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Holland Views – Aggreko plc (Price: 1054p, MCap: £2,713m)

Power Reset - still watching, still waiting

Buffett's great aphorism, "*only when the tide goes out do you discover who's been swimming naked*" is so true. Upcycles are, with hindsight, very forgiving to many companies. In this context we take another look at Aggreko, who we have always wanted to favour but valuation never really allowed. It is now certainly feeling the pinch of the down cycle, its share price is down almost 50% and its new CEO has just undertaken a timely 'root and branch' review of the business. It's not that we think Aggreko was 'swimming naked' by any means, but perhaps it was using flippers occasionally!

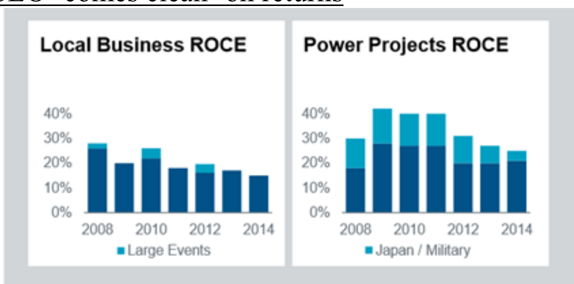
In short, Aggreko is a good but not 'great' business in our eyes, with typically good/acceptable returns (17% ROCE in a tough H1) and some growth prospects. The new CEO, in clearing the decks, has pulled no punches in reminding us that emerging markets were a strong tailwind in the last decade and more importantly that the ending of lucrative Military and Disaster contracts mean that group returns are reverting from excellent levels (say 30%) to still good (20%). The issue that we still struggle to resolve is Aggreko's competitive positioning and therefore true market power. The reason for our ongoing nervousness on this has changed somewhat from the specific threat of APR to wider competition. Importantly, we remain unable to resolve it.

So how cheap is Aggreko? If the group has some Franchise power and if it can make the EBIT margins and ROCE it suggests (both 20%), then assuming these metrics were achievable on 2014 turnover levels the valuation is as follows: PE =12.3x, EV/EBIT = 10x. These are cheaper multiples than the group traded on in the past and, notably, could represent trough multiples without those aforementioned one-off projects. That said, the shares are not so cheap as to ignore the important ifs mentioned above. We are inclined to wait for even more value or preferably a little more clarity on competition and thus franchise quality.

Brutal Honesty from the new CEO

Brutal honesty never goes amiss as far as we are concerned. Aggreko's new CEO Chris Weston (ex-Centrica) seems to agree as per his recent review of the business. We recommend reading the transcript of his inaugural investor update on August 6th. We appreciated Weston's transparent disclosure of the historical impact that Military and Disaster (i.e. Japan) contracts had on the business – as much as 10% ROCE points in the Power business (Fig.1). According to Weston, Aggreko faces a c.£100m profit headwind from the ending of those one-off contracts.

Fig.1: Aggreko's new CEO 'comes clean' on returns



Source: Aggreko August 2015 presentation

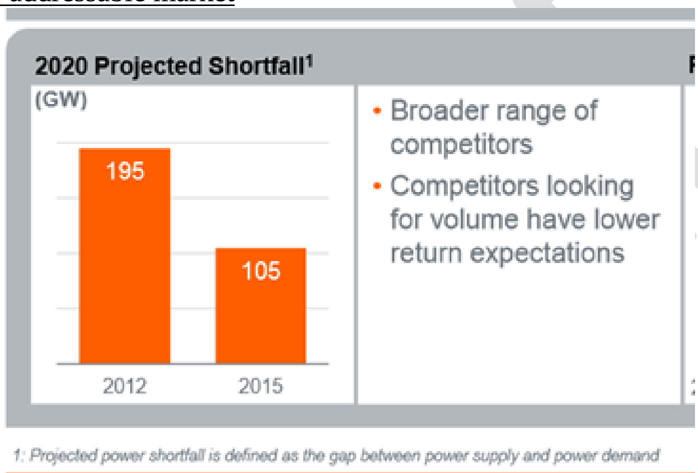
It's not that this 'over-earning' was news to us per se – we have discussed it in the past. It was just good to hear the new CEO be totally open about the true earnings power of the business and disclose the effect such lucrative contracts had on past returns.

Revised growth expectations

The aforementioned contracts are by definition unforecastable – they occur randomly. That said, the core Power Projects business (40% of sales, 60% of profits) is driven by a secular demand driver – the shortfall between the supply and demand of Utility power generation largely across the emerging markets. Notably, Weston has taken a knife to Aggreko's earlier medium-term forecasts set out in 2012 by cutting them in half (Fig.2). The CEO now thinks his addressable market for temporary utility power generation grows by 6% cagr out to 2020 (not the c.13% growth rate previous management suggested).

> *"we can't rely on exceptional events to drive growth. And we must focus on what we are going to do to drive sustainable growth in our base business"*

Fig.2: Revising the addressable market



Source: Aggreko August 2015 presentation

Weston's brutal honesty in his first business review presentation in early August covered many areas of the business but mainly competition and pricing. He also raised the spectre that Rupert Soumes might not have been as good as his seductive rhetoric suggested by highlighting some dubious decisions made under Soumes' tenure. For the record, we think Soumes did a great job at Aggreko and we loved the clarity of his thinking. That said, it remains highly notable when longstanding and successful CEOs do decide unexpectedly to jump ship (ala Leahy et. al.). Leaving aside Soames' legacy, we like and respect the new CEO' honest and open approach to the group's business model and the markets it operates in.

To view the remainder of this in-depth report, please contact Andrew Hollingworth, Andrew@hollandadvisors.co.uk for a complete PDF copy.

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