De La Rue plc
2017/18 Half Year Results Transcript
21 November 2017

Hosted by: Martin Sutherland – CEO
Jitesh Sodha - CFO

Martin

Good morning. Welcome, and thank you for joining the De La Rue half-year results. I'm Martin Sutherland, and I'm going to take you through the headlines. I'm then going to hand over to Jitesh Sodha who's going to take us through the finances. Then it's going to come back to me, where I'm going to go through strategic progress and operational highlights in the first half of the year, and then at the end, we'll take Q&A.

The performance highlights for half one are strong revenue growth driven by strong currency performance with the currency revenue up 36% half one to half one driven by high volumes in print and particularly in paper. Margin growth in currency was 16% reflecting a mix of business and our continued investment in R&D and sales.

In our product authentication and traceability business, revenue grew 20% as the integration and business performance of DuPont Authentication continues to plan, profit grew 7% again with [audio disruption – 38:56] in product development and sales. [Audio disruption – 38:59] a little lower than this time last year due to the timing of orders.

In terms of strategic progress, polymer momentum continues with volumes up to 400 tons in half one and with us securing supply of the £20 note polymer substrate. We've increased our investments in R&D and sales by over £5 million in the period focused on growth and security features, our identity business, and our brand protection business.

Jitesh

Thank you, Martin. As Martin's already mentioned, the first half revenue grew by 29% when compared to the same period last year and is at £244.7 million. Adjusted operating profit is up 11% at £26.6 million and earnings per share up 19% at 16.6 pence. Adjusted operating margin at 10.9% is down 180 basis points.

This business is characterised by large lumpy contracts so product mix and timing of contracts can materially impact period on period comparisons. The high revenue growth and lower operating margin can be explained by three factors: Firstly, product mix, there's increased volumes of relatively lower margin paper and banknote print sales, more about that in a moment; secondly, there are higher raw material costs especially cotton and inks; and thirdly, those increased investments in product, R&D, and sales especially in the growth businesses.

The dividend remains unchanged at 8.3 pence. Then £49 million for the £55 million increase in revenue was in the currency businesses. Paper sales volumes at 7,200 tons were 36% higher than last year and banknote print volumes or 3.5 billion notes were up 6% on last year. Polymer volumes of 400 tons in the first half resulting in the total volume of polymer sales for the whole of the prior year confirming our confidence that we will double volumes in the full year.

Identity revenues were up 3% and product authentication revenues increased 20% following the acquisition of DuPont Authentication Solutions last year. Currency profits were up 16% due to the increased volumes I just mentioned with lower margins due to product mix and increased raw material costs. Identity and product authentication profits were flat as we increased investment in R&D and sales. As Martin has already said, we increased spending of R&D and sales by more than £5 million in the first half, and we plan to continue to invest in our growth businesses in the second half of the year.

Net debt increased by £16.5 million in the period. This is mainly due to an increase in working capital of £23 million, and more about that in a moment. Capex spending was £6 million, and we expect the full-year spending to be approximately £30 million.

With an unwind of working capital in H2, our expectations on net debt remain unchanged for the full year. We are keen to diversify our funding sources and although it's not needed, we increased our revolving credit facility from £250 million to £275 million with the introduction of another bank.

The increase in working capital was driven by an increase in trade receivables this is due to the timing of shipments late in Q2. Overdue debt has declined in the period. Increased [indiscernible – 43:08] as we prepare for H2 deliveries resulted in increased inventories and then there's a 33% increase in advanced payments from new orders.

Exceptional costs were £1.8 million from two restructuring programs, the Footprint Program and the introduction of a new SAP financial system. The tax rate was 15.9% which is in line with our expectations for the full-year. The IAS 19 Pension Deficit reduced by £48 million with changes in inflation and mortality rates.

Today, we also announced a change in indexation from RPI to CPI on the defined benefits scheme, which is estimated to reduce the IAS 19 deficit by a further £70 [ph] million. We continue to work constructively with the pension trustees to effectively manage the pension deficits.

I'll now hand back to Martin.

Martin: Thanks, Jitesh. The management team remains focused on our longer-term strategic goals, and we've maintained progress during the first half. I'll quickly recap in the coming slides where we are against our key strategic goals.

