

# GAMMA COMMUNICATIONS

## SOFTWARE AND COMPUTER SERVICES

6 September 2022

### GAMA.L

1070p

Market Cap: £1034.4m

#### SHARE PRICE (p)



12m high/low 2,335p/1,026p

Source: LSE Data (priced as at prior close)

#### KEY DATA

Net (Debt)/Cash	£72.6m (at 30/06/22)
Enterprise value	£974.4m
Index/market	AIM
Next news	H2 Trading, Jan 2023
Shares in Issue (m)	96.7
Chairman	Richard Last
Interim CEO	Andrew Belshaw
CFO	Bill Castell

#### COMPANY DESCRIPTION

Gamma provides a broad range of communications products and services in the UK and Europe

[www.gamma.co.uk](http://www.gamma.co.uk)

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## Quality shining through

Gamma Communication's robust H1 results, released today, contained no significant surprises, following the confirmatory trading update issued at the end of July. Revenue for H1 increased by 8% to £234.7m (H1 2021: £217.4m), Adjusted EBITDA increased by 13% to £51.9m (H1 2021: £46.0m) and Adjusted EPS was up 16% to 35.6p (H1 2021: 30.6p). Net Cash at the period end was £72.6m, up from £49.5m at the end of December 2021. The business continues to grow, the growth drivers remain intact, we have raised estimates and, in our view, the recent derating seems unjustified.

- **UK Indirect – 10% revenue growth.** The growth story continues, driven by UCaaS and data product growth.
- **UK Direct – 7% revenue growth.** The post-pandemic sales effort is reflected in revenue growth and a strong pipeline.
- **Europe – 4% underlying revenue growth.** German growth drivers and Spanish issues have been addressed. Growth of 7% in Cloud PBX seats is a higher rate than seen in the UK.
- **New management, same growth story.** Despite recent moves, with Andrew Belshaw transitioning to Interim CEO from CFO on the departure of Andrew Taylor, and Bill Castell arriving as CFO, Gamma's management team is presenting a consistent and clear growth story for investors.
- **Strong cash position to help drive growth?** Net Cash at the period end of £72.6m reflects an Adj. EBITDA / cash generated from operations ratio of 95% (H1 2021: 94%). Management has the experience and understanding to translate this into both organic and acquisition-driven growth.
- **Guidance reaffirmed; forecasts raised.** Once again management has confirmed that its expectation for Adj. EBITDA and Adj. EPS is for outcomes in the upper half of the current forecast range. We have adjusted our estimates to place ourselves firmly in that upper half.

Gamma is a well-managed business that is well-positioned to take advantage of the changes in the way that people within businesses work and engage with one another, and with customers. The drivers to growth remain clear, and following the pandemic are perhaps more evident than ever. Gamma's share price appears to have suffered as if its growth credentials were either unproven or short term. They are clearly neither, in our view. We do not expect this derating to be a long-term phenomenon.

FYE DEC (£M)	2019	2020	2021	2022E	2023E
Revenue	328.9	393.8	447.7	485.5	530.7
Adjusted EBITDA	63.5	79.0	95.4	105.3	115.2
Adjusted PBT	48.1	61.7	77.2	85.8	95.2
Adjusted Dil. EPS	40.8	51.3	64.0	72.0	77.0
EV/Sales (x)	3.0x	2.5x	2.2x	2.0x	1.9x
EV/ Adj. EBITDA (x)	15.4x	12.4x	10.2x	9.3x	8.6x
P/E (x)	26.2x	20.9x	16.7x	14.9x	13.9x

Source: Company Information and Progressive Equity Research estimates.

