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EXPERT SYSTEM *update* *Italy* *FTSE AIM Italia* *Technology*

Rating: HOLD (Buy) Target Price: € 1,58 (previous € 2,28) Risk: Medium (Unchanged)

Stock Performance	1M	3M	6M	1Y
Absolute	-19,7%	-25,9%	-24,4%	-27,1%
vs FTSE AIM Italia	-19,2%	-24,9%	-41,5%	-56,6%
vs FTSE All-Share	-23,5%	-34,8%	-44,1%	-68,5%

Stock Data (del 05/04/2017)	
Price	€ 1,349
Bloomberg Code	EXSY IM
Market Cap (€m)	37,3
EV (€m)	44,0
Free Float	65,66%
Share Outstanding	28.030.953
52-week high	€ 2,06
52-week low	€ 1,30
Company Agenda	n.a.

Key Financials (*€m*)	2016A	2017E	2018E	2019E
Value of production	29,6	29,8	31,6	35,8
EBITDA	-2,25	-2,10	3,20	5,88
EBIT	-8,55	-8,47	-3,32	-0,60
Net Profit	-8,13	-8,78	-2,46	0,70
EPS	n.a.	n.a.	n.a	0,02
EBITDA margin	-7,6%	-7,0%	10,1%	16,4%
EBIT margin	-28,9%	-28,4%	-10,5%	-1,7%
CAGR Sales	33,7%	n.m.	7,2%	13,1%
CAGR EBITDA	n.a.	n.a.	n.a	90,0%

Main Ratios	2016A	2017E	2018E	2019E
EV/EBITDA	n.a.	n.a.	13,7 x	7,5 x
EV/EBIT	n.a.	n.a.	n.a.	n.a.
P/E	n.a.	n.a.	n.a.	53,2 x
NFP/EBITDA	n.a.	n.a.	5,8 x	3,3 x

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Company Profile

Expert System is a leader in the Cognitive Computing and Text Analytics. Expert System developed software that extracts meaning from unstructured, text-based natural language by understanding the components of a sentence and the context in which the text is appearing. The semantic software has a variety of potential applications (social media analytics, advertising, advanced enterprise search, etc.). Expert System has offices in Italy, France, UK, Germany, Spain, Canada and US.

1H17 Results and FY17-19F expectations

1H17 results are lower than our forecast. Sales declined by 11,2% compared to 1H16 to €11,7 mln (19% vs our forecast). Ebitda was negative for €4 mln (€-2 mln in 1H16 vs positive for €1,2 mln of our forecast). Sales reduction is primarily due to different revenues mix: increase in annual licenses sales against perpetual. This is consistent with the company's future strategy driven by the increase in the recurring component of revenues. The future strategy is also focused on increasing sales overseas, which is also confirmed by the performance of sales in 1H17, where this component has reached about 62% (+29% on 1H16) or €5,2 mln (€4 mln in 1H16). In the light of 1H17 results, taking into account Expert's management strategy and waiting for a new business plan, we reduce our expectations for 2017-19F. In other words, we believe that FY17F could be still a transition year. From 2018F, and even more since 2019F, we believe that the Expert System group could be able to express a sustainable profitability (Ebitda margin) similar to that of the last 10 years and above 20%. Our estimates for the 2019E will reach an Ebitda margin of 16,4% (21,7% our previous estimate).

Valuation Update

We value Expert System through the DCF and multiple methods. Each valuation methodology is able to capturing one or more aspects of a company's life: economic, equity, cash flow, and a comparison of listed companies operating in the same sector. For these reasons, we believe that the right mix of different valuation can better catch the fair value of a company such as the Expert System characterized by some peculiarities (cash flows, management quality, operating sector etc). DCF equity value result of €51,9 million. Multiple method result of €48,7 (at this value, we applied a 25% discount to take account of lower liquidity, reaching an average value of € 36,6 million). The average equity value, which is our target price, amounts to € 44,2 million. Our target price is €1,58 per share (from € 2.28 in the note of 4/5/2017). Thus, we change our rating to Hold (from Buy). Unchanged the medium risk.

