

25 August 2011

Molins

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/09	83.8	3.4	10.6	5.0	8.2	5.7
12/10	86.4	3.6	13.1	5.0	6.6	5.7
12/11e	88.0	4.1	14.4	5.0	6.0	5.7
12/12e	90.0	4.2	14.9	5.0	5.8	5.7

Note: *PBT and EPS (fully diluted) are calculated before goodwill amortisation, exceptional items and net financing income/expense on pension scheme balances. EPS fully diluted for LTIP.

Investment summary: The right direction

With underlying interim pre-tax profits doubled from the depressed levels of a year ago and with order books moving strongly in the right direction, Molins looks well placed to face the challenges of the next two to three years. Action has already been taken to tackle a number of recent difficulties and profits look set to move ahead steadily. The size of the pension scheme is seen as a concern, but it has been managed well in recent years and is still in surplus. The shares offer real attractions.

Profits doubled

Interim results show underlying pre-tax profits recovered from £0.8m to £1.7m, despite a 4% reduction in revenues and a slip back into losses by the Packaging Machinery division. A significant increase in the order intake over the half-year, especially in the latter division, encourages us to raise our current year PBT estimate from £3.7m to £4.1m.

Investment continues

Despite the challenging trading conditions, management continues to sustain investment in future progress. In particular, the Scientific Services division has invested in new products and methodologies aimed at meeting the potential longer-term requirements of its customers. We are optimistic that the group can sustain the profits progress into the future.

Balance sheet remains strong

Reversal of last year's favourable movement in working capital ratios was expected. Nevertheless, the balance sheet remains strong with net cash of £6.3m.

Valuation: Undervalued

Molins shares are rated at a 60% discount to that of the major UK based global capital goods manufacturers. A 65% discount to the asset value and well above average yield more than compensate for the less impressive historic record.

Price 87p
Market Cap £18m

Share price graph



Share details

Code MLIN
Listing FULL
Sector Industrial Engineering
Shares in issue 20.2m

Price

52 week High 116p Low 43p

Balance Sheet as at 30 June 2011

Debt/Equity (%) N/A
NAV per share (p) 248
Net cash (£m) 6.3

Business

Molins is a specialist engineering group, involved in the design, manufacture and service of process and packaging machinery, principally used in the tobacco products and FMCG industries.

Valuation

	2010	2011e	2012e
P/E Relative	63%	58%	64%
P/CF	1.4	3.0	2.0
EV/Sales	0.1	0.1	0.1
ROE	6%	6%	6%

Revenues by geography

	US	Other
UK	13%	71%

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Investment summary: The right direction

Company description: Specialist capital goods and services

Molins is a specialist engineering solutions and services business, with the tobacco industry the principal group customer area (62% of 2010 sales). The majority of group skills are aimed at improving the effectiveness of existing customer plant, the monitoring/testing of product quality and the analysis of cigarette smoke. Packaging machinery is supplied to the pharmaceutical and FMCG markets, again with the emphasis on improving the operational efficiency of plant. The recently developed Octave range of Tobacco Machinery has enhanced the product range, but the majority of profit will continue to be generated from working with customers to help raise their returns.

Valuation

Molins' shares are rated at a substantial discount to other global capital goods manufacturers. While we acknowledge that the record and size of such engineers does warrant a lower rating, a 20% rise in the Molins share price would still see the shares at a 50% discount rating. With net assets of 248p and cash of 31p per share and a yield of 5.7% the shares have distinct attractions.

Sensitivities

With some 90% of sales generated overseas, exchange movements are the most obvious sensitivity to earnings; the main manufacturing plants are overseas and shifts in the value of sterling will impact on earnings.

- Molins has established itself as an engineering problem-solving business for customers, reducing some of the impact of the capital goods cycle.
- The impact of forex movements is mitigated by the transfer of manufacturing to lower-cost territories, while forward transactions reduce risks on long-term contracts.
- The group operates substantial earnings-related pension schemes, with aggregate liabilities well in excess of £300m and a gross surplus of £9m.

