Innofactor

Extensive report

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Joni Grönqvist
+358 40 515 3113
joni.gronqvist@inderes.fi

Inderes corporate customer

This report is a summary translation of the report "Vahvempi kasvu tähtäimessä" published on 06/10/2021 at 6:51 am

Aiming at stronger growth

Innofactor's earnings turnaround has progressed convincingly for more than two years and brought forth the strong earnings potential of the company's Finnish business. The Finnish business is already close to the long-term 20% growth and 20% EBITDA target, but other countries depress the development at Group level. The company still invests in strengthening its Nordic operations to initiate a phase of stronger and more sustainable profitable growth. We expect the growth to accelerate this year, in the longer-term stronger growth requires pull from other Nordic countries. With our estimates, Innofactor's valuation is attractive from many viewpoints. We raise Innofactor's recommendation to Accumulate (previously Reduce) as a result of the share price drop and reiterate our EUR 2.0 target price.

Earnings turnaround has progressed well and is on a sturdier base

Throughout its history, Innofactor has grown strongly through acquisitions in Finland and abroad by consolidating the field of IT suppliers specialized in Microsoft. After several acquisitions in 2016 the company moved to a strategic phase where the focus shifted to building a uniform Nordic organization. After a pit in 2017-2018, the company's earnings turnaround has progressed well for 9 quarters in a row. The company has turned its profitability around (EBITDA 2020: 11%), achieved a strong order book (Q1'21 +27% to EUR 69 million), safeguarded the balance sheet (net gearing ~40%), and clearly strengthened the share of continuous sales (>50%). Thus, the base for continuing the Nordic growth strategy is solid.

Good growth environment over the next few years

We believe Innofactor's Finnish business has a very healthy base and the company continues to invest in fixing its other Nordic businesses. Value creation is sought from the synergies and efficiency of a unified Nordic organization, which means seeking economies of scale and acquisitions also outside Finland. The demand fundamentals of the market have strengthened due to the digital leap, which together with the good demand for the main technology Microsoft creates a good growth environment for Innofactor for the next few years.

Growth and profitability improve this year

In 2021, Innofactor focuses especially on increasing net sales. We estimate that the company's net sales will grow faster than the market (organically 8%) and that the adjusted EBITDA will rise to 12.5% driven by billable utilization (2020: 10.9%). We find the company's long-term targets achievable but to materialize they also require pull from other countries. In our estimate we expect net sales to grow at a modest 3-4% rate and EBITDA to be 13% in 2022-2024. The key risks are related to the building of a uniform Nordic organization being further prolonged and new problems appearing.

Valuation positioning is rising to the result machine category

According to our view, the positioning of Innofactor's valuation is climbing up from the turnaround company category and rising to the result machine category, which supports valuation and is partly reflected in the share. We expect the undervaluation to slowly narrow as the company's earnings turnaround continues and confidence grows. Considering the company's strategy, value creation is in future expected to be based more on organic growth and growth of own scalable products. The current 11x EV/EBIT multiple (2021e) combined with the 9% earnings growth in the next few years, 4% dividend yield, and the upside in the valuation multiples offer an attractive return expectation compared to the risks.

Recommendation

Accumulate
(previous Reduce)

EUR 2.00
(previous EUR 2.00)

Share price:
1.72

Key indicators

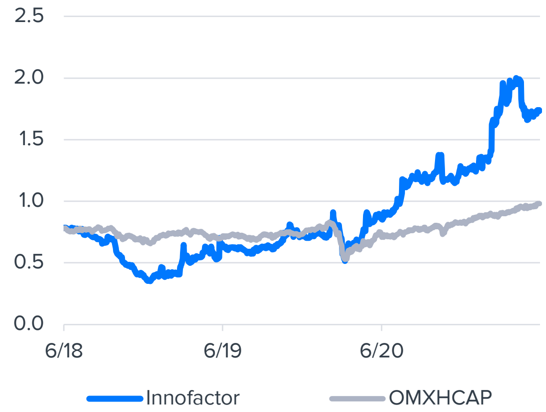
	2020	2021e	2022e	2023e
Net sales	66	69	72	75
growth %	3%	5%	4%	4%
Operating margin	7.2	11.3	8.8	9.2
Operating margin %	10.8%	16.3%	12.2%	12.2%
Net profit	1.8	5.9	5.1	5.6
EPS (adjusted)	0.10	0.10	0.14	0.15
P/E (adjusted)	12.7	16.5	12.0	11.5
P/B	2.0	2.3	2.1	1.9
Dividend yield %	3.1%	3.5%	4.1%	4.1%
EV/EBIT (adjusted)	12.5	10.8	8.7	7.9
EV/EBITDA	7.8	5.8	6.9	6.1
EV/Sales	0.8	0.9	0.8	0.7

Source: Inderes

Guidance (Unchanged)

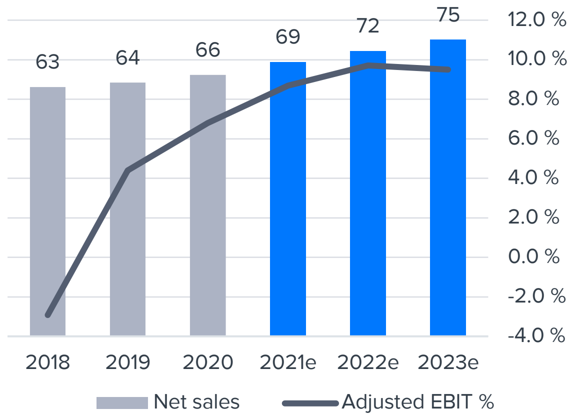
Innofactor's net sales and operating margin (EBITDA) in 2021 are estimated to increase from 2020, during which the net sales were EUR 66.2 million and operating margin was EUR 7.2 million.

Share price



Source: Thomson Reuters

Net sales and EBIT %



Source: Inderes

EPS and dividend

Source: Inderes

MCAP
64
EUR million

EV
65
EUR million

EV/EBIT
10.8
2021e

P/E (adjusted)
16.5
2021e

Value drivers

- Turnaround continuing and strengthening
- Returning investor confidence
- Profitability improvement
- Organic and acquisition-driven growth
- Increasing share of continuous business and own product business

Risk factors

- Effects of the COVID pandemic can be stronger than expected
- Failure in strengthening international business
- Delay in building a Nordic organization
- Internationalization and acquisitions raise the risk level
- Weakening of Microsoft's position

Valuation

- Net sales-based valuation among lowest in sector
- We expect the valuation difference to narrow as the earnings turnaround continues and confidence in its permanence strengthens
- We value Innofactor at a small discount to the sector
- As a whole, the valuation picture of the share is attractive

Contents

Innofactor in brief

Innofactor is Finland's leading software supplier focusing on Microsoft solutions and one of the leading suppliers in the Nordic countries.

2000
Year of establishment

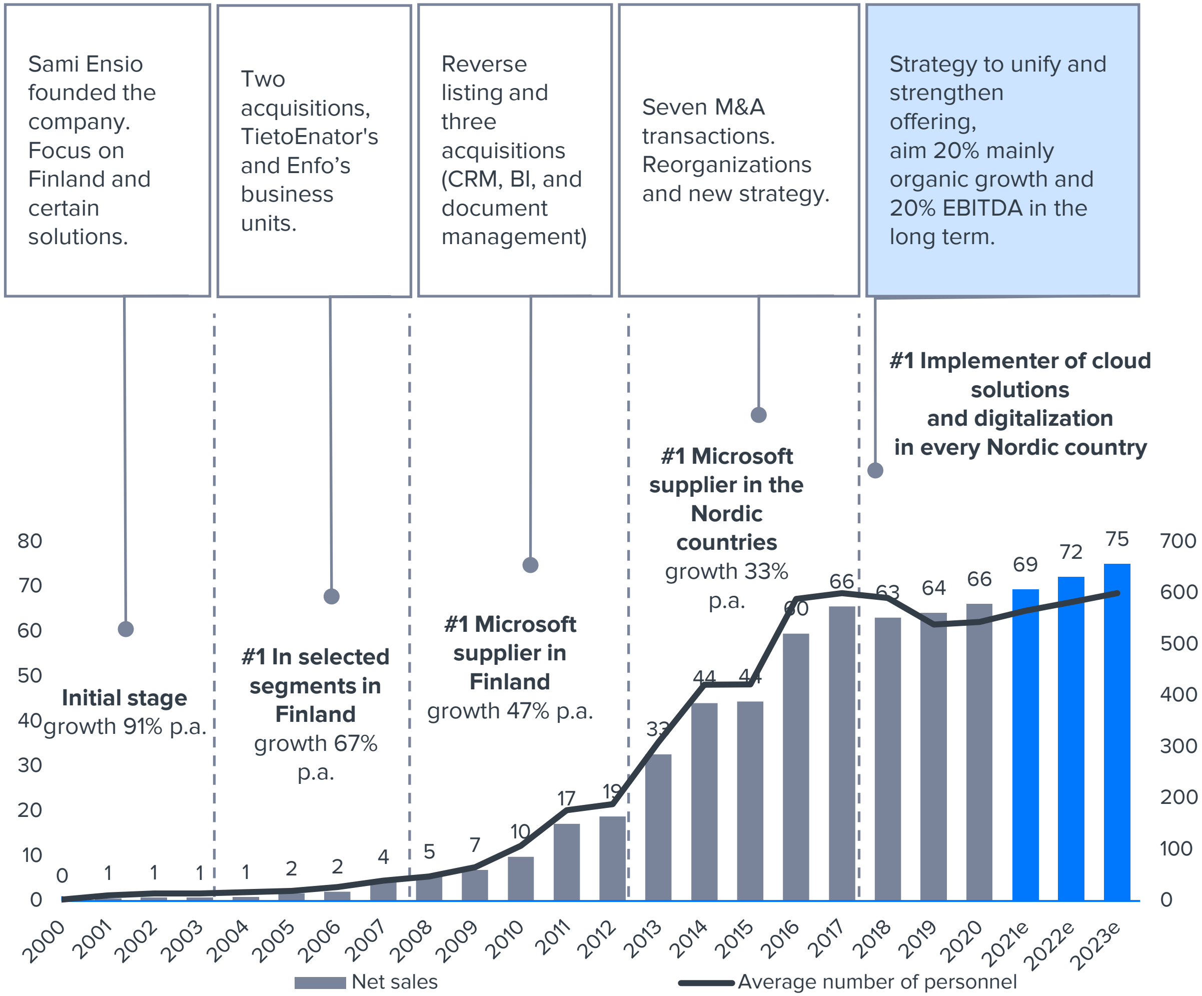
21.1%
Holding of CEO and immediate circle

EUR 66.2 million **(+3% vs. 2019)**
Net sales 2020

68% Finland
19% Sweden
9% Norway
4% Denmark
Geographical share of net sales

EUR 7.2 million **(11% of net sales)**
EBITDA 2020

536 **(-1% vs. Q1'20)**
Personnel at the end of Q1'21



Source: Innofactor / Inderes

Company description and business model 1/2

Company description

Entrepreneur-driven growth company

Innofactor established in 2000 is one of the leading software suppliers focusing on Microsoft solution in the Nordic countries. The company's business mainly consists of acting as a system integrator in IT projects, as well as developing and selling own software products and services. The company employs around 540 people in Finland, Sweden, Denmark, and Norway.

Innofactor's current structure was born out of several M&A transactions. The company was listed on the Helsinki stock exchange by making a reversed listing and acquiring Westend ICT's entire stock at the end of 2010. Since then, the company has grown quickly through acquisitions and with the latest Lumagate acquisition (2016) the company gained an extensive Nordic platform for further expansion it was seeking. Due to operational challenges, the international growth strategy hit a pit in 2018. The turn for the better began in 2019 and has continued stably especially pulled by the Finnish business.

Innofactor's founder entrepreneur Sami Ensio still acts as the company's CEO and Board member and is also the company's biggest owner with a share of some 21%.

Presence in all Nordic countries

Innofactor has over 1,000 corporations, voluntary sector, and public administration organizations as its customers in Finland, Sweden, Denmark, and Norway. The ten largest customers generated some 30% of the company's net sales in 2020. Last year, the company's net sales grew by 3% to EUR 66 million. Of the 2020 net sales, 42% came from corporate customers, 41% from public administration, and 17% from the voluntary sector. Geographically, 68% of net sales came from Finland last year, 19% from Sweden, 9% from Norway, and 4% from Denmark.

After several acquisitions, in 2017 Innofactor started to build a uniform Nordic service and product offering and a Nordic organization. The company did, however, face several challenges and instead of synergies from acquisitions operational risks materialized. In 2019, the company was, however, able to launch a brisk earnings turnaround. Now the company is in a development stage where the base, especially abroad is still being fixed before returning to a stronger growth stage.

Business model

System integrator in the Microsoft ecosystem

The business model of Innofactor is that of an IT service company that primarily delivers Microsoft technologies as projects and maintains these technologies. The company has also developed its own software product solutions to support the service business. The aim of the company in the long term is to focus on productizations that increase the scalability and continuity of the business. The company has been able to clearly increase the share of continuous net sales in the long term. In 2020, 43% of the net sales (2018: 55% and 2019: 48%) came from delivery projects and consulting, 31% (2018: 19% and 2019: 24%) from expert work based on continuous agreements, 21% (2019: 22%) from service and software maintenance based on continuous agreements (e.g. Azure cloud services), and 5% (2019: 6%) from license sales.

Innofactor's core business is to mainly work as a system integrator in the Microsoft ecosystem. As a smallish player, Innofactor must specialize on a particular expertise area in the IT market. The company believes its competitive advantage is generated from specializing in Microsoft solutions and in future increasingly from extensive geographic presence. The company's solution offering is extensive and covers all key areas in Microsoft's corporate solutions. The solutions can be delivered to the customer in Microsoft's cloud environment or in the customer's own environment. The need for Innofactor's expertise is further increased by customers' shift to Microsoft's cloud environments.

Innofactor also develops its own software products to support the Nordic service business. Own products built on Microsoft's technologies create competitive advantages in the project business and increase the scalability of the business. Most of the service and software maintenance based on continuous agreements is the company's own products. Thus, the company's own products and productized services already generate stable and quite large income flow. In software products the company seeks growth especially from the Dynasty product and trade union software. Growth is also supported by sales of solutions and services related to Virtual Datacenter and Azure that to some extent are sold together. In own products there is growth potential especially abroad.

Partners

Microsoft and other technology suppliers

Subcontractors, talent resourcers

Operations

- Recruitment
- Sales
- Consulting and projects
- Continuous services and support
- Own software products and product development

Competence areas

- Digital services and cloud solutions
- Microsoft solutions and own software
- Integration and analytics
- Maintenance

Business idea

Leading supplier of cloud solutions and digitalization in the Nordic countries

Modern digital organization

More personal digital customer experience

Secure cloud platform

INNOFACTOR®

Higher operational productivity

Modern employee experience

Data oriented business

Objectives

- Innofactor's guidance is that net sales and EBITDA will grow from 2020
- In the long term, the aim is around 20% growth and 20% EBITDA margin.

