Update

25 June 2015

Electrical Equipment

Volex

83p

Transformation complete; focus on delivery

- **FY'15 results were in-line with expectations for revenue; marginally ahead for profitability and materially ahead in terms of cash-flow and net cash. This was achieved despite H2 client volatility, primarily within Data, and speaks to the progress achieved through the Volex Transformation Plan. Although there is further to go in terms of operational execution, management have drawn a line in the sand regarding the substantive re-organisation of the group and we now expect a substantial reduction in exceptional restructuring costs. Volex has now moved into the delivery phase of its recovery and we take a great deal of comfort from the deeper customer reach demonstrated in these results as well as the better than expected balance sheet performance. The share price has staged an encouraging recovery from the lows earlier in the year, reflecting improved investor confidence in the outlook.**

- ### FY'15: A good year that could have been even better

The good headline performance in FY'15 was achieved despite a number of challenges, not least key customer volatility in Data. The ability to protect gross margins and achieve some significant new customer wins and revenue growth speaks to the progress made in delivering the key outcomes of the Transformation Plan.

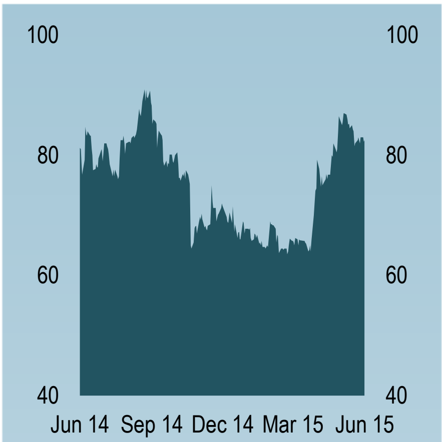
- ### Changes to estimates: potential H1 weakness with good potential for upside

Despite the good FY'15 performance, management have struck a cautious tone about the near term prospects, particularly for H1 FY'16E. Much of what the Transformation Plan has achieved has been to make group profitability more resilient in the face of customer volatility (as witnessed by three consecutive half years of gross margin expansion) which is a natural function of the group's end markets. FY'16 will see a number of new product launches from the group's largest customer and the timing of those launches and the accompanying volumes are outside of management control. We believe this is likely to be a timing issue at worst and have reflected this by bringing back our expectations for Power, whilst upgrading Data. The net effect is revenue line largely unchanged and a 13% reduction in FY'16E EBIT. This is a cautious stance and there remains a strong possibility that Power performance could be better. The better than expected FY'15 cash-flow performance has fed into a material improvement in our net cash estimate for FY'16E.

- ### Valuation and catalysts

At the current £:$ exchange rate, Volex is trading on a FY'16E PE of 17.7x and an EV/EBITDA of 6.5x. The steepness of the medium term earnings recovery curve suggests a PEG of c.0.6x, which coupled with an improving balance sheet suggests further good recovery potential in the absence of any significant customer shocks.

Year to Mar	Revenue ($m)	EBITA ($m)	Adj PBT ($m)	Adj EPS (c)	Net Cash ($m)	EV/EBITDA (x)	P/E (x)
FY15a	423.4	8.8	6.2	2.8	1.9	7.2	46.2
FY16e	444.6	12.2	10.2	7.4	(0.0)	6.5	17.7
FY17e	469.7	17.2	15.2	12.5	9.8	4.4	10.4



TIDM	VLX
Market cap (£m)	73.0
Net debt (FY1, US$)	0.0
Free float (%)	100%
Avg daily volume (3m)	75k
Broker	Investec
Listing	Full

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Investment Case

- Volex, at the most basic level, remains a turn-around story. The new management team have articulated a clear strategy for restoring the group to historic levels of profitability. The Volex Transformation Plan is now substantively complete resulting in a return to both revenue growth and margin expansion. Much has already been achieved below the surface in terms of group structure, process and commercial culture and now the focus lies on continuing improvements.

Short term multiples are not a fair reflection of the continuing recovery potential

- In our view, the current valuation is not fully reflective of the depressed level of earnings and investors will need to look through to where Volex could be in the medium term. History is a good guide here, with the group generating PBT/EPS of $22.9m/$28.3c as recently as FY10. Fundamentally, there is no reason Volex should not reaching or exceeding these levels in the future. However, the issues experienced in FY13 were significant and although management have achieved much in building a more robust and less risky platform for supporting future growth, there still remains more to go for.

The Volex platform is fundamentally strong

- Management do have a number of factors working in their favour.

  - Volex is a leading player in its space with an impressive customer base made up of large OEMs. The manufacturing base is geographically diverse and a key competitive advantage for the group.

