THE UK SHAREHOLDERS' ASSOCIATION INVESTIGATES AIM COMPANIES' ANNUAL REPORTS

Hargreaves Services plc – Number 98 in Investors Chronicle 'AIM 100' April 2015

Annual Report for year ended 31 May 2015

INTRODUCTION

Hargreaves Services plc was established in 1994. Revenue for the year ended 31st May 2015 was £662m (2014 £869m) with an operating margin of 4% (2014 6%), profit before tax of £25m (2014 £52m) and a shrinking market served by abundant worldwide resources.

THE BUSINESS

Hargreaves Services sources, produces and transports carbon based materials (primarily coal) and is the largest surface mining operator in the UK and the largest independent importer of coal. The company's primary market (98%) is the UK with a secondary market in Europe. Most of the coal is sold to the UK electricity generators, some to the UK steel sector and a little to UK speciality coal markets. A minority of work is being undertaken in Germany, South Africa and India.

Coal mining and distribution, coal for electricity generation and coal for steel are markets that are contracting worldwide and particularly in the UK. Worldwide coal oversupply, environmental, political and legislative hurdles are proving to be too much. Hargreaves Services is also a 'price taker'; that is it is not influential enough to affect the price of its product and it is forced to go with the market price e.g. power station coal.

The directors and employees are managing the decline of this business quite well but 'The boy stood on the burning deck' is brought to mind.

GENERAL COMMENT

The annual report and accounts 2015 has 89 pages, excluding covers, and is divided into three sections - the Strategic Report (18pp), Directors' Report (14pp) and Financials (54pp). The report pleasingly consists of about 25% less pages than is usual today. It is presented in a straight forward classic manner and will win no prizes for innovation but information can be found quickly (in its usual place). The picture on pp20/21 has no point except being pretty. The chairman's, group chief executive and group finance director's reviews are straightforward and succinctly contain the business facts and present the plan.

A few more graphics might help but the feeling of an old business in sharp decline with dated presentation would probably persist.

STRATEGIC REPORT

The strategic section opens with a brief summary of the company and the company's year with highlights. This is followed by the chairman's statement, group CE and group FD's reviews. The chairman's report is clear and concise, covering just two pages and leaving the detailed commentary to the executives over the next 11 pages. Narrative dominates, with little illustrative content. Not too much jargon, but I was impressed by the latest euphemism, "*Simplification Programme*" and the chairman gives us "*…leveraging our skill sets…*". The MD contributes "*…to deliver significant restoration solutions for the unfunded restoration liabilities following the failures of the ATH & SRG in 2013*" (translation: 'We're working out how to fill in holes as cheaply as possible'). None the less, a clear operational and financial review is given, including some proposed future actions.

The strategic report highlights the reduction in debt from £43m to only £1m over the year, the potential coal fired power station closures, the decline in sales (down 24% in 2015), the decline in profit before tax (down 52%), the closure of coal fired power stations, the political will to remove coal from the UK energy mix, the lack of control over prices and other key determinants for future prospects, the global oversupply, falling prices, increasing tax on each tonne of coal burned, greatly reduced competitor gas and oil price, the cost of mine restoration, etc etc.

The company has done well to remain profitable and is managing the business decline but the strategy presented does not show clearly where new business is coming from and the strategic options are not clearly defined. Stockpiling coal from the Scottish mine that is unprofitable at today's prices without price hedges seems to be a risky tactic.

The risk report is short and does not cover adequately the risk of a further slide in prices. The gross margin is only 11%.

Hargreaves Services' business model maintains that in its view coal will have a longer run-out in the UK than many commentators expect and that by the mid 2020s this will be enough to sustain its base business and provide sufficient time and opportunity to reposition and broaden the Group's activities. Supporting evidence for this opinion, however, is lacking.

FINANCES

The short section of the report from the group financial director has three simple pages to tell us the bad and good news. The bad news revenue, operating profit and margins are down significantly. The good news debt is down significantly to £1m, pension liability is decreased and is not huge, the dividend is up from16.7p to 20p and the group's financial position remains strong.

Share buy-back: the board should not have spent £6.3m on buying shares at 598p average. If they were such a bargain, why didn't they buy some for themselves? An apology from the chairman for wasting £2.6m (as at the time of his report; as at the date of this review, £4.3m) might help, although the tangible net assets at last year end were 432p/share.

DIRECTORS, EMPLOYEES & SHAREHOLDERS

At the balance sheet date there were six board members, a non-board managing director and 2700 other employees. The employee count has only reduced by 1% compared to the previous year.

The directors had remuneration, including incentives, of £1.83m. Options and employee share schemes are at reasonable levels and are clearly defined. Excluding directors, employees earned on average £40.4k each, up from £40.3k in 2014.

The group chief executive, Gordon Banham, owns over 7% of the equity. There are six institutions listed as holding more than 3%, with a total of 53% and the largest being 16.1%.

CORPORATE GOVERNANCE

The corporate governance report is clear and concise. The remuneration report is a manageable 3 pages when in many reports it can be 20 pages plus.

CONCLUSION

Hargreaves Services plc is a company in an old industry fighting for survival and with some success in managing the decline so far. The annual report is short by today's standards and appears reliable and steady like the directors.

The interim report for the six months ended 30th November 2015 was released shortly before the main work of this investigation was complete. It shows a 50% decrease in sales against the second half of 2014. The profit before tax has reduced by 95% to £0.8m and debt has increased to £32m. Increased steps are being taken to reduce the company's current high dependence on thermal coal. In January 2016 the company acquired Blackwell, a leading earthworks contractor capable of delivering major projects in the non coal mining, quarrying, development, flood defence and infrastructure sectors. The interim dividend is down 83% to 1.7p (10p). The new chairman is in place.

SF April 2016