

9 March 2009

FDM Group

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/07	49.8	4.4	12.7	2.7	7.1	3.0
12/08	52.2	5.3	15.8	3.5	5.7	3.9
12/09e	55.5	5.4	15.9	4.3	5.7	4.8
12/10e	58.3	5.7	16.9	5.0	5.3	5.6

Note: *PBT and EPS (fully diluted) are normalised, excluding amortisation and exceptional items and IFRS2 option charges.

Investment summary: Mounties lead the charge

2008 results confirm the successful transition FDM is making from a staffing organisation to an IT services company. Profitability moved ahead markedly, driven by the rising contribution from the in-house consultants, which now make up more than half of group profits. Although visibility into FY09 is somewhat limited, management remains confident over prospects and the valuation retains its attractions.

Annual results: Momentum maintained

Turnover advanced 4.7% to £52.2m, but the mix was very favourable with growth from the in-house 'Mounties' off-setting the softer freelance staffing segment. With margins from the former of 40%+, gross margins for the group advanced from 22.5% to 26.3% – moving even further ahead of the industry norm. We see further scope for this trend to continue and in the meantime, the group remains very cash generative as evidenced by a growth in the cash pile from £6.0m to £10.1m. EPS growth of 24% is testament to the successful strategy and was all organic.

Outlook: Upside still in the mix

An increase in capacity in the London training academy should ensure that the pipeline of Mounties continues to be strong. Numbers rose from 208 to 293 during FY08 and will increase further in FY09. Although there is a limit to how far the mix can shift – as the company does not want to be too operationally geared – there is still some mileage in moving it more towards 'in-house'. Visibility into FY09 is still somewhat limited and at this stage we are sticking with our conservatively based forecasts.

Valuation: Well based

With cash balances having grown significantly during FY08 to just over £10m, FDM is trading at 2x cash and with further progress likely in FY09, the equity continues to appear very undervalued. An earnings multiple of c 5x and a forecast dividend yield of 5% reinforce the valuation argument, which is also supported by a DCF more than twice the current share price. A macro shift in the appetite for smaller tech stocks may well be required to crystallise some of the valuation gap, but in the meantime FDM still remains a solid investment prospect.

Price 90p
Market Cap £21m

Share price graph



Share details

Code FDMG
Listing AIM
Sector Software & Computer Services
Shares in issue 23.2m

Price

52 week High 110p Low 62p

Balance Sheet as at 31 December 2008

Debt/Equity (%) N/A
NAV per share (p) 60.7
Net cash (£m) 10.1

Business

FDM provides IT staffing and IT services to clients across multiple business sectors in the UK, US and continental Europe. It operates a distinct, high margin model which supplements the use of freelance IT contractors with its own employees.

Valuation

	2008	2009e	2010e
P/E Relative	50%	81%	64%
P/CF	3.6	3.6	3.9
EV/Sales	0.3	0.2	0.1
ROE	28%	26%	23%

Geography based on revenues FY08

UK	Europe	US	Other
80%	14%	6%	0%

Analysts

Jason Holden 020 3077 5700
jholden@edisoninvestmentresearch.co.uk
Andrew Bryant 020 3077 5729
abryant@edisoninvestmentresearch.co.uk

FDM Group is a research client of Edison Investment Research Limited

Investment summary: Mounties lead the charge

Company description

FDM provides IT staffing and IT services to clients across multiple business sectors in the UK, US and continental Europe. It operates a distinct, high margin model which supplements the use of freelance IT contractors with its own employees. Resources are typically deployed by either blended teams of Mounties and experienced contractors or via purely Mountie-based resources on secondment. The UK currently generates the vast majority of business, but FDM now has a growing presence internationally, which could eventually lead to the establishment of training academies in overseas territories.

Valuation

A cash balance of £10.1m relative to a market capitalisation of around £20m, gives a good indication as to the value gap that currently exists in the equity market. This anomalous situation clearly reflects uncertainty over the macro-economic environment, but notwithstanding this, the valuation metrics all appear attractive. A low single figure P/E, a prospective yield of 5% and a DCF around the 200p mark all warrant upside should there be a catalyst for a shift in sentiment. Progress in earnings is likely to be restrained during FY09, but the long-term prospects bode well, supported by the balance sheet strength.

