Driver Group Plc

Inflexion point

14 June 2022

Driver Group is reaching an inflexion point as it looks to focus operations on the more profitable and less risky geographical regions. Following the H1 period end, management transferred 25 staff in the UAE and Malaysia and several contracts to an unnamed Counterparty in exchange for an advance payment of trade receivables (£2m) and help to collect further monies owed to the Group. As measured by adj. PBT, the interim results were in the middle of the guidance range. We think the resulting reduction in the cost base to the lowest annualised run rate since FY15 is likely to have a significantly positive impact on profitability.

Interestingly, after stripping out the net cash / share (7p) the shares are trading on just 2.9x peak earnings (FY14). Our fair value estimate is unchanged at 49p / share and based on a heavily discounted peer group valuation model.

H1 results

The results for the six months to March were significant in that they resulted in the change necessary to place the Group on a longer-term footing, with the existing strategy for growth accelerated and focused on the higher margin areas. Also, the transfer of staff and contracts in the ME and APAC regions to a Counterparty, in exchange for a payment of £2m and help with trade receivables, multiplying potential cost savings, which augurs well for future years.

The Counterparty agreement will take time to work through and increase short-term uncertainty. However, the transaction reduces overall risk in the ME region and pushes the cost base to its lowest annualised run rate in seven years.

The focus on oil & gas, renewable energy and infrastructure/transportation should benefit enormously from the confidence instilled by rising energy prices in related economies. The focus on higher margin areas, coupled with an increase in fee earners and experts within the EuAm region, augurs well, particularly as profit levels will benefit from the higher utilisation rates as fee earners are seconded to the smaller geographic areas (by revenue) to service contracts.

The pipeline of opportunities remains encouraging within the EuAm region, with plans to expand via its blue-chip client base throughout the Americas. The focus of the two smaller regions will be on fewer but more significant projects, part-serviced from the EuAm and with improving scope from the largely untapped Kingdom of Saudi Arabia and South Korea.

Once the business fully emerges from the uncertainty and the deferral of contracts related to the pandemic and the Ukraine war, we think that FY22 will prove to have been an inflexion point in the Group's fortunes.

No estimates and fair value unchanged

In the absence of FY22 or FY23 estimates, reflecting the timing of the completion of the deal in UAE and low levels of visibility, we have based our fair value assumption on a heavily discounted peer group comparison model. Reassuringly, the net cash amounts to 7p / share or almost 20% of the current share price.

We retain our fair value assumption of 49p / share.

Company Data

EPIC	DRV
Price (last close)	33p
52 weeks Hi/Lo	71p/21p
Market cap	£17.8m
ED Fair Value / share	49p
Net cash (Mar '22)	£3.7m

Share Price, p

Source: ADVFN

Description

Driver Group is a multi-disciplinary consultancy group, with specialist commercial management, planning, programming, and scheduling, and dispute resolution support services to the engineering and construction industries.

Driver has 31 offices in 18 countries, including nine in the UK, four in Europe, four in the Americas, seven in APAC, and six in the Middle East and Africa. The Group currently employs 299 staff.

The business is split into the following reporting divisions: Europe and Americas (EuAm), Middle East (ME), and APAC.

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Results in line with guidance

Interim results			
£m	H1 21A	H1 22A	Change, yoy
EuAm	17.18	17.37	1.1%
ME	5.69	5.41	-5.0%
AP	2.09	1.65	-20.8%
Group revenues	24.96	24.43	-2.1%
Cost of sales	-18.50	-18.41	-0.5%
Gross profit	6.46	6.02	-6.8%
GP %	25.9%	24.6%	
Operating costs	-5.48	-5.63	2.8%
Other operating income	0.07	0.08	11.9%
EuAm	2.53	2.38	-5.9%
ME	-0.40	-0.33	-16.6%
AP	-0.28	-0.49	74.5%
Central costs	-0.81	-1.10	36.4%
Group EBIT	1.05	0.46	-55.8%
EuAm %	14.7%	13.7%	
ME %	-7.0%	-6.1%	
AP %	-13.3%	-29.3%	
Group EBIT%	4.2%	1.9%	
Interest	-0.03	-0.06	81.8%
Adj PBT	1.01	0.40	-60.3%
Exceptionals	-0.22	-0.27	
Reported PBT	0.80	0.13	-83.6%
Taxation	-0.29	-0.31	6.2%
Tax %	28.7%	76.9%	
Adj. Earnings	0.72	0.09	-87.1%
Adj. EPS (p)	1.33	0.17	-87.3%
DPS (p)	0.75	0.75	0.0%

