Chronux Research
The crux of the matter

South Africa
Sponsored Research

EOH – Good to Go

Date: 10 December 2021

- After three years of rightsizing and focussing the business, EOH has returned to profitability with an EBITDA from recurring operations of R471m in FY21. The group is significantly leaner following the exit of many businesses - its revenue of R6.9bn from recurring operations approximates what the group achieved in FY14. The net debt has reduced from R4bn to R1.9bn. The last of its planned asset sales should conclude in FY22E helping to further reduce its net debt to circa R800m and creating an operational structure off which to grow.
- Tough decisions have been taken along the way as debt reduction has dictated the sale of promising profitable businesses. This together with the finalisation of loss-making legacy contracts and the implementation of appropriate risk and financial management frameworks, has distracted management significantly over the past three years. A re-focus of this time should yield considerable benefits going forward.
- 84% of revenue is earned from services with the balance coming from traditional hardware and software sales. iOCO is the dominant operation and contributes 72% to recurring revenue and 100% of recurring EBITDA, distorted by the fact that NEXTEC has undergone the bulk of the restructuring. International operations have also been rationalised and are currently 8% of revenue – the UK and Egypt operations provide a springboard into Europe and the Middle East.
- COVID-19 has meaningfully impacted operations, with reduced corporate IT spend, hardware supply constraints, and a setback in economic growth. Digitisation of data and processes, cloud computing, data analytics and app development represent strong growth opportunities as COVID-19 has exposed corporate IT shortcomings in a digital operating environment.
- Debt has been restructured with a bridge facility of R1.5bn requiring settlement by October 2022. We estimate that asset realisations and operational cash flow will be insufficient to achieve this and further support from banks is needed and/or access to the capital markets is required. Excessive interest costs are hampering growth opportunities and further business sales will negatively impact the scale of the group. Therefore, accessing the capital markets (circa R400m) seems preferable with the possibility of a B-BBEE transaction playing a part.
- We anticipate a sharp recovery in profitability in FY22E and FY23E as EBITDA margins expand, the tax charge normalises, and the interest expense declines. We forecast HEPS of 67c and 142c in FY22E and FY23E. We value the stock on a DFCF basis and achieve a fair value range of R8.70-R11.42/share. We envisage the company approaching the capital markets which could impact the stocks rerating until clarity is obtained. Missing debt redemption targets is a key risk to our estimates.

ZARmn (to July)	FY21A	FY22E	FY23E	FY24E
Revenue	6,874	7,054	7,506	8,009
EBITDA	471	535	638	703
Headline earnings	-280	113	240	288
HEPS (ZAc)	-22	67	142	170
PE Ratio	-29.1	9.4	4.4	3.7
Dividend (ZAc)	0.0	0.0	0.0	0.0

Source: Company data, Chronux Research estimates

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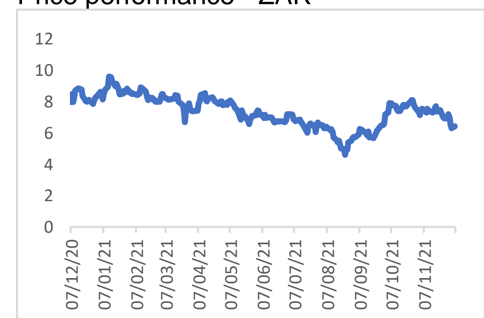
Price (10/12/2021):	R6.30
Market cap	R1063mn
Shares in issue	169mn

Sponsored Research: Chronux Research is compensated by certain corporates to produce objective and impartial research. A Recommendation is not provided. Earnings forecasts and a valuation are the independent view of the analyst, based on their view of all factors that could influence earnings and peer comparisons.

Price performance - ZAR



Refer to the last page of this document for important disclaimers

Figure 1 Financial summary

Year Ending	FY2020 A	FY2021 A	FY2022 F	FY2023 F	FY2024 F
Income Statement					
Sales	8,772	6,874	7,054	7,506	8,009
Sales growth (%)	*na*	*-21.6%*	*2.6%*	*6.4%*	*6.7%*
EBITDA	-125	471	535	638	703
EBITDA Margin (%)	*-1.4%*	*6.9%*	*7.6%*	*8.5%*	*8.8%*
EBIT	-936	36	328	426	478
EBIT Margin (%)	*-10.7%*	*0.5%*	*4.7%*	*5.7%*	*6.0%*
Profit before tax	-1,322	-229	118	333	394
Net profit	-1,693	-280	113	240	288
Net profit post minorities	-1,693	-280	113	240	288
Headline earnings	-906	-37	113	240	288
Recurring headline earnings	-851	-184	113	240	288
% Change		>100%	>100%	112%	20%
Diluted EPS (ZAc)	-1,004	-166	67	142	170
Headline EPS (ZAc)	-538	-22	67	142	170
% Change	N/A	N/A	>100%	112%	20%
Comparable HEPS (ZAc)	-505	-109	46	142	170
DPS (ZAR)	0.00	0.00	0.00	0.00	0.00
Payout ratio (%)	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*
Balance Sheet					
Cash and Cash equivalents	646	825	808	749	617
Current asset (ex – cash)	2,489	2,192	2,266	2,409	2,567
Net Fixed assets	545	342	325	312	299
Intangible assets	1,030	810	729	656	591
Investments	123	16	8	8	8
Other assets	2,353	1,235	24	50	59
Total assets	**7,185**	**5,420**	**4,160**	**4,185**	**4,141**
Debt	2,748	2,568	1,448	1,098	598
Current liabilities	2,775	2,249	2,187	2,180	2,215
Other liabilities	1,189	426	102	123	129
Total liabilities	**6,712**	**5,243**	**3,737**	**3,401**	**2,942**
Shareholders' equity	473	178	423	784	1,199
Minorities					
Total shareholders' equity	**473**	**178**	**423**	**784**	**1,199**
BVPS (ZAc)	*281*	*105*	*251*	*465*	*711*
ROE (%)	*N/A*	*-85.9%*	*37.6%*	*39.7%*	*29.0%*

Cash Flow

Reported net profit	**-1,693**	**-280**	**113**	**240**	**288**
Change in net working capital	33	-278	-183	-129	-117
Interest paid	-380	-229	-213	-93	-84
Other adjustments	2,196	868	389	310	314
Cash flow from operations	**156**	**81**	**107**	**327**	**400**
Net Capex	-48	5	-87	-93	-99
Capex/sales (%)	*0.5%*	*-0.1%*	*1.2%*	*1.2%*	*1.2%*
Other investing cash flows	-118	209	1,015	47	57
Cash flow from investing	**-165**	**215**	**928**	**-46**	**-42**
Dividends paid	-4	-1	0	0	0
Equity raised/ (bought back)	0	0	0	0	0
Net inc/(dec) in borrowings	-491	-665	-1,110	-340	-490
Other financing cash flows	0	52	9	0	0
Cash flow from financing	**-495**	**-613**	**-1,101**	**-340**	**-490**
Net cash flow	**-505**	**-318**	**-67**	**-59**	**-132**
Free cash flow	**-79**	**101**	**225**	**323**	**380**

