

Base camp reached and business stable

2nd August 2018

Like its namesake movie - where the central character overcomes testing conditions - we think Gattaca will also emerge much fitter after its recent lean spell. Encouragingly the company has made a good start, albeit there is still plenty of climbing ahead.

With regards to trading, the Board reported this morning that **FY18 NFI grew 1% LFL to £78.8m** (H1 +2%: H2 flat) with **adjusted PBT "broadly in line with expectations"**. We interpret this as c.£12.6m (vs ED £13.0m, £16.2m FY17) - implying H2 PBT of £5.7m (vs H1 £6.9m), **18% FY18 NFI conversion** (vs 23% FY17) and £1.4m of annualised cost savings.

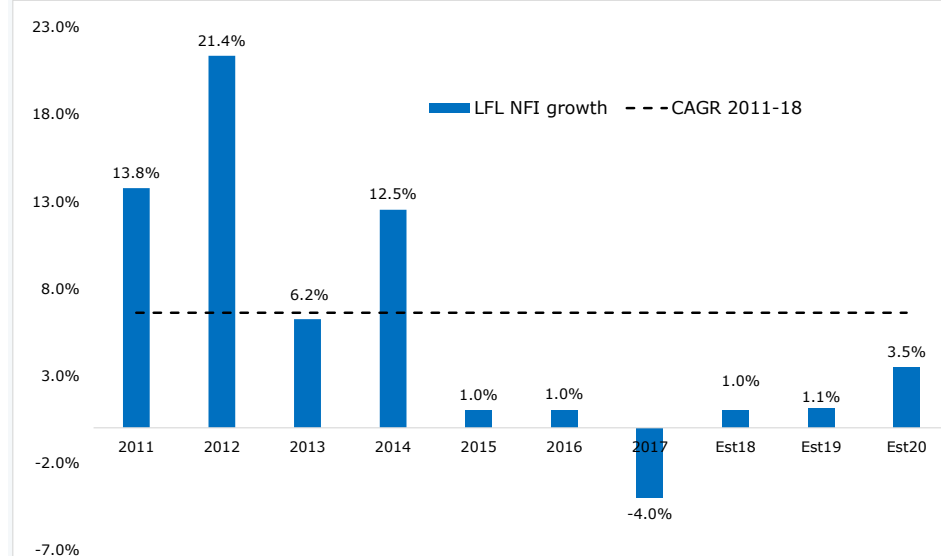
Elsewhere, **net debt closed July slightly lower than anticipated at £46m** (ED £48m; FY19 £40.3m), despite a £3.5m final payment related to the Feb'17 RSL acquisition - leaving gearing at 3x EBITDA. **The appointment of a new CEO is at an "advanced stage"**, whilst the **Strategic Review is "nearing completion"**.

Summit in sight with FY19 biased to the upside

Here, we envisage further restructuring at UK Telco (FY18 NFI fell -24% LFL; -19% H1 and est. -29% H2), alongside self-help measures within Contract (-5% LFL to £56.7m), central resources and a few overseas territories.

Let's not forget though, that **Gattaca is a fundamentally sound business**. They are enjoying profitable and expanding positions (see below) in UK Engineering (+1% LFL NFI to £47.4m eg Converged Technologies, Infrastructure), International (+7% £14.9m eg North America) and UK IT (+4% eg Cloud, cyber). It is well balanced across permanent (+19% LFL to £22.1m) and contract (-5% £56.7m) placements to take advantage of the economic cycle. The improvement in 'Perm' is partly attributable to signing a number of 'high quality, multi-year' Recruitment Process Outsourcing (RPO) clients.

