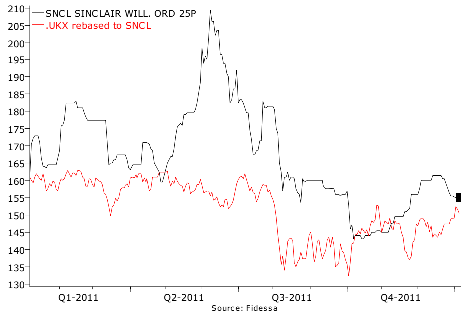
William Sinclair Holdings 158p

13 January 2012

Encouraging Numbers, A Strong Strategic Position and Loaded with Assets. Ceasing Coverage



Shares in Issue: 17.02m fully diluted

12m High: 210p

12m Low: 143p

Market Cap: £27m

NAV/Share: 94p ex intangibles as stated

164p including minimum payout for Bolton Fell

Gearing: Nil, £2.6m net cash excl. pension deficit

Interest Cover: n.a.

EPIC Code: SNCL

Sector: Household Goods

Market: London AIM

Broker: Arbuthnot Securities

PR: None

Website: www.william-sinclair.co.uk

Description: The UK market leader in growing media for the retail market, with the technically most advanced peat replacement manufacturing process. Substantial hidden value in peat reserves not included in the balance sheet.

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Full year results were as we estimated, showing pre-tax profits of £3.2m (estimate £3.2m) compared to £2.5m the previous year. Eps were 13.4p (estimate 13.5p) vs 12.2p in the previous year. Assets in the balance sheet are, once again, significantly understated.

We view these numbers as encouraging, especially given the wet summer and the disruption to the market generally caused by the collapse of Focus DIY. We particularly like the way central costs were cut back from 3.9% to 2.6% of sales revenues – Sinclair is an example to other companies in this respect.

The 2012 results will be influenced by the extent to which Sinclair's competitors react to 2011's wet summer and the increased cost of importing product from Ireland by raising prices; on the least favourable scenario Sinclair will at least hold its current level of profits, but a further profit improvement of 5 – 10% is more likely. The key factor here, however, is the increasing diversity of the raw material supply. Sinclair has a requirement, overall, for around 600,000 m^3 of growing media a year. By end-2012, its recycled product, SuperFyba, should be capable of supplying 150,000 m^3 of that.. Its peat drying process will provide a further 50,000 m^3, giving Sinclair some independence from fluctuations in the weather. We are slightly surprised by the bullishness of the CEO's wording on the outlook – "I look forward to delivering another year of significant progress". But there is no disputing that strategically Sinclair is in a strong position.

Directors own very few shares and in the event of a takeover approach the company would be vulnerable.

We cease coverage of William Sinclair with this research, and we leave while Sinclair is on a high note. Since we initiated coverage, Sinclair shares have risen 38% compared to a fall in the FTSE100 Index of 0.5%. This has been a good result for investors.

Y/E	Group Sales	Declared Profit	Adjusted Profit	Adjusted EPS	PE Ratio	Divi	Yield
Sept	£m	£m	£m	P	X	P	%
2009A	46.3	1.2	1.2	6.8	26.3	3.5	2.2
2010A	48.5	2.1	2.5	12.2	13.0	5.0	3.2
2011A	54.3	3.2	3.2	13.4	11.8	6.2	3.9
2012E	No	Estimates					

Full Year Results

The full year results for the year to end-September showed sales revenue 12% higher than the previous year, and tighter divisional operating margins offset by a reduced level of central costs.

12 months to end-September	2012 £m	2011 £m*	
Revenue			
Horticulture	44.74	40.92	+9.3%
Freeland	5.70	4.20	+35.8%
Other	3.83	3.34	+14.6%
Total Revenue	54.26	48.46	+12.0%
Operating Profit			
Horticulture	3.87	4.16	-6.9%
Freeland	0.46	0.41	+12.1%
Other	0.46	0.27	+70.8
Total OP	4.79	4.84	-0.9%
Operating Margin			
Horticulture	8.6%	10.2%	
Freeland	8.1%	9.8%	
Other	12.1%	8.1%	
Total OM			
Central Costs	1.42	1.87	-24.0%
Group Operating Profit	3.37	2.96	+13.5%
Net Finance Costs	0.01	0.13	
Other Finance Costs – Pension Charge	0.14	0.31	
Pre-tax Profit	3.18	2.52	+26.1%
Tax Charge £m	0.79	0.48	
Tax Charge %	24.8%	19.0%	
EPS Undiluted	13.9p	12.3p	
EPS Diluted	13.4p	12.2p	
Dividend Total	6.2p	5.0p	
Dividend Cover X	2.2X	2.4X	

*excludes exceptional item

The Horticulture Division continues to dominate the group, both in sales and p&l terms. Freeland, which consists almost entirely of the new SuperFyba peat replacement, showed a 35.8% sales gain which we view as satisfactory given that adjustments were still being made to the manufacturing process throughout the period. The remaining interests are its Silvaperl vermiculite based products, which are used in the construction and insulation industries as well as horticulture.

