Norcros 18/07/2013 **FAT-UK-496**

NXR GBP £0.160 Special **HIGH** **B**

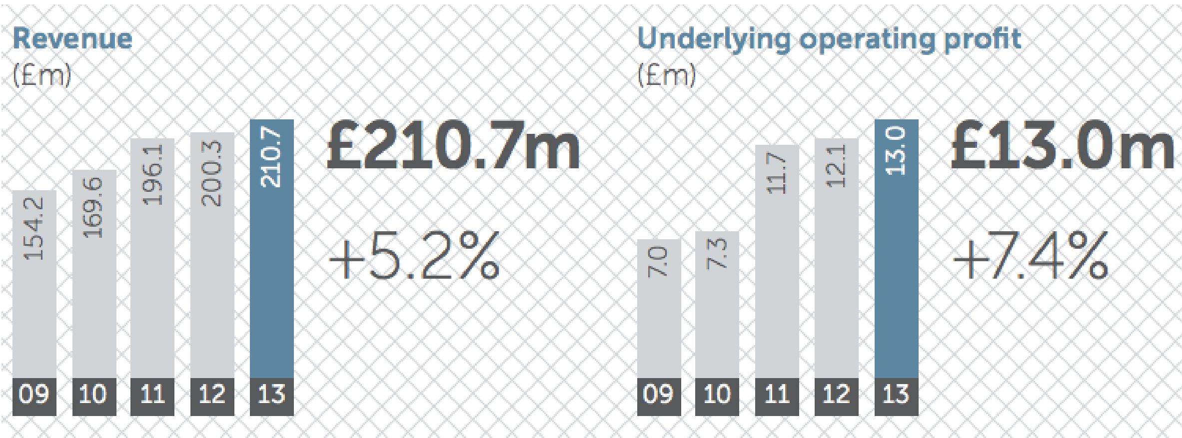
Norcros goes for growth as construction recovers

We reviewed the UK construction sector in early June, which is returning to growth as home building picks up. This will boost demand for Norcros which makes Triton showers, Johnston tiles, Vado taps and Norcros Adhesives. With a new strategy aimed at faster growth and a low valuation we rate the stock as a buy.

The floatation of Norcros plc on the London Stock exchange in July 2007 could have been better timed. The shares opened at 88p, having been placed at 78p, and slumped to 4.38p less than two years later as the downturn took hold.

However, the group's recovery looks to be firmly on track today with revenue and profits increasing in each of the last four years. The group has also recently bought the Vado taps business (March 2013) as part of its new growth strategy.

Norcros sees four years of progress



Within the UK construction sector, it is homebuilding that is driving overall growth as civil engineering and commercial building are both weak. Norcros is, in our view, a good play on housing given its position in linked products such as tiles, showers, adhesives and taps.

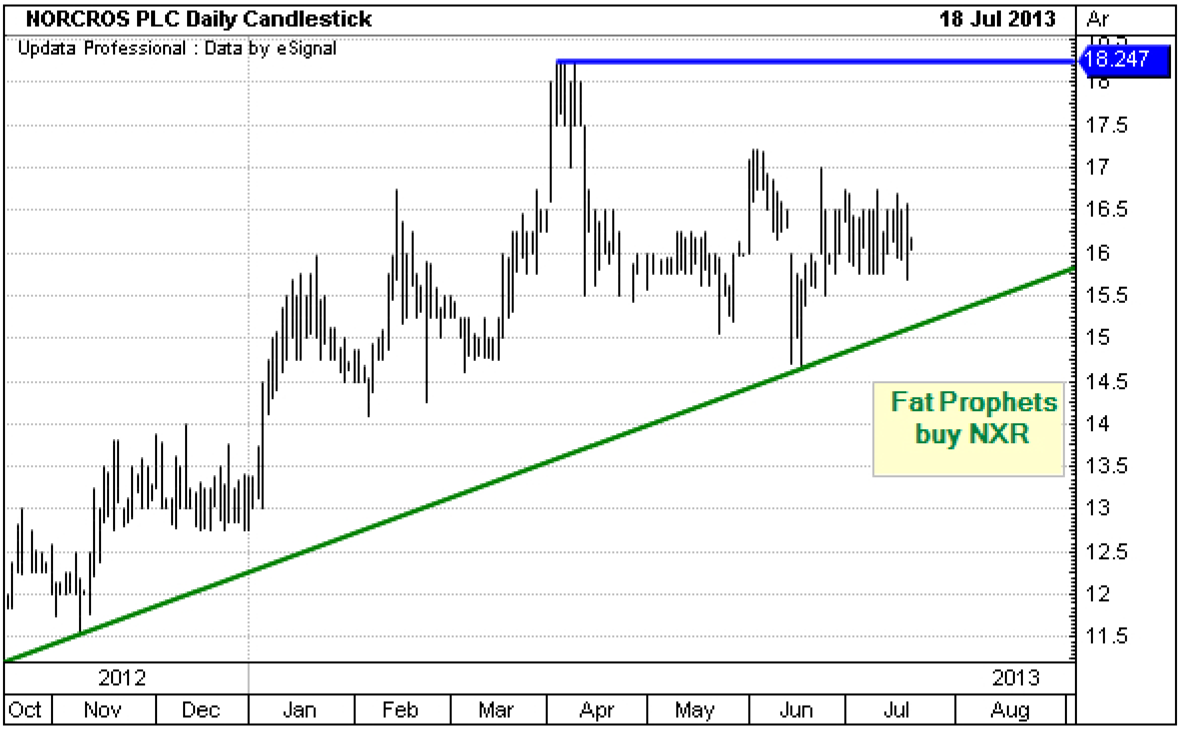
As a relatively small company (market cap £93m) the group does have a reasonable amount of company specific risk. However, acquisitions are also serving to make Norcros more diversified by product line.

