investors CHRONICLE alpha

5 October 2020

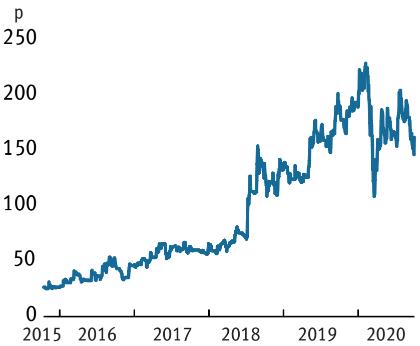
Arcontech: A lockdown software winner

This financial software provider has posted strong sales and profits growth in the past five years, a trend that looks set to continue

Arcontech (ARC)

Ticker	ARC
Current price	165.5p
12-month target price	220p
Market cap	£22m
52-week high	238p
52-week low	100p
Net cash	£5m at 30 June 2020
Shares in issue	13.3m
Financial year-end	30 June
Next event	Pre-closing trading update in February 2021
Company website	arcontech.com

Arcontech share price history



Source: FactSet

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Simon Thompson's view:

You are unlikely to see a more impressive blue-chip client base than the one offered by Arcontech. These financial organisations also generate recurring licence fees that equate to an eye-catching 93 per cent of the company's annual revenue, offering investors a stable income stream in the current uncertain economic environment. Operating margins and cash generation are just as impressive; both have more than trebled in the past five years. Even the Covid-19 pandemic is offering an opportunity for the company to grow as financial institutions look to save costs. Arcontech's smart software can help them do just that.

Bull points

- Blue-chip client base.
- High recurring revenue and low customer churn.
- High profit margins and high return on capital.
- Strong free cash flow generation and impressive working capital management.
- Hefty incremental margin earned on rising sales.
- Beneficiary of economic turmoil as financial organisations look to save costs.
- Expanded product offering and sales pipeline.
- Cash-rich balance sheet could fund bolt-on acquisitions to boost organic growth.
- Well-covered dividend.
- Significant director shareholdings.
- Progressive dividend policy.
- Legacy tax losses offset corporation tax charge.
- Takeover target.

Bear points

- Customer concentration risk.
- Small staff numbers highlight importance of key personnel.
- Long and complex sales cycles.
- Brexit may delay conversion of new sales.

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Aim-traded **Arcontech (ARC)** provides software products and bespoke solutions for the collection, processing, distribution and presentation of time-sensitive financial markets data. It is a software house as it doesn't deliver any market data, but provides the means for clients who are in the main large banks, to do so. The company is therefore independent of market data vendors (such as global giants Refinitiv or Bloomberg), but at the same time partners with them to ensure the company's software integrates with vendor data and systems as well as client's own data and systems.

Arcontech has been doing rather well in recent years, and looks well placed to maintain the progress in the coming years. However, it is still well below the radar of most investors, the primary reason why the company is valued modestly, with its enterprise value 16 times 2020 operating profit. To put the scale of the undervaluation into some perspective, UK listed peers in the software sector are valued on 25 to 35 times multiples on the same basis.

The valuation anomaly is even more compelling when you consider that 93 per cent of Arcontech's revenues are recurring and it has been generating decent organic growth by introducing new products for existing clients and signing up new customers, too. Moreover, you will struggle to find a company with a more impressive client list as Arcontech has relationships with several Tier 1 financial institutions. The roll call of blue chips includes Barclays, Citi, JP Morgan, Lloyds, Morgan Stanley, Santander and Bank of England.

Arcontech (ARC)

Ord Price: 164.5p
Market Value: £22m
Touch: 164-167p
12-Month High: 238p **Low:** 100p
Dividend Yield: 1.8%
PE Ratio: 18
Net Asset Value: 43p*
Net Cash: £5m

Year to 30 Jun	Revenue (£m)	Pre-tax profit (£m)	Diluted adjusted earnings per share (p)	Dividend per share (p)
2015	2.13	0.24	3.01	nil
2016	2.14	0.30	3.48	nil
2017	2.31	0.37	4.22	1.00
2018	2.52	0.58	5.20	1.30
2019**	2.84	0.93	6.54	2.00
2020	2.96	1.04	7.88	2.50
2021^	3.10	1.04	8.19	2.75
2022^	3.29	1.19	9.20	3.03
% change	11%	14%	4%	10%

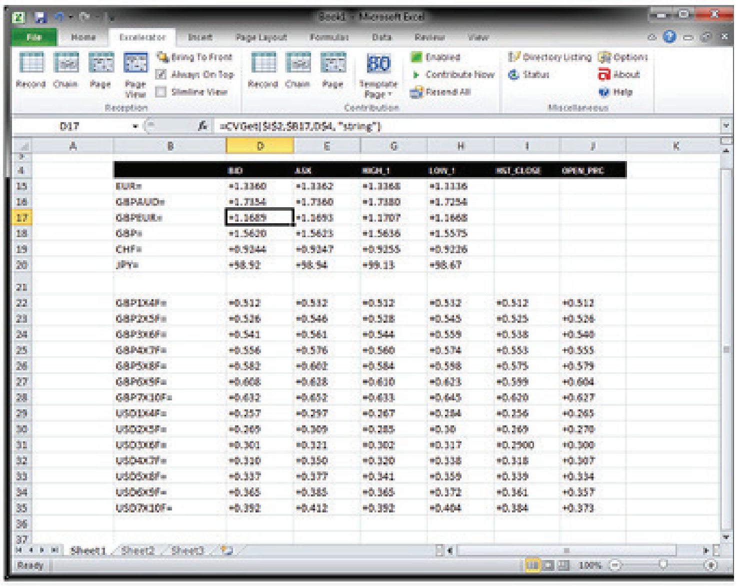
SETSqx
*Includes intangibles assets of £1.7m, or 13p a share
**Restated
^FinnCap estimates. EPS stated before share based payments and adjusted by FinnCap
Source: Arcontech annual report, London Stock Exchange

