Keywords Studios

FY20 results

An attractive proposition for uncertain times

Software & comp services

Keywords' FY20 results were in line with its trading update (FY20 revenues €373.5m, adjusted PBT €55.0m), with 12% organic growth in FY20 despite COVID-19. Adjusted EBITDA rose 29% to €74.2m, with PBT up 35% to €55.0m and adjusted PBT margins climbing to 14.7%, close to management's 15% long-term target. We believe the outlook for FY21 looks benign, with demand for Keywords' services continuing to build in the short to medium term. Sonia Sedler joined in January as COO to strengthen the management team and has been appointed interim joint CEO, alongside Jon Hauck (CFO), pending Andrew Day's return as CEO. We have updated our estimates for the €46.8m acquisition of Tantalus Media and introduced FY23 estimates. With net cash and facilities totalling €202.9m at year end, Keywords remains well placed for further M&A.

Year end	Revenue (€m)	PBT* (€m)	EPS* (c)	DPS (p)	P/E (x)	Yield (%)
12/19	326.5	40.9	48.8	0.58	57.7	0.02
12/20	373.5	55.0	60.9	0.00	46.2	0.00
12/21e	475.1	71.0	76.3	1.91	36.9	0.08
12/22e	536.9	79.9	85.4	2.11	33.0	0.09

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

Well positioned for a strong FY21

FY20 was a year of two halves, with organic revenue growth of 8% in H120, climbing to 15% in H220 as the business adapted to new COVID-19 work patterns. FY20 adjusted PBT margins rose to 14.7% (H120 12.5%, H220 16.7%), with that momentum providing a strong start to H121. However, management remains cautious on margins rising further, with capex set to increase in FY21 and costs also likely to start to normalise in H221. Keywords reported adjusted cash conversion of 97% in FY20 (FY19 80%), with strong operating cashflow and the €110m placing contributing to FY20 year-end net cash of €102.9m (FY19 net debt €17.9m), despite the seven acquisitions announced in FY20. Post year-end, Keywords also announced the acquisition of Tantalus Media, the group's first Australian deal.

Model updated, FY23 estimates introduced

We have updated our FY21 and FY22 estimates to incorporate the acquisition of Tantalus Media and latest management guidance. We have otherwise left our assumptions for FY21 and FY22 broadly unchanged at this early stage of the year, despite positive expectations. We have also introduced FY23 estimates.

Valuation: Multiples to fall with continuing M&A

Keywords' shares trade on an FY21e P/E of 36.9x, falling to 33.0x in FY22e, in line with its UK and European games industry peers. Although this is a demanding valuation, management has offered a confident outlook for FY21, based on strong client demand and a period of heightened game releases, benefiting underlying growth in the period from FY21–23. With strong organic growth, supplemented by an active buy-and-build strategy, we expect earnings to rise as the year progresses, lowering valuation multiples.

26 March 2021

Price	**2,428p**
Market cap	**£1.81bn**
	€1.16/£
Net cash (€m) at 31 December 2020 (excluding lease liabilities)	102.9
Shares in issue	74.4m
Free float	90%
Code	KWS
Primary exchange	AIM
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	(4.9)	(15.5)	79.9
Rel (local)	(5.3)	(18.0)	46.7
52-week high/low		2,942p	1,330p

Business description

Keywords Studios is the largest and most diverse supplier of outsourced technical and creative services to the games industry. Through regular acquisitions, the company is building its scale, geographic footprint and delivery capability to become the 'go-to' supplier across the industry.

Next event

AGM	May 2021

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FY20 results: A resilient performance

Keywords' FY20 results were in line with its January trading update (FY20 revenues €373.5m and adjusted PBT €55.0m), with 12% organic growth in FY20 (despite the effect of COVID-19) leading to adjusted EBITDA rising 29% to €74.2m (FY19 €57.6m). Adjusted EBITDA margins rose to 19.9% (FY19: 17.6%), reflecting operating leverage coupled with effective cost control. Adjusted PBT rose 35% to €55.0m with adjusted PBT margins climbing to 14.7% (from 12.5% in FY19), close to management's 15% long-term target. Notably, H220 (15% l-f-l organic revenue growth, 15.7% adjusted PBT margin) was markedly stronger than H120 (8.0% l-f-l organic revenue growth, 12.5% adjusted PBT margin) with that momentum carrying through to H121. FY20 adjusted EPS rose 25% to 60.93c (FY19 48.78c).

