

Grafenia plc

Pre-close Trading and Strategy Update

RNS Number : 6596V

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16 April 2021

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Grafenia plc
("Grafenia", the "Group" or "Company")

Pre-close Trading and Strategy Update

Grafenia plc today publishes a trading update, based on preliminary unaudited financial information, for the year ended 31 March 2021 ("the Year").

Trading update

In our half year report on 25 November 2020, we discussed the impact the pandemic has had on our business, and in particular sales of printed products.

Since that update, the UK has been in full or partial lockdown for most of the time. We sell to clients of different sizes, in different industries. Fortunately, we aren't reliant on one particular segment or key account. However, many of our clients in hospitality, retail, sports and events have been closed since December 2020, or earlier. And that's had an impact on our revenues.

Trading in January and February this year was the most challenging. As winter turned to spring, revenue in March 2021 improved and was 80% of the same period last year. This April has started well, as businesses in England begin to pull up the shutters and prepare to re-open. Given that last April, the whole country was watching Tiger King in the first lockdown, it shouldn't be difficult to beat last year's performance.

We expect full year revenue to 31st March 2021 to be around **£9.5m**(2020: £15.6m). Whilst that's a significant fall in product sales, income from subscription fees and services was steadier. We expect our gross profit to be around **£5.6m**(2020: £8.0m) As a result, gross margin has increased as a percentage and we expect our net loss to be lower than last year. Proportionately, a greater part of our revenues derived from licencing, subscription and service income in the Year than they did in the year ended 31 March 2020. However, we didn't get to where we wanted to be. Cash at 31 March 2021 was **£2.7m**(2020: £1.1m).

So what now?

Grafenia is essentially two businesses: a manufacturing business and a Software-as-a-Service ("SaaS") business. We've begun reorganising our internal reporting and simplifying our group structure. We'll now start reporting the two business units independently.

Business one: Works Manchester

We manufacture print and signage for clients in our main hub. Last year, we blended two factories into one. They're known internally as "Works Manchester". By combining two factories and restructuring, we significantly reduced our revenue breakeven point. However, we lost money in the manufacturing business in the second half. Life in the print sector is tough and it got tougher. Prices continue to fall and costs are rising. Every print business has high fixed overheads. When volumes decline, like they have done in the pandemic, profits disproportionately erode.

Like many businesses who export to the EU, we've faced increased shipping costs since leaving the single market and customs union on 1st January 2021. Despite our systems being ready to handle commodity codes and commercial invoices, we still continue to experience customs delays and disruption. Although product sales to Europe are a very small part of our revenues, we don't like to let our clients down. In December 2020, we began producing some orders in France, using local Works Makers connected to our platform. It's likely that more products sold in mainland Europe will be manufactured by third party Works Makers. Any printers or manufacturers interested in supplying specialist products to our network can register interest at www.nettl.works

The Works Manchester business includes our trade channel Marqetspace.com, as well as Image Group, our direct sales team. Revenue in this segment was approximately **£3.9m** for the year just ended (2020: £7.3m).

Works Manchester has been fighting with one arm tied behind its back. As a tightly integrated supplier to our network, its primary focus has been making what our partners sell. Since the pandemic began, those product sales have been impacted and our Nettl partners have sold more digital services to clients. That's meant Works Manchester is operating well below capacity.

By separating reporting, and refocusing our team, we're giving Works Manchester a new freedom. The business will be free to look for opportunities to fill capacity, from outside of our network. That might be by forming new strategic relationships or just being more nimble and opportunistic. We now have a dedicated team focused on sales development for this unit.

Business two: Nettl Systems

When you think about what used to be "the printer at the corner", it's now an integrated graphics business. *Or it's gone*. Online printers have played a role in that transition. However, the high street design business has not vanished. Far from it. It had to adapt and serve customers better by being a purveyor of solutions as opposed to products.

Grafenia's answer to this trend was to establish Nettl - the toolkit to run a neighbourhood graphics business. That format has been a success - not only in the UK but also in other countries. The Nettl platform helps design studios run their businesses more effectively. To do more for clients and get more from relationships. Over the past six or so years, Nettl has grown into a profitable business. In the second half, our subscription licence fee income was steady.

Revenue from our Nettl Systems segment was **£5.6m** for the Year (2020: £8.3m). That includes software licences, subscriptions, revenue from our five Nettl company stores and sales of products and services to Nettl "brand" partners.

