Smoothware

Software as a Service

May 2008

COMPANIES FEATURED

FFastfill	Netstore
GB Group*	ServicePower
Gresham Computing	StatPro
Kewill Systems	

Companies denoted with * are a research client of Edison Investment Research Limited

Software as a Service

The provision of Software as a Service has been around for over a decade. However, it is only in the past few years that high-speed networks and the investment in scalable architectures have enabled the emergence of a number of well positioned UK business models. In our view valuations largely reflect the negative short-term impact of SaaS delivery on revenue recognition and therefore earnings. However, importantly, these businesses have the opportunity to take market share, have high visibility of future cash flows and should significantly outperform the IT sector over the next three years.

Smoothware

In this report we highlight the trend towards the delivery of Software as a Service (SaaS). In the short term, evolving sales models to SaaS is impacting the reported earnings of UK companies. However, we highlight a number of UK players with undervalued SaaS assets that are building scalable cash flow streams.

Shift towards SaaS business models accelerating

The emergence of the original Application Service Provider (ASP) business models in the late 1990s was negatively impacted by their lack of technical scalability and insufficient growth capital. However, with the development of multi-user architectures, high-speed networks and an improvement in the funding environment, a number of pure play and evolving SaaS providers have emerged.

US leads the way: Emergence of large suppliers

US investors have been quick to value the scalability and economic potential of SaaS business models, helping the index of stocks to significantly outperform the broader technology sector. We highlight the economics and benefits of the shift from traditional software models to SaaS and identify a number of small cap UK technology stocks that are building out competitive global SaaS platforms.

UK stocks to watch: A number of players with upside

We focus on a number of stocks but highlight FFastfill as a technical leader in a complex end-market, GB Group and Kewill with well developed business models, and ServicePower and Gresham which are attempting to build out ambitious global SaaS services. We believe these companies have the business models to potentially outperform the sector and highlight other similar UK players.

Investment summary: Smoothware

Introduction: Software as a Service

SaaS is a business model whereby customers pay for a software application per usage rather than ownership. SaaS has evolved from the ASP model which stumbled because vendors were unable to scale their businesses. With the development of Service-Oriented Architecture (SOA) and greater telecoms bandwidth, companies have found not only that they are able to scale the business much more effectively but also that they are able to build highly efficient web-based applications. A number of quoted UK technology companies have established SaaS strategies while many others are working through their response to the trend.

Valuation: US SaaS stocks have heavily outperformed

Valuing the SaaS revenue streams within these businesses is quite difficult as the business models are often nascent and they certainly have very different growth and margin profiles to traditional software businesses. Exhibit 4 demonstrates the different cost structures between the two types of businesses. Where we have been able to we have used DCF or EV/EBIT multiples. We note US SaaS stocks have vastly outpaced the broader indices in recent years and trade on much higher multiples than traditional software vendors.

Exhibit 1: Edison index of US SaaS companies compared with the Nasdaq Composite Index
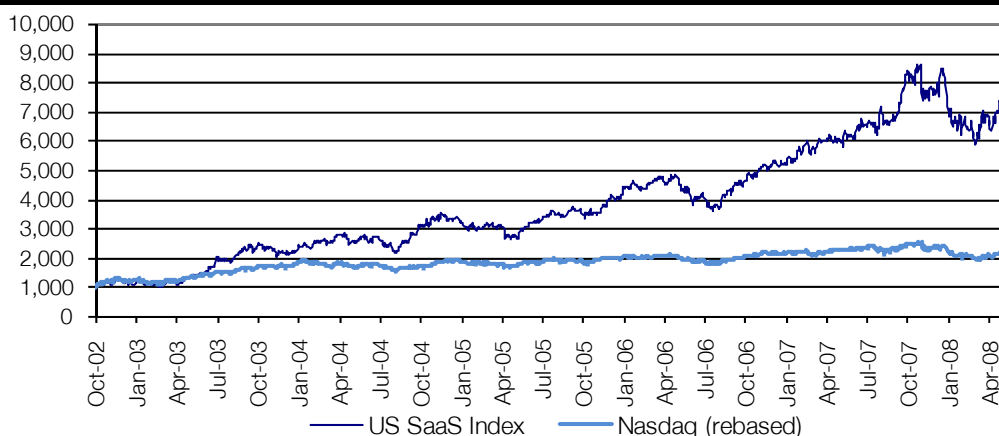
Source: Bloomberg, Edison Investment Research

Sensitivities: Challenge of building a SaaS offering

Many UK software companies have strategic, technological and capital challenges in building a SaaS offering. Traditional software businesses have the challenge of trying to add hosted and subscription customers without cannibalising existing licence sales. In addition, while the SaaS revenue profile is more stable than the traditional licence-driven model, it is easier for customers to move as they have not committed to a large perpetual licence fee.

UK stocks to watch: A number of global SaaS platforms

The stocks we focus on in this report trade on median enterprise multiples of around 1.2x revenues and 10x EBIT appearing to suggest that the market is pricing in a small premium for SaaS business models. However, the accounting approach to SaaS businesses means that short-term sales and earnings are 'depressed' compared with traditional software businesses. We therefore believe investors are undervaluing the potentially highly visible scalability of SaaS businesses and highlight significant upside to many of the stocks in this report.

The evolution of Software as a Service

Traditional software business models

In the UK there are over 100 quoted traditional software companies accounting for some £12bn of equity market value. Typically these are traditional software businesses with models which involve the sale of a perpetual licence with ongoing maintenance charges. After R&D costs the marginal rates of profitability are high since manufacturing costs are negligible.

Channels to market can be either through an in-house sales team (ie direct) or through reseller partners (ie indirect). While a traditional software business can potentially be very profitable and scalable, there is often a long and lumpy sales cycle given the challenge of convincing a customer to spend substantial funds on a few CDs. Further, the licence fee is typically not linked to usage, let alone economic payback.

Architecturally, the model is 'single-tenant' which means the application is installed on a server for use by only the end user group of a single customer. The customer therefore typically has to pay for implementation services, deploy its own hardware and deal with backup, networking and ongoing maintenance and training.

What is SaaS?

SaaS is a business model whereby customers pay for a software application per usage rather than ownership. SaaS software is developed specifically for use over the internet (ie it is web-native). It is typically delivered on a one-to-many basis (single instance, multi-tenant architecture) and is hence for the broader market rather than a customised product. SaaS is delivered over a network from the provider's own storage infrastructure and is normally associated with business software.

How SaaS has evolved

SaaS has evolved from the ASP model which began to roll out in the late 1990s as rapid internet development inspired the concept of application outsourcing. However, the ASP model had many drawbacks, for instance:

- As with traditional software licences the ASP model was architecturally 'single-tenant'. This limited ASP providers' ability to scale their businesses and many went bust.
- ASP applications were simply traditional software applications with HTML front ends which enabled remote access to them. They were not developed specifically for use over the internet and hence their performance was often less than optimal.
- ASP vendors often were unable to provide sufficient application expertise. Hence customers would often need to employ in-house expertise to ensure applications were functioning correctly.

The advancement of SOA – the technology behind 'multi-tenant' architecture – combined with falling internet bandwidth costs hastened the development of hosted web-native business applications under the term 'SaaS'. The SaaS model has evolved as a simplified cost effective solution to deliver specialised applications in an ever more complicated IT environment. As a consequence of the changing technical landscape, the term SaaS has replaced ASP and 'On Demand' as the software industry's preferred term in this space.

Key drivers of the SaaS model

The SaaS model benefits from the trend for companies to focus on their core competences and outsource other tasks. Outsourcing (from recruitment to logistics and catering) has been a major business driver in recent years as companies seek to reduce costs and boost efficiencies. The SaaS model takes it further as SaaS applications can be regularly upgraded with ease – a significant advantage over traditional on-premise upgrades. Further, some SaaS applications are radically different to traditional applications; or even entirely new concepts.

- **More than just hosting.** The provider looks after the application, network and service monitoring. The utilisation of modular-based SOA enables a SaaS provider to scale, adapt and version the software in a very efficient manner (although SaaS applications, while being configurable, are not customisable). Further, SOA has enabled the single instance one-to-many delivery method and the modular approach enables far more efficient development and maintenance of web-native applications.

- **Highly scalable.** Multi-tenant architecture not only means a customer has its own version of an application, but also that the application and the physical back end hardware infrastructure can be shared with many other customers. This means SaaS applications are highly scalable. Thus they are significantly more cost effective than ASP applications, which required heavy data centre investment.

- **Internet improvements.** Faster data rates, falling bandwidth costs and a more stable internet environment have made it more feasible for companies to operate applications over the internet. Advances in low-cost wireless internet could further strengthen the case for SaaS delivery.

- **Cost is linked to usage.** As with the ASP model, the SaaS model normally involves recurring subscription charges. Alternatively some providers offer payment methodologies linked to economic payback such as per click or transaction. While the model is normally pay as you go, contract terms can be long term. The customer is not required to deploy any hardware and can run the application over existing internet infrastructure. In exchange for the recurring subscription charges the SaaS vendor deals with all the training, support, security and infrastructure issues.

- **Widest possible delivery.** SaaS applications, as with ASP solutions, can be delivered anywhere and anytime. The SaaS vendor needs to employ infrastructure, support teams and other staff to meet these demands (especially spikes in usage as well as to cope with other technical issues that may arise across a global client base).

- **Time savings.** There are no delays resulting from the need for internal IT organisations to perform development, enhancement or deployment of the application. The ability to employ the technology immediately is especially useful for start-up companies.

- **Reduced customer risks.** A customer can test a SaaS product on the job and if it is not satisfied or finds a superior product it can switch vendor with ease. Under the traditional model, a perpetual licence fee is lost money if a customer makes the wrong decision or if the product falls behind competitors' products.

- **Simple upgrade cycle.** Only the vendor installs the upgrades, lowering support costs for enterprises. In addition managers can be sure that all employees have the same, if

not the most recent, version of the software product. SaaS has a key competitive advantage over traditional software in that it can be continually upgraded as vendors improve their product knowledge and respond to feedback from their customers. Modular-based SOA means it is easy for developers to make changes.

# Benefits for the buy side: Lower cost

Lower cost of ownership

A major factor in a customer's choice of taking a SaaS solution over an equivalent traditional application is the relative cost of ownership. A comparison can be tricky as it can involve many issues including hidden costs and intangible factors. Research firm Gartner has estimated that "customers can spend up to four times the cost of their software licence per year to own and manage their applications". People resources would represent much of this. Typically in the software businesses we have met the business model is a third, a third, a third – the licence fee is typically matched over time by the implementation and maintenance charges by the vendor. Traditional costs forgone in the SaaS model include:

- Most implementation and deployment costs.
- Licence and maintenance charges.
- Hardware and network infrastructure; probable upgrades.
- Ongoing people resources to maintain the applications.
- Security, testing, monitoring, installing upgrades, possible requirement of further software to run the applications effectively.
- Most training costs.

Exhibit 2 provides an example graphically of the cost of implementing a mid-sized enterprise software application on-premises and as SaaS over a five-year period. As SaaS the application's cost is estimated to be 30% lower than it would be to implement on-premise.

Exhibit 2: Estimated cost of deploying an enterprise application over five years
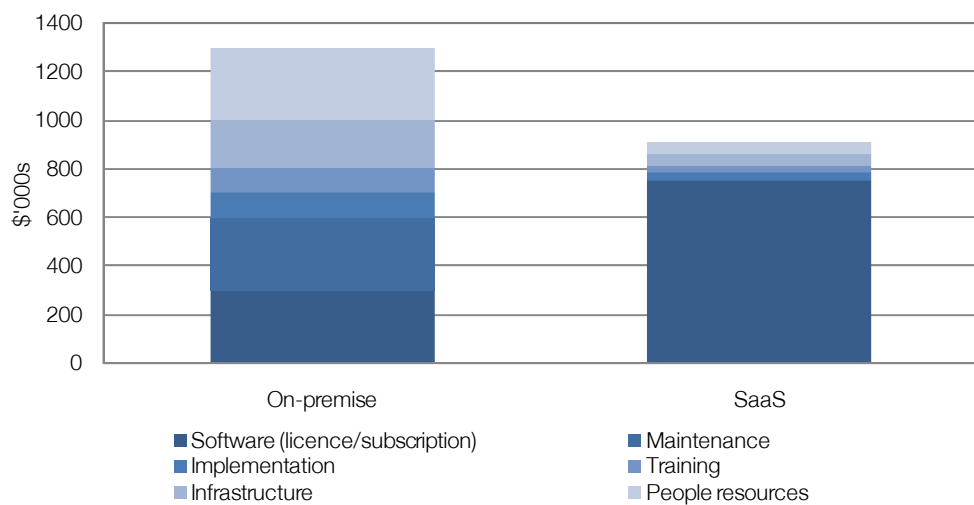
Source: Edison Investment Research

Further customer and end user considerations

In addition to lower costs, when choosing an 'on demand' SaaS application over a traditional solution 'in a box' there are a number of other advantages.

- **Security.** Traditionally a company had to trust its IT department with sensitive data; with a SaaS model it has to trust the IT people of the SaaS provider. Managers are naturally cautious about letting sensitive data outside the firewall and SaaS was initially regarded as a major security hazard. More recently the view that SaaS vendors can potentially offer greater security is gaining traction since vendors are able to leverage their security investment and skills across their customers. Indeed, some vendors are now using this as a selling point. In the US many customers require their vendors to hold the SAS 70 certification which involves an in-depth audit on security and internal controls.

- **Downtime.** SaaS applications typically have much lower downtimes than on-premise applications since the provider has application expertise and specifically monitors its performance. However, the customer is exposed to internet and ISP risks.

- **Flexibility.** SaaS enables a customer to manage its capacity increases (or decreases) more effectively. It will not have the cost of unused licences.

- **Ease of use and reliability.** Users want an application that makes tasks easier and is easy to learn. They need to be convinced that a SaaS application can do the job as well as traditional applications.

- **Timeliness.** Managers will likely favour an application that can be deployed quickly.

- **Specified and structured correctly.** Users want to be sure it is built to a technology roadmap and managers prefer an economically favourable payment mechanism.

- **Built for mobility.** Mobile users require the application to have a technical and pricing roadmap to support mobile applications.

- **Compliance benefits.** SaaS can provide benefits to companies burdened with heavy regulatory compliance requirements as it centralises IT management and can automatically generate reports.

- **Suitability.** Not all applications are suitable for SaaS. Applications that require extensive customisation or to be developed internally to establish competitive advantage will not be suited.

IT managers are typically concerned about relinquishing control over applications. They will need convincing that a SaaS provider can deliver an application better than they can. However, employing SaaS applications can allow IT departments to redirect their resources to strategic initiatives, eg business process improvement.

Benefits for the sell side: Opens up a wider market

SaaS routes to market and revenue models

Whether independent software vendors are looking to launch a start-up SaaS business or to evolve an existing traditional model, there are number of potential routes to market. As we have highlighted, if companies are to scale their service it is important they have jumped the technological hurdles around a robust scalable architecture for the software and ensured the appropriate network and application monitoring is in place. For example, in the case of transaction systems, they need to ensure that the software is up 24/7 and runs in real-time. On top of that companies looking to build out their own service need to source, pay for and manage their own data centre infrastructure.

Not surprisingly the costs associated with putting all this in place can be substantial. Alternatively, software vendors can use a partner to get their product to market and launch the application via one of the many major platforms such as Salesforce, Oracle, Google etc. The pricing of the service is typically a lot lower (since the independent vendor has to 'pay-away' a significant amount of the value of the service to the hosting partner) but this approach supports costs (ie infrastructure), significantly reduces the time to market, and importantly immediately gives the company access to a large captive potential customer base.

Case study: CODA

CODA provides financial management software and related services principally to medium and large organisations operating in all sectors and across the globe. The company earlier this year accepted an offer from Netherlands-based Unit 4 Agresso. CODA has chosen to launch its debut SaaS product – CODA 2go – on Salesforce.com's Force.com platform. CODA deduced there is a movement towards SaaS but that it is not yet massive in terms of pace or size. In addition CODA recognised that the costs of developing its own SaaS offering were large and that existing delivery platforms already 'owned' its target customer base. Many target customers are traditionally very conservative and are concerned about letting data pass the firewall; most willingness is where customers are already used to using SaaS, eg customer relationship management (CRM) products. Key points on the deal with Salesforce.com were:

- **Marketing.** CODA 2go will offer seamless integration with Salesforce's CRM application, hence enabling Salesforce to offer a wider Enterprise Resource Planning solution (ie CRM + Financial). It will be marketed by Dreamforce and will target Salesforce's existing 35k customers. These customers are tech savvy and more likely to be comfortable with security issues than the average finance department executive. Customer size will typically be smaller than CODA's existing average customer.

- **Infrastructure.** It utilises Salesforce's existing infrastructure and allows CODA to take advantage of Salesforce's encrypted security and SAS 70 certification – the latter is required by some US customers.

- **Savings.** The deal saves CODA at least two years and millions of pounds in development costs. CODA estimates it would take at least $20m of investment to start from scratch.

- **Payaway.** The levy Force.com puts on software suppliers to use its platform is $25 per month per user. There has been some scepticism about the 'Platform as a Service' route to market among software practitioners as the fixed price royalty can represent a very significant payaway for lower-priced software applications – and it puts serious limitations on a software provider's pricing strategy. However, it is potentially well suited for higher-priced software applications such as CODAs.

SaaS software is most often sold on a subscription basis (typically per user monthly or based on the number of unique daily users) and which covers upgrades, maintenance and basic support. Transaction based pricing (profit sharing) and ad based revenues also exist, as do 'hybrid' models. We expect to see SaaS pricing move more directly towards usage, given competitive pressures, and some companies already charge on a basis of revenue share or per click. Contracts can be short- or long-term; some customers prefer long-term contracts as a way to lock in pricing terms.

Exhibit 3: SaaS delivery methods of the UK companies we met

|	
CODA	Subscription
FFastFill	Monthly subscription
GB Group	Per click
Gresham Computing	Monthly subscription and transaction
Kewill Systems	Annual subscription or transaction
Nasstar	Monthly subscription
Netcall	Subscription or transaction
Netstore	Monthly subscription, per click, by the hour, request or claim (insurance)
ServicePower	Subscription and transaction
StatPro Group	Subscription

Source: Edison Investment Research

SaaS delivery cost and profit structures

In Exhibit 4 we show diagrammatically our estimate of the difference in cost structures between traditional software and SaaS companies.

- **Higher costs for delivery.** Traditional software businesses have close to 100% gross margin reflecting the very low cost of sales (ie only manufacture of CDs, manuals etc). However, SaaS providers have the major additional costs associated with hosting, and managing the application and data centre environments.

- **Sales, general and administration.** SaaS vendors typically have higher sales and marketing costs relative to earnings than traditional vendors in their start-up phase. This is primarily caused by two factors: firstly a subscription model for software produces lower revenues during the growth phase, since payments are spread over a period rather than made immediately in a one-off licence sale. Sales expenses in both models are expensed as incurred, however, leading to a higher ratio of costs to earnings for the service model. However, as SaaS businesses mature they typically require lower sales and administrative infrastructure to support a broad range of customers, ie not having to 'account manage' the implementation, maintenance and sale of 'bespoke' solutions to a wide range of customers. In addition, as SaaS providers are not typically maintaining multiple versions, lowering R&D and support (vendors often limit customer service to self-help options rather than telephone support).

