Gattaca plc

3rd November 2022

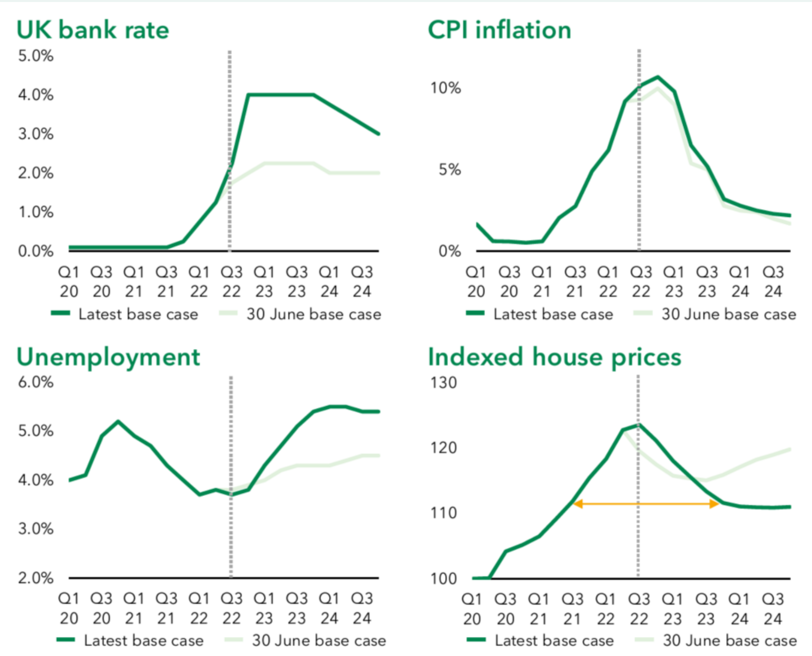
Engineering a lasting turnaround

Prime Minister Rishi Sunak warned us last week that "*difficult decisions*" have to be made in order to "*fix*" the economy. One company though which we think is ahead of curve is STEM recruiter Gattaca having already 'cut its cloth' over the past 2 years & is fully prepared 'come rain or shine'.

Plus, the **UK job market still remains the tightest it's been for years**, with 1 vacancy for every unemployed person – particularly across **GATC's sweet spot of 'difficult-to-find' engineers and technologists,** where widespread shortages exist.

Sure, the future is uncertain. Yet equally, we believe **there's unlikely to be a deep, prolonged recession**, with Lloyds Bank (see below) similarly forecasting a mild economic contraction characterised by unemployment peaking at 5.5% in 2025 vs 3.5% today.

The wheels are not expected to fall off the UK economy



Source: Lloyds (27th Oct'22)

Ok, so if the macro backdrop is sound, how is Gattaca progressing? The good news is that **the turnaround is firmly on track**.

Robust outlook and improving profits

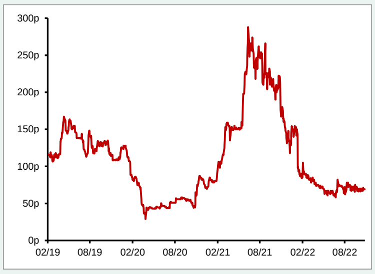
At today's FY'22 results (see overleaf), the group not only posted **'in line'** numbers, with **a**djusted PBT coming in at £0.3m on NFI up +5% to £44.1m. But also added that "***demand is robust***", which alongside **further self-help measures, favourable mix & an industry shift towards using more contractors vs. permanent placements** (re austerity) - is expected to lift FY'23 underlying PBT to £2.5m with profits being H2 weighted.

Elsewhere, the **dividend has been prudently suspended** until the group *"returns to sustainable levels of profitability*". Whilst the **balance sheet remains rock solid**, sporting **net funds of £16m** (or 49p/share) as at Jul'22, after generating **strong H2'22 cashflow** (re debtor days of 51 vs 62 Jan'22) & repaying £5.6m of deferred VAT.

Company Data

EPIC	AIM:GATC
Price (last close)	80p
52 week Hi / Lo	215p/60p
Market cap	£25.8m
Jul'22 net cash (ex IFRS16 & £9.6m of non-recourse debt)	£16m
Share count	32.3m
ED value / share	160p
TNAV/share (July 2022)	86.5p

Share Price, p



Source: Yahoo

Description

Gattaca is the UK's #1 specialist engineering recruitment agency. In FY'22, it delivered NFI up 5% to £44.1m (94% UK vs 6% overseas). 71% of NFI comes from contract/temp assignments with the rest from permanent placements.

July'22 headcount was 539, of which 385 (or 71%) were sales related.

