BELL POTTER

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Appen (APX)

Potential for positives at AGM

Recommendation
Buy (unchanged)
Price
$9.60
Target (12 months)
$11.00 (unchanged)

GICS Sector

Software and Services

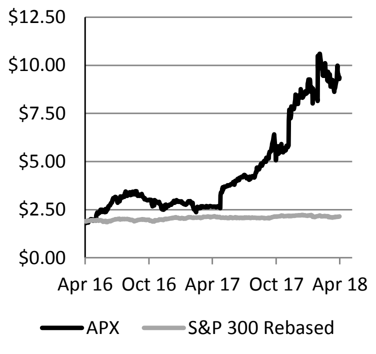
Expected Return	
Capital growth	**14.6%**
Dividend yield	**1.1%**
Total expected return	**15.7%**

Company Data & Ratios	
Enterprise value	**$1,065m**
Market cap	**$1,021m**
Issued capital	**106.3m**
Free float	**87%**
Avg. daily val. (52wk)	**$3.3m**
12 month price range	**$2.57 - $10.94**

Price Performance

	(1m)	(3m)	(12m)
Price (A$)	9.63	8.65	2.69
Absolute (%)	-2.70	8.32	248.33
Rel market (%)	-1.83	10.31	246.38

Absolute Price



SOURCE: IRESS

Expecting a reasonable if not positive update at AGM

Appen has its AGM next month and we expect the company will provide a reasonable if not positive trading update for the year thus far. Appen has upgraded its guidance at or around the AGM in each of the last two years and, while we do not rule out an upgrade to the guidance this year, we more expect the company to reiterate the already strong forecast growth it provided at the release of the 2017 result in February. This, in our view, would still be well received by the market given there may be some concern that purchase orders from its largest customer, Facebook, have been negatively impacted by the recent data scandal but we do not believe this to be the case. There is, however, the potential for a “soft upgrade” in our view where the company may narrow the guidance range towards the top end given the currency is working in its favour. That is, the current 2018 EBITDA guidance range of $50-55m assumes an AUD/USD exchange rate of 0.80 which is above the ytd average of around 0.78 and we estimate the sensitivity of a one cent move is around +/- $1m.

No change in forecasts

There is no change in our forecasts. Our 2018 forecasts are consistent with the company’s guidance range albeit we are already towards the upper end. We note, however, that we forecast particularly strong EPS growth in both 1H2018 and 2018 of 80% and 125% which should be well received by the market. We also forecast strong double digit EPS growth in 2019 and 2020 of 20% and 15%.

Investment view: Maintain BUY, PT $11.00

We maintain our BUY recommendation and $11.00 price target on Appen. We only recently updated out PT on Appen and, with no change in our forecasts, there is no subsequent change. Our $11.00 PT equates to a 2019 PE ratio of c.28x which is within the 25-30x range we believe is appropriate for the company. We acknowledge Appen is not a software company but believe a software-like PE ratio is appropriate for the company given its exposure to the AI market, the strong customer relationships and the concentration of suppliers in the market in which it operates.

Earnings Forecast

Year end 31 December	2017	2018e	2019e	2020e
Total revenue (A$m)	166.6	274.6	306.7	335.0
EBITDA (A$m)	22.2	54.6	64.5	73.4
NPAT (A$m)	14.3	34.9	42.1	48.6
EPS (diluted) (cps)	14.4	32.4	38.8	44.5
EPS growth (%)	36%	125%	20%	15%
PER (x)	66.8	29.7	24.8	21.6
Price/CF (x)	71.3	25.0	21.3	18.5
EV/EBITDA (x)	47.9	18.9	15.5	13.2
Dividend (¢ps)	6.0	11.0	15.0	17.0
Yield (%)	0.6%	1.1%	1.6%	1.8%
ROE (%)	15.3%	28.3%	27.1%	25.5%
Franking (%)	100.0%	100.0%	100.0%	100.0%

