

July 16, 2020
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(MEG - NYSE)
Initial Report

IPO Details

Shares – 10 million plus 1.5 million greenshoe

Expected Pricing Range - \$15 per share to \$17 per share

Lead Underwriters – BofA Securities, William Blair, BNP Paribas, Capital One Securities, Stifel, and Needham & Company

Expected Pricing – Post market close on July 22, 2020

Business Description

Montrose Environmental Group (MEG – NYSE), formed in 2012 and headquartered in Irvine, CA, is a leading environmental and sustainability solutions company. The company's goal is to partner with its clients in order to assist them in meeting environmental, often regulatory, obligations. If possible, Montrose works to both mitigate the environmental impact of doing business and, where possible, adds an ongoing sustainability solution to the mitigation that can even result in recovery of some of the regulatory cost. For example, Montrose may design a solution to mitigate the impact of a client's effluent stream, but also find a beneficial reuse for the effluent. The company operates largely in North America, but has followed clients outside of the US, and also has operations in Canada and Australia.

In FY19, Montrose generated revenues of **\$233.9m** and adjusted EBITDA of **\$45.1 million**. The company operates in three reporting segments:

1. Planning & Permitting (P&P) which is a technical consulting segment with EBITDA margins in the 30 – 50% range. This segment assesses client *needs*. P&P services are mostly office based, and have been relatively unimpacted by recent COVID-19 shutdowns. We believe that P&P accounts for ~30% of total revenues and has EBITDA margins in excess of 40%.

2. Measurement and Analysis (or "M&A", which could become confusing as acquisitive as Montrose is) operates both field teams and physical labs. The [M&A] segment *assesses client issues*. For energy clients, there is a leak detection and repair component in this segment. M&A is largely contract based, with ~25% in the form of Master Service Agreements (MSAs). We estimate M&A segment EBITDA margins in a range of 17 – 22%. 20 - 25% of segment revenues and activities are lab based, with the rest being field service personnel. The M&A segment accounts for ~40% of total revenues with EBITDA margins in excess of ~20%.

3. The Remediation and Reuse (R&R) segment *remediates clients issues*. We believe that R&R accounts for ~30% of total revenues with EBITDA margins in the high teens (16 – 18%). This is where Montrose provides a solution for the client, either a one-time remediation (as with soil treatment) or the company could manage an ongoing program related to remediation, treatment or beneficial reuse of a by-product or effluent (as in its biogas offering). Often times its customers understand that there is a tangential revenue opportunity when building a remediation solution (selling methane, for example). R&R are largely field service personnel.

Montrose has experienced an annual revenue CAGR of ~27% over the last 4 years (2016 – 2019), of which 7 – 9% has been organic, and we expect this trend to continue in the near to medium term due to its April 2020 acquisition of Center for Toxicology & Environmental Health LLC (CTEH). CTEH grows the company's revenue base by and additional ~30% and is also accretive to margins. Adjusted EBITDA growth has been slightly more than 60% during the period from 2016 – 2019, and has occurred largely organically, and with little investment in sales and marketing. The company already has a relatively well diversified shareholder base, there is no Private Equity involvement per se, and as we will discuss later in this report, the company has a strong management team.

Competitive Advantages

- Once public, Montrose will be the only public traded company with a sole focus on Environmental Services. Whereas other companies compete in certain environmental services, those other companies tend to be business

units of engineering firms, equipment or materials producers, solid waste management service companies, or water treatment providers, with product lines that are used to create environmental solutions, or service lines that result in disposing of waste, but not with a sole focus on the environment. The engineering market participants are the closest to what Montrose is doing, but those competitors also tend to provide civil engineering activities. **Montrose is a pure play environmental engineering company.**

