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UK Equity Research
12 December 2016

Company	Rating	Price	Target
Generalist Small/Mid Cap			
COA-LSE	Buy	38p	88p
GKN-LSE	Buy	318p	370p
NXR-LSE	Buy	185p	217p

Share price as of 8 December 2016

Initiation of Coverage

Pension deficits - tables turned?

The collapse in nominal bond yields (and more importantly real discount rates) since their October 2008 peak (7%) to low (of 1.8%) in early August of this year, on the back of unprecedented central bank market intervention, has had some well documented effects - notably the significant (and fairly indiscriminate) outperformance of bond proxies generally and, in particular, those equities which appear to offer bond-like characteristics in terms of sustainable (at least) dividend yields etc. Conversely, corporate entities with final salary pension schemes have experienced ballooning actuarial deficits, which have fed back negatively into the rating of these equities, as investors fret they may compromise expansion plans and/or constrain (or even eliminate) the ability to pay dividends.

The possible normalisation of real bond yields is a big macro issue and investors must keep their own counsel here – at risk of stating the obvious, we simply wish to highlight the sensitivity of pension deficits to a rising rate environment and publish on a diverse trio of stocks which are, to varying degrees, likely to be impacted. All three feature in a list of the Top 20 UK quoteds ranked by deficit as a percentage of market cap, with both Coats and Norcros appearing in the Top 10 and GKN registering the largest deficit in absolute nominal value terms. Taken together we hope they provide a useful prism through which to consider the pension issue.

Recommendations

Coats – initiate with BUY (TP 88p) – our Top Pick - profitable, highly cash generative, global market leader emerging from complex recent history – as the company "normalises" we expect a substantial rerating (from just 4.1x EV/EBITDA, incorporating full deficit) with sequential catalysts – likely resolution of the pension issue is the key threshold, enabling the introduction of a progressive dividend policy and more concerted (and accretive) acquisition strategy. If our thesis plays out then Mid250 entry potentially beckons in H2 2017 further expanding investor appeal.

Norcros – initiate with BUY (TP 217p) – the share price should be highly responsive to movements in yields but this is more than just an inverse bond proxy. We think the underlying valuation (7.2x fwd PER, with a strong balance sheet) already appears too low and arguably overstates the weak UK organic performance, while showing little credit for the successful acquisition strategy to date or an improving South Africa. Upside risks include further elevation in bond yields and/or tangible evidence of improved UK trading at Johnson Tile and Triton.

GKN – maintain BUY (TP 370p) - global number 1, 2 or 3 in its main products; a track record of consistent organic growth above peers and end markets; and attractive positioning for emerging trends. However, we find significant disparity between its market rating and intrinsic valuation which we attribute in large to its pension deficit (£2.1bn June-16). Recent yield movements should improve this by year end and the triennial review outcome should not materially impact capital allocation initiatives. We continue to see upside on a number of valuations, underpinned by our forecasts for strong earnings progression, solid dividend growth, and improving cash generation.

For important information, please see the Important Disclosures beginning on page 51 of this document.

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Pension Deficits

Way of playing turning point in bond yields?

The collapse in nominal bond yields (and more importantly real discount rates) since their October 2008 peak (7%) to low (of 1.8%) in early August of this year, on the back of unprecedented central bank market intervention, has had some well documented effects - notably the significant (and fairly indiscriminate) outperformance of bond proxies generally and in particular those equities which appear to offer bond-like characteristics in terms of sustainable (at least) dividend yields etc. Conversely, corporate entities with final salary pension schemes have experienced ballooning actuarial deficits, which have fed back negatively into the rating of these equities, as investors fret they may compromise expansion plans and/or constrain (or even eliminate) the ability to pay dividends.

Figure 2: UK Corporate Benchmark AA Yield (15yr)

Source: Thomson Reuters Eikon

Sterling's decline post the EU referendum in June only exacerbated these dynamics – with dollar exposure further turbocharging already elevated ratings - but Trump's election win has provoked, in the short term at least, a pronounced upsurge in yields on the back of his expansionary (inflationary) rhetoric. Could this be ignition for "the long-awaited bonfire of the bond proxies" (FT 20 Nov, 2016)? While all but the shortest field moving averages continue to suggest a declining rate trajectory, the risk/reward seems firmly in favour of selectively rebalancing towards those equities that would benefit from a rising discount rate environment, including those with net cash balance sheets or sizeable pension deficits.

Pension deficits are revealed to the market in snapshots, and while their general existence is well understood the precise quantum is often not. Implied yield volatility – nowhere more pronounced than in the past six months – has a profound impact on how the snapshot looks. August/September was the worst point in history to provide a spot deficit update – but higher inflation assumptions have seen a pivotal, nascent expansion in real yields and a 50% increase in nominal yields (2.7% versus 1.8%) in just two months! Importantly, deficits are the product of the excess present value of the liabilities above the typically mark-to-market assets supporting the scheme. Not only have discount rates risen, reducing liabilities, but so too inflation expectations may now pick up, which would typically benefit the equity component of scheme assets – further compounding deficit erosion.

Coats Group plc

Generalist Small/Mid Cap | Canaccord Genuity Limited (UK)

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To us there are no foreign markets.™

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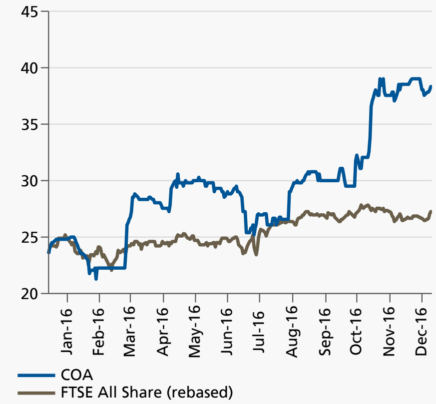
UK Equity Research
12 December 2016

BUY

PRICE TARGET	88p
Price (8-Dec)	38p
Ticker	COA-LSE

52-Week Range (p):	21 - 40
Avg Daily Vol (M) :	1.6
Market Cap (£M):	531
Shares Out. (M) :	1,407.6
Enterprise Value (£M):	743

FYE Dec	2015A	2016E	2017E	2018E
Sales (US$M)	1,490	1,521	1,567	1,614
EBITDA (US$M)	183.0	202.0	210.9	219.3
EBIT Margin (%)	9.4	10.5	11.0	11.2
EPS Adj (US$)	5.98	6.40	7.18	7.57
DPS (US$)	0.00	0.00	0.00	0.00
Net Debt (Cash) (US$M)	(241.0)	(205.1)	(260.9)	(332.2)
P/E (x)	10.4	7.4	6.6	6.2
EV/EBITDA (x)	4.9	4.6	4.1	3.7
Div. Yield (%)	0.0	0.0	0.0	0.0



Source: FactSet

Initiation of Coverage

Major rerating potential

Investment Proposition

Coats has a remarkable heritage and is a global market leader with around 30% share in its core industrial threads business, supplying primarily the global branded Footwear & Apparel manufacturing sector. It also has a growing, high return, opportunity in more Specialty fibres, including flame retardants and composites. It is highly cash generative and profitable yet trades on a very low multiple and pays no dividend. Why is this? The company is emerging from a complex ownership history, compounded in particular by issues surrounding its (and associated orphan) pension scheme deficit. Specifically, we note that these issues have prevented the company from distributing any part of its frankly very strong, net cash balance sheet. As the company looks to "normailise" as a PLC we believe there exists scope for a substantial rerating.

The primary share price catalyst would be a threshold resolution of the pension issues - which while not guaranteed seems the pragmatic conclusion for all relevant parties in our view. The ability to adopt a progressive dividend policy, to accelerate its targeted acquisition strategy and most likely qualify for Mid250 index inclusion in H2 2017 could all propel the shares. Alongside the resolution/clarity agenda the recent rally in bond yields may provide further positive momentum as the mark-to-market scale of the deficit erodes.

Valuation

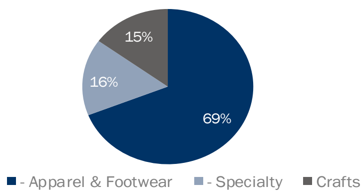
There are few easy analogues for Coats but, assuming a resumption of dividends, and putting Coats on a relevant basket average rating, we see substantial upside on several measures (EV/EBITDA, PER and DY). We derive a fair value of 88p (more than double the current price). Depending upon the precise terms of any deficit repair mandated by the Pensions Regulator, there may in truth be scope for further balance sheet optimisation - including acquisitions and/or additional capital returns - offering risk upside to our target price.

Company summary

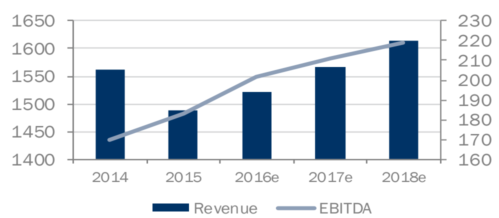
Company Description

Global market leader in manufacture/distribution of industrial yarns & threads, into clothing/footwear manufacture and also Specialty categories (such as telecoms cables, driver airbags etc.). Global No2 supplier of zips & trims (into the branded Apparel & Footwear manufacturing sector). Market leader in Americas consumer textile crafts.

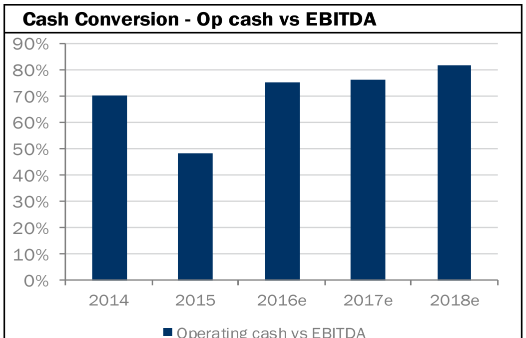
2016 Revenue By Division



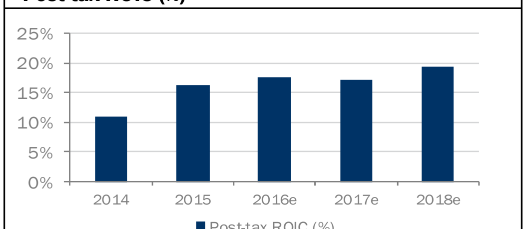
Revenue & EBITDA (USDm)



Cash Conversion - Op cash vs EBITDA



Post-tax ROIC (%)



Valuation	Dec-14	Dec-15	Dec-16E	Dec-17E	Dec-18E
EV/Sales (x)	0.6	0.6	0.6	0.6	0.5
EV/EBITDA (x)	5.7	4.9	4.6	4.2	3.7
EV/EBIT (x)	7.3	6.5	5.8	5.1	4.5
EV/NOPAT (x)	11.6	10.1	8.3	7.3	6.3
EV/Invested Capital (x)	1.3	1.6	1.5	1.3	1.2
ROIC (%)	11.0%	16.2%	17.6%	17.2%	19.3%
P/E (x)	9.3	10.5	7.4	6.6	6.3
Div. Yield (%)	–	–	–	–	–
Equity FCF Yield (%)	4.3%	2.5%	6.1%	6.8%	8.4%

Summary P&L ($m)	Dec-14	Dec-15	Dec-16E	Dec-17E	Dec-18E
Sales	1,561.4	1,489.5	1,521.0	1,566.6	1,613.6
EBITDA	170.0	183.0	202.0	210.9	219.3
EBITDA Margin (%)	10.9%	12.3%	13.3%	13.5%	13.6%
EBIT	123.4	139.4	160.0	172.9	181.3
EBIT Margin (%)	7.9%	9.4%	10.5%	11.0%	11.2%
Adjusted PBT	116.9	109.7	141.5	154.4	162.8
Adjusted EPS (p)	6.7	6.0	6.4	7.2	7.6
DPS (p)	–	–	–	–	–

Growth	Dec-14	Dec-15	Dec-16E	Dec-17E	Dec-18E
Sales (%)	(8.3%)	40.7%	2.1%	3.0%	3.0%
EBIT (%)	1.9%	147.3%	13.2%	6.5%	4.7%
PBT (%)	734.8%	(6.1%)	29.0%	9.1%	4.0%
EPS (%)	35.7%	(11.4%)	7.0%	12.3%	5.4%
DPS (%)	-	-	–	-	–

Summary Cash Flow ($m)	Dec-14	Dec-15	Dec-16E	Dec-17E	Dec-18E
EBIT	123.4	139.4	160.0	172.9	181.3
Depn. & Amortisation	46.6	43.6	42.0	38.0	38.0
Change in working capital	27.5	(15.2)	(10.0)	(10.0)	–
Net Capex	(37.7)	(31.9)	(30.0)	(30.0)	(30.0)
Interest	(21.8)	(15.3)	(30.0)	(30.0)	(30.0)
Tax	(55.7)	(49.3)	(53.0)	(55.0)	(58.0)
Other	(40.5)	(47.4)	(20.0)	(20.0)	(20.0)
Free Cash flow	**41.8**	**23.9**	**59.0**	**65.9**	**81.3**
Acquisitions / Disposals	–	(26.1)	(39.9)	–	–
Dividend	(6.7)	(10.1)	(10.0)	(10.0)	(10.0)
Share Issues / buybacks	0.2	(7.6)	–	–	–
Other	–	–	–	–	–
Movement in net debt	**35.3**	**(19.9)**	**9.1**	**55.9**	**71.3**
(Net debt) / cash	**291.5**	**241.0**	**205.1**	**260.9**	**362.2**

Summary Balance Sheet ($m)	Dec-14	Dec-15	Dec-16E	Dec-17E	Dec-18E
Non current assets	654	628	596	596	596
Current assets	1,308	1,123	1,046	1,060	1,075
Non current liabilities	985	959	912	903	893
Current liabilities	577	438	415	415	415
Net Assets	**401**	**354**	**314**	**338**	**362**

Financial Structure	Dec-14	Dec-15	Dec-16E	Dec-17E	Dec-18E
Gearing (debt / equity) (%)	(72.8%)	(68.1%)	(65.3%)	(77.2%)	(91.7%)
Net debt / EBITDA (x)	(1.72)	(1.32)	(1.02)	(1.24)	(1.51)
Interest cover (x)	6.3	3.3	(1.2)	(1.5)	(1.8)

Source: Company report, Canaccord Genuity estimates

Brief History

Founded over 250 years ago (in Paisley, Scotland) Coats is one of the world's first truly global firms with production in India from late 19th Century and China from the 1920s. First listed in 1890 it was one of the founding members of the FT30. In 1986 it famously merged with Vantona Viyella to create Coats Viyella – in 2003 Guinness Peat took the company private and in 2015 it returned to the market as Coats Group. It is headquartered in Uxbridge.

Business Summary

A market leader: 30% global market share and 3x larger than its next competitor

Coats is the global market leader in the USD3bn market for industrial threads with a c30% share and is more than 3x the size of its nearest competitor, the private equity backed roll-up A&E. It is the global No. 2 supplier of zips and trims (into the branded Apparel & Footwear manufacturing sector) and the lead player in the Americas textile crafts market (B2C recreational knitting, sewing and accessories).

It has over 19,000 employees in c50 sites with a sales presence in over 100 countries across 6 continents. As befits its size it is "massively well invested" with a world-class asset base which includes for example 100 warehouses across the globe all linked via SAP and a bespoke e-commerce platform. We note that it is unrivalled in terms of product range and service capability and can substantially outspend competitors on new product development (NPD).

Of its USD1.5bn Group revenues around two-thirds derive from Apparel & Footwear, with the remaining third split evenly between Specialty (fibres) and Crafts (consumer). Coats threads can be found in a broad range of applications from Prada jeans, Nike trainers to optic fibre cables, car airbags, Michelin tyres, composites, wearables and tea bags and customer options include over 150,000 colour ways.

It is well diversified by both geography (Americas 35%, Asia 48% and EMEA 17%) and customer (with no one customer or brand contributing >10% of group sales and a very long tail).

Industrial

Comprising the Apparel & Footwear (A&F) and Specialty segments:

Apparel & Footwear

Market leadership in Apparel & Footwear represents a strong and defendable core

Coats' market leadership here represents a strong and defendable core, with the segment displaying robust fundamentals and addressing considerable end-market scale (company estimates total value of finished goods – Clothing USD1.5trillion, Footwear USD350bn). Clothes and shoes are very much a staple category, albeit consumer demand tends to grow slightly faster than overall economic growth – in the US for example clothing retail sales have typically grown at c1.6x GDP growth (source IMF, US Census Bureau). Meanwhile Asia, with its expanding urban middle class, is forecast to grow at 6.2% compared with the developed world average of c2% per annum (source: World Bank) . As the region moves from a predominantly low cost production base to an increasingly important, and ultimately the world's largest, consumer market, we believe Coats' heritage forward position in this geography should see it well placed to capture this opportunity.

Specialty

An addressable, and growing, market valued at $1.8bn

If the core A&F activities are about steady cash generation and productivity gains, this segment is all about growth with the plausible, if rather broad and arguably hard to define, addressable market estimated to be worth around USD1.8bn and growing. Specialty currently accounts for just under a fifth of Industrial revenues versus A&F at

81% but the company does not segmentally breakdown profitability between the two. Margins are for now broadly comparable albeit we would reasonably expect Specialty margins to expand as the company grows share in its various discrete product niches and start-up costs associated with NPD etc. start to burn off. Traditional Specialty include such things as specified threads for driver airbags (where Coats hasmajor market share) but emerging categories, and major growth drivers for the Specialty division include:

- ***Telecoms*** – Glasmo SM VO brand, glass fibre strength engineered "water swellable" yarn that protects delicate optical cables against the damaging effects of rain and salt water ingress. Coats is currently the No. 2/3 player but at current "high single digits" growth, plus deep investment pockets versus the competition, it clearly wants to grow share here. Fibre optic cabling is growing in line with developing economies as the company installs key base infrastructure.
- ***Oil & Gas*** – coated and precision wound para-aramid for use in braided reinforcement for composite thermoplastic pipes
- ***Medical*** – various (undisclosed)
- ***Flame retardants*** – various end markets under the Flamepro brand – the company's flame retardant threads can withstand temperatures as high as 1000°C and progressive public sector spending and safety compliance in developing countries is a key demand driver (for example in protective clothing for utility infrastructure workers). This is an attractive segment since there is not as yet one dominant player.
- ***Carbon composites*** – the market shift from metal to textiles is a major opportunity for Coats with its unique commingling technology offering materials of high tensile strength alongside light weight and non-corrosion.

Coats has a further array of blending and extrusion yarn capabilities – as well as electricity conductive fibres - which it can leverage as appropriate across a broad range of end products.

Industrial (continued)

At H1 Asia had a good Q1 in A&F but experienced some retailer softness into Q2. The Americas were down slightly with good growth in LatAm A&F being offset by a US consumer durables slowdown. EMEA was up 8% yoy versus weak comps with better performance across A&F, zips and Specialty. The 250bps margin improvement across the division was primarily a function of volume gearing (particularly market share gains with major brand owners), productivity and procurement gains, as well as lower average oil prices – all of which more than offset challenging pricing conditions.

We forecast 4% revenue growth (from 5% in 2015) – but while H1 showed good progress with margins at 13.3% versus just 11.2% prior full year, given cautious commentary ("macroeconomic uncertainty") and likely USD and other raw material cost pressures (including now oil-related) we assume margins for the year of 12.6%.

Crafts

Crafts contribution insignificant

While the company is a market leader with c15% share in the US and around 20% share in LatAm, Group revenue generates just 3% of profits (following sharp decline in US handknittings) albeit margins are on a recovering trend. The loss-making (-£2m in H1) UK business is to close by year-end, following in the wake of EMEA Crafts divestment in 2015. The focus of the Group remains very much the global B2B opportunity in professional yarns and Specialty fibres rather than B2C recreational, consumer markets and while we do not know the extent to which Crafts leverages the professional yarns core we suspect, at the right price, it is broadly non-core in the medium term.

