Avon Protection plc

Full Year Results | Video Webcast

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Transcript

AVON PROTECTION PLC

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Jos Sclater: Well, good morning, everybody. It's now 10 months since I joined Avon, and a lot has been going on. Today I'm going to take you through a few highlights, then Rich will take you through the financials, and then I'm going to provide a strategy update. We've started the process to reposition Avon as a high performing defence company focused on protecting the lives of those who protect us. We make good progress in a limited time, but it's the start of a journey. We need to be much more efficient and cost-effective, and we need to build our order book and turn revenue and profit into cash. We exited our armour business in line with our plan. Strategically, we are a more focused business, and the exit creates a big opportunity to increase margins in head protection.

We've reorganised Avon and are already seeing the benefits, a greater feeling of ownership, a will to win, more pace, more accountability. We are now ready to move into transformation. We finished planning most of our transformation initiatives, giving us confidence that we can achieve mid-teens margins in the medium term. Margin improvement in head protection is a particular priority. We are on track to become the largest supplier of ballistic helmets to the DOD with excellent progress on both of our DOD programmes. We rapidly launched our new EPIC helmet and have quickly gained market share with around 10,000 helmets ordered so far. In respiratory, we're excited by the pipeline for rebreathers, and in both SBUs, we are seeing increased customer funding for R&D, demonstrating that the Avon franchise with its key customers is still powerful.

Revenue excluding armour of $244 million was a 7.5% decrease year-on-year. With no helmet sales on the DOD programmes in the first half of the year, and softer demand for respiratory products. Adjusted operating profit of $21 million was in line with expectations, but a decline of around 18% organically, driven by weaker sales in respiratory and high scrap and inefficiency during the ramp up of next generation IHPS. I'll talk more about that later. Adjusted operating profit margins were 8.7%, held back by higher expensed R&D, and the change in mix between higher margin respiratory sales and head protection sales.

Cash conversion was 7% due to the timing of deliveries and some inventory bill to support helmet deliveries in 2024. Leverage fell below two times at the year-end, so we're stronger now and receivables have already normalised this year. The order bit grew nearly 11%, which sets us up well for this year, particularly in head protection. I'm well aware that we want to see better results. But as you'll hear later, I'm very optimistic about our ability to

significantly improve financial performance over the next few years. I'll now hand over to Rich.

Rich Cashin: Thank you Jos, and good morning, everybody. So, starting with the P&L, the first point to make is that following the completion of outstanding armour contractual obligations, the sale of the assets and the sublease of the Lexington facility, armour is now a discontinued business. Numbers and commentary in this presentation will therefore no longer include reference to armour. Beyond that, you can see the headlines, 11% growth in the order book reflecting very strong head protection orders more than offsetting the expected softness in the respiratory market. Within this, we booked IHPS orders totalling over $38 million and $14 million worth of ACH Gen II orders. As flagged at the half year results, revenue was down year-on-year. The 7.5% decline comprised a greater than 20% increase in head protection revenue being more than offset by the decline seeing in respiratory, following strong deliveries in support of NSPA and Ukraine in 2022.

Reported operating margin was broadly flat year-on-year even after the fall in revenue, with operational gearing, helping to ease the losses in head protection, a strong product mix in respiratory as lower margin NSPA revenue subsided and further SG&A reductions. I'll take you through an EBITDA walk shortly to highlight the key moving parts. Finance costs increased reflecting higher net debt through the year and higher interest rates. As a reminder, we do have an interest rate swap in place for the duration of the revolving credit facility which has limited the effect of the higher cost of borrowing. And finally, as discussed with the half year results, we have implemented a revised capital allocation policy aimed at accelerating growth, running hard on our transformation initiatives and reducing debt. Part of this policy is to rebase dividends to a sustainable level of earnings distribution. And as such, the board is recommending a final dividend of 15.30 cents per share, giving a full year divvy of 29.60 cents per share. We expect the first half, 2024 dividend to be similarly rebased resulting in the customary one third, two thirds distribution for the full year '24.

