

Expert System

Strong organic growth with acquisition upside

Expert Systems has announced encouraging order growth, with US orders up 82% and annual subscription licensing up 92% y-o-y. In addition, the formation of the CY4Gate JV and acquisition of iSOCO assets are important steps forward in the implementation of the internationalisation and product expansion strategy. It is difficult to quantify the impact of these acquisitions at this stage and therefore we have not changed our earnings estimates, but the strategic benefits appear to be substantial. The €3m licensing agreement signed as part of the CY4Gate formation should also contribute significantly to short-term forecasts.

Year end	Revenue (€m)	PBT* (€m)	EPS* (c)	DPS (c)	P/E (x)	Yield (%)
12/12	11.6	1.5	4.6	0.0	40.2	N/A
12/13	11.1	0.5	0.8	0.0	226.5	N/A
12/14e	12.7	0.1	(1.0)	0.0	N/A	N/A
12/15e	21.4	1.6	4.6	0.0	40.1	N/A

Note: *PBT and EPS (fully diluted) are normalised, excluding acquired intangible amortisation, exceptional items and share-based payments. FY12 and FY13 exclude subsidiaries. FY14e and FY15e exclude ADmantX, but include Expert System USA.

Growth in annual licensing key to shareholder return

Recurring licensing revenue is important in realising the high-margin revenue growth on which our valuation is reliant, so it is particularly encouraging to see such strong growth in annual subscriptions. It is still early days in terms of building a material, high-margin recurring revenue stream, but this high-order growth is an encouraging early indicator. Strong growth in the US is also positive as it is a significant potential market and it is therefore important for Expert System to demonstrate strong demand there.

Acquisitions used to accelerate growth

The acquisition of iSOCO assets and the formation of CY4Gate are strategically important transactions and should help to accelerate growth and strengthen Expert's position in the Spanish-speaking world and the defence market respectively. The iSOCO assets were acquired for c €2m and Expert's 30% share of CY4Gate was granted in exchange for technical services and licensing rights. CY4Gate also purchased €3m worth of licensing and services that will predominantly be recognised in FY14. We treat this as a contribution rather than incremental to existing forecasts, and therefore our revenue forecasts are unchanged.

Valuation: Licensing growth key catalyst

The costs of the iSOCO asset acquisition and formation of the CY4Gate JV have been incorporated into our model, but revenue and earnings forecasts remain unchanged. The DCF has also been brought out a year and therefore the base case DCF valuation increases from €3.23 (excluding ADmantX) to €3.43. However, the DCF sensitivity analysis (see page 3) is the most important valuation tool. The key catalysts for share price upside include growth in recurring licence revenue, normalisation of the tax rate, further acquisitions and an increase in indirect sales.

Acquisition and order update

Software & comp services

10 February 2015

Price €1.86
Market cap €41m

Net debt (€m) at 30 June 2014	2.6
Shares in issue	21.9m
Free float	62.5%
Code	EXSY
Primary exchange	AIM Italia
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	0.6	(3.0)	N/A
Rel (local)	N/A	N/A	N/A
52-week high/low		€2.33	€1.72

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

FY14 results April 2015

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[Edison profile page](#)

Internationalising and expanding

Acquisition of iSOCO ICM and iLab divisions

Early in December Expert System announced the acquisition of the Intelligent Content Management (ICM) and iLab divisions of iSOCO for c €2m. iSOCO was founded in 1999 as a spin-off from the Spanish Artificial Intelligence Research Institute and develops semantic technology for a wide variety of sectors but particularly banking, government and pharmaceuticals. iLab is the research and development lab and ICM is a product division that provides a semantic software tool that customers can use to organise, search and manage their content. The acquisition increases Expert System's Spanish language capability and provides it with improved access to the South American market (specifically Colombia). It also adds additional capability to Expert System's product set and therefore increases the cross-sell potential. We understand that the business is broadly break-even so is not expected to contribute significantly to FY15e earnings, but should help accelerate growth in the important Spanish-speaking world.

CY4Gate joint venture

Also in December, Expert System announced the formation of a joint venture with Elettronica called CY4Gate. Elettronica designs and produces electronic defence equipment and has relationships with a number of global National defence agencies and companies. Its capabilities include search, interception and analysis of RF communications, which will be combined with Expert System's semantic analysis capabilities to provide a full suite of communications analysis tools. The JV is 30% owned by Expert System and 70% by Elettronica and the total initial capital invested was €3.1m, with Expert System's main consideration being technical services and licensing rights. As part of the transaction Expert System has been granted an option to sell its stake after five years at an undisclosed minimum price and Elettronica has been granted an option to buy Expert System's stake at an undisclosed maximum price. The joint venture with an established defence company should help accelerate Expert Systems' penetration into the defence market. In addition to the profit share from the JV, CY4Gate has also signed a contract with Expert System worth €3m that we understand relates to software licences and services already sold on to a third party and therefore it will be predominantly recognised in FY14.

