

Wednesday, 26 April 2023 | update

Sygnity: sell (reiterated)

SGN PW; SGN.WA | IT, Poland

Workable Strategy and Expensive Multiples

Sygnity's share price has skyrocketed more than 240% over the past year compared to a gain of less than 5% registered by the broad WIG index. Unfortunately, there are no good reasons that we can see in the Company's fundamentals for such massive outperformance.

Sygnity unveiled a new strategy plan in February 2023, centered around three pillars. The first pillar focuses on long-term earnings growth, which we have partially factored into our valuation models by assuming EBIT margin expansion from 12.0% in FY2021/22 to 19.5% in the residual period. In our baseline scenario, we assume mid-single-digit revenue growth in the next three years (CAGR 2022-25 = 7%), driven by better pricing and contract acquisition.

On the downside, Sygnity wants to phase out low-margin contracts, which may have negative implications for revenues, and, as a tech employer, it faces continued pay pressures despite an economic slowdown.

After 11% upward revisions each, our updated FY22/23 and FY23/24 EBITDA forecasts for Sygnity currently stand at PLN 47m and PLN 49m, respectively. On the updated estimates, SGN is trading at 19.5x '23E EV/EBITDA and 18.1x '24E multiple, i.e. at premiums greater than 125% relative to its peers, far outperforming the local competitors, Asseco Poland and Comarch, which represent much more compelling investments at the current levels due to their size and liquidity.

We maintain a sell call for Sygnity with a new target price of PLN 20.70 and implied downside potential of 49%.

Earnings Prospects Under the New Strategy

Sygnity's new strategy plan is centered around three pillars. The first pillar is to improve business by adjusting pricing to the current market conditions and ending unprofitable projects (the flagship e-Taxes contract was quoted as one example of such a project). The two other pillars are organic growth and acquisitions.

Our impression of the new strategic goals is that they sound reasonable but are not very well defined. Sygnity has not specifically pinpointed the areas of its focus, nor has it identified any specific new target customer groups, and as such it has not set a clear path to medium-term earnings growth.

M&As

Sygnity has appointed a dedicated team of M&A professionals with the view to taking pro-active measures in that area. Looking at the current financial standing, with net debt/EBITDA = 0.3x at the end of FY21/22, we put the M&A funding potential at >PLN 150m. That being said, mergers and acquisitions involve a high degree of risk and we prefer the organic route for Sygnity.

On the question of price, Sygnity says it wants to target companies with portfolios of ready solutions, proven business models, and predictable revenues, which suggests potentially sizable price tags in the future deals.

(PLN m)	20/21	21/22	22/23E	23/24E	24/25E
revenue	204.1	211.6	230.2	242.5	258.0
EBITDA	61.0	36.2	46.7	48.7	53.4
EBITDA margin	29.9%	17.1%	20.3%	20.1%	20.7%
EBIT	49.2	25.4	34.8	36.6	41.0
net profit	46.6	27.0	27.0	29.6	32.7
P/E	19.8	34.2	34.2	31.1	28.2
P/CE	15.8	24.4	23.7	22.1	20.4
P/B	6.5	5.4	4.7	4.1	3.6
EV/EBITDA	15.8	25.8	19.5	18.1	16.0
DPS	0.00	0.00	0.00	0.00	0.00
DYield	0.0%	0.0%	0.0%	0.0%	0.0%

current price	PLN 40.50
target price	PLN 20.70
mCap	PLN 922m
ADTV (3M)	PLN 0.3m

**Price as of April 25, 2023, 5:00 PM

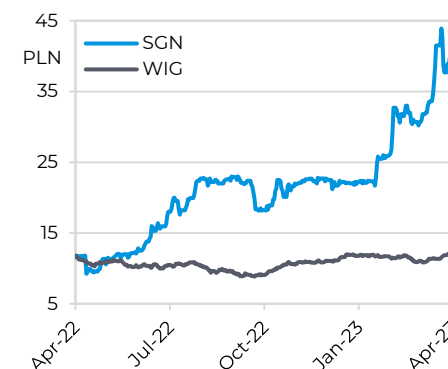
Ownership

TSS Europe B.V.	72.68%
NN PTE	10.67%
Others	16.65%

About Sygnity

Sygnity creates IT solutions and offers advisory services to customers across many different industries. The Company generates approximately PLN 215m in annual sales. Headquartered in Warsaw, Sygnity earns more than 95% its revenues in Poland.

