

Tough 1st half due to challenging conditions

29th January 2020

Let's make no bones about it, the UK recruitment sector has been hit by a 'perfect storm' over the past 6 months. Brexit, a snap General Election, delays to major infrastructure projects (eg HS2), falling car sales, a manufacturing recession and lower aerospace orders, reflecting the temporary halt in production of the Boeing 737 MAX.

In fact, we heard as much on Monday, when STEM rival SThree warned that UK NFI had dropped -11% in the quarter ending Nov'19. Similarly today, Gattaca reported that its **UK NFI had declined -11% for the 5 months to Dec'19**, and now anticipates **FY20 adjusted PBT to come in at c. £6m** vs consensus of £10m.

Adding that "**the market has not recovered as quickly as expected and short-term growth remains uncertain, despite the decisive result in December's General Election. The timing of UK investment in major infrastructure projects is still not clear and certain manufacturing, automotive and rail [re start of CP6] sectors continue to be impacted by a lack of confidence. In addition, there is continued uncertainty surrounding IR35**, [which is scheduled to go-live on 6th Apr'20 for private businesses employing 50 or more staff, & with >£10.2 turnover]."

Company Data

EPIC	AIM:GATC
Price (last close)	105p
52 week Hi / Lo	165p/105p
Market cap	£33.9m
Est net debt July'20	£25.0m
Share count	32.3m
ED valuation / share	135p

Share Price, p



Source: Share Cast

Description

Gattaca is the UK's #1 specialist engineering (70% NFI) recruitment agency, providing contract, temporary and permanent staff (Source: Recruitment International). It derives 13.6% of NFI from overseas, with the remainder coming from UK Technology (16.4%) – overall split 69.8% contractors and 30.2% permanents.

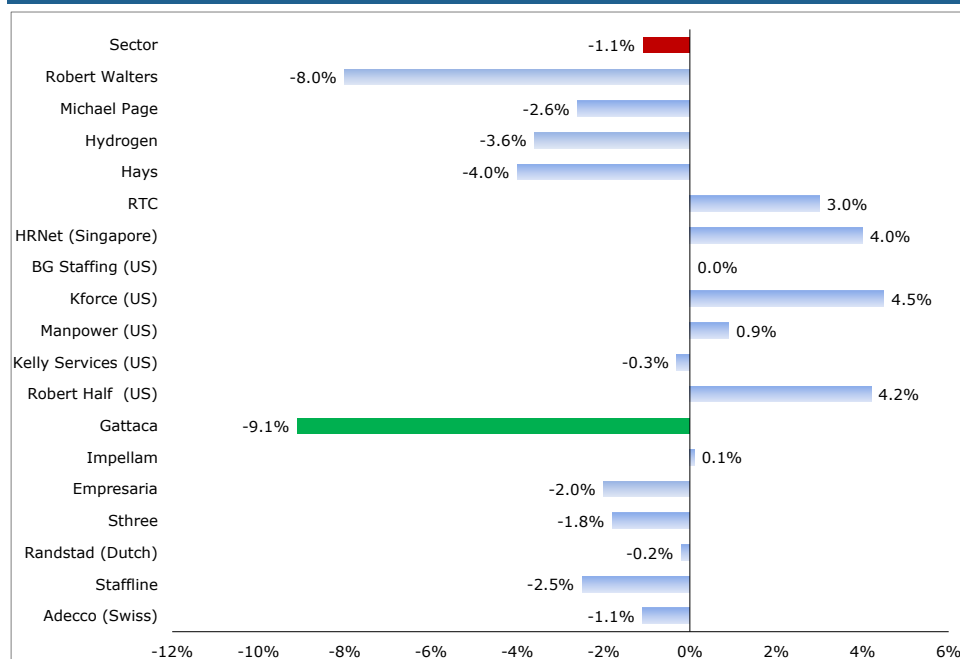
The global engineering and technology recruitment markets are valued at circa \$26bn and \$57bn respectively (Source: Staffing Industry Analysts) – offering substantial long term potential.

