Engineering Review

22nd September 2015

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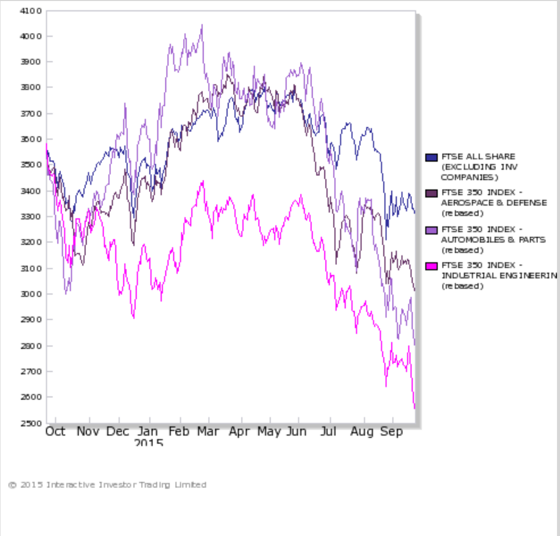

Source: www.iii.co.uk

FTSE 350 Industrial Engineering	CY2015	CY2016
PE	20.0	16.6
P/Book	2.8	1.9
EV/Sales	2.6	2.5
EV/EBITDA	12.7	11.9

FTSE 350 Automobiles & Parts	CY2015	CY2016
PE	10.1	9.2
P/Book	3.3	2.9
EV/Sales	0.7	0.7
EV/EBITDA	6.0	5.5

FTSE 350 Aerospace & Defense	CY2015	CY2016
PE	12.8	13.0
P/Book	2.9	2.7
EV/Sales	1.1	1.1
EV/EBITDA	7.9	7.9

Source: Bloomberg

HYBRIDAN LLP
20 Ironmonger Lane,
London, EC2V 8EP
Website: www.hybridan.com

Derren Nathan
Tel: 020 3764 2344
Email: derren.nathan@hybridan.com

Back to Basics: The Return of the "Old Economy"

Thus far in the markets, 2015 has largely been one for the brave – investing in the "internet of things" or the latest cutting edge targeted therapeutics in the world of biotech. Binary plays sold on the promise of future glory and fortune continue to attract the dizzying valuations that we have seen this year.

But what of one of the UK's oldest and most established sectors? The engineering sector continues to stand in the shadow of the more "glamourous" sector groups which are all at the whim of a finite pool of specialist investors dictating current investor sentiment. Whilst the engineering sector rarely hits the media spotlight in the same way as its comrades in the biotech and tech arenas, they do possesses more sustainable characteristics that companies of the more populist sectors rarely ever achieve. Sensible valuations built on scalable business models that have a visible top and bottom line with a healthy contracted order book.

One such company that fits the bill is **Newmark Security (NWT)** which provides electronic and physical security systems, which focus on personal security and the safety of assets. With a market capitalisation of c£16m, the company's recent preliminary results for YE 30th April 2015 announced an increase of 19.2% in turnover to £22.9m, operating profit of £2.2m with a proposed dividend of 0.10 pence per share. The group's focus on new business was reinforced with the recent contract win with a major global workforce management partner. The contract is for a period of ten years with guaranteed revenues of US$6m for the first five years. The technology platform Newmark is providing specialises in the provision of advanced IT clocks and terminals to enhance the time management capability of their customers' workforces. For a company that is profitable, pays a progressive dividend policy and holds a PE multiple of around 7x it would appear the current valuation does not take into account the potential positive news to come from new orders and contracts.

