Beta Systems

Technology

31 January 2018

A record year; proposed dividend

Beta's FY17 results were towards to the middle of its guidance; strong licence sales in DCI and management's efficiency drive resulted in a 70% increase in EBIT, a record for the group. While FY18 is expected to be a smaller year in terms of client renewals, management is making good progress delivering to its plan to restructure and modernise the group.

FY17: Strong uptick and proposed dividend

FY17 was a good year for licence renewals, with some of Beta's largest clients renewing, upgrading and extending their contracts. This underpinned the 7% increase in sales to €49.8m. Mix effects and the group's cost-savings programme enabled a 6.6pp expansion in EBIT margins to 18.1% and EBIT of €9.0m. Net cash was €44.1m (including €25m on deposit) and the group has reinstated a dividend of €0.41 per share (subject to approval), representing a yield of c 1.7%.

Outlook: M&A to feature more prominently

Management has made good progress against its strategy to restructure and modernise the group. FY17 was a record year for Beta in terms of profitability and a number of product enhancements were launched, which should support price increases in the years to come. Work remains to be done to diversify revenues beyond the mainframe environment; in this regard, despite its small size, we view the recent acquisition of an internet agency as strategically significant. A director of M&A was recently appointed and management is actively pursuing other targets.

Outlook: FY18 a smaller year for licence renewals

Against the strong comparative, Beta expects FY18 to be a much smaller year for licence renewals. It is guiding to revenues of €41-44m and EBITDA of €4.3-6.3m, roughly half that delivered in FY17, although still a double-digit EBITDA margin. Longer term, it believes an EBITDA margin of 15-20% is sustainable.

Valuation: Premium to peers justified

Mid of management's FY18 guidance implies an EV/EBITDA of 13.7x. While above the peer group average of 10.4x, we believe an element of premium is justified given FY18 is an atypically small renewals year, given the renewal cycle, and the potential to efficiently deploy its significant cash reserves. To justify share price upside, we would like to see evidence that initiatives to stabilise the IAM revenue base and the strategy to move beyond its core mainframe customer base are delivering to plan.

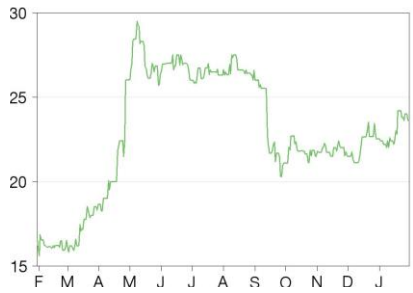
Historical financials

Year end	Revenue (€m)	EBIT (€m)	PBT (€m)	EPS (€)	DPS (€)	P/E (x)	Yield (%)
09/15	41.6	(0.5)	(0.3)	0.71	0	33.2	N/A
09/16	46.4	5.3	5.7	0.99	0	23.8	N/A
09/17	49.8	9.0	9.3	1.51	0.41	15.6	1.7

Source: Bloomberg

Price	**€23.60**
Market cap	**€125m**

Share price graph



Share details

Code	BSS
Listing	Deutsche Börse Scale
Shares in issue	5.3m
Last reported net cash as at December 2017, including €25m in deposits	€44.1m

Business description

Beta Systems provides data centre intelligence (DCI) solutions that enable efficient and secure bulk processing of data and identity access management (IAM) solutions. The company's headquarters are in Berlin and has sales and support offices in 18 markets globally. Approximately 68% of sales are derived in the DACH region.

Bull

- Market leader in mainframe environments and DCI in Europe.
- FY19 and FY20 should be more typical renewal years in DCI.
- Strong balance sheet.

Bear

- Mature mainframe market backdrop.
- Subscale IAM business.
- FY18 outlook affected by down-cycle in licence renewals.

