Update

22 December 2014

Construction

ISG

337p

Relative strength

- ISG has released an AGM trading update confirming a strongly performing core (London Fit Out and data centres), progress in UK Retail and Asia / Middle East but challenges in UK Construction and, to a lesser extent, Europe. In light of the trading update we are revising our estimates, resulting in a revenue upgrade to both FY15E and FY16E, current year PBT largely unchanged but a 7% upgrade to FY16E PBT. ISG continues to stand out amongst its peers in terms of delivered performance and estimate direction yet continues to trade at a valuation discount. Recent share price outperformance notwithstanding, we would expect this discount to narrow further.

- ### Trading update highlights the strength of the UK Fit Out, Engineering Services and Retail

UK Fit Out (incl. Engineering Services) continues to perform ahead of expectations and we are pencilling in material upgrades to our expectations for this segment. Although UK Fit Out remains the largest contributor to the group bottom line, the other segments performing well (UK Retail, Asia and Middle East) account for 47% of group EBIT pre central costs, demonstrating the strength in depth within the portfolio.

- ### UK Construction getting worse before getting better

The only major negative is UK Construction, which is likely to be loss making in FY15E as historic contracts approach completion. Much has been done to put this business on a firmer footing; the number of regional offices reduced and newer contracts struck on more attractive and sustainable terms. However, the timescale for these actions to feed through to reported numbers is likely to be later than we had originally expected.

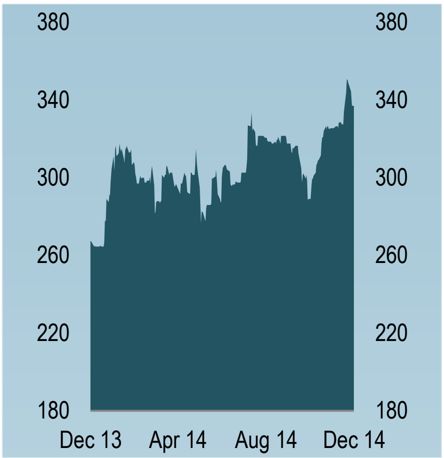
- ### Changes to estimates

We have revisited our estimates and have made a number of revisions at the segmental level. UK Fit Out, UK Retail, Asia and the Middle East are all upgraded, whilst Europe and UK Construction offset to the downside. The net effect is to leave our FY15E PBT/EPS broadly unchanged at £14.7m/28.4p respectively although we have upgraded our revenue estimate by 14% to £1,741m. For FY16E, however, both our revenue and PBT/EPS estimates are upgraded by 14% and 9% respectively.

- ### Valuation and catalysts

ISG has outperformed the Construction peer group and the broader market year to date (+32% vs Construction -7% and the All Share -2%). Despite this, ISG still trades on both a Calendar 2015 PE and EV/EBITDA discount to the Construction peer group (-14% and 47% respectively). Given the consistency and direction of news-flow, we would expect this discount to narrow further. The dividend yield of 2.9% is less than the peer group (average c. 3.9%) although dividend cover is a healthy 2.8x, giving headroom for further expansion.

Year to June	Revenue (£m)	Adj PBT (£m)	EPS (p)	DPS (p)	Net Cash (£m)	P/E (x)	Yield (%)
FY14a	1,482.9	11.5	23.1	9.5	46.3	14.6	2.8
FY14e	1,740.8	14.7	28.4	9.9	48.5	11.9	2.9
FY15e	1,811.1	18.1	34.8	10.4	57.5	9.7	3.1



TIDM	ISG
Market cap (£m)	130.0
Net cash (FY1)	47.5
Free float (%)	100%
Avg daily volume (3m)	78k
Broker	Numis
Listing	AIM

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Investment case

ISG about market leadership and execution

We believe the core of ISG's investment case is the combination of market leadership and execution. Although ISG is benchmarked against the broader UK Construction peer group; we believe this can mask the differentiation between ISG and its peers:

- ISG's leading position in the London office fit out market. Not only is ISG benefiting from strong underlying growth dynamics in this market; operational execution has been impressive. Contract news-flow over the last year suggests that ISG is maintaining its leadership position by capturing a number of significant, large scale projects.

- A key aspect of ISG's strategy has been to grow both in the UK and overseas. Adjusting for Engineering Services (reported within UK Fit Out but including data centre projects outside the UK), approaching 50% of group profitability comes from outside the UK.

