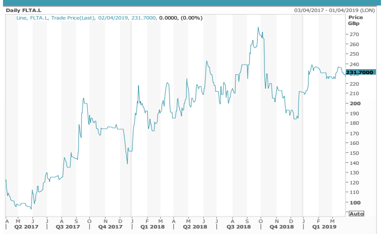
3rd April 2019

Support Services



Source: Refinitiv Eikon

Market data

EPIC/TKR	**FLTA**
Price (p)	**225**
12m High (p)	282
12m Low (p)	166
Shares (m)	29
Mkt Cap (£m)	66
EV (£m)	64
Free Float*	33%
Market	AIM

**As defined by AIM Rule 26*

Description

Filta Group provides cooking oil filtration, fryer and drain management services in North America and Europe to commercial kitchens.

Company information

CEO	Jason Sayers
CFO	Brian Hogan
Chairman	Tim Worlledge

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www.filtaplc.com

Key shareholders

Directors	67%
Gresham House	12.5%
Blackrock	5.6%
Ennismore FM	5.0%
Cannacord Genuity	3.7%

Diary

Apr'19	Prelims
Jun'19	AGM
Sep'19	Interims

Analyst

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FILTA GROUP

Cleaning up in commercial catering

Filta Group (Filta) provides cleaning services to commercial kitchens in North America, the UK and, more recently, mainland Europe. For cleaning and filtering frying machines, this is largely carried out through franchise networks. In the UK, Filta has some company-owned operations too, and it has recently accelerated the expansion of its grease management services with the acquisition of Watbio. There is no direct competition in the fryer market, and it currently addresses only 2% of the total potential. Revenues should prove both consistent and persistent, and there is scope for continuing growth for many years, in our view.

- **Strategy:** Filta provides a professional service, through franchisees, to kitchens to take over the job typically done by junior employees, if at all. The filtering of cooking oil has many benefits, including improving taste and saving money. The grease that inevitably emanates from commercial kitchens, and causes significant problems in main drains and sewer systems, also needs managing.

- **Consistent revenues:** Once customers are signed up, they are likely to prove sticky, if they receive regular attention, as their fryers need regular management, almost regardless of the level of business. The same is true of their drains. The service provided improves kitchen efficiency and food quality; it also saves Filta's customers money, and improves the lives of their employees.

- **Valuation:** Filta has no directly comparable companies. We have used a DCF to derive a value range of 226p to 282p per share, using a 10% discount rate and a mid-term (2021-25) growth rate of between 6% and 12%. Our central estimate is 262p. No account is taken of future added-value acquisitions.

- **Risks:** In addition to normal commercial risks, Filta is dependent on the behaviour of its franchisees, which it cannot control but can help to influence by means of thorough training. It has also recently made a sizeable acquisition, the integration of which will inevitably involve managing some unknowns. It is exposed to FX risk too, although most costs are local.

- **Investment summary:** Filta is a very attractive business, in our view, combining the capital-light franchise model in North America and Europe with company-owned operations in the UK. The business is naturally cash-generative and, with only a tiny proportion of the market currently served and with little or no competition, we see potential for many years of profitable growth ahead.

Financial summary and valuation

Year-end Dec (£000)	2015	2016	2017	2018E	2019E	2020E
Revenue	7,925	8,469	11,547	14,140	26,000	29,000
EBITDA	594	1,193	2,116	2,700	4,800	5,300
Underlying EBIT	450	1,011	2,059	2,000	3,950	4,500
Reported EBIT	450	-249	1,699	1,800	3,800	4,300
Underlying PTP	376	932	1,968	1,900	3,700	4,250
Statutory PTP	376	-329	1,608	1,700	3,550	4,050
Underlying EPS (p)	1.39	3.66	5.05	5.43	9.76	11.13
Statutory EPS (p)	1.39	-1.51	3.85	4.70	9.24	10.44
Net (debt)/cash	-619	3,271	2,992	1,673	1,633	3,790
Shares issued (m)	22	23	27	28	29	29
P/E (x)	162.0	61.5	44.5	41.5	23.1	20.2
EV/EBITDA (x)	83.5	40.1	27.6	22.3	13.4	11.7

Source: Hardman & Co Research

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Executive summary

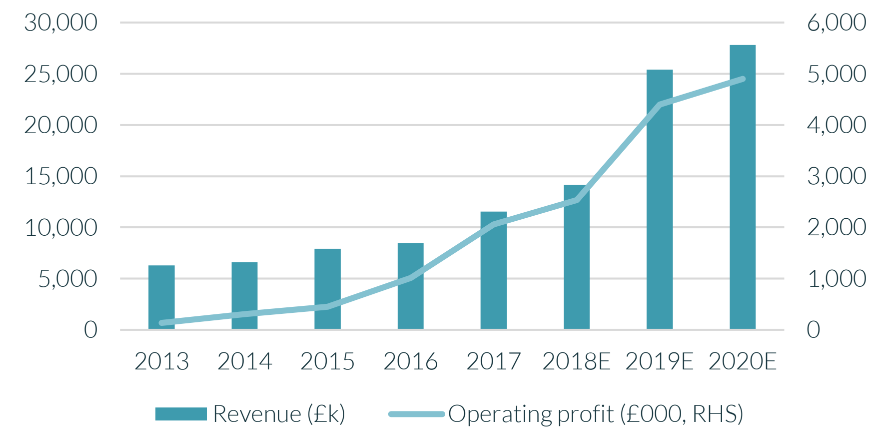
Plenty of scope for future growth

Filta has an attractive repeat revenue business. Serving mostly commercial kitchens, it provides contracted-out services covering fryer management, replacing refrigeration seals and, more recently, fat oil and grease management (FOG). These jobs are usually left to the most junior employee or until an emergency service is needed. Filta has little in the way of competition in the first two categories, and the FOG sector is very fragmented, with Filta's latest deal making it probably the largest player in the UK.

The business in North America and continental Europe is run as a franchise operation, which means relatively low capital and employee requirements. The franchisees are supported by a Filta sales team, which helps them grow their businesses, and is responsible for managing the national accounts of multi-site commercial catering operations. The UK is a mixture of company-owned operations and fryer management franchises, but the franchisees are typically one-van operations, in contrast to the North American market, where the average van count is three per franchise and top franchisees have annual revenues in excess of $1.5m.

Filta has seen steady growth in its various businesses, as the number of franchises have increased and as the franchisees have grown their own businesses. With only around 2% of the addressable fryer market currently being served, we see steady growth being achievable for many years to come. Large parts of the USA are now allocated to franchisees – including the largest metro areas – but expansion into Canada, the growth of the American franchisees themselves, the steady upgrading of the franchisee network as territories are recycled, and the opportunity to repeat the US pattern in Europe, all provide plenty of scope for future growth.

Revenue and operating profit (£000, 2013-20E)



Source: Filta Group, Hardman & Co Research

Expansion of grease management services with acquisition of Watbio

The expansion into grease management is also, in our view, promising. There is more competition here and, although Filta's acquisition of Watbio represents a significant move, it remains a very fragmented market in which Filta is one of the largest or possibly *the* largest players in the UK. Regulation is only likely to get tougher, making Filta's FOG services even more important.

The drains business is similar to the fryer business in that it requires regular visits to the kitchens to maintain the equipment *in situ*. The requirement for scheduled maintenance makes the organisation of the teams' rotas a critical factor in the efficient running of the business and, here, Filta believes there is substantial scope for increasing the productivity within Watbio.

