

Beating profit and cashflow expectations

6th August 2019

The recruitment sector is at the sharp end of the economy. Indeed it's one of the best gauges of GDP – providing a window into future business investment, right at the coal-face. The difficulty however for investors, is deciding which staffers will be the winners in today's more challenging environment.

To us, the key differentiator is vertical market focus. Concentrating on those disciplines that are enjoying secular growth, such as STEM, cyber-security, Big Data & Artificial Intelligence. As opposed to those being buffeted by macro headwinds, namely manufacturing, physical retail, capital goods & London's financial district.

UK Engineering powering ahead 7% in H2'19

One stock that fits the bill is Gattaca, underpinned by its **leading UK engineering operation (70% NFI)**. Here **FY19 NFI climbed 5% LFL (7% H2 vs 4% H1, +1% LY & -3% FY17) to £50.0m (£47.5m LY)**, thanks to **robust demand for its Solutions, Engineering Technology and Infrastructure services**, especially permanent placements. Implying too that it is not only **increasing share**, but also **poised to regain its top tier status**.

Company Data

EPIC	AIM:GATC
Price (last close)	150p
52 week Hi / Lo	167p / 103p
Market cap	£48.4m
Net debt July 2019	£25.0m
Share count	32.3m
ED valuation / share	200p

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% of NFI from overseas, with the remainder coming from UK Technology (17%) – overall split 70% contractors and 30% permanents.

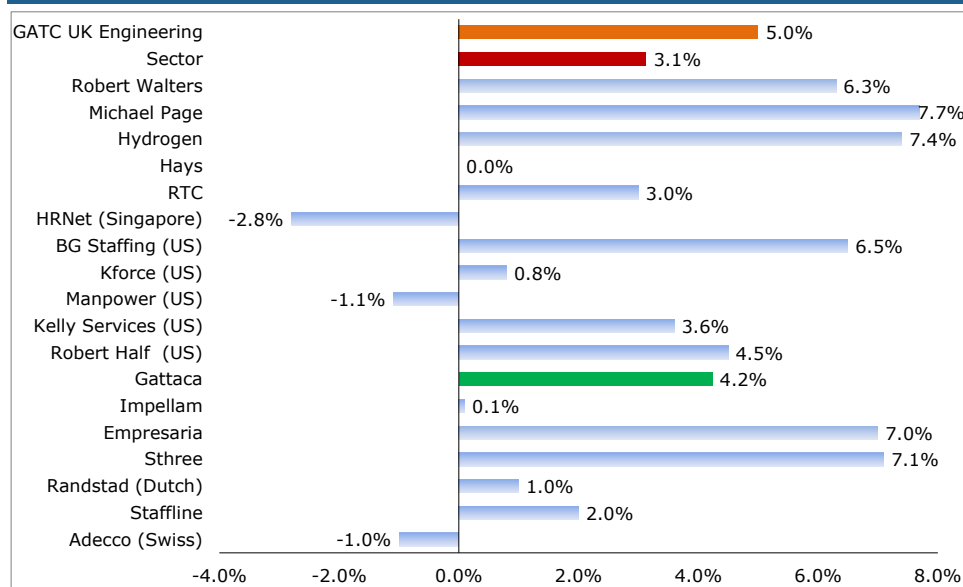
The global engineering and technology recruitment markets are valued at circa \$26bn and \$57bn respectively (Source: Staffing Industry Analysts) – offering substantial long term potential.

Next news: Prelims Wednesday 6th November 2019.

Paul Hill (Analyst)

0207 065 2690
paul.hill@equitydevelopment.co.uk

Forecast / latest LFL NFI growth



Source: Equity Development. Gattaca FY20 estimates

Better still, this **standout performance** helped the group as a whole **handily beat our FY19 adjusted PBT (prior £10.9m) and net debt (B4 £38.5m) expectations, coming in at c. £11.3m (ED est.) and £25.0m** respectively. Leading us to further **upgrade the valuation from 185p to 200p/share**.

