

Keywords Studios

Acquisition

Red Hot art acquisition

Keywords Studios' \$6m acquisition of Red Hot CG further strengthens the company's position in the art service line, in China and with Activision. Management estimates that the deal will make Keywords the number one supplier of art production services to the games industry globally and increase art production capacity by 25%. The deal further enhances our estimated FY18 earnings by 6%, with the three acquisitions made so far in May enhancing earnings by 11% versus our April forecasts.

Year end	Revenue (£m)	PBT* (£m)	EPS* (c)	DPS (p)	P/E (x)	Yield (%)
12/15	58.0	8.0	12.6	1.2	74.0	0.1
12/16	96.6	14.9	20.3	1.3	46.0	0.1
12/17e	123.1	18.6	26.0	1.5	35.9	0.2
12/18e	136.5	21.0	29.1	1.6	32.1	0.2

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

Bolstering position in art services and China

Red Hot CG is a China-based but UK-managed provider of a range of art services to the games industry. The company's operating hub is in Shanghai but it has subsidiaries in lower-cost locations elsewhere in China and in Yogyakarta in Indonesia. The addition of Red Hot CG's 220 artists should increase the group's art capacity by circa 25%. Management estimates this will make Keywords the largest provider of art production to the global games industry, ahead of Shanghai-based Virtuos, although there remains plenty of scope for further consolidation. From a customer perspective, Red Hot provides services to broad range of developers but has a particularly strong relationship with Activision and will support Keywords' drive to develop larger-scale, more strategic relationships with major games developers.

EPS upgraded by 7%

Red Hot generated revenues of \$5.4m in FY16 and PBT of \$0.9m with further growth expected in FY17. (Our estimates assume 10% growth for Red Hot in FY17.) Keywords is paying a total consideration of \$6m for the business, equating to multiple of 1.1x sales and 6.7x PBT. Of the consideration, \$4.35m will be paid immediately of which, \$1m is deferred for three years, with the remainder satisfied by the issue of 160.8k shares on the second anniversary of the acquisition. We upgrade our FY17 and FY18 EPS estimates by 3.1% and 5.8%, respectively.

Valuation: Continued execution key to further upside

At 32x 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

22 May 2017

Price 800p

Market cap £446m

€1.17/£, \$1.12/€

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 2.4 29.0 189.9

Rel (local) (2.0) 25.3 136.5

52-week high/low 830p 260p

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

H1 trading update July 2017

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Estimate changes

Our estimate changes are shown below in Exhibit 1.

The Red Hot acquisition prompts a 3% upgrade to FY17 PBT and adj EPS, with FY18 figures moving up by 6%. Factoring in all three acquisitions made in May (XLOC, GameSim and Red Hot), FY17 PBT and EPS has been upgraded by 6%, with the FY18 figures upgraded by 11%.

The company is paying a gross consideration (including deferred payments and shares issued) of €10m for these three acquisitions, resulting in a \$2m enhancement to our FY18 PBT, which equates to an attractive 5x forward PBT multiple.

Following the deals, the company's mid-year net cash is likely to be at the low- to mid-single-digit level. 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.

If the company were to invest a further €35m on acquisitions this year at the same 5x PBT forward multiple as the May acquisitions, we estimate that FY18 EPS would be upgraded by c 27%.

Exhibit 1: Estimate changes

€000s	2015	2016	2017e	2017e	Change	2018e	2018e	Change
	Actual	Actual	Old	New		Old	New	
Year end 31 December								
Revenue	57,951	96,585	119,551	123,115	3%	130,605	136,485	5%
Cost of sales	(36,172)	(59,907)	(74,833)	(76,793)	3%	(81,843)	(85,078)	4%
Gross profit	21,779	36,678	44,718	46,322	4%	48,761	51,408	5%
EBITDA	9,459	16,893	20,414	21,152	4%	22,438	23,735	6%
Operating profit (before amort. and except.)	8,162	15,090	18,339	19,077	4%	20,156	21,453	6%
Profit before tax (norm)	8,007	14,864	18,029	18,617	3%	19,846	20,993	6%
Profit after tax (norm)	6,175	11,641	14,243	14,708	3%	15,877	16,795	6%
EPS - normalised fully diluted (c)	12.6	20.3	25.2	26.0	3%	27.5	29.1	6%
EPS – (IFRS) (c)	7.0	11.2	21.6	22.4	4%	24.0	25.7	7%
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)	(15,720)	(13,244)	-16%	(25,731)	(23,943)	-7%
Source: Keywords Studios data, Edison Investment Research								

Exhibit 2: Financial summary

	€000s	2014	2015	2016	2017e	2018e
Year end 31 December		IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS						
Revenue		37,293	57,951	96,585	123,115	136,485
Cost of Sales		(24,566)	(36,172)	(59,907)	(76,793)	(85,078)
Gross Profit (inc multimedia tax credits)		12,727	21,779	36,678	46,322	51,408
EBITDA		6,027	9,459	16,893	21,152	23,735
Operating Profit (before amort. and except.)		5,159	8,162	15,090	19,077	21,453
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	16,762	19,138
Net Interest		(106)	(264)	(287)	(460)	(460)
FOREX		467	(474)	(1,737)	0	0
Profit Before Tax (norm)		5,053	8,007	14,864	18,617	20,993
Profit Before Tax (FRS 3)		3,435	5,086	9,435	16,302	18,678
Tax		(1,215)	(1,832)	(3,223)	(3,910)	(4,199)
Profit After Tax (norm)		3,838	6,175	11,641	14,708	16,795
Profit After Tax (FRS 3)		2,220	3,254	6,212	12,393	14,480
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	26.6	29.8
EPS – normalised fully diluted (c)		8.5	12.6	20.3	26.0	29.1
EPS – (IFRS) (c)		4.9	7.0	11.2	22.4	25.7
Dividend per share (p)		1.10	1.21	1.33	1.46	1.61
Gross Margin (%)		34.1%	37.6%	38.0%	37.6%	37.7%
EBITDA Margin (%)		16.2%	16.3%	17.5%	17.2%	17.4%
Operating Margin (before GW and except.) (%)		13.8%	14.1%	15.6%	15.5%	15.7%
BALANCE SHEET						
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	47,269	60,777
Stocks		0	0	0	0	0
Debtors		6,203	7,519	13,879	16,655	18,464
Cash		11,014	19,018	17,020	21,614	32,313
Other		5,903	8,347	7,778	9,000	10,000
Current Liabilities		(9,746)	(13,128)	(27,830)	(31,461)	(32,847)
Creditors		(9,746)	(11,965)	(19,805)	(23,436)	(24,822)
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	64,196	79,311
CASH FLOW						
Operating Cash Flow		2,412	4,768	17,168	21,677	23,372
Net Interest		11	(58)	(58)	(460)	(460)
Tax		(522)	(1,362)	(2,129)	(3,910)	(4,199)
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)	4,605	10,699
Opening net debt/(cash)		(15,271)	(11,014)	(17,284)	(8,650)	(13,244)
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)	(13,244)	(23,943)

Source: Keywords Studios accounts, Edison Investment Research

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