Gattaca Plc

Robust foundations in place

24 October 2023

The implementation of the ‘four pillars’ of Gattaca’s new strategy resulted in adj. EBIT rising significantly, as did conversion rates too (up to 5.4% vs 0.2%).

Impressively, this was achieved despite the Group’s markets turning more challenging during H2. NFI fell by 8.5% yoy, down by 1.8% in FY23, with a targeted exiting of lower margin contracts a factor.

We think there is more progress to come, particularly as the new hires bear fruit, additional cost savings emerge (particularly in property), and its markets recover from H2 onwards.

- Gattaca has clearly turned a corner, as self-help on costs, marketing, an improved culture, dropping low margin contracts and improved productivity levels all combine to offset the impact of more challenging markets. Conversion rates improved further to 6.9% in H2 ’23.
- Consultant headcount has started to increase again in Q1 ’24, which should help to reach the medium-term goal of contract revenues accounting for 80% of NFI. There is unlikely to be material help from its markets in the immediate - but we anticipate that productivity levels should rise further, aided by technology/digitalisation of processes, and with it the conversion rate. Consequently, we have left our financial estimates unchanged.
- The high level of net cash (£23.4m at July year-end) provides many opportunities for the Group. We think the funding of growth (a targeted expansion of headcount and working capital), the underpinning of dividend progression, further potential share buy-backs and possible bolt-on acquisitions will all be under consideration.
- We note the Board changes announced alongside the results and believe these comprise the next phase and rubber stamp the success of the Executive team since their appointment in March 2022. We highlight those changes in greater detail inside this review on page 6.

Valuation and rating still too low

Looking ahead there should be some recovery visible in recruitment markets over the next 12 months. At Gattaca we expect further improvement in the conversion rate and are comforted by net cash / share amounting to 75p (leaving the business rated on far too low multiples).

Based on a discounted cash flow model we raise our Fair Value to 175p per share.

Summary estimates

Y/e July, £m	FY21A	FY22A	FY23A	FY24E	FY25E
NFI	42.1	44.2	43.4	45.6	49.1
EBITDA	4.4	2.8	3.8	4.4	6.3
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	0.2	0.2	0.2	0.2	0.2
EV/EBITDA	1.7	2.7	2.0	1.7	1.2
PER	18.4	204.7	21.5	14.8	9.0
Yield	0.0%	0.0%	5.2%	3.4%	5.6%
Net cash	19.9	16.0	23.4	20.3	21.8

Source: Company historics, ED estimates

Company Data

EPIC	AIM: GATC
Price (last close)	97p
52 weeks Hi/Lo	123p/66p
Market cap	£30.9m
ED Fair Value / share	175p
Net cash (Jul ’23)	£23.4m

Share Price, p

Source: ADVFN

Description

Gattaca plc is a specialist STEM (Science, Technology, Engineering, and Mathematics) staffing solutions business. In FY23 it delivered net fees (NFI) of £43.4m – of which 74% was derived from temporary/contract placements, with the remainder permanent activity.

Average headcount throughout FY23 was 502 (vs. 534 in FY22), of which 347 (69% were sales related).

Next news**:** AGM in December

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Healthy progress despite the market

Preliminary results			
Y/e July, £m	**FY22**	**FY23**	**Change**
UK	395.9	378.6	-4.4%
International	8.0	6.5	-18.0%
Total revenue	403.9	385.2	-4.6%
CoGS	-359.7	-341.8	-5.0%
UK	41.4	41.2	-0.4%
International	2.8	2.2	-22.2%
Total NFI	44.2	43.4	-1.8%
NFI margin (%)	10.9%	11.3%	3.0%
NFI/Consultant	116.0	125.1	7.8%
NFI/Headcount	82.8	86.5	4.4%
OpEx	-44.1	-41.1	-6.9%
Adj. EBITDA	2.8	3.8	37.0%
EBITDA (%)	6.3%	8.8%	
Adj. EBIT	0.1	2.3	3322.1%
Conversion rate	0.2%	5.4%	
Net i/r	0.2	0.2	
Adj. PBT	0.3	2.6	710.1%
Taxation	-0.2	-1.1	
Tax (%)	51.4%	42.7%	
Adj. PAT	0.2	1.5	
Adj. EPS (p)	0.5	4.5	850.5%
DPS (p)	0.0	5.0	
Net cash / (debt)	16.0	23.4	45.9%
Net cash / share (p)	49.6	73.4	47.9%

Source: Company data, ED

The FY23 outcome is in-line with the pre-close trading update issued in mid-August. To us, the improvement in profitability was outstanding and highlights that the strategy implemented by the relatively newish Board (appointed in March 2022) is proving fruitful.

