

## Support Services



Source: Eikon Thomson Reuters

## Market data

EPIC/TKR	MUR
Price (p)	475
12m High (p)	560
12m Low (p)	370
Shares (m)	9.0
Mkt Cap (£m)	42.8
EV (£m)	40.6
Free Float*	53%
Market	AIM

\*As defined by AIM Rule 26

## Description

Offers a global service to clients on patents, trademarks etc. Operating from 15 offices worldwide, 50% revenues from USA.

## Company information

CEO	Keith Young
CFO	Keith Young
Chairman	Ian Murgitroyd
	0141 307 8400
	<a href="http://www.murgitroyd.com">www.murgitroyd.com</a>

## Key shareholders

Directors	32.0%
Ian Murgitroyd (director)	27.0%
State Street nominee	17.6%
Chase nominee	6.9%
HSBC nominee	4.8%
E Thompson (Ms)	4.3%

## Diary

26 Oct-2017	AGM
Jan 2018	Interim results

## Analysts

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# MURGITROYD

## Global growth coming through

Murgitroyd announced results on 12<sup>th</sup> September, with a welcome return to PBT growth in H2 (+6.9% vs prior year, EPS -8.4% due to tax charge which contained some H2 one offs). The long-term trends of steady market growth are intact. Margins are starting to point upwards. There is continuing investment in business development, and in scale (including a 2016 acquisition which saw H1 integration costs). We anticipate an H2 profit weighting once more, in the current year.

- ▶ **Key drivers:** Group revenues and dividends have grown each year since incorporation in 2001. Murgitroyd has a global footprint, with a cost-engineered flexible offering. US and European patent markets are at all-time highs, albeit macro-economic uncertainties must be taken into account. Historically, market volatility has been muted. Global markets continue to grow.
- ▶ **FY18E:** Our estimates take into account that the US\$ strength which benefitted FY17 is not following through. The USA, contributing 50% revenue, remains a key focus for investment. We slightly raised our dividend estimates (from 17.8p) as of the results announcement. We understand margin trends are stabilising. 1H18 will not bear integration and other costs which impacted 1H17.
- ▶ **Valuation:** 2018 will see an H2 profit skew. Earnings grew through the post-2008 financial crisis, so, the rating should reflect resilience in uncertain macro-economic times – albeit some uncertainty affects Murgitroyd's own clients. Note that the 26% FY16 tax charge rose to 32% in FY17 and same estimated for FY18E.
- ▶ **Risks:** The risks to growth rates (balance sheet and cash flow being secure and stable), centre around the details of patent filing protocols. These can influence broad trends in pipeline of work; around the fee negotiations with clients and with the risks and opportunities of technology. Murgitroyd has benefited from on-line but this also poses a threat at the level where Artificial Intelligence could be deployed. There is global exposure in revenue and costs: modestly US\$ income over £ cost.
- ▶ **Investment summary:** Ongoing good dividend growth and free cash flow are attractive, in an environment of a steadily growing global market. H1 cash flow was impacted by the investments made and strong inflow in H2 came as anticipated. The company has strong resources to build growth.

## Financial summary and valuation

Year end May (£m)	2014	2015	2016	2017	2018E
Sales (£m)	38.4	39.8	42.2	44.3	46.0
EBITDA (£m)	4.6	4.5	4.6	4.2	4.6
PBT (Ad.) (£m)	4.2	4.2	4.3	3.9	4.2
EPS (Adj) (p)	33.6	34.8	35.3	28.7	31.5
DPS (p)	13.3	14.8	16.0	17.0	18.0
Net (debt)/cash (£m)	(0.4)	0.7	2.8	2.2	2.7
Net debt/EBITDA (x)	0.1	cash	cash	cash	cash
P/E (x)	14.1	13.6	13.5	16.6	15.1
EV/Sales (x)	1.1	1.1	1.0	0.9	0.9
EV/EBITDA (x)	9.3	9.3	8.9	9.7	8.8

Source: Hardman & Co Research

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## Executive summary

### A global footprint...

Murgitroyd has a global footprint of 14 offices, providing specialist professional patent-related services.

### Excellent long-term growth...

Group revenues and dividends have grown each year since incorporation in 2001, with PBT having risen each year bar 2014, when it fell 8.9%. FY17 did however witness another PBT setback of 11.3% for a number of reasons. Murgitroyd's model is cash generative, hence this profitable growth has largely been funded internally, with minimal share issuance and a cash positive balance sheet. A series of acquisitions between 2005 and 2009 did see bank debt taken on, net debt peaking at over £8m in 2008.

### 1H17 was under pressure – full year 2017 PBT fell 9.3%...

#### *FY17: costs to support growth, allied to lower than expected 1H17 sales growth*

1H17 came under pressure from trading. Additionally, there were the costs of integrating the June 2016 acquisition as well as investments such as business development. 1H17 operating profits fell 30.1% to £1.48m, a small part being the direct costs of acquisition.

### 2H17 witnessed a change in trend – to rising operating margins...

2H17 was an improvement. 2H17 operating profits rose 6.8% on turnover up 4.3% (vs 2H16). This marked an end to four years of falling operating margins. We estimate constant currency sales declined 3% in FY17 before the benefit of the acquisition. FY17 PBT fell 9.3%. Whilst FY17 proved to be a less successful year than recent ones, margins started to rise and it consolidated the acquisition, plugging into its strongest product suites and geography (namely a global support offering, with a strong US focus).

### 27% CAGR US sales growth FY13-16%; +ve in 2017, but slower...

FY17 indicates a nascent positive change: lesser revenue momentum, with better margin trends appearing. Gross and operating margins have begun to rise in FY17 and 2H17 respectively. In the three years to FY16, we estimate US revenue grew on average 27% per annum, whereas non-US revenues declined circa 6% per annum, with slower FY17. Top line growth has slowed in FY17 and likely also in FY18E. The picture once currencies and half years are taken into account is more complex. 2H17 constant currency organic sales growth was down slightly more than the -3% for the year as a whole (note this adjustment is a Hardman estimate) but operating margins rose 10.2% (vs 10.0% in 2H16).

