

1 September 2009

British Polythene Industries

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/07	424	10.3	27.7	22.0	8.1	9.8
12/08	481	3.0	7.3	14.5	30.8	6.4
12/09e	400	10.0	27.5	11.0	8.2	4.9
12/10e	440	12.0	32.6	12.0	6.9	5.3

Note: *PBT and EPS are normalised, excluding goodwill amortisation and pension adjustments.

Investment summary: First half recovery

Interim profits beat our full year expectations and reflect a sharp turnaround in fortunes in H1. We expect the progressive recovery to continue, but note our forecast upgrades remain modest ahead of the normally seasonally weaker H2. Both the polymer price outlook and timing of volume recovery will be more certain by Q4.

Interim results: Sharp margin recovery

BPI reported headline pre-tax profits of £9.1m (£7.2m) including £2.0m of restructuring costs, and a 3.5p (7.0p) interim dividend. Polyethylene tonnage fell about 15% to 151.0kt (178.5kt). Average profit per tonne rose to £91 (£51) which reflects the turnaround in both price and cost environments. Net debt fell from £76m to £55m helped by working capital reduction and currency moves.

Second half outlook

Polymer input prices have steadily climbed again in H1 though not to the extremes of last year, and BPI has been able to hold on to respectable margins, though sometimes at the expense of volume. With a continued weak demand outlook and some new capacity coming on stream, prices may come back, which would be a net positive for BPI. Reduced energy prices will also have a positive impact in H2. The scale of H2 volume decline is likely to be much more modest, though we do not as yet predict a recovery.

Raised forecasts

We have raised our PBT forecasts by £1.5m and £0.5m, respectively, for 2009 and 2010 to reflect the improved cost position. We have also brought forecasts for year end net debt down again (to £65m). A massive swing in pension liability from £18m to £38m remains a distraction but has no effect on the business. Material changes to our sales figures reflect the change in exchange rates/prices and do not really affect profitability.

Valuation

Anticipation of improved prospects has been reflected in the share price roughly doubling in six months. The P/E remains undemanding against peers, which are still largely seeing forecast earnings go backwards. More earnings clarity is likely in Q4.

Price 225p
Market Cap £60m

Share price graph



Share details

Code BPI
Listing FULL
Sector General Industrial
Shares in issue 26.5m

Price

52 week High 249p Low 118p

Balance Sheet as at 30 June 2009

Debt/Equity (%) 147
NAV per share (p) 142
Net borrowings (£m) 55

Business

BPI is one of the largest manufacturers of polythene film products in Europe.

Valuation

	2008	2009e	2010e
P/E relative	293%	68%	66%
P/CF	2.1	1.9	2.2
EV/Sales	0.3	0.3	0.3
ROE	4%	13%	14%

Geography based on revenues

	UK	Europe	US/Can	Other
	58%	33%	5%	4%

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2009 Interim results: Sharp margin recovery

The first half was characterised by a sharp swing in profitability/tonne as both volumes and costs dropped. The cost base has been reduced and there was healthy reduction in net debt.

Key figures

BPI reported headline pre-tax profits of £9.1m (£7.2m) including £2.0m (£0.5m) of restructuring costs; the clearest indicator of performance is the trend in underlying operating profit, which rose from £9.2m to £13.7m. The interim dividend was 3.5p (7.0p), which repeats the realignment of last year's final dividend.

Polyethylene tonnage fell to 151.0 kilotonnes (kt) (from 178.5kt), which was an underlying 15% decrease. The decrease was perhaps larger than we expected and reflects several factors as well as the weak performances in industrial and construction sectors – namely competitive pressures and down-gauging. Average profit per tonne rose to £91 (£51), which reflects the turnaround in input polymer prices, lower energy prices, cost reduction and more selectivity towards better margin contracts at the expense of volume.

It was pleasing to see net debt fall significantly to £55m, though we do not think all the benefit will be held on to for the full year.

A comparison of the first half performances is shown in Exhibit 1. It is dangerous to read too much into the operating margin, as this is highly dependent on input polymer prices.

