

GAMMA COMMUNICATIONS

SOFTWARE AND COMPUTER SERVICES

21 March 2023

GAMA.L

1130p

Market Cap: £1094.1m

SHARE PRICE (p)



12m high/low 1,514p/1,012p

Source: LSE Data (priced as at prior close)

KEY DATA

Net (Debt)/Cash	£92.5m (at 31/12/22)
Enterprise value	£1014.2m
Index/market	AIM
Next news	Trading update, July
Shares in Issue (m)	96.8
Chairman	Richard Last
Chief Executive	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

GAMMA COMMUNICATIONS IS A RESEARCH
CLIENT OF PROGRESSIVE

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Continuing UK growth drives profit and cash

Gamma's results for the year ended 31 December 2022, released today, are in line with expectations and guidance, and show a strong performance with 8% growth in revenue (£484.6m vs FY21 £447.7m), 10% improvement in adjusted EBITDA (£105.1m vs FY21 £95.4m) and 12% increase in adjusted diluted EPS (71.8p vs FY21 64.0p). Cash generated by operations was up by 10%, resulting in year-end net cash (pre-leases) of £92.5m (FY21 £49.5m). Trading in the UK, in both the Indirect and Direct businesses, was strong, with Germany leading the way in Europe. The impressive and consistent progress, and notable drive on investment in technology, suggest to us that Gamma's recent derating is unjustified.

UK Indirect – add-on growth. UK Indirect revenues rose by 10% to £295.9m, driven by increasing volumes, with gross profit rising by 9% to £155.6m; an impressive performance against a difficult macroeconomic backdrop. The UK Indirect business growth was driven by UCaaS and data product growth, with ARPU being supported by sales of additional modules.

UK Direct – Teams a key factor. The enterprise-focused UK Direct business saw 10% revenue growth to £115.5m, with gross profit up by 9% to £57.4m, helped by significant new customer wins in which Microsoft Teams integration was a significant factor.

Europe – encouraging progress. European revenues rose by 1% to £73.2m (2% in constant currency), a solid result given the economic backdrop and acknowledged issues in Spain. Germany was the growth driver, although the small Spanish acquisition, NeoTel 2000, is already having a positive impact.

Strategic review – drive on products and channels. The statement sets out the results of the strategic review. There are no surprises, but we are encouraged by the commitment to investment in technology and products, ensuring that, particularly in Europe, Gamma has the right product and channel fit, with a flexible and cost-effective underlying technology suite.

Expect (and get) more of the same. We have edged down our FY23E estimates, more due to wider economic concern than specific Gamma issues, and we introduce forecasts for FY24E. We expect more of the same from the UK and look for improving growth in Europe. Against an economic and political backdrop of turbulence and uncertainty, we believe that Gamma's consistency and cash generation should have clear attractions for investors.

FYE DEC (£M)	2020	2021	2022	2023E	2024E
Revenue	393.8	447.7	484.6	518.4	550.5
Adjusted EBITDA	79.0	95.4	105.1	112.5	122.2
Adjusted PBT	61.7	77.2	87.8	92.5	99.2
Adjusted Dil. EPS	51.3	64.0	71.8	72.5	76.1
EV/Sales (x)	2.6x	2.3x	2.1x	2.0x	1.8x
EV/ Adj. EBITDA (x)	12.8x	10.6x	9.6x	9.0x	8.3x
P/E (x)	22.0x	17.7x	15.7x	15.6x	14.9x

Source: Company Information and Progressive Equity Research estimates.

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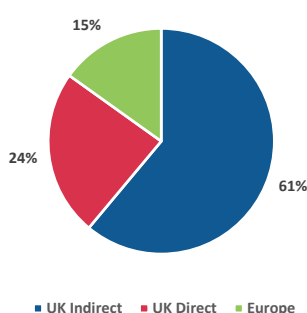
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Continuing UK growth drives profit and cash

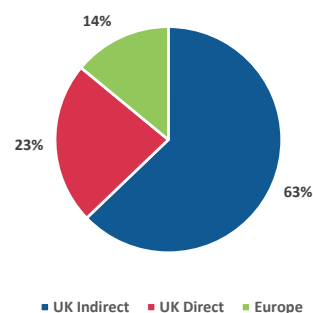
Gamma's results for the year ended 31 December 2022 are in line with expectations and guidance. The results show a strong performance across the year, with 8% growth in revenue to £484.6m (FY21 £447.7m), gross margin maintained at 51%, 10% improvement in adjusted EBITDA to £105.1m (FY21 £95.4m) and 12% increase in diluted adjusted EPS to 71.8p (FY21 64.0p). Cash generated by operations was up by 10%, resulting in year-end net cash (pre-leases) of £92.5m (FY21 £49.5m). Management has declared a total dividend for the year of 15p, an increase of 14% (FY21 13.2p).

