



## Hargreaves Services: A high yielder offering significant hidden value

*This business has transformed itself, exiting legacy assets and refocusing on growth areas in the industrial sector. It's also set to realise hidden value in its vast land bank*

### Hargreaves Services (HSP)

|                       |  |
|-----------------------|--|
| Ticker                | HSP  |
| Current price         | 200p                                       |
| 12-month target price | 320p                                       |
| Market cap            | £64.8m                                     |
| 52-week high          | 323p                                       |
| 52-week low           | 200p                                       |
| Net debt              | £34.7m                                     |
| Shares in issue       | 32.2m                                      |
| Financial year-end    | 31 Mar                                     |
| Next event            | Pre-closing trading update early June 2020 |
| Company website       | hsgplc.co.uk                               |

### Simon Thompson's view:

There are multiple catalysts on the horizon to drive a re-rating at **Hargreaves Services**, not least of which is the ramp up in profits at its German associate, a key supplier of specialist raw materials to major European customers. There is also potential to realise bumper profits from residential land sales. Add to that an eye-catching improvement in free cash flow – to support a near trebling of the dividend and deleveraging of the balance sheet – and these shares should perform well over the next few years.

### Bull points

- Substantial hidden value being realised in land holdings.
- German associate business ideally placed to take advantage of growth opportunities.
- Set to benefit from HS2 and the ramp up in UK government infrastructure spend.
- Growing and profitable logistics business.
- Strong market position in the supply chain for industrial and export speciality coal.
- Legacy assets almost all sold.
- Strong free cash flow generation set to cut borrowings sharply, thus transferring more of the economic value in the company from debt holders to shareholders.
- Board committed to paying out profits earned from German associate as dividends.
- Experienced board of directors own 9.4 per cent of equity.
- Scope for ongoing role at British Steel under its new Chinese owner.
- Brexit proof – Hargreaves has little trading activity with any EU country, and German associate trades almost exclusively within the EU.

### Bear points

- Patchy track record as legacy assets sold off and business refocused on new areas.
- Small-cap liquidity discount and low free float limit institutional investment.
- Insolvency of British Steel resulted in a bad debt write-off in the 2018-19 financial year.
- Recession risk due to Covid-19 outbreak – how robust Hargreaves could be is covered in the risk assessment at the end of this report.

Analyst: Simon Thompson  
simon.thompson@ft.com

Alpha Production Editor: Sameera Hai Baig

*“The restructuring process has seen £48.5m of legacy assets sold in the past four years”*

**Hargreaves Services (HSP)**, a diversified industrial services group and brownfield land developer has almost completed the strategic transformation of its business from what was once the largest producer of coal in the UK. The board’s decision to exit the thermal coal sector in 2016 reflected multiple structural challenges but the disposal of legacy assets has enabled the directors to invest in new areas and de-risk the business.

The restructuring process has seen £48.5m of legacy assets sold in the past four years and the business now focuses on growth opportunities in infrastructure engineering, mechanical and electrical maintenance, and brownfield land regeneration. Hargreaves also exports extensive knowledge built up from its past deep mining experience to operators around the world.

### Hargreaves Services (HSP)

|                        |                               |
|------------------------|-------------------------------|
| Ord Price: 200p        | Market Value: £64.8m          |
| Touch: 194-206p        | 12-Month High: 323p Low: 200p |
| Dividend yield: 10.4%  | PE ratio: 8                   |
| Net asset value: 403p* | Net debt: 27%                 |

| Year to 31 May | Revenue (£m) | Pre-tax profit (£m) | Earnings per share (p) | Dividend per share (p) |
|----------------|--------------|---------------------|------------------------|------------------------|
| 2015           | 662          | 24.9                | 65.3                   | 30.0                   |
| 2016           | 341          | -10.6               | -33.0                  | 2.3                    |
| 2017           | 343          | 4.1                 | 16.1                   | 7.2                    |
| 2018           | 297          | 0.5                 | 0.7                    | 7.2                    |
| 2019           | 303          | -9.9                | -14.8                  | 7.2                    |
| 2020**         | 235          | 5.7                 | 15.1                   | 7.2                    |
| 2021**         | 219          | 7.0                 | 18.7                   | 20.0                   |
| 2022**         | 195          | 10.0                | 26.4                   | 21.0                   |
| % change       | -11%         | 43%                 | 41%                    | 5%                     |

Normal market size: 1,000

SETS

\*includes intangibles assets of £11m, or 31p a share

\*\* N+1 Singer estimates. Forecast excludes £3m one-off non-recurring profit in 2020.

Prior years all stated after exceptional items.

