SHORE CAPITAL
CAPITAL MARKETS

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House Stock
Current price 63.5p
Support Services
United Kingdom

AIM	
Reuters/Bloomberg	HYDG
Shares in Issue (m)	34.1
Market Cap (£m)	21.7
Net cash /(debt) (£m)	1.3
Enterprise Value (£m)	20.4
Website	www.hydrogengroup.com

Next update	
FY Trading	January 2019

Performance	1M	3M	12M
Absolute (%)	49.4	84.1	89.6
Rel Index (%)	54.7	93.6	91.3

Relative to FTSE All Share

Exchange rate £1.00=US$1.30

Hydrogen Group+

Interim results, upgrades…

The recruitment specialist has published a strong set of results for its first half period to end June, as indicated by the interim trading update in July. The group now signals that the full year "*will be substantially ahead of current market expectations".* Accordingly, we upgrade our forecast expectations for the group for the current year; we note good traction for the group in both 'Perm' and 'Contract' markets and thus follow through with upgrades to subsequent years. Hydrogen, with improving fee generation rates, margins and underlying cash flows also expresses confidence with the declaration of a 0.5p interim dividend payment; this follows the return to the dividend list earlier this year with the declaration of a 0.8p final. We believe that last year's acquisition of Argyll Scott has delivered a materially enhanced market position to the group, with greater scale leveraging central costs and bringing an enhanced footprint in the strategically important APAC region in particular.

Interim results please. Reported group revenue for the H1 period grew by 21% to £68.6m, driving net fee income (NFI) ahead by 57% to £14.8m. Looking through the Argyll Scott acquisition, underlying pro-forma NFI grew by c10%, with the APAC region growing by c16%. The acquisition has also delivered synergies of c£1.5m to operating costs with integration now complete, additional sales synergies are anticipated for the future.

The interim period saw slight FX headwinds reducing revenues by c1%, which we believe flowed through the income statement, with a weaker US dollar and Euro relative to sterling being seen in the mix. We anticipate further weak FX in the H2 period in our forecasts impacting the APAC region, offset to an extent by a stronger US dollar. H1 saw adjusted PBT advance by 596% from £0.2m to £1.1m with underlying EPS on our measure rising from 0.5p last year to 2.7p. This drove cash generation from operations to the £2.0m mark from an outflow of c£0.7m last year, leaving the group with a net cash position of £1.3m as at end June.

Valuation thoughts. Hydrogen is beginning to see a much stronger operational performance across its business, with a new revised strategy implemented across the group empowering senior management to deliver; revenue traction appears demonstrable to us. We upgrade our adjusted PBT from £1.8m to £2.3m for the current year (+24%), also our dividend expectation which rises from 0.8p to 1.3p for the full year (+56%). We believe that Hydrogen is now strongly placed to deliver further positive results in the future.

Results and Forecasts

Year to December	NFI (£m)	EBITDA (£m)	Adj PBT (£m)	Adj EPS (p)	Net cash /(debt) (£m)	PER (x)	EV/EBITDA (x)	FCF Yield (%)	DPS (p)	Div Yield (%)
2016A	17.7	0.8	1.0	3.7	2.0	17.1	14.5	(12.2)	0.0	0.0
2017A	22.8	0.8	0.9	3.2	(0.4)	20.1	22.3	(15.7)	0.8	1.3
2018F	30.0	2.5	2.3	5.6	2.4	11.4	7.3	16.3	1.3	2.0
2019F	31.5	2.9	2.8	6.3	3.2	10.1	6.0	9.4	1.4	2.2
2020F	32.0	3.1	2.9	6.5	4.6	9.8	5.2	13.2	1.5	2.4

Source: Company Data; Shore Capital Markets

Research analyst

Robin Speakman
0151 600 3712
robin.speakman@shorecap.co.uk

Progress across the regions

APAC leading growth

Hydrogen has seen good performances across its regions, led by APAC where the Argyll Scott business has materially strengthened the group's market position. APAC NFI grew by 16% underlying to £5.5m (189% reported) with strong performance seen in Singapore, in Thailand and in Australia. In EMEA, where UK revenues dominate, NFI grew by 26% to £8.7m (pro forma 6%) driven by strength in Business Transformation and in the Perm Legal practice. In the US, reported NFI was flat, but up c10% on a constant currency basis.

