

# SLI Systems

FY18 results

## Cost savings underpin PBT turnaround

SLI's results reflect the business's transitional status. Substantial savings were made to sales and marketing expenditure, which underpinned the company's first year of profitability. We continue to forecast margin compression in the near term as the business begins its transition to an indirect sales model. Successful implementation of this shift remains the critical determinant of the business's prospects.

Year end	Revenue (NZ\$m)	EBITDA (NZ\$m)	PBT* (NZ\$m)	EPS* (c)	EV/sales (x)	P/E (x)
06/17	32.0	(0.5)	(0.8)	(1.8)	0.4	N/A
06/18	34.4	4.5	4.2	6.7	0.4	4.8
06/19e	34.2	2.6	2.3	3.2	0.4	9.9
06/20e	34.8	1.1	0.8	1.2	0.4	27.0

Note: \*PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

## FY18 results: First full year of profit

Boosted by a stronger US\$, FY18 revenues rose 7% y-o-y to NZ\$34.4m, while the business continued the process started at the interims of aggressively cutting operating costs, which saw a 10% y-o-y reduction to NZ\$30.3m. The result was a swing in reported PBT from a NZ\$1.6m loss in FY17 to a NZ\$4.1m gain in FY18, the first full year of profit since the company's listing in 2013. Reassuringly, the improved income statement translated into a NZ\$3.5m cash boost to the balance sheet, leaving the business with NZ\$9.1m net cash at period end.

## Forecasts: Margin erosion to lower profits

In addition to introducing 2020 forecasts, we have left our FY19e revenues broadly unchanged. However, we have reduced our operating costs to reflect the cost reduction programme over FY18, although we note that we still predict increases to opex over FY19e and FY20e as the business undergoes its shift to an indirect sales model. As a result, our FY19e EBIT has increased 32% to NZ\$2.2m, before falling to NZ\$0.8m in 2020e.

## Valuation: Tied to business model transition

SLI's prospects are now tied to the successful execution of the transition to the self-service API (application programme interface) sales model. While the company expects to launch the new products this fiscal year, the continued lack of visibility over growth and cost assumptions is weighing heavily on the shares. While at an acute discount to peers on FY19e figures, the anticipated margin erosion means that the (EV/EBITDA and P/E) discounts dissipate when looking further out. Nevertheless, a 0.4x EV/Sales multiple for FY19e and FY20e means that successful execution of the imminent transition could unlock significant value.

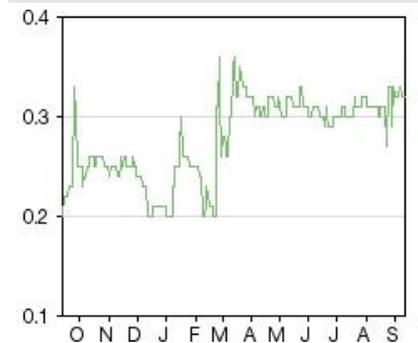
## Software & comp services

11 September 2018

Price **NZ\$0.32**  
Market cap **NZ\$20m**

Net cash (NZ\$m) at 30 June 2018	9.1
Shares in issue	62.3m
Free float	40%
Code	SLI
Primary exchange	NZX
Secondary exchange	N/A

## Share price performance



%	1m	3m	12m
Abs	4.9	4.9	60.0
Rel (local)	5.0	4.3	43.9
52-week high/low	NZ\$0.4		NZ\$0.2

## Business description

SLI Systems' core products are e-commerce site search and navigation tools that learn from customer behaviours to improve the relevance of search results and therefore increase sales conversion. Customers pay a monthly subscription based on the number of queries per month.

## Next event

Interim results	February 2019
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## Review of FY18 results and changes to forecasts

SLI reported its first full year of profitability since its listing on the NZX in 2013. Revenue growth of 7% (vs our forecasts of 5%) was flattered by favourable FX swings, as annualised recurring revenues at constant currency were flat year-on-year. This was achieved despite the 10% reduction in operating expenses and employee entitlements, which meant that total opex came in more than NZ\$1.1m (3.5%) lower than our expectations. This reduction underpinned a y-o-y swing of NZ\$5.7m at the PBT line to a NZ\$4.1m profit for the period.