### Margins have seen medium-term notable erosion, hence EPS falls since FY13...

#### *Growth trends in 2H17 set the pattern for the future*

FY17 gross margins rose, a change in the trend, and we estimate this should flow through to an operating margin upturn in the current year. Operating margins rose slightly in 2H17. Ever since a fall to 11.7% in FY14 (from 13.6% FY13), management has attempted to mitigate further EBITDA margin falls. As the growth comes principally from paralegal and technology-supported support services, an element of downward momentum can be accepted, but we are optimistic that the management actions are will increase future profit margins.

### The bounce back started 1H17 – evident at first in margins but investment does support future growth

FY18E reported sales growth of 3.8%, is likely to be flat on the basis of constant currency (ascribing the appropriate lags to receivables). This is not a straight forward calculation as there are timing issues, but we emphasise here that our Group forward-estimates are based on minimal growth if any, pre currency effects. Despite this, we estimate FY18E reverses the large majority of the FY17 profit fall, exiting FY18 with momentum for decent growth in FY19E (we do not yet initiate FY19 estimates). The costs, especially apparent in 1H17, are designed to support the kind of long-term growth which Murgitroyd has achieved.

*FY18E headline sales growth circa nil pre  
currency effect...*

*.....EBITDA growth translates to 8% EPS  
growth in the year*

*Cash generation and hence DPS prospects  
continue strongly*

*US in particular does well servicing global-leader  
clients*

For FY18 we reflect market uncertainties within overall growth trends. We estimate modest sales growth (effectively flat at constant currencies) and some margin expansion. This leads to an estimated 9.5% FY18E EBITDA growth, albeit slightly less fast on both constant currency and organic bases. With the factors above being in place (supporting the growth generators and investing across the group in both growth and cost efficiencies), we anticipate a medium-term expansion in sales and margins being more strongly underpinned. The acquisition, on-line platforms (assisting repeat-work), business development and strong capex evidence the pro-active approach.

Murgitroyd steadily generates cash and has a long history of unbroken dividend rises. Free cash flow was 27.1p per share in FY17. Dividends remain firmly in growth mode. Its markets remain demanding but positive, with decent ongoing growth and a history of resilience in economic downturns. Murgitroyd is pro-actively supporting its clients with tailored services, delivered efficiently.

### *Significant work in FY17 to create a stronger platform*

The FY17 achievements are both to support growth (internal investment in people and capex as well as the acquisition) and initiate a margin recovery. The growth support was particularly 1H17 and it is encouraging to see a little margin expansion (vs prior year) start to come through in 2H17. This needs to be consolidated and we certainly anticipate no change in clients' desire to achieve ever rising value for money for services rendered.

Murgitroyd refines and optimises its model. US growth is due in part to capturing large global leader clients and also generating what Murgitroyd refers to as downstream work. The use of paralegals and on-line servicing for value-added support work has risen. This type of support work is generated in the Global Support Services group division, which now accounts for 34% revenue and in recent years has been growing at over 200% the rate of group-wide growth.

# What Murgitroyd does

## Global footprint

Murgitroyd operates through two divisions, within the global markets for patents, trade mark, design rights, copyright, advisory work and IP support services such as search and translations. It floated in 2001 at 121p and Group revenues have grown each year since. See page 6 for more details. With good profitability and cash flow characteristics, the dividend has been raised each year, up 89% in the past 10 years.

### *Attorney Practice Groups*

Attorney Practice Groups account for 66% of group revenue: running from patents, trade mark, design rights, copyright, appeals, litigation support, patent box advice and much else – there are 14 areas of distinct offering, through the global office network, outlined on the Murgitroyd website.

### *Global Support Services – paralegals – growing slightly faster*

The Global Support Services group is higher growth and now accounts for 34% of group revenue. Four years ago (FY13) the proportion was 28.8%. This employs paralegals, specialist formalities staff, and patent and trade mark administrators, offering eight types of service from global IP filing, European patent validations, search, translations, renewals (annuities).

### *Near 50% USA*

Sterling weakness has been of benefit to Murgitroyd's reported figures. 49% to 50% of revenue derives from the USA, an area which has been exhibiting sustained marked growth over a period of years. Many of Murgitroyd clients are global so to some extent the geographical split is academic but it does offer the raw material for servicing its clients. It has significantly magnified the strong US market growth base. This is an extremely worthwhile area to dedicate resource to as Hardman estimates circa a quarter of the total global market for patents is US-based. The UK (a market where Murgitroyd has seen decline) generates 34% of total revenue, with the balance being from the rest of the world.

### *Significant foreign revenues*

Murgitroyd (HQ in the UK) states that at least 55% revenue is generated in US\$ and € combined (we believe weighted towards US\$); the balance is £ Sterling denominated. Indeed, Murgitroyd services a truly global market. Many of the costs match the local currency of supplier, where Murgitroyd sub-contracts work to Attorneys in jurisdictions in which it has no permanent presence or client representation rights.

The patent/ trademark markets Murgitroyd serves tend to exhibit low volatile trends underpinned by long-term, modest growth.

### *Pricing pressure*

Clients have been particularly price conscious since the global financial crisis, and this trend shows no sign of abating. This places the emphasis for Murgitroyd on efficiencies and revenue growth programmes. The business generates cash on a consistent basis and is cash positive (notwithstanding a modest acquisition in June 2016).

