Let's Gowex: Confusing

Recommendation: SHORT

Price: €20 | **Price Target**: €3 | **Forecast Return**: 85% | **Market Cap**: €1.5bn
Valuation Metric: FCF yield | **Current Multiple:** 150x | **Target Multiple:** 10x 2015.

- **Not clear to us what the business does or how it makes money.**
- **Valuation in the stratosphere. Riding the tailwind of hype in technology/internet.**
- **Some strange claims being made in published materials. Reality highly unlikely to match expectations.**
- **More due diligence to be conducted but important to put the idea out for discussion.**

Some reasons we are sceptical

1. We don't really understand where/how the company makes money. The company can't explain it very well and the disclosure is very opaque. Most of the revenue probably comes from offloading of data for telecom operators, which can become increasingly competitive as more players enter the market in land grab mode.

2. Valued on 10x Price/Sales and 160x free cash flow. Stock has been huge and has been hyped up in the last six months.

3. Highly promotional and confusing investor materials, with very little detail in presentations and reports.

4. Numerous red flags in the accounts around cash conversion, cost items and balance sheet.

5. Bad user experience on our recent research trip to Madrid. App reviews are mixed at best.

6. Appears to be a small business with a few employees doing too many things at the same time all around the world. Many of the deal announcements are of partnerships, where the economics between the two parties are unclear.

7. Stock can be de-rated alongside the broader correction in technology, as the market focuses on weaker business models.

8. Revenue growth probably peaked in H2.

Background & Summary

We've been examining Let's Gowex in recent weeks, as the stock reached a market capitalisation of €1.8bn, or 10x Price/Sales. We remember Solaria, from the solar bubble in 2007 and can draw some similarities here, where an equity story is promoted locally and the big picture idea captures the imagination of investors against limited liquidity and free float.

Gowex's WiFi business model is different as they are not seeking to monetise the WiFi user directly, unlike the known names such as Boingo, The Cloud or Virgin Media, who charge for access to a WiFi network. This makes it interesting, but other players are changing their own models accordingly and this will lead to competitive pressure.

Industry in Land Grab Mode, Commoditisation Likely

Let's Gowex are building and operating WiFi networks worldwide, sometimes building them themselves, sometimes subcontracting, sometimes operating a network someone else has built and sometimes partnering with another WiFi provider or telecom operator. This platform is planned to reach 300 cities by 2020 (from 84 today) and Gowex plan to make money selling advertising, social services for metropolitan councils and offloading/roaming services for telecom operators.

At the same time, Google, Facebook, Microsoft and Cisco (amongst others) are rolling out their own networks, which will disintermediate telecom operators in due course. Google signed an agreement with Starbucks (starting in San Francisco) to operate 7,000 hotspots across the USA in the first phase. Microsoft want to provide connectivity for cloud access, whilst Facebook have physical limitations on usage in the US due to scarcity of bandwidth – they want to provide WiFi so people can spend more time on Facebook. Let's Gowex are up against some big hitters.

The smaller WiFi operators such as Boingo, or even small, local private networks, typically tried to charge consumers for access and speed. This model is no longer viable and the revenue model has to change. Gowex are ahead of the curve with their model, but others are catching up.

Investor Materials are Confusing

This slide from the investor presentation shows Gowex on Calle Goya in Madrid, with the logos from H&M, Santander and Starbucks, demonstrating their We2 product. However, when we asked for more details about Calle Goya and these clients, we were told that the slide is just for illustration, and these companies are not actually clients.

Source: Let's Gowex investor presentation

The business generated €114m of revenue in 2012, with just 80 employees, of which 30 are graduates. Over the last two years, the company appears to have generated revenue in at least 20 different countries, announced contracts with numerous different partners, has built/partnered in 84 wireless cities, undertaken engineering work, sold advertising, provided roaming and offloading services to telecom operators and continued running the telecom business. In addition, they have conducted a share split, additional share listings in Paris and New York, secured vendor funding agreements with Cisco, Huawei, ZTE, CBS Outdoor and JC Decaux, launched various smartphone applications and developed new business lines such as 'We2', 'WiLoc', 'NetVertiser; and 'Wifluence'.

However, the staff costs in 2012 were just €2.8m (growing to our estimate of €4.6m in 2013). We question whether such a small team can realistically strike and support so many deals around the world without cracks beginning to appear.

Gowex reported in mid-March 2014 that they had exceeded sales guidance for 2013, and they are not due to report full year financials until the end of 2014.

What Does Let's Gowex Really Do?

Gowex historically made profits in the Gowex Telecom division, providing brokering of wholesale telecom capacity in Spain. As operators had requirements for additional bandwidth, or had excess bandwidth capacity, they bought and sold capacity through the Gowex platform. This business generated €6m of gross profit last year and is growing at +8-10% per annum. Revenue recognition policies on this division have been changed since the IPO.

