Interim Review

Edison investment research

8 March 2007

Ritchey

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	PE (x)	Yield (%)
06/05	7.6	0.5	9.0	1.35	6.9	2.2
06/06	7.9	0.4	6.4	1.35	9.8	2.2
06/07e	8.4	0.5	6.3	1.35	9.9	2.2
06/08e	8.8	0.5	6.9	1.70	9.1	2.7

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

Investment summary: Edging ahead

Interim results show that Ritchey is managing to edge its like-for-like revenues and gross margins ahead in markets that continue to be challenging. We are keeping our revenue and profit forecasts unchanged for the full year and for 2008. The business has now been stabilised and can concentrate more on growing revenues. We regard the share price as representing fair value and would regard further weakness as a buying opportunity.

Broadening horizons

With the most serious internal issues now addressed, Ritchey is starting to be in a position to be less defensive and more confident about its approach to its markets. It must now concentrate on growing revenues, itself a significant challenge given the trading backdrop of the agricultural sector.

Back to cash

With an improvement in the conversion of operating profit into cashflow we expect the group to return to a cash positive position by the year end in June, with further gains the following year (assuming no further acquisitions).

Mixed markets

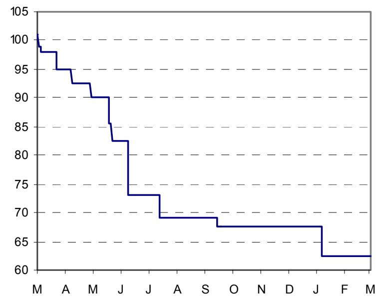
Agricultural markets in the UK are currently mixed, with sentiment improved in the arable, beef and sheep sectors but continuing substantial difficulties within dairy, with no prospects of immediate improvement. Ritchey will continue to be susceptible to alterations in the regulatory environment, particularly to changes in the Common Agricultural Policy.

Valuation: Within range

Since our last report in October, the shares have fallen another 7% to 62.5p, at the bottom of our earnings'-based target range of 63p – 69p. We reiterate our view that any further weakness should be regarded as a buying opportunity.

Price	62.5p
Market Cap	£4m

Share price graph



Share details

Code	RIT
Listing	PlusMarkets
Sector	Support Services
Shares in issue	5.2m

Price

52 week	High	Low
	101p	60p

Balance Sheet

Debt/Equity (%)	1
NAV per share (p)	90
Net borrowings (£m)	0

Business

Manufacture and distribution of branded animal husbandry product, including identification tags for livestock.

Valuation

	2006	2007e	2008e
P/E relative	65%	79%	86%
P/CF	4.5	4.9	4.9
EV/Sales	0.4	0.4	0.4
ROE	7%	8%	8%

Geography based on revenues

UK	Europe	US	Other
92%	6%	0%	0%

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Ritchey is a research client of Edison Investment Research Limited

Investment summary: Edging ahead

Company description: Manufacture and distribution of animal husbandry product

Ritchey is a long-established and well-known brand, operating principally in livestock identification product such as thermo-plastic fabricated ear tags for cattle and sheep. These tags bear a unique reference number, supplied by DEFRA (Department of Food and Rural Affairs), identifying the animal, the herd or flock from which it comes and the farmer. It is Ritchey's intention to leverage the brand across other animal husbandry product.

Valuation

Ritchey's shares are listed on PlusMarkets and have limited liquidity. Until the middle of 2005, the shares were substantially overvalued but have since corrected to a level that we regard as reasonable both in respect to the balance sheet and the prospects for earnings. We calculate a range based on earnings of 63p – 69p, backed by an adjusted book value range of 61p – 84p.

Sensitivities

Ritchey operates in a highly regulated environment with limited opportunity for differentiation in its core product, beyond customer service. The health and prospects for the UK agricultural sector are circumscribed by the EU Common Agricultural Policy. Over recent years, the effect of the CAP has been to reduce the numbers of livestock in the UK and this is likely to continue. Ritchey's largest sensitivity is to further changes to the regulatory regime.

Financials

With the interim results being delivered in line with full-year targets, we are not intending changing our forecasts at this stage. There is a marginal impact on earnings per share due to the dilutive effect of shares issued after July's EGM. We expect the group to have returned to a net cash position by the year end in June, despite a heavier second-half spend on capital projects to increase capacity.

Strategy

Ritchey's management has managed to stabilise the group's performance with no assistance from underlying trading conditions. Substantial improvements have been made in the manufacturing and customer service aspects, which have helped to protect the group's reputation and therefore the value of the Ritchey brand. However, the markets are difficult and will continue to be so. Therefore the short-term strategy is to continue to protect the gross margin by better buying and improving the business mix. The group can only move ahead more strongly by growing its revenues. Last autumn's recruitment of a new sales director with considerable experience dealing with the customer base is a key element of this strategy.