The fridge seal replacement operation is less suited to franchising because, typically, it only needs client visits annually or less frequently, so the business is company-owned. Filta has a unique proposition in this market – it replaces the seals onsite in one visit, making it a very attractive solution for the kitchens by avoiding prolonged disruption. Once the clients are signed up, they should remain for as long as they stay in business. We expect the steady progress of this business to continue and its profitability to marginally outgrow sales, as scale efficiencies kick in and as clients migrate from reactive repairs to scheduled maintenance or replacement.

Valuation

We use a DCF valuation, given that Filta has no comparable businesses

With no comparable businesses, we have fallen back on using a DCF valuation. Using a constant discount rate of 10% derives a range of values depending on the growth rate chosen between the end of our forecast period (December 2020) and when the perpetuity calculation starts (we have used 2026).

Our forecast range of values based on the DCF methodology gives a wide-range value of 172p to 424p per share, with the central value, at a 10% mid-term growth rate and using our 10% discount rate, of 262p.

DCF sensitivity table

Mid-term growth rate	6%	8%	10%	12%
Discount rate	(p)	(p)	(p)	(p)
8%	334	362	392	424
10%	226	243	262	282
12%	172	184	197	212

Source: Hardman & Co Research

Of course, these mid-term growth rates are a fraction of what Filta has achieved in the past and what we expect it can achieve in the future. They take no account of future potential acquisitions, either.

The current share price, still using a 10% discount rate, implies an assumed mid-term growth rate of around 7%.

The relatively high implied multiples of earnings and EBITDA are justified, we believe, by the high gross margins (in excess of 50% – a function of the nature of franchising), the low capital intensity, the lack of competition, and the persistency and widespread nature of the client base.

Investment conclusion

Many attractive characteristics

Filta has many attractive characteristics. The doubling of revenue with the Watbio acquisition suggests a more aggressive approach to growth, but management has proven its capability by taking on North America so successfully, having worked out that its franchise model was most likely to thrive there best. More infill deals are likely to be earnings-enhancing, and we would expect the company to be prudent with its valuable equity, as it was with Watbio.

The business

Filta's biggest territory is North America

Filta provides fryer management and other services to commercial kitchens. At its heart is the original cooking oil filtration service, FiltaFry, to which various add-on services have been developed. Most recently, it has expanded into grease management (also for commercial kitchens) through one small and one larger acquisition. Its biggest territory is North America, where the business is run solely as a franchise system. In the UK, it is a hybrid franchise and company-owned operation. In Europe, the German master-franchise has been brought back in-house to provide the starting point for the development of an operation along the same lines as in North America, with expansion into other countries likely in the coming years.

There are also some other master-franchises – in Costa Rica, Benelux, Greece, Hungary, Portugal and South Africa – but they make only a very small contribution.

Oil filtration service

FiltaFry

FiltaFry works with minimal disruption of service

The FiltaFry service incorporates the use of proprietary mobile cooking oil filtration units (MFUs). An MFU uses filters that are designed for the Group and manufactured to work only within the Group's proprietary MFU. Using a specially developed mobile micro-filtration system, the cooking oil is removed from the fryer at cooking temperature, and filtered to eliminate food particles and contaminants such as carbon. After an extensive, vacuum-based clean of the fryer, the oil is returned and the fryer is operational again within 20 minutes for minimal disruption of service.

The benefits of the service are:

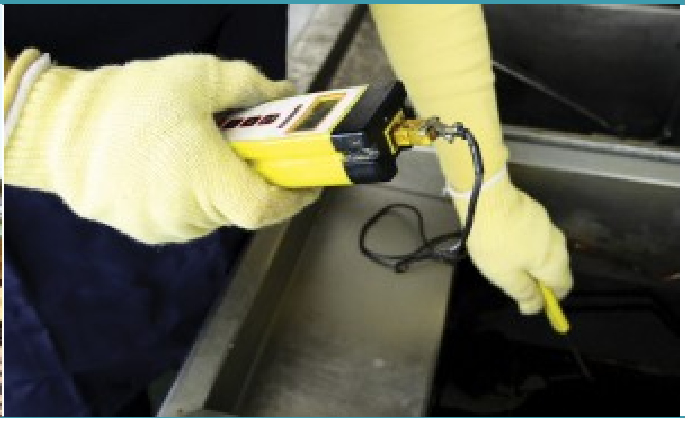
- lower frying costs – the filtration can double the life of cooking oil, effectively halving cooking-oil costs;
- happier kitchen staff – the unpleasant fryer cleaning job is no longer the employees' responsibility;
- lower health and safety risks – the potentially dangerous job of manipulating hot oil is left to a trained professional;
- improvement in food quality – cleaner oil tastes better and reduces frying odours;
- time-saving – a FiltaFry professional with a specially designed kit can do the job in 20 minutes, far faster than a kitchen employee – minimising kitchen disruption.

FiltaFry has no direct competition. There are some other outfits that offer oil filtration systems, which are expensive bits of kit that are stored in the customers' kitchens and have to be operated by them, and others who are interested in just selling fresh cooking oil. However, there are no significant other players operating as a mobile oil filtration service bringing their own equipment and taking away any waste oil.

As an additional service, Filta will also provide fresh oil. Whether customers take up this service will probably depend on their scale. At the larger end, they are likely to have their own negotiated supplier of cooking oil.

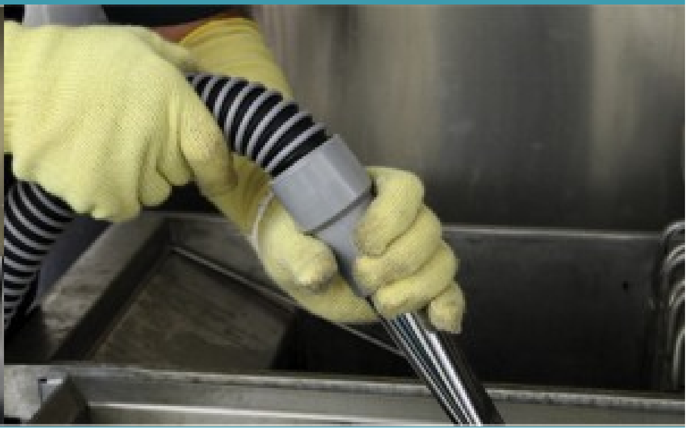
Mobile filtration unit unloaded from Filta van

Checking oil temperature – reset and advise

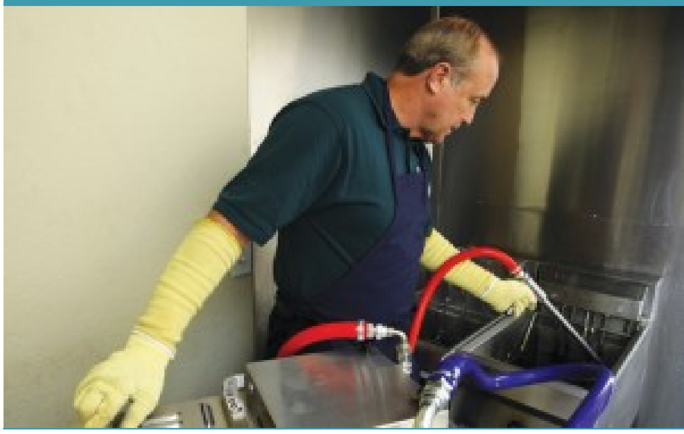


Removing oil from fryer and filter

Cleaning fryer with vacuum-based filtration system



Returning filtered oil to fryer



Cooking oil before and after filtering

Source: Filta Group

When the cooking oil has come to the end of its life, it needs to be disposed of. Filta offers a collection service called FiltaBio. It removes the oil into a waste oil tank fitted inside the van. Once the Filta operative is back at base, the oil is stored in a tank to await collection by the Group.

