

PGS Software

Buy

Riding the growth wave

TP: PLN 19.6
Upside: +95%

PGS Software provides programming services in the form of partial or full outsourcing. A structural shortage of IT specialists in Europe and good location of the Company (lower labour costs in PL vs WE) make the Company a natural beneficiary of ongoing technological changes. The history of regular long-term growth (25-30% per year) combined with high profitability (15%+) and high conversion of profits into cash makes the Company's business model credible. After many years of organic growth, PGS Software seems to be ready to conduct its first acquisitions to accelerate growth and expand its competencies. We maintain our **Buy** rating.

PGS Software provides programming and testing services to third parties in the form of **partial or full outsourcing**. Practically all sales are conducted outside Poland (mainly in Europe) by IT specialists employed in Poland. The vast majority of contracts are executed in the daily settlement system (*time and material*, T&M). The Company is diversified in terms of target sectors (the largest segment is insurance – 22% of sales) and customers (the largest customer – 19% of sales, top5 39%). In stand-alone terms, the largest market is the UK and Ireland, accounting for 47% of sales. At present, the Company employs over 650 people.

The **market** on which the Company operates is dynamically growing on a global scale. Depending on the sources/definition the historical CAGR is estimated at single digit to a dozen or so percentages with the market size USD ~100bn. Nothing indicates that this trend would reverse – the growth of the service segment in the global economy requires increased IT spending, while the structural shortage of programmers encourages companies to use the services of outsourcing companies. The location of PGS Software (Poland) allows the Company to compete freely on ~25% of the global market while maintaining high cost advantages. In addition, the inflow of new programmers from Polish universities and Ukraine provides the opportunity to increase the scale of operations.

A **long track-record of regular growths and stable margins** makes the Company's **business model credible**. PGS Software has been operating since 2005 and systematically builds the scale of its revenues. The average annual growth exceeds 25% with the net margin maintained above 15%. The high level of profit to FCF conversion (the business model is practically CAPEX-free) has allowed for systematic dividend payment. In the subsequent periods, we expect a lower DPR due to the planned acquisition activities.

The potential acquisition may be another milestone in the Company's history, which until now has been developing strictly organically. In our opinion, M&A could take place at the earliest in 2020 and will probably be a small (EUR <10m) takeover of a specialised team to expand the Company's competences or to gain a market/sector, in which the Company has been present yet.

Our valuation is based solely on the DCF - we have set our Target Price @ PLN 19.60/share and we reiterate our **BUY** rating. The comparable valuation shows PLN 33/share valuation.

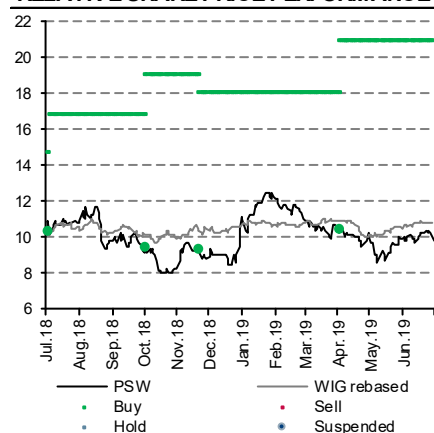
m PLN	2016	2017	2018	2019F	2021F	2021F
Sales	76,2	99,1	124,0	153,1	186,8	214,9
EBITDA	21,0	23,0	27,7	33,0	38,5	42,1
EBIT	19,9	21,4	26,0	30,9	36,0	39,2
Net profit	16,1	20,1	21,5	25,1	29,1	31,8
EPS (PLN)	0,56	0,71	0,76	0,88	1,02	1,12
P/E (x)	17,8	14,2	13,3	11,4	9,8	9,0
EV/EBITDA (x)	13,1	11,8	9,9	7,7	6,5	6,0
P/BV (x)	15,4	12,2	10,4	5,8	5,2	4,9
DY (%)	4,2%	5,3%	6,1%	0,4%	7,9%	9,2%

Source: data of the company, Trigon DM

FACT SHEET

Ticker	PSW		
Sector	TMT		
Price (PLN)	10,04		
52wk Range (PLN)	8 / 12,5		
Number of share (m)	28,4		
Market Cap (mPLN)	285		
Free-float	36,0%		
Avg Vol 3M (mPLN)	0,05		
Price performance	1M	3M	1Y
	1,6%	-4,0%	-2,0%

