

Alpha shares analysis

12 June 2023

Do these upgrade stocks still have plenty of steam?

Our stocks this week have all seen strong share price performances in the last several months, but on any share price weakness (of which all three are at some risk) investors should certainly take a look at the latter two.

- **Rolls Royce (RR)** – this business has cost investors a lot of money over a long period of time, but management change, the promise of a root-and-branch operational review, a steadily recovering civil aviation sector and a rising defence market could provide a turnaround in the group's fortunes. Unfortunately, after the shares have doubled in the past nine months any improvement seems priced in.
- **Hiscox (HSX)** – insurance is a game of risk and Hiscox has decided that it wants to up its risk profile. It is taking on more 'big ticket' or catastrophe risk and harvesting what has been a very positive environment for insurance premiums - many categories have seen premiums rise > 25 per cent in the last year. The share price has been strong reflecting higher expected returns, but all the potential is in the price at the current level.
- **NetCall (NET)** – NetCall is a software business specialising in 'low code' platforms that allow businesses from SMEs to international players to undertake digital process transformations quickly, easily and at low cost. This business has many growth paths and scope to surprise on the upside but investors have become perhaps too used to NetCall beating and upping guidance. A great business, but anything less than an exceptional trading update in August could see the shares slip. That said, this would present a great chance to buy a strong story.

Analyst: **Robin Hardy**

Rolls Royce - the comeback of the roller-coaster kid?



Source: FactSet

Rolls Royce (RR) is a FTSE 100-listed civil/military aerospace, defence and power business and not to be confused with the luxury carmaker (long since divested and now owned by BMW). RR generates around £13bn of revenues making earnings before interest and tax (EBIT) of around £600-£700mn on an underlying basis. RR has reported statutory losses since 2018 due to both Covid disruption of the aerospace sector and provisions/write-offs due to operational issues. At present, RR is not paying a dividend.

Investors have seen sizable negative returns from holding RR with a 9 per cent per annum loss over the last five years, but a more reassuring positive 47 per cent since the post Covid low in Q3 of 2020 (38p). The price has risen 127 per cent since its recent low (66p) last October.

RR is currently going through a substantial management and organisational change with the new CEO, Tufan Erginbilgic (who joined in January after a long career in the oil industry), now undertaking a root and branch review. The results of this strategic overhaul are expected to be disclosed in November 2023 and are likely to be substantial and disruptive - in a recent speech to staff, he said: "Every investment we make, we destroy value", and called RR a "burning platform".

A lot of change should be expected, although the more cynical investors might well say that they have seen and heard it all before. The bulls hope this time is different: history suggests this view is often financial folly.

Markets

The markets in which RR operates are global and have relatively few competitors owing to their specialist nature. In civil aerospace, demand for engines is largely in competition with GE Aerospace - a subsidiary of **General Electric (US:GE)**, Pratt & Whitney - a subsidiary of **Raytheon (US:RTX)** and CFM International - which is jointly owned by GE Aerospace and **Safran (FR:SAF)**.

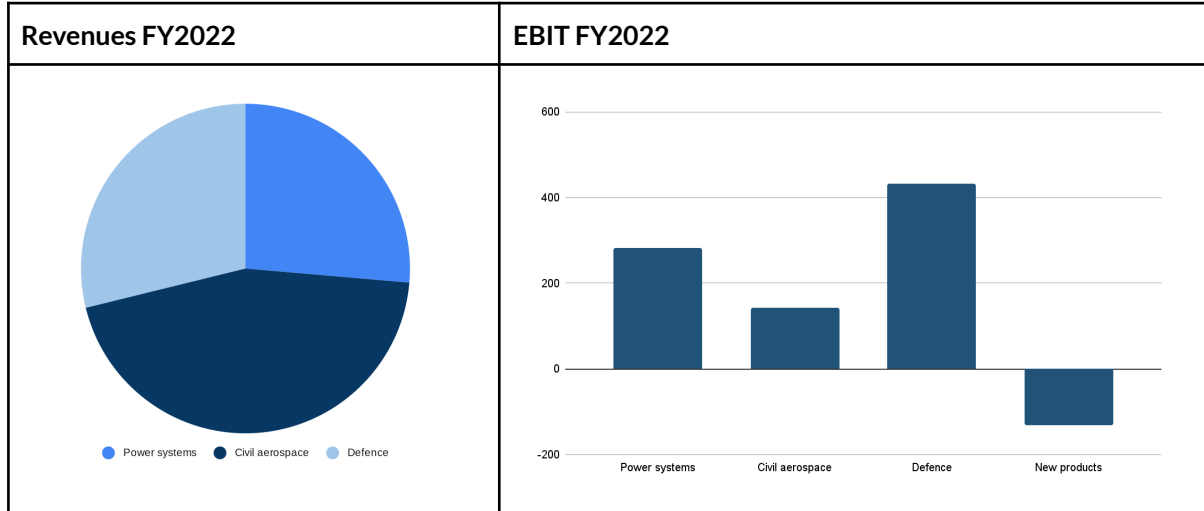
Each year around 1,700 new large passenger aircraft are delivered with Boeing (480 in 2022) and Airbus (676 in 2022) the lead suppliers, (followed by Emramer 159 and Bombardier 138) plus over 700 business jets. This translates to around 5,000 new and replacement or upgrade engines each year, and in 2022 the civil aviation market was worth an estimated \$513bn, rising to \$635bn by 2030. In 2019 (used as the best non-Covid comparator although last year was close to normalising) the civil engines market was worth around \$80bn.

The defence industry is substantial in every nation with the NATO ideal being that defence budgets will total around 2 per cent of GDP. The Ukraine war has meant that defence budgets are rising and in the UK, we are likely to see a rise from 2 to 2.5 per cent. The US remains the world's largest defence spending market with its annual budget of around \$750bn being more than that of the next 13 largest economies combined (see chart below). In defence, RR provides aerospace equipment along with power systems for land forces & ships, power systems for both nuclear & traditional submarines, avionics, digital transformation and engines for space. Global defence spending in 2023 is forecast to be a shade under \$2tn.

Operations and divisions

RR breaks into four divisions, but only three are currently active in sales, with the new products division operating in R&D mode. Revenue and profits are split as shown below.