Next news: AGM 6th December 2022

Paul Hill (Analyst)
0207 065 2690
paul.hill@equitydevelopment.co.uk

In fact, **we are tempted to upgrade our modest FY23 forecasts & 160p/share valuation**, but instead have erred on the side of caution. Preferring instead to keep our powder dry until December's AGM trading update**.** Nonetheless, **the stock at 80p trades at below NTAV** (86.5p/share), and on a 0.4x EV/NFI multiple vs peers at >1.0x – thus highlighting the upside potential.

Rebound in H2 vs H1'22 alongside robust cashflow

£'000s (continuing) - July y/e	Act H1'21	Act H2'21	Act FY21	Act H1'22	Act H2'22	Act FY22
UK	-8.1%	43.2%	-19.3%	8.9%	5.8%	7.3%
International	-30.8%	-27.1%	-29.1%	-29.8%	-11.2%	-21.2%
Total underlying NFI	***-33.6%***	***-1.3%***	***-20.2%***	***5.3%***	***4.5%***	***4.9%***
NFI	**20,522**	**21,558**	**42,080**	**21,606**	**22,534**	**44,140**
Adjusted EBITDA	**1,384**	**3,048**	**4,432**	**887**	**1,828**	**2,715**
Adjusted EBIT	**295**	**1,952**	**2,247**	**-108**	**613**	**505**
EBIT/NFI margin	*1.4%*	*9.1%*	*5.3%*	*-0.5%*	*2.7%*	*1.1%*
Underlying overheads	20,227	19,606	39,833	21,714	21,921	43,635
U/L admin as % NFI	98.6%	90.9%	94.7%	100.5%	97.3%	98.9%
Adjusted PBT	**-40**	**1,875**	**1,835**	**-261**	**517**	**256**
Tax	40	-172	-132	0	-154	-154
Underlying PAT	**0**	**1,703**	**1,703**	**-261**	**363**	**102**
Adjusted EPS (diluted)	**0.0p**	**5.3p**	**5.3p**	**-0.8p**	**1.1p**	**0.3p**
NFI (LTM) / head (£ks)			82.2			81.9
Overheads / head (£Ks)			77.8			81.0
Headcount	437		512	540		539
U/L tax rate			*-7.2%*			*-60.2%*
Non-recourse invoice discounting	-12,200	-14,200	-14,200	-10,400	-9,600	-9,600
Deferred VAT	-10,300	-5,600	-5,600	0	0	0
Cash /(recourse debt) - pre IFRS 16	**22,744**	**19,890**	**19,890**	**4,841**	**15,967**	**15,967**

Source: Equity Development.

Fine, but why hasn't Gattaca fared as well as rivals?

This is the number one question on investors' lips. However, to fully understand the performance gap, then one has to turn the clock back to the acquisitions of Networkers International for £57.9m in 2015 and Resourcing Solutions (£9.9m) two years later.

Both deals ultimately proved to be strategic missteps (now written off), with the Board having to allocate considerable resource, money & time recovering the situation.

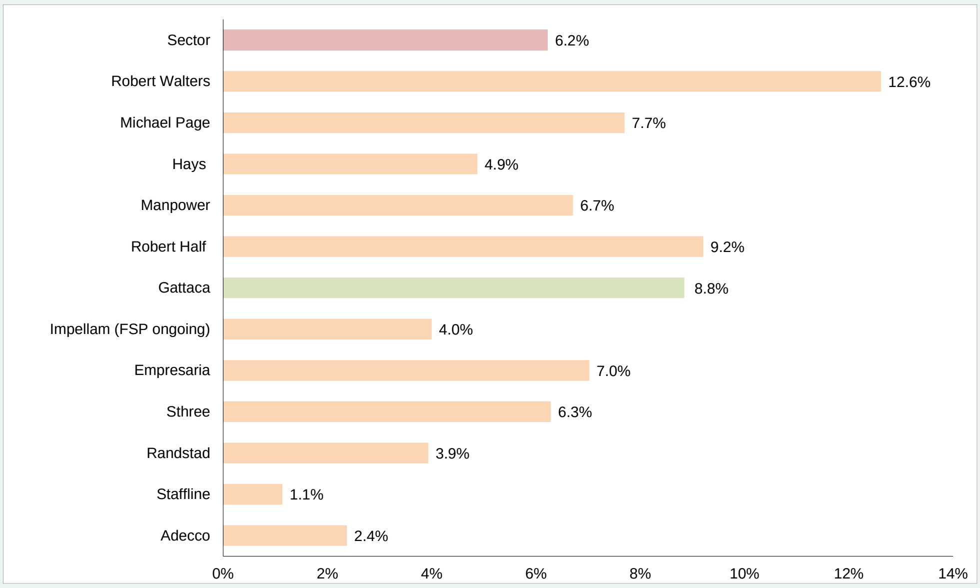
Worse still, after all the heavy-lifting, GATC was then hit by the pandemic in 2020 at the same time as it had implemented a major CRM upgrade (re PBS). Meaning that not only did the business end up cutting costs too aggressively (re loss of fee earners), but it also struggled to capitalise on the subsequent rebound as candidate/client confidence returned.

