investors CHRONICLE alpha

4 February 2019

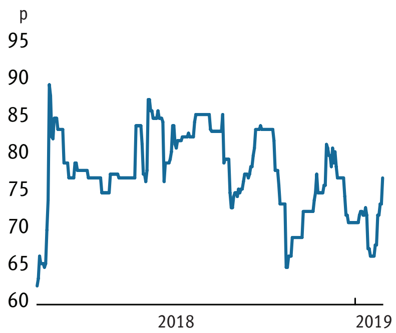
Pelatro: Big data, big profits

This software company offers Big Data solutions to help telecom operators market their services more effectively. A robust sales pipeline and game-changing acquisition last year are supportive of a step change in profits. With the shares priced on a forward PE ratio of seven, this is not reflected in the current valuation

Pelatro (PTRO)

Ticker	PTRO
Current price (p)	80
Target price (p)	120
Market cap (£m)	26.0
52-week high (p)	89
52-week low (p)	60
Net cash (£m)	$1.8m (reported at 14 Jan 2019)
Shares in issue (m)	32.5
Financial year-end	31 Dec
Next event	2018 full-year results in Mar 2019
Company website	pelatro.com

Pelatro share price



Source: Bloomberg

Analyst: Simon Thompson
simon.thompson@ft.com

Alpha Production Editor: Sameera Hai Baig

Simon Thompson's view:

Maintaining customer loyalty is critical in the highly competitive telecoms industry. Pelatro provides its telecom clients with cutting edge software and Big Data solutions so they can market their services more effectively to customers. The industry's appetite for innovative data marketing solutions is growing rapidly, and Pelatro is at the forefront in meeting this demand.

Bull points

- Big data analytics offers tangible benefits to clients.
- Contract momentum and bumper sales pipeline.
- High barriers to entry.
- Growing global footprint.
- Pipeline improves revenue visibility.
- Management have extensive industry experience.
- Operational gearing supports rapid earnings progression.
- Up-selling and cross-selling opportunities across an enlarged customer base.
- Backed by well-regarded institutional shareholders.
- Bolt-on acquisition strategy to complement organic growth.
- Cash-rich balance sheet.
- Outgunning larger rivals in competitive tender process.
- Directors have significant skin in the game

Bear points

- Liquidity.
- Small customer base.
- Lumpy revenues.
- Cash flow management

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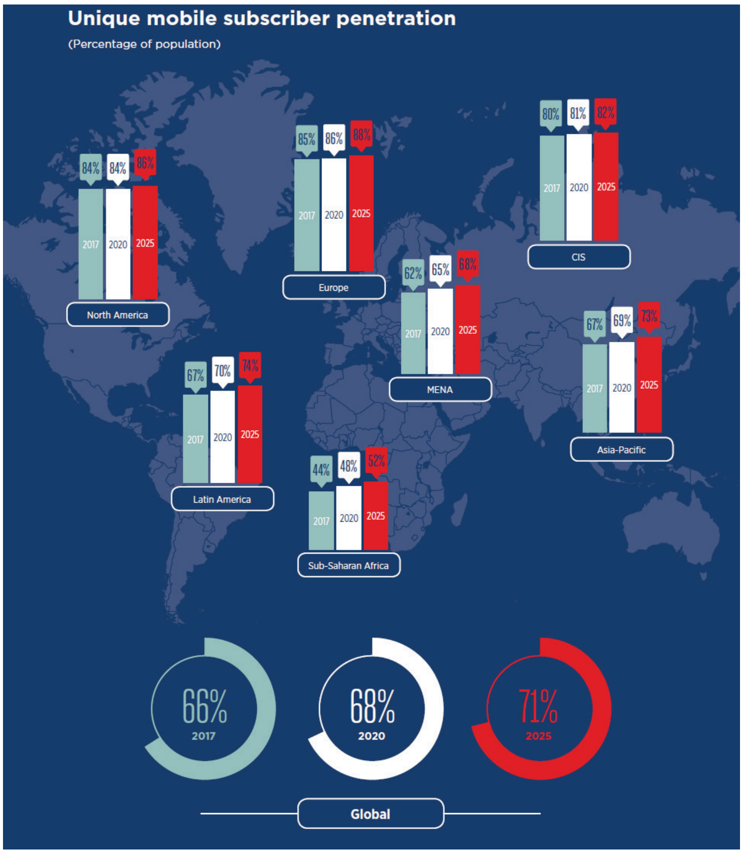
Pelatro (PTRO) floated on the Alternative Investment Market (Aim) in December 2017, raising £3m net proceeds at 62.5 p a share. The company has come a long way since March 2013, when it was founded with the objective of offering telecom operators (Telcos) specialised software solutions for precision marketing campaigns.

Telco companies operate in mature, saturated markets - analysts at GMSA intelligence (which represents the interests of mobile operators worldwide) calculate market penetration rates are above 80 per cent for Telcos in North America, Europe and former Soviet countries. On a global basis, GMSA estimate penetration rates are set to hit 71 per cent by 2025.

