Sector research

Edison investment research

Technology sector – Here come the bids?

In this report we look across the valuation wasteland of the UK mid- and small-cap technology sector to try and identify those companies where multiples have disconnected from fundamentals. We have no expectation that the demand outlook for many companies will improve over the next 12 months. Nevertheless, there are a number of cash generative companies well-positioned to weather the storm, and we do believe current valuations will increasingly drive corporate activity, led by frustrated management teams, private equity investors and overseas competitors.

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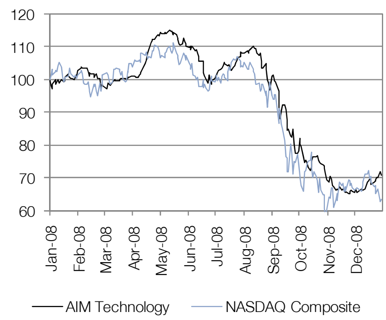
AIM Tech vs NASDAQ Composite



Depressing 2008

Following the slide in share prices witnessed during 2008, UK technology indices are now trading at similar levels to the 2003 low point reached following the burst of the TMT bubble. The weakening economic backdrop is clearly weighing on the trading outlook for UK technology companies; demand is impacted by rising unemployment, falling house prices and a lack of confidence, while supply is constrained by the impact of the financial sector malaise and credit squeeze.

Outlook remains poor but valuations are interesting

At a tech sector level, the implications of high operational gearing and in some cases stretched balance sheets will compound the economic outlook. Nonetheless for well-funded companies – particularly those with business critical applications and regulatory drivers – valuations look disconnected from fundamentals.

Screening the UK sector

Roughly a third of the companies we identify are trading at less than 0.4x revenues, a third are trading at less than 3.5x EBITDA and nearly half of the stocks are trading below book value. We believe M&A activity across the sector will accelerate and we particularly highlight a list of 30 stocks – including Wolfson and Morse – with a mix of resilient business models, valuable IP and in most cases net cash. Although the immediate earnings outlook is still very uncertain and there are no obvious short-term catalysts, these are the types of businesses where some form of corporate activity could accelerate the closing of the valuation gap.

Investment summary: Here come the bids?

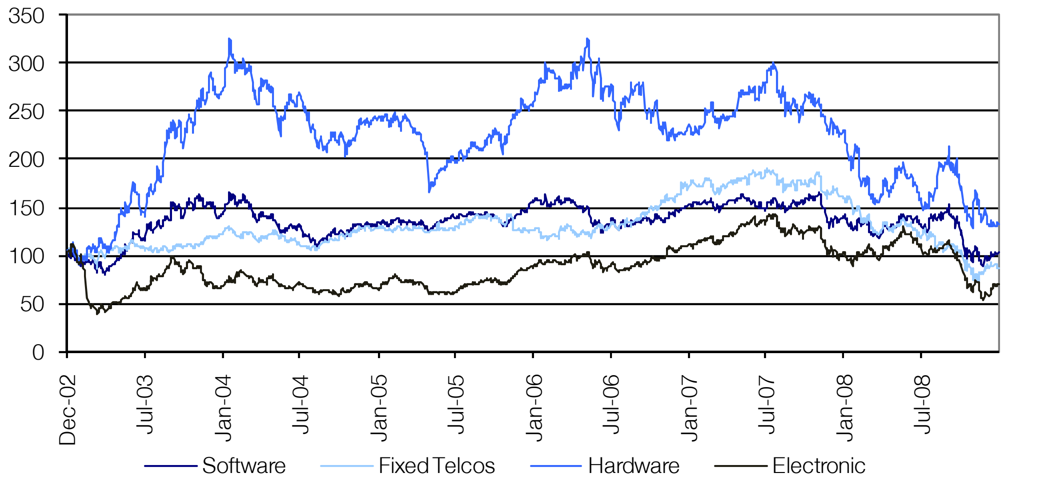
Watching value: Expect an acceleration in corporate activity

The purpose of this report is to screen the stocks in our watchlist comprising c 100 UK technology companies with a market cap range between £10m and £200m. Our rationale is to pick out those companies with solid looking business models but trading on anomalous valuations. In our view a number of factors – MBOs, private equity investors looking to consolidate smaller deals, attractions to overseas competitors of weaker sterling etc – will drive an acceleration in corporate activity.

