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Innovation Group

Interim results

Margin expansion

Software & comp services

Innovation's interim results showed a strong improvement in underlying profitability. Subsequent deal flow across software and business process services (BPS) suggests the margin expansion trajectory is well set to continue. Successful conversion of a strong pipeline, particularly in the US, should set the stage for significant further earnings growth.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
09/11	175.9	15.1	1.0	0.0	27.2	N/A
09/12	193.7	18.4	1.2	0.0	22.8	N/A
09/13e	212.2	22.1	1.4	0.0	20.1	N/A
09/14e	229.3	25.9	1.6	0.0	17.1	N/A

Note: *PBT and EPS are normalised, excluding acquired intangible amortisation, exceptional items and share-based payments. EPS is fully diluted.

Strong improvement in underlying profitability

From a financial standpoint, the main feature of the H1 results was a significant improvement in underlying profitability. Sales grew by 5% year-on-year (8% constant currency) but adjusted PBT grew by 32% to £9.6m. This was driven primarily by a c 200bp year-on-year improvement in BPS gross margins to 39%, as well as good cost control. It was also achieved despite a drop in high margin software licensing sales from £2.8m to £1.3m. Deal flow since then suggests a robust uptick in licensing in H2. The pipeline is healthy, although increasing demand for Software as a Service (SaaS) may result in a more steady build of recurring revenues vs a step up in one-time licence sales. BPS gross margins are also typically seasonally stronger in H2. Therefore, Innovation looks on track to deliver a third consecutive year of 20%+ PBT growth.

Margin expansion trajectory set to continue

Management comments that customers increasingly understand the value-add of Innovation's model, an assertion that is supported by contract extensions with AXA, a South African insurer and Enterprise Rent-A-Car, signed since period-end. While the US remained a drag on margins in H1, the company is seeing opportunities across both business process outsourcing (BPS) and software. A restructuring of its US operations should help improve the return on incremental sales. As a result, we believe the company's margin expansion trajectory, which has seen adjusted EBIT margins expand from 5.7% in 2010 to 9% in 2012 and 10.2% estimated for 2013, look well set to continue into the low- and possibly mid-teens.

Valuation: Risk/reward still positive

Our estimates have not changed significantly, with the GVS acquisition and a nudge up to underlying margins broadly offsetting the rand currency headwind. Innovation's 2014e P/E rating of 17x is towards the upper end of a broader peer group of UK and international peers, but is justified in our view, given the potential for upside to our estimates and further margin expansion. Delivery on management's 2015 goal of 12-14% annual sales growth and 15% adjusted operating margin would imply an adjusted EPS of 2.7p, which, when applying a sector average P/E of 14x on these earnings, would imply a share price of 38p.

4 July 2013

Price	**27.75p**
Market cap	**£273m**
	€1.17/£1
Net cash (£) as at end-Sept 2012	26.0
Shares in issue	985.3m
Free float	67%
Code	TIG
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	(0.9)	9.9	44.2
Rel (local)	3.4	12.7	28.9
52-week high/low		27.5p	18.25p

Business description

Innovation Group provides outsourcing and software to the insurance industry and related sectors. The group's solutions help provide much-needed efficiencies and flexibility to insurance providers.

Next events

IMS	August 2013
Full-year results	December 2013

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Operational review

Business Process Solutions (BPS)

Strong margin performance

Overall BPS sales grew by 6% y-o-y to £89m, (just over 2% organic constant currency). Growth was suppressed by the discontinuation of non-economic business in the UK and continued falls in automotive claims volumes, particularly in Europe. However, gross margins expanded to 39% from 37%, which, given the substantial weighting of revenues towards BPS (80% of sales), was the main driver of strong profit growth over the period. From a general perspective we believe this expansion reflects improved discipline and execution through the cycle of bidding for and delivering BPS services. More specific drivers of margin expansion included the restructuring of operations in the UK and Germany in 2012, a more favourable sales mix (for example, higher fleet sales in Germany), the roll-out of the Enterprise software platform across more BPS operations and the impact from acquiring higher-margin business, both directly and from synergies.