In its last financial year (to March 2013) Norcros decided to "Pursue a faster and focused growth strategy to scale up the size of the Group organically and by acquisition."

New financial targets are to double revenue by 2018 and achieving a sustainable underlying return on capital employed of 12-15%. Norcros will also seek to have 50% of revenue derived from outside of the UK.

An acquisition strategy financed with debt increases the group's risk profile, but takeovers are targeted in complementary areas. The recent Vado deal also looks to have been attractive and will boost earnings this year.

Currently the P/E ratio looks low at 8X forecast earnings but we note that the pension deficit is a key risk factor. This deficit rose to £30m at the end of last year on lower discount rates but with sovereign bonds recently selling off, discount rates look set to rise.

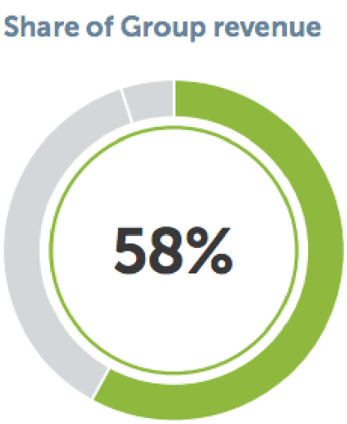


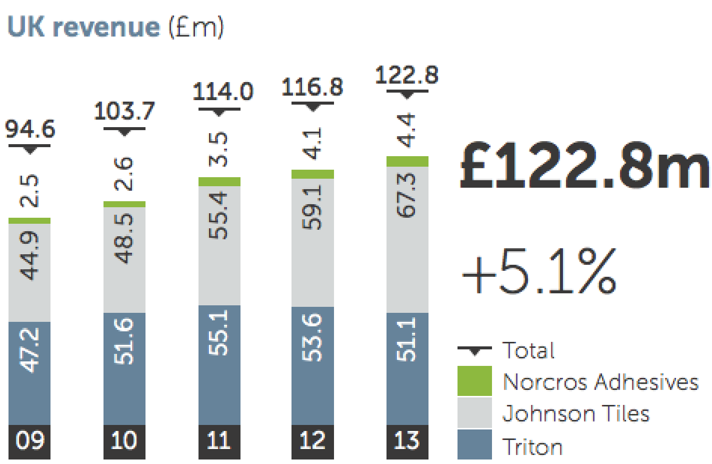
About Norcross: South Africa and the UK

Even if Norcros isn't a familiar name to members, the Triton Showers brand is likely to be as it has a strong position in electric and mixer showers. Vado taps may also be familiar to anyone that has recently had their bathroom redone.