Source: Hargreaves Services annual report, London Stock Exchange

### Hargreaves Raw Material Services

Hargreaves owns a 49 per cent equity interest, and an 86 per cent economic interest in Hargreaves Raw Material Services (HRMS). Based in Duisburg, Germany, this business is a key supplier of specialist raw materials to major European customers in several industries (including steel production, other metallurgical industries, ceramics and insulation). As an associate company, HRMS’ assets and liabilities are not consolidated into the group’s results and are shown as a separate post tax, post interest item in the income statement. Perhaps, this accounting requirement of IFRS16 explains why investors are underestimating the value that has been created.

To put the undervaluation into perspective, Hargreaves’ investment in HRMS is held in the latest accounts at only £11.7m even though the associate reported an operating



Hargreaves has built a new Carbon Drying and Pulverisation Plant at an industrial site near Duisburg, Germany

profit of £3.3m, on revenue of £150m, in the 2019 financial year. HRMS' trading operations are funded by a €10m (£8.6m) interest bearing loan and working capital facilities provided by local banks in Germany. They are further supported by a €5m (£4.3m) parent guarantee from Hargreaves. As a specialist commodity trading business, HRMS' financial performance can experience fluctuations due to changing market conditions. Despite this it has reported profitable trading every year for more than a decade. In fact, over the past 15 years HRMS has produced an average operating profit of €5m, ranging from €3m in its worst year to a high of €10m in the best year.

This fact is important considering recessionary fears due to the coronavirus. If HRMS were to replicate its worst year and make €3m (£2.6m) operating profit in 2020/21, then Hargreaves' economic share of the profits would be worth £2.26m which is still more than the £2m contribution from HRMS embedded in analysts' current forecasts.

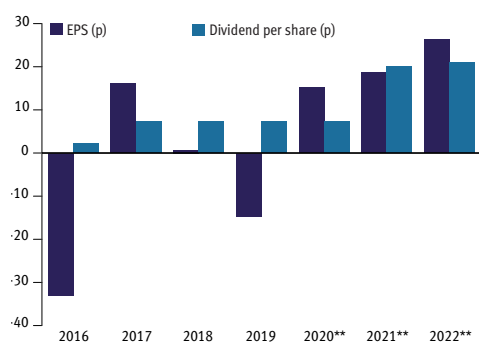
The management team has achieved the unblemished profit record by adopting a low-risk trading model that offers the flexibility to take advantage of market opportunities. The vast majority of trading is supported by back to back contracts and residual commodity risk is minimal. HRMS trades coke, minerals, ferroalloys and pig iron and employs eight specialist commodity traders.

To balance the reliance on short-term trading opportunities, HRMS has been investing in the construction of a Carbon Pulverisation Plant. The rationale is to establish a strategic production asset to improve the forward trading visibility of the operation. The plant is close in Duisburg, a key hub for central Europe, and will process carbon based raw materials, including coal and coke, into a pulverised carbon product which will offer customers logistical, technical and cost advantages over alternative materials. The plant has a capacity to process 400,000 tonnes per annum and will be fully commissioned in April this year. Funding has been provided by a 10-year loan from a German bank (€15m) together with a €3m loan from Hargreaves over the same term.

The point investors are missing is that HRMS was prevented from paying dividends to Hargreaves owing to the terms of the bank loan while the plant was under construction. Now the plant is nearing completion, and contracts have been secured for processing 70,000 tonnes of carbon-based raw materials, HRMS can start paying Hargreaves around £12m of previously undistributed profits as dividends without any recourse to borrowing. Hargreaves' board are guiding shareholders to expect an additional dividend of 12p a share to be paid in the 2020-21 financial year, all of which will come from HRMS.

*“The shares offer a prospective dividend yield of almost 10 per cent”*

### Hargreaves Services improving EPS and dividends



Source: Hargreaves Services annual report annual and \*\*N+1 Singer forecasts Jan 2020

With Hargreaves' profits set to get a boost from other parts of its business, the annual dividend per share of 7.2p is likely to get a lift, too. This explains why analysts are predicting a 20p a share payout in the 2020-21 financial year. On this basis, the shares offer a prospective dividend yield of 10 per cent.

### HRMS significantly undervalued

Clearly, Hargreaves' stake in HRMS is worth more far than the £11.7m net carrying value of its investment (total balance sheet exposure is higher as Hargreaves loaned HRMS £11.1m in addition to the £4.3m parent company guarantee).

The £3.9m dividend Hargreaves is set to receive from HRMS in the 2020-21 financial year equates to a third of the carrying value of the investment. This means that if the dividend is maintained for the next three years – as is the directors' guidance – then Hargreaves will have recouped 100 per cent of its equity investment. Analysts at broking house Investec Securities note that HRMS “may be a significant source of future profits and cash that are not yet factored into forecasts.” They have a point as the new plant turns profitable at 140,000 tonnes and the directors have already secured further contracts that will be trialled over the summer with a view to going into full scale production at the end of 2020.