Exhibit 1: H1/H2 performance

	2008			2009		
	H1	H2	FY	H1	H2e	FYe
Sales (£m)	265.9	224.1	480.7	231.4	168.6	400.0
Operating profit (£m)	9.2	3.4	12.6	13.7	3.3	17.0
Margin (%)	3.5	1.6	2.6	5.9	2.0	4.3

Source: BPI, Edison Investment Research estimates

UK operations: Strong recovery in profitability

Profit rose to £7.8m (£3.9m) despite a further fall in volumes. The volume decline reflects a similar scale of drop to that experienced in H208, with the greatest reduction in construction related areas. Outside construction, the market fell about 5%. In fact BPI has probably lost some market share as it has focused on more profitable business and not matched some competitors bidding for marginal work last year when input prices were unrealistically high. This has had an effect running in to H109 and helps explain the jump in operating margin as well as the lower volumes.

The recession has also accelerated pressure on down-gauging, which has hit volumes. We estimate this cuts volume by c 5kt per annum.

The impact from the restructuring steps taken in 2008 and from the closure of Cowdenbeath and run down of Stockton has also had a positive effect on profitability, which has risen in the UK from £29.5/t to £71.4/t. Overall staff costs have fallen about 10% year-on-year and energy costs have fallen progressively from the peaks at the end of 2008.

The UK scrap market turned around for the better in Q408 when shipments of scrap to China stopped and pricing for UK processors became more economic. Although Chinese shipments have returned to normal levels (ie about 70% of UK scrap is exported) in H1, the pricing environment is still satisfactory, although availability of scrap is not as good.

European operations solid, despite the economy

European profitability was flat though rose in sterling terms from £4.8m to £5.6m. This was a strong performance considering volumes fell by about 8% to 36.9kt. The European business has the twin advantages of a product base that is more focused on higher added value products (silage and printed consumer packaging, which held up well) and a small market share, so it can fill up capacity more easily. Like the UK, it benefited from reduced input costs too.

North America

The business has remained profitable despite a 20% fall in volume. It does look like further development of the business will depend on activity levels recovering.

Financial

Net debt reduced by £21m in H1. The major influences were a reversal of the exchange rate movement in H208, which had a £5m positive effect, a reduction in working capital of c £6m and a lower capital expenditure outlay in H1.

The net pension scheme liability jumped from a £18.4m to a £37.6m deficit, which was largely a result of an increase in long-term inflation assumptions. It remains completely out of BPI's control and we speculate whether inflation assumptions might switch back again soon. As a consequence, though, NAV has fallen from 223p to 141p.

Forecasts and outlook

The business enters the second half expecting a benefit from a lower cost base and lower energy prices. The demand outlook remains depressed, though appears to be getting no worse and this could bring polymer prices back down in H2. Profitability is seasonally much weaker in H2.

Volume outlook stabilising

Our expectations for volume in the second half are reasonably certain in the context of other variables. Destocking by customers across most sectors leaves little spare volume in the market, while volumes have begun to stabilise after the precipitous falls in Q4 and Q1. Comparative declines in volume in H2 will hence be less severe than the 15% witnessed in H1.

Energy costs benefit

The greatest adversity in 2008 was the impact of the irrational moves in UK energy costs. In 2008 the total energy bill increased by £8.5m to £22m with nearly all of the increase in the UK. Much of this cost could not be passed on to customers and resulted in the margin erosion in H208. Reductions in energy costs in 2009 will probably have a greater net benefit in H2 than in H1 and there will be similar benefits from reduction in overheads made through restructuring.

The impact of input polymer prices does, however, remain hugely uncertain.

Polymer prices

As a polymer processor BPI works from a 'margin per tonne' model. As Exhibit 6 shows this has been between £40-70/tonne in recent years. However, in the short term the scale and speed of price movements affect profit margins.

Polymer prices have risen through H109 as suppliers have sought to recover margin after the collapse in H208. There was an £80 increase in July; further price increases of £40/t were asked for in August/September, though it appears only £20 has stuck taking the market price to about £920/t. In

the face of continued depressed demand, prices are unlikely to be able to rise much further, unless oil and gas prices rise.

The other issue is supply. Up until mid 2008, the global industry was faced with a supply shortage due to delays in bringing on stream new capacity and higher demand driven by economic growth, especially in the Far East. New polyethylene capacity is now progressively coming on stream in the Middle East, and even eventually in the UK, and this should keep a lid on prices.

Exhibit 2: Polymer prices: Polyethylene LD Platts



Source: Company data

The overall performance in volume and price is shown in Exhibit 3.

