REACT Group plc

All set to clean up

12 April 2023

We see a promising outlook for REACT Group plc as a nimble, fast-growing business operating in a large, fragmented market with significant scope for rationalisation. Approximately 85% of revenues are recurring, with margins mostly high and on an improving path with a target of reaching 30% at the gross profit level by FY24. The cash generative LaddersFree operation is scalable and an important part of the Group's growth profile. Cross selling of the Group's services to a broader customer base is also expected to underpin expansion of both the top and bottom lines.

Our various valuation models suggest a fair value of 1.7p per share, which is significantly ahead of current levels.

Healthy results to build upon

The outcome for FY22 was encouraging, with revenues rising 78% (+17% on an organic like-for-like basis), gross profit 37% higher at £3.3m, and EBITDA up 20% to £1.0m. A key factor in driving the uplift across several key metrics was the acquisition of **LaddersFree**, operating at strong gross and EBITDA margins and with a cash generative model.

The specialist **Ad Hoc** cleaning division showed recovery later in the financial year and that progress has continued into the current period. Since it operates at the highest margins within the Group, this augurs well for future results. Adding a full-year contribution from LaddersFree (only 4.5 months in FY22) should on our forecasts enable the Group to achieve **revenues of £19.5m** and **adj. PBT of £2.1m,** which would represent a record year for the business.

Looking forward

The Group is led by **a very experienced management team** that includes the Executive Chairman Mark Braund, CEO Shaun Doak and CFO, Andrea Pankhurst, who are determined to improve the profitability of the Group.

The strategy to achieve this goal is via a strong focus on cross selling their unique offering to new and existing customers. REACT operates in a large, fragmented market which has significant scope for rationalisation. In view of its high and improving gross margins, the recurring nature of its revenues (c. 85%) remains a positive. LaddersFree is a scalable and very cash generative business.

Indeed, an early success was announced in January 2023 when a contract to provide Group-wide services to a fast-food chain with 350 outlets was agreed, valued at approximately £0.8m per annum for two years. Further progress on this front is expected.

Although cash reduced during FY22, meaning a neutral balance sheet by period end, working capital was the major reason for this. We expect this trend to reverse and, with a full-year contribution of LaddersFree, see the Group moving to **a net cash position** by the end of FY23.

No dividend payments are anticipated in the short-term, as management secures greater clarity in the outlook and a longer record of profitable revenue growth.

Potential for growth not reflected in current valuation

We have constructed a discounted cashflow model and peer group comparisons to determine the value to investors at current levels. The average of these measures gives a fair value per share of 1.7p.

Company Data

EPIC	REAT
Price (last close)	1.08p
52 weeks Hi/Lo	1.84p/0.72p
Market cap	£12.0m
ED Fair Value / share	1.7p
Net cash, Sep '22	£0.01m

Share Price, p

Source: ADVFN

Description

REACT Group plc (React) is a specialist cleaning business, operating across three activities:

Contract Maintenance, accounting for 65.4% of revenues in FY22, whereby the Company delivers regular cleaning regimes to customers in the healthcare, education, retail, and public transport sectors.

Contract Reactive, representing 18.3% of revenues in FY22, where the Group is the first responder to an on-call emergency response service under a formal contract/framework agreement, typically on a 24/7/365 basis.

Ad Hoc, equating to 16.3% of FY22 revenues, provides a solution to one-off situations outside a framework

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Valuation summary

Our detailed workings for the valuation appear on pages 19-20 of this report and provide a range of metrics for the Company's worth, utilising a discounted cash flow and various peer group comparative valuation models.

We have constructed a discounted cash flow (DCF) model using what we believe to be conservative assumptions; a discount rate of 10% and a terminal growth rate of 2.5%. The DCF model suggests an equity value of £23.9m, or 2.1p per share.

Our peer group comparison reflects expectations of improved profitability in FY23 due to the combination of a full-year contribution from LaddersFree and continued recovery in the Ad Hoc business.

We have applied discounts to the peer group comparative valuations to reflect the following:

a) We have limited the size-related discount to 15%, despite the marked size differential between the scale of REACT and its facilities management peers and,

b) The higher margins at REACT SC, reflecting the specialised nature of the work.

No dividend payments are anticipated in the short-term, as management secures greater clarity in the outlook and a longer record of profitable revenue growth.

The average FY1 valuation suggest a fair value of 1.7p/share, materially ahead of the current share price.

Business activities

React was divested from Autoclenz via an MBO in 2012 and listing on the Stock Market in 2015 through a reverse takeover of Verdes Management plc. The REACT Group is a leader in the specialist cleaning, decontamination, and hygiene sector, including both contracted commercial cleaning and specialist emergency decontamination work.

The Group reports three main areas:

- **Contract Maintenance**, where the Company delivers regular cleaning regimes (such as in the healthcare, education, retail, and public transport sectors)
- **Contract Reactive**, where the Company is the first responder to an on-call emergency response service operating under a formal contract or framework agreement, typically on a 24/7/365 basis.
- **Ad Hoc**, where REACT provides a solution to one-off situations outside a framework agreement, such as for fly tipping, void clearance, and decontaminations.

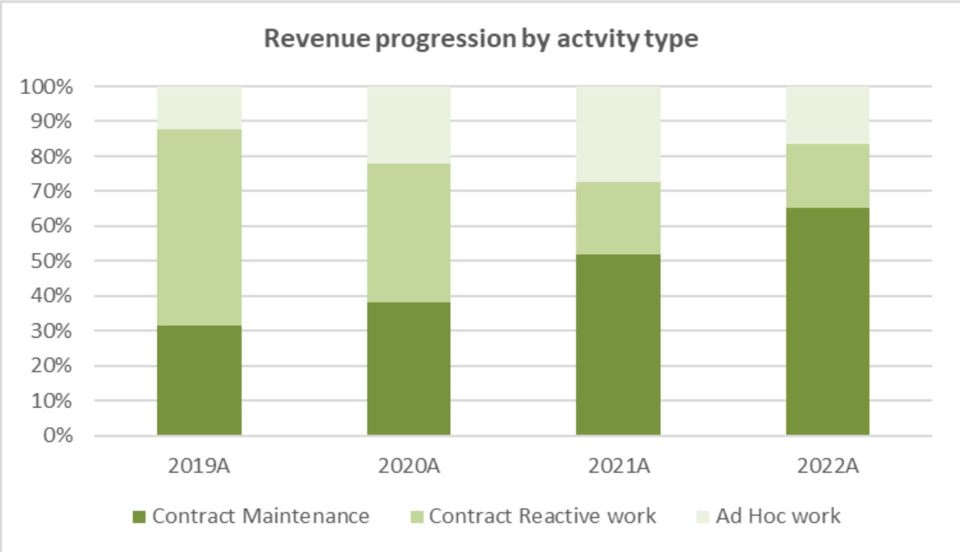
Historically, REACT Group focused on the specialist cleaning, decontamination, and hygiene market, which included contracted commercial cleaning and specialist emergency decontamination work. The focus is to return the customers' property to a safe, clean, operational condition, either through regular specialist cleaning or via a one-off emergency response to harmful/hazardous incidents.

At the end of Q1 2021, the Group acquired Fidelis Contract Services Ltd ("Fidelis"), a successful commercial cleaning, hygiene and facilities support services company headquartered in Birmingham, focused on the education and healthcare sectors. The addition of Fidelis added scale to the Group's commercial cleaning and hygiene services offering. The acquired business traditionally operates via contracts of longer term in nature, typically of three to five years and a strong track record of renewals. The initial consideration amounted to £1.7m, with further payments of £0.8m since paid. The outstanding £0.35m is to be paid on a six-monthly basis, with the final instalment due in March 2024. The figures stated are net of associated costs.

