Keywords Studios

FY19 results

A diversified, resilient business in troubled times

Software & comp services

Keywords delivered a strong performance in FY19 (revenue growth of 30.2% overall, 15.5% organic, 21.2% like-for-like), very much in line with its January trading statement. In the face of the uncertain impact of COVID-19, we are revising our FY20 revenue estimate down, assuming nominal l-f-l 1% revenue growth, with operating profit falling to €38.1m (11.2% margin). We introduce FY21 forecasts, with games industry growth in FY21 helping the business bounce back with 15% revenue growth. The company's FY21e P/E multiple of 31.1x reflects continuing industry growth, a strong track record and leading market position. The group prudently cancelled its final dividend for FY19, but has a strong balance sheet with €112m of cash and undrawn facilities as at YE19, leaving it well positioned for M&A.

Year end	Revenue (€m)	PBT* (€m)	EPS* (c)	DPS (p)	P/E (x)	Yield (%)
12/18	250.8	37.9	43.7	1.61	40.3	0.11
12/19	326.5	40.9	47.2	0.58	37.3	0.04
12/20e	339.5	35.5	41.0	1.77	43.0	0.12
12/21e	390.4	49.5	56.6	1.95	31.1	0.13

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

FY19: Strong growth and balance sheet

In FY19, Keywords delivered 30.2% revenue growth and 15.5% underlying organic growth. The company operates in the games sector, a growing industry (Newzoo: 8.4% CAGR 2019–22e) and net beneficiary of lockdown. The group has adequate liquidity, but nevertheless management has prudently sought to preserve cash, including cancellation of the FY19 final dividend. It is cash-generative, has a strong balance sheet with net debt of €17.9m at 31 December 2019 (0.4x net debt/ adjusted EBITDA) and total cash and undrawn facilities of €112m as at YE19.

Revised FY20 and introduction of FY21 estimates

As a result of COVID-19, we revise our FY20 revenue estimate down to reflect the disruption as staff move to remote working (across the business) or are temporarily furloughed (principally audio and testing) during the lockdown. For FY20, we assume nominal 1% like-for-like revenue growth to €339.5m, with operating profit falling by c 29% to €38.1m. We also introduce FY21 forecasts, with the business bouncing back strongly once lockdown measures ease. We forecast FY21 revenues of €390.4m (+15% y-o-y). Adjusted operating margins are set to improve in FY21 – we forecast margins of 13.4% (FY20: 11.2%), operating income of €52.1m (FY20: €38.1m) and normalised EPS of 56.6c, a 38% uplift on FY20 (41.0c).

Valuation: Positive returns from continued execution

Keywords' shares trade on a P/E of 43.0x our updated FY20e estimates, falling to 31.1x in FY21e. We see no prospect for M&A in H120, although potential accretive acquisition activity in H220/FY21 would bring these multiples down. Despite the current challenges, Keywords' strategy, which has delivered a five-year EPS CAGR of 42% to FY19, supported by the industry's strong underlying growth, appears sustainable in the medium to long term.

17 April 2020

Price	**1,530p**
Market cap	**£1,005m**
	€1.15/£
Net debt (€m) at 31 December 2019	17.9
Shares in issue	65.67m
Free float	89%
Code	KWS
Primary exchange	AIM
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	14.2	0.9	4.4
Rel (local)	4.9	37.3	37.7
52-week high/low		1838p	1073p

Business description

Keywords Studios is the largest and most diverse supplier of outsourced services to the games industry. Through regular acquisitions, the company is building its scale, geographic footprint and delivery capability. Its ambition is to become the 'go-to' supplier across the industry.

Next event

AGM	May 2020
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COVID-19 impact

In its COVID-19 update on 25 March 2020 (see our flash note), Keywords' management stated that the business impact had been minimal in the first two months of the year, with some short-term disruption in China affecting the company's five studios there. These have now returned to near full production. Since then, Keywords has seen disruption across all service lines and locations, mitigated by actions from its early experience applied across the group.