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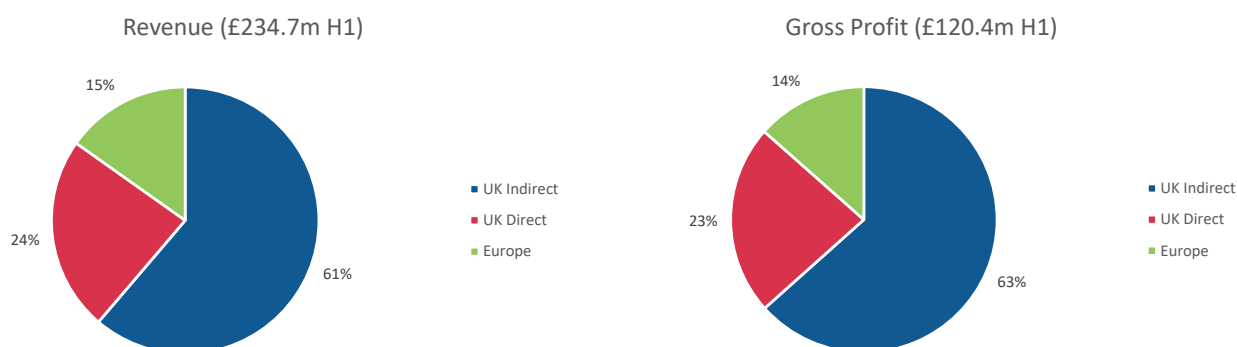
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## Robust results – still a growth story

Gamma Communication’s robust H1 results contained no significant surprises, following the confirmatory trading update issued at the end of July. Revenue for H1 increased by 8% to £234.7m (H1 2021: £217.4m), Adjusted EBITDA increased by 13% to £51.9m (H1 2021: £46.0m) and Adjusted EPS at 35.6p was 16% up on H1 2021 (30.6p). Net Cash at the period end was £72.6m, up from £49.5m at the end of December 2021.

The UK businesses continue to drive top-line growth. The European business has faced issues in Spain but elsewhere, most notably in Germany, it has generally made good progress. The medium- and long-term drivers to Gamma’s growth appear fully intact, and we have adjusted our estimates to reflect the fact that management has, once again, stated that it anticipates Adjusted EBITDA and Adjusted EPS results for the year in the upper half of the market estimates range.

### Revenue and Gross Profit mix H1



Source: Company data

### UK Indirect (61% revs H1)

#### UK Indirect – H1 2022 vs H1 2021

	H1 2022	H1 2021	Change	FY2021
Revenue (£m)	143.7	130.1	10%	270.2
Gross profit (£m)	76.3	69.2	10%	143.2
Gross margin	53.1%	53.2%		53.0%

Source: Company data

In H1 2022, the UK Indirect business continued its strong growth, driven by UCaaS (Unified Communications as a Service) and data product growth. It is worth remembering that this business saw high-single-figures annual revenue growth across the pandemic. This double-figure growth is not a bounce-back result.

### UK Direct (24% revs H1)

UK Direct – H1 2022 vs H1 2021				
	H1 2022	H1 2021	Change	FY2021
Revenue (£m)	55.4	51.9	7%	104.8
Gross profit (£m)	27.9	26.4	6%	52.6
Gross margin	50.4%	50.9%		50.2%

Source: Company data

The UK Direct business saw 7% growth in revenue in H1 2022 helped by what management describes as ‘significant levels of activity in late 2021’. Important MS Teams user contract wins, including the Home Office and Department for Work and Pensions, were made in the half. The results statement refers to the strong pipeline being significantly ahead of this time last year, giving us yet more comfort in the outcome for the full year.

The slight decline in gross margin is attributable to an increased proportion of installation and hardware sales, which are made at a lower margin.

Management had made reference to the impact of IT Hardware supply chain issues in earlier statements, pointing to the limited impact seen in H1. From the comments in today’s release it would appear that the supply of some items has caused issues in H2. This is not, however, a significant part of the business overall and would most likely lead to a deferral of revenues or temporary compression of margins.