Going forward, what has impressed us most though, is how the **new management team** have not used these legacy issues as excuses, but instead are **fully committed to return Gattaca to the Premiership**. By executing its 4-point strategy of growing the top line, re-energising staff, optimising productivity, and rebalancing costs.

NFI growth set to accelerate from 4.9% to 8.8% this year

So much so, that we reckon over the next 12 months (see below), **Gattaca is set to deliver high single digit NFI growth**. Aided by shorter communication lines (re management delayering), faster decision making and staff attrition rates that have already begun to improve – falling to 40% in FY'22 vs 45% LY, with a target of 37% by FY'25.

Expected current year NFI growth across recruitment sector

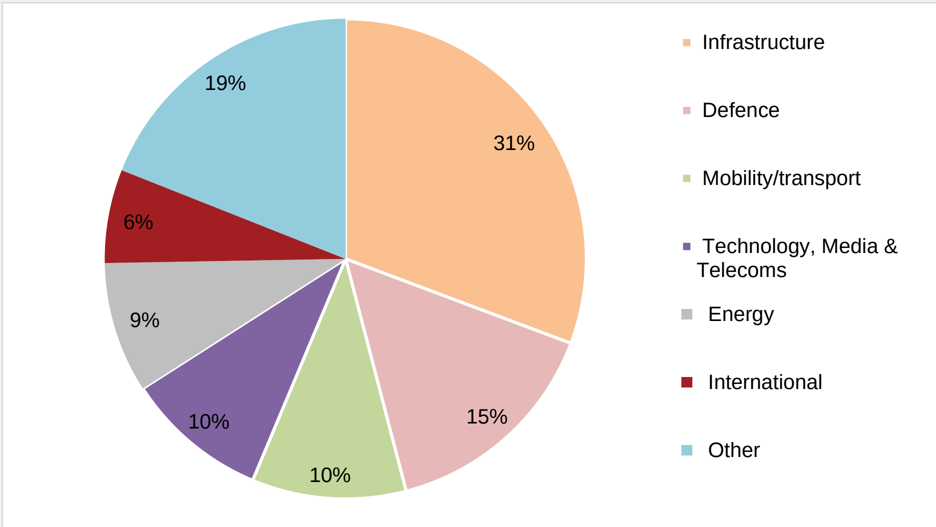


Source: Equity Development.

Long term secular tailwinds

Moreover, sales resource is being focused on the rapidly expanding areas of advanced engineering, cyber-security, defence, renewables (eg off-shore wind) & all things electrification. Supported too by multiyear infrastructure projects (see below) such as the Lower Thames Crossing and Hinckley Point C, despite rumours that the government might trim HS2's scope & budget in 2 weeks' time.

Breakdown of FY'22 NFI (+5% to £44.1m)

