Gattaca plc

Profit expectations maintained

15 February 2024

We are encouraged by several aspects of the pre-close trading update covering H1, not least the outcome and movement in net cash. A renewed focus on the cost base should result in improving conversion rates, offsetting any further shortfall in fee income during H2. We remain confident that a recovery in Gattaca's markets should emerge during Q4 '24/early FY25 supporting a further re-rating of its shares.

The Group's business development team has been very active during the period, adding two new MSP contracts and overseeing a renewal of two contracts on broadly similar terms. In addition, the pipeline within the Projects divisions continues to grow, which bodes well for FY25.

The yoy shortfall in NFI of 16% during H1 includes a large RPO contract which ended in September. The H2 '23/H1 '24 comparison is as a result more favourable, with the larger contract included for just two months of the former period, with fee income down 8.6%. Overall, contract NFI was more stable, declining 6% yoy, compared to 38% in perm.

H2 '24 onwards will witness a greater focus on productivity, resulting in outgoing sales heads in the business not being replaced and further room for cost cutting within perm focused employees. Over the medium term, we expect administration headcount as a proportion of total heads to move towards best industry practice of c.25%, down from the current 32%.

We think the outlook for CY24 remains an upbeat one, notwithstanding a challenging start to the year. Confidence is likely to improve as the effect of higher inflation dissipates and with it interest rates finally begin to fall. This should result in a recovery in its markets, initially witnessed in contract and latterly in perm placements, which augurs well for conversion rates on a lower cost base.

Valuation and ratings remain undemanding

Should we be proved correct on a recovery in the Group's markets then the current valuation appears too low. As investors chase incumbents of the sectors best placed to witness an early uplift in economic activity levels, we expect GATC shares to be re-rated ahead of later potential upgrades to estimates in FY25 and beyond.

Based on a DCF model we retain our fair value / share at 175p.

Summary estimates

Y/e July, £m	FY21A	FY22A	FY23A	FY24E	FY25E
NFI	42.1	44.2	43.4	40.9	44.0
EBITDA	4.4	2.8	3.8	3.9	5.9
Adj. PBT	1.8	0.3	2.6	2.8	4.7
Adj. EPS (p)	5.3	0.5	4.5	6.5	10.8
DPS (p)	0.0	0.0	5.0	3.3	5.4
EV/NFI	0.4	0.4	0.4	0.4	0.4
EV/EBITDA	3.9	6.2	4.5	4.4	2.9
PER	23.8	263.8	27.8	19.3	11.5
Yield	0.0%	0.0%	4.0%	2.6%	4.3%
Net cash	19.9	16.0	21.6	21.7	22.8

Source: Company historics, ED estimates

Company Data

EPIC	GATC
Price (last close)	125p
52 weeks Hi/Lo	146p/75p
Market cap	£39.8m
ED Fair Value / share	175p
Net cash (at 31/01/24)	£22.1m

Share Price, p

Source: ADVFN

Description

Gattaca plc is a specialist STEM (Science, Technology, Engineering and Mathematics) staffing solutions business. In H1 '24 it delivered net fees of £18.9m – of which 76% was derived from temporary/contract placements, with the remainder permanent activity.

Average sales headcount during H1 '24 amounted to 312 (from 315 in H2 '23), representing c.68% of employee numbers.

