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Friday, 15 September 2023 | update

Sygnity: sell (reiterated)

SGN PW; SGN.WA | IT, Poland

New Contracts Not Enough to Justify Multiples

Sygnity stock has retreated 13.0% in the last five months, showing 22.6ppt underperformance relative to the WIG index. At the same time, in the last three months Sygnity has secured two major government contracts from the Ministry of Family and Social Policy and the National Bank of Poland, According to our calculations, the new business will provide a 6.8% boost to sales in fiscal 2023/24.

On the downside, we currently opt to revise our FY2022/23 sales forecast downwards by 4%. Further, even though we believe Sygnity can maintain high sales margins in FY 2022/23-24/25, we are prompted to downgrade our EBITDA forecasts for the period by 6-10%.

After updating our models to include current peer multiples and a lower risk-free rate, we set our new target price for Sygnity at PLN 21.60, which implies substantial, 34% downside potential from the current level that mandates a reiterated sell recommendation. SGN is currently trading at 15.9x EV/EBITDA'24 and 25.3x P/E'24, showing respective implied premiums of 101% and 88% to the peer group that, as far as we can tell, are not justified by anything in the fundamentals.

New Contracts

Sygnity has secured two material government contracts in the last few months. In August, the Company was awarded an assignment by the Ministry of Family and Social Policy for the development and maintenance of the 'Syriusz^{Std}' software used by employment offices. Sygnity's total compensation under the contract is capped at PLN 45.7m.

In July, Sygnity signed an extension to a central accounting system maintenance and development contract with the National Bank of Poland. The annex raised Sygnity's contractual fees by PLN 18m, with the total compensation capped at PLN 98.9m.

Outlook for Q4 FY2022/23

Sygnity slightly exceeded our expectations with the results for Q3 2022/23, reporting a high sales margin of 31.7% after a y/y rebound of 1.3pp.

Our expectations for Q3'23, ending 30 September 2023, include a revenue of PLN 53.7m (+4.0% y/y) and a gross margin of 31.2%. We believe quarterly SG&A expenses may have grown significantly to a projected PLN 11.1m. As a result, we expect to see EBIT of PLN 5.7m after a 24% y/y rebound.

We assume a neutral impact of financing activity and an effective tax rate of 19.0% for the quarter.

(PLN m)	20/21	21/22	22/23E	23/24E	24/25E
Revenue	204.1	211.6	219.9	234.9	251.3
EBITDA	61.0	36.2	42.2	44.9	50.0
EBITDA margin	29.9%	17.1%	19.2%	19.1%	19.9%
EBIT	49.2	25.4	31.9	34.4	39.3
Net profit	46.6	27.0	25.3	29.5	33.0
P/E	16.0	27.7	29.5	25.3	22.6
P/CE	12.8	19.8	21.0	18.7	17.1
P/B	5.3	4.4	3.8	3.3	2.9
EV/EBITDA	12.9	21.0	17.5	15.9	13.7
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 32.80
target price	PLN 21.60
mCap	PLN 746m
ADTV (3M)	PLN 1.2m

*Price as of 14 September 2023, 5 p.m.

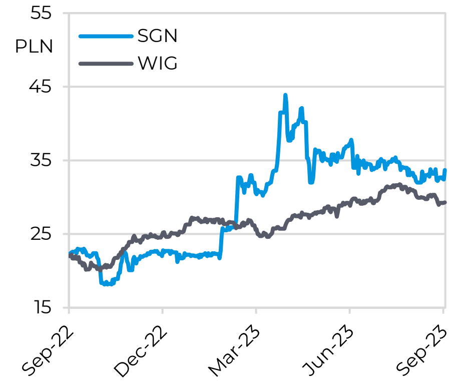
Shareholders

TSS Europe B.V.	72.68%
Blacksheep Fund Management Ltd.	6.67%
Barca Global Master Fund LP	5.46%
Others	15.19%

About Sygnity

Sygnity develops technology solutions and offers advisory services to customers across many different industries. The Company achieves approximately. PLN 220m in annual sales. Headquartered in Warsaw, Sygnity generates more than 95% of its annual sales in Poland.

