React Group Plc

Records broken and encouraging trends

29 June 2023

The Group has delivered record revenues and EBITDA in H1 to March 2023. The rising proportion of recurring revenues, improving margins and strong cash generation in consolidating, specialist markets has resulted in improved visibility. As such, we have introduced estimates for FY24 and FY25, with an expectation that EBITDA margins will improve to 13%+ by FY25 (vs. 7.0% in FY22A). As the final deferred consideration will be paid during FY24, we expect net cash to rise to £3m or 34% of the NAV during FY25. Our increased fair value assumption reflects our DCF and FY1 PER and price/book peer group models.

- The reported results for the six months to March were impressive, with revenues improving 82%, adj. EBITDA increasing 471% to record levels and a margin of 9.9%. **We think there is further to go**. In fact, organic revenue growth improved 20%, with the remainder reflecting the acquisitions of Fidelis and LaddersFree. Gross margins improved 409 bps to 26.7%, as gross profit more than doubled to £2.5m.

- **LaddersFree** was a significant contributor to the margin expansion and increase in the level of recurring revenues, which incidentally rose to 85.7% or £8.0m. The strategic focus on added-value recurring revenues provides greater visibility and in turn, a higher quality earnings stream. Several contracts of note were added during H1, highlighting the focus on cross-selling group services to the three divisions' customers. The pipeline of opportunities continues to be positive.

- Each of the three divisions contributed towards the uplift in revenues, despite the slow start to the year at Fidelis. Encouragingly, **Fidelis** has been the main recipient of recent contract wins.

- The strategy is little changed, focusing on **growing scale** across each division, whether organically or via M&A. The addition of sales & marketing at Fidelis has strengthened customer relationships and is generating cross-selling opportunities across the Group. Further investment is required at LaddersFree over the next 12+ months, not least in sales & marketing, IT, and systems/processes. Long term contracts are targeted, particularly where there is access to higher margins, to further improve the recurring revenue stream.

- Interestingly, the Board has issued quantitative guidance on its strategy, **expecting the inherent value within the business to rise five-fold (minimum expectation) over the next three to five years**. This will be driven by the improving profitability of group activities, reflecting a combination of organic and M&A-led growth.

Rise in fair value / share assumption

Improved visibility generated by the focus on added-value, long term contracts has enabled us to introduce estimates for FY24 and FY25. We anticipate a CAGR in revenues/EBITDA of 15.3%/35.8% respectively between FY22A and FY25F. Adj. EBITDA margins increase from 7.0% to 13.4%. Our expectation is investment in the business and/or M&A will take precedence over dividends for now. **We have increased our fair value / share estimate to 2.0p (from 1.7p), a 57% premium to the current price.**

Estimates

£m	FY21A	FY22A	FY23F	FY24F	FY25F
Revenue	7.7	13.7	19.5	22.0	24.2
Adj. EBITDA	0.8	1.0	2.4	2.8	3.2
Net cash/(debt)	0.6	0.0	0.6	0.7	3.0

Source: Company historics, ED estimates

Company Data

EPIC	REAT
Price (last close)	1.30p
52 weeks Hi/Lo	1.45p/0.72p
Market cap	£14.9m
ED Fair Value / share	2.0p
Net debt (March '23)	£0.26m

Share Price, p

Source: ADVFN

Description

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

Contract Maintenance, accounting for 73.0% of revenues in H1 '23, whereby the Company delivers regular cleaning regimes to customers in the healthcare, education, retail, and public transport sectors.

Contract Reactive, representing 12.7% of revenues in H1 '23, where the Group might be the first responder to an on-call emergency response service under a formal contract / framework agreement, sometimes on a 24/7/365 basis.

Ad Hoc, equating to 14.3% of H1 '23 revenues, provides a solution to one-off situations outside a framework.

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Strong revenue and EBITDA momentum

Interim results			
£m	**H1 22A**	**H1 23A**	**% change %**
Contract Maintenance	3.3	6.8	108.3%
Contract Reactive Work	0.9	1.2	26.6%
Ad Hoc Work	0.9	1.3	44.2%
Group revenue	5.1	9.3	81.9%
CoGS	-4.0	-6.8	72.2%
Contract Maintenance	0.5	1.9	262.1%
Contract Reactive Work	0.3	0.3	5.3%
Ad Hoc Work	0.4	0.3	-14.1%
Gross profit	1.2	2.5	114.9%
Contract Maintenance, %	15.9%	27.7%	
Contract Reactive, %	30.1%	25.1%	
Ad Hoc, %	38.4%	22.9%	
Gross margin %	22.6%	26.7%	
OpEx	-1.2	-2.5	103.1%
Adj. EBITDA	0.2	0.9	471.0%
Adj. EBITDA margin %	3.2%	9.9%	
EBIT	0.09	0.84	827.5%
EBIT margin %	1.8%	9.1%	
Interest	0.00	-0.07	2266.7%
Adj. PBT	0.09	0.77	778.4%
Amortisation of acqd intangibles	-0.15	-0.82	
Exceptional items	-0.03	-0.04	
Reported PBT	-0.09	-0.09	
Taxation	0.00	0.00	-100.0%
Adj. PAT	0.08	0.77	820.2%
Adj. EPS (p)	0.01	0.07	357.5%
Net cash / (debt)	-0.04	-0.26	511.9%
Dil. WAV no. of shs (m)	570.3	1147.1	101.2%

