Investors' Chronicle | Alpha

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Alpha shares analysis

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Flying high

Our two stocks this week sit at very different ends of the size spectrum. The solid mid-table FTSE 100 operator and the Alternative Investment Market (Aim)-traded minnow both have positive long-term prospects driven by industry backdrops and their own positioning. We see scope for good rates of total shareholder return (TSR) at each, but there are complexities that need to be well understood before investors take the plunge.

- Melrose Industries (MRO) – this aerospace business is driven by its engine operations and is a very different beast from its historic 'buy, improve and sell' model operating across a ragbag of previously underperforming industrial businesses. The engines business operates on a 'risk and revenue sharing partnership' (RRSP) model which provides extreme cash flow visibility (to 2050/60). In addition, the front-end nature and limited replacement cycles of Melrose's components mean its share of project revenues drive high EBIT (earnings before interest and taxes) margins and exceptional free cash flow. Melrose has underperformed its aero engine peers in the last year (not helped by an aggressive short), but is now playing catch-up. In addition, the assumption of coverage by aerospace analysts rather than industrial sector specialists could lead to materially higher valuations for this stock. The strong rally of recent months should have further to run.

- Skillcast Group (SKL) – this is a software as a service (SaaS) business specialising in staff/directors' training in a wide range of core business areas in order to allow demonstration of compliance with applicable regulations. This is a strongly growing business (it has seen largely unbroken expansion since 1993) in a market forecast to grow at 16 per cent on a compound annual growth rate (CAGR) basis through to the end of this decade. While the business consciously made losses in the last two years by ramping up costs ahead of expected revenue growth, this strategy is beginning to pay off and margins look set to flip from minus 8 to plus 10 per cent EBIT in the next two years. The numbers look good and while the valuation might be fully up with events, if growth is sustainable then positive longer term returns are very possible. We do, however, have some reservations about the lack of free float.

Analyst: **Robin Hardy**

Melrose Industries (MRO) – sharing is caring

Source: FactSet

Snapshot

FTSE 100 constituent Melrose is, today, an aerospace (mainly civil and but also military aircraft) components manufacturing business with a market cap of c. £8bn. It posts revenues of around £3.5bn and EBIT of around £500mn. Melrose has been a business of many different and diverse flavours over the years (more on this later) and has really only been in its current form since 2023. This is a business that has seen no shortage of controversy over the years, with issues ranging from executive reward structures to the aggressive handling of acquired businesses.

Calculating a TSR for shareholders is difficult here given the almost wholesale changes in the business profile, but since adopting its current 'pure-play' aerospace model in March 2023 there has been an almost exactly 100 per cent TSR overall or ~50 per cent annually. This return may have been higher save for a 'bear raid' or aggressive shorting on the group by a hedge fund, which drove the shares down by around one-third last year. In the last four months much of this has been recovered.

The nature of Melrose's operations are somewhat unusual and can easily be misunderstood and, consequently, valued incorrectly.

Analysis

As above, Melrose only came into its current form less than two years ago after rising from humble beginnings as a £10mn Aim-traded shell company in 2003. Its structure was based on a principle of 'buy, improve and sell', using primarily equity finance to buy underperforming and often unloved listed businesses across a wide range of industrial sub-sectors and international markets. This was a very successful strategy (if somewhat lumpy and unpredictable), perhaps best illustrated by the 2012 purchase of Elster, a metering business, for £1.2bn, which was then sold to Honeywell just under three years later for £3.3bn. This strategy peaked with the contentious £8bn bid for GKN in 2018. The last clear-out action was the 2023 demerger of GKN's low quality auto components and powder metallurgy operations, as Dowlais PLC, which is now in the process of being acquired by American Axle & Manufacturing after having slumped 60 per cent post spin-off. This left the group's current aerospace focus on the GKN Aerospace business, the brand under which most operations still run.

The aerospace business runs in two parts: engines and structures.

