Whitman Howard Corporate

Hydrogen*

Small Cap Growth | 1 August 2018

BUY

Initiation | At the beginning of an up cycle

After a challenging period, due to over reliance on the Energy sector, we argue Hydrogen is at the start of an up-cycle as evidenced by the expectation of a 3yr CAGR in PBT of 52%, the return to a net cash position and a resumption in the dividend. This follows a transformational acquisition in 2017 of Argyll Scott which diversifies net fee exposure to new sectors, increases exposure to the faster growing economies of Asia and enables both revenue and cost synergies. This recovery has yet to be reflected in the current share price. The most recent high was 118p in 2013, based on a PBT of £2.4m – a level of profitability which we expect Hydrogen to achieve again in 2019. We initiate with a buy recommendation and a price target of 55p representing 34% upside.

Increased diversification and exposure to faster growing economies. 48% of net fees in 2017 were generated overseas and Hydrogen now has a much more even spread of sector specialisms (Energy is only c6% of net fees). We expect the pace of geographic diversification to accelerate as each economy to which Hydrogen is exposed is growing faster than the UK as evidenced by GDP growth forecasts and the Manpower global employment survey. It is also noticeable that the large cap peer group have all recently reported faster overseas growth. We would expect Hydrogen to experience the same trend.

Improving efficiencies. We expect net fees generated per employee and conversion rates (EBIT as a percentage of net fees) to substantially improve from their relative 2017 lows. This is due to a combination of factors: technology innovations; management incentive schemes, cost savings of c£1.5m and key hires in new geographies.

Re-instated the dividend in 2017. In a significant move the dividend has recently been re-instated with the company adopting a progressive dividend policy. Our initial assumption is for dividend growth of 10% p.a. The resulting yield is 2.6% and with a dividend cover of 4.4x, the cost of the dividend can easily be met from free cashflow, meaning Hydrogen is now attractive to investors looking for income.

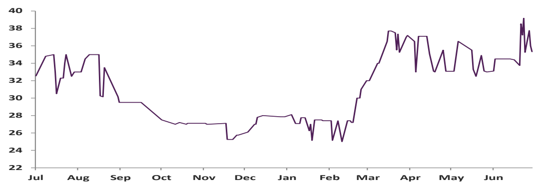
Target price of 55p – directors' have been buying. We see Hydrogen as fundamentally undervalued when comparing its expected growth against the valuation/growth profile of its peer group and valuations achieved in recent M&A transactions in the recruitment sector. It is also of interest that the directors' have recently been buying the shares – a positive sign. They now own c19%.

***Whitman Howard acts as Joint Broker to Hydrogen**

TARGET PRICE	PREVIOUS TARGET
55p	Initiation
SHARE PRICE	**UPSIDE**
41p	34%

Market Data

Ticker	HYDG.L
Market Cap	£14m
52 Week High/Low	40p – 25p
Avg. Daily Volume	6.6K
Shares in issue	34.1m
Free Float	75%



Whitman Howard Estimates

Year end Dec	2017	2018E	2019E	2020E
Net fees (£m)	22.8	29.4	30.3	31.0
Adj. PBT (£m)	0.7	1.9	2.3	2.6
Adj. EPS (p) - FD	2.4	4.7	5.6	6.4
P/E (x)	17.0	8.7	7.3	6.4
Dividend (p)	0.8	1.1	1.2	1.3
Dividend Yield (%)	2.0	2.6	2.9	3.2
Net cash (£m)	(0.3)	1.7	2.3	3.1

Next Event

Interims – 18th September 2018

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Financials and Valuations

Year to December (£m)				
Income Statement	**2017**	**2018E**	**2019E**	**2020E**
Perm	11.6	17.0	17.3	17.6
Contract	11.2	12.4	13.0	13.3
Net fees	**22.8**	**29.4**	**30.3**	**31.0**
Rent received	0.5	0.5	0.4	0.4
Income from investments	(0.1)	(0.1)	0.1	0.2
Operating costs	(22.3)	(27.6)	(28.4)	(28.7)
Operating profit	**0.9**	**2.2**	**2.5**	**2.8**
Interest expense	(0.2)	(0.3)	(0.2)	(0.2)
Interest income	0.0	0.0	0.0	0.0
Adjusted Pre-Tax profit	**0.7**	**1.9**	**2.3**	**2.6**
Exceptional expense*	(2.3)	(0.1)	(0.1)	(0.1)
Profit before tax	**(1.5)**	**1.8**	**2.2**	**2.5**
Tax	0.0	(0.3)	(0.3)	(0.4)
Retained profit	**(1.5)**	**1.6**	**1.9**	**2.1**