Sensitivities

- As discussed below, the outlook for IT spend is a key determinant, while the low interest rate environment will also negatively impact the P&L given the large cash balance.
- However, FDM's business structure should help to insulate it from the extremes of the IT investment cycle; the Mounties would still generate higher margins than freelancers and any fall in demand could be met by a reduction in the variable cost freelance segment.
- Some market trends suggest clients are moving away from offshoring as outsourcing initiatives have failed to meet expectations.
- Greater regulation and increasingly sophisticated products – particularly in the financial services industry – should mean demand for consultants remains high. The media and communications sectors are also undergoing a period of rapid rationalisation and require access to relevantly qualified professionals.

Financials

FDM continues to demonstrate a tight control of working capital as debtor days reduced again and given the highly cash generative business model, the group has once more generated annual net cash of £4m. Gross margins continue to be well ahead of the IT staffing industry norm and have the potential to rise even further as the mix continues to shift towards in-house employees. From FY09 onwards, the group will be changing reporting lines to reflect the service-led nature of its market proposition, the four segments will be Support, Testing, Training and Consultancy.

Annual results 2008

Exhibit 1: Summary of annual results for the 12 months to 31 December 2008

£m	2007	2008	%
	12 mths to 31 Dec	12 mths to 31 Dec	
Turnover	49.8	52.2	+4.7
Gross margin (%)	22.5	26.3	N/A
Normalised operating profit	4.2	5.0	+20
Profit before tax (norm)	4.4	5.3	+20
Normalised EPS (p)	12.7	15.8	+24
Cash/(net debt)	6.0	10.1	+68

Source: FDM Group

Financial performance

2008 was a record year for FDM at all levels, with an impressive financial performance. Although revenues only grew by 4.7%, this masks an improving mix whereby the placement of lower margin freelance contractors is displaced in the top line by an increasing contribution from the in-house Mounties. Given the latter generates gross margins in excess of 40%, the overall group margin moved ahead from 22.5% to 26.3%. This was the principal driver behind the 20% growth in both operating and pre-tax profits and the 24% advance in normalised EPS.

A reduction in debtor days and the intrinsically cash generative nature of the business model, saw cash balances increase by £4.1m – a similar aggregate amount to the previous year – to £10.1m. A total dividend pay-out of 3.5p (+30%) reflects cautious optimism over the current year and is clearly a reflection of the strong cash generation.

Operating review

The number of Mounties increased almost 50% during the year to 293, reflecting the first full year contribution from the Manchester academy. With utilisation rates still at around the 98% level, the in-house consultants now generate the majority of group profits at high margins. The Mounties are entirely contained within the Global Services division and their impact on the significant uplift in profits can be seen below with a 27% rise in gross profits for the division, as shown in Exhibit 2.

Exhibit 2: Divisional split for the 12 months to 31 December 2007 & 2008

£m	2007	2008	%
	12 months to 31 Dec	12 months to 31 Dec	
Revenue			
IT Staffing	36.3	36.5	0
Global Services	13.5	15.7	+16
Gross Profit			
IT Staffing	5.0	5.9	+16
Global Services	6.2	7.8	+27