Exhibit 3: Group volume and polymer price expectations

	2005	2006	2007	2008	2009e
Volume ('000 tonnes)	324	308	316	305	271
Underlying change (%)	(2.9)	(4.8)	1.0	(6.0)	(11.0)
Price at year end (£/tonne)	780	778	895	650	920
Price – average (£/tonne)	790	836	866	1,007	850
Change (%)	17	6	4	28	(19)
Operating Profit (£m)	23.9	17.1	14.6	12.6	17.0

Source: Edison Investment Research

We are still aware that seasonally profitability in H2 is not as strong for BPI, so we do not expect the same level of contribution as H1. Even so we have raised our profit forecasts by £1.5m for this year. The details are shown in the table below.

With higher capital expenditure, dividend payments and working capital values (due to higher prices), net debt is likely to increase in H2. Our forecasts year end level of £65m is still a reduction on previous forecasts.

Exhibit 4: Changes to forecasts

Note: * Including £1.5m non cash pension adjustment.

	2009 New	2009 Old	2010 New	2010 Old
Sales (£m)	400.0	360.0	440.0	370.0
PBT* headline (£m)	8.5	7.0	10.5	10.0
PBT normalised (£m)	10.0	8.5	12.0	11.5
EPS (p)	27.5	25.0	32.6	32.4
DPS (p)	11.0	11.0	12.0	12.0

Source: Edison Investment Research

Sensitivities

Earnings visibility

The sharp improvement in profitability in H1 (profit per tonne rose from £51 to £91) shows the impact of the volatility of both pricing and volumes. While only about a quarter of sales have sharp swings in demand (principally construction and industrial), volume has also been affected by competitive pressures and down-gauging of thicknesses by customers to reduce cost. As yet we have no indications of volume recovery. History shows extreme swings in both polymer input prices and energy costs, which can not always be passed on immediately. We have no reason to expect any change in this; however, the environment currently is more benign than last year.

The high volatility of polymer input prices

Polymer prices have a history of overshooting and undershooting as the supply and demand equation changes. After crashing in H208 to £650/t from an unrealistic peak (£1,255/t), prices have recovered steadily to a level this year (£920/t), which again does not look sustainable. Progressive supply increases from new plants in the Middle East and eventually UK come when demand is likely to remain depressed.

For BPI, gradual price increases are harder to pass on quickly as customers resist multiple changes, so the delay in passing on increases hits margins. Margin can be restored more quickly on larger increases. The most beneficial environment for BPI is a gradual decline or a very volatile market.

Cash performance and balance sheet

There is a perceived risk to BPI's balance sheet due to two factors: the cash flow demands of the business in recession and movements of net pension fund liabilities. Costly restructuring steps have been taken, and the improvement in profitability as a result seen in H1 means in our view the cash flow risks are now diminishing. The later effect has no impact on the running of the business, although it causes big movements in NAV. With contributions set to repair the deficit in 10 years and an expected remaining life for pension members of over 30years, BPI has taken a conservative approach. Also £113m of available banking facilities give plenty of headroom above our year end net debt forecasts (£65m). We note that the sale of freehold sites at Stockton and Essex should eventually bring in cash of potentially £8m.

Weather – always an uncertainty

The silage season is increasingly important to BPI as it focuses on its areas of competitive strength, and horticulture and to certain degree retail are also affected by the weather. Last year BPI had its second good silage season with a favourable warm wet summer across Europe. This year wet weather in the UK from July has delayed harvesting creating a shortage of silage, though it is hoped sales could extend into the autumn.

Exchange rates

The weakness of sterling has a beneficial effect on the business. Translation of overseas earnings is at better rates and imports in to the UK are less competitive, while prices for BPI's exported goods are stronger.

Valuation

In the last six months since the full year announcement, BPI's share price has virtually doubled as confidence has grown about recovery. This has been justified as we have put through modest upgrades in both July and now at the interims. Further upward earnings revisions will only be possible with a clearer view of the pricing environment going in to Q4. A reduction in input prices would act in BPI's favour.

In comparison to BPI, most of its peers have faced negative earnings revisions. Only RPC, which has very similar dynamics, has seen forecasts raised. While stock prices have also risen for most peers, this means that valuations have climbed materially from the unrealistic lows of March (average was then 4.6x for 2010). Currently BPI with P/E of 6.6x (2010) and yield of 5.6% is one of the more attractively valued.

Exhibit 5: Peer company valuations

Note: Prices as at 28 August 2009.

