EDISON

Keywords Studios

Confidence in its sustainable model

Capital markets day

Software & comp services

At the capital markets day (CMD) on 14 November, management offered a comprehensive review of Keywords' business and its drivers. This was the first event with Jon Hauck formally in place as CFO, who brings useful experience from his background at Rentokil Initial. Keywords appears to be well positioned to continue to perform robustly in FY20 despite the Q420 console transition (which may even be a net benefit to the group), balancing strong growth with a margin recovery back to more normalised levels (c 15%) with M&A, particularly in game development and marketing, very much front of mind. Keywords remains the only public games service provider at a global scale. We have updated our forecasts, but these are largely unchanged as the year end approaches.

Year end	Revenue (€m)	PBT* (€m)	EPS* (c)	DPS (p)	P/E (x)	Yield (%)
12/17	151.4	23.1	30.0	1.46	54.9	0.10
12/18	250.8	37.9	40.1	1.61	41.0	0.11
12/19e	319.7	40.2	45.0	1.77	36.6	0.13
12/20e	354.9	51.9	64.1	1.95	25.7	0.14

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

CMD: Key themes of the day

Management developed four core themes: 1) the benefits of being the scale player, offering an increasingly attractive professional service proposition to a global client base; 2) acquisitions and integration – the heads of a number of studios underlined the attractions of a Keywords acquisition – the integration of central processes and systems leaving them with autonomy to grow the business; 3) 'land and expand' – leveraging new locations from a single service line in a new hub to offer the full suite of services as client demand grows; and 4) studios are incentivised to cross-sell and cross-promote other service lines as part of the 'Keywords family', to support Keywords to become the 'go-to' provider for outsourced services to the games industry.

Valuation: Expectations of continuing growth

We have slightly updated our numbers to take account of the acquisition of TV+ Synchron in Berlin and now forecast an FY19 P/E of 36.6x and 25.7x for FY20. With the share price back down from its £18+ highs over the summer, investors have taken the opportunity to add to their exposure to Keywords after the CMD.

Keywords continues to trade at a premium to its peers in the current year (FY19: 36.6x vs 25-30x), although with the strong EPS growth forecast, FY20 PE falls to 25.7x, in line with its peer group (22-26x). Adjusted for blended average growth in FY19 and FY20, we derive a PEG ratio of 1.0x, materially below the majority of its peers (1.3-1.7x). There is limited scope for M&A in FY19, however accretive acquisition activity in FY20 (at historic multiples) could bring the 2020e P/E down further. With strong underlying growth (10%+), we continue to believe sustained execution should drive robust returns for shareholders.

2 December 2019

Price	**1,407p**
Market cap	**£931m**
	€1.17/£
Net debt (€m) at end H119	9.0
Shares in issue	66.18m
Free float	94%
Code	KWS
Primary exchange	AIM
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	24.2	(10.1)	14.2
Rel (local)	22.9	(12.9)	8.2
52-week high/low		1,838p	900p

Business description

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

Next events

Year-end trading statement	January 2020
Final results	April 2020

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Edison profile page

Keywords Studios is a research client of Edison Investment Research Limited

Capital markets day

Summary

Management offered a comprehensive review of the business and its drivers, sharing the stage with members of the Montreal and North American leadership team. The tone was open and reassuring, with ample time for Q&A.

This was the first event with Jon Hauck formally in place as CFO, who should bring useful experience to Keywords from his background at Rentokil Initial. We took reassurance that Keywords will continue to perform, balancing strong growth with a recovery of margins back to more normalised levels (c 15%) with M&A, particularly in games development and marketing, very much front of mind. Games remains the core focus, but opportunistic expansion into adjacent sectors (entertainment) should not be ruled out in due course.

Keywords remains the only games service provider with global scale, offering a suite of services across a range of geographies and of a quality and standard of professionalism that is catching the attention of the largest games studios (see Cross-selling and cross-delivery to become the 'go to' provider). Keywords continues to believe there may soon be a tipping point where a large games company (or a number of companies) hands over the responsibility for outsourcing to KWS to focus on its core creative game development.