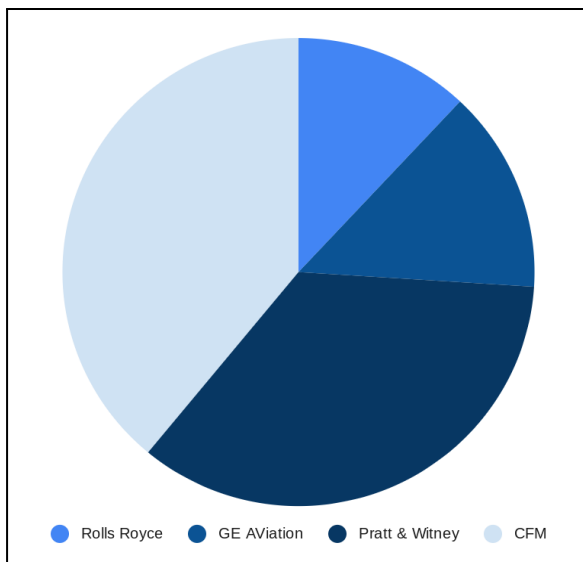
Rolls Royce's revenue and profit split



Source: Rolls Royce | New products revenue is de-minimis at £3m

Civil aerospace - as the name suggests, this division designs, builds, delivers and maintains jet engines for passenger aircraft across almost every airline in the world. It provides engines from smaller private jet power plants through helicopters, short haul passenger and up to the vast, high-bypass turbofan engines that power the likes of the Airbus A380 & A350 long haul craft and Boeing's 777 and 787 planes. In addition to the initial capital receipt for each engine (the Trent 1000 engine, the group's largest, costs \$20mn per engine), RR receives a payment for every hour each engine is flown, plus it receives sizable periodic service and overhaul revenues along with a large number of spare parts sales. Unlike the car service industry, a well run airline will tend to use original parts and not generic alternatives.

Commercial aero engine market share



Source: Statista

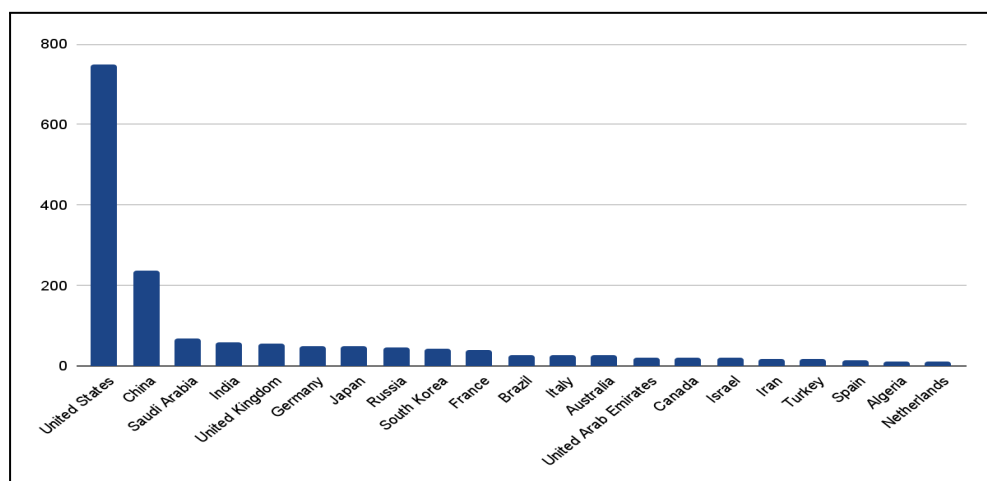
Most airlines will typically return their aircraft to RR for overhaul work, much like car owners looking to use a main dealer. The money is really made from the flying charges, services and spare parts with it always assumed (but never confirmed) that the initial sale of the engine is something of a loss-leader. Overall, RR earns only around one third of its revenues from original sales with the balance from services and some 70 per cent of revenues come from large engines, 20 per cent from business jets and the rest from helicopters and other sources.

Power Systems - under the 'mtu' brand RR provides a wide range of power systems for transit/traction of heavy land- or water-based vehicles, industrial plant and power generation. This business splits roughly equally between marine, industrial and power generation (new generation and power transition) plus around 10 per cent of revenues overlapping with defence. The revenue is split around two thirds from original equipment sales and one third for post-sale services.

Defence - the most profitable part of the group, this covers transport (helicopters and strategic transport aircraft engines), combat (jet fighter engines), naval (power systems) and submarines (nuclear and conventional power plus fleet maintenance). Revenues are a 55/45 split in favour of original equipment versus services and the largest segment is defence transport, accounting for one-third of billings.

This is a stable and long-term business with enduring contracts, long lead times and a substantial order book relative to sales. Against revenues of c.£3.5bn, there is an order backlog of £8.5bn and order intake of £5.4bn in 2022.

Top 20 nations in defence spending - \$bn 2023 forecast/budgets



Source: worldpopulationreview.com

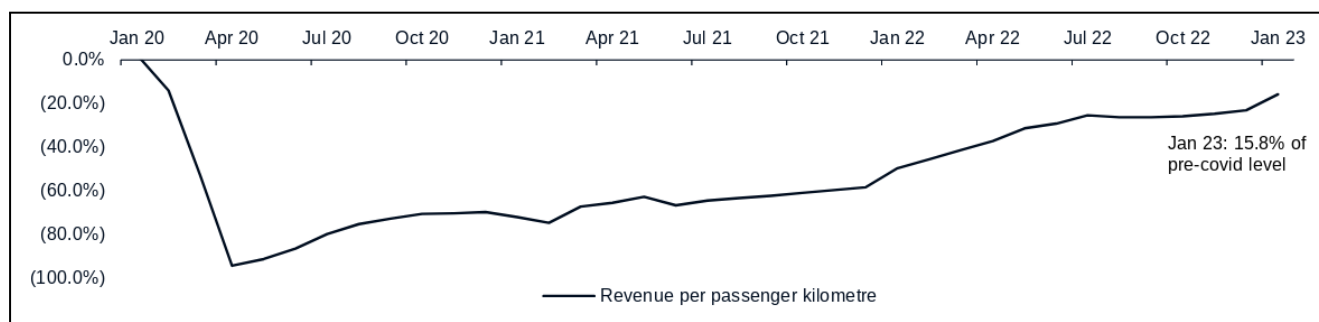
New products - this is essentially two business lines: electrical aero engines and small modular nuclear reactors (SMRs). There is minimal revenue (£2mn-£3mn) and sizable losses (over £100mn), which is mainly the early write-off of R&D spending (£108mn in 2022). The R&D spend splits broadly 2:3 in favour of SMRs.

Business issues

There have been a lot of problems at RR, but there is a large and solid core within the business that should be capable of making decent returns for investors. However, the last five years have been riddled with global macro problems alongside problems of the group's own making.

Covid-19 hit commercial air travel exceptionally hard with outright travel bans. Total hours flown remain below 2019 levels (see Figure 4), but are recovering robustly and faster than originally forecast. The world does remain vulnerable to pandemic risk (especially in China and its more draconian lockdown policies) and geopolitical instability, but the trend does suggest that within 12 months air travel should exceed 2019 levels and that 2024 as a whole will be the first year higher than 2019. That said, the pressure on consumer spending is a drag on the speculative flight boom that had dominated the previous decade and more. New engine sales will suffer a long tail effect as plane replacements and service intervals are pushed out, but as growth in hours flown continues, maintenance shop visits will improve.