Source: Company

The results for the six months to March were in-line with guidance at the adj. PBT level. The guidance was reduced during March to reflect the following issues with trading:

- A large loss-making fixed price contract in the APAC region – Singapore
- An unexpected drop in revenues within the ME region
- Slow cash collection within the ME region

However, at the half-year close management suggested that the operational review of the ME and APAC regions, supported by an external consultancy, would likely not go far enough. Previously, the level of cost savings anticipated by the review amounted to c.£1m. The scale of the required actions included the closure of marginal offices and a reduction in staff numbers. Despite the roll-out of new ERP software across the Group, reporting procedures failed to pick up the pace at which revenues declined in the ME region.

The focus of the new global strategy has been updated and is centred on:

- Core clients – blue chip
- Higher margin segments – oil & gas, renewable power & energy, and transportation
- Improved utilisation levels
- Cash generation/collection
- Ongoing investment in the Diales brand (expert witnesses) and high-end claims consulting (Trett)

As a result of said actions, the quality of the work would rise, and margins improve. The split of expert witnesses by region stands at 39 in the EuAm region, four in APAC and one in ME. Increasingly, the international expansion of the Group will focus on disputes (Trett) and expert witnesses (Diales). The UK will remain the focus of the retained Project Services division, reflecting lower margins and difficulties in cash collection elsewhere.

An elegant solution

Following the period's end, the Group announced the transfer of the bulk of operations of the UAE and Malaysian offices to a third-party competitor ("Counterparty"). The move resulted in annualised cost savings rising significantly ahead of previous plans (three-fold to £3m) and notably aiding cash collection in the process.

The Counterparty is to facilitate cash collection of trade receivables via a payment of c.£2m in mid-June, representing more than half of the existing regional debtor book. In addition, the Counterparty will assist Driver in collecting the £1.5m of remaining trade receivables. In exchange, the Counterparty retains several live assignments, subject to restrictive covenants relating to core clients and remaining employees of the Driver Group. Many contracts transferred to the Counterparty are lower margin, thereby enhancing Group profitability and returns.

The Counterparty will move to the Group's existing office and recompense the Group for fixtures and fittings. Driver is to move its remaining UAE business to a much smaller office (to house the retained nine staff), with contracts partially transferred to other offices in the UK and Europe to access experts and improve utilisation levels. Notably, the transfer of the staff/contracts to the Counterparty and the injection of cash significantly reduces risk within the Middle Eastern region for Driver.

Revenues decline modestly but the post-period shake up is beneficial

In recording the H1 outcome, there is no getting away from the modest decline in revenues (-2.1% to £24.2m) yoy during H1. **But, following the Counterparty agreement, the ME and APAC regions will benefit from lower costs moving forward, be more risk averse and have a revenue base part-serviced from the EuAm region, thereby improving utilisation levels and profitability.**

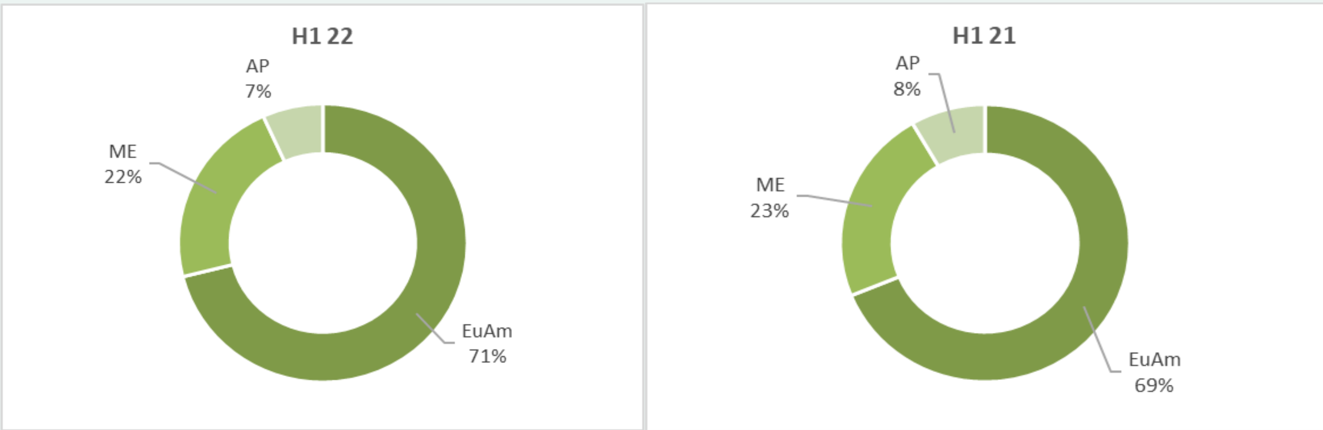
A robust performance in the EuAm region was offset by declines in the two smaller regions. The EuAm region delivered record revenues, rising 1.1% yoy to £17.4m. The key driver behind the improvement was Project Services in the UK which performed very strongly, while delivering attractive margins. The collaboration between the US and Madrid offices continues to generate new opportunities within Latin America.

