Matchtech Group plc

41% undervalued and offering a 4.8% yield

29 October 2015

Despite being forward looking, it never ceases to amaze me how often the market mis-prices stocks, especially in smallcaps where positive developments haven't yet been fully reflected in the numbers.

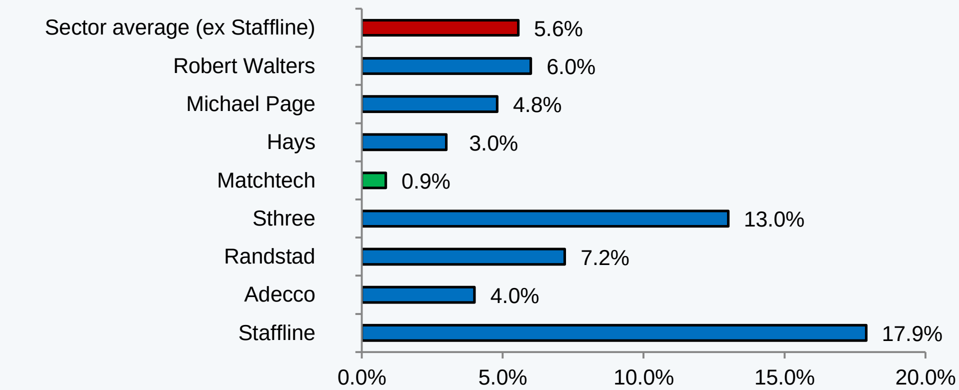
Take Matchtech, Britain's leading supplier of white collar engineering professionals. It acquired Networkers International for £66.8m in a "transformational" acquisition on 2nd April 2015. Fast forward 6 months and the **deal is bedding down nicely**, with the Board saying this morning that there is a "**huge opportunity**" in "**all our international locations**" (30% of revenues), with the greatest benefits envisaged in the Middle East, North America and South-East Asia.

Networkers acquisition is a game-changer

Here, **strong top line growth** is set to be achieved by replicating the company's UK success overseas, co-ordinated x-selling initiatives, following large clients abroad and winning a greater share of customers' wallets by providing more specialist staff as IT, telecommunication and engineering technologies converge across industries. The first revenue synergies are expected later this year, with "**early progress, such as on joint bids**" being **''highly encouraging''.**

Granted organic NFI (Net Fee Income) growth of late has been relatively modest versus listed rivals (see below). However, we think this is only temporary with FY15's +0.9% figure being largely a function of the 7% decline in Professional Services and the closure of Barclay Meade's London office – both areas which have recently been addressed.

Last reported organic NFI growth rates for sector



Source: Equity Development (Staffline is an estimate, as no comparative figure is reported by the company)

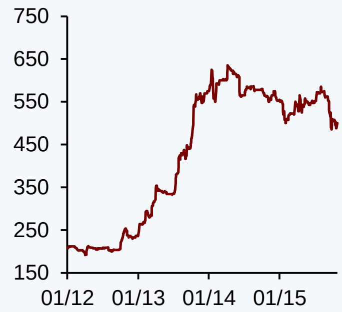
Matchtech's track record speaks for itself

In our view a better indicator of future performance is the company's 5 year track record, where **LFL NFI expanded on average by 10.7% pa between 2011-15** (see next table). What's more, as an early sign that the renewed focus on sales is working, Matchtech secured an **exclusive contract with the Royal Navy** after the period close, to source maritime defence related engineers from a range of different industries.

Company Data

EPIC	AIM:MTEC
Price (last close)	500p
52 week Hi/Lo	585p/485p
Market cap	£155m
12m target price	705p

Share Price, p



Source: ADVFN

Description

Matchtech is the UK's leading specialist engineering and professional services recruitment agency, providing contract, temporary and permanent staff.

After the £66.8m acquisition of Networkers International on 2nd April 2015, the group now derives 30% of NFI overseas, and has also become Britain's 5th largest technology agency.

73% of NFI comes from placing contractors, with the remaining 27% from permanents.