Renewals/extensions support value proposition

Management comments that the market increasingly understands and recognises the value-add of Innovation's model. This is supported by three major contract renewals/extensions signed this calendar year:

- A five-year deal with a major South African insurer originally signed in 2010 has been resigned, increasing the anticipated contract value from £25m to £37m.
- A strategic agreement has been signed with AXA France, whereby it will increase the number of automotive claims steered to Innovation's subsidiary, Nobilias, by 75% by the end of 2015, with a view to using Nobilias for all claims by the end of 2016. This will effectively triple the volumes processed. The companies will also merge their affiliate repair networks, which should eventually generate £1.5m+ incremental high margin recurring annual subscription revenues from the workshops for software management systems. As part of the deal, AXA is acquiring a 30% shareholding in Nobilias France for €3.45m (£4.0m) to strengthen the partnership.
- The company has renewed its contract with Enterprise Rent-A-Car in the UK for another five years. Like the original contract signed in 2010, the new contract is worth £25m over the five-year period.

Converting US opportunity could drive an acceleration in growth

Management also describes the pipeline as strong, particularly in the US, where the company is participating in a number of pilot/proof-of-concept trials, although deals in the US tend to be more flexibly structured in contract length and value than in Europe. However, given the size of the market and Innovation's historical under-penetration within the country, any meaningful improvement in sales conversion rates should drive acceleration in BPS growth rates in 2014 and 2015.

Software

Insurer pipeline should start to convert in H2

Software sales were flat year-on-year at £11.3m. Within this, high-margin licensing sales declined from £2.8m to £1.3m last year, whereas other software sales grew by 18% to £10m. The contraction in licensing in part reflects that the comparable period contained a £1.6m deal in Asia. It also reflects that the company's pipeline for the re-architected core "Insurer" product suite had yet

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to start converting in a meaningful way. However, it appears this is now starting to happen and we would expect the pipeline to start converting over this year. The company signed a £2.6m deal (approximately £1m licensing) with US insurer GuideOne shortly after the results, and the company has recently announced a £2m policy and analytics win with a Tier One UK mutual. We understand the immediate pipeline is healthy, and are therefore confident of a robust improvement in H2. However, the company is also seeing an increase in demand for SaaS or term licences vs the traditional perpetual model, which will reduce the near-term revenue and margin impact but add higher-margin recurring/repeat revenues. This should therefore strengthen the company's financial platform.

Addressable market should support higher revenues than forecast

We maintain our view that successful execution on the US opportunity should support substantially more than the £31.1m software revenues we have forecast for 2014. The Insurance Information Institute estimates there are 2,686 property/casualty insurers in the US. The Insurer product suite is targeted at the tier 2/3 carriers that make up the vast majority of this number, and that are increasingly adopting technology to improve efficiencies, flexibility and enhance services. Management estimates that around 100 tenders addressable by its solution set are put to market each year.

Growth in other software sales indicates that the initiatives to broaden the product suite are starting to yield returns. The portfolio now includes a range of both proprietary and third-party solutions, selling to a broader range of customers and with a wide span of price points. Over the course of H1 the company has also established an indirect sales channel, signing an agreement with Xuber (a division of Xchanging), which will distribute the company's analytics product to its customer base.

Estimates

Our estimates are detailed in Exhibit 1. Adjustments at the P&L level are only minor, but reflect a number of influencing factors.

- **Currency headwind** – The 13% weakening of the South African rand vs sterling since end-H1 has created a currency headwind, with 21% of H1 sales and 35% of EBITDA (pre-central costs) coming from the country and £14.2m cash held there at year end. In isolation, this headwind would negatively affect 2013 sales by £2.7m, EBITDA by £0.6m and cash balance by £1.8m should it prevail throughout H2.
- **Acquisition of Gemini Vehicle Solutions (GVS)** – Acquired for £4.5m in April (of which £1.5m is deferred for 12 months), GVS adds c £1.3m to 2013 sales and £400k to EBITDA.
- **Underlying nudge up to margins** – Stripping out these two factors, underlying PBT is nudged up by c £500k. This is in spite of reducing our full-year licensing revenue estimate from £6m to £4.8m to reflect the pipeline, which is weighted towards SaaS and term licence contracts. We believe these estimates remain conservative, although further SaaS and BPS deal flow between now and year end is more likely to affect 2014 than 2013 estimates.

