Elecosoft plc

17th May 2018

Building a smarter future

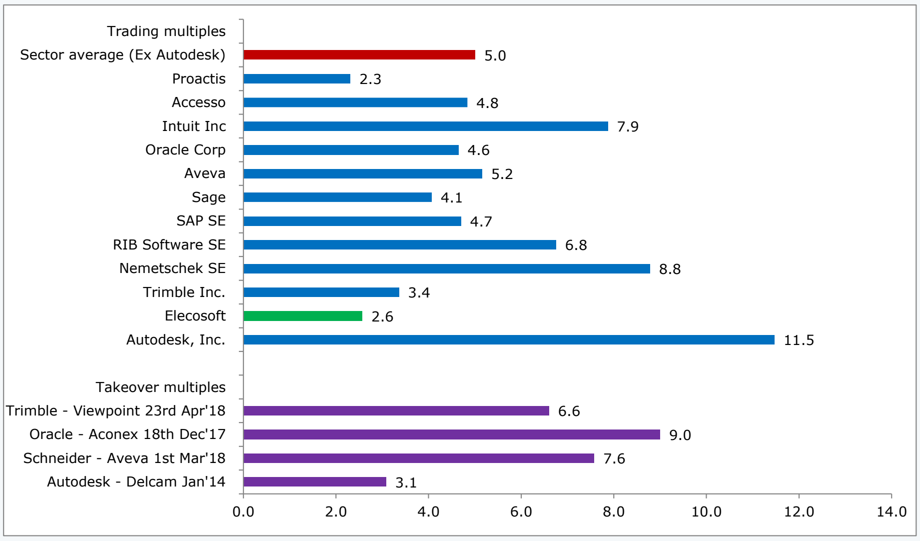
Delivering infrastructure projects on time, to-spec and within budget has proved a mine-field for corporates & politicians alike. Typically, 80% are late and 40% over-spent with little thought on how best to manage the asset once complete. Not exactly ideal, when total running costs over a property's 25-40 year life, can be >4x the upfront capex.

Luckily things are changing...and fast. Here technologies, such as data analytics, IoT, VR/AR, robotics & artificial intelligence, are transforming the $8 trillion global construction market. In turn helping to drive **strong demand at Elecosoft** (ELCO), a leading BIM (Building Information Modelling) software developer.

A tech-rich software stock operating in a rapidly...

M&A hasn't been too far behind either, with many deep pocketed rivals (eg JLG Technology, Bentley, Nemetschek, RIB Software, Autodesk, Trimble, Hexagon, Dassault & Oracle) hovering up competitors at often hefty premiums (see below).

Current year (CY) EV/Sales vs peer and M&A multiples



Source: Equity Development, various sites – closing prices as at 16th May 2018

...expanding and M&A active $5bn global market

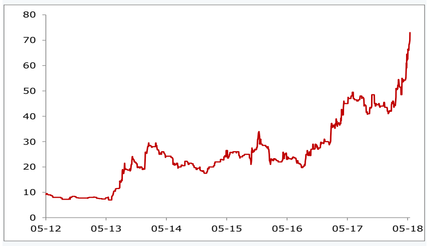
Together this has created a 'virtuous circle' for ELCO shareholders of **improving results, rapid growth, robust visibility** and future **'take-out' possibilities**, as the firm becomes one of the few remaining sizeable, pure-play BIM experts left standing. Indeed hypothetically, if long-serving Exec Chairman John Ketteley (aged 78 with a 11.7% stake) ever decided to pass on the reins, then the Board might well receive a similarly attractive 'knock at the door'.

Plus, even after its recent appreciation, **the stock is still not expensive**. Trading on EV/sales and PEG ratios of 2.5x (vs peers 5x) and 1.0x (1.6x) respectively, whilst trading 15% below **our 85p/share valuation**.

Company Data

EPIC	**AIM: ELCO**
Price (last close)	73p
52 week Hi/Lo	73p/40p
Market cap	£56m
ED valuation	85p/share
Avg. daily volume	35k

Share Price, p



Source: Web Financial

Description

Elecosoft is a **developer of on-premise and Cloud/SaaS software** for the Architectural, Engineering, Construction and Operator (AECO) and digital marketing industries. Its award winning 6D solutions (>100,000 users) cover project planning, estimating, design/CAD, visualisation, site operations and Building Information Management (BIM). **BIM acts as the essential lubricant to oil all the connecting parts**. Hence keeping users up-to-date, in-sync with each other and working on "one version of the truth".

There are 201 staff: 50 are software engineers, 59 client support and 55 sales/marketing. **Visibility is robust** with **49% of 2017 revenues recurring maintenance, ~10% SaaS and 90%+ customer retention rates.** Landmark implementations are: The Shard, the BBC Television Centre, Hong Kong International Airport and Berlin's Reichstag Dome.

Next News: H1'18 pre-close update in July

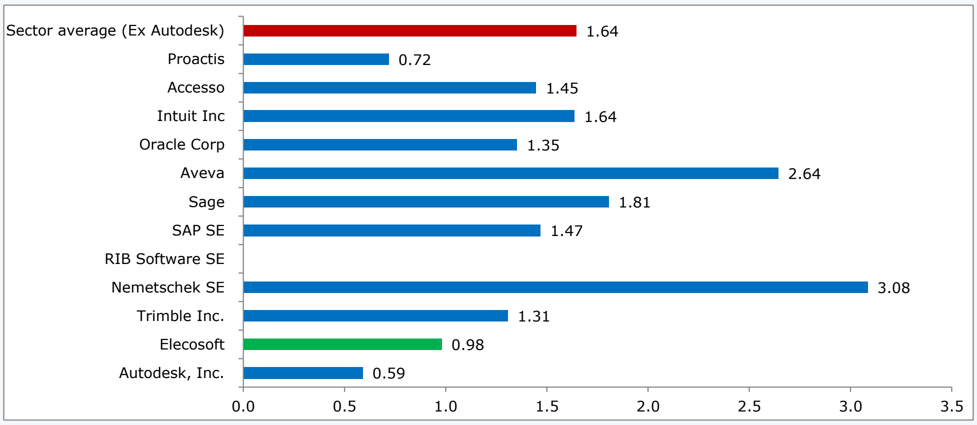
Paul Hill (Analyst)*
0207 065 2690
paul.hill@equitydevelopment.co.uk