Competition

IT generalists: accenture, tieto EVRY, CGI, digia, SOLTEQ

Medium sized players on the IT market: futurice, Reaktor, INNOFACTOR®, GOFORE, VINCIT, SIILI, BILOT, SOLITA, netum, ecraft (PART OF FELLOWMIND)

Customer segments (2020)

Corporations 42%

Public administration 41%

Voluntary sector 17%

68% | 19% | 9% | 4%

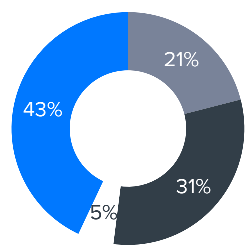
Cost structure

538 employees (2020)
EUR 64 million (2020)

Personnel costs *(68% of costs)*

Subcontractors and purchases *(10%)*

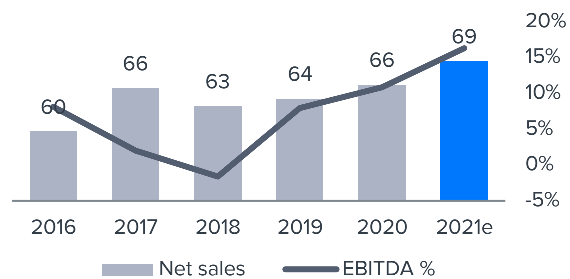
Other operating expenses *(15%)*



- Cont. agreements - services and software maintenance
- Cont. agreements - expert work
- Licenses
- Delivery projects and consulting

Income flow

Net sales EUR 66 million
EBITDA EUR 7 million (2020)



Source: Inderes

Company description and business model 2/2

With Innofactor's strategy the role of own software solutions grows, and the company tries to be a continuous service house built more strongly on products. The share of Innofactor's own product's license sales in net sales was around 5% last year and a considerable share of own product sales is visible in maintenance income (21%). Sales of own software products is very scalable net sales. Innofactor spent EUR 3.6 million on product development of its own software products, which represents 5.5% of net sales (2019: EUR 2.8 million or 4.4%). In our view, especially the Dynasty product has been renewed in recent years and its demand is strong. Innofactor has previously said that it expects its product development costs to rise in the longer term even close to the historic 10% level when the company invests more in its own software. This year we expect product development costs to be at the level of recent years as the company focuses on exploiting growth and profitability with the current offering.

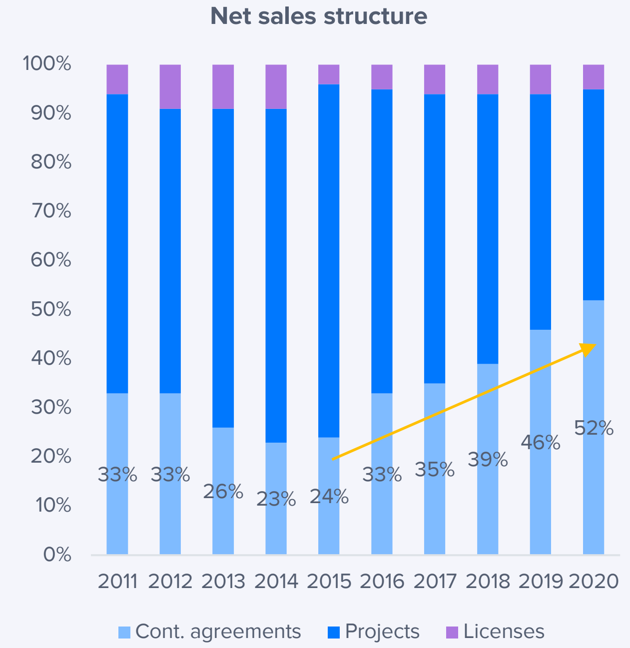
The share of third-party licenses in Innofactor's sales was around 3% last year (2019: 4%). We estimate that the average margin of third-party license reselling (in practice Microsoft) is on average around 20% but there is clear downside pressure in reselling margins throughout the sector.

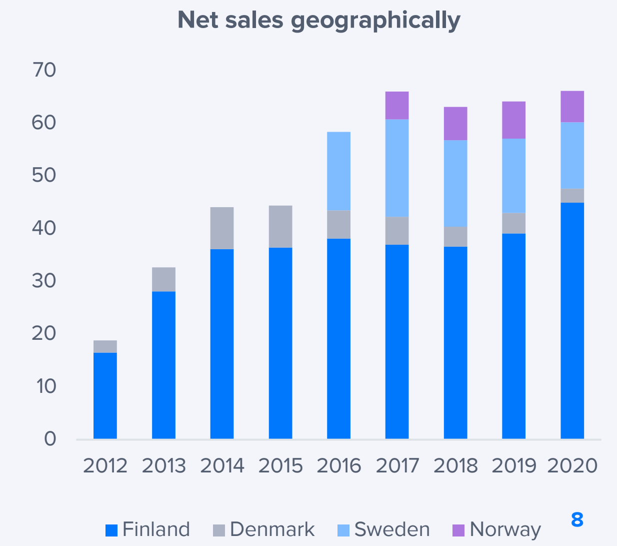
Geographically the company has historically expanded through acquisitions. In 2020, EUR 45 million of net sales came from Finland, EUR 13 million from Sweden, EUR 6 million from Norway, and EUR 3 million from Denmark. To our understanding the company wants to strengthen the offering and size class of international operations. We believe the synergies between the countries have so far been relatively small and the aim is to improve this by continuing to build a uniform Nordic organization. In recent years, the company has harmonized and concentrated its administrative tasks in particular.

Extensive offering of IT services

Innofactor has an extensive life cycle offering of IT services. The offering covers planning, integration, development, and maintenance. The entire offering with all services is rarely sold at once, customers usually first buy one part (proof of concept, e.g. a project) and after this, other additional services (e.g. maintenance services).

Projects are usually relatively short depending on the size of the project. Continuous agreements typically start out as three-year agreements after which they continue as valid until further notice typically for over 10 years as it is hard and expensive for customers to change/arrange competitive bidding for maintenance of Innofactor's solutions. Thus, there is not similar cost pressure in maintenance as in well-standardized ICT services. The profitability of a customer relationship typically improves over time.





Innofactor's expertise areas

Modern digital organization

Good 30 people in administration and other tasks

Customer path
- Service design
- Mobile applications and online services
- Digital customer service and DevOps

Operations path
- Customer relationship management (CRM)
- Enterprise resource planning (ERP)
- Project and portfolio management (PPM)
- Information and customer management
- Human resources management
- Tailored solution

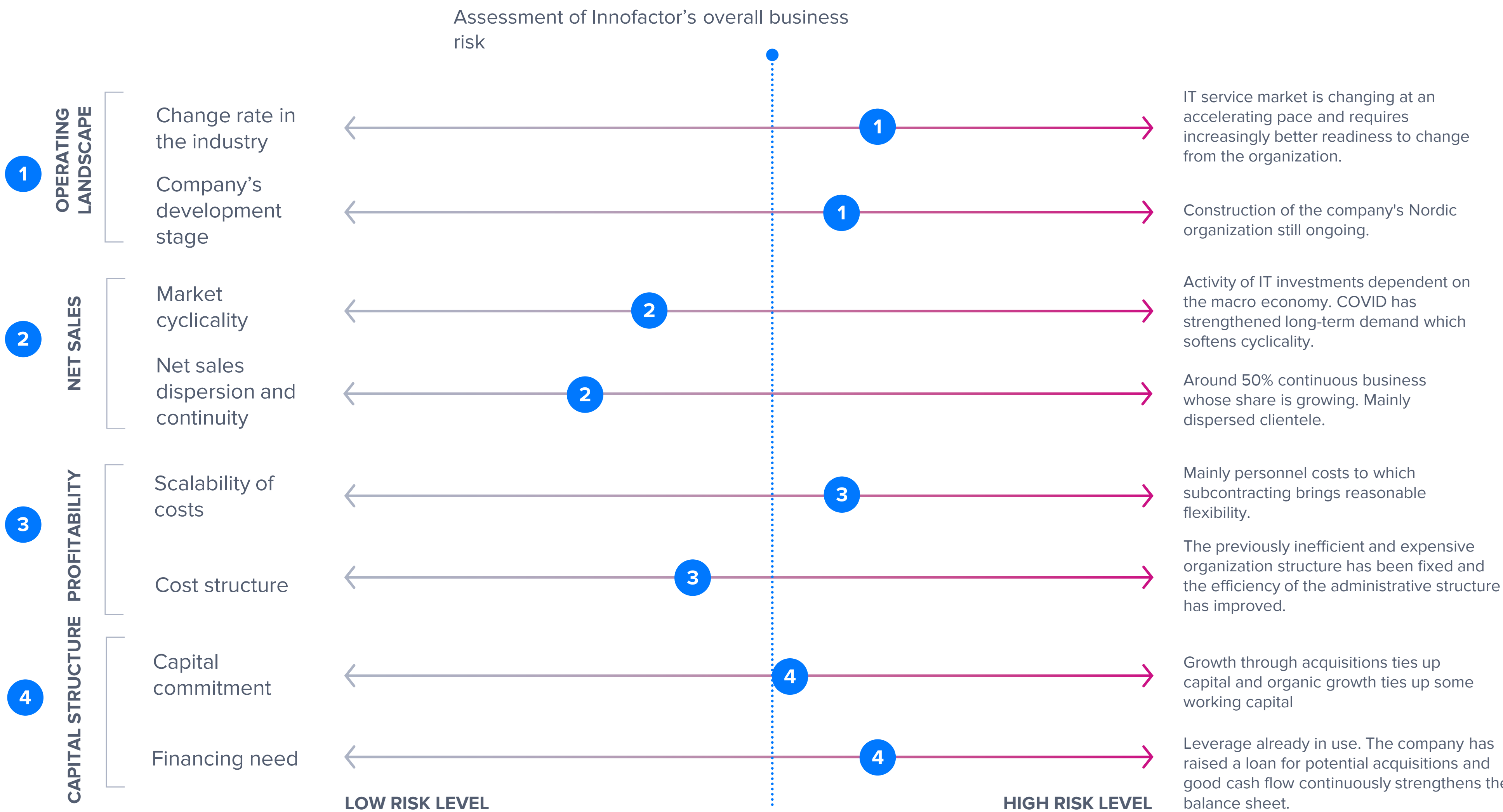
Employee path
- Digital office tools
- Modern work and teams
- Shared reality and telepresence

Cloud path
- Cloud infrastructure, management, data security and ePrivacy
- Identity management
- Integrations, Power Platform and PowerApps
- Capacity and maintenance services

Data path
- Business Intelligence (BI)
- Developed analytics, artificial intelligence, and machine learning
- Internet of Things (IoT) and digital twins

Source: Innofactor, Inderes

Risk profile of the business model



Source: Inderes

IT service market 1/7

Large overall market

According to various research institutes, the size of the Nordic (Sweden, Norway, Finland, Denmark) IT service market was USD 25 billion in 2019. The Finnish IT service market has in turn been estimated to be divided into some EUR 3.5 billion private and some EUR 1.1 billion public sector.

According to the definition of IT service markets, the market includes areas like IT consulting, software development services, integration and implementation services, outsourcing services, software maintenance and support, and IT infrastructure services.

The definition of the IT service market and its euro-denominated size continues becoming obscure as the role of IT and technology continues rising from the engine room to the operational core in various industries because of digitalization. Thus, the operating field of IT service companies crosses paths with new parallel markets that have not conventionally been considered part of the IT markets. These include, for example, strategy consulting, transformation management, design, and service design.

Market growth driven by digital services

According to various estimates, the conventional IT service areas are expected to grow by an average of 2-4% p.a. New digital services are expected to grow by an average of as much as 10% depending on the area. Market growth is slowed down by decreasing demand for infra and legacy software.

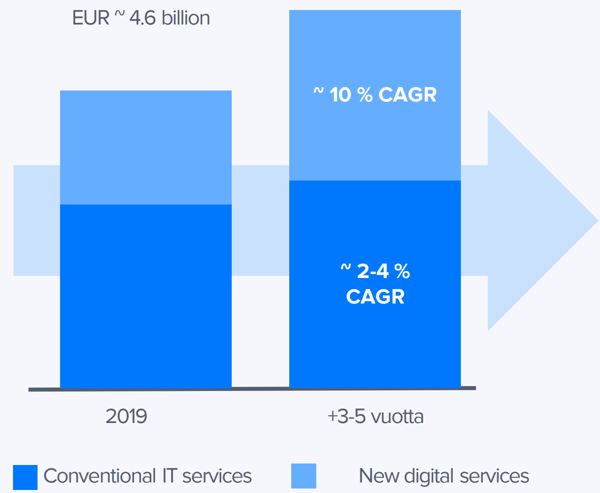
By service area, the areas that are expected to grow faster than the market are, based on a survey of listed and unlisted companies, cloud services, transformation management, data & analytics, and data security. TietoEVRY expects cloud services to grow by 15%, data & analytics by 15%, core software by 10%, and automation and DevOps by 20%. In our opinion, TietoEVRY is one of the best players to assess market development in the Nordic countries because the company has an extensive IT offering, and it operates in most customer sectors and has strong geographical presence on all Nordic markets.

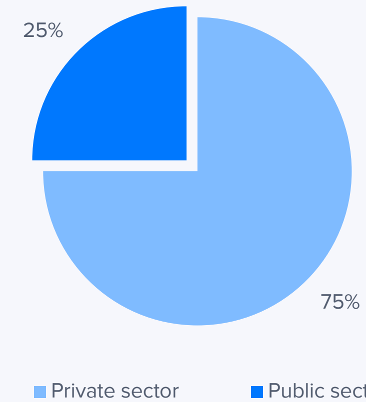
By customer sector, TietoEVRY reported in December that it expects the health care sector to grow by an average of 5-6%, public sector by 4-5%, energy sector by 3-4%, the forest industry by 6-7%, and banking and payment solutions by 4-9% in 2020-2023.

Long-term growth outlook of the market

The digitalization of society requires a huge number of hands to build, integrate and maintain new applications, which means that the long-term demand fundamentals of IT consulting companies are strong. Therefore, IT service companies offer investors a good opportunity to invest in the digitalization trend with the more limited risk profile of the service business. One can expect the market to grow more quickly than the macro economy in the long term.

Finnish market and growth picture





Source: IDC, Tutkihankintoja.fi

IT service market 2/7

Changing nature of IT investments divide the market

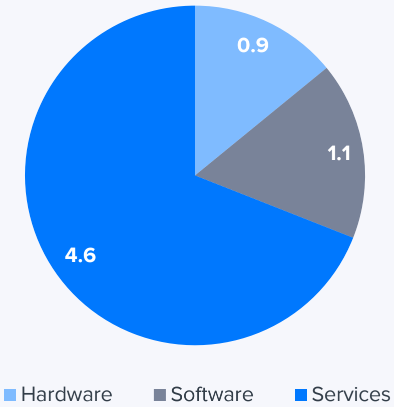
The continuously strengthening digitalization revolution launched a new era on the IT markets in the 2010s, which has redivided the market and generated new ways to operate on the market. Thanks to the digitalization revolution and accelerating technological change, IT purchases are changing, which requires IT companies to have the ability to adjust their offering constantly. The shift on the market towards IT investments that create new business and differentiating factors that began in the 2010s continues as the quest for cost efficiency is no longer enough in the competition. This means that the IT buyer is often a business unit or product development not data administration or support function. The desired expertise areas are increasingly linked to new digital services and less to background systems. The market revolution created a strong growth opportunity for many players that were born in the new era (like Futurice, Solita, Reaktor, Siili, Gofore and Vincit) that through their offering have profiled themselves as developers of new digital services. Conventional players were initially slow to adapt their offering and culture to better correspond with the changing purchasing behavior and demand for service areas.

The change on the IT service markets in the 2010s can be illustrated in a simple way by dividing the market into new digital services that grow strongly and into the faltering traditional software system development. Dividing the market in two is, however, becoming irrelevant, as new digital services cannot be discussed separately from the core business systems.

