Colts

A research initiative by Canaccord Genuity

HRL Holdings (HRL:ASX)

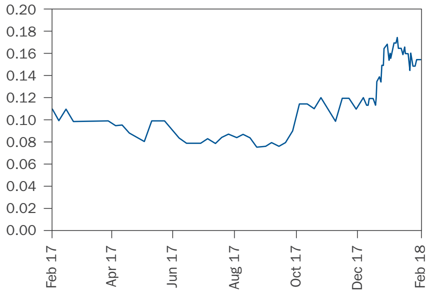
Testing Positive

Key Facts	
Company Code	HRL:ASX
Closing Price (19/02/18)	A$0.155
Price Target	A$0.18cps
Date of Report	20/02/18
Company Website	www.hrlholdings.com
Analyst	Warren Jeffries

Company Statistics	
12-Month Range	A$0.08 - A$0.20
Market Cap (A$Mil)	A$76.5m
Issued Shares	493.4m
Issued Options	4.8m
Cash (A$Mil)	A$3.1m

Major Shareholders	**%**
Viburnum Funds Pty Ltd	16.8%
Kevin Maloney (Tulla Group)	12.4%
Terry Cooney	7.4%
Adam Smith AM	5.2%

Share Price Performance



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Disclaimer: Canaccord Genuity (Australia) Limited has received a fee as the Lead Manager to the HRL Holdings capital raising announced on 16 February 2017.

Fully integrated, growing organically

HRL Holdings (HRL.ASX) have reported underlying 1H18 EBITDA of $1.4m (up 288%), which was driven by a strong organic performance from the Groups established HAZMAT operations and acquisitions.

While the result was marginally below our 1H18 EBITDA forecast of $1.6m, we are comfortable with the result given the strong organic performance, control of the corporate overhead and positive expectations around Analytica in the 2H.

Key points

Strong organic performance from HAZMAT – combining the established business of OCTIEF and Precise Consulting, the HAZMAT operations delivered a strong organic result with divisional EBITDA of $1.5m (up 52%) on revenues of $6m (up 9%). The division benefiting from increasing demand for laboratory testing services, with the New Zealand based Precise Consulting generating strong volumes across its operations in the major cities and regional locations. While OCTIEF, which was cycling a relatively soft comparable earnings period, has generated material top line growth and margin expansion.

Morrison disappoints as weather impacts – in April 2017 HRL acquired Morrison Geotechnic, a business which services the civil, engineering & construction and industries primarily across South East Queensland. The nature of Morrison's work was such that earnings risk would be associated with sustained periods of adverse weather conditions, the likes of which have been experienced in 1H18. We note the business delivered 1H18 EBITDA of $0.2m, which was approximately 50% of what the business delivered in 3-months of ownership in 2H17. The 1H18 result severely impacted by adverse weather conditions in Queensland between October and early December.

Analytica integrated and with momentum – effective 1 December 2017, Analytica made an initial EBITDA contribution of $0.3m on revenues of $0.8m, representing margins of 37%. More importantly the business has been quickly integrated and can now focus on the important 2H period in which earnings benefit from the Manuka Honey season in New Zealand, while recently released New Zealand Government guidelines for the definition on Manuka Honey has driven additional volumes in the current period.

EPS upgrades – While not without some changes within our divisional estimates, our consolidated earnings for the medium-term remain largely unchanged, with FY18 and FY19 normalised EPS forecasts of 0.8cps (up 1.7%) and 0.9cps (up 2.4%) respectively.

Valuation and recommendation – our DCF Valuation and Target Price remains unchanged at $0.18cps, and our recommendation remains a BUY.

Figure 1: HRL Holdings Limited (HRL) Canaccord Genuity forecasts

Profit & Loss ($m)	2017A	2018F	2019F	2020F
Sales Revenue	**13.6**	**28.8**	**35.3**	**36.8**
EBITDA	1.5	5.6	8.4	8.9
Depreciation	-0.3	-1.4	-2.0	-2.0
EBITA	**1.2**	**4.2**	**6.4**	**7.0**
Amort - Intangibles	-0.5	-1.8	-2.3	-2.1
EBIT	0.6	2.4	4.1	4.9
Net Interest Expense	-0.1	-0.0	-0.1	-0.0
NPBT	**0.5**	**2.4**	**4.1**	**4.8**
Tax expense	-0.1	-0.7	-1.2	-1.4
OEI	0.0	0.0	0.1	0.1
NPAT - Pre NRI's	0.4	1.7	2.9	3.5
NPAT - normalised	**0.8**	**3.0**	**4.5**	**4.9**
Significant items	-0.3	-0.5	0.0	0.0
NPAT - reported	**0.1**	**1.2**	**2.9**	**3.5**