<b>Exhibit 1: Summary of FY18 results and changes to forecasts</b>							
NZ\$000s	2018			2019			2020
	Estimate	Actual	Variance	Old	New	Variance	New
Annualised recurring revenue (ARR)	33,270	33,581	0.9%	34,933	33,615	-3.8%	34,623
Revenue	33,479	34,417	2.8%	34,515	34,181	-1.0%	34,849
Gross profit	25,607	26,369	3.0%	26,526	26,309	-0.8%	26,947
% gross profit margin	76%	77%	0.2%	77%	77%	0%	77%
EBITDA	2,662	4,456	67.4%	2,042	2,583	26.5%	1,089
Operating profit (before amort.and except.)	2,396	4,185	74.6%	1,692	2,233	32.0%	754
Operating profit margin (%)	7%	12.16%	69.9%	5%	6.53%	33.3%	2.16%
EPS – IFRS (c)	2.82	6.53	131.7%	1.68	2.53	50.1%	0.49
Closing net debt/(cash)	(7,119)	(9,146)	28.5%	(7,585)	(10,436)	37.6%	(11,257)

Source: SLI Systems accounts, Edison investment Research

Of the NZ\$3.3m opex reductions, the most significant savings were made in the sales (NZ\$2.6m, 45% reduction) and marketing (NZ\$1.8m, 37% reduction) activities. As previously highlighted, these cost reductions reflect the scaling back of all cost categories not directly linked to new product development.

Due to the flat constant currency revenues and the significant reduction in the sales and marketing teams (which we expect to suppress new business wins in the short term), we have moderated our expectations for revenue growth in FY19e. However, due to the savings in opex in FY18, our normalised operating profit forecast for FY19 has increased by NZ\$0.5m to NZ\$2.2m. We note that we expect operating margins to become compressed in the near term (5.5pp reduction in FY19e) as costs begin to rise again due to the roll-out of the new API product. Longer term (not shown), successful implementation of the business model transition should enable the re-expansion of margins. In the absence of guidance from management, we see the operating costs line as the key sensitivity to our forecasts. Nevertheless, we expect the company to remain cash-generative through the transitional period.

### Cash flow and balance sheet

Driven by the revenue growth and cost reduction programme, SLI managed to increase cash receipts from customers by 4% to NZ\$33m, while cash outflows to suppliers and employees declined 5% to NZ\$31.2m. These improvements underpinned a net cash inflow of NZ\$3.5m (FY17: NZ\$1.2m outflow), leaving the company with a strengthened net cash position of NZ\$9.1m. This swing meant that management was able to reiterate its commitment to the avoidance of further equity funding.

### Operational update: API launch due this fiscal year

As flagged at the interims and the trading update, management now expects the first products under the new business strategy to be launched in FY19, having been pushed back from H218. While the results provided little new information on the work that remains to be completed before the roll-out of the self-service tools can commence, we understand that this is likely to be a two-

phase process, with a preliminary release this calendar year and a full-scale launch in the first half of CY19. We maintain our view that successful delivery of these self-service tools (and the development of channel partners) is crucial to the longer-term prospects for the business.

## Valuation: Lack of visibility weighing down shares

SLI's depressed valuation reflects the transitional state of the business, in our view. At 0.4x FY19e and FY20e sales, the shares are at a significant discount to the immediate peer group, which typically trade at over 2x sales. This multiple has not changed significantly over the past year, despite the markedly improved cash position (and forecast profitability) of the business. The discount persists even at more traditional metrics such as EV/EBITDA and P/E, where SLI trades at a more than 50% discount to the peer group on an FY19e basis. However, the forecast deterioration in financial performance means that this discount does not persist into FY20e.

**Exhibit 2: Peer multiples**

Name	Reporting currency	Current price	Market cap (m)	EV/Sales 1FY (x)	EV/Sales 2FY (x)	EV/EBITDA 1FY (x)	EV/EBITDA 2FY (x)	PE 1FY (x)	PE 2FY (x)
SLI SYSTEMS LTD	NZD	0.32	19.9	0.4	0.4	5.2	12.4	9.9	27.0
ATTRAQT GROUP LTD	GBP	33.5	35.6	2.1	1.8	103.0	26.6	167.5	47.9
DOTDIGITAL GROUP PLC	GBP	97	288.4	6.3	4.8	21.7	16.9	32.3	24.9
SDL PLC	GBP	466	422.4	1.2	1.1	12.8	10.3	20.6	17.1
WEB.COM GROUP INC	USD	28	1,404	2.7	2.6	10.7	10.2	10.2	8.6
NASSTAR PLC	GBP	12	67.5	2.5	2.3	10.2	9.4	19.6	19.6
<b>Average</b>				<b>3.2</b>	<b>2.7</b>	<b>13.9</b>	<b>11.7</b>	<b>20.7</b>	<b>17.5</b>

Source: Bloomberg, Edison Investment Research. Priced on 10 September 2018. Note: Average multiples exclude outlier Attraqt.

