

# Keywords Studios

Trading update

Firing on all cylinders

Software & comp services

**Strong trading nearly across the board reaffirms the strength of Keywords Studios' model and prompts a further 8% upgrade to FY17 EPS. We believe there should be more to come, both organically and through acquisitions. Despite the premium rating, continued execution should drive further upside.**

Year end	Revenue (€m)	PBT* (€m)	EPS* (c)	DPS** (p)	P/E (x)	Yield (%)
12/15	58.0	8.0	12.6	1.2	95.6	0.1
12/16	96.6	14.9	20.3	1.3	59.3	0.1
12/17e	132.1	20.2	28.1	1.5	42.8	0.1
12/18e	148.9	23.1	32.0	1.6	37.6	0.1

Note: \*PBT and EPS (fully diluted) are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments. \*\*DPS in distributable currency.

## Excellent H1

H1 revenues are expected to have grown 50% y-o-y to €63.7m, with PBT up by 60% y-o-y to €9.6m. Like-for-like growth was a very healthy 17%, or 28% if adjusting for last year's exceptionally strong trading at the Audio business Synthesis. The company reports that all service lines showed good organic growth other than Audio, due to the tough comparator last year.

## Strength of model highlighted

The group's like-for-like growth rate is well above the c 6.5% estimated growth for the games industry. We believe that this reflects the strength of Keywords' position in the market, the trend to increased outsourcing and the company's ability to generate revenue synergies from its acquired businesses. Keywords' expansion into higher value-added service lines through Art Services and now Engineering with the acquisition of GameSim, could strengthen this position further. Delivery of these services occur earlier in a game's creation than more ancillary service lines and require much closer relationships with the client, which should further support cross-selling through strengthening relationships and gaining better insights into the games development pipeline.

## EPS upgraded by 8%, scope for more

We have upgraded our FY17 sales and EPS adjusted estimates by 7% and 8%, respectively which flows through to 9% and 10% respective upgrades for FY18. We believe that there is scope for more organic upgrades while earnings-enhancing acquisitions should be expected. We believe the company potentially has acquisition capital to nearly triple run-rate EPS from 20.3c in FY16 to 55-61c exiting FY18 if historical 7-9x current year EV/PBT multiples are maintained.

## Valuation: Premium rating deserved

Keywords' rating of 37.6x FY18 earnings (vs peer average of 19x) factors in further accretion from acquisitions or organic upgrades. If the company were to achieve our post-acquisitions EPS of 55-61c, the current share price would rate the company at 19-22x – a modest premium to the sector. The level of execution required to achieve this should not be underestimated, but if the company does, a wider premium rating would be merited.

4 August 2017

**Price** 1,075p

**Market cap** £600m

£/€1.12

Net cash (€m) as at 31 December 2016 8.7

Shares in issue 55.8m

Free float 69%

Code KWS

Primary exchange AIM

Secondary exchange N/A

### Share price performance



%	1m	3m	12m
Abs	45.8	31.9	241.3
Rel (local)	45.1	28.6	206.5
52-week high/low	1,075.0p	317.5p	

### Business description

Keywords Studios provides localisation, testing, artwork, community support and engineering services exclusively to the video games industry. It provides services to 20 of the top 25 games developers and is leading consolidation of this fragmented industry.

### Next events

Interim results September 2017

### Analysts

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## Scope for organic and acquisition upside

### 8% FY17 EPS upgrade, scope for more

Our estimate changes are shown in Exhibit 1, with EPS for FY17 and FY18 upgraded by 8% and 10%, respectively. We believe that these estimates remain conservative. Our FY17 revenue forecast assumes that H2 revenues are broadly flat sequentially (excluding the c €6m we expect to be added from acquisitions), whereas historically H2 has been the stronger period, although with an evolving mix we do expect this seasonality to moderate. Our estimates assume only 12.5% organic growth for FY17 and 10% for FY18.

On an underlying basis, Keywords generates healthy cash flows although cash inflows are typically strongest in H2. Net cash at year-end was €8.7m and €6.9m has been spent on acquisitions in FY17 year to date. The company has a €35m revolving credit facility with Barclays, but we believe that the company's diversity and cash flow generation profile could comfortably support 2x net debt/EBITDA or €45m in FY17 or €52m in FY18. Taking into account the cash Keywords will generate organically, we believe that the company has acquisition capital of at least €58m over the next 18 months.

