EDISON

Sureserve Group

Starting to build a track record of delivery

Trading update

Industrial support services

Sureserve continues to demonstrate it has a de-risked business and the ability to deliver growth and cash generation from its two core divisions. The recent announcements affirming end FY19 net-debt of £7.6m, FY19 earnings guidance to meet expectations and the pay down of the revolving credit facility all provide comfort that the more focused group is performing well. Our previous earnings were marginally below consensus and we are raising FY19 and FY20 PBT estimates from £7.7m and £8.3m to £8.1m and £8.6m, respectively. The valuation at 7.2x current year earnings suggests the market still has to reprice the lower risk to earnings and start to differentiate the attractive gas compliance and energy services operations from the more out of favour construction services sector.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
09/17	181.5	5.4	2.8	0.50	10.8	1.7
09/18	190.8	6.6	3.4	0.25	8.9	0.8
09/19e	205.2	8.1	4.2	0.25	7.2	0.8
09/20e	215.6	8.6	4.4	0.25	6.8	0.8

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles and exceptional items

Trading update highlights improving cash generation

The year-end trading update confirmed the business was in line with expectations in the year ending 30 September. Net debt at the year-end was £7.6m, which is in line with the £7.4m we had forecast. £4.0m of the revolving credit facility (RCF) has been repaid and currently around £10.0m is used for trading. Net debt was £12.9m at end March 2019 and £14.2m a year earlier, reflecting the improving cash generation of the more simplified business. Around £0.9m was received post year end from the buyer of Orchard Energy Services, a non-core energy consulting operation sold in late 2017.

Attractive core positions in regulated markets

Sureserve's two mainstream operations are in attractive areas and performing well with good recent track records of winning work. Compliance activities are currently mainly in gas services to the social housing sector, driven mainly by legislation. The increasingly national coverage allows the business economies of scale and it can benchmark across its regions, which improves efficiency. Energy services has a similar customer base as compliance and its activities are underpinned by long-term contracts with the Scottish and Welsh governments (Warmworks and Arbed). The order book was £350m at end March 2019, equal to over 18 months' revenue and it is growing.

Valuation: Sum of the parts suggests a 45p valuation

Our sum of the parts valuation suggests an EV of c £79m compared to the current c £55m, which would imply a 45p share price. The sum of the parts also highlights the drag central costs have on the value of the group and should be a focus for management and shareholders alike.

13 November 2019

Price	**30p**
Market cap	**£47m**

Net debt (£m) as at 30 September 2019	7.6
Shares in issue	158.9m
Free float	95%
Code	SUR
Primary exchange	AIM
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	5.4	1.7	(13.2)
Rel (local)	3.6	(1.1)	(17.3)
52-week high/low		33p	20p

Business description

Sureserve Group is engaged in the asset and energy support services business, focused on customers in the outsourced public and regulated services sectors in the UK. It comprises two divisions: compliance and energy services.

Next events

FY19 results	January 2020

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Edison profile page

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Valuation: Using a sum of the parts to examine value

Background: Valuation contrasting with business performance

Since our initiation (August 2018), the share price of Sureserve has slid from 42p to 29p. This is in contrast to the actions taken and performance delivered by the group. In particular, we would highlight:

- The successful divestment of Lakehouse Contracts and Foster Property Maintenance to streamline the group's activities into compliance and energy services.
- A good set of interim results, which were notable for the absence of any exceptional items (the financials are reflecting the more simple nature of the group's structure) or any negative surprises (reflecting the lower-risk nature of the remaining divisions).
- An encouraging trading update re-affirming the market's FY19 earnings expectations and also highlighting good cash generation in the year resulting in net debt falling from £11.4m at FY18 year end to £7.6m at FY19 year end.

