

Expert System

H117 results

Slower pipeline conversion

Expert saw a slower than expected trading environment in H117 combined with a shift in the mix of revenues towards subscription licensing. Post period end, the company signed a deal with Lloyd's of London, reinforcing its position in the insurance vertical. Management now expects flat revenues in FY17, effectively pushing out its three-year industrial plan by a year. We have revised down our revenue and EBITDA forecasts for FY17 and FY18, shifting EBITDA profitability into FY18.

Year end	Revenue (€m)	EBITDA* (€m)	EPS* (c)	DPS (c)	P/E (x)	EV/EBITDA (x)
12/15	19.4	1.5	(4.1)	0.0	N/A	35.9
12/16	25.1	(2.2)	(22.0)	0.0	N/A	N/A
12/17e	25.1	(1.5)	(14.2)	0.0	N/A	N/A
12/18e	28.6	3.0	(4.4)	0.0	N/A	17.4

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

Longer sales cycles pressure H117 results

In H117 Expert reported a revenue decline of 7.4% y-o-y and a production value decline of 11.2% y-o-y. Lower than expected revenues combined with a higher cost base resulted in the EBITDA loss widening from €1.9m in H116 to €4.0m in H117. In H117 the company signed a higher proportion of subscription licensing, which reduces upfront revenues but improves recurring revenues and visibility. Customers are still taking time to understand how they can use Expert's cognitive computing software to improve their business processes and this is resulting in long sales cycles.

Break-even pushed out by a year

Expert expects flattish revenues in FY17 versus FY16, which we estimate will result in an EBITDA loss of €1.5m for the year. This effectively pushes out the company's Industrial Plan for 2017-2019 by a year. Management is targeting reductions in the cost base in FY18. We have revised down our forecasts to reflect this delay. We now forecast revenue growth of 15% in FY18 and EBITDA of €3.0m (10.6% margin), down from our previous €6.6m forecast. The company has announced it is aiming to raise funds of up to €5m through a share placing.

Valuation: Delayed growth weighs on valuation

Expert System trades on an EV/EBITDA of 17.4x FY18e. This is at a premium to enterprise search and information management companies, and Italian software and services peers, and at a discount to high-growth big data analytics software companies. Our DCF valuation of Expert System suggests a value of €1.97/share (previous: €2.59). Expert's ability to convert customer interest in the fast-growing data mining and analytics market into commercial contracts, combined with achieving the targeted cost cuts, will be key to share price upside from this point.

Software & comp services

27 October 2017

Price €1.45

Market cap €40m

Net debt (€m) at end H117	15.1
Shares in issue	27.4m
Free float	65.2%
Code	EXSY
Primary exchange	AIM Italia
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	(3.9)	(17.8)	(27.6)
Rel (local)	(5.7)	(22.3)	(45.6)
52-week high/low		€2.0	€1.3

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 and big data analytics.

Next events

FY17 results	March 2018
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Review of H117 results

Exhibit 1: Half-yearly results				
€m	H116	H216	H117	y-o-y
Sales	8.57	14.80	8.44	-1.5%
Grants and other income	1.33	0.36	0.73	-45.1%
Total revenue	9.90	15.16	9.17	-7.4%
Capitalised development costs	2.94	2.72	2.52	-14.2%
Changes in WIP	0.39	(1.56)	0.05	-87.0%
Total production value	13.23	16.32	11.75	-11.2%
Staff costs	9.10	9.39	9.75	7.2%
Other costs	6.03	7.28	5.98	-1.0%
EBITDA	(1.90)	(0.35)	(3.98)	109.8%
Depreciation & amortisation - in-house	1.64	2.05	2.01	22.4%
Normalised EBIT	(3.54)	(2.40)	(5.99)	69.2%
Depreciation & amortisation - acquired	1.30	1.30	1.30	0.0%
Exceptional costs/(income)	0.00	0.00	0.00	
EBIT	(4.84)	(3.70)	(7.30)	50.6%
Net income	(5.05)	(3.08)	(7.63)	51.2%
Net debt	15.85	12.41	15.12	-4.6%
Source: Expert System				

Expert reported H117 sales marginally below the level achieved a year ago. The company noted that it signed a higher number of subscription licences, which have a lower upfront value than a perpetual licence but allow the company to benefit from recurring revenues. We would also argue that signing up for a subscription licence presents less of a budgetary challenge for many customers compared to the larger one-off sum that must be found for a perpetual licence. This gives customers the opportunity to use the software and extend it across the business as and when necessary. Expert continues to see plenty of interest in AI, but potential customers are still trying to understand how to apply the technology to their businesses. Consequently, Expert is still seeing long sales cycles.

