NetDimensions (Holdings)

Final results

Revenue growth sustained at 40% in H2

Software & comp services

FY14 revenues for NetDimensions (AIM: NETD, OTCQX: NETDY) grew by 40% to $22.7m, compared with January's guidance of at least $22.0m, and well ahead of the previous $20.0m guidance. The adjusted loss and cash generation were also ahead of our forecasts. The industry outlook remains favourable and the group looks well placed to achieve its goal of $50m revenues by FY18. While there has recently been a de-rating in its US peers, these peers continue to trade at significant EV/sales premiums and we continue to believe NETD shares could warrant a significant re-rating.

Year end	Revenue ($m)	PBT* ($m)	EPS* (c)	DPS (c)	P/E (x)	Yield (%)
12/13	16.2	(4.1)	(12.1)	1.0	N/A	0.8
12/14	22.7	(3.5)	(9.4)	0.9	N/A	0.7
12/15e	26.0	(1.1)	(2.0)	0.9	N/A	0.7
12/16e	29.0	0.3	0.5	1.0	245	0.8

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments. P/E and yield calculated in pence.

Investment case: Stock is in a major growth phase

In May 2013 NetDimensions announced a new three-year business plan, involving accelerated investment, supported by a $6.1m fund-raising. The goal is to attain $50m revenues along with growing, sustainable profits in five years. The strategy is supported by a strong track record of revenue growth (29% pa from 2004-14), profitability and cash generation. The industry dynamics are attractive, with the global talent management software sector continuing to grow in the high teens. The strategy involves focusing on high-consequence industries, where there are stringent requirements for training and certification.

Final results: Cash burn falls on FY13

The 40% FY14 revenue growth means the group sustained the 40% growth rate attained in H1, in H2, in spite of the tougher H2 comparatives. Invoiced sales from new business more than doubled to $10.1m as 66 new clients were added and the number of active users of the group's software rose by 42% to 4.4m. Net cash reduced by $2.8m over the period, to $4.9m (we forecast $4.6m). The group has a cash-generative business model, with FY14 working capital decreasing by $1.3m.

Forecasts: FY15 edged higher, FY16 introduced

We are maintaining our FY15 revenue forecast at $26.0m, but increasing the loss to $1.1m from $0.7m due to lower gross margins, as a result of the strong growth in lower-margin professional services. We have introduced FY16e and FY17e, and expect the group to be cash flow neutral in FY15 and profitable from FY16.

Valuation: High-growth sector with punchy valuations

If NETD can manage the growth effectively, we continue to see significant upside, as the shares trade on an EV of 1.4x our FY16e revenues, compared to the group's larger US peers (its key competitors), which typically trade at 3.5-7.0x revenues.

23 April 2015

Price	**81p/$6.00***
Market cap	**£31m/$47m**

1.49/£

*ADR price

Net cash ($m) at 31 December 2014	4.9
Shares in issue	38.8m
Free float	46%
Code	NETD/NETDY
Primary exchange	AIM
Secondary exchange	OTCQX (ADR 5:1)

Share price performance

%	1m	3m	12m
Abs	16.4	3.2	19.0
Rel (local)	16.2	(0.9)	12.4
52-week high/low		82.50p	65.00p

Business description

NetDimensions provides talent and learning management systems to global enterprises. The company's solutions allow organisations to deliver personalised learning, share knowledge, enhance performance, foster collaboration and manage compliance for employees, customers, partners and suppliers.

Next events

Q1 trading update	Estimated 30 April 2015
AGM	15 June 2015
H1 trading update	July 2015
Interim results	September 2015

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Investment summary: High-growth talent business

Company description: Talent management systems provider

Since it was founded in 1999, NetDimensions, which is registered in the Cayman Islands, has grown quickly, with c 176 employees based at offices in Hong Kong (head office), the US, UK, China, the Philippines and Germany. NetDimensions offers its software both as traditional on-premise licences (with 20% support), an on-premise "annual licence" rental model and as a hosted rental service (ie single-instance software as a service, or SaaS), which is marketed as Secure SaaS. The product is sold both directly and through a reseller network, with the emphasis now increasingly on selling direct and to larger enterprises operating in "high-consequence" industries where there are more stringent requirements for regulatory compliance and hence training. The group also provides its customers with professional services, including training, implementation, consulting and content.

Financials: Profitable from FY04-12 at the operating level

Revenues have grown in each year since FY04 (compound growth of 29% pa) and the group has been profitable in all years at the adjusted operating level up until FY12. In FY13, the company raised $6.1m in a placing and introduced a new business plan, which involved stepping up the pace of investment. This involved hiring new people including quota-carrying sales people, and headcount has risen by 35% since end-FY12. We forecast revenue to grow 15% in FY15 to $26.0m and 12% in FY15 to $29.0m. The group was loss-making in FY13 and FY14, due to the increased investment, and we expect a reduced loss in FY15 before the group returns to profitability (at the normalised level) in FY16.

