Colts

A research initiative by Canaccord Genuity

HRL Holdings (HRL:ASX)

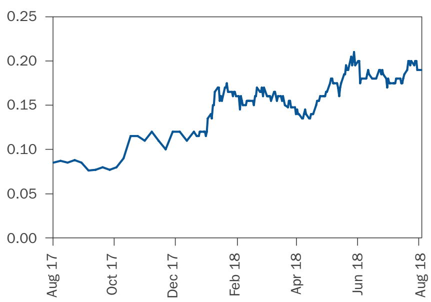
Testing positively

Key Facts	
Company Code	HRL:ASX
Closing Price (3/8/18)	A$0.19
Price Target	A$0.21
Date of Report	6/8/18
Company Website	www.hrlholdings.com
Analyst	Warren Jeffries

Company Statistics	
12-Month Range	A$0.08 - A$0.21
Market Cap (A$Mil)	A$93.7m
Issued Shares	493.4m
Issued Options	4.8m
Cash (A$Mil)	A$5.4m

Major Shareholders	%
Viburnum Funds Pty Ltd	16.8%
Kevin Maloney (Tulla Group)	12.4%
Perennial Value Management Ltd	10.3%
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 raisings announced on 16 February 2017 and 17 October 2017.

HRL Holdings (HRL.ASX) has reported underlying FY18 EBITDA of $5.8m (FY17: $1.5m), which has included an initial 7-month contribution from Analytica Laboratories of $4.1m. On a pro-forma basis HRL delivered FY18 EBITDA of $7.1m, which represented ~20% growth on the prior period.

Key points

Analytica exceeds expectations; earnings skewed to 2H. Analytica delivered pro-forma FY18 EBITDA of $5.4m (2H18: $3.8m), which represented growth of 67% on the pcp. The strong result was underpinned by ongoing demand in established markets which include milk & dairy, honey and drugs of abuse, in addition to emerging growth from environmental services, timber and food origin testing. We do note that Analytica's earnings are typically skewed to the 2H period, which captures the heightened testing regimes within the milk & dairy and honey industries. Based on pro-forma FY18 earnings the 1H/2H earnings skew was 30%/70% which was exacerbated by short-term demand for additional testing regimes from both the milk & dairy and honey industries during the 2H period.

Morrison Geotechnic disappoints. Having been acquired in April 2017, and having delivered pro-forma FY17 EBITDA of $1.5m, Morrison Geotechnic delivered FY18 EBITDA of $0.4m. The material decline in earnings resulting from challenging weather conditions across FY18 which adversely impacted operations.

HAZMAT / Octfolio. Solid organic result from the HAZMAT operations which delivered FY18 EBITDA of $2.5m (up 7%), on revenues of $10.9m (down 3%). Octfolio delivered largely flat EBITDA of $0.2m on a pro-forma basis and the business remains somewhat binary in relation to new opportunities which do exist.

Financial positon sound. Operating cashflow (ungeared; bf tax) of $5.4m represented ~96% of reported EBITDA of $5.6m, while the balance sheet remains sound with net cash of $4.3m and additional debt capacity of $2.7m. With the Analytica earn-out of up to NZ$11m (A$10m) expected to be paid in full by December 2019, we believe HRL is in a position to fund the earn-out from cash.

Outlook. We are forecasting organic growth across all divisions in FY19, with a rebound from Morrison Geotechnic being the major driver to earnings growth. We do note that Analytica will invest in demand driven product development and new market opportunities during FY19, which we estimate will pause growth marginally, however we expect the benefits from that investment will be realised in FY20.

Forecasts. We have made modest changes to near-term forecasts which have resulted in our FY19 and FY20 EBITDA forecasts being revised to $8.2m (down 2%) and $9.1m (up 2%) respectively. We're looking for a bounce back in earnings from Morrison Geotechnic in FY19, forecasting EBITDA of $0.9m, which remains well below their average EBITDA over the 4-year period to FY17 of ~$1.3m.

Valuation and recommendation. Rolling forward our assumptions and on the back of modest earnings revisions we have increased our DCF valuation and target price by 17% to $0.21/share. Our recommendation remains a BUY.

