

Expert System

H119 results

Accelerating investment in growth

While H119 revenues were slightly below those reported a year ago, Expert System is confident of meeting revenue expectations for the full year, which imply year-on-year growth of 13%. Management is using the funds raised in April to accelerate investment in sales and support. Although this reduces our EBITDA forecasts for FY19 and FY20, it should lead to stronger revenue growth in the medium term as the company takes advantage of the strong interest in the practical application of artificial intelligence in business processes.

Year end	Revenue (€m)	EBITDA* (€m)	EPS* (c)	DPS (€)	P/E (x)	EV/EBITDA (x)
12/17	27.8	1.7	(18.3)	0.0	N/A	66.7
12/18	30.5	4.6	(1.4)	0.0	N/A	24.6
12/19e	34.5	5.6	(2.0)	0.0	N/A	20.5
12/20e	38.5	7.6	1.5	0.0	180.9	15.1

Note: *EBITDA and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

Growing the recurring revenue base

In H119 Expert reported a 7.7% y-o-y decline in sales to €11.9m and an EBITDA loss of €0.4m. As part of an ongoing strategy to shift to a subscription licensing model, the company saw 91% of licence revenues generated from subscription sales compared to 79% a year ago. This increases the company's revenue visibility and presents a less challenging initial investment decision for customers. The company expects to achieve revenues of c €33m for FY19 (at the lower end of its previous guidance range), which implies a one-third/two-third revenue split for the year, typical of seasonality seen prior to FY18.

Estimate changes reflect accelerated investment

When the company raised funds of €7m in April, it highlighted that it intended to use some of the proceeds to accelerate sales, particularly in the US. It has therefore reduced EBITDA guidance for FY19 from €7–8m to €5–6m to reflect this accelerated investment. Although this slows the pace of margin expansion, it should position the company for faster revenue growth in the medium term. The company is also investing in supporting channel partners, which present another route to market and provide additional implementation resources. We have revised our estimates to reflect management guidance.

Valuation: Reflects growth potential

The share price has performed well since the fund-raising in April, as the proceeds allowed the company to reduce its debt burden and accelerate investment in growth. Compared to a diverse set of peers, Expert is forecast to grow faster but is less profitable. Evidence that the recent investment is accelerating revenue growth would be a key driver of share price upside. Progress towards operating profitability and cash generation should also provide further support.

Software & comp services

3 October 2019
Price €2.72

Market cap €109m

Net debt (€m) at end H119 5.7

Shares in issue 39.9m

Free float 73%

Code EXSY

Primary exchange AIM Italia

Secondary exchange N/A

Share price performance



% 1m 3m 12m

Abs 6.6 (16.7) 100.0

Rel (local) 7.1 (16.2) 96.0

52-week high/low €3.68 €1.15

Business description

Expert System has developed and patented technology that extracts useful information from unstructured text using semantic-based techniques. It applies this technology to a number of verticals including enterprise search, customer experience management and big data analytics.

Next events

FY19 trading update January 2020

Analyst

Katherine Thompson +44 (0)20 3077 5730

tech@edisongroup.com
[Edison profile page](#)

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Review of H119 results

Exhibit 1: Half-year results highlights			
€m	H119	H118	y-o-y
Sales	11.87	12.86	(7.7%)
Grants and other income	0.81	0.69	17.3%
Total revenue	12.69	13.56	(6.4%)
Capitalised development costs	2.76	2.34	18.0%
Changes in WIP	(0.09)	0.00	N/A
Total production value	15.36	15.90	(3.4%)
Staff costs	9.44	9.63	(1.9%)
Other costs	6.35	6.20	2.3%
EBITDA	(0.43)	0.07	N/A
<i>EBITDA margin</i>	<i>(3.4%)</i>	<i>0.5%</i>	<i>N/A</i>
Depreciation & amortisation - in-house	2.53	2.54	(0.3%)
Normalised EBIT	(2.96)	(2.47)	20.1%
<i>Normalised EBIT margin</i>	<i>(23.4%)</i>	<i>(18.2%)</i>	<i>28.3%</i>
Depreciation & amortisation - acquired	1.26	1.10	14.5%
Exceptional costs/(income)	0.00	0.00	N/A
EBIT	(4.22)	(3.57)	18.4%
Net income	(4.02)	(3.75)	7.4%
Net debt	5.70	10.00	(43.0%)
Source: Expert System			

In H119, Expert reported a 7.7% y-o-y decline in sales, while grants and other income was €0.12m higher than H118, resulting in a decline in total revenue of 6.4% y-o-y. This decline should be considered in light of the company's strong sales performance in H118, which made up 45% of FY18 sales – well ahead of the historical 35% contribution of H1 sales to full year sales.