Hannah Crowe
0207 065 2692
hannah@equitydevelopment.co.uk

*a shareholder in Elecosoft

Shares trade at a discount to peers

CY PEG ratios vs peers



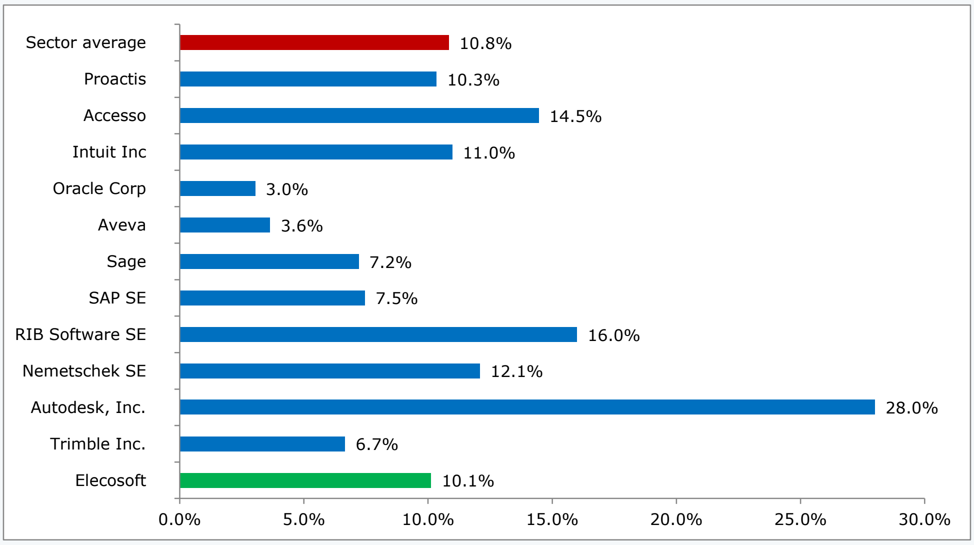
Source: Equity Development, various sites – closing prices as at 16th May 2018

In terms of the numbers, ELCO posted **2017 turnover up 12.4% to £20.0m** (split 4% LFL, 4% forex & 4% acquisitions), **EBIT margins of 13.9%** (12.4% 2016), **102% cash conversion** and a **50% hike in the dividend** to 0.6p (yield 0.8%). The balance sheet is in ship-shape too, closing December with £1.0m of net cash.

Buoyant conditions, strong growth & +ve cashflows

For 2018, **we expect more of the same** on the back of **8% higher revenues** (£21.6m) – split 7% H1 & 9% H2. Leading to a 21.4% jump in adjusted EPS (20.2% LY) to 3.5p, as the benefits of **operating leverage** and **30%+ EBITDA drop-through** rates kick in.

Current year + 1 industry growth rates



Source: Equity Development, various sites – closing prices as at 16th May 2018

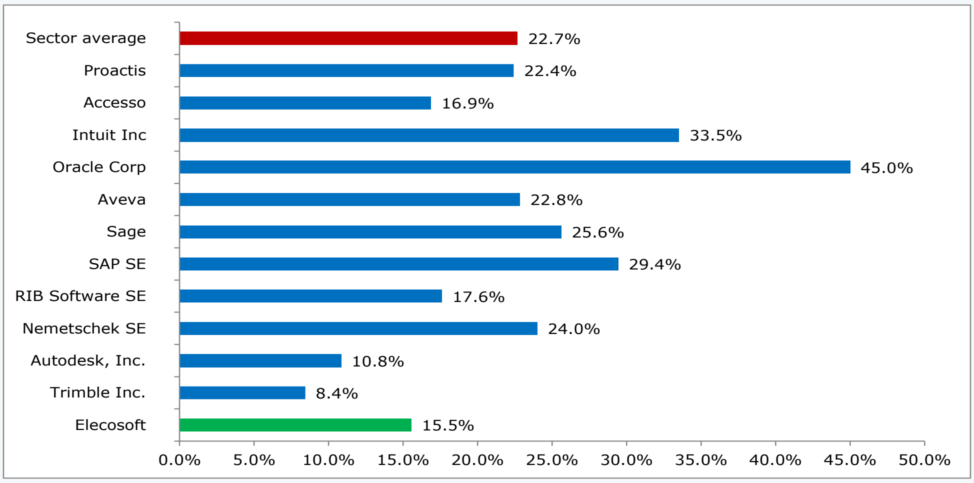
On track to "comfortably" meet targets

A view consistent with **this morning's trading update**. Where **LFL top line growth accelerated from 4% in 2017 to 7%** (constant currency) during the 1st 4 months. Translating into "***significantly higher PBT than LY, and [being] comfortably in line with market expectations***".

Mr Ketteley adding "***Elecosoft has continued to perform well reflecting both the strength and international spread of our core businesses****. I am pleased to say that Elecosoft also continues to be* ***strongly cash generative****, and as at 30 April 2018* *we had* ***net cash of £2.4m****, compared with net cash of £1.0m at 31 December 2017."*

For 2019 onwards, **this momentum should continue,** nudging organic growth to 10%+, and in doing so ultimately lift margins above 20%, consistent with peers at 22.7% (see below).

Current year EBIT margins vs peers



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ELCO isn't scrimping on IT development

Let's not forget that this is being achieved during a period of heavy investment. In 2017 **£2.75m was spent** (14% of sales vs 15% 2016) **on R&D** (£1.7m) and **capitalised development** (£1.05m vs £623k amortised). Principally undertaken by ELCO's **50 software engineers** and **59 client support staff**, situated in Sweden, UK and Germany. No small commitment, and one which should pay handsome rewards in due course.

Fine, but why do clients keep coming back

Well in short, the technology not only offers some of the most advanced features available, but we understand is also easy to deploy and user-friendly. **Providing end-to-end 6D BIM functionality** (see below & Appendix) - covering design and engineering, right through to construction and facilities/information management (see below). The latter acting as a natural lubricant that oils **all the inter-connecting parts**. Updating users, keeping them in-sync, and crucially ensuring only "**one version of the truth**" across every project.