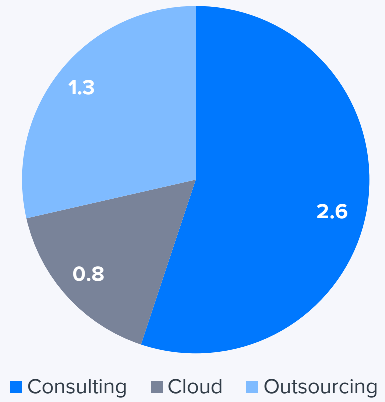
A clear trend on the market has in recent years been that IT purchases become more serious as the customer organizations have realized that you cannot get a short cut to digitalization by buying digital applications bypassing data administration. Organizations' established data systems will not disappear, but they must be modernized to work as platforms for new digital services. IT investments are directed at new functionalities that are built with interface solutions on top of existing systems. Correspondingly, this trend has restored competitive advantage to more conventional players, while many, primarily digital service developers that have succeeded mainly by acquiring talent, have been forced to reassess their strategies. As a result of increasing digital maturity in customer organizations, they have also become more demanding buyers and active in building their own software development teams.

As a result of the above-described revolution, the IT service market has undergone a considerable change over the past decade. Over the coming 10 years the change rate on the market will accelerate further and due to the complexity of technology and rapid development, it will become harder for companies to predict change. Thus, we believe that the ability of the companies in the sector to react and change will become increasingly important.

Finnish IT market in 2019, EUR billion



Finnish IT service market in 2019, EUR billion



Source: Radareco Nordic outlook 2019

IT service market 3/7

Internal division and development direction of the market

We have divided the IT service markets into three sections (page 14) as follows:

1. **Market for new digital services**, that includes development of new digital services (tailored software development). This has been the strongest growing area on the markets that was practically born only in the past decade. Well-known players on the markets are, e.g., Reaktor, Futurice, Nitor, Bitfactor, Siili and Vincit, in addition to which large IT generalists have also started investing in this area but have been late to the game. Characteristic for this market is a low threshold to enter the market.
2. **Market for background IT systems and enterprise software**, that includes ERP extensively and related systems covering primarily delivery, tailoring, integration and maintenance of firmware. Known players on this market in Finland include, e.g., Innofactor, Enfo, Solteq, Digia, Sofigate, eCraft, Bilot and IT generalists in particular (such as TietoEVRY and CGI). Market growth has been slow in this area and a high threshold to enter the market is typical for this area.
3. **Market for IT platforms**, that mainly covers infrastructure services (local, hybrid and cloud) and ICT outsourcing. This market has mainly been the strength of IT generalists (like TietoEVRY, Fujitsu) and the threshold for entering the market is high because the market has required economies of scale and investments. As a result of the cloud revolution, a redistribution of the market is ongoing that has generated new quickly growing players (like Nordcloud) and many medium-sized IT consultants (like Gofore, Siili and Enfo) are also entering the field. This market has rapidly shrinking (local infra) and drastically growing (cloud platforms) areas.

Cross-cutting service areas of these three markets are, for example, data and analytics, integration, data security and robotic process automation.

In recent years, the most visible trend on the market has been IT players striving to win over customers already when digitalization projects are being planned, as selling one hour of design work has translated into selling multiple hours of software development work. Many players seek a stronger position in the value chain by strengthening their consulting service expertise, in which case the IT supplier manages the projects and resources and does not merely deliver them. This trend has been visible as several acquisitions on the market. In addition, many IT consultants try to expand into strategy level consulting, granted with varying degrees of success.

Another clear trend for the players in this sector is the life cycle approach, as many new players now try to build the ability to offer software maintenance as well. Customers' purchases continue to shift from software development projects towards continuous software development, which changes the nature of the markets. Common for the strategies of all medium-sized and large players is also a strive towards the position of a more business critical partner for the customer. The know-how and offering of small software developers does not in this case reach deep enough into the customer's IT systems and processes. This development may accelerate market consolidation.

We believe the Finnish IT service market is now more strongly developing in a direction where the paths of conventional and new players cross and the boundary between "new" and "conventional" IT continues to blur.

Background system expertise is making a comeback and one must know how to utilize related data

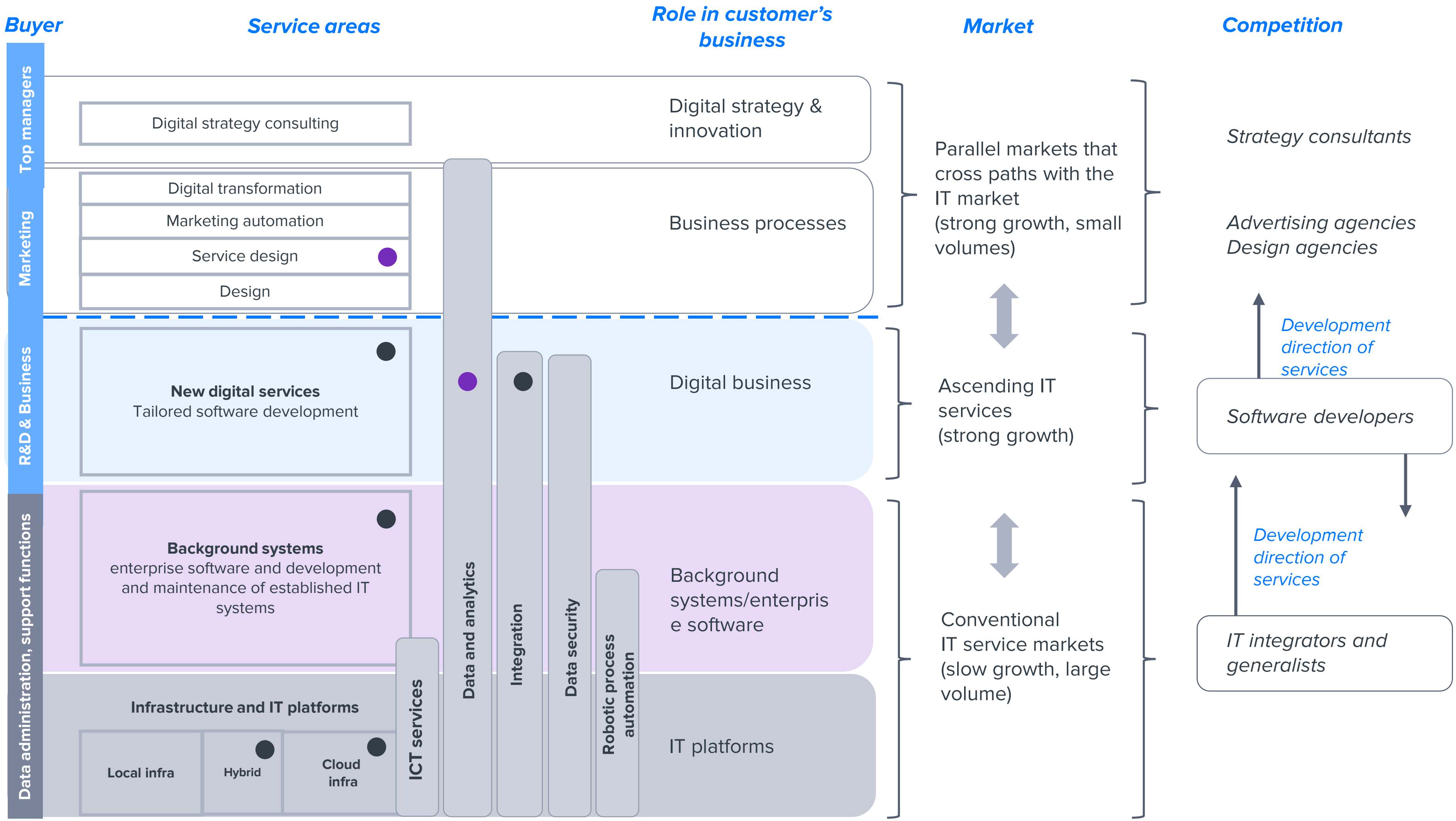
The strongest demand on IT markets has for years been in developing digital services and in software development that is still quite experimental by nature. According to our view, the market has, however, in recent years moved to a stage where one must be able to integrate new digital services and especially related data more tightly with the customer's background systems to get full business benefits from the new solutions. Customers also have increasing needs to modernize their background systems because an old ERP system may act as a break for the development of digitalization solutions. Thus, the nature of the ERP market that has suffered from slow growth for a long time will change, and the and the market is picking up. The importance of integration and data expertise also becomes emphasized.

In background systems the competitive field is much more stabilized, the threshold to enter the market is higher, customer relationships are well established, and as an expertise area these abilities are hard to build. This trend towards a life cycle approach is one challenge for pure digital service developers in the competition with generalists.

Division of the IT service market

Innofactor's offering

- Core competence area
- Competence area



Source: Inderes

IT service market 4/7

Trends in organizations' IT purchases

According to our view, the digitalization revolution will drive customers' purchasing behavior towards the following trends, where there are both winners and losers:

Data and analytics are again becoming one of the hottest trends on the market based on sector comments. Data is becoming a strategic competitive factor in several industries and the precondition for future AI solutions. For example, TietoEVRY and Digia have raised data to the core of their strategies. The challenge for customers is to combine data from silo-like data administration throughout the organization to marketing and business management. IT companies that have a combination of understanding in analytics, machine learning, and business are the winners.

Data security is still a relatively small share of IT service suppliers' offerings but like data it is becoming an increasingly strong competition and hygiene factor. Buyers focus more on data security, and it is a clear reputation risk for suppliers.

Subcontractor networks and building them is one of the clear trends of recent years. Companies partly patch-up their recruitment needs this way and increase flexibility.

Large, multi-year high-risk ERP implementation projects (SAP, Oracle, IBM) are no longer carried out and the nature of this market changes. Established ERP systems will not disappear from customers, but they will remain in maintenance mode by existing IT suppliers, and they will be moved to the cloud. Companies invest in modernizing ERP systems so that they do not become a bottleneck for digitalization projects. Generalists dependent on large projects have been the losers. Smaller players that have integration expertise are often the winners.

Buying IT as large projects will decrease further and move towards smaller, iterating processes and continuous development. Slowly reacting project organizations are the losers. Players that have expertise in agile software production, the ability to manage the services of several suppliers, and the ability to generate continuous services are the winners.

As business-oriented purchasing becomes more common, IT companies will seek new value production based, more scalable pricing models to break their business model away from poorly scalable sales of expert resources.

IT investments shift from investments that make the customers' business support processes more efficient towards core business processes or investments that improve the end product itself. Players that have conventionally served business support processes and ERP stakeholders are the losers. Developers of new digital service with technological know-how, expertise in background systems and business savvy are the winners.

Ownership of customers' IT budgets becomes blurred and moves from a CIO role more towards the role of business directors and marketing. Players that understand the customer's business and industry are the winners.

The IT market still does least of what is talked about most. The volume of services related to the biggest hype terms (AI, VR, AR, IoT, NLP, etc.) is still small on a sectoral level. These are, however, likely to become considerable service areas over the next five years.

User orientation and the customer experience continue growing. Rising areas include, e.g., digital service design, design and customer experience. Know-how in these areas will become the biggest competitive factor when selecting IT suppliers. Many players have patched up this area through acquisitions. Small, creative, design-centered players have been the winners.

Cloud revolution still divides the market. Customers' IT operations are moved to the cloud at an accelerating speed due to the benefits, and because it is often a precondition for new digital business models. Players with strong cloud technology expertise are the winners. The big losers are players in conventional local IT infrastructure.

Conventional reselling of software licenses moves to the cloud and software companies try to take over a larger share of the value chain when moving to SaaS models. License commissions of software resellers have decreased in recent years. Players that are dependent on license reselling are the losers. Customers are the winners.

IT service market 5/7

Customer organizations becoming silo-like will be a challenge for IT company sales. In addition to data administration, the IT buyer is increasingly marketing or product development, but building of a digital business requires cooperation between these areas and the ability to manage the whole. Players that manage large entities and who can address the customer's management and marketing are the winners.

The importance of **cheaper offshore resources** as a competitive factor will diminish further as it is hard to generate new digital services reliably, fast enough and cost efficiently with offshore resources located on another continent. Robotic process automation further weakens the competitive advantage of cheap labor. These trends will bring back the competitive advantage based on costs in IT expertise from Asia to Europe. Players whose competitive advantage has been based purely on offshore cost efficiency are the losers. Players who can combine local presence near the customer with sufficient cost efficiency by utilizing nearshore and/or offshore resources proportionately will be the winners. Robotic process automation experts are also among the winners.

Lack of experts, wage inflation and customer acquisition the nut to crack in the sector

According to our view lack of experts and stronger wage inflation than customer prices is one of the key medium- and long-term challenges to which the sector should find a solution. It becomes increasingly difficult over time to solve this equation through efficiency.

The expert market is in a chronically challenging situation and within it we believe that especially among more experienced experts, companies must be able to stand out with other factors than merely wage levels. In our opinion these factors include, e.g., interesting customer projects and a good work environment for individuals' own development. With the lack of experts it is also important to be able to hold on to existing talent and minimize staff turnover. In recent years, the sector has tried to solve the lack of experts by increasing and building own outsourcing networks.

Based on discussions we have had with various companies, wage inflation has been between 2% and 5% in recent years depending on adoption weight. In early 2021, TietoEVRY said that wage inflation was around 2%, which is clearly lower than other comments in the sector. Currently nothing indicates that the wage inflation is slowing down. This is partly controlled by using geographically cheaper workforce, which is not, however, a sustainable solution for the problem in the long run.

The development of customer prices has for years been 0-2% based on sector comments and thus clearly more modest than wage inflation. Due to COVID there has even been some downward pressure in customer prices in some situations. Personnel costs represent some two-thirds of costs in the sector and thus comparison with wage inflation is not one-to-one, but the effect is negative for nearly all players in the sector. As a rule of thumb, customer prices are higher in the private sector while agreements in the public sector are conventionally long and thus offer continuity. Thus, a shift in the customer focus can if successful be one driver for higher customer prices.

In the short- and medium-term, wider use of junior resources would solve both the lack of experts, alleviate wage inflation, and increase efficiency. Wider use of nearshore working would also solve the lack of experts in the short term and could curb wage inflation. In the medium and long term also those who can generate added value for customers and thus raise customer prices will be winners.

IT service market 6/7

Future winners on the market in our view

The clearest winners on the IT markets in the past five years have been companies specialized in developing new digital services that have been particularly successful in the competition for talent. The market for digital services has now reached a clearly more mature stage and the next match will be outside pure talent competition. In our view, the sector's success factors change and the winners in the next five years will be:

- The IT service market is sort of in a constant transformation. Reacting to these changes and recognizing them in advance is crucial for one's success. In an accelerating technological change, experts' ability to change also becomes key. Failure in this renewal exercise would directly affect current customer relationships, acquisition of new customers, relative competitive position, and thus long-term value creation potential. According to our view, the most sustainable competitive advantage of the IT service market comes from a constant ability to change.
- We believe that companies that are better able to combine junior resources will grow more strongly and profitably. A god example of this is the Danish IT service company NetCompany. Wider use of junior resources in Finland would to some extent also require a change in buyers (away from the CV model to buying solutions).
- The owners of strong customer relationships with a strategic partner role among customers, the ability to manage large IT projects and scale operations through a strong subcontractor network. Small players that hold the role of subcontractor and that have focused more on talent competition that on customers are weak when the macro market weakens.
- Companies with strong integration and background system expertise and the ability to provide maintenance and continuous services. Strong maintenance players are also strong when the market weakens. This is the weakness of many medium-sized digital service developers.
- Companies that can build a dynamic organization model that has the agility to react to a rapidly developing market. Many companies in the sector suffer from inefficient and inflexible, hierarchal, and silo-like organization structures, which makes renewal difficult when the market changes.
- Data and analytics are becoming an increasingly critical part of the delivery and an ability to generate added value for the customer and competitive advantage for the supplier. The role of the service area is already important but becoming even more important and also enables wider and more efficient use of AI and machine learning.

