Vasco Data Security

Forecasts raised

From strength to strength

Software & comp services

VASCO's Q2 revenues increased 28%. With three quarters of year-on-year growth and a strong pipeline reported, growth has been firmly re-established across both divisions. We raise our earnings forecasts by 31% this year and 21% next year. The current share price, while at a c 20% P/E premium to peers in 2015, does not fully capture the cyclical recovery being experienced and the structural growth possibilities available.

Year end	Revenue ($m)	PBT* ($m)	EPS* (c)	DPS (c)	P/E (x)	EV/sales (x)
12/12	154.0	27.3	56.5	0.0	23.9	2.5
12/13	155.0	20.0	43.1	0.0	31.3	2.7
12/14e	178.3	28.8	64.0	0.0	21.1	2.3
12/15e	189.5	33.8	69.3	0.0	19.5	2.2

Note: *PBT and EPS are normalised, excluding intangible amortisation, exceptional items and share-based payments.

Strong trading and margin expansion

Revenue growth of 28% to $47.7m was reported in Q2, an acceleration on that seen in Q1 (+10%), although against a much weaker comparison. Management's focus on cost savings, lower non-product costs, the stronger euro and the operational gearing effects of this strong growth were evident at the operating margin level, which at 18.4% (pro forma) was significantly stronger than Q1 (12.9%) and last year (6.9% Q213). Growth was broad based: banking revenues increased 31% with growth from traditional products and those incorporating the new Cronto technology. Enterprise and application (EA) revenues increased 14% and, although they are still nascent, we are encouraged by new customer wins in the healthcare sector and a pick-up in interest in the applications market.

Recovery established – forecasts raised

With three quarters of revenue growth now reported and with a strong pipeline into H2 (which should also benefit from inaugural revenues from HSBC US's roll-out of DIGIPASS solutions to its customers), growth appears to have been firmly re-established. We raise our revenue forecasts by 5% this year and next, and our adjusted operating forecast by 25% and 23% respectively.

Valuation: Not reflecting point in the cycle

On an FY15 P/E of 19.5x, VASCO trades broadly in line with its closest peer and at a c 20% premium to its peer group. While momentum is strong, the historically volatile trading pattern adds a degree of uncertainty to the sustainability of growth into FY15. Despite this, we believe a peer premium is justified; our reverse DCF implies the shares are discounting low single-digit growth from next year. Given its leading position in a structural growth niche of the cyber security industry, and the fact it is emerging from a trough year with strong growth, this is overly pessimistic. Although we expect a bumpy ride, over the forecast period we see scope for earnings upgrades driven by the trading cycle, management's ability to expand market share in the EA markets and initial contributions from the cloud solutions.

31 July 2014

Price	**US$13.48**
Market cap	**US$535m**

Net cash ($m) at June 2014	123.3
Shares in issue	39.7m
Free float	74%
Code	VDSI
Primary exchange	NASDAQ
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	16.2	18.1	63.4
Rel (local)	15.6	13.0	39.8
52-week high/low		US$13.5	US$6.63

Business description

VASCO is a global internet security company with a leading position in strong authentication and e-signature solutions. The DIGIPASS family of hardware and software products is used by more than 10,000 companies. 82% of revenues are from the banking sector, where it is the market leader.

Next event

Q3 results	October 2014

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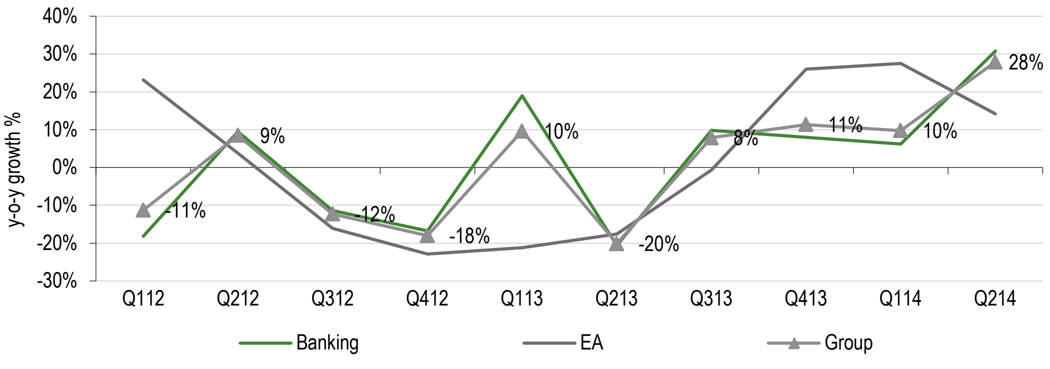
Q2 update – revenue growth and margin expansion