Our PBT upgrades are offset at the EPS level by increased minority interest charges, reflecting a restatement to 2012 figures (and therefore current run-rate) and payments to AXA as part of the Nobilias deal. Note, we upgraded 2014 adjusted PBT and EPS by 5% following the AXA deal at the beginning of May.

Operating cash flow to EBITDA conversion was approximately 93% (H112: 88%), although our year-end net cash estimate is reduced by £4.2m to £32.3m, with better cash conversion offset by currency movements, the GVS acquisition (£3m), £1m of exceptional charges related to the AXA deal, planned restructuring of the US operations, higher capex due to an office relocation in

Australia and investment in a hosting centre in the US. It is worth noting that we expect R&D amortisation charges (est £5.6m in 2013) to outweigh the amount capitalised (est £3m in 2013) through our forecast period, reflecting the maturing of the Insurer software development programme. This will further improve cash conversion, although rising amortisation charges do raise the hurdle for margin expansion.

Exhibit 1: Estimate revisions

£'000s	2012 restated	2013 old	2013 new	% chg	2014 new	2014 new	% chg
BPS revenue	171,200	187,670	185,444	(1%)	197,365	198,192	0%
BPS gross margin	39%	40%	40%		41%	41%	
Licensing revenue	3,800	6,000	4,800	(20%)	7,000	7,000	0%
Other software and services	18,730	20,603	21,914	6%	22,663	24,106	6%
Software revenue	22,530	26,603	26,714	0%	29,663	31,106	5%
Software gross margin	57%	60%	55%		60%	58%	
Revenue	193,730	214,273	212,158	(1%)	227,028	229,297	1%
Operating profit (norm)	17,363	21,460	21,735	1%	24,667	25,387	3%
Operating profit	10,704	16,080	15,139	(6%)	18,387	19,107	4%
Profit from associates	1,482	400	400		400	400	
Net Interest	(414)	(114)	(39)		111	111	
Profit before tax (norm)	18,431	21,746	22,096	2%	25,178	25,898	3%
Minority interests	2,930	1,825	2,803		1,808	2,877	
EPS - normalised FD (p)	1.21	1.45	1.38	(5%)	1.68	1.63	(3%)
EPS - FRS 3 (p)	0.63	1.08	0.91	(16%)	1.25	1.20	(4%)
Closing net debt/(cash)	(26,046)	(36,534)	(32,264)	(12%)	(51,120)	(47,208)	(8%)

Source: Edison Investment Research, Innovation Group data

Pathway to further margin expansion

Our adjusted EBIT margin estimates for 2013 and 2014 are 10.2% and 11.1% respectively. Management's goal for 2015 is to expand this to 15%, while growing sales at an annual rate of 12-14%. This remains an ambitious target in our view, but the pathway to achieving it is now becoming clearer. It will require strong execution across the board, particularly in the following interrelated areas:

- **Acquisitions:** Well-targeted and executed acquisitions will play a role in both supplementing growth and improving margins. The 300bp annual improvement in BPS gross margin was in part attributed to the contribution from higher margin acquired businesses and synergies generated. Underlying cash operating expenses increased by only £300k year-on-year in H1 (albeit with a helping hand from currency) despite acquisitions contributing an incremental £3.2m sales.
- **Improving profitability in the US**: The US presents by far the largest market for Innovation's software and BPS offerings, and the company is now looking much better placed to capitalise on this. However, the US operation made a PBT loss of £0.9m on sales of £12.3m in H1 (+14% year-on-year) and has long been a drag on margins. Successful conversion of the company's BPS, and particularly its software pipeline, should clearly bring margins up, but it has also changed senior management in the region and we have factored in £0.8m restructuring costs to further optimise the operating structure in the US.
- **Growing software revenues:** As discussed earlier, incremental licensing revenues, with 95%+ gross margins drop strongly through to the bottom line. Margins should also be high for SaaS-based contracts, although the subscription model spreads the revenue contribution over the contact period. While other software is lower margin (45% in H1) it is still higher than BPS. With a competitive suite of products and sizeable opportunity in the US, we feel that the ingredients are in place to drive an acceleration in software sales growth and continued margin expansion.

