Chief Executive Officer's Report

We delivered strong sales growth and good progress with our plans to drive operating efficiency

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Mark Kelly
Chief Executive Officer

Introduction

The Construction Products Association Winter 2019 update (published January 2020) reported on a weak Repairs, Maintenance and Improvements ('RMI') market and a decline in housing starts, with both sectors impacted by Brexit-related and political uncertainty.

Against this backdrop, we were very pleased to deliver another year of strong sales growth, with reported revenues up 10% (or 8% excluding acquisitions). Growth reflects good contributions from both existing and new accounts from across our fabricator base in Profiles, as well as strong like-for-like sales in Building Plastics, driven by better stock availability and improvements in operating standards.

It is also good to report that our gross margin improved by 170 bps to 51.2%, reflecting the benefit from selling price increases, implemented to recover cost inflation, and higher usage of recycled material.

The capital investment programme launched at the beginning of the year to improve manufacturing efficiency and increase extrusion capacity is now complete, leading to an improved manufacturing performance. However, we have continued to incur additional warehousing and distribution costs, particularly through peak periods.

Adjusted EBITDA increased by 5% to £31.7 million (pre-IFRS 16). Adjusted profit before tax was £22.7 million, or £23.1 million on a pre-IFRS 16 basis (2018: £22.5 million).

In line with our continued focus on improving operations, and to support future growth, we were delighted with the appointment of Mark Hemming to the position of Chief Operating Officer. Mark started with us in August and is proving to be an excellent addition to our operational management team. Prior to joining, Mark was Regional Director for Customer Fulfilment at Amazon UK. Before that, he has experience leading manufacturing plants in the automotive sector.

With Mark's input and expertise, we have identified new warehousing as essential to facilitating future growth and driving operating efficiency, and have commenced a project to expand our warehousing capacity significantly. Further details are included in Strategic Update below.

Operational performance

Health and safety

The safety and well-being of our employees and contractors is our first operational priority and we continue to maintain good health and safety performance. Our Lost Time Injury Frequency Rate was 0.9 in 2019, in line with 2018. There were no major injuries and 17 minor accidents (2018: 9) recorded under the Reporting of Injuries, Diseases and Dangerous Occurrences Regulations 2013 ('RIDDOR').

Production

In 2019 we manufactured 54.6k tonnes of rigid and foam PVC profiles at our primary extrusion facilities, up from 49.8k tonnes in 2018, an increase of 10%.

This reflects the sales growth in the year, as well as a drive to increase stock availability at our branches. In addition, given the possibility for raw material supply interruption due to Brexit, we invested in a stock build programme. In total, we added approximately £5 million to finished goods for key product lines in 2019, which provides a good level of protection.

This record level of production was made possible through the execution of a substantial capex programme in 2019, costing c.£5 million, to improve manufacturing efficiency and increase co-extrusion and foam capacity by 30% and 15% respectively. All 7 new lines are now fully operational and working well, leading to a better manufacturing performance in 2019. Overall equipment effectiveness ('OEE', a measure which takes into account machine availability, performance and yield) in extrusion improved to 73%, compared to 71% for 2018 and scrap levels were down to 8%, compared to 9% in 2018.

As planned, the new extrusion lines were operational for the busy final few months of the year. During this period, factory utilisation did not exceed 80%, demonstrating that we have capacity for further growth. We have also recruited additional skilled labour for our foiling plant to support increasing demand.

Recycling

We used 13.4k tonnes of recycled PVC compound alongside virgin resin in the manufacture of co-extruded rigid profiles, representing 23% of overall material consumption, up from 9.5k tonnes (or 17%) in 2018, an increase of 41% driving a substantial saving compared to the cost of using virgin material.

We have been investing to increase our recycling capability, in order to capture financial and sustainability benefits and to keep pace with our sales growth (see Strategic Update). This has been delivered through the expansion of Eurocell Recycle Midlands (based in Ilkeston and formerly 'Merritt Plastics'), the acquisition of Eurocell Recycle North (based in Selby and formerly 'Ecoplas') and by investment in new co-extrusion tooling, which allows a greater proportion of recycled material to be used in our products.

We invested c.£3 million in Eurocell Recycle Midlands in 2019, to increase output and improve reliability, including new tooling.

We acquired Eurocell Recycle North in August 2018 for consideration of £6 million (including debt assumed). Output at acquisition was c.7k tonnes of recycled compound per annum, sold into a broad mix of trade extruders. As expected, investment was required to improve the operating environment and reliability of the plant, to eliminate bottlenecks from production processes and to expand capacity. Total investment post-acquisition stands at c.£3 million, mostly in 2019. Whilst we suffered some delays with our expansion plans for Ecoplas, the project is now well advanced and performance has improved.