Historical and projected LFI NFI growth

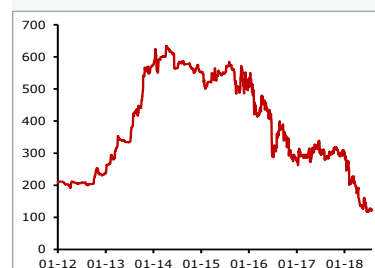


Source: Equity Development

Company Data

EPIC	AIM:GATC
Price (last close)	125p
52 week Hi/Lo	320p/117p
Market cap	£40m
ED valuation	175p

Share Price, p



Source: Web Financial

Description

Gattaca, employing c.870 staff, is the UK's #1 specialist engineering and #5 technology recruitment agency, providing contract, temporary and permanent staff (Source: Recruitment International). It derives 19% of NFI overseas (excluding international placements supplied from the UK), and circa 72% from temporary contractors 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: Prelims 8th November

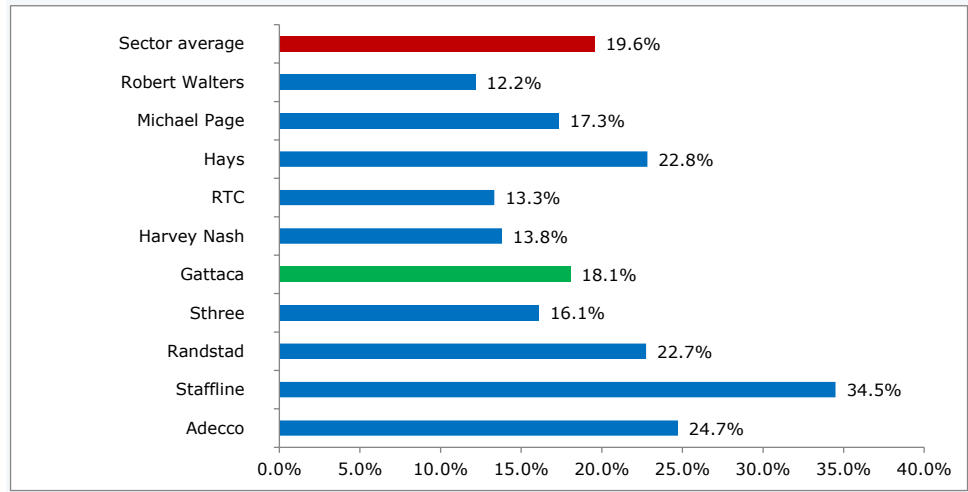
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CY EBIT conversion rates – sector



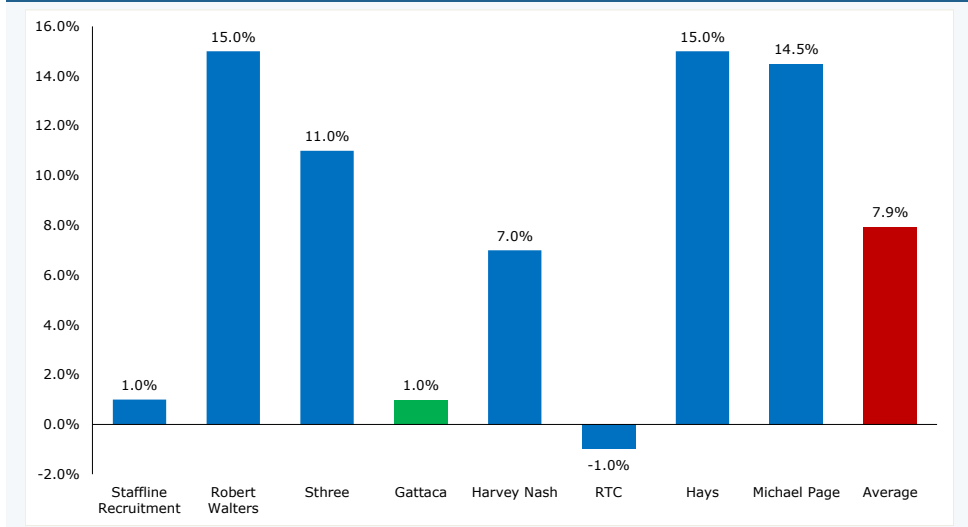
Source: Equity Development

Back to basics and resetting the bar

In our view, major surgery is not required. It's a matter of reshaping/optimising the group after a relatively heavy period of M&A, which has seen NFI jump 75% from £45m in 2014 to £78.8m. In hindsight, where the business unfortunately went astray was buying Networkers' challenged telco division back in April 2015. A mistake that probably has impacted it more than even the surprise 2016 BREXIT vote.

