Review

Edison investment research

2 September 2008

British Polythene Industries

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	PE (x)	Yield (%)
12/06	414	14.0	38.5	22.0	6.1	9.4
12/07	424	11.5	32.3	22.0	7.2	9.4
12/08e	490	9.5	26.7	22.0	8.8	9.4
12/09e	510	10.5	29.5	22.0	8.0	9.4

Note: *PBT and EPS are normalised, excluding goodwill amortisation and exceptional items.

Investment summary: Hard-wearing plastic

Yet another resilient performance makes very encouraging reading in an increasingly depressed UK industrial environment. The hard work by management to remain on top of an extremely erratic inflationary pricing environment should not be underestimated. BPI continues to look well equipped to deal with these challenging markets, while maintaining a very healthy dividend payment as share support.

Interim results hold up well

Given the 20% increase in average raw material polymer prices and the 50% rise in energy prices compared to the equivalent period, the drop in pre-tax profits to £7.2m (£8.8m) seems pretty modest. Net debt levels were maintained at the same level (c £65m), and an interim dividend of 7p was held. We are not changing our full-year forecasts, assuming a tougher H2 market environment.

Cost pressures getting worse in second half

Since the period end, input polymer prices have risen to £1,255/t, (average H1 £1,000/t), and any impact from oil prices declining from recent peaks is unlikely to feed through until Q4. Further increases in electricity prices, such that the impact will be significantly more than the £2.5m H1 impact, add to the cost pressures. BPI intends to pass on increases as usual, but the squeeze remains on margins.

Demand outlook not as bad as feared

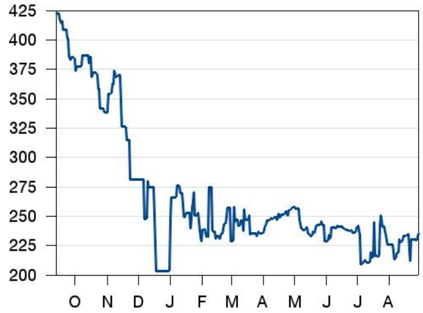
A healthy silage season across the UK and further expansion of silage products in Europe have helped maintain volume levels against weakness, predominantly in construction markets (15% of sales). Retail food and services exposure also remain healthy, making over 60% of sales in resilient sectors. Another positive is the new North American operation, which has beaten our expectations for volume and profitability with a 15% volume increase and £0.5m H1 profit.

Valuation

BPI's cash-flow outlook remains solid, and we see little threat to dividend payments despite reduced profitability. Yield provides a solid support to the shares.

Price	234p
Market Cap	£62m

Share price graph



Share details

Code	BPI
Listing	FULL
Sector	General Industrial
Shares in issue	26.2m

Price

52 week	High	Low
	425p	204p

Balance Sheet as at 30 June 2008

Debt/Equity (%)	109
NAV per share (p)	225
Net borrowings (£m)	64.8

Business

BPI is one of the largest manufacturers of polythene films and sheet products from polymer in Europe.

Valuation

	2007	2008e	2009e
P/E relative	54%	80%	79%
P/CF	2.8	2.4	2.3
EV/Sales	0.3	0.3	0.2
ROE	14%	11%	12%

Geography based on revenues

UK	Europe	US/Can	Other
63%	30%	5%	2%

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British Polythene Industries is a research client of Edison Investment Research Limited

Interim results performance

These interim results were actually slightly better than we had expected. Given the 20% increase in average raw material polymer prices and the 50% rise in energy prices compared to the equivalent period, the drop in pre-tax profits to £7.2m (£8.8m) seems pretty modest. The key figures are summarised below.

