

November 14, 2017

## Magic Software Enterprises Ltd.

### Continued Strength in Integration Platform; Full-Year Revenue Guidance Raised at the Midpoint

**Summary.** Magic reported strong third-quarter results with revenue of \$65.7 million, a 20.5% increase year-over-year, coming in ahead of the Street mean of \$62.7 million due to continued demand for digital transformations, which is a catalyst for integration projects. From a geographic standpoint, growth came primarily from strength in North American and Israel. In addition, management raised full-year revenue guidance by \$2.5 million at the midpoint, to \$250 million to \$255 million (24% to 26.5% growth), which is in line with the Street mean of \$252.6 million (25.3% growth).

The strong performance during the quarter was primarily driven by growth from new customers and expansion with existing customers. We suspect the overall demand environment remains strong for the company's integration platform and its cloud business. The company recently announced the launch of its global integration channel partner program, which aims to help the company capture the growing opportunity for integration projects by working more closely with independent software vendors, OEM partners, system integrators, value-added distributors, value-added resellers, and consulting companies. We view this initiative positively as we believe it should help grow license revenue and ultimately improve gross margins. Still, we believe this relationship could put some pressure on the company's professional services business as we suspect some partners are likely to conduct the implementation of the technology sold.

Non-GAAP gross margins were 34.7% compared with 36.9% last year and 34.0% last quarter. We believe the pressure on gross margins is driven by the continued revenue mix shift toward professional services (roughly 30% of revenue was from software and 70% from services, compared with 35% software and 65% license last year). We expect the company's overall gross margin profile to continue experiencing pressure as we do not expect any change in the revenue mix in the near term, and we would wait to see the success of the company's partner initiative before we would expect any significant improvement in gross margins.

The company has roughly \$77.2 million of cash and cash equivalents, and we suspect the company will continue its acquisitive strategy, mostly seeking complementary technology solutions. However, we continue to expect a competitive market for acquisitions. Cash flow from operating activities in the first half of 2017 was roughly \$17.8 million, compared with \$21.8 million in the same period last year; free cash flow of \$13.7 million was down from \$17.7 million over the same period.

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Stock Rating: **Outperform**

Symbol: MGIC (NASDAQ)  
Price: \$8.90 (52-Wk.: \$6.65-\$9.50)  
Market Value (M): \$396  
Dividend/Yield: \$0.26/2.94%  
Fiscal Year End: December

	2017E	2018E	
<b>Estimates</b>			
EPS	Q1	\$0.13	\$0.15
	Q2	\$0.13	\$0.15
	Q3	\$0.12	\$0.15
	Q4	\$0.12	\$0.14
	FY	\$0.50	\$0.60
Sales (M)	Q1	\$60.8	\$67.0
	Q2	\$65.5	\$72.9
	Q3	\$65.7	\$73.2
	Q4	\$62.5	\$69.2
	FY	\$254.4	\$282.3
<b>Valuation</b>			
FY P/E	17.9x	14.9x	
CY P/E	17.9x	14.9x	
EV/Sales	1.5x	1.3x	

#### Trading Data (FactSet)

Shares Outstanding (M):	44.5
Float (M):	44.2
Avg. Daily Volume (90-day):	29,011

#### Financial Data (FactSet)

Book Value Per Share (MRQ):	\$4.64
Return on Equity (TTM):	6.0%
Enterprise Value (M):	\$373

#### Two-Year Price Performance Chart



Sources: FactSet, William Blair & Company estimates

Magic develops, markets, sells, and supports an application platform and business and process integration solutions, and offers information technology (IT) professional services.

**Please refer to important disclosures on pages 4 – 5. Analyst certification is on page 4.**

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### Stock Thoughts

Given the solid top-line growth and upside optionality from its license business, we would be buyers of the stock. The stock is trading at 1.4 times our 2018 revenue estimate and 13.3 times our 2018 free cash estimate, which are both below the pure service group at 2.4 times and 17.7 times, respectively.

### Third-Quarter Financial Highlights (ending September)

**Revenue.** Magic posted third-quarter revenue of \$65.7 million, a 20.5% increase year-over-year. The result was above our expectations of \$61.3 million (12.5% growth) and the Street mean of \$62.7 million (15.1% growth).

**Non-GAAP Operating Income.** The company reported non-GAAP operating income of \$9.1 million (17.2% margin), compared with \$7.7 million (14.2% margin) last year and \$9.0 million in the prior quarter (13.7% margin). The result was slightly below our estimate of \$9.3 million (15.2% margin), but above the Street mean of \$8.8 million (14.0% margin).

