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SYSTEMHOUSE

The monthly review of the financial performance of the UK software and IT services industry

CHALLENGES AHEAD FOR INFRASTRUCTURE PLAYERS

By Kate Hanaghan

Kate Hanaghan
Analyst

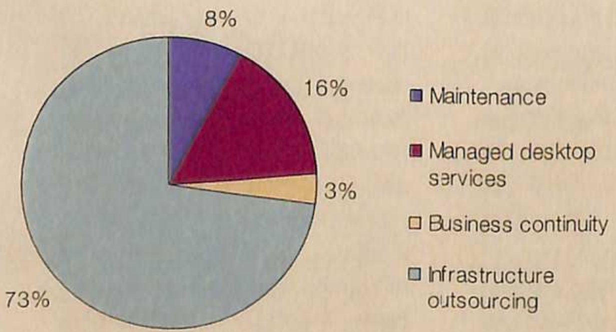
Ovum's definition of infrastructure services takes in IT support services and infrastructure-led outsourcing (see chart for more on market sizes). Suppliers to these markets, which include large multi-national outsourcers right through to local value added resellers, face one of the toughest challenges in the UK IT services market.

Much of what they do is about maintaining systems, and CIOs are under enormous pressure to keep down (even cut) the cost of keeping systems live. And, because of this, there is enormous pressure on suppliers of these services as they fight for 'wallet share'. Many of these services (e.g. the management of desktops) are now commoditised, which is putting even more pressure on suppliers, particularly in terms of pricing. The suppliers who are most attractive to customers are the ones who have strong messages around two key areas. Firstly, the maintenance of old systems (e.g. server monitoring, desktop outsourcing) and proving that these mundane, every-day tasks can be done for less and in a more efficient manner. Secondly, being creative and proactive with ideas/approaches that not only save money but help to solve business problems that enable the CIO to impress their bosses on the Board. It is of course the former of these (in other words, the non-differentiating elements of IT services) where the most intense battle for budget is happening.

Productisation

As the CIOs' purse strings tighten, so they wants more bang for their buck, and that of course affects the top and bottom line of infrastructure services companies. We've

Figure 1 **UK infrastructure services market by segment. Total market estimated to be worth £9.5 billion in 2007**



Source: Ovum

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(changes in January 2007)

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FTSE IT (SCS)	**+0.9%**	**591**
techMARK 100	**+1.9%**	**1540**

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seen this for a few years now, but just how should the industry continue to respond? There are three key areas suppliers need to focus on to deliver infrastructure services more efficiently and, importantly, more profitably. Each element on its own does not provide the ultimate solution, but if implemented well – or even combined - could help to shift the metrics in favour of the supplier.

Firstly – and in relation to the commoditisation of some infrastructure services – suppliers have looked to turn their services into products. IBM is probably the most high-profile example of this. The strategy is to take existing services, standardise them and standardise their pricing. This is a very sane antidote to the issue around commoditisation: you can't disguise the fact that server maintenance or desktop installations are activities with little or no value-add, so why not provide those services as clearly-defined, clearly priced 'modules'? Even better, tie in to those modules all the relevant processes (or related services) to create a finished product that is both easier to buy and easier to sell.

Remote infrastructure management

Secondly, remote management is becoming an incredibly active area right now, especially given the rising profile of Indian players. The ability to provide a remote service in place of an onsite visit of course makes for much more preferable economics – it means customers get more competitive rates, while suppliers can improve margins. Players such as Dell and BT (with its IT Manager offering to the SME market) are particularly keen to not even get involved in running their own field force. Instead, it's all about what can be done from the comfort of a service centre. In the UK mid-market services arena we think Dell is particularly well placed because of its emphasis on technology over field people. Indeed, we'd compare Dell's approach with the Indian players, who are gaining ground in the remote infrastructure management market. Their biggest challenge is making the move from being an application management provider to a UK customer to doing infrastructure and perhaps even management of the onshore suppliers within the contract too.

Globalisation

The third, and over-arching, imperative is global sourcing. Indeed, suppliers who don't get this right will struggle to compete effectively in the UK S/ITS market in the years to come. In terms of infrastructure services, we have seen suppliers to this market adjust their Western footprint. Players from IBM to Getronics have considered how they can reduce staff in costly geographies, increase staff in lower-cost locations and do more to prevent problems by using technology – again, preferably from a lower-cost location.

