

# SHEARWATER GROUP

IT CYBER SERVICES, SOLUTIONS & PROFESSIONAL CONSULTING

26 November 2021

**SWG.L**

122p

Market Cap: £28.9m

## SHARE PRICE (p)



12m high/low

215p/120p

Source: LSE Data

## KEY DATA

Net (Debt)/Cash	£4.4m (at 30/09/21)
Enterprise value	£24.5m
Index/market	AIM
Next news	Trading update, Apr '22
Shares in Issue (m)	23.8
Chairman	David Williams
CEO	Phil Higgins
CFO	Paul McFadden

## COMPANY DESCRIPTION

Shearwater provides cyber security, advisory and managed security services

[www.shearwatergroup.com](http://www.shearwatergroup.com)

**SHEARWATER GROUP IS A RESEARCH CLIENT OF PROGRESSIVE**

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## Cyber security for the next generation

Shearwater is a group of businesses with a single purpose and common goal: working with clients to protect their businesses against many varieties of digital threats. This note describes each business within the portfolio, and positions these in the context of the group strategy. We believe the business to be well-placed to benefit from the undeniable ongoing growth in the cyber security market.

- **Cyber threats are growing.** Investors need no reminding of the risks within business operations – not a day goes by without one large corporation or another falling victim to some kind of attack. As well as increasing in frequency, these attacks are more complex, more expensive to deal with, more damaging to brands, and more likely to lead to regulatory pressure or even fines.
- **Defence is complex.** Faced with threats of this magnitude and severity, almost every large corporation is working to anticipate, avoid and counter the most significant dangers. Most organisations, however, are also trying to make their infrastructure more flexible, more connected (to the Cloud or otherwise) and more accessible to home workers. These conflicting dynamics lead to significant complexity and difficulty in the provision of a robust, secure and modern IT infrastructure.
- **Shearwater's offering is compelling.** As we will describe in this document, Shearwater exists to offer a range of different types of security and protection, focused on different threat styles, and delivered in different ways. We believe that, between the five units, Shearwater covers a good proportion of the most likely dangers to an organisation, positioning the group well to capitalise on the current opportunity and to deliver on long-term potential, including through M&A in the near to medium term.
- **FY22 interim results.** The interim results demonstrate a good deal of resilience in the face of the effects of Covid-19, plus clear evidence of a bounce-back in the advisory business and an improving mix, with an increasing proportion of higher-margin software and advisory revenues. Our estimates reflect strong growth in revenue and adjusted EBITDA.

We believe that Shearwater is well-positioned to push forward with its strategic goals, many of which were understandably held back by the Covid-19 pandemic. We take comfort from the solid recent results, and await further newsflow across the remainder of the year.

FYE MAR (£M)	2019	2020	2021	2022E	2023E
Revenue	23.5	33.0	31.8	33.5	36.4
Adj EBITDA	-1.4	3.4	3.7	4.1	4.6
Fully Adj PBT	-1.6	2.2	2.4	2.6	3.2
Fully Adj Dil EPS (p)	-8.9	7.6	9.7	11.5	14.1
EV/Sales (x)	1.0x	0.7x	0.8x	0.7x	0.7x
EV/EBITDA (x)	-17.6x	7.2x	6.6x	5.9x	5.3x
PER (x)	N/A	16.0x	12.6x	10.5x	8.6x

Source: Company Information and Progressive Equity Research estimates.

This publication should not be seen as an inducement under MiFID II regulations.

Please refer to important disclosures at the end of the document.

## Executive Summary

Shearwater offers investors the opportunity to gain exposure to the fast-growing and lucrative cyber security arena, through a business selling both software and services to a corporate client base.

The cyber security segment enjoys several separate growth drivers, which combine to propel significant expansion in customer spend. The main corporate pressures relate to data and network security – networks are under constant threat from both external and internal threats, and protection platforms must be vigilant and flexible to detect and mitigate any potential attacks. Equally, data is at risk from either accidental or deliberate removal or misuse, and organisations increasingly face regulatory fines where they are seen to have lapsed in their vigilance in situations when security is breached. This is to say nothing of the high-profile publicity surrounding ‘hacks’ or ‘data thefts’, which can lead to material loss of consumer trust in a brand, with significant negative consequences.

The group has been built up over a number of years through a series of acquisitions, and now provides a wide range of services and products to address this lucrative market opportunity. Although the past two years have seen a degree of reshaping (as the businesses acquired were transformed into a cohesive organisation) and then delay (as Covid has held back acquisition plans), we believe that the group is likely to return to acquisitions in the core areas in the medium term. This could offer the prospect of enhanced scale, additional geographic reach and potentially expanded margins and multiples as the business adds both services and software acquisitions over time.

The interim results, reported on 25 November, show that the company is continuing its profit growth after a resilient performance in FY 2021. Covid-19 was still a major influence on the operating environment in H1 FY22 and it may continue to be a factor for a while yet. However, underlying demand for Shearwater’s products and services remains high, and we take particular encouragement from the fact that the results saw increasing proportions of the higher-margin software and advisory revenues. The group won 90 net new clients in the period, continued to make progress with cross-selling and secured a number of major contract renewals.

The business benefits from strong and experienced management, with a team displaying significant experience in all relevant disciplines, and with a strong divisional management team on which to rely. Shearwater also boasts a strong ‘advisory board’, which is useful in a business whose core offering and ethos relate to protection, trust and resilience.

In terms of valuation, Shearwater sits at a modest discount to a range of peers that we describe in the relevant section below. The group has been perhaps overlooked by a number of investors, although we suggest that this should change as scale is increased through further acquisitions and as organic delivery continues to improve. The business has arguably had the chance to both stabilise and consolidate previous acquisitions during the Covid-19 period. With this process largely complete and corporate clients moving to thinking ‘beyond Covid’, we hope that Shearwater will be able to move into both a higher organic growth phase, and to augment this through selective acquisitions.

