

# GAMMA COMMUNICATIONS

## SOFTWARE AND COMPUTER SERVICES

5 September 2023

### GAMA.L

1068p

Market Cap: £1037.6m

#### SHARE PRICE (p)



12m high/low 1,210p/1,012p

Source: LSE Data (priced as at prior close)

#### KEY DATA

Net (debt)/cash	£121.7m (at 30/06/23)
Enterprise value	£915.9m
Index/market	AIM
Next news	Update, January
Shares in issue (m)	97.2
Chairman	Martin Hellawell
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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## Switch-on to the PSTN switch-off

Gamma Communications' H1 results, released today, show strong performance in the two UK business units and very encouraging revenue and profit growth in Europe. Revenue of £256.2m was up 9% (H1 22: £234.7m), while adjusted EBITDA also improved by 9% to £56.5m (H1 22: £51.9m) and adjusted EPS grew by 5% to 37.5p (H1 22: 35.6p), or by 11% on a constant-tax basis. Gamma's strong cash generation was once again a highlight. Net cash (pre-leases) at the period-end was £121.7m, up from £92.5m at the start of the year.

- Gamma Business (formerly UK Indirect) – 10% revenue growth.** Growth continues to be driven by UCaaS products but there were also some pricing gains. The PSTN (public switch telephone network) switch-off, set for end-2025, is becoming an increasingly important (positive) issue.
- Gamma Enterprise (formerly UK Direct) – 9% revenue growth.** Gamma continues to win major clients, and the prospects for further growth with MS Teams voice enablement are strong.
- Europe – 8% revenue growth.** Recent management actions appear to be paying off, with underlying gross profit growth of 7% suggesting that the European operations are on a profitable growth path.
- Extra strength cash generation – 101%.** Gamma surpassed itself in H1 cash generation, with cash conversion (cash generated by operations / adjusted EBITDA) at 101%. Working capital movements helped but it is difficult not to be impressed by this cash machine. Period-end cash (pre-leases) was £121.7m, up from £92.5m at the start of the year.
- Positive outlook, guiding to top half of range, forecasts raised.** The outlook statement is positive and confident, and guidance for the full year has been raised to state expectations are for results in the top half of FY23 company-compiled market forecasts (adjusted EBITDA £110.4m-£117.2m, adjusted fully diluted EPS 70.0p-77.0p). We have raised estimates for FY23 and FY24 to reflect this.
- Becalmed, but change in weather on the horizon.** Gamma has continued to deliver and the issues in Europe now appear to have been addressed – but Gamma's shares remain becalmed. As the noise about the impending PSTN switch-off grows, from both Gamma and competitors, we expect an increase in both customer volumes and investor interest.

FYE DEC (€M)	2020	2021	2022	2023E	2024E
Revenue	393.8	447.7	484.6	529.0	566.9
Adjusted EBITDA	79.0	95.4	105.1	114.0	123.3
Adjusted PBT	61.7	77.2	87.8	97.1	103.6
Adjusted Dil. EPS	51.3	64.0	71.8	74.5	79.2
EV/Sales (x)	2.3x	2.0x	1.9x	1.7x	1.6x
EV/ Adj. EBITDA (x)	11.6x	9.6x	8.7x	8.0x	7.4x
P/E (x)	20.8x	16.7x	14.9x	14.3x	13.5x

Source: Company Information and Progressive Equity Research estimates.

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## Growth and cash generation continue

Gamma Communications’ interim results to 30 June confirmed the continuing impressive growth being generated in its UK operations, in both the Enterprise and Business units, and showed that its European operations are now stabilised and on a similar growth trajectory based on the wider adoption of UCaaS (Unified Communications as a Service) and other communication technologies.