So what about FY19 and beyond? Well, given the numerous moving parts and the impending Strategic Review (re possible structural changes), we accept at this stage, it is difficult to be too precise. As such, we have adopted a more cautious approach. **Trimming our FY19 PBT by -13% to £12.6m** (ie flat YoY), but recognising that as part of the turnaround plan, Management will be maximising sustainable EPS and shareholder returns. Similarly, **our valuation dips from 240p to 175p/share** - based on a conservative 8x EV/EBIT multiple, reflecting the reduced NFI progression over the next 12 months (see below).

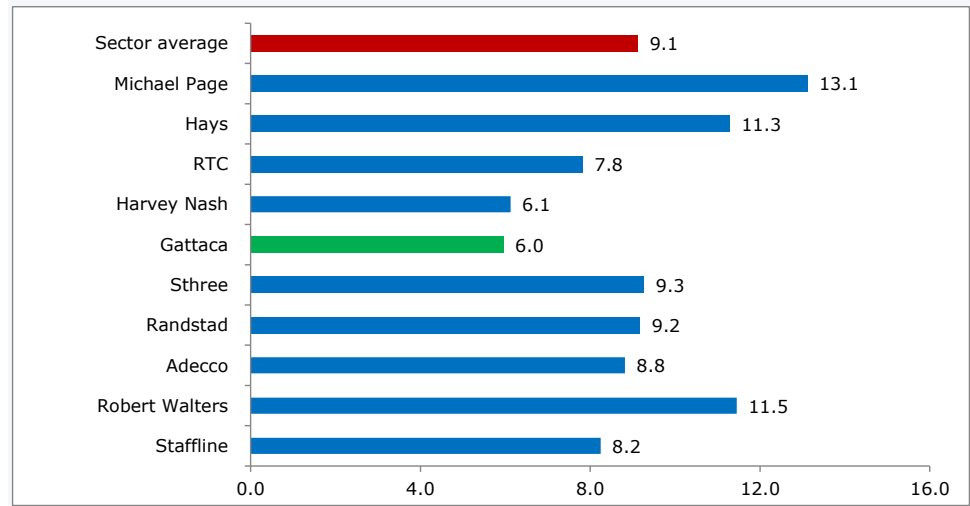
Latest NFI growth rates



Source: Equity Development, various websites

Equally, though at 125p the stock is undoubtedly cheap trading on a CY EV/EBIT multiple of 6x. And hence **could become an acquisition target**, say by an overseas recruiter seeking to take advantage of the £s slide vs the \$/€. Interestingly, too, we note that the owner of rival Morson Group (via MMGG Acquisition Limited) built up a 7.7% stake in May.

Current Year EV/EBIT ratios – sector



Source: Equity Development. Prices as per 1st August 2018

Lastly, we suspect another objective will be to reduce the level of gearing to provide greater balance sheet flexibility. As such, we have prudently modelled that the dividend could be temporarily suspended - albeit any decision will be made by the Board in November, with the official pay-out policy unchanged at the moment. Namely **“to distribute 50% of throughcycle statutory earnings”**, assuming net debt declines by >£3m pa from FY19 onwards.

IT, overseas and engineering showing growth

Patrick Shanley, Chairman, summing up, **“H2 has been one of steady progress for Gattaca as we have worked to stabilise and simplify the business. We are pleased with the performance of UK Engineering and encouraged by the improving trend we saw across Q4 in the majority of our business units.**

*In UK Technology we were pleased with the performance in our IT division, and Internationally our offices in the Americas, in particular, continue to grow strongly. **Underlying PBT for the full year is expected to be broadly in line with market expectations.***

*We are currently reviewing our international footprint and expect to update the market in the coming months, and our cost containment measures are on track. **We are also pleased to report that our CEO recruitment process is at an advanced stage.***

