

Devro

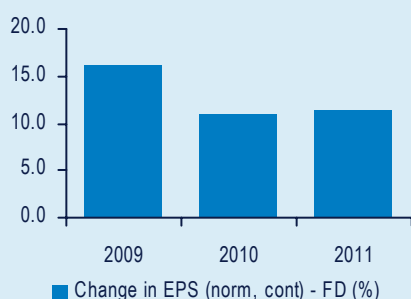
Food Producers

Buy **103p**

Potential upside **14%**

Target price **117p**

Impact on estimates

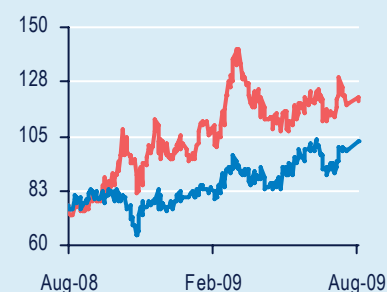


EPS (norm, cont) - FD (p)	2009E	2010E	2011E
Old	8.42	9.27	9.62
New	9.78	10.29	10.71

Source: Investec Securities estimates

Market cap	£167m
Enterprise value	£191m
Next news	Prelims, 5 Feb 10
12m high / low	104p/64p
Index	FTSE Small Cap
RIC / Bloomberg	DVO.L / DVO LN

Share price performance



	1m	3m	12m
Price	14.2	11.1	31.3
Rel. All Share	3.3	1.0	49.5
Rel. Sector (not shown)	4.3	(4.4)	23.6

Source: JCF Group

Investec acts as Broker to Devro

Price and Volume Progress Continues

Our view

Continued progress in volumes and pricing are the main driving factors behind the increased first half profits at Devro. The benefits here were more than sufficient to offset higher energy and raw material costs. With cost inflation set to reduce in 2H, we lift our full year forecast and target price.

Key points

- Despite the tougher global economy Devro has been able to show strong volume and price improvements in 1H. At the revenue line, these were further enhanced by a sizeable exchange translation benefit, although, at the EBIT line, currency was a more modest contributor. Despite higher costs, the group's pre-tax profits exceeded our forecast at £9.2m (forecast £8.6m).
- Further volume and price progress is expected in 2H and with cost inflation set to run at a more modest level, we move our full year PBT forecasts up from £19.7m to £21.8m (new EPS 9.8p). A lower interest charge also assisted this upgrade. The stock is trading at an undeserved discount to its peers. BUY.

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Financials and valuation - IFRS compliant

Year end: 31 December

	2007	2008	2009E	2010E	2011E
Turnover (£m)	156.3	183.1	215.5	222.3	229.0
EBITDA (£m)	27.9	32.2	36.5	38.9	40.4
EBITA (£m)	17.9	20.7	24.3	25.9	27.0
PBT (normalised) (£m)	15.7	19.0	21.8	23.4	24.5
Net income (normalised) (£m)	11.2	13.4	16.0	16.9	17.7
EPS (normalised, continuing) - FD (p)	7.2	8.2	9.8	10.3	10.7
FCFPS - FD (p)	3.7	6.4	4.4	10.0	10.7
NAV per share (p)	58.0	68.0	74.1	79.7	85.6
DPS (p)	4.45	4.45	4.45	4.70	5.00
PE (normalised) (x)	14.3	12.5	10.5	10.0	9.6
Price/book (x)	1.8	1.5	1.4	1.3	1.2
EV/sales (x)	1.2	1.0	0.9	0.9	0.8
EV/EBITDA (x)	6.9	5.9	5.2	4.9	4.7
FCF yield (%)	3.6	6.2	4.3	9.8	10.5
Dividend yield (%)	4.3	4.3	4.3	4.6	4.9

Source: Company accounts/Investec Securities estimates

Readers in all geographies please refer to disclosures on page 7.

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Devro

It has been another solid trading period for Devro, with sales and profits showing good progress in 1H. The group reported pre-tax profits of £9.2m, with EPS of 4.2p. which was ahead of our forecast (£8.6m) and 17% higher than 1H08. The earnings advance was 27%, assisted by a lower tax charge. The dividend was held at 1.425p - as previously stated, the intention is to improve cover.

