

6 September 2007

Food Producers

United Kingdom

Buy

88p

## A challenging second half expected

### Event

Devro has announced interim results which were in line with our expectations. Pre-tax, pre exceptional profits were £6.79m versus our forecast of £6.5m. This result showed some slippage against 2006 IH of around £1.3m. An element of this was a higher interest charge, but the bulk was a £0.9m reduction in EBIT, and this in turn was attributable to a lower revenue figure and a reduced IH margin (11% v 12%).

### Impact

Some of the issues which affected IH results will continue into 2H, most notably lower casing sales in the US and also some production cost issues in Scotland. These second half issues are expected to total £1.5m and we reduce 2007 and 2008 forecasts accordingly. For 2007, this produces £14.35m and 6.2p EPS and for 2008, £15.85m and 6.8p EPS.

### Recommendation

We have reduced our target price to 98p in light of the new EPS and also the general reduction in ratings. The food sector is now trading on a 2008E PER of 13.5x, although typically Devro has commanded a premium in the past. With better trading news expected next year we believe the group can again achieve this. Our 12 month target price represents a 2008E PER of 14.5x.

#### Performance

Year End: 31 December	2005	2006	2007E	2008E	2009E
Turnover (£m)	152.5	153.6	153.9	157.1	160.6
EBITDA (£m)	30.4	28.5	27.0	28.1	28.8
EBITA (£m)	21.3	19.3	17.0	18.3	18.9
EBITA Margin (%)	13.9	12.6	11.1	11.7	11.7
PBT (Normalised) (£m)	19.4	17.3	14.4	15.8	16.7
Tax Rate (%)	27.6	28.3	30.0	30.0	30.0
EPS (Normalised) - Fully Diluted (p)	8.6	7.6	6.1	6.8	7.1
EPS (Reported) - Fully Diluted (p)	11.4	7.1	6.0	6.8	7.1
DPS (p)	4.40	4.45	4.50	4.60	4.70

Source: Company Accounts/Investec Securities Estimates

#### Valuation

Year End: 31 December	2005	2006	2007E	2008E	2009E
PE (Normalised) (x)	10.2	11.5	14.3	13.0	12.4
EV/Sales (x)	1.1	1.1	1.1	1.1	1.1
EV/EBITDA (x)	5.3	6.0	6.5	6.3	6.1
FCF Yield (%)	8.5	(1.9)	1.1	5.2	5.3
Yield (%)	5.0	5.1	5.1	5.2	5.3