Structures provides wing structures, fuselages, empennages (movable aircraft tail control surfaces), transparencies (windows) and electrical wiring systems for helicopters, private jets and narrow-body passenger jets. This arm is primarily geared to the delivery of new aircraft, as its parts tend to be passive and wear relatively little, but there is also some level of involvement in maintenance.

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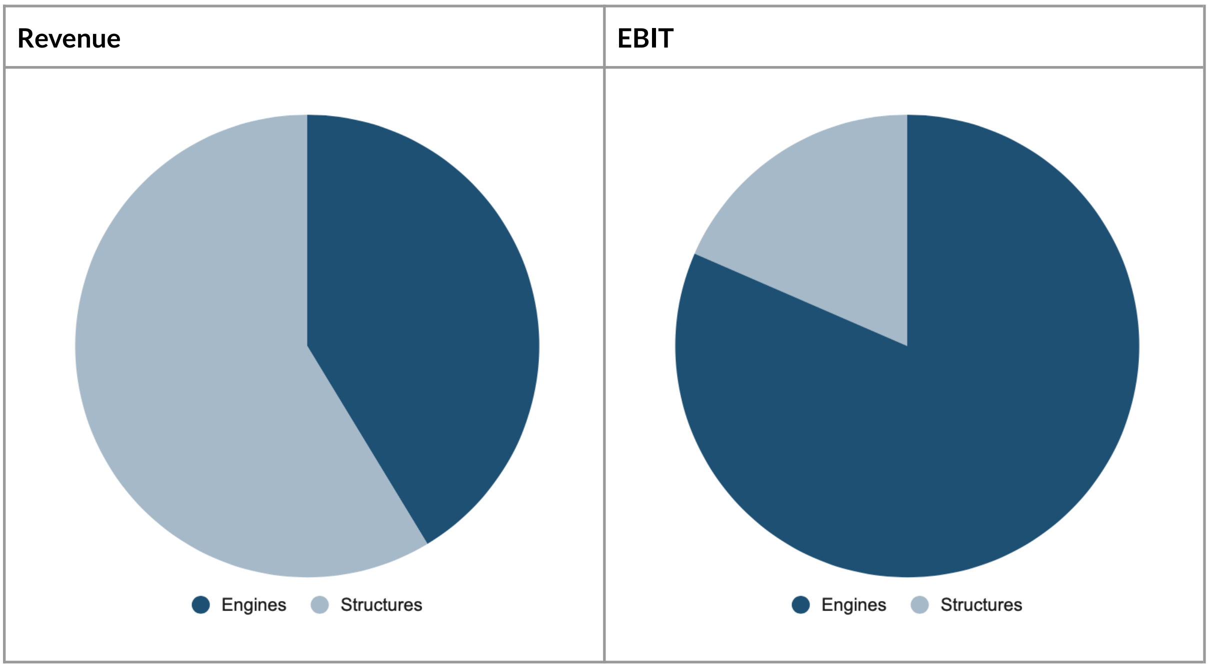
Figure 1: Revenue and profit profiles – H1 FY2024



Source: Melrose

This is a somewhat commoditised business with higher levels of competition, hence the lower margins (sub 5 per cent EBIT), but this is also subject to the vagaries of aircraft deliveries. As a result of the pandemic, airlines extended rather than replaced and episodes like the Boeing 737 Max grounding put large dents in industry revenues. It is not clear whether Melrose will exercise a final sell-on with this arm but it does not feel core, does not add materially to the group's value and can swing violently on cash flow and profits.

Engines is a very different beast, indeed. Not only are the margins significantly higher at around 30 per cent EBIT, but the operating model is a complete contrast. Engines operate through what are known as RRSPs, large and very long-term programmes between headline engine makers (such as GE, Rolls Royce, Safran or CFM) and key sub-component manufacturers such as Melrose/GKN. All parties to the RRSP agree to a fixed percentage of the development costs and the same share of the lifecycle revenues (initial sales and all maintenance/repair billings). Typically, Melrose holds a single-digit percentage stake in its RRSPs, of which it is involved in 19.