Balance Sheet (£m)	**2017**	**2018E**	**2019E**	**2020E**
Fixed assets	**14.4**	**14.4**	**14.4**	**14.4**
Receivables	23.8	25.4	26.4	26.9
Others	0.0	0.6	1.2	1.9
Prepayments	0.3	0.3	0.3	0.3
Cash	2.8	3.7	4.3	5.1
Total current assets	**26.9**	**30.0**	**32.2**	**34.2**
Total assets	**41.3**	**44.4**	**46.6**	**48.6**
Payables	15.7	18.7	19.4	19.8
Provisions	0.7	0.7	0.7	0.7
Other	0.0	0.0	0.0	0.0
Current portion long term	3.1	2.0	2.0	2.0
Total current liabilities	**19.5**	**21.4**	**22.1**	**22.5**
Long term debt	0.0	0.0	0.0	0.0
Redemption liability	1.0	1.0	1.0	1.0
Provisions	0.5	0.5	0.5	0.5
Other	0.2	0.2	0.2	0.2
Total long-term liabilities	**1.7**	**1.7**	**1.7**	**1.7**
Shareholders' funds	**20.1**	**21.3**	**22.8**	**24.5**
Total liabilities and equity	**41.3**	**44.4**	**46.6**	**48.6**

*Exceptional expense in 2018 – 2020 refers to the amortisation of acquired intangibles

Cash Flow (£m)	**2017**	**2018E**	**2019E**	**2020E**
EBITDA – recruitment	0.9	2.3	2.5	2.7
Other income (net)	0.5	0.4	0.5	0.6
Share based payment	0.2	0.0	0.0	0.0
Working capital	(3.2)	1.3	(0.3)	(0.1)
Cash exceptional	(0.6)	(0.7)	0.0	0.0
Gross Op. cashflow	**(2.2)**	**3.3**	**2.7**	**3.2**
Interest expense	(0.1)	(0.2)	(0.2)	(0.2)
Interest income	0.1	0.0	0.0	0.0
Tax	(0.4)	0.0	(0.3)	(0.3)
Net Op cashflow	**(2.5)**	**3.1**	**2.3**	**2.7**
Capex	(0.5)	(0.5)	(0.5)	(0.5)
Free cash flow	**(3.0)**	**2.6**	**1.8**	**2.2**
Deferred consideration	0.0	(0.2)	(0.8)	(0.9)
Cashflow - investing	**0.0**	**(0.2)**	**(0.8)**	**(0.9)**
Dividends	0.0	(0.3)	(0.4)	(0.4)
Cashflow -financing	**0.7**	**(0.3)**	**(0.4)**	**(0.4)**
Incr/(Decr) in net cash	**(2.3)**	**2.0**	**0.6**	**0.8**
Opening net (debt)/cash	2.0	(0.3)	1.7	2.3
Closing net (debt)/cash	**(0.3)**	**1.7**	**2.3**	**3.1**

Review of the P&L

Our estimates for net fees, net fee margin, conversion rate and EBIT are set out in the table below for the period 2017 to 2020. We expect:

- Net fees to increase from £22.8m to £31.0m;
- Group net fee margin to increase from 18.1% to 21.8%;
- The net fee split between perm and contract to be 56%/44% by 2020;
- Conversion rate to increase from 2.2% to 7.2%; and
- EBIT to increase from £0.9m to £2.8m.

Hydrogen is at the beginning of an up cycle…

Table 1 P&L – Key indicators

	2017	2018E	2019E	2020E
Net fees (£m)				
Perm	11.6	17.0	17.3	17.6
Contract	11.2	12.4	13.0	13.3
	22.8	**29.4**	**30.3**	**31.0**
Net fee margin (%)				
Contractor	9.8%	10.6%	10.7%	10.7%
Consolidated	18.1%	21.9%	21.8%	21.8%
Conversion rate (%)	2.2%	6.0%	6.5%	7.2%
EBIT (£m)				
EBIT – recruitment	0.5	1.8	2.0	2.2
Other – rent rec'd	0.5	0.5	0.4	0.4
Investment income	(0.1)	(0.1)	0.1	0.2
	0.9	**2.2**	**2.5**	**2.8**

Source: Company/Whitman Howard Research

The main reasons for our optimism in the upward trend in operating profit and margins are due to the reasons outlined below. We discuss each one in more detail.

