Gattaca plc

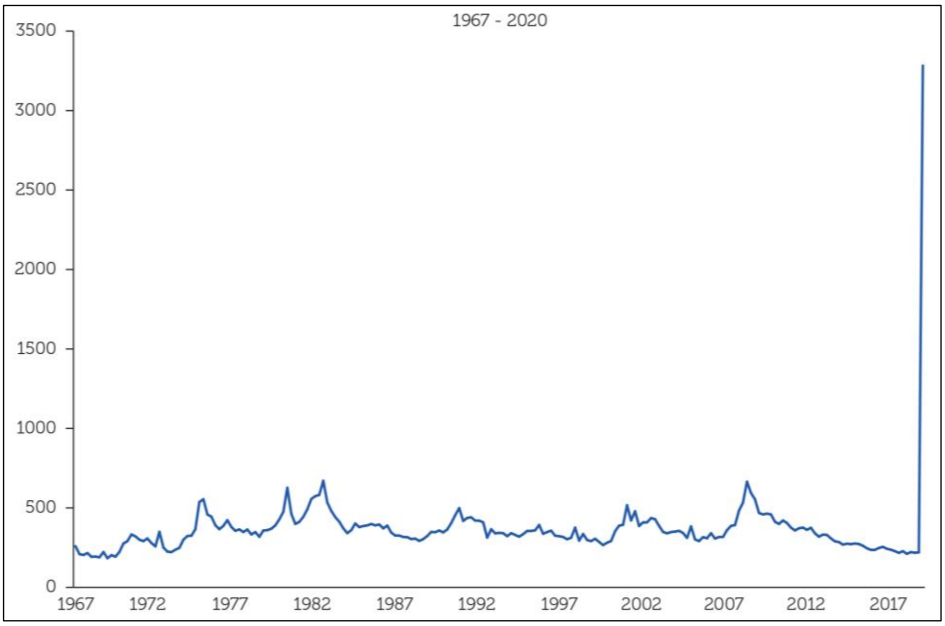
COVID-19 infects global recruitment sector

27th March 2020

The Coronavirus has already paralysed large swathes of the global economy, and is now forcing other businesses to slash discretionary costs, freeze hiring, shed staff and hunker down.

Just look at yesterday's US weekly initial jobless claims data (see below). Where the number of Americans, who applied for unemployment benefits jumped to 3.28m (vs previous record of 695k in 1982) – up 3m in 1 week alone, as companies shut their doors and laid off workers.

US weekly initial jobless claims ('000s)



Source: US Labour Department

However pandemic should be transitory

Hardly surprisingly therefore to hear that Gattaca too is being affected by this unprecedented CAT 5 economic hurricane. The crisis will ultimately blow over though. And once it does, those quality firms serving growth markets (eg STEM) should emerge fitter. We saw this during the 2008-10 Great Financial Crisis, and believe it will happen again, with Gattaca proving to be not only one of the survivors, but also a winner (see overleaf).

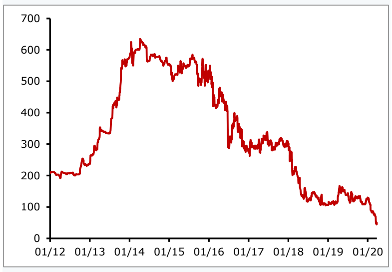
However during the intervening period, a great deal of damage will be caused with conditions set to get a lot tougher. In fact, the company is already "*experiencing a combined 20% reduction in permanent placements and active contractors from pre COVID-19 levels*".

Consequently, the smart approach for nearly all organisations is to take immediate action, de-risk and conserve cash, which the Board are already doing.

Company Data

EPIC	AIM:GATC
Price (last close)	45p
52 week Hi / Lo	165p/44p
Market cap	£14.5m
Adj net debt Jan'20 (incl non-recourse)	£19.1m
Share count	32.3m
ED valuation / share	Withdrawn

Share Price, p



Source: Share Cast

Description

Gattaca is the UK's #1 specialist engineering (70% NFI) recruitment agency, providing contract, temporary and permanent staff (Source: Recruitment International). It derives 13.6% of NFI from overseas, with the remainder coming from UK Technology (16.4%) – overall split 69.8% contractors and 30.2% permanents.

