

Finsbury Food Group

Tuesday, 22 March 2005

 SECTOR
Food producers & processors

 PRICE
68.5p

KEY DATA

Year end - June	06/03A	06/04A	06/05E	06/06E
Turnover £m	35.2	59.9	59.0	62.0
EBITDA £m	2.1	1.4	2.4	2.7
Operating profit £m	1.5	0.4	1.6	1.7
PBT £m	0.4	0.2	1.3	1.5
Tax %	36%	29%	30%	30%
EPS p	1.2	0.5	3.9	4.5
DPS p	1.0	1.0	1.1	1.2
PER x	55.5	132.5	17.5	15.1
Yield %	1.4%	1.4%	1.6%	1.8%
Change EPS %	-	(58%)	659%	15%
Change DPS %	-	0%	10%	9%

Durlacher is nominated advisor and broker to Finsbury Foods

CODE

FIF

MARKET

AIM

52-WEEK HIGH/LOW

69.5p - 29.5p

MARKET CAPITALISATION

£14.5m

SHARES IN ISSUE

21.16m

NET DEBT

(£2.8m)

GEARING

33%

INTEREST COVER

1.9

ROCE

3%

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More dough

- With the exception of Marks & Spencer, the Finsbury Food Group services all of the major retail multiples in the UK with ambient short shelf life products.
- This broad-based customer profile means that their largest customer, Tesco, represents no more than 33% of turnover.
- Finsbury has continued to grow and consolidate its business into 1H 2005. As expected, the group has refocused its activities onto its more profitable lines.
- Turnover can be expected to reduce slightly as a result, with the increase in margins meaning that a significant increase in pre-tax profits will follow.
- Therefore, following the 1H PBT of £0.7m, we have increased our full year forecast to £1.3m to reflect this change.
- The business generated an exceptional profit of £1.8m from the sale of surplus land at its Cardiff site. The sale generated £2.3m of cash, which together with positive cash flows from the business itself, is expected to leave the group almost debt free by the year end.
- The interim figures do not include the cash effect of the sale as it was not completed until January 2005.
- The group has announced that its deal with Nestlé is proceeding according to plan and that the sales of Nestlé branded products will break even in 2006.
- Adjusted EPS for 1H 2005 is 2.2p (2003: -0.97p).

1. Background & overview

Finsbury Food (Finsbury) was established in August 2002 as a result of the renaming of Megalomedica plc, a cash shell created in October 2001 following the sale of its business.

Finsbury is an AIM-listed company that is seeking to build a food business in the UK. The first stage of this strategy was completed in August 2002 with the acquisition of Memory Lane Cakes Limited (Memory Lane Cakes), a cake manufacturer in Cardiff. Subsequently, in March 2003, Finsbury completed the acquisition of Nicholas & Harris Limited (Nicholas & Harris) of Salisbury, a producer of premium and speciality breads.

In September 2003, the Group signed an exclusive five-year arrangement with Nestlé, for the use of its confectionery brands in the cake sector.

Relationships with the major multiples

With the exception of Marks & Spencer (which maintains exclusive suppliers), Finsbury supplies every major multiple in the UK. This arrangement provides significant opportunities for the group to cross-sell its different product lines. Already Nicholas & Harris has been able to develop new products for Asda through a pre-existing relationship with Asda and Memory Lane Cakes.

Finsbury maintains an even spread of multiples, with its largest customer, Tesco, accounting for only 33% of the overall group turnover.

Short shelf life expertise

Both Memory Lane Cakes and Nicholas & Harris are short shelf life operations, with high service levels. This provides a significant barrier to entry as the skills required to replicate the culture involved in the daily production of perishable goods are considerable.

Focus on premium products

Both businesses within the Finsbury Food Group are premium producers. Customer tastes and expectations in both the bread and the cake markets are moving upmarket. This not only plays to Finsbury's strengths, but also provides opportunities for the business to develop new products and to grow margins.