Sector valuation: Trading at lows

UK technology indices are now trading at similar levels to the 2003 low point reached in the wake of the burst of the TMT bubble. Our stock screening process later in this report highlights that roughly a third of the companies we analysed are trading at less than 0.4x revenues, a third are trading at less than 3.5x EBITDA and nearly a half of the stocks are trading at less than book value (three quarters have a net cash position).

Exhibit 1: Technology sector indices rebased over the last six years



Source: Bloomberg

UK stocks to watch: Focus on cash generation and balance sheets

In the table below we highlight those companies that our screening reveals to be the 'cheapest' in the sector. Clearly, there will be differing issues and risks for each stock, but in general we believe well-run businesses, with in many cases valuable IP, strong balance sheets and cash generative business models, will not languish at these valuations for long without an acceleration in corporate activity.

Exhibit 2: Stock screen ranking

		EV/Sales	EV/EBITDA	Eq MV/SHF	Net cash/MV	Total score
1	Morse PLC	99	100	100	84	383
2	Psion Plc	92	92	95	93	372
3	Wolfson Microelectronics PLC	94	99	79	99	371
4	Business Systems Group Holdings	98	98	50	98	344
5	Intec Telecom Systems PLC	81	89	85	86	341
6	FDM Group PLC	91	97	44	90	322
7	Gladstone Plc	64	90	78	88	320
8	Innovation Group PLC	85	88	90	51	314
9	Electronic Data Processing PLC	77	65	71	96	309
10	Redknee Solutions Inc	100	20	89	100	309
11	Visonic Ltd	87	82	87	53	309

Source: Bloomberg consensus forecasts and Edison estimates

The sector has correctly been massively de-rated in 2008

Fundamental demand picture is worsening

The weakening economic backdrop is clearly weighing on the trading outlook for UK technology companies. Rising unemployment, falling house prices and a lack of confidence is translating into lower levels of consumer spending in many areas including those directly served by the tech sector. In addition, the financial sector malaise has created a tighter credit environment that impacts corporate expenditure on segments within the software and IT services sector. Looking into this year these factors are unlikely to change in the short term and governments across the international landscape are stepping up their borrowing plans to counter weak tax revenues, as well as to fund fiscal stimulus plans to bail out traditional industry sectors – rising public sector borrowing has historically had the effect of 'crowding out' the private sector.

Sector landscape: High operational leverage and late cycle

Many companies in the sector have quickly seen the impact of the economic backdrop on their revenues. However, there are several software companies in particular where management and investors believe the 'business critical' or regulatory driven nature of their activities is likely to make them more resilient in the face of recession. In our experience these companies do have the most economically robust customer propositions but in reality in a prolonged downturn they become 'late cycle' in feeling the impact, ie customers will prioritise corporate spend on their solutions but when the budget is chopped for the second and third times most technology spend falls out.

