

Lakehouse

Good potential, turnaround well advanced

Initiation of coverage

Industrial support services

2 August 2018

Price 42p
Market cap £65m

Net debt (£m) at end March 2018 14.2
Shares in issue 157.5m
Free float 95%
Code LAKE
Primary exchange AIM

Share price performance



Business description

Lakehouse is engaged in asset and energy support services business, focused on customers in the outsourced public and regulated services sectors in the UK. In future, the group will comprise two divisions: compliance and energy services.

Next events

Prelims December 2018

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Growing corporate and government awareness around safety and energy efficiency create an attractive backdrop to Lakehouse's compliance and energy services business, where strong regulatory drivers have the potential to deliver substantial medium-term EBITA growth. The management team appointed in July 2016 to reverse the decline in performance is taking bold decisions. Property services and construction, which have historically been a drag on the group's performance, are now to be divested. Heads of terms have been agreed and were announced with the interim results on 26 June, but execution risks in completing the divestment remain. We believe this will result in a better business exposed to growth drivers with a lower-risk profile, which will gradually be reflected in the earnings and valuation multiples expanding.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
09/16	299.1	7.5	4.0	1.5	10.5	3.6
09/17	181.5	5.4	4.0	0.5	10.5	1.2
09/18e	185.1	6.2	3.1	0.5	13.5	1.2
09/19e	194.2	7.1	3.6	1.0	11.6	2.4

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments. 2017 and subsequent years are based on continuing operations only, after disposal of property services and construction.

Continuing operations are back on track

Lakehouse has had a difficult passage since its flotation in early 2015, when it listed at 89p. In the last two years management has reduced costs, improved risk/reward assessment, transformed work processes and sharpened its focus on what it can do well via a disposal and better choice of clients. This is now being reflected in the transformation in operations and finances. With the underlying performance improving and the group having better focus, it is on a more stable footing to grow. It has the prospect for strong, sustainable earnings growth and is in a more competitive position.

Substantial opportunities ahead, strong order book

The company's areas of operation are now mainly in services that are mandated by legislation. This legislation is increasing and becoming more complex; therefore, demand is strong and rising. The tasks in which the company specialises are usually outsourced by asset owners. The company won £100m of new work in the six months to March 2018, closing with an order book 7% higher at £396m (2x current annual revenue), and is on framework agreements with a value of up to £1.1bn.

Valuation: Attractive entry point

There are quoted entities that are close valuation comparators to Lakehouse, such as Marlowe, Bilby and Premier Technical Services Group, whereas larger entities such as Mears and Mitie provide a sense check on valuation. Based on our forecasts, Lakehouse has a prospective 2019 P/E of 11.6x and EV/EBITDA of 8.5x whereas its immediate peers trade at a prospective P/E average of 14.9x.

Investment summary

Investment thesis: Attractively positioned, now ready to benefit

Lakehouse has attractive exposure to the gas and buildings compliance markets (eg boiler, fire, lift, electricity and water certification) and the energy services market (eg installing more efficient heating, insulation and renewable energy solutions) that are underpinned by regulatory requirements. Lakehouse's scale, national footprint, cost and pricing and reputation position it well to tender for contracts awarded by local authorities and housing associations. Increasingly, post the recent acquisition of Just Energy, the proportion of private sector work is likely to rise but the main customers will continue to be public sector.

Weak performance in the group's property services and construction divisions can be traced back to a rapid expansion pre- and post-IPO that led to higher-risk contracts being taken on. This has overshadowed the opportunities in the compliance and energy services divisions. The intended disposal of the areas of substantial underperformance is welcome news.

Experienced observers know it takes time to effect change and there are always bumps in the road. We therefore focus on the potential in the medium term. Given the work done so far, we believe operating profit can expand from £7.4m in FY17 to our base case of £9.4m in 2020. There is a case for more aggressive profit growth; our current forecasts only allow modest operational gearing, with c 9% of revenue growth to flow through to profits. If this were to be increased to 25%, it would lead to 2020e operating profit at c £14.2m. In our view, the critical drivers to this growth and share price recovery are the following:

- **Disposal of property services and construction.** As indicated, this deal is not complete and the buyer will need to provide assurances that it accepts all agreed assets and liabilities at the point of transfer. Lakehouse has taken a provision of £11.8m in the current year to cover existing work and final accounts are yet to be agreed. This could potentially take a year to complete as some contract discussions in this sector can be protracted. The cash implications are not yet fully known and the £9.8m cash outflow in H118 represents some of the provision. The provision may alter and may not be 100% clear until December 2018, just before the FY18 results release.
- **Continued expansion in the compliance and energy services divisions.** The May 2018 announcement of the £55m Arbed 3 contract win in Wales is a good example of this. During the six months to end March 2018, the group won a £9m gas contract with Havering, an £8m lift maintenance contract with the Royal Borough of Greenwich, and other gas and heating contracts with Guildford Council, Hanover Housing Association, Leeds Federation and Paragon Housing Association.
- **Reputation within industry remains strong.** Lakehouse's share price fell sharply on the back of the Grenfell fire. It is now generally understood that there are no specific concerns for Lakehouse related to those tragic events. Lakehouse's Grenfell involvement (testing of the fire alarms) has not stopped the company winning work. This, however, does underscore the importance of reputation to continue securing new work.
- **Steady expansion.** The recent bolt-on acquisition of Just Energy Services (announced 17 May) was well received, and the logic of expanding the geographic and operational footprint on the back of the Arbed 3 contract win is understood. We believe the past mistakes of a rapid set of acquisitions would be met with scepticism. Just Energy will increase exposure to private sector work.