The top-line declined 5% in the ME region to £5.4m, representing the second lowest outcome in the last seven years. The Oman office was downsized, reflecting an issue with a client, moving away from Project Services, and focusing on larger markets and projects within the region.

In the APAC region, revenues fell a fifth to £1.7m (H1 '21: £2.1m), the lowest level in eight years. The large, loss-making fixed price contract in Singapore has now been completed, with a new Director of Operations in the city state appointed. The Singapore office, in conjunction with experts in the UK, is making inroads in the South Korean market. Following a slow start in Q1, Australia delivered a more promising result in Q2, reflecting more robust trading at Diales.

The Malaysian office is being wound down, following the transfer of most of its staff to the Counterparty.

Split of revenues by region

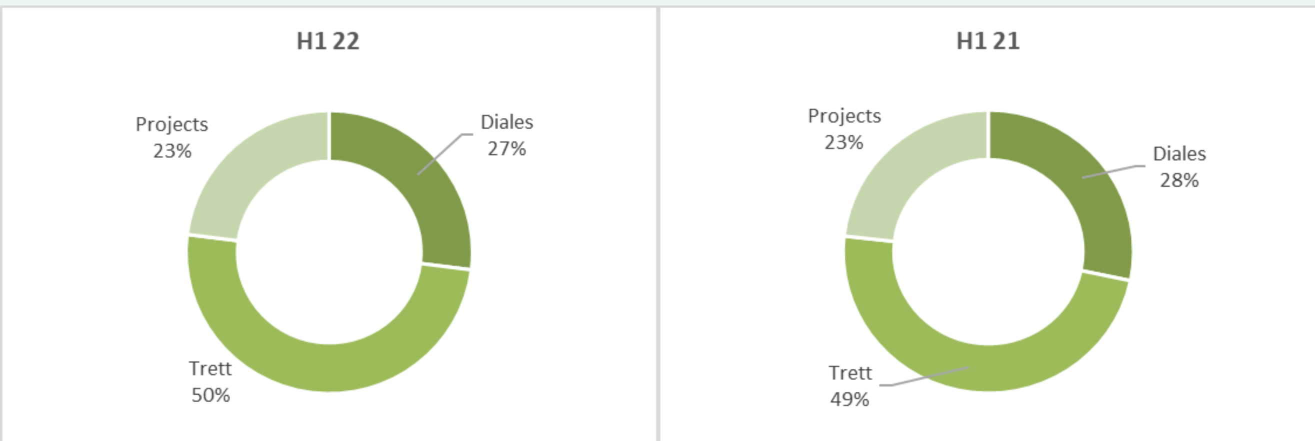


Source: Company

Fee earner headcount declined by seven or 2.3% to 294 by the end of the period. The modest decline in headcount masked a shift between regions, with recruitment in the EuAm region and lower headcount in the Middle East and APAC (more aggressively following the period end).

The strong performance of Project Services within the UK resulted in only modest changes in the split of revenues. However, we anticipate the process of reducing the scale of Project Services outside of the UK will be accelerated in H2 as part of the fine-tuning of the Group's strategy.

