

Augean

Growth fuels upside

Augean has reorganised its business and now enjoys a strong competitive position in its key markets, allowing it to capture underlying market growth and significantly improve profitability. The H119 results and recent trading update suggest this trend is set to continue. Augean's market rating, even allowing for the outstanding tax liability with HMRC, appears very modest for a company with significant growth potential.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/17	67.0	7.0	6.5	0.0	23.1	N/A
12/18	79.7	11.0	9.1	0.0	16.5	N/A
12/19e	105.1	18.4	14.9	0.0	10.1	N/A
12/20e	120.1	22.8	18.2	0.0	8.2	N/A

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

Upgrade to market expectations for FY19

Augean reported strong growth in H119 (adjusted EBITDA +71% to £14.2m) and the recent trading update (16 October) confirmed the positive momentum. Augean pointed to a 20% increase in landfill volumes and a 20% increase in landfill pricing, alongside strong performances from North Sea Services and the radioactive waste business. Management stated that adjusted PBT would be 'materially' ahead of prevailing market consensus prior to the release of the update (£16.5m).

Market positioning to underpin further growth

Since 2017 Augean has implemented a successful turnaround of the business reducing costs by c £6m, selling underperforming businesses and increasing prices and volumes in all its core operations. These actions have had a beneficial effect on profitability, with reported PBT increasing from under £5m in FY17 to over £18m expected in FY19. Augean is now well positioned in its three key markets of municipal ash, soil and North Sea Services and we expect these markets will be the dominant contributors to future profit growth. We note that in ash, Augean has already signed contracts with municipal incinerators that are due to start operation shortly and which Augean believes could add c £12m to PBT over the next two to three years. The dispute with HMRC over landfill taxes continues but Augean is now in a financial position, should it choose to do so (with some borrowing), to pay off the total liability, which we believe will be in the region of £53m when all assessments and penalties have been received. Payment of the HMRC liability would not only draw a line under the dispute, it would prevent further accrual of unpaid interest and allow the cost of borrowing to be offset against taxation.

Valuation: Further upside potential

Since the end of 2017 the shares have performed strongly but we believe additional share price appreciation is possible in view of the potential clarification of the HMRC liability and Augean's future growth prospects. Our analysis, based on a range of valuation approaches, indicates a potential valuation for Augean in the range of 175p to 225p per share.

Re-introduction of estimates

Industrial support services

18 October 2019

Price 150p
Market cap £156m

Net cash (£m) at 30 June 2019	22.8
Shares in issue	104m
Free float	84%
Code	AUG
Primary exchange	AIM
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	47.1	27.1	219.2
Rel (local)	49.2	31.6	211.7
52-week high/low	150.0p	42.5p	

Business description

Augean is a UK-based specialist waste management business. The business operates via two divisions: Treatment & Disposal and North Sea Services.

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Trading update	January 2020
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Corporate reorganisation stimulates return to growth

Management action to tackle historical challenges

We last published on Augean in March 2018 at a point when the company had embarked on a plan to transform the business. In 2017 Augean was a sprawling waste management company with a range of businesses that frequently failed to meet market expectations and in October 2017 management issued a profit warning due to a weaker trading performance, pointing to lower profitability in 2017 than 2016, and that it had reduced its outlook for 2018. In addition to these operational challenges, Augean had been served notice by the HMRC (August 2017) that it faced a substantial financial liability in relation to unpaid landfill taxes.

To tackle these challenges, Augean appointed Jim Meredith, the non-executive chairman, to the role of executive chairman (October 2017) and the company embarked upon a dual strategy of running the business for cash while dealing with the legal dispute with HMRC. Mr. Meredith has focused the management team (led on a day-to-day basis by Mark Fryer (FD) and John Rauch (COO)) on cash and ROI, allowing the position of divisional head to be eliminated. Since Mr Meredith's appointment, Augean has sold underperforming businesses such as the East Kent Incinerator, Colt and AIS, raising c £10m and eliminating ongoing losses in the process. Augean has also reorganised the business around its operational sites and now operates via two divisions (from five previously) – Treatment & Disposal and North Sea Services. The position of divisional head has been eliminated and the workforce has been incentivised by the introduction of a bonus scheme. Annual cost reductions of £6m (versus 2017) have also been achieved (original company forecast – £4m).

