Wealth Management

Smart Company Analysis

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The Company: Adapt IT Holdings Ltd

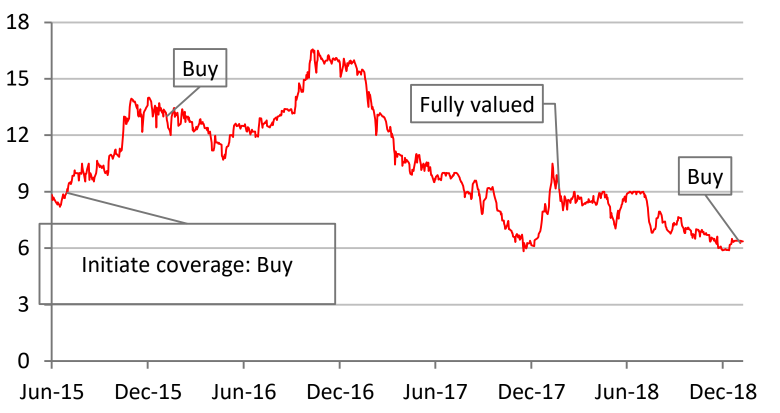
Sluggish economy dampens prospects but shares look undervalued

Our call

Buy

Intellidex estimate of fair value:	*802c*
Spot price:	*630c*
Potential move:	*27.4%*

Adapt IT share price graph and Intellidex's previous calls



Background

Adapt IT is a holding company with interests in a variety of information technology services and special solutions businesses. It services the mining & manufacturing, energy, financial services, education and hospitality industries. It has operations in southern Africa, east Africa, Asia, the US and Europe.

Sensitivity analysis

	Terminal growth	2%	4%	5.5%
Wacc	10.9%	1 107	1 352	1 777
	12.9%	811	947	1 157
	13.9%	698	802	956
	15.9%	534	600	690
	16.9%	469	521	592

This reflects the sensitivity of our forecasts to assumptions of the terminal growth rate and the weighted average *cost of capital (Wacc). The highlighted cell shows our target price in cents.*

Investment thesis

Adapt IT is starting to feel the heat from the deteriorating economic conditions in SA. The group recently reported its slowest growth in interim revenue since 2011, largely due to low project turnover in the energy and hospitality sectors.

While we anticipated muted organic growth from Adapt IT, we were disappointed by the absence of meaningful acquisitions during the interim period. We had pencilled in sizeable acquisition/s in our projections. While management still insists that the group has capacity to absorb a large acquisition, we do not see that happening this financial year. Its balance sheet on a gearing ratio of 41.2% (FY18: 29%) now looks a bit stretched to accommodate one. The recent rerating of the group's share price also diminishes its purchasing power.

Previously, Adapt IT took advantage of its high-flying share price to acquire businesses. However, with a softer share price rating, any acquisitions are going to be costlier as it will have to issue more shares. That means any large acquisitions that would make meaningful contributions to growth will not be possible without massive earnings dilutions. Even if management lands a new acquisition before the end of FY19, it is unlikely to contribute much to FY19 earnings.

In light of these developments, we have adjusted our projections for Adapt IT. We cut our revenue growth projection for FY19 to a single digit. We also slashed our margin and capex projections to align with slower growth in revenue.

However, even after making those adjustments, we still find Adapt IT undervalued. We arrive at a fair value of 802c/share, which still leaves a decent margin of safety from the counter's current price of 630c/share.

Despite a not-so-rosy outlook for SA's markets we think Adapt IT remains attractive for portfolios with a long-term horizon. Its software as a service (Saas) business model is resilient and enables it to perform reliably even when clients are cutting capital expenditure. Instead of selling a software package as a once-off transaction, the group rents out its software to clients on a usage basis. Thus, it receives licence fees, which are stable.

What we also like about Adapt IT is that it owns intellectual property. As those software systems are sold to new customers, margins will improve as there will be no need for additional development expenditure.