Next news: Interims 31st March

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Forecast / latest LFL NFI growth



Source: Equity Development.

Time to be patient

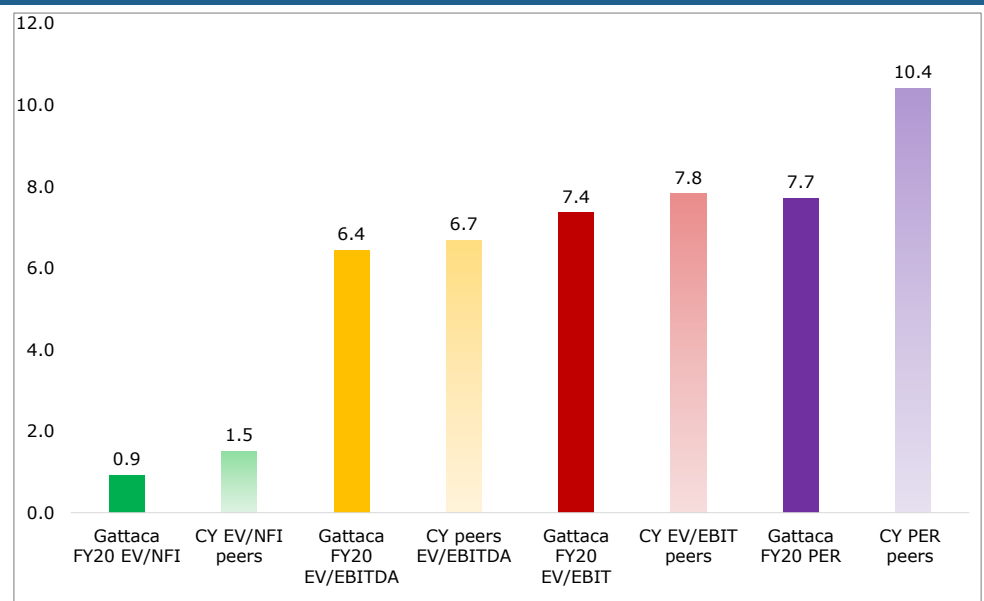
Clearly this is disappointing, however it's not all bad news. Firstly, the lower activity levels mean there is likely to be a **working capital unwind** this year, which we reckon will reduce FY20 net debt to £25m (or 2.7x EBITDA) vs £30m before. Next, **additional cost & cash savings are being considered** that would also hold the group in good stead, once this mini Cat-1 squall has blown itself out. While in the meantime, we understand Gattaca should remain comfortably within all its agreed banking covenants.

Ok, but how does this affect the numbers?

Well in line with the guidance, we've cut our **FY20 adjusted PBT estimates to £6m**, but suspect there could be a more favourable macro backdrop in H2 (re UK infrastructure spend, C-suite confidence, etc), and see some scope for upgrades as the period progresses. Further out, we think **conditions should improve again in FY21**, with PBT forecast to climb to £10m and net debt closing at £19.4m (1.5x EBITDA).

Equally, notwithstanding **a reset in the valuation from 160p to 135p/share**, we still believe there is considerable upside, with the stock (at 105p) **trading on a 'trough' PER of 7.7x** vs 10.4 peers (see below). Indeed using a 7x FY22 EV/EBIT multiple instead, this would translate into a hypothetical price of 200p in 2-3 years' time.

FY20 valuation benchmarks vs peers



Source: Equity Development

CEO Kevin Freeguard commenting **"The Board remains confident that the actions the Company has been taking, including the implementation of our ongoing Improvement Plan, will position Gattaca well for growth when market conditions improve. Nevertheless, in the short term, costs will be kept under close review."**

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) on 6th 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.
- Continued reduction in financial gearing, and consolidation of customer base.
- Political interference which could impact UK infrastructure spend (eg cancellation of rail electrification projects).
- Gattaca is presently assisting the US Department of Justice in their enquiries about an article published by Reuters in Feb'19 regarding Chinese Telco equipment manufacturer Huawei, and separately referencing Networkers International. It is not possible at this stage to determine what the conclusion of the DoJ's work will be.

