Gattaca plc

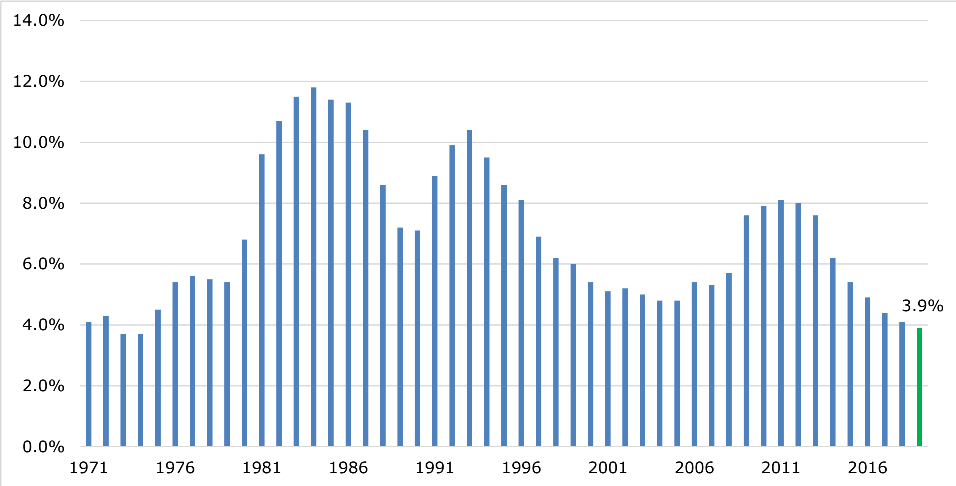
Shares could double over next 3 years

6th November 2019

Today corporates are having to dodge numerous bullets – not least Brexit, fears over a synchronised global slowdown, US-China trade tensions and a General Election. Little wonder therefore that UK business investment fell -1.4% YoY in Q2'19 (source: ONS).

Fortunately, GDP continues to tick along at a modest 1.0%-1.5% pace, on the back of low unemployment (3.9%), resilient consumer spend (+2.5%), benign interest rates (0.75%), rising wages (3.8%) and modest inflation (1.7%).

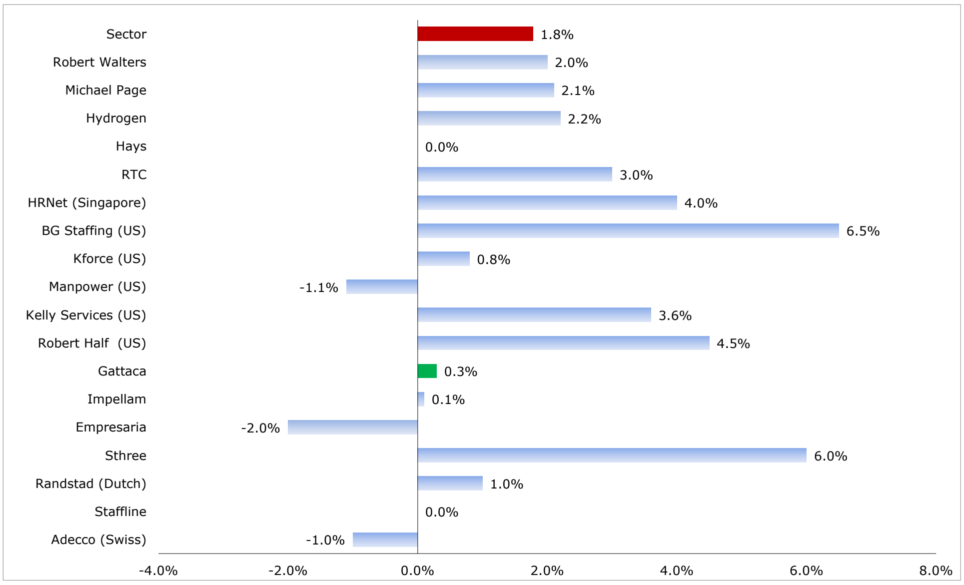
UK unemployment hits 43 year low



Source: Office of National Statistics (ONS)

However of late, a few cracks have started to appear, with several recruitment firms citing weaker C-suite and candidate confidence. Gattaca saying this morning, that it too had experienced some "***softening***" in Q1'20 (see below).

Forecast / latest LFL NFI growth

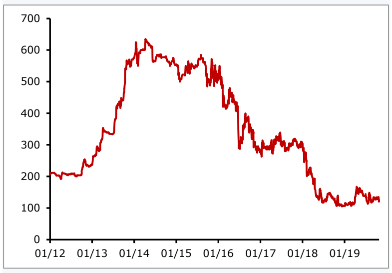


Source: Equity Development.

Company Data

EPIC	AIM:GATC
Price (last close)	118p
52 week Hi / Lo	163p/102p
Market cap	£38.0m
Est net debt July'20	£30.0m
Share count	32.3m
ED valuation / share	160p

Share Price, p



Source: Share Cast

Description

Gattaca is the UK's #1 specialist engineering (70.0% 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: AGM December 2019.

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Progress across the board

Clearly these macro headwinds are frustrating, yet equally it's not the end of the world either, especially since the Board has **master-minded a 'back-to-basics' recovery** over the past 18 months. Closing unprofitable units, re-energising the business, **focusing on faster expanding regions/disciplines** and refreshing management.

Indeed **FY19 adjusted PBT climbed 4.6% to £11.4m** (vs £10.9m LY), boosted by overhead savings (£1.8m) and improved profit margins, despite a 1.1% contraction in LFL NFI (£70.6m) and higher borrowing costs. Additionally:

1. **EBIT/NFI conversion nudged up 1.6% to 19.0%** (17.4% LY), thanks to lower headcount (739 vs 810), right-sizing and a 3.9% (1.4%) rise in UK Engineering NFI to £49.2m (70% of group). The latter driven by Maritime (+16%), Infrastructure (+4%), Aerospace (+13%), Eng. Tech (9%) and key contract wins vs declines in Projects (lumpy orders) and Automotive (-25%: subdued end user vehicle demand).