Source: Company Accounts/Investec Securities Estimates

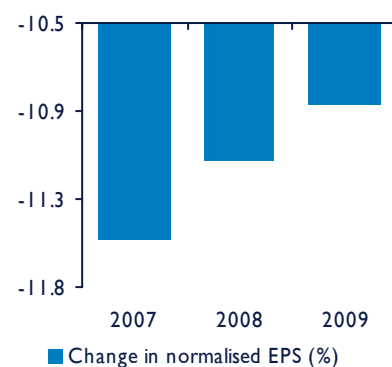
Note: Figures above are IFRS Compliant

Refer to important disclosures starting on page 5

Potential Upside 11%

Target Price 98p

#### Impact On Estimates



Source: Investec Securities Estimates

Market Cap	£143m
Enterprise Value	£176m
Reuters Code	DVO.L
12m high/low	148p/87p

#### Share Price Performance



Source: JCF Group

#### Analysts

Nicola Mallard  
+44 (0) 20 7597 5053

nicola.mallard@investec.co.uk

#### Specialist Sales

Thomas Lawrence  
+44 (0) 20 7597 5081

thomas.lawrence@investec.co.uk

Investec acts as Broker to Devro

## Key points

- Devro has reported IH results which were in line with market expectations. The pre-tax figure was £6.8m, before £0.3m of exceptional items (aborted deal costs). The interim EPS were 3.0p (versus 3.6p last year) and the dividend was held at 1.425p.
- The result was lower year on year partly due to lower revenues (-2.6%) but also a lower IH margin (11% v 12%). The revenue line slipped back despite a strong volume performance. The group showed almost a 4% gain in volumes, but this was offset by a 3% price mix effect and a 3.4% impact from currency translation (largely the US dollar versus sterling).
- Within volumes, the growth was confined to the Asia Pacific region which reported a 22% uplift (within this, volumes to China were up threefold), with both of the more mature regions of Europe and the Americas showing small volume reductions. In Europe, the UK saw a weak start to the year (largely market driven) but this was almost fully offset by a strong continental performance as both Eastern and Western Europe continue to grow. Volumes ended 0.2% lower in this region. In the US, there was a temporary loss of volume in some smaller accounts, but also a move by one customer from collagen casings to collagen gel as it introduced co-extrusion technology. Although collagen gel is higher margin than the casing equivalent, the co-extrusion process uses less gel.
- The volume gain across the group contributed an additional £1.9m to operating profits but the price mix effect, a negative £2.2m, offset this. The largest component of the price/mix impact came from mix, with the big uplift in sales to China comprising lower priced lines. The balance was attributable to some transactional currency impact (on exports from the Czech Republic) and also some discounts offered on volume additions.
- Other meaningful influences on operating profits came from the extra capacity added at Cutisin which generated an additional £1m of EBIT, but this was offset by costs incurred of a similar magnitude in Scotland on a new production process.
- In the second half, a number of the issues from IH are expected to continue. The UK is expected to improve as some lost contracts have been re-secured, but it will be from a lower base due to the sluggish nature of the underlying market. In the US, the customer's switch to gel will complete by year end and costs (albeit less than £1m) are expected to be incurred in Scotland. It is hoped that this particular production issue will be resolved by year end.
- The total of these is c£1.5m and hence we have reduced full year forecasts by this amount for both 2007 and 2008. This produces £14.35m in 2007, 6.2p EPS and £15.85m in 2008, 6.8p EPS. Also included within the

EPS calculation is the assumption of a higher 30% tax rate (versus 28.5% previously).

- The balance sheet showed an increase in net debt to £37m at the interim stage (£29m at 1H last year) which reflects the lower profit contribution and also a £3.8m contribution into the pension fund. As a result of this contribution, more favourable asset valuations and higher discount rates, the net pension deficit at the period end was just £0.8m versus the December 2006 position of £26.3m.
- On 1 June Peter Page joined the group as Chief Executive after Graeme Alexander's decision to retire was announced the previous November. Peter has announced a review of the business which he hopes to report back on early in 2008. Also announced today is John Neilson's decision to retire and a process to appoint a replacement has been started.
- We have reduced our 12-month target price to a level which reflects both the downgrade in EPS and also the lower ratings now seen in the sector generally. At 98p, the target price represents a 14.5x multiple of 2008E EPS. The sector average forecast for this period is 13.5x, but typically Devro has traded at a premium given its global branded status. It has lost this premium in the recent past as trading has been disappointing. However, we do expect to see some improvement in 2H versus 1H results in 2007 and this should flow through to an improved 2008 result too. This target still represents a 10% plus premium to the current level and we leave our recommendation at Buy.

**Summary P&L (£m) - IFRS compliant**

Year End: 31 December	2005	2006	2007E	2008E	2009E
Europe	88.9	90.3	90.3	92.1	93.9
Americas	31.4	31.6	29.6	29.6	30.2
Pacific	32.2	31.6	34.1	35.4	36.5
<b>Turnover</b>	<b>152.5</b>	<b>153.6</b>	<b>153.9</b>	<b>157.1</b>	<b>160.6</b>
<b>Operating profit</b>	<b>21.3</b>	<b>19.3</b>	<b>17.0</b>	<b>18.3</b>	<b>18.9</b>
Other Income, JV's & Associates	0.0	0.0	0.0	0.0	0.0
Net Interest	(1.8)	(2.0)	(2.7)	(2.5)	(2.2)
<b>PBT (Normalised)</b>	<b>19.4</b>	<b>17.3</b>	<b>14.4</b>	<b>15.8</b>	<b>16.7</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)	(0.3)	0.0	0.0
<b>PBT (Reported)</b>	<b>25.8</b>	<b>16.3</b>	<b>14.0</b>	<b>15.8</b>	<b>16.7</b>
Taxation	(5.4)	(4.9)	(4.3)	(4.8)	(5.0)
Minorities & Preference Dividends	0.0	0.0	0.0	0.0	0.0
Profit Attributable	18.7	11.6	9.8	11.1	11.7
Ordinary Dividend	(6.6)	(7.3)	(7.3)	(7.5)	(7.7)
Retained Profit	12.1	4.3	2.5	3.6	4.0
EPS (Reported) - Fully Diluted (p)	11.4	7.1	6.0	6.8	7.1
<b>EPS (Normalised) - Fully Diluted (p)</b>	<b>8.6</b>	<b>7.6</b>	<b>6.1</b>	<b>6.8</b>	<b>7.1</b>
DPS (p)	4.40	4.45	4.50	4.60	4.70
Average no. of Shares - Fully Diluted (m)	163.5	162.1	163.8	163.8	163.8

