

15 March 2006

Ritchey plc

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	PE (x)	Yield (%)
06/04	7.0	1.0	14.3	2.7	6.9	2.7
06/05	7.6	0.5	9.0	1.35	10.9	1.4
06/06e	7.4	0.3	3.5	1.35	28.0	1.4
06/07e	7.5	0.4	6.0	1.35	16.3	1.4

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

Investment summary: Tagging along

Interim figures published today show a loss for the first half and demonstrate how difficult it has become to make progress in Ritchey's core markets. Early moves by Simon Riddell, the managing director appointed in July 2005, are starting to have an effect, but there remains much to do. The Ritchey brand is long-established and well recognised by its target customers and has good potential for exploitation over a broader product base.

2006 profits nadir

The current financial year sees the group making the moves necessary to secure its profitable future. Declining demand and falling prices for livestock identification product mean that there will be continuing pressure on gross margins. Changes being implemented to the chemicals business will hit profits in 2006 but cut ongoing costs, creating a sustainable business. The group restructuring as a result of the strategic review will introduce major operating efficiencies which help reinforce our 2007 forecasts.

Financially sound

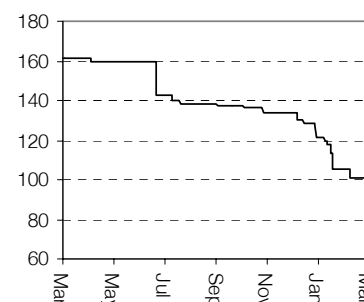
The restructuring is possible because of the level of cash in the balance sheet. We anticipate the company having modest gearing by the year-end and being cash flow neutral the following year.

Valuation: Nearer reality

The share price has come back by 29% over the last six months and 39% in the last year. In our last note, we concluded that the share should trade in a range based on NAV at the lower end with all goodwill stripped out and at the upper adjusted for goodwill with the exception of the successful Fearing acquisition. This gave a range of 57p-82p. Based on normalised earnings and assuming future growth of 10%, we derive 60p as a reasonable level of valuation.

Price 98p
Market Cap £5m

Share price graph



Share details

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

Price

52 week High 161.5p Low 98p

Balance Sheet

Debt/Equity (%) Cash
NAV per share (p) 90
Net cash (£m) 0.3

Business

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

Valuation

	2004	2005e	2006e
P/E relative	65%	190%	124%
P/CF	12.3	11.9	8.8
EV/Sales	0.7	0.7	0.7
ROE	10%	4%	7%

Geography based on revenues

UK	Europe	US	Other
93%	3%	1%	2%

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Investment summary: Tagging along

Distribution of animal husbandry product

Ritchey's core business is the manufacture and distribution of livestock identification products, principally cattle and sheep tags. These bear a unique reference number, supplied by DEFRA (Department for Environment, Food and Rural Affairs), which identifies the animal, the herd from which it comes and the relevant farmer. Management's intention is to build on its well-recognised brand for a broader range of animal husbandry product.

Valuation

The company's shares are traded on OFEX and consequently are relatively illiquid. The share price had been at a level considerably higher than was justified by the fundamentals, but since our last publication has moved towards a level more consistent with the trading background.

The new management has started its substantial task in turning the company around and it may be two or three years until their achievements are reflected in the earnings. We would therefore expect the shares to trade at a significant discount to its peers until evidence of recovery is demonstrated. Looking at the balance sheet gives a more positive picture, as the net asset value equates to nearer 90p per share. Of this, though, 33p relates to purchased goodwill. Taking a conservative approach and stripping this out gives an implied share price target of 57p, valuing the group at just under £3.0m. Adding back the goodwill relating to Fearing, which trades profitably, increases the share price equivalent to 82p.

If we assume a base for normalised earnings per share of 6.0p (our 2007 figure), down from 6.4p in our previous note, which could then be grown by 10%, then a PEG ratio of 1.0x would imply a price of 60p, falling within the range given above. This values the group at £3.1m.

