, Canada			x						Manufacturer of larger window Balances including some commercial applications (*from 24/4/12)
Schlegel NA	Rochester, NY				x					Manufacturer of urethane foam window and door seals
Foamtite	Amesbury, MA				x					Manufacturer of TPE foam weather seals for the window & door industry
Textile	Statesville, NC					x				Manufacturer of pile window and door seals
Bandlock	Ontario, CA							x		Manufacturer of custom profile extrusion and industrial vacuum couplers
PPI	Cannon Falls, MN							x		Manufacturer of custom engineered profile extrusions and assemblies
Atlanta *	Atlanta, GA							x		Manufacturer of custom profile extrusions (*from Q1 FY12)
Schlegel International		36.0	8%	0%	26%	41%	0%	15%	11%	
		3.4								
		9.3%								
Schlegel Spain	Barcelona					x				Manufacturer of pile weatherstrip
Schlegel Belgium **	Gistel					x			x	Manufacturer of pile weatherstrip and copier product (** to be closed, relocating equipment to UK & Spain)
Schlegel Germany	Hamburg				x			x		Manufacturer of foam weatherstrip & extrusions
Schlegel Italy	Milan		x			x				Distributor of pile weatherstrip and window hardware
Schlegel Brazil	Sao Paolo				x	x				Distributor of window seals and copier product
Schlegel Russia	Moscow		x		x	x				Distributor of Seals and Door and Window Hardware
LSS (Ningbo)	Zhejiang, China		x							Sourcing office for a range of window and door hardware sold through Amesbury, grouphomesafe and Schlegel worldwide
Schlegel Singapore	Singapore		x		x	x				Distributor of window seals and fenestration hardware
Schlegel Australia	Chipping Norton, NSW				x	x				Manufacturer of foam and pile weatherstrip and distributor of balances and window hardware
Schlegel New Zealand	Silverdale, NI		x		x	x				Distributor of window seals and fenestration hardware

Source: Edison Investment Research, Company

Forging business integration with market headwinds

The new executive team came together at Lupus in the midst of a significant housing recession in its major trading territories. Notwithstanding this, a range of steps have been taken to reposition the business operationally. The £75m sale of Gall Thomson (a significant but non-core specialist couplings business) in March substantially reduced net debt, providing greater flexibility to accelerate the ongoing strategic development of the business. This section looks at measures taken to integrate acquired businesses with implications for future financial performance.

Overview 2002-12

At the end of 2002, Lupus Capital shareholders were the catalyst for management change, as a precursor to Greg Hutchings becoming executive chairman in early 2004 with a private equity model. Gall Thomson was the primary business at this time. Schlegel Building Products (manufacturer of door and window seals, part of Unipoly Holdings) and Laird Security Systems (LSS, manufacturer of locks, handles and fittings from Laird plc) were acquired in April 2006 and in April 2007 respectively. Aggregate consideration for these two buildings products companies was c £327m, funded by debt and c £190m new equity.

At the point of joining, Schlegel and LSS generated combined revenues of c £300m and c £27m operating profit (c 9% margin) with around 3,000 employees. The larger Amesbury Group ('LSS Americas') absorbed Schlegel US, while Schlegel Europe management took on LSS operations outside the Americas ('UK' and 'International'). Other post-merger actions included closing two US hardware sites, shifting production to an existing Chinese facility and a new Mexican one and the disposal of a small UK conservatory business. Concurrently, deteriorating housing market volumes scaled back activity levels generally and staff numbers had reduced by over one third by mid 2009. Group revenue had fallen to £235m in the 12 months to this point. US dollar strength further exacerbated the financial stress, triggering debt refinancing and management change at this time.

After a short interregnum, the current chairman joined, with the CEO and FD roles being filled in early 2010. There have been a number of notable achievements under their tenure; at the corporate level, debt re-financing (extending to March 2016), a first acquisition in over four years (Overland Products, in December 2011) and the sale of Gall Thomson for c £72m in March 2012, reducing pro forma net debt to an estimated £23m. This team has also implemented an internal business process improvement programme over the last two years or so. The following sections focus on the development of the ongoing Building Products activities during this time.

Internal focus fine tunes operations

Actions taken to date have chiefly addressed product cost reduction (efficient manufacturing and sourcing), streamlined support functions and enhanced sales and marketing activity. Taken together, formerly disparate businesses now have a more coherent and integrated market presence. Some regional examples of this include:

UK operations: The Hardware administration was merged together, followed by a consolidation of the wider sales force, bringing together all of the UK brands under the 'grouphomesafe' banner. Additionally, the Chinese manufacturing facility was closed in the first half of FY10, replaced by a sourcing supply chain for a mix of commodity and designed product and components. In FY12, an exit from a loss-making doors business and the acquisition of Fab & Fix (a suited hardware designer and distributor) were announced with the H1 results.

