Keywords Studios

Full year results

Compelling game plan, executed well

Software & comp services

FY16 was a strong year for Keywords Studios both financially and operationally, with EPS growing by 61% and acquisitions strengthening the business across a number of service lines and geographies. It has also invested into key staff and core systems to support continued growth and we fully expect the growth trajectory to continue from here. We see scope for further upgrades through organic performance, further acquisitions and potentially larger outsourcing deals. Given the recent run, we feel the valuation prices in strong progress this year but believe that sustained execution of the strategy will continue to create shareholder value.

Year end	Revenue (€m)	PBT* (€m)	EPS* (c)	DPS (p)	P/E (x)	Yield (%)
12/15	58.0	8.0	12.6	1.2	66.5	0.4
12/16	96.6	14.9	20.3	1.3	41.4	0.5
12/17e	116.7	17.6	24.5	1.5	34.2	0.5
12/18e	126.1	19.0	26.3	1.6	31.9	0.6

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

Another strong year – some exceptional strength

FY16 results were in line with our estimates, upgraded at the time of the February trading update (see Another beat and raise). Revenues of €96.6m, up from €58.0m last year, reflect the contribution from the eight acquisitions made over the course of the year and 24% like-for-like growth, with the exceptionally strong trading at Synthesis (acquired in April 2016) boosting revenues by c €4m above run rate. PBT increased by 84% y-o-y to €14.9m, but EPS was not far behind, growing by 61% to 20.3c, highlighting the accretive nature of the acquisitions. The company generated free cashflow of €12.7m while net cash stands at €8.7m. A heads of terms agreement has been reached with Barclays for a €35m revolving credit facility, reducing the near-term likelihood of equity dilution to support acquisitions.

We expect continuation in the same vein in FY18

In our view, one of the key attractions of Keywords' investment case is its scope to continue growing earnings at a double-digit rate without substantially deviating from the existing strategy. We have nudged our FY17 EPS estimate up 3%, but buoyant games industry dynamics and a strengthened platform for cross-selling could drive organic upside. Further accretive acquisitions should clearly be expected, with a first move into engineering (coding) being a key strategic priority for FY17. A strategic outsourcing deal with a games developer also remains a management goal and could be a catalyst for upgrades.

Valuation: Returns from continued execution

At 34x FY17 earnings dropping to 32x in FY18, Keywords' rating is a substantial premium to peers (average 18x for FY18). However, it has a compelling platform and strategy for growth within a games industry growing at a healthy 6.6% pa. Further accretive acquisition activity or upgrades could quickly bring the rating more in line. So, while we believe that strong progress is now priced in for this year, continued execution should continue to deliver share price value.

7 April 2017

Price	**723p**
Market cap	**£393m**
	€1.16/£
Net cash (€m) as at 31 December 2016	8.7
Shares in issue	54.4m
Free float	68%
Code	KWS
Primary exchange	AIM
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	17.0	41.2	209.6
Rel (local)	17.0	38.6	163.1
52-week high/low		723p	229p

Business description

Keywords Studios provides localisation, testing, artwork and community support services exclusively to the video games industry. It provides services to 20 of the top 25 games developers and is looking to consolidate the currently fragmented industry.

