Corporate

Current price	125.5p
Sector	General Retailers
Code	FRAN.L
AIM	AIM

Share Performance

	1m	3m	12m
FRAN.L	-13%	12%	81%

Source: Thomson Reuters, Allenby Capital

Share Data		
Market Cap (£m)		99.8
Shares in issue (m)		79.5
52 weeks	High	Low
	151.5p	68.5p
Financial year end		December

Source: Company Data, Allenby Capital

Key Shareholders	
Nigel Wray (NED)	27.38%
Stephen Hemsley (Chair)	25.87%
David Poutney (NED)	4.34%
NetCap Limited	4.25%
Cannacord Genuity	4.22%

Source: Company Data, Allenby Capital

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Franchise Brands plc (FRAN.L)

Business model continues to deliver strong growth

Franchise Brands' results for FY2019 confirm, once again, the strength of its operating model and the robustness of its centralised support systems that have enabled sales within Metro Rod to flourish and which are now supported by the complementary acquisition of Willow Pumps in October 2019. We expect earnings growth to continue and while we are leaving FY2020 forecasts unchanged this still implies significant year-on-year EBITDA and EPS growth of c.44% and c.39% respectively, while forecasts for FY2021 call for the delivery of c.20% growth in EBITDA and EPS from a revenue growth of c.14%, illustrating the operational leverage within the business.

- **Group revenues increased by 24% to £44m** with fees and direct labour income increasing by 35% to £24.4m while the gross margin improved from 37% to 37.2%. Adjusted EBITDA was £5.2m (2018: £4.0m) and adjusted basic EPS was 4.34p (2018: 3.36p). Adjusted net debt increased to £9.2m against £5.0m a year earlier and includes the £4m initial cash consideration for Willow Pumps.

- **Metro Rod had another outstanding year** with system sales growth of 14% (2018: 8%) and a strong performance by the network where 45% (34%) of franchisees achieved annual sales of over £1m and more than 30% delivered sales growth of over 20%.

- **Willow Pumps exceeded management's expectations** over the three-month period of consolidation and has integrated well into the Group culture. Although a direct labour organisation rather than a franchise model, the business is already interacting well with Metro Rod's franchisees, adding valuable new services to the latter's commercial customer base.

- **The B2C brands demonstrated an improved level of franchisee recruitment**, which is the prime driver of revenue growth for this division. Total franchisees increased by 65 (2018: 57) to 404 and the division continues to generate strong cash flow for the Group.

- **Forecast for FY2020 have been left unchanged**, indicating c.44% yoy EBITDA and 39% EPS growth while FY2021 forecasts are projecting growth of c.20%. We increase our fair value from 145p to 165p, a price which in our view better reflects the Group's growth profile and earnings potential. With strong cash flow and a forward PER of 17.3x 2021 forecast earnings we consider the current share price offers an exceptional opportunity to exploit the stock market's temporary weakness.

Year End: December

£m	2018A	2019A	2020E	2021E
REVENUE	35.5	44.0	58.1	66.1
ADJUSTED EBITDA	4.0	5.2	7.5	8.9
ADJUSTED PBT	3.2	4.1	5.8	7.1
ADJUSTED EPS (p)	3.4	4.3	6.0	7.3
DIVIDEND (p)	0.67	0.95	1.21	1.61
ADJ NET (DEBT)/CASH	-5.0	-9.2	-6.5	-2.4
PER (x)	37.3	28.9	20.9	17.3

Source: Franchise Brands plc, Allenby Capital

Full year highlights

Focus is more on fee income than revenue

As a predominantly franchise business, our headline focus is on fee income rather than revenue, as the latter reflects the level of system sales relating to the individual franchise brands as well as revenue from the direct labour organisations (DLO). Fee income (excluding payments to franchisees) and DLO income are analysed as follows.