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Exhibit 2: Revenue model and illustration of 2015 targets

Year-end Sept	FY 2010	FY 2011	FY 2012	FY 2013e	FY 2014e	Target FY2015e
£m						
Sales						
BPS	141.9	152.9	171.2	185.4	198.2	227.9
Software licences	1.8	3.4	3.8	4.8	7.0	11.0
Other software	18.5	19.7	18.7	21.9	24.1	26.5
Total	162.1	175.9	193.7	212.2	229.3	265.4
Growth						
BPS	15%	8%	12%	3%	6%	15%
Software licences	-82%	89%	12%	26%	46%	57%
Other software	-10%	6%	-5%	17%	10%	10%
Gross margin						
BPS	38.0%	38.5%	38.5%	39.7%	40.5%	40.5%
Software licences	98.3%	97.5%	97.5%	97.0%	98.0%	98.0%
Other software	43.9%	50.5%	48.5%	46.0%	46.0%	46.0%
Overall gross margin	39.3%	41.0%	40.6%	41.6%	42.8%	43.4%
Gross profit	63.8	72.1	78.7	88.4	98.2	115.3
Cash expenses	(49.0)	(50.8)	(54.0)	(57.1)	(61.6)	(64.6)
EBITDA	14.8	21.2	24.7	31.2	36.6	50.7
Margin	9.2%	12.1%	12.7%	14.7%	16.0%	19.1%
D&A	(5.7)	(6.3)	(7.3)	(9.5)	(11.2)	(11.2)
Underlying expenses	(54.6)	(57.1)	(61.3)	(66.6)	(72.8)	(75.8)
EBIT Adj	9.2	15.0	17.4	21.7	25.4	39.5
Margin	5.7%	8.5%	9.0%	10.2%	11.1%	14.9%

Source: Edison Investment Research, Innovation Group data

Valuation

Innovation's 2013 P/E rating of 20.1x 2013 earnings, falling to 17.1x next year, is towards the upper end of a broader peer group of UK and international peers. We feel this is justified given the potential for upside to our estimates, and sustained strong earnings growth stemming from the company's potential to continue improving margins.

Based on our illustrative scenario (Exhibit 3), delivery on management's 2015 goal of 12-14% annual sales growth and 15% adjusted operating margin would imply an adjusted EPS of 2.7p (assuming no dilutive acquisitions). A sector average P/E of 14x on these earnings would imply a share price of 38p.

Exhibit 3: Peer group valuation table

Company	Reporting currency	Share price	Market cap	EV/Sales		P/E		EBIT margin	
		(local)	(local m)	Current	Next	Current	Next	Current	Next
Innovation Group	£	27.0	266	1.1x	1.0x	20.1x	17.1x	10.2%	11.1%
Combined product/service companies									
NCC Group	£	125.0	259	2.8x	2.5x	15.8x	14.2x	24.0%	24.2%
SDL	£	287.0	230	0.8x	0.8x	17.7x	11.1x	5.2%	7.7%
Quindell Portfolio	£	11.3	407	0.9x	0.6x	4.9x	3.8x	23.7%	28.0%
Outsourcing companies									
Capita	£	994.0	6,538	2.1x	1.9x	17.6x	16.0x	12.4%	12.4%
Computer Sciences Corp	US$	44.5	6,687	0.5x	0.5x	12.7x	11.1x	6.5%	7.3%
Capgemini	€	37.9	6,024	0.5x	0.5x	13.0x	11.8x	7.8%	8.2%
ExlService Holdings	US$	29.7	968	1.7x	1.5x	16.7x	14.5x	14.5%	14.3%
Product-based companies									
Guidewire Software	US$	43.6	2,501	7.7x	6.6x	88.2x	98.6x	14.2%	12.9%
Kofax	US$	338.5	303	1.3x	1.3x	17.5x	14.0x	8.7%	10.3%
Microgen	£	148.5	123	3.0x	2.9x	17.9x	17.9x	27.8%	27.9%
Solera Holdings	US$	56.0	3,857	5.4x	5.0x	20.8x	19.8x	30.0%	30.3%

Source: Bloomberg consensus, Edison Investment Research estimates. Note: Valuations as at 2 July 2013.