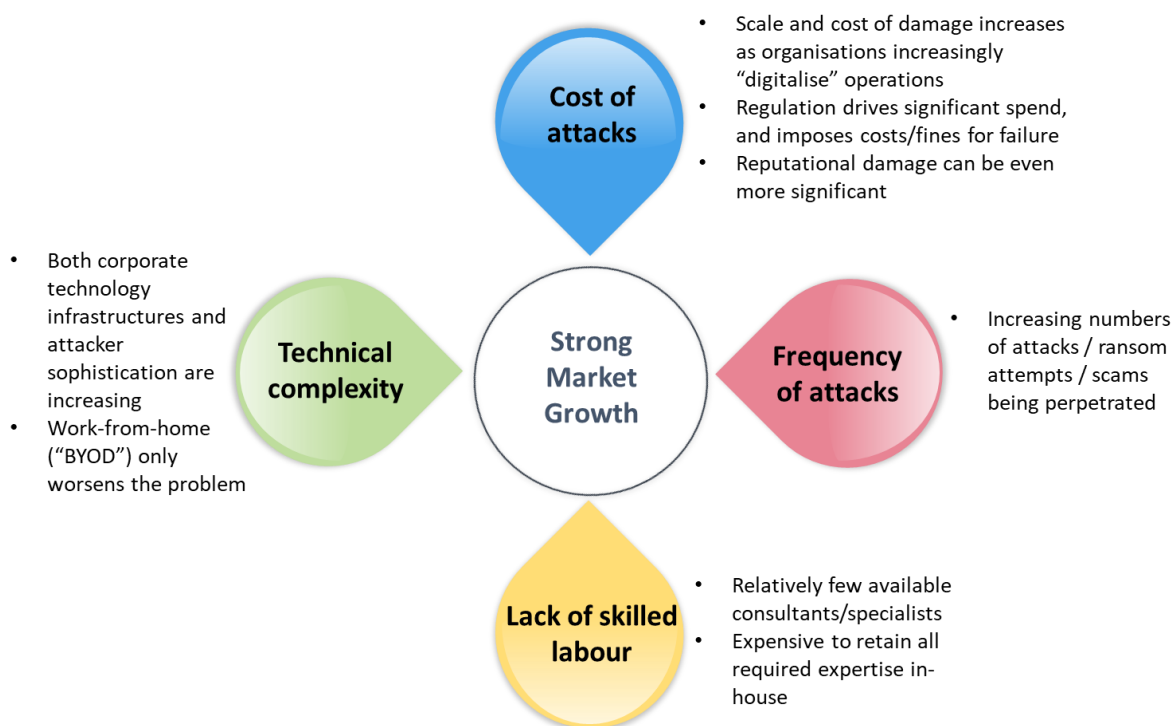
## Market backdrop and growth

The market for cyber security (both services and software/platforms) is undeniably large and growing. Exact scale, and pace of growth, depends largely on definitional choices, but on any sensible basis the market is vast in comparison to Shearwater's scale, and the growth rates are strong across all sectors where risks are faced.

Gartner, during 2020, estimated the global "security spending" market to approximate \$124bn, with the fastest-growing segments being Cloud Security (33%), Data Security (7.2%) and Application Security (6.2%).

There are several drivers of this long-term and structural growth, and the diagram below shows these drivers and forces at work. These factors combine to create an environment where corporate spend is growing strongly, especially in areas relating to data, regulation and defending corporate infrastructures.

### Drivers of growth in the cyber security market



Source: Progressive Equity Research Ltd

## Group strategy and vision

Shearwater sells into the cyber security, advisory and regulatory markets in both the corporate and public sectors. Customers generally have a 'hybrid' demand – they need specific software (and hardware) platforms and systems to allow them to protect and defend their infrastructure, but they often also have a requirement for services work to 'wrap around' the systems, to provide either installation and integration skills, or a managed service delivery where experienced consultants manage and monitor the various platforms.

This hybrid client requirement is matched by a hybrid offering from Shearwater, with an element of both software and service delivery. The diagram below depicts the group's overall structure and shows the various elements as they sit within the business. Note that, within what is described as the 'Services' side of Shearwater, the businesses also sell some software and other platforms (third-party systems), which in many cases also give rise to services work as described above. So not all of Shearwater's software-related revenue is generated within the 'Software' division.

### Services and Software segments

#### Services



Professional consulting and project management  
Installation and integration  
Ongoing managed services and monitoring  
Resale of third-party software and cloud-based platforms  
Mainly sold via direct sales teams

#### Software



Owned intellectual property  
Individual software sale / ongoing platform delivery  
Mainly sold through third-party distributors

Source: Company information

We believe that this hybrid approach works well both in terms of Shearwater's structure and the client requirements, and it arguably points the way to potentially a major driver of value across the business:

**Shearwater enjoys strong relationships with blue-chip corporate clients procuring very significant cyber and advisory projects. If even a small number of these requirements can be converted also to incorporating elements of the group's software portfolio, the margins and long-term value could be very material.**



## Software: SecurEnvoy

**Principal offering: software for multi-factor authentication and identity management**

- Tokenless Multi-Factor Authentication – the SecureIdentity platform provides software for Multi-Factor Authentication (a now well-known method to ensure a user/person is correctly identified – often involving sending a message to another device, such as a mobile phone, and either requiring verification from that device, or the entry of a code into the original platform). This is also available to customers via an Authentication-as-a-Service (AaaS) standalone service.
- Identity & Access Management – synchronisation of user directories, management of user lifecycles (including staff departures and contractor management), clear levels of access within an organisation

### Customers / customer types

The product is targeted at any organisation with a large number of end users, or for whom absolute certainty is required regarding users logging on to remote systems or platforms. Publicly available names include John Lewis, Sports Direct and Santander – alongside a long list of other blue-chip and large organisations.