Sensitivities

We highlight the following areas of risk to investors:

- The company's main customer exposure is to public sector budgets as government and related entities are its principal customers. The reductions in funding in the public sector have had an adverse impact, although the essential nature of the work of the company and demographic shifts are in its favour.
- As noted above, the business is dependent on its reputation. The company has had some criticism in the press in the last 12 months relating to work at Grenfell and Hackney Council but this has not affected its ability to win work. By sustaining its commitment to customers, even on loss-making projects, we believe it has enhanced its reputation with the decision makers in its customer base.
- Legislative developments, especially on compliance and energy standards, will have a strong influence on revenue and earnings outcomes at Lakehouse. The company is involved in influencing legislation through representations to relevant organisations. But the details and processes are outside the company's control.
- Given the long-term nature of some contracts entered into by Lakehouse, there are accounting judgments around revenue recognition. Hence, we place the importance on evidence of these revenues being reflected in cash conversion. The company has a policy of having very transparent accounting, which includes expensing bid and mobilisation costs and avoiding discounting and factoring.
- The disposal of property services and construction is clearly a key sensitivity. We expect a transaction could complete, but the issue will be around the progress of cash collection and liabilities on projects that are either incomplete or have final accounts not formally agreed. The buyer will be responsible for cash collection and should use its best endeavours to aid cash recoveries. We understand Lakehouse has assumed a pessimistic outcome with regard to recoveries in its provision and there remains uncertainty about amounts collected.

Interim results

The half-year results to March 2018, published 26 June 2018, showed the continued turnaround in the company.

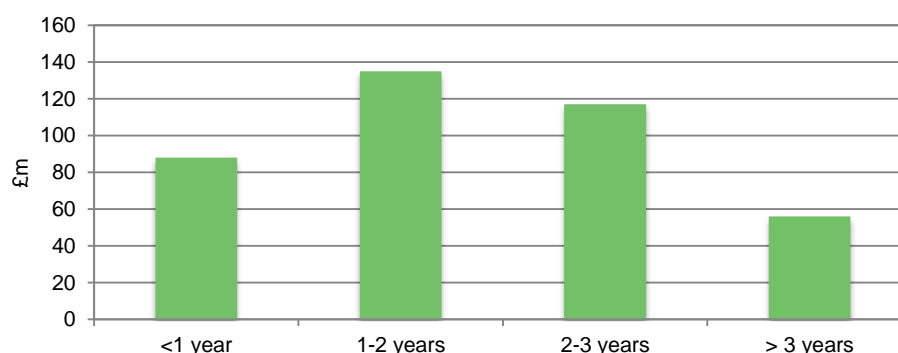
- The continuing operations saw a revenue increase of 3% in the period to £91.1m and the underlying EBITA rose 65% to £2.7m. The earnings in H1 were affected by mobilisation costs of £0.5m, taken above the line when the norm would be nearer to £0.1m. This and the seasonality of the business somewhat underpin the improved second half mentioned in the statement.
- The compliance operations had an 8% improvement in revenue at the interim stage, reaching £56.1m. EBITA fell 17% to £2.4m as the business absorbed contract mobilisation costs. Margins were below the expected long-term run rate, which we believe should be around 8% or more, as the business improves and overhead recovery is greater.
- The energy services operation had stable revenue of £36.6m and EBITA rose by 27% to £1.6m. The Arbed 3 contract and other work won so far this year should trigger an improvement late in H2 and kick in fully for FY19.
- Central overheads have been substantially reduced, including the transfers out of the Romford head office, which is now let. Lakehouse is now in much smaller premises near Liverpool Street. The former overheads were suitable for a business of a much larger scale than Lakehouse and are now 'right sized' for the current and expected operations in the mid-term.
- Cash conversion was held back by a £9.8m cost due to the discontinued activities. The company has made no secret of the fact that its construction operation had a weak first half in FY18. It has also made clear that the business climate in this area is becoming quite

adversarial, so it is difficult for a quoted entity to deliver to the standards required and do so consistently. The company had indicated there would be some considerable working capital absorption in H1 FY18 that will stabilise in H2.

- The company ended the period with net debt of £14.2m, a little higher than it expected but consistent with the seasonality of the operations and the structural changes taking place. The group is operating well inside its £25m RCF facility. The only remaining liability on past acquisitions is the potential for a £0.6m payout; the company has indicated that criteria for this payment are unlikely to be met. We have kept it in our forecast as a matter of caution and added a sum for Just Energy.
- Lakehouse has passed on its interim dividend payment, although it has every intention of returning to the dividend list as soon as possible. The board made this decision as the major disposal is still subject to final agreement. We have included a 0.5p final dividend in our estimates, based on successful exit from property services and construction by the year end and continued improvement in compliance and energy services.

At £396m the order book provides a good backdrop for future revenue and the participation in frameworks with a value of £1.1bn shows the business has good demand. The profile of the orders is shown in Exhibit 1 below. The data excludes Arbed 3 as that was awarded after the period ended. It demonstrates that underpinning of revenue for the next two years and beyond.

