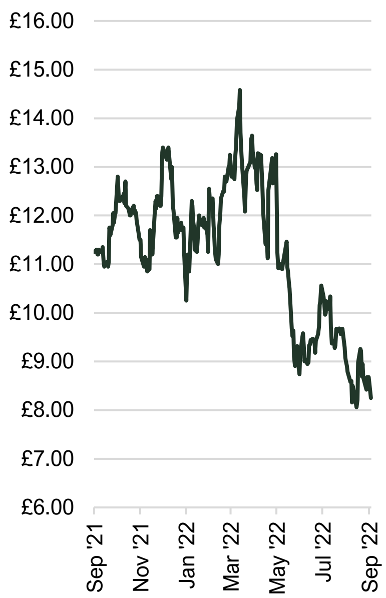
Next Fifteen Communications Group PLC

NFC | AIM | Media | 779p | £755m

Impressive H1 results – outlook maintained

1 Year Chart



The market reaction to these impressive H1 results (shares down -10%) reveals more about the state of the broader market than as a definitive conclusion on the NFC outlook. Even if NFC had been guiding towards downgrades (which it most emphatically was not) such a price reaction might be understandable if the shares were defending a market premium rating. At ***sub 9x FY24 earnings****, the valuation (barring the initial pandemic shock), now stands at an absolute nine year low and a material discount to the peer group.*

In our view, this is the key point. Heading into the results, Next Fifteen had seen a material de-rating, out of kilter against a peer group that it has materially outperformed from a delivered earnings perspective. Give the strength of trading momentum and the added comfort blanket of material US dollar exposure, what is driving this glaring valuation disconnect?

The continuing lack of clarity around the M&C Saatchi outcome is clearly unhelpful, although we strongly believe that the current rating more than captures either outcome. If the market is pricing in the likelihood of a material earnings downgrade, then it is doing so despite another re-iteration of a cautiously optimistic outlook statement. We are leaving our estimates unchanged and continue to see risks to the upside, especially if sterling remains weak versus the dollar.

- **H1 results show impressive momentum:** By any reckoning +65% revenue growth (+31% organic), +73% PBT growth and +68% EPS growth would be seen as an outstanding performance. H1 numbers were flattered by the initial Mach49 cost phasing but even adjusting for this +60% underlying EBIT growth is impressive. Period end net debt of £18.1m has subsequently improved to c.£3m, leaving the balance sheet largely ungeared.
- **Outlook unchanged:** In any other year, the combination of H1 momentum and US dollar tailwinds would suggest material upgrades. However, despite the undoubted strength of Next Fifteen's client positioning, the febrile backdrop lends a note of caution and we are leaving our headline estimates unchanged. Management have guided to a year end outcome "*at least in line with expectations*", which underscores that risks to estimates continue to sit on the upside. The only material change to our estimates reflects the increased value of the Mach49 earn out expectations.
- **Historically attractive valuation:** These results have landed in choppy market waters, which is the only explanation we can see for the subsequent negative price reaction. By any measure, the current valuation looks extremtly attractive for a growth company with such a visible and compelling track record.

28th September 2022

Iain Daly

id@radnorcp.com
+44 (0) 203 897 1832

Next Fifteen Communications Group PLC is a research client of Radnor Capital Partners Ltd.

MiFID II – this research is deemed to be a minor, non-monetary benefit.

Y/E January, £m	Sales	PBT adj	EPS (p)	Div (p)	Net Cash	Fiscal PER x	Yield %
FY 2021A	266.9	49.1	40.7	7.0	14.0	19.1	0.9
FY 2022A	362.1	79.3	59.7	12.0	35.7	13.0	1.5
FY 2023E	*560.4*	*110.4*	*75.6*	*15.1*	*49.6*	*10.3*	*1.9*
FY 2024E	*650.2*	*128.3*	*87.3*	*17.5*	*107.1*	*8.9*	*2.2*
FY 2025E	*706.2*	*140.5*	*95.4*	*19.1*	*156.3*	*8.2*	*2.4*

Source: Radnor Capital Partners

H1 results:

