THE UK SHAREHOLDERS' ASSOCIATION INVESTIGATES AIM COMPANIES' ANNUAL REPORTS

Sprue Aegis plc – Number 95 in Investors Chronicle 'AIM 100' April 2015

Annual Report for year ended 31 December 2015

INTRODUCTION

Sprue Aegis (Sprue) sells a range of Chinese made smoke and carbon dioxide (CO) alarms in Europe – 64% of sales, principally in France – and in the UK. In the year under review, calendar 2015, sales were £88.3m (2014 £65.6m) with a profit before tax of £6.8m (£9.7m) and year end cash of £22.4m (£15.9m), including £8m raised in 2014 when the company moved from ISDX to AIM. Profits would have been significantly higher had it not been for adverse exchange rate movements (-£7.6m) and a large warranty provision (-£5.5m) whose cash costs will be spread over 3/5 years. The directors' forecasts for 2016 have been reduced to sales of £55m and an operating profit of £1.9m because the French market peaked in 2015 and currency pressures are likely to continue. In looking at the report, we need to consider whether the directors, who state a *"principle objective to raise shareholder value",* should have anticipated these problems and taken more effective avoiding action.

THE REPORT

We get a straightforward document which is well laid out and easy to read with black on white, although it is surprising that the page count is a rather high 94, including covers. The 2014 report, which was the one initially examined, was free from jargon and from any attempt by the PR people to jazz it up. A new Group Chief Executive (GCE; reporting to the Executive Chairman) was appointed in 2015 and the current report presentation is actually improved by having some 'gloss' added; on the minus side, the GCE's review shows a slight tendency towards using jargon when simpler words would be more informative. Also, the Executive Chairman and the Chief Executive don't seem to have worked out yet who talks about what, resulting in a slightly messy presentation of their reviews.

The inside front cover gives data and drawings illustrating various aspects of the company including the number of employees, 140; the accompanying graphic shows 300 stylised figures.

What is not so clear from the report is precisely how the product supply line works. All fully assembled products come from China and are supplied through a company called DTL. DTL appears to be a subsidiary of CICAM, the Chinese manufacturer of the smoke alarms. CICAM itself is controlled by Jarden Corporation of the US. CICAM in turn has two subsidiaries, firstly, BRK which makes its own proprietary alarms for which Sprue has the European marketing rights on a 3 year agreement and a second company (DTL?) which makes the Sprue label smoke alarms. Sprue makes its own CO sensors in Canada and these are sold (£2.9m pa sales included in the total) to an un-named independent Chinese company which assembles the finished CO alarm.

The picture is further complicated by the fact that BRK has a 23.4% holding in Sprue and made an unsuccessful take-over bid in 2013. A search shows its owner (Jarden) to be a US consumer products group which is currently itself at the end of a bid from a similar company, Newell Rubbermaid (sic). US commentators think that the deal is likely to go through after a bit of a fight and major cost savings are anticipated.

The information on the geographical breakdown of sales is limited and does not answer two key questions, firstly as to the breakdown between sales of Sprue brand products v BRK and, secondly, between smoke and CO alarms. The first of these questions is surely key to understanding the business.

BALANCE SHEET

The balance sheet is creditable and reflects the high rate of cash conversion. Inventories were increased by £7.2m at the year end to insure against any complications arising from a factory move by CICAM but this was more than offset by an £8.5m fall in receivables largely due to a reduction in sales to France in the final quarter. Intangible assets consist mainly of £4.3m of capitalized R & D, amortised over a somewhat lengthy 7-10 years. The net capitalization for the year is £1.36m, which raises the question as to whether it would not be better to treat R & D as an expense and be done with it.

A puzzling and unexplained feature is that (Note 19), with cash standing at £22.4m, is that *"Domestic trade debtors are pledged as security to the Group's bankers…the balance at the year end… was £7.7m."* The 2014 report does say that an invoicing discount facility is available for the UK but this is not mentioned in 2015.

RISKS

The Risk Statement at the end of the previous year (2014) identifies currency and warranty as factors. However, the currency sensitivity analysis significantly under-estimated the moves which actually occurred and hedging was inadequate. A warranty provision is made and is reviewed annually in the light of actual experience. Whilst it is not possible to forecast major events such as the current battery problem, nevertheless it would appear that the balance sheet provision at end 2014 was too low.