SuperFyba

During the 2011 financial year this was produced entirely at the Basingstoke plant. We estimate that total production was probably in the region of 25,000 m^3, well below the theoretical maximum of the production line because improvements were constantly being made to the manufacturing process for this very new product. By the end of the financial year, the plant was producing at the rate of ~50,000 m^3 a year, and this is being augmented by a second production line at Doncaster for the current financial year. This second production line should have a greater throughput because, subject to planning approval, it will operate on a 24 hour day rather than the 12 hour day of Basingstoke, so total group SuperFyba output for the current financial year will probably approach 100,000 m3, with a year-end run rate of 150,000 m^3/p.a. or greater.

Management would like to establish third and fourth production lines on new sites, which have yet to be located. In addition to the site, however, Sinclair will need to establish new sources of feedstock for further locations.

SuperFyba has outperformed all other synthetic growing media and peat replacement products in independent tests, and even though it is more expensive to produce per m^3 of finished growing media than English harvested peat, we foresee a very good future ahead for this.

During 2011, the largest customer for the SuperFyba output was the Olympic Park in East London. Once the Olympic Games are over, there will be further landscaping work to be done, and we expect further significant usage of SuperFyba for that. For 2013 onwards, SuperFyba will increasingly find its way into Sinclair's bagged horticultural products, giving the group steadily rising flexibility over raw material sourcing and reducing its vulnerability to the interruption of peat supplies caused by either weather or political considerations.

The Drying Process

Traditionally, harvested peat has been dried ahead of sale by drying it outdoors, subject of course to satisfactory weather conditions (i.e. no rain, and ideally some sunshine as well). Sinclair has pioneered an artificial drying process for peat that while energy hungry and raising the cost of the finished product by possibly £4 per m^3, gives it some independence over the weather. The 2011 financial year, with its poor summer weather, was the first time this process had been used on a commercial scale, and we estimate that Sinclair probably processed 25,000 m^3 of peat by this system that it would not have been able to harvest otherwise. During 2012 this could rise to 50,000 m3. If necessary, this figure could rise significantly from 2013 onwards with the purchase of new equipment. As far as we are aware no other supplier of peat into the UK market has yet developed similar technology.

The Poor 2011 Summer Weather

We estimate that Sinclair's total requirement for growing media of all kinds is approximately 600,000 m^3 a year. By no means all of this is for peat. We estimate that Sinclair can probably operate satisfactorily, though below optimum profitability, on a harvest of as little as 400,000 m^3 of natural peat each year. The total market size is approximately 3m m^3 a year; Sinclair has a market share of roughly 20%, and this market share is growing gently.

The 2011 summer peat harvest was bad for everyone, because of the wet summer weather. We estimate that Sinclair probably harvested only 350,000 m^3 of peat and will have to draw on its inventory over the winter of 2011/12 in order to meet demand for the new sales season that traditionally starts at Easter. This means there is likely to be some importing from Irish contractors during 2012. This will be shipped in bulk. Only 7,000 m^3 is likely to be purchased, but this will take the edge off current year margins, because imported Irish peat is even more expensive than dried peat.

If it is any consolation to investors (and it should be) Sinclair's main competitors are even worse hit. For a start, two of them are Irish companies. Also, Sinclair appears to be the only company that buys its own equipment rather than renting it, which gives it greater flexibility to exploit off-season favourable weather windows.

A further issue is the poor current state of the Irish economy, which has reduced the volume of trucks carrying British goods into the Republic. Historically, all peat importers have used cheap backloading on these trucks to bring peat into the mainland British market. Because Ireland is importing fewer British goods at present, there is currently very little cheap backloading to be had.

Legal Issues

Sinclair is currently involved in two legal issues relating to supplies of natural peat.

Bolton Fell. Sinclair has agreed to cease peat harvesting at Bolton Fell, near Carlisle. This is "old news" – during 2010 the company received an interim prepayment of £9m that it has yet to recognise in its balance sheet because a balancing item, "Receipt from Natural England", appears in the liabilities section of its balance sheet.

When Sinclair agreed to cease peat harvesting, this was subject to a final financial settlement being receiving from Natural England. Natural England has since offered to raise this total to £12m (i.e. £3m more than has already been received). Sinclair has rejected this, and on the evidence that we have seen quite rightly so. The issue will now be judged by the Lands Tribunal. A process and timetable is currently being negotiated, we think that it will be 2014 before Sinclair sees any more money.

