

Gradus

Buy

Initiation of coverage

Price: BGN 1.47

Price target: BGN 1.76

Let's buy some chickens!

We initiate coverage of Gradus, with a BUY rating and a 12M price target (PT) of BGN 1.76/share (20% upside potential). The company produces chicken meat (a 39% share of its 2019 revenues) and breeding eggs (28%), and the latter segment makes the largest contribution to the group's operating profit (48% in 2019). Gradus is the largest poultry meat producer in Bulgaria (a 35% market share, according to the company) and it has strong brand recognition (the first-choice brand for 68% of consumers in Bulgaria). Moreover, we like its vertically-integrated business, which allows it to capture margins throughout the entire production chain. On top of this, we also see Gradus' financials as very encouraging: we expect a 2019-22E EBITDA CAGR of 21% (due mostly to the expansion of its chicken and eggs production in 2020E), coupled with low leverage (on our numbers: net debt/EBITDA at 0.4x at end-2020E, dropping to a net cash level of 0.2x at end-2022E). In our view, the combination of profit growth and deleveraging should result in higher dividend payments: we expect a DPS of BGN 0.04 (a 3% dividend yield) from both the 2020E and 2021E profit.

The poultry meat market should be the major driver of the global meat market in the long term, according to OECD-FAO forecasts. Poultry meat accounts for about one-third of total meat consumption worldwide. Moreover, the institutions expect the total meat production between the 2015-17 average and 2027E to increase by c.48mt worldwide, with c.43% (or 21mt) to come from the poultry market.

Gradus – largest player in Bulgaria, with a 35% market share, according to the company. Virtually all Bulgarians associate the Gradus brand with chicken meat (2015 Bluepoint survey). On top of this, more than two-thirds of Bulgarians name it as their first-choice brand, and half of consumers in Bulgaria see it as their favourite brand in the industry.

Solid growth profit, combined with a strong balance sheet, creates space for higher dividends. For 2020E, we pencil in BGN 17m of capex, related mostly to the expansion of its production capacities in the chicken and breeding eggs segments. Consequently, we expect solid EBITDA growth (2019-22E EBITDA CAGR at 21%, on our numbers), driven by higher sales volumes. This should result in FCF yields of 7-8% in 2021E and 2022E, reducing its net debt/EBITDA to 0.1x and -0.2x, respectively. Finally, we expect Gradus to pay a BGN 0.04/share dividend from both its 2020E and 2021E profits, yielding 3% (in line with the 3-4% average for the MSCI FM index, on Bloomberg estimates).

We rate Gradus a BUY, with a 12M PT of BGN 1.76/share, implying 20% upside potential. We derive our PT based on our DCF analysis and peer group valuations, assigning 100/0 weights. This implies a PT of BGN 1.76/share (20% upside). We have decided to take such an approach as we believe that our DCF valuation reflects Gradus' cash generation capacity. Currently, the company trades at its EV/12M trailing EBITDA, at 14x, 18% below its long-term average.

Expected events

2Q20	29 August (TBC)
3Q20	29 November (TBC)

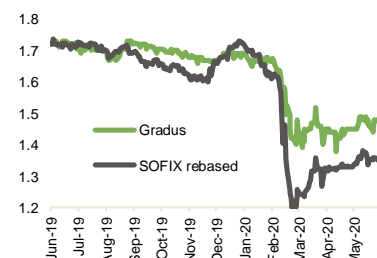
Key data

Market Cap	USD 206m
3M ADTV	USD 11k
Free float	19%
Shares outstanding	244m
Major Shareholder	
	Luka Angelov Angelov (40.7%)
	Ivan Angelov Angelov (20.7%)
	Angel Ivanov Angelov (20.7%)
Bloomberg Code	GR6 BU
SOFIX Index	424

Price performance

52-w range	BGN 1.38-1.73
52-w performance	-15%
Relative performance	+7%

Gradus 12M share price performance



	Revenues BGNm	EBITDA BGNm	EBIT BGNm	NI BGNm	EPS BGN	DPS BGN	P/E x	EV/EBITDA x	Div. yield	ND/EBITDA x
2018	141	23	17	15	0.1	0.00	24.6x	15.9x	0.0%	0.2x
2019	155	26	19	17	0.1	0.12	21.1x	14.2x	8.0%	0.5x
2020E	191	42	35	31	0.1	0.04	11.4x	8.9x	3.0%	0.4x
2021E	200	44	36	32	0.1	0.04	11.2x	8.2x	2.8%	0.1x
2022E	208	46	38	34	0.1	0.08	10.6x	7.6x	5.2%	-0.2x

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Closing Prices as of 26 June 2020

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Company snapshot – BUY, PT BGN 1.76/share

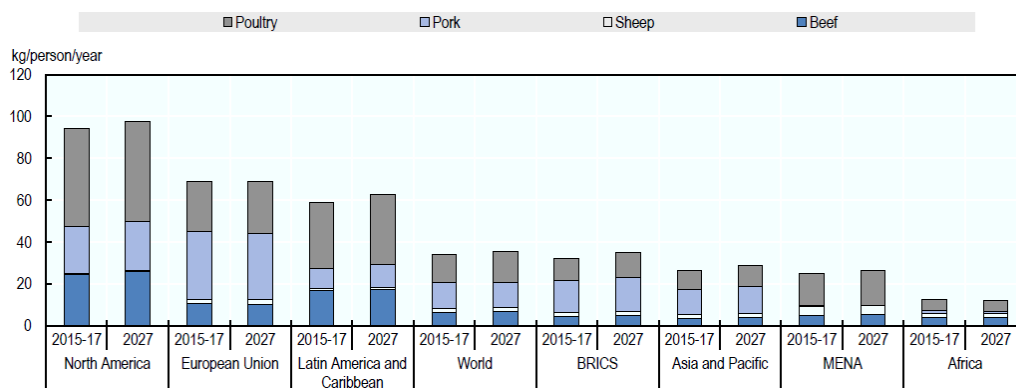
Gradus		SHARE PRICE PERFORMANCE		COMPANY DESCRIPTION	
BUY		GR6 BU		Gradus was established in 1992, and had its IPO on the Bulgarian Stock Exchange in 2018 (the largest offer for the year, and the second-largest in the history of the local capital market). It is the largest poultry producer in Bulgaria, and its brand is well-known, as the company's products are present in 95% of Bulgarian households. In 2001, Gradus opened a fodder factory, and the processing poultry plant started its operations in 2006. Exports accounted for c.44% of Gradus' top line in 2019.	
Bloomberg ticker	GR6 BU	1.8			
Closing price (BGN/share)		1.47			
PT (BGN/share)		1.76			
Upside to PT		20%			
Shares outstanding (m)		244			
Market cap (USDm)		206			
Free float		19%			
Average daily turnover (USDk)		11.4			
52 Week performance		-15%			
52 Week relative performance		7%			
52 Week Range (BGN)		1.38-1.73			
RATIOS					
PER SHARE RATIOS					
	2018	2019	2020E	2021E	2022E
EPS	0.1	0.1	0.1	0.1	0.1
BVPS	1.3	1.3	1.4	1.5	1.5
DPS (from the given year's net profit)	0.00	0.12	0.04	0.04	0.08
Dividend pay-out ratio	0%	51%	63%	60%	60%
FINANCIAL RATIOS					
	2018	2019	2020E	2021E	2022E
EBITDA margin	16.2%	16.9%	22.3%	22.0%	22.2%
EBIT margin	11.8%	12.5%	18.5%	17.9%	18.1%
Net margin	10.3%	10.3%	11.0%	16.4%	16.0%
Effective tax rate	10.5%	11.4%	10.0%	10.0%	10.0%
ROE	4.9%	5.4%	9.8%	9.3%	9.4%
ROA	4.1%	4.7%	8.4%	8.0%	8.0%
ROIC		5.1%	9.1%	8.6%	8.6%
VALUATION RATIOS					
	2018	2019	2020E	2021E	2022E
EV/EBITDA	15.9x	14.2x	8.9x	8.2x	7.6x
P/E	24.6x	21.1x	11.4x	11.2x	10.6x
FCF yield	3.0%	5.8%	1.3%	7.0%	8.3%
Dividend yield	0.0%	8.0%	3.0%	2.8%	5.2%
ND/EBITDA	0.2x	0.5x	0.4x	0.1x	-0.2x
FCF BREAKDOWN (BGNm)					
	2018	2019	2020E	2021E	2022E
EBIT	17	19	35	36	38
NOPAT	15	17	32	32	34
Depreciation	6	7	7	8	9
Change in WC	-3	8	-17	-4	-4
Capex	-7	-7	-17	-11	-9
FCF	11	25	5	25	30
COMPANY FINANCIALS					
INCOME STATEMENT, BGNm					
	2018	2019	2020E	2021E	2022E
Revenues	141	155	191	200	208
Other income	31	29	35	37	38
Costs of materials & energy	-79	-82	-89	-93	-96
Employee benefits	-23	-26	-30	-32	-33
Other	-54	-57	-72	-76	-79
EBITDA	23	26	42	44	46
D&A	-6	-7	-7	-8	-9
EBIT	17	19	35	36	38
PBT	16	19	35	36	38
Income tax	-2	-2	-3	-4	-4
Net profit	15	17	31	32	34
CASH FLOW STATEMENT, BGNm					
	2018	2019	2020E	2021E	2022E
CF from operations	7	26	22	36	39
Payments to suppliers	-149	-136	-146	-153	-159
Other	-16	-20	-58	-48	-49
CF from investments	-8	-5	-17	-11	-9
o/w capex	-7	-7	-17	-11	-9
CF from fin. activities	5	-26	1	-6	-19
o/w dividends	0	-28	-9	-10	-19
o/w paying back loans	-75	-19	0	0	0
BALANCE SHEET, BGNm					
	2018	2019	2020E	2021E	2022E
FPE	177	185	194	197	197
Goodwill	21	21	21	21	21
Intangibles	54	54	54	54	54
Others	7	8	8	8	8
Total non-current assets	259	267	277	280	280
Inventories	54	56	69	73	76
Trade accounts receivable	28	17	21	22	22
Cash and cash equivalents	7	3	8	27	38
Others	15	12	13	14	14
Total current assets	105	88	112	135	150
Total shareholders equity	325	312	334	356	371
Deferred tax liabilities	15	15	15	15	15
Other LT liabilities	2	3	3	3	3
Total non-current liabilities	17	18	18	18	18
ST Debt	12	16	26	30	30
ST payables	6	4	6	6	6
Other ST liabilities	5	5	5	5	5
Total current liabilities	22	25	37	41	41
Total equity and liabilities	364	355	388	415	430
DYNAMICS (yoy)					
	2018	2019	2020E	2021E	2022E
Revenues		9.3%	23.3%	4.9%	4.0%
Costs of materials & energy		3.6%	8.5%	4.7%	3.8%
Employee benefits		12.4%	15.8%	6.7%	3.4%
D&A		10.4%	6.7%	14.2%	5.2%
EBITDA		14.1%	62.9%	3.8%	4.8%
EBIT		15.4%	82.5%	1.7%	4.7%
Net income		16.9%	84.1%	2.2%	5.6%
Revenues breakdown					
	2018	2019	2020E	2021E	2022E
Revenue	141	155	191	200	208
Meat and meat products	67	72	86	90	93
Breeding eggs	43	52	59	63	66
Trade in grain and components	30	29	40	42	43
Unallocated revenue	4	1	1	1	1
Unallocated other income	0	5	5	5	5
ND/EBITDA and capex					
	2018	2019	2020E	2021E	2022E
CAPEX (BGNm)	7	7	17	11	9
ND/EBITDA (x; rhs)	0.2	0.5	0.4	0.1	-0.2
FCF and FCF yield					
	2018	2019	2020E	2021E	2022E
FCF (BGNm)	11	25	5	25	30
FCF yield (rhs)	3.0%	5.8%	1.3%	7.0%	8.3%