Summary

1. 1H17 Results

1.1 Our forecast vs 1H17 actual

1H17 results are lower than our forecast. Sales declined by 11,2% compared to 1H16 to €11,7 mln (19% vs our forecast). Ebitda was negative for €4 mln (€-2 mln in 1H16 vs positive for €1,2 mln of our forecast).

Fig. 1 – 1H17A results vs our 1H17 forecast and 1H16

	1H17 A	1H17 F	% Ch	1H16	% Ch on 1H17 A
Production value	11746	14500	-19,0%	13234	-11,2%
Ebitda	-3982	1200	n.m.	-1898	n.m.
Ebitda margin	*n.m.*			*n.m.*	
Ebit	-7295	-2000	n.m.	-4844	n.m.
Ebit margin	*n.m.*	*n.m.*		*n.m.*	*n.m.*

Source: Expert System e Integrae SIM

Sales reduction is primarily due to different revenues mix: increase in annual licenses sales against perpetual. This is consistent with the company's future strategy driven by the increase in the recurring component of revenues. The future strategy is also focused on increasing sales overseas, which is also confirmed by the performance of sales in 1H17, where this component has reached about 62% (+29% on 1H16) or €5,2 mln (€4 mln in 1H16).

Operating costs and payroll are under control (the management are working for further reduction of about €2,5 – 3 mln), despite that the company is managing companies around seven countries, is standardizing business procedures and commercial approaches (also with people turnover) after recent acquisitions.

Expert's management expect for FY17 to reach a results in line with FY16, but with a higher incidence of recurring revenues and expectations of growth mainly in US (management expectation +20%) and also in Europe (Spain +40%, UK +300%).

Net debt rose to €13,8 mln compared with €11 mln of FY16, mainly due to investments of €3 mln.

On 3 August, the Company obtain the qualification of Innovative SMEs from Trento Chamber of Commerce. Thanks to this qualification, which recognizes the company's broad propensity towards technological innovation in the evolution of their business model, investors will benefit from tax incentives provided by the "2017 Stability Law".

1.2 2017-19F industrial plan and our forecast

Expert's management said that they “”continue the group internationalization with growth expectations in particular in the US but also in Europe, where it could be possible to obtain the results of the great commitment for the development and management of these markets. Likewise, a progressive remodeling of the mix of revenues for licensed components of recurring nature and reducing the component of professional services also through the creation of new partnerships with industry leaders in the field ICT.

The commercial strategy will finally strengthen its presence on products and customers characterized by broad potential for development with particular reference to banking and where the Group has successfully implemented projects and case histories. The mix between market development and cost streamlining policy should allow Expert to focus on the progressive recovery of a margin starting next year, after a necessary period of great expansion, which allowed them to place the company among the leaders at international level in the field of artificial intelligence applied to cognitive computing.

In the light of the results of the first half, it is considered, with reference to the Industrial Plan 2017-2019, that for the current year, revenues will go around the 2016 values, resulting in a sliding of the plan need to update target targets for subsequent years".

In the light of 1H17 results, taking into account Expert's management strategy and waiting for a new business plan, we reduce our expectations for 2017-19F as follow:

Fig. 2 – Old and new 2017-19F expectations

	FY17F			FY18F			FY19		
	Old	**New**	**% Ch**	**Old**	**New**	**% Ch**	**Old**	**New**	**% Ch**
Production value	34,5	29,8	-13,6%	41,4	31,6	-23,6%	54,0	35,8	-33,7%
Ebitda	3,6	-2,1	-158,4%	7,3	3,2	-56,1%	11,7	5,9	-49,8%
Ebitda margin	*10,4%*	*n.m.*		*17,6%*	*10,1%*		*21,7%*	*16,4%*	
Ebit	-2,7	-8,5	n.m.	0,9	-3,3	n.m.	5,2	- 0,6	n.m.
Ebit margin	*n.m.*	*n.m.*		*2,2%*	*n.m.*		*9,6%*	*-1,7%*	

Source: Expert System e Integrae SIM

We substantially postpone 2017-19F plan expectation of about 1 year.

