Investors' Chronicle | Alpha

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Alpha shares analysis

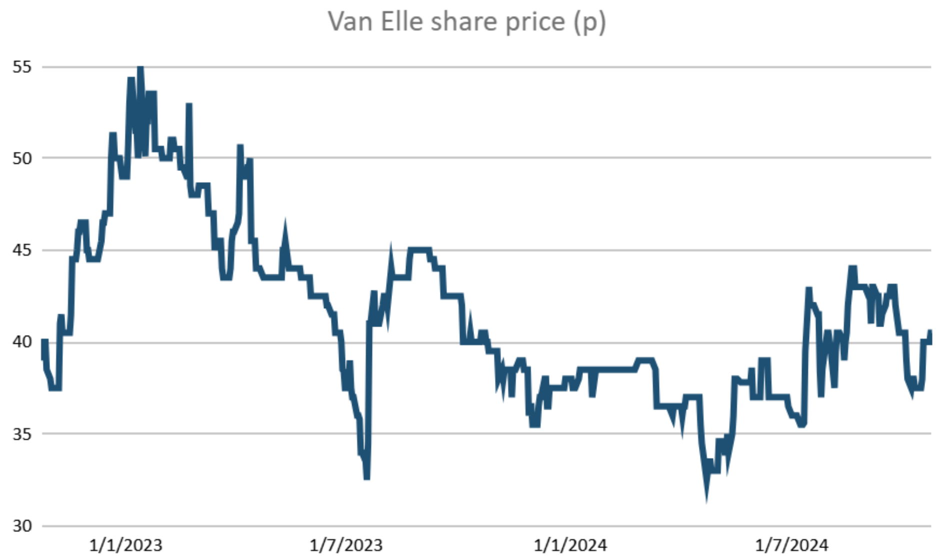
28 October 2024

Value shares waiting to convince the market

Cheap share price ratings often reflect valid risks that the market is right to price in, however it can also be worthwhile to be on the lookout for catalysts that may prompt a re-rating and positive shareholder returns.

Analyst: Phil Oakley

Van Elle Holdings (VANL)



Source: LSEG

Shares in construction or construction-related businesses don't tend to command high stock market valuations. This is because their revenues and profits tend to be very volatile. They are strong when the economy is doing well, but weak when the economy is heading down.

Investors prefer stable and consistent levels of profitability and will pay higher multiples of earnings for businesses that have these characteristics – especially if they have decent long-term growth prospects.

These truths are often forgotten by investors when looking at construction company shares. They often mistake the low valuations as a sign of value or cheapness rather than a reflection of their business models and trading environments.

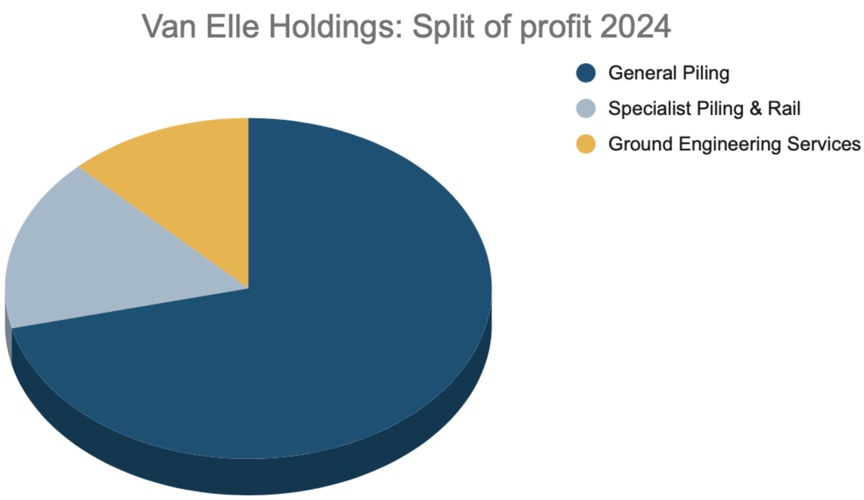
This looks to be the case of **Van Elle Holdings (VANL)**, the UK's largest geotechnical and ground engineering contractor. At its current share price of 40p, its shares trade on a one-year forecast price to earnings (PE) ratio of 8.5 times and at an 11 per cent discount to its last reported tangible net asset value (NAV) per share of 45.3p.

