Stock Market Review

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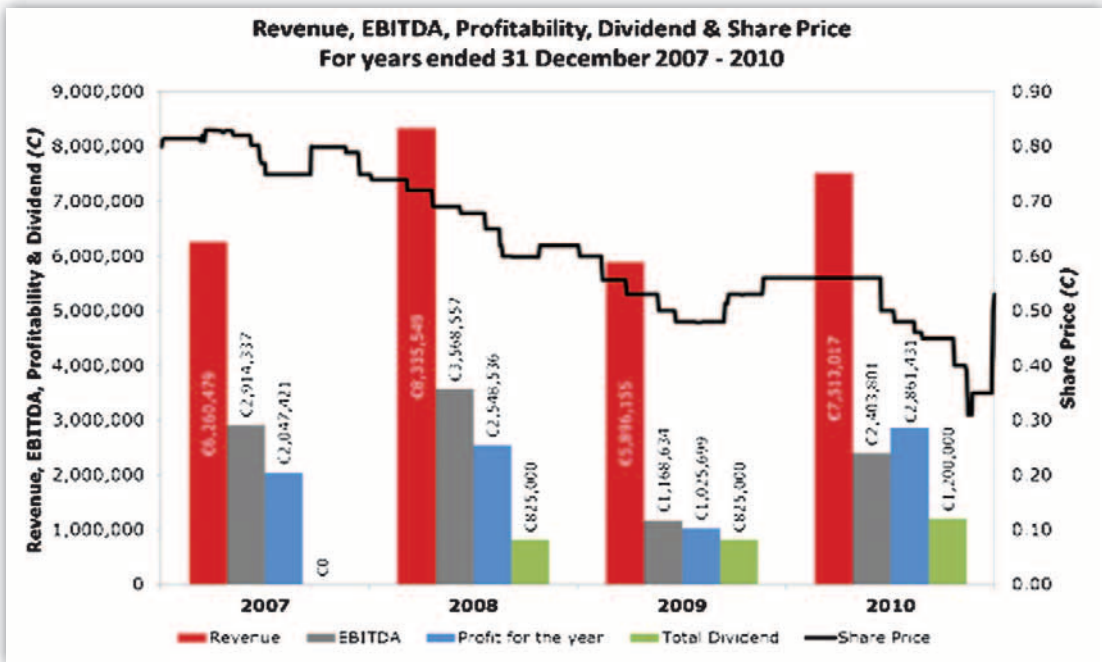
Strong performance by RS2 Software in 2010

The publication of the 2010 financial statements by RS2 Software plc on April 12 provided some encouraging news for local investors. As discussed in last week's column, local investor sentiment had been dented following the sudden onset of the crisis in Libya two months ago and some disappointing announcements by a number of the listed companies in recent weeks, most notably the 50 per cent decline in dividends by Go plc.



Although RS2 operates in the IT industry, it is important to highlight the different business model adopted by RS2 compared to the other companies in the IT sector (namely 6pm Holdings plc and Crimsonwing plc). This difference was also evident in the financial performance of these companies in recent years especially in the aftermath of the international financial crises and the global economic recession.

RS2 has been in operation for 20 years and its main focus is the development of BankWorks which is a card payment solution for global banks, service providers and retailers. In essence, while RS2's focus is on the development and sale of licences of its BankWorks product, Crimsonwing and 6pm are mainly involved in the service side of the industry providing IT solutions to companies.

The lower level of IT spend by many companies generally following the recent economic recession, and the dependence of both Crimsonwing and 6pm on clients mainly in the UK, resulted in both companies reporting losses in recent years. On the other hand, RS2 did not suffer the same fate and managed to remain profitable in 2009 in the immediate aftermath of the global economic downturn. Although RS2's overall level of profitability in 2009 declined substantially from the previous year, one of the main reasons for RS2 maintaining a positive bottom line is due to a high level of retainer income from the comprehensive package agreements in place with a number of RS2's clients for a number of years.