Investment case

We initiate coverage of Gradus, with a BUY rating and a 12M price target (PT) of BGN 1.76/share (20% upside potential). The company produces chicken meat (a 39% share of its 2019 revenues) and breeding eggs (28%), and the latter segment makes the largest contribution to the group's operating profit (48% in 2019). Gradus is the largest poultry meat producer in Bulgaria (a 35% market share, according to the company, as of 2015), and has strong brand recognition (the first choice brand for 68% of consumers). Moreover, we like its vertically-integrated business, which allows it to capture margins throughout the entire production chain. On top of this, we also see Gradus' financials as very encouraging: we expect a 2019-22E EBITDA CAGR of 21% (due mostly to the expansion of its chicken and eggs production in 2020E), coupled with low leverage (on our numbers – net debt/EBITDA at 0.4x at end-2020E, dropping to a net cash level of 0.2x at end-2022E). In our view, the combination of profit growth and deleveraging should result in higher dividend payments: we expect a DPS of BGN 0.04 (a 3% dividend yield) from both the 2022E and 2021E profits.

The poultry market accounts for about one-third of the global meat market... According to OECD-FAO (a collaborative effort of the Organisation for Economic Co-operation and Development (OECD) and the Food and Agriculture Organization (FAO) of the United Nations) data, the poultry consumption per capita in the EU should remain at a relatively stable level until 2027E. We note, however, that the consumption of poultry per citizen in the EU is nearly twofold greater than the average for the world, but smaller than in the North and Latin Americas.

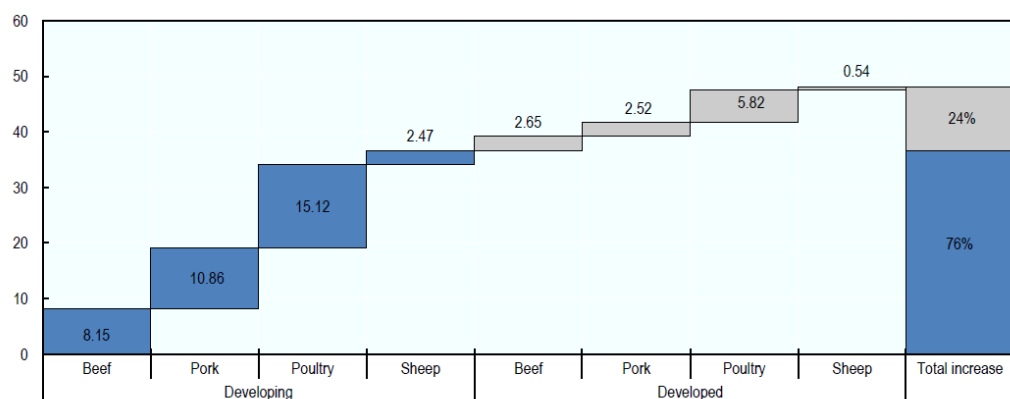
Consumption of meat per capita by region



Source: WOOD Research, OECD-FAO

...and this type of meat should contribute the most to the overall meat market growth worldwide, according to the OECD-FAO's forecasts. The institutions expect the total meat production between the 2015-17 average and 2027E to increase by c.48mt worldwide. They also indicate that the major share of this growth (c.43%, or 21mt) should come from the poultry market. It is worth noting that this ratio should be higher for developed countries, where the expansion of poultry production should account for c.50% of the growth, vs. c.41% for the developing markets.

Meat production growth by region and meat type, 2027E vs. 2015-17 average*, mt

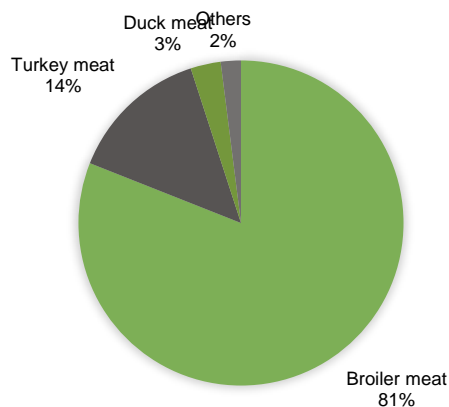
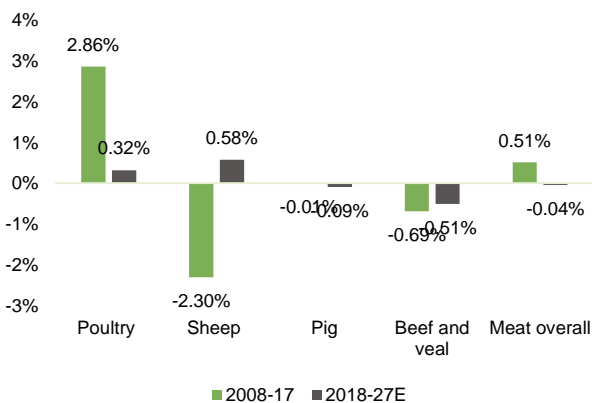


Source: WOOD Research, OECD-FAO

The poultry meat segment should be the major driver of meat market growth in the EU, according to the OECD-FAO data. European poultry consumption should expand by c.0.3% yoy between 2018-27E, vs. flat overall meat consumption in this period. It could be outpaced only by the sheep meat segment (+0.6% yoy); however, given its negligible size, the poultry market should be the main beneficiary of the meat market development, at the cost of beef and veal (-0.5% yoy). Looking at the structure of the poultry market, broilers account for the largest share (81%), followed by turkey (14%). The remaining types of poultry have only a 5% market share.

