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CONDUCTION
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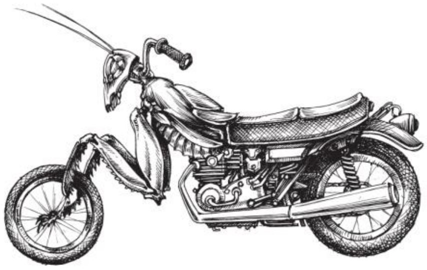


„Italian liquor protection“
Guala Closures S.p.A.

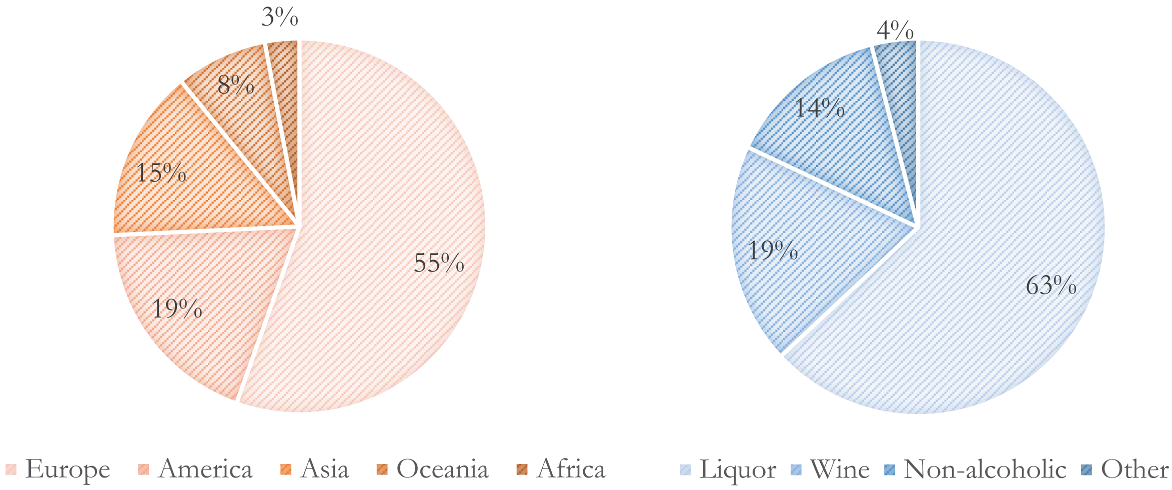
Yeah, we know: The title sounds like Al Capone during prohibition times. But believe us - these Italians make their living from entirely legal "protection activities". From a risk-adjusted perspective we think this business model is superior to a plain vanilla mob system.
Today, we are taking a look at Italian bottle closure producer Guala Closures S.p.A. („Guala“).

Business model

Guala is the world market leader in aluminum closures for spirits, wine and other bottles. The Piemont-based company has 5 main product categories. Just over 40% of revenue is derived from safety closures, also called "non-refillable closures". You know these from whiskey bottles, that will open with a loud "crack". After that you won't be able to connect the actual bottle cap with the sleeve around the bottleneck. 19% of sales come from aluminum screwcaps for wine bottles. Further 29% of sales are generated by classic aluminum "roll-on closures" which you might know from San Pellegrino water. The final 10% of sales are made up of complex and heavy luxury closures as well as pharma and food closures (others).

Safety *Luxury* *Wine* *Roll-on* *Others*

Revenue split by geography und application



Guala has been around since 1954 and today is present on 5 continents with 29 production sites. In 2018, the company generated sales of around €543m and adjusted EBITDA of €105m. From 2008 to 2018 the company was owned by private equity firm "aPriori" [1]. Through a thoroughly executed buy & build strategy, with 13 add-on acquisitions, Guala has become a dominant global player in its sector. CEO Marco Giovannini has been with the company since 1998 and has helped turn, what could be a commodity product, into an indispensable value-add component for the beverage industry.

In numbers, the business looks as follows. You will quickly notice the "surprisingly" high EBITDA margin with a relatively low capex ratio (especially maintenance capex).

in €m	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019e	FY2020e	FY2021e
Sales	487,8	520,5	500,3	534,8	543,1	578,7	623,8	638,0
% growth	*-1.3%*	*6.7%*	*-3.9%*	*6.9%*	*1.5%*	*6.6%*	*7.8%*	*2.3%*
EBITDA adj.	94.9	105.7	100.5	110.6	104.5	118.5	127.3	143.0
% of sales	*19.4%*	*20.3%*	*20.1%*	*20.7%*	*19.2%*	*20.5%*	*20.4%*	*22.4%*
Capex	33.8	22.7	31.3	28.9	36.0	36.5	36.5	35.0
% of sales	*6.9%*	*4.4%*	*6.3%*	*5.4%*	*6.6%*	*6.3%*	*5.9%*	*5.5%*
thereof maintenance capex	13.5	9.1	12.0	11.0	15.0	14.6	14.6	14.0
% of sales	*2.8%*	*1.7%*	*2.4%*	*2.1%*	*2.8%*	*2.5%*	*2.3%*	*2.2%*

source: S&P Capital IQ

Business quality

One will only understand the margins and strength of the business after considering one specific aspect of the global spirits industry. Spirits or liquor are the fourth most counterfeited product in the world. The situation is worse only for audio/video, fashion and pharmaceuticals. According to industry association INDICAM, 12% of global spirits are believed to be counterfeited. That can happen either through refilling of empty original bottles or near perfect replication of bottles, labels and closures. The problem is most pronounced in Eastern Europe, Latin America, Asia and Africa.
The complex and multi-patented closures that Guala produces are one of the most effective lines of defense for global branded spirit producers. It's hard to believe but for instance Guala's closure model "1612A"