Financials

- Interim results are ahead of expectations. Despite a 4% reduction in revenues, underlying pre-tax profits doubled from the depressed £0.8m of last year to £1.7m.
- Last year's December cash position was inflated by contract down payments; while net working capital rose by £2.4m, the group balance sheet remained strong with net cash of £6.3m, equivalent to 31p per share.

Exhibit 1: Estimate changes

Note: Figures in £m except per share data.

	EPS			PBT			EBITDA		
	Old	New	% chg.	Old	New	% chg.	Old	New	% chg.
2010	13.1	13.1	N/A	3.6	3.6	N/A	7.0	7.0	N/A
2011e	12.4	14.4	+16	3.7	4.1	+11	7.2	7.6	+6
2012e	13.6	14.9	+10	4.0	4.2	+5	7.5	7.9	+5

Source: Edison estimates; company announcements

Ahead of expectations

The cautious optimism of recent management comments has been borne out by a useful half-year profits recovery. More significantly, there has been a 'significant' increase in the order intake, which bodes well for the second half, despite the challenging trading climate; we are raising our estimates for both 2011 and 2012. Meanwhile, there are net cash balances of £6.3m.

Exhibit 2: Interim results

Note: Figures before exceptional items.

	2011 H1	2010 H1	Change	2010 Full year
	£m	£m	%	
Revenue				
– Scientific Services	9.3	10.0	-7	20.9
– Packaging Machinery	13.7	15.0	-9	32.9
– Tobacco Machinery	15.8	15.3	+3	32.6
	38.8	40.3	-4	86.4
Operating profit				
– Scientific Services	0.9	0.8	+13	2.1
– Packaging Machinery	(1.0)	0.4	N/A	1.0
– Tobacco Machinery	1.8	(0.4)	N/A	0.6
	1.7	0.8	+113	3.7

Source: Company announcements

Interim results for the six months to June 2011 make encouraging reading. Turnover has slipped back by 4% to £38.8m, but underlying operating profits have been doubled from the depressed £0.8m seen in the first half of 2010 to £1.7m. Exceptional reorganisation costs were relatively modest at £0.3m, while the net financing income on pension scheme balances amounted to £2.4m, compared to £1.0m in the first half of last year.

The performance in **Scientific Services** was largely in line with expectations. Cerulean saw a modest drop in revenues, although a more favourable product mix enabled the company to sustain profits – an encouraging order intake suggests a good third quarter and improved profits over the full year. Arista, which is still awaiting a clear indication from the FDA in the US, largely marked time, with profits a little ahead of last year. We suggested in our report last March that it would be difficult for Scientific Services to match its 2010 performance in the current year; we are now hopeful that last year's result can be sustained

The key for both companies, however, is the continued investment in the future, which augurs well for the next two to three years, although it may be 2013 before the real progress begins to emerge. Cerulean continues to invest in the next generation of products, while Arista has invested in the likely testing methodologies that are expected to be introduced shortly in the US.

The disappointment was **Packaging Machinery**, which slipped back into losses following a 9% reduction in revenues. Both of the main businesses experienced a lower than-expected throughput, although the order intake at Langen points to a much improved second half. The small number of relatively large orders always means that profits can fluctuate in the short term to reflect the incidence of contract completions. The difficulties at ITCM may be more prolonged – the levels of enquiries has held up well, but with several customers delaying certain investment projects, expected orders have yet to be placed and losses may continue in the second half.

For the division as a whole, we expect a return to profit during the second half, although the full year figure will almost certainly fall short of the £1.0m earned in 2010. In the current economic climate it is difficult to be confident about the extent to which further orders will emerge next year, but we are hopeful of the recovery continuing.

The improvement in **Tobacco Machinery** seen in the second half of 2010 was sustained with a strong first-half performance in the current year. OE deliveries were sustained, but at better margins, while the mix in service and parts was more favourable, to the benefit of the bottom line. In addition, last year's cost-cutting measures, especially in Brazil, helped profits.

Competitive pressures continue and, although the order intake has been sustained, we expect divisional margins to be lower in the second half.

