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MORNING NOTE

Software & IT Services commentary

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Time to look into 2008

After five years of sequential growth, IT spending growth is set to fall in 2008 to a more modest rate between 3% and 6%. So, conclude industry analysts AMR, IDC and industry luminary Mr Richard Holway. Gartner sees growth at 5.5% down from 8% in 2007E. We note: (1) product cycles are typically stronger than the economic cycle – so we are relaxed about the prospects for well-placed product companies like Autonomy, Aveva, Fidessa, Micro Focus and Innovation. (2) the tussle between discretionary and non-discretionary IT spend remains unclear and this will throw up surprises in the coming months. Lower spending increases forecast risk, but at 14.3x P/E the market is discounting much of this already. Investors looking for high alpha and low-cost beta should in our view stick with the *Elites*.

- **What's in store for 2008?** (1) **IT deflation continues** – the available choices of doing more IT with less budget are omnipresent – 2008 should be a good year to be a buyer but much harder to be an IT investor. The market conditions mean that life is more difficult for the day rate consultancies. As such we are negative on LogicaCMG, Detica and Morse. **(2) Financial Services exposed companies** will lurch from event to event as investors try to second guess who is prone to that harshening spending environment – on this basis we are positive about Fidessa, less so about Detica and Misys. **(3) Green computing** moves to primetime – with powering up and cooling IT is responsible for 2% of the worlds C02 emissions coupled with rising power costs companies are to jump on the 'green' bandwagon in order to reduce spend. 2008 should see companies appoint a Chief Green Officer, CGO. **(4) M&A is addictive**. Despite the ongoing questionable returns deal flow should continue. For this Sage should spend the year in and out of the news – as buyer interspersed with rumours of it being acquired. **(5) SaaS is everywhere** in 12 months and this changes the dynamics of growth (reduces it) and revenue recognition (lengthens it). We are still unsure how investors will view the trade-off. For us the move to SaaS is positive as the deferred revenue gives greater certainty to forecasts. However the transition to SaaS is likely to be frought as the cash consumptive areas remain while revenue growth diminishes. In our view the mainstay of companies are likely to adopt a blended model (perpetual and SaaS) through the transition to assuage investor concerns about companies going ex-growth.

- **Contractor rates – Down.** The market is already softening as we note that contractor rates across the 10 most commonly requested roles have declined from £33.28 in September, to £30.36 at the end of November according to figures from itjobswatch. Demand in the financial sector is at its lowest for three and a half years. According to figures from Giant Group of the 1,500 contractors it surveyed only 22% now work in the financial sector, compared to 25% in the previous quarter. In addition we note that Atsco recently released figures which claim that market uncertainties are dissuading IT staff from moving jobs. Of 5,000 tech staff questioned, just 28% were considering a job switch in November, compared to 42% in quarter three. While the numbers need to be adjusted for seasonality –this is a period quiet - the trend is negative.

- **This is not 2001.** We expect more doom mongering but relative to 2001 our companies are – highly cash generative, have more defensive business models, the management teams are by and large more practiced – and valuations are at a historic low – not the highs of 2001. Certainly, as we move forward poor companies are likely to blame a deteriorating environment for delivering poor results – giving the doom-mongers lots of credibility. And there should be more poor results, however the credit crisis has already served as a needed wake-up call to an industry that was becoming overly confident – consider the de-rating of Detica – and we expect a more aware industry to craft its outlook statements for 2008.

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- **The aging population.** We need to do a better job of appreciating the impact of the retirement of the baby boomers. On 15 October 2007, Kathleen Casey-Kirschling applied for her retirement Social Security benefits. Ms Casey-Kirschling, born in Philadelphia 1 January, 1946, at 12:00:01am, is regarded as the US's first baby boomer. Her application signalled the start of an expected avalanche of applications from that generation – this is the most significant socio–economic shift and it still unclear how to assess this, but we note that research by Mr Richard Holway concludes that this diaspora is among the most aggressive in use of social networking technology.
- **2008 - U.S. election year.** 2008 brings an election year to the U.S. And with the election comes a whole lot of uncertainty, posturing and positioning. It also brings a bevy of promises and commitments to keep the U.S. economy humming along.
- **Investment view.** For investor the market remains primarily a search for high alpha and low-cost beta. We note that for the second week running shares in the Elites fell back harder than the average with Aveva, Autonomy, Fidessa and Micro Focus all being down sharply - clearly investors are tempted to lock in the year gains having outperformed the FTSE All Share by 19.9%, 62.0%, -15.8% and 29.8%, respectively, over the last 12 months. We suggest that investors resist the temptation to snap up bombed out shares on cheap multiples. As we look into 2008 we are concerned that there are too many 'value traps' littering the sector. In addition as the M&A wave begins to slacken companies whose valuations have been propped by 'takeover' multiples – the walking dead - are likely to come unstuck.
- **The week that was - sub-sector view.** Reviewing our Software and IT Services market taxonomy we note that: Horizontal software sector P/E weakened to 18.3x from 18.5x the week prior; Vertical software weakened marginally to 17.3x from 17.8x. The P/E for the People services segment edged down to 11.5x from 11.7x, while that of the Infrastructure services group was off marginally to 10.0x from 10.3x.
- **Relative performance.** Our share selection underperformed the FTSE All Share by 18.6% on a rolling month view, now -15.3% on a 12-month view. The sector valuation has fallen to an average current year P/E of 14.6x from 14.8x a week earlier.