- **Lower margins but greater potential to scale.** The economics of the SaaS model are therefore fairly straightforward. The additional costs to host and deliver the application outweigh the savings from lower overheads and infrastructure (typical EBITDA margins c 20% versus c 30% for traditional businesses). However, at the core of the SaaS model is the potential to scale the service to a substantially wider user base than can be reached through the traditional direct sale/licence model (reflecting both the delivery method and the much lower upfront costs for customers). In addition, the incremental marketing and operating costs of adding additional subscribers, and of offering new services and applications to existing customers are minimal. Therefore, successful SaaS players may take longer to deliver revenues and profitability but in the longer term the model has the potential to deliver far greater aggregate cash flows.

Exhibit 4: Estimated apportionment of P&L items as a percentage of revenues

Traditional software company	SaaS vendor
15%	35%
15%	12%
40%	33%
30%	20%

■ COGS ■ R&D ■ SG&A ■ EBITDA
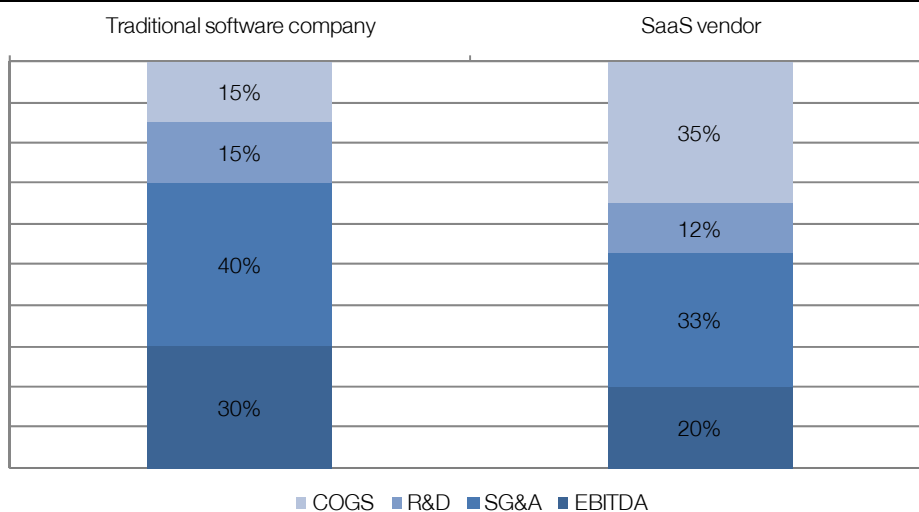
Source: Edison Investment Research

- **Typical three- to four-year payback for SaaS providers.** To highlight this, in Exhibit 5 we show the revenue profile of a software enterprise application as a traditional licence/maintenance sale compared with an equivalent application sold as SaaS. As we have highlighted, SaaS vendors are less profitable when they are young since they are essentially 'deferring' the chunky licence revenues. However, Exhibit 5 shows that between three to four years the cumulative SaaS revenues overtake the traditional revenues. In addition another benefit of having the subscription model over time is that subscription revenue streams are steadier with greater visibility as they do not depend on irregular licence fee revenues but rather monthly user subscription fees, transactions, clicks etc, which are usually less volatile and easier to forecast.

Exhibit 5: Traditional revenues versus SaaS model
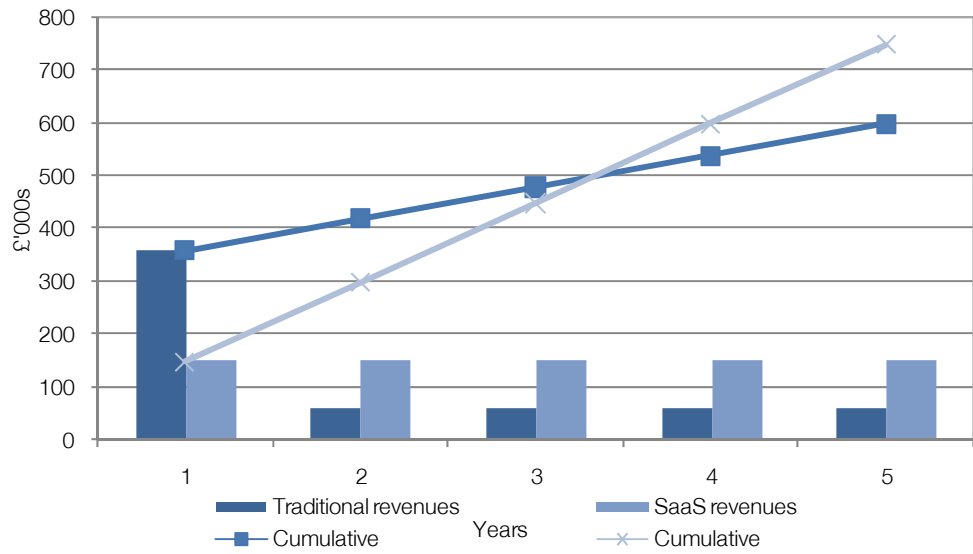
Source: Edison Investment Research

Market size

Total SaaS revenues worldwide within the enterprise software markets are estimated to have been $5.1bn in 2007 according to Gartner forecasts, a 21% increase on 2006. Market growth is expected to remain robust with worldwide revenue reaching $11.5bn by 2011. Even at the 2011 level SaaS revenues will only account for around 5% of total global software revenues.

Exhibit 6: Software as a Service market
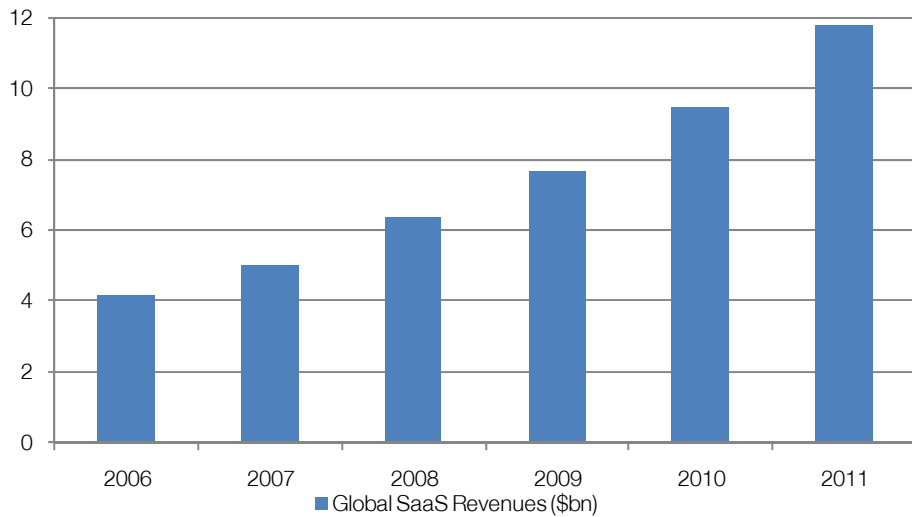
Source: Gartner: SaaS Demand Set to Outpace Enterprise Application Software Market Growth, August 2007

The US experience: Emergence of a number of large suppliers

In the US a new breed of software vendor in the form of a pure SaaS business has evolved. These companies were established in the 1990s (see Exhibit 8) and their managements manoeuvred the businesses into SaaS, while traditional software vendors remained entrenched in their existing licence-based models, with the hurdle of their established infrastructures (management, developers, customer relationships, channel partners, sales forces etc). Consequently these SaaS

vendors have been able to establish strengthening market shares in a number of niche software areas such as CRM, ERP, e-commerce and talent management.

Salesforce.com is the clear SaaS market leader and is expected to surpass $1bn of revenues in FY08. Founded in 1999 by Marc Benioff, a former Oracle executive, its IPO was priced in June 2004 at $11 and its shares have since risen nearly fivefold. Other key SaaS players include Cisco-owned WebEx which generates an estimated $400m of revenues, Digital River which is expected to reach $400m of revenues in FY08, and Omniture which has grown quickly through acquisitions. However, the industry remains relatively fragmented.

We have constructed a US SaaS sector index based on the US companies we mention in this report (it includes those that have been taken over). We have run the index from pre-SaaS times to look at the longer-term evolution of this 'on demand' sector. As is evident, the sector has strongly outperformed the Nasdaq since 2001. This is also reflected in valuations with US SaaS companies trading on significantly higher revenues and profitability multiples than traditional US software companies. NetSuite's hugely successful IPO in December added more spice to the sector. Its initial price range was set at $13–$16 and was subsequently priced at $26; the shares breached $40 shortly after the IPO. However, NetSuite's shares have halved since the peak largely due to weakening stock market sentiment. It is apparent that the US SaaS sector has a high sensitivity to market risk – earlier this year when the Nasdaq fell 20% our US SaaS index fell just over 30% and similar patterns are also evident in the periods of stock market weakness within the years 2004–06.

Exhibit 7: Edison index of US SaaS companies compared with the Nasdaq Composite
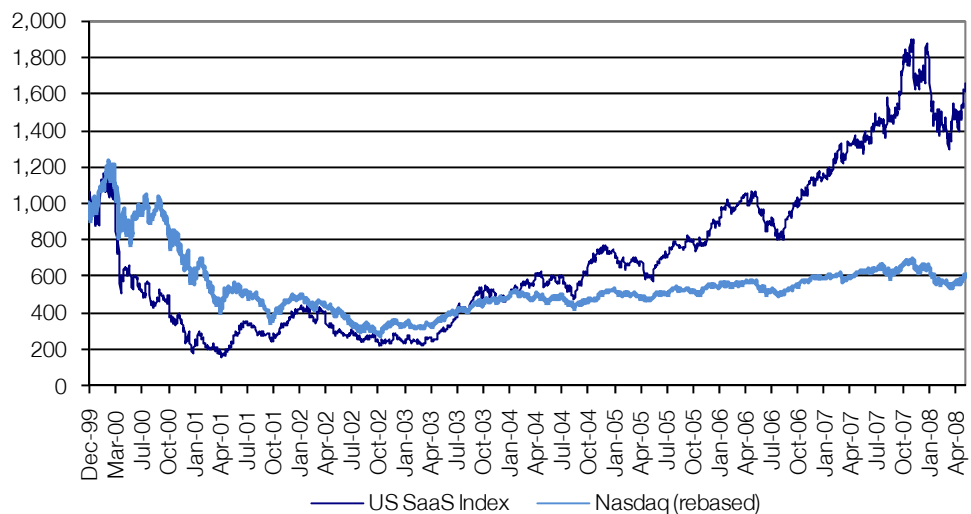
Source: Bloomberg, Edison Investment Research

Managements of the larger traditional software vendors have been cautious as this new sector has evolved. Larry Ellison of Oracle preferred to invest his money in Salesforce.com and NetSuite rather than shift Oracle's strategy. Microsoft has been moving slowly into the SaaS arena with an announcement in March 2008 that it intends to make SharePoint and Exchange available over the web in the second half of 2008. Meanwhile Germany's SAP is launching an on demand suite called Business ByDesign. However, in late April SAP said it had "elected to modify the rollout strategy" effectively setting the launch date back several months.

Companies are also looking at developing their SaaS strategies through acquisitions. Last year SaaS M&A activity in the US included Cisco acquiring WebEx for $3.2bn or 8.4x sales and Intuit

acquiring Digital Insight for $1.3bn or 6.1x sales. These deals suggest that the large companies are starting to acknowledge the presence of SaaS providers. Given the pace at which the SaaS market is growing, we would expect M&A activity to pick up as large software vendors seek to protect their ground. A range of key US SaaS companies are profiled in Exhibit 8, below.

Exhibit 8: US SaaS companies

Note: *All Dec 2008 balance dates except: Concur – Sep 2008, Salesforce – Jan 2009, Workstream – May 2009.

Company	Market Cap ($m)	Consensus 2008** Sales ($m)	Consensus FY08** P/E	Founded	Product offerings	Equity
Concur Technologies*	1,610	212	75	1993	Provider of on demand business services and software solutions that automate corporate travel and expense management processes.	Nasdaq traded
Digital Insight	N/A	N/A	N/A	1995	Leading provider of online banking services to mid-market banks and credit unions in the US.	Acquired by Intuit in 2007 for $1.3bn.
Digital River	1,380	400	20	1994	Provides outsourced e-commerce solutions globally to a variety of companies primarily in the software and high-tech products markets.	Nasdaq traded
NetSuite	1,160	156	N/A	1998	Leading provider of on demand, integrated business management software for growing and mid-size businesses.	NYSE traded
Omniture	1,710	308	55	1996	Leading provider of online business optimisation software.	Nasdaq traded
Rightnow Technologies	440	140	N/A	1995	Provider of customer experience management software solutions. Its software solutions support a business's external customer-facing channels, as well as sales, marketing and customer service operations.	Nasdaq traded
Salesforce.com*	7,480	1,041	83	1999	Provides CRM services to businesses of all sizes and industries worldwide. The company delivers its service through a standard web browser.	NYSE traded
Taleo	506	157	33	1999	Delivers on demand talent management solutions. The company enables organisations to assess, acquire, develop and align their workforce for improved business performance.	Nasdaq traded
Ultimate Software	856	190	53	1990	Designs, markets, implements and supports human resources (HR), payroll and talent management solutions in the US.	Nasdaq traded
WebEx	N/A	N/A	N/A	1996	Provides on demand CRM applications and online meeting applications.	Acquired by Cisco in 2007 for $3.2bn.
Workstream*	22	29	N/A	1996	Provides a range of services and web-based software for human capital management (HCM). Currently undergoing a merger with Empagio.	Nasdaq traded

Source: Company Annual reports, presentations and websites. Forecasts – Bloomberg

Sensitivities

- **Costs.** As highlighted in the CODA example, building out a truly robust SaaS delivery method can be very expensive both for new entrants and importantly for companies looking to evolve more traditional licence models.

- **Cannibalisation.** Traditional software businesses have the challenge of trying to add hosted and subscription customers without cannibalising existing licence sales. Adoption of a SaaS product might result in slowing or declining revenues as some customers take up the lower-priced SaaS offering.

- **Churn.** While the SaaS revenue profile is more stable than the traditional licence-driven model, it is easier for customers to move as they have not committed to the large perpetual licence fee.

- **Sales force inertia.** Existing sales teams generate healthy income from selling licences. Shifting the sales force to a recurring revenue model could be difficult as it would be less front end loaded, and more about retaining customers. While a separate channel could be created to sell SaaS it might confuse customers and lead to channel conflict.

Valuation methodology for SaaS businesses

Clearly valuing the SaaS revenue streams within the UK businesses we have met is quite difficult. This reflects the facts that the business models are often nascent and they certainly have a very different growth and margin profile to traditional software businesses. However, where we have been able to we have attempted to value the SaaS businesses, using the following approaches:

- **Discounted cash flow.** If we have a reasonable understanding of volumes, pricing and cost structures on the SaaS business, we have used a DCF model for the valuation. We conservatively assume high discount rates of 20–25% considering the nascence of the businesses. We have used this approach for GB Group and Gresham Computing.

- **EBIT multiples.** If there is a fairly definable outlook for SaaS revenues and they can be differentiated from the rest of the group, we have used an EBIT multiple for the valuation. Typically we use 10x EBIT as a basis for valuation. We have used this approach for Kewill Systems and ServicePower.

- **Revenue multiples.** If not the above we look at the enterprise value to revenue relationship or the potential of the SaaS strategy to add revenue. We have used this approach for Netstore and StatPro. We note in Exhibit 9 that US SaaS companies trade on very high multiples – significantly higher than the multiples we have used in looking at UK businesses. However, they are pure SaaS businesses and are growing quickly.

UK SaaS companies appear to be trading at a premium to the sector based on short-term forecasts. However, in our view the potential to scale the SaaS assets of the UK companies we have met is not typically valued in current market capitalisations, ie the 'push-out' in revenues is penalising the valuation of companies in the short term.

Exhibit 9: Key ratios of US SaaS companies, data based on year 2 consensus forecasts

Company	Code	Share price US$	Market cap US$m	Revenue Year 2	EBITDA Year 2	EBIT Year 2	EV/revenues	EV/EBITDA	EV/EBIT
Concur Technologies	CNQR	37.33	1610	261	65.7	52.4	6.2	24.5	30.7
Digital River	DRIV	37.06	1380	451	133.9	122.0	2.7	9.1	10.0
NetSuite	N	19.25	1160	210	10.1	(2.2)	5.5	114.9	N/A
Omniture	OMTR	24.67	1710	423	86.2	55.2	4.0	19.6	30.7
Rightnow Technologies	RNOW	13.11	440	169	10.7	2.9	2.2	34.3	126.7
Salesforce.com	CRM	62.66	7480	1361	236.2	158.0	5.4	30.8	46.1
Taleo Corp	TLEO	19.93	506	186	26.4	19.9	2.7	19.3	25.6
Ultimate Software Group	ULTI	34.78	856	232	48.7	46.1	3.6	17.0	18.0
Workstream	WSTM	0.42	22	34	-5.0	-8.2	0.6	N/A	N/A
Median							3.6	22.1	30.7
Average							3.6	33.7	41.1

Source: Bloomberg, Yahoo.com

Exhibit 10: Key ratios of UK companies we met, data based on year 2 consensus forecasts

Note: All Dec 2009 balance dates except FFastFill, GB & Kewill (Mar 2009), Gladstone (Aug 2009), Nasstar (Sep 2009), Netcall & Netstore (Jun 2009).

Company	Code	Share price p	Market cap (£m)	Revenue Year 2	EBITDA Year 2	EBIT Year 2	EV/Revenues	EV/EBITDA	EV/EBIT
FFastFill	FFA	7.25	27	15.8	3.5	2.7	1.6	7.3	9.5
GB Group	GBG	33	28	24.0	1.5	1.2	1.0	16.0	19.8
Gladstone	GLD	23	11	11.3	1.8	1.5	0.5	3.1	3.8
Gresham Computing	GHT	66	35	26.5	4.2	3.2	1.2	7.7	10.1
Kewill Systems	KWL	91	74	56.5	9.0	8.5	1.1	7.1	7.6
Nasstar	NASA	39	6	3.2	0.8	0.4	1.8	7.6	14.3
Netcall	NET	16	10	5.1	1.7	1.5	1.5	4.6	5.3
Netstore	NES	26	45	44.4	7.1	4.0	0.9	5.9	10.4
ServicePower	SVR	13	12	19.0	1.0	0.9	0.5	10.1	11.2
StatPro Group	SOG	98	53	31.7	9.3	8.8	2.2	7.5	7.9
Median							1.2	7.4	9.8
Average							1.2	7.7	10.0

Source: Bloomberg, Yahoo.com, Hemscott. GB Group are Edison forecasts.

UK companies to watch

We have met a number of UK software companies that have either a developed SaaS platform or a strategy to deliver one. We provide more details on the SaaS businesses of these companies in a later section. We also provide some indication of the potential valuation upside if the managements can deliver on their SaaS strategies. However, we have not derived group equity valuations for each business given that we have not attempted to analyse non-SaaS businesses.