The Group branched out into a related area of the specialist cleaning market in May 2022, acquiring LaddersFree Ltd, one of the largest nationwide commercial windows, gutter, and cladding cleaning businesses for up to £8.5m, part-funded by a placing of 458.33m shares to raise £5.2m net of costs a month earlier.

The business has a high visibility of earnings, typically operating on a 12-month rolling contract basis. LaddersFree operates within the commercial property, retail, hospitality, leisure, and automotive sectors, using 300+ local specialist subcontractors who operate within a unique membership programme nationwide. The business is audited, certified, with high quality standards and rigorous training and safety standards.

Split of revenues by division, 2019A to 2023F

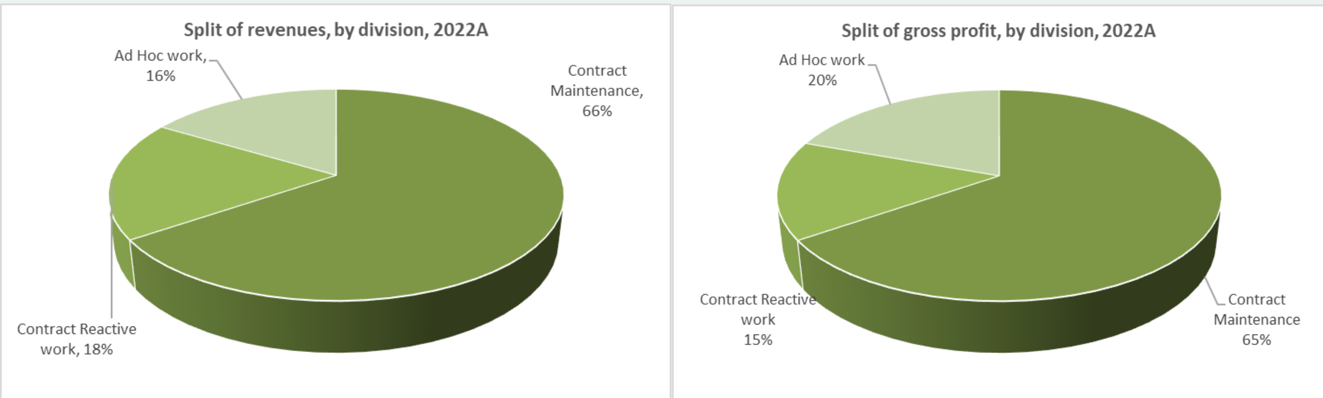


Source: Company

The make-up of revenues has changed markedly in recent years, reflecting management's aim of growing the regular, contracted work. As such, Contract Maintenance has grown in significance since 2019, with the proportion of revenues more than doubling to 65.4% in 2022 (2019: 31.4%). This progress reflected the acquisitions of Fidelis and LaddersFree, with several contracts awarded to the former post-acquisition.

When one adds Contract Reactive work into consideration, the level of contracted work has modestly declined between 2019 and FY22, from 87.8% in FY19 to 83.7%. That said, when factoring in a full year of LaddersFree, the level of contract related work is likely to nudge higher in our view to above 85%.

Segmental contribution to revenues and gross profit, 2022

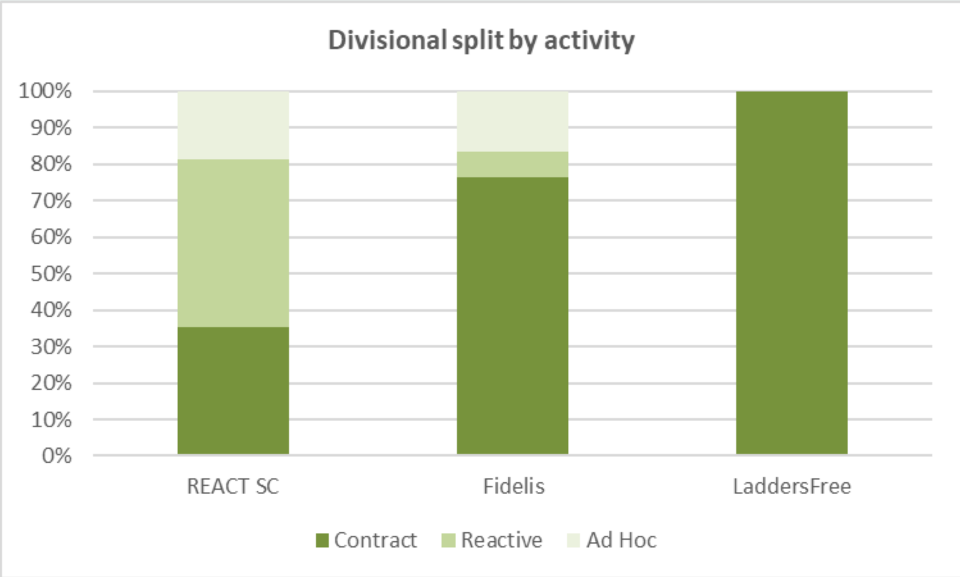


Source: Company

It is interesting to examine the divisional split of revenues by activity, highlighting a run-rate of contracted work now as high as 86%, following the acquisition of LaddersFree which is the only division to derive all its revenues from the contract maintenance area.

Encouragingly, its gross margins tend to be broadly on a par with the Ad Hoc specialist cleaning work serviced by REACT SC and Fidelis. The higher proportion of gross profit relative to revenues from ad hoc work confirms the division as the one with the highest margin.

Revenues by activity



Source: Company

The core business of REACT SC includes contracted and regular cleaning within the health and education sectors, as well as the rail network and highways. The latter two areas tend to be less predictable, reflecting the emergency response to trauma, anti-social behaviour, and other hazardous incidents. Significantly, following the acquisition of Fidelis and LaddersFree, recurring revenues have increased to 86% of turnover on a current run-rate basis.

Contract Maintenance and Contract Reactive are recurring in nature, have continued to grow at pace and represented c83% of revenue in FY22.

Contract maintenance represents strong recurring revenue and income streams from typically long-term contracts. **This is a key area of strategic growth for the Group**.

REACT Specialist Cleaning ("REACT SC")

REACT SC works closely with several tier 1 clients, including large facilities management companies and with in-house service providers who provide daily cleaning tasks with REACT SC. REACT SC supplements its partners, providing services which:

- Typically require specialist capital equipment or clothing
- Are in hard to reach, hazardous or difficult locations
- Require operatives to undergo specialist health & safety training
- Require specialist accreditation (either to ensure legal compliance or because access is to restricted or high-security locations) and,
- An infection control service, providing protection against MRSA, Swine Flu, C. difficile and Norovirus.

REACT SC is also a licensed waste carrier with a traceable disposal system.

Generally, REACT SC delivers its services either to end customers or to facilities management ("FM") companies, who are contracted to the end customer and who deal with the commonplace cleaning services. In the provision of services to FMs, REACT SC acts as a sub-contractor, providing specialist tasks the FMs are generally unable to provide.

The wide range of services provided either through FMs or directly (to the emergency services, the rail network, retail and industry, education, local authorities, landlords, housing associations and across the healthcare sector) include:

- Deep cleaning -retail, restaurant and takeaway outlets, manufacturing, hospitals and education
- Trauma – rail, housing associations, judiciary and healthcare
- Void clearances – sharp's, squat clearances, drug, hazardous waste removal and disposal
- Decontamination – bodily fluids, hazardous waste and dirty protests.

In some instances, a rapid response is required, with REACT SC available on a 24/7 basis.

In terms of sectors, the Group provides its services to several industries, as may be seen in the chart below. Of these commercial/industrial is the largest, followed by education and healthcare. Rail and retail/leisure combined account for a similar portion of revenues to healthcare. The smallest customer segments are either housing related (including local authorities), with the other category largely comprising highways and police/justice system.

REACT SC employs full time trained Technical Operators who provide 24/7 cover and respond to customers across England and Wales.

