

## Humbled, yet still fundamentally sound

19<sup>th</sup> April 2018

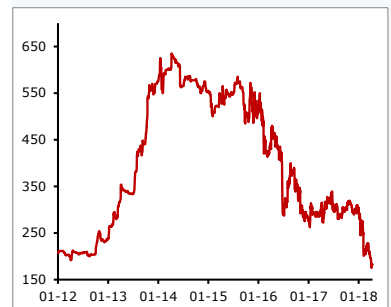
After today's 3rd profit warning within a year – this time reducing **FY18 PBT expectations by approx. 15%** (ED -12% at £13.0m vs £14.8m) - management are the first to admit that mistakes have been made. Not least, the poorly executed £66.8m acquisition of Networkers in April 2015 (re £17.1m asset impairment), investment in non-fee earning activities at a time when peers were retrenching and the odd repeat of a previous mis-step (re closure of German office).

Nonetheless **the Board**, being their own harshest critics, **know what needs to be done** and are fully committed to rectify the situation. Plus to us, despite the disappointing share price (see below), **Gattaca is still fundamentally a sound business with attractive growth prospects.**

### Company Data

EPIC	AIM:GATC
Price (last close)	185p
52 week Hi/Lo	320p/175p
Market cap	£59m
ED valuation / share	240p

### Share Price, p

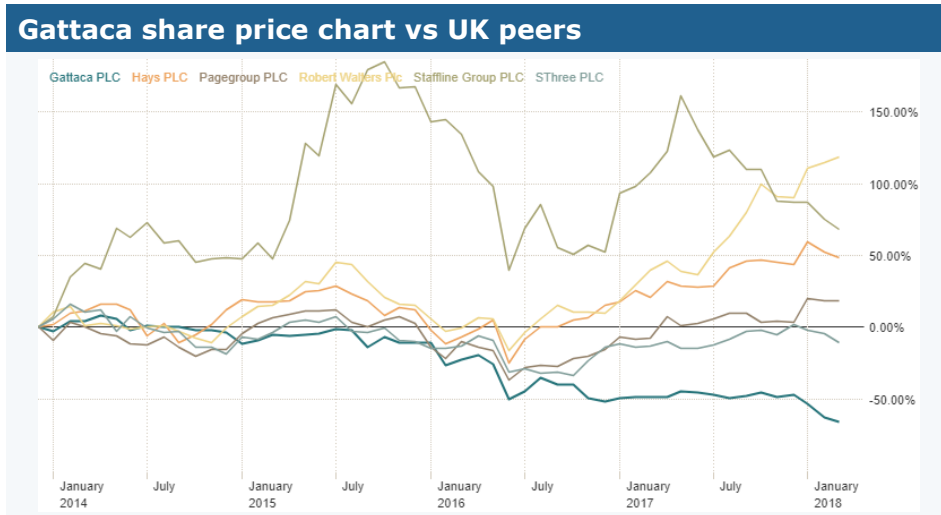


Source: Web Financial

### Description

Gattaca, employing 870 staff, is the UK's #1 specialist engineering and #5 technology recruitment agency, providing contract, temporary and permanent staff (Source: Recruitment International). It derives 18% of NFI overseas (excluding international placements supplied from the UK), and circa 72% from temporary contractors (9,500 on assignment), with the remaining 28% coming from permanents.