Companies focused in this report

FFastfill

SaaS strategy. FFastFill provides a high-speed software platform for electronic trading and risk management for derivative products. Over the last six years it has evolved its trading technology into a pure SaaS solution for its banking and trading organisation customers. The solution enables customers to trade a range of instruments across a number of exchanges and it also offers clearing and settlement capabilities. While the front office technology is multi-tenant SaaS, the back office technology is still single-tenant ASP but FFastFill intends to gradually evolve these areas into multi-tenant SaaS offerings.

Valuation. The company is growing at a fast pace with nearly 40% revenue growth expected in FY09. Assuming a 20% margin target and an EBITA multiple of 10x would imply that the group should sustain a 2x revenue multiple as the business grows, ie if management can continue to develop the business strategy then in the medium-term FFastFill can be worth over £50m.

GB Group

SaaS strategy. GB has developed its original data capture software to launch URU in the UK which helps customers check the true identify of their potential customers. The group has relationships with major personal ID databases (phone records, utility bills, passport etc) and on a 'per-click' basis enables customers in the gaming, telecoms and financial services markets to verify the ID and age of their customers electronically, which is significantly quicker and cheaper than paper-based methods.

Valuation. Adjusting for our forecast £4m of year-end cash and valuing the traditional software businesses at £7m (small profit on £10m revenues) would imply a value for the SaaS Data Authentication business of c £15m. In our view this could be too low if management can demonstrate that it can leverage its blue chip customer base into sustainable, operationally-geared, medium-term high growth. Our DCF valuation for the Data Authentication division is £48m.

Gresham Computing

SaaS strategy. Gresham is expanding the use of SaaS in its core Real Time Financial Solutions division. Gresham has two relatively young SaaS units – a real time cash reporting business for the global banking industry and a supply chain finance partnership in Australia – which offer considerable prospects for growth and account for much of the company's valuation in our view.

Valuation. Our DCF valuation for the two emerging real-time SaaS businesses at roughly £50m compares with the group's enterprise value of c £33m. While the risks are high we believe that given its strong IP, established professional relationships and new highly experienced Chairman, Gresham has a real opportunity to succeed with these ventures.

Kewill Systems

SaaS strategy. Kewill has built SOA platforms which facilitate trade processes such as enabling retailers to connect to their supply network trading partners, importers/exporters conducting customs processing and OEMs managing their logistics. The business is benefiting from strong global trade growth and outsourcing trends.

Valuation. Assuming FY09 SaaS revenues of £28m and applying a 25% EBITDA margin would imply £7m EBITDA. Putting the SaaS business on 10x 2009 EBITDA would value it at £70m compared with the current enterprise value of c £79m for the entire group.

Netstore

SaaS strategy. Netstore has traditionally had a significant hosting business and is increasing its SaaS offerings. It has hosted the likes of Agresso and Cedar software for both public and private sector businesses and recently it was crowned Microsoft's third SaaS incubation partner in the UK. Furthermore, it is seeking to build a 'Security as a Service' business from its established security software activity.

Valuation. The December share placement to finance new data centre space should enable the company to remain comfortably financed with modest debt levels. The company has £20m of tax losses and approximately £20m of annual contractually committed recurring revenues. We see limited downside with the share price trading on just 9x FY09 earnings.

ServicePower

SaaS strategy. ServicePower has introduced a number of SaaS initiatives. It has a SaaS business which enables major consumer electronics and insurance companies to manage the dispatch, logistics and invoicing of their service networks. It has a transaction-based service enabling customers to outsource their service and repairs to contracted third-party networks. Further, ServicePower offers a SaaS service for owners/managers of independent service networks to manage the scheduling of all their jobs.

Valuation. The share price has fallen back from 20p set in February amid fears of an imminent equity offering. However recent trading is still in line with expectations according to the IMS on 16 May. Based on 10x our FY08 EBIT forecast would imply a valuation for the potential SaaS revenue stream of c £12m (current group capitalisation of £11.6m). If management can execute even close to our forecasts in future years then the shares look potentially very undervalued.

StatPro

SaaS strategy. StatPro products are sold entirely on a subscription-based model and the company has operated a hosted service since 2002. The company is now planning to launch a light version of its portfolio analytics as a SaaS product in early 2009 in an attempt to tap a much larger customer base. The product will be targeted at managers of individual portfolios (pension funds, hedge funds and private wealth funds) rather than at the expert users within asset management companies.

Valuation. Assuming a market of 2m potential portfolios, a price of £2,000 per portfolio and say just 0.5% of portfolios take up the offer without cannibalising any of StatPro's existing client base, then this could potentially generate £20m of incremental revenues. Despite the stock bouncing back strongly from 70p in late March it still trades on PE of only 9.5x FY09 consensus earnings.

Other SaaS companies we have met

CODA (now part of Unit 4 Agresso)

CODA provides financial management software and related services principally to medium and large organisations operating in all sectors and across the globe. CODA's solutions help businesses to streamline and automate their finance processes (from accounting and procurement to reporting and analysis) and to achieve better compliance and corporate governance. CODA applications work seamlessly with each other or independently and they integrate with other leading operational systems.

- **SaaS strategy.** CODA is working with Salesforce's Force.com 'platform as a service' to launch its debut SaaS product in May 2008. It has chosen the Force.com platform as its preferred medium to market because it minimises time and investment to launch the product and its software will integrate with Salesforce's CRM application. Coda 2go will be rolled out in phases beginning with applications for revenue management, financial management and procurement. CODA's strategy involves tapping Salesforce.com's customer base – essentially a new market of typically smaller US tech-savvy clients – and hence minimises cannibalisation of its existing larger-size traditional customers.

- **Valuation.** CODA was taken over by Unit 4 Agresso earlier this year at 205p per CODA share, valuing the equity at approximately £158m and valuing the enterprise at roughly 2.3x consensus FY08 revenues. Netherlands-based Unit 4 Agresso is listed on Euronext Amsterdam and its enterprise valuation represents roughly 1.4x FY09 consensus revenues.

Gladstone

Gladstone provides Leisure Management Systems in the UK and worldwide, ranging from single-site entry-level leisure club operators, golf clubs and spas, through to integrated Local Authority software solutions and networked multinational private leisure chains. It is also entering the UK's Education Facilities Management Systems market.

- **SaaS strategy.** Gladstone is considering using SaaS as a way to break into some overseas markets, probably in Europe. SaaS might enable Gladstone to increase its geographical coverage while keeping a tighter control on costs. It also is investigating utilising SaaS business models in some areas of its core UK operations.

- **Valuation.** In its recent interim results revenues were up 3% to £4.4m and PBT rose 11% to £0.8m. With £4.1m of net cash Gladstone's enterprise value is just £6.8m while the business is expected to generate £10m of revenues in FY08 and the current year PE is only 5.6x. In March Toronto-based Constellation Software bought c 28% of Gladstone's shares. We note that Constellation trades at around 1.4x FY08 revenues while Gladstone is rated at half that.

Nasstar

Nasstar has evolved from a web hosting business model, to leverage its IPR and data centre network infrastructure to launch a multi-tenant architecture hosted enterprise desktop.

- **Solution.** Nasstar's sales focus is now entirely on hosting desktops and it delivers an entire desktop computing experience through a browser from a multi-tenant architecture; hence the model is highly scalable. In effect the company is delivering a desktop as a service (or platform as a service) as it can offer a range of applications as published applications to the desktop. Customers can log in anywhere in the world as long as they have an internet connection.

- **Business model.** The basic hosted desktop solution costs £75 per month per user and includes a Microsoft operating system and the latest version of Microsoft Office Professional. Nasstar also hosts other applications (eg Sage Accounts, Quickbooks and Sun Accounts) and maintains its hosted email service. Salesforce.com has recently been installed as part of Nasstar's multi-tenant architecture and has been provided to one customer. Selling points include: operating system and software are always up-to-date; data are stored on a secure data centre and backed up; and start-up companies can use the system to get going straight away without the need for a heavy IT department.

- **Customers.** The business has initially seen strong take-up from SMEs but is designed and marketed to integrate into mid and large sized organisations. In February Nasstar won a contract to supply hosted desktops to 150+ staff of Pinnacle Staffing Group plc for an initial period of three years. Pinnacle said the solution would provide its entire staff with the latest enterprise technology accessible not only from its office locations but also from home. But Nasstar believes its solutions can boost the efficiency of larger companies as well and therefore is also targeting customers with 500–1,000+ users. Last October Nasstar won a contract to provide hosted solutions to Stelios's easyGroup and the group's order book reflects increasing average customer size.

- **Financials.** Revenues in the six months to March 2008 more than doubled to £1m and market consensus is for it to reach £2.5m in the current FY08 and £3.15m in FY09. Nasstar reported a small loss in the interims (EBITDA positive) and is expected to move into a modest level of profitability for the full year according to consensus data. The business model is nascent, reflected in the current low market capitalisation of £6m. If management can deliver, the business model is highly scalable, and to put the current valuation in context, a large customer win (1,000 users plus) could generate close to £1m of annualised revenues at high gross margin.

Netcall

Netcall is a specialist in callback and auto-messaging solutions with a focus on the in-house call centre market. In 2000 Netcall developed and patented QueueBuster which is the leading callback and queue management system in the UK with a broad customer base of blue chip organisations across all market sectors. In 2004 Netcall launched a hosted SaaS version of its QueueBuster service which has seen rapid uptake in the UK and internationally.

- **Solution.** In large call centres customer 'queues' are clearly a major issue leading to unhappy callers, damage to the brand, stressed-out staff and ultimately lost business. One option for companies is to increase staff levels to meet daily, monthly or annual peaks but this is clearly expensive. QueueBuster is a software solution alternative which 'clicks in' on-demand when queues reach a pre-determined level. Callers simply leave their details and hang up and when there is an available agent QueueBuster automatically calls the customer back. In addition Netcall offers other related messaging and contact solutions.

- **Business model.** Netcall today generates revenues from a number of streams: software licences; support contracts, installations and set-up fees; and subscriptions and call usage charges. However, within all these options the key driver for the customer is the rapid payback of the software, ie particularly in 'sales led' call centres such as new mortgages, mobile phones, flowers etc. The SaaS option not only enables customers to minimise IT and manpower implementation costs but also has the option to pay for the software on a 'per transaction' basis. This further emphasises the economic value of the solution (eg a 'pay-away' of a £1 transaction fee to Netcall for the sale of say a £25 bunch of flowers, where the lost call would most probably have been lost business). Given the revenue model and the modest R&D and sales costs the business is very scalable.

- **Customers.** Today customers include Aviva, Barclays, BMW, Interflora, Lloyds and Prudential. In total management estimates there are potentially 7,000 target customers in the UK. As well as selling directly (c 60% of sales) Netcall has built a distribution channel which includes Affiniti, BT and Cable & Wireless (revenue share on call centre contracts).

- **Financials.** Currently revenues are modest (c £4m run-rate) but recurring revenue is currently over 80% and SaaS c 50%. Management believes the business can support sales approaching £20m with a gross margin of over 80% (this seems supported by the number of potential customers, limited competition, the clear economic payback from customers, and the growth in the hosted SaaS offering). In our view the SaaS business model gives the company very high visibility of future cash flows which is not valued in the current share price (ie while the use of QueueBuster within call centres may be cyclical over the longer-run call volumes can be relatively well forecast and there is a clear economic incentive for customers to retain the use of the solution).

Company profiles

Edison
investment
research

FFastFill

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	PE (x)	Yield (%)
03/06	4.8	(3.1)	(1.4)	0.0	N/A	N/A
03/07	6.1	(1.1)	(0.5)	0.0	N/A	N/A
03/08	11.4	0.2	0.3	0.0	24.2	N/A
03/09e**	16.0	2.8	0.8	0.0	9.1	N/A

Note: *PBT and EPS are normalised, excluding goodwill amortisation and exceptional items. **Consensus forecasts.

Investment summary: Trading SaaS

Over the last six years management has developed FFastFill's trading technology into a pure SaaS solution for major banks and trading organisations. This has helped it take market share and to build a contracted revenue pipeline of over £11m. The technology platform and business model is defensible and highly scalable, and given the scope to expand services to existing and new customers, we believe the company has a medium-term opportunity to grow revenues and the group's capitalisation to over £50m.

Trading SaaS: High performance, robust service

FFastFill's software enables banks and other financial organisations to trade a range of instruments across a number of exchanges. Importantly the front office service is offered on a highly invested, multi-tenant platform that enables rapid implementation, 24/7 reliability and the opportunity to easily bolt-on new customers, services and acquisitions. Arguably, given the high speed and high volume demands of financial traders, FFastFill has built one of the most robust global software services across any industry vertical.

Growth drivers: Cost savings and end market growth

These characteristics drive significant cost savings for potential customers versus developing trading platforms in-house or the lengthy implementation of buying traditional third party software. In addition, the industry trends towards electronic trading, higher volumes, and growing number of exchanges all contribute to a sizeable growth opportunity for the company.

Forecasts and valuation: Medium-term over £50m sales

The service model gives high visibility of future revenues. Currently the group has 79 customers generating £11.5m of contracted forward 12-month revenues. Management estimates there is the opportunity to drive a fourfold increase of usage within existing customers as well as win more. We believe the growth potential, and the leveragable cost structure, means that in the medium-term FFastFill has the potential to deliver revenues and a capitalisation of £50m+ and to achieve 20%+ margins.

Price*	7.25p
Market Cap	£27m

*Priced as at 21 May 2008

Share price graph
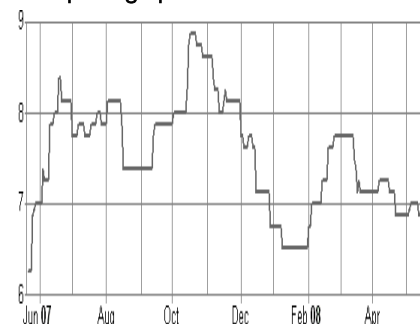
Share details

Code	FFA
Listing	AIM
Sector	Software & Computer Services
Shares in issue	377m

Business

FFastFill designs and delivers trading software applications as a service to leading banks and financial institutions.

Bull

- Very robust SaaS platform.
- Proven growth strategy and business model.
- Substantial growth potential.

Bear

- Sensitive to financial market slowdown.
- Competitors might launch SaaS services.
- Implementation risk in acquisition strategy.

Company description: SaaS trading platform

FFastFill was founded in 1999 with the objective of providing a high-speed software platform for electronic trading and risk management for derivative products. It was listed on AIM in 2000. Current management joined in 2002 with the strategy to develop a pure Software as a Service (or application service) offering.

The service went live in 2004 designing and delivering application services for the electronic trading institutions, ie typically investment banks and hedge funds. These trading solutions are provided on a SaaS (or ASP) basis and are used to automate trade flow processes across a firm's front, middle and back offices, encompassing electronic order routing, clearing, risk management and back office settlement. Clearing and settlement capabilities were added through the respective acquisitions of Future Dynamics in 2004, Exchange Systems Technology in 2007 and recently Exchange Technology Pty Ltd. While the front office technology is multi-tenant SaaS, the back office technology is still single-tenant ASP but FFastFill intends to gradually evolve into a multi-tenant SaaS offering.

Essentially FFastFill's application services provide institutions with cost savings in their administrative and IT departments and significantly reduce or eliminate the investment costs associated with maintaining their own technology infrastructure. The company currently has 79 clients (of which 20 are major global banks) including Dresdner, Landsbanki, SEB, MAN and Standard Bank.

Target market: Global financial traders

Over the last decade the number of banks and institutions that trade commodities has grown considerably. In addition, both the number of commodity exchanges and the volume of transactions have increased significantly. Therefore, there is a major need for complex software solutions to help these organisations trade and settle these transactions as well as manage their risk profile. Many firms have attempted to build these systems in-house. Others have bought in software from third party suppliers but have faced the typical industry challenges of paying for upfront licences and then costly and often lengthy implementations. FFastFill has identified around 100 target clients and offers a unique SaaS service:

- **Robust service architecture**. The core of FFastFill's software has been built on a truly robust service architecture, written in a service orientated, multi-tenant architecture. Importantly, the software has complex service and diagnostic monitoring to ensure no overloading and very high performance and reliability levels, ie trading systems need to process transactions in milliseconds and run 24/7.
- **Highly scalable and secure**. The software is built to scale by volume of transactions and within organisations. FFastFill offers highly secure, straight through processing between the front, middle and back offices. In addition, it is simple and cheap to add additional services onto the SaaS platform.
- **Flexibility and support.** All FFastFill's services are delivered against a contracted Service Level Agreement (SLA) that can be tailored to the institution's business requirements. FFastFill provides these services from specialist operational and support centres in London and Chicago (providing 24/7 support) and a software development

centre in Prague. In addition, FFastFill is able to integrate complementary software suppliers into the service to provide clients with a tailored solution.

- **Time and cost effective.** Clearly the levels of performance and support offered by FFastFill can be broadly matched by its traditional software competitors. However, the key proposition for potential customers is the rapid service delivery cycle and the potentially sizeable cost savings. Customers can essentially choose from a 'shopping list' of services and from ordering to the service going live is typically around three days (compared with several months for a traditional on-site implementation). In our view, the additional cost savings of monthly service payments versus upfront licence and implementation costs, as well as the ongoing costs of supporting an in-house solution, are almost certainly greater than FFastFill's estimate of 20–30%.

Growth drivers: Cost savings and end market expansion

FFastFill's SaaS business model gives the company high visibility of forward revenues. In addition, we believe there are a number of factors which should underpin very strong growth going forward.

- **Exchange growth.** FFastFill initially focused on trading platforms for the London Metal Exchange. Over the last few years the group has expanded the number of exchanges that it executes including CME, Liffe, Eurex, CBOT and IDEM. Clearly the business has benefited from the shift from traditional open outcry to electronic trading. Further, the changing regulatory environment (including MiFID rules) is facilitating the development of new exchanges. Meanwhile, existing exchanges expand the instruments that they trade.

- **Geographic expansion**. To date FFastFill has taken a growing share of trades in the North American and European markets. However, the group does not currently have a major presence in Asia (the company provides access to Asian markets through a partner relationship) but importantly the recent acquisition of Exchange Technology Pty provides support in the Asian time zone (as well as adding new customers). Going forward we would expect FFastFill to establish an office in Asia and target major customers in the larger Asian and Australasian countries.

- **Trend towards outsourcing**. As with all industries we would expect the trend towards IT outsourcing to accelerate given the sizeable cost savings. Currently, many organisations that do outsource to a third-party provider continue to want a traditional software implementation, ie chiefly for security reasons they want the software loaded onto their in-house servers. However, FFastFill has built a service that is cheaper, quicker to go live, and is able to satisfy the security concerns. Therefore we believe it should take further market share going forward.

- **Up-selling to existing clients.** As we have highlighted, customers are able to essentially select from a menu of services, ie in simple terms by number of exchanges and across their organisations front, middle, and back offices. Management estimates that the potential for existing customers to fully roll-out FFastFill's software service across their trading platforms could increase revenues fourfold.

- **Acquisitions and additional services**. Management has made two acquisitions and has a strategy to develop any bought-in software into a fully robust SaaS model.