Split of revenues by discipline



Source; Company

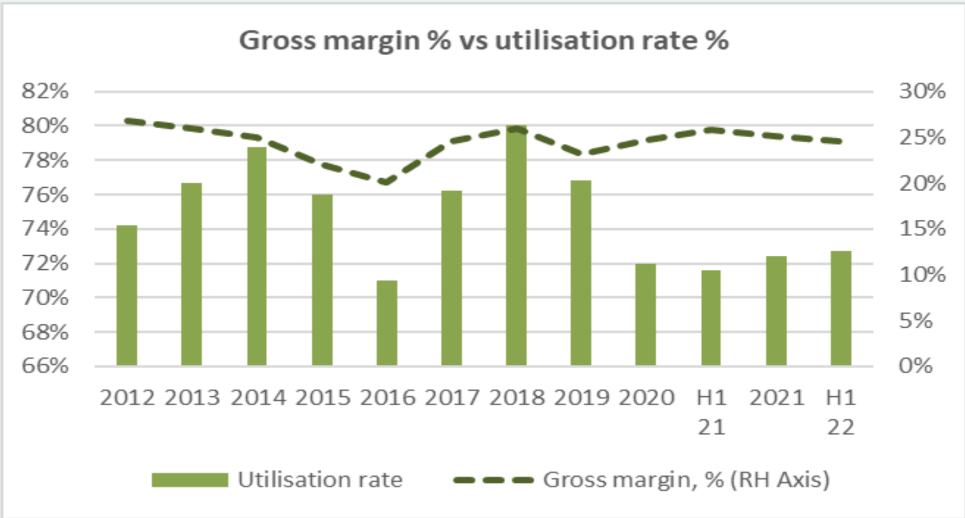
The gross margin compares relatively favourably to historic levels

Gross margins have remained in a range of 20.2% (H2 20) to 28.0% (H1 18) since H2 16, with most periods above 24% (except for FY 19 and H2 20). As utilisation levels increase, and contracts are serviced predominantly by fee earners/experts within the EuAm region, gross margins will also rise. The reduction in the cost base, which accelerated during Q3, is expected to further boost margins.

Utilisation levels declined to 69.6% Group-wide, compared to 72.1% a year ago. Two regions delivered improved utilisation rates – EuAm and APAC – to 72.7% (H1 '21: 71.6%) and 71.3% (H1 '21; 67.6%), respectively. However, the slowdown in the Middle East impacted utilisation levels which declined markedly to 60.9% in H1, down from 75.0% a year earlier. In the APAC region, utilisation levels improved to 71.3% (H1 '21: 67.6%), a reflection of the change in management and efficiencies from providing services to other parts of the Group.

The transfer of contracts/staff to the Counterparty and the subsequent increase in dependence on fee earners in the EuAm region should consign lower utilisation largely to the past.

Utilisation rate vs Gross margins



Source: Company

Costs increased modestly in H1 but are set to decline sharply from late Q3

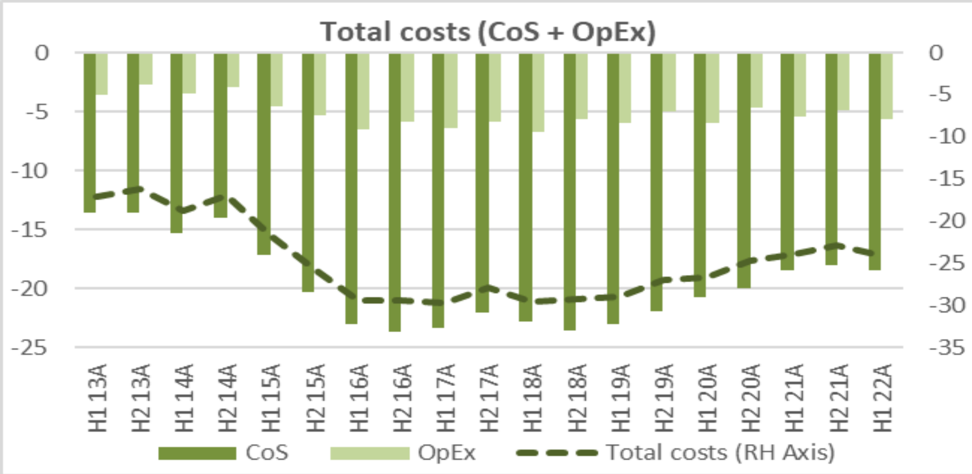
Costs peaked in H1 '17 (£29.8m), bottoming in H2 '21 (£22.9m), and increased modestly yoy in H1 '22, rising +0.3% to £24.0m. The transfer of staff and business to the Counterparty should result in a decline in costs of £3m over the next 12 to 15-month period. The annualised run-rate is likely to fall to c.£45m (that is, H1 22 costs x2, minus £3m), before allowing for revenue growth related variable cost rises.

It is worth noting that revenues last fell below this level (£48m) in FY14, suggesting strong potential for profitability growth over the next 12 to 24 months, notwithstanding any rise in variable costs as revenues improve.

