

Keywords Studios

H120 results

M&A engine revving up again

Keywords Studios has again showed the resilience of its model in H120, delivering 8% I-f-I revenue growth, 19% adjusted EBITDA growth and 17% adjusted EPS growth despite the impact of COVID-19. Adjusted EBITDA margins of 17.8% have held up better than we expected. Looking ahead, we see sustained industry growth, led by the console transition in Q420, with publishers increasingly recognising the resilience Keywords adds to their development processes. Following its third acquisition of the year, we see management once more focusing on M&A with net cash of €101m. Keywords' strategy, which has delivered a five-year EPS CAGR of 42%, appears sustainable, with dividend payments to be resumed in FY21. As such, we believe that the shares remain set for continued appreciation.

Year end	Revenue (€m)	PBT* (€m)	EPS* (c)	DPS (p)	P/E (x)	Yield (%)
12/18	250.8	37.9	45.5	1.61	52.3	0.07
12/19	326.5	40.9	48.8	0.58	48.8	0.03
12/20e	365.1	46.2	51.5	0.00	46.2	0.00
12/21e	412.5	53.4	56.4	1.95	42.2	0.09

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

H120: Resilient performance

Keywords has demonstrated its resilience in the face of COVID-19. Having downgraded our estimates at the start of the pandemic, this is our second upgrade for the year, with H120 revenues of €173.5m up 13% y-o-y, and up 8% on a like-for-like basis, with adjusted PBT increasing by 18% to €21.7m. Profit was boosted by a strong performance across its service lines, particularly Game Development, with Localisation and Audio showing weakest growth. At 30 June 2020, after the €110m share placing in May, net cash stood at €101m (H119: €9m net debt) with a further €100m of undrawn committed facilities.

Revised estimates for FY20 and FY21

Management has commented that H220 has started positively, with growth drivers for the medium term looking positive. As such, we have assumed continued 8% I-f-I growth in H220 (a conservative estimate), while also normalising PBT margins towards 13% in FY21. With three deals already announced this year, despite COVID-19, management reports a healthy M&A pipeline, with large as well as smaller deals, which should further support growth and earnings accretion.

Valuation: Continued execution to deliver upside

Sentiment towards the games industry is extremely positive, given the sector's performance this year and its outlook. As such, Keywords' shares trade on an FY20e P/E of 46.2x, falling to 42.2x in FY21e. We see scope for organic upside as well as the potential for material accretive acquisition activity with €100m+ for M&A (see sensitivity analysis, Exhibits 2 and 3). Keywords' strategy, which has delivered a five-year EPS CAGR of 42%, appears sustainable. In this context, we believe that the shares remain set for continued appreciation.

Software & comp services

21 September 2020

Price **2,184p**
Market cap **£1.61bn**

€1.09/£

Net cash (€m) at 30 June 2020
excluding lease liabilities 101.0

Shares in issue 73.9m

Free float 90%

Code KWS

Primary exchange AIM

Secondary exchange N/A

Share price performance



% 1m 3m 12m

Abs (1.4) 21.1 80.1

Rel (local) (0.4) 24.5 115.9

52-week high/low 2,274p 1,073p

Business description

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

Next events

Trading statement January 2021

Final results April 2021

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FY20 and FY21 estimate revisions

Based on the H120 results, we have updated both our FY20 and FY21 estimates. Our latest estimates are shown in Exhibit 1.

Revenues: As the business has proven that it can work flexibly (although Audio and Localisation would be challenged if there were further lockdowns), we have raised our growth forecasts for FY20 to 8% to reflect the 8% I-f-I revenue growth seen in H120. For FY21, we had previously assumed a bounce back in demand. Given the fall in FY20 has not been as severe as first anticipated, we have also pared back the growth recovery in FY21, forecasting I-f-I organic growth of 12% from 15% previously. We then forecast conservative ongoing growth of 10%, in line with management guidance.

Margins: Management have been confident that margins are building towards historical norms. They had expected this to occur in FY20, but have commented that COVID-19 has delayed the normalisation process by c 12 months. As such, we assume a 13.6% operating margin for FY20e, a slight increase on 13.2% in H120. For FY21, we continue the upward trend, with the operating margin rising to 13.8%. We believe this level leaves headroom for reinvestment in growth. Otherwise, we have assumed gross margins remain c 37% for both FY20 and FY21.

We have also updated the model for the three acquisitions completed in FY20.