2. **Underlying EBIT rose 8.0% to £13.4m** (£12.4m LY) – which, when combined with a decrease in the effective tax rate (22.0% vs 31.1%, mostly related to overseas Withholding Tax), led to **a 19% jump in diluted EPS to 26.7p** vs 22.5p.

3. **Cash conversion came in at an impressive 170%** (ED Est vs 128% LY), as **debtor days fell 13.5% to 45** (vs 52), augmented by a £7m receivables unwind from discontinued operations (nb £1.1m left & 100% provided for) and the favourable timing of contractor payments.

4. In turn, pushing **net debt down 39% to £24.8m** (vs £40.9m LY), or 1.7x EBITDA. Albeit going forward, this is set to tick up to 2.3x (or £30m) by July'20 - mirroring an £8m reversal of the weekly contractor payroll, and further investment in Business Development (BD), resulting in a 9.6% drop in FY20 EBITDA to £13.2m (£14.6m FY19).

Turn-around is on track, albeit slightly shifted to the right

£'000s - continuing	Act H1	Act H2	Act FY18	Act H1	Act H2	Act FY19	Est FY20	Est FY21
UK Engineering	3.0%	-0.2%	1.4%	3.6%	4.2%	3.9%	0.0%	4.0%
UK Technology	-4.0%	-2.0%	-3.0%	-13.4%	-26.8%	-19.9%	-4.0%	2.0%
International	5.0%	5.0%	5.0%	15.0%	-9.4%	2.1%	7.0%	8.0%
Total underlying NFI	***2.0%***	***0.0%***	***1.0%***	***1.5%***	***-3.9%***	***-1.1%***	***0.3%***	***4.3%***
NFI	**35,987**	**35,412**	**71,399**	**36,543**	**34,044**	**70,587**	**70,794**	**73,813**
Adjusted EBITDA	**7,360**	**6,035**	**13,395**	**8,382**	**6,218**	**14,600**	**13,222**	**14,546**
Adjusted EBIT	**6,853**	**5,549**	**12,402**	**7,860**	**5,533**	**13,393**	**12,000**	**13,279**
EBIT/NFI margin	*19.0%*	*15.7%*	*17.4%*	*21.5%*	*16.3%*	*19.0%*	*17.0%*	*18.0%*
Underlying overheads	29,134	29,863	58,997	28,683	28,511	57,194	58,794	60,534
U/L admin as % NFI	81.0%	84.3%	82.6%	78.5%	83.7%	81.0%	83.0%	82.0%
Adjusted PBT	**6,100**	**4,762**	**10,862**	**6,817**	**4,543**	**11,360**	**10,000**	**11,479**
Tax	-1,335	-2,045	-3,380	-1,662	-839	-2,501	-2,450	-2,755
Minorities	-219	-56	-275	0	0	0	0	0
Underlying PAT	**4,546**	**2,661**	**7,207**	**5,155**	**3,704**	**8,859**	**7,550**	**8,724**
Adjusted EPS (diluted)	**14.0p**	**8.3p**	**22.5p**	**15.8p**	**10.9p**	**26.7p**	**22.7p**	**26.1p**
NFI (LTM) / head (£ks)	86.6		88.1	97.8		95.5		
Headcount	870		810	736		739		
Net debt : EBITDA			*3.05*	*1.93*		*1.70*	*2.27*	*1.60*
Cash conversion			*128%*			*170%*	*24%*	*85%*
Net debt	**-36,180**		**-40,874**	**-27,755**		**-24,822**	**-30,000**	**-23,270**

Source: Equity Development. Nb FY19 cashflow boosted by favourable timing of contractor payroll

Plus, after exiting the underperforming telco contract business (see one-off charges below), closing overseas offices in the UAE, Malaysia, Qatar & Singapore, and consolidating the UK support functions into Whiteley (Bromley closure) – we think Gattaca **now has the right foundations and geographical footprint from which to achieve its strategic goals**.

FY19 included £15.9m of one-off charges (£'000s)

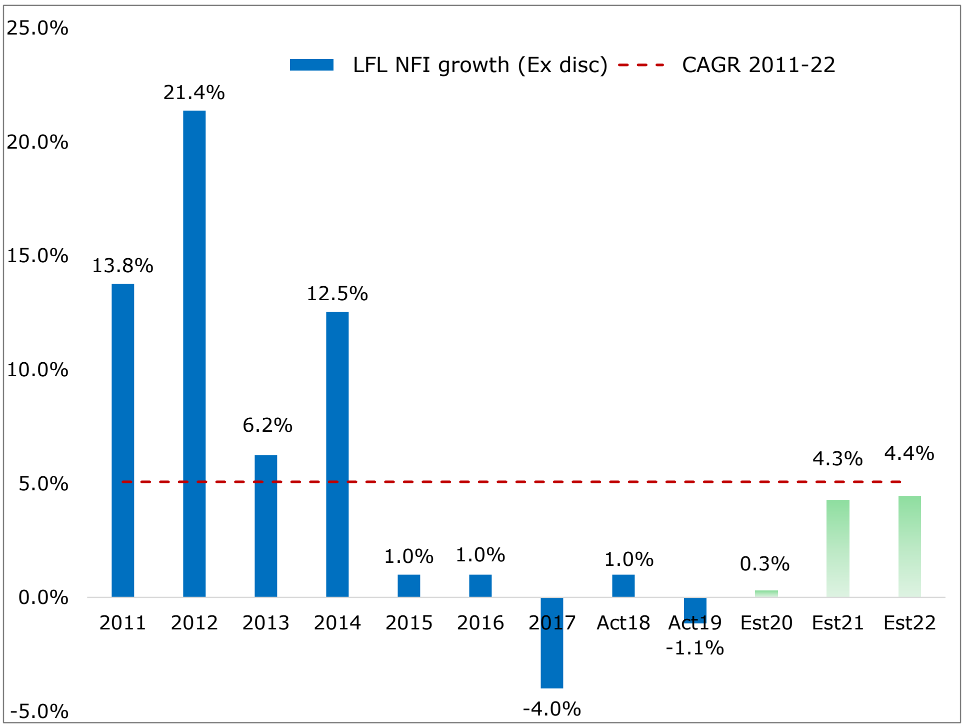
Bromley office closure integration costs (re Whitely)	1,441
Bromley onerous lease provision	1,102
Liquidation, legal, advisory fees and other fees and working capital impairments related to discontinued businesses	1,205
Advisory fees primarily related to US DoJ cooperation	3,424
Other discontinued operations losses	1,828
Goodwill write-off due to 2015 Networkers acquisition	7,146
Favourable Forex benefit	-302
Total charges	**15,844**