Where REACT SC is unable to provide the services directly, it sub-contracts qualified agency partners/members to supplement its permanent workforce. All sub-contractors must have the necessary security clearances, health & safety training, accreditations, and are supervised by REACT SC's permanent emloyees. This enables REACT SC to keep its fixed cost base relatively low.

Possession of accreditations is a pre-requisite of undertaking the specialised nature of REACT SC's operations. The Group holds ISO9001:2008 and ISO14001:2004 accreditations for management of specialist cleaning and decontamination services.

Fidelis

Fidelis has a focus on the manufacturing, void clearance, healthcare, retirement villages, and education sectors, providing a combination of daily contract cleaning, washroom hygiene, building maintenance, industrial deep cleaning, and ground maintenance. In FY22, more than 75% of revenues were derived from contract maintenance, 7% from contract reactive and 17% from the Ad hoc activity.

Typically, the contracts tend to be longer term in nature, and generally three to five years in duration. Customer churn is low, and the largest customer accounted for c.15% of divisional revenues in FY22, and the top ten less than 60%.

The head office of the division is in Birmingham, with services provided across England and Wales.

LaddersFree

LaddersFree is an established nationwide commercial window, gutter, and cladding cleaning business based in Exeter. Glazing is cleaned using 'wash and reach' systems, with extendable water fed poles (up to 65ft) and complies with working at height regulations.

Where greater complexity is involved, the business operates specialist teams who utilise rope access and mobile platforms/cradles and are fully trained and health & safety compliant. Approximately, 90% of revenues are generated from window cleaning, with the remainder split between cladding, gutters, and jet washing.

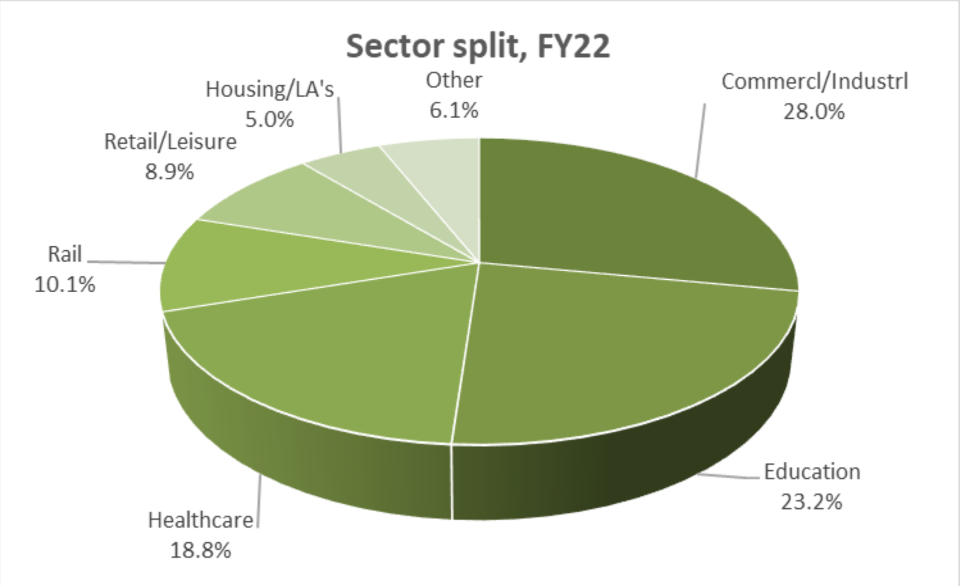
The division sub-contracts the work to 300+ approved service partner members, comprising local window cleaning companies across mainland UK. As such, the directly employed workforce is small and cost effective. There is competitive tension between the sub-contractors, who largely operate locally, ensuring that the cost of servicing contracts remains within set parameters and providing a natural barrier to entry.

Typically, clients tend to sign up for 12-month rolling contracts providing visibility of revenues. Clients are both serviced directly or via facilities management, cleaning, and property management companies on a local and nationwide basis. The business is scalable with a very low working capital requirement.

Customer churn has historically been very low. In the year to September 2022, LaddersFree saw modest churn within the local market (8%), with zero churn within the national and facilities management customers.

Within the core REACT SC business and Fidelis, customer churn is also low, typically at the low single digit per cent level. We think this reflects a combination of the high-quality service provided and the specialisation in niche areas.

Split of Group revenues by customer sector



Source; Company, Equity Development

Four strategic pillars for growth

As listed earlier, REACT's management team has four strategic pillars for growth, aiming to catapult the business into the position of the leading specialist and contract cleaner in the UK:

The addition of **scale** commenced through M&A (Fidelis and LaddersFree), resulting in revenues increasing more than six-fold between 2019 and 2023. The growth was supplemented by the broadening of existing Ad Hoc relationships to include the new entities and highlighting the ongoing investment in sales and marketing.

The process of **upselling** additional services to existing customers is key, thereby expanding the scale of ongoing contracts. New contracts are secured on a regular basis, such as the recent win to provide deep cleaning, window, and façade cleaning across c.350 mainland UK locations for a premium high-street fast-food chain over a two-year period. Encouragingly, that customer was an existing client of LaddersFree.

Customers tend to fall into two categories – Facilities Management operators and direct customers. The addition of Fidelis and LaddersFree has resulted in a cross-selling of their services to existing customers, thereby strengthening relationships.

The Group continues to be focused on areas that generate higher margins, such as Ad Hoc (deep cleans, on-call emergency response clean-ups and decontamination services) and, window cleaning, via LaddersFree. **Increases to recurring revenues in such areas are key to achieve the targeted 30% gross margin.**

The proportion of **recurring revenues** has increased markedly with the purchases of Fidelis and LaddersFree in recent years, with contracted revenues now at 83% for FY22 (86% on a run-rate basis by the year end), close to their 88% levels in FY19. The opportunity to incorporate the services of Fidelis, LaddersFree or both into existing long-term contracts remains a focus of the management team and explains the expenditure on sales and marketing recently.

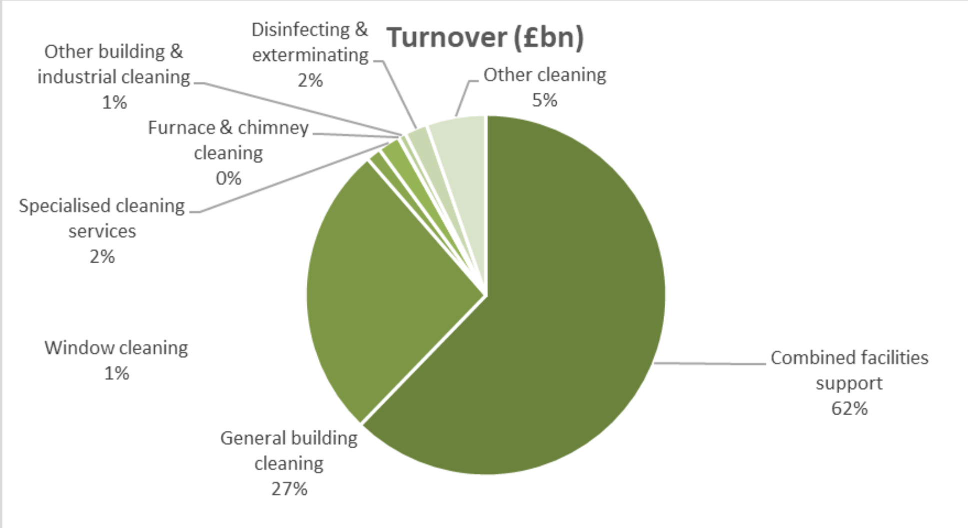
Group Markets

There is very little published data on the specialist and emergency cleaning market in the UK, although there is a plethora of data on the wider contract cleaning market. Several commentators, including the ONS, suggest the wider UK cleaning market was worth c. £30bn in 2021 (with some higher figures).