Next News: AGM on 2nd December 2015

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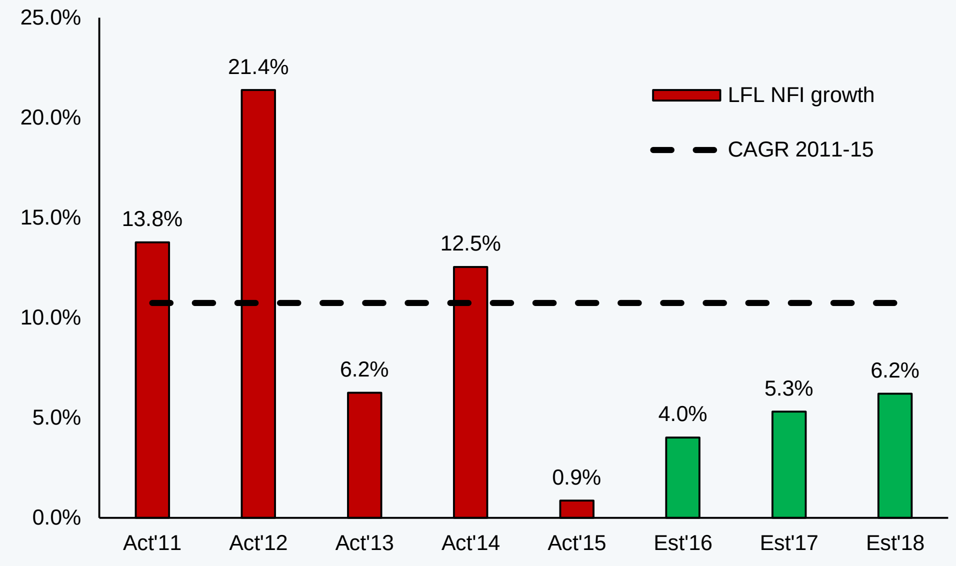
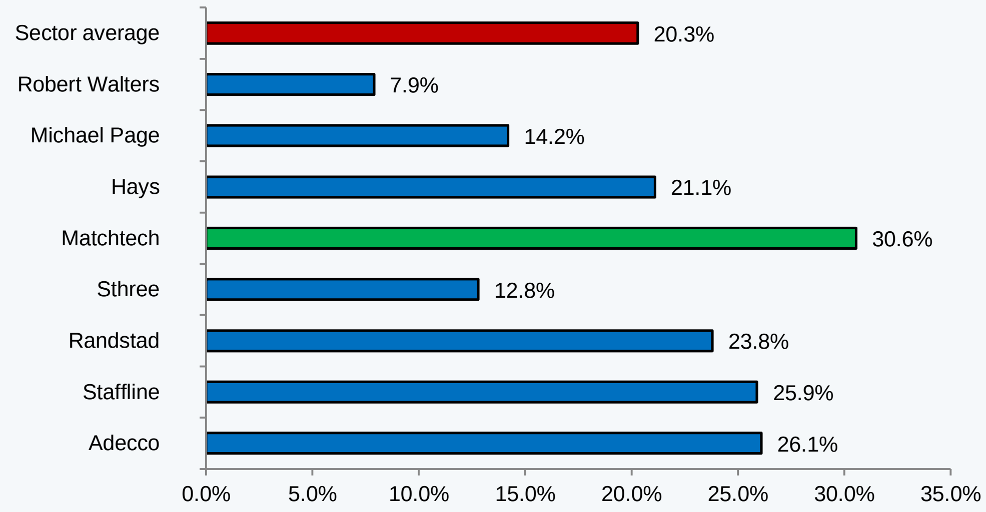
Organic NFI growth rates



Source: Equity Development

In terms of cost control, **Matchtech runs a tight ship too, as evidenced by the FY15 NFI conversion of 30.6%** (see below) – thus allowing the **Board to reinvest some of the integration savings from the merger** into accelerating LFL growth, improving connectivity in overseas offices, optimizing operational efficiency and strengthening functional management.