Costs

Relentless productivity gains

The management culture within Coats is one of relentless, progressive productivity and procurement improvement (assessed via multiple KPIs) – in essence the company states that "it's all about better buying, better productivity". By way of reference the cost base breaks down as follows:

- *Materials 40%* - raw materials (polyester, nylon, cotton) and intermediates (greythread); direct materials (dyes, cones) and bought-in finished goods (Crafts) – significant relative purchasing power versus competition
- *Distribution 16%* - including freight and warehousing
- *Administration 16%* - including corporate costs
- *Labour 13%* - impressively low in our view reflecting perhaps the high level of industrialisation - interesting to note ongoing inflationary pressure in locations where Coats operates
- *Energy 3%* - with price linked to local supply/demand dynamics

Overall SG&A overheads fell slightly in H1 to 28% of revenues, driven largely by the EMEA Crafts disposal – some of these savings have already been "re-invested to support growth" according to Coats and we assume c28% ratio going forward.

Investment

Capex typically runs at c1x depreciation and while we do not anticipate any radical change here at a Group level we would expect spend to be skewed towards the growth Specialty activities.

Ongoing bolt-on acquisitions

The company is pursuing an active, internally funded bolt-on acquisition programme (amounting to USD66m in past 18 months) targeting adjacent IP/manufacturing capability to accelerate the growth in Speciality, and niche digital competence to enhance the service proposition in textiles:

Gotex (USD32m maximum consideration) - based in Spain: specialist yarns and tapes for telecoms, energy and oil & gas sectors – proprietary technology in the manufacture of coated fibreglass yarns at significantly higher speed than conventional means – complementary to aramid product range and further strengthens presence in fibre optics - moreover Gotex can accelerate its own expansion by leveraging Coats' unrivalled geographic footprint, global relationships and strong corporate brand

Fast React (USD11m maximum consideration) – follows last year's USD6m acquisition of **GSD** (a UK based supplier of solutions to analyse time, cost and production capability in textiles industry) – FR is a UK based provider of software solutions and expertise to manufacturers and retailers to improve its operational efficiency – addresses growing customer demand for value-added services in operational efficiency.

Digital is a key differentiator

Coats has made targeted "digital" investment in recent years allowing the company a slicker and more data-rich interaction with the supply chain and customer base, which further differentiates its from its nearest competition:

- *eCommerce platform* - a real-time online system designed to make thread ordering as quick and easy as possible for customers to check such things as stock availability and payment status, from a mobile device. Eighteen months after roll out it is being used by 10,000 customers in more than 25 countries and now generates two-thirds of total thread orders. It has also enabled a reduction in back office headcount. Adjacent to this is a valid big data opportunity – with the company asking itself "can we see patterns which we can leverage both for ourselves and for the benefit of our customers".

- *Coats Colour Express* – a web-based application, backed by Coats Colour Capture (electronic shade card) which allows customers accurately to match, sample and order thread.
- *Opti Express (zips sampling)* – being rolled out on the back of a very successful pilot launch in China (with 50% customer adoption).

In aggregate the digital initiatives above address key needs of the garment industry with suppliers having to respond to a number of pressures including: speed (to market, in sampling, in sourcing), productivity (low-cost locations now scarcer due to inflationary pressures), innovation (product, process and consumer experience), and quality (as a differentiator). Thread is a critical component to both the performance and aesthetic of a garment (it does not supply Primark). Ethical compliance is a key sensitivity for major brands and Coats plays a leadership role in environmental, labour, and sourcing best practice.

So we have a well invested, global market leader, which is profitable, growing and which generates cUSD70m of free cashflow per annum (with a strong balance sheet - more of this below) yet the shares trade on a forward PE of just 7x and pays no dividend – how can this be?

It’s all about pensions

Brief History

GPG realisation and distribution programme triggers pensions investigation

Coats was taken private by Guinness Peat Group in 2003 and became part of a portfolio of c50 investments – between 2011 and 2013 GPG conducted an asset realisation programme, selling everything it owned leaving Coats as the only remaining operating entity. GPG had envisaged distributing the proceeds of the divestment programme to shareholders and various capital returns and buybacks took place between 2011 and Q1 2013. But these returns were suspended in Q2 of 2013 when The Pensions Regulator (tPR) began investigations, initially into the Coats UK and Brunel (orphan) schemes in Q2 2013 and later that year into the Staveley (also orphan) scheme. For the uninitiated orphan schemes are those where the underlying operating entities to which they relate have become separated , raising questions as to how they will be funded. tPR subsequently issued warning notices (Dec 2013 Brunel and Staveley, Dec 2014 Coats UK scheme). As reported at the time by the FT this was “the first time tPR has used its so-called anti-avoidance powers to block a corporate restructuring that may leave scheme members vulnerable”. The notification from tPR outlined the purpose of the investigation being to ascertain “whether financial support should be provided to those schemes by the company, or by one or more of the entities connected or associated with the schemes’ respective sponsoring employers”. GPG itself described the notification as carrying considerable “uncertainty as to when those investigations will conclude, whether any financial commitment will result from such investigations, or, should it be so, the quantum involved.”

Commitment to retain “parent” group cash

As the sole trading entity Coats and GPG are one and the same but for the purposes of resolution Coats committed to retaining the GPG “parent” group cash separately (just under USD400m) rather than deploying within the operating business and/or making any dividend distributions. This extract from the company’s own website encapsulates the position:

Figure 1: Coats pension liability overview

Source: Coats Group plc – Introduction to Coats presentation (August 2016)

From a modelling perspective however we prefer to consider Coats/GPG as one entity with a unified net cash balance sheet – while understanding that the optimal capital structure for the operating business (post pension resolution) would look rather different (ie not net cash, but dividend paying and between 1.5 to 2.0x geared).

1.5x EV/EBITDA?

Two years ago Coats was a very unusual proposition – mkt cap £300m, cash £150m (parent cash £300m less operating business net debt of say £150m), EBITDA c£100m, pension deficit £180m or trading on 1.5x EV/EBITDA (ex pension deficit) or just 3x (including pension as debt in the EV numerator). To complicate things further of course the deficit figure itself has been a moving target, albeit generally increasing with the fall in bond yields up to August 2016.

Returning to the chronology of events:

Late 2015: legal process begins and Coats started triennial process on its own pension scheme, the orphan schemes having reached trustee agreement earlier in the year as follows:

Figure 2: Triennial valuations, technical provision (TP) deficits and recovery plans

Company	Agreed date	TP deficit	
Brunel	Nov-15	£94m	Recovery plan £5.5 pa over 10 years
Staveley	May-15	~£100m	£34 upfront, £4.4m pa over 9 years
Coats	Ongoing	£14m	currently pays £14m pa

Source: Coats Group plc – Introduction to Coats presentation (August 2016)

Feb 2016: company initiates settlement discussions with all trustees and makes commitment to retain parent group cash with some key conditionality:

- that tPR withdraw the Warning Notices on the three schemes, thereby ending the investigations
- and for Coats to have the ability to commence the payment of normal course dividends to its shareholders and have sufficient cash to invest in growth opportunities.
- if settlement cannot be reached by end 2016 then company prepared to litigate

28 July '16: at the interims the company confirmed that discussions with Trustees are continuing with "progress being made" and now also "engaging" with tPR to attempt a

resolution. The next step would be a "hearing before the Determinations Panel of tPR, unlikely before Q4 '16 at earliest".

Watershed moment in pension resolution

So we are at a watershed moment – given good faith on the part of Coats (pledge to retain parent cash, active engagement with both trustees and tPR etc.) it would be disappointing not to reach a constructive, mutually agreeable, settlement. All parties are likely to prefer clarity versus legal process –pragmatism ought to prevail (especially given Coats' balance sheet strength and cash generative profitability). But the quantum and balance of recovery payments which would be mandated by tPR in any resolution "is not certain", nor can it be until their determination is made public.

The support structure could be any of, or a combination of:

- cash paid directly into the scheme(s) either as a lump sum and/or annual recovery payments
- contingent cash (effectively in escrow) earmarked for the schemes if subsequently required
- and/or cash retained within the Group

Conclusion

We believe any settlement, assuming it represents certainty and closure, would likely be very well received by the market. Clearly the precise terms and shape of repair payments will require some appraisal but from a shareholder perspective any settlement is likely to be materially positive, not least owing to the valuation.

Valuation

Rating low versus franchise quality

Given the qualities of the Coats franchise (rehearsed below):

- Global market leader with many of the advantages that confer (pricing power etc., better buying, digital capability, NPD etc.)
- Growth and higher value add offered by Specialty strategy
- Double digit EBIT margins
- 90%+ cash EBIT conversion
- Strong balance sheet (notwithstanding pension issue)

The shares appear severely lowly rated, trading on a forward PER of just 7.0x, EV/EBITDA 4.1x (or 2.3x ex-deficit), 0.5x EV/Sales with pensions the key driver. In particular:

- Uncertainty as to the quantum of the deficit itself (it has been rising inexorably with falling yields, at least till now)
- Uncertainty as to whether a resolution can be reached with tPR and what precise terms would be mandated in terms of deficit repair etc. For now the Company is unable freely to deploy its significant free cashflow (USD70m+ per annum) and strong balance sheet for the benefit of shareholders, alongside pension scheme interests, via a combination of progressive dividend (and possibly other) distributions and a more concerted acquisition spend (including support for the Specialty growth strategy).

In general it is fair to say that the pension issue is preventing the company from become a fully "normalised" PLC, despite various positive strides in this regard, namely:

- Change of name (in 2015) from GPG to Coats PLC.
- Developing UK focused institutional share register and move to a single London Main Market Listing (delisted from NZX and ASX in June 2016)

- Headquartered in the UK
- Strengthened executive team with appointment of Simon Boddie as CFO (ex-Electrocomponents, Diageo). In a "natural succession" Rajiv Sharma, who has been with Coats for 6 years, and running Industrial for past 4 years, will replace Paul Forman as CEO on 1 January, 2017.

Change at the top

There are several catalysts for multiple expansion with pension resolution being the key but certainly not only trigger - joining dividend list and (very possible in our view) Mid250 index inclusion in 2017 offer scope for further re-rating.

Fair value

There are no precise market analogues available for Coats – albeit its presence in threads/yarns has a natural adjacency to other polymer fibre, specialty material/composite names and we include both Low & Bonar (LWB:LSE, 66p, n/r) and Essentra (LSE:ESNT, 429p, n/r) in our comparator basket (outgoing CEO joined Coats from Low & Bonar, and is off to Essentra, which might also endorse their relevancy).

Figure 3: Valuation comps (all 12m forward)

	EV/Sales	EV/EBITDA	PER (fwd)	DY (%)
Basket multiple	2.2	10.6	15.8	3.4%
Coats multiple	0.5	4.1	7.0	7.2%*
Coats (current price, p)	38	38	38	38
Coats (fair value, p)	164	98	86	80

Source: Canaccord Genuity estimates

* assumes notional resumption of dividend 2.5x covered by EPS

Conclusion: initiating with BUY and 88p target price

Assuming Coats should trade on a peer group multiple, three of the four ratios imply a fair value for Coats of between 80p and 98p (with EV/Sales distinct if favourable outlier at 164p) – suggesting a mid-price fair value of 88p (more than double the current price). Given the basket constituents all have financial leverage, we believe it must be the case that, with net cash, Coats' balance sheet is relatively fat with ample scope for dividends, additional capital returns and/or acquisitions as detailed below. Assuming acquisitions are accretive then the rating will need to expand further.

We model for various pension repair measures

In considering the dividend potential for Coats we have modelled for a range of possible outcomes in relation to settlement with tPR (should it be reached).

Scenario 1

USD25m per annum for 10 years deficit repair cash payments + progressive dividend (2.5x covered) + scope for capital return (and/or acquisitions) while keeping Group Net debt/EBITDA at 1.5x

- *would permit progressive dividend payments (4.0 cents in 2017, growing 5%+ per annum) and notional scope for further 34 cents (27p) per share additional return or $460m acquisitions*

Scenario 2

USD50m per annum for 10 years deficit repair cash payments + progressive dividend (2.5x covered) + scope for capital return (and/or acquisitions) while keeping Group Net debt/EBITDA at 1.5x

- *would permit progressive dividend payments (4.0 cents in 2017, growing 5%+ per annum) and notional scope for further 30 cents (24p) per share additional return or $400m acquisitions*

Scenario 3

£100m deficit repair lump sum + £10m per annum for 10 years deficit repair cash payments + progressive dividend (2.5x covered) + scope for capital return (and/or acquisitions) while keeping Group Net debt/EBITDA at 1.5x

- *would permit progressive dividend payments (4.0 cents in 2017, growing 5%+ per annum) and notional scope for further 26 cents (20p) per share additional return or $350m acquisitions*

Together these scenarios suggest a further 20-27p of additional theoretical value in addition to a peer group combined rating of 88p (see above) – suggests 111p but we stick with 88p.

Asymmetric risk/reward

So ultimately it comes down to pricing the risk of a settlement being reached and what the precise terms might be – evidently one cannot know but given the chronology discussed above allied to the very low rating and extreme delta (125% notional upside) we see the risk/reward of buying here as very asymmetric. Any further rise in bond yields is likely to provoke further price expansion with a 10bp swing adding 1.3c = 1p/2.6%

Figure 4: Pension Schemes – Sensitivity Table ($m)

	BRUNEL	STAVELEY	COATS	TOTAL	
- Equities	31	39	494		
- Bonds	60	178	874		
- Other	24	5	107		
Total Assets	**115**	**222**	**1475**	**1812**	
Liabilities	**-168**	**-244**	**-1749**	**-2161**	
Net deficit	-53	-22	-274	*-349*	
Increase in real discount rate to eliminate deficit (bps)	350	90	220		
10 bps real swing	1.51	2.44	12.45	*16.4*	
Inflation rate	2.8	2.8	2.8		
Actual strike nominal discount rate	*2.9*	*2.9*	*2.9*		
Total nominal discount rate (required)	*6.3*	*3.7*	*5.0*		
Difference (bps)	340	80	210		
10bps swing (USDm)	1.56	2.75	13.05	*17.4*	1.25c

Source: Company reports, Canaccord Genuity estimates

Norcros is, in fact, more geared on this measure at 5.4% but has nothing like the same scope for rerating. Fundamentally we see Coats as a £1bn+ market cap stock with an attractive cash flow return profile supporting both a healthy dividend yield but also accretive acquisition strategy. Assuming the stock appreciates in line with our thinking then we can expect Mid250 inclusion in H2 2017 - normalisation complete.

Risks

Key risks include:

- Failure to reach a settlement with the Pension Regulator, and agree the Triennial review with the Trustees of the Coats scheme, and thus enter a period of potentially lengthy litigation, preventing resumption of dividends and associated rerating
- Further weakness in North American Crafts
- Other litigation, including Lower Passaic River
- As mentioned previously, upside would come from a possible Mid250 inclusion in H2 2017

Norcros plc

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UK Equity Research
12 December 2016

Initiation of Coverage

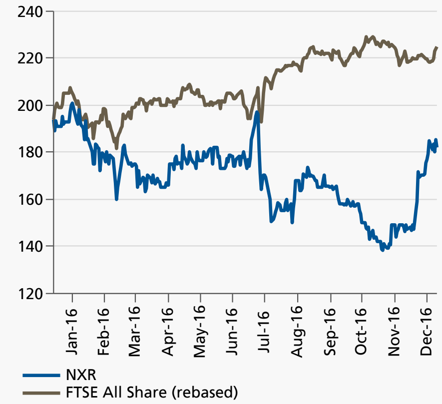
Deficit, what deficit?

BUY

PRICE TARGET	217p
Price (8-Dec)	185p
Ticker	NXR-LSE

52-Week Range (p):	137 - 204
Avg Daily Vol (M) :	0.1
Market Cap (£M):	112
Shares Out. (M) :	61.3
Enterprise Value (£M):	200

FYE Mar	2016A	2017E	2018E	2019E
Sales (£M)	235.9	267.0	281.0	288.0
EBITDA (£M)	22.2	26.5	28.5	30.0
EBIT Margin (%)	7.1	7.9	8.2	8.8
EPS Adj (p)	21.5	25.8	28.4	30.3
DPS (p)	6.6	8.0	9.5	11.0
Net Debt (Cash) (£M)	32.5	23.1	(2.9)	(17.0)
P/E (x)	8.6	7.2	6.5	6.1
EV/EBITDA (x)	9.0	7.5	6.1	5.3
Div. Yield (%)	3.6	4.3	5.1	5.9



Source: FactSet

Investment Proposition

In the UK Norcros manufactures/sources products under a growing portfolio of leading brands in the broad kitchen and bathroom tiling, brassware and accessories market. It is also a leading manufacturer and retailer of similar products in South Africa. The shares trade on a discount to (until recently a big discount) their building material and merchant peers. We believe there are three reasons for this but the tide may be turning:

Pension deficit - Norcros is fairly leveraged to movements in bond yields (10bps =c5% share price swing) and these have been rising - further yield progression is likely to be reflected in share price.

South Africa - UK-centric investors have not been keen on this emerging market exposure, not least given persistent Rand weakness, but the currency is now becoming an FX tailwind along with positive signs that underlying trading performance improving.

UK - negative LFLs at banner brands Johnson Tile and Triton have understandably perturbed investors. We believe this is largely a function of ongoing restructuring within the retail sheds as well a move by the merchants towards a lower inventory strategy. Too early to call a recovery perhaps, but arguably discounted in the price. Furthermore the poor UK organic has overshadowed the very encouraging acquisition performance - the ongoing strategy here offers scope for further accretion, including sourcing and cross-sell synergies.

Valuation

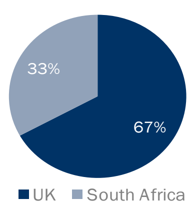
Near field the shares are likely to be very responsive to movements in yields but this is more than just a reverse bond proxy. Notwithstanding Johnson/Triton challenges, with the stable of recent acquisitions and South Africa together now accounting for over half group revenues, and both performing well, the rating is simply too low in our view. A forward PER of just 9x (well below most peers), EV/Sales 0.9x (hardly generous given margin expansion) suggests fair value of 217p. It is also interesting to note the relative attraction of the shares on an LBO free cashflow basis (11% yield).

Company summary

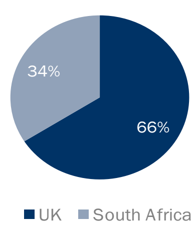
Company Description

Market leading manufacturer/supplier of ceramic tiles (Johnson Tiles), related adhesives and electronic showers (Triton) in the UK. Additionally supplies premium brassware & accessories for the bathroom (under Vado brand), mixer taps & sinks for the kitchen (under the Abode brand) and bathroom accessories (under Croydex brand). Market leading ceramic tile and adhesives operations in South Africa (both manufacture & retail).

