# How good is cash!

Reckon has announced that it has agreed to sell its Accountants Practice Management Group for $100m to private UK based company The Access Group. This segment represented around one third of the Group's FY21 revenue and earnings with the sale price representing an 8.4x FY21 EBITDA multiple which compares to the company's FY21 multiple of 4.2x. Most of the after-tax proceeds from the sale are expected to be returned to shareholders by way of an estimated A$0.59 dividend (70% franked) which we expect will be paid this year. We think that there is little risk around ACCC and FIRB approvals required before completion in around three months. Our valuation increases from A$1.27 per share to A$1.62 per share.

## The new Reckon

Reckon's two remaining segments are the Business Group and the US based Legal Group, which combined accounted for 68% of revenue and 64% of EBITDA in FY21. As detailed in our Initiation Report, the Business Group's cloud-based product Reckon One now has the same capability as the Xero, MYOB and Intuit products, and our analysis shows that Reckon has been able to hold a consistent share of cloud-based users over the last 5 years. This is not a "winner takes all" industry as demonstrated in the US and UK markets and Reckon has a sustainable position in this market. The Legal Group also remains a significant blue-sky opportunity, with an entrepreneurial management team that have had significant success in the sector. They have a 5x revenue target by 2027 which if achieved could make this segment worth A$100m.

## ACCC - no issue this time

In 2017, MYOB offered to buy the Accountants Practice Management Group for $180m (note this included Reckon Docs which was sold for $13m last year). The deal was effectively squashed by the ACCC after it released its preliminary view that the acquisition '*may substantially lessen competition in the supply of practice management software to medium-to-large accounting firms*'. We do not expect objections from the ACCC to this deal. While The Access Group already has significant business in Australia and NZ (with 17,000 customers in mostly training and payroll products), it does not appear to have meaningful exposure to the larger accounting firms.

## Valuation

Reckon's balance sheet is expected to have less than $10m of net debt after using $10m of the proceeds from the sale to reduce debt, giving the Group significant flexibility to support its growth. We have maintained the same valuation approach (market PE multiple) as we used in our initiation report (13 April 2022). In our FY22e forecasts, we have treated the Accountants Group as discontinued and assumed $10m debt repayment occurred at the start of this year. We have assumed 75% of the value of the franking credits to determine the A$0.72 per share value of the special dividend. Our valuation increases to A$1.62 (previously A$1.27).

Following the sale of its Accounting Practice Management business, Reckon Limited (ASX: RKN) will become a business accounting (Australia and NZ) and legal practice management software business (US and UK). It has successfully developed cloud-based versions of its products which it now provides across each of its customer segments. Its Business Group revenue growth is also expected to come from white labelled products and payments strategies such as the one with Novatti.

https://www.reckon.com/au/

| | |
|---|---|
| **Stock** | RKN.ASX |
| **Price** | A$1.27 |
| **Market cap** | A$144m |
| **Valuation** | A$1.62 |

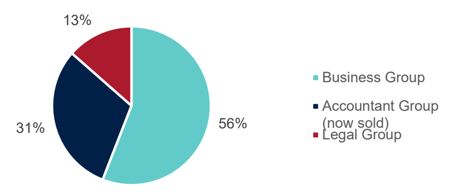
**Next News**

1H 2022 – launch of 3 new cloud-based products
3 months – completion of sale
2H 2022 – payment of special dividend
Aug-22 – 1H FY22 result

**RKN Share Price (A$)**


Source: FactSet

**FY21 Revenue by Segment**




Source: Company

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## Figure 1: Financial summary

**Reckon Limited (RKN-AU)**

| Year End 31 Dec | | FY20 | FY21 | FY22E | FY23E | FY24E |
|---|---|---|---|---|---|---|
| Core PE | x | 20.1x | 18.0x | 13.3x | 12.0x | 10.8x |
| EV/EBIT | x | 19.9x | 16.8x | 11.7x | 10.0x | 8.2x |
| **EV/EBITDA** | **x** | **6.8x** | **5.9x** | **4.7x** | **4.4x** | **3.9x** |
| Div yield | % | 7.1% | 7.1% | 6.0% | 5.0% | 5.6% |
| FCF Yield | % | 4.1% | 5.8% | 7.0% | 8.3% | 9.9% |