Functional Testing (21% of FY19 revenue), Localisation Testing (7%) and Audio Services (12%) (together representing c 40% of FY19 revenues and 38% of staff) have been most disrupted as these businesses have been harder to transition to remote-working – the testing businesses because of client concerns over the security of pre-release games and audio services as the high quality of sound studios is hard to replicate remotely. However, with revenues likely deferred rather than lost, some of the staffing costs have been offset through furloughing and the flexible cost base of freelance staff. Across the firm, 5,500 staff have now been moved to remote working, c 75% of total staffing.

Management also stated that it does not believe that COVID-19 will affect the business materially in the medium term, and indeed, it has already seen an increase in demand for services as existing and new clients re-appraise production arrangements and make contingency plans. Management hopes that Keywords will be able to benefit from this pent-up demand once the operating environment normalises, underpinning stronger expectations for FY21e.

The group has adequate liquidity, but nevertheless management has prudently sought to preserve cash, including cancellation of the FY19 final dividend payment. It is cash-generative, with FY19 cash conversion of c 79%, and has a strong balance sheet with net debt of €17.9m at 31 December 2019 (0.4x net debt/adjusted EBITDA). Keywords has total cash and undrawn facilities of €112m at 31 December 2019, including €30m of the RCF accordion facility currently being executed.

Please see our sector report, European video games: A safe haven in troubled times, published on 8 April for more information on the impact of COVID-19 on the gaming sector.

Certain sectors provide some respite for those in lockdown. The games sector is one, and as such is a beneficiary of the global lockdown. The transition from office work to remote working has caused significant business disruption, but for most games companies the disruption has been effectively managed, with business continuity plans now largely implemented. Its youthful workforce and agile development allow it to adjust to staff working from home, as well as to capitalise on back catalogues of existing games and mature digital delivery channels. Looking ahead, we see a period of three to six months with consumers isolated from normal activities and other forms of entertainment; while it lasts, this period will provide a substantial benefit for games companies. This is an acceleration of the digitalisation of the games industry. Thereafter, we expect the industry to return to its long-term growth trends (Newzoo: 8.4% CAGR 2019–22e).

Revised FY20 and introduction of FY21 estimates

We have revised down our estimates for FY20 to reflect the near-term challenges that we anticipate, particularly in H120, before Keywords can hopefully start to get back on track in H220. We have also introduced estimates for FY21 (Exhibit 1).

FY20 – our base case scenario

Trading in FY20 started in line with market expectations in the first two months of the year, with COVID-19's impact limited to Keywords' business in China. However, with the spread of COVID-19, we anticipate an impact on Keywords' business in Q2 (particularly in Audio, Localisation Testing and Functional Testing), reducing in Q3 and thereafter. Although there is a significant chance of a global recession, we believe the games industry will prove relatively resilient, continuing to benefit from strong consumer demand. As such, we very much expect Keywords to get back on track quickly in H220, seeing a degree of catch-up from pent-up demand in FY21.

With current headwinds, we have pulled back our FY20 forecasts and assumed nominal revenue growth of 1% on the FY19 year-end revenue run rate. With the group's investment in remote working (c 5,500 staff transitioned to date), furloughing of staff, lower productivity and investment in hardware and systems, we expect H120 margins to have been adversely affected and assume a 3% reduction in FY20 adjusted operating margins (14% to 11%), with PBT margins compressed to 10.5% from 12.5% in FY19.