RELATIVE SHARE PRICE PERFORMANCE



Recommendation history	Date	Price
Buy	18.04.2019	21,0
Buy	07.12.2018	18,1
Buy	18.10.2018	19,2
Buy	19.07.2018	16,9
Buy	11.07.2018	14,8
Buy	19.04.2018	15,4
Buy	08.12.2017	17,7
Buy	19.10.2017	15,7

Shareholders	Share %
Presto FIZ AN	31,9%
Infinitas FIZ AN	31,9%
NN OFE	7,4%

Important dates

2Q'19 Results	10.09.2019
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Analyst

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PGSSOFT

Bloomberg ticker

PSW PW

Recommendation

Target Price (PLN)
Buy
19,6

Current Price (PLN)

Upside
32,4
95%

Previous Recommendation

Buy

Previous Upside (PLN)

21

Number of shares (m)

28,4

Market Cap (mPLN)

285

EV (m PLN)

275

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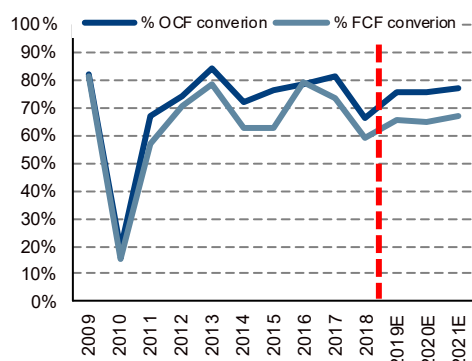
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MARKET RATIOS	2017	2018	2019E	2020E	2021E
P/E (x)	14,2	13,3	11,4	9,8	9,0
P/E adj. (x)	14,2	13,3	11,4	9,8	9,0
P/BV (x)	12,2	10,4	5,8	5,2	4,9
EV/EBITDA (x)	11,8	9,9	7,7	6,5	6,0
EV/EBITDA adj. (x)	11,8	9,9	7,7	6,5	6,0
EV/Sales (x)	2,7	2,2	1,7	1,4	1,2
FCF Yield (%)	5,7%	5,6%	7,6%	8,9%	10,0%
DY (%)	5,3%	6,1%	0,4%	7,9%	9,2%

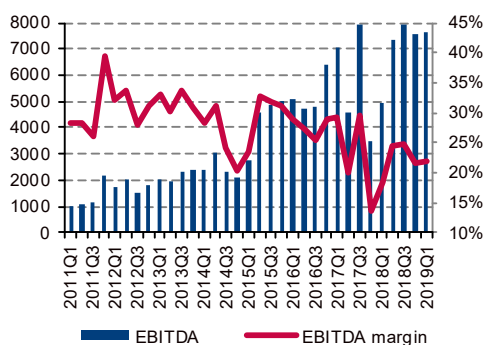
RATIOS	2017	2018	2019E	2020E	2021E
EPS (PLN)	0,7	0,8	0,9	1,0	1,1
EPS adj. (PLN)	0,7	0,8	0,9	1,0	1,1
DPS (PLN)	0,5	0,6	0,0	0,8	0,9
BVPS (PLN)	0,8	1,0	1,7	1,9	2,1

Number of shares (m)	28,4	28,4	28,4	28,4	28,4
Market Cap (mPLN)	285	285	285	285	285
EV (mPLN)	272	275	253	252	252

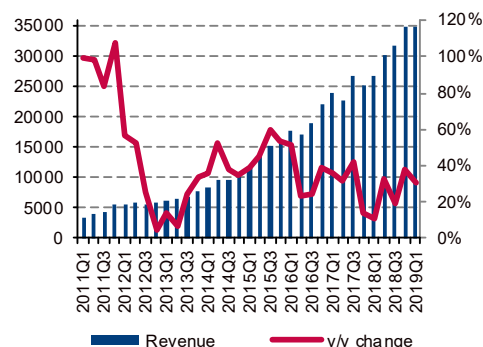
EBITDA conversion into cash



EBITDA and EBITDA margin



Revenues



P&L (mPLN)	2017	2018	2019E	2020E	2021E
Sales	99	124	153	187	215
COGS	78	98	121	150	175
Gross profit	22	26	32	37	40
EBITDA	23	28	33	39	42
EBITDA adj.	23	28	33	39	42
D&A	2	2	2	3	3
EBIT	21	26	31	36	39
Gross profit	25	26	31	36	39
Minority interest	0	0	0	0	0
Net profit	20	22	25	29	32
Net profit adj.	20	22	25	29	32