Valuation Summary

Valuation Metrics					
Share Price (ZAc)	486	630	630	630	630
P/E (Underlying) (x)	-0.9	-28.6	9.4	4.4	3.7
P/BV (x)	1.7	6.0	2.5	1.4	0.9
EV/Sales (x)	0.3	0.4	0.4	0.4	0.4
EV/EBITDA (x)	-23.6	6.2	5.5	4.6	4.2
EV/EBIT (x)	-3.1	81.0	9.0	6.9	6.2
FCF Yield (%)	-7.5	9.5	21.1	30.4	35.8
Dividend Yield (%)	0.0	0.0	0.0	0.0	0.0
Net debt	2,377	1,906	800	518	160
Net debt/EBITDA	-19.1	4.0	1.5	0.8	0.2

Source: Company data, Chronux Research estimates

For those readers that are less familiar with EOH's turnaround since 2018 when the new CEO, Stephen van Coller was appointed and implemented radical change, we refer you to our detailed company visit note published on 3 August 2021 (EOH-Company-Visit-Note-Aug-21.pdf (chronux.co.za). That note provides an overview of what went wrong, the turnaround strategy and how the business has been right sized. It also provides a detailed overview of the operating divisions and the management team.

Company Overview

EOH has had a very dynamic organogram over the past 3 years as the business has been right sized with numerous disposals and closures of businesses. Its net debt pile of R4bn in 2018 has forced management to dispose of working capital-intensive companies (mainly in NEXTEC) and internally developed IP companies that required ongoing investment to grow (CCS and Sybrin for example). In total 81 companies have been exited, a loss of R1.4bn in revenue.

Figure 2 EOH – Group structure

Source: Company data, Chronux Research

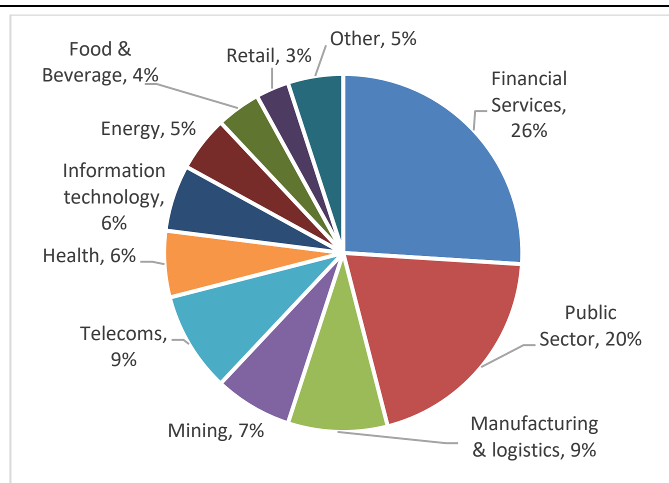
The group structure in Figure 2 is the structure off which the group will operate going forward. For reporting purposes there is an IP segment, but its assets are all in the process of being sold and therefore this segment will soon fail to exist. We don't focus on the IP segment in this report – its largely treated as a discontinued operation in the FY21 financials and we don't model for it in FY22E. IP businesses not earmarked for disposal are included in iOCO – titled the Rocketlab Ventures.

The company is finally in a state in which managements time and effort can be spent on growing the business instead of resolving legacy issues. iOCO has fared better through the turnround whilst NEXTEC is coming off a low base following significant restructuring. The issue with SITA (State Information Technology Agency) has been resolved and this paves the way for a constructive relationship with the public sector going forward.

The creation of the Go to Market (GTM) approach ensures a holistic view of its offerings is made to clients, a strategy that previously didn't exist as divisions were competing with each other. It ensures an end-to-end solution while co-ordinating the delivery of the offering. We believe this could be a significant development and will ensure greater cross sell across the group. Increasing its cross sell is valuable in a low growth environment as is currently being experienced in SA.

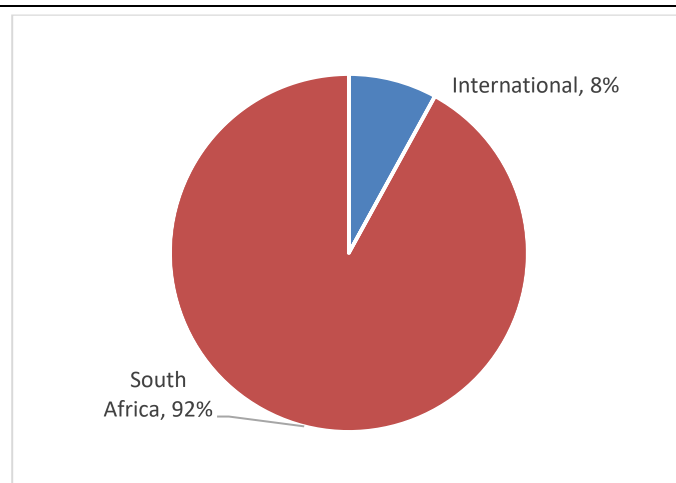
Digitisation, cloud computing and App development are services which should see double digit revenue growth in the medium term given the strong demand from corporates to become more IT efficient and to utilise their data to enhance revenue. EOH is well positioned with expertise across Africa, Middle East and Europe. Traditional hardware and software sales will provide an underpin to revenue, but growth rates remain less robust. We don't see this as a headwind to growth as services account for 84% of revenue in FY21.

Figure 3 FY21 Revenue by industry



Source: Company data, Chronux Research

Figure 4 FY21 Revenue by geography



Source: Company data, Chronux Research

EOH has a very diverse and significant client base (approximately 5 000 clients) with its two biggest sectors being financial services (26%) and the public sector (20%). SA dominates with 92% of revenue but this is envisaged to decline going forward with a drive to grow the international operations that have now been rightsized.