SGN vs. WIG



name	target price		recommendation	
	new	old	new	old
Sygnity	21.60	20.70	sell	sell

name	current price	target price	upside
Sygnity	32.80	21.60	-34.2%

Forecast Update	22/23E	23/24E	24/25E
Revenue	-4.5%	-3.1%	-2.6%
EBITDA	-9.5%	-7.8%	-6.2%
Net profit	-6.1%	-0.5%	+0.9%

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Key Risks

M&A Risk

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 2023, 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 reports a net cash position on the balance sheet, but, at the same time, the Company has a relatively small asset base after several years of curbed capital expenditures. Going forward, maintenance CAPEX and expenses on winning new business could result in negative changes in working capital, , leading to curbed medium-term dividend payments despite fairly 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. Salaries in the tech industry have been on a steady 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 30 June 2023, the Company reported having conditional off-balance-sheet obligations under performance and warranty clauses in the amount of PLN 11.5m.

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 cooperated with the authorities and turned over all requested records and items. Since we do not have knowledge about the current status of the case, we cannot tell whether or not it might affect the Company's business in the future.

Valuation

Using DCF analysis and relative valuation, we set our 12-month per-share price target for Sygnity at PLN 21.60.

Valuation Summary

(PLN)	Weight	Price
Relative Valuation	50%	17.30
DCF Analysis	50%	22.71
	Valuation	20.01
	12M Target Price	**21.60**

Source: mBank

Relative Valuation

We compared Sygnity with a peer group using forward P/E and EV/EBITDA multiples.

Each of the forecast years, calendar 2023, 2024, and 2025, is assigned an equal weight. For Sygnity, the forecast years examined are the fiscal years of FY2022/23, 2023/24, and 2024/25, as if they were the corresponding calendar years.

Relative Valuation

		P/E			EV/EBITDA	
	2023E	2024E	2025E	2023E	2024E	2025E
Sap	16.7	14.4	13.0	24.4	20.5	17.4
Oracle	14.9	14.3	12.9	21.8	19.7	17.7
Cap Gemini	9.6	8.9	8.2	14.5	13.2	12.0
Sage Group	22.2	19.8	17.6	33.2	29.6	26.3
Atos	5.2	4.5	3.5	6.9	3.0	1.9
Software AG	16.4	13.2	11.2	25.5	20.2	17.0
Indra Sistemas	6.2	5.8	5.5	11.6	10.8	10.0
Computacenter	7.4	6.9	6.6	14.4	13.7	13.0
Asseco Poland	4.1	3.9	3.7	12.4	11.6	11.1
Comarch	4.3	3.9	3.6	12.9	11.1	10.3
maximum	22.2	19.8	17.6	33.2	29.6	26.3
minimum	4.1	3.9	3.5	6.9	3.0	1.9
Median	8.5	7.9	7.4	14.4	13.5	12.5
Sygnity*	17.5	15.9	13.7	29.5	25.3	22.6
premium / discount	106.3%	100.8%	85.3%	104.1%	88.1%	80.7%
Implied Valuation						
Value per share (PLN)	16.08	17.07	18.97	16.07	17.44	18.15
Multiple weight		50%			50%	
Year weight	33%	33%	33%	33%	33%	33%
Equity value per share (PLN) **17.30**						

Source: mBank, * fiscal years, respectively, of 2022/23, 2023/24, 2024/25;