Sensitivities: IT budgets under pressure in downturns

IT budgets are typically cut in economic downturns, although the fact that many of the group's customers are required by regulation to offer training may provide some shielding. The LMS offers a highly efficient and cost-effective delivery mechanism and in some instances the LMS can be seen as mission critical. However, an LMS is a discretionary spend for many organisations and a key challenge for the group is to embed its solution into its customer businesses by offering wider functionality, improving productivity and potentially generating revenues for customers. The group's small scale may put it at a disadvantage to its larger US multi-tenant SaaS competitors.

Valuation: Very attractive relative to both its US and UK peers.

The stock trades on c 1.6x our FY15 EV/revenues, falling to c 1.4x in FY16 and c 1.3x in FY17. We expect the group to return to profitability in FY16 and trade on 245x our earnings in that year, falling to 40x in FY17. Our DCF model (assumes a WACC of 12%, a long-term margin target of 25% and terminal growth rate of 2%) values the shares at 106p, or 31% above the current share price. In our view, this valuation is supported by the group's profitable track record, strong customer base, efficient cost base and scalable business model. We believe the group's strategy to grow both geographically and by broadening its solutions offers significant upside to the valuation.

Exhibit 1: Forecast changes

	Revenue ($m)			PBT normalised ($m)			EPS (c)		
	Old	New	% chg.	Old	New	% chg.	Old	New	% chg.
2014	22.0	22.7	3	(4.0)	(3.5)	N/A	(7.4)	(9.4)	N/A
2015e	26.0	26.0	0	(0.7)	(1.1)	N/A	(1.3)	(2.0)	N/A
2016e		29.0			0.3			0.5	
2017e		32.1			1.6			3.0	

Source: NetDimensions accounts, Edison Investment Research

Company description: Talent management company

NetDimensions has established a strong foundation in supplying learning management system (LMS) software and services over more than 15 years. In 2012, it sought to broaden its profile as a Talent Management System (TMS) provider, and a new Talent Suite was launched. A Performance module was introduced shortly afterwards, followed by an Analytics module in early 2013. The company's current strategy is to target customers that operate in so-called "high-consequence industries" (see page 4). These are industries where accidents or failures can be catastrophic, whether that is disrupting society (eg financial services, government), damaging the environment (energy), risking consumer safety (food processing, healthcare, manufacturing, pharmaceuticals) or potentially maiming or causing loss of life (transportation). Furthermore, NetDimensions has been increasing its focus on larger customers with 5,000+ users, and in July 2014 it reorganised and expanded its services offering, to make the product offering more attractive to larger customers, as such customers typically have more complex services requirements. The group's software is based on single tenant architecture, but multi-instance solutions are also offered using shared, or virtualised, servers. It uses the java programming language.

What is an LMS?

An LMS is a software application that delivers online courses, assessments or training programmes and incorporates administration, documentation, tracking and reporting features. LMSs are used by enterprises to manage formal training (exams), informal training (generic employee training) and extended enterprise training (training for other parties such as customers, suppliers and partners, which can often be revenue generating).

Product offerings

NetDimensions Learning: the group's established LMS product manages the entire learning and development process from enrolment and delivery to testing, tracking and reporting. It provides a highly personalised learning environment with individual development plans, competencies, licences and certifications. Further, it has robust security as all internet requests are individually controllable and auditable, with transactions passing through a security module before being processed by back-end components. A single installation with a relatively modest hardware footprint can handle more than 500k users, while the group's cloud-based offering can cope with even larger user numbers. The software is sold as a standalone solution, and the customer configures the software and adds the content. The LMS is not used for developing content. However, NetDimensions has a growing professional services team that can help customers configure the software and help with content development. The software includes add-ons, such as links to WebEx, to enable online conferences.

NetDimensions Exams: this component of the LMS is used by people involved in developing and managing assessments, as well as for regulatory compliance requirements. It enables an organisation to manage the entire assessment process with optimal control and security.

NetDimensions Performance: launched in May 2012, this solution provides goal management, hierarchical competency modelling and assessments, performance appraisals, informal feedback recommendations, succession planning, and talent reporting and analytics.

NetDimensions Analytics: launched in January 2013 and based on Jaspersoft's Business Intelligence Platform, this is a sophisticated business intelligence application for talent and HR data, enabling organisations to gain actionable insights into their talent management processes using big data. NetDimensions Analytics is available as a cloud service that complements the capabilities of the NetDimensions Talent Suite by putting more power and flexibility into the hands of NetDimensions' clients.

Strategy: Focusing on high-consequence industries

NetDimensions' goal is to become a leading provider of talent management systems and related compliance solutions to high-consequence industries. The aim is to drive recurring revenue growth to achieve long-term sustainable profitability and hence the focus on driving SaaS rental revenues. It is looking at expanding into new markets, eg in December 2013 it established an office in Denmark targeting the Nordic region, and is seeking to drive growth both organically and via acquisition. NETD has been focusing on selling directly, and resellers are favoured in specific verticals such as airlines or geographies such as China and the Netherlands. The sales focus is on the group's Secure SaaS offering, which is a fully hosted solution, supported by the ISO 27001 security standard. The expansion into services is driven by customer demand, particularly as the group is winning more large multinational customers, in deals that typically have significantly more complex services requirements.