As we highlighted in our initiation report (Banking on stronger authentication, 15 May 2014), the nature of the business, which is driven by the roll-out schedules of key clients, and VASCO's significant exposure to the banking vertical can result in a lumpy revenue profile. However, with three consecutive quarters of year-on-year growth now reported across both divisions, Q214 results reported last week, suggest that after a challenging 2013, revenue growth has now been firmly re-established (Exhibit 1).

Following year-on-year growth of 10% in the first quarter, Q2 consolidated revenues increased by an impressive 28% to $47.7m (against a weak comparison – Q213 was reported down 20%).

- EA division – Together with a stronger industry backdrop, the results of management's re-worked sales strategy in the EA division appear to be bearing fruit; revenues here increased by 14% y-o-y in the quarter (28% in Q1) and management reports a new customer in the healthcare industry, one of its targeted verticals (PointClickCare). Furthermore, management indicated that the DIGIPASS for Apps service, which enables app publishers to integrate stronger authentication into their services for little overhead (eg OTPs, digital signatures, geo-location proof of presence tools), is gaining momentum. Increasing its exposure in the higher-margin, underpenetrated EA market is central to delivering long-term, higher-margin growth; although this growth comes against a weak basis of comparison, we are encouraged by the results being seen from this division so soon after management's recent restructuring.
- Banking division – Revenues increased by 31% y-o-y in the quarter, marking an acceleration from Q1 (+6%). Strength was broad based from both traditional products and those integrating the new Cronto technology, which following its acquisition in May 2013 is now fully integrated in VASCO's solutions. During the quarter VASCO acquired Risk IDS Ltd, a provider of risk-based authentication solutions for banking customers. This acquisition is consistent with management's strategy of identifying differentiating and innovative technologies to enhance its core products. The acquisition, once integrated, will enable VASCO to offer online transactional risk-adjusted authentication solutions; for instance, authentication requirements will be dynamically adjusted depending upon the location of a customer, the value and characteristics of the transaction and detection of any malware on a device. Technology such as this enables VASCO to offer high levels of security while limiting inconvenience to users.

Exhibit 1: Quarterly growth trends – growth seems firmly re-established



Source: VASCO DSI

Margin expansion reflective of cost focus and operational gearing

The share of revenues from non-hardware products was broadly flat on the prior year (26% of sales), and despite 19% of revenues being derived from the lower-margin card reader products (only 15% in Q213) and ongoing pressure on banking hardware margins, gross margins at 65.1% remain approximately 1pp above last year's level, benefiting from lower non-product costs (ie freight, inventory write downs) and the strengthening euro/dollar exchange rate. Adjusted operating margins of 18.4%[1] compare to 12.9% in Q114 and 6.9% in Q213, reflecting the higher gross margin, the operational gearing effects of higher revenues and management's recent focus on cost management.

EBITDA of $9.5m was reported in the quarter (vs $5.9m in Q1 and $3.3m in Q213) and adjusted operating profit[1] of $8.8m (vs $5.0m in Q1 and 2.6m in Q213). Net cash at the period end was $123.3m (vs $98.6m at March 2014).

