Technology

Source: Refinitiv

Market data

EPIC/TKR	**ASAI.SE**
Price (SEK)	**5.9**
12m High (SEK)	31.3
12m Low (SEK)	4.2
Shares (m)	43.2
Mkt Cap (SEKm)	255.1
EV (SEKm)	387.1
Free Float*	30%
Market	Nasdaq First North

**As defined by AIM Rule 26*

Description

Artificial Solutions is a leading global vendor of conversational artificial intelligence software to large multinational enterprises for their customer-facing activities and their internal operations. The company counts many of the largest enterprises in the world as customers. Similarly, partners include a number of large systems integrators and software vendors. Headquartered in Sweden, the company currently employees around 110 people.

Company information

CEO	Lawrence Flynn
CFO	Chris Bushnell
Chairman	Åsa Hedin
	+46 8 663 5450
	www.artificial-solutions.com

Diary

17 Jun	AGM
30 Jul	2Q'20 results
29 Oct	3Q'20 results
4 Feb'21	FY'20 results

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ARTIFICIAL SOLUTIONS

1Q'20 results: usage revenue starting to shine

Artificial Solutions continues to expand its customer footprint with large, multinational enterprises. 1Q'20 saw the addition of Deloitte Netherland as a customer for its own business (having delivered strong outcomes for its clients with the Teneo product), as well as a Scandinavian financial services provider, and a three-year extension with Swisscom worth SEK10.6m over three years. More than 80% of order intake came from systems integrator (SI) partners. Surging usage of the Teneo platform, based on transaction volumes, is a highlight – with this trend expected to persist.

- **Solid revenue and order intake growth in 1Q'20:** Net sales were up 21% YoY to SEK15.3m, while order intake was up 15% to SEK19.5m. New contract wins were accompanied by further additions to the SI partner base (Babel and CSG). The gross margin expanded 100bps YoY to 60%.

- **Usage revenue is a metric to watch:** As discussed in detail in our recent research reports, the shift to usage revenue within the mix is accelerating, as large customer deployments experience strong end-user volume growth. Overall transactions processed by Teneo more than quadrupled YoY in 1Q'20.

- **High revenue scalability:** Management has previously noted that individual large customers have the potential to scale to annual recurring revenue in excess of €5m each. An example cited is a major US telecoms customer that has seen broadband support volumes through Teneo treble in 1Q'20.

- **Growing visibility:** Despite the pandemic, order backlog increased, ending 1Q'20 at SEK56.4m (up from SEK40.9m at end-2019). 47% of backlog is expected to be delivered from 2021 onwards. The high usage revenue element resulted in a backlog gross margin of 82%, consistent with future margin expansion.

- **Investment summary:** Conversational Artificial Intelligence (AI) is a sweetspot in terms of enterprise digitalisation. Together with robotic process automation, it is a key element of a broader hyperautomation trend (a term coined by Gartner). Our DCF produces an equity implied fair value of €115m, while the most recent IP valuation analysis, undertaken in 2019, generated a patent valuation range of $125m to $153m.

Financial summary and valuation

Year-end Dec (€m)	2018	2019	2020E	2021E	2022E
Total income	6.1	6.5	10.4	15.5	21.5
Adjusted EBITDA	-9.8	-10.6	-5.3	0.3	4.5
EBITDA margin	-160%	-164%	-51%	2%	21%
EBIT	-11.6	-15.0	-6.5	-1.0	3.1
Pre-tax profit	-13.0	-17.2	-8.4	-2.8	1.5
Net income	-13.0	-17.2	-8.4	-2.8	1.5
EV/Revenue (x)	5.8	5.4	3.4	2.3	1.6
EV/Adj. EBITDA (x)	-3.6	-3.3	-6.6	124.7	7.8
EV/EBIT (x)	-3.0	-2.3	-5.4	-33.8	11.5