International & Technology to return to growth soon

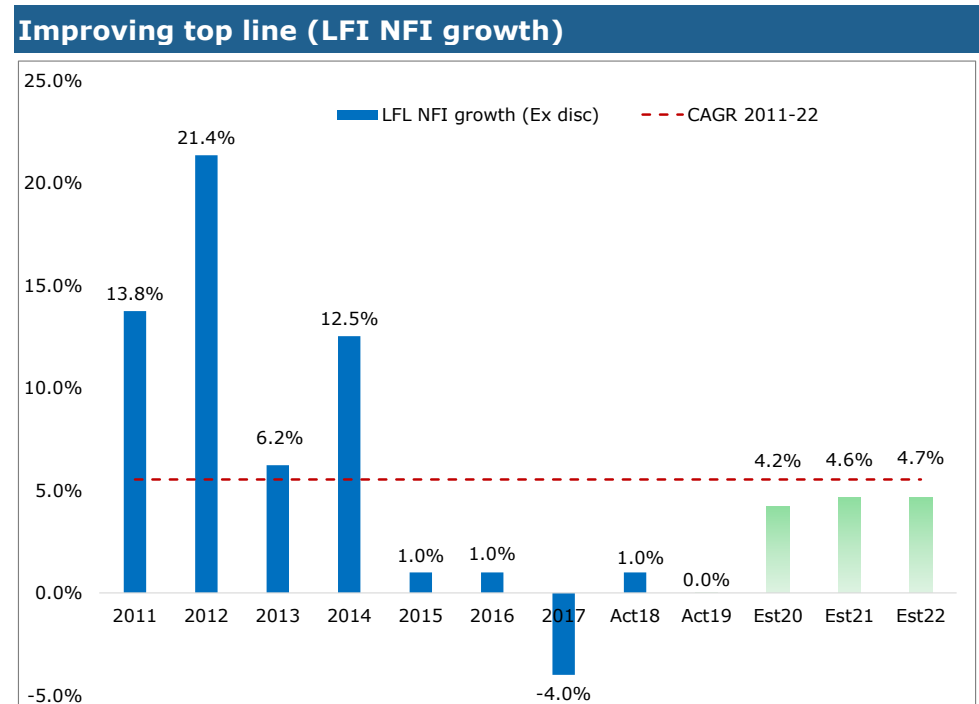
That said, there is still plenty to be done. For instance, despite advancing 3% in FY19 to £9.6m (vs £9.4m LY), International temporarily hit a 'speed-bump' in H2, experiencing an 8% LFL NFI decline (£4.6m vs £5.0m LY & +14% H1).

Reflecting tough comparatives in America, alongside temporary disruption caused by senior management changes. Nonetheless that is history, and **we expect the division to resume its expansion in FY20**, particularly on the back of a strong US employment picture. In fact, this is already happening with **Q4'19 NFI up sequentially on Q3**.

Overall LFL NFI set to hit 4.2% in FY20

Similarly, notwithstanding a 19% fall (-14% H1 vs -24% H2) in NFI to £11.8m (£14.5m LY) due to the previously flagged restructuring (eg Telecoms), **UK Technology is set to return to growth in FY20**. Moreover the quality of business is improving, with FY19 profits (pre central overheads) broadly flat at c. £5.0m (ED est. vs £5.1m), after benefitting from greater fee earner productivity and higher margins.

Therefore all told - absent any major adverse geopolitical event and/or harsh Brexit scenario - **we envisage GATC's total LFL NFI will climb 4.2% to £74.4m this year** (see below), compared to 0% in FY19 and 1.0% in FY18. Plus, the Contract vs Permanent NFI split is set to remain at around 70:30.



Source: Equity Development.

£8.7m non-recurring charge to be taken in FY19

Elsewhere, **the firm is co-operating fully with the US Department of Justice (DoJ)** enquiry, and has commissioned an independent review (now largely complete) - predominantly covering activities by Networkers International prior to its 2015 acquisition. £3.6m of legal fees have been incurred to date, which form part of a wider £8.7m FY19 one-off charge. The other components being £2.1m on restructuring, £1.9m for discontinued activities and £1.1m related to a legacy office lease (re Bromley exit).