Strategic update

Our overall strategic objective remains to deliver sustainable growth in shareholder value by increasing sales and profits at above our market level growth rates. In 2016, we identified five clear strategic priorities to help us achieve this objective. Since then we have delivered significant progress in each of them as follows:

- Target growth in market share – now the largest supplier of rigid PVC profile to the UK market (>15% share)
- Expand the branch network – 206 sites in 2019 compared to 141 in 2015
- Increase the use of recycled materials – usage up from 4.1k tonnes in 2015 to 13.4k tonnes in 2019
- Develop innovative new products – sales from products introduced since 2017 were c.£33 million of 2019 revenue
- Explore potential bolt-on acquisition opportunities – six acquisitions completed since 2015

Successful implementation of our commercial strategies has driven a very strong compound annual growth rate in sales of 12% since 2015. However profits in the last two years have been impacted by sales running substantially ahead of our expectations, thereby exceeding the available operating capacity and leading to inefficiencies and extra costs.

As described above, manufacturing constraints experienced in 2018 have been largely resolved through investment in new extrusion capacity and skilled labour, resulting in an improved manufacturing performance.

We are confident that we can continue to outperform our markets in the medium-term, through the further progression of our strategic priorities. However, we have also concluded that additional warehousing capacity is needed to facilitate future growth and deliver further operating efficiencies. As a result, we have commenced a project to expand our warehousing capacity significantly and have outlined more on this overleaf.

Target growth in market share in Profiles

In 2018 we became the leading supplier of rigid PVC profile to the UK market, with a share of >15%. Our objective is to consolidate this position and increase our share to c.20% over the next few years.

There is a compelling case for larger trade fabricators to switch to Eurocell. This includes: a strong product range and continued product development (e.g. flush windows, grey substrate and patio doors), the benefits of pull-through profile and hardware specifications and increasing opportunities to supply our branches, all delivered via best in class service.

Expanding our share of the new build market has been a key driver of recent growth and we believe favourable market dynamics, such as Help to Buy and low interest rates, are set to continue. We have strong relationships with large and medium-sized housebuilders, maintained by our specification and technical teams. In addition, with an increasing focus on sustainability, we believe our use of recycled material will become increasingly attractive to housebuilders.

In the commercial sector there is a strong case for the benefits of using PVC profile and thereby drive more value engineering away from aluminium, particularly in sub-sectors such as private rentals, build-to-rent, purpose-built student accommodation, education and local authority refurbishment – all habitual users of aluminium.

Expand the branch network

Our objective for Building Plastics is to achieve world class operations from a least 300 sites.

In the existing estate, we have plans to improve up-selling and cross-selling opportunities, to target lapsed customers, and to tighten margin controls. We also intend to enhance promotional activities with support from key suppliers. In terms of products, we will focus on improving conversion rates for high value made-to-order items and extend our range, including the introduction of new outdoor living products.

With our focus on executing the warehouse transition, we plan to open just 4 new sites in 2020. However, these will all be in a new, larger format store, with expanded trade counter and showroom-style displays designed to engage customers and drive big-ticket purchases such as windows and doors. This follows a successful trial in Leeds in 2019 and the new 2020 branches will complete the evaluation of this format. Thereafter, with additional warehousing capacity in place, we anticipate increasing branch openings, including large format branches where appropriate.

Finally, we see a significant opportunity to develop and implement a market-leading consumer online windows and doors proposition, using our branch network to provide infrastructure where needed (e.g. delivery point for installers). We will run a trial in the North West region in 2020.

Increase the use of recycled material

Expanding the use of recycled material increases our profits, because the cost of recycled compound is typically lower than the price of virgin material. It also improves product and business sustainability, with less plastic going to landfill and by reducing our exposure to volatile commodity prices.

In particular, closed-loop recycling (where windows being replaced are recycled into the new product) is attractive to decision makers such as local authorities and architects, which helps us develop tight specifications for our products. Recycling and sustainability also resonate strongly with consumers and other stakeholders.

Our total capital investment in recycling since the beginning of 2016 (including the acquisition consideration for Eurocell Recycle North) is c.£15 million. As a result, we have become the leading UK-based recycler of PVC windows and our use of recycled material increased from 4.1k tonnes (or 9% of materials consumed) in 2015 to 13.4k tonnes (or 23% of materials consumed) in 2019. In doing so, in 2019 we saved the equivalent of c.3.2 million window frames from landfill.

