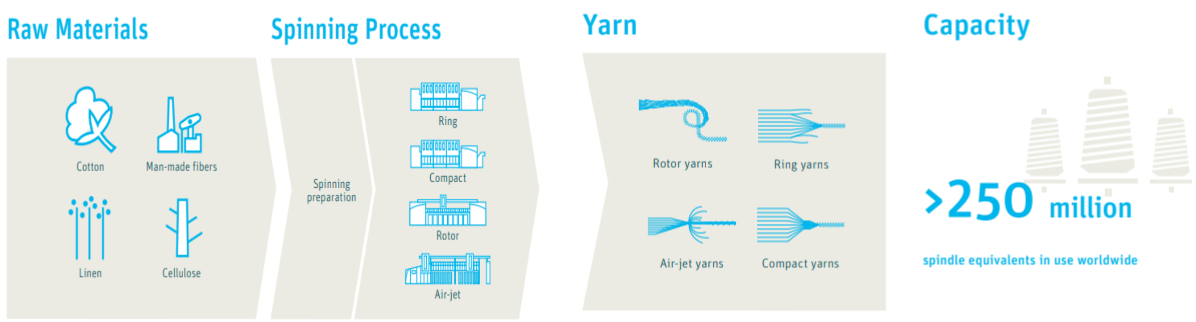
Investment case: Rieter Holding AG

What is Rieter?

Rieter is a Swiss company based out of Winterhur. It was established in 1795. They are the world's leading supplier of systems for short-staple fiber spinning. The firm develops and manufactures machinery, systems and components used to convert natural and manmade fibers and their blends into yarns. They are the sole supplier to offer spinning preparation processes as well as four end spinning processes.

Business Model



Yarn production:

In order to convert raw materials into textile, fibers need to undergo a certain process. These fibers, such as, cotton, linen, polyester or viscose are converted into different type of yarns. Then, once this yarn is made, it can be transformed into textile through various processing steps like weaving, knitting, dyeing or finishing.

Yarn is assembled in two distinct ways. You can either spin staple fibers or process the filaments to make continuous yarn. These two methods yield different results. The first technique is the one that is most commonly used in the clothing industry as yarn made from staple fibers is more comfortable.

Rieter mainly focuses in yarn production from staple fibers. The most important one is, cotton (c.24M tons per year), followed by polyester (c.16M tons per year) and viscose (c.5M tons per year).

Business segments

Machines & Systems

This business group is dedicated to the manufacturing of new equipment in the spinning systems and single machines sector. In FY 2017 they reported a significant increase in order intake of 13%. Especially in Asian countries, the main ones being China (19% of total sales), India (18% of total sales) and the key market of Turkey (10.4% of total sales). However, sales have decreased minimally by 2% and EBIT dramatically by 78%. This segment represents 61% of total sales and only 1,5% of total EBIT. It yields the lower EBIT margin of the 3 business groups, 0,8%. Machines & Systems has been affected by weak sales mix (country and product) in 2017 and by the fact that the company has not launched any significant new products during the year, apart from the one launched at the end of 2016 who had a lot of success, the RSB-D 50. In this context, the company still thinks that it contributed positively to the group's operating result considering that no major trade fairs have occurred in 2017.

After sales

The after sales segment focuses on developing and producing spare parts for Rieter machines that don't come into direct contact with fibers, such as drivers, sensors or controllers. They also provide services that allow Rieter clients to enhance the efficiency and effectiveness of their spinning mills. The extraordinary feature of this business group is that they also provide services to other machines that are not theirs. Its order intake increased by 14%. Driven by spare parts and after sales services sales grew by 3% and EBIT by 9%. This business group constitutes 15.2% of total sales and 53.9% of total EBIT, with an EBIT margin of 27.9%. In 2017, to keep the ambitious objective of considerable growth, the focal point was in the further development of the service network, the optimization of spare parts logistics and the expansion of the product portfolio. This part of the business allows existing customers to increase productivity, improve quality and extend the service life of spinning machines by retrofitting the machines and providing upgrade packages.