The reason why Arcontech has developed a robust recurring revenue stream is because its software enables financial institutions to manage a wide range of market data in real-time from a multitude of market data providers, including Bloomberg, Refinitiv/Thomson Reuters and FactSet. It's compatible on a range of operating systems such as Windows, Linux, and Solaris, thus creating a large addressable market. And because Arcontech isn't a data provider itself, its independence provides financial institutions with a route to achieve their market data aims in a cost effective manner rather than having to bundle their data requirements with other functionality of a specific data provider. Being independent also means that financial institutions can use Arcontech's platform to import and manipulate data from several different data sources at the same time.

The product suite

Arcontech's Excelerator Real-Time Excel Add-in solution has 1,410 users who use it to import, calculate and publish market data in real-time both internally and externally. It has a compatibility mode that enables users to use existing spreadsheets from other software providers in Excelerator. Importantly, the solution is compliance friendly with the data access controls of systems such as Refinitiv/Thomson Reuters and Bloomberg.

Excelerator integrates directly with multiple platforms and allows ease of data set up



On a practical level, this is exactly the type of equity analysis the staff at Investors Chronicle regularly carry out on a daily basis in their stock screens by accessing market data from global data providers and then crunching it through excel spreadsheets to identify companies that offer key characteristics. It's not just data from financial statements than can be manipulated in this way, price data can be too. Examples here include identifying companies making both absolute and relative (to the market indices) share price highs and lows, companies offering share price momentum, and those in earnings upgrades/downgrades cycles as we highlight in our Ideas Farm. Data manipulation is also used in screening out companies for my market beating Bargain Shares Portfolios, Algy Hall's stock screens and Chris Dillow's extensive research into highlighting economic and market correlations. Excelerator is user friendly, offering a desktop solution for users to manage a range of data sources and calculations on one desktop window. It was developed a couple of years ago in direct response to the needs of clients. Sold as an add-on to Arcontech's core Excelerator Excel Add-in product, it's proving popular with the user base almost trebling to 130 in the past two financial years.

Arcontech's product suite also includes its CityVision Server-Side platform business that enables organisations to receive, process and transmit a wide range of market data in real-time. The aim is to integrate clients' internal systems into the market data vendors' platforms so that the client can receive data from multiple sources, process it across a range of operating systems, and then transmit the data to multiple destinations (including vendor contribution). The market data platform offers dealing desk display and real-time streaming web updates. The solution offers four specific benefits to clients:

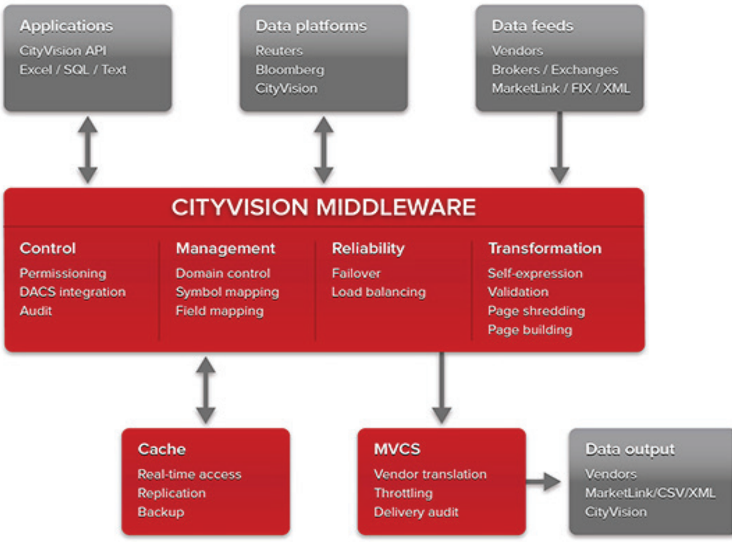
■ **Compliance.** Financial institutions can control which end-users can access which data, and therefore ensure compliance with market data vendors' restrictions and other regulations.

■ **Reliability.** Arcontech's server-side platform offers an automatic failover to a standby platform, thus enabling seamless access in the case of a server failure. This is a critical requirement for financial institutions.

■ **Integration.** The solution integrates with a range of vendor platforms, direct data feeds from brokers and exchanges, and external and internal sources of data to enable end-users access to the market data they need.

