PSI

Q2 update

On track despite Asian uncertainty

Software & comp services

PSI's H1 update is generally encouraging with order intake up 17% y-o-y driven by strength in the German energy and automotive industries and mostly solid trading across Europe. Weakness in China and Asia offset this somewhat and reduce visibility, but we believe our estimates are adequately supported. Delivery on this year's estimates should improve confidence in the longer-margin expansion strategy, which is key to unlocking significant upside potential.

Year end	Revenue (€m)	EBIT* (€m)	EPS* (c)	DPS (c)	P/E (x)	Yield (%)
12/13	176.3	4.2	10.64	0.0	107.9	0.0
12/14	175.4	7.2	27.50	0.0	41.7	0.0
12/15e	185.0	11.0	50.68	20.0	22.7	1.7
12/16e	190.9	14.6	71.34	30.0	16.1	2.6

Note: *EBIT and EPS exclude acquired intangible amortisation, but not exceptional items or share-based payments.

Domestic strength, instability in Asia

PSI's H1 update shows solid order intake, up 17% y-o-y to €104m (Q2 up 27% y-o-y at €42m) driven principally by the domestic electrical energy and automotive businesses. Revenues grew by 7.5% y-o-y to €90.5m, driven by the Energy Management (+5%) and Production Management (+13%) segments, the latter of which included the contribution (undisclosed) from the Broner acquisition. EBIT at €4.2m improved 52% from last year's suppressed levels. Most business lines appear to be performing solidly, apart from those with significant Chinese/Asian exposure: Metals (offset by solid European demand), Mining and Incontrol (which was restructured during the period).

Estimates unchanged, long-term margin upside

Our estimates are unchanged. While the uncertain situation in China and South-East Asia continues to cloud visibility, given the robust order intake and restructuring set to benefit H2, we believe our estimates are adequately supported. Looking longer term, we retain our view that with concerted, strong execution on the shift to a standard software model and migration to a unified software platform, operating margins have the potential to expand to the mid-teens level on a four- to six-year view (vs 6% for 2015e). Hence this dynamic opens up the potential for sustained double-digit earnings growth.

Valuation: Margin expansion key to upside

PSI's rating is trading at even more acute recovery multiples, with a low EV/sales (c 1x), but an uncompelling P/E (c 23x), based on our FY15 EBIT margin estimate of 6%. However, while there will be challenges along the way, with good execution on the transformation plan, we believe that EBIT margins can be expanded to the mid-teens level within four to six years. Our DCF analysis shows that expansion of operating margins to 12% should justify a share price higher than €15, while achieving 15% would justify a share price closer to €20.

3 August 2015

Price	**€11.48**
Market cap	**€179m**
Net cash (€m) at 31 December 2014, excl €47m pension provision.	24.0
Shares in issue	15.6m
Free float	76%
Code	PSAN
Primary exchange	Frankfurt
Secondary exchange	Munich

Share price performance

%	1m	3m	12m
Abs	11.3	(4.1)	(6.0)
Rel (local)	7.7	(2.8)	(21.8)
52-week high/low		€13.00	€10.30

Business description

PSI develops and integrates software control systems: (1) solutions for electricity, gas, oil and water; (2) software for production planning, control and logistics; and (3) solutions for monitoring and operating critical transport, public safety, environmental and disaster prevention.

Next events

H1 report	August 2015
Q3 release	November 2015

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Edison profile page

PSI is a research client of Edison Investment Research Limited

Divisional overview

Control software for critical infrastructure

PSI (Gesellschaft Fuer Produkte und Systeme der Informationstechnologie) develops, sells and integrates software for controlling complex systems, networks and infrastructures. Its systems are crucial components in these systems, enabling them to run efficiently, improving flexibility and avoiding failure. The company has three key segments: Energy Management, where the its systems are used to ensure a stable and dependable supply of electricity, gas, oil, heat or water; Production Management, which provides solutions for optimising metal processing, automotive production, mechanical engineering and mining processes; and Infrastructure Management, which provides highly available control systems for managing and monitoring road, rail and other public transport systems. The company transacts business across the globe, but holds a particularly strong position in Germany, which accounts for c 50% of sales.