Exhibit 1: Lakehouse order book at end March 2018

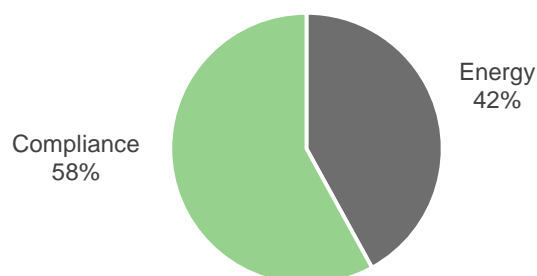


Source: Lakehouse

Strategy: Focus on improving performance

Since 2010 the company's corporate strategy has been to grow organically and through acquisition in the provision of compliance, energy, property and construction services, serving mainly the UK public sector. This strategy was the result of a strategic review under former executive chair and latterly CEO Stuart Black, who wanted to reduce the group's reliance on construction activity and move into higher-growth, higher-margin and lower-risk service activities.

Following the strategic review, the group focused its resources and capital mainly on increasing organic sales growth opportunities and acquisitions in compliance and energy services. The logic was, and remains, to create a national presence in areas of essential services provision mainly through long-term framework contracts with core public sector customers. The strategy was underpinned by strengthening the group's management team and the introduction of additional expertise and experience in these new areas of focus.

Exhibit 2: Divisional revenue breakdown post decision to exit property services and construction in June 2018


Source: Edison Investment Research

A number of acquisitions (detailed in Exhibit 3) were made between 2011 and 2014. In 2014, the board committed to further expansion and prepared for a flotation that would provide further capital for growth.

The underperformance was mainly operational and principally in one part of the business, property services, but there were issues elsewhere that needed to be resolved to create the right platform for the future.

Exhibit 3: Acquisitions made since 2011 focused on growing energy and compliance divisions

Acquired company	Date	Consideration	Business/location
K&T Heating	October 2011	£6.6m + up to £2.5m contingent deferred	Gas heating, South London
Allied Protection	November 2012	£3.6m + up to £3.6m contingent deferred	SE England focused
Foster Property Services	October 2013	£28m + up to £9.2m contingent deferred	Based in London
Everwarm	April 2014	£12m cash + £32.2m shares	Based in Glasgow
H20	October 2014	£4.9m + £1.4m deferred + £2.0m contingent deferred	Water testing, Basildon
Providor	May 2015	£5.6m + up to £2.0m contingent deferred	Smart meetings, Bristol, Liverpool and Bromsgrove
Orchard	July 2015	£8.9m + up to £3.0m contingent deferred	Energy management, based in Leeds
Sure	September 2015	£7.3m + up to £0.5m contingent deferred	Gas heating systems, Yorkshire based
Aaron	November 2015	£6.7m + up to £3.3m contingent deferred	Plumbing and heating in social housing, operates in Lincolnshire, Leicestershire and East Anglia
PLS	December 2015	£5.5m + up to £3.0m contingent deferred	Lift services, based in East Anglia
Just Energy Solutions	May 2018	Undisclosed deferred consideration	Energy services, based in St Albans

Source: Lakehouse

The IPO took place in early 2015, with Lakehouse listing at 89p. The capital raised from the IPO was used to fund further acquisitions between May and December 2015 (see Exhibit 3).

By early 2016 it was becoming clear that group financial performance was below target and the growth objectives were difficult to achieve. The problems were partly created by the speed of the expansion causing management to accept excessive risk in some areas of the business, most notably property services and construction.

A profits warning in February 2016 led to shareholders requisitioning an EGM, looking to replace most of the board. The April 2016 EGM was cancelled as investor support for the resolutions was strong enough for the existing board to concede to most of the demands. On 18 April 2016 the board brought back the original founder of Lakehouse, Steve Rawlings, who had stepped down four years earlier but remained a substantial shareholder. Mr Rawlings was reappointed as a non-executive director. On 21 April 2016 Stuart Black resigned as CEO. Steve Rawlings who had been ill for some time unexpectedly passed away in July 2016.

Continuity and stability was re-established when Bob Holt was appointed to the permanent role of executive chair in July 2016, following Ric Piper who took the role on an interim basis in mid-April,

and Michael McMahon, who came into the business via the Everwarm deal, as chief operating officer. Jeremy Simpson remained CFO throughout the period, having taken the role in April 2014.

Current strategy: Improve performance, exit non-core

The growth strategy that was present at listing remains intact and is valid. The key problems were in its implementation and a high level of risk being assumed in certain contracts, especially in roofing in property services, which drained the company's cash. That remains exacerbated by an increasingly adversarial climate in construction.

Since mid-2016 management's efforts have been focused on getting the operations in good shape and building a robust business ready to resume growth, initially organic but also through acquisition in due course.

There is a greater emphasis on organic development than there was from 2010 to 2016 but the option to buy and build remains. The sale of the non-core energy consultancy, Orchard, in September 2017 was the only completed deal under the new top team, until the recent acquisition of Just Energy.