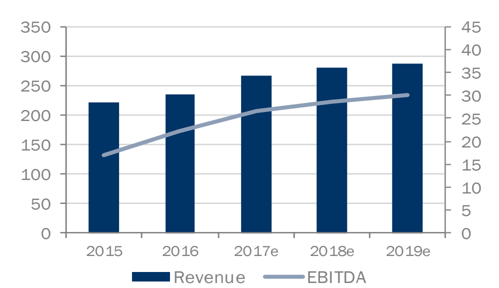
2016 Revenue By Geography



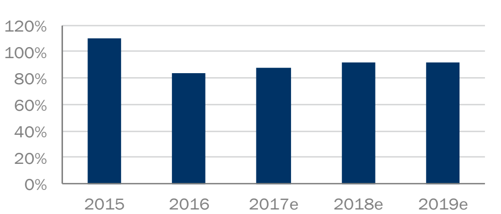
2016 EBITDA By Geography



Revenue & EBITDA



Cash Conversion - Op cash vs EBITDA



Valuation	Mar-15	Mar-16	Mar-17E	Mar-18E	Mar-19E
EV/Sales (x)	0.8	0.9	0.8	0.6	0.6
EV/EBITDA (x)	10.2	9.1	7.6	6.2	5.4
EV/EBIT (x)	16.2	12.1	9.6	7.6	6.6
EV/NOPAT (x)	21.5	14.2	12.0	10.3	9.0
EV/Invested Capital (x)	1.5	1.5	1.7	1.6	1.7
ROIC (%)	7.0%	10.4%	13.8%	16.9%	20.6%
P/E (x)	13.5	8.6	7.2	6.5	6.1
Div. Yield (%)	3.0%	3.6%	4.3%	5.1%	5.9%
Equity FCF Yield (%)	11.8%	8.9%	12.7%	16.0%	18.2%

Summary P&L (£m)	Mar-15	Mar-16	Mar-17E	Mar-18E	Mar-19E
Sales	222.1	235.9	267.0	281.0	288.0
EBITDA	16.9	22.2	26.5	28.5	30.0
EBITDA Margin (%)	7.6%	9.4%	9.9%	10.4%	10.7%
EBIT	10.6	16.7	21.0	23.0	24.5
EBIT Margin (%)	4.8%	7.1%	7.9%	8.2%	8.5%
Adjusted PBT	11.0	15.4	19.7	21.7	23.2
Adjusted EPS (p)	13.7	21.5	25.8	28.4	30.3
DPS (p)	5.6	6.6	8.0	9.5	11.0

Growth	Mar-15	Mar-16	Mar-17E	Mar-18E	Mar-19E
Sales (%)	1.6%	6.2%	13.2%	5.2%	2.5%
EBIT (%)	(17.2%)	57.5%	25.7%	9.5%	6.5%
PBT (%)	89.7%	40.0%	27.9%	10.2%	6.9%
EPS (%)	(20.0%)	56.9%	20.0%	10.2%	6.9%
DPS (%)	9.8%	17.9%	21.2%	18.8%	15.8%

Summary Cash Flow (£m)	Mar-15	Mar-16	Mar-17E	Mar-18E	Mar-19E
EBIT	10.6	16.7	21.0	23.0	24.5
Depn. & Amortisation	6.3	6.4	5.5	5.5	5.5
Change in working capital	37.8	46.3	45.3	45.3	45.3
Net Capex	(1.4)	(6.6)	(7.0)	(6.0)	(5.0)
Interest	(1.3)	(0.9)	(1.0)	(1.0)	(1.0)
Tax	(0.5)	(1.0)	(1.0)	(1.0)	(1.0)
Other	2.8	5.2	5.0	5.0	5.0
Free Cash flow	**12.9**	**10.0**	**14.3**	**18.0**	**20.5**
Acquisitions / Disposals	3.3	(23.6)	–	–	–
Dividend	(3.1)	(3.6)	(4.9)	(5.8)	(6.7)
Share Issues / buybacks	0.1	0.2	–	–	–
Other	(1.1)	(0.1)	–	–	–
Movement in net debt	**12.1**	**(17.1)**	**9.4**	**12.2**	**13.8**
(Net debt) / cash	**(14.2)**	**(32.5)**	**(23.1)**	**(10.9)**	**2.9**

Summary Balance Sheet (£m)	Mar-15	Mar-16	Mar-17E	Mar-18E	Mar-19E
Non current assets	78	93	89	89	89
Current assets	100	119	118	118	118
Non current liabilities	67	98	107	107	107
Current liabilities	59	68	68	68	68
Net Assets	**53**	**48**	**33**	**33**	**33**

Financial Structure	Mar-15	Mar-16	Mar-17E	Mar-18E	Mar-19E
Gearing (debt / equity) (%)	155.0%	230.0%	332.8%	332.8%	332.8%
Net debt / EBITDA (x)	0.84	1.46	0.87	0.38	(0.10)
Interest cover (x)	(42.3)	17.1	20.4	21.9	23.1

Source: Company reports, Canaccord Genuity estimates

Overview
Norcros' low rating is informed by three key issues as we see it (which we expand upon below in reverse order):

- ***Pension deficit*** – equal to market cap as recently as September
- ***South Africa*** – investors have never liked this emerging market exposure (persistent Rand weakness)
- ***UK negative LFLs*** – sheds destocking etc.

United Kingdom

Notwithstanding ambitions to grow overseas revenues to 50% of Group in the medium-term, the UK remains the core geography (over two-thirds of group ignoring exports from UK) and the organic business has experienced double digit percentage declines at the two pillar brands in the past year (Triton -12.6% overall, -14.6% in the UK; and Johnson Tiles -9.0% overall, -10.0% in the UK).

Triton

Triton the jewel in the crown with a 50% UK market share

Despite the weak trading environment this remains the "jewel in the crown" brand and is the UK's market leading (50%+ share) manufacturer and distributor of electric and mixer showers and accessories. Against the headwind of significant destocking across a number of its major customers, particularly pronounced ahead of the recent national merchant restructuring (with lots of branch closures, especially in Q2 from Travis Perkins, Wolseley and Grafton) trade revenues actually moved forward by 4%, driven by a new electrostatic shower solution. More detrimental to date is the ongoing decline in the DIY sector which continues to impact upon branded electric shower volumes – not least with the move from "Promotions" to "Every Day Low Prices". As with B&Q specifically it seems reasonable to assume that the trading environment in general remains "in a state of flux" and for now we remain cautious on the outlook for both trade and retail.

Brazil a key target market

On a more positive tack Triton is now selling into Latin America, including for example Paraguay, but it is Brazil that is the key target, representing as it does, the world's largest electrical shower market (20 times size of UK equivalent to put it in perspective). Norcros is well advanced in developing a low pressure (and we assume relatively low cost) product to capture share, and has had some positive validation from market testing and interest from trade shows. As is always true of any new market some considerable consumer education will be required to drive meaningful adoption. Brazil can be considered something of a closed shop – for example it is often necessary to have some local assembly, if not manufacture, to access the domestic market – so we would be unsurprised by some kind of acquisition or joint-venture to address this hurdle.

Johnson Tiles

Pronounced weakness here with the market described by Norcros as the "toughest since 2008". While UK trade declined by a modest 4%, with robust housebuilder and specification channels offsetting weaker (budgetary constrained) social housing refurbishment performance, we note that it is the radically weak UK retail (-16.4% yoy) which captures all the wrong headlines, and this against relatively weak comps. A number of factors are at play here but they include retailers importing more tiles directly themselves and a conscious withdrawal from some lower margin ranges. Additionally, as with Triton above, shed destocking continues (for example Kingfisher

B&Q redirecting sales to more the successful Screwfix distribution format which has a far lower store inventory requirement). And to cap it all, a weaker France performance versus a good prior year with Leroy Merlin saw export revenues down 20% (exports account for c11% of Tile revenues).

Promising performances in specialist retail, including Topps Tiles, with new product launches providing new opportunities

All of this masked a promising performance, albeit modest scale, in specialist retail (including Topps Tiles, who Johnson Tile famously historically did not supply). As with Triton, the company continues to innovate and has "high hopes" for commercial acceptance of its new "Cristalgrip" easyfit tile launch – unqualified, amateur consumers can now apparently hang wall tiles using this (Velcro based, sans adhesive) system, allowing for more frequent change, adjustment or replacement as required – one still needs grout for waterproofing, which suggests that some will still prefer to leave it to the professionals We also see scope for wider market adoption of ceramic tiles as a floorcovering (working especially well as they do in wet rooms, where JT is already prominent, and with underfloor heating generally), which may in time further extend volumes. Finally management appears hopeful that after a period of significant customer readjustment things may now have troughed – but as at Triton we remain cautious ahead of tangible improvement in LFLs (or at very least deceleration in the rate of decline).

Encouraging outlook for several businesses

Against this broadly challenging Triton/Johnson Tiles narrative there are some far sunnier stories in the UK portfolio.

Norcros Adhesives

Norcros Adhesives seems to be performing well; manufacturing and third party sourcing, as it does, a spectrum of ancillary tiling-related products including glues, backing boards and other wet room requirements. New product developments include a fast track levelling system "Pro Fast" which we believe is gaining market traction. On the export horizon the business is making progress with specifiers in the Middle East with a dedicated sales presence now in Dubai. We view the 20% capacity increase to be delivered in H2 and the commissioning of a new ERP system as signs of confidence.

Strong M&A track record with recent acquisitions thriving

All three recent acquisitions seem to be thriving, accounting as they do for more than 100% of UK revenue growth:

Vado

Vado (manufacturer of high-end brassware, premium taps, mixer showers and bathroom accessories) is "going very well" and benefiting from the recent increase in sales and marketing investment into the specification sector with sales to housebuilders and hotels showing "significant" growth. Additionally, under the Norcros umbrella, it has been able to invest in NPD with three new ranges to launch in H2 2016.

Croydex

Croydex (market leading designer, manufacturer and distributor of high quality bathroom furnishings and accessories, including everything from shower rods and vanity units to toilet seats) has also delivered "very pleasing" performance according to the company, with successful NPD launches (FlexiFix, Stick N Lock) and early, but promising, signs of successful intragroup cross-sell synergies (including for example exports to South Africa and the creation of an accessory offering under the Vado brand).

Adobe

Abode (leading niche designer and distributor of high-end taps, including instant hot water taps (£1350 at retail) and kitchen sinks) has been earnings enhancing in Year One. It has been very progressive in leveraging the Norcros market covenant achieving new listings with Homebase, Bathstore and Astracast, augmenting its established installed customer base which includes John Lewis, AGA Rangemaster and Howdens. NPD including the "Pronteau" branded hot water tap have been very well received and there is ample scope to launch Abode ranges into Norcros export markets. Incredibly Abode employs just 21 people (1% of Group headcount).

Conclusion

Near term pressure in Triton and Johnson Tiles remain but the strong performances from recent acquisitions are very encouraging

Yes, we believe it is entirely fair for investors to be apprehensive near-term in respect of the performance of Triton and Johnson Tiles and while these are strongly branded, market leaders, recovery is too early to call. Decent progress in the specification segment is only a partial panacea. The poor organic performance also detracts from the really very encouraging contributions from the acquisitions where cross-brand and export synergies abound – their ability to leverage the market presence of the Norcros group prove a useful blueprint for potential future acquisition targets. One note of caution in relation to the acquisitions – they are all essentially UK assembly businesses sourcing components from abroad (both Europe and the Far East) and thus are likely to face both currency and potentially underlying raw material cost inflation headwinds in the year ahead. Sterling weakness will on the other hand dissuade import penetration which might help Johnson Tiles in particular.

South Africa

At 31% of Group, UK (and typically small cap) investors have not been especially fond of this "developing market" exposure. Moribund domestic demand allied to persistently weakening translation currency has only compounded the mood – but these two factors appear to be turning. Since the start of 2016 the Rand has sustained something of a rally against a basket of world currencies, and while performance versus Sterling in recent months has had as much to do with pound weakness as Rand strength, it is nonetheless welcome relief.

£ Rand cross-rate

Source: Thomson Reuters

Encouragingly, the South African businesses themselves also appear to be on an improving trend. Johnson Tiles South Africa (JTSA) – No2 player in the domestic ceramic wall and floor tile market – grew its revenues by 10% in constant currency, driven by a combination of NPD and a fully utilised factory and despite raw material price inflation headwinds. We note that confidence levels have improved to such an extent that the Board is now actively considering capacity increases. TAL – the leading manufacturer of tile adhesives and one-stop shop for tile fixing solutions – grew its revenues by an even more impressive 20% (again constant FX) reflecting a fruitful NPD programme and domestic market share gains augmented by decent export penetration across the whole of the sub-Sahara (including for example Botswana and Zimbabwe). Ongoing input cost pressures are being partially mitigated through production efficiencies. Finally, Tile Africa – the leading retailer (34 stores) of tiles and associate products – grew its revenues by 14% with an upgraded store offering and a new CX store format (bathroom store-within-store) performing well. It also launched Vado and own label "Evox" brassware ranges, suggesting greater synergy with the rest of the Norcros group than before.

Conclusion

South Africa is no longer a drag on Group returns; indeed it is quite the opposite with H1 EBIT margins slightly above the UK's for the first time at 7.2%.

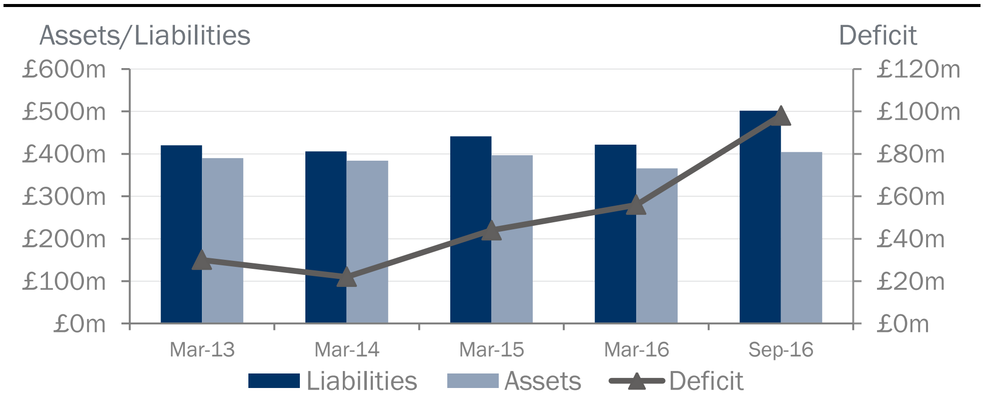
Pension deficit

The Norcros Board are well versed in the challenges and rising costs associated with the DB scheme – and that was before the arrival in April 2016 of Shaun Smith as FD following 15 years in the same role at AGA Rangemaster. He should be – and is – peculiarly well versed in all corporate pension matters and his experience is thus very pertinent to the ongoing management of the pension challenge at Norcros.

We note that the company has over recent years taken all the available generic measures to mitigate the issue including: closure to new entrants and future accrual in April 2013 (arguably quite late); various liability management initiatives (2014/15 £6.8m reduction, 2015/16 £2m but just £0.4m in H1 2016 suggesting this well has effectively run dry); and covenant improvement (aka acquisitions). Following completion of the March 2015 triennial actuarial review (deficit £73.5m) and the subsequent agreement with the Trustee of the recovery plan company is paying £2.5m + CPI for the next 10 years (barely higher than the £2.3m + CPI paid previously, and importantly achieves 3 year forward certainty). It is in the words of the company "essentially a self-funding scheme". It is shorter duration (super-mature) than most other company schemes (with 77 being the average age of beneficiaries). So all was apparently under control…

… until 2016. The gross deficit under ISA 19R increased from £55.7m at March 2016 to £97.8m at September 2016, primarily driven by 1.3% reduction in discount rate to 2.25% (from 3.55% in March) reflecting lower bond yields post the EU Referendum vote.

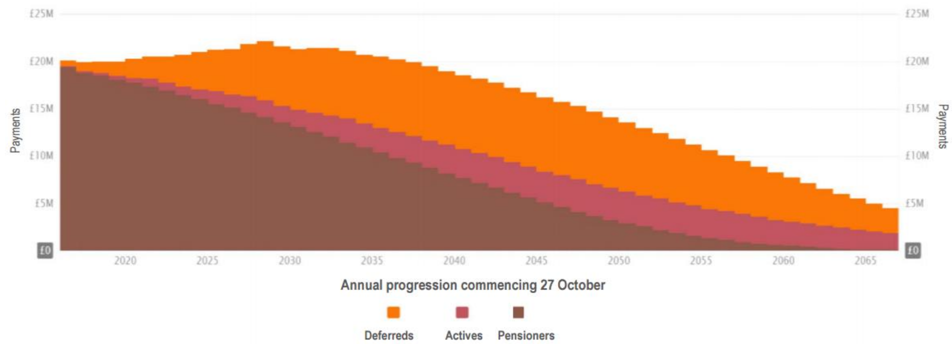
Figure 1: IAS 19R assets, liabilities and deficit (£m)



Source: Norcros plc Interim Results presentation

The company estimates that a 0.1% increase in bond yields reduces the deficit by c£6m (and a 1.5% swing eliminates it altogether). Indeed, yields have already seen a rise of c70bps since September, reducing the mark to market deficit by around a third. The mark to market volatility is far higher than the actual cashflow profile of the pension scheme (see graphic below). And the company quite fairly points out that managing volatility is something that it has been able to do through time (in 2008 financial crisis scheme assets fell by £70m or c20% in just two months).

Figure 2: Annual pension cash payment progression 2015-2065



Source: Norcros plc Interim Results 2016 presentation

Conclusion

There is no question the deficit issue has depressed what was already a low PE rating and this is evidenced in the near perfectly negatively correlated 26% rally in the shares over the past quarter versus the decline in the mark-to-market deficit, albeit much of this rise took place post results when management was better able to explain the key dynamics. Meanwhile the EV/EBITDA multiple has barely moved with deficit reduction simply feeding into the market cap component of EV). Further deficit erosion should see a similar share price expression – with a 0.1% rise in bond yield adding c10p (or 5.4%) to the share price – so the stock is for now a surprisingly efficient rising bond yield mandate. Any significant dislocation between the share price and bond yields may present a trading opportunity.

From a management perspective the deficit matters further since it is included (like net debt) in the Capital Employed denominator in the corporate ROCE target. Recent extremes have put pressure on the sustainable 12-15% aspiration across the economic cycle – does this matter? Not really in our view – it is an executive KPI and deemed an important contributing determinant to the model but is not explicitly referenced in the cumulative EPS growth based LTIP payout. The improved rating should further enable management's other key targets as it prosecutes its acquisition strategy on an implicitly more accretive basis including:

- Double revenue to £420m by 2018 (frankly looks a big ask on the acquisition front at more than five times the combined revenue of the Abode and Croydex deals, and the fact that future transactions may not integrate so well)
- Maintain 50% of revenue derived from overseas (guess more through productive export initiatives and progress in Middle East etc. rather than upscaling South Africa with its as yet stubbornly low implied rating).

Valuation

We consider Norcros against a basket of UK (and some European) Merchants, Building Materials and relevant Support Services names (see below). While not radically cheap on a cash-based multiple relative it certainly looks very lowly rated on a PER, dividend yield and sales multiple basis. Nothing in the sector comes close to that PER of just 7.0x with SIG the lowest rated on 9.5x and only the merchants trade on comparable EV/Sales perhaps reflecting their similar, if lower, single digit EBIT margins.

Figure 3: Valuation comps

	PER	DY	EV/Sales	EV/EBITDA	EBIT Margin
UK Merchants	14.5x	3.10%	1.01x	9.2x	8.90%
Building Materials	17.5x	2.00%	1.56x	9.2x	12.20%
Support Services	17.6x	2.90%	1.29x	8.8x	13.10%
Norcros	7.2x	4.30%	0.7x	7.8x	7.90%

Source: Canaccord Genuity estimates (based on CG UK analyst sector coverage and Thomson Reuters consensus estimates)

With the stable of recent acquisitions plus South Africa together now accounting for over half of group revenues and both performing well (and growing with better margins) we would have expected the shares to re-rate somewhat (on a SOTP basis) but this has not (yet) happened, implying a further de-rating of Johnson Tile UK and Triton revenues. Given the weak comps and management perspective that we may be near the trough this looks harsh in our view. A forward PER of closer to 9x (a PEG of just 0.9) and EV/Sales of 0.8x (hardly generous given forecast margin expansion) suggest fair value of between 208p and 227p (217p mid).

Balance sheet strength an attraction: 1.0x ND/EBITDA (ex. Pension)

When considering fair value it is also worth noting the balance sheet strength with underlying net debt at £27.5m (H1 '16) representing just 1.0x EBITDA. Furthermore the company has significant distributable reserves in excess of £100m which put further perspective on the perceived deficit peril. While the dividend increase of 9% reflects management confidence it only matches EPS growth, is 3 times covered and less than half of free cashflow. So clearly there remains scope to grow the income attractions but also ample firepower for further acquisitions in line with the stated growth strategy – additional balance sheet leverage would potentially enhance returns and it is interesting to note that the company looks attractive on an LBO free cash flow yield basis (at 11%, before the addition of further leverage).

Conclusion: initiating with a BUY recommendation, 217p target price

Near field the share price is likely to be very responsive to movements in yields but this is more than just a bond proxy. The underlying valuation already appears too low in our view and arguably overstates the poor UK organic performance while showing little credit for the successful acquisition strategy to date or an improving South Africa. We set a target price of 217p with upside risks presented by further elevation in bond yields and/or tangible evidence of improved UK trading at Johnson Tile and Triton.