## Firm foundation

In this segment, we outline some background to the business trends in evidence at Murgitroyd. The long-term record speaks for itself, nonetheless Murgitroyd is constantly keeping its client offering refreshed. Market growth is relatively resilient (we quantify more details on page 9), but clients seek constantly more for less cost. As the Murgitroyd Chairman stated with the 2015 results: "The Group will continue to recruit and train paralegals, specialist formalities staff, and Patent and Trade Mark Administrators whilst at the same time restructuring how it delivers services to clients to generate greater efficiencies." This has been the case for some years, particularly with the setting up of the Global Support Services group.

Five years and longer ago, use was already being made of specialist paralegals and formalities staff "in the streamlining of delivery of particular types of business", as delivery of high quality service at competitive prices has always been a core customer offering. The Global Support Services group works along with the wider range of services in the global Attorney Practice Groups.

To raise the visibility of work 'pipeline', furthermore, Murgitroyd point to the typical US client profile being one where further services tend to accrue from clients some years down the road, providing a little more visibility. US clients in particular tend to be larger corporations prepared to pay for complex services. Revenues from US clients increased from £3.1m in FY08 to £10.2m reported for FY13. By FY14, US client revenue was rising significantly: to £13m or 34% of the group. North America (ex the Nicaraguan office, which was acquired in mid-2016) contributes "just under half of total revenue", it having been 44.5% FY16. For more detail on the acquisition, see page 8. We calculate that between FY13 and FY16, total US revenues grew 27% CAGR, with all of this expansion being organic, the acquisition being June 2016.

### *A bit of history*

Murgitroyd Group PLC was incorporated in 2001, its subsidiary Murgitroyd & Company having traded before as a sole trader, then partnership and, finally, a private limited company. Flotation on AIM in November 2001 raised £3m at a share price of 121p. In the subsequent year the shares traded between 129p and 159p. At 31<sup>st</sup> May 2002 it employed 127 people in Glasgow, Aberdeen, Belfast, Dublin, London, Munich and Nice. Revenue in 2002 (year end May) was £9.05m (£71,300 per employee).

As at 31<sup>st</sup> May 2017, the Group employed 255 staff (31<sup>st</sup> May 2016: 239), the net increase primarily reflecting the acquisition completed in June 2016. (2017 sales per employee totaled £173,700).

## Opportunities

*Significant investment for the future, especially since June 2016*

The earnings growth in 2H17 was an important confirmation of Murgitroyd's prior statements that H1 costs were impacted by one-off factors, particularly the integrating of the most recent acquisition (completed on 24th June 2016). This was acquisitive and internal investment for growth.

*Both 'more of the same' in a steadily growing market.....*

### *Both 'more of the same' and also new initiatives*

Opportunities focus on both 'stable roll-out of more of the same' and 'new initiatives'. In the former, we point to growth in Global Support Services group (GSS), exhibiting revenue CAGR of 10.5% in the past three years and a major contributor to group growth. For the latter, we have indicated the new online platform for renewals services as having been a success. Clearly, across all group offices the two elements of growth combine and enhance the offering.

*..... and newer types of projects such as on-line and the integration of the 2016 acquisition*

### *European current growth opportunities*

As an example of the investment made in systems in order to raise efficiency of delivery to clients, the new on-line platform used in the provision of renewals services was introduced in November 2016. This has paid off as renewals revenue in 2H17 amounted to £4.3m (just under 19% of total revenue), a 9.7% increase on the comparative period last year. Outside the USA, it appears the value-propositions are the platforms for growth.

*An example of new repeat income from technology investment*

*EPO is bringing new examiners into its workforce following training - an important detail to bear in mind*

European growth mix: Murgitroyd is seeing the manifestation of the European Patent Office's ("EPO") strategy to reduce backlog and grant timelines. It would also expect to see raised grant rates continue going forward in the near term, notwithstanding that the EPO is bringing new examiners into its workforce following training. Murgitroyd, we understand, has seen this step up reflected in the grant of European Patent cases for its clients.

*Unitary Patent brings new challenges for clients - who should welcome support therefore*

Preparations for a new Unitary Patent have been some years in the making at supra-governmental level, prior to the opening of the Unified Patent Court and the finalisation of the ratification process at national level which is proceeding, UK-included. The implications of this for Murgitroyd are that this brings with it "new challenges and opportunities for Patent Attorneys in Europe". We therefore consider this a minor enhancement to medium term demand, maybe not material, but importantly illustrating the complexity of assistance potential Murgitroyd clients require.

### *US visibility*

US work is typically more for larger corporates and offers the opportunity to capture downstream follow-up work, over a period of years. We support this assertion by reference to the FY13 results announcement: [Murgitroyd's relevant operations] "concentrate on winning new filing work from larger corporate clients, predominantly in the USA. The success of this strategy, notwithstanding the recessionary environment of the last five years, has been seen in both the growth in overall sales and earnings, but more specifically the increase in sales to US clients.....Securing instructions to file large volumes of patents and/or trade marks is both profitable and as importantly accrues downstream work, over a three to five-year period, as applications are subsequently examined, prosecuted and granted."

*Second wave of US income deriving from 2013  
legislation - there are always lags*

The US AIA (America Invents Act) came in to force March 2013, changing from a "first to invent" country (one of the few) to a "first to file" country in terms of how Patent owners would be assessed. This, in turn, led to a surge in US provisional Patent filings to get in before the "first to invent" system ended. Murgitroyd wins work over a period of time post filing. We consider there is further scope to grow as a result of this. However, it has been in force well over four years now, so to be conservative, we model a much reduced incremental impact here in FY18 after positive but slower US growth in FY17.

### *Continuing external uncertainties*

The earnings growth reported in 2H17 was an important confirmation of Murgitroyd's prior statements that 1H17 costs were indeed impacted by one-off factors, particularly the integration of the most recent acquisition (completed on 24th June 2016). This is now past, but there have been, as Murgitroyd referred to in prior results as "continuing external uncertainties". For example, whilst UK is still a good revenue and profit generator for the group, it already had been declining and negotiations to leave the EU are clearly an issue.