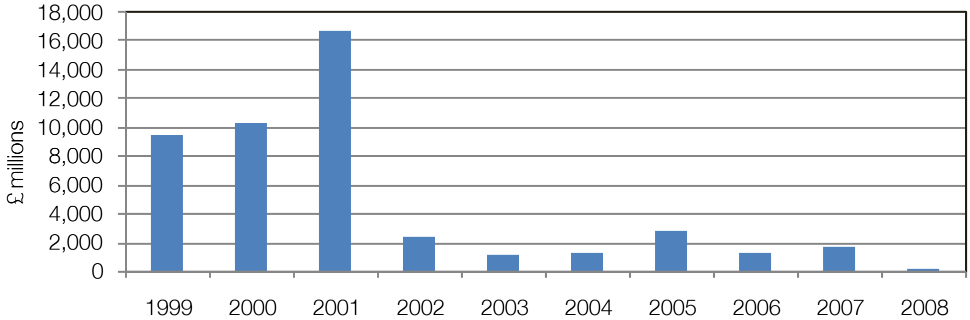
The sector: High operational leverage

The technology sector has high operational gearing – software companies typically have very high gross margins and an underlying fixed R&D cost requirement. Meanwhile 'hardware' companies often have to manage thinner margins, higher overheads and in some cases fixed manufacturing cost bases. This means that slowing revenue growth has a multiplier impact on both earnings and cash flows across the sector.

Balance sheets are getting stretched

The concern among investors that many companies in the sector are facing major cash flow issues has been a major feature of this downturn. Not only are cash flow negative businesses facing the normal re-financing challenge at this point in the cycle, but investors are unsure about the ability of indebted companies to re-negotiate existing debt facilities.

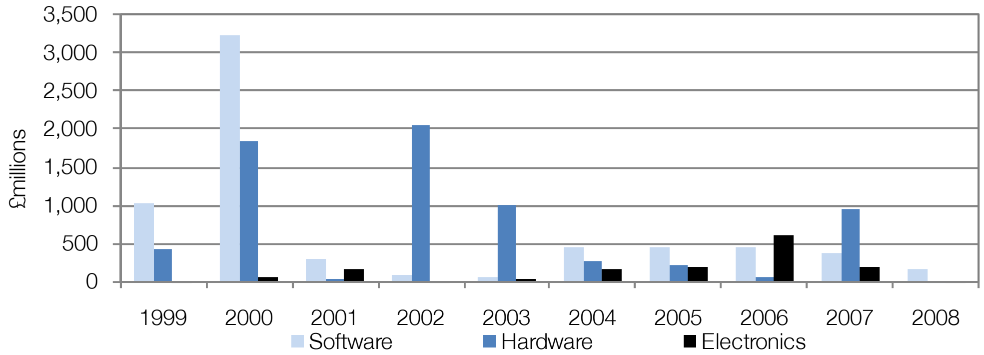
Exhibit 3: LSE/AIM equity issuance – technology and telecoms aggregate



Source: London Stock Exchange

This has been made worse by the equity funding environment. Equity issuance in the sector has remained weak for several years and was especially subdued in 2008. There were very few large cash raisings last year and within the companies we monitor only a handful of smaller secondary raisings – including Advanced Computer Software, Clarity Commerce, Infonic, Sarantel, ServicePower, StatPro, Synchronica and Vialogy.

Exhibit 4: LSE/AIM equity issuance by technology sub-sector



Source: London Stock Exchange

Offsetting factors this cycle

Evolving business models

The UK technology sector has evolved through a revolutionary period of advancement to emerge with a spread of industries across a very wide spectrum ranging from software developers to chipmakers/designers, hardware manufacturers and telecoms service providers. In our view, during this cycle the business models of the mid- and small-cap sector companies are in significantly better shape than previously. In 2000/2001 many companies were looking to simply fund concepts and design and development. Those companies that survived have enjoyed a fairly stable five-year period where technologies and business have often matured significantly.

Today even small technology companies can operate effectively on a global basis, many have been able to outsource more non-core processes (especially manufacturing) and even R&D costs have been reduced with investment in highly skilled work forces in countries in Eastern Europe, India, etc. Business models have developed most significantly in the software sector, where rapid improvements in the internet and related technologies have enabled dramatic changes. In support and maintenance, for example, this can in many cases be handled remotely without the need for high overheads and international office networks. In addition, in this cycle many players are also positioned to offer 'software as a service' (SaaS) or 'pay-as-you-go' solutions that have far more compelling pay-back periods for corporate customers.