Source: Hardman & Co Research

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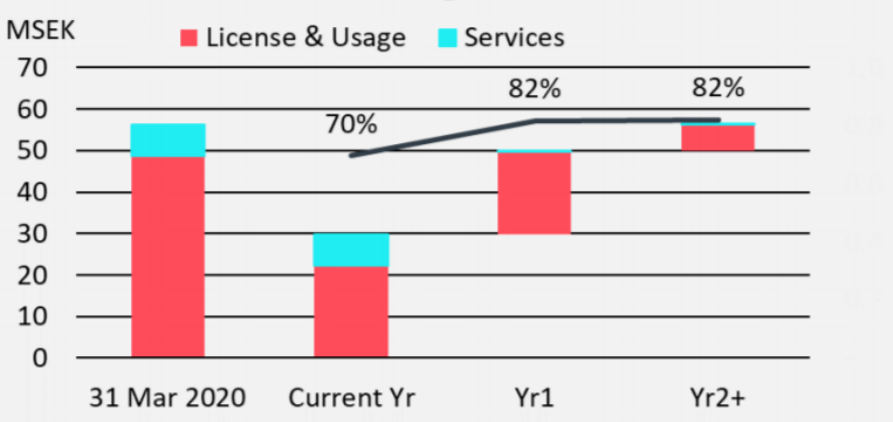
Usage revenue becoming key driver

Revisiting guidance

Artificial Solutions' management has added a further guidance metric, which is that usage revenue is expected to represent at least 80% of total revenue by the end of 2022. This is a major statement by the company, when considered in the context of the 16% of total revenue accounted for by usage revenue in FY'19. This guidance is inherently customer-driven. Usage revenue refers to the element of the pricing model that is dependent on the number of sessions, transactions, connections or period of usage. The specific details will be agreed with each individual customer, together with the pricing structure that will apply. Our current estimate is that usage revenue will represent 65% of total revenue by end-2022, although the data disclosed in the 1Q'20 presentation on transaction volumes suggest that this could prove to be rather conservative.

In terms of other guidance metrics, management continues to expect its growth to exceed the overall growth of the natural language processing market segment over the medium term, and remains confident that the gross margin from 2020 will exceed 70%. It is worth noting that the gross margin associated with backlog is 82%, with 53% of backlog due to be recognised in the current year.

Artificial Solutions – 1Q'20 order backlog as at March 2020



Source: Company data

Surge in transaction volumes

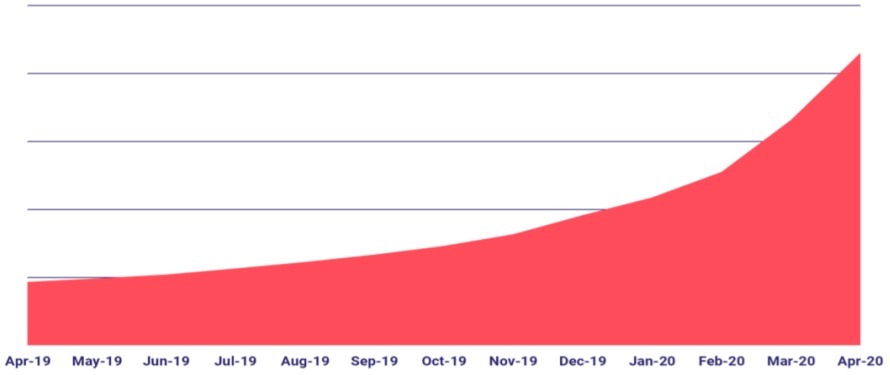
A key new disclosure in the 1Q'20 earnings presentation was the total number of transactions processed through the Teneo platform in the quarter. Management notes that these metrics are an amalgamation of the different ways in which customers classify usage (and only transactions for customers on usage-based contracts are included). Examples of usage-based pricing arrangements that Artificial Solutions has in place with its customers are as follows:

- **success-based:** some agreements are based around the number of successful interactions (i.e. does the automated chatbot resolve the customer's enquiry without requiring any manual intervention from a customer services member of staff?);
- **number of sessions:** the number of different occasions on which customers contact the chatbot; and

- **interaction-based:** this is the most granular approach, whereby, within a session, the number of interactions that a customer has with the chatbot feeds into a pricing structure.

Each of these approaches will, of course, have differing unit pricing parameters, and discounts apply once volume thresholds are crossed. For the purposes of the chart below, the company has created an amalgamated measure of transaction volume that accurately reflects underlying activity levels. Importantly, the steep trajectory is expected to continue during the balance of FY'20.