Source: Company

Navigating choppier waters

Don't get me wrong, it's not all plain sailing just yet. Sure, **Gattaca has turned a major corner**, but the economic seas have become rougher. Hence for the moment, **we've prudently cut our FY20 LFL NFI, PBT and EBIT/NFI estimates to 0.3%** (vs 4.2% before), **£10.0m** (£11.8m) and **17.0%** (18.7%) respectively (see below). Corresponding to FY20 EBIT and EPS reductions of 10.4% (£12.0m vs £13.4m) and 12.0% (22.7p vs 25.8p).

Historical and projected LFI NFI growth

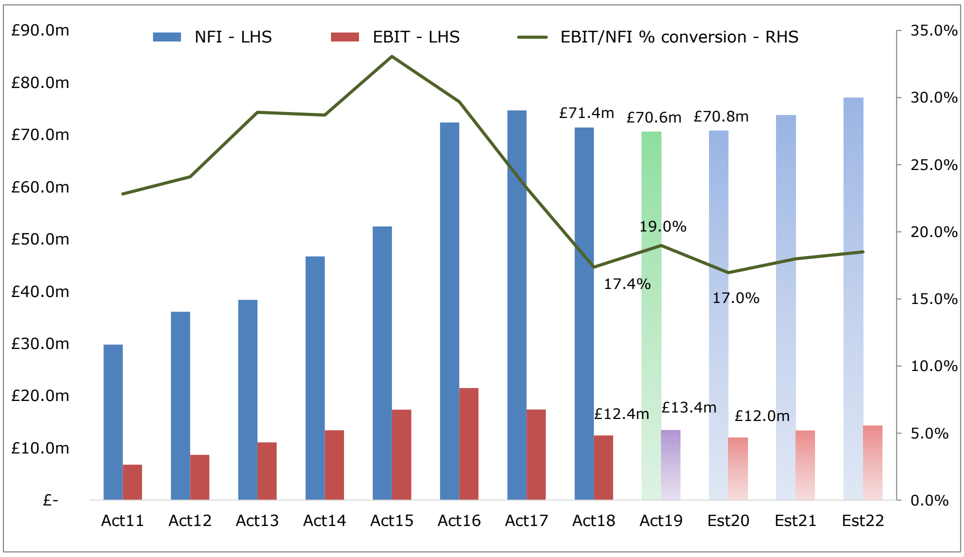


Source: Equity Development.

Ongoing tight cost and cash control

That said, **management will continue to control costs/cash tightly in light of the darker economic clouds**, and we believe will seek further savings with the view to self-fund some of the planned growth.

Financial projections

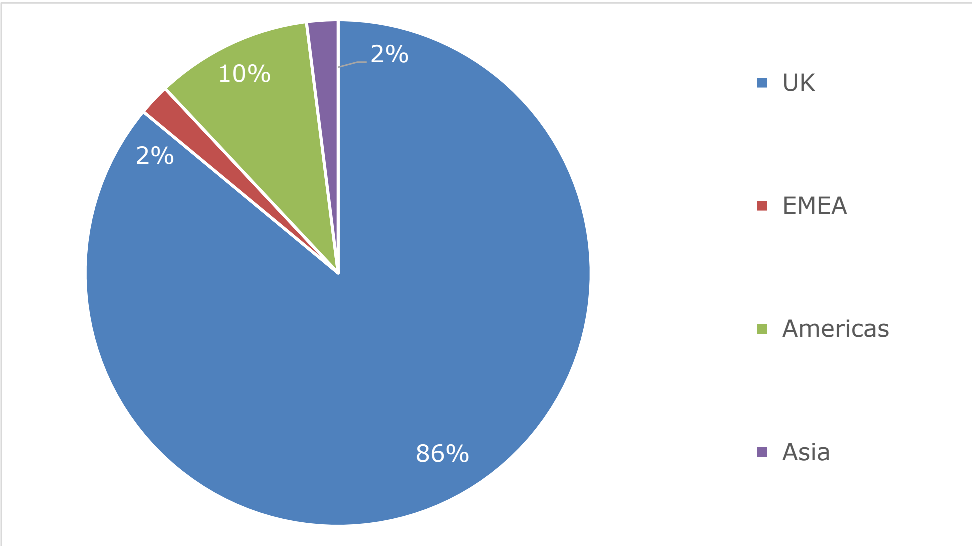


Source: Equity Development.

Long term fundamentals remain solid

Elsewhere, total FY19 NFI slipped 1.1% (split 1.5% H1 vs -3.9% H2) to £70.6m (£71.4m), although most of this was down to the US hitting a temporary speed bump (-23%, strong comparatives) - offset by Canada (+22%), China (54%) & South Africa (+22%) - and the ongoing rationalisation of UK Technology (-19.9% LFL NFI: split -16% IT & -39% UK Telecoms). What's more, since the launch of the CEO's Improvement Plan in March, **both of these divisions are in the process of being fixed**.