Factors potentially holding back the share price could be argued as:

- The negative sector sentiment following the collapse of Carillion.
- The perceived risk around parental company guarantees and bonds related to the divested businesses. The company has provided for this and to date there have been no claims.
- The loss of COO Michael McMahon, who announced his intention to leave the group for personal reasons. In the interim Bob Holt has moved back into an executive role and the appointment of Peter Smith as CFO has strengthened management resources.
- Low liquidity and sub £50m market capitalisation, which has meant that Sureserve is potentially below many institutional investors' radar.

If the group keeps delivering on performance, which we expect it will do given the lower-risk nature of the group, we believe the valuation multiples are likely to trend towards the peer group average. Sureserve is still in the 'show me' stage and we would expect it to start to get traction with investors post the full year results being delivered.

Establishing the peer group: Review of activity and competitors

The group has two principal divisions: compliance (c 60% of group revenues) and energy services (c 40%).

The compliance business provides planned response and maintenance for over 500,000 homes, mainly to local authorities but also to some industrial and commercial owners, allowing these owners to meet their safety obligations. 75% of the divisional revenues are in gas compliance, but the group also provides fire, water, electrical and lift safety. The principal competitors or peers are:

- British Gas (part of Centrica), the largest player in the gas compliance market. British Gas looks after over four million residential boilers in the UK via its Homecare unit and 250,000 social housing properties via its PH Jones unit.
- Mears Group, which acquired the assets and contracts of MPS Housing from Mitie in late 2018. This area of activity sits in Mears' Housing division, of which maintenance was 77% of revenues. As well as gas compliance, the division provides reactive and planned repairs, energy services and gas installation, primarily to local authorities and government.
- Marlowe, which has executed a buy and build strategy in the B2B segment of risk and compliance, primarily to the commercial sector. Marlowe tests, inspects and certifies commercial property to ensure it is compliant with regulatory requirements. At year end March

2019, the risk and compliance division reported revenues of c £67m, which was 52% of group revenues.

- Bilby, which provides gas, electrical and building services to 300,000 local authority and housing association in London and the South East. Bilby warned on profits in March 2019, a result of two adverse contracts in its P&R division. A new CEO has been appointed and is focused on turning the business around.
- Premier Technical Services (PTSG), which provides regulated and safety related building services nationally and activities include façade and roof access, electrical and fire safety. In June 2019, PTSG was acquired by Macquarie after a £265m (210p per share) recommended offer was accepted. Our forecasts for PTSG prior to the bid being announced was for 2018 EPS of 11.8p and 2019 EPS of 13.5p. The bid therefore valued PTSG at 17.8x 2018 earnings and 15.6x 2019 earnings. On an EV/EBITDA basis, the bid valued PTSG at 15.9x 2018 EBITDA and 11.7x 2019e EBITDA.

Looking at the peer group, we focus on companies that have a B2B focus, where demand is underpinned by regulatory compliance and there are patterns of strong recurring revenues and where the division is a meaningful part of overall group revenues. As such we would use all of these other than British Gas, which is more consumer focused and part of a much larger group. We also have excluded Bilby as there are no consensus estimates available.

Exhibit 1: Peer group valuations show significant range, reflecting track record, margins and growth

Company	Market cap (£m)	Share price (p)	FY1 P/E (x)	FY2 P/E (x)	FY1 EV/EBITDA (x)	FY2 EV/EBITDA (x)
Sureserve	**46.9**	**30**	**7.2**	**6.8**	**5.3**	**5.1**
Marlowe	203.2	443	20.0	17.0	14.4	12.4
Mears	276.2	241	8.5	7.4	5.4	4.9

Source: Edison Investment Research, Eikon. Note: Prices as at 12 November 2019.

Sureserve's energy services division has an overall aim of reducing customers' fuel usage and costs, but is made up of two very different businesses. Everwarm upgrades insulation for social housing predominantly, while Providor is a smart meter installer. The valuation challenge for this division is that there are no obvious UK quoted peers.

Everwarm's principal competitors are private companies. The Warmworks framework contract had 30 named energy efficient contractors by way of example. Providor's closest quoted peer Smart Metering System operates further up the value chain, owning and managing smart meter assets. Providor looks to compete on the installation side with meter installers such as Nexus, Fulcrum, Actavo, M Group Services (Morrison Data Services), Orion, Ganymede, Lowri Beck and Amey. It is however the only national installer, which positions it well.