…with all leading KPI's showing an upward trend

- Increased diversification of operations;
- Exposure to faster growing economies; and
- Improving efficiencies.

Increased diversification of operations

Significant international footprint and…

Following the acquisition of Argyll Scott, Hydrogen now has a significant international footprint. Previously, c35%-40% of net fees were generated overseas – this rose to 48% in 2017 and we would expect this to increase significantly following a full year's contribution from Argyll Scott. This means that when compared to its small cap recruitment peer group, Hydrogen is now one of the most internationally diverse companies in terms of net fee generation.

Table 2 Overseas contribution to net fees – last reported

	UK	Asia	Europe	Americas
Empresaria	34%	32%	24%	11%
Gattaca	82%	9%		9%
Harvey Nash	40%	4%	42%	14%
Hydrogen	**52%**	**31%**	**9%**	**8%**
Parity	100%			
RTC	100%			

Source: Companies/Whitman Howard Research

…exposure to an increasing number of specialisms

In addition, the acquisition has allowed Hydrogen to diversify its sector specialisms with Business Transformation, Technology, Legal, Life Sciences, Sales & Marketing and Finance, accounting for c90% of net fees, whereas in the recent past, the Energy specialism accounted for c40% of net fees.

Exposure to faster growing economies

Overseas economies are growing faster than the UK as evidenced by…

The significance of the geographic diversification is that Hydrogen has exposure to economies growing significantly faster than the UK. This point was demonstrated in the recent July trading statement with strong performances experienced from its EMEA and Asian operations in 1H2018 – most notably, Singapore and Thailand.

…GDP growth forecasts and…

The table below highlights the latest GDP growth forecasts published by the IMF for those countries to which Hydrogen is exposed. As can be seen, they are all expected to experience GDP growth rates significantly above those seen in the UK. This will be beneficial for net fee growth with corporates wanting to hire new staff and candidates having the confidence to move.

Table 3 GDP growth forecasts

	2018E	2019E	2020E	2021E
UK	1.6%	1.5%	1.5%	1.5%
USA	2.9%	2.6%	1.8%	1.7%
Singapore	2.9%	2.7%	2.6%	2.6%
Hong Kong	3.6%	3.2%	3.1%	3.1%
Australia	2.9%	3.0%	2.9%	2.6%
Malaysia	5.2%	4.9%	4.9%	4.7%
Thailand	3.8%	3.8%	3.6%	3.6%
UAE	1.9%	3.0%	3.2%	3.0%

Source: IMF

Manpower global employment survey

Furthermore, given the increasing dominance of overseas earnings we have also looked at Manpower's global 'Net Employment Outlook' survey to give us an indication of the current global hiring attitudes as it is the only global survey which looks at the future trends for employment. The survey is conducted on a quarterly basis and measures employers' intentions to increase or decrease the number of employees during the next quarter.

…Manpower's Global Employment Survey which is a forward looking measure …

The net employment outlook represents the percentage of employers anticipating an increase in hiring activity and subtracting from this the percentage of employers expecting to see a decrease in employment in the next quarter by asking the question – 'how do you anticipate total employment at your location to change in the next three months as compared to the current quarter?' The latest survey covers the period to 3Q18. The results and those of previous quarterly surveys are highlighted below for Hydrogen's main countries of operation.

…of hiring attitudes

Table 4 Manpower – Net Employment Outlook*

(%)	Q416	Q417	Q218	Q318
UK	4%	5%	6%	4%
USA	16%	15%	20%	21%
Singapore	8%	11%	11%	12%
Hong Kong	13%	17%	16%	17%
Australia	12%	11%	11%	8%

Source: Manpower/*figures not available for Malaysia, Thailand and UAE

The main points are as follows:

- All the major countries to which Hydrogen is exposed are reporting a positive employment outlook, including the UK;
- All countries are showing greater confidence than the UK
- Employment outlook in the UK is fairly static but remains positive; and
- USA, Singapore and Hong Kong have shown significant improvement in the employment outlook over the last 12 months, with only Australia showing a negative trend though it is still positive.