These arrangements are ultra long term with Melrose, for example, still generating revenues from the GE CF6 (first run in 1971) and Pratt & Whitney JT8D (an engine which entered service in 1963 and ceased production in 1985, but 2,400 of the total 14,500 delivered are still in operation) since signing up to an RRSP for both in the very early 1980s. Today, 17 of the 19 RRSPs generate positive cash (i.e. no more development investment is called for, only potential parts supply) and by 2028 all 19 will be cash flow positive. These are globally significant undertakings with some 70 per cent of all flight hours undertaken globally by airline operators falling within the group's RRSPs.

This structure is very positive for Melrose for two key reasons:

1. **High visibility** – with the expected lifecycles for the 19 engine programmes, Melrose has credible visibility of workflows through until at least 2050 (possibly 2060) and while no new engines are coming into development today, this portfolio is likely to expand over time. Before the end of that 2060 horizon, the development of some or all of fully electric, hybrid electric, hydrogen, geared (GTF), ultra-high bypass, VTOLs (mainly military but potentially civil), new generation fighter, new generation narrowbody specific, open fan and partial ceramic engines is expected. This should mean that even as Melrose approaches that time horizon, it should have materially extended.

   New aircraft demand is forecast to be very high, with Airbus predicting calls for 42,000 fleet extension and replacement planes in the next 20 years as core passenger demand grows at around 4-5 per cent per annum and fuel-inefficient fleets are replaced. Alton Aviation forecasts that against today's total global fleet of 31,000 there will be 41,000 in 2034. Many of these will use existing engines, meaning minimal new capital investment for the group but higher revenues.

   There will be a need for new capex such as additional plants and bringing through fresh technologies such as additive manufacturing (high tech 3D printing) to replace casting, but against the expected inflows net capex (i.e. above the depreciation charge) is likely to be low.

   All told, the visible revenue from Melrose's share of the 19 current RRSPs totals some £22bn in cash terms through to 2050, which (using a decently prudent discount rate of 7.5 per cent) has a net present value (NPV) of £5.7bn – a notable figure against the market cap of £8bn.

2. **Very high net cash flow** – while the revenues flowing in from the maintenance and repair programmes will require parts to be supplied, very few of them will need to be Melrose components. That is because most of the components it delivers are 'one and done' in nature and most remain in place, as they are installed for the whole lifespan of the engine. They tend to be more 'passive' elements (as with structures), such as engine mounting structures, nacelle parts, bearing and shafts which frequently remain intact for an entire service lifetime. Despite this, Melrose still receives revenue from that engine's servicing equal to its share in the RRSP, which means it obtains an exceptionally high net free cash flow.

Conclusion

The major and recent changes to the operational profile of Melrose do make it harder to value. Normally we would look at a stock's own valuation history and compare this with prospects then and now – but this is not the same business as even two years ago, let alone five or 10. Then there is the very different operational profile and income visibility from a traditional industrial business, plus how such long-term contract income needs to be accounted for (very prudently, ideally). This does not really feel like a business that can be valued by simply looking at the PE (price-to-earnings) or EV/Ebitda (enterprise value over earnings before interest, tax, depreciation and amortisation) ratio and comparing with other industrials stocks.

However, it is likely that as this stock is still largely covered by traditional UK-oriented engineering/industrials analysts, valuations are based on basic multiples of near-term trading figures and that does not feel right. There is a shift taking place within the coverage of this stock, from UK industrials to European or global aerospace specialists for whom this kind of ultra-extended operational profile is bread and butter. These analysts have methodologies based around long-term DCFs (discounted cash flows) on known projects and better insights into how current programmes may morph and how to attach value to potential new developments.