Risks

Key risks include:

- Further weakness in UK at Johnson Tile and Triton
- South African Rand weakness, primarily a translation effect
- Import cost pressures arising from Sterling currency weakness and underlying raw material price inflation
- Falling bond yields would inflate the deficit, likely reflected in the share price and rating. Given the triennial review agreed as recently as April 2016, cash pension repair costs are certain for at least next 2 years
- Upside risks include further elevation in bond yields and/or tangible evidence of improved UK trading at Johnson Tile and Triton

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GKN plc

Generalist Small/Mid Cap | Canaccord Genuity Limited (UK)

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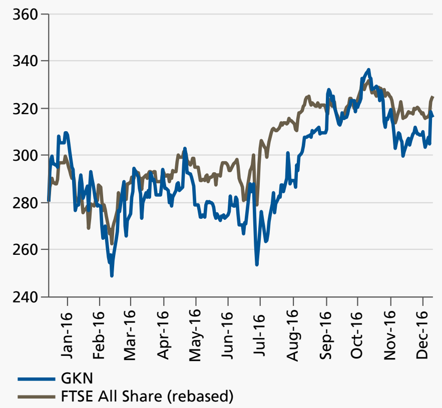
UK Equity Research
12 December 2016

BUY
unchanged

PRICE TARGET	370p
unchanged	
Price (8-Dec)	318p
Ticker	GKN-LSE

52-Week Range (p):	246 - 340
Avg Daily Vol (M) :	7.1
Market Cap (£M):	5,597
Shares Out. (M) :	1,714.3
Enterprise Value (£M):	8,501

FYE Dec	2015A	2016E	2017E	2018E
Sales (£M)	7,689	8,903↑	9,299↑	9,539↑
Previous	-	*8,819*	*9,263*	*9,530*
EBITDA (£M)	870.0	970.6↑	1,045↑	1,095↑
Previous	-	*955.4*	*1,031*	*1,088*
EBIT (£M)	679.0	771.2↑	839.3↑	883.2↑
Previous	-	*758.4*	*822.1*	*871.6*
EBIT Margin (%)	8.8	8.7	9.0	9.3
EPS Adj (p)	27.8	29.9↑	33.1↑	35.2↑
Previous	-	*29.3*	*32.3*	*34.7*
DPS (p)	8.7	9.0	9.3↓	9.6↓
Previous	-	*9.0*	*9.4*	*9.8*
Net Debt (Cash) (£M)	769.0	766.6↑	414.1↓	175.9↑
Previous	-	*666.0*	*454.1*	*167.9*
P/E (x)	11.5	10.6	9.6	9.0
EV/EBITDA (x)	9.1	8.8	7.8	7.2
Div. Yield (%)	2.7	2.8	2.9	3.0



Source: FactSet

Estimates Revised

Still waiting for take-off

With an increasing focus on bond yields and pension deficits we see an appropriate time to revisit our investment case. In our view, GKN is an extremely well run business; it is the global number 1, 2 or 3 in its main products (Aerostructures, Driveshafts, PM components), has consistently delivered organic growth above peers and end markets, and with technology leadership and a strong M&A track record is attractively positioned for emerging trends. However, we find significant disparity between its market rating and intrinsic valuation. Despite some recent concerns around slowing end market growth we believe the company's pension deficit is the major contributor to suppressed valuations. We continue to see upside potential from current levels and maintain our BUY recommendation and 370p target price.

Investment proposition

GKN's track record over the past few years is self-explanatory: it has grown organically every half period since 2012 and every quarter since Q1 2014. Our forecasts point to strong earnings progression (8.2% CAGR FY15-18E) and secure dividend growth (3.5% CAGR), with continuing operating cash conversion and FCF improvements contributing towards continued financial stability (0.4x FY17E ND:EBITDA ex. pension).

We believe our forecasts are supported by GKN's strong position in major growth segments (5 year CAGR estimated at 4.2% in aircraft production, 3.5% in light vehicle assembly, and 5.4% in metal powder production) and its recent shift in focus towards greater efficiency, margin improvements and cash flow - the £35m restructuring initiative and Stromag disposal being two recent examples.

Given this positioning, we think GKN should trade at a premium to the sector. However, it currently trades, and has historically traded, significantly below its UK peers, which we attribute to investor reservations over the pension deficit. We acknowledge the impact of a £2.1bn liability (30th June) on enterprise value but are confident the conclusion of the triennial review will not affect the day to day trading of the business, our dividend growth and capex expectations, or potential M&A activity. Furthermore, should bond yields continue on their current trajectory, the deficit will have reduced by year end.

Forecast changes

We account for the Stromag disposal (£177m, Oct-16), bring forecasts in line with current FX rates, and make some minor divisional amendments. FY16 net debt movements predominantly relate to increased negative FX translation expectations.

Valuation

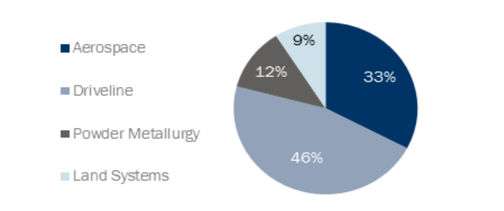
Negative sentiment around the pension liability is, in our view, disproportionately hindering GKN's rating, which fails to reflect its track record and long-term growth prospects. This is supported by our analysis, which shows GKN is undervalued on a SoTP, DCF, EVA and adj Quest® valuation, as well as compared to its 3 year average historical ratings. We derive a 344-432p valuation range, suggesting upside on each valuation. However, given GKN's suppressed historical rating, we expect it to continue to trade nearer its long-run average. Our 370p TP suggests a modest premium to GKN's 3 year average ratings, and a 30% PE and 20% EV:EBITDA discount to its UK Industrial peers.

Company summary

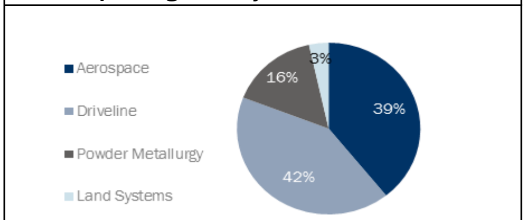
Company Description
GKN is a global FTSE 100 business with manufacturing facilities in over 30 countries across five continents. The company operates in four segments: Aerospace, Driveline, Powder Metallurgy, and Land Systems.

Key Competitors
Aerospace - Spirit, Triumph, MTU, Safran
Automotive - BorgWarner, Magna, Dana, Schaeffler
Powder Metallurgy - Höganäs AB, Metaldyne

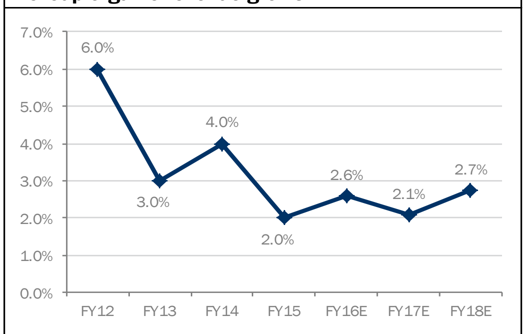
2015 Revenue By Division



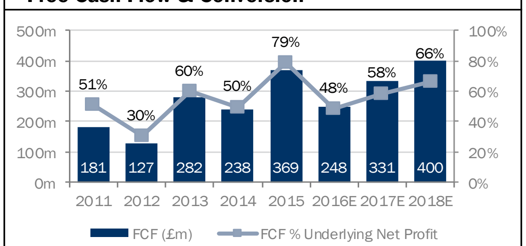
2015 Operating Profit by Division



Group organic revenue growth



Free Cash Flow & Conversion



Source: Company reports, Canaccord Genuity estimates

Valuation	Dec-14	Dec-15	Dec-16E	Dec-17E	Dec-18E
EV/Sales (x)	1.1	1.0	0.9	0.9	0.8
EV/EBITDA (x)	9.6	9.0	8.6	7.7	7.1
EV/EBIT (x)	12.1	11.5	10.8	9.5	8.8
EV/NOPAT (x)	15.1	14.8	14.4	12.6	11.7
EV/Invested Capital (x)	3.9	3.0	3.3	2.9	2.7
ROIC (%)	25.8%	19.9%	22.8%	23.2%	23.1%
P/E (x)	12.5	11.8	10.6	9.6	9.1
Div. Yield (%)	2.3%	2.7%	2.8%	2.9%	3.0%
Equity FCF Yield (%)	4.0%	6.7%	4.5%	6.1%	7.3%

Summary P&L (£m)	Dec-14	Dec-15	Dec-16E	Dec-17E	Dec-18E
Sales	7,456.0	7,689.0	8,902.5	9,299.3	9,539.0
EBITDA	860.0	870.0	970.6	1,044.8	1,095.2
EBITDA Margin (%)	11.5%	11.3%	10.9%	11.2%	11.5%
EBIT	687.0	679.0	771.2	839.3	883.2
EBIT Margin (%)	9.2%	8.8%	8.7%	9.0%	9.3%
Adjusted PBT	601.0	603.0	679.2	751.3	799.2
Adjusted EPS (p)	29.0	27.8	29.9	33.1	35.2
DPS (p)	8.4	8.7	9.0	9.3	9.6

Growth	Dec-14	Dec-15	Dec-16E	Dec-17E	Dec-18E
Sales (%)	(1.8%)	3.1%	15.8%	4.5%	2.6%
EBIT (%)	3.9%	(1.2%)	13.6%	8.8%	5.2%
PBT (%)	4.0%	0.3%	12.6%	10.6%	6.4%
EPS (%)	0.9%	(4.1%)	7.6%	10.6%	6.4%
DPS (%)	6.3%	3.6%	3.2%	3.5%	3.5%

Summary Cash Flow (£m)	Dec-14	Dec-15	Dec-16E	Dec-17E	Dec-18E
EBIT	612.0	609.0	691.2	759.3	803.2
Depn. & Amortisation	248.0	261.0	279.4	285.5	292.0
Change in working capital	(33.0)	82.0	(138.4)	(96.9)	(89.2)
Pension payments	(42.0)	(42.0)	(42.0)	(70.0)	(70.0)
Net Capex	(385.0)	(404.0)	(383.0)	(368.3)	(352.8)
Interest	(80.0)	(54.0)	(80.0)	(76.0)	(72.0)
Tax	(68.0)	(111.0)	(133.1)	(147.3)	(156.6)
Other	(14.0)	28.0	54.0	45.0	45.0
Free Cash flow	**238.0**	**369.0**	**248.1**	**331.4**	**399.5**
Acquisitions / Disposals	29.0	(505.0)	(8.0)	177.0	–
Dividend	(133.0)	(142.0)	(147.7)	(155.8)	(161.3)
Share Issues / buybacks	–	200.0	–	–	–
Other	(26.0)	(67.0)	(90.0)	–	–
Movement in net debt	**108.0**	**(145.0)**	**2.4**	**352.5**	**238.2**
Net (debt) / cash	**(624.0)**	**(769.0)**	**(766.6)**	**(414.1)**	**(175.9)**

Summary Balance Sheet (£m)	Dec-14	Dec-15	Dec-16E	Dec-17E	Dec-18E
Non current assets	4,143	4,702	5,119	5,201	5,262
Current assets	2,537	2,807	3,209	3,708	4,088
Non current liabilities	(3,273)	(3,379)	(4,067)	(4,067)	(4,067)
Current liabilities	(1,906)	(2,244)	(2,474)	(2,524)	(2,577)
Net Assets	**1,501**	**1,886**	**1,786**	**2,319**	**2,707**

Financial Structure	Dec-14	Dec-15	Dec-16E	Dec-17E	Dec-18E
Gearing (debt / equity) (%)	231.0%	215.5%	248.6%	193.7%	167.8%
Net debt / EBITDA (x) - ex. Pension	0.73	0.88	0.79	0.40	0.16
Interest cover (x)	4.3	4.3	4.6	5.2	5.6

Leading positions in growing markets

Occupying global number 1, 2 or 3 positions in numerous capabilities

A technology-led business, GKN occupies global number 1, 2 or 3 positions in a number of its capabilities including Aerostructures, Engine Systems, Driveshafts, AWD systems, and Powder Metallurgy component manufacture. With market forecasts anticipating a 4.2% CAGR in aircraft production, 3.5% in light vehicle assembly, and 5.4% in metal powder production over the next five years, we are confident GKN is well-positioned to benefit.

Aerospace and Driveline remain the core proposition

The Aerospace and Driveline businesses remain the company's core proposition – it supplies components for around half of all new cars sold worldwide and an even bigger proportion of aircraft – but across the whole Group GKN designs and manufactures market leading products. The majority of these are within growth areas of their respective markets driven by overarching macro factors such as globalisation and a rising population, and more specific drivers such as electrification, automation, weight reduction and efficiency improvements.

Driveline (46% FY15 Group sales)

GKN is the world number one in driveline systems. In AWD (All-Wheel Drive) systems it has a market leading position with the growth of SUVs expected to drive medium-term growth ahead of the market; in eDrive systems it is well positioned for the acceleration of Electric (EV) and Hybrid (HEV) vehicle growth; and the CVJ (Constant Velocity Joint) business, which dates back to the 1960s, is expected to remain strong even through future disruptive technologies.

Figure 1: Driveline market positions

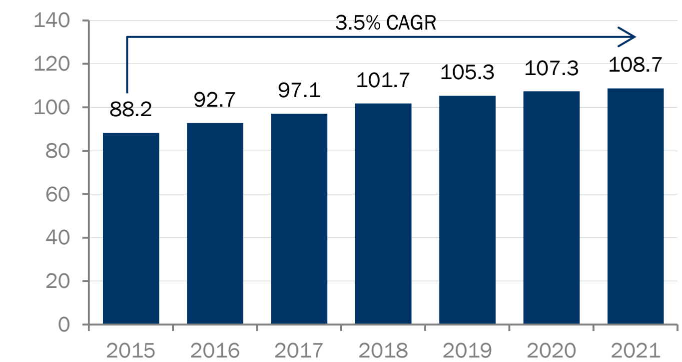
Source: Company Reports

Figure 2: Driveline technologies

Source: Company Reports

To quantify the opportunity that these technologies offer, total passenger car sales are forecast to grow at a 3.5% CAGR over the next six years (PWC Autofacts) with growth in EV and HEV vehicles accelerating over this period.

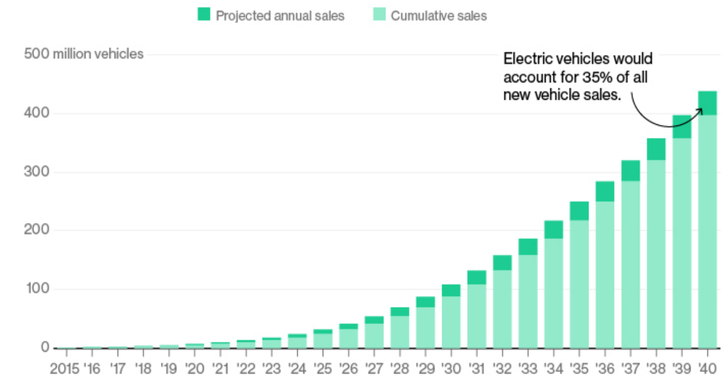
Figure 3: Global light vehicle* assembly forecast (million units)



Source: PWC Autofacts

*Light vehicle = passenger cars and commercial vehicles up to 6000kg weight

Figure 4: Electric car sales forecast



Source: Bloomberg New Energy Finance

In 2015, the global sales volume of EVs grew 60% year on year to around 500,000, predominantly attributable to the growth in Europe and China which has been particularly rapid. The current market size remains fractional compared to total car sales (88.2m in 2015); however, growth is accelerating.

Growth in electric and hybrid vehicles should provide significant opportunities

In the coming years a number of OEMs (Tesla, Nissan etc.) will release EVs or HEVs with longer ranges and at a cheaper retail price. Batteries, which currently make up around a third of the cost of an EV, are quickly reducing. By 2022 EVs are expected to cost approximately the same as internal combustion engine vehicles and this is expected to be the time that electric car sales growth accelerates most rapidly (Figure 4). GKN forecasts that by 2025 40-50% of vehicles will have some level of electrification whilst the Bloomberg New Energy Finance report (Figure 5) expects EV sales to reach 41m by 2040, representing 35% of total passenger vehicle sales and a market size over 80 times the current level.

GKN's technologies are already proving a success

300,000 vehicles on the road today already use GKN's eDrive technology and recent successes include delivering the world's first disconnecting eAxle on a premium SUV, the Volvo XC90. The new AWD system is the clear market leader (>40%) with GKN the only company offering the complete service in the fast growing segment, and the software (although bundled with component sales) is wholly GKN's IP and offers increasing opportunities in big data with OEMs seeking greater maintenance information.

Short-term order cover and longer-term growth potential is compelling

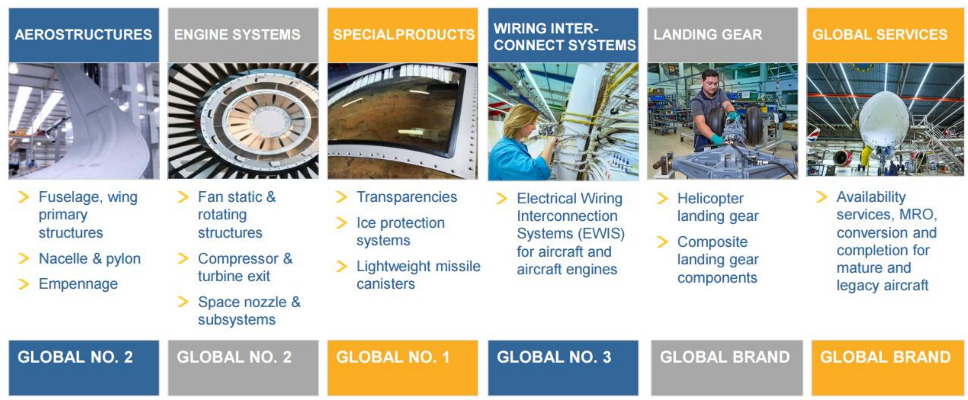
GKN's order book is essentially full for the next 3-4yrs and, given its market leading positions in these growth segments, we are confident it is well placed to continue growing above the market both in the short and longer term.

GKN Aerospace offers the widest capabilities of any tier one supplier

Aerospace (37% Group sales)

GKN offers customers the widest capabilities of any tier one supplier. The chart below (Figure 5) provides an overview of the market leading positions it occupies, attained through both organic investment and M&A transactions such as Volvo Aerospace (October 2012) and, more recently, Fokker Technologies (October 2015).

Figure 5: Aerospace technologies and market positions



Source: Company Reports

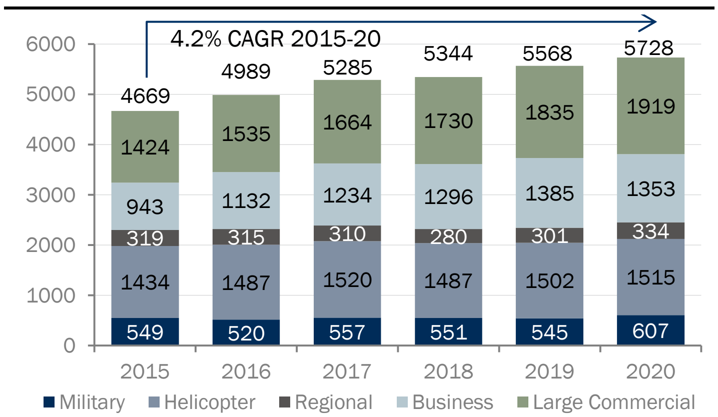
Commercial (75% Aerospace sales)

Over the past seven years GKN has increased its commercial exposure from 52% (2007) to 75% (2015) of divisional sales; a decision we view favourably with it now better positioned in the faster growing commercial aerospace market. Figure 10 highlights the attractive growth prospects.

