

GAMMA COMMUNICATIONS TELECOMMUNICATION SERVICES

GAMA.L

472p

Market Cap: £432.2m

SHARE PRICE (p)



12m high/low

528p/364p

Source: LSE Data

KEY INFORMATION

Enterprise value	£404.0m
Index/market	AIM
Next news	AGM – May 2017
Gearing	N/A
Interest cover	N/A

GAMMA COMMUNICATIONS IS A
RESEARCH CLIENT OF PROGRESSIVE

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FY 2016 results confirm further strong delivery

Gamma's FY 2016 revenues, Adjusted EBITDA and Adjusted EPS numbers were a touch ahead of our estimates. We make small upward adjustments to forecasts for all three years of our forecast horizon reflecting that performance. Gamma is capitalising on its position as a nimble player in an attractive marketplace. It made strong progress in 2016 as Voice over IP technology drove uptake of SIP Trunking and Hosted PBX services - both areas where Gamma has strong platforms. In addition, data services reflected Gamma's investment in its network, channel partner numbers increased again and the indirect business accordingly showed strong revenue growth. The Direct Business also produced good growth and won some significant new contracts. The outlook statement is 'enthusiastic' about the current year and comments that the Board 'remains open to suitable M&A opportunities and areas for strategic capital investment'. Overall, an optimistic picture, in our view.

- The number of Gamma's channel partners grew from 834 to 970. The indirect business increased revenues by £17.0 million (+11%) to £169.0 million in 2016 (2015: £152.0 million) representing 79% of total revenues in FY 2016. Profit improvement from Growth products more than offset the expected (first) decline in the Traditional business.
- The direct business grew revenues by 12% to £44.5 million (2015: £39.8 million). It secured £33 million of contracts in the enterprise market with companies such as Strutt & Parker and City Electrical Factors.
- Gamma's core strategic products, SIP Trunking and Cloud PBX (branded Horizon), saw strong growth FY 2016. The former grew by 42% to 511,000 channels while the number of users on Horizon grew by 62% from 142,000 to 230,000.
- As previously noted by management, there is growing competition in both markets. We see Gamma's scalability and strong channel offering as useful counters to overseas and smaller domestic competitors while nimbleness, innovative products/solutions and strong customer service act as helpful differentiators relative to the larger players. We think that relatively few groups can compete effectively with the combination of Gamma's strategy, range of products and low-cost route to market.
- FY 2016 adds to many years of strong growth from Gamma and we believe that it remains well positioned within its marketplace. As we note above, the Board appears confident of ongoing delivery.

FYE DEC	2015	2016	2017E	2018E	2019E
Revenue	191.8	213.5	233.9	250.6	268.7
Adjusted EBITDA	28.3	34.2	39.5	43.6	48.2
Adjusted PBT	21.4	24.9	27.0	27.3	28.5
Adjusted EPS (p)	17.9	21.1	22.9	23.7	24.7
EV/Adj. EBITDA	14.3x	11.8x	10.2x	9.3x	8.4x
P/E	26.4x	22.4x	20.6x	19.9x	19.1x
Dividend yield	1.4%	1.6%	1.7%	1.9%	2.2%