In May 2013, the company raised £4.1m in a placing of 10.75m shares at 38p and introduced a new business plan, which involved stepping up the pace of investment. The goal is to attain $50m revenues along with growing, sustainable profits in five years, through both organic growth and acquisitions.

The primary focus is on six verticals, listed below. Over time, the company may become more specialist, as each sector requires its own tailored development programme.

- **Healthcare:** the unit is built around eHealthcareIT, based in Atlanta, Georgia, USA, acquired in March 2013. Its target market is primarily hospitals and doctors' surgeries and has been focused on the south-eastern US states; NETD is keen to expand the market across the US and internationally. Customers include Mission Health, Unity Health and Nuffield Health.
- **Life Sciences:** this includes pharmaceutical and medical device companies. In 2013, Fresenius Medical Care selected NetDimensions Talent Suite for a roll-out to 30k employees in 24 countries. Key to the decision to choose NetDimensions was the software's ability to meet the regulatory compliance requirements that will enable Fresenius to comply with 21 CFR Part 11 and EU GMP Annex 11 regulations. Another notable blue-chip customer is Roche.
- **Manufacturing:** NetDimensions has been building a strong position in the automotive space, with customers including Delphi and Geely Automotive. Other customers include SEW-EURODRIVE, which recently selected NetDimensions Talent Suite to train over 16,000 employees worldwide, and Uster Technologies.
- **Financial services:** companies need their employees to stay ahead of a rapidly changing and complex regulatory landscape. There are frequent regulatory audits and significant fines if companies are found to be non-compliant. Customers include ING Bank, which is one of the group's biggest customers, Butterfield, Endsleigh, EastWest Bank and Credit Corp.
- **Energy:** customers include Khafji Joint Operations, Fugro, Nigeria LNG, ENOC and Castrol.
- **Aviation:** training is a fact of life in the airline industry, as pilots and cabin crew are required to take courses each year to keep up to date with the latest developments in safety and in the industry. Much of the group's exposure has been via Peak Pacific, a specialist e-learning consultancy, including Cathay Pacific. NetDimensions has also won airline industry customers on its own, including industry regulators such as the UK's Civil Aviation Authority (CAA) and European Aviation Safety Agency (EASA).

There are two other areas:

- **Government:** NETD has sold to the public sector for many years, in areas such as ambulances, police and social housing. Customers include the Health Service Executive (HSE) of Ireland, Metropolitan Housing Partnership (UK) and City of Chicago Police.
- **Technology:** a potential interest is on infrastructure players such as telecoms companies. Existing customers include Progress Software.

Acquisition strategy

NetDimensions is seeking to acquire businesses in the TMS space with a focus on software vendors, content/courseware providers or potentially specialist consultancies in healthcare or life sciences. Acquisitions could be used to broaden the Talent Suite into new modules, such as recruitment, on-boarding, compensation or succession planning. Target companies are likely to operate in North America and/or Europe, with customer bases focused on high-consequence industries and are likely to have revenues in the range of $10m to $20m. Verticals of particular interest include US healthcare and life sciences. Financing could include existing cash resources, equity and/or debt, including via an existing debt facility with Silicon Valley Bank.

Expansion of Global Services Division (GSD)

In 2014, the group reorganised and expanded its services offering. GSD will be organised into several practices, each with its own sales target and business plan. The initial core practices will be the Technical Services Practice (implementation, customisation), Analytics Practice and the Training Practice. The aim is to take advantage of increasing demand from clients operating in high-consequence industries. The main investment is in the UK, as the recent large multinational customer wins with the greatest services opportunities have been in Europe. There will be a significant variable cost element, as much of the work will be handled by short-term contractors. The enlarged unit will provide upsell opportunities to existing customers and will help the group win new customers.

Growth drivers: Taking opportunities in growth market

- The group has established a healthy track record of revenue growth, with revenues jumping from $1.8m in FY04 to $22.7m in FY14. In our view, there are several industry-specific drivers along with management initiatives that are set to sustain the growth:
- **A large and growing market:** the LMS market was estimated to be at least $2.5bn in FY14, up from c $1.2bn in 2011, according to specialist research firm Bersin & Associates. We estimate that NetDimensions' market share was 0.7% in FY14. It is seeking to boost market share by focusing on larger global firms with at least 5,000 users. LMS represented nearly half of the $5.3bn market for Talent Management Systems (TMS – includes Recruiting, Performance, Succession Planning and Compensation). MarketsandMarkets, the market research firm, forecasts the TMS market to grow 16.6% pa from $5.3bn in 2014 to $11.4bn in 2019. TMS is a subset of Human Capital Management Systems, which MarketsandMarkets estimates was a c $11bn market in 2014 and forecasts to growth to $17.5bn by 2019.
- **Focusing on high-consequence industries:** given the more stringent requirements for regulatory compliance among companies in these industries, there is a significantly greater demand for training. The companies that operate in this area are typically larger, global businesses, with complex structures, and hence require a greater emphasis on implementation and customisation, meaning significantly greater professional services revenues.
- **Expanding product range and functionality:** NetDimensions updates its products every three months. The bulk of the growth has been via the LMS module and sector-specific development is expected to be a factor going forward. However, we believe the Performance and Analytics modules have the potential to generate significant cross-selling opportunities with greater sales focus, and we would expect a new module by the end of FY16. Additionally, NetDimensions may acquire or work with partners to broaden its offerings.
- **International expansion:** while NetDimensions has always been based in Hong Kong, its growth has predominantly been in North America and Europe. In recent years it has opened

offices in Germany, China and Denmark, and we would expect the company to look at expanding into other regions.