There is also profitable upside from HRMS' opportunistic acquisition late last year of a 94.9 per cent stake in DK Recycling und Roheisen (DK), a German company that makes high quality pig iron by recycling waste from the steel industry. DK's facility is adjacent to HRMS' plant at Duisburg and the company has been a customer of HRMS for many years.

DK is operating around break-even, so HRMS' management are focusing on boosting profitability by making operational changes. Implementing cost reduction measures and improving its sales and procurement processes, both align well with the expertise of HRMS. It's a win-win situation as Hargreaves only paid €1 consideration for the equity stake and DK is separately financed from both HRMS and Hargreaves, so is completely ring-fenced. It's not the only smart looking deal.

### Valuable land holdings

Hargreaves owns over 13,500 acres of land across more than 50 brownfield sites and is crystallising the value in the assets. The land holdings are hardly being overvalued at only £34m in the interim accounts (to 30 November 2019) even though 4,700 residential plots already have planning consent, as does 4m sq ft of retail and commer-





Blindwells Master Plan secured planning permission in 2017 and the first plots will be released shortly



Blindwells plans for 1,600 new homes across 390 acre site

cial space. The Hargreaves Land division is also promoting 1,200 residential plots on four sites through the planning process on sites not owned, but where its position is secured by options or conditional purchase agreements.

For instance, Hargreaves Land was awarded outline planning permission three years ago for the construction of 1,600 new houses on the group's flagship 390-acre site at Blindwells, East Lothian, a former open cast mine located 12 miles from Edinburgh. The development plan includes social housing, education facilities, a healthcare centre, and retail outlets. Since outline planning was granted, Hargreaves has been installing infrastructure and services on site and by the end of May 2020 will have invested £22m in the development.

Hargreaves has already sold 10.75 acres to Bellway, and another 3.25 acre land parcel to Cruden Homes. These two conditional sales are expected to complete by the end of May this year when they will realise in excess of £10m for 222 plots in total. Hargreaves is marketing a third parcel of land of 188 plots across 11 acres and notes "strong interest from residential developers", so there could be further positive news flow on land sales later this year. The second phase of the project, known as Greater Blindwells, has approval in principle (to be allocated through the local development plan) for an additional 900 homes.

If you value the 1,600 plots in phase one at an average of £50,000 each – the Bellway and Cruden Homes sales achieved an average of more than £45,000 per plot – then land sales in the first phase at Blindwells could ultimately back up two-thirds of Hargreaves' last reported net asset value of £130m, highlighting substantial unrealised value in the balance sheet. The homes are affordable, costing around £150,000 - a price point that is highly supportive of home buyer demand.

### **Former Hatfield Colliery land redevelopment**

The Hargreaves Land division has identified several other development opportunities in Scotland and the north of England which it plans to commercialise through joint ventures or partnerships.

One such opportunity is near Doncaster in Yorkshire where Hargreaves Land has entered into a joint venture, Unity, to develop a 618-acre site surrounding the former Hatfield Colliery. Joint venture partner, Waystone, is a leading construction and development specialist. Waystone has been involved in the project for over a decade and has successfully secured planning permission for 3,100 residential homes and 2m sq ft of industrial, commercial and logistics space. Access will be improved by a new link road from the M18, which is scheduled to be



Hargreaves Services is part of a joint venture that's revitalising the former Hatfield Colliery



Blackwell has been providing HS2 with earthmoving advice and support as a sub-consultant to Professional Services Consultants, Atkins and Mott MacDonald

completed by the end of this year.

The £16.7m cost of the road is largely being funded by Sheffield Council, thus improving the appeal of the site to developers. Not surprisingly, strong interest has been received from national housebuilders and commercial occupiers. Negotiations on the first plot sales, both residential and commercial, are progressing and the joint venture partners are currently pursuing third party financing on the project.

### Major civil engineering projects

In 2016, Hargreaves acquired Blackwell, one of the leading earthworks contractors in the UK. Blackwell works in partnership with many of the major civil engineering contractors to deliver major infrastructure projects across the transportation sector, specialising solely on bulk earthworks. The business recently completed the bulk earthworks on the A14 widening scheme in Cambridgeshire, working with Skanska, Costain and Balfour Beatty.

It is also preferred supplier to one of the major consortia, Eiffage Kier, for major linear earthworks on HS2. The UK government's decision to proceed with HS2 leaves Blackwell well placed to win work on the £86bn project. It's worth noting, too, that the UK government has committed to increase UK infrastructure spend and it's increasingly likely that there could be an accelerated fiscal policy response to mitigate the economic impact of the coronavirus.