Importantly, given the design and architecture of FFastFill's service it is very straightforward to 'bolt-on' additional software services to the platform. Therefore we believe there is scope for the company to make further small acquisitions and significantly leverage the value of the software across its customer base.

- **Competition.** In the UK there are quoted competitors in the broadly the same space such as Fidessa and Patsystems. Other international players include GL TRADE, RTS, SunGard, and Rolfe and Nolan. Fidessa can provide a hosted service but is focused predominantly on the cash equities market (currently not a target market for FFastFill) while the other companies have far more traditional software business models. FFastfill is able to sell on the economic attractions of the SaaS offering but also the web front end enables it to build "layers" of customer loyalty, ie buy-in from the bank it is contracted with, and the bank's clients who are given its screens for direct market access.

- **Financial sector uncertainty?** In the current environment a clear issue is the risk to banks' IT budgets. FFastfill's SaaS business model is obviously helpful in signing customers (contributing to high recurring contracted revenue) but also the group has a core business with derivatives clients where volatility is a positive, ie more hedging is going on through futures contracts.

Business model: Highly visible

As we have highlighted, FFastFill offers a menu of services and charges for each service on a monthly basis (for example access to the trading platform for one user for two exchanges costs around £750 a month). Customers sign 12-month contracts (which roll with typically one- or three-month notice periods) payable in advance, ie high upfront balance and revenue recognition month-by-month. This therefore gives management very high forward revenue visibility, ie contracted for a forward 12 months (given the expense and IT challenges of changing trading systems we would expect contracts to roll for a life cycle of five to 10 years).

Sensitivities

- A financial market downturn could impact trading volumes and demand for FFastFill's services.
- Other software companies could enter the space with a SaaS offering.

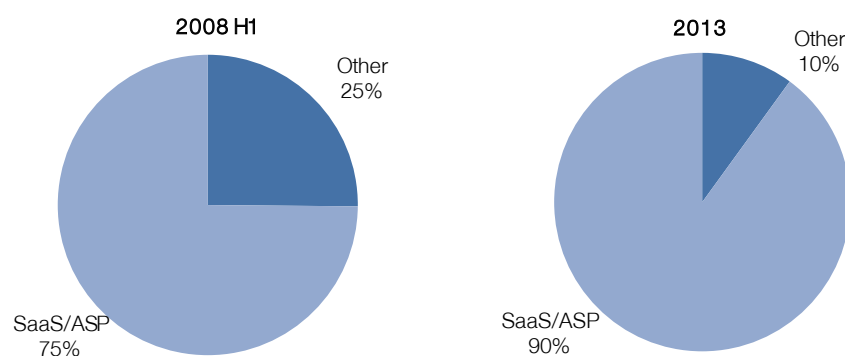## Financials and valuation: Medium-term sales £50m+

FFastFill has 79 clients, of which 20 are large international banks and the rest mid-sized banks, hedge funds, trading firms etc. Given the SaaS model the key metric to focus on is the 12-month contracted order book (ie next 12 months' revenue) which reached £11.5m at the end of March.

- **Cost structure.** Gross margins are c 85% (Cost of Sales includes bespoke developments, third party software costs, allocated telecoms costs etc) and the group has a further c £8m of operating costs (of which around £2m is R&D based in Prague).

- **Highly scalable**. We have highlighted that the business is highly scalable (low cost of adding new services and data centre capacity to meet growth within the existing customer base and the addition of new customers). Given the range of services management estimates that the large banks could have demand for around £2m of

annual services and the mid-sized clients around £0.5m. Currently the 20 major global banking customers pay an average of £0.4m.

- **Move into profitability**. To March 2008 the growth in revenues to £11.4m (up 87%) and control of costs contributed to an EBITDA of £1.5m. Net cash was £2.4m.

- **Medium-term revenues.** With the addition of new customers (management estimates that there are around 50 target large global banking customers) that would imply that the group could achieve long-term target revenues in the range of £50m to £100m. Given the gross margin structure and the modest additional investment required to support much higher revenues, we believe the business has the potential to achieve greater than management's 20% target EBITA margin.

- **Valuation**. FFastFill is currently valued at £27m which equates to just over 2x contracted revenue. Assuming a 20% margin target and an EBITA multiple of 10x would imply that the group should sustain a 2x revenue multiple as the business grows, ie if management can continue to develop the business strategy then in the medium-term FFastFill can be worth over £50m.

Exhibit 1: Estimated revenues split in latest FY and Edison five-year target

2008 H1

Other 25%

SaaS/ASP 75%

2013

Other 10%

SaaS/ASP 90%

Source: Edison Investment Research

Management

Exhibit 2: Management

Executive Chairman and CEO: Keith Todd	Keith was appointed an Executive Director in September 2002. He was Non-Executive Chairman of Easynet plc until January 2006 when it was sold to BSkyB and of E C Soft which was sold to Cyber Inc in January 2003. Keith was CEO of ICL plc from 1996–2000 (now Fujitsu Services) and was responsible for the transformation of ICL from a hardware product company to a $4bn IT services company. He held a number of other senior financial positions in ICL and GEC Marconi's defence businesses, including working in the US for five years between 1981 and 1986. He started his career in the public sector.
Corporate Development Director: Nigel Hartnell	Nigel was appointed an Executive Director in September 2002. Previously he worked for ICL where he was also Corporate Development Director.
Joint Deputy Chairman and Senior Independent Non-Executive Director: Nigel McCorkell	Nigel has been a Director since August 2000. He was Finance Director of Flight Refuelling plc (now Cobham plc) from 1981 to 1984. From 1984 to 1996, he was Finance Director, Managing Director and subsequently Deputy Chairman of Meggitt plc. He was Chairman of Cork Industries Limited from 1996 until its acquisition in 1999.
Non-Executive Joint Deputy Chairman: James Oliff	James was appointed an Executive Director in May 2003 and in 2005 was promoted to Joint Deputy Chairman in a non-executive role. James is a member of the CME Group board, having served on CME's board since April 2002 and as a director of CME since 1994. He has been a member of the exchange for more than 25 years.

Source: FFastFill

GB Group

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	PE (x)	Yield (%)
03/06	12.8	(0.2)	(0.2)	0.75	N/A	2.3
03/07	14.9	(1.1)	(1.4)	0.75	N/A	2.3
03/08e	19.4	(0.4)	(0.5)	0.75	N/A	2.3
03/09e	24.0	1.4	1.7	0.85	19.4	2.6

Note: *PBT and EPS are normalised, excluding goodwill amortisation and exceptional items.

Investment summary: Identity value

GB Group has built a leading position in the electronic verification of individuals' ID. The full year trading statement highlighted strong operating momentum in H2. Importantly the group is seeing increasing evidence of a move from manual to electronic methods of identity verification, and management is targeting a new industry sector that requires the verification and management of the identity of its customers to minimise fraud and regulatory risk.

Electronic SaaS ID verification market

ID checks are typically made when making a large purchase (eg mortgage or car), opening a bank account, buying a phone contract, trading online etc. GB estimates that in the UK around 0.5bn checks are made each year, of which the majority are currently physical checks. GB has built a leading position offering an online electronic verification service, hosting its proprietary software, and charging on a per transaction basis.

Full year trading: H2 profit

Results for the full year (29 May) are expected to show revenue growth of approximately 30% to £19.4m (Edison £19.1m) and a narrowing of the full year loss (before tax and after the charge for share-based payments of £0.2m) to approximately £0.4m (Edison £0.2m loss). The 45% uplift in second half revenue more than offset additional costs, with the group expected to generate second half profits before tax of approximately £0.6m (H207 £0.6m loss). Year end March net cash was £4.3m (Edison forecast £4.0m).

Valuation: Data Authentication undervalued

Demonstrating that the SaaS Data Authentication business can deliver a profit in FY09 is clearly key to the outlook for the shares. While the market and the business are still relatively immature we believe the growth prospects are significant and we show a theoretical value for the business of nearly £50m.

Price*	33p
Market Cap	£28m

*Priced as at 21 May 2008

Share price graph
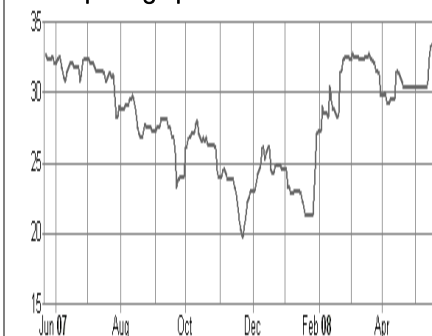
Share details

Code	GBG
Listing	FULL
Sector	Software & Computer Services
Shares in issue	84m

Price

52 week	High	Low
	33.25p	19.50p

Balance Sheet as at 31 March 2008 (est)

Debt/Equity (%)	N/A
NAV per share (p)	13.0
Net cash (£m)	4.4

Business

GB helps companies capture, validate and analyse personal identity and age information and provides anti-fraud solutions.

Valuation

	2007	2008e	2009e
P/E relative	N/A	N/A	180%
P/CF	N/A	N/A	18.6
EV/Sales	1.5	1.2	0.9
ROE	N/A	N/A	13%

Geography based on revenues

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

GB Group is a research client of Edison Investment Research Limited

Company description: Identification verification

Leader in data capture, analysis and identity verification

GB is a data services company with a range of solutions based upon its own proprietary algorithms. This software (trademarked ID3) is at the core of its three businesses and enables its customers to rapidly search third-party databases (eg postcodes, electoral roll, passport, utilities etc) to gather personal data (ie name, address, telephone number etc), analyse it and increasingly use it to verify the identity of their customers. Some of its data capture and analysis tools within its Data Integration and Solutions operations are selling into maturing markets with a fairly traditional software business model. However, the opportunity for the group to leverage its technology with its SaaS ID verification service is substantial. GB only started the business four years ago but already has over 200 customers swapping traditional paper-based approaches for paying GB to check the identity of their new customers online.

Exhibit 1: GB divisional revenue (£m) and margin forecasts
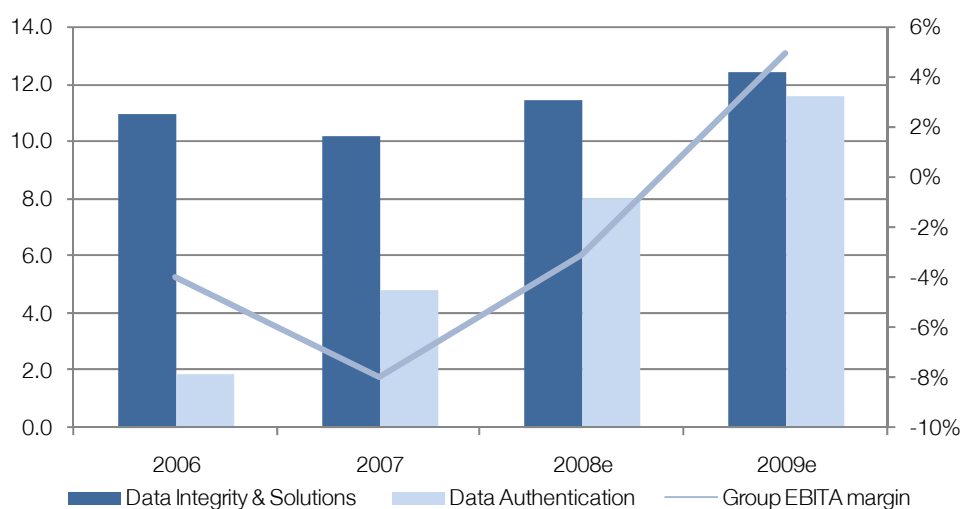
Source: Company Reports, Edison Investment Research

SaaS data authentication: Leader in online checks

Traditional ID checks: Time consuming and costly

ID checks are typically made when making a large purchase (eg mortgage or car), opening a bank account, buying a phone contract, trading online etc. GB estimates (research by Manchester Business School) that in the UK around 0.5bn checks are made each year, of which over 95% are currently physical checks (ie having to present or post copies of passport, driving licence, utility bills etc) costing around £7.5bn a year in terms of expenditure and processing time.

Underlying ID checking market: Growing 10–20% per year

Simple checks against address and telephone details are common, reasonably cheap and straightforward to make. However, the growth in internet trading, the need for money laundering and anti-fraud checks, as well as regulatory pressure from gaming legislation and organisations like the FSA are increasing the need for ever more complex and comprehensive verification of personal data.

Push factors for ID verification: Regulators and legislators

Increasingly regulatory bodies such as the FSA and gaming legislators are insistent on ID verification for a vast range of trading activities.

- **Financial Services Authority.** FSA regulations now cover all service companies handling client money and include lawyers, accountants, car retailers etc as well as traditional banking and financial services organisations. These organisations have to verify client ID for all transactions of over €15,000.

- **Gaming legislation.** Online gaming providers need to check customers' ID to satisfy legislative requirements (eg proof of ID and age). There are around 2,000 English language gambling sites and the number of UK online gamblers is close to 2m.

Pull factors for ID verification: UK fraud costs in excess of £1.7bn

As companies build out their online retailing presence, the risk of identity impersonation and fraud is growing. In addition retailers are increasingly recognising the need to identify and profile their 'anonymous' online users to build affinity and repeat custom.

- **ID fraud.** Many other companies and retailers make additional ID checks because of the risk of ID fraud. ID fraud can take the form of physical theft (cheque books, passports etc), interception of mail, or increasingly lawful or unlawful collection of personal data from the internet (an experienced fraudster can find a significant amount of relevant personal data legitimately over the internet). The problem has been exacerbated by the massive growth in networking websites, with millions of UK individuals willing to place personal data online. In the UK one in four people have either been victims or know a victim of ID theft and the Home Office Identity Fraud Steering Committee estimates that ID fraud costs UK consumers and companies around £1.7bn a year, with financial services (credit cards) and telecoms among the most targeted sectors. However, the actual figure is likely to be significantly higher (in the US ID fraud is estimated to cost c $35bn).

- **Customer relationship management.** As well as protecting themselves against fraud, retailers are increasingly aware of the need to profile and build relationships with their online users. In the UK around 60% of the population have internet access (of this figure, 70% use broadband) and an estimated £7bn was spent online last Christmas. However, retaining these customers and winning new ones is a major marketing challenge (especially given that in the UK around 20m people have 'opted out' from receiving marketing mail or phone calls). Therefore, all the major retailers and service providers are looking for solutions that can help them verify not only the identity of their online customers but also to use this data to help build out wider data sets and help profile buying patterns, etc ie these organisations are increasingly looking to capitalise on their greatest asset – their customers.

GB's ID verification proposition

The cost, increasing complexity (staff time) and the risks (ie it is straightforward and cheap to purchase forged documentation) of traditional paper-based ID checks has pushed many

companies to look for new technical solutions to verify their customer data. With its Data Authentication business (trade mark URU in the UK and ID3-Check overseas), GB has leveraged its core database technology to develop an electronic web-based solution for ID checks. URU provides a service that has a number of key advantages: 1) very fast – typically seconds; 2) cheap – the total cost of each check at 80–100p is typically less than 25% of traditional paper-based process costs of £5–£15; 3) accountable – holds an electronic record of identification rather than paper files; 4) accurate – URU searches across a larger range and breadth of databases increasing the accuracy of the ID check and significantly reducing the risk of fraud; 5) often more secure – no risk of customers presenting fake documents; and importantly 6) the electronic process replicates the physical manual method that most customers have been used to employing (ie GB's offering is instantly 'familiar' to a potential customer). These initiatives gained extra momentum last year when the FSA approved electronic web-based verification of customer ID.

How does it work?

GB's solution is based upon a complex open software algorithm (trade mark ID3) that is able to search for information very quickly across a range of disparate databases. It is clearly simple to make checks across one or two easily accessible databases (eg postcodes, electoral roll etc) but the ID verification assurance is low (ie a fraudster or money launderer could interfere with these databases). The value in GB's solution is that it has commercial agreements with over 30 database owners and is able to rapidly check personal ID data against the data kept in all these databases.

This gives a very high level of ID assurance (ie multiple checks of identity rather than just one or two) to the service, ie customers are able to make an instant decision whether or not to accept the identity claimed by any given individual and confirm their age in seconds. URU also provides a valuable audit trail demonstrating that the necessary checks have taken place, thereby helping companies comply with legislation, including the Second European Money Laundering Directive, the Proceeds of Crime Act 2002 and minimum legal age requirements of certain industry sectors.

The agreements with the data providers are on a non-exclusive basis with typically a commercial (ie the data providers receive a fee for each check against their data) rolling contract ranging in length from one to five years. Importantly, the Joint Money Laundering Steering Group of the FSA stressed the importance of accessing multiple sources and having a large electronic footprint to ensure depth, breadth and quality of data. In our view it is possible for new entrants to seek similar relationships, but GB has invested four years and c £10m in building these partnerships and 'wrapping' its software algorithms around each data source. In addition GB already has over 200 customers using the service including some of the major players in the gaming and financial services industries.

Target market: Should grow at over 50% pa

GB's sales effort has been targeted initially at UK end markets: 1) with high volume transactions that need ID checks; 2) where online transactions are growing rapidly; 3) where customers have few legacy ID checking systems or have cumbersome paper-based processes; and 4) where legislation or regulation is underpinning the need for ID checks. Currently the finance and gaming sector accounts for around one-third of revenue and telecoms a quarter. Customers include DSG International, Lloyds TSB, 02, PartyGaming and Tesco.

SaaS business model: Developed with BT

The solution has been developed with BT which jointly markets URU (the offering and trade mark in the UK) with GB group. The software is hosted by the partners, and customers pay based on usage – there is no traditional software licence. Customers typically pay per search (or 'click') and are willing to make upfront prepayments in return for better payment terms (shown as deferred income in the balance sheet and only recognised against each search). BT hosts the service and takes a share of the revenue dependent upon the sales channel. GB pays 10–20% of each transaction to the database providers. This variable mix adds up to around an average 40% gross margin on each transaction for URU. With BT hosting the infrastructure and only a need for modest growth in the key variable costs of headcount and product development, the business is operationally very scalable.

Growth prospects

GB estimates that the current market is worth c £500m, ie based upon all 0.5bn ID checks. We believe there are a number of opportunities that will help support continued high growth.

- **Customer growth.** Estimating the total available number of customers is difficult but we would estimate there are probably around 1,000 major corporate users and potentially 8,000 to 10,000 smaller accounts. Many other customers have only rolled out URU on a localised basis and GB has announced that it has installed URU into a large number of retail banks but currently only in 'niche' applications.

- **New geographies.** Internationally there are not such well defined legislative drivers and US gaming legislation has limited the scope for GB to grow in North America over the past year. However, the business model is repeatable and the technology is very scalable. `GB announced` earlier in the year the roll-out of a multi-territory, multi-language product called ID3 Check, now capable of checking IDs in 26 different countries including the US, Canada and Australia (covering c 800m people). The group currently has 14 overseas customers.

Sensitivities: Uptake, competition and technology

Market uptake slower than expected

While revenues have continued to grow strongly, the rate of growth has been slower than we had expected. Given that this is such a nascent market it is difficult to assess the pace of market uptake from market share movements but recent sequential growth in searches of over 30% does seem to highlight a significant uptick in usage from existing and new customers.