Obvious large scale examples include the emergence of innovative business models such as Salesforce.com and Google to challenge the traditional software vendors and channels to market. Within our coverage list alone there are several examples that have been able to 're-engineer' their businesses post the technology bubble – both GB Group and FFastFill have been able to build the platforms for scalable, pay-as-you-go, SaaS offerings, while Workplace Systems, for example, has been able to dispose of non-core businesses to focus on workforce management software (again with a very clear pay-back for customers looking to reduce costs in a tougher environment).

Economic factors

While the economic backdrop is clearly deteriorating, steep falls in interest rates and oil prices should provide a stimulus to Western economies while the slump in sterling should help UK exporters. However, for a sustained rally, private sector investment needs to strengthen and at this stage in the cycle there is little optimism in this respect.

We have generated simple multiple regression models of the sector's indices using data going back to the end of 1999. The beta coefficients generated provide a useful gauge of the sector's sensitivities to major market factors. Not surprisingly, falling interest rates (one indicator of slowing economic growth) are negatively correlated with the sub-sectors. However, the slumps in both the oil price and sterling are positive for the sector.

Exhibit 5: Econometric model of technology sector indices

	3-mth rate	£-TWI	Oil price	R-squared
Software	1.14	(0.64)	(0.79)	75%
Telecom-fixed	1.18	(0.52)	(0.64)	78%
Hardware	1.19	(0.71)	(0.84)	82%
Electronics	1.11	(0.60)	(0.78)	73%

Source: Data from Bloomberg, Bank of England

Valuation will drive an acceleration in corporate activity

While software sector M&A was relatively active in 2008, deal flow was subdued in the other technology sub-sectors. In Exhibit 6 we have identified 23 technology sector takeovers of LSE and AIM companies that were announced during 2008. The value of the deals totals nearly £1.5bn and this was substantially paid for in cash. The average takeover premium was roughly 60%.

Exhibit 6: Takeovers on the LSE and AIM announced during 2008

Target	Announced	Business	Listing	Value (£m)	Premium (%)	Acquiror
Superscape	23-Jan	Mobile gaming technology	LSE	18	52	Glu Mobile
CODA	31-Jan	Financial management software	AIM	158	20	Unit 4 Agresso
Chelford	06-Mar	Provider of enterprise solutions	AIM	16	37	Marlin Equity Partners
Computerland	11-Mar	IT service provider	AIM	29	31	Capita
Civica	28-Mar	Public sector software	AIM	190	34	3i & mgmt
Zetex	04-Apr	Makes discrete and analog semiconductor solutions	LSE	89	96	Diodes
Horizon Tech	18-Apr	Technical integrator and distributor of IT products	LSE	€103m	154	Avnet
Gilat Satcom	06-May	International broadband satellite service provider	AIM	2	7	Satcom Systems
Mediasurface	16-May	Software to enable the operation of websites	AIM	18	150	Alterian
Cyberview	04-Jun	Downloadable server-based gaming technology	AIM	43	60	Intl Game Technology
IBS Opensystems	05-Jun	Public sector software	AIM	78	52	Capita
Flomerics	01-Jul	"virtual prototyping" and computer-aided engineering	AIM	30	37	Mentor
Financial Obects	03-Jul	Software to banking, wealth mgmt and energy sectors	AIM	27	90	Temenos
Vigilant	08-Jul	Digital video/audio solutions for CCTV surveillance	AIM	1	126	BATM
SSP	23-Jul	IT systems and services to the general insurance sector	AIM	162	19	Hellman & Friedman
Netstore	12-Aug	Outsourced IT/ data centres	AIM	58	78	2e2
Axismobile	18-Aug	Mobile email vendor for the mass market	AIM	4	N/A	Synchronica
Axon	26-Sep	SAP software consultancy	LSE	441	43	HCL Technologies
Abacus	10-Oct	Electronic component distributor	LSE	42	139	Avnet
Macro4	05-Dec	Document mgmt and mainframe computer softwares	LSE	28	39	UNICOM Systems
Fayrewood	10-Dec	Computer peripherals and hardware distributor	AIM	29	10	Letchworth
Ascribe	17-Dec	Software solutions for the UK and intl health markets	AIM	33	17	ECI & management
Dmatek	29-Dec	Provider of remote people monitoring technologies	LSE	53	82	Francisco Partners