The arrival of global sourcing and remote management in the market means that the threat the offshore companies pose to UK players is undoubtedly real. Their initial moves have typically been to add chunks of infrastructure management to existing application management contracts, leveraging the trust and credibility they have built up with customers. Our concern is that quite soon we will see UK support services players starting to lose out to Indian companies who are able to do remotely what has historically been done onsite by a visiting engineer. Support companies must evolve hybrid strategies (i.e. a mix of remote and onsite services) that are more competitive with the offshore offering.

Mid-market

While we've seen large corporate client firms take a firm grip of the global sourcing concept, mid-market customers have given it a cooler reception. Offshoring is still virgin territory for many customers here, and their loyalty to local, smaller IT services providers (such as Computacenter and Getronics, who have no offshore offering) has restricted their contact with it. However, we think larger S/ITS suppliers could run elements of their offshore and mid-market strategies in parallel. Those who are productising their services, offering remote infrastructure management services and developing a robust global sourcing strategy are best placed to compete onshore with mid-market specialists and offshore with the RIM pure-plays. In other words, there is the potential for larger players to serve the mid-market in a way that hasn't really been economically viable in the past.

The challenge for the UK's largest suppliers – and this is in many ways a more difficult issue to address – is how to effectively engage with the mid-market customer. For example, are suppliers really close enough to the customer to really understand their needs? Can they give the customer the degree of attention required? Are they flexible enough to adapt to the changing needs of a fast-growing smaller player? The winning formula in the mid-market, therefore, is a combination of having the right offerings, but also having a good, close relationship with the customer. ■

SOPHOS PLANS AGGRESSIVE GROWTH

Graham Titterington
Principal Analyst

Surviving in a chaotic market

The security market is highly fragmented, with about 150 vendors active in the market and the top ten vendors only accounting for about 30% of the market. The pace of acquisitions within the sector is increasing, but more significant are mergers which make the major IT vendors more active in the sector, or which provide opportunities for closer integration with other parts of the IT business. Major vendors taking an increasing interest in the security market include Microsoft, IBM and Cisco, while other notable cross-sector acquisitions include Symantec and Veritas, and EMC and RSA Security.

Other security vendors, and particularly the anti-virus vendors, are expanding their coverage of the security spectrum. Sophos is firmly in this group. Sophos has chosen to become a "security and control company".

Acquisitions and partnerships

Sophos's development strategy requires it to acquire additional capabilities, something it has achieved through acquisition of Endforce and a partnership with SurfControl.

Endforce

It has bought Endforce, a US-based company specialising in Network Access Control (NAC), which is a Cisco led initiative to allow enterprises to enforce corporate security policies on all devices (in particular laptops) that connect to their networks. NAC has become a standard and Endforce has one of the better implementations of its provisions, with regard to the flexibility of the policies that it can execute. This acquisition will open up some attractive cross selling opportunities.

Endforce also strengthens Sophos's geographical expansion plan. Sophos is unusual in that it remains a privately owned UK company, although it has moved to having "co-headquarters" in the US and UK. Endforce further tips this trans-Atlantic balance.

SurfControl

The purpose of this partnership is the sharing of information about the categorisation of websites. SurfControl plc is a prominent UK information security company, which also has become global in its operations. Web browsing protection is its core offering. This is however a new opportunity for Sophos.

An appliance vendor

The SurfControl partnership has enabled Sophos to launch a web access security "appliance", where the software is pre-configured in a special hardware module. Sophos entered the appliance market last year with a similar e-mail security device, despite having reservations about the business challenges that it faced in moving from being a purely software vendor. However, it has gained confidence from the success of this product and is now more committed to this form factor. The innovation has been welcomed by its channel partners who feel that the appliance gives them a more tangible relationship with their customers. The unified appliance makes it possible to intercept malware on incoming web pages and then immediately add the suspect page to its blacklist to block any further access to it, for example by a bot that has already infiltrated the enterprise network.

Developing its core technology

Sophos has a core technology that can block unwanted software, be it viruses, adware, spyware, bots or simply legitimate applications that are contrary to corporate policy. Basically it allows enterprises to decide what types of software can be run be each group of employees and associated block lists are maintained as policies by the system administrators. It can do this more easily than its competitors because it only sells to enterprises that have established system administration processes. Policies can be specified for each group of users.