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	17.0	18.3	18.9
Depreciation	9.1	9.2	10.0	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)	(3.0)	(2.0)	(2.5)
Other Cash Movements	(1.5)	(3.1)	(4.0)	(1.5)	(1.5)
<b>Operating cash flow</b>	<b>28.5</b>	<b>22.6</b>	<b>20.0</b>	<b>24.6</b>	<b>24.8</b>
Interest	(1.9)	(2.0)	(2.7)	(2.5)	(2.2)
Dividends from Associates & JV's	0.0	0.0	0.0	0.0	0.0
Tax	(6.4)	(5.1)	(4.3)	(4.8)	(5.0)
Net Capex	(8.0)	(18.3)	(11.5)	(10.0)	(10.0)
<b>Free Cash Flow</b>	<b>12.2</b>	<b>(2.7)</b>	<b>1.5</b>	<b>7.4</b>	<b>7.6</b>
Dividends Paid	(6.6)	(7.2)	(7.3)	(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	(0.3)	0.0	0.0
<b>Change in net debt</b>	<b>7.7</b>	<b>(9.2)</b>	<b>(6.1)</b>	<b>(0.1)</b>	<b>(0.1)</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	110.4	111.9	112.1	112.2
Net Working Capital	17.5	20.3	23.3	25.3	27.8
<b>Assets Employed</b>	<b>136.6</b>	<b>148.5</b>	<b>153.0</b>	<b>155.2</b>	<b>157.8</b>
Investments/Other Assets	0.0	0.0	0.0	0.0	0.0
Net Cash/(Debt)	(17.7)	(27.0)	(33.1)	(33.2)	(33.3)
Provisions & Other Liabilities (inc. Pension)	(57.6)	(54.7)	(50.9)	(49.4)	(47.9)
<b>Net assets</b>	<b>61.4</b>	<b>66.8</b>	<b>69.0</b>	<b>72.6</b>	<b>76.7</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 vs the FT Allshare
<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

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	Coverage Universe		Investment Banking Clients	
	Count	% of total	Count	% of rating category
<b>Buy</b>	119	54%	38	32%
<b>Hold</b>	81	37%	12	15%
<b>Sell</b>	20	9%	1	5%

Source: Investec

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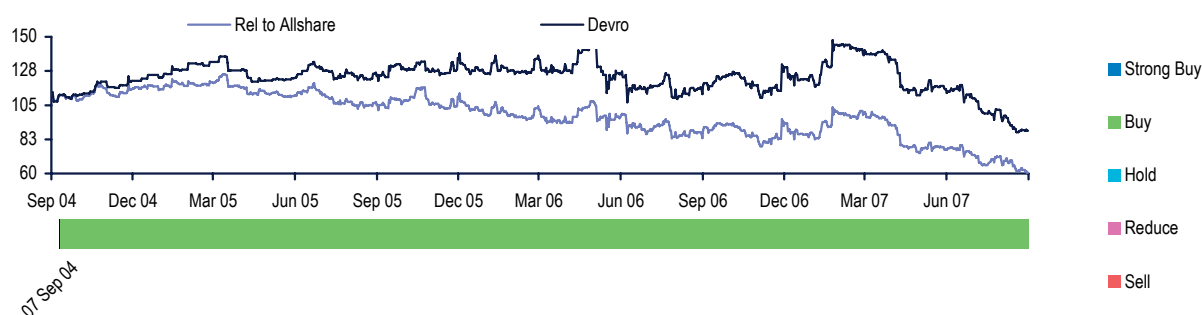
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**Devro Ratings Plotter as at 06 Sep 07**

Source: JCF Group/Investec Securities

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