Filta purifies the waste vegetable oil, and the majority of it is sent to be made into biodiesel, the safe and environmentally-friendly alternative to petrochemical-based diesel. Filta removes the oil from its franchisees for a charge, based on their geographical location, and makes a small profit by selling it on in bulk.

Two further add-on services are FiltaCool and FiltaDrain.

FiltaCool

FiltaCool and FiltaDrain are very natural upsells to customers already using FiltaFry

FiltaCool is the installation and servicing of a proprietary filter in walk-in coolers, freezers and other refrigeration units to absorb and desorb moisture, capture ethylene and pectin gases, and stabilise cold storage temperatures. The benefit to customers of using the filters is that they extend the life of perishables and equipment, and reduce mould, bacteria growth, odours and food waste within the refrigeration units.

FiltaCool filters are provided as rental equipment to customers by Filta franchisees, who, in turn, purchase the filters from the Group at a monthly cost of $3 per filter. Franchisees place the filters at customer locations and rotate out used filters every three months, on average. The filters are then de-gassed by the franchisees for reuse.

This is a very natural upsell to a customer who is already taking the FiltaFry service.

FiltaDrain

FiltaDrain is a weekly-applied drain-cleansing service. It uses a natural foam containing bacteria that literally eat the grease, sugars and starches that build up in kitchen drains. The grease build-up is inevitable in any kitchen: it comes from pot washing, dishwashers and even cooking vapour. As it gets trapped in the drains, it causes blockages and odours, and becomes a breeding ground for drain flies.

It too is a natural upsell for FiltaFry customers, although there tends to be more competition in drain management. FiltaDrain is offered only in North America, as Filta has a separate and growing grease management business in the UK.

Franchising

FiltaFry and add-ons are natural for franchising

The FiltaFry business and its add-ons are natural for franchising. As the franchisees build up their clients, they see them regularly and are paid a regular income. Assuming they provide a good service, the business should prove very sticky.

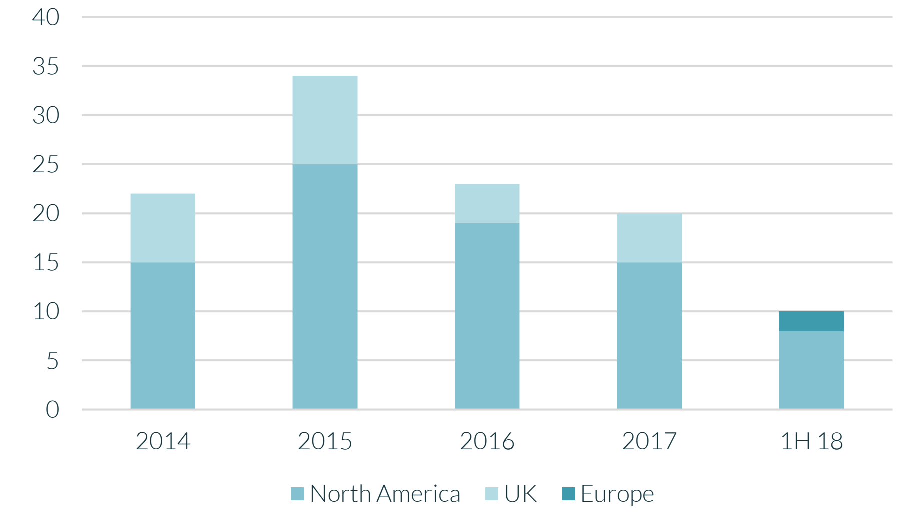
The main issue for the franchisees is how fast they want to grow their business. In the UK, most franchises are one-man operations. The typical UK franchises just want to work for themselves and not take on the hassle of employees and multiple vans. In North America, it is the opposite. The entrepreneur culture assures a steady supply of would-be business magnates keen to expand their business and exploit their territory fully. In 2017, Filta's largest franchisee had revenue in excess of $2m, and six franchisees had revenue in excess of $1m.

On average, Filta generates revenue of approximately $30,000 per franchised MFU each year in North America.

Each franchise is an exclusive geographical territory for which the franchisee pays an initial, non-refundable fee. The fee can vary depending on the size and potential of the territory. Franchise fees consist of two components: the territory fee and the opening package fee. The revenue associated with the opening package fee is recognised by the Group when substantially all initial services required by the FiltaFry franchise agreement are performed – generally on the completion of the training of the franchisee.

The territory fee represents the exclusive right to operate in a designated territory for a stated length of time. The territory fee, although received upfront, is recognised over the length of the franchise agreement, typically 10 years in North America and five years in the UK and Europe, and released to income on a straight-line basis.

Number of franchise sales (2014-1H'18)



Source: Filta Group

Franchise terms

Typical franchise terms – defining obligations of both sides of deal

Filta's franchise agreement is fairly typical, defining the obligations of both sides of the deal. The franchisee must use its best endeavours to grow the business and not compete with Filta's own products and services. It must not actively engage outside its own territory and, if it does get enquiries, it must pass them on to Filta.

Should a franchisee wish to sell his/her business, Filta has first option on it. It is clearly in the best position to find a buyer, and a sale typically provides an opportunity for Filta to upgrade the quality of its franchisee and, at the very least, ensure that the purchaser is, at the minimum, acceptable. It is always entitled to a commission on the purchase price.

For Filta's part, it has to provide the equipment and initial (and subsequent) training.

New franchisees

Group receives ca.300 enquires in North America and UK per month from franchise sale web portals

The Group advertises its franchises on franchise sale web portals in both North America and the UK, and through franchise brokers in North America. The Group receives approximately 300 enquires in North America and the UK from the franchise sale web portals every month. Following an initial enquiry from a potential franchisee, the Group undertakes a telephone interview, followed by a 'discovery day', after which a potential franchisee may be invited to enter into a FiltaFry franchise agreement.

The purpose of the discovery day is to allow potential new FiltaFry franchisee owners to learn more about the franchise opportunity, and also to allow the Group to evaluate the individuals (or corporates) to assess their suitability. It is only following a discovery day that the potential Franchise Owner and the Group discuss the terms and conditions, and enter into a franchise agreement. Typically, a new Franchise Owner will launch with a single MFU and van.

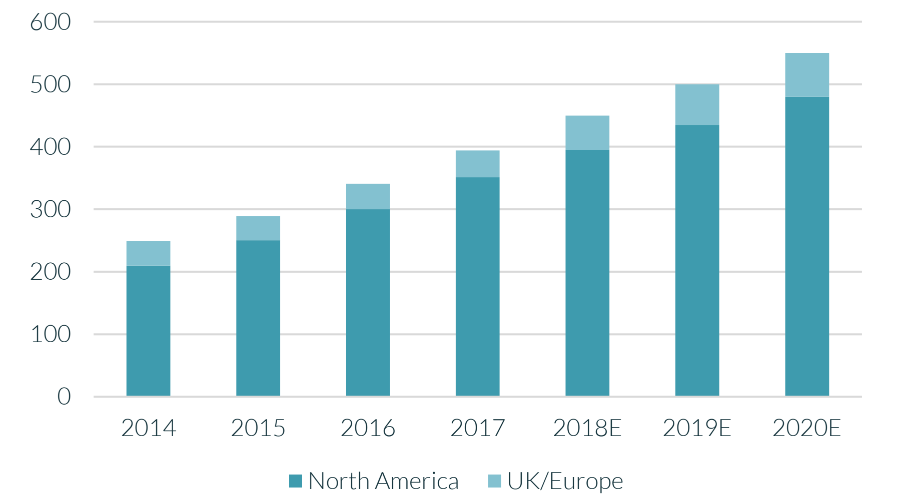
Strategy to recruit quality franchise owners with ambition and business ability to expand their franchises

Filta's strategy is to recruit quality Franchise Owners, who have the ambition and business ability to expand their franchises, helping Filta's own fryer management repeat revenues to increase year after year. With Filta already operating in many key markets in North America, it is increasingly using business brokers, who are particularly useful in targeting markets where it needs additional coverage. Sales through brokers accounted for 43% of Filta's new franchise sales in 2017.

