

Expert System

Company update

Leveraging Cogito technology internationally

Expert System is transitioning from being largely Italy-facing into a truly international business with operations in the US, UK, France and Germany. The company estimates that the TEMIS acquisition (completed in September) will increase foreign exposure from 11% (H114) to 65% (H115 pro forma). Based on H115 results, we have reduced our FY15 revenue forecast for Expert System. With the inclusion of TEMIS, we forecast 46% group growth for FY15. We introduce a forecast for FY16 of 52% growth, supported by the recently announced commercial partnerships with Google and Atex, and a full-year contribution from TEMIS.

Year end	Revenue (€m)	PBT* (€m)	EPS* (c)	DPS (c)	P/E (x)	Yield (%)
12/13	11.1	0.5	0.8	0.0	N/A	N/A
12/14**	13.0	0.6	0.1	0.0	N/A	N/A
12/15e	19.0	(1.0)	(3.1)	0.0	N/A	N/A
12/16e	28.8	1.8	4.6	0.0	43.7	N/A

Note: *PBT and EPS are normalised, excluding intangible amortisation, exceptional items and share-based payments. **FY14 was the first year that subsidiaries were consolidated, making direct comparisons with FY13 difficult.

Acquisition and partnerships expand sales reach

Expert System completed its acquisition of French text analytics company TEMIS at the end of September, adding a business with complementary products, while also introducing Expert System to new European markets. Expert System has also announced two significant partnerships. It has become a Google for Work Search Technology Premier Partner, making its Cogito API available on Google Search Appliance and giving it access to Google's partner network. It has also announced a strategic partnership with digital media software company Atex to integrate its Cogito technology into the Atex Digital Media platform.

Solid H115 – introducing FY16 forecasts

Expert System's H115 results illustrate that it is making solid progress with its internationalisation plans. Sales rose by 59% y-o-y, driven largely by strong growth in international revenues, which represented 41% of sales (16% in H114). Licensing revenues also grew as a proportion of sales from 28% to 37% over the same period. We expect the proportion of licensing revenues to continue to grow over time, positively affecting the company's margin profile. We are reducing our FY15 forecasts, but still expect revenues to grow to €19.0m. We also introduce FY16 forecasts, where we expect revenue growth of 52% to €28.8m driven by double-digit organic growth and a full year's contribution from TEMIS.

Valuation: TEMIS contribution reveals value

Taking a full-year contribution from TEMIS, Expert System trades on an FY16e EV/EBITDA of 13.8x. We believe this underappreciates the accretive nature of the TEMIS acquisition and the significant increase in Expert System's addressable market. We believe this valuation co Google Search Appliance mpensates for the inherent risks given the early stage of the internationalisation.

Software & comp services

17 December 2015

Price **€2.01**

Market cap **€50.4m**

\$1.52/€1.42/£

Net debt (€m) at 30 June 2015 4.0

Shares in issue 25.1m

Free float 62.5%

Code EXSY

Primary exchange AIM Italia

Secondary exchange N/A

Share price performance



% 1m 3m 12m

Abs 3.7 3.1 2.0

Rel (local) 6.2 6.2 (12.3)

52-week high/low €2.4 €1.8

Business description

Expert System has developed and patented technology that extracts useful information from unstructured text using semantic-based techniques. It applies this technology to a number of verticals including enterprise search, customer experience management, advertising and big data analytics.

Next event

IMS February 2016

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Business overview and revised estimates

Strategic partnerships

Expert System has made significant operational performance recently, which should provide it with a solid foundation to achieve further commercialisation of its core Cogito technology in the coming months.

- **Google for Work Premier Technology Partner:** Expert System has become a Google for Work Premier Technology Partner. In practice, this means that its Cogito technology will now be integrated into Google Search Appliance, opening up Google's global enterprise user base as potential Cogito customers. Cogito serves to augment Google's core search technology by adding a semantic layer that enhances searches in largely unstructured enterprise data. This accreditation is a strong endorsement of the quality of the IP behind the Cogito technology.
- **Atex strategic partnership:** Expert announced a strategic partnership with media software provider Atex. The partnership will bring semantic technologies to the media world that will optimise content management workflows for publishers and journalists. Content management and discovery is a big challenge in the media world and the integration of the Cogito technology should enable improved referencing and links across all online publishing channels.