The lack of top-line growth (excluding the currency effects in FY18), the forecast margin erosion, and the lack of visibility as to the progress of the shift in business model are the likely factors weighing down the share price. We also note the high volatility of recent financial performance and the fact that the cost reductions seen over FY18 will not be a sustainable way to expand the business and improve shareholder returns.

Nevertheless, operating performance has materially improved over the past year and the balance sheet (and forecasts) has been significantly strengthened over this time. These developments have had minimal impact on the share price, which has remained relatively flat over the year.

**Exhibit 3: Financial summary**

	NZ\$'000s	2015	2016	2017	2018	2019e	2020e
30-June		NZ GAAP	NZ GAAP	NZ GAAP	NZ GAAP	NZ GAAP	NZ GAAP
<b>PROFIT &amp; LOSS</b>							
Revenue		28,592	35,652	32,035	34,417	34,181	34,849
Delivery costs		(7,211)	(7,958)	(7,571)	(8,048)	(7,872)	(7,902)
Gross Profit		21,381	27,694	24,464	26,369	26,309	26,947
EBITDA		(6,684)	1,136	(473)	4,456	2,583	1,089
Operating Profit (before amort. and except.)		(7,198)	687	(833)	4,185	2,233	754
Intangible Amortisation		0	0	0	0	0	0
Exceptionals		0	0	0	0	0	0
Other/SBP		(526)	(888)	(763)	(97)	(430)	(430)
Operating Profit		(7,724)	(201)	(1,596)	4,088	1,803	324
Net Interest		174	39	27	18	28	28
Profit Before Tax (norm)		(7,024)	726	(806)	4,203	2,262	782
Profit Before Tax (FRS 3)		(7,550)	(162)	(1,569)	4,106	1,832	352
Tax		190	(77)	(284)	(84)	(275)	(53)
Profit After Tax (norm)		(6,834)	649	(1,090)	4,119	1,987	729
Profit After Tax (FRS 3)		(7,360)	(239)	(1,853)	4,022	1,557	299
Average Number of Shares Outstanding (m)		61.6	61.6	61.6	61.6	61.6	61.6
EPS - normalised (c)		(11.1)	1.1	(1.8)	6.7	3.2	1.2
EPS - (IFRS) (c)		(11.9)	(0.4)	(3.0)	6.5	2.5	0.5
Dividend per share (c)		0.0	0.0	0.0	0.0	0.0	0.0
Gross Margin (%)		74.8	77.7	76.4	76.6	77.0	77.3
EBITDA Margin (%)		N/A	3.2	N/A	12.9	7.6	3.1
Operating Margin (before GW and except.) (%)		N/A	1.9	N/A	12.2	6.5	2.2
<b>BALANCE SHEET</b>							
Fixed Assets		2,369	2,056	1,809	1,659	2,246	2,168
Intangible Assets		99	65	139	87	78	77
Tangible Assets		1,582	1,316	1,202	1,096	1,693	1,615
Deferred Tax assets		688	675	468	476	476	476
Current Assets		12,213	12,641	11,987	16,661	17,419	18,310
Stocks		0	0	0	0	0	0
Debtors		6,631	5,876	6,341	7,515	6,982	7,054
Cash		5,582	6,765	5,646	9,146	10,436	11,257
Other		0	0	0	0	0	0
Current Liabilities		(9,641)	(8,870)	(9,143)	(9,387)	(8,363)	(8,882)
Creditors		(9,641)	(8,870)	(9,143)	(9,387)	(8,363)	(8,882)
Short term borrowings		0	0	0	0	0	0
Long Term Liabilities		(29)	(42)	(45)	(56)	(56)	(56)
Long term borrowings		0	0	0	0	0	0
Other long term liabilities		(29)	(42)	(45)	(56)	(56)	(56)
Net Assets		4,912	5,785	4,608	8,877	11,246	11,540
<b>CASH FLOW</b>							
Operating Cash Flow		(5,892)	747	(763)	3,767	1,662	1,107
Net Interest		246	111	25	14	28	28
Tax		8	(50)	(54)	(75)	(275)	(53)
Capex		(472)	(163)	(327)	(206)	(255)	(262)
Acquisitions/disposals		0	0	0	0	0	0
Financing		303	538	0	0	130	0
Dividends		0	0	0	0	0	0
Net Cash Flow		(5,807)	1,183	(1,119)	3,500	1,290	821
Opening net debt/(cash)		(11,389)	(5,582)	(6,765)	(5,646)	(9,146)	(10,436)
HP finance leases initiated		0	0	0	0	0	0
Other		0	0	0	0	0	0
Closing net debt/(cash)		(5,582)	(6,765)	(5,646)	(9,146)	(10,436)	(11,257)

Source: Company accounts, Edison Investment Research

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