

Monday, 15 April 2024 | update

Sygnity: sell (reiterated)

SGN.PW; SGN.WA | IT, Poland

Steep Valuation

Sygnity stock has markedly outperformed the broad market benchmark index in the year to date with a gain of +53.0% vs. +5.6% WIG.

Sygnity has substantially improved its earnings by optimizing its backlog, raising prices for selected customers, and reducing headcount. We assume the Company will continue to take measures to grow sales profits in 2024.

Our valuation model for Sygnity has been updated to include the recently acquired companies, Edrana and Sagra. On our updated 2024 pro-forma financial forecasts, SGN is trading well above its peers at 22.4x EV/EBITDA and 33.7x P/E. Meanwhile we see limited room in the long term for further growth in gross margin given that Sygnity already achieves some of the highest margins compared to other Polish IT companies (our 2024 gross margin forecast not counting the latest acquisitions is 35% vs. a Polish IT sector median of 25%).

After updating our valuation model to reflect a revised RFR trajectory, we set our new target price at PLN 35.80, implying downside potential of 44% which mandates a reiterated sell recommendation for Sygnity.

Backlog Optimization and Negotiations with Customers

Sygnity has noticeably scaled back the number of projects taken on across all business segments, most notably the segment of banking and finance solutions. This is consistent with the Management Board's strategy of prioritizing the most lucrative projects and phasing out low profit contracts. Moreover, the value of an average project across all categories, especially government contracts, has increased, owing largely to an ongoing renegotiation of prices with the customers as Sygnity works towards passing on price inflation.

Profits Improve, Partly Due to Downsizing

Sygnity generated revenue of PLN 2,91.2m in FY2022/23 (fiscal year lasting from Oct'22 thru Dec'23), an increase of 6.5% from the corresponding year-ago period. The gross margin for the year also improved thanks to downsizing, with average headcount reduced from 686 in FY2021/22 to 628 in FY2022/23. Of this, the number of employees in the projects department decreased by 36 to 548. As a result, Sygnity has seen a big improvement in productivity.

Growth Through Acquisitions

Sygnity is sticking to its growth-through-acquisitions strategy, aiming to complete 3-5 deals a year – a goal that might prove too ambitious to achieve. Over the last few quarters, Sygnity submitted 21 non-binding acquisition bids of which only two turned into actual deals – a sign of stiff competition.

Nonetheless, the Company does have sizable financial resources to pursue M&As (we would put these funds, not counting an equity issuance, at as much as PLN 200m). The two companies acquired most recently, Edrana and Sagra, generate fairly high profits.

current price*	PLN 64.00
target price	PLN 35.80
mCap	PLN 1.46bn
ADTV (3M)	PLN 0.3m

*Price as of 12 April 2024, 5 p.m.

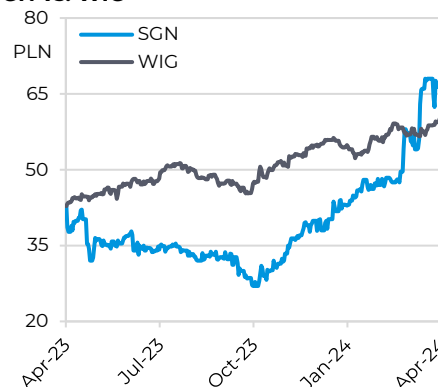
Shareholders

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 230m 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	35.80	21.60	sell	sell

name	current price	target price	upside
	Sygnity	64.00	35.80

(PLN m)	2022 adj.*	2023 adj.*	2024E	2025E	2026E
Revenue	219.1	229.3	284.6	314.6	339.3
EBITDA	41.5	49.0	60.9	68.9	76.2
EBITDA margin	19.0%	21.4%	21.4%	21.9%	22.5%
EBIT	31.1	39.2	50.5	58.7	65.7
Net profit	31.6	39.3	42.2	48.6	54.1
P/E	46.1	37.1	34.5	30.0	26.9
P/CE	34.6	29.6	27.6	24.7	22.5
P/B	8.1	6.6	5.5	4.7	4.0
EV/EBITDA	34.2	28.1	22.9	19.6	17.0
DPS	0.00	0.00	0.00	0.00	0.00
DYield	0.0%	0.0%	0.0%	0.0%	0.0%

*calendar year

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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.

