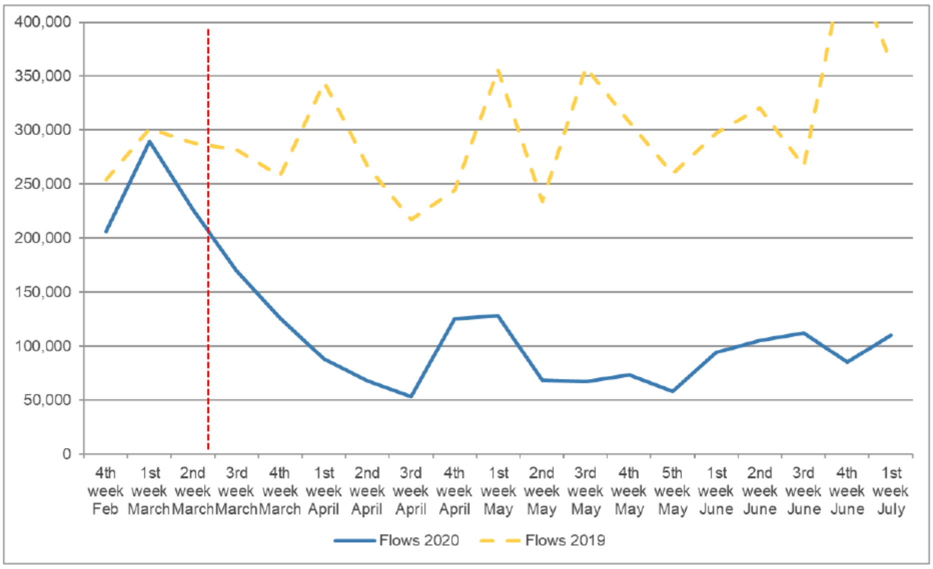
Gattaca plc

Light at the end of COVID-19 tunnel

17th July 2020

Once the lockdowns began on 23rd March, the number of UK job adverts literally went fell off a cliff, declining c. 80% from pre COVID-19 levels (see below). Since then though the situation has stabilised and is now gradually improving.

Number of new UK job adverts fell off a cliff in April

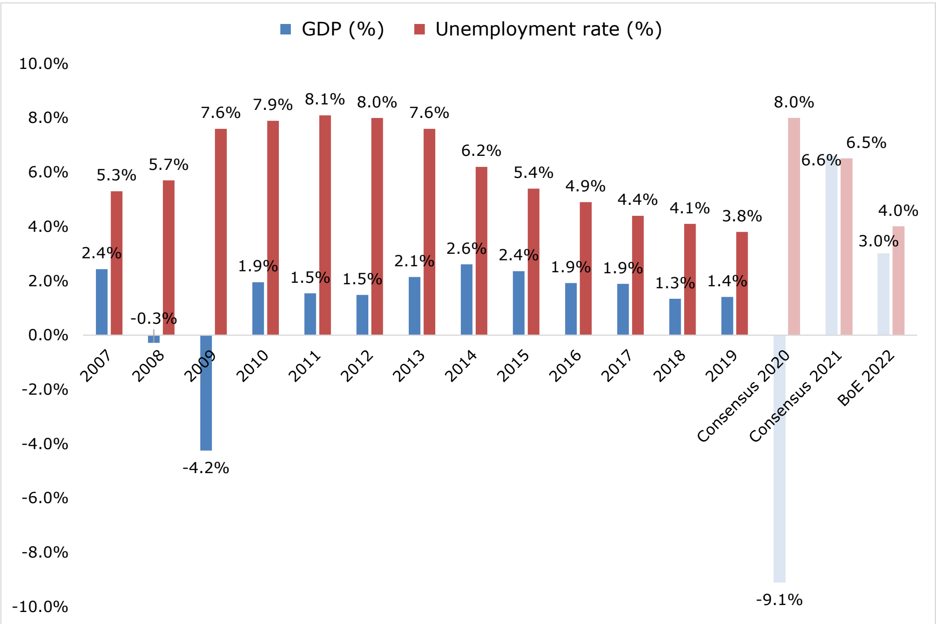


Source: *Institute for Employment Studies analysis of Adzuna vacancy data*

Pandemic could trigger a multi-year jobs boom

This also chimes with the June jobs data tracker (REC), where the total number of vacancies rose by 3% MoM, along with the broader macro outlook (see below).

UK GDP set to rebound 6.6% in 2021 vs -9.1% 2020



Source: *Bank of England (BoE) & Office of National Statistics (ONS)*

Company Data

EPIC	AIM:GATC
Price (last close)	43p
52 week Hi / Lo	165p/44p
Market cap	£12.9m
Net cash Jun’20 (incl non-recourse debt)	£1.0m
Share count	32.3m
ED valuation / share	130p/share

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: Prelims 4th Nov’20

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Fine, but what does this all mean for Gattaca, the UK's #1 specialist engineering (70% NFI) recruitment agency?