All major economies to which Hydrogen is exposed is reporting a positive employment outlook…

…though the outlook overseas is better than in the UK

The fact that faster growth can be achieved overseas is borne out by the 'larger cap' peer group of Hays, Page Group, Sthree and Robert Walters, all of whom have recently reported faster net fee growth from their respective overseas operations. We would expect Hydrogen to report a similar trend.

A fact borne out by the large cap peer group

Table 5 Net fee growth – UK vs. Overseas (large cap peer group)

(%)		UK	Aus/Asia Pac	Europe	ROW	Americas
Hays	3m to Jun 18	5	14	16	15	25
Page	6m to Jun 18	-4	16	18		
Robert Walters	3m to Jun 18	12	13	23	21	
Sthree	6m to May 18	-2	43	18		9

Source: Companies

Improving efficiencies

A major factor behind the expected improved EBIT levels for Hydrogen is gains in in efficiency. We look at the following:

A number of factors are leading to an expected increase in productivity

- Increasing productivity per employee;
- Enhanced conversion rates; and more importantly
- The factors behind these improvements.

Increasing productivity per employee

Looking at productivity per employee (i.e. net fees generated per employee), Hydrogen recorded its lowest net fee generated per average employee of £79.4k in 2017 – the most recent peak was in 2013 at £89.6k (see table below). This was primarily due to the Argyll Scott acquisition and its reliance upon emerging markets which lowers productivity. That said, we expect to see the net fees generated per employee to rise to £89.1k in 2018.

We expect net fees generated per employee to increase from the low of 2017

Table 6 Productivity per employee

	Ave. Headcount	Net Fees (£m)	Fees per employees (£000)
2010	329	27.6	83.9
2011	362	29.8	82.3
2012	370	31.3	84.6
2013	356	31.9	89.6
2014	343	28.2	82.2
2015	227	18.6	81.9
2016	214	17.7	82.7
2017	287	22.8	79.4
2018E	330	29.4	89.1

Source: Company

Enhanced conversion rates

A key measure of efficiency for staffing companies is the conversion rate which is operating profit as a percentage of net fees. In 2017, Hydrogen reported a conversion ratio of 2.2% (excluding other income) which is very low compared to its peer group as highlighted in the table below.

Conversion rates are a key measure of efficiency

Table 7 Last reported conversion rates

Company	Conversion rate
Empresaria	16.8%
Gattaca	17.0%
Harvey Nash	11.6%
Hydrogen*	**2.2%**
RTC	11.6%

Source: Companies/*recruitment activity only

That said, a low conversion ratio has been a consistent theme for Hydrogen with it reporting a declining ratio since 2011 as indicated below. However, it is highly significant that Hydrogen has recently stated that it aims to increase the ratio to over 15% by 2020 and to be more in line with the peer group. Our current expectation for 2018 is 6%, increasing to 7.2% by 2020.

We expect them to start to trend upwards

Table 8 Hydrogen – historical conversion rates

	Conversion rate*
2010	9.4%
2011	12.8%
2012	10.7%
2013	7.9%
2014	8.9%
2015	n.a.
2016	1.1%
2017	2.2%

Source: Company/* recruitment activity only

We calculate there is significant upside to earnings if Hydrogen can achieve a conversion rate in-line with the peer group. The table below highlights the upside potential to EBIT in 2018 should conversion rates be above our base case assumption of 6%. As can be seen, a conversion rate of 8% would imply an uplift of 27% to our base case EBIT in 2018, indicating how sensitive EBIT is to an improving conversion ratio.

Significant upside potential to our estimates from increasing conversion rates

Table 9 Upside to 2018 EBIT from increased conversion rates

2018E	**6% - base case**	**8%**	**10%**	**15%**
Net fees – base case	29.4	29.4	29.4	29.4
Operating profit - recruitment	1.8	2.4	2.9	4.4
Rent received	0.5	0.5	0.5	0.5
Income from investments	(0.1)	(0.1)	(0.1)	(0.1)
EBIT	**2.2**	**2.8**	**3.3**	**4.8**
Uplift	**n.a.**	**27.2%**	**54.3%**	**122.5%**

Source: Whitman Howard Research

The factors behind these improvements

We see four main factors behind the improved prospects for Hydrogen, as follows:

There are a number of factors behind our efficiency assumptions

- Technology;
- Management incentive scheme;
- Cost synergies arising from the Argyll Scott acquisition; and
- Key hires.