Source: Company Information and Progressive Equity Research estimates

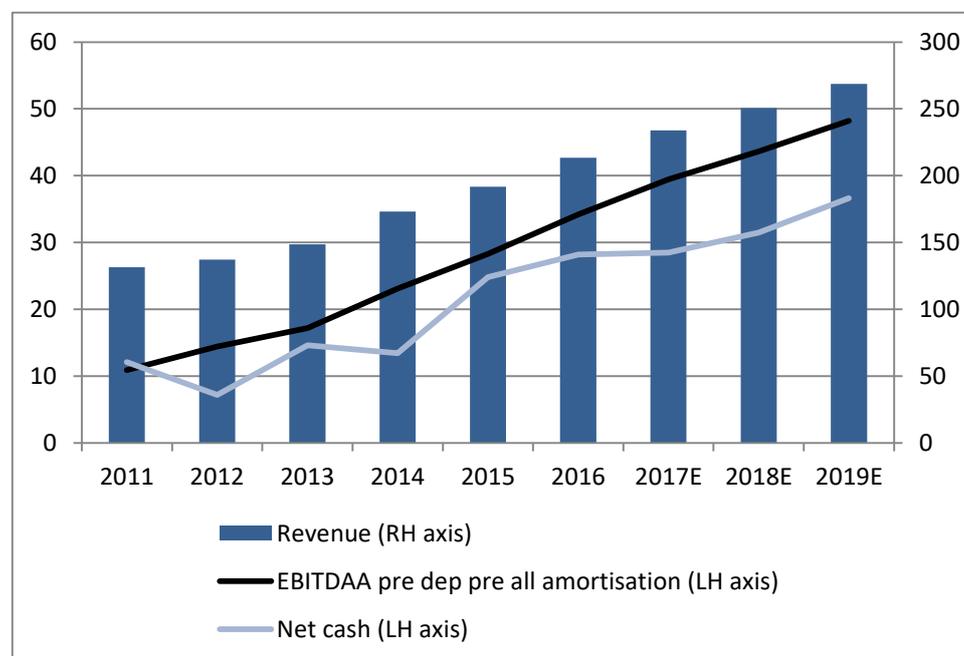
FY 2016 result summary

SIP Trunking and Hosted PBX services - both areas where Gamma has strong platforms – grew strongly as other Growth products performed well too. Both the indirect business and direct business produced good growth. Group revenue of £213.5 million (2015:£191.8m) was a touch ahead of our estimate. Gross profit increased by 20% to £98.8 million, with an overall gross margin of 46.3% compared to 42.9% in FY 2015. Adjusted EBITDA of £34.2 million (2015: £28.3m) was also a little ahead of our estimate as was Adjusted EPS, up 17.9%, at to 21.1p (2015: 17.9p) versus our estimate of 20.8p. The Group declared a final dividend of 5.0p making 7.5p for the full year – a little better than our estimate of 7.35p. Adjusted net operating cash inflow of £31.3 million represented a conversion ratio from Adjusted EBITDA of 92% on FY 2016 (FY 2015, 89%). Net cash as at 31 December 2016 was £28.2 million compared to £24.8 million as at 31 December 2015.

Capital expenditure in FY 2016 was £19.6 million versus £11.5 million in FY 2015. The larger elements of this comprised £8.3 million on customer premises equipment – a number which is expected to increase in line with new sales of data and Cloud PBX products and £4.0 million on enhancement, replacement, increasing capacity and development of the core network. An additional £2.8 million was spent on enhancing the mobile platform purchased in 2014 in preparation for the launch of Gamma's live service. It also spent around £1.8m on other, predominantly IT, assets and fixtures and fittings. Forward expenditure will include an anticipated £5 million investment in Gamma's new national network which will replace its existing fibre ring.

This chart shows the FY 2016 results in the context of historical performance and our revised estimates. It reflects a consistent performance with revenues and Adjusted EBITDA growing well while the net cash position improves.

Revenue, EBITDA and net cash (£m)



Source: Gamma information, Progressive Equity Research estimates

Indirect Business – key points

- Revenue: +11.2%, from £152.0 million to £169.0 million
- Gross profit: +22%, from £64.1 million to £78.2 million
- Key drivers: SIP Trunking and Cloud PBX
- Investment in the network has resulted in a lower cost base has helped to drive sales
- Percentage of gross profit coming from Channel Partners who buy four or more products: 74% (2015: 73%).
- Traditional business: first (but anticipated) signs of decline – profit reduced by £2.0m to £16.5m
- Growth products revenue: +20.7%, from £93.8 million to £113.2 million
- Growth products gross profit: +35.3% from £45.6 million to £61.7 million
- Growth products gross margin: grew from 48.6% to 54.5% reflecting the higher margin of SIP Trunking

Direct Business – key points

- Revenue: +11.8% from £39.8 million to £44.5 million
- Gross profit: +13.2% from £18.2 million to £20.6 million
- Gross margin: from 45.7% to 46.3%
- Increase due to Growth products from which gross profit grew from £14.0 million to £16.8 million
- Continuing shift towards larger customers on multi-year deals
- Strong order book bodes well for revenues and gross profit in 2017

Strategic positioning

Overall, in our view, the group's position is strong. The group is active in an exciting growth area of the telecoms market, and its strategic positioning has placed it at the confluence of three positive drivers – BT's relatively pedestrian and unresponsive activities, a market where customers are looking to adopt telephony and data services, and the availability of VoIP technology that is seen to be reliable and to work efficiently.