Estimates raised

The extent of the profit recovery seen in the first half of 2011 is somewhat better than we had been expecting, while the encouraging order intake, especially at Langen, suggests that the seasonal pattern, with higher second-half profits, can be sustained. It is too early for us to look for second half profits at the £2.9m level seen in 2010, but our previous underlying pre-tax target of £3.7m for the full year clearly looks over cautious. On the basis of a minimum estimate of £2.4m for the second half, we have decided to raise our estimate to £4.1m. We remain cautious about the medium term, but there should be further net progress – we are lifting our 2012 target from £4.0m to £4.2m.

Specialist engineering and services group

Scientific services (24% of revenue)

Scientific Services comprises two distinct businesses, supplying quality control and analytical equipment and services to the global tobacco industry.

Cerulean

Cerulean is the larger of the two businesses, supplying specialist measuring instruments and machinery to multinational and regional cigarette producers, independent laboratories and to government bodies. Cerulean works closely with customers to identify industry trends, producing machinery to sustain controls across all stages of the production cycle to deliver a more consistent product. The company's range of analytical smoke constituent capture machinery complements the control equipment, enabling producers and regulatory bodies to assess product parameters.

Cerulean is based in Milton Keynes, with sales offices in Germany, Malaysia, India, the US and China, plus service centres in a further 10 countries. Exports represent more than 95% of revenue with an experienced team of sales/field engineers (30% of the workforce) able to move quickly and effectively to where their services are required.

Arista Laboratories

Arista is a globally accredited independent smoke constituent analytical laboratory business, operating from premises in Richmond, Virginia (US) and Kingston-upon-Thames (UK). It provides a

high-quality analysis of tobacco and cigarette smoke constituents for regulatory, research and product development purposes.

It operates long-term quality assurance and product validation contracts with the major multinational and regional cigarette manufacturers, for which there is a growing overall market to meet the changing regulations in different countries. The majority of the Arista's revenue tends to be generated in the more regulated markets (North America, EU, Brazil), but there is growing interest arising elsewhere.

Packaging machinery (35% of revenue)

Packaging Machinery (MPM) comprises businesses involved in the design and manufacture of innovative, high performance process and packaging machinery. Products are supplied largely to the food manufacturing, personal care, healthcare and other FMCG markets. Engineering skills are fundamental to working with customers to improve the operational efficiency and speed of their process plant.

Langen Packaging Group

Langen Packaging, based in Ontario, Canada and Wijchen, Holland, is responsible for a majority of divisional revenues. It is an end-of-line packaging specialist, designing and producing product-handling, cartoning and case packing machinery. Management of the two operations was merged in 2009.

Each operation has benefited from a pooling of resources on product development and customer relationships. A majority of throughput remains in the form of standard models, but both businesses have responded to a growing customer need for adapted equipment to meet the specific requirements of production lines, especially where production speeds are to be increased. Capabilities are constantly being upgraded and include innovative materials handling and infeed equipment, including the use of robotics. Langen also offers integrated solutions to customer problems, involving turnkey projects.

ITCM

ITCM, based in Coventry, has developed a global reputation for innovative solutions to packaging problems for blue-chip clients in the pharmaceuticals and certain FMCG industries. It works closely with its customer base, frequently building prototypes as part of the engineering process. ITCM has specific skills in the high-speed packing of small quantities of relatively high-value ingredients.

Most contracts are one-offs, although batches of machines will occasionally subsequently be manufactured. Certain development work tends to be funded by customers; hence ITCM does not always own the patents for the processes it develops, but the skill-base remains to solve problems for other customers. ITCM has won numerous industry/customer awards over the past five years, in recognition of its innovative skills.

Cerulean Packing

Cerulean Packing is a successful offshoot of the group's main Scientific Services business, designing and manufacturing tube packing machinery.

Tobacco machinery (41% of revenue)

Molins Tobacco Machinery (MTM) is the original core business of the group, but has required considerable restructuring in recent years to remain competitive in a mature and consolidating market, where the multinational cigarette producers have been progressively raising global market share. The restructuring has involved the transfer of virtually all of the machining and manufacturing operations to group subsidiaries in the Czech Republic and Brazil, while other components are sourced globally. Business relationships are held both in the centre and in a network of regional offices, with specialist teams of field engineers; faster moving parts are held in the regional offices, supplemented as appropriate from the main warehouse in the UK.