Chat Moss. This is Sinclair's second major UK peat site. Sinclair completed harvesting all land for which it had planning permission during the course of 2011. An application to expand the harvesting area has been turned down. Sinclair is appealing the decision to the Secretary of State for the Environment. The appeal will be heard in March 2012, but the decision is unlikely to be announced in time to permit harvesting to take place in the current summer season, even if Sinclair wins.

Sinclair has peat reserves in Scotland that are large enough to replace the Bolton Fell and Chat Moss deposits, certainly in the short term. The Scottish deposits have full planning consent and can be started at short notice. They will, however, have a higher total cost, both for extraction (each individual site lacks economies of scale) and for transport (both are further from the major consumer markets in the South-East of England).

Pensions

Sinclair has a Defined Benefit pension scheme that is closed, but represents a liability of £10.1m in the balance sheet. This liability has risen from £9.6m at the close of the previous financial year, largely because of the fall in the discount rate used on all pension liabilities by all actuaries over the past year. This is the only thing in the balance sheet that we do not like.

Last year, Sinclair increased its payment to the pension scheme from £600,000 to £750,000. It can do this because its balance sheet is strong, with net cash of £2.6m before the pension deficit. A further increase in payments, to £900,000, is scheduled for 2012, and the payments will continue to increase, but at a more modest rate, thereafter. These payments should ensure that the pension issue remains under control. By comparison, the 6.2p/share, 2.2X covered total dividend declared for the last financial year will cost the company £1.05m.

This £750,000 payment is a cash item, not a p & l item. The charge to the p & l account on pensions last year was down from £0.32m to £0.14m. This was one factor behind the significant increase in pre-tax profits in 2011.

Tax Charge

After a number of years when its tax charge was almost as unpredictable as its earnings streams, Sinclair has returned to a position where both can be predicted with a certain amount of precision (as shown by the company achieving our 2011 estimate to within £18,000). 2010 was the final year of a sub-standard tax charge, and the 2011 charge of 25% marks the "new normal", subject of course to the modest reductions in the UK corporation tax rate that are being introduced by the current Government.

The Underlying Asset Value

We are somewhat surprised that Sinclair has not yet been forced to recognise the £9m received for Bolton Fell as an “asset”, given that Natural England has already conceded that in its own view Sinclair is entitled to £3m more than this.

The balance sheet, as presented by the company and its auditors, gives net assets, after stripping out intangibles, of £16.1m. This is £1m higher than at the end of the previous financial year. On the 17.02m shares in issue, this is equivalent to 94p/share.

If management were to capitulate to Natural England and accept the total £12m settlement currently on offer, this would provide an additional 70p/share, raising nav to 164p/share.

If the final outcome is, as we think likely, a settlement more in the region of £20m, the net asset value would rise to 212p/share. We have presented our reasoning behind higher valuations for Bolton Fell in past research notes.

The additional peat reserves in Scotland are included in the accounts at cost, rather than market value. Given the almost complete lack of exploitable peat resources South of the Border currently, the Scottish reserves, with their planning approvals, must have significant value.

Additionally, Sinclair owns 9 acres of freehold land near the Centre of Lincoln, and would arguably be better served by moving its production/distribution facilities to a less congested Greenfield site and selling this valuable land for development. The value of this land is, we believe, possibly in excess of 50p/share, and while a site move would incur relocation costs, it would almost certainly reduce ongoing operating costs.

Sinclair, therefore, has an underlying real asset value considerably in excess of its current share price. We leave it to investors, and potential investors, to form their own judgement as to just what that value might be.

Management	Major Shareholders
Non-Executive Chairman: Bill Simpson **Chief Executive:** Bernard Burns **Finance Director:** Peter Williams **Non-Executive Directors:** Hugh Etheridge, Ken Piggott	Noguer Inv SA 8.9% Richard Emslie 6.9% (dup) J M Finn Nominees 5.0% Henderson Global Investors 4.8% Slater Investments 4.0% Alasdair Emslie (dup) 3.9%
Key Dates	**Key Milestones**
24 February 2012: Annual Meeting **March 2012:** Appeal heard by Secretary of State for the Environment re. Salford Council's refusal of planning permission for further peat extraction at Chat Moss.	**2004 – 5:** Board Changes that resulted in the current management of the group. **2010:** Commercial start-up of the first SuperFyba production line. **2010:** Receipt of £9m interim compensation for cessation of peat harvesting at Bolton Fell. **2010:** Two small acquisitions add £5m to sales revenue. **2011:** Acquisition of Yorkshire Horticultural Supplies, which becomes the site of the second SuperFyba production line.

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