Sensitivities

Ritchey's key market is in decline due to falling herd sizes and pressure on farm incomes. This is expected to continue for the foreseeable future but further changes to the Common Agricultural Policy could accelerate the pace.

Financials

Exhibit 1: Current year downgrades

Note: Figures in £m except per share data

	EPS			PBT			EBITDA		
	Old	New	% chg.	Old	New	% chg.	Old	New	% chg.
2005	9.0	9.0		0.54	0.54		0.72	0.72	
2006e	5.9	3.5	-41	0.43	0.26	-39	0.61	0.43	-29
2007e	6.4	6.0	-6	0.47	0.44	-6	0.65	0.63	-3

Source: Edison; Company

- The interim figures show the combined effects of falling gross margins with increased operating costs.
- Net effect of operational changes is to virtually preserve forecasts to June 2007.
- Strong cash flow to support sufficient capital expenditure programme to enhance profitability and support acquisition programme.
- Balance sheet expected to be marginally geared by year end and broadly cash flow neutral in 2007.

Company description/strategy

Ritchey's core business is the supply of livestock identification product (ear tags and chemical-based) into the agricultural market in the UK and Ireland. It has a long-established and widely recognised brand that has enabled it to operate at premium price points. End markets are under severe economic pressure which has exposed the company's weaknesses. The management team installed last year is taking action to put the business on a sustainable footing.

Factors behind the current year downgrade

At the time of our last note, we were anticipating 2006 revenues of £7.6m, normalised pre-tax of £0.4m and earnings per share of 5.9p. We now forecast revenues of £7.4m, normalised pre-tax of £0.3m giving eps of 3.5p

Top line weakness

That the market continues to be difficult should come as no surprise. Farmers' incomes are under severe pressure and this was exacerbated in the first half by the delayed issuance of the Single Farm Payments. This had been built into our numbers. However, the performance of the chemicals business has been particularly poor, with new products failing to sell. There was also a loss of market share in sheep tagging product after the major competitor launched a new automatic tagger.

Gross margin pressure

Ritchey has not reduced its pricing on tags, despite competitors doing so. It has always been the premium-priced product in the sector and therefore remains so. The reduction on gross margins is therefore due to a combination of raw material price increases, particularly in the chemicals business, and sales mix. In face of the rises in input costs, Ritchey is working to reformulate its products and use the buying skills within its new chemicals acquisition (Travik) to reduce its raw material bill. Sales performance has been better in the lower margin areas of the business than in the higher margin tags. There has also been a further modest impact on the gross margin from the movement in the New Zealand dollar.

Increased overheads

Higher overheads for the current financial year are as a result of extra costs put in the second half of the previous year being carried over. Cost reductions already put through in the current year and those to come through the restructuring programme at Ritchey in Masham mean that these overheads are back on a downward trend. The closure of the Marabo facility and the transfer of its production into the newly-acquired site at Travik will also benefit the operating cost line.

2007 forecasts show improvements coming through

For the following year, we are assuming flat revenues and are continuing to take a cautious view on gross margin, although there should be some recovery beginning to come through towards the year-end. There will be a full year benefit from the cost reductions within chemicals and also from operating efficiencies achieved at the Ritchey operation in Masham. It is too early to determine accurate forecasts for Travik for 2006/7 and these are not included in our estimates. Management currently anticipate that it will deliver around £600k of revenues and be earnings' neutral.

Addressing the issues

The company has historically enjoyed high gross margins and high market shares. Faced with a declining end market and greater competition, those margins were unsustainable. Previous diversification attempts had met with mixed success. The new team has the benefit of a strong balance sheet and high levels of brand recognition. However, it was also faced with a number of operational issues in both manufacturing and distribution. Important steps have already been taken but there remains much to do.

Restructuring at Ritchey

Major improvements have already been made on some of the key issues on product quality and service. Further changes are needed to resolve stock management issues and to improve manufacturing efficiency. IT systems are in need of upgrading, both to improve the flow of orders through production to despatch but also to provide management with the quality of information required to plan effectively. For the time being, there are a very large number of SKUs of which a small proportion generates the vast bulk of sales. Presentation of the brand is still inconsistent across the product range and this will also need to be addressed if the brand is to fulfil its potential.

