



SYNCHRONICA

BUY*

Cutting its cloth to fit its width

8.6p[#]

Year-end December	2009A	2010A	2011E	2012E
Revenue (\$m)	5.9	10.9	22.5	36.0
EBITDA (\$m)	-3.5	-0.8	-3.8	8.0
Adj. Pre-tax Profit (\$m)	-3.8	-4.9	-8.2	3.8
Adj. EPS (cents)	-13.8	-6.3	-6.2	2.6
DPS (cents)	0.0	0.0	0.0	0.0
Net Cash/(Debt) (\$m)	4.3	1.2	0.0	1.5
P/E (x)	NEG	NEG	NEG	5.2
Dividend yield (%)	0.0	0.0	0.0	0.0
EV/EBITDA (x)	NEG	NEG	NEG	2.5

Key Data	
Rating (12 month)	BUY
Price Target	20p
Risk	Moderate
Sentiment	Positive
Ticker	SYNC.L
Shares in issue	157.2m
Market cap	£13.6m
12-mth price range	8.6p-33.7p
Net debt (H1)	£1.4m
Next event	Q3

SOURCE: Northland Capital Partners Limited estimates

[#]Priced at market close, 14th October 2011

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Synchronica has announced a substantial restructuring and cost saving exercise to bring the cost base into line with the recurring revenue base. It has also announced new short term payment arrangements with its customers. This follows the announcement last month that delays on payments expected in Q4 from Tier 2 device manufacturers (c. \$2m) had placed the balance sheet under short term stress. Substantially reduced forecasts reflect the more conservative growth plan, a shift from the perpetual licencing of software to provision of software as a service. We reduce our price target to 20p (from 53p) but retain our BUY rating.

COMPANY DESCRIPTION

Provider of next generation mobile messaging and data services infrastructure software and associated services to Mobile Network Operators and Device Manufacturers.

- FARM THE BASE:** The new plan set out by the new CEO (formerly CFO) and Executive Chairman focuses on exploiting the considerable customer base (93 MNOs and 10 device manufacturers) amassed through acquisition and organic growth rather than pursuing a continued 'land grab' strategy. Given the base, sector outlook and Synchronica's resources, this seems appropriate.
- COST/REVENUE BALANCE:** Recurring revenue is c. \$3m per month but the cost base was c. \$4m. The planned cuts will reduce costs by a third and the business should be profitable purely on recurring revenue with one-off and new licences mainly dropping to the bottom line. There is an associated c. \$2m cash cost to the cuts.
- FUNDING:** Synchronica's customers have, for a discount, agreed to make advance payments. Synchronica is also looking at factoring its invoices with its North American MNO customers. Finally, there is scope to take on short term debt, although not assumed in our forecasts. The balance sheet will remain tight for FY11 and FY12 but Synchronica should be able to trade through without recourse to the markets.

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INVESTMENT APPRAISAL

The substantial cost saving programme represents an important shift in ambition and outlook from 'land grab' to farming the base of customers (mobile network operators and handset manufacturers) already amassed. The shift follows the departure of two founders of the business (Carsten Brinkschulte and Nicole Meissner) and the promotion of Angus Dent to CEO from CFO and David Mason to Executive Chairman from a non-executive role. We believe the more conservative growth model and lower cost base is appropriate given a relatively uncertain outlook for IT spending and capital markets. As management deliver the plan and concerns about its balance sheet abate, the shares should enjoy a rerating that reflects the good visibility on Nokia-associated revenue and the growth opportunity afforded by farming a substantial customer base. Forecasts are substantially reduced to reflect the changes but we maintain our BUY rating and set a price target of 20p (from 53p).

Shift to farming from 'land grab'

After the Nokia OBM acquisition and its organic growth, Synchronica has a substantial recurring revenue base of c. \$3m per month but a cash cost base of c. \$4m per month. Under the previous model, the company expected large one-off licences and rapid growth of incremental licence sales to the base would more than bridge the gap. The new senior management team has taken a much more conservative view of the timing and scale of such sales and has initiated a programme that will cut costs by around a third at a cash cost of c. \$2.0m.

Cost/revenue imbalance addressed

Delays to payments of c. \$2m from Tier 2 handset manufacturers that were expected in Q4 have also focused the minds of senior management. These delays, caused by issues with third party software, put the balance sheet under additional short term stress and precipitated and expanded the cost cutting exercise that was always scheduled post the Nokia deal. Meanwhile, Synchronica has purchased the third party software and will complete the development with delivery expected by year end and payments should come through from Q2 2012.

