BRADY INTERVIEW - 21 DEC 2015

Key: **Paul Scott ("PS")**
Gavin Lavelle ("GL")

PS:
Hello, I am Paul Scott. Today I am talking to Gavin Lavelle, Chief Executive of Brady Plc. This interview has come about because the company wanted to engage after my critical comments on Stockopedia in my reports of 7 September and 1 December 2015. So firstly thank you for your willingness to discuss things Gavin which I respect.

GL:
Paul, absolutely my pleasure and I look forward to giving some answers to yourself and the investors.

PS:
Thanks, okay. And I would suggest that you are wearing a flak jacket because some of these questions are going to be quite cutting, but hopefully not too bad. So let's really talk about the key issue which is the profit warning.

So your interim results came out on 7 September (2015), and in my opinion those results were quite poor, showed a deterioration and a move into losses, a pre-tax loss of £389,000. But the outlook statement was still upbeat despite needing a very large second half profit to meet full year expectations. And then a profit warning came on 30 November, a "materially below" profit warning. So given the sector woes in the energy and commodities sector, why didn't you see this downturn coming?

GL:
Well first and foremost we operate in the technology space. So we are providing software to energy, metal and recycling companies. And the way software procurement happens is typically companies hold back their IT spend until the end of the year and that is typically the financial year-end. If they have had a good year they will commit and spend money, if they haven't had a good year then they may defer investment decisions.

Now in the first half of the year we don't normally expect to sign a lot of business, it is typically people wait to Q4. In fact we signed two very significant pieces of business, one with the largest recycling company in the world, who are deploying Brady's software around the world to manage their business, this is a multi-billion dollar business. And secondly we signed another very significant piece of business with one of the top four commodity companies on the planet for their global metal business and we signed a total of nine contracts in total.

So whilst the overall commodity markets have been under pressure actually for a number of years we have continued to sign some great names, some very good business. What happens then when the first half concludes, people go away for the summer. We have, and still have, a good pipeline of prospects for us for signature and typically people go away, they come back in September, get reorganised. October/November we had significant amounts of client presentations. Then you roll into contract negotiations in November and December. That is

true not just for Brady, that is true for any technology company. I think if you look at IBM or some of the very big tech companies that it is the same, it is the way the business works.

So what did happen actually in the end of the first half, we had a good pipeline. What did happen was the Chinese market collapsed, I think there is a lot of public discussion about the market in August and September. And off the back of that we have seen a continued sharp decline in prices for metal, for energy, and in fact scrap and recycling prices have all fallen sharply as there has been Chinese dumping in the marketplace and that has been hurting some of the weaker suppliers overall, so I think there was an acceleration. You will have seen a number of profit warnings I think come out from the commodities sector and I think a lot of damage was done over the summer months and then coming back into September. So it was difficult to foresee that.

In fact since that outlook we put in the beginning of September we had a healthy pipeline, we have gone ahead and signed another eight contracts, so we continue to do business. But there are a number and critically a couple of very significant deals that we have been working on that have just been deferred into 2016. So we take it very seriously. If we had felt that there was no chance of doing the year, in September we would have said that, we have had significant contracts, we haven't lost anything significant, I just think there has been a deferral in the market overall.

PS:
Okay. Given the nature of your business then, that Q4 sounds to be absolutely critical to meeting full year numbers, would it not be better to put out very conservative forecasts and then under promise and over deliver rather than setting yourself, or the brokers setting you, a very challenging target for the year?

GL:
Yes. I think that is absolutely fair. We obviously set a budget at the beginning of the year, an expectation at the beginning of the year. We did sign significant business coming into 2016, sorry into 2015, I was really pleased with the quality of the names that we had signed and we felt that that would augur well for the rest of the year. It is just a number of contracts got pushed out and I think we have been in a bear market in commodities since the peak in 2008, the markets are down two thirds, we have continued to sell good business throughout that period and we have continued to show good margin throughout that period. And I do think the last downturn we have seen has been harder and sharper and faster than people anticipate it. And I don't think anybody expected that. We are not in the oil sector per se but I think a year ago nobody expected oil to be low, $40 a barrel at this point. So I think it has been sharper and harder than people anticipated.

PS:
Okay. Looking at your business model then, I was reading through your accounts last night, and you seem to have about approximately half of revenues are recurring and the other half seem to be sort of lumpy licence revenues which does seem to make the business inherently rather unpredictable in terms of profits. Are you trying to move the business more towards a higher proportion of recurring revenues, and if so how far do you think that can go?