FEE AND DIRECT LABOUR INCOME ANALYSIS

	2018	2019	*change*
	£m	£m	
MSF income	10.11	11.21	*10.9%*
Area sales	1.51	2.01	*32.6%*
Product sales	0.89	0.91	*2.0%*
Direct labour	4.56	9.10	*99.3%*
NAF	1.06	1.18	*11.0%*
Fee income	**18.14**	**24.40**	***34.5%***

Source: Franchise Brands; Allenby

Success in incentivising franchisees to grow sales and hence benefit the Group through higher MSF resulted in growth of 11%

Income derived from the Management Service Fee (MSF) is generated from fixed monthly fees charged to the franchisees or from income based on a percentage of their sales. As growth in the MSF is the Board's primary focus, over the recent past it has sought to incentivise franchisees to build their sales through a series of MSF discounts and schemes designed to encourage system sales growth which in turn will translate into higher MSF. This was successful in 2019 with MSF increasing by 11% to £11.2m and the fee income margin rising from 51.1% to 55.4% (see below).

Strong franchisee recruitment with 65 new franchisees in the year

Areas sales (fees generated by the sale or resale of franchise territories) improved by 32.6%. This growth reflected a good year for B2C franchisee recruitment with 65 new franchisees recruited and also the launch of the franchise resale activity at Metro Rod and Metro Plumb. The sale and resale of territories helps invigorate and refresh the franchisee base ensuring that all franchisees are motivated to actively grow their sales.

DLO income doubled due to the inclusion of Willow

Income derived from the Group's DLO businesses almost doubled to £9.10m reflecting the inclusion of Willow Pumps which was consolidated for the last three months of the financial year.

SUMMARY P&L

	2018	2019	*change*
	£m	£m	
Statutory revenue	35.47	44.01	*24.1%*
Franchisee payments	-17.33	-19.61	*13.2%*
Fee income	18.14	24.40	*34.5%*
margin	*51.1%*	*55.4%*	*8.4%*
Gross profit	13.13	16.38	*24.8%*
Gross margin	37.0%	37.2%	*0.5%*
Adjusted EBITDA	4.00	5.18	*29.5%*
margin	*11.3%*	*11.8%*	*4.4%*
Adjusted PBT	3.22	4.07	*26.5%*
Adjusted EPS (p)	3.36	4.34	*29.2%*
Adjusted net debt	4.97	9.18	*84.7%*

Source: Franchise Brands; Allenby

Adjusted EBITDA grew by almost 30%...

Adjusted EBITDA (stated before share-based payments) grew by almost 30% yoy. Management has further analysed EBITDA into two divisions: B2B and B2C, the former being further broken down into Franchisor (Metro Rod and Metro Plumb) and DLO activities (Willow).

ADJUSTED EBITDA			
£m	2018	2019	*change*
B2B - Franchisor	2.68	3.18	*18.7%*
B2B - DLO	0.00	0.49	
B2C	2.37	2.53	*7.0%*
Group overheads	-1.05	-1.03	*-1.9%*
Adjusted EBITDA	**4.00**	**5.18**	***29.4%***

Source: Franchise Brands; Allenby

...driven by strong Franchisor B2B

B2B – Franchisor adjusted EBITDA rose by 18.7% to £3.2m as a result of growth in the system sales of Metro Rod and Metro Plumb and the related improvement in MSF, while the DLO business of Willow contributed just under £0.5m to adjusted EBITDA in the three months of consolidation. As noted earlier, increased franchisee recruitment was a feature during the year and resulted in a 7% improvement over FY2018. Group overheads were well contained, falling by 2% yoy and illustrating the Group's continued focus on cost containment.

Adjusted PBT grew by 27% to £4.1m and EPS by 29% to 4.34p

Depreciation and amortisation costs rose from £0.7m to £1.0m as a result of investment in the Group's DLO businesses and continuing software development at Metro Rod. Adjusted profit before tax increased by 26.5% to £4.1m and adjusted basic EPS (before amortisation of acquired intangibles, share based charges and acquisition-related costs) rose by 29%, from 3.36p to 4.34p reflecting the growth in earnings and share buy-backs during the year. A final dividend was declared of 0.65p giving a total dividend for the year of 0.95p covered 4.6x by adjusted profit after tax.

Strong cash conversion

Cash conversion as a percentage of adjusted EBITDA rose to 90% (2018: 79%) following an operating cash inflow of £4.7m vs £3.2m stated after a £0.5m working capital outflow (2018: outflow of £0.8m). Expenditure on capital and intangible investment rose significantly relative to the previous year at £1.8m (2018: £0.6m) and related to the fit-out of the new Car Care Centre at Kidderminster (£0.1m), new equipment for the DLO business (£1.0m) and the capitalised element of IT investment (£0.7m).