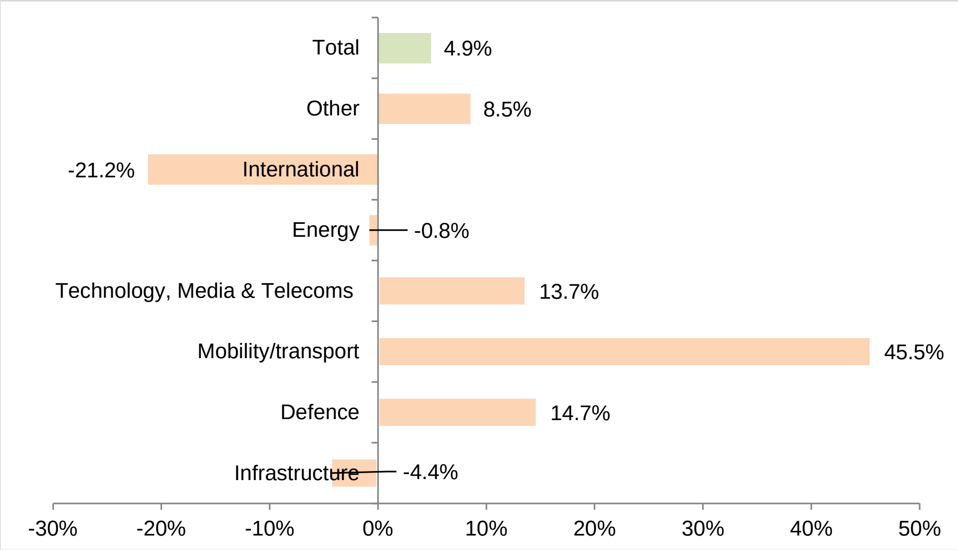


Source: Equity Development

Nevertheless, there is still work to do

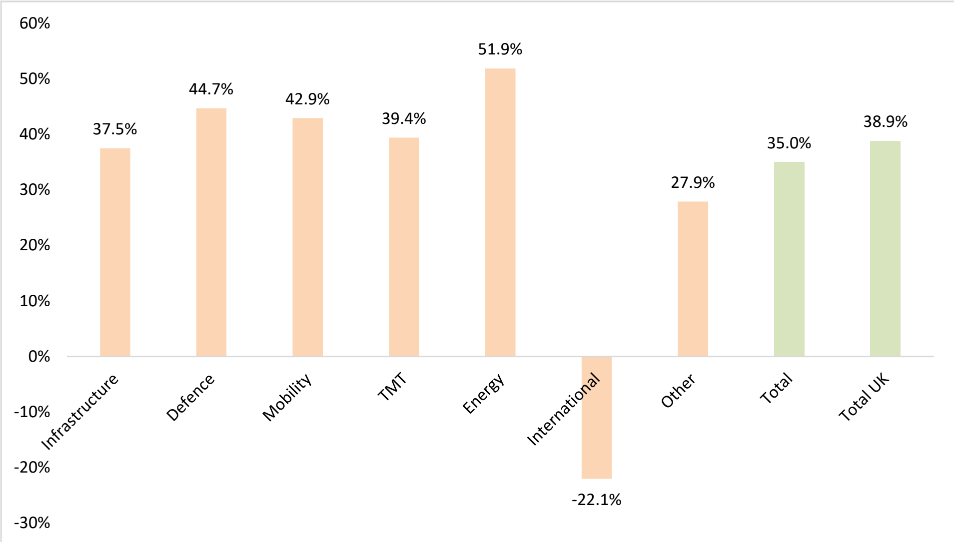
But that's not all. Apart of winning new clients and stemming churn (re 3 accounts lost in H1'22), there is a significant opportunity to transfer best practice across sectors, further improve account mix & boost profit margins, especially in overseas where earnings volatility has been greatest (see below).

FY'22 NFI sector growth rates (%)



Source: Equity Development

FY'22 Operating Contribution margins by sector (%)



Source: Equity Development.

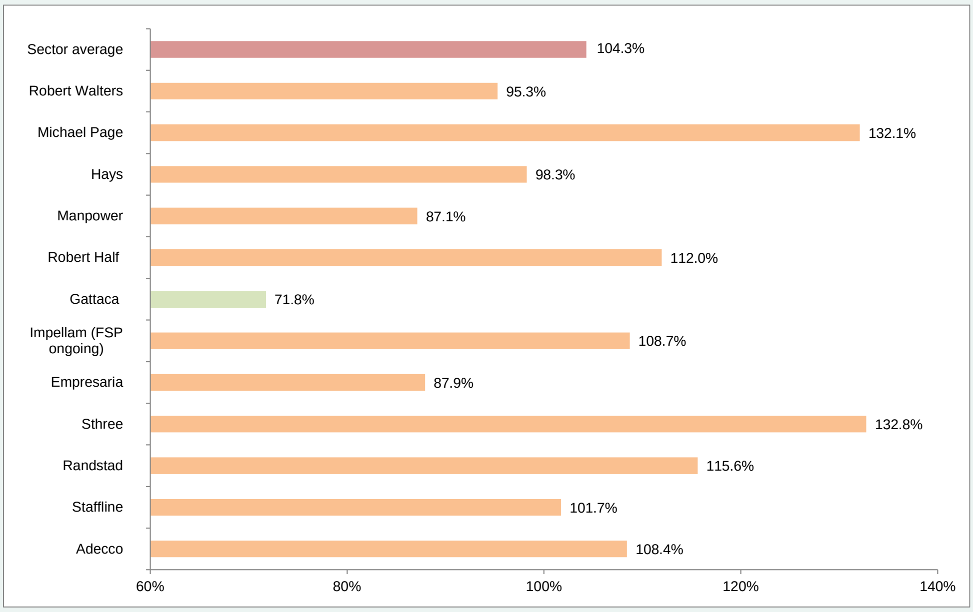
Additionally, as an indication of the 'coiled spring' potential, Gattaca was one of the hardest hit by Covid, and hence still has the greatest upside with regards to returning to pre-pandemic levels (see overleaf).

Scope for future upgrades

CEO Matthew Wragg commenting: "*We are mindful of the current macro-economic conditions, but as a STEM skills-focused business, we do not believe they will have a significant impact on our business model as* ***we continue to see robust demand in our key markets****. There remains a shortage of candidates which plays to our key strength of deep knowledge and understanding of our sectors and niche skills.*

Today, with a new leadership structure, a more engaged workforce, and early signs of more consistent and improved performance, ***we are on track to be a stronger business****.* ***Our expectations for FY'23 remain unchanged at underlying profit before tax of £2.5m for the year****."*

Current year NFI as a % of pre Covid levels



Source: Equity Development.