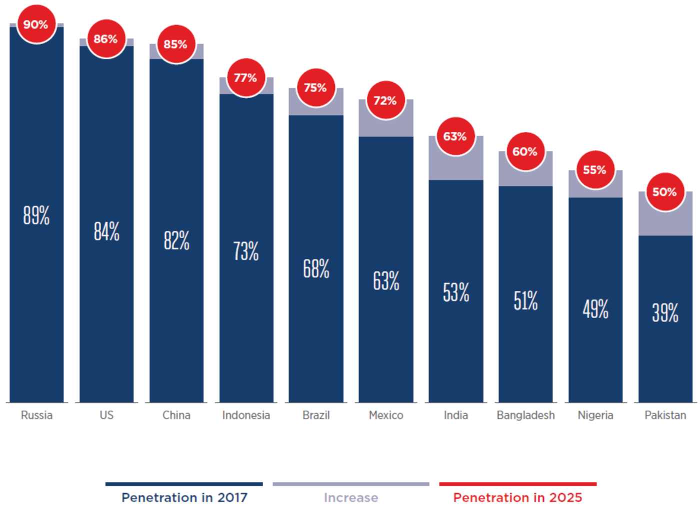
In such highly competitive markets, Telco companies face significant challenges reducing churn amongst existing customers and raising average revenue per user (APRU), as well as high costs to acquire new customers.



Source: GMSA Intelligence (The Mobile Economy 2018)

Mobile penetration in the 10 largest countries by population

Unique mobile subscribers as a percentage of population

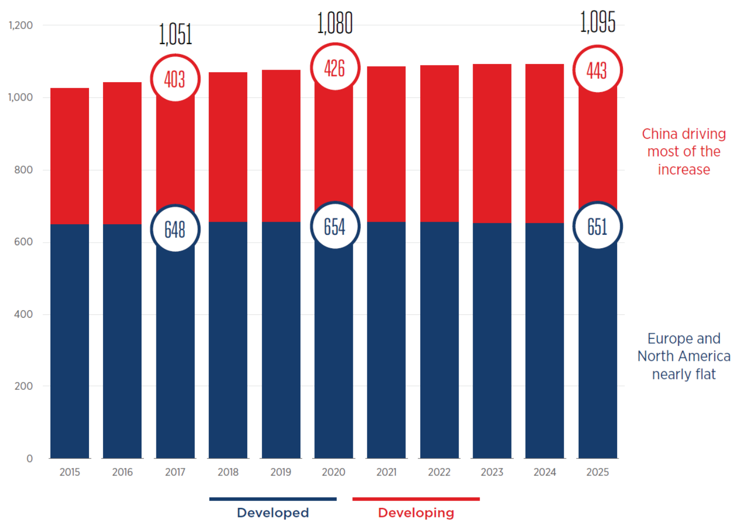


Source: GMSA Intelligence (The Mobile Economy 2018)

The revenue outlook for mobile telecom operators hardly gets the pulse racing either. GMSA Intelligence, which unites nearly 800 operators with more than 300 companies in the broader mobile ecosystem, forecasts that revenues in Europe and North America will be flat for the period from 2015 to 2025.

Mobile revenue outlook

$ billion



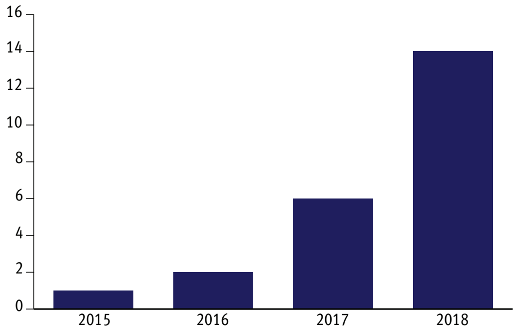
Note: totals may not add up due to rounding.

Source: GMSA Intelligence (The Mobile Economy 2018)

Pelatro's directors believe Telcos need to adopt a new data-driven and personalised approach to engage customers, rather than the ineffective mass marketing campaigns used in the past. Pelatro's mViva product aims to provide the solution. The mViva system is designed to handle large amounts of live streaming data from multiple sources. Its algorithms analyse this information to provide real time insights into customers' behavioural traits.

The key to precision-marketing is being relevant to end users and Pelatro believes its mViva product can play a vital role as it enables companies to better understand their customers and deliver the right message, to the right person, at the right time. Based on the mViva analysis, Telco companies can send tailored offers and campaigns, via appropriate communication channels like SMS, email and apps. The objective is that a more customer-centric and less product-centric approach, will drive up the acceptance rate of marketing offers.

Pelatro's growing client base



Source: Pelatro

Upselling and adding value to the user

By using mViva's targeted approach, Pelatro's Telco customers have experienced an increase of up to 5 per cent in annual incremental revenue per end user through the up-selling of products.

A good example of how this smart Artificial Intelligence (AI) works in practice is a pre-paid mobile customer who consumes 100 voice minutes per month and is given 100MB of data usage free if he/she consumes 120 voice minutes per month. The point is that the cost to the Telco of offering the free 100MB of data is lower than the additional revenue earned.

Another example is a mobile subscriber who has a 5GB monthly contract data limit, but regularly breaches it. So, the customer is offered a 6GB pack which creates additional revenue for the Telco, and helps out the customer too. Up-selling 4G services to customers with a 4G mobile device, but who are on a 3G connection contract, is another opportunity that Pelatro's Artificial Intelligence can identify.

It sounds simple, but mViva is based on cutting edge technology that adds value to the Telco's offering, and enhances their customer experience too, thus improving retention rates as well as enhancing ARPU. It's proving popular.

When Pelatro listed its shares on Aim in December 2017, mViva was deployed by six Telcos across Asia, Africa and the Caribbean to target a combined user base of more than 120m customers. The company now has 14 Telco customers with a user base of 325m customers, and has been winning a raft of new contracts to support expectations of a step change in profitability in 2019, and beyond. Pelatro also has a pipeline of 20 qualified opportunities from both existing and potential customers.