**This table is based on post payment of special dividend**

| Stock information | |
|---|---|
| Share Price ($) | $1.27 |
| Market capitalisation (Basic SOI) ($m) | 144 |
| **Valuation ($)** | **$1.62** |
| Shares on issue (Basic) (m) | 113.3 |
| Shares on issue (diluted) (m) | 116.5 |

| Profit & Loss Statement | A$m | FY20 | FY21 | FY22E | FY23E | FY24E | 1H19 | 2H19 | 1H20 | 2H20 | 1H21 | 2H21 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Revenue** | | **49.0** | **49.5** | **52.4** | **54.9** | **57.8** | **26.2** | **21.7** | **26.2** | **22.8** | **26.2** | **23.3** |
| Change pcp | % | | 1.0% | 5.8% | 4.8% | 5.3% | | | 0.0% | 5.0% | -0.1% | 2.3% |
| **Underlying EBITDA** | | **17.7** | **17.6** | **19.6** | **21.4** | **23.6** | **9.7** | **6.8** | **9.7** | **8.1** | **10.0** | **7.6** |
| EBITDA growth | % | | -0.9% | 11.5% | 9.4% | 10.1% | | | 0.0% | 19.5% | 3.5% | -6.2% |
| EBITDA margin | % | 36.2% | 35.5% | 37.4% | 39.1% | 40.9% | 36.9% | 31.1% | 36.9% | 35.4% | 38.2% | 32.5% |
| Depreciation & Amortisation | | -11.7 | -11.4 | -11.7 | -11.9 | -12.2 | -6.0 | -6.3 | -5.2 | -6.5 | -5.5 | -5.9 |
| **EBIT** | | **6.1** | **6.2** | **7.9** | **9.5** | **11.4** | **3.7** | **0.4** | **4.5** | **1.6** | **4.5** | **1.7** |
| Net interest expense* | | -0.6 | -0.4 | -0.6 | -0.6 | -0.6 | 14.1% | 1.9% | 17.1% | 7.0% | 17.3% | 7.1% |
| **Profit Before Tax*** | | **5.4** | **5.8** | **7.3** | **8.9** | **10.8** | | | | | | |
| Tax and adjustments* | | -1.3 | -1.8 | -1.7 | -2.2 | -2.7 | | | | | | |
| Minorities | | 0.0 | 0.6 | 0.6 | 0.2 | -0.4 | | | | | | |
| **NPAT (underlying)*** | | **4.1** | **4.6** | **6.2** | **6.9** | **7.6** | | | | | | |
| Discontinued and significant items | | 5.6 | 5.2 | 2.1 | 0.0 | 0.0 | | | | | | |
| **NPAT (owners)** | | **9.7** | **9.8** | **8.3** | **6.9** | **7.6** | | | | | | |

* Accountant Group treated as discontinued

| Performance ratios | FY21 | FY22E | FY23E | FY24E |
|---|---|---|---|---|
| ROE (%) | 38.7% | 26.1% | 55.3% | 55.8% |
| ROIC (%) | 8.2% | 12.0% | 34.0% | 38.1% |
| ND/(ND + Equity) | 0.4x | 0.4x | 0.4x | 0.3x |
| ND/EBITDA | 1.1x | 0.4x | 0.5x | 0.4x |

| Per Share Data | | FY20 | FY21 | FY22E | FY23E | FY24E |
|---|---|---|---|---|---|---|
| Ave. diluted shares outstanding | m | 116 | 116 | 116 | 116 | 116 |
| **Underlying EPS** | **cps** | **3.5** | **3.9** | **5.3** | **5.9** | **6.6** |
| growth pcp | % | | 11.5% | 35.0% | 11.4% | 10.9% |
| Reported EPS (owners) | cps | 8.4 | 8.4 | 7.1 | 5.9 | 6.6 |
| growth pcp | % | | 0.4% | -15.6% | -16.8% | 10.9% |
| DPS (declared) | cps | 5.0 | 5.0 | 4.3 | 3.6 | 3.9 |
| Payout (on underlying) | % | 142% | 127% | 80% | 60% | 60% |

