



8th December 2011

# Synchronica

## Q3 results highlight roadmap to profitability

**Synchronica is a UK-based company specialising in next generation mobile messaging and social networking technology and services. Blue chip customers and distributors include Nokia, Huawei, NSN, mobile operators, and device manufacturers.**

- Synchronica's Q3 was the first to include the new Nokia Operator Branded messaging business (OBM) and associated Professional Services business acquired at the end of July, thus including two months of the new business. Revenues grew over 8-fold to \$6.97m, with \$4.68m of revenues coming from the acquired businesses. Recurring revenues increased 11-fold over the same period.
- EBITDA losses widened from \$2.24m to \$3.55m, including a \$1.62m bad debt write off, with the acquired businesses contributing \$77k EBITDA in the period. Operating losses widened from \$3.92m to \$9.48m, due to larger EBITDA losses as well as larger exceptional costs and intangible asset write offs. The Balance Sheet now includes \$12.6m of liabilities for the remaining Nokia deal price, reflecting the IFRS discounted measure of the headline \$20.2m liability.
- Given the various one off costs and the partial contribution from the Nokia businesses, the Q3 results do not provide an accurate picture of Synchronica's performance. We have estimated a pro forma quarter, which shows that in the absence of any cost reductions, quarterly EBITDA losses would be of the order of \$1.9m rather than the \$3.5m reported for Q3. Subtracting the \$3m of operating costs per quarter that the company has recently secured leads to quarterly EBITDA of \$1.1m and a small operating profit of \$0.25m and, assuming reasonably working capital management, positive cash flow.

**Synchronica shares have fallen heavily after recent events, to an all-time low of 5p. On paper, they should be worth considerably more given the move to profitability plus the undoubted strategic value of Synchronica's customer base and technology.**

**Support for much higher valuations should start to come through in early 2012, as the company becomes profitable off the back of the recently implemented cost reductions.**

### Company Details

EPIC	SYNC
Share price, p	5
52 week High/Low, p	34 / 5
Issued share cap, m	127.9
Market cap, £m	6.4

### Share Price, p



Source: ADVFN

All our research is available at [www.equitydevelopment.co.uk](http://www.equitydevelopment.co.uk)

### Forecasts

Year to 31 December	2010A	2011E	2012E	2013E
Adj Pre-tax \$000s	-7,285	-16,755	2,469	6,284
Adj EPS, p	-2.52	-5.11	2.75	4.24
PER	Na	Na	1.8	1.2
Div, p	0	0	0	0

Company historic data, ED estimates

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## Q3 RESULTS

Synchronica's Q3 was the first to include the new Nokia Operator Branded messaging business (OBM) and associated Professional Services business acquired at the end of July, thus including two months of the new business. Given the various one off costs and the partial contribution from the Nokia businesses, it would be fair to say that the Q3 results do not provide an accurate picture of Synchronica's performance. After the results analysis, we estimate a pro forma quarter based on the cost savings initiated by Synchronica.

The results are summarised in the following table, broken out where possible to show the various contributions from the existing ('Old') and acquired businesses. The major headlines are as follows:

- Revenues grew over 8-fold to \$6.97m, with \$4.68m of revenues coming from the acquired businesses. Recurring revenues increased 11-fold over the same period.
- Gross profit grew nearly 7-fold to \$5.29m, for a margin of 76%, the 14pp reduction in margin reflecting the impact of the Nokia Professional Services business, at 57% margin.
- EBITDA losses widened from \$2.24m to \$3.55m, with the acquired businesses contributing \$77k EBITDA in the period. Note that EBITDA losses included \$1.62m bad debt write offs related to issues with device manufacturers (see below).
- Operating losses widened from \$3.92m to \$9.48m, due to \$1.3m extra EBITDA losses, \$1.4m additional exceptional costs, and \$3.4m of additional D&A and intangibles write-offs relating to previous acquisitions, offset by \$0.6m of favourable exchange movements.
- Q3 cash outflows totalled \$12.0m against an inflow of \$2.1m in Q3 2010, reflecting \$2.8m higher operating cash spend, a \$3.2m working capital swing, \$0.8m higher capex/R&D capitalisation and the \$4m initial payment for the Nokia businesses, compared with a \$3.4m cash inflow from acquisitions last year.
- The cash spend in Q3 was funded by the July net \$14.5m equity fund raise, leaving the company with \$1.29m of cash. In addition, \$12.6m of borrowings were added to the balance sheet, reflecting the discounted IFRS value of the \$20.2m owed by Synchronica for the Nokia businesses, which is due to be paid by the 31<sup>st</sup> December 2015 as an on-going revenue share.