The key drivers behind the improved profit were volume and price. Together, these generated a 10% increase in revenue. Reported revenues were ahead by 27% at £105m and the difference reflects the benefit of currency translation on the group's overseas sales. Around 80% of revenues are generated outside of the UK.

Volume growth of 5.6% was driven by the emerging markets of Latin America and Asia (China and Japan). This has been helped by gut conversion to collagen, but also the growth of protein consumption in the developing markets as these economies and populations become increasingly wealthy.

The developed markets showed more modest growth, although the sluggish result from Europe (+0.8%) was due to a set back in Eastern Europe, and particularly Russia, where the economic crisis seems to have had a more severe impact. The UK and Germany both showed modest growth. In the Americas, US domestic sales proved resilient whilst Latin America provided the growth. The disruption to production at one of the group's larger US-based customers (as a result of a fire) was not material in the numbers and is not expected to have any major impact on 2H either.

Volume Growth – 1H

	% change 1H 09 v 1H 08
Europe	0.8%
Americas	6.2%
Asia Pacific	15.5%
Group	5.6%

Source: Devro plc

Pricing continued to make headway in the half, increasing by 4.4%. This gave rise to an additional £3.7m of operating profit, again highlighting the importance of price - the volume increase of 5.6% lifted profit by £2.4m. All regions contributed to the price improvement, although in the Americas and Asia Pacific, the price increase was diluted by a mix change. The developing markets within these regions are the lower priced markets, but these showed the stronger growth.

Price/mix – 1H

	% change 1H 09 v 1H 08
Europe	7.6%
Americas	0.9%
Asia Pacific	1.1%
Group	4.4%

Source: Devro plc

A further £2m of profit benefit was extracted from improving efficiencies in Scotland and Australia, and this was after absorbing some costs from variable quality raw

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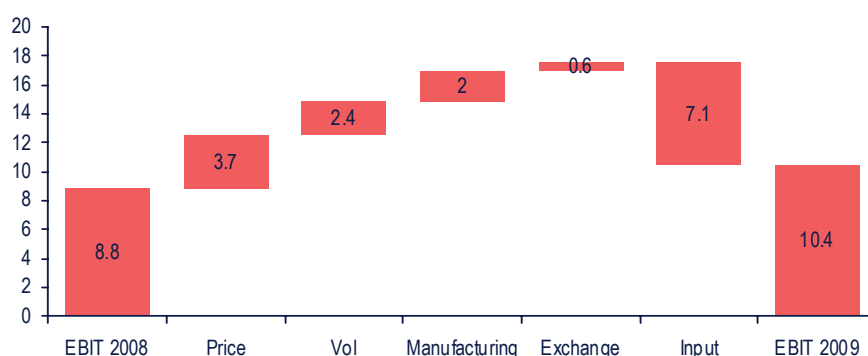
materials. As the supply of collagen was tight in 1H, the group has been buying from a wider group of suppliers, but this does give rise to more variability in the collagen and hence some challenges to the production team.

As can be seen from the revenue line, Devro's international spread gives rise to currency exposure. In the half, it was hugely beneficial on the sales line, adding 17%, but made a much smaller impact on profit. This is largely due to the geographic distribution of profit, with the larger profit earners least impacted by currency. The net addition to EBIT was just £0.6m, which also drove the change in operating margin – a reduction from 10.7% to 9.9%. Excluding currency, operating margins would have increased slightly. In 2H, it's possible the exchange impact on the P&L could be a small negative as Devro comes up against some tough comparatives in the last few months of 2009.

The EBIT improvement was achieved despite some noticeably higher costs in the half, both of which had been flagged up by the group in February. Energy costs were £3m higher, reflecting higher priced contracts – now expired – and collagen costs were up £2.3m, this is in addition to the costs included in Manufacturing from variable supplies. Other costs increased by £1.8m.

In 2H, energy cost inflation is expected to be lower year on year and although collagen costs are expected to be higher, the increment here will again be less, estimated at £1.5m for 2H. Supplies have been safeguarded, so we do not expect a repeat of the 1H collagen manufacturing challenges.

EBIT Bridge - 1H 08 to 1H 09 (£m)



Source: Devro plc

Net debt at the half year was £29m against our forecast of £30m, and this largely reflected the timing of capex spend. The group is still budgeting £19m-20m capex for FY09E (versus depreciation of £12m) which includes some expenditure in Australia as well as the finishing touches to the expansion at Jilemnice. For the full year, net debt should fall below £25m which is comfortably less than 1x EBITDA.