We disclosed last year's divisional numbers for the first time with the trading update released last month. This slide sets out the 2023 performance for respiratory, where you can see that order intake and revenue both fell by around 19%, reflecting the generally tough demand referenced in the first half results and the particularly strong comparator from last year, which benefited from NSPA and Ukraine as I mentioned earlier. The largest single contributor to the 40% decline in the order book relates to the delivery in full during 2023 of a $17 million filter order. This order represented 24 months of demand, and while we expect to receive further similar orders in the future, we will not be delivering many DOD filters this year.

Margin improved despite the decline in revenue from 17.4% OP margin in '22, to a very respectable 18.7% in '23. Historical NSPA margins have been below the divisional average, so the high level of revenue from these sales in the prior year represented a drag on margin which did not repeat in '23. Further, repricing on a couple of key products provided a useful tailwind. Beyond these price and mix effects, we took rapid action to rightsized the cost base in the face of weaker demand, the effects of which are evident in the reported margin number.

In contrast to respiratory, you can see that head protection orders and revenue grew by over 20% in the year. The order book was up by 65% as further orders were received against the long-term IHPS and ACH Gen II helmet contracts. Critically, we achieved ramp up on the IHPS programme during the course of '23, closing the year manufacturing product at the rate required to satisfy expected customer demand levels. As you can see from the numbers, however, we still have a long way to go to improve the operational efficiency of the business, and to bring profitability up to an acceptable level. As part of the IHPS ramp up, we experienced a number of production inefficiencies and an excessive amount of scrap. We're now tackling these weaknesses as part of our focus on continuous improvement, which is starting to bear fruit, and we are in advanced planning on some longer-term initiatives which will structurally improve margins in this business.

So now we move on to the EBITDA walk for the period, and note that for future results, our focus will be on gross margin and operating profit as more meaningful benchmarks for the performance of this business. The red and green volume bars to the left of centre show the EBITDA impact for the respiratory revenue decline, partially offset by growth in head protection. As you can see, this was a significant net headwind to returns compared to 2022. This headwind was strengthened by heightened levels of scrap and rework in head protection as we went through the ramp up to full production on IHPS.

And then the last red bar is worth pulling out as it's the level of R&D investment expense to the P&L that would previously have been capitalised. This will continue to be a drag on earnings in '24 as we grow investment in R&D while still bearing the amortisation from previously capitalised amounts. However, we remain of the view that not capitalising development costs until they're supported by a customer and a contract is the right thing to do. And then going the other way, I have set out the product mix tailwind seen in the respiratory business for the reasons I highlighted earlier.

Next, we have spent significantly less on freight in 2023, partly from lower respiratory volume, but also from the minimisation of air freight and consolidation of much of our logistics spend with one provider. And then

finally, in the other column, there are as ever many moving parts, including better control of direct material purchases, lower central overhead costs and incentives, partially offset by the strengthened head protection SBU team ahead of further growth this year.

Moving to the cashflow statement, you can see that net debt was up by $20.3 million in the year. Working capital increases of $33 million accounted for more than all of this movement, largely due to the increased level of receivables at the end of the year. This followed heightened levels of shipments in the fourth quarter, including $17 million of IHPS helmets and $14 millionof respiratory products to a Middle Eastern customer, which had been expected to go earlier in the year. Overall, billed receivables were around $26 million higher than last year, although three-quarters of this cash overhang related to Q4 deliveries, which will have been received by the end of this month, while payables were lower year-on-year in line with our target of achieving prompter supplier payments.

Other lines worth highlighting include a reminder that we paid the 2023 pension contributions in full during the prior year. Contributions will restart this year, including a one-off £3 million cash payment in the first quarter, agreed as part of the now complete triennial valuation exercise. Aside from this one-off payment, future contributions will be broadly in line with guidance issued previously and are detailed in the appendix. Net cash receipts from the sale of armour totalled $7.5 million. And as a reminder, the buyback impact on cash flow last year will not recur following the cancellation of the programme at the first half.