Revenue and Gross profit mix FY22

Revenues FY22 (£484.6m)



Gross profit FY22 (£247.7m)



Source: Company data

Trading in the UK, in both the Direct and Indirect businesses, was strong, with Germany leading the way in Europe. The £12.2m write-down on Spanish acquired intangibles is a frustration but management has taken actions to address what should now be a historical issue in Gamma's smallest market. The progress with UCaaS (Unified Communications as a Service) in Germany gives us further faith that Europe will be making a material contribution to Gamma's continuing strong growth over the coming years.

UK Indirect

UK Indirect

	2022	2021	Change
Revenue (£m)	295.9	270.2	10%
Gross profit (£m)	155.6	143.2	9%
Gross margin	52.6%	53.0%	

Source: Company data

UK Indirect revenue rose by 10% driven by increasing volumes, with gross profit rising by 9%. This is an impressive performance against a difficult macroeconomic backdrop, and we note that guidance given in May 2022 on gross profit growth was for 8% (consistent with the prior year). The UK Indirect business is by some way the largest element of the group and its growth was driven by UCaaS and data products, with ARPU being supported by sales of additional modules. The generally stable product mix ensured that the gross margin was in turn stable.

UK Direct

The enterprise-focused UK Direct business was helped by significant new customer wins, with 10% revenue growth benefiting from the significant sales activities in H2 21, compared with guidance given in May 2022 of revenue growth ‘approaching’ 10%.

UK Direct

	2022	2021	Change
Revenue (£m)	115.5	104.8	10%
Gross profit (£m)	57.4	52.6	9%
Gross margin	49.7%	50.2%	

Source: Company data

Microsoft Teams integration was a significant factor in a number of sizeable SIP contract wins during the year, including the DWP and Cardfactory. Although these larger client wins attract the headlines, we note from previous discussions with management that Teams is having a wider impact from the larger SME market upwards.

UK Direct gross profit increased by 9%. The small decline in gross margin is ascribed to the mix shift towards higher installations and hardware sales, which have lower margins and which accompanied the hardware supply chain issues during the year.

UK market growth (Indirect and Direct)

Although it is easy to view Gamma as a relatively mature business having become accustomed to the technology story and the company’s consistent performance, the majority of businesses in the UK still have a physical rather than a software cloud-based PBX solution.

Gamma added 75,000 new seats on its Horizon product in FY22, a figure that is consistent with prior years and with current activity levels. There is still some distance to go and no technological reason to expect the transition to slow.

The UK switch-off of PSTN (Public Switched Telecom Network) in 2025 is now looming, and Gamma’s management remains confident that it will help to grow its voice and data revenues. That said, the transition does involve some customers moving away from legacy contracts that we believe, because of the nature of their costs and pricing, were at advantageous margins.

Europe

European revenue rose by 1%, to £73.2m (2% in constant currency), but accounts for only 15% of group revenue. We view this as a solid result given the economic backdrop and acknowledged issues in Spain.

Europe

	2022	2021	Change
Revenue (£m)	73.2	72.7	1%
Gross profit (£m)	34.7	32.7	6%
Gross margin	47.4%	45.0%	

Source: Company data

As indicated in recent company statements, Germany has been the key driver to growth in Europe, although the small acquisition of NeoTel 2000 would appear from today's statement to be having a positive impact within Spain.

The Netherlands, where offerings are not bundled together in the same way as in the UK, saw a small decline in revenue due to mix impacts of lower pay-as-you-go voice calls. Given that Gamma customers call non-Gamma customers, and vice-versa, we regard this as a market rather than a Gamma issue.

Overall, the 1% revenue growth is clearly a frustration to management and investors alike, but the statement suggests a significant degree in confidence that the necessary steps have been taken in Spain and that the growing traction in Germany will help to deliver an improved performance in FY23.

The fundamental growth story for Gamma in Europe remains intact. The adoption of cloud PBX has not been as rapid as was generally forecast, but management's observation that there are more than two times as many UCaaS business users in these countries as in the UK suggests that continental European businesses are far from averse to unified communications and new technologies.