Summary financials

Gattaca (continuing operations) (July yearend)	2014 Act £'000s	2015 Act £'000s	2016 Act £'000s	2017 Act £'000s	2018 Est £'000s	2019 Est £'000s	2020 Est £'000s
Net Fee Income (NFI) : Gross profit							
UK Engineering	27,077	37,853	40,865	43,080	46,774	47,242	49,131
UK Technology	17,905	14,605	17,413	16,178	15,359	14,592	14,592
International			14,109	15,450	16,667	17,834	18,725
Total	44,982	52,458	72,387	74,708	78,800	79,667	82,449
NFI growth rate							
UK Engineering	13.2%	39.8%	8.0%	5.4%	8.6%	1.0%	4.0%
UK Technology	23.9%	-18.4%	19.2%	-7.1%	-5.1%	-5.0%	0.0%
International				9.5%	7.9%	7.0%	5.0%
Total NFI growth rate	17.2%	16.6%	38.0%	3.2%	5.5%	1.1%	3.5%
UK Engineering	10,548	13,105	23,126	23,758	24,710	23,147	24,350
UK Technology	3,073	4,242	8,229	7,061	5,990	5,691	5,837
International			6,868	5,619	5,317	6,402	7,490
Central overheads			-16,726	-19,050	-21,794	-20,851	-21,526
Adjusted EBIT	13,621	17,347	21,497	17,388	14,223	14,389	16,151
Total Opex as % NFI	-69.7%	-66.9%	-70.3%	-76.7%	-82.0%	-81.9%	-80.4%
NFI / EBITA conversion	30.3%	33.1%	29.7%	23.3%	18.0%	18.1%	19.6%
Net interest	-1,015	-1,074	-1,076	-1,196	-1,600	-1,750	-1,650
Adjusted PBT	12,606	16,273	20,421	16,192	12,623	12,639	14,501
Adjusted diluted EPS (p) - post minorities	37.1	43.8	44.1	33.8	26.4	27.7	31.7
Adjusted EPS growth rate	17.5%	18.2%	0.5%	-23.4%	-21.7%	4.8%	14.2%
Dividend (p)	20.0	22.0	23.0	23.0	3.0	0.0	0.0
Dividend yield	16.0%	17.6%	18.4%	18.4%	2.4%	0.0%	0.0%
Dividend cover	1.9	2.0	1.9	1.5	8.8		
Valuation benchmarks							
P/E ratio (diluted)	3.4	2.9	2.8	3.7	4.7	4.5	3.9
EV/NFI	1.9	1.7	1.2	1.2	1.1	1.1	1.1
EV/EBITA (diluted)	6.4	5.0	4.0	5.0	6.1	6.0	5.4
PEG ratio	0.19	0.16	5.45	-0.16	-0.22	0.93	0.28
Adjusted corporate tax rate	-23.3%	-14.5%	-30.9%	-31.4%	-28.3%	-28.3%	-28.3%
Adj ROACE	30.6%	21.5%	19.7%	15.6%	13.3%	13.5%	13.9%
EBITDA drop through rate as % NFI	48.9%	53.8%	21.3%	-186.7%	-72.4%	19.7%	64.6%
Cash conversion (EBITDA - Capex - W/Cap)/EBIT	103%	109%	93%	68%	73%	88%	76%
Unlevered/adj. free cashflow yield	6.3%	19.0%	18.2%	7.7%	7.9%	10.5%	9.5%
Net cash/(debt)	-3,109	-33,644	-25,013	-40,288	-46,000	-42,000	-35,430
Net debt : EBITDA	0.22	1.83	1.11	2.20	3.00	2.71	2.05
Diluted sharecount (Adj for 2015)	26,073	31,730	32,040	32,392	32,522	32,682	32,843
Shareprice (p)	125						

Source: Equity Development estimates, Company historic data

Key risks

- Economic downturn affecting engineering and technology recruitment.
- Greater competition, especially from new technology platforms (eg LinkedIn, Monster).
- Overseas expansion along with foreign exchange fluctuations.
- Acquisition integration, albeit management have a decent batting average.
- Consolidation of customer base (eg takeovers of Atkins:SNC-Lavalin and CH2M:Jacobs).
- Political interference which could impact UK infrastructure spend (eg cancellation of rail electrification projects).



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