



4 May 2007

Food Producers

United Kingdom

Buy

112p

## A Mixed Start

### Event:

Devro released its AGM statement this week and it carried a brief trading update, the first since the company ended bid talks in April. It highlighted that the group has had a mixed start to the year. The mature markets of the UK, US and Australia have been sluggish, but this has been more than offset by good progress from the emerging markets such as Eastern Europe and China.

### Impact:

However, currency continues to be a problem and this is impacting both revenues and profits. Other profit impacting issues include the costs incurred in recruiting the new chief executive, aborted deal costs (which we treat as exceptional) and also some production issues in Scotland. In total these, plus an upward adjustment in the interest charge, total a £1.6m downward revision to our 2007 pre-tax figure to £17.5m, giving EPS of 7.7p. 2008 estimates are reduced by a similar amount leaving EPS at 8.3p (previously 9.0p).

### Recommendation:

On our new numbers, the group is trading on a PER just below the sector average having lost its premium during last year. However, we expect trading prospects to improve in 2H and this could help restore the rating. We set our target price at 124p (11% potential upside).

#### Performance

Year End: 31 December	2005	2006	2007E	2008E	2009E
Turnover (£m)	152.5	153.6	156.2	159.7	163.2
EBITDA (£m)	30.4	28.5	29.6	31.0	31.8
EBITA (£m)	21.3	19.3	20.1	21.2	21.9
EBITA Margin (%)	13.9	12.6	12.9	13.3	13.5
PBT (Normalised) (£m)	19.4	17.3	17.5	18.8	19.7
Tax Rate (%)	27.6	28.3	28.5	28.5	28.5
EPS (Normalised) - Fully Diluted (p)	8.6	7.6	7.7	8.3	8.7
EPS (Reported) - Fully Diluted (p)	11.4	7.1	7.5	8.3	8.7
DPS (p)	4.40	4.45	4.55	4.65	4.75

Source: Company Accounts/Investec Securities Estimates

#### Valuation

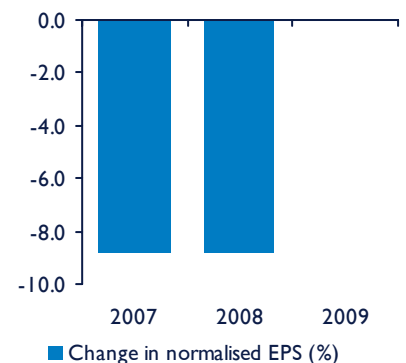
Year End: 31 December	2005	2006	2007E	2008E	2009E
PE (Normalised) (x)	13.3	15.0	14.9	13.8	13.3
EV/Sales (x)	1.3	1.4	1.4	1.3	1.3
EV/EBITDA (x)	6.7	7.5	7.3	6.9	6.6
FCF Yield (%)	6.5	(1.4)	3.0	5.0	5.4
Yield (%)	3.8	3.9	4.0	4.1	4.1

Source: Company Accounts/Investec Securities Estimates

Note: Figures above are IFRS Compliant

Refer to important disclosures starting on page 5

#### Impact On Estimates



Source: Investec Securities Estimates

Market Cap	£187m
Enterprise Value	£216m
Reuters Code	DVO.L
12m high/low	148p/107p

#### Share Price Performance



Source: JCF Group

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Investec acts as Broker to Devro

## Key Points:

- Devro has issued a trading update with its AGM that highlighted a mixed start to the year. The mature markets of the UK, US and Australia have seen a slower start, but the developing markets are compensating for this with strong performances recorded by E Europe, China and Latin America. Overall, the group is ahead in volume terms after the first four months.
- In the UK, the revenues reflect the temporary loss of volume in the early months – this volume will return from April/May so the performance is expected to be better in 2H. In Australia and the US, the slower revenues reflect trading difficulties encountered by certain customers. In developing markets, strong demand continues in E Europe and the group is hopeful of fully utilising its recently added capacity in the Czech Republic.
- On the profit front, there are a number of issues that need to be highlighted. First the advisory costs associated with the recent bid approach are c£400k and will impact in 1H. These are accompanied by a further £300k of costs associated with the recruitment of the new chief executive<sup>1</sup>. We treat the aborted deal costs as exceptional as they are one-off in nature and not part of normal trading, but include the recruitment costs within operating profits.
- Additionally, exchange rates continue to be a feature, and in particular the strength of the Czech crown. Whilst a small element of this is translation, the larger part is transaction impact and will affect both revenue and profit numbers. At the revenue level, the movement to date more than offsets the volume growth; in profit terms, we estimate the impact for the full year will be closer to £1m, against our previous estimate of £0.5m.
- Finally, there continue to be some operational issues around the production of new products in Scotland. These have affected factory efficiencies in 1H, but the group is anticipating a steady improvement in 2H
- We have already reflected some of these costs (£0.4m of aborted deal costs and £0.5m of currency) but need to increase the currency impact to £1m and include recruitment and Scottish production costs (a further £0.6m). Hence, we will be reducing our EBIT forecast by around £1.1m. In addition, we are increasing our interest assumption too, to reflect the slightly lower profit (and cashflow) and also higher interest rates. This results in a downgrade of around £1.6m against previous numbers to £17.5m, with EPS of 7.7p.