Summary financials (pre IFRS 16)

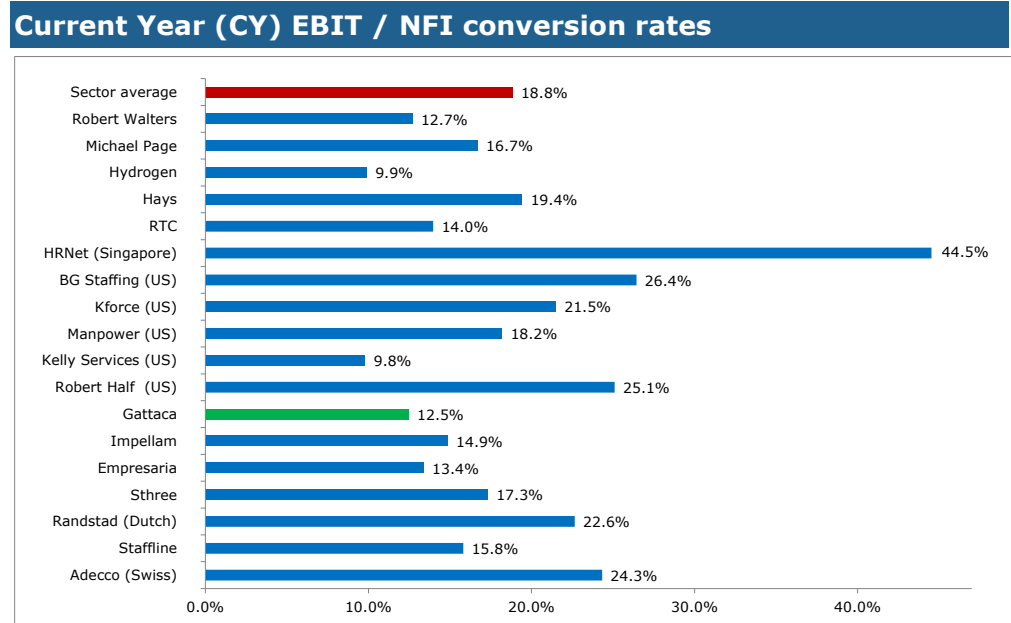
Gattaca (continuing operations) (July yearend)	2016 Act £'000s	2017 Act £'000s	2018 Act £'000s	2019 Act £'000s	2020 Est £'000s	2021 Est £'000s	2022 Est £'000s	2023 Est £'000s	2024 Est £'000s
Net Fee Income (NFI) : Gross profit			<i>Restated</i>	<i>Pre IFRS16</i>					
UK Engineering	40,865	43,080	47,568	49,442	44,003	47,084	48,967	50,926	52,963
UK Technology	17,413	16,178	14,457	11,575	10,302	10,508	10,823	11,148	11,482
International	14,109	15,450	9,374	9,570	9,857	10,843	11,710	12,647	13,659
Total	72,387	74,708	71,399	70,587	64,162	68,434	71,500	74,720	78,104
NFI growth rate									
UK Engineering	8.0%	5.4%	10.4%	3.9%	-11.0%	7.0%	4.0%	4.0%	4.0%
UK Technology	19.2%	-7.1%	-10.6%	-19.9%	-11.0%	2.0%	3.0%	3.0%	3.0%
International		9.5%	-39.3%	2.1%	3.0%	10.0%	8.0%	8.0%	8.0%
Total NFI growth rate	38.0%	3.2%	-4.4%	-1.1%	-9.1%	6.7%	4.5%	4.5%	4.5%
EBITDA	22,617	18,284	13,395	14,600	9,138	12,981	13,944	14,869	15,599
UK Engineering	23,126	23,758	26,033	27,489	22,112	24,954	25,952	26,991	28,070
UK Technology	8,229	7,061	6,610	5,902	4,713	5,254	5,412	5,574	5,741
International	6,868	5,619	2,723	1,820	2,390	3,253	3,864	4,426	4,781
Central overheads	-16,726	-19,050	-22,964	-21,818	-21,215	-21,661	-22,511	-23,397	-24,318
Adjusted EBIT	21,497	17,388	12,402	13,393	8,000	11,800	12,717	13,594	14,273
Total Opex as % NFI	-70.3%	-76.7%	-82.6%	-81.0%	-87.5%	-82.8%	-82.2%	-81.8%	-81.7%
EBIT / NFI margin	29.7%	23.3%	17.4%	19.0%	12.5%	17.2%	17.8%	18.2%	18.3%