Sophos is able to offer a unified product across its functions, crucially backed up by a single management console controlling all its services across the enterprise.

The ability to extend beyond protection from malware into support for corporate IT policies is a major bonus for both security and compliance delivery. For example it can fairly easily block public instant messaging applications or VoIP services which network based products cannot manage because these services use standard protocols.

Getting more proactive

Sophos is changing into a more proactive defender. In December it identified 7,000 new forms of malware - mostly Trojan downloaders that use an embedded URL to download a malware component. Sophos is also identifying new malware websites at a rate of 5,000 per day.

"Behavioural Genotype Technology"

Sophos has a powerful approach to blocking intrusive malware. It scans incoming executables before they can run. This substantially reduces the burden on IT support services, and has the bonus of not needing to use rootkits and being fully compatible with Microsoft's kernel protection features in the 64 bit versions of Microsoft Vista. Sophos is therefore avoiding the grief that these features are causing for the leading anti-malware vendors.■

INDIAN FIRMS TARGETING THE INFRASTRUCTURE MARKET

Samad Masood
Analyst

Something else has got past King Canute. Infrastructure outsourcing was once considered a "no go" area for offshore outsourcers. But now it is has become a major part of the top Indian player's UK strategy. Though still a small part of their overall business now, infrastructure services are being eyed up as the next high-growth market for Indian services firms.

In the last year alone, three groundbreaking offshore infrastructure deals have been announced: TCS's with Somerfield, and HCL's two deals with the Dixons Group and Skandia UK. Importantly, all these deals involve transfer of assets or resources. It's all quite different from a couple of years ago when Indian companies would actively avoid signing deals that required a large investment in onshore assets and resources.

This change in tack has been driven by the need for the top Indian vendors to maintain growth between 30% and 40% - the informal benchmark at which investors have set their expectations. But with all of the top five Indian vendors having crossed the $1bn revenue mark, they are also battling the law of large numbers: the bigger they get, the bigger and more numerous deals they must sign to maintain growth rates. To keep up the pace, these vendors must sign more than a handful of $50m deals annually, and must increasingly target $100m+ deals.

But there are simply not enough $100m+ deals in application services – the Indian vendors' core market - to sate the appetite for growth. This largely explains the move by Indian vendors into new markets of outsourcing such as BPO and more recently infrastructure management. Deals in these markets are naturally much bigger than those in applications services.

But why Europe? One reason is that Indian vendors have had longer outsourcing relationships with clients here. This contrasts with the US, where clients have been that bit slower to embrace outsourcing deals, having typically begun their offshore relationships by handing out short-term project work.

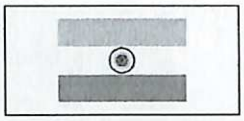
This difference between continents is important because Indian firms generate the vast majority of their growth by expanding existing client accounts rapidly. Upselling higher-value work, and cross-selling new solutions is one of the things these businesses do best. With that in mind, Europe represents some of the best opportunities for cross-selling of infrastructure services to existing outsourcing clients. It is potentially the lowest-hanging fruit.

That said, it will be a real challenge for the Indian vendors to maintain margins in this market. Especially when much of an infrastructure service must be delivered onshore. Infrastructure management margins are typically around 6-12% - much lower than the existing 25-30% margins they currently have around applications work. The initial solution to this has been to partner with domestic support services firms. But progress down this route has been slow, and so far only a few strategic partnerships between Indian and domestic vendors have been announced.

We expect more aggressive attempts by offshore vendors to solve the margin challenge going forward. One recent development has been to innovate on deal structures. For example, the Somerfield deal gives TCS the responsibility of managing the client's onshore partners without taking on any margin-diluting "pass-through" revenue. This model could give an offshore vendor the ability to take end-to-end responsibility for infrastructure provision, while only delivering the high-margin offshore services.

And if this level of control over onshore provision is not enough, there is always the potential that an Indian player will take the leap and acquire its own infrastructure assets and resources onshore in the UK or Europe. Indeed it might not be too big a jump to make. The infrastructure services market accounts for 40% of the total UK IT services market. And if the Indian firms are ever to achieve their long-term ambitions to become leaders in the IT services market, they will have to take a significant piece of infrastructure on board. Acquiring their own onshore resources may well be the most profitable way to achieve that in the long term.

