

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%
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	12-month high: R10.99
Net debt:equity ratio: 41.2%	12-month low: 570c
Price:earnings ratio: 9.29	Ave monthly volume: 2.72-million
Forward PE ratio (FY19): 7.6	Financial year-end: 30 June
Dividend yield: 2.71%	Latest event: Interim results
Forward dividend yield: 3.27%	Date announced: 29 January 2019
Risk: High	

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

Intellidex Disclaimer:

This research report was issued by Intellidex (Pty) Ltd. Intellidex aims to deliver impartial and objective assessments of securities, companies or other subjects. This document is issued for information purposes only and is not an offer to purchase or sell investments or related financial instruments. Individuals should undertake their own analysis and/or seek professional advice based on their specific needs before purchasing or selling investments. The information contained in this report is based on sources that Intellidex believes to be reliable, but Intellidex makes no representations or warranties regarding the completeness, accuracy or reliability of any information, facts, estimates, forecasts or opinions contained in this document. The information, opinions, estimates, assumptions, target prices and forecasts could change at any time without prior notice. Intellidex is under no obligation to inform any recipient of this document of any such changes. Intellidex, its directors, officers, staff, agents or associates shall have no liability for any loss or damage of any nature arising from the use of this document.

Remuneration:

The opinions or recommendations contained in this report represent the true views of the analyst(s) responsible for preparing the report. The analyst's remuneration is not affected by the opinions or recommendations contained in this report, although his/her remuneration may be affected by the overall quality of their research, feedback from clients and the financial performance of Intellidex (Pty) Ltd. Intellidex staff may hold positions in financial instruments or derivatives thereof which are discussed in this document. Trades by staff are subject to Intellidex's code of conduct which can be obtained by emailing mail@intellidex.co.za. Intellidex may also have, or be seeking to have, a consulting or other professional relationship with the companies mentioned in this report.

Guide to recommendations:

A buy recommendation is made where the target price is 10% above the current price, a sell when it is 10% below the current price, and a hold recommendation when it is within 10% of the current price. The risk measure is a subjective determination guided by the beta of the share price. We also examine the financial and operating leverage of the business. ©This document is copyrighted by Intellidex (save for information contained in this document provided by third parties which may be copyrighted to them) and may not be distributed in any form without the express prior written permission of Intellidex.

Absa Stockbrokers disclaimer:

This research note is prepared for Absa Stockbrokers (Pty) Ltd and / or Absa Portfolio Managers (Pty) Ltd ("Absa ") by Intellidex (Pty) Ltd, a company registered in South Africa, registration number: 2008/005881/07 ("Intellidex"). Intellidex is an independent company contracted to Absa.

The views expressed in this note are those of Intellidex and/or its analysts and are not necessarily the views of Absa or any officer or agent thereof. The information contained in this communication does not constitute an offer or the solicitation of an offer to enter into any transaction for the sale or purchase of any security, nor does it constitute any recommendation, guidance or proposal to enter into any transaction for the sale or purchase of any security. The information is provided for illustrative purposes only and is not guaranteed. Absa does not represent or warrant that the information contained in this report is true or accurate and no undertaking (express or implied) is given and no responsibility nor liability is accepted by any member of Absa, its employees and agents, as to the accuracy of the information contained herein. Past performance is no indication of future performance. While every effort has been made to ensure the accuracy of the above information, Absa does not accept any liability or responsibility for any loss, damage or expense incurred in relying on the above information or in the use thereof, nor makes any representation as to the accuracy or completeness of the above information. All opinions, estimates and findings contained in this document may be changed after distribution by Intellidex at any time without notice.

This document has been prepared in accordance with local regulations which may differ from the requirements of US, UK and European regulations. In distributing this research to you, Absa does not hold this out to be impartial (objective) as it may have been prepared by persons who may be exposed to conflicts of interest.

You should be aware that this document might have been originally disseminated by Intellidex to its clients other than Absa. As such, employees and clients of Intellidex and any persons connected with it may have had the opportunity to act upon the information contained in this document. The recipients of this document are urged to seek independent advice with regard to the securities and investments referred to in this document.

Absa Stockbroking and Portfolio Management is made up of:

Absa Stockbrokers Pty Limited and Absa Portfolio Managers (Pty) Ltd.

Absa Stockbrokers (Pty) Ltd is a Member of the JSE Equity Market and a Registered Credit Provider Reg No. NCRCP68, an Authorised Financial Services Provider with FSP No 45849.

Absa Portfolio Managers (Pty) Ltd trading as Absa Asset Management Private Clients, an Authorised Financial Services Provider, License No. 552. Content for non-US residents only.

FAIS Notice and Disclaimer:

This brochure/document/material/report/communication/commentary ("this commentary") has been prepared by Absa Stockbroking and Portfolio Management.

Absa Stockbroking and Portfolio Management has issued this commentary for information purposes only and you must not regard this as a prospectus for any security or financial product or transaction. We do not expressly, tacitly or by implication represent, recommend or propose that the securities and/or financial or investment products or services (the "Products") referred to in this commentary are appropriate and/or suitable for your particular investment objectives or financial situation or needs. This commentary is not, nor is it intended to be, advice as defined and/or contemplated in Financial Advisory and Intermediary Services Act, 37 of 2002 ("FAIS"), or any other financial, investment, trading, tax, legal, accounting, retirement, actuarial or other professional advice or service whatsoever ("advice"). All the risks and significant issues related to or associated with the Products are not disclosed herein and therefore, prior to investing or transacting, you should fully understand the Products and any risks and significant issues related to or associated with them. This commentary is neither an offer to sell nor a solicitation of an offer to buy any of the Products, which shall always be subject to our internal approvals and the execution of all requisite documentation.

You have to obtain your own advice prior to making any decision or taking any action based hereon and we, our affiliates, officers, directors, partners, or employees (in whose favour this constitutes a stipulation on behalf of another) do not accept any liability whatsoever for any direct, indirect or consequential damages or loss arising from any use of or reliance on this publication or its contents, and irrespective of whether or not you have obtained independent advice.

Should you be a consumer in terms of the Consumer Protection Act No 68 of 2008, as amended, (i.e. a natural person or an entity with an asset value and annual turnover below R2m), then the above provisions limit and exclude the liabilities which we will have towards you and also place obligations on you.

Absa Stockbroking and Portfolio Management is made up of:

Absa Stockbrokers Pty Limited and Absa Portfolio Managers (Pty) Ltd.

Absa Stockbrokers (Pty) Ltd is a Member of the JSE Equity Market and a Registered Credit Provider Reg No. NCRCP68, Absa Portfolio Managers (Pty) Ltd, an Authorised Financial Services Provider with FSP No 552.

Absa Portfolio Managers (Pty) Ltd trading as Absa Asset Management Private Clients, an Authorised Financial Services Provider, License No. 552