Competitive advantages

- Ability to renew
- Ability to react
- Life cycle offering
- Hot expert areas:
  - Transformation ability
  - Data utilization
  - Data security
- Agility and speed
- Experts' abilities (CV)

Value added

- Digitalization and digital transformation
- Business approach
- Developing new business
- Data utilization

IT service market 7/7

Acquisitions and consolidation continue in the sector

Consolidation of the IT service sector was active throughout the past decade. It has been typical for the sector to patch up shortcomings in strategic expertise areas with acquisitions.

Many players have strong cash positions and acquisitions are part of their strategy. When COVID broke out, M&A transactions stopped but since last fall M&A transactions have again become active. The pricing of the companies in the sector has increased considerably over the past five years and this high pricing has also spilled over to the unlisted side. Valuations that have risen close to that of listed companies weaken buyers' preconditions to carry out acquisitions that create shareholder value. Thus, the recipe that was highly efficient five years ago, where listed companies bought unlisted companies with lower valuation utilizing their own shares, no longer works as well.

Foreign players also look for acquisition targets in Finland, which increases the consolidation pressure in the sector. From the viewpoint of international investors, Finland is interesting because of an exceptional market of medium-sized digital service developers and the expertise of these players.

Capital investors are also still active and building IT expert houses. Last fall, Triton purchased HiQ listed in Sweden. In addition, several capital investors have continued consolidating smaller IT service companies.

As the market for digital service development is becoming more mature and the various areas of the IT market become integrated, a broader consolidation is likely as was seen in the Tieto and EVRY, and the KnowIT and Cybercom mergers. An interesting scenario could be the merger of two medium-sized players into a stronger player to challenge the large generalists. In our view a merger should have clear net sales synergies and factors that strengthen competitive advantages. We believe there are listed players on the Finnish market whose expert focus, geographical presence and customer portfolio would fit in well with different listed players.

Clear expert areas that in recent years have been acquired to strengthen the offering are consulting, transformation management, as well as data and analytics. Deals have naturally also been made for delivery capacity.

Acquisitions in the sector

Date	Buyer	Target	Sales	EBITDA	Personnel	EV/S	EV/EBITDA
06/21	eCraft	Project-IT	12		30		
05/21	Eficode	Beecom (SUI)	10	15 %	58	1.0x	7x
05/21	Loihde	Talent Base Oy	7	15 %	58	1.4x	7x
05/21	HiQ	Scandio (GER)			100		
05/21	Knowit	Cybercom			1,200		13x
04/21	Vincit	Bonsky Digital	2.7	7 %	30	1.0x-1.1x	13x-15x
03/21	TSS	Innofactor Prime business	>2		15		
02/21	Aucerna	TietoEVRYn oil and gas business	~50		430	3.2x	
02/21	Solteq	Partiture Oy	2.4	~40 %	16	1x	2x-3x
02/21	Gofore	CCEA and Celkee oy	5.6	21 %	50	1.1x	5.1x
12/20	IBM	Nordcloud	80		490		
12/20	Digia	Climber (SE, FI, DK, NED)	14	5 %	77	0.6x-1.0x	12x-20x
12/20	Siili	Supercharge (Hungary)	9	23 %	115	~1.8x	~8x
08/20	Triton	Hiq	~180	14 %	1,500	1.9x	13.6x
08/20	Bilot	CastorIT	7.3	12 %	60	1.2x	10x
08/20	Gofore	Qentinel	12.0	14 %	100	~0.9x	~6.4x
08/20	Pinja	PiiMega					
11/19	Solita	Ferrologic	13.1		100		
11/19	Fellowmind	eCraft and Orango					
06/19	Tieto	Evry	1290	14 %	9,400	1.4x	9x
06/19	Digia	Accountor Enterprise Solutions	12.7		114	0.7x	6x
05/19	Eficode	Praqma (SE, NO, DK)	5.5		46		
03/19	Nixu	Ezenta (DK)	8.8			0.7x-0.9x	
03/19	Nixu	Vesper Group	2			1.0	
03/19	CGI (tarjous)	Acando (SE and 2018 figures)	280	10 %	2,100	1.5x	14.6x
02/19	Digia	Starcut	~1.5	~5 %	19		
02/19	Gofore	Silver Planet	7.2	0.3	40	1.5x	6.0x
01/19	eCraft	Evry (Fi - Dynamics activities)			40		
01/19	Vincit	LeanCraft	3.0	>30%		1.8x	5.5x

Competitive landscape 1/3

Competitors on three levels

Following the fragmented structure of the Finnish IT service market the competitive landscape is also fragmented. At the top level we feel the competitive field can be divided into three layers. The first layer is international IT generalists whom according to different market sources hold a market share of around 50%. Such global giants include TietoEVRY, CGI, Fujitsu, Accenture and CapGemini. The second layer is suppliers with a net sales of around EUR 20-150 million and their combined market share is estimated to be around 30%. The third layer and thus the tail-end of the market includes smaller solution houses that employ less than 200 people.

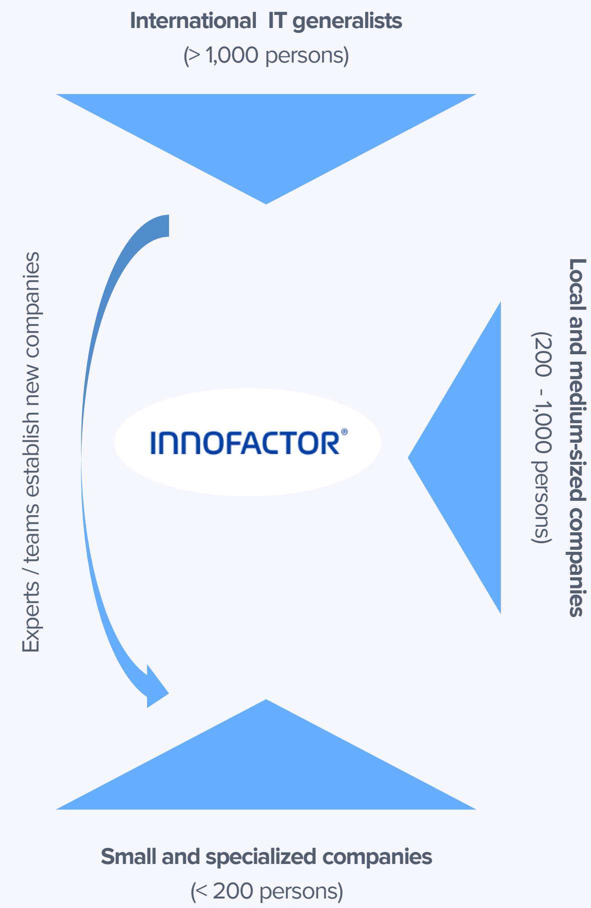
Innofactor's competitors are large often international IT generalists, medium-sized IT service companies, and small players specialized in certain solutions. Examples of generalists are TietoEVRY, CGI, Capgemini, Fujitsu and Accenture (Avanade). Among medium-sized IT service companies Digia, eCraft, HiQ and KnowIT can be mentioned as competitors. It is, however, hard to pick clear individual main competitors due to the fragmented sector and Innofactor's Microsoft specialization. Of individual companies, Innofactor faces TietoEVRY most often in tender processes. Small software developers (like Vincit, Reaktor and Futurice) mainly operate on different markets and thus Innofactor seldom faces them in competition but with Siili the company participates in some of the same competitive biddings in the area of digital customer experience. In public administration the company faces Gofore in competition who has succeeded in public administration with a strategy based on open-source code. Next to Innofactor, also Digia and eCraft are strong in Microsoft's ERP solutions in Finland. In Microsoft's cloud-based solutions and especially in the Office365 area the company competes with the rapidly growing Sulava.

Innofactor stands out from its biggest competitors with its agility, service, productized offering, local expertise, and know-how in Microsoft solutions. Customer organizations rarely want to buy from players that are clearly bigger than themselves, so the company also has a more natural position among medium sized customers. Innofactor stands out from smaller competitors with its Microsoft expertise, productization, as well as the credibility and references of a larger player.

Various ways to combat the scale of big players

We feel the clearest strengths of large IT generalists are extensive resources and offerings, which are often strengthened with cost-efficient offshore production. The customer and industry portfolios of these players are typically extensive. Customer and industry understanding is also often deeper than for smaller players. Strong background system expertise lies at the core of IT generalists genetic ancestry.

Dynamics of the competitive landscape



Source: Inderes

Competitive landscape 2/3

In practice this means that the solutions of these companies are both very business critical and established from the customer's viewpoint. In addition, these background system deliveries are also technically very challenging and high-risk projects, which raises the threshold of market entry. The key competitive advantages of IT generalists can in our opinion be summarized as large resources, the costs the customer faces if changing suppliers, and high thresholds to enter the market.

Next to agility, small companies usually also need some expert spearhead to be competitive against large generalists. Smaller companies also break into customers through some other buyer than IT management by selling digitalization solutions, for example, directly to the business. Thus, smaller companies do not necessarily ever face the customer's established system supplier in competition. Large generalists and small suppliers often operate in slightly different areas. In recent years, the biggest players in the sector have, however, started strengthening their abilities in the development of new digital services, which has made the competition tighter (e.g. more overlapping).

Because the earnings logic in the industry is capital light and personnel intensive the thresholds to enter the industry are also low in general. Many new payers on the IT service market have been born when experts that have left established IT generalists have founded their own companies. We believe the biggest weakness of smaller players is that they often get stuck in the value chain and must serve end customers only as a part of the value chain.

Therefore, small companies are not necessarily able to offer ambitious experts interesting career paths which also makes it more difficult to grow the business and improve the company's position in the value chain. In the competition for experts the key assets of small companies are usually cultural.

Competitive advantages are constantly being built

Despite the good growth outlook in the industry there is a lot of competition as there are several suppliers on the market, and, as stated before, the thresholds to enter the market are low. We also believe that the preconditions to stand out merely with technical skills and individual point solutions are small. In the long term, we believe competitive advantage must be built based on more extensive skills that aim at strategic partnerships. This in turn requires that the company's operations offer continued dynamism, flexibility, and renewal ability. To be successful in the long term, we believe companies must be able to read the development of both technologies and customer needs and react to these changes by applying/building their own capabilities. Considering this, we believe that building truly sustainable competitive advantages is structurally hard. We do not, however, consider this to be a barrier for long-term value creation.

Innofactor's competitive factors

Strengthening factors

- Ability to deliver and maintain business critical systems
- Solid Microsoft expertise
- Productization of offering and own software products
- Good position in public sector in Finland
- Product offering that covers life cycle

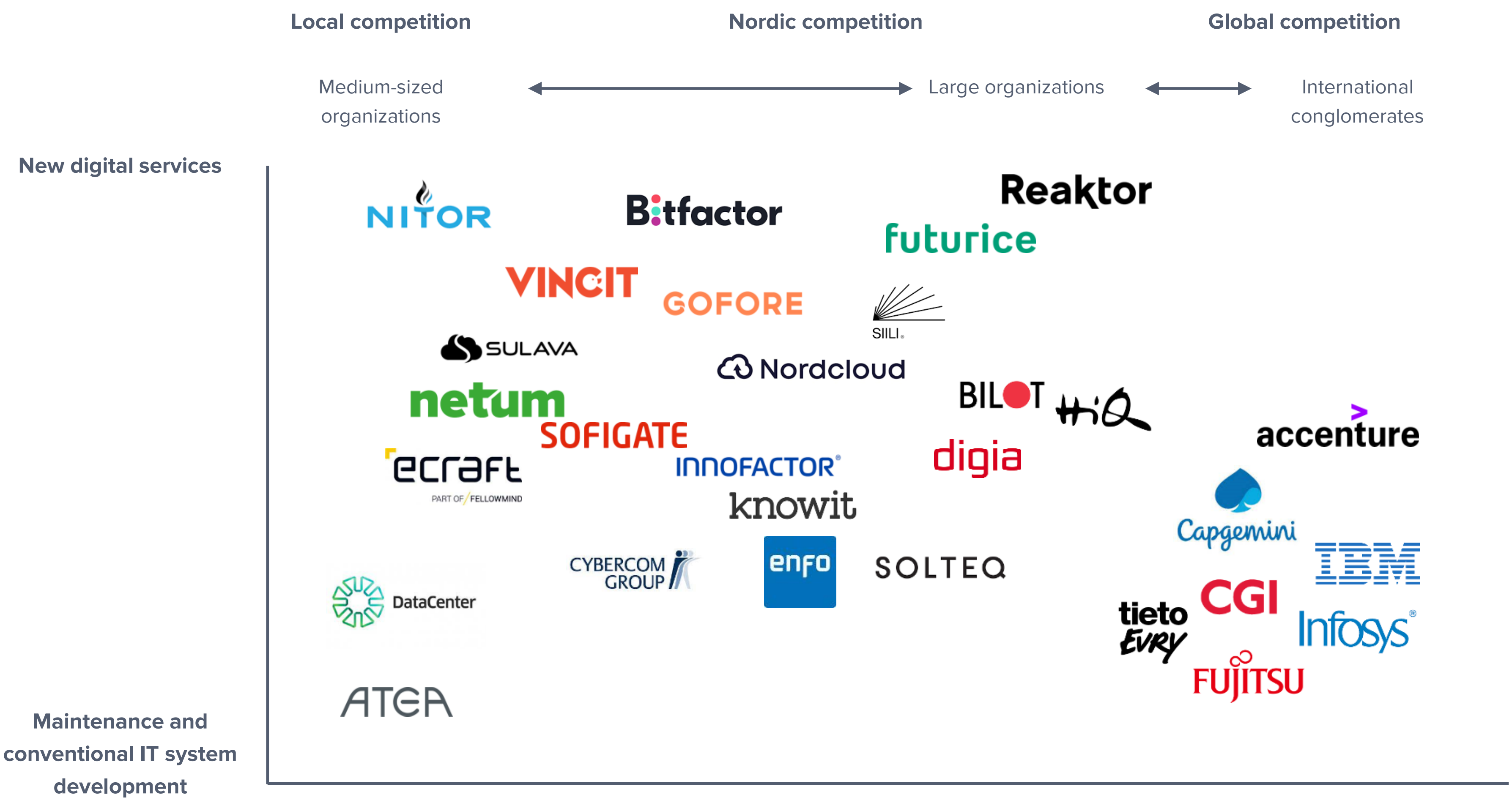
Weakening factors

- Facing large generalists with extensive offshore resources
- Several small, agile players as challengers
- Strong competition for experts limits growth
- Excluding other technologies

Source: Inderes

Competitive field

Finland's market structure based on customer size and service area-specific positioning



Source: Companies, Inderes

Competitive landscape 3/3

Growth and profitability of the peer group

The figure on page 23 examines the growth and profitability of listed and unlisted Finnish and other Nordic IT service companies.

The annual growth of the peer group has been 16% on average in 2016 to 2020, **which is explained by market growth, rapid organic growth of several small players, and acquisitions between several players.** The companies that have grown most strongly have expanded both through acquisitions and organically. Strong organic growers have been Vincit, Siili, Solita, Futurice, Gofore, Reaktor NetCompany and Kainos, and in recent years also Digia. Growth has been slowest for the largest players that have suffered from the market revolution (like TietoEVRY, CGI, Know-IT).

When examining growth, you can see that small, specialized players have clearly reached the fastest growth on the Finnish IT markets. This reflects the faltering of the demand for conventional system development, and IT demand focusing on new areas to which smaller and more agile players have been able to respond more efficiently. Over the past few years many formerly small and agile players have, however, grown relatively into a larger size class and maintaining the growth rate is becoming more challenging, which was visible as slowing organic growth in 2019-2020. A company that stands our clearly is the Danish Netcompany that despite its 3,500 experts has been able to grow its service business organically by ~20% and generate a 30% EBITDA %.