Looking at the Perm/Contract split:

- Permanent NFI grew 100% to £8.5m (H1 2017: £4.3m);
- Contract NFI increased by 23% to £6.3m (H1 2017: £5.1m);

Contract revenues and NFI remains a strong long-term opportunity

We hope to see stronger growth over time coming from Contract as this business opportunity ramps up from a small position in the market across APAC, we also note that Perm remains strong at present. Group contract margin increased to 10.4% (H1 2017: 9.7%).

Synergies to come, to leverage client relationships

Synergies played an important part in the improved operational performance with more to come from the synergies now realised in the second half and into FY2019F. In addition, management also states that:

"Expected cross fertilisation of client relationships across the Group's brands are anticipated to generate incremental NFI of some £0.4m in 2018 and the Group's largest client accounted for 8% of NFI in the first half of 2018 (H1 2017:14%)."

So, we hope to see further opportunity for forecast upgrades driven by further market penetration with existing and new clients in due course.

Strategic pillars

Firm strategic foundations

We note the emphasis placed by management on Hydrogen's continued development, with a target of continuing to improve the group's NFI conversion rate, driven by:

- a focussed operating model building specialist niche businesses driven through consistent targeting and reporting, to grow these to be market leaders;
- a minority interest share scheme (launched in H2 2017) improving the retention, motivation and development of key staff and attracting new talent to Hydrogen Group
- a digital marketing programme that supports a multi brand specialist niche business strategy by allowing the development of key client and candidate relationships on a scalable, but bespoke, one to one basis;
- a single global technology and CRM platform that promotes communication and the cross fertilisation of key client relationships across the Group, driving a "go to market" strategy; and
- investment in people. A commitment to create a genuine learning and development culture throughout the Group. Bespoke training programmes have been developed for each job function and grade, which are being delivered across the Group by the leadership and management teams.

Forecast upgrades

Momentum building

We upgrade our adjusted PBT from £1.8m to £2.3m for the current year (+24%), EPS growth (+23%) sees dilution from the acquisition, higher tax and sales performance staff incentives, but momentum is now evident across the business and stronger cash generation on the net cash balance sheet drives income paying capability. We upgrade our dividend estimate for FY2018F from the 0.8p paid for FY2017 to 1.3p (+56%). Forecast upgrades, following management's stronger confidence in the outlook, follow for subsequent years. Key forecast changes are set out in Figure1.

Figure 1: Hydrogen, key forecast changes

Yr to	Revenue (£m)		NFI (£m)		Adj. PBT (£m)		Adj. EPS (p)		FCF (£m)		Net cash (£m)		DPS (p)	
Dec	Old	New	Old	New	Old	New	Old	New	Old	New	Old	New	Old	New
FY2017	125.9	**125.9**	22.8	**22.8**	0.9	**0.9**	3.2	**3.2**	(2.8)	**(2.8)**	(0.4)	**(0.4)**	0.8	**0.8**
FY2018 F	136.8	**138.5**	28.2	**30.0**	1.8	**2.3**	4.5	**5.6**	1.1	**3.3**	0.5	**2.4**	0.8	**1.3**
FY2019 F	143.2	**145.0**	29.9	**31.5**	2.2	**2.8**	5.2	**6.3**	1.1	**1.9**	1.3	**3.2**	0.8	**1.4**
FY2019 F	148.2	**150.0**	31.1	**32.0**	2.3	**2.9**	5.4	**6.5**	1.6	**2.7**	2.5	**4.6**	0.8	**1.5**

Source: Shore Capital Markets

Strong cash generation anticipated

Figure 2 shows revised full year estimates across the income statement, cash flow statement and the balance sheet. We note the asset value of the group per share roughly equates to the current share price, with the balance sheet strengthening with continued cash generation and a strong free cash flow yield (dipping in FY2019F to c8.8%).