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DCF Valuation

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 30 September 2022.
- Perpetuity D&A and CAPEX are assumed as 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+
Revenue	**219.9**	**234.9**	**251.3**	**267.7**	**285**	**303.1**	**322.2**	**342.1**	**363**	**384.8**	
YoY change	3.9%	6.8%	7.0%	6.5%	6.5%	6.4%	6.3%	6.2%	6.1%	6.0%	
EBIT	**31.9**	**34.4**	**39.3**	**43.9**	**48.7**	**53.9**	**59.4**	**65.2**	**71.3**	**77.8**	
EBIT margin	14.5%	14.7%	15.6%	16.4%	17.1%	17.8%	18.4%	19.1%	19.6%	20.2%	
Tax on EBIT	6.1	6.5	7.5	8.3	9.3	10.2	11.3	12.4	13.6	14.8	
Effective tax rate	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	
NOPLAT	**25.9**	**27.9**	**31.8**	**35.5**	**39.5**	**43.7**	**48.1**	**52.8**	**57.8**	**63.0**	
D&A	3	3.2	3.4	3.7	3.9	4.2	4.4	4.7	5	5.3	
CAPEX	-5.5	-5.6	-5.7	-5.8	-5.8	-5.9	-6	-4.7	-5	-5.3	
Working capital & other	-3.1	-1.4	-1.6	-1.8	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	
FCF	20.3	24.1	28	31.6	37.4	41.8	46.4	52.7	57.6	62.9	64.2
WACC	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	
Discount factor	1	0.9	0.8	0.7	0.6	0.6	0.5	0.5	0.4	0.4	
PV FCF	19.8	21.2	22.2	22.6	24	24.1	24	24.3	23.8	23.2	
WACC	10.6%	10.9%	10.9%	11.1%	11.3%	11.2%	11.5%	11.9%	11.9%	11.8%	10.2%
Cost of debt	5.9%	6.3%	6.2%	6.4%	6.6%	6.6%	6.9%	7.3%	7.3%	7.1%	5.5%
Risk-free rate	4.9%	5.3%	5.2%	5.4%	5.6%	5.6%	5.9%	6.3%	6.3%	6.1%	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	10.6%	10.9%	10.9%	11.1%	11.3%	11.2%	11.5%	11.9%	11.9%	11.8%	10.2%
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	1	1	1	1	1	1	1	1	1	1

FCF growth after the forecast period	2.0%
Terminal value	785.8
Present value of terminal value	290.3
Present value of FCF in the forecast period	229.2
Enterprise value	519.5
Net debt (eop FY'21/22)	2.6
Other noncore assets	0.0
Minority interest	0.0
Goodwill	517.0
Shares outst. (m)	22.8
Equity value per share (PLN)	**22.7**
12M cost of equity	7.9%
Target price (PLN)	**24.5**
EV/EBITDA ('23) at target price	12.3
P/E('23) at target price	20.3
TV / EV	55.9%

Source: mBank

Sensitivity Analysis

	FCF growth in perpetuity				
	1.0%	1.5%	2.0%	2.5%	3.0%
RFR terminal period +1.0 bps.	21.70	22.30	22.99	23.76	24.62
RFR terminal period +0.5 p.p.	22.24	22.93	23.69	24.56	25.53
RFR terminal period (g =4.5%)	22.87	23.63	**24.53**	25.46	26.56
RFR terminal period -0.5 p.p.	23.57	24.42	25.39	26.48	27.75
RFR terminal period -1.0 p.p.	24.35	25.31	26.41	27.67	29.13

New Contracts

Sygnity signed of two material contracts in recent weeks.

The first, awarded in August 2023, is an assignment from the Ministry of Family and Social Policy for the development and maintenance of the Syriusz^{Std} software used by employment offices. The contract sets a 24-month Syriusz^{Std} maintenance period and a 12-month period for development, user support, administration, and troubleshooting of one of the software components. Sygnity's total compensation under the contract is capped at PLN 45.7m.

In July 2023, Sygnity signed an extension to a central accounting system maintenance and development contract with the National Bank of Poland. The annex raised Sygnity's total remuneration under the contract by PLN 18m, with the total compensation capped at PLN 98.9m.

Forecast Revision

Sygnity's growing backlog is clearly a positive development, however, we are nevertheless prompted to lower our FY2022/23 revenue forecast for the Company by 4%.

To account for one-time losses booked in the first quarter of FY'22/23, we also have to downgrade our EBITDA forecast for the year by nearly 10%. The net profit target remains largely intact thanks to net cash and high interest rates.

