



RESEARCH COVERAGE

PayGroup Limited

BUY RECOMMENDATION – price target upgraded

Price: \$0.685 | 12 Month Target: \$1.94 | Implied Return: 183% | 30 August, 2019

Astute takeover

Multi-Country Software with a Service (SaaS) Payroll solutions and APP enabled Cloud Software as a Service (SaaS) Human Capital Management (HCM) provider PayGroup Limited (ASX: PYG), has announced the acquisition of private SaaS and HCM company Astute One Ltd (Astute) on 30 September 2019 (estimated completion date).

Acquisition terms

PYG has executed a binding term sheet to acquire Astute for a consideration of \$11m payable in PYG shares at \$0.85, a 24% premium to the current share price, representing 1.6 times pro forma FY20 revenue. PYG will issue 12.9m shares which will give the merged group a market capitalisation of \$54.9m and forward PE of 10.8 times at \$0.85. The new shares will be escrowed for 24 months. The final acquisition price is subject to certain price adjustments at completion (including for working capital). Further, an earn-out consideration of up to \$1.5m is payable, subject to Astute revenue and earnings hurdles for the period up to 30 June 2020. Similarly, a claw-back mechanism is in place if Astute does not meet its revenue and earnings targets.

Synergies

PYG today provides BPO Payroll and SaaS solutions to multinational clients (MNCs) operating in the APAC region focusing on the full-time employee (FTE) component of their workforce. The acquisition will now enable PYG to service the large and growing contractor segment of the broader HCM market. The acquisition of Astute will deliver strategic advantages for the Group, namely:

- provide immediate scale in the Australian market (with opportunity to service these clients in APAC)
- grow Annual Recurring Revenue (ARR) to over \$15m (on a FY19 pro-forma basis)
- enable PYG to service the contractor component of MNCs operating in the APAC.
- provide cross-selling opportunities such as PYG's BPO payroll services to Astute's clients.
- increase the SaaS component from 6% of revenue to more than 40%.
- improve the forward PE from current 10.8 to 8.9 times
- add an additional 330 clients placing the merged group at 780 clients; and
- process an additional 350,000 payslips per month.

Recommendation

We estimate the acquisition to be EPS accretive by 23.3% on our FY20 forecasts on a pro-forma basis. The acquisition of Astute will bring significant synergies, such as cross-selling opportunities, and we have accordingly increased our growth forecasts from 2H FY20. We have updated our Discounted Cash Flow (DCF) model to include the added earnings from Astute, which has resulted in a retention of our BUY Recommendation and a 27.6% increase of the 12-month price target to \$1.94 (previously \$1.52).

PYG is presently trading on a forward (FY20) PE multiple of 8.9 times and as it capitalises on the market growth for multi-country payroll in APAC and transaction revenue synergies from FY20, we would expect the company to start trading more in line with its international peers, which trade on an average forward PE multiple of 49 times. Automatic Data Processing (NYSE:ADP, market cap US\$73bn) generates 66% of revenue from SaaS and trades on a forward PE of 27 times.

Company Data

Recommendation: BUY
Price (Date 30 August): \$0.685
ASX Code: PYG
Shares on Issue: 51.67m
Market capitalization: \$35.4m
Enterprise Value: \$33m

Board Structure

Ian Basser: Non-Exec Chairman
Mark Samlal: Managing Director
Franck Neron-Bancel: Exec Director
David Fagan: Non-Exec Director

Major Shareholders

Samantha Samlal*: 42.73%
Lawrence Pushpam*: 13.65%
Newgate Capital Partners: 12.4%
Simon Forrester: 4.10%
HSBC Custody Nominees: 3.20%

*escrowed for 24 months from IPO date

Financial Highlights (with Astute)