- **Montrose has built a portfolio of differentiated technologies, processes & applications** that it is able to apply to specific customer needs. These applications are replicable and often provide Montrose with an ongoing revenue stream from perpetually managing remediation and reuse activities. For example, Montrose owns a proprietary technology that combines ion exchange with adsorption (which uses granularized, activated carbon, or GAC), unique in that it is “regenerable” – meaning that it doesn’t need to be regularly serviced – no GAC needs to be swapped out and periodically “reactivated” (cleaned), etc.
- Montrose has **a resilient business regardless of the economic climate and regulatory environment** and thus far, regardless of the political party or Presidential administration. Montrose has grown equally strongly through both the Obama and Trump Administrations, the Harper and Trudeau Administrations in Canada and the Abbott/Turnbull and now Morrison Administrations in Australia. Montrose has also not been significantly impacted, through the current COVID-19 induced economic disruption, as most of its services have been deemed *essential* by various government entities since the start of the pandemic.
- Montrose has **a diverse customer and revenue base** with 80% private industry and 20% Fed/State/Local Government, and customers across a diverse set of end markets. No customer represents more than 7% of sales and no end market is more than 13% of sales. The company has little customer concentration and has only one relatively large customer, that gets serviced across four different contracts and two product lines. Furthermore, Montrose’s revenue stream is highly recurring, and 90% of the company’s 2018 revenues repeated in 2019. Whereas these revenues do not fit the classic definition of recurring revenues, Montrose boasts 4000 clients, many of whom are under Master Service Agreements (MSAs), providing the company with a fair amount of insight into future opportunities.
- Montrose will emerge post IPO in **an improved financial position and with a strong balance sheet**, reasonable debt/leverage (we estimate **2.3 – 2.5x** leveraged to our FY21 EBITDA estimate of \$58m), and with a solid cash position. We estimate **\$175m** of debt and **\$40 – 50m** of Balance Sheet cash resulting in Net Debt of **\$135m** plus **\$50m** of undrawn revolver capacity. Furthermore, the company is capital light, with over 75% of the business being professional services, meaning that it should continue to generate strong cash flows. The company plans to use the IPO proceeds to retire its Term Loan-A debt facility. Because of a high (9.0%) coupon rate on the remaining \$175m of debt, management’s goal is to retire the rest of its [A-2 preferred] debt before it is eligible for conversion (in ~4 years). Management’s goal is to quickly drive the leverage ratio below **2.0x**. We estimate this goal will be achieved in FY22.

Assessment of Management

Montrose is led by President and CEO Vijay Manthripagada and CFO Allan Dicks, both of whom have been with Montrose since 2016, and have been at the helm of the company’s recent strong growth. Mr. Manthripagada, an Oxford educated, American biochemist with a Wharton MBA, was formerly an Investment Banker at **Goldman Sachs** (GS – NYSE) and the former CEO of **PetCareRx**. Prior to being with Goldman, he was with **Johnson & Johnson** (JNJ – NYSE). Mr. Dicks, educated at University of the Witwatersrand in Johannesburg, South Africa, is a **PriceWaterhouseCoppers** alumnus who spend his career there in its mergers and acquisitions group. He is both a Chartered Accountant (CA) and a CPA. He has held finance roles of increasing responsibility at **Dole Food Company, Inc.** and **Land O’ Lakes, Inc.**, and was also a VP of Finance at **HD Supply, Inc.** (HDS - NYSE) at the time when HDS was spun from Home Depot in 2012. These two have guided the company through its recent period of rapid expansion by both improving the operations and through a series of acquisitions that have augmented the company’s ability to grow organically.

Management compensation appears reasonable by industry standards and includes incentives upon achieving organic revenue and adjusted EBITDA growth targets. Insiders will hold approximately **18%** of the company’s outstanding shares post-IPO.

Montrose has a *9-person classified board*, one in which groups of three Directors serve for staggered 3-year terms, suggesting that there is opportunity for improvement. Many of the Board Members have longstanding and close connections to Chairman of the Board Richard E. Perlman, who was co-founder of ExamWorks Group, Inc., a

provider of independent medical examination services, where he has served as Executive Chairman since October 2010. Many also have connection to Mr. Perlman (who was Executive Chairman of TurboChef Technologies, Inc.) from his time at TurboChef, now owned by Middleby, Corp (MIDD – NASDAQ), and PracticeWorks, Inc., a provider of software for managing Dental practices. Two of the company’s Directors are James K. Price, the former Co-Chair and Co-CEO of ExamWorks, who was also formerly President, CEO, and director of TurboChef Technologies, Inc., and former President and CEO of Practiceworks, and Miguel Fernandez de Castro who was CFO of both Examworks and TurboChef Technologies and also had a tenure with Practiceworks. These two member have followed Mr. Perlman through three previous companies so at this point we question their independence. Thomas Presby, the former Global COO of Deloitte, also serves on Montrose’s Board. He has served on the board of nine publicly listed companies, including *TurboChef Technologies, Inc.*, therefore also having had prior experience with Messrs. Perlman, Price and Fernandez. Peter Graham, a partner at One Better Ventures LLC, a private investment vehicle, *also has ties to Examworks*, having served on its board until 2016. There are two Board Members with connection to Oaktree Capital, Montrose’s debt provider, Brook Hinchman and Peter Jonna.