Key themes of the day

1. The benefits of being the scale player
2. Acquisitions and integration
3. Leveraging location – 'land and expand'
4. Cross-selling and cross-delivery to become the 'go-to' provider

Exhibit 1: Keywords CMD video

Source: Keywords

The benefits of scale: Leading global games services company

Keywords remains a complex seat utilisation business. The logistics of putting teams together and scaling up and down with project demands is hugely complex and an area of real competitive advantage and differentiation. Keywords has proven ability to work in a distributed fashion, coordinating delivery from teams in different studios and locations although clients usually prefer the lead team to be local and based in the same time zone.

Historically, staff numbers have varied significantly through the year, with a peak between June and October. This cyclicality has moderated substantially in recent years, varying by less than 10% in FY19 because Keywords is now broader based and less dependent on consoles, and it reflects the increase in GaaS (Games as a Service) and DLC (downloadable content). Keywords also has an increasing range of evergreen project work, with teams providing multi-year post-launch support (as long as eight years in some cases).

The business has always valued flexibility, but with greater stability and predictability there is a strong argument to increase the ratio of permanent staff. Keywords recognises an increasing industry shift towards outsourcing non-core development, as publishers switch from having dedicated internal teams to leveraging Keywords' services.

Exhibit 2: Keywords is the scale player in outsourced services

Source: Keywords CMD presentation

Acquisitions and integration: More deals expected

Since IPO, Keywords has completed 43 acquisitions across 18 geographies. Historically, most acquisitions have been priced between €3–30m, with an average historic sales multiple of 1.1x. Looking ahead, acquisitions of engineering and development studios were mentioned as the likely future focus and with only a few weeks to go until year end, Keywords did not rule out further acquisitions in FY19.

For M&A, Keywords does not use external advisers or participate in sale processes, with due diligence and integration led by Keywords staff and management. All companies are integrated with a structured transition plan and acquisitions tend to use a similar structure, pricing and methodology.

Keywords does not often compete with other buyers – developers and publishers normally look to acquire IP and content, whereas Keywords is primarily seeking service competence and is not interested in IP acquisition. In future, as well as looking for engineering and development studios, management indicated it would also consider opportunities to expand in adjacent sectors outside the games industry, although gave no defined timeline.

A number of studio heads presented to the audience, with case studies including Volta, Fire Without Smoke, Sunny Side Up, VMC and Snowed In Studios. The presenters delivered a consistent message, where each was acquired at a point where the business required increasing investment in admin and support functions, with the founding team being drawn away from its focus on the day-to-day business. Keywords was a welcome solution, taking away central functions, freeing up the management team to get back into the business and re-enabling growth.

Studios remain independent brands run semi autonomously with a high degree of independent decision making, but central functions are removed to become part of the Keywords family.

Leveraging location: 'Land and expand' service expansion

Keywords' expansion strategy has been to establish a beachhead in a new territory through a single service line then expand the capabilities of that hub by building the suite of services. This strategy applies equally to clients, whereby a new client is won or acquired then cross-sold additional services to enable the relationship to be built and deepened. The breadth of Keywords' acquisition strategy since IPO (43 deals across 18 geographies) highlights the effectiveness of this approach.