*Problems addressed - much (but not all) of  
1H17 PBT decline was from increased  
investment in growth initiatives / acquisition*

## Acquisition

In June 2016, Murgitroyd & Company Limited completed the acquisition of certain trade and assets from Dallas-based MDB Capital Group, LLC and Managua-registered Patentvest S.A, for a consideration of US\$2.43m. To this consideration of £1.82m, employment-related liabilities of £94,000 were added. £0.26m revenue was booked 1H17 from the Managua, Nicaragua office;

Non-recurring professional fees in connection with the acquisition amounted to £57,000, and the post-acquisition net operating cost of the investment in Nicaragua totalled £216,000.

These costs and revenues were as expected at the time of acquisition, namely a loss-making first six months for Managua, but growth to becoming earnings-neutral in its first year (funded by debt), and earnings enhancing thereafter.

The opportunities in Managua include expansion of its existing search, technical illustration and third party docketing service offerings, as well as realising the cost-saving benefits that having an educated, but lower-cost, workforce in a near-shoring environment offer for Murgitroyd's back-office functions.

## Growth

### Market growth

*EUIPO and EPO statistics...*

Data quantifying volumes in Murgitroyd's markets is collected regularly by the authorities and enables year on year comparisons to be made. However, there are diverse sources and differing sub-markets. Data points capturing patents granted will differ from applications. Murgitroyd's work covers a range pre- and post-grant, encompassing trade marks, patents and other IP rights. At the latest results, nonetheless, Murgitroyd stated: "The EUIPO's and the EPO's statistics continue to be considered good indicators of the current state of what remains the Group's principal market."

*...illustrate global markets at an all time high...*

The EU Intellectual Property Office ("EUIPO") statistics show that there was an increase in 2016 EU Trade Mark applications to 135,000 (2015: 130,400). 2016 was the seventh consecutive year of growth, with the number of applications filed setting a new record. Looking at the types of corporates filing, most appear to be technology, with a bias to consumer technology.

*EPO statistics showed a 6.2% year-on-year increase...*

The European Patent Office ("EPO") statistics showed a 6.2% year-on-year increase in Patent filings in 2016 (2015 was somewhat 'below trend'): to more than 296,000, an all-time high. We note, notwithstanding the time lag whilst applications are "patent pending", that under a quarter of filings go through to granted status.

*Cyclicity has been modest.....*

Looking at longer term EPO trends, we consider it important to note that the former peak was 2006 and the peak to trough was a fall of 17%, spread over three years. By 2010, one year after the low, the market numbers had risen back up to figures third highest on record, only 7% below the (then) all-time high. This is not a particularly volatile market and various types of work would tend to peak and leading or lagging the 'main' cycle. We have referred above (page 7) to various 'initiatives' from the offices and courts, such as the Unitary Patent and the America Invents Act in the USA.

*...2006 peak: peak to trough was a fall of 17%, spread over three years...*

*...Approximately 2% secular growth annually...*

We see the historical ten-year trend of growth in volumes of some 2% CAGR as being a fair indication of the kind of long term growth for the future.

### Historic Murgitroyd annual trends

#### *Trends since flotation in 2001*

*Murgitroyd sales and revenue up each year since incorporated in 2001...*

Group revenues have grown each year since Murgitroyd was listed in 2001. The dividend, rising each year, is up 89% in the past 10 years. PBT has risen each year bar 2014, when it fell 9%. This profitable growth trend has been funded internally, with a mere 0.6% average annual rise in shares in issue, over the past ten years, all as a result of share options being exercised.

*Use of paralegals has risen...*

The long and strong record is not without Murgitroyd needing skilfully to refine and optimise its model. It has grown from a small presence in the USA to the current position. The use of paralegals and on-line servicing has risen. Office rationalisation has been required and effected, servicing a global business.

#### *Trends since FY13*

*Global Support Services' premium growth vs group*

Between FY13 and FY16, Global Support Services (GSS) sales grew 10.5% CAGR (raising share of total sales from just under 29% to 34% of the total), but the growth at the rest of the group has been modest. We believe the growth here at GSS may be structurally at lower gross margins than average. It involves an element of recurring work which has some annuity-like characteristics.

## Murgitroyd

The division generates slightly lower gross margins....

...but margin erosion has other causes...

FY12 to FY16, gross margins fell each year, from 58.5% to 53.8%. FY17 registered a rise to 54.6%

Operating margins have also started to rise

FY17 sales rose well, but with currency tailwind

Global Support Services has provided much (but not all) growth

Recent US sales growth exceeds 20% (in US\$ as well as £ terms)

For the past five years, whilst sales have risen each year (and we calculate organic, constant currency sales have risen each year bar FY17), gross and net margins have been under pressure. Murgitroyd services a growing market, but one where clients are understandably constantly seeking efficiency benefits.

FY12 to FY16, gross margins fell each year, from 58.5% to 53.8%. In FY17, the gross margin percentage rose. Organic constant currency revenues fell 3.8% (Hardman estimate, including delays in currency effects due to risk-hedging and billing timetables).

The gross margin percentage rose to 54.6% last year, after a number of down years. We consider this important. While it might be preferable to grow top line as long as profits rise, the success of the work to arrest the gross margin percentage decline is paying off, it would appear. These are early days however.

EBITDA margins fell in FY17, however, there was a small rise 2H17 vs 2H16. See page 15. The trend is likely to be a rise in FY18E too (weighted to H2). For FY17, overhead ratios (to sales) grew – investment in growth (including the acquisition and business development). That is why the EBITDA margin rise lagged gross margins, but now there is scope to catch-up. We see gross margins stable in FY18E (consolidating the rise of FY17) and EBITDA margins starting to tick up, driven by tight control on costs after the rise in FY17 which was based on gearing up visibility of Group growth capacity.