### Europe (15% revs H1)

Europe – H1 2022 vs H1 2021				
	H1 2022	H1 2021	Change	FY2021
Revenue (£m)	35.6	35.4	1%	72.7
Gross profit (£m)	16.2	16.1	1%	32.7
Gross margin	45.5%	45.5%		45.0%

Source: Company data

In local currency terms, the growth in revenue and gross profit was 4% H1 on H1. However, the impact of euro weakness has meant that in GBP terms this was constrained to only 1%. The European business is, of course, an amalgam of entities across a number of countries, and the European result is a mix of strong trading progress and business improvement actions. Gamma has been doing well in Germany, while in Spain there have been issues. For the business in Spain, we hope that the disposal in August of ComyMedia, a non-core subsidiary that was acting as a drag on sales growth, and the acquisition of NeoTel, another UCaaS / CCaaS business, for an initial consideration of €5.5m plus a contingent €3.5m subject to regulatory approval and certain closing conditions, will mark something of a watershed for Gamma in that country.

One of the main attractions of the European markets for Gamma is that, with one or two exceptions, the shift towards cloud-based telephony lags that of the UK. The fact that Gamma saw the number of Cloud PBX seats in its European business increase by 7% to 137,000 from 128,000 at the start of the period (ie annualised 14.5%) is particularly encouraging.

We note that the key factor behind the difference in gross margins between the UK and European operations is that the European operations contain a material level of revenues from the Epsilon business in Germany, which resells mobile connections. We take some reassurance from this that the markets are broadly comparable for similar products, albeit at differing levels of development. This focuses our attention firmly on Gamma's potential to drive revenue growth in these geographies and thus to see the benefits of operational gearing and greater scale to the bottom line.

### **Operating expenses**

The trading updates in May and July highlighted the pressure on cash expenses and management's ongoing efforts and success in limiting the impact of inflation. H1 on H1 cash operating costs increased by 4% with higher staff costs being one of the primary drivers to this. We regard this as a very creditable result and note that Gamma is perhaps a stock that investors should regard as relatively well-protected from the scourge of inflation.

### **Balance sheet and cashflows**

As at 30 June, Gamma had Net Cash of £72.6m, up from £25.6m the year before and £49.5m at the year-end. These figures are excluding contingent consideration and other acquisition-related costs of £10.0m. Cash conversion remained strong and consistent with Adjusted EBITDA / cash generated from operations at 95% (H1 2021: 94%).

Despite the changes to management, the commitment to dividends and dividend growth is clearly still present. The interim dividend of 5.0p is a 14% increase on FY21's interim payment.

### **Management changes**

There have recently been several significant changes to the senior management structure of Gamma Communications. First was the promotion of Andrew Belshaw from CFO to Deputy Chief Executive Officer in May. His position as Chief Financial Officer has been taken on by Bill Castell, who has an impressive track record in a number of senior finance roles, most recently as CFO at Ovo Energy. His experience has included utilities, technology/media, finance, rapid growth ventures and dealing with regulators. We believe he is well-placed to understand Gamma's opportunities and challenges. In July, Andrew Taylor indicated his intention to retire from his role as CEO and from the Board, and Andrew Belshaw took on the role of Interim Chief Executive Officer.

### **Revisions to estimates – limited impact on valuation after mystery derating**

The trading outlook restates the message from the May and July updates that management expects Adjusted EBITDA and Adjusted EPS to be in the upper half of the market estimates range. Management points to an Adjusted EBITDA estimate range for FY22 of £102.3m to £106.8m and an Adjusted EPS estimate range of 67.1p to 74.6p. Taking heart from these strong interim results, we are moving our FY22 Adjusted EBITDA estimates into the top half of the range indicated by management. We have also adjusted our forecasts for FY23, with the main drivers to changes in FY22 having similar impacts in FY23.

The change to group revenue is a mix of a reduction in the estimate for revenue in Europe and increases in those for the UK business areas. We have also edged up margins in the UK business areas. We have adjusted our tax charge for FY23 and, following the increased level of development spend capitalised and purchases of other (non-acquisition related) intangibles in H1 FY22, £5.6m vs £2.5m H1 FY21 and £7.7m FY21, increased this for FY22 and FY23 while reducing tangible capex slightly. Following the 14% increase in the interim dividend to 5.0p, we have increased our dividend estimate for FY22 from 13.9p to 15.0p and for FY23 from 15.2p to 16.5p.