**Exhibit 1: Estimate changes**

Year end 31 December, €000s	2016	2017e			2018e		
	Actual	Old	New	Change	Old	New	Change
Revenue	96,585	123,115	132,136	7%	136,485	148,894	9%
Cost of Sales	(59,907)	(76,793)	(85,815)	12%	(85,078)	(97,486)	15%
Gross Profit	36,678	46,322	46,322	0%	51,408	51,408	0%
EBITDA	16,893	21,152	22,688	7%	23,735	25,807	9%
Operating Profit (before amort. & except.)	15,090	19,077	20,613	8%	21,453	23,525	10%
Profit Before Tax (norm)	14,864	18,617	20,153	8%	20,993	23,065	10%
Profit After Tax (norm)	11,641	14,708	15,921	8%	16,795	18,452	10%
EPS - normalised fully diluted (c)	20.3	26.0	28.1	8%	29.1	32.0	10%
EPS - (IFRS) (c)	11.2	22.4	24.6	10%	25.7	28.6	11%
Dividend per share (pence)	1.3	1.5	1.5	0%	1.6	1.6	0%
Closing net debt/(cash)	(8,650)	(13,244)	(14,195)	7%	(23,943)	(26,333)	10%

Source: Edison Investment Research, Keywords Studios data

### Acquisitions could nearly double EPS over the next 18 months

The figures above clearly only incorporate acquisitions made so far. While it is impossible to forecast future acquisitions with any accuracy, the earnings accretion driven by future acquisitions is clearly core to Keywords' investment case. It is worth highlighting that, as a result of acquisitions and organic upgrades, our FY17e EPS of 28.1c is 60% higher than our 17.5c estimate for the same year from April 2016.

In Exhibit 2 we show a sensitivity analysis that calculates Keywords' EPS run rate exiting FY18 based on various different organic growth rates and EV/PBT multiples paid for acquisitions (it has spent €6.9m year to date in FY17). We assume that the company deploys €58m of cash in acquisitions, matched with equity on a 70/30 ratio. This suggests that if Keywords can maintain a high single-digit/low double-digit organic growth rate and continue making acquisitions at the average 7.2x EV/PBT level of FY15 and FY16, the company's EPS exiting FY18 could nearly triple to 55-61p from the 20.3c FY16 level.

**Exhibit 2: Scenario analysis – EPS run rate (c/share) exiting FY18 based on varying organic growth and average acquisition multiples, assuming €56m acquisition investment**

		Average EV/PBT paid for acquisitions in H217 and FY18 (x)				
		6.0	7.0	8.0	9.0	10.0
Organic growth	7.5%	58.6	55.3	52.7	50.8	49.2
	10.0%	60.0	56.6	54.1	52.2	50.6
	12.5%	61.3	58.0	55.5	53.6	52.0
	15.0%	62.8	59.4	56.9	55.0	53.4
	17.5%	64.2	60.9	58.4	56.4	54.9

Source: Edison Investment Research

**Other key assumptions and comments**

- The consideration for acquisitions is paid 70% cash, 30% in shares, in line with recent transactions, with the shares priced at a notional 1,054p.
- If €56m is deployed progressively over the period, the company should remain comfortably within its €35m overdraft facility and a 2x net debt/EBITDA ratio.

**Continued execution should continue to drive appreciation**

At c 38x FY18 earnings, Keywords' rating is a substantial premium to peers (average 19x for FY18) and clearly factors in some accretion from acquisitions or organic upgrades. The former should be expected, the latter very possible.

If we consider the scenarios portrayed in Exhibit 2, the company has the potential to nearly triple EPS from the FY16 level by 2019. On this basis, the shares would be at a mid-teens rating or potentially lower if stronger cross-selling synergies materialise.

A sector rating of 19x on this post-acquisitions EPS of c 55-61c would suggest a share price of 924-1,025p but if the company delivers this level of earnings growth and shows that it is well placed to continue on a similar trajectory, then a premium rating will almost certainly be retained.

Consequently, we believe that the shares do have good prospects for continued appreciation in the longer term, although we believe that there is plenty for the company to execute on to put itself in this position.

**Exhibit 3: Peer multiples**

Company	Quoted Currency	Current price (ccy value)	Market cap (m)	EV/sales FY1 (x)	EV/sales FY2 (x)	EV/EBITDA FY1 (x)	EV/EBITDA FY2 (x)	P/E FY1 (x)	P/E FY2 (x)
<b>Outsourcing</b>									
Keywords Studios	£	1054.0	588	4.8	4.3	28.0	24.6	41.9	36.9
SDL	£	580.0	593	1.6	1.6	13.6	12.2	21.2	19.4
RWS Holdings	£	329.8	941	4.8	4.4	18.1	16.5	23.7	23.1
Capita	£	567.0	4,759	1.3	1.3	9.4	9.2	10.4	10.0
Serco Group	£	115.5	1,592	0.5	0.4	11.7	10.8	42.9	32.1
Wipro Ltd-ADR	US\$	10.2	24,868	2.7	2.5	12.9	12.0	19.7	18.1
Poletowin Pitcrew Holdings	JPY	1221.0	209	0.8	0.8	na	na	13.2	11.8
Capgemini	€	86.5	15,600	1.2	1.2	9.1	8.5	14.5	13.3
<b>Average</b>				1.8	1.7	12.5	11.6	20.8	18.2
<b>Games Developers</b>									
Microsoft Corp	US\$	65.9	508,935	4.9	4.6	13.1	11.8	22.3	20.2
Sony Corp	JPY	3664.0	41,553	0.6	0.6	7.6	5.4	93.8	17.7
Square Enix Holdings Co	JPY	3180.0	3,493	1.1	1.1	7.2	5.7	18.8	14.4
Ubisoft Entertainment	€	39.6	4,826	2.9	2.6	6.8	5.3	30.1	23.4
Bandai Namco Holdings	JPY	3350.0	6,675	1.0	0.9	6.9	6.3	17.7	15.7
Konami Holdings Corp	JPY	4735.0	6,098	2.6	2.3	11.2	9.6	25.9	21.6
Electronic Arts	US\$	89.5	27,596	4.9	4.7	14.1	13.6	23.2	21.5
<b>Average</b>				2.6	2.4	9.6	8.2	33.1	19.2

Source: Bloomberg consensus estimates, Edison Investment Research. Note: Priced on 26 July 2017.