Exhibit 1: Revised estimates

€000s	2019	2020e			2021e	
		Old	New	Change	New	y-o-y growth
Revenue	326,463	374,913	339,451	(9.5)%	390,369	15.0%
Cost of Sales	(206,234)	(234,889)	(213,067)	(9.3)%	(244,547)	14.8%
Gross Profit (inc multimedia tax credits)	120,229	140,024	126,385	(9.7)%	145,822	15.4%
Gross Margin (%)	*36.8%*	*37.3%*	*37.2%*	*(0.3)%*	*37.4%*	*0.3%*
EBITDA	50,278	61,192	45,165	(26.2)%	60,227	33.3%
Operating Profit (before amort. & exceptionals)	42,983	53,419	38,127	(28.6)%	52,133	36.7%
Operating Margin	*13.2%*	*14.2%*	*11.2%*	*(21.2)%*	*13.4%*	*18.9%*
Profit Before Tax (norm)	40,913	52,419	35,527	(32.2)%	49,533	39.4%
Profit After Tax (norm)	33,451	42,983	29,048	(32.4)%	40,500	39.4%
EPS - normalised (c)	47.2	64.8	41.0	(36.8)%	56.6	38.2%
Dividend per share (p)	0.58	1.95	1.77	(9.2)%	1.95	10.2%
Closing net debt/(cash)	17,924	(7,647)	(11,228)		(39,367)	

Source: Company accounts, Edison Investment Research

Introduction of FY21 forecasts

As stated above, we expect Keywords to bounce back relatively quickly once global lockdowns ease (as has already been seen in its Chinese studios), supported by pent-up demand from its core client base wishing to keep major projects on track (particularly ahead of Thanksgiving and the Q4 console launches) and underpinned by strong consumer demand for games across all platforms and geographies.

Revenues: we have assumed 15% revenue growth with FY21 revenue of €390.4m, at the top end of management's 10–15% guidance. This assumes a contained impact from COVID-19, with the company benefiting from a degree of catch-up from FY20, supported by the return of underlying growth in the games sector.

Margins: our 13.4% operating margin forecast builds on the 11.2% we now forecast for FY20. We believe the company could achieve a higher margin, but at this stage we would prefer to be conservative. We assume gross margins remain at c 37% for both FY20 and FY21.

Tax rate: through effective planning, Keywords' tax rate has reduced steadily from 22% in FY16 to 18.2% in FY19. We expect this level is sustainable and forecast a tax rate of 18.2% in both FY20 and FY21.

Capex: as COVID-19 has bitten, management has put a temporary hold on discretionary capex spend. We expect capital spend to resume later in the year, with an element of catch-up in FY21.

On this basis, we have assumed a c 25% fall in capex to €10.3m in FY20 (FY19: €13.1m), rising to €15.7m in FY21.

Deferred consideration: after a relatively quiet year for M&A in FY19 (eight acquisitions), the contingent consideration on the balance sheet fell from €19.3m at year-end 2018 to €6.0m at year-end 2019. We forecast that up to €5m will be payable in FY20 if performance conditions are met.

We have also assumed that tax credits – the Multimedia Tax Credit (MMTC – Canada) and the Video Games Tax Relief (VGTR – UK) – grow at 10% in FY21.

The final dividend for FY19 has been cancelled, meaning the total dividend payable for FY19 was 0.58p. We expect a resumption of dividend payments with the FY20 interim dividend, assuming 10% growth for the FY20 dividend over FY18. This implies a total FY20 dividend of 1.77p per share (FY18: 1.61p, FY19: 0.58p). We assume continuing 10% y-o-y dividend growth for FY21.

Acquisition pipeline – H220 weighted

Keywords' strategy of using earnings-enhancing acquisitions whilst consolidating a fragmented games outsourcing market is intrinsic to the investment case. Given the current environment and the steps management has taken to preserve cash, we do not anticipate M&A in H120. However, we may well see deals resume in H220 with distressed/ready sellers looking to exit towards the end of what will have been a difficult year for many.

The group retains good firepower for M&A with net debt of €17.9m, gearing of 0.4x net debt/adjusted EBITDA and total cash and undrawn facilities of €112m as at 31 December 2019. Although acquisitions are necessarily opportunistic, management's focus is likely to be around building the group's higher-margin marketing and development capacity.