Exhibit 1: Augean's recent disposal of underperforming businesses

Date	Disposal announced	Amount	Comments
16/03/2018	Sale of East Kent High Temperature Incinerator	£3.35m	Loss making in 2017 and 2018
22/06/2018	Sale of Colt Assets to Future Industrial	Cash consideration of £1m + £1.25m for Colt property sold	Attributable loss of £0.75m in 2017
25/01/2019	Sale of AIS to Regen Devco	Initial consideration = £3m + £0.8m	AIS made a loss after tax in 2017

Source: Augean, Edison Investment Research

Successful financial turnaround

The disposals, corporate reorganisation and cost reductions have helped to significantly improve the financial performance of the company. In broad terms, in 2017 Augean reported profits of £4.6m, to which can be added £6m of annual cost savings, £4m from price increases and £4m of volume-related benefits (including those recently announced), taking profits to around the c £18.4m that we forecast for 2019. The balance sheet has been transformed over the period (see Exhibit 2) and interestingly, Augean generated almost as much in EBITDA in H119 as it did in the whole of 2017. Returns, as calculated by Augean, have also risen significantly. We forecast further growth in H219 and beyond.

Exhibit 2: Transformation of Augean's financial performance

	Period end (net debt)/cash (£m)	Period reported EBITDA (£m)	Period reported basic EPS (p)	Annualised ROCE
FY17	(10.8)	14.5	3.88	9%
H119	22.8	14.2	7.03	44%

Source: Augean, Edison Investment Research

HMRC landfill tax dispute

Although Augean has dealt successfully with the operational issues facing the business, the dispute with HMRC remains unresolved. At the H119 results Augean disclosed a potential outstanding

liability of £37.3m (including interest) and has subsequently (31 July 2019) received an additional assessment of £3.1m and a penalty notice of £4.6m (2 August 2019), taking the current liability to c £45m. A further penalty notice and assessment cannot be ruled out; assuming they are of a similar scale to the recent announcements, the total liability would amount to c £53m. In reality, it is important to remember the dispute with HMRC covers three separate areas of tax, including hazardous mixed load (c £20m of the £53m), biomass ash (£15m of the £53m) and drill cuttings from the North Sea (£10m of the £53m), as well as penalties and interest payments (£8m of the £53m).

Augean continues to believe that it has a strong case and that its legal challenge will ultimately be successful. Of course, given the tripartite nature of the dispute, success in one area, but not another, cannot be ruled out. However, with a strengthened balance sheet (net cash of £22.8m at 30 June 2019) and generating cash at the rate of c £1.5–2.0m per month, Augean could, if successful in negotiating a credit facility of c £30m (c 1.2x EBITDA), pay off the liability to the HMRC, while awaiting the outcome of the tax tribunal expected next year.

The company believes that such a payment would be beneficial, as it would draw a line under the dispute, bringing to an end the rate of interest accrual on the unpaid potential liability, thus allowing Augean to reduce tax from the interest shield of the debt incurred to pay off the liability. It is also worth noting that HMRC interest is payable at the rate of 4% versus a figure of 2% for bank loans. Future cash flow could be used to pay down borrowings, recommence dividend payments, which have been suspended for the duration of the dispute, or to fund expansion (no policy yet enunciated). Augean has long argued that the UK waste management industry is undergoing a process of consolidation, leaving Augean as either predator or prey.

Augean argues that payment to HMRC would not constitute an admission of error (we understand the payment would be expensed as an exceptional item) but remains the only way of securing the benefits of the tax shield.

Trading update

The recent (16 October 2019) trading update from Augean confirmed the current strength of the business. A strong Q3 led the company to state that it expected the result for the year to 31 December 2019 to be 'materially ahead' of consensus figures of adjusted PBT of £16.5m. The latest upgrade is in fact the third market upgrade of 2019 and follows three upgrades in 2018, highlighting the cautious nature of management guidance. Augean pointed to a 20% increase in landfill volumes and a further 20% increase in pricing (versus 2018), increased profit from the radioactive waste business and a good performance by treatment and the North Sea Services businesses as the principal factors behind the improved outlook. Our new forecasts for 2019 and beyond reflect this latest trading update.

Longer-term business outlook

The longer-term business outlook for Augean appears encouraging, particularly in three key areas.