Competition from credit agencies

As we have highlighted, nearly all ID checks today are paper-based, managed by in-house departments or agencies. Apart from GB, the chief web-based solutions providers are broadening their offering outside of their core credit checking market. The biggest player is Experian (group sales of c £1.5bn) along with smaller players Equifax and Callcredit. Given that these companies grew out of credit checks for the financial services sector (they have strong relationships with the major banks), they remain competitive in offering ID checks within their core sector.

Technology risk

At the recent *Identity Matters* conference in London, around 100 delegates (including representatives from RBS, HBOS, Ladbrokes and Coral) attended to discuss the risks, costs and benefits of verifying the ID of their online and offline customers but also to try to review options for technical solutions to the problem. In general the investment that companies make to protect their data and verify the customers they are dealing with will depend upon the value of the data (eg blogs are publicly available but banking details are heavily password protected). Service companies and retailers therefore typically have a breadth of ID checks on customers ranging from simple password questions (address, mother's maiden name etc) through to chip and pin type solutions and at the extreme end, potentially biometric authentication. However, in practice companies need to trade off the need for 100% target levels of customer ID verification against the cost of the solution, ie passwords are cheap but easily breached, while biometrics are highly reliable but currently have a massive infrastructure cost. Therefore, while we believe there are potentially competing technologies, GB offers a solution which is robust, cost effective and, importantly, has backing from legislators.

Exhibit 2: Trade-off between investment and fraud risk
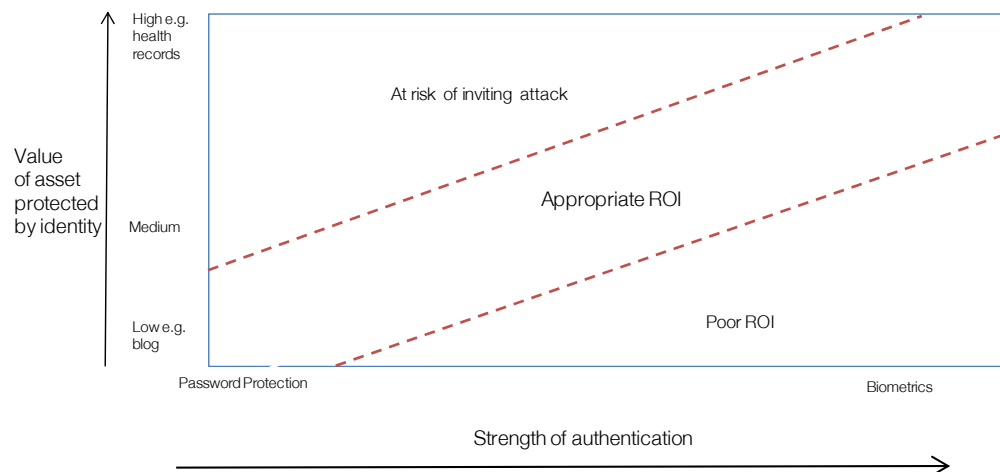
Source: Microsoft, Edison Investment Research

Financials and valuation

In our detailed Data Authentication forecasts we reach a theoretical divisional valuation of £48m even assuming a 25% discount rate. Adjusting for our forecast £4m of year-end cash and valuing the traditional software businesses at £7m (small profit on £10m revenues) would imply a value for the SaaS Data Authentication business of c £15m. In our view this could be too low if management can demonstrate that it can leverage its blue chip customer base into sustainable, operationally-geared, medium-term high growth.

Exhibit 3: Data Authentication forecast assumptions

	2006A	2007A	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Continuing 2018
UK Customer Assumptions													
Number of Customers	105	154	223	257	290	322	351	376	394	406	410	406	394
- growth rate	*71%*	*47%*	*45%*	*15%*	*13%*	*11%*	*9%*	*7%*	*5%*	*3%*	*1%*	*-1%*	*-3%*
Average "clicks" per customer	20,000	25,000	33,000	40,590	49,114	58,446	68,381	78,638	88,861	98,636	107,514	115,039	120,791
- growth rate	*57%*	*25%*	*32%*	*23%*	*21%*	*19%*	*17%*	*15%*	*13%*	*11%*	*9%*	*7%*	*5%*
Total Clicks (m)	2.1	3.9	7.4	10.4	14.3	18.8	24.0	29.5	35.1	40.1	44.1	46.7	47.6
- growth rate	180%	83%	91%	41%	37%	32%	28%	23%	19%	14%	10%	6%	2%
International Customer Assumptions													
Number of Customers		10	35	53	76	107	144	187	234	281	323	355	373
- growth rate		*100%*	*250%*	*50%*	*45%*	*40%*	*35%*	*30%*	*25%*	*20%*	*15%*	*10%*	*5%*
Average "clicks" per customer		2,500	12,500	16,250	21,125	26,406	31,688	36,441	40,085	42,089	43,352	45,086	46,889
- growth rate		*100%*	*400%*	*30%*	*30%*	*25%*	*20%*	*15%*	*10%*	*5%*	*3%*	*4%*	*4%*
Total Clicks (m)		0.0	0.4	0.9	1.6	2.8	4.6	6.8	9.4	11.8	14.0	16.0	17.5
- growth rate			1650%	95%	89%	75%	62%	50%	38%	26%	18%	14%	9%
Revenue Assumptions													
Gross Revenue per click £	0.80	0.85	0.90	0.92	0.93	0.93	0.94	0.95	0.95	0.95	0.95	0.95	0.95
Consultancy/Other income	0.3	1.5	1.0	1.2	1.3	1.5	1.6	1.8	1.9	2.1	2.3	2.6	2.8
UK Revenues	1.7	3.3	6.6	9.6	13.3	17.5	22.6	28.1	33.3	38.1	41.9	44.4	45.2
International revenues	0.0	0.0	0.4	0.8	1.5	2.6	4.3	6.5	8.9	11.2	13.3	15.2	16.6
Gross Revenue £m	1.9	4.8	8.0	11.6	16.1	21.6	28.5	36.3	44.1	51.4	57.5	62.2	64.6
Gross Cost Assumptions													
GB/BT Revenue split	80%	81%	95%	97%	98%	98%	99%	99%	100%	100%	101%	101%	102%
BT Sales Commissions £m	(0.9)	(2.1)	(2.9)	(4.2)	(5.7)	(7.7)	(10.1)	(12.8)	(15.5)	(18.0)	(20.1)	(21.6)	(22.3)
Database Commissions %	20%	20%	15%	15%	14%	14%	13%	13%	12%	12%	11%	11%	10%
Database Commissions £m	(0.4)	(1.0)	(1.2)	(1.7)	(2.2)	(2.9)	(3.7)	(4.5)	(5.3)	(5.9)	(6.3)	(6.5)	(6.5)
Other Commissions / Cost of Sales £m	(0.1)	(0.3)	(0.4)	(0.5)	(0.6)	(0.7)	(0.8)	(0.9)	(1.0)	(1.1)	(1.2)	(1.3)	(1.4)
GB Gross Profit	0.6	1.4	3.5	5.2	7.5	10.3	13.9	18.0	22.3	26.4	30.0	32.8	34.4
Gross Margin	*31%*	*29%*	*44%*	*45%*	*47%*	*48%*	*49%*	*50%*	*51%*	*51%*	*52%*	*53%*	*53%*
Operating Cost Assumptions													
UK S,G & A £m	(2.2)	(2.7)	(3.8)	(3.9)	(4.5)	(5.2)	(5.9)	(6.8)	(7.8)	(9.0)	(10.4)	(11.9)	(13.7)
International Investment	0.0	(0.3)	(0.6)	(0.7)	(0.8)	(1.0)	(1.2)	(1.5)	(1.8)	(2.1)	(2.5)	(3.0)	(3.6)
EBIT £m	(1.6)	(1.6)	(0.9)	0.7	2.1	4.1	6.7	9.8	12.7	15.3	17.1	17.8	17.1
	-83%	-33%	-11%	6%	13%	19%	24%	27%	29%	30%	30%	29%	26%
Cashflow Assumptions													
Cash Tax £m			0.3	(0.2)	(0.6)	(1.2)	(2.0)	(2.9)	(3.8)	(4.6)	(5.1)	(5.3)	(5.1)
Depreciation £m			0.1	0.1	0.2	0.2	0.2	0.3	0.3	0.4	0.4	0.5	0.6
Net Capex £m			(0.5)	(0.6)	(0.8)	(0.9)	(1.1)	(1.3)	(1.6)	(1.9)	(2.2)	(2.7)	(3.2)
Working Capital £m			(0.2)	(0.2)	(0.3)	(0.4)	(0.6)	(0.7)	(0.9)	(1.0)	(1.2)	(1.2)	(1.3)
Operating Cashflow £m			(1.3)	(0.2)	0.7	01.9	03.5	05.3	07.1	08.5	09.3	09.4	08.4
Discount Factor £m			1.00	0.80	0.64	0.51	0.41	0.33	0.26	0.21	0.17	0.13	0.11
Discounted Cashflow £m			(1.3)	-0.2	0.5	1.0	1.4	1.8	1.9	1.8	1.6	1.3	0.9

Discount Rate	25%
NPV Forecast Period £m	10
NPV Continuing Value £m	11
Equity Value £m	**20**

Source: Edison Investment Research

Exhibit 4: Product Revenue Analysis in 2008 and Edison five-year target

2008

2013
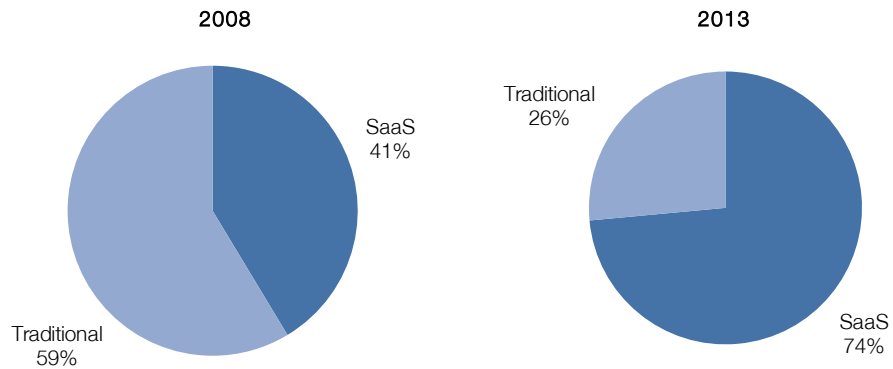
Source: Edison Investment Research

Management

Exhibit 5: Management

Chairman: John Walker-Haworth	John was appointed to the board in 2000. He is Managing Director of Integrated Finance Limited, Deputy Chairman of the Takeover Panel and Chairman of Merrill Lynch Greater Europe Investment Trust.
CEO: Richard Law	Richard joined the board in June 1995 as Finance Director and was appointed as Chief Executive in December 2001. Before joining GB Group he was a corporate financier with Ernst & Young.
CFO: Mona Navin-Mealey	Mona was appointed to the board in January 2003. She joined the company in 1995 as Financial Controller. Prior to her appointment to the board she was the group's Chief Financial Officer.

Source: GB Group

Gresham Computing

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	PE (x)	Yield (%)
12/06	14.5	(0.4)	(0.7)	0.0	N/A	N/A
12/07	13.4	(2.9)	(4.7)	0.0	N/A	N/A
12/08e**	17.5	1.6	3.0	0.0	22.0	N/A
12/09e**	26.5	3.5	6.0	0.0	11.0	N/A

Note: *PBT and EPS are normalised, excluding goodwill amortisation and exceptional items. **Consensus forecasts.

Investment summary: Real-time banking focus

Concern about Gresham's balance sheet strength and ability to translate recent investment into cash flow in a competitive global market has hit its shares. The investment case is largely dependent on the success of two emerging real-time SaaS businesses: Cash Reporting, which is now gaining scale; and a nascent Asia Pacific Supply Chain Finance venture, which in our view offers considerable potential.

SaaS business model: High hopes for Payables Financing

While Payables Financing – the Australian supply chain finance venture – is nascent, difficult to forecast and barriers are relatively low, this business could potentially be generating run-rate revenues of £10m within three years. The Cash Reporting business is more developed and we forecast it will deliver £3.5m of sales this year.

Recent trading: Picking up pace

FY08 has begun with a much healthier order book and Q108 trading was significantly better than Q107. Net cash balances at the end of Q108 were £2.3m. Cash Reporting continues to sign up banks and corporates and in our view now has the scale necessary to generate healthy profits. Payables Financing is now integrating a further four customers and has a strong pipeline. The group started FY08 with £10m of contracted revenue.

Management changes: New Executive Chairman

We view the appointment of Eric Sepkes as a very positive development given his highly relevant background at Citigroup, and strong reputation in the marketplace. We note that Mr Sepkes' initial share option grant is only exercisable in its entirety if the share price reaches 400p by 2014, requiring c 35% pa returns. Further, both the new Chairman and CEO have recently purchased shares.

Valuation: Attractive SaaS DCF valuations

Recent earnings have been held back by heavy investment in Cash Reporting and Payables Financing. The group is now beginning to leverage this investment but remains a small player attempting to offer a real-time global service to a market with major customers and competitors with bigger balance sheets. The risks are therefore high, but if management can show evidence that it can deliver to plan over the next 24 months then our potential £50m+ valuation for the SaaS businesses may look more supported.

Price*	66p
Market Cap	£35m

*Priced as at 21 May 2008

Share price graph

Share details

Code	GHT
Listing	FULL
Sector	Software & Computer Services
Shares in issue	53m

Business

Provision of real-time financial solutions and storage solutions.

Bull

- New ventures have significant potential.
- Value in non-core units.
- New highly experienced Chairman.

Bear

- Small player in large market.
- Exposed to financial services IT budgets.
- Balance sheet constraints.

Company description: Increasing focus on SaaS

Founded in 1969 Gresham Computing plc has offices in Europe, North America and Asia Pacific serving a global client base which includes more than 120 of the Fortune Global 500.

- **Real-Time Financial Solutions**. This is the group's primary business and real-time is the philosophy that underpins all offerings in the Clareti solution family – it is about delivering the right information to the right place at the right time. Clareti solutions help Gresham's customers to:

  - More quickly consolidate and view data to better understand their transactions, their customers and their businesses.

  - Remove duplication of systems and processes that hinder this understanding.

  - Improve connections between people, the systems they use, and the businesses they work for.

In addition to Gresham Real-Time Financial Solutions the group includes:

- **Gresham Enterprise Storage** – a storage division that helps businesses deal with the unrelenting growth of data.
- **Gresham Computer Personnel** – provides a total IT recruitment service, committed to fulfilling corporate staffing requirements for both permanent and contract staff.
- **Redstone Software** – delivering test and automation tools for Windows, Mac OSX, Linux, Solaris, AIX, and HP/UX.
- **Systems Management Software** – for the VME and HP Non-Stop mainframe and open systems markets.

In this report we focus on the two financial SaaS revenue streams within Real-Time Financial Solutions: Cash Reporting (a real-time banking solution); and Payables Financing (supply chain finance solution). Together we forecast they will only account for £4m or c 23% of group revenues in FY08 rising to £7.7m or c 29% in FY09. However, in our view they are core to the investment case of the group.

Cash Reporting

Gresham's real-time banking solution service (branded Clareti Cash Reporting), is a hosted offering that improves cash and liquidity management for major banks. It does this by providing banks and their account holders with a single consolidated view of their cash and foreign exchange positions, including transaction information, in real time.

Traditional versus real-time reconciliation of banking fund flows

Currently banks typically aggregate international and foreign currency payments between them and other banks and process them on a 'batch' basis, ie they may reconcile their payments (cash out) and receipts (cash in) often only once or twice a day. However, there are a number of reasons why it is preferable for banks to monitor their nostro balances on a real-time basis:

- **Cost savings.** Currently banks capture their cash receipt data from multiple sources. This is often directly (through their own bespoke IT network connections) from banking

counterparties or from SWIFT. The number of counterparties can run into thousands. This process can therefore be time consuming, error prone and costly.

- **Treasury management.** With immediate availability of transaction and balance information, banks can fund loan books based on actual positions instead of estimates, improving liquidity management and reducing credit and settlement risk (ie risk that expected receipts have been delayed, misplaced etc).

- **Higher returns.** As well as more efficient operational management, real-time data typically enables banks to fund higher book positions, increasing their leverage (banking covenants restrict banks to lending c 1–1.5x their capital base) and contributing to higher returns.

- **Regulation and compliance.** Real-time information supports the calculation of operational losses and verification of deposits and movements of monies as required under Basel II and Sarbanes-Oxley.

- **Customer service and management.** Real-time monitoring of data significantly increases the likelihood of banks identifying errors in payments to their customers, eg daily batch reconciliations may not capture in time that an expected major payment customer receipt (from a business sale, major contract etc) has been delayed or misplaced. In addition, a real-time view of their cash balances may be a major value-added service for corporate clients or enable the banks to market other services around the customers' daily flow of funds.

Cash reporting solution – SaaS delivery

Therefore, over the last six years Gresham has developed its Clareti Cash Reporting Service into a hosted solution, which offers a consolidation of information that allows financial institutions to share aggregated, multi-currency, multi-bank account information intra-day.

- **Supply of real-time transaction data**. Data is delivered to a secure, central repository via SWIFTNet or proprietary link, in a format of the provider's choice. The information is then transformed to a normalised format for onward presentation and delivery to banking customers. Gresham currently has 29 major banks that have agreed to provide data to the service, with 20 of these banks providing near real-time data to the hub. The increase in the number of live provider banks that are populating the database with multi-currency payment information clearly increases the value of the hub service to both new and existing users. Gresham provides coverage of 19 currencies, including AUD, CAD, EUR, GBP, HUF, JPY, NZD, PLN, SEK, THB, TRY, USD, ZAR; and more are on the way.

- **SaaS delivery**. 'Receiving' banks (Gresham's customers) can therefore view cash account transactions in real-time via SWIFTNet or over a secure authenticated internet connection. The data they receive is reformatted and aggregated into a 'single view' and is immediately available in real time on the desktop browser in the front office or integrated into back-office systems. The service is securely hosted by Cable & Wireless and information is stored in high-resilience data centres (streamed using end-to-end encryption technology across SWIFTNet). Flexible, secure hierarchical access allows for precise control as to what data can be viewed and by whom.

Cash reporting – target market and valuation model

Currently Gresham has nine client banks taking a service and the value of transactions is in excess of US$500bn per day on average. In total, the SWIFTNet network covers around 7,600 banks. However, there are around 14,000 banks globally and a further 250,000 financial institutions (brokers, trusts etc). However, the target market for the Clareti service is the major primary, multi-regional banks. In total there are c 1,000 of these banks but Gresham has an initial target to reach c 30 clients. Within a sale to a bank there are essentially two revenue opportunities for Gresham:

- **Bank to bank.** This has been the initial primary market with banking customers taking the real-time service to monitor and analyse their bank-to-bank cash positions either via an internet browser or through a data stream delivered directly into back-office systems. Typically customers are paying up to £10,000 per user per month.

- **Bank to corporate.** Gresham's strategy has been to expand its service offering of real-time intra-day cash management into the corporate market, providing national data as well as international data. It therefore offers a range of SaaS solutions to enable banking customers to provide intra-day/real-time payment information to their corporate customers. The client bank essentially acts as the sales channel (Gresham is enabling it to offer a value-added service to customers and potentially bolt-on additional services to the platform) and targets customers that have thousands of individual accounts where there are high transactional volumes, eg brokers, trust, property managers etc. The service is priced on a modest 'per-account' usage basis but the potential is clearly substantial.