The group's current strategy is based on:

- Its branded service offering in markets where it has a notable presence
- Participation in long-term contracts and frameworks
- Expanding the most successful parts of the business and exiting non-core
- Low central costs and a streamlined head office
- Benefits of scale from integration, group procurement, skill sharing and cross-selling
- Creating even stronger relationships with its existing customers and building new ones
- Building a national network

The SWOT analysis of the group shown in Exhibit 4 summarises the picture we see of the business. Within these, we would place emphasis as follows:

- The key **strengths** lie in its well-established brands and customer relationships along with the revenue streams that arise from the frameworks.
- The main **weakness** arises from the failure of the previous management to integrate the acquired operations and develop a common operating platform across the businesses. The acquired companies have performed well but not yet taken full advantage of being part of a larger entity.
- The main **opportunities** lie in expanding the compliance operations and extending them and the energy services businesses to create comprehensive national coverage. The company has been distracted by the loss-making activities and inefficient projects; as the business is now stable, it will soon transfer attention to exploring opportunities, identifying asset ownership as a possibility in the metering area.
- The main **threat** to the business arises from changes in government policies. In compliance and energy services demand and funding are driven substantially by government policy.

Exhibit 4: Lakehouse SWOT analysis

Strengths	Weaknesses
<ul style="list-style-type: none"> Brands with good reputations Long customer relationships Track record of good performance Over 250 framework agreements National coverage Well-trained workforce No legacy or pension issues 	<ul style="list-style-type: none"> Integration could be improved Further cost savings to be made IT systems need to be upgraded Training and skills being improved
Opportunities	Threats
<ul style="list-style-type: none"> Increased demand for compliance Government policy in energy efficiency Smart meter roll-out/asset ownership Education facilities' spending plans Common IT platform 	<ul style="list-style-type: none"> Labour shortages (skills and people) Government policy changes Increased competition

Source: Edison Investment Research

Compliance: Regulatory drivers and benefits of scale

Exhibit 5: Principal trading entities in the compliance division

Division	Key subsidiaries	Activity	Geographic focus	Markets
Compliance <ul style="list-style-type: none"> 2017 Rev: £104m (+15% cfp) 2017 EBITA: £8.0m (+30% cfp) 	K&T	Gas	South England	Focus on social housing. Sure, Aaron and K&T are c 75% of revenues. On 204 frameworks with a £608m value.
	Aaron	Gas	Midlands, East England	
	Sure Maintenance	Gas	North England	
	Allied Protection	Fire and safety	South England	
	H2O Nationwide	Water hygiene	South England	
	Precision Lifts	Installs/maintains lifts	South England	

Source: Lakehouse

The compliance division's work is mostly ensuring that gas appliances, lift, water, air, electrical and fire safety equipment is maintained, compliant with regulations and in good working order.

£1.6bn addressable market, of which £1.3bn is in gas

For the purposes of analysis, we split the compliance division into gas and building services. The addressable market for Lakehouse's compliance services is estimated to have a current annual value of at least £1.6bn (2014 data, based on the Lakehouse prospectus, post Grenfell we would expect this to have expanded). The largest element of that is gas, comprising around £1.3bn, split broadly 50/50 between the annual servicing of boilers and the safety certification, which is needed for each boiler, annually. Building services includes the other market areas of lifts, water, electricity and fire.

Growth drivers: Regulation, strategy and cross-sell

The main driver of demand are regulations that require, in many cases, annual inspection and certification of equipment; this particularly applies to gas boilers but also to lifts, fire and safety equipment.

The backbone of revenue in the gas division is the annual gas safety certificate required by all UK rented properties that use gas as fuel. The main tasks are inspecting domestic boilers, issuing the required certificate and, usually, conducting a boiler service; this also provides an opportunity for additional revenue via boiler replacement where needed.

The market for compliance within buildings is characterised with increased legislative demands, especially since the Grenfell fire, which has raised awareness of compliance.

These services operate in social housing markets and on public building assets, as well as on some industrial and commercial properties. The workload is in planned and responsive maintenance, installation and repair services in the areas of gas, fire and electrical, water and air hygiene and lifts. The customers will usually have several items that are covered by regulations, on the same premises, which provides an opportunity for cross-selling.

Compliance now includes 204 frameworks (end September 2017), up from 108 a year earlier, with an aggregate potential value of £608m (30 September 2016: £447m). We expect to see Lakehouse expand further in this area, given its market position and the likely rise in demand as legislation becomes increasingly tight and onerous for building owners.

Competitive position, growth strategy and recent performance

The main competitors in compliance are local operators, working mostly on a regional basis. The market remains highly fragmented, and while there is evidence of consolidation, in our view this is at a very early stage. Lakehouse benefits from being larger than many rivals, especially in procurement. Scale also brings higher than average overhead recovery and resources to maintain knowledge of the frequent changes in legislation, and enables the company to be more competitive as it has a broad geographic presence.

In the South of England, Bilby competes against Lakehouse. It has been operating a buy-and-build strategy and competes via its branded subsidiaries, P&R Installations, Spokemead and Purdy. Its offering extends to building services as well as the core gas compliance operations. It works both directly for the client (as what is known as a tier one contractor) and through larger organisations (which are the tier one), such as Mitie and Mears and on the Ministry of Defence housing contract via Amey.

In the North West, Liberty Gas provides some competition to the Lakehouse subsidiary Sure. Competition is through quality and price for the core compliance business, which is important to win, as it provides access to cross selling opportunities and higher margin installation projects.

Edison expects that the [events at Grenfell in June 2017](#) to trigger an increase in the market, especially in fire compliance and that is reported to be happening by industry participants but is not yet quantified. The procurement process usually involves a formal tendering period and the appointment of one or a small number of suppliers to a framework contract that can last up to 10 years, but usually have a smaller contractual period.

