EAST DEVON ENGINEERING LTD

2015 FINANCIAL REVIEW AND FORECAST

BROADOAK
CONSULTING

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1. Introduction

The following Financial Review and Financial Forecast has been prepared for East Devon Engineering Ltd ("EDE"), a family-owned business which has been designing, developing and manufacturing electrical equipment for construction projects since 1985.

With both engineers and service technicians, EDE are able to provide multi-disciplined project consultation and installation services. While established in Exeter, Devon, the Group now trade globally and have generated a strong balance sheet with sustainable cash flow generation and dividend distribution.

The information in this Review, which does not purport to be comprehensive, has been provided by EDE and has not been independently verified by Broadoak Financial Consulting Ltd.

2. Income Statement

GBPk	FY 2013	FY 2014	FY 2015	+/-%
Total revenue	3,462.9	3,699.2	4,001.5	8.2
COGS	(2,173.0)	(2,285.6)	(2,645.8)	15.8
Gross profit **(GP)**	1,289.9	1,413.6	1,355.7	(4.1)
EBITDA	804.5	854.5	946.7	10.8
Operating profit **(EBIT)**	687.3	721.6	832.4	15.4
Profit before tax **(PBT)**	674.9	682.4	788.3	15.5
Net profit/loss	502.1	555.7	624.8	12.4
Return to S/H	(146.6)	(241.0)	(444.8)	
Transfer to equity	355.5	314.7	180.0	(42.8)

Total revenue has grown at a **CAGR**[1] of 6.1% over the past 3 years. This has in turn supported **gross profit** growth in absolute terms over the same time period. We would however note that the gross margin has declined by 3pp in FY 2015 due to an increase in the cost of production.

EBITDA[2] has however increased in both absolute terms and margin as the increase in COGS has been addressed by management with savings made on overheads. Non-operational expenses remain in line with plan as margin improvements have translated to bottom line growth. This has consequently seen increases in both **profit before tax** and **net income**, which have increased by 16% and 12% respectively.

This has enabled shareholders to significantly increase the dividend payout ratio as well as finance a share buyback programme. The **sustainable growth rate** has consequently declined, however it remains well above the company's revenue growth target so we do not foresee any short term need to increase financial leverage or consider external financing.

The **ROE** and **ROCE**[3] have however both declined as substantial free cash generation and strong earnings has resulted in a significant increase in the equity balance.

[1] Compound Annual Growth Rate
[2] Earnings Before Interest, Tax, Depreciation and Amortisation
[3] Return on Equity, Return on Capital Employed

GBPk	FY 2013	FY 2014	FY 2015	+/-%
Revenue growth (%)	3.3	6.8	8.2	
Revenue CAGR (%)			6.1	
Gross margin (%)	37.2	38.2	33.9	↘
EBITDA margin (%)	23.2	23.1	23.7	↗
EBIT margin (%)	19.8	19.5	20.8	↗
Net margin (%)	14.5	15.0	15.6	↗
ROA (%)	26.4	26.2	25.1	↘
ROCE (%)	71.9	64.1	56.2	↘
ROE (%)	174.2	228.1	117.1	↘
Dividend payout ratio (%)	29.2	43.4	71.2	↗
Sustainable growth rate (%)	123.4	129.2	33.7	↘

3. DuPont Analysis

	FY 2013	FY 2014	FY 2015	+/-
Net margin (%)	14.50	15.02	15.61	↗
Asset turnover (x)	1.84	1.84	1.74	↘
Financial leverage (x)	6.60	8.72	4.66	↘
ROE per DuPont (%)	175.7	240.7	126.3	↘

As can be seen above, while **ROE** has declined significantly this has been due solely to the retained cash balance resulting in a deduction in leverage. In this respect, EDE may be seen as under-levered.

While EDE has the capacity to return additional funds to owners (and increase their level of leverage). It is not consistent with the long term strategy of the Group. EDE has set aside funds for a substantial capex programme which will see them increase production capacity over the next 3-4 years.

4. Cash Flow Assessment

GBPk	FY 2013	FY 2014	FY 2015	+/-%
Cash flow from operations				
Operating profit/loss	687.3	721.6	832.4	15.4
Depreciation & amortisation	117.2	132.9	114.3	(14.0)
Change in working capital	27.4	(96.3)	(25.2)	
Other	(31.6)	(8.7)	(33.3)	
	800.3	749.5	888.2	18.5
Cash taxes paid	(149.9)	(146.8)	(149.6)	
Cash flow from operations	**650.4**	**602.7**	**738.6**	22.5
Cash flow from investing				
Capital expenditure (net)	(93.0)	(105.2)	(114.1)	
Investments	(5.5)	-	(6.9)	
Other	10.5	1.6	17.0	
	(88.0)	**(103.6)**	**(104.0)**	0.4
Cash flow from investing				
Change in external debt	2.5	166.0	(1.3)	
Change in equity	(322.4)	(350.9)	(173.5)	
Interest paid	(24.1)	(21.6)	(30.5)	
Interest received	2.3	0.8	1.2	
Dividends paid (cash)	(148.8)	(165.9)	(240.6)	
Other	(11.8)	(1.2)	13.8	
	(502.3)	(372.8)	(430.9)	15.6
Increase/decrease in cash	**60.1**	**126.3**	**203.7**	61.3