Clearly, forecasting the timing of customer wins and the pace of roll-out of the service is very difficult. However, we have made initial assumptions about customer numbers, average revenue per customer, gross profit (main cost of the software service is hosting) and operating costs (mainly development and marketing), and we currently reach a potential DCF valuation for the real-time banking solutions business of £25m.

Exhibit 1: Cash Reporting Service assumptions and discounted cash flow valuation

	2008e	2009	2010	2011	2012
Number of banks	10	15	19	23	27
Incremental banks		5	4	4	4
Revenue/bank (£m)	0.35	0.37	0.39	0.41	0.43
Total revenue (£m)	3.5	5.5	7.3	9.3	11.5
Gross Profit	2.8	4.4	5.7	7.2	8.8
Gross margin	80%	79%	78%	78%	77%
Operating costs	(2.5)	(2.9)	(3.3)	(3.7)	(4.1)
Operating profit	0.3	1.5	2.5	3.6	4.8
Operating margin	9%	27%	34%	38%	42%
Depreciation	0.1	0.2	0.2	0.3	0.3
Capex	(0.1)	(0.2)	(0.2)	(0.3)	(0.4)
Working capital	(0.0)	(0.0)	(0.0)	(0.0)	(0.1)
Cash tax	0.0	(0.1)	(0.4)	(0.7)	(1.0)
Operating FCF	0.3	1.4	2.0	2.8	3.7
WACC	20.0%				
Perpetuity growth rate	3.0%				
DCF Valuation	£25m				

Source: Edison Investment Research

Payables Financing Solutions

What is supply chain finance?

Supply Chain Finance (SCF) is when a company uses its superior credit rating to provide funding (by giving its bank clear instructions to make payments on specified invoices at specified dates in the future) to its less credit-worthy suppliers at rates related to the company's own credit standing. SCF provides suppliers with the opportunity to convert some of their trade receivables into cash ahead of payment date at far better terms than offered by other forms of trade finance such as factoring.

Gresham's Payables Financing Solutions – an SCF offering

Gresham SCF software is now in action in Australia hosted by SingTel Optus MarketSite and with client finance provided by Citigroup. The joint venture partners are focusing on attracting blue chip clients or 'buyers'. The platform has one major client (corporate buyer) and four more clients are currently being integrated into the service. The partners had aimed to add four new clients a year over the next three years but now believe this could accelerate. Gresham derives revenue on a transaction basis.

Exhibit 2: Supply Chain Finance model in Australia
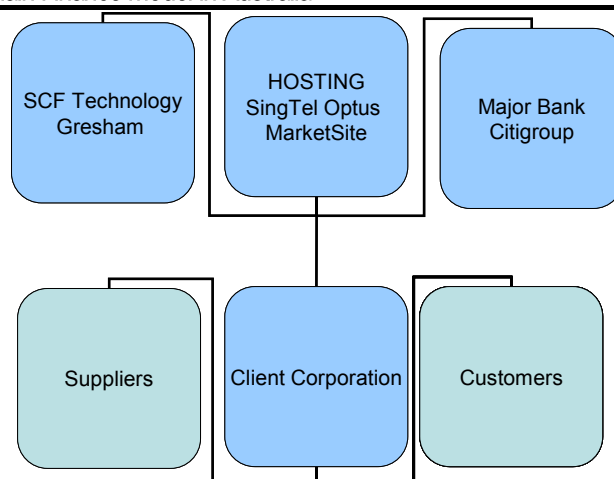
Source: Gresham Computing

How does Gresham's SCF consortium work?

The consortium's platform provides access to real-time payment information. Combined with a service provider and a bank it provides a complete SCF solution for corporations (Gresham's client) and their suppliers.

- **Customer benefits.** It enables suppliers to manage their cash flows much more effectively than offered by traditional methods of trade finance. Pricing transparency and ease of use are major benefits for the customer. The structure can also be extended across to the corporation's customers (as we show in Exhibit 2) allowing a supplier access to a customer's (superior) credit standing.
- **Split revenues.** This SaaS business model generates revenues on a transaction basis. A typical target customer has a payables book of between £1bn and £2bn and is probably financing 15–20% of this at any one time. Based on winning these types of

customers and the revenue share agreement, a target major client is expected to generate around £0.5m of revenues per annum for Gresham when fully up and running. This is based on expectations of 20% of a client's suppliers taking up the service. Again it is very early to try to forecast the success or failure of this business. However, there are clear economic drivers for a major market opportunity to develop and if Gresham can build one of the leading technology supplier positions then there is the potential to significantly outperform our forecasts.

- **Competition.** Technology enablers that compete with Gresham in this specialised area include PrimeRevenue, Xign (bought recently by JP Morgan Chase), TradeCard and Orbian (originally a joint venture between SAP and Citi). The main threat to Gresham is other consortiums or banks devising more attractive offerings. Along with technological expertise, pricing would clearly be a factor.

Payables Financing – financials and valuation

In our DCF model in Exhibit 3 we have assumed that Australian corporate customers are acquired at a more conservative rate than planned, ultimately peaking at 30. The platform already has one corporate buyer (ie Gresham customer), is integrating a further four and has a significant pipeline. We assume average revenue per customer rises over a roll-out period to £0.5m. It is estimated to take 18 months to three years to roll-out to a customer's suppliers. We have highlighted above that this revenue assumption may be very conservative. In addition we believe the group could expand into Asia in 2009 and we have assumed Asian customers will generate similar average revenues to the Australian operation. We assume Asian customer numbers ultimately peak at 55. We apply a weighted average cost of capital of 20% to reflect the business's nascency and the supply chain finance industry's competitive dynamics. Based on these assumptions the model generates a valuation of £26m for this business.

Exhibit 3: Payables Financing Solutions assumptions and discounted cash flow valuation

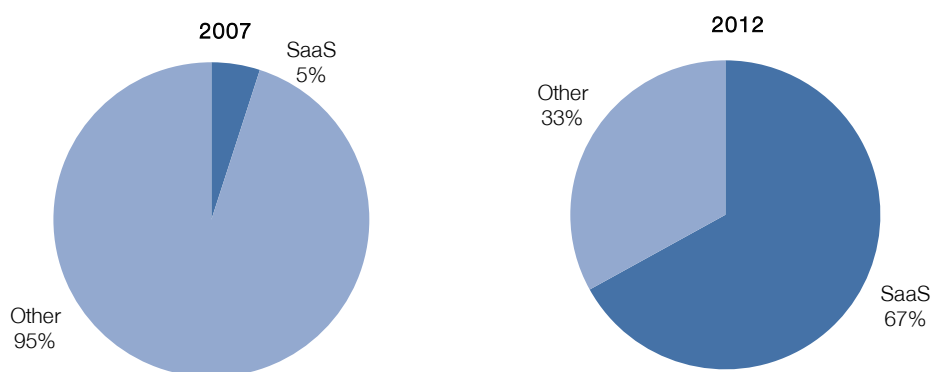|	2008e	2009	2010	2011	2012
Australia					
Customers	5	10	15	19	22
Incremental customers	4	5	5	4	3
Average revenue per customer (£m)	0.1	0.2	0.3	0.4	0.5
Revenue	0.5	2.0	4.5	7.6	11.0
Asia					
Customers	0	1	6	16	24
Incremental customers	0	1	5	10	8
Average revenue per customer (£m)	0.0	0.1	0.2	0.3	0.4
Revenue	0.0	0.1	1.2	4.8	9.6
Total revenue	0.5	2.1	5.7	12.4	20.6
Gross profit	0.4	1.5	4.1	8.8	14.3
Gross margin	75%	74%	72%	71%	69%
Operating costs	(1.5)	(2.0)	(2.7)	(3.4)	(4.2)
Operating profit	(1.1)	(0.5)	1.4	5.3	10.0
Operating margin	N/A	N/A	25%	43%	49%
Depreciation	0.0	0.1	0.2	0.3	0.6
Capex	(0.0)	(0.1)	(0.2)	(0.4)	(0.6)
Working capital	(0.0)	(0.0)	(0.0)	(0.1)	(0.1)
Cash tax	0.0	0.3	0.1	(0.4)	(1.5)
Operating FCF	(1.1)	(0.2)	1.5	4.8	8.3
WACC	20.0%				
Perpetuity growth rate	3.0%				
DCF Valuation	£26m				

Source: Edison Investment Research

Sensitivities

- **Economic activity.** SCF venture is exposed to falling debtor volumes in a downturn.
- **Financial services sector.** Gresham's specialisation in financial services leaves it sensitive to this sector, which is very susceptible to economic slowdown. However, in a downturn banks are focused on IT solutions that increase revenues and reduce risk and therefore real-time solutions are a less exposed part of the overall IT budget.
- **Technological change.** Products are at risk from being bettered by competitors.
- **Other competitive factors.** We believe within the SCF business not only are there several competitors but there are relatively low barriers to entry.
- **Currencies.** Translational risk relating to overseas activities, notably A$.

Group financials and valuation

Gresham has a long history and yet its valuation is largely dependent on two key SaaS businesses – Real-Time Banking Solutions and Payables Financing Solutions – which have only evolved in recent years. Both these units are part of the Real-Time Financial Solutions division which is now the core business of Gresham. The storage business also holds significant potential value following recent technical advances and is now positioned to ramp up sales. We believe management will review options for releasing value from the storage business and other assets. We have not attempted to value the storage or other business in this report. However, adding our valuation of the two SaaS businesses and Q1 cash of £2m would imply an equity value of £53m. Clearly this valuation today is largely theoretical, but evidence over the next 12 months that management can deliver on the SaaS investment could drive significant valuation upside in our view.

Exhibit 4: Estimated revenues split in latest FY and Edison five-year target

Source: Edison Investment Research

Management

Exhibit 5: Management

Executive Chairman: Eric Sepkes	Eric joined the board as Executive Chairman in April 2008. Eric completed 38 years with Citigroup where he held various management positions, including Operations and Treasury and Cash Management, and most recently held a senior strategic role in Global Transaction Services.
CEO: A J S Walton-Green	Andrew joined Gresham as Chief Executive in April 2000. He previously spent 10 years in consulting and senior management positions as a chartered accountant: first with Ernst & Young, then with Deloitte & Touche.
CFO: C M Errington	Chris joined Gresham in February 2004 as Company Secretary and was appointed Finance Director in April 2004. He has over 13 years' experience as a chartered accountant, most recently with BDO Stoy Hayward.

Source: Gresham Computing

Kewill Systems

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	PE (x)	Yield (%)
03/06	31.6	3.7	6.0	0.0	15.2	N/A
03/07	41.6	4.8	6.7	0.5	13.6	0.5
03/08e**	51.3	7.0	8.6	0.7	10.6	0.8
03/09e**	56.5	8.4	9.5	0.9	9.6	1.0

Note: *PBT and EPS are normalised, excluding goodwill amortisation and exceptional items. **Consensus forecasts.

Investment summary: Blue sky opportunity

Kewill is utilising a Service Oriented Architecture (SOA) platform to deliver a complete suite of solutions focused on connecting supply networks and accelerating global trade and logistics. This strategy enables Kewill to reduce costs over time but more importantly build full real-time interoperability between all its systems. If Kewill can build a trusted global trade exchange with a customer list of global players, this asset would be very valuable. It will essentially 'own' the customer relationships, the infrastructure and provide a huge opportunity to 'up-sell' customers to a SaaS solution that will significantly enhance recurring revenues for the future.

Business description: International trade and logistics

Kewill's Dynamic Supply Network software solutions enable global businesses to implement their international trade and logistics processes and to communicate related information both internally and externally with supply chain partners and regulators highly efficiently.

SaaS business model: Greater efficiencies all round

Strategically the SaaS model helps Kewill to increase revenue per customer, margins and volumes and also to close deals faster. SMEs may pay double under a managed service to get a better service and remove their IT headaches. New services can be offered to the same channel and SaaS reduces the need for annual upgrade cycles, labour intensive helpdesks, and implementation. SaaS services have a lower initial cost for their customers and therefore often do not require board sign-off.

Forecasts and valuation: SaaS looks undervalued

In the April trading update the company said profits were ahead of expectations on in-line revenues. Net cash at 31 March was up sharply over the six months at £10m. Management targets suggest that managed services/SaaS revenues will approach 50% of group revenues within two years. Assuming FY09 group revenues of £55m this would imply a SaaS component of £28m and applying a 25% EBITDA margin would imply £7m EBITDA. Putting the business on 10x 2009 EBITDA would value it at £70m compared with the current enterprise value of c £79m for the entire group.

Share price graph
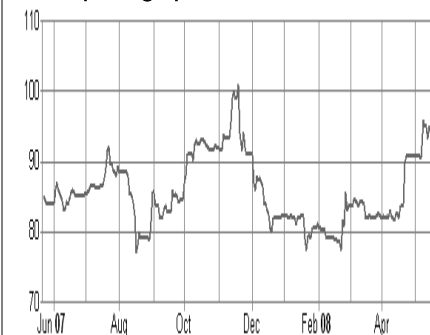
Share details

Code	KWL
Listing	FULL
Sector	Software & Computer Services
Shares in issue	81.27m

Business

Provides Dynamic Supply Network software solutions which enable global businesses to implement their international trade and logistics processes and communicate related information both internally and externally.

Bull

- Strong recurring revenue base.
- Recent spate of contract wins.
- Gaining useful scale on global perspective.

Bear

- Sensitive to global trade growth.
- Customer consolidation can hurt revenues.
- Risk of disruption while integrating acquisitions.

SaaS strategy and business model

Kewill has an opportunity to build a global trade exchange utilising its SOA platform strategy. The platform enables Kewill to reduce cost over time but more importantly build full real-time interoperability between all its systems. A UK company could transact with a supplier in China, managing the order/invoice, customs clearance, third party check etc. Hence in the long term, Kewill could build a large recurring SaaS revenue stream from a global trade exchange.

Strategically the SaaS model helps Kewill:

- Increase revenue per customer – eg SMEs paying maintenance of c £500 pa may pay double under a managed service to get a better service and remove their IT headaches. There is also an opportunity to offer new services to the same channel (again SOA architecture is key).

- Increase margins – SaaS reduces need for annual upgrade cycle, labour intensive help desks and need for implementation.

- Increase volumes and close deals faster – Kewill's SaaS services have a lower annual cost for their customers and therefore often do not require board sign-off etc.

We highlight three key customer segments in which Kewill has built a SaaS strategy.

Retail

Electronic Data Interchange (EDI) and Carrier Management software connects retailers to their supply network trading partners. It enables real-time ordering/invoicing as well as the opportunity for add-on functionality like forecast sharing, carrier selection and document preparation and management/data reporting/reconciliation. Sainsbury's and JD Williams (a division of N Brown Group) have been long term customers of Kewill.

- **Move to SaaS.** Some customers still want to pay for a licence and 'own' the software, reflecting their perceived security risks of outsourcing as a service. But others are now moving to a SaaS model given their lack of in-depth in-house EDI expertise and the business distraction of managing and investing in their own solutions and infrastructure. Further, there are significant cost advantages. Currently a mid-sized UK retailer pays c £0.5m to a value-added network (eg GXS) for electronic connectivity to their suppliers. Kewill can offer an outsourced service for typically half that annual cost and without the required in-house IT investment. In addition, there is the emergence of virtual online retailers which rely on their suppliers to fulfil customers' orders so require solutions that provide visibility into their suppliers' supply chains. Delivering this in a SaaS model allows the costs to be shared where appropriate.

- **Revenue model.** The service is offered on an annual subscription basis based upon volume of data, number of transactions or the number of suppliers on the system. Revenue is received from the retailer and often its suppliers depending on the retailer's preferred structure. Kewill has some 200 retail customers, 5,000 suppliers and around 9,000 connections (representing multiple links between suppliers and retail customers).

- **Costs model.** Kewill's main cost is servers and hosting the service and some third-party software costs. In some cases to help customers it will 'take-over' the existing

VAN interface structure and carry the costs while the customer moves to the Kewill platform. Furthermore, in the growing home delivery market the ability to reduce carrier costs through enhanced carrier selection and management can significantly increase profitability. EBITDA margins therefore range 10–40% across the customer base but there is scope to grow the average as they manage out the 'dual' costs of the VAN infrastructure. We estimate annual revenues for this business at around £10m.

Global trade management

The key application is 'customs processing and related compliance', ie messaging to customs for clearance of imported goods. Kewill's software handles more than 25% of all US imports, has more than 800 customers across Asia and clears approximately 70% of the total shipments through Singapore, and in Germany annually clears over 11 million electronic customs declarations which equates to over 50% of the total declarations. The European business has been developed through the acquisition Interchain BV in November 2005 and CSF GmbH in June 2006.

The German business champions the SaaS business model with standard software managed over two sites for robust failover purposes on shared common hardware. Customers pay an annual subscription or an upfront set-up charge and on a per transaction basis after that. There is an opportunity to up-sell other services, eg third party checking which verifies if a party you are importing from or exporting to is a fit and proper person.

Service logistics

This is a more recent opportunity as major OEMs seek to outsource their product delivery and manage their break/fix maintenance. The business is predominantly enacted by large multinational hi-tech enterprises and logistics service providers servicing this market. Kewill supplies (as a service) the software that manages the transaction of collecting, fixing and returning damaged or replacement goods. HP is a key customer. Customers pay either per transaction or an upfront set-up cost and then a lower price per transaction.

Sensitivities

- Risks of technological change within this industry are tempered by Kewill's long-standing customer relationships. There can be considerable burdens for customers should they wish to switch to a new software provider.
- Economic downturn or increased trade barriers could reduce customer volumes, increase bad debtors and/or result in customer losses.
- Existing competitor rivalry and new entrant threats may put pressure on pricing.
- Kewill experiences occasional occurrences of litigation in its US businesses.
- Consolidation among key customers could reduce revenues as merged companies seek cost reductions by reducing the number of their systems.

Financials and valuation

In a bullish April trading update the company said profits were ahead of expectations on in-line revenues. Margin improvements were particularly strong in Europe and Asia as a result of successful recent acquisitions. Net cash at 31 March was up sharply over the six months at £10m.

Management expects recurring revenues to rise to around 65% of group revenues within the next two years from the current 49%. This suggests the managed services/SaaS component will be approaching 50% of group revenues by that time. Hence if we assume FY09 group revenues of £55m (based on global trade growth of 8%) then this would suggest around £28m will be SaaS related. We highlight a range of 10–40% EBITDA margins with scope to move towards the top of that range. Applying 25% EBITDA margins would imply £7m EBITDA. Putting the business on 10x 2009 EBITDA would value it at £70m compared with the current enterprise value (including £9.1m of earnouts and £3.9m cash as at September 30, 2007) of c £79m for the entire group.

Further, if Kewill can build a trusted global trade exchange with a customer list of global players this asset would very valuable. It will essentially 'own' the customer relationships, the infrastructure and provide a massive opportunity to 'up-sell' new SaaS to this customer base.