At the moment, Sygnity is aiming to acquire between three and five software companies per year – a high number of transactions that seems an unrealistic goal for the IT industry, indicating heightened risk of failure.

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. That said, Sygnity said its strategy would be to use free cash flow to pay for acquisitions. As such, this strategy in our view might lead to curbed medium-term dividend payments despite fairly good cash flow generation.

Dependence on Third-Party Solutions

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. In 2024, pay pressures in the IT industry are expected to ease compared to 2023. Nevertheless, nearly 80% of IT firms surveyed are expecting salaries in 2024 to grow by at least 10% (Hays report).

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 of a long-term contract hinges on many factors, some of which are beyond the control of the provider. 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 35.80.

(PLN)	Weight	Price
Relative Valuation	50%	31,92
DCF Analysis	50%	34,29
	Valuation	33,10
	12M Target Price	35,80

Source: mBank

Valuation Summary

Relative Valuation

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

Each of the forecast years, calendar 2024, 2025, and 2026, is assigned an equal weight.

Forecasts for Sygnity we expected 2024, 2025 and 2026 earnings, respectively. The 2024E valuation multiples use proforma financial data.

Relative Valuation

	P/E			EV/EBITDA		
	2024E	2025E	2026E	2024E	2025E	2026E
Sap	24.4	18.4	16.2	35.3	26.8	23.3
Oracle	15.9	14.3	12.8	21.8	19.5	17.1
Cap Gemini	10.7	9.8	9.1	16.8	15.4	14.0
Sage Group	22.0	19.6	17.5	33.6	29.3	25.9
Atos	4.1	3.6	3.0	2.8	1.1	0.9
Software AG	15.6	12.8	12.7	29.4	22.7	23.8
Indra Sistemas	7.0	6.4	5.7	12.7	11.4	9.7
Computacenter	7.3	6.9	6.6	14.9	14.1	13.4
Asseco Poland	4.8	4.6	4.3	13.2	11.6	9.3
Comarch	7.5	6.6	6.2	21.3	14.4	12.7
maximum	24.4	19.6	17.5	35.3	29.3	25.9
minimum	4.1	3.6	3.0	2.8	1.1	0.9
Median	9.1	8.4	7.9	19.0	14.9	13.7
Sygnity	22.4*	19.6	17.0	33.7*	30.0	26.9
premium / discount	146.9%	134.0%	116.3%	77.1%	101.0%	96.7%
Implied Valuation						
Value per share (PLN)	27.58	30.08	33.33	36.15	31.84	32.54
Multiple weight		50%			50%	
Year weight	33%	33%	33%	33%	33%	33%
Equity value per share (PLN)	31.92					

Source: mBank, *based on proforma figures



DCF Valuation

Assumptions:

- The forecast period spans the years of 2024-2033.
- The perpetuity risk-free rate is 4.5%.
- We assume FCF after the forecast period will grow at a rate of 2.0%.
- Net debt is on an IFRS 16 basis as of December 2023, adjusted for payments for two acquisitions completed by Sygnyty.
- Perpetuity D&A expenses and CAPEX are assumed equal.