Technology

Technology has allowed…

Technology has changed the recruitment business out of all recognition from ten years ago never mind the 1990's. Firstly, candidates are better connected and more personnel data is on-line than ever before. For a consultant within a recruitment firm this allows for multiple points of online and offline contact with potential candidates. In the case of Hydrogen this is also facilitated by its partnership agreement with Linked In and the roll out of a single global IT platform following the acquisition of Argyll Scott.

…recruitment consultants to spend more time on…

The ability to 'mine the data' is where technology for the recruitment companies is a key differentiating factor in terms of generating efficiencies. The application of intelligent digital marketing techniques using key words, key experience and key phrases to segment candidates enables firms to build up relationships with candidates and develop a 'passive pool' of talent i.e. people who may not necessarily be looking to change jobs but would be open to move for the right opportunity. This contrasts with the previous practice of cold calling candidates and sifting through CV's, and allows consultants to concentrate a greater proportion of their time on fee generating work rather than administrative tasks. It also allows consultants to embed themselves into tight knit networks of specialised candidates, building their trust, gathering intelligence and to map careers. In doing so, candidates can be changed from 'passive to active' from which fees can be generated.

…fee generating work than admin

Moreover, once candidates have been identified they can be further streamlined by on-line assessment and profiling tests which can be done at the convenience of the candidate i.e. out of office, in the evenings or weekends. In this way recruitment companies can quickly narrow down potential candidates before the formal interview process starts thus aiding efficiency.

Management incentive scheme

Management incentive scheme is key to attract, retain, motivate and develop talent

Hydrogen launched a Minority Interest Share Scheme in 2017 to align the goals of the management to support the profitable growth of niche business within the Group. Once pre-determined levels of profitability are determined the staff are rewarded with shares in Hydrogen. This is viewed by the directors' as a key way to attract, retain, motivate and develop talent.

Cost synergies arising from the Argyll Scott acquisition

A key benefit of the Argyll Scott acquisition was cost synergies which are expected to achieve annualised cost savings of c£1.5m for a one-off cash cost of c£1m. Savings have been primarily achieved in property, headcount and the streamlining of principally IT procurement.

We expect substantial cost synergies from the Argyll Scott acquisition

Key Hires

During the past 12 months Hydrogen has made two key hires to run its US and Australian operations, both of whom have previous experience of building up recruitment businesses in these regions with the larger cap recruitment firms.

A number of key hires have been made to develop the overseas operations

Sustainability of progressive dividend

With increased confidence over its prospects, Hydrogen re-established the dividend in 2017 with it having been waived for a number of years. The 2017 dividend was 0.8p and was covered 3x suggesting there is room to increase it further should management have confidence.

Dividend was re-instated in 2017…

Looking forward we expect the dividend to grow at 10% p.a, based upon our current forecasts. The resulting cover ratio is 4x-5x and the cost can be easily met from free cashflow suggesting there is potential to accelerate the dividend further especially when considering Hydrogen is expected is to enjoy a net cash position. Nevertheless, our base case assumption still represents a yield of 3%-4%. Accordingly, Hydrogen will increasingly become attractive to those investors seeking income. Our current estimates for the dividend and related ratios are set out below.

…and it will adopt a progressive policy going forward. This is a good measure of management confidence

Table 10 Sustainability of the dividend

	2018E	2019E	2020E
DPS (p)	1.1p	1.2p	1.3pp
DPS growth (%)	10%	10%	10%
Yield (%)	2.6%	2.9%	3.2%
DPS cover (x)	4.4x	4.7x	4.9x
FCF (£m)	2.6m	1.8m	2.2m
Cost of dividend (£m)	0.3m	0.4m	0.4m
Net cash (£m)	1.7m	2.3m	3.1m

Source: Whitman Howard Research

Valuation

Our price target is 55p

Our price target of 55p reflects a number of methodologies which tries to capture the cyclical nature of the earnings stream. These are outlined below.