Estimate revisions						
	Old 2022E	New 2022E	Change (%)	Old 2023E	New 2023E	Change (%)
Revenues (£m)	488.0	485.5	-1%	545.0	530.7	-3%
Adj EBITDA (£m)	104.0	105.3	1%	116.1	115.2	-1%
Adj PBT (£m)	83.7	85.8	3%	95.4	95.2	0%
Adj Dil EPS (p)	68.6	72.0	5%	74.4	77.0	3%
Dividend per share (p)	13.9	15.0	8%	15.2	16.5	9%
Net Cash (£m)	87.5	85.8	-2%	139.8	136.2	-3%

Source: Progressive Equity Research

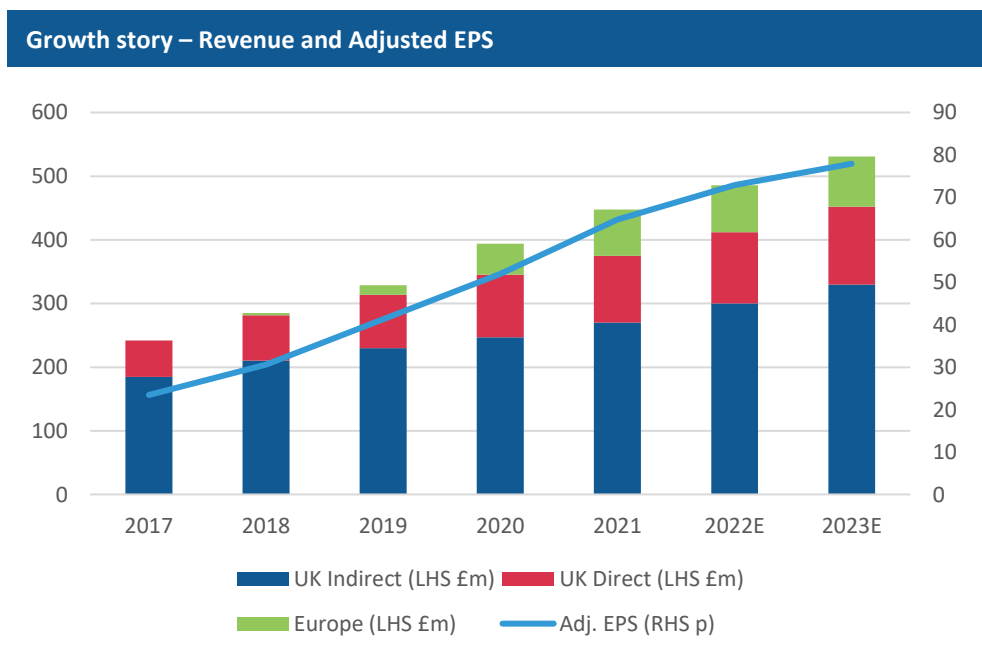
These estimate changes do not, however, make much difference to the question of valuation. Gamma Communications stands on a current year P/E of 15x with forecast earnings growth of 12.5%.

It would appear that the market is 'looking through the pandemic' (ie not looking at what happened) and not giving Gamma the credit for growth that it deserves.

It could also be that the market has labelled Gamma as a technology story based on unproven or unrealistically optimistic hopes to a transition in the way that people work. And, having done so, the share price has suffered as if it were an untested market newcomer.

The vast majority of what Gamma is seeing is not bounce-back growth. Gamma is not looking to return to FY19 levels in FY22. Gamma has grown across the pandemic. FY19 Adjusted EPS was 40.8p, and we are forecasting a result for FY22E of 72.0p, an annualised growth rate of 21%. Furthermore, Gamma still has plenty of growth ahead of it.

