Gattaca plc

Getting its 'Mojo' back

8th November 2018

As with any walk of life, the occasional setback is inevitable when tackling complex new challenges. The key is recognising when difficulties arise, responding quickly, learning from the experience and ultimately reaching one's goals - perhaps via a different route. It's no different in the corporate world.

Indeed, Gattaca is the first to admit that in April 2015 it bit off more than it could chew with the £66.8m transformational acquisition of Networkers International (NI). Attempting in one fell swoop to expand outside of its UK engineering heartland. Only then to discover a catalogue of deep-rooted issues. Namely, NI's problematic Telco Infrastructure arm (eg Africa, Asia and Latin America), sub-scale operations (eg Singapore, Malaysia, Dubai & Qatar), extended customer payment terms and overseas withholding tax (WHT).

The Board fought tooth & nail to fix the problems, but after nearly 3 years of trying, decided enough was enough. And in early Feb'18 kicked-off a radical restructuring plan in order to right-size the ship. So 9 months' on, how are things progressing?

Stage 1: Stabilise and refocus the business

From this morning's FY18 prelims, the good news is that **the self-help measures are starting to bear fruit**. Sure there's still plenty to do, and most of the benefits (eg £3m of annualised savings) will be only fully realised in future periods.

However, overheads have been cut, headcount reduced (870 Jan vs 810 in July), underlying cashflow improved (y/e debtor days 52 vs 55 LY) and LFL NFI growth stabilised at +1% (see below). Moreover, apart from a temporary air-pocket in demand at Network Rail which hurt RSL (HS2, CP5, Crossrail winding down & Carillion), we understand UK Engineering's FY18 NFI would have actually been up 3.5%, rather than the 1.4% reported (see below).

Gattaca turn-around is taking shape

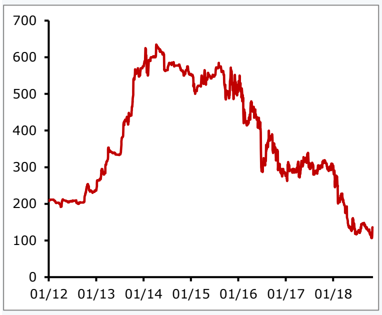
£'000s	Act FY17	Act H1	Act H2	Act FY18	Est FY19	Est FY20	Est FY21
UK Engineering	-3.0%	3.0%	-0.2%	1.4%	0.5%	3.0%	3.0%
UK Technology	-6.0%	-4.0%	-2.0%	-3.0%	0.0%	1.0%	4.0%
International	-4.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
Total underlying NFI	***-4.0%***	***2.0%***	***0.0%***	***1.0%***	***1.0%***	***2.8%***	***3.5%***
NFI	74,708	39,766	39,034	78,863	72,048	74,080	76,644
Adjusted EBIT	**17,388**	**7,728**	**6,554**	**14,282**	**13,090**	**14,004**	**14,725**
EBIT/NFI margin	*23.3%*	*19.4%*	*16.8%*	*18.1%*	*19.2%*	*19.5%*	*19.8%*
Underlying admin expenses	57,320	32,038	32,543	64,581	58,957	60,076	61,919
U/L admin as % NFI	76.7%	80.6%	83.4%	81.9%	81.8%	81.1%	80.8%
Adjusted EPS (diluted)	**33.7p**			**22.6p**	**23.1p**	**25.8p**	**28.7p**
Headcount	869	870		810			
Net debt : EBITDA	*2.20*			*2.67*	*2.91*	*2.36*	*1.85*
Net debt	**-40,288**	**-36,180**		**-40,874**	**-41,000**	**-35,348**	**-29,161**

Source: Equity Development. Q4'18 cashflow impacted by £3.55m payment for 30% RSL

Company Data

EPIC	AIM:GATC
Price (last close)	140p
52 week Hi / Lo	320p / 100p
Market cap	£46m
ED valuation / share	180p

Share Price, p



Source: Web Financial

Description

Gattaca (c.810 staff) is the UK's #1 specialist engineering (60% NFI) and #6 technology (21%) recruitment agency, providing contract, temporary and permanent staff (Source: Recruitment International). It derives 30% of NFI from overseas (including international placements supplied from the UK), and circa 72% from temps, with the remaining 28% coming from permanents.