EU meat market's segments: consumption CAGR

European poultry market (shares based on kg of meat production), 2016

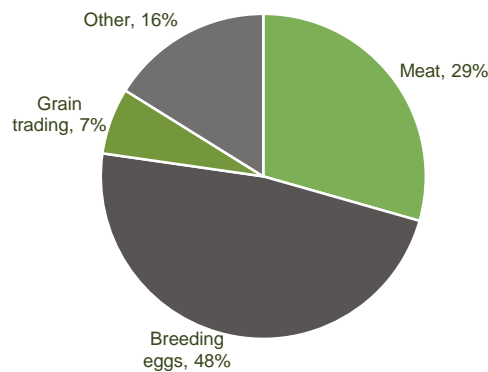
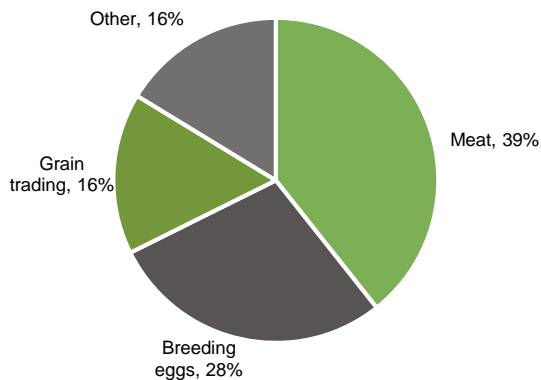


Source: WOOD Research, OECD-FAO

Breeding eggs is Gradus' most profitable segment. The company's business consists of three segments: meat and meat products; breeding eggs; and trade in grain components. Although the largest contribution to the top line comes from the meat (39% in 2019), the breeding eggs segment has the highest operating margin (18% in 2019) and, consequently, it accounts for nearly half of the Gradus group's EBIT.

2019 revenues structure

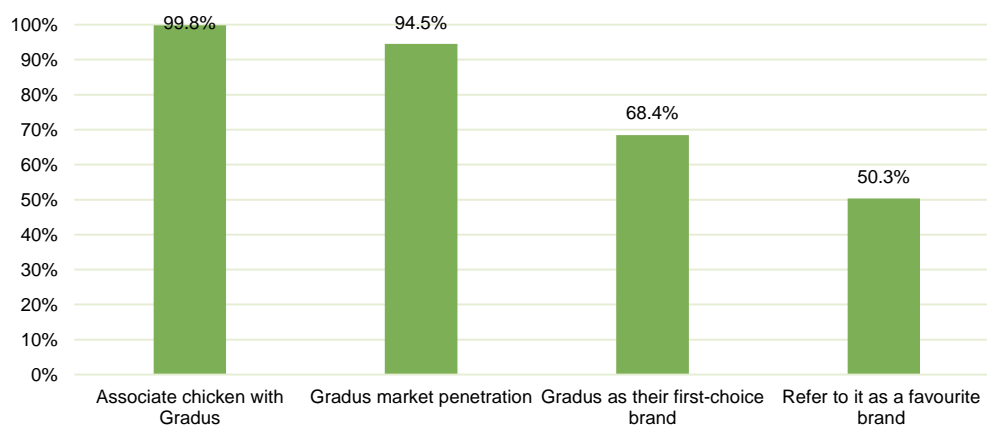
2019 EBIT structure



Source: WOOD Research, company data

Gradus has very strong brand recognition in the Bulgarian market. There is a very strong association of the brand with chicken meat, and the company has very deep (95%) market penetration. More than two-thirds of Bulgarians name Gradus as their first-choice brand, and half of consumers see it as their favourite brand in the industry (2015 BluePoint survey).

Gradus: brand recognition in the Bulgarian market, 2015

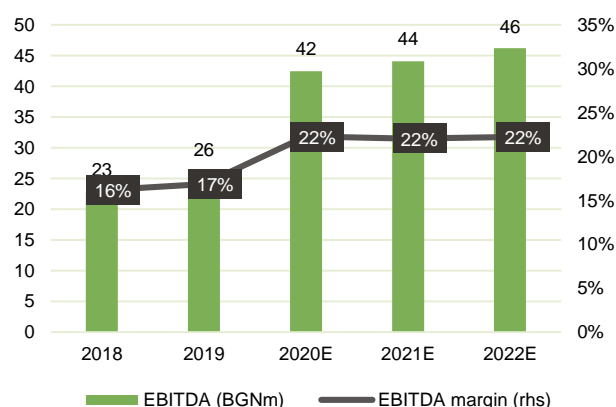
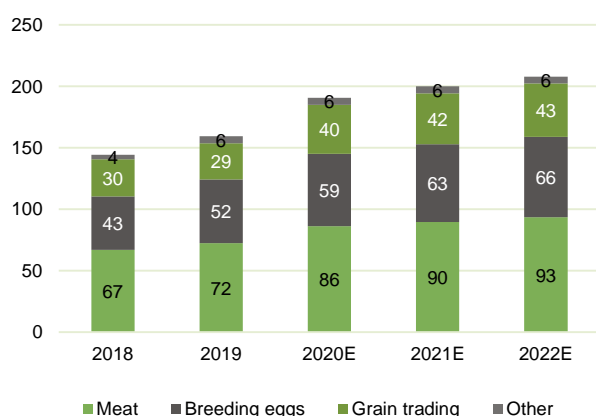


Source: WOOD Research, BluePoint, company data

We see space for the expansion of both meat and breeding eggs production. Gradus has flagged its plans for the expansion of production capacity in both the meat segment, as well as breeding eggs this year. We see greater egg production (we pencil in 33% yoy growth in breeding eggs sales in 2020E) as the main driver of the EBITDA growth this year, which should also support Gradus' margins (up from 16-17% in 2018-19 to 22% from 2020E-onwards). Consequently, we see its 2020E EBITDA landing at PLN 42m, translating into a 2019-22E EBITDA CAGR of 21%.

Gradus: revenue forecasts (BGN m)...

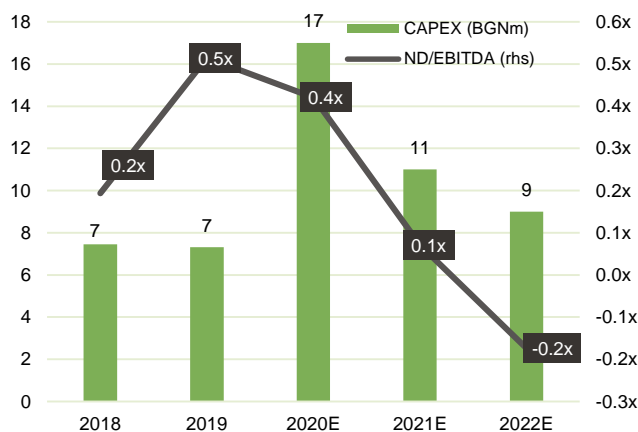
and EBITDA (BGN m)



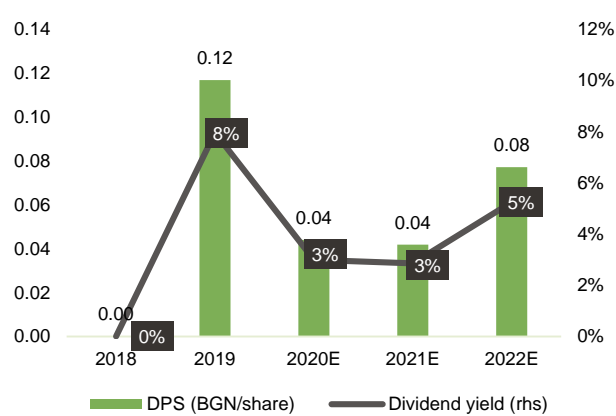
Source: WOOD Research, company data

Leverage is low and should drop further, opening up space for higher dividends. For 2020E, we pencil in BGN 17m of capex, related mostly to the expansion of production capacities, as described above. In the coming year, we see lower investment needs. This, taking into consideration the FCF generation capacity (a 7-8% FCF yield in 2021E and 2022E), should help to reduce the net debt/EBITDA to 0.1x and -0.2x, respectively. This should create more room for higher dividend payments: we expect Gradus to pay out a BGN 0.04/share dividend from both of its 2020E and 2021E profit, yielding 3% (in line with the 3-4% average for the MSCI FM index, on Bloomberg estimates).

Capex and leverage forecasts



DPS forecasts



Source: WOOD Research, company data

Up to 3% of Gradus' shares are subject to a five-year buyback programme. At the AGM, held in June 2020, the company's shareholders approved the launch of a share buyback programme. It assumes that up to 3% of Gradus' stocks may be repurchased and redeemed within the next five years. The price range for the programme has been set at BGN 1.2-2.0/share. This implies that the last closing price poses 36% upside to the cap price. As the programme is rather a small one (in terms of the number of shares that can be repurchased) and spread over five years, we do not pencil it into our forecasts. Consequently, we highlight that there is upside potential for our forecasts of cash distribution to the shareholders in the medium term.

Valuation

We rate Gradus a BUY, with a 12M PT of BGN 1.76/share, implying 20% upside potential. We derive our PT based on our DCF analysis and a peer group valuation, assigning 100/0 weights. This implies a PT of BGN 1.76/share (20% upside). We have decided to take such an approach as we believe that the key elements of the equity story (low leverage and EBITDA growth) are reflected more adequately in our DCF valuation. Also, in our view, the difference in the PT derived by using the two valuation methods is associated with the high valuation multiples at which the company trades at this stage.

Gradus: valuation summary

	Weight	PT	Current price	Upside
DCF	100%	1.76	1.47	20%
Peer-based valuation	0%	1.36	1.47	-8%
Weighted PT	100%	1.76	1.47	20%

Source: WOOD Research

DCF: 12M PT at BGN 1.76/share

We base our DCF valuation on the following assumptions:

- A WACC of c.10% and a COE of 11%.
- A present value of the discounted free cash flows of BGN 163m for 2020-28E.
- A present value of the terminal value of BGN 222m.
- The cash conversion cycle at 173 days in 2020E-onwards.
- A terminal growth rate of 2.2%.
- The number of shares at c.244m.