Grants and other income was 45% lower year-on-year, resulting in total revenue 7.4% lower than a year ago. The company capitalised a lower level of development costs, resulting in production value 11.2% lower than a year ago. Expert typically sees strong seasonality, with a large proportion of business signed in Q4. This was evident in H216 and the company expects a similar pick-up in revenues in H217.

Staff costs were 7.2% higher than a year ago. The company continues to restructure its workforce, and has replaced some staff with more experienced, senior salespeople, with a focus on building and training the partner channel. This figure also includes one-off redundancy costs. Other costs were marginally lower than a year ago. Lower production value combined with higher costs resulted in a widening of the EBITDA loss from €1.9m in H116 to €4.0m in H117.

International sales strong

International revenues totalled €5.2m in H117, compared to €4.0m in H116. This is an increase in contribution from 47% to 62% of revenues over the year, and was mainly due to a stronger contribution from the US.

Business update

Developing the insurance vertical

Expert previously reported that it had signed up Zurich Insurance Group ([Turning the AI hype into reality](#)). It has now signed an agreement with Lloyd's of London. We understand that Expert and Lloyd's are working together to ascertain the best use of the software and we would therefore not expect material revenues from this relationship until FY18.

Building the channel

The company is keen to increase the amount it sells through partner channels, particularly consultants and system integrators. It is focusing resources on a small number of large global partnerships, and is currently training some of these partners to prepare them to sell Cogito. This should boost licence revenues in the longer term, but the company would not need to scale up professional services staff for the implementations as these would be undertaken by the partners. Thus successful sales through the channel should improve margins for Expert.

Tax incentives for investors

Expert qualified as an Innovative SME in August. This means that any Italian tax payers (corporates or individuals) investing in Expert's shares for a minimum period of three years can get a reduction in corporation or income tax of 30% of the amount invested. For individuals, this is limited to an investment of up to €1m and for corporates the limit is €1.8m.

Outlook and changes to forecasts

The company now expects to generate a similar level of revenues in FY17 as in FY16, but with a higher level of recurring revenues. Effectively Expert's Industrial Plan for 2017-2019 has been pushed out by at least a year. The company is planning to provide a revised industrial plan in early 2018. Within 2017 revenues, the company expects to see growth of c 20% in the US and 40% from Spain, with a quadrupling in revenues in the UK (which only started generating revenues last year). The company is also working on its cost base and is targeting cost reductions of €2.5-3m in FY18. The table below summarises our changes to forecasts.

Exhibit 2: Changes to estimates									
€m	FY17e old	FY17e new	Change	y-o-y	FY18e old	FY18e new	Change	y-o-y	
Sales	28.0	23.4	-16.7%	0.0%	33.6	26.9	-20.1%	15.0%	
Other income & grants	1.6	1.8	7.7%	3.6%	1.7	1.8	1.5%	0.0%	
Total revenues	29.7	25.1	-15.3%	0.2%	35.4	28.6	-19.1%	14.0%	
Capitalised development costs & changes in WIP	4.7	5.0	6.4%	11.2%	4.7	5.5	17.0%	10.0%	
Production value	34.4	30.1	-12.4%	1.9%	40.1	34.1	-14.8%	13.3%	
EBITDA	3.2	(1.5)	-147.5%	-31.9%	6.6	3.0	-54.0%	(298%)	
<i>EBITDA margin</i>	<i>10.8%</i>	<i>-6.1%</i>	<i>-16.9%</i>	<i>2.9%</i>	<i>18.6%</i>	<i>10.6%</i>	<i>-8.0%</i>	<i>16.6%</i>	
D&A	(4.0)	(4.0)	0.3%		(4.4)	(4.4)	0.8%		
Normalised operating profit	(0.8)	(5.6)	578.7%	-6.2%	2.2	(1.4)	-165.4%	(75%)	
<i>Normalised operating margin</i>	<i>-2.8%</i>	<i>-22.2%</i>	<i>-19.4%</i>	<i>1.5%</i>	<i>6.1%</i>	<i>-5.0%</i>	<i>-11.1%</i>	<i>17.2%</i>	
Amortisation of acquired intangibles	(2.6)	(2.6)			(2.6)	(2.6)	0.0%		
Reported operating profit	(3.4)	(8.2)	138.6%	4.3%	(0.4)	(4.0)	810.8%	50.8%	
Normalised EPS (c)	(3.2)	(14.2)	351.8%		3.9	(4.4)	-214.3%		
Net debt	11.6	14.0	20.3%	12.6%	10.7	17.1	60.2%	22.4%	