Source: Regulatory news, companies

We expect an acceleration in 2009

We expect M&A deals to pick up in the sector in 2009, as bidders seek to pre-empt an economic recovery and buy businesses at low valuations. We have identified the following drivers of takeover activity:

MBOs. We expect many bewildered management teams to look to cash-out disillusioned public equity shareholders. In many cases management teams have built resilient, cash generative businesses but are 'bundled' with the same 'financially risky' valuation as the rest of the sector.

Private equity. We believe there is private equity money to support acquisitions. In addition, in our meetings with industry players in this sector, it is clear that in an environment without debt leverage, many private equity investors are focused on 'rolling-up' smaller companies.

Synergy driven M&A. We are aware of a large number of small-cap technology stocks that have similar business models and operate in the same vertical markets. Given the disconnection of valuations from fundamentals, agreeing valuations is going to be very challenging. Nevertheless, there are already many discussions going on between these companies. In addition, we would expect larger shareholders to become more active in encouraging mergers among their investee companies, ie they would rather provide new funding to a merged and re-focused £40m company than two similar £20m companies.

Exchange rates. The sharp fall in sterling makes UK-quoted businesses significantly cheaper for foreign based acquirers. The bid for Gladstone by Canadian software company Constellation provides an early example.

Interest rates. In our view credit is available albeit at significantly more expensive levels than it has been historically. A fall in LIBOR rates and gradually tightening spreads in the wake of recent sharp interest rate cuts could drive further deal activity. Many companies still have sufficiently strong banking relationships to raise further debt and the number of 'distressed' targets will increase. In addition, most companies in the sector have net cash positions – indeed some have substantial cash piles.

Screening the sector

We have constructed a stock screen across a range of UK listed technology companies. We began by screening out both the largest and the very smallest stocks to focus on companies with market capitalisations between £10-200m. The screening process was carried out across software, hardware and several electronics stocks and we began the process with just under 100 companies.

We have conducted two screens relating to P&L-based measures and two relating to the balance sheet – ratio of enterprise value to revenues, enterprise value to EBITDA, equity market value to stated shareholders funds and net cash (debt) to market value.

In Exhibit 7, we show the 30 highest ranking companies in each of the four categories. We can see the market is scattered with lowly valued companies, which reflects the weak economic environment. The cheapest 30 in the first category all trade at below 0.4x revenues while in the second category the cheapest 30 all trade at less than 3.5x EBITDA. Further, many companies are trading at substantial discounts to book value and most have net cash positions, often sizeable. A few companies are even trading at less than, or close to, net cash – something that is very rare, although we also witnessed this in valuations during the 2003 technology sector rout.

We emphasise that this screening process is more of an art than a science. We highlight the following factors that could have significant bearing on the result of the screen process: accounting treatments, corporate/capital structures, forecasting methodologies, balance sheet dates, a company's maturity profile, recent acquisitions and disposals and currency fluctuations. Tax rates and investment levels are not considered.

