

Keywords Studios

Acquisition

A new string to the bow

Keyword's acquisition of GameSim for \$4.76m marks the company's long planned entry into engineering. We expect follow-on acquisitions as it replicates its strategy of building a service line through consolidating the fragmented games outsourcer market. As with the company's Art service line, GameSim's teams work closely with the core engineering teams of its games developer customers, creating cross-selling opportunities and deeper relationships with customers. Incorporating GameSim, together with the earlier \$0.9m acquisition of XLOC, we upgrade FY17e EPS by 3%.

Year end	Revenue (€m)	PBT* (€m)	EPS* (c)	DPS (c)	P/E (x)	Yield (%)
12/15	58.0	8.0	12.6	1.2	73.5	0.1
12/16	96.6	14.9	20.3	1.3	45.6	0.1
12/17e	119.6	18.0	25.2	1.5	36.8	0.2
12/18e	130.6	19.8	27.5	1.6	33.7	0.2

Note: *PBT and EPS (fully diluted) are normalised, excluding intangible amortisation, exceptional items and share-based payments.

Landing point for building an engineering service line

GameSim is a Florida-based provider of engineering services for the games industry (c 70% of revenues), but also for the defence and geospatial industries. Its range of services for the games industry includes its proprietary technology for creating 3D simulated environments, which is core to its other service lines. The business has some similarities with Keywords' Art service line in that teams of specialised staff work closely with the clients' core games developer teams. Hence management sees good scope for cross-selling between engineering and art and for deeper customer relationships at this level. As a reminder, Keywords entered the art segment through the €3.2m acquisition of Lakshya Digital in 2014. Spending a total of €16.5m on Lakshya, Mindwalk and Liquid Development, the company has built this into an estimated €22m run rate service line. Management envisages a similar build-out profile for engineering.

Reasonable multiples, further earnings enhancement

GameSim's FY16 revenues were \$4.1m. As with the Art service line, gross margins are higher than the group average, but a higher relative fixed cost base (lower use of contract staff to deal with demand peaks and troughs) offsets this at the operating level. We understand that operating margins were slightly below Keywords' group level during the year, but with synergies management expects to normalise margins within a year. The valuation equates to reasonable 1.16x historic sales and sub 10x EBIT multiples and the company has a good track record of accelerating growth under the group's umbrella.

Valuation: Continued execution key to further upside

At 35x FY18e earnings, Keywords' rating is a substantial premium to peers (average 19x for FY18) and, in our view, further strong progress is now priced in for this year. Nevertheless, the company has a compelling platform and strategy for growth in a games industry growing at a healthy 6.6% pa. Consequently, we believe continued execution should deliver share price value in the longer term.

Software & comp services

18 May 2017

Price 792p

Market cap £441m

£/€1.17

Net cash (€m) at 31 December 2016 8.7

Shares in issue 55.8m

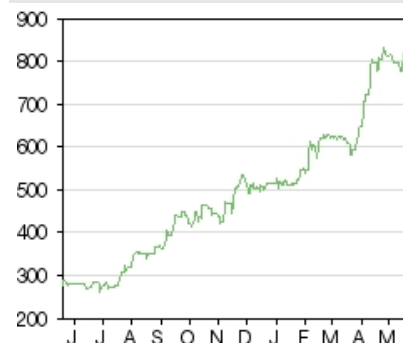
Free float 69%

Code KWS

Primary exchange AIM

Secondary exchange N/A

Share price performance



% 1m 3m 12m

Abs (0.8) 27.7 183.9

Rel (local) (2.9) 23.6 134.7

52-week high/low 830.0p 260.0p

Business description

Keywords Studios provides localisation, testing, artwork, community support and now 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

H1 trading update July 2017

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Estimate changes

Our estimate changes are shown below and incorporate the acquisitions of both GameSim and XLOC, a provider of localisation services acquired for \$0.9m (€0.63) on 10 April 2017.

Our FY17 revenue estimate implies a mere 3% like-for-like growth – although if we adjust for the c €4m of above run rate revenues from Synthesis this increases to 7% – still significantly below the 20% (Synthesis adjusted) level from FY16. We assume 8% like-for-like growth in FY18.

The company had €8.7m of cash at end FY16. It has a €35m revolving credit facility with Barclays and generates robust free cash flows, giving it plenty of firepower to make more earnings-enhancing acquisitions.