Exhibit 1: Key figures

	2008			2007		
	H1	H2e	FYe	H1	H2	FY
Sales (£m)	265.9	224.1	490.0	226.0	198.1	424.1
Pretax profit (£m)	7.2	2.3	9.5	8.8	2.7	11.5
EPS (p)	19.8	6.7	26.5	24.3	8.0	32.3
DPS (p)	7.0	15.0	22.0	7.0	15.0	22.0

Source: BPI

The increase in sales partly reflects the new contribution from the North American business, and an underlying 13% increase in sales. This was almost entirely a result of higher prices; volumes in the UK and Europe were essentially flat. Overall volumes rose from 171kT to 179kT, with a first-time contribution of c 6kT in North America. Within the profit breakdown, operating profits fell nearly 14%, including a rise in restructuring costs at £0.5m (£0.3m) and a £2.5m increase in UK energy costs, and a £0.6m translation benefit. Profit per tonne of product fell from £61 to £51.

Few changes to forecasts

While further spikes in polymer prices mean an upward readjustment in sales forecasts this year, we are not changing our view for profitability. This assumes a sharp decline in H2 margins (like last year), as further rises in polymer and energy prices keep the pressure on margins until BPI can progressively pass these on.

Exhibit 2: Changes to forecasts

	2008 New	2008 Old	2009 New	2009 Old
Sales (£m)	490	480	510	500
Pretax profit (£m)	9.5	9.5	10.5	10.5
EPS (p)	26.5	26.7	29.3	29.5
DPS (p)	22.0	22.0	22.0	22.0

Source: Edison Research

Control of cash remains tight

Net debt at the half-year stage was unchanged since the year end at c £65m. This reflects significant work to reduce working capital across the business in all areas in the face of significant higher values of stock owing to rising prices. A £2.2m reduction in working capital helped offset a similar-sized increase from translation of overseas debt. In H2, more effort is being directed to maintain these gains in the face of further price increases. All other movements were similar to last year.

BPI has not been afraid to continue investing in new plants in selective areas, with two new silage lines commissioned in the UK in H1 to upgrade much older plants, and a new line in Europe for silage, which adds a further 4.5kT to a European silage capacity currently of 17.5kT. The cash cost of restructuring remains modest, with a reduction of a further 100 people in H1 and the closure/relocation of the Essex plant. With excess capacity in some product areas in the UK, we see this as a continued pattern.

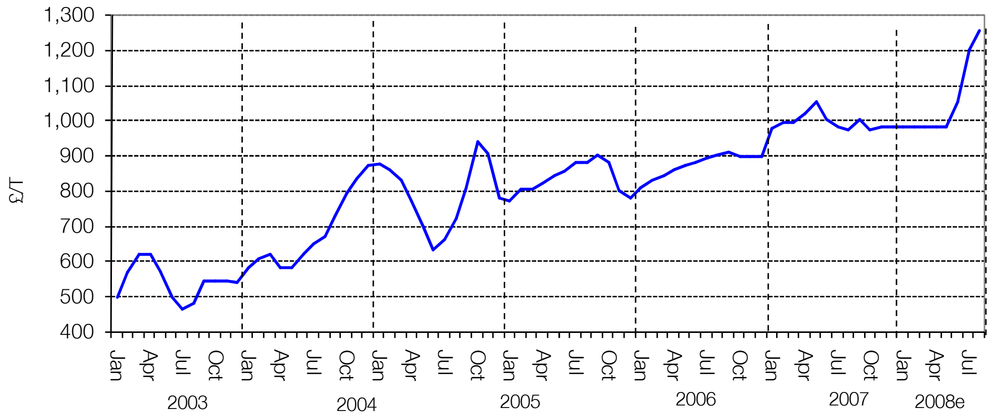
With interest cover expected to remain over 3.0x and tight controls on operating cash flow, we have no doubts about funding the 22p dividend (£5.7m). BPI's outstanding pension deficit has not materially increased since year end.

No respite in the rising price outlook

Oil price spike drives polymer prices up

While the trend in polymer prices follows the same seemingly relentless drive upwards (see Exhibit 3), the causes this year are slightly different. Some of the price issues have historically been due to lack of both ethylene and polyethylene capacity in Europe. The outlook for capacity changes has changed little, though we are nearer projected increases in Middle Eastern capacity planned over the next three years. The main issue in 2008 has been the sharp spike in oil prices and this has particularly affected Europe, as it sources most of its polymer from the Naphtha route (from oil) rather from natural gas.