We note the key elements of the expansion strategy and evidence of recent wins as follows:

- In **gas compliance** the company has sought contracts in areas of high population density, which allow optimisation of revenue as travel times are relatively short and aborted visits can be more easily replaced than in widespread geographies. Recent wins include projects in Ealing, Brent, Hyde and Shepherds Bush. The goal of extending the presence nationally is shown by the national contract awarded by Guinness Trust and work won in Corby (£5m over two years) and for Southern Housing.
- In **water compliance** where operations supply testing and remedial services, the business performed well in 2017 and is extending its markets from social housing, making inroads into industrial and commercial markets.

- In **fire and safety** we note that Allied tested the fire system at Grenfell in January 2017, less than six months before the fire and it was found to be operating according to specification; Allied was not involved the specification or the installation at Grenfell. There are, therefore, no specific concerns for the company related to those tragic events. The Grenfell involvement has not stopped the company winning work from Coventry and Wythenshawe during the last year. In our view, the role of Lakehouse is understood fully in the markets in which it operates.
- In the **lifts business** a new top team is now in place. The operations are substantially London based and recent wins include £27m, 10-year project with Westminster City Council, a £1.6m modernisation programme with Hammersmith and Fulham and a £1m programme with Brent. We have suspected this area might become non-core but it does lend itself to above average rewards, relative to the risks involved.

Energy services: Underpinned by regulatory drivers

Exhibit 6: Principal trading entities in the energy services division

Division	Key subsidiaries	Activity	Geographic focus	Markets
Energy Services <ul style="list-style-type: none"> ■ 2017 Rev: £8m (+30% cf py) ■ 2017 EBITA: £5.3m (-7% cf py) 	Everwarm Provider Just Energy Solutions	Energy saving Smart metering Energy saving	Scotland National South England	Social housing focus for Everwarm, private for Just Energy Solutions. Provider is domestic and commercial. On 54 frameworks with a value of £466m.
Joint ventures	33% holding in Warmworks, a JV in Scotland with Energy Saving Trust and Changeworks. Lakehouse's share is held through Everwarm.			

Source: Lakehouse

Lakehouse energy services delivers energy efficiency projects. These include installing heating and renewable technologies and insulation measures for social housing and private homes, through its Everwarm subsidiary. Everwarm uses these services to deliver carbon emissions savings for energy companies, enabling them to meet their legislative targets. Provider offers smart metering services and has a small presence in the installation of electrical vehicle charging points, which is growing. As outlined, the business obtains its work mainly through framework agreements and it is on 54 such arrangements (as at end September 2017) worth £466m.

£2.1bn addressable market in Lakehouse's operating regions

At the time of the flotation, the company estimated its addressable market in Scotland had an annual value of around £1bn and in South East England was around £1.1bn. In our view, these markets will not have grown but the need for measures remain high. There is a large market worth £3bn per year for gas boiler replacement in private homes but that is not a target at present.

The vehicle charging point installation programme is still in an early phase so a market value is not wholly relevant. Lakehouse is an approved installer for vehicle charging point manufacturers, such as Schneider and Chargemaster. The smart meter installation market has considerable potential over the five-year initial installation period as there are around 27m dwellings in the UK, most of which will require two new meters at a cost of £300-350 per installation.

Growth drivers: Regulation, strategy and cross-sell

The markets for the energy services operation are driven mainly by government policy and direction. Of the three key areas for the division, energy efficiency, smart metering and the emerging charging points for electric vehicles, only the latter is funded by private sources.

In energy efficiency there are many funding schemes. The main ones are:

- **Energy Company Obligation (ECO)** in which power companies pay for energy-saving measures in homes that will reduce consumption and usage, and therefore carbon emissions. While much work has been done to improve insulation in homes and some schemes going back over 40 years, Eurostat data show there are 19m homes (out of 25m) in the UK with poor levels of energy efficiency and are grade C or below. The October 2017 government paper, the Clean Growth Strategy, committed to all upgrading all fuel-poor homes to Energy Performance Certificate (EPC) Band C by 2030. The funding for achieving that objective is vague but the intention is clear. The 2017 strategy commits to supporting around £3.6bn of investment to upgrade around a million homes through the ECO and extend support for home energy efficiency improvements until 2028 at the current level of ECO funding.
- **Home Energy Efficiency Programmes Scotland (HEEPS)**, which is government funded. It was launched in September 2015 with a stated value of £224m over seven years; the 2017/18 budget was £19m.
- In **smart meters** the market is still emerging. The 2017 Clean Growth Strategy commits to offering all households a smart meter to help save energy by the end of 2020. That means a total of 53m meters replacing all domestic gas and power meters in around 25m homes. This extends the policy first started in 2008, which promised smart meters in every home by 2019. The slow adoption rate in the domestic sector is due in a substantial measure to the issue of data transmission; the current installations use SMETS1 technology. This is to be replaced by the more advanced SMETS2 technology, but that is only being introduced now. The current plan from government is that SMETS2 will be ready no later than October 2018 but that is in further doubt; our forecasts assume that start date at present. Any further delays would therefore impact the FY19 forecasts.

Competitive position, growth strategy and recent performance

One of the core contracts is the Scottish government's flagship HEEPS. Lakehouse has a 33.3% share in Warmworks along with its JV partners Energy Saving Trust and Changeworks.