CASH FLOW STATEMENT (mPLN)	2017	2018	2019E	2020E	2021E
Cash flow from operations	19	18	25	29	33
Cash flow from investing	-2	-2	-3	-4	-4
CAPEX	-3	-2	-3	-4	-4
Cash flow from financing	-15	-18	-1	-24	-28
Dividend	-15	-18	-1	-23	-26
FCF	16	16	22	25	28
Net cash flow	1	-2	21	1	0

BALANCE SHEET (mPLN)	2017	2018	2019E	2020E	2021E
ASSETS	4	5	6	8	9
PPE	3	4	5	6	7
Goodwill	0	0	0	0	0
Intangible assets	0	0	0	0	0
Cash and equivalents	14	11	32	33	34
EQUITY AND LIABILITIES	34	40	65	73	80
Equity	23	27	50	55	58
Minority shareholders capital	0	0	0	0	0
Interest-bearing liabilities	0	0	0	0	0
Net debt	-14	-11	-32	-33	-34
Net working capital	11	15	25	31	35

OPERATING INDICATORS	2017	2018	2019E	2020E	2021E
Sales growth (%)	30%	25%	23%	22%	15%
EPS adj. growth (%)	25%	7%	16%	16%	9%
Gross profit margin (%)	21,7%	20,9%	20,7%	19,8%	18,8%
EBITDA adj. margin (%)	23,2%	22,4%	21,6%	20,6%	19,6%
Operating profit margin (%)	21,6%	21,0%	20,2%	19,3%	18,3%
Net profit adj. margin (%)	20,3%	17,4%	16,4%	15,6%	14,8%
ROE (%)	95,7%	84,5%	65,0%	56,0%	56,2%
ROA (%)	65,3%	57,9%	47,7%	42,2%	41,6%
CAPEX/Sales (%)	2,6%	2,0%	2,1%	2,1%	1,9%
CAPEX/D&A (x)	1,6	1,5	1,5	1,5	1,4
Net debt/Equity	-0,6	-0,4	-0,7	-0,6	-0,6
Net debt/EBITDA (x)	-0,6	-0,4	-1,0	-0,9	-0,8
Cash conversion cycle (days)	36	35	46	54	56
Inventory turnover (days)	0	0	0	0	0
Receivables turnover (days)	53	53	54	54	56
Liabilities turnover (days)	17	18	8	0	0

Source: Company, Trigon DM

Risk factors

Currency

PGS Software generates the vast majority (95%+) of its sales revenues outside Poland, where its main cost centre is located. For this reason, the Company is exposed to the currency risk if PLN weakens vs other currencies, in particular GBP and EUR. In such a case, the Company may be unable to symmetrically raise prices in order to protect its margin. In the short term, PGS Software secures its exposure by means of future contracts.

Increase in wages

Wages constitute the largest cost item of PGS Software (90%+). Labour costs in the IT sector have been steadily rising above the average wage in Poland for many years now. If this trend continues, the Company may find it difficult to proportionally raise prices for its services, in which case PGS's margins may erode in the long term.

Problems with recruiting employees

PGS Software operates on the highly competitive IT services market, competing with both domestic and international players. The growth of the Company's business is closely related to the increase in the number of employees. Due to the structural shortage of IT specialists in Europe, PGS may have a problem with obtaining the required number of employees. As a result, the Company's growth rate may be lower than in the past.

Project

PGS Software carries out contracts for its clients. Incorrect estimation of the required resources necessary to implement its projects may lead to losses for the Company. In order to mitigate this risk, PGS strives to carry out the majority of its contracts on a time-and-material basis, under which it makes settlements with the client on the basis of real hours worked rather than the final product delivered. Another significant project risk is the potential low quality of services, which could adversely affect the clients' perception of the Company.

Backlog

PGS Software operates on the basis of short term contracts for specific projects and client orders. In other words, the Company's business 'visibility' is relatively low. If there is a serious economic crisis, PGS' counterparties can quickly terminate their cooperation with the Company with no contractual penalties.