SGN vs. WIG



name	target price		recommendation	
	new	old	new	old
Sygnity	20.70	13.70	sell	sell
name	current price	target price	upside	
	Sygnity	40.50	20.70	-48.9%
forecast update		22/23E	23/24E	24/25E
revenue		+0.4%	+0.9%	+2.4%
EBITDA		+11.3%	+11.3%	+17.4%
net profit		+6.2%	+12.0%	+19.9%

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Key Risks

Mergers & Acquisitions

Growth through acquisitions represents one of the three pillars of Sygnity's new strategy plan. There is a substantial amount of risk involved in business acquisitions, both at the stage of carrying out the transaction and in terms of achievable synergy.

Sygnity is aiming to ultimately acquire between 3 and 5 software companies per year – this is a very high number of transactions at the same time for the IT sector, indicating heightened risk of failure for each.

Goodwill Impairment

Sygnity recorded goodwill in the amount of PLN 157.2m as of 30 June 2022, representing more than half of the balance sheet total. A deterioration in the Company's financial standing could lead to impairment of that goodwill, which in turn could lead to a violation of debt covenants.

No Dividends

Sygnity's net debt is relatively low, with the IFRS 16 ending FY2021/22 balance at approximately PLN 12m, equivalent to 0.3x adjusted EBITDA. At the same time, the Company has a relatively small asset base after several years of curbed capital expenditures.

A return to replacement capital expenditures after a period of restructuring, coupled with higher expenses on customer acquisition, could result in negative changes in working capital, leading to curbed medium-term dividend payments despite good cash flow generation.

Supplier Risk

Sygnity serves as a local partner to global technology companies, integrating their solutions into customer systems and providing a range of services from training, to maintenance, upgrades, and extensions.

If global software providers were to change the terms of their partner policies, for example by limiting the number of local partners, or by bringing implementation services in different markets in house, this could have a negative effect on revenues.

Increase in Labor Costs

Payroll accounts for a major part of Sygnity's operating expenses. Even at the height of the coronavirus pandemic, salaries in the Polish technology industry have been on the rise for the last several years. According to research by No Fluff Jobs, the median monthly pay range offered to senior tech talent was PLN 18-25k net in 2022, marking an increase of 19% from the year before. The compensation offered to junior talent was up 8% on average to PLN 6-9.5k net a month.

Liquidated Damages

Sygnity is always at risk of claims under liquidated damages- and warranty clauses contained in its many contracts with customers and business partners. As of 31 December 2022, the Company reported having conditional off-balance-sheet obligations under performance and warranty clauses in the amount of PLN 14.5m.

Public Contracts

Sygnity competes in government tenders for IT services which are typically awarded to the lowest bidder. Meanwhile, the biggest contracts usually require the onboarding of subcontractors, which heightens the risk of default. Another risk are cost overruns on underestimated projects (Sygnity's 2013 e-Taxes contract is one example of an underrated budget).

Long-Term Contracts

The valuation and successful delivery a long-term contract hinges on many factors, some of which are beyond the control of the supplier. For example, the actual figures at the end of the contract might miss the initial revenue, cost, and profit targets, leading to provisions, adjustments and write-offs (cost overruns are the most common issue), and in the worst case to events of default.

Exchange Rate Risk

Sygnity's revenues and costs are affected by changes in the zloty's exchange rates relative to the euro and the US dollar. On the balance sheet, assets and liabilities denominated in foreign currencies consist exclusively of trade receivables and trade payables.

Corruption Probe

In 2019, Sygnity became involved in an investigation into allegations of corruption in the award of contracts by the Polish Post Office brought against its employees, including the CEO and the Supervisory Board Chairman. The Company fully cooperated with the authorities and turned over all requested records and items.

Since we do not have further knowledge about the current status of the case, we cannot tell whether and how it could affect future business.

Valuation

Using DCF analysis and relative valuation, we set our nine-month per-share price target for Sygnity at PLN 20.70.

Valuation Summary

(PLN)	weight	price
relative valuation	50%	18.07
DCF analysis	50%	19.95
	valuation	19.01
	9M target price	20.70

Source: mBank

Multiples Comparison

We compared Sygnity with a peer group based on forward P/E and EV/EBITDA multiples. Each of the forecast years, calendar 2023, 2024, and 2025, is assigned an equal weight. For Sygnity, we took forecasts for the fiscal years of FY2022/23, 2023/24, and 2024/25, as if they were the corresponding calendar years.