### Average deal sizes

Deals can range from a few thousand pounds per year to tens of thousands for larger customers with large numbers of users. Revenue is recognised net of margin paid to resellers.

### Route to market

SecurEnvoy is sold through a large number of security specialist service partners on a multinational basis. These are organisations providing security-related services to customers normally within a local region. Rather than try to sell direct, SecurEnvoy pays these partners a margin in return for the partner managing the end-customer relationship and supporting the product locally.

### Scale at time of acquisition

SecurEnvoy was acquired in May 2017, at which time it was generating sales of £3.2m and EBITDA of £2.2m – a very strong margin despite the relatively small scale of the operation. We suspect that the cost base has been expanded as the business has invested for growth, but this performance (even historical) demonstrates that security software can generate very strong levels of profit as additional revenues are achieved.

**To us, the margin potential for increased sales of SecurEnvoy (or GeoLang, or other software added in the future) is a key element of the Shearwater investment case, as the (relatively larger) services businesses could cross-sell material volumes of software over time.**



## Software: GeoLang

**Principal offering: sensitive data discovery and data loss prevention software, with associated other systems and related services**

GeoLang offers two main products through its ASCEMA platform:

- Sensitive Data Discovery – related to Data Loss Prevention, this system allows an organisation to search file content (not just names, to avoid users bypassing the analysis) to identify sensitive data wherever it resides within the corporate IT infrastructure
- Data Loss Prevention – this platform identifies and tags information classed as confidential or business-critical, ensuring that accidental or malicious use cannot cause this information to leave an organisation

### Customers / customer types

The software is applicable across all sectors, especially those with high levels of exposure to sensitive or consumer data, especially with GDPR or similar regulations extending rapidly in reach across the globe.

### Average deal sizes

We assume that average deal sizes are relatively small, with revenues in the range £10-50k per annum, but with some deals significantly larger than this.

### Route to market

Like SecurEnvoy, GeoLang operates through a reseller model, with a number of services partners responsible for sale and support of the platforms within their own end-client IT systems. We understand that a number of material sales have also been made on a direct basis.

### Scale at time of acquisition

GeoLang was acquired in April 2018 for £1.9m. No details were disclosed at the time around the revenue or profitability of the business. Based on Companies House data, the business was small enough to avoid reporting revenues, and had been modestly lossmaking in recent years.



## Services: Brookcourt

**Principal offering: services around cyber security, preparing for (and responding to) attacks, installing, implementing, maintaining and monitoring third-party software and Cloud-based security platforms**

Brookcourt is a multi-award-winning company that draws on years of experience and a deep level of understanding to offer its customers a full range of cyber-related consulting services: predicting, preventing and detecting attacks, working to secure and protect infrastructure, and dealing with incident response in the event of a successful attack.

The business provides installation, implementation and management/monitoring around a range of specialist third-party software and security platforms. Brookcourt resells and provides managed services around these best-in-class partner technologies, some of which are listed in the diagram below:

### Brookcourt – selected technology partners

**IMPERVA**

**NETSCOUT**

**Recorded Future**

**ARBOR NETWORKS**  
The Security Division of NETSCOUT

**DEVO**

**deepinstinct**

Source: Company information

## Customers / customer types

As with other elements of the Shearwater Group, and unsurprisingly given the nature of the services provided, Brookcourt's customers are generally unwilling to be publicly named. The unit does, however, have a number of customer comments and references where the type of client is available. These include "global banking and financial services company", "UK Mobile Network Operator", "American Multinational Retail Corporation for Sporting Goods". These descriptions clearly suggest a number of major and multinational clients with significant and ongoing requirements for cyber security provision.

## Average deal sizes

Brookcourt does not disclose total numbers of customers, and we understand that there is significant variation in contract sizes, from small one-off consulting projects through to large multi-year managed services deals with significant up-front implementation and installation projects. By way of example, Brookcourt announced in October 2019 a contract worth some £8.5m over three years with one of the UK's largest mobile phone networks; this was around an "advanced monitoring solution" (presumably from a third party) with Brookcourt then providing a managed services "wrapper" for ongoing monitoring and support.

**Route to market**

Brookcourt employs a direct sales team that works with customers to understand their thinking and planning around cyber security, engages in project work and evolves relationships over time to provide multi-year revenue structures and ongoing assistance, managed service provision and holistic support.

**Scale at time of acquisition**

Brookcourt is the largest part of Shearwater by size. At the time of its acquisition in October 2018, the business had reported sales of £21m and EBITDA of c.£2.0m.

**Potential for cross-selling software into services customer base**

Importantly, Brookcourt is often involved in large deals with large clients. Some of these deals generate significant revenues for Brookcourt, but in many cases Brookcourt's own sales may be relatively modest as it provides services or consulting around a major platform or software implementation.

From a group perspective, the opportunity is clear. Brookcourt (and the other services divisions) often provides consulting to large clients around their significant platform needs, and if Shearwater can effectively cross-sell its software assets (currently SecurEnvoy and GeoLang, but potentially more in future) into this customer base, then the software revenues (and high gross margin) could be transformative to the group P&L.

Recent evidence is positive. FY22 interim results disclosed that 2% of revenues are now generated through cross-selling, compared with 0.27% in 2020. With the business now clear in its purpose, and with both SecurEnvoy and GeoLang products well-referenced, there is potential for significant additional sales of these (or other) software platforms into the services client base.