Exhibit 3: Hub-based model of international expansion

Source: Keywords CMD presentation

Trust, flexibility and scalability more critical than pricing

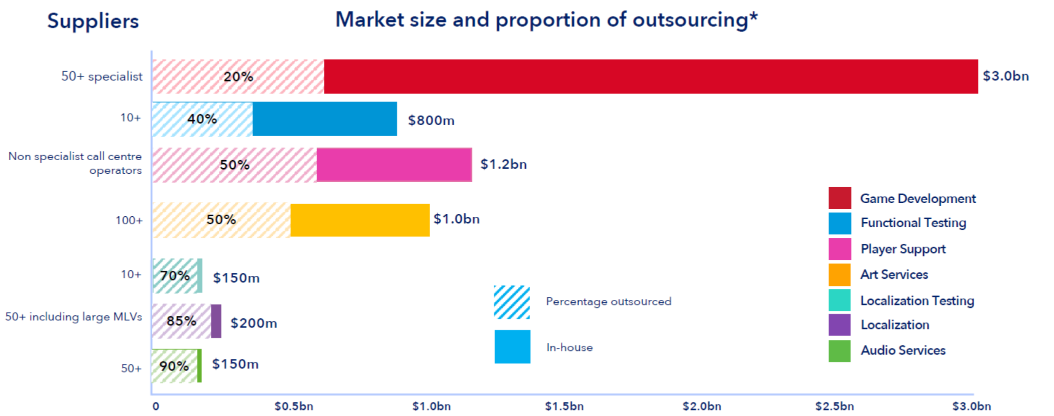
Keywords made the point that price is not normally the chief concern for most clients. Generally, trust, quality, flexibility, scalability and Keywords' ability to offer a local point of contact are more important considerations than rock-bottom pricing. If pricing is critical, then Keywords can offer services from some of its lower cost locations.

Publishers and developers are beginning to realise that Keywords is better at managing outsourcing than they are. Keywords has more experience, better systems and more effective management processes than developers and publishers, so rather than getting a poorer solution through outsourcing (which may be their expectation), clients often get a better product than they would from managing the outsourcing process themselves. Keywords' teams are involved in many more projects than in-house teams. As an indication, the Montreal studio has worked on >100 projects so far in 2019, whereas a larger publisher may only be working on c 10 projects.

Keywords avoids fixed price contracts – the risk is too high – it would prefer to walk away from a client than take on an unquantifiable level of risk. Keywords always prices based on time and materials, with clearly defined KPIs, milestones and break clauses. This approach, together with open and early communication with the client, is the only basis to build a long-term multi-project client relationship.

Keywords may look to increase its pricing, but the group will look to apply pricing more intelligently for projects that restrict Keywords' flexibility through special conditions, such as high confidentiality, short notice projects, dedicated teams etc.

Exhibit 4: Significant scope for further growth in outsourcing



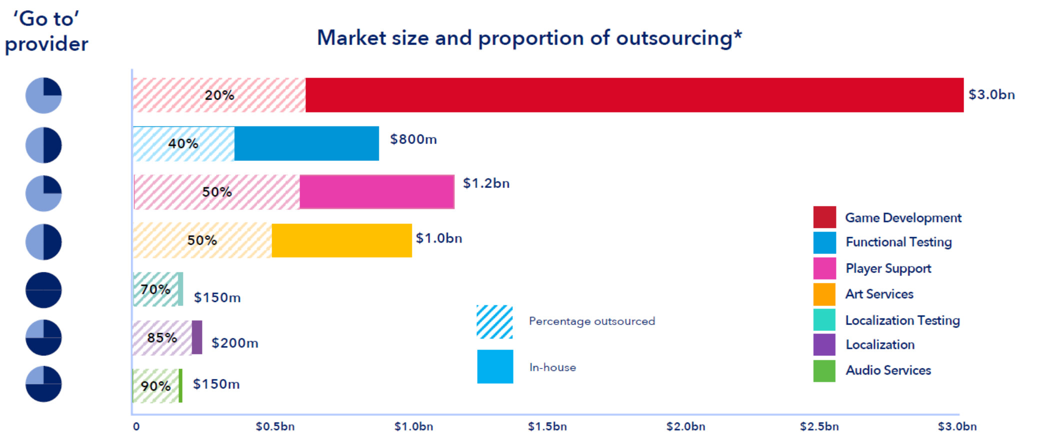
Source: Keywords CMD presentation

Cross-selling and cross-delivery to become the 'go to' provider

Management noted that most of its large contract wins over the last 18 months have come as a result of the VMC acquisition – the explanation is that large clients need a counterpart at scale and, following the acquisition of VMC, Keywords is increasingly being recognised by a number of major US clients as having the necessary scale and professionalism they are looking for. Although there are no immediate plans, the acquisition of VMC may allow Keywords the option to increase pricing in the future.

It is hard to document Keywords' success at cross-selling, however, each of the studios presenting (Volta, Fire Without Smoke, Sunny Side Up, Babel and Snowed In Studios) talked about and could demonstrate both incoming and outgoing referrals within the group. This was reinforced by the finance function, with the number of inter-company transactions recorded by the finance team highlighting the success of Keywords' cross-selling policy.