Americas: Manufacturing refinements have included expansion (of balance capacity in Juarez, Mexico) and integration (of a component producer into an existing balance factory) to both reduce costs and maintain short supply lines. In 2011, 'Amesbury' was adopted as a single identity and umbrella brand in the region to reinforce a reinvigorated account management focus. Additionally, two sites in South Dakota were consolidated into a single hybrid balance and hardware facility. At the end of 2011, Lupus acquired Overland Products (a stampings supplier, for £10.3m), bringing in additional component capability and vertical integration and Unique Balance (acquired in April 2012), broadened the balance product offering.

International: The manufacturing footprint for International (ie outside the UK and the Americas) has been intact since Schlegel was acquired in 2006. Our sense is that operations have been flexed to the level of prevailing demand and the original production capacity is substantially unchanged. We now understand that the three sites are to be consolidated into two by the end of Q1 FY13, with the closure of the Belgian site.

Note that the primary ongoing manufacturing and distribution operations for Lupus are shown in Exhibit 2 (on page 4).

Adapted business model delivers margin uplift

In reported terms, FY11 building products revenue was £230.4m (which was similar to the mid 2009 run rate), around one-quarter lower than pre-acquisition levels. Adjusting for exchange rate movements and a UK disposal, we estimate that the underlying decline was more like 10%, comprising UK -10%, US -14% and other areas slightly ahead. Undoubtedly, the pass through of higher input prices masks a larger underlying volume decline but, compared to the fall in activity in housing markets, these more resilient performances almost certainly represent market share gains.

Despite the lower revenue base, we estimate that the FY11 gross margin (at 31.5%) and underlying, pre-central cost operating margin (at c 10%) were c 400bp and c 130bp respectively higher than when the businesses were first combined in 2007. (Note that these are our start/end estimates – intervening margin analysis is restricted by structural business change.) In the initial phase, operations were downsized and loosely connected, reflecting both corporate integration and recessionary impacts. The vast majority of staff reductions were made during this time. Since then, current management's influence has seen a more subtle re-balancing between manufacturing and increased focus on service, supply chain management and operating cost flexibility. This includes increased outsourcing (especially in hardware) and a more co-ordinated sales, marketing and product portfolio approach. We estimate that c 70bp of the 130bp operating margin improvement has been achieved under the current management team (on flat revenues). We view this margin performance as being very creditable especially against a testing backdrop of subdued volumes, input cost pressures and balance sheet constraints.

The cost structure for the ongoing building products activities has changed. If anything, the gross margin improvement noted above probably understates a stronger uplift on manufactured product due to the dilutive effect of increased outsourcing. Assuming that core production capacity is intact (though capex has lagged depreciation), we would expect greater operational gearing on the upside now with rising/recovering volumes especially if the mix increasingly favours manufactured – particularly seals – product. Margins should expand more rapidly under this scenario.

Solid platform for strategic development

A significant business disposal and funding visibility (with debt facilities in place to 2016) mean that Lupus now has greater financial flexibility than at any time since LSS and Schlegel were first put together. Additionally, having re-shaped the ongoing buildings products operations, management now has a more solid platform from which to develop its strategic agenda. We see future progress coming in three key areas.

1. Capturing market recovery

Housing markets in the UK and US appear some way from their mean activity levels let alone their peaks. Recent official data shows annualised US existing home transactions of 4.82m (11% below the 2000-10 average and 30% below the 2005 peak – National Association of Realtors) and new build sales of 0.37m (50% below average 70% below peak – US Department of Housing). In the UK, housing transactions are running at around 40% below average pre-financial crisis levels. The US (Lupus's largest single territory) appears to be ahead of the UK in coming out of its housing market recession. These trends are yet to be fully established (and other factors such as mortgage availability and stock of unsold homes will affect the rate of recovery), but there is clear upside from current levels, on a mean reversion basis at least. The data also shows that Schlegel and LSS were acquired at or close to peak market activity levels. Consequently, actions taken to downsize the business, increase operational efficiencies and gain market share (bettering the market by 300-400bp in 2010-2011) should serve to magnify the upswing when housing market momentum gathers pace.