| Segments | FY21 | FY22E | FY23E | FY24E |
|---|---|---|---|---|
| **Revenue** | | | | |
| Business Group | 39.9 | 41.3 | 42.2 | 43.1 |
| Accountant Group | now treated as discontinued | | | |
| Legal Group | 9.6 | 11.1 | 12.7 | 14.7 |
| **Total Group** | **49.5** | **52.4** | **54.9** | **57.8** |
| **EBITDA** | | | | |
| Business Group | 20.4 | 21.2 | 21.8 | 22.4 |
| Accountant Group | now treated as discontinued | | | |
| Legal Group | 0.5 | 1.8 | 3.2 | 4.9 |
| Central Admin Costs | -3.3 | -3.4 | -3.6 | -3.8 |
| **Total Group** | **17.6** | **19.6** | **21.4** | **23.6** |
| **Margin** | | | | |
| Business Group | 51.1% | 51.4% | 51.7% | 52.0% |
| Accountant Group | now treated as discontinued | | | |
| Legal Group | 5.3% | 15.9% | 25.3% | 33.7% |
| **Total Group** | **35.5%** | **37.4%** | **39.1%** | **40.9%** |

| Balance sheet | A$m | FY20 | FY21 | FY22E | FY23E | FY24E |
|---|---|---|---|---|---|---|
| Cash & Deposits | | 1 | 1 | 2 | 1 | 0 |
| Receivables | | 4 | 3 | 3 | 3 | 3 |
| Inventory | | 1 | 1 | 1 | 1 | 1 |
| PP&E | | 2 | 2 | 2 | 2 | 2 |
| Intangibles | | 66 | 58 | 29 | 32 | 34 |
| Other Assets | | 9 | 7 | 5 | 5 | 5 |
| **Total Assets** | | **83** | **72** | **43** | **44** | **46** |
| Payables | | 4 | 4 | 5 | 5 | 5 |
| Borrowings (incl. Lease Liab) | | 38 | 21 | 11 | 11 | 9 |
| Provisions / other | | 15 | 14 | 14 | 14 | 14 |
| **Total Liabilities** | | **58** | **40** | **30** | **30** | **29** |
| **Shareholders' Funds** | | **25** | **32** | **12** | **14** | **17** |
| **Net Cash (AASB 16)** | | **-37** | **-20** | **-9** | **-10** | **-9** |

**Share price and volume**


| Cashflow statement | A$m | FY20 | FY21 | FY22E | FY23E | FY24E |
|---|---|---|---|---|---|---|
| EBITDA | | 17.7 | 17.6 | 19.6 | 21.4 | 23.6 |
| Net interest | | -0.9 | -0.5 | -0.6 | -0.6 | -0.6 |
| Tax paid | | -2.5 | -1.1 | -2.2 | -2.7 | -3.2 |
| Working capital movements | | 18.1 | 15.2 | 0.1 | 0.1 | 0.1 |
| Capitalised Development + Other | | -19.5 | -20.3 | -10.5 | -13.8 | -13.1 |
| **Operating CF** | | **12.9** | **10.8** | **6.3** | **4.4** | **6.8** |
| Capital expenditure | | -0.5 | -0.7 | -1.1 | -1.1 | -1.1 |
| Asset and business sales (net of cash) | | 0.0 | 12.9 | 80.0 | 0.0 | 0.0 |
| Purchase of investments | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Other | | 1.1 | 0.7 | 0.0 | 0.0 | 0.0 |
| **Investing CF** | | **0.6** | **12.9** | **78.9** | **-1.1** | **-1.1** |
| Net borrow + princ. lease payments | | -7.8 | -17.8 | -8.5 | 0.0 | -2.0 |
| Dividends paid | | -5.7 | -5.7 | -75.8 | -5.0 | -4.1 |
| Dividends to non-controlling interests | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| New share issues | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **Financing CF** | | **-13.5** | **-23.5** | **-84.3** | **-5.0** | **-6.1** |
| Effect of FX Rate Changes on Cash | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **Net change in cash** | | **0.0** | **0.3** | **0.9** | **-1.7** | **-0.5** |

