Driver Group

Reasons for optimism

24 January 2022

Despite the delay, the results for the year to September were in-line with expectations at the adj. PBT level, with the level of dividend doubling y-o-y. The latter highlights the Board's confidence in improved trading in H2 2022 and the levels of net cash. Q4 '21 enjoyed a pick-up in activity levels, which continued into the first two months of the new year, albeit disrupted briefly by Covid in December. With costs at a multi-year low and a rising number of fee earners operating in the added-value areas and on an international basis, we see utilisation rates and gross margins rising with them. As recent Covid restrictions ease, we expect the pipeline of opportunities to convert into higher activity levels.

We have reduced estimates to reflect the disruption caused by a slowdown in December on the back of Covid-related restrictions and, as a result, lowered our fair value estimate to 62p / share (22% above the current share price).

Although results were in-line with expectations at the adj. PBT level, the FY21 outcome represents the lowest levels of revenue and profitability since 2015. Now that Covid restrictions increasingly look to be behind us, we see reasons for optimism over the short to medium term. **As activity levels improve, so will fee earner utilisation and, in turn, gross margins.**

Further rationalisation of the cost base has taken place, reducing the number of fee earners operating in the lower margin Project Services, with several offices downsized in underperforming regions. Hiring has, however, continued but with a **focus on the added value dispute resolution and expert witness areas of the business.** Also, the fee earners are increasingly operating across international offices, **thereby resulting in higher utilisation rates**. The newer Madrid and NYC offices are performing well.

The EuAm region continues to perform well, accounting for some 69% of revenues and 100% of profitability. The smaller ME and APAC regions have been more badly affected by a variety of disruptions, with the loss of the Singapore team to a competitor having a marked effect in the latter. The smaller regions moved into losses during FY21, resulting in the cost rationalisation and a firmer base once activity levels improve.

With a lot of cost rationalisation behind them, we believe that Driver is well placed to benefit from improved activity levels, likely from H2 '22 onwards. The operationally geared model suggests that this should rapidly translate into higher profitability levels and, in turn, a progressive dividend policy.

Our fair value stands at 62p/share, representing a 22% premium to the current price.

Forecasts

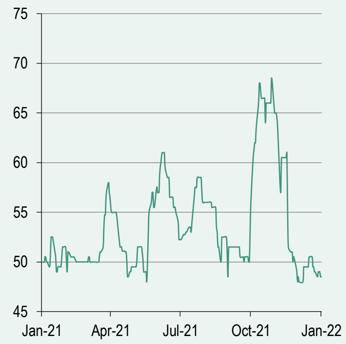
Y/e 30 Sep, £m	2019A	2020A	2021A	2022E	2023E
Revenue	58.5	53.1	48.8	50.0	52.5
Adj. PBT	2.6	2.5	2.0	2.6	3.0
Adj. EPS (p)	3.7	4.0	2.4	3.5	4.2
Div. Yield (%)	1.5	1.5	3.0	3.2	3.6
P/E (x)	13.6	12.6	21.0	14.2	12.1
EV/EBITDA (x)	7.0	4.8	6.0	4.6	3.7

Source: ED estimates, Company historic data

Company Data

EPIC	DRV
Price (last close)	50p
52 weeks Hi/Lo	71p/46p
Market cap	£27.2m
ED Fair Value per share	62p
Net cash (09/21)	£6.5m

Share Price, p



Source: ADVFN

Description

Driver group is a multi-disciplinary consultancy group, providing clients with specialist commercial management, planning, programming, and scheduling, and dispute resolution support services to the engineering and construction industries. Driver group has 31 offices in 18 countries, including eight in the UK, five in Europe, four in the Americas, seven in APAC, and seven in the Middle East and Africa.