Gradus: DCF valuation

BGN m	2020E	2021E	2022E	2023E	2024E	2025E	2026E	2027E	2028E	Terminal
Revenues	226	237	246	256	266	277	287	299	311	323
yoy	23%	5%	4%	4%	4%	4%	4%	4%	4%	4%
EBIT	35	36	38	39	42	44	46	48	51	53
EBIT margin	19%	18%	18%	18%	18%	19%	19%	19%	19%	19%
Cash tax on EBIT	-4	-4	-4	-4	-4	-4	-5	-5	-5	-5
NOPAT	32	32	34	36	37	39	41	43	45	48
(+) D&A	7	8	9	9	9	9	10	10	10	11
(-) CAPEX	-17	-11	-9	-9	-9	-9	-10	-10	-10	-11
(-) Change in WC	-17	-4	-4	-4	-4	-4	-4	-5	-5	-5
Net Investment	-27	-7	-4	-4	-4	-4	-4	-5	-4	-5
Free Cash Flow	5	25	30	32	33	35	37	39	41	42
Terminal growth [g(t)]	2.2%									
PV TV	222									
PV FCF 2020-28E	163									
Enterprise value	385									
Net debt (end-2019)	13									
Minorities (end-2019)	2									
Equity value, BGNm	370									
Number of shares (m)	244									
Value per share (BGN, 1 Jan 2020)	1.52									
12M PT (BGN/share)	1.76									

Source: WOOD Research

Gradus: DCF sensitivity

		WACC						
		7%	8%	9%	10%	11%	12%	13%
Terminal growth rate	-1%	1.50	1.48	1.47	1.46	1.44	1.43	1.41
	0%	1.57	1.56	1.54	1.53	1.52	1.50	1.49
	1%	1.67	1.65	1.64	1.62	1.60	1.59	1.58
	2%	1.81	1.79	1.78	1.76	1.74	1.73	1.71
	3%	1.93	1.91	1.89	1.88	1.86	1.84	1.83
	4%	2.13	2.11	2.09	2.07	2.05	2.03	2.01
	5%	2.40	2.38	2.35	2.33	2.31	2.29	2.27

Source: WOOD Research

Gradus' EBITDA growth over 2019-22E should be double its peers' profit dynamics, on our estimates, and it trades at a premium to them. On our numbers, the company should enjoy a 21% EBITDA CAGR over the next three years. This is c.11ppts more than its peers' medial annual profits growth (c.10%), according to the consensus. We also note that the company has significantly lower leverage (on our numbers, its 2020E ND/EBITDA is at only 0.4x) than the other companies operating in this sector (median at 2.1x). Therefore, we are not concerned that Gradus trades, on our figures, at 33-36% premiums to its peers on its 2020-22E EV/EBITDAs.

Gradus: peer valuation

	Country	Market cap USDm	ND/ EBITDA	P/E			EBITDA CAGR 19-22E	EV/EBITDA			Dividend yield		
				2020E	2021E	2022E		2020E	2021E	2022E	2020E	2021E	2022E
Gradus	Bulgaria	206	0.4x	11.4	11.2	10.6	21%	8.9	8.2	7.6	3.0%	2.8%	5.2%
EME peers													
Kernel (WOOD)	Ukraine	837	2.4x	5.9	6.4	4.3	10%	5.1	4.8	3.9	2.4%	2.4%	9.5%
Ros Agro	Russia	1,238	3.5x	7.5	6.9	6.4	12%	7.0	6.3	5.6	6.1%	7.2%	6.6%
MHP	Ukraine	642	3.3x	n.a.	3.5	3.0	10%	4.3	3.9	3.2	8.6%	12.5%	12.5%
Astarta Holding	Ukraine	102	2.5x	n.a.	3.8	3.1	15%	3.9	3.1	3.0	0.0%	0.0%	0.0%
International peers													
Wens Foodstuffs	China	19,458	na	n.a.	n.a.	n.a.	6%	n.a.	n.a.	n.a.	7.1%	5.6%	3.6%
San Miguel Food&Bev	Philippines	8,117	0.7x	27.4	24.5	21.8	-1%	10.8	9.0	8.4	2.5%	2.2%	3.8%
Darling Ingredients	United States	3,763	2.0x	15.4	14.6	7.5	-4%	8.4	7.7	n.a.	n.a.	n.a.	n.a.
QI Resources	Malaysia	3,598	2.0x	62.4	56.1	50.4	10%	31.6	28.6	26.2	0.5%	0.6%	0.7%
Shandong Minhe	China	938	na	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Thaifoods Group	Thailand	908	2.1x	16.0	14.7	12.8	7%	9.9	8.4	7.6	2.2%	2.4%	2.3%
Forfarmers	Netherlands	658	0.6x	11.9	11.2	11.8	22%	6.3	6.0	5.7	4.8%	4.7%	4.7%
Gfpt Public	Thailand	524	1.1x	14.8	12.5	11.5	11%	7.5	6.6	6.2	1.7%	2.0%	2.1%
Astral Foods	South Africa	362	0.2x	8.9	6.8	6.3	15%	4.6	3.6	3.3	5.1%	8.7%	9.4%
Devro	Britain	333	9.3x	10.5	9.6	9.1	73%	5.3	5.0	5.4	5.6%	5.7%	5.9%
Peers median			2.1x	13.3	10.4	8.3	10%	6.6	6.1	5.6	3.7%	3.6%	4.2%
Gradus vs peers median			-1.7x	-14%	8%	28%	11pp	33%	34%	36%	-1pp	-1pp	1pp

Source: WOOD Research, Bloomberg

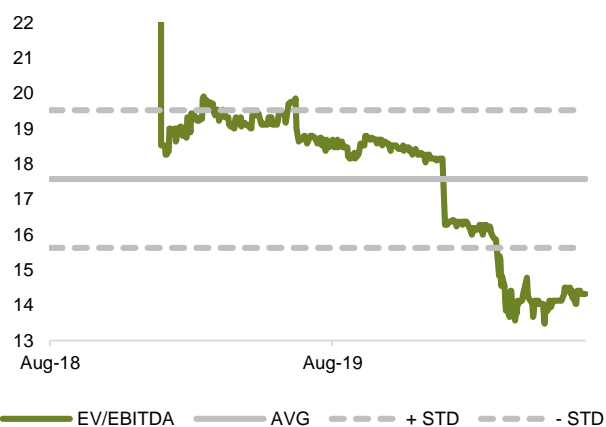
Gradus: peer valuation

	P/E			EV/EBITDA		
	2020E	2021E	2022E	2020E	2021E	2022E
Total weighted median (x)	13.35	10.37	8.26	6.64	6.10	5.55
EPS (BGN/share) for P/E and EBITDA (BGNm) for EV/EBITDA	0.1	0.1	0.1	42	44	46
Gradus: implied enterprise value				282	269	257
Gradus implied Equity value	418	332	279	262	264	262
Gradus: implied Equity value per share (BGN)	1.71	1.36	1.15	1.08	1.08	1.08
Weight (%)	16.7%	16.7%	16.7%	16.7%	16.7%	16.7%
Implied weighted equity value per share (BGN)				1.24		
12M price target (PT)				1.36		

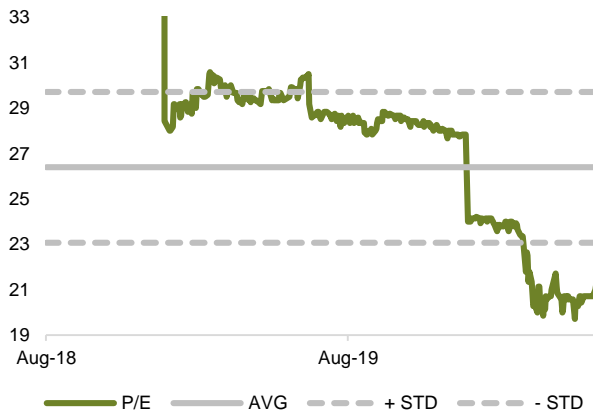
Source: WOOD Research, Bloomberg

Gradus trades at 14x EV/12M trailing EBITDA, implying an 18% discount to its long-term average.
Also, on its P/12M trailing EPS, it is valued at 21x, i.e., below the 26x average.