The one truly *independent* director, and the one tied most closely to the business, is Dr. Robin Newmark, a Director Emeritus at the U.S. Department of Energy’s National Renewable Energy Laboratory with advanced degrees in Earth Sciences, Geophysics and Marine Geophysics. Her expertise includes having co-invented a suite of environmental remediation technologies, some of which are patented. She has also authored numerous papers and reports in the open [environmental remediation] literature. The remainder of the Board contains individuals with experience largely in finance, software and technology, and business operations.

Growth Drivers

- **Growth in environmental regulation will continue to be an ongoing driver** for Montrose. Couple this with increasing corporate awareness that if creative enough, sustainability itself, regardless of the form that it takes (reduce environmental impact, reduction of waste, beneficial reuse of waste streams, converting waste to new products), can be a profit center within most organizations. In this case, the “*trend is your friend*” and what we like is that these opportunities tend to build upon themselves as companies move from regulatory compliance to more creative solutions and view them as opportunities. Examples of this might be reducing, sequestering or capturing methane leaks from pipelines and beneficially reusing that gas, or perhaps converting Ag waste to biofuel.
- **ESG is a hot investment trend.** Environmental [and social] issues have been gaining significant momentum. Whereas it is yet difficult to identify social investing, environmental has been a clear trend for the better part of the past decade. Several corporate crises impacting consumers, the environment, and society at large (Horizon oil spill, battle over the Keystone XL pipeline, trends favoring renewables and cleaner natural gas and away from dirtier fossil fuels such as coal and petroleum have all prompted calls to action for sustainable business practices. Many asset managers and owners became signatories to the UN’s Principles for Responsible Investment (PRI) leading to a corresponding surge in ESG-related investor interest, including increased support for environmental and social shareholder proposals that has led to capital inflows into ESG-themed investment products. This has also resulted in heightened pressure on companies to improve disclosures related to ESG.
- **Montrose is acquisitive, and M&A is a core competency, but it’s not a “roll-up”.** The company has made 6 acquisitions since the beginning of 2020 and 52 acquisitions in its history. It is not a roll-up because there are few if any cost synergies because most of the deals focus on acquiring technologies and services to add to the company’s solutions portfolio. Acquisitions are private deals, as Montrose shies away from competitive bid situations. Management does not specifically provide the multiples that it pays, but does believe that they are “attractive”, which we believe are in the vicinity of ~5 – 7x EBITDA...
- **The company has more than adequate access to capital** and currently has plenty of deal flow. We understand that Montrose’s acquisition team, a full-time, 2-person team at Montrose that identifies acquisition candidates and negotiates the deals, will soon be back on the road visiting potential candidates. Candidates remain plentiful as the company has sized the [addressable and fragmented] market at \$1.2t.
- **The Center for Toxicology & Environmental Health LLC (CTEH) acquisition,** completed in April 2020, **appears to be highly accretive.** It is particularly attractive as it will enable Montrose to continue to grow rapidly as management settles into the requirements related to life as a public company. Management describes CTEH as essentially a crisis manager (an ER) for environmental situations that should feed its downstream testing, lab, and remediation businesses. CTEH manages and mitigates crises, which is quite a business to be in right now as

CTEH receives a surge of project inquiries related to the pandemic as clients try to figure out what is needed in order to reopen during and post COVID-19. We understand CTEH itself has more than fifty Fortune 500 clients.

- The company's organic growth has occurred with minimal **investment in internal systems** and sales and marketing capability, which **is** in the process of **being upgraded**. The company has recently implemented Salesforce, which will improve its customer facing activities, and is currently in the process of implementing a new ERP system (Workday) to replace its older [NetSuite] ERP system and a handful of other applications. These projects are expected to be completed by Q420. This will simplify the organization, provide management with real time operational dashboards (rather than a monthly KPI review) and should lower software licensing costs.
- **We expect margins to expand meaningfully**. CTEH adds ~30% to the company's revenue base at margins that are well ahead of the company average, resulting in what we believe will be ~500BPs of EBITDA margin accretion going forward. Furthermore, we believe that efficiencies from Salesforce and Workday, minus the costs being retired from the outdated and disparate older systems could add 1 - 2¢ to annual EPS.