Forecasts raised

After a challenging 2013, growth seems to be firmly re-established across both divisions, and with a solid pipeline in the second half, which includes a landmark roll-out of DIGIPASS solutions to HSBC's retail clients in the US (the first bank to do so in the US), the trading outlook for the second half of the year remains strong. While gross margins on banking hardware solutions are coming under pressure, with 49% of revenues absorbed by quasi-fixed operating expenses, the operational gearing effect of a strong top line is significant and, after a trough in FY13 (11% pro forma operating margins), operating margins should start to recover.

We increase our FY14 revenue forecast 5% to $178m (from $170m), our adjusted operating income forecast by 25% to $28.5m (from $22.8m) and our normalised and fully diluted EPS estimate by 31% from 49.0c to 64.0c. At the earnings level, our upgrade is enhanced as we have reduced our estimate of the full year tax rate to 15% from our previous estimate of 22% (based on management's current expectations).

Exhibit 2: Forecast changes

$'000	2014			2015			2016		
	Previous	New	Change	Previous	New	Change	Previous	New	Change
Revenue	170,063	178,304	4.8%	180,767	189,502	4.8%	192,083	201,342	4.8%
Gross profit	107,078	113,054	5.6%	115,015	121,680	5.8%	123,518	130,938	6.0%
Gross margin	63.0%	63.4%		63.6%	64.2%		64.3%	65.0%	
Operating profit – company basis*	20,004	25,766	28.8%	24,457	30,605	25.1%	27,894	34,467	23.6%
Operating margin	11.8%	14.5%		13.5%	16.2%		14.5%	17.1%	
Operating profit – Edison adjusted*	22,754	28,516	25.3%	27,290	33,437	22.5%	30,811	37,384	21.3%
PBT – normalised	23,166	28,836	24.5%	27,731	33,774	21.8%	31,292	37,744	20.6%
EPS – normalised and fully diluted	49.0	64.0	30.6%	57.4	69.3	20.7%	63.8	76.3	19.6%

Source: Edison Investment Research. Note: *Company basis excludes amortisation of purchased intangibles. Edison basis also excludes share-based payments.

Our forecasts are presented in full at the back of this report.

Our new forecasts for FY14, are broadly in line with managements revised guidance; it now expects revenues between $175m and $180m (previous guidance $168m to $170m), with operating margins between 13% and 15% (from 11% to 13%).

1 VASCO basis – excluding amortisation on acquired intangibles

Valuation

On our forecasts, VASCO trades on an FY15 P/E of 19.5x – broadly in line with its closest peer (Gemalto), although a premium to other cyber security companies (average CY15 P/E of 15.8x).

With its unique exposure to the structurally growing strong authentication segment, the broad-based upturn in trading to levels previously seen before the financial crisis, and the longer-term potential that the cloud services offer, we believe the premium rating is justified.

In FY15, consensus is looking for 10% revenue growth. Given the historically volatile nature of trading, investors may be unwilling to fully price the ongoing double-digit revenue growth that VASCO is currently delivering beyond the current year. However, a reverse DCF (on a WACC of 11% and perpetuity growth of 2% 10 years out) suggests that the share price is discounting low single-digit revenue growth (3%), with flat EBITDA margins from FY15. For a company with a leading position and a strong balance sheet at this point in the cycle, this seems overly pessimistic. Operating margins have reached 27% in the past (2007) on revenues considerably below current levels. Accepting that the cost base has moved on over the last five years, we believe there remains considerable scope for operating margin expansion provided solid trading continues (eg via operational gearing effects, bringing cloud solutions to break even), and given the growth opportunities that remain in both the banking and non-banking verticals, we see little reason for growth to reverse.