DCF Model

(PLN m)	2024E	2025E	2026E	2027E	2028E	2029E	2030E	2031E	2032E	2033E	33+
Revenue	291.4	314.6	339.3	362.8	387.5	413.4	440.3	468.5	497.1	527.3	
Y/Y pct. change	8.6%	8.0%	7.8%	6.9%	6.8%	6.7%	6.5%	6.4%	6.1%	6.1%	
EBIT	51.6	58.7	65.7	71.8	78.2	85.0	92.0	99.5	107.0	115.0	
EBIT margin	17.7%	18.6%	19.4%	19.8%	20.2%	20.6%	20.9%	21.2%	21.5%	21.8%	
Tax on EBIT	8.4	10.1	11.5	12.9	14.5	15.7	17.0	18.4	19.8	21.3	
Effective tax rate	16.2%	17.1%	17.6%	18.0%	18.5%	18.5%	18.5%	18.5%	18.5%	18.5%	
NOPLAT	43.2	48.6	54.1	58.8	63.8	69.3	75.0	81.1	87.2	93.7	
D&A	10.0	10.2	10.6	11.0	11.5	12.3	13.2	14.2	15.5	17.0	
CAPEX	-12.8	-13.2	-13.6	-14.0	-14.5	-14.9	-15.4	-15.9	-16.4	-17.0	
Working capital & other	-0.4	-0.7	-0.9	-0.9	0.4	0.8	0.9	0.9	0.9	1.0	
FCF	40.1	45.0	50.1	54.9	61.2	67.4	73.7	80.3	87.2	94.7	96.6
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	0.8	0.7	0.6	0.5	0.5	0.4	0.4	0.3	
PV FCF	37.1	37.6	37.6	37.1	37.0	36.8	36.0	35.2	34.1	33.1	
WACC	10.9%	10.8%	11.2%	11.2%	11.6%	10.9%	11.5%	11.7%	11.9%	11.9%	10.5%
Cost of debt	5.9%	5.8%	6.2%	6.2%	6.6%	5.9%	6.5%	6.7%	6.9%	6.9%	5.5%
Risk-free rate	4.9%	4.8%	5.2%	5.2%	5.6%	4.9%	5.5%	5.7%	5.9%	5.9%	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	16.2%	17.1%	17.6%	18.0%	18.5%	18.5%	18.5%	18.5%	18.5%	18.5%	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	10.9%	10.8%	11.2%	11.2%	11.6%	10.9%	11.5%	11.7%	11.9%	11.9%	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	1136.5
Present value of terminal value	397.3
Present value of FCF in the forecast period	361.8
Goodwill (EV)	759.1
Net debt (31 Dec. 2023)	-21.2
Other noncore assets	0.0
Minority interest	0.0
Goodwill	780.3
Shares outst. (m)	22.8
Equity value per share (PLN)	34.3
12-month cost of equity	8.2%
Target price (PLN)	37.1
EV/EBITDA ('24) at target price	12.5
P/E('24) at target price	18.5
TV / EV	52.3%

Source: mBank

Sensitivity Analysis

	FCF growth in perpetuity				
	1.0%	1.5%	2.0%	2.5%	3.0%
RFR terminal period +1.0 p.p.	33.34	34.17	35.10	36.12	37.27
RFR terminal period +0.5 p.p.	34.09	35.01	36.03	37.18	38.46
RFR terminal period (g =4.5%)	34.93	35.95	37.08	38.36	39.81
RFR terminal period -0.5 p.p.	35.86	36.99	38.26	39.71	41.35
RFR terminal period -1.0 p.p.	36.90	38.17	39.60	41.24	43.14

P&L

(PLN m)	2022 Adj.	2023 Adj.	2024E	2025E	2026E
Revenue	219.1	229.3	284.6	314.6	339.3
YoY	6.4%	4.7%	24.1%	10.6%	7.8%
EBIT	31.1	39.2	50.5	58.7	65.7
Margin	14.2%	17.1%	17.7%	18.6%	19.4%
D&A	10.5	9.9	10.5	10.2	10.6
EBITDA	41.5	49.0	60.9	68.9	76.2
Financing activity	-1.9	0.6	0.0	0.0	0.0
Pre-tax profit	-0.1	0.0	0.0	0.0	0.0
Margin	0.0%	0.0%	0.0%	0.0%	0.0%
Tax	2.5	-0.4	-8.2	-10.1	-11.5
Discontinued ops.	0.0	0.0	0.0	0.0	0.0
Net profit	31.6	39.3	42.2	48.6	54.1