We therefore look at deal multiples for the energy services business. BDO's Mergers & Acquisitions team publish an annual Building Products and Services insights book. The 2019 book highlights the UK and the US as the most active markets for deals (29% and 35% of global transactions, respectively) and notes the growing participation of financial buyers that are attracted to fragmented and highly regulated industries. The average EV/EBITDA for the roof, cladding and insulation market was 6.3x between 2012 and 2018, which in the absence of any quoted peers for Sureserve's energy business looks to be a reasonable proxy. It should be noted that the multiples paid have been increasing each year, so the average looks to be conservative.

Sum of the parts valuation

Given the lack of direct peers for the group, we look at a sum of the parts valuation to examine the potential value of each division and the impact of central costs. Key inputs we have used in constructing this valuation are as follows:

- The group reports adjusted EBITA by division. For compliance we have an EBITA estimate of £7.5m for 2019e and for energy services we have an estimate of £4.2m.
- We have apportioned depreciation and amortisation that is not reported at a divisional basis to the two divisions. For 2019e there is £1.4m of depreciation and amortisation that is not allocated to the two divisions. £850k is allocated to the compliance division, the balance to the energy services division. Divisional EBITDA is therefore £8.35m for compliance and £4.75m for energy services.
- For the compliance division, we use a simple average of the FY1 EV/EBITDA multiple for Mears and Marlowe of 9.9x to value the division. As a sense check we have the PTSG takeout multiple of 11.7x 2019e EBITDA.
- For the Energy Services division, we apply the 6.3x EV/EBITDA multiple we referred to earlier from BDO.
- We estimate 2019e central costs at £2.7m. Without allocating these to the divisional valuations we would be overvaluing the group. There are a range of approaches to do this; we have opted to take the calculated EV of the two divisions (£112.6m), calculate the multiple this gives on 2019 EBITA and apply this to establish a value in perpetuity for central costs. This applies a 12.5x multiple to central costs.

Exhibit 2: Sum of the parts valuation

	£m	2019e EBITDA (£m)	EV/EBITDA (x)	EV (£m)
Compliance		8.4	9.9	82.7
Energy Services		4.8	6.3	29.9
Total				**112.6**
Central costs	2.7		12.5	33.8
2019e EBITA	9.0			
Central costs/2019e EBIT	30%			
Calculated enterprise value				**78.8**
Current enterprise value				**54.5**
% discount to calculated value				31%

Source: Edison Investment Research, Refinitiv

This highlights three things. First, it firms up our view that the group is currently attractively priced based on the recent trading announcements, the sum of the parts valuation suggesting that 45p/share would be closer to fair value. Second, it highlights the significant drag central costs have on group valuation and this should be a focus for management, either by growing the EBITA to central cost ratio (organically or via acquisitions) or keeping costs under control. Third, it highlights the potential attraction for trade and financial buyers who felt they could eliminate a significant part of the central costs, particularly given the trends highlighted in the BDO Insights paper of regulated and fragmented industries being of growing interest to financial buyers.