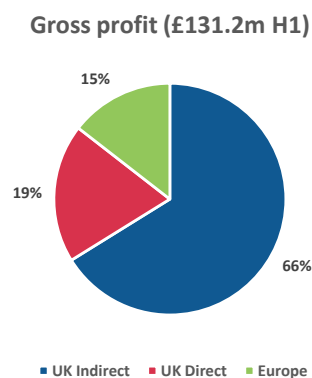
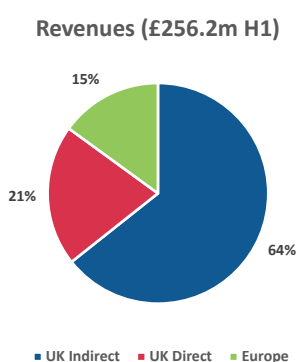
Revenue for H1 of £256.2m was up 9% (H1 22: £234.7m), while adjusted EBITDA also improved by 9% to £56.5m (H1 22: £51.9m) and adjusted EPS grew by 5% to 37.5p (H1 22: 35.6p).

Gamma’s strong cash position and generation was once again a feature of the results. With net cash (pre-leases) at the period-end of £121.7m, up from £92.5m at the start of the year and £72.6m at the close of H1 22.

Cash conversion (cash generated by operations / adjusted EBITDA) was 101%, ahead of prior periods (H1 22: 95%), although it included some benefit from what management describe as favourable working capital movements.

The UK businesses remain Gamma’s main growth driver, with both the Business and Enterprise units showing revenue growth. After the management actions taken over recent years, it is not a surprise to see the European operations contributing to growth with similar growth rates to their UK siblings, but it is reassuring and something that we expect will cheer investors.

### Revenue and Gross profit mix H1



Source: Company data

### Gamma Business (formerly UK Indirect) – 64% revs H1

#### Gamma Business – H1 2023 vs H1 2022

	H1 2023	H1 2022	Change	FY2022
<b>Revenue (£m)</b>	164.8	150.4	10%	309.4
<b>Gross profit (£m)</b>	86.8	80.2	8%	163.7
<b>Gross margin</b>	52.7%	53.3%		52.9%

*Source: Company data*

The main driver to growth for Gamma’s sales into small and medium-sized enterprises was Gamma’s UCaaS range of products, which includes cloud-based exchanges and SIP trunks (telephony over internet connections). Gamma also benefitted from its ability to apply and sustain price increases for some of its products and services.

The major issue for Gamma Business is the long-scheduled switch-off of the UK PSTN (public switched telephone network) and the end of ISDN (integrated service digital network), the system that allows digital services on the old switched network. This is to take place at the end of 2025. If businesses do not convert before then, they will be left with no voice service. They could also be left with no connections for their security systems, lift management, fire alarms and a host of other crucial connections that are nowadays taken for granted. The issues following the German switch-off in 2018 demonstrated how easy it can be for small businesses to ignore such things.

Gamma has developed and now launched PhoneLine+, a simple solution for micro-businesses that do not require the sophisticated call and data handling capabilities of its Horizon offer. In H1 it achieved sales of 5000 seats; an encouraging start. Gamma estimates that there are more than 3m single telephony lines are used by micro businesses (<10 employees) working on the old technology, so the upside potential is considerable.

In addition to impacting voice services, the PSTN switch-off will drive data services off some legacy solutions (most notably ADSL) to new products not reliant on the PSTN. The effect on volumes is going to be positive, but these new services will be at lower margins.

We note that this market is serviced by Gamma’s channel partners and that they will all be playing their part in helping to capture these micro-businesses as they are shunted off their existing services with their current providers.

### Gamma Enterprise (formerly UK Direct) – 21% revs H1

#### Gamma Enterprise – H1 2023 vs H1 2022

	H1 2023	H1 2022	Change	FY2022
<b>Revenue (£m)</b>	53.0	48.7	9%	102.0
<b>Gross profit (£m)</b>	25.4	24.0	6%	49.3
<b>Gross margin</b>	47.9%	49.3%		48.3%

*Source: Company data*

As noted in previous statements, Gamma Enterprise has won a number of important contracts recently, notably with the Home Office, Lidl and the NHS for a range of telephony, network and contact centre solutions. Voice enablement of Microsoft Teams also continues to see growth with a strong pipeline.

The slight knock to gross margins is due to the slight increase in the proportion of sales of hardware, which are at a lower margin, within the overall mix.