Source: Edison Investment Research

Valuation

The majority of Expert's direct competitors are private companies or subsidiaries of large companies such as IBM or HP Enterprise. We have compared Expert's valuation and operating metrics to peers operating in the natural language processing, big data analytics, enterprise search and information management markets, as well as to Italian software and IT services peers. With a forecast return to positive EBITDA in FY18, Expert is trading on an EV/EBITDA multiple of 17.4x in FY18e. This is at a premium to enterprise search & information management companies as well as Italian peers, and at a discount to the high-growth big data analytics companies.

Our 10-year DCF analysis values the company at €1.97/share, down from our previous €2.59 valuation, mainly due to pushing out revenue growth and EBITDA profitability by one year. We forecast a revenue CAGR of 10.1% from FY16 to FY26, with EBITDA margins rising to 28%. We had previously forecast peak EBITDA margins of 25%, but now we assume a larger proportion of R&D spend is capitalised; we therefore have increased our capex/sales assumptions, factoring in a decline from 20.7% in FY17 to 9.5% by FY26. We use a WACC of 9% and long-term growth of 3%. A 1% increase in the WACC results in a valuation of €1.49/share, while a 1% decrease results in a valuation of €2.67.

Exhibit 3: Peer group valuation analysis

	Market cap (€m)	CY EV/S	NY EV/S	CY EV/ EBITDA	NY EV/ EBITDA	CY P/E	NY P/E	CY sales (€m)	CY EBIT margin	CY EBITDA margin	Sales growth NY	EPS growth NY
Natural language understanding												
Expert System	40	2.1x	1.8x	N/A	17.4x	N/A	N/A	25.1	-22.2%	-6.1%	14%	N/A
Nuance Communications	4,395	3.1x	3.0x	10.9x	10.0x	15.3x	13.7x	1,954	1.5%	28.7%	3%	11.1%
Big data analytics												
Splunk	8,025	6.8x	5.4x	60.6x	38.4x	123.7x	81.7x	1,222	8.0%	11.1%	25%	51.4%
Tableau	5,399	6.0x	5.5x	78.1x	62.5x	356.0x	281.5x	882	2.0%	7.7%	9%	26.5%
Teradata	3,529	1.7x	1.7x	9.9x	9.9x	26.0x	25.1x	2,106	13.8%	17.1%	0%	3.8%
Average		4.8x	4.2x	49.5x	37.0x	26.0x	129.4x		7.9%	12.0%	11%	27.2%
Enterprise search and information management												
OpenText	7,842	4.2x	4.0x	11.6x	10.6x	13.9x	12.7x	2,689	34.5%	35.1%	4%	9.7%
IHS Markit	14,745	5.9x	5.6x	15.4x	14.1x	20.9x	19.0x	3,560	18.2%	20.7%	6%	9.9%
CommVault	2,018	2.6x	2.4x	21.0x	16.8x	47.2x	40.2x	707			9%	17.5%
Average		4.2x	4.0x	16.0x	13.9x	27.3x	24.0x		26.4%	27.9%	6%	12.3%
Italian software & services												
TXT e-solutions	150	1.9x	1.8x	16.8x	14.8x	22.9x	20.1x	75	10.4%	11.1%	8%	14.3%
Exprevia	89	.8x	.8x	7.6x	6.9x	17.2x	14.4x	154	7.7%	8.1%	3%	20.0%
Piteco	93	5.7x	4.8x	14.6x	11.8x	20.6x	15.1x	17	30.1%	31.8%	19%	36.0%
Reply	1,695	1.9x	1.7x	13.3x	11.9x	21.9x	19.3x	886	12.8%	13.2%	10%	13.6%
Average		2.6x	2.3x	13.1x	11.4x	20.7x	17.2x		15.2%	16.0%	9.9%	21.0%

Source: Edison Investment Research, Bloomberg (as at 27 October)