Aside from incorporating the Nokia businesses in the quarter, Synchronica also revealed that Microsoft in Latin America had ordered an operator branded instant messaging client app for its WP7 mango mobile operating system. Whilst this is intended initially for a Latam-based mobile operator, it could potentially open up similar opportunities with other mobile operators globally.

Synchronica Q3 results		\$'000s			
	3Q10	3Q11		3Q11	
P&L		Old	OBM	Prof Svc	Total
Revenue:	746	2,294	1,889	2,786	6,969
Gross profit	674	2,159	1,543	1,586	5,288
Gross margin	90%	94%	82%	57%	76%
Operating costs					
Exceptional items	(505)	(232)	(1,707)		(1,939)
Staff costs charged		(2,354)	(2,661)		(5,015)
Bad debt provision		(1,618)			(1,618)
Other administrative costs	(2,910)	(1,812)	(391)		(2,203)
Forex losses (gains)	(258)	304			304
Impairment of Customer Relationships		(2,927)			(2,927)
Impairment of Contract rights		(600)			(600)
Amortisation & depreciation	(921)	(578)	(188)		(766)
<b>Total</b>	<b>(4,594)</b>	<b>(9,817)</b>	<b>(4,947)</b>		<b>(14,764)</b>
EBITDA	(2,236)	(3,625)	(1,509)	1,586	(3,548)
Operating Profit	(3,920)	(7,658)	(3,404)	1,586	(9,476)
Finance costs	(701)				(815)
<b>PBT</b>	<b>(4,621)</b>				<b>(10,291)</b>
<b>CASH FLOW</b>					
Operating Cash flow pre wc	(2,684)				(5,444)
Working capital	1,272				(1,902)
Tax	306				325
Acquisitions	3,421				(4,000)
Capex	(183)				(976)
Total	2,132				(11,997)
Shares issues	1,806				14,482
Other funding	(1)				(2,226)
Net funding	1,805				12,256
Change in cash	3,937				259
Exchange rate impacts	(181)				381
Starting cash	1,168				654
Ending cash	4,924				1,294
Borrowings	-				12,617
<b>Net cash (debt)</b>	<b>4,924</b>				<b>(11,323)</b>

Source: Company reports

Just prior to the Q3 results release, Synchronica had given an update on its cost rationalisation programme (see our note of 17<sup>th</sup> October) and on problems with device manufacturers, which will delay the receipt of \$4m of cash payments. The target cost reductions have been achieved, delivering annual savings of \$12m. Meanwhile, Synchronica is addressing the handset issue by taking over production of the third party software necessary to ensure the proper working of Synchronica's software on the MediaTek OS-based devices in question. Synchronica believes that it will ultimately recover \$2.4m owed, with the remaining \$1.6m written off as bad debt in Q3. However, now being part of the MediaTek Toolkit may open up other opportunities.

## ACHIEVING PROFITABILITY

As we noted above, the Q3 results are not particularly indicative given both only a partial contribution from the Nokia businesses as well as the large one off costs and the subsequent cost rationalisation programme. Hence, below we show an estimate of pro-forma quarterly performance, based on the following assumptions:

- The same existing Synchronica revenues and gross margins as in Q3.
- For Nokia OBM and professional Services, we gross up revenues and staff and other costs for three months rather than the two, and assume the same gross margin as in Q3.

