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Scale research report - Update

Beta Systems

Technology

30 May 2018

Positive outlook

Beta's H118 results reflect the anticipated lull in the DCI licence renewal cycle, with EBITDA down 54% y-o-y. Despite the decrease, management believes it is on track to deliver to the top end of its guided range for the full year. With an anticipated pick-up in performance over the next two years, combined with the recent uptick in M&A activity, we feel that the FY18 EV/EBITDA premium to peers is justified.

H118 results – low point in renewals cycle

As expected, fewer DCI licences were up for renewal in the period, and against a very strong basis of comparison, H118 saw revenues down 23% to €25.1m, and EBITDA and net profits roughly half the previous year's level. Cash generation remained strong and, despite €5m acquisition expenditure over the period, the balance sheet strengthened further to a net cash position of €47.8m at period end.

Guidance and outlook

Despite the y-o-y declines, H1 EBITDA of €6.1m is already at the top end of management's full year guidance for EBITDA of €4.3-6.3m, and while H1 is typically the more significant half, management has indicated that it expects to deliver to the upper half of its guidance range. Visibility in DCI is fairly strong and, given the historical renewal cycles, we would expect FY19 and FY20 to show a return to growth.

Operating update – continued M&A

Beta is actively diversifying its revenue base away from the mature mainframe environment. Evidence of this can be seen in the two recent acquisitions – an internet agency (LYNET) and a software provider (AUCONET), both of which are expected to smooth the somewhat volatile licensing revenues from DCI. In aggregate, management expects these acquisitions to be performance neutral in FY18, but earnings enhancing from FY19 onwards.

Valuation: Justified premium rating

Delivery towards the top end of management's FY18 guidance implies an EV/EBITDA multiple of 12.8x, compared with the peer group average of 10x. Given the likelihood of stronger performance in FY19 and FY20 as the renewals cycle becomes more favourable, coupled with the M&A strategy, and with cash accounting for 40% of the market cap, we believe the premium is justified.

Historical financials

Year end	Revenue (€m)	EBIT (€m)	PBT (€m)	EPS (€)	DPS (€)	P/E (x)
09/15	41.6	(0.5)	(0.3)	0.71	0.0	31.8
09/16	46.4	5.3	5.7	0.99	0.0	22.8
09/17	49.8	9.0	9.3	1.51	0.0	15.0

Source: Bloomberg

Price	€22.60
Market cap	€119.4m

Share price graph

Share details

Code	BSS
Listing	Deutsche Börse Scale
Shares in issue	5.3m
Last reported net cash at 31 March 2018, including €25m deposits	€47.8m

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 it has sales and support offices in 18 markets globally. Approximately 70% 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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Review of H118 results

Smaller year for licence renewals: against a very strong basis of comparison (H117 +28%) and as previously guided by management, the H118 results reflect a significantly lower period for licence renewals. The 23% (c €7m) reduction in y-o-y revenues to €25.1m translated to PBT, which decreased by 57%. The newly acquired businesses contributed €0.9m to revenues during the period.

Ongoing efficiency efforts: total operating costs (including depreciation and amortisation) were slightly reduced at €20.5m vs €20.8m in H117, despite the inclusion of €0.3m one-off, acquisition-related costs following the acquisition of LYNET and AUCONET, which completed during the half year. Management's ongoing efforts to improve efficiency resulted in savings of €0.6m, and further reductions in the use of external contractors led to an additional €0.4m saving.

Expected full-year EBITDA achieved at the half year: H1 tends to be the stronger period for licence renewals at Beta Systems, and last year this seasonality was even more pronounced. H1 EBITDA of €6.1m (-54% y-o-y) is on a 24% EBITDA margin. While it is down from 41% in H117 (where H1 represented 124% of FY17 EBITDA), the H118 result is already within the guidance range for the full year of €4.3-6.3m.

Exhibit 1: Summary of H118 results

€m	H117	H118	Y-o-y change (%)
Revenues	32.5	25.1	(23)
Operating profit	12.4	5.2	(58)
Margin	38%	21%	
Normalised operating profit	12.5	5.5	(56)
EBITDA	13.4	6.1	(54)
Margin	41%	24%	
PBT	12.5	5.4	(57)
Net profit	11.1	4.9	(56)
Margin	34%	19%	
EPS	2.1	0.9	(56)
Operating cash flow	8.6	8.8	2
Investing cash flow	0.1	(5.0)	N/A
Financing cash flow	(0.1)	0.0	(99)
Net cash flow	8.7	3.7	(57)

Source: Company accounts

Cash conversion improved significantly, with operating cash flow representing 143% of EBITDA (H117: 64%). This was largely driven by Beta's revenue recognition policy, which frequently results in a greater proportion of revenues being recognized upfront than payment terms require. This is also in line with the new revenue recognition guidelines according to IFRS 15 (which will be adopted from FY19).The strong cash conversion meant that, despite the €5m payments for the two acquisitions, gross of the €25m deposit with majority shareholder Deutsche Balaton, Beta reported end-March 2018 net cash of €47.8m, up from €44.1m at the year end.

Outlook: Guidance reiterated

Management has not altered its guidance, but expects to achieve the top end of the range provided. Furthermore, the guidance excludes the contributions from acquisitions made during the year, which management expects to provide €3m revenues, zero EBITDA and a €0.5-1m loss at the operating profit level in 2018. These companies are expected to make positive contributions from 2019 onwards.

Exhibit 2: 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. Note: *Exclusive of contributions and cash costs from acquisitions. Inclusive of the c €5m cash costs for the two acquisitions, liquidity is expected to be correspondingly lower.

AUCONET acquisition

Further to the €2.5m acquisition of LYNET in December 2017, Beta completed the acquisition of AUCONET on 31 January 2018. The company was acquired from administration for total costs of c €3.1m. It contributed negative EBITDA of €0.1m over the period, and management expects this loss to worsen over H218 (EBITDA losses of €0.5m for FY18). However, a positive contribution to group EBITDA is expected from 2019 onwards, as the company recovers from the significant turmoil during the bankruptcy and subsequent acquisition process. AUCONET will complement Beta's Data Centre Intelligence (DCI) division through its 'BICS' IT Operations Management software. The recent hire of an M&A director indicates that the company is open to further utilisation of its balance sheet.

Valuation

The shares are trading at lower levels than 12 months ago, and have seen little movement since the FY17 results.

Exhibit 3: Recent share price performance

Source: Bloomberg

Peer valuation

We benchmark Beta's valuation against a basket of comparable mainframe-related companies. Given management's expectation of delivering towards the top end of its guidance, we are assuming the higher end (75th percentile of range) of Beta's revenue and EBITDA guidance (€43.25m and €5.8m respectively) when calculating multiples. Furthermore, we adjust our calculation of EV to account for the €25m cash deposits with Deutsche Balaton which, due to its accessibility, we see as a cash equivalent.

This would imply FY18e EV/Sales multiples of 1.7x and EV/EBITDA of 12.8x, which compare with peer averages of 3.2x and 10.0x.

We believe an element of EV/EBITDA premium is justified and the shares should be well supported at these levels:

- FY18 is anticipated to be a low point in Beta's three- to four-year renewals cycle which, together with management's goal of keeping EBITDA margins in the 15-20% range longer term (FY18e: 12%), points to a recovery in profitability in FY19 and FY20.
- Furthermore, the two recent acquisitions should become earnings enhancing from FY19 and the strategy to continue to make bolt-on acquisitions could enhance earnings further.

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

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