Pelatro (PTRO)

Ord Price: 80p	**Market Value:** £26.0m
Touch: 77-80p	**12-Month High:** 89p **Low:** 60p
Dividend Yield: nil	**PE Ratio:** 7
Net Asset Value*: 45¢	**Net Cash:** $1.8m

Year to 31 Dec	Revenue (US$m)	Pre-tax profit (US$m)	Earnings per share (¢)	Dividend per share (¢)
2015	0.35	0.03	0.3	nil
2016	1.21	0.36	2.2	nil
2017	3.15	1.80	8.9	nil
2018**	6.00	2.90	8.5	nil
2019**	10.50	6.00	15.4	nil
% change	**75%**	**107%**	**81%**	**–**

Normal market size: 3,000 SETSqx
*Includes intangible assets of $1.87m, or 5.7¢ a share as per June 2018 balance sheet. NAV per share adjusted for subsequent £6m share placing in August 2018
**FinnCap forecasts. Pre-tax profits and fully diluted EPS stated before exceptional items and goodwill amortisation. £1=$1.32
Source: Pelatro annual report, London Stock Exchange

Expanding geographic footprint

This has been achieved by expanding Pelatro's reach into new geographies, principally Europe and North America, whilst continuing to expand its presence in Latin America, Africa and Asia.

For instance, in April 2018, Pelatro signed a $1.7m (£1.3m) contract with Tele2, the Central Asian subsidiary of a Western European Telco, which has more than 6m customers. The contract was for the sale and implementation of mViva and includes a 12 month consultancy agreement to assist Tele2 in setting up a customer value management department. The contract was the largest entered into by Pelatro at the time, with the majority of the fees expected to be recognised in 2018. Moreover, once an initial sale is made into a new Telco, Pelatro has potential to sell its services and products to other subsidiaries within the same group.

Bearing this in mind, last summer's acquisition of assets from Singapore-based Danateq, a company that uses data analytics to provide Telcos with campaign management, loyalty management and personal notification solutions, has been a real game changer for Pelatro. That's not only in terms of scaling up the business to target a far larger market, but in terms of extending the geographic footprint of Pelatro's activities, and the customer base too. Prior to the acquisition, Pelatro had eight customers operating in regions outside Europe (Bangladesh, Morocco, Caribbean, Sudan, Cambodia, Sri Lanka, Malaysia and Kazakhstan). Danateq operates in the Philippines, Bangladesh, Myanmar and Bulgaria.

Key to the acquisition is the global framework agreement (GFA) Danateq has in place with Telenor, one of the world's largest mobile telecoms companies with operations focused in Scandinavia, Eastern Europe and Asia. Telenor owns networks in 13 countries, and has operations in 29 countries. As a result Pelatro can now pitch to Telenor operating companies in Sweden, Norway and Denmark. The Telenor GFA covers 90m subscribers across three operating contracts in Bulgaria, Myanmar and Bangladesh, and there is potential for Danateq to win a further eight contracts across Central Europe and Asia, covering an additional 85m subscribers.

Funding the acquisition

The initial cash cost of the acquisition was $7m (£5.3m), with a further $5m of consideration deferred, funded by a placing that raised £6m at 73p a share. At a stroke, it brought in 160m potential subscribers to offer Pelatro's services to and doubled the size of the company's customer base. It has also strengthened mViva's offering by adding a personal notification platform that can channel all communications with subscribers, and a loyalty management product that can be upsold.

Strategically, the deal makes commercial sense as Pelatro was planning to hire additional sales staff in Asia, and Danateq already has a sales office in Singapore. In Europe, a joint sales effort should be more cost effective too. Importantly, the deal was sensibly priced as house broker finnCap estimates that Danateq was generating annual pre-tax profits of $1.4m on revenues of $3m at the time of the acquisition, thus justifying the $7m initial cash consideration paid.

Also, the earn-out has been structured so that a further sum of $2m is paid 12 months after completion if the acquired assets of Danateq generate revenues of $2.25m, with an additional $1m payable if they produce in excess of $4.5m of revenue in the same 12-month period. In the second year post acquisition, the acquisition will need to generate at least $2.9m of revenue ($1m cash payable) for the $1m earn-out payment to be made, and an additional $1m is only payable if Danateq exceeds $5.8m of revenue in the 12-month trading period.

The earn-out targets are not pie in the sky as Danateq already earns recurring annual revenue of $730,000, and a total revenue of $1.5m, from a contract it has with Globe Telecom, a Philippines Stock Exchange listed company which has a market capitalisation of US$5.3bn. Globe is part owned by Singapore Telecom. Danateq has provided software and services to Globe since 2013 under a re-seller agreement which renews annually, and covers 75m subscribers across the Philippines.

The other point is that Pelatro no longer needs to fund the development of a personal notification platform [that can channel all communications with subscribers], or a loyalty management product as the Danateq acquisition has provided the company with these software platforms, which can be upsold. It is also moving away from being a single product company, thus de-risking the investment case by having multiple platforms to offer to Telcos and generate additional revenue streams.

Growing contract momentum

It hasn't taken long for Pelatro to reap the upside of the Danteq acquisition.

In the autumn, Pelatro announced that it had been selected to supply its loyalty management solution – that helps Telcos expand and deepen their relationship with their customers (thereby increasing ARPU and reducing churn) to Grameenphone, the leading Telco in Bangladesh. Grameenphone has 65m subscribers, and is part of the Telenor Group. Pelatro had already been supplying its contextual marketing platform to three operating companies of Telenor, but the fact that it has been selected for this key marketing activity highlights the opportunity to sell multiple products to each customer, and also to other Telcos. Pelatro has now been selected to supply its loyalty management solution to the operations of Telenor globally, thus extending its relationship and creating multiple opportunities to provide Telenor's operating companies with both its mViva Contextual Marketing Solution and mViva Loyalty Management Solutions.