### Summary statistics

- ▶ FY17 Group revenue +5.0% (equal rises H1 and H2).
- ▶ FY17 Group revenue +3.5% pre-acquisition effect.
- ▶ FY17 Group revenue -3.0% organic growth on a constant currency basis (small US rise, falls elsewhere).
- ▶ We calculate that between FY13 and FY16, GSS sales grew 10.5% CAGR.
- ▶ Attorney Practice Groups FY13 to FY16 CAGR was c. 3%.
- ▶ We calculate that between FY13 and FY16, total US revenues grew 27% CAGR in £ at a period of minimal £ / US\$ exchange rate swing.
- ▶ We calculate that between FY13 and FY16, non-US revenues fell 6% CAGR.
- ▶ Currency effect, on the 4 points above, is de minimis – whereas its effect on FY17 and to a lesser degree FY18E comparables is significant.
- ▶ FY18E Group: we estimate 3.8% sales growth (no acquisition distortion to the comparables) which translates to unchanged sales on constant currency.
- ▶ Our FY18 estimates are based on broadly unchanged local currency revenue. We anticipate an operating margin rise for the first time since FY13.
- ▶ FY18: constant FX sales unchanged – margins up for first time since FY13

## Divisional and regional growth

*Paralegal and on-line renewal based GSS is in secular growth mode*

*34% of group total*

### *Global Support Service (GSS) has been driving growth*

Global Support Services has exhibited premium growth. Murgitroyd captures 'downstream work' which may include Global Support Services group practice engagements such as European patent validations and/or renewals. The renewals business, whilst it might be lower margin, is a repeat market and Murgitroyd's use of proprietary technology makes this work more likely to be retained by it. Turnover growth is consistently in positive territory at the Attorney Practice Groups, but at modest single figure in % terms. These three years saw very modest 'following winds' on currencies but de minimis impact.

*USA had been growing sales 27% CAGR...*

### *USA has been delivering growth*

We calculate that between FY13 and FY16, total US revenues in £ Sterling grew 27% CAGR, with the non-US sales falling some 6% pa. Over these three years the US\$ appreciated circa 2% vs £. Revenues from US clients have increased from £3.1m in 2008 to the £10.2m reported for 2013 and circa £22m in the past year.

*..... but FY17 this slowed and likely small +ve FY18E*

FY17 saw a significant slowdown – to low single figure % growth (in local currency). The nature of the target client base –larger corporates – has not changed and does lend itself to repeat business. We have referred to the AIA legislation which, whilst still a positive, created greatest momentum in recent, prior years.

As regards geography, Murgitroyd is responsive to areas of future potential for expansion and changes in emphasis of services required and markets in growth or retrenchment mode. Some offices have been consolidated (two in the UK) and its presence in the Americas has been expanded, including the June 2016 acquisition. Group-wide, we estimate the USA has generated more than all the sales and profit growth over the past five years approximately.

*June 2016 acquisition, US\$2.43m*

### *June 2016 acquisition*

We assess the opportunities within the acquisition in more detail on page 7. Here however we note how it ties in to previously stated US business strategies.

*Dallas and Nicaragua*

The USA's focus includes Murgitroyd looking to capture 'downstream work', which may comprise Global Support Services group practice engagements. A good example of this strategy at work for high-value services to global corporates and law firms is the 2016 acquisition. In June 2016, Murgitroyd completed the acquisition of certain trade and assets from Dallas-based MDB Capital Group and Managua-registered Patentvest S.A. MDB's core offering is its IP Software & Services Group. A US patent attorney based in Managua works with sixteen Managua-based Patent engineers predominantly engaged in US Patent searching. As stated by Murgitroyd at time of purchase, this is to leverage a "comprehensive suite of IP advisory and support services to global companies and international law firms in the Group's largest geographical market, the USA, with the objective of increasing Murgitroyd's market share of high value European Patent Attorney services purchased by them."

*Significant investment 1H17*

## Investment for growth allied to cost control

Growth investment accelerates: new technology platforms (on-line winning new clients), senior people (business development). Office network rationalisation is actioned.

Expansion in paralegals is important, securing cost-efficient client service delivery. In part, this greater support work can also be tied in to Murgitroyd's technology investment.

As of the September statement of the full year results there was announced a "significant increase in the level of investment in business development, sales and marketing..... This investment also included capital expenditure on the Group's IT infrastructure, client interfaces and web presence. Reflecting this, capital expenditure on tangible fixed assets almost doubled year-on-year, to £318,000."

Its "new online annuities platform in November 2016 is a good example of the investment made in systems and has already directly led to new, recurring, GSS revenue being secured."

As stated by Murgitroyd in January at the time of its interim figures: "Murgitroyd's central Scotland operations have recently been consolidated in Glasgow, following the successful bringing together of London operations in Croydon, together saving office rental costs of over £100,000 on an annual basis." York has been relocated.

## Risks

Whilst Murgitroyd sees A.I. as an opportunity – for example its online renewals business represents a growing income stream – it could be perceived as a threat. The Murgitroyd business is in a strong position to take advantage of ‘machine learning’ and web-based solutions but must take care to secure incremental advantage and not cannibalise work.

The GSS operation is growing well, employing paralegal and support staff, but this growth, too, must seek to optimise Murgitroyd outcomes. The main avenue for growth is securing new business lines but there is also the risk of cannibalising workloads.

Recent rises in margins are encouraging but this trend is at an early stage after some years’ decline. This indicates ongoing pricing pressure from clients.

As well as having grown well, over a period of years, Murgitroyd has evidenced how it rationalises its cost base as well as invests in infrastructure to both engender then service new clients and product lines.

Growth has been particularly evident in the USA. Indications are that the market opportunities still offer significant growth potential.