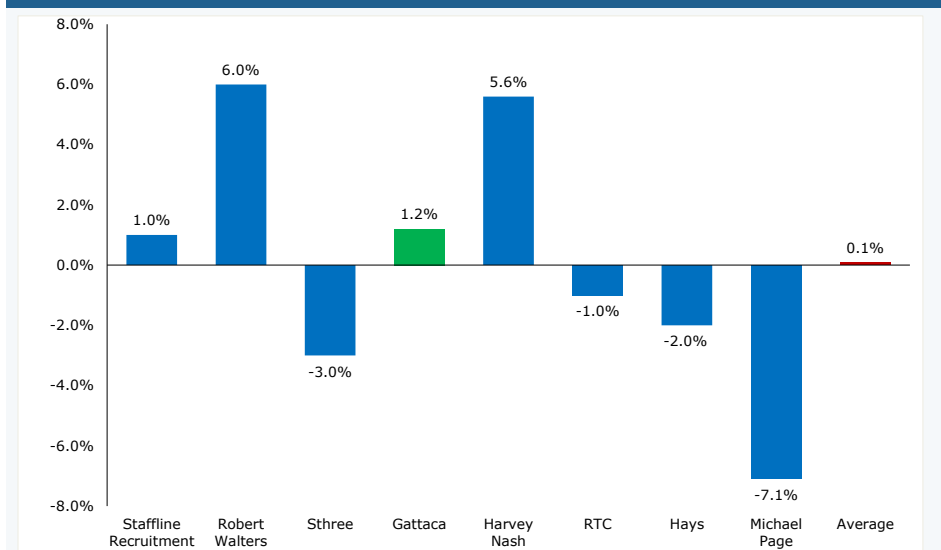
The global engineering and technology recruitment markets are valued at circa \$26bn and \$57bn respectively (Source: Staffing Industry Analysts) – offering substantial long term potential.



Source: Investors Chronicle

Indeed in its **UK heartland** (82% H1'18 NFI), **the firm continues to out-perform rivals** (H1'18 NFI 1.2% LFL vs 0.1%) amid a **"challenging" backdrop** (see below).

### Latest / CY LFL NFI growth



Source: Equity Development

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## Strategic shift to growth markets

Moreover across the pond, **the Americas is posting “excellent” LFL NFI growth** (+30% to £3.7m) on the back of a tight labour market, Texas’ “high-tech IT” boom and the launch the Matchtech brand in Energy (US Shale) and Engineering. That said, this international success has been tempered by difficulties in Asia (-14%), continental Europe and South Africa (-25%), which has led to closures of the Singapore & Munich sales offices that lacked “critical mass”.

Back at home, UK Engineering (+3% to £24.2m) was boosted by strength in Converged Technologies (+24%), Automotive (+15% - electric/autonomous vehicles, telematics, etc), Smart factories (Production 4.0), Alderwood (+35%: apprentice training) and connected cities/infrastructure. Partly offset by CP5 budgetary constraints at Network Rail and HS2 delays (RSL -13%), and compounded by subdued demand from 3 large South Coast customers.

Elsewhere, **UK IT (+3%) continued to benefit from Cloud implementations**, albeit UK Telecoms (-19%) suffered from pricing pressures and lower OEM demand (eg Huawei and Ericsson), reflecting delayed roll-outs of 5G/4G wireless networks, and necessitating a leadership change post period end. Going forward, **we reckon management will be far less tolerant of persistently under-performing units.**

Adding all this together, total H1 LFL NFI rose modestly (+2%) to £39.8m, with EBIT (assuming 12 months RSL ownership) declining -13% to £7.7m after factoring in a £1.7m YoY jump in admin expenses.

## Cash management moves to #1 priority

Operationally **there is now a much more focused approach to day-to-day cash management**, which led to a nice **H1 drop in net debt from £40.2m in July’17 to £36.2m as per Jan’18**. This was partly due to a favourable £6m swing in billings over Christmas, and will reverse in H2. Solid progress was made on debt collection, where days outstanding fell -1 to 53 from July’17, generating a further +£1.6m, offset by -£1.4m of capex, -£0.5m restructuring and adverse forex (B/S) translation (-£1.45m).

Cashflow bridge (£'000s)			
<b>Key movements</b>	<b>H1'18</b>	<b>H2'18</b>	<b>FY19</b>
<b>Opening net debt</b>	<b>-40,288</b>	<b>-36,180</b>	<b>-48,000</b>
EBITDA	8,250	7,950	18,122
RSL call option		-3,400	
Restructuring costs (incl office closures)	-476	-1,127	
Carillion Insurance		700	
Working capital / trade debtors	1,618	-1,287	-1,498
Billings swing over Xmas (contractors)	6,000	-6,000	0
Capex	-1,398	-1,600	-2,500
Interest payable	-685	-800	-2,500
Tax (Corp & WHT)	-480	-1,700	-4,103
Dividends	-5,474	-956	-3,376
Forex translation / other	-3,247	-3,600	
<b>Closing net debt</b>	<b>-36,180</b>	<b>-48,000</b>	<b>-43,854</b>