Shaken, but not perturbed

Well, today the company provided an update on trading for the period ending July 2020 (prelims 3rd November). Here:

- Client demand was originally impacted by the General Election and Brexit, then later by IR35 and the coronavirus. The latter also infecting APAC (China now closed) from January, followed by EMEA and the Americas in H2.
- As a consequence, total NFI dropped -41% for the 3 months ending June (vs -11.9% H1'20, & Hays UK -42%): split -36% contract vs -52% permanent.
- Pushing **FY20 NFI down -25.5% to £54m** (vs £70.6m LY, or -22% LFL £69.2m), which we estimate generated an adjusted EBIT of approx. £5.5m (conversion rate 10.2%). Higher than "***the Board's initial expectations***", aided by **several new business wins** & **rigorous cost control**.
- Sure July revenue run-rates haven't yet witnessed a material rebound, however there are promising early "***signs of increased activity***" (eg interviews) - with some previously furloughed staff now being re-deployed. Gross margins have been little affected.

Net funds improved by £25.9m over past 11 months

Better still, **cash generation was outstanding**, with net debt decreasing from £24.9m in Jul'19 (-£19.1m Jan'20) to **£1m of net cash as at 30th June** (incl £22m non-recourse finance). Driven by an unwind in contractor related debtors, disciplined working capital management, tax deferrals (£10m VAT) & cost cutting, partially offset by restructuring (eg China) and IT capex. On top, **covenant tests for the HSBC £10m RCF have been revised** through to July 2021.

Hence going forward, while the near-term outlook remains cloudy, we reckon the group should return to positive LFL NFI growth in H2 (see below). With **the Board's immediate focus to accelerate the 'Improvement Plan'**, centred on lifting sales & customer service (eg dedicated fulfilment process), alongside further expense savings.

Robust NFI growth set from Q4'21 onwards

Nonetheless, **overheads are projected to climb sequentially**, as the business returns to more normal working, voluntary pay cuts are reversed and government job support measures tail-off. Meaning that GATC is likely to be modestly loss-making H1'21, with a return to profitability thereafter, supported by **45%+ EBITDA drop through rates** and >**£3m of annualised savings beginning in H2'21**. Altogether delivering **£1.75m of EBIT in FY21 on £45.9m NFI** (-15% LFL), equivalent to a total fall of -35% peak-to-trough vs -21% during the 2008-10 Financial Crisis.

Reassuringly too, even if things don't quite go to plan, there appears to be **plenty of wiggle room**, given current liquidity stands at a healthy £59m. **Providing more than sufficient**

headroom to both get through the COVID valley &/or pay down the RCF in its entirety.

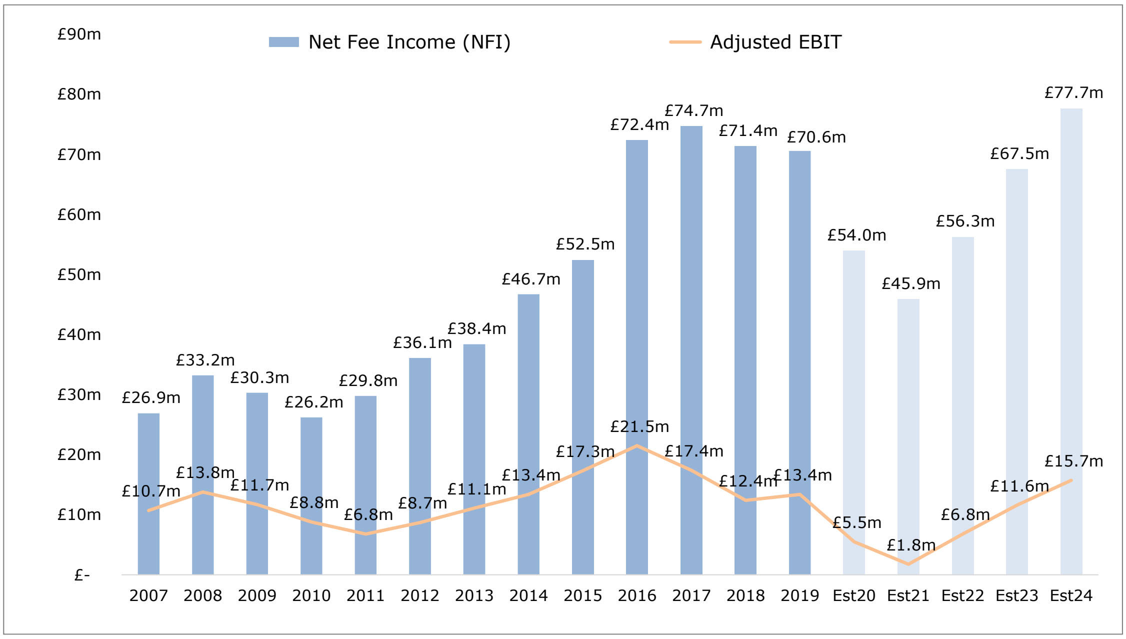
Elsewhere **net debt is predicted to climb to £13.5m** in July 2021 (incl non-recourse finance) vs **£2m as at July 2020**. Representing 3.2x EBITDA (incl non-recourse finance) – assuming £10m of deferred VAT is repaid by Mar'21, partially offset by some benefits from rescheduling contractor payments (£2m so far in FY20).

