

SHEARWATER GROUP

IT CYBER SERVICES, SOLUTIONS & PROFESSIONAL CONSULTING

3 August 2022

SWG.L

131p

Market Cap: £31.1m

SHARE PRICE (p)



12m high/low

163p/74p

Source: LSE Data (priced as at prior close)

KEY DATA

Net (Debt)/Cash	£5.6m (at 31/03/22)
Enterprise value	£25.5m
Index/market	AIM
Next news	AGM, Sept '22
Shares in Issue (m)	23.8
Chairman	David Williams
CEO	Phil Higgins
CFO	Paul McFadden

COMPANY DESCRIPTION

Shearwater provides cyber security, advisory and managed security services

www.shearwatergroup.com

SHEARWATER GROUP IS A RESEARCH CLIENT OF PROGRESSIVE

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Services driving impressive progress

Shearwater released an impressive set of estimate-beating FY22 results on 29 July. The revenue figure of £35.9m was £0.4m ahead of our estimate and the guidance given back in April, and 13% ahead of FY21. The outperformance was driven by strong results from the Services business. The Software business is mid-product transition, so understandably saw a decline in revenues. Adjusted EBITDA of £4.4m was 5% ahead of our expectation and 19% above FY21. We are raising our FY23E estimates and look forward to the investor presentation on 3 August (details below) to find out more about the strength in Services and how the new products / platform in the Software business can drive growth.

- Services business surges forward.** The strong performance in the Services business was well highlighted in advance, with the string of contract announcements earlier this year. The principal driver for the strength in Services was in Security Solutions, which saw a 70% increase in revenue as clients returned to offices, and projects previously on hold or slowed were restarted. The 10% increase in Advisory and Engineering revenue is not as dramatic but suggests that this area is moving on from its lockdown slowdown and that Shearwater will see further benefits there from improving day rates and utilisation.
- Software business held back by product transition.** The longer-than-anticipated development cycle for new software products has led to a reduction in the Software business's revenue and profitability. We provide further details overleaf. A number of new products are expected to be released in H2, with more to follow. While we expect these products to drive growth, we do not expect that it will be dramatic in the short term – although the fundamental attractions of such products as passwordless and location-controlled access are clear.
- Forecasts raised.** We have increased our FY23E estimates for revenue and adjusted EBITDA and are publishing FY24E estimates for the first time. These figures show strong progress in revenues and earnings, with continuing progress in Services, albeit not as strong as FY22 on FY21, along with growth in Software as the new products hit the market.

Shearwater is a growth business in a growth sector and management is driving it forward with a clear strategic plan. The pandemic and the software product transition have caused delays, but the path and destination remain the same.

FYE MAR (£M)	2020	2021	2022	2023E	2024E
Revenue	33.0	31.8	35.9	37.9	40.6
Adj EBITDA	3.4	3.7	4.4	4.8	5.1
Fully Adj PBT	0.9	2.2	2.8	3.0	3.2
Fully Adj Dil EPS (p)	7.6	9.7	10.3	12.0	12.7
EV/Sales (x)	0.8x	0.8x	0.7x	0.7x	0.6x
EV/EBITDA (x)	7.5x	6.9x	5.8x	5.4x	5.0x
PER (x)	17.2x	13.5x	12.7x	10.8x	10.2x

Source: Company Information and Progressive Equity Research estimates.

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Please refer to important disclosures at the end of the document.

Services – impressive performance driving growth

The strong performance in the Services business was highlighted in advance with the string of contract win and renewals announcements earlier this year. See our note of 27 April, *Trading significantly ahead of estimates*.

The principal driver for the strength in Services was in Security Solutions, which saw a 70% increase in revenue as clients returned to offices, and projects previously on hold or slowed were restarted. The 10% increase in Advisory and Engineering revenue is not as dramatic but suggests that this area is moving on from its lockdown slowdown and that Shearwater will see further benefits there from improving day rates and utilisation. The Managed Services and Warranties business was little changed at the top line. Although Shearwater won a number of significant new contracts with existing clients during the year, this was against the headwind of multi-year contracts signed in previous years that were not renewable in FY22.

Services revenue breakdown, 2022 vs 2021

	2022 £m	2021 £m	change
Managed services and warranties	16.4	16.2	1%
Security solutions	10.6	6.2	70%
Advisory and engineering	5.6	5.1	10%
Total Services	32.5	27.4	19%

Source: Company data, Progressive Equity Research

Software – shortfall understood and short term

Investors have become accustomed in recent years to software companies seeing hiccups in their revenue lines as they transition between new products and platforms. We are therefore not drawing any adverse conclusions from the £1.0m revenue shortfall for Shearwater's Software licenses vs FY21 (£3.3m vs £4.3m). The FY21 figures included a significant enterprise sale of c.£400k that would not have been expected to be repeated in FY22. However, we note that this sale has meant that Shearwater now has a new product validated and tested with an enterprise client, positioning it to potentially make further such deals in coming periods. Management has stated that of the remaining decline approximately half was due to delays in new product sales, with the remainder due to missed renewal opportunities on multi-year subscriptions – where the customers are still using the legacy products but have not been transitioned onto new Shearwater products and contracts. It is noteworthy that for those customers that did come up for renewals, the renewal rates remained high and in line with the prior year at around 80%.