It was reassuring to see high adjusted cash conversion of 97% (FY19 80%), with strong operating cashflow (together with the €110m placing in May) contributing to the company reporting FY20 year-end net cash of €102.9m (FY19 net debt of €17.9m), despite having spent €39.9m of net cash on acquisitions in FY20. Together with an additional €100m of uncommitted facilities, Keywords has ample firepower to commit to future M&A.

As we mentioned in our note published on 1 March (Looking like a winner as the dust settles), the outlook for Keywords in FY21 looks strong. Publishers are developing and launching increasing numbers of new titles to serve a growing next-generation console base in FY21–23, meaning that demand for Keywords' services should continue to build in the short to medium term.

Strengthened management team and management changes

Sonia Sedler was appointed as COO on 18 January 2021, to lead Keywords' operational growth strategy. She brings experience in scaling businesses internationally through senior roles at Diebold Nixdorf, Sutherland Global Services, HCL and Accenture.

On 15 March 2021 the board announced that Andrew Day, CEO, would take a temporary leave of absence from the business for health reasons. Andrew Day remains a member of the board of directors pending his return, with Sonia Sedler (COO) and Jon Hauck (CFO) stepping up to become interim joint CEOs and providing the cover the group needs while Andrew Day recuperates.

M&A: Six acquisitions completed in FY20, two more in Q121

Keywords announced seven acquisitions in FY20, focused on the higher-margin business lines of Game Development (Coconut Lizard, High Voltage and Heavy Iron) and Marketing Services (Maverick Media, g-Net and Indigo Pearl), with an opportunistic acquisition of Jinglebell strengthening the Audio service line. The company committed net cash of €39.9m to the six acquisitions completed in FY20 (Heavy Iron and Tantalus Media completed in FY21), with a total maximum consideration of up to €97.2m in cash and shares, dependent on performance based earn-outs. As a result of these acquisitions, Keywords ended the year with a pro forma revenue run-rate of €409.2m (2019 €333.6m).

Post year-end, as well as completing the Heavy Iron transaction (January 2021), Keywords also announced the acquisition of Tantalus Media (March 2021).

- **Tantalus Media – a first foothold in Australia.** Keywords acquired an 85% stake in the Australian games developer, Tantalus Media, for total consideration of US$46.8m (US$30.6m up-front, US$16.2m subject to a two year earn-out). Up-front consideration was payable 60% in cash, 40% in shares with the earn-out also a mix of cash and shares. Initial consideration equated to a multiple of c 6x FY20 Adj. EBITDA (adjusted for the 85% shareholding) and we understand the earn-out is structured to deliver a 6x overall adjusted EBITDA multiple. Tantalus

Media is Keywords' first acquisition in Australia, so we expect Keywords to follow its 'land and expand' strategy, expanding the suite of services available from its new base in Melbourne. Tom Crago (who retains a 15% shareholding), the founder of Tantalus Media, will work with Keywords to drive this regional expansion, both organically and through acquisition.

Seven service lines to become eight for H121 results

Over FY20, Keywords has strengthened its position in Marketing Services and Game Development, announcing acquisitions of three further companies in each service line. As a result of the acquisition-driven growth in Marketing Services, management has confirmed that from H121, it will break Marketing Services out separately from Art Services, creating an eighth service line.

Exhibit 1: FY20 service line performance

	% of revenue	Organic Revenue growth H1	H2	2020
Keywords Art Services	15%	7.9%	28.3%	17.9%
Keywords Game Development	21%	25.7%	10.4%	17.1%
Keywords Audio Services	13%	0.5%	8.7%	5.8%
Keywords Functionality QA	21%	10.7%	20.6%	16.1%
Keywords Localization	12%	(7.4%)	0.3%	(4.0%)
Keywords Localization QA	6%	1.9%	5.9%	4.4%
Keywords Player Support	11%	5.5%	29.7%	17.5%

Source: Keywords

Exhibit 2: FY21 service line outlook

Art Creation & Marketing started 2021 with better than normal revenue visibility partly due to some carry forward from 2020 but perhaps also signalling a year of even stronger demand ahead.