The industrial plan 2017-19F, which aims to further enhance the geographical diversification of the group and to capture the results of the important growth path that has been pursued over the last two-three years.

The foreseeable growth is therefore based in particular on the development of foreign markets, where the company believes that there are large growth margins both for the size of the markets (higher than the Italian one) and for the growth rates expected by the major and most important analysts of the industry.

The progressive creation of products and solutions and their replicability on various market segments, we believe it can also lead to a significant increase in the percentage of software and maintenance licenses that will affect the recurring component of the same turnover.

In 2017, considered the substantial stability of sales compared to FY16, we believe that Ebitda may decline to -€2,1 mln (€2,2 mln in FY16).

In other words, we believe that FY17F could be still a transition year, where a large part of the investments made in recent years would not begin to benefit both Ebitda and Ebit margin, that would remains negative also due to heavily D&A (depreciation and goodwill amortization).

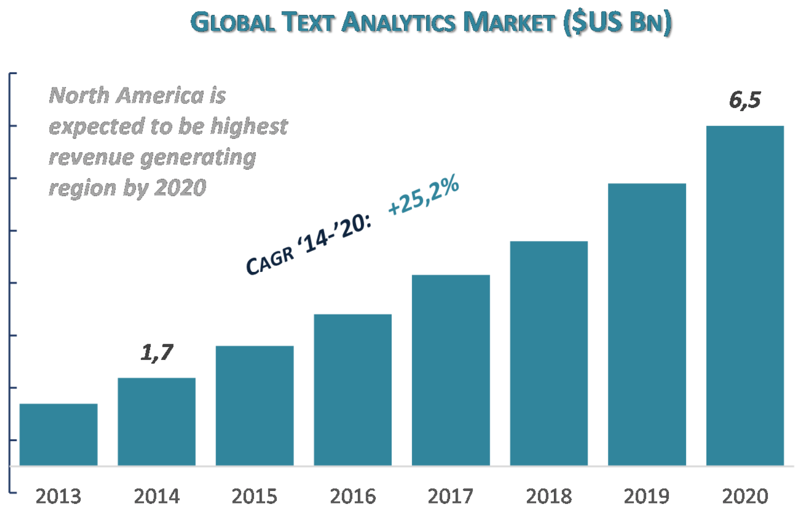
From 2018F, and even more since 2019F, we believe that the Expert System group could be able to express a sustainable profitability (Ebitda margin) similar to that of the last 10 years and above 20%. Our estimates for the 2019E will reach an Ebitda margin of 16,4% (21,7% our previous estimate).

We also estimate an improvement in operating cash flow. The improvement that we think would also be tied to the reduction in average payment times on foreign markets being much shorter than Italy. Moreover, thanks to the completion of the process of integration of foreign branches, we are also believe that the group could benefit from significant economies of scale, benefiting both gross and net margins.

Our estimates are also based on the expectations of increasing the artificial intelligence market:

- Text Analytics. According to the World Text Analytics Market - Opportunities and Forecasts, 2013-2020, a CAGR 2014-20F is expected to be 25.2% per industry, with the market expected to reach 2020 by US $ 6.5 billion versus US $ 1.5 billion in 2014;

Fig. 3 – Text Analitycs market



Source: World Text Analytics Market – Opportunities and Forecasts, 2013-2020

- Cognitive System. We believe that the widespread adoption of cognitive and artificial intelligence systems in a wide range of industries worldwide will drive revenues from nearly US $ 8.0 billion in 2016 to more than US $ 47 billion in 2020 (CAGR + 55%). The sectors that have invested more in cognitive systems in 2016 are banking and retail, followed by health and manufacturing (these four sectors generated more than half of the cognitive system revenue in the world in 2016). North America (USA and Canada) are by far the world's largest cognitive-expenditure region, with 2016 sales close to $ 6.2 billion. Europe, the Middle East and Africa (EMEA) will remain the regions with the second largest global spending even in 2020F. This is why this Expert System has decided to invest heavily in the US.

We believe that Expert System is currently able to attacking a growing part of the entire market.

