## Stock Market Review

# RS2 confirms strong business pipeline

**Edward Rizzo**

Edward Rizzo is a director at Rizzo, Farrugia & Co. (Stockbrokers) Ltd.

Following the publication of the 2013 annual financial statements on April 22, RS2 Software plc convened a stockbrokers meeting a week later to delve deeper into the financial results and to update financial analysts on their strategy and future outlook.

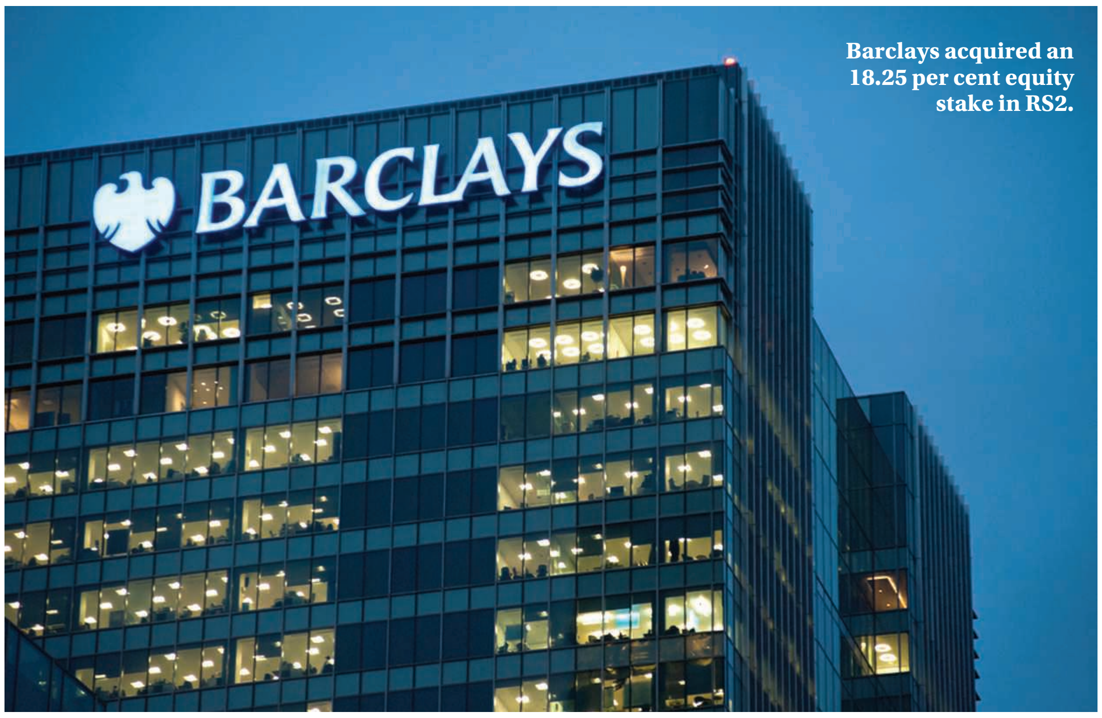
Chairman Mario Schembri commenced the meeting by stating that 2013 was a milestone year for the company. Following the €5 million investment to set up RS2 Smart Processing Ltd, the company was immediately very successful in attracting its first client – a major financial institution that processes transactions globally.

The chairman indicated that the profile of their first client was a sign of confidence in the company's ability to make steady progress in this new line of business. Moreover, 2013 saw the culmination of negotiations on a licence agreement with a major Tier 1 bank, Barclays Bank plc. RS2 was awarded a licence agreement of £8.5 million (equivalent to circa €10 million) and, separately, Barclays then acquired an 18.25 per cent equity stake in the company. This resulted in the UK-based major player becoming the second largest shareholder in the company.

In November 2013, RS2 issued its interim statement confirming that it was in negotiations on further agreements with both new and existing clients. The company stated that it expected such agreements for licensing of Bankworks as well as for managed services to be concluded in early 2014.

During Q1 2014, RS2 officially announced that it signed a licence agreement with the Swedish oil company OK Q8. However, the value of the contract was never disclosed. Shortly afterwards, RS2 issued a press release in connection with the new collaboration agreement with Fexco, Ireland's most successful financial and business solutions provider.

Fexco's Dynamic Currency Conversion (DCC) service was rolled out via RS2's Bankworks card management system. Through this innovative technology, international visitors to Malta now have the choice and convenience of paying for goods and services in their home currency in 400 locations. RS2 has fully integrated the Fexcoservice within its core product Bankworks and the aim is for RS2 and Fexcoto extend the DCC service to many more acquirers globally across the Bankworks platform.




Barclays acquired an 18.25 per cent equity stake in RS2.

Due to the incidence of revenue recognition according to international accounting standards, the 2013 annual financial statements require a deeper analysis especially when comparing the full-year performance to that achieved in the first six months.

During H1 2013, RS2 had recognised €5.5 million in licence fee income following the agreement entered into with Barclays Bank. This boosted the revenue during H1 to €9.7 million. Meanwhile, revenue for the entire 12-month period amounted to €14.1 million. Although this is a record level for the group, many analysts at the recent meeting immediately requested information on the amount of licence fee income recognised during the second half of the year.