■ **Monitoring systems performance.** Financial organisations can monitor the status of their systems using Arcontech's own solution or third-party monitoring systems. In response to client demand, the company developed its user interface to assist administration by raising alerts when issues occur rather than when reported, thus reducing risk for the organisation.

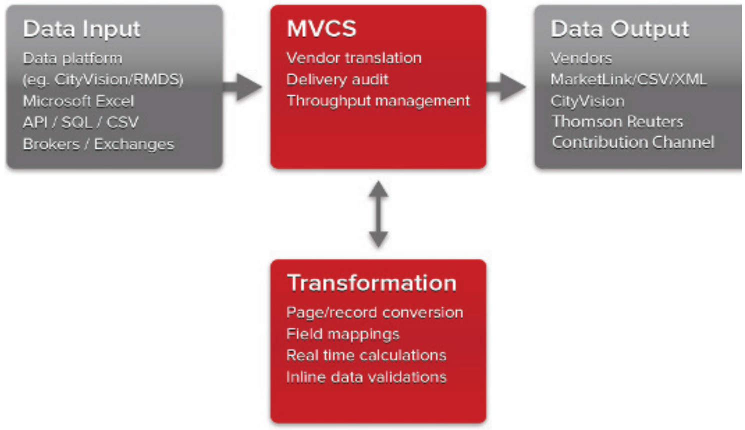
Arcontech's CityVision server-side solutions



Arcontech's CityVision server-side business has four specific solutions:

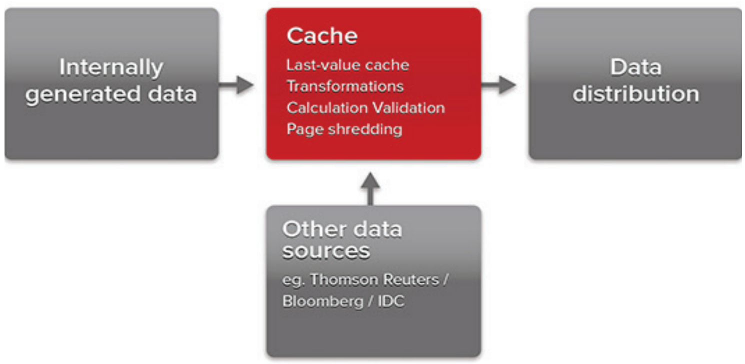
■ CityVision MVCS (multi-vendor contribution system). This is the core and most popular solution used by Tier 1 clients. It enables organisations to contribute data automatically and simultaneously to multiple destinations, including Refinitiv, Bloomberg, IDC and Telekurs. Data can be received from any source, such as TREP, Excel spreadsheets, trading systems, pricing engines and other contributions systems. MVCS works with all CityVision modules such as Excelerator to build a complete and compelling alternative for a data platform.

CityVision MVCS offers controlled publishing from many sources to many destinations



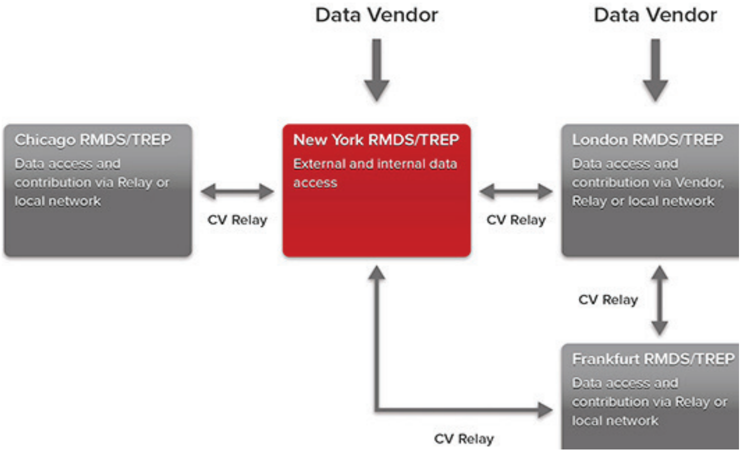
■ **CityVision Cache: Connected Real-Time Data Sharing.** A "last-value" cache is at the heart of many market data publishing systems, providing the means to exchange data in real-time throughout the enterprise. The CityVision Cache is a high performance, reliable real-time data repository that can add value with its calculation engine. It connects to various protocols, including TREP, SSL (Marketfeed), and RSSL (OMM). With high data through-put it can operate as a resilient hub for making data available enterprise wide. The Cache solution continuously backs up data, and can replicate it in multiple caches, thus enabling organisations to keep operations running with no downtime, even during software upgrades or network failure.