H115 results: Internationalisation progressing well

Expert System is making good progress towards achieving its internationalisation strategy. Its H115 earnings release showed growth in the company's international revenues to 41% from 16% in H114. Growth in the company's US revenues was particularly strong, up 285% to €1.9m from €0.5m in H114. Including the contribution from the TEMIS acquisition on a pro forma basis, Expert System's international revenue would have been 65% during H115. The company is now present in Italy, the US, UK, Germany, France, Spain, Canada and Columbia. This shift in the company's geographic footprint significantly increases its addressable market. It will also enjoy significant tax benefits, as historically its largely Italian business has suffered from an effective tax rate of c 60% in its home market. We expect the group-level figure to come down significantly to c 30% as more favourable international tax rates dilute the impact of the Italian rate.

We expect international revenues to continue to grow ahead of the domestic business on an organic basis, given the relative maturity of the Italian business and the larger addressable market of the international business.

Completion of the TEMIS deal

Expert System completed the previously announced acquisition of French text analytics company TEMIS on 23 September 2015. TEMIS operates in the text analytics market, similar to Expert System. TEMIS adds French, German and Canadian geographical exposure to Expert System's existing footprint and reinforces Expert's presence in both the US and the UK. TEMIS also serves an impressive number of blue-chip clients in the life sciences, financial and media industries, including BASF, BNP Paribas, Bayer Schering Pharma, Novartis, Sanofi, Thomson Reuters, The McGraw-Hill Companies and Bloomberg BNA.

TEMIS's flagship platform Luxid identifies and extracts targeted information from bodies of unstructured information. Luxid offers a more structured but less sophisticated solution than Expert System's core Cogito technology. As a result, Luxid is more standardised and requires less bespoke work than has historically been the case for Cogito. Consequently, TEMIS currently achieves a higher proportion of software sales than Expert System and is complementary to its offering. TEMIS's offering is also cloud-based, while Expert System's is server-based. TEMIS achieved revenue of €8.1m in FY14, which management expects to rise to €9.1m in FY15.

Structure of the deal

- Total consideration of €12m (1.5x FY14 revenue) to be settled by a mix of cash and shares.
- €3m cash paid on closing and €1m deferred over three years; €1m debt inherited.
- 3.1m new shares in the combined entity worth €7m issued to TEMIS shareholders.

US reorganisation – a stronger platform for growth

The US continues to form an important part of the commercial opportunity for Expert System. Following the completion of the TEMIS acquisition, the company has announced a reorganisation of its US operations designed to enable better focus on its two distinct target markets:

- The original Expert Systems USA business will now concentrate on public sector-related opportunities in areas such as intelligence and defence. Although the company has already achieved some traction in this area, so far it has had to rely on security-cleared system integrators as intermediaries.
- TEMIS USA will be renamed Expert System Enterprise and will be the company's face when pursuing all private sector opportunities. The company's focus will continue to be in those areas where it has already had early success, including publishing, energy and financial services.

We believe this move is prudent as the two markets have very different sales cycles and product needs. Expert System USA is presently looking to achieve the necessary security clearances required to sell direct to government security agencies, rather than through system integrators. This will give it greater control of its sales channels.

Reduction of ADmantX stake

Expert System reduced its stake in its non-consolidated subsidiary ADmantX during September by choosing not to take part in a capital raise conducted by ADmantX. As a result, its stake fell from 69% to 60%. The pre-money valuation of ADmantX valued Expert System's stake at €10m. This represents a significant proportion of Expert System's enterprise value, which we believe is underappreciated by the market. The company has stated that ADmantX is no longer a part of its long-term strategic objectives. As a result, we would expect it to continue to reduce its exposure over time.

