Progressive EQUITY RESEARCH

SHEARWATER GROUP

IT CYBER SERVICES, SOLUTIONS & PROFESSIONAL CONSULTING

2 December 2022

SWG.L

100p

Market Cap: £23.8m

SHARE PRICE (p)

12m high/low	139p/74p

Source: LSE Data (priced as at prior close)

KEY DATA

Net (Debt)/Cash	£0.9m *(at 30/09/22)*
Enterprise value	£22.9m
Index/market	AIM
Next news	Trading update, Apr. '23
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

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SHEARWATER GROUP IS A RESEARCH CLIENT OF PROGRESSIVE

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Robust trading despite macro headwinds

Interim results for the six months ended 30 September 2022 show that Shearwater has delivered a robust trading and operational performance. The Services division saw an increase in revenue, while Software division revenue was once again impacted by the impending new product launches and revisions. Current trading is strong, with newly released software products generating encouraging interest. The financial performance was, however, affected by a significant unrealised forex charge and working capital drag. We have revised our forecasts to reflect these transient negatives and sustainable positives. Cyber and Shearwater are long-term stories with dynamics that are significantly more attractive than mainstream software and services; Shearwater's market valuation does not appear to reflect this.

- **Robust services.** Services revenues increased H1 on H1 by 5%, driven by both market strength and Shearwater's ongoing ability to deliver the products and services customers require. This latter point was evidenced by Shearwater winning an expanded contract for services with a blue-chip multinational and the solutions business becoming an approved supplier on the UK government's G-Cloud.
- **Software set for bounce back.** The subdued software revenue, down 12% in H1 FY23, was not surprising. The issues regarding new product launches and revisions had been seen already in FY22, and highlighted by management. Importantly, however, the new products and features have now been launched. The GeoLang optical character recognition feature, with which users can scan documents for sensitive data, is particularly interesting: already sold to and working at an international bank, it has generated strong interest from potential customers
- **Forecasts revised.** We have adjusted our forecasts to reflect the interim results and positive current trading commentary, with group revenue for the seven months to end-October 2022 being 6% above the same period of last year. Our revenue forecasts for FY23 and FY24 are unchanged. Revised FY23 profits reflect the impact of the £0.9m FX charge (see overleaf), but we reflect some clawback of this amount during H2 and our expectations for FY24 profitability are unchanged. To reflect the working capital movements, we have, however, reduced our year-end net cash forecasts for FY23 and FY24, by £2.9m and £1.8m, respectively.

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	4.4	5.1
Fully Adj PBT	0.9	2.2	2.8	2.8	3.4
Fully Adj Dil EPS (p)	7.6	9.7	10.3	11.2	13.6
EV/Sales (x)	0.7x	0.7x	0.6x	0.6x	0.6x
EV/EBITDA (x)	6.7x	6.2x	5.2x	5.3x	4.5x
PER (x)	13.2x	10.4x	9.7x	8.9x	7.3x

Source: Company Information and Progressive Equity Research estimates.

Robust trading vs financial roadbumps

Shearwater delivered a strong sales and operational performance with revenue at £10.8m vs H1 FY22's £10.6m. At a divisional level, revenue in the Services division increased while Software revenue continued to see the impact of the impending new product launches and revisions. The strong operational performance was, however, impacted by a significant unrealised forex charge following recent currency turmoil. Stripping out the impact of foreign exchange movements, the statement confirmed that H1's financial performance at the underlying level was little changed from H1 FY22.

H1 FY23 vs H1 FY22

	H1 FY23 £'000	H1 FY22 £'000	YoY Change %
Revenue	10,790	10,576	2%
Gross profit	2,715	4,101	-34%
Gross profit margin	25%	39%	
Overheads	2,653	2,840	7%
Adjusted EBITDA	61	1,261	-95%

Source: Company information

Services – robust revenue once again

Services revenues increased H1 on H1 by 5%. This was driven by both market strength and Shearwater's ongoing ability to deliver the products and services customers require. This latter point was evidenced by Shearwater winning an expanded contract for services with a blue-chip multinational and the solutions business becoming an approved supplier on the UK government's G-Cloud. However, bottom-line financial performance was heavily impacted by the unrealised foreign exchange loss on a USD liability, as described above.