One should also bear in mind that during H1, revenues continued to be affected by the legacy of the COVID-19 pandemic and the war in Ukraine, resulting in deferred starts to contracts. Once such uncertainties wane and the higher energy prices improve confidence levels, particularly in the Middle East, revenues should move north of current levels, all things being equal.

As such, we remain optimistic about the medium-term outlook for Driver Group.

Cost progression, £m

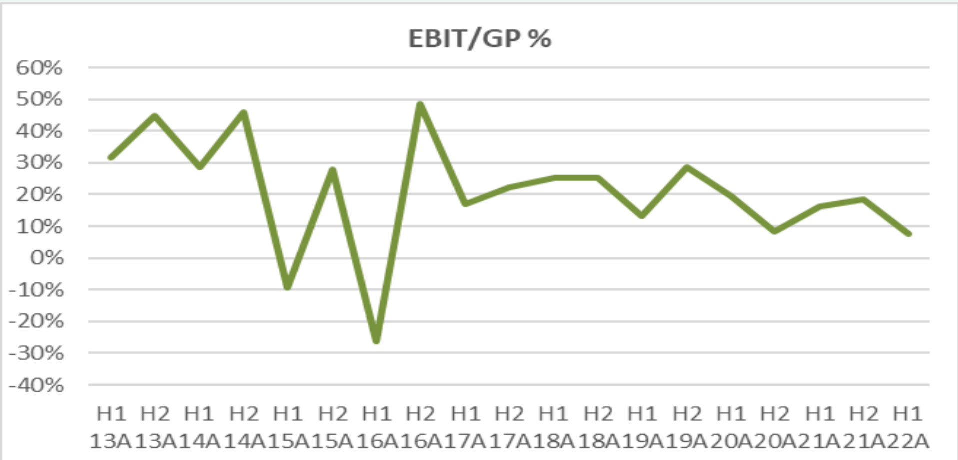


Source: Company

The level of gross profit levels feeding through into EBIT in H1 '22 was the lowest since H1 '16. We think the developing strategy to move to higher margin areas, with blue chip clients (improving cash collection) and at increasing levels of utilisation, should lead to a rise in gross margin.

With costs set to decline markedly, we anticipate that the proportion of gross profit feeding through to EBIT should improve materially from Q4 '22 onwards.

Operational leverage



Source: Company

The EuAm region continues to be the driver of Group profitability

By region, EuAm continues to be the driver of the Group based on top-and-bottom-lines, reporting adj. EBIT of £2.4m (pre-central costs), with an associated margin of 13.7%. Costs in the region rose 2.3% yoy to £15m, representing a current peak and reflecting the increase in headcount to facilitate the growth in Project Services, the USA and in Spain (with the number of experts in the region rising to 39).

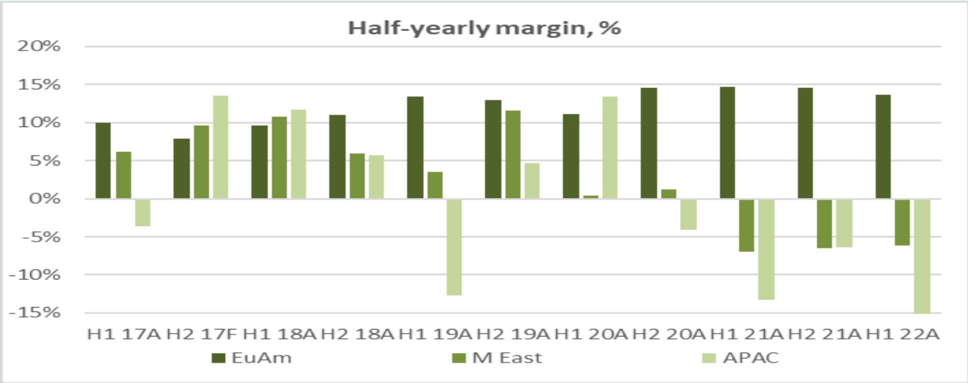
The Netherlands and German offices remain profitable as they continue to serve large clients in northern Europe, and the Paris office returned to profitability following a change in the senior management team.

The significant decline in utilisation levels, coupled with the modest fall in the top-line within the ME region, explains the ongoing H1 loss of £0.3m, albeit modestly ahead of the £0.4m delivered in the comparative period. Operating margins, before central costs, improved yoy to -6.1% (H1 '21: 7.0%.

The loss-making contract in Singapore resulted in the lowest margin on record in the **APAC region**, at -29.3%, albeit the loss was restricted at the EBIT level to £0.5m (H1 '21: -£0.3m) before central costs.