US orders up 82% and annual licensing orders up 92%

The announcement in early February that US orders and licensing orders were up significant y-o-y is encouraging. The growth in recurring licences is particularly important as the key to achieving the long-term profitability and growth targets. The absolute level of orders has not been disclosed, so it is difficult to assess how material the order book is relative to revenue expectations. Therefore, based on this news we have not changed our estimates, but view it as a positive sign that the business is moving closer towards the high-margin recurring licensing model that should generate significant shareholder value.

Changes to estimates

The revenue from the CY4Gate JV with Elettronica is unconsolidated since Expert System only has a 30% holding, but the €3m contract signed as part of the transaction adds assurance to our FY14 revenue forecasts. It is unclear how much the iSOCO division acquisitions will contribute to revenues in FY15, but assuming total consideration of €2m and an EV/Sales ratio of >2 we estimate revenues will be less than c €1m. We have therefore taken a conservative approach and left our revenue forecasts unchanged. We also assume that the additional costs from the acquisition replace some of the organic growth costs that were planned and so we also leave expense unchanged. We forecast the net cash position to be negligible at the end of FY15.

Valuation: De-risking the upside potential

We have incorporated the costs of the acquisition and JV formation into our model, but conservatively left revenue and earnings forecasts unchanged. We have also moved the DCF forward by a year and the net effect of these changes is an increase in valuation from €3.23 to €3.43. However, there remains a high degree of uncertainty over forecasts and the sensitivity analysis shown in Exhibit 1 should therefore be used to understand the variance in potential outcomes.

Exhibit 1: Valuation sensitivity analysis (€) – licence fee vs CAGR in client numbers

		Client number CAGR to 2024					
		1%	6%	11%	16%	21%	26%
Average perpetual licence fee (€)	50,000	1.44	1.69	2.05	2.50	2.91	3.40
	60,000	1.54	1.85	2.28	2.73	3.18	3.75
	70,000	1.65	2.01	2.50	2.93	3.43	4.09
	80,000	1.76	2.17	2.66	3.11	3.68	4.41
	90,000	1.86	2.33	2.81	3.29	3.92	4.73

Source: Edison Investment Research. Note: Data in table is share price (€).

We have also updated our peer valuation table as shown in Exhibit 2. There is no direct peer against which Expert can be directly compared, but it is useful to indicate how it is valued relative to other software and SaaS companies. There is clearly a wide spread of valuations among the peer group, but Expert System is at a clear discount to the SaaS, enterprise search and big data analytics average EV/EBITDA and next year (NY) P/E basis. It is at less of a discount on a P/E basis than EV/EBITDA because of a high effective tax charge, but this should fall as a higher proportion of revenue comes from outside Italy.

Exhibit 2: Peer comparison table

	Current year end	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	31/12/2014	40.8	3.0x	1.8x	17.5x	9.3x	N/A	40.1x	12.7	3.9%	17.3%	68%	N/A
Nuance	30/09/2015	3,412.4	3.1x	3.0x	10.8x	9.9x	12.8x	12.1x	1,453.1	24.6%	29.0%	4%	5.8%
eCommerce search													
SLI Systems Ltd	30/06/2015	63.1	2.3	1.7	N/A	N/A	N/A	N/A	22	N/A	N/A	34%	N/A
eDiscovery													
Ubic Inc	31/03/2015	281.9	6.4x	4.8x	N/A	N/A	68.2x	65.0x	43.5	N/A	N/A	33%	5.0%
Big data analytics													
Splunk Inc	31/01/2015	5,392.6	14.6x	11.1x	333.3x	210.2x	1591.6x	598.8x	323.8	1.7%	4.4%	32%	N/A
Teradata Corp	31/12/2014	4,781.3	2.3x	2.2x	8.8x	8.4x	16.3x	14.7x	1,989.9	18.8%	25.8%	4%	11.5%
PRGX Global Inc	31/12/2014	107.2	0.6x	0.6x	6.2x	4.5x	N/A	27.7x	121.3	N/A	10.1%	-2%	N/A
PROS Holdings Inc	31/12/2014	512.7	3.4x	2.9x	25.1x	17.3x	72.8x	44.5x	141.1	N/A	13.5%	19%	63.6%
Average			5.2x	4.2x	93.4x	60.1x	16.3x	171.4x		10.2%	13.4%	13%	N/A
Enterprise search and information management													
OpenText	30/06/2015	5,240.1	4.2x	3.9x	11.9x	11.1x	15.2x	14.2x	1,411.5	26.9%	35.0%	7%	7.2%
CommVault	31/03/2015	1,454.9	2.4x	2.3x	12.8x	11.5x	30.5x	28.7x	450.7	13.9%	19.0%	7%	6.6%
Average			3.3x	3.1x	12.4x	11.3x	22.9x	21.4x		20.4%	27.0%	7%	6.9%
SaaS companies													
salesforce.com	31/01/2015	26,901.0	6.9x	5.7x	39.0x	29.4x	111.7x	83.9x	3,948.6	10.4%	17.7%	21%	33.1%
NetSuite	31/12/2014	5,344.1	9.8x	7.6x	158.9x	91.9x	285.3x	196.1x	530.6	4.4%	6.2%	28%	45.5%
Ultimate Software	31/12/2014	3,251.6	7.0x	5.7x	30.0x	23.6x	63.1x	50.7x	453.7	20.8%	23.3%	22%	24.5%
Constant Contact	31/12/2014	946.1	2.9x	2.5x	14.9x	11.7x	29.6x	24.7x	285.4	11.2%	19.5%	17%	20.2%
Digital River	31/12/2014	606.5	1.4x	1.3x	10.9x	10.1x	51.0x	43.3x	277.2	5.8%	12.7%	5%	17.8%
Average			5.6x	4.6x	50.7x	33.3x	108.1x	79.7x		10.5%	15.9%	19%	28.2%