Gradus: EV/EBITDA*



Gradus: P/E**



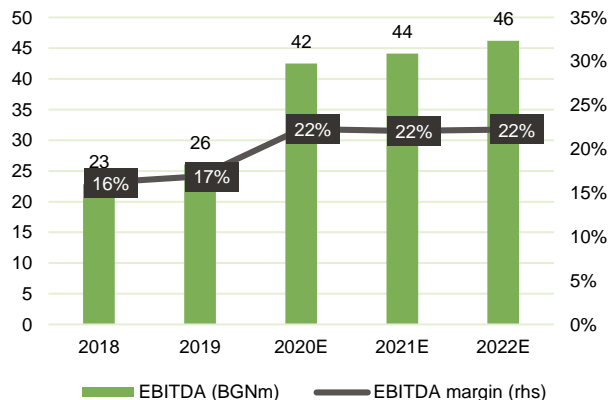
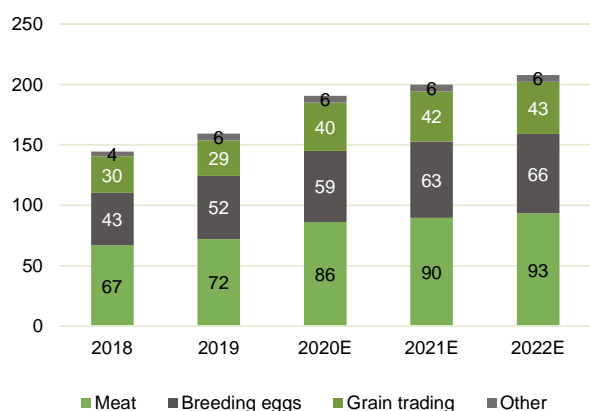
Source: WOOD Research, Bloomberg; *current EV dividend by the trailing 12M EBITDA; **current price divided by trailing 12M EPS; multiples prior to 2019 were treated as outliers for the purpose of the average and standard deviations calculations

Financial forecasts

We see space for the expansion of both meat and breeding eggs production. Gradus has flagged its plans for the expansion of production capacity in both the meat segment, as well as breeding eggs this year. We see greater egg production (we pencil in 33% yoy growth in breeding eggs sales in 2020E) as the main driver of the EBITDA growth this year, which should also support Gradus' margins (up from 16-17% in 2018-19 to 22% from 2020E-onwards). Consequently, we see its 2020E EBITDA landing at PLN 42m, translating into a 2019-22E EBITDA CAGR of 21%.

Gradus: revenue forecasts (BGN m)...

and EBITDA (BGN m)

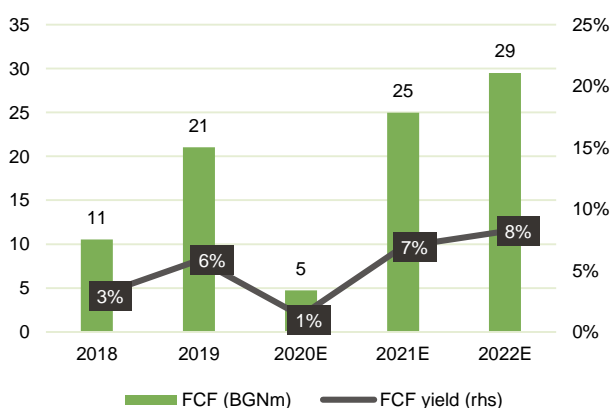
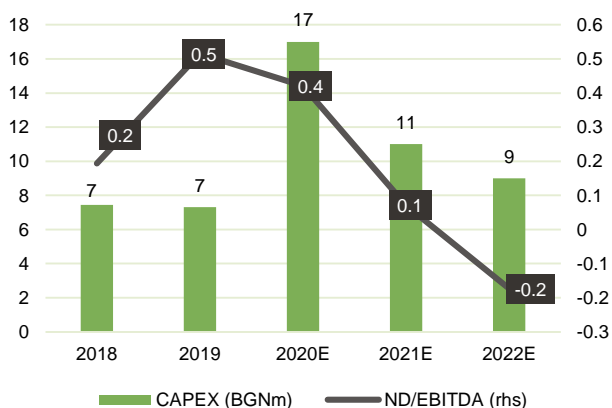


Source: WOOD Research, company data

2020E should mark a peak in the capex cycle, but leverage should remain at a low level, according to our forecasts. For 2020E, we pencil in BGN 17m of capex, related mostly to the expansion of production capacities, as described above. In the coming year, we see lower investment needs. This, taking into consideration the FCF generation capacity (a 7-8% FCF yield in 2021E and 2022E), should help to reduce the net debt/EBITDA to 0.1x and -0.2x, respectively.

Capex and leverage forecasts

FCF forecasts

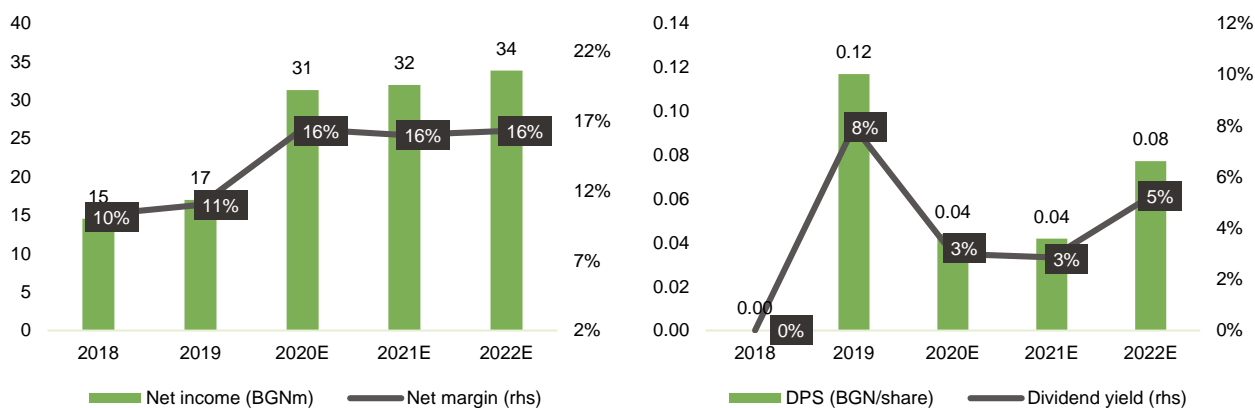


Source: WOOD Research, company data

Net income growth should result in higher dividends from the 2021E and 2022E profit. Based on our forecasts, Gradus should report BGN 31-34m on the bottom line over 2020-22E. The company's dividend policy, outlined in the IPO prospectus, assumes the distribution of a minimum of 90% of the parent company's net profit, after respective adjustments at its subsidiaries (e.g., capex). The BGN 0.044/share dividend from the 2019 profit, approved at the AGM in June, implies a dividend payout ratio of c.63%. We conservatively pencil in a dividend payout ratio of 60%, which translates into a DPS of BGN 0.04 to be paid in 2021E, and BGN 0.08 to be paid in 2022E. This implies a 5% dividend yield, which is well above the 3-4% average for the MSCI FM index, according to Bloomberg estimates.

Net income and net margin

DPS and dividend yield



Source: WOOD Research, company data

Up to 3% of Gradus' shares are subject to a five-year buyback programme. At the AGM, held in June 2020, the company's shareholders approved the launch of a share buyback programme. It assumes that up to 3% of Gradus' stocks may be repurchased and redeemed within the next five years. The price range for the programme has been set at BGN 1.2-2.0/share. This implies that the last closing price poses 36% upside to the cap price. As the programme is rather a small one (in terms of the number of shares that can be repurchased) and spread over five years, we do not pencil it into our forecasts. Consequently, we highlight that there is upside potential for our forecasts of cash distribution to the shareholders in the medium term.

1Q20 review

Gradus reported its 1Q20 results on 28 May 2020. The top line reached BGN 40m, flat yoy, while the meat products segment's revenue increased by 18% yoy, and the breeding eggs segment's sales rose by 16% yoy, driven mainly by the expansion of the breeding eggs' top line (+20% yoy), while the day-old chicken segment was up by 5% yoy.

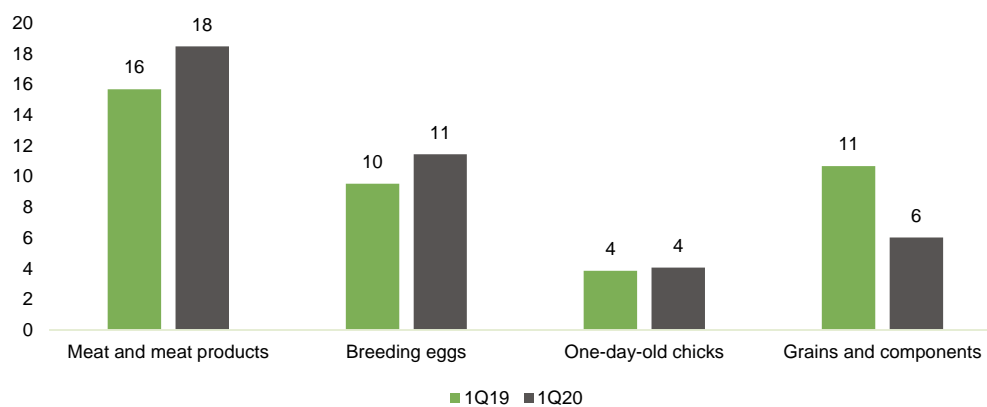
The EBITDA expanded by 24% yoy to BGN 21m. Similar dynamics were reported for both the operating profit (+26% yoy, to BGN 19m) and the bottom line (+25% yoy, to BGN 17m).