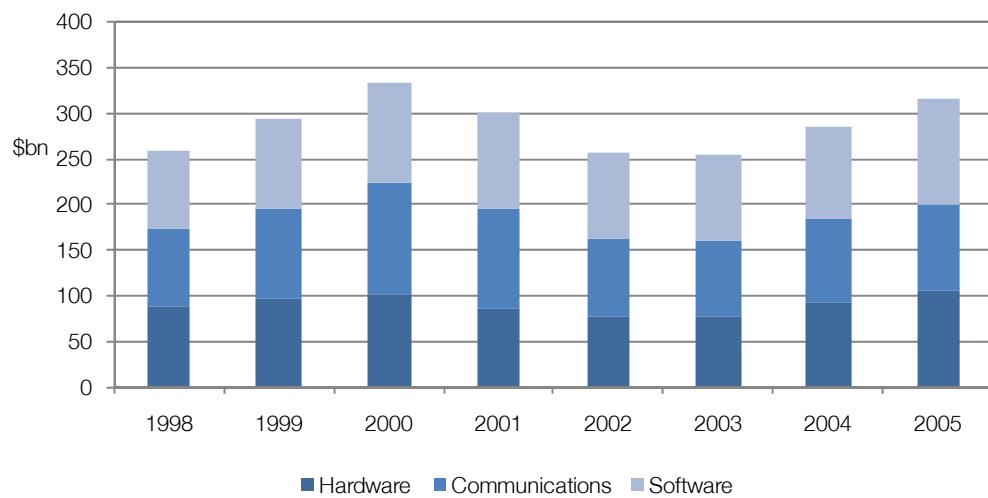
Source: FDM Group

High levels of customer retention were also a feature during 2008 as were new business wins in both the financial and non-financial sectors. New contracts included RBS, Credit Suisse and Legal & General in the former category and BAE Systems, EADS and BSKyB in the latter. The international businesses in Europe and the US are also growing contributors to the bottom line – c 12% and 6% of group PBT, respectively. FDM serves over 40 clients from its international offices with good opportunities to cross-sell to the existing customer base.

Market outlook for the IT services sector

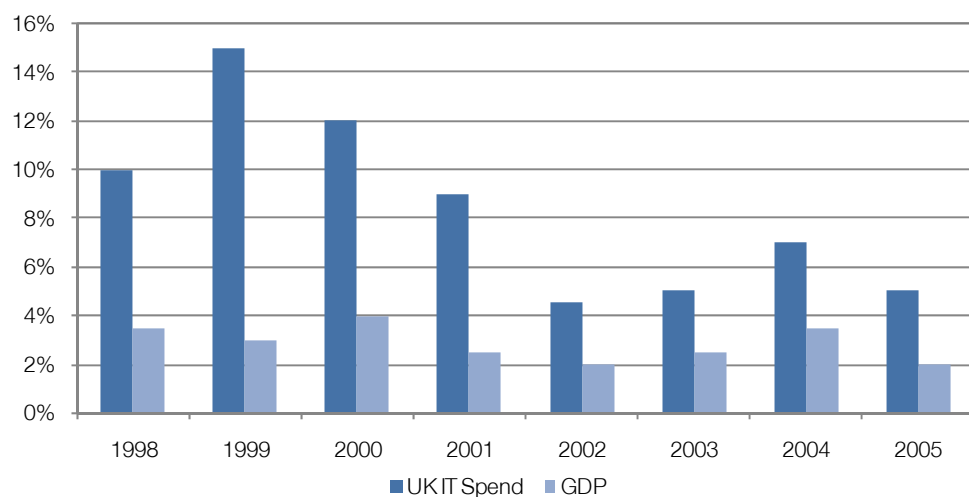
In our view looking back to the last economic downturn is helpful in trying to assess the outlook for UK quoted IT services stocks. We have already seen in recent company statements a significant fall-off in hardware expenditure over the last few months and signs of delays and 'push-outs' in major IT infrastructure investment. However, looking back at the industry through 2000-2003 reveals that although IT expenditure fell back materially, it still outperformed GDP growth by 200+ basis points. In 2009 we are expecting IT expenditure overall to be broadly flat against 2008.

Exhibit 3: Previous cycle – US IT spend 1998-2005



Source: Forrester research

Exhibit 4: Previous cycle – UK IT spend growth 1998-2005



Source: Kew Associates

In the bubble years at the end of the last decade, IT expenditure growth averaged 10% pa against GDP expansion of 2.0-2.5%. However, since 2002 there has been a pretty stable progress in IT spend of approximately 5% annually and therefore a run-rate of 2-3 percentage points above GDP.

In this context, current industry forecasts still look overly optimistic, with Ovum forecasting growth of between 3-5% in 2009. However, with the UK in particular likely to be looking at negative GDP of c 3% this implies IT spend is likely to be flat at best in the current year.

Exhibit 5: Industry forecasts

	It Project Services	Software	Information Management	Business Applications	Systems Infrastructure
2009e	2.9%	4.0%	5.5%	3.5%	4.0%
2008	3.8%	4.9%	N/A	N/A	N/A

Source: Ovum

When assessing the implications for individual companies a number of other factors should also be taken into account that will have varying outcomes:

- **Delayed IT investment decisions** – There is a tendency for corporate UK to simply delay IT spend and temporarily extend replacement intervals to conserve cash; this would mean a sharper spike down in IT spend in the short term than currently forecast.
- **First signs of margin pressure** – In sub-sectors prone to over capacity and intense competition, as opposed to niche providers, pressure on margins will inevitably accelerate.
- **Greater managed service content** – In mitigation, the amount of more resilient ‘value-add’ managed service business within the industry as a proportion of the total is much greater than in previous downturns.
- **Outsourcing** – We would expect the trend towards outsourcing to increase since fundamentally it can generally reduce costs relative to in-house IT service provision.
- **Sector exposure matters** – Regulatory and business critical drivers are particularly important and will yield defensive characteristics to IT expenditure despite a deteriorating macro outlook.