SOURCE: BELL POTTER SECURITIES ESTIMATES

Upcoming AGM

Expecting a Reasonable if not Positive Update

Appen has its AGM next month and we expect the company will provide a reasonable if not positive trading update for the year thus far. Appen has upgraded its guidance at or around the AGM in each of the last two years and, while we do not rule out an upgrade to the guidance this year, we more expect the company to reiterate the already strong forecast growth it provided at the release of the 2017 result in February. This, in our view, would still be well received by the market given there may be some concern that purchase orders from its largest customer, Facebook, have been negatively impacted by the recent data scandal but we do not believe this to be the case.

The upgrades in guidance at or around the AGM in each of the last two years are highlighted below. The key reason why we do not necessarily expect an upgrade this year is, in our view, the company is getting better at forecasting given the CEO and CFO have now both been in their respective roles for more than a couple of years. Also, the annual renewal for Facebook occurs at the end of the calendar year so, when the company provides its initial guidance in February, it already has a good idea of the purchase orders from this customer for the year ahead.

Figure 1 - Guidance track record over past two years

Year end 31 December	2016	2017
Guidance provided in February	**Low double digit revenue and earnings growth**	**EBITDA growth at mid-to-high teen percentages**
Upgrade provided at or around AGM	Earnings growth trending to high teen % and above	EBITDA to be 40-50% above prior year's result
Any subsequent upgrade	Earnings growth to exceed 20%	NA
Actual result	**Revenue growth 34% and EBITDA growth 24%**	**Underlying EBITDA up 62%***

SOURCE: COMPANY DATA *INCLUDES ACQUISITION OF LEAPFORCE WHICH CONTRIBUTED FOR AROUND THREE-AND-A-HALF WEEKS IN 2017

Potential for Narrowing of Guidance Range

In our view there is potential for a "soft upgrade" of the 2018 guidance where the company may narrow the guidance range towards the top end given the currency is working in its favour. That is, the current 2018 EBITDA guidance range of $50-55m assumes an AUD/USD exchange rate of 0.80 which is above the ytd average of around 0.78 and we estimate the sensitivity of a one cent move is around +/- $1m. If the current average of 0.78 is maintained for the rest of the year it would therefore add around $2m to EBITDA. We note the current exchange rate is below the ytd average of 0.78 and so if this continues for the next several months then this will further lower the average exchange rate and provide further upside to EBITDA.

Another factor which supports a soft upgrade is the current EBITDA guidance range of $50-55m is reasonably wide and, given we are now in the second quarter of the calendar year, Appen may be in a position to narrow the range. There is also some precedent for the company doing a soft upgrade when in 2016 it moved from the initial guidance of "*low double digit revenue and earnings growth*" to "*earnings growth trending to high teen percentages and above*" at the AGM.

Note one factor we do not expect to be an obstacle for a soft upgrade or narrowing of the guidance range is the required renewal of the Microsoft contract. This still occurs every year around the end of June but now is not of a sufficient relative size to be the key driver of the guidance. Microsoft is still a top five customer of Appen but is now much less significant than the top two key customers (Facebook and Google).

2018 Outlook

Forecasting Strong EPS Growth in both 1H2018 and 2018

Our 2018 forecasts are consistent with the company's guidance range albeit we are already towards the upper end. We note, however, that we forecast particularly strong EPS growth in both 1H2018 and 2018 of 80% and 125% which should be well received by the market. A key driver of the forecast strong results is obviously the full six and twelve month contributions from Leapforce but it is notable how strong the forecast EPS growth is which includes the dilution impact of both the equity raising and shares issued to the vendor as part of the funding of the acquisition.

Our forecasts for the 1H2018 and 2018 results are shown below. Note our 2018 forecasts do not include any further transaction costs from the acquisition of Leapforce which may or may not be the case. The company flagged in February there may be some additional transaction costs in 2018 – and hence why the guidance is for underlying EBITDA – and we would expect some update on these – if there are any – at the AGM. For now, however, we assume no further transaction costs and so our 2018 forecasts are both reported and underlying.