Legal

PGS Software operates internationally and under many legal jurisdictions. That exposes the Company to various legal risks in every country of its operation. In our opinion, the two major legal risks are: **(1) Labour law in Poland.** The majority of the Company's IT specialists work on a B2B basis as they are mostly self-employed. There is a risk of legal changes hindering this settlement model. In this case, we note a risk of a rise in labour costs for the Company and potential retroactive liabilities towards the ZUS. **(2) Regulations tightening the principles of providing off-shore services in one of the Company's main countries of operation.**

Valuation

Valuation summary:

- DCF: PLN 19,60
- Comparable valuation: PLN 33,20
- Target Price (100% DCF): PLN 19,60

DCF Valuation

PGS Software: DCF valuation

	2019P	2020P	2021P	2022P	2023P	2024P	2025P	2026P	2027P	2028P	Terminal
EBIT	31	36	39	42	44	46	47	48	48	47	
ETR	19%	119%	219%	319%	419%	519%	619%	719%	819%	919%	
NOPLAT	25	29	32	34	36	37	38	39	39	38	37
D&A	2,1	2,5	2,9	3,3	3,7	4,1	4,5	4,9	5,3	5,7	
CAPEX	3,2	3,8	4,1	4,6	5,1	5,6	6,0	6,5	7,0	7,4	
WC	-2,3	-2,7	-2,2	-2,3	-2,4	-2,4	-2,4	-2,3	-2,3	-2,2	
FCF	22	25	28	31	32	34	35	35	35	34	35
ND / Equity	0%										
RFR	2,5%										
MRP	6,0%										
Beta unlevered	1,0										
Debt costs after tax (%)	3,6%										
CoE (%)	8,5%										
WACC (%)	8,5%										
Sum PV FCF 2019-28	197										
Terminal growth rate > '28	3,0%										
Discounted TV	281										
Net debt	-11										
Minorities	0										
Nonoperating assets	0										
Equity (PLN, m)	490										
# of shares (m)	28,4										
Value per share (PLN, 1/1/2019)	17,2										
Target Price (12m)	19,6										

Source: Trigon DM

PGS Software: DCF's sensitivity analysis

Terminal growth rate	WACC						
	5,5%	6,5%	7,5%	8,5%	9,5%	10,5%	11,5%
0,0%	24,6	20,7	17,8	15,7	13,9	12,6	11,4
1,0%	27,9	22,8	19,2	16,6	14,6	13,1	11,8
2,0%	33,1	25,8	21,1	17,9	15,5	13,7	12,3
3,0%	42,4	30,5	23,9	19,6	16,7	14,5	12,9
4,0%	64,3	39,0	28,2	22,1	18,3	15,6	13,6
5,0%	173,6	58,9	35,9	26,1	20,6	17,0	14,6
6,0%		158,4	54,1	33,1	24,1	19,1	15,9

Source: Trigon DM

PGS Software: DCF's sensitivity analysis in %

Terminal growth rate	WACC						
	5,5%	6,5%	7,5%	8,5%	9,5%	10,5%	11,5%
0,0%	25%	5%	-9%	-20%	-29%	-36%	-42%
1,0%	42%	16%	-2%	-15%	-25%	-33%	-40%
2,0%	68%	31%	8%	-9%	-21%	-30%	-37%
3,0%	116%	55%	22%	0%	-15%	-26%	-34%
4,0%	228%	99%	44%	13%	-7%	-21%	-31%
5,0%	784%	200%	83%	33%	5%	-13%	-26%
6,0%		707%	175%	69%	23%	-3%	-19%

Source: Trigon DM

Comparable valuation
PGS Software: Comparable valuation

	M Cap (m EUR)	2019P	P/E 2020P	2021P	EV/EBITDA 2019P	2020P	2021P	EV/EBIT 2019P	2020P	2021P	FCF Y 2019P	2020P	2021P
GLOBANT	3472	62,9	49,2	40,5	39,6	30,6	25,3	45,0	35,4	28,6	1,3	1,7	1,9
ENDAVA	1977	44,3	38,7	31,8	33,9	27,2	22,1	62,8	35,1	29,9	1,8	2,4	-
EPAM SYSTEMS	9515	45,5	37,8	31,1	29,2	23,8	19,3	32,3	25,4	19,9	2,2	2,9	4,2
Median		45,5	38,7	31,8	33,9	27,2	22,1	45,0	35,1	28,6	1,8	2,4	3,0
PGS Software	67	11,3	9,7	8,9	8,3	7,1	6,5	10,5	8,8	7,6	7,6	8,9	10,0
PGS Software wycena wynikowa		34,7	34,4	32,8	33,7	32,3	30,5	41,1	38,1	36,1	42,9	32,3	25,2
Valuation (3-year average)			34,0			32,1			38,4			33,5	