The global engineering and technology recruitment markets are valued at circa $26bn and $57bn respectively (Source: Staffing Industry Analysts) – offering substantial long term potential.

Next news: AGM in December 2019

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On track to hit our FY19 forecasts

What's more, this has been achieved during a period of considerable change, and against a backdrop of slightly softer conditions across UK recruitment (*source: British Chambers of Commerce*), ahead of Britain's formal exit from the EU (ie BREXIT) in Mar'19.

Elsewhere, there was a shift in FY18 NFI between contractor (-5% LFL) vs permanent (+19%) placements - coming in at 72:28 vs 76:24 FY17, and mirroring the new public sector IR35 rules, buoyant conditions in the US and IT exclusivity agreements. For FY19, this mix should move further towards perms thanks to the withdrawal from Telecoms Infrastructure, partly offset by an increase in the North American contractor base.

Encouragingly too, despite the recent slump in UK car production (JLR, Michelin, Schaeffler, diesel, etc), **Q1 trading is consistent with <u>our</u> FY19 expectations** at the NFI, PBT and EPS levels.

So what's next?

Phase 2: Reduce borrowings

Well, the **medium-term priority is to reduce net debt to below 2x EBITDA**, compared to 2.7x in July and an estimated 2.9x in FY19. This will not just provide the Board will extra flexibility, but also eventually enable dividends (temporarily suspended) to resume. The pay-out policy being to distribute c.50% of statutory EPS over the economic cycle.

In parallel, **the Board reacted promptly in Mar'18 and renegotiated its banking arrangements with HSBC**, including a more generous covenant profile. As of Nov'18 the group had £90m of funding available (vs £50.6m utilised as at Jul'18) - consisting of a £75m working capital facility and a £15m term loan, both committed until October 2020. 90% of invoiced trade debtors can be drawn against the former.

Better still, **FY19 underlying cash generation should be positive**, boosted by working capital inflows from exiting Telco Infrastructure and continued tight cost control. Albeit equally offset by one-off restructuring costs (£4.5m) and further capex (£4m+ vs £2.7m LY) on IT systems. Consequently, **net debt is set to end the year flat at £41.0m vs £40.9m LY, but decline rapidly from FY20 onwards**.

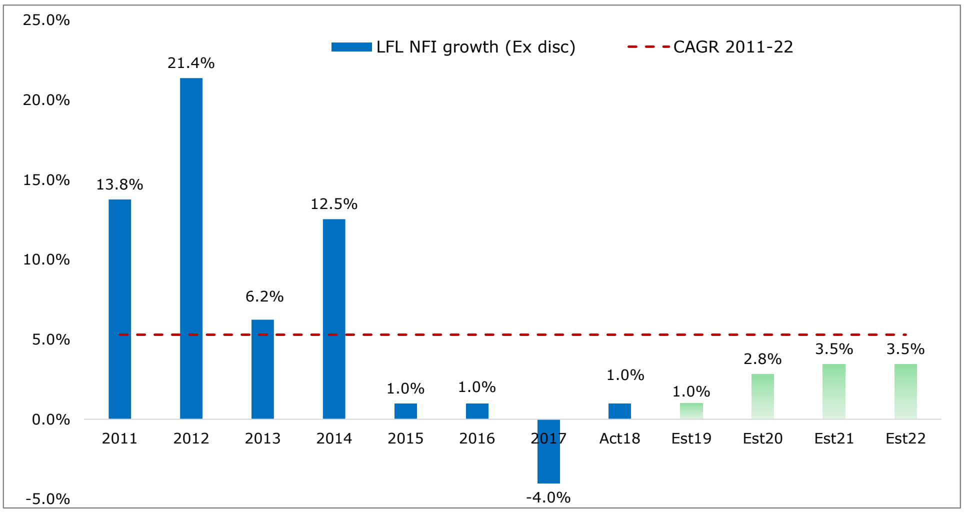
Step 3: Deliver sustainable profits growth