The good news is that because of **tight working capital management (+£7m)**, and favourable timing of the weekly contractor payment run (ED est. £8m) - **net debt closed July at £25m vs £40.8m LY**, representing **1.7x EBITDA** (vs 3.1x LY). Granted some of this

is likely to unwind in FY20, yet even so **we anticipate net borrowings to close July 2020 at a comfortable 2.0x EBITDA.**

CEO Kevin Freeguard adding: *“The Group delivered NFI growth both in UK Engineering and our International businesses, partially offset by UK Technology where we are refocusing on profitable business. These improvements will flow through to profit before tax. In addition net debt has come in comfortably below expectations, despite the exceptional restructuring and other costs incurred in the year.*

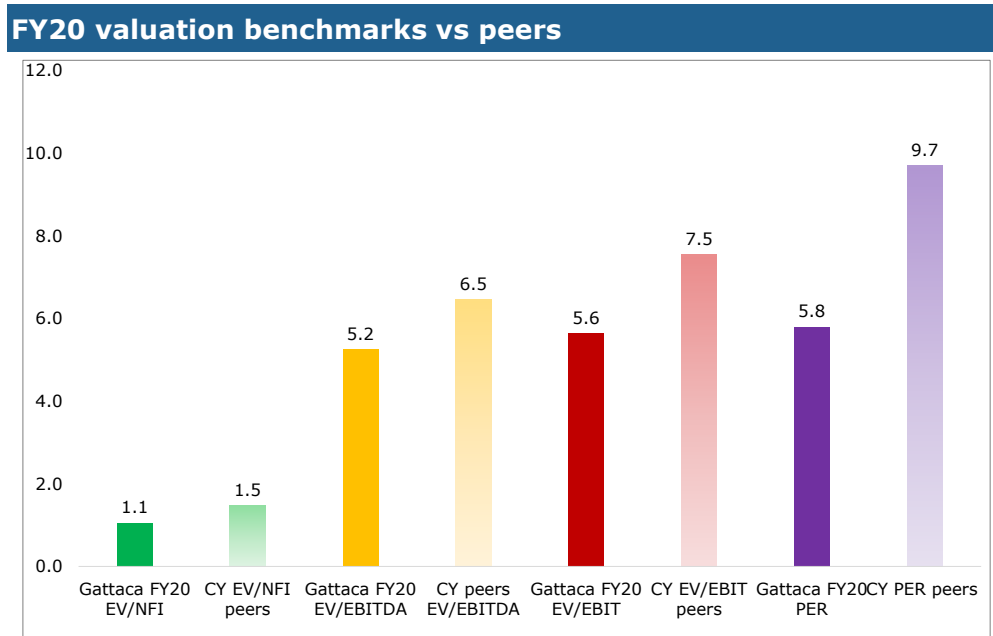
We are making good progress improving the business and I am confident that the actions we are taking will continue to position us well for the future.”

Stake building by two possible strategic buyers

What’s more, we could see the stock’s discount vs peers (see below) close relatively quickly. Maybe simply as the macro fog (hopefully) lifts over the next 12 months - triggering a re-rating towards peer averages of 7.5x EV/EBIT, equivalent to a **theoretical 230p/share.**

Or perhaps via some form of corporate transaction. Here both Morson (UK STEM recruiter) and HRNetGroup (Singaporean staffer) have recently increased their stakes to 15.1% and 5.5% respectively. Meaning that, in light of the potentially significant synergies of combining with GATC, their presence could both put a floor under the stock, and/or even result ultimately in a hefty takeover premium.

Equally though, our financial projections and valuation do not include any possible future DOJ redress that might ensue (if at all) – since at this stage, it would be pure conjecture to try to guess the quantum of any hypothetical penalty.



Source: Equity Development

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.
- 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 (if any) of the DoJ's work will be.