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

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FY21 preliminary results

2021 prelims, half-year split

Y/e 30 Sep, £m	H1 20	H2 20	FY20	H1 21	H2 21	FY21	YoY change, %
Revenue	28.0	25.0	53.1	25.0	23.8	48.8	-8.1%
Cost of sales	-20.7	-19.2	-39.9	-18.5	-17.9	-36.4	-9.0%
Gross profit	7.3	5.8	13.1	6.5	5.8	12.2	-6.8%
Gross margin	26.0%	23.3%	24.7%	25.9%	24.3%	25.1%	
OpEX	-5.9	-4.7	-10.6	-5.5	-4.8	-10.3	-3.2%
Other operating income	0.1	0.1	0.1	0.1	0.1	0.2	49.2%
Op Profit	1.4	1.2	2.6	1.0	1.1	2.1	-19.1%
Operating margin, %	5.1%	4.8%	4.9%	4.2%	4.5%	4.3%	
Net interest	-0.1	-0.1	-0.1	0.0	-0.1	-0.1	-3.5%
Adj. PBT	1.4	1.1	2.5	1.0	1.0	2.0	-19.8%
Exceptional items	-0.1	-0.6	-0.8	-0.2	0.1	-0.1	
Reported PBT	1.3	0.5	1.7	0.8	1.1	1.9	7.1%
Taxation	-0.3	-0.1	-0.4	-0.3	-0.5	-0.7	87.0%
Tax, %	22.0%	8.6%	15.9%	28.7%	45.7%	37.1%	
Adj. PAT	1.1	1.0	2.1	0.7	0.5	1.3	-40.0%
Adj. EPS (p)	1.9	2.1	4.0	1.3	1.1	2.4	-40.0%
DPS (p)	0.00	0.75	0.75	0.75	0.75	1.5	100.0%
Net cash/(debt)	3.3	4.9	8.2	7.2	-0.8	6.5	-21.3%
Net assets	20.1	20.4	20.4	20.8	21.3	21.3	4.3%

Source: Company

The results for the year to September 2021 were in-line with our expectations at the adj. PBT level. Although revenue and gross profits were 2.2% and 6.0% below our estimates, at £48.8m and £12.2m, respectively, the gross margin increased y-o-y to 25.1% (FY20; 24.8%) and operating margins declined modestly to 4.3% (in part a factor of lower revenues and the operationally geared nature of the business model).

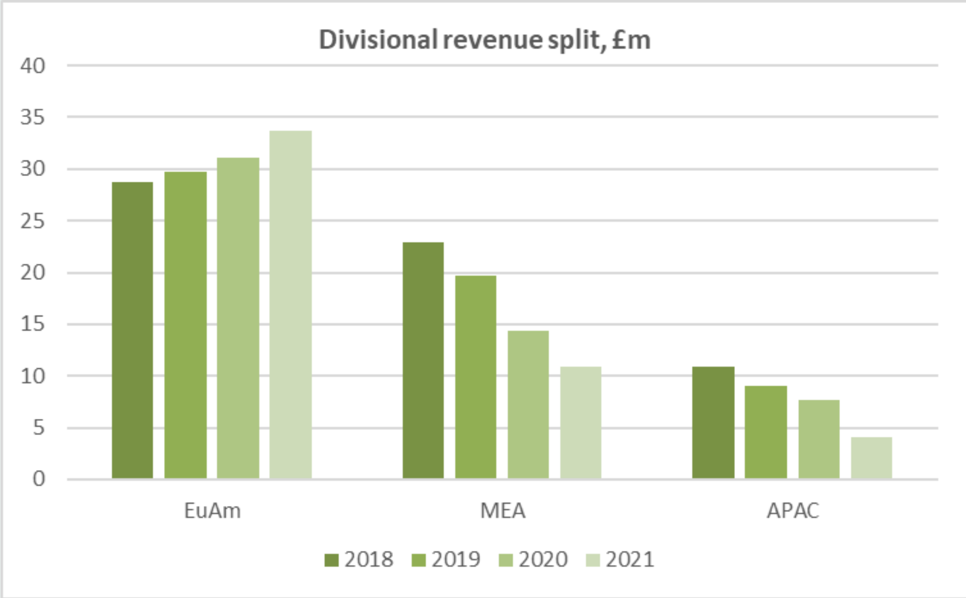
Adj. PBT was 0.3% above our target, at £2.0m. Reported 'clean' EPS amounted to 2.4p, some 17.9% below our estimate, reflecting the higher tax charge. Tax paid rose markedly y-o-y to £0.75m (FY20: £0.4m), increasing to an effective rate of 40.3%. The rise in tax reflected a £0.46m increase in UK tax payable to £0.54m, compared to £0.09m a year earlier, due to a combination of losses/declining profitability in lower taxation jurisdictions.