Components

They are in charge of producing technology components and precision winding machines for use in the textile value chain. These components need to be replaced at regular intervals. They are the world's leading supplier of components for short staple and long staple yarn production. The order intake increased 28%, from CHF 178.4M to CHF 228.5M. The acquisition of SSM Textile Machinery (which I will talk about lately) contributed significantly with CHF 42.5M, in the second part of the year. Components constitutes 23.8% of total sales and 44.6% of EBIT with the highest margin of the three groups 30.8% EBIT. Without the SSM Textile acquisition, the order intake would have only increased 3% and sales would have been CHF 49.1M lower, CHF 180.7M instead of CHF 229.8M. Thus, decreasing from CHF 200M in 2016, a 10% decline.

Acquisition

In June 2017, Rieter acquired SSM Textile Machinery Division. Rieter paid CHF 124.1M in cash, 7.9x EBITDA. The acquired company, is the world's preeminent supplier of precision winding machines in the fields of dyeing, weaving and sewing-thread preparation. They are also very successful in the production of individual segments of filament yarn. SSM is present in all major markets with twelve service stations and 80 agents. This acquisition enables Rieter to invest in bordering fields of the textile value chain. SSM's strong brand and stable cash flows, along with their expertise in precision winding, will offer Rieter new opportunities with short-staple spinning machines. SSM is now part of the Components Group as an independent unit. The SSM acquisition should yield, access to other markets, proficiency in other areas where Rieter does not excel and an EBITDA of CHF 17.1M.

To conclude, Rieter business model is quite a special one. They are able to charge the customer three times. First, they sell the machines, then they provide services that increase the useful life and efficiency of the machines and lastly, they also replace the technological components of the machines they sell. Think of it as HP does with their printers or Gillette (P&G) with their razors. They sell the main product with a low margin but where they really create value is by selling ink cartridges for HP or by selling razor blades for Gillette. Rieter sells the machines where the margins are minimal (0.8% EBIT) and then, they retrofit and upgrade the machines and finally they provide components that have a decisive impact on the performance of the machines.

Management remuneration

GROUP EXECUTICE COMMITTEE

	2017					2016
CHF	Basic salary	Cash bonus	Share-based compensation	Social contributions[2]	Total	Previous year
Dr. Norbert Klapper, Chief Executive Officer[1]	620 000	99 200	99 200	183 832	1 002 232	1 121 749
Other Members[3]	1 800 000	288 000	288 000	475 506	2 851 506	2 985 727
Members of the Group Executive Committee	**2 420 000**	**387 200**	**387 200**	**659 338**	**3 853 738**	**4 107 476**

The group executive committee is formed by the CEO, the CFO, the heads of each business group and by the general secretary. They receive variable remuneration depending on certain targets set by the Board of Directors. The weight of each objective is the following, EBIT before restructuring charges 60% with an objective of 10%, RONA 20% and target of 14% and cash conversion rate 20% with 85%-90% objective. This is key, that manager's interests are aligned with the business'. Nevertheless, we would prefer if the EBIT objective weighted less and a bit more were attributed to other goals that create value for the shareholder.

Shareholders

Two members of the board of directors are the biggest shareholders of the company. This is important for us as it demonstrates that shareholders and managers have skin in the game. It is also important to mention that the company has treasury stock (3.16%).

