EDISON

Avon Rubber

Interims and site visits

Accelerating growth drivers

Aerospace & defence

Avon Rubber's interim results highlighted that it has both near- and medium-term growth drivers that are set to benefit the group and allow it to deliver accelerating growth. Despite a challenging dairy market in H1, Avon increased revenues by 20% driven by a strong performance from Protection & Defence and highlighting the benefits of the previous investment in the division. Having visited the group's facilities in Wisconsin and Michigan, US, we witnessed first-hand the focus on operational delivery and building new markets across the group that will support our forecast 16%+ EPS CAGR over the next two years.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
09/11	107.6	10.2	25.2	3.0	16.9	0.7
09/12	106.6	11.0	26.9	3.6	15.8	0.8
09/13e	120.3	13.1	32.5	4.3	13.1	1.0
09/14e	128.0	14.9	36.4	5.0	11.6	1.2

Note: *PBT and EPS are normalised, excluding intangible amortisation, exceptional items and share-based payments.

Interims delivered, despite dairy headwind

Avon's interims demonstrated the impact of the group's investment strategy with revenues up 20% to £59.6m (H112: £49.6m) driven by a strong performance from the Protection & Defence (P&D) division (up 31%) and despite a flagged headwind in the Dairy division (down 2%). With the resultant mix change, operating profit was up 17% to £5.8m (H112: £5.0m), while a flat interest charge of £0.1m and £0.1m non-cash finance income (H112: £0.2m charge) combined to increase PBT 24% to £5.7m (H112: £4.6m). Following a reduced tax rate of 28% (H112: 29%), EPS was up 24% to 14.0p (H112: 11.3p). Operating cash conversion was 132% and net debt increased marginally to £9.9m. DPS increased 20% to 1.44p reflecting the board's confidence for the year.

Investments leading to top- and bottom-line growth

During the period, Avon Rubber invested 6% of revenue in new products and new markets, continuing the trend seen over the past two years. In our view it is this strategy of investing in future growth that has allowed a step change in Avon's performance and provided the ability to grow in ostensibly difficult markets. This investment is delivering increased international sales and enhanced margin opportunity across the group and we believe that Avon's strategy is set to deliver further gains in both top- and bottom-line growth over the coming years.

Valuation: Seeing is believing

We visited Avon's Johnson Creek, WI, (Dairy) and Cadillac, MI, (P&D) facilities in February and witnessed first-hand the implementation of the group's strategy. This encompassed continuous improvement in efficiency and product development to address new markets. We believe that Avon is just at the start of a sustained growth phase and, with good order visibility and future product introductions providing substantial upside potential, we raise our SOTP fair value to 510p/share.

3 May 2013

Price	**426p**
Market cap	**£131m**

Net debt (£m) as at Sep 2012	8.7
Shares in issue	30.7m
Free float	86%
Code	AVON
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	9.5	(2.0)	51.7
Rel (local)	10.1	(4.2)	33.5
52-week high/low		447.0p	288.8p

Business description

Avon Rubber designs, develops and manufactures products in the respiratory protection, defence (70% of 2012 sales) and dairy (30%) sectors. Its major contracts are with national security and safety organisations such as the DoD.

Next events

Preliminary results	November 2013

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Edison profile page

Avon Rubber is a research client of Edison Investment Research Limited

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Sustainable growth drivers set to accelerate

Company description: High-performance products

Avon Rubber provides respiratory protection equipment across military, homeland security, fire and industrial markets. These encompass gas masks and associated filters, self-contained breathing apparatus (SCBA), powered air products and emergency hoods. In addition, the group is a market-leading manufacturer of consumable milk liners to the dairy market and, increasingly, a broader range of associated products for the automated milking process. 82% of sales are derived from the US, while the remaining 18% comes from Europe.

Valuation: Supported by accelerating growth profile

Given the strong set of interims and following our site visits to US Dairy operations in Johnson Creek, WI, and P&D in Cadillac, MI, we believe that Avon has entered a stage of sustained, profitable and accelerating growth. This is supported by investments in business development and the broadened range of markets the group is addressing. Our relative peer group sum-of-the-parts valuation yields a fair value of 510p/share, equating to a P/E rating of 15.3x CY13 EPS, which we believe is fair given good order visibility and our forecast 16%+ EPS CAGR.

Sensitivities: Macroeconomic and performance factors

Given the global nature of the business there are both economic and performance factors to consider.

- **The interplay between milk and feed prices.** With feed prices remaining stubbornly high and milk prices weak, the dairy business has been affected by a slowing demand in H113. Importantly, Milkrite sales remained buoyant, while the impact on sales to original equipment (OE) manufacturers was greater, partially attributed to cannibalisation of OE customer sales.
- **Defence budgets and sequestration.** With sequestration a reality in US defence, there is a risk that budgets may be curtailed. Given that the M50 mask is a 10-year sole-source contract and Avon has an IDIQ for M61 filters, both of which have rising budget allocations, we feel confident that the personal protective equipment budget will be maintained.
- **Filter second source.** Avon currently has a sole-source filter contract for the M61, which has been opened up to competition, with final acceptance tests due in January 2014. This should largely be offset by increasing demand from the expanding installed base.