It's not the only contract win as Pelatro also announced in October 2018 that it has been selected by PrimeTel to supply its mViva Contextual Marketing Solution. PrimeTel has 200,000 subscribers and is one of the leading and fastest growing telecom providers in Cyprus. The terms of the contract provide a fixed fee every month and a share of the incremental revenue generated. PrimeTel operates its own 4G Mobile Network and has the largest privately owned fibre-optic network in Cyprus. Furthermore, its high-performance international network spans across Germany, Greece, Russia and the United Kingdom providing network connectivity, data communications and IP-based services.

Other contract awards announced by Pelatro in the final quarter last year include one with NCell, the fastest growing telecom providers in Nepal with approximately 15m subscribers. As a result of these customer acquisitions, Pelatro ended 2018 with 14 customers and a visible pipeline of revenue worth $4.4m, representing 40 per cent of analysts' 2019 revenue forecast of $10.5m. In addition, the company also has a $15m pipeline of business for conversion, offering credibility to the revenue build required to hit this year's turnover estimate.

“Telcos are in a strong position to leverage the ubiquity of mobile phones.”

Data monetisation: a potential game changer for Telcos

The obvious gains from more effective marketing aside, Telcos are in a strong position to leverage the ubiquity of mobile phones.

That’s because they have valuable data about their subscribers and not just from conventional telecom related activities like making calls, downloads, and internet browsing. The data is getting enriched by the day, due to the increasing level of interactions using mobile phones for a variety of transactions such as purchases, cash transfers, hotel reservations, and ticket bookings.

In depth and continuous analysis of this data provides a deeper understanding of the behaviour of each subscriber and paves the way for further commercial interaction. In fact, the directors of Pelatro believe that Telcos are on the cusp of a data-led revolution which could be a panacea for their pains thereby delivering superior revenue gains, profitability and above all, a sustainable and more valuable business model.

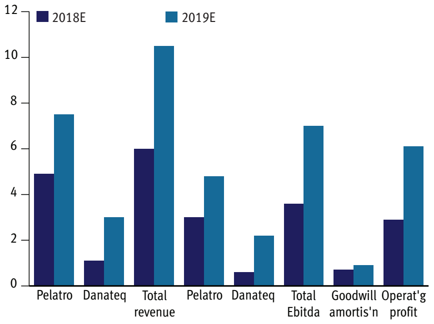
For example, a Telco can easily help an insurance company to identify potential customers for overseas travel insurance on the basis of roaming data that is readily available with the Telco. Taking one step forward, the Telco can provide valuable data about subscribers who stay in hotels regularly to a hospitality chain, thereby paving the way for targeted selling of hotel room packages to those individuals. The point is that the AI being used to help the precision marketing of customer mobile accounts has potential to be monetised in a far bigger way.

That’s because mViva has been built using Big Data technology to enable processing of large volumes of data, streaming in at a high velocity from a wide variety of sources. Upon collecting all the required data in real time, mViva analyses it to arrive at appropriate findings to help send relevant and contextual campaigns. mViva is highly advanced and employs machine language, algorithms, and sophisticated statistical techniques.

Currently, Pelatro’s primary revenue model is to licence the mViva application on a perpetual basis, combining licensing and support and maintenance. Software licences are typically ring-fenced by a scope of use based on quantitative limitations, such as subscriber numbers. This ensures that the charges are appropriately aligned to the value being received by the customer and provides opportunities for additional fees for higher usage in the future. The company also has revenue share agreements with some of its customers. With these arrangements, the incremental revenue generated for the Telco by mViva is shared with Pelatro, as per a pre-agreed percentage, every month. Over time, management intends to offer a managed services model, where the entire campaigning activity is undertaken by a Pelatro team for a fixed fee, which is payable every month.

Pelatro is well placed to gain traction in the global marketplace for multi-channel telecoms campaigns. This market has grown at a compound annualised rate of 19 per cent since 2014 and could be as large as $2.7 bn this year, according to experts at Gartner. Pelatro is also seen as a trusted partner to the Telcos, which is worth considering given the opportunity Telcos have to monetise their data with other commercial organisations.

Pelatro's sales and profit build 2018 and 2019



Source: Pelatro annual reports & FinnCap forecasts

Profits and revenues building

In a pre-close trading update a few weeks ago, the directors confirmed that the robust contract momentum from Pelatro's enlarged customer base has helped the business hit analysts' profit estimates for 2018.

Lorne Daniel, technology analyst at broking house FinnCap expects Pelatro to increase full-year adjusted pre-tax profits by 61 per cent from $1.8m to $2.9m on a near-doubling of revenues to $6m in the 2018 financial year. Expect fully diluted EPS to be slightly down at 8.5¢ as a result of the timing of the August 2018 share placing. Please note that reported pre-tax profits will almost treble from $1.1m to $2.9m as I have added back $700,000 of exceptional costs to the 2017 reported pre-tax profit of $1.1m, to take into account the IPO costs incurred in December 2017.

Pelatro sales and profits build 2018 and 2019

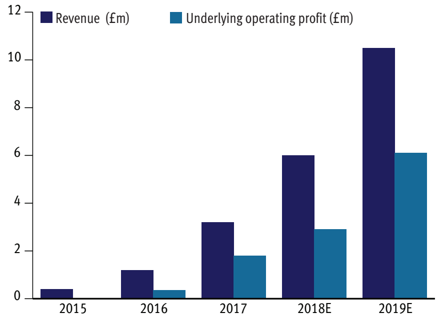
	2018E	2019E
Pelatro	£4.9m	£7.5m
Danateq	£1.1m	£3.0m
Total revenue	**£6.0m**	**£10.5m**
Pelatro	£3.0m	£4.8m
Danateq	£0.6m	£2.2m
Total Ebitda	**£3.6m**	**£7.0m**
Goodwill amortisation	£0.7m	£0.9m
Operating profit	£2.9m	£6.1m

Source: Pelatro annual reports, and FinnCap forecasts

More importantly, with the full benefit of the Danateq contracts in 2019, and also after factoring in organic growth too, analysts expect Pelatro's revenues to surge by 75 per cent to $10.5m in 2019 of which Danateq will account for $3m.

