Keywords Studios

Reassuring CMD, residual concerns dispelled

London capital markets day

Software & comp services

Keywords Studios' capital markets day (CMD) on 5 February 2020 was very well attended and reassuring. The company will continue to grow a balanced, diversified business. Organic growth remains strong over the short to medium term: for FY20 we forecast 15% y-o-y revenue growth, up 12% on the FY19 closing annual run rate (ARR), supported by the launch of next-gen consoles. Increasing scale helps to attract larger clients and raise barriers to entry. Keywords' strategic approach to 'buy and build' delivers for both the company and the studios. We retain our view that Keywords is strongly positioned as the only games service provider at a global scale. The company's P/E rating (29.2x FY20e) reflects its leading market position, track record and potential, but should fall further as Keywords continues to execute its buy-and-build strategy.

Year end	Revenue (€m)	PBT* (€m)	EPS* (c)	DPS* (p)	P/E (x)	Yield (%)
12/17	151.4	23.1	30.0	1.46	62.9	0.09
12/18	250.8	37.9	40.1	1.61	47.1	0.10
12/19e	326.0	41.0	46.0	1.77	41.1	0.11
12/20e	374.9	52.4	64.8	1.95	29.2	0.12

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

CMD: Key themes of the day

Keywords has been investing in its platform and capacity to ensure that it can deliver its full suite of services, with a similar level of professionalism, to clients wherever they are based – with services able to be delivered on a round-the-clock, distributed basis. Keywords' next step is to demonstrate to even the largest, most demanding AAA clients that it now uniquely has the scale to be a professional and reliable partner for all their studios.

Financials: Strong growth and improving margins

In FY19, Keywords delivered 30% revenue growth and 15% underlying organic growth. Underpinned by a growing industry (Newzoo: 8.4% CAGR 2019–22), this trend looks set to continue – we forecast FY20 revenues of €374.9m (+15% y-o-y, +12% on an FY19 closing ARR basis). Adjusted operating margins are set to improve through FY20 – we forecast 14.2% (FY19: 13.1%), operating income of €53.4m (FY19: €42.7m) and normalised EPS of 64.8c, a 41% uplift on FY19 (46.0c). Keywords benefits from the trend towards outsourcing, increasing its market share as a market leader in a fragmented global industry with growth further supplemented by M&A. With the console transition in Q420, the medium-term growth outlook remains robust.

Valuation: Rating undemanding, likely to fall further

Keywords has delivered an adjusted EPS FY13–19 CAGR of 43% and we believe it looks set to maintain double-digit revenue growth for the foreseeable future. In this context, we believe that a 29.2x FY20e P/E is not overly demanding and fairly reflects Keywords' leading market position, track record and potential. This rating should fall further as Keywords continues to execute its buy-and-build strategy, focused around higher-margin marketing and development.

10 February 2020

Price	**1,600p**
Market cap	**£1,044m**
	€1.18/£
Forecast net debt (€m) at 31 December 2019	18.0
Shares in issue	65.27m
Free float	89%
Code	KWS
Primary exchange	AIM
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	8.8	29.8	60.0
Rel (local)	10.3	27.5	49.7
52-week high/low		1,838p	900p

Business description

Keywords Studios is 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

Final results	31 March 2020
AGM	May 2020

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Capital markets day – London

Summary: A reassuring afternoon

The capital markets day in Montreal in November 2019 focused on the benefits of scale, cross-selling and the integration of new studios into the 'family'. For the London CMD, Keywords focused on the opportunities for the different service lines, highlighting the higher value-added service lines, development and art services (including marketing services, which will be broken out when it reaches €30m). Management has been clear that this is where Keywords is likely to focus its future M&A activity to drive growth.

Andrew Day (CEO) and Jon Hauck (CFO) bookended the presentation, with the stage largely left to representatives of the different service lines as well as studio heads in development and marketing services. This showcased the company's collaborative approach and helped to underline that Keywords is not overly centralised, and that there is broad buy-in to the 'family' values that the management team espouses, with teams and studios ready and willing to work together to deliver broad-based client solutions. Following an acquisition, Keywords seeks to remove the administrative burden from the studio, to allow them to do what they have done, only better.