The global engineering and technology recruitment markets are valued at circa \$26bn and \$57bn respectively (*Source: Staffing Industry Analysts*) – offering substantial long term potential.

Next news: Trading update Aug'20

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

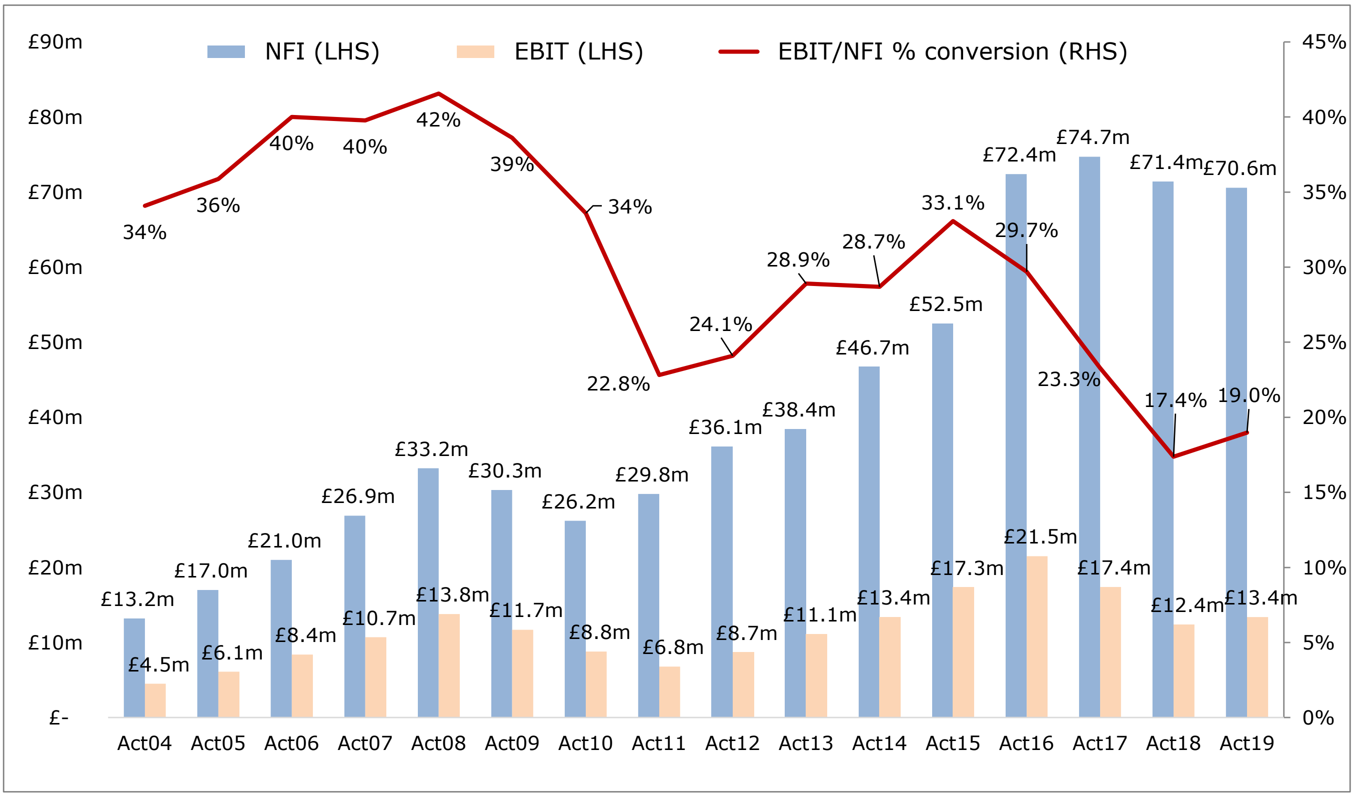
Gattaca is ahead of the curve

Indeed, the over-arching message from this morning's H1'20 statement is that, Gattaca is **well prepared**, **ahead of the curve** and **has stress tested the 'worse-case' scenarios**.

Here **adjusted net debt** (including £16.0m of non-recourse finance) **fell by £5.7m to £19.1m as at Jan'20** from £24.8m only 6 months earlier. Reflecting tight working capital management (debtor days 39 vs 45 LY), partially offset by outflows of £1.3m for the US DoJ enquiry, £1.5m discontinued/restructuring, £1.8m forex and £1.3m capex.