Artificial Solutions – 12-month total interactions for usage-based customers



Source: Company data

Understanding the scale of the usage opportunity

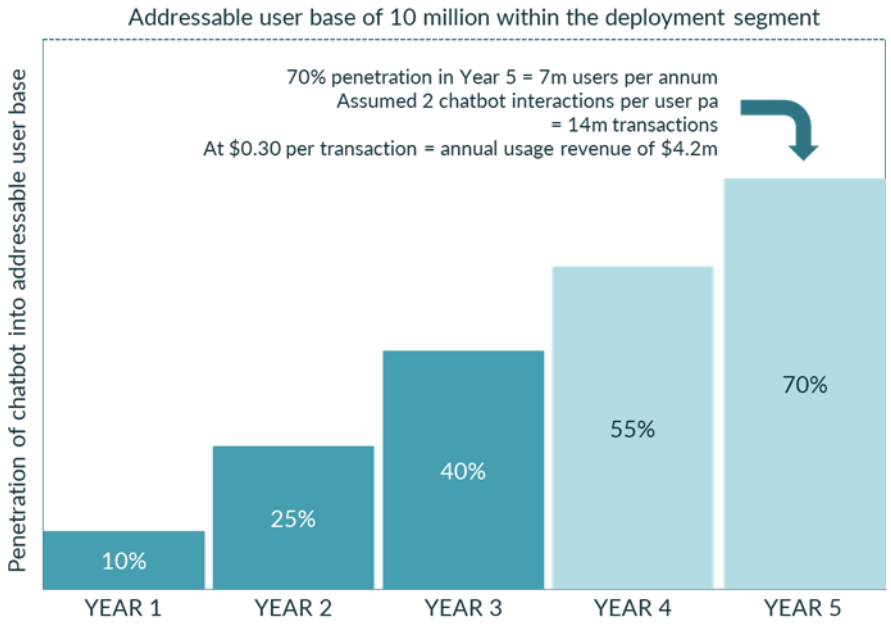
The schematic below sets out an example of how usage revenue could evolve for a large customer. While this is a stylised example and not based on specific customer data, our starting point is the expansion that was announced for 4Q'19 of a large US telecoms operator customer from an addressable user base of 0.5m people to around 11m people. This, of course, suggests a very large increase in the number of potential addressable transactions for the applications built upon Teneo by that customer.

Taking into account that the agreed transaction fee structure is generally based on a volume-driven sliding scale, a minimum fee might be cents per "transaction". A transaction might comprise either a call that is successfully handled by a virtual digital assistant without requiring referral to a human customer services assistant, or an online chat session with an automated chatbot. The chart below makes assumptions regarding the extent to which an addressable base of 10m customers interacts with the chatbots built on Teneo, and also on the proportion of interactions that are handled entirely by the chatbot. One would expect the success rate to progressively improve as Teneo learns from the customer-specific interactions through the platform.

By way of this simple example, if, by the third year post implementation of Teneo, 40% of the addressable users interacted with the chatbot twice per year and had their queries resolved, this would represent 8m transactions on an annual basis. At a transaction fee of only $0.30 per transaction, this would equate to $2.4m of usage revenue. On the same basis, assuming 70% penetration by year five, the annual usage revenue for two chatbot transactions p.a. per user would be $4.2m. These are modest assumptions, and the outcome of the analysis is supportive of management's assertion that the larger active customers are all capable of generating usage revenue in excess of €5m each.

It is worth remembering that this fee would apply to the transactions that were successfully handled by the chatbot; so the customer would be saving multiple dollars for each customer interaction that did not need to be handled by a human. The ROI for the customer is substantial, but this only works if the chatbot is sophisticated enough to deliver resolved transactions. As we reiterate in this note, Artificial Solutions is often selected by large enterprises once they have tried other, less capable solutions that offer far less customisation and require specialist skills for changes to be processed.