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

Profit & Loss ($m)	2017A	2018A	2019F	2020F
Sales Revenue	**13.6**	**27.3**	**33.4**	**35.7**
EBITDA	1.5	5.8	8.2	9.1
Depreciation	-0.3	-1.5	-2.1	-1.8
EBITA	**1.2**	**4.3**	**6.1**	**7.4**
Amort - Intangiables	-0.5	-1.9	-2.6	-2.6
EBIT	0.6	2.4	3.5	4.8
Net Interest Expense	-0.1	-0.1	-0.2	-0.1
NPBT	**0.5**	**2.3**	**3.3**	**4.6**
Tax expense	-0.1	-0.8	-1.0	-1.4
OEI	0.0	0.0	0.0	0.0
NPAT - Pre NRI's	0.4	1.5	2.3	3.2
NPAT - normalised	**0.8**	**2.9**	**4.2**	**5.1**
Significant items	-0.3	-3.0	-5.1	-2.2
NPAT - reported	**0.1**	**-1.5**	**-2.8**	**1.1**

Cash Flow ($m)	2017A	2018A	2019F	2020F
Operating EBITDA	**1.5**	**5.8**	**8.2**	**9.1**
- Interest & Tax Paid	0.6	0.9	1.2	1.5
+/- change in Work. Cap.	-1.0	-1.3	-0.1	0.5
- other	-0.7	-0.8	2.3	0.1
Operating Cashflow	**0.5**	**4.4**	**4.6**	**8.0**
- Capex	-0.3	-1.5	-3.0	-1.5
- other	0.0	-0.4	-5.1	-2.2
- acquisitions	-6.2	-12.0	0.0	0.0
Free Cashflow	**-6.1**	**-9.5**	**-3.6**	**4.3**
- Ord Dividends	0.0	0.0	0.0	0.0
- Equity /other	7.9	14.7	0.0	0.0
Net Cashflow	**1.8**	**5.2**	**-3.6**	**4.3**
Cash at beginning of period	0.4	0.7	5.4	3.3
+/- borrowings / other	-1.5	-0.4	1.5	-1.0
Cash at end of period	**0.7**	**5.5**	**3.3**	**6.6**

Balance Sheet	2017A	2018A	2019F	2020F
Cash	0.7	5.4	3.3	6.6
Inventories	0.0	0.6	0.7	0.7
PP&E	1.5	7.0	7.9	7.6
Debtors	3.4	4.2	5.3	5.4
Intangibles	11.7	24.6	22.0	19.4
Other assets	1.6	2.3	2.3	2.3
Total Assets	**18.8**	**44.1**	**41.6**	**42.1**
Borrowings	0.8	1.1	2.6	1.6
Trade Creditors	1.3	1.5	2.7	3.2
Other Liabilities	1.6	6.2	3.9	3.7
Total Liabilities	**3.7**	**8.9**	**9.2**	**8.6**
NET ASSETS	**15.1**	**35.2**	**32.4**	**33.5**

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%
Stephen Howse - Executive Director	12.2	2.5%
James Todd - Non-Executive Director	Nil	0.0%
Substantial Shareholders	**Shareholding**	**%**
Viburnum Funds Pty Ltd	82.9	16.8%
Kevin Maloney (Tulla Group)	61.3	12.4%
Perennial Value Management Ltd	50.6	10.3%
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	2018A	2019F	2020F
EPS (cps) - underlying	0.2	0.4	0.5	0.7
EPS (cps) - normalised	0.4	0.7	0.8	1.0
PER (x)	40.4	24.6	21.2	17.4
PER Rel - All Ind.	135%	52%	39%	19%
PER Rel - Small Ind.	105%	40%	35%	17%
Enterprise Value ($m)	44.1	84.5	88.1	83.8
EV / EBITDA (x)	29.2	14.6	10.7	9.2
EV / EBIT (x)	68.5	35.9	25.0	17.6
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	0.9	0.9	1.6
P / CFPS (x)	85.2	20.1	19.4	11.2

Profitability ratios	2017A	2018A	2019F	2020F
EBITDA Margin (%)	11.1	21.1	24.6	25.6
EBITA Margin (%)	8.6	15.7	18.4	20.6
EBIT Margin (%)	4.7	8.6	10.6	13.3
ROE (%)	2.8	4.2	7.1	9.7
ROA (%)	6.5	11.1	16.0	20.8
ROIC (%)	8.3	12.2	14.4	18.4

