24 November 2011

EMIS

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/10	61.9	21.8	29.9	11.2	15.9	2.4
12/11e	73.3	23.7	31.3	12.4	15.2	2.6
12/12e	79.7	24.4	31.5	13.6	15.1	2.9
12/13e	85.9	26.7	34.4	15.0	13.8	3.2

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles, share-based payments, discontinued operations and exceptional items.

Investment summary: The right connections

EMIS is well positioned in the primary care software market to take advantage of the NHS's "connect all" strategy – product development is focused on creating solutions that allow different parts of the NHS to access patient data. The move of existing customers to web-based software is the key revenue driver in the short to medium term; longer-term we see growth from the expansion into extended primary care and from the commercialisation of products that improve interoperability across the NHS.

Prime position in primary care

EMIS has a strong position in the GP clinical software market and its loyal customer base supports a high level of recurring revenues. EMIS generates strong operating margins and cash flows and we forecast healthy revenue growth for FY11-13. We factor in a controlled roll-out of EMIS Web to English GP practices until the end of FY11 then accelerating in FY12 and FY13, limited sales of EMIS Web outside of the GP market and growth in RX market share to 34% by the end of FY11. EPS growth is moderated by the increase in infrastructure to support the EMIS Web roll-out, higher depreciation of hosting assets and amortisation of development costs.

Upside potential from providing better access to data

Our forecasts do not include potential revenues from selling EMIS Web into Scottish, Welsh and Northern Irish GP practices, as well as material sales of EMIS Web outside of the GP market. We estimate that every extra 10,000 EMIS Web non-GP users will add c 4p to EPS pa (FY12 +13%, FY13 12%). Other sources of upside include monetising the Healthcare Gateway, business intelligence tools, and new pharmacy solutions.

Valuation: Reflects superior profitability

The current valuation is justified by EMIS's strong profitability, cash generation and 80%+ recurring revenues. A key trigger to performance will be the acceleration of the EMIS Web roll out. As EMIS trades at a discount to healthcare software peers that generate similar or lower margins, we believe there is scope for EMIS to trade up to at least 20x FY12e EPS on any positive news to this effect.

Price	475p
Market Cap	£278m

Share price graph

Share details

Code	EMIS
Listing	AIM
Sector	Software & Computer Services
Shares in issue	58.6m

Price

52 week	High	Low
	580.0p	406.0p

Balance Sheet as at 30 June 2011

Debt/Equity (%)	N/A
NAV per share (p)	84.5
Net cash (£m)	12.8

Business

EMIS is a clinical software supplier to the primary care market in the UK, supplying over 50% of UK GP practices. EMIS also supplies software to UK pharmacies through its 78.9% stake in RX Systems Ltd.

Valuation

	2010	2011e	2012e
P/E relative	96%	153%	152%
P/CF	10.6	10.0	8.9
EV/Sales	3.8	3.4	3.0
ROE	34%	30%	29%

Revenues by geography

UK	Europe	US	Other
100%	0%	0%	0%

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Investment summary: Making the right connections

Company description: Primary care software supplier

EMIS is a clinical software provider for primary care and supplies its solutions to more than 50% of the 10,300 GP practices in the UK. A recent acquisition added pharmacy software to the product range. EMIS was founded in the 1980s by two GPs, who wrote the software with the founding principle that the systems used by GP surgeries should improve patient care. The company is profitable (30%+ operating margins), highly cash generative and has high levels of recurring revenues. Recent and future product development is focused on creating solutions that allow access to patient data across different parts of the NHS. Revenue growth during the forecast period is predominantly driven by the move of existing customers to EMIS's web-based solution, EMIS Web; longer-term we see revenue upside from the expansion into extended primary care and from the commercialisation of products that improve inter-operability across the NHS.

Financials: Revenue growth, cash generation

We forecast revenue growth of 18.4% in FY11, driven by the rollout of EMIS Web to 310 practices, installations at new Scottish practices, and a full year of RX business combined with increasing market share in the pharmacy market. In FY12 and FY13, we forecast growth of 8.7% and 7.9% respectively, almost entirely from the acceleration of the EMIS Web transition. To support this, EMIS is hiring support and training staff and is investing in its datacentre capacity – these additional costs suppress earnings growth in FY12 before EPS growth resumes in FY13 at 9%. We expect EMIS will grow its net cash position from £1.7m at the end of FY10 to £28.1m by the end of FY13.

Valuation: EMIS Web build out is key

With the UK software sector trading on 17.2x current FY and 13.0x next FY forecasts, EMIS's valuation reflects the company's strong profitability and cash generation and its high level of recurring revenues (>80%). The stock has represented a safe haven during the recent market weakness (despite the chaotic restructuring of the NHS), up 14% year-to-date versus -12% for the FTSE 100 and -4% for FTSE techMARK 100. We think that the share price is likely to be sensitive to changes in the pace of the EMIS Web rollout, as material delays in installing EMIS Web could lead to earnings downgrades for FY12 and FY13. Given that EMIS trades at a discount to healthcare software peers that generate similar or lower margins, we believe there is scope for EMIS to trade up to at least 20x FY12e EPS on positive news on the pace of the rollout. Investors should be mindful of the large stock overhang that reduces liquidity.

Sensitivities: NHS restructuring, competition, liquidity

Our forecasts and the share price could be influenced by the following factors: 1) **NHS restructuring and funding**: as well as having to adapt to the current proposed changes, EMIS is always at risk of future governments making changes that could reduce EMIS's addressable market. 2) **EMIS Web transition**: our forecasts will be influenced by the rate of customer uptake of EMIS Web, the speed of the transition, and the ability of the company to resource the transition. 3) **Competitive environment:** we assume that EMIS maintains its market share at the H111 level – any material gains or losses will affect our forecasts. 4) **Stock liquidity**: post IPO, the majority of EMIS shares were subject to three-year lock-up agreements; 47.6% of shares are still subject to lock-up.