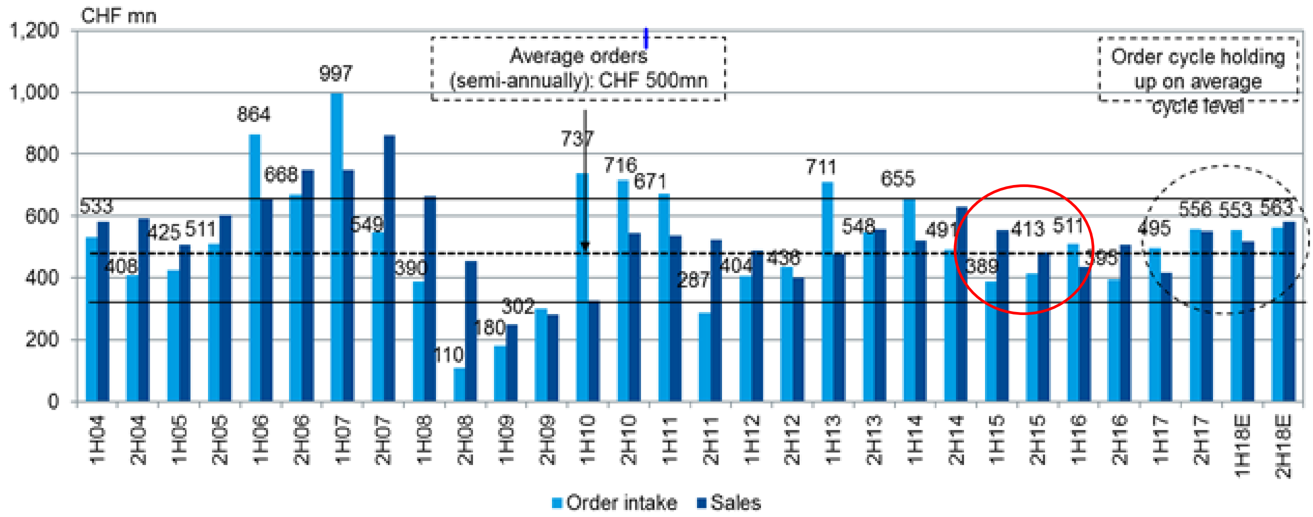
Shareholders		
Name	Equities	%
Peter Christoph Spuhler	894,223	19.1%
Michael Pieper, MBA	541,685	11.6%

Source: 4-traders

ITMA 2019: Barcelona

ITMA is the biggest international fair of textile machinery in the industry. It happens every four years. It is a big opportunity for industrials to show their new technologies. If companies manage to present new machines to textile firms that will increase their efficiency and yield more benefits, then the order backlog will be very high in the next years. Thus, ensuring, in theory, stable cash-flows in the later periods.

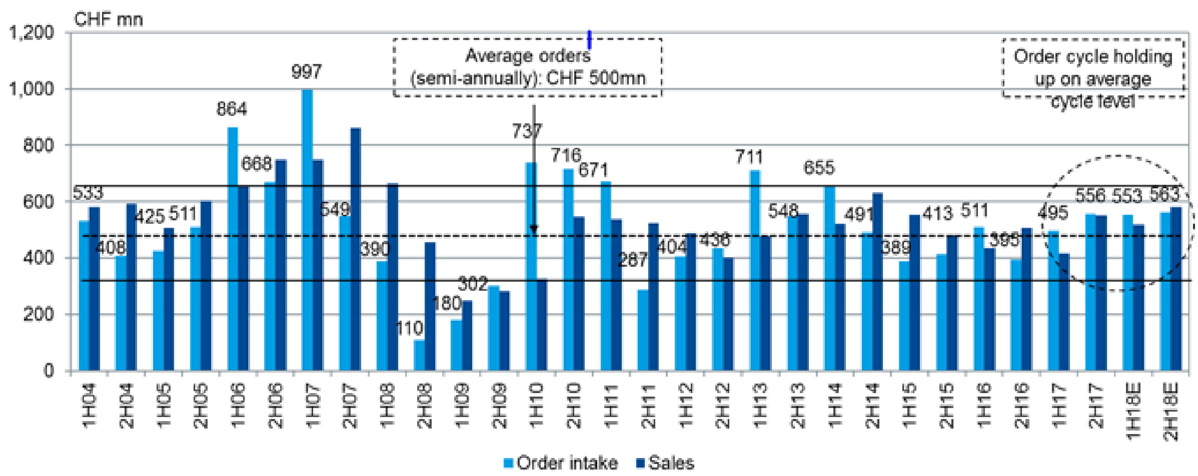
It can also explain why the order backlog is a bit flattish at the moment. Buyers are waiting for the fair. We can see this in the next graph, ITMA 2015 was in November and the order backlog increased almost 24% from 2H15 to 1H16.