Balance Sheet ratios	2017A	2018A	2019F	2020F
Net Debt (cash)	0.1	-4.3	-0.7	-5.0
Net Gearing (%)	0.7	cash	cash	cash
Interest Cover (x)	15.2	108.7	cash	cash
NTA per share ($)	0.0	0.1	0.1	0.1
Price / NTA (x)	3.8	3.2	3.3	2.9
Shares on issue	244.2	493.4	493.4	493.4
EFPOWA (m) - fully diluted	179.6	391.0	493.4	493.4

Growth ratios	2017A	2018A	2019F	2020F
Sales revenue ($m)	62.7%	100.1%	22.2%	7.0%
EBITDA ($m)	41.1%	282.7%	42.0%	11.5%
EBIT ($m)	10.3%	266.5%	49.8%	34.8%
NPAT ($m)	12.6%	248.8%	57.8%	40.4%
EPS (cps)	20.5%	64.2%	15.8%	22.3%
DPS (cps)	100.0%	200.0%	300.0%	400.0%

Interim Analysis	1H17A	2H17A	1H18A	2H18F
Revenues	5.5	8.2	11.0	16.3
EBITDA	0.3	1.1	1.4	4.3
EBITDA margin (%)	6.8%	13.9%	13.1%	26.6%
EBITA	0.2	0.9	1.1	3.2
NPAT - normalised	0.1	0.4	0.7	2.1
EPS -normalied	0.1	0.7	0.0	0.7
DPS	0.0	0.0	0.0	0.0

Valuation	2019F
Normalised EBITDA multiple (x)	
EBITDA ($m)	8.2
Target EBITDA multiple (x)	11.3
Net Debt (cash) ($m)	-4.3
Implied Valuation	97.2
Per Share	**$0.20**
Target PE Multiple	
EPS (c)	0.8
PER Target (x)	19.6
Per Share	**$0.17**

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**	**$0.21**

FY18 earnings summary

Figure 2: Interim result summary

($m) - unless stated	FY17A	FY18A	Δ
Revenues			
- Hazmat	11.2	10.9	-3%
- Geotech	2.3	7.7	238%
- Food & Enviro Lab.	0.0	8.2	nmn
- Software	0.1	0.5	358%
Total Revenues	13.6	27.3	100%
EBITDA - pre-NRI's			
- Hazmat	2.3	2.5	7%
margin	20.7%	22.9%	↑220bp
- Geotech	0.5	0.4	-20%
margin	19.7%	4.7%	↓15pps
- Food & Enviro Lab.	0.0	4.1	n/a
margin	n/a	49.8%	n/a
- Software	0.1	0.2	229%
margin	51.5%	36.9%	nmn
- Corp. O/head.	-1.3	-1.3	2%
Total EBITDA - pre-NRI's	1.5	5.8	283%
Total EBITDA margin	11.1%	21.1%	↑10pps
Depreciation	-0.3	-1.5	338%
EBITA - pre NRI's	1.2	4.3	267%
Amort - Intangibles	-0.5	-1.9	267%
EBIT - pre NRI's	0.6	2.4	266%
Net Interest Expense	-0.1	-0.1	-46%
NPBT - pre NRI's	0.5	2.3	324%
NPAT - pre NRI's	0.4	1.5	249%
NPAT - normalised	0.8	2.9	262%
Significant items	-0.3	-3.0	926%
NPAT - reported	0.1	-1.5	nmn
EPS - normalised	0.4	0.7	64%

Source: Company reports & CGAu

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Underlying FY18 EBITDA increased to $5.8m (FY17: $1.5m), which was underpinned by an initial 7-month contribution from Analytica of $4.1m, a result that significantly outperformed our initial expectations.

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Analytica drives FY18 growth

Underlying FY18 EBITDA increased to $5.8m (FY17: $1.5m), which was underpinned by an initial 7-month contribution from Analytica of $4.1m, a result that significantly outperformed our initial expectations for EBUTDA of $2.4m when acquired in December 2017. In contrast to Analytica, Morrison Geotechnic saw FY18 EBITDA decline to $0.4m which was a 20% below a 3-month contribution of $0.5m in FY17, and materially below pro-forma FY17 EBITDA of $1.5m.

We note that in the 4-year period up to and including FY17, Morrison Geotechnic had achieved average EBITDA of ~$1.3m.

Other key points

Amortisation of intangibles increased to $1.9m, of which $1.1m was applicable to Analytica having been acquired on 1 December 2017.