NFI breakdown by geographical region



Source: Company

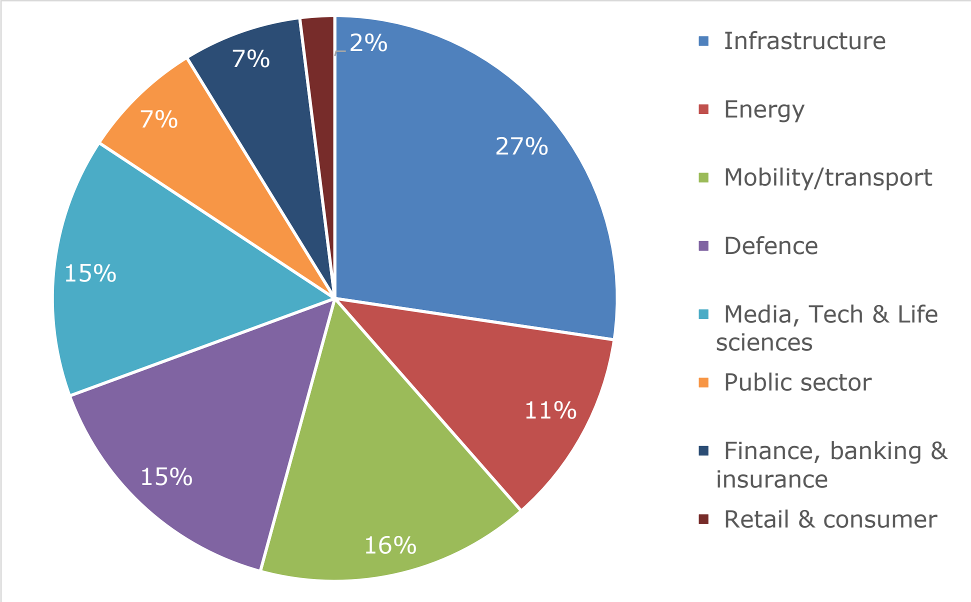
Americas set up to become major growth engine

In particular, the US has been repositioned away from its historical dependency on a small number of sole supply agreements. While the leadership team has been refreshed, and new offices opened in Houston and Atlanta, complementing the Dallas regional HQ. Together triggering a rebound in Q4'19 performance, with **International NFI shaping up to hit 7% LFL in FY20**.

Creating a high performance culture

Likewise **UK Technology is responding favourably to new blood**. Not only targeting buoyant verticals, such as data science, artificial intelligence, Fintech, cyber security, Java and software development. But also maximising cross, up & solution selling opportunities, creating a core UK delivery function covering both Tech & Engineering fulfilment (40 staff redeployed) and extending the product portfolio. All underpinned by a new integrated IT platform (PBS), which is being rolled-out.

NFI split by vertical market



Source: Company

Solutions enhance customer lifetime values

Encouragingly too, **FY19 NFI at Gattaca Solutions** (27% of group) **leapt 16% to £19.1m** benefitting from new client wins and the scaling up of existing major accounts. Moreover generating robust visibility, superior lifetime values, attractive retention rates (100% FY19) and enabling clients to be serviced more productively, regardless of the lower gross margins.

However, there is still work to be done, namely:

1. **Achieving sustainable LFL NFI growth**, with new senior management, BD staff and fee earners being suitably appointed and the group's Improvement Plan well underway. Looking ahead, notwithstanding the tougher backdrop, **we expect to see pipeline expansion in H2'20, alongside gross profit flow-through next year and beyond**.

2. **Managing the UK introduction of IR35** (6th April 2020) across the private sector. As with all key employment tax legislation, this is likely to cause some consternation, albeit the firm has been pro-actively assisting clients & contractors to minimise any possible disruption.

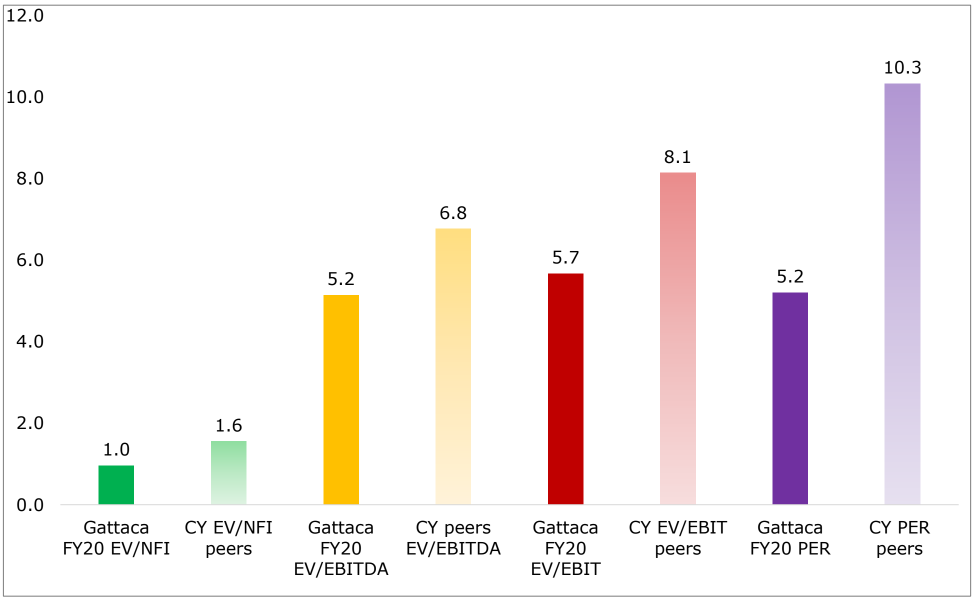
3. **Continuing to reduce indebtedness to below 2x EBITDA**, before reinstating the dividend (Nb: Policy to pay-out 50% of 'through-cycle' statutory PAT). Separately in Sept'19, the company's £90m banking agreement with HSBC was renewed until Oct'23, incorporating a £75m working capital facility and a £15m term loan.

4. **Finalising the US Department of Justice enquiry**, in respect of the pre-acquisition activities of Networkers. Here management are cooperating with the DoJ, but presently not in a position to know, or quantify what the outcome may be. To date, £3.4m of advisory/legal fees have been incurred.

Valuation reduced to 160p/share

So, what does this all mean? Well the good news for investors, is that Gattaca's frugal £38.0m marketcap appears to more than factor in these risks, whilst equally not recognising much (if any) of the heavy-lifting which has already been completed. Instead - assuming things go to plan and using 7x-8x EV/EBIT multiples for FY22 – **we would not be surprised to see the shareprice reach 215p-260p in 3 years' time**.

FY20 valuation benchmarks vs peers



Source: Equity Development

Stake building by two possible strategic buyers

Similarly, **even our more conservative valuation comes out at 160p** (vs 200p before) - **offering 35% potential upside** - with the stock currently trading on miserly FY20 EV/EBIT and PE ratios of 5.7x & 5.2x vs 8.1x & 10.3x for the sector. Saying to us, **the company doesn't need to shoot the lights out, for patient investors to be richly rewarded**.