IATA passenger miles flow



Source: Shore Capital, IATA

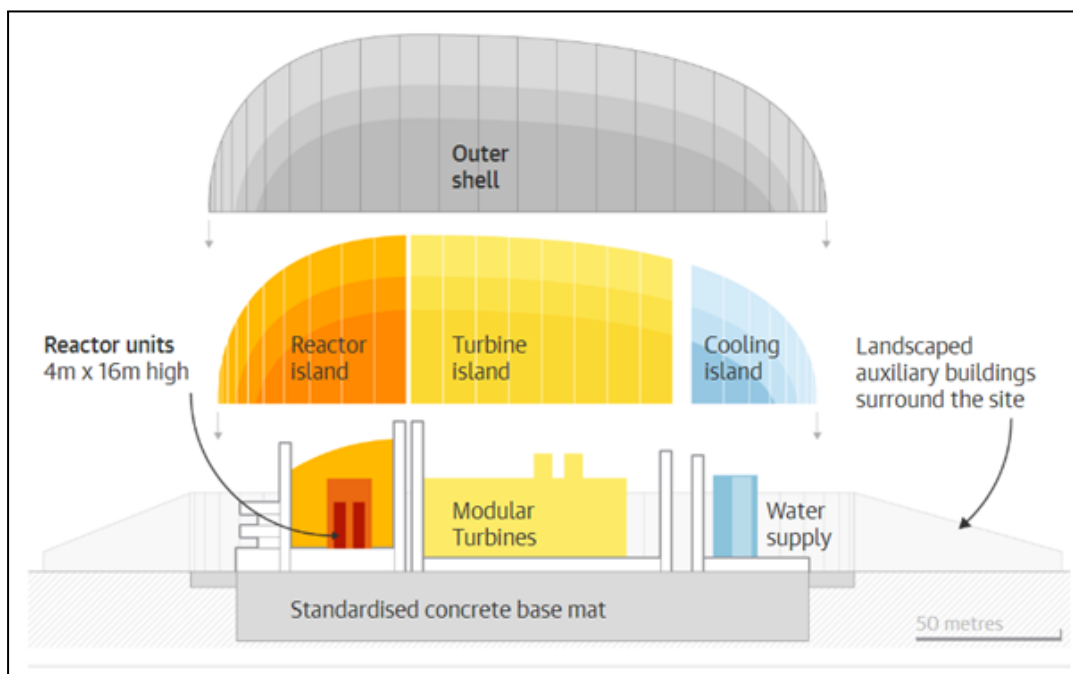
Trent - the flagship Trent range of engines has become something of a liability for RR with problems now reaching back more than a decade with engine reliability problems, premature blade wear and fan blade fractures leading to both expensive repair costs absorbed for operators and significant de-design and re-working in production. It is not entirely clear that even today all of the issues are addressed. This has led to a material loss of market share with US airlines gravitating to GE and Pratt & Whitney and Airbus also looking more to GE and CFM.

SMR - these are smaller nuclear reactors (typically up to 300 MW as compared with large format reactors running at above 1 GigaW) that offer a range of advantages over large stations. These include longer re-fuelling cycles, faster development, lower cost, more flexible siting, having common elements of design (most large stations are bespoke) and allowing poorer nations access to nuclear power. This market was worth \$3.5bn in 2020, but forecasts suggest \$20bn by 2030; that is 20 per cent compound growth.

Globally the market is good, but the UK is lagging behind the global trend and is not expected even to publish its tender proposals until the end of 2023. RR, given that it is in joint venture with the UK government, was assumed to be certain to secure the contract to develop the UK SMR programme. However, in March, the chancellor announced that there would be a competition and tendering process rather than a direct award to RR.

This has damaged confidence in the group both in this area and overall. If RR was to lose out to one of the established international players (GE Hitachi, Moltex, NuScale Power or Terrestrial Energy) on its home turf, then there would be grave doubts about its ability to ever make money in this space.

Rolls Royce SMR schematic



Source: Neutronbytes.com

Electric aero engines - it is still far from clear whether this is a realistic proposition that could revolutionise flight or whether it is a vanity project. RR does need to be in the game in case an electric revolution does happen and traditional engines begin to be phased out.

The danger has to be that if electric does become viable it is likely that new names will have material market share, such as Textron, that are not involved in fossil fuel engines.

Hedge rate - like many international businesses, RR sells in US dollars but reports in sterling and, as is also typical, there is hedging in place to smooth out currency fluctuations. These are contracts set to a similar duration as the service agreements or defence contracts, so are typically set to durations of five years or more. This can often result in mismatches between contract and spot exchange rates which will distort the reported profits, cash flows and asset values from their constant currency levels. While this is a common issue for international businesses, it has long been more extreme with RR and is a drag on the visibility and reliability of forecasting.

Debt - RR has fairly high debt, unsurprising as it has had to absorb the huge repair costs in Trent while at the same time seeing depressed income and still having to commit heavily to R&D. Although debt is falling, it remains at more than 3x Ebitda (earnings before interest, tax, depreciation and amortisation). However, some observers see RR's practical debt as being much higher due to something called LTSA or long-term service agreements. These are prepayments by customers in the civil division on an annual basis meaning that when RR undertakes a 'shop visit' for overhaul the customer does not have to pay then but rather deduct the costs from their prepayment balance. Payments are typically made five to 10 years in advance.

While this is not debt in the true sense (as it is not interest bearing nor are the balances 'callable' by the other party), it is substantial at £12bn and risks becoming more of a financial burden should the flow of new engine business begin to decline.

Structural review - this is the most important issue today when looking at RR. Essentially, no one has any realistic insight into what the review will look like and what business areas will be either reshaped, put in joint venture or even sold. While the real focus of problems is civil aerospace, there is a risk that any reshaping also spills over into the more robust parts of the group with an eye on debt reduction. The only area where there is a more solid expectation is electric aero engines where a sale or closure is seen as likely.

The most likely outcome does risk being that there are promises of improvement and action plans across a wide range of activities with plant closures and the sale of some sub-business units that prove a hard sell to both customers and investors. It will be hard to convince investors that a piecemeal approach will yield either rapid or substantial results and tougher, larger actions risk pushing new business away to the competition. This is a real tightrope exercise. It is unlikely that any of the three divisions will be sold or

demerged outright, although doubtless some investors might like to see the civil aerospace divisions receive more aggressive action.

There is a risk that the review turns out to be a damp squib and investors see too many empty promises, only generic cost saving plans over the long-term, big savings promised without fine detail or re-hashes of things that have been tried and failed previously.

On a more bullish note, the problems at RR are largely contained within the civil aero business with more than half of revenues and a greater amount of the profit arising in businesses with much more positive prospects.

Defence - things are looking pretty good here with both the global uplift in defence budgets and more specifically successes for RR such as the AUKUS (Australian submarines) contracts a notable win. This is for now the bedrock of the group's business and it is hard to see either trading weakness or market share losses with the order backlog rising so strongly. Profits did drop in 2022, but that was due to a one-off sale of legacy spares in 2021 and increased, not yet recovered R&D.

Power systems - this is another bullish area primarily due to more nations (and some national public bodies) looking to improve their energy independence and core infrastructure resilience. There is a global trend towards local rather than centralised generation with a greater focus on clean energy systems. Revenues in 2022 in this division rose by almost a quarter and the order intake by almost 30 per cent.