Below are the key headlines from the H1 FY23 results:

- Net revenue +65% YoY to £274.0m. The company has broken out a revenue bridge between H1 FY22 and H1 FY23
  - → **Organic** revenue growth +31% (+£51.4m)
  - → **Acquisitions** +27% (+£44.2m)
  - → **FX** +8% (+£12.5m)
- Adjusted EBIT +75% YoY to £61.3m
- Adjusted EBIT margins +130 basis points to 22.4%
- Adjusted PBT +73% YoY to £60.7m
- Statutory loss before tax of £8.5m after a number of adjusting items
  - → £29m charge driven by an increase in the estimated Mach49 earn out liability
  - → £11.7m charge driven by the unwinding of the discount applied to future earn out payments
  - → £6.7m charge relating to employment linked acquisition payments
  - → £3.9m of property impairment charges
  - → £3.1m of restructuring costs (Engine related)
  - → £2.7m of deal costs (Engine and M&C Saatchi)
- Period end net debt £18.1m (H1 FY22: net cash £6.6m), with end September net debt narrowing to c.£3m.

Headline revenue growth was positively impacted by the maiden contribution from Engine (consolidated from March) and the initial contribution from the Mach49 contract win. Below, we run through the key divisional headlines:

Engage – 48% H1 revenue

Headline revenue **+46%** to £133.3m (organic growth **+13%**). Segment EBITA margins declined 210 basis points to 20.1%.

Two of the Engine component agencies (MHP and Engine Creative) are reported within this segment. Overall, Engage remains the largest and most mature of the segments within NFC. Underlying organic growth in excess of 10% has held steady in this segment for a while and reflects a solid performance from the larger agencies (ie Archetype) and a very strong performance from MBooth, MBooth Health and Brandwidth.

Part of the attraction of the Engine acquisition (above and beyond the organic growth opportunities represented by the three main component parts) was the ability to drive material property and operating cost synergies without diluting operational performance. The initial cost savings secured (running at an annualised £3m) are likely to grow further. The company has not disclosed the pre Engine operating margins for the segment but we would expect the initial Engine impact will have contributed to the H1 margin decline for the segment as a whole.

Business Transformation – 25% H1 revenue

Headline revenue **+241%** to £67.2m (organic growth **+157%**). Segment EBITA margins increased +1600 basis points to 39.4%.

From a standing start three years ago, Business Transformation now sits as the second largest segment within the group. Of all the group segments, this is the area that is perhaps least well understood by investors. As opposed to being focused on how client companies engage with and sell to their customers; Business Transformation is more focused on the shape and value of client companies themselves.

This segment has itself been transformed by the acquisition in 2020 of Mach49, a US based growth incubator and corporate venturing consultancy. Not only has Mach49 grown its broad business significantly since being acquired, in March 2021 Mach49 announced the largest single contract win ($500m over five years) with an unnamed global client. H1 saw the first contribution from this contract win and was a significant driver behind the +157% organic revenue growth delivered by this segment.

Business Transformation is more than Mach49 and also now includes the digital transformation business from Engine as well as private equity led digital transformation specialist, Palladium and the US capital markets focused Blueshirt Group.

The initial revenue contribution from the Mach49 contract in FY23 is expected to be $60m, which will scale to $90m in FY24. The initial H1 profit contribution from this contract was higher than originally expected due to the associated cost investment coming in later than expected. This ultimately is a timing issue and flattered H1 margins by c.£5m, which we expect will reverse in H2.

Customer Delivery - 18% H1 revenue

Headline revenue **+34%** to £48.8m (organic growth **+17%**). Segment EBITA margins decreased -400 basis points to 32.3%.

This segment is focused on using data and analytics to directly impact customer purchasing activity and generate direct new customer leads. Even though all the NFC segments performed materially better through the pandemic than had been originally expected, Customer Delivery was the stand-out performer with the Activate business in particular leading the way.

The more recent acquisition, Shopper Media Group has been a positive contributor, which is now expected to accelerate even further following a material new contract win with Morrisons. The H1 margin decline was driven by a combination of revenue mix (Activate had a particularly strong FY22) and also cost investment in the account based marketing agency, Agent3.