Internal progress

Since the arrival of the new management team in July 2005, Ritchey has been tackling some fundamental issues regarding its product, production, working capital management, customer service and pricing. Although there remains work to do, it appears that the business is now on a more stable footing and can look to grow its top line with a greater level of confidence.

Satisfactory interim figures

Whilst revenues were ahead by 12% in the first half, the bulk of this is accounted for by Travik, the chemicals business bought last year. Like-for-like growth was 2%. The second-half last year benefited from a surge in sales following the much-delayed payouts to farmers under the Single Payments Scheme, making the comparatives more onerous.

The gross margin improved from 56.9% to 57.4% as a result of better buying and a slight change in mix. In the six months to 31st December, Ritchey returned a profit at the operating and at the pre-tax level for the first time in a number of years.

Operational improvement

Progress in the operations is perhaps less dramatic than in the early stages of the company's rehabilitation, but there is a continuing programme of improvement. With little that can be achieved in pricing, there remain opportunities to manage the gross margin through improved buying and product mix. Demand for replacement tags in response to more onerous inspection regimes has also helped support the achieved margin.

The purchase of Travik Chemicals has given Ritchey a far more commercial proposition for its agricultural chemical offering (iodine, lubricants, marking fluid etc.). Although margins are tight, the commodity product is starting to generate more lucrative cross-selling opportunities, particularly within the wholesale sector. The integration has not gone entirely to plan, however, with sales to third-party industrial customers falling off as effort was concentrated on the internal business. This is being addressed with the recruitment of a sales representative focused on this aspect.

Investing in the business

The capital expenditure earmarked for the second half is to be spent on enhancing tag manufacturing and printing capacity.

A new web-based tag ordering system is currently being trialled with a sample of merchants which would automate much of the process, considerably reducing the degree of manual intervention.

In addition, the company intends to strengthen sales and marketing through the recruitment of new personnel.

Concentrating on sales

The new sales director is already having a noticeable impact with some of the larger potential customers in the agricultural merchants sector, which must be the focus of sales efforts if the top line is to grow efficiently. Early moves are also being made with the wholesalers, which would have obvious administrative benefits to a company that has traditionally dealt with a large and disparate customer base.

New product

Ritchey has a mixed record with product innovation and there have been further delays with the introduction of the new automated sheep-tagger. This is now expected to reach the market later this year.

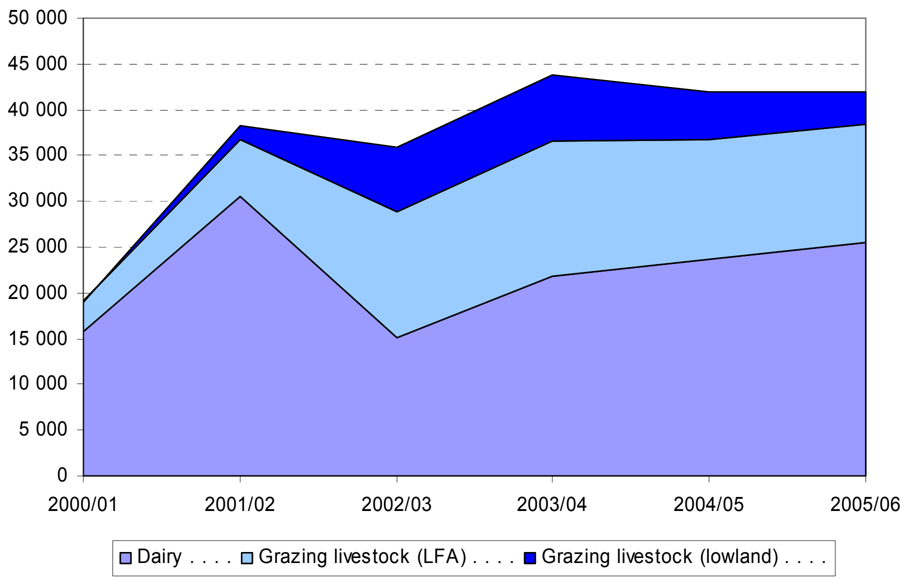
The likely delay in the introduction of Electronic Identification (EID) gives Ritchey an opportunity to hone its offering.

Mixed markets

The UK agricultural sector is suffering mixed fortunes at the moment. Arable farmers are benefiting from the drought in Australia and the emergent demand for bio-fuels and prices for sheep have been improving with the unwinding of oversupply. However, the dairy sector continues to struggle, with no immediate prospect of improvement.