We think the recovery in profitability has further to go with management **targeting a conversion rate of 10%-15% during FY26**, levels that look achievable and are still below previous peaks.

The new strategy is founded on:

- A simplified brand architecture, coupled with increased marketing spend,
- An overhaul of the structure, focused on employee engagement, reduced attrition, with both linked to bonus/LTIP targets for managers,

- Improved operational performance – review of low margin contracts and to seek productivity gains, and
- Cost rebalancing – elimination of duplicated costs, reduction of third-party costs, invest in automation of processes, a simplification of the Group's corporate structure and, migrate clients to online billing/timesheet processes.

The progress against those strategic aims has been impressive, as yields have improved (perm fees and timesheet values markedly higher yoy), while two new major clients were secured. Engagement scorecards continue to improve, with attrition lower and particularly within those employed for 12-24 months. NFI productivity improved yoy, with a Head of Business Improvement appointed during the period.

The largest cost reduction was in property, as management took advantage of break clauses re two leases. Over 80% of contractors now submit their timesheets online (increasing accuracy and reducing the associated administration burden), with further focus on the Group's corporate structure.

There are more gains to come from this process, with an expectation that sales capability is likely to grow 10% across several target sectors during FY24. As markets recover attrition rates typically rise and this remains a key focus of the management team, with new onboarding and leadership programmes expected to help in this regard.

We expect productivity (NFI/average headcount to rise 6%+ yoy) as further efficiencies and improved standards are delivered (including a reduction in the use of job boards). Further cost savings should emerge within the ongoing property requirement, as well as the implementation of digital delivery processing for clients and candidates.

Divisional NFI breakdown

Contract fee income improved 2% yoy to £32.0m on an underlying basis, while perm fees declined 12%. During FY23, the average number of sales consultants fell 9% to 347 (overall headcount was 6% lower), with low margin contract exits accounting for the remainder of the decline.

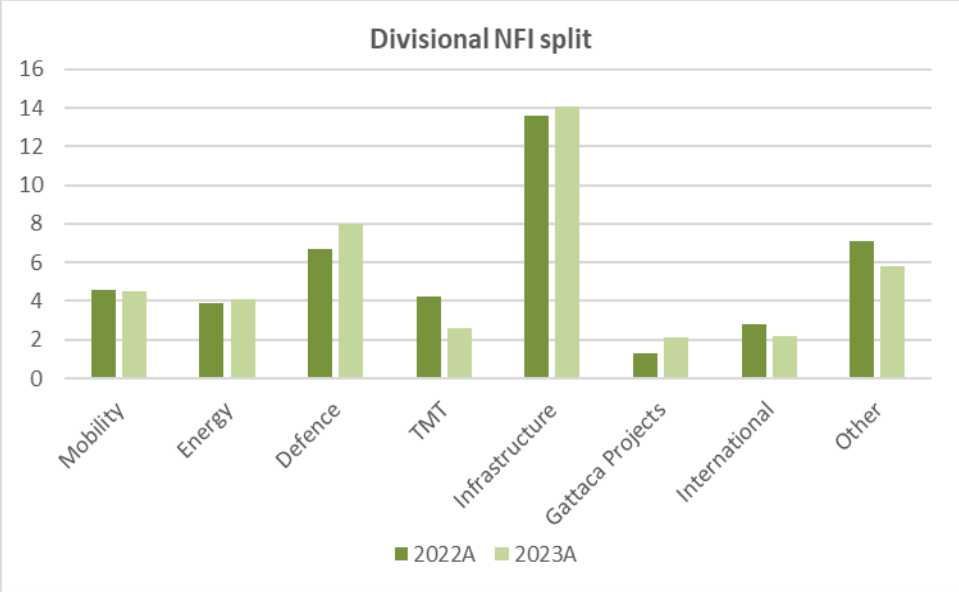
Overall, NFI was broadly unchanged yoy (-2% to £43.3m). Contract represented 74% of net fee income, compared to 71% a year earlier.

UK NFI declined 4%, while international fee income fell by 27%, with the latter having a higher exposure to permanent placements within the tech market. A focus on contract placements and alignment with UK processes should see an improvement within the international business during FY24.

The two largest categories, **Defence (political instability) and Infrastructure (improved contract demand for white collar roles) performed particularly well** during FY23 and increasing their combined share of fee income to 51% (FY22: 46%). The smaller Gattaca Projects delivered a strong yoy improvement, rising 59% to £2.1m.

Fee income declined 8.5% yoy during H2, which followed a 5.2% uplift during H1. Sequentially, NFI declined 9.1% during H2.