CityVision Cache is used by blue-chip clients across the globe



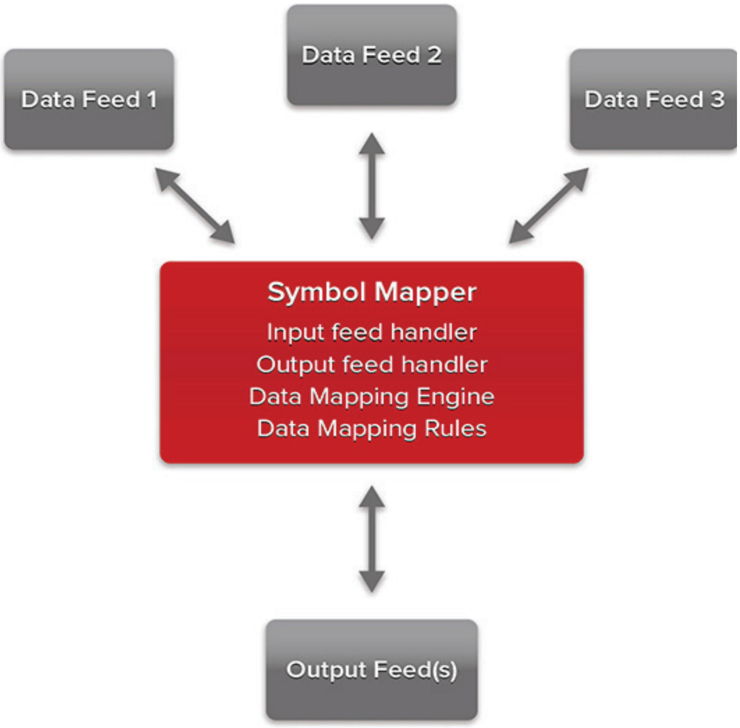
■ **CityVision Relay.** Relay allows market data to be accessed seamlessly and bi-directionally either locally or from other locations, so enabling the organisation to streamline its global infrastructure from one central connection to a market data vendor. It reduces data, infrastructure and support costs by optimising market data distribution, and is supported across Linux, Solaris X86 and Windows operating systems.

CityVision Relay data distribution platform allows market data to be accessed seamlessly



■ **CityVision Symbol Mapper.** The solution allows market data managers to separate data integration from the data source, thus enabling an organisation to select their market data independently of the connecting application. Integrated with market data platforms such as RMDS/TREP, data can be presented in a format determined by the client to meet their specific requirements such as coverage, cost, latency and/or data quality and reliability. It also helps to reduce overall market data spend, can be used as a tool for gradual on-boarding and/or migration to a new data vendor, and allows bridging of data vendors across multiple data platforms.

CityVision Symbol Mapper real-time data conversion enables the separation of data integration from the data source

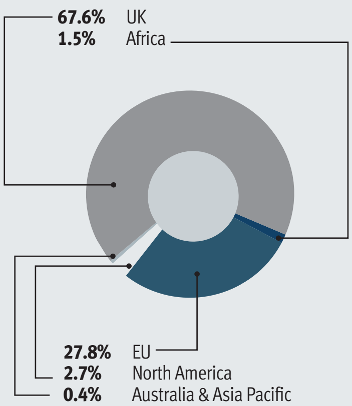


Barriers to entry

The clear benefits of the product suite to clients aside, other reasons for Arcontech's high recurring revenue stream are the high switching costs and the economies of scale it generates. Sales cycles are long and complex which discourages clients from switching to another provider, and means that the company's revenue stream has strong defensive qualities. Indeed, when pitching for a new contract, Arcontech has to demonstrate: the potential cost savings of its solutions; how the company can replicate the functionality of the clients' existing products, and deliver new benefits, in a seamless manner to minimise disruption; and provide support to the organisation when required.

As a result, Arcontech usually wins small contracts initially which then scale up, generating organic growth in future years. For instance, its four largest clients accounted for 62 per cent of annual revenue of £2.95m reported in the 2019/20 financial year. The fourth largest customer now accounts for £301,000 of revenue, or 10 per cent of the total. However, in 2019 the same [undisclosed] customer, a leading US investment bank, accounted for £281,000 of revenue, and in the 2018 financial year around £96,000. In other words, revenue from one client alone has trebled within two years, the driver being an increased uptake of the Excelerator product. Arcontech rarely suffers client losses either. In fact, the company

Arcontech revenue by geographic region



Source: Arcontech annual report 2020

has only lost three clients in the past six years, and none of which were down to Arcontech's product offering. Limited churn combined with a high recurring revenue stream highlight the company's defensive qualities.

Arcontech largest customers by revenue

Business activity	Percentage
Customer 1	22%
Customer 2	17%
Customer 3	13%
Customer 4	10%
All other customers	38%

Source: Arcontech annual report 2020

Potential to scale up

Analysts estimate there are around 1m market data terminals in the industry of which both Bloomberg and Refinitiv have a 20 per cent market share each. To put Arcontech's market share into perspective, it reported 1,410 end users for its Excelerator solutions in the recent annual results. Even if it wins only 0.3 per cent of the overall market then its user base could double. For an operationally geared business the impact on profits would be significant.

In addition, there should be decent growth potential from its server-side solutions business as financial institutions will now be taking a close look at their cost bases and looking to make savings in light of the Covid-19 induced downturn. Unbundling current arrangements with market data providers is one easy way to do so. That's because Arcontech's product suite still offers the same data quality as other premium service providers, and is highly regarded in the industry, having built up a reputation for software quality and reliability in this niche market over several decades.

This means that Arcontech can compete head on with an organisation's internal technology teams and persuade new clients to use its products rather than take on the risk and cost of developing their own. Importantly, being independent means that it can pitch to clients as a trusted partner who will help them choose the most appropriate solutions for their business.

