

Keywords Studios

Equity placing

£100m placing, trading resilient

Keywords announced a £100m equity placing on 14 May 2020. The funds are to increase flexibility for the group's buy-and-build M&A strategy and reinforce its financial position. Management also updated on trading over March and April (7% y-o-y growth), with January and February showing 21% y-o-y growth. Recognising this resilience during lockdown, we have raised our revenue growth forecast for FY20 to 8% y-o-y (4% previously), with a consequential impact on FY21e (€405.8m, 15% growth). We maintain our view that Keywords is well placed as the only games service provider on a global scale. The P/E rating (45.8x FY20e, 34.9x FY21e) reflects the company's leading market position, track record and potential, but should fall further as Keywords executes its buy-and-build strategy.

Year end	Revenue (€m)	PBT* (€m)	EPS* (c)	DPS (p)	P/E (x)	Yield (%)
12/18	250.8	37.9	43.7	1.61	43.9	0.09
12/19	326.5	40.9	47.2	0.58	40.7	0.03
12/20e	352.9	37.3	41.9	1.77	45.8	0.10
12/21e	405.8	51.6	55.1	1.95	34.9	0.11

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

Equity placing: £100m raised for M&A/balance sheet

The equity placing was announced after close of business on 14 May 2020 and carried out through an accelerated bookbuild on a non-pre-emptive basis (although in consultation with its major shareholders) to minimise cost, risk and management distraction. 6.9m shares, representing a c 10.5% increase in the issued share capital on a pre-placement basis, were issued at a price of 1,450p, a 5.8% discount to the closing price on 14 May 2020 (1,540p). £100m (gross) has been raised through the placing and will be used to provide management with increased flexibility around its buy-and-build M&A strategy, as well as to reinforce the group's financial position.

Forecasts: FY20/21 revised upwards

Keywords' trading update confirms that short-term trading has been more resilient than we had assumed (7% y-o-y growth reported in March and April) and with hindsight, we may have been overly aggressive in our estimate cuts in April. Accordingly, we have increased our estimates to reflect 5% annual growth on the FY19 year-end revenue run rate (8.1% y-o-y), where previously we had assumed revenue growth of 1%. We have not changed our key assumptions for FY21, with forecast revenue growth of 15% over FY20 (€405.8m), operating margins normalising to 13.4% (FY20e: 11.3%) and the tax rate held at 18.2%.

Valuation: M&A firepower of €220m

Keywords' shares trade on a P/E of 45.8x our updated FY20e estimates, falling to 34.9x in FY21e. We see little prospect for material M&A in H120, although accretive acquisitions in H220/FY21 would bring these multiples down. Despite current uncertainties, Keywords' buy and build strategy, which has delivered a five-year EPS CAGR of 42% to FY19, supported by the industry's strong underlying growth, appears sustainable in the medium to long term.

Software & comp services

19 May 2020

Price 1,714p

Market cap £1.25bn

€1.12/£

Net debt (€m) at 31 December 2019 17.9

Shares in issue (post May 2020 placing) 72.66m

Free float 90%

Code KWS

Primary exchange AIM

Secondary exchange N/A

Share price performance



% 1m 3m 12m

Abs 15.9 10.4 1.6

Rel (local) 11.4 37.0 23.2

52-week high/low 1,838p 1,073p

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 event

AGM 27 May 2020

H120 results September 2020

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COVID-19: Trading resilient in spite of COVID-19

In Keywords' trading update with its FY19 results in April 2020, management reported that there had been some short-term disruption to all service lines, particularly Functional Testing, Localisation Testing and Audio Services (together representing c 40% of FY19 revenues and 38% of staff) as these businesses have been harder to transition to remote-working.

Alongside its placing announcement, on 14 May 2020, management provided a short business update. This highlighted that trading was up 21% in January and February over the same period in 2019, while March and April were up 7% against the same two months in 2019. Over 6,000 staff (>80%) are now remote-working (up from 5,500 in April) with a further 800 working from facilities (mostly in China) (>90% are now operational out of a total employee base of c 7,300). Management expects revenue to continue to improve as testing staff are enabled to work from home (as client confidentiality concerns are addressed) and the audio business gains access to its studios.

Management has stated that it does not believe that COVID-19 will affect the business materially in the medium term, and indeed, it has already seen an increase in demand for services (although the business is capacity-constrained) as existing and new clients re-appraise production arrangements and make contingency plans.