- **Expanding professional services:** the group's strategy is to increase its direct sales in most major economies, which will boost the group's services revenues (ie direct customers will use NetDimensions' services rather than those of resellers). The group will continue to use resellers in other regions. The group could also expand its content and consulting capabilities.

Competitive environment: A major sector for SaaS players

The group competes with a number of predominantly US-based talent management companies. It also competes with Oracle and SAP, which offer LMS functionality in various ways, including as part of their integrated suite offerings. The peers it most often comes up against in competitive tenders are Cornerstone OnDemand and Saba Software, which both have multi-tenant SaaS offerings (multi-tenant means a single instance of the software is used by multiple customers). We note that NetDimensions' single-instance SaaS architecture appeals to a range of security-conscious companies. Indeed, some customers require on-premise solutions while others are required to have their data hosted inside their country of operation, which supports on-premise or single-tenant hosted solutions. Further, Saba has recently been acquired by a private equity company, suggesting it could face a disruptive period. We believe NetDimensions stands to benefit from its Hong Kong base and strong knowledge of Asia.

Financials: Strong growth opportunities in talent space

Business model: Traditional licence or software rental

NetDimensions operates a traditional on-premise software licensing business model with associated support and maintenance, along with a broad professional services offering. Pricing of the software is determined on the basis of the number of users and the group sells directly and via resellers, which extends its geographic coverage to more than 40 countries and rising.

Alongside the standard perpetual licence there is an annual licence option, which is popular with smaller customers wanting greater flexibility. The group also has a hosted single-instance SaaS option for customers that prefer to pay from the opex budget rather than capex. In FY14, the average customer spend, across all segments, was c $106k via the direct channel and c $10-20k via resellers (which purchase the software at wholesale prices and offer their own professional services).

1. **Software licencing** (24% of FY14 revenues).
   - **Traditional perpetual licence:** offered to direct customers and via resellers, this appeals to customers who see it as cheaper in the long run and have access to a capex budget. This area is being de-emphasised and perpetual licence revenues have fallen sharply since FY11.
   - **Annual licence** (c 87% of FY14 Software licensing revenues)**:** customers are also offered the software as a one-year licence paid annually in advance. This option is more commonly used by resellers, who can sell the software to their customers on their own terms, along with professional services and hosting. Despite the name, the contract term is typically for three years, but can extend much longer and renewal rates have been around 90%. They are mostly invoiced in Q4.
2. **Hosted** (36%)**:** this is a single-instance SaaS, ie the customer rents the software inclusive of support and maintenance. This typically involves a three-year contract paid annually in advance. Minimum term is one year with attractive discounts for two and three years. Since the software is hosted, the customer requires minimal IT infrastructure to support the application.

3. **Support and maintenance** (12%)**:** perpetual licence holders are charged 20% annually in advance.
4. **Professional services** (28%)**:** NetDimensions offers professional services, which cover everything from implementation, customisation, content authoring, consulting and training. Consultants are charged out to customers based on time and materials. The team is also involved in product development, implementing improvements requested by customers in the subsequent versions of the software. While this is effectively customer-funded development, it does affect utilisation rates.

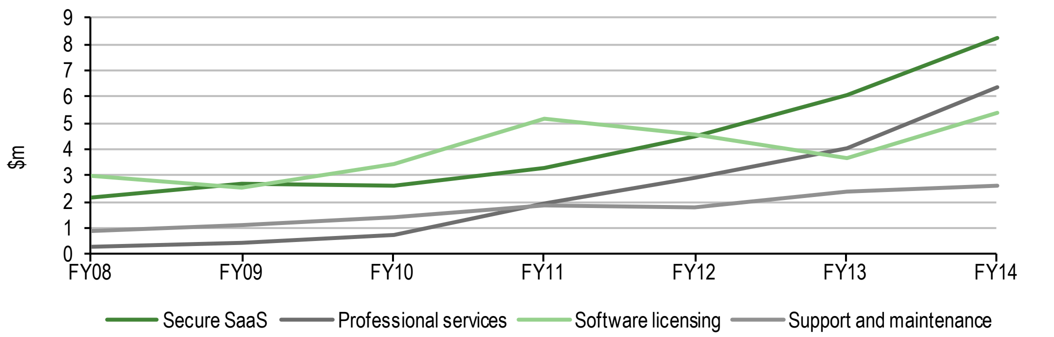
Final results: Revenues, pre-tax loss and cash all beat

FY14 revenue grew by 40% to a record $22.7m. Invoiced sales from new business more than doubled to $10.1m, and 66 new clients were added, including 34 in H2. The number of active users of the group's software rose by 42% to 4.4 million. Invoiced sales to clients in high-consequence industries jumped by 42% to $18.5m, representing 78% of total invoiced sales (FY13: 76%). The group has a cash-generative business model, with FY14 working capital decreasing by $1.3m.However, net cash reduced by $2.8m over the period, to $4.9m (we forecasted $4.6m) since the business is currently loss-making, due to accelerated investment. The average deal size for direct new clients in the period increased to $106k (FY13: $101k).