Franchise and MFU growth

Between 2014 and 2017, nearly all Filta's franchise growth came from North America. The numbers of MFUs rose steadily, from 210 to 351 (and to an estimated 398 at the end of 2018), while, in the UK, only four were added over the same period.

Number of franchisee MFUs (2014-20E)



Source: Filta Group, Hardman & Co Research

Expect sales of franchises in Europe and Canada to counter-balance slowdown in US

As the coverage in the US expands, there will be a reduction in the number of available territories for sale, which will result in a decrease of new franchise sales in the US in the future. However, we fully expect the existing franchisees to continue to grow their own businesses, adding more MFUs as their client numbers increase. Furthermore, we would expect the sales of franchises in Europe and Canada to counter-balance, to a great extent, the slowdown in the US.

Franchise resales

Increasing demand and opportunity for franchise resales

As the franchise base grows and matures, there will be an increased demand and opportunity for franchise resales. In 2017, 10 Filta Franchise Owners sold their businesses, which generated fees for Filta of £0.1m. A further five resales were made in the first half of 2018. We expect resale transactions to grow in value and number in the coming years, which will not only generate increasing fees but will also provide opportunities to strengthen the franchise network. Weaker franchisees can be managed out and their territories sold on to more ambitious new franchisees.

Future growth

Growth should come from Canada and Europe

We expect future franchise growth to come from the expansion into Canada, where Filta expects to have 12-15 multi-unit Franchise Owners in the next few years, and also in Europe.

In January 2018, Filta bought back its German master franchise and kept the managing director to implement the new business strategy. It paid £0.2m, with a further £0.1m in earnout to be paid over the following two years.

The plan is to build up the franchise business in Europe in the same way as in North America, with large territories with franchisees with multiple vans. It has started well, with eight franchises added in 2018, and the franchise fee has been raised from £45,000 to £50,000.

The economics of the franchise

Straightforward sales methodology

In addition to the initial fee, franchisees pay royalties. They are also contracted to buy Filta cartridges for the MFU from Filta. The franchise royalty is based on the number of mobile units, not the revenue each generates. Despite Filta not benefiting directly from increased sales, it runs a unit called the 'inside sales' group; this comprises five people in the US who assist the franchisees in winning new business.

The sales methodology is straightforward: franchisees approach potential customers directly and offer them, if they are suitable, a free evaluation, followed by a four-week free trial. Filta estimates that the conversion rate, from free evaluation to paying a customer, is about a half. The direct sales approach is supported by an online advertising strategy.

The inside sales team also encourages franchises to upsell the other services; it targets national accounts that it manages on behalf of the group and links them to its local franchisees.

National Accounts are typically the accounts of contract caterers, restaurant chains, sports stadiums, etc. Filta is on the approved supplier list with many national caterers, but the decision of whether or not to take on an external fryer service will typically be left to individual kitchens. National account customers pay Filta, not the local franchisee, for services received, and Filta charges a 5% fee for the collection and matching of invoices.

Market opportunity

Significant market opportunity

Typically in a report like this, we would discuss the size of the market and the market shares of the leading players. In Filta's case, there are no competitors. The 'competition' is the kitchen doing the work itself (or not). The scale of the market opportunity is enormous. Filta estimates that it has about 2% of the potential UK market and less than 2% of the US market.

In the UK, the company estimates that there are around 80,000 sites that would be suitable for Filta's services out of a total of over quarter of a million eating-out venues. The 80,000 includes over 70,000 restaurants and 8,000 supermarkets. The numbers do not include contract caterers or hospitals.

Market opportunity for FiltaFry – number of outlets

Sector	North America	UK	Germany		Fryers	Seals & drains
Restaurants	630,000	72,000	165,000	Core to Filta's business in both the US and UK.	Some	All
Supermarkets	37,000	8,000	25,000	Multi-unit organisations and therefore potentially attractive customers.	Some	All
Universities and colleges	2,000	106	100	Most have fryers; all have many seals and refrigeration units. Mostly accessed through contract caterers.	Most	All
Sports stadiums	1,000	50	100	Only stadiums with over 5,000 capacity. Filta services over 300 US stadiums.	All	All
Hospitals	5,600		1,900	Mostly accessed through contract caterers.	Some	All
Casinos	500		50	Casinos can have many restaurants. and most provide fried food.	All	All
Contract caterers	50,000		13,000	Whether outside contract or provision of onsite staff, provide valuable access to many sectors.	Some	All

Source: Filta Group

In North America the market size is probably 10 times bigger. The population is five times the size, and the country is particularly keen on fried food. The German opportunity is probably twice the size of the UK.

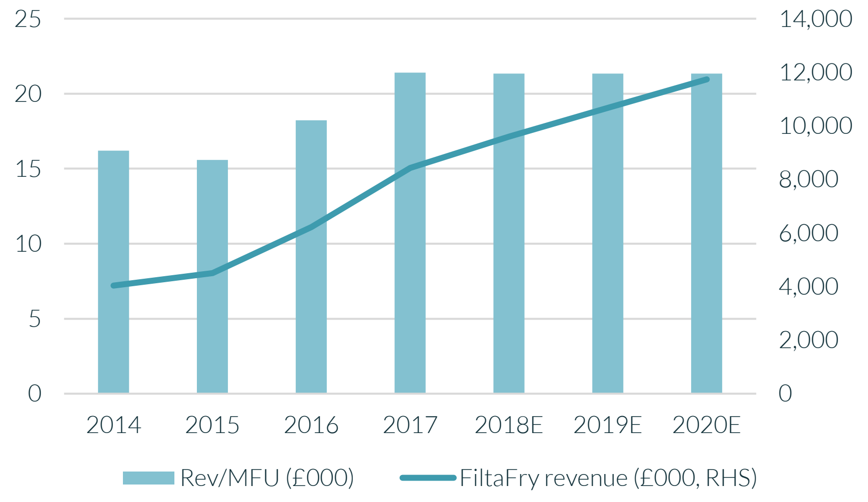
Put simply, the scale of the market opportunity is no limit to Filta's ambitions.

Persistency and repetition

Steady stream of revenue after signing of contracts

The FiltaFry business is characterised by very consistent and persistent business. Once a contract is signed, there will be a very steady stream of revenue. The cooking oil will need filtering regularly, almost regardless of the level of business in the kitchen. And with no competition, as long as the service levels are maintained, the restaurants are very unlikely to go back to cleaning their fryers themselves. If the price of cooking oil were to fall precipitously, then restaurants might be less concerned with the cleaning of the oil, but this is only one consideration: they would then have the task of disposing of the used oil, something which is likely to become increasingly regulated.

FiltaFry revenue (£000) and revenue per MFU (£000)



Source: Filta Group, Hardman & Co Research

Royalties increase at about the cost of living index each year. Most other prices are effectively determined by the market.

FiltaFry has, in our view, the scope to carry on growing for many years.