Long-term commercial aerospace trends remain attractive

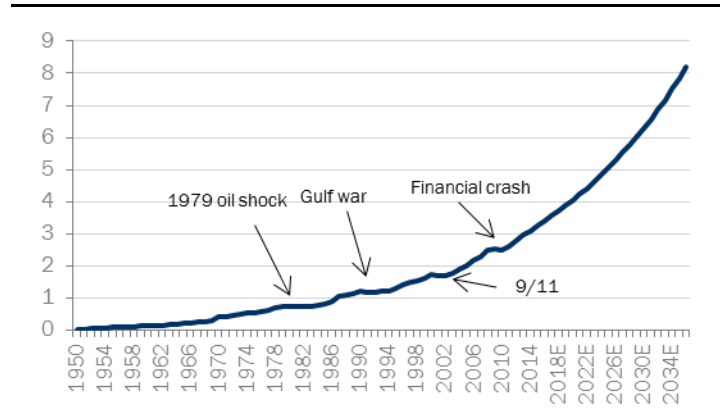
The market backdrop remains positive with Airbus and Boeing order books remaining around record highs with nine year backlogs. The key driver of commercial aerospace, air traffic growth, is expected to continue at 4.5% annually for the next two decades, and demand for new aircraft over that period is forecast at around 40,000 (Airbus, Boeing). In the nearer term, global aircraft production is expected to grow at a 4.2% CAGR over the next five years (Figure 6) with the majority of growth in the narrowbody aircraft (A320neo, 737Max) which GKN has content on.

Figure 6: Global aircraft production forecast (units) 2015-2020



Source: Roland Berger

Figure 7: Global air traffic growth (per billion passengers) forecast



Source: Airbus, Boeing

The risk of order deferrals or cancellations impacting this growth rate remains but there has been little evidence of cancellations above normal levels at the airframers Airbus and Boeing thus far. Instead, we think the nearer term risk is around the ramp up in production with suppliers struggling to meet the demanding schedule.

Military (25% Aerospace sales)

The F-35 JSF is one of the GKN's most valuable programmes (US$3-6m content per aircraft) and with the ramp up in production drawing closer it should be a strong contributor to growth in the division. Over 3,000 are scheduled for production over the lifetime of the programme, of which we expect 46 in 2016, 60 in 2017, and 94 in 2018.

Major programme contributions

We highlight some of the major commercial and defence programmes that GKN has secured content on; these contribute towards around half the Aerospace divisional revenues. As the table suggests, growth is expected to accelerate from 2017 onwards and we think this provides a solid underpinning for our Aerospace forecasts and the attractive growth prospects of the Group as a whole.

Figure 8: Major commercial and military programme forecasts: expecting growth to accelerate from 2017

		Expected Production (units)				Estimated Revenues ($m)			
		2015	2016	2017	2018	2015	2016	2017	2018
Commercial	*Shipset content ($m)*								
737	0.8	495	494	496	400	396	395	397	320
737MAX	0.8	0	0	36	200	0	0	29	160
787	3.5	135	140	143	144	473	490	501	504
A320ceo	0.8	491	462	396	173	393	370	317	138
A320neo	1.0	0	34	156	421	0	32	148	400
A330ceo/A330neo	3.1	103	58	68	75	319	180	211	233
A380	7.7	27	28	20	12	208	216	154	92
A350	3.4	14	40	73	112	48	136	248	381
Total						**1,836**	**1,819**	**2,004**	**2,228**
Military & defence									
Black Hawk	0.5	179	170	150	115	90	85	75	58
C-130J	2.3	21	24	24	24	48	55	55	55
JSF (F-35)	3.5	45	46	60	94	158	161	210	329
A400M	2.0	11	18	20	23	22	36	40	46
Total						**317**	**337**	**380**	**488**
Grand total						**2,153**	**2,156**	**2,384**	**2,716**
$ adjustment to GBP	1.30					£1,656	£1,658	£1,834	£2,089
Growth							*0.1%*	*10.6%*	*13.9%*
Contribution to total Aerospace sales							*51.5%*	*53.8%*	*58.3%*

Source: Company reports, Canaccord Genuity estimates

Figure 9: Powder Met markets

Source: Company Reports

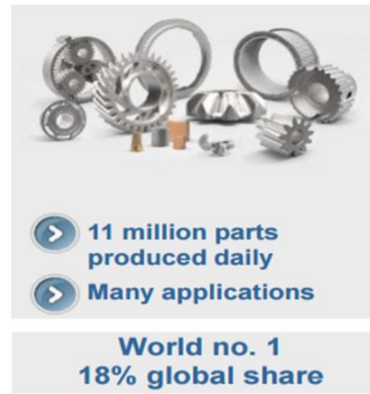
Powder Metallurgy (10% Group sales)

Whilst smaller than Aerospace and Driveline in the context of the investment proposition, Powder Metallurgy (PM) remains core to the Group. It is also the number one in specialist products and number three in electrical wiring.

Figure 10: GKN Hoeganaes – powder production

Source: Company Reports

Figure 11: GKN Sinter Metals – component manufacture



Source: Company Reports

The demand for lighter weight, more durable products a major growth driver

Highly engineered, lighter weight and more durable products are being increasingly demanded for fuel efficiency and reduced emission purposes, and we expect this to be one of the major drivers of sintered products, and therefore also powdered metal, demand. The global metal powder production market (most closely linked to GKN Hoeganaes) is forecast to grow at 5.4% annually to an expected value of $8.7bn by 2020 (Transparency Market Research) and the global market for PM component manufacture (more closely linked to GKN Sinter Metals) is forecast to reach $15.7bn by 2020 (Global Industry Analysts).

We also see potential vertical integration opportunities between PM and Driveline. Around 80% of all PM structural components are manufactured for automotive applications, of which around 75% are for transmissions and engines, yet at present the PM division sells very few parts into Driveline. Likewise, the use of sintered components in Aerospace applications, such as aircraft engines, is also increasing providing interesting future opportunities.

Land Systems (8% Group sales)

The disposal of Stromag will see the discontinuation of the Land Systems division from 2017

Land Systems as a division will cease to exist from 2017 following the disposal of Stromag for £177m in October 2016. Expected to complete in Q1-17, the business contributed £117m sales in 2015. Given the difficulties in this division over the past couple of years we view the sale of Stromag as a positive decision. The remainder of the Land Systems business will be merged into the remaining divisions as follows: Wheels & Structures into Other Business and Shafts and Services into Driveline. Given the downturn in the agriculture, construction, and mining industries we expect the profitability of the Wheels and Structures business to be relatively low, whilst Shafts and Services should be more profitable.

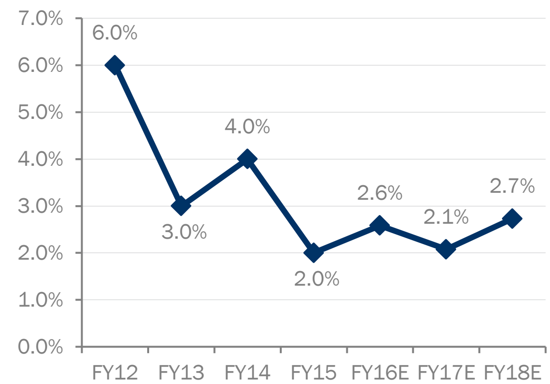
Consistent outperformance of end markets and peers

Impressive organic growth track record

Organic growth every half period since 2012 and every quarter since Q1 2014

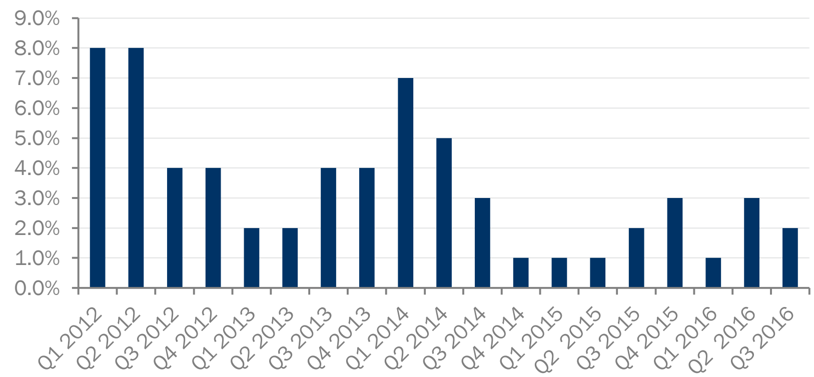
GKN's organic sales growth over the past five years has been impressive; it has delivered growth every half period since 2012 and every quarter period since Q1 2014. Driven predominantly by a strong automotive market, it should also be remembered that the Land Systems business has been in decline for the last four years, at its worst posting a 10% organic decline in 2010. Whilst growth in Aerospace has always felt like it is one more year away, on average, organic growth has been around 3% over the past five years. We expect this to accelerate in our forecast periods with the ramp up in key military (F-35) and commercial (A350, A320neo, 737Max) programmes.

Figure 12: Group organic growth (annual)



Source: Company report, Canaccord Genuity estimates

Figure 13: Group organic growth (quarterly)



Source: Company report, Canaccord Genuity estimates

In our view, most impressive has been GKN's growth relative to peers. Only DS Smith (Not Rated) and Tyman in the Industrials sector Acan match this yet both trade at a significantly higher premium to GKN on consensus numbers.

The pension deficit is not materially concerning

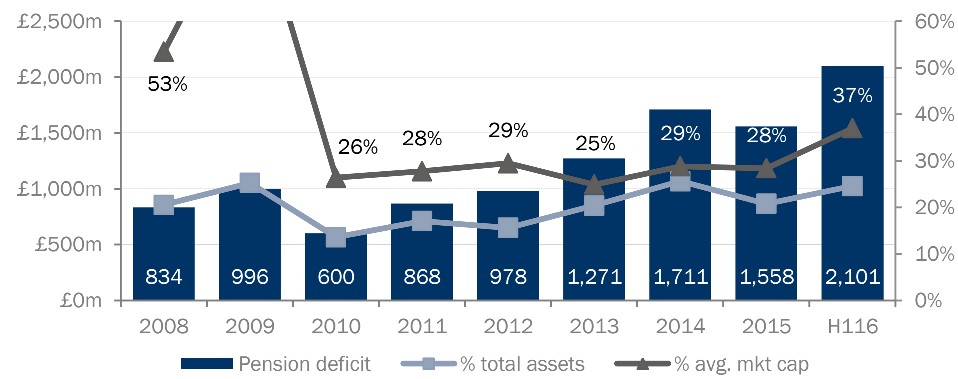
One of the biggest concerns of the stock remains the pension deficit and, whilst we acknowledge investor apprehensions, we think it has been disproportionately hindering GKN's valuation. As our analysis finds, it should not impact the day to day trading of the business, expected dividend growth, capex plans, or longer-term M&A firepower. Furthermore, if the recent trend in bond yields continues to year end then some of the deficit increase reported at the H1 results should have reversed.

Why the pension liability should not impact day to day trading

The pension deficit should have minimal impact day to day trading

A combination of discount rate changes and adverse currency translation (sensitivity in Figure 22) caused GKN's pension liability to increase by £500m between December 2015 and July 2016 to £2.1bn (the company's last reported deficit figure). As Figure 19 shows, at that date, as a percentage of market capitalisation it was the highest it had been since 2009 and by total assets the highest since 2014.

Figure 14: Pension liabilities now around 40% market capitalisation



Source: Company Reports, Canaccord Genuity estimates

However, the deficit increase does not have an immediate bearing on GKN's annual cash contributions, which is instead determined by a triennial valuation on the *UK* obligations. The triennial valuation determines the next three years of payments (based on a 5th April 2016 valuation date) and is currently under negotiation with the trustees.

Figure 15: Net obligations on balance sheet (£m)

	UK	USA	Europe	ROW	Total
Jun-16	-1234	-173	-676	-18	-2101
Dec-15	-912	-133	-498	-15	-1558
Jun-15	-920	-117	-483	-13	-1533
Dec-14	-1005	-136	-556	-14	-1711

Source: Company reports

Figure 16: Net obligation breakdown (as at 31st Dec 2015) (£m)

	UK	USA	Europe	ROW	Total
PV unfunded obligations	-15	-39	-495	-2	-551
PV funded obligations	-3219	-280	-36	-32	-3567
FV of plan assets	2322	186	33	19	2560
Net obligations on BS	**-912**	**-133**	**-498**	**-15**	**-1558**

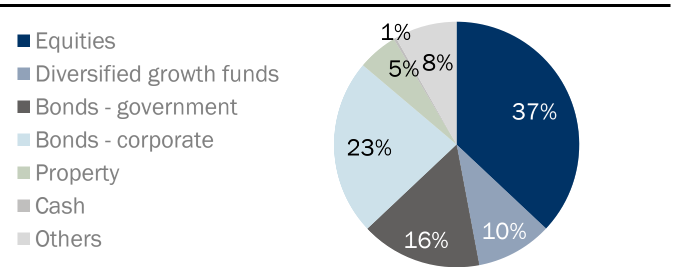
Source: Company reports

Figure 17: Assumption sensitivity analysis (£m)

	UK	USA	Europe	ROW
Discount rate +1%	509	44	101	4
Discount rate -1%	-663	-55	-126	-2
Inflation +1%	-583	-1	-105	0
Inflation -1%	427	0	89	0
Life expectancy +1 year	-110	-9	-24	0
Life expectancy -1 year	109	9	21	0

Source: Company reports

Figure 18: FV of assets in the scheme



Source: Company reports

As Figure 15 suggests, despite the total deficit growing to £2.1bn as at 30th June 2016, the UK obligation contributes just 57% of this at £1.2bn. Furthermore, backdating this to the 5th April 2016 triennial valuation date and we expect the deficit to be nearer £1bn.

We acknowledge there to be other drivers involved in determining the annual contribution but given the current £42m annual contributions (based on the obligation of around £621m at 30th June 2013) we would expect annual contributions to be around 50% higher; we prudently assume it increases to £70m. A result is likely to be announced around the FY16 results (late February 2017).

Despite this increase impacting cash flow, we view it as an insignificant amount. We remain confident in the security of dividend growth (now into its 7th consecutive year of growth) and organic investment plans, and over the next three years forecast an increase in free cash flow generation and cash conversion despite this headwind.

The pension deficit has not impacted organic investment in the past

Organic investment unthreatened

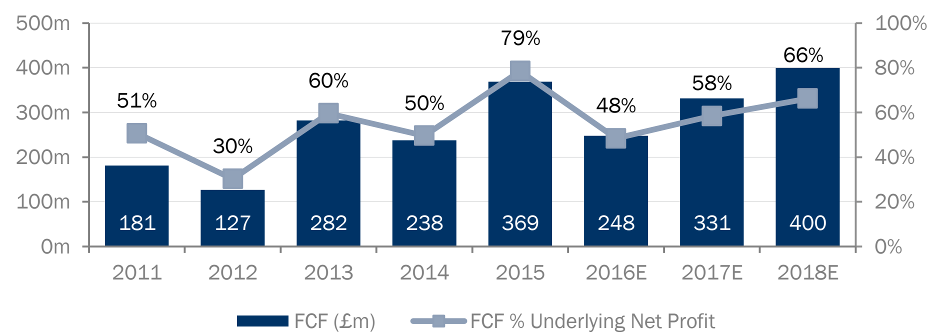
GKN's capex programme has run at around 1.5x depreciation (average of last 5 years) which suggests the pension deficit has not materially impacted the business in prior years. Given we expect this to gradually fall to around 1.2x-1.3x now that major investment activities (such as the £220m spent on A350 facilities) are reducing we do not expect any impact from rising pension contributions. In terms of R&D expenditure, total investment has tended to be in the 4%-5% region; a level we anticipate to continue.

Improving free cash flow generation

An improvement in free cash flow generation

GKN's free cash flow generation has been mixed in the past; however, we forecast a steady improvement from FY16 onwards. The £100m customer advance received in FY15 is the predominant reason for the swing between FY15 and FY16E but we expect an improvement in working capital and a reduction in capex, despite increasing pension payments, to improve cash conversion.

Figure 19: FCF generation (£m)

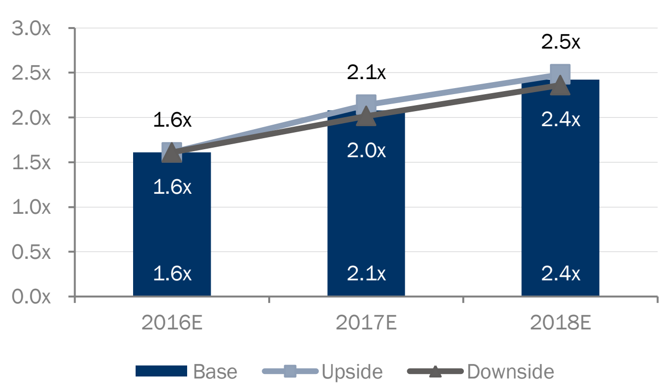


Source Company report, Canaccord Genuity estimates

Continued dividend growth looks secure

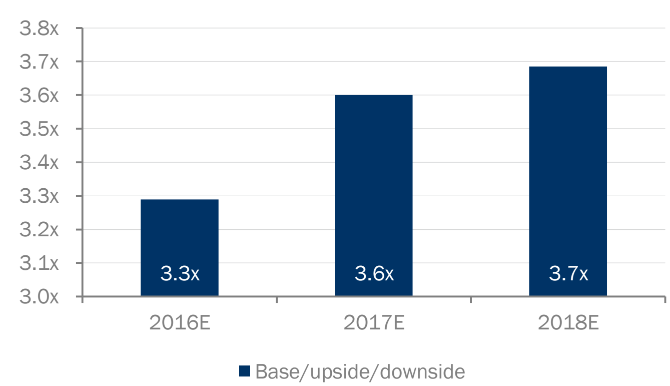
Dividend payout within the 2016 calendar year is already confirmed (we expect £147m; the 5.8p 2015 final dividend of £97m plus the 2.95p 2016 interim dividend of £50m) and we are confident that future dividend growth remains secure, even in the event that pension contributions increase above our £70m forecast. We compare our base case forecast of £70m to a downside case of £80m and upside case of £60m.

Figure 20: FCF dividend cover (x)



Source: Canaccord Genuity estimates

Figure 21: EPS dividend cover (x)



Source: Canaccord Genuity estimates

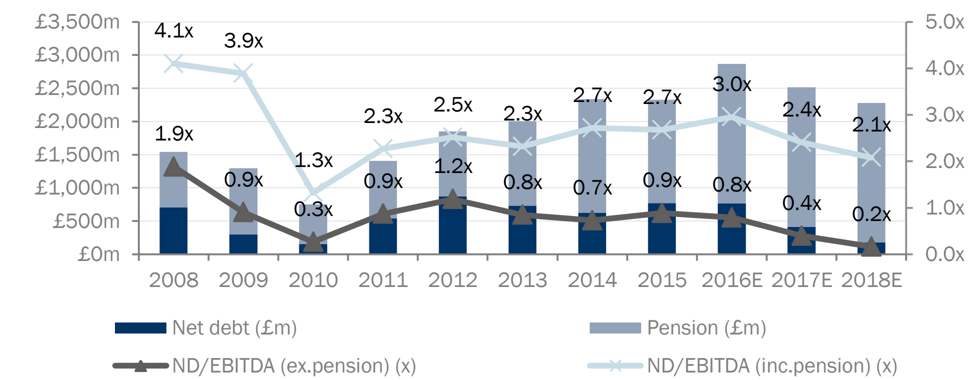
Holding all other things equal, even in our downside scenario FCF cover rises above 2.0x by FY17E year end (Figure 20) which we think is more than sufficient. Earnings cover at over 3.0x has never been an issue (Figure 21) and is the highest across our Industrials and A&D peer group – the averages are 1.9x and 2.5x, respectively.

If the pension deficit does not impact day to day trading, what does it affect?