Furthermore, Arcontech has been on the Steering Committee of open source messaging and data application programming interface OpenMAMA, the financial markets shareware operated under the Linux foundation. The aim of the organisation is to offer users the ability to create new applications and software without being locked into a market data vendor. Adoption of OpenMAMA is growing amongst financial institutions, and Arcontech is tapping into the opportunity, having developed a range of code that interface with OpenMAMA for its clients.

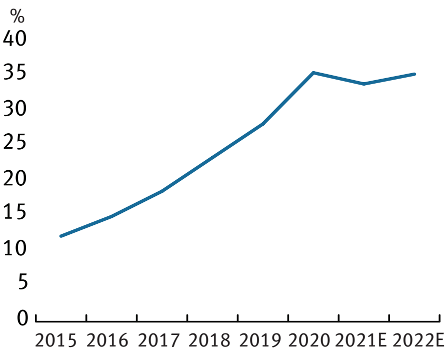
Bearing this in mind, it was reassuring to note in last month's annual results that although some "potential clients were less inclined to take on new products during the pandemic, our pipeline of new opportunities with potential new customers is looking increasingly positive, particularly on the server-side software products." It's worth noting, too, that chief executive Matthew Jeffs points out that "the expanded product offering and sales capability, along with our clients and potential clients' need to reduce costs, should improve the frequency of sales."

For instance, the company has developed a RESTful interface which enables clients to significantly increase the volume of data they can pull into the company's software. The new CityVision MVCS (Director) interface has been well received by clients, too. Of course, you need an increased sales capability to exploit the increased market opportunity that Covid-19 has created for Arcontech. The company already has one in place, having added two new sales staff in January to take its total sales force to three. Although they had a minimal impact on revenue in the first six months of 2020 due to the outbreak of the pandemic, they have uncovered new opportunities that could lead to material new client wins.

In fact, the company has just announced winning a new Tier 1 bank client for its MVCS (Multi-Vendor Contribution System). Although anticipated revenues are not expected to be material initially, it is the start of an important relationship that should scale up over time. Commenting on the contract win, Mr Jeffs notes "We frequently provide our software to enable contributions to be made to Bloomberg and Refinitiv, however, we are increasingly receiving requests to send client data to other vendors and venues like Factset and Tradeweb along with a need to repurpose data internally for risk management systems or use by other desks."

He adds that "regulatory pressures coupled with the need to reduce risk, are encouraging financial market participants to ensure any data sent to the market is managed and recorded for audit. We enable our clients to do this by consolidating the data so it is known exactly what is being sent to whom as well as to monitor the data flow. The monitoring function can alert the client by e-mail and block the data if a price is not within market parameters or simply alert the administrator if a communications line fails. We therefore enable our clients to take action at the soonest possible moment and minimise any risk associated with their prices being sent to the market." I expect more contract wins.

Arcontech's operating margin expands on higher revenue



Source: Arcontech annual report, FinnCap forecasts

Highly operationally geared to rising sales

Arcontech has a relatively fixed cost base. Annual staff costs of £1.4m, research & development costs of around £469,000 and £146,000 lease costs on its London office accounted for almost all the company's £1.92m administration costs in the 2019/20 financial year. As a result, operating profit is highly operationally geared to new sales wins, one reason why adjusted operating profit margin has almost trebled from 12.2 per cent to 35.5 per cent in the past five financial years as revenue increased from £2.1m to almost £3m.

Arcontech's margins expand as revenues rise

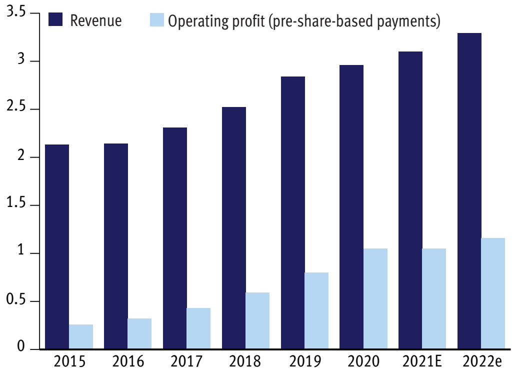
	2015	2016	2017	2018	2019	2020	2021E	2022e
Revenue	£2.13m	£2.14m	£2.31m	£2.52m	£2.84m	£2.96m	£3.10m	£3.29m
Operating profit (pre-share based payments)	£0.26m	£0.32m	£0.43m	£0.59m	£0.80m	£1.05m	£1.05m	£1.16m
Operating margin	12.2%	15.0%	18.6%	23.4%	28.2%	35.5%	33.9%	35.3%

...and improving profits is driving up net cash

	2015	2016	2017	2018	2019	2020	2021E	2022E
Net cash (debt)	£1.07m	£1.63m	£2.64m	£3.21m	£4.06m	£5.01m	£5.75m	£6.60m