## Services: Xcina

### Principal offering: risk advisory and assurance services to support organisational resilience

Xcina's offering involves understanding, managing and mitigating risks related to business continuity, data protection, information security and a number of regulatory frameworks including GDPR, PCI DSS, FCA and PRA regimes.

Assistance is also provided to customers looking for independent assurance, compliance procedures and internal audit, all areas where external providers can offer valuable verification or validation of internal procedures. The table below shows the range of services on offer.

#### Xcina range of services offered

xcina Consulting			ABOUT US ▾	SERVICES ▾	REGULATORY CALENDAR	NEWS	INSIGHTS ▾	CONTACT
COMBINED SERVICES			TECHNOLOGY RISK MANAGEMENT			BUSINESS RISK MANAGEMENT		
Internal Audit			Business Continuity			Financial Processes and Procedures		
Risk Management			Data Protection			Operational Processes and Procedures		
Process Review			Information Security			Regulatory Compliance		
Controls and Compliance Attestations			PCI Data Security Standard					
Third Party Management and Assurance								
Project and Change Management								

Source: Company information

### Customers / customer types

Xcina mainly sells its consulting and advisory services to SME customers – second or third tier organisations, as well as several larger corporate clients and the not-for-profit sector. Publicly available customer names include the National Bank of Kuwait, a small property business, a brand specialist and a number of technology start-ups.

### Average deal sizes

The group has not disclosed average deal sizes, but we expect that most customer engagements will be in the tens of thousands of pounds per annum, with an element of the overall revenue recurring in nature, and some being more one-off project based but with potential for additional projects over time.

### Route to market

Xcina sells direct to end customers through its in-house sales team.

### Scale at time of acquisition

Xcina was acquired in July 2017, at which point total revenues were some £2.4m and the business was broadly breakeven in terms of profitability.



## Services: Pentest

**Principal offering: simulating the actions of malicious parties aiming to breach organisations' security and cyber defences**

Pentest provides “red team” attack simulation, using highly trained “ethical hackers” capable of breaching security perimeters to demonstrate and highlight any weaknesses. In addition to this, the unit provides consulting services around information security processes.

### Customers / customer types

The unit sells to both end users (corporate customers) and software developers who look to Pentest for assurance around application security and robustness.

Given the work involved, it is natural that clients are unwilling to provide references or be publicly named. That said, we understand that Pentest works with a range of corporate clients of different sizes, and across a number of sector verticals.

### Average deal sizes

Consulting fees can vary in scope and scale, and we assume that average deal sizes are relatively small, with revenues in the range £10-50k per annum, but with some deals significantly larger than this.

### Route to market

Pentest employs its own team of salespeople, often providing consulting services in advance of full penetration test projects – some of which are one-off in nature, others being run on a regular/repeating cycle to ensure strength of defences over a period of time.

### Scale at time of acquisition

When Pentest was acquired in April 2019, it had reported revenues of £3.7m per annum and EBITDA of c.£0.5m.

## Competitive landscape

Given the large and growing market for cyber security services and solutions, it is unsurprising that the market has become populated with a significant number of organisations competing for corporate expenditure.

### In-house provision

Some organisations have large in-house security teams, but even the largest enterprise customers are often keen to work with specialist partners for specific aspects of their security provision – partly to ensure that they remain constantly “up to date” with ever-changing threat technologies, partly to manage costs and headcount, and partly to demonstrate ‘best practice’ in terms of robust processes in the event of a breach or security failure.

### Services – large global integrators and regional/local specialists

The global market for cyber security is populated by a vast number of services providers, specialist software and hardware platforms and ‘as a service’ infrastructure players. We cannot hope to describe even a small subset of the global market, but suffice to say that all major IT Services groups (Accenture, IBM, Wipro, Infosys, TCS etc) have significant security practices. These compete with large security-specific services groups that are often regional or local in nature. All these services providers interact with the various available software and hardware products (firewalls, threat detection, packet inspection, activity monitoring etc etc) and the newly emerging Cloud providers. Sometimes companies will procure these platforms directly but need help with implementation; at other times the customer will simply want to procure all of a certain security-related system through a reliable and trusted vendor. Therefore, Shearwater competes with a wide variety of operators in different areas of the market, and with different specialisations and business models.

Within the UK cyber security services market, best known to the UK investor base, there are a number of cyber-related investment opportunities, although Shearwater seldom encounters these in competitive situations. NCC sells a range of services around software escrow and cyber consulting/managed services and ECSC similarly provides cyber security services, managed services and penetration testing.

### Software – few quoted in the UK, but a broad global market

The security software landscape is equally broad, with a number of large global players, but with a number of UK-listed groups with which investors will be familiar – examples include Avast (antivirus software) and Kape (a wide range of security and identity protection platforms, mainly targeting the consumer market).

Within the specific area where SecurEnvoy is active (multi-factor authentication and identity management), there are a number of specific competitors in addition clearly to Microsoft – the best known of these are Okta, CyberArk and One Identity.

## Management team and Advisory Panel

Shearwater Group's board consists of two executive directors (CEO and CFO), a non-executive chairman, and three independent non-executive directors, which provides an appropriate balance for a business of its size. The working backgrounds and professional experience of the non-executive directors enables them to provide a solid foundation for good corporate governance for the group, while their independence from management should prevent any individual or group from dominating the board's decision-making process. The Advisory Panel helps support the group through the members' contact networks, and generally helps Shearwater stay abreast of developments in the cyber security market. The panel meets four times a year and holds separate meetings with the divisional management team when additional assistance is requested around specific opportunities.

### David Williams – Non-Executive Chairman

David has chaired Entertainment One, Breedon Group and Waste Recycling Group. He has experience building and chairing companies in both the public and private sector, in executive and non-executive roles. David is currently chairman of the Remuneration Committee and Nomination Committee for Shearwater, while also being a member of the Audit Committee.

