30th November 2016

TMT

Indra Sistemas

Price EUR9.69

Tecnocom acquisition conference call feedback: a defensive move, synergies ahead

Fair Value EUR12 (+24%) **BUY vs. NEUTRAL**

Bloomberg	IDR SM
Reuters	IDR.MC
12-month High / Low (EUR)	12.3 / 7.7
Market Cap (EUR)	1,590
Ev (BG Estimates) (EUR)	2,287
Avg. 6m daily volume (000)	772.0
3y EPS CAGR	

	1 M	3 M	6 M	31/12/15
Absolute perf.	-14.2%	-16.4%	-5.3%	11.8%
Softw.& Comp.	-1.2%	-1.3%	3.7%	3.3%
DJ Stoxx 600	0.0%	-0.7%	-2.5%	-6.8%

YEnd Dec. (€m)	2015	2016e	2017e	2018e
Sales	2,850	2,738	2,813	2,920
% change		*-3.9%*	*2.7%*	*3.8%*
EBITDA	107	218	307	372
EBIT	-641.0	155.0	236.0	297.0
% change		*NS*	*52.3%*	*25.8%*
Net income	-73.0	84.0	150.0	196.0
% change		*NS*	*78.6%*	*30.7%*

	2015	2016e	2017e	2018e
Operating margin	1.6	5.7	8.4	10.2
Net margin	-22.5	2.9	5.2	6.6
ROE	-208.1	20.7	27.6	26.4
ROCE	-11.7	11.3	17.7	22.0
Gearing	227.0	181.0	98.0	41.0

(€)	2015	2016e	2017e	2018e
EPS	-0.40	0.44	0.78	1.02
% change	*-*	*NS*	*77.3%*	*30.8%*
P/E	NS	22.0x	12.4x	9.5x
FCF yield (%)	NM	0.6%	9.4%	12.0%
Dividends (€)	0.00	0.00	0.00	0.00
Div yield (%)	NM	NM	NM	NM
EV/Sales	0.8x	0.8x	0.8x	0.6x
EV/EBITDA	21.4x	10.5x	6.9x	5.1x
EV/EBIT	49.8x	14.8x	9.0x	6.4x

We raise our recommendation from Neutral to Buy following the conference call held yesterday for the acquisition of Tecnocom for EUR305m in cash and shares. At first glance, this tie-up may cause scepticism as it looks like a defensive move. However, if the EUR41m in projected synergies is successfully implemented, based on a strong overlap between the two companies in Spain and LatAm, we consider it could enhance adj. EPS by 3% in 2017, 9% in 2018, and 10%+ beyond.

ANALYSIS

- **A tale of economies of scale**. For Indra, the rationale behind the acquisition of Tecnocom is essentially the need for economies of scale. With Tecnocom, Indra will increase revenues in Spain by 39% and will be the clear leader in its domestic IT Services market with 38% more revenues than the No. 2 Accenture (EUR1,136m vs. EUR823m based on 2015 revenues, while it was at EUR819m). This would result in significant operating leverage on fixed costs due to a strong overlap not only in Spain (80% of sales and staff) and LatAm. In addition, Tecnocom teams would benefit from Indra's delivery model including offshoring. Indra would increase revenue exposure to Financial Services to 34% from 30% - with complementary offerings (Indra in Core Banking and Core Insurance, Tecnocom in Payment Systems) - and the commercial sector in Spain (78% of revenues vs. 75%). As the top 5 players in Spain (Indra, Accenture, Ibermatica, Everis, Tecnocom) have a combined 30% market share in IT Services, an issue with antitrust authorities is unlikely.
- **Significant synergies ahead**. Indra expects to deliver EUR41m in synergies within two years. This includes EUR10.5m in revenue synergies (upselling, cross-selling especially in Financial Services, Industry and Utilities) and EUR30.5m in cost synergies (potential SG&A optimisation through sales and overhead costs, higher production efficiency and enhancement of the operating model on utilisation rates, the salary pyramid, offshore leverage, facilities rationalisation, optimisation of R&D efforts and capex). The deal is expected to close in April or May 2017 and management expects that 50% of these synergies to be effective in year 1 and the other 50% in year 2, while 75% of the costs (restructurings, integration, etc.: 2x the amount expected for cost synergies, i.e. an est. EUR60m) will be spent in year 1 and the remaining 25% in year 2. Management estimates the NPV of synergies at EUR306m including a WACC of 9%.
- **Potential double-digit EPS accretion**. The acquisition of Tecnocom is expected to add free cash flow on top of the EUR200m guided for Indra by 2018. The net debt/EBITDA ratio is expected to worsen by only 0.2-0.3x by end 2018, but the effect will be stronger at end-2017. The capital increase for the share exchange offer (40% of the acquisition price) is expected to create 12.4m new Indra shares and then generate a 7% initial dilution (6% on a fully diluted basis incl. convertible bonds). Finally, Indra's op. margin target for 2018 (10-11%) is unchanged if we take into account the synergies it would derive from Tecnocom. At first glance, taking into account the implementation of synergies and associated costs from May 2017 (cost synergies: est. EUR9m for 2017 and est. EUR24m for 2018; restructuring costs: est. EUR46m for 2017 and est. EUR16m for 2018), and Tecnocom's 2018 goals (sales CAGR 7.5-10% for 2015-2018, EBITDA margin 7.5-8.5% in 2018 implying an est. EBIT margin of 5-6%), we expect Tecnocom to have a slight negative impact on our current op. margin ests. (-0.2ppt for 2017 to 8.2% and -0.1ppt for 2018 to 10.1%) and be accretive to our current adj. EPS ests. (est. +3% for 2017, est. +9% for 2018, 10%+ beyond).

VALUATION

- Indra's shares are trading at est. 14.8x 2016 and 9.0x 2017 EV/EBIT multiples.
- Net debt on 30th September 2016 was EUR666.4m (net gearing: 187%).

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