  - The business is well invested. FY'13 saw the peak of a significant capital investment programme which included the expansion and upgrading of two of the group's key manufacturing plants. Volex now enjoys significant latent capacity, which will allow the group to service materially higher volumes without further need for expansionary capital investment.

  - There are a number of new sales and geographic opportunities, which are being prioritised by management. Coupled with a renewed focus on key account management and a higher level of local sales autonomy, these should enable the group to target higher levels of utilisation from a more diverse and less volatile customer base.

Customer volatility is a fact of life for Volex but the ability to mitigate the effects is the key measure of success

- However, challenges clearly remain. The Volex business model is highly operationally geared, particularly with current profitability still below historic levels. The H2 FY'14 and FY'15 performance suggest strongly that a corner has been turned, especially in terms of global customer breadth and gross margin protection. Volex remains, and is likely to remain exposed to a number of key customers, so a degree of volatility will always be part of the mix. The ability of the group to deliver revenue and especially margin expansion in spite of natural volatility is the key measure of the effectiveness of management actions.

- The $30.3m FY'14 equity fundraise; alongside the renewal of the group's banking facilities, had already gone a long way to de-risking the investment case. FY'15 cash-flow performance was also ahead of expectations suggesting management how have a more solid and flexible financial platform underpinning commercial execution.

Indications continue to be positive

- Indications are that the transformation plan has achieved the primary aims, the key outcome being enhanced margins on a more stable and visible revenue base moving forward. In a fast moving, price sensitive market place the focus on moving Volex closer to its customers, whilst optimising internal efficiency, is intended to maximise Volex's ability to capture and sustain growth.

FY'15 final results

FY'15 was a good year for Volex

Overall, FY'15 was a good year for Volex with revenue in line with expectations; profit / EPS marginally ahead of expectations and net cash well ahead. Perhaps the only real sense of disappointment comes from the Data division where larger customer volatility denied Volex the opportunity to beat estimates to a greater extent.

Volex has also taken this opportunity to clarify elements of its segmental reporting. Previously, group central costs had included a number of cost lines (mainly relating to human resources and IT) which were actually managed and delivered at the divisional level. Although there is no impact to the group bottom line, the old classification had the effect of flattering segmental EBITA margins whilst over inflating central costs, which by definition should be more fixed than variable. The re-allocation, although requiring investors to work harder to look through the year on year and half year comparatives, will paint a more accurate picture of divisional margins.

During FY'15, the Internal Cable Assembly business was transferred from the Power division into Data. This business generated $13.2m revenue and $1.2m of gross profit in FY'14 and the impact has been fully factored into the y / y comparatives outlined below.

Power

Revenue $273.7m (+8.5%), EBITA $5.4m (+390%), Margin 2.0% (+160 bps)

Volex has resolved many of the historic issues in this division, not least with the group's largest customer

The prime driver behind the headline revenue performance was the performance of the Top 3 customers, who collectively delivered revenue growth of 14.7%. Outside of the Top 3, Volex was able to successfully able to re-engage with a number historic OEM customers; that this was achieved at equivalent levels of gross margin suggests that pricing alone was not the only factor. This outcome was a key deliverable of the Transformation Plan, which prioritised re-establishing customer proximity and pursuing a far more rigorous "design to cost" methodology. Increasing emphasis on product safety and reliability was also instrumental a number of the allocations.

On the less positive front, many Japanese consumer focused OEM's are continuing to struggle with competition from South Korea and Japanese revenues declined by c.19%. There is little indication that this longer term trend is likely to change anytime in the near future.

Copper, the primary raw material cost, continued to see significant price falls through FY'15 (declining on average by 7.5%). However, this was not a significant contributor to the overall segment gross margin improvement (+20 bps to 13.4%) due to the speed of customer pass through and the group's forward hedging strategy. The increase was driven primarily by a positive sales mix effect.

Margin expansion is unlikely to be dramatic but is still likely to be positive

The 160 basis point improvement in the EBITA margin to 2.0% was due to a combination of gross margin expansion and continuing operating cost control, where divisional operating expenses (under the new classification) declined by $0.8m to $31.4m.

Outlook

The near term outlook is more cautious although this is primarily due to customer timing issues

Although there have been significant improvements across the board in this division, there is a note of caution regarding the near term outlook. FY'16E is likely to be impacted by the timing and volume implications of a series of high profile product launches from the division's largest customer. Volex has made considerable progress in re-engaging and achieving better allocations from this customer over the last 18 months and this leaves the company well positioned to benefit from new volume opportunities. However, the timing of launches and the likely introduction of new generation power connectors are largely out of Volex's immediate control. As a result, management are rightly cautious about assuming too much for FY'16E relative to FY'17E and we have bought our expectations back accordingly. In mitigation, we do note the increased capital expenditure for FY'16E, which relates to new tooling investment to support the anticipated new volume opportunity and the commentary regarding new customer wins outside the Top 3 where volumes did not impact fully in FY'15. Overall, it would seem that FY'16 is likely to see a H2 revenue bias.