Exhibit 3: Peer comparison

Company		Sales (ccy m)		Sales growth		EBITDA (ccy m)			EBITDA margin			EPS (ccy)		
	Crncy	CY14	CY15	CY14	CY15	CY13	CY14	CY15	CY13	CY14	CY15	CY13	CY14	CY15
VASCO – Edison forecasts	USD	178	190	15%	6%	25	35	39	16%	20%	21%	0.4	0.6	0.7
VASCO - Consensus	USD	175	193	13%	10%	19	29	37	16%	17%	19%	0.3	0.5	0.7
Gemalto NV	EUR	2,591	2,857	8%	10%	399	470	540	17%	18%	19%	3.0	3.6	4.2
AVG Technologies	USD	384	430	(6%)	12%	135	143	157	33%	37%	37%	1.2	2.0	2.3
Palo Alto Networks	USD	581	779	47%	34%	(9)	67	115	1%	12%	15%	(0.4)	0.4	0.7
EMC Corp/MA	USD	24,849	26,262	7%	6%	6,039	7,531	7,883	26%	30%	30%	1.4	1.9	2.2
Symantec Corp	USD	6,692	6,815	0%	2%	1,944	2,295	2,365	29%	34%	35%	1.3	1.9	2.0
Trend Micro Inc/Japan	JPY	113,540	116,992	5%	3%	36,693	36,987	37,862	34%	33%	32%	147.5	148.8	154.7
Barracuda Networks Inc	USD	273	315	17%	15%	(2)	68	79	(1%)	25%	25%	(0.10)	0.17	0.3
FireEye Inc	USD	412	604	155%	47%	(151)	(218)	(185)	(94%)	(53%)	(31%)	(2.7)	(2.2)	(1.8)

Company	Crncy	% auth*	% cyber sec**	Share price ccy	Market cap (ccy m)	Net debt/ (cash (ccy m))	EV/sales (x)			EV/EBITDA (x)			P/E (x)	
							CY13	CY14	CY15	CY13	CY14	CY15	CY14	CY15
VASCO – Edison	USD			13.5	535	(123)	2.7	2.3	2.2	16.7	11.8	10.5	21.1	19.5
VASCO – consensus	USD	**100%**	**100%**	13.1	519	(123)	2.6	2.3	2.1	21.1	13.6	10.7	24.1	19.8
Gemalto NV	EUR	17%	43%	71.5	6,294	(449)	2.4	2.3	2.0	14.6	12.4	10.8	19.8	16.9
AVG Technologies	USD	0%	100%	19.8	1,044	(12)	2.5	2.7	2.4	7.6	7.2	6.6	9.7	8.8
Palo Alto Networks	USD	0%	100%	81.7	6,293	(420)	14.8	10.1	7.5	N/A	87.7	51.2	204.6	123.7
EMC Corp/MA	USD	4%	4%	29.4	60,252	(3,505)	2.4	2.3	2.2	9.4	7.5	7.2	15.4	13.6
Symantec Corp	USD	30%	100%	23.9	16,552	(1,989)	2.2	2.2	2.1	7.5	6.3	6.2	12.7	11.7
Trend Micro Inc/Japan	JPY	0%	100%	3,635.0	509,965	(140,590)	3.4	3.3	3.2	10.1	10.0	9.8	24.4	23.5
Barracuda Networks Inc	USD	0%	100%	29.1	1,499	(131)	5.9	5.0	4.3	N/A	20.1	17.3	172.3	115.1
FireEye Inc	USD	0%	100%	36.5	5,293	(174)	31.7	12.4	8.5	N/A	N/A	N/A	N/A	N/A
Average							**3.1**	**2.9**	**2.6**	**11.9**	**11.1**	**9.8**	**17.8**	**15.8**

Source: Bloomberg, Edison Investment Research. Note: Prices as at 28 July. *Estimated percentage of sales attributable to authentication products. **Estimated percentage of sales attributable to cyber security products, including authentication.