Stemming chemicals outflow

The Preston-based Marabo business was purchased by Ritchey in August 2004, but has failed to live up to expectations. The products are inherently low margin and there are limited opportunities to add value. The group has now announced the purchase of Travik Chemicals, based in Newton Aycliffe, for an initial consideration of £350,000 plus the assumption of £200,000 of debt. Further sums of up to £200,000 will be payable subject to sales performance and other conditions. Travik is a very efficient production facility and its management has a good record on cost control. The Preston facility is to be closed and production transferred to Travik. Although some of Travik's product is destined for use with animals, the bulk of its output is in industrial including car cleaning products, with a blue chip customer list including Halfords, British Rail and Nissan.

Distribution deal gives alternate brand positioning

Ritchey has signed a four-year contract with Danish tag manufacturer Daploma (a subsidiary of the large US concern, Digital Angel) for the exclusive UK and Irish distribution of its product. This is potentially a very important move as it will give the customer base an option of a lower-priced alternative and consolidate the group's supply relationship with larger agricultural merchants. Whilst the available margins will be lower than those for Ritchey product, there will be none of the manufacturing issues. Further out, it also gives Ritchey access to Daploma's electronic product, including Radio Frequency Identification Devices (RFID) without the requirement to invest in expensive new tooling. There will be some upfront investment, of the order of £10-£15,000, in supplying the necessary applicators to the farmers and associated promotional support.

Automatic Sheep Tagging

Having lost market share in sheep tagging after Roxan ID launched its time-saving automatic product, Ritchey has a competitive product in development. The products are intended to be launched in the late summer. Any slippage from the timetable would mean missing the key season when lambs go to market, i.e. August/September. The potential loss of business from not developing new product would be considerable and, provided that the market adopts Ritchey's version, the upside from bringing it in is attractive.

Sensitivities

Regulatory and legislative-led demand pressures

- The size of the cattle herd in the UK and Ireland has been reducing under the Common Agricultural Policy with the number of births expected to decrease by 5-10% this year. The speed of this decline is dependent on any further changes to the Policy. Many less efficient producers are already leaving the beef sector and this process is bound to continue.
- The recent news of the rescinding of the EU ban on UK beef exports may slow the rate of decline.
- The UK currently has derogation from the double tagging of sheep, but this will be reviewed later in the year.
- The Hill Farmers' Allowances are scheduled to be withdrawn under EU proposals in 2008-9. If this goes ahead, the impact on the size of the UK flock would be devastating.
- The intention to introduce RFID, initially in sheep in 2008, will give an opportunity. The Diploma distribution deal should enable Ritchey to cater for demand without the need for expensive tooling.

Competition

The competitive situation has worsened as the market has weakened. Whilst Ritchey has resisted downwards pricing pressure to date, there may come a stage where the premium becomes unsustainable. Ritchey has acted to defend and grow its market positioning with the Diploma distribution deal which will considerably improve its ability to react to new competitive product reaching the market.

Attrition of the customer base

The agricultural merchant sector has been suffering from both its customers' reduced spending power and from the reduced scale of their activities. Many of the smaller concerns are becoming uneconomic and are withdrawing from the market. This should present Ritchey with an opportunity to align with the larger, more successful concerns, bringing higher average order values and consequential operational efficiencies.

Ritchey's market reputation

Improvements to quality and service have seemingly come in time to protect Ritchey's reputation with its customers. Any renewed deterioration in these standards could prove costly.

Acquisition policy

The company needs to be seen to have a coherent acquisition policy which enhances group prospects.

Valuation

In our previous report in October 2005, we established a valuation range that we felt appropriate for the stock to trade within, based on the group's net asset value with adjustments made for the goodwill arising on previous acquisitions. This gave a range of 57p-82p. We see no reason to alter this. Our earnings'-based forecast falls within this range at 60p, down from 64p at the time of the previous note.

