

# Keywords Studios

Affected by industry flux but still performing well

Trading in H2 was affected in some areas by flux in the games industry, so although the overall picture remains relatively healthy (we est 8% I-f-I revenue growth, 49% EPS growth for FY18) FY18 revenues and PBT are expected to be 2% and 6% below our respective forecasts. Looking through this disruption, we still believe Keywords remains attractively positioned in a games industry that should continue to deliver robust growth. There remains plenty of scope for Keywords to continue accretive M&A, as demonstrated by the acquisition of games marketing services specialist, Sunny Side Up for C\$5.9m (c €3.8m) for c 4.9x trailing EBITDA.

Year end	Revenue (€m)	PBT* (€m)	EPS* (c)	DPS (p)	P/E (x)	Yield (%)
12/16	96.6	14.9	20.3	1.3	56.6	0.13
12/17	151.4	23.0	29.9	1.5	38.3	0.14
12/18e	250.0	37.0	44.6	1.6	25.7	0.16
12/19e	292.1	44.4	55.1	1.8	20.8	0.17

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

## Healthy performance despite industry disruption

In a brief trading statement made together with the announcement of the acquisition of Canadian marketing services specialist, Sunny Side Up, Keywords flags that FY18 revenues and PBT are expected to be €250m (€258m in constant currency) vs our estimates of €254.6m and €37m (Edison old: €39.2m). This represents respective FY18 growth figures of 61% and 65% and we estimate I-f-I revenue growth was c 8%. Management does not point to one factor, but we highlight that a relatively muted H1 left some catching up to do and the industry has seen some turbulence, with the dramatic success of Fortnite counterbalanced by some studio closures and mixed title performance elsewhere.

## Remains attractively positioned

We still believe Keywords is attractively positioned within a growth end market. We expect the games industry will continue growing at a high single-digit rate and Keywords should benefit from increased outsourcing. The acquisition of Sunny Side Up, for C\$5.9m (c €3.8m, c 4.9x trailing EBITDA) highlights the company's ongoing ability to enhance its portfolio and earnings with acquisitions. There is an argument that the de-rating of the sector will ease vendor price expectations. The business will complement the company's other marketing studios – Fire-Without Smoke (acquired in May) and Trailerfarm (acquired in September).

## Valuation: Undemanding given growth prospects

We reduce our FY18 and FY19 adj EPS estimates by 6% and 5% respectively, which assumes a 9% revenue growth rate from the lower base offset by the Sunny Side Up acquisition (detailed overleaf). With the recent sell off, the shares have de-rated substantially to a FY19 P/E of 21x (vs 40x at the interims). While still a growth rating, it looks undemanding given the company's track record of generating EPS growth (52% EPS CAGR 2013–2018e) and acquisition activity should bring this down further. Gaining better visibility on trading into FY19 will likely be the key catalyst for a re-rating upwards.

Acquisition/trading update

Software & comp services

21 December 2018

Price **1,032p**

Market cap **£658m**

£/€1.11

Net cash (€m) at end June 2018 0.1

Shares in issue 63.8m

Free float 83%

Code KWS

Primary exchange AIM

Secondary exchange N/A

### Share price performance



% 1m 3m 12m

Abs (12.4) (45.2) (28.4)

Rel (local) (9.0) (39.2) (19.2)

52-week high/low 2065p 1034p

### Business description

Keywords Studios is now the largest 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 industry.

### Next events

Scheduled trading update January

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## Estimate changes

While FY18 revenues and PBT are expected to be somewhat below our expectations, it is worth highlighting that estimated I-f-I growth was still a relatively healthy 8% in FY18 and, factoring in acquisitions, we estimate EPS growth at 49%.

We also believe the overall outlook for the games industry remains robust, even if it is recovering from a bout of optimism and investment witnessed in H217 and H118. The dramatic success of Fortnite has likely accelerated the growth of the overall industry, but this success has also cannibalised revenues elsewhere. Whether related to Fortnite or not, H2 has seen the closure or significant scaling back of a number of studios (Telltale Games, Capcom Vancouver, Carbine). Trading at the major studios has been mixed, while a reshuffling of the games launch timetable can also disrupt near-term trading.

We highlight that none of the above factors are particularly unusual within this highly dynamic industry, but the degree of flux witnesses in H2 is above historical norms and likely reflect a bout of over optimism and investment in the preceding period.

We also highlight that while now a substantially larger and more diversified business that it was before, the company has shown its ability to recover rapidly from disruptions in the past (in FY13 related to the console replacement cycle).

On an I-f-I basis, our adj EPS estimate is brought back by 6% for FY18 and 7% for FY19. This assumes a 9% I-f-I revenue growth in FY19 from the reduced base. To calibrate, NewZoo forecasts a 8.2% CAGR for the industry through 2020 and Keywords should also continue to benefit from the trend towards outsourcing.

The acquisition of Sunny Side Up enhances FY19 EPS by 1% from the revised base. Further acquisition activity should enhance earnings, and we reiterate our view that the derating of the sector could ease vendor price expectations, providing support to the acquisition strategy. With a revolving credit facility of €105m (at 1.5% above Euribor), Keywords retains plenty of firepower for future acquisitions.