Exhibit 5: Aiming to be the 'go-to' provider across all service lines

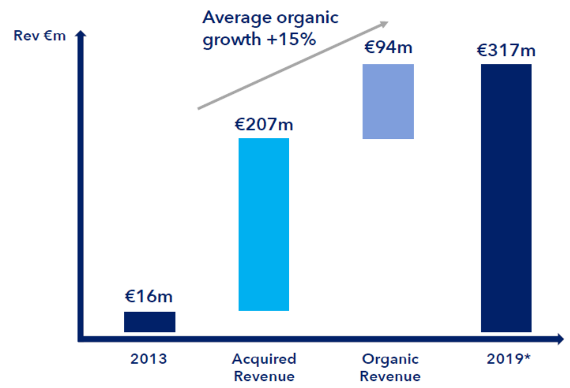


Source: Keywords CMD presentation

Growth and margins to normalise at c 15% by end FY20

Organic revenues have grown at a 15% CAGR from €16m in 2013 to an expected (based on market consensus) €110m in 2019. Keywords has acquired revenue of €207m across 43 acquisitions at an average multiple of c 1.1x historic revenues. Consensus FY19e revenues are now forecast to be c €317m (vs our revenue forecast of €320m).

Exhibit 6: Sustainable recipe of organic growth supplemented by M&A



Source: Keywords CMD presentation. Note: *FY19 forecasts are based on market consensus.

As reported in H119, the company saw exceptional organic growth that, together with advance investment in the Montreal facilities to support continuing growth, affected H1 margins. Keywords expects operating margins to recover steadily to c 15% over FY20 (vs 12.6% in H119). However, if there is an opportunity to benefit from continuing high revenue growth, management will look to capitalise on this, trading off additional growth for a slower normalisation of profit margins. Nevertheless, management expects margins to have normalised by the end of FY20 (vs our forecasts of 13.2% for FY19 and 14.9% for FY20).

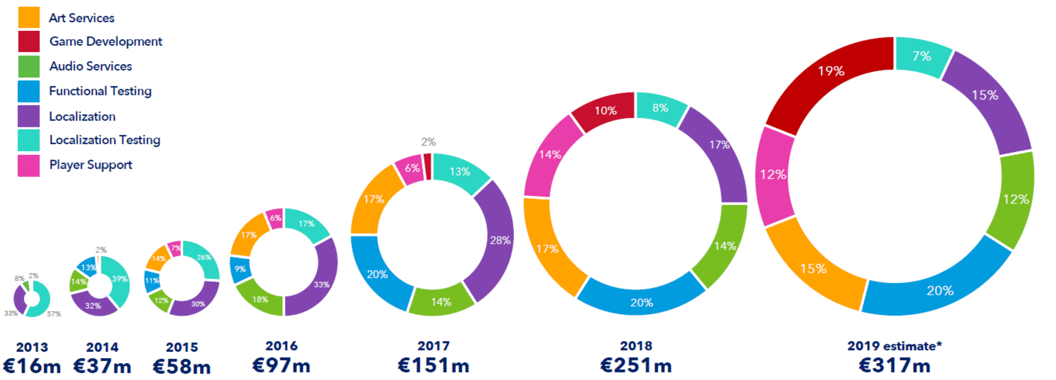
To explain background growth, management broke down its organic growth expectations, showing why it envisaged 10% sustainable revenue growth in the medium to long term:

- Sustainable games industry growth – c 9% (Newzoo 2018–22)
- Stripping out an element of growth attributable to China – minus 2%
- Additional growth from the trend towards outsourcing – 2% (Keywords)
- Additional growth from Keywords increasing market share – 1% (Keywords)
- Resultant organic growth expectations – c 10%

Console transition: Active FY20 pipeline, benign transition

The last console transition (2013) was unexpectedly bumpy for Keywords in the run up to its IPO (over-exposure to a single key client). Keywords' exposure to key console players is much lower than it was in 2013 and the business is more broadly based (the top five clients represent c 25% of revenues). In addition, the number of new distribution models such as mobile, VR, Stadia and Apple Arcade diversifies revenue sources. Clients tend to share their release roster with Keywords 12 months ahead for planning purposes. On this basis, although Q419 was relatively quiet in the run-up to Thanksgiving, the launch schedule for FY20 looks much busier.