Near-term M&A hindered but longer-term broadly unaffected

GKN has a solid track record of successful acquisitions and we continue to see the potential for M&A activity given the low net debt position (£736m FY16E). Whilst the bank covenants (3.5x net debt/EBITDA) do not include the pension deficit, two of the ratings agencies do. Hence, with leverage inclusive of the pension deficit rising to 3.0x net debt/EBITDA at FY16E year end, we believe near-term deal activity is reduced. GKN aims to remain below 3.0x including the deficit and/or under 1.0x excluding it.

Figure 22: Net debt remains low but rating agencies include the pension deficit



Source: Company Reports, Canaccord Genuity estimates

However, we estimate strong cash generation through FY17 will cause leverage to fall to 2.4x by year end, which we estimate will provide around £500m of firepower to enable the company to remain below its 3.0x target. The disposal of Stromag for £177m has improved the cash position but we would not be entirely surprised to see further targeted disposals; Fokker Services, the low margin MRO business acquired in the Fokker Technologies deal, a case in point.

An obstacle in a break-up/takeout scenario

Pension deficit a potential obstacle in a takeout bid

There has long been speculation of a GKN break-up with the Driveline and Aerospace divisions' market leaders in their own right. The Stromag disposal and subsequent discontinuation of the Land Systems division adds further fuel to the speculation. However, the impact of the pension liability on enterprise value is sure to create an impediment for potential acquirers.

Undervalued on (nearly) all valuations

Figure 23: Valuation summary

Method	Value per share
DCF	432p
P/E	396p
EV/EBITDA	381p
SoTP	378p
Adjusted Quest®	368p
EVA	344p

Source: Canaccord Genuity estimates

We consider several valuation methods with our findings, at face value, appearing fairly conclusive:

- GKN trades at a *discount* compared to UK peers on numerous valuations
  - However, it has always historically traded at a *discount* to UK peers
- GKN is *undervalued* on SoTP valuation
- GKN is *undervalued* on a DCF valuation
- GKN is *undervalued* compared to its 3 year average multiples
- GKN is *undervalued* on an EVA valuation
- GKN is *undervalued* on an adjusted Quest® valuation
- GKN is *fairly valued* compared to its 10 year average multiples

We conclude that GKN should trade at a significantly higher rating than it currently does based on intrinsic valuations and historical average multiples. However, whether justifiably or not, GKN has always traded at a discount to its UK peers, with concerns around the pension deficit likely to be one major reason. It therefore seems unlikely to us that GKN will rerate in line with the sector, which is broadly the outcome of our DCF valuation against its UK A&D and General Industrial peers on an FY2 P/E basis. However, we do view significant upside potential to the current share price and for the themes already discussed in this note believe GKN should trade above its current share price. We therefore maintain our BUY recommendation and 370p target price. At this level it trades moderately above its historical average ratings but, as always, significantly below peers (30% PE and 20% EV:EBITDA discount to its UK Industrial peers.)

Figure 24: Valuation at our 370p target price (FY2)

	Current	At 370p TP	3yr avg.	10yr avg.	UK A&D peers	UK Industrial peers
P/E	9.4x	11.2x	10.9x	9.7x	14.9x	16.8x
EV/EBITDA	7.0x	8.4x	7.9x	7.0x	9.3x	10.3x
EV/EBIT	9.3x	10.5x	10.9x	10.3x	12.4x	13.3x
EV/Sales	0.8x	1.0x	1.0x	0.8x	1.5x	1.8x

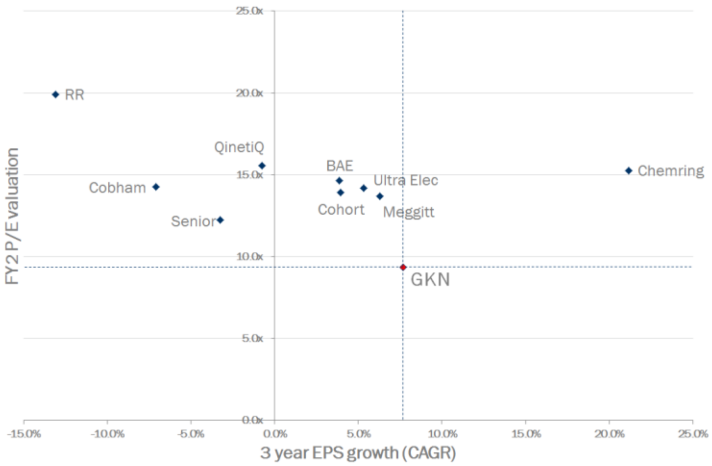
Source Company reports, Canaccord Genuity estimates, Thomson Reuters Eikon
Note: current, 3 year avg, 10 year avg, and peer group valuations are based on Eikon consensus estimates

GKN currently looks cheap compared to peers…

When comparing GKN's valuation to its closest UK peers we find it consistently looks cheap on a number of metrics, as shown in Figures 25 to 28.

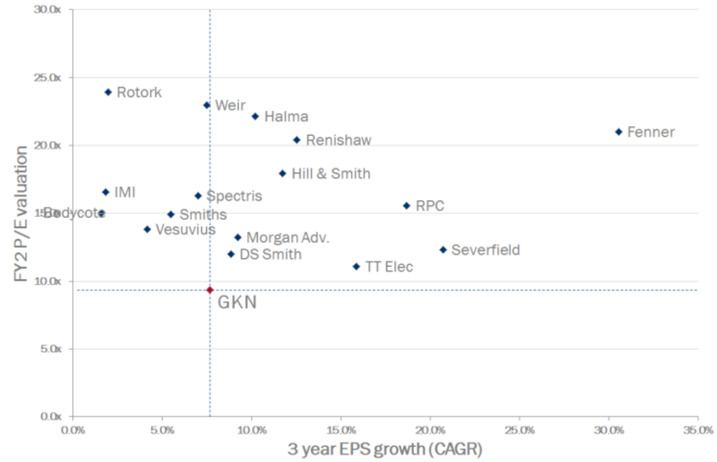
We have problems in assigning GKN to a specific UK peer group because its diversification and size make it a unique company and we therefore compare it across both UK A&D and UK Industrials. We acknowledge only 13% of GKN's sales are derived from the UK but the majority of its Capital Goods peers are global businesses with similar dynamics: Cobham (11%), Meggitt (9%), Rolls-Royce (Not Rated) (13%), Senior (16%), Smiths Group (Not Rated) (4%), and TT Electronics (17%).

Figure 25: EPS growth vs. P/E valuation (UK A&D)



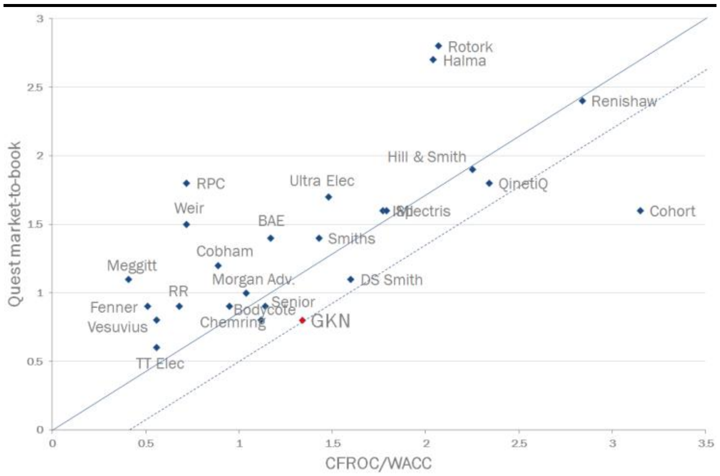
Source: Thomson Reuters Eikon 7th December

Figure 26: EPS growth vs. P/E valuation (UK Industrials)



Source: Thomson Reuters Eikon 7th December

Figure 27: CFROC/WACC vs. Quest® market-to-book +12m



Source: Quest®

Figure 28: GKN vs. UK A&D vs. UK Industrials (FY2) valuations

	GKN	UK Industrial	UK A&D
P/E	9.4x	16.8x	14.9x
EV/EBITDA	7.0x	10.3x	9.3x
EV/EBIT	9.3x	13.3x	12.4x
EV/Sales	0.8x	1.8x	1.5x
EBIT Margin	8.6%	13.2%	12.2%
Div. Yield	3.1%	2.9%	2.9%
FCF Yield	7.2%	6.4%	7.8%
ND/EBITDA	0.5x	0.8x	0.7x

Source: Thomson Reuters Eikon consensus

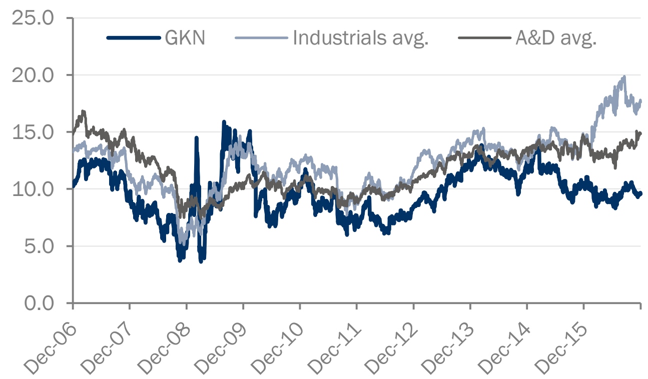
Note: we adjust consensus EV calculations to include GKN's pension deficit

As per Figures 25 and 26, GKN trades on the lowest P/E rating despite offering higher EPS growth than two thirds of its UK peers. It also ranks as one of the cheapest stocks on a CFROC/WACC vs. Quest® market-to-book valuation (a parallel measure to ROIC/WACC and EV/IC where the relationship ought to be 1:1) in which companies falling below the line are suggested to be are undervalued, and above the line overvalued. Likewise as Figure 28 shows, it appears undervalued on several other metrics.

...But it has always traded at a discount...

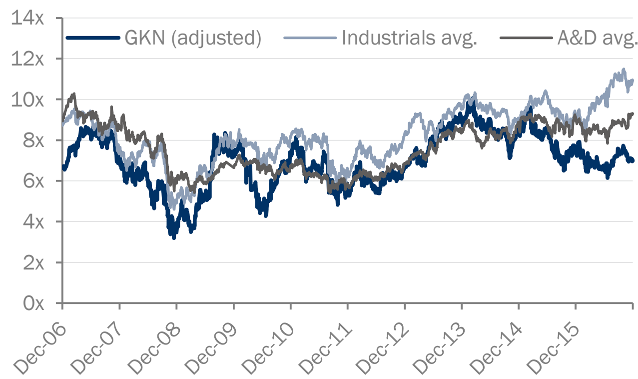
We are confident GKN currently trades at a discount compared to peers, but according to historical data the stock has consistently done so compared to both its UK A&D and Industrial peers. This is particularly so over the past five years, which we find remarkable given its consistent delivery.

Figure 29: FY2 P/E: GKN vs. UK Industrials vs. UK A&D



Source: Thomson Reuters Eikon 7th December

Figure 30: FY2 EV/EBITDA: GKN vs. UK Industrials vs. UK A&D



Source: Thomson Reuters Eikon 7th December

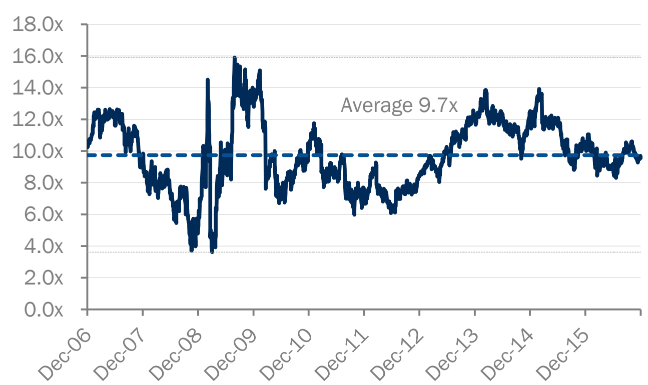
Note: we adjust GKN's EV/EBITDA multiple as consensus does not include the pension deficit within the EV calculation

…However, at current trading levels it still remains below its 3 year average rating

As we have established, GKN has (whether justifiably or not) traded at a discount to competitors which makes valuing it directly against its UK peers problematic. Hence, considering its long-run average ratings is a useful gauge of current sentiment and performance.

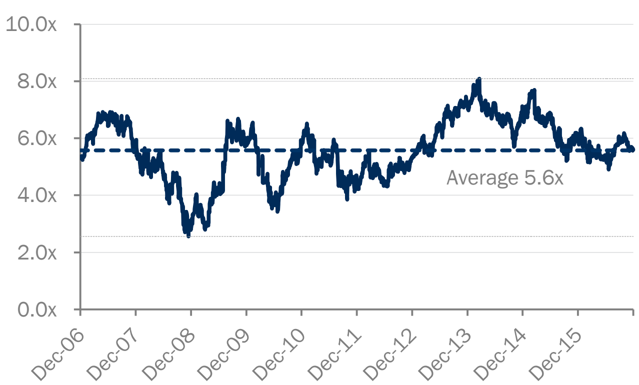
At present GKN trades in line with its 10 year FY2 P/E and EV/EBITDA average ratings (Figures 31 and 32) but at a discount to its 3 year FY2 P/E and EV/EBITDA average ratings (Figures 33 and 34).

Figure 31: 10yr FY2 P/E valuations



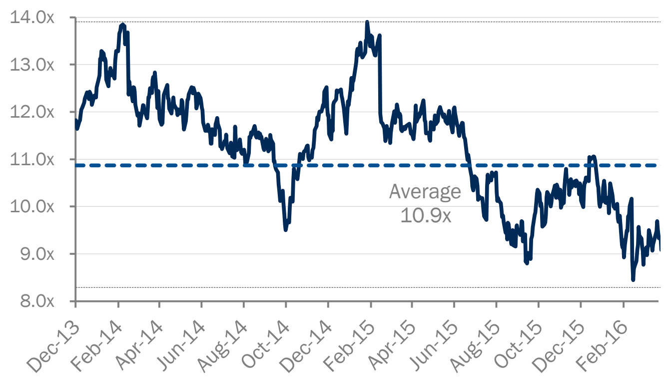
Source: Thomson Reuters Eikon 7th December

Figure 32: 10yr FY2 EV/EBITDA valuations



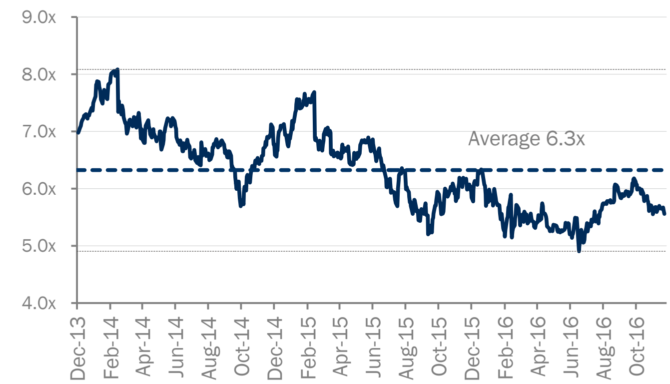
Source: Thomson Reuters Eikon 7th December

Figure 33: 3yr FY2 P/E valuations



Source: Thomson Reuters Eikon 18th October

Figure 34: 3yr FY2 EV/EBITDA valuations



Source: Thomson Reuters Eikon 18th October

Given the change over the past decade (£1.5bn spent on acquisitions, management changes, increased diversification) we prefer to compare GKN to its 3 year average rating which we think is more representative of the current business. It is surprising to see the stock trading below its average given we expect growth to start accelerating in the Aerospace division, alongside full integration benefits of Fokker, and continued strength in the Driveline division amongst other drivers.

Valuations 1 and 2: Multiples valuation based on historic ratings

Based on the above charts, we believe GKN is undervalued against its historical P/E and EV/EBITDA ratings and hence derive two valuations based on a 10% premium to GKN's 3 year averages. We believe this is more than justified given the company's growth potential and strength of the underlying business which has consistently delivered organic growth even through bumps in the cycle.

Figure 35: FY17E P/E valuation

FY17E EPS	33.07
Ind. Peer Group	17.4x
GKN FY2 10yr avg.	9.7x
GKN FY2 3yr avg.	10.9x
Premium	10%
Multiple applied	12.0x
Value per share (p)	395.5

Source: Canaccord Genuity estimates, Thomson Reuters Eikon

Figure 36: FY17E EV/EBITDA valuation

FY17E EBITDA	1044.8
Ind. Peer Group	10.9x
GKN FY2 10yr avg.	5.6x
GKN FY2 3yr avg.	6.3x
Premium	10%
Multiple applied	8.7x
Implied EV	9,090.5
Net debt + pension + NCI (FY17E)	-2,551.1
Implied MktCap	6,539.4
Shares	1,715.0
Value per share (p)	381.3

Source: Canaccord Genuity estimates, Thomson Reuters Eikon

As Figures 35 and 36 suggest, our valuations are still below the highs in early 2015 and below the Industrials and A&D sector averages, just as GKN has traditionally traded, leading us to believe they are not overly stretching.

Note that consensus EV fails to include the pension deficit and minority interests within the calculation. Historically this has been around 25% higher which we adjust for in our calculation (Figure 36).

Valuation 3: Sum of the parts (SoTP) valuation

GKN's diversification and global reach causes some problems in applying one specific peer group and hence we find a SoTP helpful in valuing each division. Given the current takeout/breakup speculation in the press it is also a useful guide for estimating the intrinsic value of each separate business. To derive the peer group average EV/EBIT multiples we use a basket of companies that we view as GKN's closest peers. Hence, we *do not* use the UK A&D and Industrial peer groups that GKN has historically traded at a discount to on a Group basis as we do not view these as its closest peer group.

Figure 37: SoTP valuation (£m)

	2017E EBIT	Peer group	Premium/discount	Multiple	EV
Aerospace	370.4	10.3x	10%	11.3x	4,195.5
Driveline	359.0	9.0x	10%	9.9x	3,563.8
Powder Metallurgy	128.7	11.3x	5%	11.8x	1,523.2
Other business	6.1	-	-	8.0x	49.2
Corporate costs	-25.0			12.0x	-300.0
Implied EV					**9,031.7**
Net debt + pension + NCI (FY17E)					-2,551.1
Implied MktCap					**6,480.7**
Shares (m)					1,715.0
Value per share (p)					**377.9**

Source Company reports, Canaccord Genuity estimates, Thomson Reuters Eikon
*EV/EBIT using Thomson Reuters Consensus.

Given GKN's market leading positions, organic growth track record, and positioning in key growth areas we believe the Aerospace, Driveline, and Powder Metallurgy divisions warrant a premium rating to peers. As the SoTP valuation suggests, the combined value of each division far exceeds the current and implied market capitalisation given the pension deficit and net debt position.

Valuation 4: Economic Value Add (EVA) valuation

ROIC is one of GKN's three financial KPIs and we therefore believe an EVA valuation is a useful method. The company targets a ROIC of over 20% although we have difficulty in making direct comparisons between this and our forecasts as it makes several adjustments (for M&A, tax, pension, derivative financial instruments) that are difficult to estimate going forward.

Our ROAIC calculation ((NOPAT / (Net Assets + Net Debt)), which we use across our whole coverage, averages 19% over the past eight years and 22% for our three forecast years driven by the expectation of strong earnings progression above the increase in asset base. On our base case assumption for FY17, the value per share at 344p offers modest upside to GKN's current share price.

Figure 38: Economic Value Add model summary (£m)

	2014	2015	2016E	2017E	2018E
Net assets	1501.0	1886.0	1786.4	2318.6	2706.9
Net debt	-624.0	-769.0	-766.6	-414.1	-175.9
Avg. invested capital	2326.0	2390.0	2604.0	2642.8	2807.7
NOPAT	**548.7**	**529.2**	**582.2**	**633.7**	**666.8**
ROAIC	23.6%	22.1%	22.4%	24.0%	23.7%
WACC	7.1%	7.1%	7.1%	7.5%	7.8%
ROAIC/WACC	**3.3x**	**3.1x**	**3.2x**	**3.2x**	**3.1x**
Implied EV	7753.4	7466.2	8250.3	8455.1	8591.9
Net debt	-624.0	-769.0	-766.6	-414.1	-175.9
Pension	-1711.0	-1558.0	-2101.0	-2101.0	-2101.0
NCI	-22.0	-23.0	-36.0	-36.0	-36.0
Implied MktCap	**5396.4**	**5116.2**	**5346.7**	**5904.0**	**6279.0**
Shares in issue (m)	1640.6	1674.1	1715	1715	1715
Value per share (p)	**328.9**	**305.6**	**311.8**	**344.3**	**366.1**
Discounted (p)			305.5	315.3	313.3
Net debt/EBITDA (ex. pension)			0.8x	0.4x	0.2x
Net debt/EBITDA (inc. pension)			3.0x	2.4x	2.1x

Source Company reports, Canaccord Genuity estimates

We do not include M&A transactions within our base case assumptions but in reality we would expect GKN to invest if net debt to EBITDA was to reduce to 2.2x by end FY18 as we estimate. The company has previously stated a 2.5x-3.0x target range (including the pension deficit) which, as previously discussed, provides around £500m of firepower.