FDM in context

FDM's business model is clearly not immune from the effects of a widespread downturn in IT expenditure, but it does possess a number of attributes that should enable it to outperform a flattish overall IT market during 2009:

- The Mountie model reduces a dependency on a shared pool of freelance contractors and enables FDM to achieve industry-leading gross margins. Mounties are continuing to achieve utilisation rates of almost 100% and contribute more than 50% of profits. Further scope to increase their proportionate contribution should partly assuage macro concerns.
- Comprising c 50% of group sales, the financial services sector represents FDM's most important industry vertical and although its structural problems warrant no further comment, there are still powerful regulatory and compliance drivers that require significant IT investment.
- FDM has a focus on a niche where there is a particular shortage of specific skills – ie Sun Microsystems' Java and Microsoft's .Net – and growth in this segment should beat the market.

Forecasts and outlook

Visibility for 2009 is somewhat limited for all IT service based businesses. However, FDM has started the current year strongly with encouraging business wins from both new and existing customers. At this stage we are not materially altering our estimates for FY09 and our projections for 2010 factor in very modest growth in both sales and profitability on the back of FDM's attractive niche position and its strategic shift towards supplying more in-house, higher margin contractors.

Forecasts

Despite the more challenging environment presented by FY09 current trading is 'in-line' with expectations and given the upside to be gained from shifting the revenue mix, we are retaining our conservatively based estimates. Our forecasts for FY10 reflect a similar trend in mix and a modest uplift in operating margins, which translates into 6% growth in earnings per share. Meanwhile, the net cash balance in 2010 is likely to continue to make further progress to just north of £14m and underpins a progressive dividend policy increase of c 15%.

Exhibit 6: Summary of forecasts 2009-2010

£m	2009	2010
	Un-changed est.	New forecast
Revenue	55.5	58.3
Operating Margin (%)	9.3	9.5
PBT	5.4	5.7
EPS (p)	15.9	16.9

Source: Edison Investment Research

Outlook

The increase in capacity at the London academy will help drive the pipeline of Mounties which should be expected to increase by 100+ in FY09 to beyond 400. Despite the increase in personnel, the success of the strategy so far is evident in the significant uplift in profitability and management is confident of maintaining levels of utilisation approaching 100%. This progression emphasises the scalability of the business and we would expect profitability to continue to rise.

The pipeline of business from both new and existing customers is "encouraging" for the current year and reflects the need of customers to deliver business critical IT solutions for committed projects in spite of tight budget constraints. FDM has a differentiated offering in its market place and the ongoing move to a services rather than staffing solution should position the company at the more value-added end of the spectrum.

Valuation and conclusion

FDM has a unique business model which strategically is moving towards an in-house and service based – rather than staffing – culture. This holds out significant upside potential but in the meantime, the valuation metrics remain attractive in all respects despite a challenging environment.

Market backdrop

Our expectations for the IT market in 2009 are that the overall provision of services will see basically no growth. However, within the specialised area of operation for FDM of Java and .Net, growth has historically been at a premium to the market and there are still further opportunities to advance profitability through continuing to shift the mix from freelancers to Mounties. Nonetheless, the IT services sector is set for a very demanding 2009 and any short-term shifts in stock market sentiment look unlikely.

Earnings and yield

At current levels, FDM is trading on just 5x earnings and has a prospective yield of approximately 5%. Although the relative lack of visibility in FY09 adds a higher than typical risk factor, the current multiples are to a degree already discounting this. The company is still confident over trading prospects in the current year and our relatively conservatively based estimates look realistic at this stage given the inherent opportunity to grow profitability through the Mounties.

DCF analysis

Our DCF analysis gives a good indication as to just how strongly cash generative FDM is, since even applying a 15% discount rate – somewhat drastic in the current interest rate environment – underpins a valuation more than twice the current share price.