Moreover, **the firm has been through this type of short, sharp, shock before - and come out the other side in far better shape than many of its rivals**. We reckon this will happen again, even if near term demand is pushed to the right by hiring freezes, site closures, business interruption and social distancing measures. The longer term fundamentals of STEM play to its strengths too.

Gattaca proved its resilience during the 2008-10 Great Financial Crisis



Source: Equity Development

Ok, so what's the plan?

Well, there are a number of key facets, not least temporarily:

- Continuing to reallocate resource towards the more favourable Engineering (smart motorways, civils, renewable energy & TechEng) and Technology (Data Science, Cloud, AI, Cyber, Java, Python & Javascript) segments across the group.
- Furloughing >33% of the workforce, and placing them into the UK Government Coronavirus Job Retention Scheme (GCJS).

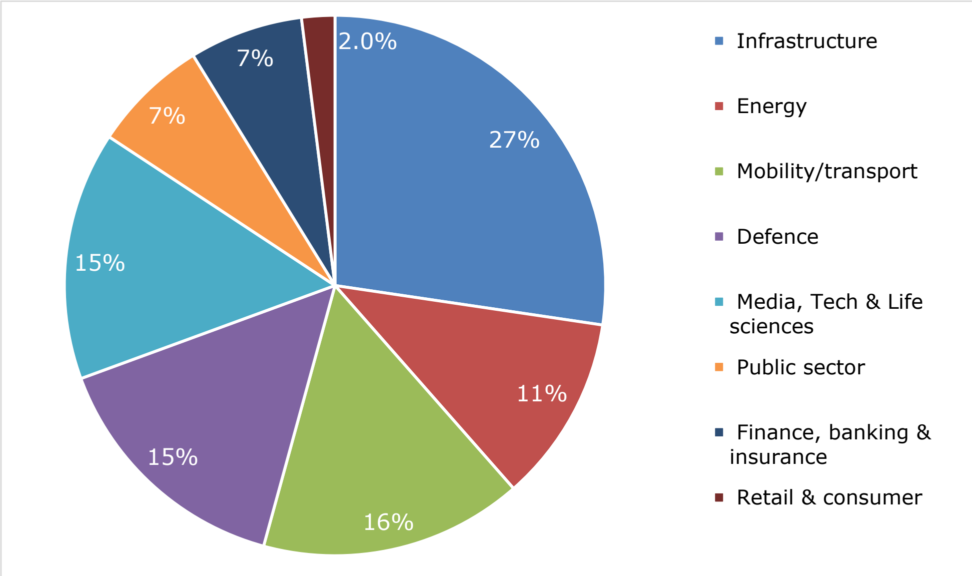
- Deferring HMRC payments to the end of the tax year - providing a significant boost to liquidity.
- Reducing working hours and pay of the remaining workforce by 20%.
- Cutting discretionary spend and capex, albeit mindful not to harm operational capability. Whilst further evaluating any other fiscal support programs that might be available across various jurisdictions.

Elsewhere, the loss making Chinese unit (-£0.5m H1'20) is being closed, while in January £16m of the committed 3 year £75m working capital facility was converted into non-recourse finance. With the associated risk of customer non/late payment transferring to the lender.

End markets are vital to the nation's health

Additionally, & regardless of what happens over the next few months - we think essential building/maintenance work (tracks, roads, sewage) within systemically important sectors like defence, infrastructure (water, electricity, rail), housebuilding and construction will still have to completed. As underlined at the UK Budget on 11th March.

2019 NFI split by vertical market



Source: Company

Shares are attractively priced

Besides, **there are other levers to pull if things were to significantly deteriorate**. For instance, pushing capex to the right (eg IT system implementations), assigning more staff to the GCJS and possibly even converting deferred VAT payments into short-term loans from HMRC.

Nonetheless given the uncertainty, **the Board have sensibly withdrawn FY20 guidance**. Likewise we've retracted our forecasts until there's greater clarity surrounding COVID-19. But believe at 45p, **the stock is attractively priced** for patient risk tolerant investors - trading on a trailing EV/NFI multiple of 0.5x (see below) compared to typical industry multiples pre COVID-19 crisis of between 0.7x – 2.0x.