### Phil Higgins – Chief Executive Officer

Phil has more than 30 years of industry experience, with a focus on technology within FTSE 100 and FTSE 250 companies. He served as International Business Director for Info Products Europe (now SCC), co-founded Brookcourt Solutions in 2005, became Executive Director for Shearwater in 2018, and was appointed as CEO of Shearwater Group in 2019.

### Paul McFadden – Chief Financial Officer

Paul worked at Wilmington plc for a number of years, where he created the group's scalable shared service centre, helping to grow the business. The role spanned a number of digital information companies, and training and events businesses. Paul has more than 10 years' overall experience in financial roles.

### Robin Southwell – Non-Executive Director

Robin's background is in the aerospace and defence industry, with over 35 years of experience in senior positions in BAE, and as the CEO of Airbus UK and Airtanker Ltd. He received his OBE in 1997 and has been appointed as a DTI Business Ambassador by the UK Government. Robin is a member of the Remuneration Committee.

### Stephen Ball – Non-Executive Director

Stephen has over 35 years' experience working in the technology, defence, information technology and communications industries. He was Chief Executive Officer of Lockheed Martin UK, and served as the Managing Director prior to this. Stephen was also CEO of HMGCC, focusing on developing and manufacturing security and communications equipment. Stephen is a member of the Nomination and Audit Committees.

## **Giles Willits – Non-Executive Director**

Giles has over 20 years' experience in senior leadership and financial roles. He currently serves as the CFO of IG Group Design, and was previously CFO of Entertainment One Ltd, having started as a Non-Executive Director. Giles also served as the Director of Group Finance of J Sainsbury and Woolworths Group. He is currently Chairman of the Shearwater's Audit Committee.

## **Advisory Panel**

### **Rt Hon. the Lord Reid of Cardowan – Panel Chairman**

Lord Reid joined as Chairman of the Advisory Panel in 2017, having served in multiple UK cabinet positions, such as Home Secretary and Secretary of State for Defence. He is now in the House of Lords and is Executive Chairman of University College London's Institute for Strategy, Resilience and Security.

### **Marcus Willett CB OBE – Panel Member**

Marcus joined the Advisory Panel in 2019. In his 33 years with GCHQ, he served as the first Cyber Director of GCHQ and as their Deputy Head. Marcus is currently the Senior Advisor for Cyber at the International Institute for Strategic Studies.

## Financial commentary and basis for forecasts

### FY 2022 interim results

The FY 2022 interim results, reported on 25 November, show that Shearwater is continuing its profit growth after a resilient performance in FY 2021. Covid-19 was still a major influence on the operating environment in H1 FY22 and may continue to be a factor for a while yet. However, underlying demand for Shearwater's products and services remains high, and we take particular encouragement from the fact that the results showed increasing proportions of the higher-margin software and advisory revenues.

The first half is traditionally very much the quieter half of the year for Shearwater. It is normal for the majority of the group's managed services sales to be made in the final quarter. Management stated that approximately half of H2 revenues are already identified from existing contract renewals, on top of which they see a healthy pipeline of new business with both new and existing clients.

Group revenue in H1 FY 2022 of £10.6m was down on the prior year as expected (H1 FY21: £11.2m), while margin growth and good cost control resulted in an increase in Adjusted EBITDA to £1.3m, up 19% on H1 FY2021. The table below shows the contributions of the business segments and the group performance to the Adjusted EBITDA level.

#### Segment and Group performance

£m	H1 FY 2022	H1 FY 2021
<b>Software</b>		
Revenue	1.9	1.9
Gross profit	1.5	1.4
Gross margin %	77%	77%
Overheads	-0.6	-0.7
Adjusted EBITDA	0.9	0.8
Adjusted EBITDA margin %	48%	41%
<b>Services</b>		
Revenue	8.7	9.3
Gross profit	2.6	2.3
Gross margin %	30%	24%
Overheads	-1.7	-1.5
Adjusted EBITDA	0.9	0.8
Adjusted EBITDA margin %	10%	8%
<b>Group</b>		
Revenue	10.6	11.2
Gross profit	4.1	3.7
Gross margin %	39%	33%
Overheads (Adj, including Group)	-2.8	-2.6
Adjusted EBITDA	1.3	1.1
Adjusted EBITDA margin %	12%	10%

Source: Company information

Shearwater reported 90 new customer wins in H1 FY 2022 (H1 FY 2021: 62) and that it had generated new Software revenue of £0.4m from new clients and up-selling (H1 FY 2021: £0.5m prior to Covid-19).

Management highlighted that 2% of revenue in H1 FY 2021 was generated through cross-selling compared with 0.27% in H1 FY 2020, and that initiatives to improve this further remain in place.