Adapt IT is also heavily entrenched in some of the niche markets in which it operates, making it difficult for its clients to switch to other providers. For instance, its flagship software in the higher education segment, the ITS Integrator, is fully integrated with systems of the Department of Higher Education & Training and the National Student Financial Aid Scheme.

In the meantime we expect the group to continue pursuing growth in markets outside of SA. The recently acquired Wisenet Group places the group into a lucrative vocational training sector in Australia.

Analysis of results

Revenue for the six months to end-December grew 4%, driven purely by acquisitions. There was no organic growth from continuing operations. Annuity turnover was a healthy 58%.

Expenses (cost of sales and operating expenses) were well managed, resulting in a 6% rise in earnings before interest, tax, depreciation and amortisation (Ebitda). However, the gains made at Ebitda level were wiped out by significant increases in depreciation and amortisation expenses. That, coupled with higher finance costs, led to a 6% drop in the bottom line.

Headline earnings increased marginally thanks to a share repurchase programme which reduced weighted outstanding shares by 5.3%. The board declared a dividend of 17.1c, 25% up on the previous interim period.

Prospects

Adapt IT is exposed to five sectors: education, financial services, energy, manufacturing and hospitality. In the education sector, the group is heavily entrenched with more than 200 clients covering most of the public universities and privately owned institutions of higher learning. While that is a good source of annuity income, public universities, which are the major source of income, are operating on tight budgets due to government restrictions on the rate at which they can hike their fees.

We expect the recently acquired Wisenet Group to boost the education division. Wisenet comes with some proprietary software which can be sold in other markets. Its annuity-based revenue model, where Saas subscriptions account for 90% of total revenue, is an added advantage.

General conditions in the manufacturing industry remain gloomy despite a surprise 3% year-on-year uptick in manufacturing output in November. However, Adapt IT's clients in the sugar industry have recovered from drought conditions and are seeing some improvements in their profitability and balance sheets, albeit with pricing pressures.

In the financial services industry, Adapt IT provides software solutions for audit and accounting firms and to a lesser extent government entities and municipalities. During FY18, revenue from the sector was bumped up by sales emanating from changes in technology for account submissions to the Company and Intellectual Property Commission and general changes in reporting standards. However, those drivers may not be replicated during FY19, which could see slower growth.

Fundamentals in the energy and hospitality sectors, which disappointed during 1H19, look strong on paper. In the energy industry oil prices have firmed and are expected to remain elevated in the short term. That, coupled with the relatively weak rand, supports profitability for businesses in the sector.

Overall, we don't see any plausible catalyst for robust organic growth in the short term.

Bull Factors

- Strategic focus on expanding higher-margin businesses
- Acquisitive growth strategy and expansion into markets outside SA
- Margins to improve as the group increases scale

Bear Factors

- Group needs larger acquisitions to meet growth targets
- Continued weakness in public sector expenditure on ICT services and hardware
- Intensely competitive market
- Core South African market still under pressure

Key statistics

Share details – JSE Code: ADI
Sector: **Softwares and computer services**

Market cap: **R998.6m**
Net debt:equity ratio**: 41.2%**
Price:earnings ratio: **9.29**
Forward PE ratio (FY19): **7.6**
Dividend yield: **2.71%**
Forward dividend yield: **3.27%**
Risk: **High**

12-month high: **R10.99**
12-month low: **570c**
Ave monthly volume: **2.72-million**
Financial year-end: **30 June**
Latest event**: Interim results**
Date announced: **29 January 2019**

RESULTS IN BRIEF	1H19	Change (%)	1H18	FY18
Turnover (R'm)	669	-1%	678	1,354
Operating profit (R'm)	86	0%	86	218
Operating margin (%)	12.89%	1%	12.71%	16.12%
Attributable earnings (R'm)	45	-5%	48	123
Heps (c)	29.89	1%	29.70	66.97