

A record half year

24 April 2023

The indicative H1 outcome, as suggested within the pre-close trading update, sees revenues, gross profit, and EBITDA at record levels, with the latter close to FY22 levels. The pipeline of opportunities remains strong, thereby underpinning FY23 expectations for adj. PBT and net cash. The cross-selling of services to the clients of LaddersFree is bearing fruit, with a focus on higher gross margins and recurring revenues providing better visibility. With estimates unchanged, we see little reason to adjust our fair value, suggesting a re-rating remains likely.

The pre-close trading update highlights the strong continued growth, notwithstanding the impact of the acquisition of LaddersFree in May 2022. We note the high levels of operational gearing within the business highlighted by an 80%+ improvement yoy in revenues to c.£9.3m; a more than doubling of gross profit to c.£2.5m; and a near six-fold increase in EBITDA to £0.9m. Those metrics amount to a record half-year.

LaddersFree continues to secure additional contracts in the retail (including a furniture retailer), leisure (a national restaurant operator) and motor retailing sectors, with the low-cost base translating into high gross margins. The pipeline of repeat business remains encouraging.

The recovery at Fidelis was dramatic, with record revenues in Q2 following some operational challenges during Q1 which have since been resolved. Contract renewals/wins within the education sector have added c.£0.5m to the annualised run-rate of revenues, with further progress made with several NHS Trusts and a property services business. The run-rate of revenues is significantly higher than at the time of its acquisition.

H1 '23 witnessed a continuation of the recovery at REACT Specialist Cleaning, which had previously experienced a decline in revenues in the immediate aftermath of the COVID-19 related lockdown period. The improvement reflects the upselling of Group services to the clients of LaddersFree and taking the business into new market segments.

The strong progress in the top-line reflects the improving capabilities of the Group to handle larger contracts and sustain a positive cadence of sales across its entire business, thereby improving its visibility in sectors that Fidelis and REACT SC have previously only had limited exposure to. The large pipeline of opportunities augurs well for the outlook, with the Group on track to deliver our FY estimates. The improving cash generation, as highlighted by the significant improvement in EBITDA, remains a positive driven by the momentum within LaddersFree and Fidelis.

Valuation

We use DCF and peer group comparison models to determine the fair value of the shares. Taking an average of the two suggests an unchanged 1.7p / share .

Estimates				
Year to Sept, £m	FY20A	FY21A	FY22A	FY23F
Revenue	4.5	7.7	13.7	19.5
EBITDA	0.3	0.8	1.0	2.4
Adj. PBT	0.3	0.5	0.0	2.1
Adj. EPS (p)	0.05	0.07	0.05	0.14
PER	23.8	17.0	23.8	8.3
EV/EBITDA	16.1	6.9	13.1	5.1

Source: Equity Development

Company Data

EPIC	REACT
Price (last close)	1.1p
52 weeks Hi/Lo	1.36p/0.72p
Market cap	£12.2m
ED Fair Value / share	1.7p
Net cash (as at 09/22)	£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