- We expect that the primary contributor to growth will be the Energy from Waste (EfW) incinerator ash business (revenue of £7.7m in H119, +28% in H119 vs H118). In the period FY19 to FY23 we expect ash will drive over half the growth of the non-North Sea business. Augean is only one of three operators in this market (market share c 40% and win rates of 90%) and it expects the market to grow at a CAGR of 9% until 2022 (400k tonnes pa of ash contracts will come on stream Source: Tolvik). Structural market growth is expected as additional EfW plants are commissioned in order to reduce the volume of municipal solid waste going to landfill (in the absence of recycling alternatives). However, it is worth noting that in

2018 Augean managed to grow revenue by 14%, despite no new incinerators commencing operation. In fact, Augean has already signed contracts with several incinerators that are due to commence operations shortly so there is a high degree of visibility over future revenues, although any delay in commissioning these incinerators would have obvious implications for the timing of Augean's receipt of revenues. Our forecasts assume a win rate of c 40% for the new incinerators coming on stream in the next two to three years, although the current win rate is much higher.

- Construction soils remain a key input into Augean's landfill sites. Although the market for construction waste remains flat and is linked to the market for construction (and as such can exhibit volatility), Augean was recently able to reassemble a previously successful team in this business division and construction soils played a significant role in the 39% increase in H119 treatment and disposal revenues. In the longer term, Augean expects continuing growth as a result of tighter regulation (from HMRC and the Environment Agency) on developers relating to soil disposal and the potential for soil waste from London (around one-third of the UK market) to be shipped to its Port Clarence treatment facility. Augean continues to enhance its long-term infrastructure and recently announced (18 October 2019) it has acquired an option to purchase c 90 acres of land adjacent to its East Northants Resource Management Facility (ENRMF). The acquisition of the option offers the potential to prolong the life of the site and enhance Augean's position in the hazardous waste and soil landfill market, particularly in the resource-constrained south-east of England.
- The North Sea Services business also continues to grow strongly. In H119 revenue rose to £13.7m (+43% from £9.6m in H118) and we expect further strong growth in H2 as Augean continues its work on the Curlew floating production storage and offloading (FPSO) unit, which forms part of its agreement with Shell to decommission North Sea infrastructure. Significantly, the scale of the project has increased (from £3m to £10m) as a result of a widening in the scope of the job and additional waste volumes. Augean believes that the experience gained in the Curlew project should provide it with valuable expertise in a sector that the Oil and Gas Authority estimates to be worth in the region of £58bn in total and which is expected to grow rapidly over the next 10 years (total decommissioning work of £15–20bn, of which Augean believes it will be in a position to bid for c £1bn). Market growth, allied to Augean's strategically located decommissioning sites and position as the leading provider of waste management services to the North Sea oil and gas sector, should underpin growth forecasts.

Financial forecasts

Augean demonstrated strong growth in revenue and EBITDA in H119 and the recent trading update confirmed that Q3 has been similarly strong. We have significantly revised our forecasts compared to our last published estimates (March 2018) to reflect the cost reductions, disposals and corporate reorganisation that has taken place and the strength of current trading. We have also extended the timeframe of our projections to 2023. Our revenue forecasts include a base case and a slightly more optimistic scenario, with a higher win rate for ash bids.

Revenue: In H119, Augean reported a 40% increase in adjusted revenue versus H118. We expect strong growth in H219 boosted by continuing strong performance as detailed above. Under our base case, we expect revenue to increase at a CAGR of 14% for the period 2018–2023, while our high case forecasts a CAGR of 15%. We assume most of the growth will be generated by ash, soil and North Sea Services as outlined above. The main difference between the two forecasts is due to additional waste volumes (ash) and some small accretion in the margin.

EBITDA margin: We expect an EBITDA margin of 26% for FY19 and FY20, rising to 30% in 2023 under the base case and 31% under the high case.

Exhibit 3: Base and high case key financial indicators

(£m)	2019e	2020e	2021e	2022e	2023e
Base case					
Revenue	105.1	120.1	132.0	141.4	151.4
EBITDA	27.1	31.9	36.1	41.3	45.6
EPS (p) (IFRS)	14.1	17.6	20.5	24.2	27.2
Net cash	30.0	52.7	79.4	109.7	143.9
High case					
Revenue	109.8	122.1	135.6	147.0	157.5
EBITDA	27.9	33.5	39.6	44.1	48.7
EPS (p) (IFRS)	14.8	18.9	23.2	26.3	29.5
Net cash	30.7	54.0	83.0	115.9	152.5

Source: Edison Investment Research

Strong cash generation: We do not expect any further disposals in FY19 or FY20 so cash generation is likely to remain strong (c £1.5–2.0m per month) due to the improving profitability of the business, the absence of dividend payments and capex in the range of c £5–6m. We do, however, expect a cash tax payment of £3.0m in FY19 and £4.7m in FY20 (versus £0m in H119). Our forecasts do not include any landfill tax repayment to HMRC, although, as discussed, this remains a possibility.