Next steps on the roadmap include adding more 7D, VR/AR and geospatial mapping capability.

Fully integrated suite of software applications

Source: Company

>100k satisfied users can't be too far wrong

However, don't just take our word for it. **In November 2017 the company won 2 prestigious accolades at the 2017 UK Construction Computing Awards**. Here being singled out as the supplier of the 'Best Project Management/Planning' tool for the 4th year in a row, in addition to winning the category for 'Best Use of IT in a Construction Project'. The latter in recognition of the Icon implementation at McCarthy & Stone, the UK's largest retirement house builder.

What's more a 'Who's Who' of leading brands (see below) take the platform, namely:

- >90% of the UK's top 100 construction contractors
- 7 of the UK's top 10 retailers (Boots, ASDA, Sainsburys, John Lewis, M&S, Morrisons)
- 40 of the top 50 Swedish and 14 of the largest German construction companies
- 70% of EU flooring manufacturers and 15% of top 400 US contractors.

Stamp of approval from many blue chip clients

Source: Company

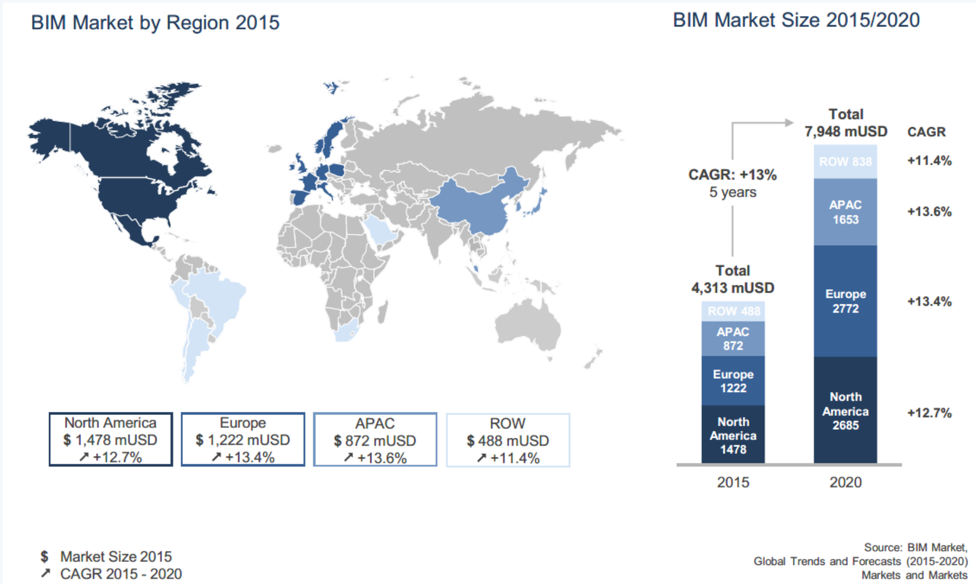
In total **there are >100,000 active users**, with the software being deployed on numerous landmark locations such as; The Shard, Hong Kong International Airport, Berlin's Reichstag Dome, Dubai's Jumeirah Park and by the Pennsylvania Department of Transportation.

All in all, acting as a **formidable economic 'moat'** to deter new entrants, coupled with generating >**90%+ retention rates, 49% recurring revenues** (Support & maintenance) and **robust forward visibility**. Elsewhere we understand there is a small yet rapidly expanding SaaS business (circa 10% sales), which is currently being reported under software licenses.

What are ELCO's other key growth engines?

But that's not all. Apart from enjoying **buoyant market conditions** (see below), there are **plenty of self-help measures presently being progressed**.

Double digit BIM market growth rates



Source: Nemetschek

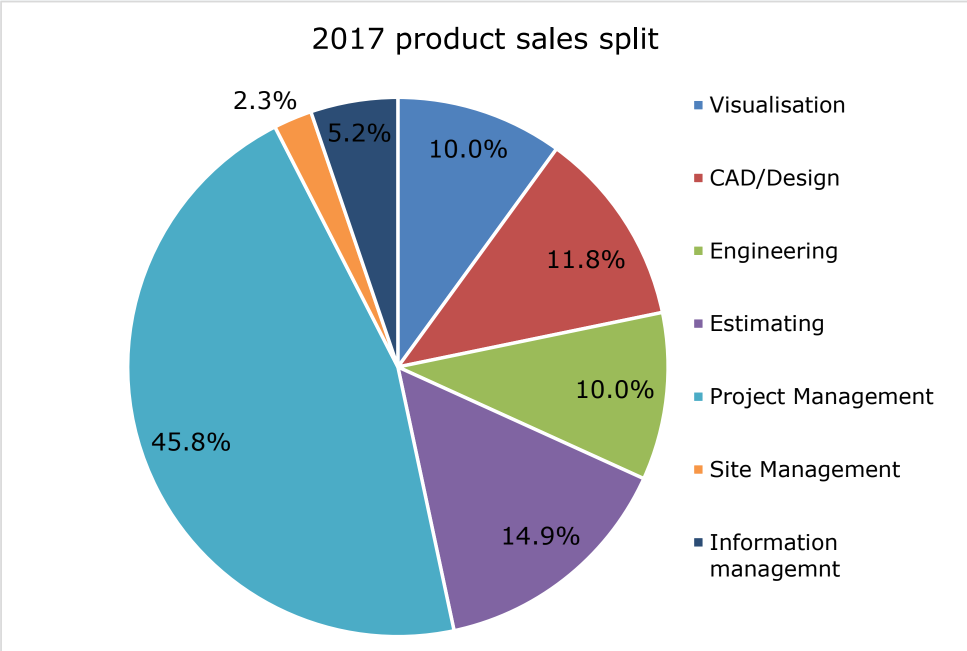
#1: Up/X-selling end-to-end solutions

Up/x-selling - say by leveraging the company's unified brand and extensive customer footprint, as clients can realise even greater returns by purchasing > 1 module.

To put this in context, we guess <20% of customers currently purchase multiple products, leaving ample room to increase attachment rates. Especially with regards to linking the Bidcon (estimating) & Powerproject (project management) modules, along with encouraging customers to roll-out the whole integrated package.