Game Development demand remains strong but some delays in new projects due to COVID-19 may moderate growth from maintaining the previously very strong growth rates.

Audio: Whilst COVID-19 restrictions continue during 2021, our adoption of a reliable remote recording solution will enable us to continue to deliver on our clients' needs.

Functional Testing: We remain a leading player in this large and growing market that is seeing an acceleration towards outsourcing.

Localization: Having strengthened our sales efforts, we expect to build on the improvement seen in H2 2020 as we move into 2021.

Localization Testing: Having worked to mitigate the constraints experienced in 2020 we expect to build on the momentum seen in H2 2020.

Player Support: We expect to make further progress in 2021 but driven by a more moderate growth rate.

Source: Keywords

In terms of FY20 performance, the service lines can be broken into two groups. The first group includes Art Services (including Marketing Services), Game Development, Functionality QA and Player Support. These were all able to translate their working patterns to accommodate remote working in H220, delivering strong organic growth in FY20 and seeing a markedly stronger H220 than H120, save for Games Development, where recruitment, training, on-boarding and business development issues restricted growth in H220. These issues are also likely to constrain growth in Game Development in H121.

The other group includes Audio Services, Localisation and Localisation QA, which struggled with the transition to remote working. Audio Services was heavily reliant on voice actors visiting physical recording studios. An online recording solution has now been developed as projects pick up again in FY21. Localisation experienced delays in the receipt of content in H120, as some clients experienced disruption to production schedules. Localisation returned to modest growth in H220, which Keywords expects to build on in FY21, with a strengthened sales effort. Localisation QA also suffered from disruption in H120, largely addressed in H220 through flexible working arrangements, using studios for priority activities. However, challenges remain around the recruitment of native language testers in lockdown.

Environmental, social and governance strategy

Keywords is committed to conducting its business responsibly, while operating to the highest standards of honesty, integrity and ethical conduct. Six priority areas have been identified, with the group due to report regularly on progress in each of these areas. The six areas are: People;

Diversity; Customer Centricity & Innovation; Communities; Governance; and the Environment. Further details of Keywords' strategy in each of these areas is expected to be provided in the FY20 annual report.

Other ESG progress made in FY20 included:

- The publication of Keywords' Code of Conduct, available in 12 languages on its website.
- The establishment of a Global Diversity & Inclusivity Counsel, with unconscious bias training introduced for individuals involved in recruitment.
- The group launched a Keywords Cares matched fund raising programme, in which the group will match funds raised for good causes by its teams around the world.
- The establishment a US$0.5m hardship fund to support Keywordians experiencing financial hardship as a result of COVID-19.
- Keywords has quantified its scope 1 and 2 greenhouse gas emissions, establishing an FY20 baseline for future reporting.

Updated estimates, introduction of FY23 estimates

As stated in our Outlook note in March 2021 (Looking like a winner as the dust settles), the key growth drivers for Keywords remain intact: in the short term, growth should be supported by continued development spending and the increasing trend towards outsourcing; medium-term growth will be boosted by a strong pipeline of launches for next-generation consoles in FY21–23; and long-term demand is underpinned by strong secular and technology trends.

We have revised our estimates for FY21, principally to reflect the acquisition of Tantalus Media, the impact of which then flows through into FY22, but also to pick up on the revised management guidance included with the FY20 results on PBT margins and effective tax rate. We have also introduced our estimates for FY23.