Industry

The spinning equipment industry is cyclical which is reflected by Rieter's semi-annual order intake potentially fluctuating by +20%/-20% within six months. Key factors and triggers for the investment cycle in the spinning industry are: spinning mills' margins (conversion between raw material and yarn price), textile countries' subsidy programmes (e.g. in China: latest programme running-off, India: new programme started, Turkey: new programme running), availability of financing (e.g. linked to political risk and FX/interest rate situation), innovations (e.g. reduce labour and energy costs, increase yarn quality in downstream of weaving and knitting) or textile value chain shifts (e.g. emerging textile industry in Uzbekistan or East Africa).

The structural growth in the spinning industry is in the single digit range. The spinning industry is a mature market while the average fiber consumption / demand growth is in the low single digit which is, to a higher extent, covered by the productivity gains from new spinning equipment. Hence, the demand for spinning equipment is, to a large degree, driven by the replacement of the large installed capacity globally.



Rieter's competitive advantage in the industry rises from the fact they possess the highest system supplier competence and expertise. They offer integrated, end-to-end spinning systems (pre-spinning AND end-spinning) with the lowest total cost of ownership especially for high-quality ("compact" brand) yarn though a global set-up.

Competitors

Competitive landscape

By region		The three largest countries: China	India	Turkey
Rieter (Switzerland)		No.3	No.3	No.1
Jingwei (China)		No.1	-	-
Lakshmi (India)		No.5	No.1	-
Murata (Japan)		No.4	Present	Present
Jinsheng (Germany, China)		No.2	No.2	No.2
Trützschler		Present	Present	No.3

By spinning technology	Ring: *Preparation*	Ring: *Spinning*	Rotor	Air-jet
Rieter (Switzerland)	No.1	No.1 high-end*	No.2	Runner-up
Jingwei (China)	No.2	No.1 – low/mid	-	-
Lakshmi (India)	No.3	No.4 – low/mid	-	-
Murata (Japan)	No.5	No.3 – low/mid	No.3	No.1
Jinsheng (ex Oerlikon, China)	–	No.2 – low/mid	No.1	-
Trützschler (Germany)	No.4	-	-	-

As we can see here, Rieter is top 3 in every country and top 2 in every technology, except for the air-jet as it is an emerging innovation that is yet to be fully developed.

Some financial data of Rieter's listed competitors.

All figures in millions of USD	Sales	EBITDA	Margin	Net Income	Net Debt	Net Debt/EBITDA
Rieter	983,45	59,68	6%	13,55	-44,81	(0,75)
Jingwei (China)	1.520,38	503,19	33%	187,82	-582,39	(1,16)
Lakshmi (India)	336,95	41,03	12%	27,88	-138,04	(3,36)
Saurer (China)	1.335,19	179,82	13%	114,85	-544,83	(3,03)

Saurer is a subsidiary of the Jinsheng Group, listed in the Shangai stock exchange.