Farm incomes

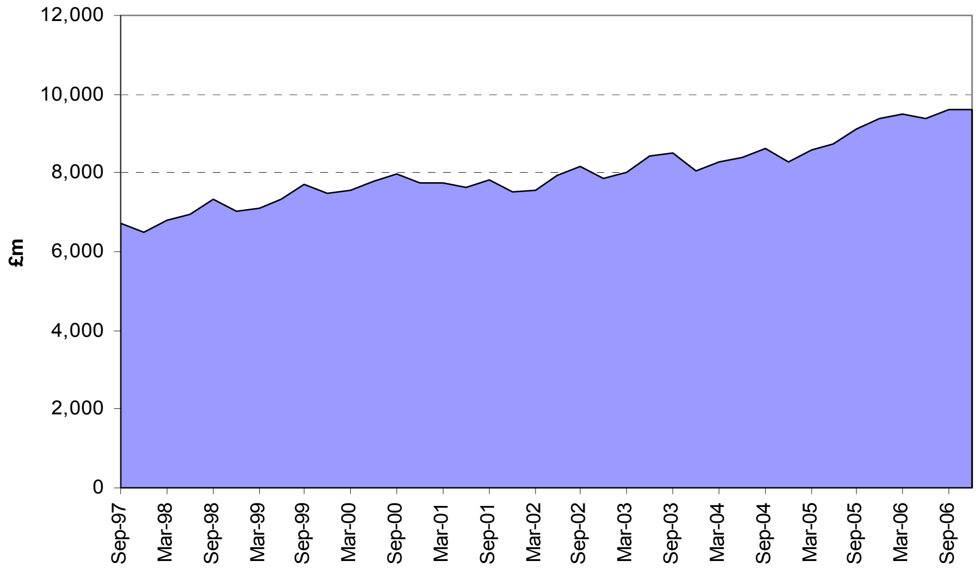
Exhibit 1: Farm incomes – year ended February



Source: DEFRA

Whilst the impact on farm incomes does not look to have been that detrimental up to 2005/06, it is the effect on continuing pressure on the Dairy sector since February 2006 that has caused the greatest concern. Farm gate prices for milk have fallen by 3% year-on-year to December and the changes to the CAP are expected to continue the downward pressure on prices. Farm lending, which had been expected to show a reduction, increased in the final quarter of 2006.

Exhibit 2: Farm lending (not seasonally adjusted)



Source: Bank of England Quarterly Statistics Text

The importance of tagging

Whilst tagging may seem a straightforward administrative procedure, the repercussions of errors and omissions can be considerable. Compliance with the regulations is a pre-condition for receiving remuneration under the Single Payment Scheme, administered by the Rural Payments Agency. For the 2005 payments, there were a total of 1,846 farms penalised for non-compliance and in 1,750 of those cases, the reason was a failure to comply with the cattle identification requirements. Whilst in most cases the failures were *de minimis* and payments were reduced by less than 1%, other failures and fines were significant.

The greater incidence of TB in the South West has led to a higher level of inspection, which has been partly responsible for the greater demand for replacement tags.

Sensitivities

Regulatory changes

The key issues current in the regulatory environment are;

- the proposed introduction of electronic identification (EID), initially in sheep and goats
- The proposed withdrawal of the Hill Farmers' Allowance (HFA)

The intention had been to introduce electronic identification from 1 January 2008, but extensive trials of different methods and equipment across the UK demonstrated that there was not yet available a suitable solution that worked on both farms and in the abattoir. The on-farm cost of implementation of full EID was estimated by DEFRA to be £73.2m, compared with a current identification cost of £13.3m.

The UK has the largest total flock in the EU at 35.5m in June 2005, with each flock an average of 380 sheep. Around half of the flock is estimated to be hill breeds and the proposals regarding the withdrawal of the HFA have caused much concern. The latest Government statements have indicated that the HFA will continue through 2007 to 2009, after which it may be replaced, at least in part, by a separate strand of the Entry Level Stewardship programme specifically relating to those uplands which are not suited to any other agricultural purpose.

Competition

Allflex, the leading global tag supplier, has purchased Roxan, the manufacturer of the leading sheep auto-tagger in the UK. It is likely that Allflex will focus on expanding sales of the Roxan auto-tagger in mainland Europe.

With excess capacity in the industry, suppliers continue to chase sales through lowering prices, frequently to unsustainable levels. This is expected to continue until the smaller suppliers run out of cash.

Supply chain issues

As outlined in the market section above, the pressure on farm incomes is unlikely to abate, although some areas are less affected than others. The industry needs reliable product and is coming to expect higher standards of service from its suppliers. Within the supply chain, there has been some consolidation within the wholesale sector, with stronger regional agricultural merchants emerging, such as Wynnstay (LSE: WYN) and Mole Valley Farmers. Whilst they may have more leverage on pricing, larger customers will provide Ritchey with greater opportunities for growing volumes and for cross-selling other product.