Source: Bloomberg, Trigon DM

Income statement (PLNm)

	2016	2017	2018	2019E	2021E	2021E
Revenues	76	99	124	153	187	215
COGS	56	78	98	121	150	175
Profit from sales	20	22	26	32	37	40
Other, net	0	0	0	-1	-1	-1
EBITDA	21	23	28	33	39	42
EBITDA adj.	21	23	28	33	39	42
Amortization	1	2	2	2	3	3
EBIT	20	21	26	31	36	39
Financial net	0	3	0	0	0	0
Gross profit	20	25	26	31	36	39
Income tax	4	5	5	6	7	7
Minority interest	0	0	0	0	0	0
Net profit	16	20	22	25	29	32
Net profit adj.	16	20	22	25	29	32

profit on sales margin	26,6%	21,7%	20,9%	20,7%	19,8%	18,8%
EBITDA adj. margin	27,6%	23,2%	22,4%	21,6%	20,6%	19,6%
EBIT margin	26,1%	21,6%	21,0%	20,2%	19,3%	18,3%
net profit adj. margin	21,1%	20,3%	17,4%	16,4%	15,6%	14,8%

sales growth y/y	33%	30%	25%	23%	22%	15%
profit on sales growth y/y	24%	6%	21%	22%	16%	9%
EBITDA adj. growth y/y	22%	9%	21%	19%	17%	9%
EBIT growth y/y	22%	8%	21%	19%	16%	9%
net profit adj. growth y/y	17%	25%	7%	16%	16%	9%

	4Q17	1Q18	2Q18	3Q18	4Q18	1Q19
Revenues	26,9	25,4	26,8	30,3	32,0	34,9
COGS	19,5	22,3	22,4	23,4	24,5	27,8
Profit from sales	7,4	3,1	4,5	6,9	7,4	7,1
Other, net	0,0	0,0	0,0	0,0	0,0	0,0
EBITDA	7,9	3,5	4,9	7,4	7,9	7,6
EBITDA adj.	7,9	3,5	4,9	7,4	7,9	7,6
Amortization	0,4	0,4	0,4	0,4	0,4	0,4
EBIT	7,5	3,0	4,5	6,9	7,5	7,1
Financial net	-0,7	1,4	0,1	-1,9	1,8	0,3
Gross profit	6,8	4,5	4,6	5,0	9,3	7,5
Income tax	1,4	0,9	0,5	1,0	1,8	1,5
Minority interest	0,0	0,0	0,0	0,0	0,0	0,0
Net profit	5,5	3,6	4,0	4,0	7,5	6,0
Net profit adj.	5,5	3,6	4,0	4,0	7,5	6,0

profit on sales margin	27,6%	12,4%	16,6%	22,8%	23,3%	20,4%
EBITDA adj. margin	29,4%	13,6%	18,3%	24,3%	24,7%	21,7%
EBIT margin	27,9%	12,0%	16,8%	22,9%	23,3%	20,4%
net profit adj. margin	20,4%	14,1%	15,1%	13,4%	23,4%	17,0%

	0	0	0	0	0	0
sales growth y/y	14,4%	11,2%	33,1%	19,1%	37,4%	30,4%
profit on sales growth y/y	-49,4%	-34,0%	64,6%	0,5%	126,4%	61,9%
EBITDA adj. growth y/y	-45,9%	-30,4%	61,2%	-0,2%	119,0%	56,2%
EBIT growth y/y	-49,8%	-32,8%	64,7%	-0,3%	134,7%	60,4%
net profit adj. growth y/y	-18,8%	-44,1%	6,0%	36,7%	65,9%	32,0%

Source: the company, Trigon DM

Balance (PLN m)