Yet, its earnings per share (EPS) is expected to grow at more than 20 per cent per year for the next three years. Could Van Elle shares be too cheap, even with its lumpy profits?

Let's take a closer look at its business.

How does it make money?

Van Elle makes most of its money from an activity known as piling.



Source: Company/Investors' Chronicle

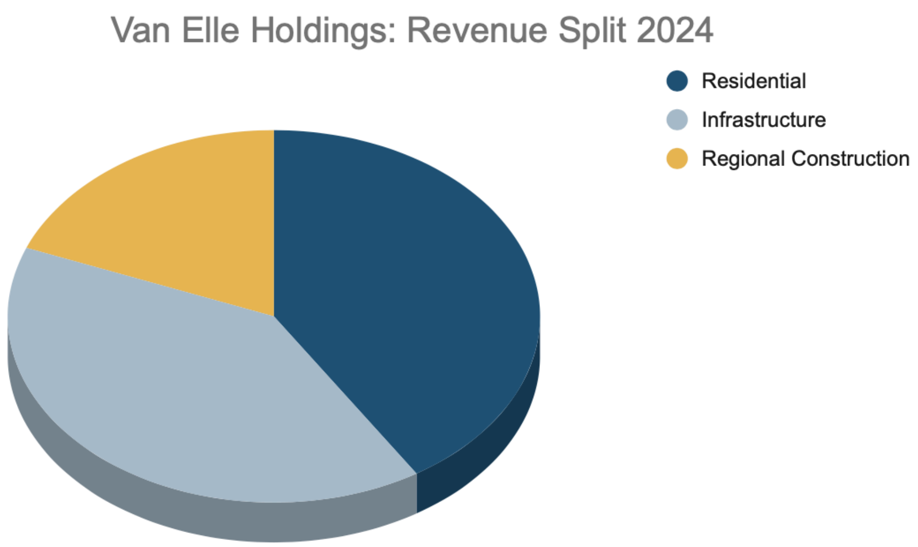
Piling is the use of long cylinder-shaped structures called piles – usually made of concrete – that are put into the ground in order to provide stable and reliable foundations for buildings and construction projects.

They are installed with heavy-duty machines (pile drivers), which force the pile into the ground until it meets a solid layer of rock or soil. The piles are then built up to create a deep foundation that will evenly distribute the weight of structures such as buildings, bridges, roads and homes. They are also used to fix faulty foundations and weak structures.

Van Elle's profits are dominated by its general piling business, which are used in large construction projects such as housing.

Its Specialist and Rail business is focused on projects where there is restricted access and low headroom such as tunnels, under bridges, inside buildings and in basements.

Ground engineering services are based around activities such as drilling, sampling, analysing and reporting ground information to support design and construction activities.



Source:Company/Investors' Chronicle

Van Elle's end markets are dominated by residential construction and infrastructure markets.

The company operates in competitive markets – especially in general piling which is very price-driven – but does have some competitive advantages.

It has 132 piling rigs which is the largest in the sector. It has kept this portfolio of assets well invested and up to date. It also benefits from 25 specialist ground engineering techniques, which give it the opportunity to work in many different sectors and do its work better than some of its competitors can.