**Non-GAAP EPS.** Non-GAAP EPS of \$0.12 came in \$0.03 below the Street mean, and \$0.04 below our estimate.

### Fourth Quarter 2017 Estimates (ending December)

*Management does not issue quarterly guidance.*

**Revenue.** Consensus expectations are \$63.8 million (15.7% growth). We maintain our estimate of \$62.5 million (13.3% growth).

**Non-GAAP Operating Income.** Consensus expectations are \$8.5 million (13.3% margin). We decreased our non-GAAP operating income estimate of \$8.3 million (13.3% margin) to \$8.0 million (12.7% margin).

**Non-GAAP EPS.** The Street mean is \$0.14. We decrease our non-GAAP EPS estimate by a penny, to \$0.12.

### Full Year 2017 Guidance

**Revenue.** Management increased full-year revenue guidance by \$2.5 million at the midpoint to \$250 million to \$255 million (24.0% to 26.5% growth), in line with the Street's estimate of \$252.6 million (25.3% growth). We increased our estimate of \$250.0 million (24.0% growth) to \$254.4 million (26.1% growth).

**Non-GAAP Operating Income.** Consensus expectations are \$34.6 million. We decrease our non-GAAP operating income estimate slightly to \$34.4 million (13.5% margin) from \$35.0 million (14.0% margin). The drop in operating margin is primarily due to continued gross margin pressure.

**Non-GAAP EPS.** The Street's estimate is \$0.56. We lower our non-GAAP EPS estimate to \$0.50 from \$0.55.

### Valuation

Given that the company is services heavy, we compare Magic with the onshore services group (which includes companies such as Accenture [ACN \$143.92], Hackett [HCKT \$15.26], and Perficient [PRFT \$18.84]) as well as with a blended group given the company's mix of both software and maintenance and license revenue). Compared with the IT services group (and the blended group), Magic is at a discount on a calendar 2018 enterprise-value-to-EBITDA basis, trading at 7.2 times.

Calendar 2018	EV/Rev	P/E	EV/EBITDA	EV/FCF
<b>Magic Software</b>	<b>1.4x</b>	<b>14.3x</b>	<b>7.2x</b>	<b>13.3x</b>
App lifecycle management/dev grp r	6.2x	29.0x	21.0x	33.0x
Infrastructure software grp median	4.7x	20.0x	12.6x	17.2x
IT services grp median	2.4x	15.3x	10.4x	17.7x
Blended group median	3.4x	18.4x	12.5x	20.2x

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(\$ in millions except for per share items)