\$m	FY19A*	FY20E*	FY21E*	FY22E*
Total Revenue	8.4	17.5	20.7	24.2
Operating Expenses	(5.7)	(12.1)	(13.4)	(15.5)
EBITDA	2.7	5.4	7.3	9.4
NPAT	2.3	4.98	6.76	8.8
Dividend yield	N/A	3.7%	4.8%	6.0%
PE	15.4	8.9	6.5	5.1

*Normalised Pro Forma results



Astute overview and group synergies

Astute commenced operations in 2006 and is a cloud-based system delivering a flexible and easy to use payroll solution to the workforce management and corporate sector, which is accessible online from anywhere. Their interface allows the user to review and sign off on timesheets, expense claims, leave forms as well as invoicing, payroll tasks and receipting. Astute is one of only a few software firms with direct integration into the Australian Taxation Office. Key modules within the workforce management software include:

- Invoices, payroll and receipting
- Timesheets, expenses and leave.
- Compliance, induction and TFN submissions
- Pay and award interpretation
- Employee onboarding and self-service
- Interoperability with global HRIS, CRM and accounting platforms

Astute currently services more than 330 clients, including 50 recruitment agencies that cater for 3,500 employees. In FY19 Astute had revenues of \$6.9m of which 87% was attributable to SaaS. Astute operates on an Annual Recurring Revenue (ARR) model with implementation fees and recurring subscription revenues on contract terms of 3 years. Clients include Kelly Services Australia, Michael Page, and Adcorp Shared Services.

The Astute business is highly complementary to PayGroup. Combined the group will offer more than 17 modules to its clients which includes payroll function across Asia, Australia and New Zealand giving PayGroup the ability to add clients within a large multi-national area. The main modules of the combined group are listed in the graph below with Astute adding important capabilities PayGroup did not have before.

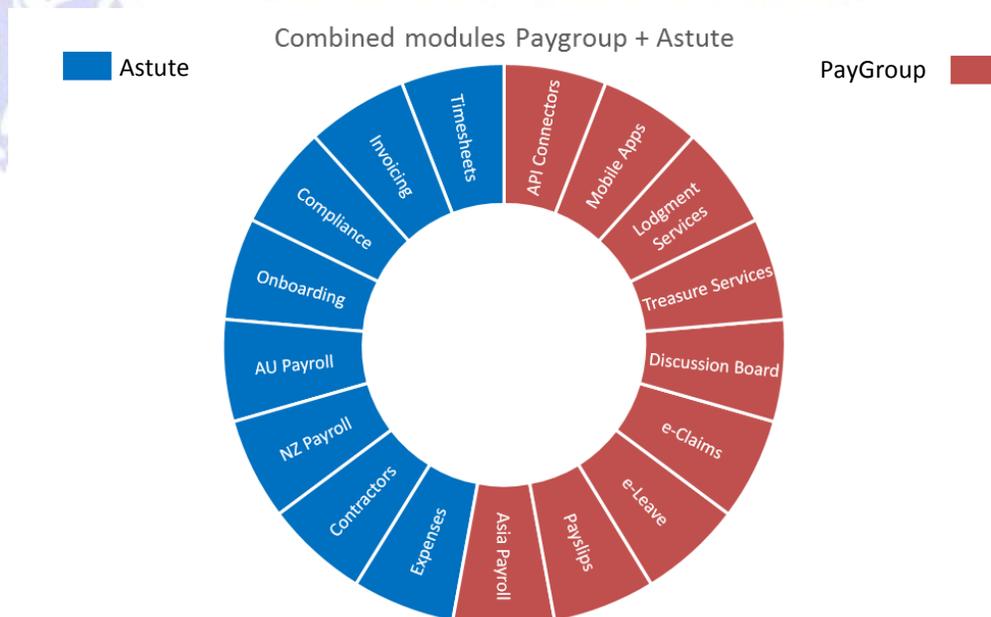


Chart 1: Merged modules. Source: PYG

With the additional modules we expect PYG to win new clients over and above our forecasts, not just in Asia but also in Australia and New Zealand, as it provided the capability to bid for clients that cater for contractors. Further, the additional modules give PYG the ability to cross sell modules to the current client base.