Exhibit 4: Financial summary

£'000s	2010	2011	2012	2013e	2014e
Year end 30 September	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue	162,144	175,925	193,730	212,158	229,297
Cost of Sales	(98,311)	(103,842)	(115,037)	(123,801)	(131,081)
Gross Profit	63,833	72,083	78,693	88,358	98,216
EBITDA	15,903	21,249	24,684	31,235	36,587
Operating Profit (before amortisation and except)		10,251	14,957	17,363	21,735
Amortisation of acquired intangibles	(3,496)	(3,425)	(3,265)	(3,580)	(3,580)
Cash exceptionals	(4,178)	195	(1,479)	(1,016)	0
Other	(3,846)	(1,648)	(1,915)	(2,000)	(2,700)
Operating Profit	(1,269)	10,079	10,704	15,139	19,107
Net Interest	(277)	(331)	(414)	(39)	111
Share of profit of associate	(150)	459	1,482	400	400
Profit Before Tax (adj)	9,824	15,085	18,431	22,096	25,898
Profit Before Tax (FRS 3)	(1,696)	10,207	13,251	16,516	19,618
Tax	(2,654)	(4,515)	(2,892)	(3,875)	(4,905)
Profit After Tax (adj)	6,270	10,258	14,745	16,572	19,424
Profit After Tax (FRS 3)	(4,350)	5,692	10,359	12,641	14,714
Minority interests	748	439	2,930	2,803	2,877
Net income (adj)	5,522	9,819	11,815	13,769	16,547
Net income (FRS3)	(5,098)	5,253	7,429	9,838	11,837
Average Number of Shares Outstanding (m)	884.6	938.1	947.3	973.1	992.1
EPS - adj (p)	0.62	1.05	1.25	1.41	1.67
EPS - adj fully diluted (p)	0.62	1.02	1.21	1.38	1.63
EPS - FRS 3 (p)	(0.58)	0.56	0.63	0.91	1.19
Dividend per share (p)	0.0	0.0	0.0	0.0	0.0
Gross Margin (%)	39.4	41.0	40.6	41.6	42.8
EBITDA Margin (%)	9.8	12.1	12.7	14.7	16.0
Operating Margin (before GW and except.) (%)	6.3	8.5	9.0	10.2	11.1
BALANCE SHEET					
Fixed Assets	112,701	117,323	139,282	133,562	127,482
Intangible Assets	93,395	96,682	117,364	113,784	110,204
Tangible Assets	16,235	16,907	17,753	15,613	13,113
Investment in associates	3,071	3,734	4,165	4,165	4,165
Current Assets	89,026	87,387	97,581	108,831	128,455
Stocks	35,900	30,252	31,884	34,917	37,738
Debtors	10,900	14,016	21,015	23,014	24,873
Cash	42,226	43,119	44,682	50,900	65,844
Current Liabilities	(78,561)	(78,542)	(83,521)	(89,480)	(96,310)
Creditors	(75,768)	(75,508)	(81,787)	(87,746)	(94,576)
Short term borrowings	(2,793)	(3,034)	(1,734)	(1,734)	(1,734)
Long Term Liabilities	(20,953)	(17,283)	(29,869)	(27,970)	(29,687)
Long term borrowings	(10,662)	(7,372)	(16,902)	(16,902)	(16,902)
Other long term liabilities	(10,291)	(9,911)	(12,967)	(11,068)	(12,785)
Net Assets	102,213	108,885	123,473	124,943	129,940
CASH FLOW					
Operating Cash Flow	13,573	22,831	20,627	27,948	33,721
Net Interest	(956)	39	(545)	(39)	111
Tax	(3,499)	(3,652)	(4,062)	(5,443)	(6,889)
Capex	(7,359)	(8,974)	(10,241)	(9,000)	(8,500)
Acquisitions/disposals	(622)	(2,803)	(11,758)	(7,900)	(1,950)
Financing	18,958	(1,063)	3,172	2,200	0
Dividends (to minority interests)	(866)	(1,339)	(1,549)	(1,549)	(1,549)
Net Cash Flow	19,229	5,039	(4,356)	6,218	14,944
Opening net debt/(cash)	(10,622)	(28,771)	(32,713)	(26,046)	(32,264)
HP finance leases initiated	(800)	0	0	0	0
Other	280	(1,097)	(2,311)	0	0
Closing net debt/(cash)	(28,771)	(32,713)	(26,046)	(32,264)	(47,208)

Source: Innovation Group accounts, Edison Investment Research

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