Everwarm's competition comes from several areas. In the recent bid for Arbed 3, the social housing maintenance provider Fortem and a consortium of local housing associations provided the competition. British Gas is focused mainly on compliance and boiler maintenance but also has offerings in the energy services area. Provider is in competition with several meter installers such as Nexus, Fulcrum, Actavo, M Group Services (Morrison Data Services), Orion, Ganymede, Lowri Beck and Amey. Lakehouse, via Provider, has the largest number of trained engineers and a true national presence, unlike most rivals.

In addition to Arbed 3, Everwarm has recently won a £44m Housing Investment Programme (HIP) framework in Aberdeenshire with an existing partner, and significant External Wall wins for West Dunbartonshire (£2.1m) as a new client, West Lothian Council (£2m) and Almond Housing Association (£1.4m). Everwarm secured a first ranked place in 28 out of 32 areas on the multi-million-pound Scotland Excel framework in 2017, from which it has obtained works orders. In May 2018 the company secured the Arbed 3 contract in Wales, a three-year £55m contract for delivering energy efficiency to 6,000 homes in Wales. On the back of this, in May 2018 the group also announced the acquisition of St Albans-based Just Energy Services with an aim of delivering similar services in other geographies.

Provider is at the forefront of the efforts to install smart meters throughout the UK. It is one of the few operators capable of managing a national roll-out of smart meter installations. As noted above, the hiatus in sorting out the technology has been unhelpful for Provider. Given the government's push to install SMETS2 meters, it is anticipated to create a difficult position for installers as meters will be installed at a rate that is faster than the conventional replacement rate. Provider is one of a small number of companies with the relevant capabilities. Lakehouse has persevered with Provider,

given the strong political drive to implement the smart meter project, it could be justified. But the results will not be evident until FY19, when the roll-out gets into full swing.

Highly experienced management team

The management team at Lakehouse has substantial experience in the sector (see page 15). There are also two NEDs: Robert Legget came onto the board in April 2016; he is chair at Progressive Value Management, which specialises in creating value for investors in poorly performing entities with illiquid shareholdings. Derek Zissman was appointed in November 2017 having spent much of his career at KPMG; he is chair of the audit committee and director of several private companies.

Management incentives scheme has nine months to run

Management is incentivised to perform well through cash bonuses and shares. In addition to the usual performance incentives, the company introduced a special incentive award plan that covers the period up to January 2019, or earlier should the results for the year to September 2018 be announced before then. The chair, Bob Holt, can be awarded up to 2.3m Lakehouse shares at nil cost, with the amount on a sliding scale based on absolute total shareholder return (TSR). An award can be made at a minimum TSR of 78.48p and the maximum is reached at 98.4p. The other executive directors are eligible to participate in this scheme. It was designed to provide a strong incentive for management that aligned with those of the shareholders and have simple criteria for calculation. It has just over nine months to run and, with the share price near 40p, it seems unlikely the criteria will be met.

We expect that the remuneration committee will extend the period, given the ongoing need to lock-in management and the potential achievability of the goals. Our experience suggests that turnarounds in the broader sector often take longer than expected.

Sensitivities: Reputation key to winning work

In making our forecasts, we assume broadly unchanged circumstances. There are risks to this assumption so below we outline some of the key issues.

- Brexit features as a potential issue affecting many sector companies. We have assumed it has little or no impact on Lakehouse over the next two to three years. In the longer term it may cause GDP growth to be lower than it may otherwise have been, but that should have only a minor impact on the company. The company operates in areas that are not directly affected by Brexit.
- The key market issues for Lakehouse relate to the increased level of legislation that will drive demand in the compliance operations and the level of support for energy efficiency measures. On the first matter, Grenfell has highlighted the importance of buildings being refurbished to an adequate standard, which is currently too low in the UK. There is therefore no expectation that legislation will reduce or that testing regimes for gas, fire, water and power will reduce. On the second matter, energy efficiency funding is key and is subject to change but the longer-term trend to using less energy and measures to achieve that will predominate.
- The reputation of the company is important in securing local authority work. Lakehouse continues to win new work, which provides confidence that the reputation of the business within industry is sound. Given the nature of the work, investors should be aware of the following, none of which as we have noted appear to be impacting the ability of Lakehouse to secure new work:

- The company recently concluded an insured claim relating to a fire incident at Haberdasher's school in 2010. A subcontractor's actions caused a fire. The financial settlement, which was reached in late March 2018, was for compensation of just under £9m. The incident has no financial impact on the company. It is mentioned here for the avoidance of misunderstandings about recent newsflow that might affect an investment decision.
- In July 2017 Lakehouse was involved in a fraud investigation carried out by Scotland Yard. The Mayor of Hackney Council wrote a letter to social housing landlords across the country saying it had contacted the police after suspecting fraud, overcharging and defective work carried out by a subcontractor on behalf of Lakehouse. At no stage has there ever been any implication of corporate wrongdoing. The investigation began in 2014 and has been focused on individuals and so far no one has been charged with any offence; Lakehouse continues to work and win work with Hackney Council. We conclude that the issues are not affecting the business, nor seem likely to do so.

Valuation

We use comparative valuations focused on P/Es given the UK focus of direct peers to provide an indication of valuation. The peer group can be split in two. Close valuation comparators involved in similar businesses include Marlow, Bilby, Premier Technical Service Group and T Clarke.

A broader group of support service companies also provides a sense check around these multiples and we include larger groups such as Mears and Mitie

Based on our forecasts Lakehouse has a prospective P/E of 11.6x. This compares to the closely aligned set of peers who trade on an average prospective P/E of 14.9x.