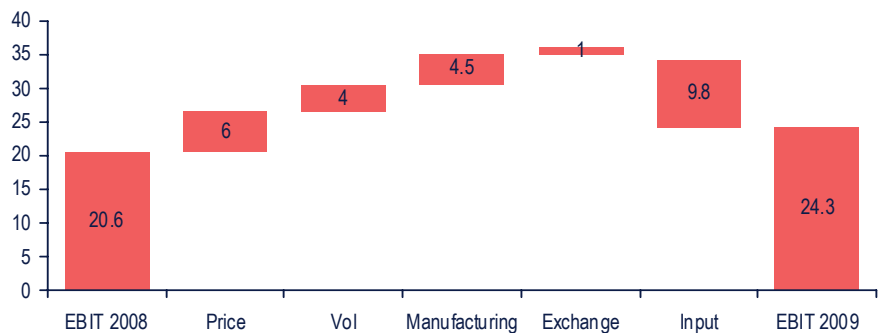
The pension deficit increased at the half year from £27.7m in Dec 08 to £37.7m. The group has just completed triennial discussions with the trustees and the ongoing cash top-up will be in the region of £2m.

Given this good start to the year, we have revisited our forecasts and are upgrading. The bridge below shows the main assumptions we have made for FY09E. On price, we have allowed for less progress in 2H as the comparisons are tougher. In 1H 08, the new pricing strategy was not implemented until March, whereas 2H 08 had a full period of price improvements. On volume, we have assumed further progress, again at a slightly lower level.

On manufacturing, we have assumed a slightly better result in 2H as there should be less impact on efficiencies from variable collagen and also the first benefits of the Jilmenice lines should be apparent. For exchange, we have assumed a negative contribution as discussed earlier.

We do anticipate a lower level of inflation in 2H from both energy and collagen costs (previously discussed) so in total we arrive at an EBIT of £24.3m which is £1.7m higher than our previous estimate.

EBIT Bridge – FY 08 to FY09E (£m)



Source: Investec Securities

The (bank) interest charge should also be more favourable than originally forecast at £1m versus £1.4m as the group benefits from lower rates. Interest cover at the half was around 22x. Most of the debt is held in sterling or Australian dollars and the facility runs out to January 2012. In addition to the bank interest charge, there is also a £1.5m pension finance charge – last year, this was a credit of £0.6m. This is included in the group's pre-tax number and EPS, although we note that several peers are now stating EPS excluding this item.

Our new pre-tax forecast is £21.8m (prev £19.7m). New EPS are 9.8p versus the prior year's 8.5p. This should result in much improved dividend cover (2.2x) on an unchanged FY dividend forecast. The upgrade drives a new higher target price of 117p (110p prev). We have based this on a peer group 2009 EV/EBITDA multiple of 5.8x. On our new forecasts, the group is currently trading on 5.2x to Dec 09. With 14% potential upside suggested, we reiterate our Buy recommendation.

Food Producers

Company profile

Devro manufactures collagen casings for the food industry under the Devro, Coria, and Cutisin brands. The collagen casings and gel are used to package ham, salami, sausage, and other processed meats. Devro has leading share (50%) of the global collagen market, with products sold in the Americas, Asia, Australia, and Europe. Around 20% of revenues come from developing and emerging markets where collagen continues to replace natural gut casings.

Other information

Average daily volume (000s)	552
Free float	97%
Number of shares in issue (m)	164
Website	www.devro.plc.uk

Calendarised valuation - IFRS compliant

	2007	2008	2009E	2010E	2011E
Calendar PE (x)	14.3	12.5	10.5	10.0	10.0
Calendar price/book (x)	1.8	1.5	1.4	1.3	1.3
Calendar EV/sales (x)	1.2	1.0	0.9	0.9	0.9
Calendar EV/EBITDA (x)	6.9	5.9	5.2	4.9	4.9
Calendar FCF yield (%)	3.6	6.2	4.3	9.8	9.8
Calendar dividend yield (%)	4.3	4.3	4.3	4.6	4.6