Valuation and conclusion

This is a stock driven much more by perception and operational practicalities than it is by more traditional valuation approaches. The operational review is pivotal to whether investors will consider taking a fresh view and the outcome of that process is still four to six months away. As discussed, the risk has to be that the review is seen as lacking bite and is not really capable of delivering a more robust business footing, confidence about the future levels of profitability and assurance that the problems with Trent that have dogged the business for so long will not recur and, more importantly, will not arise in any future variants or new engine ranges. Unless the review is very compelling, too many investors are likely to remain indifferent, those who did believe substantial change could come may join the negative camp and airline/aircraft manufacturers customers could continue to drift away to the competition.

This is not a sound basis for making an investment and starts to feel more like a gamble. The statements from the new CEO have been very aggressive and that could mean that the business that emerges from the review is very different from the one we see today.

The market would then have to take a view on both the timing and deliverability of the changes, then try to work out the earnings, cash flow, debt and dividend implications and then work out how best to value those key metrics.

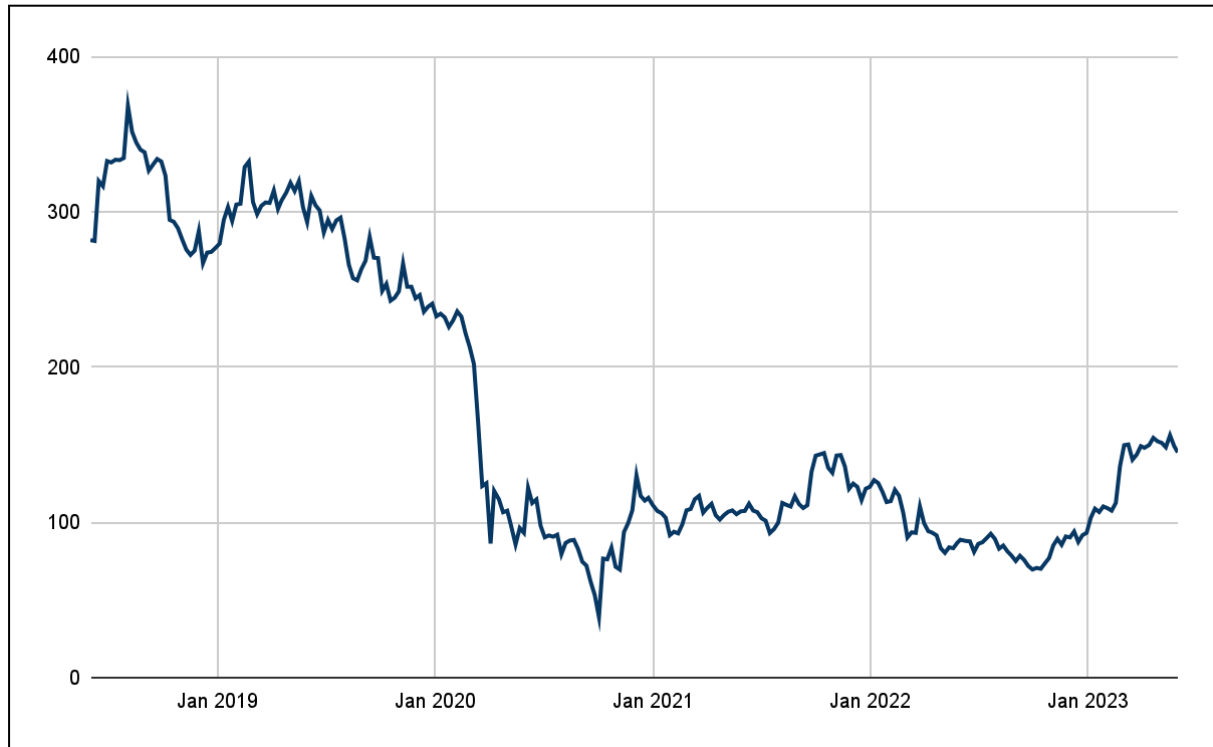
The bullish view says that all of the problems with Trent will soon be addressed; that defence spending is set to rise for many years to come; that the civil aviation market returns to a growth path after more rationalisation; and that the new markets (especially SMRs) begin to make a solid contribution later in the decade. If all of those come to pass, the argument would be that RR is good value on a recovery rating basis: on Year 2 earnings per share (EPS) of 7.7p, the price to earnings ratio (PE) is 20x. That might be right but one cannot be sure that this will be delivered or even what levels of earnings we will be looking at in light of the review.

Analysts are fairly split on this stock with target prices in the range of 92p to 210p against the current 148p. Clearly some analysts believe that the strategic review is going to present an unattractive new Rolls Royce and/or that Trent remains an issue; China becomes a major drag on the industry and business; and that there is material risk of future long shutdowns that need at least to be acknowledged in any valuation. That said, most target prices are actually sitting pretty close to the current price suggesting that unless the CEO's review really knocks the ball out of the park, any good it will deliver is already pretty well priced in.

The shares were cheap last autumn at below 70p, as at that price only negative outcomes can have been in the business assessment, but they have doubled since then as the market began to see that the rot had been stopped. To really improve from here there would need to be a really radical change pushing margins to levels hitherto unknown in the industry, belief in big market share wins, a very bullish outlook for total hours flown, faith in major defence wins and big returns from new ventures.

That feels like too many ifs and maybes for a business with a bad rap sheet. While it feels like the bears have got this one wrong and the shares seem unlikely to fall back to below 100p (although they would in the event of another pandemic, but then the whole market would suffer not just RR), there just looks to be too little upside. Perhaps the shares could reach 180p by the end of 2025 (that would be an 8 per cent annual return) but for the risks still present, that figure really needs to be higher. Holders should stay put but speculators should look elsewhere.

Hiscox - the art of risk



Source: FactSet

Hiscox is a Lloyd's insurance syndicate specialising in catastrophe, SME (small and medium enterprise) commercial and specialist/complex personal lines. It does not offer 'mainstream' insurance (life, household or motor) which remains the preserve of the general insurers such as Aon, Aviva, LV= or Direct Line.

Hiscox is a constituent of the FTSE100 index, sitting towards the bottom end of the table with a market cap of just over £4bn. It collects premiums of around \$5bn per annum and like all insurers of its class has highly volatile profits and the shares are valued against the net book value (on an economic value added or excess over cost of capital basis) rather than by profit multiples. Returns for shareholders have been negative (-16 per cent) over five years as Covid sharply lowered demand for many types of insurance (such as shipping) but in the rebound over the last three years, total shareholder return (TSR) has averaged above 15 per cent with over 25 per cent in the last year.

Market

The insurance market is immense, annual premiums written approach \$6tn with the split between life cover and insurance of goods and chattels standing at around 40:60, but market growth has been led by non-life insurance, the field in which Hiscox operates.

Insurance can be provided either fully against the balance sheet of a single insurer or 'syndicated' (pooled) across a number of smaller insurers or underwriters: Hiscox more typically works in the latter.

Insurance at its heart is quite straightforward. Insurers collectivise a basket of risks (potential negative outcomes) with customers paying for the insurer (the premium) to assume risk on their behalf. Insurers tend to specialise by risk type (weather damage, shipping losses, cyber-losses, professional liability, art, aviation etc), size of any potential payout (potentially \$billions in catastrophe risk such as US hurricanes), level of risk assumption (wholly owned or 'laid-off' to the third parties) and geographical bias (US settlements are typically largest, for example). Across the cycle, insurers typically collect more in total premiums than legitimate claim payouts and this is their profit. This means that performance in any one year should not be viewed in isolation.