PYG currently has 52,142 client employees with the split being 39,987 in BPO and 12,555 in SaaS. For FY19 PYG reported pro-forma revenues of \$8.4m and NPAT of \$2.3m. Currently BPO makes up 93.8% of total revenue and SaaS 6.2%. Once Astute is fully integrated SaaS revenue will constitute more than one-third of total revenue. SaaS based solutions are gaining greater acknowledgement in the payroll and HR services industry due to their convenience as clients can access these services from any remote location through the internet. Therefore, it is important for PYG to increase its competitiveness by having a greater presence in the SaaS based solutions market. Once the Astute acquisition is completed, we expect:

- PYG's SaaS revenue percentage to jump from 6.2% to 44.76%.
- PYG's BPO revenue percentage to reduce from 93.8% to 57.8%.
- Astute to bring in an additional 330 clients bringing total clients to 780.

The acquisition complements and enhances PYG's overall service offering in the APAC region and gives the group a strong foothold in Australia. The increase in SaaS clients significantly increases PYG's product suit. In addition, Astute owns a software platform that processes payrolls for contractors, a segment PYG were unable to win clients within Asia. We have increased our growth forecast by 2% per annum to reflect the additional synergies.

The table below shows the growth in client employees since FY15. Astute currently processes 350,000 payslips per month and the enlarged group will process more than 4.7m payslips per annum.

Period	Payslips at end of period	Increase
FY15A	26,213	
FY16A	28,027	6.9%
FY17A	29,802	6.3%
FY18A	34,725	16.5%
FY19A	48,279	39.0%
With Astute	398,279	
Per annum	4,779,348	

Table 1: Increasing number pay slips processed. Source: PYG and Lodge estimates

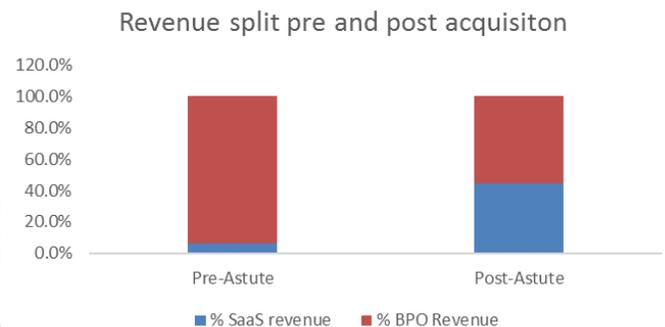
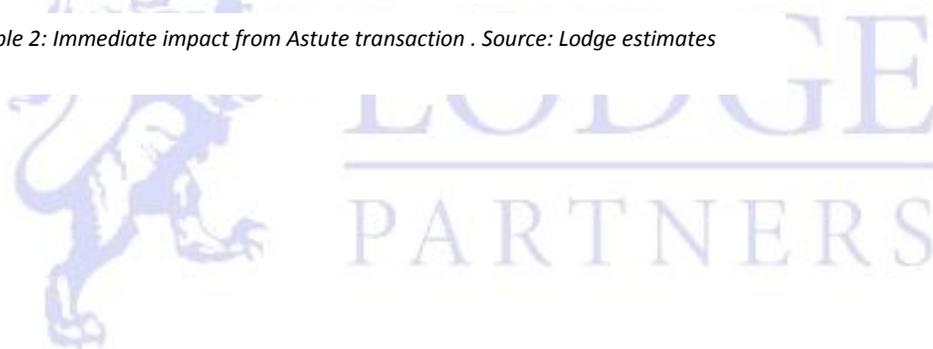


Chart 2: Increased SaaS revenue percentage. Source: Lodge estimates

The main synergies are listed in the table below. It is likely PYG will gain several cost synergies following the acquisition, namely savings in the area of payroll platform licensing and ongoing development costs for new modules. We expect the acquisition of Astute to have a positive impact on PYG's valuation, placing the company in a stronger position compared to its competitors.