Company description: Primary care software supplier

EMIS is a primary care clinical software provider, supplying the majority of the UK GP market. The company is profitable (30%+ operating margins), highly cash generative and has high levels of recurring revenues. EMIS is well positioned to take advantage of the NHS's "connect all" strategy – recent and future product development is focused on creating solutions that allow communication across different parts of the NHS. In the shorter term, we expect revenue growth from the move of existing customers to web-based software; in the longer term we see growth from the expansion into extended primary care and from the commercialisation of products that improve inter-operability across the NHS.

Background

EMIS is a clinical software provider for primary care and supplies its solutions to more than 50% of the 10,300 GP practices in the UK. The company was founded in the 1980s by two GPs, who wrote the software with the founding principle that the systems used by GP surgeries should improve patient care ('written by doctors, for doctors'). EMIS listed on AIM in March 2010.

On-premise solutions moving to web-based

EMIS develops its software solutions in-house and offers the following product range for primary care:

- **EMIS LV**: launched in the late 1980s and used by the majority of the installed base.
- **EMIS PCS:** launched in 1999; broadly the same as LV, but with a Microsoft Windows interface.
- **EMIS PCS Enterprise**: launched in 2002; fully-hosted version of PCS.
- **EMIS Web**: EMIS started developing EMIS Web in 2006 – it is designed to be fully hosted and, in addition to holding patient records, has modules for appointments, medication, document management, care planning, workflow management, dispensing, patient administration and search and population reporting. The software enables healthcare practitioners (not just GPs) working across different locations to access live patient records centrally. With the addition of a module called **Qute**, the practitioner can also access secondary care information.

EMIS also supplies dental practice software, business continuity services, tape validation services, training, software support, hardware and hardware maintenance. The company has developed a patient-focused website (www.patient.co.uk) that allows patients to access medical information, book appointments and order repeat prescriptions online.

Transition to EMIS Web now well underway

EMIS Web was accredited by Connecting for Health (CfH) in September 2010, enabling GP practices to be centrally funded to upgrade to and use EMIS Web software. EMIS and CfH also facilitated a familiarisation service to enable GP practices to run EMIS Web in read-only mode alongside their existing software. The intention is that practices run service-free for six months then upgrade to the full version. Exhibit 1 shows the transition of EMIS customers to EMIS Web. The company expects to take up to four years in total to roll it out to its GP user base in England.

Exhibit 1: Progress of adoption of EMIS Web by GP practices in England

Rollout progress by practice	31 Dec 10	8 Mar 11	14 Apr 11	30 Jun 11	2 Sep 11
EMIS Web installed (cumulative)	44	77	100	150	229
Orders received					
EMIS Web	433		874	1,130	
Familiarisation service	1,665		1,994	2,091	
England customers	4,736	4,736	4,666	4,666	4,666
% EMIS Web	0.9%	1.6%	2.1%	3.2%	4.9%
% familiarisation service	35.2%		42.7%	44.8%	

Source: EMIS

EMIS Web supports move into extended primary care

As surgeries using EMIS Web have their patient data stored centrally in EMIS datacentres, other users will be able to access this data if permissioned. EMIS is targeting extended primary care providers such as community health workers. EMIS Web is currently being used outside its GP customer base by 49 speciality healthcare teams across 14 PCTs, covering 13m patient records.

Presence in pharmacy market allows joined up service

EMIS has had a 20% stake in Pharmacy2U since 2005. Pharmacy2U is the UK's largest mail order and online pharmacy, and using technology developed by EMIS, offers electronic repeat prescription requesting and reminders. In August 2010, EMIS acquired a 78.9% stake in RX Systems, a supplier of dispensary management and pharmacy management software to the UK retail pharmacy market. Since then, EMIS has been working with RX to develop more integrated solutions that will enable "straight-through" prescription processing. This has the potential to reduce the time from visiting the doctor to receiving prescription drugs from days to hours and also has the potential to reduce dispensing errors.

Management

EMIS's management team has many years' experience in the healthcare IT market. CEO Sean Riddell has been with the company for over 20 years and Dr David Stables, director of strategic development, has worked developing software for EMIS since 1984. CFO Phillip Woodrow joined EMIS more recently after over 35 years as a partner at Baker Tilly. The board is headed up by non-executive Chairman Mike O'Leary, who has over 20 years' main board experience at public companies. Two of the original founders, Peter Sowerby and Tony Jones, no longer have management positions with the company, but both are shareholders (11.5% and 5.4% respectively).

Primary care in the UK

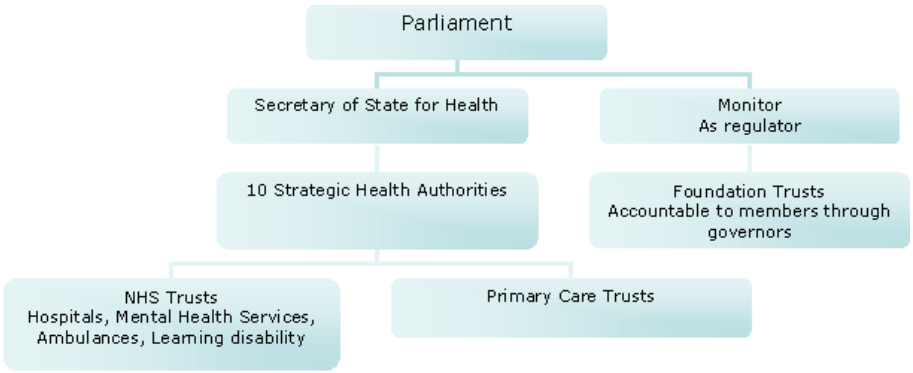
EMIS operates in the UK primary healthcare market. We summarise the current and proposed structures of the NHS in England and the IT environment in which the NHS operates. The move from PCT-based service commissioning to Clinical Commissioning Groups should be at worst neutral and at best an opportunity for EMIS to sell its web-based software into the wider extended primary care market.