Despite the limited overall top-line growth, Gamma has been making progress within its markets. Across Europe last year Gamma gained 36,000 cloud PBX seats and had its first two >1,000 seat customer wins in Germany.

Focus on costs

Group adjusted EBITDA increased by 10%, suggesting that management has maintained its focus on costs. Cash operating and cost of goods sold expenses increased by 7% across the group.

However, at the profit from operations level Gamma saw a decline of 4% from £68.3m to £65.4m, mainly because of the £12.5m of exceptional non-cash items. As previously guided, there was an impairment charge of £12.2m relating to the impairment of acquired intangibles in the Spanish business. There was also a £0.3m charge on the sale of the small, non-core Spanish business ComyMedia, which was disposed of for €1 in August 2022.

As previously reported, 2022 saw higher levels of employee churn and a more difficult recruitment market. However, in these results, management states that these pressures have begun to relent in 2023.

Taxation

The effective tax rate on profits before the exceptional item was 19%, in line with the UK statutory rate. Our forecasts reflect the increase in the UK corporation tax rate to 25% from April 2023, which compresses the diluted adjusted EPS growth from 9% down to 4%.

Cash and more cash generation

FY22 was another year of strong cash generation for Gamma, with year-end net cash (pre-leases) of £92.5m up substantially on the £49.5m at 31 December 2021. The ratio of cash generated from operations to adjusted EBITDA was, once again, 94%. This cash generation was after £20.7m of capex, £9.8m of payments for acquisitions, £3.1 receipts for shares issued and £13.3m of dividends.

What Gamma intends to do with this cash is a question that we expect management to increasingly hear from investors over coming weeks and months.

Investment in technology takes a step up

Gamma invested significantly more in development in FY22 than it did in FY21, £13.4m vs £4.8m, with the driver to this being voice application products based on Gamma's own technologies. The increase in spend on its own in-house technology was to an extent offset by a decrease in purchasing of third-party technologies from £2.9m to £0.8m. Gamma also spent slightly less in FY22 (£6.8m) on the core network than it did in FY21 (£9.1m).

Gamma's shift towards becoming a technology company driven by technology that it both owns and controls began with the acquisition of Mission Labs in 2021. These results suggest that this dynamic is gaining momentum even though much of the work may not yet be particularly evident. We note that of the assets under development, £10.2m was not yet in service at the year-end vs £1.4m at the end of FY21.

Gamma's ability to offer more products and services in line with its customers' needs has long been a competitive advantage and differentiator for the group. Therefore, we would regard investment in new technology or software that allows Gamma more control or flexibility in this area as money well spent, and we look forward to the results presentation as an opportunity to find out more about where and why this investment is being made.

Dividend growth continues

Although it is fundamentally a technology-driven growth story, Gamma has a strong record of increasing its dividends. This has continued in FY22, with management declaring a full-year dividend of 15p (5p interim, 10p final), up 14% on FY21 (13.2p).

Acquisitions

With regard to acquisitions, with £92.5m in net cash (pre-leases), and a highly cash-generative business model, management remains on the lookout for opportunities to add to scale and channels access in those countries where the group is already active. This is evidenced by the purchase of small Spanish UCaaS / CCaaS (Contract Centre as a Service) business NeoTel for £5.2m in October 2022; a transaction that has apparently already had a positive impact on Gamma's local sales performance.

Most of the potential candidates are privately owned. Feedback from most UK-listed tech companies looking to acquire, and also willing to comment, is typically that price expectations among private vendors remain high, although heading in the right direction. We look forward to the results presentation as an opportunity to find out more from management on this matter.

Strategic review

Following a five-year strategic review covering the market landscape out to the end of 2026, management has identified four strategic priorities with the goal of becoming a leading provider of UCaaS in Western Europe:

- Develop a common pan-European product set for UCaaS and CCaaS for SMEs.
- Develop multiple routes to market in each country in which we operate.
- Become a trusted partner to Enterprises across Europe, transforming their communications estates.
- Create an organisation that engages all our people with a common set of values and goals.

Develop a common pan-European product set for UCaaS and CCaaS for SMEs

Having acquired a number of businesses across Europe, the fact that Gamma has ended up with some replication of products and resources is almost inevitable. This is evidently inefficient, and management's objective of both developing Gamma's own software and integrating third-party products where more appropriate, with a goal of one product set across all geographies, makes perfect sense to us.