Next events

AGM	Late May

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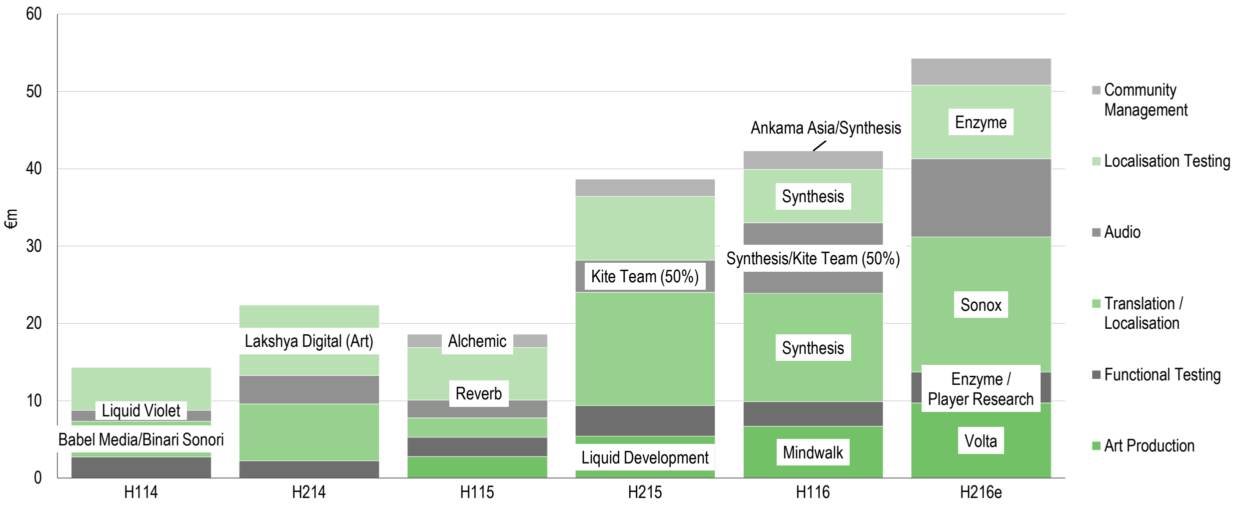
Investment summary

Some exceptional trading, but strength across the board

FY16 was a strong year for Keywords Studios, both operationally and financially. Like-for-like growth (calculated as if acquisitions had been included for equivalent prior year periods) was a very healthy 24%, with all service lines bar localisation testing (8%) growing like-for-like revenues at a strong double-digit rate. As previously flagged, performance across localisation and audio was boosted by a particularly strong performance from Synthesis, acquired in April, during the second and third quarters, which management estimates boosted revenues by c €4m above the usual run rate.

Exhibit 1: Revenue progression by service line. Acquisitions labelled, positioned in period of acquisition and by service line or lines of revenue contribution.



Source: Keywords Studios data, Edison Investment Research

Buoyant industry, market share gains and cross selling

Growth is being supported by a generally buoyant environment in the global games development industry; market analyst Newzoo estimates the industry grew 8.5% in 2016 and will expand at an annual rate of 6.6% through to 2019. We believe that Keywords' more rapid growth rate is being driven by a combination of factors:

- **Increased outsourcing** – Developers outsource non-core functions to providers with dedicated expertise and scale benefits.
- **Market share gains** – Market share gains are supported by Keywords' ability to leverage its status as the largest outsourced supplier operating in a fragmented competitive market. While ongoing consolidation among the developer/publisher communities carries some risk of disruption, Keywords should be a net beneficiary of this trend through the cycle.
- **Cross selling** – While acquisitions were also a factor in this, the company recorded 25% of clients using three of more of the group's services, from 51 to 64 over the course of the year.

Acquisitions strengthening capability and geographic footprint

Keywords Studios made eight acquisitions over the course of the year, paying a total of €20.1m cash, 585.6k shares with a total c €2.1m deferred or contingent consideration for the acquired companies. Whereas in FY15 the company established two new service lines through acquisition, in FY16 the focus was on strengthening its position in established service lines.

The largest acquisition, Synthesis (€10.2m plus 2.4m shares), boosted the company's position across translation, audio and to a lesser extent localisation testing. It performed particularly well, with the business contributing €18m revenues and €3.5m PBT over the period, well above the €10m and €1m respective figures we forecast at the time of the acquisition.

The company extended its position in art, adding early stage concept art studio Volta. Since year-end, the acquisition of Spov for up to £1.2m adds cinematics, user interface, visual effects and motion graphics capability to the equation.

The acquisition of Enzyme boosted the company's position in localisation and functional testing. The studio also provides focus group testing services for optimising game design and user experience. This is a new domain for Keywords, but should complement the activities of its Player Research operations, acquired in October, and support the company's drive to build more comprehensive, retained, strategic relationships with clients.