6 monthly financial forecasts

£'000s (continuing) - July y/e	**Act FY19**	**Act H1'20**	**Est H2**	**Est FY20**	**Est H1'21**	**Est H2'21**	**Est FY21**
UK Engineering	3.9%	-6.8%	-39.8%	-23.1%	-32.0%	10.0%	-15.8%
UK Technology	-19.9%	-25.0%	-21.8%	-23.6%	-32.0%	10.0%	-12.8%
International	2.1%	-20.9%	-31.0%	-25.6%	-32.0%	10.0%	-13.7%
Total underlying NFI	***-1.1%***	***-11.9%***	***-35.9%***	***-23.5%***	***-32.0%***	***10.0%***	***-15.0%***
NFI	**70,587**	**32,178**	**21,822**	**54,000**	**21,881**	**24,005**	**45,886**
Adjusted EBITDA	**14,600**	**5,153**	**3,347**	**8,500**	**1,018**	**3,232**	**4,250**
Adjusted EBIT	**13,393**	**3,610**	**1,890**	**5,500**	**-232**	**1,982**	**1,750**
EBIT/NFI margin	*19.0%*	*11.2%*	*8.7%*	*10.2%*	*-1.1%*	*8.3%*	*3.8%*
Underlying overheads	57,194	28,568	19,932	48,500	22,113	22,023	44,136
U/L admin as % NFI	81.0%	88.8%	91.3%	89.8%	101.1%	91.7%	96.2%
Adjusted PBT	**11,360**	**2,747**	**1,153**	**3,900**	**-832**	**1,582**	**750**
Tax	-2,501	-899	-76	-975	0	-180	-180
Minorities	0	0	0	0	0	0	0
Underlying PAT	**8,859**	**1,848**	**1,077**	**2,925**	**-832**	**1,402**	**570**
Adjusted EPS (diluted)	**26.7p**	**5.5p**	**3.2p**	**8.8p**	**-2.5p**	**4.2p**	**1.7p**
NFI (LTM) / head (£ks)	95.5	97.2	135.5	79.2			
Headcount	739	681	682	682			
Net debt : EBITDA	*1.70*	*0.27*	*-1.11*	*0.24*			*3.18*
U/L tax rate	*-22.0%*	*-32.7%*	*-6.6%*	*-25.0%*			*-24.0%*
Non-recourse invoice discounting		-16,000	-22,000	-22,000	-22,000	-22,000	-22,000
Net cash /(recourse debt)	**-24,822**	**-3,075**	**20,000**	**20,000**	**19,168**	**8,500**	**8,500**

Source: Equity Development

Gattaca proved its resilience during the 2008-10 recession…

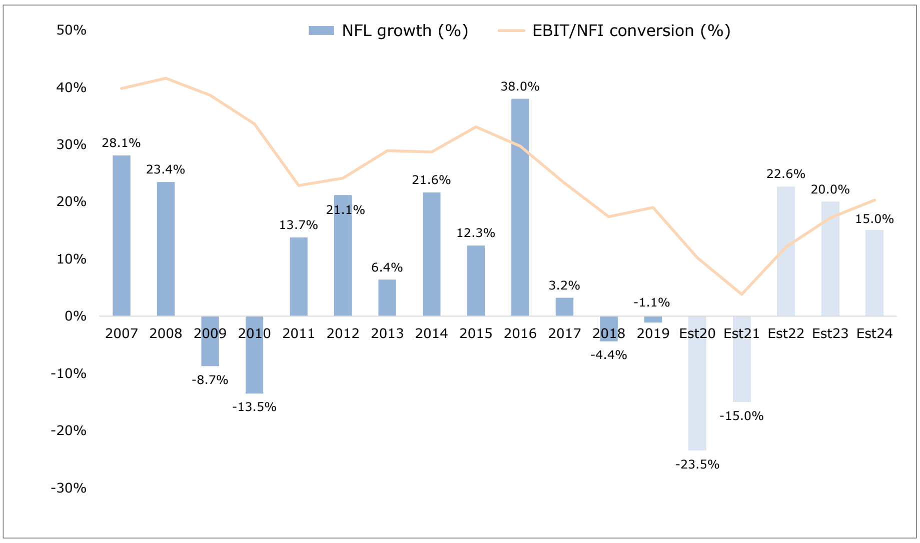


Source: Equity Development

The strong to get stronger, favouring Gattaca

Further out, our assumption is that **NFI should return to at least 80% of pre-Covid levels by FY22,** reaching full speed 18 months later (see below). With ultimately EBIT/NFI conversion rates jumping from 3.8% in FY21 to 20.3% by FY24 (see below) thanks to favourable operational gearing.