Primary care consumes majority of NHS operating budget

NHS services in England, Scotland, Wales and Northern Ireland are managed separately, although all are funded centrally from national taxation. The NHS in England serves the majority of patients

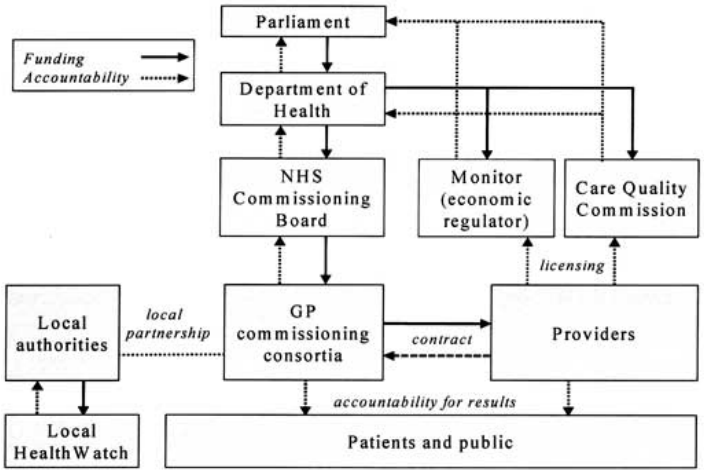
(c 51m out of over 60m patients). NHS England spent £102bn in the year to 31 March 2011. Healthcare in England is divided into primary care (ie GP and community-based care) and secondary or acute care (mainly hospital-based care). Successive governments have restructured the NHS and the current government is in the midst of a further reorganisation. The diagrams below show the current structure that is in the process of being dissolved, and the planned structure, which is still subject to change.

Exhibit 2: Current NHS England structure



Source: www.nhshistory.net

Exhibit 3: Proposed NHS England structure



Source: www.nhshistory.net

Primary care trusts (PCTs) hold the majority of the NHS England budget (c 80%) and are free to commission health services to meet local needs. They can choose to commission services from within the NHS as well as from the independent and voluntary sectors. The current restructuring will not change the budget allocation significantly; instead it will change who has control of the budget. Until the reorganisation was announced, 151 PCTs overseen by 10 strategic health authorities (SHAs) made the majority of commissioning decisions. The new structure will move control of the purse strings to GP-led consortia. Changes accepted during the recent "listening" phase include the addition of hospital doctors, nurses and other health professionals such as physiotherapists to the GP consortia, necessitating a change in the proposed consortia name from GP Commissioning Consortia to Clinicial Commissioning Groups (CCG). The target date for CCGs to start operating is April 2013, although those that are not ready by that date can operate as "shadow" CCGs with the NHS Commissioning Board taking on responsibility until they are ready. Currently, many staff are

leaving PCTs, which is leading to a slow-down in decision-making until the new consortia are fully up and running.

NHS IT has a chequered past, and is still work in progress

The NHS has not historically operated an integrated IT system, with GP practices, hospitals and other providers using multiple systems with little or no interoperability. An example of this is the multitude of health care records held for most patients. GP surgeries hold the patient's cradle-to-grave record whereas hospitals hold their own set of records (often paper-based) detailing all the treatment a patient has undergone in acute services, including any scans/X-rays. There is no automatic link between GP records and hospital records. On attendance at a hospital, the patient's records may be requested from the patient's GP, but will not be automatically available. The Summary Care Record (SCR) scheme (in the process of being implemented) has a very basic level of information (drugs, allergies) and this is available to hospitals, assuming the patient has not opted out. When a patient is discharged from hospital, a discharge letter is sent by post or email to the patient's GP, detailing the treatment received, drugs prescribed and any ongoing care requirements.

NPfIT: laudable aims, but execution has been far from satisfactory

In 2002, the Labour government launched the National Programme for IT (NPfIT) with the aim of modernising IT in the NHS by replacing existing systems with new centralised systems. The main target was to create a single electronic health record (EHR) for every patient that would be accessible by primary and secondary care providers. The scope was subsequently reduced, concentrating instead on moving hospitals from paper to digital records without necessarily making them accessible outside of the hospital. This has resulted in the planned installation of two separate health records schemes: detailed and summary. NPfIT consists of several projects implemented at a national level and a series of contracts with local service providers (LSPs). Exhibit 4 shows the key targets for the project and the level of completion of each target.

LSP contracts have proved toughest to fulfil

After the departure of several LSPs (through choice or dismissed by CfH), there are now only two LSPs: CSC covering the North, Midlands and East of England regions and BT covering London and the South of England. Many hospitals are still awaiting new Patient Administration Systems (PAS)/EHR installations from the NPfIT scheme. There have been several inquiries into the failings of the NPfIT and the government has said on several occasions that the project should be terminated. However, we suspect that it would cost more to cancel the project (in contractual penalty fees or litigation) than to continue it in a materially reduced form. The major contract with CSC is being renegotiated (a process that started in November 2009 and is imminently due for completion) and we believe it is highly likely that the scope of the project (and hence funding) will be reduced, leaving many hospitals to find and fund their own PAS/EHR systems.

Exhibit 4: Progress of NPfIT

Provider	Service	Progress
National		
BT	N3 - broadband network	Complete
	Spine - forms core of the NHS Care Records Service	Complete
Atos Origin	Choose & Book - system that enables appointments to be booked at GP surgeries, online or through a call centre	Complete
Cable & Wireless	NHSmail - national email and directory service for NHS staff	Complete
Local		
CSC	North, Midlands & East: Acute/mental health (supplied by iSoft)	c10%
	North, Midlands & East: GP systems (supplied by TPP/iSoft)	>30%
	North, Midlands & East: Community systems (supplied by TPP/iSoft)	>60%
	South: Picture archiving & communications system (PACS) and radiology information systems	Complete
BT	South: Acute (supplied by Cerner) to 10 trusts	70%
	South: Community/mental health (supplied by CSE) to 25 trusts	Complete
	London: Acute (supplied by Cerner)	>50%
	London: Community/mental health (supplied by CSE)	Complete
	London: PACS	Complete
CSE	South: PACS	Complete
Accenture	North East, East: PACS	Complete

Source: National Audit Office

GP rebellion kept most primary care software outside of NPfIT

Primary care software is only included within the NPfIT contract in CSC regions, and, even there, GP practices can choose not to use LSP software. When the NPfIT was first announced, GPs were concerned that the software on offer via the LSPs contained poorer functionality than the software they were already using and would represent a major upheaval to install. It was therefore agreed that GPs could continue to choose their own software providers, but if they wanted to receive central funding, they would need to select a supplier approved by Connecting for Health's GP Supplier of Choice (GPSoC) contract. EMIS was approved for GPSoC in 2007, and this was renewed in June 2009 until August 2011, and then again until March 2013.