Exhibit 1: Revised estimates

€'000s	2019	2020e	2020e	Estimate	2021e	2021e	Estimate	Y-o-y
Year end 31 December	Actual	Old	New	Change	Old	New	Change	Change
Revenue	326,463	352,895	365,056	3.4%	405,829	412,461	1.6%	13%
Gross Profit (inc multimedia tax credits)	120,229	131,636	138,021	4.9%	151,593	153,868	1.5%	11%
Gross Margin (%)	36.8%	37.3%	37.8%		37.4%	37.3%		
EBITDA (Adjusted)	57,611	55,037	64,066	16.4%	70,531	77,560	10.0%	21%
Operating Profit (before amort. and except.)	42,983	39,883	49,677	24.6%	54,194	56,939	5.1%	15%
Operating Margin	13.2%	11.3%	13.6%		13.4%	13.8%		
Profit Before Tax (norm)	40,913	37,283	46,177	23.9%	51,594	53,439	3.6%	16%
Profit After Tax (norm)	33,451	30,483	37,755	23.9%	42,184	43,693	3.6%	16%
EPS - normalised (c)	48.8	41.9	51.5	23.0%	55.0	56.4	2.5%	9%
Dividend per share (p)	0.58	1.77	0.00		1.95	1.95		

Source: Company accounts, Edison Investment Research

Management has stated an intention to continue with its progressive dividend policy from FY21.

Acquisitions

To date, management has announced three acquisitions in FY20, one in H120 and two after the period end in H220 – all three have been in Game Development or Marketing Services. After an understandable hiatus in H120 as the business adjusted to the challenges of COVID-19, Keywords completed its placing, raising €110m to strengthen the balance sheet as well as to provide additional capacity for M&A. All three transactions followed the placing:

- **Up to £2m – Coconut Lizard, Game Development (June 2020)** – a Gateshead-based provider of game development engineering services (game optimisation, game hardening, porting and middleware integration) acquired for up to £2m (1.3x historical revenues, 5.7x adjusted EBITDA), two-thirds upfront, one-third deferred. With c 30 staff, Coconut Lizard specialises in the Unity game engine and has a strong relationship with Microsoft's Rare studio.
- **Up to £3.6m – Maverick Media, Marketing Services (August 2020)** – a London-based video game creative agency with a track record in TV commercial and live action projects in addition to video game trailers, key art and social media. Keywords paid up to £3.6m (1.04x historical revenues, 3.6x adjusted EBITDA), £2.7m of non-contingent consideration (£2.4m in cash, with

£0.3m in equity to be issued after 12 months) with an additional amount of up to £0.9m payable in a mixture of cash and equity dependent on business performance in the six months following completion.

- **Up to US\$13.3m – Heavy Iron, Game Development (September 2020)** – a Los Angeles-based games developer, with a 43 strong team that provides game development, co-development, live operations and porting services. Heavy Iron has multiple proprietary engine technologies and development experience across all major platforms, particularly PC and console, with recent projects for Crystal Dynamics, Disney and Activision. Keywords paid up to US\$13.3m (2.5x historical revenues, 13.3x adjusted EBITDA), with US\$4.5m payable upfront and a performance-related payment of US\$8.8m in a mixture of cash and shares, one and two years from completion. The acquisition also delivers Keywords a foothold on the US West Coast, close to the head offices of many of the major games publishers.

Strong acquisition pipeline to support growth

Keyword's strategy of making earning enhancing acquisitions while consolidating a fragmented market is intrinsic to the investment case. Management has stated the acquisition pipeline remains strong and that it continues to receive healthy inbound interest from around the world. The pipeline contains both large, transformational acquisitions as well as small and mid-sized deals. With net cash of €101m and an undrawn committed revolving credit facility of up to €100m, the company retains good firepower for M&A activity, with the company guiding towards €100m of acquisitions over the next 18 months.

By its nature, the acquisition process is opportunistic, but management has highlighted Game Development and Marketing Services (where all three deals completed so far in FY20 have been) as the two most likely areas for future acquisitions.

While our base case estimates do not reflect any contribution from M&A, our sensitivity analysis in Exhibits 2 and 3 suggests that if management retains historical price discipline (ie paying 7–11x EV/PBT for acquisitions) and deploys €100m in cash (plus equity, assuming a 70/30 cash/equity split) on acquisitions, then, based on a notional 18% tax rate, it is reasonable to expect at least 50% accretion to our FY21 normalised EPS estimate.

Exhibit 2: Sensitivity analysis – FY21 EPS (c) adjusted for €100m in cash (plus equity) to be spent on acquisitions

		Average EV/PBT paid for acquisitions (x)				
		7.0	8.0	9.0	10.0	11.0
Organic revenue growth	10.0%	104.5	96.9	91.2	86.8	83.2
	12.5%	106.2	98.5	92.8	88.3	84.7
	15.0%	107.8	100.1	94.3	89.8	86.3

Source: Edison Investment Research

Exhibit 3: Sensitivity analysis – Acquisition adjusted FY21 EPS (c) accretion

		Average EV/PBT paid for acquisitions (x)				
		7.0	8.0	9.0	10.0	11.0
Organic revenue growth	10.0%	92%	78%	67%	59%	53%
	12.5%	95%	81%	70%	62%	55%
	15.0%	98%	84%	73%	65%	58%

Source: Edison Investment Research

Exhibit 4: Sensitivity analysis – Acquisition adjusted FY21 P/E (x) (assuming a share price of 2,184p)