Financials: Strong interims, despite dairy headwind

Avon delivered a strong set of interim results, despite a challenging dairy market in the half:

- **Revenues** were up 20% to £59.6m (H112: £49.6m) and **operating profit** was up 17% to £5.8m (H112: £49.6m). Following flat finance charges of £0.1m (H112: £0.1m) and a £0.1m other finance benefit (H112: £0.2m charge), **PBT** increased by 24% to £5.7m (H112: £4.6m).
- With the **tax rate** reducing to 28% (H112: 29%), offsetting a higher number of shares in issue following the vesting of the group's performance share plan, **EPS** increased by 24% to 14.0p (H112: 11.3p). Highlighting the board's confidence, the progressive dividend policy continued with **DPS** up 20% to 1.44p.
- **Cash flow** was strong with a 132% operating cash flow conversion, while **net debt** remained largely static at £9.9m (31 March 2012: £9.8m) as cash inflow was offset by a £4.5m investment in developing the business, a £0.5m increase due to the strengthening US dollar and a £1.8m funding provided to the Employee Share Trust to fund Performance Share Plan awards.

Company description: Sustaining the growth path

In our view, over the course of the past five years, management has demonstrated its ability not only to manage risks, but also to identify market opportunities and put in place the appropriate people, systems and development plans to put the group on a sustained growth path.

What the company does: High performance products

Avon Rubber provides respiratory protection equipment for military and other markets (c 70% of revenue). In addition, it is the market-leading manufacturer of consumable milk liners and a broadening range of associated products for the dairy market (c 30% of revenue). 82% of sales are from the US and 18% from Europe.

Strategy: Investment rewarded by top- and bottom-line growth

Avon is leveraging its core products in both the P&D and Dairy divisions to drive new market demand and structurally higher margins. It is currently in a phase where it is investing in product and market development, while beginning to reap the initial rewards of that investment. While substantial progress has been made, we are of the opinion that Avon is just at the start of its real growth phase. In particular we see several key short- and medium-term drivers:

- **Expanding the market.** Avon has leading positions in the North American and EU dairy markets, as well as being the sole source provider of the M50, the largest US military respirator programme. It is building on these to expand market share, develop internationally and break into adjacent markets
- **Developing aftermarket/services**. Avon is developing a broader range of aftermarket products and services, ranging from consumables that would previously have been bought-in from third parties, to increasing service contracts such as Cluster Exchange in the Dairy division. With budgets staying tight, the group is also building capabilities in financing and lifecycle services.
- **Increasing technological content.** As demonstrated with the group's ImpulseAir vented liner, innovation is a key determinant of successful growth. Through Project Fusion, there is a drive for increasing technology content and differentiation. With regulatory approvals and certification requirements also present, such product evolution provides a significant barrier to entry.

Management driving change, focusing on growth

Avon has moved through various stages since the current management came together in 2008 with Peter Slabbert appointed CEO in April 2008 and Andrew Lewis as CFO in September 2008:

- **Phase 1 – Turnaround (2009-11).** The initial focus was on transformation, outsourcing European dairy manufacturing to the Czech Republic and establishing the Cadillac manufacturing facility. Measures to address the pension deficit and long-term debt facilities were also achieved.
- **Phase 2 – Investment (2012-14).** Avon entered an investment phase with additional R&D and business development resource to develop new products and market expansion. This phase is ongoing with new international markets being addressed and Project Fusion being undertaken.
- **Phase 3 – Growth Opportunities (2013-16).** While initial signs of progress were witnessed in 2012 through the rapid growth in the ImpulseAir vented liner, we anticipate that we will see an acceleration of revenues throughout the course of 2013 with substantial tangible benefits from 2014 onwards as new products lead to further top-line growth and margin progression.

Interims reflect benefits of previous investment

Avon delivered strong interims, which highlighted the impact of previous investments made by Avon in the P&D division, more than offsetting short-term weakness in Dairy:

- **Revenues** increased by 20% to £59.6m (H112: £49.6m) with P&D up 30% driven by increased sales to non-DoD customers, growth in M50 mask and M61 filter sales and an increase in AEF and DoD spares. This strength was tempered by a 2% decline in the Dairy division as North American demand fluctuated due to high feed and low milk prices, extending replacement cycles as seen in 2009. Despite this, sales of ImpulseAir continued to grow to an 18% market share, largely at the expense of OE revenues, while Chinese dairy revenues reached c £600k.
- **Operating profit** was up 17% to £5.8m (H112: £5.0m) due to the resultant shift in mix between P&D and Dairy, with P&D margins typically lower. Following a flat finance charge of £0.1m (H112: £0.1m) and other finance benefit of £0.1m (H112: £0.2m charge), **PBT** increased by 24% to £5.7m (H112: £4.6m).
- With the **tax rate** reducing to 28% (H112: 29%), offsetting a higher number of shares in issue following the vesting of the group's performance share plan, **EPS** increased by 24% to 14.0p (H112: 11.3p). Highlighting the board's confidence, the progressive dividend policy continued with **DPS** up 20% to 1.44p.
- **Cash flow** demonstrated a continued focus on operational performance with a 132% operating cash flow conversion. **Net debt** remained largely static year-on-year at £9.9m (31 March 2012: £9.8m) as cash inflow was offset by a £4.5m investment in developing the business, a £0.5m increase due to the strengthening US dollar and a £1.8m funding provided to the Employee Share Trust to fund Performance Share Plan awards.