Source: Bloomberg, Edison Investment Research. Note: Priced at 10 February 2015. Exchange rates (per EUR): PLN4.14, NZ\$1.55, JPY137.92, US\$ 1.36.

Exhibit 3: Financial summary

	€000s	2012	2013	2014e	2015e
31-December		IT GAAP	IT GAAP	IT GAAP	IT GAAP
PROFIT & LOSS					
Revenue		11,593	11,109	12,718	21,371
EBITDA		2,655	2,014	2,200	4,144
Operating Profit (before amort. and except.)		1,765	916	500	2,000
Intangible Amortisation		0	0	0	0
Exceptionals		(319)	45	0	0
Other		0	0	0	0
Operating Profit		1,446	961	500	2,000
Net Interest		(298)	(376)	(367)	(367)
Profit Before Tax (norm)		1,467	539	133	1,633
Profit Before Tax (reported)		1,148	584	133	1,633
Tax		(452)	(359)	(360)	(615)
Profit After Tax (norm)		1,015	180	(227)	1,018
Profit After Tax (reported)		697	225	(227)	1,018
Average Number of Shares Outstanding (m)		22.0	22.0	22.0	22.0
EPS - normalised (c)		4.6	0.8	(1.0)	4.6
EPS - normalised and fully diluted (c)		4.6	0.8	(1.0)	4.6
EPS - (IFRS) (c)		3.2	1.0	(1.0)	4.6
Dividend per share (p)		0.0	0.0	0.0	0.0
EBITDA Margin (%)		22.9	18.1	17.3	19.4
Adj Operating Margin (%)		15.2	8.2	3.9	9.4
BALANCE SHEET					
Fixed Assets		6,691	9,905	15,673	15,929
Intangible Assets		1,111	2,462	3,725	3,981
Tangible Assets		635	606	606	606
Investments		4,945	6,836	11,342	11,342
Current Assets		12,767	15,491	22,951	22,685
Stocks		722	476	476	476
Debtors		5,488	5,820	6,584	11,247
Cash		2,065	2,967	10,525	8,781
Other		4,492	6,228	5,367	2,181
Current Liabilities		(8,871)	(10,333)	(11,322)	(11,165)
Creditors		(6,538)	(7,350)	(8,338)	(8,182)
Short term borrowings		(2,332)	(2,984)	(2,984)	(2,984)
Long Term Liabilities		(4,642)	(5,172)	(5,172)	(5,172)
Long term borrowings		(4,642)	(5,172)	(5,172)	(5,172)
Other long term liabilities		0	0	0	0
Net Assets		5,945	9,890	22,129	22,276
CASH FLOW					
Operating Cash Flow		1,899	2,979	1,768	1,638
Net Interest		(298)	(376)	(367)	(367)
Tax		(452)	(359)	(360)	(615)
Capex		(3,095)	(2,384)	(2,963)	(2,400)
Acquisitions and Investment in subs/disposals		0	0	(3,705)	0
Financing		0	0	13,184	0
Dividends		0	(180)	0	0
Net Cash Flow		(1,946)	(320)	7,557	(1,743)
Opening net debt/(cash)		6,352	4,909	5,189	(2,368)
HP finance leases initiated		0	0	0	0
Other		3,389	40	0	0
Closing net debt/(cash)		4,909	5,189	(2,368)	(625)

Source: Edison Investment Research, Expert System

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