Exhibit 2: Acquisitions in FY16

Name	Date	Business segment	Cost	Reported		Pro forma	
				Sales contribution (€k)	PBT contribution (€k)	Sales contribution (€k)	PBT contribution (€k)
Ankama Asia	22/03/2016	Customer care	N/A	528	(17)	541	(0)
Synthesis	14/03/2016	Audio, localisation and localisation testing	€18m	18,013	3,494	20,662	3,887
Mindwalk	01/04/2016	Art	$5.5m	3,166	228	4,825	301
Volta	29/07/2016	Art	$5.25m	1,181	209	2,407	278
Player Research	26/10/2016	Player research	1.3m	183	65	921	308
Enzyme Testing Labs	17/11/2016	Localisation and functional testing	C$5.4m	1,095	60	8,632	934
Sonox	22/12/2016	Localisation	£650,000	52	88	1,308	455
Total				24,217	4,126	39,297	6,163

Source: Keywords Studios

Pace of M&A to continue – funds/facilities to support €50m of acquisitions

We expect the pace of M&A to continue, and perhaps accelerate. The company has €17m of cash on the balance sheet with borrowings of €8.4m but has also announced that it has reached a heads of terms agreement with Barclays for a €35m revolving credit facility. Taking into account our forecast that the company will generate net cash flow of €10.9m of cash in FY17, the company has the firepower to spend circa €50m on acquisitions over the course of the year without requiring equity or stretching net/debt to EBITDA beyond a reasonable 2x threshold.

Entry into engineering the priority

The key strategic priority, from an M&A standpoint, is likely to be the addition of capability in engineering (ie coding, for example to port games to different platforms, etc), which has the potential to grow into a major service line and which management believes is ripe for outsourcing with strong cross-sell potential. The company is also looking at opportunities in games analytics, an area that is seen as offering strong growth potential.

Following on from the acquisition of Spov, the company plans to extend its capabilities in areas such as visual special effects, user interface design, cinematics and motion graphics. The Spov acquisition also give Keywords a toe hold in the film/video production industry, where management also sees opportunities for localisation and audio as production cycles accelerate and the rise of global players such as Amazon and Netflix drive demand for localisation services.

Investing to scale

Management is taking steps to ensure the model continues to scale, through investment in core platforms in some areas and increased decentralisation in others. These are summarised below:

Group level – The company is investing in a new accounting platform, which will be rolled out across the group over the next 12-18 months. Over the course of the year, the executive team was strengthened with the addition of David Broderick as CFO and Jaime Gine as chief commercial officer. A global director of IT has been appointed and the company is recruiting a group head of HR. A unified sales team also facilitates cross selling.

Service line – Each service line (which comprises a number of studios) is run on a global basis, led by a global service head, whose responsibilities include defining and executing the M&A strategy for the segment. All service lines other than Art now use a common operating platform across their studios for project management, workforce and operational reporting.

Regional – Service lines are supported by regional management teams. The company is generating cost synergies through consolidating studios into shared offices in Montreal and Madrid and with plans for London as well.

Financials and estimates

Scope for upside in revenues and margins

We have nudged up our FY17 estimates slightly (detailed in Exhibit 3), while our FY18 estimates are new. We believe that they remain conservative at all levels. Our FY17 revenue estimate implies a mere 3% like-for-like growth – although if we adjust for the circa €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.

Gross margins in FY16 were 35.6% (38% including games development tax credit), up from 35.4% last year, although the exceptional trading and utilisation at Synthesis did boost this figure. We are forecasting a return to previous levels in FY17 due to this not repeating, although there may be scope for some upside, as on a blended group basis, the company is not seeing any significant changes in either price or cost pressure.

We expect to see some benefits from operational gearing at the admin expenses level, which we forecast dropping to c 20% of revenues versus the 22% level in FY16.

We also forecast a progressive 1% pa reduction in tax rate over the period (21.7% in FY16) as the company leverages its diverse geographical footprint to improve tax efficiency.

Operating model generates healthy cash flows

The company generated free cash flow (including capex, tax, interest but not acquisitions) of €12.7m over the period although this figure was supported by a catch up in multimedia tax credits (€1.6m), Adjusting for this, free operating cash flow per share (19.2c) was within 6% of EPS adj (20.3c). Keywords' business model requires only modest working capital and capex investment and hence we expect the company to continue generating healthy cash flows on an underlying basis.