Last reported EBITA/Gross Margin conversion rates

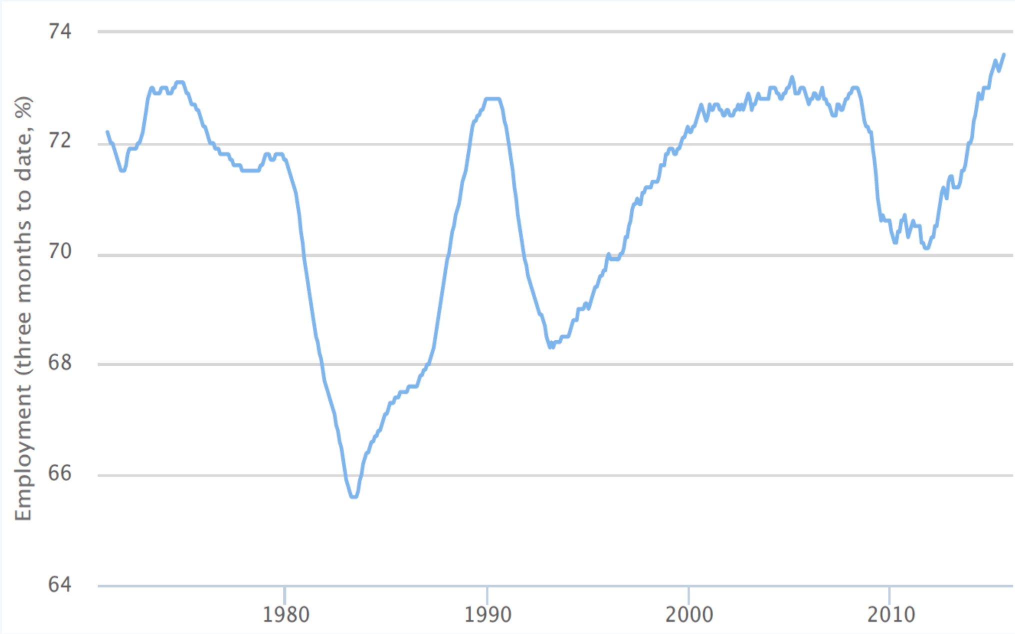


Source: Equity Development

Conditions in UK engineering are "buoyant"

On the domestic front, **UK macro economic conditions are generally supportive** with Tuesday's 1st estimate of Q3 GDP coming in at a creditable 2.3%. This coupled with unemployment at a 7 year low of 5.4%, and real wages (ie inflation adjusted) rising at approx 3%, means the **broader labour market for skilled professionals offers a favourable tailwind for recruiters**.

UK employment rate has climbed to record levels



Source: Office of National Statistics

Engineering permanent hires up 24% in FY15

Moreover, for Matchtech there is **considerable new infrastructure investment heading down the track**, such as the £11.8bn HS2 high speed rail link from London to Birmingham, Heathrow expansion, London's super sewer, electrification of the Manchester–Leeds train line and the Hinkley Point nuclear reactor. All of these projects will require substantial engineering resource over the next decade.

Elsewhere, continued worries over cybercrime (eg TalkTalk) and the need for 4G mobile services globally, should also **play to the company's strengths in IT and Telecommunications**. Further complemented by the rollout of the Internet of Things and the 'connected car', where software content and advanced electronics in the automotive, aerospace and marine sectors is becoming increasingly important.

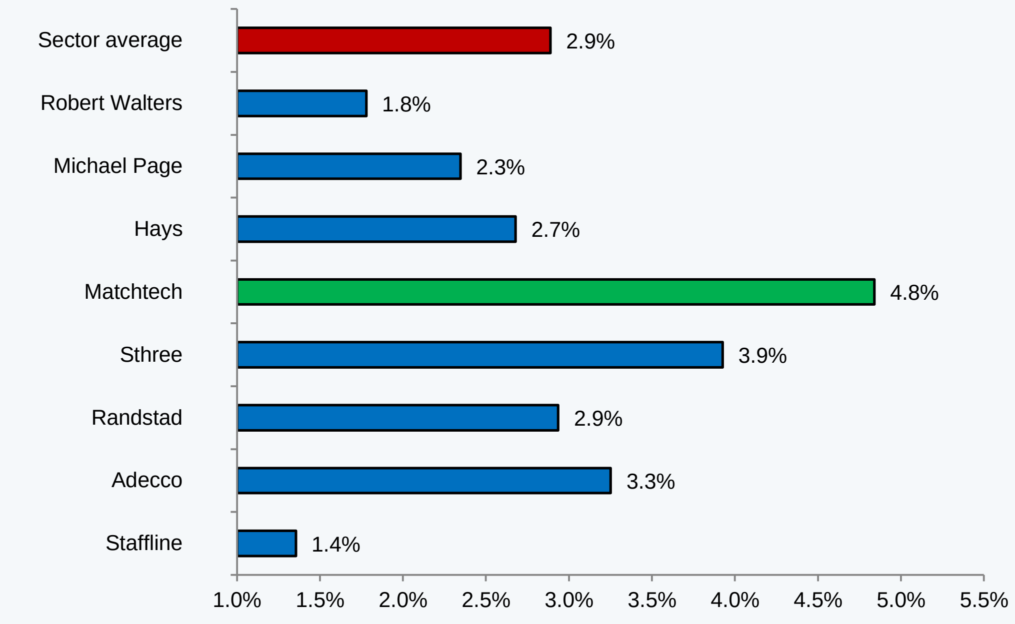
Hence, taken together with Networkers now on board, the enlarged group has the capability and geographical footprint to "**meet more of the R&D recruitment needs of the biggest players in all these markets**."