This shows that in the absence of any cost reductions, quarterly EBITDA losses would be of the order of \$1.9m rather than the \$3.5m reported for Q3. Subtracting \$3m of operating costs per quarter leads to quarterly EBITDA of \$1.1m and a small operating profit of \$0.25m and, assuming reasonably working capital management, positive cash flow.

Synchronica Route to Profitability \$'000s				
	3Q11			3Q11
	Old	OBM	Prof Svc	Total
Revenue:	2,294	2,834	4,179	9,307
Gross profit	2,159	2,315	2,379	6,853
Gross margin	94%	82%	57%	76%
Operating costs				
Staff costs charged	(2,354)	(3,992)		(6,346)
Other administrative costs	(1,812)	(587)		(2,399)
Amortisation & depreciation	(578)	(282)		(860)
Total	(4,744)	(4,860)		(9,604)
Operating profit - Q3 rate	(2,585)	(2,546)	2,379	(2,752)
EBITDA - Q3 rate	(2,007)	(2,264)	2,379	(1,892)
Net of c\$1m monthly cost saving				
<b>Operating profit</b>				<b>249</b>
<b>EBITDA</b>				<b>1,109</b>

Source: ED

This analysis is necessarily simplistic, and whilst we have a reasonable idea of costs, revenues are still relatively unpredictable. First, the OBM business is currently in decline, and will take time for a product upgrade supplied by Synchronica, as well as renewed marketing efforts by the client mobile operators, to take effect, such that our pro-rated estimate may be optimistic. Similarly, the assumed pro-rate Professional Services revenues, at \$4.2m, are higher than the broad average rate for the duration of the contract (\$18m over 18 months). On the other hand, the 'Old' Synchronica business is typically relatively quiet in Q3, with contracts weighted towards Q2 and Q4, and our assumed revenues may therefore understate this element of the profitability analysis.

## FORECASTS

We have retained our forecasts for 2012 and 2013, which broadly incorporate the efficiency gains highlighted above, but have adjusted the 2011 forecast below the revenue line to reflect the Q3 results. The unchanged 2011 revenue forecast of \$22.6m requires \$9.8m in Q4, compared with our pro forma quarterly revenue estimate of \$9.3m. However, the Q3 release states that Synchronica expects revenues to accelerate in Q4, with several large licence deals with high profile customers in prospect. Below revenues, a combination of a lower gross margin assumption (80% versus 95% to reflect the impact of the Professional Services business) and higher cash costs including the Q3 bad debt charge, mean that our forecast EBITDA loss has widened from \$4m to \$7.9m, implying \$1.7m of losses in Q4 (a period which only partly includes the cost savings).

Synchronica forecast Profit and Loss Account \$'000s					
	2009A	2010A	2011F	2012F	2013F
Synchronica existing			11,500	14,700	18,000
Operator branded messaging			4,600	10,000	11,000
Nokia professional services			6,500	10,400	5,000
<b>Total Revenue</b>	<b>5,934</b>	<b>10,924</b>	<b>22,600</b>	<b>35,100</b>	<b>34,000</b>
Growth	3.2%	85.4%	106.9%	55.3%	-3.1%
Cost of sales	(263)	(480)	(4,520)	(1,755)	(1,700)
Gross profit	5,671	10,444	18,080	33,345	32,300
Gross profit %	95.6%	95.6%	80%	95%	95%
Depreciation	(210)	(277)	(834)	(1,478)	(1,478)
Amortisation	(696)	(3,335)	(5,392)	(4,398)	(4,398)
Exceptional costs	(1,419)	(1,887)	(609)		
Other administrative expenses	(8,530)	(11,277)	(26,000)	(25,000)	(20,140)
Finance (losses)/gains on operating activities	113	(139)	-	-	-
Operating profit (loss)	(5,071)	(6,194)	(14,755)	2,469	6,284
<b>EBITDA</b>	<b>(2,859)</b>	<b>(833)</b>	<b>(7,920)</b>	<b>8,345</b>	<b>12,160</b>
EBITDA margin	-48%	-8%	-35%	24%	36%
Finance income	320	79	-		
Finance cost	(432)	(852)	(2,000)	-	-
Taxation	231	465	200	200	200
<b>Profit (loss) after tax</b>	<b>(4,952)</b>	<b>(6,502)</b>	<b>(16,555)</b>	<b>2,669</b>	<b>6,484</b>
<b>Earnings per share</b>					
Average shares in issue (m)	33.2	61.1	127.8	158.7	158.7
Diluted shares in issue (m)			176.5	231.6	231.6
Adjusted basic EPS (cents)	-10.6	-6.4	-8.3	4.5	6.9
Adjusted basic EPS pence	-6.6	-4.0	-5.1	2.8	4.2
<b>Fully diluted EPS (cents)</b>			<b>-6.0</b>	<b>3.1</b>	<b>4.7</b>
<b>Fully diluted EPS (pence)</b>			<b>-3.7</b>	<b>1.9</b>	<b>2.9</b>