In terms of profitability, the average for the peer group is 12% measured by EBITDA % at an annual level in 2016 to 2020 (2015 to 2019 11.5%). On average, the profitability of the companies is on a healthy level. The IFRS-16 amendment raised the EBITDA margins of companies using IFRS accounting by some 1 to 3 percentage points starting from 2019 (more moderate effect when examining averages). This weakens comparability with the period preceding 2019, and especially with companies using FAS accounting. In the IT service sector, we have considered an EBITDA level of over 10% to be a good profitability level (excluding the IFRS-16 effect). Companies should not be satisfied with single-digit profitability levels. Large generalists TietoEVRY and CGI have generated good profitability despite slow growth, which is based on their strong market position and software business.

By comparing the combination of profitability and growth over the past few years, a few players stand out above the rest. The key players include the Finnish Gofore, Vincit, Sofigate, Netum and Reakto, the Danish NetCompany, British Kainos, and Swedish Enea. On the Swedish market, the clear winner is HiQ that has been able to revise its business model to respond to market trends. Capital investor Triton acquired HiQ last year.

Key growth drivers

Long-term

- Digitalization will accelerate and grow the market
- IT will become more of a key area of companies' business and strategy
- The definition of the IT service market becomes broader

Short-term

- Increasing customer prices
- Recruitment - Employee image, low turnover
- Improving efficiency through billable utilization and/or process efficiency
- Increasing subcontracting
- Acquisitions

Key profitability drivers

Short-term

- Billable utilization
- Improving efficiency
- Controlling wage inflation
- New operating methods caused by COVID and thus permanently lowered fixed cost efficiency and probable drop in travel expenses

Competitive field

Financial history of competitors

Source: Inderes, companies
*years 2016-2019
**Independent years 2016-2019
Figures include the IFRS 16 amendment since 2019

Profile of competitive field

Stars

- Forerunners with a history of profitable growth
- Mainly small and agile players that have positioned themselves and invested in growing areas of the IT service market
- The organization structures of stars are light, and they are highly business oriented

Growers

- Companies that are growing but whose investments depress profitability
- Growth has often been accelerated with acquisitions

Result machines

- Companies whose customers have high costs of changing supplier, for example due to tailored software solutions
- Profitability partially optimized at the expense of growth

Turnaround companies

- Mainly conventional IT companies that are in transition or have not been fully capable to adjust to the IT market revolution

Microsoft solutions in the IT market

Microsoft's position on the IT market is good

Microsoft has grown clearly faster in several product areas than the rest of the IT market, which also supports Innofactor's strategic choice. We believe Microsoft's position on the IT market is very strong and we see no signs of the position of Innofactor's principal weakening. The demand for Microsoft's products has grown with the cloud transformation and as a company Microsoft has shown its ability to renew itself and has also invested in renewal through acquisitions (e.g. LinkedIn, GitHub).

In its strategy, Innofactor believes Microsoft and thus also its partners will be strong in the key trends that shape the IT markets. These trends include, e.g., software moving to the cloud, mobility, IoT, machine learning and analytics, as well as data security and data protection. Microsoft is in a leading position on several IT market areas, its offering is competitive, and its cloud solutions have been growing strongly.

Now around one year after COVID broke out Microsoft says digitalization is accelerating and only in its initial stages. Telecommuting and distance learning, sales and customer service, critical cloud infrastructure and security have taken a huge leap forward forced by COVID. Of Microsoft's products, the use of the online meeting service Teams, in particular, is assumed to have grown significantly. Innofactor has developed its own TeamsMate solution next to Microsoft's Teams product that makes it easier to use and manage the product in organizations.

From Innofactor's viewpoint Azure, Office 365 and Dynamics 365 are currently Microsoft's key products. Of the top products, Azure is still most important, but the cloud-based Dynamics 365 product area is also growing well.

Innofactor also believes that Microsoft's strong product development investments will secure the competitiveness of its products in the long run. Microsoft has spent USD 10-19 billion on product development annually in 2012-2020 financial periods. The level of product development investments is clearly higher than for the main competitors. Headed by the CEO Satay Nadella, Microsoft has moved its focus especially towards digital transformation, cloud platforms, as well as data-driven business and solutions that are more compatible with its competitors' solutions. R&D costs (15% and USD 17 billion) in 2020 were raised by investments in cloud services, games, equipment, and LinkedIn. Microsoft's key competitors in various corporate solutions include, e.g., IBM, Oracle, HewlettPackard, SAP (ERP), Amazon (cloud services), Google and Salesforce (CRM).

Over the past decade, Microsoft has suffered from weak PC sales but the company's development has been good when examining the corporate solution areas that are key for Innofactor. Especially in the Commercial cloud solution reporting area (e.g. Office 365, Windows Azure Dynamics CRM) growth has been strong and the annualized net sales of Microsoft's cloud solutions in Q3'21 was already over EUR 60 billion compared to EUR 53 billion in corresponding period in the year before and the EUR 35 billion before that. On product level, Azure grew by 50% (59%), corporate side Office 365 by 22% (25%), Dynamics 365 product by 45% (47%) and LinkedIn by 25% (21%) in Q3'21.

Growth %	FY17	FY18	FY19	FY20	Q3'21
Office Commercial product & cloud service	7 %	11 %	13 %	12 %	14 %
Server product & cloud service	14 %	21 %	25 %	27 %	26 %
Dynamics product & cloud service	5 %	13 %	15 %	14 %	26 %
Commercial cloud - sales	50 %	56 %	43 %	36 %	33 %
Office 365 Commercial*	31 %	41 %	33 %	24 %	22 %

Source Microsoft, *2017 user numbers, 2018-> net sales growth

As software solutions move to the cloud, success in cloud solutions is key for Microsoft's competitiveness. In market research company Gartner's Magic Quadrant reports on different cloud revolution areas (BI, IaaS and CRM) Microsoft is the only player that is still ranked in the Leaders box in every comparison. In the bigger picture the positioning is at last year's level in all quadrants. According to Gartner, the cloud infrastructure market is still, despite the strong growth, heavily concentrating in the hands of a few players that are in order AWS, Microsoft and Google. Microsoft's position has weakened in the cloud infrastructure market quadrant. In the BI and analytics report, Microsoft and Tableau are on top but at the same time several competitors are on their heels.

Microsoft's competitive position

Gartner's Magic Quadrant for Business Intelligence and Analytics

Source: Gartner (February 2021)

Gartner's Magic Quadrant for Cloud Infrastructure as a Service (IaaS)

Source: Gartner (August 2020)

Gartner's Magic Quadrant for the CRM Customer Engagement Center

Source: Gartner (May 2020)

Strategy 1/3

Nordic Microsoft expert

Innofactor has made a strategic choice to focus on technologies and solutions implemented on Microsoft's platforms or that utilize these platforms, where Microsoft's growth exceeds the average growth of the IT service and software market. In terms of customer groups the company focuses on large and medium-sized Nordic companies and public administration organizations with high requirement levels for IT solutions. A strong position in the Microsoft ecosystem makes Innofactor a desired partner for Microsoft which helps the company stay at the forefront of the development of Microsoft's solutions.

Competitive edge and scalability from own software and productization

Innofactor develops its own software products to support scalability and service sales. As a rule, the company does not develop software products for the global markets but locally to strengthen the offering to existing customers and markets where the company already has a strong presence.

According to the company, Innofactor's own software components act as a key competitive advantage and an important factor in the customer's decision making in many project tenders. Own software also brings a considerable share of continuous maintenance income and license sales.

With own products built on Microsoft's technologies and platforms Innofactor builds continuity, competitive edge, and scalability for its business. This is a key driver with which the company tries to improve its profitability towards the targeted 20% EBITDA level. Thus, the company can decrease the dependence of the business model on less scalable expert work, which would also justify a higher valuation level for the share.

Strengthening the base of a Nordic Microsoft house still in focus

With the Lumagate acquisition in fall 2016 Innofactor achieved the number one position as a supplier of Microsoft-based solution in the Nordic countries in line with its vision. Thus, the company's strategy moved to the next phase. In 2017-2019, Innofactor primarily tried to unify its offering in the Nordic countries in the selected areas. In 2020, the company focused on navigating through the COVID crisis. Now in 2021, the company focuses especially on increasing net sales.

The company's focus still lies on strengthening its international operation and building a Nordic organization while improving efficiency, which should support continued gradual improvement in profitability. Success of the strategy is no longer strongly tied to finding good acquisition targets, but it depends more on the company's ability to create a uniform and efficient group from the international player it has built with acquisitions. At the beginning of 2021, the company hired a head in Sweden to develop the entire organization's offering and personnel skills who is to unify the offering also geographically.

The company tries to avoid becoming a silo-like organization where country units are separate, independent companies and synergies are not utilized. At the end of 2018, the company moved to a lighter self-managed organization structure, which seems very successful in light of costs. Organization levels were cut, and the number of managers decreased in Finland as a historic challenge had been a heavy and expensive organizational structure.

We expect the wide Nordic offering will improve Innofactor's competitiveness in medium-sized and large companies with operations in several Nordic countries. At the same time, the company will be able to utilize cross selling between countries in products and expert areas more strongly. We estimate that the utilization of the synergies between different operating countries is in the initial stages at the moment. The company has, however, had success, e.g., the Virtual data-center product developed in Norway has been sold in other countries. If successful more extensive cross selling of products and expertise between countries could, however, clearly improve Innofactor's organic growth and scalability.

The past few years have been a turn for the better for implementing Innofactor's strategy after the weak development in the two preceding years. To our understanding there is still clear potential to be realized in internal efficiency especially through billable utilization outside Finland.

Strategy 2/3

Financial objectives

In 2016, Innofactor published ambitious financial objectives in connection with its strategy. Due to the challenges in 2017, the company postponed the schedule for achieving the objectives. The company targets around 20% growth and some 20% EBITDA in the long term by maintaining a positive cash flow and safeguarding financial solvency.

Innofactor's means to reach the primarily organic 20% growth target are:

- Focusing on industries and customer segments with the biggest growth potential and scalability to other Nordic countries. The company has commented that it is now after COVID focusing more on private sector customers that have a higher average price as a customer sector.
- Increase efficiency in product and service sales. Innofactor's sales organization has been able to develop the order book in 2019-2020 especially in Finland. We estimate there is still a lot of improvement potential in sales in other Nordic countries.
- Efficiency in sales is improved with digital marketing efforts and better sales abilities.
- Focusing on skills governance, recruitment, and resource optimization at a Nordic level. We believe resource optimization still requires a lot of work. There seems to be upside potential in billable utilization and thus recruitment need only in a few expertise areas in Finland.

Innofactor's annual growth target of some 20% that is to be achieved mainly organically is ambitious and requires success in both sales and recruitment and especially in all countries. Last year, the business in Finland grew organically by an estimated ~15% but on organization level organic growth was below sector growth last year. We do not expect Innofactor to reach the targeted 20% growth for the entire group, but we believe that the company can accelerate growth beyond COVID supported by the positive demand on the IT service market.

Innofactor's means to reach the 20% EBITDA margin target are:

- Shift the offerings and focus of net sales more towards own products and services, which has already been happening for several years.
- Developing its own personnel so that customers are ready to pay a higher price, which we believe is difficult in the short term.
- Move to self-managing teams and reduce organizational levels. Innofactor moved towards a self-managing organization at the end of 2018. During 2020 the company's financial administration was centralized to Finland. HR and payroll have also been centralized and made more efficient.
- Improve billable utilization by minimizing unnecessary work or non-billable work. Here the company has progressed well in 2019-2020 and we estimate is that in the short term the company still has clear potential especially in other Nordic countries.

In our view, Innofactor reaching its profitability target requires the company to be highly successful in realizing the synergies between the countries, productization, own software products and sales. In Finland, the company already reaches around 20% EBITDA margin, but the weak profitability of the other countries depresses the overall picture. The average EBITDA margins of the industry are above 10% and for the best players close to 20%. The aim is no longer unrealistic considering the track record in Finland and the estimated profitability of the products but also requires strong performance from other Nordic countries.

The only change in the strategy from one year ago is that Innofactor renewed its dividend policy in 2020. The aim of the company is to pay around one-half of the result as dividends considering the company's financial position, possible M&A transactions, and other development needs.

Company has grown strongly pulled by acquisitions

Innofactor has histrionically grown strongly pulled by acquisitions and in our view most of the company's value creation has been based on sensibly built M&A transactions. In practice, companies have been acquired with a structure where only a small amount of cash is paid for the target company and a more significant share with own shares. This has enabled rapid growth without Innofactor needing a strong balance sheet or large amounts of capital in advance. In addition, a large share of the deal price has typically focused on an earnout additional deal price.

Strategy 3/3

The valuation levels of the deals have also without exception been lower than Innofactor's own valuation multiples on the stock exchange. These factors have lowered the risk of paying an excessive price. When looking at the whole, the company has in our opinion managed its capital structure sensibly and utilized a small leverage in the acquisitions. We believe that as a rule the use a small leverage in acquiring service companies with positive cash flow is justified.

However, the company has not been as successful in integrating the deals and realizing profitability synergies. For example, the acquisitions in Denmark (2012-2013) have been challenging for the company and the integration of the atBusiness acquisition (2013) was also difficult. The integration of the Cinteros acquisition completed in 2015 and the Lumagate acquisition completed at the end of 2016 were challenging. The entrepreneurs of the acquired companies have mainly left Innofactor and the turnaround in members of the management group has probably slowed down operational development. The company knows from experience what factors the key risks are related to and can minimize these.

Acquisitions outside Finland

Innofactor's strategic goal is to grow stronger outside Finland. We expect that the company primarily seeks acquisition targets abroad to strengthen these markets to reach similar economies of scale as in Finland and stronger synergies on a Nordic level. In addition, the business of the company to be acquired must be profitable and sustainable.

When technology development, companies' strategies or focus change, businesses can also become non-strategic. Innofactor is not excluding business divestments either. In early 2021, the company sold a small non-strategic Prime business to unify its offering.

Importance of acquisitions smaller in future

In its current strategy phase Innofactor probably focuses on slightly smaller companies with a few dozen experts with which the company tries to strengthen the coverage of is offering in each country. Thus, the weight of acquisitions decreases. Geographically we find it more likely that the company would strengthen its market position either in Sweden or Denmark.

Microsoft expertise and own software as competitive advantage

Innofactor's key competitive advantage still comes in our understanding from focusing on and specializing in Microsoft solutions. Competitive advantage in carrying out acquisitions comes in turn from the company's experience in M&A transactions and the capital channel enabled by the listing.

In our opinion, the biggest weakness of the strategy focusing on Microsoft is Innofactor's dependence on Microsoft's strategy being successful in the long term and the increasing popularity of open-source code software. Innofactor does not exclude the use of other technologies and Microsoft's strategy also changes constantly, e.g., as a result of the GitHub acquisition. The benefit of competitors that are not technology dependent like Innofactor is that they can select among several technologies to best respond to the customer's problem.

Other competitive benefits of Innofactor are the agility and flexibility generated by the relatively small size. Against smaller players higher productization of the own offering and own software products is a competitive advantage. Especially when the customer organizations' activities are taken to the cloud it is critical for an IT supplier to own the tools and manage the processes to enable a smooth transition without use being disrupted. In this area, Innofactor has the expertise especially in the Azure environment, including its own Innofactor Virtual Data Center and Innofactor Managed Azure services.

In Finland where Innofactor sells solution models, the strategy works and brings a competitive edge. Outside Finland, the business is still relatively small, and the company is not selling total solution models. More teams are sold outside Finland, which does not bring any competitive edge. To our understanding the development has, however, been positive also outside Finland even though the company is still far from its potential.

