APi Group [NYSE: APG]

Initiate at BUY at 2.5% | PT: $31.71

April 10, 2023

CIMG Investment Research

Another Industrial Company in a Fragmented Industry

APi Group is a leading provider of safety and specialty services across North America, Europe, Australia, and APAC. Within the safety services segment, APi Group provides design, installation, inspection, monitoring, and other services for life safety systems. Life safety systems include fire sprinklers, alarms, and fire extinguishers. Furthermore, they are the largest Fire Safety Services provider in the United States, with APi's 2020 revenue being greater than the next 19 largest companies combined. For the specialty services segment, APi provides maintenance, repair, design, fabrication, and installation of critical infrastructure that tends to be acyclical: such as underground electric, gas, water, sewer, and telecommunications infrastructure. Additionally, APi also provides design, maintenance, and installation services for HVAC units.

Investment Thesis

APi's differentiated approach to Safety Services gives them an edge. APi's approach to gaining revenue and market share in the Safety Services segment is different than most of their peers. Most of APi's competitors target revenue by competing for and bidding on installation work and new construction projects. Upon completing that installation work or new construction project, they then hope to maintain the relationship with the customer by providing inspection services. APi's model is different, in that they target inspection revenue aggressively. APi has a large inspection sales force, which aggressively bids on inspection contracts to displace existing providers. From there, they also get the first opportunity to service life safety equipment. In essence, this allows APi to create their own business, as every $1 in inspection revenue leads to an additional $3-4 in service revenue to maintain compliance. This strategy has been very effective, as APi has been able to grow inspection, service, and monitoring revenue by nearly 10% annually. This is important as this revenue is very stable and acyclical, as most of it is statutorily required. The reason smaller competitors use a different business model is because of the higher price tag associated with installation and new construction projects, but the inspection, service, and monitoring revenue has much higher margins than the installation and new construction work. APi recognizes the benefits of higher margins and more consistent revenues that Safety Services provides and has been aggressively expanding that part of the business, while divesting lower margin segments like Industrial Services.

An ongoing cost management strategy shift by Corporate America benefits national players with scale. For the past decade, there has been an ongoing trend of centralizing cost accounts by national and multinational companies. Previously, it was more common for companies like Home Depot to allow regional executives and managers to set up their own contracts with service providers for their stores. Different sub-geographies of the country could have inspection services being provided to them by numerous firms. However, this standard is changing, and more companies are starting to try and centralize their accounts for cost simplicity and consistency. These companies wish to have their safety inspection reports all done by the same company to maintain the same level of quality in all their stores. This greatly benefits companies that have nationwide inspection capabilities, which frankly, leaves APi Group and Cintas as the only options. As this trend continues, it should be beneficial to APi with regards to continuing to grow market share.

Chubb acquisition provides potential upside. In mid-2022, Chubb was acquired by APi Group for an enterprise value of $3.1bn. Prior to APi ownership, Chubb was owned by Carrier after the UTC spinoff. Under Carrier, Chubb was run poorly. Carrier implemented systems that reduced cross-selling incentives by dividing operations by segment and giving managers no incentive to cross-sell to other segments. In addition, Carrier always thought of Chubb as an

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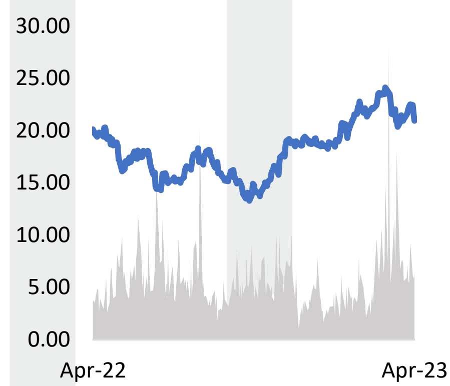
Figure 1: LTM Stock Chart & Volume



Price	$20.91
Dividend Yield	-
PT	$31.71
Upside	52%
52-Week Range	$13.09 – $24.49
Dil Shrs Outstand	267 M
Mkt Cap	$4.90 B
Ent Value	$8.13 B
NTM P/E	14.39x
NTM EV/EBITDA	10.85x

asset to be sold, as it really had no synergies with the rest of the business. Now under APi ownership, Chubb has already seen material improvements. For one, Chubb is now experiencing significant organic growth, whereas during its previous 5 years, it had a 0% organic revenue growth CAGR. In addition, Chubb is also seeing improving margins. APi has been reducing redundant headcount and improving the sales strategy, and EBITDA per employee increased 24% in 2022 compared to 2021. In addition to these improving metrics, Chubb compliments APi's safety services portfolio nicely. Similar to APi, Chubb's revenue profile tends to be acyclical inspection and servicing revenue, with organic revenue staying relatively stable compared to the Global PMI index. With 65% of Chubb's revenue coming from inspection, servicing, and monitoring, it has now boosted APi's percentage of revenue coming from inspection, servicing, and monitoring from around 40% to a little above 50%.