So, with Pelatro earning gross margins north of 85 per cent on sales (and operating expenses only expected to rise from $1.7m to $2m this year), this means that with revenues forecast to rise by three-quarters, a greater proportion of this year's gross profit should drop straight to the bottom line.

Pelatro's high margins underpin accelerated profit growth



Source: Pelatro's annual report and accounts & FinnCap forecasts

Based on Pelatro achieving FinnCap's revenue estimate of \$10.5m, pre-tax profits are set to more than double to \$6m to produce earnings per share (EPS) of 15.4¢, or 11.7p at the current exchange rate of £1:US\$1.32.

On this basis, the shares are priced on a forward price/earnings (PE) ratio of 7, hardly a punchy rating for a company that's predicted to generate EPS growth of 81 per cent in 2019.

Pelatro's high margins underpin accelerated profit growth

Financial year to 31 Dec	Revenues	Gross profit	Gross profit margin
2015	£0.4m	£0.1m	32.6%
2016	£1.2m	£0.6m	47.8%
2017	£3.2m	£2.3m	74.5%
2018E	£6.0m	£5.3m	88.3%
2019E	£10.5m	£9.0m	85.7%

High gross margin feeds through to bumper operating profit growth on incremental revenues....

Financial year to 31 Dec	Revenues	Underlying operating profit	Operating profit margin
2015	£0.4m	£0.03m	8.6%
2016	£1.2m	£0.36m	30.0%
2017	£3.2m	£1.80m	57.1%
2018E	£6.0m	£2.90m	48.3%
2019E	£10.5m	£6.10m	58.1%

Source: Pelatro's annual report and accounts, FinnCap forecasts

Sustainable margins

Reassuringly, the hefty gross margin looks sustainable. That's because the company owns its intellectual property and has been seeing off competition from all ten of its main competitors. These include global corporations, IBM and Oracle, which often offer their campaign management systems as part of wider software and service offering, and several regional and niche companies. In competitive tendering, mViva has beaten both software giants and has even replaced both as incumbents. That's impressive given that it would have been cheaper and easier for customers just to upgrade.

Importantly, there are several barriers to entry in Pelatro's business, including deep knowledge of the domain, data science, algorithms and advanced software languages. In addition to these, the time required to develop a commercial product like mViva runs into several years and the directors believe that mViva is currently the most advanced product available. It is also heavily patent protected.

Improving cash flow & working capital management

The other important take from last month's pre-close trading update is that Pelatro was cash flow positive in the second half of 2018, reflecting much better cash collection and significantly reduced debtor days.

In the first half of 2018, trade receivables increased from $1.78m to $2.67m, so a focus on tighter working capital management is positive even if one would expect debtors to increase as revenues rise for a fast growing company. Pelatro allows for an average debtor payment period of 90 days and ended 2018 with no impaired receivables on its balance sheet. Furthermore, the $732,000 receivable in the 2017 annual accounts from a North African customer that had gone past the standard 90-day payment period has now been paid in full. The company ended the 2018 financial year with net funds of $1.8m.

It's worth noting that as part of its reported debtors' balances, Pelatro may at any one time have significant amounts outstanding, representing unbilled revenue. This may arise, for example, where Pelatro undertakes work for customers in accordance with contract terms, but the "Go Live" date (which may represent the initial invoicing date) is much later in the term of the contract. As is standard practice in the telecoms industry, contractual revenue milestones (and completion of performance obligations for the purposes of revenue recognition for IFRS 15) are typically reached much earlier than invoicing milestones and credit terms of 90 days start following the invoice.

Furthermore, Pelatro typically accumulates a volume of completed minor change requests before formally contracting with the customer to receive a purchase order and invoice accordingly. The process is further lengthened by the need for certain customers to enter into Letters of Credit with correspondent banks. Pelatro views this as sound commercial practice as the customer continues to generate significant volumes of change requests and hence valuable repeating revenue. In fact, the North African customer referred to above generated around $600,000 of change requests in 2018.

"Importantly, Pelatro's balance sheet is not stretched"

Importantly, Pelatro's balance sheet is not stretched as the only borrowings outstanding when the company last reported was a 10-year term-loan of $489,000 secured against the personal property of a director.

Also, if the company can deliver a doubling of both its cash profit and operating profit to £7m and £6.1m in 2019, then cash conversion rates are set to improve no end. Cash profits are also referred to as Ebitda (earnings before interest, taxation, depreciation and amortisation charges) and give a more accurate idea of the overall cash profitability of the business. It's not unrealistic to expect a cash flow from operating activities north of £6m this year. This would cover the cash cost of capital expenditure of around £2.3m, corporation tax and interest costs, and still leave Pelatro with free cash flow of £3m.

That sum will easily cover the first 12-month post completion earn-out of $2m (£1.5m) on the Danateq acquisition. Also, the additional $1m payment for that earn-out period is only made if Danateq generates annual revenues of $4.5m. The point is that if Danateq achieves that target, then Pelatro's cash profits will be significantly higher still, thus providing additional operating cash flow to cover the potential second conditional earn-out payment.