While revenues fell again during H2, the rate of decline moderated from H1, suggesting stabilisation in the top-line. Investors should remember that the pandemic began approximately halfway through FY20, affecting decision making on the order book which is usually limited to a few months. As per the strategic review, the move away from lower margin projects, in favour of expert witness/Diales and technical activities, which typically produce added-value returns, was always likely to see an element of transition.

The focus of the strategic review is to improve utilisation rates, retain key staff, markedly increase the proportion of higher margin work, broaden the regional presence, and strengthen internal systems. We witnessed progress on all fronts during FY21. Although margins remain some way below the double-digit target, they rose to 4.5% during H2 21, mainly reflecting the decline in OpEx compared to H1 21.

The previous trend in revenues continued into FY21. **The EuAm region now accounts for 69.2% of overall activity**, rising by a CAGR of 5.5% since 2018. Conversely, the ME and APAC regions have witnessed a more than halving of revenues over the same period, at CAGRs of -21.9% and -27.8%, respectively. The APAC region accounted for just 8.4% of activity in FY21, down from 17.5% of revenues in FY18.

Divisional split of revenues



Source: Equity Development Ltd/Company

EuAm division

Europe and the Americas (EuAm) delivered revenues 8.7% ahead of the previous year to £33.7m. The resilient performance of the UK (driven by strong progress within Driver Trett and the North East England office) and strong performances in Central Europe and the USA, were the key drivers of the overall regional improvement.

The encouraging performance in North America reflected both the new office opening in NYC but also the related effect of additional customer wins in Canada. The UK remains the single largest contributor to revenues, at c.49% (FY20: 41%).

Consultant utilisation levels rose encouragingly during FY21 to 7.9% (FY20: 72.1%), notwithstanding the 5% headcount increase in the UK and the Americas. The newer NYC and Madrid offices are generating leads in Latin America. Business development activity remains high in the UK, with all offices now open on at least a part-time basis.

EBIT increased 24% in the EuAm region to £4.9m, highlighting the combination of the top-line growth, improved utilisation levels and the high levels of operational gearing within the business model. Operating margins improved to 14.7% (before central costs) and compared to 12.9% in the prior year. The improvement at the EBIT level was despite the move to a loss in France, which followed the departure of the branch manager within the Paris office, and the additional cost of the new offices in the US and Spain.

The US reported an overall profit in its first year of trading, reinforcing the reasons to invest.

ME division

The second largest region, the Middle East & Africa (ME), underwent a challenging year, with revenues declining 24.0% to £10.9m and experiencing a £0.8m turnaround at the operating level to a loss of £0.7m. The loss includes severance payments as headcount declined by approximately one-third as several offices were aligned to focus on more profitable workstreams. Utilisation rates were static y-o-y at 72.3%. The rate of decline in the top-line reduced during H2, coupled with a reduction in half-yearly loss.

Of note was the strong performances in Qatar y-o-y, with a presence established in Saudi Arabia to drive future growth in the region. The UAE, Oman and to a lesser extent, Kuwait, delivered marked declines compared to the previous year, resulting in headcount reductions. The improved performance commenced during Q4 continued into the new year. The focus in Abu Dhabi was shifted during the year in favour of oil & gas, with the Kuwait office now managed from Qatar. The closure of the Project Services business in parts of the Middle East was also a contributory factor to the lower headcount.

APAC division

Revenues within the Asia Pacific region (APAC) declined 46.3% during FY21 to £4.1m, with strong growth seen in Australia, which remined profitable and heavy declines experienced in Singapore and Malaysia. The loss of a team to a competitor in Singapore at the beginning of the period was significant, notwithstanding the recruitment of two experienced staff during H1. Also, the region bore the brunt of the COVID-19 related disruption to the business.