Gamma is well managed and strategically well positioned. The market is moving in the direction of the group's products, which provide reliable service and are well structured for sale through the partner channel. The financial performance has been reliable, and conversion of operating profit to cash strong.

Strategy and prospects

The group has a strategy to develop and own its infrastructure and platforms. Sometimes in a new market (like mobile) Gamma will white-label the service of another provider (Vodafone), but it will then invest to develop its own in-house capabilities. In this way, Gamma is able to ensure both that quality of service is assured, and that the services can be easily and smoothly delivered through its channel partners.

With this backdrop, the group's decision to own its own platforms is a key differentiator from much of the competition. By owning its platforms, Gamma can provide business-grade, reliable systems that companies want. By working with channel partners, the group is able to access large numbers of end customers without the cost or administrative pressure of running a large direct sales team.

In 2017, Gamma's core strategy is to continue to support the channel and to 'remain both market leader and disruptor in the high growth or displacement sectors of the business communications market'. The results announcement also points out the importance of the quality of service it delivers and the 'ease of doing business' with the Group. This latter point is something which we explored with two of Gamma's channel partners and which was a positive point in their opinion (see our initiation note *Seizing the opportunity* published in January 2017).

Direct

The main sales focus for the direct business is on larger opportunities and the public sector as the group has a specific strategic aim of targeting fewer overall customers – but attracting bigger, better customers who agree larger, longer contracts with Gamma. This has reduced overall customer numbers from a peak of around 9,000 to nearer 5,000 – but with a significantly better profile and more visibility of revenue.

Direct customers typically sign term agreements which range from one year to five years depending on the services taken. Gamma's direct business is focused on larger enterprises, the public sector and customers who want a specifically tailored solution. The acquisition of Varidion in March 2012, was central to the development of Gamma's direct sales strategy as it brought the necessary skills around managed, network-centric applications.

Indirect

Gamma has previously said that service provision via the channel has been shifting from niche services such as IT support, or PBX installation, to a full ICT bundle. That is allowing Gamma to access new channel partners who would not necessarily have engaged with the Group. It has also noted a greater number of midmarket end clients as well as those from the channel's traditional SME target market.

As previously noted, SIP Trunking and Cloud PBX products were the main contributors to growth in the channel. Investment in data products has brought encouraging growth as some channel partners have moved their business customers away from competitors to Gamma's data services. Growth in these products has more than offset the expected decline in the traditional business.

Overall

The Group expects volumes to continue to grow in SIP Trunking and Cloud PBX, while the traditional services (phone calls and lines) are expected to show a continued decline. Gamma hopes to build on the accelerated growth that it saw in data services during 2016 and is working towards launching a converged product later in 2017 to take advantage of the market trend towards fixed/mobile integration (see below).

The key to providing convergence products

Gamma bought its mobile assets in December 2014 through the acquisition of control equipment that now provides the core of its mobile network. This mobile infrastructure allowed Gamma to develop and manage a range of mobile services. The results announcement says that much of 2016 was focused on bringing Gamma's full mobile virtual network operator (MVNO) service into active use in the second half of the year giving it comparable functionality to a mobile operator, using 3rd party radio access networks. Gamma acts as a virtual operator under its own brand or that of its channel partner.