Cash Flow ($m)	2017A	2018F	2019F	2020F
Operating EBITDA	**1.5**	**5.6**	**8.4**	**8.9**
- Interest & Tax Paid	0.6	0.7	1.3	1.4
+/- change in Work. Cap.	-1.0	-0.6	-0.6	-0.1
- other	-0.7	0.8	0.1	0.1
Operating Cashflow	**0.5**	**3.4**	**6.5**	**7.3**
- Capex	-0.3	-1.4	-1.8	-1.3
- other	-0.0	0.0	0.0	0.0
- acquisitions	-6.2	-12.0	-7.5	-5.5
Free Cashflow	**-6.1**	**-10.0**	**-2.8**	**0.6**
- Ord Dividends	0.0	0.0	0.0	0.0
- Equity /other	7.9	14.9	0.0	0.0
Net Cashflow	**1.8**	**4.9**	**-2.8**	**0.6**
Cash at beginning of period	0.4	0.7	4.9	2.6
+/- borrowings / other	-1.5	-0.7	0.5	0.5
Cash at end of period	**0.7**	**4.9**	**2.6**	**3.7**

Balance Sheet	2017A	2018F	2019F	2020F
Cash	0.7	4.9	2.6	3.6
Inventories	0.0	0.0	0.0	0.0
PP&E	1.5	6.5	6.3	5.6
Debtors	3.4	5.0	6.2	6.4
Intangibles	11.7	16.9	22.1	25.5
Other assets	1.6	2.0	2.0	2.0
Total Assets	**18.8**	**35.3**	**39.2**	**43.2**
Borrowings	0.8	0.1	0.6	1.1
Trade Creditors	1.3	2.4	3.0	3.1
Other Liabilities	1.6	1.6	1.6	1.6
Total Liabilities	**3.7**	**4.2**	**5.2**	**5.8**
NET ASSETS	**15.1**	**31.2**	**34.0**	**37.3**

Board of Directors / Substantial Shareholders		
Name	**Shareholding**	**%**
Kevin Maloney - Non-Executive Chairman	61.3	12.4%
Darren Anderson* - Executive Director	43.4	8.8%
John Taylor - Non-Executive Director	1.8	0.4%
Frederick Kempson - Alternative Non-Exec. Director	0.0	0.0%
Substantial Shareholders	**Shareholding**	**%**
Kevin Maloney (Tulla Group)	61.3	12.4%
Viburnum Funds Pty Ltd	82.9	16.8%
Terry Cooney	36.6	7.4%
Adam Smith Asset Management	25.9	5.2%

* Includes family interests. D. Anderson direct holding 21.3m shares

Valuation ratios	2017A	2018F	2019F	2020F
EPS (cps) - underlying	0.2	0.4	0.6	0.7
EPS (cps) - normalised	0.4	0.8	0.9	1.0
PER (x)	35.2	20.3	17.0	15.5
PER Rel - All Ind.	105%	25%	11%	7%
PER Rel - Small Ind.	79%	15%	8%	4%
Enterprise Value ($m)	38.0	71.7	74.5	74.0
EV / EBITDA (x)	25.2	12.9	8.9	8.3
EV / EBIT (x)	59.0	29.6	18.1	15.2
DPS (cps)	0.0	0.0	0.0	0.0
Dividend Yield (%)	0.0%	0.0%	0.0%	0.0%
Franking (%)	0%	0%	0%	0%
CFPS (cps)	0.2	0.7	1.3	1.5
P / CFPS (x)	73.3	22.5	11.8	10.5

Profitability ratios	2017A	2018F	2019F	2020F
EBITDA Margin (%)	11.1	19.3	23.7	24.2
EBITA Margin (%)	8.6	14.6	18.1	18.9
EBIT Margin (%)	4.7	8.4	11.6	13.2
ROE (%)	2.8	5.6	8.6	9.3
ROA (%)	6.5	13.9	17.5	17.6
ROIC (%)	8.3	14.6	15.6	15.2