2. Ongoing business development

As outlined earlier, much has been done to change the shape of the business and how it operates. The continuous improvement culture established by new management means that business development is seen as an ongoing process. In tangible terms, some examples of this include investment in a new extrusion facility in Georgia (operational in Q1), the implementation of a common IT platform (underway, three-year programme) and increasing momentum behind new product development for local markets. Also, we note the recruitment of new MDs for UK/Ireland and International in the early part of 2012. They both bring larger building materials organisation experience and, after reviewing their respective business area, may bring fresh ideas and impetus to build onto their existing platforms.

3. Build out capability and footprint

With this robust supply and market presence platform in place and given the much reduced net debt position, we would not be surprised to see complementary acquisitions continuing to supplement headline growth rates. We have seen three deals now. Overland Products (December 2011) to in-source stamped component capability, Unique Balance Canada (April 2012) added a heavier balance product to the existing range and Fab & Fix (August 2012) added suited hardware ranges to grouphomesafe. Overland represents vertical integration (and greater supply chain control), while Unique and Fab & Fix both expand the product offering. To these we would add extending geographic coverage as the third likely key target area for acquisitions. We expect fit with existing operations to be a prime consideration in any future deals.

Sensitivities

Lupus has a hybrid business model with a core manufacturing base complemented by significant sourcing and distribution activities. Sales of fittings and seals into the residential door and window supply chains are the dominant group activity. This sector is largely driven by local economic factors and, therefore, there are likely to be regional performance differences across Lupus's various international markets.

Increased operational gearing to manufactured product

Housing markets are cyclical and both transactions and new-build activity are well below pre-acquisition levels in the leading markets for Amesbury and grouphomesafe. The combined business now has a higher gross margin and lower SG&A costs compared to pre-acquisition levels. Actions taken to combine operations, eg site consolidation and an increased proportion of sourced hardware product, have reduced and flexed the cost base respectively. This is particularly representative of North American operations. The key sensitivity for Lupus is volume of manufactured product and we believe that margins from the seals sub sectors are ahead of the others in the group. Note that International has the highest proportion of seals revenue (two-thirds) and the UK the lowest (c 10%). While market trends are currently subdued outside North America, given the business re-positioning undertaken, we feel that operational gearing in a rising volume environment has increased. The extent depends upon the product and regional mix, and we believe that manufacturing capacity in the key seals, balances and hardware products is intact.

Exposure to international markets and input prices

In FY11, less than 40% of revenues were generated in the UK. The Americas (46%) and International (16%, primarily eurozone) made up the remainder, making the US dollar the leading currency for translating overseas results. With a proportion of sourced hardware products, mainly from China, there is also some transactional exposure to moving cross rates (though less than 20% of COGS overall). We would expect this to be managed through forward contracts. The export of finished manufactured goods is not thought to make up a significant proportion of sales (ie less than 5%).

Lupus buys a range of components and polymer intermediate products and is exposed to price changes in underlying metals and feedstock materials. Bought in materials and goods represent c 70% of group COGS. In each region, operating companies serve a diverse customer base, chiefly in the distribution supply chain for window and door products. Hence, the impact of input cost changes depends on the local pass-through mechanism. We understand that longer-term relations with important US distributors include greater materials transparency than in other markets.

Other

Following debt reduction, as we have seen, Lupus is now in a position to acquire and consolidate in its market sectors, bringing the usual attendant risks and potential rewards which we are unable to judge until details (eg scale, entry multiples, synergies and funding) are announced. Lastly, we note that Greg Hutchings retains an ongoing interest (10.7% shareholder, former chairman). In the past, a couple of EGMs have been called by him to replace management, though the last of these was over two years ago.

Valuation

The investment proposition is for a stabilised current business with earnings progression from debt reduction and the prospect of a meaningful market recovery to come. Lupus's core building products markets remain at or near their recent cyclical lows reflecting a range of challenges faced by local consumers in their respective markets. Our forecast FY12 PBT increase comes from lower finance costs and a maiden contribution from Overland. The de-geared group with modest underlying growth delivers a healthy earnings uplift (and c 15% DPS CAGR) and our FY14 EBIT approaches the peak level achieved in 2008, without a significant market recovery. Our forecasts for all three reported regions are below 2008 levels (ie first full year of both large acquisitions). In our view, the share price currently anticipates a degree of near-term recovery ahead of our underlying estimates.

Conventional measures for an established business

Lupus is an established international business; even at the cyclical low, all regions are profitable and the group is cash generative. We use conventional P/E and cash flow multiples to appraise the current market view. Valuation must balance a low underlying growth forecast under the near-term market outlook against the achievable levels of profitability in better conditions.