The company increased capitalised development costs by €0.42m y-o-y whereas staff and other costs were broadly flat year on year. This resulted in EBITDA declining from €0.07m in H118 to a €0.43m loss in H119. With depreciation and amortisation effectively flat, normalised EBIT was lower by a similar amount.

Reflecting the €7m in funds raised during H119, net debt at the end of H119 fell to €5.7m, down from €10.0m at the end of H118 and €12.6m at the end of FY18.

Shift to subscription licensing continues

The company noted that of licence revenues reported in H119, 91% were from subscription licences, compared to 79% in H118 and 72% in FY18. Professional services made up 40.5% of H119 revenues (vs 40% in H118), with the remaining 59.5% consisting of licence and maintenance revenues. Although the company did not disclose the split between licence and maintenance revenues, the fact that perpetual licences have now fallen to 9% of total licence revenues implies that recurring revenue (subscription licences plus maintenance) is approaching 60% of group revenue (we estimate it was nearer 50% in H118).

International business growing faster than Italy

The company disclosed the geographic revenue split in Exhibit 2. Sales outside Italy were flat year-on-year compared to a decline in sales from Italy. The company noted that business in the UK saw strong growth (+62% y-o-y), with particular success in the insurance market. After a period of restructuring, the French business saw better growth (+23% y-o-y). Sales in the US were helped by strong demand from US government customers. Business in Italy was lower year-on-year, with delays in decision making due to the uncertain political and economic environment.

Exhibit 2: Geographic split of sales			
€m	H119	H118	y-o-y
Italy	5.0	5.9	(15.7%)
Europe (ex-Italy)	4.2	4.6	(10.3%)
US	2.7	2.3	17.9%
Total	11.9	12.9	(7.7%)
Revenue contribution			
Italy	42%	46%	
Europe (ex-Italy)	35%	36%	
US	23%	18%	
Source: Expert System			

Share capital increase from fund-raise and option exercise

The company issued 3.89m shares to ERGO (a group of private investors) in April and received gross proceeds of €7m. Also in H119, an additional 0.2m shares were issued from various share grant schemes, including the final tranche from the Temis acquisition.

Business update

So far this year, the company has continued to receive positive reviews from market research analysts. For the fifth year running, it is included in KM World's '100 Companies That Matter in Knowledge Management'. It also featured in Gartner's recently published Insight Engines Magic Quadrant.

Notable customers this year include:

- Swiss Re: the company is collaborating with Expert to use Cogito to manage 'high intensity information'. This includes helping to automate processes such as risk assessment or analysing requests for reimbursement as well as identifying news that could indicate sources of future losses.
- AXA Group: AXA XL Risk Consulting chose Cogito to enhance its capabilities in Property Risk Engineering. This includes reducing the time required to read all necessary documentation and to therefore speed up the quote process.
- OCP, the world's largest producer of phosphate and phosphoric acid and one of the largest fertiliser producers in the world. The company is using Cogito to manage flows of information from external and open sources to help to identify strategic insights for internal analysts and management.

Product development

The company launched Cogito v14.4 in April. The latest version of the platform speeds up the ability to expand the knowledge graph via the acquisition of new information, has improved machine learning functionality and makes it easier to integrate with robotic process automation tools.

The company noted that product developments expected in H2 include:

- a new release of the Cogito Intelligence Platform;
- a beta version of Cogito for Life Sciences;
- a restructure and widening of the knowledge graph for German, Arabic, Dutch and Chinese; and
- new intelligent analysis of complex documents.