GL:
Well over the last ... I think actually in terms of the revenue model for ourselves, we are about 53% of our revenue is recurring, another 27 or 30% comes from services. So as we sell

contracts we deploy people to install the software and configure it. So another 25-30% is service work. We have very good visibility on that, we are rolling out projects, we have good view on that. The last 20% is the licence business, and you are right it does become binary, if we sign a contract good, if we don't sign a contract then that presents a small risk to our overall profitability. But I have always maintained over the last six or seven years our recurring revenue has moved up from 30% to 53% and it continues to move up, and so we do have good visibility coming into the year.

And I think critically we don't have a leveraged balance sheet and I think a lot of the problems that are getting reported in the press are from people with commodity assets that have very highly leveraged balance sheets. Brady we have no leverage in the balance sheet, we generate cash, we have cash, and as our recurring revenue increases this then just puts us in a more and more confident position as we go forward. And I don't think many companies would have more than half their revenues directly contracted, another 30% is services, coming into any one year. So there is always business to sign, I think that is entirely reasonable, and I have always maintained just look at the quality of people we are signing with.

And whilst the markets remain challenging, we are not leveraged, we have a good cash generation, typically we have focused on margin. I acknowledge this year things slowed down faster than we expected but overall we have a very good business model.

PS:
Okay. Just in terms of the profit warning then again, this obviously pole-axed the share price. It was just around about £1 a share in the summer, we are now at less than half that. One reader queries the timing of the announcement. He said 'Normally announcements are put out at 7:00am but this one was put out at 5:47pm'. So there is always a suspicion amongst investors, perhaps we are being paranoid, but feeling that it is slipping out bad news after everyone has gone home for the evening.

GL:
Well I think if that has been a concern, I apologise if that has given any concern to our investors. We had a board meeting in November where it was at that point, as I say November is the time we start to engage in contracts. We had a couple of very significant transactions that hadn't gone away but it became clear they would *not* sign in 2015. We had a board meeting, at that point it was clear that we were not going to make the forecast in the market. As soon as the board meeting finished we went to see our advisers, we realised this was material information. And collectively both our advisers and ourselves agreed that as soon as we had this information it is our responsibility to put it into the market as soon as possible. I think that is good governance overall.

I think in today's market we are very open in terms of what we do, we are not trying to bury anything, there is blogs and tweets. And the service you provide Paul, no-one is trying to obfuscate, it was just a question of as soon as we were aware and the market was aware, we didn't want it leaking out by a third party getting into the market, put it out as soon as possible and we were absolutely available to discuss with our investors. So if that has caused concern I apologise if that is the case, but there has been no question on our mind that that was just getting it into the market as soon as people knew about it.

PS:

Yes, fair enough. I think from my perspective personally as long as the market is shut, I think it is fine to put out trading updates. My nightmare and everyone's nightmare is when an announcement comes out unscheduled in the middle of the day and people don't have time to react. So that wasn't the case here, so yes I am fairly relaxed about that point. Okay, what shall we look at next? Shall we go onto ... oh just at the cost cutting. I noticed in the announcement you said you were going to reduce overheads by £1.7 million in 2016?

GL:
Yes.

PS:
Which is quite a substantial chunk, looking at your last year accounts looks to be about 10% of overheads?

GL:
Yes.

PS:
Could you sort of expand on that and what areas you are making the savings? And will it impair the ability of the business to sort of renew business and so on?

GL:
Yes. No obviously it is disappointing to have to cut back costs. We do spend a lot of time looking forward in the marketplace, understanding our client procurement requirements. It is clear that there has been less buying going on in 2015. I think there is still some uncertainty in the market coming into 2016, so we are being prudent by reducing our cost base. We are absolutely focused on cash and profit generation for our investors. And for our customers, we are working with them to ensure them that we have the right levels of resourcing to meet their current and future needs. So whilst it is disappointing I think in the context of what is going on overall this is a prudent step to take, it is going to put us back on a positive footing for profitability. And it is only non customer, non revenue facing elements that will have been affected.

PS:
Okay. So is it mainly people then, redundancies?

GL:
In the software business 70% of our cost base is people, so inevitably some cost has come out. But we have taken back ... we have cut back in areas which are things like our IT investments or some of our marketing type things which are non people related. Whilst the market is looking a little bit cautious, we are trimming back, this is not untypical in the commodities segment overall. What you will see is basically people are long inventory, they will dump metal or oil or power into the marketplace, this will clear out some of the weaker players. The next thing you know there is a shortage of supply from mines or oil rigs or power stations, there is a shortage of supply, and the next thing you know commodities are moving up sharply.