Balance Sheet

(PLN m)	2022 Adj.	2023 Adj.	2024E	2025E	2026E
Fixed assets	186.6	179.2	235.8	238.7	241.8
Goodwill	157.2	157.2	157.2	157.2	157.2
Current assets	114.1	147.0	135.3	184.3	238.9
Inventory	0.1	0.1	0.1	0.1	0.1
Accounts receivable	1.5	1.2	1.2	1.2	1.2
Cash	72.4	102.9	87.5	132.4	182.5
Equity	179.9	220.6	263.8	312.4	366.5
Minority interest	0.0	0.0	0.0	0.0	0.0
Noncurrent liab.	27.3	16.7	16.7	16.7	16.7
Loans	0.0	12.0	12.0	12.0	12.0
Bonds	18.2	0.0	0.0	0.0	0.0
Current liabilities	93.6	88.9	90.6	93.9	97.4
Loans	0.0	12.0	12.0	12.0	12.0
Bonds	18.7	0.1	0.1	0.1	0.1
Trade and other payables	36.6	38.3	39.9	43.3	46.8
Net debt	-35.5	-78.8	-63.4	-108.3	-158.4
Net debt/EBITDA	-0.9	-1.6	-1.0	-1.6	-2.1

Source: mBank

Cash Flow

(PLN m)	2022 Adj.	2023 Adj.	2024E	2025E	2026E
Operating CF	55.1	54.8	51.2	58.1	63.7
working capital	18.1	0.2	-0.4	-0.7	-0.9
Investing CF	-8.2	-3.8	-58.8	-5.4	-5.8
CAPEX	-8.2	-3.8	-4.9	-5.4	-5.8
Financing CF	-26.4	-20.5	-7.8	-7.8	-7.8
Change in debt	-18.0	-9.0	0.0	0.0	0.0
CF	20.4	30.6	-15.4	45.0	50.1
OCF/EBITDA	132.6%	111.8%	84.0%	84.4%	83.6%
FCFF	39.0	45.3	38.4	45.0	50.1
FCFF/EV	2.7%	3.3%	2.8%	3.3%	3.9%
FCFE	38.4	42.2	38.4	45.0	50.1
FCFE/MCAP	2.6%	2.9%	2.6%	3.1%	3.4%
ROIC	17.4%	22.2%	23.9%	23.5%	25.8%
ROCE growth	15.0%	17.6%	19.5%	19.2%	18.4%
DPS	0.00	0.00	0.00	0.00	0.00
Divid. 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

	2022 Adj.	2023 Adj.	2024E	2025E	2026E
P/E	46.1	37.1	34.5	30.0	26.9
P/CE	34.6	29.6	27.6	24.7	22.5
EV/EBITDA	34.2	28.1	22.9	19.6	17.0
EV/EBIT	45.7	35.2	27.6	23.0	19.8
P/S	6.6	6.4	5.1	4.6	4.3
P/BV	8.1	6.6	5.5	4.7	4.0
P/FCFE	37.9	34.6	37.9	32.4	29.1
EBITDA margin	19.0%	19.0%	21.4%	22.0%	22.7%
y/y % EBITDA change	-8.1%	18.0%	24.2%	13.1%	10.6%
Net margin	14.4%	17.1%	14.8%	15.5%	15.9%
Y/Y net change	19.2%	24.3%	7.5%	15.1%	11.3%
Price (PLN)	64.0	64.0	64.0	64.0	64.0
Shares outst. (millions)	22.8	22.8	22.8	22.8	22.8
MCap	1456.6	1456.6	1456.6	1456.6	1456.6
EV	1421.1	1377.7	1393.2	1348.2	1298.1



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
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DCF – acknowledged as the most methodologically correct method of valuation; it consists in discounting financial flows generated by a company; its weak point is the significant susceptibility to a change of forecast assumptions in the model.

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.

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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 Sygnty in the 12 months prior to this publication:

Sygnty (Paweł Szpigiel)

recommendation	sell	sell
date issued	2023-09-15	2023-04-26
target price (PLN)	21.60	20.70
price on rating day	32.80	40.50

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