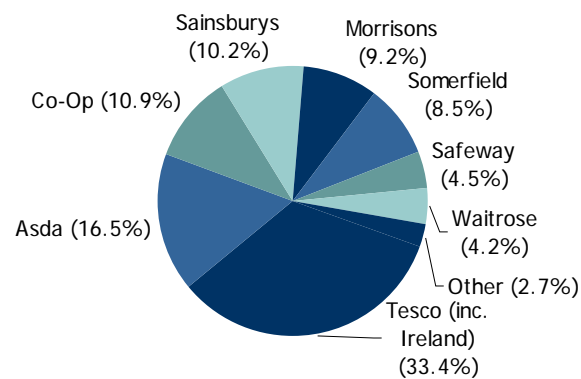
2. Customers & products

Memory Lane Cakes

Memory Lane Cakes is a baker of branded and supermarket own label cakes, with around 130 products. The business currently generates sales of £50m from its freehold site in Cardiff.

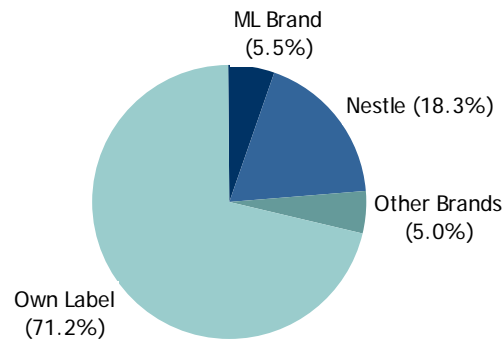
Memory Lane Cakes' sales are split as follows:

Figure 1. Sales split per customer



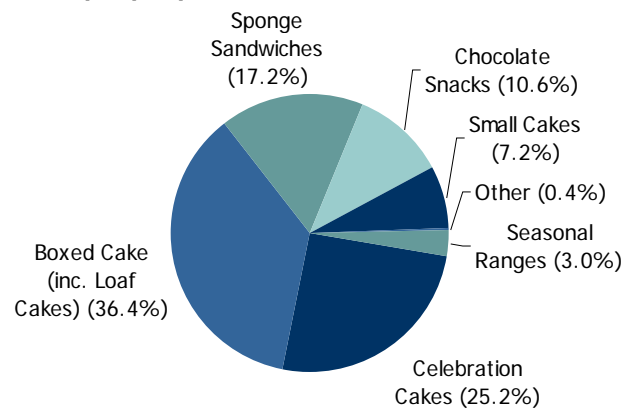
Source: Finsbury Food Group

Figure 2. Sales split per brand



Source: Finsbury Food Group

Figure 3. Sales split per product



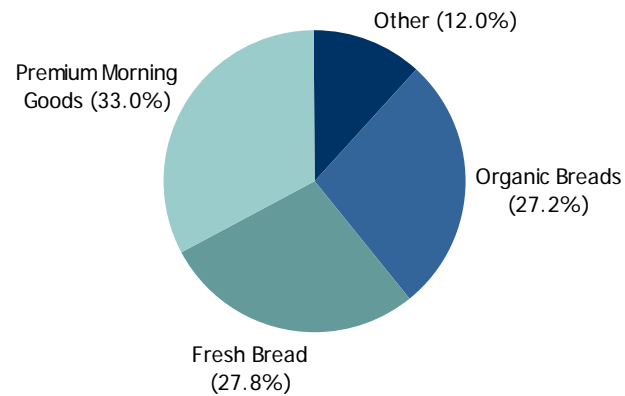
Source: Finsbury Food Group

Nicholas & Harris

Nicholas & Harris is a producer of premium and speciality breads, with 112 products, generating annual sales of £9m from its site in Salisbury.

Nicholas & Harris' sales are predominantly to Waitrose, however the business is now winning listings with Asda:

Figure 4. Sales split per product



Source: Finsbury Food Group

3. Market & industry

Premium cake market

Nearly 4 in 10 of the UK population purchase cakes and pastries on a regular basis, consuming an average 89 grams of cake per person per week. The pre-packed cake market is worth over £1bn per year, or an average of £1.60 per household per week. The market value grew 4% over the year to 2005.

Characteristics of the market include:

- Consumption and prices are growing at 1.3% per year. This is higher than the biscuit segment, where volume is declining and prices are stagnant.
- The highest consumption per head is in the East Midlands, where 30% more cakes are eaten than in London.
- Demand is slightly seasonal, increasing at Christmas and at traditional events such as Halloween.

Major trends within the cake sector include:

- Whole cake is keeping up with the overall growth in the market. Indulgence and premium sectors are out-performing standard ranges.
- Growing demand for snack items.
- Branding is becoming increasingly important and is led by premium retailer brands, such as Tesco Finest, and new entrants such as Nestlé and Thorntons.
- Consumers increasingly search for products offering quality ingredients and freshness.