Exhibit 3: Revised estimates

31-December	2020 Actual	YoY Chge	2021e Old	2021e New	Chge	YoY Chge	2022e Old	2022e New	Chge	YoY Change	2023e New	YoY Chge
Revenue	373,538	14%	464,520	475,118	2.3%	27%	520,263	536,858	3.2%	13%	590,544	10%
Gross Profit (inc multimedia tax credits)	141,772	18%	176,214	181,068	2.8%	28%	197,941	204,084	3.1%	13%	224,492	10%
Gross Margin (%)	38.0%		37.9%	38.1%			38.0%	38.0%			38.0%	
EBITDA (Adjusted)	74,177	29%	89,703	92,729	3.4%	25%	100,821	102,896	2.1%	11%	112,393	9%
Operating Profit (before amort. and except.)	57,259	33%	70,303	72,979	3.8%	27%	79,321	81,948	3.3%	12%	90,143	10%
Operating Margin	15.3%		15.1%	15.4%			15.2%	15.3%			15.3%	
Profit Before Tax (norm)	54,954	34%	67,803	70,979	4.7%	29%	76,821	79,948	4.1%	13%	88,143	10%
PBT (norm) Margin	14.7%		14.6%	14.9%			14.8%	14.9%			14.9%	
Profit After Tax (norm)	43,927	31%	55,437	56,783	2.4%	29%	62,810	63,959	1.8%	13%	70,515	10%
EPS - normalised (c)	60.9	25%	74.3	76.3	2.6%	25%	83.8	85.4	1.8%	12%	93.8	10%
Dividend per share (p)	0.00	-	1.91	1.91	-	-	2.11	2.11	-	-	2.32	-
Closing net debt/(cash)	(102,875)		(139,530)	(110,475)				(154,611)			(201,898)	

Source: Company accounts, Edison Investment Research

Assumptions underpinning our estimates

Revenues: for FY23, we have assumed 10% revenue growth from FY22, in line with management's 10–15% long-term guidance, indicating FY23 revenues of €591m.

Margins: although there is potential for Keywords to achieve higher margins, for the moment we assume management will continue to target revenue growth over margin enhancement and, as such, we assume gross margins remain stable at c 38% for FY21-23, with an adjusted PBT margin conservatively slightly below management's long-term target of 15%.

Tax rate: Keywords' tax rate rose to c 20% in FY20, up from 18.2% in FY19. Management has guided towards the effective tax rate rising further in FY21 to 21%. We expect this level to be sustainable and maintain this assumption for FY22 and FY23.

Capex: with the impact of COVID-19, management put a temporary hold on discretionary capex in FY20. We have assumed this will rise again in FY21, with an element of catch up, with lower utilisation of assets in a work-from-home environment or a potential more flexible future working environment. On this basis, we have assumed a c 40% y-o-y rise in capex in FY21 to €19.1m, rising steadily to €23.8m in FY23.

Deferred consideration: contingent consideration on the balance sheet rose to €18.8m at year-end 2020 from €6.0m at year-end 2019, with c 80% payable in 2021. We estimate liabilities of c €14m for FY22 and FY23, assuming 75% of maximum potential consideration is paid.

We have also assumed that tax credits – the Multimedia Tax Credit (Canada) and the Video Games Tax Relief (UK) – grow at 10% in each of FY21, FY22 and FY23. We note that €2.5m of FY21 tax credits were brought forward and recognised in FY20.

Finally, we expect a resumption of Keywords' progressive dividend policy in FY21, starting with the FY21 interim dividend. We assume a one-third/two-thirds split between interim and final dividend, with a total dividend of €1.91 per share in FY21. We assume 10% y-o-y dividend growth for FY22 and FY23.