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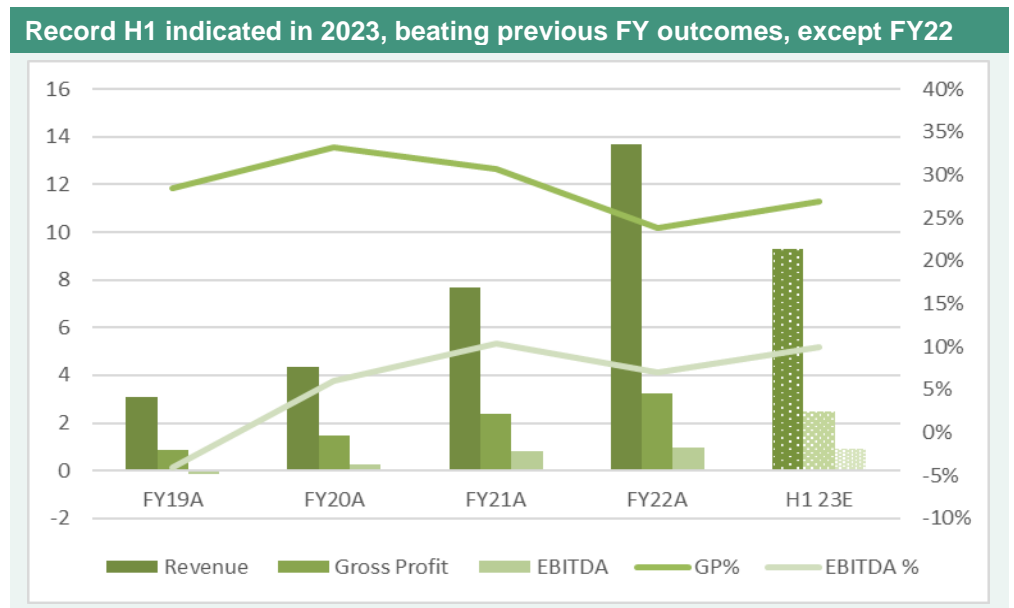
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Confidence underpinned by H1 trading

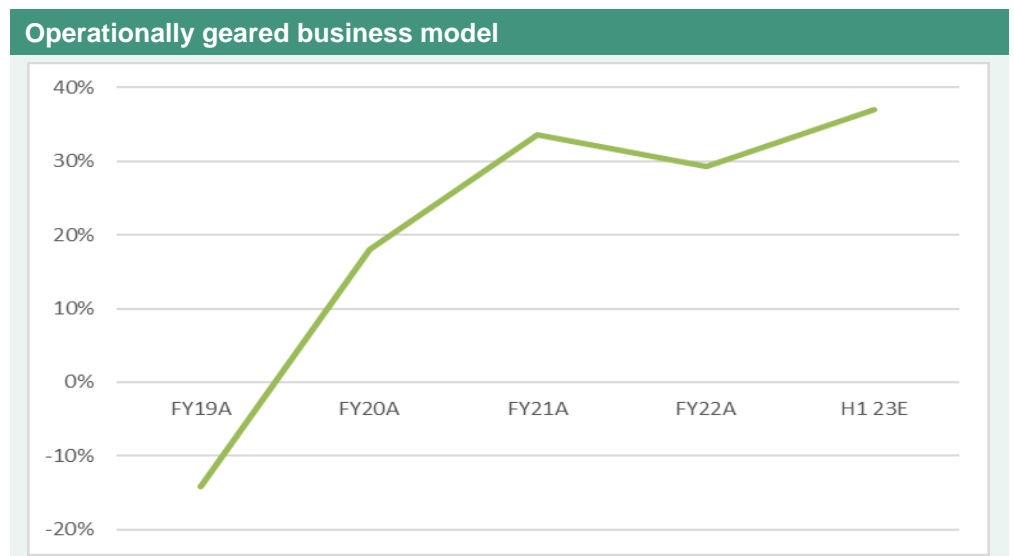
We reiterate our financial estimates first issued on [12 April](#), with previous confidence in the outlook underpinned by the findings of the pre-close trading update covering the first six months of the year. Encouragingly, the indicated revenue, gross profit and EBITDA of £9.3m / £2.5m / £0.925m were ahead of FY21 (£7.7m/£2.4m/£0.795m).

Gross margins reached c.26.9%, a record post-acquisition of Fidelis and LaddersFree. However, our medium-term target is for gross margins to reach 30%. Also, the indicated EBITDA of £0.925m is close to the FY outcome in 2022 of £0.953m. EBITDA margins improved to 9.9% (FY22A; 7.0%), close to the previous record of 10.3% reported in FY21A.