Big picture though, companies can't save themselves to prosperity forever. This is where we suspect new CEO Kevin Freeguard (joined 1st October) will have greatest benefit. Continuing the Board's work, re-energising the sales team, creating a high performance culture and crucially accelerating top line profitable growth.

In fact given his extensive leadership experience, we imagine Kevin is intending to review the entire group/industry in detail over the next 6 months. Possibly releasing his thoughts publicly on how best to position Gattaca going forward at the interims in April.

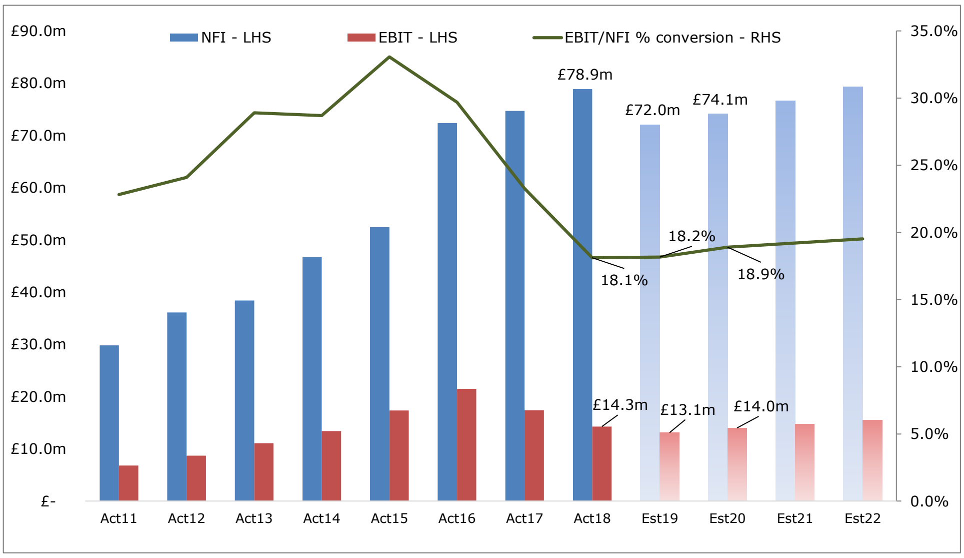
One area that is sure to be under the microscope is enhancing LFL NFI, since this used to be a major competitive advantage pre 2015, alongside the 25%+ EBIT/NFI conversion rates (see below).

Historical and projected LFI NFI growth



Source: Equity Development.