Range of sector valuation benchmarks pre COVID-19 crisis

	Gattaca 2019 Trailing	Typical industry multiples pre COVID-19 crisis	
		Low	High
EV/NFI	0.5	0.7	2.0
EV/EBITDA	2.3	4.0	9.0
EV/EBIT	2.5	4.5	10.0
PER	1.7	6.0	14.0
Dividend yield	0.0%	2.0%	4.0%
EBIT/NFI conversion	19.0%	10.0%	25.0%

Source: Equity Development

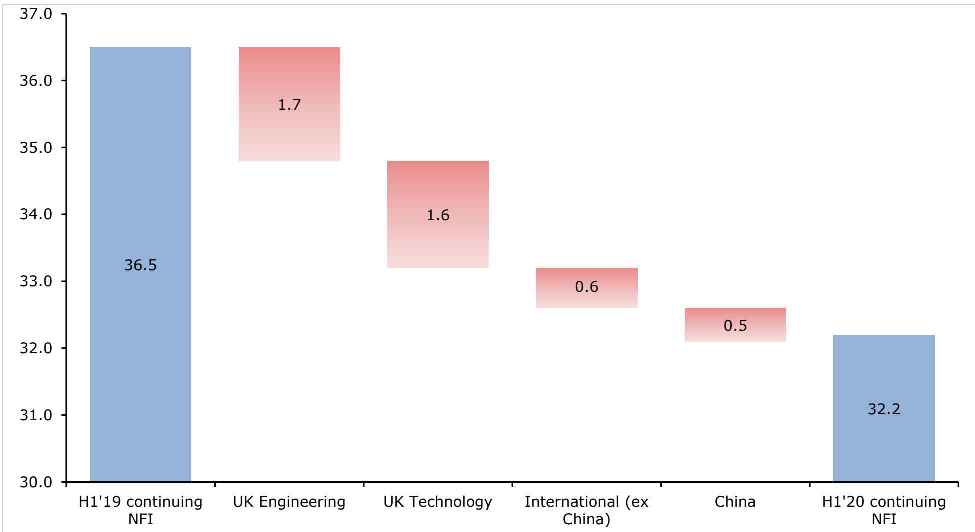
What else was in the numbers?

Well **overall LFL NFI fell -11.9% to £32.2m** (£36.5m LY), due to softer than predicted worldwide demand - particularly International (-20.9% LFL NFI to £4.0m: -14% ex China), UK Technology (-25.0% to £4.8m, headcount reductions) and to a lesser extent UK Engineering (-6.8%, £23.4m).

The former being **hurt by** continued **US underperformance** (-17%), and the latter by the **UK General Election, planned introduction of new IR35 contractor rules** (now postponed to April 2021) and subdued activity levels within automotive, aerospace (re Boeing 737 MAX grounding) and Maritime. This is consistent with Gattaca's closest STEM competitor, SThree, who recently said that it had seen a -9% decline in UK NFI over the past 6 months.

Many rivals are in the same boat

NFI Bridge (£'ms)



Source: Company

More positively, there are indications that UK Technology is stabilising, with Q2'20 NFI climbing +6% sequentially vs Q1'20.

However due to operational gearing, **adjusted EBIT/NFI conversion came in at 11.2%** (vs 21.5% LY) with the effective tax rate rising to 32.7% (24.4%), as overseas losses could not be recovered. All told, leading to a **decline in diluted EPS from 15.8p to 5.5p** (see below).