### Europe – 15% revs H1

#### Europe – H1 2023 vs H1 2022

	H1 2023	H1 2022	Change	FY2022
Revenue (£m)	38.4	35.6	8%	73.2
Gross profit (£m)	19.0	16.2	17%	34.7
Gross margin	49.5%	45.5%		47.4%

Source: Company data

The European operations provided an encouraging result. In recent reporting periods, it has been a case of examining the European operations to discover that the overall story was not as frustrating as the headlines suggested. This time we find the opposite. The results are good, but the turnaround is not quite as dramatic as the main numbers suggest.

The fundamental message, however, is that, helped by UCaaS growth, Europe saw a good H1. The weakness of GBP vs EUR also contributed. The underlying revenue growth was not quite the full 8% and there was a shift in cost allocation at the gross profit vs operating profit level, but the underlying gross profit growth was a very encouraging 7%.

### Operating expenses

Overall operating expenses grew broadly in line with revenues, but this masks the underlying operational developments. The UK operating expenses within the businesses increased by 7%, lagging revenue growth. European operating expenses increased by only 6% on a constant currency basis, although the headline figure was higher due to currency and the accounting changes noted above.

### Taxation

The increase in the tax rate to 24% was as expected, given the shift in the UK statutory rate in April 2023. Without this increase in tax rates, the growth in adjusted EPS would have been 11% rather than 5%.

### Interest income

Interest income increased significantly (£1.5m vs £0.2m in H1 22), principally as a result of higher interest rates compared to when our forecasts were framed. We have increased our interest income estimates for FY23 and FY24 (see below).

### Cash and cash generation

Gamma's strong cash position and generation were once again a feature of the results. Net cash (pre-leases) at the period-end was £121.7m, up from £92.5m at the start of the year and £72.6m at close of H1 22.

Cash conversion, or cash generated by operations / adjusted EBITDA, was 101%, ahead of prior periods, and included benefit from what management describes as favourable working capital movements – which we take to mean as cash conversion being likely to reverse slightly in subsequent reporting periods to a still-impressive 90-95% range.

Below the cash generated from operations level, there were a number of significant but wholly expected outgoings.

There was a capital spend of £10.5m (H1 22: £7.8m) and £9.7m was paid in dividends (H1 22: £8.5m). There was also a payment of £2.4m of contingent consideration for Mission Labs. (As at 30 June, the contingent consideration liability in the balance sheet was £2.7m, although this will increase following the acquisition in August of Satisnet, discussed below.)

### **Development and capitalisation**

The capitalisation of development costs of £7.8m (within the £10.5m total) was a marked increase on H1 22 but as expected given management's statements regarding increasing the proportion of its products and services that are supported and enabled by Gamma's own technology. This figure is in line with the spend seen in H2 22.

The amortisation charge against development costs was £2.2m (H1 22: £2.2m), but this is expected to increase as more of Gamma's own developed software products come to market.

### **Dividend**

The interim dividend declared is 5.7p (interim 2022: 5.0p) an increase of 14% and in line with, and on the upper side of, the company's progressive dividend policy. We have edged up our estimate for the FY23 dividend to 17.1p from 16.5p.

### **Strategic update**

The results statement included an update on the progress on the four strategic goals. Some are more tangible than others, but all show progress being made.

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

In H1 23, the technology teams across the group have been brought together as one team. During the period, Gamma launched Operator Connect in Germany, Spain and Belgium, bringing these markets in line with the UK and the Netherlands.

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

Gamma continues to work towards a common customer interaction portal, as having acquired several businesses with different offerings and business structures Gamma is not consistent across Europe in how it interacts with existing and potential customers.

In H1, Gamma launched CircleLoop in Germany and the Netherlands, having already done so in the UK. CircleLoop is based on the PhoneLine+ platform and provides a simpler solution for those smaller customers that want to buy their products and services online, while also providing an opportunity for channel partners to earn commission on referrals.

#### *Become a trusted partner to enterprises across Europe, transforming their communications estates*

Although it is difficult to measure progress on this front, Gamma has continued to win Enterprise clients in the UK and to strengthen its relationships with Microsoft and Amazon as they become more active in the delivery and hosting of software to enterprises.