Customer Insight - 9% H1 revenue

Headline revenue **+31%** to £24.7m (organic growth **+16%**). Segment EBITA margins increased +360 basis points to 21.3%.

Customer Insight represents, at its core, the online market research component of the NFC group offer. This segment has the highest proportion of B2C customer exposure (whereas the rest of the group is predominantly B2B) and had been the hardest hit through the pandemic, although like the rest of the group, the effects here were less pronounced than first feared.

The core Savanta business delivered +20% organic revenue growth and continued their positive EBITA margin trend.

Outlook

At the headline level, the group has framed the FY23 outcome as being *"at least in-line with market expectations"*. The analyst presentation did provide some more colour on this.

- At the group revenue level there has yet to be any material slowdown in overall group performance. At the individual agency level, we expect a broader range of revenue outcomes, some positive and some negative.

  → **Customer Insight**, the most B2C exposed of the group segments, would appear to be trading well with little to no evidence of any customer slow-down, or delays to customer decision making.

  → **Engage**, has the broadest spread of clients (relatively high proportion of exposure to North American technology names) and here the picture is more mixed with a number of clients coming under pressure but being offset by increased spending by others.

  → **Activate** is lapping some very tough comparatives but the underlying picture is of continued growth albeit at lower levels than FY22 and FY21. New client wins are likely to have a more pronounced impact here with the Morrisons win by Shopper Media particularly notable. This is a material win based around a core retainer (generating a positive margin) with variable and contingent upside which could be material.

  → **Business Transformation** is dominated by the large Mach49 contract (although this has overshadows a strong performance by Mach49 outside of the contract win). To an extent, this contract win creates a degree of fixed certainty around revenue and margin ($500m over five years) and materially outweighs a weaker outlook for the capital markets focused businesses within this segment.

  The one new change to forward expectations around Business Transformation relates to the rebasing of the Mach49 earn out commitments (driven in part by the strengthening of the dollar but also by the probability that that max $300m earn out cap will now be reached). We have adjusted our forward net cash expectations accordingly.

- The cost picture is complicated by a number of moving parts; not least the H1 / H2 split of Mach49 contract profits (weighted to H1 but equalising for FY24) and further property and operational cost savings from the Engine integration. More broadly; internal wage inflation (which is running at mid to high single digit range) is being more than matched by pricing growth and volume growth from new and existing clients. Excluding FX, we see a broadly neutral cost impact for the group as a whole in terms of forward cost expectations.

- Finally, FX was a material contributor to the H1 results with 53% of group revenue delivered out of North America and a further 7% of group revenue delivered out of the UK but billed in US dollars. The average rate in the period was $1.27 against a budgeted $1.34. Clearly the picture for H2 will also be heavily impacted by FX, with the H2 average rate so far since the end of July of $1.17 (+8% dollar strengthening). As H2 progresses, we will get greater clarity on the average rate for the year as a whole but the risks clearly point to prolonged dollar strength. As a rule of thumb, each 1c move in the US dollar equates to £0.7m of EBIT for NFC, which gives an indication of the further upside potential should rates persist at current levels.

Although FX should not be the primary benchmark by which to assess any company's performance and outlook, at the very least for NFC, FX provides a strong underpin to the current year outcome. Should trading continue at current levels deeper into H2, the risks to earnings estimates lie clearly on the upside.

Looking beyond FY23, we see two themes that are likely to grow in prominence for NFC.

- **Return on Investment.** In old marketing parlance, NFC has always been a "below the line" as opposed to "above the line" play. We believe the shift in the group mix represented by the substantial contributions now being made by the Customer Delivery and Business Transformation segments provide investors with a much clearer picture of the return on investment theme in action. Both of these segments are ultimately driven by a measurable, value-based outcome as opposed to softer metrics around brand impact or eyeballs.