Summary of Innofactor's strategy

Strategic development projects

Best Nordic experts

Cloud solutions and digitalization offering

Industry focus

- The aim is to increase net sales and turn Sweden, Norway, and Denmark back to profitability in 2021
- Strengthening the organizational base especially in other Nordic countries
- Stronger level of productization

Strategic measures

- Stronger focus on industries and solution areas that offer a large growth potential and scalability.
- Making sales of own products and services more efficient in the current clientele
- Increasing the weight of productized services
- Raising the level of expertise and thus higher pricing
- Investing in operational efficiency

- The strategy aims at a leading position in every Nordic country
- Focus of the business shifts heavily towards own products and services
- Honing acquired activities into a uniform whole and making own processes more efficient
- Complementing acquisitions expected in the medium term not the short term

Financial objectives in the long term

- Around 20% annual growth with the aim to achieve most of it organically
- Around 20% EBITDA margin
- Pay around one-half of the result as dividends considering the company's financial position, possible M&A transactions, and other development needs

- Very ambitious objectives
- The company should reach >5% organic growth with the current portfolio
- Successful sales and growth in existing customers through cross selling
- Reaching the goals needs own solutions to break through strongly

Source: Inderes

Strategy positioning

	Software developers (like Vincit)	Innofactor	IT generalists (like TietoEVRY)
Customer segments	Small and medium sized, in bigger subcontractor / a point solution supplier	Medium-sized companies, public administration, and voluntary sector (medium-sized organizations)	Large corporations and public sector
Geographical	Finland + scattered internationalization	Nordic countries	Nordic countries (+ global organization)
Solution areas	Tailored software development, technologically independent	Microsoft technologies with extensive offering, own software products	End-to-end, own software products
Strengths	Talent competition Agility Change rate Low organization model Positioning on growing areas No substantial project risks	Microsoft expertise Extensive offering Productization and continuous services Established customers	Offshore/nearshore talent Global deliverability Most extensive offering Strong customer maintenance
Weaknesses	Remaining in the role of talent resourcer Maintenance abilities Ability to deliver turnkey solutions	Pricing power	Need for constant renewal and legacy business Change rate Heavy organization
Growth and profitability at the moment	Stronger growth than in the sector Excellent profitability on current market	Modest organic growth Profitability at sectoral level	Modest organic growth Growth through acquisitions Good profitability
Business model	Resource supplier for customer projects	Consulting, integrator, maintenance, own software	Integrator, strong maintenance portfolio, own software

Source: Inderes

Past development

Growth has been strong historically, partly at the expense of profitability

Innofactor's long-term net sales growth has been strong and driven by acquisitions. In the early 2010s, Innofactor's growth was strong (35% on average) organically and driven by acquisitions. In the second half of the 20210s, organic growth has again been weaker, and acquisitions have dominated growth.

Company growth has partly come at the expense of profitability, which has been below other companies in the sector. Before its listing, the company still reached EBITDA levels of over 20%. The company's EBITDA % adjusted for non-recurring items has been between 8% and 12% in 2011-2019, except in 2017-2018 (2% and -2%). The fluctuations in Innofactor's profitability have been quite high in recent years compared to its peers and the strong fluctuations in profitability are, according to our estimates, also partly reflected in the volatility of the share price.

Earnings growth has continued for nine quarters despite COVID

Innofactor's net sales continued growing (3%) in 2020 despite the headwind from COVID. Finland's operations grew by an estimated 15% while Group development was still depressed by the weakness in Sweden, Norway, and Denmark. The company's sales continued winning over good deals and the order book grew strongly (by an average of 23% and 21% in Q4) throughout the year creating a stronger basis for more sustainable growth and accelerated growth. The company did, however, occasionally have to drop prices somewhat in sales.

The number of personnel rose a bit (0.6%) and stood at 541 at the end of the year (2019: 538). Net sales showed better growth and reflected the fact that the company's billable utilization has continued rising. There is still clear potential in billable utilization, the company can even improve in Finland, but the potential is clearly larger in other countries.

Earnings growth has continued for nine quarters despite COVID. In 2020, the EBITDA margin rose heavily and was 11% of net sales (2019: 8%). Profitability was supported by higher billable utilization, lower cost structure due to COVID, adjustment measures made outside Finland and EUR 0.7 million in COVID support from the government. Thus, EBITDA grew to EUR 7.2 million in 2020 (2019: EUR 5.1 million).

COVID changed the structure of net sales

COVID generated a change in the customer mix last year that remained at the 2020 level in Q1'21. In Q1, 41% of Innofactor's net sales came from corporate customers (2019: 50%), 43% from public sector customers (2019: 34%), and 16% from voluntary sector customers (2019: 16%). The change in public administration during COVID depicts the defensiveness of the customer segment and the softness of the private sector. When looking beyond COVID we estimate that the structure of net sales will gradually change back to the pre-COVID era.

When distributing net sales by delivery method, delivery projects and consulting represented 43% (2019: 48%) expert work based on continuous agreements 32% (2019: 24%), service and software maintenance based on continuous agreements 21% (2019: 22%), and licenses sales 4% of net sales (2019: 6%). In the long term, the company's aim is to increase the share of delivery projects and consulting to around one-third of net sales, which would shift the focus of net sales to higher margin deliveries and continuous business. The net sales structure is heading in the right direction and has also been visible in profitability.

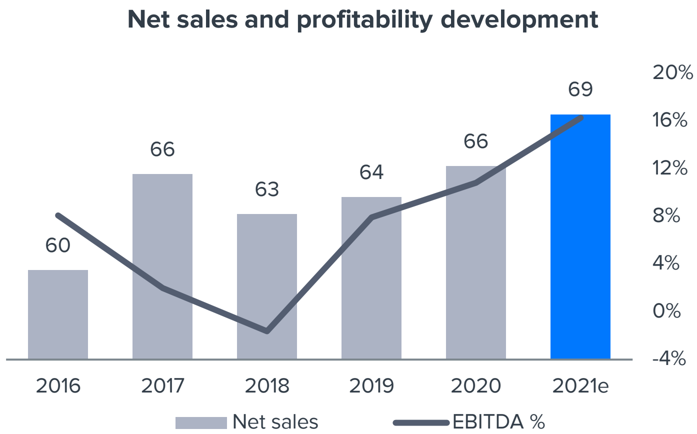
Balance sheet and financing

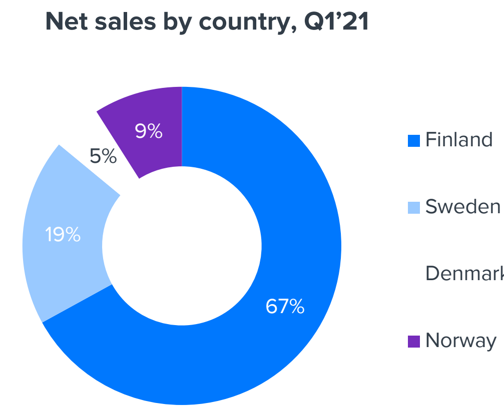
Innofactor's balance sheet strengthened further in 2020 and the equity ratio at the end of Q1'21 was 47% and gearing was 57% (Q1'20 44% and 61%). With the company's positive profitability development the balance sheet is now at a healthier base. The balance sheet was also strengthened by the EUR 2.6 million sales gain recorded from the Prime business in Q1'21.

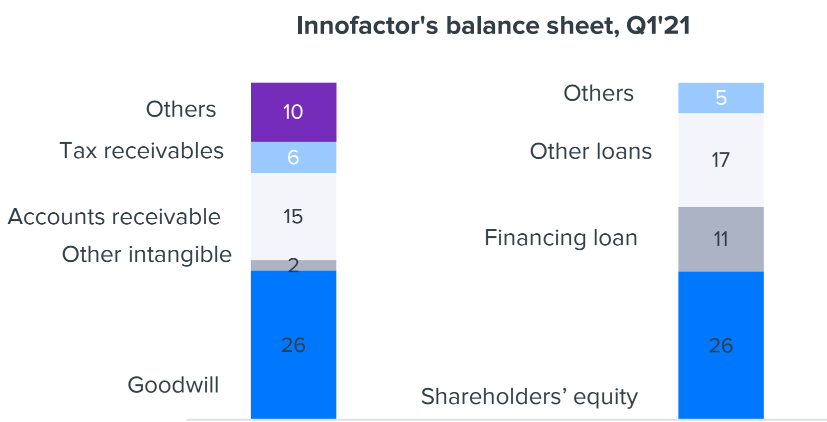
At the end of the first quarter, the company had EUR 6.2 million in cash in hand. The company's cash is exceptionally high compared to historic figures. In the past, the company has consolidated the market strongly using own shares and bank loans.

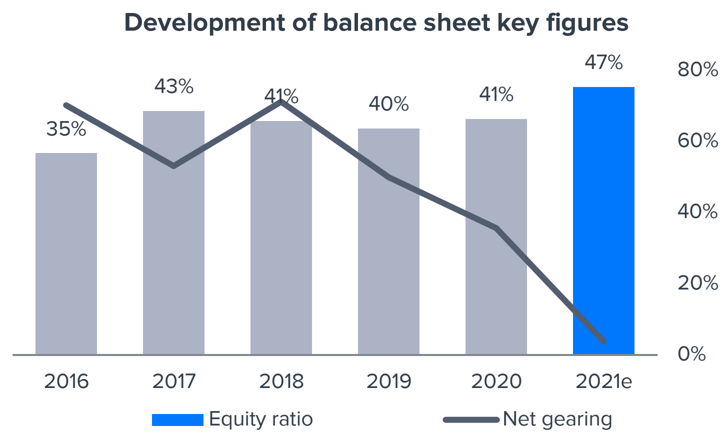
At the end of the first quarter, Innofactor had EUR 1.8 million left in capitalized customer relationships and technologies in its balance sheet related to acquisitions of which we estimate the company will write-down some EUR 0.6 million annually in line with IFRS3 depreciations. This has a negative accounting result effect, which we adjust from the company's operating profit and EPS for comparability reasons. At the end of the first quarter, the company had EUR 26 million in goodwill in its balance sheet. The company also had EUR 5.6 million in tax receivables in the balance sheet at the end of the first quarter.

Past development









Source: Inderes

Estimates

We expect earnings growth to continue

In 2021, Innofactor will after COVID focus especially on increasing net sales and the goal is to get Sweden, Norway, and Denmark back to profitable growth in 2021. The company has commented that it expects strong growth outside Finland in Q2-Q3. In terms of sales, focus will according to our understanding be more in the private sector here the average price is better. If the shift in focus towards the private sector works, it will support the net sales structure and thus also profitability.

Innofactor's guidance for 2021 is that net sales and EBITDA will grow from 2020, when net sales was EUR 66.2 million and EBITDA EUR 7.2 million. We estimate net sales will grow by 5% to EUR 69 million. Growth is slowed down by the divestment of the Prime business which causes some EUR 2 million headwind in the 2021 net sales. So we expect net sales to grow by 8% in 2021, which is a better growth rate than that of the sector. Growth is supported by a strong EUR 69 million order book at the end of Q1'21 (growth 27%).

The timing of the good order book materializing as sales and assessing the profitability structure of the order book is still difficult. In its annual report, Innofactor opened up the structure of the order book and expects EUR 35.7 million of it to be recognized as income in 2021, which represents a 22% increase in the revenue-generating order book from the comparison period. The order book focuses varyingly on different areas (strong order book for Dynasty product) and geographically in different areas, so it has not been directly reflected as dramatic growth. We believe the order book in Finland is good if not even strong, while the weaker performance in other countries slows down the development. Toimitusjohtaja avasi videolla tilauskannan rakennetta ja sen dynamiikkaa.

We made small adjustments in our estimates and raised our earnings estimates by 1% for 2021. We estimate that the EBITDA adjusted by the EUR 2.6 million sales gain from the Prime business to grow to EUR 8.7 million and represent 12.5% of net sales (2020: EUR 8.2 million or 12.3% adjusted for depreciation). Thanks to Innofactor's improved internal efficiency and own product sales, the company can continue growing faster than the number of personnel in the short term, which supports profitability. We estimate that Innofactor has considerable improvements to make in billable utilization outside Finland. We believe the profitability improvement is slowed down by smaller COVID support from EUR 0.7 million in 2020 and partially recovery of costs in H2.

We expect IFRS3 depreciations to amount to EUR 0.6 million in 2021. We estimate that the adjusted operating profit will be EUR 6.0 million or 8.7% of net sales. Thus, we expect adjusted EPS to be EUR 0.10 and reported EPS EUR 0.16 per share.

Medium- and long-term estimates

We expect Innofactor to reach 3-4% organic annual growth with the current structure and an EBITDA margin of good 13% in 2022-2023. Our estimates are in line with or slightly below general market growth. The company's IFRS3 depreciations are expected to stop in H1'22 if no new acquisitions occur. Considering the uncertainty created by COVID and the company's weak organic development in recent years we maintain our growth estimates cautious. Our growth estimate practically assumes the level of service companies. The company should have the preconditions to reach better profitability levels than the sector thanks to own products and big growth in continuous business but we keep our estimates conservative for the time being due to weak development in other Nordic countries.

We estimate that the company's EPS adjusted for IFRS3 depreciation will be ER 0.14 in 2022 and rise to EUR 0.15 in 2023. We raised our dividend estimates and expect the company to distribute around one-half of the result as dividends considering the company's dividend policy. We expect the company to distribute EUR 0.06 in dividend per share in 2021 and EUR 0.07 in 2022-2023, which corresponds with an annual dividend yield of around 4%.

Innofactor still has around EUR 6 million tax receivable in its balance sheet, so the company's tax expenses do not have cash flow effect in the next few years. This supports the cash flow of some EUR 0.5 million in the next couple of years. Thus the cash flow per share will be higher than the earnings per share in the next few years if no significant changes take place in working capital and investments.

After 2023, we estimate that Innofactor's net sales will continue growing by 2.5-3.0% until the terminal assumption. At the same time we expect profitability to gradually drop towards 9% EBITDA level in the terminal assumption. Thus, our estimates put the company clearly below its own targets.