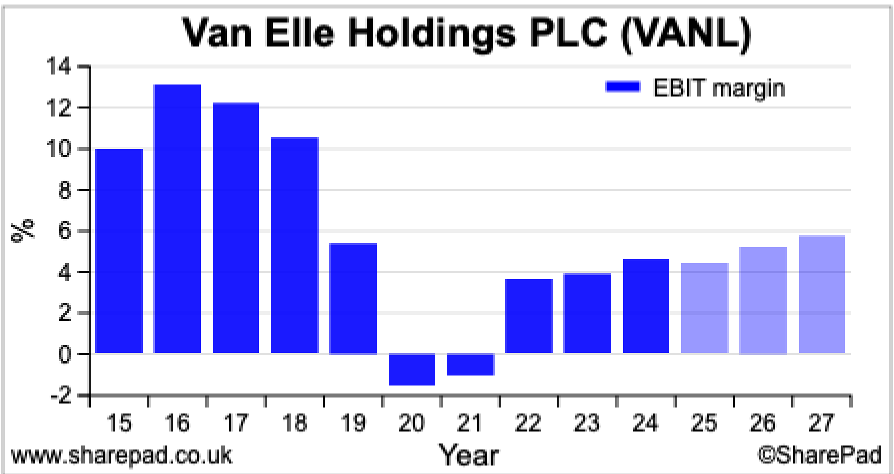
Van Elle also has a directly employed workforce which has helped it build the confidence and long-term relationships with its customers.

Revenue visibility for the business is quite short. For example, Van Elle's order book at the end of April 2024 was £35.1mn and amounted to around a quarter of its full-year revenues.

Revenues are volatile due to economic factors, as well as industry-specific factors. Its customers in infrastructure sectors such as rail, water and electricity grids have five-year spending plans set by their regulators. This often leads to a ramp-up in spending at the start of a period with a tail-off towards the end which is then reflected in Van Elle's revenues from them.

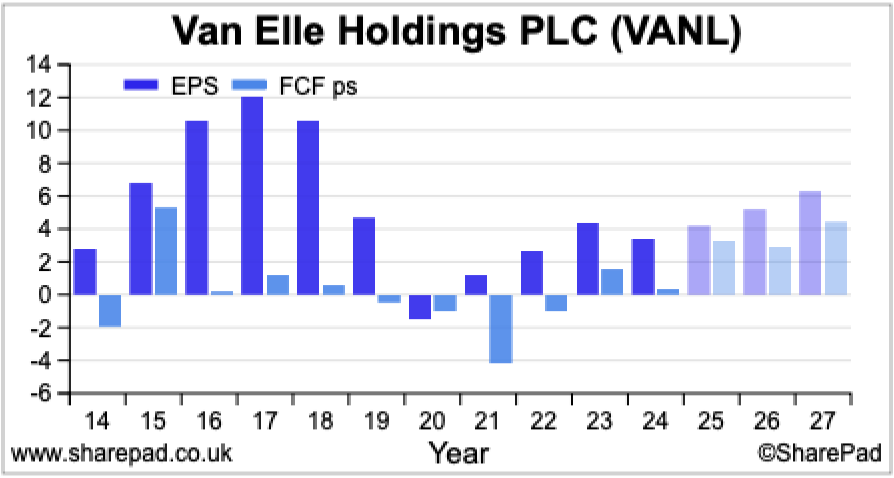
Low profit margins and weak free cash flow generation

While general piling can make high single-digit percentage profit margins, Van Elle's margins in general are not very high, which is quite typical for the construction industry.



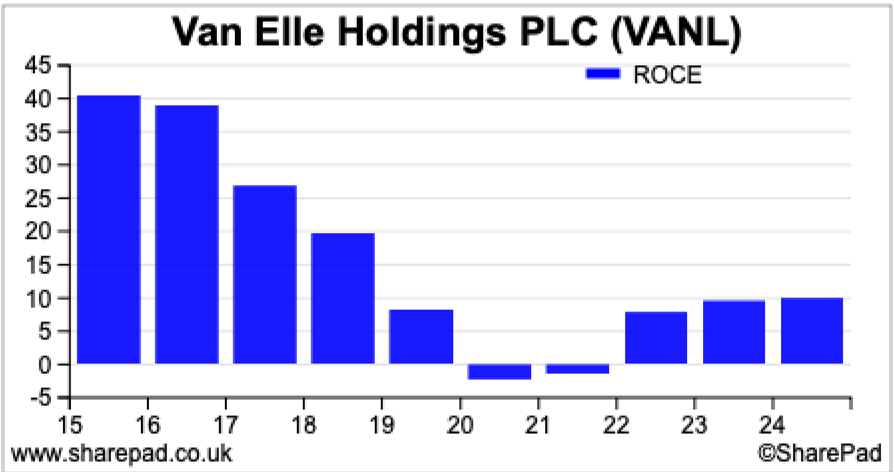
Another characteristic of the business is that its free cash flow generation is quite weak with free cash flow (FCF) per share often much lower than earnings per share (EPS).