Source: Company reports, ED estimates

Adding in the various exceptional costs (\$2m in Q4 for cost savings) plus the intangibles write-offs in Q3 expands the overall operating loss from \$7.9m to \$14.8m.

It should be noted that the exceptional cost total of \$0.6m includes a positive \$3.9m of gains from the Neustar acquisition, offset by the \$2.5m of costs taken to date plus the \$2m to come in Q4. Our cash flow forecast has also worsened due to the bigger EBITDA loss and other factors, with a year end net debt of \$21.9m. This net debt estimate assumes the full \$20.2m remaining liability for the Nokia acquisitions rather than the IFRS discounted value of \$12.6m which is reported by Synchronica.

<b>Group Cashflow Statement</b>		<b>\$'000s</b>				
	<b>2009A</b>	<b>2010A</b>	<b>2011F</b>	<b>2012F</b>	<b>2013F</b>	
Profit (loss) before taxation	(5,183)	(6,967)	(16,755)	2,469	6,284	
Depreciation and amortisation	906	3,335	6,226	5,876	5,876	
Finance (losses)/gains on operating activities	(113)	139	-	-	-	
Finance Income/costs	112	773				
Equity settled share based payment	123	318	318	318	318	
Change in working capital	(3,195)	(6,277)	(1,168)	(1,250)	110	
<b>Operating Cash flow</b>	<b>(7,350)</b>	<b>(8,679)</b>	<b>(11,379)</b>	<b>7,413</b>	<b>12,588</b>	
Finance income (costs)	17	(16)	(2,000)	-	-	
Tax (paid) / received	416	157	200	200	200	
Tax and Finance cash flow	433	141	(1,800)	200	200	
Acquisition of subsidiaries	-	2,670	(6,442)	(4,488)	(3,520)	
Purchase of intangible assets	(2,049)	(3,327)	(2,300)	(4,000)	(4,000)	
Purchase of property plant and equipment	(224)	(260)	(1,000)	(1,000)	(1,000)	
Investing cash Flow	(2,273)	(917)	(9,742)	(9,488)	(8,520)	
Net proceeds from issue of ordinary share capital	7,669	6,048	15,646	-	-	
Other funding	713	460	4,200	(4,200)	-	
Financing Cash Flow	8,382	6,508	19,846	(4,200)	-	
Exchange rate differences	37	(140)				
Cash and cash equivalents at period beginning	5,023	4,252	1,182	(1,892)	(7,967)	
<b>Cash flow in period</b>	<b>(808)</b>	<b>(2,930)</b>	<b>(3,074)</b>	<b>(6,075)</b>	<b>4,268</b>	
<b>Cash and cash equivalents at period end</b>	<b>4,252</b>	<b>1,182</b>	<b>(1,892)</b>	<b>(7,967)</b>	<b>(3,699)</b>	
Nokia liability			20,000	15,512	11,992	
<b>Net cash (debt)</b>			<b>(21,892)</b>	<b>(23,479)</b>	<b>(15,691)</b>	

Source: Company reports, ED estimates

## VALUATION

As we noted at the time, the Nokia acquisition substantially strengthened the valuation case for Synchronica, by bringing forward profitability and positive cash flow, improving the quality and visibility of revenues, and significantly improving the company's competitive position (and strategic value). These Q3 results give a hint of the impact, but also contain a lot of red ink due to the various write offs, which the rejigged management team has prudently taken. On paper, as our analysis suggests, the recently implemented cost reductions should get Synchronica to profitability and positive cash flow, whilst the greater focus on the existing mobile operator customer base (rather than a land grab of new contracts) should hopefully support our revenue growth estimates.