This is precisely what's happened at McCarthy & Stone. After adding Icon (information) and Bidcon to PowerProject – the client was able to reclaim multi-£m volume rebates from suppliers that otherwise might have been missed.

Less than 20% of customers take >1 module

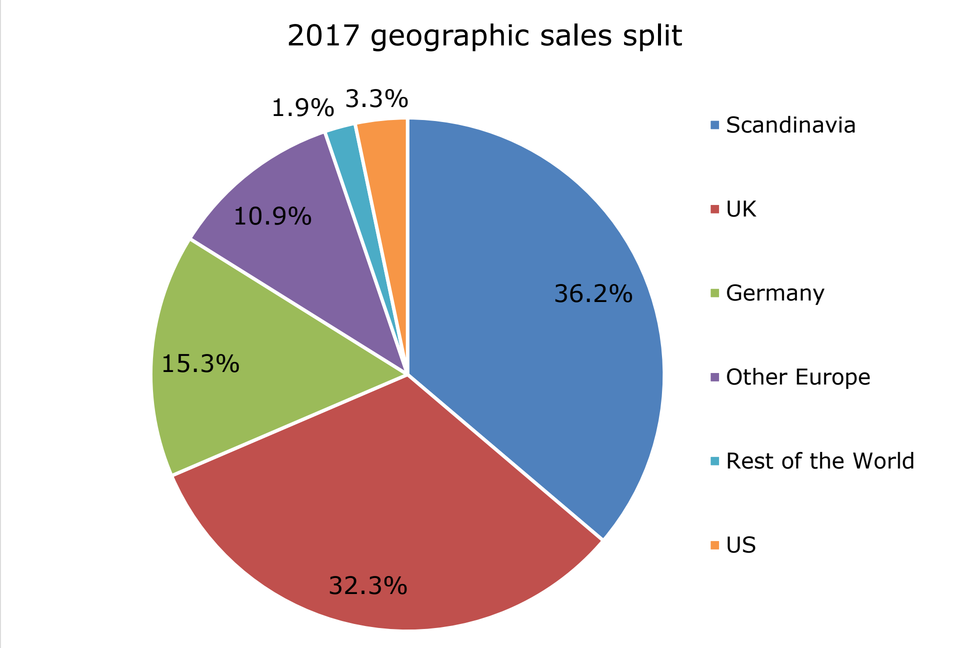


Source: Equity Development

#2: Greater exposure outside of EU

Secondly, **replicating Elecosoft's European/UK success** in places like North America, Australia/NZ, China, India, Asia, Middle East and South/Latin America, where it is under-represented (5.2% of 2017 revenues: see next graphic).

Expansion abroad



Source: Equity Development, Company

In December, a strategic partnership was struck with Texas-based Innovative Management Solutions, which serves the construction, engineering, oil & gas, utilities, financial services and government sectors.

Jeff Collins, President of IMS, commenting "*By combining 3D models with scheduling tools in one easy-to-use solution, we believe that Elecosoft's market leading software portfolio comprises ideal tools for many of our customers who are looking to maintain their competitive edge in a range of fast-moving industries*." Eventually, we think around a third of turnover will be derived from non-EU territories (eg North American).

#3: Expansion into adjacent verticals

Elsewhere, ELCO's software can also be deployed within other verticals. Yet in order to access these, the Board will probably need to tilt more towards channel partners (~10% revenues) and/or acquisitions, rather than building a separate in-house salesforce.

#4: New technologies and acquisitions

Similarly, introducing new 'disruptive' technologies is likely to be achieved via a combination selective bolt-on acquisitions and/or the firm's own development team. The former in the same vein as the **Oct'16 £2.4m Icon acquisition** (2.7x trailing sales), which bolstered the group's SaaS and BIM expertise, along with opening up the retail vertical.

#5: E-Sign, a potential 'game-changer'

Last but certainly not least, is Hannover-based E-Sign (branded "Interiormarket" & "Marketingmanager"), a developer of interactive software for visualising property interiors. Although relatively low-key at the moment, we reckon this unit has considerable potential across a multitude of different settings.

For example, by taking HD images of a person's home (or one they're planning to buy), E-Sign's systems can automatically convert these pictures into their constituent parts to form a 3D virtual model (see below).

Allowing customers at the 'point-of-sale' to see exactly how their own possessions might look/feel inside a room/house. Whilst simultaneously providing a tool for furniture stores, other homeware retailers and/or house-builders to sell fixtures, fittings, sofas and all manner of other goods/services from an online brochure.

Allowing people to 'try before they buy'

In turn, boosting revenues and reducing the frustration/cost of having to process returns in the event an item doesn't either fit, or the colour scheme match. Plus, if the catalogue is fed with cost, margin & other info, then retailers could theoretically alter their prices in real-time to maximise turnover, profits or any other KPI.

To us, this is potentially 'game-changing', and why some major retailers are already adopting similar technology. One being **IKEA**, which launched its PlaceApp in Sept'17, combining VR with Apple's ARKit platform. Amazon and US retailer Target offer comparable products too.

Addressable market for E-Sign's 'visualisation' software could be substantial

Source: Company

Solid balance sheet sporting £2.4m of net cash

Fine, but how will all this be funded? Well given ELCO's cash generative nature, augmented by £2.4m of net funds as at April'18, we're confident organic growth (ie as modelled in our forecasts) can be financed entirely from internal resources. In fact, if there's little M&A, there might even be bandwidth to nudge up the dividend.