Exhibit 3: Estimate changes

€000s	2015	2016e	2016	Change	2017e	2017e	Change	2018e
Year end 31 December	Actual	Est	Actual		Old	New		New
Revenue	57,951	96,600	96,585	0%	115,248	116,671	1%	126,096
Cost of sales	(36,172)	(60,671)	(59,907)		(70,301)	(73,203)	4%	(79,314)
Gross profit	21,779	35,929	36,678	2%	44,947	43,468	-3%	46,782
EBITDA	9,459	16,544	16,951	2%	18,984	19,919	5%	21,556
Operating profit (before amort. and except.)	8,162	15,044	15,090	0%	17,224	17,845	4%	19,274
Profit before tax (norm)	8,007	14,784	14,864	1%	16,974	17,558	3%	18,987
Profit after tax (norm)	6,175	11,679	11,641	0%	13,581	13,871	2%	15,190
EPS - normalised fully diluted (c)	12.6	20.9	20.3	-3%	24.0	24.5	2%	26.3
EPS - (IFRS) (c)	7.0	13.2	11.2	-15%	21.4	20.9	-2%	22.8
Dividend per share (pence)	1.2	1.3	1.3	0%	1.5	1.5	0%	1.6
Closing net debt/(cash)	(17,284)	(9,032)	(8,650)	-4%	(17,939)	(19,538)	11%	(29,858)

Source: Keywords Studios data, Edison Investment Research

Valuation

Execution on plan should create further value

At 34x FY17 earnings dropping to 32x in FY18, Keywords' rating is a substantial premium to peers (average 18x for FY18).

However, the company has a compelling platform and strategy for growth within a games industry growing at a healthy 6.6% pa, with a strong track record of execution. Further accretive acquisition activity should be expected. Our organic estimates are conservative given historical and market growth rates, and the securing of a major strategic outsourcing deal could provide a further boost to forecasts. So while we believe that strong progress is now priced in for this year, if the company executes to plan it should grow into this valuation and continued execution should continue to deliver upside for shareholders.

Exhibit 4: Peer valuation table

Name		Current price (ccy value)	Quoted currency	Market cap (m)	EV/sales 1FY (x)	EV/sales 2FY (x)	EV/ EBITDA 1FY (x)	EV/ EBITDA 2FY (x)	P/E 1FY (x)	P/E 2FY (x)
Outsourced services										
KEYWORDS STUDIOS PLC	KWS LN EQUITY	723	£	393	3.9	3.6	22.6	20.9	34.2	31.9
LIONBRIDGE TECHNOLOGIES INC	liox us equity	6	US$	350	0.8	0.7	8.6	7.2	11.6	8.6
SDL PLC	sdl ln equity	580	£	593	1.6	1.6	13.6	12.2	21.2	19.4
RWS HOLDINGS PLC	rws ln equity	330	£	941	4.8	4.4	18.1	16.5	23.7	23.1
CAPITA PLC	cpi ln equity	567	£	4,759	1.3	1.3	9.4	9.2	10.4	10.0
SERCO GROUP PLC	srp ln equity	116	£	1,592	0.5	0.4	11.7	10.8	42.9	32.1
WIPRO LTD-ADR	wit us equity	10	US$	24,868	2.7	2.5	12.9	12.0	19.7	18.1
POLETOWIN PITCREW HOLDINGS	3657 JT equity	1,221	JPY	209	0.8	0.8	N/A	N/A	13.2	11.8
CAPGEMINI	cap fp equity	86	€	15,600	1.2	1.2	9.1	8.5	14.5	13.3
Average					**1.8**	**1.7**	**11.9**	**10.9**	**20.8**	**17.0**
Games industry										
MICROSOFT CORP	MSFT US Equity	66	US$	508,935	4.9	4.6	13.1	11.8	22.3	20.2
SONY CORP	6758 JT Equity	3,664	JPY	41,553	0.6	0.6	7.6	5.4	93.8	17.7
SQUARE ENIX HOLDINGS CO LTD	9684 JT Equity	3,180	JPY	3,493	1.1	1.1	7.2	5.7	18.8	14.4
UBISOFT ENTERTAINMENT	UBI FP Equity	40	€	4,826	2.9	2.6	6.8	5.3	30.1	23.4
BANDAI NAMCO HOLDINGS INC	7832 JT Equity	3,350	JPY	6,675	1.0	0.9	6.9	6.3	17.7	15.7
KONAMI HOLDINGS CORP	9766 JT Equity	4,735	JPY	6,098	2.6	2.3	11.2	9.6	25.9	21.6
ELECTRONIC ARTS INC	EA US Equity	90	US$	27,596	4.9	4.7	14.1	13.6	23.2	21.5
Average					**2.6**	**2.4**	**9.6**	**8.2**	**33.1**	**19.2**