Issues/Risks

Risk factors include, but are not limited to the following:

- **The COVID-19 crisis is expected to have a material negative impact on government/public budgets, 20% of Montrose's revenue base.** Although we are encouraged by the company's performance in the 5 – 6 months since the onset of the pandemic, and we understand that much of what Montrose does is regulatory compliance, if the tax base is impacted, cuts are inevitable. And whereas the company has grown nicely since inception, this is its first recession and the financial pressure on clients could further intensify. In the least, the pandemic has increased uncertainty across its customer base which causes clients to be more hesitant about undertaking new projects
- **The company's business depends on both man-made and natural occurrences that are difficult to forecast or predict.** These could include responding to a Natural Disaster (or a pandemic) which tend to occur infrequently and whose scales, scope and duration are unpredictable. These types of events tend to be unique in their nature, could cause large fluctuations in the company's revenues from year-to-year, impacting profitability and making business planning difficult. They also temporarily increase customer concentration.
- **The environmental services business is highly fragmented and highly competitive.** Competition in the industry is based on quality, breadth of offerings, pricing, technology, and service availability. There is no clear cut industry leader. Montrose competes with a broad spectrum of companies, many of whom specialize in water, air, or soil technologies. The fragmented nature of the market means that there is currently no clear market leader, which could weigh on pricing (for an undifferentiated product or service), but also provides the acquisition opportunities that make the Montrose growth story so interesting...
- ...but **there is risk in acquisition as well** such as the risk that that the acquired business will not perform as expected and that the company's judgments concerning the value, strengths and weaknesses of acquired businesses will prove wrong. There is integration risk. And there may come a time in the future in which Montrose may not be able to find suitable acquisition candidates.
- Montrose works on projects that impact health and public safety and **the company's solutions could fail, which could lead it to incur liability**. Particularly in emergency situations and natural disasters, many of which have a high public profile, such as implementing a disinfection plan for a contaminated international cruise ship in the early stages of the COVID-19 pandemic. This could lead to negative publicity, costly litigation, and could materially impact the company's reputation and its ability to win future project work.
- Many of the company's opportunities require the application of technologies, some of which are not yet developed, and **there is no guarantee that the company will be able to develop** these **technologies**. Some opportunities require acquisition of accreditations and/or authorizations that the company may not be able to secure.
- The company is in the process of implementing its ERP system. Any **failure to successfully complete the project** could have a material adverse impact on the company's operations.

- Finally, the company's revenues are largely driven by environmental regulations and standards. New regulations are promulgated and older ones are modified or repealed. **Modification or repeal of certain regulations** could negatively impact the need for the company's services.

Summary and Recommendation

We believe that Montrose Environmental Group (MEG – NYSE) shares represent a compelling investment opportunity for growth oriented, small-cap investors. Montrose is well positioned as an Environmental Services pure play with a secular tailwind from ESG-concerned asset managers and investors. This should lead to a favorable long-term secular growth trend in environmental services as a result of increasing demand from investors for environmentally and socially responsible investments.

We like Montrose's approach of targeting reasonably priced, technology-based acquisitions and growing the patent portfolio. Furthermore, the company has been innovative in developing solutions uniquely tailored to customer needs. We are impressed with the success that senior management has had over the past 4 – 5 years in growing the business organically and via acquisition and the consolidation opportunities given the size of the addressable market and Montrose's relatively modest size, appear compelling. That Montrose pays less than 7.0x EBITDA on average, and we expect the shares to trade at a multiple in excess of 10.0x implies immediate value creation via acquisition. We expect the acquisition engine to reaccelerate later this year once CTEH is digested.