Delivering operational excellence, we're continuing with our Footprint Restructuring Program aligning better banknote print capacity with the market, and also creating a common footprint across all sites. During half one, we upgraded our lines in Kenya and Sri Lanka. Flexibility from working with outsourced partners is also an important part of our strategy, and we outsourced 110 million notes during the first half.

In parallel with the Footprint review, our Operational Excellence Program is also making headway focused on optimising processes, reducing spend, and strengthening quality control. It's starting to show results as we printed 6% more banknotes in the period with two fewer lines than in the prior year.

The efficiency program is not just constrained to delivery, it's across the group. Jitesh is working to restructure the finance team within the introduction of a new finance system consolidating 19 different ledgers and accounting systems across nine sites into one. Three sites have already migrated to the new system and the rest are expected to complete within the next 12 months.

Of course our new COO joined us in July from the automotive industry. He's brought a fresh pair of eyes looking at where we can drive more efficiency, something which I will update you on more fully at the full-year.

Investing for growth is about ensuring that we have market leading products and capabilities presented to the market with an up skilled and motivated sales team. We are increasingly flexible between in-house R&D and external partnerships depending on what makes most sense for the business.

The DAS acquisition last year demonstrates our desire to bring new technologies to our customers from outside the group, but equally, we've increased R&D spend by 33% half one to half one. During the first half, we've entered into a joint development partnership and an exclusive sales with Opalux, whose tunable photonic crystal technology allows personalization of security features. This is a great example of the potential of De La Rue's global reach combined with Opalux's technology driving new opportunities for us in the market.

In Malta, we're setting up a new PA&T printing and finishing capabilities in our centre of excellence adding to the polycarbonate line introduced in March. Within our commercial team, we continue to move sales people closer to our clients and now have regional sales hubs in Miami, Dubai, and China with plans to open in Kuala Lumpur later this year. What I want to see is more localization of our sales teams, more direct access to our clients, and an ever-reducing reliance on third-party sales partners.

I'd now like to turn our attention to the operational highlights for the period. Firstly, banknote print. We started the year with a strong order book for banknotes, and I've seen strong demand continue during the first half. Also, we've eroded some of the backlog during the period. This is largely due to order timing and still see a short-term buoyant market.

Net movements in the commercial print sector, we believe, reduced capacity by approximately 10% leading to stable pricing. We've seen volume growth of 6% to 3.5 billion in the first half, our highest half one volume since 2010, giving us a stronger half on weighting than we had previously forecast.

We have worked with two state print works during the period to optimize plant efficiency. The Bank of England launched a new £10 note in September of this year, which has been well received by the public. Designed by De La

Rue working in close collaboration with the bank, we've been busy behind the scenes printing the volumes required for this launch.

As trailed at our full-year results our new De La Rue Analytics Service continues to gain significant traction in the market. We're now working with approximately a third of all central banks, some not traditional delivery customers, helping them better understand the performance characteristics of their notes in circulation.

In banknote paper, we have seen even stronger sales volumes in our paper business, up 36% half one to half one. Our longer-term view of this market remains unchanged, and so we continue to focus on reducing costs and improving efficiency. We continue to engage in constructive discussions with third parties as to the nature of possible future collaborations.

We've made excellent progress in polymer during the period. Our first-half volumes were approximately 400 tons already outstripping the total volumes we produced during the course of the last financial year. In October, the Bank of England announced the results of their tender for the supply of polymer substrate for the new £20 note due to be launched in 2020. De La Rue is one of two suppliers who will share volumes over the ten years of this contract. An initial volume of circa 500 tons is confirmed for the first two years. This is a key milestone in our polymer strategy now providing us with a key reference for future growth of our market share.

Then, north of the border, the issuing banks in Scotland also launched new £10 note designs into circulation during September and October. All of these are on our safeguard polymer products.

Outside of currency, I think we should look at identity solutions. Both the headline revenues show only modest growth in this business. Ex-investments in R&D and sales underlying profit is up by 20% in the period. I remain confident that we're making good strategic headway. We signed an agreement with Note Printing Australia during half one to jointly develop Australia's next generation passport due for launch in 2020. This is coming off the back of our renewed focus and design services across all of our markets.

We closed new passport orders with the Dominican Republic and Malta, who are now using e-passports. As previously set out on our strategy, we're seeking to expand our offering for ID customers with increased focus on service and maintenance contracts.