Utilisation rates in the region improved modestly to 72.3% (FY20: 72.0%), as headcount was adjusted in line with revenues. That said, expert witness hires were added to the Australian business, potentially improving the outlook for margins in the country. A highlight during the year was the opening of an office in Seoul, South Korea to support revenues in the country and to secure potential projects with large Korean contractors/engineers globally.

Regional EBIT declined to a loss of £0.4m (FY21: profit of £0.5m), resulting in margins of -9.9% (FY20: +6.7%).

Utilisation rates

There is some correlation in the direction of travel between utilisation rates and the gross margin. We highlight this in the chart below. We note that the highest gross margin of recent years (26.0% in FY18) coincided with the strongest utilisation rate (80.0%).

Gross margin (%) vs. Utilisation rates (%)

Source: Equity Development Ltd, Company

Given the hiring of new expert witnesses and technical experts, who can undertake work internationally, we expect utilisation rates to creep up from here. The new ERP system is also likely to help manage utilisation levels.

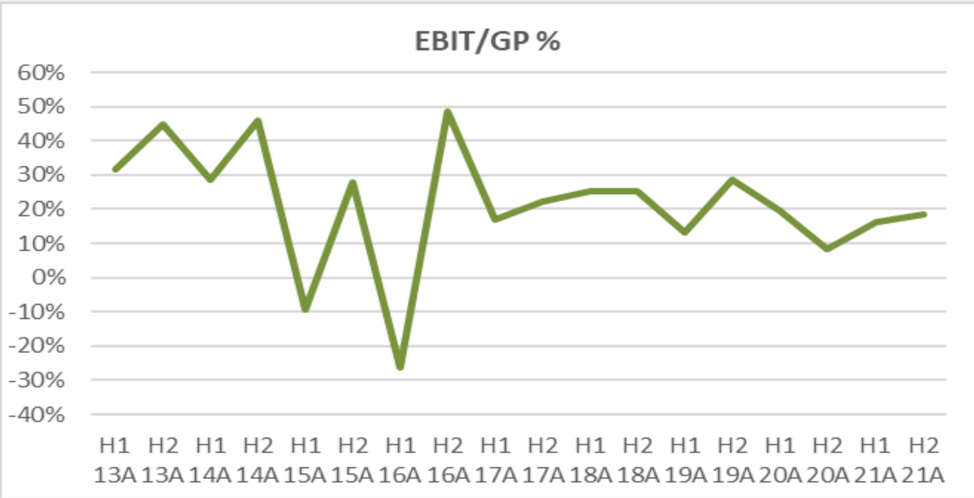
Recovery from the pandemic-led recession should further benefit utilisation rates.

Operationally geared model

We highlight in the chart below the extent of **the operationally geared model.** The peak of gross profit conversion into EBIT was in H2 16 (at 48.7%), with the second half of both 2013 and 2014 also demonstrating high levels of 44.6% and 46.0%, respectively. We note that in H2 2016, the monthly run rate of revenue amounted to more than £5.0m per calendar month. Costs rose markedly from FY2012 onwards following the acquisition of Trett Consulting and the opening of several offices globally from 2013, the launch of Diales in Asia and the purchase of Initiate consulting in late 2014.

Costs have been reduced markedly following the start of the pandemic. Should the revenue run rate increase meaningfully above £4.5m (based on costs averaging £4m pcm over the last 18 months), we are likely to witness profitability approaching the levels of H2 '16.