Exhibit 7: DCF valuation based on WACC of 15%

Discount rate	15%
NPV forecast Period £m	19.4
Growth rate in perpetuity	5%
 NPV terminal value £m	 18.0
Net cash 2008 £m	10.1
Equity value per share (pence)	205p

Source: Edison Investment Research

Conclusion

In the context of our expectations for the IT Services market in general, FDM possesses an attractive business model that has a relatively appealing core marketplace and also has the upside from implementing its strategy at a micro level. A more service-based culture along with an increasing contribution from the Mounties should see earnings at the very least maintained during FY09, while the balance sheet strength makes for a robust investment case in the long term.

Exhibit 8: Financials

Year-ending 31 December	£'000s	2006	2007	2008	2009e	2010e
Accounting basis		IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS						
Revenue		44,504	49,826	52,212	55,500	58,275
Cost of Sales		(35,906)	(38,595)	(38,501)	(41,070)	(43,124)
Gross Profit		8,598	11,231	13,711	14,430	15,152
EBITDA		2,939	4,406	5,279	5,416	5,790
Operating Profit (before except.)		2,835	4,196	5,042	5,179	5,553
Amortisation		0	0	0	0	0
Exceptionals		0	0	0	0	0
Other (IFRS2 adjustment)		(137)	(147)	(17)	(17)	(17)
Operating Profit		2,698	4,049	5,025	5,162	5,536
Net Interest		81	205	247	200	150
Profit Before Tax (norm)		2,916	4,401	5,289	5,379	5,703
Profit Before Tax (FRS 20 adjusted)		2,779	4,254	5,272	5,362	5,686
Tax		(689)	(1,421)	(1,581)	(1,614)	(1,711)
Profit After Tax (norm)		2,227	2,980	3,708	3,765	3,992
Profit After Tax (FRS 20 adjusted)		2,090	2,833	3,691	3,748	3,975
BALANCE SHEET						
Average Number of Shares Outstanding (m)		22.9	23.0	23.0	23.2	23.2
EPS - normalised (p)		9.7	13.0	16.1	16.2	17.2
EPS - normalised fully diluted (p)		9.6	12.7	15.8	15.9	16.9
EPS - FRS 3 (p)		9.1	12.3	16.0	16.2	17.1
Dividend per share (p)		1.9	2.7	3.5	4.3	5.0
Gross Margin (%)		19.3%	22.5%	26.3%	26.0%	26.0%
EBITDA Margin (%)		6.6%	8.8%	10.1%	9.8%	9.9%
Operating Margin (before GW and except.) (%)		6.4%	8.4%	9.7%	9.3%	9.5%
BALANCE SHEET						
Fixed Assets		319	695	549	549	549
Intangible Assets		16	110	102	102	102
Tangible Assets		303	585	447	447	447
Investment in associates		0	0	0	0	0
Current Assets		12,082	15,480	19,452	22,122	24,884
Stocks		0	0	0	0	0
Debtors		10,080	9,527	9,394	9,500	10,500
Cash		2,002	5,953	10,058	12,622	14,384
Current Liabilities		(4,575)	(5,671)	(5,917)	(5,987)	(5,987)
Creditors		(4,548)	(5,671)	(5,917)	(5,987)	(5,987)
Short term borrowings		(27)	0	0	0	0
Long Term Liabilities		0	0	0	0	0
Long term borrowings		0	0	0	0	0
Other long term liabilities		0	0	0	0	0
Net Assets		7,826	10,504	14,084	16,684	19,446
CASH FLOW						
Operating Cash Flow		1,024	5,759	5,837	5,363	4,773
Net Interest		81	205	247	200	150
Tax		(824)	(1,059)	(1,503)	(1,500)	(1,500)
Capex		(102)	(489)	(267)	(500)	(500)
Acquisitions/disposals		0	0	10	0	0
Financing		(170)	(22)	(7)	0	0
Dividends		(368)	(482)	(664)	(998)	(1,161)
Net Cash Flow		(359)	3,912	3,653	2,564	1,762
Opening net debt/(cash)		(2,342)	(1,975)	(5,953)	(10,058)	(12,622)
HP finance leases initiated		0	0	0	0	0
Other		(8)	66	452	0	0
Closing net debt/(cash)		(1,975)	(5,953)	(10,058)	(12,622)	(14,384)

Source: Company accounts/Edison Investment Research

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Lincoln House, 296-302 High Holborn, London, WC1V 7JH ■ tel: +44 (0)20 3077 5700 ■ fax: +44 (0)20 3077 5750 ■ www.edisoninvestmentresearch.co.uk
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