- **Productisation.** Although at pains not to paint a SaaS picture, there is a growing emphasis within the group on delivering scalable client solutions where the cost to deliver is not the prime determinant behind pricing. We do not envisage a near term scenario where time and materials represents less than 50% of group revenue but the proportion represented by alternative value models will become more material as time progresses. We can already see evidence building in the acceleration of the group EBIT margin over the last five years (14.6% in FY17 to 21.9% in FY22).

Valuation Opportunity

In our last note in June 2022 (*Historically Attractive Valuation Point, see note here)*, we outlined how attractive the NFC valuation was looking against a historic context. Without wishing to repeat unnecessarily, this valuation picture is now even starker.

In Figures 1 & 2 below we show the 2 year forward PE multiple for both Next Fifteen and the Agency peer group. We also show this in relative terms.

Figure 1: Next Fifteen FY2 **PE**

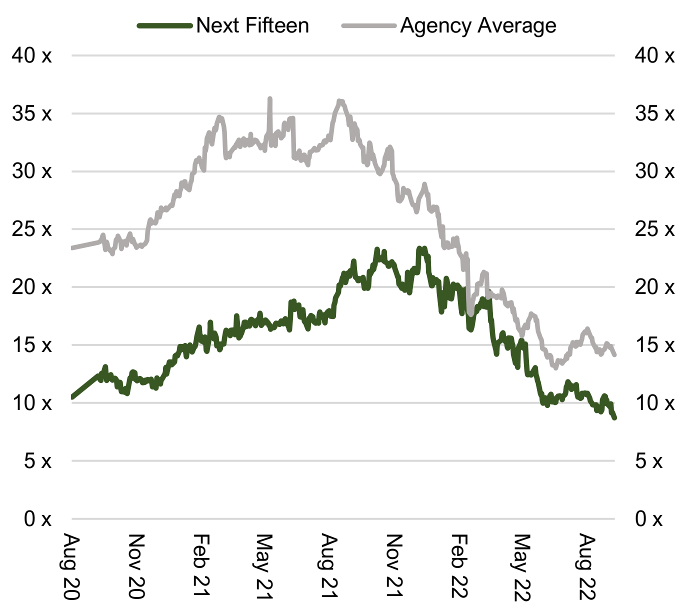
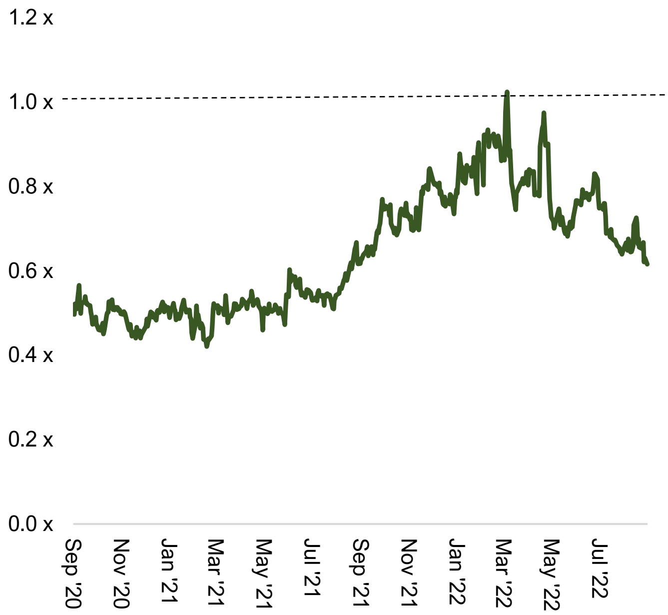


Figure 2: Next Fifteen FY2 PE relative to Peer Group



Source: FactSet, Radnor

We can see that Next Fifteen's PE discount to the peer group reached its narrowest point on 1st April 2022, before falling in line with the market response to external risks. The discount subsequently narrowed again sharply as the market digested a very strong set of final results, which triggered a further round of upgrades. The announcement of the Next Fifteen offer to acquire M&C Saatchi was made on 20th May 2022 and since then Next Fifteen's discount to the peer group has widened sharply.