- ISG has also demonstrated impressive flexibility in entering and securing market share in new sectors such as Data Centres and Hospitality. The rapid growth in the Data Centre business in particular has been a significant contributor to recent performance

- ISG also holds a leading position in the UK Retail sector, which is the second largest contributor to group EBIT after Fit Out and Engineering Services. Although not growing as quickly as Fit Out, UK Retail has been a solid source of profitability, despite the trading challenges affecting the sector. This solidity is testament to ISG's market position and the breadth of its customer offering.

UK Construction remains the weak spot, with historic contracts continuing to weigh on short term performance. However, the business has been restructured and the terms of newer contract wins are improving, laying the foundation for improved future performance.

Moving beyond recovery

Whilst the broad construction environment in the UK remains in the foothills of a sustained recovery; this is no longer the case for ISG. The near term growth prospects for the London fit out and the data centre market are looking robust. It is therefore not surprising that ISG offers, by some distance, the best near term growth prospects of any in the peer group.

Recovery re-rating has run out of steam

2013 witnessed a significant sector re-rating as investors looked to construction as a geared play on UK economic recovery. However, sector news-flow in 2014 has been volatile with a number of high profile companies coming under significant pressure. In this environment, which favours stock picking, ISG has stood out for the consistency of delivery and a growing confidence in the short to medium term growth outlook, which remains best in class.

ISG is differentiated from the peer group

We believe ISG offers better growth prospects at a cheaper valuation than the peer group. ISG may suffer from a size discount but if so then it is unwarranted. ISG earnings quality (evidenced by estimate upgrades vs. downgrades) is superior, as is short to medium term earnings and dividend growth. UK Construction remains a drag but does offer further earnings upgrade potential than for others if margins recover to industry normalised levels.

All of this is driven by ISG's leadership positions in what are relatively narrow but buoyant sectors; a niche approach not really replicated elsewhere. Investors are unlikely to be able to rely on a general upward re-rating to drive share price performance in the current environment. Operational performance should continue to be the key yardstick and ISG continues to lead the way.

Trading update

On 5th December 2014, ISG released an AGM trading update. The key headlines relating to current trading were as follows:

- Overall group trading for the period July through to the start of December has been in-line with management expectations.
- Within the group portfolio there has been a wider divergence than usual. UK Fit Out and Engineering Services, and to a lesser extent, UK Retail have performed ahead of initial expectations.
- Asia and the Middle East have also performed well.
- UK Construction Services, conversely, has continued to experience challenging trading conditions and is now expected to be loss making at the half year.
- Continental Europe has seen a mixed performance with Germany stable but the French business suffering from broader macro-economic weakness. FY15E will see a maiden contribution from the Spanish acquisition announced in July 2014, which is likely to largely offset the French decline. The timing of the Spanish acquisition is looking propitious with the Spanish economy now showing signs of life.

Growth in the order book underpins the near term outlook …

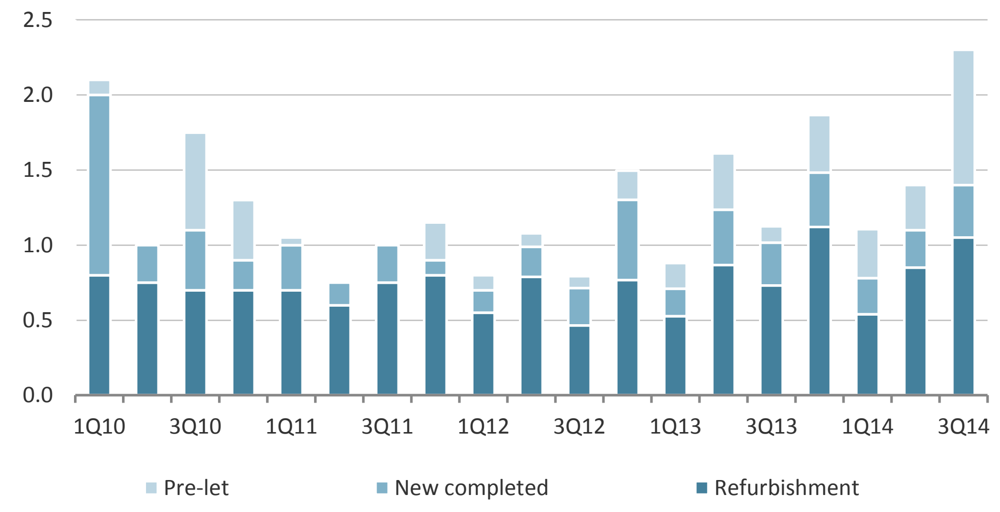
- The overall group order book at the end of October was £1,010m (+10% y/y), of which £770m is expected to be delivered in the current financial year.