Financial projections

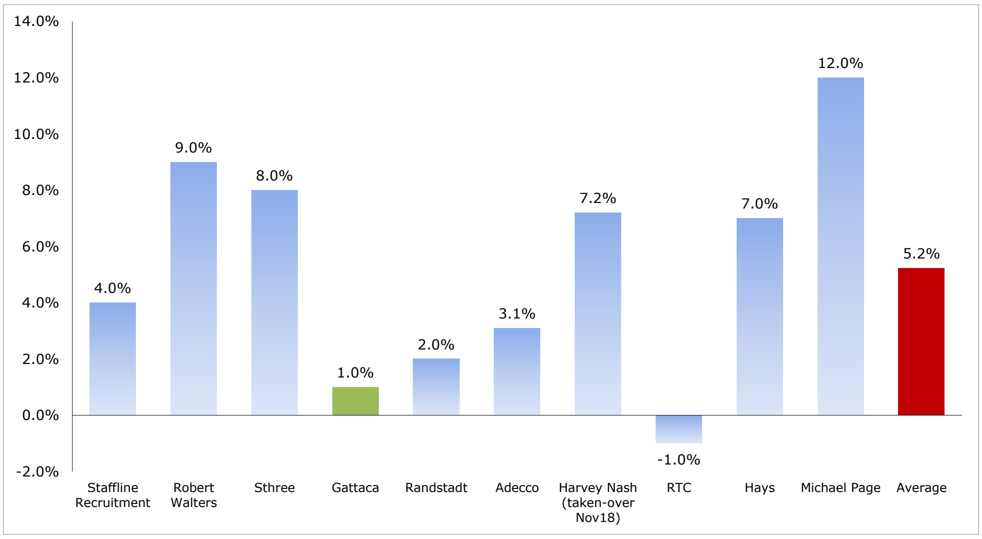


Source: Equity Development.

Substantial upside assuming things go to plan

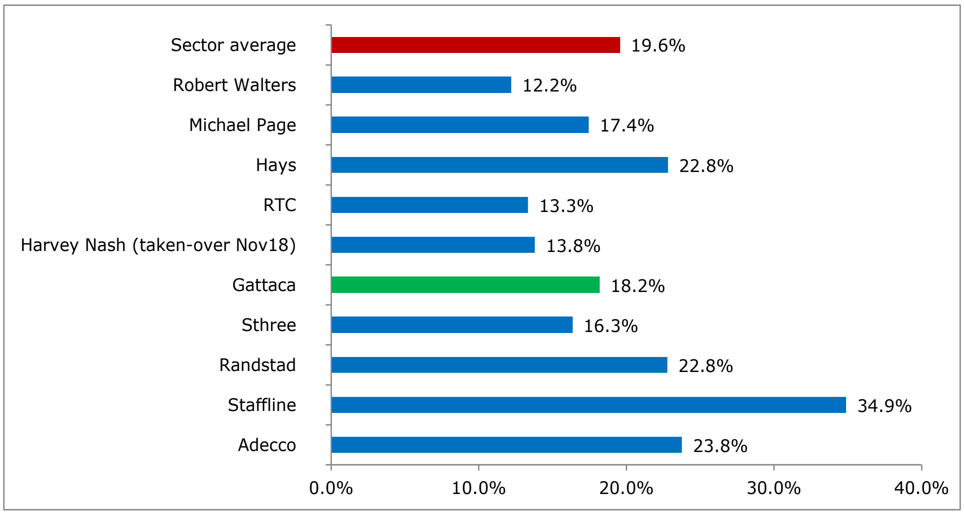
As you can tell, both KPIs have stalled over the past few years vs historical performance and peer averages (see below). Meaning that **there could be significant upside for patient investors**, if the desired turn-around is realised.

Current year (CY) / latest LFL NFI growth for recruitment sector



Source: Equity Development

CY EBIT conversion rates – sector



Source: Equity Development.

Cutting to the bone, but not into it

Additionally, a lot of heavy lifting has already been achieved since Feb'18, not least:

- Reducing headcount by 60 to 810 from 870 in Jan'18 (869 Jul'17), with NFI/fee-earner improving from £124.3k in FY17 to £126.1k. More is anticipated in FY19, particularly from productivity (Bullhorn CRM implementation) and back office consolidation.
- Closure of international offices in Malaysia, Dubai & Qatar in Sept, on top of those located at Munich (Germany) and Singapore during H1.
- Exiting the Telco Infrastructure contractor business in Asia, Africa & Latin America, accompanied by a £33.3m goodwill impairment of Networkers International.