Adjusted year end net debt rose to £9.2m from £5.0m

Year-end adjusted net debt rose from £5.0m to £9.2m as a result of the initial cash payment of £4m to the vendors of Willow Pumps, a new bank loan of £4m and repayment of existing loans of £2.5m. The Board makes the point that due to the introduction of IFRS16 the Group has recognised obligations in relation to operating leases. However, it notes that as its banking arrangements determine its interest rate margin and covenant compliance using net debt before operating lease obligations, it uses adjusted net debt as its KPI, as shown in the table below.

ANALYSIS OF NET DEBT			
£m	2018	2019	*change*
Cash	2.94	1.68	*-42.8%*
Term loan	-5.44	-6.40	*17.8%*
RCF	-2.51	-3.00	*19.4%*
Loan fee	0.11	0.13	*17.3%*
Hire purchase debt	-0.07	-1.59	*2105.6%*
Adjusted net debt	**-4.97**	**-9.18**	***84.7%***
Other lease debt	-0.94	-1.89	*101.8%*
Net debt	**-5.91**	**-11.07**	***87.4%***

Source: Franchise Brands; Allenby

Capital gearing was 33% with net debt/EBITDA of 1.8x

Capital gearing stood at 33% (2018: 20%) with the ratio of net debt to adjusted EBITDA being 1.77x. On a pro forma basis, with Willow in for a full 12 months, the ratio would have been 1.41x. As a policy the Group would not gear beyond net debt/pro forma adjusted EBITDA of more than 3.0x.

Operational Review

Metro Rod

Metro Rod was founded in 1983 and is a leading provider of commercial drain clearance and maintenance services delivered on a largely reactive basis. These services are provided by 42 franchisees with geographical coverage across the whole of the UK. The business was acquired by Franchise Brands in April 2017.

Clear signs that franchisees are becoming more entrepreneurial with CAGR in system sales of 12% over past three years

It was encouraging to note the continued growth within the Metro Rod franchise. Clearly, the Board's initiative to drive system sales and thereby MSF under the overarching Vision 2023 strategy is working well with individual franchisees taking more direct responsibility for their own business development and consequently relying less on the Support Centre to initiate sales and generate leads.

Investment in IT and back office systems has resulted in increased efficiency and cost reductions

This would not have been possible without significant investment in IT, back office systems and support functions but has resulted in a system sales CAGR of 12% over the nearly three years since acquisition. Investment in IT systems is leading to the automation of previously repetitive labour-intensive processes while digitally enabling the business will also lead to improved customer experience and reduced costs.

In addition, a new quotation system now allows franchisees to submit quotations to customers using pre-populated templates in line with customer requirements which also has enabled the business to substantially reduce headcount and reduce the time to provide a quote by nearly 70% from 12 to 4 days.

Investment by the franchisees in their own businesses has also been a feature with a total of 20 additional sales and marketing executives, 55 additional engineers and 44 additional vehicles being deployed during the year.

New apprenticeship scheme to nurture home grown talent

We also note the proactive approach taken by management to stimulate home-grown talent and future capacity through a new ITOL (Institute & Occupational Learning)-accredited apprenticeship scheme which has resulted in an initial intake of eight apprentices.

Since 2019 the Group had operated two Metro Rod territories as DLOs but following the acquisition of Willow Pumps, responsibility for the Kent & Sussex territory was transferred to the Willow field service team, both to improve the local management of the business and give Willow Pumps direct hands-on experience of a Metro Rod territory.

New WMS to be rolled out during 2020

FY2020 will see the full roll-out of the new works management system (WMS). It is envisaged that the roll-out will have been completed by the end of the year, providing much needed improvements in efficiency and productivity, that will begin to benefit the businesses in the second half of the year.

Under Vision 2023 it was recognised that not all franchisees would wish to or would be capable of making the transition to a more entrepreneurial culture and consequently there have been four businesses that have changed hands during 2019. The Group has also recruited franchisees for two vacant territories in Cumbria and Northern Ireland which were previously serviced through the use of sub-contractors.