So we need to ensure we have the skills to respond as and when the market picks up as inevitably it will. I think the super cycle of the world's population going to 10 billion over the next 20 to 30 years and the demand from the emerging markets, India and China in particular,

for the standard of living that we enjoy in the west, that hasn't gone away, there will be continued demand for commodities in the foreseeable future.

PS:
Yes, that makes sense, okay. Now if we move on to the readers' questions and as I say some of these are quite cutting, so brace yourself, this one isn't particularly. Just one reader asks about capitalising of internal costs into intangible assets. Now I had a look at that and I think you capitalised about £1.8 million into intangibles which I presume is development spending?

GL:
Yes.

PS:
Now my personal view is that I think EBITDA is a bit of a nonsense number for software companies because it is ignoring a large chunk of costs which are necessary to run the business. How do you view EBITDA?

GL:
Well from a regulatory requirement, from IFRS, we are obliged to capitalise some elements of new software development. So we do that in line, we run that through our audit department, and I am absolutely confident that that is the correct way to do it. The IFRS rules were strengthened in recent years and I think you will find that between our capitalisation and our amortisation -.

PS:
They are roughly the same aren't they?

GL:
- They are roughly the same.

PS:
Yes.

GL:
So to be honest with you I think that is absolutely reasonable. I think if you compare us, and we do spend a lot of time comparing ourselves with other software companies, our level of capitalisation and the fact that we are breaking even between capitalisation and amortisation, is I think very healthy. I think there are many other software companies who have much higher levels of capitalisation than we do.

PS:
Yes, fair comment, okay. And then a reader called Edward asks about your competitive landscape. He is saying how many key clients do you have and is there any concentration risk?

GL:
So I think there is two questions there. So the first question is the client concentration. We have over 400 customers, no one customer ... and some of these are very large organisations, no one customer is no more than 2% of our revenue, obviously we wouldn't like to lose any of them. But if one of them decided to leave the business or they get bought out or taken out it is no existential risk to our business, I think that is the first point. And the second point, I feel

absolutely passionate that in the industry overall it has been challenging over the last few years in the commodities segment. Of the market leaders in this space we are the only ones without a highly leveraged balance sheet. Some of our perceived leaders in the space have highly geared balance sheets, their revenues are dropping, their earnings are dropping, and I think they are in very tough position.

And secondly our overall market share through this period has definitely been increasing. If you look at the total market size and Brady's position in it, whilst the top line revenue has not been terribly exciting this year, our overall share of the market is no doubt improving and we are increasingly being seen as one of the world leaders in the commodity technology space. And at the end of the day everybody is going to need food, energy and metal, and Brady would take an increasing market share with some great names on the books.

PS:
Okay. And just kind of picking you up on the first point there, the 2% of revenue point, given that the profit warning was material and was because a few contracts didn't close by the year end, then presumably the one off licence chunks are more than 2% of revenue I would take it are they, the initial licence revenues?

GL:
Yes. So the initial licence fees are about 20% of revenue overall. And as I say some of that has slipped, it has been less than we anticipated. As licences slip our service revenues are also lower than we anticipated and therefore we needed to trim in certain areas and services, just making sure we have got the right resources to deliver in 2016 and beyond.

PS:
Okay. And I suppose the licence revenues are effectively 100% profit are they? Is that why they are so material to the bottom line?

GL:
Licences typically, once the customer accepts the software, that is the highest margin for us, it drops straight into P&L. So we try to sell software licences with minimum of customisation, get our customers into production as quickly as possible. And when customers accept the software that is when we can recognise the revenue.

PS:
Okay. Next question is from Max. He is focusing on the dividends. He is saying that historically the dividends have been relatively small but have been steadily increasing, so there is a good progression there. Do you envisage the dividends being cut, maintained or increased going forwards?

GL:
Well I think in terms of the dividends being small, we looked at the average for AIM and FTSE last year. It was below 2% or around the 2% level. At Brady we paid slightly higher than the average in the market, so I would counter we pay a small dividend, so it was about 2.3% last year. Our policy for the last six years our dividends increased each year and we always review dividend policy in the spring, we will see how the year end finishes up, we will see how cash collection goes, see what the forecast is like going forward, and we will make that decision again in the spring.

PS:
Okay. Are you giving the brokers any particular guidance on this, that it is being maintained?