Jon Hauck closed the day with a presentation providing further clarification on the recent trading update, particularly dealing with concerns around margin progression as well as cash conversion. Wrapping up, Andrew Day reiterated his view of the growth prospects for the firm, with increased development budgets ahead of the Q420 console transition likely to benefit Keywords in FY20, and the increase in new releases expected in FY21 and beyond as the next-gen user base builds (with current-gen running in parallel with next-gen) set to benefit Keywords in the medium term.

In FY19, Keywords has been investing in its platform and capacity to ensure that it can deliver its suite of services, with a similar level of professionalism, to clients wherever they are based, with services fronted by a local team, but deliverable on a round-the-clock, distributed basis to meet client needs. The next step for Keywords is to demonstrate to even the largest, most demanding AAA clients that it now uniquely has the scale to be a professional and reliable partner.

Key themes of the day

- A focus on Keywords' business lines
- In-depth review of Art and Marketing Services and Development
- Addressing outstanding concerns over the trading update (growth margins, cash conversion)
- Reconfirmation of the growth proposition and highlighting the barriers to entry from scale

Key takeaways

- Keywords will continue to stick to what it does best (games services)
- Organic growth prospects remain strong over the medium term (we forecast 15% in FY20)
- The console transition is expected to benefit Keywords in FY20–22 and beyond
- Increasing scale delivers new client propositions (targeting the largest AAA titles)
- Barriers to entry are only increasing as Keywords grows
- The business remains balanced by service line
- Keywords' strategic approach to 'buy and build' delivers for both Keywords and the studios

Keywords' strategy: Continuing to deliver

The clear message from the CMD is that management feels that the successful model it has built with Keywords has a lot further to run. In FY19, the company experienced some growing pains, which meant it had to pause growth in certain service lines (eg Player Support) and invest ahead of the curve to build out the facilities, teams, management and technology platforms to allow for sustainable future growth. However, this investment is now set to support sustained scale and growth over the course of FY20 and beyond.

Keywords committed €13m to eight acquisitions in FY19 (it expects to complete six to 10 deals annually), and there was confirmation that VMC, which had dragged on results in FY18 and FY19, is finally starting to deliver on its promise. VMC, acquired in October 2017, was the company's largest acquisition and was bought to build scale for the localisation and QA service lines in North America. Management recognised that VMC needed restructuring, but with the scale and market presence that it has delivered, Andrew Day suggested that it might now provide a model for the expansion of these service lines in Europe, India and Asia.

Growth prospects for FY20 and beyond

In FY19, Keywords delivered 30% revenue growth and 15% underlying organic growth. Underpinned by strong industry growth (Newzoo: 8.4% CAGR 2019–22), this level of growth looks set to continue – we forecast FY20 revenues of €374.9m (+15% y-o-y, +12% on FY19 closing ARR). Adjusted operating margins are set to improve through FY20 to c 15% so for FY20 we forecast an average operating margin of 14.2% (FY20 EBITDA of €61.2m, operating income of €53.4m) and normalised EPS of 64.8c, a 41% uplift on FY19. This is before factoring in any incremental contributions from M&A.

As we have noted previously, Keywords benefits from the trend towards outsourcing, increasing market share as a market leader in a fragmented global industry with growth further supplemented by a proven M&A model. With the next console transition in Q420, the short- and medium-term growth outlook remains robust.

Management highlighted that FY19 had also been a year of investment in the business and capacity (for example, the investment in the Montreal studio) and given that clients tend to share their release roster with Keywords 12 months ahead for planning purposes, Keywords has an excellent view of the pipeline of work through the console transition and beyond. Noting a number of announcements in H219 that major AAA releases have been delayed (Ubisoft, CD Projekt – CyberPunk), it is worth noting that even if games that Keywords is working on are delayed, this will usually mean an extended project with extra work for Keywords.

Scale begets scale

In FY19, Keywords invested in its platform and capacity to ensure that it can deliver its suite of services, with a similar level of professionalism, to clients wherever they are based, with services fronted by a local team, but deliverable on a round-the-clock, distributed basis to meet client needs.