We're now working with two African nations implementing solutions that underpin the end-to-end issuing of passports. We've extended the service contract we have with Malta for the provision of their ID card system and the renewed e-voting card solution in the Caribbean. And of course, we've submitted our bid for the next UK passport, the ten year contract up for renewal from 2019.

Lastly, our product authentication and traceability business. We had very strong growth in our PA&T business the last financial year, which has slowed during the first half of this year driven by timing on key orders. As with ID, we see strong potential for our position in this market in the longer term and continue to focus on driving product innovation and sales closures. Investments in these areas mask underlying growth and profit in this part of our business.

As I said earlier, the integration of DAS is progressing to plan, and the business is performing well against the original acquisition case. We have a number of new name client wins in the commercial bank protection space including Biogen, Pioneer, and Schneider. On the tax note side of this business, we are rolling out DLR Certify, our software solution for a tobacco tax scheme in an East African country from which we can expect stable and recurring revenues going forward.

Finally, outlook. The strong revenue growth in our first half was driven by high volumes of lower margin banknote paper and print orders and reflect the lumpy nature of contracts in our business. Performance in the second half is expected to be broadly in line with the same period last year. So overall, our outlook for the year remains unchanged.

I'm more than happy to take any questions that we may have from analysts. Thank you.

Q&A

Coordinator: Thank you. We have a question which comes from the line of Thomas Rands from Investec. Please go ahead.

Thomas: Good morning, gents. Three questions from me. First one, can you detail the significant increase in the R&D investment that you're making, just give us some kind of flavour as to what projects that's going into. It is a rather large increase year-over-year. Do you want to do individually, or should I give all three questions?

Thomas: Okay. I will carry on talking. I can't hear you. Second question was input cost inflation, obviously we've seen that in currency in the first half. Can you just talk through what your expectations are for the second half? Thirdly, on the capex your, new guidance of £30 million for the full year having spent £6 million in the first half, can you just talk us through what kind of projects are coming through in the second half to account for the £24ish million of potential investment in the second half. Thank you.

Martin: Great. Thomas, thanks for those questions. Just to check, can you hear me okay?

Thomas: I can hear you now. Thank you.

Martin	Okay. So assuming you can hear me, because I hear you're now on mute. So first question, Thomas, was on R&D spend. We've increased it by 33% half one to half one. That equates to about £5 million but actually spend across three areas R&D, product development, and sales. The focus area for investment for us in terms of product development and R&D is twofold. One is into security features where we are seeking to invest in new technology platforms that will be relevant to all of our markets, so relevant to banknotes, identity, and product authentication. We're looking at investments there around holographics and other new areas of material science which we think will bring new features to the market in the coming months and years. The second area for investment is around digital technology. So we have significant investments going into software thus particularly focused around our Certify software platform, our Identify software platform, and thirdly the Analytic Service that we're now offering to central banks. We signed up 60 central banks since launch in May of this year to the new Analytic Service, which is very much focused on helping central banks better forecast around demand to notes and better understand the performance of their note whilst in circulation. So we are quite pleased with the traction that we have with that so far. Hopefully that answers your first question. The second one was about input cost inflation, I think, which I'm going to pass on to Jitesh. If that's okay.
Jitesh	Yes. That's absolutely fine, and I can also take the third one as well.
Martin	Okay.
Jitesh	Input cost inflation, we said there's input cost inflation in the first half. We expect that to continue into the second half in exactly the same way. We do hedge out our purchases as full [ph] up to 12 months as we can. We don't see any change in our input costs in the next six months. In terms of capex, we've held for our capex on a cash basis. So although the figure in the first half was £6 million, we can have a little more visibility in terms of work and when it's due to complete to be able to get to the approximately £30 million by the end of the year. The main focus of capex and spending in the second half is to run our Footprint Program, which is coming towards an end. In addition to that, we also continue to invest in our normal health and safety projects and run rate capex that we have in there. In terms of the overall spend, the first half to second half, it's really just a question of phasing rather than anything else.
Martin	Are there any more questions?
Coordinator	There are no further questions at the moment.
Martin	If there are no more questions, then I think we're happy to draw things to a conclusion. Thank you very much for listening in. Thank you.

Coordinator	Thank you. Ladies and gentlemen, that concludes your call for today. You may now disconnect. Thank you for joining, and have a good day.