



27 June 2007

Food Producers

United Kingdom

Buy

110p

Potential Upside 9.3%

Target Price 120p

IH Trading Update

Event

Devro's IH trading update, released this week, highlighted a continuation of the sales trends reported at the May AGM. The group has made some progress, although emerging markets are providing most of the momentum, with the developed markets quieter. However, the group has highlighted two issues which are expected to impact margins this year. These are rising raw material costs in the US and also continuing issues with the new technology introduced in Scotland.

Impact

The rising collagen prices in the US will have an estimated impact on costs of £0.5m in 2H, although the group will, of course, attempt to mitigate this where possible. The problems in Scotland will cost an extra £0.5m in 1H (to total £1m) but we have also prudently assumed £0.5m is incurred in 2H.

Recommendation

IH trading will be disappointing, but we expect the group to start to bounce back in 2H, with improved volumes helping to steady the figures and move back into growth thereafter. Our target price assumes better trading brings with it a return to a premium rating as we have seen in the past and this suggests 120p with 13% upside in the current share price. Buy.

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	27.9	29.6	30.3
EBITA (£m)	21.3	19.3	18.4	19.8	20.4
EBITA Margin (%)	13.9	12.6	11.8	12.4	12.5
PBT (Normalised) (£m)	19.4	17.3	15.8	17.3	18.2
Tax Rate (%)	27.6	28.3	28.5	28.5	28.5
EPS (Normalised) - Fully Diluted (p)	8.6	7.6	6.9	7.6	8.0
EPS (Reported) - Fully Diluted (p)	11.4	7.1	6.7	7.6	8.0
DPS (p)	4.40	4.45	4.55	4.65	4.75

Source: Company Accounts/Investec Securities Estimates

Valuation

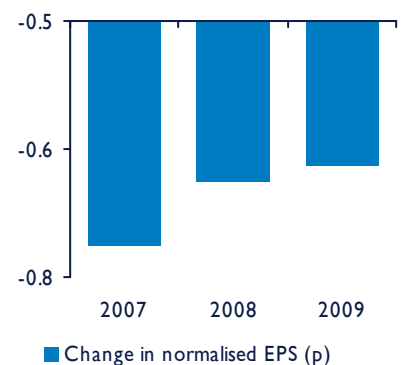
Year End: 31 December	2005	2006	2007E	2008E	2009E
PE (Normalised) (x)	12.7	14.4	15.8	14.4	13.7
EV/Sales (x)	1.3	1.3	1.3	1.3	1.3
EV/EBITDA (x)	6.5	7.2	7.5	7.0	6.8
FCF Yield (%)	6.8	(1.5)	2.5	5.4	5.0
Yield (%)	4.0	4.1	4.1	4.2	4.3

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	£179m
Enterprise Value	£209m
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 brought forward its half year trading update by a week in light of the placing of Accomita's 13.8% stake.
- The revenue trends appear unchanged from the AGM statement, which highlighted that the emerging markets were showing good growth, but that developed markets had had a slower start to the year.
- The statement also highlighted some margin issues which will impact this year, and particularly the first half. In May, we reduced our full year forecast by £1.6m to £17.5m, which reflected currency issues (a strong Czech koruna), chief executive recruitment costs (£300k) and also some costs incurred in Scotland as new technology is introduced. However, at the end of the half year, further issues have arisen and we reduce our 2007 forecast by a further £1.7m to £15.8m.
- The larger of the two is the continuing difficulties being encountered in the Scottish operating unit as a result of new technology. The group has developed a new casing which is designed for export markets (and hence is very different to products manufactured in Scotland presently) but gearing up to full commercial production has been less straightforward. In 2H last year, the group incurred £700k of costs from this and in May it was highlighted that these costs were running into 2007 too - we pencilled in £500k. However, it now looks as if the costs will total £1m in 1H and prudently we have assumed a further £500k in 2H, although clearly the group is working hard to try and avoid this spilling over much into the second half. In this respect, we have adjusted our forecast by £1m, with £0.5m falling into both 1H and 2H.
- The second issue highlighted yesterday was new and this was the possibility of rising collagen costs in the US in 2H. The group takes its collagen only from top quality hides and reduced demand for the leather from these hides has in turn reduced the supply of collagen from current sources. The group is anticipating that this will drive up collagen costs in 2H by an estimated £0.5m. The balancing £200k in the 2007 forecast change reflects a slight increase in the interest charge due to lower cash flow.
- Many of the negatives impacting full year figures will fall into 1H. These include recruitment costs, £1m of Scottish production costs, an element of currency and also the £400k of aborted deal costs which we have classified as exceptional. As a result, we expect 1H profits to be lower year on year at £6.6m (pre exceptional) versus £8.2m last year. For the full year, we are now forecasting £15.8m pre exceptional, which indicates a better 2H period with profits expected to be level year on year.