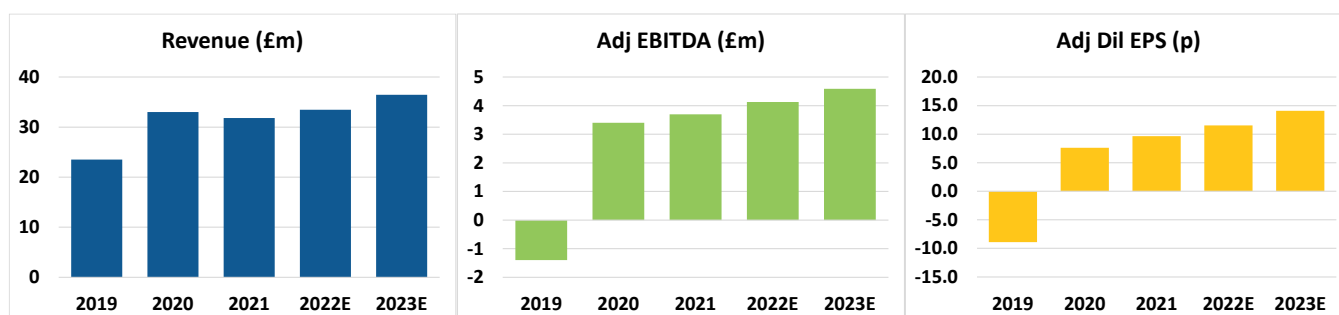
Importantly, the group's balance sheet remains robust, and Shearwater ended with a period-end net cash balance of £4.4m (H1 FY2021 £3.0m) following the payment of £1.1m of VAT deferrals and £0.3m of outstanding legacy loan liabilities during the period. While this net cash balance is a decline from the year-end figure (FY 2021 £7.3m), we note the group's strong cash generation in recent years, with cash conversion rates that could not be seen as sustainable, and the fact that the relatively lumpy nature of some its contracts can impact cash balances in the short term. We forecast a year-end net cash figure of £6.9m. We also note that the group has an undrawn, three-year £4m revolving credit facility, and believe that the group's banks would be supportive of debt being used as part of an acquisition.

## Estimates

Our estimates reflect a continuation of the improvement in adjusted EBITDA and the associated EBITDA margin. We expect the group to show revenue growth in the current financial year as the Services business sees a recovery in advisory services and the Software business starts to reap the benefits of the launch of new product sets. We expect the latter to be more influential in the second half of FY 2022E given the prospective lead time for the sales process to produce a signed contract. We note the investment plans that management have outlined in terms of new people and the ongoing commitment to training – but we also expect day-to-day costs to remain well-controlled to support a small improvement in EBITDA margin from 11.7% in FY21 to 12.2% in FY22E, rising further to 12.6% in FY23E.

We expect depreciation and amortisation charges to total around £3.75m in FY 2022E (compared with £3.2m in FY 2021) given the growth in the business, investment in software and the amortisation associated with FY 2020's bespoke training contract. However, we anticipate the latter dropping away in our £3.4m total for FY 2023E.

### Estimates show good growth



Source: Company information, Progressive Equity Research estimates

As noted above, our estimated net cash position for the end of FY 2022E (absent any acquisitions) is £6.9m. However, with fewer anticipated fluctuations, we expect an improvement to £9.2m of net cash at the end of FY 2023E, again assuming no acquisitions.

## Investment thesis and peer valuations

In our view, Shearwater offers investors three key attractions:

- Exposure to the fast-growing and secular expansion opportunity of cyber security provision to corporate clients. This market is well-known and highly attractive. It is competitive but the various businesses have established niches, strong customer bases from which to reference, and many years' experience of operation
- Software-style gross (and, over time, operating) margins from high-quality own-IP software products, being cross-sold by large and strongly performing services businesses, notably Brookcourt but also Pentest and Xcina
- Opportunity to enjoy medium-term earnings growth, driven by a 'rebound' from depressed Covid-impacted trading, by a newfound clarity, drive and focus across the previously disparate group, and by acquisitions, which we believe are now likely to be effected as the group benefits from its stronger position and market backdrop

The table below depicts Shearwater alongside a number of its UK-quoted comparators and peers, some chosen for their exposure to cyber security or related areas, and others simply because they are also technology businesses with a mix of software and services and enjoying global growth markets or selling to enterprise customers. We compare Shearwater to a selection of companies using three valuation metrics: EV/EBITDA, EV/sales and PER (price/earnings ratio). This table is based on consensus forecast data from Refinitiv Eikon and our own estimates for Shearwater, and is presented on a calendar-year basis to permit direct comparability as company year-ends differ (Shearwater's year-end being March). Shearwater's revenue growth for CY1 includes a partly historical part-year due to the group's March year-end, and we note that Shearwater's growth for the full forecast period (CY2E as shown below) is much more in line with the remainder of the group.

### Shearwater peer comparisons

	Listing location	Market cap £m	EV/EBITDA (x)		EV/Sales (x)		PER (x)		Sales growth	
			CY1E	CY2E	CY1E	CY2E	CY1E	CY2E	CY1E	CY2E
<b>Shearwater Group PLC</b>	<b>United Kingdom</b>	28	<b>5.3</b>	<b>4.8</b>	<b>0.6</b>	<b>0.6</b>	<b>10.8</b>	<b>8.9</b>	<b>3.1%</b>	<b>8.0%</b>
Absolute Software Corp	United Kingdom	339	19.3	15.1	4.3	3.1	N/A	N/A	38.5%	37.4%
Avast PLC	United Kingdom	6174	16.7	15.8	9.3	8.8	21.9	20.5	10.6%	5.8%
Blanco Technology Group PLC	United Kingdom	184	17.5	16.0	4.6	4.3	41.4	38.7	8.4%	7.7%
Cerillion PLC	United Kingdom	257	25.8	19.7	9.6	7.8	38.2	27.5	23.6%	22.3%
Sage Group PLC	United Kingdom	8036	19.9	18.2	4.4	4.2	33.4	29.7	-0.7%	4.9%
Piteco SpA	Italy	191	14.6	13.3	6.9	6.5	21.3	18.1	34.9%	7.5%
Sopheon PLC	United Kingdom	98	24.6	22.4	3.4	3.1	N/A	N/A	9.0%	10.0%
Ideagen PLC	United Kingdom	675	25.2	20.7	8.6	7.1	n/a	n/a	29.7%	21.7%
Verimatrix SA	France	80	6.2	14.3	1.5	1.8	8.1	125.6	-13.8%	-15.1%
NCC Group PLC	United Kingdom	738	11.8	9.9	2.3	2.1	22.5	18.7	12.6%	11.0%
Intercede Group PLC	United Kingdom	47	20.8	16.6	3.6	3.3	34.9	24.8	4.8%	9.0%
Osirium Technologies PLC	United Kingdom	5	N/A	N/A	4.0	3.3	N/A	N/A	-8.8%	19.0%
<b>Unweighted average*</b>			<b>17.3</b>	<b>15.6</b>	<b>4.9</b>	<b>4.3</b>	<b>25.8</b>	<b>34.7</b>	<b>11.7%</b>	<b>11.5%</b>
<i>Shearwater indexed to average</i>			<i>30.9</i>	<i>30.8</i>	<i>13.4</i>	<i>14.0</i>	<i>41.8</i>	<i>25.6</i>	<i>26.1</i>	<i>69.8</i>
<b>Median*</b>			<b>18.4</b>	<b>15.9</b>	<b>4.3</b>	<b>3.3</b>	<b>22.5</b>	<b>24.8</b>	<b>8.7%</b>	<b>9.0%</b>
<i>Shearwater indexed to median</i>			<i>29.0</i>	<i>30.1</i>	<i>15.2</i>	<i>18.0</i>	<i>48.0</i>	<i>35.8</i>	<i>34.9</i>	<i>89.0</i>