Changes to estimates

TEMIS is already profitable and, as a result, we expect the acquisition to be immediately earnings accretive. For FY15 we now expect Expert System to record revenues of €19.0m and EBITDA of £1.3m including the contribution from TEMIS. Based on company guidance, we have reduced our assumptions for FY15 revenue growth for the core Expert System business without the contribution from TEMIS from €21.4m to €16.5m. We note that the company has previously shown a large degree of H2-weighted seasonality due to the contractual timing of some orders, giving us confidence that our revised estimates can be met despite requiring H2 revenues of €10.2m versus the €6.3m achieved in H1. This still equates to growth of 25% y-o-y for the core business. We have incorporated TEMIS from the completion date based on annualised revenues of €9.1m and costs of €7m. We introduce FY16 forecasts assuming 15% organic growth for Expert System and 10% revenue growth for TEMIS.

Exhibit 1: Changes to estimates

	Revenue (€m)			EBITDA (€m)			PBT (€m)			Net income (€m)		
	Old	New	% change	Old	New	% change	Old	New	% change	Old	New	% change
2015e	21.4	19.0	(11.2)	4.1	1.3	(68.3)	1.7	(1.0)	(158.8)	1.0	(0.7)	(170.0)
2016e	N/A	28.8	N/A	N/A	4.3	N/A	N/A	1.8	N/A	N/A	1.1	N/A

Source: Edison Investment Research

Recent bond issue

Expert System executed a successful bond issue over the summer, which raised €5m. The company intends to use the proceeds to continue its international expansion plans, particularly in the US and the UK. The semi-annual bond has a nine-year term that matures in 2024, and an attractive 4% rate of interest. The first payment is due at the end of January 2016.

Valuation

Taking a full-year contribution from TEMIS and what we believe to be modest growth forecasts, Expert System trades on an FY16e EV/Sales of 2.2x and an EV/EBITDA of 13.8x (the EV is based on H115 reported net debt adjusted for the TEMIS acquisition). There is no directly comparable peer; the closest in terms of products is Nuance, but it is more established and considerably larger and generates a large proportion of revenues from its speech recognition software. Expert System trades at a significant discount to Nuance on an EV/Sales basis (2.2x vs 3.9x), reflecting Nuance's higher proportion of software sales and hence great current profitability. On an EV/EBITDA basis, Expert System trades at a premium (13.8x vs 11.1x). However, Nuance is a more mature company growing at c 4%. We believe that Expert System should be able to significantly outgrow Nuance as it moves further into markets that are far greater in size than its home market. Moreover, Expert System should see its margins rise as it increases the proportion of its software sales. Consequently, we believe there is strong scope for the company to surprise on the upside in terms of both revenue growth and margins. The fact that TEMIS is already profitable provides further de-risking of Expert System's investment case.

Catalysts for share price appreciation

- Through its internationalisation, Expert System has increased its addressable market significantly. We believe this opens the possibility of growth surprising on the upside in FY16 and beyond. Evidence of this would be extremely positive for the shares. We note that heightened global geopolitical tensions, coupled with a desire to use military solutions as a last resort, serve to increase the demand from international intelligence agencies for 'smarter' counter-terrorism solutions.
- As demonstrated by its H1 results, Expert System is growing its licensing revenues well ahead of growth in the broader group. As is the case for software, the licensing revenues benefit from much higher margins, and hence would provide the company with much greater profitability than has been the case historically. Continued growth in the proportion of software licensing revenues should be rewarded by the market. The company continues to support this shift in the business mix by introducing more practical application-focused software solutions such as Cogito Risk Watcher. The Risk Watcher software helps enterprise operational risk and compliance analysts build better risk profiles of current and potential vendors, suppliers or other stakeholders. It comes with existing corporate liability taxonomy and critical event identification, which allows companies to scan terabytes worth of data efficiently and with little additional tailoring required.

In addition to the aforementioned valuation catalysts, we believe that the greater US exposure, together with the Google partnership and other third-party relationships that the company is

developing, provide Expert System with far greater commercial visibility for its Cogito technology. This increases the possibility of a potential take-out at a valuation well in excess of where Expert System is presently trading, taking completed transactions in the space as guidance, such as the 2014 acquisition of cognitive computing company DeepMind (founded in 2010) by Google for an estimated \$400m. While we do not expect a take-out price of that magnitude for Expert System at this stage, it is illustrative of the significant investment and M&A activity in the space at the moment.