Exhibit 7: Stronger and more balanced business than in 2013



Source: Keywords CMD presentation

Looking ahead to the forthcoming 2020 console transition, there are a number of factors that suggest the transition this time will be different: 1) consoles are a far less important part of the games mix than in 2013 (the number of new distribution models, eg Stadia, Apple Arcade, further diversifies revenue sources); 2) both major consoles are backwards compatible, so developers are likely to continue to focus on the current generation of consoles as the installed base of next-gen consoles builds; and 3) the increasing prevalence of the GaaS business model indicates a commercial rationale for a high level of ongoing support for ongoing titles on existing platforms.

Valuation: Forecast update

We have taken advantage of the CMD to slightly update our forecasts, in particular taking account of the TV+ Synchron deal that completed shortly after the interim results.

Exhibit 8: New/old forecasts

€'000s	2018	2019e			2020e		
	Actual	Old	New	Change	Old	New	Change
Revenue	250,805	315,202	319,720	1.4%	349,874	354,889	1.4%
Cost of sales	(154,997)	(197,542)	(200,799)	1.6%	(217,868)	(221,416)	1.6%
Gross profit (inc multimedia tax credits)	95,808	117,659	118,921	1.1%	132,005	133,473	1.1%
Gross margin (%)	38.2%	37.3%	37.2%		37.7%	37.6%	
EBITDA	44,232	48,546	48,817	0.6%	59,838	60,271	0.7%
Operating profit (before amort. and except.)	38,916	42,011	42,188	0.4%	52,584	52,913	0.6%
Operating margin	15.5%	13.3%	13.2%		15.0%	14.9%	
Profit before tax (norm)	37,911	40,011	40,188	0.4%	51,584	51,913	0.6%
Profit after tax (norm)	30,720	32,609	32,753	0.4%	42,299	42,569	0.6%
EPS - normalised (c)	40.1	45.8	45.0	-1.8%	59.5	64.1	7.7%
Dividend per share (p)	1.61	1.77	1.77		1.95	1.95	
Closing net debt/(cash)	423	6,716	3,982	-40.7%	(15,776)	(29,688)	88.2%

Source: Keywords Studios, Edison Investment Research

In terms of valuation, Exhibits 9 and 10 below show Keywords' comparator groups, both outsourcing and games companies. In terms of P/E multiples, Keywords continues to trade at a premium to its peer groups in the current year (FY19: 36.6x vs 25-30x), although with the strong EPS growth forecast, FY20 PE falls to 25.7x, in line with its peer group trading range (22-26x). Adjusted for blended average growth in FY19 and FY20, we derive a PEG ratio of 1.0x, materially below the majority of its peers (1.3-1.7x).

There is now limited scope for M&A in FY19, however accretive acquisition activity in FY20 (at multiples in line with historic levels) could bring the 2020e P/E down further. With strong underlying growth (10%+), we continue to believe sustained execution should drive robust returns for shareholders.