There is currency risk, but a global income stream is to be welcomed, particularly as there is natural hedging through a global cost base. We suspect the £ sterling costs are somewhat greater than income whereas the reverse is the case on overseas currencies, particularly the US dollar.

Note on currencies that Hardman & Co undertakes analysis which attempts to take SOME recognition of the currency mix when assessing revenue and profit trends. When estimating historic and prospective trends in currency-adjusted terms, we take a broad brush approach. The figures utilised comprise 45% US\$, 30% £, 25% €. We also apply a lag of four months. We highlight that this is a very broad brush analysis, purely derived from Hardman & Co estimates.

Certain trade and assets from Dallas-based MDB Capital Group, LLC and Managua-registered Patentvest S.A. were acquired in June 2016. We consider this reduces risks, through broadening the market opportunities Murgitroyd addresses. It also ‘deepens’ capabilities in particular in the Murgitroyd IP support services offering, through the expansion of its IP strategy and Patent searching capabilities. As with all growth through acquisition, the people are most important.

Overall, for Murgitroyd, cash flow is strong and the long track record of success is a robust platform. It is important, however, for Murgitroyd constantly to review and enhance its capabilities in a market which, whilst global, is specialist in nature.

## Financial trends

### Long term trend summary

Growth markets, but margin pressure has been an issue...

...now showing signs of positive turn around...

We see Murgitroyd as a growth company in growing markets. However, pressure on margins for the past five years has been material, see the chart on page 15. In FY17, markets remained difficult in pricing terms and investments were made for growth. However, crucially positively, the gross margin percentage began a rising trend. In 2H17 operating margins rose. Going forward, we anticipate some sales growth – but maybe at modest levels – and an ongoing series of initiatives supporting margins (including new products such as on-line which is growing).

In order to assess comparable data, investors need to adjust for the currency impact, with 45% sales in Sterling. The translation impact can only be estimated by Hardman. Transactional risk (currency movements) is not large as the numerous local offices (in nine countries) mean local revenue and costs broadly match.

% Growth rates including estimated constant currency						
Year end May	2013	2014	2015	2016	2017	2018E
Sales growth						
Sales (yoy) %	0.8	6.7	3.6	6.0	5.0	3.8
Organic Sales (yoy) %	0.8		3.6	6.0	3.5	3.8
Organic sales estimated constant currency (yoy) %	0.8	6.7	3.1	3.9	(3.2)	(0.3)
EBITDA growth						
EBITDA (yoy) %	4.3	(8.2)	-	2.2	(8.7)	9.5
Organic EBITDA estimated constant currency (yoy) %	4.3	(7.1)	(0.5)	0.1	(16.8)	5.4
PBT, EPS, DPS growth						
PBT (yoy) %	4.5	(8.7)	-	2.4	(9.3)	7.7
EPS (yoy) %	4.9	(10.5)	3.4	0.8	(16.4)	7.7
DPS (yoy) %	4.2	6.0	11.3	8.5	6.3	5.9

Source: Murgitroyd accounts and Hardman & Co Research estimates

NOTE: All adjustments for currency and acquisition are based on Hardman estimates

A reversal in sales growth trends – nothing too dramatic...

FY17 setback...

See page 17 for a chart of % annualised growth rates.

Hardman currency mix input						
Year end May	2013	2014	2015	2016	2017	2018E
Currency: modelling input						
Ave £/estimated basket currencies	1.28	1.30	1.28	1.25	1.14	1.12
Ave £/US\$	1.55	1.59	1.56	1.50	1.30	1.30

Source: Murgitroyd accounts and Hardman & Co Research estimates

NOTE: All adjustments for currency are based on Hardman estimates

Look at currency – a 'tailwind' FY17, much less so FY18E...

Various trends, principally a lesser emphasis on sales and a margin improvement...

### Recent trends

- ▶ **Sales:** 2H17 reported sales were up. Sales on a constant currency basis excluding acquisition fell slightly more than the 3% fall for the year as a whole (note this adjustment is a Hardman estimate). We estimate 2H17 sales on this basis fell c. 4%. Reported sales rose 5.3% and 4.7% in H1 and H2 respectively.
- ▶ **FY18E:** We anticipate a modest (3.8%) rise in reported sales, translating to 'flat' on a constant currency adjusted basis.
- ▶ **Margins:** 2H17 operating margins rose slightly to 10.2% from 10.0%. The FY17 year as a whole fell (with a difficult H1), to 8.8% from 10.2%.

- ▶ **Tax:** 2H17's rate was showing an element of 'catch up' and we do anticipate a rate in FY18E above earlier years (partly as the US exposure keeps rising).
- ▶ **Cash flow:** Free cash flow fell (profits down) but at 27p per share, remains attractive and the long term record is a strong one.
- ▶ **Dividends:** The +6.25% dividend was above expectations.

#### Recent half yearly trends

Year end May	EPS [1] (p)	EPS % change [2]	PBT £m	PBT % change	Tax £m	Tax as % PBT
1H16	17.6	-	2.11	-	0.54	25.7
2H16	17.8	-	2.18	-	0.58	26.6
1H17	12.0	-31.8	1.48	-29.9	0.39	26.6
2H17	16.3	-8.4	2.33	+6.9	0.87	37.3

There has been a significant tax rate increase...

Source: Murgitroyd accounts and Hardman & Co Research estimates

NOTE: [1] EPS stated is basic undiluted

[2] All changes are calculated as comparative to prior year's relevant HALF year period

The table above assesses recent half years as 1H17 traded outside the normal robust trends. We seek to enable readers to look at the 2H17 results in the proper context as we consider this the basis for FY18's starting point.

#### Revenue

US growth has been an excellent story and continues (assisted by the acquisition)...