This can be explained by its customers having significant buying power and favourable payment terms, which results in cash being tied up in trade debtors. Van Elle also typically spends reasonable sums of money each year replacing its rig fleet. The amount spent has been roughly equal to its depreciation expense over the last decade.



A sharp fall in operating margins from a decade ago has seen return on capital employed (ROCE) fall to just over 10 per cent in the year to April 2024, which is a modest level.

What seems to have been an issue for the business is that the utilisation of its rigs – how often they are in use – has been quite low at just 51 per cent in 2024. Improving utilisation here could see a big improvement in profits and ROCE.



Things can only get better

Management is very upbeat about the future of the business and has set itself some very ambitious financial targets:

- Revenue growth of at least 10 per cent a year.
- Improve operating margins from 4 per cent to 6-7 per cent.
- Improve ROCE from 10 per cent to 15-20 per cent.

If it can do this and sustain the targeted improvements then Van Elle will deserve to be a much more valuable business in a few years' time than it is today.

There are good grounds for thinking that lots of extra work could come its way.

The key to a sustained uplift in profits rests with its exposure to the residential housing market. Higher mortgage rates have dampened the effective demand for homes in the UK and house-building companies have been building fewer homes as a result. A recovery is needed here to help Van Elle as is the ability of the current government to stimulate the building of more affordable homes.

The infrastructure of the UK is in dire need of more investment to replace old assets and to cope with a growing population and the increased electrification of daily life. This is leading rail, water and electricity network companies to spend more on assets which should feed through into higher revenues and profits for Van Elle.

Van Elle is also improving its growth prospects by moving into new business areas such as civil engineering and entering into partnerships with companies such as Galliford Try and M&J Evans to strengthen their revenue base. The company has also moved into the Canadian rail market.

Acquisitions have also brought new capabilities to Van Elle such as the Smartdeck™ housing foundation solution, Screwfast™ foundations used in highways and energy markets and the Smartfoot™ precast concrete foundation system.

If the volumes of extra work come through then the improved asset utilisation and operating leverage in the business could well see Van Elle get close to meeting its financial goals and the current bullish profit forecasts of City analysts.

So why are the shares so subdued?

The shares have gained 9.7 per cent year to date and offer a reasonable forecast dividend yield of 3.5 per cent.

That's ok, but with such a bullish outlook, there are reasons for thinking that the shares should have performed better than they have done.

One possibility for the subdued share price performance is that current trading is quite sluggish. Despite an order book that has grown by 14 per cent this year and a strong bidding pipeline of projects, housing and rail spending remains quite weak compared with the recent past.

In its annual general meeting (AGM) trading statement on 26 September, the company said it expected its profits for the year to April 2025 to be "second-half weighted". This kind of tone can raise suspicion amongst investors that the company is really behind its budgeted profits currently, but hopes to get back on track later in the year. Some investors will then worry that this increases the risk of a company not meeting its forecasts.