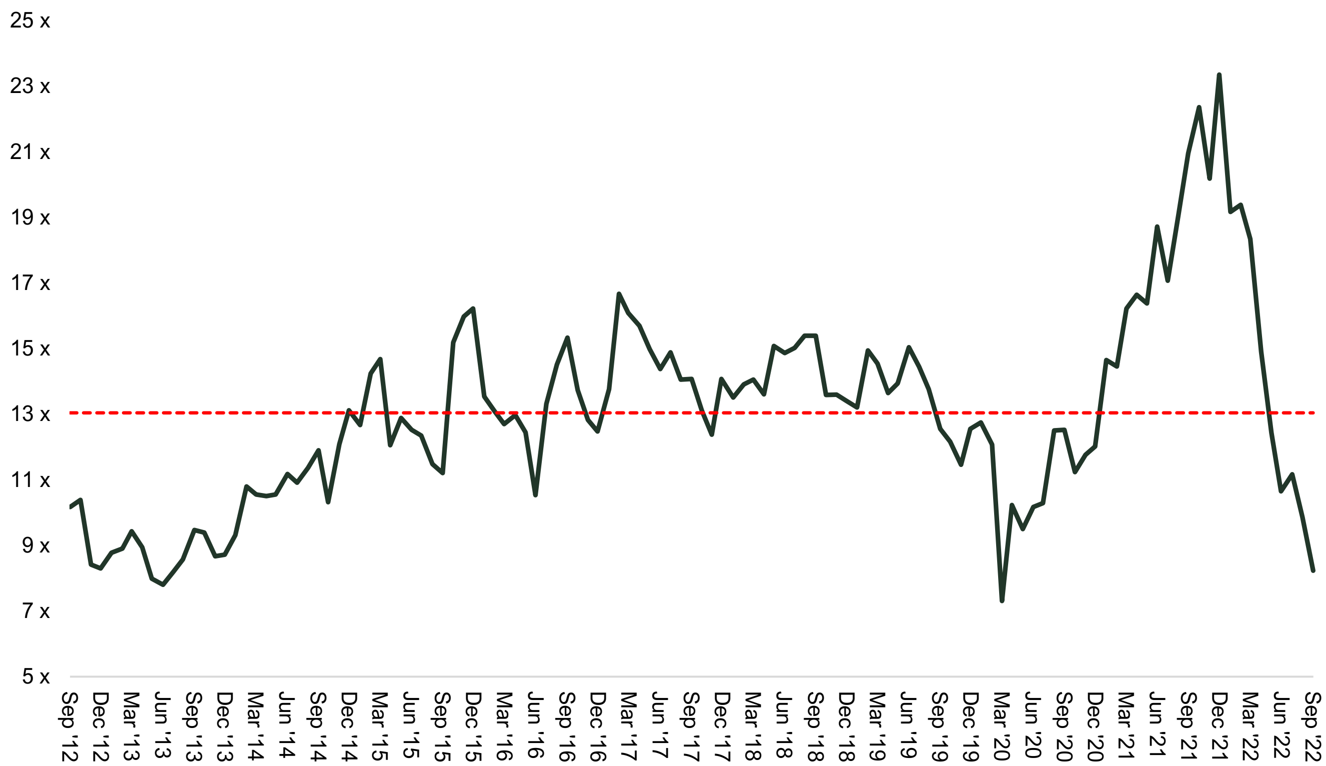
We believe the market has yet to price in the potential earnings enhancement the deal offers Next Fifteen and certainly has not factored the material top, and bottom-line synergies that the combination, with a high degree of portfolio and geographic fit, offers.

The net result is that should the deal complete; the natural EPS enhancement and the upside from cost savings is not captured in the current share price. In raw terms, and factoring our rough +9% EPS enhancement into our existing FY24 Next Fifteen EPS estimate, this suggests a post acquisition Next Fifteen FY24 PE currently stands at c.**8.2x.**

Although we believe the acquisition makes a great deal of financial and strategic sense for Next Fifteen, we should also consider what the implications are if the deal **does not** complete.

The short answer is that an obvious risk, in the eyes of some, will have been removed and we are left with the current valuation that, from a historical perspective, looks extremely attractive.