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2017 highlights: Record profits and dividend reinstated

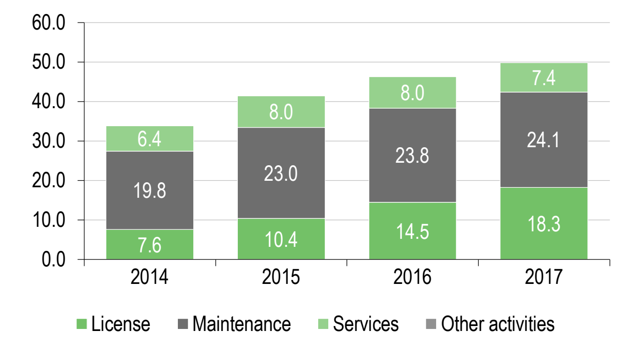
FY17 revenues increased by 7% to €49.8m, with the DCI division growing by 12% and IAM contracting by 5%. EBIT of €9m increased by 70% with margins of 18.1% significantly improved (FY16 11.5%), benefiting from mix effects as well as the continued implementation of its efficiency programme. The second half is typically seasonally weaker for Beta and was particularly so this year (H117 revenues +28%), so despite a contraction in second-half sales and profits, revenues were mid of management's guidance range and overall 2017 was a record year of profitability for the company. Year-end net cash was €44.1m (including the €25m on deposit with its largest shareholder) and, given the significant recovery in profitability over the last few years, subject to investor approval, the group has reinstated a dividend of €0.41 per share (€2.2m total), representing a yield of c 1.7%.

Exhibit 1: Financial summary

€m	2013	2014	2015	2016	2017
Year-end 30 September	IFRS	IFRS	IFRS	IFRS	IFRS
Income statement					
Revenue	37.7	33.8	41.6	46.4	49.8
Revenue growth	-9%	-10%	23%	12%	7%
Gross margin	0.91	0.91	0.94	0.94	0.96
EBITDA	2.30	-1.30	3.53	6.95	10.8
EBITDA margin	6.1%	-3.8%	8.5%	15.0%	21.7%
Total opex	(36.5)	(36.0)	(42.1)	(41.0)	(40.8)
EBIT	1.2	(2.2)	(0.5)	5.3	9.0
EBIT margin	3.2%	-6.6%	-1.2%	11.5%	18.1%
Profit before tax (as reported)	1.5	(1.9)	(0.3)	5.7	9.3
Net income (as reported)	0.4	(2.2)	2.8	5.2	8.0
EPS (as reported) (€)	0.08	(0.51)	0.71	0.99	1.51
Dividend per share (€)	0.00	0.00	0.00	0.00	0.41*
Balance sheet					
Total non-current assets	1.9	2.7	14.4	14.0	11.5
Total current assets	50.3	46.4	48.6	54.1	60.9
Total assets	52.1	49.1	63.0	68.1	72.4
Total current liabilities	(15.5)	(15.0)	(25.9)	(18.7)	(15.5)
Total non-current liabilities	(2.9)	(2.8)	(2.9)	(3.9)	(2.8)
Total liabilities	(18.3)	(17.7)	(28.7)	(22.5)	(18.2)
Total equity	33.8	31.4	34.2	45.6	54.2
Cash flow Statement					
Net cash from operating activities	4.2	3.3	4.5	5.0	5.3
Net cash from investing activities	0.9	(0.0)	(6.1)	(17.9)	0.1
Net cash from financing activities	(0.6)	(0.4)	7.2	(0.7)	(0.1)
Net cash flow	4.4	(7.7)	5.5	(13.5)	5.3
Cash	29.5	21.8	27.4	13.8	19.1
Cash on deposit	0.0	0.0	7.5	25.0	25.0
Net cash and equivalent	29.5	21.8	34.9	38.8	44.1

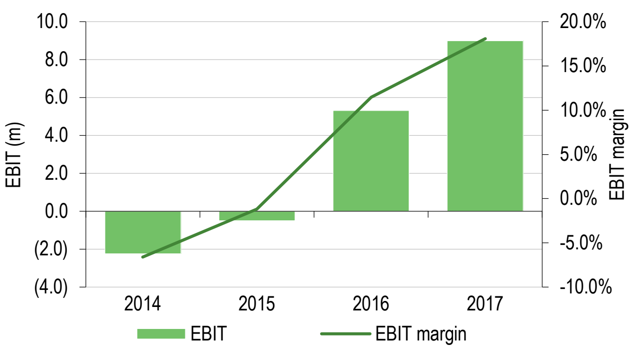
Source: Company accounts. Note: *Refers to proposed dividend, which is subject to shareholder approval at the 19 March AGM.