Figure 2 - Forecast 1H2018 and 2018 results

Year end 31 December	1H2017	2H2017	2017	1H2018e	2H2018e	2018e
Sales revenue (A$m)	**74.1**	**92.5**	**166.6**	**129.3**	**145.3**	**274.6**
Growth	*39%*	*61%*	*50%*	*75%*	*57%*	*65%*
Cost of sales	-43.6	-56.2	-99.8	-76.3	-85.8	-162.0
Gross profit	**30.4**	**36.3**	**66.7**	**53.0**	**59.6**	**112.6**
Gross margin	*41.1%*	*39.2%*	*40.1%*	*41.0%*	*41.0%*	*41.0%*
Other income (e.g. rent)	0.0	0.0	0.0	0.0	0.0	0.0
Total expenses (excl. D&A and int.)	**-18.2**	**-27.2**	**-45.5**	**-27.9**	**-30.1**	**-58.0**
Expenses as % of revenue	*-24.6%*	*-29.5%*	*-27.3%*	*-21.5%*	*-20.7%*	*-21.1%*
EBITDA	**12.8**	**9.5**	**22.2**	**25.1**	**29.5**	**54.6**
Depreciation	-0.2	-0.2	-0.4	-0.2	-0.2	-0.5
Amortisation	-0.9	-0.5	-1.5	-0.9	-0.9	-1.8
EBIT	**11.6**	**8.7**	**20.4**	**24.0**	**28.3**	**52.3**
Net interest expense	0.0	0.0	0.0	-1.2	-1.2	-2.5
Pre-tax profit	**11.6**	**8.7**	**20.4**	**22.7**	**27.1**	**49.8**
Income tax expense	-3.5	-2.6	-6.1	-6.8	-8.1	-14.9
NPAT	**8.1**	**6.2**	**14.3**	**15.9**	**18.9**	**34.9**
Growth	*50%*	*21%*	*36%*	*96%*	*207%*	*144%*
EBITDA margin	*17.2%*	*10.2%*	*13.4%*	*19.5%*	*20.3%*	*19.9%*
EBIT margin	*15.7%*	*9.4%*	*12.2%*	*18.6%*	*19.5%*	*19.0%*
Effective tax rate	*-30.3%*	*-29.3%*	*-29.9%*	*-30.0%*	*-30.0%*	*-30.0%*
Diluted EPS	**8.2c**	**6.2c**	**14.4c**	**14.8c**	**17.6c**	**32.4c**
Growth	*48%*	*23%*	*36%*	*80%*	*186%*	*125%*
Dividend	3.0c	3.0c	6.0c	5.0c	6.0c	11.0c
Franking	*100%*	*100%*	*100%*	*100%*	*100%*	*100%*
Payout ratio	*37%*	*49%*	*42%*	*34%*	*34%*	*34%*

SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

Appen

Company Description

Appen Ltd (Appen) is a leading global provider of language technology data and services to enterprise and government customers. The company has a unique combination of proprietary technology, experienced management and an extensive network of native language evaluators.

The company has two operating divisions:

- **Content Relevance**: Provides smart data to increase online discovery and search relevance of global search engines and e-commerce and social media platforms; and
- **Language Resources**: Provides training data for speech-recognition technologies in devices such as mobile phones, computer games and TV consoles.

Appen was established in 1996 and has a long track record of revenue growth and strong margins. The company currently has circa 375 staff across offices in Australia, the US, the UK and the Philippines.

