Brenntag (BNR GY)

Idea Played Out, Upside but Move on

NO CURRENT RECOMMENDATION

THE ANALYST

17 March 2021
11:30

Current Price:	**€70**
2Y Price Target:	**€90**
Forecast Return:	**~30%**
3m ADV:	**$50m**
Market Cap:	**€10.8bn**

Mark Hiley

Founding Partner

mh@theanalyst.co.uk

+44 203 743 9848

- The stock is up 60% since initiation and much of the thesis has played out.
- Ongoing upside from compounding profit and cash flow growth with potential for high returns in a stable business model.
- We see 20-30% upside from here, based on 20x FY'23e PE.
- Impressive new management executing well, much left to be done.

We had a management meeting with Brenntag which was positive for our thesis on the company. Brenntag is still a good idea which can have a place in any mid-cap portfolio.

From here, however, we do not see massive upside or controversy and misunderstanding in the name. We have reviewed the idea and decided to drop it from coverage with a full review published in this note for clients.

- The execution and early delivery of Project Brenntag by the new CEO has been exceptional, particularly under pandemic crisis management, yet there is still plenty left to be done.
- In 2020, Brenntag exhibited the strengths of the distribution business model by improving asset turn and producing stable EBITDA in the COVID-19 environment. The CFO sees working capital ratios sustainable at the current low level, which marks a step-change in the returns of the business (source: company call).
- Free cash flow reached €1bn (FY'20), benefitting from improved working capital management, and net debt has been reduced materially to €1.3bn, giving improved M&A options and a strong balance sheet. The new management is now in a very strong position financially and Brenntag could manage higher leverage if a meaningful M&A opportunity becomes available.

Brenntag is now in a healthy position to deliver the Project Brenntag benefits through to 2023 and then look at the second phase to accelerate growth and pivot into specialties. Beyond the current horizon, the CEO is already beginning to articulate another strategic leg.

- Brenntag has not grown in organic terms for five years and this was the overarching issue to address. Organic growth in a distribution business is highly accretive to cash flow and returns. There is underlying structural growth in chemical distribution, and Brenntag can capture share as a large platform and move up the value chain into more speciality solutions.
- The company expects an uplift of €220m (~20%) to EBITDA by FY'23e from the cost savings programme (alongside site optimisation of 100 locations), at a one-off cash cost of €370m (~67% opex, ~33% capex).
- The restructuring of the group into Essentials and Specialties will be a positive driver. Peer company IMCD is more highly rated by the equity market (source: Bloomberg estimates) and focuses exclusively on Speciality products. Speciality chemicals have a higher gross profit per shipment and are sold more as solutions rather than commodity inputs. Brenntag must continue to pivot the business model to focus on this high return business (Specialties also has materially lower capital intensity).
- The site optimisation plans are impressive and surprised us when they were announced in 2020. According to the CEO on our call, the company described an enormous data model, looking at every shipment, every product, every location and

every customer. Brenntag was surprised by the inefficiencies created by national borders and believes it can take out 100 sites without losing revenue, whilst maintaining customer service and decreasing the average distance travelled per delivery. Brenntag also runs third party warehouses and can create mega-sites in which to consolidate smaller pieces of capacity.

- Working capital to sales has declined to 11-12% from ~14% and Brenntag released >€400m of cash in FY'20. The CFO confirmed on our call that there is more room for improvement after the first wins from management's focus. This will need improved analytical tools, harmonised by divisions and segments.

- By spending €200-250m p.a. (target M&A budget), Brenntag can potentially add another 3-4% to profit growth per year, expanding both geographically (particularly in China) and in product verticals. The CEO still sees highly accretive M&A deals as Brenntag is often in exclusive negotiations with reasonable valuations, cost synergies, and low risk. For context, the No. 10 chemical distributor globally is ~10% the size of Brenntag and the No. 100 player is ~1%. This means there are plenty of opportunities.