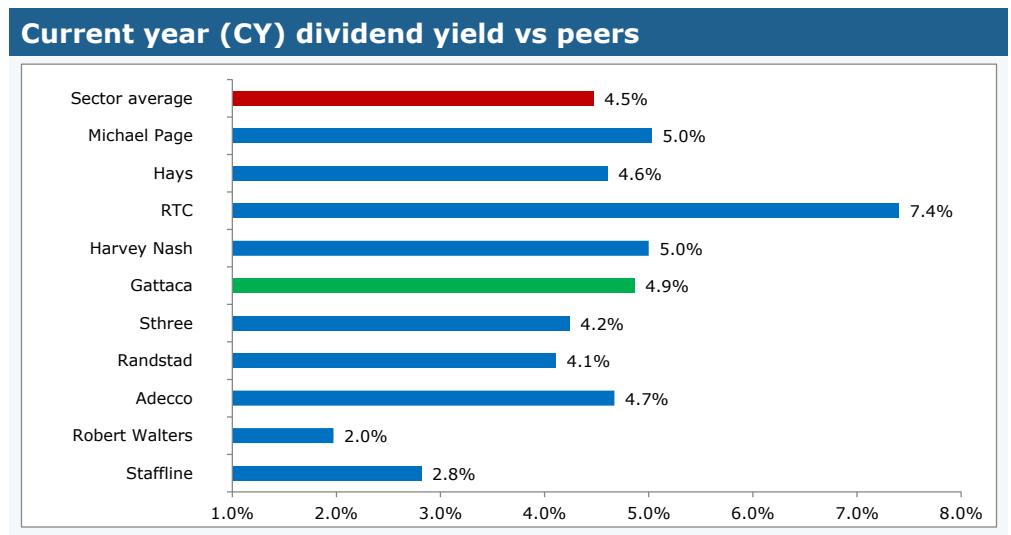
Source: Equity Development

Therefore, along with the outstanding 'RSL call option (-£3.4m for 30%)', further one-off charges (-£1.1m) and forex (£ appreciation vs \$), net borrowings are predicted to end July'18 at £48m – equivalent to a net debt:EBITDA ratio of 3.0x (vs 2.2x in July)

### FY18 dividend reset to 9p (4.9% yield) vs 23p LY

Not surprisingly something has had to give, and the proposed interim dividend of 3p (vs 6p LY) has taken some of the strain. Similarly going forward, the pay-out policy has been revised with the aim of distributing 50% of **“through-cycle” statutory earnings**, assuming net debt declines of £3m+ pa from FY19 onwards. Or in other words, rebasing the FY18 payment to 9p (vs 23p), representing a CY yield of 4.9% (see below).

What’s more, the HSBC facility (£20m term loan @ 3.0%+Libor, and £75m invoice factoring @ 1.1%+base) has been re-negotiated to provide *“greater flexibility”* over the next 12 months, in return for a 0.5% bump in the interest rates. Here 90% of invoiced trade debtors (>£100m as at Jan'18), up to a max. of £75m, can be drawn down against. Meaning that in aggregate, GATC (subject to other covenants being met) has access to a gross debt capacity of £95m vs balances utilised as at Jan'18 of £46.6m, and a forecast £59m at y/e.