In Figure 39 we assume this amount is split equally across FY17E and FY18E (£225m in each year) with the hypothetical businesses acquired at a 10x EV/NOPAT multiple. At these levels Net Debt to EBITDA rises to within the target range. The impact increases NOPAT, increases invested capital, and reduces the weighted average cost of capital given the higher debt weighting now applicable.

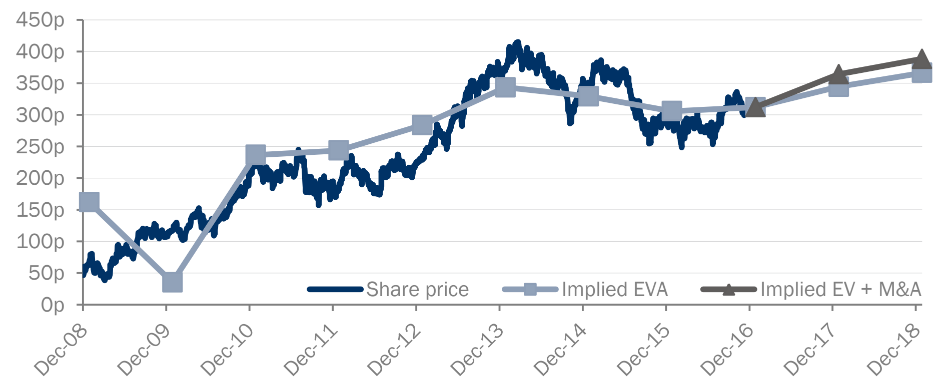
Figure 39: EVA with M&A scenario analysis summary (£m)

	2016E	2017E	2018E
M&A investment	0.0	-250.0	-250.0
EV/NOPAT multiple		10.0x	10.0x
Net debt/EBITDA	*0.8x*	*0.7x*	*0.7x*
Net debt(inc pension)/EBITDA	*3.0x*	*2.7x*	*2.6x*
Net assets	1786.4	2318.6	2706.9
Net debt	-766.6	-664.1	-675.9
Avg. invested capital	2604.0	2767.8	3057.7
NOPAT	**582.2**	**658.7**	**691.8**
ROAIC	22.4%	23.8%	22.6%
WACC	7.1%	7.3%	7.3%
ROAIC/WACC	**3.2x**	**3.3x**	**3.1x**
Implied EV	8250.3	9040.9	9469.1
Net debt	-766.6	-664.1	-675.9
Pension	-2101.0	-2101.0	-2101.0
NCI	-36.0	-36.0	-36.0
Implied MktCap	**5346.7**	**6239.8**	**6656.3**
Shares in issue (m)	1715.0	1715.0	1715.0
Value per share (p)	**311.8**	**363.8**	**388.1**
Discounted (p)	305.5	333.2	332.2

Source Canaccord Genuity estimates

As Figure 40 shows, the value per share in FY17E increases to 350p. In our view, this is an entirely plausible scenario and we therefore equally weight the two scenarios (333p and 350p) to derive our 342p fair value.

Figure 40: Economic Value Add model (p)



Source: Company Reports, Canaccord Genuity estimates, Thomson Reuters Eikon 7th Dec

Valuation 5: Discounted Cash Flow (DCF) valuation

Given the majority of growth in Aerospace programmes is expected to come after our forecast period, just as with the anticipated growth in eAxles and AWD driveline systems, we think a DCF valuation is a useful method. In our view, a 3% medium-term growth rate is conservative although we lower this to 2% on a longer-term view given the lower organic opportunities in the Aerospace industry post-2021, as previously discussed.

One of GKN's KPIs is a Group margin target of 8-10% which we believe is achievable through improved Aerospace margins (operational gearing with key programme ramp up), the full benefits of the Fokker integration, and other operational efficiency initiatives such as the £35m restructuring plan announced at H116. 9.5% feels achievable and we expect this could even be realised earlier than forecast should the company dispose of the lower margin Fokker Services (although this is not assumed in our DCF). Downward pricing pressure remains a constant headwind in both the Automotive and Aerospace sectors hence our caution in continued margin progression.

Pension contributions for the next three years are under review although we forecast £70m from FY17. For simplicity we apply this to all future years although the payout is reviewed triennially. Capex is currently running at around 1.4x depreciation although the company has stated a more likely target level of 1.2x capex going forward.

Key assumptions:

- WACC: 7.0%
- Medium-term sales growth: 3.0%
- Long-term sales growth: 2.0%
- EBIT margin target: 9.5%
- Terminal growth rate: 1.0%

Figure 41: Discounted cash flow (£m)

	2016E Forecast	2017E Forecast	2018E Forecast	2019E Medium	2020E Medium	2021E Medium	2022E Medium	2023E Long	2024E Long	2025E Long	2026E Long
Revenue	8902.5	9299.3	9539.0	9825.2	10119.9	10423.5	10736.2	10950.9	11170.0	11393.4	11621.2
Growth	15.9%	2.6%	2.6%	3.0%	3.0%	3.0%	3.0%	2.0%	2.0%	2.0%	2.0%
EBIT margin	8.7%	9.0%	9.3%	9.5%	9.5%	9.5%	9.5%	9.5%	9.5%	9.5%	9.5%
EBIT	771.2	839.3	883.2	933.4	961.4	990.2	1019.9	1040.3	1061.1	1082.4	1104.0
Tax rate	24.5%	24.5%	24.5%	24.5%	24.5%	24.5%	24.5%	24.5%	24.5%	24.5%	24.5%
NOPAT	**582.2**	**633.7**	**666.8**	**704.7**	**725.9**	**747.6**	**770.1**	**785.5**	**801.2**	**817.2**	**833.5**
D&A	279.4	285.5	292.0	304.6	313.7	323.1	332.8	339.5	346.3	353.2	360.3
Pension contributions	-42.0	-70.0	-70.0	-70.0	-70.0	-70.0	-70.0	-70.0	-70.0	-70.0	-70.0
Change in wcap	-138.4	-96.9	-89.2	-59.0	-60.7	-62.5	-64.4	-65.7	-67.0	-68.4	-69.7
Capex	-383.0	-368.3	-352.8	-365.5	-376.5	-387.8	-399.4	-407.4	-415.5	-423.8	-432.3
Dividends from JVs	55.0	55.0	55.0	55.0	55.0	55.0	55.0	55.0	55.0	55.0	55.0
FCFF	**352.2**	**439.0**	**501.8**	**569.8**	**587.4**	**605.5**	**624.1**	**636.9**	**649.9**	**663.2**	**676.8**
Discounted FCFF	345.1	402.0	429.4	455.8	439.0	422.9	407.4	388.5	370.5	353.4	337.0
Discounted terminal value	5612.9										
Theoretical EV	9964.0										
Net debt+pension+NCI	-2551.1										
Derived MktCap	7412.9										
No. shares	1715.0										
Value per share (p)	432.2										

Source: Canaccord Genuity estimates

Sensitivities

Figure 42: Sales growth and EBIT margin sensitivity table

EBIT margin (%)	Revenue growth (%)				
432	0.0%	1.0%	2.0%	3.0%	4.0%
8.0%	281	306	333	361	391
8.5%	310	337	366	396	429
9.0%	339	368	399	432	467
9.5%	368	399	432	467	505
10.0%	398	430	465	503	542
10.5%	427	462	499	538	580
11.0%	456	493	532	574	618

Source: Canaccord Genuity estimates

Figure 43: WACC and EBIT margin sensitivity table

EBIT margin (%)	WACC (%)				
432	5.02%	6.02%	7.02%	8.02%	9.02%
8.0%	333	333	333	332	332
8.5%	366	366	366	366	366
9.0%	399	399	399	399	399
9.5%	432	432	432	432	432
10.0%	466	466	465	465	465
10.5%	499	499	499	499	499
11.0%	532	532	532	532	532

Source: Canaccord Genuity estimates

Figure 44: WACC and pension contributions sensitivity table

Pension contributions	WACC (%)				
432	5.02%	6.02%	7.02%	8.02%	9.02%
-60	437	437	437	437	437
-70	432	432	432	432	432
-80	427	427	427	427	427
-90	422	422	422	422	422
-100	417	417	417	417	417

Source: Canaccord Genuity estimates

Valuation 6: Quest® valuation

Quest® is Canaccord Genuity's proprietary offering of online analytical tools, valuation models and market commentary. The Quest® website provides comprehensive financial analysis and interactive valuation for c.9000 stocks. The Quest® DCF valuation model is based on cash flow return on capital (CFROC) and cash flow return on operating assets (CFROA) excluding goodwill.

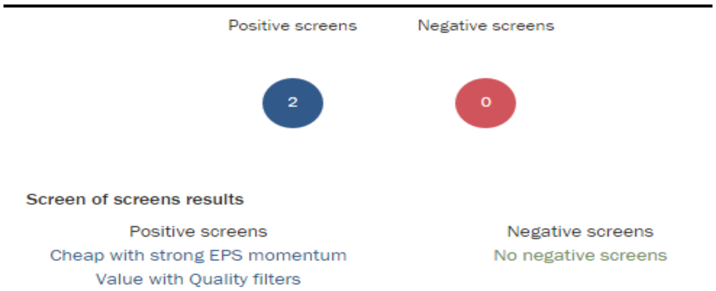
Default valuation: 311p

The default Quest® valuation of 311p would suggest that GKN is currently fairly valued at the current share price. However, the company appears on two positive screens "Value with Quality" (which seeks stocks with all round value support that also pass a series of tests which provide protection on Quality score, solvency and financial strength) and "Cheap with strong EPS momentum". It also offers one of the highest triAngle scores in the sector. triAngle evaluates Value, Quality and Momentum and to put into perspective, across the entire UK Industrials and A&D sector, only Smiths Group and Spectris achieve a higher rating than GKN.

Figure 53: Quest® triAngle score

Source: Quest®

Figure 54: Quest® screener

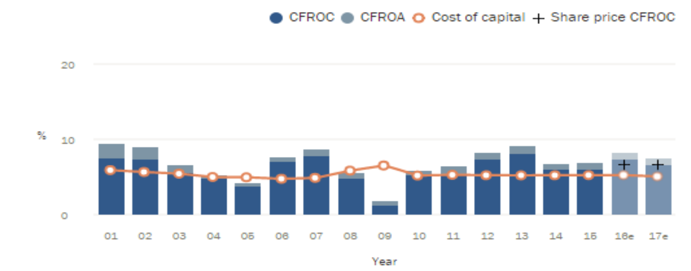


Source: Quest®

Adjusted valuation: 368p

Over the past 5 years GKN has achieved an average CFROA of 7.3%, reaching 8.2% and 9.0% in 2012 and 2013 (Figure 47). We do not believe it is unreasonable to assume GKN can reach these levels again; something which is not reflected in the default valuation's two year forecast.

Figure 47: Cash flow returns profile

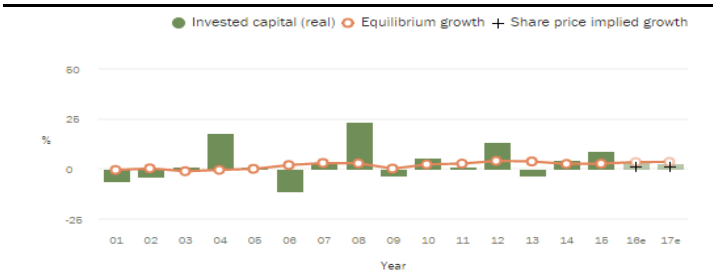


Long Run Averages (%)

	Current*	3yrs	5yrs	10yrs
CFROC	6.8	6.8	6.7	6.0
CFROA	7.6	7.7	7.6	6.8

Source: Quest®

Figure 48: Capital growth profile



Long Run Growth Averages (%)

	Current*	3yrs	5yrs	10yrs
Invested capital (real)	2.8	3.4	4.9	4.0
Equilibrium growth	3.6	3.0	3.2	2.6

Source: Quest®

Using the Quest® modeller we apply an 8.5% CFROA target to be reached by 2021. We feel this reflects the longer-term potential of Aerospace programmes ramping up, Fokker acquisition integration, operational efficiency improvements, and AWD and eAxle growth in Driveline. Applying these targets causes our value per share to rise from the default 311p to an adjusted **368p**.

Forecast changes

We update our forecasts with current FX rates, adding some top line growth improvements, but leave our organic growth expectations unchanged (Aerospace 2%, Driveline 4.5%, Powder Metallurgy 1.5%) for FY16 for the continuing business. In Land Systems we moderately reduce organic growth expectations which offsets any FX benefits. For FY17 we account for the Stromag disposal (FY15 sales were £117m) which reduces the Land Systems revenue, and merge the remainder of the business into Driveline and Other Business. We estimate sales of around £180m for the Wheels & Structures business which we incorporate within Other Business, with the remaining revenue applied to Driveline. With profitability in the Land Systems business remaining constrained we adjust our Driveline and Other Business margins accordingly. We also moderately amend our DPS growth forecasts from 4.0% to 3.5% bringing it in line with last year's growth which we think is more reflective of growth going forward.

Other changes include slightly less optimistic working capital improvements and anticipation of increasingly negative exchange rate movements on net debt given the prevailing FX rates.

Figure 49: Forecast changes (£m)

	FY16			FY17			FY18		
	New	Old	*Change*	New	Old	*Change*	New	Old	*Change*
Revenue									
Aerospace	3,242.5	3,217.5	*0.8%*	3,461.4	3,410.6	*1.5%*	3,634.4	3,581.1	*1.5%*
Driveline	3,956.0	3,902.8	*1.4%*	4,603.2	4,078.4	*12.9%*	4,649.2	4,119.2	*12.9%*
Powder Metallurgy	978.5	969.4	*0.9%*	1,029.9	1,013.0	*1.7%*	1,050.4	1,033.3	*1.7%*
Land Systems	689.5	689.5	--	0.0	720.6	*(100.0%)*	0.0	756.6	*(100.0%)*
Other business	36.0	40.0	*(10.0%)*	204.9	40.0	*412.3%*	204.9	40.0	*412.3%*
Total (Underlying)	**8,902.5**	**8,819.3**	***0.9%***	**9,299.3**	**9,262.6**	***0.4%***	**9,539.0**	**9,530.2**	***0.1%***
Margins									
Aerospace	10.3%	10.3%	--	10.7%	10.7%	--	11.1%	11.2%	*(0.9%)*
Driveline	8.0%	8.0%	--	7.8%	8.0%	*(2.5%)*	7.9%	8.0%	*(1.3%)*
Powder Metallurgy	12.5%	12.0%	*4.2%*	12.5%	12.0%	*4.2%*	12.5%	12.0%	*4.2%*
Land Systems	4.5%	4.5%	--	--	4.8%	*(100.0%)*	--	5.5%	*(100.0%)*
Other business	(16.7%)	(16.7%)	--	3.0%	--	--	3.0%	--	--
Total (Underlying)	**8.7%**	**8.6%**	***0.7%***	**9.0%**	**8.9%**	***1.4%***	**9.3%**	**9.1%**	***1.7%***
PBT	679.2	666.4	*1.9%*	751.3	734.1	*2.3%*	799.2	787.6	*1.5%*
EPS (p)	29.9	29.3	*2.0%*	33.1	32.3	*2.4%*	35.2	34.7	*1.4%*
DPS (p)	9.0	9.0	*(0.2%)*	9.3	9.4	*(1.1%)*	9.6	9.8	*(1.8%)*

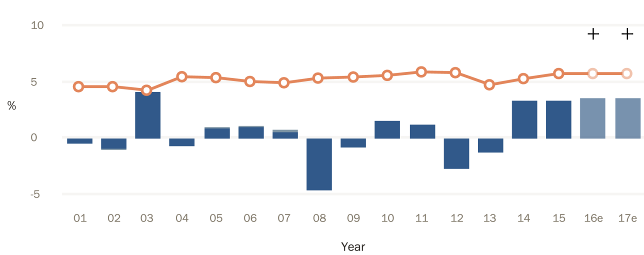
Source: Canaccord Genuity estimates

QUEST A DIVISION OF CANACCORD GENUITY

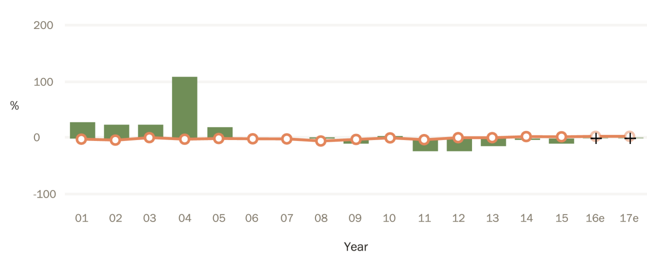
Quest® value per share	Share price	Quest® valuation (%)	QRR percentile	triAngle decile
8.8 p	38.3 p	-77	11 /100	9 /10

Quest Summary - Coats

Cash Flow Returns



Capital Growth



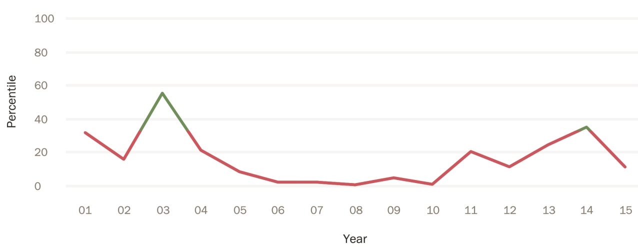
Long Run Averages (%)

	Current*	3yrs	5yrs	10yrs
CFROC	3.6	1.9	0.8	0.2
CFROA	3.6	1.9	0.8	0.2

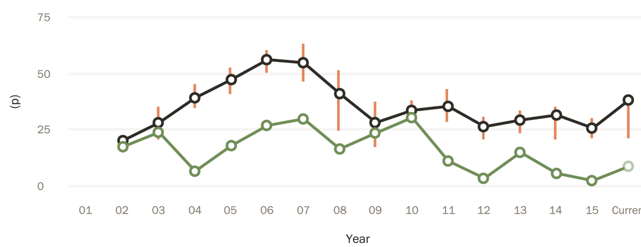
Long Run Growth Averages (%)

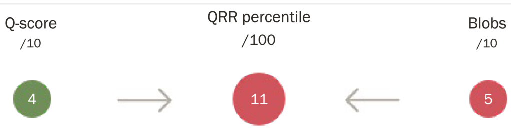
	Current*	3yrs	5yrs	10yrs
Invested capital (real)	2.8	-7.4	-13.5	-6.9
Equilibrium growth	2.5	1.3	0.1	-1.3

Quest Risk Rater



Default Quest® Valuation





Valuation Ratios

	Current*	2016e	2017e	Industry
P/E	7.6	8.3	7.5	21.6
EV / sales	0.2	0.3	0.2	1.7
EV / EBITDA	1.7	1.9	1.6	10.0
FCF yield	4.3	4.1	4.3	4.1
Dividend yield	0.0	0.0	0.0	2.1
Quest® market-to-book	0.8	0.8	0.8	1.2

Momentum

	1 week	1 month	3 months	6 months	1 year
Share price relative	-2.0	-2.6	20.2	8.2	15.0
Share price absolute	0.7	-0.6	27.5	29.7	45.7
Brokers' views	u/c	u/c	u/c	u/c	-

Consensus Brokers' Recommendation

Number of brokers: 2

Consensus Growth (%)

	2015	2016e	2017e	5Y Average
Sales	-1.3	17.5	4.4	-5.6
EBITDA	1.7	39.4	5.6	0.5
Net income	4.9	-5.5	5.0	18.3
EPS	5.4	90.1	9.8	24.4
DPS	-	-	-	-
Quest® value per share	-56.5	155.3	44.6	-39.6

Consensus Forecasts

	2016e	2017e
Sales £(m)	1186.7	1238.7
Sales 1 month change (%)	2.0	2.6
Sales 3 month change (%)	6.0	6.1
EPS (p)	4.6	5.1
EPS 1 month change (%)	9.3	9.9
EPS 3 months change (%)	11.6	12.4
DPS (p)	0.0	0.0

Financing

	2014	2015	2016e	2017e
Net debt / cap employed	0.0	0.0	0.0	0.0
Net debt / EBITDA	-1.9	-1.4	-1.4	-1.5
Interest cover	9.1	7.6	82.4	152.3
Fixed charge cover (P&L)	4.3	4.3	9.7	10.6
Dividend cover	-	-	-	-

Fact Sheet

Market capitalisation £(m)	516.7
Ticker	LSE:COA
SEDOL	B4YZN32
Country	United Kingdom
GICS level 3	Textiles, Apparel and Luxury Goods
Year End	Dec 31

Data as at 09 Dec 2016

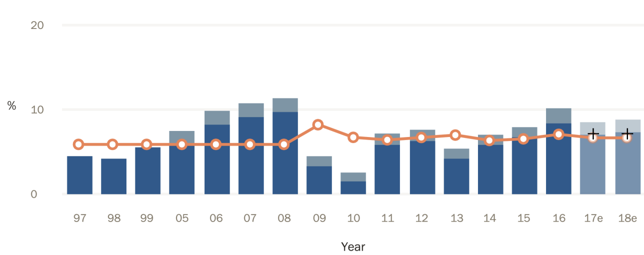
Please note that analyst data and Quest® data may differ due to different sources and calculation methods. The Quest® analysis on this page is based on consensus forecasts.