Management set out the acquisition of Satisnet, a managed security services provider in August for up to £20m, as a step forward for this strategy. Satisnet's offering includes managed firewalls, 24/7 managed security operations centres and incident response.

The fact that many customers had apparently been asking Gamma to provide such services suggests that, for some customers, the trust may already be firmly established.

We regard this acquisition as an interesting development, providing an entry into what is clearly an attractive and growing market. The financial dynamics differ from those of Gamma's communications and software products and services, and we look forward to finding out more at the results presentation.

Although the exact figures for consideration allocation are yet to be confirmed, we have included Satisnet in our revised forecasts with consideration of £15m, assuming no payout on the £5m contingent element (see below).

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

This strategic goal is also tricky to measure. However, having attended the recent Gamma GX:Frontiers event for enterprise and public sector customers, we were struck by how, unlike events for some other companies, there was an evident common enthusiasm and sense of purpose. All those customers and partners we spoke with talked positively about Gamma and its focus on doing the right things.

### **Still very much a growth stock**

Looking across Gamma's target markets, management estimates that more than 50% of businesses in the UK and about 70% in Gamma's European markets still use physical internal phone exchange (PBX) rather than a cloud-based software solution.

Although Gamma, and its competitors, have been operating in this market for some years, there is still a considerable market opportunity to address both in terms of the core Hosted PBX solution and by adding extra services such as call recording or contact centre management.

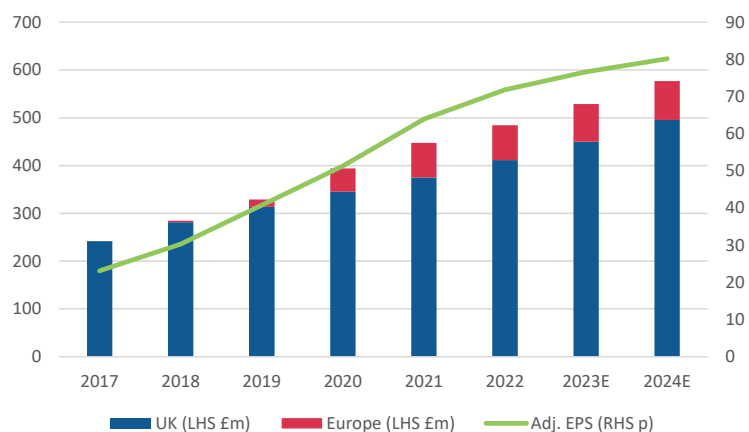
Gamma continues to grow the number of 'seats', although there has been some increase in 'churn' as customers have trimmed staff numbers. In H1, Gamma added 31,000 UK cloud PBX seats, of which 26,000 were on its Horizon product.

In Europe, Gamma added 2,000 cloud PBX seats. This is not as many as Gamma has added in previous half years, but historically it has seen a lumpy sales lines in Germany where it has previously secured client wins of large numbers of seats, and in the Netherlands priority has been given to driving sales of Operator Connect (which voice enables MS Teams). The Netherlands market is similar to the UK, with an established cloud PBX market, so Gamma sees its competitive advantage there as being its ability to offer more value-added elements, particularly with larger customers.

Gamma also benefitted from increased adoption of voice-enablement solutions, most notably MS Teams. In H1, Gamma added 38,000 MS Teams users in the UK and 5,000 in Europe. We share management's enthusiasm for the potential to call customers and colleagues directly from one's Microsoft applications.

Although neither the European businesses nor the markets in which they operate have grown as rapidly as industry analysts, management and (to be frank) investors had hoped, Gamma is, after some ‘management actions’, making solid progress. Gamma saw 8% growth in cloud seats in Germany, and the recently acquired Neotel in Spain has helped turn that region’s fortunes around for Gamma.

**Still a growth story – Revenue and Adjusted EPS**



Source: Company data, Progressive Equity Research

**Outlook**

The outlook statement is positive and confident in tone.

With growth expected to continue in H2, management now expects adjusted EBITDA and adjusted EPS to be in the top half of the current analyst forecast range for FY23.