Inflation and staff costs being addressed

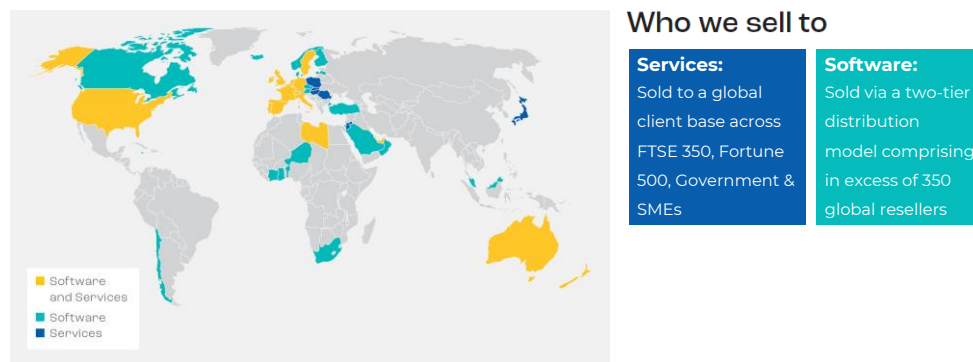
The issues of inflation and staff costs are key considerations at present for all companies and investors. Shearwater has been addressing these issues by sourcing talent across the full geographic spread of the group. Wages have been increased and employee benefits enhanced during the period to attract and retain high-quality staff, and we note that the specialist nature of much of the staff means that the group is not as exposed as many UK-listed software and services companies to the volatility of pricing for more generic staff and skills.

Widening the geographic spread

The geographic spread of the group’s entities now includes mainland Europe, in addition to the US. In FY22, Shearwater opened an entity in the Netherlands to better service its customers across Europe, and further similar expansion is expected in Ireland. These actions should also allow Shearwater to more cost-effectively source staff. The presentation slide below, taken from the analyst presentation, serves as an excellent reminder that Shearwater is an international business serving multinational customers as they face a growing global issue.

Shearwater – an international company addressing a global issue

Providing cybersecurity, managed security and professional advisory solutions to help create a safer online environment for organisations and their end users



Source: Company data

Strong balance sheet + M&A opportunities

The year-end net cash figure of £5.6m was below our estimate, but we were prepared for that following the trading update in April. Our revised forecasts are somewhat more conservative with regards to cash generation, noting that after several years of particularly strong cash conversion we are returning to – and adjusting to – more normal times, at least with regard to working capital cycles.

Shearwater’s strong balance sheet and robust cash generation position the group to make further progress with its acquisition strategy.

In line with the group’s acquisition criteria, we would look for such transactions to be earnings-accretive, with the targets being cash-generative and at, or near to, profitability with offerings that add to Shearwater’s existing software companies or can stand alongside them. In Services, we see Shearwater looking for scale and market access in the UK, and in Software, we see it looking for technologies and skills on an international basis.

While we would not expect that deals are imminent, the tone of the analysts’ call was clearly that management are on the front foot in this regard.

Forecasts raised, again

We have increased our FY23E estimates for revenue and adjusted EBITDA, and are publishing FY24E estimates for the first time. These figures show strong progress in revenues and earnings, with continuing progress in Services, albeit not as strong as FY22 on FY21, and growth in Software as new products hit the market.

Revised and new estimates

£m	FY23E			FY24		
	Old	New	Change (%)	Old	New	Change (%)
Revenue	36.4	37.9	4%	-	40.6	n/a
Adj EBITDA	4.6	4.8	4%	-	5.1	n/a
Cash at y/e	9.4	7.9	-16%	-	10.8	n/a

Source: Progressive Equity Research

Presentation by Marcus Willett CB OBE – very insightful and very useful

The presentation to analysts on 29 July included a section on the cyber security market by Marcus Willett CB OBE, a member of the group's Advisory Panel. Marcus was formerly the deputy head of GCHQ and its first Director Cyber. This presentation was useful not only as an insight into the nature, direction and the scale of cyber security issues globally, but also as a reminder of the underlying quality of Shearwater and the people it works with. The session is to be repeated within the presentation to current investors on 3 August at 12:30pm, at <https://www.investormeetcompany.com/shearwater-group-plc/register-investor>

Conclusion

While the Software business is clearly being held back by the product transition, the Services businesses are evidently making good progress. We regard our forecasts as realistically optimistic, but note that good traction with the new software products later this year and into next and possibly the win of another larger-scale enterprise software client (more likely FY24) both provide opportunities to the upside. In our view, market valuations appear to not adequately reflect the currently estimated growth at Shearwater, let alone this potential upside.