Services division H1 FY23 performance

	H1 FY23 £'000	H1 FY22 £'000	YoY change %
Revenue	9,136	8,689	5%
Gross profit	1,571	2,639	-40%
Gross profit margin%	17%	30%	
Overheads	1,738	1,735	
Adjusted EBITDA	(167)	905	
Adjusted EBITDA %	-2%	10%	

Source: Company information

Employee availability has long been a pinch point with cyber security businesses. Faced with a strong backlog of business within its security services operations, Shearwater has succeeded in growing its revenue-generating security consultant capacity by 20% through recruitment and investment in training. We look forward to this being reflected in the strengthening performance in this area in H2 and beyond.

Software – expecting growth in H2 and beyond

Software revenue for H1 declined 12% vs H1 FY22. The issues regarding new product launches and revisions had been seen already late in FY22 and highlighted by management. Importantly, however, the new products and features have now been launched for both GeoLang and SecurEnvoy, and we anticipate further launches across the remainder of the year.

We regard the GeoLang optical character recognition feature, with which users can scan documents for sensitive data, as particularly interesting. The product is already being used by a leading international bank and has generated strong interest from potential customers.

Operational developments have also extended to the sales channel where Shearwater now has a global distribution agreement in place with Ingram Micro, the major North American distributor, for identity and access authentication products.

H1 saw investment in new sales roles and a temporary increase in cloud hosting costs that impacted profitability. This extended sales resource is now active in the field, and we anticipate a positive impact upon sales and profitability in H2. Cloud costs are expected to return to previous levels in H2.

Software division H1 FY23 performance

	H1 FY23 £'000	H1 FY22 £'000	YoY change %
Revenue	1,654	1,887	-12%
Gross profit	1,144	1,462	-22%
Gross profit margin%	69%	77%	
Overheads	441	552	20%
Adjusted EBITDA	703	910	-23%
Adjusted EBITDA %	43%	48%	

Source: Company information

Financial bumps in the road – forex

The primary driver to the decline in Group Adjusted EBITDA from £1.3m H1 FY22 to £0.1m H1 FY23 was the £0.9m charge from the increase in unrealised USD liabilities on payables to a US supplier on a long-term liability that is due for payment in May 2023 and May 2024.

Against the backdrop of sterling volatility in recent months, this charge reflects something of a snapshot of the position at the end of September (immediately post the Truss/Kwarteng mini-budget, and a recent low in the value of sterling).

By the end of October, the position had unwound to the extent of £0.2m. Forward contracts were put in place after the period end, providing 75% coverage on the exposure to further sterling weakness. We anticipate that the management will be following a policy of active hedging going forward.

Financial bumps in the road – working capital

In addition to the forex matter, the net cash figure of £0.9m (vs £4.4m H1 FY21, £5.6m FY22) was lower than we expected due to the shifts in working capital. The main reason for this was a large contract win in FY22, on top of which there was also some drag on cash receipts at the end of September. The October cashflow saw the inflow from the delayed September receipts, and we expect that H2 will once again see strong cash generation for Shearwater, with the period covering the year-end of Shearwater's major customers.

Acquisitions remain under consideration

The balance sheet remains robust and Shearwater still has a £4.0m revolving credit facility, which was not drawn upon during the period. We believe that Shearwater continues to actively explore potential acquisitions within both services and software, both in the UK and internationally, looking to add product to the software portfolio or scale in services, in all cases with an eye to the potential of cross-selling.