Artificial Solutions – stylised view of usage revenue evolution



Source: Hardman & Co Research

Top-tier customers and partners

Artificial Solutions – examples of customers and partners

Source: Company data

Profit and loss

Artificial Solutions – profit and loss account						
Year-end Dec (€m)	2017	2018	2019	2020E	2021E	2022E
Income						
Net sales	4.95	4.39	4.64	8.26	13.05	18.92
Capitalised costs	0.87	1.19	1.14	1.20	1.27	1.30
Other operating income	1.23	0.52	0.70	0.91	1.18	1.30
Total income	7.06	6.09	6.48	10.37	15.50	21.52
Operating expenses						
Other external costs	-4.28	-5.02	-7.18	-3.63	-3.41	-3.23
Personnel costs	-9.57	-10.33	-11.13	-10.99	-10.85	-12.91
Other operating expenses	0.00	0.00	-2.13	-1.06	-0.96	-0.86
Total operating expenses	-13.85	-15.35	-20.43	-15.68	-15.22	-17.00
EBITDA (reported)	-6.79	-9.26	-13.95	-5.32	0.28	4.52
Adj. EBITDA	-6.79	-9.76	-10.61	-5.32	0.28	4.52
Depreciation & amortisation	-2.64	-2.32	-1.09	-1.20	-1.32	-1.46
EBIT (reported)	-9.44	-11.58	-15.05	-6.52	-1.04	3.06
Adj. EBIT	-9.44	-12.08	-11.70	-6.52	-1.04	3.06
Net financial income	-1.49	-1.44	-2.11	-1.90	-1.71	-1.54
Pre-tax profit	-10.93	-13.02	-17.16	-8.42	-2.75	1.52
Adj. PTP	-10.93	-13.52	-13.81	-8.42	-2.75	1.52
Taxation	0.00	0.00	0.00	0.00	0.00	0.00
Net income	-10.93	-13.02	-17.16	-8.42	-2.75	1.52

Source: Company data, Hardman & Co Research

Balance sheet

Artificial Solutions – balance sheet					
@ 31 Dec (€m)	2018	2019	2020E	2021E	2022E
ASSETS					
Fixed intangible assets					
Capitalised expend. for licences & software	2.9	3.0	3.2	3.2	3.2
Goodwill	0.0	0.0	0.0	0.0	0.0
Total intangible assets	2.9	3.0	3.2	3.2	3.2
Fixed tangible assets					
Equipment, furniture & fittings	0.2	0.2	0.3	0.4	0.6
Total tangible fixed assets	0.2	0.2	0.3	0.4	0.6
Total fixed assets	3.0	3.2	3.4	3.7	3.9
Other non-current receivables	0.5	0.5	0.5	0.5	0.5
Total non-current assets	3.6	3.7	3.9	4.2	4.4
Current assets					
Accounts receivable – trade	0.6	0.9	1.0	1.3	1.5
Tax receivable	0.9	1.2	1.2	1.2	1.2
Other receivables	0.3	0.2	0.3	0.3	0.3
Prepaid expenses & accrued income	0.5	0.7	0.9	1.0	1.2
Total current receivables	2.2	3.1	3.4	3.8	4.3
Cash & bank balances	4.6	0.4	4.5	4.3	7.4
Total current assets	6.8	3.5	7.9	8.1	11.7
TOTAL ASSETS	10.4	7.2	11.8	12.3	16.0
EQUITY & LIABILITIES					
Equity					
Share capital	3.6	4.2	6.0	6.0	6.0
Share premium reserve	75.6	106.8	115.4	115.4	115.4
Other equity, including result for year	-87.6	-129.3	-137.7	-140.5	-138.9
Total equity	-8.4	-18.2	-16.3	-19.1	-17.6
Long-term liabilities					
Liabilities to other lenders	5.1	10.2	10.2	10.2	10.2
Total long-term liabilities	5.1	10.2	10.2	10.2	10.2
Current liabilities					
Liabilities to other lenders	9.1	11.2	11.2	11.2	11.2
Accounts payable – trade	0.4	0.6	1.0	1.6	2.4
Other liabilities	0.3	0.4	0.4	0.4	0.4
Accrued expenses & deferred income	3.9	3.1	4.7	7.1	8.1
Total current liabilities	13.7	15.3	18.0	21.2	23.4
TOTAL EQUITY & LIABILITIES	10.4	7.2	11.8	12.3	16.0