Exhibit 4: Financial summary

€'000s	2019	2020	2021e	2022e	2023e
31-December	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue	326,463	373,538	475,118	536,858	590,544
Cost of Sales	(206,234)	(231,766)	(294,050)	(332,774)	(366,052)
Gross Profit (inc multimedia tax credits)	120,229	141,772	181,068	204,084	224,492
Investment income	-	1,437	-	-	-
EBITDA (adjusted)	57,611	74,177	92,729	102,896	112,393
EBITDA (reported)	43,375	66,760	92,729	102,896	112,393
Operating Profit (before amort. and except.)	42,983	57,259	72,979	81,948	90,143
Amortisation of acquired intangibles	(7,318)	(8,808)	(11,317)	(13,376)	(14,714)
Exceptionals	(4,348)	(2,650)	-	-	-
Other (incl share based payments)	(9,775)	(15,350)	-	-	-
Operating Profit	21,542	41,119	61,662	68,572	75,429
Net Interest	(2,513)	(2,522)	(2,000)	(2,000)	(2,000)
FOREX	(1,658)	(6,103)	-	-	-
Profit Before Tax (norm)	40,913	54,954	70,979	79,948	88,143
Profit Before Tax (FRS 3)	17,371	32,494	59,662	66,572	73,429
Tax	(7,462)	(11,027)	(14,196)	(15,990)	(17,629)
Profit After Tax (norm)	33,451	43,927	56,783	63,959	70,515
Profit After Tax (FRS 3)	9,909	21,467	45,466	50,582	55,801
Average Number of Shares Outstanding (m)	65.1	70.8	74.5	74.9	75.1
EPS - normalised (c)	48.8	60.9	76.3	85.4	93.8
EPS - normalised fully diluted (c)	47.2	57.7	73.1	82.1	90.5
EPS - (IFRS) (c)	15.2	30.3	61.1	67.5	74.3
Dividend per share (p)	0.58	0.00	1.91	2.11	2.32
Gross Margin (%)	36.8%	38.0%	38.1%	38.0%	38.0%
EBITDA Margin (%)	13.3%	17.9%	19.5%	19.2%	19.0%
Operating Margin (before GW and except.) (%)	13.2%	15.3%	15.4%	15.3%	15.3%
PBT Margin (%)	12.5%	14.7%	14.9%	14.9%	14.9%
BALANCE SHEET					
Fixed Assets	245,461	309,685	338,541	352,731	370,225
Intangible Assets	196,769	240,810	264,522	269,495	276,111
Tangible Assets	22,163	26,419	31,563	40,780	51,658
Right of use assets	21,469	27,807	27,807	27,807	27,807
Investments	5,060	14,649	14,649	14,649	14,649
Current Assets	120,483	189,567	211,101	267,289	325,824
Stocks	-	-	-	-	-
Debtors	43,243	47,832	55,537	62,202	68,422
Cash	41,827	103,070	110,670	154,807	202,093
Other	35,413	38,665	44,894	50,281	55,309
Current Liabilities	(57,292)	(91,130)	(95,588)	(98,382)	(101,021)
Creditors	(49,471)	(83,696)	(88,154)	(90,948)	(93,587)
Short term borrowings	(80)	(73)	(73)	(73)	(73)
Lease liabilities	(7,741)	(7,361)	(7,361)	(7,361)	(7,361)
Long Term Liabilities	(85,694)	(36,887)	(36,887)	(36,887)	(36,887)
Long term borrowings	(59,671)	(122)	(122)	(122)	(122)
Lease liabilities	(14,166)	(21,503)	(21,503)	(21,503)	(21,503)
Other long term liabilities	(11,857)	(15,262)	(15,262)	(15,262)	(15,262)
Net Assets	222,958	371,235	417,167	484,752	558,141
CASH FLOW					
Operating Cash Flow	46,069	80,879	85,509	98,843	108,035
Net Interest	(9,411)	(9,816)	(9,047)	(9,047)	(9,047)
Tax	(13,288)	(4,459)	(14,196)	(15,990)	(17,629)
Capex	(13,145)	(13,908)	(19,131)	(21,617)	(23,778)
Acquisitions/disposals	(27,762)	(39,936)	(33,874)	(6,217)	(8,269)
Financing	-	111,698	-	-	-
Dividends	(1,197)	-	(1,662)	(1,836)	(2,026)
Net Cash Flow	(18,734)	124,458	7,600	44,137	47,287
Opening net debt/(cash)	430	17,924	(102,875)	(110,475)	(154,611)
Forex gain on cash	1,293	(3,426)	-	-	-
Other	(53)	(233)	-	-	-
Closing net debt/(cash) (excluding lease liabilities)	17,924	(102,875)	(110,475)	(154,611)	(201,898)

Source: Company accounts, Edison Investment Research

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