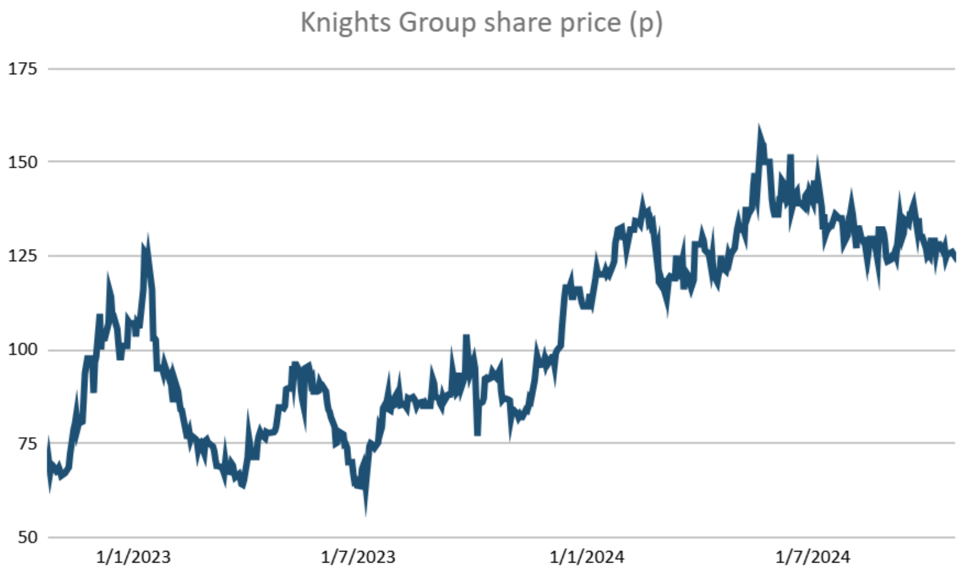
2025 EPS forecasts were 4.6p at the start of the year and are 4.2p currently. Forecast upgrades drive share prices upwards and the absence of them for Van Elle hasn't helped.

It is interesting to note from Van Elle's 2024 annual report that it received a large chunk of its operating profit (over 40 per cent) from other operating income related to research and development expenditure credits. Last year saw a big increase in this income from 2023 and if it is not going to be as big this year then it could provide a headwind to profit forecasts.

Another factor is that the small market capitalisation of £42mn means that the shares are illiquid and thinly traded. Eight institutional shareholders control about 60 per cent of the company. Of them, Otus Capital and Premier Miton have been selling down their stakes recently, while Puma Investments has recently acquired a 3 per cent stake.

There's nothing to suggest that the company is poorly managed, while its exposure to growing markets should serve it well. However, perhaps the attraction of bigger and less risky alternative investments such as **Renew Holdings (LSE:RNWH)**, which provides maintenance and renewal services to similar infrastructure markets, will continue to serve investors better.

Knights Group Holdings (KGH)

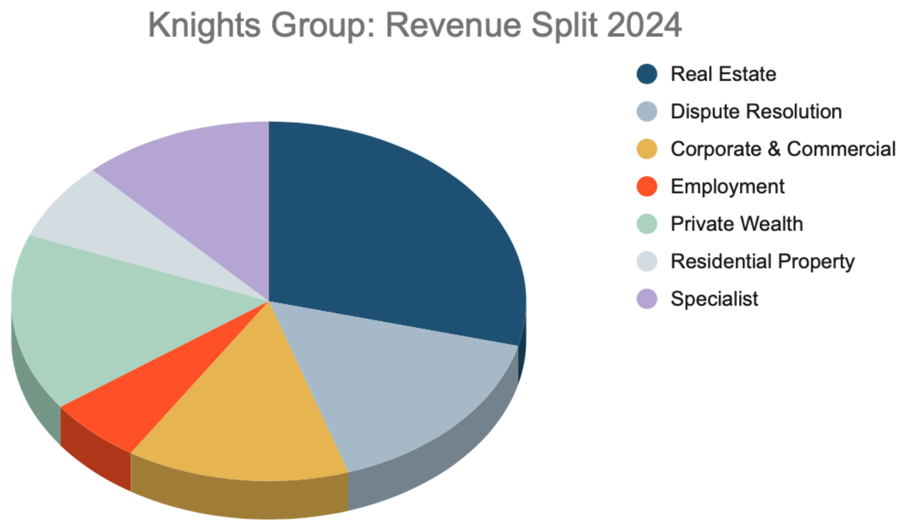


Source: LSEG

Knights Group (KGH) is a legal and professional services company. Its aim is to be the leading legal and professional services business outside London.