The largest players in the wider market and in terms of revenue generation are the facilities management companies, of which cleaning tends to form a relatively small part of their activities and covering a myriad of areas, ranging from general building cleaning to healthcare and educational establishments and window cleaning services.

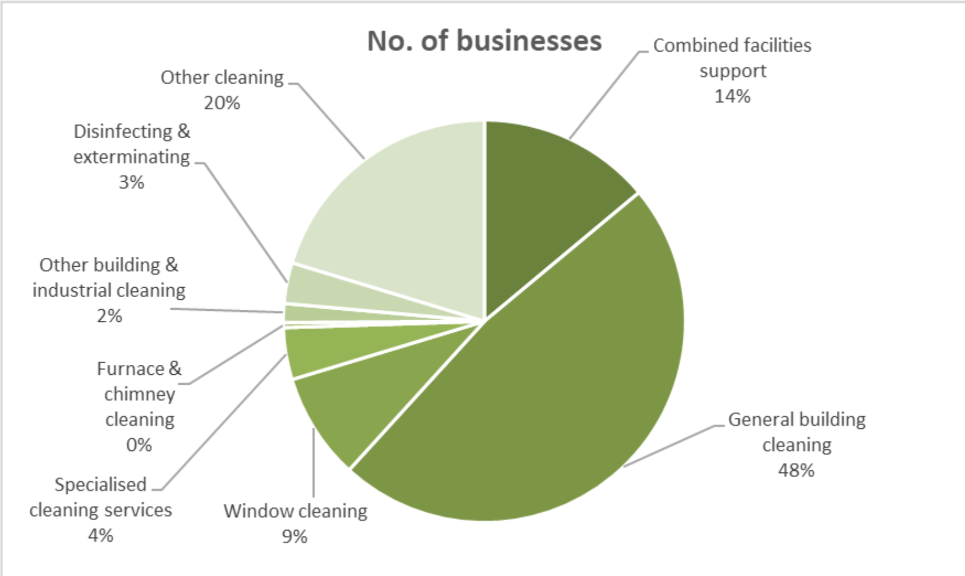
The greatest concentration of cleaning businesses is within the general building cleaning category, which also accounts for the bulk of the sector's employment levels.

Split of revenue of the £30bn UK cleaning industry



Source: ONS

The proportion of businesses by sub-sector

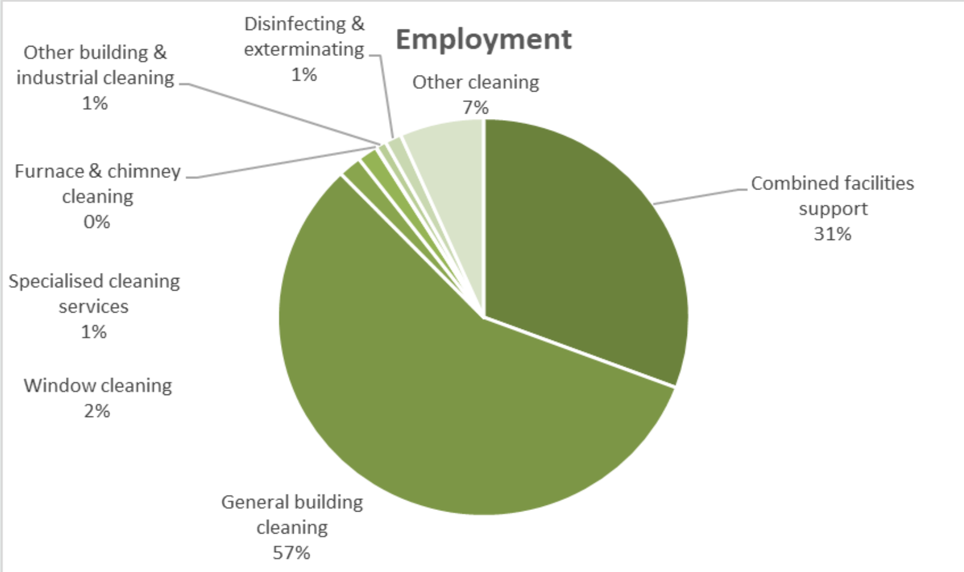


Source: ONS

One should bear in mind that most cleaning companies employ less than ten people (*source: British Cleaning Council*), with almost a million people employed in the industry and representing c. 3% of UK employment levels.

The cost of cleaning materials, labour rates (high inflation levels in the economy) and energy costs remain issues within the industry, with some degree of difficulty in passing this on to end customers. Approximately 73% of facilities management and cleaning companies suggested they regularly have difficulty sourcing labour (*Source: Plimsoll*), with Brexit a major factor on the availability of labour.

General building cleaning accounts for over half of the sector's employment



Source: ONS

The ONS does not specify what it classifies as 'specialised cleaning services'. We note that this segment forms a small part of the wider sector's revenue (2.0%), employment (1.6%), and proportion of businesses (4.2%). Also, the higher proportion of businesses relative to employment suggests that the size of the specialist segment's firms tends to be lower than average in general.

The public sector is expected to remain a large consumer of contract cleaning services, especially within the health and education sectors as, in the case of the former, the UK population ages. Although the Covid-19 pandemic had a mixed impact on the sector as offices were downsized within the private sector, the emphasis placed on cleanliness has continued to be a positive.

The current economic uncertainty may well dampen demand for the sector's services, particularly should redundancies/site closures become a factor. However, the post-covid return to work is likely to be a strong counterbalance to this. Our expectation is that any shortfall in demand is likely to be temporary, with recovery by 2024.

What does this mean in terms of the specialist cleaning market?

Demand has recovered post-pandemic, with trading in emergency cleaning services ahead YoY. The addition of new services such as window cleaning expands the Group's target market and selling the wider portfolio of services to a broader customer base should underpin growth over the next 18-24 months, in our opinion.

Customer concentration

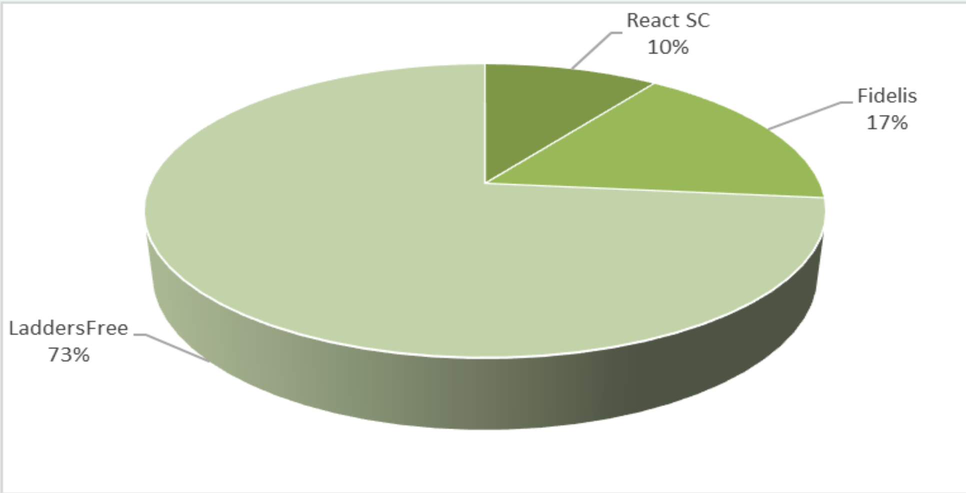
The top 10 customers accounted for c. 46% of Group revenues in the year to September 2022.

The customer list is varied, ranging from public bodies (hospitals, education establishments, road management, prisons, councils, and rail operators) to private organisations, across several sectors, from retailers (food and non-food), restaurants, facilities management providers, manufacturers, and housing associations.

The ten largest customers fall within REACT Specialist Cleaning and Fidelis, with the clients of LaddersFree typically smaller. The top ten customers of REACT SC account for c. 81% of the overall revenues of the division, compared to c. 59% at Fidelis. The top ten customers at LaddersFree account for c. 47% of its revenues in FY22.