Gamma currently has 751,000 cloud PBX seats, having started selling cloud PBX in 2006. This is a competitive and evolving market with customers that are demanding better pricing and more functionality.

In order to continue to grow these seat numbers and to build/maintain ARPU, Gamma has in recent years developed and launched a number of new modules that augment the core Horizon Cloud PBX offering. These are recurring monthly, per-seat revenues that not only help to increase ARPU but also improve customer retention.

- Call recording, which has been applied to 96,000 seats since its launch in 2019.
- Horizon Collaborate – launched in 2020 but then re-architected to a pure Gamma solution, Collaborate is now applied to 73,000 seats and could be described as how Microsoft would do Teams if it had Gamma's focus on and understanding of the smaller business communications market.
- Microsoft Teams integration – aiming at larger SMEs and the enterprise market, the integration of Teams with Gamma's cloud PBX was launched in July 2021 and already has 7,000 seats.
- Contact centre functionality through multi-channel communications was launched in April 2021 and Gamma now has 11,000 seats.

Gamma does not see the demand for all these products as immediate requirements across the European markets that it serves, but it has the objective of providing its full suite of products and services across its European markets in due course.

Develop multiple routes to market in each country in which we operate

While in the UK Gamma sells to most of its SME customers through partners and to its larger enterprise customers directly, in Europe the routes to market are more varied and include wholesale, resale, dealer and direct.

Gamma's intention is to develop the offering so that it is compatible with the appropriate route for the customer and the geography. Examples of this are the (direct) digital CircleLoop offering that has recently been launched in Germany and the Netherlands, and the ongoing development of the Gamma Hub user portal that allows UK Direct enterprise customers to more easily and cost effectively purchase more seats and functionality.

Become a trusted partner to Enterprises across Europe, transforming their communications estates

Management expects that, in common with the UK experience, Enterprise sales will be a major long-term driver to growth in Europe. Enterprise sales include the full range of Gamma's products, often sold as part of a managed solution, and with integration with offerings from third parties. The most obvious of these is that with Microsoft Teams but, notably, Gamma also integrates with Amazon Connect, Amazon's own contact centre solution.

Although the usage of Teams is now quite pervasive in business, its use for voice calls remains limited. Gamma's management believes that although less than 5% of Teams users have voice enabled their setup thus far, the Teams voice market could reach 3.5m users in the UK by 2026 – a transition that gives Gamma an opportunity to sell several services.

At a basic level, Gamma can provide the SIP service to Teams users for their voice calls. Gamma sells this itself as 'Microsoft Teams Direct Routing' and, when it is sold via Microsoft's accredited portal, 'Operator Connect'. It is shortly to be made available in Germany, Spain and Belgium. It is already offered in the UK and the Netherlands, and interestingly in the Netherlands it has allowed Gamma to create relationships with new channel partners and access new areas of the market.

For customers that want to integrate Teams onto their core Horizon Cloud PBX product, Gamma offers a solution, but it can also offer a far higher level of integration with its Cloud UCX product; the product that has helped Gamma win several large public sector contracts in recent years.

Create an organisation that engages all our people with a common set of values and goals

While statements like this can often seem like hot air, we believe that this is definitely not the case with Gamma. In an industry that has a long history of failing to serve its customers – in the UK and many other countries – Gamma has built its UK position on the back of providing the customer with what they want and making their lives easier. From what we have seen of the European acquisitions, a similar ethos, or at least aspiration, was already in place for most prior to their acquisition.

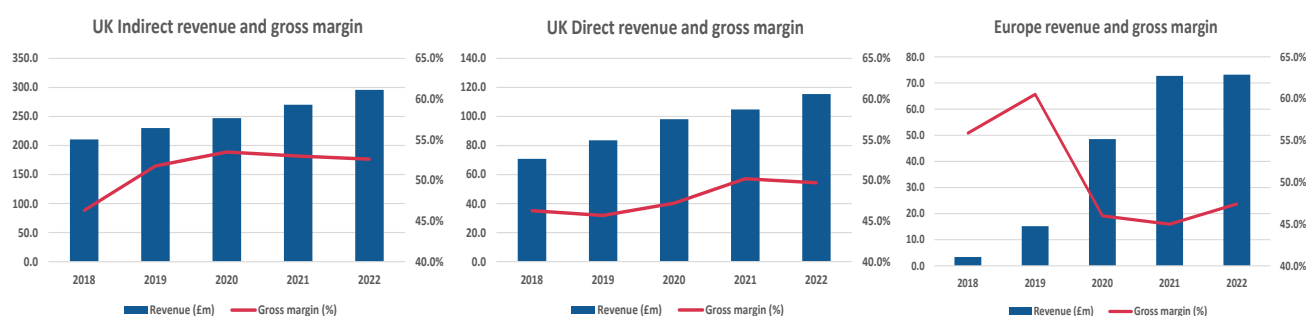
Outlook

The outlook statement from management is positive. Growth is expected to continue in 2023, with more investment in extending the product portfolio across Europe and additional users in both the UK and Europe.