Investment Thesis

We maintain our BUY recommendation on Appen. Our investment thesis is based on:

- **Valuation**: Our 12 month price target on Appen is $11.00. The price target is generated from a blend of three valuation methodologies we apply to the company: PE ratio, EV/EBITDA and DCF. The price target is a 15% premium to the current share price and the total expected return (which includes the forecast dividend yield) is 16%.
- **Long track record**: Appen was established in 1996 and has a long track record of revenue growth and strong margins. In 2017 the company recorded underlying revenue and EBITDA growth of 50% and 62% respectively.
- **Strong customer relationships**: The key competitive advantage of Appen is the long-standing relationships it has with many of its customers. For instance, Appen has been working with Microsoft Research for over 22 consecutive years. Further, the majority of revenue is from repeat customers as they update and upgrade their products.

Key Risks

Key downside risks to our estimates and valuation include (but are not limited to):

- **Concentration of customer base**: The customer base of Appen is relatively concentrated with the largest five clients representing >80% of revenue. The loss of one of these large clients or a meaningful shortfall in the forecast level of revenue from one or more would negatively impact the financial performance of the company.
- **Unpredictability of revenue model**: Appen generates most of its revenue from individual projects rather than long term contracts. The award of these projects can be lumpy and unpredictable and there is also no guarantee a customer will re-engage with Appen on future projects.
- **Level of competition**: Appen competes in the global Language Services industry which is competitive but fragmented with around 18,000 service providers. An increase in the level of competition through consolidation or vertical integration could negatively impact the financial performance of the company.

Appen
as at 24 April 2018

Recommendation	Buy
Price	$9.60
Target (12 months)	$11.00

Table 1 - Financial summary

Appen (APX)				
Share price:	$9.60		Target price:	$11.00
No. of issued shares:	106.3m		Market cap:	$1,021m

Profit & Loss (A$m)					
Year end 31 Dec	**2016**	**2017**	**2018e**	**2019e**	**2020e**
Sales revenue	**111.0**	**166.6**	**274.6**	**306.7**	**335.0**
Change	*34%*	*50%*	*65%*	*12%*	*9%*
Gross profit	**48.7**	**66.7**	**112.6**	**127.3**	**140.7**
Gross margin	*43.9%*	*40.1%*	*41.0%*	*41.5%*	*42.0%*
Other income (e.g. rent)	0.1	0.0	0.0	0.0	0.0
Other gains/losses (e.g. forex)	0.0	0.0	0.0	0.0	0.0
Expenses (excl. D&A, int.)	**-31.2**	**-45.5**	**-58.0**	**-62.8**	**-67.3**
% of sales	*-28.1%*	*-27.3%*	*-21.1%*	*-20.5%*	*-20.1%*
EBITDA	**17.2**	**22.2**	**54.6**	**64.5**	**73.4**
Depreciation	-0.4	-0.4	-0.5	-0.6	-0.6
Amortisation	-0.8	-1.5	-1.8	-1.9	-1.9
EBIT	**16.0**	**20.4**	**52.3**	**62.1**	**70.9**
Net interest expense	0.0	0.0	-2.5	-2.0	-1.5
Pre-tax profit	**16.0**	**20.4**	**49.8**	**60.1**	**69.4**
Income tax expense	-5.5	-6.1	-14.9	-18.0	-20.8
NPAT	**10.5**	**14.3**	**34.9**	**42.1**	**48.6**