Source: Company

When one considers that revenues improved 80%+ yoy, gross profit rose 100%+ yoy and EBITDA almost six-fold, we think this highlights evidence of operational gearing at work. The targeting of a higher gross margin mix of business and improved visibility, as the proportion of recurring revenues increases augurs well, in our opinion, for the ongoing growth in profitability.



Source: Company, ED

The average H1/H2 revenue split from 2018 onwards equates to 42.8% / 57.2%, albeit this is somewhat distorted by the timing of the acquisition of LaddersFree in FY22 (mid-May 2022) and the impact of the COVID-19 related lockdowns. The indicated outcome for H1 '23 of revenue of £9.3m represents 48% of our FY23 estimate of £19.5m. Similarly, indicative H1 gross profit and EBITDA of £2.5m and £0.925m, equate to 48.2% and 37.7% of our FY23 estimates respectively. In view of the strong contract pipeline momentum during the first half of the year and the improving outlook, we reiterate our confidence in our FY23 estimates, particularly given the operationally geared nature of the business and rising gross margins.

We anticipate a modest step up in costs during H2 as a new Financial Controller is appointed (from late Q3) and improved processes begin to be implemented at LaddersFree, ultimately improving scalability and efficiency over the short-to-medium term. Based on continued growth via the conversion of the strong pipeline we expect revenue run-rates will be higher at the year end, which augurs well for FY24F.

In addition, we believe that the strong improvement in EBITDA points towards strengthening cash generation. Two of the three divisions are highly cash generative (Fidelis and LaddersFree), with REACT Specialist Cleaning ("REACT SC") generally more working capital intensive. Of the three divisions, REACT SC appears to be growing more modestly and as a result, we think the overall outflow in terms of working capital is likely to be limited for the full year.

With capex for the year likely to be modest at c.£0.1m (predominantly IT) **we expect free cash flow to amount to £1.6m for the year**. However, with deferred consideration of £1.3m, the increase in cash amounts to £0.1m and resulting in an overall modest net cash position by the end of September.

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	-0.6	2.1
Tax	0.0	0.0	0.3	-0.1	-0.5
Adj. Earnings	-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	0.0	0.0
Ave no of shares (FD) (m)	460.5	543.6	565.6	780.9	1112.0

Source: Company historic, Equity Development estimates

Summary Cash Flow

Year to Sep, £m	2019A	2020A	2021A	2022A	2023F
Operating profit	-0.2	0.2	0.5	0.0	2.2
Depn. & Amortn.	0.1	0.1	0.3	0.9	0.2
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

Valuation

We have constructed several models in the process of determining the fair value of REACT Group plc's shares. First, we look at 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.**

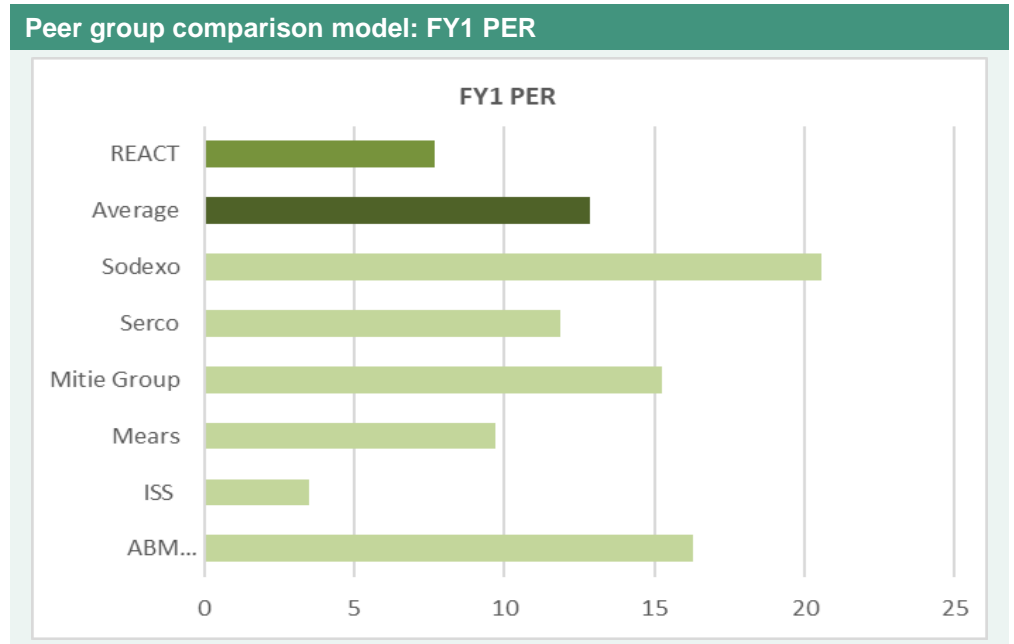
REACT Group DCF calculation										
£m	2023F	2024F	2025F	2026F	2027F	2028F	2029F	2030F	2031F	2032F
Free cash flow	1.7	1.8	1.8	1.9	1.9	1.9	2.0	2.0	2.1	2.1
WACC (%)	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00
Timing factor	0.50	1.50	2.50	3.50	4.50	5.50	6.50	7.50	8.50	9.50
Discount rate	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	2.1p									