Hosting services (ie the group's Secure SaaS product) rose 36% to $8.3m and Professional services (including content from the interactive division) jumped 59% to $6.4m. These are the key areas of focus and are clearly trending sharply higher in Exhibit 2. The revenue growth benefited slightly from eHealthcareIT, which was acquired on 1 March 2013. Software licensing, which includes rental (annual licences) and perpetual licences, jumped 46% to $5.4m, which reflected a big jump in annual licences as the de-emphasised perpetual licence revenues slipped below $0.9m. Support and maintenance, which relates to perpetual licences, rose by 9% to $2.6m. The adjusted operating costs rose by 18% to $22.2m and the adjusted operating loss shrank by 16% to $3.5m.

Headcount stands at 176, up from 173 at the end of June, 167 at end-December 2013,155 at end-June 2013 and from 130 at the end of December 2012, ie before the new business plan was implemented. The number of quota-carrying salespeople now stands at 20 people, along with five divisional heads who are also incentivised for winning new business. The only significant area of recruitment is in software engineering.

Exhibit 2: Divisional revenues



Source: NetDimensions accounts, Edison Investment Research

Outlook: management remains confident that there is "an excellent market opportunity in focusing on high-consequence industries". However, growth in quota-carrying salespeople has been slower than we had anticipated, hence we do not expect the group to deliver the same level of growth in FY15. Nevertheless, we still expect group to be profitable in 2016 and with the help of acquisitions, we believe the group should comfortably reach its goal of attaining $50m revenues along with growing, sustainable profits by 2018.

Forecasts: FY15 maintained, FY16 and FY17 introduced

We continue to assume healthy growth in software hosting (secure SaaS), software licensing (ie on-premise rental) and professional services with modest growth from support and maintenance. In all, we forecast group revenues will rise 15% in FY15 to $26.0m, 12% in FY16 to $29.0m and 11% to $32.1m in FY17. Recurring revenues, represented by annual licences, hosting and support, were c 57% of the total in FY14.

Revenues: we assume growth in licence sales will come from increased direct sales, selling the bigger product range to both new and existing customers and from the investment in new geographies. We assume growth from hosting revenues will come from customers seeking speed of deployment and greater flexibility. Support and maintenance growth is a function of renewal rates on the existing support book plus contracts from new perpetual licence sales. We assume professional services growth follows the growth in licence and hosting revenues.

Gross margins: cost of sales mainly represents payments to consultants (for client implementation services), direct hosting costs and content. We assume modestly easier margins as lower-margin professional services revenue continues to grow.

Operating costs: we assume opex rises by 1% in FY15, reflecting the stabilised headcount, and then rising by 5% in FY16. We expect the group to return to profitability, as well as positive cash generation, in FY16.

Taxation: we assume a tax rate of 28% going forward.

Investment: we assume a capex rate of 1.2% of sales, based on historical data. As the group has a cash-generative revenue model, we assume positive cash generated from working capital of 1% of sales. The group expenses all of its development costs.

Exhibit 3: Forecasts

Revenues ($'000s)	2012	2013	2014	2015e	2016e	2017e
Software licensing	4,569	3,673	5,381	6,135	6,871	7,613
Hosting services	4,477	6,072	8,279	9,687	10,946	12,227
Support and maintenance	1,831	2,433	2,644	2,697	2,750	2,805
Content, implementation and customisation	2,919	4,030	6,397	7,484	8,457	9,447
Group revenue	13,796	16,208	22,701	26,002	29,025	32,092
Growth (%)	12.5	17.5	40.1	14.5	11.6	10.6
Gross profit	12,590	14,622	18,699	21,353	23,802	26,286
Gross margin (%)	91.3	90.2	82.4	82.1	82.0	81.9
Operating expenses	(12,233)	(18,780)	(22,215)	(22,437)	(23,559)	(24,669)
Adjusted operating profit	357	(4,158)	(3,516)	(1,084)	243	1,617
Operating margin (%)	2.6	(25.7)	(15.5)	(4.2)	0.8	5.0
Growth (%)	(71.2)	(1,266.2)	(15.4)	(69.2)	(122.4)	565.8
Net interest	67	65	25	25	25	25
Profit before tax norm	424	(4,093)	(3,492)	(1,059)	268	1,642
Adjusted EPS (c)	1.3	(12.1)	(9.4)	(2.0)	0.5	3.0
Adjusted EPS (p)	0.8	(8.1)	(6.3)	(1.3)	0.3	2.0
P/E - Adjusted EPS	**96.4**	**(10.0)**	**(12.9)**	**(61.6)**	**245.4**	**40.3**

Source: NetDimensions accounts, Edison Investment Research

Sensitivities: Budget constraints in downturns

LMS businesses benefit from regulatory-induced demand combined with the ability to reduce costs. However, an LMS is seen as discretionary spend for many organisations. A key challenge for the group is to embed its solution into the businesses of its customers to mitigate the risk of customer loss during economic downturns or due to a competitor's solution. This would involve widening the functionality as much as possible across the talent management space and, when possible, including revenue-generating attributes for the customer.