Plus, in light of the **20%-30% EBITDA drop-through rates** and **expanding international footprint**, we reckon there is every chance of re-introducing the dividend sometime over the next few years. In the meantime, it's not out of the question either that the company might attract predatory interest. Perhaps from the likes of Morson (UK STEM recruiter) and/or HRNetGroup (Singaporean staffer), who have both accumulated stakes of 15.1% and 5.5% respectively.

On track to achieve sustainable long term growth

CEO Kevin Freeguard commenting "*As with other staffing groups, **we have noticed softening in our markets in Q1'20**. Given the economic and political uncertainty, both in the UK and overseas, **we are cautious about how markets will develop during FY20**.*

*Additionally, as we continue to implement our Improvement Plan in FY20, and as we further reposition our approach to certain markets, **we will continue to be more selective around the quality of business we choose to service, and will invest further in our sales resources**.*

*[While] the **headwinds around Brexit and IR35, combined with these necessary actions are likely to impact short-term profitability**, **we are confident they will position the business for a return to sustainable, long-term growth**.*"

Patrick Shanley, Chairman adding "***We have demonstrated that we can grow our engineering business even during difficult periods**, and have taken action to address the issues in our technology business."*

In addition further out, we reckon **Gattaca is well placed 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.

Lastly on the personnel front, after 26 years of service, Keith Lewis (COO) has decided to stand down from the Board and will leave the Group with immediate effect.

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 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			*Restated*	*Pre IFRS16*					
UK Engineering	40,865	43,080	47,568	49,442	49,442	51,420	53,476	55,616	57,840
UK Technology	17,413	16,178	14,457	11,575	11,112	11,334	11,674	12,024	12,385
International	14,109	15,450	9,374	9,570	10,240	11,059	11,944	12,899	13,931
Total	**72,387**	**74,708**	**71,399**	**70,587**	**70,794**	**73,813**	**77,095**	**80,539**	**84,157**
NFI growth rate									
UK Engineering	*8.0%*	*5.4%*	*10.4%*	*3.9%*	*0.0%*	*4.0%*	*4.0%*	*4.0%*	*4.0%*
UK Technology	*19.2%*	*-7.1%*	*-10.6%*	*-19.9%*	*-4.0%*	*2.0%*	*3.0%*	*3.0%*	*3.0%*
International		*9.5%*	*-39.3%*	*2.1%*	*7.0%*	*8.0%*	*8.0%*	*8.0%*	*8.0%*
Total NFI growth rate	***38.0%***	***3.2%***	***-4.4%***	***-1.1%***	***0.3%***	***4.3%***	***4.4%***	***4.5%***	***4.5%***
EBITDA	**22,617**	**18,284**	**13,395**	**14,600**	**13,222**	**14,546**	**15,584**	**16,587**	**17,392**
UK Engineering	23,126	23,758	26,033	27,489	26,204	27,252	28,343	29,476	30,655
UK Technology	8,229	7,061	6,610	5,902	5,000	5,327	5,487	5,652	5,821
International	6,868	5,619	2,723	1,820	2,765	3,318	3,941	4,515	4,876
Central overheads	-16,726	-19,050	-22,964	-21,818	-21,970	-22,618	-23,503	-24,424	-25,382
Adjusted EBIT	**21,497**	**17,388**	**12,402**	**13,393**	**12,000**	**13,279**	**14,268**	**15,219**	**15,970**
Total Opex as % NFI	*-70.3%*	*-76.7%*	*-82.6%*	*-81.0%*	*-83.0%*	*-82.0%*	*-81.5%*	*-81.1%*	*-81.0%*
EBIT / NFI margin	*29.7%*	*23.3%*	*17.4%*	*19.0%*	*17.0%*	*18.0%*	*18.5%*	*18.9%*	*19.0%*
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**	**10,000**	**11,479**	**12,668**	**13,819**	**14,770**
Tax	-6,306	-5,076	-3,380	-2,501	-2,450	-2,755	-3,040	-3,317	-3,545
Minorities	0	-172	-275	0	0	0	0	0	0
Adjusted PAT	**14,115**	**10,908**	**7,207**	**8,859**	**7,550**	**8,724**	**9,628**	**10,502**	**11,226**
Adjusted diluted EPS (p)	**44.1**	**33.7**	**22.5**	**26.7**	**22.7**	**26.1**	**28.6**	**31.1**	**33.0**
Adjusted EPS growth rate	*0.5%*	*-23.6%*	*-33.3%*	*19.0%*	*-15.2%*	*15.0%*	*9.8%*	*8.6%*	*6.4%*
Dividend (p)	**23.0**	**23.0**	**3.0**	**0.0**	**0.0**	**0.0**	**14.3**	**15.5**	**16.5**
Dividend yield	*19.5%*	*19.5%*	*2.5%*	*0.0%*	*0.0%*	*0.0%*	*12.1%*	*13.2%*	*14.0%*
Dividend cover	*1.9*	*1.5*	*7.5*				*2.0*	*2.0*	*2.0*
Valuation benchmarks									
P/E ratio (diluted)	*2.7*	*3.5*	*5.3*	*4.4*	*5.2*	*4.5*	*4.1*	*3.8*	*3.6*
EV/NFI	*0.94*	*0.91*	*0.95*	*0.96*	*0.96*	*0.92*	*0.88*	*0.85*	*0.81*
EV/EBITA (diluted)	*3.2*	*3.9*	*5.5*	*5.1*	*5.7*	*5.1*	*4.8*	*4.5*	*4.3*
PEG ratio	*5.14*	*-0.15*	*-0.16*	*0.23*	*-0.34*	*0.30*	*0.42*	*0.44*	*0.56*
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%*	*15.9%*	*15.9%*	*15.8%*	*15.9%*	*15.8%*
EBITDA drop through rate as % NFI	*21.3%*	*-186.7%*	*147.7%*			*43.9%*	*31.6%*	*29.1%*	*22.3%*
Cash conversion (EBITDA - Capex - W/Cap)/EBIT	*93%*	*63%*	*128%*	*170%*	*24%*	*85%*	*85%*	*85%*	*85%*
Unlevered/adj. free cashflow yield	*23.1%*	*9.8%*	*11.2%*	*29.7%*	*0.6%*	*12.5%*	*13.3%*	*14.2%*	*14.8%*
Net cash/(debt)	**-25,013**	**-40,288**	**-40,874**	**-24,822**	**-30,000**	**-23,270**	**-20,475**	**-17,317**	**-13,879**
Net debt : EBITDA	*1.1*	*2.2*	*3.1*	*1.7*	*2.3*	*1.6*	*1.3*	*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)	**118**								