Source: ED – closing prices as per 18<sup>th</sup> April 2018

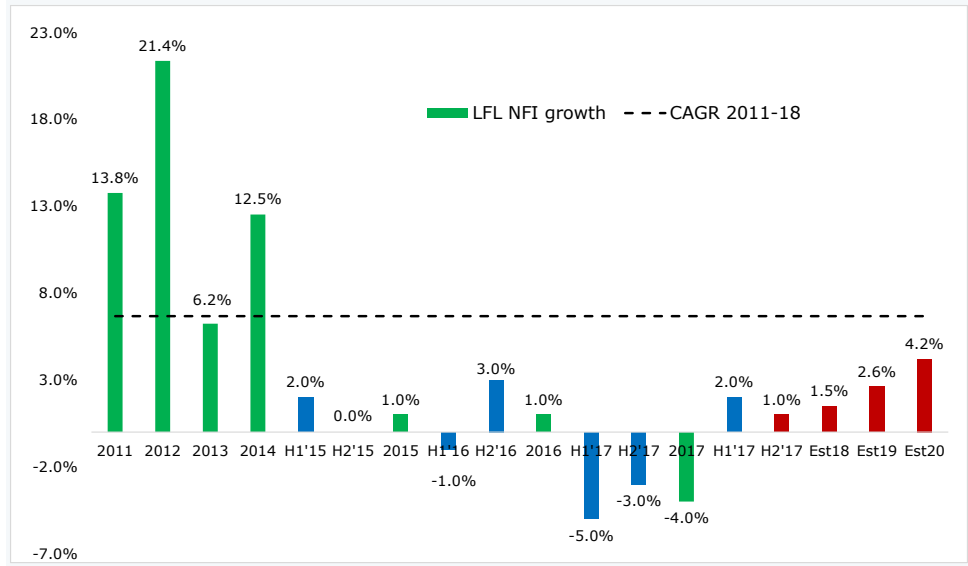
### Fair degree of 'wiggle room' baked into our base case

With regards to Q3 trading, February & March have “broadly” been “in line with expectations”, albeit macro conditions have not yet caught up with previously optimistic Q4'18 assumptions. Hence the Board decided this morning to realign FY18 PBT guidance.

Likewise, **we have erred on the side of caution** (see below NFI growth assumptions vs historical averages) and factored in most, if not all 'known' eventualities. However, the broader UK recruitment market is still fragile - and as such, if there is another 'Carillion type' event, then further changes may be required.

Separately, we understand that Jaguar Land Rover’s (re sharp decline in diesel car sales) announcement earlier this week to lay off ~1,000 contractors at its UK factories, should not materially affect the number of Gattaca’s design consultants placed there, but instead is centred on blue-collar production staff.

### Historical and projected LFI NFI growth



Source: Equity Development.

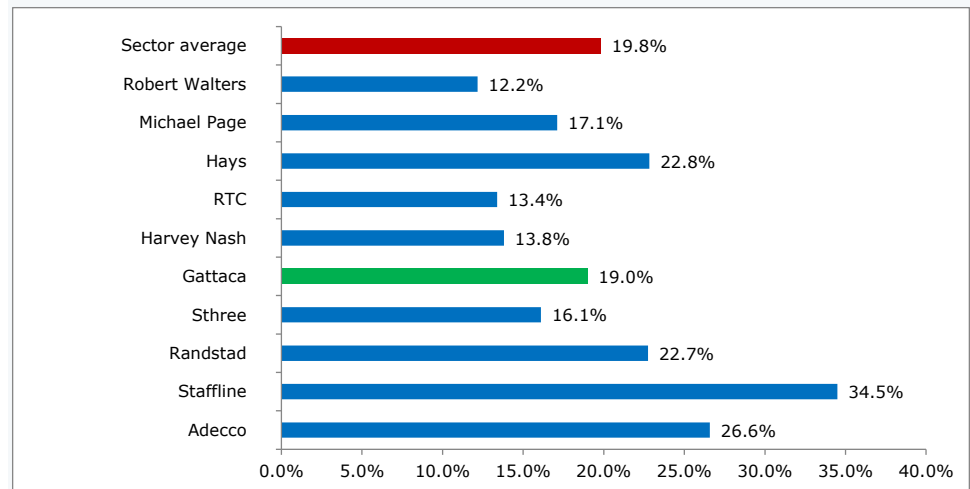
### Cutting to the bone, but not into it

Whilst after 3 years of layering in overhead, we suspect there is plenty of scope for future cost savings. For one, the Board are **reviewing the profitability of all major customer contracts**, especially those suffering unrelieved with-holding tax (WHT eg Telco). Moreover further economies of scale can be achieved by simply reverting back to Matchtech’s successful centralised ‘Hub & Spoke’ model, which minimises unnecessary duplication.