Exhibit 2: Revenues by classification (€m)



Source: Beta Systems, Edison Investment Research

Exhibit 3: EBIT and EBIT margin profile



Source: Beta Systems, Edison Investment Research

Divisional review – a big year for DCI licence renewals

The 7% overall revenue growth was driven predominantly by the DCI division, which enjoyed a 31% increase in licence sales. Sales cycles tend to be driven by the renewal timetables of existing customers, which generally involves price increases that come with the introduction of new versions of the software and the take-up of additional modules by customers. 2017 was an 'up' year in terms of licence renewals, with a number of its largest customers renewing. Having launched its new Discovery product in 2014 and launched two new products during 2017, Beta was able to both increase prices and upsell to these customers (please refer to our report dated 31 May 2017 for more detail on Beta's products). The company was particularly pleased with the initial performance of the Enterprise Control Center, which has a higher price point and has now been taken up by three existing customers, already making a material contribution to revenues.

Within IAM, the group continues to work on improving the interface of its Garancy Portal, in order to strengthen its sales proposition. It has increased its sales capacity within the DACH region and is looking to build out a partner network to widen its reach. Despite these initiatives, while customer retention is strong, new business was disappointing and revenues contracted 5%. However, we note that management commentary alludes to a much stronger start to FY18 for the segment.

The ongoing efficiency programme, which is focused on decreasing the administrative overhead and in reducing reliance on external consultants meant that across the group operating expenses were broadly flat year-on-year. Savings made in these areas compensated for the group's increased investment into expanding its sales effort outside the DACH region, as well as an increase in the level of investment being made into training the next generation of mainframe engineers (which in turn enables the group to continue to reduce its reliance on external resources). Together with the mix effects of a greater share of revenues being generated by licences, this enabled the EBIT margin to increase to 18.1%.

Exhibit 4: Revenue breakdown (€m)

	2016			2017			Change		
	DCI	IAM	Total	DCI	IAM	Total	DCI	IAM	Total
Licence	12.4	2.1	14.5	16.3	2	18.3	31%	-5%	26%
Maintenance	18.5	5.3	23.8	18.6	5.6	24.1	1%	6%	1%
Services	2.2	5.8	8	2.4	4.9	7.4	14%	-16%	-8%
Total	**33.2**	**13.2**	**46.4**	**37.3**	**12.6**	**49.8**	**12%**	**-5%**	**7%**

Source: Beta Systems

Balance sheet and cash flow

Beta reported a net cash balance of €19.1m, or €44.1m if we include the €25m on deposit (with a c six-month notice to draw) as part of its arrangement with its largest shareholder, Deutsche Balaton, slightly down on that reported at the interim (€47.6m).

Cash conversion at approximately 49% of EBITDA is lower than that reported in recent periods (92% and 64% in FY15 and FY16). This is largely due to IFRS revenue recognition provisions for licence sales, which require companies to recognise a greater proportion of revenues up front than payment terms require; this is also reflected in the 18% increase in trade receivables to €15m. In FY18, where we expect the mix of revenues to be weighted more towards maintenance and services, this should recover somewhat.

The potential 0.41c dividend that has been proposed represents approximately €2.2m in total; leaving ample headroom for bolt on, or a more transformative acquisition, in line with the group's strategy to diversify its revenue base.

Strategy update: More active M&A strategy

Since appointment during 2015, the new management team has made considerable headway in its efforts to restructure and modernise the group:

- DCI and IAM have been carved out into separate business units and legal entities under a central holding structure.
- The level of overhead has been reduced, particularly with regards to the group's previous reliance on consultants and freelancers, returning the group to profitability.
- The sales units, which has included re-training in order to inject a more aggressive sales culture, has been reorganised, with a greater focus on winning new customers and upselling to current ones, as opposed to the historical emphasis on software renewals.
- A new generation of products has been introduced across both divisions, including the Enterprise Control Center and the Agilizer within DCI, the re-branded and enlarged functionality of the Garancy Portal within IAM.