Source: Company accounts/Investec Securities estimates

Ratios and metrics - IFRS compliant

Year end: 31 December

	2007	2008	2009E	2010E	2011E
Sales growth (y-on-y) (%)	2.3	17.1	17.7	3.2	3.0
EBITDA growth (y-on-y) (%)	(4.5)	15.7	13.4	6.5	3.9
Net income (normalised) growth (y-on-y) (%)	(8.5)	20.2	19.4	5.2	4.7
EPS (normalised) growth (y-on-y) (%)	(10.5)	14.3	19.4	5.2	4.1
FCFPS growth (y-on-y) (%)	n/a	71.7	(30.4)	124.9	6.7
NAVPS growth (y-on-y) (%)	29.0	17.1	9.0	7.6	7.4
DPS growth (y-on-y) (%)	0.0	0.0	0.0	5.6	6.4
Interest cover (x)	8.4	8.6	24.3	25.9	27.0
Net debt/EBITDA (x)	1.0	0.7	0.7	0.4	0.1
Net debt/equity (%)	28.7	21.5	19.7	11.6	4.1
Dividend cover (x)	1.6	1.9	2.2	2.2	2.2
EBITDA margin (%)	17.8	17.6	17.0	17.5	17.7
EBITA margin (%)	11.4	11.3	11.3	11.7	11.8
ROCE (%)	12.6	11.7	13.2	14.1	14.7
NWC/sales (%)	12.5	15.7	13.3	13.3	13.4
Tax rate (normalised) (%)	25.4	29.2	26.5	28.0	28.0
Tax rate (reported) (%)	25.9	18.7	27.4	28.0	28.0

Source: Company accounts/Investec Securities estimates

Divisional breakdown - IFRS compliant

Year end: 31 December

	3yr CAGR (%)	2008	2009E	2010E	2011E
Turnover (£m)	7.7	183.1	215.5	222.3	229.0
Europe	6.2	107.3	122.3	124.8	128.5
Americas	8.0	33.7	40.0	41.2	42.4
Pacific	11.3	42.1	53.2	56.4	58.1
Operating profit (£m)	9.2	20.7	24.3	25.9	27.0

Operating margin (%)	11.3	11.3	11.7	11.8
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Source: Company accounts/Investec Securities estimates

Devro
Summary financials (£m) - IFRS compliant

Year end: 31 December

Income statement	2007	2008	2009E	2010E	2011E
Turnover	156.3	183.1	215.5	222.3	229.0
EBITDA	27.9	32.2	36.5	38.9	40.4
Depreciation	(10.0)	(11.5)	(12.3)	(13.0)	(13.4)
Operating profit	17.9	20.7	24.3	25.9	27.0
Other income, JVs and associates	0.0	0.0	0.0	0.0	0.0
Net interest	(2.1)	(2.4)	(1.0)	(1.0)	(1.0)
Share-based payments/pension finance charges	0.0	0.6	(1.5)	(1.5)	(1.5)
PBT (normalised)	15.7	19.0	21.8	23.4	24.5
Impairment of acquired intangible assets	0.0	0.0	0.0	0.0	0.0
Exceptionals	0.7	(3.5)	1.8	0.0	0.0
PBT (reported)	16.4	15.5	23.6	23.4	24.5
Taxation	(4.3)	(2.9)	(6.5)	(6.6)	(6.9)
Minorities & preference dividends	0.0	0.0	0.0	0.0	0.0
Discontinued / assets held for sale	(0.6)	0.0	0.0	0.0	0.0
Profit attributable	11.6	12.6	17.1	16.9	17.7
Net income (normalised)	11.2	13.4	16.0	16.9	17.7
EPS (reported) - FD (p)	7.1	7.7	10.5	10.3	10.7
EPS (normalised, continuing) - FD (p)	7.2	8.2	9.8	10.3	10.7
EPS (normalised) - FD (p)	6.8	8.2	9.8	10.3	10.7
DPS (p)	4.45	4.45	4.45	4.70	5.00
Average number of group shares - FD (m)	163.8	163.8	163.8	163.8	164.8
Average number of group shares (m)	162.8	162.9	162.8	162.8	162.8
Cash flow	2007	2008	2009E	2010E	2011E
Operating profit	17.9	20.7	24.3	25.9	27.0
Depreciation	10.0	11.5	12.3	13.0	13.4
Other non-cash movements	0.0	0.0	0.0	0.0	0.0
Change in working capital	(0.9)	2.0	0.0	(1.0)	(1.0)
Other cash movements	(3.8)	(2.8)	(2.8)	(2.0)	(2.0)
Operating cash flow	23.2	31.4	33.7	35.9	37.4
Interest	(2.8)	(2.5)	(1.0)	(1.0)	(1.0)
Dividends from JVs & associates	0.0	0.0	0.0	0.0	0.0
Tax	(3.7)	(5.2)	(6.5)	(6.6)	(6.9)
Maintenance capex	(10.7)	(13.3)	(19.0)	(12.0)	(12.0)
Free cash flow	6.1	10.5	7.3	16.4	17.6
Expansionary capex	0.0	0.0	0.0	0.0	0.0
Dividends paid	(7.2)	(7.2)	(7.2)	(7.7)	(8.1)
Cash impact of exceptionals	0.0	0.0	0.0	0.0	0.0
Acquisitions	0.0	0.0	0.0	0.0	0.0
Disposals	0.0	0.0	0.0	0.0	0.0
Share issues	0.0	0.0	0.0	0.0	0.0
Other financial	1.0	0.0	0.0	0.0	0.0
Change in net debt	(0.1)	3.2	0.0	8.7	9.4
Net cash (debt)	(27.3)	(24.0)	(23.9)	(15.2)	(5.8)
FCFPS - FD (p)	3.7	6.4	4.4	10.0	10.7
Balance sheet	2007	2008	2009E	2010E	2011E
Intangible fixed assets	7.0	13.2	13.3	13.3	14.3
Tangible fixed assets	115.1	134.7	141.5	140.5	139.1
Net working capital	19.5	28.7	28.7	29.7	30.7
Assets employed	141.6	176.5	183.4	183.4	184.0
Investments/other assets	0.0	0.0	0.0	0.0	0.0
Net cash (debt)	(27.3)	(24.0)	(23.9)	(15.2)	(5.8)
Provisions & other liabilities (inc. Pension)	(19.3)	(41.3)	(38.2)	(37.7)	(37.2)
Net assets	95.1	111.3	121.4	130.6	141.1
Minority interests	0.0	0.0	0.0	0.0	0.0
NAV per share (p)	58.0	68.0	74.1	79.7	85.6