Financial Summary: Shearwater Group

Year end: March (£m unless shown)

	2020	2021	2022	2023E	2024E
PROFIT & LOSS					
Revenue	33.0	31.8	35.9	37.9	40.6
Adj EBITDA	3.4	3.7	4.4	4.8	5.1
Adj EBIT	0.7	0.5	1.0	1.2	1.4
Reported PBT	(1.3)	0.0	0.9	0.8	1.0
Fully Adj PBT	0.9	2.2	2.8	3.0	3.2
NOPAT	1.7	2.3	2.5	3.0	3.2
Reported Dil EPS (p)	(6.8)	0.6	(1.2)	3.2	3.9
Fully Adj Dil EPS (p)	7.6	9.7	10.3	12.0	12.7
Dividend per share (p)	0.0	0.0	0.0	0.0	0.0
CASH FLOW & BALANCE SHEET					
Operating cash flow	4.9	6.6	(0.3)	3.7	4.5
Free Cash flow	5.2	6.6	(0.4)	3.7	4.5
FCF per share (p)	23.7	27.9	(1.5)	15.6	19.0
Acquisitions / Investment	(1.4)	(0.7)	(1.1)	(1.3)	(1.5)
Disposals	0.0	0.0	0.0	0.0	0.0
Shares issued	0.0	3.8	0.0	0.0	0.0
Net cash flow	2.7	4.7	(2.5)	2.3	3.0
Overdrafts / borrowings	(4.8)	(0.8)	0.0	0.0	0.0
Cash & equivalents	3.3	8.0	5.6	7.9	10.8
Net (Debt)/Cash	(1.4)	7.3	5.6	7.9	10.8
NAV AND RETURNS					
Net asset value	52.5	56.5	56.2	57.3	58.6
NAV/share (p)	237.5	255.5	236.1	240.6	245.9
Net Tangible Asset Value	(4.3)	1.9	3.6	7.0	10.5
NTAV/share (p)	(19.2)	8.5	15.3	29.2	44.3
Average equity	50.9	54.5	56.3	56.8	57.9
Post-tax ROE (%)	3.3%	4.2%	4.5%	5.2%	5.4%
METRICS					
Revenue growth		(3.8%)	12.9%	5.7%	7.1%
Adj EBITDA growth		8.7%	18.7%	8.2%	7.5%
Adj EBIT growth		(25.2%)	95.2%	21.5%	14.5%
Adj PBT growth		136.3%	27.1%	5.4%	5.9%
Adj EPS growth		27.0%	6.4%	17.1%	5.9%
Dividend growth		N/A	N/A	N/A	N/A
Adj EBIT margins		1.6%	2.7%	3.2%	3.4%
VALUATION					
EV/Sales (x)	0.8	0.8	0.7	0.7	0.6
EV/EBITDA (x)	7.5	6.9	5.8	5.4	5.0
EV/NOPAT (x)	15.1	11.1	10.0	8.6	8.1
PER (x)	17.2	13.5	12.7	10.8	10.2
Dividend yield	N/A	N/A	N/A	N/A	N/A
FCF yield	18.2%	21.4%	(1.2%)	11.9%	14.6%

Source: Company information and Progressive Equity Research estimates

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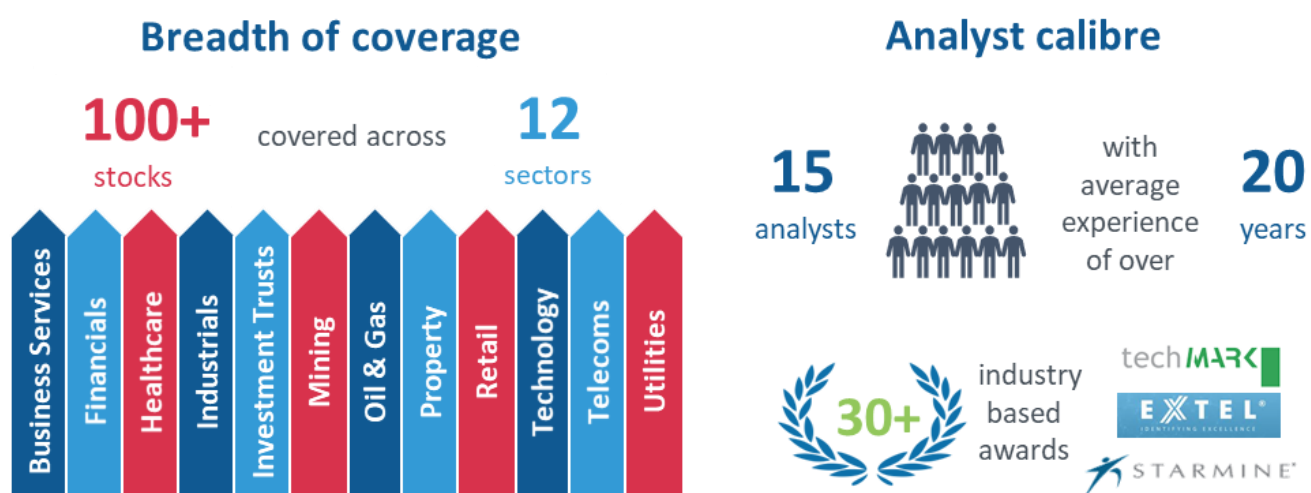
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