Thanks to R & D investments, Expert System has been included in the "Forrester Wave ™". The sample analyzed by Forrester Wave ™ has about 200 suppliers in the Big Analytics Market Analytics segment. The competitive view taken by Forrester Wave ™ in the "Big Data Text Analytics Platforms, Q2 2016: The 10 Providers", includes multinational groups with significant critical mass and much greater size (HP, SAS, IBM) than Expert Systems, The only European company included in the "Forrester Wave ™".

In addition, Gartner, one of the leading consulting and market analysis consultants in Information Technology, has selected Expert System for the first Magic Quadrant dedicated to enterprise search and analysis applications (Gartner in the 2017 Insight Engines Magic Quadrant).

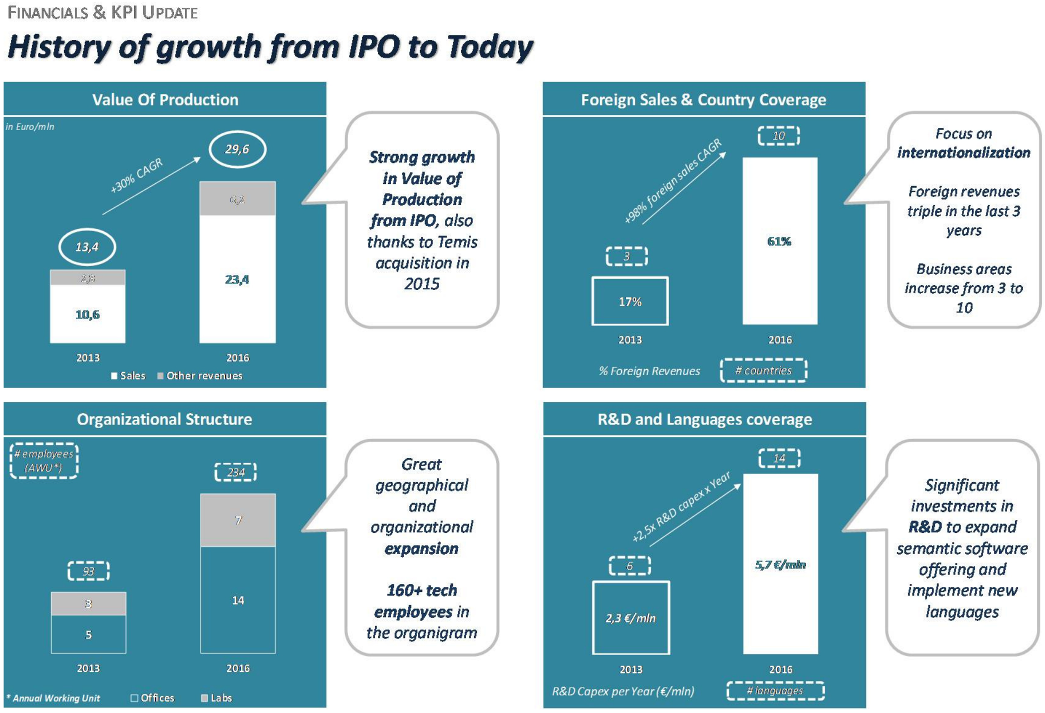
The companies currently present in both research (Forrester Wave and Gartner) are three: Expert System, HP and IBM.

We made the following assumptions based on the new consolidated estimates and the acquisition of TEMIS:

- Sales force: strong attention to foreign markets, especially the United States and Germany. In order to strengthen the Group's position and increase market penetration, we expect the increase of an indirect sales force dedicated to COGITO's sales activities to third-party distributors;
- Costs: We estimate a significant increase in staff costs (direct sales). The focus of R & D in the coming years will be adressed to standardize products in order to reduce integration activities. In FY16F Expert System increased international sales force (United States and Germany), project managers and software developers;
- Investments: We expect about € 5 million of R & D annual investments for 2016-21F to levelled off the quality of other languages (eg Mandarin, Japanese and Korean) and continue to develop Cogito and his characteristics. In addition, we do not exclude the possibility of future acquisitions in order to increase our customer base and / or enter new markets.