Source: Company

Revenue growth in the six months to March 2023 was very strong, rising 82% yoy to a record £9.3m. Although the majority of the top-line growth reflected the acquisition of LaddersFree (completed in May 2022), the Group delivered positive levels of organic growth (c. 20% yoy). The pipeline of potential contracts remains positive, with several of note added during the period, with Fidelis the main beneficiary.

A strong recovery in Q2 in which Fidelis delivered record revenues, followed a weak start to the year due to operational challenges. Since the Group acquired Fidelis in late March 2021, revenues have risen dramatically within the business – double pre-acquisition levels – with systems, processes, and management strengthened supporting future growth. New contracts were secured within education, healthcare, and a property services business.

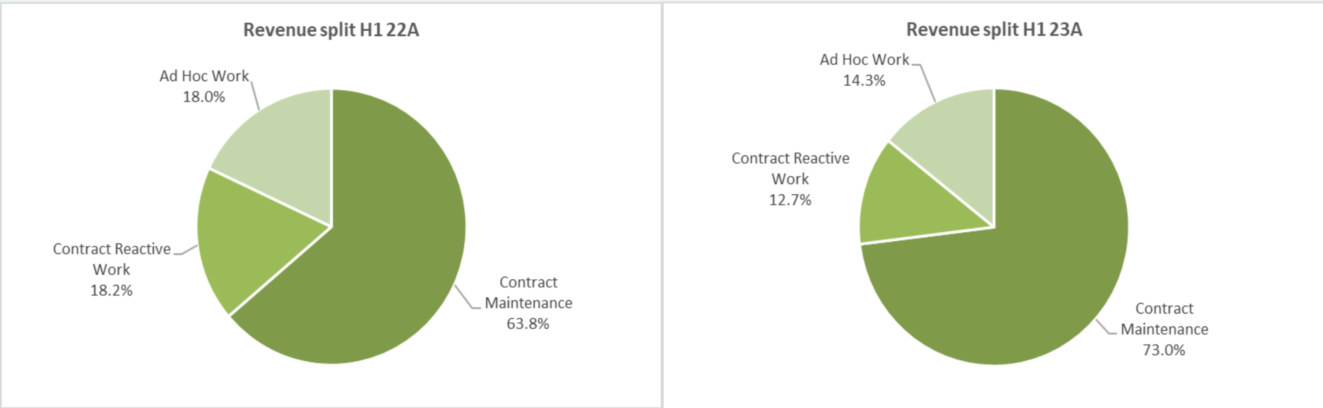
Similarly organic growth at LaddersFree amounted to 25% relative to pre-acquisition levels. The largest contract won during the period was with a nationwide fast-food restaurant, benefitting all three divisions of the Group, with specialist deep cleaning services provided by REACT SC and Fidelis, with LaddersFree continuing to clean the windows and facades of the chain's outlets.

REACT SC delivered top-line progress, with its markets buoyant during the period. The momentum reflected the upselling of its services to the clients of LaddersFree as well as taking the business into new segments.

We highlight in the charts below how the acquisition of LaddersFree has further improved the proportion of revenues derived from contracts, notwithstanding the slow start to the year at Fidelis. The proportion of revenues under contract rose to 85.7% during H1 '23 and compares to 82.0% a year earlier.

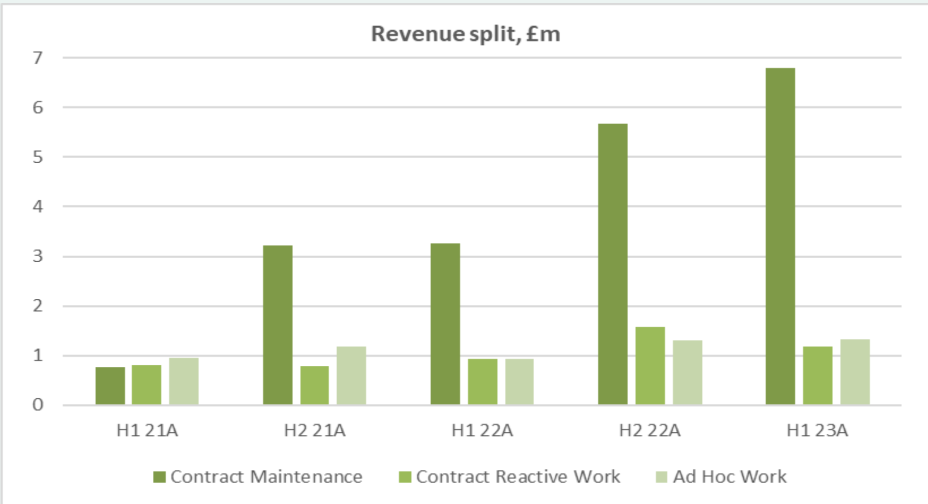
The second chart underlines with perhaps greater clarity the impact of LaddersFree, as the level of contract maintenance revenues **more than doubled** from H1 '22 levels. It is perhaps worth pointing out that prior to the acquisitions of Fidelis and LaddersFree, Ad Hoc represented the largest category, equating to 37.6% of revenues!