Next news: Interim results on 16/04/24

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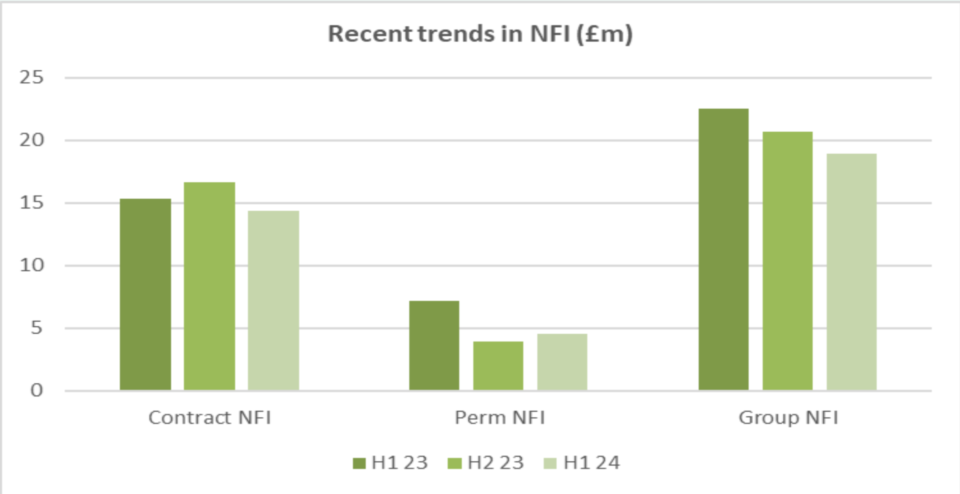
Relative stability within contract

The first half witnessed an improving outlook during Q1 resulting in a modest hiring of contract sales headcount, with its markets turning more challenging from November onwards as demand for permanent hires reduced further. That said, of the yoy reduction in fee income c.£1m is attributable to the completion of a project during September, exacerbating the decline in perm NFI. Overall, net fees fell 16% yoy, highlighted by a c.6% reduction in contract NFI and a 38% fall in perm placements. Stripping out the effect of the project, perm NFI declined 23% yoy and overall, the underlying reduction for the Group is c.12% yoy.

The reduction in permanent activity was led by the international businesses and in line with the strategy stated at the year end, the focus remains on contract activity within sectors of the UK, such as energy, defence, and Projects – all areas where the Group has strong levels of expertise. Defence continues to benefit from political instability (+9% yoy, excluding the effect of the RPO exit), with opportunities within energy markets positive (especially in white collar roles), while the pipeline within Projects continues to improve. The next major project is likely to commence during late Q3/early Q4, with the remainder of the pipeline benefitting FY25.

The shortfall in NFI ameliorated between H2 '23 and H1 '24, falling 9%, but on excluding the impact of the cessation of the major RPO project, the underlying decline was lower on a sequential basis.

Recent half yearly movement in fee income



Encouragingly the focus on Business Development has reaped rewards during the period with two large client contracts successfully renegotiated on similar terms and two Managed Service Provider (MSP) wins.

The focus on costs is expected to continue for the foreseeable future, not least to offset the weaker markets experienced YTD and particularly within Q2 but also to rebalance headcount to reflect opportunities and longer-term goals. Our expectation is a retention/modest growth of contract sales headcount, with the Group focused on productivity levels in both perm-related sales and in admin.

Longer-term, the target for the proportion of admin headcount is to move towards best practice, that is a quarter of overall employees, down from 32% currently. We expect this focus to continue into FY25, aided by the wider roll-out of technology across the business.

Net cash was broadly stable from year end levels at £22.1m, representing 68p/share and compares to £21.6m in July '23. The unwinding of working capital as activity levels declined, more than offsetting the cash outflow related to the final dividend and further share buy-backs. The net cash is to be utilised in funding future growth and optimising capital allocation, as highlighted by the recent share buy-backs.

Encouragingly, the Board has stated that it continues to trade in line with consensus expectations, notwithstanding the more challenging Q2. The ongoing focus on costs and resultant higher margins will, ceteris paribus, offset the new lower top-line estimates for FY24 and beyond.

We note the tragic recent loss of Chief Sales Officer, Grahame Carter, following a skiing accident.

Inflection point now passed?

We monitor the **US ISM Manufacturing New Orders index** as a longer leading indicator of the global staffing sector. The index is significant as it closely measures changes in future activity and in turn confidence levels within the world's largest economy.