This is borne out in some distinctly different valuations for Melrose. Looking at analysts' target prices, we see traditional industrials valuations running out at around 600p-650p, suggesting that the stock is today fairly fully valued. However, a notable change recently occurred in coverage at JPM Morgan Cazenove, with an aero sector specialist bringing through a different and more positive view. This broker increased its target price from 650p to 850p, suggesting that views on the stock may be out of touch with steeply accelerating free cash flows and other developments likely in the next five years. It also points to past market failures to spot deep value in aero engine stocks, such as with Rolls Royce, MTU, Safran and GE. That may now be the case for Melrose.

As the chart below shows, Melrose has lagged its immediate peers in the last year or so, but it would have perhaps tracked them more closely were it not for the now dismissed aggressive short position taken by one hedge fund and a very aggressive stance taken by one broker last summer. The broker's target price was cut from 770p to 400p, suggesting that the RRSP cash flows were overvalued: notably, they have since pushed their target back up to 665p in a climb-down. Without this now recanted negative, would the Melrose share price have followed the pack? That is speculative, but when a potentially unfounded negative is placed on a stock, there is a solid base for a rebound. We have seen that at Melrose since October, but to have tracked its peers for the last year the share price would need to now be above even that 850p target – this indicates potential for this stock.

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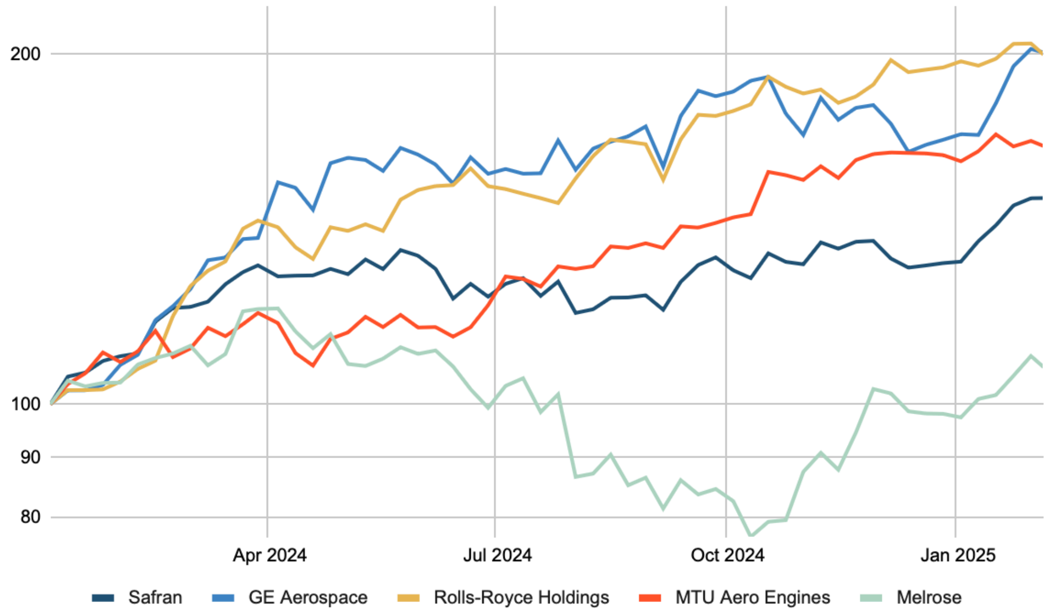
Figure 4: Aero engine share price comparables – Jan 2024 = Base 100



Source: FactSet

This is a complex business and long-term future flows and their valuations can create valuation distortions, plus we still have a lack of clarity over what Melrose will do with the far less attractive and potentially volatile Structures business. This is not yet as pure a play on aero engines as the peer group, but in terms of its profit and cash flow delivery, it is now pretty close to that position. So, does Melrose look undervalued? Yes it does, and that more ambitious price target of 850p does not seem out of line with the peer group's performance, the potential further rationalisation to become a pure engines business, the use of disposal proceeds to lower debt, the likely increase in returns to shareholders as cash flows ramp up through the back of this decade and a likely further shift in the nature of analyst coverage. The latter should drive more sophisticated and higher valuation targets. There is certainly the potential for solid double-digit TSR here.