Current trading strong – positive outlook across services and software

The results highlight that the second half has begun well. For the seven months to end-October 2022, group revenues are 6% ahead of the prior year. Approximately 30% of expected H2 revenues are visible from contracted, scheduled or existing contract renewals, before cross-selling and other new projects for both new and existing customers.

Forecasts revised – some clawback of short-term pain

We have adjusted our forecasts to reflect the FX and working capital issues, the current strong trading, the positive reception for GeoLang's new software and some improvement on costs. Our revenue forecasts for FY23 and FY24 are unchanged. FY23 profits see some clawback in the £0.9m forex charge during H2, with expectations for FY24 profitability unchanged. We have, however, reduced our year-end net cash forecast for FY23 and FY24, with the reduction in FY24 principally being a limited follow-through from the FY23 revision.

Forecast revisions

	FY23E			FY24E		
	Old £m	New £m	Change %	Old £m	New £m	Change %
Revenue	37.9	37.9	0%	40.6	40.6	n/a
Adj EBITDA	4.8	4.4	-8%	5.1	5.1	n/a
Cash at y/e	7.9	5.0	-37%	10.8	9.0	-17%

Source: Progressive Equity Research

Shearwater / Cyber – not standard tech dynamics or valuation

Shearwater's market valuation metrics remain subdued, even compared to more mainstream software and services businesses. This seems unjustified, in our view, given the attractions of cyber-business in a broader industry sector that places a premium on long-term growth, customer relationships and opportunities to gain from structural change.

Cyber is a structural growth market. Unlike many applications that we have seen before, such as ERP or CRM or even perhaps AI, cyber is by its nature ever evolving. The relentless changes in technology, shift to working from home, 5G, industrial internet of things et al ensure that cyber is not something that can be paused even in the face of economic uncertainty.

The relationships are stronger. The price of failure with cyber is far greater, for both parties, than in mainstream businesses. This applies not just for writers of software but also for suppliers. Cyber software resellers and consultants are valued and trusted by users in a way that mainstream players are not. Furthermore, this form of trust extends between cyber software providers and their channel partners. No one wants their product sold through into an application where it does not work as promoted.

Cyber industry structure is changing, providing opportunities. Many of the mainstream software markets have moved through the process of industry specialisation. This is not the case in cyber, where vertical specialisation in some areas is yet to fully take hold. Shearwater's management has suggested that specific industry verticals could become increasingly important in cyber security and opportunities may arise for Shearwater to target additional niches, for example transport or healthcare. We note that these opportunities could be either organic or through acquisition, and occur both in services and software.

Financial Summary: Shearwater Group

Year end: March (£m unless shown)

