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Aryzta AG – Take up Your Rights

9th Nov 2018

Introduction

The massive and deep-discounted Aryzta rights issue has been announced and investors have only days to respond. Our understanding is that Irish-based investors can take up their rights until next Wednesday. If you own Aryzta shares you should instruct your broker to take up the rights on your behalf without delay. If you do not take up your rights they will be sold in the marketplace, but you will not receive any on the excess over the CHF1 issue price (Swiss law is different to Irish law in this regard). We have heard that an Irish-based stockbroker has been recommending not taking up the rights. We do not believe that this constitutes sound advice and would ignore it.

The Aryzta Investment Case

While we never formally covered Aryzta AG for subscribers, in Weekly Newsletter dated 11th August last we discussed the Aryzta AG investment case and titled it 'Value or Value Trap'. At the time, we suggested subscribers who were attracted to the potential turnaround story in Aryzta should wait for the upcoming fund raising that the company had signaled was on the way. It's now clear that this was the right call at the time.

Aryzta is raising a gross €790 million (CHF900 million) with the issue of 900 million new shares at CHF1 each (one Swiss Franc each). It represents a 10 for 1 rights issue given that there were just 90 million shares in issue prior to the rights issue, and there will be 990 million shares in issue post the rights issue.

Aryzta AG - Valuation Post Rights Issue	
No of Shares in Issue (million)	991
Current Price	€1.25
Market Valuation (million)	€1,239
Capital Employed (net of goodwill)	€1,410
Market Value / Capital Employed	0.88
Discount to tangible assets	12%
Kerry Group (MV/CE)	8.7

The table opposite highlights Aryzta's valuation compared to its asset base post the rights issue. It often helps to looks at a company's valuation from the asset side (or balance sheet side) when there is an earnings hiatus, as there currently is at Aryzta.

The group has a market value of €1.24 billion post the rights issue and this compares to the capital employed in its business of €1.41 billion (excluding all goodwill). By excluding goodwill, we are, in effect, looking at replacement cost of the existing assets. So, Aryzta's shares are trading at 0.88 times the assets in the business or a 12% discount to the likely replacement cost of these assets.

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Kerry Group shares, by way of a comparative example, trade at 8.7 times the capital employed in its business (also excluding goodwill). Kerry will always deserve a higher valuation compared to the majority of companies due to its pricing power, leading market positions, global spread and growing markets. But we hope the comparison serves to highlight that, all other things being equal, Aryzta's shares offer significant potential upside from here. Valuation risks, then, are minimal.

Next up is a look at the residual financial risks. At year end (31st July 2018) Aryzta's net debt was €2.27 billion. Post the net rights issue proceeds of €0.75 billion, net debt reduces to €1.52 billion.

Aryzta - Debt Profile	31-Jul-18 €m
Cash balanaces	520
Short-term Debts	-260
Long-term Debts	-1,770
Traditional Debt	**-1,510**
Hybrid Equity	-760
Total Debt	**-2,270**

Aryzta has flagged that it will look to sell its 49% interest in Picard, the non-core French business-to-consumer producer of premium specialty foods. Picard is performing well and has a carrying value of €420 million on Aryzta's balance sheet. If we assume that Picard generates €350 million for the group when sold on a, say, 3-year view, group debt reduces to €1.17 billion.

Of that €1.17 billion, the Hybrid Equity accounts for €0.76 billion. The Hybrid Equity instruments are similar in nature to perpetual preference shares; they have no repayment date and interest due on them can be deferred. Hence, traditional debt is more like €0.41 billion if we assume the disposal proceeds from Picard are almost inevitable at some stage. Earnings before interest, tax and depreciation in the year to July 2018 were €0.31 billion. On the face of it, financial risks now look low. That said, they are not non-existent as much depends on the group generating cash flow to keep lenders and customers confident.

On the business risks, looking over management's presentation following the release of full-year results in September (available on the website) and after discussions with the analyst in Davy (Cathal Kenny), the key issues have been (i) turnover lost due to competing with customers (following the Cloverhill purchase, but since sold) which has resulted in an under utilisation of capacity and an under-absorption of overheads, thus lowering gross margins (ii) an increase in employee costs beyond those needed to match inflation and therefore not easily recoverable from customers and (iii) a lack of recovery of increases in transport and raw material costs. In essence, operational management failed. None of these problems look insurmountable, and there was evidence in the full-year results that things have at least stabilised.

The risk/reward balance in the Aryzta turnaround is highly attractive, but the business must be turned around. In that regard, it's worth looking at the quality of the underlying business (ignoring the operational issues).

Aryzta has a leading global position as a business-to-business provider of frozen par-baked savoury products, breads rolls, and artisan breads (57% of revenues) and sweet-baked

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and morning goods (43%). It supplies the large retailers (33% of revenues), quick service restaurants (27%), other food service providers (29%) and retail multiples and convenient stores (11%). Aryzta acts, in effect, as an outsourced service providing a quality, reliable and efficient service at scale.

These are key differentiators for a business like Aryzta. The group is a key supplier of buns globally to McDonalds. And in Europe key customers include the likes of Aldi and Lidl. Aryzta tends to be embedded in a company's supply chain, and the relationship between Aryzta and its customers tends to be symbiotic in nature, and both parties need it to work. In that regard, cost increases outside Aryzta's control (wage inflation, transport costs and raw material cost increases) can normally be recovered from the client, if not immediately then with a lag.

Tailwinds for growth at Aryzta include an increasing trend towards on-the-go snacking, better-for-you indulgence and a broadening of flavour profiles. In emerging markets, growing consumer incomes are leading to a demand for higher quality products, western tastes and local specialisation. All in all, while the sweet-baked goods side of the business is unlikely to be in tune with the current 'healthier eating' trends, Aryzta's basic business is sound.

While operating margins were virtually zero in the year to July 2018, EBITDA margins were just under 9% (earnings before interest, tax and depreciation). Management now has the money to repay some bank debt, to rationalise plants and reduce headcount (involving redundancies and other costs). Management also has to recover the industry-wide increase in wages, transport and raw material costs that it failed to recover over the past few years. An important part of the turnaround is at least stable revenues (they have been declining), but good customer relationship management should see to that and, indeed, there is already evidence that turnover has stabilised.

Looking back, Aryzta is a case of too many debt-financed acquisitions, a loss of focus and a lack of management depth to ensure sound operational control.

Summary View

There's a good business in Aryzta and margin recovery looks very achievable. But, at this stage, business risks remain. Buying Aryzta's shares today is a bet that the new management team succeeds in repairing margins and in arresting the decline in revenues. Should they succeed, the share price is likely to be a multiple of the current price on a 3-year view. Should management fail, debt could still wipe out the remaining equity. But we like the risk/reward ratio. The GM Fund did not have a holding in Aryzta prior to the rights issue but is building a *circa* 2% position during the rights issue period. We won't be including Aryzta in the Lump-sum Growth Portfolio so subscribers need to make up their own mind on it.

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