We opt this time not to apply the usual 15% discount that reflected Sygnity's slower earnings growth to the final valuation outcome.

Multiples Comparison

	P/E			EV/EBITDA		
	2023E	2024E	2025E	2023E	2024E	2025E
Sap	23.1	19.7	17.1	16.4	14.6	13.0
Oracle	18.9	17.2	15.1	13.2	12.1	11.1
Cap Gemini	14.3	12.9	11.4	8.7	8.0	7.3
Sage Group	27.1	24.5	21.7	18.0	16.6	14.9
Atos	6.1	4.2	3.0	4.0	3.6	3.0
Software AG	22.5	18.8	15.8	13.4	11.6	9.9
Indra Sistemas	11.1	10.0	9.3	6.6	6.1	5.8
Computacenter	16.0	14.0	12.4	12.0	11.0	10.1
Asseco Poland	13.2	12.7	12.0	6.6	6.2	6.0
Comarch	13.3	12.8	12.5	4.1	3.9	3.7
maximum	27.1	24.5	21.7	18.0	16.6	14.9
minimum	6.1	4.2	3.0	4.0	3.6	3.0
median	14.3	12.9	12.4	8.7	8.0	7.3
Sygnity*	34.2	31.1	28.2	19.5	18.1	16.0
premium / discount	139.7%	141.1%	127.4%	125.3%	127.1%	118.9%
Implied Valuation						
value per share (PLN)	16.89	16.59	17.81	18.24	18.77	20.14
multiple weight		50%			50%	
year weight	33%	33%	33%	33%	33%	33%
equity value per share (PLN)	18.07					

Source: mBank, * FY2022/23, 2023/24, 2024/25, respectively;



DCF valuation

DCF model assumptions:

- The forecast period spans the fiscal years of FY2022/23 - 2031/32.
- The perpetuity risk-free rate is 4.50%.
- We assume FCF after the forecast period will grow at a rate of 2.0%.
- Net debt is ex IFRS 16 as of the end of FY 2021/22.
- Perpetuity D&A expenses and CAPEX are assumed equal.

DCF Model

(PLN m)	22/23E	23/24E	24/25E	25/26E	26/27E	27/28E	28/29E	29/30E	30/31E	31/32E	31/32+
EBIT	34.8	36.6	41.0	45.1	49.6	54.3	59.3	64.5	70.1	76.0	
EBIT margin	15.1%	15.1%	15.9%	16.5%	17.0%	17.6%	18.1%	18.6%	19.1%	19.5%	
tax on EBIT	6.6	7.0	7.8	8.6	9.4	10.3	11.3	12.3	13.3	14.4	
effective tax rate	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	
NOPLAT	28.2	29.7	33.2	36.6	40.2	44.0	48.0	52.3	56.8	61.5	
D&A	4.6	4.8	5.1	5.4	5.8	6.1	6.5	6.9	7.3	7.7	
CAPEX	-5.8	-5.8	-5.9	-5.9	-6.0	-6.0	-6.1	-6.9	-7.3	-7.7	
working capital & other	-2.9	-1.5	-1.6	-1.9	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	
FCF	24.1	27.2	30.8	34.2	39.9	44.0	48.3	52.2	56.7	61.4	62.6
WACC	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	
discount factor	0.9	0.8	0.7	0.7	0.6	0.5	0.5	0.4	0.4	0.3	
PV FCF	22.3	22.4	22.5	22.3	23.0	22.6	22.1	21.2	20.5	19.7	
WACC	11.9%	12.4%	12.5%	12.6%	12.5%	12.6%	12.4%	12.3%	12.3%	12.7%	10.5%
cost of debt	6.9%	7.4%	7.5%	7.6%	7.6%	7.7%	7.4%	7.4%	7.4%	7.8%	5.5%
risk-free rate	5.9%	6.4%	6.5%	6.6%	6.6%	6.7%	6.4%	6.4%	6.4%	6.8%	4.5%
risk premium	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%
effective tax rate	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%
net debt / EV	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
cost of equity	11.9%	12.4%	12.5%	12.6%	12.5%	12.6%	12.4%	12.3%	12.3%	12.7%	10.5%
risk premium	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%
beta	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0