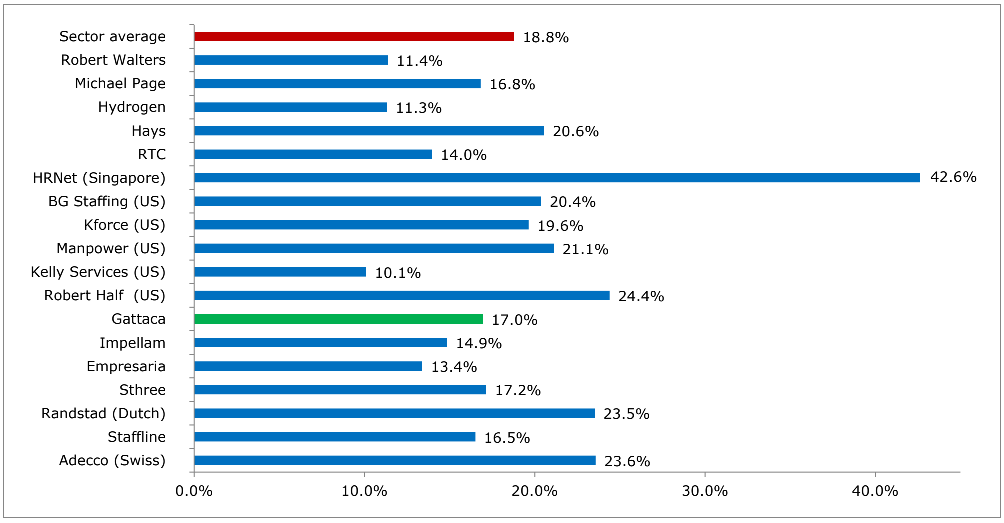
Source: Equity Development estimates, Company historic data

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.

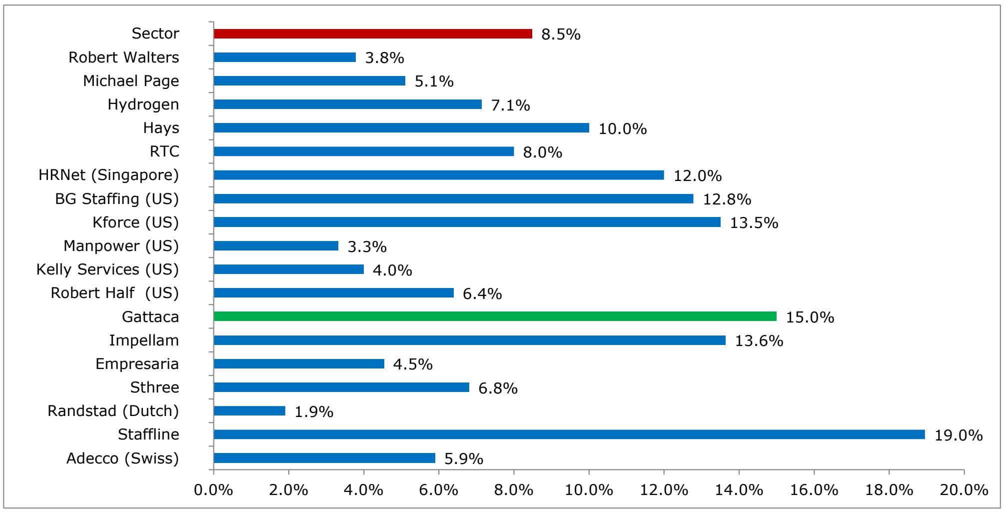
Appendices - sector valuation metrics and KPIs

Current Year (CY) EBIT / NFI conversion rates



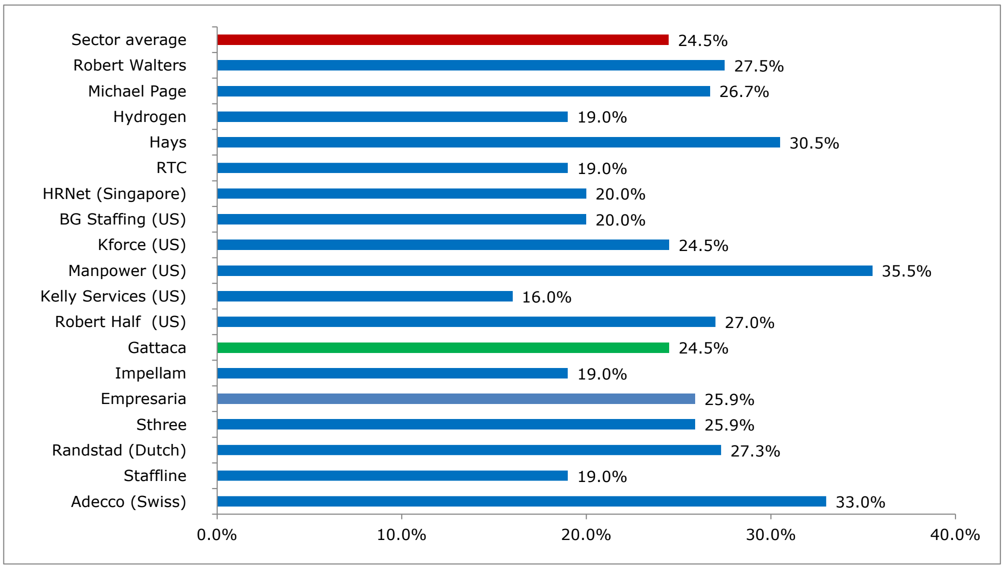
Source: Equity Development: arithmetic average for sector. CY = FY20 for Gattaca