Figure 3: Next Fifteen FY2 **PE** over the last 10 years



Source: FactSet, Radnor

In Figure 3 above we show the 2 year prospective PE multiple for Next Fifteen over the last 10 years. We can see that the current level (disregarding the short-lived pandemic shock in March 2020) was last seen back in June 2013.

Since FY14, Next Fifteen's 2 year prospective PE has ranged typically between 11x and 17x. although peaked as high as 23x at the end of 2021. The average PE multiple through this 10 year period has been **13.0x**.

It is worth considering what has been delivered by the company since 2014 that has underpinned this average multiple.

- Revenue growth +267% (£98.7m → £362.1m) – CAGR of **+16%**
- Adjusted PBT growth +959% (£8.3m - → £79.3m) – CAGR of **+29%**
- Adjusted EPS growth +708% (7.4p → 59.7p) – CAGR of **+26%**

If we take the long run, historic average 2 year prospective PE multiple of 13.0x as a benchmark and apply to our FY24 EPS estimate, this implies a Next Fifteen share price of **1130p**, or **+45%** ahead of current levels.

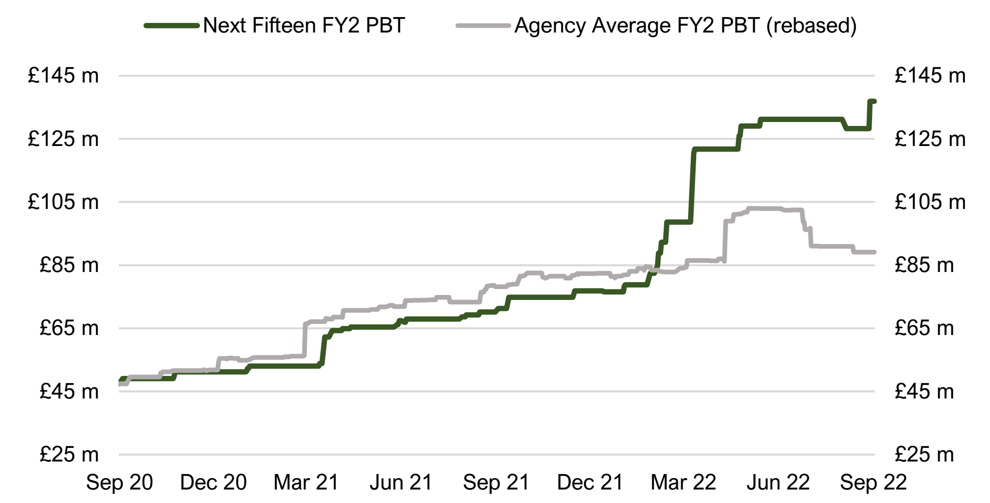
These figures are based on historic reported results and do not factor the pace of upgrades over the last year.

- FY23 revenue has increased by 72% to £560.4m
- FY23 adjusted PBT has increased by 82% to £110.3m

Although the largest inflection point came in February 2022 (driven by a combination of better then expected results; the acquisition of Engine UK and the announcement of the Mach49 material client win), we can see progress has been consistent through the period.

In Figure 4 below, we rebase the UK Agency peer group FY2 PBT estimate history against NFC's FY2 PBT estimate history. We can see that, since September 2020, NFC has seen its FY2 PBT estimate has increased by 188%, compared to 88% for the peer group in aggregate. The two closest peers; **S4 Capital** (+73%) and **YouGov** (+106%) lag some way behind.