- Investing in Americas, where FY18 NFI jumped 28%, augmented by the Sept'18 opening of a new Atlanta (Georgia) site, alongside existing offices in Dallas (Texas), Canada and Mexico. Looking ahead the Board are hoping to replicate similar success in China (+6% LY).
- Continued growth in Engineering Technology (+19% NFI) and Solutions (+8%), with the latter representing 22% of NFI
- Closure of Bromley (Kent) at end of October, whilst also centralising the UK finance, legal and HR functions into Whiteley, and re-orientating marketing towards revenue-generating client-related activities.
- Refocusing on key performance drivers, such as NFI per £ of sales cost (FY18 1.69 vs 1.80 FY17), and EBIT/NFI conversion (FY18 18.1% vs 23.3% FY17).

Expanding in the most attractive areas

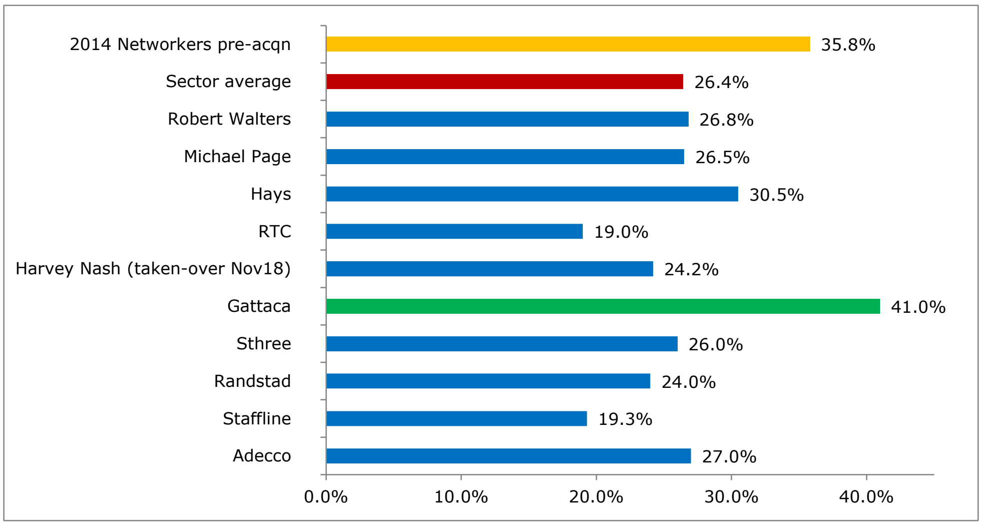
Altogether, the rationalisation programme has generated £3m of annualised savings to date, with the ***modus operandi*** being that **all sites must deliver "*significant, scalable and sustainable*" profits**.

Indicating to us (& to its credit) that the firm has learnt from past mistakes, but sensibly not battened down the hatches so tightly that risk taking is stifled. No, instead the Board appear to have cherry picked what works, cut those that don't, and importantly expand in areas which deliver returns above the group's cost of capital. **Simplicity personified**.

Scope to improve tax efficiency

Below the line too, there is opportunity. The FY18 effective tax rate came in at a hefty 41% vs 31% LY and 26.4% for the sector (see below). CFO Salar Farzad adding that regardless of the expected YoY dip in EBIT, "***PAT [should] be broadly neutral***," thanks to "*a* ***significant reduction in non-recoverable WHT****, as a result of the withdrawal from the Telecoms Infrastructure markets in Africa, Asia and Latin America*."