Estimates

RATIOS

	2017	2018E	2019E	2020E
MAIN MAGNITUDES				
Revenues	966	1.062	1.168	1.300
EBITDA	59	117	137	175
EBIT	16	74	93	130
Net Income	13	56	71	99
NFD	-44	-123	-164	-220
Total Assets	1.048	1.034	1.058	1.092
Equity	458	508	553	619
Gross Margin	**0,55**	**0,55**	**0,55**	**0,55**
EBITDA margin	6,1%	11,0%	11,8%	13,5%
EBIT margin	1,6%	7,0%	8,0%	10,0%
Net Income Margin	1,4%	5,3%	6,1%	7,6%
Tax Rate	20,8%	16,9%	23,0%	23,0%
Current Liabilities	290	305	326	351
Fixed Assets	461	449	439	431
Trade Receivables	88	81	90	100
Other current Assets	62	61	67	75
Inventories	192	198	218	242
Trade Payables	88	92	101	113
Other current liabilities	117	127	139	153
Goodwill				
INDEBTNESS				
Leverage on Equity	-0,10x	-0,24x	-0,30x	-0,36x
NFD / EBIT	-2,79x	-1,65x	-1,75x	-1,70x
NFD / EBITDA	-0,75x	-1,04x	-1,19x	-1,26x
Total Assets less current liabilities	758	729	732	741
Total Capital Employed	599	570	573	582
Working Capital	138	121	134	151
Debt / EV	-6,2%	-19,4%	-27,7%	-41,3%
NFD / MARKET CAP	-5,8%	-16,2%	-21,7%	-29,2%
Invested Capital	413	385	389	399

To get these estimates we have used a growth rate of 10%, stable gross margin and increasing EBIT and EBITDA margins. The reason for the low margins in 2017 was the acquisition of the SSM Textile and the restructuring charges (CHF 36M) linked to the purchase. Margins recover in the next years due to the annual costs savings of CHF 15M as of 2019. Following a recent call with the company, the target of CHF 1,300M sales in 2020 is very feasible for the following reasons: 1/ The launch of next-generation key products in ring and compact spinning (high margin), due later this year. 2/ Possibility of growth through M&A as we saw with SSM acquisition. The company states that if they see any possibilities that will generate value they will not hesitate as they have enough cash. 3/ The recovery of the industry cycle, especially in high-margin country Turkey. 4/ ITMA 2019 has the possibility of boosting the order backlog as we saw in 2015.

Working capital is mainly consisted of inventories for the components part. There have been some minimal variations during the years but linked to specific events such as the acquisition involving a cash outflow or in 2017 where orders came in late December and were materialised in early 2018. For the most part WC remains stable and positive.

It is also important to mention that capex needs are easily financed by the company's ability to generate free cash flow.

The company has an important net cash position that keeps increasing over the years.

Valuation

Price today: around CHF 167

Using a DCF model, assuming a g of 1% and a WACC of 9%, we value it at CHF 291/share with an FCF to EV (2019E) of 11.4%, an upside of 74.2%. Furthermore, compared to Swiss industrials the valuation is too low, EV/EBITDA 5-6x vs market 10x, in other words a discount of more than 40%. Expectations are low considering the positive outlook for 2H18 with margin recoveries expected to have a really considerable effect in 2019, 8% EBIT margin (2019E) compared to 1.6% in 2017. Why? Well, a flattish start in 1H18 has decreased the share price by more than 25% YTD. The afore mentioned margin improvements, the recovery of the industry cycle and the annual costs cuts of CHF 15M by 2019E, are all crucial factors that are lining up a very good 2H18. It is also important to notice that this valuation comes at a time where the industry cyclicality is affecting the company.

Furthermore, Rieter intends to create new offices in their existing facility in Winterthur on around 30 000 sqm of the 100 000 they own, meaning there is no significant capex needed. The remaining 70 000 sqm will be up for sale or redevelopment. If they decide to sell the they will get around CHF 500/sqm, equalling CHF 35M. However, they have not yet announced what their plan is and have stated that they are not in a rush to do so. The impact of the sale will not have a big repercussion on our valuation since it is only a probability and the amount is small. Same thing happens with Ingolstadt as they are moving production to the Czech Republic they will have a big portion of land available to sell but they will have to incur decontamination costs if they want to do so.