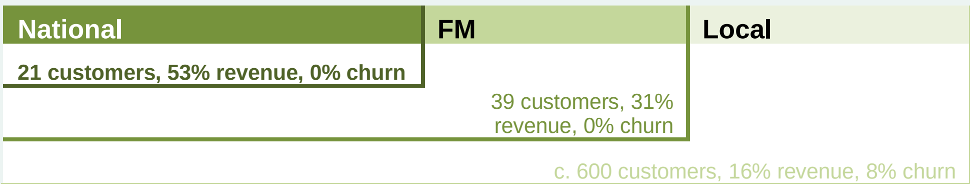
In total, the Group has c. 700 active customers with revenues over £1,000. To further emphasise the widespread nature of LaddersFree's customer base, it accounts for 73% of active customer numbers of the Group.

Proportion of customers with revenue > £1k, by division



Source; Company

LaddersFree – customer segmentation



Source: Company

Management team

The Board was transformed in 2020 with the appointment of the current Chairman, CEO and CFO.

Mark Braund, Executive Chairman

Mark is a strategic and operational advisor, which follows several years' experience as a strategy leader and CEO. Mark has a strong track record of leading teams through profitable change and materially improving shareholder value. In addition to his appointment as Chairman of REACT Group plc. in December 2020, Mark is the Chairman of Parity (from June 2021), BCN (from October 2022), and NFS Technology (from September 2021), as well as a Director of CRMSquad (from December 2020). Mark worked as an operational and strategic adviser to REACT, contributing to its development before joining the Board in December 2020.

Mark has significant experience in the UK and overseas including outsourcing, managed services & digital technology. Immediately prior to setting up his own advisory practice, Mark was CEO of RedstoneConnect plc., leading the team through a well-documented turnaround and sale of the core business. Mark was the Chairman of Livingstone Group until February 2023 following its successful trade sale, and CEO of Interquest plc until 2015.

Shaun Doak, Chief Executive officer

Shaun joined the business in 2019 as Managing Director, ahead of promotion to his current role in February 2020. Shaun's background is in sales and business development, with a proven track record of growing businesses in the specialist cleaning, facilities management, and HVAC (heating, venting and air conditioning) services sectors. Prior to joining REACT Group plc, he spent 15 years as the National Sales Manager of Systems Hygienics Ltd, a Regional Director of Emtec Energy Ltd, the Sales Manager of Nuaire and the Business Development Manager of Pitney Bowes.

Andrea Pankhurst, Chief Financial Officer

Andrea joined the Group in January 2019 and was Finance Director of REACT Specialist Cleaning Limited, the Group's operating subsidiary from 1 January 2020, before being appointed Chief Financial Officer and joining the main board on 18 May 2020. After qualifying as a Chartered Accountant with Coopers & Lybrand in 1993, Andrea has worked in SMEs in sectors as varied as natural resources, IT & software, consultancy, leisure, care, and automotive giving her extensive commercial experience and perspective. She has a strong track record of improving financial controls, systems, and reporting.

Rob Gilbert, Non-Executive Director

Rob has held several senior sales and leadership positions across a 20-year career with extensive experience and focus in securing high value, multi-year contracts with FTSE 250 and major public sector organisations. Rob has experience in senior sales positions with United Managed Services, Lone Worker Solutions, and Office Canopy Group. Rob also founded and successfully exited his own start-up in 2016. Currently, Rob is the Managing Director of the Commercial and Logistics operations of Totalmobile Ltd.

Michael Joyce, Non-Executive Director

Michael is currently the CFO of RED Global, the SAP and tech talent business. an independent non-executive director with recent and relevant financial experience. Michael has held similar positions for the last 19 years, including at Lucid, FiveTen Group, and InterQuest. Previously Michael held senior finance positions at Heath Lambert Group, Rebus Group and Robert Walters. Michael spent the first seven years of his career, between 1990 and 1997, at Coopers & Lybrand in the UK and Australia and qualified as an ACA in 1993. Michael joined the Board of REACT plc in a Non-Executive role in 2019.

Financials

Preliminary results							
£m, Yr. to Sept	**H1 21A**	**H2 21A**	**FY21A**	**H1 22A**	**H2 22A**	**FY22A**	**YoY change**
Contract	0.8	3.2	4.0	3.3	5.7	8.9	123.9%
Reactive	0.8	0.8	1.6	0.9	1.6	2.5	57.5%
Ad Hoc	0.9	1.2	2.1	0.9	1.3	2.2	5.2%
Group revenue	2.5	5.2	7.7	5.1	8.5	13.7	77.5%
Cost of sales	-1.5	-3.8	-5.2	-4.0	-6.4	-10.4	98.7%
Contract	0.3	0.7	1.0	0.5	1.6	2.1	117.1%
Reactive	0.3	0.2	0.5	0.3	0.2	0.5	-4.5%
Ad Hoc	0.5	0.5	1.0	0.4	0.3	0.6	-34.1%
Gross profit	1.0	1.4	2.5	1.2	2.1	3.3	32.5%
Contract	35.6%	22.0%	24.6%	15.9%	28.4%	23.8%	
Reactive	33.9%	31.0%	32.5%	30.1%	13.5%	19.7%	
Ad Hoc	50.3%	41.5%	45.4%	38.4%	21.4%	28.4%	
Gross margin	40.6%	27.8%	31.9%	22.6%	24.6%	23.8%	
OpEx	-0.7	-1.2	-1.9	-1.2	-2.0	-3.2	67.3%
Adj. EBITDA	0.4	0.4	0.8	0.2	0.8	1.0	19.9%
%	14.7%	8.2%	10.3%	3.2%	9.3%	7.0%	
Adj. EBIT	0.3	0.2	0.5	-0.1	0.1	0.0	-94.0%
%	12.7%	4.1%	6.9%	-1.1%	1.0%	0.2%	
Interest	0.0	0.0	0.0	0.0	-0.1	-0.1	
Adj. PBT	0.3	0.2	0.5	-0.1	0.0	0.0	-104.4%
Exceptionals	-0.3	-0.1	-0.4	0.0	-0.5	-0.5	
PAT	0.0	0.1	0.1	-0.1	-0.5	-0.7	-536.2%
Tax	0.0	0.2	0.3	0.0	-0.1	-0.1	
Adj. PAT	0.3	0.5	0.8	-0.1	-0.1	-0.2	-119.6%
WAV & Dil. Shares (m)	560.9	565.6	565.6	570.3	780.9	780.9	38.1%
EPS (p)	0.1	0.0	0.1	0.0	0.0	0.1	-28.6%
DPS (p)	0.0	0.0	0.0	0.0	0.0	0.0	
Net (debt)/cash			0.6			0.0	-98.2%

Source: Company, ED

The preliminary results for the year to September showed progress on several fronts, not least with regards to revenue growth. Revenues improved 78% to £13.7m, driven by the maiden full-year contribution of Fidelis and the four-and-a-half months of LaddersFree, following its purchase in May 2022.

The two deals were the key factors behind the 124% increase in the level of Contract Maintenance work and 58% rise in Contract Reactive revenue booked during the year. Ad Hoc revenues rose by a more modest 5% yoy, albeit, in view of its higher margins, this remains a positive development.

The four-and-a-half-month contribution from LaddersFree was £1.63m in revenues and £0.59m in net profit. Had the acquisition occurred at the start of the financial year revenues would have been £2.4m higher, contributing £4.04m on a proforma basis. Net profits of LaddersFree in the year to September amounted to a proforma £1.08m.