That said, in the short-term, Indian vendors will mainly pose a threat to those vendors already providing remotely managed services to their existing clients. The strategies to move beyond existing clients are not yet set in stone. And while the way ahead here is unclear, domestic S/ITS companies must stay alert for any developing opportunities or threats. Indian vendors could be about to change the face of infrastructure outsourcing in the UK, and S/ITS companies can no longer bury their heads in the sand.■



INDIAN OUTSOURCERS AND THE FIVE STAGES OF GRIEF

Gary Barnett
Research Director

The rise of the Indian outsourcers, led by the likes of TCS, Infosys, Wipro, Satyam and HCL has been well documented. The dramatic growth of the Indian outsourcers has been met with a reaction that is a little like the five stages of grief. And well it might, since the globalisation of the services industry does signpost the death of an Era; the key is in figuring out how to survive and prosper in the one that replaces it.

Phase 1: "Denial"

In the early 1990s Western outsourcers comforted themselves by saying that sending development work offshore was a false economy, much harder to do in reallife than it first appears. But the issues were resolved, and the work did go offshore.

Phase 2: "Anger"

Frightened by the perceived threat posed by the offshore players, some have sought to invoke national interest - "They're stealing our jobs" - and create fear uncertainty and doubt - "Your data won't be safe". On both of these points, the people that make them are deluded. Firstly, jobs aren't being "stolen"; they're being handed over, voluntarily, by clients. Secondly, hysteria about data protection while sufficient to grab some headlines won't stem the tide – technology and processes will address concerns about data privacy. Pushing for government action to protect jobs, or lobbying for protectionist data protection laws may bring some emotional relief, but these actions won't stem the tide.

Phase 3: "Bargaining"

"But we can add value that the Indians can't". The bad news for people who cling to this view is that the Indian players are quickly moving beyond the "your mess for less" proposition of first generation offshoring towards a proposition better characterised as "We'll take your mess and make it better; Better – and, by the way, we can do it for less too". There is a view that we encounter far too often that there are some "things" that simply cannot be done offshore. Thomas Freidman expresses this view in his book "The World is Flat". He differentiates between work that is easily digitized (and therefore easily transferred to low-wage locations) and work that is "special" or "specialised" (and therefore, according to Friedman, cannot be transferred to low-wage locations). So "Basic tax preparation" can be sent offshore, but "Complex tax preparation" cannot. As an example he cites the expertise of a heart surgeon as something that cannot be sent offshore. There's a disturbing set of assumptions underlying this thesis – The notion that "they'll never be able to do heart surgery" is not only foolish, but is directly contradicted by the growth in health-tourism – where people are willing to travel long distances to get high quality medical care at lower cost. If you think that your Indian competitors are not "smart enough" to take on more complex business then you are very, very wrong. Broadly speaking this is where most of the industry is right now. Some are a little behind, and some have moved on.

Phase 4: "Depression"

Depression is a healthy and natural response to the growth of the Indian outsourcers – if you're an established Western outsourcer, you're entitled to feel a little down-in-the-dumps. Our advice is "Move on", because the next phase is the one in which you get not only to save your business, but to profit as well.

Phase 5: "Acceptance"

The final phase, at which relatively few Western outsourcers can claim to have arrived, is Acceptance.

Accepting that the market has changed dramatically and permanently. Accepting that the "quality" differentiator is spurious. Accepting that to compete they're going to have to radically change their execution models.

The need for "Action" – Phase 6?

Perhaps there should be a sixth step. In order to respond to the real alternative that the Indian outsourcers represent – in terms of value as well as cost, the Western outsourcers need to act.

Regional integrators should partner with Indian outsourcers. Indeed, taking things a step further, worse things could happen to a medium sized integrator than being bought by a larger firm that's growing at more than twice the industry average.