Exhibit 2: Financial summary

	€000s	2012	2013	2014*	2015e	2016e
Year-end 31 December		IT GAAP	IT GAAP	IT GAAP	IT GAAP	IT GAAP
PROFIT & LOSS						
Revenue		11,593	11,109	13,045	19,009	28,776
EBITDA		2,624	2,014	2,309	1,266	4,294
Operating Profit (before amort. and except.)		1,765	916	609	(883)	1,915
Intangible Amortisation		0	0	0	0	0
Exceptionals		(319)	45	59	(692)	0
Other		0	0	0	0	0
Operating Profit		1,446	961	669	(1,575)	1,915
Net Interest		(298)	(376)	29	(107)	(160)
Profit Before Tax (norm)		1,467	539	638	(990)	1,755
Profit Before Tax (reported)		1,148	584	697	(1,682)	1,755
Tax		(452)	(359)	(609)	283	(614)
Profit After Tax (norm)		1,015	180	29	(707)	1,141
Profit After Tax (reported)		697	225	89	(1,399)	1,141
Average Number of Shares Outstanding (m)		22.0	22.0	22.0	22.8	25.1
EPS - normalised (c)		4.6	0.8	0.1	(3.1)	4.6
EPS - normalised and fully diluted (c)		4.6	0.8	0.1	(3.1)	4.6
EPS - (IFRS) (c)		3.2	1.0	0.4	(6.1)	4.6
Dividend per share (p)		0.0	0.0	0.0	0.0	0.0
Gross Margin (%)		100.0	100.0	100.0	100.0	100.0
EBITDA Margin (%)		22.6	18.1	17.7	6.7	14.9
Adj Operating Margin (%)		15.2	8.2	4.7	-4.6	6.7
BALANCE SHEET						
Fixed Assets		6,691	9,905	5,719	21,032	21,275
Intangible Assets		1,111	2,462	4,640	19,626	19,748
Tangible Assets		635	606	692	649	771
Investments		4,945	6,836	387	757	757
Current Assets		12,767	15,491	32,681	32,088	32,107
Stocks		722	476	1,563	1,145	1,145
Debtors		5,488	5,820	7,866	6,366	6,366
Cash		2,065	2,967	4,900	8,962	8,981
Other		4,492	6,228	18,352	15,616	15,616
Current Liabilities		(8,871)	(10,333)	(13,639)	(14,318)	(14,318)
Creditors		(6,538)	(7,350)	(10,698)	(10,214)	(10,214)
Short term borrowings		(2,332)	(2,984)	(2,940)	(4,104)	(4,104)
Long Term Liabilities		(4,642)	(5,172)	(7,803)	(16,581)	(16,581)
Long term borrowings		(4,642)	(5,172)	(4,799)	(12,561)	(12,561)
Other long term liabilities		0	0	(3,005)	(4,020)	(4,020)
Net Assets		5,945	9,890	16,958	22,221	22,484
CASH FLOW						
Operating Cash Flow		8,077	2,891	737	2,198	4,294
Net Interest		(298)	(376)	29	(107)	(160)
Tax		(452)	(359)	(609)	283	(614)
Capex		(3,095)	(2,384)	(3,905)	(5,160)	(3,500)
Acquisitions/disposals		0	0	(6,436)	(1,250)	0
Financing		0	0	12,341	(693)	0
Dividends		0	(180)	0	0	0
Net Cash Flow		4,232	(408)	2,156	(4,730)	19
Opening net debt/(cash)		6,352	4,909	4,822	2,839	7,703
HP finance leases initiated		0	0	0	0	0
Other		(2,788)	40	(173)	(135)	0
Closing net debt/(cash)		4,909	5,276	2,839	7,703	7,684

Source: Edison Investment Research, Expert System. Note: *FY14 was the first year that subsidiaries were consolidated, making direct comparisons with FY13 difficult.

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