We think Montrose can maintain a 5% + organic growth rate augmented by acquisition over the next 2 – 3 years, resulting in revenue growth of **10%-12%** and adjusted EBITDA growth in a **20%-25%** range. We see adjusted EBITDA of **~\$58m** in FY21 and **\$70m** in FY22 and therefore, at the mid-point of the proposed IPO pricing range, Montrose is valued at only **9.1x** our FY21 adjusted EBITDA estimate and **7.5x** our FY22 adjusted EBITDA estimate, well below the multiples ascribed to the peer group that we have assembled. However, we believe that with its impressive growth rate and singular focus on environmental services, that *Montrose deserves a premium valuation*, one closer to its higher valued peers. Therefore, we assign a valuation multiple above the mean, but at a slight discount to group leaders Tetra Tech (TTEK – NASDAQ) and Stericycle (SRCL – NASDAQ). We anticipate that Montrose's multiple will expand meaningfully over time and begin to reflect that of its peers as management delivers consistent performance over its first few quarters as a publicly traded entity. Our only concern with an investment in Montrose is its [classified] board. We believe that there should be more environmental, water, and earth sciences talent, fewer finance people, and more diversity. We plan to continue to make this clear to management. Therefore, our 12- to 18-month price target for MEG shares is **\$25.00 per share**, or approximately **13.5x** our adjusted FY21 EBITDA estimate, representing upside potential of **56%** from the mid-point of the proposed IPO pricing range and deserving of a **Strong BUY rating. We recommend participating in the IPO.**

Environmental Services Providers		FY	Share	52-wk	52-wk	Market	EV	FY2021	FY2022	FY2021	FY2022	FY2021	FY2022
		End	Price	High	Low	Cap. (\$M)	(\$M)	Rev (\$M)	Rev (\$M)	EBITDA	EBITDA	EV/EBITDA	EV/EBITDA
Service Corporation International	SCI	Dec	\$38.35	\$52.83	\$34.71	\$6,685.7	\$10,220.9	\$3,279.8	\$3,447.7	\$903.44	\$1,001.28	11.3x	10.2x
AECOM	ACM	Sep	\$37.37	\$51.92	\$23.82	\$5,796.7	\$8,019.6	\$6,181.8	\$6,420.0	\$766.54	\$828.69	10.5x	9.7x
Stericycle, Inc.	SRCL	Dec	\$56.94	\$66.05	\$40.69	\$5,081.0	\$8,197.9	\$2,726.1	\$2,933.1	\$492.93	\$588.95	16.6x	13.9x
Tetra Tech, Inc.	TTEK	Sep	\$81.26	\$98.26	\$65.94	\$4,231.9	\$4,883.7	\$2,401.8	\$2,565.0	\$272.37	\$287.60	17.9x	17.0x
Evoqua Water Technologies Corp	AQUA	Sep	\$19.88	\$25.13	\$8.21	\$2,241.2	\$3,172.5	\$1,437.9	\$1,507.7	\$234.49	\$254.51	13.5x	12.5x
US Ecology, Inc.	ECOL	Dec	\$32.72	\$66.54	\$25.53	\$1,013.8	\$1,859.1	\$1,025.9	\$1,083.7	\$212.85	\$246.68	8.7x	7.5x
NV5 Global Inc	NVEE	Dec	\$52.00	\$85.34	\$29.14	\$647.6	\$1,041.1	\$700.8	\$767.2	\$101.29	\$122.90	10.3x	8.5x
							\$3,671.1	\$5,342.1			12.70x	11.32x	

Valuation Matrix

(Share Price)

FY21	EV/EBITDA Multiple			
EBITDA	13.0x	13.5x	14.0x	14.5x
\$55	\$22.09	\$23.22	\$24.34	\$25.47
\$58	\$23.63	\$24.82	\$26.00	\$27.18
\$61	\$25.17	\$26.41	\$27.66	\$28.90
\$64	\$26.79	\$28.09	\$29.40	\$30.70

(% Return from Mid-Point)

FY21	EV/EBITDA Multiple			
EBITDA	13.0x	13.5x	14.0x	14.5x
\$55	38.1%	45.1%	52.1%	59.2%
\$58	47.7%	55.1%	62.5%	69.9%
\$61	57.3%	65.1%	72.9%	80.6%
\$64	67.4%	75.6%	83.7%	91.9%

(Share Price)

FY22	EV/EBITDA Multiple			
EBITDA	13.0x	13.5x	14.0x	14.5x
\$66	\$27.94	\$29.29	\$30.64	\$31.99
\$70	\$29.79	\$31.21	\$32.63	\$34.05
\$73	\$31.63	\$33.13	\$34.62	\$36.11
\$77	\$33.57	\$35.14	\$36.71	\$38.27

(% Return from Mid-Point)

FY22	EV/EBITDA Multiple			
EBITDA	13.0x	13.5x	14.0x	14.5x
\$66	74.6%	83.1%	91.5%	99.9%
\$70	86.2%	95.1%	103.9%	112.8%
\$73	97.7%	107.0%	116.4%	125.7%
\$77	109.8%	119.6%	129.4%	139.2%