There have been issues though, which is why Hargreaves' earthworks business operated at break-even in the first half of the 2019-20 financial year. This mainly reflected the liquidation of Wolf Minerals in October 2018, and the subsequent loss of revenue and profit. Hargreaves had previously supplied Wolf with contract mining services for its tungsten mining operation at Hemerdon, Devon – when it went into administration Hargreaves was owed £8.1m. That impairment charge and a similar sized provision after British Steel went into administration explain why the group reported a pre-tax loss of £9.9m in the 12 months to 31 May 2019.

However, a nifty bit of deal making by Hargreaves at the tail end of 2019 has recouped some of the losses. That's because following the collapse of Wolf, Hargreaves acquired various freehold and leasehold properties, including the assignment of the mineral lease at the tungsten mine in Devon. These assets were subsequently sold on to the mine's new operator, Tungsten West, for £2.8m in November 2019. Hargreaves booked a £2.4m exceptional gain on that transaction in its first half accounts. Also, Hargreaves simultaneously entered into a 10-year mining



Hargreaves Logistics has grown to become one of the largest bulk haulage operators for customers across the United Kingdom

contract (starting no later than November 2021) with Tungsten West to carry out works similar to those previously fulfilled for Wolf. Hargreaves will earn a minimum £1m per year annual fee plus additional payments for other services provided. Importantly, it will not be exposed to any credit risk as the contract contains advance payment provisions.

In addition, Hargreaves has three major completed legacy civil engineering contracts, with an outstanding contract asset value of £9.2m, awaiting final account settlements. It's reassuring to know that all three of these contracts (undisclosed for commercial reasons) are with credit worthy blue chip companies, all with market capitalisations north of £1bn. Guidance from management is to expect full settlement of the contracts in the 2020 calendar year.

### **Logistics business**

Along with HRMS, and the mining activities, Hargreaves' logistics business forms part of its production and distribution division.

The transport logistics business is doing well enough, doubling operating profit to £1m on slightly lower revenue of £38m in the 2018/19 financial year, and improving profitability again in the first half of the 2019-20 financial year. A focus on servicing term contract work in sectors such as waste has helped deliver higher margins, as has greater selectivity on contracts and some overhead reduction.

### **Industrial services**

Hargreaves' industrial services division encompasses two distinct businesses offering materials handling, logistics, facilities management and mechanical and electrical services to a wide variety of clients operating within the following sectors: power, steel, mining, port operations, refineries and industrial bulk materials manufacture.

The UK operation is mainly focused on providing innovative mechanical and electrical solutions to the energy and infrastructure sectors. This involves multi-skilled teams of engineers, technicians and craftsmen building, maintaining and improving business critical assets to optimise plant availability for clients including Air Liquide, a French multi-national company which supplies industrial gases and services to medical, chemical and electronic manufacturers, and French energy giant EDF.

Hargreaves is currently working with 25 clients across 40 projects. In Scunthorpe, the group manages several on-site contracts at British Steel's plant including coal and coke haulage, operation of coal handling plant, raw materials handling of ferro alloy supplies and internal logistics



of finished and semi-finished products. Since British Steel went into administration in May 2019, Hargreaves has been earning a monthly operating profit of £100,000 on revenue of £1m from The Official Receiver.

Although British Steel has just been acquired by Chinese firm, Jingye, analysts have not factored in any contribution beyond the end of February 2020 into their forecasts from Hargreaves' work at Scunthorpe, given the previous uncertainty of the plant's future. However, Hargreaves has entered into a 12-month agreement with Jingye while it negotiates a longer term contract. The point is that analysts' operating profit forecast of £6.4m for the current financial to 31 May 2020, and their forecast of £7.2m for the financial year to 31 May 2021, both fail to take into account any of the contracted work with Jingye, thus offering scope for material profit upgrades. Also, around 30 per cent of the £8m aforementioned write-off Hargreaves incurred when British Steel went into administration relates to provisions for future redundancies. If Hargreaves does enter a long term agreement with Jingye, then the impairment charge could be reversed.

Overseas operations are focused on Hong Kong and are principally concerned with supporting the power generating operations of China Light & Power and Hong Kong Electric with a range of engineering services (mechanical, electrical and access solutions at two coal power stations). The initial five year contract has just been extended for another five years, thus guaranteeing Hargreaves £20m per year of revenue, a sum equating to 9 per cent of group revenue forecasts of £219m in the 2020-21 financial year. Importantly, these activities have been unaffected by the geopolitical unrest in Hong Kong and the outbreak of Covid-19.

The industrial services division delivered underlying operating profit of £1.9m in the latest six-month period, up from £1.4m in the same period in 2018. That was on 10 per cent higher revenue of £44m, the result also reflecting a much-improved margin performance.

### **Financial performance set to improve markedly**

Hargreaves' restructuring has seen legacy assets worth £48.5m sold in the past four years. This leaves only Tower Regeneration, a joint venture with Tower Colliery in Glamorgan remaining. The project is delivering remediation and reclamation, through surface coal extraction and redevelopment of the former colliery site. Hargreaves' £11.6m loan to the joint venture is underpinned by tangible assets (property, plant and equipment).