Quarterly estimates

Income statement	2018	2019	Q1'20	Q2'20	Q3'20	Q4'20	2020	Q1'21	Q2'21e	Q3'21e	Q4'21e	2021e	2022e	2023e	2024e
Revenue	**63.1**	**64.2**	**17.2**	**16.8**	**14.0**	**18.3**	**66.2**	**17.8**	**17.7**	**14.8**	**19.1**	**69.4**	**72.2**	**75.1**	**77.3**
EBITDA	**-1.0**	**5.1**	**2.0**	**2.0**	**1.6**	**1.6**	**7.2**	**4.7**	**2.2**	**1.9**	**2.5**	**11.3**	**8.8**	**9.2**	**9.4**
Depreciation	-2.8	-4.3	-1.1	-1.2	-1.2	-1.2	-4.7	-0.8	-0.8	-0.8	-0.8	-3.2	-2.1	-2.0	-2.0
EBIT (excl. NRI)	**-1.8**	**2.8**	**1.3**	**1.3**	**0.9**	**1.0**	**4.5**	**1.3**	**1.5**	**1.3**	**1.9**	**6.0**	**7.0**	**7.1**	**7.3**
EBIT	**-3.9**	**0.8**	**0.8**	**0.9**	**0.4**	**0.4**	**2.5**	**3.8**	**1.4**	**1.2**	**1.7**	**8.1**	**6.7**	**7.1**	**7.3**
Net financial items	0.1	-0.8	-0.9	0.3	-0.4	0.5	-0.5	-0.5	-0.1	-0.1	-0.1	-0.6	-0.4	-0.1	-0.1
PTP	**-3.8**	**0.0**	**-0.1**	**1.2**	**0.0**	**1.0**	**2.1**	**3.4**	**1.3**	**1.1**	**1.7**	**7.5**	**6.3**	**7.0**	**7.3**
Taxes	0.6	0.4	0.3	0.1	0.0	-0.7	-0.3	-0.7	-0.3	-0.2	-0.3	-1.5	-1.3	-1.4	-1.5
Minority interest	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net earnings	**-3.5**	**0.4**	**0.2**	**1.2**	**0.0**	**0.3**	**1.8**	**2.6**	**1.1**	**0.9**	**1.4**	**5.9**	**5.1**	**5.6**	**5.8**
EPS (adj.)	**-0.08**	**0.07**	**0.02**	**0.05**	**0.01**	**0.02**	**0.10**	**0.00**	**0.03**	**0.03**	**0.04**	**0.10**	**0.14**	**0.15**	**0.15**
EPS (rep.)	**-0.10**	**0.01**	**0.01**	**0.03**	**0.00**	**0.01**	**0.05**	**0.07**	**0.03**	**0.02**	**0.04**	**0.16**	**0.14**	**0.15**	**0.15**

Key figures	2018	2019	Q1'20	Q2'20	Q3'20	Q4'20	2020	Q1'21	Q2'21e	Q3'21e	Q4'21e	2021e	2022e	2023e	2024e
Revenue growth-%	-3.8 %	1.7 %	6.2 %	0.6 %	0.3 %	4.7 %	3.1 %	3.8 %	5.4 %	5.7 %	4.9 %	4.9 %	4.0 %	4.0 %	3.0 %
Adjusted EBIT growth-%		-253.3 %	215%	102%	14%	-1%	59%	3%	13%	48%	93%	34%	16%	1.8 %	3.0 %
EBITDA-%	-1.6 %	7.9 %	11.6 %	12.2 %	11.1 %	8.7 %	10.8 %	26.2 %	12.2 %	13.1 %	13.2 %	16.3 %	12.2 %	12.2 %	12.1 %
Adjusted EBIT-%	-2.9 %	4.4 %	7.7 %	7.9 %	6.2 %	5.4 %	6.8 %	7.6 %	8.5 %	8.7 %	9.9 %	8.7 %	9.7 %	9.5 %	9.5 %
Net earnings-%	-5.5 %	0.6 %	1.3 %	7.4 %	0.2 %	1.4 %	2.7 %	14.8 %	6.0 %	5.9 %	7.1 %	8.5 %	7.0 %	7.5 %	7.5 %

Source: Inderes

Investment profile

Value creation more from organic development and own products in future

For investors Innofactor has historically been profiled as a quickly growing IT company that acts as the consolidator of its own segment in the Nordic countries. Throughout history Innofactor's value creation has been based heavily on growing through acquisitions. Innofactor has a reasonably good long-term track record especially in acquisition-driven growth but the track record in profitability and integration of acquisitions has not been as good. With the Lumagate acquisition, the company moved in 2017 to a stage where after strong acquisition-driven growth the focus has shifted to building a uniform Innofactor. This change proved harder than expected and created a dip in the growth strategy. Now the Finnish business is on a solid base and the next development leap is dependent on countries outside Finland. Considering the company's strategy value creation is in future expected to be based more on organic growth and growth of own scalable products.

Positioning rising to result machine category

In our view, the positioning of Innofactor's valuation is climbing out of the turnaround company category and rising to the result machine category. In recent years, the company has been priced at relatively low valuation multiples due to several disappointments and the weaker confidence that followed. As the 2019 turnaround has progressed, the company's share has risen considerably which has been justified because the company avoided the crisis scenario, and the earnings turnaround has progressed stably which provides confidence in a stabler development also in future.

Next the company tries to strengthen the operations in other Nordic countries to get more country-specific efficiency benefits. Innofactor also still has underutilized efficiency benefits from unifying the Nordic organization and the offering and processes between the countries, and the company has hired a manager in Sweden to implement this. This probably means striving for bigger economies of scale in the long term in Sweden, Norway, and Denmark.

The key risk in the short term is still the COVID situation becoming prolonged and its effects on the economy. Especially in international operations the company has faced surprising problems in the past. The company must prove that the turnaround continues and strengthens for investors' confidence in the company to improve and the result machine category to be justified. Innofactor's markets are growing when examining the long term and performing well so growth should not hinge on the market situation.

Ambitious long-term objectives

After reaching its previous vision (number one supplier of Microsoft-based solutions in the Nordic countries) the company now also strives for the leading position as a cloud solution and digitalization implementor separately in every Nordic country. In our view, Innofactor's value creation in the long term will consist of the company's ability build a uniform Nordic player out of the acquisitions carried out in different countries. Service productization and the role of own products are also important in reaching the company's profitability target, These should be visible as stronger organic growth and better profitability. We do, however, not expect the company to reach its own ambitious 20% primarily organic growth and 20% EBITDA margin target and our own estimates are clearly below the profitability target and especially compared to the growth objectives. We do not, however, find the expectations to be unrealistic as for Finnish operations organic growth has been an estimated 15% and profitability close to the targeted 20% level.

The risk of the strategy is that the company cannot strengthen its international operations and new problems appear. The long-term risk is the company's dependence on Microsoft's success. The risks are evened out by Innofactor's own product business, the current stronger order book, increasing share of continuous services and strong demand outlook, as well as the continued development of Microsoft's product on the IT market.

Entrepreneur-driven growth company

Innofactor is strongly personified in the biggest owner, the company's founder, and CEO Sami Ensio, who owns some 21% of Innofactor. Ensio established the company in 2000 after which Innofactor has grown strongly with acquisitions and organically under his management. We feel the company as an investment object next to growth-seeking also reflects strong entrepreneurship and personified ownership. The entrepreneur-drive is visible in how despite several challenges the company has been developed in a disciplined manner and unyieldingly.

Investment profile

1. **Template of a Nordic player built through acquisitions**

2. **Base in place for long-term growth**

3. **Strong growth fundamentals on the market**

4. **Turnaround continuing supported by strong order book and next stage in international operations**

5. **Entrepreneur-driven growth company in the long term**

Potential

- Organic and inorganic growth
- Still potential for profitability improvement
- Clear upside in acceptable valuation level
- IT service markets in general and Microsoft solutions performing strongly
- Strong and growing continuous business and own products

Risks

- Further delay in building a Nordic organization
- Weakening employee culture
- Internationalization and acquisitions raise the risk level
- Weakening of Microsoft's market position
- COVID situation growing worse and becoming prolonged

Source: Inderes

Valuation 1/2

Value drivers and risks of the share

As a whole, Innofactor's earnings turnaround has been clearly faster than expected and the company's profitability potential is turning out to be higher than we expected. The 20% EBITDA target that previously sounded completely unrealistic now starts to seem possible even though our own estimates are based on a clearly more moderate scenario.

We have divided the value drivers of the share into short (1-4) and long term (5-6). The key value drivers are:

1) The ability to get all countries to an organic growth rate of at least the level of the IT service market of 3-5%.
2) Success in strengthening the post-acquisition organization to raise the efficiency of all countries to a good level.
3) The company's ability to raise profitability sustainably to a better level.
4) Strengthening investors' confidence as the turnaround continues.
5) The ability to tie the group together with a unified offering, which would help realize the synergies between the countries.
6) Increasing acceptable valuation level especially as the focus of the business shifts to product business in line with strategic objectives.

Innofactor has clearly more continuity and scalability in its business than many peer companies involved in project business. Continuity holds high value especially in the "normal" tight expert market situation.

The turnaround has progressed well for good two years but there is still work ahead in strengthening and unifying the organization. In addition, the company's many difficulties in international operations in the past are still in the back of the mind.

We believe the key risks are:

- Success in turning around and strengthening the growth in other Nordic countries, as well as unifying the organization
- New challenges appearing Historically the company has faced many surprising challenges especially in other Nordic countries
- COVID situation growing worse/becoming prolonged
- Unsuccessful integration in new acquisitions The company has faced challenges in several integrations
- Microsoft's market position weakening in the IT market in corporate solutions Microsoft's market position has strengthened further in recent years, but the IT market develops and changes quickly
- The favorable cycle of the IT market turning around, which would require a turn for the weaker in the macro economy

Peer group

When examining the business structure Innofactor has next to project work also some own scalable software business. The company should not, however, be equated with pure software companies. Our peer group consists of Nordic IT service companies of which some also have their own software business. We can find a Nordic and Finnish peer group for the company to which the valuation can be compared and supported on.

In general we still find IT service companies to be an attractive sector to own due to the strong demand fundamentals in the industry. As a result of COVID, the long-term demand fundamentals have strengthened when the virus has forced many dormant industries to digitize and strengthen their IT core.

The dispersion between the companies' valuations is still quite large and, in our view, depicts the different development stages of the companies and different strategies, as well as their various implementation stages.

Looking at earnings multiples, Innofactor's pricing is as a whole at the cheaper end of the sector. The company is priced clearly below (good 20%) the IT service sector with 2021-2022 P/E and EV/EBIT multiples. Tax receivables further increase the attractiveness of the valuation. In terms of the EV/Sales multiple, the company's pricing is also clearly below the peer group even though profitability has improved clearly.

In our view, a gradually higher valuation can be accepted for the share as the earnings turnaround strengthens further and becomes wider and does not lie only on the shoulders of Finland. Thus the value increase in the share is driven both by earnings growth and acceptable multiples.

Valuation 2/2

Valuation multiples

In recent years, Innofactor has been priced at relatively low valuation multiples due to several disappointments and the weaker confidence in the company that followed. As the 2019-2020 earnings turnaround has progressed, the company's share has risen considerably which has been justified because the company avoided the crisis scenario that still seemed to be threatening the company at the end of 2018. With the earnings growth the share is still modestly valued especially considering the potential in other Nordic countries.

The primary valuation multiples we use for Innofactor are adjusted P/E and EV/EBIT. The figures are adjusted for IFRS3 book depreciations from acquisitions. With our estimates, Innofactor's adjusted P/E multiples for this and next year are 17x and 12x, which is absolutely and especially relatively a modest level considering the earnings turnaround and potential of the company. EV/EBIT multiples are 11x and 9x, which are modest both absolutely and relatively.

In our view a slightly higher than "normal" P/E level can be accepted for the share due to the company's high tax receivables and the fact that tax expenses do not have a cash flow effect for the company. The book value of the tax receivable is currently EUR 5.6 million, which corresponds to a value of around EUR 0.15 per share. If the current value of this tax receivable would be priced conservatively, e.g., as half of the book value some 5% higher valuation multiples could be accepted for the share.

DCF analysis

Our DCF model indicates a value of EUR 2.2 per share for Innofactor. In our estimate model the company will grow by 3-5% p.a. in 2021-2024 and achieve a good 13% EBITDA margin. In the long term (after 2024), growth will remain at 3% (2.5% in terminal) and EBITDA % will stabilize at 10% level. In the model the taxes in the income statement do not have a cash flow effect in Finland because the company can utilize profits against the tax receivables in the balance sheet. The weight of the terminal assumption is 50% in the model. In the cash flow model, the average cost of capital (WACC) used is 7.7% and the cost of capital is 8.5%. Thus the DCF model also supports the share's currently modest pricing with relatively conservative estimates.

Components of the expected returns for the share

We also examine Innofactor's share from the viewpoint earnings growth, dividend yield and the accepted valuation multiple. According to our estimate, the company has preconditions to reach annual earnings growth of ~9% in coming years driven by net sales and increased profitability. The dividend also supports the valuation when the company updated its dividend policy last year. With our dividend estimates that are in line with the dividend policy (around 50% of the result) the dividend yield is at 5%. Strong cash flow provides good preconditions for relatively high distribution of profits, but we believe the company will continue to also strive for inorganic growth in line with its strategy.

The share is moderately priced with 2021 multiples. Thus the share's return expectation consisting of dividend yield and earnings growth is around 15% and the return/risk ratio is attractive. As the Nordic integration progresses and other countries return to the growth path, we can gradually start accepting valuation levels that are close to the sector's valuation.

TSR drivers 2021-2023

Positive | Neutral | Negative

Performance

- Strong order book supports growth
- Success on expert markets
- Still room for improvement in profitability

→ Earnings growth around 9% p.a.

Dividend yield

- Earnings growth and strong cash flow
- Healthy balance sheet position and low investment needs
- Preparing for M&A transactions

→ Dividend income around 4% p.a.

Valuation multiples

- Valuation multiples are low measured absolutely and relatively
- Scalable and continuous business supports valuation
- Historical disappointments depress acceptable valuation level

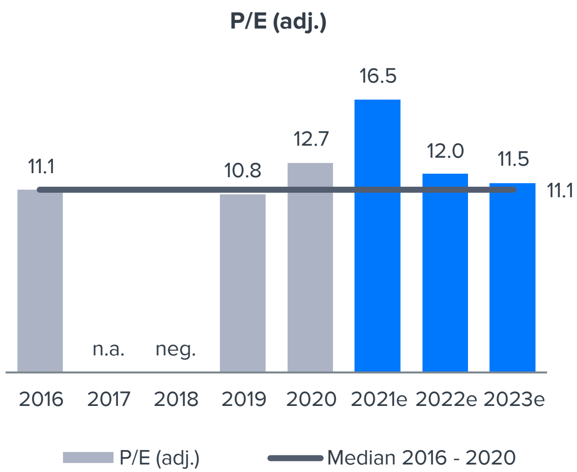
→ Upside in multiples

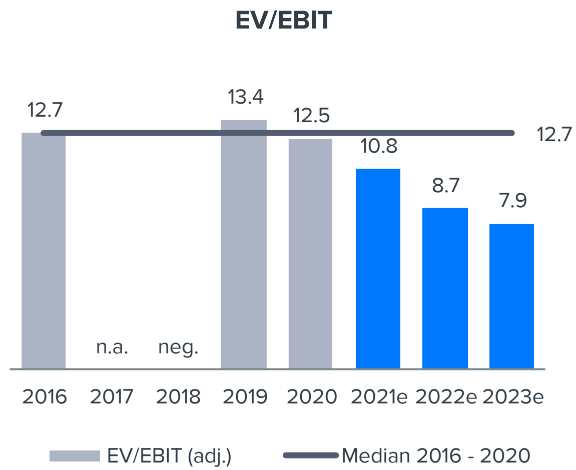
Share's expected total return around 15% p.a.