Growth in the proportion of contracted revenues



Source: Company

Revenue progression by category

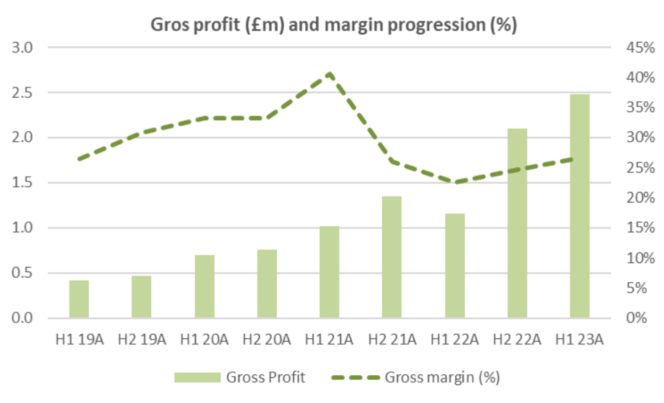


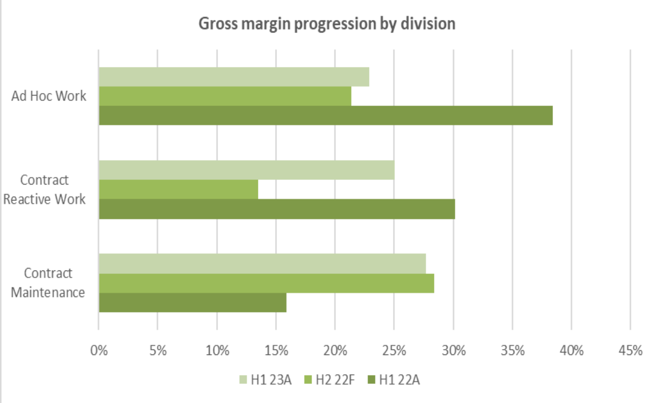
Source: Company

What is perhaps more significant, is the improvement in gross margin.

Year-on-year the mix by sector changed, with LaddersFree (100% contract maintenance) operating at higher margins than Fidelis. The H1 recovery at REACT SC, where margins tend to be higher than the norm, combined to result in gross margins improving by 409 bps y-o-y. We note that margins remain below peak levels and with a focus on improving returns, we see scope for progress on this metric over the short and medium term.

Gross profit and margin progression



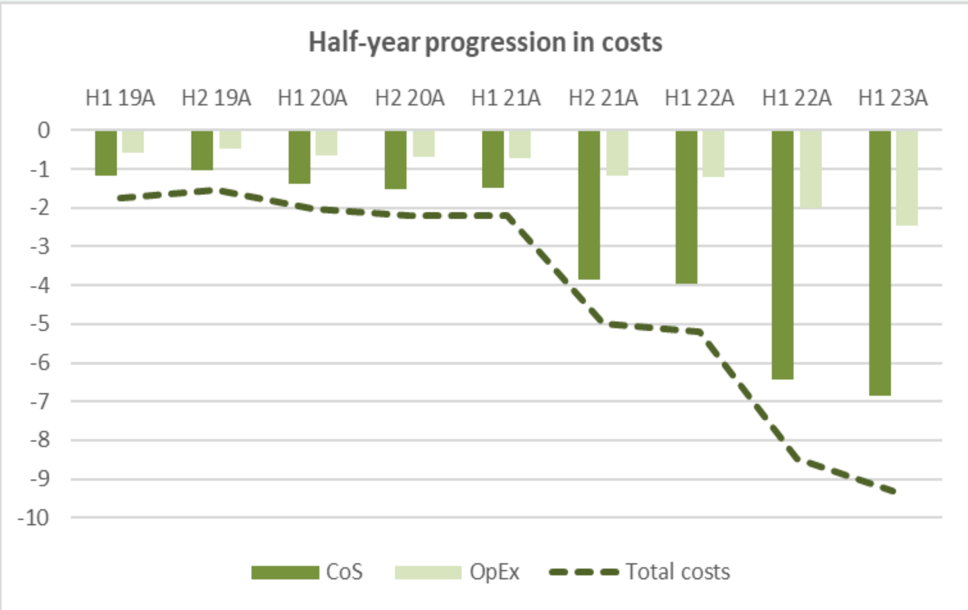


Source: Company

The rise in total costs largely reflects the acquisitions, albeit at +79.4% yoy it remains below the increase in revenues. Costs of sales rose at a slower rate of +72.2% to £6.8m, as the margin mix of the business improved following recovery at REACT SC and the purchase of LaddersFree.