Metro Plumb and Kemac

Initiative to grow the Metro Plumb franchise network

To date the majority of management's focus and time has been spent on the development of the Metro Rod business but there remains a significant opportunity to build the Metro Plumb franchise which, although showing growth in FY2019, is still reliant on one principal customer resulting in volatile sales volume and a lack of pricing flexibility.

Currently, the franchised territories have been operated by Metro Rod franchisees or as DLOs under the Kemac banner. Management will now begin franchising Metro Plumb separately from Metro Rod and offering any Metro Rod franchisee the opportunity to exit the Metro Plumb business and to sell it to new franchisees. This should result in a new cadre of entrepreneurial franchisees who are dedicated to building their business and with the aid of the Group's Central Support functions can devote all of their time to making their business a success.

Willow Pumps

Willow consolidated for three months

Willow Pumps, a leading pump supply, installation and servicing business with an above and below-ground capability was acquired in October 2019 and has thus been consolidated into Group results for three months of the year to December 2019. This business has exceeded management expectations in its first three months of ownership.

Operating as a DLO rather than a franchise business, Willow offers the Metro Rod franchisees an opportunity to enlarge the scope of the services offered to their commercial customers by including the capability to add pump supply and servicing to their existing draining expertise.

Clear rapport being developed between Willow and Metro Rod engineers

We were very impressed when attending one of the "Discovery Days" set up last year to introduce Metro Rod and Metro Plumb franchisees to the opportunities presented by Willow and it was clear that a rapport between the two parties developed very quickly with both sides keen to learn more of the others' capabilities and cross selling opportunities.

Strong management team

The management and operational teams were equally impressive and are clearly capable of growing the Willow Pumps service offering to a much wider customer base and this will be supported by the Metro Rod franchisees as the two businesses exploit cross-selling opportunities.

20% of Metro Rod engineers already trained in pump maintenance

We note that around 20% of Metro Rod engineers have since been trained in the basic skills required to work safely on pump maintenance and would guess that many more will take advantage of this opportunity in the current year. Obviously, FY2020 Group results will benefit from a full 12-month contribution from Willow against just three months in FY2019.

B2C Division

B2C brands consolidated into one division

To facilitate future acquisitions and improve operational efficiency, the B2C brands of ChipsAway, Ovenclean and Barking Mad have been formed into an integrated division of the Group.

Strong franchisee recruitment resulted in net franchisee growth of 17 across the B2C division (2018: reduction of net 10) resulting in growth of the combined network to 404 franchisees with ChipsAway remaining the largest brand with 205 franchisees representing some 74% of divisional gross profit (before divisional overheads).

As noted above, the division is now set up to be able to facilitate the addition of complimentary new B2C brands through acquisition where a meaningful element of the overhead can be absorbed by the Group's central support function.

Forecasts and conclusion

FY2020 forecasts unchanged

Following on from a highly successful FY2019 we are maintaining our EBITDA and EPS forecasts for FY2020 which would result in anticipated adjusted EBITDA growth of 44% and adjusted EPS growth of 39%.

Projections for FY2021 see EBITDA and EPS growth of c.20%

Our projections for FY2021 see adjusted EBITDA and EPS growth of around 20% against a revenue and gross profit increase of around 14%, once again illustrating the Group's operational leverage. We also anticipate adjusted net debt falling from £9.2m at the end of 2019 to £6.5m and £2.4m by the end of FY2021.

But does not include acquisitions…

This assumes that the Group does not conclude any acquisitions. However, given the Board's ambitions and its stated buy & build strategy this is highly unlikely and we believe it is odds-on that further acquisitions will be consummated during the forecast period.

…which could be bolt-ons in the B2B and B2C arenas

These could be either complementary bolt-ons in the same space as Metro Rod/Metro Plumb/Willow, thus helping facilitate the Board's ambitions for a full Water in/Waste out service.

In addition, smaller B2C franchise businesses may be contemplated or even new unrelated but substantial franchise systems although here the opportunities are less obvious given the prominent role that private equity has historically played in this space.

FY2020 has started well

For FY2020 management reveals that the year has started well with job intake at Metro Rod, Metro Plumb and Willow Pumps ahead of the same period last year and a strong start to the year for franchisee recruitment in the B2C division.