At the other end of the spectrum, there is less cause for celebration with **Rotork's (ROR)** recent profits warning which sent shockwaves across FTSE engineers including **Smiths Group (SMIN), Babcock (BAB) and Intertek Group (ITRK)**. The catalyst behind these share price falls sheds some light on the danger of over-exposure to certain industries where they have key customers. In the aforementioned, it was the continued chaos in the oil and gas sector that caused the issues. Crumbling oil prices have caused many oil and gas companies to slash spending on key projects that many engineering companies rely on; in Rotork's case it is the supply of valve control systems to the sector. **Weir Group (WEIR)** is another high profile victim to the oil and gas sector turmoil with their expectant exit from the FTSE 100. The company has seen significant decline in its share price due to their exposure to the sector through the provision of valves and pumps to oil and gas companies. This has triggered a multi-million pound cost saving programme in a bid to counteract the continuing negative impact of the oil price. Sector sentiment across all walks of life on AIM is quite often susceptible to the performance of their older siblings on the main market. With Rotork and Weir Group sending tremors across the sector, it will do little to help sentiment at the bottom end of the market, especially those with exposure to the energy industry.

As with any sector, engineering provides no safe haven in harsh markets but can offer investors a more defensive stance away from companies that are less resilient to certain boom/bust cycles we have seen in other sectors. To play devil's advocate, smaller engineering companies can be overly reliant on customers much larger than themselves that can dictate payment terms and be the ghost behind "New Contract Win" RNSs where they tend to shy away from the limelight. Despite this and as we have seen with instances such as Newmark Security, there are companies occupying the junior end of the engineering sector that can offer investors opportunities that attract sensible valuations, scalable business models with clear visibility of earnings. A far cry from the biotech and tech themes that have dominated 2015 but a return in investor sentiment to the "old economy" is long overdue.

Reviewed by Niall Pearson

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Economic Review

Measuring the GDP of any economy, not least one the size of China, is a very hard thing to do. So it is very surprising that ambitious Chinese GDP targets have always been achieved or exceeded and never significantly revised. Perhaps less surprising is that these numbers are generally taken with a pinch of salt by outside observers (and even some high ranking insiders too) and of no surprise is that an illusion of this magnitude could not be maintained indefinitely. The genie is out of the bottle regarding the make believe numbers but as to what the actual state of the economy is, no-one knows. The Chinese economy may be receding for all we know, but in all likelihood is still growing somewhere between zero and the published 7%.

Debt is arguably a more pressing issue for China than growth. Federal level debt might be relatively low (Perhaps 65% of GDP) but total debt is estimated to be running around 300% of GDP. The numbers are huge by any measure, and likely to be increasing as domestic banks' lending to 'zombie' companies grows: allowing continued opportunities for poorly run companies to damage well run ones as they undercut and over-produce.

Devaluing the currency in itself will have helped bolster some new overseas markets but it also makes the debt harder to repay, and by the time all the competitors (by and large other developing nations) have devalued their currencies too, any benefits will be transitory. There is also an argument that Chinese inflation has been running higher than official figures for years and this will also have offset some the perceived benefit. A further ticking bomb is the potential for US rates to rise and that will make USD denominated debt even harder to repay; and it would seem that a good deal of emerging market debt is denominated in USD.

On the positive side the impacts to the West are limited. There has been a reduction in reported imports by China which given that these are predominantly commodities or raw materials used to generate product, this is likely to continue the slide in Chinese exports down the line. In June, China represented around 7% of exports for the US, the UK and Germany, so the immediate impact to these economies is limited. However, there is also some considerable offset for the Western economies, from reduced commodity pricing generally, and oil pricing specifically.

Without booming BRIC economies, (Brazil and Russia are probably in recession) the prospects for an oil price recovery seems very limited. There is already excess oil supply globally – estimated at 2-3m barrels a day - and with Libya and Iran both looking to get back on stream this oversupply could both grow and last. Inevitably some of the more expensive production will have to stop. US producers have more than halved investment in recent months, but production remains high (once the investment is in the ground you may as well sell the oil and try to get some of your costs back) and is arguably small beer in the global production arena anyway. OPEC could intervene and make a difference but there seems to be little appetite from its main members 'subsidise' oil producers operating in more expensive jurisdictions.