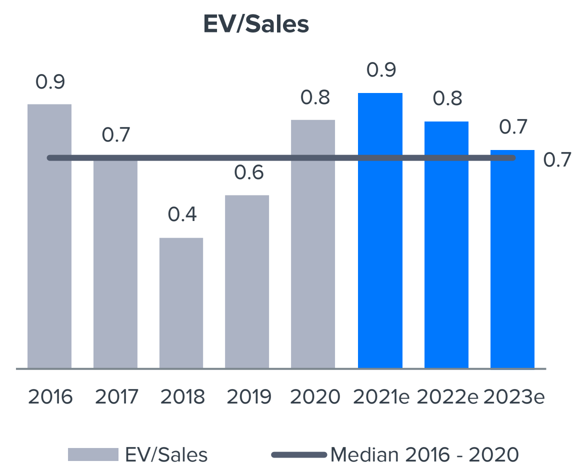
Valuation table

Valuation	2016	2017	2018	2019	2020	2021e	2022e	2023e	2024e
Share price	1.15	0.94	0.36	0.72	1.28	**1.72**	**1.72**	**1.72**	**1.72**
Number of shares, millions	32.9	36.2	36.2	36.8	37.4	**37.4**	**37.4**	**37.4**	**37.4**
Market cap	38	34	13	27	48	**64**	**64**	**64**	**64**
EV	54	47	28	38	56	**65**	**61**	**56**	**51**
P/E (adj.)	11.1	n.a.	neg.	10.8	12.7	**16.5**	**12.0**	**11.5**	**11.1**
P/E	24.6	neg.	neg.	63.3	27.1	**10.8**	**12.7**	**11.5**	**11.1**
P/FCF	neg.	neg.	neg.	2.7	13.7	**6.9**	**9.2**	**8.7**	**8.5**
P/B	1.7	1.3	0.6	1.2	2.0	**2.3**	**2.1**	**1.9**	**1.7**
P/S	0.6	0.5	0.2	0.4	0.7	**0.9**	**0.9**	**0.9**	**0.8**
EV/Sales	0.9	0.7	0.4	0.6	0.8	**0.9**	**0.8**	**0.7**	**0.7**
EV/EBITDA	11.1	36.1	neg.	7.4	7.8	**5.8**	**6.9**	**6.1**	**5.5**
EV/EBIT (adj.)	12.7	n.a.	neg.	13.4	12.5	**10.8**	**8.7**	**7.9**	**7.0**
Payout ratio (%)	0.0 %	0.0 %	0.0 %	0.0 %	84.9 %	**37.8 %**	**51.7 %**	**46.8 %**	**51.8 %**
Dividend yield-%	0.0 %	0.0 %	0.0 %	0.0 %	3.1 %	**3.5 %**	**4.1 %**	**4.1 %**	**4.7 %**

Source: Inderes







Peer group valuation

Company	Share price	Market cap MEUR	EV MEUR	EV/EBIT 2021e	EV/EBIT 2022e	EV/EBITDA 2021e	EV/EBITDA 2022e	EV/S 2021e	EV/S 2022e	P/E 2021e	P/E 2022e	Dividend yield-% 2021e	Dividend yield-% 2022e
Bilot*	7.50	37	26	12.3	10.1	11.4	9.5	1.1	0.9	19.8	17.6	1.1	1.3
Digia*	7.62	204	221	13.2	11.9	10.4	9.5	1.5	1.3	15.1	14.2	2.2	2.6
Gofore*	18.60	261	257	18.2	15.7	15.4	13.3	2.6	2.3	22.5	20.3	1.9	6.2
Nixu*	9.00	67	70	46.4	23.5	21.2	15.0	1.3	1.1	76.7	33.3		
Siili*	15.74	110	122	13.1	10.8	10.3	8.8	1.3	1.1	14.6	13.1	2.2	2.5
Solteq*	5.68	110	129	14.1	11.1	8.9	7.4	1.9	1.6	18.5	14.5	1.8	2.6
TietoEVRY*	26.48	3136	3795	9.9	9.0	7.2	7.3	1.4	1.3	11.3	10.2	5.1	5.3
Vincit*	9.88	120	117	13.3	11.0	12.5	10.2	1.9	1.6	17.8	15.4	2.0	2.2
Netum*	4.37	50	44	13.2	11.6	15.5	11.1	2.1	1.9	19.8	18.1	1.6	1.8
Bouvet	61.80	640	605	19.0	17.3	15.5	14.2	2.3	2.1	25.9	23.6	3.5	3.7
ENEA	215.00	470	505	20.9	16.0	14.2	11.5	5.3	4.5	23.7	18.8		
KnowIT	296.00	585	572	16.5	15.3	12.6	12.0	1.5	1.5	22.7	20.9	2.4	2.6
Innofactor (Inderes)	**1.72**	**64**	**65**	**10.8**	**8.7**	**5.8**	**6.9**	**0.9**	**0.8**	**16.5**	**12.0**	**3.5**	**4.1**
Average				**17.5**	**13.6**	**12.9**	**10.8**	**2.0**	**1.8**	**24.0**	**18.3**	**2.4**	**3.1**
Median Nordic companies				**13.7**	**11.8**	**12.5**	**10.7**	**1.7**	**1.5**	**19.8**	**17.9**	**2.1**	**2.6**
Diff-% to median				*-21%*	*-26%*	*-54%*	*-35%*	*-45%*	*-45%*	*-17%*	*-33%*	*67%*	*57%*
Median Finnish companies				***13.2***	***11.1***	***10.9***	***9.5***	***1.4***	***1.3***	***18.2***	***14.9***	***2.0***	***2.6***

Source: Thomson Reuters / Inderes NB: The market cap Inderes uses does not consider own shares held by the company

Balance sheet

Assets	2019	2020	2021e	2022e	2023e
Non-current assets	**41.3**	**39.6**	**36.8**	**35.3**	**33.7**
Goodwill	26.0	26.5	26.5	26.5	26.5
Intangible assets	3.7	2.1	1.7	1.4	1.1
Tangible assets	5.3	4.3	3.4	3.5	3.6
Associated companies	0.1	0.0	0.0	0.0	0.0
Other investments	0.0	0.0	0.0	0.0	0.0
Other non-current assets	0.6	0.2	0.2	0.2	0.2
Deferred tax assets	5.6	6.4	4.9	3.6	2.2
Current assets	**14.4**	**17.0**	**22.5**	**25.5**	**30.8**
Inventories	0.0	0.0	0.0	0.0	0.0
Other current assets	0.0	0.0	0.0	0.0	0.0
Receivables	13.4	13.9	14.6	15.2	15.8
Cash and equivalents	1.0	3.1	7.9	10.4	15.0
Balance sheet total	**55.7**	**56.6**	**59.3**	**60.8**	**64.5**

Source: Inderes

Liabilities & equity	2019	2020	2021e	2022e	2023e
Equity	**22.1**	**23.4**	**27.9**	**30.7**	**33.7**
Share capital	2.1	2.1	2.1	2.1	2.1
Retained earnings	-0.9	0.4	4.8	7.6	10.6
Hybrid bonds	0.0	0.0	0.0	0.0	0.0
Revaluation reserve	0.1	0.1	0.1	0.1	0.1
Other equity	20.9	20.9	20.9	20.9	20.9
Minorities	0.0	0.0	0.0	0.0	0.0
Non-current liabilities	**7.8**	**12.9**	**12.0**	**11.0**	**11.0**
Deferred tax liabilities	0.8	1.8	1.8	1.8	1.8
Provisions	0.0	0.0	0.0	0.0	0.0
Long term debt	3.7	8.9	8.0	7.0	7.0
Convertibles	0.0	0.0	0.0	0.0	0.0
Other long term liabilities	3.3	2.2	2.2	2.2	2.2
Current liabilities	**25.8**	**20.2**	**19.4**	**19.1**	**19.8**
Short term debt	8.3	2.5	1.0	0.0	0.0
Payables	15.9	16.0	16.7	17.3	18.0
Other current liabilities	1.6	1.7	1.7	1.7	1.7
Balance sheet total	**55.7**	**56.6**	**59.3**	**60.8**	**64.5**

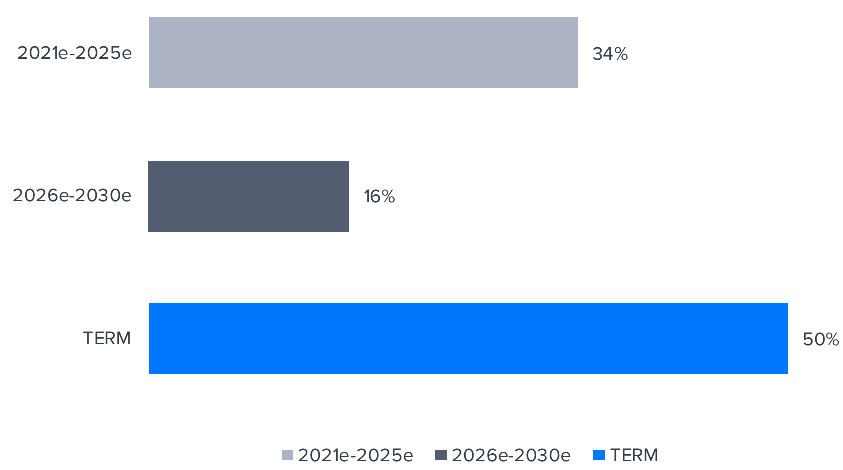
DCF calculation

DCF model	2020	2021e	2022e	2023e	2024e	2025e	2026e	2027e	2028e	2029e	2030e	TERM
EBIT (operating profit)	**2.5**	**8.1**	**6.7**	**7.1**	**7.3**	**5.6**	**5.7**	**5.9**	**6.0**	**6.2**	**6.3**	
+ Depreciation	4.7	3.2	2.1	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.1	
- Paid taxes	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	-1.2	-1.3	-1.3	-1.4	
- Tax, financial expenses	-0.1	-0.1	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	
+ Tax, financial income	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1	
- Change in working capital	-0.3	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	
Operating cash flow	**6.7**	**11.2**	**8.8**	**9.2**	**9.4**	**7.7**	**7.8**	**6.7**	**6.9**	**7.0**	**7.2**	
+ Change in other long-term liabilities	-1.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
- Gross CAPEX	-2.2	-2.0	-1.8	-1.8	-1.9	-1.9	-1.9	-2.0	-2.0	-2.1	-2.4	
Free operating cash flow	**3.5**	**9.3**	**7.0**	**7.4**	**7.5**	**5.8**	**5.9**	**4.8**	**4.8**	**5.0**	**4.8**	
+/- Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
FCFF	3.5	9.3	7.0	7.4	7.5	5.8	5.9	4.8	4.8	5.0	4.8	94.4
Discounted FCFF		**8.9**	**6.2**	**6.1**	**5.8**	**4.1**	**3.9**	**2.9**	**2.8**	**2.6**	**2.4**	**46.5**
Sum of FCFF present value		92.3	83.4	77.1	71.0	65.2	61.1	57.2	54.3	51.5	48.9	46.5
Enterprise value DCF		**92.3**										
- Interesting bearing debt		-11.4										
+ Cash and cash equivalents		3.1										
-Minorities		0.0										
-Dividend/capital return		-1.5										
Equity value DCF		**82.4**										
Equity value DCF per share		**2.20**										

Wacc	
Tax-% (WACC)	20.0 %
Target debt ratio (D/(D+E)	20.0 %
Cost of debt	6.0 %
Equity Beta	1.25
Market risk premium	4.75%
Liquidity premium	0.50%
Risk free interest rate	2.0 %
Cost of equity	**8.4 %**
Weighted average cost of capital (WACC)	**7.7 %**

Source: Inderes

Cash flow distribution



Summary

Income statement	2018	2019	2020	2021e	2022e
Revenue	63.1	64.2	66.2	**69.4**	**72.2**
EBITDA	-1.0	5.1	7.2	**11.3**	**8.8**
EBIT	-3.9	0.8	2.5	**8.1**	**6.7**
PTP	-3.8	0.0	2.1	**7.5**	**6.3**
Net Income	-3.5	0.4	1.8	**5.9**	**5.1**
Extraordinary items	-2.0	-2.0	-2.0	**2.0**	**-0.3**

Balance sheet	2018	2019	2020	2021e	2022e
Balance sheet total	51.9	55.7	56.6	**59.3**	**60.8**
Equity capital	21.3	22.1	23.4	**27.9**	**30.7**
Goodwill	26.1	26.0	26.5	**26.5**	**26.5**
Net debt	15.2	11.1	8.4	**1.1**	**-3.4**

Cash flow	2018	2019	2020	2021e	2022e
EBITDA	-1.0	5.1	7.2	**11.3**	**8.8**
Change in working capital	0.7	3.2	-0.3	**0.1**	**0.1**
Operating cash flow	-0.4	8.1	6.7	**11.2**	**8.8**
CAPEX	-0.9	-7.0	-2.2	**-2.0**	**-1.8**
Free cash flow	-1.6	9.8	3.5	**9.3**	**7.0**

Largest shareholders	% of shares
Ensio Sami	21.1 %
Ilmarinen	4.8 %
Linturi Kaija ja Risto	3.4 %
Laiho Rami Tapani	3.1 %
Jyrki Hallikainen	2.7 %

Source: Inderes

Per share data	2018	2019	2020	2021e	2022e
EPS (reported)	-0.10	0.01	0.05	**0.16**	**0.14**
EPS (adj.)	-0.08	0.07	0.10	**0.10**	**0.14**
OCF / share	-0.01	0.22	0.18	**0.30**	**0.23**
FCF / share	-0.04	0.27	0.09	**0.25**	**0.19**
Book value / share	0.59	0.60	0.63	**0.75**	**0.82**
Dividend / share	0.00	0.00	0.04	**0.06**	**0.07**

Growth and profitability	2018	2019	2020	2021e	2022e
Revenue growth-%	-4%	2%	3%	**5%**	**4%**
EBITDA growth-%	n.a.	n.a.	41%	**58%**	**-22%**
EBIT (adj.) growth-%	n.a.	n.a.	59%	**34%**	**16%**
EPS (adj.) growth-%	n.a.	n.a.	51%	**3%**	**38%**
EBITDA-%	-1.6 %	7.9 %	10.8 %	**16.3 %**	**12.2 %**
EBIT (adj.)-%	-2.9 %	4.4 %	6.8 %	**8.7 %**	**9.7 %**
EBIT-%	-6.1 %	1.2 %	3.8 %	**11.6 %**	**9.3 %**
ROE-%	-14.9 %	1.9 %	7.7 %	**23.1 %**	**17.3 %**
ROI-%	-10.2 %	2.3 %	7.3 %	**22.7 %**	**18.3 %**
Equity ratio	41.0 %	39.7 %	41.4 %	**47.0 %**	**50.5 %**
Gearing	71.2 %	49.9 %	35.7 %	**3.8 %**	**-11.0 %**

Valuation multiples	2018	2019	2020	2021e	2022e
EV/S	0.4	0.6	0.8	**0.9**	**0.8**
EV/EBITDA (adj.)	neg.	7.4	7.8	**5.8**	**6.9**
EV/EBIT (adj.)	neg.	13.4	12.5	**10.8**	**8.7**
P/E (adj.)	neg.	10.8	12.7	**16.5**	**12.0**
P/E	0.6	1.2	2.0	**2.3**	**2.1**
Dividend-%	0.0 %	0.0 %	3.1 %	**3.5 %**	**4.1 %**

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Date	Recommendation	Target price	Share price
01-08-17	Accumulate	1.70 €	1.53 €
16-10-17	Accumulate	1.20 €	1.11 €
01-11-17	Accumulate	1.20 €	1.05 €
07-02-18	Reduce	0.90 €	0.87 €
07-03-18	Reduce	0.90 €	0.90 €
09-05-18	Reduce	0.85 €	0.84 €
15-06-18	Reduce	0.80 €	0.79 €
25-07-18	Reduce	0.77 €	0.76 €
09-10-18	Reduce	0.63 €	0.63 €
31-10-18	Reduce	0.52 €	0.50 €
28-01-19	Sell	0.35 €	0.40 €
06-03-19	Reduce	0.45 €	0.47 €
15-05-19	Reduce	0.58 €	0.60 €
05-06-19	Reduce	0.68 €	0.71 €
24-07-19	Accumulate	0.68 €	0.63 €
30-10-19	Accumulate	0.80 €	0.75 €
26-02-20	Accumulate	0.90 €	0.78 €
01-04-20	Reduce	0.68 €	0.66 €
05-05-20	Accumulate	0.90 €	0.84 €
23-06-20	Accumulate	0.95 €	0.90 €
24-06-20	Accumulate	1.30 €	1.19 €
28-10-20	Accumulate	1.40 €	1.28 €
19-02-21	Buy	1.80 €	1.43 €
28-04-21	Reduce	2.00 €	1.97 €
10-06-21	Accumulate	2.00 €	1.72 €

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Itämerentori 2

FI-00180 Helsinki, Finland

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