Treatment of research and development costs

The directors use their judgement to determine whether research and development (R&D) costs should be expensed or whether they meet the criteria for capitalisation.

The criteria includes assessing whether the product being developed is commercially feasible, whether Pelatro has adequate technical, financial and other requisite resources to complete the development, and whether the costs will be fully recovered through future sales or licensing of the product.

In the 2017 financial year, around 60 per cent of Pelatro's cash R&D cost of $1.27m was capitalised and the balance (software development) of $525,000 was written off through the income statement. At the end of June 2018, the company had $1.45m of development costs capitalised on its balance sheet, a sum equating to 20 per cent of shareholders funds at the time. The £6m equity fund raise last summer means that shareholder funds should now be north of $15m, and historic capitalised development costs will have fallen to 10 per cent of the company's net asset value.

As long as Pelatro can maintain its high gross margins, and generate the high revenue growth analysts are predicting, then the policy of capitalising more than half of R&D costs is acceptable, albeit it's worth noting that the assets acquired from Danateq are far more profitable if the same accounting treatment is applied to them as the policy of that company is to expense all its R&D costs.

Meet the management

The management team is all important when backing a fast growing company with a limited track record.

In the case of Pelatro, it was co-founded by chief executive and managing director Subash Menon in March 2013, and was incorporated in the US two years later when it had a product to sell and started generating revenues.

Mr Menon had previously founded **Subex (SBXA)**, a global provider of business support systems for Telcos, in 1992 with just $400. In particular, Subex developed and supplied business critical fraud prevention and revenue assurance solutions. It was successful and by the time Subex listed its shares on the London stock market, it was generating revenues of $55m, having grown revenues at a compound annual growth rate of 33 per cent since 2000. However, an ill-timed acquisition funded by $180m of convertible debt meant that control of the company Mr Menon founded ultimately ended up in the hands of debt vulture funds. He left Subex in 2012. It was a hard lesson, but not the end.

Seeing the opportunity to use his extensive industry experience and contacts he had built in the telecoms industry over the previous 20 years, Mr Menon teamed up with his brother and former Subex chief operating officer Sudesh Yezhuvath to co-found Pelatro in March 2013. Mr Yezhuvath is an executive director of the company and has a seat on the main board.

The board is led by non-executive chairman, Richard Day, the co-founder of broking house Arden Partners, who joined the company in 2017. Around 18 months ago, Nic Hellyer was appointed finance director. He is a chartered accountant and former investment banker with over 25 years of experience, having spent the majority of his career at UBS and HSBC. Non-executive director Pieter Christiaan Verkade is a well respected telecoms veteran, having held board positions at Orange, MTN and Telenor. Pelatro's head of engineering, Arun Kunar Krishna, heads up the SDC and is another recruit from Subex.

Directors salaries in 2017 were only $248,000, so can hardly be deemed excessive in relation to the company's underlying operating profit of $1.8m. Importantly, both the founders have significant skin in the game, controlling around 47 per cent of the issued share capital, including family interests. This means that the direction of the share price is more important than a monthly pay cheque, thus aligning their interests with those of outside shareholders.

"Directors' salaries in 2017 were only $248,000, so can hardly be deemed excessive in relation to the company's underlying profit of $1.8m"

Liquidity and major shareholders

It's reassuring to note that there are some well respected institutional investors on Pelatro's share registrar including funds managed by Chelverton, Artemis, Herald, Rathbones and Hargreave Hale. True, the company's two founders and their direct family control 47 per cent of the 32.5m shares in issue, and 53 per cent of the shares are not in public hands. This also means that the top 10 shareholders control around 75 per cent of the issued share capital, so liquidity is below average.

That said, it's still possible to buy and sell the shares in bargain sizes up to 15,000 shares, so well above the London Stock Exchange official Normal Market Size (NMS) of 3,000 shares on the SETS order book. Trades in lower lots seem to go through the market between the bid-offer spread which is well worth considering if you are trying to build a large position through several share purchases.

It's also worth noting that share price moves are likely to be accentuated in both directions given only 8m of the shares are held by investors with holdings below the 3 per cent London Stock Exchange disclosure threshold. That's not an issue if Pelatro delivers the good news on trading I am anticipating, but clearly if the company disappoints at any stage then the share price is likely to be hit harder.

Having issued that cautionary note, it's also worth noting that the shares are only trading on a forward PE ratio of six, so the current rating is hardly excessive to start with, which should limit downside risk. Also, the company's new shareholders subscribed for 44 per cent of the enlarged share capital at prices of 62.5p and 73p, so are unlikely sellers below this level unless Pelatro seriously disappoints.

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Pelatro significant shareholders

Shareholder	Number of ordinary shares (m)	% of issued share capital
Kiran Menon	4.84	14.9
Varun Menon*	4.84	14.9
Sudeesh Yezhuvath	3.31	10.2
Suresh Yezhuvath	2.29	7.1
Chelverton Asset Management	2.05	6.3
Rathbones Investment Management	1.75	5.4
Herald Investment Management	1.56	4.8
Artemis Fund Management	1.54	4.7
Hargreave Hale Limited	1.03	3.2
Maven Capital Partners	1.00	3.1

Source: Pelatro annual report, London Stock Exchange RNS

Peer group analysis

On any basis Pelatro is significantly undervalued compared to its closest peers in the small-cap software and computer services sector.