Net interest	-1,076	-1,232	-1,540	-2,033	-2,000	-1,800	-1,600	-1,400	-1,200
Adjusted PBT	20,421	16,156	10,862	11,360	6,000	10,000	11,117	12,194	13,073
Tax	-6,306	-5,076	-3,380	-2,501	-1,470	-2,400	-2,668	-2,927	-3,138
Minorities	0	-172	-275	0	0	0	0	0	0
Adjusted PAT	14,115	10,908	7,207	8,859	4,530	7,600	8,449	9,267	9,936
Adjusted diluted EPS (p)	44.1	33.7	22.5	26.7	13.6	22.7	25.1	27.4	29.2
Adjusted EPS growth rate	0.5%	-23.6%	-33.3%	19.0%	-49.1%	67.0%	10.6%	9.2%	6.7%
Dividend (p)	23.0	23.0	3.0	0.0	0.0	0.0	12.6	13.7	14.6
Dividend yield	21.9%	21.9%	2.9%	0.0%	0.0%	0.0%	12.0%	13.1%	13.9%
Dividend cover	1.9	1.5	7.5				2.0	2.0	2.0
Valuation benchmarks									
P/E ratio (diluted)	2.4	3.1	4.7	3.9	7.7	4.6	4.2	3.8	3.6
EV/NFI	0.81	0.79	0.82	0.83	0.92	0.86	0.82	0.79	0.75
EV/EBITA (diluted)	2.7	3.4	4.7	4.4	7.4	5.0	4.6	4.3	4.1
PEG ratio	4.58	-0.13	-0.14	0.21	-0.16	0.07	0.39	0.42	0.54
Adjusted corporate tax rate	-30.9%	-31.4%	-31.1%	-22.0%	-24.5%	-24.0%	-24.0%	-24.0%	-24.0%
Adj ROACE	19.7%	15.6%	13.1%	18.1%	10.8%	14.8%	14.8%	15.0%	15.0%
EBITDA drop through rate as % NFI	21.3%	-186.7%	147.7%			90.0%	31.4%	28.7%	21.6%
Cash conversion (EBITDA - Capex - W/Cap)/EBIT	93%	63%	128%	170%	12%	83%	83%	84%	84%
Unlevered/adj. free cashflow yield	26.7%	11.3%	13.0%	34.4%	-0.9%	12.6%	13.4%	14.3%	15.0%
Net cash/(debt)	-25,013	-40,288	-40,874	-24,822	-25,000	-19,407	-17,223	-14,705	-11,936
Net debt : EBITDA	1.1	2.2	3.1	1.7	2.7	1.5	1.2	1.0	0.8
Diluted sharecount (Adj for 2015)	32,040	32,392	32,079	33,144	33,323	33,486	33,649	33,813	33,977
Shareprice (p)	105								