Gradus: 1Q20 review

BGN m	1Q19	2Q19	3Q19	4Q19	1Q20	yoy
Revenues	40	47	35	33	40	1%
Other revenues	15	6	4	4	16	11%
EBITDA	17	4	6	-1	21	24%
EBIT	15	3	5	-3	19	26%
Net profit	14	2	5	-4	17	25%
EBITDA margin	31%	8%	16%	-3%	37%	6pp
EBIT margin	28%	5%	12%	-8%	34%	6pp
Net margin	25%	4%	13%	-9%	30%	5pp

Source: WOOD Research, company data

Gradus: sales by segments (BGN m)



Source: WOOD Research, company data

Risks

Poultry diseases. If Gradus' chickens caught a poultry disease (e.g., bird flu), this could disrupt the company's operations severely and cause financial losses. Nonetheless, the company's assets are spread over a large area, which should reduce the risk of diseases spreading.

COVID-19 epidemic. We note that, if the scale of the epidemic increases again (e.g., during the autumn/winter season), there would be a risk of logistics problems, or additional sanitary/hygiene measures being introduced to fight the virus. In such a case, Gradus could face temporary problems with exporting its products.

Credit risk. The current economic crisis could undermine the financial position of Gradus' customers, posing a risk for the company's receivables.

FX risk. The company is exposed, to a limited extent, to EUR/BGN risk, given the currency board, which means, technically, that the exchange rate is fixed. However, some of the company's revenues are generated in USD, hence exposing it to the USD/BGN fluctuations. We also believe that, along with the greater export volumes we expect, the FX risk may increase.

Competition. The chicken market (and the meat market in general) is highly competitive. Any intensification of the competition could endanger Gradus' market position and its financial outlook. The company perceives its distribution network, product quality and product portfolio variety, and highly recognisable brand, as its key competitive advantages.

State support for the ethical treatment of birds. This subsidy contributes to Gradus' top line, but it could be reduced in the future.

Grain trading. The results in this segment of Gradus' operations depend on the prices on the global soft commodities markets. Hence, crops prices fluctuations could affect the company's results.

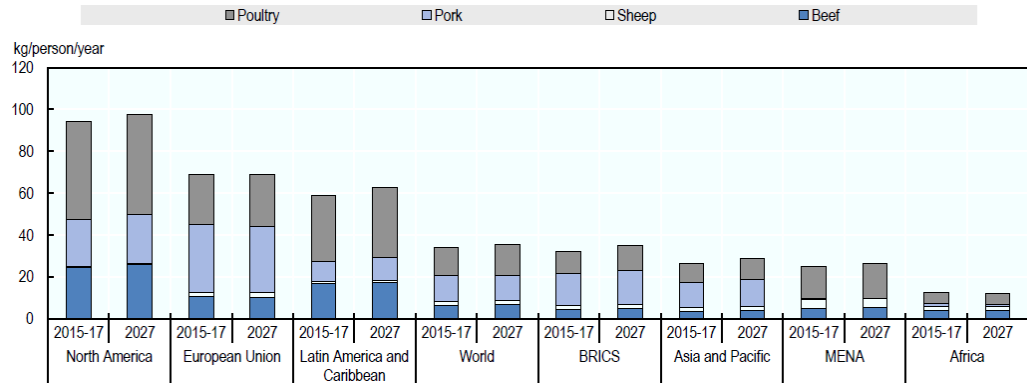
Low liquidity of the stock. We note that Gradus' trading volumes tend to be very small. Over the past three months, the average daily traded value amounted to USD 11k. This implies that exiting investments in the name may take some time.

Competition. Should competitors expand their production capacities, it could endanger the position of the company on the Bulgarian market, and/or potentially pose a risk for its profits/margins. This may be the case especially for the greater sales volumes we expect.

Poultry market

The poultry market accounts for about one-third of the meat market... According to OECD-FAO data, the poultry consumption per capita in the EU should remain at a relatively stable level until 2027E. We note, however, that the consumption of poultry per citizen in the EU is nearly twofold greater than the average for the world, but smaller than in the North and Latin Americas.

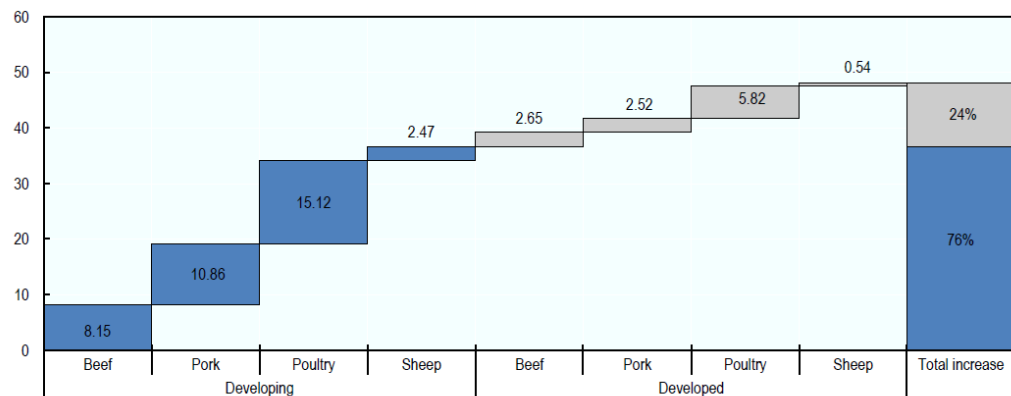
Consumption of meat per capita by region



Source: WOOD Research, OECD-FAO

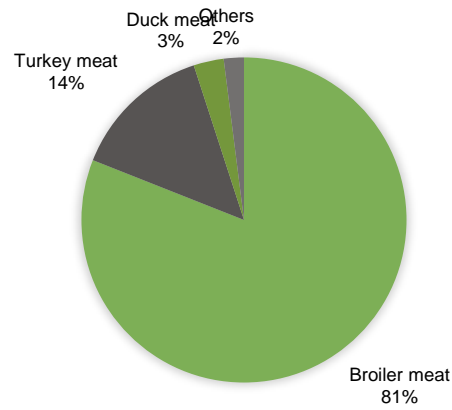
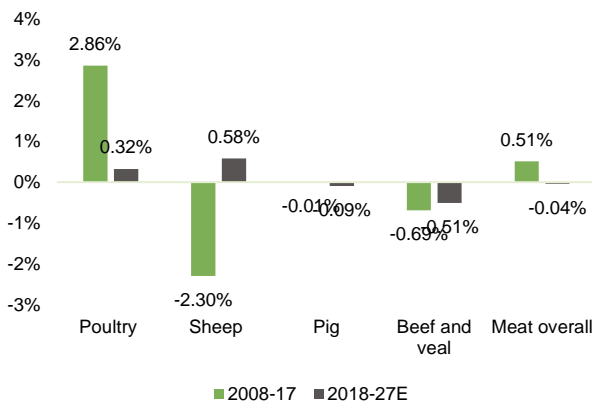
...and this type of meat should contribute the most to the overall meat market growth worldwide, according to the OECD-FAO's forecasts. The institutions expect the total meat production between the 2015-17 average and 2027E to increase by c.48mt worldwide. They also indicate that the major share of this growth (c.43%, or 21mt) should come from the poultry market. It is worth noting that this ratio should be higher for developed countries, where the expansion of poultry production should account for c.50% of the growth, vs. c.41% for the developing markets.

Meat production growth by region and meat type, 2027E vs. 2015-17 average*, mt



Source: WOOD Research, OECD-FAO

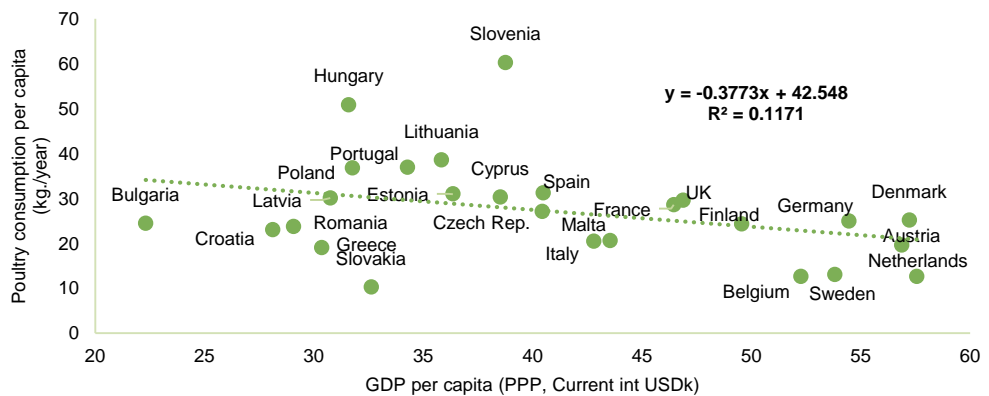
The poultry meat segment should be the major driver of meat market growth in the EU, according to the OECD-FAO data. European poultry consumption should expand by c.0.3% yoy between 2018-27E, vs. flat overall meat consumption in this period. It could be outpaced only by the sheep meat segment (+0.6% yoy); however, given its negligible size, the poultry market should be the main beneficiary of the meat market development, at the cost of beef and veal (-0.5% yoy). Looking at the structure of the poultry market, broilers account for the largest share (81%), followed by turkey (14%). The remaining types of poultry have only a 5% market share.



Source: WOOD Research, OECD-FAO

There is no significant relationship between income level and poultry consumption in the EU. As depicted in the chart below, there is no statistically significant correlation between wealth level and poultry consumption per capita. We believe that this implies that the overall poultry market growth in the region should be driven mainly by population growth.