As lockdowns ease, management continues to see an increase in client demand as the industry builds towards the next-generation console launches in Q420. Management expects to benefit from this pent-up demand once the operating environment normalises and management can start to increase capacity, underpinning stronger expectations for FY21.

The placing: £100m gross proceeds for M&A

The placing was announced after close of business on 14 May 2020 and carried out through an accelerated bookbuild on a non-pre-emptive basis (although in consultation with its major shareholders) to minimise cost, risk and management distraction. The gross proceeds were £100m, with 6.9m shares being issued at a price of 1,450p, a 5.8% discount to the closing price on 14 May 2020. The new shares list on 20 May.

The primary purpose of the placing is to provide Keywords with flexibility to continue to execute its buy-and-build M&A strategy, as well as to reinforce the company's financial position to ensure it will continue be viewed as a strong partner by its clients through FY20 and beyond.

Exhibit 1: Details of the placing

Shares in issue (pre-placing)	65.76m
Closing share price on 14 May 2020	1,540p
Gross proceeds from placing	£100m
Issue price	1,450p
Discount to closing share price	5.8%
Number of new shares to be issued	6.90m
Total number of shares in issue (post-placing)	72.66m
Dilution (before considering the benefit of any funds used for M&A)	9.5%

Source: Company, Edison Investment Research

Forecasts: Upward revisions to FY20 and FY21

We take this latest update as confirmation that trading has been more resilient than we had assumed in the short term (7% y-o-y growth reported in March and April) and with hindsight, we may have been overly aggressive in our estimate cuts in April 2020.

FY20 – 5% growth on YE19 revenue run-rate

Accordingly, we are raising our estimates to reflect annual growth of 5% on the FY19 year-end revenue run rate of c €336m (8.1% y-o-y growth), where previously we had assumed revenue growth of 1%. We believe this is still conservative, but with ongoing uncertainties about the economic situation, new work patterns and the pace of recruitment, we believe prudence is still the right call.

With the group's additional investment in remote working, furloughing of staff, investment in hardware and systems, and factoring in lower productivity, as we had forecast previously, we continue to expect margins (particularly in H120) to be adversely affected and assume FY20 adjusted operating margins fall to c 11.3% (FY19: 13.2%), with PBT margins compressed to 10.6% from 12.5% in FY19.

We have not changed our key assumptions for FY21, with forecast revenue growth of 15% over FY20 (€405.8m), operating margins normalising to 13.4% (FY20: 11.3%) and the tax rate held at 18.2%.

Exhibit 2: Revised estimates									
€'000s		2019	2020e			2021e			Y-o-y
		Actual	Old	New	Change	Old	New	Change	Change
Revenue		326,463	339,451	352,895	4.0%	390,369	405,829	4.0%	15%
Cost of Sales		(206,234)	(213,067)	(221,259)	3.8%	(244,547)	(254,236)	4.0%	15%
Gross Profit (inc multimedia tax credits)		120,229	126,385	131,636	4.2%	145,822	151,593	4.0%	15%
Gross Margin (%)		36.8%	37.2%	37.3%	0.2%	37.4%	37.4%	0.0%	0%
Operating Profit (before amort. and except.)		42,983	38,127	39,883	4.6%	52,133	54,194	4.0%	36%
Operating Margin		13.2%	11.2%	11.3%	0.6%	13.4%	13.4%	0.0%	18%
Profit Before Tax (norm)		40,913	35,527	37,283	4.9%	49,533	51,594	4.2%	38%
Profit After Tax (norm)		33,451	29,048	30,483	4.9%	40,500	42,184	4.2%	38%
EPS - normalised (c)		47.2	41.0	41.9	2.3%	56.6	55.1	(2.7%)	31%
Dividend per share (p)		0.58	1.77	1.77	-	1.95	1.95	-	10%
Closing net debt/(cash)		17,924	(11,228)	(106,837)		(39,367)	(135,676)		

Source: Company accounts, Edison Investment Research

Acquisition pipeline – super-charged by placing

Keywords' strategy of using earnings-enhancing acquisitions whilst consolidating a fragmented games outsourcing market is intrinsic to the investment case. Given the current environment, we do not anticipate material M&A in H120 (although we wait to be proven wrong). However, we strongly believe that deals will resume in H220, with distressed/ready sellers looking to exit towards the end of what will have been a difficult year for many.

Even before the placing, the group had net debt of €17.9m, modest gearing of 0.4x net debt/adjusted EBITDA and total cash and undrawn facilities of €112m as at 31 December 2019. After the placing, the company now has an additional c £97m of net cash post raise – and total M&A firepower of c €220m. The company has previously guided towards €30–80m of M&A in a 'typical' year.