Expert System is today different from one in 2005-13. The significant and important investments made has been able to create a leading group on the European market, with a technology capable of competing globally in the field of cognitive computing. We believe that Expert System would have encountered greater difficulties in developing with smaller investments and it could not have the size to be able to talk to current customers.

Fig. 4 – From IPO to 2016



Source: Expert System

2. Economics & Financials

Fig. 5 – FY16 and 2017-19 forecast

P&L (€/000 data)	2015A	2016A	2017F	2018F	2019F
Total Sales	16.564	22.198	23.296	24.959	29.004
VALUE OF PRODUCTION	**22.647**	**29.553**	**29.815**	**31.638**	**35.797**
Total Costs	(21.445)	(31.798)	(31.917)	(28.434)	(29.921)
EBITDA	**1.201**	**(2.245)**	**(2.102)**	**3.204**	**5.876**
Ebitda margin %	*5,3%*	*-7,6%*	*-7,0%*	*10,1%*	*16,4%*
Depreciation & Amortization	(5.238)	(6.304)	(6.368)	(6.526)	(6.473)
EBIT	**(4.036)**	**(8.549)**	**(8.470)**	**(3.321)**	**(597)**
Ebit margin %	*-17,8%*	*-28,9%*	*-28,4%*	*-10,5%*	*-1,7%*
NET INCOME	**(3.284)**	**(8.126)**	**(8.775)**	**(2.462)**	**701**

A&L (€/000 data)	2015A	2016A	2017F	2018F	2019F
Total Assets	24.051	24.540	22.686	21.307	20.090
Working Capital	9.182	4.696	116	3.043	5.793
Total Provisions	(1.443)	(1.699)	(1.979)	(1.303)	(1.239)
INVESTED CAPITAL	**31.790**	**27.537**	**20.823**	**23.047**	**24.644**
Equity	(20.718)	(16.437)	(6.249)	(3.787)	(4.488)
Net Debt	(11.072)	(11.100)	(14.574)	(19.260)	(20.155)
of which Bond	*(5.000)*	*(5.000)*	*(10.000)*	*(10.000)*	*(10.000)*
TOTAL FUNDS	**(31.790)**	**(27.537)**	**(20.823)**	**(23.047)**	**(24.644)**

Cash flow (€/000 data)		2016A	2017F	2018F	2019F
EBITDA		(2.245)	(2.102)	3.204	5.876
Cash flow from Operating activities		2.175	3.109	1.243	5.032
Cash flow from Investing activities		(6.789)	(4.514)	(5.147)	(5.256)
Net cash flow from Operating activities		**(4.613)**	**(1.405)**	**(3.904)**	**(223)**
Cash flow from Financing activities		2.389	(2.768)	(4.225)	(3.604)
Net Increase / (Decrease) in Cash		(2.224)	(4.173)	(8.129)	(3.827)
Cash at the beginning of the period		12.595	10.371	6.198	(1.931)
Final cash position		**10.371**	**6.198**	**(1.931)**	**(5.758)**

Source: Expert System e stime Integrae SIM

3. Valuation

We value Expert System through the DCF and multiple methods. Each valuation methodology is able to capturing one or more aspects of a company's life: economic, equity, cash flow, and a comparison of listed companies operating in the same sector.

For these reasons, we believe that the right mix of different valuation can better catch the fair value of a company such as the Expert System characterized by some peculiarities (cash flows, management quality, operating sector etc).

3.1 DCF valuation

The results of the DCF method are a function of estimate and variables, including business visibility. Visibility that, in the case of Expert System, allows you to extend the time horizon up to 2021F when the profitability of the projects and the impact of TEMIS acquisition, will be fully visible. For this reason, thanks to the DCF method we can capture some aspects of the business that the ratio analysis would not be able to approximate.