At 125p per share, the business currently has a stock market valuation of £108mn. The shares have not recovered from a massive profit warning in 2022 – and are below their floatation price from June 2018.

The company has over 1,000 fee earning professionals and has offices in most of the major English towns and cities outside of London. It earns its revenues from a variety of legal and professional services and markets and has a significant exposure to real estate transactions.



Source:Company/Investors' Chronicle

Around two-thirds of its revenues come from business customers, with nearly a quarter from personal services. The remainder comes from specialist services such as remortgaging transactions on properties and medical negligence claims.

Unsurprisingly, the company's biggest cost is its employees where payments accounted for just over 62 per cent of revenues last year. This gives Knights a substantial fixed cost base and high levels of operating leverage which is great when revenues are growing – as profits grow at a faster rate – but not so good if there is a revenue slump.

Growth by acquisition

Knights is an industry consolidator. It wants to succeed by improving its fee income on a regional cost base. In order to do this, it has regularly bought up regional legal and professional services businesses in order to grow.

These businesses are fully autonomous and run as separate companies with minimal interference from Knights' senior management who see the preservation and promotion of an entrepreneurial culture as key to its future prospects.

Knights believes that there is still lots to go for in terms of acquisitions. There are around 200 regional firms with revenues of between £2mn and £75mn that would fit with its business model.

Acquisitions have been a good way for Knights to diversify its revenue stream and gain exposure to growth markets. Its recent acquisition of the West Midlands firm Thurlsfied for £12.5mn in July is a good example of this as it increases its exposure to private wealth markets.

Is the strategy working?

Investors are rightly suspicious of acquisitive companies as they often unravel. Integrating acquired businesses comes with a number of risks with the retention of key fee earning employees particularly important in Knights' case.

However, investors need to be aware of other issues as well. Acquisitions can be used to hide weak underlying growth in an existing business. Cost savings can bring extra profits but can be costly to achieve and they eventually run out.

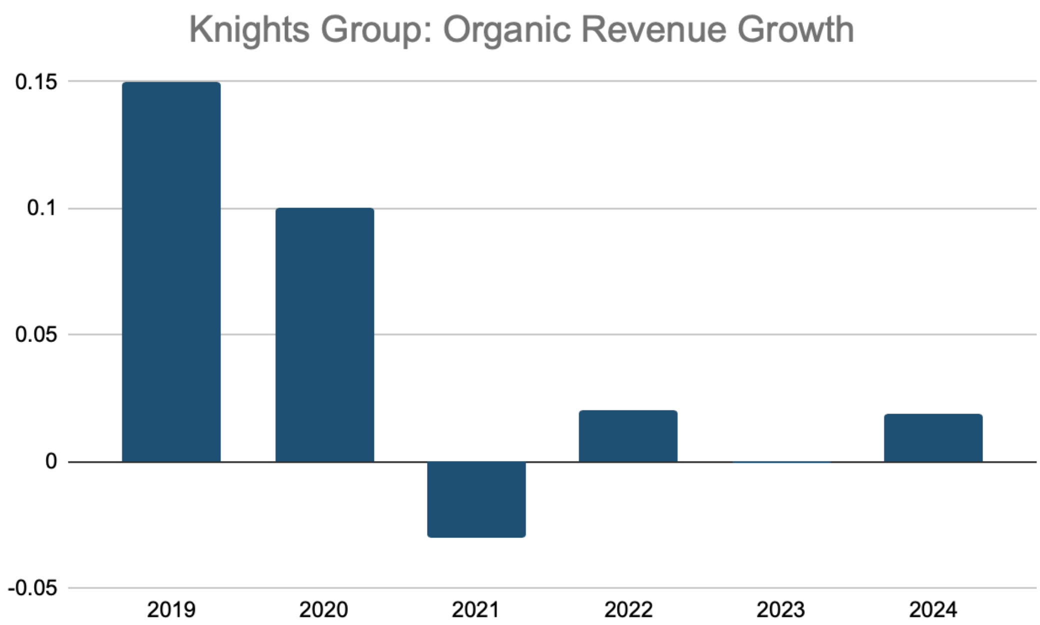
Businesses can also pay too much to buy other businesses and earn poor returns on investment or ROCE for shareholders.