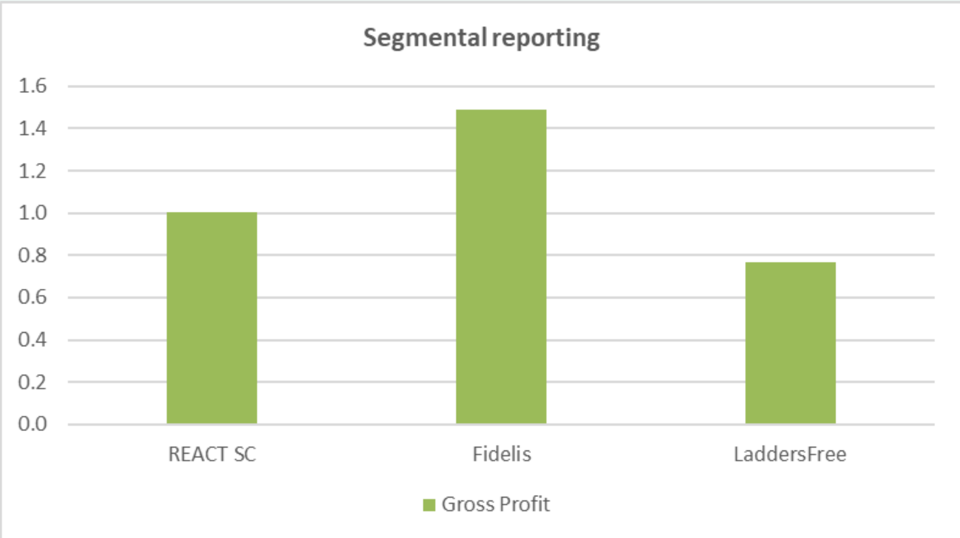
Gross profit increased 38% to £3.3m, representing a gross margin of 23.8%. Margins were impacted by the mix of business during H1 reflecting newer contracts at Fidelis. However, the level of gross profit in H2 ’22 increased markedly (+66.1% H2/H1) to £2.0m, reporting a margin of 24.6%. The H2 improvement reflects a combination of the recovery in the non-contract reactive business and the acquisition of LaddersFree in May.

We believe that margins have turned a corner from the recent lows experienced in H1 ’22 at both the gross and operating level.

The addition of LaddersFree, operating at similar gross margins to REACT SC should result in returns starting to head back towards 30%, while the continuation of the H2 recovery into Q1 ’23 of the Ad Hoc business should underpin the gross margin during FY23 and beyond.

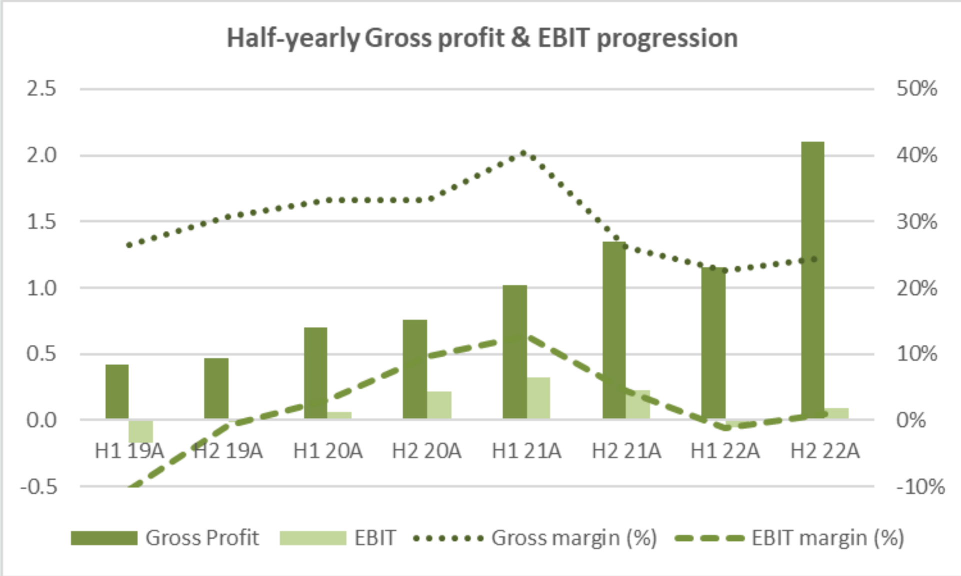
Despite contributing only four-and-a-half months of FY22, LaddersFree accounted for 24% of the Group’s gross profit. A full-year contribution of LaddersFree underpins the expected ongoing recovery in Group profitability for FY23.

Divisional reporting - gross profit



Source: Company

Half-yearly GP & EBIT progression, £m

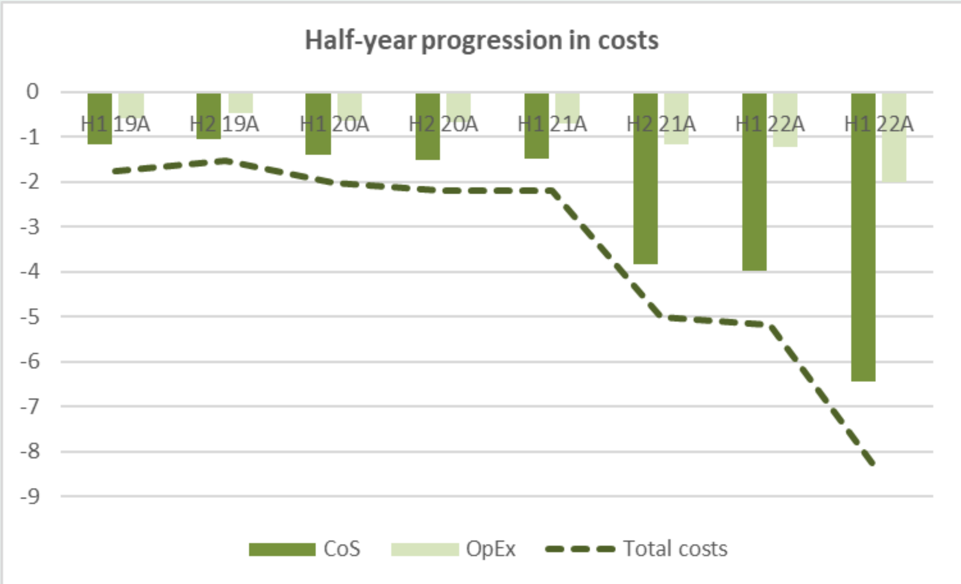


Source: Company

Costs increased significantly during FY22, with Cost of Sales rising to £10.4m (FY21: £5.3m). However, much of the increase reflects a full year of Fidelis and the addition of LaddersFree. Costs within Contract Maintenance operations rose 120% to £6.8m, with Contract Reactive costs rising 87% to £2.0m, accounting for £4.6m or 91% of the increase in Costs of Sales. Of further note was the reduction in Ad Hoc revenues, reflecting the hangover from the pandemic.

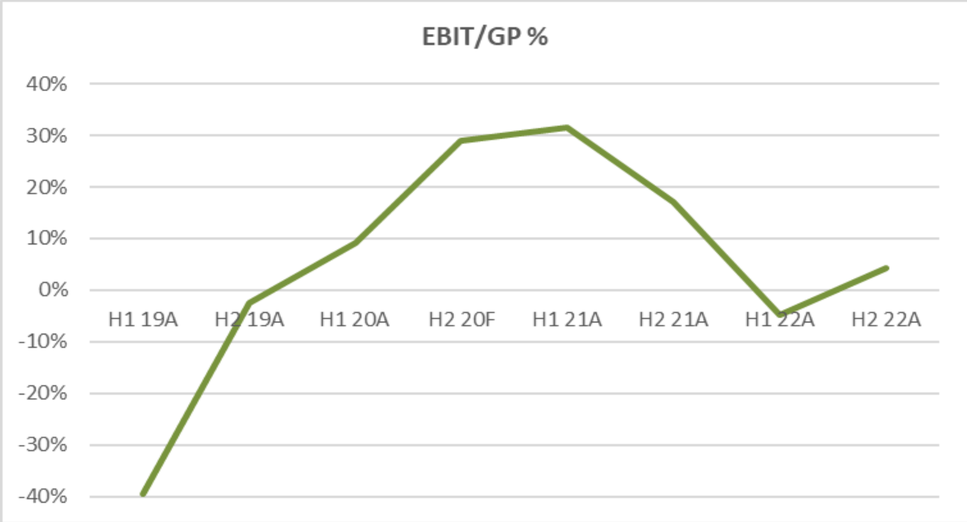
This will have reduced the gross margin mix of business, particularly in H1. Underlying operating expenses rose £1.37m or by 73.7% to £3.2m. which is modestly below the 77.5% yoy uplift in revenues.