Exhibit 4: Financial summary

	€000s	2012	2013	2014	2015	2016	2017e	2018e
Year end 31 December		IT GAAP	IT GAAP	IT GAAP	IT GAAP	IT GAAP	IT GAAP	IT GAAP
PROFIT & LOSS								
Revenue		11,593	11,109	13,045	19,368	25,057	25,118	28,623
EBITDA		2,624	2,014	2,339	1,463	(2,245)	(1,528)	3,021
Operating Profit (before amort. and except.)		1,765	916	609	(1,226)	(5,941)	(5,575)	(1,417)
Intangible Amortisation		0	0	0	(2,549)	(2,608)	(2,608)	(2,608)
Exceptionals		(319)	45	59	0	0	0	0
Other		0	0	0	0	0	0	0
Operating Profit		1,446	961	669	(3,775)	(8,549)	(8,183)	(4,025)
Net Interest		(298)	(376)	29	213	(156)	(487)	(467)
Profit Before Tax (norm)		1,467	539	638	(1,013)	(6,097)	(6,062)	(1,884)
Profit Before Tax (reported)		1,148	584	697	(3,562)	(8,705)	(8,670)	(4,492)
Tax		(452)	(359)	(609)	277	579	3,034	1,572
Profit After Tax (norm)		1,015	180	29	(934)	(5,692)	(3,940)	(1,225)
Profit After Tax (reported)		697	225	89	(3,284)	(8,126)	(5,635)	(2,920)
Average Number of Shares Outstanding (m)		22.0	22.0	22.0	22.8	25.8	27.7	27.7
EPS - normalised (c)		4.6	0.8	0.1	(4.1)	(22.0)	(14.2)	(4.4)
EPS - normalised and fully diluted (c)		4.6	0.8	0.1	(4.1)	(22.0)	(14.2)	(4.4)
EPS - (IFRS) (c)		3.2	1.0	0.4	(14.4)	(31.5)	(20.4)	(10.6)
Dividend per share (c)		0.0	0.0	0.0	0.0	0.0	0.0	0.0
EBITDA Margin (%)		22.6	18.1	17.9	7.6	-9.0	-6.1	10.6
Adj Operating Margin (%)		15.2	8.2	4.7	-6.3	-23.7	-22.2	-5.0
BALANCE SHEET								
Fixed Assets		6,691	9,905	5,719	20,301	20,379	18,924	17,679
Intangible Assets		1,111	2,462	4,640	18,539	18,372	16,976	15,705
Tangible Assets		635	606	692	916	915	856	882
Investments		4,945	6,836	387	846	1,092	1,092	1,092
Current Assets		12,767	15,491	32,681	42,588	37,012	30,857	30,665
Stocks		722	476	1,563	1,797	627	627	627
Debtors		5,488	5,820	7,866	10,228	10,233	10,233	11,768
Cash		2,065	2,967	4,900	11,249	9,063	4,032	1,732
Other		4,492	6,228	18,352	19,314	17,088	15,965	16,537
Current Liabilities		(8,871)	(10,333)	(13,639)	(20,517)	(22,679)	(21,957)	(22,605)
Creditors		(6,538)	(7,350)	(10,698)	(15,082)	(16,459)	(16,419)	(17,067)
Short term borrowings		(2,332)	(2,984)	(2,940)	(5,435)	(6,219)	(5,538)	(5,538)
Long Term Liabilities		(4,642)	(5,172)	(7,803)	(22,227)	(18,275)	(15,838)	(16,672)
Long term borrowings		(4,642)	(5,172)	(4,799)	(18,240)	(15,252)	(12,466)	(13,300)
Other long term liabilities		0	0	(3,005)	(3,987)	(3,023)	(3,372)	(3,372)
Net Assets		5,945	9,890	16,958	20,145	16,437	11,986	9,066
CASH FLOW								
Operating Cash Flow		8,077	2,891	737	2,738	2,088	3,302	3,134
Net Interest		(298)	(376)	29	(324)	(155)	(487)	(467)
Tax		(452)	(359)	(609)	(1,576)	0	0	0
Capex		(3,095)	(2,384)	(3,905)	(20,045)	(6,378)	(5,200)	(5,800)
Acquisitions/disposals		0	0	(6,436)	3,045	46	0	0
Financing		0	0	12,341	6,573	4,418	863	0
Dividends		0	(180)	0	0	0	0	0
Net Cash Flow		4,232	(408)	2,156	(9,588)	18	(1,523)	(3,134)
Opening net debt/(cash)		6,352	4,909	4,822	2,839	12,426	12,408	13,972
HP finance leases initiated		0	0	0	0	0	0	0
Other		(2,788)	128	(173)	0	0	(41)	(0)
Closing net debt/(cash)		4,909	5,189	2,839	12,426	12,408	13,972	17,106

Source: Expert System accounts, Edison Investment Research

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