However, OpEx more than doubled to £2.5m (+103.1% yoy), reflecting the acquisition of LaddersFree but also the investment in management and marketing teams, as well as systems at Fidelis to support future growth expectations.

Total costs = CoGS + OpEx

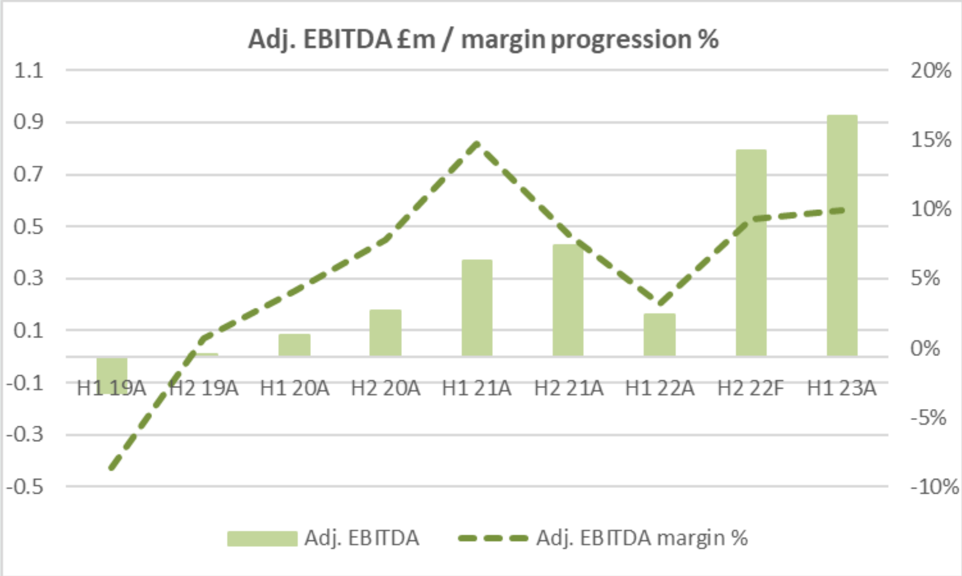


Source: Company

Adj. EBITDA improved 471% to £0.9m (H1 '22: £0.2m), with the associated margin rising 676 bps to 9.9%.

The EBITDA margin is a whisker away from the record of 10.3% reported in FY21A. Nevertheless, as we demonstrate in the Financials section, we continue to be of the view that there is further to go in terms of the EBITDA margin during the forecast period.

Continued recovery in EBITDA and margin

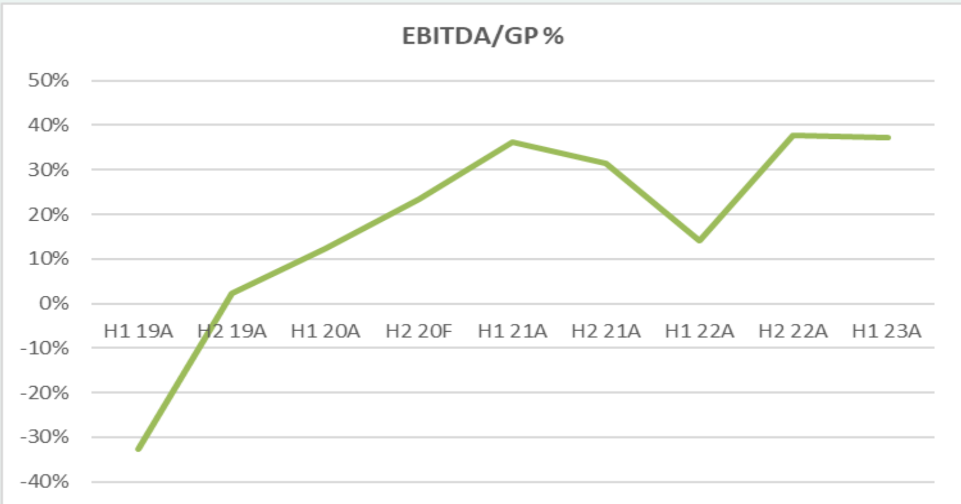


Source: Company

With revenues 81.9% higher, gross profit +114.9% and EBITDA up by a staggering 471%, the Group is clearly operationally geared.

The targeting of a higher gross margin mix of business, coupled with an improved visibility (85.7%) and a strong pipeline of contract opportunities, aided by cross-selling the Group's services, augurs well for further top-line growth and margin improvement over the short-and-medium term. We highlight the operationally geared nature of the business in the chart below.

Contracted revenues)



Source: Company

Adj. EBIT, excluding exceptionals and amortisation (including on acquisitions) and depreciation, delivered a strong uplift to £0.8m yoy (+£753k). This equated to a 9.1% EBIT margin (H1 '22: 1.8%).