According to the TNS, 80% of cake and biscuit purchases take place in supermarkets, with the remainder spread across a variety of outlets. In common with the rest of the industry, Memory Lane Cakes does not operate under contract with supermarkets. Instead, customers purchase the highest quality of products that are available at the best price. As a result of this system, suppliers regularly lose business and continually search for innovative solutions to avoid price erosion or a loss of business. For example, McVitie's tube format and the launch of mini-cakes by a number of suppliers have both stimulated sales.

Speciality bread market

Nicholas & Harris forms a much smaller part of Finsbury's revenue than Memory Lane Cakes, however, the business is currently showing 6% annual growth.

- Originality is the key driver in the market. The reason behind this is that consumption habits have become more adventurous over recent years.
- Increasing demand for more continental breads is being experienced by all of Nicholas & Harris's customers. This steady demand for more exciting products is showing no sign of reducing at present.
- In addition, following recent high profile press coverage, dietary requirements are becoming an increasing priority for the customer, with far more choice having to be offered than ever before. This translates into an ongoing need for innovation within the speciality bread market.
- The artisan and premium morning goods sectors of the UK bread market are very fragmented, with consolidation likely. The large bread suppliers are not active in this part of the market because volumes are lower and the labour too intensive; highly skilled traditional processes are not easily automated.

4. Competitors

The industry has undergone a period of consolidation – and continues to do so – with almost all of the main players changing ownership over the last few years. The largest player in the industry is Manor Bakeries (Mr Kipling), which has a strong brand and broad product range.

Table 1. Finsbury Food Group's competitors

Company	Brands	Owner	Revenues
Manor Bakeries	Mr Kipling, Lyons, Cadburys	Ranks Hovis McDougall	£300m
Inter Link Foods	Own label	AIM Listed	£126m
Park Cakes	Own label	Northern Foods	£100m
McVities	McVities, Mars	United Biscuits	£70m
Hazlewood Bakery	Own label	Greencore	£60m
Lightbody	Own label	Private	£40m

Source: Finsbury Food Group

5. Strategy

Finsbury has now recovered from its 2003 problems and emerged with a stronger base from which to develop. The group has strengthened its management capacity and now maintains a strong capital base with low levels of debt.

Finsbury is to focus primarily on premium products, which offer better margins and are more dependable than mainstream offerings. In addition, Finsbury will continue to target profitable select opportunities where it can be a “least cost producer” of certain lines.

Although involved exclusively on baking at present, the group set out to be a food group rather than simply a baker. Diversification can therefore be expected into other areas where the group can use its relationships with the multiples, as well as its ability to handle short shelf life premium products.

Nevertheless, in the immediate future, Finsbury can be expected to concentrate on the consolidation opportunities offered by the highly fragmented speciality bread market. Such a move would avoid the heavily invested mass production giants whilst at the same time exploiting growing demand by the multiples for traditionally made speciality breads from credible suppliers. In addition, as the group's Nestlé business expands, it is likely that a cake acquisition would be needed within the next 18 months.

6. Management

Lord Saatchi (non-executive chairman)

Lord Saatchi graduated from the London School of Economics with a first class honours degree in 1967. He founded Saatchi & Saatchi with his brother Charles in 1970. At the beginning of 1995 he formed a new agency, M & C Saatchi. He holds 23% of Finsbury.

David Brooks (group chief executive)

David Brooks was appointed group chief executive on 1 November 2002. He is a chartered management accountant and had been with Memory Lane Cakes for six years where he was managing director for three years and commercial director for the previous three years. Prior to that, he worked with Brake Bros plc, initially as cost accountant for a single site and subsequently as divisional finance director. He is a member of the General Council of the Biscuit, Cake, Chocolate and Confectionery Association.

John Lomer (finance director)

John Lomer was appointed group finance director on 1 August 2003. He is a Fellow of the Chartered Association of Certified Accountants and has considerable experience in the food industry having been finance director of Sunjuice Limited, one of the leading makers of fresh fruit juice and smoothies. Formerly, John was with Marlborough Stirling Plc where he was involved in fund raising, financial restructuring and acquisitions.