Insurance premiums are driven not only by an assessment of a risk itself, but also the capacity in the market of those willing to assume risk. At present there is a general lack of insurance capacity globally (many players have withdrawn capital) so insurance rates have been rising, in particular in big ticket risk.

Historically, it would have been assumed that the global insurance market was likely to show growth similar to global GDP but that is no longer the case. There are today totally new risks (cyber/ransom attacks, social media casualty etc) and changes in the periodicity of major risks, especially in catastrophe cover. We now see what were previously 'once in every 50 years' storms every 10 years, for example. This means that there are more customers, in more fields, looking for more cover.

Operations and divisions

Hiscox's operations can be broken down a few different ways, by:

- **Risk class:** Retail/big ticket - this looks at the precise nature of the risk being insurance.
- **Risk type:** granular analysis of the sub-classes of risk
- **Mechanism:** own risk underwriting, participation as a Lloyd's syndicate or managing reinsurance of risk to third parties.
- **Geography:** USA, UK, Europe and Asia - this looks at the domicile of the insured.

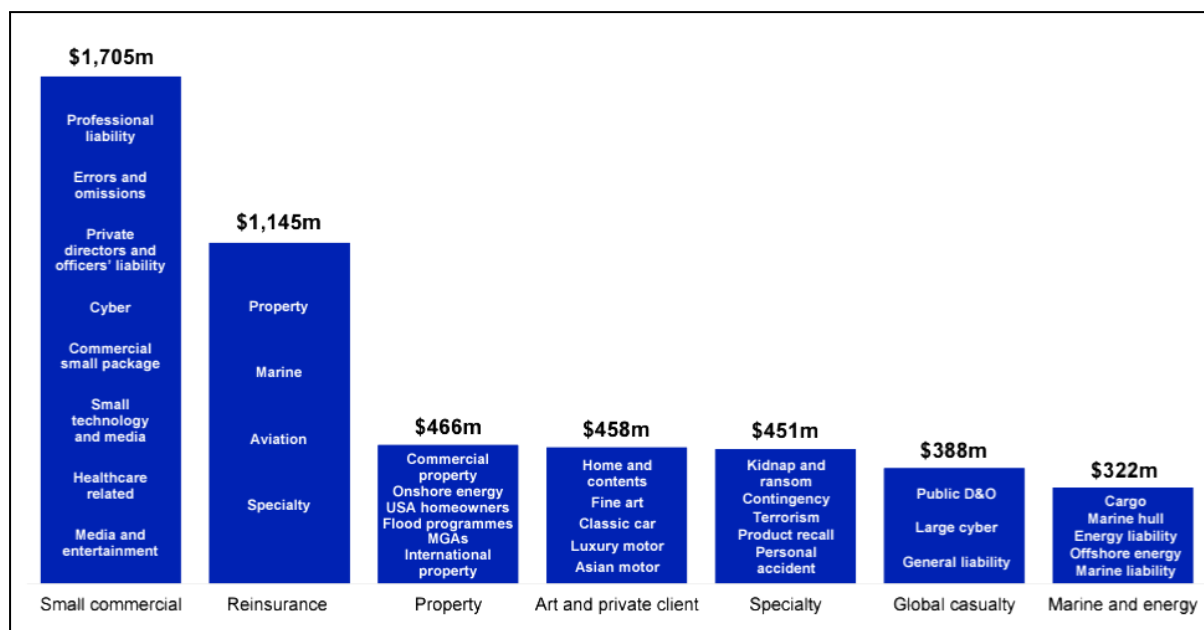
Risk class

There is close to a 50/50 split on gross premiums collected on this basis; actually 51/49 in favour of 'big ticket' risks. Big ticket insurance covers the likes of weather catastrophe, oil spills, natural disasters, major building failures, terrorism, commercial product recall and marine shipping/cargo. About half of total risk is 'laid off' through reinsurance. Retail covers risks carried against the group's own capital (i.e. it is underwritten) as each risk is smaller and, generally, relatively predictable. Half of the risks here are operational risks for SMEs with the balance spread between art, kidnap, ransom (personal and IT hijacking), technology failures, media casualty (negligence in media content, websites and social media) and personal property (high ticket, specific risks). In common with investment risk, big ticket has the highest risk and should/can be the most profitable but is more volatile.

Risk type

This is a granular analysis of what is being insured, and is best viewed as a graphic..

Granular analysis of total gross premiums



Source: Hiscox

Mechanism

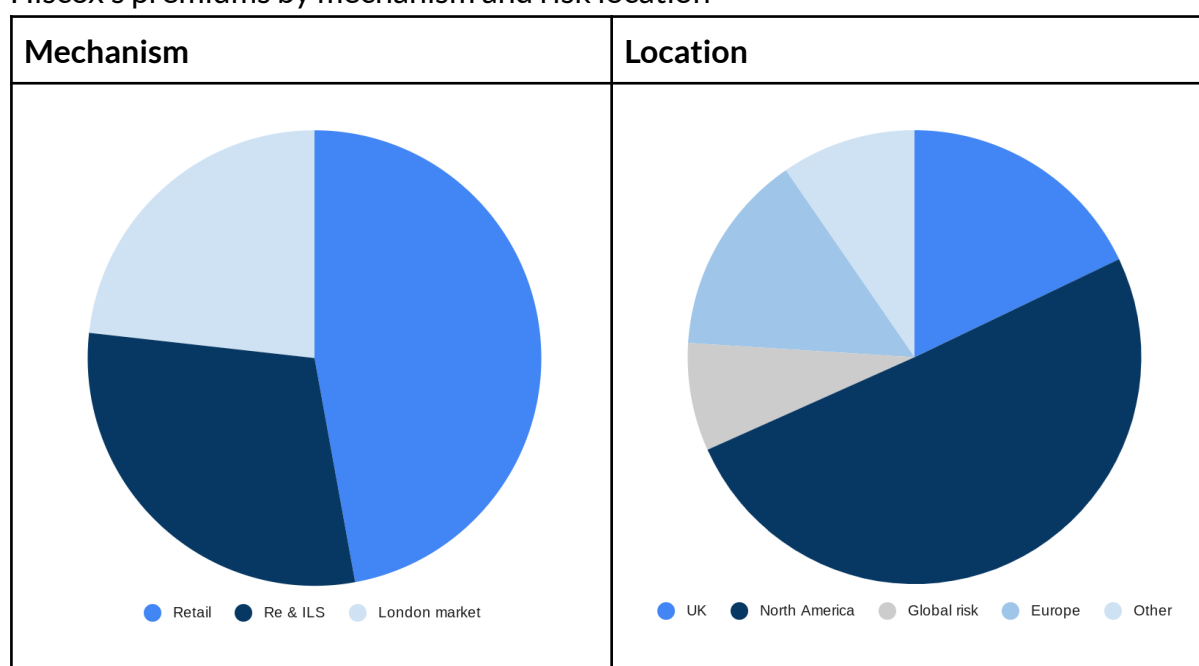
There are three basic mechanisms by which Hiscox writes premiums: **Retail** is risk fully taken onto the company's own balance sheet; **London Market**, again on its own balance sheet, but sharing risk with other Lloyds' names; **Re** (reinsurance); and **ILS** (insurance linked strategies) which is a way to lay off risk to third parties for large ticket risks and collect management fees. In Re, the counterparty is another insurer and in ILS, they are

private investors or investment funds buying 'shares' in pooled or specific risks - these are sometimes called 'catastrophe bonds'. See the charts below for the split.