A reading over 50 highlights that orders have risen from the previous month, while a reading below 50 measures a decline in orders. The index hit an inflection point in October 2023 (reading of 45.5), improving relatively thereafter to a reading of 52.5 in January 2024. Improving order books provides confidence for manufacturers to hire additional staff, thereby resulting in increases in disposable incomes, which ultimately reverberates around the globe.

Longer leading indicator, US ISM Manufacturing New Orders Index

Source: Institute for Supply Management

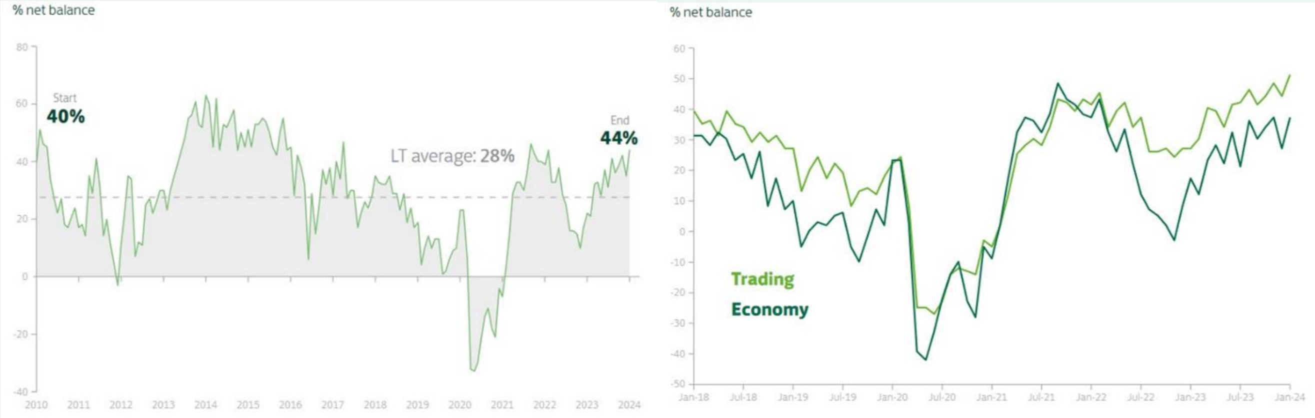
Moving closer to home, we examine one of the UK's longest business surveys, **the Lloyds Bank Business Barometer**, a survey of 1,200 companies measuring confidence within UK businesses every month. The report covers a range of standard monthly questions ranging from business activity, economic optimism to staff levels, wages and prices charged.

Net confidence levels improved nine points to 44% (59% higher, 9% lower month-on-month), reaching the highest level since February 2022 and compares to 17% a year ago. The reading in January 2024 represents the most positive start to a year since 2016 and the largest monthly increase since August 2023. The downward trajectory of inflation during 2023 and a growing belief that interest rates have peaked have bolstered confidence in a soft landing and improving trading prospects.

In fact, a net 37% of firms reported greater economic optimism (57% higher versus 20% anticipating a decline), representing the joint highest level since February 2022. The net balance of trading outlook, rising 7% in the month to 51%, represents the highest reading since April 2017. 60% anticipated stronger business activity in the next 12 months, compared to 9% expecting trading to weaken.