Nevertheless, the positive margin is further evidence of the recovery in process by the current Board. Our expectation is that EBIT is likely to increase significantly from here, not only during H2 but also over the medium term.

Net interest payable rose to £71k (H1 ’22: £3k), reflecting a combination of rising interest rates, the funding of deferred consideration and a broader revenue base. No taxation was paid during the period as tax losses are utilised. We do expect taxation on the FY23 profits, although in reflection of the tax losses there will be no immediate payment on account but rather it will be seen within the cash flow during FY24. Adj. EPS improved to 0.07p from 0.01p per share during H1 ’22, despite the significant increase in the diluted number of shares following the acquisition of LaddersFree.

It remains the goal of the Board to ultimately pay dividends, but in the short term the preference remains fixed on securing above trend organic growth, alongside expected M&A activity.

Cash flow statement

Strong growth was experienced in cashflow from operations, with £0.8m generated, more than offsetting the outflow experienced in FY22. The crucial difference was the modest outflow in working capital, notwithstanding the significant increase in revenues. Generally, contracted revenues tend to be cash positive, in that the Group is paid ahead of it paying its creditors. The addition of LaddersFree, which is the only division that comprises solely contracted revenues, has improved the Group’s overall working capital cycle.

The level of depreciation and amortisation reflected the acquisition of LaddersFree over a year ago, rising to £0.9m (H1 ’22: £0.2m) and matching levels seen in the 12-months to September 2022.

Capex was modest at £38k (H1 ’22: £64k), comprising a vehicle and limited IT spend at LaddersFree. M&A expenditure of £0.9m (H1 ’22: £0.5m) reflected deferred consideration relating to the Fidelis and LaddersFree purchases.

As a result, net outflow of cash equated to £0.3m (H1 ’22: £0.7m), moving the Group into a modest net debt position.

Balance sheet

The balance sheet was broadly unchanged from the year end, with net assets of £8.3m. The Group moved to a modest net debt position of £0.26m, from a neutral balance sheet at the FY22 year-end 9+£0.01m).

Although working capital increased modestly, the composition changed markedly, as long-term debtors reduced and the increase in short-term debtors reflected the growth in revenues and the broadening of the customer base.

The level of intangibles (other) reduced by £0.8m from year end levels, reflecting amortisation. Apart from ‘other creditors’ (a £1.2m reduction since the year-end) and taxation (a £0.1m fall from the year end position), current and non-current liabilities were broadly static compared to September 2022’s levels.

Financials

The rising proportion of contracted revenues, rising margins and an improving pipeline following several contract wins during H1, all give greater confidence of the Group meeting full year expectations. Looking to the medium term, the same factors enable us to introduce estimates for FY24 and FY25.

We highlight our medium-term estimates in the table below.

Maiden expectations for FY24 and FY25 added

Year-end Sept, £m	FY23F	FY24F	FY25F
Revenue	19.5	22.0	24.2
EBITDA	2.4	2.8	3.2
Adj. EPS (p)	0.14	0.16	0.19
Net cash/(debt)	0.6	0.7	3.0

Source: Equity Development

Encouragingly, the positive momentum witnessed during H1 continued into H2. Additionally, several contract wins were secured during the period, including:

- £0.8m contract with a nationwide fast-food restaurant covering all three Group subsidiaries
- LaddersFree added furniture and automotive retailers to its list of customers
- A £0.5m, 18-month contract with a Midlands school by Fidelis
- A £0.54m three-year contract within the education sector (Fidelis), and
- A one-year, £0.2m contract with an NHS Trust benefitting Fidelis.

The average H1/H2 revenue split at 42.8% / 57.2% was distorted by the timing of the Fidelis and LaddersFree acquisitions. On this basis, the £9.3m of revenues reported in H1 '23 represents 47.8% of our FY23 expectation and in view of several sizeable contract wins during H1 engenders confidence that FY revenue estimates will be met. Similarly, H1 '23 gross profit of £2.5m represents 47.9% of our FY23 expectation, compared to the post-2017 average of 44.6%/55.4%.

The relative weakness in the economy has resulted in some site closures within the retail and leisure sectors and a reduction in the frequency of the work. However, the pipeline of potential orders within the Group remains positive, with the scale of wins more than offsetting any weakness seen to date. Momentum continued to build into H2 and shows no signs of slowing down at this stage. If anything, the Group has just started to cross-sell its services to the customers of LaddersFree and as a result, there is further to go.

In terms of the cost base, we anticipate a modest increase, reflecting:

- The addition of a Financial Controller from late Q3
- Improved processes implemented at LaddersFree, with a focus on digitalisation, where appropriate
- Investment in sales & marketing within LaddersFree

The latter two areas represent the Board repeating the process which followed the integration of Fidelis. In upgrading its systems and processes, the aim is to improve the ability of the business to deal with rising revenues in a cost effective and timely manner. The addition of sales resource is expected to further drive the cross-selling of the Group's services across all divisions.