Exhibit 3: Financial summary

£m	2017	2018	2019e	2020e
Year end 30 September	IFRS	IFRS	IFRS	IFRS
INCOME STATEMENT				
Revenue	181.5	190.8	205.2	215.6
Cost of Sales	(154.5)	(163.4)	(176.9)	(186.9)
Gross Profit	27.0	27.4	28.3	28.7
EBITDA	9.0	9.2	10.4	10.7
Operating Profit (before acquisition amort. and except).	7.4	8.0	9.0	9.4
Exceptionals and amortisation of acquired intangibles	(11.0)	(4.6)	(2.8)	(2.2)
Share-based payments	0.0	0.0	0.0	0.0
Reported operating profit	(3.6)	3.4	6.2	7.2
Net Interest	(2.0)	(1.5)	(0.9)	(0.7)
Joint ventures & associates (post tax)	0.0	0.0	0.0	0.0
Exceptionals	0.0	0.0	0.0	0.0
Profit Before Tax (norm)	5.4	6.6	8.1	8.6
Profit Before Tax (reported)	(5.6)	1.6	5.0	6.1
Reported tax	0.9	(0.8)	(1.5)	(1.6)
Profit After Tax (norm)	6.4	5.8	6.6	7.0
Profit After Tax (reported)	(4.6)	0.8	3.4	4.5
Minority interests	0.0	0.0	0.0	0.0
Discontinued operations	4.6	(11.5)	0.0	0.0
Net income (normalised)	6.4	5.8	6.6	7.0
Net income (reported)	0.0	(10.7)	3.4	4.5
Average Number of Shares Outstanding (m)	157.5	157.5	158.0	158.9
EPS (p)	2.7	3.2	4.2	4.4
EPS - normalised (p)	2.8	3.4	4.2	4.4
EPS - basic reported (p)	0.0	(6.6)	2.4	3.0
Dividend per share (p)	0.50	0.25	0.25	0.25
Revenue growth (%)	(44.5)	5.1	7.6	5.0
Gross Margin (%)	14.9	14.3	13.8	13.3
EBITDA Margin (%)	5.0	4.8	5.1	4.9
Normalised Operating Margin	4.1	4.2	4.4	4.3
BALANCE SHEET				
Fixed Assets	57.0	50.2	47.0	44.5
Intangible Assets	51.4	47.9	44.7	42.2
Tangible Assets	1.9	1.5	1.5	1.5
Investments & other	3.7	0.9	0.9	0.9
Current Assets	96.6	49.3	51.8	56.1
Stocks	4.5	4.2	4.5	4.8
Debtors	65.4	42.6	45.9	48.3
Cash & cash equivalents	26.1	1.7	1.4	3.0
Other	0.6	0.8	0.0	0.0
Current Liabilities	(72.0)	(57.4)	(54.1)	(56.3)
Creditors	(71.0)	(39.3)	(40.1)	(42.2)
Tax and social security	0.0	0.0	(0.3)	(0.3)
Short term borrowings	(0.2)	(13.0)	(8.9)	(8.9)
Other	(0.9)	(5.1)	(4.8)	(4.8)
Long Term Liabilities	(31.3)	(3.0)	(2.9)	(2.9)
Long term borrowings	(27.2)	(0.1)	0.0	0.0
Other long term liabilities	(4.1)	(2.9)	(2.9)	(2.9)
Net Assets	50.2	39.1	41.8	41.4
Minority interests	0.0	0.0	0.0	0.0
Shareholders' equity	50.2	39.1	41.8	41.4
CASH FLOW				
Op Cash Flow before WC and tax	9.0	8.9	10.4	10.6
Working capital	5.7	(6.4)	(4.3)	(4.8)
Exceptional & other	(1.3)	(8.2)	0.3	0.0
Tax	0.7	(0.2)	(1.5)	(1.6)
Net operating cash flow	14.0	(5.8)	4.8	4.2
Capex	(0.9)	(0.4)	(1.0)	(1.1)
Acquisitions/disposals	9.1	(1.7)	0.3	0.0
Net interest	(1.4)	(1.1)	(1.1)	(1.1)
Equity financing	0.0	0.0	0.0	0.0
Dividends	(0.8)	(0.8)	(0.4)	(0.4)
Other	(0.3)	(0.0)	(0.3)	(0.0)
Net Cash Flow	19.8	(9.8)	2.3	1.8
Opening net debt/(cash)	21.0	1.3	11.4	7.6
FX	0.0	0.0	0.0	0.0
Other non-cash movements	0.0	(0.3)	1.5	(0.1)
Closing net debt/(cash)	1.3	11.4	7.6	5.9

Source: Sureserve Group accounts, Edison Investment Research

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