Data

Revenue $149.8m (+1.2%), EBITA $11.2m (+13.1%), Margin 7.5% (+80 bps)

Data had a good year that could have been even better

Despite the solid headline revenue performance, combined with good margin expansion, FY'15 was a challenging year for the Data business, H2 in particular. On the positive side, revenue growth from outside the Top 3 customers was an impressive 24%. Also, divisional gross margins were able to increase (+30 basis points), pointing to the robustness of pricing and the higher level of inherent value add engineered into Data products relative to Power.

On the less positive front, Data was impacted by volatility in the Top 3 customers (which in aggregate saw revenue decline by 8.9% y/y). One of these clients was impacted by an enforced North American manufacturing plant closure (subsequently re-opened), whilst another in the Telecoms sector was impacted by heightened competition. However, in all cases, the Volex share of customer spend remained stable.

Outlook

With order cycle visibility relatively short (less than 3 months in many cases), the outlook remains unclear and management are understandably cautious in their assessment of likely outcomes for FY'16. In the company's favour is the fact that for one of the clients, the issue looks to be temporary rather than permanent and there is every possibility for return to historic volume levels. There is also a clear geographic opportunity with 87% of the Data business sourced from North America and Europe. Leveraging the broad commercial and manufacturing infrastructure Volex enjoys in Asia Pacific is therefore a key short and medium term opportunity for Volex.

Volex has been successful in winning new customers, helping to offset volatility elsewhere

There are reasons to be optimistic for the outlook. The short term issues facing one of the largest customers has now been largely resolved and there is a reasonable expectation for a resumption of volumes. Elsewhere, the growth from the smaller clients (from a relatively low base) has been highly encouraging and will continue to help offset volume volatility elsewhere. Looking further out to the medium term, management see the potential for further margin enhancement with 10% EBITA margins a realistic aspiration.

Exceptional Costs

FY'15 $12.5m vs FY'14 $11.6m

FY'15 should represent the last year of material operating exceptional charges

With Volex Transformation Plan now substantively complete, FY'15 marks the final year of material operating exceptional items relating to the restructuring programme. Within the FY'15 charge of $12.5m, there are a number of different items:

- The largest element is $5.8m (FY'14: nil) relating to the impairment of the carrying value of capitalised development costs and goodwill of two historic product development projects which have been discontinued and are unlikely to become commercially active. This is a non-cash item and was previously announced at the half year.

- Operational restructuring costs of $3.6m (FY'14: $3.7m) driven by reductions in direct and indirect manufacturing headcount and the streamlining of certain mid-tier management functions.

- Senior management restructuring costs of $0.7m (FY'14: $4.9m), relating primarily to the change in CFO and investment in the Data management team.

- Elsewhere $2.5m of various further costs (FY'14: $3.7m) relating to onerous property leases, one-off IT investments and due diligence costs.

FY'15 also saw a share option charge of $0.9m being recognised as opposed to the $2.3m credit recorded in FY'14.

Cash-flow & Balance Sheet

FY'15 net cash $1.9m vs FY'14 net debt of $32.2m

Operating cash-flow saw a marked improvement in FY'15 with an in-flow of $7.8m (FY'14 out-flow of $11.1m), driven primarily by increased profitability, a decline in the cash-cost of restructuring and an improvement in working capital.

Working capital management has improved significantly

Overall, tight working capital management (the inventory increase was more than offset by an increase in creditors) saw $4.9 released from working capital in the year, compared to a cash absorption of $8.7m in FY'14. Although more efficient use of working capital was one of the targeted outcomes of the Transformation Plan, we would not assume further material releases from working capital and have modelled small cash out-flows in future years in line with our revenue growth assumptions.

Elsewhere, capital expenditure was $3.9m, down $4.3m on FY'14, due to an absence on capacity investment (the current capex cycle peaked in FY'13, with an element of planned expenditure falling into FY'14). The majority of current capital spending relates to machinery tooling, which is normally aligned with customer order activity. The guidance for FY'16 is for an increase in capital expenditure to c. $10m-$12m as a result of a likely increase in tooling costs.

