2nd February 2016

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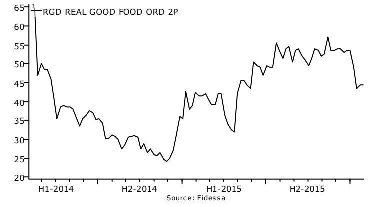
Food manufacturing



Market data

EPIC/TKR	RGD
Price (p)	39.0
12m High (p)	58.0
12m Low (p)	24.0
Shares (m)	69.5
Mkt Cap (£m)	27.1
EV (£m)	30.1
Free Float* %	63%
Market	AIM

**As defined by AIM Rule 26*

Description

Food manufacturing with an emphasis on specialties and premium routes to market. Principally UK and an element of exports.

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Next Event

June 2016	Full year results
Sept 2016	AGM
Nov 2016	Interim results

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Real Good Food plc

Profits downgraded but still growing FY16E, FY17E

Real Good Food's focus is towards premium product segments and routes to market via specialists who bring premium pricing opportunities. This includes focus on supporting the various brands, the costs of which have always been included in our forward estimates. However, Monday's update is negative in that the 2.9% (year to March 2015 continuing businesses) EBITA margins are now estimated to rise to only 3.2% in FY16, before (we estimate) rising in FY17E. We reduce FY16E PBT from £5.2m to £2.7m, suspending FY17E. March 2016 we estimate net £2m debt.

- **1st February:** "The Board now expects that within the continuing business EBITDA will remain flat year on year, as this investment, when combined with other one-off events within the various business divisions, has led to a short term impact on margins… confident however that the negative impact on margins is short-term."
- **Profit estimates FY16E reduced £2.5m:** H2 profits expected to rise vs seasonally lower H1 figures, which were announced 11th November. We understand there are a number of small short term profit pressures, predominantly from areas of the business already on low margins. FY17E is suspended, but strategy intact.
- **Strategy and outlook:** We estimate businesses in FY16E excluding Renshaw and Rainbow Dust Colours and pre the whole Group central overheads charge is losing a modest amount of money. The c.£60m sales in these lower margin businesses has scope to be profitable and do not compromise the Group.
- **Risks:** Real Good Food financial gearing is de minimis. The (estimated) loss making businesses are operating in competitive areas such as multiple grocers or still fledgling. Former are expanding to next phase and latter have already executed significant growth to new clients with strong margin potential.
- **Investment summary: Real Good Food trades today on 6.0x EV/EBITDA FY16E.** It operates offer attractive growth markets, through their premium pricing nature. Real Good Food has cemented its transition to these growing sales channels routes to growth markets. There have been various elements of turbulence in other areas, blowing temporarily off-track.

Financial summary and valuation

Year end March (£m) *[1]*	**2012**	**2013**	**2014**	**2015**	**2016E**	**2017E**
Sales	305.5	265.8	272.6	232.9	107.5	
EBITDA	8.6	10.0	2.7	1.1	5.0	
Underlying EBIT	6.2	8.0	0.5	-1.2	3.2	
Underlying PTP	4.5	6.5	-1.2	-3.2	2.7	
Statutory PTP	4.4	6.3	-1.5	-3.5	10.8	No
Underlying EPS (p)	5.3	7.0	-0.4	-4.1	2.6	current
Statutory EPS (p)	5.1	6.4	-1.0	-4.9	13.5	estimate
Net (debt)/cash	-28.7	-25.0	-31.1	-30.1	-2.0	
Dividend (p)	0.0	0.0	0.0	0.0	0.0	
Ave Shares issued	65.0	68.4	69.5	69.6	69.6	
P/E (x)	7.4	5.6	-ve	-ve	15.0	
EV/sales (x)	0.22	0.24	0.26	0.29	0.34	

[1] 15 months end December 2012. 2016 continuing businesses only
Source: Real Good Food Accounts, Hardman & Co Estimates

Overview of business and strategy

Focus a high proportion towards premium margin products.

► **Strategy:** Real Good Food's focus is towards premium product segments and towards routes to market via specialists who bring premium pricing opportunities. This includes focus on supporting Real Good Food's various brands and thus Real Good Food highlighted again at their results announcement of 11th November that H1 featured a significant long term industrial contract coming to an end. This was profitable business but it was significantly lower margins work, offered no significant growth opportunity and – useful at the time – it became less core in the new strategy. There are other effects of non-branded sales which we believe are in the mix within the trading update of yesterday.

► **Significant margin potential, but FY16 downgrade:** Operating margin rises are ongoing but today's announcement is negative. At 2.9% (year to March 2015 continuing businesses), we had estimated 5.0% EBITA margin in 2016E. Now we are guided towards flat margins on EBITDA and similar EBITA margins FY16E.