Source: Company accounts/Investec Securities estimates

Food Producers

Definition of research ratings

	Expected 12m performance
Buy	Appreciation of 10% or more
Hold	Appreciation or depreciation of less than 10%
Sell	Depreciation of 10% or more

UK stock ratings distribution

	Coverage universe		Investment banking clients	
	Count	% of total	Count	% of total
Buy	121	53%	68	56%
Hold	82	36%	12	15%
Sell	27	12%	0	0%

Source: Investec Securities

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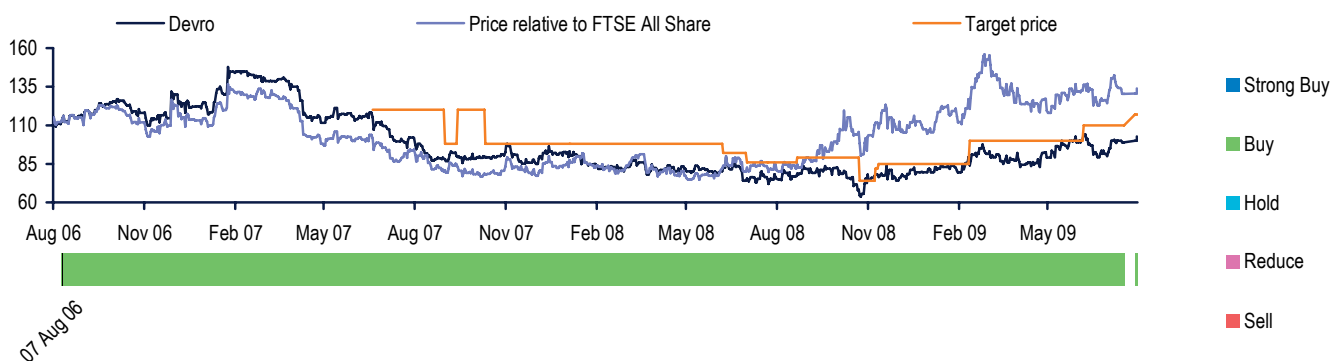
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Devro Ratings Plotter as at 04 Aug 09



Source: Investec Securities estimates, FactSet

Devro

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