To do this and demonstrate its capacity to deliver for clients at scale, Keywords felt that it had to build facilities in order to generate the demand to fill those facilities. Larger clients will only be comfortable placing major projects with Keywords if they can first see the assets – the facilities, staff and technology – to deliver a successful project.

Exhibit 1: Scale delivers numerous barriers to entry

Source: Keywords Studios CMD presentation

To reinforce the benefits that increasing scale delivers, Keywords highlighted the barriers to entry that increase as the group scales:

- **Scale begets scale** – access to larger clients as they prefer large suppliers to provide the necessary resources for standardised service level agreements (SLAs) and AAA projects
- **Global presence** – the lead office is generally local to the client, so a broader geographic footprint opens more client opportunities
- **Depth of knowledge and breadth of expertise** – as a specialist games services network, Keywords offers access to its multiple service lines and studios around the world. Its teams will have worked on many more projects than any single games publisher or studio
- **Technology** – able to invest in better security and more effective systems and processes
- **Scalable model** – with a larger unified resource base comes the opportunity to absorb project spikes and troughs, flexing resource to meet the client's needs
- **Acquisition track record** – Keywords has a proven M&A track record (Exhibit 3 below), building out capabilities but more importantly integrating acquisitions and ensuring there is a good cultural fit. This track record is a powerful reference for future M&A
- **Financial strength** – enables investment in tools, infrastructure and people, as well as providing stability and resilience to external 'shocks'
- **Reputation for quality** – Keywords is working hard to build a consistent culture around quality of delivery, professionalism and service across the business

Balanced business mix

Since its IPO in 2013, Keywords has delivered average annual organic growth of 15% and an overall revenue CAGR of 65%. As can be seen in Exhibit 2, even with this strong growth, management has managed to build and maintain a diversified business that remains balanced across its seven service lines.

Exhibit 2: A fast-growing, diversified and balanced business

Source: Keywords Studios CMD presentation

Strategic 'buy and build' model

Keywords' buy and build model has served it well since the company's IPO, helping to deliver over €200m of additional revenues with 46 acquisitions across 16 countries. In a typical year, Keywords expects to make six to 10 acquisitions (2019: €13m across eight deals, +€15m of deferred consideration from 2018) and has so far managed to maintain price discipline, having paid an average ~1.2x revenue multiple historically.

Exhibit 3: Keywords typically targets six to 10 deals per year

Year	Art services	Game development	Audio services	Functional testing	Localisation	Localisation testing	Player support	Total cost* (€m)
2014	Lakshya Digital		Liquid Violet Binari Sonori	Babel Media	Babel Media Binari Sonori	Babel Media		19.0
2015	Liquid Dev		Reverb Kite Team				Alchemic Dream	10.9
2016	Mindwalk Volta		Synthesis Sonox	Enzyme Player Research	Synthesis Sonox	Synthesis Enzyme	Ankama	32.6
2017	SPOV RedHot	GameSim d3t Sperasoft	La Marque Rose Dune Sound AsRec	VMC	VMC XLOC La Marque Rose Around the Word Dune Sound AsRec LOLA	VMC	VMC	101.4
2018	Fire Without Smoke Trailer Farm	Snowed In Studio Gobo Electric Square Yokozuna	Maximal Cord Laced Blindlight					60.4
2019	Sunny Side Up Ichi	GetSocial Wizcorp	Descriptive Video Works Syllabes		TV+Synchron Kantan			21.8 (€13m net)