Broad market conditions – London Fit Out leadership

ISG is the clear market leader in London office fit out

According to Metropolis Property Research, during the period 2009-2013, ISG completed a total of 3.2m sq ft of fit out projects, representing 29% of all space fitted out by the Top 10 firms. This compares to 21% for the second placed firm, Overbury. In total the top four firms accounted for 78% of the major fit out projects in Central London.

Exhibit 1 - City office take-up (m sq ft)



Source: CBRE Central London Property Market Review

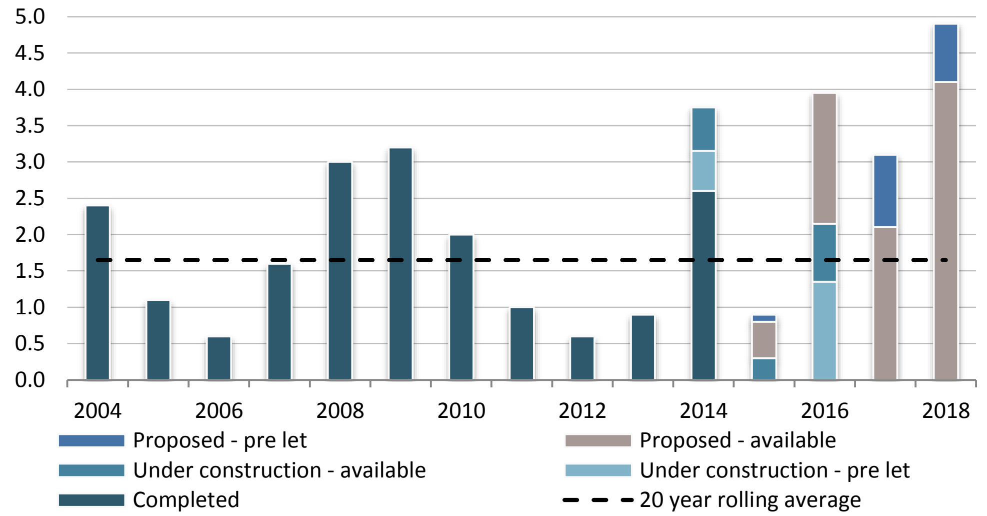
- Following a relatively quiet Q1, City office take-up has now seen two consecutive quarters of increasing take-up, resulting in the rolling 12 month figure now standing 33% ahead of the prior year at 6.8m sq ft. The continuing disparity in rents between the West End and City is also driving volumes towards the City.

- Furthermore, the amount of space currently under offer remains above the historic trend suggesting that current take up levels are likely to be maintained in the short term.

Lease expiry peak has yet to hit

- CBRE also highlight the recurring theme of lease expiries, which are expected to peak during 2014 and 2015 bring in excess of 12m sq ft of space, a large proportion of which will need to be refurbished. Not only that, but existing tenants will be seeking new space which itself will need to be refreshed for incoming tenants.

Exhibit 2 - City development pipeline, m sq ft



Source: CBRE Central London Property Market Review

- Unsurprisingly, given the rent driven flow towards the City, the development pipeline continues to build significantly with a total of 16.7m sq ft now anticipated (including the remainder of 2014). Of this, 72% is expected to be delivered from 2016 onwards suggesting a healthy overall demand environment for ISG over the medium term.

Data Center market

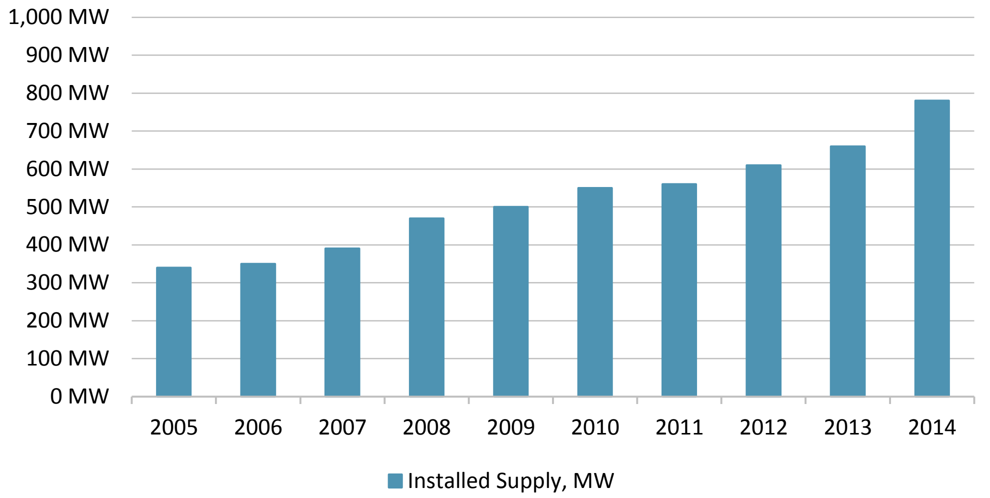
ISG's penetration into this market (primarily in the Nordic region, UK and more recently Spain) has been a notable contributor to group revenues and profitability over the last two years. The overall market opportunity remains significant as cloud computing investment remains very much in an expansionary phase.