Whilst operational and reputational risk has largely normalized (there remains some litigation matters and a tax dispute), financial risk remains elevated given the large debt pile and the setback COVID-19 has presented with the realization of assets. Funders have continued to provide support and a further debt package has been agreed, providing comfort until October 2022. However, its unlikely to see the debt obligation being entirely met with asset disposals and internal cash generation. There is a strong possibility of a capital market event in the next 12 months - we elaborate further on page 18.

iOCO

Figure 5 iOCO divisional breakdown

iOCO

iOCO Advisory

Product Agnostic
Solutioning

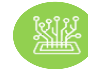
iOCO Technology

Software reseller
Enterprise Applications
Hardware Reseller

iOCO Digital

App Dev
Data Analysis
Cloud & Security
International
Automation

iOCO Services

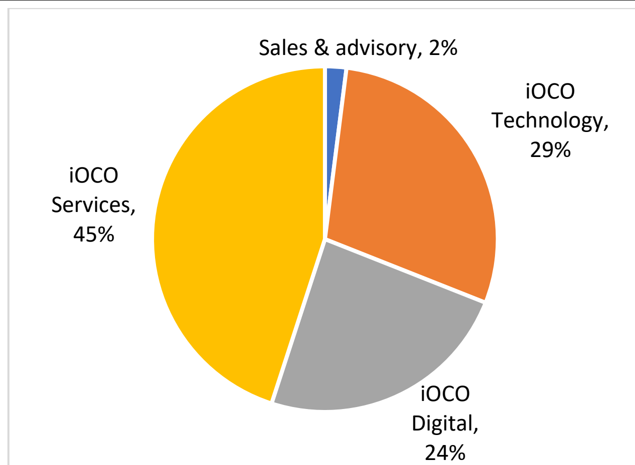


Network Solutions
Manage & Operate
Digital Industries
Knowledge Process Outsourcing

Source: Company data, Chronux Research

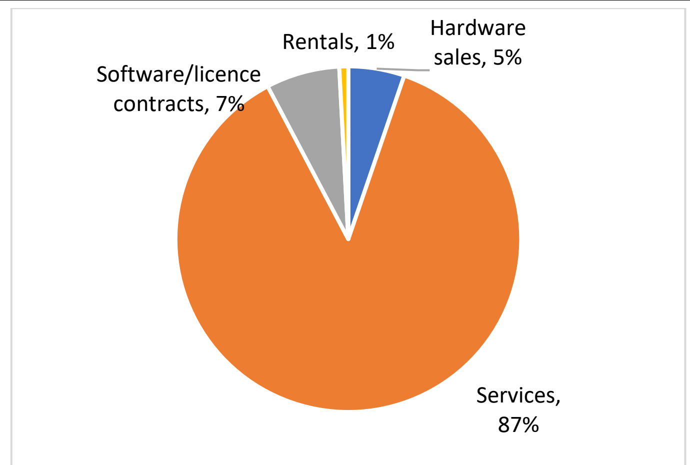
This is the core ICT (Information and Communications Technology) business which attracts the largest client base (circa 3 000 clients) within the group and the so-called core of EOH. It's structured around four pillars of activities – Sales & Advisory; Technology; Services and Digital. Together they cover almost the entire ICT value chain and are therefore capable of providing a holistic client solution from a single organisation.

Figure 6 Disclosed iOCO revenue contributions



Source: Company data, Chronux Research

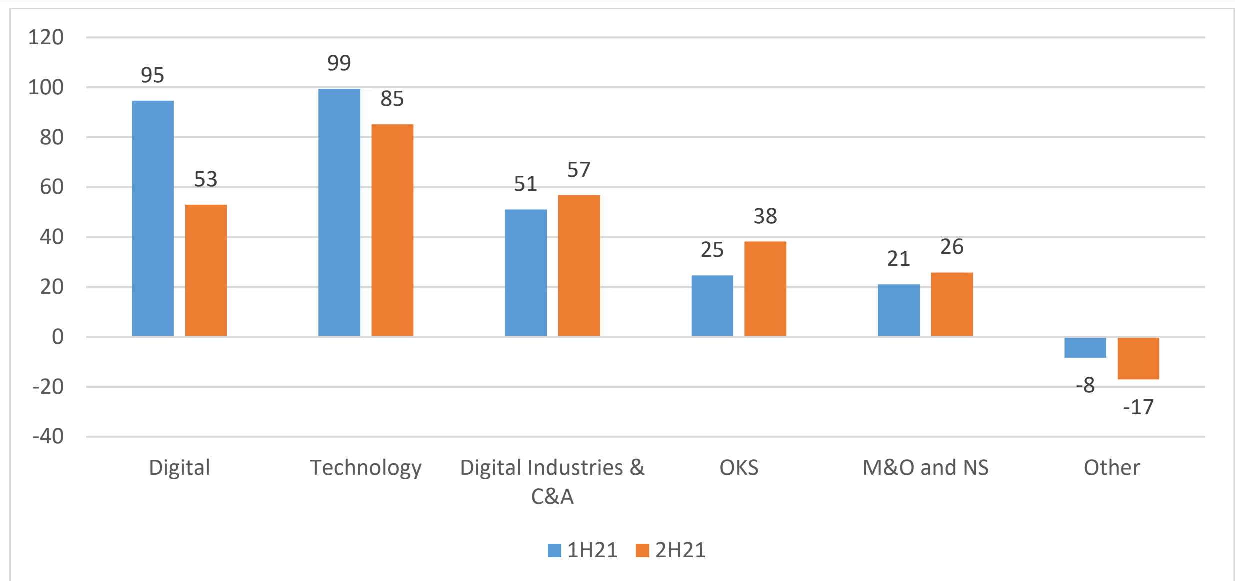
Figure 7 Disclosed iOCO sources of revenue



Source: Company data, Chronux Research

Note: Fig 6 as disclosed in the FY21 results presentation. This differs to our analysis in which we focus, where possible, on recurring operations excluding intersegment revenue.

Figure 8 iOCO FY21 EBITDA R'm – pre discontinued operations and intersegment eliminations



Source: Company data, Chronux Research

Note: Clear divisional EBITDA and revenue disclosure for the four pillars isn't provided. Digital and Technology are provided separately. Digital Industries and C&A, OKS, M&O and NS will comprise Services whilst Sales and Advisory is included in Digital Industries and C&A. Other relates to terminated public sector contracts and would form part of Technology.

Sales & Advisory

It overlaps the three other pillars. Advisors are appointed by corporates to identify IT solutions for their business problems. A fee is agreed for the service and recommendations are provided. The client is not obliged to make use of EOH for the solution but in most cases it does. Advisory works closely with GTM and would normally follow them into the client.

iOCO Technology

This could be considered the retail arm of the group and centres around the following:

- Software reseller - This is the franchise part of the business where iOCO represents its key OEM brands in its market.
- Hardware reseller – sales and maintenance of traditional hardware from OEMs, including Dell, HP and Huawei. This business has been negatively impacted by COVID-19 with sales falling an estimated 50% from FY20 to FY21.
- Enterprise Applications - This entails the sale and implementation of an appropriate Enterprise Resource Planning system to run all phases of a corporates operations.