**Exhibit 4: Financial summary**

	€'000s	2014	2015	2016	2017e	2018e
31-December		IFRS	IFRS	IFRS	IFRS	IFRS
<b>PROFIT &amp; LOSS</b>						
Revenue		37,293	57,951	96,585	132,136	148,894
Cost of Sales		(24,566)	(36,172)	(59,907)	(85,815)	(97,486)
Gross Profit (inc multimedia tax credits)		12,727	21,779	36,678	46,322	51,408
EBITDA		6,027	9,459	16,893	22,688	25,807
Operating Profit (before amort. and except.)		5,159	8,162	15,090	20,613	23,525
Intangible Amortisation		(468)	(857)	(1,629)	(1,629)	(1,629)
Exceptionals		(1,461)	(1,089)	(1,316)	0	0
Other		(156)	(392)	(686)	(686)	(686)
Operating Profit		3,074	5,824	11,459	18,298	21,210
Net Interest		(106)	(264)	(287)	(460)	(460)
FOREX		467	(474)	(1,737)	0	0
Profit Before Tax (norm)		5,053	8,007	14,864	20,153	23,065
Profit Before Tax (FRS 3)		3,435	5,086	9,435	17,838	20,750
Tax		(1,215)	(1,832)	(3,223)	(4,232)	(4,613)
Profit After Tax (norm)		3,838	6,175	11,641	15,921	18,452
Profit After Tax (FRS 3)		2,220	3,254	6,212	13,606	16,137
Average Number of Shares Outstanding (m)		45.0	48.2	55.9	55.3	56.5
EPS - normalised (c)		8.5	12.8	20.9	28.8	32.7
EPS - normalised fully diluted (c)		8.5	12.6	20.3	28.1	32.0
EPS - (IFRS) (c)		4.9	7.0	11.2	24.6	28.6
Dividend per share (p)		1.10	1.21	1.33	1.46	1.61
Gross Margin (%)		34.1%	37.6%	38.0%	35.1%	34.5%
EBITDA Margin (%)		16.2%	16.3%	17.5%	17.2%	17.3%
Operating Margin (before GW and except.) (%)		13.8%	14.1%	15.6%	15.6%	15.8%
<b>BALANCE SHEET</b>						
Fixed Assets		20,874	32,132	61,873	54,577	57,571
Intangible Assets		17,677	27,675	55,495	48,971	47,342
Tangible Assets		2,761	3,486	5,498	4,726	9,349
Investments		436	971	880	880	880
Current Assets		23,120	34,884	38,677	48,379	63,199
Stocks		0	0	0	0	0
Debtors		6,203	7,519	13,879	16,815	18,496
Cash		11,014	19,018	17,020	22,565	34,703
Other		5,903	8,347	7,778	9,000	10,000
Current Liabilities		(9,746)	(13,128)	(27,830)	(31,357)	(32,281)
Creditors		(9,746)	(11,965)	(19,805)	(23,332)	(24,256)
Short term borrowings		0	(1,163)	(8,025)	(8,025)	(8,025)
Long Term Liabilities		(2,607)	(3,294)	(6,016)	(6,190)	(6,190)
Long term borrowings		0	(571)	(345)	(345)	(345)
Other long term liabilities		(2,607)	(2,723)	(5,671)	(5,845)	(5,845)
Net Assets		31,642	50,594	66,704	65,409	82,299
<b>CASH FLOW</b>						
Operating Cash Flow		2,412	4,768	17,168	22,950	25,226
Net Interest		11	(58)	(58)	(460)	(460)
Tax		(522)	(1,362)	(2,129)	(4,232)	(4,613)
Capex		(1,252)	(1,635)	(2,306)	(4,308)	(5,600)
Acquisitions/disposals		(8,889)	(7,409)	(21,104)	(7,580)	(1,500)
Financing		7,342	14,199	643	0	0
Dividends		(609)	(737)	(825)	(814)	(915)
Net Cash Flow		(4,256)	7,194	(8,611)	5,556	12,138
Opening net debt/(cash)		(15,271)	(11,014)	(17,284)	(8,650)	(14,195)
Forex gain on cash		0	0	1	0	0
Other		(1)	(924)	(24)	(11)	0
Closing net debt/(cash)		(11,014)	(17,284)	(8,650)	(14,195)	(26,333)

Source: Keywords Studios accounts, Edison Investment Research

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