		Average EV/PBT paid for acquisitions (x)				
		7.0	8.0	9.0	10.0	11.0
Organic revenue growth	10.0%	24.7	26.4	27.9	29.2	30.4
	12.5%	24.3	26.0	27.4	28.7	29.8
	15.0%	23.9	25.5	27.0	28.2	29.2

Source: Edison Investment Research

Exhibit 5: Financial summary

	€'000s	2017	2018	2019	2020e	2021e
Year end 31 December		IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS						
Revenue		151,430	250,805	326,463	365,056	412,461
Cost of Sales		(96,345)	(154,997)	(206,234)	(227,035)	(258,594)
Gross Profit (inc multimedia tax credits)		55,085	95,808	120,229	138,021	153,868
EBITDA (adjusted)		26,645	43,729	57,611	64,066	77,560
EBITDA (reported)		22,203	34,304	43,375	54,355	65,732
Operating Profit (before amort. and except.)		23,915	38,916	42,983	49,677	56,939
Amortisation of acquired intangibles		(3,038)	(6,872)	(7,318)	(11,324)	(12,868)
Exceptionals		(3,016)	(5,296)	(4,348)	(2,370)	0
Other (incl share based payments)		(1,426)	(4,129)	(9,775)	(10,753)	(11,828)
Operating Profit		16,435	22,619	21,542	25,231	32,244
Net Interest		(818)	(1,316)	(2,513)	(3,500)	(3,500)
FOREX		(3,623)	791	(1,658)	0	0
Profit Before Tax (norm)		23,097	37,911	40,913	46,177	53,439
Profit Before Tax (FRS 3)		11,994	22,094	17,371	21,731	28,744
Tax		(4,731)	(7,191)	(7,462)	(8,422)	(9,747)
Profit After Tax (norm)		18,366	30,720	33,451	37,755	43,693
Profit After Tax (FRS 3)		7,263	14,903	9,909	13,309	18,997
Average Number of Shares Outstanding (m)		58.7	64.3	65.1	69.5	74.0
EPS - normalised (c)		31.3	45.5	48.8	51.5	56.4
EPS - normalised fully diluted (c)		30.0	43.7	47.2	49.6	54.5
EPS - (IFRS) (c)		12.4	23.2	15.2	19.1	25.7
Dividend per share (p)		1.46	1.61	0.58	0.00	1.95
Gross Margin (%)		36.4%	38.2%	36.8%	37.8%	37.3%
EBITDA Margin (%)		14.7%	13.7%	13.3%	14.9%	15.9%
Operating Margin (before GW and except.) (%)		15.8%	15.5%	13.2%	13.6%	13.8%
PBT Margin (%)		15.3%	15.1%	12.5%	12.6%	13.0%
BALANCE SHEET						
Fixed Assets		142,927	198,215	223,992	220,723	216,965
Intangible Assets		131,610	180,086	196,769	192,087	182,342
Tangible Assets		10,111	15,002	22,163	23,577	29,564
Investments		1,206	3,127	5,060	5,060	5,060
Current Assets		80,182	100,348	120,483	251,172	294,423
Stocks		0	0	0	0	0
Debtors		27,473	37,019	43,243	46,702	52,307
Cash		30,374	39,870	41,827	166,224	199,280
Other		22,335	23,459	35,413	38,246	42,836
Current Liabilities		(51,677)	(95,031)	(49,551)	(49,948)	(47,478)
Creditors		(32,734)	(54,960)	(49,471)	(49,868)	(47,398)
Short term borrowings		(18,943)	(40,071)	(80)	(80)	(80)
Long Term Liabilities		(10,420)	(11,158)	(71,528)	(71,194)	(73,194)
Long term borrowings		(337)	(230)	(59,671)	(59,671)	(59,671)
Other long term liabilities		(10,083)	(10,928)	(11,857)	(11,523)	(13,523)
Net Assets		161,012	192,374	223,396	350,754	390,716
CASH FLOW						
Operating Cash Flow		21,389	33,954	46,069	60,487	67,750
Net Interest		(253)	(502)	(9,411)	(6,263)	(3,425)
Tax		(4,731)	(6,304)	(13,288)	(8,422)	(9,747)
Capex		(3,803)	(9,440)	(13,145)	(11,024)	(16,608)
Acquisitions/disposals		(90,090)	(25,766)	(27,762)	(7,380)	(3,470)
Financing		82,936	0	0	97,000	0
Dividends		(867)	(1,080)	(1,197)	0	(1,444)
Net Cash Flow		4,581	(10,090)	(18,734)	124,398	33,056
Opening net debt/(cash)		(8,650)	(11,094)	431	17,924	(106,474)
Forex gain on cash		(891)	(3)	1,293	0	0
Other		(1,246)	(1,432)	(52)	0	0
Closing net debt/(cash)		(11,094)	431	17,924	(106,474)	(139,530)

Source: Keywords Studios accounts, Edison Investment Research

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