Divisional NFI breakdown

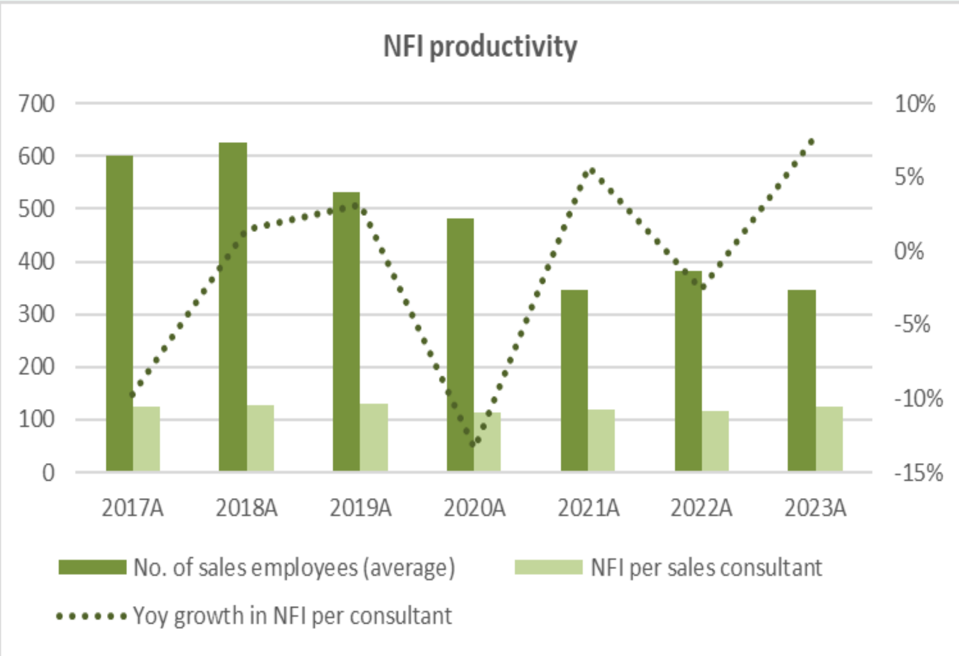


Source: Company, ED

Productivity improved, as measured by NFI/average sales heads and by NFI/average headcount, rising 7.8% to £125.1k (versus £116.0k in FY22) and by 4.4% to £86.5k, respectively. The number of consultants fell 8.9% to 347, while overall headcount declined 6.0% to 502.

In fact. the level of NFI/consultant rose to the highest level since FY19, in turn confirming that the new strategy is having a positive effect on the top-line.

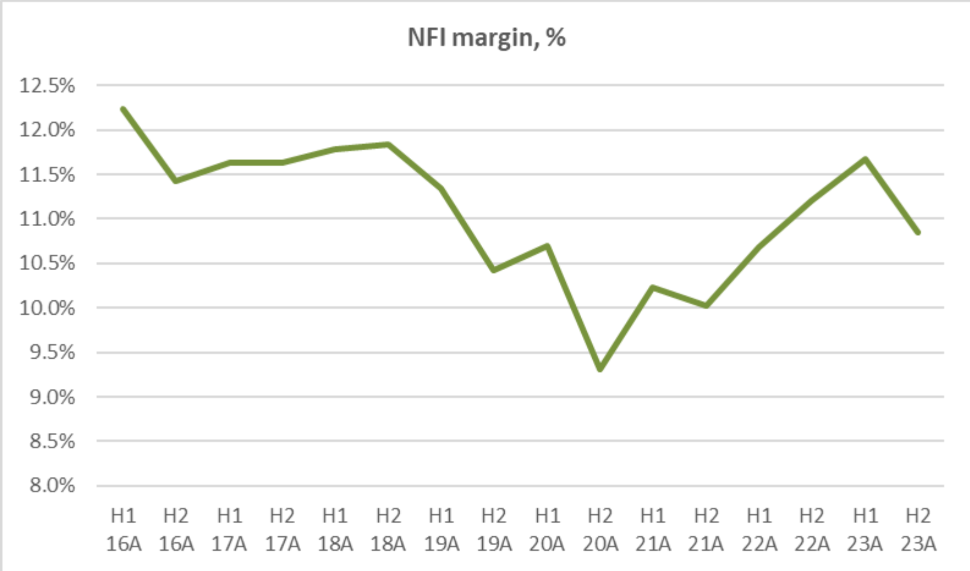
Improving levels of productivity



Source: Equity Development

The overall NFI margin improved modestly during the year to 11.3% (FY22: 10.9%), albeit during H2 it slightly fell back to 10.9%, reflecting the shift from perm to contract NFI. **The NFI margin rose to 11.7% during H1, its highest level since H2 '18.**