Other businesses

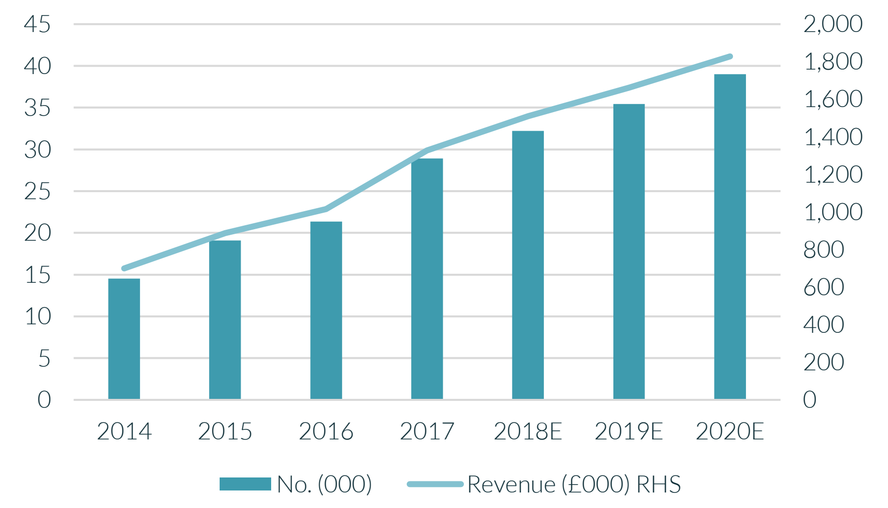
FiltaSeal

FiltaSeal is a system for replacing damaged or perished refrigerator and freezer door seals

In the UK only, Filta runs a non-franchise business called FiltaSeal. FiltaSeal is a patented system for replacing damaged or perished refrigerator and freezer door seals onsite in commercial kitchens, in a cost- and time-effective manner. Specifically, the system allows engineers, using patented equipment and materials housed in the vans, to replace a seal in one visit, producing cost and time savings for its clients, who would otherwise experience ordering and fitting delays following an initial engineer's visit.

The benefit of this service, apart from avoiding the disruption that multiple engineer visits causes, is the energy cost saving and avoidance of longer-running food hygiene risks. It is also up to 40% cheaper than other commercial solutions.

Number of fridge seals replaced and FiltaSeal revenue (£000)



Source: Filta Group, Hardman & Co Research

A fridge seal will typically last between 12 and 18 months, depending on the amount of usage the door gets. Once the contract is won, it should be for life. Because the business involves only annual or less frequent visits, Filta does not see it as a suitable franchise opportunity, and owns the operations itself. A key part of the business is the efficient routing of the vans and the density of the client base. FiltaSeal made a positive contribution for the first time in 2017, when it replaced 35% more seals without an additional van. It commented that it was approaching optimal utilisation, but expected the trend to continue into 2018.

In the first half of 2018, revenue grew by a further 9%, and we are anticipating that growth will have continued in the second half. The average price per seal has been fairly constant, at £46.

We see FiltaSeal continuing to grow at a steady pace well into the future. Its growth may also be helped by the expansion of the grease management business driving more cross-referrals.

FiltaGMG

With FiltaGMG, Filta broadened services to include preventative drain maintenance

In 2016, Filta recognised that there was a developing demand, driven by both legislation and commercial efficiency benefits, for the provision of preventative drain maintenance to commercial kitchens. It started supplying and servicing auto-dosing drip systems to keep commercial kitchen drains clear, but it became apparent that there was a far greater opportunity if it broadened its services to include the maintenance of grease recovery units.

FOG

In August 2017, Filta acquired Grease Management Limited

The industry has its own acronym: FOG (Fat Oil and Grease). All kitchens produce wastewater that contains some fats, oils and greases, as well as food debris. The wastewater from commercial kitchens tends to contain a higher proportion and volume of FOG than domestic wastewater. If this wastewater is not managed in some way, then this FOG can be detrimental to the drainage/sewer network and possibly in contravention of Section 111 of the Water Industry Act 1991, which gives the water companies power to prosecute offenders and recharge the costs of clearing blockages, and any environmental collateral damage caused by blockages.

Grease Management is a term given to products/services that trap and/or treat the wastewater to reduce the amount of FOG within it before discharging to a sewer. There are three types of grease management product:

- Grease Traps – also known as separators or interceptors, these products physically trap the FOG within them and allow the cleaned wastewater to pass through.
- Grease Removal Units (GRU) – these have the same initial function of a grease trap. with additional processes that remove food debris and FOG into external containers for separate disposal.
- Dosing Systems – these add a biological element to the drainage system that is designed to break down the FOG into less harmful products. (This is essentially what FiltaDrain does in the US.)

All of these options are effective only if they are properly maintained. A combination of all of these options can be implemented.

This is a highly fragmented, but growing, market and, in August 2017, Filta acquired Grease Management Limited, a company local to Filta's own head office, with a strong reputation and a well-established client base.

Grease Management Limited was integrated into the existing FiltaDrain business (essentially the UK equivalent of the US business) to create FiltaGMG, sharing the existing call-centre resources and implementing new operational systems. The integration was relatively straightforward, after a few initial hiccups, and Filta decided to expand further in this area.

Watbio

Acquisition of Watbio accelerates expansion of Filta's grease management services

At the end of 2018, Filta announced the acquisition of Watbio Holdings Ltd, a business providing grease and drain solutions to commercial kitchens across the UK. With this deal, Filta believes it is now the leading service provider in this market in the UK. Watbio had revenues of just over £10m in the year to end-September 2018 and made adjusted EBITDA of £1.1m.

The consideration for the deal was £6.09m, after finalising the working capital adjustment in the business at the time of completion.

The deal was financed by the issue of 2.05m shares at 200p (525,000 to the vendors and 1.5 million to new and existing institutional shareholders), and the balance from cash resources and a new £4m facility from HSBC.

The rationale for the deal is straightforward: it fits in with the target market Filta is looking to grow, and makes the company a leading player. It has a high margin and repeat revenue business, and will strengthen and diversify Filta's relationships with national blue-chip customers. There will be opportunities for margin improvement, as well as opportunities to cross-sell FiltaSeal.

Filta estimates that there should be operational synergies of the order of £0.9m once Watbio is fully integrated, and so the deal will be significantly earnings-enhancing. As an example, currently Watbio's teams typically attend three to four clients per day, whereas Filta manages five to six. Filta also uses considerably cheaper equipment. This is a relatively low-priced service business, and so volume, and how it is managed, is critical to profitability.

About two-thirds of Watbio's business is similar to FiltaDrain; the other third is a reactive business – i.e. it responds to call-outs. Some of it is high-end drain management and highly specialised, dealing with commercial sewage – for example, for Anglian Water or the 02 stadium.

The combination of FiltaGMG and Watbio should provide not only significant synergies but ample growth opportunities over the next few years.

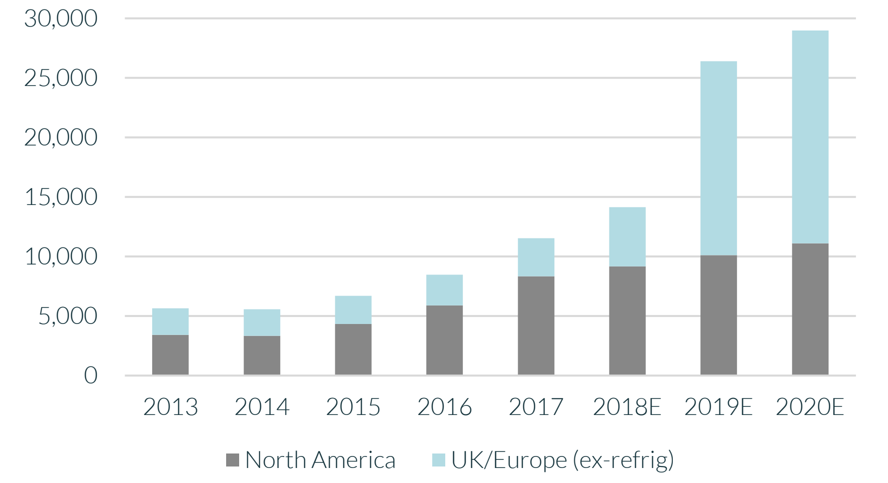
Financials

Profit and revenue growth between 2014 and 2017, and we forecast 'more of the same' ahead

Filta's revenues are inherently stable – from both the franchise business and the company-owned operations. Each provides a regular service, and the proposition is still immature, so there remains a very substantial market opportunity. Outside the FOG business, it faces no direct competition.