The whole sector has been suffering from negative investor sentiment after the collapse of Carillion. In the near term we believe this is reasonable. Lakehouse itself noted the collapse added uncertainty to the sector and clients are taking a tougher negotiating stance on contracts.

Exhibit 7: Peer group valuations show potential if growth is delivered

Company	Market cap (£m)	Share price (p)	EPS FY18 (p)	EPS FY19 (p)	FY18 P/E (x)	FY19 P/E (x)
Lakehouse	65.4	42.0	3.1	3.6	13.4	11.6
Closest peers average					16.1	14.9
Marlowe	195.6	500.0	15.1	17.2	33.4	29.4
Premier Technical Service Group	208.2	188.5	11.0	12.2	17.1	15.5
Bilby	51.6	131.0	13.1	14.0	9.8	9.1
T Clarke	34.0	82.5	13.2	14.1	6.1	5.7
Large peers average					9.8	8.4
Mears	336.8	328.0	32.8	36.0	9.9	9.0
Mitie	562.8	153.0	17.5	19.9	8.8	7.7

Source: Edison Investment Research, Eikon. Note: Prices as at 1 August 2018.

Financials: Improving performance and balance sheet

The key actions since July 2016 have been to get stability in the operations and start a performance improvement plan, strengthen the balance sheet and resolve the legacy issues. We have altered our forecasts for FY18 onwards to reflect the new situation of the discontinued areas.

Revenue stable, performance improving in key areas

In our main forecasts, we have assumed modest revenue development and that Lakehouse will expand its compliance and energy services as swiftly as possible while assuming low risk. The company is seeking to balance risk and reward, so we expect it will be cautious in expanding.

Our forecasts for revenue show it rising in total from £182m in 2017 to £204m by 2020 with growth of 13.0% and 11.8% in compliance and energy services respectively over this period.

Forecast operating margins are only slightly higher than current levels as we expect the framework pricing will not be substantially different from present levels, which are competitive. But with the benefit of lower central overheads and their absorption over greater revenue, there are margin gains.

It is possible we are being overly cautious in our approach. Our margin assumptions of compliance effectively maintaining a 7.5% operating margin in 2020 and energy services increasing its margins from 5.1% in 2017 to 6.8% assume an additional £5.0m and £5.8m of costs above inflation increases. Consequently, only c 9% of the additional revenues are flowing through to operating profit. If management can continue to show strong cost control and discipline and start to leverage the group's scale, and if we see a more traditional c 25% of revenues flowing through to the operating profit line, it would lead to an operating profit of £14.2m.

Stronger balance sheet

In mid-July 2016 the balance sheet was an issue given the deterioration in trading and the £21m net debt at end 2016. The sale of Orchard provided a £12.4m boost to the position that, along with favourable working capital movements in September, caused net debt of just £1.3m at the year end. Our forecast net debt position at year end 2018 is £14.4m, still higher than 1x EBITDA, which is regarded as a 'safe' level within the industry but an improvement on 2016 and we expect it to fall to 1x by 2020.

With the sale of Orchard, the company also reduced its revolving credit facility from £35m to £25m with RBS. The company has a £5m overdraft facility in addition to the credit facility; these are being renegotiated.

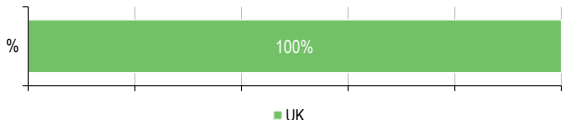
A strong balance sheet is important when tendering for public sector contracts as many customers need it as evidence of ability to fund work. It also allows the company to be more selective about projects as it is not chasing cash and often paid up front, which works well in the growth phase but can be negative if the company downsizes.

Operating cash flow before working capital movements is expected to exceed operating profit in our forecasts. The working capital used in this year and next is higher than usual, partly due to the downsizing of parts of the business creating negative working capital for the group and partly due to growth in the services area. The company is targeting 80%+ operating cash flow conversion. We expect a large cash outflow this year as legacy contracts are settled and a normal position to be achieved in 2019 when operating cash flow will equal 92% of adjusted operating profit.