Significant items of $3.0m includes $2.9m being recognised in relation to the Analytica's earn-out for 7-months of ownership in FY18, and represents a maximum amount that could be recognised for the period. It is assumed that the full earn-out amount of NZ$11m (A$10m) will be paid to Analytic vendors by December 2019.

Division summary and estimates

Figure 3: Divisional summary

($m) - unless stated	FY17A Pro-forma	FY18A Pro-forma	Δ	FY19F Original	FY19F Revised	Δ	FY20F Revised
Revenues							
- Hazmat	11.2	10.9	-3%	13.0	11.6	-10%	12.0
- Geotech	9.4	7.7	-18%	9.3	8.2	-12%	8.5
- Food & Enviro Lab.	8.7	12.4	42%	12.3	13.0	5%	14.6
- Software	0.6	0.5	-10%	0.7	0.6	-23%	0.7
Total Revenues	29.9	31.5	5%	35.3	33.4	-6%	35.7
EBITDA							
- Hazmat	2.3	2.5	7%	3.2	3.1	-2%	3.3
margin	20.7%	22.9%	↑220bp	24.5%	26.7%	↑220bp	27.2%
- Geotech	1.5	0.4	-76%	1.1	0.9	-20%	0.9
margin	16.0%	4.7%	↓11.3pp	12.1%	11.0%	↓110bp	11.0%
- Food & Enviro Lab.	3.2	5.4	68%	5.1	5.7	12%	6.4
margin	36.8%	43.4%	↑660bp	41.0%	43.5%	↑250bp	44.0%
- Software	0.2	0.2	-10%	0.3	0.3	-4%	0.4
margin	36.7%	36.8%	↑1bp	45.0%	56.0%	↑900bp	58.0%
- Corporate	(1.3)	(1.3)	2%	(1.3)	(1.8)	37%	(1.8)
Total EBITDA	5.9	7.1	19%	8.4	8.2	-2%	9.1
EBITDA margin	19.8%	22.4%	↑ 240bp	23.7%	24.6%	↑ 90bp	25.6%

Source: Company reports & CGAu

Food & Environmental Laboratory Services (Analytica)

"Analytica will look to invest further into product development and entering new markets in FY19, with a focus on leveraging its current milk & dairy work and alliance with MilkTest NZ into broader opportunities…"

On being acquired on 1 December 2017, Analytica was forecast to deliver pro-forma FY18 EBITDA of $4.0, and contribute EBITDA of $2.4m to HRL for FY18. However expectations were comfortably exceeded with the business delivering pro-forma FY18 EBITDA of $5.4m and making a $4.1m contribution in the 7-months to 30 June 2018.

The strong result driven by record levels of testing in relation to drugs of abuse, which predominantly relates to methamphetamine linked testing, recently launched environmental testing regimes and continued strong demand for dairy & milk and honey testing regimes. We note that additional, short-term demand for testing from both the dairy & milk and honey industries during 2H18 helped exacerbate a typical 2H earnings skew for Analytica to a 30%/70% 1H/2H split based on pro-forma FY18 EBITDA of $5.4m (margin 43%), with 2H18 earnings of $3.8m (margins 51%) against 1H18 earnings of $1.6m (margins 32%).

A more typical earnings skew for Analytica being a 1H/2H split of 40% /60% and that occurs as a result of testing regimes for both the dairy & milk and honey industries being heightened in the 2H period.

Outlook

Analytica will look to invest further into product development and entering new markets in FY19, with a focus on leveraging its current milk & dairy work and alliance with MilkTest NZ into broader opportunities, while also leveraging Analytica's broader IP and established testing regimes in both New Zealand and Australia.

We note much of Analytica's investment during FY19 into new product development and new markets is demand driven, the benefits of which are likely to start positively impacting earnings in FY20, hence our FY19 EBITDA forecast of $5.7m (up 12%) represents relatively modest growth at this stage. We are also mindful that methamphetamine related work will decline subsequent to the NZ Office of the Prime Minister's Chief Science Advisor making recommendations that current thresholds for contamination as published by Standards NZ relating to methamphetamine use are too low, and recommended thresholds increase to 15µg/100cm2 from ~1.5 µg/100cm2 previously.

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...We have reduced our FY19 EBITDA forecast to $3.1m (down 2%) however growth of >20% is still forecast as the division benefits from a previous investment in operational efficiencies, new regional branches and new service lines.