David Marshall (non-executive deputy chairman)

David Marshall was educated in South Africa and trained in England. He was appointed to the board in 1979 and was elected deputy chairman in 1994. He is also chairman of a number of listed public companies, including London Finance & Investment Group plc, which is a substantial shareholder in Finsbury Food Group plc. In recent years he has taken a leading role in the reorganisation and development of a number of medium-sized listed companies in the UK and overseas. He is a member of the remuneration and audit committees.

Edward Beale (non-executive)

Edward Beale was appointed a director on 29 August 2002. He served as a non-executive finance director until John Lomer was appointed finance director on 1 August 2003. He is a chartered accountant and the chief executive of City Group plc, the group's company secretary. He is a member of the QCA's accounting standards and corporate governance committees and sits on both the audit committee and remuneration committee.

Ian Farnsworth (non-executive)

Ian Farnsworth has been a member of the board since 1997. He joined National Westminster Bank in 1956 and retired in 1997 having held various senior positions including chief executive and deputy chairman of Coutts & Co. He is chairman of both the remuneration and audit committees.

Paul Monk (non-executive)

Paul Monk was appointed to the board on 9 December 2002. He has extensive experience in the food manufacturing industry and is a director of the Snack Nut and Crisp Manufacturers Association Limited. He was the chief executive of Golden Wonder Limited and his other experience includes roles with Marks & Spencer and the Mars Corporation. He also holds other non-executive roles within the food industry.

7. Pension

Memory Lane Cakes has a defined benefit pension scheme that was last valued at December 2001. The scheme is currently closed to new members.

The scheme is at present undergoing its tri-annual valuation, the results of which will be known by the year end in June 2005. However, given the rise in the stock market, management anticipates that the scheme will be fully funded and will not create any onerous liabilities.

8. Financials

Full year results June 2004

- The group posted a 1H loss of £317k following problems within its Memory Lane Cake subsidiary over the Christmas period 2003. Memory Lane Cakes encountered operational problems as a result of taking on too much seasonal business. This was primarily due to staffing issues over the period, as well as raw material price pressure.
- The 2H saw a significant improvement. Management targeted capital expenditure to reduce its dependency on seasonal labour and to reduce its costs, which coupled with a strengthening of Memory Lane Cake's middle management team, saw annualised growth in excess of 20%. In addition, low margin lines were removed from production and price increases across the range were made.
- 2004 saw investment made at Nicholas & Harris, with processes and controls improved. The business achieved its first profit during the 2H of the year.
- The above actions recovered the 1H loss and enabled the group to break-even for the full year.
- January 2004 also saw the start of Finsbury's agreement to have exclusive use of Nestlé confectionery brands for the ambient cake market within the UK.

Interim results December 2004

- The group has succeeded in continuing to grow and consolidate its business into 1H 2005.
- Finsbury generated an exceptional profit of £1.8m from the sale of surplus land at its Cardiff site. The sale generated £2.3m of cash, which together with positive cash flows from the business itself, is expected to leave the group almost debt free by the year end.
- The interim figures do not include the cash effect of the sale as it was not completed until January 2005.
- The group has announced that its deal with Nestlé is proceeding according to plan and that the sales of Nestlé branded products will break even in 2006.
- Adjusted EPS for 1H 2005 is 2.2p (2003: -0.97p).

Forecasts

- As mentioned in our pre-close note, as the group has concentrated its activities onto its more profitable area of the business, revenues can be expected to reduce slightly. The result of this will be a significant increase in pre-tax profits, however. Following the 1H PBT of £0.7m, we have upgraded our full year forecast to £1.3m from £1.2m previously.
- FY 2005 will include the effect of the sale following its completion at the start of the calendar year. This will mean that the group's net debt figure will fall to just £138k from £2.8m in FY 2004.
- Adjusted diluted EPS for FY 2005 will be 3.9p, up from 0.5p in 2003. This will put the company on a rating of 17.5x.
- FY 2006 should see this growth continue as the group increases its product offering and broadens the Nicholas & Harris business.
- The strengthening of Finsbury's balance sheet and cash flow position should position the company well to take best possible advantage of the opportunities that the currently fragmented cake and speciality bread sectors offer.