Exhibit 1: Product revenue analysis in H1 2007/08 and Edison five-year target
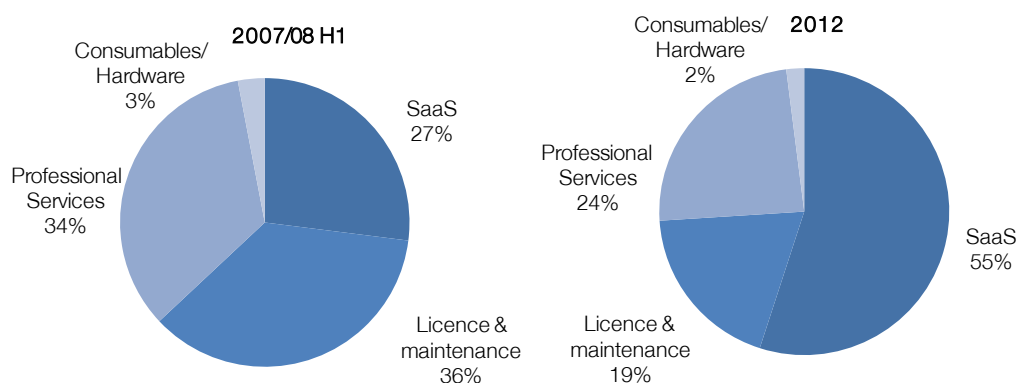
Source: Kewill/Edison Investment Research

Management

Exhibit 2: Management

CEO: Paul Nichols	Paul joined Kewill as CEO in August 2002. Previously he was President and CEO of Logica Inc, the North American subsidiary of Logica plc. In his earlier career Paul held sales and business management positions at International Computers Ltd and Digital Equipment Corporation before joining Data Sciences Ltd as Executive General Manager for the Commercial and Financial Services business in 1994. Following DSL's acquisition by IBM in 1997 Paul became a director of IBM Global Services in EMEA with responsibility for the Banking and Financial Services industry.
CFO: Guy Millward	Guy joined Kewill in January 2000 as group Financial Controller and was appointed Finance Director in November 2002. He began his career with Ernst & Young before moving, in 1993, to GE Information Services (now GXS), a division of the US conglomerate General Electric. At GE he held a number of roles including UK Finance Director.
Chairman: Andy Roberts	Andy was appointed as a Non-Executive Director in April 1997 and Non-Executive Chairman in April 1998. He held senior management positions within ICL between 1982 and 1993 and then served as Chief Executive of Data Sciences plc between 1993 and 1997.

Source: Kewill

Netstore

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	PE (x)	Yield (%)
06/06***	N/A	N/A	N/A	0.42	N/A	1.6
06/07***	37.0	1.4	0.4	0.45	65.0	1.7
06/08e**	41.1	3.4	2.4	0.40	10.8	1.5
06/09e**	44.4	4.7	2.9	0.40	9.0	1.5

Note: *PBT and EPS are normalised, excluding goodwill amortisation and exceptional items. **Consensus forecasts. ***FY06 and FY07 accounts have been restated.

Investment summary: Low valuation

Graham Kingsmill, the new CEO, has conducted a major review of the business which has resulted in significant accounting restatements. He has been streamlining the businesses and last year signed a key partnership deal with Microsoft. Further, he is nearly doubling the company's data centre capacity with finance raised through a successful equity offering in difficult market conditions. The SaaS strategy is a key component in Netstore's plan to generate 15% pa organic revenue growth.

SaaS business model: SaaS enabler

Netstore builds, delivers and hosts complex software solutions utilising software from a range of suppliers; it does not develop its own software. In November Microsoft made Netstore its third SaaS partner in the UK as Microsoft seeks to speed the transition of its independent software vendors (ISVs) from an on-premise to a SaaS delivery model. Netstore is now hoping to double the ISVs with whom it works and Microsoft is now the company's preferred platform.

Possible offer and interim results

In February Netstore announced that it had received a number of early-stage approaches from parties interested in making an offer for the business. It also said that following an internal review by the new management the company had discovered accounting discrepancies and appointed PricewaterhouseCoopers to conduct an independent review. Interim results in March revealed prior year restatements including a £0.6m reduction in FY07 revenue and £1.6m cut to FY07 operating profit. The numbers were also restated for IFRS. In the announcement management said early-stage discussions were continuing with potential bidders.

Forecasts and valuation: Data centre assets in demand

The December share placement to finance new data centre space should enable the company to remain comfortably financed with modest debt levels. We see limited downside in the share price with it trading on just 9x FY09 earnings. We believe Netstore has the potential to generate good returns over the medium term and the SaaS strategy will be an important driver of earnings in our view.

Price*	26p
Market Cap	£45m

*Priced as at 21 May 2008

Share price graph
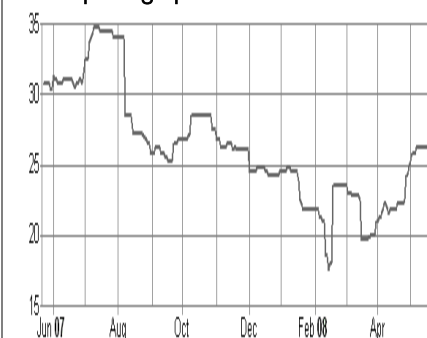
Share details

Code	NES
Listing	AIM
Sector	Software & Computer Services
Shares in issue	172.6m

Business

The provision of outsourced IT services and related consultancy services.

Bull

- Proactive new management team.
- Ambitious growth targets.
- Data centre assets in demand.

Bear

- Discovery of accounting discrepancies.
- Profits restatements.
- Disappointing track record.

Company description: IT security and outsourcing

Netstore is a leader in the field in mid-market IT security and outsourcing where it has been helping clients change their performance for more than 10 years. Most of Netstore's services can be described under the following headings:
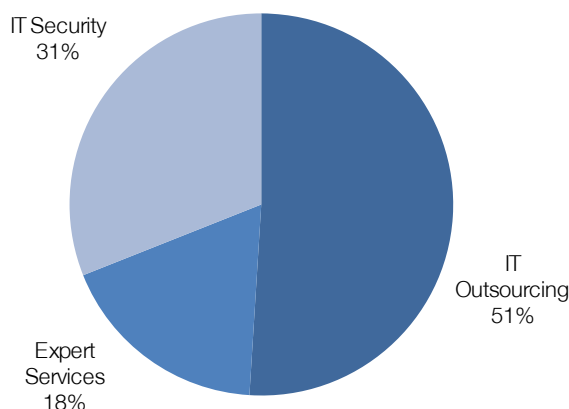
Solutions

- **Outsourcing.** This includes: heterogeneous managed services, 'Software as a Service', next-generation Microsoft platforms, best-of-breed security hosting and Agresso and Cedar hosting.
- **Expert services.** This includes: IT Transformation, Infrastructure Optimisation, Unified Communications, Security as a Service, Application Hosting, Business Process Management and SaaS Enablement.
- **IT Security.** This includes: Secure Accountable Internet Access, Remote Working Enablement, Perimeter Security, E-Mail Productivity and Control, Vulnerability Assessment, Compliance Governance – IS027001 & CLAS, Managed Security Services, Internal Network Protection and Security Reviews.

Background

Netstore was founded in 1996 and floated on the stock exchange in 2000. The company has grown to become a leading provider of selective, or specialist, IT managed services. Further, its security business has grown to be one of the largest providers of IT security services in the UK.

Netstore currently has some 1,400 customers, nearly all of which are based in the UK. It is strong in both private and public sectors. A maiden profit was achieved in 2004.

- **Acquisitions.** Netstore has made acquisitions including QSP in 2001, Netconnect in 2003, Cassium in 2005 and SSS and Intercea in 2006. Earn-out clauses inhibited the swift integration of several of the acquired companies but the new CEO is speeding up the process to take advantage of the scalability offered. In November Netstore closed its Birmingham office which was inherited with the SSS acquisition.
- **Recent fund-raising.** In December the company raised £7m in a share placement to finance the addition of 550 square metres of prime data centre space at the Reading Technology Centre and which is due for completion in July 2008. This will nearly double the group's data centre space to c 1,200 square metres at its Gateshead and Reading centres.

Exhibit 1: Product revenue analysis 2007

Source: Netstore

SaaS strategy and business model

Netstore utilises its knowledge of the SaaS technology and business model to design, build and host SaaS solutions for both end customers and resellers. As it does not develop its own software it is a 'SaaS enabler'. It builds, delivers and hosts complex software solutions utilising software from a range of suppliers. Netstore's value is in understanding and managing complex network architectures at both the enterprise and security level.

A customer has many issues to consider when choosing between a SaaS solution and a traditional solution, including: reliability; correct specification and structure; security; and built for mobility. Therefore the customer often needs to work with an IT services company that is capable of managing complex SaaS solutions.

Netstore absorbs an upfront cost in designing and hosting a SaaS solution as it has to buy the infrastructure. Hence short-term earnings will be 'depressed' by new customer wins. It faces penalties for not delivering. The company is sometimes willing to pay traditional software companies upfront to 'facilitate' a SaaS sale for them. Contracts are long term (three to eight years) and long-term recurring contracts represent approximately 50% of revenues. Outstanding contractually-committed future revenues were up by about 18% to c £39m in the year to 30 June 2007. Netstore offers a variety of payment methods.

Managed services

Netstore has traditionally hosted simple desktop applications, eg Agresso (financials) and Cedar (financials and HR) and the company is increasingly building out a Microsoft (exchange and dynamics) capability. In November Netstore became Microsoft's third SaaS partner in the UK as Microsoft seeks to speed its independent software vendors' transition from an on-premise to a SaaS delivery model as more end users embrace hosted applications. Netstore is now hoping to double the ISVs whom it works with and Microsoft is now its preferred global technology platform – Netstore is one of 15 Microsoft global SaaS incubation partners.

- **Solution.** Netstore's real value is where customers are looking for a complex solution with high connection requirements. Netstore identifies four key reasons to consider its SaaS enablement service: lower total cost of ownership; higher flexibility; better service; and on demand performance management.

- **Revenue model.** Netstore's pricing is flexible, charging by the hour, click, request etc. Contracts are long term.

Security

Netstore is a major reseller of leading security software. The company adds its own design and know-how to build bespoke solutions for customers. While this activity currently operates under a traditional business model there is a major opportunity to shift to a 'Security as a Service' model, which is regarded as analogous to the conventional Software as a Service model. Netstore takes the view that any comprehensive security solution needs to look at every aspect of an organisation's systems, infrastructure and working practices. This holistic and consultative approach enables it to deliver comprehensive solutions. Forty new customers were contracted in H108 with the average contract size rising from £12,500 to £22,700.

Long-term strategy

Prior to the news of the talks with potential bidders, Netstore had been aiming to build sales from £40m to £100m over five years with growth coming two-thirds from organic means and one-third from acquisitions. This would imply organic growth of around 15% per annum. Netstore is looking to acquire customer bases (the plan is to acquire and cross-sell services), IP (ie software solutions – example of business intelligence tool that can detect fraud) and data centre space.

Sensitivities

- Technological risks are relatively low as Netstore does not develop its own software.
- Management risk in implementing the acquisition strategy.
- Economic downturn could reduce customer demand.
- Existing competitor rivalry (eg Attenda) and traditional software company tactics may put pressure on pricing.

Financials and valuation

The December share placement helped turn the financial position from £3.1m net debt at 30 June 2007 to £3.2m net cash at 31 December 2007. We expect the cost of the new data centre space, which is expected to be commissioned shortly after year end, to take the balance sheet back into a modest net debt position.

In the recent interim results management said that trading prospects remained strong and in line with expectations. We also note the company has £20m of tax losses and approximately £20m of annual contractually committed recurring revenues. Hence, with the stock trading on less than 1x revenues and on a single digit PE ratio we see limited downside in the share price while having the potential to generate good returns over the medium term in our view.

Exhibit 2: Product revenue analysis in H1 2007/08 and Edison five-year target

2007/08 H1

Other
53%

Recurring
revenue
(incl
SaaS)
47%

2012

Other
25%

Recurring
revenue
(incl
SaaS)
75%

Source: Edison Investment Research

Management

Exhibit 3: Management

CEO: Graham Kingsmill	Graham joined Netstore in July 2007 from SAP where he held the position of Managing Director, UK and Ireland. Graham's career spans more than two decades in the IT sector: 11 years in senior management within global leaders SAP, as an architect of its channel business and previously at IBM as European Director of its Lotus and Engineering Software business. Graham has a proven record of delivering business performance excellence. He started his career in IT at Norsk Data, before moving to Intergraph and Parametric Technology Corp.
CFO: David Memory	David, aged 48, ACA, joined Netstore in September 2007 from Tie Rack where he was group Finance Director for 12 years. He played a leading role in the privatisation and the sale of the business earlier in 2007. Prior to joining Tie Rack, he was at PricewaterhouseCoopers for 15 years.
Chairman: Paul Barry-Walsh	Paul co-founded Netstore in 1996. He left IBM after nine years to form Safetynet, one of the UK's leading providers of business continuity services, in 1986. In February 1999 he led the management buyout of Safetynet and became Managing Director and majority shareholder. During 2000, Safetynet was sold to Guardian IT. Paul was both Chairman and Chief Executive of Netstore until March 2004.

Source: Netstore

Edison investment research

ServicePower

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	PE (x)	Yield (%)
12/06	11.1	(4.2)	(4.1)	0.0	N/A	N/A
12/07	14.1	(0.6)	(0.5)	0.0	N/A	N/A
12/08	16.7	0.5	0.6	0.0	21.7	N/A
12/09	19.0	1.2	1.3	0.0	10.0	N/A

Note: *PBT and EPS are normalised, excluding goodwill amortisation and exceptional items. **Consensus forecasts.

Investment summary: Evolving SaaS business

ServicePower has introduced a number of SaaS initiatives for its customers and we estimate these activities will generate c 25% of group revenues in FY08. We expect that number to grow sharply as more customers switch to the SaaS option. The group has recently appointed a new CEO, Mark Duffin, who has the task of developing these initiatives along with the related GPS activity.

SaaS business model: Subscription and transaction based

ServicePower recently launched a subscription-based SaaS option to its service chain optimisation solution which enables major consumer electronics and insurance companies to manage the dispatch, logistics, and invoicing of their service network. It also offers a transaction-based SaaS solution for customers who need to outsource their service and repairs to contracted third-party networks. Further ServicePower has started to offer the owners/managers of independent service networks a SaaS solution to manage the scheduling of all their jobs.

Annual results: Moved into profits in the second half

Trading was boosted in H2 by significant H2 contract wins and the business was profitable. Cash balances of £1.5m at year-end have since declined and we believe that a capital raising is a strong possibility in the near term. ServicePower has signed a number of contracts since the year end and has a large pipeline. The new CEO has made changes to establish a more effective sales operation.

Valuation: Potentially very cheap

Clearly management has remaining challenges in building out the business, but based on a similar valuation approach to the one we have used in this report, 10x our FY08 EBIT forecast, would imply a valuation for the potential SaaS revenue stream of c £12m (current group capitalisation of £11.6m). If management can execute even close to our forecasts in future years then the shares look potentially very undervalued. US competitor ClickSoftware (Nasdaq CKSW) has a similar sales profile to ServicePower (small profit on c $50m of sales) but is valued at c $90m.

Price*	13p
Market Cap	£12m

*Priced as at 21 May 2008

Share price graph
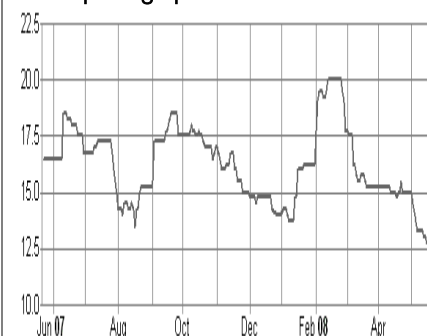
Share details

Code	SVR
Listing	AIM
Sector	Software & Computer Services
Shares in issue	89m

Business

Development, sales and implementation of scheduling software.

Bull

- Huge untapped potential markets.
- Extensive existing client base.
- Heavily developed products.

Bear

- Chequered track record.
- Historically has failed to meet expectations.
- Capital raising likely in the near-term.

SaaS strategy and business model

Workforce optimisation – moving from a traditional licence model

Service chain optimisation is the task of optimising the chain of activities arising from the capture of a service request through to the successful on-site delivery of the required service event.

- **The solution.** Essentially it enables major consumer electronics and insurance companies to manage the dispatch, logistics, and invoicing of their service networks, ie vehicle-based technicians driving between five and 10 pre-booked repair and service jobs in a particular geographic region of the US. The software enables real-time efficient planning of jobs with estimated travelling times, start times, completion times etc. ServicePower's solution is now used daily to schedule over 50,000 mobile field resources at over 100 leading field service and insurance claims companies.

- **The revenue model.** The majority of these companies have historically bought traditional licences with ongoing maintenance. However, ServicePower last year launched a SaaS option and that has been taken up by two major customers so far. Under the SaaS model, ServicePower forgoes the upfront licence and cash (as well as the ongoing maintenance) in return for an annual rental income (typically around a third of the licence value). The company therefore targets a payback breakeven of between three and four years (and like all SaaS models after year four the customer is generating additional profit versus the licence model).

Third-party workforce optimisation – mix of SaaS and labour intensity

ServicePower also offers a solution for customers that do not have their own field technicians but instead outsource all of their service and repairs to contracted third-party networks.

- **Solution.** Similarly to in-house solutions it offers web-based workforce management tools which enable job providers to know the actual individual performing the repair or installation service along with scheduling information. This offering was launched in 2004 and currently ServicePower has over 60 customers taking a SaaS service.

- **Revenue model.** Each job process is charged at c $1 and we estimate that this revenue stream accounts for around £2m. A major part of ServicePower's revenue currently is sourcing independent engineers in areas where customers either do not have their own in-house employee or have details of a third-party contractor. This process has a fairly labour intensive cost base (ie a team in a call centre sourcing new engineers) and is priced at $100 a job (at much lower gross margin) and currently accounts for around £7m of revenues.

Mobile resource management – future major opportunity

Field engineers working for independent service networks receive details of allocated jobs through email or mobile communication. In addition ServicePower has recently started to offer the owners/managers of these independent service networks a SaaS solution to manage the scheduling of all their jobs (ie jobs possibly in addition to those received through the ServicePower network) and additional productivity enhancing tools such as route optimisation and turn-by-turn directions. Currently this offering is in development with expected initial launch in FY08. However, ServicePower already has the details of c 100,000 field engineers in its database (ie through

despatching them jobs from its current consumer electronics and insurance customers) and in total we estimate there are probably c 200,000 independent service networks in the US (ie independent fleets of contractors with 20 or more vans).

Opportunity to up-sell GPS capability

Currently the scheduling data within ServicePower's software is based upon information provided by the service engineers, ie where they are, what time they completed a job etc. However, in the last 12 months ServicePower has developed a hardware solution that enables the major customers and the ISN owners to 'bolt-on' a device (currently available through a partnership with Circuit City) to their vans that can track their position in real-time. This enables the schedule managers to cross check actual van positions against input scheduling information improving efficiency of the schedule and ensuring better network management. ServicePower offers a unit price option (c $500 per unit) or a SaaS solution (c $150 a year). Currently the take-up of the GPS option is relatively small (around four job providers and c 15 ISNs covering around 250 vans) but clearly there is a major opportunity to up-sell to existing customers as well as to the broader solution sale. We would expect ServicePower to announce major partners over the next 12 months to assist in the national roll-out of this service. Early in 2008 ServicePower acquired certain assets of KonaWare for $155,000 to give the business an in-house GPS solution.