All of which non-inflationary news and slightly disappointing non-farm payroll numbers has stalled the imminent need for Fed rate hikes. Dovish noises from the ECB (who have only recently started to see the benefit of their version of QE) will not encourage UK hawks either, though Bank of England Governor Mark Carney recently noted, "Consumer confidence is at its highest level in over a decade and retail sales have been growing at well past average rates. Firms' investment intentions are robust." Adding that recent events in China were unlikely to have much impact on rate decisions.

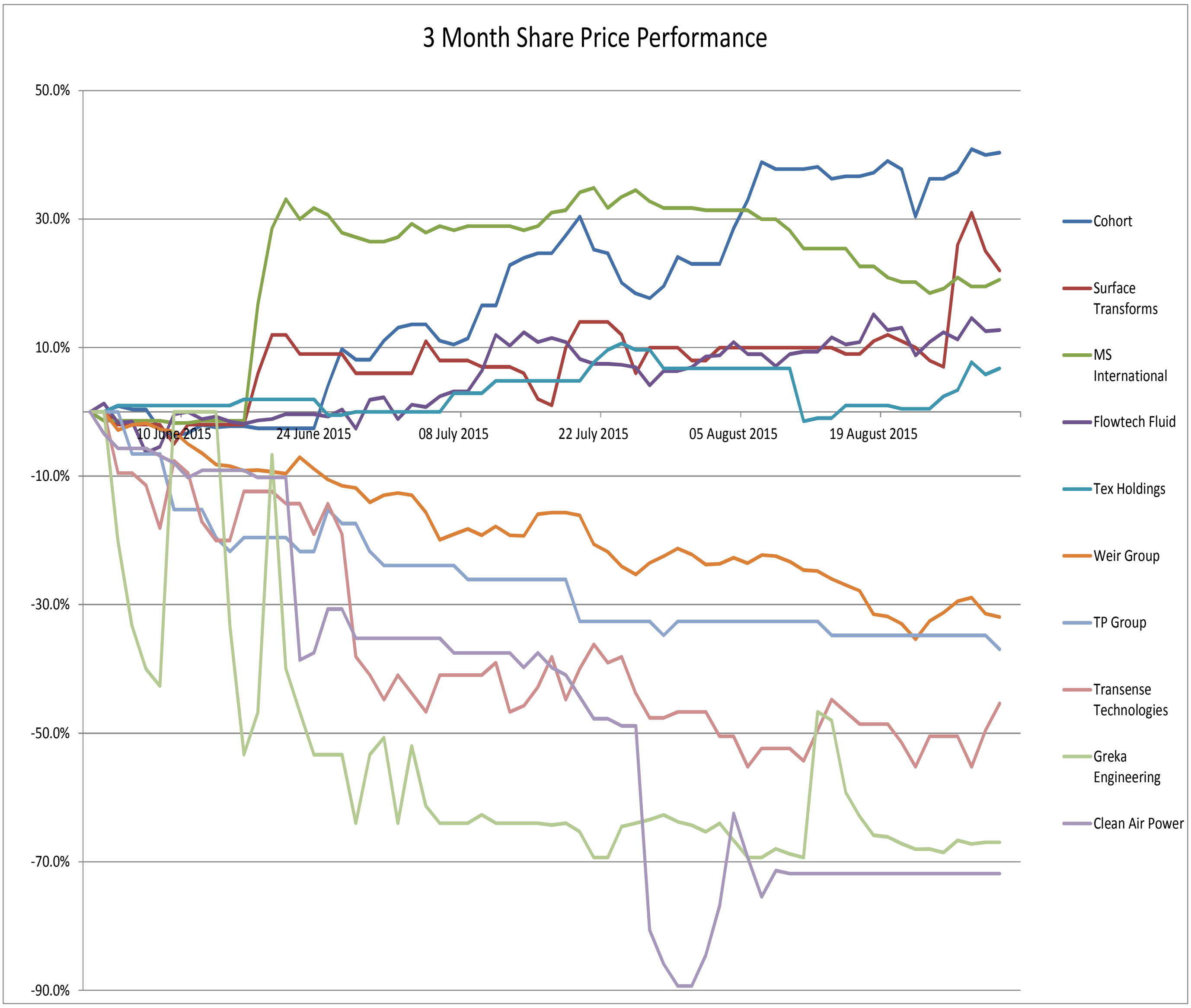
Excepting stock market sentiment, and the resource based industries, the broad UK economic position is not hugely compromised by events in China and the accompanying commodity sell off. For many of the smaller UK companies selling their goods and services predominantly into 'western' countries, the outlook remains benign to positive, and recent surveys have supported this.