Skillcast Group (SKL) – in compliance

Source: FactSet

Snapshot

Skillcast is an Aim-traded microcap stock (£36mn market cap but as low as £16mn within the last two years) operating today largely as a SaaS business. Its software enables client businesses to assure and demonstrate that their staff/directors and operations are compliant with all relevant regulatory requirements. It also allows them to show that they are well versed in non-binding good practice. Many of the group's clients have high compliance obligations in industries such as finance. It provides web and app-based services, referred to as 'subscriptions', that can be either generic or bespoke in nature. It also provides 'professional services', larger-scale client specific projects which have lumpier revenues and are viewed by management as non-core.

In the core SaaS business arm, Skillcast offers three service levels, an expansion from a previous single level:

> **Basic** – tailored to small businesses with under 50 employees and directors, this is a self-build platform. Many more smaller businesses are required today to be able to exhibit compliance with regulations such as GDPR.
>
> **Standard** – the long-standing core of the business offering access to a full suite of learning libraries and courses for either self-build or tailored training. This still drives the great majority of the group's revenue.

Premium – this builds on the more straightforward training from the standard level, layering on top a learning management system, policy hub, surveys, declarations and registers for staff compliance automation.

More than 80 per cent of the software revenue is now on recurring subscriptions (i.e. SaaS vs boxed/licenced) and revenues forecast for the latest financial year (to December 2024) are around £13mn (versus £11.3mn in 2023). The business was not Ebitda-positive in either of the previous two years (see later), but forecasts indicate a positive outcome for 2024 of around £0.6mn and EBIT of £0.3mn, driven by the second half. Services revenues are flat to declining and are forecast to have fallen from almost 40 per cent of revenues in 2021 (the year of the IPO) to just 12-15 per cent. Subscription revenues, in contrast, have been growing consistently at >20 per cent per annum.

Total returns over the last five years have been close to zero overall, but in the last two years have been >100 per cent and in the last year ~50 per cent. In addition to strong revenue growth, Skillcast also has a very robust balance sheet with an historic £7mn+ cash balance, forecast to rise to more than £9mn.

Analysis

Requirements on businesses that they are fully compliant - both internally and externally - with any and all pertinent rules and regulations are becoming ever more onerous. Many contracts, especially with public sector bodies, today require the highest level of auditable compliance for training, surveying and monitoring employees. Many industries and single businesses were once able to self-certify and in some industries very small companies were permitted an exemption – this is increasingly not the case. There are significant possible fines for compliance failures, of up to £17.5mn or 4 per cent of annual worldwide turnover for major GDPR breaches.

The library of training modules has something of a skew towards the financial sector/FCA (Financial Conduct Authority), which is possibly the most dynamic and intricate industry sector, but the group's library also encompasses broader industrial and commercial areas such as data protection, anti-bribery, market abuse, health & safety, DEI (diversity, equality and inclusion), whistleblowing and safeguarding. Many of these other, non-FCA areas also open up opportunities in the not-for-profit, education and voluntary sectors. The number of potential fields for those needing to take courses is immense and growing.

This is why Skillcast has been able to show such a high rate of growth over more than a decade. The combination of wider adoption of e-learning, teaching apps and the ways in which the extensive library of resources can be organised into a business-specific suite have further helped the business to grow.

Skillcast did not have the best start as a listed company, with its shares falling more than 50 per cent in its first year on Aim. In the three years prior to the IPO, the business had reported rising profit before tax of more than £1mn, but it posted pre-tax losses in 2022 and 2023. This was not, however, due to a weakening of the business per se or the trading climate, but rather a decision by the board to invest in its platform and library and accelerate staffing expansion, with all additional costs being expensed to the income statement (some businesses may have capitalised these costs).