- In a November 2014 survey, IDC estimated that global public IT cloud service spending in 2014 was $56.6 billion and forecast this to increase to $127 billion by 2018, representing a CAGR of 23%.

- This growth rate is expected to be roughly six times greater than growth in overall IT expenditure. In fact, by 2018, IDC estimate that over 50% of all global IT expenditure will be on cloud based platforms.

- It is against this backdrop that the growth in the physical data center market should be viewed.
- According to CBRE (*European Data Centres MarketView, Q3 2014)*, 2014 has experienced the highest level of available data center space take up in Europe since 2008, with over 40% of the available space being taken up by cloud based IT service providers.
- The current development pipeline suggests a further 135 MW of new capacity (c. 15% growth) is expected to be delivered during 2015

Exhibit 3 - European Tier 1 Colocation market, installed supply in megawatts



Source: CBRE

Estimates and Valuation

Changes to estimates

We have revisited our estimates and have made a number of revisions at the segmental level. UK Fit Out, UK Retail, Asia and the Middle East are all upgraded, whilst Europe and UK Construction offset to the downside. The net effect is to leave our FY15E PBT/EPS broadly unchanged at £14.7m/28.4p respectively although we have upgraded our revenue estimate by 14% to £1,741m. For FY16E, however, both our revenue and PBT/EPS estimates are upgraded by 14% and 9% respectively.

Exhibit: 4 - Revisions to Broker Profile estimates

Year to Jun, £m	FY15E Old	FY15E New		FY16E Old	FY16E New	
Revenue	**1,526.3**	**1,740.8**	**14%**	**1,583.3**	**1,811.1**	**14%**
EBITA	15.2	15.4	2%	17.0	18.8	11%
PBT, adj	**14.7**	**14.7**	**0%**	**16.6**	**18.1**	**9%**
EPS, adj	**29.4 p**	**28.4 p**	**-3%**	**32.4 p**	**34.8 p**	**7%**
Net cash	43.5	47.7		49.7	50.0	

Segmental	FY15E Old	FY15E New		FY16E Old	FY16E New	
UK Fit Out						
- Revenue	550.3	665.0	21%	577.9	698.2	21%
- EBITA	9.4	13.5	44%	10.1	13.9	37%
UK Retail						
- Revenue	289.1	317.1	10%	297.7	326.6	10%
- EBITA	6.6	6.7	1%	7.1	6.8	-5%
UK Construction						
- Revenue	450.5	523.6	16%	459.5	534.1	16%
- EBITA	1.4	-3.0		1.8	0.1	
Europe						
- Revenue	110.8	92.5	-16%	116.3	97.2	-16%
- EBITA	1.7	1.6	-8%	2.0	1.6	-21%
Asia						
- Revenue	89.8	99.3	11%	94.2	105.2	12%
- EBITA	2.7	3.2	16%	2.9	3.4	15%
Middle East						
- Revenue	35.9	43.3	21%	37.7	49.7	32%
- EBITA	0.5	0.7	58%	0.6	0.8	50%

Source: Broker Profile

Upgrades.

- **UK Fit Out and Engineering Services**. Performance here continues to be strong, with the group benefiting from both a strong existing pipeline (nine London projects each with a value in excess of £15m) and further contract wins for the data center business across the UK, the Nordics and Continental Europe. The fundamentals of the core London office market remain weighted in ISG's favour. We have therefore upgraded our revenue expectations for both FY15E and FY16E by c.20% and EBITA by 44% and 37% respectively.