	2012	2013	2014	2015	1Q16	2Q16	3Q16	4Q16	2016	1Q17	2Q17	3Q17	4Q17E	2017E	2018E
<b>Revenue</b>	<b>\$126.4</b>	<b>\$145.0</b>	<b>\$164.3</b>	<b>\$176.0</b>	<b>\$44.7</b>	<b>\$47.4</b>	<b>\$54.5</b>	<b>\$55.1</b>	<b>\$201.6</b>	<b>\$60.8</b>	<b>\$65.5</b>	<b>\$65.7</b>	<b>\$62.5</b>	<b>\$254.4</b>	<b>\$282.3</b>
Cost of revenues	73.4	85.9	99.7	113.2	29.2	31.2	35.7	37.2	133.3	41.1	44.7	44.3	41.9	172.0	188.7
Gross Profit	53.0	59.1	64.6	62.8	15.4	16.2	18.7	18.0	68.4	19.7	20.8	21.3	20.6	82.4	93.7
Research and development, net	2.9	3.7	4.8	4.9	1.3	1.2	1.6	1.8	5.8	1.6	1.9	1.7	1.7	6.9	7.2
Selling, marketing and general and administrative	33.6	36.2	39.1	36.5	8.9	9.7	11.2	11.0	40.8	11.7	12.5	12.6	12.6	49.4	55.3
Increase in valuation of contingent consideration related to acquisitions								0.8	0.8	0.0					
Operating income	16.4	19.1	20.7	21.4	5.3	5.3	6.0	4.3	20.9	6.3	6.3	7.1	6.3	26.1	31.2
Financial (expense) income, net	0.0	(0.7)	(1.8)	(0.7)	0.1	0.2	(0.1)	(0.3)	(0.2)	(0.2)	(0.6)	(0.3)	(0.5)	(1.7)	(1.5)
Other (expense) income, net	0.1	(0.0)	(0.1)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Income before income taxes	16.6	18.4	18.9	20.8	5.3	5.5	5.8	4.0	20.7	6.1	5.7	6.8	5.8	24.4	29.7
Taxes on income	0.1	1.6	2.3	3.7	1.3	1.0	1.0	0.6	3.9	1.3	1.6	2.1	1.2	6.1	6.1
Net income	16.5	16.9	16.6	17.1	4.1	4.5	4.8	3.4	16.7	4.9	4.2	4.6	4.6	18.3	23.6
Change in redeemable non-controlling interests	0.3	0.4	0.0	0.6	0.3	0.3	0.7	3.2	4.5	0.5	0.4	0.8	0.8	2.4	3.1
Net income attributable to non-controlling interests	0.0	0.6	1.2	0.2	0.1	0.1	0.1	0.1	0.3	0.1	0.2	0.0	0.0	0.4	0.2
<b>Net income attributable to Magic shareholders</b>	<b>\$16.2</b>	<b>\$15.9</b>	<b>\$15.4</b>	<b>\$16.2</b>	<b>\$3.7</b>	<b>\$4.1</b>	<b>\$4.0</b>	<b>\$0.1</b>	<b>\$11.9</b>	<b>\$4.3</b>	<b>\$3.6</b>	<b>\$3.8</b>	<b>\$3.8</b>	<b>\$15.5</b>	<b>\$20.3</b>
<b>Diluted GAAP EPS</b>	<b>\$0.44</b>	<b>\$0.43</b>	<b>\$0.36</b>	<b>\$0.36</b>	<b>\$0.08</b>	<b>\$0.09</b>	<b>\$0.09</b>	<b>\$0.00</b>	<b>\$0.27</b>	<b>\$0.10</b>	<b>\$0.08</b>	<b>\$0.09</b>	<b>\$0.09</b>	<b>\$0.35</b>	<b>\$0.45</b>
Diluted shares	37.108	37.294	43.305	44.397	44.492	44.511	44.530	44.530	44.516	44.554	44.593	44.609	44.613	44.592	44.625
<b>Non-GAAP Adjustments</b>															
Amortization	6.7	7.7	7.9	7.3	1.1	2.4	2.9	1.6	8.1	1.6	3.1	3.2	1.6	9.5	6.0
Stock compensation	0.5	0.3	1.6	0.2	0.1	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.4
Other	(5.0)	(4.5)	(4.3)	(1.8)	0.2	(1.2)	(1.2)	1.3	(0.8)	0.4	(0.4)	(1.2)	0.0	(1.2)	0.0
Non-GAAP operating income	18.6	22.7	25.9	27.2	6.7	6.5	7.7	7.3	28.2	8.4	9.0	9.1	8.0	34.4	37.6
Amortization and other	(0.1)	0.0	(0.2)	(0.2)	(0.3)	(0.1)	(0.4)	1.2	0.4	(0.6)	(0.5)	(0.5)	0.0	(1.6)	0.0
Non-GAAP net income	18.3	19.5	20.3	21.7	4.8	5.2	5.3	4.3	19.6	5.7	5.7	5.2	5.5	22.2	26.7
<b>Non-GAAP EPS</b>	<b>\$0.49</b>	<b>\$0.52</b>	<b>\$0.47</b>	<b>\$0.49</b>	<b>\$0.11</b>	<b>\$0.12</b>	<b>\$0.12</b>	<b>\$0.10</b>	<b>\$0.44</b>	<b>\$0.13</b>	<b>\$0.13</b>	<b>\$0.12</b>	<b>\$0.12</b>	<b>\$0.50</b>	<b>\$0.60</b>
Non-GAAP diluted shares	37.198	37.337	43.341	44.462	44.492	44.514	44.535	44.530	44.518	44.558	44.595	44.610	44.614	44.594	44.626
<b>RATIO ANALYSIS (% of revenue)</b>															
Gross margin	41.9%	40.7%	39.3%	35.7%	34.6%	34.2%	34.4%	32.6%	33.9%	32.4%	31.7%	32.5%	33.0%	32.4%	33.2%
Research and development, net	2.3%	2.6%	2.9%	2.8%	2.8%	2.6%	2.9%	3.3%	2.9%	2.7%	2.9%	2.5%	2.8%	2.7%	2.5%
Selling, marketing and general and administrative	26.6%	25.0%	23.8%	20.7%	20.0%	20.4%	20.6%	20.0%	20.3%	19.3%	19.1%	19.1%	20.1%	19.4%	19.6%
Operating margin	13.0%	13.2%	12.6%	12.2%	11.8%	11.2%	10.9%	7.8%	10.3%	10.4%	9.7%	10.8%	10.1%	10.3%	11.0%
Effective tax rate	0.6%	8.5%	12.2%	17.7%	23.8%	18.0%	17.9%	16.2%	19.1%	20.5%	27.6%	31.6%	20.0%	25.1%	20.6%
Net margin	12.8%	11.0%	9.4%	9.2%	8.3%	8.6%	7.4%	0.2%	5.9%	7.0%	5.5%	5.8%	6.1%	6.1%	7.2%
Non-GAAP operating margin	14.7%	15.7%	15.8%	15.4%	14.9%	13.8%	14.2%	13.2%	14.0%	13.8%	13.7%	13.8%	12.7%	13.5%	13.3%
Non-GAAP net margin	14.5%	13.4%	12.4%	12.4%	10.8%	10.9%	9.8%	7.8%	9.7%	9.4%	8.8%	8.0%	8.8%	8.7%	9.4%
<b>GROWTH ANALYSIS</b>															
<b>Year-over-year</b>															
Revenue	11.5%	14.7%	13.3%	7.1%	10.7%	11.4%	20.2%	15.2%	14.6%	36.0%	38.3%	20.5%	13.3%	26.1%	11.0%
Operating income	11.5%	16.6%	8.4%	3.4%	-9.4%	-0.8%	12.7%	-13.4%	-2.7%	20.5%	19.1%	19.0%	46.4%	25.1%	19.5%
Net income	7.6%	-1.9%	-3.0%	5.2%	-13.7%	-0.2%	-3.5%	-96.6%	-26.5%	15.6%	-12.3%	-5.1%	2937.3%	29.9%	31.0%
EPS	7.4%	-2.4%	-16.5%	2.6%	-14.2%	-0.4%	-3.7%	-96.6%	-26.7%	15.4%	-12.5%	-5.3%	2931.6%	29.7%	30.9%
Non-GAAP operating income	28.9%	21.7%	14.1%	5.0%	-0.5%	1.0%	16.7%	-1.0%	3.9%	25.7%	37.4%	17.2%	9.1%	21.8%	9.3%
Non-GAAP net income	23.9%	6.2%	4.5%	6.9%	-7.2%	0.3%	-7.3%	-23.5%	-9.6%	18.5%	10.8%	-2.1%	27.0%	12.9%	20.2%
<b>Sequential</b>															
Revenue					-6.7%	6.0%	15.0%	1.2%		10.2%	7.8%	0.3%	-4.9%		
Operating income					5.8%	1.2%	12.1%	-27.8%		47.1%	0.0%	11.9%	-11.1%		
Net income					0.3%	10.8%	-2.0%	-96.9%		3283.3%	-15.9%	6.0%	0.7%		
EPS					0.2%	10.8%	-2.1%	-96.9%		3281.5%	-16.0%	6.0%	0.7%		
Non-GAAP operating income					-9.5%	-2.0%	18.3%	-5.6%		14.8%	7.1%	1.0%	-12.2%		
Non-GAAP net income					-14.3%	7.3%	3.0%	-19.2%		33.0%	0.3%	-9.1%	4.9%		