Energy Management (35% of H115 sales)

The Energy Management segment comprises of three divisions: Electricity and multi-utility, Oil and gas, and Energy trade and sales. Overall revenues for the segment increased 5% year-on-year in H1 to €31.8m, while EBIT increased 20% to €1.7m from €1.4m last year, reflecting both operational gearing and lower development costs.

The German electrical energy business was, as expected, a key driver of growth in the order book. This is in part cyclical, with demand being buoyed by investment ahead of the German tariff-setting ‘photo year’ (when feed-in tariffs are decided) in FY16. More structurally, we believe that PSI’s investment in re-architecting its solutions in this domain is helping it expand its share of the market. Enabled by the new software, the company is also looking to structure its deals towards a more recurring maintenance/update-weighted format. These factors should add support to trading beyond 2016, although the extent is difficult to gauge at this stage. Looking further out, it seems likely that the German government will exclude software investment from the tariff-setting cycle, which should substantially remove this cyclicality in future years.

Demand in the company’s Oil and gas business, which supplies control software primarily for gas distribution grids (mainly domestic) and pipelines (mainly overseas) has remained solid, despite the company’s exposure to instability in Russia and the Ukraine.

The small energy trading division, which supplies software for enterprises working in the liberalised energy market to allow them to manage all sales and trade-related processes, also appears to be making forward progress, driven by migration of the solutions onto the group’s Eclipse platform.

Production Management (49% of H115 sales)

The production segment consists of two of PSI’s larger but relatively mature businesses, PSI Metals and PSI Automotive (Penta), together with the smaller PSI Logistics and PSI Mining businesses. The division’s sales grew by 13% y-o-y to €44.2m, although this was boosted by the November acquisition of Broner (contribution undisclosed; FY13 revenues were €10m). The segment’s EBIT more than doubled to €2.7m from a poor €1.0m in H1 last year, which was significantly affected by cost overruns in the Logistics division. Broner broke even during the period, so did not contribute to this earnings expansion, while investment in the Mining division negatively affected EBIT by c €0.5m. Prospects for H2 generally look encouraging, although the Chinese/Asian economic situation adds a level of uncertainty.

The company states that it is seeing a stabilisation in new orders in the metals business, driven from Europe. The integration of Broner appears to be progressing largely to plan, with all but one customer committed to migrating to the PSI product suite. As we have discussed in previous notes, we believe that the key synergies from the Broner acquisition are likely to come through in improved geographical reach and pricing power for incumbent PSI Metals business.

Automotive business won a small number of significant licensing deals late in the period, driven by the launch of an updated product that should drive further licensing activity in H2. Following the travails of FY13 and FY14, the Logistics business now appears to be on the front foot, winning a number of orders over the period and significantly expanding margins. PSI Mining has completed test operations of the mining control room development with its lead customer in China. While the company still hopes for follow-on orders, given the weak Chinese/commodities environment, these are now unlikely before FY17. However, the company has now reallocated staff to the Electricity and multi-utility division, which shares a core underlying platform and where demand is robust. Consequently, losses should reduce in H2.

Infrastructure Management (16% of H115 sales)

The two main divisions in the Infrastructure Management segment are Transcom (c 4% of full year sales), which supplies software for controlling public transport infrastructure, and PSI Incontrol, which is a project-based implementation company PSI acquired in 2009 to give it better access to South-East Asian markets. Revenues declined 2% year-on-year, reflecting weakness in Incontrol as a result of instability in South-East Asia, whereas Transcom continued to perform steadily. Incontrol made a loss over the period, and as a result, segment operating profit declined to €0.4m from €0.9m last year. Incontrol has restructured over the period and management says it is now seeing signs of a recovery in orders, which should support a stronger result in H2.

Estimates

We are not changing our estimates. Given the robust order book intake and typical seasonal H2 weighting, our FY revenue estimate of €185.0m (requiring €94.5m in H2) looks well underpinned. While the required EBIT uplift to reach our €11m EBIT estimate (from €4.2m in H1 to €6.8m in H2) is more marked, with operational gearing and rationalisation measures in Mining and Incontrol set to benefit H2, we believe this estimate is well supported.