Exhibit 3: LD Polyethylene polymer price



Source: BPI, Edison Research estimates

Average prices in H1 were £1,000/T (£834/T); however, since the period end, further increases have pushed the current price to £1,255/T. With most contracts settled quarterly, the recent drop in oil prices is unlikely to feed through until the last quarter. In our view, prospects of a sustained fall in polymer prices still look to be fairly remote in the next year.

Our forecasts are based on an average price of about £1,100/t for the whole of 2008, and a similar level in 2009.

UK electricity costs remain an equal concern

A 50% increase in electricity prices added £2.5m to BPI's energy bill in H1, and further planned increases will result in a significantly bigger additional cost in H2. While BPI will be passing the excess costs on to customers, this keeps the pressure on group margins in H2 in the UK.

In Europe, longer-term contracts give BPI a degree more protection, and costs have risen less than 10%, while in Canada it has an even more favourable energy cost. The higher UK cost structure continues to be a contributing factor in the need to rationalise UK capacity in favour of expansion in Europe.

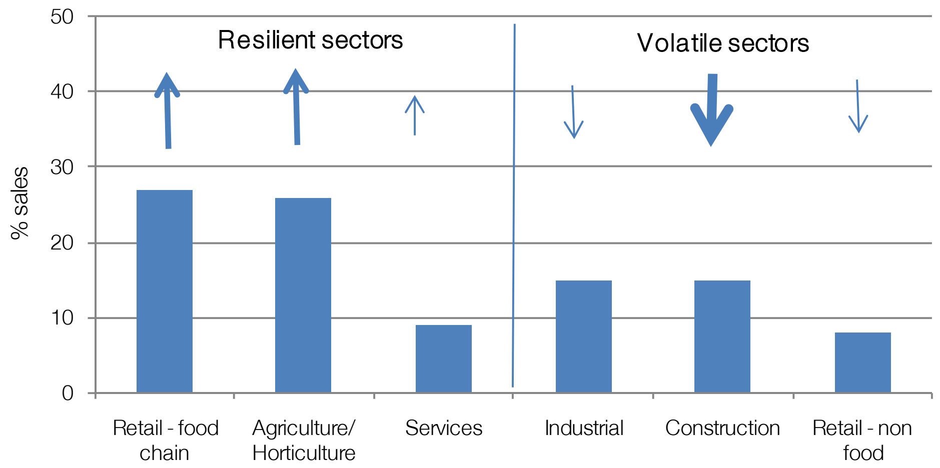
The demand outlook is surprisingly stable

UK performance: Healthy silage season

UK volumes remained flat at 132.2m T, though profits fell from £5.2m to £3.4m. While demand fell significantly in the construction sector, BPI has seen a large part of the impact from the new house build slowdown, while the majority of its construction exposure relates to maintenance or other new build sectors. Lost ground in this sector was again compensated for by increases in silage sales. The warm and wet growing season has produced healthy demand in a more normal pattern (the season was delayed last year), while prospects for H2 also look good, with demand continuing in July and August.

The chart below shows the overall performance across the UK and European markets.

Exhibit 4: Sector performance



Source: BPI

Capacity constrained in Europe for the time being

Volumes rose only marginally to 40.1kT, while profits remained level at £4.8m (£4.9m). These figures include a £0.6m benefit from translation of the stronger euro, showing that the underlying performance was, as in the UK, hit by margin compression.

Demand for silage products in Europe remains strong, with capacity sold out in Europe owing to expansion in Eastern Europe and good demand across central Europe where opening stocks were low. A new line is due to be installed in December, which will add another 4.5kT capacity and will allow for the introduction of new products.

Looking at the economic backdrop, growth rates have fallen dramatically in Europe and the UK; however retail food, agriculture, horticulture and services should remain largely immune to the economic outlook, leaving under 40% dependent directly on the economy.