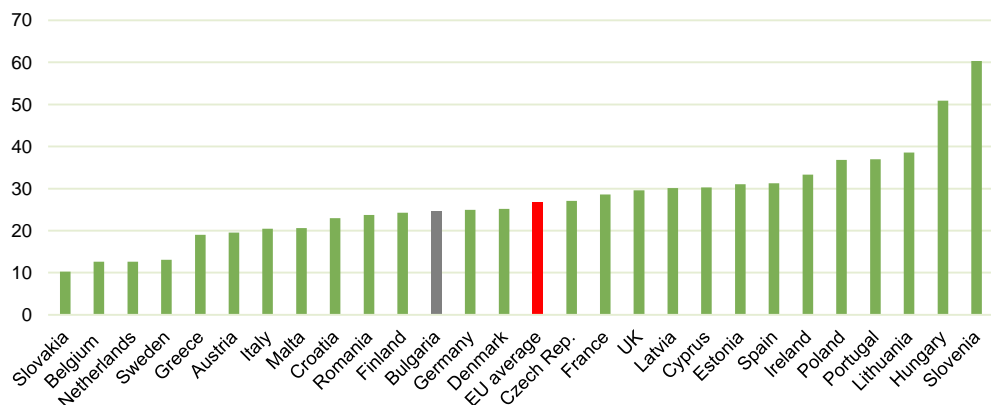
GDP per capita (PPP, int. current USD) vs. poultry consumption per capita (kg/person/year), 2018



Source: WOOD Research, World Bank, AVEC

Bulgarian market growth should be in line with the EU, in our view. We believe that there is limited scope for Bulgarian citizens' consumption to outpace the average for the EU. We base our view on the observation that the per capita consumption in this country is close the EU average. Therefore, we see no room for consumption to catch up. Nonetheless, we believe that the market growth in Bulgaria should outpace other types of meat, as noted earlier.

Poultry consumption per capita (kg/citizen), 2018



Source: WOOD Research, World Bank, AVAC

Company description

Gradus has been operating for nearly 30 years, and its listing was the second biggest in the history of the Bulgarian stock exchange. The company was established in 1992 and, over the following almost three decades, it has added new business lines, and improved its vertical integration. In 2001, it opened a fodder factory, which was complemented in 2005 with the launch of the hatchery operations, and a poultry processing plant later on. In 2016, Gradus started operating in the pork sausages market in Bulgaria. Finally, after a quarter of a century of operations, in 2018, the company IPO-ed on the local stock exchange, raising USD 48m (the second-largest IPO in Bulgaria's history).

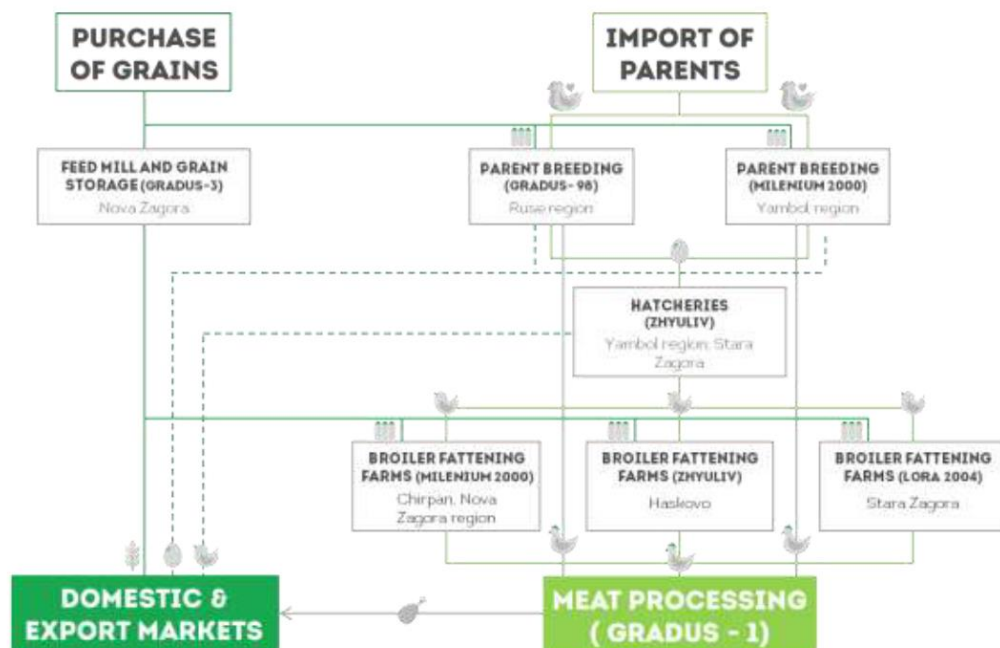
Gradus: key milestones



Source: WOOD Research, company data

Gradus operates in the poultry and pork meat business. The company buys grain from third parties (it does not own any substantial landbank and is not involved in grain harvesting), and produces fodder mixtures at its own fodder plant (the largest in Bulgaria, with annual capacity of 60k tonnes). At the parental flock farms, the rearing and fattening cycle of a parental flock takes place, lasting between 60 and 65 weeks. The egg production (9m+/week) takes place between the 23rd and 56th week of the mentioned period. Most of the eggs are sold, while the remainder are kept to produce one-day chickens at the hatcheries. Gradus claims that, thanks to its embryo temperature control technology, these chickens are 2 grams heavier and 5 millimetres longer than those from other producers. The next step of the poultry production process is the fattening of flocks at special flock fattening farms, resulting in annual production of c.25m broilers. The last stage of the process is the poultry production at the meat processing plants owned by Gradus. Finally the products are distributed by the company's fleet of trucks.

Gradus' business – wrap-up



Source: WOOD Research, company data

Gradus: products



Chicken Fillet



Chicken Legs



Chicken Wings



Flavoured Chicken Wings



Chicken Fillet Kebabs

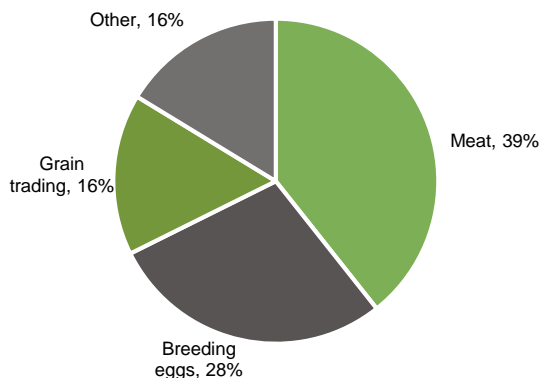


Chicken Grill Mix

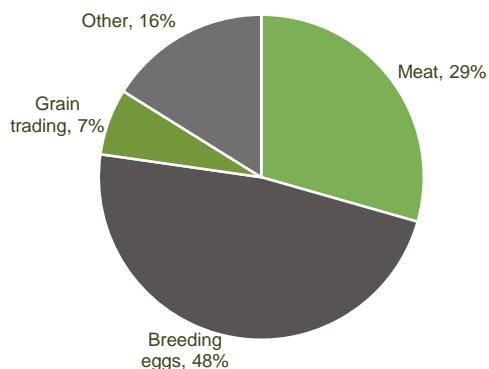
Source: WOOD Research, company data

Breeding eggs is Gradus' most profitable segment. The company's business consists of three segments: meat and meat products; breeding eggs; and trade in grain components. Although the largest contribution to the top line comes from the meat (39% in 2019), the breeding eggs segment has the highest operating margin (18% in 2019); consequently, it accounts for nearly half of the Gradus group's EBIT.

2019 revenues structure

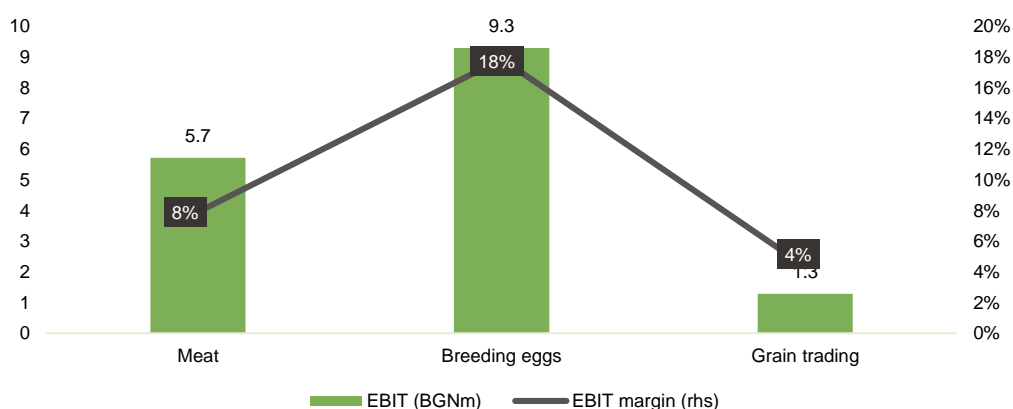


2019 EBIT structure



Source: WOOD Research, company data

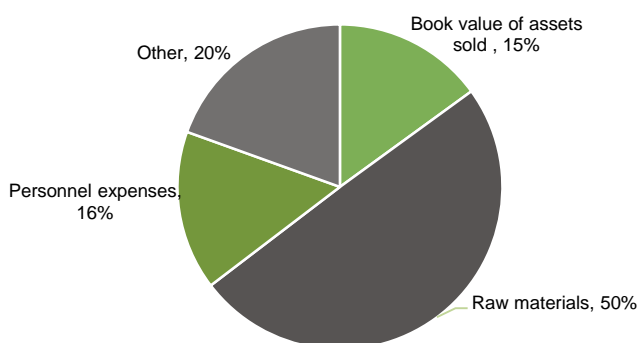
2019 EBITDA (BGN m) and EBITDA margins by segments



Source: WOOD Research, company data

Most of the opex is related to the meat segment. As presented in the chart below, raw materials (mainly red meat) account for half of the costs. This is followed by wages (16%) and the grain (15%) that Gradus needs to purchase to feed its chickens.