Metric	Based on pro-forma FY19 earnings		% improvement
	Current	Post-Astute	
Revenue (\$m)	\$8.4	\$15.30	82.1%
NPAT (\$m)	\$2.300	\$3.50	52.2%
EPS	\$0.044	\$0.055	25.0%
P/E Ratio	11	8.9	+2.1
% Revenue from BPO	93.8%	55.2%	
% Revenue from SaaS	6.2%	44.8%	
Forward EV/Revenue	3.4	1.97	+1.43
Forward EV/EBITDA	9.66	6.35	+3.31
Clients	450	780	73.3%
Valuation/share	1.52	1.94	27.6%

Table 2: Immediate impact from Astute transaction . Source: Lodge estimates



Valuation Ratios (A\$'000's) Proforma

Year ending Mar	2019A	2020E	2021E	2022E	2023E
Proforma profit	2,293	4,981	6,769	8,732	10,830
EPS_{adj} (¢)	0.044	0.077	0.105	0.135	0.168
EPS growth	N/A	73.7%	35.9%	29.0%	24.0%
P/E ratio	15.4 x	8.9 x	6.5 x	5.1 x	4.1 x
Enterprise Value (m)	32,904	33,835	33,647	32,895	39,270
EV/Sales (x)	3.92 x	1.93 x	1.62 x	1.36 x	1.40 x
EV / EBIT (x)	14.3 x	6.8 x	4.9 x	3.7 x	3.6 x
EV / EBITDA (x)	12.3 x	6.3 x	4.6 x	3.5 x	3.4 x
DPS (¢)	0.00	3.9	5.2	6.8	8.4
Dividend Yield	0.0%	5.6%	7.6%	9.9%	12.2%
Payout Ratio	0.0%	50.0%	50.0%	50.0%	50.0%
Franking	0.0%	0.0%	0.0%	0.0%	0.0%
FCFPS	0.06	0.08	0.11	0.14	0.17
P/FCFPS	11.32	8.57	5.98	4.98	4.07

Cashflow (A\$'000's)

Year ending Mar	2019A	2020E	2021E	2022E	2023E
EBIT	2,293	4,944	6,815	8,833	10,974
Dep'n and amort'n	376	441	493	534	467
Deferred tax benefit	(41)	(154)	(209)	(270)	(335)
Share option expenses	0	0	0	0	1
Change in Work cap	568	196	217	233	0
Operating cashflow	2,670	5,990	7,457	9,483	11,530
Investing cashflows					
Capex	(500)	(500)	(500)	0	0
Acquisitions/Divestments	0	0	0	0	0
Other	0	0	0	0	0
Free Cash Flow	2,170	5,490	6,957	9,483	11,530
Equity	7,760	0	0	0	0
Other	(2,100)	0	0	0	0
Dividends paid	(750)	(2,491)	(3,384)	(4,366)	(5,415)
Net cashflow	7,080	2,999	3,573	5,117	6,115
Cash at beginning 01/04	5	6,366	5,435	5,623	6,375
Cash at end 31/03	6,366	5,435	5,623	6,375	7,075

Revenue Split (A\$'000's)

Year ending Mar	2019A	2020E	2021E	2022E	2023E
Payroll Services	8,067	9,811	12,105	14,737	18,036
Other	320	320	320	320	320
Group Revenue	8,387	17,547	20,707	24,208	27,965