In the revenue figures below, we have removed the refrigeration business completely. It was sold in 2017 and treated as discontinued in the 2016 and 2017 accounts. The refrigeration business was fundamentally a different sort of business: it was mainly an installation service requiring disproportionately higher working capital and did not have the same growth profile as the rest of the group. It was also lower-margin.

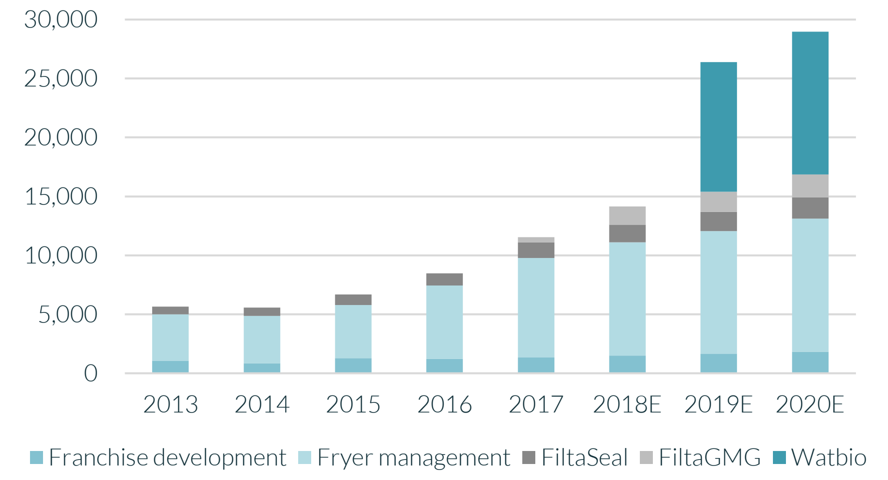
Filta Group – revenue by geography (£000, 2013-20E)



Source: Filta Group, Hardman & Co Research

Between 2014 and 2017, revenue grew at a compound rate of 27% p.a., and pre-tax profits (excluding one-off costs like the IPO) grew from £229k to £1.7m. For 2018, we are estimating profits will have grown a further 36% to £2.4m.

Filta Group – revenue by business (£000, 2013-20E)



Source: Filta Group, Hardman & Co Research

Growth has been achieved almost all organically, with all the key operating metrics showing steady growth: number of franchises, number of MFUs, and number of seals replaced. There has also been some increase in the revenue per MFU, as franchisees become more efficient and add more clients. The revenue per seal replaced has been fairly constant.

The GMG business is too new to show any discernible trends, but the company reported, at its interims, that revenue for the half year was £0.7m, with 46% growth between the first and second quarter. It did not anticipate this rate of growth every quarter, but said that it reflected a growing pipeline of business that fully justified the decision to move into this more specialist activity.

The acquisition of Watbio turns the geography of the Group upside down. From two-thirds of revenues coming from North America in 2018, we expect this to flip over in 2019. Of course, because North America is a franchise business, the revenues reflect only Filta's share, and not the scale of the underlying business, which was estimated to be $36m (£28m) in 2017.

Another product of the franchise model is that the costs within Filta are low, as is the employee count. Prior to the Watbio deal, the total number of employees in Filta was fewer than 70. After Watbio, that more than doubles to 150.

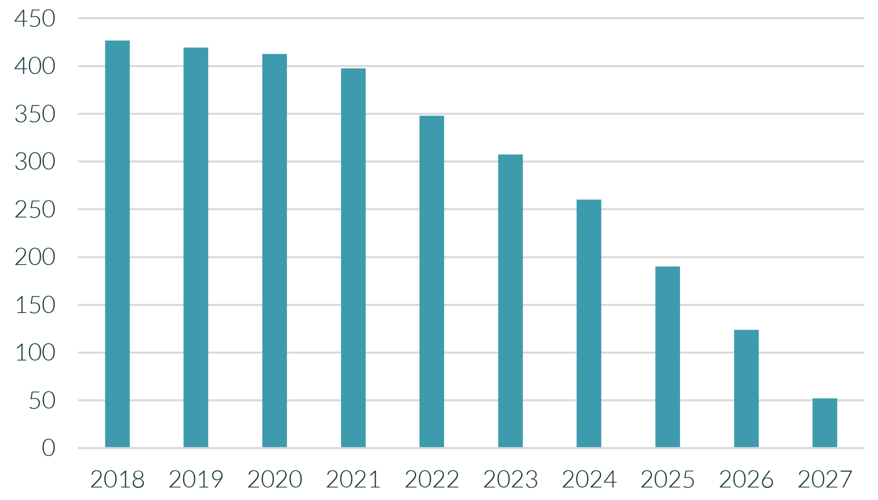
Franchise revenue

Franchise revenue is added to deferred revenue

Revenue from the sale of franchises and territories is added to deferred revenue and released to the income statement over the life of the franchise – typically 10 years in North America and five years in Europe. The sale of the initial MFU, and other equipment and training costs, are booked straightaway.

The balance of deferred revenue as at the end of 2017 was £2.9m, and will be released according to the schedule in the chart below.

Deferred income (£000) recognition as at December 2017



Source: Filta Group

As the number of new franchises falls (at least as a percentage of the number in operation but possibly also in absolute numbers, as Filta focuses on building out the businesses within already allocated territories), the difference between what is released from the deferred revenue account and what is added to it will shrink and, at some stage in the future, probably reverse.

Revenue from MFU royalties and filter sales are booked as soon as they are invoiced.

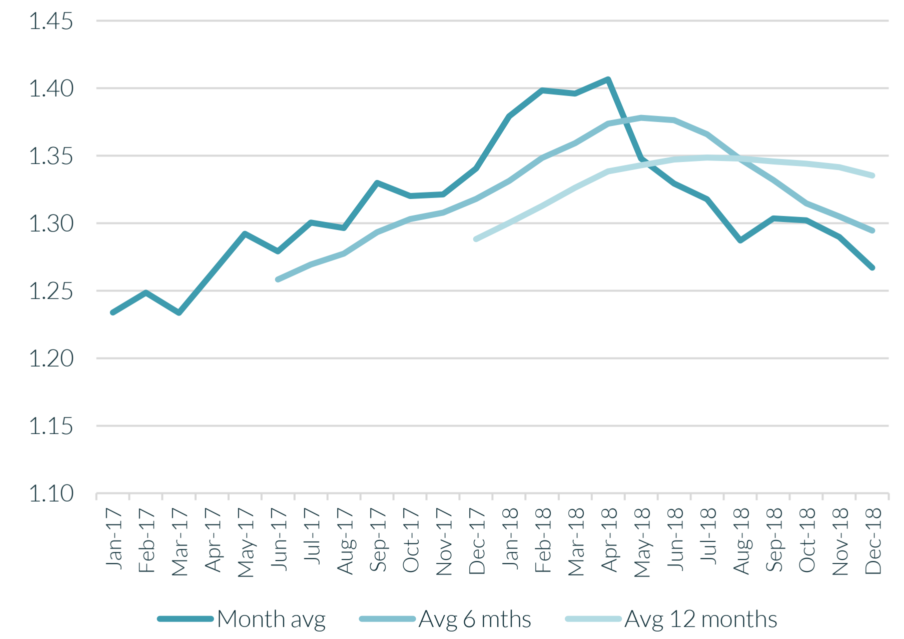
By year-end, much of the negative US dollar/sterling exchange rate impact will have been reversed

Currency

A large proportion of Filta's revenues arises in US dollars (and an increasing amount in euros, too, as the European business grows). It does not hedge these revenues, but simply offsets whatever costs it incurs in US dollars against them.