Balance Sheet ratios	2017A	2018F	2019F	2020F
Net Debt (cash)	0.1	-4.8	-2.0	-2.5
Net Gearing (%)	cash	cash	cash	cash
Interest Cover (x)	15.2	113.0	cash	cash
NTA per share ($)	0.0	0.0	0.0	0.0
Price / NTA (x)	3.3	3.6	4.0	4.0
Shares on issue	244.2	493.4	493.4	493.4
EFPOWA (m) - fully diluted	179.6	390.8	493.4	493.4

Growth ratios	2017A	2018F	2019F	2020F
Sales revenue ($m)	62.7%	111.2%	22.6%	4.2%
EBITDA ($m)	41.1%	269.2%	50.5%	6.5%
EBIT ($m)	10.3%	276.6%	69.7%	18.1%
NPAT ($m)	12.6%	310.2%	68.0%	19.8%
EPS (cps)	18.9%	73.5%	19.6%	9.6%
DPS (cps)	100.0%	200.0%	300.0%	400.0%

Interim Analysis	1H17A	2H17A	1H18A	2H18F
Revenues	5.5	8.2	11.0	17.8
EBITDA	0.4	1.1	1.4	4.1
EBITDA margin (%)	6.8%	13.9%	13.1%	23.2%
EBITA	0.2	0.9	1.1	3.2
NPAT - normalised	0.1	0.4	0.7	2.2
EPS -normalied	0.1	0.7	0.3	0.5
DPS	0.0	0.0	0.0	0.0

Valuation	2019F
Normalised EBITDA multiple (x)	
EBITDA ($m)	8.4
Target EBITDA multiple (x)	9.1
Net Debt (cash) ($m)	-4.8
Implied Valuation	81.4
Per Share	**$0.17**
Target PE Multiple	
EPS (c)	0.9
PER Target (x)	15.7
Per Share	**$0.15**

Discounted Cash Flow			
Cost of equity	11.0%	WACC	11.0%
Cost of debt	4.8%	Terminal Growth Rate	3.0%
Net Debt/ Net debt + equity	0.7%	**Per Share**	**$0.18**

Interim result Analysis

Figure 2: Interim result summary

($m) - unless stated	1H17A	1H18A	%Δ
Sales			
- Hazmat	5.5	6.0	9%
- Geotech	-	3.9	-
- Food & Enviro Lab.	-	0.8	-
- Software	-	0.2	-
Total Sales	5.5	11.0	101%
EBITDA - pre-NRI's			
- Hazmat	1.0	1.5	52%
margin	17.9%	24.9%	↑5PPS
- Geotech	-	0.2	-
margin	-	5.3%	-
- Food & Enviro Lab.	-	0.3	-
margin	-	37.4%	-
- Software	-	0.1	-
margin	-	31.3%	-
- Corp. O/head.	-0.6	-0.6	5%
Total EBITDA - pre-NRI's	0.4	1.4	288%
Total EBITDA margin	6.8%	13.1%	↑6.3PPS
Depreciation	-0.1	-0.4	181%
EBITA - pre NRI's	0.2	1.1	349%
Amort - Intangiables	-0.2	-0.6	223%
NPBT - pre NRI's	-0.0	0.4	nmn
NPAT - pre NRI's	0.0	0.3	947%
Significant items	0.0	-0.5	nmn
NPAT - reported	0.0	-0.2	nmn
NPAT - normalised	0.2	0.7	351%
EPS - normalised	0.1	0.3	**170%**

Source: Company reports, CGAu & Factset estimates (Market cap in $M)

"revenues doubled to $11m (up 101%) on the back of initial contributions from Analytica, Morrison's and Octfolio against the comparable period."

Key highlights

Revenues – revenues effectively doubled to $11m (up 101%) on the back of initial contributions from Analytica, Morrison's and Octfolio against the comparable period. The established operations of OCTEIF and Precise, now combined for divisional reporting purposes as HAZMAT, generated organic revenue growth of 9%.

EBITDA – significant uplift in underlying EBITDA to $1.4m (up 288%) as the group benefited from initial contributions from acquisitions, strong organic EBITDA growth from the HAZMAT operations, which delivered EBITDA of $1.5m (up 52%) and sound management of the corporate overhead which lifted a modest 5% to ($0.6m) despite the significant expansion of the Group.

NPATA – normalised NPAT of $0.7m was reported for the period, which includes the post-tax add-back of ($0.4m) of amortisation of identifiable intangibles arising from acquisitions, in addition to some other minor adjustments post tax.