We have adjusted our forecasts to reflect the divisional dynamics seen in H1 and we forecast the headwinds in Dairy will be more than offset by gains in P&D. We also reflect the post year-end acquisition of VR Technology and the purchase of the freehold of a purpose built facility for its AEF business for a combined £3.0m. Our group level estimates for the full year remain broadly unchanged as shown in Exhibit 1 below:

Exhibit 1: Edison forecasts

	H112	H212	FY12	H113	H213	FY13	Prev FY13	FY14
Dairy								
Sales	16,436	15,614	32,050	16,131	16,881	33,012	34,294	34,662
Segment Result	2,905	3,078	5,983	2,572	3,304	5,876	6,722	6,412
Margin	17.7%	19.7%	18.7%	15.9%	19.6%	17.8%	19.6%	18.5%
P&D								
Sales	33,196	41,390	74,586	43,459	43,807	87,266	77,569	93,374
Segment Result	2,992	4,511	7,503	4,344	4,844	9,188	8,300	10,471
Margin	9.0%	10.9%	10.1%	10.0%	11.1%	10.5%	10.7%	11.2%
Unallocated	-943	-922	-1,865	-1096	-769	-1,865	-1,865	-1,865
Op Profit	**4,954**	**6,667**	**11,621**	**5,820**	**7,379**	**13,199**	**13,156**	**15,019**
Finance income	0	7	7	0	3	3	3	3
Finance costs	-144	-105	-249	-152	-48	-200	-200	-190
Other Finance	-198	-176	-374	58	42	100	100	100
PBT	**4,612**	**6,393**	**11,005**	**5,726**	**7,377**	**13,103**	**13,060**	**14,932**
Tax	-1,337	-1,839	-3,176	-1,602	-1,927	-3,529	-3,657	-4,125
	29%	29%	29%	28%	26%	27%	28%	28%
PAT	**3,275**	**4,554**	**7,829**	**4,124**	**5,450**	**9,574**	**9,403**	**10,807**
Shares Outstanding	28.893	29.3	29.2	29.4	29.6	29.5	30.0	29.7
EPS(p)	**11.3**	**15.5**	**26.9**	**14.0**	**18.4**	**32.5**	**31.3**	**36.4**

Source: Edison Investment Research

Dairy: Strategy to drive Milkrite internationally

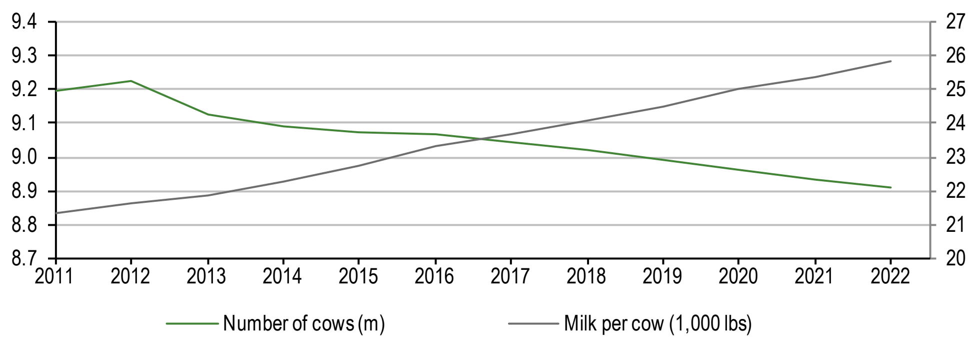
Avon's Dairy division provides own-brand and OEM milk parlour consumables covering various milk liners, designed to increase efficiency while improving animal health during the milking process.

Over the last two years Avon has moved from a predominantly OEM supplier and has increased share of its own-brand Milkrite products. Sales are split across three distinct geographic markets: the US, EU and RoW, each with their own structures and demands.

North America: Driving Milkrite penetration and innovation

The North American dairy market is large and mature, with a concentration of larger farms where automation is commonplace. The market is forecast to decline in numbers, but with improvements in technology and genetics leading to increased yields and output, as shown in Exhibit 2 below.

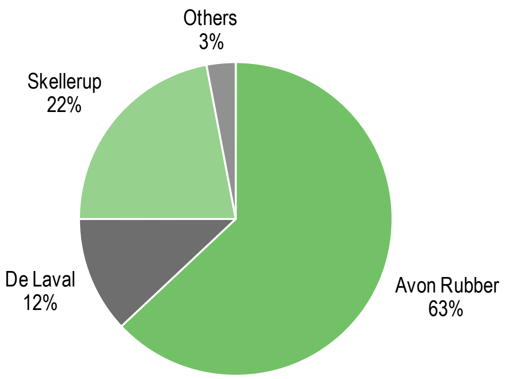
Exhibit 2: US dairy herd (lhs) and production (rhs) forecasts



Source: US Department of Agriculture – Agricultural Projections to 2022 February 2013