Fig. 6 – Input Data

Wacc calculation	
Risk Free Rate (Bank of Italy - average rendistato)	0,57%
Market Premium (Damodaran)	7,95%
Beta Unlevered	0,91
Tax Rate (Ires + IRAP)	27,90%
D/E (average)	61,87%
Beta Relevered	1,97
Alpha (specific risk)	2,50%
Ke	18,77%
Wacc	8,94%

Source: Integrae SIM

We took the parameters in the previous table based on the following assumptions:

- the risk free rate is the gross yield of the Bank of Italy) of the Series with maturities between 4 years and 7 months and 6 years and 6 months for the period October 2016 - September 2017;
- The market premium is that calculated by Prof. A. Damodaran for Italy, equal to 7.95% (Update January 2017);
- The Beta levered of 1.9x.
- The "g" growth rate used for calculating the Terminal Value is conservatively equal to 1%;
- For the calculation of terminal value, the median value 2020 and 2023 were prudently used;

- Alpha, or specific additional risk, typical of equity investments in companies characterized by small operating sizes. As small as it is, the additional small cap risk was assumed to be 2.5%.

This results in a WACC of 8,94%.

Fig. 7 – DCF Model

Cash Flow	2017	2018	2019	2020	2021	2022	2023	TV
EBIT	***- 8.470***	***- 3.321***	***- 597***	***2.249***	***8.380***	***11.554***	***15.020***	
Operating Taxes	2.363	927	167	(627)	(2.338)	(3.223)	(4.190)	
NOPLAT	(6.107)	(2.395)	(430)	1.621	6.042	8.330	10.829	
Depreciations	6.368	6.526	6.473	6.366	6.460	6.627	6.893	
Δ NWC	1.949	(4.159)	(2.756)	4.597	(2.248)	(1.498)	(1.500)	
Investments	(4.514)	(5.147)	(5.256)	(5.415)	(5.865)	(5.940)	(3.500)	
FCFO	**(2.304)**	**(5.175)**	**(1.969)**	**7.170**	**4.390**	**7.520**	**12.722**	**100.188**
Discounted FCFO	**(2.115)**	**(4.361)**	**(1.523)**	**5.091**	**2.862**	**4.500**	**6.988**	**55.034**

FCFO actualized	*11.441*
TV actualized DCF	*55.034*
Enterprise Value	***66.476***
NFP (2017)	*(14.574)*
Equity Value	***51.902***

Source: Integrae SIM

With the above data and assumptions, we have an Expert System equity value of € 51,9 million.

Fig. 8 – Sensitivity Analysis (Wacc – Long Term Growth)

		WACC						
		7,44%	**7,94%**	**8,44%**	**8,94%**	**9,44%**	**9,94%**	**10,44%**
	2,5%	95,8	83,5	73,3	64,7	57,4	51,1	45,6
	2,0%	86,8	76,3	67,4	59,8	53,3	47,7	42,7
	1,5%	79,3	70,2	62,3	55,6	49,7	44,6	40,0
TV	**1,0%**	73,0	64,9	58,0	51,9	46,6	41,9	37,7
	0,5%	67,6	60,4	54,2	48,6	43,8	39,4	35,6
	0,0%	63,0	56,5	50,8	45,7	41,3	37,3	33,7
	-0,5%	58,9	53,0	47,8	43,2	39,0	35,3	31,9

Source: Integrae SIM

3.2 Ratio valuation

Our sample is made up of companies operating in the same sector as Expert System with a higher capitalization.

These companies with multiples for the period 2017-20F (Source Infinancials). The Expert System value for 2017 was excluded from the calculation due to its poor significance. The equity value of the ratio valuation methodology is the average of each single ratio for each individual exercise.