Further growth to come

Franchise Brands goes from strength to strength delivering strong organic growth and the ability to find earnings enhancing acquisitions to supplement this home-grown momentum. To expect more of the same is, in our view, entirely realistic and should be substantially beneficial to shareholders in the years to come. Consequently, we have raised fair value from 145p to 165p to reflect our new projections for FY2021 and recognise the strong growth in earnings and cash generation already achieved.

Income Statement & Forecasts

	£m	£m	£m	£m
Y/E December	**2018A**	**2019A**	**2020E**	**2021E**
ADJUSTED				
Revenue	35.5	44.0	58.1	66.1
Franchisee payments	-17.3	-19.6	-27.2	-31.3
Fee income	18.1	24.4	30.9	34.8
Fee income margin	*51.1%*	*55.4%*	*53.1%*	*52.7%*
Other cost of sales	-5.0	-8.0	-8.2	-9.9
Gross profit	**13.1**	**16.4**	**22.6**	**24.9**
Gross profit margin as a % of fee income	*37.0%*	*37.2%*	*39.0%*	*37.7%*
Administrative expense before D, A, SBC, E	-9.1	-11.2	-15.2	-16.0
as a % of revenue	*-25.7%*	*-25.4%*	*-26.1%*	*-24.2%*
Adjusted EBITDA	**4.0**	**5.2**	**7.5**	**8.9**
margin as a % of fee income	*22.1%*	*21.2%*	*24.2%*	*25.6%*
Depreciation	-0.4	-0.6	-1.1	-1.4
Amortisation of software	-0.0	-0.1	-0.0	-0.0
Underlying operating profit	3.6	4.4	6.3	7.5
Operating margin	19.6%	18.1%	20.6%	21.4%
Finance expense	-0.3	-0.4	-0.5	-0.4
Adjusted profit before tax	**3.2**	**4.1**	**5.8**	**7.1**
Tax	-0.6	-0.7	-1.0	-1.2
Tax rate	*18.8%*	*16.9%*	*16.6%*	*17.0%*
Adjusted post tax profit	**2.6**	**3.4**	**4.9**	**5.9**
STATUTORY				
Adjusted operating profit	3.6	4.4	6.3	7.5
Share based charges	-0.1	-0.2	-0.3	-0.3
Acquisition of acquired intangibles	-0.2	-0.3	-0.4	-0.4
Cost of acquisition	0.0	-0.3	0.0	0.0
Exceptional items				
Statutory operating profit	3.2	3.6	5.6	6.7
Operating margin	*17.6%*	*14.9%*	*18.1%*	*19.3%*
Finance expense	-0.3	-0.4	-0.5	-0.4
Statutory profit before tax	**2.9**	**3.3**	**5.1**	**6.3**
Tax	-0.5	-0.6	-0.8	-1.1
Tax rate	*18.7%*	*17.3%*	*16.5%*	*16.9%*
Statutory post tax profit	**2.3**	**2.7**	**4.2**	**5.2**
Shares				
Basic, weighted average (m)	77.687	77.948	79.279	79.279
Diluted, weighted average (m)	78.787	79.139	82.779	82.779
Shares in issue at year end (m)	77.532	79.314	79.314	79.314
EPS				
Basic adjusted (p)	**3.36**	**4.34**	**6.01**	**7.27**
Basic statutory (p)	2.99	3.48	5.20	6.49
Dividend				
Interim (p)	0.21	0.30	0.40	0.50
Final (p)	0.46	0.65	0.81	1.11
Total dividend per share (p)	**0.67**	**0.95**	**1.21**	**1.61**