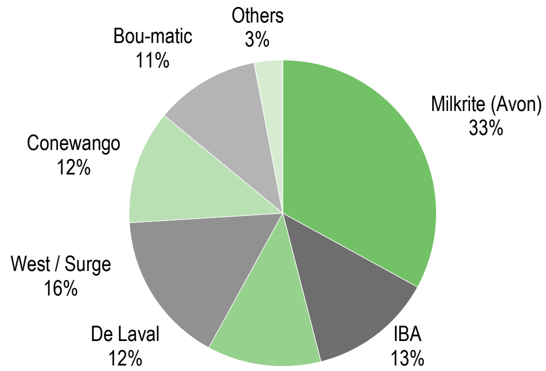
The top 10 milk producing states are concentrated around the West Coast and Northern states. Avon has operations nearby, with manufacturing facilities in Johnson Creek, WI, and a sales and distribution facility in Modesto, CA. Customers are served through a network of distributors and, for larger farms, directly by the Milkrite sales team. Avon's market share is shown in Exhibits 3 and 4:

Exhibit 3: Market share by manufacturer



Source: Avon Rubber, Edison Investment Research

Exhibit 4: Market share by brand



Source: Avon Rubber, Edison Investment Research

The strategy in the US is to drive Milkrite market share, particularly the more technically advanced products such as ImpulseAir. While in the short term this may lead to some cannibalisation of OEM revenues, the margin enhancement opportunity will more than outweigh any top-line drag.

The EU: A competitive market with diverse customers

Avon has a c 50% share in the EU market, with Milkrite accounting for c 12%. The EU market consists of a broad array of farms with sales predominantly through OEMs and distributors. There are several factors that make it a more challenging market than the US:

- **Milkrite less established.** The Milkrite brand has been established for a little over 10 years in the EU market, compared to 30+ years in the US. This is compounded by the fact that there are several strong OEMs in the EU, which also has a more nationalistic tendency among buyers.

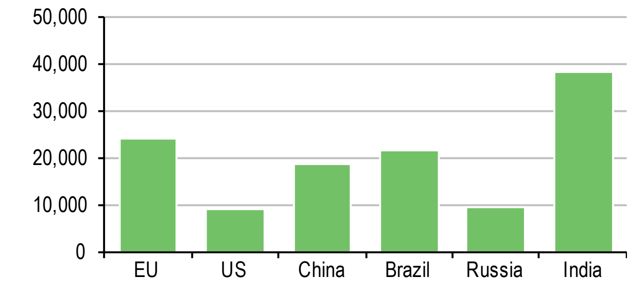
- **Sales resource.** With Avon's focus over the past three years on operational efficiency, less investment was made in sales. With costs under control, Avon is now driving Milkrite's market share, investing in sales and business development resource, effectively doubling coverage.
- **Structure of the EU market.** Herd sizes are typically smaller, providing a fragmented customer base and slowing uptake of innovation. However, there is a strong focus on animal health and this provides an opportunity for ImpulseAir, which currently has a market share of less than 1%.

The recent investment in sales resource is anticipated to flow through to greater Milkrite penetration. However, in the short term this will provide a continued small drag on margins.

RoW: Rapidly increasing demand leading to structural change

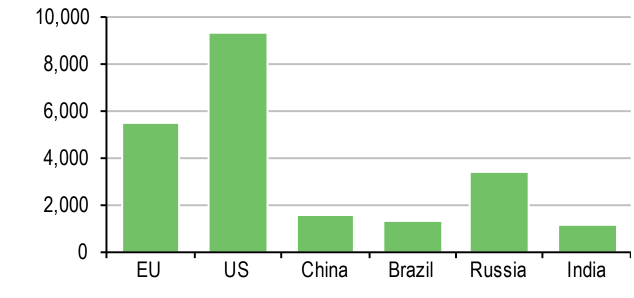
Demand in the RoW is increasing, with emerging markets such as China, India and Brazil seeking to improve dairy efficiency as increasing populations and wealth drive a higher dairy intake. Exhibits 5 and 6 show the relative herd sizes and milk production across mature and developing markets.

Exhibit 5: Cow numbers (1,000 heads)



Source: Avon Rubber, Edison Investment Research

Exhibit 6: Milk production per cow (kg)



Source: Avon Rubber, Edison Investment Research

While many emerging countries have total herd sizes in excess of the EU and US, production per cow lags significantly behind. This is caused by a combination of livestock health, as well as milking techniques. With population growth set to continue and an increasing focus on human health, the need to increase efficiency will accelerate. For example, the Chinese government has announced a c $3bn investment to automate the milking process to secure the supply chain and quality of milk.

Product development: Innovation and reach

Avon has an incremental product development strategy to capture market share and drive margins:

- **Stage 1 – develop Milkrite liners.** Starting with innovative triangular liners, this has extended to incorporate the ImpulseAir vented liner, which provides additional health and yield benefits for the cow. The uptake of this in the US market has been substantial, with weekly sales approaching 150k units from launch in early 2010, a market share of c 18%.
- **Stage 2 – develop own-brand cluster.** Avon has finalised the development of its own plastic claw and shell, which has allowed it to produce its own cluster in support of cluster exchange.
- **Stage 3 – develop an enhanced cluster.** This will take Avon to the next level of cluster technology and allow a step change in much the same way as ImpulseAir in liners.
- **Longer-term.** Management has indicated future developments may explore areas such as pulsation to allow it to develop a full system approach and may also include sensor and telemetry elements to aid animal health and yield monitoring to further improve farm efficiency.