Source: Equity Development estimates, Company historic data

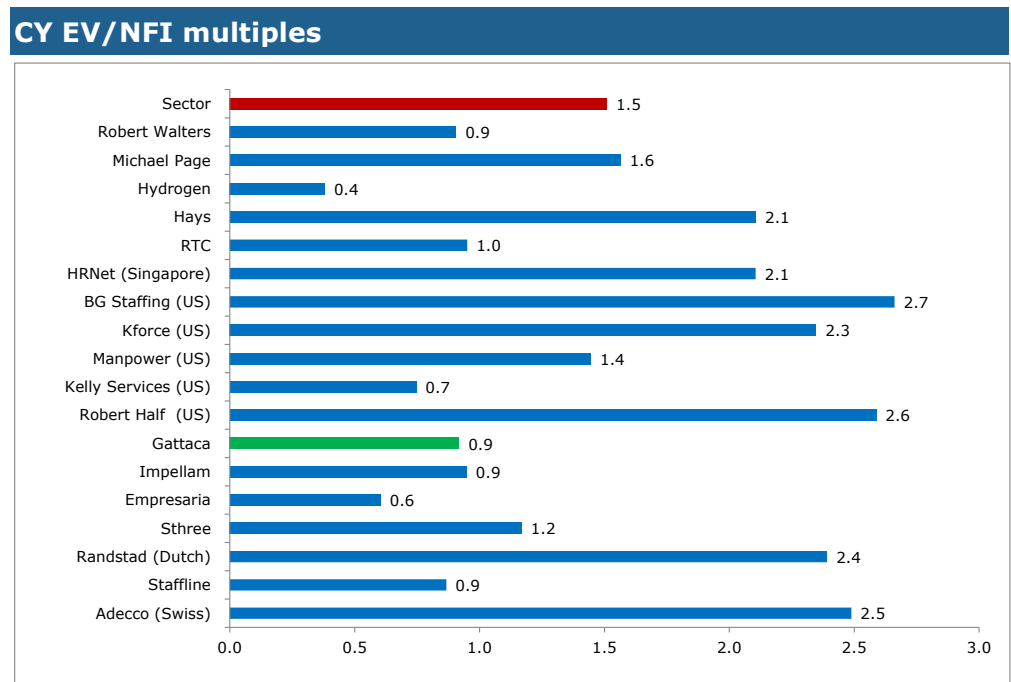
Note 1: Our financial projections and valuation do not factor in any possible future DOJ redress and/or fines.

Note 2: Effect of IFRS 16 (ie from Aug'19 onwards). FY20 adjusted PAT is not expected to be impacted materially, although FY19 results, EBITDA would have risen £2.3m and finance costs by £0.2m, as operating leases are replaced by depreciation and interest expense.