Owning its own mobile core network gives Gamma the same control that it has over fixed voice services when routing calls, text and data traffic onto the Gamma network. It also offers a reduced cost base and full control over its technical infrastructure. The network is a 4G data service and Gamma Mobile is independent from mobile operator control, using the network infrastructure of mobile operator 3. Its mobile service was soft launched in Q2 2016 with a full, formal launch taking place in Q4 2016. Gamma has 'largely completed' the process of migrating customers on to the new network. The previous mobile offering from Gamma was provided through a relationship with Vodafone but did not include 4G (which Vodafone used for its own direct business).

Ownership of the mobile network means that Gamma has joined a select group of companies in the UK that own the infrastructure which allows them to develop a converged fixed and mobile service. It positions Gamma well for supplying converged fixed and mobile services – something which will be a differentiating factor for the Group's service offering. We understand that, in supplying convergence products, the mobile business will look less at KPIs that focus on customer numbers and more on how the asset can support the long term delivery of Group's range of products and services. Gamma expects to bring a first release converged product to market in late 2017.

Estimates

Our estimates are based on our views on the growth of the business lines. We also consider the prospects for the routes to market via the channel and direct (noting that contract lengths are extending, and value expanding, in the latter). We continue to think that SIP and Cloud PBX will be the main drivers of growth in the short term and we expect Broadband and Ethernet revenues to grow, albeit at slower rates than SIP and Cloud PBX in the near term. We view the long term impact of the mobile business as a support for the Group's product and services (and the prospects for the convergence of fixed and mobile offerings) rather than as a standalone mobile network.

As Gamma's FY 2016 revenues, Adjusted EBITDA and Adjusted EPS numbers were a touch ahead of our estimates, we have made small upward adjustments to our numbers for all three years of our forecast horizon reflecting that performance.

Estimate changes

£m unless stated	FY17E			FY18E			FY19E		
	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)
Revenue	233.1	233.9	0%	250.0	250.6	0%	268.9	268.7	0%
Adj EBITDA	38.9	39.5	1%	43.0	43.6	1%	47.9	48.2	1%
Reported PBT	23.2	23.4	1%	23.7	24.0	1%	25.2	25.2	0%
Fully adj PBT	26.1	27.0	3%	26.5	27.3	3%	28.0	28.5	2%
Reported EPS (p)	19.6	19.7	1%	20.0	20.2	1%	21.2	21.2	0%
Fully adj EPS (p)	22.0	22.9	4%	22.9	23.7	4%	24.1	24.7	2%

Source: Gamma information, Progressive Equity Research estimates

Given the expected areas of growth, we expect to see an increase in customer numbers and the associated CPE (Customer Premises Equipment) such as configured handsets and routers. Consequently, our estimates reflect this through significantly higher levels of Capex and Depreciation. We also note the continued investment in the business. There is also a flagged cost of an upgrade to Gamma's network (installing fibre-optic, refreshing platform etc).

The table below shows selected data.

Selected financial data

£m unless stated	2014	2015	2016	2017E	2018E	2019E
Revenue	173.2	191.8	213.5	233.9	250.6	268.7
Profit post central costs	23.1	28.3	34.2	39.5	43.6	48.2
Depreciation	-5.1	-6.1	-8.6	-11.7	-15.3	-18.6
Amortisation of acquired intangibles	-0.4	-0.4	-0.4	-0.1	0.0	0.0
Amortisation of capitalised development costs	-0.9	-0.9	-0.9	-1.0	-1.1	-1.3
Depreciation & amortisation	-6.4	-7.4	-9.9	-12.8	-16.4	-19.8
EBITDAA pre dep pre all amortisation	23.1	28.3	34.2	39.5	43.6	48.2
EBITAA post dep pre all amortisation	18.0	22.2	25.6	27.7	28.3	29.6
EBITA post dep post amort of cap devt spend	17.1	21.3	24.7	26.8	27.2	28.4
Adjusted PBT	17.1	21.4	24.9	27.0	27.3	28.5
Adj. Diluted EPS before exc. items (p)	15.0	17.9	21.1	22.9	23.7	24.7
Dividend (p)	3.95	6.6	7.5	8.25	9.15	10.20
Net cash	13.4	24.8	28.2	28.5	31.5	36.6