Costs progression, £m



Adj. EBITDA rose 20% yoy to £1.0m (FY21: £0.8m), representing a margin of 7.0% (FY21: 10.3%). Stripping out combined depreciation and amortisation of £0.9m (FY21: £0.3m), which increased significantly - largely due to acquisition of LaddersFree (goodwill of £2.8m). Adj. EBIT amounted to £0.03m (FY21: £0.53m), representing a positive margin of 0.2% (FY21: 6.9%).

The % of EBIT falling through from GP has improved



Source: Company, ED

Interest costs fell to a modest -£56k (FY21: +£16k), as the level of net cash reduced over the period. Adj. PBT moved to an effective break-even position of -£0.024m vs FY21: +£0.547m.

The exceptional costs included:

- The cost of a failed acquisition, superseded by the purchase of LaddersFree, amounting to £0.05m
- The write-back of goodwill, relating to the Fidelis acquisition.
- The professional costs associated with the acquisition of LaddersFree, amounting to £0.46m, and
- Goodwill associated with the customer lists of acquisitions are typically written off over four years.

A modest tax charge was incurred of £0.13m, notwithstanding the reported loss before tax. This reflected the addition of the profitable LaddersFree part way through its tax year.

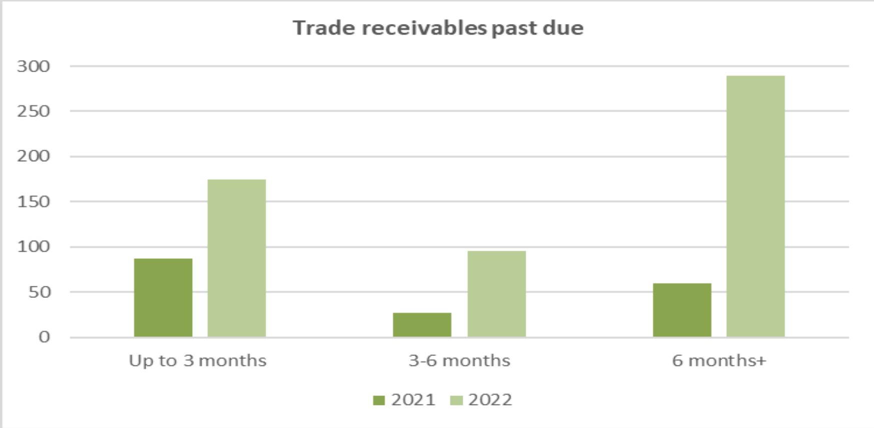
The Group has estimated excess management expenses carried forward of £1.3m (2021; £1.3m) and trading losses of c. £0.9m available, which can be used to reduce future taxable profits. Overall deferred tax assets amount to £0.5m, with £0.3m of this amount expected to be utilised in the short-to-medium term.

In terms of cash, the most significant element during FY22 was the consideration of the LaddersFree acquisition, amounting to £4.7m on completion on a cash and debt-free basis, with a further £1m of equity transferred. Deferred consideration of £1.45m is due in four instalments every six months commencing 1 December 2022. The contingent element of the consideration is calculated at six times the annual increase in EBITDA (over and above the £1.2m level) will be payable in three instalments, up to a maximum of £1.4m. The total consideration amounts to £8.5m on a cash and debt-free basis.

Significantly, **LaddersFree is highly cash generative** and does not tend to consume much in the way of working capital, reflecting its strong cash collection policies.

At the Group level, there was a working capital outflow of £1.8m, in part reflecting the jump in revenues but also the increase in the level of trade receivables more than three months past due. A large portion of the related increase relates to two customers, with a payment plan agreed and progress made with respect to collections during Q1, thereby boosting FY23's cash levels.

Trade receivables



Source: Company

The cash outflow resulted in a £0.8m cash outflow at the operating level. Capex was typically at modest levels (FY22: -£0.1m vs -£0.01m in FY21), with little requirement for new IT, motor vehicles or equipment during the year. As a result, the Group moved from net cash of £0.6m at the start of the year to a neutral position at the year end.

The key features of the balance sheet included:

- A £6.9m increase in the level of intangible assets, part reflecting the acquisition of LaddersFree (+£2.8m)
- A £2.2m rise in trade and other receivables
- A £3m jump in trade and other payables, including those less than and above one-year in duration
- Net assets markedly improving to £8.3m (FY21: 2.8m), equating to 0.85p per share.

Trading outlook

The outlook statement within the preliminary results suggested that the trading momentum experienced during Q4 '22 had continued in Q1 '23, with a record performance delivered notwithstanding the traditional slowdown over the festive period. The key features of this momentum included:

- A recovery in reactive business following a Covid-19 related slowdown, as competitors entered the decontamination market temporarily and budgets were exhausted and more normal trading patterns emerge
- Sequential quarterly growth into Q1 '23 across all divisions
- The inclusion of a full-year contribution from LaddersFree (FY22; 4.5 months) is significant.

The increased focus on a rising proportion of recurring revenues provides management with greater degree of visibility and, in turn, certainty. This enables better planning and utilisation of staff and resources. Significantly, it also provides a larger, more predictable revenue base to cover costs. We anticipate that any further acquisitions are likely to expand the level of recurring revenues, albeit in the short-term management is focused on maximising sales and profitability from LaddersFree, particularly via cross-selling of the Group's combined services through the expanded customer base.

New long-term contracts to be secured, with the delivery of revenues expected to bolster the current year. In addition, we anticipate full-year contributions from contracts secured in FY22 by Fidelis during FY23. The recent announcement of the long-term agreement with the nationwide fast-food restaurant chain across multiple locations is good example of the Group providing services from all three divisions. The combination of the emergency response Ad Hoc business and LaddersFree form **a national proposition for customers**.

The addition of the value-added nature of the LaddersFree revenue stream is expected to be a major driver in the recovery of gross margins. Also, the recovery in the reactive Ad Hoc work will also improve the margin mix of sales.

Investment in sales and marketing headcount is at the forefront of the Group's engagement with its large addressable market. The acquisitions of Fidelis and LaddersFree bring long customer lists with the potential for cross-selling services provided across the wider customer base. The scope to provide customers with services from all three divisions offers significant potential upside, in our opinion. The pipeline of potential opportunities continues to grow as new customers are identified. Prior to its acquisition by REACT, LaddersFree had limited exposure to outbound sales and marketing effort.

Future M&A will focus on larger targets, those with the ability to not only enable the Group to enter new markets but also, to take profitability to the next level. In the shorter term, however, there is much to be done in improving the revenues and profitability of the existing businesses.