		Price	Mkt Cap	Calendar 2009			Calendar 2010		
		(p)	(£m)	P/E	EV/sales	Yield	P/E	EV/sales	Yield
Polymer-based Industrial companies									
BPI	Polyethylene film	216	57	7.9	0.27	5.1%	6.6	0.25	5.6%
Fenner	Reinforced polymer belts	123	215	9.8	0.81	5.4%	9.2	0.79	5.4%
Plastics Capital	Engineered plastics	28	7	2.8	0.95	0.0%	2.8	0.95	0.0%
RPC	Plastic packaging	250	248	11.8	0.49	3.7%	10.2	0.49	3.9%
Other Peer Industrial companies									
Castings	Foundry & machining	198	86	28.8	1.02	5.1%	18.9	1.04	5.1%
Hill & Smith	Metal barriers	300	227	8.4	0.81	3.7%	7.9	0.77	4.0%
Metalrax Group	Specialist steel products	8	9	(4.6)	0.31	0.0%	11.3	0.30	0.0%
Renold	Chain, gears & couplings	32	25	7.0	0.34	0.0%	7.4	0.34	0.0%
Senior	Stainless steel fabrications	54	214	7.2	0.72	4.8%	9.1	0.77	4.8%
Titan Europe	Wheels, undercarriages	29	24	(2.8)	0.55	7.6%	4.8	0.55	0.0%
Average				7.6	0.63	3.5%	8.8	0.62	2.9%

Source: Edison Investment Research, Digital Look

Exhibit 6: Company data sheet

Operations		Performance
<p>BPI has 22 plants, located in the UK (16), Belgium (2), Netherlands, Canada (2) and China. Operations are managed as four UK businesses (210k tonnes), one in Europe (60k tonnes) and one in Canada. Main European competitors: RKW (Ger), Trioplast (Swe), Aspla (Spa), Manuli (Italy). Main UK competitors: Britton, Total, Amcor. Raw material polymers are bought from multiple sources including Dow Chemicals, Exxon Mobil, Ineos and SABIC, and account for c 60% of group sales.</p>		
<p>Film</p> <p>The 100k tonne operation is run from six factories in the UK and a sales office in Ireland and combines plain film and stretch film operations. Product is either sold to other parts of the group to convert into higher added-value products or direct to customers. The main products are stretch-wrap and shrink-wrap (silage, packaging and food), and films for other converters.</p>		
<p>Recycled</p> <p>BPI operates four plants in the UK and one in China and is the largest re-processor of polyethylene in Europe, producing c 70k tonnes of product. The plants take waste from its operations, from customers and from the open market and recycle into products like refuse sacks or building films. The lowest grade plastic is converted into moulded products like plastic wood for street furniture, decking, etc. Having a recycling operation improves the group's efficiency. It is a fragmented market and waste had been increasingly going to the Far East, where labour costs for sorting are cheaper.</p>		
<p>Converted Product – Industrial/Consumer</p> <p>In this business, BPI makes c 60k tonnes polyethylene film into specific products by printing and converting it. In total there are six plants and the business is run as two separate operations: industrial, which produces heavy duty sacks, large bags and pallet shrink wrap/hoods as well as short-run packaging products; and consumer, which does not extrude, but processes a wide range of printed bags for produce and the food industry. Converted products have higher added-value content than the film business.</p>		
<p>Europe</p> <p>This business runs the group's one Dutch and two Belgian plants (c 60k tonnes). It replicates the UK Film and Converted Products operations, although it performs limited recycling. The three strongest non-UK territories for BPI are Belgium, Netherlands and France, which each account for about 5% of group sales. (NB Ireland is serviced from the UK.) The main products are silage wrap, printed film, FFS and heavy duty sacks.</p>		
<p>Canada</p> <p>The main agricultural and horticultural markets are truly international and the recent acquisition adds c 13k tonnes of capacity in Canada, and silage and grain bags as new products.</p>		
<p>Process breakdown</p> <p>Based on 2008 sales. European operations are also split into these three groups.</p>	<p>Geographic breakdown</p> <p>Based on sales by destination.</p>	<p>End-user market breakdown</p> <p>Based on 2008 sales.</p>