- **UK Retail**. Given the volatile news-flow emanating from the UK Retail sector over the course of the year, ISG's performance has been doubly impressive. As traditional retail formats have come under pressure, newer formats (often smaller and more numerous) have become a larger part of the retail estate mix. ISG continues to benefit from its market leading position and is delivering a fuller range of services such as project management and design for certain retail customers. Elsewhere, ISG has a growing exposure to the hospitality sector, in particular airports and hotels. Overall, we have upgraded our revenue estimate for both FY15E and FY16E by 10% although we are taking a cautious view over margins. Our FY15E EBITA expectation has risen marginally by 1% whilst FY16E has come down by 5%.

- **Asia and Middle East.** Both of these segments have seen improved trading through the course of the year and are likely to come in ahead of prior expectations. ISG's Middle East exposure is concentrated in Dubai and Abu Dhabi, where the recovery has been more pronounced. ISG's recent focus on the hospitality sector has also borne fruit (especially in the Middle East) and the outlook is promising. Taken together, we have upgraded our FY15E revenue / EBITA estimate by 13% and 22% respectively. For FY16E we have upgraded by 17% and 21% respectively.

Downgrades.

- **UK Construction**. This segment continues to be challenging as the group works through the historic contract pipeline. Margins are continuing to come under pressure as these contracts complete. As a result, management have guided towards a loss for H1 and we are now assuming a loss for the year as whole (£3.0m). This division has been subject to a significant degree of restricting over the last year, resulting in a tighter geographic focus and the closure of the Tonbridge office. However, despite the challenges of bringing historic contracts to completion, the newer contract pipeline is focused on frameworks and repeat customers (78% of the order book was from this category at June 2014, up from 72% at June 2013) with more attractive and sustainable commercial terms. At this stage, visibility over FY16E is more limited but we are pencilling in a breakeven position.

- **Europe**. This has been a mixed bag for ISG. Germany remains relatively solid, although unexciting, whilst France has been more challenging with declining activity levels indicative of macro challenges. Back in July, ISG announced the acquisition of 50.1% of a new Spanish venture (ISG Espana), which itself was formed from the combination of a Spanish fit out business, Diadec, and a Spanish data centre specialist, Emerald. The timing of this acquisition has been good, with the Spanish economy beginning to show signs of a material recovery. FY15E is therefore likely to see the first material contribution from this acquisition (£0.8m), although this will be partly offset by a £0.3m minority interest. Overall (including the maiden Spanish contribution), we have reduced our FY15E revenue / EBITA expectations by 16% and 8% respectively.

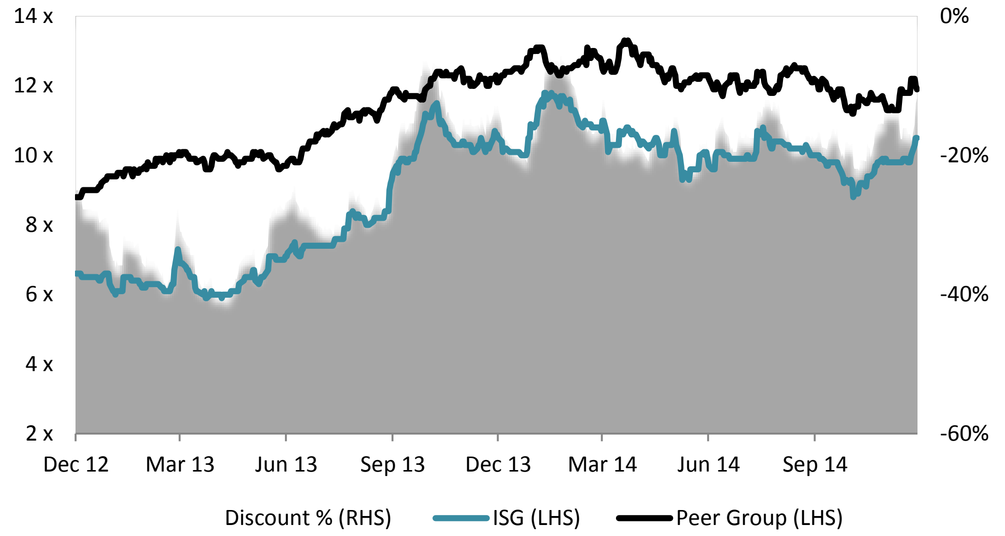
Relative valuation

In Exhibit 5 below, we show the relative 12m rolling forward PE for both ISG and the Construction peer group over the last two years (source: Bloomberg consensus estimates).