NFI margin progression



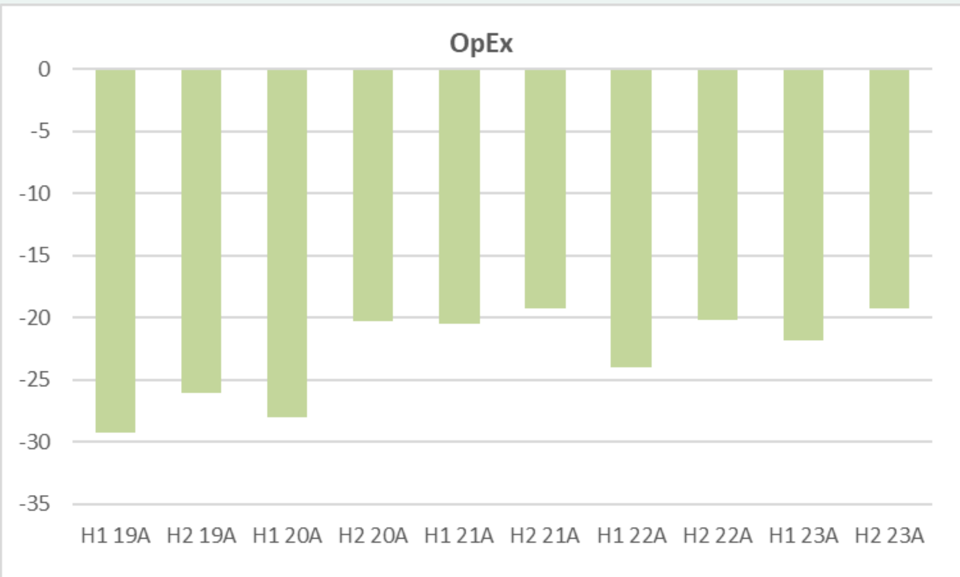
Source: Company, ED

With NFI broadly stable (and declining during H2), it was important that the Group could reduce overheads and improve margins to drive an improvement in profitability.

OpEx declined yoy by 6.9% or £3.1m to £41.1m. In fact, during H2 '23 OpEx fell to the joint lowest level for many years, to £19.3m in line with strategy. Of the overall decline in FY23, the greatest savings were experienced in:

- A reduction in lease costs, saving £0.7m
- Lower commissions paid (-£1.0m) because of underperformance in a minority of sectors
- The reduction in headcount modestly offset higher salaries/promotions, and
- Other admin costs rose £0.2m yoy.

OpEx costs, approaching recent lows (£m)

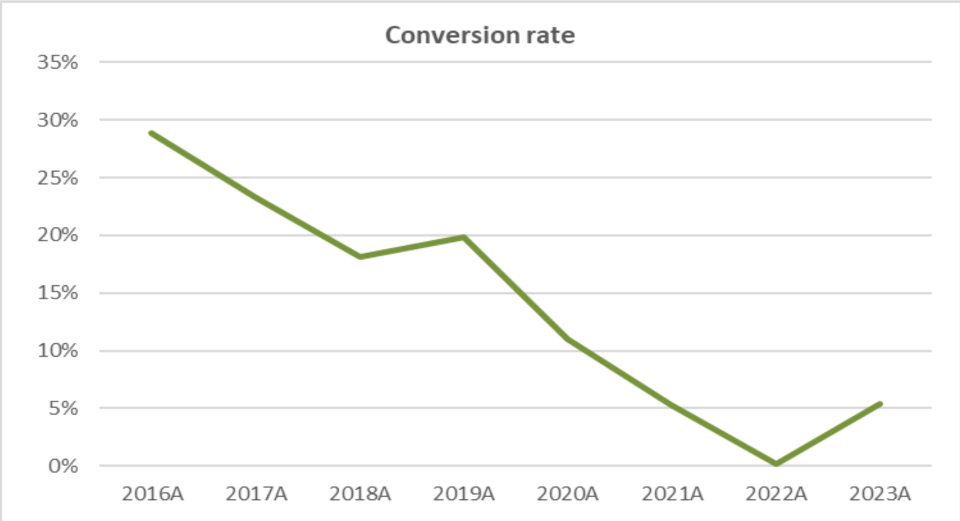


Source: Company, ED

The chart below demonstrates the deterioration in the conversion rate between FY16 and FY22 and the improvement or inflection point passed during FY23. Adj. EBIT of £2.3m (FY22: £0.1m) resulted in an improvement in the conversion rate to 5.4% in FY23 (further improving during H2 '23 to 6.9%), the highest level achieved since FY20. A combination of improving fee income, higher average rates on placements, market recovery, and the ongoing self-help programme (culture, productivity, external focus, and cost reduction) **augurs well** going forward.

The medium-term target for the conversion rate is 10%-15%, at least double the level witnessed during FY23 and suggesting strong upside, particularly as the combined effect of the recruitment of sales heads takes effect and economic uncertainty abates.