The past several years' investment (in skilled professionals and a small acquisition) has been the stated strategy. The nature of much of the work Murgitroyd does provides visibility of 'downstream' work. There is every indication long-term revenue growth trends in most areas of activity will continue, but elsewhere pockets of decline remain. And, pricing, overall, is competitive.

Almost half group revenue emanates from the USA (most of which in US\$), growing at 27% CAGR FY13 to FY16 (US\$ £ exchange rates moved little in this period).

... but likely at a lesser rate...

In FY17, we estimate the US growth was low single figures % in local currency terms. Our model assumes low single figures % US revenue growth (in local currency terms) again in FY18E. This growth has been a result of a steadily growing market, within a positive-looking US economy, expansion Murgitroyd's investment in the US market and professional skill base and, in June 2016, a modest acquisition (which has to date made only a modest impact on revenue). On page 8, we pointed to the positive impact we infer from the US AIA (America Invents Act) which came in to force March 2013. For a conservative assessment we therefore model slower US growth continuing in FY18E.

UK shrinking but a number of growth opportunities...

The UK is Murgitroyd's second largest market. However, growth in UK has been negative for well over six straight years now and, whilst we do not see material acceleration in the down trend, the UK focus is initially on selecting value and reducing costs. Within this there are distinct growth opportunities being secured. We have pointed to the on-line renewals growth (see page 7).

Historically, margin declines....

#### Margins

These factors, together, have placed pressure on margins. The gross margin percentage has reduced from 58.5% in FY12 to 53.8% in FY16. It rose to 54.6% in FY17 however and we estimate this being maintained in FY18E – a significant change in the trend of prior years. In the period of gross margin pressure, operating costs were reduced as a proportion of sales.

Murgitroyd is now seeking further growth opportunities, thus is investing modestly and selectively in programmes which add to the cost base. This, we emphasise, is in conjunction with the ongoing efficiency programmes for example Murgitroyd's central Scotland operations were consolidated in Glasgow during the year, following the successful amalgamation of London operations in Croydon. These, combined with the relocation of Murgitroyd's York office during the year, will result in more than £0.14m savings on annual office rental and associated costs.

..... with EBITDA margins now growing too...

With the growth investment having been put in place in 1H17, we therefore estimate a rise in EBITDA margins in FY18 to 10.0%, from 9.4% FY17, based on this prior year investment and on stable gross margins.

### Gross and operating margin trends



Source: Murgitroyd accounts and Hardman & Co Research estimates

We would highlight the following:

Gross margins rising....

- ▶ Historic trends have seen margin falls until FY17 reported.
- ▶ The gross margin percentage has risen in FY17. This is after some years of Murgitroyd investing to make its offering value-added and value for money, so the rise is from recent years' efforts from Murgitroyd.
- ▶ Whilst FY14 and FY17 both saw a step up in overheads and hence operating margins performed worse than gross, Murgitroyd has specifically pointed to the fact of some of the FY17 rise being one-off factors (see bullet point above).
- ▶ In 1H17, Murgitroyd absorbed one-off transaction and integration costs attaching to the acquisition (completed in late June 2016). There was significant business development cost. Business development costs rose by £0.34m in 1H17 alone. These costs were some 8% of total operating costs 1H17, we estimate, but Murgitroyd has stated (at the time of the interims) that business development spend would continue to be monitored into 2H17 and the level addressed to match market conditions and budgets.
- ▶ The 2H17 operating margin percentage rose slightly to 10.2% from 10.0%, after a difficult 1H17. This encourages us to view FY18 as benefiting from a better H1

..... in FY17, overheads rose and as this factor fades in FY18, further upward EBITDA margin move...

– without the headwinds of integration costs, etc. which pertained in 1H17 – but also a firming underlying trend.

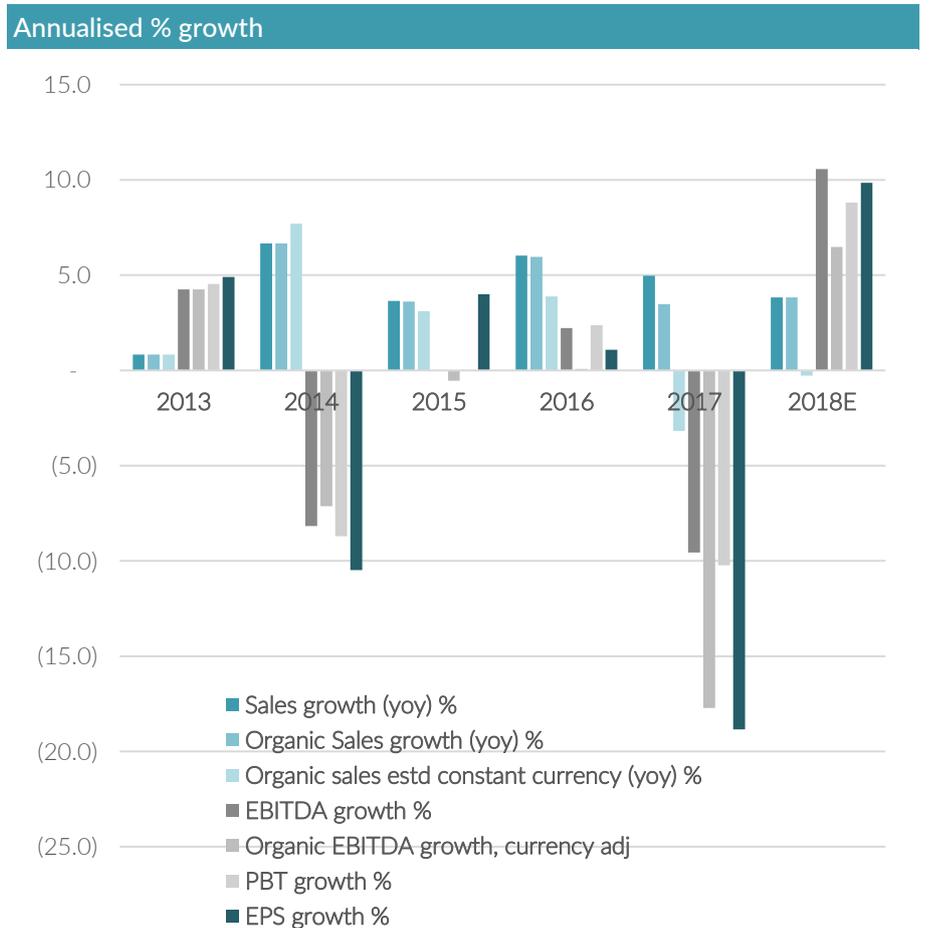
2H17 operating margins ticked up slightly vs 1H16...