### Exhibit 1: Estimate changes

	€000s	2017	2018e	2018e		2019	2019e		2019e	
31-December		Actual	Old	New	Change, %	Old	New pre Sunny Side Up*	% change pre Sunny Side Up	New with Sunny Side Up	Total change, %
<b>PROFIT &amp; LOSS</b>										
Revenue		151,430	254,570	249,967	(2)	300,212	289,024	(4)	292,111	(3)
Cost of Sales		(96,345)	(160,361)	(157,579)	(2)	(190,439)		(100)	(185,394)	(3)
Gross Profit		55,085	94,208	92,389	(2)	109,772		(100)	106,718	(3)
EBITDA		26,645	44,539	42,357	(5)	53,911	50,593	(6)	51,451	(5)
Operating Profit (before amort. and except.)		23,915	39,339	37,157	(6)	47,778	44,461	(7)	45,374	(5)
Profit Before Tax (norm)		23,043	39,196	37,014	(6)	46,843	43,737	(7)	44,439	(5)
Profit After Tax (norm)		18,312	31,435	29,685	(6)	37,943	35,427	(7)	35,996	(5)
EPS - normalised fully diluted (c)		30	47	45	(6)	58	54	(7)	55	(5)
EPS - (IFRS) (c)		12	33	30	(8)	47	44	(7)	44	(6)
Dividend per share (pence)		1	2	2	0	2	2	0	2	0
Closing net debt/(cash)		(11,094)	(3,749)	(2,783)		(9,788)	(6,196)		(3,108)	(68)

Source: Keywords, Edison Investment Research. Note: \*Not in financial summary.

**Exhibit 2: Financial summary**

	€'000s	2016	2017	2018e	2019e
31-December		IFRS	IFRS	IFRS	IFRS
<b>PROFIT &amp; LOSS</b>					
Revenue		96,585	151,430	249,967	292,111
Cost of Sales		(59,907)	(96,345)	(157,579)	(185,394)
Gross Profit (inc multimedia tax credits)		36,678	55,085	92,389	106,718
EBITDA		16,893	26,645	42,357	51,451
Operating Profit (before amort. and except.)		15,090	23,915	37,157	45,374
Intangible Amortisation		(1,629)	(3,038)	(5,000)	(5,500)
Exceptionals		(1,316)	(3,016)	(3,400)	0
Other		(686)	(1,426)	(1,854)	(2,410)
Operating Profit		11,459	16,435	26,903	37,465
Net Interest		(287)	(872)	(143)	(935)
FOREX		(1,737)	(3,569)	0	0
Profit Before Tax (norm)		14,864	23,043	37,014	44,439
Profit Before Tax (FRS 3)		9,435	11,994	26,760	36,529
Tax		(3,223)	(4,731)	(7,329)	(8,443)
Profit After Tax (norm)		11,641	18,312	29,685	35,996
Profit After Tax (FRS 3)		6,212	7,263	19,431	28,086
Average Number of Shares Outstanding (m)		55.9	58.7	63.9	64.1
EPS		20.9	31.2	46.5	56.2
EPS - normalised (c)		20.3	29.9	44.6	55.1
EPS - (IFRS) (c)		11.2	12.4	30.4	43.8
Dividend per share (p)		1.33	1.46	1.61	1.77
Gross Margin (%)		38.0%	36.4%	37.0%	36.5%
EBITDA Margin (%)		17.5%	17.6%	16.9%	17.6%
Operating Margin (before GW and except.) (%)		15.6%	15.8%	14.9%	15.5%
<b>BALANCE SHEET</b>					
Fixed Assets		61,873	143,872	165,787	180,005
Intangible Assets		55,495	132,555	153,103	167,036
Tangible Assets		5,498	10,111	11,477	11,764
Investments		880	1,206	1,206	1,206
Current Assets		38,677	80,182	74,516	81,205
Stocks		0	0	0	0
Debtors		13,879	27,473	37,118	40,896
Cash		17,020	30,374	22,063	22,388
Other		7,778	22,335	15,335	17,920
Current Liabilities		(27,830)	(52,503)	(47,729)	(44,017)
Creditors		(19,805)	(33,560)	(28,786)	(25,074)
Short term borrowings		(8,025)	(18,943)	(18,943)	(18,943)
Long Term Liabilities		(6,016)	(10,420)	(10,365)	(10,365)
Long term borrowings		(345)	(337)	(337)	(337)
Other long term liabilities		(5,671)	(10,083)	(10,028)	(10,028)
Net Assets		66,704	161,131	182,209	206,828
<b>CASH FLOW</b>					
Operating Cash Flow		17,168	18,373	35,498	38,799
Net Interest		(58)	(253)	(143)	(935)
Tax		(2,129)	(4,731)	(7,329)	(8,443)
Capex		(2,306)	(3,803)	(6,121)	(6,363)
Acquisitions/disposals		(21,104)	(87,074)	(28,387)	(21,592)
Financing		643	82,936	0	0
Dividends		(825)	(867)	(1,027)	(1,140)
Net Cash Flow		(8,611)	4,581	(7,510)	325
Opening net debt/(cash)		(17,284)	(8,650)	(11,094)	(2,783)
Forex gain on cash		1	(891)	(500)	0
Other		(24)	(1,246)	(301)	0
Closing net debt/(cash)		(8,650)	(11,094)	(2,783)	(3,108)

Source: Company data, Edison Investment Research

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