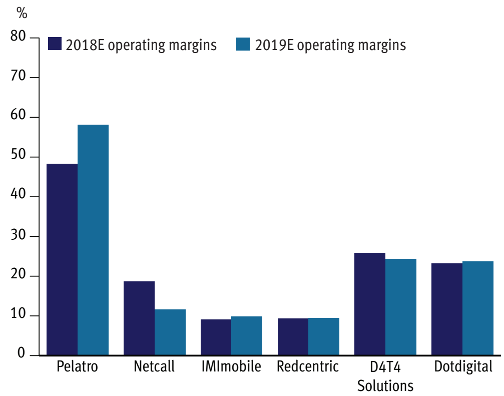
For starters, its forward PE ratio of 7 for the 2019 financial year is not only sub-market, but is between 60 to 75 per cent below the rating of its peers even though Pelatro's forecast EPS growth rate of 81 per cent is the highest. Even if Pelatro was attributed a 2019 forward PE ratio of 10, still a third less than the rating of both IMImobile and Redcentric, then this would warrant a share price around 60 per cent higher than the current level. That would still put the shares on a 40 per cent discount to the earnings multiple of D4T4 Solutions, arguably the closest comparable given that the company is focused on data analytics and data capture for clients operating within the financial services sector and consumer-facing organisations.

Moreover, it's not as if Pelatro has a heavily geared balance sheet to warrant the low-ball valuation. Indeed, on an enterprise valuation (market capitalisation less net cash or plus net borrowings) to operating profit basis, the company is rated on a multiple of just 5.4 times for 2019, less than half that of cash-rich D4T4 Solutions, and just a third of the multiple both Netcall and Dotdigital are valued on.

True, there is a case for a small-cap liquidity discount given Pelatro's below-average free float, its lower market capitalisation and short track record, but even so the current discount being applied is extreme. The lack of a dividend is not an issue for a fast growing company especially as Pelatro is likely to have posted a post-tax return on equity north of 20 per cent in 2018, and this could rise. It makes sense to recycle capital back into the business at this stage of its development.

The low earnings multiples are certainly not justified by the company's level of profitability as Pelatro's forecast

Pelatro's impressive operating margins



Source: Forecasts for Pelatro, Netcall, Redcentric, D4T4 Solutions & Dotdigital (FinnCap); IMImobile (Investec)

operating margin of 48 per cent for 2018, and 58 per cent for 2019, is more than double that of its peers.

Furthermore, even if Pelatro wrote off all its R&D (estimated cost of $1.9m in 2018 and $2.3m in 2019) through the income statement rather than capitalising around 60 per cent of it, the company would still make an operating margin of 30 per cent in 2018, rising to 42 per cent in 2019, far higher than that of D4T4 Solutions and Dotdigital, the most profitable companies in the peer group.

Peer group comparison

	Pelatro	Netcall	IMImobile	Redcentric	D4T4 Solutions	Dotdigital
Share price	80p	32p	222p	72p	193p	80p
Market value	£26m	£46m	£147m	£107m	£74m	£238m
2018E EPS	8.5c	2.0p	11.2p	4.3p	11.0p	3.1p
2019E EPS	15.4c	1.2p	14.7p	4.7p	11.9p	3.7p
2018 PE	11.5	16.0	19.8	16.7	17.5	25.8
2019 PE	7	26.7	15.1	15.3	16.2	21.6
2019 forecast EPS growth	81.2%	-40.0%	31.3%	9.3%	8.2%	19.4%
EV/Ebit 2019	5.4	16.6	11.3	13.7	11.0	17.3
2019E Dividend yield	nil	0.9%	nil	1.7%	1.5%	1.1%

	Pelatro	Netcall	IMImobile	Redcentric	D4T4 Solutions	Dotdigital
2018E Operating margin	48.3%	18.7%	9.1%	9.4%	25.9%	23.2%
2018E Operating margin	58.1%	11.6%	9.9%	9.5%	24.3%	23.7%

Source: FinnCap forecasts for Pelatro, Netcall, Redcentric, D4T4 Solutions and Dotdigital; and Investec for IMImobile

Admittedly, the track record of both these companies and their broader product offering make them a higher quality proposition at this stage. However, Pelatro is building up its business at a far faster rate, and has significant barriers to entry too. The deep ratings discount the shares are trading on relative to peers looks harsh considering the company's high level of profitability. As I have noted earlier, the gross margin earned is sustainable, so with revenue growth outpacing that of operating expenses, then the high operational gearing of the business is such that Pelatro can be expected to post higher EPS growth rate than its peers for some time yet.

Target price

Having taken all the risk factors below into consideration, and the relative rating on a peer group basis, it seems that Pelatro has fallen well below the radar and is anomalously priced especially as the company can be expected to deliver strong earnings growth in the coming years. It is also clearly benefiting from a game changing acquisition. Indeed, the acquisition of certain assets from Danateq is enhancing the quality of its earnings stream by diversifying the product offering and opening up new geographic territories for expansion.

In my view, a 2019 PE ratio of 10 to 11 is warranted for the business at this stage of its development, implying a target price range of between 116p to 128p, giving an initial target price of 120p. **Buy**.

Risk assessment

Of course, there are risks to consider when making any investment and there are several to consider with Pelatro:

■ **Winning new business in line with forecasts:** Central to Pelatro's strategic growth plan is winning new mViva contracts. Failure to do so early enough in a financial year would jeopardise management's ability to deliver and recognise the associated revenues in that period.

The company continues to see strong market demand for mViva solutions, but the risks associated with timing, type, mix and quantum of revenues are largely driven by customers' requirements and budgeting processes. Sales cycles are often lengthy and may sometimes be delayed or restructured late in the process.

That said, the fact that Pelatro has started the 2019 financial year with 40 per cent of projected sales of $10.5m booked already, and has a $15m pipeline of opportunities to target, de-risks the investment case.