.. and will do so again

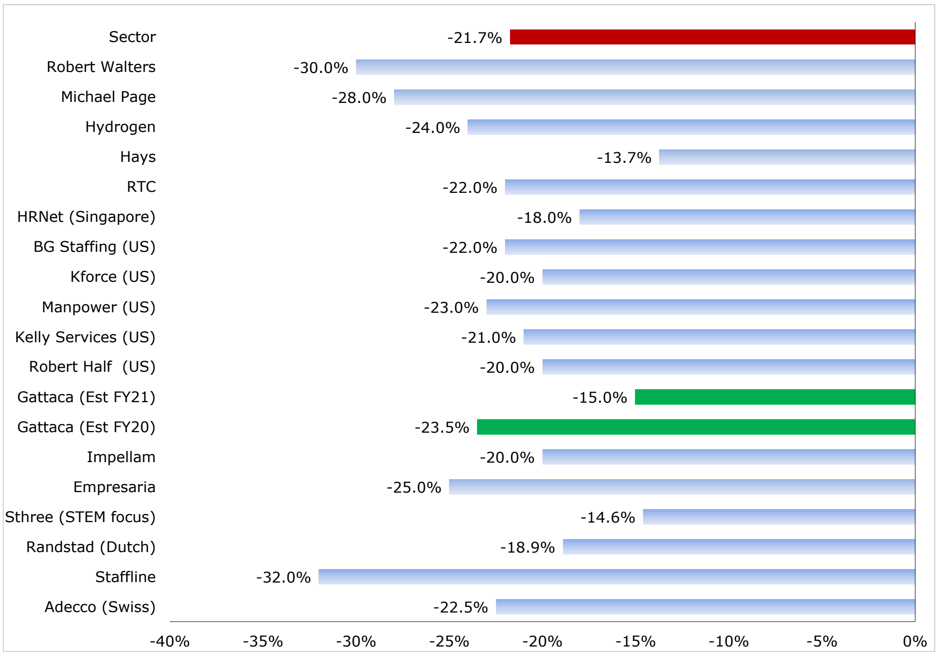


Source: Equity Development

How does this compare across the recruitment sector?

The picture is not dis-similar elsewhere. Albeit GATC's closest STEM rival, Sthree is thought to be slightly less impacted due to its heavier exposure to life sciences.

Current year LFL NFI growth



Source: Equity Development. Current year relates mostly to calendar 2020

Ok, but what is the stock worth?

Well, using a 7x EV/EBIT multiple on FY23 profits, and discounting back at 12% we arrive at a **fair value of 130p/share**, equivalent to >185% upside vs 43p currently.

Moreover longer term, **the fundamentals of STEM play to GATC's strengths**. Where the Board will continue to allocate resource towards the Engineering (smart motorways, civils, renewable energy & TechEng) and Technology (Data Science, Cloud, AI, Cyber, Java, Python & Javascript) verticals.

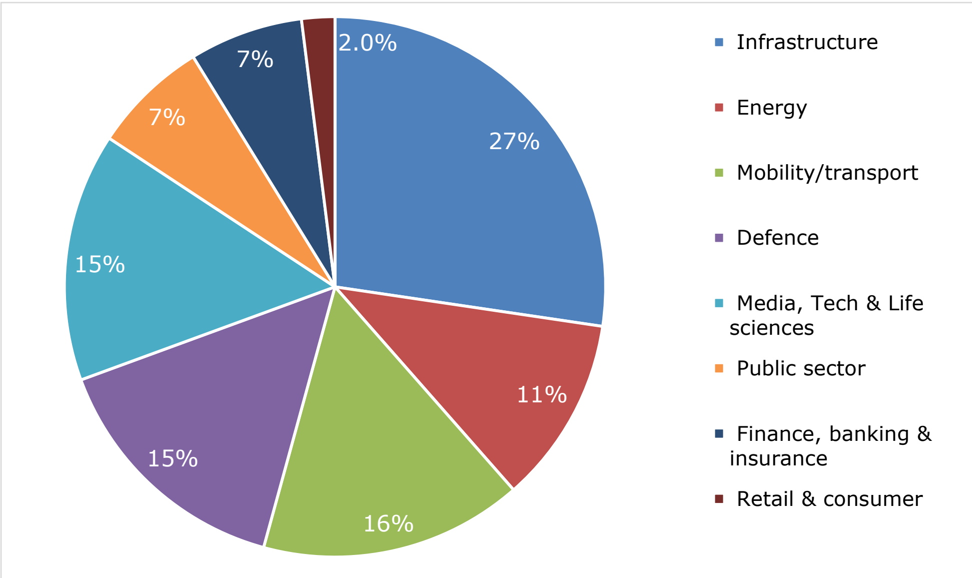
End markets are vital to the nation's health

Besides, regardless of what happens over the next few months - we think essential building/maintenance work (tracks, roads, sewage) within systemically important areas like defence, infrastructure (water, electricity, rail), housebuilding and construction will still have to completed. As underlined at the mini Budget on 8th July.

In fact, risk tolerant investors seeking bargains should remember that **it's always 'darkest before the dawn'**. And **quality recruiters like Gattaca,** trading at near all-time lows, **will almost certainly have their day in the sun again**.