Channel partner progress

Expert continues to work with channel partners to broaden its addressable market and get access to implementation resources. It offers partners an e-learning platform and has so far issued 139 certifications to individuals at 21 companies in 18 countries.

Outlook and changes to forecasts

The company expects to achieve sales of c €33m in FY19. It previously suggested it could achieve of €33–34.5m and we forecast sales of €33.3m for the year. This implies that revenues in H119 would make up roughly one-third of full-year revenues. Although this looks low compared to the prior year when H1 revenues made up 45% of full-year revenues, this is more like the pattern seen in FY17 and prior years. Based on deals signed since the end of H119, renewals of subscription contracts expected in H2 and deals in the pipeline, management is confident it will see a step-up in revenues in H2 to meet the €33m FY19 target.

The company has reduced guidance for FY19 EBITDA from €7–8m to €5–6m. When it raised funds of €7m in April, the company noted that proceeds were to be targeted at growing the business. It plans to do this by increasing headcount for sales and pre-sales, technical support for channel partners and R&D to simplify the implementation of Expert's software by partners. We have revised our forecasts for staff and other operating costs to take this extra investment into account. The company noted it would be drafting and presenting its 2020–2022 business plan in the next few months.

Exhibit 3: Changes to forecasts								
€m	FY19e old	FY19e new	Change	y-o-y	FY20e old	FY20e new	Change	y-o-y
Sales	33.3	33.0	(1.1%)	14.9%	37.4	37.0	(1.0%)	12.4%
Other income and grants	1.5	1.5	0.0%	(14.7%)	1.5	1.5	0.0%	0.0%
Total revenues	34.8	34.5	(1.0%)	13.2%	38.9	38.5	(1.0%)	11.8%
Capitalised development costs & changes in WIP	5.1	5.1	(0.0%)	0.9%	5.2	5.2	0.0%	2.0%
Production value	39.9	39.6	(0.9%)	11.4%	44.1	43.7	(0.9%)	10.6%
EBITDA	7.6	5.6	-26.9%	20.2%	9.8	7.6	-22.9%	35.5%
<i>EBITDA margin</i>	21.9%	16.2%	(5.7%)	0.9%	25.2%	19.6%	(5.6%)	3.4%
D&A	(5.7)	(5.7)	0.0%	N/A	(6.0)	(6.0)	0.0%	N/A
Normalised operating profit	2.0	(0.1)	N/A	(84.4%)	3.8	1.5	(59.2%)	N/A
<i>Normalised operating margin</i>	5.6%	-0.3%	(5.9%)	1.9%	9.7%	4.0%	(5.7%)	4.3%
Amortisation of acquired intangibles	(2.6)	(2.6)	0.0%	N/A	0.0	(0.9)	N/A	N/A
Exceptional items	0.0	0.0	0.0%	N/A	0.0	0.0	N/A	N/A
Reported operating profit	(0.6)	(2.7)	333.6%	17.3%	3.8	0.7	(81.7%)	N/A
Normalised net income	1.2	(0.8)	N/A	(53.9%)	2.8	0.6	N/A	N/A
Reported net income	(1.1)	(3.1)	170.6%	18.2%	2.8	(0.2)	N/A	94.6%
Diluted normalised EPS (c)	3.0	(2.0)	N/A	(42.5%)	7.1	1.5	(78.8%)	174.3%
Net debt	4.9	6.6	35.4%	(47.7%)	2.3	6.5	184.7%	(2.0%)

Source: Edison Investment Research

Valuation

Most of Expert's direct competitors are private companies or subsidiaries of large companies such as IBM or Micro Focus. We have compared Expert's valuation and operating metrics to peers operating in the natural language processing, big data analytics, enterprise search and information management markets, as well as to Italian software and IT services peers.

Based on EV/sales, Expert is trading at a premium to Italian peers and at a discount to all other peer groups, with forecast revenue growth towards the upper end of the group. On an EV/EBITDA basis, Expert is trading at a premium to Italian and enterprise search and information management

peers and at a discount to data analytics peers. Evidence that the recent investment in sales and support is driving accelerating revenue growth would be a key driver for share price upside.

Progress towards net cash generation and operating profitability should provide key support to the share price.