Meanwhile, during 2010, total revenue generated by RS2 grew by 27.4 per cent to €7.5 million mainly from the increased licence fee income which doubled during the year. A new licence had been announced in the May 2010 Interim Statement while a further licence had been awarded to RS2 by a US client and this was disclosed in the November 2010 Interim Statement. Moreover, support services from existing clients also picked up during the past 12 months vindicating the recent claims by RS2's CEO Mario Schembri that the lower level of service requests in 2009 did not represent "lost business" but "business postponed to the future". The CEO had explained that clients will eventually need to undertake the investment in their card processes due to regular technological upgrades to the BankWorks software. The level of revenue growth in 2010 may have caught the market by surprise given the relatively cautious statements made by RS2 in recent months.

Earnings before interest, tax, depreciation and amortisation (EBITDA) climbed to €2.4 million compared to €1.2 million in 2009 as a direct consequence of the growth in revenue registered during the past 12 months.

In line with its strategy to further expand its operations, RS2 increased its marketing and promotional expenses during 2010 by 33.9 per cent to €0.46 million while administrative expenses grew by 7.8 per cent to €0.97 million, mainly reflecting the full-year operations of the support service centre in the Philippines.

The pre-tax profit generated by RS2 during the past 12 months grew significantly to €1.62 million (2009: €0.43 million) while the profit for the period of €2.86 million was boosted by the recognition of a tax credit of just under €1 million. RS2 is eligible to tax credits under the Business Promotion Act and the overall level of these tax credits is based on the investments carried out and the expected future financial performance of the company.

In last week's announcement, RS2 stated that as at their December 2010 year-end, the outstanding level of tax credits amounted to €2.69 million which can be utilised against taxable profits in future years. RS2 noted that at a tax rate of 35 per cent, this balance has the potential of relieving from tax up to €7.7 million of future taxable profits. In essence, RS2 and its shareholders should continue to benefit from this favourable tax scenario for a number of years based on the current outstanding level and further tax credits due to arise from the upcoming investment in the head office in Mosta and continuous upgrades to the BankWorks product.

The Income Statement also reflected a minority interest figure of €248,095 (2009: €145,810) related to Transworks in the US. Although RS2 only has a shareholding of 26 per cent in this company, the financial results of the US company are consolidated in RS2's financial statements on a line-by-line basis since RS2 and its majority shareholder ITM Holding Ltd have overall control of the board of directors of Transworks.

This company is still incurring losses and is possibly the only bit of disappointing news in the recent financial statements of RS2. Transworks is seeking to enter a different area of the market (the processing of transactions) which is currently not being serviced by RS2. Although RS2's financial statements are being impacted by the losses being incurred by Transworks, the exposure of RS2's involvement in the US is helping RS2 being awarded licences and support service requests from new clients.

Last week's Company Announcement revealing the sharp upturn in the profitability of RS2 and the Directors' recommendation to shareholders at the upcoming annual General Meeting of a 45.5 per cent hike in dividends was well received by the market with an immediate positive reaction by the share price. Fresh demand for RS2 shares helped the equity rally 42.9 per cent to €0.50 on the first day of trading following the announcement.

This was followed by a further six per cent gain the day after as investors possibly reacted to the fundamental ratios of RS2 revealing the lowest price to earnings multiple and the highest dividend yield among other local equities. The strong upturn in the share price also provides further evidence on the importance of a healthy and attractive dividend policy for shareholders.

At the current level of €0.53 per share, the price is around 34 per cent below the May 2008 IPO offer price of €0.80. Since RS2 is a relatively newcomer to the financial market and the investing public may have a low level of understanding of the Company's business model, the equity may struggle to recover further towards the IPO price. Shareholders and the financial community will therefore expect clearer guidance from the company in the upcoming Interim Statement and Half-Year Report on the expected level of business activity in 2011.

However, the last week's comment by the directors of their intention to maintain and improve on the dividend distribution in future years is a strong indication of the secure business pipeline and future prospects of RS2 in this niche market.

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