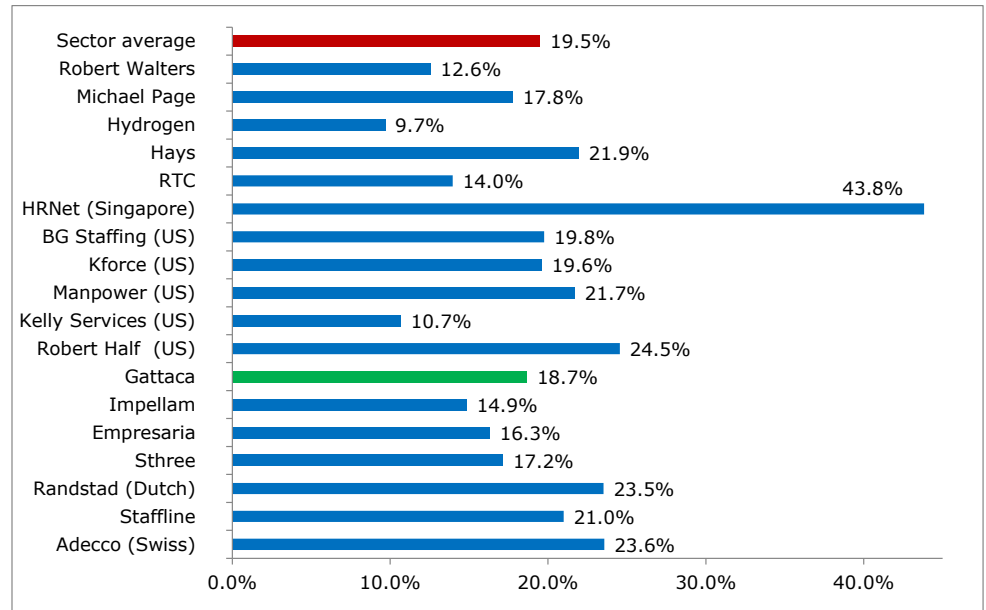
Summary financials

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
Net Fee Income (NFI) : Gross profit					<i>Restated</i>				
UK Engineering	27,077	37,853	40,865	43,080	47,525	50,000	52,500	55,125	57,881
UK Technology	17,905	14,605	17,413	16,178	14,500	11,800	12,036	12,277	12,522
International			14,109	15,450	9,374	9,600	9,888	10,481	11,110
Total	44,982	52,458	72,387	74,708	71,399	71,400	74,424	77,883	81,514
NFI growth rate									
UK Engineering	13.2%	39.8%	8.0%	5.4%	10.3%	5.2%	5.0%	5.0%	5.0%
UK Technology	23.9%	-18.4%	19.2%	-7.1%	-10.4%	-18.6%	2.0%	2.0%	2.0%
International				9.5%	-39.3%	2.4%	3.0%	6.0%	6.0%
Total NFI growth rate	17.2%	16.6%	38.0%	3.2%	-4.4%	0.0%	4.2%	4.6%	4.7%
EBITDA	14,343	18,363	22,617	18,284	13,392	14,400	14,941	15,872	16,663
UK Engineering	10,548	13,105	23,126	23,758	25,472	25,900	26,775	28,114	29,519
UK Technology	3,073	4,242	8,229	7,061	5,100	5,000	5,055	5,156	5,259
International			6,868	5,619	2,723	3,000	3,115	3,302	3,500
Central overheads			-16,726	-19,050	-20,896	-20,500	-21,046	-21,789	-22,752
Adjusted EBIT	13,621	17,347	21,497	17,388	12,399	13,400	13,898	14,783	15,527
Total Opex as % NFI	-69.7%	-66.9%	-70.3%	-76.7%	-82.6%	-81.2%	-81.3%	-81.0%	-81.0%
EBIT / NFI margin	30.3%	33.1%	29.7%	23.3%	17.4%	18.8%	18.7%	19.0%	19.0%
Net interest	-1,015	-1,074	-1,076	-1,232	-1,454	-2,100	-2,100	-1,900	-1,700
Adjusted PBT	12,606	16,273	20,421	16,156	10,945	11,300	11,798	12,883	13,827
Tax	-2,937	-2,367	-6,306	-5,076	-3,463	-3,390	-3,245	-3,221	-3,457
Minorities	0	0	0	-172	-275	0	0	0	0
Adjusted PAT	9,669	13,906	14,115	10,908	7,207	7,910	8,554	9,662	10,370
Adjusted diluted EPS (p)	37.1	43.8	44.1	33.7	22.5	24.0	25.8	29.1	31.0
Adjusted EPS growth rate	17.5%	18.2%	0.5%	-23.6%	-33.3%	6.9%	7.6%	12.4%	6.8%
Dividend (p)	20.0	22.0	23.0	23.0	3.0	0.0	0.0	0.0	15.5
Dividend yield	13.3%	14.7%	15.3%	15.3%	2.0%	0.0%	0.0%	0.0%	10.3%
Dividend cover	1.9	2.0	1.9	1.5	7.5				
Valuation benchmarks									
P/E ratio (diluted)	4.0	3.4	3.4	4.5	6.7	6.2	5.8	5.2	4.8
EV/NFI	1.74	1.49	1.08	1.05	1.10	1.10	1.05	1.01	0.96
EV/EBITA (diluted)	5.8	4.5	3.6	4.5	6.3	5.9	5.6	5.3	5.0
PEG ratio	0.23	0.19	6.54	-0.19	-0.20	0.90	0.76	0.42	0.71
Adjusted corporate tax rate	-23.3%	-14.5%	-30.9%	-31.4%	-31.6%	-30.0%	-27.5%	-25.0%	-25.0%
Adj ROACE	30.6%	21.5%	19.7%	15.6%	13.1%	16.6%	15.6%	15.1%	14.7%
EBITDA drop through rate as % NFI	48.9%	53.8%	21.3%	-186.7%	147.8%		17.9%	26.9%	21.8%
Cash conversion (EBITDA - Capex - W/Cap)/EBIT	103%	109%	93%	63%	128%	100%	87%	87%	87%
Unlevered/adj. free cashflow yield	7.0%		20.1%	8.5%	9.6%	12.8%	11.3%	12.3%	12.9%
Net cash/(debt)	-3,109	-33,644	-25,013	-40,288	-40,874	-26,000	-30,000	-22,237	-18,939
Net debt : EBITDA	0.2	1.8	1.1	2.2	3.1	1.8	2.0	1.4	1.1
Diluted sharecount (Adj for 2015)	26,073	31,730	32,040	32,392	32,079	32,929	33,090	33,253	33,416
Shareprice (p)	150								