Source: Gamma information, Progressive Equity Research estimates

Summary Financial Information

PROFIT & LOSS	FY-14A	FY-15A	FY-16A	FY-17E	FY-18E	FY-19E
Revenue	173.2	191.8	213.5	233.9	250.6	268.7
Adj EBITDA	23.1	28.3	34.2	39.5	43.6	48.2
Adj EBIT	16.7	20.9	24.3	26.7	27.2	28.4
Reported PBT	11.5	22.6	21.6	23.4	24.0	25.2
Fully adj PBT	17.1	21.4	24.9	27.0	27.3	28.5
NOPAT	17.1	21.3	22.3	21.7	22.0	23.0
Reported EPS (p)	10.0	19.5	18.7	19.7	20.2	21.2
Fully adj EPS (p)	15.0	17.9	21.1	22.9	23.7	24.7
Dividend per share (p)	3.95	6.60	7.50	8.25	9.15	10.20
CASH FLOW & BALANCE SHEET	FY-14A	FY-15A	FY-16A	FY-17E	FY-18E	FY-19E
Operating cash flow	19.4	30.4	31.3	35.6	39.1	43.4
Free Cash flow (£m)	(1.1)	11.7	3.3	0.3	3.0	5.1
FCF per share (p)	(1.2)	12.4	3.5	0.3	3.1	5.4
Acquisitions	0.0	0.0	0.0	0.0	0.0	0.0
Disposals	0.0	0.0	0.0	0.0	0.0	0.0
Shares issued	(0.1)	0.5	0.1	0.0	0.0	0.0
Net cash flow	(1.2)	11.4	3.4	0.3	3.0	5.1
Overdrafts / borrowings	0.0	0.0	0.0	0.0	0.0	0.0
Cash & equivalents	13.4	24.8	28.2	28.5	31.5	36.6
Net (Debt)/Cash	13.4	24.8	28.2	28.5	31.5	36.6
NAV AND RETURNS	FY-14A	FY-15A	FY-16A	FY-17E	FY-18E	FY-19E
Net asset value	51.2	66.7	80.2	95.5	110.5	125.6
NAV/share (p)	56.9	74.1	87.6	104.3	120.7	137.1
Net Tangible Asset Value	40.4	56.3	70.2	85.6	100.8	116.3
NTAV/share (p)	44.9	62.6	76.7	93.5	110.1	127.0
Average equity	25.6	59.0	73.5	87.8	103.0	118.0
Post-tax ROE (%)	36.7%	31.0%	24.1%	21.6%	18.9%	17.3%
METRICS	FY-14A	FY-15A	FY-16A	FY-17E	FY-18E	FY-19E
Revenue growth	<i>n.a.</i>	10.7%	11.3%	9.6%	7.1%	7.2%
Adj EBITDA growth	<i>n.a.</i>	22.5%	20.8%	15.4%	10.6%	10.5%
Adj EBIT growth	<i>n.a.</i>	25.1%	16.3%	9.8%	2.0%	4.3%
Adj PBT growth	<i>n.a.</i>	25.1%	16.4%	8.4%	1.2%	4.3%
Adj EPS growth	<i>n.a.</i>	19.4%	18.2%	8.6%	3.3%	4.2%
Dividend growth	<i>n.a.</i>	67.1%	13.6%	10.0%	10.9%	11.5%
Adj EBIT margins	9.6%	10.9%	11.4%	11.4%	10.9%	10.6%
VALUATION	FY-14A	FY-15A	FY-16A	FY-17E	FY-18E	FY-19E
EV/Sales	2.3	2.1	1.9	1.7	1.6	1.5
EV/EBITDA	17.5	14.3	11.8	10.2	9.3	8.4
EV/NOPAT	23.6	19.0	18.1	18.6	18.3	17.6
PER	31.6	26.4	22.4	20.6	19.9	19.1
Dividend yield	0.8%	1.4%	1.6%	1.7%	1.9%	2.2%
FCF yield	-0.2%	2.6%	0.7%	0.1%	0.7%	1.1%

Source: Company information, Progressive Equity Research estimates

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