Appendices - sector valuation metrics and KPIs

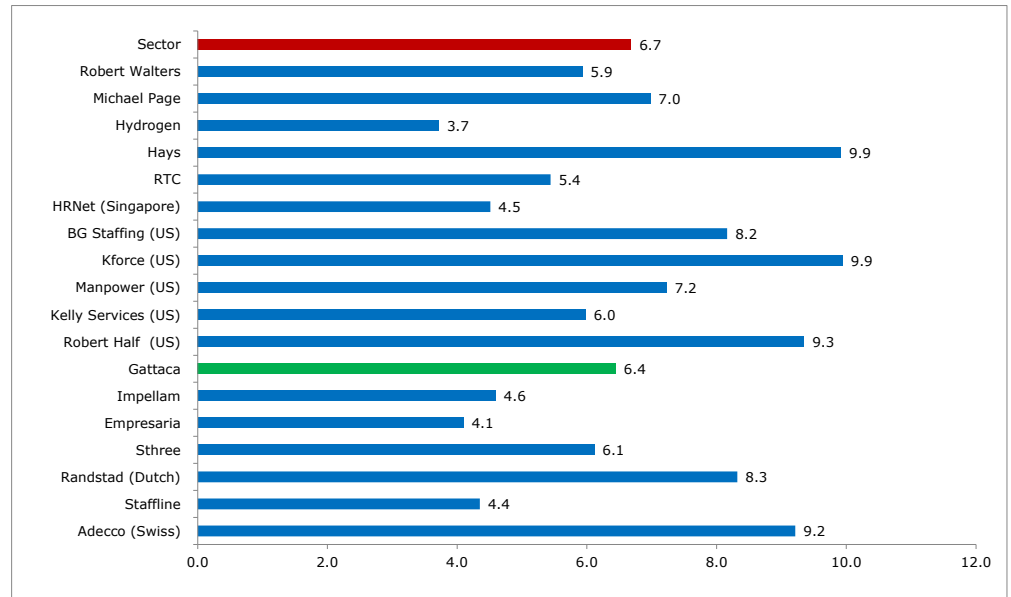


Source: Equity Development: arithmetic average for sector. CY = FY20 for Gattaca



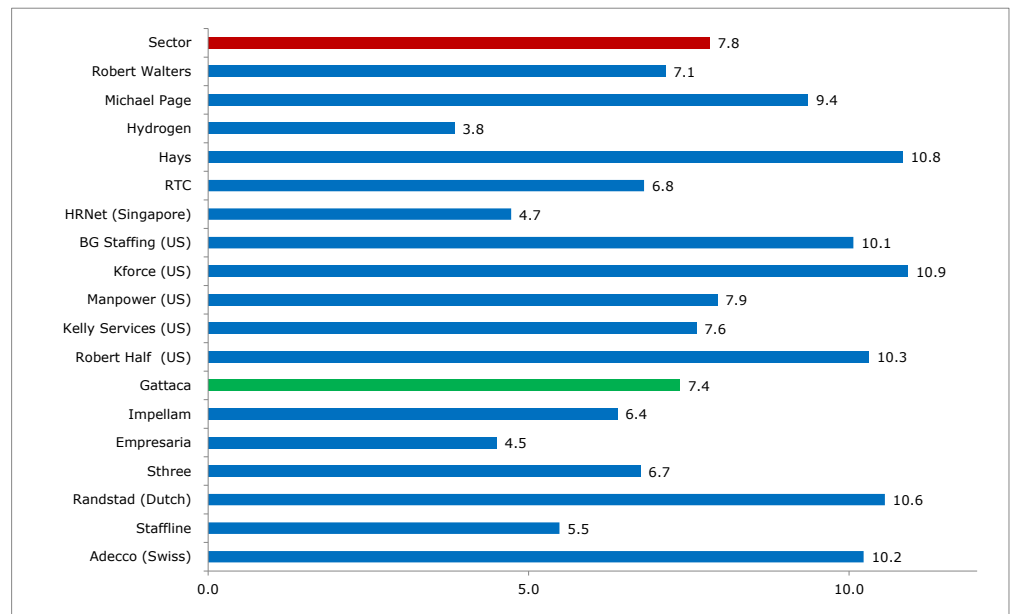
Source: Equity Development : arithmetic average for sector

CY EV/EBITDA multiples



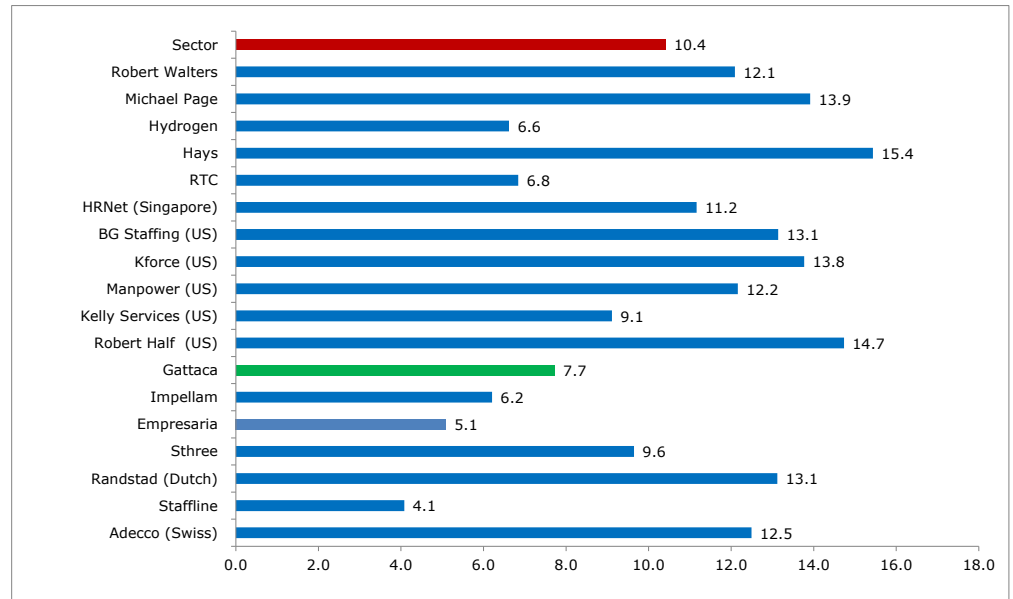
Source: Equity Development : arithmetic average for sector