Figure 4: NFC FY2 PBT estimate vs peer group rebased to NFC



Source: FactSet, Radnor

Next Fifteen Communications PLC

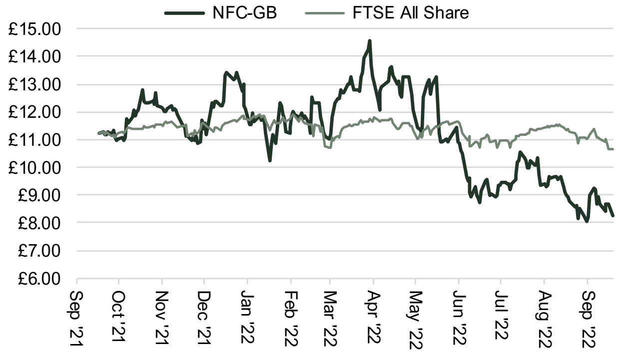
Iain Daly
+44 203 897 1832
id@radnorcp.com

Price (p): **779 p**
Market Cap: 755 m
EV: 705 m

PROFIT & LOSS

Year to 31 January, £m	FY20	FY21	FY22	FY23e	FY24e	FY25e
Customer Engagement		*166.5*	*187.6*	*282.3*	*311.7*	*332.1*
Customer Delivery		*49.6*	*80.0*	*99.9*	*111.9*	*123.1*
Customer Insight		*33.1*	*42.1*	*52.6*	*57.4*	*61.4*
Business Transformation		*17.7*	*52.5*	*125.6*	*169.2*	*189.5*
Group Net Revenue	**248.5**	**266.9**	**362.1**	**560.4**	**650.2**	**706.2**
Customer Engagement		*36.9*	*40.4*	*64.3*	*70.6*	*75.8*
Customer Delivery		*15.2*	*28.5*	*31.0*	*34.9*	*38.4*
Customer Insight		*4.9*	*9.0*	*11.1*	*12.0*	*12.9*
Business Transformation		*3.9*	*15.2*	*29.2*	*39.4*	*43.9*
Head Office	*(9.5)*	*(11.4)*	*(13.8)*	*(25.2)*	*(28.6)*	*(30.4)*
EBITA - Adjusted	**40.9**	**49.5**	**79.3**	**110.3**	**128.3**	**140.6**
Associates & JV's	0.2	0.4	0.2	0.2	0.2	0.2
Net Bank Interest	(0.8)	(0.8)	(0.3)	(0.3)	(0.3)	(0.3)
PBT - Adjusted	**40.2**	**49.1**	**79.3**	**110.3**	**128.2**	**140.5**
Non Operating Items	(23.0)	(37.2)	(40.4)	(32.0)	(29.0)	(29.0)
Other Financial Items	(11.6)	(13.2)	(119.0)	(10.0)	(10.0)	(10.0)
PBT - IFRS	**5.6**	**(1.3)**	**(80.1)**	**67.2**	**88.2**	**100.4**
Tax	(2.7)	(2.6)	14.5	(16.8)	(22.0)	(25.1)
Tax - Adjusted	(8.0)	(9.9)	(17.2)	(27.6)	(32.1)	(35.1)
Tax rate - Adjusted	*20.0%*	*20.2%*	*21.6%*	*25.0%*	*25.0%*	*25.0%*
Minority interests	0.6	1.0	3.6	5.2	6.7	7.5
No. shares m	85.3	89.4	92.4	96.9	96.9	96.9
No. shares m, diluted	90.9	93.8	98.1	102.6	102.6	102.6
IFRS EPS (p)	2.7	(5.5)	(74.9)	46.7	61.4	70.0
Adj EPS (p), diluted	**34.8**	**40.7**	**59.7**	**75.5**	**87.2**	**95.4**
Total DPS (p)	2.5	7.0	12.0	15.1	17.4	19.1

PRICE CHART - 1 YEAR ABSOLUTE vs FTSE ALL SHARE



Source: FactSet

SHAREHOLDERS

	% of ord. Share capital
Octopus Investments	12.4%
Aviva Investors	11.8%
Liontrust Investment Partners	11.6%
Slater Investments	6.7%
BlackRock	6.3%
Aberdeen Stan Life	6.1%
Tim Dyson (CEO)	5.9%
JPMorgan AM	5.9%
	66.7%

