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## Holland Views – Regus (Price: 170p, MCap: £1,581m)

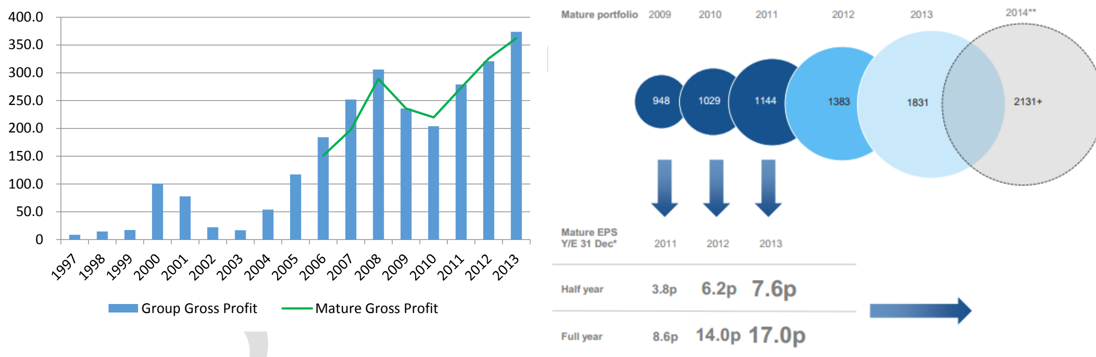
# Jam on its way / Dixon's Second-Coming

If we could point you to a UK business with potential Franchise characteristics, a dominant market position with double-digit growth potential, an 'Outsider-like' founder/CEO, whose shares are for sale on just 7x P/E - would you be interested? Of course you would.

So what is the catch? The catch is that the stock is Regus plc – the world's largest provider of temporary office services – a divisive stock over the course of the 14 years since its (first) floatation. Long-standing readers know that we often highlight businesses even if they don't display *all* Franchise characteristics we normally look for but which do display asymmetric risk/rewards relative to their starting price (e.g. Ryanair in 2012 and GM earlier this year).

In Regus, we see a business that, whilst undoubtedly operationally geared and cyclical, has a dominant market position and high returns on capital in its core business. The 'problem', as Mr Market sees it, is that Regus chooses to heavily reinvest its core cash flows (and earnings) in growth which dilutes stated group earnings and returns. Of course there is a name for the best companies, like Amazon, who astutely reinvest in high-return operations – 'Compounders'! Mr Market is mostly only keen to decide with hindsight whether such reinvestment is a good idea or not. We suggest that should Regus' reinvestment in time prove indeed astute, given today's lowly starting valuation and distrust of it could lead to very significant upside for shareholders.

Fig 1: Regus' profit are entirely from 'Mature' centres – i.e. only half today's asset base!




**Source: Regus, Capital IQ**

The bullish case for Regus is largely encapsulated in Fig.1 above. The left hand side shows that almost all of Regus' profits are derived from mature business centres. Yet, such has been the growth since 2012, mature centres are roughly only half of the estate now. In other words, the headline earnings power of the business (7p) understates not only the mature estate (17p of earnings last year) but also the likely growth (we suggest at least 24p or 7x P/E in 2-3 years is plausible if EPS power as immature centres develop).

If our observations about the Franchise qualities, growth and valuation are even only partly correct, the upside ought to take care of itself. Therefore it is important for us to consider the downside. Leases and cyclicality clearly suggest there is plenty but Regus looks to have significantly reduced its downside risk by making its traditional *fixed* rental costs much more flexible in a downturn. It may also interest readers to note that the board of management has

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recently changed its bonus incentive targets from adjusted EPS (i.e. the 17p that the mature estates produces) to Basic EPS (i.e. the 7p)….Jam might be on its way sooner than many think but we accept this is a stock that comes with risks.

Making the case for Regus

*"You can have cheap stocks or good news, but you can't have both"*

Our in-depth look at Regus in this note centres on five key areas:

1. An overview of the investment case
2. The increasingly asymmetrical risk/reward
3. A structurally changed business model via renegotiated leases
4. Accurate models but inaccurate conclusions (or why analysts are fighting the last war).
5. Need to know: The 'key man' (Mark Dixon).

## An overview of why we are interested in Regus

1. **Reduced downside risk.** The Regus brand dominates the fragmented global temporary office market, a market that founder and CEO Mark Dixon effectively created from scratch in 1989. Despite having a much-improved cost structure and increased scale (capacity is 2.5x higher since 2006), our sense is that after the collapse (and, frankly, near-death) of the business in 2002/03, it remains a much-feared stock due to this extreme cyclicality in the past. Regus does remain operationally geared (the bulk of its costs are commercial property rents after all), but crucially the company has taken great steps in recent years to add flexibility to its cost base in the event of a downturn. Ergo, 84% of all of Regus' lease agreements with landlords are now 'flexible' meaning they are terminable at Regus' option within six months and are structurally independent. This is a key point.
2. **Flexible working: an idea whose time has come.** There are many structural tailwinds in the temporary office space market. Post the recession, start-ups and flexible work arrangements are commonplace; commercial property landlords have much less pricing power and not least, technology now allows a myriad of seamless connectivity services which are scalable globally. On that basis – i.e. that there is a secular growth opportunity here for which Regus seems uniquely positioned (and seems to generate decent returns from) – then it would surely make sense for the company to keep investing – which it is clearly doing.

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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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