Geography

This shows where the risks are assumed by the end-client or asset insured's location. See below for the split.

Hiscox's premiums by mechanism and risk location



Source: Hiscox

Business issues

Insurance companies make their money by taking risks, so taking on board more risks or shifting the bias towards bigger risks means that the returns should increase. The strategy at Hiscox for some time was to grow by taking on more of the smaller risks, primarily in the retail side because the big ticket side of the industry was not able to deliver high enough premiums for the often bruising losses that arose especially in catastrophe insurance.

The problem with smaller and retail risks is that the market has been very competitive impacting premiums: most work was sourced through brokers meaning that a sizable amount of the premium was paid away especially for more complex risks, insufficient risk could not be 'laid off' as reinsurance is only interested in large risks and while more capital could be deployed, the returns were not able to increase. In addition, with Hiscox retail's bias towards SMEs' general business risks, Covid hit hard and even led to Hiscox needing to raise more capital.

The combination of these two downward pressures on RoE (returns on equity) helped to drive the stagnation and then decline of what had been a steady uptick in the rating of the stock which fell from trading at 2.5x book value of equity pre-Covid, bottoming out at just 1.0x book.

There are now a number of strategies in hand that appear capable of pushing up returns.

Swing back to big-ticket - management has decided that it wants to push itself into more large risk insurance both in the Lloyds' business and in reinsurance. Hiscox is clearly confident that it is able to both manage and offset these larger risks profitably especially as it is looking to move to much larger risks (100-year interval events rather than five to 10 years) where the competition is lower and the premiums much healthier. Overall, this is seen as a better quality risk. The largest increase has come in the reinsurance sector (up 38 per cent in Q1) meaning that Hiscox's overall risk on its own account has increased to a lesser extent. While the type of risk that it will assume has changed, the total amount of business that Hiscox is looking to write has not changed: the reason why is below.

Harvesting higher premiums - in the last 18 months or so the premiums collected on larger and more complex insurance have been rising rapidly across most categories. In the catastrophe sector premiums are up by 25-40 per cent, 'non-cat' by 25-30 per cent and in specialist retail there have been high single digit percentage increases.

The main drivers have been: indexation on some contracts so winning from high inflation; insurers more aggressively pre-empting inflationary pressures on claims; a lack of capacity in the reinsurance market (in particular in the ILS segment); and demand for more volume and a higher value of cover, especially in the US. Hiscox has chosen not to seek a double benefit of higher premiums and higher volume but has instead chosen only to harvest the higher premiums to push up its returns. While this is a positive now, however, it may not be sustainable.

Digital trading - starting in the US retail market, Hiscox is looking to replicate the changes made many years ago in personal insurance that allowed clients to deal directly with the insurer rather than using a broker. Costs are lower (no shared premiums) and increasingly (as ever, here comes the impact of AI and machine learning) premiums can be determined automatically in a number of less complex and more data rich end markets. The US portal has been live for a year and has gained a lot of traction. A similar platform is now being developed in Europe but we see no signs of this repeating in the UK.

Growing European critical mass - this has been an underweight division for many years and struggled to compete with the large domestic insurers and the very strong reinsurance sector especially in Germany and France. Premiums collected have doubled in the last five years although still something of a minnow: gross annual premiums are \$500mn as compared with Munich Re which is forecast to collect €58bn in 2023. This is a profitable operation but while it remains a drag on overall returns, it is less so year by year.

Valuation and conclusion

We had previously been expecting Hiscox's strategy to sharpen up the retail business and drive up overall returns by removing this drag on profitability. This is still taking place across the US, UK and Europe but management has instead decided to light the afterburners to take a higher risk and (ideally) higher return route by pushing big-ticket risks as well. It is easy to see why this would be preferred - the higher average returns are simply there for the taking without the grind involved in making the retail arm a structurally better business.

This is picking the low hanging fruit, which is understandable but does this produce the best quality of earnings? Probably not. First, upping the exposure to big ticket risks makes everything more volatile although driving a lot of the growth down the reinsurance channel does smooth things out to some extent. The net asset value (NAV, is the main valuation metric) might be higher than today in 2025 this way but there could be another Hurricane Katrina in 2026.

Second, by using inflationary pressure to drive premiums rather than pushing volume or a mix of the two could be viewed as delivering incremental growth with a "PE of 1x", much the same as the low quality of earnings the market sees for house builders when rising house prices are the primary driver.

Third, the strength in premiums could easily prove unsustainable. If the rising premiums are a function of too little market capacity, it is likely that new capital and capacity will ultimately be injected back into the market and switch the pricing momentum around. It is also possible that a couple of relatively benign claims periods could even see premiums dropping in later years, possibly by 2025.

What matters in terms of the equity valuation is that:

- 1) The NAV continues to rise by retention of premiums minus claims and that is certainly what the consensus is expecting. There should be a solid NAV uptick in 2023 with expansion moderating but continuing in 2024 and 2025 - analysts have

raised their 2025 NAV forecasts sharply in the last six to nine months. This has helped push up the share price accordingly. Note, however, that the NAV dropped in 2022 largely due to currency fluctuations.

2) The return on equity (RoE) is sustained above the weighted average cost of capital (WACC). This is comfortably the case today with historic RoE of 20 per cent, forecast to rise to 22.5 per cent by 2024, but then likely falling back to nearer 20 per cent by 2025. Analysts' RoE forecasts have also stepped up in recent months following the refocusing of the risk strategy, which has also been a key part of pushing up the share price.

In the current interest rate environment, however, we would also expect the WACC to rise as risk free returns rise. The 10-year Gilt is edging higher and is now only around 20 bps lower than in the wake of September's corrosive mini Budget. Analysts reckon the WACC is around 12 per cent, but that could easily rise another 100 bps (a basis point or 'bp' is a hundredth of one per cent).

3) Investment losses are controlled. Another issue (and one that hit in 2022) is the nominal capital losses on the bonds in which the premiums are invested to make a secondary return. Bond yields are still rising (so their prices are falling), which means that Hiscox is again in 2023 likely to post book losses on the bond portfolio. In 2022 bond losses (albeit largely unrealised book or 'mark-to-market' losses) came close to wiping out the profits from underwriting.