Indeed we believe Gattaca has all the **hallmarks of turning into a major secular growth story over the next 2-4 years**, especially as recruitment picks up and the global economy gets back to work.

2019 NFI split by vertical market



Source: Company

Through the worst with plenty to spare

CEO Kevin Freeguard adding: *"The COVID-19 pandemic has created unprecedented challenges for Gattaca and for UK industry in general. However, I am pleased with the way the business has responded and the* ***resilience*** *we have shown. During the period, we have taken a number of measures to strengthen the business, including* ***the acceleration of the Group-wide Improvement Plan,*** *and the outstanding response from our staff to the* *challenges arising from COVID-19 has enabled Gattaca* ***to perform ahead of our expectations in these difficult circumstances****."*

"The balance sheet has continued to improve beyond our normal cycles, increasing our financial stability, and the ***significant liquidity will allow us to aggressively pursue growth opportunities to take advantage of the inevitable recovery in our markets****. In particular, we are well aligned with the anticipated UK Government investment targets such as Infrastructure and other STEM-driven sectors where Gattaca has a significant track record and capability*."

Key risks

- Coronavirus induced problems at some of its largest customers, which either lead to late payments and/or doubtful debts. Likewise the pandemic should delay the anticipated economic recovery
- Lenders do not grant Gattaca waivers over possible future temporary breaches in banking covenants. Although with ample liquidity we accept this is a low probability event.
- General economic downturn affecting engineering and technology recruitment. For example, the cessation of the Brexit transmission period in Dec'20 could knock business 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.
- Consolidation of customer base.
- Gattaca is presently assisting the US Department of Justice in their enquiries about certain Networkers International activities prior to its 2015 acquisition.

Summary financial forecasts

Gattaca (continuing operations) (July yearend)	2016 Act £'000s	2017 Act £'000s	2018 Act £'000s	2019 Act £'000s	2020 Est £'000s	2021 Est £'000s	2022 Est £'000s	2023 Est £'000s	2024 Est £'000s
Net Fee Income (NFI) : Gross profit			*Restated*	*Pre IFRS16*					
UK Engineering	40,865	43,080	47,568	49,442	38,036	32,028	39,256	47,107	54,174
UK Technology	17,413	16,178	14,457	11,575	8,848	7,717	9,486	11,384	13,091
International	14,109	15,450	9,374	9,570	7,117	6,141	7,532	9,039	10,395
Total	**72,387**	**74,708**	**71,399**	**70,587**	**54,000**	**45,886**	**56,275**	**67,530**	**77,660**
NFI growth rate									
UK Engineering	*8.0%*	*5.4%*	*10.4%*	*3.9%*	*-23.1%*	*-15.8%*	*22.6%*	*20.0%*	*15.0%*
UK Technology	*19.2%*	*-7.1%*	*-10.6%*	*-19.9%*	*-23.6%*	*-12.8%*	*22.9%*	*20.0%*	*15.0%*
International		*9.5%*	*-39.3%*	*2.1%*	*-25.6%*	*-13.7%*	*22.7%*	*20.0%*	*15.0%*
Total NFI growth rate	***38.0%***	***3.2%***	***-4.4%***	***-1.1%***	***-23.5%***	***-15.0%***	***22.6%***	***20.0%***	***15.0%***
EBITDA	**22,617**	**18,284**	**13,395**	**14,600**	**8,500**	**4,250**	**9,925**	**15,353**	**20,056**
UK Engineering	23,126	23,758	26,033	27,489	19,779	16,014	20,413	24,967	29,254
UK Technology	8,229	7,061	6,610	5,902	3,097	2,701	3,795	4,667	5,498
International	6,868	5,619	2,723	1,820	1,779	1,535	2,636	3,616	4,262
Central overheads	-16,726	-19,050	-22,964	-21,818	-19,154	-18,500	-20,044	-21,647	-23,271
Adjusted EBIT	**21,497**	**17,388**	**12,402**	**13,393**	**5,500**	**1,750**	**6,800**	**11,603**	**15,743**
Total Opex as % NFI	*-70.3%*	*-76.7%*	*-82.6%*	*-81.0%*	*-89.8%*	*-96.2%*	*-87.9%*	*-82.8%*	*-79.7%*
EBIT / NFI margin	*29.7%*	*23.3%*	*17.4%*	*19.0%*	*10.2%*	*3.8%*	*12.1%*	*17.2%*	*20.3%*
Net interest	-1,076	-1,232	-1,540	-2,033	-1,600	-1,000	-800	-600	-400
Adjusted PBT	**20,421**	**16,156**	**10,862**	**11,360**	**3,900**	**750**	**6,000**	**11,003**	**15,343**
Tax	-6,306	-5,076	-3,380	-2,501	-975	-180	-1,440	-2,641	-3,682
Minorities	0	-172	-275	0	0	0	0	0	0
Adjusted PAT	**14,115**	**10,908**	**7,207**	**8,859**	**2,925**	**570**	**4,560**	**8,362**	**11,661**
Adjusted diluted EPS (p)	**44.1**	**33.7**	**22.5**	**26.7**	**8.8**	**1.7**	**13.6**	**24.7**	**34.3**
Adjusted EPS growth rate	*0.5%*	*-23.6%*	*-33.3%*	*19.0%*	*-67.2%*	*-80.6%*	*696.1%*	*82.5%*	*38.8%*
Dividend (p)	**23.0**	**23.0**	**3.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Dividend yield	*53.5%*	*53.5%*	*7.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*
Dividend cover	*1.9*	*1.5*	*7.5*						
Valuation benchmarks									
P/E ratio (diluted)	*1.0*	*1.3*	*1.9*	*1.6*	*4.9*	*25.3*	*3.2*	*1.7*	*1.3*
EV/NFI	*0.38*	*0.37*	*0.38*	*0.39*	*0.51*	*0.60*	*0.49*	*0.41*	*0.35*
EV/EBIDA	*1.2*	*1.5*	*2.0*	*1.9*	*3.2*	*6.4*	*2.8*	*1.8*	*1.4*
EV/EBITA (diluted)	*1.3*	*1.6*	*2.2*	*2.0*	*5.0*	*15.6*	*4.0*	*2.4*	*1.7*
PEG ratio	*1.87*	*-0.05*	*-0.06*	*0.08*	*-0.07*	*-0.31*	*0.00*	*0.02*	*0.03*
Adjusted corporate tax rate	*-30.9%*	*-31.4%*	*-31.1%*	*-22.0%*	*-25.0%*	*-24.0%*	*-24.0%*	*-24.0%*	*-24.0%*
Adj ROACE	*19.7%*	*15.6%*	*13.1%*	*18.1%*	*7.5%*	*2.3%*	*8.8%*	*13.8%*	*16.8%*
EBITDA drop through rate as % NFI	*21.3%*	*-186.7%*	*147.7%*			*52.4%*	*54.6%*	*48.2%*	*46.4%*
Net recourse cash/(debt)	**-25,013**	**-40,288**	**-40,874**	**-24,822**	**20,000**	**8,500**	**8,885**	**13,496**	**22,334**
Non recourse invoice factoring					-22,000	-22,000	-22,000	-22,000	-22,000
Net debt : EBITDA	*1.1*	*2.2*	*3.1*	*1.7*	*0.2*	*3.2*	*1.3*	*0.6*	*0.0*
Diluted sharecount (Adj for 2015)	*32,040*	*32,392*	*32,079*	*33,144*	*33,323*	*33,486*	*33,649*	*33,813*	*33,977*
Shareprice (p)	**43p**								