- We have benchmarked Hydrogen's current valuation/growth profile and the last 12 months share price performance against its small cap peer group to establish it is undervalued; and
- Estimated a value for Hydrogen based upon recent acquisition multiples in the staffing sector.

Benchmarking valuation/growth with the peer group

We believe Hydrogen is undervalued compared to its small cap peer group considering its growth profile and based…

The table below details the current valuation (PE rating and dividend yield), the share price performance over the last 12 months and the PEG ratio for Hydrogen and its peer group. As can be seen Hydrogen offers a compelling story with it offering the highest expected PBT growth of 159% and 19% in 2018 and 2019 respectively, yet at the same time the PEG ratio of 0.1x is the lowest of the sector. Clearly, Hydrogen's PBT growth in 2018 benefits from a full year's impact from the acquisition of Argyll Scott, but this growth does not appear to have been fully reflected in the share price performance over the last 12 months given our price target. As such, we believe Hydrogen at the current share price is undervalued and offers significant upside potential.

Table 11 Valuation benchmarks at Hydrogen's actual share price

	PBT g (%)	PE (x)	Yield (%)	Price Last 12m	Mkt Cap (£m)	PEG (x)
Empresaria	3%	6.3	2%	-47%	39.7	2.3x
Gattaca*	12%	4.7	7%	-57%	39.7	0.4x
Hydrogen	156%	8.7	3%	23%	14.0	0.1x
Parity	12%	8.8	0%	19%	12.8	0.6x
RTC	42%	5.6	7%	-21%	8.2	0.1x

Source: Whitman Howard Research/*Calendarised

Acquisition multiples from recent M&A activity

…on recent M&A activity in the sector

Having established that Hydrogen is undervalued we have reviewed the recent acquisition multiples (PE and EBITDA) paid for small cap staffing companies in the recent past. As can be seen in the tables below the average PE multiple paid has been 11x, whereas the average EBITDA multiple has been 8x.

Table 12 M&A – recent PE multiples paid

Transaction	PE multiple
Adecco/Penna	16.6x
Gattaca/Networkers Int'l	13.5x
Harvey Nash/PAT Management	8.4x
Harvey Nash/Crimson	5.9x
Average	**11.0x**

Source: Whitman Howard Research

Table 13 M&A – recent EBITDA multiples paid

Transaction	**EBITDA multiple**
CPL/RIG	4.5x
Empresaria/Pharmaceutical Strategies	12.3x – max – 7.4x min
Average	**8.1**

Source: Whitman Howard Research

Price target represents 34% upside

If we then apply these PE and EBITDA multiples of 11x and 8x respectively to our respective 2018 estimates for Hydrogen we calculate a valuation range of 53p to 62p as seen in the table below. Our actual price target of 55p is at the lower end of this range.

Table 14 Valuation range for Hydrogen

PE based valuation	
PE multiple (x) - as above	11x
2018E - EPS (p)	4.7p
Value (p)	**52.5p**
EBITDA based valuation	
EBITDA multiple (x) – as above	8.1x
2018E – EBITDA* (£m)	2.7m
Value (£m)	21.5m
# of diluted shares (m)	34.8m
Value (p)	**61.7p**

Source: Whitman Howard Research/*includes rent received and investment income

Management Bio's

Stephen Puckett – Chairman

Stephen has been a Board member since 2012, chairs the Audit and Nomination Committee and is a member of the Remuneration Committee. Prior to joining Hydrogen he was Group Finance Director of Michael Page International plc (now Page Group plc). He is a Chartered Accountant and is also a director of ITE Group plc and Redcentric plc.

Ian Temple – CEO

Ian is a co-founder of Hydrogen and has been a board member since 2005. He is a Chartered Accountant.

John Hunter – COO and CFO

John co-founded Argyll Scott in 2010 and was appointed its CEO in 2012. Post the acquisition of Argyll Scott in 2017, John joined the board of Hydrogen in June 2017. He is a Chartered Accountant.

Richard Green – Non Executive Director

Richard has been a board member since 2016 and is an experienced Non-Executive Director in both public and private companies. He was previously the Managing Partner and subsequently Chairman of August Equity LLP. He is a Chartered Accountant.

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