The consensus shows a P/E for 2018 of 16.3x, however if you take into account other aspects like the net cash the P/E goes down to 11.2x.

In the subsequent sensitivity table, we can see the different target prices depending on WACC and g.

Sensitivity table

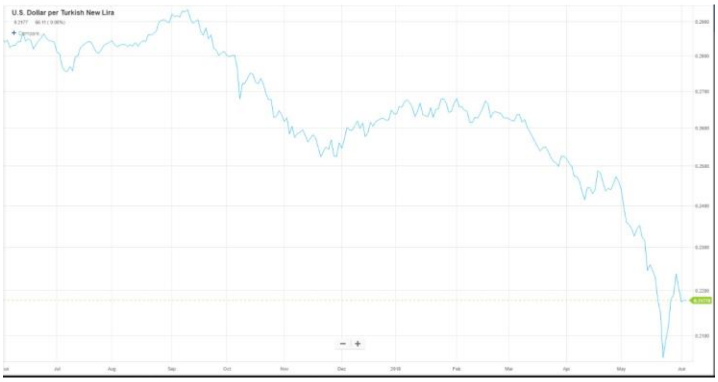
	291	WACC 8,0%	8,5%	9,0%	9,5%	10%
	0,5%	309	292	277	264	252
g	1,0%	326	307	291	276	263
	1,5%	347	325	306	290	275
	2,0%	371	345	324	305	289

The following is a table with different EBIT margins and how they would affect the value per share. Being extremely conservative, considering the multiple stimulants that Rieter has for an increase in profitability, with an EBIT margin of 7% and sales of CHF 1,000M we reach a target price of CHF 174, which leaves an upside of 4%, as of today. We think that the market is pricing the worst-case scenario.

Sales CHF	EBIT Margin	Target price
1,000.00	7.00%	174
1,075.00	7.75%	200
1,150.00	8.50%	228
1,225.00	9.25%	258
1,300.00	10.00%	291

Risks

Country risk: Rieter achieves about 80% of sales in emerging countries, of which a few countries show a higher political risk and instability. For example, Turkey accounts for 10.4% of total sales. Its political situation is already affecting Rieter as in 2017 sales, in Turkey, fell by 16% due to stagnant order intake for new machines in 1H17. Moreover, related to country risk there is foreign exchange risk. Especially for Turkey as the Lira has depreciated more than 20% against the USD.



Source: Factset

Technology/market risk: It's key that Rieter keeps its innovation and technological leadership in supplying system solutions, thereby expanding further its installed base of machines which are driving the high-margin aftersales business. Rieter spends CHF 49.2M on R&D, 5% of total sales. However, there is a rotor spinning machine by Saurer that is stealing market share and Rieter needs to close the gap quickly if they don't want to fall behind.

<u>Execution risk</u>: Rieter have planned to transfer production from Ingolstadt (Germany) to the Czech Republic. This will generate annual savings of CHF 15M as of 2019. The project is on track, but it hasn't been completed yet. Launches of 2018 are in process and with sales in the Machines & Systems sector decreasing they need to be very effective.

<u>Chinese competitors</u>: China has moved from an emerging economy to the 2nd biggest economy of the world. This means that FDI is decreasing. Thus, Chinese textile machine manufacturers are moving from the Chinese market as it slows down. They are shifting to other markets such as the European one. This can have a negative effect on Rieter as they can lose their competitive advantage to Chinese giants with lower labour costs.