Exhibit 9: Peer valuations – outsourcing/localisation businesses

Name	Current price (local ccy)	Market cap ($m)	EV ($m)	EV/sales 1FY (x)	EV/sales 2FY (x)	EV/ EBITDA 1FY (x)	EV/ EBITDA 2FY (x)	P/E 1FY (x)	P/E 2FY (x)	PEG FY1/2	FCF yield 1FY (%)
Keywords Studios PLC	**1407.0p**	**1,198**	**1,207**	**3.4**	**3.1**	**22.3**	**18.1**	**36.6**	**25.7**	**1.0**	**3.0**
Outsourcing/Localisation											
Constellation Software	CAD1420	22,665	23,112	6.6	5.7	24.8	21.1	37.5	29.7	1.3	3.0
Capita	158.4p	3,413	5,230	1.1	1.1	9.4	8.3	12.5	10.7	0.8	nm
Reply	€71.1	2,928	2,912	2.3	2.1	14.5	13.2	25.0	22.7	2.3	2.6
RWS Holdings	656.0p	2,333	2,415	5.3	4.9	22.4	20.9	31.3	28.5	3.3	2.4
Appen	A$24.5	2,002	1,977	5.4	4.3	30.2	22.8	49.4	37.0	1.1	-0.3
Learning Technologies	122.0p	1,055	1,090	6.5	6.0	19.2	17.5	27.7	25.4	2.6	2.6
Wavestone	€24.0	534	576	1.2	1.1	8.8	7.5	15.2	11.9	0.6	5.5
SDL	594.0p	697	723	1.5	1.4	12.0	10.7	20.5	18.1	1.5	2.6
ZOO Digital Group	81.0p	78	85	2.4	1.9	26.2	14.6	nm	25.1	nm	1.4
Mean			**Mean**	**3.6**	**3.2**	**18.6**	**15.2**	**27.4**	**23.2**	**1.7**	**2.5**
Median			**Median**	**2.4**	**2.1**	**19.2**	**14.6**	**26.3**	**25.1**	**1.4**	**2.6**

Source: Edison Investment Research, Refinitiv data. Note: Priced at 2 December 2019.

Exhibit 10: Peer valuations – games companies

Name	Current price (local ccy)	Market cap ($m)	EV ($m)	EV/sales 1FY (x)	EV/sales 2FY (x)	EV/ EBITDA 1FY (x)	EV/ EBITDA 2FY (x)	P/E 1FY (x)	P/E 2FY (x)	PEG FY1/2	FCF yield 1FY (%)
UK games											
Frontier Developments	1220.0p	614	568	6.2	5.2	18.8	14.1	48.5	31.7	0.5	0.4
Team17 Group	337.5p	572	527	7.4	7.0	21.4	20.4	31.6	30.2	6.1	3.0
Codemasters Group	235.5p	426	394	3.7	3.3	16.8	13.7	19.0	15.4	1.2	2.8
Sumo Group	154.3p	300	301	4.6	3.8	16.8	14.3	23.4	20.8	1.7	3.8
Mean			**Mean**	**5.5**	**4.8**	**18.5**	**15.6**	**30.6**	**24.5**	**2.4**	**2.5**
Median			**Median**	**5.4**	**4.5**	**17.8**	**14.2**	**27.5**	**25.5**	**1.5**	**2.9**
US/European Games											
Activision Blizzard Inc	$54.80	42,124	39,859	6.3	5.8	17.9	15.0	24.8	22.0	1.6	4.0
Electronic Arts Inc	$101.0	29,493	25,605	4.9	4.8	14.5	13.9	21.6	20.7	1.9	5.4
Take-Two Interactive	$121.4	13,755	12,250	4.3	4.3	17.7	16.4	24.9	24.3	1.7	3.8
Ubisoft Entertainment SA	€55.1	7,312	7,800	4.5	2.8	14.1	6.6	nm	16.3	0.1	nm
Zynga Inc	$6.20	5,893	5,077	3.3	2.9	16.8	14.7	24.0	23.5	2.2	3.1
Embracer Group AB	SEK67.8	1,988	1,690	2.7	2.2	8.2	6.1	41.6	27.4	0.8	nm
Glu Mobile Inc	$5.50	806	704	1.7	1.5	18.0	17.2	20.7	21.5	0.6	3.2
Mean			**Mean**	**4.0**	**3.5**	**15.3**	**12.9**	**26.3**	**22.2**	**1.3**	**3.9**
Median			**Median**	**4.3**	**2.9**	**16.8**	**14.7**	**24.4**	**22.0**	**1.6**	**3.8**

Source: Edison Investment Research, Refinitiv data. Note: Priced at 2 December 2019.

CMD presentation

The CMD presentation is available on the Keywords website.