In the transition, branded bias is benefitting but some non-branded margin downgrade

► **Transition:** "The Board is confident however that the negative impact on margins is short-term and that the Group is well positioned for future growth following its investment programme." The confidence in good part stems from the investment in people and assets and marketing for the branded sales.

No organic sales growth FY16E – as anticipated

► **Sales growth, no change in top line estimate:** We had previously seen nil organic sales growth FY16, with the Group focused on margins. This remains the strategy. We anticipate growth FY17 (all organic as the 10th December acquisition of ISO2 Nutrition was a very small business). ISO2's role is a case in point: to accelerate the move of Garrett towards consumer demand as opposed to commodity ingredients.

£2m debt estimate year end

► **Balance sheet and cashflow:** The end September position was £3.0m debt (£36.3m). £44.4m was received tax free from the sale of Napier Brown (a sum including significant release of working capital). As we outlined in our November 2015 research document "Even if some of this is used for accelerating expansion opportunities of an organic nature, the free cashflow itself is most supportive to the current share price. This is a management KPI."

Cashflow anticipated at marginally positive H2

► **However, with a £2.5m reduction in EBITDA, we reduce our year end cash estimate** of £2m. Debt was £3m end September and we anticipate a reduced debt – compared to that level – at end March. Naturally, balance sheets represent a snapshot figure.

Three key product 'pillars'….core plank of continually investing to enrich the branded route to market is the right strategy

► **Investment summary:** Real Good Food is working successfully to raise the proportion of profit (already well over half total) derived from branded. Its multiple grocer exposure is modest. It thus has the core plank exhibiting enviable – within a sector context – routes to market. It is strategically focused on 1) cake decoration (UK and overseas); 2) food ingredients (currently UK); and 3) premium bakery (UK). We would like to see the good expansion in numbers of premium clients in premium bakery translate to good profit expansion in FY18, but had never expected this to be FY16 or FY17. Certain parts of food ingredients operate in commodities of dairy and sugar but this remains profitable and is going more to added value. This division is on a journey in this respect. **Profit expansion:** 1) More of the same in terms of expansion in premium routes-to-market in cake decoration 2) Food ingredients and premium bakery profit expansion from lower levels 3) Selective acquisitions.

H2 currently exhibits modest execution risk – thus £2.5m profit downgrade

Current trading

In November (interims) we had maintained PBT and trimmed sales 4%.

As of 11th November 2015 current trading was seen as encouraging, December and January have had turbulence. We at that stage had maintained our existing FY16 and FY17 estimates, both profits and cash.

The 11th November interims had led us to trim FY16 sales estimates: from £112m to £107.5m, reduced at Renshaw and Haydens Bakery. Renshaw's issue was the lower margin industrial contract ending, thus sales -7% H1. This is part of the Real Good Food strategy: move up the value chain in clients and route to market. At Haydens, in contrast, H1 sales were down 5% which was worse than we had expected.

December, January have seen a number of "other one-off events within the various business divisions" cumulating in the EBITDA downgrade. The important issues we would highlight as follows:

We estimate c£2m debt end March 2016 vs prior estimate £2m cash

New cash numbers of £2m debt year end 2016 and interest cover 12x (on unchanged estimate of £0.3m interest and bank fee charge pre £0.2m pension finance accounting cost).

EBITDA FY16E (continuing businesses) £2.0m H1, new estimate £3.0m H2 (down from £5.5m H2 estimated).

We are now guided to cut EBITDA and PBT each by £2.5m for FY16E (year to March)

Full year PBT reduces to £2.7m from former estimate £5.2m

FY15A PBT £1.9m from continuing businesses, grows 42% to our new FY16E.

FY15A EBITDA £4.85m from continuing businesses, grows de minimis to our new £5.0m FY16E.

Revenue, depreciation and interest estimates unchanged.

We are strongly of the view FY17E profits will rise. We suspend estimates until an assessment (April) of how the new fiscal will have started.

Where does this leave FY17E? "The Board is confident however that the negative impact on margins is short-term and that the Group is well positioned for future growth following its investment programme." At this stage we are re-assessing FY17. We fully commit to an estimate that profits will rise (both EBITDA and PBT adjusted) vs FY16. It may prove that we should not alter FY17E, but clearly there is some element of lower momentum entering that fiscal period in two months' time.