Exhibit 2: Financial summary

€'000s	2017	2018	2019	2020e	2021e
31-December	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue	151,430	250,805	326,463	339,451	390,369
Cost of Sales	(96,345)	(154,997)	(206,234)	(213,067)	(244,547)
Gross Profit (inc multimedia tax credits)	55,085	95,808	120,229	126,385	145,822
EBITDA	26,645	44,232	50,278	45,165	60,227
Operating Profit (before amort. and except.)	23,915	38,916	42,983	38,127	52,133
Intangible Amortisation	(3,038)	(6,872)	(7,318)	(8,050)	(8,855)
Exceptionals	(3,016)	(5,607)	(4,348)	0	0
Other	(1,426)	(4,129)	(9,775)	(10,753)	(11,828)
Operating Profit	16,435	22,308	21,542	19,325	31,451
Net Interest	(818)	(1,316)	(2,513)	(2,600)	(2,600)
FOREX	(3,623)	791	(1,658)	0	0
Profit Before Tax (norm)	23,097	37,911	40,913	35,527	49,533
Profit Before Tax (FRS 3)	11,994	21,783	17,371	16,725	28,852
Tax	(4,731)	(7,191)	(7,462)	(6,480)	(9,034)
Profit After Tax (norm)	18,366	30,720	33,451	29,048	40,500
Profit After Tax (FRS 3)	7,263	14,592	9,909	10,245	19,817
Average Number of Shares Outstanding (m)	58.7	64.3	65.1	65.3	65.4
EPS	31.3	45.5	48.8	42.2	58.3
EPS - normalised (c)	30.0	43.7	47.2	41.0	56.6
EPS - (IFRS) (c)	12.4	22.7	15.2	15.7	30.3
Dividend per share (p)	1.46	1.61	0.58	1.77	1.95
Gross Margin (%)	36.4%	38.2%	36.8%	37.2%	37.4%
EBITDA Margin (%)	17.6%	17.6%	15.4%	13.3%	15.4%
Operating Margin (before GW and except.) (%)	15.8%	15.5%	13.2%	11.2%	13.4%
PBT Margin (%)	15.3%	15.1%	12.5%	10.5%	12.7%
BALANCE SHEET					
Fixed Assets	142,927	198,215	223,992	219,755	218,525
Intangible Assets	131,610	180,086	196,769	189,004	180,149
Tangible Assets	10,111	15,002	22,163	25,692	33,316
Investments	1,206	3,127	5,060	5,060	5,060
Current Assets	80,182	100,348	120,483	150,420	191,478
Stocks	0	0	0	0	1
Debtors	27,473	37,019	43,243	43,675	50,227
Cash	30,374	39,870	41,827	70,978	100,118
Other	22,335	23,459	35,413	35,767	41,132
Current Liabilities	(51,677)	(95,031)	(49,551)	(49,846)	(50,846)
Creditors	(32,734)	(54,960)	(49,471)	(49,766)	(50,766)
Short term borrowings	(18,943)	(40,071)	(80)	(80)	(80)
Long Term Liabilities	(10,420)	(11,158)	(71,528)	(71,194)	(73,194)
Long term borrowings	(337)	(230)	(59,671)	(59,671)	(59,671)
Other long term liabilities	(10,083)	(10,928)	(11,857)	(11,523)	(13,523)
Net Assets	161,012	192,374	223,396	249,136	285,963
CASH FLOW					
Operating Cash Flow	21,389	33,954	46,069	53,619	52,594
Net Interest	(253)	(502)	(9,411)	(6,263)	(1,425)
Tax	(4,731)	(6,304)	(13,288)	(6,480)	(9,034)
Capex	(3,803)	(9,440)	(13,145)	(10,251)	(15,718)
Acquisitions/disposals	(90,090)	(25,766)	(27,762)	(316)	0
Financing	82,936	0	0	0	1,000
Dividends	(867)	(1,080)	(1,197)	(1,157)	(1,277)
Net Cash Flow	4,581	(10,090)	(18,734)	29,152	27,140
Opening net debt/(cash)	(8,650)	(11,094)	431	17,924	(11,228)
Forex gain on cash	(891)	(3)	1,293	0	0
Other	(1,246)	(1,432)	(52)	0	1,000
Closing net debt/(cash)	(11,094)	431	17,924	(11,228)	(39,367)

Source: Company accounts, Edison Investment Research

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