The exciting days when the sources of growth were novel may have passed but these are almost all long-term drivers to growth, and to our minds the events of the pandemic have simply made them more evident and tangible than was the case three years ago.



Source: Company data, Progressive Equity Research

In his section of the results statement, Interim CEO Andrew Belshaw sets out, with evident conviction, his belief in the growth drivers for Gamma Communications.

Our view on the growth drivers that he identifies are set out below:

**Cloud comms is growing in the UK.** Gamma can grow with the transition and by increasing the functionality/products that it provides to those who have adopted already and those going to adopt. We agree strongly with this proposition.

**The European market is underpenetrated and less evolved than the UK.** The fact that Europe lags the UK in adoption of cloud communications might be a frustration but if it were not so then Gamma would not have been able to get itself on at the bottom of the escalator. These markets are several times the size of the UK, and Gamma’s experience and technology solutions mean it is well-placed to replicate much/some of the success it has seen in the last several years in the UK.

**Acquisitions.** With over £70m of cash on the balance sheet and a relatively capital-light business model, Gamma is well-positioned to improve its technological, geographic and strategic position through further acquisitions. In recent years, management has shown that Gamma is able to execute on such opportunities. This growth driver was highlighted within the ‘Europe’ growth opportunity by Andrew Belshaw, but we believe that it deserves to be given prominence on its own.

**Customer trends and behaviours plus technology changes and MS Teams adoption provide opportunities to improve ARPU.** Gamma is not a utility company; it provides solutions to help companies communicate more effectively both internally and externally. It can do this with its own technology and through selling the products of others, most notably perhaps Microsoft Teams. Andrew Belshaw presents this in three parts, split between customers, technologies and MS Teams, and gives some detail on how this relates to Gamma’s products. We look forward to more detail in the results presentation, but for now we see this as a restatement of a fundamental shift that is occurring in business management and communications as software and telecom companies alike focus on increasing and extracting the value in B2B human-to-human engagement.

### **Conclusion**

Gamma is a well-managed business that is well-positioned to take advantage of the changes in the way that people within businesses work and engage with one another, and with customers. Its roots may lie in being a telecoms provider, but the secret of its success – past, present and future – is that it is not run as one and is not seen as one by its key partners and customers. The drivers to its growth remain clear, and following the pandemic are perhaps more evident than ever. But the transition will still take years to complete. Gamma's share price appears to have suffered as if its growth credentials were either unproven or short term. They are clearly neither, in our view. We do not expect this derating of the stock to be a long-term phenomenon.

**Financial Summary: Gamma Communications**

Year end: December (£m unless shown)