We can see that ISG has traded, persistently, at a PE valuation discount to the UK Construction peer group over the last two years. However, since mid-October (when the discount stood at 22%) the discount has narrowed considerably to its current 12% (14% based on our estimates).

The ISG valuation discount has narrowed considerably since October …

Exhibit 5 - ISG vs UK Construction Peer Group – 12m rolling PE multiple



Source: Bloomberg

In our view, this discount remains unjustifiably wide when one considers the superior short to medium term earnings growth profile ISG offers, higher dividend growth and a better earnings revision trend. As a result of strong share price performance, the dividend yield (2.9%) is now lower than the peer group average (c.3.9%), however growth is higher and the cover (2.8x for FY15E and 3.2x for FY16E) provides a good base for further expansion.

Financial Summary – Year ended 30 June

INCOME STATEMENT, £m	FY12A	FY13A	FY14A	FY15E	FY16E
UK Fit Out	202.1	287.5	519.5	665.0	698.2
UK Retail	322.8	267.3	283.2	317.1	326.6
Europe	101.3	91.6	102.8	92.5	97.2
Asia	81.0	73.5	79.4	99.3	105.2
Middle East	20.7	26.1	34.6	43.3	49.7
UK Construction	553.6	537.9	463.4	523.6	534.1
Revenue	**1,281.5**	**1,283.9**	**1,482.9**	**1,740.8**	**1,811.1**
Group EBIT	**7.8**	**9.8**	**12.2**	**15.4**	**18.8**
Exceptional items	(3.3)	(3.9)	(2.8)	0.0	0.0
Goodwill amortisation	(2.9)	(2.2)	(2.0)	(2.0)	(2.0)
Net interest	(0.3)	(0.7)	(0.7)	(0.8)	(0.7)
Reported PBT	1.2	3.0	6.8	12.7	16.1
Adjusted PBT	**7.5**	**9.1**	**11.5**	**14.7**	**18.1**
Tax	(0.2)	(0.2)	(1.6)	(2.9)	(3.7)
Minority interests	0.0	0.2	(0.0)	(0.3)	(0.3)
Average no shares - diluted (m)	31.5	32.2	38.2	38.7	39.2
EPS - Reported, basic (p)	3.2	7.9	6.2	24.5	30.9
EPS - Adjusted, basic (p)	**18.1**	**22.1**	**23.1**	**28.4**	**34.8**
DPS	9.0	9.0	9.5	9.9	10.4

CASH FLOW, £m	FY12A	FY13A	FY14A	FY15E	FY16E
EBITDA	10.3	11.9	14.9	18.9	22.2
Working capital	(5.2)	0.2	25.0	(5.0)	(6.0)
Other	(4.1)	(4.2)	(11.4)	(2.4)	(0.9)
Operating cash flow	1.0	7.9	28.4	11.5	15.3
Net interest paid	(0.1)	(0.3)	(0.2)	(0.3)	(0.3)
Net tax	(2.6)	0.5	(2.5)	(2.7)	(3.6)
Net capital expenditure	(2.7)	(1.8)	(4.4)	(3.3)	(3.2)
Net acquisitions / disposals	(0.8)	(0.2)	(2.8)	(0.2)	(2.0)
Other	-0.2	-0.4	-1.5	0.2	0.0
Pre financing cash flow	(5.2)	5.8	16.9	6.0	6.2
Dividends	(4.8)	(2.8)	(3.4)	(3.8)	(3.9)
Net equity issued	(0.7)	7.4	(0.3)	0.0	0.0
Net movement in debt	(3.8)	1.7	(2.7)	(2.4)	(1.2)
Net change in cash	(14.5)	12.1	10.5	(1.0)	1.1

BALANCE SHEET, £m	FY12A	FY13A	FY14A	FY15E	FY16E
Goodwill	82.3	83.2	82.8	83.3	83.8
Intangible assets	7.0	5.0	3.8	3.8	3.8
P,P & E	6.4	5.6	7.2	7.1	7.0
Other	0.1	0.1	1.9	1.9	1.9
Fixed assets	95.8	93.9	95.7	96.0	96.4
Net working capital	(71.5)	(71.1)	(85.1)	(78.6)	(72.7)
Total capital employed	24.2	22.8	10.6	17.5	23.7
Net cash / (debt)	25.4	36.1	46.3	47.7	50.0
Net Assets	49.7	58.9	56.9	65.2	73.8

Source: Broker Profile

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