Historical 6 monthly adjusted financials

£'000s - continuing	**Act H1**	**Act H2**	**Act FY18**	**Act H1**	**Act H2**	**Act FY19**	**Act H1'20**
UK Engineering	3.0%	-0.2%	1.4%	3.6%	4.2%	3.9%	-6.8%
UK Technology	-4.0%	-2.0%	-3.0%	-13.4%	-26.8%	-19.9%	-25.0%
International	5.0%	5.0%	5.0%	15.0%	-9.4%	2.1%	-20.9%
Total underlying NFI	***2.0%***	***0.0%***	***1.0%***	***1.5%***	***-3.9%***	***-1.1%***	***-11.9%***
NFI	**35,987**	**35,412**	**71,399**	**36,543**	**34,044**	**70,587**	**32,178**
Adjusted EBITDA	**7,360**	**6,035**	**13,395**	**8,382**	**6,218**	**14,600**	**5,153**
Adjusted EBIT	**6,853**	**5,549**	**12,402**	**7,860**	**5,533**	**13,393**	**3,610**
EBIT/NFI margin	*19.0%*	*15.7%*	*17.4%*	*21.5%*	*16.3%*	*19.0%*	*11.2%*
Underlying overheads	29,134	29,863	58,997	28,683	28,511	57,194	28,568
U/L admin as % NFI	81.0%	84.3%	82.6%	78.5%	83.7%	81.0%	88.8%
Proforma PBT pre China				**6,970**	**4,716**	**11,686**	**3,244**
China losses (discontinued)				-153	-173	-326	-497
Adjusted PBT	**6,100**	**4,762**	**10,862**	**6,817**	**4,543**	**11,360**	**2,747**
Tax	-1,335	-2,045	-3,380	-1,662	-839	-2,501	-899
Minorities	-219	-56	-275	0	0	0	0
Underlying PAT	**4,546**	**2,661**	**7,207**	**5,155**	**3,704**	**8,859**	**1,848**
Adjusted EPS (diluted)	**14.0p**	**8.3p**	**22.5p**	**15.8p**	**10.9p**	**26.7p**	**5.5p**
NFI (LTM) / head (£ks)	86.6		88.1	97.8		95.5	97.2
Headcount	870		810	736		739	681
Net debt : EBITDA			*3.05*	*1.93*		*1.70*	*0.27*
Cash conversion			*128%*			*170%*	
U/L tax rate	*-21.9%*	*-42.9%*	*-31.1%*	*-24.4%*	*-18.5%*	*-22.0%*	*-32.7%*
Non-recourse invoice discounting							-16,000
Net recourse debt	**-36,180**		**-40,874**	**-27,755**		**-24,822**	**-3,075**

Source: Equity Development

Time to be patient

CEO Kevin Freeguard commenting "***Gattaca experienced a challenging environment across the staffing market, driven by economic and political uncertainty in the UK for the first 5 months of FY20*** *(August to December 2019).*

Subsequently, ***the COVID-19 pandemic has brought significant uncertainty to our business and we have implemented our continuity plans accordingly****, with the entirety of our staff working remotely, enabling the business to remain fully operational. The response from the Gattaca team has been exceptional. In addition, Government support including the Job Retention Scheme and HMRC payment deferrals, is welcome and increases our financial resilience.*

The coming months will be very challenging*, but we believe that the actions we are taking will position us well for when the economy begins to recover."*

Greater flexibility on bank covenants being sought

Finally, we understand the group is in constructive discussions with its bank (ie HSBC) to agree revised terms that should address any possible temporary covenant issues. This should be relatively straight forward, since the majority of the group's funding lines relate to its £75m invoice discounting facility, with only £10m being in the form of a traditional RCF.

What's more, as central banks pour $trillions of liquidity into the financial system - spearheaded by the US Federal Reserve going 'all in on QE infinity' (ie Helicopter money, Chinook style), involving unlimited purchases of Treasuries, mortgage-backed securities & investment grade corporate bonds - it should (in theory) only be a matter of time before corporate bond markets quieten down.

Plus, the political mood music in Washington seems to be now questioning whether 'the cure is worse than the disease'. With **President Trump stating he <u>ideally</u> wants to 'reopen' the US economy by the 12th April Easter holiday**. Maybe a little premature, but an aspirational target nonetheless.

Key risks

- Coronavirus induced problems at some of its largest customers, which either lead to late payments and/or doubtful debts.
- Lenders do not grant Gattaca waivers over possible future temporary breaches in banking covenants.
- Economic downturn affecting engineering and technology recruitment. For example, Brexit could negatively impact confidence and UK GDP.
- In the Oct'18 budget, the Chancellor stated the Government's intention to extend the IR35 rules to the private sector (re self-employed persons) on 6th April 2020, following the 2017 implementation in the public sector. The introduction date has apparently now been delayed by 12 months to April 2021
- Greater competition, especially from new technology platforms (eg LinkedIn, Monster).
- Overseas expansion along with foreign exchange fluctuations.
- Continued reduction in financial gearing, and consolidation of customer base.
- Political interference which could impact UK infrastructure spend (eg cancellation of rail electrification projects).