Source: Arcontech annual report, FinnCap forecasts

Arcontech operational gearing kicks in as revenue increases



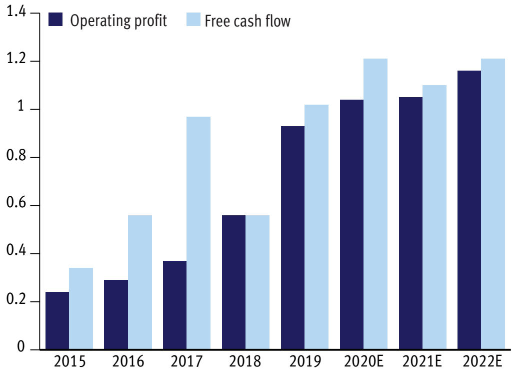
Source: Arcontech annual report, FinnCapp forecasts

Although house broker FinnCap is forecasting flat operating and pre-tax profit performance in the financial year to 30 June 2020, and that looks conservative given potential for the company to convert its "increasingly positive pipeline of new opportunities" into firm contracts, it's worth noting that the additional £190,000 of revenue forecast in the 2021-22 financial year is expected to produce incremental operating profit of £110,000. On this basis, the incremental operating margin is around 60 per cent, highlighting the high drop through of revenue to profit as the top-line expands. It also explains why the relatively asset light business generated a thumping post-tax return on equity of 26 per cent in the last financial year.

Importantly, the company's defensive qualities protect it from operational gearing working in the other direction, given that recurring licence fees account for 93 per cent of annual revenue. It also helps that existing clients benefit from ongoing improvements to Arcontech's core products at no extra cost, thus creating another reason for them to stay loyal.

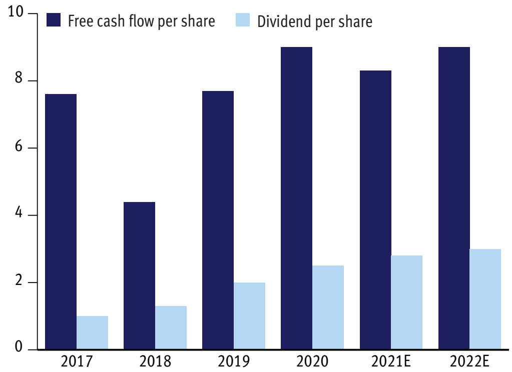
The point is that with the benefit of a relatively fixed cost base, and a small team of 16 staff of which three are employed in sales, then if Arcontech manages to double its customer base and revenue to £6m over the next few years, then it's realistic to expect operating profit to surge

Arcontech's robust free cash flow generation



Source: Company data and FinnCap estimates September 2020

Arcontech's dividend well covered by free cash flow



Source: Company data and FinnCap estimates September 2020

from £1.05m in the 2019-20 financial year to around £3m. That's the scale of the opportunity for a company that has market capitalisation of £22m and an enterprise valuation of £17m after factoring in net cash of £5m.

Bumper cash flow generation

Arcontech's ability to generate robust cash flow is mightily impressive, too. Free cash flow has been consistently on an upward curve for the past five years. It's worth noting that the directors fully expense all research & development (R&D) spend through operating expenses, and depreciation and amortisation charges account for less than one per cent of annual sales. Arcontech's R&D tax credits relate to its current spend on qualifying R&D expenditure. In addition, the company has £7.4m of historic income tax losses to offset future corporation tax liabilities. After taking account of tax credits, net profit has exceeded reported pre-tax profit every year since 2015.

So, with annual revenue rising from £2.14m to £3m in the past five financial years, an eye-watering amount of operating profit is being converted to free cash flow. In turn, this has been boosting Arcontech's cash pile. It has risen five-fold to £5m since June 2015 even though the board introduced a dividend in 2017 and has since hiked it by 150 per cent.

Arcontech's robust free cash flow generation

Financial year to 30 Jun	Operating profit	Free cash flow
2015	£0.24m	£0.34m
2016	£0.29m	£0.56m
2017	£0.37m	£0.97m
2018	£0.56m	£0.56m
2019	£0.93m	£1.02m
2020E	£1.04m	£1.21m
2021E	£1.05m	£1.10m
2022E	£1.16m	£1.21m

...which supports a well-covered and progressive dividend

Financial year to 31 Dec	Free cash flow per share	Dividend per share
2017	7.6p	1.0p
2018	4.4p	1.3p
2019	7.7p	2.0p
2020	9.0p	2.5p
2021E	8.3p	2.8p
2022E	9.0p	3.0p

Source: Arcontech annual accounts; FactSet (free cash flow); and FinnCap estimates (operating profit pre share-based payments).

It's reasonable to expect further dividend increases. The prospective 2.75p a share payout for the 2020-21 financial year will cost the company £365,000, or a third of the £1.1m free

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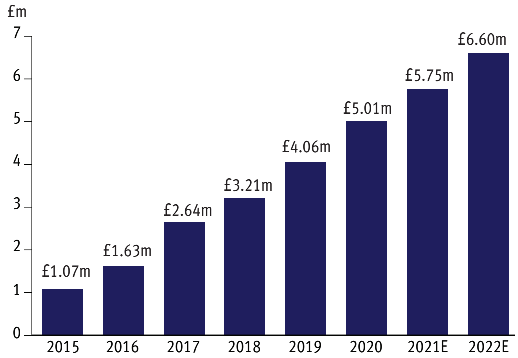
Arcontech's net cash rises sharply



Source: Arcontech annual report, FinnCapp forcasts

cash flow house broker FinnCap is predicting Arcontech will make. This means that after paying out the dividend, around £750,000 (5.6p a share) of surplus free cash flow is set to boost net funds by 15 per cent to £5.75m (43p a share). It's a similar story in 2021/22 when FinnCap is predicting free cash flow of £1.21m, a further 10 per cent hike in the payout to 3.03p per share at a cost of £403,000, with the balance of free cash flow swelling net funds to £6.6m (50p a share).