Operationally geared model



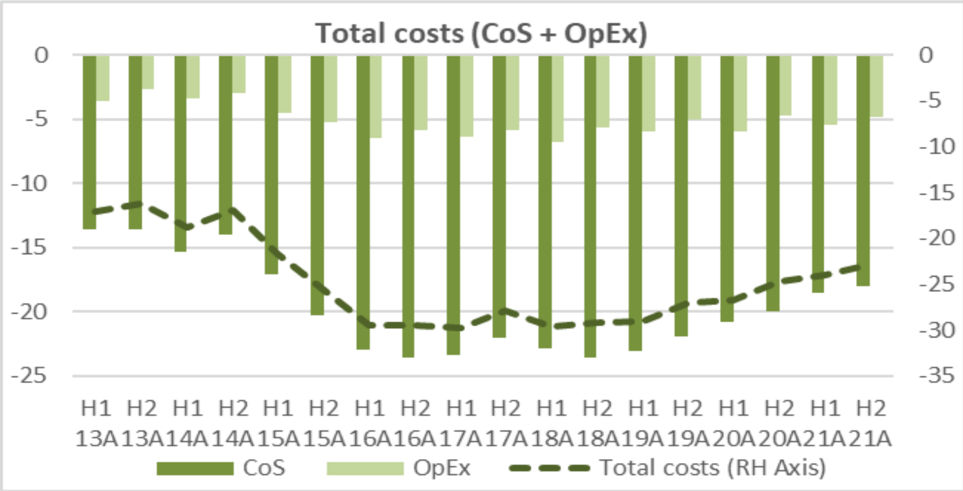
Source: Equity Development Ltd/Company

We highlight the cost progression below. It is worth mentioning that OpEx is now back to the level of H1 '15. We think introducing the new ERP system in Q2 '22 is likely to produce increased data to enable management to monitor the business more efficiently.

Fee earner headcount declined during the year by 50 to 273, with utilisation rates rising to 72.4% (versus 72.1% during H1 and 72.0% for FY20). Significantly, the number of technical experts within Diales increased to 50 by the end of FY21 and compared to 47 a year earlier.

On this basis, the Diales brand accounted for 18.3% of fee earners by the end of the period (FY20: 14.6%), with the aim of increasing EBIT margins moving forward.

Half-yearly cost progression (CoS & OpEx), £m



Source: Equity Development Ltd/Company

Other operating income increased to £0.19m (FY20: £0.13m) and with minimal interest payable, reflecting the level of net cash unchanged y-o-y at £0.11m, adj. PBT declined 19.8% to £2.0m.

Adj. EPS declined more significantly than Adj. PBT, reflecting the marked increase in the tax charge to 40.3% (FY20: 15.9%). With the reinstating of the interim dividend, the payout for the year doubled to 1.5p, covered 1.6x by earnings. We anticipate that the level of dividend cover will increase in the forecast period, notwithstanding the level of net cash.

The level of net cash fell to £6.5m (FY20: £8.2m) and reflected higher working capital, the rise in taxation, and a modest increase in capex (new ERP system). The increase in working capital reflected the more challenging market conditions, some clients taking longer to settle than under normal circumstances and the reduction in creditors, which included the severance of the previous CEO (£0.5m).

Delay to results

The preliminary results were delayed by six weeks. The Board and the auditors required additional time to sign off the results due to an investigation into its main customer in Oman, becoming aware of the issue in early December. Both the auditors and Driver Group are confident that the investigation does not involve the Group's operations in Oman, and as such, the former have now signed off the accounts.

Financials

The combination of the Q4 uptick in trading and the positive pipeline augurs well for the FY22 outlook. With the positive trend continuing into Q1 '22, a degree of uncertainty that fed into customer decision-making appeared to be ease. However, the Omicron variant of Covid slowed progress in December. We are hopeful that as restrictions are eased globally the 'wobble' in trading at the end of the quarter is consigned to history. The trading update highlighted a view that H2 is likely to prove stronger than H1.

The outlook statement highlighted a run-rate of activity that is consistent with profit of more than £3.5m, once the pandemic related uncertainty eases and significantly, utilisation rates rise (peaking at 79.2% in July). Trading in December resulted in the average monthly revenue declining to £4.0m, but if levels return to those seen in the earlier part of the quarter, the run-rate profitability will be some way north of our new FY22 adj. PBT expectation.

The pipeline of opportunities remains strong, especially within the engineering and construction sectors, where the work backlogs have risen inexorably during the pandemic.

The focus of hiring for the international, rather than just local, offices, and the addition of further experts within Diales, is positive. Projects should become a less significant part of the business. The additional hires come at a cost, but because they can work internationally and are not consigned to a singular office, this will help maintain high utilisation levels.