This is a stable and sticky revenue stream for EOH as some of its key OEM software implementation brands are typically sold to clients on 3-year contracts. GP margins of 30% and EBITDA margins of 12% was disclosed in FY21 (per the results presentation). Revenue growth was impacted by a decline in hardware sales due to supply shortages caused by global supply chain issues and lower corporate spend. Margins are strong in the OEM space. Hardware sales attracts lower margins and its poorer performance for the year had a favourable impact on iOCO's margins. 2H21 saw a drop in revenue and EBITDA to R650m (R784m) and R85m (R99m) from 1H21. We anticipate a recovery in sales as corporate spend comes back in line with GDP expansion and hardware supply issues normalise. Management is guiding towards 3% industry growth in hardware and 5% in software sales. On our estimates we have 6% revenue growth in FY22E given the base effect and % growth in EBITDA, broadly in line with the annualised 1H21 result.

iOCO Services

This division facilitates communication across the client's IT platform (Wi-Fi, networking etc) and ensures the day to day managing of the system. There are four separate business units which are currently being consolidated as the "Engine room" or "manage your IT infrastructure" offering. Knowledge Process Outsourcing will not be consolidated. The creation of a single support structure will remove significant duplication and create cost efficiencies.

- Network solutions (NS) - this is a competitive space and hence margins are tight. The offering includes Wi-Fi as a service; firewalls; perimeter security and voice mobility enablement in the enterprise space.
- Manage & Operate (M&O) - managing a client's end to end IT ecosystem, helping clients cut IT costs and migrating clients to the Cloud are examples of services offered in this division. It ensures the effective day to day running of a client's IT system and is therefore a stable and consistent revenue source. It is the dominant component of the iOCO Services suite and is a large player in service desk, modern workspace and managed print services. It offers hybrid cloud services and is hardware agnostic.
- Digital Industries - this is about iOCO being a successful Operational Technology (OT) supplier and service provider. OT is the use of hardware and software to monitor and control physical processes, devices and infrastructure. It assists clients with the digital transformation journey in critical OT environments. This could include the automation of an operational process, for example a factory line and enable the client remotely. The group is highly active in the mining and industrial sectors. This cluster has seen significant growth recently and it achieves the highest GP and EBITDA margins in iOCO.
- Knowledge Process Outsourcing - the diverse cluster offerings include forensic and legal services. There are a few new and exciting ventures in this division that could be rolled out globally and which is EOH IP. These are referred to as the Rocketlab Ventures. They not to be confused with the assets in the IP division – those are earmarked for sale.

  There is an electronic document signature business called **Impressions** which is housed in the client domain and operates as a consent engine. **Nuvoteq** assists in clinical trials and has FDA approval. **Cerebro** focuses on digitising governance processes and has many application possibilities in the compliance and regulatory environments. **Veritas** is a business that focuses primarily on the insurance sector and specialises in validating claims - it's one of only two certified companies in SA using this tech. The current global demand for Cyber security and threat analysis makes this offering high in demand. **Symplexity** focuses on SME opportunities, particularly in mining and construction.

  The Rocketlab Ventures are early-stage product companies. They only represent around 2.5% of group revenue but double-digit annual growth is anticipated in the medium term.

Manage & Operate and Network Solutions are disclosed jointly as per Figure 8 above. Management disclosed GP and EBITDA margins of 10% and 5% respectively in FY21, the lowest in the iOCO business. The business was significantly impacted by COVID-19 due to corporate financial strain with some client losses – 2H21 revenue more than halved to R235m, however, EBITDA rose from R21m to R26m benefitting from cost efficiencies. We forecast 5% growth in revenue in FY22E and 6% growth in EBITDA. Margins are anticipated to widen slightly as management aims to switch more costs to variable. Management anticipates 4% industry growth rates.

Digital Industries – this is the most profitable iOCO business, with disclosed GP and EBITDA margins of 43% and 21% respectively. The outlook remains favourable given a strong mining sector, improved economic growth and rising infrastructure spend. 2H21 revenue was down on 1H21 (R220m vs R263m) but EBITDA rose from R51m to R57m. We anticipate further double-digit revenue growth of 10% in FY22E with 10% growth in EBITDA.

OKS (knowledge process outsourcing) – with the IP business in this division, the outlook is for double digit revenue growth. It has disclosed GP and EBITDA margins of 38% and 12% respectively in FY21. Momentum improved into 2H21 with EBITDA of R63m for FY21. We forecast 9% revenue growth and 10% EBITDA growth in FY22E driven by traction in the Rocketlab ventures.

iOCO Digital

GP margins of 25% and EBIDA margins of 11% were disclosed in FY21. This incorporates the new age aspect of technology – digital transformation. This is a faster growing segment of iOCO as the world navigates the fourth industrial revolution. There is vast opportunity in this space given most older companies have legacy systems which require a complete transformation to remain competitive.

COVID-19 has exposed some of the shortcomings in many corporates and a desire to digitalise has been expedited. This is evidenced by stronger revenue growth in 2H21 vs 1H21.

The products are solution based with no off the shelf options. It is comprised of the following divisions:

- App development

  This encompasses the development of software applications as well as App's for client solutions. One area of focus is on call centre technology where the group is active. The biggest challenge to this units' growth is skills availability in SA, a reason why the Egypt and UK offices have been retained.

- Data analysis

  This is a niche offering for iOCO at present as the group has never acquired in the space. It is, however, a significant growth area (especially for large customers looking to increase cross selling by utilising data insights within their organisations) and focus is being applied. iOCO assists companies in evaluating the potential of their data and ensuring their data is accurate, safe and relevant.

- Cloud & Security

  Cloud forms the foundation for any digital strategy and a migration away from legacy and more costly systems. The offering is positioned as a "journey to the cloud partner", which includes advisory as well as providing a management layer and offering that enables ease of use, management and decision making.

- Automation

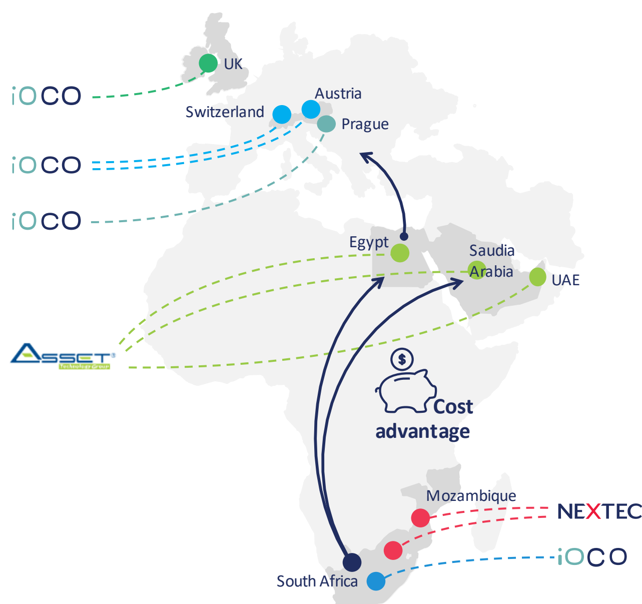
  This is the automation of manual business processes as well as the use of robotics. Automation of call centres is a fast-growing trend with an increased use of Bots. iOCO will partner with software and product providers to deliver a solution to the client but is also capable of adding additional internally developed applications. This is an exciting space and strong growth is expected.