The Gowex Wireless division has gone from zero to €160m revenue in 2013, as the company built out 84 wireless cities. We estimate Roaming & Offloading revenues are likely to account for €90-100m of this revenue, implying Gowex now makes most of the profits from the offloading of telecom operator data onto their owned/operated WiFi networks. However, when we spoke to Boingo, they told us that telecom operators were not yet paying for offloading in the USA, as consumer devices and networks are not ready to seamlessly move a 3G customer onto someone else's WiFi network:

- As 2G/3G/4G networks are capacity-constrained in urban areas, telecom operators choose to transfer data over WiFi networks and 'offload' their customers accordingly.
- We understand that Gowex has a number of telecom operators on a volume/price-based contract to provide offloading. As AT&T's name has appeared numerous times in the Gowex communications, we guess that AT&T is a customer in New York for offloading. However, it is not clear that your telco provider can offload you onto someone else's WiFI network, without you acknowledging it.
- Gowex claimed to us that in Spain, for example, Telefonica can go into your iPhone, switch on the WiFi chip without you knowing and move your data over a WiFi network, without you knowing, whilst the 3G symbol remains on the screen. We would like to further investigate this claim.

Gowex also seek to create consortiums of private operators to provide more extensive coverage of an urban area, beyond their own routers.

Gowex claims to have 1.8 million WiFi users worldwide, of which 5-7% buy premium speed services.

Disclosures and Guidance

In a local press article, the CEO disclosed to a journalist that they had received offers for 100% of the business. However, these offers were not disclosed to the stock market..

Gowex target coverage of 300 cities by 2020, are at 84 today and should reach 100-110 by the end of 2014. This will require significant capex on routers, and engineering. We asked the company and were told that they have 'no idea' on capex in the coming years, but it may have been something like €25-30m in 2013. There is no guidance in the coming years, but it should be funded by vendor financing, which is already agreed.

On the basis of 35-65% revenue growth for the next three years, the IR team from Gowex think the market capitalisation can reach €4-4.5bn.

Red Flags in Accounts

A number of issues in the accounts gives us concern as investors, and we would like to receive greater clarity from the company in these areas:

- **Telecoms revenue recognition:** At the IPO, Gowex recognised the gross revenue from the Telecom business (€48m in 2011), whereas the net revenue to Gowex (i.e. from brokerage fees, not total capacity brokered) was actually €20m. This realignment of revenue recognition makes sense in that it reflects the underlying economics of the business. However, at the time of IPO, revenue was presented on a larger scale.
- **Disclosure of revenue is poor:** Revenue is reported broken down by the two divisions: Gowex Telecom and Gowex Wireless. Beyond that it is guesswork as to what revenue comes from engineering projects, offloading and advertising. We know Spain was <50% of revenue in FY12 and 'recurring' income was €72m in FY12. However, the use of the term 'recurring' does not provide us with the level of clarity we would like, as it excludes engineering revenue, but it is unclear how much revenue is actually contracted (and we do not know the duration of contracts).
- **Very low employee costs:** Let's Gowex only recognised €2.8m of employee costs in 2012. This looks very low against the amount of activity undertaken and we would question its sustainability.
- **Insolvency provisions are high:** As at the end of 2012, there was a €9.4m insolvency provision in the balance sheet and €2.3m was charged to the P&L for credit impairment. We do not understand why this is so high (8% of sales) considering customers are large telecom operators and Gowex build pre-agreed contracts for municipalities. The company's explanation to us focused on the tax benefits of this provision, but we would like to understand more fully the reasons behind it.
- **Working capital consumption:** Free cash flow was negative in H1, despite 19% operating margins in the P&L. This was due to net change in provisions (€2.6m), net growth in receivables (€2.3m) and capital expenditure (€11.7m against depreciation of €4.4m).

- **No asset backing for the business:** Gowex has €75m net assets, of which €63m is cash. The business therefore has no assets of any substance to support it.
- **Revenue growth may have peaked:** H2 2013 revenue growth was ~70% and the IR team helpfully suggest 35-65% organic growth per year for the next three years is possible, with at least 50% as reasonable, but no guidance is being offered by the management team. Therefore, H2 was peak revenue growth and the second derivative has probably turned negative (rate of sales growth is slowing). In the past, we have found that second derivative of sales growth is useful on timing of shorts.