Source: Bloomberg consensus, Edison Investment Research estimates. Note: Share prices as of 6 April 2017.

Exhibit 5: Financial summary

	€'000s	2014	2015	2016	2017e	2018e
31-December		IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS						
Revenue		37,293	57,951	96,585	116,671	126,096
Cost of Sales		(24,566)	(36,172)	(59,907)	(73,203)	(79,314)
Gross Profit (inc multimedia tax credits)		12,727	21,779	36,678	43,468	46,782
EBITDA		6,027	9,459	16,893	19,919	21,556
Operating Profit (before amort. and except.)		5,159	8,162	15,090	17,845	19,274
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	15,530	16,959
Net Interest		(106)	(264)	(287)	(287)	(287)
FOREX		467	(474)	(1,737)	0	0
Profit Before Tax (norm)		5,053	8,007	14,864	17,558	18,987
Profit Before Tax (FRS 3)		3,435	5,086	9,435	15,243	16,672
Tax		(1,215)	(1,832)	(3,223)	(3,687)	(3,797)
Profit After Tax (norm)		3,838	6,175	11,641	13,871	15,190
Profit After Tax (FRS 3)		2,220	3,254	6,212	11,556	12,875
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	25.1	26.9
EPS - normalised fully diluted (c)		8.5	12.6	20.3	24.5	26.3
EPS - (IFRS) (c)		4.9	7.0	11.2	20.9	22.8
Dividend per share (p)		1.10	1.21	1.33	1.46	1.61
Gross Margin (%)		34.1%	37.6%	38.0%	37.3%	37.1%
EBITDA Margin (%)		16.2%	16.3%	17.5%	17.1%	17.1%
Operating Margin (before GW and except.) (%)		13.8%	14.1%	15.6%	15.3%	15.3%
BALANCE SHEET						
Fixed Assets		20,874	32,132	61,873	60,412	61,204
Intangible Assets		17,677	27,675	55,495	54,191	52,562
Tangible Assets		2,761	3,486	5,498	5,341	7,762
Investments		436	971	880	880	880
Current Assets		23,120	34,884	38,677	53,562	66,228
Stocks		0	0	0	0	0
Debtors		6,203	7,519	13,879	16,655	18,000
Cash		11,014	19,018	17,020	27,908	38,228
Other		5,903	8,347	7,778	9,000	10,000
Current Liabilities		(9,746)	(13,128)	(27,830)	(31,048)	(32,138)
Creditors		(9,746)	(11,965)	(19,805)	(23,023)	(24,113)
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	76,737	89,104
CASH FLOW						
Operating Cash Flow		2,412	4,768	17,168	20,205	21,522
Net Interest		11	(58)	(58)	(287)	(287)
Tax		(522)	(1,362)	(2,129)	(3,687)	(3,797)
Capex		(1,252)	(1,635)	(2,306)	(3,618)	(4,703)
Acquisitions/disposals		(8,889)	(7,409)	(21,104)	(900)	(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)	10,898	10,320
Opening net debt/(cash)		(15,271)	(11,014)	(17,284)	(8,650)	(19,538)
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)	(19,538)	(29,858)

Source: Keywords Studios data, Edison Investment Research estimates

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