Source: Equity Development

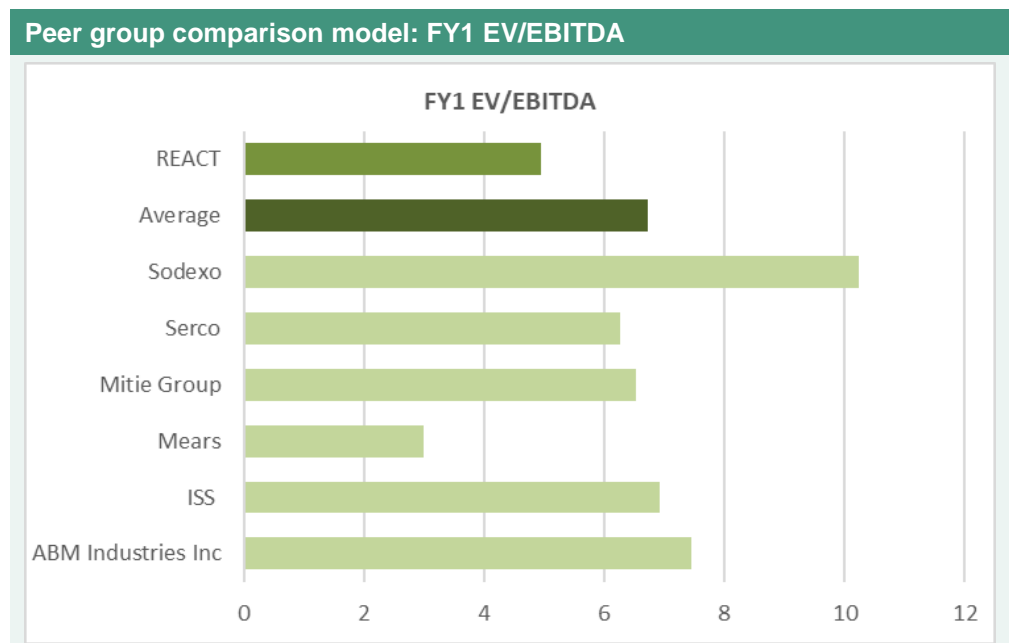
Peer group comparisons

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:



Source; Marketscreener



Source; Marketscreener

Peer group comparison model: FY1 Price/Book


Source; Marketscreener

Valuation 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 / share

	FY1 fair value, p
DCF	2.1
PER	1.6
EV/EBITDA	1.3
Price/Book	1.8
Average	1.7p

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 that the strong momentum within the business, as highlighted by the pre-close trading update for the six months to March, should result in the valuation gap narrowing.

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