A strong pace of underlying expansion was evident, with subscription revenues from 2020 to 2023 more than doubling (£4mn to £8.5mn). Gross margins held steady at c.70 per cent, but admin costs rose from 54 per cent to 77 per cent of revenues, which drove the loss of profitability. While this was all planned and executed as promised, such a move is not typically welcome in the listed arena. It is more common in a private business where period-ends are far less important, or would be carried out before rather than after an IPO.

Going forward, the gross margin is expected to rise (as SaaS revenues dominate) to 75 per cent while admin costs grow much more slowly, declining to 65 per cent of revenues, an increase of less than half the rate of the top-line growth. So EBIT margins are forecast to flip from -8 per cent in 2023 to +10.5 per cent by 2026. While forecasts (there is only one broker making forecasts and they are the 'home team' broker) are limited, their bases appear sound for revenue and cost expansion. Revenue growth is forecast to drop to a more sustainable level of sub 20 per cent, which is more in line with the forecast market growth for 'regtech' (regulatory technology) or Learning Management Systems (LMS) revenues of 16 per cent compound from 2024 to 2030, per Maximise Market Research data.

If we attempt to model a slightly longer trend using that 16 per cent top-line growth and cost expansion at 10 per cent, by 2030 EBIT margins could have expanded to 20 per cent with earnings per share (EPS) of around 5.5p against c.0.5p for 2024 (results are expected in late April). That 10 to 11-fold increase over a six-year period equates to compound growth of close to 50 per cent.

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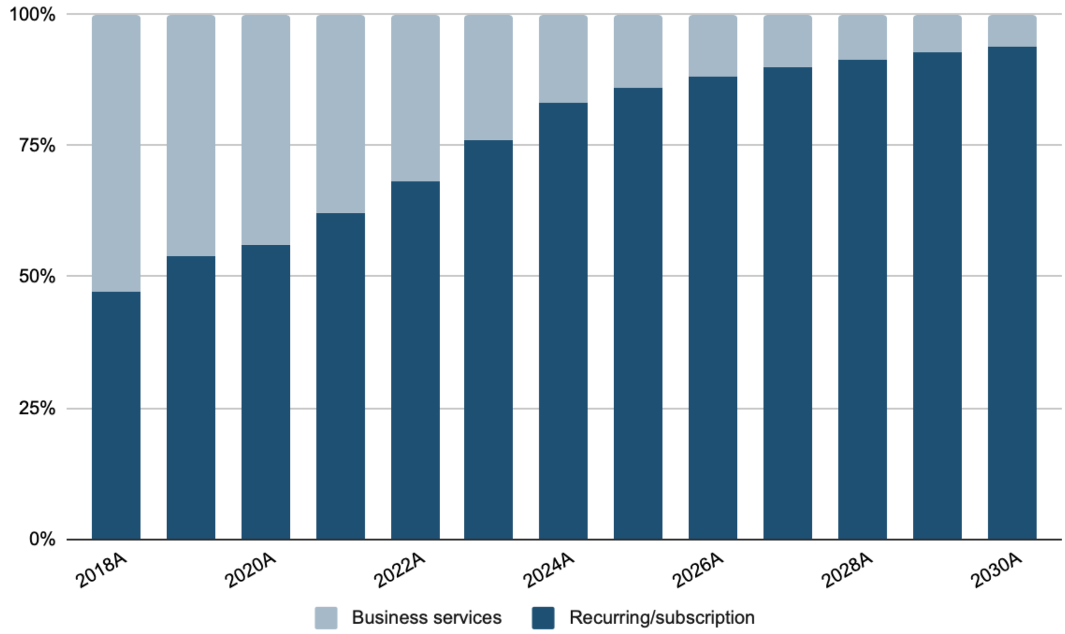
Figure 1: The power of SaaS – changing revenue base



Source: Skillcast (A), Allenby Capital (F), Investors' Chronicle (F *)

Skillcast operates in a fairly crowded and fragmented market with customers able to secure a similar flavour of service from the likes of Gresham Technologies, Tracsis, Eleco,, Intercede Group, Spectra Systems, Microlise Group, Eagle Eye Solutions Group, Sopheon, Tax Systems, and Celebrus Technologies. While mostly SaaS, many of these have notable differences to Skillcast. A closer comparison group for valuation purposes would be Learning Technologies Group, Access Intelligence, Celebrus Technologies, Dotdigital, Eagle Eye Solutions, Getbusy and IDOX.