A balancing item of hiring international/Diales experts has been the consolidation of teams/management within the smaller regional divisions, ME and APAC, resulting in a greater control of headcount related costs. We expect further annualised benefits of this continuing into FY22.

Should run rates in activity improve beyond the £4m average witnessed during Q1, we believe the reduced estimates are likely to prove conservative.

Change in estimates

£m	Old FY22E	New FY22E	Change, %	Old FY23E	New FY23E	Change, YoY
Revenue	53.1	50.0	-5.8%	n/a	52.5	5.0%
Op Profit	3.3	2.7	-19.3%	n/a	3.1	16.2%
Adj. PBT	3.2	2.6	-19.9%	n/a	3.0	17.2%
Adj. EPS (p)	4.9	3.5	-28.0%	n/a	4.2	17.2%
DPS (p)	1.75	1.60	-8.6%	n/a	1.8	12.5%
Net cash	7.1	7.2	1.8%	n/a	8.0	10.0%

Source: Equity Development

We highlighted the operationally geared nature of trading earlier within this document and the Board's strategy to achieve double-digit margins by 2025 (last experienced in H2 '16). Our projected 5.9% operating margin in FY23 suggests strong upside, on modest gross margin improvement. Even a CAGR of 6% in top-line growth from FY23 to FY25 would result in revenues of £59m.

Applying a 10% operating margin to this would see EBIT of £5.9m and adj. PBT of £5.8m / adj. EPS of 9.3p (more than double our current FY23 projection).

Summary Profit & Loss					
Y/e 30 Sep, £m	**2019A**	**2020A**	**2021A**	**2022F**	**2023F**
Europe & Americas	29.8	31.0	33.7	35.0	36.5
Middle East	19.6	14.4	10.9	11.0	11.4
APAC	9.1	7.7	4.1	4.0	4.6
Revenue	58.49	53.07	48.77	50.01	52.52
CoGS	-45.0	-39.9	-36.5	-37.4	-39.3
Gross profit	13.5	13.1	12.2	12.6	13.3
Gross margin (%)	23.1%	24.7%	25.1%	25.2%	25.3%
Op costs	-11.0	-10.6	-10.3	-10.1	-10.3
Other Op. income	0.2	0.1	0.2	0.1	0.2
Operating profit	2.7	2.6	2.1	2.7	3.1
Op margin (%)	4.6%	4.9%	4.3%	5.3%	5.9%
Net Interest	-0.1	-0.1	-0.1	-0.1	-0.1
Associates	0.0	0.0	0.0	0.0	0.0
PBT (Adjusted)	2.6	2.5	2.0	2.6	3.0
Exceptionals	0.6	-1.5	-0.1	0.0	0.0
PBT (Reported)	3.2	1.0	1.9	2.6	3.0
Tax	-0.5	-0.4	-0.7	-0.6	-0.8
PAT	2.7	0.6	1.1	1.9	2.3
Minority interests	0.0	0.0	0.0	0.0	0.0
Earnings	2.7	0.6	1.1	1.9	2.3
Ordinary Dividends	-0.7	0.0	-0.8	-0.9	-1.0
Retained Profit	2.1	0.6	0.3	1.1	1.3
EPS (Adjusted) (p)	3.7	4.0	2.4	3.5	4.2
DPS (p)	0.8	0.8	1.5	1.60	1.8
Ave no of shares (FD) (m)	56.8	54.7	54.3	54.3	54.3

Source: Company historics, Equity Development estimates

We have not factored in significant capex over the medium-term nature of our projections, except for the new ERP system, which is set to be operational during the current quarter.

The dividend, which we expect to rise to £0.9m during FY23 is likely to a relatively major cash expense, with working capital continuing to be the largest. Dividend cover is set to increase to 2.3x by FY23, from 1.6x in FY21.