Source: Company data, Hardman & Co Research

Cashflow

Artificial Solutions – cashflow statement					
Year-end Dec (€m)	2018	2019	2020E	2021E	2022E
Operating loss	-11.58	-15.05	-6.52	-1.04	3.06
Depreciation	2.32	1.09	1.20	1.32	1.46
Other items excluded from cashflow	0.03	3.60	0.00	0.00	0.00
Adjusted operating loss	-9.23	-10.36	-5.32	0.28	4.52
Net financial income	-1.44	-2.11	-1.90	-1.71	-1.54
Taxation paid & received	0.00	0.30	0.00	0.00	0.00
Op. cashflow before working capital changes	-10.67	-12.17	-7.21	-1.43	2.98
Changes in working capital					
(Increase)/decrease in receivables	-1.96	-0.81	-0.34	-0.41	-0.49
Increase/(decrease) in liabilities	0.82	-0.49	2.01	2.95	1.79
Net change in working capital	-1.14	-1.30	1.67	2.55	1.31
Cashflow from operating activities	-11.81	-13.46	-5.54	1.12	4.29
Investing activities					
Purchases of tangible fixed assets	-0.09	0.17	0.22	0.28	0.36
Purchases of intangible fixed assets	-1.24	-1.40	-1.47	-1.54	-1.62
Change in fixed assets	0.00	0.00	0.00	0.00	0.00
Cashflow from investing activities	-1.33	-1.23	-1.25	-1.26	-1.26
Financing activities					
Issue of new shares	12.82	5.00	10.91	0.00	0.00
Costs of new share issues	-0.35	-0.93	-0.60	0.00	0.00
Issue of new non-registered shares	0.00	0.00	0.00	0.00	0.00
Change in loans	4.68	7.11	0.00	0.00	0.00
Cashflow from financing activities	17.15	11.18	10.31	0.00	0.00
Net change in cash & cash equivalents	4.01	-3.52	3.51	-0.14	3.03
Cash & cash equivalents at start of year	0.49	4.50	0.98	4.49	4.35
Cash & cash equivalents at end of year	4.50	0.98	4.49	4.35	7.38

Source: Company data, Hardman & Co Research

Valuation

DCF analysis produces implied fair enterprise value of €128m and equity implied fair value of €116m

Our approach to understanding the potential valuation of Artificial Solutions centres on a DCF analysis. At the same time, we take account of a detailed valuation of the company's intellectual property (IP) assets in the form of patents and software licences.

In summary, our DCF analysis produces an implied fair enterprise value of €127m and an equity implied fair value of €115m, while the most recent IP valuation analysis, undertaken in 2019, generated a patent valuation range of $125m to $153m. These valuation outcomes compare with the current enterprise value of ca.€39m (SEK387m) and market capitalisation of ca.€26m (SEK255m).

DCF valuation

On our base assumptions, which are set out in their entirety in the table below, we derive, as noted, an implied enterprise value for the company of €127m, which, after the current net debt position of ca.€12m, equates to an equity value of €115m. In Swedish Krona, the implied equity fair value is SEK1,276m, which compares with the company's current market capitalisation on the NASDAQ First North Exchange in Stockholm of SEK255m.

Artificial Solutions – Hardman & Co DCF analysis

Key inputs	
Terminal FCF growth rate	3.0%
Long-term sustainable EBIT margin	35.0%
Long-term tax rate on EBIT	20.0%
WACC	**10.0%**

Y/end December, €m	**2020E**	**2021E**	**2022E**	**2023E**	**2024E**	**2025E**	**2026E**	**2027E**	**2028E**	**Terminal value**
Revenues	**10.4**	**15.5**	**21.5**	**28.0**	**35.5**	**44.4**	**53.3**	**59.7**	**62.7**	
yoy growth	*2.7%*	*49.5%*	*38.8%*	*30.0%*	*27.0%*	*25.0%*	*20.0%*	*12.0%*	*5.0%*	
EBIT margin	-62.9%	-6.7%	14.2%	7.5%	12.8%	18.0%	23.5%	29.0%	35.0%	
EBIT	**-6.5**	**-1.0**	**3.1**	**2.1**	**4.5**	**8.0**	**12.5**	**17.3**	**21.9**	
Depreciation & amortisation	-1.2	-1.3	-1.5	-1.5	-1.6	-1.7	-1.8	-1.9	-2.0	
Adj. EBITDA	**-7.7**	**-2.4**	**1.6**	**0.6**	**2.9**	**6.3**	**10.7**	**15.4**	**19.9**	
Tax rate	0.0%	0.0%	0.0%	0.0%	0.0%	5.0%	10.0%	15.0%	20.0%	
Tax on EBIT	0.0	0.0	0.0	0.0	0.0	-0.4	-1.3	-2.6	-4.4	
Change in net working capital	1.7	2.5	1.3	0.9	0.6	0.4	0.3	0.2	0.2	
Cashflow from operations	**-6.1**	**0.2**	**2.9**	**1.5**	**3.6**	**6.3**	**9.8**	**13.0**	**15.7**	
Capex	-1.3	-1.3	-1.3	-0.7	-0.2	0.4	0.9	1.5	2.0	
Unlevered free cash flow	**-7.3**	**-1.1**	**1.7**	**0.8**	**3.4**	**6.7**	**10.7**	**14.5**	**17.7**	**252.9**
Year	1	2	3	4	5	6	7	8	9	10
Discount factor	1.10	1.21	1.33	1.46	1.61	1.77	1.95	2.14	2.36	2.36
Present value	**-6.6**	**-0.9**	**1.2**	**0.5**	**2.1**	**3.8**	**5.5**	**6.8**	**7.5**	**107.3**