North America beats our expectations

The recently acquired Canadian business showed sales volume of 6.2kT and a profit of £0.5m, a stronger result than we had expected. Released from its conglomerate ownership, the business has been allowed to build the sales team, which has lead to new contracts and a 15% rise in volumes. Although it has experienced raw material increases, these have not been on the same scale as in Europe, meaning margins have quickly recovered from the breakeven level before ownership by BPI.

The strength of demand in North America has meant the strategic objectives of product crossover between Europe and North America are yet to be realised; however, BPI's sales team research shows good demand for some of the North American product in Europe.

Valuation update

The share price has been pretty stable for the last six months, and we expect this situation to continue. Core to this support is the belief that the dividend will continue to be paid (as in the last recession). BPI offers a 9.4% yield. Despite the pressures on costs, BPI looks very capable of remaining in profit and maintaining debt levels, and it has no pressing refinancing needs. A recovery in the share price is, however, entirely dependent on some easing in the negative input cost fundamentals.

Our peer group analysis, shown below, continues to focus on industrial stocks of similar size (mostly up to £400m mkt cap), and similar positions in the value chain. With a 2008 P/E of 8.8x, BPI trades close to the average. Against this group of small industrial peers, it is hard to draw trends. Performance has been entirely sector-specific, with earnings and share price rising in energy- and aerospace-related sectors and falling elsewhere.

BPI's only directly comparable company, RPC, a manufacturer of rigid-plastic packaging, has in fact performed very similarly to BPI. Its last trading statement echoes the same issues as BPI: lower first-half profits, margin compression, restructuring, control of debt and the need to pass on material costs to customers against the uncertainty of the H2 pricing environment. The share prices of both companies are about half the level of 12 months ago.

Exhibit 5: Peer company valuations

		Price	Mkt Cap.	Calendar 2008			Calendar 2009		
		(p)	(£m)	P/E	EV/Sales	Yield	P/E	EV/Sales	Yield
BPI	Polyethylene film	234	61	8.8	0.22	9.4%	8.0	0.22	9.4%
Peer Industrial companies									
Acertec	Reinforcing bar, body panels	10	5	N/A	0.18	0.0%	1.8	0.17	0.0%
Castings	Foundry & machining	267	116	10.7	0.91	3.7%	10.1	0.85	3.9%
Fenner	Reinforced polymer belts	227	397	12.7	1.07	2.9%	11.1	0.97	3.1%
Foseco	Ceramic foundry products	342	259	12.1	0.70	2.8%	10.5	0.67	2.9%
Hill & Smith	Metal barriers	16	19	7.9	0.28	6.3%	7.2	0.27	7.0%
Metalrax Group	Specialist steel products	72	55	8.0	0.43	0.0%	6.9	0.41	1.0%
Renold	Chain, gears & couplings	147	146	7.0	0.41	6.1%	6.8	0.39	6.6%
RPC	Rigid plastic packaging	109	433	10.7	1.01	2.7%	10.1	0.97	3.0%
Senior	Stainless steel fabrications	143	118	7.1	0.53	4.5%	6.5	0.50	4.9%
Titan Europe	Wheels, undercarriages	234	61	8.8	0.22	9.4%	8.0	0.26	9.4%
Average				8.4		3.9%	7.9		4.2%

Source; Edison Research, Hemscott. Prices taken on 29/08/08.

Exhibit 6: Company data sheet

Operations

BPI has 25 plants located in the UK (19), Belgium (2), Netherlands, Canada (2) and China. Operations are managed as four UK businesses (250k tonnes) and one in Europe (60k tonnes). 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 & SABIC & account for c 60% of group sales.

Film

The 105k tonne operation is run from six factories in the UK, and a sales office in Ireland and combines the 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. Main products are stretch-wrap and shrink-wrap (silage, packaging and food), and films for other converters.

Recycled

BPI operates five plants in the UK and one in China and is the largest re-processor of polyethylene in Europe, producing c 80k tonnes of product. The plants take waste from its operations and from customers 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 is increasingly going to the Far East, where labour costs for sorting are cheaper. Supply of waste polyethene is short due to high demand from the Far East (UK is 75% export).