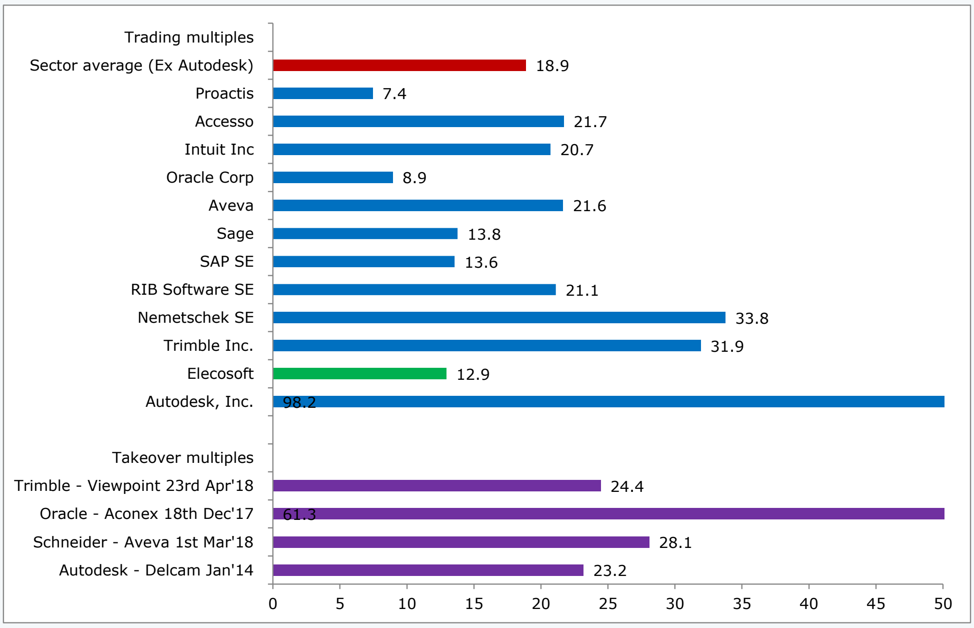
With regards to deal-making, this will depend on both the quantum and company's debt capacity. The latter of which we would pitch at approx. 2x EBITDA:net debt, equivalent to £8-9m**.**

Ok, but how much is the stock worth?

Bottom line, after using a range of valuation metrics and running various DCF scenarios, we calculate ELCO is worth **85p/share**. Meaning that at 73p**, Elecosoft looks under-valued** both in absolute and relative terms, sitting at a discount to peers (see comparative tables).

In our view, this gap should logically close as the business expands, and lead to a positive re-rating. Particularly if either actual results are better than expected, and/or the Board receives a predatory approach. Something that we understand has occurred before, but been rejected on economic grounds.

CY EV/EBITDA vs peers and M&A multiples



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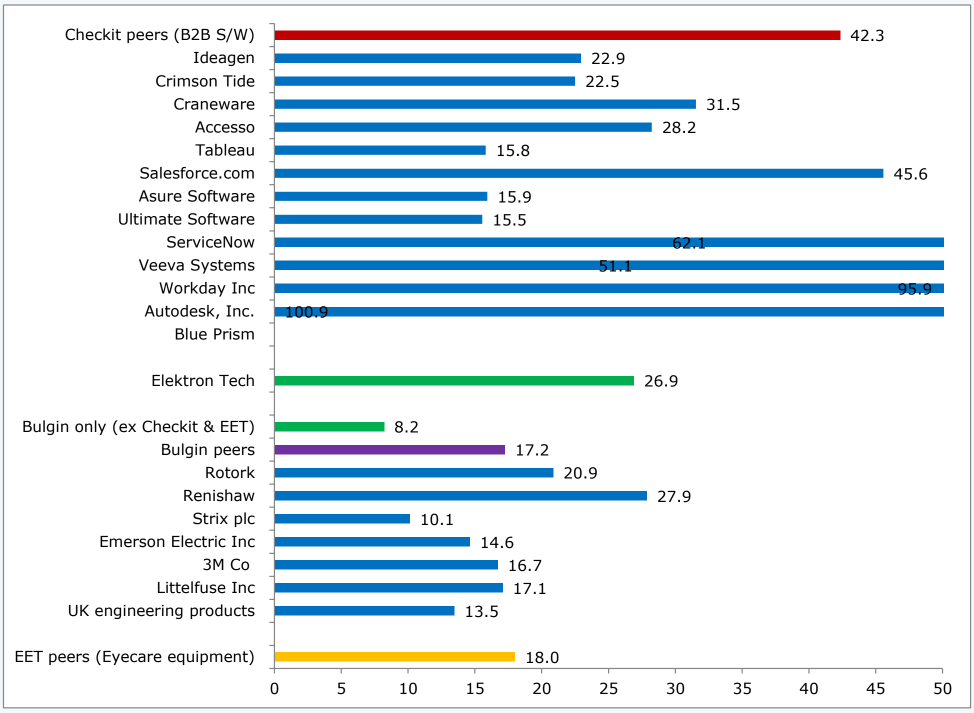

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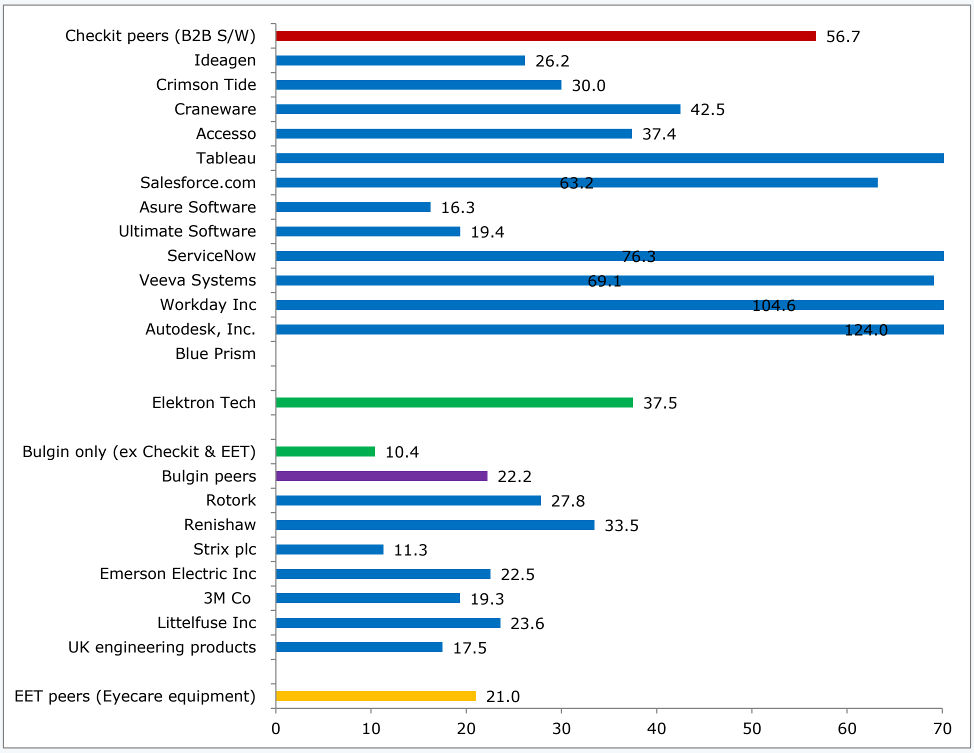
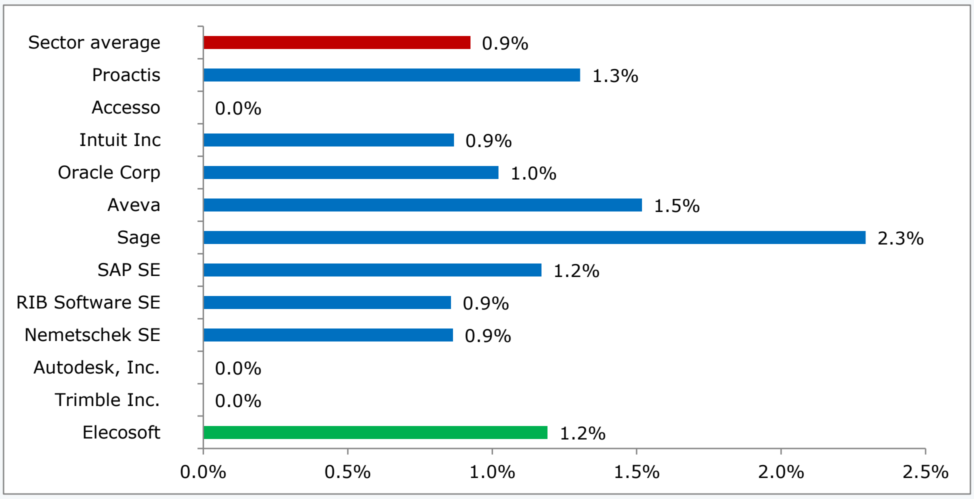
CY PERs vs peers and M&A multiples