The equity valuation here is essentially a mechanical economic value added (EVA) calculation:

Fair value of equity = $(\text{RoE} \div \text{WACC}) * \text{NAV}$

- That means that using historic book value of US¢701, the fair value for the equity looking back is: $(\text{¢}701 * (20 \div 12))$ or ¢1,168.
- On a forward basis using FY2023 NAV: $(\text{¢}819 * (21.6 \div 12.75)) = \text{¢}1,387$ of fair value.
- Now, the shares trade in sterling so we need to adjust this for the £/\$ rate now at almost 1.25 (up from a 12 months low of 1.075). That means fair value for Hiscox is around 1,110p, pretty close to today's share price.

That suggests that there is now limited upside in the Hiscox share price with the increase in NAV and RoE estimates most likely having run their course. There is scope for some

drag along improvement as the NAV should keep rising into 2025. However, the expectation is that premiums may be falling by then and the RoE likewise (maybe back towards 20 per cent), which could push shares higher, perhaps to 1,300-1,350p. However, that means a TSR of only 4.5 per cent per annum across three years.

The shares are neither cheap nor expensive, are likely to mark time through the summer hurricane season and could be discounting a reasonably benign catastrophe profile for 2023, so there would be little benefit if Hiscox avoids major losses. The risk feels slightly more on the downside with higher catastrophe risk assumed and there are grounds for some reservations about the quality of earnings. So it looks best to wait for a fall back in the share price before taking another look at this one.

NetCall - driving digital conversion



Source: FactSet

Netcall is an Aim-listed software business operating in the business automation and digital transformation sector. Founded in 1984 and listed on Aim since 1996, this business has a market cap of close to £200mn, delivers revenues of £30mn, generates Ebitda of c.£6.5mn and profit before tax (PBT) of around £4mn.

It has net cash of £14mn on its balance sheet and, perhaps unusually for a growth business, pays out 25 per cent of its earnings in dividends. However, the yield is less than one per cent. TSR has been a very respectable 11 per cent per annum in the last five years but in three three years (including the Covid period) it has been greater than 33 per cent in the last two years and in the last year more than 70 per cent.

Market

Netcall's business area is digital transformation, the adoption of digital technology and processes by organisations (companies and public sector bodies) to migrate manual products, services or operations to a digital format. Today, such services are typically managed online or 'in the cloud' and are sold as Software as a Service (SaaS). This means users 'rent' or pay subscriptions for the software that runs remotely (in this case on the Amazon AWS infrastructure) rather than the traditional model of licensing and installing software on owned, local servers.

Globally, this is a vast and fast growing market as organisations look to both modernise internal and customer-facing processes and overcome the double-headed problem of labour shortages and spiralling employment costs. In 2022, GrandView Research estimated a market value for digital transformation of \$164bn and sees growth of more than 25 per cent from 2023 to 2030, suggesting the market will by then be worth \$500bn-\$600bn.

This transformation process is impacting organisations of all sizes from local government departments through to global financial services organisations. Change can be anything from a basic mimicking of manual tasks right through to process automation using machine learning (ML) and artificial intelligence (AI) potentially replacing or bypassing human tasks.

Operations and divisions

Prior to 2017, NetCall was essentially a telco software provider focused on customer engagement solutions (call centre and customer services call handling, data retrieval and logging systems), before buying MatSoft which accelerated the group's positions in automation tools, cloud services (SaaS and PaaS - P being 'Platform') and in 'low code' solutions that are now the heart of the group's Liberty software suites.

The core product is **Liberty Create** which is essentially a 'drag and drop', graphical user interface online solution. This allows its customers to build cloud-based webapps without any coding requirement to build either internal or external interfaces for staff and customers. This means that intuitive solutions can be built and adapted quickly without needing expensive IT consultants to build bespoke solutions or having to make-do with

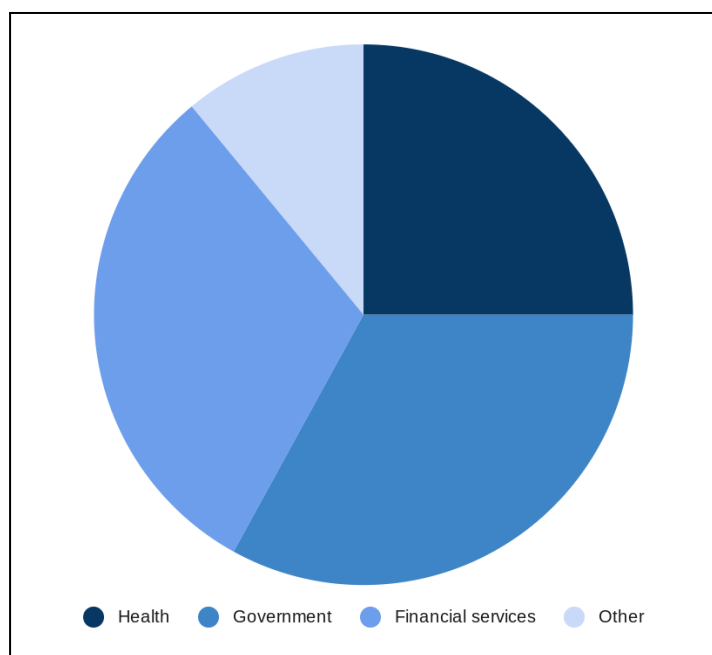
off-the-shelf software (such as Microsoft Azure or 365) that never quite fit the precise requirements.

In addition to the 'low-code' platform builder tools, customers are able to access underlying code to allow competent coders to build very specific requirements. They can also programme robotic or repeat processes to free up staff (using **Liberty RPA**), provide 'chat bots' for wait-free customer communication or 'chat services' to expand capacity (using **Liberty Connect**) and build contact centre data access and logging (using **Liberty Converse**). RPA, Connect and Converse are increasingly integrating ML and AI capabilities.

In addition to its own IP, NetCall also allows customer and external developers to create and share in a library of apps to avoid users having to reinvent the wheel. It also provides bridging software to connect its platform with other proprietary platforms such as Experian, SAP, Oracle, DocuSign and Salesforce and to use social media or SMS platforms for communication.

The bulk of Netcall's services are now cloud-hosted with two-third of revenues arising from SaaS channels and the remainder from servicing and maintaining legacy local install products. This means that some 79 per cent of its reported revenues are recurring.

Netcall's customer industry bias



Source: NetCall

NetCall reports that it has over 600 customers from SMEs right up to multinational financial services players. It works with local and central government, hospitals / health

trusts, utility companies, Nationwide Building Society, Santander, franchise railway operators, insurance companies (including Legal & General and the Lloyd's Market Association) and some of the 'challenger' banks. Users typically start small such as with Nationwide which commenced with managing account transfer only before deploying NetCall's products elsewhere. Customers in this space appear to be very 'sticky' and 90-95 per cent of NetCall's revenues are consistently renewed.

Business assessment

NetCall feels like a strong business in an attractive market with high and enduring growth. Automation and digital solutions are some of the largest themes in IT and are widely seen as business essentials rather than optional or vanity projects.

A more defensive IT sub-sector - digital transformation should be more defensive if we are heading into both a tougher economic climate (as we discuss below NetCall is heavily biased towards the UK for its revenues) and concerns that many IT budgets are being, at best, trimmed. In addition, this type of lower cost, somewhat DIY approach to digital transformation makes very high levels of return on investment/outlay for those customers using it. Market share may even grow into stiffening economic headwinds.