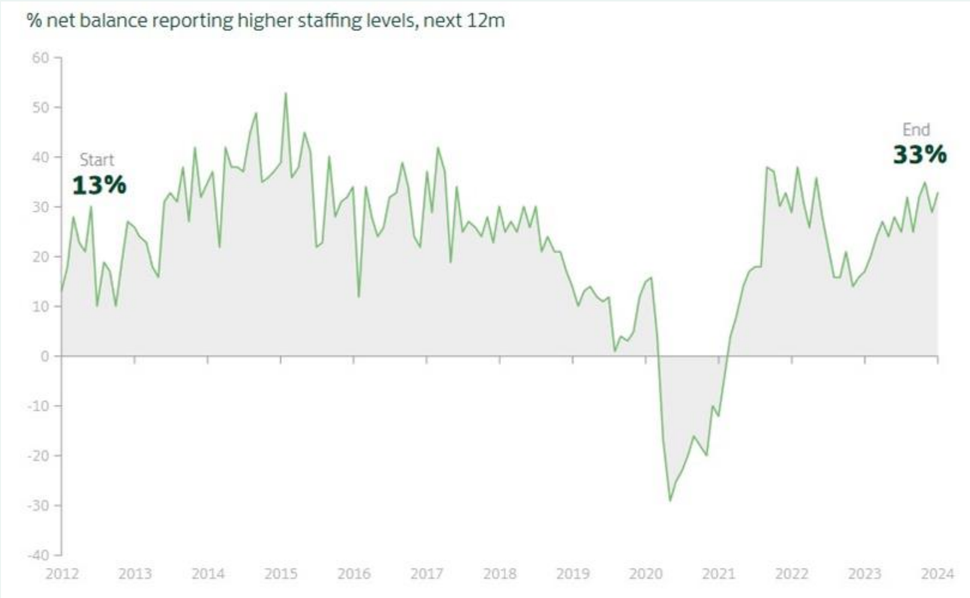
The improvements in business confidence and the trading outlook bodes well for the employment outlook in the UK. Businesses reported a net hiring intention of +33%, increasing four points in the month, as 50% planned to add to their payroll in 2024, while 17% expected to downsize.

Business confidence upbeat, while trading prospects are at the strongest levels in over six years



Source: Lloyds Bank Business Monitor, January 2024

Businesses reported solid hiring intentions for 2024



Source: Lloyds Bank Business Monitor, January 2024

Valuation

There has been a healthy improvement in the share price following the FY23 preliminary results. Nevertheless, as our valuation models suggest, we still believe the current fair value of the Group's shares lies north of the current valuation. We include a discounted cash flow model and peer group comparative models within our fair value calculation.

One should bear in mind our view of where we are in the economic cycle and the implications this has in the recovery of the sector, as confidence returns. It is the returning confidence in the outlook which will result in companies hiring additional staff – initially on a contract basis and as belief builds, in permanent hires.

In turn, the improved environment for hiring will drive fee income levels and enable the Group to achieve (and potentially exceed) our conservative financial estimates. Our DCF model includes conservative assumptions in our opinion:

- A discount rate of 9%, above the long-term average and,
- A terminal growth rate of just 2.25%.

The DCF suggests a fair value / share of 175p, 40% above the current share price.

Discounted Cash Flow valuation

£m, unless otherwise stated	2024F	2025F	2026F	2027F	2028F	2029F	2030F	2031F	2032F	2033F
Free cash flow	-3.0	1.0	2.8	2.9	2.9	3.0	3.0	3.1	3.2	3.3
WACC (%)	9.0	9.0	9.0	9.0	9.0	9.0	9.0	9.0	9.0	9.0
Timing factor	0.3	1.3	2.3	3.3	4.3	5.3	6.3	7.3	8.3	9.3
Discount rate	1.0	0.9	0.8	0.8	0.7	0.6	0.6	0.5	0.5	0.5
Present value	-3.0	0.9	2.3	2.2	2.0	1.9	1.8	1.7	1.6	1.5
Sum of discounted cash flows	12.8									
Terminal growth rate (%)	2.25									
Terminal value	21.8									
Net debt	20.3									
Equity value	54.8									
Number of shares	31.4									
Value per share (p)	**174.5**									