Effective tax rates across recruitment sector



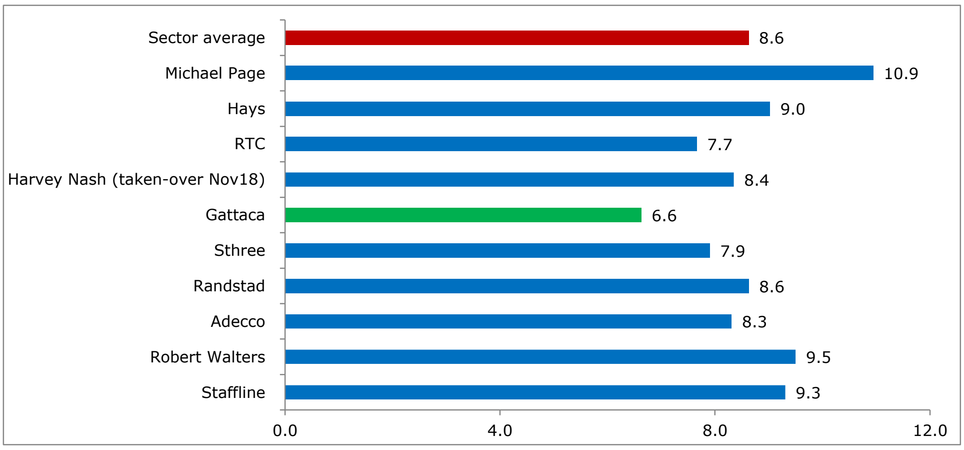
Source: Equity Development

Reiterate our 180p/share valuation

Lastly, in light of the improving outlook, **our FY19 NFI, PBT and adjusted EPS** (diluted) **forecasts** have been broadly held **at £72.0m** (vs £72.1m before), **£10.9m** (£10.9m) **and 23.1p** (24.5p) respectively.

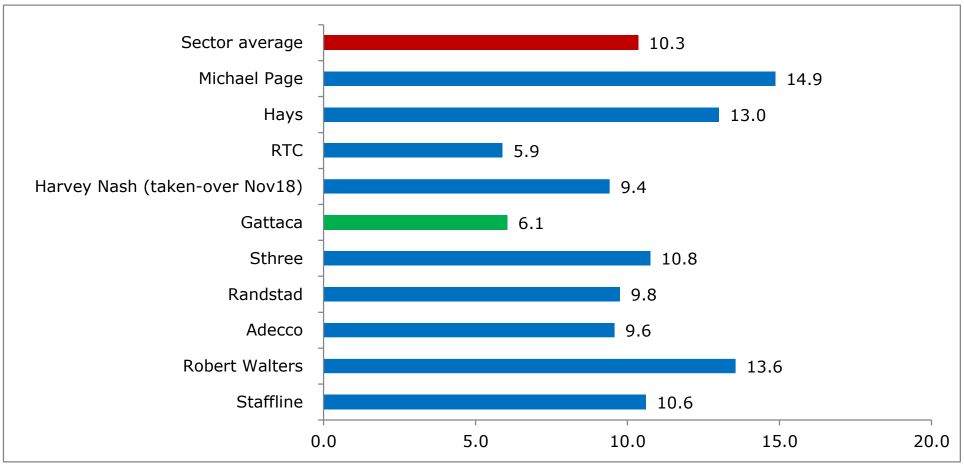
Similarly, **the 180p/share valuation has been retained** – with the **stock at 140p** trading on modest FY19 EV/EBIT and PER multiples of 6.6x and 6.1x respectively vs 8.6x and 10.3x for the sector.

Current Year EV/EBIT ratios – sector



Source: Equity Development. Prices as per 7th November 2018

Current Year P/E ratios – sector



Source: Equity Development. Prices as per 7th November 2018

Further out, prospects look even brighter with **Gattaca's STEM expertise set up to benefit from rising global spend on infrastructure** (Heathrow, Hinkley Point, Crossrail 2, HS2, rail electrification, smart cities), **engineering and technology** (eg Cyber security, IoT, Cloud, 5G, autonomous vehicles), augmented by X-selling synergies, expansion abroad and the ongoing adoption of IT/Telecoms within its other key verticals of Automotive, Aerospace, Defense, Energy and Maritime.

Long-term fundamentals are robust

Patrick Shanley, Chairman commenting "***since February, we have acted to stabilise our business and focus our resources on areas which offer significant, scalable and sustainable profit potential in the near term****. UK Engineering and IT have shown growth and resilience, to add to an excellent performance in the Americas. We are continuing with this phase of our stabilisation, which will reset the business on a much firmer footing. On this,* ***our new CEO, management team and our industry leading staff will create the next chapter in the Group's success***.