PROFIT & LOSS	**2020**	**2021**	**2022**	**2023E**	**2024E**
Revenue	33.0	31.8	35.9	37.9	40.6
Adj EBITDA	3.4	3.7	4.4	4.4	5.1
Adj EBIT	0.7	0.5	1.0	0.8	1.4
Reported PBT	(1.3)	0.0	0.9	0.6	1.0
Fully Adj PBT	0.9	2.2	2.8	2.8	3.4
NOPAT	1.7	2.3	2.5	2.8	3.4
Reported Dil EPS (p)	(6.8)	0.6	(1.2)	2.4	3.9
Fully Adj Dil EPS (p)	7.6	9.7	10.3	11.2	13.6
Dividend per share (p)	0.0	0.0	0.0	0.0	0.0
CASH FLOW & BALANCE SHEET	**2020**	**2021**	**2022**	**2023E**	**2024E**
Operating cash flow	4.9	6.6	(0.3)	0.8	5.6
Free Cash flow	5.2	6.6	(0.4)	0.8	5.6
FCF per share (p)	23.7	27.9	(1.5)	3.6	23.4
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)	(0.6)	4.0
Overdrafts / borrowings	(4.8)	(0.8)	0.0	0.0	0.0
Cash & equivalents	3.3	8.0	5.6	5.0	9.0
Net (Debt)/Cash	(1.4)	7.3	5.6	5.0	9.0
NAV AND RETURNS	**2020**	**2021**	**2022**	**2023E**	**2024E**
Net asset value	52.5	56.5	56.2	56.9	58.2
NAV/share (p)	237.5	255.5	236.1	238.8	244.2
Net Tangible Asset Value	(4.3)	1.9	3.6	6.5	10.1
NTAV/share (p)	(19.2)	8.5	15.3	27.5	42.5
Average equity	50.9	54.5	56.3	56.5	57.5
Post-tax ROE (%)	3.3%	4.2%	4.5%	4.9%	5.9%
METRICS	**2020**	**2021**	**2022**	**2023E**	**2024E**
Revenue growth		(3.8%)	12.9%	5.7%	7.1%
Adj EBITDA growth		8.7%	18.7%	(0.8%)	17.3%
Adj EBIT growth		(25.2%)	95.2%	(20.7%)	75.6%
Adj PBT growth		136.3%	27.1%	(1.5%)	21.2%
Adj EPS growth		27.0%	6.4%	9.5%	21.2%
Dividend growth		N/A	N/A	N/A	N/A
Adj EBIT margins		1.6%	2.7%	2.1%	3.4%
VALUATION	**2020**	**2021**	**2022**	**2023E**	**2024E**
EV/Sales (x)	0.7	0.7	0.6	0.6	0.6
EV/EBITDA (x)	6.7	6.2	5.2	5.3	4.5
EV/NOPAT (x)	13.6	10.0	9.0	8.2	6.8
PER (x)	13.2	10.4	9.7	8.9	7.3
Dividend yield	N/A	N/A	N/A	N/A	N/A
FCF yield	23.7%	27.9%	(1.5%)	3.6%	23.4%

Source: Company information and Progressive Equity Research estimates

2 December 2022

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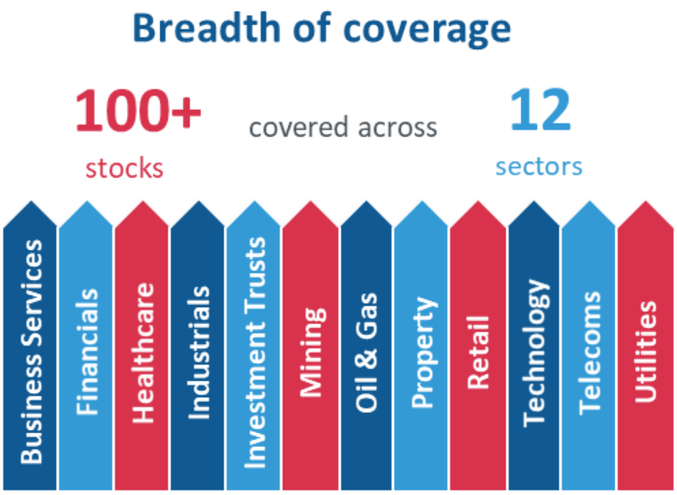

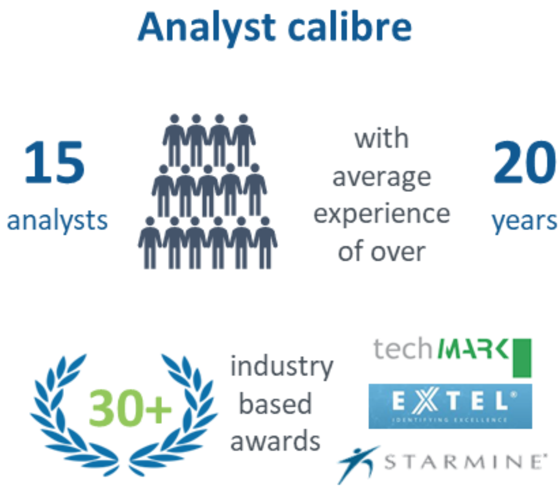

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