Source: Equity Development

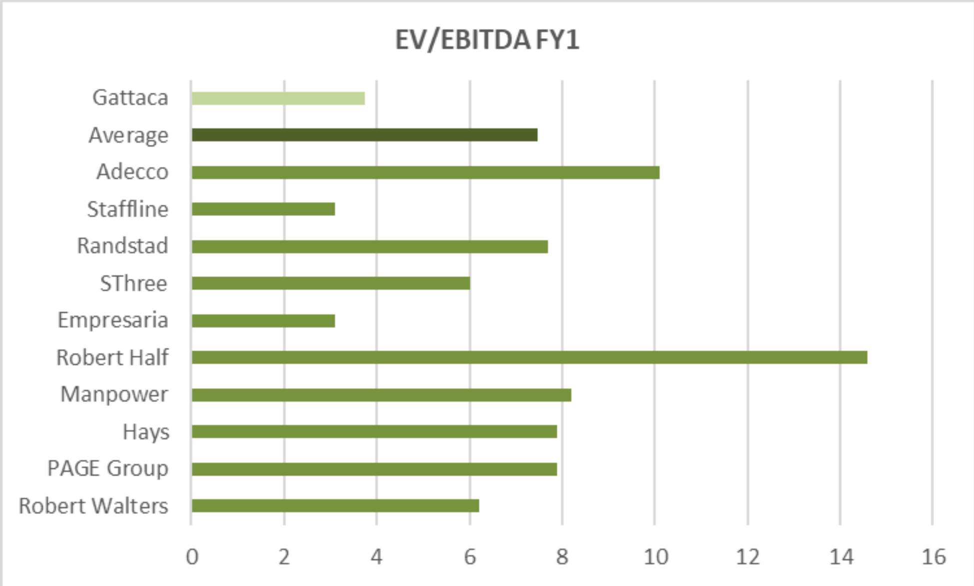
The period end cash of £22.1m, representing 68.2p / share and 57% of the Group's market capitalisation.

On this basis, GATC is valued excluding cash at a FY1 PER of only 11.8x, after stripping out the interest contribution to profitability. This low valuation stands at a higher discount to the one in the following peer group comparison model.

We highlight charts encompassing FY1 EV/EBITDA, FY1 PER and FY1 Yield, with the effect of the net cash not applied to the models. The Group continues to trade at a discount to its peers on a FY1 EV/EBITDA and FY1 PER basis, which we consider to be unwarranted.

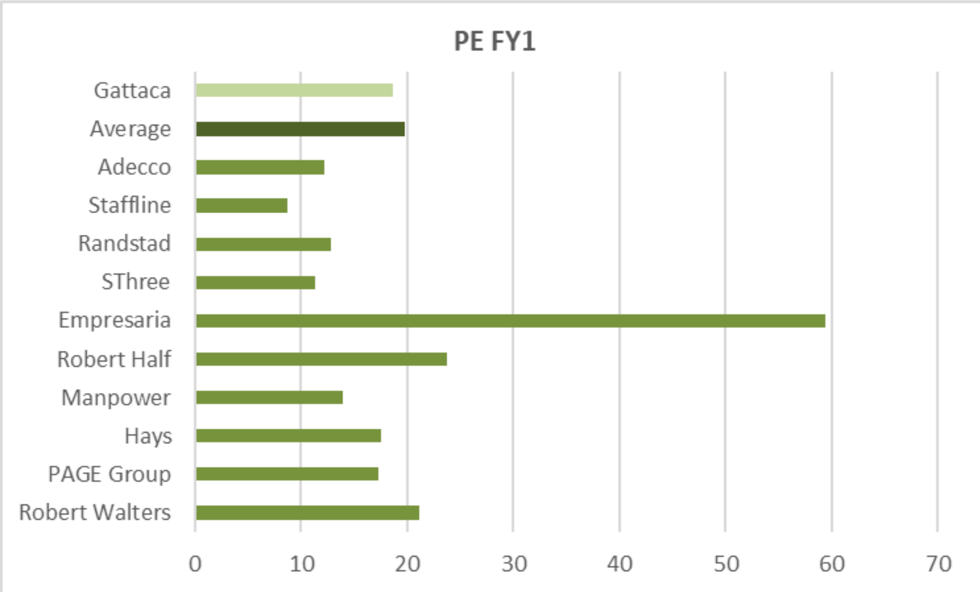
Although the FY1 yield is below its sector average, we estimate strong future growth in the dividend as cover improves and the recovery in its markets feeds through.