A few years ago, we made a core strategic choice to acquire signage firms to expand our product mix. The logic was, and still is, compelling. A Nettl partner has more products to help solve problems for a client. *Solution-provider* not *product-seller*. Since we first started adding signage capabilities, that product range has become an important part of our offering. Nettl is better because we can provide signs.

We've also added other adjacent product lines to the offering. They all play into the strategy of Nettle: having more arrows in the quiver to solve clients' problems. Interestingly, most of these categories - take search engine optimisation (SEO) as an example - did not require us to buy a supplier. Rather we were able to source, integrate and quality control a third-party supplier. Our partners buy from us, because they like the centralised aspect. They like the convenience of an integrated offering within the operating system. They like inspiration on how to sell these products and the arsenal of marketing they can put to work.

Time to reflect

When Covid19 happened, it made us rethink our whole supply chain. Travel was restricted and the idea of running a lot of different sign production hubs throughout the UK became, well, less appealing. Also, 'necessity' became a virtue. We wanted to include more suppliers into our supply chain - partly driven by the need for including personal protection equipment in our offering. And do it quickly.

The software behind Nettle - which we refer to as w3p Flyerlink - turned out to be optimal for integration of third-party suppliers. We call them "Works Makers". We did the work to give these niche suppliers the tools to list, make and ship orders within our platform.

As we've done that, it has raised the question of whether we really need to buy signage capacity to achieve our goal of enriching our product offering. We can source it from quality suppliers and still increase the value Nettle provides to our partners. Do we need to own more machines in a warehouse in the Midlands?

Why did we want to buy signage businesses in the first place?

Besides the industrial logic, there was a second reason we liked buying signage firms. In fact, it looked like small-to-medium sized signage firms could be bought at below 5x EBIT (what we think of as a good acquisition price for a stable business). Allocating capital at such a valuation would make a compelling case to either deploy free cash flows or to raise more capital. Any business that deploys substantial amounts of capital at 5x sustainable EBIT will thrive. Needless to say, life is simple in Excel and in real life EBITs are not numbers, but the fruits of hard labour and happy customers. We thought we could be a platform for both and facilitate sign acquisitions.

We are happy with Image Group, our first acquisition in the space. Since acquisition, we've moved most of the team into our core production hub and numbers have held up alright. We make in EBIT what we thought of as our "low case" at acquisition. Certainly not something to be smug about, but also not a disaster.

On the other hand, we have not been successful in finding more signage firms that meet our quality and price threshold. We bought several smaller ones - acquisitions we would do again - but none of them really moved the needle. Nonetheless, we are not unhappy about the outcome. The integration of Image Group - whilst successful - showed the immense management attention and work required to grow a physical production footprint by way of M&A.

We've learned a lot about the sign survey, manufacture and installation process. In 2020, a large part of our R&D has been extending our platform to do this more effectively. Connecting clients, with design studios, sign makers and installers. Now, we think the right approach is to licence the software and systems we've built to other sign businesses. And to achieve our aim of providing national installation, by licencing our technology, rather than filling a shopping cart with beige machines.

So what of acquisitions?

We will double down on the software part of Grafenia. With Nettle + w3p Flyerlink we own a pretty nice little nucleus: a profitable, entrenched and appreciated software business. Now we're looking to acquire other software businesses to complement our group, under the plc umbrella. We're not starting from zero - because we already own one such software firm.

When we talk about software companies, maybe you think of artificial intelligence or blockchain or underwater facial recognition or something exciting and dangerous. The reality is, in business today, software is much more boring. But also much simpler. In the wider world, lots of roles will be automated and taken over by some form of software. Twenty years ago, it was Excel replacing pen and paper. Nowadays it's some vertical-market software replacing, or adding to, Excel. In the end, niche vertical-market software doesn't win because it has some kind of amazing tech inside. It wins, because it's very well-tailored to the very specific needs of a very specific audience.

We've updated our target acquisition profiles at www.grafenia.com/acquisition - we'd welcome businesses to start a conversation by emailing letmein@grafenia.com

Outlook

The road to economic recovery looks a little hazy. Are those sunlit uplands? Or did someone start a fire in the top field? Tricky to say. We made significant and permanent reductions to our overhead base during 2020, to reduce our breakeven point.

There's lots of reason to believe our clients will reopen to increased demand. Events will restart. Diners will feast. Drinkers will sip, or gulp. And when they do, we'll be ready. In hundreds of neighbourhoods, ready to design. To make. To ship. All using our software platform to smooth the process.

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