Progression in the conversion rate – EBIT/NFI (%)



Source: Company, ED

Net interest was broadly unchanged on an underlying basis at £0.2m, resulting in adj. PBT of £2.6m (FY22: £0.3m). Tax on an underlying basis of £1.1m (FY22: £0.2m) results in adj. and diluted EPS of 4.5p (FY22: 0.5p).

The Group has paid its first dividend since FY18, with a 2.5p final dividend and a special dividend, totalling 5p per share payable in January. Also, the Group purchased £0.7m of shares during the year, of which £0.5m were cancelled, with the remainder for treasury/executive incentivisation purposes.

Board changes

The shake-up of the Non-Executive Directors, with three leaving and one appointment represents the final phase which commenced with the promotion of Matthew Wragg as CEO and Oliver Whittaker as CFO in March 2022. We have referenced on several occasions within this review the success of the new strategy and, clearly, this has accelerated the current moves.

Richard Bradford, previously a NED of the business (2011-2020), returns to replace Patrick Shanley as Independent Non-Executive Chair. Richard has extensive experience both in the UK and internationally of leading solutions/services/facilities management businesses.

George Materna, the founder of the business in 1984, steps down from his role as Deputy Chairman. George will not be replaced on the Board and has stated his intention to retain his shareholding.

Ros Haith, the Independent Non-Executive Director will step down from the Board at the AGM. Following the changes, the Board will comprise two executives and three Non-Executive members, including David Lawther and Tracey James.

Valuation

Despite a recent recovery in its share price, Gattaca still appears overlooked by investors.

This stems from the marked discounts on which it trades relative to the average of its peer groups (and highlighted in the charts below). One should also bear in mind that GATC has a FY1 yield of 3.4%, representing a 24.5% discount to its peer group, although we anticipate that growth into FY25 will push levels ahead of its peers.

While we anticipate that cash will be utilised in growing the business (contract placements tend to be cash consumptive), the net balance provides the Board with scope to further consider further share purchases, special dividends, and potentially bolt-on acquisitions.

We have spoken earlier of the improving returns and rising productivity levels, highlighting that the turnaround of the business is well underway. As its markets recover, we expect returns to ultimately rise to a medium-term target of 15% (conversion rates were in the high teens as recently as FY18 and FY19, albeit this was well below peak levels).

We have constructed a discounted cash flow model with its suggested fair value outcome underpinned by the valuation gap relative to its peers. Our DCF is based on conservative assumptions:

- A discount rate of 9%, and
- A terminal growth rate of just 2.25%.

The model suggests a fair value / share of 174.5p, which represents an 80% premium to the current share price.

Gattaca: 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 cash	20.3									
Equity value	54.8									
Number of shares,m	31.4									
Value per share (p)	174.5									

Source: Equity Development

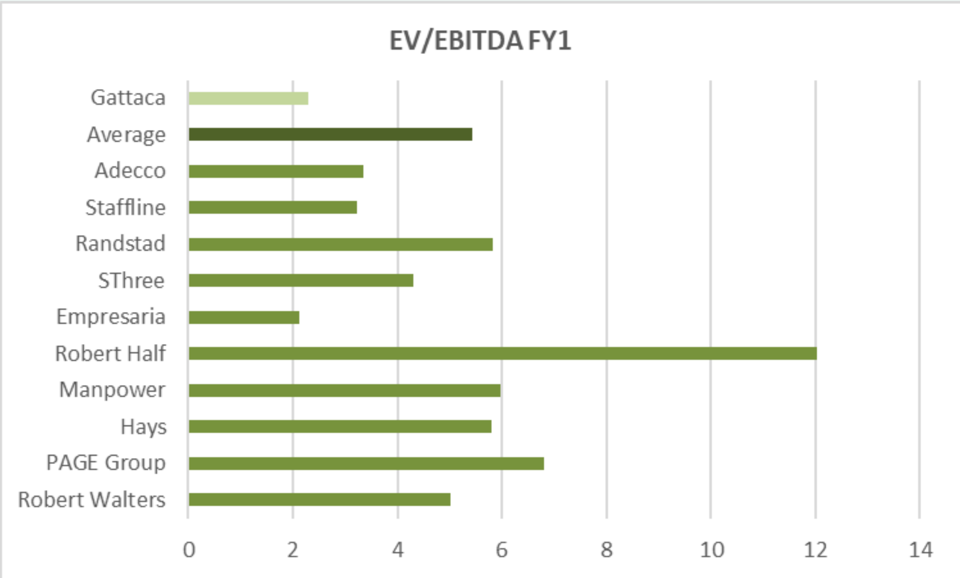
At the period end net cash increased to £23.4m or 73.4p / share, representing 75.7% of the market capitalisation.