Peer group comparative analysis: FY1 EV/EBITDA



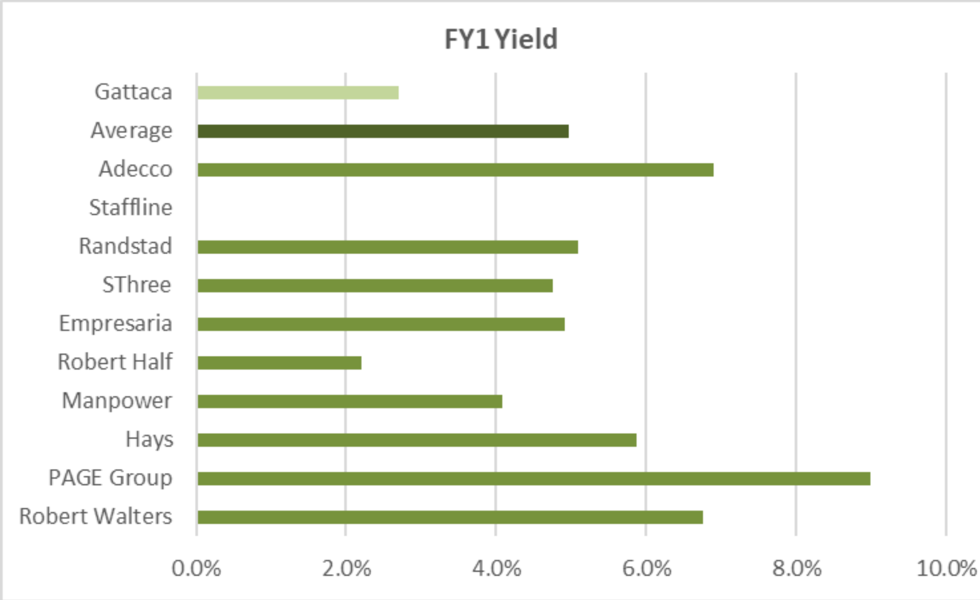
Source: Koyfin

Peer group comparative analysis: FY1 PER



Source: Koyfin

Peer group comparative analysis: FY1 Yield %



Source: Koyfin

Financials

Following a challenging Q2, with confidence levels lower from November to January, affecting permanent placement activity, we have reduced our FY expectations for NFI. However, we note the continued focus on costs and in particular, headcount. As a result, we expect margins to improve, offsetting any ongoing short-term weakness in activity levels. We anticipate improvements to:

- Productivity (NFI/average headcount), as the focus returns to contract and away from international markets
- Contract NFI is expected to grow as a proportion of Group net fees during H2
- Cost levels, as on-going efficiency improvements feed through
- Conversion rates (EBIT/NFI), reflecting the action on costs and
- Net cash to be utilised in expanding working capital as the recovery feeds through.
- The economy, as green shoots appear, with the UK experiencing a soft landing, ahead of expansion commencing in Q4 '24 and beyond

Changes to estimates

Year-end July, £m	Old FY24	New FY24	Change	Old FY25	New FY25	Change
NFI	45.6	40.9	-10.3%	49.1	44.0	-10.4%
Adj. EBIT	2.6	2.2	-15.4%	4.5	4.2	-6.7%
Conversion rate %	5.7%	5.4%	-5.7%	9.2%	9.5%	4.2%
Adj. PBT	2.8	2.8	0.0%	4.7	4.7	0.0%
Adj EPS (p)	6.5	6.5	0.0%	10.8	10.8	0.0%
DPS (p)	3.3	3.3	0.0%	5.4	5.4	0.0%
Net cash	20.3	21.7	6.9%	21.8	22.8	4.6%