QUEST A DIVISION OF CANACCORD GENUITY

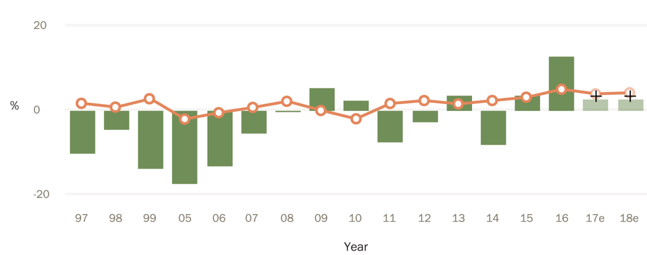
Quest® value per share	Share price	Quest® valuation (%)	QRR percentile	triAngle decile
186.8 p	185.0 p	1	42 /100	6 /10

Quest Summary - Norcros

Cash Flow Returns



Capital Growth



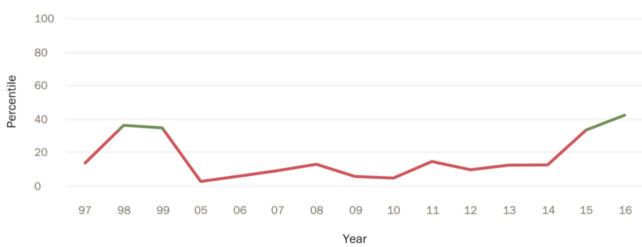
Long Run Averages (%)

	Current*	3yrs	5yrs	10yrs
CFROC	7.3	7.1	6.4	6.2
CFROA	8.9	8.5	7.8	7.6

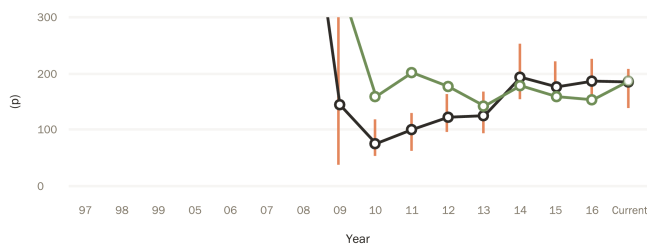
Long Run Growth Averages (%)

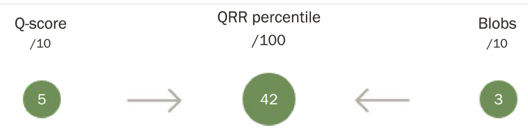
	Current*	3yrs	5yrs	10yrs
Invested capital (real)	2.8	2.5	1.7	0.2
Equilibrium growth	3.9	3.3	2.7	1.5

Quest Risk Rater



Default Quest® Valuation





Valuation Ratios

	Current*	2017e	2018e	Industry
P/E	6.5	6.8	6.3	20.1
EV / sales	0.5	0.5	0.5	1.2
EV / EBITDA	4.0	4.3	3.8	9.0
FCF yield	11.7	10.7	12.1	4.7
Dividend yield	4.0	3.8	4.1	1.7
Quest® market-to-book	0.8	0.8	0.7	1.0

Momentum

	1 week	1 month	3 months	6 months	1 year
Share price relative	0.6	22.5	9.0	-13.3	-27.4
Share price absolute	3.4	25.0	15.6	3.9	-8.0
Brokers' views	u/c	u/c	u/c	u/c	-

Consensus Brokers' Recommendation

Number of brokers: 2

Consensus Growth (%)

	2016	2017e	2018e	5Y Average
Sales	6.2	11.4	4.4	3.8
EBITDA	20.0	29.6	5.8	5.3
Net income	65.6	4.9	8.6	14.9
EPS	61.9	6.7	6.9	13.7
DPS	17.9	6.1	7.1	12.9
Quest® value per share	-3.5	14.3	9.9	-5.3

Consensus Forecasts

	2017e	2018e
Sales £(m)	262.8	274.4
Sales 1 month change (%)	0.8	1.8
Sales 3 month change (%)	0.8	1.8
EPS (p)	27.4	29.3
EPS 1 month change (%)	0.5	4.7
EPS 3 months change (%)	5.8	8.6
DPS (p)	7.0	7.5

Financing

	2015	2016	2017e	2018e
Net debt / cap employed	21.2	40.6	23.4	14.2
Net debt / EBITDA	0.7	1.4	0.6	0.4
Interest cover	10.5	999.9	31.6	50.3
Fixed charge cover (P&L)	3.2	4.9	5.0	5.4
Dividend cover	2.8	3.9	3.8	3.9

Fact Sheet

Market capitalisation £(m)	113.3
Ticker	LSE:NXR
SEDOL	BYYJL41
Country	United Kingdom
GICS level 3	Building Products
Year End	Mar 31

Data as at 09 Dec 2016

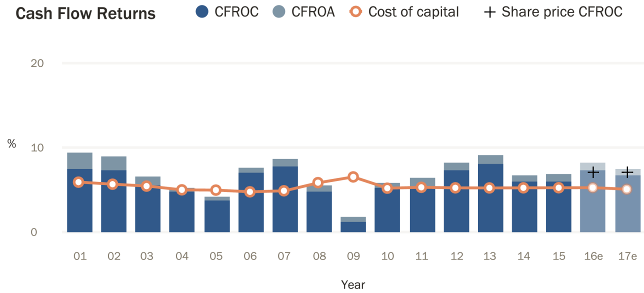
Please note that analyst data and Quest® data may differ due to different sources and calculation methods. The Quest® analysis on this page is based on consensus forecasts.

QUEST A DIVISION OF CANACCORD GENUITY

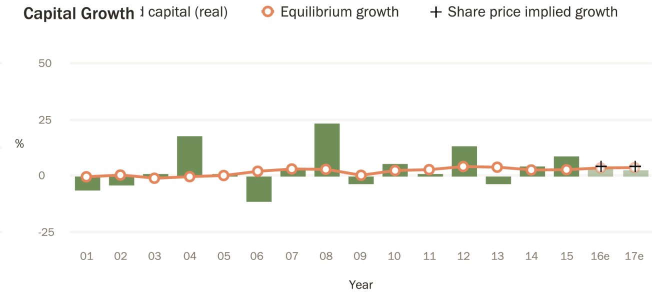
Quest® value per share	Share price	Quest® valuation (%)	QRR percentile	triAngle decile
312.0 p	316.8 p	-2	31 /100	7 /10

Quest Summary - GKN

Cash Flow Returns



Capital Growth



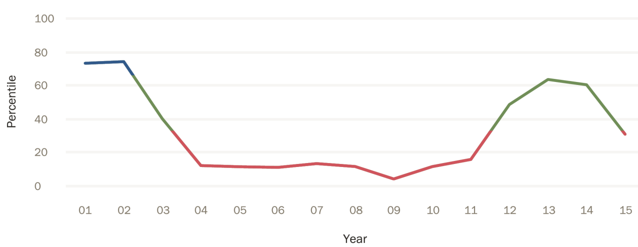
Long Run Averages (%)

	Current*	3yrs	5yrs	10yrs
CFROC	6.9	6.8	6.7	6.0
CFROA	7.7	7.7	7.6	6.8

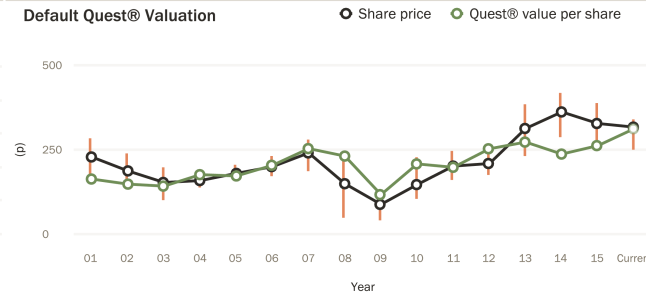
Long Run Growth Averages (%)

	Current*	3yrs	5yrs	10yrs
Invested capital (real)	2.8	3.4	4.9	4.0
Equilibrium growth	3.6	3.0	3.2	2.6

Quest Risk Rater



Default Quest® Valuation



Q-score /10		QRR percentile /100		Blobs /10
4	→	31	←	3

Valuation Ratios

	Current*	2016e	2017e	Industry
P/E	9.9	10.2	9.8	13.1
EV / sales	0.6	0.7	0.6	0.8
EV / EBITDA	5.5	5.8	5.4	5.6
FCF yield	7.4	6.9	7.4	5.1
Dividend yield	3.0	2.8	3.0	2.2
Quest® market-to-book	0.8	0.8	0.8	0.8

Momentum

	1 week	1 month	3 months	6 months	1 year
Share price relative	0.7	0.5	-6.8	-6.0	-14.4
Share price absolute	3.5	2.6	-1.1	12.7	8.4
Brokers' views	neg	neg	neg	pos	-

Consensus Brokers' Recommendation

Number of brokers: 17

Consensus Growth (%)

	2015	2016e	2017e	5Y Average
Sales	3.6	15.6	12.2	7.3
EBITDA	4.7	21.8	4.3	8.2
Net income	3.6	21.1	3.1	6.3
EPS	1.5	18.3	4.0	4.7
DPS	3.6	3.6	4.5	11.7
Quest® value per share	10.6	13.7	5.1	4.7

Consensus Forecasts

	2016e	2017e
Sales £(m)	8362.0	9383.7
Sales 1 month change (%)	0.7	1.0
Sales 3 month change (%)	1.6	3.7
EPS (p)	31.0	32.3
EPS 1 month change (%)	0.0	0.7
EPS 3 months change (%)	3.6	3.6
DPS (p)	9.0	9.4

Financing

	2014	2015	2016e	2017e
Net debt / cap employed	28.5	27.1	19.1	14.0
Net debt / EBITDA	0.7	0.8	0.5	0.4
Interest cover	7.8	6.6	9.6	40.7
Fixed charge cover (P&L)	5.1	4.4	6.1	10.5
Dividend cover	3.1	3.0	3.4	3.4

Fact Sheet

Market capitalisation £(m)	5423.2
Ticker	LSE:GKN
SEDOL	3064650
Country	United Kingdom
GICS level 3	Auto Components
Year End	Dec 31

Data as at 09 Dec 2016

Please note that analyst data and Quest® data may differ due to different sources and calculation methods. The Quest® analysis on this page is based on consensus forecasts.

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Investment Recommendation

Date and time of first dissemination: December 12, 2016, 02:30 ET

Date and time of production: December 12, 2016, 02:30 ET

Target Price / Valuation Methodology:

Coats Group plc - COA

Our target price is derived from a basket of relevant peers, considering EV/EBITDA, PER and notional dividend yield.

GKN plc - GKN

Our target price is based on a blended average P/E and EV/EBITDA at a 10% premium to GKN's long run average.

Norcros plc - NXR

Our target price is derived from an average of target PER and EV/Sales multiples but our assessment of fair value also includes consideration of peer group dividend yield and EV/EBITDA multiples as well as relative EBIT margins.

Risks to achieving Target Price / Valuation:

Coats Group plc - COA

Key risks include:

l Failure to reach a settlement with the Pension Regulator, and agree the Triennial review with the Trustees of the Coats scheme, and thus enter a period of potentially lengthy litigation, preventing resumption of dividends and associated rerating

l Further weakness in North American Crafts

l Other litigation, including Lower Passaic River

l As mentioned previously, upside would come from a possible Mid250 inclusion in H2 2017

GKN plc - GKN

The major risks are a slowdown in global automotive and civil aerospace markets. Changes in UK pension deficit funding could also have a material impact. Adverse currency moves could have a negative impact but would be almost entirely translational. Other risks include rising raw material prices and energy costs. The major risk for a global sector is that the global macro backdrop is softer than current expectations. Even though cost bases are more flexible, there is still operational gearing within the companies.

Norcros plc - NXR

Key risks include:

- Further weakness in UK at Johnson Tile and Triton
- South African Rand weakness, primarily a translation effect
- Import cost pressures arising from Sterling currency weakness and underlying raw material price inflation

- Falling bond yields would inflate the deficit, likely reflected in the share price and rating. Given the triennial review agreed as recently as April 2016, cash pension repair costs are certain for at least next 2 years
- Upside risks include further elevation in bond yields and/or tangible evidence of improved UK trading at Johnson Tile and Triton

Distribution of Ratings:

Global Stock Ratings (as of 12/12/16)

Rating	Coverage Universe		IB Clients
	#	%	%
Buy	576	60.63%	35.76%
Hold	281	29.58%	17.79%
Sell	29	3.05%	20.69%
Speculative Buy	64	6.74%	73.44%
	950*	100.0%	

*Total includes stocks that are Under Review

Canaccord Genuity Ratings System

BUY: The stock is expected to generate risk-adjusted returns of over 10% during the next 12 months.

HOLD: The stock is expected to generate risk-adjusted returns of 0-10% during the next 12 months.

SELL: The stock is expected to generate negative risk-adjusted returns during the next 12 months.

NOT RATED: Canaccord Genuity does not provide research coverage of the relevant issuer.

"Risk-adjusted return" refers to the expected return in relation to the amount of risk associated with the designated investment or the relevant issuer.

Risk Qualifier

SPECULATIVE: Stocks bear significantly higher risk that typically cannot be valued by normal fundamental criteria. Investments in the stock may result in material loss.

12-Month Recommendation History (as of date same as the **Global Stock Ratings** table)

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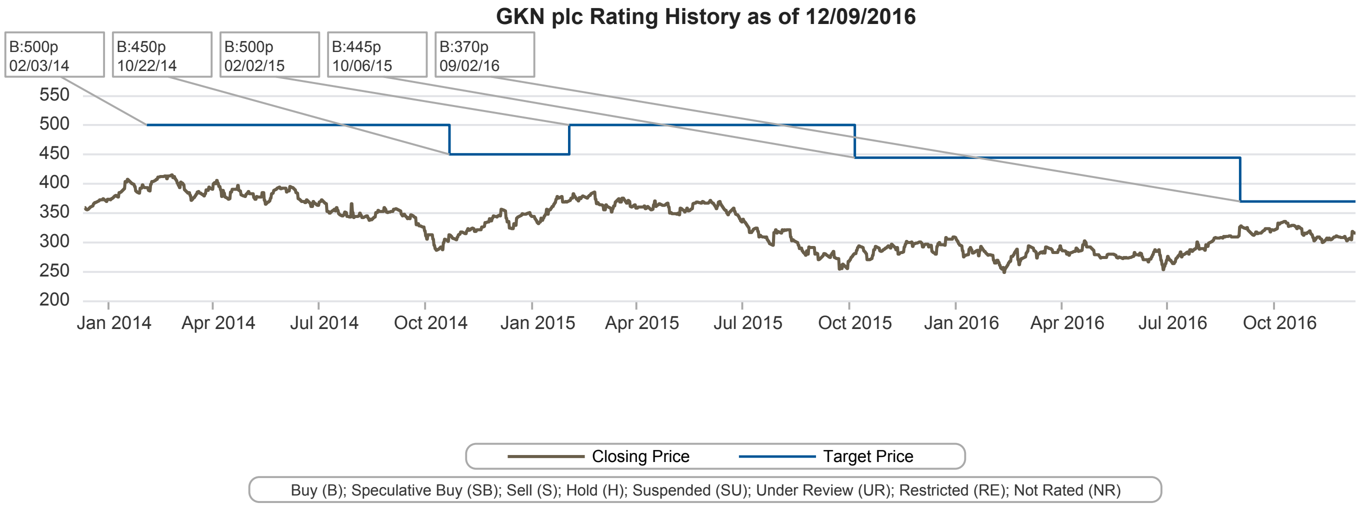
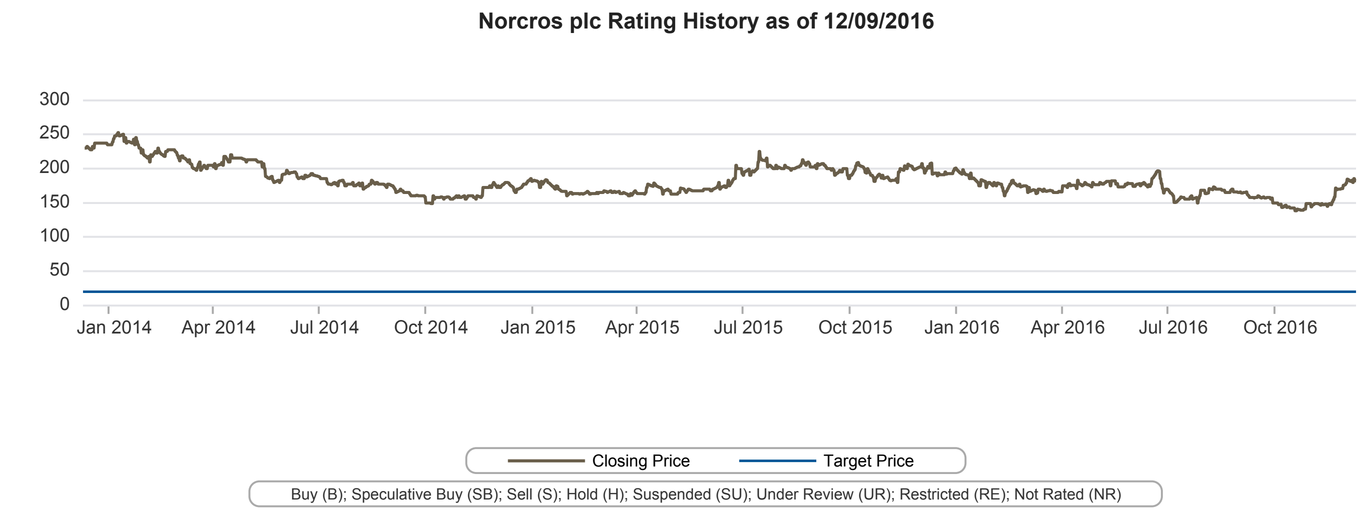
An analyst has visited the material operations of Norcros plc. No payment was received for the related travel costs.

Coats Group plc Rating History as of 12/09/2016





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