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<sup>1</sup> Peter Page, previously at Aviagen, starts on June 1

- Most of these issues will impact on the first half so we expect profits to be lower year on year, perhaps by c£1m on last year's adjusted pre-tax of £8.1m. However, the second half should look much better with an improving volume picture and fewer one-off issues.
- The balance sheet remains strong and we expect the group to close the year with around £29m of net debt (almost 8x interest cover).
- As the market absorbs this latest news, we expect little outperformance, but in the longer term, Devro's strong market positions and innovation skills should stand it in good stead. The rating on the lower numbers shows a small PER discount versus the sector (14.9x v15.9x to Dec 2007). Typically Devro has commanded a premium and with better newsflow, we expect this to be restored. Our capitalised contribution model (using a 7.8% WACC and 2% terminal growth rate) suggests a valuation of around 124p (11% potential upside) which is where we pitch our target price. The key risks to achieving this are if there were any further profit setbacks or adverse currency movements.

**Summary P&L (£m) - IFRS compliant**

Year End: 31 December	2005	2006	2007E	2008E	2009E
Europe	88.9	90.3	91.1	92.9	94.8
Americas	31.4	31.6	32.6	33.2	33.9
Pacific	32.2	31.6	32.5	33.5	34.5
<b>Turnover</b>	<b>152.5</b>	<b>153.6</b>	<b>156.2</b>	<b>159.7</b>	<b>163.2</b>
<b>Operating profit</b>	<b>21.3</b>	<b>19.3</b>	<b>20.1</b>	<b>21.2</b>	<b>21.9</b>
Other Income, JV's & Associates	0.0	0.0	0.0	0.0	0.0
Net Interest	(1.8)	(2.0)	(2.6)	(2.4)	(2.2)
<b>PBT (Normalised)</b>	<b>19.4</b>	<b>17.3</b>	<b>17.5</b>	<b>18.8</b>	<b>19.7</b>
Pension Finance Cost	0.0	0.0	0.0	0.0	0.0
Goodwill	0.0	0.0	0.0	0.0	0.0
Exceptionals	6.3	(1.0)	(0.4)	0.0	0.0
<b>PBT (Reported)</b>	<b>25.8</b>	<b>16.3</b>	<b>17.1</b>	<b>18.8</b>	<b>19.7</b>
Taxation	(5.4)	(4.9)	(5.0)	(5.4)	(5.6)
Minorities & Preference Dividends	0.0	0.0	0.0	0.0	0.0
Profit Attributable	18.7	11.6	12.1	13.5	14.1
Ordinary Dividend	(6.6)	(7.3)	(7.4)	(7.5)	(7.7)
Retained Profit	12.1	4.3	4.7	5.9	6.4
EPS (Reported) - Fully Diluted (p)	11.4	7.1	7.5	8.3	8.7
<b>EPS (Normalised) - Fully Diluted (p)</b>	<b>8.6</b>	<b>7.6</b>	<b>7.7</b>	<b>8.3</b>	<b>8.7</b>
DPS (p)	4.40	4.45	4.55	4.65	4.75
Average no. of Shares - Fully Diluted (m)	163.5	162.1	162.1	162.1	163.1