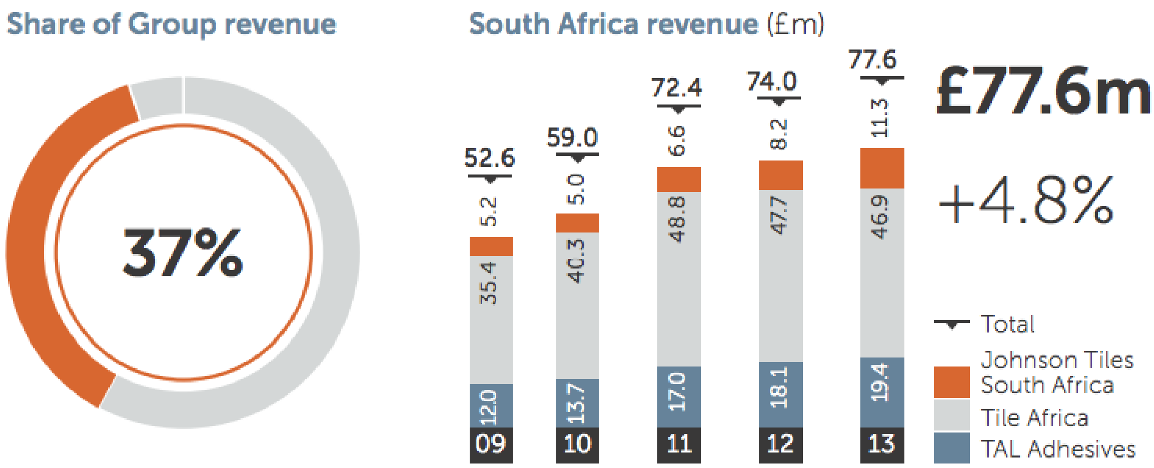
In the building industry Norcros adhesives and Johnston tiles are relatively well known. Meanwhile, in the financial year to March 13 the group saw 37% or revenue coming from South Africa and 58% from the UK.

Norcros UK business





Norcros South African business



Looking at the UK first and Johnston Tiles provided 54.8% of revenue last year with the division showing revenue growth for the last four years. Triton Showers provided 41.6% of revenue and has seen revenue decline for the last two years.

In South Africa the largest revenue generator was the tile retailer, Tile Africa, which generated 60% of last year’s revenue. The Adhesives and Johnston Tiles South Africa businesses made up the rest of sales.

The South African connection gives the group exposure to faster growing markets and returned to profit last year. The remaining 5% of sales outside of Africa and the UK came from Johnston Tiles Australia.

For the group as a whole, Johnston Tiles is the biggest single division with it making and supplying imported tiles in order to be a "one stop shop" for customers. The division is described as "the leading ceramic tile maker in the UK and the second largest in South Africa."

Johnston Tiles UK saw a 14% increase in energy costs last year which pushed operating costs down marginally. In the current year a cost reduction program is underway which may involve 75 redundancies and is expected to produce a £1.5m exceptional charge.

Looking at the weekly chart NXR has been moving constructively through an upwards trending channel for the past 5 years. The next near term challenge will be resistance around 18.25p while support around 15.5p ought to act as a buttress.

Financials and balance sheet

Net debt rose to £30.7m as of the end of March 2013 which compares to £17.8m the year before. This was principally driven by a net cashflow outflow of £10.6m spent during the period for the acquisition of Vado.

Nevertheless, after factoring in the profits boost Vado would have provided last year, the net debt to EBITDA ratio is only 1.4X. Meanwhile, as of the end of March 2013 current assets were nearly double current liabilities.

Risk/reward ratio

As a small company with a debt-financed acquisition strategy the stock is above average risk. Margin pressures in the tile business and competitive pressures for Triton showers are likely to be on going.

The pension liability is also a key concern with it increasing significantly last year to £30m. However, discount rates look to have bottomed out as gilt yields increase and so going forward the liability should fall.

On the rewards side the group is pursuing a growth strategy just as demand within its industry is starting to recover. The P/E ratio is low and acquisitions will diversify the product range and boost earnings.

Summary and valuation

Norcros appears to be overlooked by investors on account of its size and its pension deficit. However, acquisitions and profits growth should make both factors less of an issue.

The initial Vado deal looks to have been an attractive takeover and saw the stock price rally. Further deals are likely to have the same result given the low P/E ratio of 8X earnings.

In terms of recent trading Norcros reported on 13th June that demand in the UK was weaker than expected due to the cold weather and destocking. A weaker exchange rate and higher costs at Johnston Tiles were also issues.

However, Vado has performed well since its acquisition and the group as a whole has continued to grow market share. We expect a positive interim management statement at the group's AGM on 24th July.

A further trading update is set for early October and then interim results should be in November. With limited newsflow the shares may be flat until the group undertakes its next acquisition.

Accordingly, we recommend Norcros as a buy to all members. As a small cap stock it is best to buy the shares over time.

Snapshot NXR

Norcros

Norcros is engaged in the development, manufacture and marketing of home consumer products in the United Kingdom, South Africa and others. The company operates under four brands: Triton Showers, Johnson Tiles, Vado (taps, shower mixers and accessories) and Norcros Adhesives.

Market Capitalisation:£93m

	FY1	FY2
Price to Earnings	7.8	7.7

Dividend Yield (%)	3.1	3.3
Price to Book	1.0	0.9
Return on Equity (%)	10.9	10.8