Forecasts – FY23 estimates trimmed and FY24 forecasts introduced

We have revised our FY23E estimates for Gamma following these results and are publishing FY24E forecasts for the first time. The charts of historical performance below have the same scale on the gross margin axis, showing that both the UK Indirect and Direct businesses are firmly established with stable margins, while suggesting that the European business is not fundamentally different from its UK siblings. We expect more of the same from the UK and look for growth to improve in Europe. Against an economic and political backdrop of turbulence and uncertainty, we view Gamma’s consistency and cash generation as having considerable attractions.

Revenue and gross margin progression – more similar than headlines suggest



Source: Company data

For FY23, in light of the continuing economic uncertainty we have trimmed our revenue estimate from £530.7m to £518.4m, edging down our revenue growth estimates for UK Indirect from 10% to 7.5%, UK Direct from 9% to 7.5% and Europe from 7% to 4%. We have maintained forecast gross margins for the UK Indirect and Direct businesses, at 52.5% and 49%, respectively, and increased European gross margins slightly, from 45% to 46%. This flows through to the adjusted EBITDA figure, with the margin moving to 21.7%. At the cash level, the FY23 year-end net cash (pre-leases) estimate is reduced from £148.1m to £130.8m, still a ratio of Cash from Operations to adjusted EBITDA of 93%.

FY23 estimate revisions and FY24 new estimates

	Old 2023E	New 2023E	Change (%)	New 2024E
Revenues (£m)	530.7	518.4	-2%	550.5
Adj EBITDA (£m)	115.2	112.5	-2%	122.2
Adj PBT (£m)	95.2	92.5	-3%	99.2
Adj Dil EPS (p)	77.0	72.5	-6%	76.1
Dividend per share (p)	16.5	16.5	0%	18.2
Cash and equivalents (£m)	151.4	132.9	-12%	176.8
Net Cash pre-leases (£m)	148.1	130.8	-12%	174.7
Net Cash post-leases (£m)	136.2	119.7	-12%	163.6

Source: Progressive Equity Research

Our new FY24E forecasts reflect an expectation of continuing high-single-figure revenue growth in the UK (6.75%) and low- to mid-single figures in Europe (3%), combined with broadly constant gross margins from FY23. This flows, as usual, through to healthy cash generation and a year-end net cash (pre-leases) figure of £174.7m – assuming that there are no acquisitions or other distributions.

Conclusion

Gamma has again delivered strong growth in revenues, earnings and cash generation. Since the FY21 results, the shares have derated significantly. After the FY21 results, the shares stood on a forward P/E of 22.0x; today it is 15.7x. Tech may no longer be in favour as a sector, but strong underlying growth is difficult to find, while consistency and predictability should currently demand a premium. And cash generation, so we are told by fund managers, is always in fashion.

This share price weakness appears odder still when we scratch beneath the surface and consider the impact that the investment in technology could yield over coming years if it provides Gamma with a more flexible, effective and cost-efficient technology suite, improving both revenues and margins beyond current estimates.

Financial Summary: Gamma Communications

Year end: December (£m unless shown)