■ **Product and service delivery failures:** Issues or failures with the company's software products or services could lead to failed implementations, project delays, cost overruns, data loss, security issues, customer dissatisfaction, early termination, service level breaches and contractual claims, all of which could adversely impact revenues, earnings and Pelatro's reputation.

The risks of servicing large Telcos are significant, but generally stable and well understood, and Pelatro has not suffered any material product or service failures since inception. Risks are generally greater with new clients, but formal requests for proposal processes are routinely carried out by Telcos, which provides clarity as to requirements and expectations.

Pelatro mitigates inherent product and service risks through robust quality assurance and project governance processes. Product releases are unit tested prior to delivery and subjected to further customer testing prior to first use. Customer testing and acceptance sign-offs are required prior to going-live.

■ **Misdirected product, operational or strategic investments:** Pelatro continually invests in product development and operational requirements to support mViva-led growth. Failure to achieve meaningful returns on investments would hinder its strategic growth plan and potentially jeopardise the company's position in the market and its future prospects. To mitigate this risk, the management team was strengthened prior to the IPO, which provides greater control and efficiency to operations. Strong communication lines between relevant stakeholders are ensured through regular formal meetings and monthly reporting. The board also reviews and challenges all strategic investments.

■ **Economic, trade and market risk:** Pelatro is generally exposed to economic, trade and market risk factors. These include global or localised economic downturn, changing international trade relationships, foreign exchange fluctuations, consolidation or insolvency of existing or prospective customers or competitor products, all of which could significantly threaten Pelatro's performance and prospects. The focus on emerging markets customers may increase such risks, too.

Mitigation against the short-term impact of such risks is provided through an increasing spread of geographies and customers, and by monitoring political developments to seek to mitigate emerging risks where possible. Pelatro's high-margin revenues provide a level of protection against volatile economic or market conditions and the policy of ongoing product development helps to maintain a competitive advantage.

■ **Geo-political risk:** A substantial part of the software development operations are undertaken in India. Consequently, political, economic, and social factors, changes in Indian law or regulations and the status of India's relations with other countries may adversely affect these operations and the company's ability to carry out its business. Since 1991, successive Indian governments have pursued policies of economic liberalisation and financial sector reforms. However, there can be no assurance that such policies will continue. Pelatro and its customers also have operations in developing countries, including Morocco, Sudan, Sri Lanka, Malaysia and Bangladesh. Investors in emerging markets should be aware that these markets are subject to greater risk than more developed markets, including in some cases significant legal, economic, tax and political risks. Investors should also note that emerging economies are subject to rapid change.

■ **People risk:** Pelatro is dependent on its ability to attract and retain qualified management and software engineering personnel. Competition for such personnel is intense.

A loss or material issue with key members of staff could cause disruption and skills shortage. Rivals poaching staff could result in intellectual property leakage too. Moreover, employee misconduct, negligence or fraud could cause Pelatro significant reputational damage and potential financial loss.

Although people risks are liable to increase as the company expands, rapid growth presents opportunities for personal development for key staff and engages the workforce generally. Pelatro aims to provide a rewarding working environment, with strong culture and ethics. Key staff are identified through talent assessments and retention plans are implemented, particularly the encouragement of equity ownership by all employees. Moreover, the company has a policy of organising its research and development so that its projects are not dependent on any one individual.

■ **Competition and technology:** The international software industry is subject to rapid and substantial technological change and there can be no assurance that developments by others will not render Pelatro's software obsolete or uncompetitive. To mitigate this threat, the company employs highly qualified software engineers and senior management who monitor and are aware of developments in technology that might affect Pelatro's research capability and product evolution.

■ **IP, data and cyber risks:** A significant IP loss, third party IP challenge, data loss, security breach or cyber attack could threaten Pelatro's ability to carry out its business, particularly in the short term, and could lead to a substantial financial loss. To mitigate this threat, the company has robust processes across IP and IT systems, which are overseen by its head of engineering.

■ **More onerous and tighter data legislation:** The regulatory framework for privacy and data protection issues worldwide is evolving, and various government and consumer agencies and public advocacy groups have called for new regulation and changes in industry practices. New laws and regulations could be adopted in jurisdictions where the company operates, handles or shares data and result in the company requiring additional employees and resources to ensure compliance. The additional overhead is likely to result in a lower level of profitability.

■ **Customer concentration:** A small number of customers represent a significant proportion of total revenue, although customer concentration is reducing as the company scales up.

The relationship of Pelatro with its key customers could be materially adversely affected by a number of factors, including a decision by a key customer to change how, or from whom, they source the products currently provided by the company, an inability to agree on mutually acceptable pricing terms or a significant dispute with the company.

Furthermore, customers may cease to use or reduce their use of Pelatro's products, which would adversely impact the business. Although customers have no obligation to renew their contracts after the expiration of their initial licence period, it's reasonable to expect them to be renewed as long as they are achieving a satisfactory return on their marketing budgets by using mViva.

■ **Currency risk:** Pelatro generates revenues in currencies including pounds sterling, Indian Rupee, Singapore dollar, US dollar and incurs costs in Indian Rupees and pounds sterling. It also prepares its financial statements in US dollars.

This means that the company may be subject to foreign exchange risk which arises as a result of having operations located in various parts of the world, as revenue and costs generated by international operations will be impacted by foreign exchange rates. Fluctuations in exchange rates between currencies in which Pelatro operates may cause fluctuations in its financial results and cash flows which are not necessarily related to the underlying operations.

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Registered office: Number One, Southwark Bridge,
London SE1 9HL. ISSN 0261-3115.