Source: Equity Development, various sites – closing prices as at 16th May 2018

CY dividend yield vs peers



Source: Equity Development, various sites – closing prices as at 16th May 2018

Proven track record of directors

Finally, it is worth mentioning the management, who to us are not only **investing in all the right areas,** but also displaying **disciplined capital management and cost control**.

What's more, the **Executive Chairman** (aged 78, FCA) **has not shied away from pushing through tough decisions**. Mr Ketteley instigated the original transition from UK building systems into software between 2010-14. A strategy which has subsequently lead to a 9-fold return in the shareprice, since hitting all-time lows of 7.5p in Sept'12 (>30% pa CAGR).

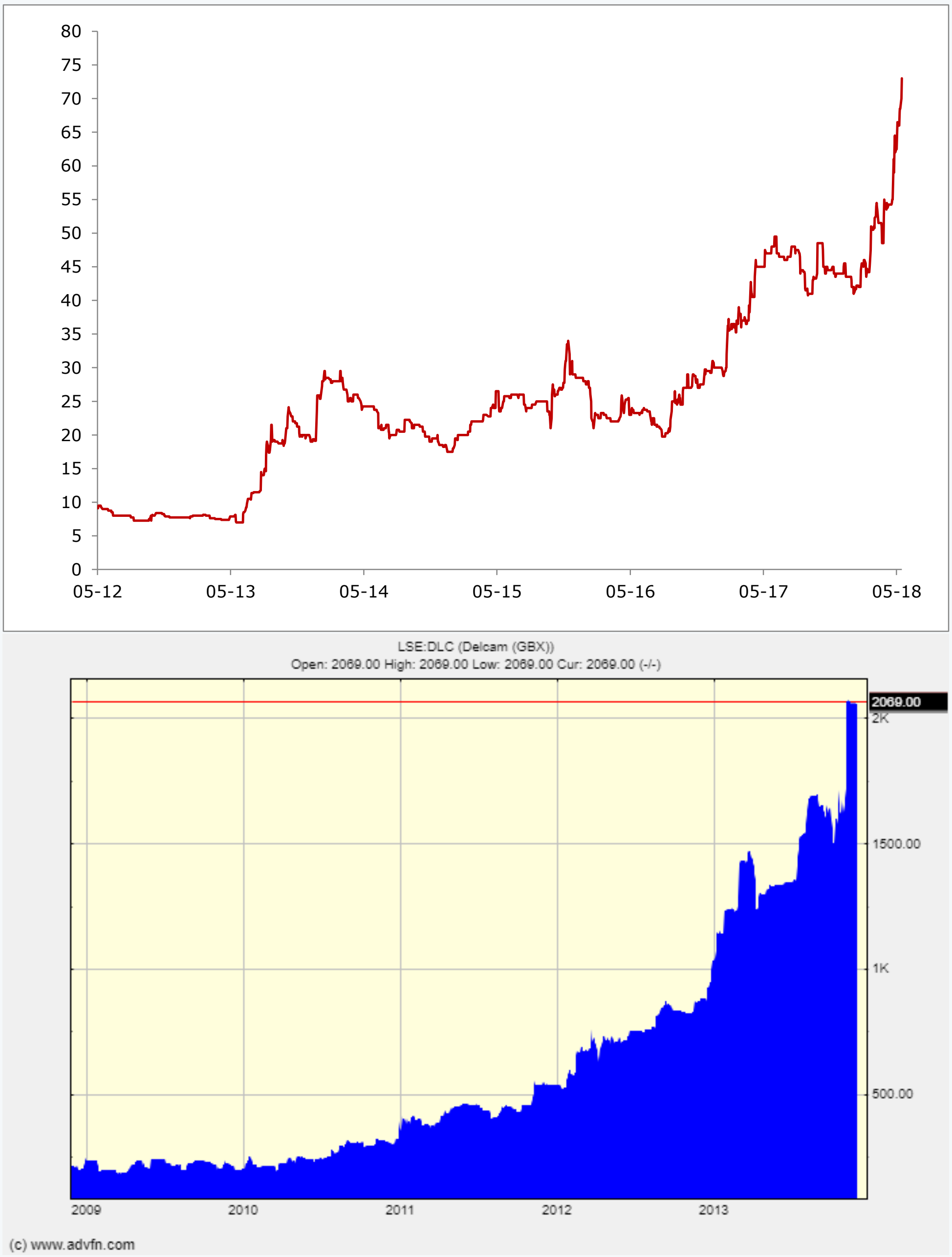
Additionally, along with COO Jonathan Hunter (aged 39) - who was the chief architect behind the Icon deal and move into cloud/SaaS – we think these 2 individuals are a complementary blend of experience, youth, commercial acumen and technological expertise.