Reviewed by William Lynne

Risers and Fallers

As at 2 September	*3 month Share price movement*
Cohort	40.74%
Surface Transforms	25.00%
MS International	19.51%
Flowtech Fluid	12.55%
Tex Holdings	5.80%
Weir Group	(31.30%)
TP Group	(37.50%)
Transense Technologies	(45.36%)
Greka Engineering	(66.96%)
Clean Air Power	(71.82%)

Source: Fidessa



Source Fidessa

Risers

Cohort (LON:CHRT 381p/£156m 3mth +40.74%)

The parent company for four innovative, agile and responsive businesses working primarily for defence, wider government and industry clients released FY April 2015 results on 25 June with organic revenue and adjusted operating profit growth of 22% and 17% respectively. Total revenue was up 40% to £99.9m, adjusted profit before tax up 23% to £10.2m and adjusted EPS up 7% to 20.45p. The final dividend was increased 21% to 3.4p (5p for the year).

Cohort reported a closing order book of £134.0m (2014: £81.7m) providing a good underpinning to the coming year. Although the UK defence market remains tight, the Cohort businesses have strong and relevant capabilities, established positions on some key long-term UK MoD programs, and a good pipeline of new opportunities. Export prospects continue to strengthen. A number of long term orders were secured during the year just ended, so Cohort does not expect to see a repeat of 2015's sharp increase in order book over the coming financial year.

On 5th August, Cohort announced a €19m cash acquisition for a Portugal based supplier of advanced electronics, communications and command and control products and systems for the global defence market, funded from existing cash resources. The acquired company generated revenue in the year to December 2014 of €14.5m and EBIT of €1.4m. Gross Assets as at 31 December 2014 were €25.5m. We believe EID's strong order book (€35.2m at 31 March 2015) and prospects position it well to make progress in 2015 and beyond. At the end of March 2015, €12.4m of revenue for the year ending 31 December 2015 was already on order, supplemented by a promising pipeline of further sales prospects.

On 13th August, Cohort announced an £11.2m contract with the MoD for its hearing protection systems.

Surface Transforms (LON:SCE 15.3p/£8.1 3mth +25%)

In June, manufacturers of carbon fibre reinforced ceramic (CFRC) materials, updated on H1 May 2015 trading. Revenue was below expectations at £1.1m (2014: £1.3m), primarily due to a temporary breakdown of the CVI furnace in May. Importantly however, road car sales increased 52% to £418k (2014: £276k) and total annual revenues when normalised to take account of non-recurring 2014 items were actually 10% higher than the prior year, despite the aforementioned operational issue.

David Bundred, Chairman, said "The temporary breakdown of the CVI furnace in May has been investigated and understood and is currently being rectified. The furnace is again operational although not yet operating at full capacity. We are confident the majority of the revenue shortfall will be recovered in the first quarter of the new financial year." The Group cash position as at 31 May 2015 was £776k (2014: £151k) and the Board also anticipate receiving a R&D Tax Credit in excess of £200k (2014: £217k) in the next four months. Since then the company has received quality accreditations for both the Aerospace and Automotive industries.

MS International (LON:MSI 173p/£28.98m 3mth +19.51%)

The Group comprises three diverse operating divisions, 'Defence'; 'Forgings' and 'Petrol Station Superstructures'. On 18th June, MS International reported FY May 2015 results, and following a much improved recovery in H2, reported that FY profit before tax was £1.54m (2014 - £2.93m) on revenue of £45.50m (2014 - £47.13m). Earnings per share were 8.20p (2014 - 14.6p).