Exhibit 4: Peer group metrics

	YE	Market cap (€m)	CY EV/S	NY EV/S	CY EV/ EBITDA	NY EV/ EBITDA	CY P/E	NY P/E	CY sales (€m)	CY EBIT margin	CY EBITDA margin	Sales growth NY	EPS growth NY
Natural Language Understanding													
Expert System	Dec-18	109	3.3x	3.0x	20.5x	15.1x	N/A	180.9x	34.5	(0.3%)	16.2%	11.8%	N/A
Nuance Communications	Sep-19	4,587	3.1x	3.0x	10.5x	N/A	13.6x	13.1x	1,648	27.1%	29.8%	3.1%	3.5%
Big Data Analytics													
Splunk	Jan-20	15,813	7.3x	6.0x	44.6x	32.8x	61.6x	49.6x	2,047	14.4%	16.4%	21.8%	24.2%
Teradata	Dec-19	3,119	1.8x	1.7x	9.1x	7.6x	20.8x	14.8x	1,750	12.0%	19.3%	3.0%	40.7%
Average			4.5x	3.9x	26.9x	20.2x	41.2x	32.2x		13.2%	17.9%	12.4%	32.4%
Enterprise search and information management													
OpenText	Jun-20	12,836	4.2x	4.1x	11.0x	10.5x	14.0x	13.3x	2,630	35.6%	36.2%	2.7%	5.2%
IHS Markit	Nov-19	23,307	7.1x	6.7x	17.8x	16.4x	25.5x	22.8x	3,909	28.9%	29.6%	5.0%	11.8%
Elastic	Apr-20	5,616	15.2x	11.2x	N/A	N/A	N/A	N/A	363	(23.1%)	(20.9%)	35.6%	2.8%
CommVault	Mar-20	1,749	2.3x	2.2x	17.4x	13.9x	33.0x	26.9x	597	11.4%	13.8%	4.1%	22.7%
Average			7.2x	6.1x	15.4x	13.6x	24.2x	21.0x		13.2%	14.7%	11.9%	10.6%
Italian software & services													
TXT e-solutions	Dec-19	106	1.1x	1.0x	10.6x	8.2x	27.8x	24.6x	57	6.1%	7.8%	12.3%	13.2%
Exprivia	Dec-19	46	0.5x	0.5x	6.7x	6.1x	N/A	9.9x	582	3.4%	4.1%	4.3%	N/A
Piteco	Dec-19	93	4.2x	3.8x	9.7x	8.7x	12.6x	10.9x	25	N/A	N/A	10.6%	16.2%
Reply	Dec-19	2,011	1.7x	1.6x	11.7x	10.7x	19.7x	17.8x	1,175	12.2%	12.5%	8.4%	10.6%
Average			1.9x	1.7x	9.7x	8.4x	20.1x	15.8x		7.2%	8.1%	8.9%	13.4%

Source: Edison Investment Research, Refinitiv. Priced at 30 September.

Since the company raised funds in April at €1.80 (at an 18% premium to the share price at the time), the share price has performed well, peaking at €3.68 and now trading at €2.72. The proceeds have reduced Expert's debt burden and provided funds to accelerate growth.

We have performed a reverse DCF to calculate the growth and profitability that is factored into the share price beyond our forecast period. We estimate the share price is factoring in a revenue CAGR of 9.5% from FY20 to FY28, with EBITDA margins rising to 28% by FY28. Assuming the company continues to capitalise development spend, we forecast capex/sales reducing to 7.8% by FY28, with a terminal EBIT margin of 19.6% (in line with established software companies). We use a WACC of 8.5% and long-term growth of 3%. A 1% increase in the WACC results in a valuation of €2.19/share, whereas a 1% decrease results in a valuation of €3.53.