- When we initiated on Brenntag, there was some concern amongst clients about potential disintermediation of chemical distribution by new digital platforms. Interestingly, the new CEO built an online platform with Alibaba on the manufacturing side with 'lacklustre success' (source: company call). Manufacturers generally do not want to handle the complexity of distribution logistics and the chemicals have to be moved physically, often involving hazardous products with regulatory concerns. On the Speciality side, customers need application advice and technical know-how. Suppliers are often too large to deal with small customers effectively (average order size is ~€3000), whereas Brenntag is independent and has its own technical centres. Therefore, disruption risk is negligible for the chemical distribution model.

We were very impressed in our meeting with the CEO and CFO last week. We have studied the chemical industry for many years and followed Brenntag since its IPO. The sum total of many small measures in a distribution business can be highly accretive to returns.

Brenntag can now potentially be re-rated to 20x PE with compounding earnings growth (8-10%) and dividends. This gives more upside in the stock to around €90 based on FY'23e estimates.

However, a substantial part of the improvement has played out and is known and recognised by the stock market, as reflected in the higher share price and rerating.

- There could be another 30% upside in the name. This would require a multiple of ~20x PE on the FY'23e estimates (alongside cumulative dividends).

- A recovery in market conditions and growth in FY'21 is likely to absorb cash in working capital, which means we expect free cash flows will be lower this year compared to last year.

Lessons Learnt

- Stable businesses with high returns can become highly rated by the market. Brenntag struggled to deliver growth under previous management, but the qualities of the business model were always present.

- Small things matter in a simple business. Brenntag is consolidating sites, improving IT systems, and focusing on working capital management. These small changes add up to a material long-term cash flow improvement in a distribution business.

- The stock was almost a 'forgotten' midcap. By this, we mean that the company was potentially overlooked by chemical analysts (a distribution business in an industrial manufacturing sector) and received a lower level of sell-side coverage. After some years of poor performance (we estimate no organic growth between FY'13-FY'19 after the IPO), we noted that clients (who had owned stock before) had become frustrated by the lack of organic growth.

- The stock was rerated from 13x (FY'19) to 19x (FY'21e), showing that an undervalued and simple equity idea can be very powerful regardless of the equity market environment.

- We could have added to conviction by conducting more fieldwork around the site optimisation programme. Brenntag's European distribution footprint is relatively inefficient compared to its high margin business in the US. The site optimisation programme positively surprised the market at the Capital Markets Day in 2020, and travel in Europe could have revealed the opportunity ahead of time.

Conclusion

We drop Brenntag from coverage and move on to other more differentiated ideas. We believe there is still upside, but it is no longer the best idea we have. We encourage clients to reach out to us to discuss and receive detailed feedback.

Important Information and Disclaimers

The accompanying documents have been prepared and issued by The Analyst Research LLP ("The Analyst"). This research is confidential and is intended only for use by persons to whom it has been directly distributed by The Analyst. This research is strictly confidential and must not be distributed to any third party by the recipient named in the watermark.

The Analyst is a limited liability partnership authorised and regulated by the Financial Conduct Authority ("FCA") of the United Kingdom (firm reference number 605593) and registered as an investment adviser in the United States of America by the U.S. Securities and Exchange Commission (registration number 801-76777). Registered office: Arthur House, Chorlton Street, Manchester, M1 3FH. Trading address: 35 Bedford Road, London, SW4 7EF.

THE ACCOMPANYING DOCUMENTS ARE MARKETING COMMUNICATIONS. The documents are not independent investment research and have not been prepared in accordance with legal requirements designed to promote the independence of investment research and, in producing these documents, The Analyst is not, and has not been, subject to any prohibition on dealing ahead of the dissemination of these documents.

The accompanying documents are intended only to promote the investment research and related advisory services of The Analyst, by using examples and case-studies to give potential clients of The Analyst a sample of The Analyst's investment research services and how such services will be provided. The examples used may be actual investment research issued previously and/or research in relation to hypothetical situations.