Competition – TPP is the main threat

There are four main GP practice software providers in the UK and the table below shows EMIS's estimate of market share in each country in the UK as at 30 September 2010. EMIS has the largest market share in England, Northern Ireland and Scotland and is the second largest provider in Wales. Scotland recently moved from the GPASS scheme to a new GP software framework and selected EMIS and InPS as the two suppliers. EMIS estimates that it will ultimately supply 560 practices in Scotland and expects to be rolled out to them all by mid-2012.

Exhibit 5: GP practice market share as at 30 September 2010

	England		N. Ireland		Scotland		Wales	
EMIS	4819	56.8%	149	40.9%	466	45.1%	159	31.5%
InPS	1594	18.8%	82	22.5%	339	32.8%	241	47.8%
TPP	1232	14.5%	0	0.0%	0	0.0%	2	0.4%
iSoft	621	7.3%	70	19.2%	25	2.4%	95	18.8%
Other	222	2.6%	63	17.3%	203	19.7%	7	1.4%
	8488		364		1033		504	

Source: EMIS

We estimate that TPP has been gaining market share as it is the primary care software provider for CSC in the North, Midlands and East of England – the company states that as of August 2011, it had 1,673 GP practices running its software. It remains to be seen what shape the CSC contract will be in once negotiations with the Department of Health are complete, but Christine Connelly (the ex-Department of Health director general of informatics) was quoted as saying that primary care would be removed from the contract. This would put TPP on a more equal footing with the other

GP software providers. iSoft has had a troubled past and we expect that doubts over its survival will have had a negative impact on its market share, although this may stabilise now that CSC has acquired the company. In terms of product, both TPP and InPS have web-based solutions with centralised hosting.

Sharing records should improve patient service

The information contained within the cradle-to-grave record is crucial for a patient to receive proper care. With the current structure of data sharing within the NHS, there is scope for important information to be missed when diagnosing patients in hospital, and even if the correct information is received, the process is slow and unwieldy. EMIS Web opens up the possibility for other healthcare providers to access patient records (always with patient consent). EMIS's initial target is extended primary care, which includes services such as district nursing, health visitors, physiotherapy, podiatry, phlebotomy and clinics for long-term conditions such as diabetes or COPD.

To counter concerns about privacy and data protection, EMIS Web is designed to enable selective access to data. Access controls can be set so that non-GP users can only access data relevant to the service they are involved in. In all cases, a patient must consent before the non-GP user can access the records. We would expect the level of consent to be very high, as from a patient perspective, allowing healthcare providers access to the data should enable them to receive faster and better care.

NHS restructuring proposals appear positive for EMIS

EMIS has a strong GP user base, serving as it does the majority of GP practices in the UK. We think it unlikely that the move to CCGs would reduce EMIS's addressable GP practice market. In fact, the company expects that CCGs may look to consolidate around one supplier, and calculates that this would be beneficial for EMIS due to its already strong market position.

In addition to using clinical software to serve their patients, GPs (and other CCG participants) are going to start to need access to much wider-ranging information in order to make commissioning decisions. EMIS has already started commercialising its business intelligence operation (EMIS IQ): with access to more than half of all patient records, EMIS is in a good position to enable CCGs to collate data for trend and performance analysis. This would enable CCGs, among other things, to understand the costs incurred in treating certain types of patients or conditions, and to assess the performance of practices within a CCG.

Growth opportunities

EMIS has the potential to drive revenue growth across several products and target markets.

EMIS Web roll-out to existing GP customer base

EMIS Web customers pay more on average per practice than customers using earlier versions of EMIS software. The company estimates it will earn on average £12,200 per practice for EMIS Web compared to nearly £9,500 per practice for earlier software versions (excluding revenues received for hosting). In addition, the company will generate deployment revenues as each practice moves over to EMIS Web – the company estimates c £2,500 per practice. EMIS started the process as a controlled rollout to ensure that bugs were identified and fixed on a timely basis and has the capacity to rollout two practices per night. Once the company is comfortable that it has sufficient

staff and datacentre capacity in place, and that the implementation process is well-understood and relatively free from bugs, the plan is to move out of controlled rollout. At this point, the company expects to be able to switch over five practices per night. We expect the controlled rollout process to remain in place until at least until the end of Q112, before accelerating to the higher rollout rate.

Sale of EMIS Web to extended primary care providers

EMIS has already started selling EMIS Web to other primary care providers at a price of up to £400 per seat per annum. Extended primary care providers account for c 290,000 of NHS employees. The maximum addressable market would therefore be £58m per annum, assuming one licence per two employees. We would not expect EMIS to fully penetrate the extended care market as the service will not be appropriate in all geographic regions. The most suitable areas for EMIS Web are those where EMIS is the majority supplier to GPs in the area, or where EMIS/InPS is in the majority. If users were in a predominantly TPP area, they would be unable to access the majority of patient records. We estimate that every extra 10,000 users signed up to EMIS Web will add c 4p to EPS per annum, roughly equivalent to at least a 10% uplift to FY12 and FY13 EPS.

In June 2010, EMIS announced that University Hospital Aintree had started using EMIS Web on an extended trial basis, enabling hospital staff working in emergency medicine to access GP records for EMIS-based practices (100 practices covering 450,000 patients) via its Medway clinical system. A year later, EMIS announced that this process had become two-way, with GPs at EMIS Web-based practices able to access secondary patient data on the Medway system.

In March 2011, Central and Eastern Cheshire PCT signed a five-year contract worth £1.8m to provide a shared healthcare record across Cheshire. The contract includes 933 access points for EMIS Web, roughly equivalent to £400 per access point per annum.