Acquisitions can also pave the way for a company to employ aggressive accounting or to treat certain costs as exceptional or one off, which may not be the case if acquisitions are part of an ongoing business strategy and happen regularly.

It makes sense to look at these closely for Knights, as while it frequently promotes its track record of revenue and underlying profit growth, a lot of this has come from acquisitions and the share price performance of the company has been poor.

Weak organic growth

Knight's organic growth has been very weak over the last few years having previously been good.



Source:Company/investors' Chronicle

Since 2020, Knights has struggled to generate additional revenues from its existing businesses. Organic revenue was a weak 1.9 per cent in its last financial year.

Should this trend of weakness continue then it begs the question as to how much real growth potential there is from the business model if Knights makes no further acquisitions.

The company is striking a more upbeat tone on its organic revenue prospects for its current financial year and the future. Price hikes of around 6 per cent should see an improvement this year.

Looking further out, a recovery in the residential property market would also give a decent kicker to organic growth. More growth can be generated by selling more services to existing customers and recruiting more professional fee generators without buying companies.

Organic growth is arguably the main catalyst to generate profit forecast upgrades and a higher share price.

Lots of exceptional items raise questions over profit quality

Acquisitions bring along extra costs such as redundancies, transaction and integration costs. These are largely uncontentious and one off to a separate identified acquisition

However, Knight's one-off costs or exceptional items in recent years have been very big which has resulted in them being a large proportion of its underlying or unadjusted profits. This can be a red flag and a potential warning that a company's accounting may have become at least a little bit aggressive.

Knights Group: Exceptional costs as a percentage of adj operating profit

Year £mn	Exceptional items	Adjusted op Profit	Exceptionals %
2020	8.1	13.7	59.1%
2021	10.3	17.7	58.2%
2022	13.3	16.7	79.6%
2023	6.5	25.2	25.7%
2024	6.6	30.2	22.0%

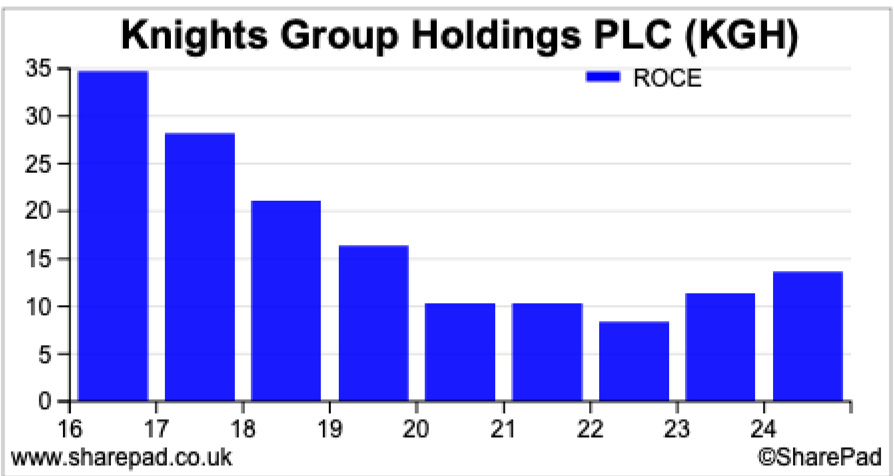
Source:Company Accounts/Investors' Chronicle

One particular item worth mentioning is the treatment of contingent acquisition costs as remuneration. This is where the cost of keeping key individuals in acquired companies – in the form of bonuses or lock-in agreements for example – are charged against revenues rather than a contingent consideration through the cash flow statement.

There is a case for excluding this from underlying earnings, but it is worth noting that of the £44mn of non-underlying costs posted by Knights since 2020, half of them have been related to contingent consideration.