CASH FLOW

Year to 31 January, £m	FY20	FY21	FY22	FY23e	FY24e	FY25e
Net Profit: (add back)	2.8	(3.9)	(65.6)	50.4	66.1	75.3
Depreciation & Amortisation	*26.4*	*28.0*	*28.8*	*33.0*	*32.0*	*32.0*
Net Finance costs	*14.1*	*15.4*	*120.3*	*11.3*	*11.3*	*11.3*
Tax	*2.7*	*2.6*	*(14.5)*	*16.8*	*22.0*	*25.1*
Working Capital	(3.3)	6.6	0.2	(6.0)	(0.4)	(0.4)
Other	6.8	24.3	23.7	16.0	16.0	16.0
Cash from Ops	**49.5**	**72.9**	**92.9**	**121.5**	**147.1**	**159.3**
Cash Tax	(6.0)	(8.4)	(14.1)	(16.8)	(22.0)	(25.1)
Tangible Capex	(3.5)	(2.0)	(3.1)	(6.0)	(6.0)	(6.0)
Intangible Capex	(1.8)	(2.1)	(2.7)	(4.0)	(4.0)	(4.0)
Free Cashflow	**38.2**	**60.4**	**73.0**	**94.7**	**115.0**	**124.2**
Dividends	(7.5)	(0.7)	(12.4)	(14.1)	(18.1)	(20.9)
Acquisitions & Inv.	(24.2)	(23.6)	(28.1)	(107.0)	(47.2)	(67.3)
Financing	1.8	(37.7)	(1.1)	40.2	(8.3)	(8.4)
Net Cashflow	**8.3**	**(1.6)**	**31.4**	**13.8**	**41.4**	**27.7**
Net Cash (Debt)	(9.4)	14.0	35.7	49.5	90.9	118.5

Announcements

Date	Event
September 2022	H1 results
May 2022	Recommend Offer for M&C Saatchi
March 2022	Engine acquisition & £50m placing
February 2022	Mach49 $400m contract win
September 2021	H1 results
August 2021	Trading update
April 2021	Final results (y/e Jan 2021)

RATIOS

	FY21	FY22	FY23e	FY24e	FY25e
RoE	32.7%	95.3%	45.8%	48.1%	50.8%
RoCE	29.8%	37.1%	40.7%	52.0%	62.3%
Asset Turnover (x)	0.8x	0.7x	0.6x	0.4x	0.4x
NWC % Revenue	18.2%	14.3%	7.9%	6.7%	6.2%
Op Cash % EBITA	147.4%	117.0%	110.1%	114.6%	113.3%
Net Debt / EBITDA	0.1x	-	-	-	-

BALANCE SHEET

Year to 31 January, £m	FY20	FY21	FY22	FY23e	FY24e	FY25e
Intangibles	155.4	163.8	183.1	234.1	214.1	194.1
P,P+E	14.2	8.9	7.5	14.5	12.5	13.9
Tax Asset & Other	54.7	43.4	75.6	67.6	64.6	61.6
Total Fixed Assets	**224.4**	**216.1**	**266.2**	**316.2**	**291.2**	**269.6**
Net Working Capital	(42.8)	(48.6)	(51.6)	(44.2)	(43.9)	(43.5)
Capital Employed	**181.5**	**167.5**	**214.5**	**271.9**	**247.3**	**226.1**
Earn Out Liabilities	(59.5)	(64.6)	(188.8)	(152.2)	(152.2)	(152.2)
Net Funds	(9.4)	14.0	35.7	49.5	90.9	118.5
Net Assets	**112.7**	**116.9**	**61.5**	**169.2**	**185.9**	**192.4**

VALUATION

Fiscal	FY21	FY22	FY23e	FY24e	FY25e
P/E	19.1x	13.0x	10.3x	8.9x	8.2x
EV/EBITDA	8.6x	8.9x	6.4x	5.5x	5.0x
Div Yield	0.9%	1.5%	1.9%	2.2%	2.4%
FCF Yield	8.6%	10.3%	13.4%	16.3%	17.6%
EPS growth	17.1%	46.6%	26.5%	15.5%	9.3%
DPS growth	180.0%	71.4%	25.9%	15.5%	9.3%

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Radnor Capital Partners Ltd
1 King Street
London
EC2V 8AU

www.radnorcp.com

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