Growth of the RX business

On acquisition, RX was supplying its ProScript dispensary management software to 20.5% of the community pharmacy market in the UK. The remainder of the market was split between Cegedim RX (c 50%) and in-house software. In 2009, RX had signed an agreement with AAH (a large pharmacy wholesaler that also owns the chain of c 1,700 Lloyds pharmacies) to transition AAH's LINK software users over to ProScript LINK. By August 2011, RX had increased its market share to 31%, mainly as a result of the ongoing transfer of AAH users to ProScript LINK. This transition should be complete by the end of 2011. EMIS is also piloting point-of-sales (PoS) software with selected customers.

Monetising the healthcare gateway

In June 2010, EMIS entered into a joint venture with InPS to create a medical interoperability gateway (called Healthcare Gateway Limited). The gateway facilitates the sharing of data between health professionals (working in primary or secondary care). Together EMIS and InPS software serves over 75% of UK GP practices and supports 46 million patient records. Advanced Computer Software's Adastra business has been accredited, enabling the c 90% of out-of-hours providers who use Adastra to access the Gateway. We understand that the JV could charge for the service in two ways: 1) on a per transaction basis, or 2) by granting a licence for the user of the service based on a set number of users.

In June 2011, Mersey Care NHS Trust said it will use the Gateway to join a health-community wide patient information sharing programme.

In July 2011, EMIS announced that all clinicians across Cumbria would be using the gateway enabling them to share electronic records with patient consent; participating software providers are EMIS and InPS for GP-based records, Adastra for out-of-office solutions and Ascribe's Symphony software used in A&E departments.

Overseas opportunities

In early 2011, EMIS won a five-year contract via CSC to provide an electronic health information system for the Australian Defence Force, based on EMIS PCS Enterprise. EMIS had previously tried to crack the Canadian market, but this was not successful and the company made the decision to withdraw in 2010, finally selling the business in April 2011. Due to the cost of developing a thorough understanding of target markets, and the risky nature of entering markets with high levels of government involvement, the company is not actively marketing overseas - future overseas sales are likely to happen on an ad-hoc basis.

Financials

Revenue assumptions

In the table below, we show our revenue forecasts for FY11-13. We make the following assumptions in arriving at our forecasts:

- We assume the total number and EMIS's market share of GP practices remains at the H111 level.
- EMIS charges an annual licence fee for on-premise and hosted software and also sells hardware and other services. We use annual revenue per practice of £9.5k for English practices and £9.2k for Northern Irish and Welsh practices using existing software, £4.5k for Scottish practices and £12.2k per EMIS Web practice. We factor in GPSoC-approved inflationary increases for the non-EMIS Web practices for FY12. As the GPSoC contract runs out in March 2013 and it is not yet clear what will replace it, we leave the FY13 revenue per practice at the same level as FY12.
- We assume that EMIS rolls out EMIS Web to 310 practices in 2011, 1,000 in 2012 and 1,500 in 2013. We do not include any estimates for transitioning customers in Wales and Scotland to EMIS Web, although this is possible.
- We estimate EMIS Web deployment revenue of £2.5k per practice (per company guidance).
- We separately forecast annual revenues for hosting to CfH approved levels. See below for further explanation.
- We assume that RX increases its market share to 34% by the end of 2011.
- We factor in revenues for other contracts such as the Australian Armed Forces deal and other contracts in the UK and overseas (including a 10-year contract to supply GP and dental software for the MoD). This also includes non-GP EMIS Web users.

EMIS has traditionally had a high level of recurring revenues as it charges annual software renewals. Recurring revenues were 75% of the total in FY09 and increased to 82% in FY10 as more customers moved to accredited hosting. Recurring revenues should gradually increase from

the FY10 level as more practices move to a fully-hosted set-up. There will be a small reduction in the proportion of hardware sales and maintenance as practices will own less of their own hardware.

Exhibit 6: Breakdown of EMIS revenue forecast

£m	FY10	FY11e	FY12e	FY13e
GP Revenues				
Non-EMIS Web	47.7	46.8	42.0	30.1
EMIS Web	0.3	2.2	10.4	25.7
Hosting	4.5	5.5	6.0	7.0
Deployment	0.1	0.8	2.5	3.8
RX	5.0	12.8	13.2	13.4
Other	4.4	5.3	5.5	6.0
Total revenues	**61.9**	**73.3**	**79.7**	**85.9**
Revenue growth	**8.2%**	**18.4%**	**8.7%**	**7.9%**

Source: Edison Investment Research

Cost base

In order to transition customers over to EMIS Web, EMIS needs sufficient numbers of technically knowledgeable staff to undertake the data transfer from customer servers to the EMIS datacentres and to train and support customers before and after the installation. After a period of rapid rollout of EMIS Web, the company is pausing in order to rollout upgrades to the software and to ensure that new EMIS Web users have sufficient training and support to use the new systems.

To support this, we forecast a significant increase in staff and other operating costs for the EMIS business in FY11, moderating in FY12. We factor in a full year of operating costs for RX in FY11 and 5% growth in FY12. RX has started using Egton, EMIS's engineering division, to carry out installations, hardware supply, maintenance and support. The move from a third-party supplier to in-house staff should improve Egton staff utilisation and overall group profitability.

Development costs

EMIS capitalises development costs related to EMIS Web (£8.5m as at end FY10), and once the company received accreditation by CfH, started amortising in line with the roll-out programme. As EMIS had only rolled out to 44 practices by the end of 2010, only minimal amortisation was charged in FY10. We expect this to grow to £0.1m in FY11, £0.6m in FY12 and £1.6m in FY13. The company continues to capitalise development costs related to enhancements to EMIS Web. We estimate that the company will capitalise development costs in the range of £2.0-2.5m per annum. Edison forecasts are based on the IFRS treatment of development costs, however some prefer to base forecasts on cash accounting for development costs. In Exhibit 7, we present our forecasts under both methods for comparison purposes, although we continue to use the IFRS version for valuation purposes.