We highlight the following sensitivities:

- **Economic backdrop:** IT budgets are cut back in economic downturns, putting pressure on capex budgets in particular. We note that Software Licensing revenues dipped by 14% in FY09, following the global downturn (although gains in Hosting more than compensated for this).
- **Competitive environment:** there is a risk that the group's products could be bettered by its direct competitors. The industry is competitive with c 500 LMS players globally. While there are relatively low barriers to entry, building a broader talent management offering is a greater challenge, reflected in fewer talent management players of c 50+ companies. There is a potential threat from free open source packages. There is a risk that NetDimensions focuses too much on highly regulated industry sales and misses out on broader talent management opportunities.
- **Small scale:** the group has grown strongly since inception, but has recorded relatively volatile profits and cash flows, reflecting operational risk. The strong cash position acts as a useful buffer and will help to appease customers about the group's long-term viability.
- **Key employees:** the loss of a key employee could have a significant impact on the growth prospects of a small company like NetDimensions.

Valuation: Enterprise software growth play

Having established its position as a serious player in the global LMS market, NetDimensions has in recent years been broadening its offerings to become a Talent Management player to create fresh growth opportunities. The group was profitable at the operating level in every year from FY04 until the new business plan was implemented in FY13. The accelerated investment resulted in losses in FY13 and FY14, albeit with strong 40% revenue growth in FY14. Further, the group has a healthy financial position with an end-December $4.9m net cash position equating to c 8p per share at current exchange rates. The shares have recovered to trade at a c 30% premium to the 2007 IPO price and our cash flow and peer analysis below suggests the shares are an attractive investment.

We highlight the following points:

- **Cash generation:** NetDimensions has reported positive cash flows in most years (see Exhibit 4), supported by a cash-generative payment in advance business model. From FY06 to FY12, the group generated operating cash flow of $5.4m and free cash flow totalling $4.5m, representing 7.6% of cumulative sales. The group generated cash outflows in both FY13 and FY14, but the accelerated revenue growth also fed through to working capital, due to the attractive business model. We forecast the group to be cash generative again from FY16.

Exhibit 4: Cash flow

	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15e	FY16e	FY17e
Adjusted operating profit	607	124	132	716	399	1,240	357	(4,158)	(3,516)	(1,084)	243	1,617
Depreciation (incl software)	42	89	150	138	110	151	168	166	196	218	265	297
Working capital	(889)	350	366	1,179	(546)	(121)	590	1,471	1,253	260	290	321
Miscellaneous	(0)	2	1	1	0	3	0	7	(17)	0	0	0
Operating cash flow	(241)	564	649	2,034	(36)	1,272	1,115	(2,514)	(2,085)	(606)	798	2,235
Net interest	16	156	199	7	61	59	67	65	25	25	25	25
Tax	0	0	0	(11)	(20)	(1)	(338)	(31)	(57)	(124)	106	(54)
Purchase fixed assets (incl software)	(70)	(260)	(100)	(108)	(92)	(229)	(161)	(256)	(144)	(312)	(348)	(385)
Free cash flow	(296)	460	748	1,921	(87)	1,102	683	(2,736)	(2,261)	(1,018)	581	1,822

Source: NetDimensions (historicals), Edison Investment Research (forecasts)

- **Discounted cash flow valuation:** noting the group's small size and volatile licence revenues, balanced by its healthy recurring revenues (c 57% of sales in FY14), we assume a weighted average cost of capital of 12%. Applying our forecasts, which include a 25% long-term operating margin target and revenue growth tapering down from 14.5% in FY15 to 2% in the long run, our DCF model values the shares at 106p, 31% above the current share price. Discounting back from our forecasts, we estimate that the market is attributing a break-even WACC of 14.2% to the stock.
- **Traditional valuation measures:** in traditional valuation terms, the stock trades on 245x our earnings forecasts in FY16, falling to 40x in FY17.
- **Peer comparison:** we compare the stock with its listed US competitors and UK peers, which are not direct competitors (except for Access Intelligence, which has an LMS solution). NetDimensions' stock trades on 1.4x our FY16 revenue forecast, which is comfortably below its UK peers, and just a fraction of its US peers. This is in spite of NetDimensions' very good track record of profitability and cash generation. Cornerstone OnDemand has been loss making and recorded free cash outflows in each of the last five years and is expected to remain loss making (at the normalised level) for another two years.