Gradus: 2019 opex breakdown

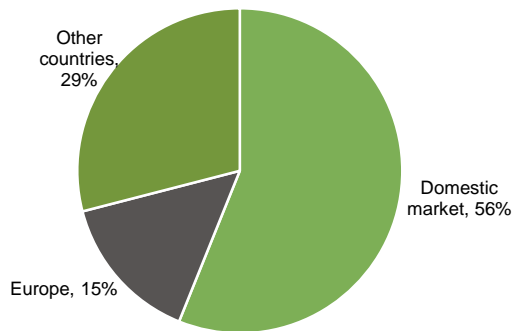


Source: WOOD Research, company data

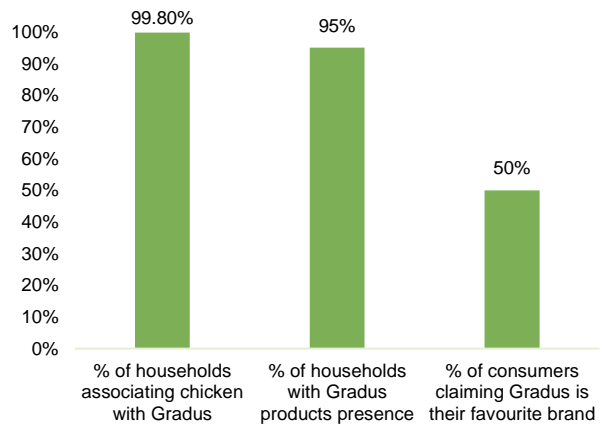
Gradus – leader in the domestic market, but the export contribution is also important. The company has the largest market share in Bulgaria (c.35%, according to Gradus), and the domestic market accounted for 56% of the company’s sales in 2019, while the remaining 44% came from exports. One-third of its foreign sales came from the European markets in 2019, and the remaining two-thirds from other countries. Gradus claims to have a strong position in its domestic market. Its brand recognition

is close to 100%, whereas half of consumers point to Gradus as their favourite brand (2015 BluePoint survey).

2019 sales breakdown by countries



Gradus' brand recognition in Bulgaria



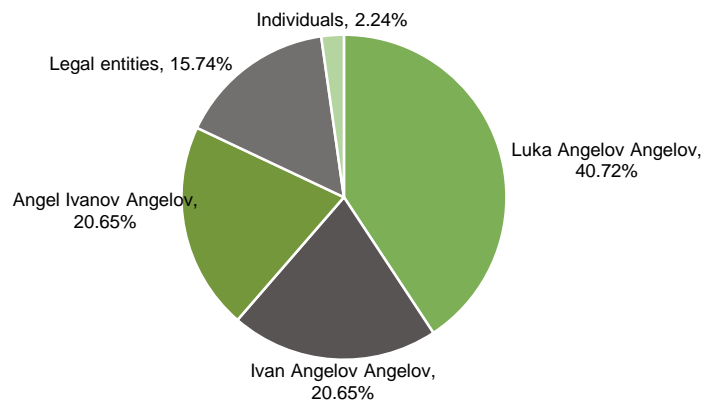
Source: WOOD Research, company data

Gradus claims to have several competitive advantages, such as:

- ✓ A vertically-integrated business model.
- ✓ Operations in the poultry meat market, one of the fastest-growing meat market segments.
- ✓ A high market share (35% in Bulgaria, the second-largest producer of hatching eggs in the EU).
- ✓ The high quality of its products – its closed production cycle and the breeding of its own parent flocks, supported by high tech equipment, results in a very high hatching ratio of over 84% for its exported eggs, well above its competitors.
- ✓ Well-developed distribution network (Gradus has its own truck fleet).

Gradus' major shareholders are the company's founders, Ivan and Luka Angelov, who control c.61% of the company. Another 21% stake is owned by Angel Ivanov, the son of one of the founders. The remaining shares are held by institutional (16%) and retail investors (2%).

Gradus: shareholders' structure as of 31 March 2020



Source: WOOD Research, company data

Financials

Profit and loss account

BGN m	2018	2019	2020E	2021E	2022E
Revenue	141	155	191	200	208
Other income	31	29	35	37	38
Opex	-156	-164	-191	-201	-209
EBIT	17	19	35	36	38
EBITDA	23	26	42	44	46
Net financial cost	0	0	0	0	0
Profit before tax	16	19	35	36	38
Tax	-2	-2	-3	-4	-4
Net income	15	17	31	32	34
EPS (BGN/share)	0.06	0.07	0.13	0.13	0.14
DPS (BGN/share)	0.00	0.12	0.04	0.04	0.08

Source: WOOD Research, company data

Margins

	2018	2019	2020E	2021E	2022E
EBITDA margin	16%	17%	22%	22%	22%
EBIT margin	12%	13%	19%	18%	18%
Net profit margin	10%	11%	16%	16%	16%
ROA	4%	5%	8%	8%	8%
ROE	5%	5%	10%	9%	9%
ROIC		5%	9%	9%	9%

Source: WOOD Research, company data

Balance sheet

BGN m	2018	2019	2020E	2021E	2022E
Non-current assets	259	267	277	280	280
Property, plant and equipment	177	185	194	197	197
Intangible assets	54	54	54	54	54
Goodwill	21	21	21	21	21
Other	7	8	8	8	8
Current assets	105	88	112	135	150
Inventories	54	56	69	73	76
Related party receivables	6	5	6	7	7
Trade receivables	28	17	21	22	22
Other	9	7	7	7	7
Cash and cash equivalents	7	3	8	27	38
TOTAL ASSETS	364	355	388	415	430
Total equity	325	312	334	356	371
Share capital	244	244	244	244	244
Issue premium	62	62	62	62	62
Retained earnings	17	4	26	48	63
Equity of owners of parent company	323	310	332	354	369
Non-controlling interest	2	2	2	2	2
Non-current liabilities	17	18	18	18	18
Deferred tax liabilities	15	15	15	15	15
Deferred revenue from government grants	2	2	2	2	2
Current liabilities	22	25	37	41	41
Bank loans	12	16	26	30	30
Trade payables	6	4	6	6	6
Other	5	5	5	5	5
TOTAL LIABILITIES AND EQUITY	364	355	388	415	430
Debt (BGNm)					
Gross debt	12	16	26	30	30
Net debt	4	13	18	3	-8
ND/EBITDA	0.2x	0.5x	0.4x	0.1x	-0.2x

Source: WOOD Research, company data

Cash flow statement

BGN m	2018	2019	2020E	2021E	2022E
Net income	15	17	31	32	34
D&A	6	7	7	8	9
Working Capital	-3	8	-17	-4	-4
Other	-11	-6	1	0	0
CFO	7	26	22	36	39
Capex	-7	-7	-17	-11	-9
Other	0	2	0	0	0
CFI	-8	-5	-17	-11	-9
Proceeds from issue of securities	41	0	0	0	0
Proceeds from bank loans	40	23	10	4	0
Payments on bank loans	-75	-19	0	0	0
Dividends paid	0	-28	-9	-10	-19
Other	-1	-1	0	0	0
CFF	5	-26	1	-6	-19
Net change in cash	4	-4	6	19	11
Cash at the beginning of the period	3	7	3	8	27
Cash at the end of the period	7	3	8	27	38

Source: WOOD Research, company data

Valuation multiples

	2018	2019	2020E	2021E	2022E
P/E	25	21	11	11	11
EV/EBITDA	16	14	9	8	8
Dividend yield	0%	8%	3%	3%	5%
FCF Yield	3%	6%	1%	7%	8%

Source: WOOD Research

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This investment research was completed on 29/06/2020 at 18:15 CET and disseminated on 30/06/2020 at 07:40 CET.

WOOD&Co's rating and price target history for Gradus in the preceding 12-month period:

Date	Rating	Date	PT
30/06/2020	BUY – initiation of coverage	30/06/2020	BGN 1.76

A history of all WOOD&Co's investment research disseminated during the preceding 12-month period can be accessed via our website at <https://research.wood.com>.

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HOLD: The stock is expected to generate total returns of 0-15% during the next 12 months as measured by the price target.

SELL: The stock is expected to generate a negative total return during the next 12 months as measured by the price target.

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