PANMURE GORDON & CO

9 June 2008

Equity Research

MORNING NOTE

Sell	122.3p
(Remains Unchanged)	(Priced at close 5/6/08)
Target Price:	94p
Stock Codes:	LOG.L / LOG LN
EPS	
Dec 2007 A	10.20p
Dec 2008 E	10.31p
Dec 2009 E	11.70p
Panmure Gordon Estimates	
Market Cap:	£1787m
Last published research	14 May 2008

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Logica

Watch the debt covenant

Logica has very little room for manoeuvre in a deteriorating operating environment and risks hitting debt covenants. Given concerns about falling day rates, declining utilisation and IDC reducing industry revenue growth forecast, we revisited our Logica forecasts to pose the question – what if? On a poorer sales scenario 2008E, EPS hits 7.6p down from 10.3p, and net debt EBITDA moves to 2.5x - a fraction off the 2.6x covenant level. Sell.

- **What we are assuming.** We use a 'sum of the inputs' model to forecast Logica – using assumptions for day rates, headcount and utilisation across the operating regions. We assume day rates remain unchanged, but a 10% fall in staff utilisation (we use the term billable days with utilisation measured as a percentage of the 240 days). We assume that the reduced utilisation has only a one percentage point reduction on EBITA – in truth the impact should be greater but any fall in utilisation can have a short term uptick on margin – staff are shed, saving wage costs, unplanned attrition increases (to competitors like Capgemini) and fewer contractors are hired. Nonetheless, 2008E EBITA falls from £234.1m to £182.5m – the impact on EPS takes it from 10.3p to 7.6p. However, we feel that the important impact is on cash levels, where we see 2008E operating cash reduce from £280.7m to £218.8m. The knock-on effect is that Logica sits too close to its net debt to EBITDA forecast at 2.5x – the covenant is 2.6x. Our view is that there is very little room for manoeuvre.

- **Latest news Q1 IMS – The headlines.** Q1 revenue up 3.6% on a pro forma constant currency basis and Logica reaffirms 2008 guidance – i.e. revenue growth c3% at constant currency and margins c7.6% unchanged year-on-year. Also pleasingly, Group book to bill is 1.06:1 suggesting some order flow. Logica continues to see "a few" examples of slower spending in an uncertain market environment but overall activity levels appear "resilient". The UK is in line and its problems are illustrated in the 8.3% fall in UK commercial account revenue. Relying on UK public sector spend is risky. In our view much of Logica is tied to longer term implementation projects so, with the exception of its financial services practice, it is too soon for it to see any marked changes in demand. Logica says that it has initiated consultations with unions and works councils on the c1,300 potential job losses.

- **The plan.** Mr Green gets a pat on the back for delivering a fair enough Q1, but the gain was due to currency rather than the revitalisation plan. Mr Green concludes that previously management has been distracted by M&A, and did not concentrate either on integrating the business or on the UK – then the problem was 'execution'. Disappointingly execution remains the hard part, equally so for Mr Green. We warm to the workmanlike approach, but the plan is not radical enough; Logica remains the halfway house – too small to be large, too large to be small.

- **What is good in the plan? 1)** The move to develop the Consulting front end. **2)** The idea behind innovative offerings is very positive and builds on traditional Logica strengths. **3)** Creating a matrix management structure is positive as it should engender some cross-company economies. **4)** Very positively, Mr Green wants to engage with the investor base – in our view taking investors on this journey is critical and sets the company on a new course. **5)** The cost reduction programme shows good/rational insight across the UK business and there is evidence of good thinking here. Of the cost reduction programme, creating a 'blended' service platform is undoubtedly the correct approach – but once again the numbers are too small to significantly enable Logica to bid against peers on a day-rate basis. **We remain unsure about the following areas**. **1)** Increasing the sales force. Sales teams are notoriously difficult to hire. As CEO Andy Green comments – he is not a salesperson. With the exception of Mr Green's alma mater, we ponder why should sales people join, given the better momentum in competitors like Cap Gemini. **2)** We are unsure about how many poor contracts Logica signed, particularly as it tried to ramp its outsourcing business, and has this deflated the company's (low) revenue/head results. Are there contracts at low gross margins that bind the business into lower profitability?

- **What is missing?** Our view is that the revitalisation plan should be more radical – we would have liked to have seen greater emphasis in certain areas. **1)** The IT Services landscape is changing. This is particularly so in the development of multi-sourcing and building an ecosystem, which are critical to success. The plan looks to three constituencies (shareholders, employees and customers) but 'partners' are the missing link. That said, CEO Andy Green has identified this as an action area. **2)** While outsourcing is the growth engine, the plan does not address the spotty performance in outsourcing across the business and the lack of specialism in BPO. In our view, Logica BPO is defined in terms of Payments Processing and Human Resource Outsourcing, and these are not the most attractive areas – in fairness Xansa (Steria) had a better pitch in Finance and Administration. We have a similar view on managed services. **3)** There was no bold new link to accelerated growth in the company. Notably we have not increased forecasts to reflect company statements about stronger growth. The market is getting more difficult for companies like Logica – it faces entrenched European competitors and offshore companies where output prices are a third of Logica's input prices. Across the board the numbers are too small – from consulting to blended delivery.