On this basis, the Group is valued at a FY1 PER, ex-cash of just 3.9x (after stripping out the interest contribution to profitability).

Our comparative peer group analysis considers FY1 EV/EBITDA, FY1 PER, FY1 EV/Sales, FY1 Price/Book and FY1 Yield. GATC trades at a clear discount to its peer group average on four of the five metrics. The Group's FY1 PER is modestly ahead of its peer group average (14.8x vs 14.5x), albeit we expect growth in GATC's EPS to recover strongly into FY24 and FY25 and as such, the PER will decline quickly over this period as market recovery and self-help feed through.

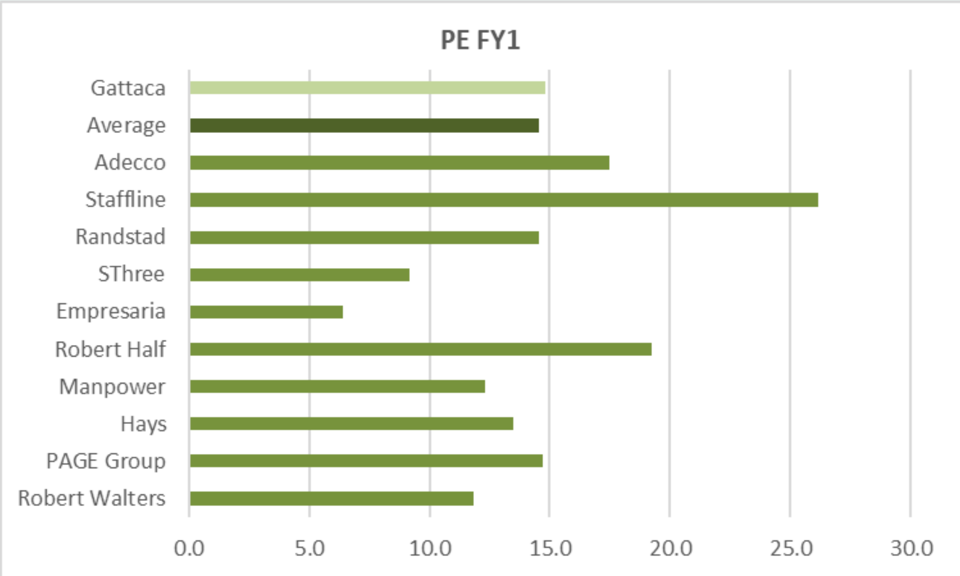
Although the yield is below average currently, one should bear in mind that dividend cover of 1.8x (excluding the special dividend) in FY23 is set to rise in FY24 and FY25. We estimate growth in the dividend of 32% in FY24.