So, the first item to note on the balance sheet is the $23.4 million goodwill impairment taken as part of the move to a divisional reporting structure. At the time, the armour business was written down in January 2022, goodwill was not impaired as the headroom at a group level was more than adequate. Now that all goodwill associated with Ceradyne and Team Wendy sits in the head protection business, it felt prudent to impair the goodwill balance. Further to the commentary around cash flows, you can see the swing from inventory to receivables in the year, which has left year-end net debt higher. As mentioned earlier, though, a large proportion of this balance will have unwound by the end of this month. And finally, the pension accounting deficit saw a sizable increase. Liabilities went up from the application of adverse actuarial experience adjustments following the triennial valuation with assets failing to keep pace through investment underperformance. As a reminder, the accounting deficit does not impact cash. This is driven by the repayment schedule determined as part of the triennial valuation.

So, this is the slide on capital allocation that I mentioned earlier. The underlying principles here are threefold. Firstly, we want to focus on improving returns through transformation activities whilst driving growth

through targeted organic investment in the business. Secondly, we want to reduce debt. The days of super cheap debt are behind us for the time being. And as you can see by finance costs compared to earnings last year, interest is a significant drag on EPS. And thirdly, while we recognise the importance of dividends to some of our shareholders, we want to ensure that these distributions are sized appropriately and set at a level from which they can grow in the future. With this in mind, we believe that dividend payments should be 2.5 to three times covered by EPS through the cycle. And beyond these core principles, we will consider inorganic bolt-on opportunities that can accelerate the delivery of our strategy, although this won't be for some time.

And finally, moving on to our expectations for the full year, we expect further good growth in helmet deliveries as we get the effects of IHPS ramp up and deliveries of ACH Gen II helmets commence in the second half. This is expected to more than offset a further modest decline in respiratory revenue reflecting ongoing demand weakness, giving rise to a high single digit revenue growth at the group level. Given the impact of the ACH ramp up in H2 and the expected phasing of respiratory revenue including rebreathers, we expect to see the customary weighting towards the second half. Turning to operating profit margin, significant growth in the lower margin head protection business, offsetting a dip in higher margin respiratory is expected to represent a product mix headwind for the year, and R&D will be a further headwind in '24. These will be partially offset by improved operational gearing as the helmet’s facilities become more fully utilised.

And then as we drive our transformation agenda, we would expect some tailwinds to kick in during the second half, notably with the impact of our continuous improvement efforts, reducing scrap and rework costs and lower central SG&A as we begin to see the benefits of functional excellence activities coming through. The combination of all of these should see operating margin move towards 10% with the improvements skewed towards the second half. Margin still have plenty of room to expand beyond 2024 as the other key transformation pillars start to deliver benefit. And on cash flow, we would expect to see cash conversion of over 100% as the improved operating performance and working capital reduction more than offset the planned investment in transformation and transformation costs and higher pension contributions. And with that, I'll hand back to Jos to talk about our focus for the rest of the year.

Jos Sclater: Thank you very much, Rich. We've done a lot already, but there is a lot more to do. Our strategy is to strengthen the fundamentals to provide a stable platform for transformation, then transform the company to improve efficiency and working capital terms while organically growing the core and investing in innovation to deliver longer term growth.

Importantly, our strategy is much more than a PowerPoint deck. We've aligned all of our people by translating the strategy into defined initiatives and then into annual and quarterly objectives with clear teams and owners. I regularly review progress of every initiative. This is a major cultural change. But it's starting to work, pace is increasing.

As a reminder, our objective is to deliver growth significantly above the market, mid-teens margins and strong ROIC and cash conversion. In parallel, we are confident that we will protect more lives and reduce our impact on the environment by reducing scrap rates and CO2 emissions. We'll provide more detail around our targets at our Capital Markets Day in February of next year.

We have successfully strengthened our businesses and are now shifting our attention to our transformation initiatives with a particular emphasis on increasing margins. The margin challenge is different in each of our strategic business units. In respiratory protection, we already have strong margins, but we do need to shrink the cost base in order to create the right platform to grow from. In head protection, we have very strong demand for our technology, but need to significantly improve margins, particularly on the DOD helmet programmes.