- **Investment case.** Our current forecasts Logica's the earnings-based valuation looks attractive: on our revised estimates Logica shares are trading on a P/E of 11.8x, an EV/Sales of 0.8x and an EV/EBITDA of 8.7x, with a dividend yield of 4.9% - cover is 1.7x. Net debt for 2008E is £496.7m, gearing is 33%, although interest cover is 6.1x, but this reduces the room for manoeuvre. The restructuring – which given the staff numbers has yet to commence is likely to lead to: 1) worse sales growth than expected, as the account management process is altered; and 2) a cash outlay contributing to higher than expected net debt. Any enthusiasm we may have is tempered by the forthcoming restructuring, which in our view is likely to keep the shares under the cosh. We feel that it is premature at this juncture to factor in the cost of any restructuring; however, it should lead to: 1) worse sales growth than expected, as the account management process is altered; and 2) a cash outlay contributing to higher than expected net debt.

Logica: What if? (£m)

Year to December	2008E	2009E	2010E
Current forecasts			
Group revenue	3137.1	3229.2	3329.5
Group EBITA	234.1	250.2	268.8
Operating cash	280.7	367.8	412.0
Net cash (debt)	-496.7	-345.5	-175.6
Net debt/EBITDA	1.8	1.2	0.6
'What If' forecasts			
Group revenue	2823.4	2906.3	2996.6
Group EBITA	182.5	196.1	211.9
Operating cash	218.8	288.3	324.9
Net cash	-559.0	-487.5	-405.0
Net debt/EBITDA	2.5	1.9	1.4

Source *Panmure Gordon*

Logica country revenue and profit assumptions (£m)

Year to December	2008E	2009E	2010E
United Kingdom			
Headcount	5,070	5,120	5,080
Day rate (£)	737.6	749.6	771.5
Forecast utilisation - 179 day	131.7	133.9	137.8
Current revenue estimate (£m)	667.9	685.5	700.0
Revised revenue on revised utilisation – 161 days	601.1	616.9	630.0
EBITA (%)	*6.0*	*6.3*	*7.0*
Revised EBITA (%)	*5.0*	*5.3*	*6.0*
Revised EBITA (£m)	30.1	32.7	37.8
Netherlands	**85.2**	**90.5**	**97.3**
Headcount	5,850	5,680	5,480
Day rate	473.3	502.9	540.5
Forecast utilisation – 180 days	85.2	90.5	97.3
Current revenue estimate (£m)	498.4	514.1	533.2
Revised revenue on revised utilisation – 162 days	448.5	462.7	479.8
EBITA (%)	*9.1*	*9.1*	*9.1*
Revised EBITA (%)	*8.1*	*8.1*	*8.1*
Revised EBITA (£m)	36.3	37.5	38.9
Germany	**93.6**	**94.4**	**108.7**
Headcount	1,950	2,000	1,800
Day rate	536.6	541.0	623.4
Forecast utilisation – 174 days	93.6	94.4	108.8
Current revenue estimate (£m)	182.5	188.8	195.8
Revised revenue on revised utilisation – 157 days	164.3	169.9	176.2
EBITA (%)	*5.0*	*7.0*	*7.5*
Revised EBITA (%)	*4.0*	*6.0*	*6.5*
Revised EBITA (£m)	6.6	10.2	11.5
France	**73.3**	**77.4**	**84.7**
Headcount	8,190	8,000	7,600
Day rate	418.8	442.4	484.0
Forecast utilisation – 175 days	73.3	77.4	84.7
Current revenue estimate (£m)	600.2	619.4	643.8
Revised revenue on revised utilisation – 158 days	540.2	557.4	579.4
EBITA (%)	*7.4*	*7.5*	*7.7*
Revised EBITA (%)	*6.4*	*6.5*	*6.7*
Revised EBITA (£m)	34.6	36.2	38.8
Nordics			
Headcount	9,360	9,600	9,440
Day rate	507.9	508.6	533.4
Forecast utilisation – 180 days	91.4	91.6	96.0
Current revenue estimate (£m)	855.7	878.9	906.4
Revised revenue on revised utilisation – 162 days	770.1	791.0	815.7
EBITA (%)	*9.1*	*9.1*	*9.1*
Revised EBITA (%)	*8.1*	*8.1*	*8.1*
Revised EBITA (£m)	62.4	64.1	66.1
ROW			
Headcount	8,580	9,600	10,600
Day rate	261.8	241.1	223.4
Forecast utilisation – 148 days	38.7	35.7	33.1
Current revenue estimate (£m)	332.5	342.6	350.5
Revised revenue on revised utilisation – 133 days	299.2	308.3	315.4
EBITA (%)	*5.2*	*6.0*	*7.0*
Revised EBITA (%)	*4.2*	*5.0*	*6.0*
Revised EBITA (£m)	12.6	15.4	18.9

Source *Panmure Gordon*

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