Source: Refinitiv EIKON, Progressive Equity Research, prices as at 24 Nov. 2021



It is worth noting that the number of analysts covering individual stocks varies considerably and that the number of forecast years may vary between analysts (typically meaning some fall-off in the number of FY3E estimates, which is why we do not include CY3 metrics). We have also included the specific year-on-year sales growth figures, as this more explicitly shows the relativity between higher- and lower-growth companies than simply relying on the EV/sales metric. It also gives some context to the overall level of ratings for individual stocks. We have also included the market capitalisation, expressed in sterling for ease of comparison, alongside the country where each stock has its primary listing.

As the table shows, we have included a wide range of companies by size, and we have included unweighted averages and the median for each metric for each year, which also include Shearwater.

**We have indexed Shearwater's valuation metrics to the average and median figures collated (where 100 would equate to the average/median). Given the return to growth that we are forecasting, Shearwater's sales growth indexes closer to the average and median for this group of companies in CY2 – although there is clearly quite a wide spread of growth rates across this selection. Otherwise, Shearwater's indexing against the valuation metrics shows it to be generally between 15 and 50 across the two calendar years at current share prices. We remind investors that they should use their own views of the relevant risks and rewards when assessing and applying any valuation criteria.**

## Risks and challenges

### Risks

Risk	Risk/impact	Management action/comments
<b>Cyber security attacks</b>	Any breach of the Group's networks or products may cause significant business disruption to the Group or its customers and result in the Group incurring the costs of remedying any breach. Reputational damage may be incurred.	The Group has established a secure network infrastructure which can identify and respond to any incident, and if required, recover any data or information. The Group's owned software products are subject to third-party testing and customers receive ongoing product updates.
<b>Intellectual property</b>	The Group owns a number of software assets that it has created and continuously developed over a number of years. These form the products that are sold within the Software division of our business. The Group continues to invest in the development of new product sets to complement existing products.	The Group maintains robust security around its internally developed technology and patents are filed where possible. Employment contracts provide some protection around the release of information relating to its know-how.
<b>Technology</b>	If the Company is unable to anticipate and respond to technological changes and customer preferences in a timely and cost-effective manner, it is possible that existing customers and prospective customers may turn to competitor offerings.	In addressing this risk, the Group has a number of industry experts across its Group companies, who are able to work together to continue to improve the Group's products and to develop and market new products that keep pace with technological change and the threats that the Group's customers face.
<b>Key contracts</b>	The Group relies on certain key customers for a material proportion of its revenue. If the Group was to lose one or more of its major customer contracts, the resultant loss of sales could adversely affect the Group's business.	The Group looks to build strong, long-term relations with its customers. At a minimum, the Group seeks to always deliver in line with customer expectations. The Group is actively looking to continue to grow and diversify its customer base.
<b>Recruitment and retention of key personnel</b>	The Group's success depends upon its ability to attract and recruit, retain and incentivise highly skilled employees across all areas of the business. Failure to do so could delay or prevent the implementation of its strategy.	The Group has a people strategy which encompasses, among other things, culture, training and development, capability and competence assessments, succession planning and reward and recognition structures, to help attract and appropriately incentivise key personnel.
<b>Regulation</b>	If the Group is unable to provide products or services to its customers which enable them to meet the changing regulatory or legislative requirements laid down by industry or government, then its current or prospective customers may turn to competitor offerings.	The Group's Data Protection Officer is responsible for ensuring the Group's continued compliance with the new data protection requirements. With the collective experience of the Board and the Group's Advisory Panel, the Group is well placed to monitor and process industry or legislative developments.
<b>Economic uncertainty and COVID19</b>	Economic uncertainty could result in the loss of customers and additional pressures on the Group's supply chain. COVID19 has brought with it additional challenges to the trading environment and businesses, which includes restrictions on movement, and our stakeholders are having to adapt to this accordingly.	Owing to the non-discretionary nature of many of the Group's products, the Group is in a robust position; however, over the past year the Group has retained close contact with its key stakeholders to strengthen relationships in the long term.
<b>Acquisition</b>	Failure to identify suitable potential acquisitions, or failing to properly integrate an acquisition, will impact our strategy for growth.	The Board actively monitors the market for opportunities and maintains a very active M&A pipeline. Once a potentially suitable target is identified it is vital that a thorough due diligence assessment is undertaken.