Profit and loss (A\$'000's) Proforma

Year ending Mar	2019A	2020E	2021E	2022E	2023E
Operating revenue	8,387	17,547	20,707	24,208	27,965
EBITDA	2,669	5,385	7,308	9,367	11,441
D&A	(376)	(441)	(493)	(534)	(467)
EBIT	2,293	4,944	6,815	8,833	10,974
Net interest income	0	191	163	169	191
NPBT	2,293	5,135	6,978	9,002	11,165
Tax Expense (benefit)	0	(154)	(209)	(270)	(335)
NPAT	2,293	4,981	6,769	8,732	10,830
Significant Items	0	0	0	0	1
NPAT (Proforma)	2,293	4,981	6,769	8,732	10,830
EBITDA Margin	31.8%	30.7%	35.3%	38.7%	40.9%
EBIT Margin	27.3%	28.2%	32.9%	36.5%	39.2%
NPAT Margin	27.3%	28.4%	32.7%	36.1%	38.7%

Balance sheet (A\$'000's)

Year ending Mar	2019A	2020E	2021E	2022E	2023E
Bank Balance	6,366	5,435	5,623	6,375	7,075
Receivables	1,700	3,556	4,197	4,907	5,668
Prepayments	0	0	0	0	0
Other	3,150	3,150	3,150	3,150	3,150
Current assets	11,216	12,141	12,970	14,431	15,893
Net PPE	85	85	85	85	85
Intangibles	1,204	1,463	1,671	1,336	1,069
Deferred Tax Assets	0	0	0	0	0
Other	0	0	0	0	0
Non-current assets	1,289	1,548	1,756	1,421	1,154
Total assets	12,505	13,690	14,726	15,853	17,047
Trade payables	4,644	5,481	6,408	7,402	0
Borrowings	0	0	0	0	0
Employee entitlements	0	0	0	0	0
Deferred Revenue	0	0	0	0	0
Total liabilities	5,520	7,944	8,781	9,708	10,702
NET ASSETS	6,985	5,745	5,945	6,145	6,345

Balance Sheet Ratios

Year ending Mar	2019A	2020E	2021E	2022E	2023E
Net Debt	(6,366)	(5,435)	(5,623)	(6,375)	(7,075)
NTA	0.11	0.07	0.07	0.07	0.08
Price / NTA (x)	6.1 x	10.3 x	10.4 x	9.2 x	8.4 x
Return on assets	20.9%	9.6%	33.8%	42.7%	51.2%
Return on equity	13.9%	34.5%	31.9%	29.2%	26.6%

Valuation

Year ending Mar	2019A	2020E	2021E	2022E	2023E
Discounted Cash Flow					9.84%
Beta	0.9				9 years
Cost of Equity	9.84%				DCF/Price Target

Table 3: Earnings estimates. Source: Lodge

Comparable analysis

PayGroup trades at a deep discount relative to its listed international peers and a comparable analysis is detailed in Table 4 below. Comparable valuation analysis does not presently form part of our valuation model for PayGroup, however we believe it is important to note the material discount which the company trades at relative to listed international BPO Payroll and HCM Software providers. On a forecast PE basis, PayGroup currently trades at a 81.9% discount to other listed international BPO Payroll and HCM Software providers (49.1 times average) and a 90.4% discount to HCM Software provider (92.3 times average).

We would also note that in 2018, the NASDAQ listed Ultimate Software Group, Inc. was acquired by a private equity group led by Hellman & Friedman for US\$11 billion, representing a 32% premium to its then 30-day VWAP and 52.69 times net earnings.

A summary of 8 domestic and international listed comparable listed companies and multiple analysis is detailed in Table 4 below.