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HAZMAT (Octief & Precise)

Delivered EBITDA of $2.5m (up 7%), with revenues declining by 3% to $10.9m. Earnings also benefitted from what is expected to be peak levels of methamphetamine related work specific to the NZ based Precise Consulting business, while a previous investment made in the division saw operational efficiencies realised during the period. Revenues were impacted by the completion of an asbestos related contracted in May ’18, and the suspension of another asbestos related contract during the period.

Outlook

Precise Consulting will be impacted by reductions in methamphetamine related testing, however while there is a threshold in place for unacceptable methamphetamine levels in properties suspected of usage, then the initial inspection testing regimes to determine methamphetamine levels can be expected to continue. Nevertheless we have reduced our FY19 EBITDA forecast to $3.1m (down 2%) however growth of >20% is still forecast as the division benefits from a previous investment in operational efficiencies, new regional branches and new service lines.

Geotech (Morrison)

Having been acquired in April ’17, Morrison Geotechnic delivered FY18 EBITDA of $0.4m (1H18: $0.2m), against pro-forma FY17 EBITDA of $1.5m. The dramatic decline in earnings being attributed to challenging weather conditions across south-east Queensland during Oct to Dec ‘17 and again in Feb to April ’18. While the landscape for Morrison Geotechnic appears favorable, and the pipeline of work appears strong, the volatility in earnings as a result of weather conditions has represented a drag on consolidated earnings for the group.

Outlook

While not without some trepidation, we are looking for a bounce back in earnings from Morrison Geotechnic in FY19, forecasting EBITDA of $0.9m, which remains well below average EBITDA of ~$1.3m achieved by the business over a 4-year period to FY17 with EBITDA ranging during that period between ~$1m and $1.5m.

Software (Octfolio)

A largely flat result with EBITDA of $0.2m (down 10%) and the business remains somewhat binary in relation to new opportunities, however to that extent a number of new opportunities with both HAZMAT and new markets are well advanced, hence any new business will be incrementally material to the earnings of the division.

Outlook

FY18 EBITDA forecast at $0.3m largely reflect success on one of those discussions.

Forecast changes

Figure 4: Financial forecast changes

($m) - unless stated	FY19F			FY20F		
	Orig	Rev	Δ	Orig	Rev	Δ
Sales Revenue	35.3	33.4	-6%	36.8	35.7	-3%
EBITDA	8.4	8.2	-2%	8.9	9.1	2%
EBITDA margin	23.7%	24.6%	↑90bps	24.2%	25.6%	↑140bps
Depreciation	-2.0	-2.1	5%	-2.0	-1.8	-10%
EBITA	6.4	6.1	-4%	7.0	7.4	6%
Amort - Intangibles	-2.3	-2.6	13%	-2.1	-2.6	24%
EBIT	4.1	3.5	-14%	4.9	4.8	-2%
Net Interest Exp	-0.1	-0.2	350%	0.0	-0.1	174%
NPBT	4.1	3.3	-19%	4.8	4.6	-4%
Tax expense	-1.2	-1.0	-19%	-1.4	-1.4	0%
NPAT - Pre NRI’s	2.9	2.3	-20%	3.5	3.2	-6%
NPAT - normalised	4.5	4.2	-7%	4.9	5.1	4%
Significant items	0.0	-5.1	nmn	0.0	-2.2	nmn
NPAT - reported	2.9	-2.8	-198%	3.5	1.1	-69%
EPS	0.6	0.4	-36%	0.7	0.7	-6%
EPS - normalised	0.9	0.8	-7%	1.0	1.0	4%

Source: Company reports & CGAu

Reflecting the current dynamic in the business of demand driven investment taking place in FY19, and the expected realisation of that investment to emerge in FY20, we are now forecasting FY19 and FY20 EBITDA of $8.2m (down 2%) and $9.1m (up 2%) respectively.

We note that earlier take up of new products by clients, or a more rapid take up of services in new markets may prove our current forecasts conservative as we have assumed the uplift from these initiatives to impact favorably from FY20, however initiatives will be underway in FY19.

Valuation & Target Price – $0.21 cps

Rolling forward our DCF Valuation and on the back of modest earnings revisions we have increased our DCF valuation and target price increases by 17% to $0.21/share.

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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Additional information is available on request.

Sydney
Level 26, 9 Castlereagh Street,
Sydney, 2000
Ph: +61 2 9263 2700

Melbourne
Level 4, 60 Collins Street,
Melbourne, 3000
Ph: +61 3 8688 9100