Opportunities for additional top-line growth: Markets and services

Avon has invested in dairy to secure a market-leading position in the US and EU and has established Milkrite as a route to drive margins. The group has also undertaken a number of strategies aimed at driving top-line growth over the medium term:

- **Chinese sales office and warehouse opened.** The first step on the international market expansion was the opening of a sales and distribution warehouse in China, which commenced operation in 2012. This office now has 13 employees, with a dedicated general manager and has demonstrated quarter-on-quarter sales improvements with c £600k of revenues in H113.
- **Brazilian opportunity commenced.** Avon has established initial distributor agreements in Brazil and has appointed a regional sales manager. The next step is to follow a similar model to China with the appointment of a general manager with a subsequent decision as to whether a sales office or manufacturing centre would be most appropriate.
- **Cluster exchange programme.** The cluster exchange programme is designed to provide a service-based approach to milking consumables. This is structured with the dairy farm swapping out the entire cluster and replacing it with a new one provided by Avon. This reduces turnaround time and improves yield and quality as clean equipment is being used each time. The used cluster is then returned to Avon where it cleaned and made available for re-use.

Johnson Creek site visit: Delivering the strategy

We visited the group's Johnson Creek, Wisconsin, operation in February and met with various leaders in the organisation, including Larry Gunderson, VP global operations & supply chain; Tom Novotny, regional sales manager North America; and Dan Romfoe, North America finance director. We also toured the manufacturing facility and the cluster exchange facility adjacent to the plant. In our view, there was clear evidence of the strategy, in particular:

- **Complexity of production.** We were surprised at how complex the process was to produce the liners, with the key ingredient being the unique formulations of the rubber mix to determine characteristics. This was supported by lab analysis prior to final production to ensure batch quality and consistency. This provides a significant barrier to entry.
- **Focus on lean.** From the moment the rubber entered goods-in, there was a focus on reducing waste and ensuring efficient production. This has seen steps either eliminated where superfluous, or added (eg sieving) to capture potential issues at the earliest point possible.
- **Capacity can be created.** With c 20 million liners produced a year, there is a considerable volume going through the facility. There is a combination of older, manually loaded presses and more modern, automated presses that have a much reduced footprint (10'x10') and operate at nearly twice the throughput. New presses could be added at a cost of c $400k, increasing capacity by 3-4% capacity without the need for new facilities.
- **Product development lab.** A relatively recent addition to the facility is the product development lab. Avon effectively has a replica milking parlour in which products are tested and improved, and providing a customer-facing environment to demonstrate new concepts.
- **Cluster exchange facility.** We visited the newly refurbished dedicated cluster exchange facility next to the main plant, which, along with a similar capability in Modesto, will receive, clean and prepare clusters for re-use. Initial trials have been successfully conducted, with Modesto due to commence operation in April and Johnson Creek in Q3.

P&D: Benefits of investment highlighted at Cadillac

P&D manufactures respiratory protection equipment for the US military, as well special forces and first responders internationally. US Military masks and filters are manufactured in Cadillac, Michigan, while components, masks and safety hoods for international markets are manufactured in Melksham, UK. The ISI fire safety business, now rebranded Avon Protection, is based in Lawrenceville, Atlanta, and manufactures Self Contained Breathing Apparatus (SCBA) as well as the ST53 mask/SCBA system for special forces and SWAT teams. Avon Engineered Fabrications (AEF), based in Picayune, Mississippi, supplies fuel and water storage tanks and hovercraft skirts for US forces.

Building on core M50 and M61 programmes

Avon has set about creating a strategy to fully leverage its position as the supplier of the largest military respirator programme in the world, the M50 mask, along with automated production capability of the M61 filters. This has seen substantial investment, both by the group and by the DoD in R&D and manufacturing capability, providing Avon with a unique opportunity to take this military pedigree across its markets. This is both in adjacent markets in the US such as homeland security, law enforcement and fire services, and also in international markets as highlighted by sales to Oman and New Zealand during H113. Progress in each of these markets is as follows:

Core DoD programmes well supported

Avon's core programmes remain well funded with the M50 mask system delivering 200k masks a year as part of a 10-year programme to replace up to 3m masks and Avon's sole-source position on M61 filters delivering c 500k filter pairs a year both for initial delivery and ongoing aftermarket replacement. Importantly, Avon has already received sufficient orders in H113 to underpin forecast volumes throughout the remainder of 2013 and into 2014. Given the current uncertainties in US defence procurement, we believe that this provides evidence of the support for these programmes.