Peer group comparative analysis: FY1 EV/EBITDA x



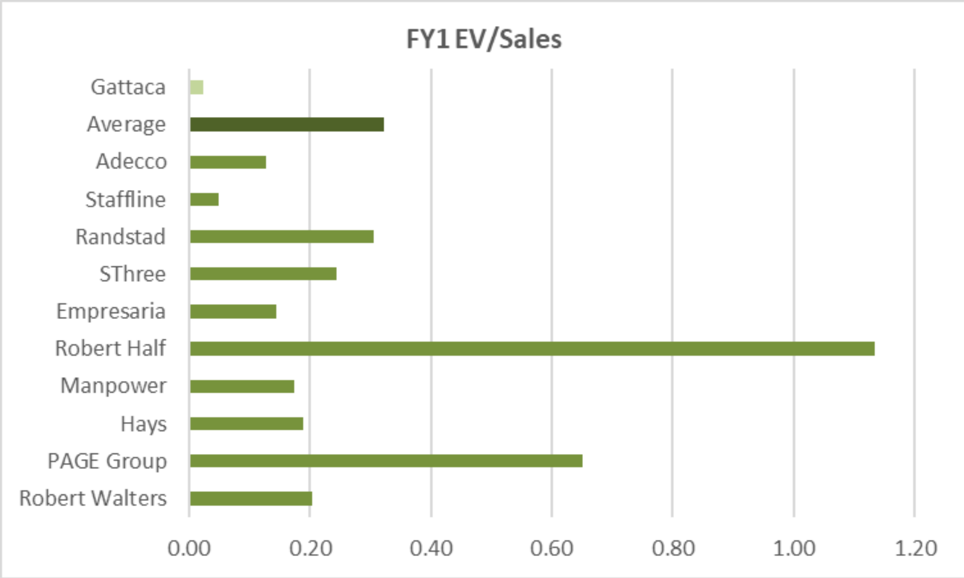
Source: MarketScreener, ED

Peer group comparative analysis: FY1 PER x



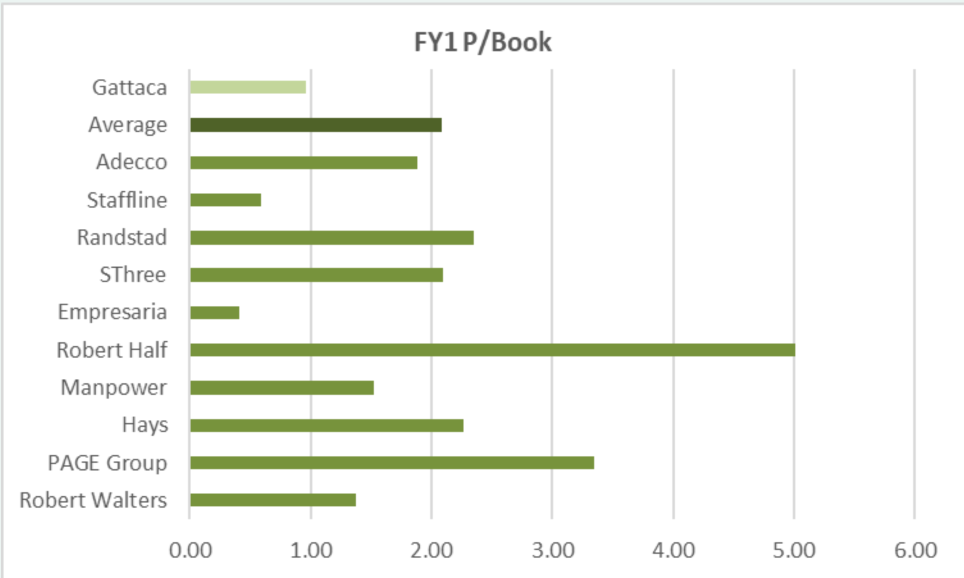
Source: MarketScreener, ED

Peer group comparative analysis: FY1 EV/Sales x



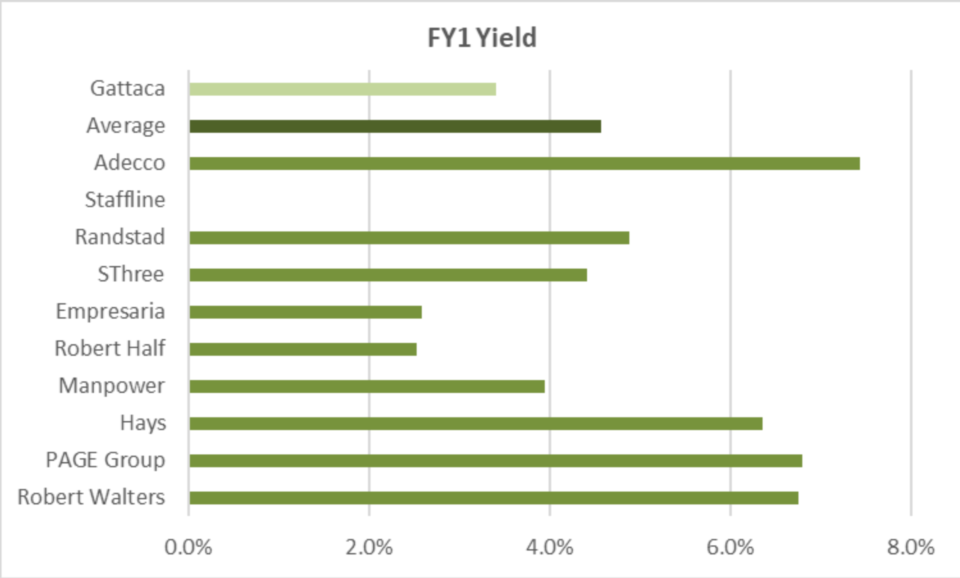
Source: MarketScreener, ED

Peer group comparative analysis: FY1 Price/Book x



Source: MarketScreener, ED

Peer group comparative analysis: FY1 Yield %



Source: MarketScreener, ED

Group Financials

Following the publication of FY23 preliminary results we have left estimates unchanged. Guidance provided by the Board suggested that the business continues to trade in-line with expectations for FY24, although with little help from its markets in the short term we expect the weighting of NFI and EBIT to favour H2.

We anticipate a continuation of the following trends within the business during FY24:

- Further productivity improvements (rising NFI/average headcount) to c.£92k (+6.4% yoy)
- Growth in sales headcount, particularly contract (which commenced during Q1 and reflecting market activity)
- Improvement in the wider STEM market, with vacancies at good levels currently
- Green shoots appearing in the UK economy, and
- A further reduction in the cost base – not least in property requirements

Also, management suggested the conversion rate should improve further during FY24, on a higher level of net fees.