Exhibit 5: Financial summary

	€'000s	2015	2016	2017	2018	2019e	2020e
31-December		IT GAAP					
PROFIT & LOSS							
Revenue		19,368	25,057	27,783	30,457	34,463	38,545
EBITDA		1,463	(2,245)	1,711	4,638	5,575	7,554
Operating Profit (before amort. and except.)		(1,226)	(5,941)	(3,189)	(662)	(103)	1,545
Intangible Amortisation		(2,549)	(2,608)	(2,608)	(2,567)	(2,567)	(854)
Exceptionals		0	0	(700)	0	0	0
Other		0	0	0	0	0	0
Operating Profit		(3,775)	(8,549)	(6,496)	(3,229)	(2,670)	691
Net Interest		213	(156)	(2,191)	97	(766)	(878)
Profit Before Tax (norm)		(1,013)	(6,097)	(5,380)	(565)	(869)	667
Profit Before Tax (reported)		(3,562)	(8,705)	(8,687)	(3,131)	(3,435)	(187)
Tax		277	579	348	(650)	344	19
Profit After Tax (norm)		(934)	(5,692)	(5,164)	(508)	(782)	601
Profit After Tax (reported)		(3,284)	(8,126)	(8,339)	(3,781)	(3,092)	(168)
Average Number of Shares Outstanding (m)		22.8	25.8	28.1	35.8	38.6	39.9
EPS - normalised (c)		(4.1)	(22.0)	(18.3)	(1.4)	(2.0)	1.5
EPS - normalised and fully diluted (c)		(4.1)	(22.0)	(18.3)	(1.4)	(2.0)	1.5
EPS - (IFRS) (c)		(14.4)	(31.5)	(29.6)	(10.6)	(8.0)	(0.4)
Dividend per share (p)		0.0	0.0	0.0	0.0	0.0	0.0
EBITDA Margin (%)		7.6	-9.0	6.2	15.2	16.2	19.6
Adj Operating Margin (%)		-6.3	-23.7	-11.5	-2.2	-0.3	4.0
BALANCE SHEET							
Fixed Assets		20,301	20,379	18,864	16,655	13,719	12,556
Intangible Assets		18,539	18,372	16,944	14,734	12,102	10,967
Tangible Assets		916	915	792	715	702	675
Investments		846	1,092	1,128	1,206	915	915
Current Assets		42,588	37,012	37,634	38,004	52,184	53,853
Stocks		1,797	627	99	109	109	109
Debtors		10,228	10,233	12,384	15,792	18,003	20,523
Cash		11,249	9,063	11,235	7,883	20,887	21,017
Other		19,314	17,088	13,916	14,220	13,184	12,203
Current Liabilities		(20,517)	(22,679)	(19,480)	(21,170)	(21,732)	(22,406)
Creditors		(15,082)	(16,459)	(14,104)	(15,511)	(16,073)	(16,746)
Short term borrowings		(5,435)	(6,219)	(5,376)	(5,659)	(5,659)	(5,659)
Long Term Liabilities		(22,227)	(18,275)	(17,742)	(18,411)	(25,411)	(25,411)
Long term borrowings		(18,240)	(15,252)	(14,683)	(14,811)	(21,811)	(21,811)
Other long term liabilities		(3,987)	(3,023)	(3,060)	(3,600)	(3,600)	(3,600)
Net Assets		20,145	16,437	19,276	15,077	18,761	18,593
CASH FLOW							
Operating Cash Flow		2,738	2,088	(1,921)	2,583	4,902	6,684
Net Interest		(324)	(155)	(626)	(441)	(742)	(854)
Tax		(1,576)	0	0	0	0	0
Capex		(20,045)	(6,378)	(6,321)	(5,830)	(5,446)	(5,700)
Acquisitions/disposals		3,045	46	1,275	(76)	291	0
Financing		6,573	4,418	11,178	0	7,000	0
Dividends		0	0	0	0	0	0
Net Cash Flow		(9,588)	18	3,585	(3,764)	6,005	130
Opening net debt/(cash)		2,839	12,426	12,408	8,824	12,587	6,583
HP finance leases initiated		0	0	0	0	0	0
Other		0	0	0	0	0	0
Closing net debt/(cash)		12,426	12,408	8,824	12,587	6,583	6,453

Source: Expert System, Edison Investment Research

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Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
1,185 Avenue of the Americas
3rd Floor, New York, NY 10036
United States of America

Sydney +61 (0)2 8249 8342
Level 4, Office 1205
95 Pitt Street, Sydney
NSW 2000, Australia