FCF growth after the forecast period	2.0%
Terminal value	741.4
Present value of terminal value	225.2
Present value of FCF in the forecast period	207.2
Enterprise value	456.5
Net debt (eop FY'21/22)	2.6
Other noncore assets	0.0
Minority interest	0.0
Equity value	454.0
Shares outst. (m)	22.8
Equity value per share (PLN)	19.9
9M cost of equity	8.9%
Target Price	21.7

EV/EBITDA ('23) at target price	9.8
P/E('23) at target price	16.8
TV / EV	52.1%

Source: mBank

Sensitivity Analysis

	FCF growth in perpetuity				
	1.0%	1.5%	2.0%	2.5%	3.0%
Residual period RFR +1.0pp	19.45	19.96	20.51	21.14	21.83
Residual period RFR +0.5pp	19.91	20.46	21.08	21.77	22.55
Residual period RFR (g=4.5%)	20.41	21.03	21.72	22.49	23.37
Residual period RFR -0.5pp	20.98	21.66	22.44	23.31	24.31
Residual period RFR -1.0pp	21.61	22.38	23.25	24.24	25.40

P&L					
(PLN m)	20/21	21/22	22/23E	23/24E	24/25E
revenues	204.1	211.6	230.2	242.5	258.0
y/y	-11.3%	3.7%	8.8%	5.3%	6.4%
COGS	-139.3	-151.2	-156.4	-164.8	-174.5
gross profit	64.8	60.4	73.8	77.7	83.5
other operating income	15.5	1.2	0.8	0.0	0.0
sales and marketing costs	-6.7	-6.8	-6.7	-7.1	-7.5
administrative expenses	-23.9	-29.2	-33.0	-34.0	-35.0
other operating charges	-0.6	-0.2	0.0	0.0	0.0
EBIT	49.2	25.4	34.8	36.6	41.0
margin	24.1%	12.0%	15.1%	15.1%	15.9%
D&A	11.8	10.8	11.9	12.1	12.4
EBITDA	61.0	36.2	46.7	48.7	53.4
financing activity	3.2	-2.4	-1.5	-0.5	-0.5
pre-tax profit	52.3	23.0	33.3	36.1	40.4
margin	25.6%	10.9%	14.5%	14.9%	15.7%
tax	-5.8	4.0	-6.3	-6.5	-7.7
discontinued ops.	0.0	0.0	0.0	0.0	0.0
profit after tax	46.6	27.0	27.0	29.6	32.7
Balance sheet					
(PLN m)	20/21	21/22	22/23E	23/24E	24/25E
fixed assets	188.9	188.7	189.9	190.9	191.6
PP&E	2.3	3.5	3.5	3.5	3.5
intangible assets	4.2	7.6	8.8	9.8	10.5
goodwill	157.2	157.2	157.2	157.2	157.2
current assets	90.2	93.9	124.0	154.8	189.5
inventory	0.0	0.0	0.0	0.0	0.0
accounts receivable	39.5	29.4	36.8	40.4	44.7
cash	24.8	34.5	57.3	84.5	114.9
equity	141.6	169.2	196.2	225.8	258.6
minority interest	0.0	0.0	0.0	0.0	0.0
noncurrent liab.	48.8	28.0	28.0	28.0	28.0
loans	0.0	0.0	0.0	0.0	0.0
bonds	36.0	18.3	18.3	18.3	18.3
current liabilities	88.7	85.4	89.8	91.9	94.6
loans	0.0	0.0	0.0	0.0	0.0
bonds	18.1	18.8	18.8	18.8	18.8
trade and other payables	35.3	35.7	40.1	42.2	44.9
net debt	42.5	11.8	-11.0	-38.1	-68.5
net debt/EBITDA	0.7	0.3	-0.2	-0.8	-1.3

Source: mBank

Cash Flow					
(PLN m)	20/21	21/22	22/23E	23/24E	24/25E
operating CF	20.2	44.7	37.4	40.7	44.0
working capital	-24.3	13.2	-2.9	-1.5	-1.6
investing CF	-2.0	-8.1	-5.8	-5.8	-5.9
CAPEX	-0.4	-0.3	-5.8	-5.8	-5.9
financing CF	-30.8	-25.9	-8.8	-7.8	-7.8
change in debt	22.5	-17.0	0.0	0.0	0.0
CF	-12.6	10.7	22.8	27.2	30.4
CFO/EBITDA	33.1%	123.6%	80.2%	83.6%	82.5%
FCFF	9.6	28.3	24.4	27.7	30.9
FCFF/EV	1.0%	3.0%	2.7%	3.1%	3.6%
FCFE	8.5	27.7	22.8	27.2	30.4
FCFE/MCAP	0.9%	3.0%	2.5%	2.9%	3.3%
ROIC	21.6%	11.3%	15.4%	15.9%	17.6%
ROCE	25.8%	13.1%	16.5%	15.3%	15.2%
DPS	0.00	0.00	0.00	0.00	0.00
dividend payout ratio	0.0%	0.0%	0.0%	0.0%	0.0%
dividend yield	0.0%	0.0%	0.0%	0.0%	0.0%