Converted Product — Industrial/Consumer

In this business, BPI makes c 70k tonnes polyethylene film into specific products by printing and converting it. In total there are eight 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.

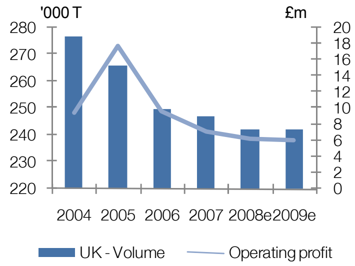
Europe

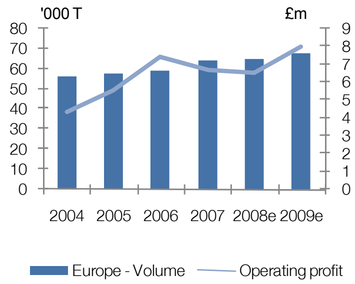
This business runs the group's one Dutch and two Belgian plants (60k tonnes). It replicates the UK Film and Converted Products operations, although it performs limited recycling. The three strongest non-UK territories for BPI are Belgium, Netherlands and France which each account for about 5% of group sales. (NB Ireland is serviced from the UK.) The main products are: silage wrap, printed film and heavy duty sacks.

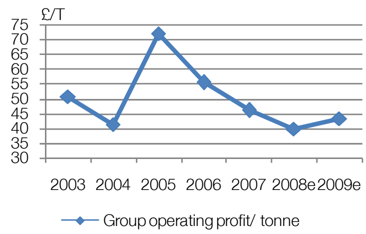
Canada

The main agricultural and horticultural markets are truly international and the recent acquisition adds c 12k tonnes capacity in Canada, and grain bags as a new product.

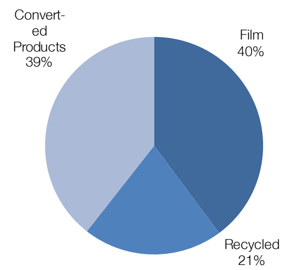
Performance





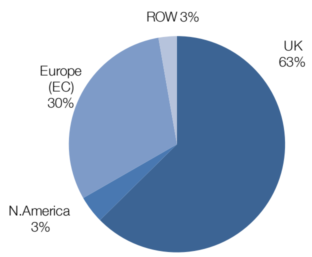


Process breakdown



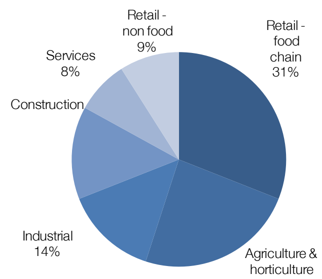
Based on 2007sales. European operations are