- Quality assurance and testing

  This is a key offering for large scale, turn-key, complex programs, providing automated testing, as well as fully-fledged resource intensive testing services and management. This also compliments the other offerings and ensures the complete wrap of services so that clients can choose to receive a complete, fully-fledged, end-to-end delivery program.

- International

Figure 9 International Representation



Source: Company data, Chronux Research

The groups international operations sit within iOCO Digital. Management has indicated its desire to significantly grow the contribution from its international operations from the current 8% of revenue. There were numerous international businesses that EOH acquired historically. Many of these businesses have been exited and the operations are now rightsized. Apart from opening the group to new markets and customers, they also provide new skills to the group and in the case of Egypt cheaper skills.

Given capital constraints, growth in the medium term will be organic and little capex is required. Its Africa strategy is largely driven by SA corporates looking for solutions in their Africa operations. On the continent management does not intend to open offices outside of SA and Egypt.

The international strategy revolves around leveraging off SA's differentiated offerings and gaining access to IT resources which are becoming scarce in SA. Focus is on mid-market corporates. The international offering will not be exclusive to Digital – other value-added services within the group will also be marketed where there is a value proposition. Development of the international operations has been slow during the turnaround phase, but the structure and strategy is now finalised and poised for growth. All operations are currently profitable.

Egypt

This is the biggest revenue generator in the international portfolio and is essentially a mini iOCO with strong government and private sector contracts (circa 50 clients). App Development is a core focus for this business. The office is used as a steppingstone into the UAE and Saudi Arabia where a presence already exists. Management intends building a global delivery centre in Egypt that can deliver services to SA corporates given its broad and affordable skills base.

UK

This is largely an App development and Cloud focussed business that will spearhead growth into Europe. 80-90% of its clients are UK based. There is a strong internal drive to grow this operation. This will include the strategy of growing the client base in the UK and Europe and where possible leverage off the cheaper SA and Egypt resource base. It will also provide the SA operations with skills and training.

There is no divisional reporting within iOCO Digital. The main drivers of future growth will be App dev, automation, big data and the move to Cloud. This should be the strongest growth driver in iOCO; management anticipates 14% industry growth. Revenue of R1353m was achieve in FY21 with EBITDA of R148m. EBITDA dropped in 2H21 given the exit of certain international operations. We forecast 10% and 16% revenue and EBITDA growth in FY22E.

Outlook for iOCO

Figure 10 iOCO Revenue – pre discontinued operations (immaterial)

iOCO Divisional Revenue	FY20	1H21	2H21	FY21	FY22E	FY23E
Total R'mn	6700	2737	2208	4945	5012	5294
Digital	0	662	691	1353	1488	1637
Technology	0	784	650	1434	1520	1588
Digital Industries	0	269	220	489	538	581
OKS	0	246	264	510	556	611
M&O and NS	0	563	235	798	838	876
Other	0	213	148	361	72	0

Source: Company data, Chronux Research

Figure 11 iOCO EBITDA – pre intersegment and discontinued operations (immaterial)

iOCO Divisional EBITDA	FY20	1H21	2H21	FY21	FY22E	FY23E
Total R'mn	392	282	242	524	603	656
Digital	0	95	53	148	171	190
Technology	0	99	85	185	198	206
Digital Industries	0	51	57	108	119	129
OKS	0	25	38	63	69	77
M&O and NS	0	21	26	47	50	53
Other	0	-8	-17	-25	-4	0
EBITDA margin	5.8%	10.3%	11.0%	10.6%	12.0%	12.4%

Source: Company data, Chronux Research

Note: Page 20 of the FY21 AFS provides segment disclosure between iOCO, NEXTEC and IP. Revenue disclosure provides the intersegment sales per segment allowing it to be stripped out individually in Figure 10. EBITDA numbers provide the intersegment values across all segments (R88.5m) and therefore it has not been eliminated above. The bulk of discontinued operations relate to IP and therefore are immaterial for iOCO. The EBITDA breakup for FY21 is from the FY21 results presentation.

The Other category refers to legacy public sector contracts which are being exited in FY22E. This would largely be Enterprise Application contracts and hence part of Technology. Overall iOCO remains the

stalwart of the group and has a mix of high and low margin businesses as well as those which would track GDP growth and those that are likely to achieve double digit growth.

Divisional disclosure has been provided in FY21 with no comparatives, and therefore it's difficult to assess the trends in profitability apart from what management has stated in the results and the 1H vs 2H splits. Group iOCO revenue reflects the ongoing negative COVID-19 industry impact on hardware sales (Technology) and Manage & Operate with both declining in 2H21. iOCO revenue declined by 26% from R6.7bn to R5bn. EBITDA margins did, however, rise from 5.8% to 10.6% due to a low base, mix changes as well as a focus on cost containment. This resulted in FY21 EBITDA rising 34% to R524m. We anticipate further margin expansion from Rocketlab, International and iOCO Digital.

Based on our divisional forecasts set out individually in the sections of the report above, and a sharp drop in the legacy contracts (Other category), we forecast revenue growth of 1% in FY22E. We forecast EBITDA to grow 15% to R603m with EBITDA margins expanding from 10.6% to 12%.

NEXTEC

Figure 12 NEXTEC divisional breakdown

Source: Company data, Chronux Research

NEXTEC consists of a variety of businesses that are focused on business process outsourcing and technology infrastructure. Its two main pillars include People Outsourcing Solutions and Intelligent Infrastructure Solutions. It has approximately 2 000 clients.

NEXTEC has undergone a significant restructuring with many of its business sold given either their capital-intensive nature (projects in solar, rail, water etc) or simply not core to the group offering. Some of its businesses were moved into iOCO and vice versa. A base has now been established off which to grow and focus and an improved financial performance is anticipated.

Intelligent Infrastructure Solutions

This is 58% of NEXTEC revenue as disclosed in the FY21 results presentation (broadly in line with our estimates). Designing, installing, managing and creating bespoke data platforms using the latest OEM technology solutions in the infrastructure environment across numerous sectors. Contracts are largely fixed price based (a preferred route) but an element of variable revenue exists from variation orders. Certain contracts also allow for the sharing of cost savings (e.g., water leakage reduction targets). Its active in the public sector and would benefit from governments infrastructure spend.

OEM relationships were not damaged throughout the transformation period and NEXTEC was not blacklisted by any of its customers. It is a niche solutions provider and highly regarded by its customers. A small component (circa 5%) of NEXTEC's revenue is derived offshore, predominantly in Africa. The strategy is to follow OEM's or customers.