In other words, Arcontech is on course to boost its cash pile by almost a third to £6.6m within the next two financial years, a sum that also represents 30 per cent of the company's current market capitalisation of £22m. And that's in addition to paying out dividends of close to 6p a share.

Arcontech's working capital management is eye-catching, too. Not only does the company have a strong liquid ratio of 2.6 times – current assets of £5.2m cover current liabilities of £2m – it only had £192,000 of receivables at the 2020 financial year-end, the balance of current assets being the £5m cash pile. Effectively, debtor balances are being collected every 24 days, whereas creditors are extending the company credit for an average of 229 days on payable balances of £1.85m. That's good business. Moreover, with a high class customer base, Arcontech doesn't have to worry about bad debts.

M&A possibilities

The ability to generate high levels of cash means that Arcontech is well positioned to look at mergers & acquisitions (M&A) to further leverage its strong structural position by making a complementary earnings accretive acquisition. Admittedly, the potential for the board to pursue corporate activity has been mentioned by the directors for the past three years, and there has yet to be any movement in this regard.

However, with a cash rich balance sheet, Arcontech could become a target itself. Indeed, the major players in the financial information industry – Thomson Reuters, FactSet, CME and ION Investment Group – have all been acquisitive in recent years, and in certain cases have pursued acquisitions of a similar size to Arcontech. Furthermore, M&A activity is happening in the financial sector at the moment, with the London Stock Exchange pursuing the acquisition of Refinitiv.

It's even possible that a private equity player could bid for the company, given Arcontech's free cash flow of £1.2m in the financial year just ended equates to almost 7 per cent of its enterprise value of £17m. It's easy to see the appeal as the business offers an asset light business model that's delivering high returns and profit progression, while at the same time delivering a high recurring revenue stream.

I wouldn't be surprised at all if predators are running their slide rule over the business especially as former chairman Richard Last retired after last week's general meeting, having held the position for 13 years. He holds a 11.7 per cent stake. Non-executive director Louise Barton owns a 8.1 per cent stake and chief executive Matthew Jeffs holds a further 6.9 per cent. This means that over 26 per cent of the issued share capital is in the hands of three insiders who have overseen a dramatic improvement in Arcontech's fortunes over the past five years.

The third alternative is that the board may decide to hand back some of the burgeoning cash pile to shareholders, something that would bring into sharp focus the value on offer to prompt a re-rating.

Meet the management

■ Arcontech's board is now led by new chairman **Geoff Wicks** who was appointed a non-executive director in July. He was most recently chairman of ULS Technology (ULS), the provider of online technology platforms for the UK conveyancing and financial intermediary markets. Prior to this, he was chief executive of Group NBT, a specialist in online brand protection and digital asset management, from 2001 until he led the sale of the business to HG Capital in 2011. He remained part of the Group NBT business, now renamed NetNames, as a non-executive director until 2013. Mr Wicks spent much of his earlier career at Reuters, including heading divisions in the UK, France and Nordic regions and latterly was director of corporate communications. Prior to joining Reuters, he worked in the banking and insurance industries.

■ The company's chief executive is **Matthew Jeffs,** who has held the position since April 2013, so has been a key player in the operational improvement seen in the business. He previously spent 10 years with Barclays International, 10 years with Dow Jones and then six years with Reuters in a variety of senior roles. In addition to the UK, he has extensive experience in the Asia Pacific region where he was a country manager for Reuters and a country representative for Dow Jones.

■ The company has one non-executive director **Louise Barton**, who was appointed to the role in February 2007. She worked for five years with the Institute of Applied Economic and Social Research in Melbourne before joining Prudential Portfolio Managers in 1979. She moved into stockbroking/investment banking in 1987, joining CCF Laurence Prust and subsequently moved to Investec Henderson Crosthwaite in 1990. Mrs Barton retired from the City in 2002 when she was ranked UK No 1 small company media analyst and is now an independent consultant.

■ Finally, the company secretary is **Ben Hodges** who is also the finance director of Arcontech's principal subsidiary.

Admittedly, the board is small, but Arcontech is a tightly run small-cap company that employs only 16 staff. Importantly, the directors are sensibly paid, drawing total remuneration of £363,000 in the last financial year, hardly exacting for a company that made a £1.2m net profit. To put that sum into perspective, the 2020 annual dividend will cost the company £333,000, so outside shareholders are seeing a decent slice of those earnings.

Shareholders and liquidity

The top eight shareholders control 56 per cent of the issued share capital, and 40 per cent of the shares are not in public hands as defined by Aim rules. However, they are still readily tradeable on a bid-offer spread of 4p and individual bargains as large as 10,000 to 12,500 shares have gone through the market at pretty close to the indicative bid and offer prices in the past month.