Largely through the previous acquisitions, Synchronica has assembled an experienced management team that can deliver on the new plan. Synchronica has also made selective hires e.g. a new VP of Sales North America, formerly at Intellisync.

Experienced management to deliver

The lower revenue reflects a shift, partly driven by the carriers and partly at the company's insistence, from the perpetual licencing of software to the rental/SaaS model. This is painful for Synchronica in the short term, but should build more predictable revenue and cash streams for the business in the mid term. Synchronica's aim is to have more than 90% of its revenue from recurring sources by end 2012.

The restructuring programme includes c. 80 redundancies across all offices (down c. 22%); closing three US satellite offices; the reduced use of contractors; rationalising the hosting; in-sourcing testing and migrating other development work to low cost offices (Manila and Mumbai); and changes to the development roadmap. The latter change will not impact functional enhancement for customers (centred around unified messaging and location-based services) but rather Synchronica will maintain and enhance two platforms (Mobile Gateway and OZ inherited from Nokia) for longer.

Broad based restructuring



Under previous stewardship, the North American business was focused on the development of the Nokia Mobile Messaging platform rather than the North American MNOs. This meant that many functional developments were not extended to the MNO customers. Synchronica has re-engaged with those customers and will roll out existing functionality as well as offering new functionality such as location-based services and unified messaging (SMS, IM, email, social networking and voice mail). These take advantage of the operators' strengths versus apps or OTT (over the top) services that can be downloaded onto smartphones and threaten to turn the MNO into a commodity 'dumb pipe' provider.

Re-engaged with North American MNOs

REVISED FORECASTS

We have substantially reduced our top and bottom line forecasts for FY11 and FY12. This reflects the more conservative growth plan and assumptions. The revised forecasts for FY11 also reflect the estimated costs associated with the departure of the founders and the restructuring. Trading in North America post acquisition has been in line with expectation (c. \$1m revenue per month) and likewise the delivery against the Professional Services contract (c. \$1.4m per month) but the accelerated payment terms will result in a top line discount (c. 10%) on the latter. Given H1 revenue of \$5.8m and recurring revenue of c. \$0.5m per month from the Synchronica core, our revenue target of \$22.5m (previously \$31.7m) assumes new product sales of \$1.7m in H2. This is amply covered by the prospect pipeline.

Substantial forecast reductions

On top of the adj. EBITDA loss of \$3.8m (previous forecast EBITDA profit of \$5.8m), we expect a restructuring cost of \$2.0m as well as one-off costs of \$1.6m associated with the Nokia OBM acquisition. There is also likely to be a non-cash impairment charge relating to the carrying value of intangibles.

Restructuring charges

Our FY12 revenue forecast of \$36m (from \$56.1m) includes \$10.4m from the Nokia Professional Services contract. There is considerable opportunity to increase the scale of the Professional Services contract and provide other services but these are not included in our current forecasts. \$9.6m comes from OBM with revenue continuing to decline on a monthly basis in H1 before partially recovering in H2. In the core Synchronica business, we expect \$8m to come from recurring revenue with a similar amount from new sales. This represents a 53% increase in recurring revenue and a 51% increase in new sales. With the more conservative growth profile, new business that we expected to be secured in FY11 has been pushed out and hence recurring and incremental sales come off a lower base.

FY12 move to profit

The EBITDA of \$8m (from \$18.6m) reflects the lower operating cost base. In terms of cash conversion, there is an additional c. \$1m of capitalised development spending and the initial deferred payments to Nokia for the OBM business based on 22% of the Nokia-related revenue (c. \$4.5m). Synchronica should also receive the outstanding \$2.0m from the Tier 2 device manufacturers. Coupled with normal working capital requirements, year-end net cash should be \$1.5m.

The substantial reduction in forecasts for FY11 and FY12 means we are also substantially reducing our price target to 20p (from 53p) but retain our BUY rating. This price target represents 12.2x FY12 forecasts falling to around 7x expected FY13.

20p price target



REVISED FORECASTS

Year end December	2010A	2011E New	2011E Old	2012E New	2012E Old
Revenue (\$m)	10.9	22.5	34.0	36.0	56.1
Adj. EBITDA (\$m)	-0.8	-3.8	6.2	8.0	18.6
Adj. PBT (\$m)	-5.3	-8.2	2.4	3.8	14.2
EPS (cents)	-6.3	-6.2	1.9	2.6	7.5
Net cash (\$m)	1.2	0.0	2.6	1.5	11.3

SOURCE: NORTHLAND CAPITAL PARTNERS LIMITED ESTIMATES



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