Gattaca is presently assisting the US Department of Justice in their enquiries about an article published by Reuters in Feb'19 regarding Chinese Telco equipment manufacturer Huawei, and separately referencing Networkers International. It is not possible at this stage to determine what the conclusion of the DoJ's work will be.

Summary financials (pre IFRS 16)

Gattaca (continuing operations) (July yearend)	2016 Act £'000s	2017 Act £'000s	2018 Act £'000s	2019 Act £'000s
Net Fee Income (NFI) : Gross profit			*Restated*	*Pre IFRS16*
UK Engineering	40,865	43,080	47,568	49,442
UK Technology	17,413	16,178	14,457	11,575
International	14,109	15,450	9,374	9,570
Total	**72,387**	**74,708**	**71,399**	**70,587**
NFI growth rate				
UK Engineering	*8.0%*	*5.4%*	*10.4%*	*3.9%*
UK Technology	*19.2%*	*-7.1%*	*-10.6%*	*-19.9%*
International		*9.5%*	*-39.3%*	*2.1%*
Total NFI growth rate	***38.0%***	***3.2%***	***-4.4%***	***-1.1%***
EBITDA	**22,617**	**18,284**	**13,395**	**14,600**
UK Engineering	23,126	23,758	26,033	27,489
UK Technology	8,229	7,061	6,610	5,902
International	6,868	5,619	2,723	1,820
Central overheads	-16,726	-19,050	-22,964	-21,818
Adjusted EBIT	**21,497**	**17,388**	**12,402**	**13,393**
Total Opex as % NFI	*-70.3%*	*-76.7%*	*-82.6%*	*-81.0%*
EBIT / NFI margin	*29.7%*	*23.3%*	*17.4%*	*19.0%*
Net interest	-1,076	-1,232	-1,540	-2,033
Adjusted PBT	**20,421**	**16,156**	**10,862**	**11,360**
Tax	-6,306	-5,076	-3,380	-2,501
Minorities	0	-172	-275	0
Adjusted PAT	**14,115**	**10,908**	**7,207**	**8,859**
Adjusted diluted EPS (p)	**44.1**	**33.7**	**22.5**	**26.7**
Adjusted EPS growth rate	*0.5%*	*-23.6%*	*-33.3%*	*19.0%*
Dividend (p)	**23.0**	**23.0**	**3.0**	**0.0**
Dividend yield	*51.1%*	*51.1%*	*6.7%*	*0.0%*
Dividend cover	*1.9*	*1.5*	*7.5*	
Valuation benchmarks				
P/E ratio (diluted)	*1.0*	*1.3*	*2.0*	*1.7*
EV/NFI	*0.46*	*0.45*	*0.47*	*0.48*
EV/EBIDA	*1.5*	*1.8*	*2.5*	*2.3*
EV/EBITA (diluted)	*1.6*	*1.9*	*2.7*	*2.5*
PEG ratio	*1.96*	*-0.06*	*-0.06*	*0.09*
Adjusted corporate tax rate	*-30.9%*	*-31.4%*	*-31.1%*	*-22.0%*
Adj ROACE	*19.7%*	*15.6%*	*13.1%*	*18.1%*
EBITDA drop through rate as % NFI	*21.3%*	*-186.7%*	*147.7%*	
Cash conversion (EBITDA - Capex - W/Cap)/EBIT	*93%*	*63%*	*128%*	*170%*
Unlevered/adj. free cashflow yield	46.8%	19.9%	22.7%	60.3%
Net recourse cash/(debt)	**-25,013**	**-40,288**	**-40,874**	**-24,822**
Non recourse invoice factoring				
Net debt : EBITDA	*1.1*	*2.2*	*3.1*	*1.7*
Diluted sharecount (Adj for 2015)	*32,040*	*32,392*	*32,079*	*33,144*
Shareprice (p)	**45p**			

Source: Equity Development estimates, Company historic data

Note 1: Our financial projections and valuation do not factor in any possible future DOJ redress and/or fines.

Note 2: Effect of IFRS 16 (ie from Aug'19 onwards). FY20 adjusted PAT is not expected to be impacted materially, although FY19 results, EBITDA would have risen £2.3m and finance costs by £0.2m, as operating leases are replaced by depreciation and interest expense.

Investor Access

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

Equity Development Limited is regulated by the Financial Conduct Authority

More information is available on our website

www.equitydevelopment.co.uk