Net cash position: At H119, Augean had a net cash position of £22.8m and given the strong cash flow that we are forecasting, we expect this to increase to c £30.0m by FY19 and c £52.7m by FY20. By 2023, we expect Augean to have accumulated a cash pile of £143.9m under the base case scenario, rising to c £152.5m in our high case. If Augean reaches a financial settlement of its dispute with the HMRC, the net cash figures would be reduced by up to a maximum of £53m.

Tax rate: We assume a tax rate of 19% for FY19, FY20 and beyond (H119: 19%).

EPS: In light of the revenue growth and stability in the operating margin and tax rate, we forecast EPS of 14.1p in FY19 and 17.6p in FY20. For the period 2018–2023, we forecast a CAGR in EPS of 27% in our base case and 29% in our high case.

DPS: We assume no dividend payments while the uncertainty surrounding the HMRC landfill tax dispute persists. In the event of an early financial settlement however, Augean possesses the financial firepower to recommence payments. For example, an FY20 DPS of 10p a share would represent a pay-out ratio of 53% of FY20 EPS.

Valuation

To provide an indicative valuation guide for Augean we have considered peer multiples and PEG ratios for both the base case and the high case scenario. In the context of the valuation analysis it is important to remember that Augean continues to face the prospect of the payment of back taxes and penalties relating to the landfill tax liability to HMRC. Assuming full pay back of £53m, this is equivalent to c 51p/share.

Exhibit 4: Augean peer group comparable valuation

Name	Price (local)	Market cap (local, m)	EV/EBITDA (x) FY1	EV/EBITDA (x) FY2	P/E (x) FY1	P/E (x) FY2	Dividend yield (%) FY1	Dividend yield (%) FY2
Renewi	32	250	5.3	4.8	8.2	5.8	5.3	5.3
Veolia Environnement	23	13,271	6.3	6.1	17.8	16.4	4.3	4.6
Suez	14	8,463	5.8	5.7	22.4	20.8	4.9	4.9
Clean Harbors	77	4,278	9.9	9.4	37.6	32.4	0.0	0.0
Average			6.8	6.5	21.5	18.5	3.6	3.7

Source: Refinitiv. Note: Prices as at 16 October 2019.

Applying the peer group average EV/EBITDA multiples of 6.8x and 6.5x to FY19 and FY20 forecasts would indicate a valuation range of 208p to 250p (average 229p) before the impact of the

HMRC repayment under the base case. Simply subtracting 51p from this total would reduce the average valuation to 178p. Applying the peer group average EV/EBITDA multiples to the high case profile increases the average valuation to 236p before the landfill tax repayment and 185p after repayment. If our forecasts are met, Augean also offers significant earnings growth potential; therefore, it is also worth considering PEG ratios. Placing Augean on a PEG ratio of 1.0x would yield a valuation of 223p (base case) and 242p (high case). By way of comparison, we calculate that the FTSE All-Share Index is trading on a multiple of just under 1.0x, while the Support Services sector is trading on a multiple of c 1.5x.

The table below shows illustrative valuations struck before and after the payment of the HMRC tax liability with most approaches showing a valuation in the broad 175–225p range. By way of illustration, at a price of 176p/share Augean would be trading on an FY20 EV/EBITDA multiple of 5.7x and 6.5x at 200p/share (in line with the peer group averages for FY2 as shown in Exhibit 4). In the event of a takeover a change of control premium might be expected, which could add 20–30% to the totals. To put this into context, a 20% premium would represent c 30p/share at current levels, equivalent to c £31.2m, or 7.8x Augean's central costs of £4m.

Exhibit 5: Augean illustrative valuations (p/share)

	EV/EBITDA FY1	EV/EBITDA FY2	EV/EBITDA Average	PEG	EV/EBITDA + PEG Average	HMRC liability	Post HMRC payment valuation
Base	207	250	229	223	226	(51)	175
High	208	263	236	242	239	(51)	188