Source: Equity Development estimates, Company historic data

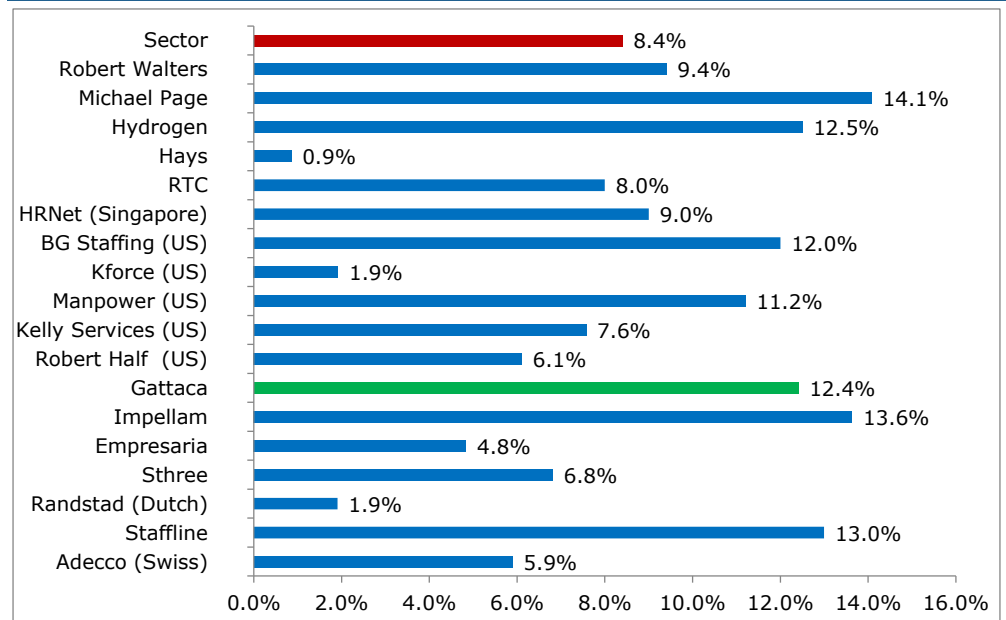
Appendices - sector valuation metrics and KPIs