The uncertainty surrounding Brexit continues to affect nearly all our markets, prompting close discussions with our key customers. Their concerns are on the impact new custom arrangements will have on their ability to import and export, and the availability of skilled labour in the market place. We are well placed to help our customers attract the key skills they need, but are reliant on the UK Government reaching agreement with the EU on customs arrangements."

*Kevin Freeguard, CEO concluding "****I am pleased to see the progress that has been made during H2'18, and I am looking forward to developing the business further with the Board and the rest of the Gattaca team****".*

Summary financials

Gattaca (continuing operations) (July yearend)	**2014 Act £'000s**	**2015 Act £'000s**	**2016 Act £'000s**	**2017 Act £'000s**	**2018 Act £'000s**	**2019 Est £'000s**	**2020 Est £'000s**	**2021 Est £'000s**	**2022 Est £'000s**	**2023 Est £'000s**
Net Fee Income (NFI) : Gross profit										
UK Engineering	27,077	37,853	40,865	43,080	47,567	47,805	49,239	50,716	52,238	53,805
UK Technology	17,905	14,605	17,413	16,178	16,599	15,351	15,505	16,125	16,770	17,441
International			14,109	15,450	14,697	8,892	9,336	9,803	10,293	10,808
Total	**44,982**	**52,458**	**72,387**	**74,708**	**78,863**	**72,048**	**74,080**	**76,644**	**79,301**	**82,053**
NFI growth rate										
UK Engineering	*13.2%*	*39.8%*	*8.0%*	*5.4%*	*10.4%*	*0.5%*	*3.0%*	*3.0%*	*3.0%*	*3.0%*
UK Technology	*23.9%*	*-18.4%*	*19.2%*	*-7.1%*	*2.6%*	*-7.5%*	*1.0%*	*4.0%*	*4.0%*	*4.0%*
International				*9.5%*	*-4.9%*	*-39.5%*	*5.0%*	*5.0%*	*5.0%*	*5.0%*
Total NFI growth rate	***17.2%***	***16.6%***	***38.0%***	***3.2%***	***5.6%***	***-8.6%***	***2.8%***	***3.5%***	***3.5%***	***3.5%***
EBITDA	***14,343***	***18,363***	**22,617**	**18,284**	**15,309**	**14,068**	**15,007**	**15,762**	**16,551**	**17,377**
UK Engineering	10,548	13,105	23,126	23,758	26,033	24,375	25,369	26,187	27,030	27,898
UK Technology	3,073	4,242	8,229	7,061	7,617	7,522	7,752	8,224	8,720	9,244
International			6,868	5,619	4,814	3,912	4,201	4,411	4,632	4,864
Central overheads			-16,726	-19,050	-24,182	-22,719	-23,319	-24,098	-24,903	-25,736
Adjusted EBIT	**13,621**	**17,347**	**21,497**	**17,388**	**14,282**	**13,090**	**14,004**	**14,725**	**15,480**	**16,270**
Total Opex as % NFI	*-69.7%*	*-66.9%*	*-70.3%*	*-76.7%*	*-81.9%*	*-81.8%*	*-81.1%*	*-80.8%*	*-80.5%*	*-80.2%*
EBIT / NFI margin	*30.3%*	*33.1%*	*29.7%*	*23.3%*	*18.1%*	*18.2%*	*18.9%*	*19.2%*	*19.5%*	*19.8%*
Net interest	-1,015	-1,074	-1,076	-1,232	-1,540	-2,200	-2,200	-2,000	-1,800	-1,600