Company description: Field service optimisation

Solutions

ServicePower provides software and services designed to optimise field service business. These products and services support mobile field organisations comprising any or all of full-time employees, contractors, and networks of third parties. ServicePower capabilities include:

- Real-time workforce management, planning, and analytics.
- Schedule and route optimisation.
- Wireless dispatch, status update and GPS-based location tracking.
- Third-party service network management and recruitment.
- Warranty claims processing.

Background

ServicePower originally dates back to 1988 when a jointly funded European Development project (ESPRIT) between Bull, Siemens Nixdorf and ICL produced a toolkit based on PROLOG. In 1996 the Senior Management Team at ICL saw the opportunity to buy out the Artificial Intelligence Technology being developed at the time and form ServicePower Business Solutions Limited. The focus of the company would be to provide a packaged solution for the Field Service industry. In 2004 ServicePower acquired certain assets of KeyPrestige, Inc., a best in class web-based warranty chain management solution for manufacturers, third-party administrators, parts distributors and authorised service providers. By 2005 the company made progress in its strategy to move from being purely a software provider to a provider of computer services. This resulted in the launch of the Field Service in a Box mobile phone solution. The application enables technicians to receive job details, driving directions and GPS tracking via a mobile phone. Sprint Nextel is its partner for this solution and is managing all sales and marketing activities across the US.

Sensitivities

- Economic downturn could reduce customer volumes but in practice service/repair is relatively recession resistant.
- Existing competitors (privately held company ServiceBench and Nasdaq quoted ClickSoftware) may put pressure on pricing.
- Consolidation among key customers could reduce revenues as merged companies seek cost reductions by reducing the number of their systems.
- The company has a number of execution risks as it looks to find key partners in building out its SaaS strategy.
- In our view an equity offering is likely in the near-term to strengthen the balance sheet. Further, ServicePower may be expected to have renewed hunger for capital in the medium term given its ambitions and the scale of its potential markets.

Financials and valuation

Currently SaaS revenues are running at c £3.5m out of group revenues of c £17m. As we have discussed above, helping major customers find contractors accounts for around £7m and the balance is traditional software, maintenance and service revenues. The group is forecast to make just under £1m of EBITDA reflecting the mixed business models and the ongoing investment in R&D (c £1m) and sales and marketing (c £2m). Clearly the key overtime will be growing SaaS sales, helping to improve overall group revenue visibility as well as enhance margins.

Exhibit 2 provides an illustration of the future potential shape of SaaS revenues. This includes rental of the software solution as well the 'up-sell' of the GPS option. We also make an assumption of the blended gross margins for the SaaS revenues as well as an assumption on overheads. Clearly management has remaining challenges in building out the business but based on a similar valuation approach to the one we have used in this report, 10x our FY08 EBIT forecast, would imply a valuation for the potential SaaS revenue stream of c £12m (current group capitalisation of £13.4m). If management can execute even close to our forecasts in future years then the shares look potentially very undervalued. US competitor ClickSoftware (Nasdaq CKSW) has a similar sales profile to ServicePower (small profit on c $50m of sales) but is valued at c $86m.

Exhibit 1: Product revenue analysis in 2008 and Edison five-year target
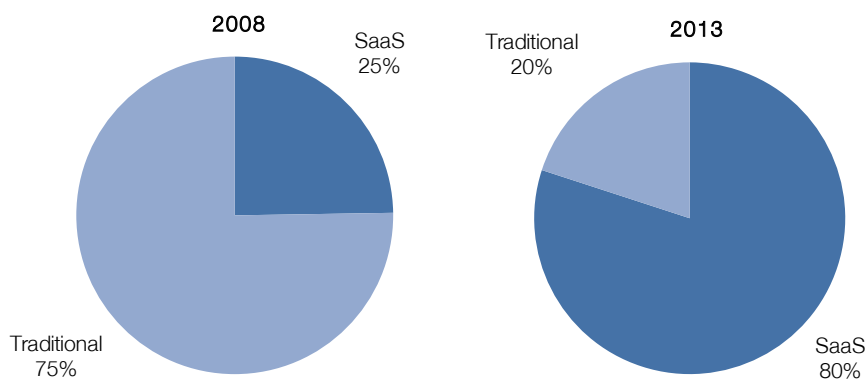
Source: Edison Investment Research

Exhibit 2: ServicePower SaaS revenue forecasts

Workforce Optimisation	2008	2009	2010	2011	2012
Customer Additions	4	5	6	7	8
Total Customers	6	11	17	24	32
Optimisation revenue per customer $'000s	400	400	400	400	400
GPS hardware revenue per customer $'000s	50	60	70	80	90
Total Revenues $'000s	2,700	5,060	7,990	11,520	15,680
Third party workforce optimisation					
Customer Additions	12	13	14	15	16
Total Customers	72	85	99	114	130
Optimisation revenue per customer $'000s	50	50	50	50	50
GPS hardware revenue per customer $'000s	25	35	45	55	65
Total Revenues $'000s	5,400	7,225	9,405	11,970	14,950
Mobile resource management					
Number of target ISNs	200,000	200,000	200,000	200,000	200,000
Nummber of ISN customers	0	50	125	200	275
Number of ISN customers	0	50	175	375	650
Trucks per customer	0	25	25	25	25
Market Share	0	0	0	0	0
Optimisation revenue per customer $'000s	0	6	6	6	6
GPS hardware revenue per customer $'000s	0	5	5	5	5
Total Revenues $'000s	0	525	1,838	3,938	6,825
Total SaaS revenues $'000s	8,100	12,810	19,233	27,428	37,455
Total SaaS revenues £'000s	*4,133*	*6,536*	*9,813*	*13,994*	*19,110*
Blended gross margin	1	1	1	1	1
Gross Profit $'000s	6,480	10,248	15,386	21,942	29,964
Operating Costs $'000s	4,000	4,600	5,290	6,084	6,996
EBIT $'000s	2,480	5,648	10,096	15,859	22,968
EBIT £m	*1,265*	*2,882*	*5,151*	*8,091*	*11,718*

Source: Edison Investment Research

Management

Exhibit 3: Management

CEO: Mark Duffin	Mark joined ServicePower as Chief Executive Officer in November 2007 from Rentokil Initial where he was a Director. Previously Mark built a start-up business which he sold to Rentokil and then integrated it with Rentokil's other businesses. Mark is a qualified engineer with an MBA.
CFO	The company is in the process of recruiting a new Finance Director.
Chairman: Barry Welck	Barry was a founding member of ServicePower Business Solutions Limited (SBS), the group's main trading company. He is also Chairman of STILO, an AIM-listed company, and is on the board of three other companies at which he has been an early stage investor. Barry has his own family interests being managing director of Bow Finance Ltd.

Source: ServicePower

StatPro

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	PE (x)	Yield (%)
12/06	14.6	2.8	6.3	1.0	15.6	1.0
12/07	24.1	5.0	7.9	1.5	12.4	1.5
12/08e**	27.3	6.1	8.6	2.0	11.4	2.0
12/09e**	31.7	7.9	10.3	2.5	9.5	2.6

Note: *PBT and EPS are normalised, excluding goodwill amortisation and exceptional items.
**Consensus forecasts.

Investment summary: Analytics consolidator

StatPro has widened its product offerings for the global asset management industry in recent years via a series of acquisitions. The growth strategy involves cross-selling products and offering professional services to the acquired customers. We think this strategy will help drive EPS up by a further 15%+ in FY09. The traditional business model involves long-term contracts hence the company has a high level of recurring revenues and a low churn. In spite of this the shares trade on a single digit PE.

SaaS business model: Mass market web-native product

As with SaaS, StatPro's business model has always been a rental model, largely on-premise but with a growing hosted service. StatPro now expects to launch a pure SaaS product in early 2009. The plan is to utilise the SaaS model's scalability to offer a light product to a much broader client base. This will involve targeting hedge funds and pension funds as well as individual fund managers within asset management companies. StatPro already offers 'Data as a Service' for a limited set of data, which the company intends to expand; in conjunction with the SaaS product it will be a complete offering. Fund managers will be able to add in their portfolios, pick up the data and present the information without any need for specialist support.

Annual results and recent acquisition

In March StatPro announced a solid set of annual results with underlying revenues up 22% and recurring revenues 17% higher at £20.3m. Adjusted operating margin expanded by more than 5% to 25%. In February StatPro bought Performa for £6.5m net. This deal is a continuation of the strategy to drive growth through acquisition and subsequently cross-selling, and it lifts StatPro's recurring revenue base to £22m.

Forecasts and valuation: Offers both value and growth

StatPro has established strong growth trends in recent years. In our view the proposed SaaS product has the potential to drive earnings forward significantly from FY10 given the much wider potential market for the product. Based on consensus forecasts the shares trade on a FY09 PE of just 9.5x. We think this is too low given management's track record and the company's growth prospects.

Price*	98p
Market Cap	£53m

*Priced as at 21 May 2008

Share price graph
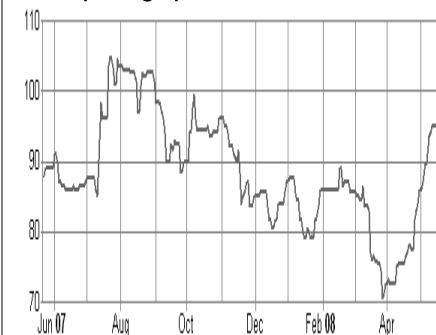
Share details

Code	SOG
Listing	AIM
Sector	Software & Computer Services
Shares in issue	54.52m

Business

StatPro provides portfolio analytics solutions for the global asset management industry.

Bull

- Proven growth strategy.
- SaaS might add to impetus.
- Modest valuation.

Bear

- Sensitive to financial market slowdown.
- Competitors might develop better products.
- Implementation risk in acquisition strategy.

SaaS strategy and business model

StatPro expects to launch a SaaS product in early 2009. The strategy is to utilise the SaaS model's scalability to offer a light version of the product to a much broader client base. The plan involves:

- **Targeting fund managers themselves,** rather than expert users, which typically use StatPro's products to analyse asset management companies' funds.
- **Customising a light product** from StatPro's existing IP range of analytical tools. The goal is to keep it very simple so fund managers can add in their own portfolios, pick up the data and present the information without any need for specialist support. StatPro is currently trialling 'Data as a Service' for a limited set of data, which it intends to expand so that in conjunction with the SaaS product it will be a complete offering.
- **Moving to a multi-tenant architecture** for scalability and to satisfy US SAS 70 reporting rules for some customers in North America. StatPro will probably look to partner with a managed service company for connectivity and hosting.
- **Short-term contracts.**
- **Lower price level,** charging by the portfolio (eg £2,000 per portfolio per year) or alternatively on a data consumption basis.
- Further out, StatPro might consider launching a SaaS product for third-party developers on the basis of revenue share.

SaaS positioning

Strategically the SaaS model could help StatPro to:

- Significantly broaden its customer base by targeting smaller clients such as hedge funds.
- Offer a route for customers to trial a product before taking on the full version.
- Increase its global profile and enable the company to further expand its product offering.
- Give larger asset management companies an alternative approach to meet their regulatory and customer requirements.
- Prepare for the potential switch to SaaS as the dominant delivery method in the longer-term in this industry.

Company description: Portfolio analytics solutions

Solutions

StatPro provides portfolio analytics solutions for the global asset management industry. Software solutions are offered for:

- **Risk management.** StatPro Risk Management provides a world-class risk model covering all asset classes and markets, available in a web-based technology.
- **Fixed income analysis.** StatPro Fixed Income deconstructs returns, attribution effects and bond risks using a large range of segmentations and effects.
- **Performance measurement and attribution analysis.** StatPro Performance & Attribution enhances user experience, while significantly reducing the cost of analysing portfolio performance.

- **Portfolio management.** StatPro Portfolio Management is a fully-featured, comprehensive portfolio management solution offering analytics, accounting, and reporting functionality as standard.
- **Portfolio compliance.** StatPro Portfolio Compliance is a single, transparent and consistent system that meets all investment compliance needs and reduces the cost of embedding compliance throughout a firm.
- **GIPS compliance.** StatPro Composites enables full control over the GIPS audit and verification process.
- **Reporting.** StatPro Enterprise Reporting is a sophisticated, flexible rules-based reporting solution for the investment community. StatVaR™ provides an efficient, inexpensive reporting service to ensure compliance with UCITS III risk regulations in every country in Europe.
- **OTC pricing service.** As a result of the 2003 risk acquisition StatPro inherited a range of pricing libraries and the company is currently developing a service based on the libraries to price complex derivatives for banks.

StatPro offers a range of services to support its client base from project management and consulting services to training and bespoke development. It also provides the data. Hence StatPro is able to offer a full service to the asset management industry.

Background

StatPro was founded in 1994 by Justin Wheatley to develop portfolio analysis software systems. It was floated on the London Stock Exchange in May 2000 raising £5.5m, and in June 2003 StatPro's listing was transferred to AIM.

The company has made a series of acquisitions to extend its offerings, buying a performance product in 2000, a fixed income attribution product in 2002 and a risk management product in 2003. In 2004 it acquired SiSoft to develop Composites Manager and in 2005 it bought Delve for enterprise reporting. In 2006 StatPro acquired ALPHAI in Australia, Kizen for compliance solutions and FRI for its data solutions and portfolio management system. In 2007 it bought Initram for bond data solutions and in 2008 it has purchased Performa for compliance solutions (main drivers GIPS and MiFID).

Traditional strategy and business model

StatPro currently operates a subscription-based business model for its high-value solutions and this is backed by a range of service offerings. Further it offers a hosted solution, so the SaaS concept appears a natural fit for StatPro. Key points:

- **Rental model.** There have been no traditional licensing or maintenance fees. The company charges customers a year in advance and hence it has a high level of deferred income (£9m) on its balance sheet.
- **Installed on users' own servers or hosted.** The company has offered a single-tenant hosted service since 2002.
- **Targeted at specialists.** StatPro products are targeted at experts such as performance analysts and risk managers.
- **Long-term contracts.** Due to the high 15% cancellation rate in the 2002 bear market StatPro increased the contract terms to three years (with three months notice). Churn

- since 2002 has been around 5% a year. Currently some 71% of contracts have more than a year left and the software is a lot more 'embedded' in customer processes than it was in 2002. Hence revenues are 'stickier' and the company feels fairly well insulated from the recent credit crisis.
- **High priced and long sales process.** Customers need a dedicated expert (c £50k), software (£120k a year) and hosting (£30k), ie a £200k a year investment. For compliance reasons they require multiple independent data sources. The sales process takes six to 12 months.

Data is largely purchased from external suppliers and extends across some 500k instruments. However, through the recent acquisition of FRI, StatPro now collects its own pricing information on Canadian and US bonds. This is significant as the company has several large Canadian clients and it can offer them bespoke data such as pricing at more liquid times of the trading day as a preference to end-of-day data. Data buy-in is StatPro's main payaway and hence gross margins are high at around 85%.

Growth is achieved by cross-selling products to customers – hence the acquisition strategy – and providing high levels of service. The company channels new product acquisitions through its existing sales network of 12 offices across the globe. StatPro has around 240 customers taking an average of 1.9 products; the top 30 customers take on average 4.5 products each and generate half of total revenues.

The business generates £26m run-rate revenues of which £22m is contracted revenue and £4m professional services with high visibility. We estimate the main operating costs are Research & Development (£3m) and Sales & Marketing (£2m).

Exhibit 1: Recurring revenue by product/service 2007
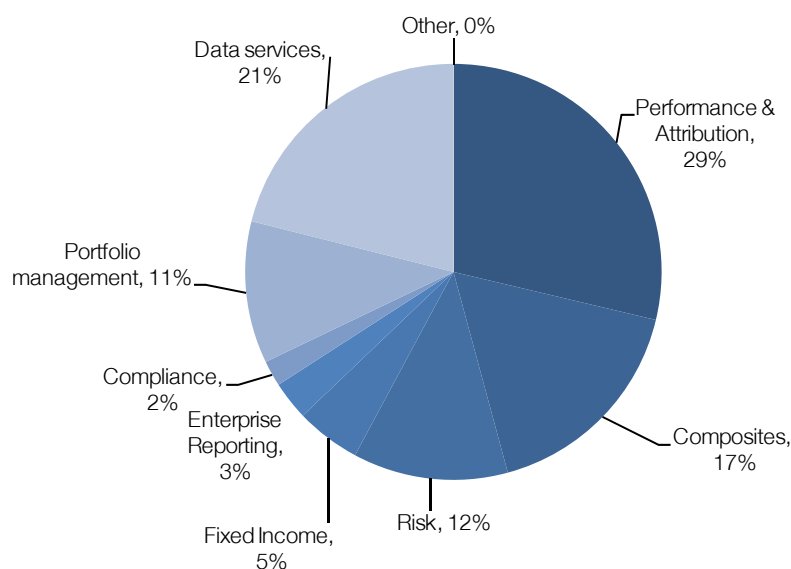
Source: StatPro

Sensitivities

- A financial market downturn could increase bad debtors and/or result in customer losses, though churn is tempered by the long-term contracts.
- Existing competitors might develop superior products.
- Large software companies might enter the space by offering a more general solution which could compete with the SaaS offering.
- Some customers might trade down to the SaaS product.

Financials and valuation

StatPro estimates its potential client base at c 5,000 asset management organisations globally of which 220 are presently StatPro clients. However, there are a substantially larger number of individual portfolios across the globe (some 200,000 pension funds, 10,000+ hedge funds and countless private wealth portfolios). Assuming a market of 2m potential portfolios, a price of £2,000 per portfolio and say just 0.5% of portfolios take up the offer without cannibalising any of StatPro's existing client base, then this could potentially generate £20m of incremental revenues.

StatPro's costs include developing the product from its existing IP and testing and integrating the data. We estimate this investment at around £2m–3m. On top of that there will be marketing and hosting costs. In our view the SaaS model provides StatPro with an opportunity to substantially boost its revenue base at a relatively modest cost.

Exhibit 2: Product revenue analysis in 2007 and Edison five-year target

Source: Edison Investment Research

Management

Exhibit 3: Management

CEO: Justin Wheatley	Justin founded StatPro in 1994 to develop portfolio analysis software systems. He began his career in the financial services industry in 1988 at Micropal, selling performance measurement software to fund managers in the UK. In 1991, he founded an agency in Switzerland to distribute Micropal products and in 1993 he wrote the first version of TAP.
CFO: Andrew Fabian	Andrew was appointed Finance Director in 2000. He previously was group Financial Controller at William Baird PLC. Andrew is a chartered accountant and qualified corporate treasurer.
Chairman: Carl Bacon	Carl was appointed Chairman in 2000. He previously was Director of Risk Control and Performance at Foreign & Colonial Investment Management Limited. Before that he was Vice President – Head of Performance at JP Morgan Investment Management Inc.

Source: StatPro