Chairman Patrick Shanley adding: *"We believe that large infrastructure and defence projects will continue under existing government policies. However, in the UK, spend is likely to be slower to materialise due to economic headwinds and therefore the next 6 months will remain relatively flat."*

Key risks

- Coronavirus induced problems which could delay the anticipated economic recovery.
- General economic downturn affecting engineering and technology recruitment.
- Greater competition, especially from new technology platforms (eg LinkedIn, Monster).
- Remote risk of US Department of Justice action relating to certain Networkers International activities prior to its 2015 acquisition.

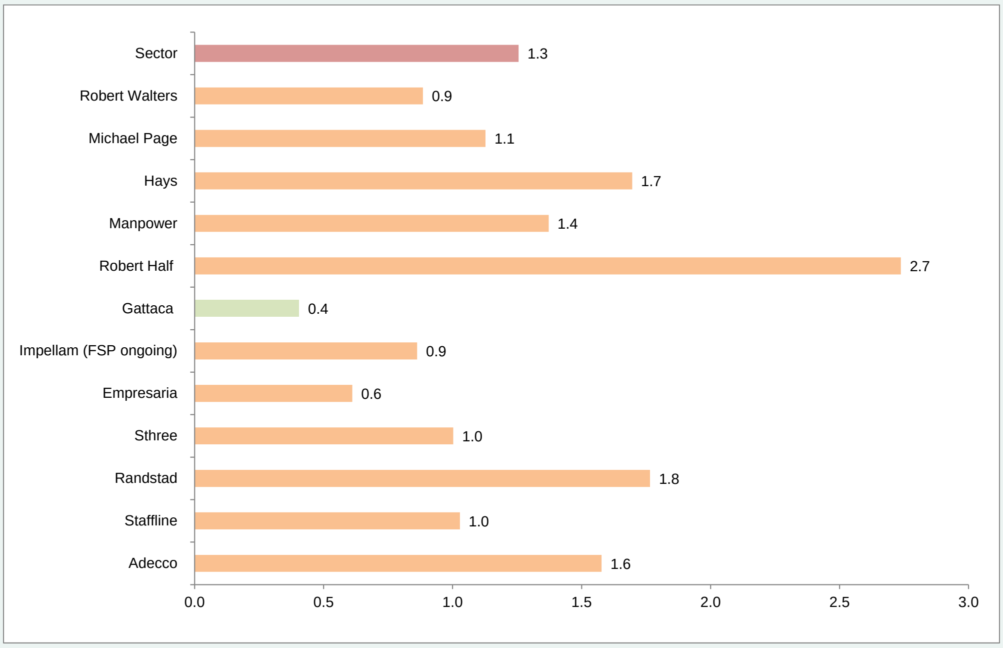
Summary projections (£'000s)

Gattaca (continuing operations) (July yearend)	2020 Act £'000s	2021 Act £'000s	2022 Act £'000s	2023 Est £'000s	2024 Est £'000s	2025 Est £'000s
Net Fee Income (NFI) : Gross profit						
UK Engineering & Technology	47,779	38,552	41,361	44,900	50,457	56,347
International	4,977	3,528	2,779	3,145	3,555	4,017
Total	**52,756**	**42,080**	**44,140**	**48,044**	**54,012**	**60,364**
NFI growth rate						
UK Engineering & Technology	*10.5%*	*-19.3%*	*7.3%*	*8.6%*	*12.4%*	*11.7%*
UK Technology	*-23.5%*					
International	*-15.9%*	*-29.1%*	*-21.2%*	*13.2%*	*13.1%*	*13.0%*
Total NFI growth rate	***-21.2%***	***-20.2%***	***4.9%***	***8.8%***	***12.4%***	***11.8%***
EBITDA	**9,413**	**4,432**	**2,715**	**4,947**	**8,267**	**11,268**
EBITDA/NFI conversion %	*17.8%*	*10.5%*	*6.2%*	*10.3%*	*15.3%*	*18.7%*
UK Engineering & Technology	20,913	12,178	17,696	17,915	20,889	24,173
UK Technology	7,061					
International	1,319	-1,923	-2,234	0	711	803
Central overheads	-23,125	-12,502	-14,957	-15,192	-15,579	-15,978
Adjusted EBIT	**6,168**	**2,247**	**505**	**2,723**	**6,021**	**8,999**
Total Opex as % NFI	*-88.3%*	*-94.7%*	*-98.9%*	*-94.3%*	*-88.9%*	*-85.1%*
EBIT / NFI margin	*11.7%*	*5.3%*	*1.1%*	*5.7%*	*11.1%*	*14.9%*
Net interest	-1,389	-412	-249	-199	-149	-99
Adjusted PBT	**4,779**	**1,835**	**256**	**2,524**	**5,872**	**8,900**
Tax	-995	-132	-154	-555	-1,468	-2,225
Minorities	0	0	0	0	0	0
Adjusted PAT	**3,784**	**1,703**	**102**	**1,969**	**4,404**	**6,675**
Adjusted diluted EPS	**11.7p**	**5.3p**	**0.3p**	**6.0p**	**13.4p**	**20.2p**
Adjusted EPS growth rate	*-57.6%*	*-55.0%*			*122.6%*	*50.8%*
Dividend (p)	**0.0**	**1.5**	**0.0**	**3.0**	**5.0**	**7.0**
Dividend yield	*0.0%*	*1.9%*	*0.0%*	*3.8%*	*6.3%*	*8.8%*
Valuation benchmarks						
P/E ratio (diluted)	*6.8*	*15.2*		*13.3*	*6.0*	*4.0*
EV/NFI	*0.37*	*0.46*	*0.44*	*0.41*	*0.36*	*0.32*
EV/EBITDA	*2.1*	*4.4*	*7.2*	*3.9*	*2.4*	*1.7*
EV/EBITA (diluted)	*3.2*	*8.7*		*7.1*	*3.2*	*2.2*
PEG ratio	*-0.12*	*-0.28*			*0.05*	*0.08*
Adjusted corporate tax rate	*-20.8%*	*-7.2%*		*-22.0%*	*-25.0%*	*-25.0%*
Adj ROACE	*8.7%*	*3.3%*	*0.8%*	*4.4%*	*9.4%*	*13.4%*
EBITDA drop through rate as % NFI				*57.2%*	*55.6%*	*47.2%*
Net recourse cash/(debt) pre IFRS 16	**27,341**	**19,890**	**15,967**	**17,053**	**19,011**	**22,044**
Non recourse invoice factoring (off Balance Sheet)	-13,800	-14,200	-9,600	-9,600	-9,600	-9,600
Diluted sharecount	*32,353*	*32,358*	*32,500*	*32,661*	*32,824*	*32,987*
Shareprice (p)	**80p**					