North America non-DoD markets supported by improved distribution

The non-DoD market in North America encompasses law enforcement, homeland security, fire departments and other first responders. There are several key levers to deliver consistent growth:

- **Leverage the military pedigree.** Avon is ensuring that the offering in non-DoD markets benefits from the military heritage through technology, rigorous safety standards and increasingly branding. This is epitomised by the rebranding of the old ISI fire safety business to coincide with the launch of the new Deltair at the FDIC trade show, which combines a new product delivered from Project Fusion with a new look and feel, as well as associated branding.
- **Develop a leading sales and distributor model.** Given the fragmented nature of the customer base, Avon has made significant changes to the way it goes to market. It has combined its internal sales force across different markets, as well as enhancing the distributor base to include several key national managers, which now account for c 80% of sales compared to 20% for regional distributors, as well as improving these partners' training on Avon's products. This has resulted in a 600% increase in the effective sales footprint over the last year.
- **Pursuing market opportunities.** Avon has spent considerable time understanding and analysing the market and has identified several key trends that provide an opportunity. With many law enforcement customers having made large acquisitions post 9-11 and the typical replacement cycle of c 10 years, there is a significant replacement requirement and an installed base of over 1m systems. In addition, management also estimates Avon's current market share of the fire market is c 3%, highlighting the upside potential in this $400m market segment.

With a strong order intake in H113 for non-DoD, we are seeing the benefits of the investment undertaken in P&D over the past two years to strengthen its business development teams.

International successes demonstrate power of model

Avon has also demonstrated success in international markets, where there are several key points:

- **They are lumpy in nature.** International markets tend to be characterised by long periods of bidding and lumpy order intake. It is therefore essential to maintain a pipeline of opportunities and win lead-in contracts where possible. In H113, Avon delivered sales to Oman and New Zealand, the latter being of particular interest as New Zealand had typically followed the UK's lead. However, it has opted for Avon instead of Scott in this instance.
- **Higher margins can typically be achieved.** As a commercial order, Avon can typically achieve higher margins on international contracts than DoD activities. Therefore as win rates increase, there should be potential for margin enhancement.

- **Further opportunities targeted.** There are several strategic market opportunities being addressed by Avon, which include South America and the Middle East. These two regions have significant law enforcement and safety needs that provide unique requirements. These may be event driven, such as the World Cup and Olympics in Brazil, or structural in nature. Avon has put increased focus on such regions and is now seeing the benefit.

Product development: Expanding the reach

Key to the strategy is the Project Fusion development programme, which has seen investment of £8m thus far, with the first products now entering service and the pipeline remaining on track:

- **PC50 selling well.** The group's first Project Fusion product, the PC50 mask for correctional facilities, has already received several orders.
- **Qi filters launched.** Avon has developed a series of commercial filters that are compatible with both Avon masks and competing products. This has enabled the group to remove its reliance on suppliers such as 3M and Scott, providing better margins and opening up new markets in commercial filters once NIOSH approves the CBRN and Riot Filter, expected in H213.
- **Deltair SCBA revealed.** The first new SCBA to come to market for several years, the Deltair incorporates features that have been developed to comply with new 2013 NFPA certification. The product was revealed at the FDIC trade show in April 2013 and is currently undergoing a certification process that should see it available for sale in the summer.
- **Future products deliver increasing technology.** Future products developed through Fusion are set to deliver powered air and combination systems throughout 2013 and 2014, providing a fully modular suite of products across markets.

In addition to products, Avon is also developing enhanced service offerings that encompass financing, asset management and testing, through to a full through-life service offering.

Further opportunities exist with DoD

In addition to the opportunities from the commercial market, Avon has two distinct funded programme opportunities with the DoD, despite the current defence environment:

- **Joint Service Aircrew Mask (JSAM**) – Avon responded to a sole-source invitation to tender for the JSAM aircrew respiratory protection mask. This is a two-year funded development and testing programme with contract award anticipated in H213 that would see Avon move into aerospace technology for the first time.
- **EEBD Navy Rebreather** – The group is in the process of submitting a bid for the EEBD programme (emergency escape breathing device) for the US Navy, which has an initial estimated value of $30m. This highlights the group's expansion beyond terrestrial respiratory equipment, a move further supported by the bolt-on acquisition of VR Technology, which has market-leading underwater rebreather systems.

Cadillac site visit highlighted potential

We visited the group's Cadillac, Michigan, facility and met with several key members of the executive, including John Kime, COO of Avon Protection Systems, a former VP and general manager of North Safety Systems (now part of Honeywell); and Mike Hamner, VP and site manager. We toured the M50 production line, supply chain facility and automated filter line:

- **Clear focus on quality and lean manufacturing.** The attention to detail we saw as we walked around the facility was clear, along with the culture of openness when there were operational improvements to be made. Given the critical nature of the products, quality is the number one priority and the focus on this as a key metric was visible throughout the facility.
- **Increasing use of automation.** The second filter line was an impressive construction and we had not truly appreciated the overall complexity of the automation. With this line up and running

and dedicated to the M61 filters, the original line is being reconfigured to produce both M61 filters and new commercial filters, increasing utilisation and enhancing margins.

- **Differentiated capability.** We saw numerous instances of bespoke equipment that has been designed for the manufacturing of the military masks. One of the most interesting was the manufacture of the single eyepiece for the masks, a key differentiator for Avon.
- **Capacity for expansion and new programmes.** Through a process of continuous improvement, Avon has created a lean manufacturing environment, freeing space to support an increased manufacturing pace or new programme wins, without the need for significant capex.