We are suggesting revenue, gross profit, and EBITDA growth of 12.5%, 11.8% and 14.9% respectively in FY24. In FY25 we again factor in only growth generated organically, suggesting revenues will rise by a further 10%, gross profit by 10.0%, and EBITDA by 17.4%. Again, this demonstrates the inherent operational gearing implicit within the Group's business model.

The critical element of the Group's strategy is targeting a minimum five-fold increase in value over the next three to five years. We strongly suspect the growth will be derived from a combination of organic growth and M&A, with margin expansion resulting in faster EBITDA momentum, in turn resulting in a re-rating of the shares as it narrows the gap to its peers.

The Group has begun to utilise its tax losses, amounting to c.£0.9m and which we expect to be used up in the current year. As such, we expect the tax payable in FY24 and FY25 to rise considerably.

We note the short-term impact of the higher diluted number of shares on adj. EPS in the current year. That said, our expectation is one of strong growth into FY24 and FY25.

We expect the Group to remain off the dividend list until FY25. This reflects:

- The expected deferred consideration, payable in cash, of c. £1.3m payable in FY22/23 and a further £2.0m in FY23/24
- A focus on using any cash generated to grow revenues and profitability as margin expansion is targeted.

Cash flow estimates

Moving forward, we anticipate net cash to improve to £0.7m by the end of FY24 and to £3.0m at the end of FY25. The movement in cash is likely to be as follows:

- Deferred consideration of £1.3m in FY23 and £2.0m in FY24 suppressing the level of cash generated
- No deferred consideration payable in FY25 on either Fidelis or LaddersFree
- EBITDA margins rising to 13.4% by the end of FY25, from 7.0% in FY22A
- Working capital broadly neutral, highlighting the positive contribution of LaddersFree
- Following the utilisation of tax losses in FY23, cash tax will increase to a £0.6m outflow by FY25
- Capex modest, predominantly comprising vehicles and IT
- Net cash generation rising to £2.3m during FY25, ceteris paribus.

Abbreviated balance sheet estimates

We estimate net assets will improve modestly over the next two years to £8.4m by the end of FY24 and to £8.9m a year later. Our assumptions include:

- Net cash rising to £0.7m by the end of FY24 and to £3.0m by the end of FY25
- Net cash equating to 34% of net assets by the end of FY25
- The level of amortisation associated with the LaddersFree acquisition is having a marked impact on the level of non-current assets during the forecast period.

FINANCIALS

Summary Profit & Loss					
Year to Sep, £m	**2021A**	**2022A**	**2023F**	**2024F**	**2025F**
Contract Maintenance	4.0	8.9	14.7	16.6	18.2
Contract Reactive work	1.6	2.5	2.5	2.8	3.1
Ad Hoc work	2.1	2.2	2.3	2.6	2.8
Revenue	7.70	13.67	19.52	21.96	24.16
CoGS	-5.3	-10.4	-14.3	-16.2	-17.8
Gross profit	2.4	3.3	5.2	5.8	6.4
Gross margin (%)	30.8%	23.8%	26.6%	26.4%	26.4%
Op costs	-1.9	-3.2	-4.6	-4.9	-5.0
Other Op. income	0.0	0.0	0.0	0.0	0.0
EBITDA	0.8	1.0	2.4	2.8	3.2
EBITDA margin (%)	10.3%	7.0%	12.3%	12.6%	13.4%
EBITA	0.7	0.8	2.2	2.6	3.1
EBITA margin (%)	8.8%	5.7%	11.5%	11.8%	12.7%
Net Interest	0.0	-0.1	-0.1	-0.1	-0.1
Associates	0.0	0.0	0.0	0.0	0.0
PBT (Adjusted)	0.7	0.7	2.1	2.5	3.0
Amortisation of acqd intangibles	-0.1	-0.7	-1.6	-1.6	-1.7
Exceptionals	-0.4	-0.5	0.0	0.0	0.0
PBT (Reported)	0.1	-0.6	0.4	0.8	1.3
Tax	0.3	-0.1	-0.3	-0.6	-0.8
Adj. PAT	1.0	0.6	1.8	1.9	2.2
Minority interests	0.0	0.0	0.0	0.0	0.0
Adj. Earnings	1.0	0.6	1.8	1.9	2.2
Reported PAT	0.4	-0.7	0.1	0.2	0.5
Ordinary Dividends	0.0	0.0	0.0	0.0	0.0
EPS (Adjusted) (p)	0.17	0.07	0.14	0.16	0.19
DPS (p)	0.0	0.00	0.00	0.00	0.00
Ave no of shares (FD) (m)	565.6	780.9	1147.1	1147.1	1147.1