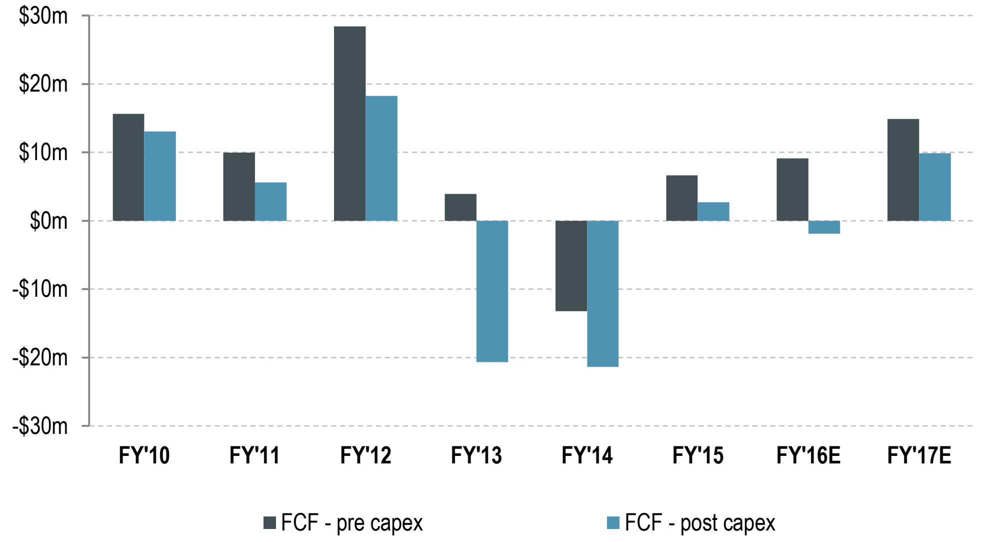
FY'15 year end net cash was $1.9m, substantially ahead of expectations (we had been looking for net debt of $9.9m). That this is a very positive outcome should not be underplayed. However, it is worth caveating that Volex remains a high volume, relatively low margin business and as such, subject to working capital swings, which can be as high as $15m on an intra-month basis, underlining the importance of the bank facility renegotiation that took place alongside the $30m equity fundraise in July 2014.

Under the new facility arrangements, Volex has a revolving credit facility of $45.0m, with current undrawn headroom of $10.2m ($25m is drawn against the RCF, $7.5m is drawn as effective overdraft and c.$2.5m guaranteeing letters of credit). Offsetting the debt facilities are separately held gross cash balances of $33.7m.

Volex is a cash generative business and we expect the overall balance sheet to continue to de-lever

The key point here is that despite the headline net cash position recorded at the year end, we would continue to expect the group to incur a net finance cost in the P&L as the facility remains drawn and this is reflected in our estimates. It is also worth noting that (subject to changes in annual capital expenditure, for which we have modelled c.$11m in FY'16E and $5m in FY'17E), we expect Volex to be generating positive free cash-flow, which will further de-leverage and de-risk the balance sheet. In Figure 1 below, we show the Volex free cash generation track record, pre and post capex but before finance activities.

Figure 1: Free Cash-flow track record, pre and post capex, FY'12 to FY'17E



Source: Volex PLC, Broker Profile

Completion of the Volex Transformation Plan

A key highlight of FY'15 was the substantive completion of the Volex Transformation Plan. In total (and here we exclude the intangible asset impairment charge recognised in FY'15), the cost incurred was $13.8m. What has been achieved?

- **Restoring revenue growth.** At a simplistic level, this answer would seem obvious with both Power and Data delivering headline growth in FY'15, following three consecutive years of decline. However, the underlying picture is more complex, with prior year revenue levels inflated by an effective over exposure to one particular client at a particularly steep point in the growth curve. The real challenge was addressing the visibility, quality and depth of the sales pipeline in order to de-risk (as far as possible) and optimise the gross margin mix. Against this context, the real highlights of FY'15, in our book, were; the gross margin uplifts in both Power and Data (both set against very different sales dynamics); the ability of Data to generate growth despite the weakness in the Top 3 customers; and finally, the restoration of the largest Power customer to growth.

- **Customer engagement.** The progress outlined above is largely due to a substantial re-organisation and investment in the group sales and engineering infrastructure. This involved the creation of four new sales regions and to ensure a closer integration between sales and engineering and a closer focus on both customer requirements and account management. The greater devolution of sales responsibility at a regional level was also intended to allow the local manufacturing presence greater responsibility for local sales; where incremental capacity utilisation can have a beneficial impact on margins.