With this in mind, support activities (28 heads) will be transferred from Bromley to the Whiteley office over the next 9 months. The corporate Marketing & HR teams are also being streamlined, with resource being diverted to drive short/medium term profits.

**This exercise will take an estimated 6-12 months to complete**, and should realise at least £1m of extra expense savings in FY19 (ie above H1 levels), at a one-off cost of ~£1.6m. Fee earner productivity is being monitored to deliver the full benefits from a new CRM platform (Bullhorn) being implemented group-wide. Hopefully, leading to an improvement in EBIT:NFI conversion rates (see below).

### CY EBIT conversion rates – sector



Source: Equity Development.

### New CEO search has kicked off

In relation to leadership, head-hunters have been engaged to help appoint a new CEO after Brian Wilkinson's resignation in February. Typically, this can take 6-9 months with a similar period expected if the new exec is an outside candidate and has 'gardening leave' to sit through. Both internal and external personnel are being considered.

In the meantime the **Group is in the capable hands of** Keith Lewis (COO), Salar Farzad (CFO) and the broader exec team, who are being closely assisted by non-exec Chairman Patrick Shanley.

### Scope to further optimise tax efficiency

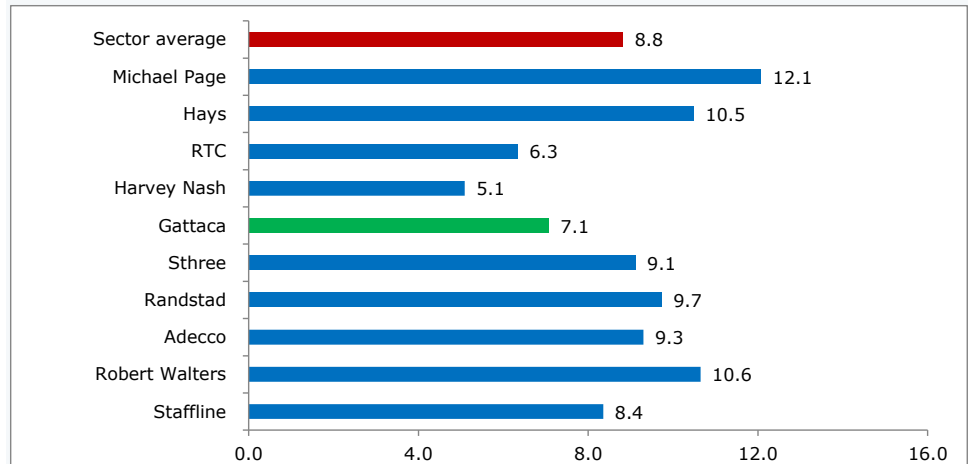
Below the line too there is opportunity. The H1 statutory effective tax rate (ETR) nudged up to 37.8% from 35.5% LY, reflecting irrecoverable with-holding tax (WHT) largely in overseas Telecoms, which typically generates higher gross margins. Nonetheless, via standard tax planning measures, management are hoping to bring this down. In fact, prior to its 2015 acquisition, Networkers reported a 35.8% ETR, even though it possessed a much greater exposure (ie proportionally) to emerging markets.

(Note: H1'18 *underlying* ETR was 28.3%, after adjusting to purchased goodwill write-offs, exceptionals, etc)