	2020	2021	2022	2023E	2024E
PROFIT & LOSS					
Revenue	393.8	447.7	484.6	518.4	550.5
Adj EBITDA	79.0	95.4	105.1	112.5	122.2
Adj EBIT	56.1	68.1	77.9	84.0	90.7
Reported PBT	75.0	67.2	64.9	82.9	89.6
Fully adj PBT	61.7	77.2	87.8	92.5	99.2
NOPAT	49.4	62.1	70.0	70.9	74.4
Reported EPS	66.6	55.2	50.6	64.8	68.3
Fully adj EPS	51.3	64.0	71.8	72.5	76.1
Dividend per share	11.7	13.2	15.0	16.5	18.2
CASH FLOW & BALANCE SHEET					
Operating cash flow	82.5	100.2	108.4	117.6	127.3
Free Cash flow	56.2	76.5	84.6	85.3	92.8
FCF per share	59.1	79.8	87.6	88.0	95.8
Acquisitions	(62.7)	(65.9)	(29.3)	(29.7)	(30.0)
Disposals	19.4	0.0	(0.3)	0.0	0.0
Shares issued	1.5	5.9	3.1	0.0	0.0
Net cash flow	0.0	(1.1)	41.2	38.4	43.9
Overdrafts / borrowings / leases	(19.0)	(15.2)	(13.2)	(13.2)	(13.2)
Cash & equivalents	53.9	52.8	94.5	132.9	176.8
Net (Debt)/Cash	34.9	37.6	81.3	119.7	163.6
NAV AND RETURNS					
Net asset value	204.4	254.2	299.7	352.3	406.9
NAV/share	214.3	263.9	309.5	363.8	420.2
Net Tangible Asset Value	109.1	124.9	175.4	229.6	286.8
NTAV/share	114.4	129.7	181.1	237.1	296.2
Average equity	178.5	229.3	277.0	326.1	379.7
Post-tax ROE (%)	19.3%	28.0%	19.4%	15.1%	16.7%
METRICS					
Revenue growth	19.7%	13.7%	8.2%	7.0%	6.2%
Adj EBITDA growth	24.4%	20.8%	10.2%	7.0%	8.6%
Adj EBIT growth	20.9%	21.4%	14.4%	7.8%	8.0%
Adj PBT growth	28.3%	25.1%	13.7%	5.4%	7.2%
Adj EPS growth	25.7%	24.8%	12.2%	1.0%	4.9%
Dividend growth	11.4%	12.8%	13.6%	10.0%	10.3%
Adj EBIT margins	14.2%	15.2%	16.1%	16.2%	16.5%
VALUATION					
EV/Sales	2.66	2.33	2.11	2.00	1.8
EV/EBITDA	12.8	10.6	9.6	9.01	8.34
EV/NOPAT	20.5	16.3	14.5	14.3	13.6
PER	22.0	17.7	15.7	15.6	14.9
Dividend yield	1.0%	1.2%	1.3%	1.5%	1.6%
FCF yield	5.2%	7.1%	7.8%	7.8%	8.5%

Source: Company information and Progressive Equity Research estimates

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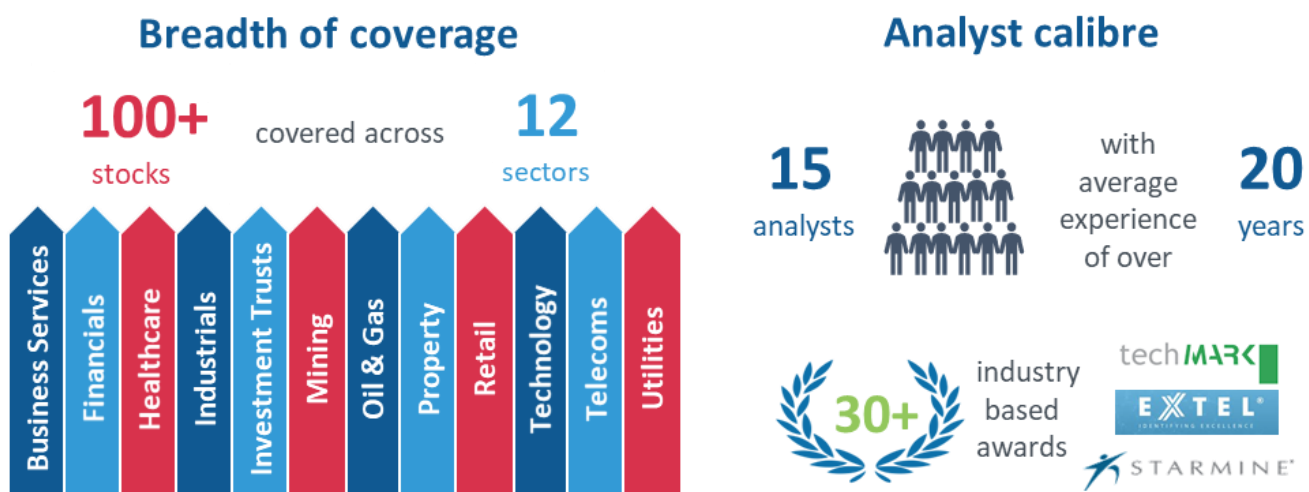
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