Valuation metrics

On EV measures, at 171.5p, Lupus is trading just over 1x revenues and 9.7x FY12 EBITDA (after pension and property cash outflows), falling to 7.8x for FY13. We also note that Lupus is trading on a c 20% discount to our projected year end NAV of 216p. After projected earnings growth of 49% and 23% respectively, Lupus is on an FY12 (to December) P/E multiple of 17.5x, falling to 14.3x one year further out. (NB we include other finance costs – the company does not – adding around a point to this measure). PEG ratios would appear attractive but are distorted with earnings near cyclical lows, well below previous levels.

Given the changes implemented, we believe that actions taken have increased the profit potential from existing operations (eg FY11 operating profit was £3.5m ahead of FY09 on comparable revenue). That said, our estimates are set conservatively (eg on comparable revenue, our FY14 EBIT estimate is below that for FY08 – the first full year of owning Schlegel and LSS). Including the beneficial effects of stronger market positions, if we take FY08 as being more representative of mid cycle earnings now (c 15.3p), this would equate to a P/E ratio of 11.1x. As currently structured, Lupus would be an ungeared business generating c £35m EBITDA or c £20m+ free cash flow per annum. We are likely to see further acquisitions, with some debt carried, and a higher earnings base in due course. We also believe that there is scope for better margins, even on modest underlying revenue growth.

Tracking partial peers

Lupus's specific market sub sector focus and geographic spread makes finding direct peers for comparative valuations of limited use. However, for market intelligence purposes we track Wolseley, Travis Perkins, Howden Joinery, Marshalls and Walker Greenbank, which have some degree of profile overlap. Of these, Wolseley has the greatest North American exposure. The current consensus appears to be for a flat/slightly lower UK market, while Wolseley has also commented on both European weakness and North American growth in its FY12 results (2 Oct). In the US, Quanex operates in some similar markets to Lupus while Home Depot and Lowes are retail players.

Financials

FY11 results reported a clean P&L for the ongoing building products operations, though the cash flow statement and balance sheet also included Gall Thomson (as did prior years), as the sale completed post year end in March 2012. This has partly masked the financial characteristics of the ongoing business. H1 trading results (4 September) were broadly flat, before acquisition effects, with good North American progress offset by weaker International markets plus some UK drag. Overall guidance was unchanged, supported by two UK deals, exiting a loss maker and adding the profitable Fab & Fix.

Gentle profit progression in the absence of major market rebound

We have addressed the trading performance of building products activities since acquisition in earlier sections. Revenue progress is made up of a combination of volume (in markets chiefly driven by confidence in both RMI and newbuild housing) together with price effects (including new products, mix and input price pass throughs). In recent years, volumes have declined, while prices have improved such that FY09 revenue was equivalent to FY11. Some operating margin improvement was achieved over this period (though FY10 was the best year of the three). We expect:

- FY12 to have a broadly flat underlying revenue performance, with some boost from acquisitions, and a very similar pattern in operating profit. The Americas territory is effectively projected to deliver all of the year-on-year progress shown.
- Beyond this, we currently expect underlying top line growth broadly equivalent to GDP (c 2%) and modest operating margin improvements. In other words, these estimates do not factor in a material rebound in housing markets back to historic average levels at this stage.

Note that the debt reduction and new bank facilities will result in sharply lower interest and facility amortisation fees respectively versus prior years, raising PBT and EPS growth rates, especially in FY12 and FY13.

Free cash flow c £14m per year

Factoring in the Gall Thomson disposal proceeds (c £72m) we estimate that pro forma net debt at the beginning of FY12 stood at c £23m. Our estimates indicate continuing free cash flow generation in the order of £14m a year, approaching 50% of EBITDA. (This includes a capex run rate at or slightly above depreciation and c £2m cash outflow for pensions and property provisions.) The expected FY12 cash dividend cost is just almost £6m, leaving plenty of headroom for growth on current estimates and still resulting in a low gearing position by the end of FY14. While Lupus cannot be entirely immune from downcycles in its housing markets, we believe that the combination of reduced gearing, cash generation and greater cost flexibility should mean that company should be relatively more robust during such phases.

A faster rate of top line growth (most likely requiring more working capital investment) or more infill acquisitions could temper dividend growth, though this would also be expected to have a positive impact on earnings and cash generation. In FY13, the first full year without Gall Thomson, our estimates indicate that interest cover will be c 7.5x (over 9x on a cash basis) and cash dividends c 2.2x. Until guided otherwise, our model assumes Lupus carries both significant cash and debt balances. A faster repayment of debt would clearly improve these multiples and earnings growth rates.