In the year ahead, the group plans to push with the introduction of new product functionality. For instance, it plans to launch a new, more intuitive graphical interface for its decentralised solutions and the bundling of the Enterprise Control Center into other core DCI products, which should add pricing power in the years to come.

M&A is also expected to play a core part of management's strategy to consolidate its leading position in the mainframe while diversifying its revenue base; either in decentralised solutions, or the wider software arena. The group recently appointed a new Director of Mergers and Acquisitions, and in December 2017 announced its first acquisition under current management (see below). It is currently exploring a number of other potential acquisitions.

LYNET Kommunikation acquisition

In December 2017, Beta announced the acquisition of 100% of the share capital of LYNET Kommunikation, an internet agency that offers B2B and B2C software development, IT consulting and related services, with particular strength in the e-commerce space.

The group paid €2.5m in cash and LYNET has reported revenues of approximately €2.5m in sales and €0.5m EBITA in FY17. There are potential earnouts of €1.25m over the next four years, which means that net of a property acquired with the business worth €1m, the effective EV/EBIT multiple is 4x, considerably below Beta's own multiple.

While a small deal, the acquisition reflects the group's strategy to diversify its revenue base. LYNET was founded in 1994, has a strong and relatively stable customer base, but further diversifies the group's revenues and brings a range of SMEs and public institutions in northern Germany to the client roster. The founders have been incentivised to remain with the company for at least four years through part of the earnout structure.

Outlook – FY18 a smaller year for licence renewals

Licences tend to be renewed on a 3-5-year timetable. Dependent on the nature and volume of renewals, licence sales can be lumpy. As discussed earlier, FY17 benefited from a high number of large value clients renewing. FY18, on the other hand, is expected to be a smaller year in terms of the value of licences being renewed (Exhibit 5). While no specific guidance has been given for the out years, the revenue profile in Exhibit 5 would suggest renewals should pick up once again in FY19 and longer term it expects to be in an EBITDA and EBIT margin range of 15-20%.

Exhibit 5: Management's FY18e guidance

€m	FY14	FY15	FY16	FY17	FY18e
Revenues	33.8	41.6	46.4	49.8	41-44
Licences	7.6	10.4	14.5	18.3	11-12
Maintenance	19.8	23	23.8	24.1	23-24
Other	6.4	8.1	8.0	7.4	7-8
EBITDA	-1.3	3.5	6.9	10.8	4.3-6.3
EBITDA margin	N/A	8%	15%	22%	12%
Liquidity	21.8	27.4	39.0	44.1	47.2-49.2

Source: Company accounts

Valuation

Beta's shares responded well to the release of the group's H117 figures, which reflected the excellent first-half numbers and the group's improved profitability (Exhibit 6), but have since partially retreated since management communicated its more cautious expectations for FY18.

Exhibit 6: Beta Systems' recent share price performance

Source: Bloomberg

In the absence of consensus estimates in the market, we base Beta's implied valuation multiples on management's guidance for FY18. We note that in our calculation of EV, we adjust for both the €19m cash and the €25m cash on deposit with its largest shareholder, Deutsche Balaton, which we view as cash equivalent.

Taking the mid-point of guidance would suggest that Beta trades on an FY18e EV/EBITDA multiple of 13.7x. Should EBITDA reach the top-end of guidance, the multiple would fall to 11.5x. In either case, this implies it trades at a premium to its infrastructure peer group average of 10.4x.

Based on the current renewal cycles for DCI licences, we would expect FY19 and FY20 to be larger renewal years and, together with management's goal of keeping EBITDA margins in the 15-20% range longer term (FY18: 12%), this would suggest a recovery in profitability in FY19 and FY20. Furthermore, the potential to efficiently deploy its balance sheet through acquisitions (which management aims to do at a lower rating), could enhance earnings. Consequently, we believe an element of premium is justified and the shares should be well supported at these levels.

However, until there is better visibility regarding FY19 revenues, for the shares to justify further ratings expansion, we would like to see evidence that the initiatives to stabilise the revenue base in IAM and that the group's strategy to move beyond its core mainframe customer base are delivering to plan.

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