Current Year (CY) EBIT / NFI conversion rates



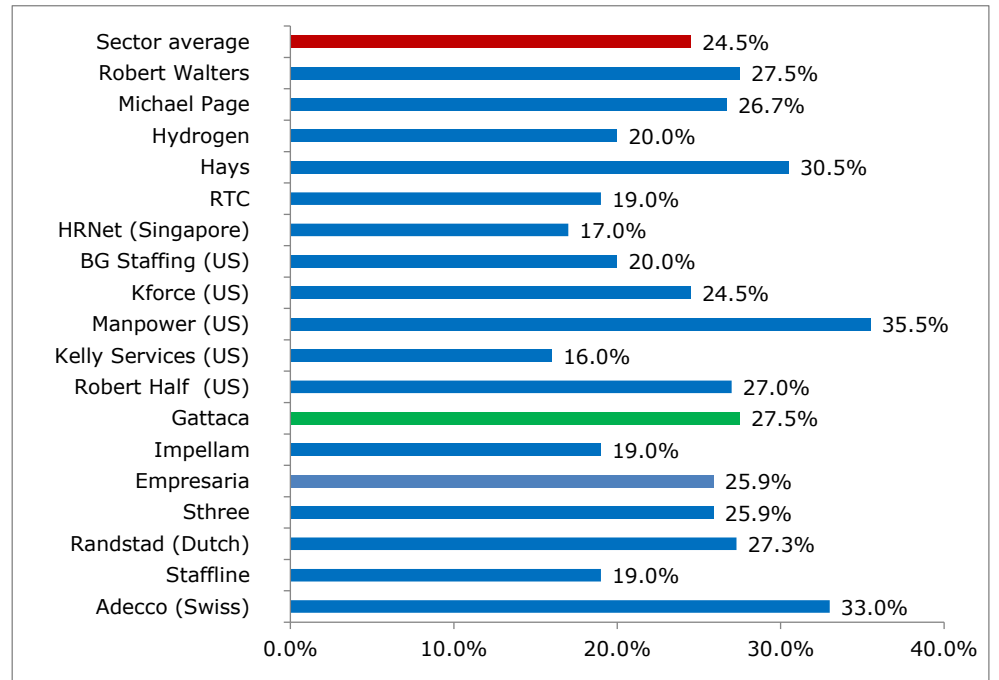
Source: Equity Development : arithmetic average for sector. CY = FY20 for Gattaca

CY + 1 EPS growth rates



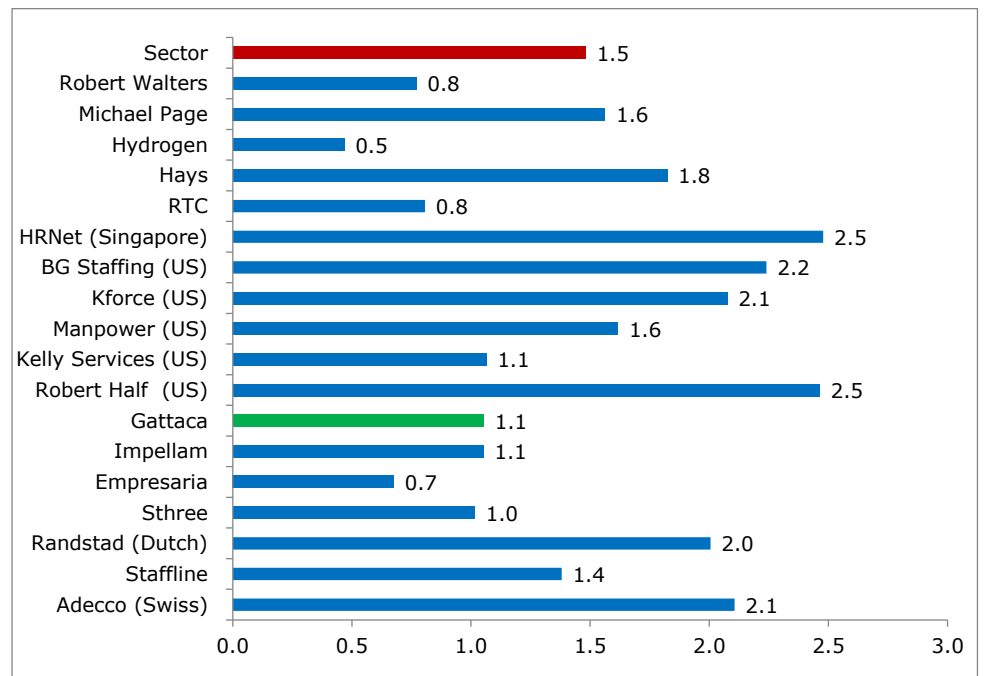
Source: Equity Development, arithmetic average for sector