- ▶ We see the 2H17 operating margin percentage rise as a precursor to a (modestly) firming trend FY18.

...this is significant for the future

% EBITDA margins						
Year end May	2013	2014	2015	2016	2017	2018E
EBITDA margin %	13.6	11.7	11.3	10.9	9.5	10.0

*Source: Murgitroyd accounts and Hardman & Co Research estimates*



*Source: Murgitroyd accounts and Hardman & Co Research estimates*

See page 14 for tabularised data, summarised in this chart, above.

## Financial analysis

Income statement						
May year end £m	2013	2014	2015	2016	2017	2018E
Sales	36.0	38.4	39.8	42.2	44.3	46.0
Gross profit	20.9	22.1	22.1	22.7	24.2	25.1
<i>Gross profit margin</i>	<i>58.1%</i>	<i>57.6%</i>	<i>55.5%</i>	<i>53.8%</i>	<i>54.6%</i>	<i>54.6%</i>
Operational costs	(16.0)	(17.6)	(17.6)	(18.1)	(20.0)	(20.5)
EBITDA	4.9	4.5	4.5	4.6	4.2	4.6
<i>EBITDA margin</i>	<i>13.6%</i>	<i>11.7%</i>	<i>11.3%</i>	<i>10.9%</i>	<i>9.4%</i>	<i>10.0%</i>
Depreciation	(0.2)	(0.3)	(0.3)	(0.3)	(0.3)	(0.4)
EBITA pre exceptional	4.7	4.2	4.2	4.3	3.9	4.2
Amortisation acqn related intang.	(0.0)	(0.1)	(0.0)	(0.0)	(0.1)	(0.1)
EBIT	4.7	4.1	4.2	4.3	3.8	4.1
Interest cost	(0.1)	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)
Exceptional	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)
PBT Reported	4.6	4.1	4.2	4.3	3.8	4.1
PBT (Adj)	4.6	4.2	4.2	4.3	3.9	4.2
Tax rate	28%	28%	25%	26%	32%	32%
EPS (Adj., dil) (p)	37.5	33.6	34.9	35.3	28.7	31.5
DPS (p)	12.5	13.25	14.75	16.00	17.00	18.00
Ave shares (diluted) (m)	8.9	9.0	9.0	9.1	9.1	9.1
Shares (year end) (m)	8.9	9.0	9.0	9.0	9.0	9.0

Source: Company accounts, Hardman & Co estimates

Cash flow						
May year end £m	2013	2014	2015	2016	2017	2018E
Operating cash flow	4.8	4.3	4.5	4.6	4.2	4.6
WIP	(1.2)	(0.4)	(1.1)	0.4	(0.1)	(0.6)
Cash interest	(0.1)	0.0	0.0	0.0	0.0	0.0
Tax	(1.4)	(0.9)	(0.9)	(1.6)	(1.2)	(1.5)
Capex	(0.4)	(0.4)	(0.2)	(0.2)	(0.4)	(0.4)
Other	0.0	(0.1)	0.0	0.0	0.0	0.0
Net cash flow	1.7	2.5	2.3	3.2	2.5	2.1
Dividends	(1.1)	(1.1)	(1.2)	(1.4)	(1.5)	(1.6)
Equity	0.6	0.1	0.0	0.1	0.0	0.0
Acquisition	0.0	0.0	0.0	0.0	(1.9)	0.0
Other	0.0	0.0	0.1	0.3	0.4	0.1
Net cash change	1.2	1.5	1.1	2.1	(0.6)	0.5
Net cash	(1.9)	(0.4)	0.7	2.8	2.2	2.7
Free cashflow	1.8	2.5	2.3	3.2	2.5	2.1
<i>Free cashflow per share (p)</i>	<i>20.3</i>	<i>27.8</i>	<i>25.4</i>	<i>35.3</i>	<i>27.1</i>	<i>23.2</i>

Source: Company accounts, Hardman & Co estimates

<b>Balance sheet</b>						
May year end £m	2013	2014	2015	2016	2017	2018E
Intangible assets	14.9	14.9	14.9	14.9	16.8	16.8
Property, plant, equipment	2.3	2.5	2.4	2.3	2.4	2.4
Other non current assets	0.1	0.0	0.0	0.0	0.0	0.0
Total non-current assets	17.3	17.4	17.3	17.2	19.2	19.2
Trade receivables, inventories	14.7	15.3	16.3	16.1	16.4	17.0
Total Current assets (incl cash)	15.7	16.8	18.0	19.4	19.0	19.9
Current liabilities (ex debt)	(6.7)	(6.0)	(6.0)	(5.6)	(5.9)	(5.9)
Current liabilities (incl debt)	(6.7)	(6.8)	(6.3)	(5.8)	(6.0)	(6.0)
Net current assets	9.0	10.0	11.7	13.6	13.0	13.9
Long term liabilities	(1.9)	(1.0)	(0.6)	(0.4)	(0.3)	(0.2)
Net assets	24.3	26.4	28.4	30.4	31.9	32.9

Source: Company accounts, Hardman & Co estimates

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