This business was negatively impacted by COVID-19 given delays in infrastructure projects. This is evident in its decline in 2H21 revenue as per Figure 13 below. The mining industry remained buoyant but there were considerable delays in municipal work, the construction industry and the water and energy sectors. Despite reporting 19% GP margins the business achieved a R47m EBITDA loss, R45m of this relating to losses in Pia Solar and Autospec, which are both being exited as contracts complete. We forecast revenue growth of 8% in FY22E to R1207m and anticipate EBITDA of R24m (2% margin). We anticipate a sharp improvement in FY23E with EBITDA up 92% to R46m. This as the business benefits from its restructuring and revenue improves on anticipated increased infrastructure spend.

People Outsourcing Solutions

42% of NEXTEC revenue. Supplying solutions around recruitment, staffing, training and development and change management. It assists clients with B-BBEE scorecards by finding the correct talent and training them. Client outsourcing of call centres is also key to this operation. Momentum continues in this business with revenue in 2H21 up on 1H21, a total of R780m. EBITDA increased considerably in 2H21 to achieve R11m in FY21, largely on the back of cost containment. We forecast FY22E revenue and EBITDA growth of 7% and 36% off a low base.

NEXTEC Outlook

Figure 13 NEXTEC revenue and EBITDA forecasts – pre discontinued operations

R'mn	**FY20**	**1H21**	**2H21**	**FY21**	**FY22E**	**FY23E**
Revenue	3376	1028	870	1898	2042	2213
Digital Infrastructure	0	648	470	1118	1207	1328
People/Learning	0	380	400	780	835	885
EBITDA	-111	-6	-29	-35	39	76
Digital Infrastructure	0	-7	-40	-47	24	46
People/Learning	0	1	10	11	15	14
EBITDA margin	-3.3%	-0.6%	-3.4%	-1.9%	1.9%	3.4%

Source: Company data, Chronux Research

Note: Page 20 of the FY21 AFS provides segment disclosure between iOCO, NEXTEC and IP. Revenue disclosure provides the intersegment sales per segment allowing it to be stripped out individually in Figure 10. EBITDA numbers provide the intersegment values across all segments (R88.5m) and therefore it has not been eliminated above. The bulk of discontinued operations relate to IP, but we believe an element still relates to NEXTEC. The EBITDA breakup for FY21 is from the FY21 results presentation.

NEXTEC is anticipated to show a significant improvement in its profitability in FY22E as loss making businesses have been exited, costs have been contained, focus has been regained and projects are expected to come back online. Adjusting for the R45m Pia Solar and Autospec losses, it reported an EBITDA profit of R10m in FY21. Its adjusted EBITDA margin of 0.5% lags significantly behind iOCO, but this is where the opportunity lies. Management guidance has been limited apart from stating that a rebound will occur and group EBITDA margins of 10% are envisaged, suggesting a sharp recovery from NEXTEC. We forecast for a gradual recovery with EBITDA margins at 1.9% and 3.4% in FY22E and FY23E. Revenue growth of 8% is forecast for both years. Forecast risk remains high with little visibility

Opportunities for EOH

We see the following as opportunities for EOH going forward:

- Focus – management will dedicate a minimal amount of time to legacy issues in FY22E, allowing it to gain new clients, improve service levels and increase its cross sell of services. Increasing its cross sell is valuable in a low growth environment as is currently being experienced in SA.
- Reputational risk significantly lowered – this could see new OEM partnerships and improved existing relationships. This will broaden its client offering and improve service levels. It may also lead to better financial terms in the partnerships.
- Longer contract terms – with such huge uncertainty during its turnaround, shorter term contracts were entered with clients. This is already beginning to reverse and will be positive for annuity revenue.
- Invest – as debt costs are lowered it frees up more cash to invest in its IP businesses and offshore expansion, areas of significant growth.
- International – its existing portfolio of businesses are all profitable and well established in their geographies. What is required is capital to growth them and management time and effort, something which has been constrained. Leveraging off the EOH IP in SA opens opportunities for increased expansion and skills transfer from abroad will benefit the SA offering.
- Public sector – at 20% of revenue it's still a major focus area for EOH. With a total overhaul of its onboarding of public sector contracts (now in line with any other corporate client) it can enter business with public sector entities more freely and with the confidence of government. Any strengthening of its B-BBEE credentials (currently circa 15% ownership) would also be well perceived by government.

Financial

As far as possible management has presented FY21 results in a format that allows investors to better appreciate the core earnings ability of the group going forward. Discontinued operations are still meaningful (generating higher operating profit than the recurring business primarily due to NEXTEC) but have been clearly identified. We highlight the following disclosure features:

- An income statement that shows the recurring operations on a line-by-line basis with discontinued operations as a separate line item.
- The balance sheet separately shows assets and liabilities held or re-sale. The NAV of the assets provides a basis for determining the cash realisation proceeds.
- Segmental reporting across the two primary businesses is available for FY21 and FY20. However, the breakdown within iOCO and NEXTEC is only available for 1H21 and FY21. Management has provided some guidance on revenue growth prospects for the underlying divisions. Divisional reporting is limited to EBITDA, revenue and GP margins.

- Within the segmental disclosure, head office costs are grouped together with inter segment revenues – the “reconciliation” segment. Disclosure around the split is limited. The FY21 cost to be offset against the iOCO and NEXTEC divisional performance is R89m (p21 of AFS). The head office costs remain relevant into FY22E and onwards.
- Additional disclosure and clarity is provided in the FY21 results presentation.
- There is no meaningful financial history beyond FY20 and even FY20 has its own limitations, especially as the group was undergoing considerable change and hence its operating environment was far from normal. We therefore look at FY20 with caution.

In the light of these limitations, forecast risk remains very high. As highlighted in the divisional commentary in the report, management has provided some guidance around EBITDA margin targets and divisional industry revenue growth rates. It also indicated a normalised net debt/EBITDA range of 1-1.5x. We summarise our financial outlook below:

Revenue

Figure 14 Group revenue forecasts – recurring operations

R’mn	FY20	FY21	FY22E	%	FY23E	%
Revenue	**8772**	**6874**	**7054**	**3%**	**7506**	**6%**
Sum of divisional revenue (A+B+C)	11277	7883	7054	-11%	7506	6%
Less Intersegment (eliminated at a divisional level)	0	0	0		0	
Less Discontinued operations	-2505	-1009	0		0	
iOCO (A)	6700	4945	5012	1%	5294	6%
Digital	0	1353	1488	10%	1637	10%
Technology	0	1434	1520	6%	1588	4%
Digital Industries & C&A	0	489	538	10%	581	8%
OKS	0	510	556	9%	611	10%
M&O and NS	0	798	838	5%	876	4%
Other - legacy	0	361	72	-80%	0	
NEXTEC (B)	3376	1898	2042	8%	2213	8%
Digital Infrastructure	0	1118	1207	8%	1328	10%
People/Learning	0	780	835	7%	885	6%
IP – discontinued (C)	1201	1040	0		0	

Source: Company data, Chronux Research

Note: R6874m is the FY21 disclosed continuing operations revenue in Appendix 1 of the results presentation

Revenue from continuing operations declined by 22% to R6.9bn in FY21. We anticipate iOCO and NEXTEC revenue growth of 1% and 8% in FY22E and 6% and 8% in FY23E. This equates to 3% growth at a group level in FY22E and 6% in FY23E. Management indicated that the ICT industry grows revenue at 2% ahead of nominal GDP growth, suggesting growth around 7-8%. We have EOH just outside this range in FY23E. GDP growth remains a key determinant for future growth assumptions and there is considerable uncertainty as to the medium-term growth rates.