We note also a small benefit of $11k from HRL's 26% JV interest in CAIQTest Pacific Ltd, which only completed its accreditation for testing in August 2017.

Operating cashflow – the underlying conversion of EBITDA to OCFBIT (Operating cashflow b/f interest & tax) was $1.3m, representing a conversion rate of 92%. We deem this a good result given the level of organic growth within HAZMAT, and the adverse performance of Morrison.

We see potential for improved conversion rates of EBITDA to OCFBIT going forward, particularly with the Analytica operations becoming a larger contributor to consolidated earnings.

We note a net cash position of $3.1m as at 31 December 2017, and with significantly higher earnings forecast for 2H18, we are currently forecasting a net cash position of $4.8m for FY18.

Division summary and estimates

Figure 3: Hazmat divisional summary

Revenues	1H17A	1H18A	%Δ	2H18F	FY18F Orig	FY18F Revised	FY18F %Δ	FY19F
- Hazmat	5.5	6.0	9%	6.5	12.4	12.5	1%	13.0
- Morrison		3.9		5.1	9.4	9.0	-4%	9.3
- Analytica		0.8		5.8	6.7	6.7	0%	12.3
- Octfolio		0.2		0.4	0.7	0.7	0%	0.7
- eliminations								0.0
Total Revenues	5.5	11.0	101%	17.8	28.7	28.8	0%	35.3
EBITDA								
- Hazmat	1.0	1.5	52%	1.6	3.0	3.1	3%	3.2
- Morrison		0.2		0.7	1.5	0.9	-41%	1.1
- Analytica		0.3		2.3	2.5	2.6	5%	5.1
- Octfolio		0.1		0.2	0.3	0.3	-11%	0.3
- Corporate	(0.6)	(0.6)	5%	(0.7)	(1.6)	(1.3)	(0.2)	(1.3)
Total EBITDA	0.4	1.4	288%	4.1	5.662	5.573	-2%	8.389
EBITDA % - pre Corp o/h.								
- Hazmat	17.9%	24.9%	↑7pps	24.2%	24.1%	24.6%	↑0.5pps	24.5%
- Morrison	-	5.3%	-	13.0%	15.6%	9.6%	↓6pps	12.1%
- Analytica	-	37.4%	-	39.8%	37.6%	39.5%	↑1.9pps	41.0%
- Octfolio	-	31.4%	-	51.8%	50.5%	45.0%	↓5pps	45.0%
Total EBITDA %	6.8%	13.1%	↑16.4pps	23.2%	19.7%	19.3%	↓1pp	23.7%

Source: Company reports, CGAu & Factset estimates (Market cap in $M)

"The combined OCTIEF and Precise Consulting operations delivered an impressive organic result with EBITDA of $1.5m (up 52%) on revenues of $6.0m (up 9%). We understand both business contributed materially to the result."

Hazmat

The combined OCTIEF and Precise Consulting operations delivered an impressive organic result with EBITDA of $1.5m (up 52%) on revenues of $6.0m (up 9%). We understand both business contributed materially to the result.

The NZ based Precise Consulting operations delivered a material uplift in earnings on the back of largely flat revenue growth on a NZD basis. Earnings benefited from a material OPEX investment in the prior period into new branches located in Palmerston North, Auckland and Dunedin, from which material earnings are now being derived from strong volumes, concurrent with operational efficiencies.

With regards to OCTIEF the business has experienced positive revenue and earnings growth as a result of strong demand for services in Queensland, which is OCTIEF's largest market. The business has also benefited also from a Northern Territory Department of Housing contract and the NSW Government 'Mr Fluffy' asbestos program in 1Q18, which has been subsequently suspended and likely to resume at some stage in 2018.

We note also strong environmental engineering / sciences services revenue growth was reported, and OCTIEF has secured a number of large contaminated land projects during the period, of which a number were direct referrals or joint bids with Morrison Geotechnic.

Higher revenue volumes are driving scale benefits for OCTIEF, complimented by operational efficiencies being realised, while new laboratory testing capabilities will come on stream later in the year.

We note that both OCTIEF and Precise enter 2H18 with strong momentum in volumes, and expectations are for a 2H period at least in-line with 1H18.

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Geotechnical (Morrison Geotechnical)

1H18 revenues and EBITDA of $3.9m and $0.2m respectively was disappointing, with operations being hampered by large rain events across South - East Queensland from October through to early December.