Since the interim results, we've done a lot to strengthen the business. We've changed the operating model so that we now have a focused, energised, empowered, strategic business units and much higher levels of accountability. We're already seeing benefits from this. For example, we're seeing accelerated innovation in both businesses and have freed up some real innovation magic in head protection by bringing the best of Ceradyne together with the best of Team Wendy. The EPIC helmet is the first example of this. There is more to follow. We have a clear strategy. To deliver this strategy, we need a strong team. So, we've changed some people to improve capability in key areas such as finance, sales, programme management, continuous improvement, operations, engineering, and HR. The strategic clarity has helped to track some great people. We have moved fast to reduce costs in respiratory protection as a result of the softer demand and have reduced costs in head protection to improve productivity. We've taken around a hundred people out of the business through these initiatives. We have implemented much stronger performance management. And as already mentioned, we've got out of the loss-making armour business.

In order to accelerate the strategy, we need the right culture. To help with this, we are driving a consistent culture around a new mission, vision, and set of values. Once we've fully embedded our new values, which we call FIERCE, it will be clear to everybody what behaviours are encouraged, tolerated, and forbidden. This will enable us to empower our people to move fast while keeping them on track without a lot of bureaucracy. With the business now

stronger, we have firmly turned our attention to transformation. We've defined the programme work streams and have appointed a very experienced Chief Transformation Officer reporting directly to me. He has thirty-five years of experience of implementing profit improvement plans, including seven years at AlixPartners, in a very hands-on results-focused role. This experience will help us accelerate transformation and manage the risks carefully. We've aligned our incentives to the new strategy with the emphasis on operating profit and average working capital terms in the short-term and 2026 earnings and ROIC in the longer-term.

Now, we're further through the planning stage of transformation. We are confident that we can achieve mid-teens' margins. This level of margin improvement is going to require careful planning and risk mitigation. It's also going to require some investment, which I'll talk about in a minute.

This chart shows how our transformation initiatives are progressing through our transformation gates. On the left-hand side, we have listed each element of the programme. The rest of the chart shows that each element is moving through the gates with the degree of shading in each star, showing my assessment of progress so far. Over the next three years, you should expect to see every star filled in.

We've made excellent progress validating the value of our footprint optimisation, operational excellence, and functional excellence programmes, but we have some more work to do on validating our procurement opportunities. We have found some quick wins in commercial optimisation, have not yet validated the full opportunity.

Importantly, we have nearly finished planning the footprint optimisation and functional excellence programmes and will move firmly into execution this year. This is important because it means we'll see the full benefits of these initiatives in 2026 and some earlier than that.

There is a lot going on in transformation, so I'll just pull out a few highlights from this slide. We've already moved EPIC finishing from California to Cleveland and also consolidating high volume ACH Gen II Manufacturing in our Cleveland and Salem facilities instead of California. This is an important first step to improving head protection margins.

We make good progress building the capability to improve our processes through continuous improvement. With progress now visible through new operational metrics, everywhere we look, we're finding opportunities to improve.

Just to bring this to life for you a little: in Cleveland, we've reduced helmet assembly time from 20 minutes per helmet to 16 minutes, a 20%

improvement. And by removing wait time from the process, we've reduced manufacturing throughput times from 51 hours to 16 minutes. This saves work in progress and improves customer lead times.

In commercial optimisation, we've introduced three tiers of EPIC® helmet, and interestingly, we're seeing around 50% of customers choose the EPIC Specialist helmet, which is our top of the range helmet.

Looking forwards, we have a lot more to do to get the manufacturing footprint where we want it, and we have an exciting funnel of continuous improvement projects, which we're working through.

Our priorities are improving productivity and reducing scrap. Scrap rates were very high on Next Generation IHPS in the last six months at around 20%, or to put that in financial terms, around a million dollars a month. We are very focused on this and are already starting to see meaningful improvements.

We'll also increase prices on our low margin SKUs this year, optimize our routes to market, and realise the savings we've identified in functional excellence. The level of margin improvement we are aiming for will require some investment.

This year, we plan to spend 9 to 10 million dollars of OpEx and 1 to 2 million dollars of CapEx. We expect the non-capital element of this spend to be recognised as an exceptional cost in the 2024 results.

Investments likely to be pretty similar in 2025 with a sharp drop expected in 2026. We are confident that this investment will give us healthy returns and will pay back within three years from the time we spend the cash.