One downside of a lower free float is accentuated price moves. However, with 93 per cent of Arcontech's revenue recurring, the business largely unimpacted by the Covid-19 pandemic to date, and a pipeline of new sales opportunities being pursued by an enlarged sales team, the risk to the house broker's conservative earnings estimates look skewed to the upside.

Arcontech significant shareholders

Name	Percentage of issued share capital
A Cross	13.5%
Richard Last (former chairman)	11.7%
Louise Barton (non-executive director)	8.1%
Matthew Jeffs (chief executive)	6.9%
S Chari	4.5%
L Boros	4.0%
N Ridge	4.0%
Clive & Sylvia Richards Settlement Trust	3.5%
Total	**56.2%**

Source: Arcontech annual report and accounts, FinnCap

Peer group analysis

Amongst small-cap listed peers in the sub £125m market capitalisation segment of the Aim financial software market, Arcontech is by far the lowest rated. The shares trade on a 12-month forward PE ratio of 20.2, representing a 24 per cent ratings discount to mobile payment platform Bango, a 40 per cent discount to Beeks and a 35 per cent discount to the FinnCap N50 Enterprise software index average. The ratings anomaly is even more pronounced when you take into account Arcontech's hefty cash pile. On an enterprise valuation to Ebitda basis, the shares are rated on a 65 per cent discount to Bango and a 24 per cent discount to D4T4 Solutions.

Peer group comparison

Company	Share price	Market capitalisation	NTM PE ratio	Enterprise valuation	EV/Ebitda	Free cash flow yield
Bango	168p	£125m	26.7	£122m	40.5	nil
Beeks	98p	£49m	33.6	£50m	28.9	0.7%
D4T4 Solutions	187p	£75m	28.3	£63m	18.5	2.7%
Arcontech	152p	£22m	20.2	£17m	14.1	5.0%

Source: Beeks Financial and Bango (Progressive Equity Research); Arcontech (FinnCap); D4T4 Solutions (FinnCap)

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Moreover, Arcontech offers a prospective free cash flow yield of 5 per cent, or almost double that of D4T4 Solutions and almost seven times higher than Beeks Financial. Arcontech's free cash flow yield is 2.5 times higher than the 2.1 per cent average for the FinnCap N50 Enterprise software index, and is two-thirds higher than a global financial information peer group comprising FactSet, Moody's, MSCI, S&P Global and Thomson Reuters. For good measure, Arcontech's 12-month forward enterprise valuation to operating profit multiple of 14 is half the rating of that global financial information peer group, thus highlighting the potential for M&A activity.

Target price

Arcontech is not only materially undervalued relative to its listed small-cap peers, but it offers potential for earnings outperformance given that current forecasts are conservative. The business has the highest level of recurring revenue stream, too, which mitigates downside risk to earnings.

The case for a narrowing of the ratings gap is pretty compelling and one that could happen sooner rather than later as investors may buy in ahead of the interim pre-close trading statement in early February. They certainly have done so in recent years, as the shares have a tendency to perform strongly in the final calendar month, having produced an average monthly return of 16 per cent in December in the past four years. Bearing this in mind, the share price appears to be basing out around the 150p level, and is in oversold territory, too, having succumbed to profit taking following the annual results a month ago. The share price action adds further substance to the likelihood of a rally unfolding in the weeks ahead, and one that should make inroads to my 12-month target price of 220p.

This is based on a target enterprise valuation of £23.6m, after taking into account forecast net cash of £5.75m at 30 June 2021, to value Arcontech's equity at £29.3m. Even at this level, the company would still only be valued on an ex-cash free cash flow yield of 5.5 per cent. **Buy**.

Risk assessment

Of course there are risks to consider before making an investment. These include:

■ **Customer concentration risk.** Arcontech generated 62 per cent of its £2.95m revenue from four clients in the 2019-20 financial year, so income is heavily concentrated. However, the company has an incredibly low churn rate, having only lost three clients since the start of the 2014 financial year. Lengthy and complex sales cycles also provide an incentive for existing clients to keep their business with Arcontech, as does its competitive pricing and independence.

■ **Loss of key personnel.** The company only lost one member of staff in the 2019/20 financial year, and none the year before. Staff are incentivised with share option schemes and a competitive remuneration package to prevent them leaving.

■ **Brexit may delay conversion of new sales.** There is a risk that Brexit uncertainty could delay conversion of new business opportunities. However, the Covid-19 pandemic has created a much larger shock to the economy than Brexit could ever have, and one that now means financial institutions are looking to save costs. Unbundling current arrangements with market data providers is one easy way to do this, thus offering the opportunity for Arcontech to increase sales of its price competitive software platform.

■ **Credit risk.** This is primarily attributable to trade receivables. Appropriate credit checks on potential customers are made before sales are made and the amount of exposure to any individual counterparty is subject to a limit, which is reassessed annually by the board. Trade receivables are considered in default and subject to additional credit control procedures when they are more than 30 days past due, in line with industry practice. Trade receivables are only written off when there is no reasonable expectation of recovery due to insolvency of the debtor. This is not an issue with Arcontech as its blue-chip client base pay their bills promptly.

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