CY+1 EPS growth rates (related to FY21 for Gattaca)



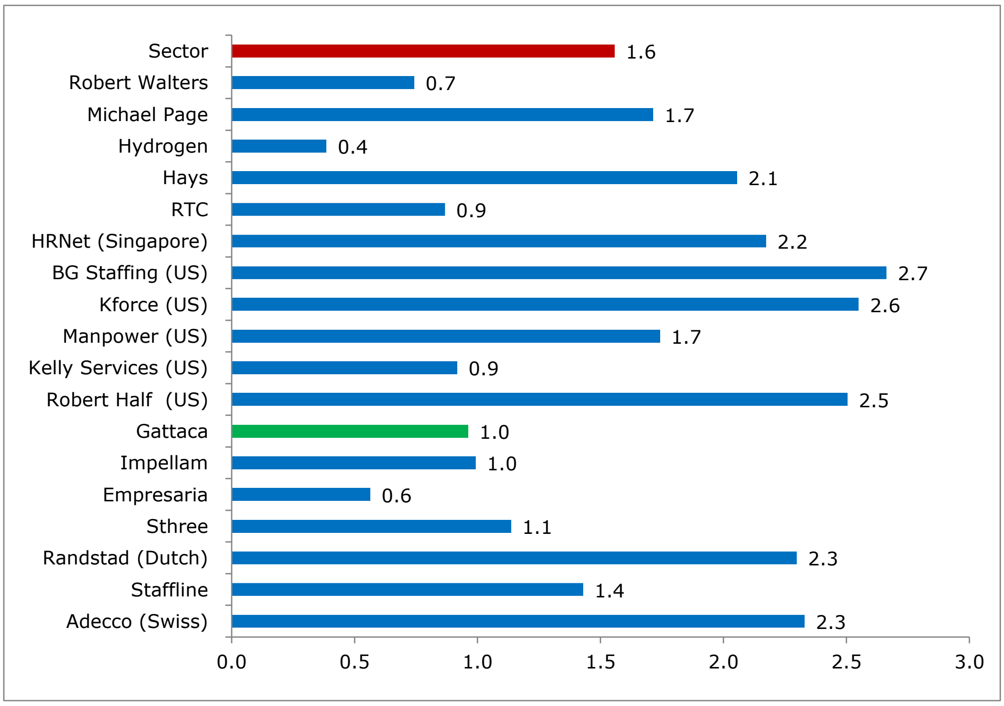
Source: Equity Development, arithmetic average for sector

CY Effective tax rates



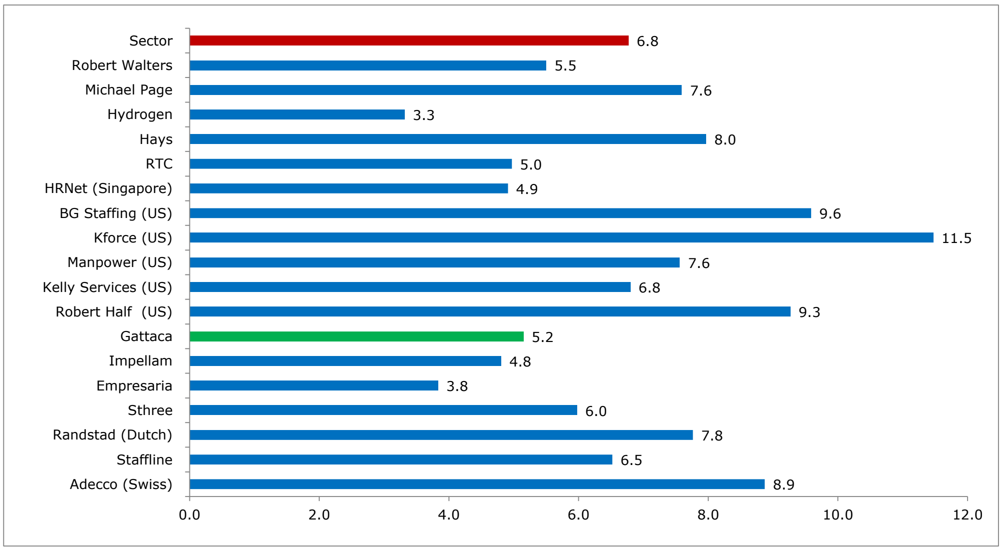
Source: Equity Development, arithmetic average for sector

CY EV/NFI multiples



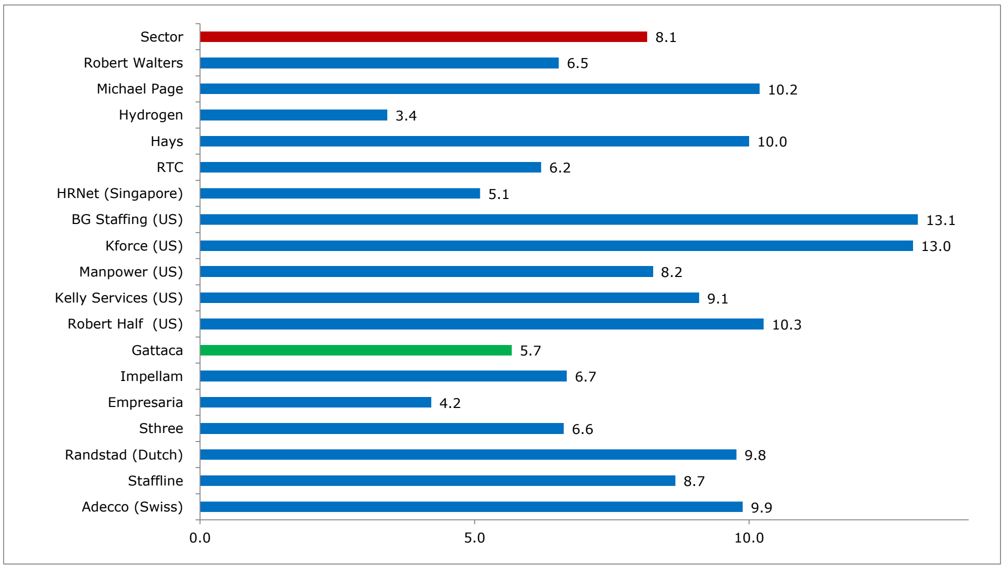
Source: Equity Development : arithmetic average for sector