Financial controller Clive Spiteri explained that no additional licence fee income on the Barclays agreement was recognised during the second half of 2013. He added that the balance of €4.5 million will be taken in 2014 and 2015 once certain implementation milestones are achieved in accordance with the agreement. The 2013 revenue figure of €14.1 million also includes €1 million in revenue from the first managed services client.

During the discussion it became evident that apart from the €10 million licence fee income from Barclays, the implementation of the Bankworks software at Barclays, will also translate into substantial service fee income. Once the system goes live, maintenance fees will then be recognised on an annual basis.

In a meeting last year explaining the Barclays relationship, CEO and majority shareholder Radi El Haj had indicated that service fees normally add up to approximately 20 to 30 per cent of any agreement while maintenance fees are an additional 18 to 21 per cent of the contract value.

The CEO noted that due to the strategy to target Tier 1 banks and service providers for new licence agreements, this will bring about large amounts of service fee income also in the years ahead. In fact, during the recent meeting, the chairman highlighted the strong growth in service fee income in recent years. These increased to €4.6 million in 2013 from only €1.2 million in 2011.

> **"The balance sheet also provides some important findings"**

The 2013 financial performance was negatively impacted by the higher administrative costs incurred as a result of the increase in the number of employees to support the growth in business.

Moreover, the company recognised a cost of €409,000 related to the share option scheme. Mr Spiteri explained that this was required in line with accounting standards but the figure does not reflect an actual cost incurred.

RS2's EBITDA and pre-tax profits during 2013 were also at record levels of €5.9 million (+31%) and €4.25 million (+35%) respectively. The company's margins are also important indicators for financial analysts and investors. The EBITDA margin of 42 per cent and the pre-tax margin of 30 per cent are very attractive and show the profitability of the company's business model.

The balance sheet also provides some important findings. RS2's cash balance has grown to €3.6 million at the end of 2013 with bank borrowings reduced by €1 million to €4.3 million. Essentially, given the cash balance, the RS2 Group is virtually debt-free, providing the required flexibility to finance upcoming investments to support the growth strategy. Moreover, another important consideration is that on the asset side of the balance sheet, one finds accrued income amounting to €2.9 million. This represents the value of certain works taking place which will then be recognised in the income statement upon completion.

During the presentation, CEO Radi El Haj naturally spoke about the outlook and future strategy. Mr El Haj seemed very upbeat given the potential business pipeline. He disclosed that the company has already commenced implementation works for two new clients for managed services. Contractual obligations have not yet been finalised but letters of intent have been signed and such contracts will be officially announced once financial terms are formally entered into.

The CEO also confirmed that the company is in intense negotiations on a multimillion-euro licence agreement. Mr El Haj explained that discussions took longer than anticipated due to the magnitude of the project. However, he expressed his confidence on reaching a successful outcome shortly.

While licensing agreements with Tier 1 banks and service providers will remain a core focus of the business going forward, the objective of RS2 is to diversify revenue streams and reduce the volatility in the financial performance due to the recognition of revenue on the signing of a licence agreement which normally takes a long time to conclude. As such, the immediate focus is on the managed services business which has shorter lead times and provides recurring revenue to the group.

According to the chairman, it is also higher margin business compared to the licensing and maintenance of Bankworks. Mr Schembri expanded on the strategy going forward and explained that the medium-term objective is for income from managed services to grow to a level which matches the current revenue from the traditional business of licensing, service and maintenance income from Bankworks.

During the meeting it became evident that following the agreement with such a globally recognised institution like Barclays, as well as the investments undertaken in the Mosta property and the managed services business, RS2's Bankworks software is now potentially being looked at by various large financial institutions and service providers.

Given the nature of the business and the various potential contracts being negotiated, financial analysts require guidance from RS2 and other similar companies with high growth prospects to assess the fair value of the company and guide investors accordingly.

The requirement for bond issuers to issue financial projections is a step in the right direction and this greatly assists analysts in their work. The financial projections drawn up by some of the recent bond issuers which also have their equity listed on the MSE such as International Hotel Investments plc, Medserv plc and now also Island Hotels Group Holdings plc provide very important information for equity investors who view financial projections in greater detail compared to investors seeking to invest in bonds.

Other equity issuers should also replicate this exercise and annually publish their financial projections. Although there are regulatory obligations involved in doing so – since companies would then be required to explain to the market the reason for any variances – it would surely instigate a more professional analysis of the future outlook on the company. Regular publication of financial projections should also increase trading activity in a company's shares.

Should management feel uncomfortable with the obligations attached to the publication of financial projections (although this is the norm internationally), they could also consider engaging international companies with significant expertise in this field. Such specialised analysts would be engaged by the company and their role would be to provide their own forecast after looking into the business and creating a financial model based on the profile and future outlook.

Equity investors are interested in the future business potential rather the historical performance. As such, the publication of financial projections would be a step in the right direction.

Local publicly traded companies need to consider the benefits arising from such an ongoing exercise as it could revolutionise the operation of the local financial market and instigate much-needed improved trading activity.