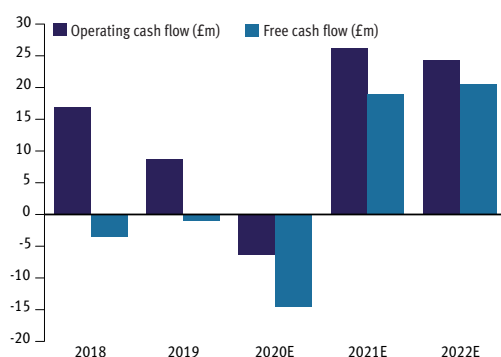
With legacy assets all sold apart from the loans outstanding to Tower Regeneration, there should be a step



**Hargreaves is one of the few remaining developers and operators of surface mines in the UK.**



### Hargreaves Services free cash flow generation set to improve



Source: Company data and \*\*N+1 Singer forecasts Jan 2020

change in profits in the coming years. Hargreaves is set to benefit from its new carbon pulverisation plant in Germany and land sales on former mining sites. The investment risk is mitigated to some extent by strategic refocusing on less volatile and higher margin areas of activity.

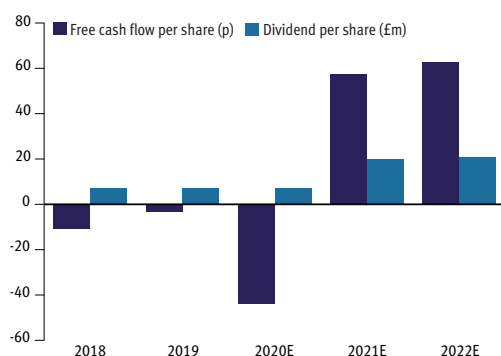
Hargreaves first-half results to 30 November 2019 highlighted a positive trend as underlying operating profit increased by almost a fifth to £2.5m, on revenue down a quarter to £125m. Also, central overheads have been reduced from £2.7m to £2.1m which will feed through to the second half when broking house N+1 Singer expects Hargreaves to report operating profit of £3.5m on revenue of £110m. The full-year reported results will also benefit from a likely £3m one-off profit (including the previously noted £2.4m gain on the land sales at the Devon tungsten mine) whereas the 2018/19 results were dragged down by a £16.1m exceptional loss.

Closing net debt is forecast to be around £36.4m on 31 May 2020 using the new IFRS16 accounting standard, but this is likely to be a high water mark as Hargreaves' cash generation kicks in big time in the new financial year. That's because operating profit is stated after the non-cash depreciation charge of £14m in 2019-20. With the drag of exceptional items a thing of the past, and working capital build set to unwind as legacy contracts are settled and land sales complete, both operating cash flow and free cash flow are set to surge markedly.

Based on operating profit rising from £6.4m in 2019-20 to £7.2m in 2020-21, a positive working capital inflow of £6m and a slightly reduced depreciation charge of £13m, broker N+1 Singer is pencilling in operating cash flow north of £26m and free cash flow of £19m (57.6p a share). That's after accounting for net interest payments of £1.3m and capital expenditure of £5m. On this basis, net borrowings will be slashed by almost half, to £19.8m, by May 2021.

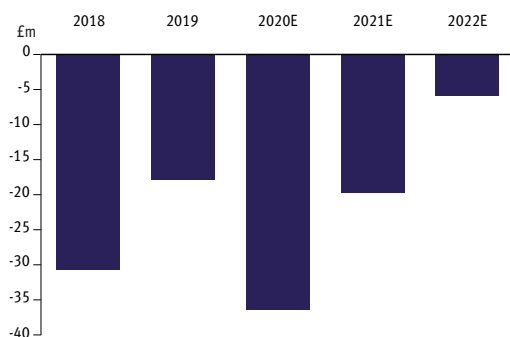
The broking house is modelling for even higher free cash flow of £20.6m (62.5p a share) in the 2021-22 financial year based on a higher operating profit of £9.3m, to take into account the increasing profit contribution from HRMS (up from £1.5m to £2.7m over the two-year reporting period) and Hargreaves Land (up from £2.6m this year to £5.5m in 2021-22). On this basis, net debt falls to £5.9m by May 2022.