In early 2014 Sprue reached a new 3 year supply agreement for BRK products with pricing in dollars at 1.62/£ (about the then going rate) plus a distribution fee starting at £4.2m pa and falling to £2.9m in 2017. Due to the major changes in the $/£ rate, this agreement, together with that for Sprue's own smoke products, has been renegotiated (March 2016) so that all CICAM made products are on a variable exchange rate with volume adjustments; higher prices due to the currency adjustments are thus increased further by the fall in sales volume and, combined with the reduction in £ gross profit on the lower sales, are the factors decimating profits.

The adverse currency movement of £7.6m in 2015 was itemized in the preliminary statement but, in the report, only appears in the Finance Review. The 2015 risk report does give greater consideration to currency and some hedging is in place. No mention is made of the possible effect if the UK votes to leave the EU.

The warranty provision relates to Sprue labelled, 10 year sealed-for-life smoke alarms, some of which are starting to chirp after 3 years, due to a faulty battery. The alarms will be replaced when they start chirping and the company is bearing the cost, only passing mention being made of any costs being charged to their supplier (and 23.4% shareholder). Even Private Eye (No 1418, 13/05/16) is on to this and draws our attention to an earlier problem in 2011/12 with *"thousands"* of smoke alarms supplied to the UK Department for Communities for fitting in privately rented property. Apparently the alarms, named FireAngel, were at risk of causing fires if the battery was dislodged. Ironically, the cover of the 2014 Report bears the strapline "*Products that save lives*."

A fall in the French smoke alarm market had been forecast by observers but it appears that the company was not fully prepared for the actual decline, which started in late 2015, and there does not seem to be any likelihood of a return to previous levels. Costs are being cut back, rather late in the day.

DIRECTORS & SHAREHOLDERS

Graham Whitworth (Executive Chairman) joined Sprue in 2000 when it floated on ISDX. Nicholas Rutter (a co-founder and nominally Managing Director) is now focusing on technology and has handed over his line management role to Neil Smith, the new Group Chief Executive. John Gahan (Group Finance Director) joined Sprue in 2010. This senior staffing seems top heavy for a small company even after two executive directors stepped down in April 2014.

There are 4 non-executive directors, all male. One non-executive is a BRK nominee and another is appointed jointly by Sprue and BRK.

The board's remuneration for 2015 was £870k (2014, £856k omitting the directors who left) excluding a small gain on share options. No bonuses were paid but a significant proportion of a 2014 bonus has been incorporated in 2015 salaries. Share options have been modest until 900,000 – equivalent to 2% of the issued share capital - were granted to the executive directors in June 2015 at an exercise price of 2p compared with the then market price of around 300p. This seems extraordinarily generous and guarantees a substantial reward even if performance is uninspiring. Also, it seems reasonable to question whether a Chairman, even when executive, should be receiving options, particularly when they are effectively being given away.

The directors hold 15.4% of the equity (G Whitworth 7.7%, N Rutter 6.5%), BRK 23.4% and practically all the balance is in nominee accounts, so presumably held on behalf of private shareholders who can have little control over the Board.

AVOIDING THE PITFALLS

It seems that the directors did not read their own 2014 Risk report. Currency hedging is commonplace in business and, faced with renminbi manufacturing costs and euro selling prices, it should be a logical step for Sprue to be adequately covered. As to warranty, there should have been a strong case for making a higher routine accrual in the accounts, supplier agreements should provide for them to contribute to warranty costs when it is a manufacturing problem and warranty terms for Sprue's customers should be restricted. These aspects are now under consideration by the company. The French market was driven up by legislation over the fitting of smoke alarms but management should have been ready for the inevitable decline in sales when the market started to become mature. One cannot escape the opinion that the directors should have been more alive to the risks and should have taken avoiding action sooner.

CONCLUSION

The directors are currently full of confidence for future sales in Germany and the UK but the headwinds for sales in France as well as for manufacturing costs, currency effects and gross margins are, at best, unpredictable. There is also the difficulty that the dominant supplier is in China, is a major shareholder and is itself – via its holding company - subject to a takeover bid. We are also unhappy about the bonuses incorporated into salary and the over-generous options granted to the executive directors, including the Chairman. The market believes the directors have erred on the cautious side in making the large warranty provision and in forecasting only £1.9m of operating profit in 2016; the share price is factoring in a good profit level for 2017, although it will be almost 2 years before the relevant figures appear.

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