We note that we have taken a more conservative view for the Geotechnical business into the 2H18 period, forecasting 2H18 EBITDA of $0.65m which we feel is consistent with average half-year periods in which weather doesn't represent a material disruption to operations.

While positives can be drawn on some business and revenue synergies being derived from the Geotechnical business, we see some need for greater geographical diversification in the mix of work attributable to the operation longer-term in an effort to smooth earnings.

Food & environmental laboratory services (Analytica)

While only contributing for 1- month during the 1H18 period, the business delivered revenues of $0.8m and EBITDA of $0.3m, representing margins of 37%. We note the strongest period of the financial year for Analytica is the 2H period as a result of the Manuka Honey season in New Zealand. We expect Honey related testing will represent ~25% of FY18 revenues for Analytica on an annualised basis.

The 2H period will also benefit from the recent release from the New Zealand Ministry of Primary Industries of their revised guidelines for the definition of Manuka Honey, which has already resulted some heightened short term testing demand.

“ The 2H period will also benefit from the recent release from the New Zealand Ministry of Primary Industries of their revised guidelines for the definition of Manuka Honey, which has already resulted some heightened short term testing demand. ”

We note also more recent environmental testing lines have been launched by Analytica which incorporates testing on air, water and soil (organics & inorganics), and these relatively new lines will be a key driver of growth for Analytica in the medium-term.

Software (Octfolio)

Still at a relatively earning stage of rolling out Octfolio' s flagship product with clients, which is the 'Octfolio Hazardous Material Compliance Software', the business is generating profitable earnings on a sustainable basis.

We note 1H18 EBITDA of $68k does appear modest after delivering FY17 pro-forma EBITDA of $0.2m, however new contracts are expected to come on stream in 2H18, albeit likely to be slightly lower than initially forecast.

Corporate overhead

Given the level of expansion both organically and though the acquiring of meaningful businesses in Morrison's and Analytica, we deem it a significant positive that the management and board have been able to maintain a largely static corporate overhead which increased by a modest 5% to $0.6m, and we expect a similar overhead charge in 2H18. Note we have reduced our corporate overhead to $1.3m p.a., from $1.6m previously.

Forecast changes

While some moving parts within our divisional forecasts, our consolidated earnings for the medium-term remain largely unchanged at this stage, with FY18 and FY19 normalised EPS forecasts of 0.8cps (up 1.7%) and 0.9cps (up 2.4%) respectively.

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Figure 4: Financial forecast changes

	FY18F			FY19F		
($m) - unless stated	Orig	Rev	%Δ	Orig	Rev	%Δ
Sales Revenue	28.7	28.8	0.3%	35.5	35.3	-0.3%
EBITDA	5.7	5.6	-2.1%	8.4	8.4	-0.4%
EBITDA margin	19.8%	19.3%	-2.4%	23.8%	23.7%	-0.1%
Depreciation	-1.5	-1.4	-10.0%	-2.1	-2.0	-4.8%
EBITA	4.2	4.2	0.7%	6.3	6.4	1.0%
Amort - Intangiables	-1.8	-1.8	0.0%	-2.3	-2.3	0.0%
EBIT	2.4	2.4	1.2%	4.0	4.1	1.5%
EBIT margin	8.3%	8.4%	↑10bps	11.4%	11.6%	1.9%
Net Interest Expense	-0.1	-0.0	-9.2%	-0.1	-0.1	-23.9%
NPBT	2.3	2.4	1.5%	4.0	4.1	2.0%
Tax expense	-0.7	-0.7	1.5%	-1.2	-1.2	2.0%
OEI	0.0	0.0	nmn	0.0	0.1	nmn
NPAT - pre NRI's	1.7	1.7	3.0%	2.8	2.9	3.8%
Significant items	0.0	-0.5	nmn	0.0	0.0	0.0%
NPAT - normalised	2.9	3.0	1.7%	4.4	4.5	2.4%
EPS	0.4	0.4	3.0%	0.6	0.6	3.8%
EPS - normalised	0.8	0.8	1.7%	0.9	0.9	2.4%

Source: Company reports, CGAu & Factset estimates (Market cap in $M)

Valuation & Target Price – $0.18 cps

Our DCF Valuation and Target Price remains unchanged at $0.18cps.

Our DCF Valuation methodology incorporates a WACC of 11.0% which is derived from a 4.25% risk free rate, a 1.35x beta and a 5.0% equity risk premium.

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A site visit has been conducted.

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