Both the costs and the benefits of this programme have been diligenced by a third party who are specialists in this type of value creation plan. We therefore believe the modelling to be robust, but given that things always go wrong, we are planning transformation initiatives with benefits which exceed those needed to achieve our mid-teens' margins.

In respiratory protection, we're building the sales pipeline. During 2023, we won the NATO-CBRN boots and gloves contract and received our first order under that contract.

We have made good progress strengthening our relationship with the DOD programme office and are seeing much higher levels of collaboration on future product developments.

Unfortunately, we did not expect overall respiratory sales to the DOD to be strong this year, partly because of the lower filter deliveries that Rich mentioned, which we do expect to bounce back in 2025.

We are very excited by our pipeline in rebreathers, but we remain cautious about how we guide the market until we see concrete orders. It is fair to say we've never seen so much interest in our rebreathers from navies across NATO.

Looking forward, we're focused on launching new products. We have an ambitious plan to launch our new MiTR product, which is a completely new type of respiratory and eye protection system, which our market testing tells us we'll create an interesting new addressable market for us. This is also the year we need to prove we can make money from rebreathers after some 20 years of continual product development.

In head protection, we signed a five-year IDIQ on Next Generation IHPS with a ceiling value of $676 million. As a reminder, IDIQs provide a framework for future orders and should not be taken as a forecast, but a higher ceiling is of course better than a lower ceiling. We receive FAT approval for IHPS, at least 15 months ahead of the competition. So, we have received all the orders on this programme so far.

On ACH Gen II, we have an IDIQ with five production years remaining with a ceiling value of $200 million. Last Friday, we received formal FAT approval for this programme. This is a very important de-risking step. We're on track to start production of this helmet, this financial quarter, and expect to ship 15 to 20,000 helmets this year, hitting full run rate in 2025.

The head protection team did an outstanding job launching the new EPIC range of helmets with impressive speed to market. This helmet uses our pedigree from the ACH Gen II helmet and a non-DOD helmet and has immediately helped us gain market share.

For this year, the focus is on ramping up production and improving productivity and scrap rates to drive the margin up. Of course, we're not forgetting the long term. We'll cover this in more detail at the Capital Markets Day.

For now, here are some highlights: we have received funding from the MOD for a new underwater face mask and for a shallow water rebreather. We are developing a next generation of our popular bump helmet and we're starting to leverage the serrodyne technology into other high-performance helmets. Watch this space.

We have had plenty of advice not to include this slide on the basis that it's unusual, but our style is to be transparent, so we've included it anyway. We see both risks and opportunities and are working to mitigate the risk and realise the opportunities.

On the risk side, the UK MOD has announced that it will ask for competitive tenders on the General Service Respirator programme. We currently sell GSR at 175 pounds a masks and 76 pounds of filter pair and make lower margins than normal because this is a build-to-print contract in contrast to our normal design and build programmes.

We will bid for the contract but want to make a reasonable margin. If we lose the programme, we'll optimise manufacturing around our other programmes.

We have very good visibility of the pipeline for rebreathers, but our experiences is that orders can slip out more than we expect. We've tried to budget accordingly, but accurately forecasting when the orders land is tricky given government bureaucracy and timing of budget availability. Importantly, though, we also have some real opportunities. The rebreather pipeline could translate into more orders than we've planned. It's possible that the orders will be like buses, and all arrive at once. The current geopolitical uncertainty is increasing our head protection pipeline and there are opportunities for more epic sales and more pad sales than we've planned. And when I look at October scrap and productivity rates in helmets, there looks to be some opportunity to do better than we've planned.

In summary, with the strength and phase of the strategy now largely complete, Avon is simpler and stronger. We have the right platform from which to launch our transformation projects and the transformation is gaining momentum. We have detailed plans to optimise operational efficiency and the footprint and deliver mid-teens margins.

Demand for helmets is high and respiratory demand is stabilising. The innovation pipeline is looking good and the amount of customer funding we are receiving shows how valued our engineering is. It will take some time to get Avon where we want, but I'm confident in the medium-term outlook. And with that, we're very happy to take questions.

Richard Paige: Good morning, Richard Paige from Numis, just to make sure you're aware. Three questions from me please. Firstly, a point of clarification on the mid-teen margin target. Would you be able to do that on the current revenue and product mix within the business, or is that dependent on growth of particular contracts?