### Hargreaves dividend per share well covered by forecast free cash flow in 2020-21 and 2021-22 financial years



Source: Company data and \*\*N+1 Singer forecasts Jan 2020

### Hargreaves Services improving free cash flow to reduce net debt significantly



Source: Company data and N+1 Singer forecasts Jan 2020

### Hargreaves Services free cash flow to markedly improve

| Financial year to 31 May | Operating cash flow | Free cash flow |
|--------------------------|---------------------|----------------|
| 2018                     | £17.0m              | -£3.5m         |
| 2019                     | £8.8m               | -£1.0m         |
| 2020E                    | -£6.4m              | -£14.5m        |
| 2021E                    | £26.2m              | £19.0m         |
| 2022E                    | £24.3m              | £20.6m         |

### ...which feeds through to a well covered dividend

| Financial year to 31 May | Free cash flow per share | Dividend per share |
|--------------------------|--------------------------|--------------------|
| 2018                     | -10.9p                   | 7.2p               |
| 2019                     | -3.1p                    | 7.2p               |
| 2020E                    | -44.1p                   | 7.2p               |
| 2021E                    | 57.6p                    | 20.0p              |
| 2022E                    | 62.5p                    | 21.0p              |

### ...and still leave surplus cash to pay down debt

| Financial year to 31 May | Closing net debt |
|--------------------------|------------------|
| 2018                     | -£30.8m          |
| 2019                     | -£17.9m          |
| 2020E                    | -£36.4m          |
| 2021E                    | -£19.8m          |
| 2022E                    | -£5.9m           |

Source: company data; and N+1 Singer estimates January 2020

Hargreaves is on course to produce 120p a share of free cash flow over the next two financial years, an outcome that will enable the directors to return a third of this sum to shareholders through total dividends of 41p a share, invest around £10m (33p a share) in net capital expenditure while at the same time cut debt by around £30m (95p a share).

Not only will shareholders benefit from the much improved payout, but with borrowings set to be cut to less than 5 per cent of shareholders' equity of £130m, then shareholders' economic interest in the company is set to increase as that of debt holders falls.

Or put it another way, unless Hargreaves' share price re-rates then its current enterprise valuation of £100m (net debt of £34.7m at 30 November 2019 plus market capitalisation of £64.8m) is set to fall to £70m by May 2022 given the hefty debt pay down, a multiple of only eight times analysts' post-tax profit estimate of £8.5m for the 2021-22 financial year. That seems harsh given that Hargreaves Land and HRMS will account for the vast majority of Hargreaves' net profits.

A far more likely scenario is that the enterprise valuation is maintained at £100m, so with net debt set to be reduced to £5.9m by May 2022, the equity element increases to £94m. Based on 32.265m shares in issue, this implies a share price of around 291p.

*“Multiple factors should drive earnings multiple expansion, and a narrowing of the discount to net asset value”*

Also, with borrowings much reduced, the financial risk is lower too. Therefore, investors are more likely to attribute a higher earnings multiple to the shares given the group’s much improved cash generation, earnings per share (EPS) growth, and absence of exceptional charges – Hargreaves has booked almost £45m of one-off costs in the past five financial years.

Hargreaves certainly appears to be at the inflexion point whereby multiple factors should drive earnings multiple expansion, and a narrowing of the discount to net asset value.

### **Meet the management**

Hargreaves’ transformation in the past couple of years has been under the watchful eye of 65-year old **chairman Roger McDowell**. He is also chairman of **Avingtrans (AVG)** and **Brand Architekts (BAR)**, constituents of my 2017 and 2020 Bargain Shares Portfolios, respectively. Mr McDowell owns 300,000 shares in Hargreaves, or 0.9 per cent of the issued share capital.

**Chief executive Gordon Banham** joined Hargreaves in 2001, and led a management buyout in 2004, ahead of the IPO on the London Stock Exchange the following year. Previously, he was managing director of his family firm, F Banham, negotiating its sale to Charrington Fuels in 1994. When Charrington was acquired by CPL Group, Mr Banham was appointed distribution director of the enlarged group’s coal distribution activities. He holds an 8.2 per cent stake in the company.

**Finance director John Samuels** held the same role at **Renew Holdings**, a £388m market capitalisation engineering services group, for 12 years until he joined Hargreaves in 2018. He qualified as a chartered accountant at Deloitte, and worked as a partner at Baker Tilly.

**Property director David Anderson** joined Hargreaves in November 2018, having previously held the position of managing director for 13 years at Henry Boot Developments, the principal property development subsidiary of Henry Boot, one of the UK’s leading property and construction companies. During his tenure, revenue of Henry Boot Developments increased from less than £10m in 2005 to over £220m in 2017. Mr Anderson has over 25 years’ experience in the field of property development, so adds considerable expertise to assist Hargreaves’ growth in this key segment.

**Non-executive director Nigel Halkes** served as a partner at Ernst & Young for 25 years (retired 2013), rising to become Managing Partner Markets for the UK & Ireland where he was responsible for the firm’s growth strategy, relationship with major clients and business development. He served some of the firm’s largest clients,

*“With the board committed to a substantially higher dividend policy, there is now material yield support underpinning the shares”*

including auditing British Coal in the period up to that company’s privatisation.