The main source of profit tends to be the supply of spare parts and the servicing/rebuilding of machinery, although MTM has responded to the steady erosion of its core customer base (regional tobacco companies), with the development of Octave, a new range of original equipment (OE). Octave may not match the ultra high speeds of the equipment supplied to the multinationals, but is readily adaptable to the specific requirements of its customers, providing significant improvements to existing production and efficiency levels.

Demand for rebuild activity can be quite varied, but can involve the total overhaul of an existing production line, including stripping machinery down to base castings, with faulty parts automatically replaced and control systems updated to match the latest techniques. Specific aspects of the plant will also be rebuilt, with a view to clearing a bottleneck in the customer production line.

Sensitivities

Macro issues — while Molins is a capital goods manufacturer, the high level of turnover related to the tobacco industry (62% of sales) includes substantial revenue in the form of rebuilds, specialist services and spare parts. Such demand is more related to the use of manufacturing plant rather than the fluctuating confidence of manufacturers. Much of the machinery parc comprises mature and upgraded plant, for which there is a constant need for servicing and, hence, spare parts. Packaging Machinery sales tend to be more cyclical, though the impact is again mitigated by supplying engineering solutions to manufacturing bottlenecks within industries where demand is fairly inelastic. In Scientific Services, Arista's US business will be subject to the timing of the introduction of new disciplines under the auspices of the FDA. Recent economic turbulence leads to low order book visibility and potential cancellations.

Foreign exchange — with only 13% of group sales generated in the UK, exchange movements can be material to group profits, especially the inter-relationships between sterling, the Brazilian real, and the Canadian and US dollars. Manufacturing facilities are in a number of countries, including Canada, Holland, the Czech Republic and Brazil; parts are sourced from a number of countries, including Russia. Where appropriate, especially with long-term contracts, the group undertakes forward currency transactions to minimise risks.

Aftermarket competition — there is a large installed base of Molins machinery across the world, providing a substantial spare parts business. Part of this market is supplied by third-party parts manufacturers. However, the majority of higher specification parts continue to be supplied by

Molins, while many multinational tobacco companies and leading regional players demand an efficient logistics operation, which can rarely be provided by the smaller operators.

Pensions – the group operates a substantial defined benefit pension scheme in the UK and three small schemes in the US, with aggregate liabilities of £328m at June 2011. Following an agreement with the UK trustee to use the CPI measure of inflation, there was a nominal combined surplus, under IAS related calculations at that date, of just £9.2m before taxation. The overall figures are large in relation to shareholders' funds of just £50m, and any sharp shift in either underlying asset valuations or the criteria for assessing liabilities can have a disproportionate impact on the group balance sheet. In response to the 2009 actuarial valuation, the group will pay £1.2m per year as part of an agreed deficit recovery plan. The weakness in global stock markets since the end of June will not have helped calculations, but the agreement with the trustees is comfortably manageable.

Valuation

It is difficult to find suitable comparators for Molins, largely because most of the smaller UK based global capital goods manufacturers have either gone out of business or been taken over. The size of the pension scheme is undoubtedly a factor in Molins remaining independent, while the trading record has not been consistent in recent years. However, the current discount rating, the high yield (5.7%), net assets of £50m (248p per share) and net cash of £6.3m (31p per share) all offer considerable attractions.

Peer group comparison

In our report published in March we compared the rating of Molins to Rotork, Spirax Sarco and Weir Group. While each business has an enviable record over a number of years, with a global market supported by a strong service and parts operation, they are materially larger than Molins. Despite the recent stock market weakness, the average prospective rating across the three companies is a forward looking 14.6x and 13.1x for 2011 and 2012.

We obviously do not suggest that a similar rating can be justified for Molins in the foreseeable future, but the prospective 6.0x and 5.5x, based on our estimates make interesting comparison. For example, a 20% increase in the Molins share price would still leave the shares on half the rating of these major global engineers.

The FTSE sector rating for engineers is also on a significant premium to that of Molins at 12.0x and 11.1x for 2011 and 2012.