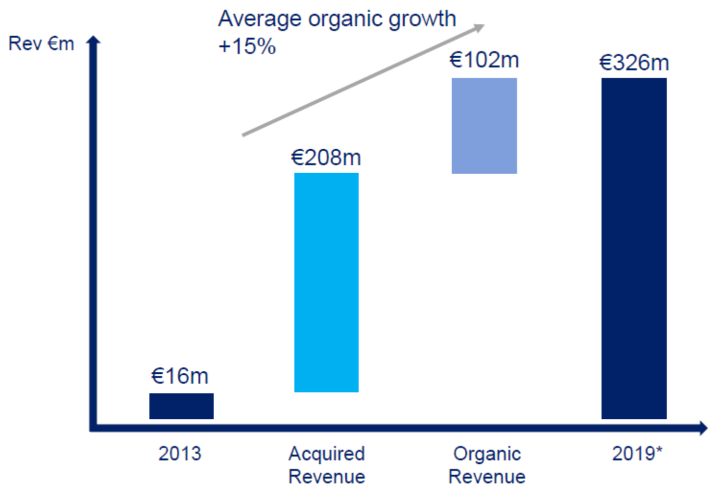
Source: Keywords Studios. Note: *Includes all cash, deferred and equity consideration.

The key point to note is that Keywords is not bulking up, seeking size for size's sake, but rather is building out a global service proposition with business lines of appropriate scale to deliver consistency. Local offices hold the client relationships, regional hubs help to ensure consistency of offering and delivery across all major service lines, together with global specialists able to offer niche services to meet the client's specific needs. Examples cited included Sperasoft's work on Assassin's Creed, Electric Square working with Microsoft on Forza Street and the Trailer Farm's round-the-clock work for Gearbox on Borderlands 3.

Keywords is also building out an operating framework and IT infrastructure to support distributed service delivery, seamlessly pulling together teams and studios from separate locations to deliver client projects professionally.

Finally, it is worth highlighting that each of the various studios represented at the CMD felt that they had made the right decision to sell to Keywords. As small studios, joining a large company meant they no longer needed to rely on constantly finding the next project and could now concentrate on what they enjoyed most, working with and delivering for their clients. In addition, the Keywords family provided access to a greater pool of resource and expertise, meaning they could work on bigger, more challenging projects and draw on specialists from around the group when needed.

Exhibit 4: Proven M&A track record



Source: Keywords Studios CMD presentation

M&A: Targeting higher-margin service lines

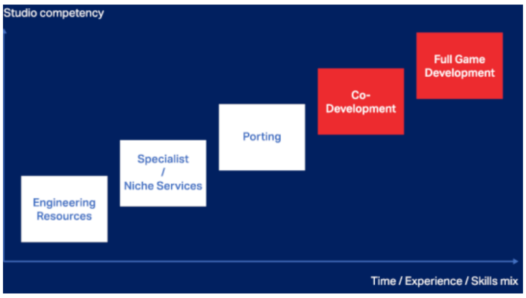
Each business line has its own growth proposition, but future M&A, although opportunistic, is likely to be concentrated on higher-margin business lines, with Development and Marketing Services highlighted in particular. For example, Keywords discussed the spectrum of development expertise (Exhibits 5 and 6) where, historically, Keywords' delivery has been based around lower-margin engineering and porting work. However, as studios build experience and establish their reputation, they are increasingly pushing into higher-margin co-development and full development projects.

Despite this progression towards higher-margin projects, management was very clear that studios are not aiming to take revenue share. The Keywords model is built on a cost plus approach with any revenue share expected to be marginal (eg to ensure an alignment of interest with the client), rather than to exchange development fees for potential future upside.

Opportunistic acquisitions in other service lines remain likely and, in particular, Andrew Day suggested that the VMC acquisition (offering localisation and quality assurance (QA) scale in North America) might provide a model for expansion in Europe, India and Asia.

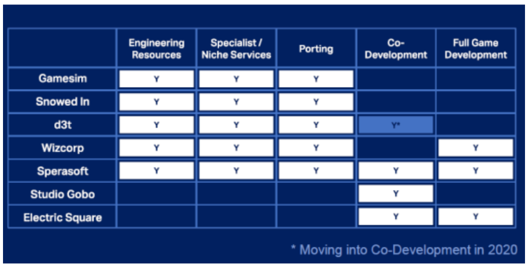
In terms of approach, Keywords conducts its own due diligence, avoids auctions and has maintained rigorous price discipline to date (we estimate recent deals at 1.5–2.0x sales and a long-term average ~1.2x revenue multiple). These low multiples are achievable because Keywords tends not to compete with 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.