The five directors were paid salary and benefits of £1.06m in the 2018/19 financial year, a sum that is less than half the £2.3m cash cost of the annual dividend. That doesn’t seem unreasonable.

### Major shareholders

The seven largest shareholders control 72.6 per cent of the issued share capital, which means a reduced free float as 48.6 per cent of the shares are not in public hands under Aim rules.

#### Hargreaves Services major shareholders

| Name                           | Percentage   |
|--------------------------------|--------------|
| Harwood Capital                | 20.4%        |
| Schroder Investment Management | 18.9%        |
| Gordon Banham                  | 8.2%         |
| Artemis Investment Management  | 7.7%         |
| Downing                        | 7.2%         |
| Axxion S.A.                    | 6.0%         |
| NFU Mutual                     | 4.2%         |
| <b>Total</b>                   | <b>72.6%</b> |

Source: Hargreaves Services Annual Report, London Stock Exchange RNS

As a result of the reduced liquidity, the company’s bid-offer spread is wider than ideal, although it is possible to deal within the official spread and in bargain sizes well above the normal market size of 1,000 shares. Single bargains worth over £100,000 have passed through the market this month. One consequence of the lower liquidity is that share price moves can be accentuated. This can work in investors’ favour if positive news flows emerge in the months ahead.

Clearly, liquidity works both ways as any disappointing news is likely to be punished. That said, with the board committed to a substantially higher dividend policy, there is now material yield support underpinning the shares – which offer a prospective dividend yield of almost 8 per cent for the 2020-21 financial year. Also, with significant value now being released from the land bank to underpin a deleveraging of the balance sheet, the hefty share price discount to book value should have a limiting effect on any downside risk.

Interestingly, there has been significant institutional buying around the current price. Harwood Capital, representing Oryx International Growth Fund, Harwood Capital Limited Partnership and North Atlantic Smaller Companies Investment Trust, raised its stake from 15.3 to 20.4 per cent earlier this month. Schroder Investment Management reduced its stake by 2 per cent to 18.9 per cent, and Axxion reduced its stake by 1.85 per cent to 5.99 per cent, both being likely counterparties to facilitate the Harwood stake building.



### Target price

Having taken account of the risk assessment below, I feel that prospects of Hargreaves delivering a step change in profitability and dividend income over the next couple of years is being under rated by the market, as is the anticipated deleveraging of its balance sheet.

After taking into account the forecast reduction in borrowings by May 2022, a target price of 320p seems appropriate. That values the high yielding shares on a price/earnings (PE) ratio of 12 for the 2021-22 financial year, and on a 29 per cent discount to analysts' May 2022 NAV per share estimate of 451p.

Offering potential for a 83 per cent total return including dividends over the next two years, Hargreaves' heavily oversold shares – the 14-day relative strength indicator (RSI) has a reading in the mid-teens – are worth buying.

### Risk assessment

#### **Covid-19: the recessionary risk for Hargreaves' activities.**

With markets highly volatile and fears measures to tackle the coronavirus will cause a recession, it is worth going into detail where the effects might be felt for Hargreaves and why I think there are factors which could mitigate some of the risk to the business.

A downturn in markets could soften demand for HMRS' trading activities, but this already looks priced in. That's because HRMS has produced an average operating profit of €5m, ranging from €3m (£2.6m) in its worst year to a high of €10m in the best year.

Let's say that HRMS has a bad year and makes only £2.6m operating profit in the 2020-21 financial year. Hargreaves has an 86 per cent economic share of these profits and analysts have only embedded a £2m profit contribution from HRMS into their forecasts. Also, there is a possibility that HRMS' new plant could be operating at break-even by early 2021, so the plant's first year budgeted operating loss of £500,000, which is embedded into the 2020-21 forecasts as output ramps up, could be overdone. This mitigates earnings risk as does the £100,000 monthly operating profit Hargreaves is now earning from British Steel (thanks to a 12-month short term contract with Jingye), which is not embedded into profit forecasts for the 2020-21 financial year.

It's also reassuring that the land sales in Edinburgh are competitively priced and the property market there (unlike London and South East England) has been rising for the past couple of years. There are strong fundamentals (low unemployment for one) supporting demand for new build housing that's clearly affordable. The same is true

at Hatfield. Furthermore, the bottom end of the housing market always holds up better during a soft patch and Hargreaves can afford to be flexible on price during land parcel negotiations in order to keep the cash flow from land sales flowing in. The Bank of England's decision to slash interest rates and the sharp fall in UK government bond yields, are highly supportive of affordability for home buyers, a factor that will be reflected in the future pricing of mortgage products. This will not be lost on land buyers at the major housebuilders either.

Regarding Hargreaves' logistics business, the collapse in the oil price is really good news for the company as fuel is one of the biggest costs in haulage rates. Also, the business is targeting the waste sector, and Covid-19 or not, waste still needs dealing with.