[1] Former private equity division of Credit Suisse

has a total of 9 security components, some of which you won't even recognize from the outside. (if you're really interested, we can send over a technical image). This technology obviously makes it impossible to re-close an original bottle. But even if a professional counterfeiting organization wanted to perfectly copy those closures, it would probably be too expensive for them. Naturally, such security closures are more expensive than standard ones and companies like Pernod Ricard, Diageo and Bacardi (by the way all key accounts of Guala) monitor their cost base closely. The math for the branded producers, however, is more holistic than a simple gross margin per bottle. When a consumer buys a bottle of fake Johnnie Walker and, due to lower quality, wakes up with an even stronger headache than usual on the next morning, he will probably go for a different brand next time. This threat of customer loss is much more expensive than a few extra cents on the security closure. Thus, in the grand scheme of things, with a low-cost component, Guala is making a big contribution to brand hygiene for its clients. Now, remember that high EBITDA margin? It's not so surprising any more…

Over the years, Guala has earned its market position not only through M&A, but also through technological leadership. It owns 60% of the safety closure market for spirits. Despite being six times bigger than the next competitor, the company is innovating. Recently, they launched the first RFID chip enabled closure in cooperation with Malibu liqueur.
All these dynamics drive Guala's 5-10% organic growth. In 2018, the company achieved 6.5% organic, fx-adjusted growth. The first quarter 2019 also kicked off nicely with 7.1% organic, fx-adjusted sales growth.

Growth drivers

The spirits market in the developed world is not incredibly exciting. Large mainstream products grow with inflation through gradual price increases. The big producers generate growth by making their product portfolio more complex and thus become better at precisely harvesting customers' willingness to pay. (Does any of our readers know how many different label colors Johnnie Walker has by now?) Guala wins on several levels. More and more producers realize that it makes sense to roll out safety closures across the board. The market is still fragmented and has standardization potential. Ballantine's whiskey for example decided to use only one type of closure around the world (a safety closure, of course). Only few closure producers can deliver on that scale. The fragmented market further provides opportunity for more buy & build. Guala's latest acquisition of Scottish UCP added Johnnie Walker to its client portfolio. In addition, important purchase synergies could be realized. UCP used to buy aluminum sheets in all kinds of different sizes. Guala buys aluminum rolls and cuts them down as needed. If you use enough aluminum, this is much cheaper.

We haven't even talked about wine. Guala owns 30% of the global aluminum screwcap market. Penetration of screwcaps is increasing. On a global scale it currently stands at 22% and the potential is large. China, for example, has a penetration of 8%, while the UK, Australia and Germany stand at 85%, 70% and 44% respectively.

Valuation

Competitors and packaging players such as Amcor, Orora or Berry Global trade between 8-11x (13-15x) 2019e EBITDA (EBIT). With an expected year-end net debt of €450m, this would imply a share price of €7-12 for Guala. Potential upside to the current share price (€6.40) ranges from +10% to +90%.
If you were to expand the peer group based on the underlying quality of the business model, one could argue that flavor & fragrance players like Symrise, IFF or Givaudan would also make for a good comp set. Common features include:

- products are sold into robust, non-cyclical end markets (there is in fact customer overlap between the closure and F&F industry)
- organic growth drivers lead to mid- to high single digit growth
- ability to generate sustainable EBITDA margins around 20% and high free cash flows

- the products are a fraction of the overall bill of materials for end products but have a significant impact on end-customer perception
- once installed the products are hard to replace without changing customer perception
- interesting buy & build opportunities

Despite all similarities, there is significant discrepancy when it comes to valuation. Symrise trades on 19x EBITDA and 27x EBIT (2019e). Guala stands at 7.5x and 11x.

What we also find interesting is the fact that at just over 7x EBITDA and a leverage ratio of 4x, Guala looks like a textbook LBO (maybe a bit conservatively levered). Just the process of deleveraging over the next 3-4 years should yield a 20% IRR – you don't even need a multiple rerating. We talked to bankers and heard that there would be a willingness to lever the business up to 7x EBITDA. This means that you could buy the whole business at a significant premium to its current valuation and still expect a decent return.

How did this opportunity come about?

We believe that we are looking at a suboptimal private equity exit that was followed by a few unfortunate events. PE funds have a typical lifetime of 10 years. As Guala was acquired in 2008, we speculate that pressure to exit the business had been mounting in 2017. Reading the news coverage from 2017, we understand that there were quite a few interested parties, but a final agreement wasn't reached.[2] Hence, the company ended up in an Italian Special Purpose Acquisition Company (SPAC), presumably associated with CEO Giovannini. SPACs are common in Italy and we would describe them as „listed cash boxes“ through which companies can enter the public markets through the backdoor. SPACs are typically funded by old Italian industrial money and some retail investors. Guala's entry into the public markets in August 2018 couldn't have been much worse. The company was first hit by high aluminum prices and then by poor wine markets in Oceania caused by a bad harvest. (Guala has overcompensated the aluminum prices already through price increases in Q1 2019). Both events pushed EBITDA margin under its normal level of 20%. This turn of events made for a nasty overall picture just months after going public. The stock hadn't been placed with a broad European investor base and many investors were scared out of the stock immediately without enough buyers on the other side to provide liquidity. The price declined from an initial €10 to €5.34. With 2019 Q1 results the price has been starting to stabilize again over €6.

What can we say – with such a company it probably makes sense to wait for further percentage points…

[2] https://www.reuters.com/article/guala-closures-ma/italys-guala-boss-puts-auction-on-hold-with-own-bid-plan-sources-idUSL8N1O44O6

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