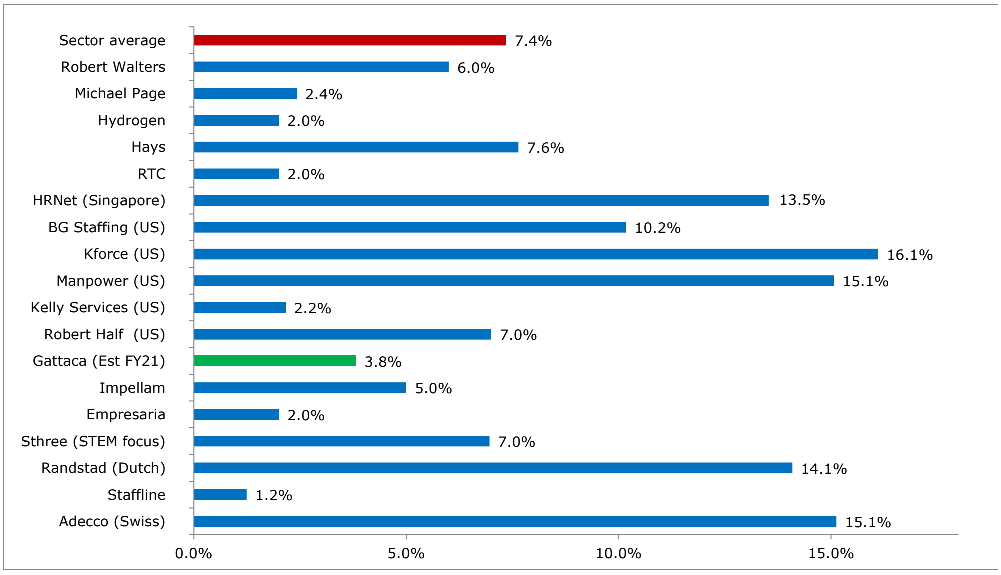
Source: Equity Development

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.