The full CMD video can be found at: https://www.youtube.com/watch?v=SUy8j73oNpc

Exhibit 11: Financial summary

€'000s	2016	2017	2018	2019e	2020e
31-December	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue	96,525	151,430	250,805	319,720	354,889
Cost of Sales	(59,907)	(96,345)	(154,997)	(200,799)	(221,416)
Gross Profit (inc multimedia tax credits)	36,618	55,085	95,808	118,921	133,473
EBITDA	16,833	26,645	44,232	48,817	60,271
Operating Profit (before amort. and except.)	15,030	23,915	38,916	42,188	52,913
Intangible Amortisation	(1,629)	(3,038)	(6,872)	(7,559)	(8,315)
Exceptionals	(1,316)	(3,016)	(5,607)	(2,981)	0
Other	(686)	(1,426)	(4,129)	(6,000)	(6,600)
Operating Profit	11,399	16,435	22,308	25,648	37,998
Net Interest	(287)	(818)	(1,005)	(2,000)	(1,000)
FOREX	(1,737)	(3,623)	791	(1,159)	0
Profit Before Tax (norm)	14,804	23,097	37,911	40,188	51,913
Profit Before Tax (FRS 3)	9,375	11,994	22,094	22,489	36,998
Tax	(3,223)	(4,731)	(7,191)	(7,435)	(9,344)
Profit After Tax (norm)	11,581	18,366	30,720	32,753	42,569
Profit After Tax (FRS 3)	6,152	7,263	14,903	15,054	27,654
Average Number of Shares Outstanding (m)	55.9	58.7	64.3	65.1	65.1
EPS	20.8	31.3	41.8	45.9	65.4
EPS - normalised (c)	20.2	30.0	40.1	45.0	64.1
EPS - (IFRS) (c)	11.0	12.4	23.2	23.1	42.5
Dividend per share (p)	1.33	1.46	1.61	1.77	1.95
Gross Margin (%)	37.9%	36.4%	38.2%	37.2%	37.6%
EBITDA Margin (%)	17.4%	17.6%	17.6%	15.3%	17.0%
Operating Margin (before GW and except.) (%)	15.6%	15.8%	15.5%	13.2%	14.9%
BALANCE SHEET					
Fixed Assets	61,873	142,927	198,215	218,080	212,507
Intangible Assets	55,495	131,610	180,086	197,579	189,365
Tangible Assets	5,498	10,111	15,002	17,534	20,176
Investments	880	1,206	3,127	2,967	2,967
Current Assets	38,677	80,182	100,349	112,863	154,183
Stocks	0	0	0	0	0
Debtors	13,879	27,473	37,019	42,572	47,255
Cash	17,020	30,374	39,871	43,313	76,983
Other	7,778	22,335	23,459	26,978	29,945
Current Liabilities	(27,830)	(51,677)	(95,031)	(80,415)	(81,303)
Creditors	(19,805)	(32,734)	(54,960)	(33,343)	(34,231)
Short term borrowings	(8,025)	(18,943)	(40,071)	(47,072)	(47,072)
Long Term Liabilities	(6,016)	(10,420)	(11,158)	(11,703)	(10,718)
Long term borrowings	(345)	(337)	(230)	(230)	(230)
Other long term liabilities	(5,671)	(10,083)	(10,928)	(11,473)	(10,488)
Net Assets	66,704	161,012	192,375	238,825	274,669
CASH FLOW					
Operating Cash Flow	17,108	21,389	38,481	49,406	61,291
Net Interest	(58)	(253)	(502)	(7,542)	(6,394)
Tax	(2,129)	(4,731)	(6,304)	(7,435)	(9,344)
Capex	(2,306)	(3,803)	(9,440)	(9,000)	(10,500)
Acquisitions/disposals	(21,104)	(90,090)	(30,296)	(27,836)	(112)
Financing	643	82,936	174	0	0
Dividends	(825)	(867)	(1,080)	(1,152)	(1,271)
Net Cash Flow	(8,671)	4,581	(9,919)	(3,558)	33,670
Opening net debt/(cash)	(17,284)	(8,650)	(11,094)	423	3,982
Forex gain on cash	1	(891)	(3)	0	0
Other	36	(1,246)	(1,596)	0	0
Closing net debt/(cash)	(8,650)	(11,094)	423	3,982	(29,688)

Source: Keywords Studios accounts, Edison Investment Research

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