Looking further out, a number of key initiatives are being implemented to add resilience and put the business back on a margin expansion trajectory. A shift towards a more product-led vs project-based model should reduce exposure to cost overruns. The progressive migration of customers and products onto a unified technology platform should improve development, product maintenance and implementation efficiency. It will also give the company scope to reallocate staff from challenged domains to promising ones more easily.

We forecast EBIT margin expansion from 5.9% in FY15 to 7.7% in FY16 reflecting the progressive benefit of these initiatives, along with the Broner synergies and full year benefit of the Incontrol rationalisation. On a four- to six-year view, with good execution and commitment, we believe mid-teens margins should be achievable. This should open up the potential for sustained double-digit earnings growth.

Valuation: All about margin expansion

PSI remains rated at typical recovery multiples, with a low EV/sales ratio but a relatively high P/E, although the latter is actually not out of kilter with its broader peer group. However, PSI's margins are substantially below the majority of its peers, which reflects the fragmentation of the current product set and project-based business model.

Typical recovery multiples

While the very high margins enjoyed by the likes of AVEVA (subject to a reverse takeover from Schneider Electric) and Dassault are likely to be out of reach, with some rationalisation, broader roll-out of the Eclipse 4 software platform and a successful shift to a standard software model, we believe that expansion to the mid-teens level should be achievable with a five-year view. This would open up the potential for sustained double-digit earnings growth, which we do not believe is priced in.

Exhibit 1: Peer group analysis

				EV/Sales		P/E (x)		EBIT margin (%)	
	Share price currency	Share price	Market cap	Current	Next	Current	Next	Current	Next
PSI	EUR	11.9	187	1.2x	1.2x	23.5x	16.7x	6.0%	7.8%
Local peers									
Init Innovation In Traffic Systems	EUR	26.2	263	2.5x	2.3x	20.2x	18.2x	17.8%	18.3%
IVU Traffic Technologies	EUR	4.0	71	1.1x	1.1x	14.9x	13.4x	9.8%	10.4%
Nemetschek	EUR	34.8	1,338	5.0x	4.5x	33.6x	28.0x	20.0%	21.0%
International industrial software									
ANSYS	USD	92.9	8,343	7.9x	7.3x	26.9x	24.5x	46.3%	46.7%
Autodesk	USD	51.8	11,788	4.0x	4.1x	49.9x	64.2x	12.6%	3.5%
AVEVA Group*	GBP	2209.0	1,413	6.3x	5.9x	29.2x	27.0x	28.0%	29.2%
Constellation Software Inc/Canada	USD	322.4	6,832	3.9x	3.4x	23.0x	19.0x	9.7%	11.2%
Dassault Systemes	EUR	50.7	12,978	5.0x	4.4x	28.4x	25.2x	28.0%	28.8%
PTC	USD	38.1	4,384	3.7x	3.6x	16.9x	15.6x	24.6%	26.6%

Source: Company data, Edison Investment Research, Bloomberg consensus. Note: *Being taken over by Schneider Electric. Prices as at 28 July 2015.

A discounted cash flow analysis suggests that the current valuation is pricing in minimal EBIT margin expansion beyond our 7.7% FY16 estimate. In Exhibit 2, we show a DCF sensitivity analysis with our assumptions on the company achieving various operating margins by 2020 and differing organic growth rates between now and 2020. The analysis suggests that a share price of €20+ should be justifiable if operating margins can be expanded to 15% or €15+ if margins reach 12% even on low single digit growth multiples. The valuation is much less sensitive to variations in growth rate.

Exhibit 2: DCF – sensitivity to differing long-term margin and medium-term growth rates

		EBIT margin attained by 2020				
		8%	10%	12%	14%	16%
Organic growth rate to 2020	0%	9.0	12.1	15.2	18.3	21.4
	2%	9.2	12.6	16.0	19.4	22.7
	4%	9.6	13.2	16.8	20.5	24.1
	6%	9.9	13.8	17.7	21.6	25.5

Source: Edison Investment Research. Note: WACC = 10%, Terminal growth rate 2.5%.