In light of the potential for further good sales growth described above, we expect internal demand for recycled material to increase. We believe this incremental demand can be satisfied largely through the expansion of Eurocell Recycle North, with only limited additional investment plus maintenance capital expenditure across the recycling operations.

Develop innovative new products

We are committed to maintaining market leadership by offering the very latest in product improvement, both through development of existing products and the introduction of new ones. We work closely with our customers and technical advisors on development and to help maintain our product pipeline. Highlights in 2019 include the introduction of a flush window sash profile for our popular Eurologik profile range, a new patio door system (Syncro) and development of a through-colour grey substrate profile.

Explore potential bolt-on acquisitions

We have completed 6 acquisitions since our IPO, including in 2019 the acquisition of Trimseal, a building plastics distributor on the south coast of England, for total net consideration of £0.4 million. We will continue to assess and consider bolt-on acquisition opportunities in the markets in which we operate over the medium-term. However, our focus for 2020 will be delivering operating efficiencies from recent and on-going investment in manufacturing and warehousing capacity.

Warehousing capacity expansion

We have concluded that our existing main warehouse is a major constraint to future growth and operating efficiency.

In order to keep up with recent demand, we have exceeded the capacity of the site and the loading facilities, operating in peak periods well above the target of 85% utilisation for efficient operations. This has resulted in extra costs incurred to operate safely and maintain, so far as possible, customer service.

We therefore evaluated options to expand our warehousing capacity.

I am pleased to say that we have now secured a new facility, located within 3 miles of our primary manufacturing site, existing main warehouse and head office. The new site has 260,000 ft^2 of high bay, state of the art warehouse accommodation, dedicated office space and car parking.

We intend to take this opportunity to modernise our storage solutions, using cantilever racking to store up to twelve stillages high (our current warehouse is restricted to seven); and mobile racking to allow high density storage, which will increase capacity by more than 60%. Similarly, we will modernise picking processes, with the use of mobile platforms to replace manual techniques, thereby providing a safer and more productive solution. We expect the new site to be operational early in 2021.

We will convert our existing warehouse to a specialist manufacturing site, relocating from 2021, our secondary operations including foiling, injection moulding and conservatory roofs. This will free up space to future-proof extrusion capacity.

We are very excited about the opportunities for growth opened up by this investment. The costs and financial implications of the new warehouse are included in the Group Financial review.

Brexit

There remains significant uncertainty over the impact of Brexit, be it related to general macroeconomic factors or specific company risks. Key to understanding the medium-term impact on Eurocell will be the nature of the future trading relationship between the UK and the EU.

We have taken a number of steps to protect the business from any potential negative effects. In this context, it is worth noting that almost all of our sales are to UK-based customers and that the vast majority of our workforce has the right to remain and work in the UK.

Some of our key raw materials do originate from Europe, so any future disruption in supplies could impact our manufacturing operations. With that in mind, whilst we have only limited capacity to hold excess raw materials at our own sites, we completed a significant investment in additional stocks in 2019, adding c.£5 million to finished goods for key product lines. More generally, we increased our bank facilities in March 2020, securing additional funding with no change to pricing, and hold selective credit insurance for large customer accounts. We have also fixed electricity prices for the coming year at competitive prices.

Therefore, whilst we are not able to predict the impact of Brexit on our business, we have taken sensible steps to help mitigate known risks.

Outlook

We have reported robust financial results for 2019 and, despite Brexit-related and political uncertainty, delivered another year of strong sales growth and a good improvement in gross margin.

Over the last 4 years, successful deployment of our commercial strategies has led to sales substantially exceeding our expectations. However, profits have been impacted more recently as we build the operating capacity to service our sales and we have experienced inefficiencies and extra costs. With manufacturing constraints now resolved, our focus for 2020 will be on executing the warehouse transition successfully, thereby facilitating future growth and the delivery of further operating efficiencies. As a result, looking forward we see good potential to outperform our markets.

As yet, there has been no discernible impact on our business from COVID-19, although we remain very alert to this possibility. We have a strong balance sheet, and in March 2020 we were pleased to increase our bank facility to £75 million. We maintain a conservative approach to debt, in order to ensure good liquidity and to manage any emerging risks.

Despite the impact of very wet weather so far this year, we have made a good start to 2020. Sales and margins for the first two months are in line with our expectations, and notwithstanding macroeconomic and political uncertainty, we expect to deliver further progress this year.

Mark Kelly
Chief Executive Officer