Top marks for 5 years' turn-around

Sure, investors will ponder whether after the recent good-run there's much left on the table. However, based on the firm's growth trajectory and relatively modest rating vs peers, we see further upside. And perhaps a lot more, if the company ever became the target of an unsolicited take-over bid.

This is not unchartered waters either. There have been several other notable transformations in the CAD/CAM space previously. One being the 9-fold rise at Delcam (a CAD/CAM software developer) in the 5 years preceding its purchase by Autodesk in Jan'14 (see below).

Comparative 5 year price charts for Elecosoft & Delcam



Source: Equity Development

So, what does this all mean?

Well, for people looking to ride the coat-tails of hi-tech 'disruptive technology', and who are prepared to invest in smallcaps that have the potential to significantly out-perform, then Elecosoft fits the bill.

Long term, we see adjusted EPS climbing >185% from 2.9p LY to 8.3p by 2024, boosted by a near doubling of turnover from £20m to £39.1m (see below), and delivering EBIT margins and cash conversion of 21% and 85.6% respectively.

Summary financial projections

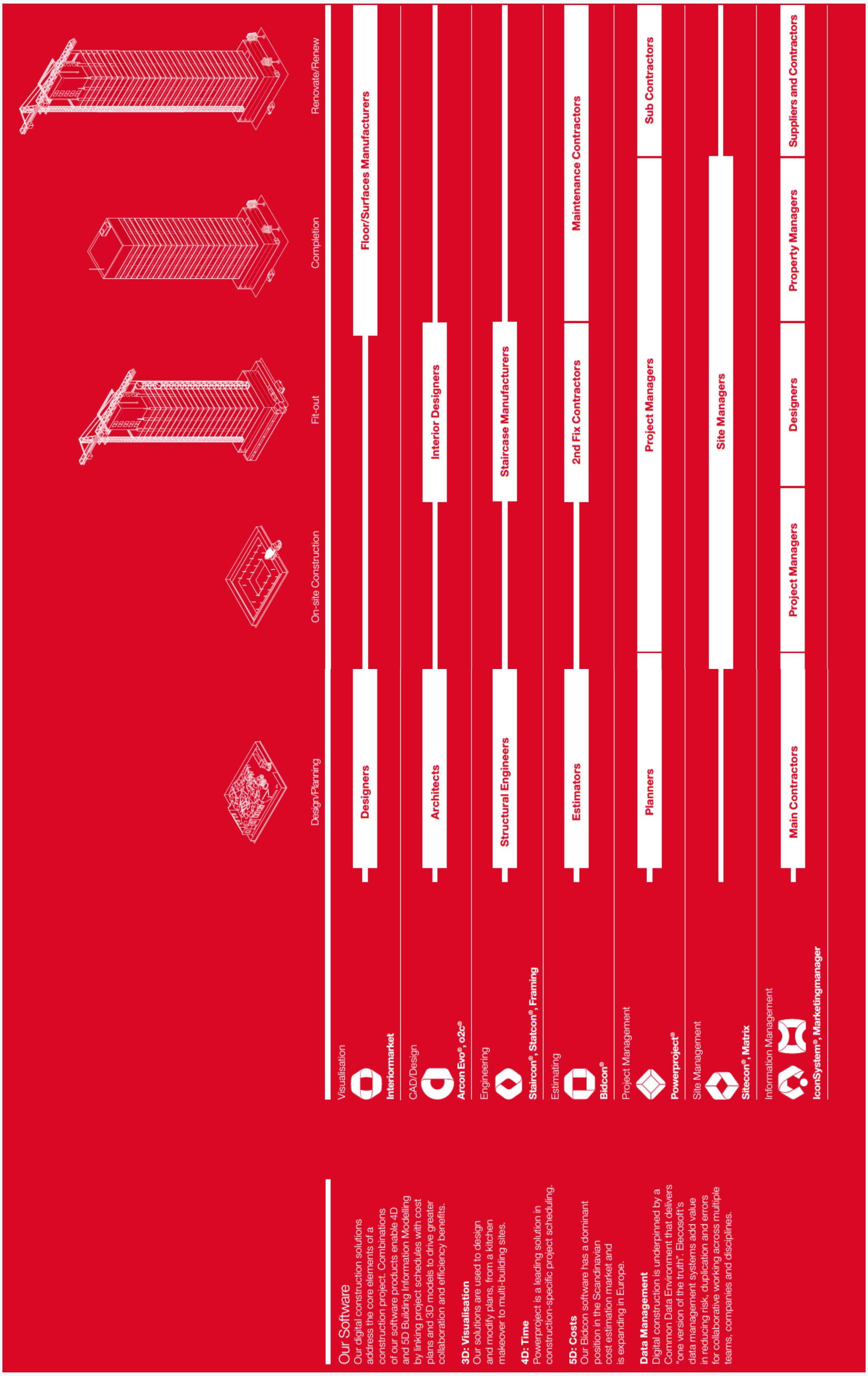
Elecosoft (Dec yearend)	2014 Act £'000s	2015 Act £'000s	2016 Act £'000s	2017 Act £'000s	2018 Est £'000s	2019 Est £'000s	2020 Est £'000s	2021 Est £'000s	2022 Est £'000s	2023 Est £'000s	2024 Est £'000s
Software licenses (Incl SaaS)	4,008	4,536	4,955	5,775	6,318	7,076	7,925	8,876	9,941	11,134	12,470
Support and maintenance	7,351	7,278	8,622	9,856	10,782	12,076	13,526	15,149	16,966	19,002	21,283
Services	3,813	3,446	4,218	4,365	4,496	4,631	4,770	4,913	5,060	5,212	5,368
Turnover	**15,172**	**15,260**	**17,795**	**19,996**	**21,596**	**23,783**	**26,220**	**28,938**	**31,968**	**35,349**	**39,121**
% growth	*-7.0%*	*0.6%*	*16.6%*	*12.4%*	*8.0%*	*10.1%*	*10.2%*	*10.4%*	*10.5%*	*10.6%*	*10.7%*
Gross Profit	**13,314**	**13,572**	**15,560**	**17,575**	**18,883**	**20,796**	**22,927**	**25,303**	**27,952**	**30,908**	**34,207**
% margin	87.8%	88.9%	87.4%	87.9%	87.4%	87.4%	87.4%	87.4%	87.4%	87.4%	87.4%
Adj. EBITDA (post SBPs)	**1,465**	**1,795**	**2,753**	**3,643**	**4,287**	**4,816**	**5,558**	**6,409**	**7,384**	**8,502**	**9,783**
% Margin	*9.7%*	*11.8%*	*15.5%*	*18.2%*	*19.9%*	*20.3%*	*21.2%*	*22.1%*	*23.1%*	*24.1%*	*25.0%*
Adj. EBIT (post SBPs)	**1,266**	**1,506**	**2,207**	**2,773**	**3,357**	**3,805**	**4,457**	**5,209**	**6,074**	**7,070**	**8,215**
% Margin	*8.3%*	*9.9%*	*12.4%*	*13.9%*	*15.5%*	*16.0%*	*17.0%*	*18.0%*	*19.0%*	*20.0%*	*21.0%*
Adj. Profit before Tax	**1,046**	**1,386**	**2,117**	**2,666**	**3,300**	**3,798**	**4,500**	**5,209**	**6,124**	**7,070**	**8,215**
Adjusted EPS (p)	**1.3**	**1.5**	**2.4**	**2.9**	**3.5**	**4.0**	**4.6**	**5.3**	**6.2**	**7.1**	**8.3**
EPS growth rate		*20.1%*	*58.2%*	*20.2%*	*21.4%*	*13.8%*	*16.5%*	*15.2%*	*17.0%*	*14.9%*	*15.6%*
Dividend (p)	***0.0***	***0.0***	***0.4***	***0.6***	***0.9***	***1.0***	***1.2***	***1.3***	***1.6***	***1.8***	***2.1***
Yield			*0.5%*	*0.8%*	*1.2%*	*1.4%*	*1.6%*	*1.8%*	*2.1%*	*2.4%*	*2.8%*
Recurring maintenance % sales	48.5%	47.7%	48.5%	49.3%	49.9%	50.8%	51.6%	52.3%	53.1%	53.8%	54.4%
Adjusted cash conversion		55.0%	69.8%	102.2%	83.0%	80.8%	82.0%	83.0%	84.0%	84.8%	85.6%
Valuation benchmarks											
P/E ratio	*58.1*	*48.4*	*30.6*	*25.5*	*21.0*	*18.4*	*15.8*	*13.7*	*11.7*	*10.2*	*8.8*
EV/Sales	*3.6*	*3.5*	*3.0*	*2.7*	*2.5*	*2.3*	*2.1*	*1.9*	*1.7*	*1.5*	*1.4*
EV/EBITDA	*36.9*	*30.2*	*19.7*	*14.9*	*12.6*	*11.2*	*9.7*	*8.4*	*7.3*	*6.4*	*5.5*
EV / EBITA	*42.8*	*35.9*	*24.5*	*19.5*	*16.1*	*14.2*	*12.1*	*10.4*	*8.9*	*7.7*	*6.6*
Adjusted tax rate	*-20.0%*	*-19.5%*	*-16.1%*	*-17.9%*	*-17.5%*	*-18.0%*	*-19.0%*	*-19.0%*	*-19.0%*	*-19.0%*	*-19.0%*
EBITDA drop through rates			*37.8%*	*40.4%*	*40.2%*	*24.2%*	*30.4%*	*31.3%*	*32.2%*	*33.1%*	*34.0%*
Divdend cover			*6.0*	*4.8*	*4.0*	*4.0*	*4.0*	*4.0*	*4.0*	*4.0*	*4.0*
PEG ratio		*2.41*	*0.53*	*1.26*	*0.98*	*1.33*	*0.96*	*0.91*	*0.69*	*0.69*	*0.57*
Net cash/(debt)	**-2,035**	**-803**	**-1,304**	**1,031**	**2,800**	**4,343**	**6,209**	**8,421**	**11,095**	**14,240**	**17,965**
Sharecount (Ks)	66,611	73,971	74,433	76,309	78,228	78,619	79,012	79,407	79,804	80,203	80,604
Shareprice (p)	**73.0**										