Source: Company Accounts/Investec Securities Estimates

**Summary Cash Flow (£m)- IFRS compliant**

Year End: 31 December	2005	2006	2007E	2008E	2009E
Operating profit	21.3	19.3	20.1	21.2	21.9
Depreciation	9.1	9.2	9.5	9.8	9.9
Other Non-Cash Movements	0.0	0.0	0.0	0.0	0.0
Change in Working Capital	(0.3)	(2.8)	(2.5)	(2.5)	(2.5)
Other Cash Movements	(1.5)	(3.1)	(2.9)	(1.5)	(1.5)
<b>Operating cash flow</b>	<b>28.5</b>	<b>22.6</b>	<b>24.2</b>	<b>27.0</b>	<b>27.8</b>
Interest	(1.9)	(2.0)	(2.6)	(2.4)	(2.2)
Dividends from Associates & JV's	0.0	0.0	0.0	0.0	0.0
Tax	(6.4)	(5.1)	(5.0)	(5.4)	(5.6)
Net Capex	(8.0)	(18.1)	(11.0)	(10.0)	(10.0)
<b>Free Cash Flow</b>	<b>12.2</b>	<b>(2.6)</b>	<b>5.6</b>	<b>9.3</b>	<b>10.0</b>
Dividends Paid	(6.6)	(7.2)	(7.4)	(7.5)	(7.7)
Cash Impact of Exceptionals	0.0	0.0	0.0	0.0	0.0
Acquisitions & Disposals	0.0	0.0	0.0	0.0	0.0
Share Issues	0.3	0.7	0.0	0.0	0.0
Other Financial	1.8	0.0	0.0	0.0	0.0
<b>Change in net debt</b>	<b>7.7</b>	<b>(9.1)</b>	<b>(1.8)</b>	<b>1.7</b>	<b>2.3</b>

Source: Company Accounts/Investec Securities Estimates

**Summary Balance Sheet (£m)- IFRS compliant**

Year End: 31 December	2005	2006	2007E	2008E	2009E
Intangible Fixed Assets	17.7	17.7	17.7	17.7	17.7
Tangible Fixed Assets	101.4	110.3	111.8	112.0	112.1
Net Working Capital	17.5	20.3	22.8	25.3	27.8
<b>Assets Employed</b>	<b>136.6</b>	<b>148.3</b>	<b>152.3</b>	<b>155.0</b>	<b>157.6</b>
Investments/Other Assets	0.0	0.0	0.0	0.0	0.0
Net Cash/(Debt)	(17.7)	(27.0)	(28.8)	(27.0)	(24.7)
Provisions & Other Liabilities (inc. Pension)	(57.6)	(54.7)	(52.2)	(50.7)	(49.2)
<b>Net assets</b>	<b>61.4</b>	<b>66.7</b>	<b>71.4</b>	<b>77.4</b>	<b>83.8</b>
Minority Interests	0.0	0.0	0.0	0.0	0.0

Source: Company Accounts/Investec Securities Estimates

## Definition of Research Ratings

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

## UK Stock Ratings Distribution

	Coverage Universe		Investment Banking Clients	
	Count	% of total	Count	% of rating category
<b>Buy</b>	118	48%	34	29%
<b>Hold</b>	107	44%	20	19%
<b>Sell</b>	20	8%	1	5%

Source: Investec

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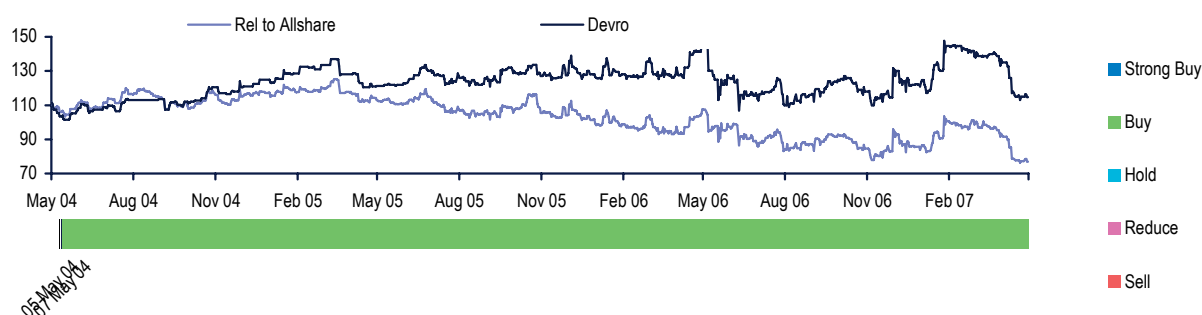
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**Devro Ratings Plotter as at 04 May 07**

Source: JCF Group/Investec Securities

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