WITHOUT PREJUDICE TO THE FOREGOING, THESE MARKETING DOCUMENTS DO NOT RECOMMEND OR SUGGEST ANY INVESTMENT STRATEGY, DO NOT CONSTITUTE INVESTMENT ADVICE AND MUST NOT BE TREATED AS DOING SO BY RECIPIENTS OF THIS DOCUMENT.

The accompanying documents are issued by The Analyst only to and/or are directed only at (and The Analyst's services will be made available only to) persons who are "professional clients" or "eligible counterparties" (as defined in the rules of the FCA). Persons of any other description (including, without limitation, persons who are "retail clients" for the purposes of the FCA Rules) must not act or rely on this material, and the services of The Analyst will not be available to such persons.

All content within these marketing documents (including text, trademarks, illustrations, photographs, graphics, designs, arrangements etc.) are protected by copyright and other protective laws. The marketing documents should not be passed on, duplicated nor reproduced in whole or in part under any circumstances without The Analyst's express written consent.

The information in the accompanying documents is provided for information purposes only and is not comprehensive. These accompanying documents are not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation which would subject The Analyst to any registration or licensing requirement within such jurisdiction. The financial instruments described in these accompanying documents research may not be eligible for sale in all jurisdictions or to certain categories of investors.

The Analyst gives no undertaking that it will update any of the information, data and opinions in this document. The Analyst may at its discretion decide to provide you with further data or material but makes no representation that such further data or material will be calculated or produced on the same basis, or in the same format, as this material.

The Analyst's methodology for determining valuations and price targets may include, but are not restricted to, the following methodologies: analyses of market risk, growth rate, revenue stream, discounted cash flow ("DCF"), earnings before interest, tax, depreciation and amortisation ("EBITDA"), earnings per share ("EPS"), cash flow ("CF"), free cash flow ("FCF"), enterprise value ("EV")/EBITDA, price-earnings ratio ("PE"), PE/growth, price/CF, price/FCF, premium (discount)/average group EV/EBITDA, premium (discount)/average group PE, sum-of-the-parts ("SOTP"), net asset value ("NAV"), dividend returns and return on equity ("ROE").

The investments described in the accompanying documents place an investor's capital at risk (i.e. an investor might lose some or all of the amount invested). Past performance is not necessarily a guide to future performance and an investor may not get back the amount originally invested. The price, value of, and income from, any of the financial instruments mentioned can rise as well as fall and may be affected by changes in economic, financial and political factors. The accompanying documents do not seek to provide an exhaustive statement of the risks associated with the investments or types of investments referred to. All information is provided AS IS with no warranties and confers no rights. If a financial instrument is denominated in a currency other than the investor's home currency, a change in exchange rates may adversely affect the price of, value of, or income derived from the financial instrument described in this report. In addition, investors in securities such as American Depositary Receipts ("ADR"s), whose values are affected by the currency of the underlying security, effectively assume currency risk. Please note that in particular the bases and levels of taxation may change.

Any prices stated in this research are for information purposes only and do not represent valuations for individual securities or other instruments. There is no representation that any transaction can or could have been affected at those prices. Different assumptions, made by The Analyst or any other source, may yield substantially different results. The accompanying documents are intended to be for information and marketing purposes only and are not intended to constitute, and should not be construed as, investment advice. These documents have no regard for the specific investment objectives, financial situation or needs of any person. Recipients of these documents should seek their own independent financial advice. They are not and should not be construed as a recommendation, offer or solicitation for the purchase or sale of any financial instrument.

No liability is accepted by The Analyst for the reliability, accuracy or completeness of such information. In no event will The Analyst be liable to any person for any direct, indirect, special or consequential losses or damages of any kind arising out of any use of or reliance on the information in the accompanying documents, including without limitation, any loss of profit, business interruption, loss of programs or data on your equipment or otherwise. This does not exclude or restrict any duty or liability that The Analyst has to its customers under the relevant regulatory systems.