Exhibit 5: Development value chain



Source: Keywords Studios CMD presentation

Exhibit 6: Positioning of internal studios



	Engineering Resources	Specialist / Niche Services	Porting	Co-Development	Full Game Development
Gamesim	Y	Y	Y		
Snowed In	Y	Y	Y		
d3t	Y	Y	Y	Y*	
Wizcorp	Y	Y	Y		Y
Sperasoft	Y	Y	Y	Y	Y
Studio Gobo				Y	
Electric Square				Y	Y

* Moving into Co-Development in 2020

Source: Keywords Studios CMD presentation

FY19 margins and cash conversion

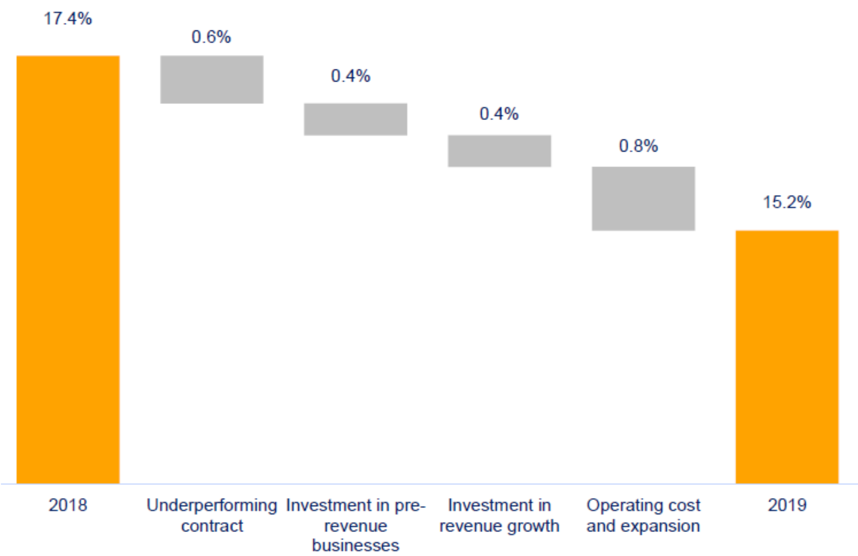
To help explain the margin erosion seen in the unaudited FY19 figures, Jon Hauck explained the bridge in Exhibit 7, accounting for the EBITDA margin changes between FY18 and FY19.

FY18: 17.4% EBITDA margin

- **One-off contract** – impact from a single, materially underpriced fixed price contract acquired in FY18. This was finalised in FY19 and does not carry over into FY20.
- **Keywords Ventures** – has been investing in pre-revenue start-ups to help develop artificial intelligence (AI) and machine-learning technologies for nurturing and later release across the business
- **Investment in growth** – as noted elsewhere, Keywords has chosen to accelerate investment ahead of the curve to support future growth (eg Montreal facilities)
- **Elevated opex** – operational investment in technology, strengthened management and additional functional support to ensure the consistency of the global offering

FY19: 15.2% EBITDA margin

Exhibit 7: FY18–19 EBITDA margin bridge



Source: Keywords Studios CMD presentation

Jon Hauck also reconciled the cash flow to highlight that underlying cash conversion was comparable to prior periods. The principal normalisation adjustments were:

- **Timing of tax credits** – €6m from a timing difference for tax credits in Canada (MMTC) and the UK (VGTR) reflecting the strong growth of the business in these two territories.
- **Accelerated capex** – €1m expansion in capex as Keywords invested ahead of growth

The full (unaudited) reconciliation is shown in Exhibit 8 below. This is compared to normalised PAT of €30.7m (FY18) and €33.4m (FY19) to show that the underlying cash conversion had improved marginally from 84% in FY18 to 85% in FY19.