Exhibit 7: Stock screen

Enterprise value to sales		Enterprise value to EBITDA		Market value to SHF		Net cash to market value	
Redknee Solutions Inc	0.0	Morse PLC	0.4	Morse PLC	17%	Redknee Solutions Inc	107%
Morse PLC	0.0	Wolfson Microelectronics PLC	0.7	Redstone PLC	23%	Wolfson Microelectronics PLC	82%
Business Systems Group Holdir	0.1	Business Systems Group Holdir	1.2	TT electronics PLC	24%	Business Systems Group Holdir	81%
DataTec Ltd	0.1	FDM Group PLC	1.4	Eidos PLC	27%	ARC International PLC	81%
Volex Group Plc	0.1	Bond International Software PL(	1.9	Raymarine PLC	33%	Electronic Data Processing PLC	78%
Computacenter PLC	0.1	Sepura Ltd	2.0	Psion Plc	39%	CryptoLogic Ltd	65%
Wolfson Microelectronics PLC	0.1	IDOX PLC	2.0	DataTec Ltd	43%	Amino Technologies PLC	65%
Vyke Communications PLC	0.1	Vislink PLC	2.1	Bond International Software PL(	43%	Psion Plc	59%
Psion Plc	0.1	Psion Plc	2.1	Volex Group Plc	47%	Brady PLC	52%
FDM Group PLC	0.1	Globo PLC	2.3	Vislink PLC	47%	Batm Advanced Communicatior	52%
Pace PLC	0.2	Gladstone Plc	2.3	Innovation Group PLC	48%	FDM Group PLC	52%
Redstone PLC	0.2	Intec Telecom Systems PLC	2.4	Redknee Solutions Inc	51%	Vyke Communications PLC	52%
ARC International PLC	0.2	Innovation Group PLC	2.4	Telit Communications PLC	51%	Gladstone Plc	49%
Visonic Ltd	0.2	Batm Advanced Communicatior	2.4	Visonic Ltd	52%	Alphameric Plc	49%
TT electronics PLC	0.2	TT electronics PLC	2.6	Trafficmaster PLC	53%	Intec Telecom Systems PLC	49%
Innovation Group PLC	0.2	Dealogic Holdings PLC	2.7	Intec Telecom Systems PLC	54%	Norkom Group PLC	47%
Vislink PLC	0.3	Pace PLC	2.7	ARC International PLC	55%	Morse PLC	45%
Amino Technologies PLC	0.3	Eservglobal Ltd	2.8	Microgen Plc	58%	iomart Group Plc	45%
Oxford Instruments Plc	0.3	Visonic Ltd	2.8	Artilium PLC	59%	Dealogic Holdings PLC	43%
Intec Telecom Systems PLC	0.3	Volex Group Plc	2.8	Vyke Communications PLC	59%	System C Healthcare PLC	42%
CryptoLogic Ltd	0.3	Anite PLC	2.8	CryptoLogic Ltd	62%	Vialogy PLC	42%
Eidos PLC	0.3	DataTec Ltd	2.9	Wolfson Microelectronics PLC	64%	MedicSight PLC	41%
Telit Communications PLC	0.4	Intelek Plc	2.9	Gladstone Plc	64%	Kofax PLC	40%
Electronic Data Processing PLC	0.4	Redstone PLC	3.0	K3 Business Technology Group	64%	Artilium PLC	40%
Kofax PLC	0.4	Raymarine PLC	3.0	Eservglobal Ltd	69%	Advanced Computer Software F	37%
Eservglobal Ltd	0.4	GEONG International Ltd	3.1	Computacenter PLC	71%	OMG PLC	35%
Alphameric Plc	0.4	Oxford Instruments Plc	3.1	Maxima Holdings PLC	74%	Anite PLC	35%
Delcam PLC	0.4	Kofax PLC	3.1	Sandvine Ltd	76%	Strategic Thought Group PLC	35%
OMG PLC	0.4	Focus Solutions	3.2	iomart Group Plc	77%	Delcam PLC	32%
Bond International Software PL(	0.4	K3 Business Technology Group	3.2	Electronic Data Processing PLC	78%	Focus Solutions	31%

Source: Bloomberg consensus forecasts and Edison estimates

Conclusion: Highlighting the 'cheapest' stocks

In Exhibit 8 we have whittled the companies down to 30. We did this by ranking the companies and giving them a score with a maximum of 100 for each of the four categories and then added the scores to get a total for each company. We then sorted the stocks by their total scores. This is not meant to be a list of definite takeover targets but it does highlight several businesses with a mix of resilient business models, valuable IP and in some cases net cash positions.