Ok, so how does this translate to the numbers?

Dividend hiked 10% to 22p/share

Well, although there will inevitably be a time lag before these developments are fully recognised in the P&L, shareholders can nonetheless enjoy a **generous 4.8% yield** (see next table) while they wait:

Current year (CY) dividend yields – sector



Source: Equity Development – includes FY16 estimates for MTEC. Prices as per 28th October 2015

In fact, from an income perspective **we believe the payout is secure given the 2x earnings cover, robust balance sheet and strong cash generation**. FY15 operating cash conversion was a healthy 124%, helping push net debt down to £33.6m (equivalent to 1.9x FY15 EBITDA and falling to 1.1x in FY16) versus to our year-end target of £35.5m. Furthermore, there is plenty of headroom left for further M&A activity and/or organic investment in light of the firm's £95m facility with HSBC.

FY15 PBTA bang in line with consensus at £15.7m

'Big picture' wise, today's prelims once again illustrate **the business' favourable operating leverage** with FY15 PBTA climbing to £15.7m (+25%) from £12.6m - despite the weaker € vs £ (£0.3m forex hit in FY15) – bang in line with consensus and slightly above our £15.5m estimate.

This double digit expansion was delivered largely thanks to the 4 month contribution from Networkers, augmented by a **standout performance from permanent recruitment fees in Engineering (+24%).** Likewise, underlying EBITA was up an impressive +24% to £16.8m (+7% LFL) on NFI +22% higher at £54.8m with adjusted diluted EPS of 43.3p (+17%).

Summary financials, £'000s					
(July year end)	2014 Act	2015 Act	2016 Est	2017 Est	2018 Est
Turnover	**451,591**	**502,293**	**649,061**	**684,759**	**732,692**
% growth	10.4%	11.2%	29.2%	5.5%	7.0%
Engineering	27,077	28,688	29,549	31,174	33,356
Professional	17,905	16,677	17,177	18,122	19,391
Networkers		9,454	30,906	32,452	34,074
Gross margin / NFI	**44,982**	**54,819**	**77,632**	**81,747**	**86,821**
NFI growth rate	17.2%	21.9%	41.6%	5.3%	6.2%
Engineering	10,548	10,546	11,253	11,871	13,036
Professional	3,073	4,213	4,566	4,817	5,348
Networkers		1,991	6,917	7,263	7,967
Adjusted EBITA	**13,621**	**16,750**	**22,736**	**23,951**	**26,351**
Net interest	-1,015	-1,074	-1,200	-1,030	-830
Adjusted PBTA	**12,606**	**15,676**	**21,536**	**22,921**	**25,521**
Adjusted diluted EPS (p)	**37.1**	**43.3**	**48.1**	**51.2**	**57.0**
Adjusted EPS growth rate	17.5%	16.8%	11.1%	6.4%	11.3%
Dividend (p)	20.0	22.0	24.2	26.6	29.3
Valuation benchmarks					
Adj NFI / EBITA conversion	30.3%	30.6%	29.3%	29.3%	30.4%
P/E ratio (diluted)	13.5	11.5	10.4	9.8	8.8
EV/NFI	4.2	3.4	2.4	2.3	2.2
EV/EBITA	13.8	11.2	8.3	7.9	7.1
PEG ratio	0.77	0.69	0.94	1.52	0.77
NFI margin	10.0%	10.9%	12.0%	11.9%	11.8%
Dividend yield	4.0%	4.4%	4.8%	5.3%	5.9%
Adj corporate tax rate	-23.3%	-22.4%	-27.0%	-27.0%	-27.0%
Adj ROACE	30.6%	20.7%	19.2%	19.5%	20.6%
Net cash/(debt)	**-3,109**	**-33,644**	**-26,406**	**-17,905**	**-8,329**
Net debt : EBITDA	0.22	1.89	1.09	0.70	0.30
Diluted sharecount, k	26,073	28,104	32,688	32,688	32,688
Share price (p)	500				

Source: ED - excludes £1.7m of deal costs, £1.0m for restructuring and £1.7m of amortisation from acquired intangibles.

No change to our FY16 and FY17 PBTA forecasts

Going forward, we have held our PBTA forecasts of £21.5m and £22.9m for the next 2 years, with **FY16 diluted EPS and the dividend set to come in at 48.1p (+11.1%) and 24.2p (yield 4.8%) respectively**.