Jos Sclater: It does not depend on a lot of growth, but it does assume some operational gearing from ACH ramping up. But that growth is very certain as we said.

Richard Paige: And in terms of timeline, from what you are saying, it says if you get payback from within three years on the investment, and that's across FY24 and '25, we're talking '27, '28 in terms of-

Jos Sclater: No, 2026 is...

Richard Paige: '27.

Jos Sclater: Well, I should be circumspect. I think we would expect very meaningful steps towards that in 2026. And certainly by 2027 we would expect to be there. If we can do it faster, we will.

Richard Paige: Okay. Sorry to push too hard.

Jos Sclater: That's okay.

Richard Paige: Go. And then just an update on the competitor position on FAT approval on both the helmet protection contracts, where they are. Are you aware of where they are in the approval process and what time?

Jos Sclater: The competitor, Gentechs, we think they have got FAT submissions in on both helmets. We don't know exactly where they are. All we know is that they're a long way behind us. I think our view remains that they'll probably get there.

Richard Paige: Okay. And then visibility on respiratory and what sort of timeframe could things improve and what sort of visibility would you have ahead of that? And obviously with the transformation planning you're doing, enabling sufficient capacity and people around the business to satisfy that.

Jos Sclater: Yeah, I think we've tried to be quite clear that we want to size respiratory appropriately for its colorant revenue, which we see as pretty stable. We are working with the DOD. In fact, we have a meeting with them in a couple of weeks with a senior person in the programme office. We are working on some exciting development programmes with them for the future. But our planning assumption is that it's going to be pretty stable, and we should work on that basis.

Richard Paige: Okay, thank you.

Andy Douglas: Morning, Andy from Jefferies. Just a follow-up from the question on respiratory protection. You've got an order book, which is down about 40-ish. I appreciate it's $22 million. The law of small numbers is I guess

something we need to talk about. In terms of your guidance for flattish slightly down this year, what is it that bridges that gap in between existing order book and expectations for it? Is that the rebreather or is it more than that?

Jos Sclater: It's more than that, but rebreathers are a contribution. We haven't sold many of those in the years up until now. The pipeline now is actually very significant, although the probability of winning all of it, well, we'll win some of it, but not all of it. Rebreathers does help.

The order book, of course, we made all of the filter order last year, so that ate that order book. And that's actually a two-year order profile. We'll get another order like that this year we think. But mostly it's because we can see the pipeline for respiratory products generally, including some of the NATO contract countries taking orders off the NATO contract. I think we feel that the pipeline looks reasonably solid. We would agree with you though, that order book is weaker than we would like.

Andy Douglas: Okay. And you talk in your presentation about lots of changes at the management level throughout the group, sales, HR, et cetera. Have you done a lot more since the last spoke to you? Because it felt like there's been quite a lot of change. Has there been subsequently more change or is this just a summary of the prior year?

Jos Sclater: There's been more change since the Interims. Yeah.

Andy Douglas: Yeah. Okay. Thank you.

Henry Carver: Quick one. Henry Carver from Peel Hunt. Just interested in the commercial customers in helmets. And you're obviously winning new ones. I just wondered what sort of visibility on orders you have on those sort of customers compared to what we've seen with the DOD and military customers over the years being quite tricky to judge timing. Is it any different for the commercial customers?

Jos Sclater: Funnily enough, I see the commercial customers in respiratory and helmets as fairly similar. You don't get big programmes up front and big orders that you can report on, but the sales are actually pretty stable and you can predict the future reasonably well through looking at past history.

I think respiratory commercial will carry on much as it was last year. And head protection commercial I think will be a very good year for us because we've introduced the new EPIC helmet that's generating excitement in the market. Gives the sales guys something to talk to when they go and talk to the customers.

And actually, the current geopolitical situation is also helping with what we call commercial sales. But when we say commercial, we really mean anything that isn't US military.

Moderator: If there are no further questions in the audience, I just want to give an update, there are no questions online, so I'll hand back for any closing remarks.

Jos Sclater: No closing remarks. Thank you for coming guys.

Rich Cashin: Thanks a lot.