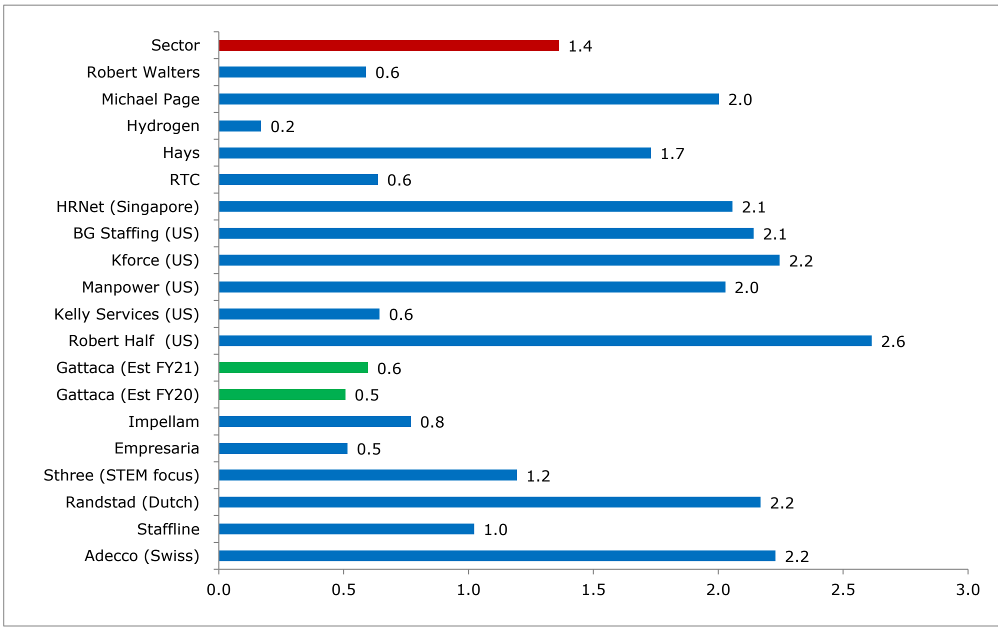
Appendices - sector valuation metrics and KPIs

Current Year (CY) EBIT / NFI conversion rates



Source: Equity Development: arithmetic average for sector.

CY EV/NFI multiples vs peers



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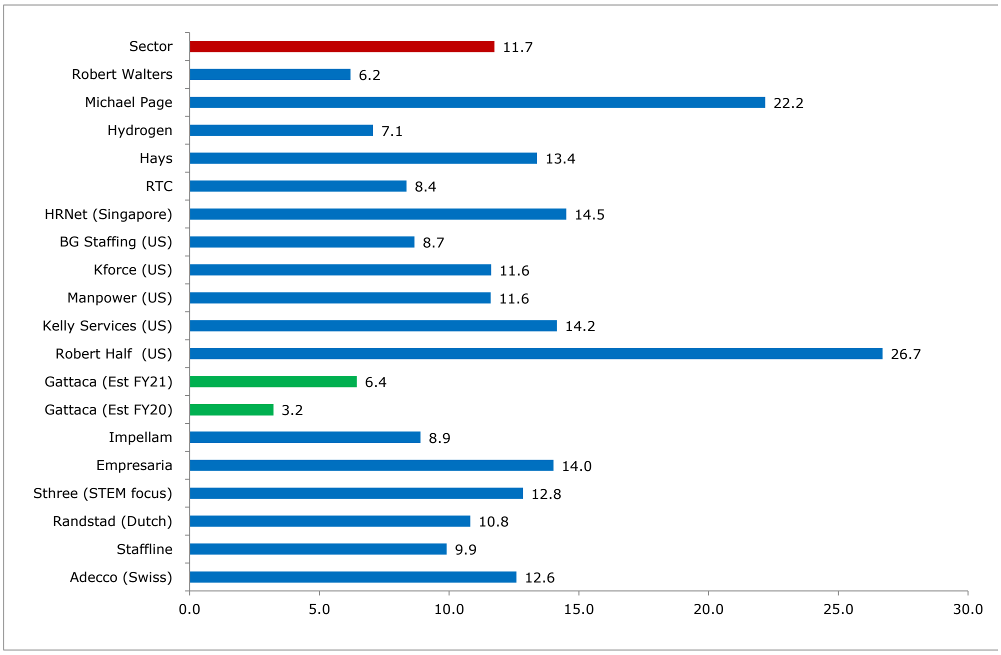
CY EV/EBITDA multiples vs peers