Channels remain strong and playing increasingly to those strengths ……

Renshaw remains the big driver. Its market positioning is as strong as ever and marginal weakness is in the non-Renshaw or Rainbow Dust Colour brands. Point of sale promotion through positioning on shelves and not through pricing – that all remains in place. Indeed the positioning in outlets such as Lakeland and Hobbycraft is important and positive. At a visit to Hobbycraft in January we noted strong shelf space and location within the store and buying interest.

…. Execution risk has transpired….

Haydens has significantly expanded outside the more difficult multiple grocer end of the market. Waitrose remains the largest customer however. We believe Haydens is profitable at the operating profit level, but margins were never high and they certainly are not rising in recent trading.

… in a number of small cumulative negative client-driven effects

In summary: Real Good Food has some 60% of sales to well branded non commodity and to non multiple grocer markets. This is transitioning higher but FY16 is seeing a number of modest incidents of execution risk within that strategy. Despite this, H2 profits are set to be greater than H1, but some momentum is lost in a restricted number of sub-segments.

Risks

With the exception of highlighting that we do not believe the downgrades derive from the more 'fashion' end of the Renshaw customer and product mix, the following Risk Analysis is exactly the same as published in our November 2015 research.

Historic high gearing (in part due to high working capital). Now no longer the case

The history of Real Good Food has been one of high financial gearing and working capital. This stemmed from the ownership of Napier Brown. This business provided a profitable disposal: the £44m price was good (better than the market had expected, by some way). We do not expect this financial situation to be replicated, though we do not rule out the Group acquiring for debt. It owns its assets freehold.

The food industry is challenging regarding multiple grocers' margin pressure. 15% (only) of estimated profits medium term derive from this area

Real Good Food is cautious on exposure to multiple grocers' pricing pressure but some 15% (estimated) profits derive from this area – maybe rather less FY16E. Garrett Ingredients' markets are commodity related.

Renshaw is in a narrow market which has some fashion elements

Renshaw sells into a marketplace which is both discretionary and fashion conscious. Within FMCG categories this has been boosted by the prominence of baking and encouragingly 1) there is an age demographic from children to 'empty-nesters' 2) the 'Bake-off' phenomenon has been in place for many years and is an established market as opposed to a 'fashion trend'. Renshaw has a series of routes-to-market but the category is relatively narrow: cake decoration being dominant also it also provides specialist ingredients.

Haydens has exposure to Waitrose in its bakery and its Waitrose dedicated distribution centre. On multiple grounds the relationship is strong but multiple grocery markets are difficult

Haydens Bakery has its main exposure to Waitrose, whose sales growth has been moderating and may even reverse. Waitrose is expanding geographically and the Haydens distribution centre is important in embedding it with the client's expanding logistics. Margins are still in transition and we understand the benefits of rising efficiencies are still coming through. That said, the distribution centre is expanding and is used nationally for Waitrose to support its logistics and also to support its commitment to regional/ local producers

Rainbow Dust Colours very much is a fashion business

Rainbow Dust Colours is a high fashion market. It appears to be robust in its UK and export growth and gross margins are stable. Stocking risk is low, the main risk is the quantum of profit advances. It faces no systemic competition risk despite attractive margins. Social media 'excitement' is important and RDC is well placed.

Garrett operates in difficult commodity markets. It is doing well considering this

Garrett Ingredients sells milk and sugar related ingredients. Sugar prices have fallen over 20% and, whilst recently there have been rises, milk prices are under pressure. In summary the historic core is food commodity based. Nonetheless, a greater service element has prevented worse damage to the business' profits and is a positive for the near future too. A further material downturn in the cycle from its depressed level would not prove substantially embarrassing in the context of the Group as a whole

R&W Scott needs to increase its value added in order to step away from potential input price risks, not least cocoa. It has been moving this way for a number of years.

Real Good Food Europe is an early stage business though the presence and contacts the Group has had for some time on Continental Europe are extensive. This is not a new business start-up, it is a marketing channel for existing sales to be enlarged to a wider geographical footprint (indeed including outside Europe).

For a fuller analysis and description of each business within Real Good Food, please see our research published 20th July 2015 and 23rd September 2015.

Financials

2015 is stated in both forms, including Napier Brown and (under note 3) excluding Napier Brown as this is no longer part of the Group. FY16 will, when reported, include some weeks' Napier Brown trading but our figures exclude this business. 2016E includes £10.0m exceptional credit, resulting from the book profit on the disposal of Napier Brown. Note: "significant items" are itemised within the Real Good Food accounts and principally comprise management restructuring. In no year does this item exceed £0.85m. In FY16E we estimate £0.3m. Our Adjusted profits are taken post these costs and pre modest costs of amortisation of acquisition related goodwill.