Sensitivities around macroeconomic factors

Given the global nature of the business there are both economic and performance factors:

- **The interplay between milk and feed prices.** With feed prices remaining stubbornly high and milk prices weak, the dairy business has been affected by slowing demand in H113 as customers have extended intervals between consumables replacement. Demand is likely to resume with either a drop in feed prices or a rise in milk prices and management believes that an equilibrium is likely to slowly return. Importantly, Avon's Milkrite sales remained buoyant, while the OE sales were affected to a greater degree.
- **Cannibalisation of OEM sales.** A consequence of Avon's focus on driving Milkrite is that current OE customers may become frustrated that it is competing directly, and therefore OE sales may be cannibalised, leading to slowing top-line revenues. However, given the higher margins achieved by Avon on Milkrite, this should be offset at the operating profit level.
- **Sequestration.** With sequestration a reality in US defence, there is a risk that budgets may be curtailed. Given that the M50 mask is a 10-year sole source contract and that Avon has two IDIQ contracts for M61 filters, both of which have rising budget allocations, we feel confident that the personal protective equipment budget will be maintained.
- **Filter second source.** Avon currently has a sole-source filter contract for the M61, which has been opened up to competition, with final acceptance tests due in January 2014. This should largely be offset by increasing demand from the expanding installed base.

In our view, over the course of the last five years, management has demonstrated its ability not only to manage risks, but also to identify market opportunities and put in place the appropriate people, systems and development plans to put the group on a sustained growth path.

Valuation

We consider Avon on a sum-of-the parts, peer comparison basis, taking the FY14 figures of the separate trading divisions, to account for the heavy Dairy investment in 2013. This yields a fair value of 510p/share, as shown in Exhibit 7:

Exhibit 7: Edison sum-of-the-parts fair value

	FY 2014 NOPAT	P/E	Value (£m)	Notes
Protection & Defence	7.7	12.6	96.4	20% premium to A&D sector multiple
Dairy	4.7	13.8	64.8	25% premium to Skellerup / 40% discount to Genus
Net debt			(4.7)	Sep 14 year end estimate
Equity value			**156**	
Shares in issue			30.7	
Implied fair value per share (p)			**510**	

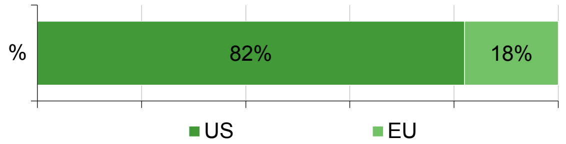
Source: Edison Investment Research

Given the strong interims and following site visits to US Dairy operations in Johnson Creek, WI and Protection & Defence in Cadillac, MI, we believe that Avon has entered a stage of sustained, profitable and accelerating growth. This is supported by investments in business development and the broadened range of markets. Our fair value of 510p/share equates to 15.3x CY13 EPS, which we believe is fair given good order visibility and our forecast 16%+ EPS CAGR.