- **Supply chain.** The emphasis was not solely on the driving down of input costs (although there have been direct cost improvements) but also to allow Volex to more quickly align the supply chain with customer pricing and volume changes. This was a key area where the historic Volex model had come under pressure, with the company experiencing considerable gross margin deflation between FY'12 and FY'14 (gross profit declined 35% over this period compared to a 23% decline in revenue). The supply chain improvements have involved a re-structuring of the group's direct procurement and a steady adoption of multi-sourcing (in effect mirroring how Volex itself engages with its OEM customers). Although investors only have three half years to go on, Volex has now recorded a consistent run of year on year gross margin increases. Taken in conjunction with the keener focus on sales mix, this suggests that a key corner has indeed been turned.

Changes to estimates

We have incorporated the new segmental cost classification into our estimates. Although our revenue mix assumptions have changed (Power revenue estimate down 5.7%, Data up 11%) our headline FY'16E estimate of $444.6m is broadly unchanged (previously $446.1m). However, caution relating to the potential timing of certain Power volumes has resulted in a 13% reduction in our FY'16E EBIT. We continue to expect stable gross margins across both divisions and some further direct cost reductions within Power. Despite an increase in our capex assumption for FY'16E (now $11m vs $6.6m previously) we expect the cash-flow performance to continue to improve and now look for a flat $0.0m compared to our previous expectation of $7.0m net debt.

Financial Summary – Year ended 31March

INCOME STATEMENT, US $m	FY13A	FY14A	FY15A	FY16E	FY17E
Power Cables	310.6	252.2	273.7	287.3	304.6
Data	162.5	148.0	149.8	157.2	165.1
Revenue	**473.2**	**400.2**	**423.4**	**444.6**	**469.7**
Power Cables	11.9	1.1	5.4	8.0	11.6
Data	9.1	9.9	11.2	12.1	14.0
Central costs	(8.7)	(6.4)	(7.8)	(8.0)	(8.5)
Group EBIT	**12.3**	**4.5**	**8.8**	**12.2**	**17.2**
Exceptional items	(8.0)	(11.6)	(12.5)	(1.0)	(1.0)
Share based payments	(0.2)	2.3	(0.9)	(3.0)	(3.0)
Net interest	(2.3)	(2.7)	(2.6)	(2.0)	(2.0)
Reported PBT	1.9	(7.6)	(7.2)	6.2	11.2
Adjusted PBT (pre share options)	**10.1**	**1.2**	**6.2**	**10.2**	**15.2**
Tax - reported	(2.8)	(6.6)	(3.5)	(3.5)	(3.9)
Average no shares - diluted (m)	57.7	59.8	83.8	90.2	90.2
EPS - Reported, basic (c)	(1.6)	(22.6)	(12.8)	2.9	8.0
EPS - Adjusted, diluted (c)	10.9	(8.6)	2.8	7.4	12.5
DPS (c)	5.0	0.0	0.0	0.0	0.0

CASH FLOW, £m	FY13A	FY14A	FY15A	FY16E	FY17E
EBITDA	18.3	12.5	16.0	18.2	24.2
Working capital	3.2	(8.7)	4.9	(3.0)	(3.0)
Other	(9.4)	(12.0)	(8.2)	(1.0)	(1.0)
Operating cash flow	12.0	(8.2)	12.8	14.2	20.2
Net interest paid	(1.8)	(1.7)	(2.4)	(2.0)	(2.0)
Net tax	(3.9)	(1.2)	(2.6)	(1.8)	(2.0)
Net capital expenditure	(27.2)	(10.4)	(5.2)	(12.3)	(6.4)
Net acquisitions / disposals	0.0	0.0	0.0	0.0	0.0
Other	(0.0)	(0.1)	(0.4)	0.0	0.0
Pre financing cash flow	(20.8)	(21.5)	2.1	(1.9)	9.9
Dividends	(2.8)	(0.7)	0.0	0.0	0.0
Net equity issued	0.4	11.1	28.4	0.0	0.0
Net movement in debt	5.9	1.1	(18.0)	0.0	0.0
Net change in cash	(17.4)	(10.1)	12.5	(1.9)	9.9

BALANCE SHEET, £m	FY13A	FY14A	FY15A	FY16E	FY17E
Goodwill	2.9	3.2	2.9	2.9	2.9
Intangible assets	4.1	5.4	1.4	2.5	3.5
P,P & E	39.7	38.7	35.2	40.4	38.7
Other	0.0	0.0	0.0	0.0	0.0
Fixed assets	46.8	47.4	39.5	45.8	45.1
Net working capital	18.4	21.6	13.1	14.4	15.4
Total capital employed	65.1	68.9	52.6	60.2	60.5
Net cash / (debt)	(19.5)	(32.2)	1.9	(0.0)	9.8
Net Assets	45.6	36.7	54.5	60.2	70.4

Source: Broker Profile

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