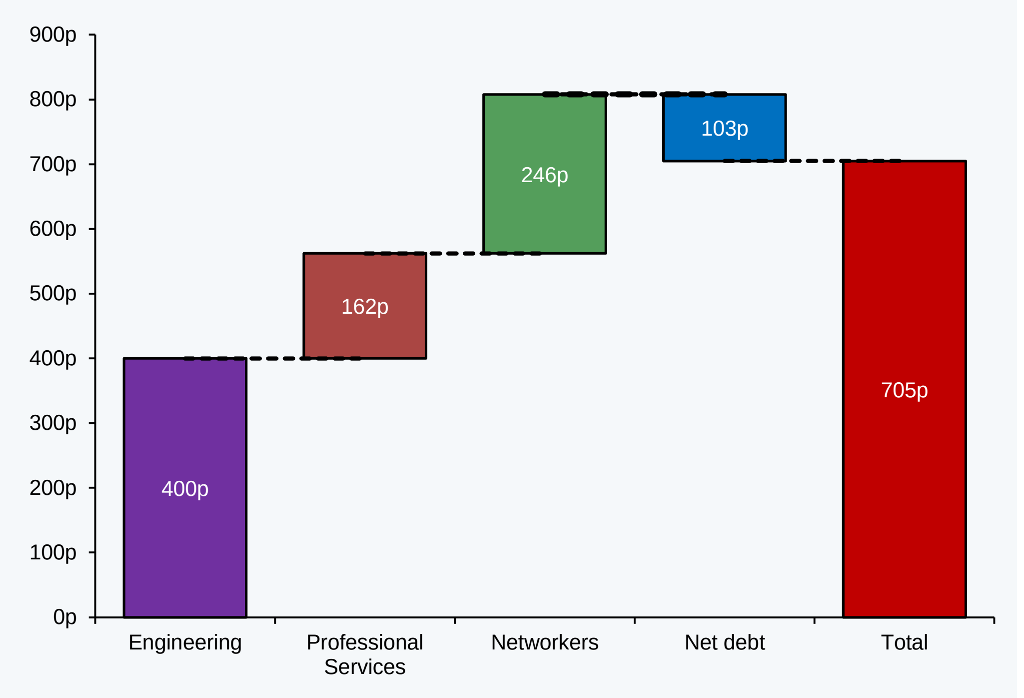
This assumes organic NFI growth of 4.0% (vs +41.6% in total) and 5.3% respectively for FY16-17, with a slightly higher weighting towards H2'16 vs H1, as sales synergies begin to kick in. Our projections also model a 27% corporate tax rate as a result of the broader geographical footprint, together with **£1.3m of annualised cost savings** due to the reduction in plc, Board, management and property overheads, of which we estimate about a third to a half will be re-invested.

Further savings are also likely (but prudently not forecast yet) by the end of FY17 (at the latest) from the elimination of duplicate CRM/back office systems and the possible rationalisation of the group's brand portfolio.

Raising price target from 680p to 705p/share

In terms of valuation, **we continue to believe that the shares are cheap on an absolute and relative basis** – and have introduced FY18 estimates for the first time, as well as raised our **price target from 680p to 705p/share** (see bridge below) based on an 11x FY16 EV/EBITA multiple:

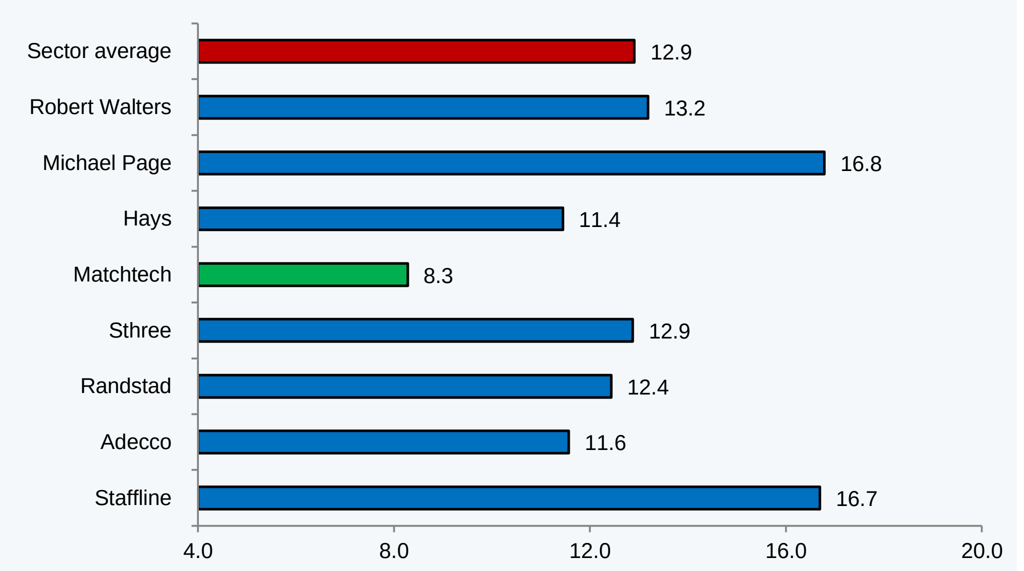
Sum-of-the-parts valuation at 705p per diluted share