Source: Equity Development

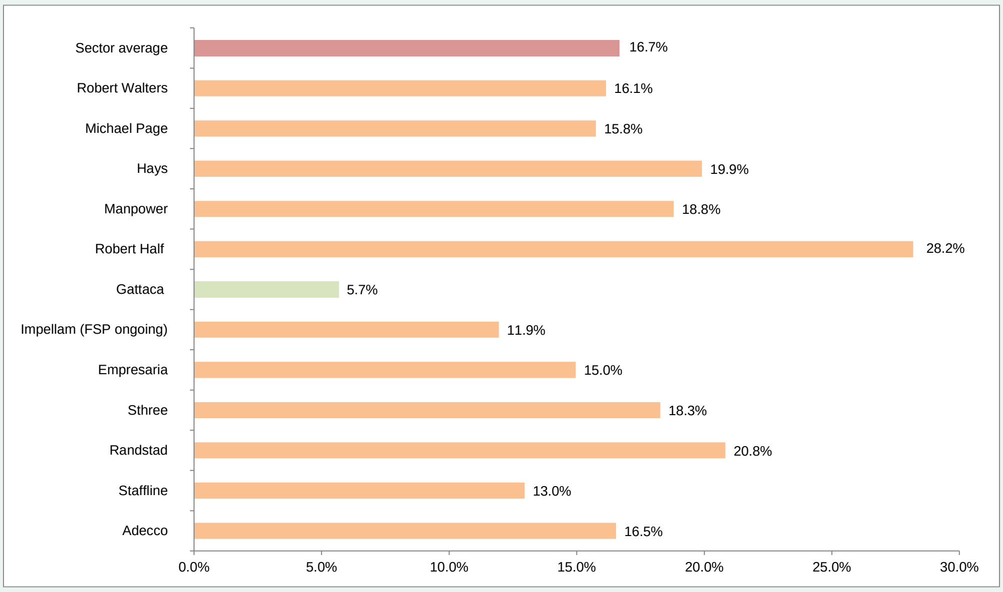
Appendices - sector valuation metrics and KPIs