Key Ratios					
	20/21	21/22	22/23E	23/24E	24/25E
P/E	19.8	34.2	34.2	31.1	28.2
P/CE	15.8	24.4	23.7	22.1	20.4
EV/EBITDA	15.8	25.8	19.5	18.1	16.0
EV/EBIT	19.6	36.7	26.1	24.1	20.8
P/S	4.5	4.4	4.0	3.8	3.6
P/BV	6.5	5.4	4.7	4.1	3.6
P/FCFE	108.5	33.3	40.4	33.9	30.4
EBITDA margin	29.9%	17.1%	20.3%	20.1%	20.7%
y/y % EBITDA change	15.0%	-40.7%	29.1%	4.4%	9.5%
net margin	22.8%	12.7%	11.7%	12.2%	12.7%
y/y net change	59.4%	-42.1%	0.1%	9.8%	10.5%
price (PLN)	40.50	40.50	40.50	40.50	40.50
shares outst. (millions)	22.8	22.8	22.8	22.8	22.8
mCap	921.7	921.7	921.7	921.7	921.7
EV	964.3	933.6	910.8	883.6	853.2



List of abbreviations and ratios used by mBank:

EV (Enterprise Value) – Equity Value + Net Debt; **EBIT** – Earnings Before Interest and Taxes; **EBITDA** – EBIT + Depreciation & Amortisation; **Net Debt** – Borrowings + Debt Securities + Interest-Bearing Loans - Cash and Cash Equivalents; **P/E** (Price/Earnings) – Price Per Share Divided by Earnings Per Share; **P/CE** (Price to Cash Earnings) – Price Per Share Divided by Earnings + Depreciation & Amortisation; **P/B** (Price to Book Value) – Price Per Share Divided by Book Value Per Share; **P/CF** (Price to Cash Flow) – Price Divided by Cash Flow from Operations; **ROE** (Return on Equity) – Earnings Divided by Shareholders' Equity; **ROCE** (Return on Capital Employed) – EBIT x (Average Assets - Current Liabilities); **ROIC** (Return on Invested Capital) – EBIT x (1-Tax Rate) / (Average Equity + Minority Interest + Net Debt); **FCFF** (Free Cash Flow to Firm) – Cash Flow from Operations - CAPEX - Lease Payments; **FCFE** (Free Cash Flow to Equity) – Free Cash Flow to Firm - Net Interest Expense (incl. Debt + Leases)
EBITDA margin - EBITDA/Sales

OVERWEIGHT (OW) – a rating which indicates that we expect a stock to outperform the broad market
NEUTRAL (N) – a rating which indicates that we expect the stock to perform in line with the broad market
UNDERWEIGHT (UW) – a rating which indicates that we expect the stock to underperform the broad market

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 - HOLD** – we expect that the rate of return from an investment will range from -5% to +5%
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- Relative** – based on a comparison of valuation multipliers of companies from a given sector; simple in construction, reflects the current state of the market better than DCF; weak points include substantial variability (fluctuations together with market indices) as well as difficulty in the selection of the group of comparable companies.
- Economic profits** – discounting of future economic profits; the weak point is high sensitivity to changes in the assumptions made in the valuation model.
- Discounted Dividends (DDM)** – discounting of future dividends; the weak point is high sensitivity to changes in the assumptions as to future dividends made in the valuation model.
- NAV** – valuation based on equity value, one of the most frequently used method in case of developing companies; the weak point of the method is that it does not factor in future changes in revenue/profits of a company.

mBank issued the following recommendations for Sygnity in the 12 months prior to this publication:

Sygnity (Paweł Szpigiel)

recommendation	sell	sell	sell	accumulate	reduce
date issued	2022-12-01	2022-10-18	2022-07-08	2022-05-06	2022-04-07
target price (PLN)	13.70	13.30	13.50	10.70	10.70
price on rating day	22.30	18.15	15.80	9.40	11.80

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