Gross Profit Margins

Group continuing GP margins are at 25.1%, and we anticipate a widening of the margin to 26% in FY22E and 26.2% in FY23E. This is partly due to Digital Industries (disclosed GP margin of 43%) and OKS (disclosed GP margin of 38%) becoming greater group contributors.

EBITDA

Figure 15 EBITDA forecasts - recurring operations

R'mn	FY20	FY21	FY22E	%	FY23E	%
EBITDA	**-125**	**471**	**535**	**14%**	**638**	**19%**
Sum of divisional revenue (A+B+C)	548	756	642	-15%	732	14%
Less discontinued	-144	-196	0		0	
Less Intersegment/head office costs (not allocated below)	-528	-89	-108	21%	-94	-13%
iOCO (A)	392	524	603	15%	656	9%
Digital	0	148	171	16%	190	11%
Technology	0	185	198	7%	206	4%
Digital Industries & C&A	0	108	119	10%	129	8%
OKS	0	63	69	11%	77	11%
M&O and NS	0	47	50	7%	53	6%
Other - legacy	0	-25	-4	>100%	0	
NEXTEC (B)	-111	-35	39	>100%	76	93%
Digital Infrastructure	0	-47	24	>100%	46	93%
People/Learning	0	11	15	33%	29	94%
IP – discontinued (C)	267	267	0		0	

Source: Company data, Chronux Research

Note: FY21 EBITDA of R471m is the disclosed adjusted EBITDA from continuing operations in Appendix 1 of the results presentation.

As per the segmental commentary above, we forecast EBITDA margins in iOCO and NEXTEC to grow to 12% and 1.9% in FY22E, with a combined EBITDA margin of 9.1%. This equates to 15% iOCO EBITDA growth to R603m and a swing from a R35m loss in NEXTEC to R39m. At a group level we forecast R535m EBITDA (7.6% EBITDA margin), +14% following the allocation of head office expenses which is reported within the intersegment number. We estimate this number to be higher in FY22E given a low 2H21, but forecast risk is high given poor disclosure around its composition.

In FY23E our EBITDA margin estimates are 12.4% for iOCO (equates to R656m, +9%) and 3.4% for NEXTEC (equates to R76m, +93%), a combined 9.7% EBITDA margin excluding intersegment. Our intersegment/head office cost estimate is R94m, 13% lower than FY22E as head office cost reductions materialise. The result is an EBITDA of R638m, up 19%, an EBITDA margin of 8.5%. Management is guiding towards group EBITDA margins of 10% in the medium term. We conservatively forecast 8.8% in FY24E.

We don't forecast revenue or EBITDA for IP in detail, however, there will remain some earnings from this division in FY22E given the staggered sale of the assets during the year. Discontinued operations contributed R46m of earnings in FY21, we forecast this to drop to R35m in FY22E and zero in FY23E.

Our implied cost growth is 4% in FY22E and 2% growth in FY23E. This is driven by:

- Ongoing reduction in property space – the target is to reduce 50% of office space. The full benefit to be felt in FY23E.
- A reduction in legal entities from 272 to 145 and 30 envisaged to go in FY22E.
- The business is digitising its own processes, and this should result in further cost efficiencies.
- Staff numbers have broadly stabilised. We assume wage inflation of 3% in FY22E. We estimate staff costs at 76% of operating costs.
- A sharp decline in expected credit losses given a more favourable economic outlook.

Interest & debt

A new loan structure was entered into in FY21 alleviating some liquidity pressure from the balance sheet as duration has been pushed out. The facilities include a R500m senior facility repayable in 3 years and a R1500m bridge facility repayable in October 2022. Management alluded to this being repaid by disposals of non-core assets, internally generated cash flow and additional funds from capital markets.

Figure 16 Estimate of Infosys realisation value

R'mn	
Assets held for sale - NAV	832
Less: Sybrin	334
Less: Energy Solutions and Analytics	26
Less: Afiswitch	49
InfoSys	423

Source: Chronux Research

Figure 17 Unwind of bridge facility to October 2022

Bridge Facility R'mn	1500
Less asset realisations	832
Sybrin	334
Energy Solutions	26
Afiswitch	49
InfoSys	423
Outstanding debt	668
Less: Cash flow paydown	250
Debt balance	418

Source: Chronux Research

On our pay down assumptions above, we see the R1.5bn reducing to R668m by October 2022. The proceeds from the sale of InfoSys has not been disclosed, however, we believe the sales prices of the remaining assets would be line with the NAV as disclosed on the balance sheet as assets held for sale. Within this category we are aware of four investments, three of which have the sales proceeds disclosed. Therefore, we calculate InfoSys NAV at R423m.

We see scope to pay a further R250m of debt from operational cash flow and existing cash resources. This would see an outstanding bridge facility liability of R418m at its due date in October 2022. A few options remain available to management:

- A further bridging facility could be arranged. Given the progress made by EOH in its debt reduction we see continued support from the banks at this stage of the company's rehabilitation. The cost of debt will remain elevated.

- The issuance of stock directly to a B-BBEE partner to increase the B-BBEE holding from approximately 15% at present. Management has alluded to wanting to increase it B-BBEE credentials as it will benefit EOH with public sector contracts as well as with its large corporate clients.
- A book build to gain new shareholders.
- A rights issue

We see a further bridging facility as the fallback position but not a solution to the problem, particularly as interest rates rise with an already elevated interest rate around 10%. Ongoing servicing of debt is preventing the company from investing for growth and the continued sale of businesses is diminishing the scale of the group. A R418m capital raising from a single B-BBEE partner may be too aggressive (at current valuations it would imply a 28% stake). A book build to broaden its institutional shareholding seems a viable option – currently 27% of its stock is held by retail investors.

Our view is that management would want to avoid rolling the bridge facility and opt for a capital raise, incorporating a B-BBEE transaction.