Source: Edison Investment Research

Exhibit 6: Financial summary

	£'000	2017	2018	2019e	2020e	2021e	2022e	2023e
31-December		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS								
Revenue		67,036	79,749	105,134	120,073	132,040	141,412	151,442
Cost of Sales		(58,810)	(67,269)	(72,734)	(85,948)	(94,727)	(98,860)	(104,538)
Gross Profit		8,226	12,480	32,400	34,125	37,313	42,551	46,905
EBITDA		14,005	19,276	27,073	31,875	36,091	41,348	45,637
Operating Profit (before amort. and except & SBP.)		8,067	12,244	19,607	24,015	27,728	32,525	36,346
Intangible Amortisation		(447)	(58)	0	0	0	0	0
Exceptionals		(2,021)	(322)	(238)	0	0	0	0
Share Based Payments		(194)	(523)	(600)	(600)	(600)	(600)	(600)
Operating Profit		5,405	11,341	18,769	23,415	27,128	31,925	35,746
Associated company		0	0	0	0	0	0	0
Exceptionals		0	0	0	0	0	0	0
Net Interest		(850)	(748)	(600)	(600)	(600)	(600)	(600)
Profit Before Tax (norm)		7,023	10,973	18,407	22,815	26,528	31,325	35,146
Profit Before Tax (IFRS)		4,555	10,593	18,169	22,815	26,528	31,325	35,146
Tax		(563)	(2,043)	(3,452)	(4,335)	(5,040)	(5,952)	(6,678)
Profit After Tax (norm)		6,654	9,453	15,555	19,080	22,088	25,973	29,068
Profit After Tax (IFRS)		3,992	8,550	14,717	18,480	21,488	25,373	28,468
Average Number of Shares Outstanding (m)		102.8	103.4	104.3	104.8	104.8	104.8	104.8
EPS - normalised (p)		6.5	9.1	14.9	18.2	21.1	24.8	27.7
EPS - normalised and fully diluted (p)		6.5	9.1	14.9	18.2	21.1	24.8	27.7
EPS - (IFRS) (p)		3.9	8.3	14.1	17.6	20.5	24.2	27.2
Dividend per share (p)		0.00	0.00	0.00	0.00	0.00	0.00	0.00
Gross Margin (%)		12.3	15.6	30.8	28.4	28.3	30.1	31.0
EBITDA Margin (%)		20.9	24.2	25.8	26.5	27.3	29.2	30.1
Operating Margin (before GW and except.) (%)		12.0	15.4	18.7	20.0	21.0	23.0	24.0
BALANCE SHEET								
Fixed Assets		68,001	61,977	60,295	58,259	55,203	51,775	47,800
Intangible Assets		20,080	19,823	19,823	19,823	19,823	19,823	19,823
Tangible Assets		46,678	40,373	38,972	36,552	33,190	29,366	25,075
Investments		1,243	1,781	1,500	1,883	2,190	2,586	2,902
Current Assets		26,589	33,371	51,794	77,593	106,775	138,944	175,241
Stocks		440	277	280	316	345	359	379
Debtors		19,570	18,628	21,500	24,555	27,002	28,919	30,970
Cash		6,579	11,162	30,014	52,722	79,427	109,667	143,892
Other		0	3,304	0	0	0	0	0
Current Liabilities		(18,989)	(23,585)	(26,800)	(30,454)	(33,462)	(35,201)	(37,423)
Creditors		(18,989)	(23,585)	(26,800)	(30,454)	(33,462)	(35,201)	(37,423)
Short term borrowings		0	0	0	0	0	0	0
Long Term Liabilities		(25,496)	(11,463)	(9,571)	(10,601)	(11,631)	(12,661)	(13,691)
Long term borrowings		(17,378)	(2,922)	0	0	0	0	0
Other long term liabilities		(8,118)	(8,541)	(9,571)	(10,601)	(11,631)	(12,661)	(13,691)
Net Assets		50,105	60,300	75,717	94,797	116,885	142,858	171,927
CASH FLOW								
Operating Cash Flow		10,530	17,413	31,353	32,497	36,875	41,184	46,019
Net Interest		(429)	(360)	(600)	(600)	(600)	(600)	(600)
Tax		(650)	(1,063)	(3,015)	(3,747)	(4,570)	(5,345)	(6,194)
Capex		(8,830)	(3,413)	(6,064)	(5,441)	(5,000)	(5,000)	(5,000)
Acquisitions/disposals		62	6,212	0	0	0	0	0
Financing		361	250	100	0	0	0	0
Dividends		(1,027)	0	0	0	0	0	0
Net Cash Flow		17	19,039	21,774	22,708	26,705	30,240	34,225
Opening net debt/(cash)		10,816	10,799	(8,240)	(30,014)	(52,722)	(79,427)	(109,667)
HP finance leases initiated		0	0	0	0	0	0	0
Other		0	0	0	(0)	0	0	0
Closing net debt/(cash)		10,799	(8,240)	(30,014)	(52,722)	(79,427)	(109,667)	(143,892)

Source: Augean accounts, Edison Investment Research

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