Adjusted PBT	**12,606**	**16,273**	**20,421**	**16,156**	**12,742**	**10,890**	**11,804**	**12,725**	**13,680**	**14,670**
Adjusted diluted EPS (p)	**37.1**	**43.8**	**44.1**	**33.7**	**22.6**	**23.1**	**25.8**	**28.7**	**30.7**	**32.7**
Adjusted EPS growth rate	*17.5%*	*18.2%*	*0.5%*	*-23.6%*	*-33.0%*	*2.6%*	*11.7%*	*11.0%*	*7.0%*	*6.7%*
Dividend (p)	**20.0**	**22.0**	**23.0**	**23.0**	**3.0**	**0.0**	**0.0**	**0.0**	**15.3**	**16.4**
Dividend yield	*14.3%*	*15.7%*	*16.4%*	*16.4%*	*2.1%*	*0.0%*	*0.0%*	*0.0%*	*11.0%*	*11.7%*
Dividend cover	*1.9*	*2.0*	*1.9*	*1.5*	*7.5*					
Valuation benchmarks										
P/E ratio (diluted)	*3.8*	*3.2*	*3.2*	*4.2*	*6.2*	*6.1*	*5.4*	*4.9*	*4.6*	*4.3*
EV/NFI	*1.9*	*1.7*	*1.2*	*1.2*	*1.1*	*1.2*	*1.2*	*1.1*	*1.1*	*1.1*
EV/EBITA (diluted)	*6.4*	*5.0*	*4.0*	*5.0*	*6.1*	*6.6*	*6.2*	*5.9*	*5.6*	*5.3*
PEG ratio	*0.22*	*0.18*	*6.10*	*-0.18*	*-0.19*	*2.37*	*0.46*	*0.44*	*0.65*	*0.64*
Adjusted corporate tax rate	*-23.3%*	*-14.5%*	*-30.9%*	*-31.4%*	*-41.0%*	*-30.0%*	*-27.5%*	*-25.0%*	*-25.0%*	*-25.0%*
Adj ROACE	*30.6%*	*21.5%*	*19.7%*	*15.6%*	*15.1%*	*16.3%*	*15.8%*	*15.1%*	*14.7%*	*14.7%*
EBITDA drop through rate as % NFI	*48.9%*	*53.8%*	*21.3%*	*-186.7%*	*-71.6%*	*18.2%*	*46.2%*	*29.4%*	*29.7%*	*30.0%*
Cash conversion (EBITDA - Capex - W/Cap)/EBIT	*103%*	*109%*	*93%*	*63%*	*111%*	*96%*	*79%*	*77%*	*78%*	*78%*
Unlevered/adj. free cashflow yield	6.3%	18.9%	18.1%	7.7%	6.9%	10.7%	9.0%	9.4%	9.9%	10.4%
Net cash/(debt)	**-3,109**	**-33,644**	**-25,013**	**-40,288**	**-40,874**	**-41,000**	**-35,348**	**-29,161**	**-27,401**	**-25,381**
Net debt : EBITDA	*0.22*	*1.83*	*1.11*	*2.20*	*2.67*	*2.91*	*2.36*	*1.85*	*1.66*	*1.46*
Diluted sharecount (Adj for 2015)	*26,073*	*31,730*	*32,040*	*32,392*	*32,120*	*32,956*	*33,117*	*33,280*	*33,443*	*33,607*
Shareprice (p)	***140***									

Source: Equity Development estimates

Key risks

- Economic downturn affecting engineering and technology recruitment. For example, Brexit could negatively impact confidence and UK GDP.
- In the Oct'18 budget, the Chancellor stated the Government's intention to extend the IR35 rules to the private sector (re self-employed persons) in April 2020, following the 2017 implementation in the public sector.
- Greater competition, especially from new technology platforms (eg LinkedIn, Monster).
- Overseas expansion along with foreign exchange fluctuations.
- Reduction in financial gearing, given FY19 net debt:EBITDA is forecast to be circa 2.9x as at July 2019.
- Consolidation of customer base.
- Political interference which could impact UK infrastructure spend (eg cancellation of rail electrification projects).

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