Source: Edison Investment Research

Exhibit 7: Financial information

Year end 31 December	£m	2005 IFRS	2006 IFRS	2007 IFRS	2008 IFRS	2009e IFRS	2010e IFRS
PROFIT & LOSS							
Revenue		410.2	414.2	424.1	480.7	400.0	440.0
Cost of Sales		(338.7)	(352.4)	(363.5)	(425.4)	(339.2)	(371.8)
Gross Profit		71.5	61.8	60.6	55.3	60.8	68.2
EBITDA		37.2	29.8	27.3	27.2	31.0	32.0
Operating Profit (before GW and restruct.)		23.9	17.1	14.6	12.6	17.0	18.0
Goodwill Amortisation		0.0	0.0	0.0	0.0	0.0	0.0
Net restructuring costs		(0.6)	0.0	(0.7)	(5.4)	(3.0)	(2.0)
Operating Profit		23.3	17.1	13.9	7.2	14.0	16.0
Net Interest		(3.2)	(2.7)	(3.6)	(4.2)	(4.0)	(4.0)
Pension adjustments		(0.4)	(0.3)	1.2	0.9	(1.5)	(1.5)
Profit Before Tax (norm)		20.1	14.3	10.3	3.0	10.0	12.0
Profit Before Tax (FRS 3)		19.7	14.0	11.5	3.9	8.5	10.5
Tax		(5.4)	(3.9)	(3.0)	(1.1)	(2.8)	(3.5)
Profit After Tax (norm)		14.7	10.4	7.3	1.9	7.2	8.5
Profit After Tax (FRS3)		14.3	10.1	8.5	2.8	5.7	7.0
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Average Number of Shares Outstanding (m)		25.7	26.0	26.2	26.4	26.5	26.5
EPS - normalised (inc restructuring)(p)		53.6	39.8	27.7	7.3	27.5	32.6
EPS - FRS 3 (p)		55.3	38.8	32.4	10.6	21.5	26.5
Dividend per share (p)		22.0	22.0	22.0	14.5	11.0	12.0
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Gross Margin (%)		17.4	14.9	14.3	11.5	15.2	15.5
EBITDA Margin (%)		9.1	7.2	6.4	5.7	7.8	7.3
Operating Margin (before GW and except.) (%)		5.8	4.1	3.4	2.6	4.3	4.1
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BALANCE SHEET							
Fixed Assets		93.5	85.4	86.6	99.9	102.9	101.4
Intangible Assets		2.0	2.1	2.1	2.2	2.2	2.2
Tangible Assets		79.2	77.3	82.5	90.3	85.4	83.9
Investment/tax credits		12.3	6.0	2.0	7.4	15.3	15.3
Current Assets		119.4	120.5	127.8	124.0	108.3	118.5
Stocks		55.3	59.5	62.1	62.5	52.0	57.2
Debtors		63.2	60.5	65.1	61.1	55.3	60.3
Cash		0.9	0.5	0.6	0.4	1.0	1.0
Current Liabilities		(75.5)	(68.3)	(81.4)	(92.2)	(65.1)	(73.8)
Creditors		(68.7)	(60.9)	(63.5)	(62.5)	(35.4)	(44.1)
Short term borrowings		(6.8)	(7.4)	(17.9)	(29.7)	(29.7)	(29.7)
Long Term Liabilities		(100.2)	(83.2)	(70.6)	(78.6)	(91.1)	(86.1)
Long term borrowings		(41.2)	(45.1)	(47.5)	(46.7)	(36.3)	(31.3)
Other long term liabilities		(59.0)	(38.1)	(23.1)	(31.9)	(54.8)	(54.8)
Net Assets		37.2	54.4	62.4	53.1	55.0	60.0
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CASH FLOW							
Operating Cash Flow		33.8	19.4	22.0	27.8	30.6	26.6
Net Interest		(3.2)	(2.8)	(3.6)	(4.1)	(3.8)	(4.0)
Tax		(4.0)	(5.6)	(2.2)	(3.3)	(3.0)	(2.5)
Capex		(11.6)	(11.6)	(13.2)	(14.2)	(15.8)	(11.5)
Acquisitions/disposals		0.0	0.0	(6.5)	0.0	0.0	0.0
Financing		0.0	1.4	(3.5)	(0.6)	0.9	(0.7)
Dividends		(5.4)	(5.7)	(5.8)	(5.8)	(2.9)	(2.9)
Net Cash Flow		9.6	(4.9)	(12.8)	(0.2)	6.0	5.0
Opening net debt/(cash)		56.7	47.1	52.0	64.8	76.0	65.0
HP finance leases initiated		0.0	0.0	0.0	0.0	0.0	0.0
FX movement		(0.0)	0.0	0.0	(11.0)	5.0	(0.0)
Closing net debt/(cash)		47.1	52.0	64.8	76.0	65.0	60.0

Source: Company accounts/Edison Investment Research

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