Source: Equity Development

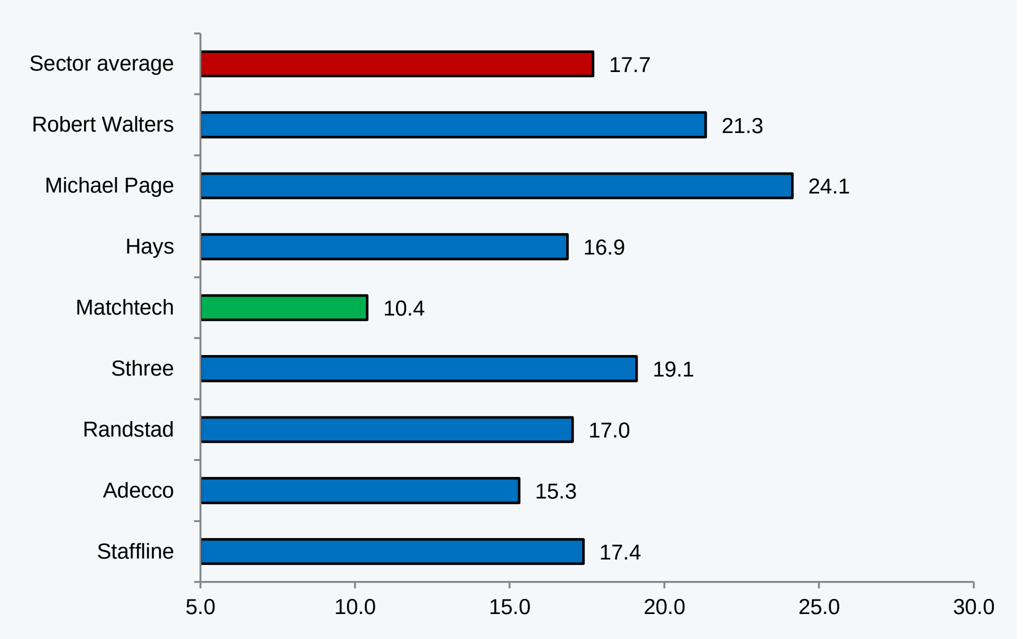
Matchtech trades at a significant discount to peers (see below) in terms of forward EV/EBITA and PE multiples – with this gap expected to close once LFL NFI growth rates pick up later this year:

CY EV/EBITA ratios – sector



Source: Equity Development – includes FY16 estimates for MTEC. Prices as per 28th October 2015

CY P/E ratios – sector



Source: Equity Development – includes FY16 estimates for MTEC. Prices as per 28th October 2015

CEO Brian Wilkinson concluding "*Looking ahead, we regard all international locations to be a **huge opportunity to advance our activities in local and regional markets across the world** and are planning for substantial growth over the next few years.*

The 2016 financial year has started well, in-line with management's expectations, with many buoyant markets across our core sectors. [There is] a good new business pipeline and signs of sales synergies are coming through, with early joint bids progressing well. We are now in a position to pursue more larger-scale relationships and have identified opportunities across multiple geographies and disciplines in our three verticals.

*I am optimistic about the future prospects for the Group and **look forward to strong growth in all our markets based on the truly global scale and the greater brand awareness that comes with leadership status.***"

Last, but not least, Patrick Shanley will take over the reins from Interim Chairman, Ric Piper, to become Non-Executive Chairman at the Annual General Meeting on 2 December 2015.

Risks

- Economic downturn impacting engineering and technology recruitment,
- Greater competition,
- Overseas expansion along with foreign exchange fluctuations,
- Political interference which could impact UK infrastructure spend, and
- Acquisition integration

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