Exhibit 7: IFRS versus cash accounting for development costs

£'000	FY09	FY10	FY11e	FY12e	FY13e
Edison EBIT	17,848	22,022	23,598	24,203	26,504
EBIT - cash R&D	13,328	18,223	21,202	22,266	26,104
Edison net income	12,015	16,844	18,359	18,855	20,721
Net income - cash R&D	7,495	13,045	15,963	16,918	20,321
Edison EPS (p)	24.0	29.9	31.3	31.5	34.4
EPS - cash R&D (p)	15.0	23.1	27.2	28.2	33.8

Source: Edison Investment Research

Hosting assets

EMIS hosts the data for PCS Enterprise and EMIS Web at two fully-owned datacentres in Leeds (based 10 miles apart). In 2010, Connecting for Health approved EMIS's hosting as reaching its standards. As a result, it reimburses capex costs related to the accredited hosting plus a small profit margin. EMIS receives the reimbursement each year and credits it to deferred income, releasing it to hosting revenues in line with the asset depreciation schedule (typically three years). In 2010, EMIS spent £3.9m on equipment for the datacentres and received £4.5m from CfH.

Tax

EMIS has a relatively straightforward tax position, with all profits generated in the UK. We reduce our tax rate from the 2010 level to reflect changes to the UK corporation tax rate.

Cashflow

EMIS is highly cash generative – we forecast that the company will generate cash from operating activities of £21.9m in FY11 rising to £26.8m in FY13. We forecast that EMIS will increase net cash from £1.7m at the end of FY10 to £9.7m at the end of FY11 and £28.1m by the end of FY13. We estimate that EMIS will generate a free cash flow yield of 4.9% in FY11 rising to 6.5% in FY13.

Dividend growth

EMIS announced an interim dividend of 6.2p per share in H111; we assume an identical final dividend resulting in a full year dividend of 12.4p (+10.7% y-o-y). We assume that the dividend grows 10% per annum, equating to a payout ratio of 40-45%.

Sensitivities

Our forecasts and the stock price are sensitive to the following factors:

- NHS restructuring and funding: successive governments have restructured the NHS and the current government is no exception. As well as having to adapt to the current proposed changes, EMIS is always at risk of future governments making changes that reduce EMIS's addressable market. EMIS is currently approved under the GPSoC contract until March 2013 – it is not yet known what will replace this and there is the risk that the new system will not be as favourable to EMIS. However, as EMIS solutions power the majority of UK GP practices and are the cheapest available from the GPSoC contract, it seems unlikely that the government would mandate changes that would require practices to incur the cost of changing systems.
- Competitive environment: we assume that EMIS maintains its market share at the H111 level (this takes into account recent wins in Scotland) – any material gains or losses will affect our forecasts. We note that 65% of EMIS's GP users have been customers of EMIS for more than 10 years. We also assume that EMIS Web will be gradually adopted outside of the GP market place – other software providers with more expertise in these areas may prevent EMIS from gaining a position in non-GP markets.
- Managing the move to EMIS Web: EMIS has started the process of moving its customers over to its web-based solution. Our forecasts will be influenced by the rate of customer uptake of the service, the speed of the transition, and the ability of the company to resource the transition in terms of technical staff and datacentre capacity.

- **Stock liquidity**: post IPO, 71.4% of EMIS shares (mainly held by management and co-founders) were subject to three-year lock-up agreements. Shares are being unlocked at the rate of one third each anniversary such that all shares are free to be sold by 29 March 2013. In March 2011, locked-up shareholders sold 3.63% of outstanding shares, leaving 47.6% of shares still subject to lock-up and a further 20.2% available for immediate sale.

Valuation

With the UK software sector trading on 17.2x current FY forecasts and 13.0x next FY forecasts, EMIS's valuation appears reasonable considering the company's strong profitability and cash generation and its high level of recurring revenues. The stock has represented a safe haven during the recent market weakness (despite the chaotic restructuring of the NHS), up 14% year-to-date compared to -12% for the FTSE 100 and -4% for the FTSE techMARK 100. We believe that there is scope for EMIS to trade at a higher multiple, but think that the share price is likely to be sensitive to changes in the pace of the EMIS Web rollout. As each practice moves to EMIS Web, EMIS earns higher annual revenues and gets the one-off benefit of deployment revenues, so material delays in installing EMIS Web could lead to earnings downgrades for FY12 and FY13. There is also the risk that if there is a perception that EMIS is struggling with the implementation, potential EMIS Web users could lose patience and move to a competitor's hosted product. Once the company has announced that the pace of rollout is accelerating, we believe there is scope for multiple expansion towards 20x FY12e EPS more in line with healthcare software peers.

Discounted cash flow analysis

We have calculated a base case valuation that assumes that EMIS Web is rolled out to 97% of the current installed base in England by 2015 followed by revenue growth of 3% per annum (ie EMIS receives inflationary increases in prices from 2015). This is an attempt to calculate the underlying value of the GP business combined with the RX pharmacy business, not taking into account the potential upside from selling EMIS Web to non-GP users, from transitioning GP practices in Scotland, Wales or Northern Ireland to EMIS Web, from monetising the Healthcare Gateway or from commercialising business intelligence tools. We perform the same calculation for a much slower roll-out to show the impact on valuation of a significant delay in the transition (which we believe is unlikely).

Our base case scenario is very close to the current share price, implying that the market is either not factoring in other revenue opportunities or is expecting a slower rollout rate.

Exhibit 8: DCF valuation based on EMIS Web rollout timetable

EMIS Web rollout per annum	FY11e	FY12e	FY13e	FY14e	FY15e	FY16e
Base case	310	1000	1500	1500	150	0
Bear case	275	300	800	1200	1500	400
Total revenues (£m)						
Base case	73.3	79.7	85.9	91.3	92.2	92.0
Bear case	71.7	75.5	77.6	80.8	85.6	90.6
	Valuation	vs share price		Assumptions:		
Base case (p)	464.0	-3%		WACC = 10%		
Bear case (p)	424.2	-12%		Long-term growth rate = 3%		

Source: Edison Investment Research

Peer group multiples analysis

Exhibit 9 compares EMIS with a peer group of healthcare software-related companies. EMIS trades at a slight premium to the average for all profit-based multiples (both including and excluding McKesson[1]), but is forecast to generate higher EBIT and EBITDA margins than the entire peer group. On a P/E basis, EMIS trades at a significant discount to its closest peers in terms of financial performance (Craneware and Cerner, both generating 20%+ EBIT margins). We believe that confirmation that the EMIS Web rollout is accelerating could drive the stock price up to at least 20x FY12e EPS (629p).