Sector valuation and relative performance

	EV/EBITDA (x)		PE (x)		Yield (%)		FCF yield	EV/Sales (x)		Rel Perf FTSE*	
	FY0	FY1	FY0	FY1	FY0	FY1	(%)	FY0	FY1	1 mth	12 mth
Horizontal	21.8	11.7	24.0	18.3	1.4	1.6	4.1	4.3	3.4	-14.5	8.8
Infrastructure	6.7	5.7	10.6	10.0	7.7	3.4	2.9	0.7	0.5	-22.2	-26.8
People	10.3	8.4	12.5	11.5	2.6	2.9	8.1	1.3	1.1	-25.8	-33.6
Vertical	13.5	10.7	20.8	17.3	1.5	1.6	5.7	2.4	1.9	-11.8	-9.6
All sectors	*13.1*	*9.1*	*16.9*	*14.3*	*3.3*	*2.4*	*5.2*	*2.2*	*1.7*	*-18.6*	*-15.3*

1 and 12 month relative performance4 to FTSE All Share* **Source Panmure Gordon

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People

People	EV/EBITDA (x) FY0	EV/EBITDA (x) FY1	PE (x) FY0	PE (x) FY1	Yield (%) FY0	Yield (%) FY1	FCF yield (%)	EV/Sales (x) FY0	EV/Sales (x) FY1	Rel Perf FTSE* 1 mth	Rel Perf FTSE* 12 mth
Anite	4.9	5.4	7.5	7.8	1.9	2.1	9.9	1.0	1.0	-29.2	-52
Detica	16.2	10.9	18.8	15.5	1.3	1.8	5.8	1.9	1.3	-29.9	-33.6
LogicaCMG	9.8	8.8	11.2	11.4	4.6	4.7	8.8	0.9	0.9	-18.4	-15.1
Average	*10.3*	*8.4*	*12.5*	*11.5*	*2.6*	*2.9*	*8.1*	*1.3*	*1.1*	*-25.8*	*-33.6*
Infrastructure											
Computacenter	4.9	4.7	11.3	9.8	28.8	4.6	10.1	0.1	0.1	-17.3	-36.6
Horizon	7.7	6.2	9.2	7.7	0.0	2.3	4.3	0.3	0.3	-15.7	-13.7
Morse	5.5	5.4	11.7	10.2	6.1	6.3	7.7	0.3	0.3	-30.5	-39.6
Netstore	7.3	6.6	9.6	9.4	1.8	2.0	-7.0	1.0	1.0	-21.5	-33.8
Phoenix IT	8.1	5.5	11.1	12.8	1.7	1.9	-0.5	2.0	1.0	-26.2	-10.5
Average	*6.7*	*5.7*	*10.6*	*10.0*	*7.7*	*3.4*	*2.9*	*0.7*	*0.5*	*-22.2*	*-26.8*
Horizontal											
Alterian	26.3	11.1	23.7	13.9	0.0	0.0	3.1	3.5	2.6	-7.6	14.5
Aveva	21.1	15.5	30.5	24.7	0.4	0.5	4.4	6.4	5.3	-18.8	19.8
Autonomy	51.9	24.5	66.3	39.8	Na	na	3.2	12.3	8.3	-16.4	62
Coda	10.9	7.7	13.4	14.5	1.7	1.9	9.6	2.2	2.0	-12.6	-2.3
Dicom	7.1	6.3	12.3	12.0	1.7	1.9	8.3	0.8	0.7	-16.0	-20.1
Intec	0.0	8.6	0.0	10.4	0.0	0.0	3.2	0.9	0.8	-18.2	-5.1
Macro 4	3.6	3.8	5.6	8.0	4.8	4.9	-3.1	0.9	0.9	-10.7	-28.6
Micro Focus	31.4	16.4	40.1	22.8	1.1	1.8	4.4	7.6	6.2	-16.0	29.8
Average	*21.8*	*11.7*	*24.0*	*18.3*	*1.4*	*1.6*	*4.1*	*4.3*	*3.4*	*-14.5*	*8.8*
Vertical											
Innovation	18.0	11.3	16.9	15.8	0.0	0.0	9.0	2.7	1.6	-0.4	11.7
Misys	10.8	9.6	15.9	18.5	3.9	4.1	5.7	2.0	2.1	-16.8	-15.6
Portrait	12.9	9.7	26.8	14.5	0.0	0.0	7.8	1.1	1.0	-12.0	-9.2
Fidessa	14.2	13.6	27.5	23.1	1.5	1.8	0.7	2.6	2.2	-23.2	-15.8
Sage	11.5	9.4	16.7	14.5	1.9	2.1	5.6	3.3	2.6	-6.5	-19.1
Average	*13.5*	*10.7*	*20.8*	*17.3*	*1.5*	*1.6*	*5.7*	*2.4*	*1.9*	*-11.8*	*-9.6*
All sectors	*13.1*	*9.1*	*16.9*	*14.3*	*3.3*	*2.4*	*5.2*	*2.2*	*1.7*	*-18.6*	*-15.3*

1 and 12 month relative performance4 to FTSE All Share* **Source Panmure Gordon

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10/12/2007

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