Exhibit 1: Estimate changes

€000s	2015	2016	2017e			2018e		
	Actual	Actual	Old	New	Change (%)	Old	New	Change (%)
Revenue	57,951	96,585	116,671	119,551	2	126,096	130,605	4
Cost of Sales	(36,172)	(59,907)	(73,203)	(74,833)	2	(79,314)	(81,843)	3
Gross Profit	21,779	36,678	43,468	44,718	3	46,782	48,761	4
EBITDA	9,459	16,893	19,919	20,414	2	21,556	22,438	4
Operating Profit (before amort. and except.)	8,162	15,090	17,845	18,339	3	19,274	20,156	5
Profit Before Tax (norm)	8,007	14,864	17,558	18,029	3	18,987	19,846	5
Profit After Tax (norm)	6,175	11,641	13,871	14,243	3	15,190	15,877	5
EPS - normalised fully diluted (c)	12.6	20.3	24.5	25.2	3	26.3	27.5	5
EPS - (IFRS) (c)	7.0	11.2	20.9	21.6	3	22.8	24.0	5
Dividend per share (pence)	1.2	1.3	1.5	1.5	0	1.6	1.6	0
Closing net debt/(cash)	(17,284)	(8,650)	(19,538)	(15,720)	(20)	(29,858)	(25,731)	(14)

Source: Company data, Edison Investment Research

Exhibit 2: Financial summary

	€'000s	2014	2015	2016	2017e	2018e
31-December		IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS						
Revenue		37,293	57,951	96,585	119,551	130,605
Cost of Sales		(24,566)	(36,172)	(59,907)	(74,833)	(81,843)
Gross Profit (inc multimedia tax credits)		12,727	21,779	36,678	44,718	48,761
EBITDA		6,027	9,459	16,893	20,414	22,438
Operating Profit (before amort. and except.)		5,159	8,162	15,090	18,339	20,156
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	16,024	17,841
Net Interest		(106)	(264)	(287)	(310)	(310)
FOREX		467	(474)	(1,737)	0	0
Profit Before Tax (norm)		5,053	8,007	14,864	18,029	19,846
Profit Before Tax (FRS 3)		3,435	5,086	9,435	15,714	17,531
Tax		(1,215)	(1,832)	(3,223)	(3,786)	(3,969)
Profit After Tax (norm)		3,838	6,175	11,641	14,243	15,877
Profit After Tax (FRS 3)		2,220	3,254	6,212	11,928	13,562
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	25.8	28.1
EPS - normalised fully diluted (c)		8.5	12.6	20.3	25.2	27.5
EPS - (IFRS) (c)		4.9	7.0	11.2	21.6	24.0
Dividend per share (p)		1.10	1.21	1.33	1.46	1.61
Gross Margin (%)		34.1%	37.6%	38.0%	37.4%	37.3%
EBITDA Margin (%)		16.2%	16.3%	17.5%	17.1%	17.2%
Operating Margin (before GW and except.) (%)		13.8%	14.1%	15.6%	15.3%	15.4%
BALANCE SHEET						
Fixed Assets		20,874	32,132	61,873	61,102	62,791
Intangible Assets		17,677	27,675	55,495	54,191	52,562
Tangible Assets		2,761	3,486	5,498	6,031	9,349
Investments		436	971	880	880	880
Current Assets		23,120	34,884	38,677	49,745	62,295
Stocks		0	0	0	0	0
Debtors		6,203	7,519	13,879	16,655	18,195
Cash		11,014	19,018	17,020	24,090	34,101
Other		5,903	8,347	7,778	9,000	10,000
Current Liabilities		(9,746)	(13,128)	(27,830)	(31,236)	(32,449)
Creditors		(9,746)	(11,965)	(19,805)	(23,211)	(24,424)
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	73,421	86,447
CASH FLOW						
Operating Cash Flow		2,412	4,768	17,168	20,864	22,304
Net Interest		11	(58)	(58)	(310)	(310)
Tax		(522)	(1,362)	(2,129)	(3,786)	(3,969)
Capex		(1,252)	(1,635)	(2,306)	(4,308)	(5,600)
Acquisitions/disposals		(8,889)	(7,409)	(21,104)	(4,565)	(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)	7,081	10,011
Opening net debt/(cash)		(15,271)	(11,014)	(17,284)	(8,650)	(15,720)
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)	(15,720)	(25,731)

Source: Company data, Edison Investment Research

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