Exhibit 5: Peers

	Share price	Market cap	EV/sales		EV/EBITDA		P/E	
		m	Year 1	Year 2	Year 1	Year 2	Year 1	Year 2
NetDimensions ($)	**81.00**	**46.9**	**1.6**	**1.4**	**N/A**	**81.9**	**N/A**	**245.4**
1) North American Human Capital Management software peers ($'m)								
Callidus Software	13.36	715	4.2	3.5	32.6	22.5	53.2	39.5
Cornerstone OnDemand	29.42	1585	4.5	3.6	198.2	69.0	N/A	N/A
Halogen Software (C$)	8.66	190	1.7	1.5	N/A	N/A	N/A	N/A
HealthStream	29.05	807	3.8	3.3	27.8	21.6	87.5	69.5
Paycom Software	32.95	1923	9.8	7.7	57.5	42.4	117.7	83.6
Paylocity	31.29	1580	10.1	8.0	359.7	154.5	N/A	N/A
Ultimate Software	180.61	5370	8.5	7.0	34.3	26.7	72.9	58.5
Workday	87.59	16597	13.3	9.6	308.1	138.8	N/A	29196.7
Medians			**6.5**	**5.3**	**57.5**	**42.4**	**80.2**	**69.5**
2) Human Capital Management software peers quoted on AIM (£'m)								
Access Intelligence	2.875	7	0.8	0.7	18.2	8.2	N/A	N/A
Bond Intl Software	120.5	46	N/A	N/A	N/A	N/A	N/A	N/A
Dillistone Systems	103	20	2.1	1.9	7.8	6.7	12.9	12.0
Learning Technologies	23.5	84	3.8	3.5	19.9	17.3	33.6	29.4
ServicePower	4.625	9	0.5	0.5	75.1	11.3	N/A	N/A
Tracsis	425	113	4.4	4.1	17.3	16.2	25.3	22.3
Medians			**2.1**	**1.9**	**18.2**	**11.3**	**25.3**	**22.3**

Source: Edison Investment Research, Bloomberg. Note: *Currently considered to be in an offer period due to a strategic review. Prices as at close on 22/23 April 2015.

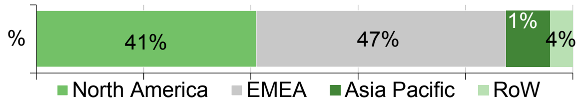
- **Sector M&A:** M&A activity in the sector continues to be busy, with Saba acquired by private equity firm Vector Capital in February for c $400m including debt. Also, SumTotal was acquired by Skillsoft in August 2014 from affiliates of US private equity firm Vista Equity Partners for an undisclosed price. Skillsoft, which is focused on content, was purchased by Charterhouse Capital Partners in April 2014. In the 2011 and 2012 period, Taleo was acquired by Oracle, SuccessFactors was acquired by SAP, Kenexa was acquired by IBM and AIM-listed Workplace Systems was taken private. These deals were executed at high multiples to sales (see our initiation note). The IPO market for this sector has picked up recently, with Workday listed on NYSE in October 2012 and trading at very punchy sales multiples (see Exhibit 5). Earlier in FY13, Paycom Software and Paylocity debuted on NASDAQ, and trade on 5.4-5.7x FY15 EV/sales, while Halogen Software listed on the Toronto Stock Exchange and trades at a smaller, albeit still significant, premium to NetDimensions.

Exhibit 6: Financial summary

US$'000s	2012	2013	2014	2015e	2016e	2017e
Year end 31 December	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS						
Revenue	13,796	16,208	22,701	26,002	29,025	32,092
Cost of Sales	(1,206)	(1,586)	(4,002)	(4,649)	(5,223)	(5,806)
Gross Profit	12,590	14,622	18,699	21,353	23,802	26,286
EBITDA	525	(3,992)	(3,320)	(866)	508	1,914
Adjusted Operating Profit	357	(4,158)	(3,516)	(1,084)	243	1,617
Amortisation of acquired intangibles	(338)	(477)	(472)	(470)	(470)	(470)
Exceptional items and exchange movements	(170)	(110)	(379)	0	0	0
Associates and joint ventures	0	0	0	0	0	0
Share based payments	(117)	(266)	(674)	(300)	(325)	(350)
Operating Profit	(268)	(5,011)	(5,041)	(1,854)	(552)	797
Net Interest	67	65	25	25	25	25
Profit Before Tax (norm)	424	(4,093)	(3,492)	(1,059)	268	1,642
Profit Before Tax (FRS 3)	(201)	(4,946)	(5,016)	(1,829)	(527)	822
Tax	(108)	()	(124)	297	(75)	(460)
Profit After Tax (norm)	315	(4,094)	(3,616)	(763)	193	1,182
Profit After Tax (FRS 3)	(310)	(4,946)	(5,141)	(1,533)	(602)	362
Average Number of Shares Outstanding (m)	25.2	33.8	38.5	38.9	39.2	39.5
EPS - normalised (c)	1.3	(12.1)	(9.4)	(2.0)	0.5	3.0
EPS - FRS 3 (c)	(1.2)	(14.6)	(13.3)	(3.9)	(1.5)	0.9
Dividend per share (c)	0.81	0.99	0.90	0.90	1.00	1.10
Gross Margin (%)	91.3	90.2	82.4	82.1	82.0	81.9
EBITDA Margin (%)	3.8	(24.6)	(14.6)	(3.3)	1.7	6.0
Operating Margin (%)	2.6	(25.7)	(15.5)	(4.2)	0.8	5.0
BALANCE SHEET						
Fixed Assets	905	3,980	3,359	2,982	2,596	2,213
Intangible Assets	567	3,522	3,059	2,589	2,119	1,649
Tangible Assets	238	316	270	364	447	535
Other	100	142	30	30	30	30
Current Assets	13,021	15,031	13,104	12,931	14,253	16,789
Stocks	0	0	0	0	0	0
Debtors	6,194	7,303	8,197	9,389	10,480	11,587
Cash	6,827	7,728	4,907	3,543	3,773	5,202
Current Liabilities	(7,815)	(10,673)	(12,476)	(13,940)	(15,334)	(16,774)
Creditors	(7,811)	(10,671)	(12,473)	(13,938)	(15,331)	(16,771)
Short term borrowings	(3)	(2)	(2)	(2)	(2)	(2)
Long Term Liabilities	(70)	(113)	(182)	(182)	(182)	(182)
Long term borrowings	(9)	(6)	(3)	(3)	(3)	(3)
Other long term liabilities	(61)	(106)	(179)	(179)	(179)	(179)
Net Assets	6,041	8,225	3,805	1,791	1,333	2,047
CASH FLOW						
Operating Cash Flow	1,115	(2,514)	(2,085)	(606)	798	2,235
Net Interest	67	65	25	25	25	25
Tax	(338)	(31)	(57)	(124)	106	(54)
Capex	(161)	(256)	(144)	(312)	(348)	(385)
Acquisitions/disposals	0	(2,242)	(258)	0	0	0
Equity financing	91	6,133	250	0	0	0
Dividends	(773)	(287)	(389)	(347)	(350)	(392)
Net Cash Flow	0	868	(2,658)	(1,365)	230	1,429
Opening net debt/(cash)	(6,862)	(6,814)	(7,719)	(4,902)	(3,537)	(3,767)
HP finance leases initiated	0	0	0	0	0	0
Other	(48)	37	(160)	0	()	()
Closing net debt/(cash)	(6,814)	(7,719)	(4,902)	(3,537)	(3,767)	(5,197)