Revisions to mBank's 2022/23-2024/25 earnings forecast for Sygnity

New Forecast	2022/23	2023/24	2024/25
Revenue	219.9	234.9	251.3
EBITDA	42.2	44.9	50.0
Net profit	25.4	29.6	33.1

Old Forecast	2022/23	2023/24	2024/25
Revenue	230.2	242.5	258.0
EBITDA	46.7	48.7	53.4
Net profit	27.0	29.6	32.7

Change	2022/23	2023/24	2024/25
Revenue	-4.5%	-3.1%	-2.6%
EBITDA	-9.5%	-7.8%	-6.2%
Net profit	-5.8%	-0.2%	1.2%

Source: mBank

Forecast of Q4 FY2022/23 Results

Sygnity slightly exceeded our expectations with the results for Q3 2022/23, ended 30 June, which included a high sales margin of 31.7% after a y/y rebound of 1.3pp.

Our expectations for Q3'23, ending 30 September, include a revenue of PLN 53.7m (+4.0% y/y) and a gross margin of 31.2%. We believe quarterly SG&A expenses may have grown significantly to a projected PLN 11.1m. As a result, we expect to see EBIT of PLN 5.7m after a 24% y/y rebound.

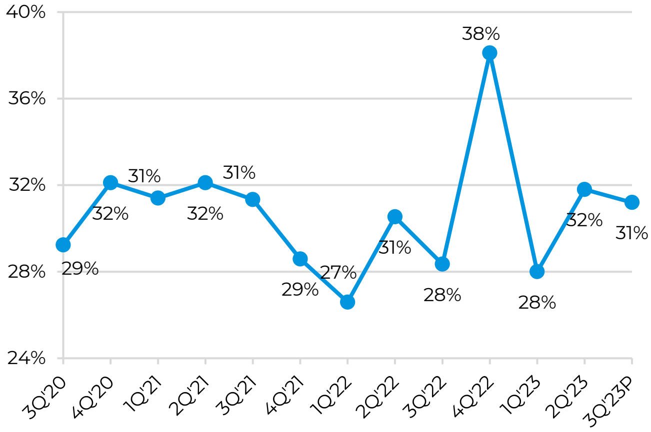
We assume a neutral impact of financing activity and an effective tax rate of 19.0% for the quarter.

Forecast of Q4 FY'22/23 results of Sygnity

(PLN m)	4Q'22/23E	4Q'21/22E	y/y
Revenue	53.7	51.7	4.0%
EBITDA	8.3	7.3	13.5%
margin	15.4%	14.1%	-
EBIT	5.7	4.6	24.4%
Pre-tax profit	5.7	3.1	81.0%
Net profit	4.6	4.4	4.6%

Source: mBank

Quarterly gross margins of Sygnity



Source: Sygnity, E – mBank estimates

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P&L

(PLN m)	20/21	21/22	22/23E	23/24E	24/25E
Revenue	**204.1**	**211.6**	**219.9**	**234.9**	**251.3**
y/y	-11.3%	3.7%	3.9%	6.8%	7.0%
COGS	-139.3	-151.2	-148.4	-159.7	-170.1
Gross profit	64.8	60.4	71.5	75.2	81.2
Other operating income	15.5	1.2	1.2	0.0	0.0
Sales and marketing costs	-6.7	-6.8	-6.7	-7.0	-7.4
Administrative expenses	-23.9	-29.2	-33.8	-33.8	-34.5
Other operating charges	-0.6	-0.2	-0.2	0.0	0.0
EBIT	**49.2**	**25.4**	**31.9**	**34.4**	**39.3**
Margin	24.1%	12.0%	14.5%	14.7%	15.6%
D&A	11.8	10.8	10.3	10.5	10.7
EBITDA	**61.0**	**36.2**	**42.2**	**44.9**	**50.0**
Financing activity	3.2	-2.4	-0.5	1.6	1.6
Pre-tax profit	52.3	23.0	31.4	36.0	40.8
Margin	25.6%	10.9%	14.3%	15.3%	16.2%
Tax	-5.8	4.0	-6.1	-6.5	-7.8
Discontinued ops.	0.0	0.0	0.0	0.0	0.0
net profit	**46.6**	**27.0**	**25.3**	**29.5**	**33.0**