Following the completion of the contract, combined with appointment of a new COO, Tom Comerford, and a new MD in Singapore, we expect no further repeat of the issue moving forward.

Divisional margin progression



Source: Company

Guidance met

The guidance provided in mid-March amounted to an underlying H1 PBT of between £0.3m and £0.5m, which reflected the loss-making contract in Singapore and a drop in revenues in the Middle East. The £0.4m outcome was in the middle of the anticipated range and is after net interest of £0.1m. The EBIT margin amounted to 1.9% (H1 '21: 4.2%).

Taxation paid amounted to £0.3m, reflecting the robust contribution from the EuAm region, resulting in adj. PAT of £0.1m. The maintained dividend of 0.75p per share was not covered by adj. EPS during H1. Rather, the payout reflects a combination:

- The net cash on the balance sheet
- The confidence of the Board in the outlook
- The recent deal with the Counterparty to improve cash collection and further reduce the cost base
- The strong pipeline of opportunities in the EuAm region

We think the previously guided cash return is likely to prove more significant in the current year than dividends. However, we anticipate some improvement in the payout ratio in FY23 and beyond given cash levels. **In our view, profitability should only grow from these levels.**

Balance sheet and cash flow

At the period end, net cash stood at £3.7m, representing a £2.8m shortfall from the September 2021 year end (£6.5m). The key movements in cash during the period included:

- EBITDA of £0.6m
- An increase in working capital of £1.9m, of which £1.3m reflected an increase in debtors within the Middle East region

- Capex of £0.6m, including the new ERP software and the fit out costs to the office in UAE
- Tax of £0.4m highlighting profits within the EuAm region, and
- Dividends of £0.4m.

Approx. £0.75m of the trade debts arising in Oman have been repaid during Q3. Net assets declined by £1.1m during the period to £20.1m, after the change in working capital, capex and reduction in cash levels.

Return of cash

The imminent receipt of £2m from the Counterparty, plus the net cash on the balance sheet, results in a nice problem for Driver. Management has considered a return of cash to investors, which is likely to materialise in the form of a special dividend or a share buy-back programme. We anticipated a related announcement before the September year-end.

The agreement to transfer the bulk of Driver Group's UAE office, plus others in Malaysia (25 employees in total) and several live assignments to the unnamed third party, is in exchange for the advance payment of a significant portion of the regional debtor book and assistance in collecting a further £1.5m owed to the Group by customers.

Estimates suspended – despite the strong pipeline

We continue with our suspension of financial estimates as we expect the transfer of most of the UAE business to the Counterparty to take time to fully complete. Generally, revenues tend to be volatile owing to projects running across more than one reporting period and tend to be lumpy as a result. Summer is generally quieter (July and August, as staff take vacations), albeit with a rebound in September. Also, the ongoing economic uncertainty further restricts visibility.

That said, cost-cutting had been identified in the two smaller regions, initially leading to approximately £1m of savings. The disposal of a team and related assignments to the above Counterparty results in the annualised cost savings increasing to a figure closer to £3m, benefitting H2 '22 and H1 '23 initially. Increasingly, projects in the ME and APAC regions will benefit from utilising professionals from the UK and elsewhere in Europe.

There continues to be a strong pipeline of opportunities in the EuAm region, with the cooperation between the Madrid and New York offices helping secure new projects in central and South America. There are plans to target eastern Canada, in addition to a cross-fertilisation of clients across the Americas from existing offices. Targeted vicinities include Washington DC, Florida, Houston and California, Brazil, Colombia, Peru, Chile, and Mexico, focused on claims support and expert witnesses.

The expectation is that following the recent moves in the UAE, the ME region will see a revised focus on a smaller number of large projects from a skeletal cost base. There is a growing pipeline of opportunities in Africa. In the Middle East, the reduced headcount focuses on higher margin dispute work predominantly in Oman, Saudi Arabia, and Qatar, with high levels of investment anticipated in the latter following this year's FIFA World Cup.

The focus in the APAC region will narrow following the decline in the significance of its Malaysian operation, following the transfer of related headcount to the Counterparty. The preferred regions for expansion include Australasia and Southeast Asia, including South Korea, identifying and targeting key accounts in the Group's preferred market segments.

We think the above augurs well for the Group, providing a lower cost base, improved utilisation, and a focus on higher margin areas. FY22 may well, as a result, prove to be the nadir in terms of profitability.

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