Source: Company historics, Equity Development estimates

Summary Cash Flow

Year to Sep, £m	2021A	2022A	2023F	2024F	2025F
EBIT	0.5	0.03	0.59	0.95	1.41
Depn. & Amortn.	0.3	0.92	1.81	1.81	1.83
Working capital movement	-0.4	-1.8	-0.2	-0.1	-0.1
Other	0.1	0.1	-0.1	0.0	0.0
Operating cash flow	0.5	-0.8	2.1	2.7	3.1
Net Interest	0.0	-0.1	-0.1	-0.1	-0.1
Taxation	0.3	-0.1	0.0	-0.3	-0.6
Net capex	-0.1	-0.1	-0.1	-0.2	-0.2
Operating FCF	0.8	-1.0	1.8	2.2	2.3
Net (Acquisitions)/Disposals	-2.1	-5.8	-1.3	-2.0	0.0
Dividends	0.0	0.0	0.0	0.0	0.0
Share Issues	0.2	6.2	0.0	0.0	0.0
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)	-1.2	-0.6	0.5	0.2	2.3
Opening Net Cash/(Debt)	1.7	0.6	0.0	0.6	0.7
Closing Net Cash/(Debt)	0.6	0.0	0.6	0.7	3.0

Source: Company historics, Equity Development estimates

Movement on Net Assets

Year to Sep, £m	2021A	2022A	2023F	2024F	2025F
Opening Net Assets	2.2	2.8	7.8	8.1	8.4
Earnings	0.4	-0.7	0.1	0.2	0.5
Dividends paid	0.0	0.0	0.0	0.0	0.0
Share Issues	0.2	6.2	0.0	0.0	0.0
Goodwill	0.0	0.0	0.0	0.0	0.0
Other	0.0	-0.5	0.2	0.0	0.0
Closing Net assets (ex minorities)	2.8	7.8	8.1	8.4	8.9
Movement on Net Assets	0.6	5.0	0.3	0.2	0.5

Source: Company historic data, Equity Development estimates

Valuation

We have constructed two valuation models to determine a fair value for REACT Group plc's shares. The widening of the forecast period from one year to three years is underpinned by the rising proportion of contracted revenues, as witnessed during H1 '23.

Discounted cash flow

We have introduced a discounted cash flow model for REACT Group using what we believe are conservative assumptions: a discount rate of 10%, a terminal growth rate of 2.5% and capex ahead of depreciation throughout (investment to drive revenue growth).

The model suggests a fair value / share of 2.7p, more than double the current share price.

REACT Group DCF calculation

£m	2023F	2024F	2025F	2026F	2027F	2028F	2029F	2030F	2031F	2032F
Free cash flow	2.0	2.3	2.4	2.4	2.5	2.6	2.6	2.7	2.8	2.8
WACC (%)	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00
Timing factor	0.75	1.75	2.75	3.75	4.75	5.75	6.75	7.75	8.75	9.75
Discount rate	0.93	0.85	0.77	0.70	0.64	0.58	0.53	0.48	0.43	0.39
Present value	1.9	1.9	1.8	1.7	1.6	1.5	1.4	1.3	1.2	1.1
Sum of discounted cash flows	15.3									
Terminal growth rate (%)	2.50									
Terminal value	14.9									
Net debt	0.6									
Equity value	30.7									
No. of shares (m)	1,147.1									
Value per share, p	2.7									

Source: Equity Development

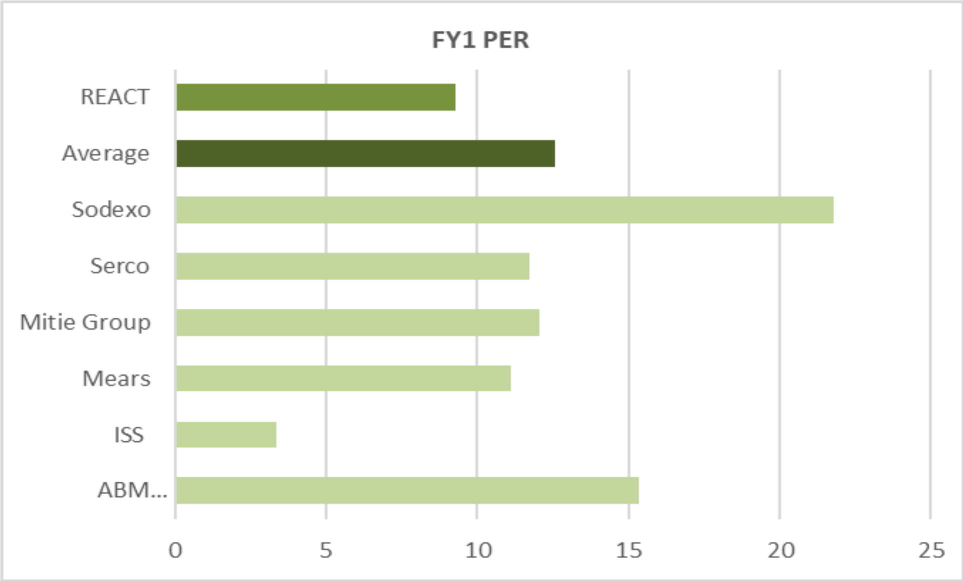
Peer group comparisons

Although there are no direct, listed competitors to REACT, we have included several facilities management companies who offer general cleaning as one of the services provided to customers. Several such businesses in fact sub-contract their specialist, emergency, and window cleaning services to third parties, such as REACT.