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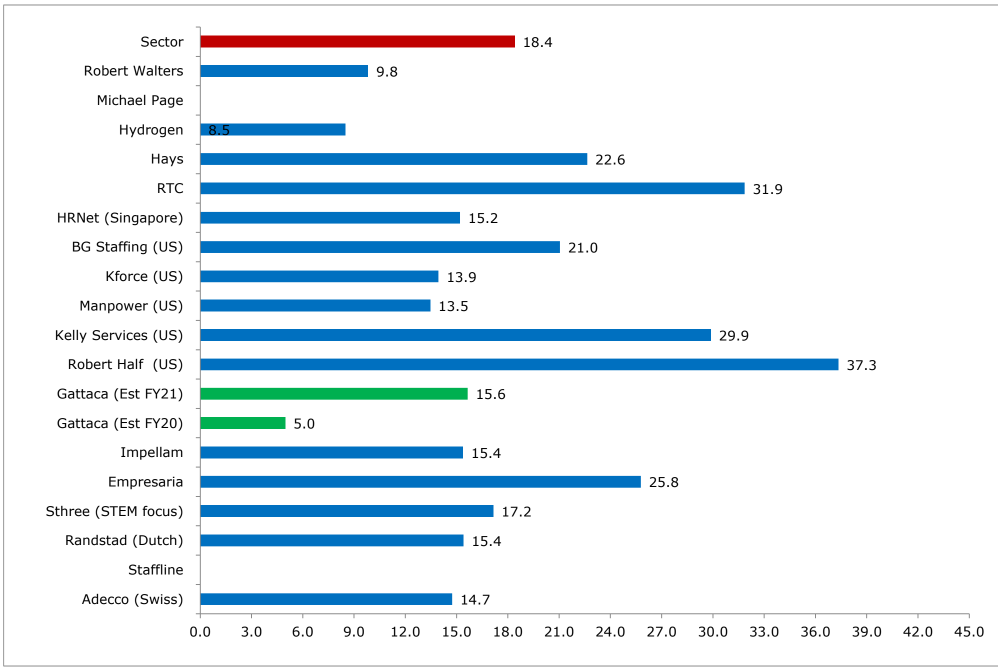
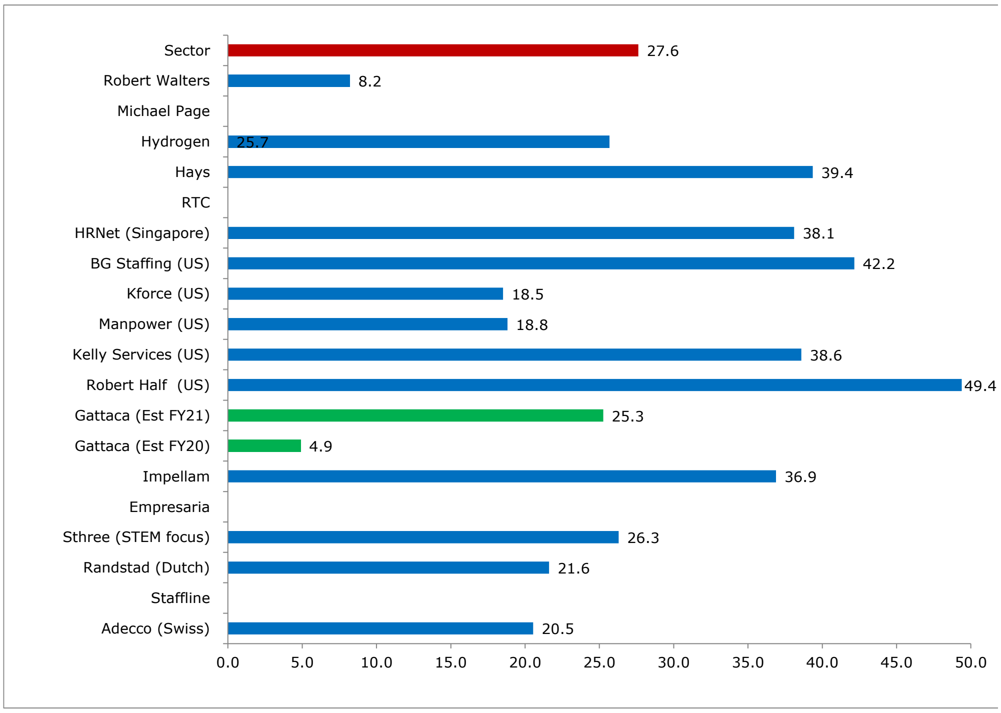


Source: Equity Development : arithmetic average for sector

CY PER multiples vs peers



Source: Equity Development : arithmetic average for sector

Market capitalisation of peers

	Shareprice	Mrk Cap (Millions)	CY net cash / (debt) Millions	Enterprise Value (Millions)
Adecco (Swiss)	€ 42.52	€ 7,357	-€ 426	€ 7,783
Staffline	33p	£22.7	-£59.5	£82.2
Randstad (Dutch)	€ 41.50	€ 7,636	-€ 681	€ 8,317
Sthree (STEM focus)	263p	£349.8	£22.2	£327.6
Empresaria	36p	£17.4	-£13.3	£30.7
Impellam	230p	£105.8	-£71.7	£177.5
Gattaca (Est FY21)	43p	£13.9	-£13.5	£27.4
Robert Half (US)	$51.50	$5,871	$250	$5,621
Kelly Services (US)	$14.00	$549	$11	$538
Manpower (US)	$68.00	$4,012	$55	$3,957
Kforce (US)	$27.00	$629	-$68	$697
BG Staffing (US)	$9.70	$100	-$47	$147
HRNet (Singapore)	$0.50	$499	$250	$249
RTC	36p	£5.1	-£2.8	£7.9
Hays	122p	£2,052	£365	£1,687
Hydrogen	32p	£10.7	£6.5	£4.2
Michael Page	378p	£1,213	-£20	£1,233
Robert Walters	400p	£304.0	£119.0	£185.0

Source: Equity Development : arithmetic average for sector

Investor Access

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