The first clean, ex Gall Thomson, balance sheet was presented with the first-half FY12 results. The Fab & Fix acquisition and composite doors disposal both occurred after the period end.

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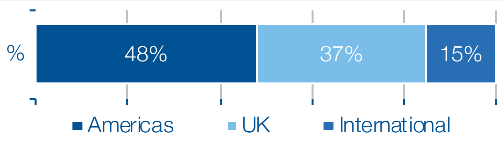
Exhibit 3: Financial summary

£'m	2008	2009	2010	2011	2012e	2013e	2014e
December	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS	Group	Group	Group	Continuing			
Revenue	266.6	241.6	266.2	230.4	239.5	246.3	251.0
Cost of Sales	(175.7)	(161.1)	(173.4)	(157.9)	(161.7)	(166.2)	(169.4)
Gross Profit	90.9	80.5	92.8	72.5	77.9	80.0	81.6
EBITDA	42.9	32.4	40.2	26.7	29.5	32.3	33.8
Operating Profit (Edison)	36.7	25.6	33.7	21.4	23.9	26.3	27.8
Net Interest	(7.8)	(7.5)	(8.9)	(5.918)	(4.2)	(3.5)	(3.0)
Other Finance	(2.2)	(4.8)	(2.9)	(3.648)	(0.9)	(1.0)	(1.0)
Share Based Payments	(0.1)	(0.0)	(0.1)	(0.172)	(0.2)	(0.2)	(0.2)
Intangible Amortisation	(9.8)	(11.6)	(11.7)	(10.6)	(11.0)	(12.0)	(12.0)
Exceptionals	(6.0)	(2.1)	(0.4)	(0.8)	0.5	0.0	0.0
Other	(0.0)	(0.4)	(0.3)	(0.1)	(0.3)	(0.3)	(0.3)
Profit Before Tax (Edison norm)	26.6	13.3	21.9	11.6	18.5	21.6	23.6
Profit Before Tax (Company norm)	28.8	18.1	24.8	16.3	21.2	22.3	24.2
Profit Before Tax (FRS 3)	10.8	(0.6)	9.5	0.1	7.7	9.3	11.3
Tax	(4.3)	1.1	(2.5)	6.8	(4.5)	(6.6)	(7.2)
Profit After Tax (norm)	22.3	14.4	19.4	18.4	14.0	15.0	16.4
Profit After Tax (FRS 3)	6.5	0.4	7.0	6.9	3.2	2.7	4.1
Average Number of Shares Outstanding (m)	130.0	129.8	129.8	129.7	129.7	129.7	129.7
EPS - Edison normalised (p) FD	14.0	7.5	11.1	5.4	9.4	11.6	12.6
EPS - Company normalised (p) FD	14.6	9.3	12.9	9.0	9.8	12.0	13.0
EPS - FRS 3 (p)	5.0	0.3	5.4	5.3	2.5	2.1	3.2
Dividend per share (p)	2.1	0.0	2.0	3.5	4.3	4.8	5.5
Gross Margin (%)	34.1	33.3	34.9	31.5	32.5	32.5	32.5
EBITDA Margin (%)	16.1	13.4	15.1	11.6	12.3	13.1	13.5
Operating Margin (before GW and except.) (%)	13.8	10.6	12.7	9.3	10.0	10.7	11.1
BALANCE SHEET	Group	Group	Group	Group			
Fixed Assets	419.2	376.1	367.4	352.9	352.6	341.4	330.9
Intangible Assets	369.3	334.0	328.2	312.8	312.1	302.1	292.1
Tangible Assets	41.7	34.3	31.5	30.5	30.9	30.4	29.9
Investments	8.3	7.8	7.7	9.6	9.5	8.9	8.9
Current Assets	104.0	81.2	86.7	96.2	95.1	96.2	97.2
Stocks	36.9	26.0	26.0	26.4	30.9	31.8	32.4
Debtors	29.9	24.9	28.2	28.2	25.8	26.5	27.0
Cash	32.4	25.0	27.7	20.4	36.0	35.2	34.8
Current Liabilities	(73.6)	(45.8)	(51.8)	(55.1)	(48.9)	(52.5)	(55.6)
Creditors	(45.5)	(42.7)	(46.6)	(42.2)	(40.9)	(44.5)	(47.6)
Short term borrowings	(28.1)	(3.1)	(5.2)	(12.9)	(8.0)	(8.0)	(8.0)
Long Term Liabilities	(212.2)	(185.1)	(163.7)	(144.7)	(102.0)	(92.4)	(82.8)
Long term borrowings	(149.6)	(132.9)	(114.3)	(100.2)	(65.2)	(57.2)	(49.2)
Other long term liabilities	(62.6)	(52.2)	(49.4)	(44.5)	(36.8)	(35.2)	(33.6)
Net Assets	237.4	226.5	238.6	249.2	296.8	292.7	289.7
CASH FLOW	Group	Group	Group	Group			
Operating Cash Flow	34.2	38.6	38.6	32.6	22.9	28.8	31.4
Net Interest	(8.1)	(10.5)	(9.3)	(6.7)	(4.2)	(3.5)	(3.0)
Tax	(3.4)	(2.2)	(2.3)	(1.9)	(6.0)	(4.5)	(6.6)
Capex	(4.5)	(2.2)	(3.5)	(4.9)	(7.3)	(7.5)	(7.5)
Acquisitions/disposals	(12.5)	0.0	0.0	(10.3)	52.4	0.0	0.0
Financing	(5.6)	0.0	0.0	(0.3)	0.0	0.0	0.0
Dividends	(7.2)	0.0	0.0	(2.6)	(5.9)	(6.1)	(6.7)
Net Cash Flow	(7.1)	23.7	23.5	6.0	52.0	7.2	7.6
Opening net debt/(cash)	100.0	145.3	111.0	91.7	92.7	37.2	30.0
HP finance leases initiated	(0.1)	(0.2)	(0.0)	(2.7)	0.0	0.0	0.0
Other	(38.1)	10.9	(4.2)	(4.4)	4.5	(0.0)	0.0
Closing net debt/(cash)	145.3	111.0	91.7	92.7	36.2	30.0	22.4