Summary Cash Flow					
Y/e 30 Sep, £m	**2019A**	**2020A**	**2021A**	**2022F**	**2023F**
Operating profit	2.7	2.6	2.1	2.7	3.1
Depn. & Amortn.	0.4	1.4	1.2	1.3	1.4
Working capital movement	-2.7	2.3	-2.3	-1.3	-1.6
Other	0.0	0.0	0.0	0.0	0.0
Operating cash flow	0.4	6.3	1.0	2.7	2.8
Net Interest	-0.1	-0.1	-0.1	-0.1	-0.1
Taxation	-0.6	-0.5	-0.8	-0.6	-0.8
Net capex	-0.3	-0.3	-0.5	-0.4	-0.4
Operating FCF	-0.7	5.3	-0.4	1.6	1.6
Net (Acquisitions)/Disposals	0.0	0.0	0.0	0.0	0.0
Dividends	-0.3	-0.7	-0.4	-0.8	-0.9
Share Issues	-1.0	0.0	0.0	0.0	0.0
Minority payment	0.0	0.0	0.0	0.0	0.0
Other financial	0.4	-1.8	-1.0	0.0	0.0
Increase Cash/(Debt)	-1.5	2.8	-1.7	0.8	0.7
Opening Net Cash/(Debt)	6.9	5.4	8.2	6.5	7.2
Closing Net Cash/(Debt)	5.4	8.2	6.5	7.2	8.0

Source: Company historics, Equity Development estimates

A factor of the business is relatively high working capital levels, which reflects the long-term nature of many of the projects undertaken (and in some jurisdictions, the extended time for a minority of customers to pay outstanding balances).

Significantly, **we anticipate the cash flow to remain robust and positive**, with the level of net cash rising to £8.0m by the end of FY23, which equates to 14.7p / share and up from the current £6.5m and 11.9p / share (or 23.6% of the current share price).

Abbreviated Balance Sheet					
Y/e 30 Sep, £m	**2019A**	**2020A**	**2021A**	**2022F**	**2023F**
Intangible Assets	3.0	3.2	3.5	2.5	1.4
Tangible Assets	0.7	0.5	0.4	0.5	0.5
Investments/other	0.3	2.1	2.1	2.1	2.1
Net Working Capital	10.2	7.4	9.8	11.1	12.7
Capital Employed	14.1	13.2	15.8	16.1	16.7
Other	0.0	-1.0	-1.0	-1.0	-1.0
Net Cash/(Debt)	5.4	8.2	6.5	7.2	8.0
Provisions Liabilities/Charges	0.0	0.0	0.0	0.0	0.0
Net Assets	19.5	20.4	21.2	22.3	23.7

Source: Company historics, Equity Development estimates

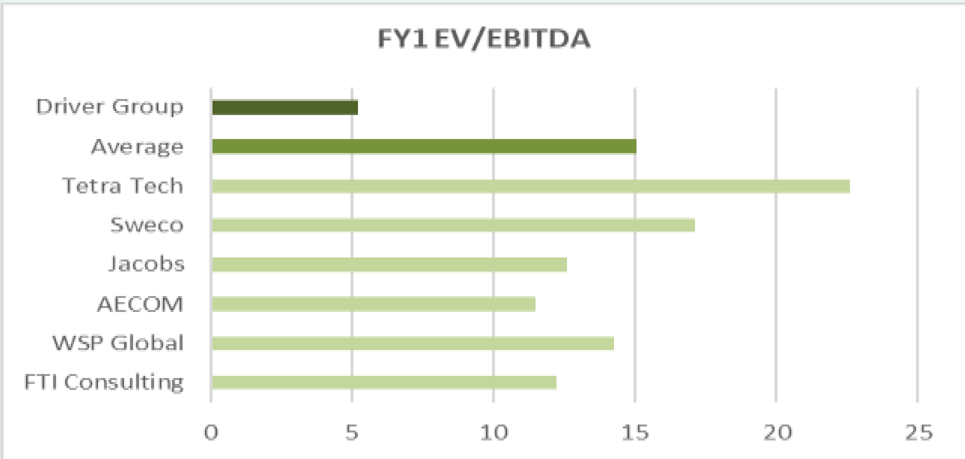
Valuation

We have constructed a comparative peer group valuation model to determine the fair value of Driver Group's shares. Since Driver Group is markedly smaller than its quoted international peers, we have applied a bigger discount in generating a suggested fair value using a peer group comparative valuation model. The valuation model uses FY22 market consensus expectations only. As the following charts demonstrate, Driver Group sits at **a substantial discount to its peers** using forecast year one (FY1) EV/EBITDA, PER, EV/Sales and Price to book valuations.