Exhibit 8: Financial summary

Year end 30 September	£'000s	2009	2010	2011	2012	2013e	2014e
PROFIT & LOSS		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
Revenue		100,900	117,574	107,600	106,636	120,277	128,036
Cost of Sales		(76,524)	(89,256)	(77,892)	(75,803)	(87,069)	(92,686)
Gross Profit		24,376	28,318	29,708	30,833	33,208	35,350
EBITDA (before amort. and except.)		9,660	13,577	15,723	16,358	18,036	18,822
Operating Profit (before amort. and except.)		5,509	9,255	11,136	11,621	13,199	15,019
Amortisation of Intangibles		0	0	0	0	(200)	(200)
Exceptionals		(2,535)	0	0	0	(300)	0
Other		0	0	0	0	0	0
Operating Profit		2,974	9,255	11,136	11,621	12,699	14,819
Net Interest		(1,506)	(969)	(481)	(242)	(197)	(187)
Other finance costs		394	(1,152)	(443)	(374)	100	100
Profit Before Tax (norm)		4,397	7,134	10,212	11,005	13,103	14,932
Profit Before Tax (FRS 3)		1,862	7,134	10,212	11,005	12,603	14,732
Tax		(2,004)	(2,808)	(3,094)	(3,176)	(3,529)	(4,125)
Discontinued operations		0	0	0	0	0	0
Profit After Tax (norm)		2,393	4,326	7,118	7,829	9,574	10,807
Profit After Tax (FRS 3)		(142)	4,326	7,118	7,829	9,074	10,607
Average Number of Shares Outstanding (m)		28.5	28.3	28.3	29.2	29.5	29.7
EPS - normalised (p)		8.3	15.3	25.2	26.9	32.5	36.4
EPS - FRS 3 (p)		(0.6)	15.3	25.2	26.9	30.8	35.7
DPS (p)		0.0	1.5	3.0	3.6	4.3	5.0
Gross Margin (%)		24.2%	24%	28%	29%	28%	28%
EBITDA Margin (%)		9.6%	12%	15%	15%	15%	15%
Operating Margin (before amort. and except.) (%)		5.5%	8%	10%	11%	11%	12%
BALANCE SHEET							
Fixed Assets		30,384	25,762	27,467	31,159	34,174	35,886
Intangible Assets		9,936	8,794	10,469	13,281	13,837	15,639
Tangible Assets		20,177	16,968	16,718	17,878	20,337	20,247
Other		271	0	280	0	0	0
Current Assets		23,192	26,755	29,699	30,362	34,805	37,039
Stocks		9,528	11,525	10,679	15,449	16,588	17,658
Debtors		12,614	14,653	18,461	14,737	18,042	19,205
Cash		1,050	577	559	176	176	176
Assets held for sale		0	0	0	0	0	0
Current Liabilities		(31,566)	(16,550)	(17,818)	(21,524)	(24,200)	(25,438)
Creditors		(16,196)	(15,664)	(15,386)	(16,364)	(19,200)	(20,438)
Short term borrowings		(14,697)	0	(392)	0	0	0
Tax		(673)	(886)	(2,040)	(5,160)	(5,000)	(5,000)
Liabilities for assets held for sale		0	0	0	0	0	0
Long Term Liabilities		(19,737)	(27,190)	(18,176)	(16,100)	(12,835)	(8,041)
Long term borrowings		0	(13,166)	(11,983)	(8,901)	(9,674)	(4,880)
Deferred Tax		(2,104)	(2,517)	(2,985)	(2,584)	(2,584)	(2,584)
Retirement benefit obligations		(9,152)	(7,134)	0	(2,238)	1,800	1,800
Provisions		(6,649)	(4,373)	(3,208)	(2,377)	(2,377)	(2,377)
Other		(1,832)	0	0	0	0	0
Net Assets		2,273	8,777	21,172	23,897	31,944	39,446
CASH FLOW							
Operating Cash Flow		3,147	11,919	11,105	14,101	16,129	17,826
Net Interest		(1,549)	(752)	(471)	(293)	(197)	(187)
Tax		(282)	(1,787)	(1,542)	(262)	(3,529)	(4,125)
Capex		(2,684)	(5,384)	(5,672)	(9,512)	(10,127)	(7,452)
Acquisitions/disposals		5,964	(268)	17	4	(1,500)	0
Equity financing		0	(267)	(250)	(279)	0	0
Dividends		(283)	(298)	(706)	(941)	(1,049)	(1,269)
Net Cash Flow		4,313	3,163	2,481	2,818	(273)	4,794
Opening net (debt)/cash		(15,139)	(13,647)	(12,589)	(11,816)	(8,725)	(9,498)
Cash FX effect		188	(56)	(151)	(1)	(500)	0
Discontinued operations / relocation		0	(2,052)	(1,557)	0	0	0
Debt FX and Other		(3,009)	3	0	274	0	0
Closing net (debt)/cash		(13,647)	(12,589)	(11,816)	(8,725)	(9,498)	(4,704)

Source: Avon Rubber accounts, Edison Investment Research

Contact details	Revenue by geography
Hampton Park West Melksham Wiltshire, SN12 6NB UK 01225 896899 www.avon-rubber.com	

CAGR metrics		Profitability metrics		Balance sheet metrics		Sensitivities evaluation	
EPS 10-14e	18.9%	ROCE 13e	6.3%	Gearing 13e	10.0%	Litigation/regulatory	◖
EPS 12-14e	10.7%	Avg ROCE 10-14e	8.3%	Interest cover 13e	N/A	Pensions	○
EBITDA 10-14e	6.8%	ROE 13e	30.0%	CA/CL 13e	1.0	Currency	◖
EBITDA 12-14e	4.8%	Gross margin 13e	27.6%	Stock days 13e	50.3	Stock overhang	○
Sales 10-14e	1.7%	Operating margin 13e	11.0%	Debtor days 13e	54.8	Interest rates	○
Sales 12-14e	6.3%	Gr mgn / Op mgn 13e	2.5	Creditor days 13e	29.4	Oil/commodity prices	○

Management team

CEO: Peter Slabbert

Appointed in April 2008, Peter Slabbert is a chartered accountant and chartered management accountant. He was previously a divisional financial director and group financial controller at Tilbury Douglas and finance director at Bearing Power International. He joined Avon in 2000 as group financial controller before moving to group finance director in 2005.

CFO: Andrew Lewis

Andrew Lewis joined Avon as group financial director in September 2008. He was previously a director at PWC and group financial controller at Rotork Plc. He holds a first-class joint honour's degree in mathematics and accounting from the University College of North Wales.

Chairman: David Evans

David Evans took over as chairman in February 2012, having joined the board in 2007. He has over 30 years' experience in the UK and US defence market having spent 17 years with GEC-Marconi before joining Chemring Group in 1987 and being appointed CEO in 1999. He remained as an NED following his retirement in April 2005 and was previously a NED of Whitman.

Principal shareholders	(%)
Schroder Investment Management	19.3
BlackRock Investment Management	11.3
Henderson Global Investors	10.3
Cazenove Capital Management	5.0
Avon Runner ESOT	4.6
EFG Harris Allday	3.4

Companies named in this report

3M, Honeywell, Tyco, Mine Safety Applications (MSA), Draeger, Skellerup, Genus