Source: NetDimensions accounts, Edison Investment Research

EDISON

Contact details	Revenue by geography
17/F Siu On Centre 188 Lockhart Road Wan Chai Hong Kong 852 2122 4500 www.netdimensions.com	

CAGR metrics		Profitability metrics		Balance sheet metrics		Sensitivities evaluation	
EPS 2012-16e	N/A	ROCE 15e	N/A	Gearing 15e	N/A	Litigation/regulatory	◖
EPS 2014-16e	N/A	Avg ROCE 2012-16e	N/A	Interest cover 15e	N/A	Pensions	○
EBITDA 2012-16e	N/A	ROE 15e	N/A	CA/CL 15e	0.9	Currency	◖
EBITDA 2014-16e	N/A	Gross margin 15e	82.1%	Stock days 15e	N/A	Stock overhang	◖
Sales 2012-16e	20.4%	Operating margin 15e	N/A	Debtor days 15e	132	Interest rates	○
Sales 2014-16e	13.1%	Gr mgn / Op mgn 15e	N/A	Creditor days 15e	194	Oil/commodity prices	○

Management team

CEO: Jay Shaw

Before founding NetDimensions, Jay was with NASDAQ-listed The Princeton Review for more than a decade. Jay ran TPR's operations in the US, holding executive responsibility for academic and corporate training programmes. He is responsible for general group management and sales.

CFO: Matthew Chaloner

Matthew joined NetDimensions as CFO in January 2013. Previously, he worked in a variety of senior financial positions before the appointment as CEO of UK-listed company, Howle, in 2003. After successfully executing the sale of Howle to AIM-listed electronics manufacturer Elektron in 2006, Matthew became financial controller for Elektron's largest division and subsequently business development director for Asia. He is a fellow of the ACCA and an associate of the CIMA.

Chief Scientist: Ray Ruff

Ray co-founded NetDimensions with Jay Shaw in 1999, having previously worked with Sybase. Before Sybase, he served as open systems group manager at Unisys in the US. Ray is responsible for managing the technical and product development areas of the group. He holds an MS in computer science from the University of North Carolina at Chapel Hill.

Non-Executive Chairman: Roger Durn

Roger has held senior management positions in Asia Pacific, the US, UK, Australian and Japanese companies including VP and senior director positions at Arkologic, EnterpriseDB, Novell, SilverStream Software, Sybase, Powersoft, Mitsubishi Electric, GEC Alsthom and Apricot Computers. Roger started his career in research and development in the electronics and software industry in the UK in the 1980s before moving into sales, marketing and business development. He holds a degree in chemical physics from the University of Sheffield. Roger chairs the nomination committee.

Principal shareholders	(%)
Henderson Global Investors	24.1
Jay Mervin Shaw	12.4
Ray Cecil Ruff	9.8
Hargreave Hale	7.1
Winston Leong	5.8
Herald Investment Management	3.6

Companies named in this report

Cornerstone OnDemand (Nasdaq: CSOD), HealthStream (Nasdaq: HSTM), Oracle (Nasdaq: ORCL), SAP (NYSE:SAP), Access Intelligence (LSE: ACC), Bond International Software (LSE:BDI), Dillistone Group LSE:DSG), ServicePower Technologies (LSE: SVR), Tracsis (UK:TRCS)

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