Figure 2: Hydrogen, summary financials and forecasts

Yr to Dec	2016 A	2017 A	2018 F	2019 F	2020 F
Summary Profit & Loss (£m)					
Sales	**116.2**	**125.9**	**138.5**	**145.0**	**150.0**
Gross profit/Net Fee Income (NFI)	**17.7**	**22.8**	**30.0**	**31.5**	**32.0**
Gross margin	*15.3%*	*18.1%*	*21.6%*	*21.7%*	*21.4%*
Operating costs	(16.9)	(22.0)	(27.5)	(28.6)	(29.0)
EBITDA	**0.8**	**0.8**	**2.5**	**2.9**	**3.1**
Depreciation & amortisation	(0.3)	(0.4)	(0.3)	(0.3)	(0.3)
EBITA	**0.5**	**0.4**	**2.2**	**2.6**	**2.7**
Other income	0.6	0.5	0.4	0.4	0.4
Net Interest	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)
Minority	0.0	0.1	(0.2)	(0.2)	(0.1)
PBT (Adjusted)	**1.0**	**1.0**	**2.3**	**2.8**	**2.9**
Exceptional, SBP's	0.6	(2.3)	(0.1)	(0.2)	(0.2)
Amortisation of customer contracts	0.0	(0.1)	(0.1)	(0.1)	(0.1)
PBT (Reported)	**1.7**	**(1.4)**	**2.3**	**2.7**	**2.7**
Tax	(0.1)	0.1	(0.3)	(0.5)	(0.5)
Tax rate	*8.1%*	*7.4%*	*12.1%*	*17.0%*	*20.0%*
PAT	**1.5**	**(1.3)**	**2.0**	**2.2**	**2.2**
Adj. EPS (pence)	**3.72**	**3.17**	**5.58**	**6.29**	**6.46**
Growth	-	*(14.9%)*	*76.3%*	*12.7%*	*2.7%*
Fully diluted number of shares (m)	23.7	30.8	35.8	36.1	36.3
Summary Cash Flow (£m)					
EBITA	**0.5**	**0.4**	**2.2**	**2.6**	**2.7**
Depreciation / amortisation	0.3	0.4	0.4	0.4	0.4
Working capital movement	(2.3)	(3.0)	1.4	(0.3)	0.2
Other	0.5	(0.1)	0.2	0.2	0.4
Interest paid	(0.1)	(0.0)	(0.1)	(0.1)	(0.1)
Taxation	(0.2)	(0.2)	(0.2)	(0.4)	(0.5)
Cash from operations	**(1.2)**	**(2.5)**	**3.8**	**2.4**	**3.2**
Net capex	(0.5)	(0.3)	(0.5)	(0.5)	(0.5)
Interest received	0.0	0.0	0.0	0.0	0.0
Free cash flow (FCF)	**(1.7)**	**(2.8)**	**3.3**	**1.9**	**2.7**
Net (Acquisitions)/Disposals	0.0	0.0	(0.2)	(0.8)	(0.8)
Dividends paid	0.0	0.0	(0.2)	(0.4)	(0.5)
Shares Issued (net)	0.0	0.0	0.0	0.0	0.0
Other financial (debt repaid)	1.8	2.6	(1.3)	(0.5)	0.0
Increase Cash/(Debt)	**0.1**	**(0.2)**	**1.6**	**0.3**	**1.4**
Closing Cash	**3.1**	**2.9**	**4.5**	**4.7**	**6.2**
FCF per share (pence)	**(7.7)**	**(9.9)**	**10.3**	**6.0**	**8.4**
Summary Balance Sheet (£m)					
Intangible/Tangible assets	1.7	1.7	1.8	1.9	2.0
Goodwill	10.1	12.2	12.2	12.2	12.2
Working capital	6.1	9.4	7.4	7.7	7.5
Capital Employed	**17.9**	**23.4**	**21.5**	**21.8**	**21.7**
Investments / Deferred tax / Minority	(0.9)	(2.8)	(2.7)	(2.4)	(2.4)
Cash / (debt + contingent consideration)	**2.0**	**(0.4)**	**2.4**	**3.2**	**4.6**
Net assets	**19.0**	**20.2**	**21.2**	**22.6**	**23.9**
NAV per share (pence)	**84.4**	**61.9**	**65.7**	**70.0**	**74.0**

Source: Company Data; Shore Capital Markets

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Member of the Shore Capital group

London Office

Bond Street House
14 Clifford Street
London W1S 4JU
T: +44 (0)20 7408 4080

Liverpool Office

The Corn Exchange
Fenwick Street
Liverpool L2 7RB
T: +44 (0)151 600 3700

Edinburgh Office

76 George Street
2nd Floor
Edinburgh EH2 3BU
T: +44 (0)20 7079 1670