Exhibit 9: Multiples for selected peer group

Note: ACS forecasts are for y/e 28 Feb 2012, 2013; Allocate for y/e 31 May 2012, 2013; Craneware for y/e 30 June 2012, 2013, 2014, McKesson y/e 31 March 2012, 2013, 2014. Prices as at 21 November 2011.

		EV/Sales			P/E			EV/EBIT			EV/EBITDA			EBIT margin			EBITDA margin		
	y/e	11e	12e	13e	11e	12e	13e	11e	12e	13e	11e	12e	13e	11e	12e	13e	11e	12e	13e
EMIS	31-Dec	3.7	3.3	2.9	15.3	15.3	13.9	11.5	10.9	9.6	10.1	8.9	7.6	32.2%	30.4%	30.8%	36.6%	37.1%	38.6%
ACS	28-Feb	1.7	1.5		10.9	10.4		8.5	6.7		6.8	6.0		20.6%	22.6%		25.5%	25.3%	
Allocate	31-May	1.3	1.1		11.3	9.9		7.7	6.1		7.3	5.7		16.3%	17.3%		17.4%	18.5%	
AllScripts	31-Dec	2.6	2.3	1.9	20.6	17.4	15.0	12.5	10.4	8.5	9.1	7.7	6.7	20.9%	21.9%	22.9%	28.6%	29.4%	28.8%
Cegedim	31-Dec	0.7	0.7	0.6	5.1	4.4	3.5	7.8	6.5	5.4	4.2	3.7	3.2	9.1%	10.2%	11.2%	17.1%	18.2%	18.8%
Cerner	31-Dec	4.2	3.6	3.0	31.1	25.5	21.0	19.0	14.9	11.6	13.2	10.7	8.6	22.2%	24.0%	25.6%	31.8%	33.2%	34.6%
Craneware	30-Jun	3.8	3.0	2.3	29.2	21.7	21.3	15.7	11.7	8.7	14.8	11.1	8.1	24.3%	25.5%	26.7%	25.9%	27.0%	28.7%
McKesson	31-Mar	0.2	0.2	0.1	12.3	11.0	10.0	7.6	6.8	6.3	6.4	5.8	5.5	2.1%	2.3%	2.3%	2.5%	2.6%	2.7%
Average		**2.1**	**1.7**	**1.6**	**17.2**	**14.3**	**14.2**	**11.3**	**9.0**	**8.1**	**8.8**	**7.2**	**6.4**	**16.5%**	**17.7%**	**17.7%**	**21.3%**	**22.0%**	**22.7%**
Ave ex-McKesson		**2.4**	**2.0**	**2.0**	**18.0**	**14.9**	**15.2**	**11.9**	**9.4**	**8.5**	**9.2**	**7.5**	**6.7**	**18.9%**	**20.3%**	**21.6%**	**24.4%**	**25.3%**	**27.7%**

Source: Thomson and Edison Investment Research

Recent M&A

The healthcare software space has been relatively active in terms of M&A. Most deals have been at lower valuations than EMIS but are for businesses operating at significantly lower margins. McKesson acquired AIM-listed System C Healthcare in March 2011, bolstering its UK-specific hospital EHR/PAS solutions with System C's Medway product range (note that System C integrates EMIS Web into Medway). The all-cash deal valued System C at 2.3x historic revenues and 11x historic EBITDA. In May 2011, CSC acquired the loss-making iSoft, although we expect that this deal was done more out of necessity than desire. As an LSP for NPfIT, CSC is supposed to be rolling out iSoft's Lorenzo software to its three English regions, and could not risk iSoft going into administration. In the staff rostering space, Allocate acquired Zircadian (a doctor-rostering SaaS provider) in August for up to 2.4x historic sales, for a business that generated a historic 8% EBITDA margin.

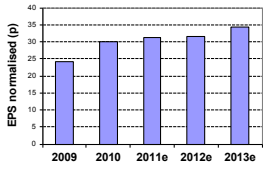
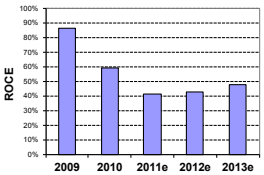
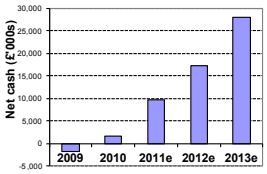
[1] As the majority of McKesson's revenues are generated from its distribution business, it generates single-digit EBIT margins. In the year to March 2011, its Technology Solutions business generated 3% of revenues at a gross margin of 44% and an operating margin of 9.3%, still at a discount to most of the peer group.

Exhibit 10: Financials

Note: FRS 3 EPS includes discontinued operations.