The Group's current order book remains very strong. While marginally lower at year-end than that the £46m reported for 2014, it has since increased following the award of a follow-on two year contract by the UK MoD for the maintenance and support of

MSI-DS 30mm naval gun systems and associated ancillary equipment in the RN fleet. The contract is worth in excess of £12m.

The company also announced the acquisition of 'Petrol Sign' a company based in the Netherlands. The consideration for the acquisition is €3.4m on a cash and debt free basis. Petrol Sign designs, restyles, produces and installs the complete appearance of petrol station superstructures and forecourts. The acquisition will enhance and widen the ability of the Company's 'Petrol Station Superstructure Division' to offer a more complete package of services to customers.

For the financial year ended 31st December 2014, Petrol Sign had unaudited revenues of €4,156,000 (€3,190,000:2013) and an unaudited profit before taxation of €446,000 (€196,000:2013). As at 31st December 2014, Petrol Sign had unaudited net assets of €756,000.

Flowtech Fluidpower (LON:FLO 150.6p/£64.46m 3mth +12.55%)

In July, the distributor of technical fluid power products announced the acquisition of Nelson Hydraulics Limited and its parent company Nelson Fluid Power. The consideration comprises £4.1m (part of which is subject to an earn-out) for the trading operation and £1.7m for the net cash position held at completion, a total of £5.8m. The consideration is being funded from the Company's own cash resources.

Nelson Fluid Power has been in the ownership of the Nelson family for 50 years. It currently employs 40 staff and distributes hydraulic equipment, components and hose assemblies from its locations at Lisburn and Dungannon in Northern Ireland and Dublin in the Republic of Ireland. The business has a broad customer base in Ireland with emphasis in the crushing and screening, agricultural and marine and fishing sectors. For the year ended 30 September 2014, turnover was £6.7m producing EBIT of £0.7m. Net assets at the same date were £4.1m.

Flowtech also commented that trading was in line with market expectations, while trading remains competitive.

Tex Holdings (LON:TXH 110.5p/£7.01m 3mth +5.8%)

In August, the UK based manufacturer and supplier of engineering products, piling equipment, plastic injection moulding, and boards and panels reported H1 June 2015 numbers. Trading was broadly flat with revenue of £17.5m and EPS of 6.1p (up 7%). The order book at the half year was in line with 2014. 'The current political turmoil in the world tempers any optimism that the Board could draw from the first half results. It is anticipated the full year trading will be consistent with recent full year results.' Later in the month the company announced that it had agreed to acquire the stock and assets of G&M Power Plant from the administrator. G&M Power Plant specialises in the design and assembly of bespoke high quality diesel powered electrical generator sets, covering both the global marine and UK industrial sectors, and has a number of synergies with the existing companies in the Tex Holdings Engineering Division.

Fallers

Weir Group (LON:WEIR 1,343p/£2,874m 3mth -31.3%)

Weir Group, a major provider of engineering solutions to the minerals, oil & gas and power markets, reported H1 results to 3 July on 30 July in line with the expectations set in June. These results were in the context as what was referred to as the most severe downturn in oil and gas markets for nearly thirty years. As a result North American upstream activity has reduced substantially, significantly impacting the Group's interim financial performance. Revenue was down 14% to £1bn and operating profit down 38% to £129m. The company is focussing on cash generation and reported a 124% EBITDA cash conversion ratio with cash from operations up 25% to £202m. The dividend was held steady at 15p.

"Looking ahead, oil and gas will continue to be tough, with industry expectations of a modest improvement at best in North American activity levels towards the end of the year. However, with the normal seasonal bias of the Minerals and Power & Industrial divisions, increased restructuring benefits, further cost savings and a good contribution from recent acquisitions, we expect a meaningful sequential improvement in our financial performance in the second half of 2015, alongside continued strong cash generation."