	2019	2020	2021	2022E	2023E
<b>PROFIT &amp; LOSS</b>					
Revenue	328.9	393.8	447.7	485.5	530.7
Adj EBITDA	63.5	79.0	95.4	105.3	115.2
Adj EBIT	46.4	56.1	68.1	77.2	86.6
Reported PBT	45.2	75.0	67.2	76.1	85.5
Fully adj PBT	48.1	61.7	77.2	85.8	95.2
NOPAT	39.0	49.4	62.1	70.2	75.1
Reported EPS	36.1	66.6	55.2	62.0	67.0
Fully adj EPS	40.8	51.3	64.0	72.0	77.0
Dividend per share	10.5	11.7	13.2	15.0	16.5
<b>CASH FLOW &amp; BALANCE SHEET</b>					
Operating cash flow	66.1	82.5	100.2	111.9	122.3
Free Cash flow	46.5	56.2	76.5	83.8	90.4
FCF per share	49.3	59.1	79.8	87.0	93.8
Acquisitions	(19.8)	(62.7)	(65.9)	(19.9)	(22.9)
Disposals	0.0	19.4	0.0	0.0	0.0
Shares issued	2.0	1.5	5.9	0.0	0.0
Net cash flow	18.4	0.0	(1.1)	48.2	50.4
Overdrafts / borrowings / leases	(12.6)	(19.0)	(15.2)	(15.2)	(15.2)
Cash & equivalents	53.9	53.9	52.8	101.0	151.4
Net (Debt)/Cash	41.3	34.9	37.6	85.8	136.2
<b>NAV AND RETURNS</b>					
Net asset value	152.5	204.4	251.7	303.1	358.0
NAV/share	160.9	214.3	261.3	314.7	371.7
Net Tangible Asset Value	115.1	109.1	122.4	183.5	246.1
NTAV/share	121.4	114.4	127.1	190.5	255.5
Average equity	137.1	178.5	229.3	279.9	333.1
Post-tax ROE (%)	25.2%	36.0%	23.4%	21.6%	19.6%
<b>METRICS</b>					
Revenue growth	15.4%	19.7%	13.7%	8.4%	9.3%
Adj EBITDA growth	31.5%	24.4%	20.8%	10.4%	9.4%
Adj EBIT growth	34.9%	20.9%	21.4%	13.4%	12.2%
Adj PBT growth	37.9%	28.3%	25.1%	11.2%	11.0%
Adj EPS growth	34.7%	25.7%	24.8%	12.5%	6.9%
Dividend growth	12.9%	11.4%	12.8%	13.6%	10.0%
Adj EBIT margins	14.1%	14.2%	15.2%	15.9%	16.3%
<b>VALUATION</b>					
EV/Sales	3.0	2.5	2.2	2.0	1.89
EV/EBITDA	15.4	12.4	10.2	9.3	8.6
EV/NOPAT	25.0	19.7	15.7	13.9	13.0
PER	26.2	20.9	16.7	14.9	13.9
Dividend yield	1.0%	1.1%	1.2%	1.4%	1.5%
FCF yield	4.6%	5.5%	7.5%	8.1%	8.8%

Source: Company information and Progressive Equity Research estimates



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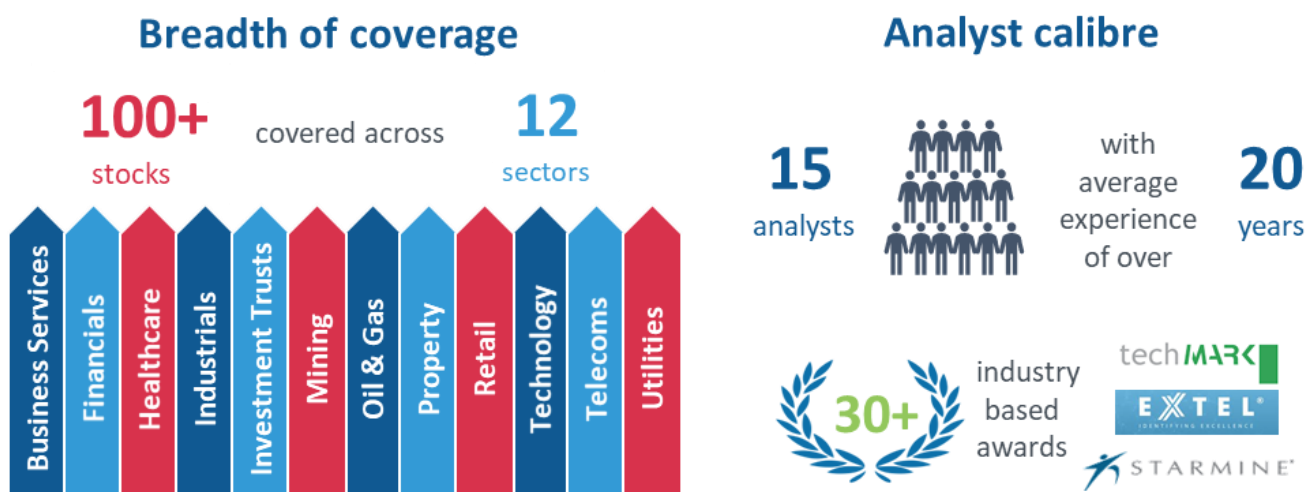
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