£'000s	2009	2010	2011e	2012e	2013e
Year end 31 December					
PROFIT & LOSS					
Revenue	**57,696**	**61,900**	**73,314**	**79,674**	**85,932**
Cost of Sales	(9,520)	(8,846)	(10,997)	(11,951)	(12,890)
Gross Profit	48,176	53,054	62,317	67,723	73,043
EBITDA	**20,232**	**24,844**	**26,802**	**29,566**	**33,204**
Operating Profit (before amort. Of acq. intang, SBP and except.)	**17,848**	**22,022**	**23,598**	**24,203**	**26,504**
Amortisation of acquired intangibles	(2,074)	(2,431)	(3,007)	(3,007)	(3,007)
Exceptionals	0	(1,258)	0	0	0
Share-based payments	0	0	0	0	0
Operating Profit	**15,774**	**18,333**	**20,591**	**21,195**	**23,496**
Net Interest	(1,510)	(375)	20	80	130
Profit Before Tax (norm)	**16,536**	**21,756**	**23,728**	**24,393**	**26,744**
Profit Before Tax (FRS 3)	**14,462**	**18,067**	**20,721**	**21,385**	**23,736**
Tax	(4,521)	(4,868)	(5,072)	(5,214)	(5,717)
Profit After Tax (norm)	**12,015**	**16,888**	**18,656**	**19,179**	**21,027**
Profit After Tax (FRS3)	**9,941**	**13,199**	**15,649**	**16,171**	**18,020**
Average Number of Shares Outstanding (m)	50.0	56.4	58.6	59.0	59.2
EPS - normalised (p)	**24.0**	**29.9**	**31.3**	**31.5**	**34.4**
EPS - FRS 3 (p)	**19.9**	**19.8**	**22.3**	**26.9**	**29.9**
Gross Margin (%)	83.5%	85.7%	85.0%	85.0%	85.0%
EBITDA Margin (%)	35.1%	40.1%	36.6%	37.1%	38.6%
Operating Margin (before GW and except.) (%)	30.9%	35.6%	32.2%	30.4%	30.8%
BALANCE SHEET					
Fixed Assets	**48,966**	**65,954**	**66,743**	**66,073**	**63,565**
Intangible Assets	36,908	51,235	50,624	49,554	46,946
Tangible Assets	9,506	12,058	13,458	13,858	13,958
Other fixed assets	2,552	2,661	2,661	2,661	2,661
Current Assets	**13,395**	**17,192**	**22,965**	**29,932**	**40,270**
Stocks	674	668	668	668	668
Debtors	7,500	9,082	8,000	8,694	9,377
Cash	5,221	7,442	14,297	20,571	30,225
Current Liabilities	**(15,694)**	**(22,533)**	**(22,533)**	**(22,533)**	**(22,533)**
Creditors	(14,510)	(21,349)	(21,349)	(21,349)	(21,349)
Short term borrowings	(1,184)	(1,184)	(1,184)	(1,184)	(1,184)
Long Term Liabilities	**(35,287)**	**(13,831)**	**(12,631)**	**(11,431)**	**(10,231)**
Long term borrowings	(5,763)	(4,580)	(3,380)	(2,180)	(980)
Other long term liabilities	(29,524)	(9,251)	(9,251)	(9,251)	(9,251)
Net Assets	**11,380**	**46,782**	**54,544**	**62,041**	**71,071**
CASH FLOW					
Operating Cash Flow	**19,864**	**22,181**	**26,984**	**28,872**	**32,521**
Net Interest	(2,099)	(358)	20	80	130
Tax	(3,127)	(3,889)	(5,072)	(5,214)	(5,717)
Capex	(8,633)	(9,412)	(7,000)	(7,700)	(7,200)
Acquisitions/disposals	295	(2,853)	50	(750)	0
Financing	(524)	1,030	0	0	0
Dividends	0	(3,278)	(6,927)	(7,814)	(8,880)
Net Cash Flow	5,776	3,421	8,055	7,473	10,854
Opening net debt/(cash)	**7,486**	**1,726**	**(1,678)**	**(9,733)**	**(17,207)**
HP finance leases initiated	0	0	0	0	0
Other	(16)	(17)	0	0	0
Closing net debt/(cash)	**1,726**	**(1,678)**	**(9,733)**	**(17,207)**	**(28,061)**

Source: EMIS and Edison Investment Research

Growth	Profitability	Balance sheet strength	Sensitivities evaluation	
			Litigation/regulatory	◖
			Pensions	○
			Currency	○
			Stock overhang	●
			Interest rates	○
			Oil/commodity prices	○

Growth metrics	%	Profitability metrics	%	Balance sheet metrics		Company details	
EPS CAGR 09-13e	9.4	ROCE 12e	41.2	Gearing 12e	N/A	Address:	
EPS CAGR 11-13e	4.8	Avg ROCE 09-13e	45.6	Interest cover 12e	N/A	Fulford Grange, Micklefield Lane, Rawdon, Leeds, LS19 6BA	
EBITDA CAGR 09-13e	13.2	ROE 12e	33.7	CA/CL 12e	1.0		
EBITDA CAGR 11-13e	11.3	Gross margin 12e	85.0	Stock days 12e	3	Phone	0113 380 3000
Sales CAGR 09-13e	10.5	Operating margin 12e	32.2	Debtor days 12e	40	Fax	0113 380 3439
Sales CAGR 11-13e	8.3	Gr mgn / Op mgn 12e	2.6	Creditor days 12e	81	www.emis-online.com	

Principal shareholders	%
Sean Riddell	14.2
Peter Sowerby	11.5
Standard Life Investments Ltd	8.9
Andrew Whitwam	8.8
David Stables	7.6
Phillip Woodrow	6.7
William Jones	5.4

Forthcoming announcements/catalysts	Date *
Trading update	January 2012
Prelims	March 2012
AGM	May 2012
*Note: * = estimated*	

Management team

CEO: Sean Riddell

Sean has 20 years' experience of healthcare IT, all gained with EMIS. He joined EMIS in 1989 as a Field Support Manager and then moved into a broader sales and marketing role. He joined the EMIS board in 1999, became MD of EMIS in 2006 and MD of EMIS Group in 2008 upon its incorporation. Before EMIS, Sean was a business information analyst for Provident Financial Group and has a degree in Psychology. Sean is also a non-exec director of Pharmacy2U and the Spa Retreat Ltd.

CFO: Phillip Woodrow

Phillip joined EMIS Group as finance director on completion of the MBO in 2008. Prior to this, he was a partner in Baker Tilly advising corporate clients in relation to business planning and acting on company M&A. He joined the firm in 1965, qualified as a Chartered Accountant in 1970 and became a partner in 1972. Phillip is also a non-executive director of Bradford City Challenge Foundation Limited and a Fellow of the ICAEW.

Chairman: Mike O'Leary

Mike joined the board in March 2011. He has 20 years of main board experience in public companies. Mike is a non-executive director of Headlam Group plc, Psion plc and is also chairman of Digital Healthcare Limited. He was CEO of Marlborough Stirling plc and Huon Corporation and an executive director of Misys plc, where he ran the group's US healthcare division.

Companies named in this report

TPP, Cegedim (EPA: CGM), McKesson (NYSE: MCK), Cerner (NASDAQ: CERN), CSC (NYSE: CSC), Craneware (LON: CRW), Allocate Software,(LON: ALL), AllScripts (NASDAQ: MDRX)