Balance Sheet

(PLN m)	20/21	21/22	22/23E	23/24E	24/25E
Fixed assets	**188.9**	**188.7**	**191.2**	**193.6**	**195.9**
PP&E	2.3	3.5	3.5	3.5	3.5
Intangible assets	4.2	7.6	10.1	12.5	14.8
Goodwill	157.2	157.2	157.2	157.2	157.2
Current assets	**90.2**	**93.9**	**119.3**	**149.0**	**182.6**
Inventory	0.0	0.0	0.0	0.0	0.0
Accounts receivable	39.5	29.4	35.1	39.1	43.6
Cash	24.8	34.5	54.3	79.9	109.1
Equity	**141.6**	**169.2**	**194.5**	**224.0**	**257.1**
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**	**88.0**	**90.6**	**93.4**
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	38.3	40.9	43.8
Net debt	**42.5**	**11.8**	**-7.9**	**-33.6**	**-62.8**
Net debt/EBITDA	0.7	0.3	-0.2	-0.7	-1.3

Source: mBank

Cash Flow

(PLN m)	20/21	21/22	22/23E	23/24E	24/25E
Operating CF	**20.2**	**44.7**	**37.2**	**41.2**	**44.8**
Working capital	-24.3	13.2	-3.1	-1.4	-1.6
Investing CF	**-2.0**	**-8.1**	**-5.5**	**-5.6**	**-5.7**
CAPEX	-0.4	-0.3	-5.5	-5.6	-5.7
Financing CF	**-30.8**	**-25.9**	**-12.0**	**-9.9**	**-9.9**
Change in debt	22.5	-17.0	0.0	0.0	0.0
CF	**-12.6**	**10.7**	**19.7**	**25.7**	**29.2**
OCF/EBITDA	33.1%	123.6%	88.2%	91.7%	89.6%
FCFF	9.6	28.3	24.4	28.3	31.8
FCFF/EV	1.2%	3.7%	3.3%	4.0%	4.7%
FCFE	8.5	27.7	19.7	25.7	29.2
FCFE/MCAP	1.1%	3.7%	2.6%	3.4%	3.9%
ROIC	21.6%	11.3%	14.1%	14.8%	16.5%
ROCE growth	25.8%	13.1%	15.2%	14.5%	14.6%
DPS	0.00	0.00	0.00	0.00	0.00
Divid. payout ratio	0.0%	0.0%	0.0%	0.0%	0.0%
DYield	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**

Key Ratios

	20/21	21/22	22/23E	23/24E	24/25E
P/E	**16.0**	**27.7**	**29.5**	**25.3**	**22.6**
P/CE	12.8	19.8	21.0	18.7	17.1
EV/EBITDA	**12.9**	**21.0**	**17.5**	**15.9**	**13.7**
EV/EBIT	16.0	29.8	23.1	20.7	17.4
P/S	3.7	3.5	3.4	3.2	3.0
P/BV	5.3	4.4	3.8	3.3	2.9
P/FCFE	87.9	26.9	37.8	29.1	25.6
EBITDA margin	**29.9%**	**17.1%**	**19.2%**	**19.1%**	**19.9%**
Y/Y % EBITDA change	15.0%	-40.7%	16.8%	6.4%	11.4%
Net margin	22.8%	12.7%	11.5%	12.5%	13.2%
Y/Y net change	**59.4%**	**-42.1%**	**-6.0%**	**16.4%**	**12.1%**
Price (PLN)	32.80	32.80	32.80	32.80	32.80
Shares outst. (millions)	22.8	22.8	22.8	22.8	22.8
MCap	**746.5**	**746.5**	**746.5**	**746.5**	**746.5**
EV	**789.0**	**758.3**	**738.6**	**712.9**	**683.7**

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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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BUY – we expect that the rate of return from an investment will be at least 10%
HOLD – we expect that the rate of return from an investment will range from 0% to +10%
SELL – we expect that an investment will bear a loss
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mBank issued the following recommendations for Sygnity in the 12 months prior to this publication:
Sygnity (Paweł Szpigiel)

Rating	sell	sell	sell
Rating date	2023-04-26	2022-12-01	2022-10-18
Target price (PLN)	20.70	13.70	13.30
Price on rating day	40.50	22.30	18.15

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