Exhibit 3: Financials

Year end 31 December	£'000s	2008	2009	2010	2011e	2012e
		IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS						
Revenue		91,500	83,800	86,400	88,000	90,000
Cost of Sales		(67,700)	(59,700)	(63,100)	(62,000)	(63,000)
Gross Profit		23,800	24,100	23,300	26,000	27,000
EBITDA		6,200	6,600	7,000	7,600	7,900
Operating Profit (before GW and except.)		3,000	3,500	3,700	4,100	4,200
Amortisation of development expenditure		(1,200)	(1,300)	(1,500)	(1,500)	(1,500)
Exceptionals		1,700	(400)	(1,600)	(300)	0
LTIP		0	0	0	0	0
Operating Profit		4,700	3,100	2,100	3,800	4,200
Net Interest (including pension scheme)		4,100	(1,000)	2,000	5,000	5,000
Profit Before Tax (norm)		2,300	3,400	3,600	4,100	4,200
Profit Before Tax (FRS 3)		8,800	2,100	4,100	8,800	9,200
Tax on normalised earnings		(200)	(1,200)	(1,000)	(1,200)	(1,200)
Tax on other items		(1,900)	300	(200)	(1,800)	(1,800)
Profit After Tax (norm)		2,100	2,200	2,600	2,900	3,000
Profit After Tax (FRS 3)		6,700	1,200	2,900	5,800	6,200
Average Number of Shares Outstanding (m)		19.0	19.0	19.0	19.0	19.0
EPS - normalised (p)		10.9	11.3	13.9	15.3	15.8
EPS - normalised fully diluted (p)		10.3	10.6	13.1	14.4	14.9
EPS - FRS 3 (p)		35.2	5.8	15.3	30.6	32.7
Dividend per share (p)		5.0	5.0	5.0	5.0	5.0
Gross Margin (%)		26.0	28.8	27.0	29.5	30.0
EBITDA Margin (%)		6.8	7.9	8.1	8.6	8.8
Operating Margin (before GW and except.) (%)		3.3	4.2	4.3	4.7	4.7
BALANCE SHEET						
Non Current Assets		31,200	28,300	36,100	40,800	44,300
Intangible Assets		14,900	14,100	13,800	13,500	13,200
Tangible Fixed Assets		10,600	10,200	10,500	10,500	9,300
Others		5,700	4,000	11,800	16,800	21,800
Current Assets		47,100	46,000	45,000	45,800	48,961
Stocks		17,100	18,100	15,600	16,000	16,319
Debtors		22,200	17,600	15,600	18,000	18,395
Cash		7,200	10,200	13,800	11,800	14,248
Other		600	100	0	0	0
Current Liabilities		(25,600)	(23,200)	(21,100)	(21,900)	(22,961)
Creditors		(25,300)	(23,200)	(21,100)	(21,900)	(22,961)
Short term borrowings		(300)	0	0	0	0
Long Term Liabilities		(12,500)	(19,800)	(12,900)	(14,700)	(16,500)
Long term borrowings		(7,300)	(5,200)	(4,800)	(4,800)	(4,800)
Other long term liabilities		(5,200)	(14,600)	(8,100)	(9,900)	(11,700)
Net Assets		40,200	31,300	47,100	50,000	53,800
CASH FLOW						
Operating Cash Flow		(2,500)	8,200	12,100	5,500	8,248
Net Interest		(700)	(100)	100	0	0
Tax		(700)	(200)	(700)	(1,200)	(1,300)
Capex		13,200	(1,100)	(4,000)	(3,000)	(2,000)
Acquisitions/disposals		0	0	0	0	0
Financing, discontinued, reorganisation & pension deficit		0	0	(2,200)	(2,300)	(1,500)
Dividends		(1,500)	(1,000)	(1,000)	(1,000)	(1,000)
Other		(600)	(400)	(300)	0	0
Net Cash Flow		7,200	5,400	4,000	(2,000)	2,448
Opening net debt/(cash)		7,600	400	(5,000)	(9,000)	(7,000)
HP finance leases initiated		0	0	0	0	0
Other		0	0	0	0	0
Closing net debt/(cash)		400	(5,000)	(9,000)	(7,000)	(9,448)

Source: Company accounts/Edison Investment Research

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