Sterling strengthened against the US dollar steadily from the beginning of 2017 to April 2018. It has retraced much of that gain since. Consequently, the first-half reported profits of Filta in FY18 were impacted, as it translated US dollar profits into sterling. By the year-end, much of this negative impact will have been reversed.

Sterling/USD exchange rates, January 2017 to December 2018



Source: Hardman & Co Research

The company estimates that a 10% move in the US dollar sterling exchange rate currently has an impact of between £150k and £200k on the sterling reported profits.

Forecasts

Our forecasts largely anticipate 'more of the same'. We expect the core FiltaFry business to continue growing at around 10% p.a., and the FiltaSeal business to grow at around a similar level. There is a small positive operational gearing impact as overheads grow at a slower rate.

We have added the Watbio business to the FiltaDrain line. We are anticipating approximately half the £900k synergies being realised in 2019, with the balance in 2020.

Profit & Loss

Income statement, 2015-20E						
Year-end Dec (£000)	**2015**	**2016**	**2017**	**2018E**	**2019E**	**2020E**
Revenue	7,925	8,469	11,547	14,140	26,000	29,000
Cost of sales	-4,208	-4,449	-5,870	-7,070	-14,300	-15,660
Gross profit	3,718	4,019	5,677	7,070	11,700	13,340
Other income	36	25	38			
Distribution costs	-84	-80	-125	-150	-300	-400
Admin. expenses	-3,220	-2,953	-3,532	-4,920	-7,450	-8,440
Operating profit	450	1,011	2,059	2,000	3,950	4,500
EBITDA	*594*	*1,193*	*2,116*	*2,700*	*4,800*	*5,300*
Finance expenses	-74	-80	-91	-100	-250	-250
PBT	376	932	1,968	1,900	3,700	4,250
Exceptional costs		-1,261	-360	-200	-150	-200
Tax	-74	-101	-590	-408	-850	-1,001
PAT	302	-430	1,017	1,292	2,700	3,050
Discontinued ops.		87	33			
Net profit	302	-343	1,050	1,292	2,700	3,050
Exchange differences	-45	-186	-94			
Comprehensive income	257	-528	956	1,292	2,700	3,050
Avg. no. of shares (m)	21.8	22.7	27.3	27.5	29.2	29.2
EPS (p)	1.4	-1.5	3.9	4.5	9.3	10.5
Statutory EPS (fully-dil., p)	1.4	-1.5	3.9	4.7	9.2	10.4
Underlying EPS (fully-dil., adj., p)	1.4	3.7	5.1	5.4	9.8	11.1
DPS (p)			1.3	2.1	3.3	3.8
GP margin	47%	47%	49%	*50%*	*45%*	*46%*
Admin. as % of revenue	41%	35%	31%	*35%*	*27%*	*27%*
EBIT margin	6%	12%	18%	*14%*	*15%*	*16%*
Tax rate	20%	11%	30%	*21%*	*23%*	*24%*
Growth YoY						
Revenue	20%	7%	36%	22%	84%	12%
Operating profit	45%	125%	104%	-3%	98%	14%
PBT	64%	148%	111%	-3%	95%	15%
EPS	63%	164%	38%	7%	80%	14%

Source: Hardman & Co Research

We have stripped out the exceptional costs incurred in acquisitions and the IPO. We have also adjusted for the tax in 2017. When the US tax rate was cut, it caused a substantial reduction in the value of deferred tax assets, and so pushed up the tax charge significantly. We have used an estimated normalised tax rate of 30% for the year, and put the balance in exceptional costs.

Balance sheet

Balance sheet, 2015-20E						
@ 31 Dec (£000)	2015	2016	2017	2018E	2019E	2020E
Non-current assets						
Property, P&E	1,121	1,191	1,216	1,316	1,216	1,116
Intangible assets	90	167	485	6,985	6,385	5,785
Goodwill			631	1,231	1,431	1,431
Amounts due from related parties	170					
Deposits	2	3	2	2	2	2
Trade receivables	215	379	302	370	680	759
Deferred tax assets	520	756	652	852	1,002	1,202
Total non-current assets	2,117	2,495	3,289	10,757	10,717	10,296
Current assets						
Trade receivables	1,591	1,961	2,506	5,069	7,020	7,830
Inventories	299	288	438	1,036	1,905	2,125
Cash	979	4,392	4,031	6,712	5,773	7,030
Total current assets	2,870	6,641	6,975	12,817	14,698	16,985
Assets held for sale		88	74			
Total assets	4,987	9,224	10,339	23,574	25,415	27,281
Current liabilities						
Trade payables	-1,726	-1,990	-2,143	-2,624	-4,825	-5,382
Borrowings	-597	-104	-108	-4,108	-3,208	-2,308
Due to director/deferred consideration	-1,522			-1,700		
Deferred income	-194	-401	-533	-533	-533	-533
Total current liabilities	-4,039	-2,495	-2,783	-8,965	-8,566	-8,222
Non-current liabilities						
Borrowings	-1,001	-1,018	-932	-932	-932	-932
Deferred income	-1,555	-2,310	-2,405	-3,205	-3,405	-3,405
Deferred tax			-95	-95	-95	-95
Total non-current liabilities	-2,556	-3,328	-3,432	-4,232	-4,432	-4,432
Liabilities held for sale		-33	-66			
Total liabilities	-6,595	-5,856	-6,281	-13,196	-12,997	-12,654
Net liabilities	-1,609	3,368	4,057	10,378	12,418	14,627
Equity						
Share capital	380	2,695	2,713	2,723	2,723	2,723
Share premium		3,480	131	3,846	3,996	4,196
Accumulated losses/profits	-1,914	-2,257	1,863	2,759	4,649	6,658
Other reserves	-75	-551	-650	1,050	1,050	1,050
Total equity	-1,609	3,368	4,057	10,378	12,418	14,627

Source: Hardman & Co Research

Cashflow

Cashflow, 2015-20E						
Year-end Dec (£000)	2015	2016	2017	2018E	2019E	2020E
Operating activities						
PBT	376	-218	1,641	1,700	3,550	4,050
Finance costs	74	80	91	100	250	250
Depreciation	90	119	110	200	300	300
Amortisation	54	63	100	200	700	700
Other	9	49	97	-200	-150	-200
Working capital changes	17	-53	-197	252	-930	-552
Cash from operations	620	40	1,842	2,252	3,720	4,548
Tax paid	-54		-510	-200	-850	-1,001
Net cash from operations	566	40	1,332	2,052	2,870	3,548
Investing activities						
Purchase of P,P&E	-180	-43	-113	-100	-200	-200
Purchase of intangibles	-60	-154	-55	-100	-100	-100
Sales of assets	64		25			
Acquisitions			-1,138	-6,400	-1,700	
Net investing cash	-176	-197	-1,281	-6,600	-2,000	-300
Financing activities						
Issue of shares		3,999	149	3,725	150	200
Net borrowings	291	-146	-47	4,000	-900	-900
Interest paid	-70	-105	-91	-100	-250	-250
Dividends paid			-226	-396	-810	-1,041
Net financing cash	221	3,748	-215	7,229	-1,810	-1,991
Net change in cash	611	3,591	-165	2,681	-940	1,257
Cash at beginning of year	452	979	4,392	4,031	6,712	5,773
FX	-84	-178	-196			
Cash at end of year	979	4,392	4,031	6,712	5,773	7,030

Source: Hardman & Co Research

Valuation

With no comparable businesses, we have fallen back on using a DCF valuation

Filta presents a problem when considering valuation. It is *sui generis*. There are no other sensibly comparable companies that we are aware of, and trying to compare it with just another franchise business makes no sense, as they all tend to work in competitive areas (such as Domino's Pizza), rather than having the field to themselves, like Filta.