Exhibit 8: FY19 cash flow analysis

€m	2019 FY		2018 FY		Movt
2019 adjusted PBT	**41**		**38**		**3**
Movement in MMTC / VGTR	(6)		(0)		(6)
Capex	(14)		(11)		(3)
Other	(7)		(6)		(1)
Adjusted free cash flow	**14**		**21**		**(7)**
Acquisition spend	(32)		(31)		(1)
Dividend	(1)		(1)		(0)
Underlying increase in debt	**(19)**		**(11)**		**(8)**
FX and other items	1		0		1
Increase in net debt	**(18)**		**(11)**		**(7)**
Opening net debt	(0)		11		(11)
Closing net debt	**(18)**		**(0)**		**(18)**
Adjusted free cash flow	**14**	46%	**20**	65%	
Add back MMTC / VGTR	6		0		
Adjusted free cash flow before MMTC / VGTR	**20**	66%	**21**	66%	
Add back capex ahead of depreciation	6		6		
Underlying free cash flow	**26**	85%	**27**	84%	

Source: Keywords Studios CMD presentation

Exhibit 9: Financial summary

€000s	2016	2017	2018	2019e	2020e
Year end 31 December	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue	96,525	151,430	250,805	326,004	374,913
Cost of Sales	(59,907)	(96,345)	(154,997)	(205,021)	(234,889)
Gross Profit (inc multimedia tax credits)	36,618	55,085	95,808	120,982	140,024
EBITDA	16,833	26,645	44,232	49,500	61,192
Operating Profit (before amort. and except.)	15,030	23,915	38,916	42,741	53,419
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	26,201	38,504
Net Interest	(287)	(818)	(1,005)	(1,740)	(1,000)
FOREX	(1,737)	(3,623)	791	(1,159)	0
Profit Before Tax (norm)	14,804	23,097	37,911	41,001	52,419
Profit Before Tax (FRS 3)	9,375	11,994	22,094	23,302	37,504
Tax	(3,223)	(4,731)	(7,191)	(7,585)	(9,435)
Profit After Tax (norm)	11,581	18,366	30,720	33,416	42,983
Profit After Tax (FRS 3)	6,152	7,263	14,903	15,717	28,068
Average Number of Shares Outstanding (m)	55.9	58.7	64.3	65.3	65.4
EPS (c)	20.8	31.3	41.8	46.8	65.8
EPS - normalised (c)	20.2	30.0	40.1	46.0	64.8
EPS - (IFRS) (c)	11.0	12.4	23.2	24.1	42.9
Dividend per share (p)	1.33	1.46	1.61	1.77	1.95
Gross Margin (%)	37.9%	36.4%	38.2%	37.1%	37.3%
EBITDA Margin (%)	17.4%	17.6%	17.6%	15.2%	16.3%
Operating Margin (before GW and except.) (%)	15.6%	15.8%	15.5%	13.1%	14.2%
BALANCE SHEET					
Fixed Assets	61,873	142,927	198,215	223,669	222,865
Intangible Assets	55,495	131,610	180,086	197,727	189,696
Tangible Assets	5,498	10,111	15,002	22,975	30,202
Investments	880	1,206	3,127	2,967	2,967
Current Assets	38,677	80,182	100,349	107,916	145,357
Stocks	0	0	0	0	0
Debtors	13,879	27,473	37,019	48,125	55,343
Cash	17,020	30,374	39,871	29,295	54,942
Other	7,778	22,335	23,459	30,497	35,071
Current Liabilities	(27,830)	(51,677)	(95,031)	(83,595)	(84,279)
Creditors	(19,805)	(32,734)	(54,960)	(36,523)	(37,207)
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	236,288	273,225
CASH FLOW					
Operating Cash Flow	17,108	21,389	38,481	41,278	58,069
Net Interest	(58)	(253)	(502)	(7,542)	(6,394)
Tax	(2,129)	(4,731)	(6,304)	(7,585)	(9,435)
Capex	(2,306)	(3,803)	(9,440)	(14,572)	(15,000)
Acquisitions/disposals	(21,104)	(90,090)	(30,296)	(28,000)	(316)
Financing	643	82,936	174	0	0
Dividends	(825)	(867)	(1,080)	(1,155)	(1,276)
Net Cash Flow	(8,671)	4,581	(9,919)	(17,577)	25,647
Opening net debt/(cash)	(17,284)	(8,650)	(11,094)	423	18,000
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	18,000	(7,647)

Source: Keywords Studios data, Edison Investment Research

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