TP Group (Formerly Corac Group) (LON:TPG 6.6p/£15.4m 3mth -37.5%)

The specialist engineering group focused on the aerospace & defence and energy & process industry sectors, announced that Interim Results for the half-year ended 30th June 2015 will be announced on Tuesday 15th September 2015. The Group expects to continue reducing losses and to deliver a full-year performance in line with market expectations.

Earlier in the period under review the company announced that it had received its first commercial order from Spirax Sarco for its steam expander products. This order follows the announcement of the ten year commercial agreement announced on 27 March 2015, for packaged steam products containing Corac's micro-turbines and compressors. The initial order consists of five micro-turbine units, and an additional spares package. The units will be built at Corac's high technology assembly centre in Portsmouth for delivery in early 2016.

Transense Technologies (LON:TRT 1.3p/£6.3 3mth -45.4%)

The provider of sensor systems for the transportation and industrial markets, announced a £2m placing and £1m Open Offer at 1.5p Eventually a total of £2.6m was raised to strengthen the Company's balance sheet and working capital position. In particular, the shift within the Company's Translogik business to include a new rental sales model, whilst expected to increase the longer term revenues of the Company, has increased the requirement for working capital. This coupled with the on-going developmental and early stage commercialisation projects being undertaken, particularly within the Company's SAWSense business prompted the Board to raise further funds.

The company expects to report trading for the financial year ended 30 June 2015 in line with management expectations, with full year sales, subject to audit, of approximately £1.6m. The Board remains in discussions with a number of interested parties regarding a possible sale of the IntelliSAW business. In August, Transense announced that its trading division, Translogik, had won another contract through its Australian partner, Brownfield Engineering & Maintenance. The agreement is to supply 47 iTrack mining tyre monitoring systems for large haul trucks to the Saraji coal mine in the Bowen Basin, Queensland, owned by the BHP Billiton Mitsubishi Alliance

Greka Engineering & Technology (LON:GEL 0.6p/£2.5 3mth -66.96%)

In July, the unconventional gas sector engineering and technology business with pipeline, gas compression and power generation assets in China gave an operations update for H1 2015 in line with expectations.

Gas processed in H1 2015 was 661,520 thousand cubic feet, a 16% increase over H1 2014. Electricity generated in H1 2015 was 8,420,174 kwh, of which, power sales volume was 6,824,111 kwh, a 26% increase over H1 2014 (5,429,281 kwh).

Randeep S. Grewal, Executive Chairman of Greka Engineering, commented: "This operational update is in line with our expectations. We have forecasted a gradual increase in business operations which is being demonstrated. It continues to be clear that Greka Engineering & Technology offers comprehensive solutions to companies looking to take advantage of the opportunities offered by the rapidly growing unconventional gas market. We continue to be focused on creating a 'one-stop-shop' for the many entrants into this niche sector."

On 13 August, the company announced that it had entered into a construction contract with China United Coalbed Methane Corporation, Ltd. (CUCBM), the state-owned Chinese coalbed methane company. The Contract requires that the work be completed by no later than 31 December 2015 and is expected to result in the ongoing supply of power by Greka Engineering to the connected wells.

Clean Air Power (LON:CAP 0.6p/£1.6. 3mth -72%)

The developer and supplier of compression-ignited natural gas systems and software for heavy duty vehicles updated on trading in June. Its partner, a global truck manufacturer, requested an extension to the first phase of its production development program for a MicroPilot compression-ignited natural gas engine for the South East Asian and other markets. The extension, which is being finalised and is expected to last four to six months, will collect additional data under a broader range of test conditions, including testing with natural gas compositions from different local markets. The project extension led the Board to undertake a more comprehensive review of the Group's short-term funding options.

On 12 August, it was confirmed that detailed offer discussions were underway and the stock was suspended. On 3rd September, it was announced that the sale of its subsidiaries had been agreed and any return to shareholders is expected to be minimal.

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