We note the challenges within the sector currently, with uncertainties in the economy resulting in reduced demand for permanent hires generally. Growing fee income is unsurprisingly focused on contractor growth, with a medium-term target of 80% of NFI by the end of FY25.

Net cash improved further, reflecting:

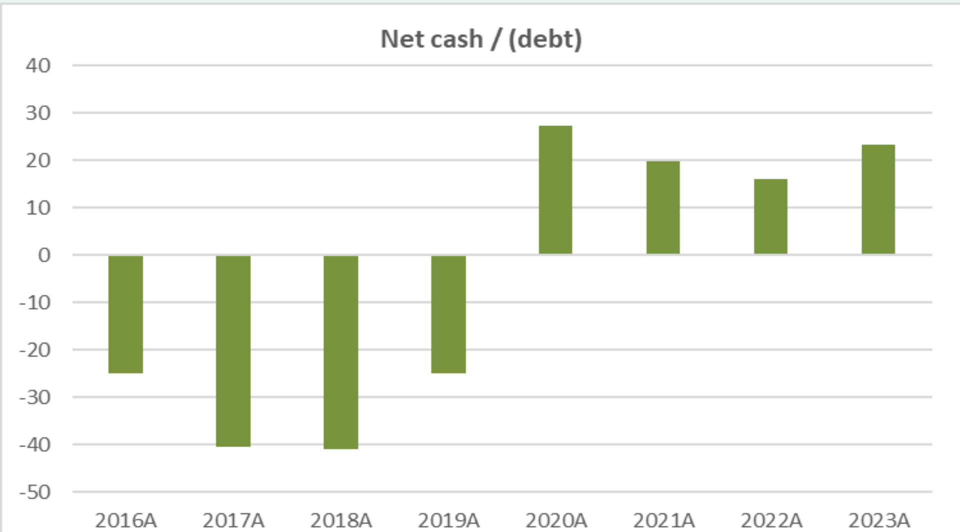
- Improved profitability, and
- An unwinding of working capital (not least as the Group exited low margin contracts and cash collection improved).

Forecasts

Year to July, £m	2021A	2022A	2023A	2024F	2025F
Revenue	415.7	403.9	385.2	411.1	442.4
CoGS	-373.6	-359.7	-341.8	-365.5	-393.3
UK NFI	38.6	41.4	41.3	42.5	45.8
International NFI	3.5	2.8	2.3	3.1	3.3
Group NFI	42.1	44.2	43.4	45.6	49.1
NFI margin (%)	10.1%	10.9%	11.3%	11.1%	11.1%
Op costs	-39.8	-44.1	-41.1	-43.1	-44.6
EBITDA	4.4	2.8	3.8	4.4	6.3
EBITDA/NFI conversion (%)	10.5%	6.3%	8.8%	9.6%	12.8%
Adj. EBIT	2.2	0.1	2.3	2.6	4.5
Conversion rate (EBIT/NFI, %)	5.3%	0.2%	5.4%	5.6%	9.1%
Net Interest	-0.4	0.2	0.2	0.3	0.2
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 (FD) (m)	32.4	32.5	32.7	32.4	32.4

Source: Company historics, Equity Development estimates

Net cash/(debt)progression (£m)



Source: Company, ED

Summary Cash Flow

Year to July, £m	2021A	2022A	2023A	2024F	2025F
Adj. EBIT	2.2	0.1	2.3	2.6	4.5
Depn. & Amortn.	0.9	1.1	1.5	1.8	1.8
Working capital movement	-5.4	-3.3	6.7	-4.1	-2.4
Other	-4.3	-0.8	-2.3	-0.7	-0.1
Operating cash flow	-6.6	-3.0	8.3	-0.4	3.8
Net Interest	-0.4	0.2	0.2	0.3	0.2
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	-1.2	2.8
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	0.0	0.0	0.0
Increase Cash/(Debt)	-7.5	-3.9	7.4	-3.1	1.5
Opening Net Cash/(Debt)	27.3	19.9	16.0	23.4	20.3
Closing Net Cash/(Debt)	19.9	16.0	23.4	20.3	21.8

Source: Company historics, Equity Development estimates

Movement on Net Assets

Year to July, £m	2021A	2022A	2023A	2024F	2025F
Opening Net Assets	39.8	35.1	30.0	30.8	31.4
Earnings	0.5	-0.2	1.0	2.1	3.5
Dividends paid	0.0	0.0	-1.6	-1.0	-1.7
Share Issues	0.1	-0.1	-0.7	-0.5	0.0
Goodwill	0.0	0.0	0.0	0.0	0.0
Other	-5.2	-4.8	2.1	0.0	0.0
Closing net assets	35.1	30.0	30.8	31.4	33.2
Movement on Net Assets	-4.7	-5.1	0.8	0.6	1.8

Source: Company historic data, Equity Development estimates

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