User Experience in Madrid was Bad

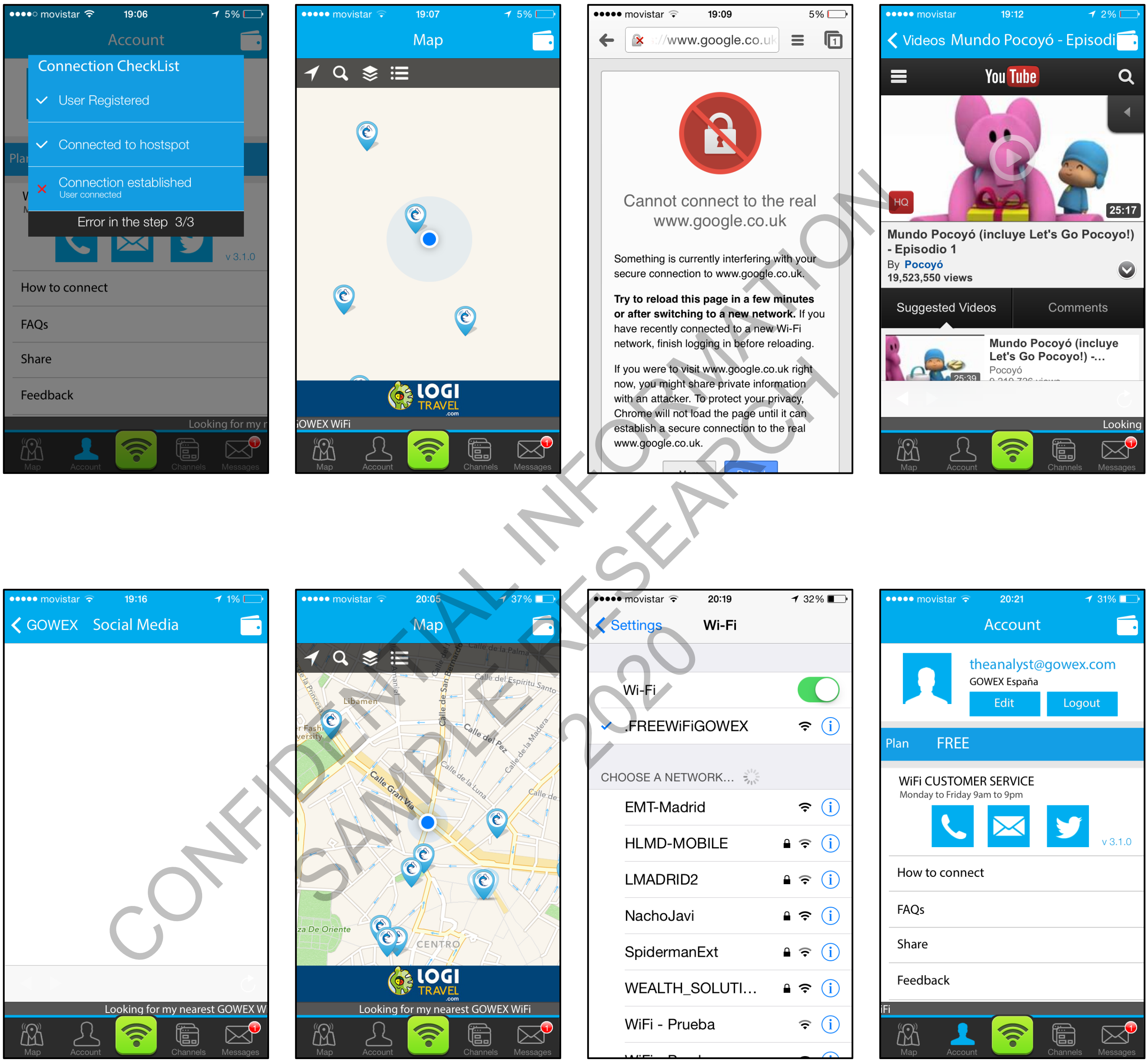
We walked for two kilometres down the Gran Via in Madrid for one hour and failed to log-on to Gowex Wifi. The photos and screenshots in the appendix anecdotally illustrate our bad user experience in Madrid. In fairness, our email enquiry to customer services was answered promptly the next day and the company advised that we should have logged on through the web browser as the app doesn't really work properly yet (!!!). Perhaps if we had phoned customer services, got a new password and tried through the web browser instead of the app we would have had more success. We will travel to Edinburgh and do a similar trial in due course as Gowex is now rolling out in Edinburgh as part of the Wireless city scheme. There is more due diligence to be undertaken here.

Valuation & Conclusion

Gowex now has a market capitalisation of €1.5bn after the recent round of hype in the local press. We believe timing is opportune for the following reasons:

- The size of the business and fundamentals will come under more scrutiny by serious investors as the stock gets onto the radar screen of mainstream European fund managers.
- Further coverage by bulge-bracket investment banks could support a higher share price and allow investors to build positions on further hype.
- The business may already have passed the peak growth rate in H2 2013, meaning the second derivative of sales growth is declining (a key indicator for timing on shorts).
- The broader tech rotation means excessive valuations will be difficult to maintain.
- The industry is likely to become commoditised as capacity is built.

<u>APPENDIX 1</u> – THE ANALYST'S EXPERIENCE OF LET'S GOWEX IN MADRID (MARCH 2014)



Source: The Analyst research trip to Madrid, March 2014

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