Cash Flow (A$m)					
Year end 31 Dec	**2016**	**2017**	**2018e**	**2019e**	**2020e**
EBITDA	17.2	22.2	54.6	64.5	73.4
Change in working capital	-0.4	-1.3	1.1	0.7	1.5
Gross operating cash flow	**16.7**	**20.9**	**55.8**	**65.2**	**74.9**
Interest received	0.0	0.0	0.0	0.0	0.0
Interest paid	0.0	0.0	-2.5	-2.0	-1.5
Tax paid	-4.1	-7.5	-12.0	-14.4	-16.7
Operating cash flow	**12.7**	**13.4**	**41.3**	**48.8**	**56.8**
Payments for PPE	-0.7	-3.2	-1.5	-1.5	-1.5
Payments for intangibles	-1.8	-2.6	-1.5	-1.5	-1.5
Payment for acquisitions	-2.1	-91.8	0.0	0.0	0.0
Investing cash flow	**-4.6**	**-97.6**	**-3.0**	**-3.0**	**-3.0**
Proceeds from issue of shares	0.4	29.4	0.3	0.3	0.3
Proceeds from borrowings	0.0	69.2	0.0	0.0	0.0
Repayment of borrowings	0.0	0.0	-20.0	-20.0	-20.0
Dividends paid	-4.9	-5.9	-8.5	-13.9	-17.2
Financing cash flows	**-4.4**	**92.8**	**-28.2**	**-33.6**	**-37.0**
Net change in cash	**3.7**	**8.6**	**10.1**	**12.1**	**16.8**
Cash at start of period	12.7	16.5	24.0	34.1	46.2
Exchange rate impact	0.1	-1.1	0.0	0.0	0.0
Cash at end of period	**16.5**	**24.0**	**34.1**	**46.2**	**63.0**

Balance Sheet (A$m)					
Year end 31 Dec	**2016**	**2017**	**2018e**	**2019e**	**2020e**
Cash	16.5	24.0	34.1	46.2	63.0
Receivables	21.9	42.9	54.9	58.3	60.3
Other current assets	0.4	1.2	1.2	1.2	1.2
PPE	0.7	1.8	2.8	3.7	4.6
Intangibles - Goodwill	11.5	111.9	111.9	111.9	111.9
Intangibles - Other	3.1	4.4	4.0	3.7	3.2
Deferred tax assets	0.0	1.9	1.9	1.9	1.9
Total assets	**54.0**	**188.0**	**210.8**	**226.8**	**246.2**
Payables	12.2	21.2	34.3	38.3	41.9
Current borrowings	0.0	0.0	0.0	0.0	0.0
Current provisions	0.9	1.2	1.2	1.2	1.2
Current other	2.4	2.6	2.6	2.6	2.6
Non-current borrowings	0.0	67.9	47.9	27.9	7.9
Non-current provisions	0.4	0.5	0.5	0.5	0.5
Deferred tax liabilities	2.8	1.4	1.4	1.4	1.4
Total liabilities	**18.6**	**94.6**	**87.8**	**71.8**	**55.3**
Contributed equity	19.5	69.6	69.8	70.1	70.4
Reserves	19.8	27.7	30.7	34.3	38.5
Retained earnings/(losses)	-3.9	-3.9	22.5	50.6	82.0
Total shareholders' equity	**35.4**	**93.4**	**123.0**	**155.0**	**190.8**

Valuation data					
Year end 31 Dec	**2016**	**2017**	**2018e**	**2019e**	**2020e**
NPAT (A$m)	10.5	14.3	34.9	42.1	48.6
Diluted EPS (Ac)	**10.5**	**14.4**	**32.4**	**38.8**	**44.5**
Change	*23%*	*36%*	*125%*	*20%*	*15%*
P/E ratio (x)	**91.2**	**66.8**	**29.7**	**24.8**	**21.6**
CFPS (Ac)	12.7	13.5	38.4	45.0	52.0
Price/CF (x)	**75.4**	**71.3**	**25.0**	**21.3**	**18.5**
DPS (Ac)	5.0	6.0	11.0	15.0	17.0
Yield	**0.5%**	**0.6%**	**1.1%**	**1.6%**	**1.8%**
Franking	100%	100%	100%	100%	100%
EV/EBITDA (x)	**58.4**	**47.9**	**18.9**	**15.5**	**13.2**
EV/EBIT (x)	62.6	52.2	19.8	16.2	13.6
NTA per share (Ac)	21.5	-21.6	6.7	36.8	70.1
Price/NTA (x)	**44.7**	**-44.5**	**144.0**	**26.1**	**13.7**