\*\*\*Source: Abridged company information

# Financial Summary: Shearwater Group

Year end: March (£m unless shown)

<b>PROFIT &amp; LOSS</b>	<b>2019</b>	<b>2020</b>	<b>2021</b>	<b>2022E</b>	<b>2023E</b>
Revenue	23.5	33.0	31.8	33.5	36.4
Adj EBITDA	(1.4)	3.4	3.7	4.1	4.6
Adj EBIT	(1.5)	3.1	3.4	3.8	4.3
Reported PBT	(6.7)	(1.3)	0.0	0.2	0.8
Fully Adj PBT	(1.6)	2.2	2.4	2.6	3.2
NOPAT	(1.5)	2.8	2.6	2.6	3.3
Reported Dil EPS (p)	(40.3)	(6.8)	0.6	0.7	3.2
Fully Adj Dil EPS (p)	(8.9)	7.6	9.7	11.5	14.1
Dividend per share (p)	0.0	0.0	0.0	0.0	0.0
<b>CASH FLOW &amp; BALANCE SHEET</b>	<b>2019</b>	<b>2020</b>	<b>2021</b>	<b>2022E</b>	<b>2023E</b>
Operating cash flow	(2.4)	5.6	6.6	0.5	3.2
Free Cash flow	(3.9)	3.8	5.7	(0.7)	1.8
FCF per share (p)	(28.0)	17.4	24.1	(3.0)	7.8
Acquisitions	(14.3)	0.0	0.0	0.0	0.0
Disposals	0.0	0.0	0.0	0.0	0.0
Shares issued	16.5	0.0	3.8	0.0	0.0
Net cash flow	(1.7)	2.4	8.8	(0.7)	1.8
Overdrafts / borrowings	(4.4)	(4.8)	(0.8)	(0.5)	0.0
Cash & equivalents	0.6	3.3	8.0	7.3	9.2
Net (Debt)/Cash	(3.8)	(1.4)	7.3	6.9	9.2
<b>NAV AND RETURNS</b>	<b>2019</b>	<b>2020</b>	<b>2021</b>	<b>2022E</b>	<b>2023E</b>
Net asset value	49.4	52.5	56.5	56.7	57.4
NAV/share (p)	350.0	275.8	237.2	238.0	241.2
Net Tangible Asset Value	0.2	0.7	0.4	0.3	0.2
NTAV/share (p)	1.8	3.6	1.7	1.2	0.8
Average equity	24.7	50.9	54.5	56.6	57.0
Post-tax ROE (%)	(6.6%)	4.4%	4.4%	4.5%	5.6%
<b>METRICS</b>	<b>2019</b>	<b>2020</b>	<b>2021</b>	<b>2022E</b>	<b>2023E</b>
Revenue growth		40.7%	(3.8%)	5.4%	8.8%
Adj EBITDA growth		(344.5%)	8.7%	11.4%	11.3%
Adj EBIT growth		(311.4%)	8.8%	13.1%	12.7%
Adj PBT growth		(235.5%)	8.5%	6.7%	23.9%
Adj EPS growth		(185.3%)	27.0%	19.5%	22.2%
Dividend growth		N/A	N/A	N/A	N/A
Adj EBIT margins		9.4%	10.6%	11.4%	11.8%
<b>VALUATION</b>	<b>2019</b>	<b>2020</b>	<b>2021</b>	<b>2022E</b>	<b>2023E</b>
EV/Sales (x)	1.0	0.7	0.8	0.7	0.7
EV/EBITDA (x)	-17.6	7.2	6.6	5.9	5.3
EV/NOPAT (x)	-16.8	8.9	9.4	9.4	7.4
PER (x)	N/A	16.0	12.6	10.5	8.6
Dividend yield	N/A	N/A	N/A	N/A	N/A
FCF yield	(23.0%)	14.3%	19.8%	(2.5%)	6.4%

Source: Company information and Progressive Equity Research estimates

## Disclaimers and Disclosures

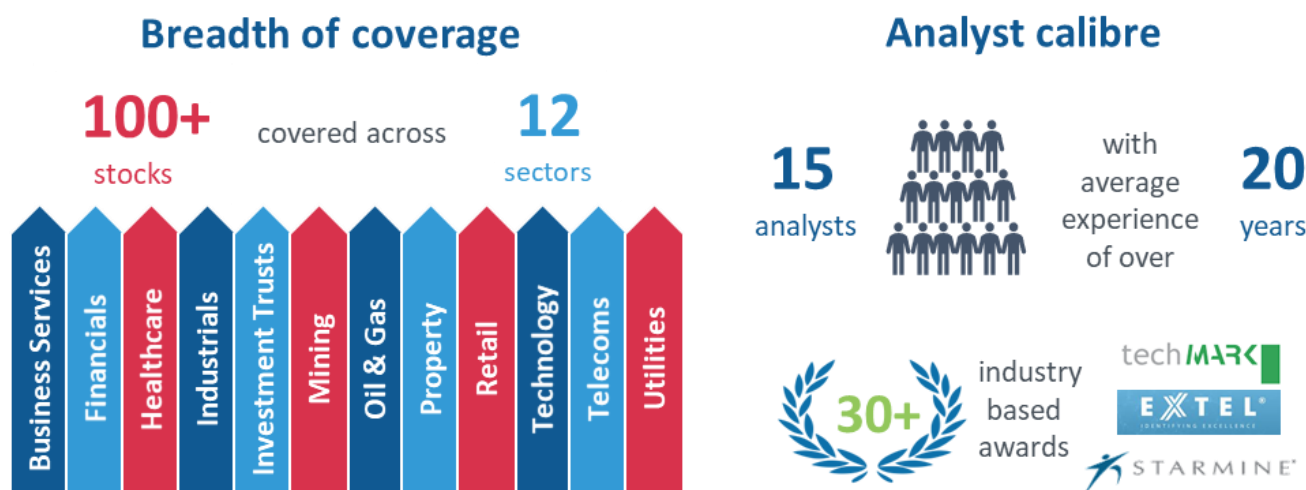
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