Source: Franchise Brands; Allenby

Balance Sheet & Forecasts

	£m	£m	£m	£m
Y/E December	**2018A**	**2019E**	**2020E**	**2021E**
Assets				
Non-current assets				
Intangible assets	27.2	35.1	34.9	34.8
Property, Plant & Equipment	0.4	1.3	1.0	0.4
Right-of-use assets	0.9	3.5	3.5	3.5
Total non-current assets	**28.5**	**39.8**	**39.4**	**38.7**
Current assets				
Inventories	0.2	0.6	0.6	0.6
Trade and other receivables	11.0	16.9	17.9	17.9
Cash and Cash equivalents	2.9	1.7	0.4	2.5
Total current assets	**14.2**	**19.2**	**18.9**	**21.0**
Total Assets	**42.8**	**59.0**	**58.3**	**59.7**
Liabilities				
Current liabilities				
Trade and other payables	-8.6	-12.7	-13.0	-14.5
Loans and borrowings	-3.4	-4.1	-2.9	-2.0
Obligations under finance leases	-0.3	-0.9	-0.9	-0.9
Current tax liability	-0.2	-0.6	-0.7	-0.7
Total current liabilities	**-12.6**	**-18.3**	**-17.5**	**-18.1**
Non-current liabilities				
Loans and borrowings	-4.4	-5.2	-4.0	-2.5
Obligations under finance leases	-0.7	-2.6	-0.6	-0.6
Provisions	0.0	-3.6	-3.5	-3.5
IFRS16 leases	0.0	0.0	-1.4	-1.4
Deferred tax liability	-0.7	-1.5	-1.5	-1.5
Total non-current liabilities	**-5.8**	**-12.9**	**-11.0**	**-9.5**
Total liabilities	**-18.3**	**-31.2**	**-28.5**	**-27.6**
Net current assets	**1.7**	**0.9**	**1.4**	**3.0**
Net Assets	**24.4**	**27.9**	**29.8**	**32.1**

Source: Franchise Brands; Allenby

Cash flow & Forecasts

	£m	£m	£m	£m
Y/E December	**2018A**	**2019E**	**2020E**	**2021E**
Operating cash flow:				
Post tax profit after exceptional costs	2.3	2.7	4.2	5.2
Depreciation	0.4	0.6	1.1	1.4
Amortisation	0.0	0.1	0.0	0.0
Amortisation of acquired intangibles	0.2	0.3	0.4	0.4
Acquisition related costs	0.0	0.3	0.0	0.0
Finance expense	0.3	0.4	0.5	0.4
Other	0.0	0.0	0.0	0.0
Income tax expense	0.5	0.6	0.8	1.1
Share Based charges	0.1	0.2	0.3	0.3
Operating cash flow before changes in working cap & provisions	**4.0**	**5.2**	**7.3**	**8.8**
Decrease/(increase) in inventories	*0.0*	*0.0*	*0.0*	*0.0*
Decrease/(increase) in trade receivables	*-3.0*	*-1.5*	*-2.6*	*-1.6*
Increase (decrease) in trade and other payables	*2.1*	*1.0*	*0.3*	*1.5*
Net movement in working capital	***-0.8***	***-0.5***	***-2.2***	***-0.1***
Net cash inflow/(outflow) from operating activities	3.2	4.7	5.1	8.6
Income tax paid	0.0	-0.1	-0.9	-1.1
Net cash (outflow)/inflow from operating activities	**3.2**	**4.5**	**4.2**	**7.5**
Investing Activities:				
Purchase of intangible assets	-0.3	-0.8	-0.3	-0.3
Purchase of property, plant and equipment	-0.2	-0.9	-0.6	-0.5
Acquisition of subsidiary	0.0	-4.0	0.0	0.0
Net cash inflow/(outflow) from investing activities	**-0.6**	**-5.7**	**-0.8**	**-0.8**
Financing Activities:				
New term loan	0.0	4.0	0.0	0.0
Repayment of term loan	-1.6	-2.5	-2.4	-2.4
Other loans made	-0.1	-0.0	0.0	0.0
Interest charges	-0.3	-0.4	-0.5	-0.5
Receipts from share issue net of costs	0.0	0.4	0.0	0.0
Purchase of treasury shares	-0.2	-0.3	-0.3	-0.3
Dividend payments	-0.4	-0.6	-0.8	-1.0
Capital element of finance lease repaid	-0.3	-0.7	-0.7	-0.5
Net cash inflow/(outflow) from financing activities	**-2.9**	**-0.1**	**-4.6**	**-4.6**
Total net increase/(decrease) in cash and cash equivalents	**-0.3**	**-1.3**	**-1.2**	**2.1**
Cash and cash equivalents at start of period	3.2	2.9	1.7	0.4
Cash and cash equivalents at end of period	**2.9**	**1.7**	**0.4**	**2.5**

Source: Franchise Brands; Allenby

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