Fig. 9 – Comparables

Company	EV/Sales				EV/Ebitda				EV/Ebit				P/E			
	2017F	2018F	2019F	2020F	2017F	2018F	2019F	2020F	2017F	2018F	2019F	2020F	2017F	2018F	2019F	2020F
Ellie Mae Inc.	7,4	6,1	5,0		25,5	19,7	15,1		37,2	28,2	22,6		66,7	53,4	40,4	
Imperva Inc.	4,0	3,4	2,9		31,5	22,6	17,4		42,3	30,3	24,0		57,7	48,1	39,4	
Splunk Inc.	6,2	5,0	3,9	3,2	55,4	38,4	25,1		77,4	48,9	29,0	22,4	120,0	80,8	49,5	39,7
Proofpoint Inc.	7,4	5,8	4,5	3,5	62,4	41,8	24,5		101,6	60,1	33,3	22,7	134,0	87,5	52,3	33,6
Qualys Inc.	6,0	5,1	4,3		18,1	15,2	11,7		24,8	20,8	17,4		48,1	42,1	34,7	
Adobe Systems Incorporated	9,4	7,8	6,7	6,0	22,4	18,6	15,7		25,1	20,6	17,3	15,4	34,0	27,8	23,0	20,4
salesforce.com, inc.	6,2	5,1	4,3	3,7	28,0	22,1	18,0	17,5	42,4	32,1	24,7	21,1	68,6	52,7	40,3	33,9
Open Text Corporation	4,1	4,1	3,7	3,2	11,5	10,5	9,9	8,6	11,8	11,2	11,3		13,5	12,4	11,2	9,1
Alphabet Inc.	6,3	5,4	4,6	4,0	12,8	10,8	9,2	7,7	21,4	16,3	13,7	11,7	30,7	23,6	20,0	16,3
Oracle Corporation	4,8	4,6	4,4		10,2	9,7	8,8		10,8	10,2	9,5		16,2	15,1	14,0	
Average	**6,2**	**5,2**	**4,4**	**3,9**	**27,8**	**20,9**	**15,5**	**11,3**	**39,5**	**27,9**	**20,3**	**18,7**	**59,0**	**44,3**	**32,5**	**25,5**

Source: Integrae SIM

The Expert System's equity value calculated using multiples methodology was € 48,7 million. At this value, we applied a 25% discount to take account of lower liquidity, reaching an average value of € 36,6 million.

The average equity value, which is our target price, amounts to € 44,2 million. Our target price is €1,58 per share (from € 2.28 in the note of 4/5/2017). Thus, we change our rating to Hold (from Buy). Unchanged the medium risk.

3.3 Final consideration

The results of the last two financial years are indicative of a company strongly committed to important investments aimed at completely changing the future. The strong demand in the digital treatment / understanding of texts and artificial intelligence, increasingly derived from several production sectors, we believe will enable Expert System in the next few years to increase the profitability of what has become the largest European group operating in cognitive computing.

The growing understanding of mass phenomena in an increasingly digital and more and more connected world we are convinced will be a key success factor for those companies that will address strategic investments in cognitive computing and artificial intelligence.

Artificial intelligence that is now everywhere, thanks to the expansion of machines that take advantage of deep learning skills. Deep learning that promises to become ubiquitous even in the scientific sphere. For example, future radio astronomers will need to find useful signals in the otherwise unmanageable data of their data; Gravity wave detectors will use it to identify and eliminate the smallest sources of noise; and publishers will use it to sift and "tag" millions of articles and scientific books.

Expert System we believe will be able not only to take advantage of the growing demand expected but also to act as aggregator pole for the companies in the industry.

Disclosure Pursuant to Article 69 Et seq. of Consob (Italian Securities Exchange Commission) Regulation No. 11971/1999

Analyst/s certification

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The table below, shows INTEGRAE SIM's recommendation, target price and risk issued during the last 12 months:

Date	*Recommendation*	*Target Price*	*Risk*	*Comment*
29/11/16	*Buy*	*2,38*	*Medium*	*1H16 Results*
18/1/17	*Buy*	*2,38*	*Medium*	*Esri Operation*
4/5/17	*Buy*	*2,28*	*Medium*	*FY16 Results*
3/8/17	*Buy*	*2,28*	*Medium*	*Innovative SME*

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Equity Total Return (ETR) for different risk categories			
Rating	Low Risk	Medium Risk	High Risk
BUY	ETR >= 22,5%	ETR >= 25%	ETR >= 30%
HOLD	-20% < ETR < 22,5%	-20% < ETR < 25%	-15% < ETR < 30%
SELL	ETR <= -25%	ETR <= -20%	ETR <= -15%
U.R.	Rating e/o target price Under Review		
N.R.	Stock Not Rated		

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