Table 2. Finsbury Food Group profit and loss

Profit & loss forecasts £m	06/03A	06/04A	06/05E	06/06E
Turnover	35.2	59.9	59.0	62.0
Operating profit	1.5	0.4	1.6	1.7
<i>Operating margin</i>	<i>4.2%</i>	<i>0.6%</i>	<i>2.7%</i>	<i>2.7%</i>
Net interest	0.0	(0.2)	(0.3)	(0.2)
Pre-disposal profit	1.5	0.2	1.3	1.5
Disposals/exceptionals	(1.1)	0.0	1.8	0.0
Profit before tax	0.4	0.2	1.3	1.5
Taxation	(0.1)	(0.1)	(0.4)	(0.5)
Profit after tax	0.2	0.1	0.9	1.1
Ordinary dividends	(0.2)	(0.2)	(0.2)	(0.3)
Retained earnings	0.0	(0.1)	2.5	0.8

Table 3. Finsbury Food Group earnings data

Earnings data	06/03A	06/04A	06/05E	06/06E
Shares in issue m	20.2	21.1	21.1	21.1
Shares fully diluted m	20.2	24.2	23.2	23.2
Adj EPS p	1.2	0.6	4.3	5.0
Adj EPS % change	n/a	(51.9%)	628.0%	15.4%
Adj diluted EPS p	1.2	0.5	3.9	4.5
Adj diluted EPS % change	n/a	(58.1%)	658.7%	15.4%

Table 4. Finsbury Food Group metrics

Metrics	06/03A	06/04A	06/05E	06/06E
Tax rate %	36.5%	29.0%	30.0%	30.0%
PE adjusted x	55.5	115.4	15.8	13.7
PE - Fully diluted adjusted x	55.5	132.5	17.5	15.1
Dividend per share p	1.0	1.0	1.1	1.2
Dividend yield %	1.4%	1.4%	1.6%	1.8%
Dividend cover x	1.2	0.5	3.6	3.8
Interest cover x	n/a	1.9	5.3	8.5
ROCE %	6%	3%	-	-
Gearing %	46%	33%	-	-

Table 5. Finsbury Food Group cash flow

Cash flow £m	06/03A	06/04A	06/05E	06/06E
Operating profit	1.5	0.4	1.6	1.7
Depreciation	0.6	1.0	0.8	0.9
EBITDA	2.1	1.4	2.4	2.6
Exceptional	(1.1)	0.0	2.3	0.0
Movement in working capital	1.6	(1.0)	0.1	0.3
Net interest	0.0	(0.2)	(0.3)	(0.2)
Taxation	(1.1)	(0.3)	(0.1)	(0.4)
Operating cash flow	1.6	(0.3)	4.4	2.3
Dividends paid	0.0	(0.2)	(0.2)	(0.2)
Capex	(0.6)	(1.2)	(1.5)	(1.5)
Net acquisitions & disposals	(7.1)	0.0	0.0	0.0
Share issue	1.2	0.0	0.0	0.0
Change in cash & equivalents	(4.9)	(1.7)	2.7	0.6
Opening Cash (Debt)	3.6	(1.3)	(2.8)	(0.1)
Closing Cash (Debt)	(1.3)	(2.8)	(0.3)	0.4
Depreciation/sales	1.7%	1.7%	1.4%	1.5%
Net cash/(debt) £m	(1.3)	(2.8)	(0.1)	0.4

Sources: Finsbury Food Group & Durlacher

Table 6. Finsbury Food Group balance sheet

Balance sheet £m	06/03A	06/04A
Fixed assets		
Tangible assets	7.7	8.1
Intangible assets	1.7	1.6
	<u>9.4</u>	<u>9.7</u>
Current assets		
Stocks	1.6	1.6
Trade debtors	6.4	7.6
Other debtors	0.7	2.0
Cash at bank and in hand	2.0	0.0
	<u>10.7</u>	<u>11.2</u>
Current liabilities		
Short term debt	(0.9)	(1.5)
Trade creditors	(5.4)	(7.0)
Other creditors	(4.5)	(4.0)
	<u>(10.9)</u>	<u>(12.5)</u>
Net current assets	(0.1)	(1.3)
Total assets less current liabilities	9.3	8.4
Creditors > 1yr		
Long term debt	(2.4)	(1.6)
Other creditors	0.0	0.0
Provisions	(0.5)	(0.5)
	<u>(2.9)</u>	<u>(2.1)</u>
Net assets	6.4	6.3
Capital and reserves		
Called up share capital	0.2	0.2
Share premium account	6.4	6.4
Capital redemption reserve	0.6	0.6
Profit and loss account	(0.8)	(0.9)
Equity shareholders' funds	6.4	6.3

Source: Finsbury Food Group & Durlacher

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