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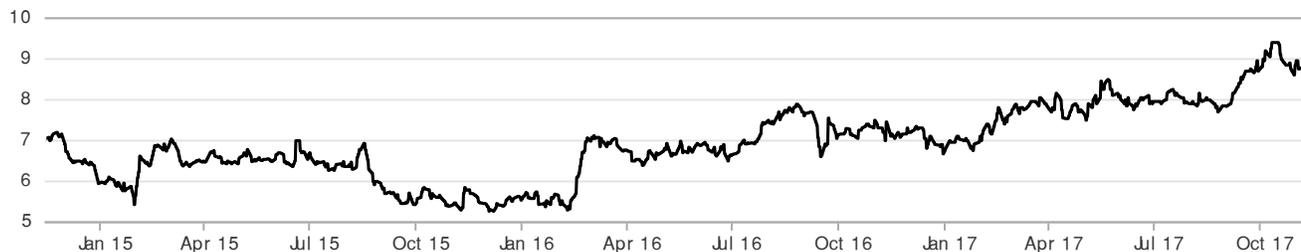
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DOW JONES: 23439.70  
 S&P 500: 2584.84  
 NASDAQ: 6757.59

**Magic Software Enterprises Ltd. Rating History as of 11/13/2017**

powered by: BlueMatrix



— Closing Price

OP: Outperform Mkt: Market Perform UP: Under Perform NR: Not Rated I: Initiation of Coverage D: Dropped Coverage

Source: FactSet & William Blair

Additional information is available upon request.

**Current Rating Distribution (as of November 14, 2017):**

Coverage Universe	Percent	Inv. Banking Relationships *	Percent
Outperform (Buy)	63	Outperform (Buy)	20
Market Perform (Hold)	35	Market Perform (Hold)	10
Underperform (Sell)	1	Underperform (Sell)	0

\*Percentage of companies in each rating category that are investment banking clients, defined as companies for which William Blair has received compensation for investment banking services within the past 12 months.

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