### Reducing our valuation from 295p to 240p/share

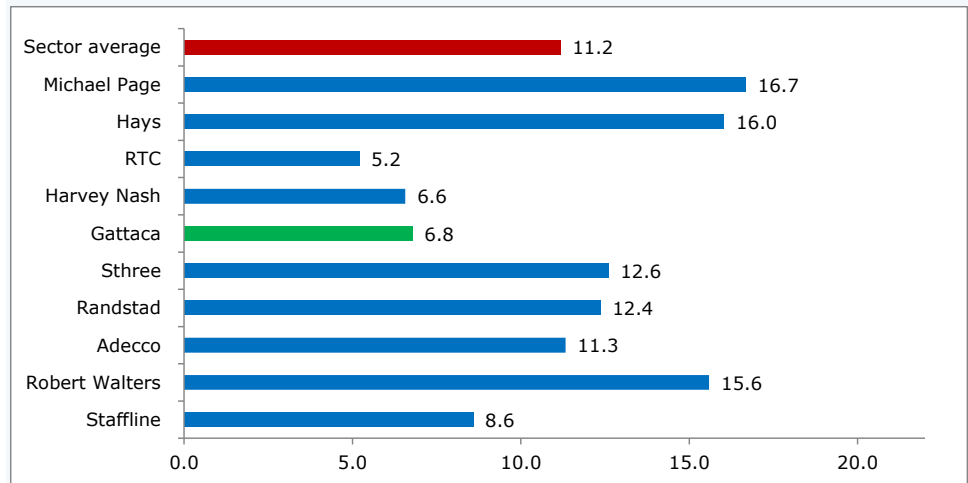
Lastly in light of today's news, **we have reduced our valuation from 295p to 240p/share**, but still believe **the stock at 185p offers good upside**, trading on FY18 EV/EBIT and PER multiples of 7.1x and 6.8x respectively, whilst paying a hefty 4.9% dividend yield.

### Current Year EV/EBIT ratios – sector



Source: Equity Development. Prices as per 18th April 2018

### Current Year P/E ratios – sector



Source: Equity Development. Prices as per 18th April 2018

Structurally, **we believe Gattaca is ideally placed to benefit from rising global spend on infrastructure** (Heathrow, Hinkley Point, Crossrail 2, HS2, rail electrification, smart cities), **engineering and technology** (eg Cyber security, IoT, Cloud, 5G, autonomous vehicles), augmented by X-selling synergies, expansion abroad and the ongoing adoption of IT/Telecoms within its other key verticals of Automotive, Aerospace, Defense, Energy and Maritime.

### Plenty of scope for self help

Patrick Shanley commenting "***Gattaca delivered an improvement in NFI in H1, and it is pleasing to see our core UK Engineering and IT businesses delivering growth and our International operations in the Americas continuing to perform well. However, the continued underperformance in Telecoms is disappointing and actions are being taken to address this.***"

***The Board is focussed on ensuring the Group can better execute its strategy, delivering sustainable and profitable growth in segments and markets which are scalable.***

We have undertaken a number of actions to improve our underlying performance; albeit at a time when the **UK recruitment market continues to be challenging**. [Additionally] in some International operations outside of the Americas, where we do not have critical mass.

To counteract this we have instigated a program to reduce the cost base of the business within the current financial year and beyond. **In February and March the business broadly traded in line with the Board's expectations**. However..alongside the economic challenges facing some of our sectors and territories ...**the Board has [decided to] reduce underlying PBT expectations by approx 15%.**"