We forecast a net interest cost of R213m and R93m in FY22E and FY23E on the assumption of 10% interest rates as guided by management. We understand the bridging facility attracts the higher interest rate and it escalates closer to maturity (we apply 10.5% in 2H22). We assume all sales proceeds apart from InfoSys occur in 1H22. **Our forecasts don't incorporate a capital raise given the uncertainty around structure, size, timing and pricing. We model for ongoing debt and a gradual pay down through operational cash flow.**

We calculate a net debt of R800m in FY22E, a 1.5x net debt/EBITDA ratio. Management has guided towards a 1-1.5x normalised ratio.

Tax

The company is extremely inefficiently tax structured including the inability to use assessed losses and claim the full deductibility of interest on debt. The current effective tax rate is not repeatable and with time it will trend towards the official tax rate of 27%. Visibility is poor and we have assumed a two-year reversion to the 27% company tax rate in our forecast. We estimate a tax rate of 34% and 28% in FY22E and FY23E.

Capex

Capex maintenance expenditure commitments amount to circa R86m in FY22E.

Headline earnings and DPS

In our HEPS calculation we include R35m of discontinued earnings (R46m in FY21) in FY22E, zero in FY23E. We forecast HEPS in FY22E and FY23E of 67c (>100%) and 142c (>112%). It was -22c in FY20. On recurring earnings, we have HEPS rising from -109c in FY21, to 46c in FY22E and 142c in FY23E. Both FY22E and FY23E benefit significantly from a declining tax rate and interest expense. In FY23E HEPS growth is 112% vs EBIT growth of 30%. No dividends are envisaged in the medium term.

Figure 18 HEPS vs Recurring operations HEPS

	FY21	FY22E	%	FY23E	%
HEPS	-22	67	>100%	142	112%
Recurring HEPS	-109	46	>100%	142	209%

Source: Company data, Chronux Research

Valuation

Figure 19 DFCF valuation assumptions

WACC Assumptions	
Risk free rate	9.5%
Beta	2.0
Market risk premium	6.5%
Marginal tax rate	28.0%
Pre-tax cost of debt	10.5%
Cost of equity	22.5%
Target debt/value ratio	40%
Target equity/value ratio	60%
WACC	16.5%
Growth Rate assumption	
Sustainable long term growth rate	4.0%

Source: Chronux Research estimates

Figure 20 DFCF sensitivity to WACC and growth rate

		WACC				
		-1%	-0.50%	0%	0.5%	1.0%
Terminal Growth	3.0%	1122	1021	927	841	761
	3.5%	1164	1058	960	870	787
	4%	1210	1098	996	902	816
	4.5%	1259	1142	1035	937	846
	5%	1313	1190	1077	974	879

Source: Chronux Research estimates

We value the group on a DFCF basis, applying a WACC of 16.5%, a market risk premium of 6.5%, a beta of 2 (a reflection of volatile earnings, volatile share price, forecast risk, potential capital raise and high financial leverage) and a sustainable long-term growth rate of 4%, as highlighted in the table above. We apply our FY25E debt:equity ratio of 40%:60% (management is guiding towards an optimal 30%:70%). Applying some sensitivities to WACC and terminal growth rates leads to a valuation range of R8.70-11.42/share, a mid-point valuation of R10.

A historical review of its P/E has little value given the stocks radical transformation over the past three years. We note, however, that at its peak its P/E was >30x. Whilst there are numerous ICT competitors to EOH, apart from Alviva Holdings there are no pure ICT listed stocks for comparison purposes. Using consensus numbers for Alviva, its trading on a historic 6x P/E and a 9-month forward P/E of 5x. Its P/E on FY23E HEPS is 4.5x, in line with EOH. Its derated significantly as a consequence of COVID-19 and the impact to its FY20 earnings. Its 10-year average P/E is 7.8x. Applying this to EOH's FY23E HEPS, which represents a more normalised earnings base, equates to a discounted fair value of R9.50 11-months forward.

We believe the company has turned the corner and is on an earnings recovery path. FY22E remains a depressed earnings base given the high net interest expense and the high effective tax rate – this normalises considerably in FY23E. An increase in its client base, longer duration contracts, better terms with OEM's, an improving economy, a move to digitisation and Cloud computing and lower financial gearing all bode well for the outlook. Above average risks remain, and we allow for that in our WACC. We do envisage the company approaching the capital markets and therefore there is a share overhang which could limit the stocks rerating until clarity is provided.

Risks

- A stalled economic recovery in SA. Corporate IT spend is highly correlated to the underlying economy. Our estimates are based on an improving economic outlook.
- Timely execution of asset sales given the disruptions during COVID-19. We anticipate cash proceeds of R832m in FY22E to alleviate the debt position.
- Potential dilution of a capital raise at a ruling discount to the market. Our forecasts don't consider a capital raise given the uncertainty around timing, pricing, size and format. We model for ongoing debt and a gradual pay down through operational cash flow.
- The Group is involved in various litigation matters arising in the ordinary course of business. Management has indicated that at this stage it is not possible to predict what the outcome of the various matters will be, nor what portion of any costs will be attributable to the Group, or whether all or any portion of such costs will be covered by insurance or will be recoverable from other sources. Management states that it has no reason to believe that the disposition of these matters will have a material adverse effect on the consolidated financial position of the Group There is currently no outstanding litigation, that the directors believe has not been adequately provided for, that could pressurise the Group's ability to meet its obligations (extract from the Annual Financial Statements).
- Ongoing negative media commentary relating to numerous current legal matters that are in the process of being finalised. Whilst most likely relating to past events these do inhibit EOH from moving on.
- Elevated reputational risk is an impediment to investors and customers. We feel that this risk has subsided significantly given the transparency of the group and a return to profitability, but it is remaining somewhat elevated. This will impact any discount at which a capital raise is pursued. Reputational risk will continue to decline as evidenced by customer and supplier numbers increasing.
- COVID-19 – This has reduced hardware and other IT related spend as well as hamper economic growth which is key to IT spend. On a positive note, it's benefiting spend on digital transformation.
- Negative B-BBEE score card changes. Currently a Level 1 contributor and highest among its peers on the JSE. Its scorecard is broad based which mitigates some of the risk.
- The Group has an ongoing tax dispute dating back to 2012 related to a PAYE dispute in one of its staff outsourcing businesses. At 31 July 2021, the Group had provided for R267 million on the PAYE liability assessed and potential future assessments and has submitted a notice of objection to SARS. Based on internal and external legal and technical advice obtained, the Group remains confident that it has a strong legal case to contest the remaining exposure. A total of R52 million of the R267 million provision was repaid up to 31 July 2021 (Extract from Annual Financial Statements, note 34). **Whilst provided for, it would negatively impact the ability to pay down debt as forecast.**

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