	2016	2017	2018	2019E	2021E	2021E
Fixed assets	3	4	5	6	8	9
Tangible fixed assets	2	3	4	5	6	7
Intangible assets	0	0	0	0	0	0
Company's value	0	0	0	0	0	0
Long-term receivables	0	0	0	0	0	0
Long-term investments	0	0	0	0	0	0
Other	0	1	1	1	1	1
Current assets	25	30	35	58	65	70
Inventory	0	0	0	0	0	0
Trade receivables	13	15	20	25	31	35
Other	0	1	3	1	1	1
Cash	11	14	11	32	33	34
Assets	27	34	40	65	73	80
Equity	19	23	27	50	55	58
Share capital	1	1	1	1	1	1
Other	2	3	5	24	25	26
Net profit (loss)	16	20	22	25	29	32
Minority capital	0	0	0	0	0	0
Long-term liabilities	0	1	1	1	1	1
Interest-bearing liabilities	0	0	0	0	0	0
Other	0	1	1	1	1	1
Short-term liabilities	8	9	10	13	16	18
Interest-bearing liabilities	1	0	1	0	0	0
Trade liabilities	3	4	5	0	0	0
Other	4	4	5	13	16	18
Liabilities	27	34	40	65	73	80
Net working capital	11	11	15	25	31	35
Net debt	-10	-14	-11	-32	-33	-34
Net debt corr.	-10	-14	-11	-32	-33	-34
Net debt / EBITDA (x)	-0,5	-0,6	-0,4	-1,0	-0,9	-0,8
Net debt / equity (x)	-0,5	-0,6	-0,4	-0,7	-0,6	-0,6
ROE (%)	96%	96%	84%	65%	56%	56%
ROA (%)	67%	65%	58%	48%	42%	42%
Cash conversion cycle (days)	42	36	35	46	54	56
Inventory turnover (days)	0	0	0	0	0	0
Receivables turnover ratio (days)	57	53	53	54	54	56
Accounts payable turnover ratio (days)	16	17	18	8	0	0

Cash Flow (PLNm)

	2016	2017	2018	2019E	2021E	2021E
Cash flows from operating activities	17	19	18	25	29	33
Net profit (loss)	16	20	22	25	29	32
Amortization	1	2	2	2	3	3
Changes in working capital	0	-1	-3	-2	-3	-2
Inventory changes	0	0	0	0	0	0
Trade receivables change	-3	-2	-5	-5	-6	-5
Trade liabilities change	3	1	2	2	3	2
Other	-1	-2	-1	0	0	0
Cash flows from investment activities	0	-2	-2	-3	-4	-4
CAPEX	-2	-3	-2	-3	-4	-4
Other	2	1	0	0	0	0
Cash flows from financial activities	-12	-15	-18	-1	-24	-28
Interest-bearing liabilities change	0	0	0	0	0	0
Revenues from shares emission	0	0	0	0	0	0
Dividend	-12	-15	-18	-1	-23	-26
Other	0	-1	-1	0	-2	-2
Net cash flows	4	1	-2	21	1	0
Cash opening balance	8	11	14	11	32	33
Closing balance of cash	11	14	11	32	33	34

Source: the company, Trigon DM

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Definitions

capitalisation – market price multiplied by the number of a company's shares

free float (%) – a percentage of a company's shares held by shareholders with less than 5% shareholding reduced by treasury shares held by the company

min/max 52 wks – minimum/maximum share price within the last 52 weeks

average turnover – average volume of share trading within the last month

EBIT – operating profit

EBITDA – operating profit increased by depreciation and amortisation

adjusted profit – net profit adjusted for one-off items

CF – cash flow

capex – sum of investment expenditures on fixed assets

ROA – rate of return on assets

ROE – rate of return on equity

gross profit margin – a ratio of gross profit to net revenue

EBITDA margin – a ratio of sum of operating profit and depreciation/amortisation to net revenue

EBIT margin – a ratio of operating profit to net revenue

net margin – a ratio of net profit to net revenue

EPS – earnings per share

DPS – dividends per share

P/E – a ratio of market price to earnings per share

P/BV – a ratio of market price to book value per share

EV/EBITDA – a company's EV to EBITDA ratio

EV – sum of a company's current capitalisation and net debt

DY – dividend yield, dividend paid to share price ratio

ISSUER – PGS Software S.A.

Recommendations of the Brokerage House

BUY – we expect that the rate of return on an investment will be at least 10%

NEUTRAL – we expect the price of an investment to be relatively stable, optionally it will increase no greater than 10%

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Recommendation prepared by: Zbigniew Porczyk

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