Clearly the fundamental outlook is unlikely to get any better in the short term for the companies highlighted, but we do believe the factors identified will mean that these businesses are under increasing corporate focus over the next six months. Nonetheless, 'investing for the bid' can prove a very costly exercise against a backdrop of P&L pressure and there are a number of fundamentals that need to be factored in when assessing the relative merits:

Value of IP. Clearly any of these companies may be going through a period of cyclical swings in its customer base (with knock-on implications for earnings). However, businesses with highly competitive or leading intellectual property should emerge strongest from a slowdown. In addition, many businesses will have IP that has a much higher strategic value to a company competing in the same vertical. This is particularly true for software companies where competitors are able to 'bolt-on' new software onto their platforms and through the distribution channels – the bids in the financial sector for Coda (by Unit 4 Agresso) and Financial Objects (by Temenos) provide examples.

End-markets and business models. We are aware of private equity buyers and corporates looking to buy technology businesses that are supported by regulatory and indeed 'business-critical' drivers. In addition, the same buyers are looking specifically for SaaS business models providing more visible earnings streams.

Recurring revenues. We have highlighted that the majority of companies in our list have net cash positions. In addition, several will have high recurring revenue bases through product lifecycle 'design-ins', software maintenance contracts, etc. In some cases software businesses are trading very close to 1x their 'maintenance books' – this would appear to be an obvious mis-pricing metric for any software business with valuable and growing IP.

Balance Sheet. In terms of risk, due diligence of the balance sheet is clearly key. Many technology companies have significant intangible assets (with the risk of write-downs) and are likely to be capitalising chunks of cash spent on R&D. In some cases there are also other unknown liabilities on the balance sheet, eg litigation. However, more positively, there are also many 'undervalued assets' within the companies in the list, eg shareholdings in other companies or – subject to market conditions – property portfolios with the potential for sale or leaseback.

Shareholding structure. Given depressed valuations, buying or merging companies with very high 'founder' shareholdings can be difficult. However, we believe the willingness of boards to do deals is changing quickly and the benefits of scale on a merger and exchanging paper for a larger entity are as compelling as ever. Notwithstanding this, a large number of the businesses do have more balanced shareholding structures without the over-riding influence of one sizeable stakeholder.

Exhibit 8: Stock screen ranking

		EV/Sales	EV/EBITDA	Eq MV/SHF	Net cash/MV	Total score
1	Morse PLC	99	100	100	84	383
2	Psion Plc	92	92	95	93	372
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12	Bond International Software PLC	71	96	93	42	302
13	Vislink PLC	84	93	91	34	302
14	DataTec Ltd	97	79	94	29	299
15	Alphameric Plc	74	69	68	87	298
16	Eservglobal Ltd	75	83	76	61	295
17	Pace PLC	90	84	54	64	292
18	ARC International PLC	88	20	84	97	289
19	Amino Technologies PLC	83	49	62	94	288
20	Batm Advanced Communications	63	87	46	91	287
21	Vyke Communications PLC	93	20	81	89	283
22	Volex Group Plc	96	81	92	12	281
23	TT electronics PLC	86	86	98	10	280
24	OMG PLC	72	67	65	75	279
25	Kofax PLC	76	73	51	78	278
26	Redstone PLC	89	77	99	13	278
27	IDOX PLC	61	94	60	62	277
28	CryptoLogic Ltd	80	20	80	95	275
29	Dealogic Holdings PLC	54	85	49	82	270
30	Norkom Group PLC	59	68	58	85	270

Source: Bloomberg consensus forecasts and Edison estimates

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