Our previous forecasts were in the lower half of the range. Prompted by the revisions to guidance and the strong results, we have raised our forecasts for FY23 and FY24 (see below). The ranges given by the company for market estimates (at the time of the results) are adjusted EBITA £110.4m-£117.2m and adjusted EPS (fully diluted) 70.0p-77.0p.

The outlook statement makes reference to acquisition opportunities where they would provide access to new areas within Gamma’s current market or where they would allow Gamma to better serve customers’ needs. The strong balance sheet and cash generation provides Gamma with significant capacity on this front, but we do not expect major strategic moves in the short to medium term.

## Revisions to estimates

Estimate revisions						
	Old 2023E	New 2023E	Change (%)	Old 2024E	New 2024E	Change (%)
Revenues (£m)	518.4	529.0	2%	550.5	566.9	3%
Adj EBITDA (£m)	112.5	114.0	1%	122.2	123.3	1%
Adj PBT (£m)	92.5	97.1	5%	99.2	103.6	4%
Adj Dil EPS (p)	72.5	74.5	3%	76.1	79.2	4%
Dividend per share (p)	16.5	17.1	4%	18.2	18.8	3%
Cash and equivalents (£m)	132.9	136.4	3%	176.8	184.5	4%
Net Cash pre-leases (£m)	130.8	134.3	3%	174.7	182.4	4%
Net Cash post-leases (£m)	119.7	123.2	3%	163.6	171.3	5%

Source: Progressive Equity Research

The revisions to forecasts are mainly driven at the underlying level by the slightly increased European revenues, improvements in UK pricing and by the inclusion of Satisnet.

The improved fortunes of the European business are a key factor in the increased adjusted EBITDA estimate for FY23, with Satisnet adding around £1m to the FY24 estimate. With transactions costs and the like, we do not expect an EBITDA contribution from Satisnet in what remains of FY23.

The changes to the cash and equivalents result from income statement changes and the cash outflows relating to the purchase of Satisnet, but most of all the strong cash generation seen in H1. The change to cash forecast is upwards even after the £12.2m non-contingent purchase payments for FY23 for Satisnet.

## Valuation and conclusion

We find ourselves writing almost the same commentary as we did this time last year. Gamma has once again delivered, and we are raising forecasts. This time, however, we also have clear evidence of the issues with the European business having been addressed, with Gamma looking to be on the front foot in Europe.

Like this time last year, Gamma stood a P/E of 15 with forecast earnings growth of 12.5%. This year the P/E is 14 and, if we assume 19% tax rate for FY23 on adjusted EPS, the forecast earnings growth rate is 11%. Gamma has continued to deliver strong growth with a cash-generative business model, but this is not reflected in the rating.

The core growth story remains intact and the way that people are working and communicating post-pandemic has only made Gamma's offering more relevant to businesses in the UK and Europe. While we are not in a position to make a call on when growth stocks will return to favour in the UK, we note that the impending PSTN switch-off and the noise that will surround it could act as a loud reminder to investors that there are UK companies able to grow profitably and internationally, building on visible and understandable changes in technology and its application.



**Financial Summary: Gamma Communications**

Year end: December (£m unless shown)