**Company description**

Following the sale of its Accounting Practice Management business, Reckon Limited (ASX: RKN) will become a business accounting (Australia and NZ) and legal practice management software business (US and UK). It has successfully developed cloud-based versions of its products which it now provides across each of its customer segments. Its Business Group revenue growth is also expected to come from white labelled products and payments strategies such as the one with Novatti.

Source: Company, MST Access

## Investment View

We believe both earnings quality (or certainty) and earnings growth is better than market, meaning that we think this stock should trade on at least a market multiple (after applying a discount for the size of the Company). We use a PE multiple to value the business but note that other FY22e metrics are attractive: EV / EBITDA of 4.7x, fully franked dividend yield of 6%, and a free cash flow yield of 7%.

We also expect that from a broader market perspective, it is likely that companies such as Reckon with strong earnings and cash flow are likely to become relatively more attractive to investors. In relation to its competition, the market's focus on delivering cash and earnings rather than simply revenue may put pressure on the advertising spend of high growth / low profit competitors.

Reckon was late to the cloud-based software party, mostly due to the nature of its Intuit licence. In the Business software segment, which competes with Xero - Reckon now has a full cloud-based product with similar functionality and usability (as determined by independent surveys) and has been holding market share in cloud users for the last five years. We do not think that this is a 'winner-takes-all' market and that there is room for multiple competitors; the US and UK business accounting software markets show a much higher level of fragmentation than ANZ. In addition, Reckon is pursuing revenue growth in niche applications that leverage market position: white labelled versions of its software, and payments based solutions such as that most recently announced with Novatti.

Reckon's US based Legal Group, nQ Zebraworks, resulted from a merger with Zebraworks in 2020. The management team that came with Zebraworks has a highly successful track record of developing software for legal firms, having developed and sold products to both Thomson Reuters and Bloomberg which have become the core software solutions that these companies provide to the legal industry. In addition, the team comes with expertise in cloud-based product development while also being able to leverage the work done elsewhere in the Reckon Group. The terms of the merger set an ambitious 5x revenue target to be achieved by 2027 for the division (c.$50m), highlighting the potential upside of the business. We think that that should this target be achieved, Reckon's share of this business could be worth A$100m.

We chose a PE multiple to value the company. Our preferred metric across our coverage universe is EV / EBITDA multiples, but the high level of capitalised development costs and resulting amortisation makes an EV / EBITDA based valuation less useful.

### Transaction Details

The book value (net assets) of The Accountants Group at 31 Dec 2021 was $30.5m. We have assumed that there is $20m of tax payable on this transaction (which implies a 30% tax rate) but depending on tax losses in the Group, this could be lower. The payment of $20m of tax would generate franking credits of $46.7m – ie dividends of $46.7m could be fully franked. If Reckon reduces debt by $10m (it has only said that it expects to reduce debt without specifying an amount), there is $70 payable as a special dividend which would be franked to 70%.

On a per share basis, this represents a dividend A$0.59 per share with a further A$0.18 per share value in the franking credits for shareholders that can fully utilise the tax benefits. From a valuation perspective, we apply a 75% discount to the full value of franking credits to give a value to the dividend of A$0.72 per share.