The costs are a material transfer of value away from shareholders and arguably need to be taken into account by investors if they are valuing the company solely on the basis of its underlying profits.

ROCE has been trending downwards

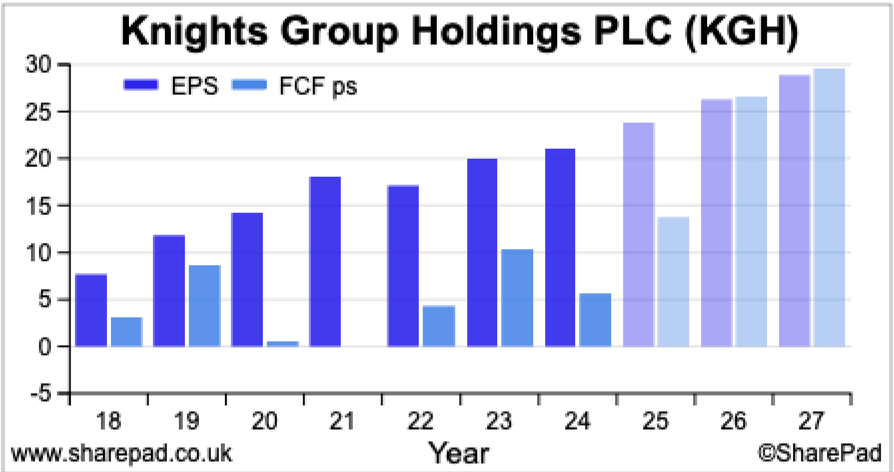


Acquisitions have helped Knights to grow its adjusted operating profits, but its profitability has come down markedly when looking at ROCE, which takes into account the money invested to generate those profits.

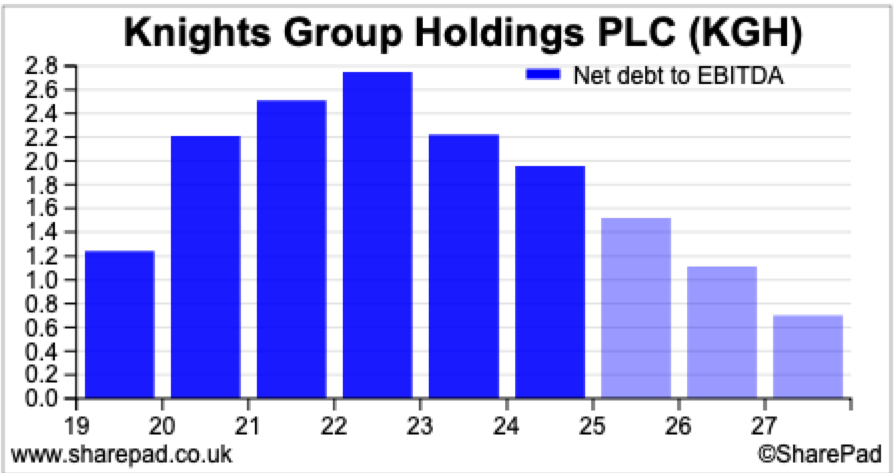
Encouragingly, ROCE is still at a respectable level and has been improving for the last couple of years.

Debts have been going up

Knights has not been great at turning its profits into free cash flow. The business has a reasonable working capital requirement with trade debtors and work in progress which generates profits, but not cash flow until sometime later on.



When weak free cash flow is combined with the cost of acquisitions, the company's debt levels – as measured by the net debt to Ebitda ratio – had increased to quite high levels.



Based on analysts' forecasts, free cash flow conversion of profits is expected to improve going forward, which should lead to much lower levels of debt.

Are the shares too cheap?

There are legitimate reasons to be concerned about some of these key financial metrics when analysing Knights.

That said, there is the potential to grow the business. Management wants to double the size of the business over the medium term. How it goes about this is arguably key to the future direction of the share price.

If it can materially grow its earnings organically then its shares look very cheap at just five times its next year's forecast EPS which prices in a lot of risks.

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