CY EV/EBITDA multiples



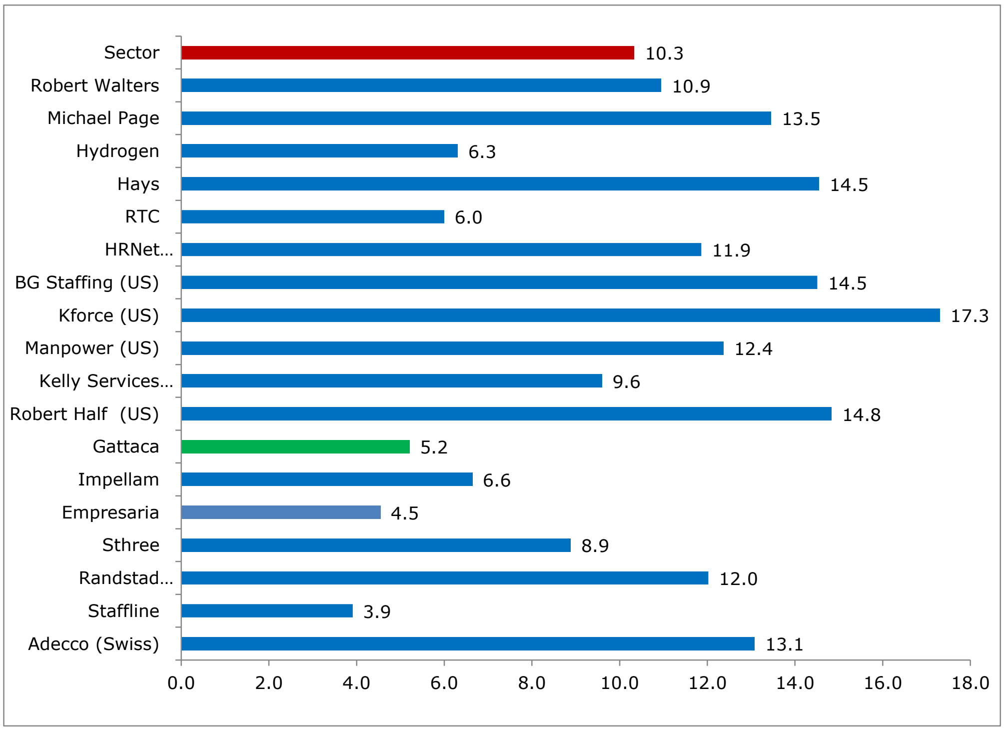
Source: Equity Development : arithmetic average for sector

CY EV/EBIT multiples vs peers



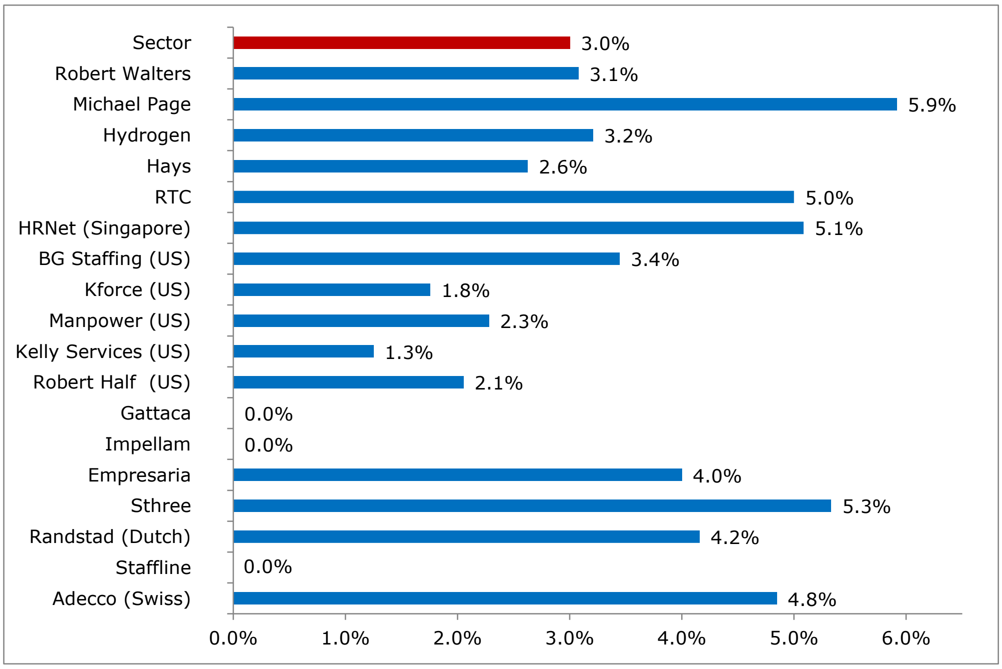
Source: Equity Development : arithmetic average for sector

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)	€ 53.24	€ 8,869	-€ 1,440	€ 10,309
Staffline	97p	£66.8	-£89.0	£155.8
Randstad (Dutch)	€ 50.50	€ 9,343	-€ 1,550	€ 10,893
Sthree	287p	£378.8	-£12.0	£390.8
Empresaria	50p	£24.6	-£18.0	£42.6
Impellam	380p	£184.3	-£90.2	£274.5
Gattaca	118p	£38.1	-£30.0	£68.1
Robert Half (US)	$58.00	$6,844	$458	$6,386
Kelly Services (US)	$24.00	$936	$18	$918
Manpower (US)	$93.00	$5,617	-$304	$5,921
Kforce (US)	$41.00	$1,005	$10	$995
BG Staffing (US)	$19.30	$201	-$15	$216
HRNet (Singapore)	$0.59	$594	$275	$319
RTC	57p	£8.4	-£4.0	£12.4
Hays	160p	£2,480	£90	£2,390
Hydrogen	53p	£18.2	£5.9	£12.3
Michael Page	448p	£1,472	-£16	£1,488
Robert Walters	520p	£395.2	£81.6	£313.6

Source: Equity Development

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