Performance ratios					
Year end 31 Dec	**2016**	**2017**	**2018e**	**2019e**	**2020e**
EBITDA margin	**15.5%**	**13.4%**	**19.9%**	**21.0%**	**21.9%**
EBIT margin	14.4%	12.2%	19.0%	20.2%	21.2%
Return on assets	19.4%	7.6%	16.5%	18.5%	19.7%
Return on equity	**29.6%**	**15.3%**	**28.3%**	**27.1%**	**25.5%**
ROIC	91.9%	26.1%	38.2%	45.4%	52.0%
Payout ratio	47.5%	41.8%	34.0%	38.7%	38.2%
Effective tax rate	-34.6%	-29.9%	-30.0%	-30.0%	-30.0%

Leverage ratios					
Year end 31 Dec	**2016**	**2017**	**2018e**	**2019e**	**2020e**
Net debt/(cash) (A$m)	-16.5	43.9	13.8	-18.3	-55.2
Net debt/equity	**NM**	**47%**	**11%**	**-12%**	**NM**
Gearing	NM	32%	10%	-13%	NM
Net debt/EBITDA (x)	NM	2.0x	0.3x	-0.3x	NM
Net interest cover (x)	>100	>100	21.0x	31.4x	48.3x

Segmentals (A$m)					
Year end 31 Dec	**2016**	**2017**	**2018e**	**2019e**	**2020e**
Sales revenue					
Content Relevance	73.2	120.2	144.2	162.2	178.4
Language Resources	37.7	40.4	45.4	49.8	53.5
Leapforce	0.0	6.0	85.0	94.8	103.1
Total sales revenue	**110.9**	**166.6**	**274.6**	**306.7**	**335.0**
EBITDA					
Content Relevance	10.5	20.6	26.7	33.3	39.3
Language Resources	14.8	12.2	15.5	17.2	18.7
Leapforce	0.0	1.5	22.1	25.1	27.8
Corporate overheads	-8.2	-12.1	-9.6	-11.0	-12.4
Total EBITDA	**17.2**	**22.2**	**54.6**	**64.5**	**73.4**
EBITDA margin					
Content Relevance	*14.4%*	*17.2%*	*18.5%*	*20.5%*	*22.0%*
Language Resources	*39.4%*	*30.1%*	*34.0%*	*34.5%*	*35.0%*
Leapforce	*0.0%*	*25.5%*	*26.0%*	*26.5%*	*27.0%*
Overheads as % of sales	*-7.4%*	*-7.3%*	*-3.5%*	*-3.6%*	*-3.7%*
Total EBITDA margin	***15.5%***	***13.4%***	***19.9%***	***21.0%***	***21.9%***

Interims (A$m)				
Year end 31 Dec	**1H2017**	**2H2017**	**1H2018e**	**2H2018e**
Revenue	**74.1**	**92.5**	**129.3**	**145.3**
Gross profit	**30.4**	**36.3**	**53.0**	**59.6**
Gross margin	*41.1%*	*39.2%*	*41.0%*	*41.0%*
Expenses (excl. D&A, int.)	**-18.2**	**-27.2**	**-27.9**	**-30.1**
% of sales	*-24.6%*	*-29.5%*	*-21.5%*	*-20.7%*
EBITDA	**12.8**	**9.5**	**25.1**	**29.5**

SOURCE: BELL POTTER SECURITIES ESTIMATES

Recommendation structure

Buy: Expect >15% total return on a 12 month view. For stocks regarded as 'Speculative' a return of >30% is expected.

Hold: Expect total return between -5% and 15% on a 12 month view

Sell: Expect <-5% total return on a 12 month view

Speculative Investments are either start-up enterprises with nil or only prospective operations or recently commenced operations with only forecast cash flows, or companies that have commenced operations or have been in operation for some time but have only forecast cash flows and/or a stressed balance sheet.

Such investments may carry an exceptionally high level of capital risk and volatility of returns.

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