Cash flow from operations for FY 2015 improved as a result of an 11% increase in EBITDA and a lower working capital balance. This was particularly notable given the 8% increase in revenue and reflects management's diligence in managing both stock levels and debtors.

While **capex** has increased marginally this remains in line with both revenue & depreciation so does not present a concern. We would also note that this is not unexpected as EDE is in the midst of a number of large projects.

Free cash flow has increased by 25% and clearly exceeds debt service requirements. While long term debt remains substantial, with substantial cash on hand we don't anticipate any servicing issues with net leverage[4] at 0.4x.

GBPk	FY 2013	FY 2014	FY 2015	+/-%
Funds from operations	627.2	804.0	822.3	2.3
Cash flow from operations	650.4	602.7	738.6	22.5
Capex (net)	(93.0)	(105.2)	(114.1)	8.5
Free cash flow	557.4	497.5	624.5	25.5
Debt Service requirements	(82)	(78)	(87)	10.6
DSCR (x)	6.8	6.3	7.2	↗
FFO / ST debt (x)	6.6	9.8	7.7	↘
FFO / Total debt (x)	0.9	0.9	0.9	-

Free cash flow generation remained extremely strong with a DSCR of 7.2x, up on the prior year. This enabled substantial cash to be returned to shareholders through a combination of dividends (£241k) and share buybacks (£174k). We would note that returning cash to shareholders has not been at the expense of investment in the business nor has it increased net debt.

[4] Net debt / EBITDA

5. Balance Sheet Assessment

GBPk	FY 2013	FY 2014	FY 2015	+/-% (a)	+/-% (b)
Current assets					
Cash at bank	137.5	275.6	478.9	100.4	73.8
Investments	22.2	11.2	70.3	(49.5)	527.7
Trade debtors	720.2	803.9	854.6	11.6	6.3
Inventory	333.0	369.5	421.9	11.0	14.2
Prepayments	-	-	-		
Other	-	-	-		
	1,212.9	**1,460.2**	**1,825.7**	20.4	25.0
Non-current assets					
Property, plant & equip	538.2	510.0	501.3	(5.2)	(1.7)
Financial assets	31.9	18.0	66.9	(43.6)	271.7
Intangibles	45.8	46.9	43.9	2.4	(6.4)
Other	72.9	89.0	47.1	22.1	(47.1)
	688.8	**663.9**	**659.2**	(3.6)	(0.7)
Current liabilities					
Bank loans & overdrafts	(6.4)	(2.7)	(1.9)		
Other ST loans	(88.8)	(79.6)	(105.4)	↘	↗
Trade creditors	(536.1)	(582.0)	(632.5)	↗	↗
Dividends payable	(85.0)	(75.2)	(78.2)		
Tax Payable	(95.4)	(78.3)	(63.1)		
Other	(8.3)	(38.4)	4.7		
	(820.0)	**(856.2)**	**(876.4)**		
Non-current liabilities					
Long term loans	(572.9)	(799.9)	(840.6)	↗	↗
Accruals	(211.1)	(196.6)	(198.6)		
Other	(9.5)	(27.8)	(35.7)		
	(793.5)	**(1,024.3)**	**(1,074.9)**		
Total Equity	**288.2**	**243.6**	**533.6**	(15.5)	119.0

(a) 2013 vs. 2014

(b) 2014 vs. 2015

As can be seen above, strong FCF generation has resulted in strong and improving **liquidity** levels.

Both debtor days and inventory turn has remained relatively stable, which is consistent with industry peers. Overall **working capital** management has improved with a lower **cash conversion cycle**. Ordinarily we would expect to see growth in stock and debtors in line with sales and while this has occurred in absolute terms after adjusting for the sales growth, cash conversion continues to decline.

With minimal intangibles of £47k (2014: £44), **tangible net worth** (TNW) remains a close proxy for equity.

Although **gearing**[5] remains high at 178% (2014: 362%), serviceability represents little concern with EBITDA interest cover of 30.7x (29.5x) and extremely low net leverage at 0.4x (2014: 0.7x). Both gearing and capitalisation have dropped dramatically in the past year as the Group have wound back their share buyback programme.