Source: Edison Investment Research. Note: The disposal of Gall Thomson was announced with the FY11 results but completed in March 2012. Financial statements for 2008-11 are for the group as at December 2011, save for the 2011 P&L which represents the continuing operations only. (As shown on page 1, the comparative 2010 figures are Revenue £252.2m, PBT £14.2m and EPS 6.7p.) Compared to the company's definition of normalised earnings, Edison norm includes Other finance (including borrowing cost amortisation) and excludes Other (pension net finance costs). Both are represented in the P&L table above.

Edison investment research

Contact details	Revenue by geography
65 Buckingham Gate London London SW1E 6AS United Kingdom 020 7976 8000 www.lupuscapital.co.uk	

CAGR metrics		Profitability metrics		Balance sheet metrics		Sensitivities evaluation	
EPS 10-14e	0.3%	ROCE 13e	5.7%	Gearing 13e	10.2%	Litigation/regulatory	○
EPS 12-14e	15.1%	Avg ROCE 10-14e	7.1%	Interest cover 13e	7.5x	Pensions	◖
EBITDA 10-14e	N/A	ROE 13e	5.1%	CA/CL 13e	1.8x	Currency	●
EBITDA 12-14e	7.1%	Gross margin 13e	32.5%	Stock days 13e	70	Stock overhang	◖
Sales 10-14e	N/A	Operating margin 13e	10.7%	Debtor days 13e	39	Interest rates	○
Sales 12-14e	2.4%	Gr mgn / Op mgn 13e	3.0x	Creditor days 13e	57	Oil/commodity prices	◖

Management team

CEO: Louis Eperjesi

Became CEO in February 2010, joining from Kingspan where he was a main board director and divisional MD. Other building industry experience from Baxi Group, Redland, Lafarge and Caradon.

CFO: James Brotherton

Initially joined as head of corporate development in 2004 before becoming CFO in May 2010. Previously a director in the Investment Banking Division of Citigroup. Chartered Accountant.

Chairman: Jamie Pike

Non exec chairman role since November 2009 after heading Burmah Castrol Chemicals and its subsequent buyout and IPO as Foseco. He is also currently non exec chairman at RPC Group and MBA Polymers Inc as well as the Defence Support Group.

Principal shareholders	(%)
Standard Life	14.9%
Aviva	12.0%
F&C Asset Management	11.1%
G. Hutchings	10.7%
Polar Capital	6.9%
SVG	6.7%

Companies named in this report

Wolseley, Travis Perkins, Marshalls, Walker Greenbank, Howden Joinery, Home Depot, Lowes, Quanex