Therefore, we fall back on a discounted cashflow (DCF) calculation. The problems with the DCF method are well documented – most notably the huge sensitivity to both assumed growth rates and the discount rate used. What perhaps works better is to use the DCF to estimate the underlying growth assumptions (and discount rates) that are contained within the current price.

We tend to use a central assumption of 10% cost of equity, and value the equity in the business, adjusting for net cash. We also use a nominal 4% growth rate for the perpetuity calculation – equivalent to a long-run estimate of nominal GDP growth. For Filta Group, we have assumed growth in cashflows between 2021 (our last forecast year) and 2025 of 10% for our central case.

DCF valuation

£m	2018	2019	2020	2021	2022	2023	2024	2025
Revenue	14.1	26.0	29.0	31.9	35.1	38.6	42.5	46.7
EBITDA	2.7	4.8	5.3	5.8	6.4	7.1	7.8	8.5
Working capital	0.3	-0.9	-0.6	-0.6	-0.7	-0.7	-0.8	-0.9
Capex	-0.2	-0.3	-0.3	-0.3	-0.4	-0.4	-0.4	-0.5
Tax	-0.2	-0.9	-1.0	-1.1	-1.2	-1.3	-1.5	-1.6
Net cashflow	2.6	2.7	3.4	3.8	4.2	4.6	5.0	5.6
Discount factor		1.0	1.1	1.2	1.4	1.5	1.6	1.8
Discounted cashflow		2.7	3.1	3.1	3.1	3.1	3.1	3.1

Source: Hardman & Co Research

Note: it is a straight function of assuming 10% growth and a 10% discount rate that the present value of the cashflows from years 2020 through to 2025 remains constant.

DCF summation

Value components	£m
2019-20	6
2021-25	15
2026 onwards	53
Total	74
plus net cash end-2018	2
Equity value	76
Equity value per share (p)	262

Source: Hardman & Co Research

Our central estimate thus comes out at an equity value of £76m, or 262p per share.

Our forecast range of values based on the DCF methodology gives a value of 172p to 424p per share, with the central value, using a 10% mid-term growth rate and a 10% discount rate, of 262p.

DCF sensitivity table

Mid-term growth rate	6%	8%	10%	12%
Discount rate	(p)	(p)	(p)	(p)
8%	334	362	392	424
10%	226	243	262	282
12%	172	184	197	212

Source: Hardman & Co Research

At the current price, and still using a 10% discount rate, the implied mid-term growth rate falls to around 7%.

The methodology necessarily ignores value derived from future accretive acquisitions.

Risks

- In addition to the normal commercial risks any business will encounter, perhaps the biggest risk facing Filta is reputational risk from a franchisee behaving badly or suffering a bad injury. By its nature, a franchise system is in the hands of its franchisees. Filta does everything it can to counter this risk by means of thorough training.

- In the core FiltaFry business, we do not see competition as an issue. With 2% or less of the addressable market, any new competitor is likely to prove beneficial, as it will represent another voice advocating the contracting-out of fryer management.

- Although there is something of an obesity crisis in both the USA and Europe, we consider it unlikely that the popularity of fried foods will deteriorate enough to have an impact on Filta's business.

- A marked fall in the price of cooking oil might make the marginal customer decide to change oil more often, rather than clean it, and this could have a knock-on effect on the price Filta achieves for its waste oil recycling. We see this risk as small.

- There is always a risk in making acquisitions, and Filta's recent deal to buy Watbio inevitably brings some uncertainties. It is not an enormous business, and any problems are likely to surface quickly and should be readily containable. Future deals will carry similar risks, but if Filta continues to follow an infill strategy, then it is likely, in our view, that such risks will also be containable.

Company matters

Registration

Incorporated in the UK with company registration number 10095071

Registered Office

The Locks
Hillmorton,
Rugby
Warwickshire CV21 4PP

Board of Directors

Board of Directors			
Position	Name	Remuneration	Audit
Chairman	Tim Worlledge	C	M
Chief Executive Officer	Jason Sayers		
Chief Financial Officer	Brian Hogan		
Executive Director	Victor Clewes		
Executive Director	Jlubomir Urosevic		
Non-executive Director	Lloyd Martin		
Non-executive Director	Roy Sayers	M	M
Non-executive Director	Graham Woolfman	M	C

M = member, C = chair
Source: Company reports

Tim Worlledge – Non-executive Chairman

Tim is a Director of Evolution Securities China, and has 30 years' experience in financial services. Tim is a former Director of the Quoted Companies Alliance, and Head of Corporate Finance at Evolution Group and Williams de Broe.

Jason Sayers – Chief Executive Officer

Jason founded Filta in the UK in 1996, and has been the driving force for the business. Jason moved to Florida in 2003 to successfully grow the US business. Jason has a degree in European Business System and Major Systems Analysis.

Brian Hogan – Chief Financial Officer

Brian is a senior financial executive with 30 years' experience, including roles as the Corporate Controller at Andersen Distribution and Vice President of Finance Amkor Technologies (based in Asia). Since 1995, Brian has held various North American Vice President and Chief Financial Officer roles, most recently as Chief Financial Officer at Canada-based private equity firm Cobalt Capital Inc. Brian has a degree in Accounting, an MBA, and is a Certified Public Accountant (inactive).

Victor Clewes – Executive Director

Victor is a former land and property buyer for CCHA Housing Association. He founded Emerson Richards estate agency and financial services in 1987 and, consequently, in 2000, the first high street mortgage broking chain, The Mortgage Advice Shops, which were franchised throughout the UK. Victor joined Filta at inception as Managing Director in 1996 to develop the franchise business model, and he has steered the US operation to date as Chairman.

Jlubomir Urosevic – Executive Director

Jlubomir joined FiltaFry Ltd in 1999 as Commercial Director, becoming Managing Director of the UK operations in 2000, and he currently serves in the role of Corporate Development Director for the UK. Jlubomir has overseen the FiltaFry UK franchise network, developed the internal franchise network, and has introduced FiltaSeal and FiltaGMG services to the business. Jlubomir was formerly a Midlands Area Manager and Regional Developer Wales & South West for TNT, co-developing the successful TNT overnight business.

Graham Woolfman – Non-Executive Director

Graham is a Fellow of the Institute of Chartered Accountants in England & Wales, and was previously a partner and Head of Corporate Finance at Levy Gee. Graham has over 25 years' experience advising growth businesses, and was a founder Director of Gateway VCT plc. Graham is currently Managing Director of Intrust Corporate Finance Limited.

Roy Sayers– Non-Executive Director

Roy was appointed Non-Executive Director of Filta Group UK in 2000, serving the company from that date. Roy has a background in civil engineering and property development, founding, operating and running his own companies in both sectors for many years.

Lloyd Martin – Non-executive Director

Lloyd was appointed Non-Executive Director of Filta Group UK in February 2019. Lloyd has more than 35 years' experience of the water industry, in the UK and internationally. He recently retired as Chief Executive of British Water, the leading association supporting the UK water industry, having joined the organisation as a Non-Executive Director in 2014, and he became Chief Executive in 2016.

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