Exhibit 3: Financial summary

	€m	2013	2014	2015e	2016e
Year end 31 December		IAS	IAS	IAS	IAS
PROFIT & LOSS					
Revenue		176.3	175.4	185.0	190.9
Cost of Sales		(34.8)	(33.3)	(35.1)	(36.3)
Gross Profit		141.5	142.1	149.8	154.6
EBITDA		8.0	11.1	14.5	18.2
Operating Profit (before aqu'd int amortisation.)		4.4	7.4	11.2	14.8
Amortization of acquired intangibles		(.2)	(.2)	(.2)	(.2)
Operating Profit		4.2	7.2	11.0	14.6
IFRS 2 charges		-	-	-	-
Net Interest		(1.6)	(1.5)	(1.6)	(1.2)
Profit Before Tax (norm)		3.3	5.9	9.6	13.6
Profit Before Tax (FRS 3)		3.1	5.7	9.4	13.4
Tax		(2.7)	(1.6)	(1.7)	(2.4)
Profit After Tax (norm)		1.7	4.3	8.0	11.2
Profit After Tax (FRS 3)		0.4	4.1	7.7	11.0
Average Number of Shares Outstanding (m)		15.7	15.7	15.7	15.7
EPS - normalised (c)		10.6	27.5	50.7	71.3
EPS - normalised fully diluted (c)		10.6	27.5	50.7	71.3
EPS - FRS 3 (c)		2.4	26.2	49.4	70.0
Dividend per share (c)		0.0	0.0	20.0	30.0
Gross Margin (%)		80%	81%	81%	81%
EBITDA Margin (%)		4.5%	6.3%	7.8%	9.5%
Operating Margin (before GW and except.) (%)		2.4%	4.1%	5.9%	7.7%
BALANCE SHEET					
Fixed Assets		69.3	80.5	80.6	80.9
Intangible Assets		49.1	61.7	60.4	59.2
Tangible Assets		13.8	12.9	14.4	15.9
Goodwill		0.0	0.0	0.0	0.0
Other		6.4	5.8	5.8	5.8
Current Assets		108.8	111.8	121.6	130.1
Stocks		3.9	3.5	5.0	5.0
Receivables		77.8	73.6	77.6	80.1
Cash		21.8	29.3	33.6	39.6
Other		5.3	5.4	5.4	5.4
Current Liabilities		(64.8)	(75.7)	(77.9)	(79.3)
Trade & Tax Payable		(35.5)	(41.1)	(43.4)	(44.8)
Short term borrowings		(3.5)	(5.1)	(5.1)	(5.1)
Other creditors		(25.7)	(29.5)	(29.5)	(29.5)
Long Term Liabilities		(45.9)	(48.2)	(48.2)	(48.2)
Long term borrowings		(3.4)	(.2)	(.2)	(.2)
Pension provision & other long-term liabilities		(42.6)	(48.0)	(48.0)	(48.0)
Net Assets		67.4	68.3	76.0	83.4
CASH FLOW					
Operating Cash Flow		1.8	27.4	9.8	15.2
Net Interest		(.2)	(.2)	(.2)	0.2
Tax		(1.6)	(1.3)	(1.7)	(2.4)
Capex		(5.0)	(3.0)	(3.7)	(3.8)
Acquisitions/disposals		1.0	(11.5)	0.0	0.0
Financing		(.6)	(.5)	0.0	0.0
Dividends		(4.7)	(1.2)	0.0	(3.1)
Net Cash Flow		(8.6)	9.7	4.3	6.0
Opening net debt/(cash)		(24.0)	(14.9)	(24.0)	(28.3)
HP finance leases initiated		0.0	0.0	0.0	0.0
Other		(.5)	(.5)	0.0	0.0
Closing net debt/(cash)		(14.9)	(24.0)	(28.3)	(34.3)

Source: Edison Investment Research, PSI accounts