CY EV/EBIT multiples vs peers



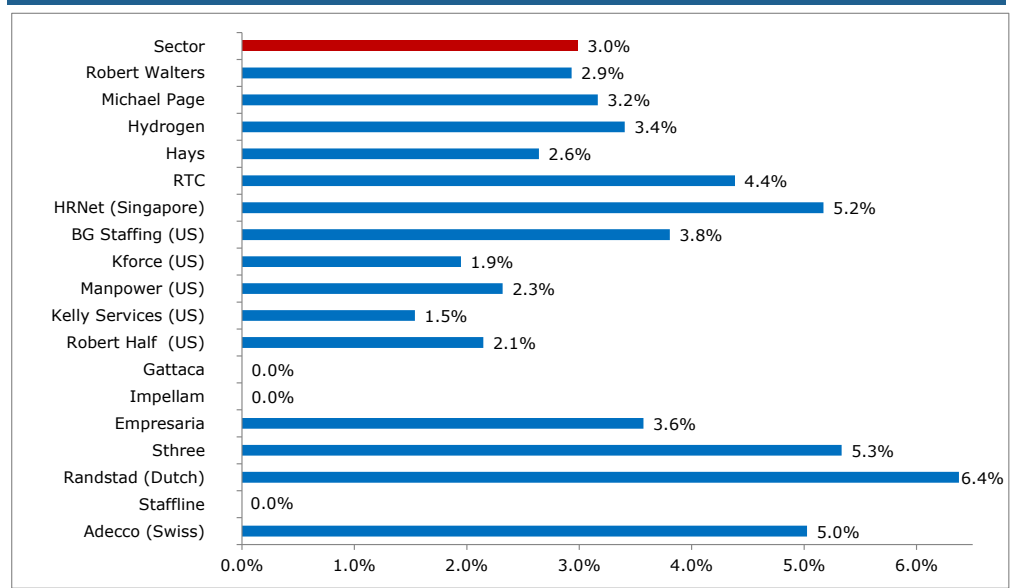
Source: Equity Development : arithmetic average for sector

CY PER multiples



Source: Equity Development : arithmetic average for sector

CY dividend yield



Source: Equity Development : arithmetic average for sector

Sector market capitalisations

	Shareprice	Mrk Cap (Millions)	CY net cash / (debt) Millions	Enterprise Value (Millions)
Adecco (Swiss)	€ 52.73	€ 9,312	-€ 1,439	€ 10,751
Staffline	80p	£55.1	-£54.5	£109.6
Randstad (Dutch)	€ 53.00	€ 9,805	-€ 1,451	€ 11,256
Sthree	300p	£403.2	£10.6	£392.6
Empresaria	56p	£27.5	-£18.0	£45.5
Impellam	355p	£172.2	-£90.2	£262.4
Gattaca	105p	£33.9	-£25.0	£58.9
Robert Half (US)	\$61.00	\$7,015	\$312	\$6,703
Kelly Services (US)	\$19.50	\$764	\$5	\$759
Manpower (US)	\$94.00	\$5,546	-\$223	\$5,769
Kforce (US)	\$38.00	\$885	-\$24	\$910
BG Staffing (US)	\$20.50	\$212	-\$17	\$229
HRNet (Singapore)	\$0.58	\$584	\$275	\$309
RTC	65p	£9.6	-£4.0	£13.6
Hays	159p	£2,465	£15	£2,450
Hydrogen	47p	£16.0	£4.5	£11.5
Michael Page	455p	£1,456	£93	£1,363
Robert Walters	590p	£448.4	£78.9	£369.5

Source: Equity Development



Investor Access

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