[5] Debt / equity

GBPk	FY 2013	FY 2014	FY 2015	
Liquidity Ratios				
Cash ratio (x)	0.19	0.33	0.63	↗
Quick ratio (x)	1.07	1.27	1.60	↗
Current ratio (x)	1.48	1.71	2.08	↗
Activity ratios				
Trade debtor turnover (x)	4.9	4.9	4.8	↘
Days of sales outstanding (DSO)	75.1	75.2	75.6	↗
Inventory turnover (x)	6.2	6.5	6.7	↗
Days of inventory on hand	59.3	56.1	54.6	↘
Trade creditor turnover (x)	3.6	3.4	3.3	↘
Number of days payable	100.2	106.0	110.1	↗
Cash conversion cycle	34.1	25.3	20.2	↘
Total asset turnover (x)	1.8	1.8	1.7	↘
Working capital turnover (x)	2.2	2.2	2.2	↘
Solvency ratios				
EBIT/Interest (x)	25.1	24.9	27.0	↗
EBITDA/Interest (x)	29.4	29.5	30.7	↗
Total debt / EBITDA (x)	0.8	1.0	1.0	↘
Net debt / EBITDA (x)	0.6	0.7	0.4	↘
Gearing (%)	231.8	362.2	177.6	↘
Capitalisation (%)	69.9	78.4	64.0	↘

6. Financial Forecast

GBPk	FY 2015	2016 (F)	2017 (F)	2018 (F)	CAGR
Revenue	4,001.5	4,050.0	4,175.0	4,350.0	2.8
Growth (%)		1.2	3.1	4.2	
Gross profit	1,355.7	1,321.0	1,401.2	1,415.6	
Salary & wages		(531.0)	(545.0)	(552.0)	
Lease expense		(112.0)	(124.0)	(135.0)	
Other expenses		(257.0)	(230.3)	(242.3)	
EBITDA	946.7	935.0	962.5	970.9	0.8
Gross interest	(30.8)	(30.8)	(29.5)	(28.6)	
Depreciation & amortisation		(126.0)	(112.0)	(104.0)	
Change in working capital		(30.2)	(10.2)	5.8	
Corporations tax paid (cash)		(152.6)	(151.3)	(165.4)	
Cash flow from operations		752.2	801.0	811.3	
Capex - maintenance		(120.1)	(149.4)	(132.4)	
Capex - expansion			(85.5)	(125.4)	
Free cash flow	624.5	632.1	566.1	553.5	(3.9)
EBITDA margin (%)	23.7	23.1	23.1	22.3	
EBITDA/gross interest (x)	30.7	30.4	32.6	33.9	
DSCR	7.9	8.0	8.7	8.5	

(1) Compound annual growth rate

The above forecast is based on both management projections and an extrapolation of prior year financials. We consider these projections to be conservative. <u>*For further information on how we develop financial projections please refer to our separate Factsheet.*</u>

We would highlight the improvement in both **revenue** and **EBITDA** growth, which will drive EDE's continued strong cash flow generation over the coming three years.

EBITDA margin growth is expected to be achieved for the next 2 years, however EDE have conservatively forecast an increase in direct costs as a number of contracts are due to expire in 2017. EDE have initiated contract negotiations, however given the ongoing discussions, management have deliberately taken a conservative approach with respect to being able to passthrough through additional future costs.

EDE also intends to expand their production facilities, with construction due to commence in 2017. This will be financed with cash on hand. However after allowing for prudent **working capital** management, **free cash flow** generation is expected to decline marginally. The expansion programme will however have a marginal impact on **covenant measures** and headroom is expected to remain substantial.

7. Covenant projections

GBPk	FY 2015	2016 (F)	2017 (F)	2018 (F)
EBITDA/gross interest (x)	30.7	30.4	32.6	33.9
Covenant	2.5	2.6	2.7	2.8
Headroom (%)	*1,229.5*	*1,167.6*	*1,208.4*	*1,212.4*
	Met	Met	Met	Met
EBITDA margin (%)	23.7	23.1	23.1	22.3
Covenant	12.5	13.0	13.5	14.0
Headroom (%)	*189.3*	*177.6*	*170.8*	*159.4*
	Met	Met	Met	Met
DSCR (x)	7.2	7.3	7.3	8.5
Covenant	1.4	1.4	1.4	1.4
Headroom (%)	*514.5*	*520.8*	*518.4*	*608.2*
	Met	Met	Met	Met

As can be seen above, given the Company's strong current and expected **credit metrics**, sufficient covenant headroom and a balanced debt maturity profile, we believe that the benefits of analysing the above for sensitivities would provide only limited additional information.