Profit & Loss account

Year end March (£m)	2010[1]	2012[2]	2013	2014	2015	2015[3]	*FORMER 2016E[3]*	CURRENT 2016E[3]
Revenue	200.1	305.5	265.8	272.6	232.9	104.6	*107.5*	107.5
EBITDA (post significant items)	5.21	8.63	9.96	2.71	1.09	4.85	*7.50*	5.00
Operating profit pre amortisation	3.21	6.18	7.97	0.47	-1.23	3.03	*5.70*	3.50
Amortisation	0.24	0.17	0.23	0.35	0.35	0.35	*0.35*	0.35
Operating profit	2.97	6.01	7.74	0.12	-1.58	2.68	*5.35*	2.85
Exceptional	0.00	0.00	0.00	0.00	0.00	0.00	*9.40*	9.40
Interest net [4]	-1.37	-2.02	-1.67	-1.60	-1.71	-0.86	*-0.30*	-0.30
Pension finance accounting	0.09	0.24	0.08	-0.06	-0.24	-0.24	*-0.20*	-0.20
Pretax profits PRE 'significant items'	2.34	4.91	6.77	-1.00	-2.68	2.10	*14.55*	12.05
Napier Brown Loan note [5]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	*-0.90*	-0.90
Pretax profits stated [6]	1.95	4.36	6.26	-1.54	-3.53	1.58	*13.27*	10.77
Pretax profits Adjusted [7]	**2.19**	**4.53**	**6.49**	**-1.19**	**-3.18**	**1.93**	***5.20***	**2.70**
Tax	-0.42	-0.75	-1.34	0.88	0.13	-0.95	*-1.46*	-0.75
EPS (p) diluted Adjusted [7]	**2.59**	**5.30**	**6.95**	**-0.41**	**-4.11**	**1.32**	***5.06***	**2.63**
EPS (p) diluted Stated	2.20	5.10	6.40	-0.95	-4.90	0.85	*15.96*	13.54
Dividend per share (p)	0.00	0.00	0.00	0.00	0.00	0.00	*0.00*	0.00
Average shares in issue	65.01	65.02	68.41	69.57	69.60	69.60	*69.57*	69.57
Average shares in issue diluted	68.3	71.38	74.11	75.58	74.20	74.20	*74.00*	74.00

Source: Real Good Food accounts, Hardman & Co estimates

[1] 12 months to December 2010

[2] 15 months to March

[3] Excluding Napier Brown, disposed post FY15 year end

[4] Excludes pension finance cost includes bank fees and break costs

[5] Loan note to Napier Brown. £0.9m redemption fee. As part of disposed business, excluded from Adjusted PBT. Note that there was £0.3m outstanding interest referred to in prior announcement which was a FY15 figure, not FY16.

[6] Including £84,000 operating loss from Napier Brown, disposed on 19 May 2015 and Napier Brown loan note

[7] Pre-exceptional credit and amortisation of goodwill and Napier Brown £84,000 loss or loan note. Post 'significant items' of £0.3m FY16E

Cashflow

Year end March (£m)	2009[1]	2010[1]	2012[1]	2013	2014	2015	NEW ESTd 2016E
Operating cash flow	5.0	5.2	8.6	10.0	2.8	1.2	5.0
Working capital	4.5	0.0	-7.7	-2.3	0.6	4.1	2.5
Pensions	0.0	0.0	-0.2	-0.2	-0.3	-0.5	-0.3
Tax	1.0	0.0	-0.9	-1.0	-0.8	0.6	-1.4
Interest	-1.9	-1.3	-1.9	-1.6	-1.6	-1.7	-0.3
Net cash flow from operating activities	*8.6*	*3.9*	*-2.1*	*4.9*	*0.7*	*3.8*	*5.5*
Net capex	-1.0	-2.4	-4.0	-3.8	-6.9	-1.5	-5.5
Disposal and other	0.0	0.0	0.0	0.0	0.0	0.0	34.0
Acquisition	0.0	0.0	0.0	0.0	0.0	-1.2	-6.0
Share issues	0.0	0.0	0.0	2.5	0.0	0.0	0.0
Dividend	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net cash change	7.6	1.5	-6.1	3.6	-6.2	1.0	28.0
Cash total	-24.1	-22.7	-28.7	-25.0	-31.1	-30.1	-2.0
Free cash flow	7.6	1.5	-6.1	1.1	-6.2	2.3	0.0
Free cash flow pps	**11.6**	**2.2**	**-8.5**	**1.5**	**-8.2**	**3.1**	**0.0**

Source: Real Good Food accounts, Hardman & Co estimates

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