CODE	COMPANY	STOCK EXCHANGE	PRICING	MARKET CAP	PRICE	P/E	EV/EBITDA	EV/REV	SOLUTION
ADP	Automatic Data Processing	U.S.	USD\$	73.5B	169.44	27.5	20.54	5.29	BPO Payroll and HCM Software
WDAY	Workday	U.S.	USD\$	30.39B	187.65	111.33	67.49	13.24	HCM Software
PAYX	Paychex	U.S.	USD\$	29.42B	81.86	26.51	16.86	6.95	BPO Payroll and HCM Software
PAYC	Payce	U.S.	USD\$	14.6B	254.1	74.92	43.1	18.1	BPO Payroll and HCM Software
PCTY	Paylocity	U.S.	USD\$	5.9B	110.9	67.31	39.12	11.12	BPO Payroll and HCM Software
CSOD	Cornerstone OnDemand	U.S.	USD\$	3.2B	52.42	50.24	25.07	5.41	HCM Software
ZAL	Zalaris	OSL (Norway)	NOK	439m	20.6	115.24	10.1	1.03	HCM Software
ELO	Elmo Software	ASX	AUD\$	433m	6.84	N/A	N/A	7.6	BPO Payroll and Software
PYG	Paygroup*	ASX	AUD\$	35.4m	0.685	8.9	7.9	2.06	BPO Payroll and Software

Table 4: Market comparables Source: Thomson Reuters Consensus and Lodge Research, 30 August 2019. *Forward P/E, EV/EBITDA and EV/Revenue based on FY20 pro-forma forecasts including Astute

Disclaimer

In accordance with section 949A of the Corporations Act 2001, any recipient of the information contained in this document should note that information is general advice in respect of a financial product and not personal advice. Accordingly, the recipient should note that: (a) the advice has been prepared without taking into account the recipient's objectives, financial situations or needs; and (b) because of that, the recipient should, before acting on the advice, consider the appropriateness of the advice, having regard to the recipient's objectives, financial situation and needs.

Although Lodge Partners Pty Ltd ("Lodge") consider the advice and information contained in the document is accurate and reliable, Lodge has not independently verified information contained in the document which is derived from publicly available sources. Lodge assumes no responsibility for updating any advice or recommendation contained in this document or for correcting any error or admission which may become apparent after the document has been issued. Lodge does not give any warranty as to the accuracy, reliability or completeness of advice or information which is contained in this document. Except in so far as liability under any statute cannot be excluded, Lodge, its employees and consultants do not accept any liability (whether arising in contract, in tort or negligence or otherwise) for any error or omission in this document or for any resulting loss or damage (whether direct, indirect, consequential or otherwise) suffered by the recipient of this document or any other person.

General Securities Advice Warning

This report is intended to provide general securities advice. In preparing this advice, Lodge did not take into account the investment objectives, the financial situation and particular needs of any particular person. Before making an investment decision on the basis of this advice, you need to consider, with or without the assistance of a securities adviser, whether the advice is appropriate in light of your particular investment needs, objectives and financial circumstances

Disclosure of Interests

PayGroup Limited (PYG) currently are, or in the past 12 months have been, a client of Lodge Partner's affiliated company and authorised representative Lodge Corporate Pty Ltd. During this period, Lodge Corporate provided investment banking services to the company. In the past 12 months, Lodge Corporate have received compensation for Investment Banking services from the company. Lodge Corporate intends to seek or expect to receive compensation for Investment Banking services from the Company in the next three months.

Lodge directors, consultants and advisers currently hold less than 1% of issued shares in PayGroup Limited (PYG) and may buy or sell the shares from time to time. Lodge has earned and will continue to earn broking commissions by acting for individual clients that are buying or selling their shares in the company.

Analyst Verification

I verify that I, Sven Restel, have prepared this research report accurately and that any financial forecasts and recommendations that are expressed are solely my own personal opinions. In addition, I certify that no part of my compensation is or will be directly or indirectly tied to the specific recommendation or financial forecasts expressed in this report. I do not currently own any shares in the Company.

Contact Lodge Partners

Melbourne

Lodge Partners Pty Ltd
ABN: 25 053 432 769 AFSL: 246271
Level 6, 90 Collins Street, Melbourne VIC 3000
T +61 3 9200 7000

lodgepartners.com.au

Sydney

Lodge Partners Pty Ltd
ABN: 25 053 432 769 AFSL: 246271
Lvl 22, 227 Elizabeth Street
+61 2 9225 4433