We have historically valued Synchronica on the basis of forward looking EBITDA and PE multiples, though the significant change in forecasts that have occurred during our coverage of Synchronica highlights the potential weaknesses of that approach. Nevertheless, on the hope that our current forecasts are a cautious view of the future, and using a 9x EBITDA multiple and a 14x PE, the outlook for 2012 supports a share price of 14-26p, whilst 2013 supports 23-40p. This has come down from our previous valuation of 17-26p and 26-40p for 2012 and 2103 due to the increase in net debt outlook. Given the leverage in the business, any outperformance against our forecasts would support a reasonably significant share price upgrade.

Leaving aside the company's financial performance, we believe that Synchronica's strategic value is much higher than the pure financials (and indeed its current share price) would suggest, given that the company now has 90 mobile operator customers with a total addressable market of 1.8bn subscribers, and almost global market coverage, as well as a strong technology under-pinning reflecting many man-years of R&D.

A large, well financed buyer (for example a telecom equipment, software or services provider) with existing complementary products, customers and sales/distribution channels would probably value Synchronica on the basis of higher sales forecasts than we have used in our valuation and/or would apply higher multiples than the market-average multiples that we have used.

Valuation metrics				
	FV/EBITDA (\$,000)		Price Earnings (c)	
	2012	2013	2012	2013
Forecast	8,345	12,160	3.1	4.7
Multiple	9.0	9.0	14.0	14.0
FV	75,105	109,440		
Net cash	-21,892	-21,892		
<b>Equity value</b>	<b>53,213</b>	<b>87,548</b>		
Shares in issue (m)	231.6	231.6		
<b>Value per share (c)</b>	<b>23.0</b>	<b>37.8</b>	<b>42.7</b>	<b>65.8</b>
<b>Value per share (p)</b>	<b>14.2</b>	<b>23.4</b>	<b>26.4</b>	<b>40.7</b>

Source: ED Note: based on fully diluted earnings and shares.

Some examples of strategic mobile M&A deals are shown next, with many at high revenue multiples. A take-out multiple of 3x 2012 forecast revenues would, for example, represent a share price over 4x today's level for Synchronica.

### Examples of Strategic Mobile Investments

Date	Buyer	Target/sector	Details
Mar 2011	Facebook	Snaptu, social networking	Reported \$60-70m
Feb 2011	HTC	Saffron Digital, mobile video	£30m, 4.5x revenues
March 2010	Amdocs	MX Telecom, mobile messaging	£105m, estimated c9x EBITDA and 14x PE
Jan 2010	Apple	Quattro, mobile advertising	\$275m
Nov 2009	Google	AdMob, mobile advertising	\$750m, or 7.5x current revenues
Mar 2009	Nokia	Obopay, mobile banking	Reported \$70m for a stake
Nov 2008	Nokia	Oz Communications, mobile messaging	Reported \$200m
Nov 2007	Qualcomm	Firethorn, mobile banking	\$210m
Nov 2007	Microsoft	Musiwave, music	\$46m
Sept 2007	Nokia	Navteq, navigation	\$8.1bn
July 2007	Nokia	Twango, social networking	\$97m
Dec 2005	EA Games	Jamdat, mobile games	\$680m

Source : Company, ED

### Conclusion

The Q3 results give a hint of the transformative impact of the summer Nokia deals, but also contain substantial red ink due to multiple write offs. On paper, the recently implemented cost reductions should get Synchronica to EBITDA profitability and positive cash flow, which should become evident in the Q1 and Q2 2012 numbers.

Investors are understandably cautious following the recent management upheaval and strategic change, but the depressed share price of 5p substantially understates the potential value of Synchronica to a strategic buyer.

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