- The EPS on £15.8m are 6.9p and this suggests a forward PER for December 2007 of 15.8x. This is broadly in line with the sector average (if we strip out the inflationary impact of recovery/bid stocks). Typically, Devro has sat at a premium to its peers as it is a branded, global player and one which does not have the same “supermarket pressures” faced by the own label food producers. However, with forecasts having slipped over the past 12 months, the stock has lost this premium.
- For 2008, we are expecting the improved trading in 2H 2007 to flow through and are forecasting a 10% uplift in profits and EPS to £17.3m and 7.6p. If the group delivers the expected improvement in trading through 2007 and into early 2008 this might help restore some of the confidence in the medium-term outlook and some degree of premium in the rating. We have assumed in our 12 month price target that the prospective rating is slightly higher at 15.5x and applied to 7.6p EPS this yields a target of 120p. This would represent around 9% upside on the price today. Buy.

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
Turnover	152.5	153.6	156.2	159.7	163.2
Operating profit	21.3	19.3	18.4	19.8	20.4
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)
PBT (Normalised)	19.4	17.3	15.8	17.3	18.2
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
PBT (Reported)	25.8	16.3	15.4	17.3	18.2
Taxation	(5.4)	(4.9)	(4.5)	(4.9)	(5.2)
Minorities & Preference Dividends	0.0	0.0	0.0	0.0	0.0
Profit Attributable	18.7	11.6	10.9	12.4	13.0
Ordinary Dividend	(6.6)	(7.3)	(7.4)	(9.0)	(7.7)
Retained Profit	12.1	4.3	3.5	3.4	5.3
EPS (Reported) - Fully Diluted (p)	11.4	7.1	6.7	7.6	8.0
EPS (Normalised) - Fully Diluted (p)	8.6	7.6	6.9	7.6	8.0
DPS (p)	4.40	4.45	4.55	4.65	4.75
Average no. of Shares - Fully Diluted (m)	163.5	162.1	162.8	162.8	162.8

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	18.4	19.8	20.4
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)	(2.0)	(2.5)
Other Cash Movements	(1.5)	(3.1)	(2.9)	(1.5)	(1.5)
Operating cash flow	28.5	22.6	22.5	26.1	26.3
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)	(4.5)	(4.9)	(5.2)
Net Capex	(8.0)	(18.3)	(11.0)	(9.0)	(10.0)
Free Cash Flow	12.2	(2.7)	4.4	9.7	8.9
Dividends Paid	(6.6)	(7.2)	(7.4)	(9.0)	(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
Change in net debt	7.7	(9.2)	(3.0)	0.7	1.2

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	111.1	111.2
Net Working Capital	17.5	20.3	22.8	24.8	27.3
Assets Employed	136.6	148.5	152.5	153.7	156.3
Investments/Other Assets	0.0	0.0	0.0	0.0	0.0
Net Cash/(Debt)	(17.7)	(27.0)	(30.0)	(29.3)	(28.1)
Provisions & Other Liabilities (inc. Pension)	(57.6)	(54.7)	(52.2)	(50.7)	(49.2)
Net assets	61.4	66.8	70.3	73.8	79.0
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
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 rating category
Buy	106	47%	32	30%
Hold	100	44%	20	20%
Sell	21	9%	2	10%

Source: Investec

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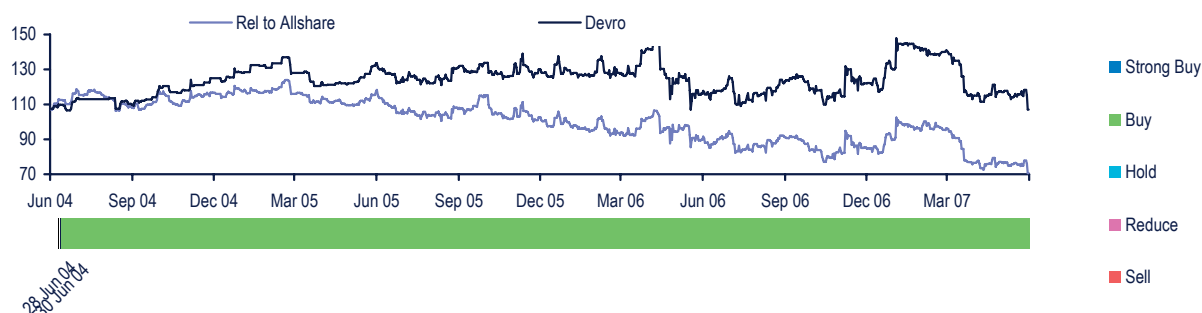
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Devro Ratings Plotter as at 27 Jun 07



Source: JCF Group/Investec Securities

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