There are several other risks to consider before making an investment, including:

■ **Contractual risk:** Hargreaves enters into and manages diverse and complex contracts as part of its core operations. Bad planning, agreeing to onerous terms, ineffective management and delivering services outside of the group's core competencies could all erode the value of the contract and increase risk exposure. There is potential for financial and reputational impacts on the group, too, in the event of defective works and warranty claims following contract completion.

■ **Sudden decline in markets:** To reduce dependency on the coal market and to diversify the group's activities into other industries, Hargreaves has been broadening its offering into activities with lower price volatility including transport logistics, mechanical and electrical engineering, and brownfield land regeneration.

Hargreaves Land is forecast to account for almost half of group operating profit of £7.2m in the 2020-21 financial year, an estimate that is underpinned by the release of oven-ready land parcels on its developments near Edinburgh and Doncaster. Also, an estimated net profit contribution of £2m in the 2021-21 financial year from HRMS seems a sensible prediction given that the associate has averaged €5m (£4.3m) of operating profit over the past 15 years. In addition, the Duisburg Carbon Pulverisation Plant becomes operational next month, and should be operating above its break-even output level of 140,000 tonnes by the start of 2021 on the back of the 70,000 tonnes already secured and several contracts management have lined up for trial over the summer.

■ **Environmental risks:** There are inherent environmental risks within elements of the group's operations. If not properly managed, these could result in environmental contamination with disruption of business, financial costs and loss of reputation. The group provides clear guidance on the environmental standards which its operations must adhere to, and sets compliance with laws, regulations and industry best practice as a priority across the business.

■ **Liquidity and credit risk:** Hargreaves capital structure requires the ongoing provision of liquid credit provision from banks and asset funding institutions. The group has a £50m borrowing base facility and a £1.5m overdraft facility, both of which mature on 31 August 2020. They are competitively priced at 1.5 per cent above Libor, and the group is trading comfortably within its borrowing limits. Refinancing should be completed by the 31 May 2020 financial year end, according to the directors.

Trading relationships require contract and credit exposures to customers. If they are unable to pay their debts, or the group fails to maintain access to liquidity, this could have an adverse financial impact. The majority of trade receivables are due for payment within 45 days and only £1.6m of receivables were 90 days past their due date at the 2019 financial year-end, representing less than 6 per cent of total receivables. All have since been collected.

At 30 November 2019, trade receivables of £28.2m accounted for 21 per cent of Hargreaves net assets of £130m. The largest debtor represented 9 per cent of trade receivables, and the next nine debtors around 41 per cent. The fact that half of all trade receivables are split across half the customer base reduces concentration risk to bad debt.

In addition, Hargreaves vigilantly monitors and controls material counterparty exposures.

■ **Failure of a material business unit:** The failure of HRMS, in particular, is a material risk as Hargreaves' share of HRMS' profits represents a significant contribution to group profit. The investment in HRMS is governed by a shareholders' agreement which provides a series of rights to Hargreaves (controls over the approval of budgets, the granting of security and business activities) and 'step in rights' in the event of a material breach of the agreement. Financial information is submitted by HRMS to Hargreaves on a monthly basis, and Mr Banham is a member of HMRS' board.

© The Financial Times Limited 2020. Investors Chronicle is a trademark of The Financial Times Limited. “Financial Times” and “FT” are registered trademarks and service marks of The Financial Times Limited. All rights reserved. No part of this publication or information contained within it may be commercially exploited in any way without prior permission in writing from the editor.

**Permitted Use:** By purchasing this magazine, you agree that the intellectual property rights (including copyright and database rights) in its content belong to The Financial Times Limited and/or its licensors. This magazine is for your own personal, non-commercial use. You must not use any of the content as part of any commercial product or service, including without limitation any which reduces the need for third parties to use the Investors Chronicle magazine and/or website, or which creates revenue from the content, or which is to the detriment of our own ability to generate revenues from that content. For example, you must not use any of our content in any syndication, content aggregation, news aggregation, tips aggregation, library, archive or similar service, and you must not capture any such content, whether systematically, regularly or otherwise, in any form of database without our prior written permission. These contractual rights are without prejudice to our rights to protect our intellectual property rights under law.

Investors Chronicle adheres to a self-regulation regime under the FT Editorial Code of Practice: A link to the FT Editorial Code of Practice can be found at [www.ft.com/editorialcode](http://www.ft.com/editorialcode). Many of the charts in the magazine are based on material supplied by Thomson Datastream and S&P Capital IQ.

Material (including tips) contained in this magazine is for general information only and is not intended to be relied upon by individual readers in making (or refraining from making) any specific investment decision. Appropriate independent advice should be obtained before making any such decisions. The Financial Times Limited does not accept any liability for any loss suffered by any reader as a result of any such decision.

ISSN 0261-3115.