Note: based on medium-term assumptions from 2023E

Implied valuation metrics	**EURm**
Sum of 9-year cash flow	19.8
Terminal value	107.3
Value of the firm	127.1
Net funds	-12.0
Total equity value	**115.1**
No.of shares in issue (m)	43.2
Fair value share price (EUR)	**2.7**
€:SEK exchange rate	11.0
Fair value share price (SEK)	**29.3**

Source: Hardman & Co Research estimates

Patent valuation range of $125m to $153m, derived by independent valuation specialist OxFirst

IP asset valuation

The patent portfolio was revalued during 2019 by OxFirst, an independent valuation specialist. Artificial Solutions' patent portfolio consists of six patents, five of which have been granted, and one for which a patent application has been submitted and further approval is pending. All of these patents are relatively recent, with publication dates ranging between 2013 and 2018, and all are geographically limited to the United States.

The table below, sourced from OxFirst, provides further details of the six patents, and sets out details that are key to the evaluation of patents, including claims count and forward and reverse citations. OxFirst notes that the patents relate primarily to natural language interaction and natural language processing, forms of AI that allow humans to interact with computerised applications and electronic devices in free-format, natural language, using speech, text, touch or gesture.

Artificial Solutions – patent portfolio

Patent Number	Published	Claims Count	Reverse Count	Forward Count	Keywords
US8346563B1[6]	01/01/2013	3	6	133	Natural Language, Virtual Assistant, Interaction
US20130268260A1 US8892419B2	10/10/2013 18/11/2014	2	5 6	76 21	NL, VA, User Interface, Analytics Framework
US20140019116A1 US8903711B2	16/01/2014 12/02/2014	2	5 6	38 15	NL, VA, User Interface, Analytics Framework
US20140244712A1 US9172747B2	28/08/2014 27/10/2015	6	5 5	54 5	VA Network, VA brokers, connected-devices
US20150339376A1	26/11/2015	20	2	2	NL Analytics, Data Analytics, Machine Learning
US20180089572A1 US10068174B2	29/03/2018 04/09/2018	20	0 5	0 1	NL, Machine Learning, User-provided, Hybrid

Source: OxFirst

Overall, the patent portfolio has 177 forward citations (when considering only the granted versions, where possible), 53 claims and 30 reverse citations. OxFirst ascribes considerable importance to the first patent, which was published in 2013 and is deemed to be the "core patent", as it is important to in excess of 100 patents from key vendors in the natural language processing and related segments. The core patent accounts for 133 of the total forward citations, of which seven are worldwide. Microsoft is the largest source of these citations, at 21. The second patent has been cited 27 times by Apple.

The valuation conclusions reached by OxFirst are set out in the table below. OxFirst reaches these using a combination of two approaches: net present value and a "top-down approach", the latter noted to be specific to patent valuation and a methodology that is stated to be used in legal matters relating to patents. Taking into account the value of the licensing opportunity and Artificial Solutions' software platform market opportunity, OxFirst derives a valuation range of $125m to $153m, which, at the mid-point, represents a 44% uplift vs. the valuation reached in 2016.

OxFirst's 2019 patent valuation for Artificial Solutions

($m)	Basis	Upper	Lower	2016 valn.
Patents	Overall market opportunity	100.6	77.3	56.4
Software	Artificial Solutions' market opportunity	52.3	47.3	40.2
Total		**152.9**	**124.6**	**96.6**

Source: OxFirst, Hardman & Co Research

Notes

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