Conclusion

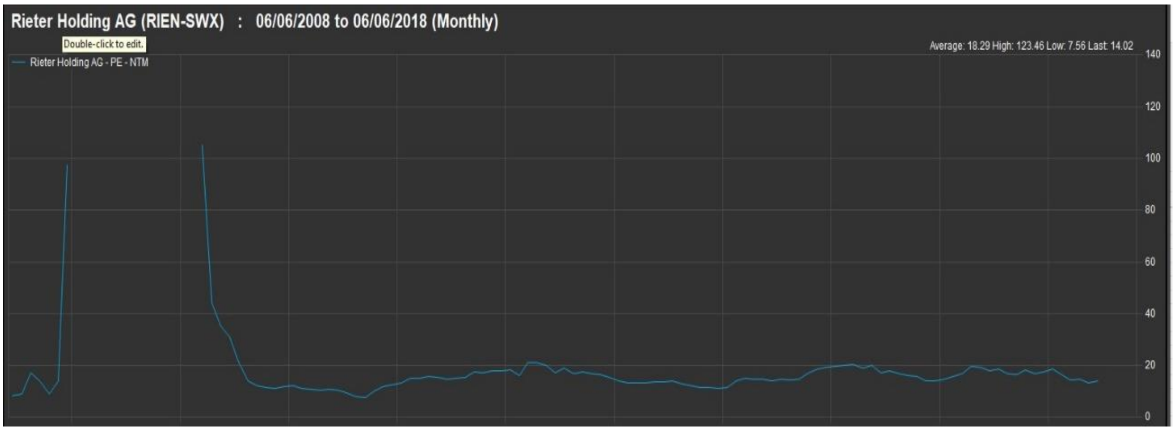
All in all, we think Rieter is a company that is undervalued by the market. The margin bounce backs will improve the P&L and all the factors previously mentioned are establishing a favourable scenario for the company's rerating. Even if demand remains dull, Rieter has a margin of safety as they are still market leaders and Chinese rivals are still far away. Moreover, as shown previously, supposing growth doesn't spike up and sales target are not met, Rieter stock should not fall further.

PE last 10y (average 18.29 vs actual 13.42)

Source Factset

RIETER Holding AG

EV/EBITDA 10y (average 6.18 vs actual 5.39)



Source Factset

Annex:

Managers

Name	Age	Since	Title
Norbert Klapper, PhD	55	2014	Chief Executive Officer
Bernhard Jucker	64	2016	Chairman
Joris Gröflin	41	2006	Chief Financial Officer
Mathias Ernst Schneider	66	2009	Vice Chairman
Michael Pieper, MBA	72	2009	Non-Executive Director
Hans-Peter Schwald	59	2009	Non-Executive Director
Peter Christoph Spuhler	59	2009	Non-Executive Director

Source 4-traders

Norbert Klapper, CEO

German national

Member of the Group Executive Committee
since 2014

Educational and professional background
Industrial Engineer, Technical University of Darmstadt and Phd in Economics, Technical University of Munich.

Rieter Management AG, Winterthur, Chief Executive Officer and member of the Group Executive Committee of the Rieter Holding Ltd., Winterthur, since 2014; in addition to his present position, Head of the Business Group Machines & Systems, 2014 to 2016; Voith Turbo GmbH & Co. Kommanditgesellschaft, Heidenheim, member of the Board of Management, 2011 to 2013; Voith Industrial Services Holding GmbH, Heidenheim, member of the Board of Management, 2005 to 2010; Dürr AG, Stuttgart, member of the Executive Board, 2000 to 2005; Arthur D. Little, Munich, Partner, 1993 to 2000; University of Passau and Technical University Munich, Teaching and Research Assistant, 1989 to 1993.

Joris Gröflin, CFO

Swiss and Dutch national

Member of the Group Executive Committee
since 2011

Educational and professional background
Licentiate in Business Administration/Economics, CEMS Master, University of St. Gallen.

Rieter Management AG, Winterthur, Chief Financial Officer and member of the Group Executive Committee of the Rieter Holding Ltd., Winterthur, since 2011; Head of Corporate Controlling, 2009 to 2011; Bräcker AG, Pfäffikon ZH, Chief Financial Officer, 2007 to 2009; Rieter Management AG, Winterthur, Corporate Planning & Development, 2006 to 2007; A.T. Kearney (Int.) AG, Zurich, project manager, 2001 to 2006.