It is worth mentioning that in view of the turnaround of the business, which was loss-making in FY21 and break even in FY22 to double digit EBITDA margins from FY23 and low double-digit EBITA returns in FY24 and FY25, comparisons to its peers using metrics such as PER and EV/EBITDA are not entirely appropriate in our opinion.

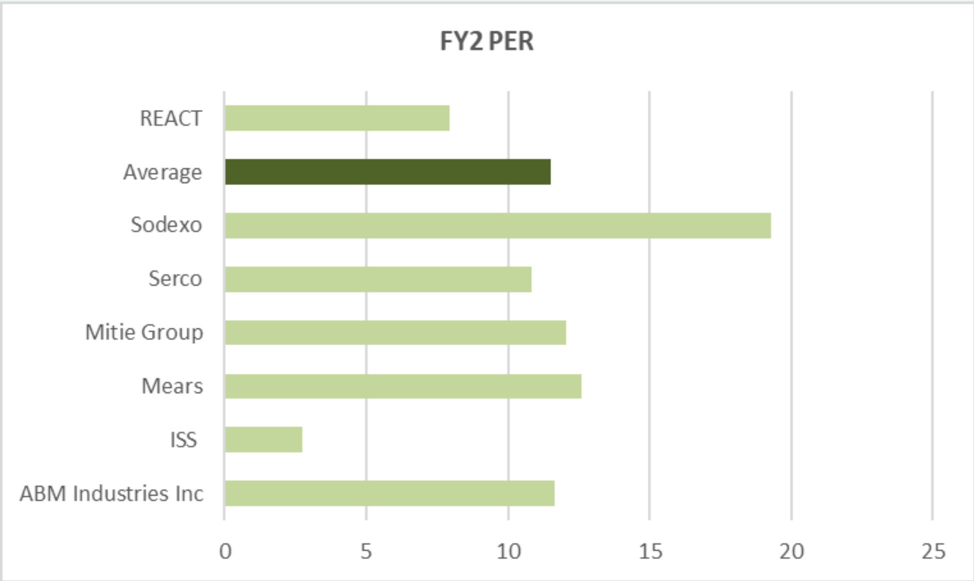
Instead, we demonstrate in the chart below the scale of the discount the group trades on relative to its peers' price/book and PER ratios.

Peer group comparison model – FY1 PER (x)



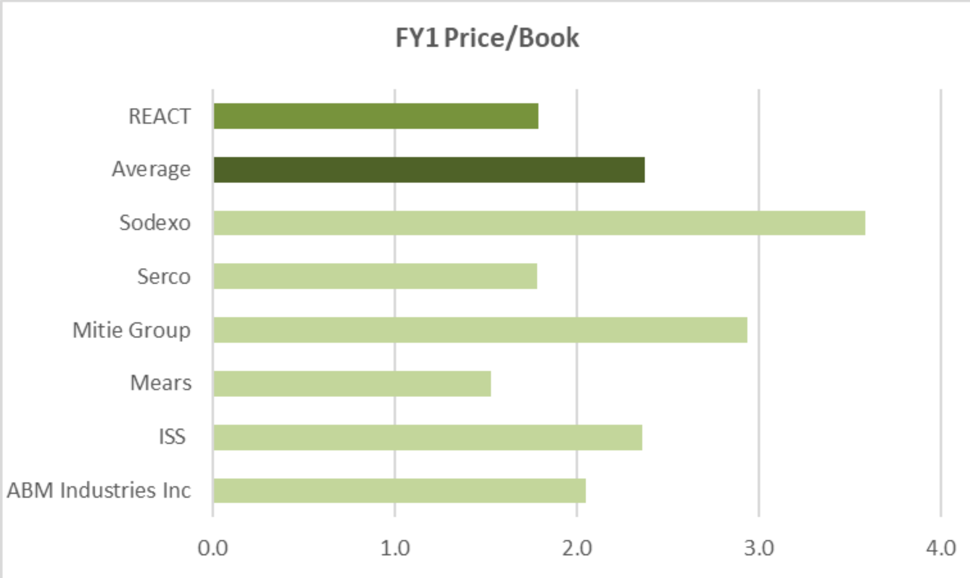
Source; Market Screener

Peer group comparison model – FY2 PER (x)



Source; Market Screener

Peer group comparison model – FY1 Price/Book (x)



Source; Market Screener

Valuation conclusions

We have taken account of the comparative valuations on a FY1 price/book basis, 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. We counter the argument of a larger size discount being required by highlighting the pace of recovery and anticipated top-and-bottom line growth relative to its peer group.

Fair value

	FY1 fair value	FY2 fair value
DCF	2.7	2.7
PER	1.5	1.7
Price/Book	1.5	n/a
Average	**1.88**	**2.19**

Source: ED

We have increased our fair value / share estimate to 2.04p (from 1.7p), representing a 57% premium to the current price.

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