Summary financials							
Gattaca (continuing operations) (July yearend)	2014 Act £'000s	2015 Act £'000s	2016 Act £'000s	2017 Act £'000s	2018 Est £'000s	2019 Est £'000s	2020 Est £'000s
<b>Net Fee Income (NFI) : Gross profit</b>							
UK Engineering	27,077	37,853	40,865	43,080	47,922	48,881	50,836
UK Technology	17,905	14,605	17,413	16,178	15,507	15,507	16,127
International			14,109	15,450	16,071	17,196	18,056
<b>Total</b>	<b>44,982</b>	<b>52,458</b>	<b>72,387</b>	<b>74,708</b>	<b>79,500</b>	<b>81,583</b>	<b>85,019</b>
<b>NFI growth rate</b>							
UK Engineering	13.2%	39.8%	8.0%	5.4%	11.2%	2.0%	4.0%
UK Technology	23.9%	-18.4%	19.2%	-7.1%	-4.1%	0.0%	4.0%
International				9.5%	4.0%	7.0%	5.0%
<b>Total NFI growth rate</b>	<b>17.2%</b>	<b>16.6%</b>	<b>38.0%</b>	<b>3.2%</b>	<b>6.4%</b>	<b>2.6%</b>	<b>4.2%</b>
NFI margin	10.0%	10.6%	11.7%	11.6%	11.9%	12.0%	12.0%
UK Engineering	10,548	13,105	23,126	23,758	25,399	25,009	26,085
UK Technology	3,073	4,242	8,229	7,061	6,513	6,823	7,257
International			6,868	5,619	4,982	6,019	6,681
Central overheads			-16,726	-19,050	-21,794	-20,851	-21,707
<b>Adjusted EBIT</b>	<b>13,621</b>	<b>17,347</b>	<b>21,497</b>	<b>17,388</b>	<b>15,100</b>	<b>17,000</b>	<b>18,316</b>
Total Opex as % NFI	-69.7%	-66.9%	-70.3%	-76.7%	-81.0%	-79.2%	-78.5%
NFI / EBITA conversion	30.3%	33.1%	29.7%	23.3%	19.0%	20.8%	21.5%
Net interest	-1,015	-1,074	-1,076	-1,196	-2,100	-2,500	-2,450
<b>Adjusted PBT</b>	<b>12,606</b>	<b>16,273</b>	<b>20,421</b>	<b>16,192</b>	<b>13,000</b>	<b>14,500</b>	<b>15,866</b>
<b>Adjusted diluted EPS (p) - post minorities</b>	<b>37.1</b>	<b>43.8</b>	<b>44.1</b>	<b>33.8</b>	<b>27.3</b>	<b>31.8</b>	<b>34.6</b>
Adjusted EPS growth rate	17.5%	18.2%	0.5%	-23.4%	-19.2%	16.6%	8.9%
<b>Dividend (p)</b>	<b>20.0</b>	<b>22.0</b>	<b>23.0</b>	<b>23.0</b>	<b>9.0</b>	<b>10.5</b>	<b>11.4</b>
Dividend yield	10.8%	11.9%	12.4%	12.4%	4.9%	5.7%	6.2%
Dividend cover	1.9	2.0	1.9	1.5	3.0	3.0	3.0
<b>Valuation benchmarks</b>							
P/E ratio (diluted)	5.0	4.2	4.2	5.5	6.8	5.8	5.3
EV/NFI	2.4	2.1	1.5	1.4	1.4	1.3	1.3
EV/EBITA (diluted)	7.9	6.2	5.0	6.2	7.2	6.4	5.9
PEG ratio	0.28	0.23	8.06	-0.23	-0.35	0.35	0.60
Adjusted corporate tax rate	-23.3%	-14.5%	-30.9%	-31.4%	-28.3%	-28.3%	-28.3%
Adj ROACE	30.6%	21.5%	19.7%	15.6%	14.2%	16.3%	16.4%
EBITDA drop through rate as % NFI	48.9%	53.8%	21.3%	-186.7%	-43.5%	92.3%	39.6%
Cash conversion (EBITDA - Capex - W/Cap)/EBIT	103%	109%	93%	68%	75%	83%	75%
Unlevered/adj. free cashflow yield	5.1%	15.2%	14.5%	6.2%	7.1%	9.3%	8.6%
<b>Net cash/(debt)</b>	<b>-3,109</b>	<b>-33,644</b>	<b>-25,013</b>	<b>-40,288</b>	<b>-48,000</b>	<b>-43,854</b>	<b>-40,682</b>
Net debt : EBITDA	0.22	1.83	1.11	2.20	2.96	2.42	2.09
Diluted sharecount (Adj for 2015)	26,073	31,730	32,040	32,392	32,522	32,682	32,843
Shareprice (p)	185						

Source: Equity Development estimates, Company historic data

## Key risks

- Economic downturn affecting engineering and technology recruitment.
- Greater competition, especially from new technology platforms (eg LinkedIn, Monster).
- Overseas expansion along with foreign exchange fluctuations.
- Acquisition integration, albeit management have a decent batting average.
- Consolidation of customer base (eg takeovers of Atkins:SNC-Lavalin and CH2M:Jabobs).
- Political interference which could impact UK infrastructure spend (eg cancellation of rail electrification projects).





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