Valuation – multiples expected to fall as deals executed

Keywords has delivered an adjusted EPS FY13–19 CAGR of 42% and we believe should revert to double-digit revenue growth in the medium term (FY21 onwards). We retain our view that Keywords is strongly placed as the only games service provider on a global scale. The company's P/E rating (45.8x FY20e, 34.9x FY21e) reflects its leading market position, track record and potential, but should fall further as Keywords continues to execute its buy-and-build strategy.

Exhibit 3: Financial summary

	€'000s	2017	2018	2019	2020e	2021e
31-December		IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS						
Revenue		151,430	250,805	326,463	352,895	405,829
Cost of Sales		(96,345)	(154,997)	(206,234)	(221,259)	(254,236)
Gross Profit (inc multimedia tax credits)		55,085	95,808	120,229	131,636	151,593
EBITDA (adjusted)		26,645	43,729	57,611	55,037	70,531
EBITDA (reported)		22,203	34,304	43,375	44,285	58,703
Operating Profit (before amort. and except.)		23,915	38,916	42,983	39,883	54,194
		(3,038)	(6,872)	(7,318)	(8,325)	(9,574)
Exceptionals		(3,016)	(5,296)	(4,348)	0	0
Other		(1,426)	(4,129)	(9,775)	(10,753)	(11,828)
Operating Profit		16,435	22,619	21,542	20,806	32,793
Net Interest		(818)	(1,316)	(2,513)	(2,600)	(2,600)
FOREX		(3,623)	791	(1,658)	0	0
Profit Before Tax (norm)		23,097	37,911	40,913	37,283	51,594
Profit Before Tax (FRS 3)		11,994	22,094	17,371	18,206	30,193
Tax		(4,731)	(7,191)	(7,462)	(6,800)	(9,410)
Profit After Tax (norm)		18,366	30,720	33,451	30,483	42,184
Profit After Tax (FRS 3)		7,263	14,903	9,909	11,406	20,782
Average Number of Shares Outstanding (m)		58.7	64.3	65.1	69.0	72.3
EPS – normalised (c)		31.3	45.5	48.8	41.9	55.1
EPS – normalised and fully diluted (c)		30.0	43.7	47.2	41.9	55.1
EPS - (IFRS) (c)		12.4	23.2	15.2	16.5	28.7
Dividend per share (p)		1.46	1.61	0.58	1.77	1.95
Gross Margin (%)		36.4%	38.2%	36.8%	37.3%	37.4%
EBITDA Margin (%)		14.7%	13.7%	13.3%	12.5%	14.5%
Operating Margin (before GW and except.) (%)		15.8%	15.5%	13.2%	11.3%	13.4%
PBT Margin (%)		15.3%	15.1%	12.5%	10.6%	12.7%
BALANCE SHEET						
Fixed Assets		142,927	198,215	223,992	218,512	216,210
Intangible Assets		131,610	180,086	196,769	188,728	179,154
Tangible Assets		10,111	15,002	22,163	24,724	31,996
Investments		1,206	3,127	5,060	5,060	5,060
Current Assets		80,182	100,348	120,483	249,176	290,404
Stocks		0	0	0	0	1
Debtors		27,473	37,019	43,243	45,405	52,216
Cash		30,374	39,870	41,827	166,587	195,426
Other		22,335	23,459	35,413	37,184	42,761
Current Liabilities		(51,677)	(95,031)	(49,551)	(49,846)	(50,846)
Creditors		(32,734)	(54,960)	(49,471)	(49,766)	(50,766)
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	346,648	382,574
CASH FLOW						
Operating Cash Flow		21,389	33,954	46,069	53,076	59,426
Net Interest		(253)	(502)	(9,411)	(6,263)	(3,425)
Tax		(4,731)	(6,304)	(13,288)	(6,800)	(9,410)
Capex		(3,803)	(9,440)	(13,145)	(10,657)	(16,341)
Acquisitions/disposals		(90,090)	(25,766)	(27,762)	(316)	0
Financing		82,936	0	0	97,000	0
Dividends		(867)	(1,080)	(1,197)	(1,279)	(1,412)
Net Cash Flow		4,581	(10,090)	(18,734)	124,761	28,839
Opening net debt/(cash)		(8,650)	(11,094)	431	17,924	(106,837)
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	(106,837)	(135,676)

Source: Company accounts, Edison Investment Research

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