The balance sheet has remained intact and we calculate the net asset value per share at 90p. Of this amount, 33p relates to the intangible assets, primarily due to the acquisition programme since 2001. Ritchey's value with reference to its tangible NAV would therefore be 57p per share (excluding purchased goodwill). A share price at this level would value the company at around £3.0m. Although the value of the acquisition programme is not proven in all cases, Fearing, acquired in 2001 is profitable. Of the goodwill of £1.7m on the balance sheet, £1.3m relates to the written down intangible assets related to Fearing. It could therefore be argued that this goodwill should be added back, giving a value per share of 82p. This gives a range of 57p to 82p in which the shares should be trading.

Calculations of valuation based on the current year are clearly going to be misleading because of the depressed nature of the earnings. We regard the 2007 figure as being more relevant and representing a more normalised figure. If we further assume that growth from that point on can be achieved at around 10% and apply a PEG ratio of 1.0x, we derive a share price equivalent of 60p, falling within the asset-based range described above.

Exhibit 2: Financials

Year-ending 30th June		2003	2004	2005	2006e	2007e
Accounting basis	£'000s	UK GAAP	UK GAAP	UK GAAP	UK GAAP	UK GAAP
PROFIT & LOSS						
Revenue		6,853	7,045	7,555	7,400	7,450
EBITDA		1,503	1,227	722	431	645
Operating Profit (before GW and except.)		1,348	1,038	540	257	450
Goodwill Amortisation		(227)	(238)	(265)	(256)	(306)
Exceptionals		0	0	(199)	0	0
Other		0	0	0	0	0
Operating Profit		1,120	800	77	1	144
Net Interest		(1)	(3)	(0)	2	(4)
Profit Before Tax (norm)		1,346	1,035	540	259	446
Profit Before Tax (FRS 3)		1,119	796	77	3	140
Tax		(389)	(293)	(75)	(77)	(134)
Profit After Tax (norm)		958	742	466	182	312
Profit After Tax (FRS3)		730	504	2	(74)	6
Average Number of Shares Outstanding (m)		5.2	5.2	5.2	5.2	5.2
EPS - normalised (p)		18.5	14.3	9.0	3.5	6.0
EPS - FRS 3 (p)		14.1	9.7	0.0	(1.4)	0.1
EBITDA Margin (%)		22%	17%	10%	6%	9%
Operating Margin (before GW and except.) (%)		20%	15%	7%	3%	6%

BALANCE SHEET

Fixed Assets	2,815	2,876	2,773	3,193	2,782
Intangible Assets	1,825	1,772	1,712	1,806	1,500
Tangible Assets	990	1,103	1,061	1,387	1,282
Investment in associates	0	0	0	0	0
Current Assets	2,939	3,045	2,823	2,646	2,722
Stocks	1,038	1,152	1,031	1,054	1,076
Debtors	1,225	1,357	1,469	1,421	1,455
Cash	676	536	323	171	191
Current Liabilities	(1,327)	(1,129)	(873)	(908)	(904)
Creditors	(1,327)	(1,129)	(873)	(858)	(856)
Short term borrowings	0	0	(0)	(50)	(48)
Long Term Liabilities	(73)	(75)	(74)	(424)	(324)
Long term borrowings	0	0	0	(150)	(150)
Other long term liabilities	(73)	(75)	(74)	(274)	(174)
Net Assets	4,353	4,717	4,649	4,506	4,276

CASH FLOW

Operating Cash Flow	749	924	424	442	592
Net Interest	(1)	(3)	(0)	2	(4)
Tax	(599)	(393)	(153)	(75)	(96)
Capex	(154)	(492)	(344)	(300)	(300)
Acquisitions/disposals	(36)	0	0	(350)	(100)
Financing	0	0	0	0	0
Dividends	(168)	(175)	(140)	(70)	(70)
Net Cash Flow	(209)	(140)	(213)	(352)	22
Opening net debt/(cash)	(885)	(676)	(536)	(323)	29
HP finance leases initiated	0	0	0	0	0
Other	0	0	0	0	0
Closing net debt/(cash)	(676)	(536)	(323)	29	7

Source: Company accounts; Edison Investment Research

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