SPAC ownership and recent listing creates market confusion, and we believe this gives us an excellent opportunity to enter. In 2020, APi Group was acquired by J2 Acquisition Corporation, a SPAC sponsored by Martin Franklin. Given the market perception of SPACs and the incentive structure given to SPAC owners via preferred shares, we believe this is turning off some investors to the company. However, the preferred share structure gives significant incentive to SPAC owners to increase the stock price, otherwise they get no additional benefit or dividends. In 2022, SPAC owners received no preferred dividends as the stock price during the last week of the calendar year did not exceed the highest stock price previously used to calculate the dividend. We believe the preferred dividend, while not necessarily ideal, forces SPAC management to be aligned to the overall goal of shareholders, and we believe there is excessive market concern over this. In addition, we believe the market is only looking at this company from the lens of a construction company, with APi trading at multiples closer to pure-play specialty services companies like Dycom Industries and Quanta Services. Meanwhile, companies that derive a large portion of their revenue from inspection, servicing, and monitoring, such as Cintas and Otis Worldwide, are trading at multiples several turns higher than APi Group. We also believe the market overreacted negatively to the Chubb acquisition, as many people were concerned about increasing revenue exposure to Europe, but we believe the highly recurring and acylical nature of Chubb's revenues protect it from any prolonged downturn in Europe. In addition, we believe the market is misunderstanding APi's newfound cyclicality resistance. During COVID, APi had large organic revenue decline compared to some of their more broad and diversified competitors, such as Cintas and Otis. However, we believe this is not fair to the true reality of APi's acyclicality. The truth behind APi's revenue decline was simple: fire safety inspections can only be performed in person, thus it makes sense that in a lockdown, it was difficult to get inspectors inside the buildings. Additionally, many businesses decided to delay their inspections as long as they possibly could due to health concerns and legal restrictions. We can see how this revenue was pushed back in 2020 into 2021, as organic revenue growth during 2021 was significantly higher than their peers, mainly due to revenue gained from the pushing back of inspections in 2020. As a result of these reasons, we believe it presents an opportunity to enter a position into APi Group at an attractive time.

Valuation

We used a blended valuation methodology, giving 50% weight to a DCF with a 10% discount rate and a 2.5% Long-Term Growth Rate and another 50% weight to a DCF with a terminal multiple of 14x EBITDA, to reach a price target of $31.71. We have modeled organic topline growing at mid-single digits. SGA expenses gradually go down as the company gains operating leverage and realizes synergies from Chubb. We project EBITDA margin expansion to 12% by 2024, which is in line with management guidance.

Company Overview

APi Group is a provider of safety and specialty services across the world. It operates under two segments: Safety Services and Specialty Services. Within the Safety Services segment, APi Group mostly provides services related to fire safety, whether it be inspecting buildings to ensure it meets statutory requires or servicing needs such as replacing a fire sprinkler system. Within Specialty Services, APi provides repair, maintenance, design, fabrication, and installation of critical infrastructure. A majority of revenue for the Specialty Services division is tied to acyclical end markets, with 58% of revenues coming from infrastructure and utility companies. Much of APi's revenue is tied to statutorily required inspection, servicing, and monitoring revenues. After the acquisition of Chubb in 2020, APi derives nearly 55% of their revenues from this highly stable and recurring revenue base. This is a huge improvement compared to 2008, where only 15% of the company's revenues were tied to this acyclical, recurring revenue. Despite this, APi remained cash flow positive during the Great Financial Crisis.

Industry Overview

The safety services space is highly fragmented, with many different regional and mom-and-pop players in the space. Recently, a common strategy has been to acquire more players to integrate more contracts into their network. Private equity money has also flooded the space, with many large regional players now receiving private equity backing. During COVID, the industry suffered due to health codes making it difficult to get inspectors into the building. This was especially true for healthcare customers, such as hospitals and doctor's offices. Most of the industry views inspection revenue as ancillary, with their primary focus on getting high price tag project and installation work revenue. However, APi is unique to the industry in that it focuses on inspection and service revenue first, as it is much higher margin and predictable.