	2020	2021	2022	2023E	2024E
<b>PROFIT &amp; LOSS</b>					
Revenue	393.8	447.7	484.6	529.0	566.9
Adj EBITDA	79.0	95.4	105.1	114.0	123.3
Adj EBIT	56.1	68.1	77.9	85.5	91.8
Reported PBT	75.0	67.2	64.9	87.5	94.0
Fully adj PBT	61.7	77.2	87.8	97.1	103.6
NOPAT	49.4	62.1	70.0	72.9	77.7
Reported EPS	66.6	55.2	50.6	66.7	71.5
Fully adj EPS	51.3	64.0	71.8	74.5	79.2
Dividend per share	11.7	13.2	15.0	17.1	18.8
<b>CASH FLOW &amp; BALANCE SHEET</b>					
Operating cash flow	82.5	100.2	108.5	119.1	128.4
Free Cash flow	56.2	76.5	84.7	96.3	94.4
FCF per share	59.1	79.8	87.7	99.3	97.0
Investing	(62.7)	(65.9)	(29.3)	(37.1)	(27.1)
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)	41.3	41.8	48.2
Overdrafts / borrowings / leases	(19.0)	(15.2)	(13.2)	(13.2)	(13.2)
Cash & equivalents	53.9	52.8	94.6	136.4	184.5
Net (Debt)/Cash post leases	34.9	37.6	81.4	123.2	171.3
<b>NAV AND RETURNS</b>					
Net asset value	204.4	254.2	299.7	356.5	413.7
NAV/share	214.3	263.9	309.5	366.7	425.5
Net Tangible Asset Value	109.1	124.9	175.4	218.8	278.6
NTAV/share	114.4	129.7	181.1	225.0	286.5
Average equity	178.5	229.3	277.0	328.1	385.1
Post-tax ROE (%)	19.3%	28.0%	19.4%	15.0%	16.9%
<b>METRICS</b>					
Revenue growth	19.7%	13.7%	8.2%	9.2%	7.2%
Adj EBITDA growth	24.4%	20.8%	10.2%	8.5%	8.1%
Adj EBIT growth	20.9%	21.4%	14.4%	9.8%	7.3%
Adj PBT growth	28.3%	25.1%	13.7%	10.6%	6.6%
Adj EPS growth	25.7%	24.8%	12.2%	3.8%	6.4%
Dividend growth	11.4%	12.8%	13.6%	14.0%	10.0%
Adj EBIT margins	14.2%	15.2%	16.1%	16.2%	16.2%
<b>VALUATION</b>					
EV/Sales	2.3	2.0	1.9	1.7	1.6
EV/EBITDA	11.6	9.6	8.7	8.0	7.4
EV/NOPAT	18.5	14.7	13.1	12.6	11.8
PER	20.8	16.7	14.9	14.3	13.5
Dividend yield	1.1%	1.2%	1.4%	1.6%	1.8%
FCF yield	5.5%	7.5%	8.2%	9.3%	9.1%

Source: Company information and Progressive Equity Research estimates

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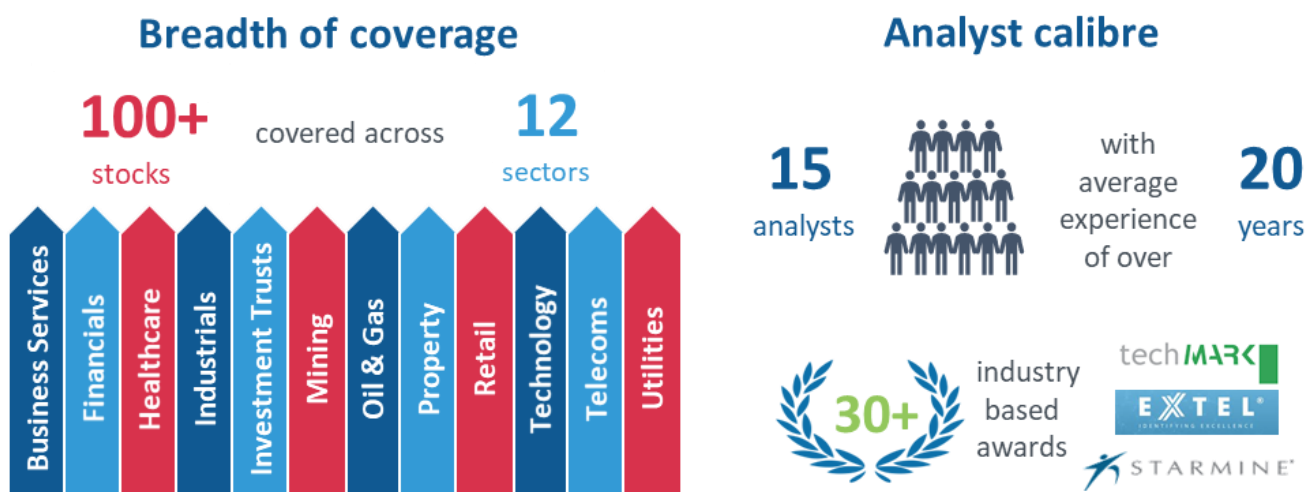
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