Figure 2: Transaction summary

| Sale of Accountants Group | Units | | Notes |
|---|---|---|---|
| Date announced | | 19/05/2022 | |
| Completion / Settlement | | 31/08/2022 | est |
| Sale price | A$m | 100.0 | |
| Costs | A$m | -3.0 | est |
| Net sale price | A$m | 97.0 | |
| Book Value | A$m | 30.5 | FY21 AR |
| | | | |
| Profit on sale | A$m | 66.5 | |
| Tax | A$m | 20.0 | est |
| Implied tax rate | | 30% | |
| Franking credits generated | A$m | 46.7 | |
| Repayment of debt | A$m | 10.0 | est |
| **Special dividend** | A$m | **67.0** | |
| **% of Dividend franked** | | **70%** | |
| Value of these franking credits @ 75% | A$m | 15.0 | |
| SOI | #m | 113.3 | basic SOI |
| **Dividends / share** | **A$** | **0.59** | |
| DPS including value of 75% of franking | A$ | 0.72 | |

Source: Company, MST Access

We assume that the dividend is paid before the end of the year and therefore falls in FY22. To achieve this, we assume that Reckon is able to pre-pay and thereby generate the franking credits to allow the dividend to be franked.

## Valuation

Our valuation methodology remains unchanged from our initiation report (13th April 2022). We have applied our new estimate of underlying FY22e earnings (where the Accountants Group is treated as discontinued) and used the same market multiple approach to estimate Group value: this will include only the earnings from the Business Group and the Legal Group, and the value of the special dividend (A$0.72 which includes 75% of the value of the franking credits).

Figure 3: Valuation – including comparison with previous valuation (Initiation report)

| | | Initiation report | Current |
|---|---|---|---|
| FY22e NPAT | A$m | 8.8 | 6.2 |
| Diluted SOI | #m | 116.5 | 116.5 |
| EPS | A$ | 0.076 | 0.053 |
| PE multiple (market multiple) | x | 16.8 | 16.8 |
| Valuation | A$ | 1.27 | 0.89 |
| Special dividend | A$ | 0 | 0.72 |
| **Valuation** | **A$** | **1.27** | **1.62** |

Source: Company, MST Access

The Legal Group now represents a much greater proportion of Group revenue than previously, but a simple earnings-based valuation implies only limited value for this segment given its limited contribution to Group earnings. While there are some strong growth targets for this business – 5x revenue growth by 2027 – the products have only recently been released. Once we have further visibility of the growth and performance of this segment, a sum-of-the-parts valuation may be more appropriate to capture this value.

## Risks

- A key risk for the Business Group is that larger competitors compete more aggressively through marketing spend or price, which could cause Reckon's traction to wane/share to decline, negatively impacting revenue/earnings as well as Reckon's potential to fight back. Currently Xero holds a significant amount of power given its c.60% share and dominant position. However, as outlined Xero's current geography of focus is North America, and we therefore expect that the company will rely on stable earnings within ANZ to fund aggressive growth in North America and as such will not compete as aggressively with Reckon.
- The other risk is that given Reckon initially lagged the market in developing a cloud-based solution is that the company will never be able to 'close the gap' to its competitors that are enjoying early-mover advantages. This is a significant risk given the size of the development spend that the global worldwide players are willing to continue to invest in their technology to sustain their competitive advantage. In YEM21 Xero's total R&D expense was NZ$250m (c.A$239m) which completely dwarfs Reckon's development investment of A$19m in FY20 and A$20m in FY21. Again, Xero's product development road map is highly focussed on execution in North America, but one of their strategic priorities is to build for global scale innovation which incorporates investments in AI/machine learning, as well as their platforms, people, and operations. It is for this reason that Reckon has focussed its operations on niche opportunities such as white labelling and tailored solutions. Reckon has committed to continue R&D investment of a similar magnitude and continues to attract talent given the desirability of working on Cloud technology.
- In June 2021, Novatti purchased a 20% strategic stake in Reckon. To date, Novatti remains loss making and focussed on revenue growth. Should the access to new capital be substantially reduced, and Novatti need to raise additional capital to continue to drive revenue growth, Novatti may consider disposing of its stake in Reckon to generate cash flow. Should this happen, it may lead to short term share price weakness. This transaction is expected to result in a dividend of $14m with the franking credits unlikely to be of value to Novatti shareholders.

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