Exhibit 4: Financial summary

$000s	2011	2012	2013	2014e	2015e	2016e
Year end 31 December	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS						
Revenue	168,082	154,029	155,047	178,304	189,502	201,342
Cost of Sales	(59,970)	(54,464)	(55,176)	(65,250)	(67,822)	(70,405)
Gross Profit	108,112	99,565	99,871	113,054	121,680	130,938
EBITDA	36,658	30,302	24,666	34,862	39,369	43,127
Operating Profit (before amort. and except.)	32,849	26,658	19,624	28,516	33,437	37,384
Intangible Amortisation	(1,967)	(1,905)	(3,325)	(4,400)	(4,400)	(4,400)
Share based payments	(6,117)	(3,726)	(2,587)	(2,750)	(2,833)	(2,917)
Other	500	409	240	240	240	240
Operating Profit	25,265	21,436	13,952	21,606	26,445	30,307
Net Interest	543	261	162	80	97	120
Profit Before Tax (norm)	33,892	27,328	20,026	28,836	33,774	37,744
Profit Before Tax (FRS 3)	25,808	21,697	14,114	21,686	26,542	30,427
Tax	(1,557)	(5,468)	(3,147)	(3,253)	(5,839)	(6,694)
Profit After Tax (norm)	32,335	21,860	16,879	25,583	27,935	31,050
Profit After Tax (FRS 3)	24,251	16,229	10,967	18,433	20,702	23,733
Average Number of Shares Outstanding (m)	38.6	38.7	39.2	40.0	40.3	40.7
EPS – normalised (c)	83.8	56.5	43.1	64.0	69.3	76.3
EPS – normalised and fully diluted (c)	83.8	56.5	43.1	64.0	69.3	76.3
EPS – (IFRS) (c)	47.0	40.3	28.5	46.0	51.3	58.3
Dividend per share (c)	0.0	0.0	0.0	0.0	0.0	0.0
Gross Margin (%)	64.3	64.6	64.4	63.4	64.2	65.0
EBITDA Margin (%)	21.8	19.7	15.9	19.6	20.8	21.4
Operating Margin (before GW and except.) (%)	19.5	17.3	12.7	16.0	17.6	18.6
BALANCE SHEET						
Fixed Assets	29,165	27,071	50,232	42,687	38,287	33,887
Intangible Assets	21,001	19,683	40,265	35,865	31,465	27,065
Tangible Assets	4,405	4,052	3,145	0	0	0
Investments	3,759	3,336	6,822	6,822	6,822	6,822
Current Assets	139,758	159,435	161,645	190,904	223,639	257,725
Stocks	16,033	18,675	25,653	30,337	31,533	32,733
Debtors	33,958	29,885	31,790	36,437	38,662	41,039
Cash	84,497	106,469	98,607	118,535	147,850	178,357
Other	5,270	4,406	5,595	5,595	5,595	5,595
Current Liabilities	(31,168)	(29,948)	(37,106)	(39,859)	(44,191)	(47,013)
Creditors	(31,168)	(29,948)	(37,106)	(39,859)	(44,191)	(47,013)
Short term borrowings	0	0	0	0	0	0
Long Term Liabilities	(1,956)	(238)	(493)	(493)	(493)	(493)
Long term borrowings	0	0	0	0	0	0
Other long term liabilities	(1,956)	(238)	(493)	(493)	(493)	(493)
Net Assets	135,799	156,320	174,278	193,239	217,242	244,106
CASH FLOW						
Operating Cash Flow	17,918	23,035	10,331	20,951	30,378	31,637
Net Interest	0	0	0	0	0	0
Tax	0	0	0	0	0	0
Capex	(8,483)	(1,546)	(971)	(1,000)	(1,063)	(1,129)
Acquisitions/disposals	(1,301)	0	(19,495)	0	0	0
Financing	153	441	2,434	0	0	0
Other incl. discont. Ops	(9,323)	42	(161)	(23)	0	0
Dividends	0	0	0	0	0	0
Net Cash Flow	(1,036)	21,972	(7,862)	19,928	29,315	30,507
Opening net debt/(cash)	(85,533)	(84,497)	(106,469)	(98,607)	(118,535)	(147,850)
HP finance leases initiated	0	0	0	0	0	0
Other	0	0	0	(0)	(0)	(0)
Closing net debt/(cash)	(84,497)	(106,469)	(98,607)	(118,535)	(147,850)	(178,357)

Source: Vasco reported accounts (historic figures), Edison Investment Research (forecasts). Note: VASCO has had no input into forecasts. Profit and loss reflects continuing operations only.

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