Summary Profit & Loss

Year to Sep, £m	2019A	2020A	2021A	2022A	2023F
Contract Maintenance	1.0	1.7	4.0	8.9	14.7
Contract Reactive work	1.8	1.8	1.6	2.5	2.5
Ad Hoc work	0.4	1.0	2.1	2.2	2.3
Revenue	3.10	4.45	7.70	13.67	19.52
CoGS	-2.2	-2.9	-5.3	-10.4	-14.3
Gross profit	0.9	1.5	2.4	3.3	5.2
Gross margin	28.5%	34.6%	30.8%	23.8%	26.6%
Op costs	-1.1	-1.3	-1.9	-3.2	-3.0
Other Op. income	0.0	0.1	0.0	0.0	0.0
Operating profit	-0.2	0.3	0.5	0.0	2.2
Op margin	-5.7%	6.8%	6.9%	0.2%	11.3%
Net Interest	0.0	0.0	0.0	-0.1	-0.1
PBT (Adjusted)	-0.2	0.3	0.5	0.0	2.1
Exceptionals	0.0	0.0	-0.4	-0.5	0.0
PBT (Reported)	-0.2	0.3	0.1	0.0	2.1
Tax	0.0	0.0	0.3	-0.1	-0.5
Adj. PAT	-0.2	0.3	0.8	-0.2	1.6
Reported PAT	-0.2	0.2	0.4	-0.7	1.6
Ordinary Dividends	0.0	0.0	0.0	0.0	0.0
EPS (Adjusted) (p)	0.0	0.1	0.1	0.05	0.14
DPS (p)	0.0	0.0	0.0	0.00	0.00
Ave no of shares (FDil) (m)	460.5	543.6	565.6	780.9	1112.0

Source: Company historics, Equity Development estimates

Summary Cash Flow

Year to Sep, £m	2019A	2020A	2021A	2022A	2023F
Operating profit	-0.2	0.2	0.5	0.03	2.20
Depn. & Amortn.	0.1	0.1	0.3	0.92	0.25
Working capital movement	0.2	0.0	-0.4	-1.8	-0.2
Other	0.0	-0.1	0.1	0.1	-0.1
Operating cash flow	0.0	0.2	0.5	-0.8	2.1
Net Interest	0.0	0.0	0.0	-0.1	-0.1
Taxation	0.0	0.0	0.3	-0.1	-0.3
Net capex	0.0	0.0	-0.1	-0.1	-0.1
Operating FCF	0.0	0.2	0.8	-1.0	1.6
Net (Acquisitions)/Disposals	0.0	0.0	-2.1	-5.8	-1.3
Dividends	0.0	0.0	0.0	0.0	0.0
Share Issues	0.0	1.1	0.2	6.2	-0.2
Minority payment	0.0	0.0	0.0	0.0	0.0
Other financial	0.0	0.0	0.0	0.0	0.0
Increase Cash/(Debt)	0.0	1.3	-1.2	-0.6	0.1
Opening Net Cash/(Debt)	0.4	0.4	1.7	0.6	0.0
Closing Net Cash/(Debt)	0.4	1.7	0.6	0.0	0.1

Source: Company historics, Equity Development estimates

Abbreviated Balance Sheet

Year to Sep, £m	2019A	2020A	2021A	2022A	2023F
Intangible Assets	0.2	0.2	3.0	9.9	9.7
Tangible Assets	0.1	0.1	0.2	0.2	0.2
Investments/other	0.0	0.0	0.2	0.2	0.2
Net Working Capital	0.2	0.2	-0.6	-0.3	-0.1
Capital Employed	0.4	0.4	2.8	10.0	10.1
Other	0.0	0.0	-0.7	-1.8	-0.4
Net Cash/(Debt)	0.4	1.7	0.6	0.0	0.1
Provisions Liabilities/Charges	0.0	0.0	0.0	0.0	0.0
Net Assets	0.9	2.2	2.7	8.2	9.8

Source: Company historics, Equity Development estimates

Detailed valuation

We have constructed several models in the process of determining the fair value of REACT Group plc's shares. We commence with a discounted cash flow valuation for REACT, followed by a peer group valuation model utilising PER, EV/EBITDA, and Price/Book multiples.

Discounted cash flow

Our discounted cash flow model uses conservative assumptions: a discount rate of 10.0% and a terminal growth rate of 2.5%. **The model suggests a value / share of 2.1p**

REACT Group DCF calculation

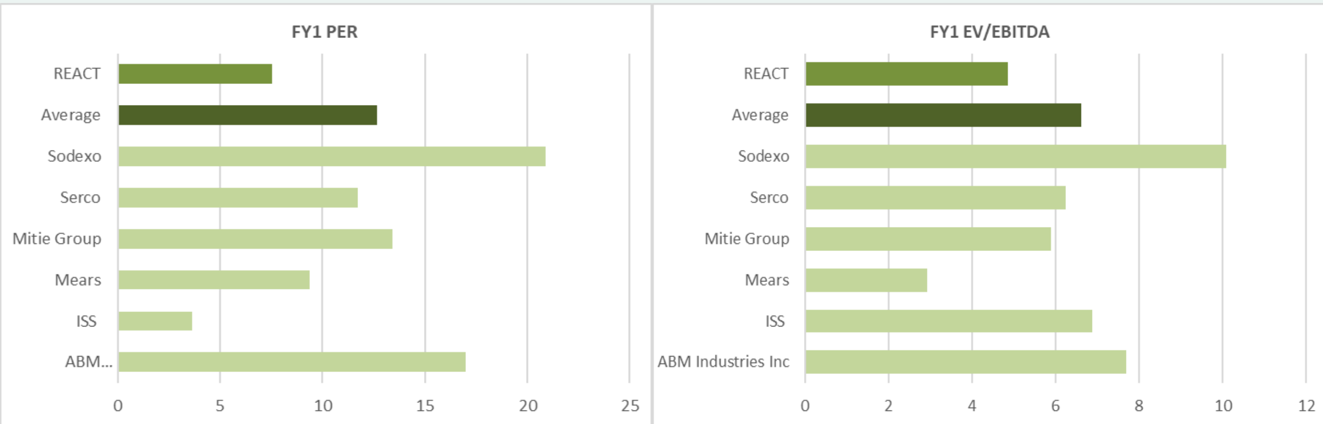
£m	2023F	2024F	2025F	2026F	2027F	2028F	2029F	2030F	2031F	2032F
Free cash flow	1.7	1.8	1.8	1.9	1.9	1.9	2.0	2.0	2.1	2.1
WACC (%)	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00
Timing factor	0.50	1.50	2.50	3.50	4.50	5.50	6.50	7.50	8.50	9.50
Discount rate	0.95	0.87	0.79	0.72	0.65	0.59	0.54	0.49	0.44	0.40
Present value	1.6	1.5	1.4	1.3	1.2	1.2	1.1	1.0	0.9	0.9
Sum of discounted cash flows	12.2									
Terminal growth rate (%)	2.50									
Terminal value	11.6									
Net debt	0.1									
Equity value	23.9									
No. of shares (m)	1,112.0									
Value per share, pence	2.1									

Source: Equity Development

Peer group considerations

There are no direct, listed competitors to REACT. However, there are several listed facilities management companies who offer general cleaning as part of the service packages offered to customers, although in several cases, they choose to sub-contract the specialist, emergency, and window cleaning services to the likes of REACT Group plc. **We highlight the FY1 peer group comparisons utilising PER, EV/EBITDA, and Price/Book in the following charts:**

Peer group comparison: FY1 PER (x) and FY1 EV/EBITDA (x)



Source: MarketScreener

Peer group comparison: FY1 Price/Book (x)

Source: MarketScreener

Conclusions

We have taken account of the comparative peer group valuations, as well as our DCF model to determine the average fair value of the Group in the table below.

A 15% size-related discount has been applied in calculating the fair value of REACT compared to its peers. While one could argue that the size differential compared to its larger peers arguably warrants a larger discount, we think this is countered by the higher margins returned by REACT compared to its facilities management peers.

Fair value

	FY1 fair value
DCF	2.1
PER	1.5
EV/EBITDA	1.3
Price/Book	1.7
Average	1.7

Source: ED

The table above summarises the DCF and peer group comparison fair values, with the average at 1.7p per share, materially ahead of the current price.

We believe the strong momentum within the business, including the securing of the additional contracts and the cross-fertilisation of the Group's customer base to further drive revenue and profits growth, will help that valuation gap narrow.

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