CY Effective tax rates



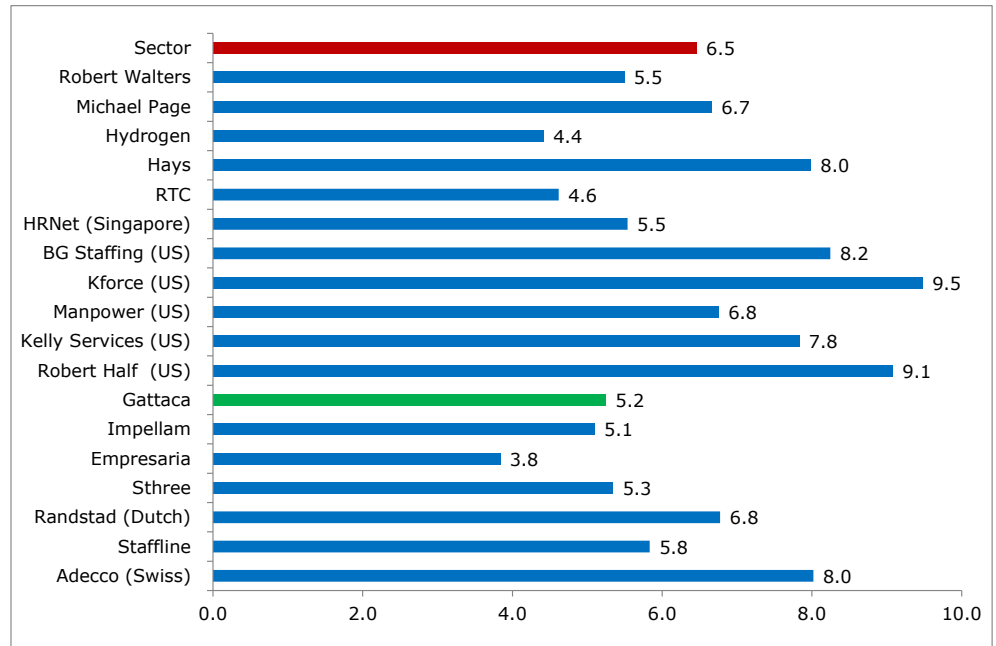
Source: Equity Development, arithmetic average for sector

CY EV/NFI multiples vs peers



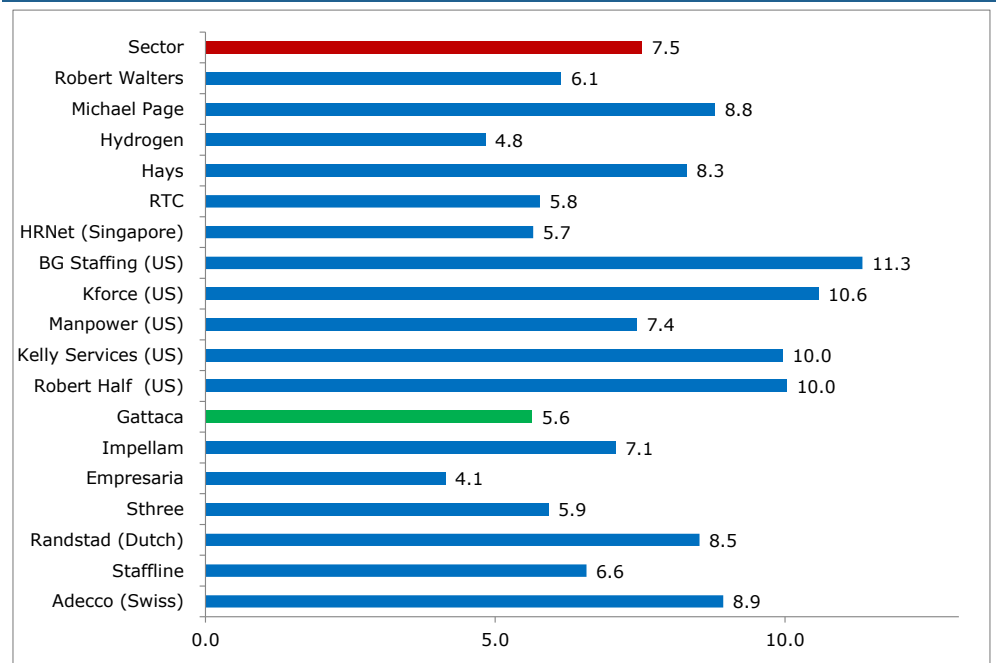
Source: Equity Development : arithmetic average for sector