Valuation

Following the correction in the share price, we now view the shares as being fairly valued, backed by both the balance sheet and the prospects for earnings. Any further weakness should be regarded as a buying opportunity.

Balance sheet basis

The book value per share as at 30 June 2006 was 90p per share. 29p of this relates to purchased goodwill. Whilst the acquisitions of Fearing and, more recently, of Travik had more realistic reflections of the value of the intangibles purchased, some of the earlier deals did not. Stripping these out gives an adjusted NAV of 84p. The balance sheet therefore suggests a valuation range of 61p – 84p.

Earnings basis

Whilst progress in earnings per share for the current year is hampered by the dilutive effect of the new shares, our earlier assumption of a normalised rate of earnings growth of 10% continues to look realistic. Applying a PEG ratio of 1.0 produces a share price target of 63p based on earnings to June 2007 and 69p to June 2008.

Exhibit 3: Financials

Year-ending 30th June	£'000s	2003	2004	2005	2006	2007e	2008e
Accounting basis		UK GAAP	UK GAAP	UK GAAP	UK GAAP	UK GAAP	UK GAAP
PROFIT & LOSS							
Revenue		6,853	7,045	7,555	7,852	8,350	8,750
EBITDA		1,503	1,227	722	622	703	753
Operating Profit (before GW and except.)		1,348	1,038	540	434	463	513
Goodwill Amortisation		(227)	(238)	(265)	(268)	(274)	(274)
Exceptionals		0	0	(199)	(59)	0	0
Other		0	0	0	0	0	0
Operating Profit		1,120	800	77	106	189	239
Net Interest		(1)	(3)	(0)	(8)	(13)	(4)
Profit Before Tax (norm)		1,346	1,035	540	425	450	509
Profit Before Tax (FRS 3)		1,119	796	77	98	176	235
Tax		(389)	(293)	(75)	(92)	(99)	(120)
Profit After Tax (norm)		958	742	466	333	351	389
Profit After Tax (FRS3)		730	504	2	6	77	115
Average Number of Shares Outstanding (m)		5.2	5.2	5.2	5.2	5.5	5.7
EPS - normalised (p)		18.5	14.3	9.0	6.4	6.3	6.9
EPS - FRS 3 (p)		14.1	9.7	0.0	0.1	1.4	2.0
EBITDA Margin (%)		22%	17%	10%	8%	8%	9%
Operating Margin (before GW and except.) (%)		20%	15%	7%	6%	6%	6%
BALANCE SHEET							
Fixed Assets		2,815	2,876	2,773	3,266	2,967	2,633
Intangible Assets		1,825	1,772	1,712	1,525	1,251	977
Tangible Assets		990	1,103	1,061	1,740	1,715	1,655
Investment in associates		0	0	0	0	0	0
Current Assets		2,939	3,045	2,823	3,130	3,257	3,527
Stocks		1,038	1,152	1,031	957	1,018	1,066
Debtors		1,225	1,357	1,469	1,798	1,893	1,974
Cash		676	536	323	375	346	487
Current Liabilities		(1,327)	(1,129)	(873)	(1,382)	(1,244)	(1,322)
Creditors		(1,327)	(1,129)	(873)	(1,146)	(1,186)	(1,242)
Short term borrowings		0	0	(0)	(236)	(58)	(80)
Long Term Liabilities		(73)	(75)	(74)	(359)	(324)	(75)
Long term borrowings		0	0	0	(186)	(150)	(75)
Other long term liabilities		(73)	(75)	(74)	(173)	(174)	0
Net Assets		4,353	4,717	4,649	4,655	4,656	4,763
CASH FLOW							
Operating Cash Flow		749	924	424	727	708	778
Net Interest		(1)	(3)	(0)	(8)	(13)	(4)
Tax		(599)	(393)	(153)	(71)	(94)	(106)
Capex		(154)	(492)	(344)	(398)	(265)	(300)
Acquisitions/disposals		(36)	0	0	(550)	(75)	(75)
Financing		0	0	0	0	0	0
Dividends		(168)	(175)	(140)	(70)	(75)	(99)
Net Cash Flow		(209)	(140)	(213)	(370)	186	194
Opening net debt/(cash)		(885)	(676)	(536)	(323)	48	(138)
HP finance leases initiated		0	0	0	0	0	0
Other		0	0	0	0	0	0
Closing net debt/(cash)		(676)	(536)	(323)	48	(138)	(332)

Source: Company accounts / Edison Investment Research

Edison Investment Research

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