GL:
No. Again because a lot of our business happens in Q4, this is where we announced three deals in an RNS last week. We are busy signing other business, we are busy collecting cash for the year end, and once the dust settles really by the end of January we will have visibility on how we close the year out and what the prospect for the first half looked like. So I think it is too early to make that call. I think we have a great history on paying progressive dividend, even since 2008 the dividend has increased, and we take it very seriously, we appreciate that is important to our customers (I think he meant to say shareholders, not customers). But we will take a view of where we stand with that in spring.

PS:
Okay. And obviously because the share price has halved, the dividend yield has doubled, so the forecast yield now is quite good at 4.4% I note, providing it is maintained of course? Okay, let's look at the next question. Oh yes, let's look at institutions. A reader asks about the attitude of the institutional shareholders. I think about 85% of the shares are held by over 3% shareholders roughly?

GL:
Yes.

PS:
I note that Kestrel have been buying a lot, they are up to about 20% now and Investec have been reducing. So what is the sort of overall picture there, are they supportive or not?

GL:
Yes. Our institutional investors clearly were disappointed with the downgrade and they were disappointed with the share price performance, that is absolutely understandable. However in terms of our strategy of being a leader in the commodity technologies space has great support from our institutional investors. I am delighted that our main shareholder has been taking this opportunity to buy and I think that augurs very well. And I think AIM does have significant investment in the commodities segment, they have seen the commodities cycle, where you get a drop in prices, production shuts down, you get a shortage and the market bounces back. And from our side as I say we are not leveraged, we have a very healthy balance sheet overall with very high recurring revenues and it is just great to see our institutional investors backing us with taking the opportunity to buy.

PS:
Okay. And another reader who asks about Kestrel said 'Have they pushed the board into taking cost cutting actions or any other strategic changes?'

GL:
No. Well I think we clearly have announced our cost cutting. We are discussing this with our major shareholders, we will see how the year finishes up. We will be making a trading statement in January and a full roadshow in March. But we welcome feedback from all of our investors and I am confident that we are doing the right things to protect the long term interest of our shareholders. I would note that the Brady board own more than 10% of the shares and I personally bought more shares in September. I think that is an important statistic.

PS:
Oh that is interesting yes, yes. Actually another reader asks 'Why have the board not personally bought any shares since the profit warning?'

GL:
Well the board own over 10% already and actually I have consistently bought, I have never actively sold other than one case I had some share options which I had to exercise, I bought again in September. And I think the board have not sold shares, they have stood behind the company and I think we are invested.

PS:
Okay. This is probably the most cutting question of them all. But another reader asks 'With the current senior management having run the company for eight years and the share price is down on when he took over, is it time to give some new blood a chance?'

GL:
I think that is a fair question. I would say you have to look at the context. From 2008 to today the commodity markets are down about two thirds in aggregate, so these have not been particularly ... if you are not selling as much as you would like to do you have to ask is the market conditions healthy and vibrant? I think you will read in the headlines on a lot of the commodity companies, in this period we have absolutely transformed Brady from nobody had heard of us when we first got involved and I would remind everybody this year we signed one of the top four commodity companies on the planet to rollout their software globally. We sold the number one recycling company on the planet employing our software globally. We have come a long way.

And actually Brady's position and standing in this market has improved massively whilst companies that were perceived market leaders are dropping significantly because they are over geared, over geared balance sheets, and we are signing great business with great names. And I think that we shouldn't lose sight of that in terms of the market context.

PS:
Yes, yes, no that is a fair point. Okay, that is it. Well done for weathering that onslaught, I hope it wasn't too bad? We are probably out of time now, I think we have answered all the questions. So over to you for any closing remarks?

GL:
Yes. I think one thing we should ... I think some of your questions refer to what are we doing to increase in the recurring revenues and remove our reliance on lumpy licence sales. One of the really important statistics this year is to date 75% of our new contracts have been delivered via the Cloud. So we started the Cloud programme about three years ago, our Cloud revenues and our ability to deliver via the Cloud is gaining momentum significantly. This means that we get a higher recurring revenue, it means we get more of the overall customers' IT spend whilst at the same time we can do that more effectively and more efficiently for our customers. So I think this is a terrific progress in the business model overall, it will give financially more recurring revenues. And we are clearly at the cutting edge of deploying technology and we will see the benefits of that as we go forward.

PS:

Okay, great. Well thanks for that Gavin. We will probably wrap up now. And just if I can conclude by saying thank you for approaching me and being willing to engage. I think it is really good and I hope more companies will do that to talk to investors after bad news as well as after good news, so thank you and well done for that.

GL:
Paul, thank you for taking the time.

PS:
Righto, cheers then.

GL:
Goodbye.

PS:
Thanks goodbye.