A quick scout around this field located more than 2,400 software providers in the compliance software space with a vast array of different and often narrow specialisms.

Conclusion

Skillcast is a fast growing business, seemingly well-regarded, clearly winning clients and driving an impressive and consistently high rate of revenue growth. The market still looks to be highly fragmented, which offers a twin strand of potential for growth: market expansion and consolidation. If we are right in extrapolating this group's growth and costs out to the end of the decade then the resulting near 50 per cent compound growth and likely net cash (assuming no material change in the capital allocation) of close to three-quarters of the current market capitalisation are eye-catching. In practice, a good deal of that cash is likely either to be handed back to shareholders or used to accelerate growth, but it does bear on the valuation just how much free cash flow could be generated.

The shares have risen strongly since the lows of only a little over a year ago, doubling and more before settling back a little but at 42p. EPS for 2026 (now effectively year 2) of around 2p means a PE of just over 20 times, which is on the high end but does not feel demanding for the level of growth we could and should see here. The closer peer group mentioned above, and used for valuation comparisons, shows that on an EV/Sales basis (the metric those looking at SaaS businesses seem to prefer) Skillcast is trading on 2 times 2025 sales. This is below that of the much larger Dotdigital and IDOX but higher than Access Intelligence, GetBusy or Learning Technologies, which does not help when trying to assess a fair value. but would suggest that around 2x is about right for Skillcast and that it, for now, stands at around fair value.

That does mean, however, that if revenue growth can be delivered as expected and sector baseline valuations hold steady, there could be a positive drag-along effect on the share price as revenues climb. There is solid, long-term revenue growth available here over a 30-year lifespan and if one is happy using EV/Sales (profits are far better for setting value I believe, but followers of SaaS prefer sales – what's that adage about sales versus profits? vanity vs sanity?) there could be scope for share price growth in the teens per cents, fairly steadily and fairly long term.

That said, we have a number of caveats:

1. There is a substantial 'insider' holding in this stock with c.78 per cent held by people connected with the business and 58 per cent in the hands of the CEO (chief executive officer). When this level of non-free float exists, actions can be taken that do not align with the interests of all shareholders.

2. Spinning off from this is the post-IPO action to ramp up costs and embrace short-term losses in pursuit of longer-term gains. That does appear to be working out for the positive now, but does raise the risk of what actions may be taken in future.

3. There is no independent research or forecasting on the company. This is not automatically a bad thing, but does mean that forecasts do not come with any kind of sense check. It is notable that a hefty reduction in forecasts was made in January 2024 for the financial year 2024 figures. Ebitda was cut from £1.2mn to £0.5mn without a great deal of explanation from the broker, without any substantial notification in formal releases from the business itself and indeed statements indicating that trading was in 'line with expectations'. This perhaps suggests that external investors might always find themselves a little outside the information loop.

4. The low free-float is likely to lead to trading liquidity issues. For a very small stake this is unlikely to be an issue, but for say 10,000 shares there could be problems achieving an acceptable price for a trade. On that front, the share price has, unsurprisingly, a wide 'spread' or the difference between the buy/sell or bid/offer price. At the time of writing, the bid-offer is 40p-45p. This means that the share price needs to rise by over 12 per cent to break-even. This is, of course, not specific and is very common for low free-float shares.

Personally, the shape of the listed entity would deter me from investing here. However, on pure number work, for investors willing to take a long buy-and-hold position there is a good chance of making a decent (potentially very decent) return based on underlying market growth and specific positioning. But be aware of holding too large a position on liquidity grounds.

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