Current Year (CY) EV/NFI multiples vs peers



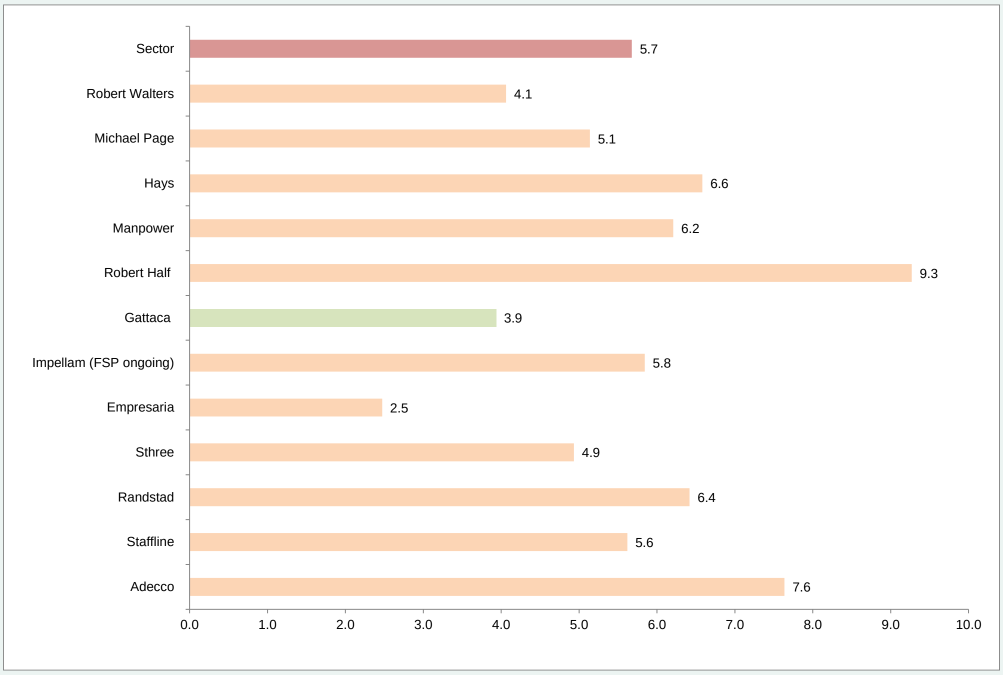
Source: Equity Development

Current Year (CY) EBIT / NFI conversion rates



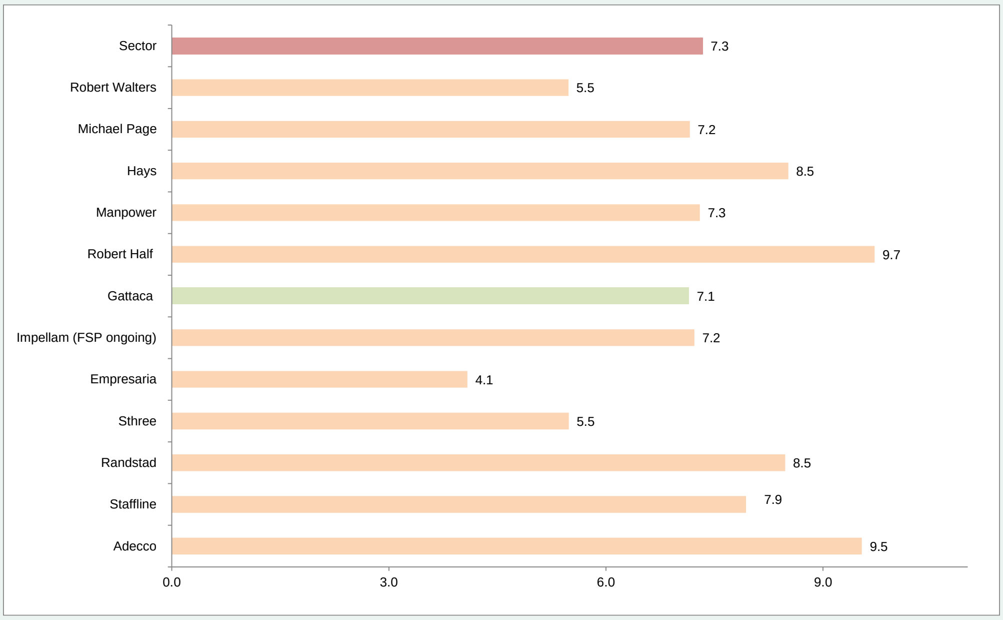
Source: Equity Development

CY EV/EBITDA multiples vs peers



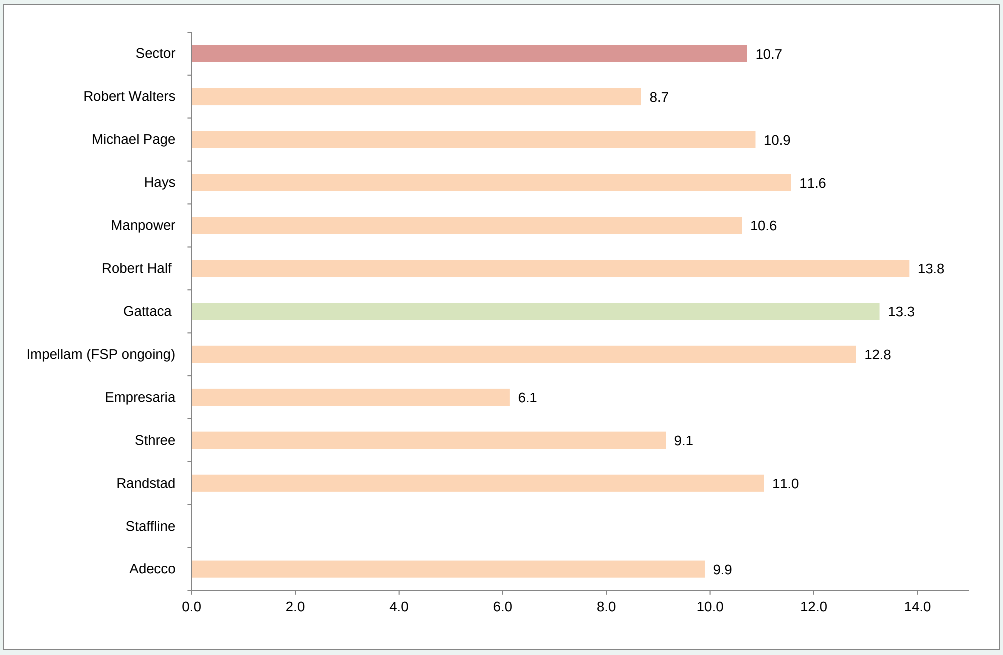
Source: Equity Development

CY EV/EBIT multiples vs peers



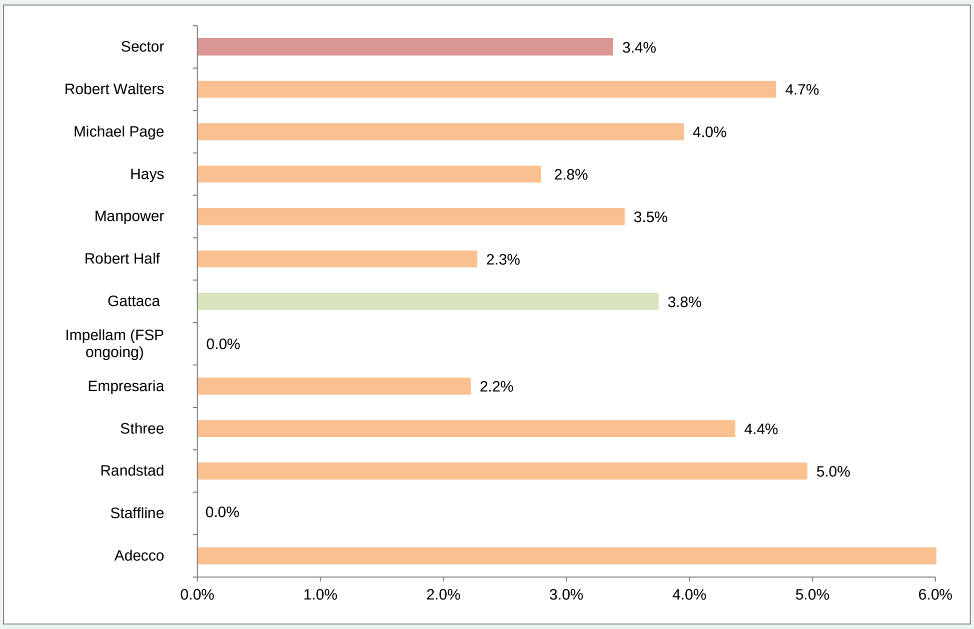
Source: Equity Development

CY PERs multiples vs peers



Source: Equity Development

CY dividend yield (%)



Source: Equity Development

Market capitalisation of peers

	Shareprice	Mrk Cap (Millions)	CY net cash / (debt) Millions	Enterprise Value (Millions)
Adecco	€ 30.98	€ 5,359	-€ 2,347	€ 7,706
Staffline	41p	£68.9	-£21.6	£90.5
Randstad	€ 50.00	€ 9,165	-€ 482	€ 9,647
Sthree	383p	£512.5	£62.5	£450.0
Empresaria	54p	£27.5	-£12.5	£40.0
Impellam (FSP ongoing)	610p	£275.1	£18.0	£257.1
Gattaca	80p	£25.8	£6.4	£19.5
Robert Half	$76.00	$8,360	$619	$7,741
Manpower	$78.00	$4,056	$20	$4,036
Hays	111p	£1,976	£93	£1,883
Michael Page	435p	£1,396	£122	£1,274
Robert Walters	510p	£388.1	£46.0	£342.1

Source: Equity Development

Contacts

Andy Edmond
Direct: 020 7065 2691
Tel: 020 7065 2690
andy@equitydevelopment.co.uk

Hannah Crowe
Direct: 0207 065 2692
Tel: 0207 065 2690
hannah@equitydevelopment.co.uk

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More information is available on our website www.equitydevelopment.co.uk

Equity Development, Park House 16-18 Finsbury Circus, London EC2M 7EB

Contact: info@equitydevelopment.co.uk | 020 7065 2690