CY EV/EBITDA multiples vs peers



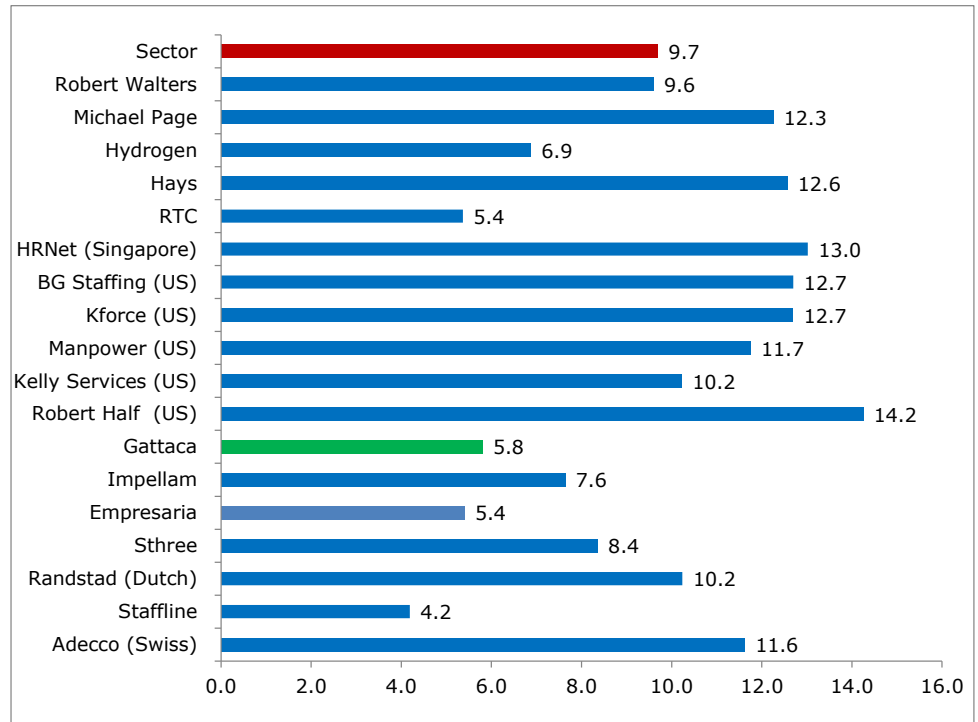
Source: Equity Development : arithmetic average for sector

CY EV/EBIT multiples vs peers



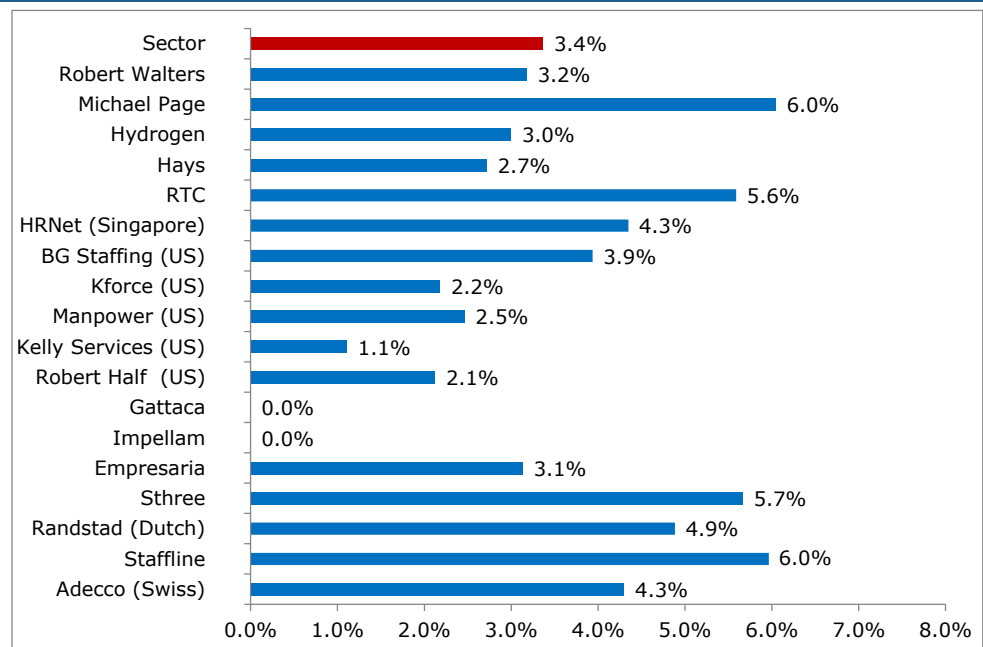
Source: Equity Development : arithmetic average for sector

CY PER multiples vs peers



Source: Equity Development : arithmetic average for sector

CY dividend yield vs peers



Source: Equity Development : arithmetic average for sector



Investor Access

Hannah Crowe

Direct: 0207 065 2692

Tel: 0207 065 2690

hannah@equitydevelopment.co.uk

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