Geographic breakdown



Based on proforma 2007 sales by destination

End-user market breakdown



Based on 2007 sales

Source: Edison Investment Research

Exhibit 7: Financials

£m	2004	2005	2006	2007	2008e	2009e
Year end 31 December	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS						
Revenue	**359.4**	**410.2**	**414.2**	**424.1**	**490.0**	**510.0**
Cost of Sales	(300.5)	(338.7)	(352.4)	(363.5)	(430.2)	(445.8)
Gross Profit	58.9	71.5	61.8	60.6	59.8	64.3
EBITDA	**26.8**	**36.6**	**29.8**	**26.6**	**25.8**	**27.1**
Operating Profit (before GW and except.)	**13.7**	**23.3**	**17.1**	**13.9**	**12.7**	**14.0**
Goodwill Amortisation	0.0	0.0	0.0	0.0	0.0	0.0
Exceptionals	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.2	(0.4)	(0.3)	1.2	1.0	1.0
Operating Profit	**13.9**	**22.9**	**16.7**	**15.1**	**13.7**	**15.0**
Net Interest	(2.9)	(3.2)	(2.7)	(3.6)	(4.2)	(4.5)
Profit Before Tax (norm)	**11.0**	**19.7**	**14.0**	**11.5**	**9.5**	**10.5**
Profit Before Tax (FRS 3)	**11.0**	**19.7**	**14.0**	**11.5**	**9.5**	**10.5**
Tax	(2.9)	(5.4)	(3.9)	(3.0)	(2.6)	(2.8)
Profit After Tax (norm)	**8.1**	**14.3**	**10.1**	**8.5**	**6.9**	**7.7**
Profit After Tax (FRS3)	**8.1**	**14.3**	**10.1**	**8.5**	**6.9**	**7.7**
Average Number of Shares Outstanding (m)	25.7	25.7	26.0	26.2	26.4	26.4
EPS - normalised (p)	31.5	54.3	38.5	32.3	26.5	29.3
EPS - FRS 3 (p)	31.5	55.3	38.8	32.4	26.3	29.0
Dividend per share (p)	21.0	22.0	22.0	22.0	22.0	22.0
Gross Margin (%)	16.4	17.4	14.9	14.3	12.2	12.6
EBITDA Margin (%)	7.5	8.9	7.2	6.3	5.3	5.3
Operating Margin (before GW and except.) (%)	3.8	5.7	4.1	3.3	2.6	2.7
BALANCE SHEET						
Fixed Assets	**90.7**	**93.5**	**85.4**	**86.6**	**87.9**	**87.4**
Intangible Assets	2.6	2.0	2.1	2.1	2.3	2.3
Tangible Assets	79.4	79.2	77.3	82.5	83.5	83.0
Investment/tax credits	8.7	12.3	6.0	2.0	2.1	2.1
Current Assets	**121.3**	**119.4**	**120.5**	**127.8**	**146.2**	**152.0**
Stocks	58.4	55.3	59.5	62.1	71.7	74.7
Debtors	61.9	63.2	60.5	65.1	73.5	76.4
Cash	1.0	0.9	0.5	0.6	1.0	1.0
Current Liabilities	**(104.9)**	**(75.5)**	**(68.3)**	**(81.4)**	**(92.7)**	**(98.6)**
Creditors	(70.4)	(68.7)	(60.9)	(63.5)	(74.8)	(80.7)
Short term borrowings	(34.5)	(6.8)	(7.4)	(17.9)	(17.9)	(17.9)
Long Term Liabilities	**(71.0)**	**(100.2)**	**(83.2)**	**(70.6)**	**(77.4)**	**(74.9)**
Long term borrowings	(23.2)	(41.2)	(45.1)	(47.5)	(53.1)	(52.1)
Other long term liabilities	(47.8)	(59.0)	(38.1)	(23.1)	(24.3)	(22.8)
Net Assets	**36.1**	**37.2**	**54.4**	**62.4**	**64.0**	**66.0**
CASH FLOW						
Operating Cash Flow	**16.4**	**33.8**	**19.4**	**22.0**	**21.3**	**26.1**
Net Interest	(3.0)	(3.2)	(2.8)	(3.6)	(4.2)	(4.5)
Tax	(3.2)	(4.0)	(5.6)	(2.2)	(2.2)	(2.8)
Capex	(13.0)	(11.6)	(11.6)	(13.2)	(12.8)	(12.0)
Acquisitions/disposals	0.0	0.0	0.0	(6.5)	0.0	0.0
Financing	(0.2)	0.0	1.4	(3.5)	(1.6)	0.0
Dividends	(5.4)	(5.4)	(5.7)	(5.8)	(5.7)	(5.7)
Net Cash Flow	(8.4)	9.6	(4.9)	(12.8)	(5.2)	1.1
Opening net debt/(cash)	**48.3**	**56.7**	**47.1**	**52.0**	**64.8**	**70.0**
HP finance leases initiated	0.0	0.0	0.0	0.0	0.0	0.0
Other	(0.0)	(0.0)	0.0	0.0	(0.0)	(0.0)
Closing net debt/(cash)	**56.7**	**47.1**	**52.0**	**64.8**	**70.0**	**69.0**

Source: Company accounts/Edison Investment Research