Exhibit 8: Financial summary

	£m	2016	2017	2018e	2019e	2020e
30-September		IFRS	IFRS	IFRS	IFRS	IFRS
INCOME STATEMENT						
Revenue		299.1	181.5	185.1	194.2	204.1
Cost of Sales		(265.4)	(154.5)	(157.7)	(166.1)	(175.2)
Gross Profit		33.8	27.0	27.4	28.1	29.0
EBITDA		10.2	9.0	8.8	9.5	10.4
Operating Profit (before amort. and except).		8.5	7.4	7.8	8.5	9.4
Amortisation of acquired intangibles		0.0	0.0	0.0	0.0	0.0
Exceptionals		(42.6)	(5.6)	(2.4)	0.0	0.0
Share-based payments		0.0	0.0	0.0	0.0	0.0
Reported operating profit		(34.0)	1.8	5.4	8.5	9.4
Net Interest		(1.0)	(2.0)	(1.6)	(1.4)	(1.3)
Joint ventures & associates (post tax)		0.0	0.0	0.0	0.0	0.0
Exceptionals		(0.6)	0.0	0.0	0.0	0.0
Profit Before Tax (norm)		7.5	5.4	6.2	7.1	8.1
Profit Before Tax (reported)		(35.7)	(0.2)	3.8	7.1	8.1
Reported tax		4.5	0.9	(1.2)	(1.4)	(1.6)
Profit After Tax (norm)		6.3	6.4	5.0	5.7	6.4
Profit After Tax (reported)		(31.1)	0.8	2.5	5.7	6.4
Minority interests		0.0	0.0	0.0	0.0	0.0
Discontinued operations		1.9	(0.8)	(11.8)	0.0	0.0
Net income (normalised)		6.3	6.4	5.0	5.7	6.4
Net income (reported)		(29.3)	0.0	(9.3)	5.7	6.4
Average Number of Shares Outstanding (m)		75.2	127.8	157.5	157.5	157.5
EPS - normalised fully diluted (p)		3.9	3.9	3.0	3.5	3.9
EPS - normalised (p)		4.0	4.0	3.1	3.6	4.1
EPS - basic reported (p)		(18.6)	0.0	(5.9)	3.6	4.1
Dividend per share (p)		1.50	0.50	0.50	1.00	1.50
Revenue growth (%)		(3.8)	(44.5)	2.0	4.9	5.1
Gross Margin (%)		11.3	14.9	14.8	14.5	14.2
EBITDA Margin (%)		3.4	5.0	4.8	4.9	5.1
Normalised Operating Margin		2.9	4.1	4.2	4.4	4.6
BALANCE SHEET						
Fixed Assets		74.2	57.0	49.2	47.2	45.3
Intangible Assets		69.3	51.4	47.1	45.1	43.2
Tangible Assets		2.8	1.9	1.8	1.8	1.8
Investments & other		2.1	3.7	0.2	0.2	0.2
Current Assets		75.4	96.6	75.1	70.3	78.9
Stocks		5.2	4.5	4.6	4.8	5.1
Debtors		68.8	65.4	42.6	48.5	51.0
Cash & cash equivalents		0.0	26.1	3.8	7.0	12.9
Other		1.5	0.6	24.1	10.0	9.9
Current Liabilities		(68.7)	(72.0)	(63.2)	(52.2)	(54.8)
Creditors		(66.5)	(71.0)	(48.3)	(51.5)	(54.1)
Tax and social security		0.0	0.0	(0.3)	(0.3)	(0.3)
Short term borrowings		(0.3)	(0.2)	(0.2)	(0.2)	(0.2)
Other		(1.9)	(0.9)	(14.4)	(0.2)	(0.2)
Long Term Liabilities		(30.0)	(31.3)	(21.0)	(21.0)	(21.0)
Long term borrowings		(20.8)	(27.2)	(18.1)	(18.1)	(18.1)
Other long term liabilities		(9.2)	(4.1)	(2.9)	(2.9)	(2.9)
Net Assets		51.0	50.2	40.2	44.3	48.4
Minority interests		0.0	0.0	0.0	0.0	0.0
Shareholders' equity		51.0	50.2	40.2	44.3	48.4
CASH FLOW						
Op Cash Flow before WC and tax		10.5	9.5	10.9	11.5	12.3
Working capital		1.1	3.5	(19.2)	(2.8)	(0.0)
Exceptional & other		(14.6)	0.1	1.0	0.6	0.1
Tax		(0.3)	0.7	(1.2)	(1.4)	(1.6)
Net operating cash flow		(3.3)	13.7	(8.6)	7.8	10.8
Capex		(0.8)	(0.9)	(0.9)	(1.0)	(1.0)
Acquisitions/disposals		(17.8)	9.1	(1.5)	(0.6)	0.0
Net interest		(0.8)	(1.4)	(1.4)	(1.4)	(1.4)
Equity financing		0.0	0.0	0.0	0.0	0.0
Dividends		(4.6)	(0.8)	0.0	(1.6)	(2.4)
Other		(0.4)	(0.3)	(0.0)	(0.0)	(0.0)
Net Cash Flow		(27.7)	19.5	(12.4)	3.3	6.0
Opening net debt/(cash)		(6.2)	21.0	1.3	14.4	11.3
FX		0.0	0.0	0.0	0.0	0.0
Other non-cash movements		0.5	0.3	(0.7)	(0.1)	(0.1)
Closing net debt/(cash)		21.0	1.3	14.4	11.3	5.4

Source: Lakehouse, Edison Investment Research

Contact details	Revenue by geography
50 Liverpool Street London EC2M 2PY England +44 20 3961 5210 www.lakehouse.co.uk	 <p>100% ■ UK</p>
Management team	
Executive chairman: Bob Holt	CFO: Jeremy Simpson
Mr Holt was appointed in July 2016. He brings industry experience and is overseeing the turnaround in Lakehouse's operations. He is also the non-executive chair at Mears and Totally.	Mr Simpson joined Lakehouse in April 2014 in his current role. He has prior experience of working in quoted companies in a senior position at Shanks, Hunting and Smiths group.
COO: Michael McMahon	
Mr McMahon joined Lakehouse as part of the acquisition of Everwarm in early 2014, where he was a founding director. He brings substantial experience in senior roles in the services sector, especially in compliance and energy.	
Principal shareholders	(%)
Harwood Capital	18.9
Estate of Steve Rawlings	15.5
Slater Investments	7.2
L&G	5.6
Michael McMahon	3.4
Carol King	3.4
Soros	3.0
Companies named in this report	
Bilby, Premier Technical Services, Marlowe, T Clarke, Mears, Mitie, Totally	

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