It is likely that a growing number of businesses abandon a 'making do' approach using off-the-shelf products or using high cost, bespoke coding / development to instead go down the 'low code' platform development route.

M&A scope - much of what we see today in NetCall came about through well-executed and strategic acquisitions. Having a strong balance sheet (£20mn this year end and then on towards £30mn of net cash is forecast) and arguably too narrow a business footprint given the market potential (see below), we could see some value-adding M&A opportunities. AI & ML are fast growing areas ideally matched to what the group's other products aim to deliver but would likely be too hard and slow to develop organically.

There are also numerous developments in web applications that could usefully be bolted on: optimised voice search, cybersecurity, serverless architecture (a way to stop relying on the likes of AWS) or progressive web apps (eliminating the need to separate mobile apps and traditional websites) amongst many others that again are better acquired than built organically. However, a more likely path of investment initially would likely be to improve the geography.

Too focused on the UK - around 80 per cent of the group's revenues today come from the UK and this would not be considered the most attractive IT or digital transformation market, and likely to lag the rates of market growth we indicated in the section on the group's markets. Ideally there would be a great footprint in the US but the board would need to be careful to avoid a skills overlap. There would need to be a useful, additional technical skill set acquired, but primarily a strong customer base that can be readily cross and/or up-sold on the Liberty suite.

The board looks to be in no hurry and there is no current pressure from shareholders to make a spend or return decision on the cash - that might, however, not be the case within a couple of years. A good deal should boost the share price and potentially trigger a re-rating process.

Contracts getting bigger - typically a contract value for NetCall will be around £200k per annum, but contracts are getting larger either from the outset or by customers taking more products. A great example of the former is the unnamed international financial services company that placed a \$19mn, three-year initial contract (\$5mn + \$7mn + \$7mn) for Liberty Create and RPA in June 2022, but management is keen to stress that this was likely to prove an exceptional, perhaps a one-off, deal size. However, it is possible that contracts worth \$1mn per annum initial consideration could follow as NetCall proves it can deliver for much larger businesses. For the latter growth driver, UK Power Networks is a great example of expansion by product and deploying across more disciplines and here an initial \$50k contract has grown to now be closer to \$500k.

New wins - winning new customers is important but management is much more focused on cross/up selling existing customers to take more of the Liberty suite of software and to persuade customers on legacy, locally installed software to migrate to SaaS. This means that the current consensus is based on very conservative assumptions about the securing of new and/or larger clients and is primarily (i.e. about 70 per cent) driven by projected expansion of business with existing customers. While the \$19mn deal is unlikely to be matched, any new deals of a larger size (say \$3mn-\$5mn over three years) would trigger forecast upgrades and the share price would likely follow suit.

Bigger contracts are more efficient and allow more of the over 80 per cent gross margin to fall through to net returns and help the still below average margins on the more exotic end of the portfolio to improve. Within an overall 20 per cent Ebitda margin, legacy contracts, installations and service revenues still make above 25 per returns while the likes of RPA, AI and ML probably still struggle to

make a decently double digit percentage return. As these newer business lines mature, analysts believe that they will comfortably exceed the group average returns, potentially allowing the group to make overall Ebitda returns pushing 30 per cent.

Enhancing the solid and stable software suite - an important development for NetCall is making sure that emerging technologies such as OpenAI or ChatGPT are able to be (and be seen as) complementing the group's existing technologies rather than becoming rivals to them. There is a lot of headless-chicken thinking about what AI is going to do, such as dismantling existing business models and observing existing processes, bettering them and stealing their customers. ChatGPT is really just a language engine and is not capable of the disruption and chaos with which some observers seem to credit it. That is not what AI is likely to do and it is still a harnessable technology rather than a plague of locusts and when these big name AI systems begin to make their platforms open (or more likely 'ajar') NetCall should be able to augment its existing offering.

Valuation and conclusions

This is transparently a business with strong prospects. Digital transformation is a huge area of IT as a baseline and NetCall's suite of products and services have shown that the 'low-code' approach is not just something for SMEs with limited IT capabilities but can also scale up for global business, even those in heavily regulated markets and with high security requirements.

The group has shown that it can grow its business strongly mainly by having its existing customers take on more services; this is a very attractive profile. This also means that it has the scope to accelerate its growth by pushing harder for new sign-ups especially where those new customers now could easily be much larger and coming from outside the UK. The latter would be accelerated by investment in acquisitions or joint-ventures and the burgeoning net cash balance makes that possible. On top of all this, there are benefits or economies of scale and operational efficiency with a larger revenue base capable of narrowing the gap between the high (but fairly typical for the industry) gross margins and the net margins.

This sort of multifaceted profile is very attractive as it provides market-beating growth in a favourable climate but also provides something of a safety net should market headwinds develop. On that latter point, underlying market momentum in digital transformation is sufficiently strong (it is now really a 'must have' investment for organisations of all types and sizes) that even a fairly testing economic environment would only be likely to slow growth rather than cause a reversal.

So the prospects are very favourable but what about the likely share price performance? The shares are today five times higher than the Covid low of 22p, they have more than doubled from the low point after the 2022 technology sector sell off (they fell from 85p to 52p in that process) and are standing at all time high. But what is the market now expecting?

Recent performance has set expectations high and in a now long string of trading updates investors have been rewarded with positive trading news and earnings upgrades, so much so that this has now become something of the norm. While analysts believe that the next trading update is likely to indicate that the 2023 full-year outcome (to June and out in early August) will suggest that the consensus will be beaten, there is a danger that is already baked into the valuation. That means potentially we have a case of it being better to travel than to arrive.

Anything in the next update suggesting that trading is in line or that consensus is about right does risk the shares facing a bit of a sell off in the near term. However, were that to happen, that should be seen as a decent buying opportunity for a strong equity story.

Broker Singers sees the nearest comparables as **Cerillion (CER)**, **Eagle Eye (EYE)**, **Quartix (QTX)**, **Bango (BGO)**, **dotDigital (DOTD)**, **iQGeo (IQG)** and **Gresham Technologies (GHT)**. NetCall shares are trading at a modest discount to this peer group but only if you look at the valuation on a free-cash flow yield basis.

If you look at the PE, then NetCall is on a higher rating than many of these others and is on the same rating as Cerillion. That said, growth is faster at NetCall and the growth feels more broadly based suggesting that a premium rating is supported. None of these are cheap stocks with the year 1 PE over 30x at NetCall but when both the rate and quality of earnings growth are high, the rating will be too.

After a sudden spike in the share price at the end of May (up 16 per cent in two days) the shares are in need of a very positive update in early August if they are not to slip back to a level closer to 100p, around where they had sat for most of 2023 to date. There probably is a fair value around 130 to 140p on an 18-24 month view but holding fast and assuming that the trading update only confirms a beating of the consensus rather than 'beating the beat' as it were, the coming weeks feel likely to present a better buying opportunity. If we see any more substantial contract wins, major contract expansions or NetCall makes a good acquisition, there is scope for a re-rating and fair value could easily run out higher than the 130p-140p, but this is much more speculative.

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