Applying a 20% discount suggests a fair value of 70p / share, representing a 38.3% premium to the current price.

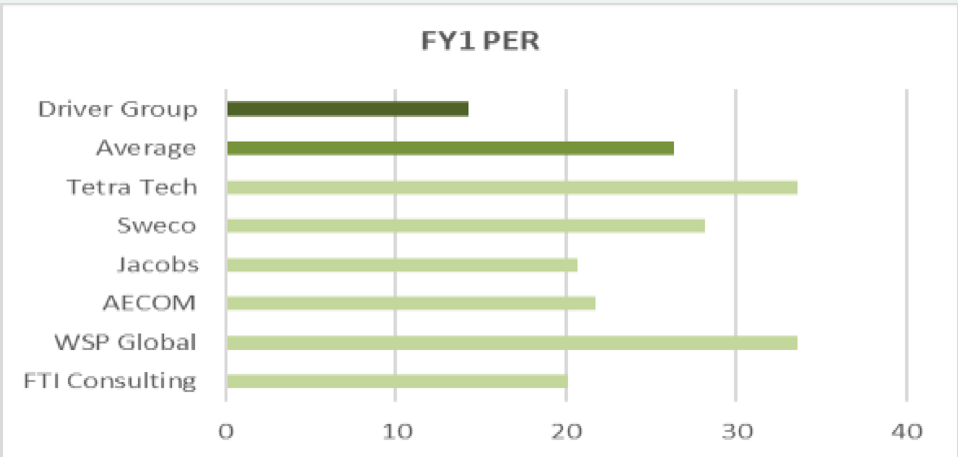
Increasing the discount to a substantial 40% still results in a fair value ahead of the current market capitalisation, equivalent to 53p / share and representing a premium of 5.6%. Taking the middle ground, applying a 30% discount suggests a fair value of 61.7p, some 22.2% north of the current price.

Peer group comparison: FY1 EV/EBITDA



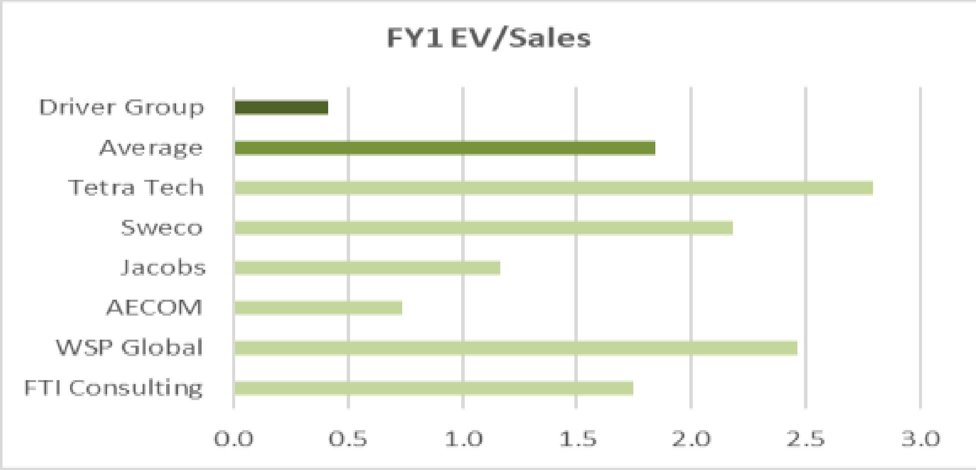
Source: Market Screener, Equity Development Ltd

Peer group comparison: FY1 PER



Source: Market Screener, Equity Development Ltd

Peer group comparison: FY1 EV/Sales



Source: Market Screener, Equity Development Ltd

Peer group comparison: FY1 Price/Book

Source: Market Screener, Equity Development Ltd

Conclusion

We have updated our fair value for Driver Group to 62p (from 72p) per share, utilising the valuation models above and conservatively settling on the 30% discount to the comparative peer group average.

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