Source: Equity Development

Summary Income statement					
Year to July, £m	**2021A**	**2022A**	**2023A**	**2024F**	**2025F**
Revenue	415.7	403.9	385.2	382.2	403.8
CoGS	-373.6	-359.7	-341.8	-341.3	-359.8
Group NFI	42.1	44.2	43.4	40.9	44.0
NFI margin (%)	10.1%	10.9%	11.3%	10.7%	10.9%
Op costs	-39.8	-44.1	-41.1	-38.7	-39.8
EBITDA	4.4	2.8	3.8	3.9	5.9
EBITDA/NFI conversion (%)	10.5%	6.3%	8.8%	9.5%	13.3%
Adj. EBIT	2.2	0.1	2.3	2.2	4.2
Conversion rate (EBIT/NFI, %)	5.3%	0.2%	5.4%	5.4%	9.5%
Net Interest	-0.4	0.2	0.2	0.6	0.5
PBT (Adjusted)	1.8	0.3	2.6	2.8	4.7
Exceptionals	-0.1	-5.0	0.2	0.0	0.0
PBT (Reported)	1.8	-4.7	2.8	2.8	4.7
Tax	-0.1	-0.2	-1.1	-0.7	-1.2
PAT	1.6	-4.9	1.7	2.1	3.5
Profit from discontinued items	-1.2	-0.4	-0.5	0.0	0.0
Minority interests	0.0	0.0	0.0	0.0	0.0
Earnings	0.4	-5.2	1.1	2.1	3.5
EPS (Adjusted) (p)	5.3	0.5	4.5	6.5	10.8
DPS (p)	0.0	0.0	5.0	3.3	5.4
Ave no of shares (FDil) (m)	32.4	32.5	32.7	32.4	32.4

Source: Company historics, Equity Development estimates

Summary Cash Flow

Year to July, £m	2021A	2022A	2023A	2024F	2025F
Adj. EBIT	2.2	0.1	2.3	2.2	4.2
Depn. & Amortn.	0.9	1.1	1.5	1.7	1.7
Working capital movement	-5.4	-3.3	6.7	-1.8	-2.6
Other	-4.3	-0.8	-2.3	-0.7	-0.1
Operating cash flow	-6.6	-3.0	8.3	1.4	3.2
Net Interest	-0.4	0.2	0.2	0.6	0.5
Taxation	-0.5	-0.2	0.1	-0.8	-1.0
Net capex	-0.4	-0.4	0.0	-0.3	-0.3
Pref. dividends	0.0	0.0	0.0	0.0	0.0
Operating FCF	-7.9	-3.3	8.6	0.9	2.4
Net (Acquisitions)/Disposals	0.0	0.0	0.0	0.0	0.0
Dividends	0.0	-0.5	-0.5	-1.4	-1.3
Share Issues	0.1	-0.1	-0.7	-0.5	0.0
Minority payment	0.0	0.0	0.0	0.0	0.0
Other financial	0.4	0.0	-1.8	1.1	0.0
Increase Cash/(Debt)	-7.5	-3.9	5.6	0.1	1.1
Opening Net Cash/(Debt)	27.3	19.9	16.0	21.6	21.7
Closing Net Cash/(Debt)	19.9	16.0	21.6	21.7	22.8

Source: Company historics, Equity Development estimates

Abbreviated Balance Sheet

Year to July, £m	2021A	2022A	2023A	2024F	2025F
Intangible Assets	6.3	2.1	2.1	2.1	2.1
Tangible Assets	1.6	1.4	1.0	0.1	-0.9
Right of use assets	5.7	3.1	3.1	3.1	3.1
Investments/other	1.0	0.6	0.6	0.6	0.6
Net Working Capital	6.2	10.0	7.6	9.4	12.0
Capital Employed	15.1	14.0	11.3	12.1	13.8
Deferred tax	4.3	2.5	2.5	2.5	2.5
Deferred consideration					
Net Cash/(Debt)	19.9	16.0	23.4	21.7	22.8
Provisions Liabilities/Charges	1.3	0.5	0.4	0.4	0.4
Net Assets	29.4	26.9	31.8	30.9	33.7

Source: Company historics, Equity Development estimates

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