Source: Equity Development.

Key risks

- Substantial slowdown in global GDP which could impact the worldwide property, construction and infrastructure markets.
- Anticipated growth/profitability may take longer than envisaged, cost more or not be fully realised.
- Larger license deals can lead to lumpy revenues, albeit this is being equally balanced by recurring revenues from support/maintenance (49% 2017) and another ~10% from SaaS contracts.
- Foreign exchange. However, this is primarily a translation risk with >66% of Elecosoft's turnover being generated outside the UK.
- Regulatory and tax changes.
- Competition may intensify due to new/existing players.
- Being relatively small, Elecosoft could get squeezed by larger rivals, partners and customers.
- Generic risks of retention/recruitment of key staff, etc.
- Potential (yet small) impact from implementing the new "FRS15 sales recognition" accounting standard from 1st Jan'18.
- As with many smallcap AIM stocks, daily trading volumes can occasionally decline, particularly during seasonally quieter periods and/or between newsflow.

Appendix: Software coverage across construction & facilities management



Source: Company

Head of Corporate

Gilbert Ellacombe
Direct: 0207 065 2698
Tel: 0207 065 2690
gilbert@equitydevelopment.co.uk

Investor Access

Hannah Crowe
Direct: 0207 065 2692
Tel: 0207 065 2690
hannah@equitydevelopment.co.uk

Felix Grant-Rennick
Direct: 0207 065 2693
Tel: 0207 065 2690
felix@equitydevelopment.co.uk

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More information is available on our website: www.equitydevelopment.co.uk

Equity Development, 15 Eldon Street, London, EC2M 7LD. Contact: info@equitydevelopment.co.uk 0207 065 2690