If you're a larger player it certainly makes sense to return the favour by developing your own offshore presence, but that only addresses the cost element. You need to be willing (and humble enough) to emulate some of your up-start competitors in terms of their willingness to assume risk, form creative agreements and develop partnerships. In a sense the Indian outsourcers have the advantage of the underdog – under the radar and under estimated. Our advice is worry less about your "next biggest competitor"; worry about the competitors that are a fifth of your size today, because they'll be a whole lot bigger tomorrow.■

HAMSARD CHANGES SHAPE AND EYES PROFITS

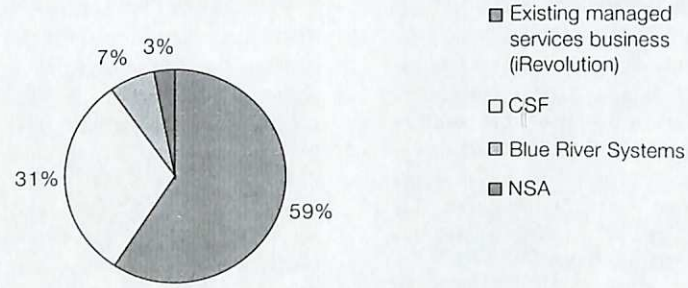
Kate Hanaghan
Analyst

In January, we caught up with Eamus Halpin, the CEO of Hamsard Group, a rapidly-changing managed services firm. It's been a very busy six months for a company that has closed three acquisitions in the past few months alone. And those acquisitions have helped to change the face of the company. In fact, this isn't the first time the company has changed its 'DNA' . The Hamsard Group was originally created as "a vehicle to bring technologies together", and initially acquired three companies with respective specialities in managed services, security software and data visualisation. The result? Not surprisingly, an organisation that lacked focus. By summer 2006, Hamsard management concluded it wasn't really going anywhere.

What we've seen since then is a rapid and significant transformation, under the leadership of Halpin. Following the divestment/closure of certain parts of the business, and cost-cutting and capital reorganisation programmes, the finances of the company are now on a stronger footing. The company has found its focus by homing in on the managed services market (note that it's closed the non-managed services and significantly loss-making Synartra business, and has a 'for sale' sign over the profitable but again non-managed services Panopticon business) following the acquisitions of Blue River Systems (turnover in FY06 = £0.9m), NSA Solutions (turnover in FY05 = £0.4m) and CSF Managed Services (turnover in FY05 = £4.2m). The newly-enlarged group is targeting the SME market (specifically, companies with 100-500 employees) where there is a significant appetite for managed services. A key attraction for companies in this target range is the predictability of cost for a managed IT service. These size companies also tend to lack a coherent IT strategy and have limited numbers of IT staff. All in all, getting someone else in to do the work makes good economic sense.

Hamsard's core business is now around the provision of servers/co-location facilities in data centres, right through to the management of the desktop. Depending on the application, Hamsard will also provide management/support - if it's Microsoft, it will support that, if its SAP, it will only provide first line support.

Hamsard's business including acquisitions
Total = £13.47m*



*Based on latest available financial results
Source: Company information

So what next? Put simply, more acquisitions, more scale and more focus. Now its plans are to acquire other managed services businesses (or even software vendors where it sees an opportunity to provide the software as a service).

Hamsard is actually a very small firm and needs more scale; in the 13 months to end May 2006, it turned over £7.97m and produced operating losses of £6.37m including goodwill amortisation and impairment of £2.6m. (See chart for more on the company's financials.) Those are not the healthiest figures in the world and it's difficult to imagine it being able to sustain that ratio of revenues to losses for much longer. Given that, and the opportunity we see to serve the smaller end of the mid-market, Hamsard's M&A strategy makes good sense. That is, of course, if it can maximize the cost benefits (from consolidating numerous companies) while building up scale. Encouragingly, the company is promising that it will be profitable by 1 March this year - indicating that it is already gaining traction from this strategy.

Other examples of mid-market consolidators spring to mind, such as Computer Software Group and 2e2, and it's a highly beneficial strategy if you can get it right. In other words, if you have the experience and contacts to acquire the right companies at the right price and if you can then appropriately integrate/leverage those purchases. We think Halpin's previous experience with managed services firm iRevolution will be invaluable here as Hamsard builds up its managed services business, which is focused on application hosting.

If it can successfully scale and return to/maintain profits, it will pose a threat to the numerous smaller managed services firms that are out there. Indeed, it may well choose to acquire them! While we've seen some good foundations being put in place, this next period is going to be critical for the company as it attempts to move from recovery to sustained profitable growth.

And finally, no change of strategy would be complete without a name change! So, from the 1 March, Hamsard will also change its name, to Cantono.■

MARKET TRENDS IN 2007: CARPE DIEM!

Phil Codling
Principal Analyst

The Holway@Ovum team has recently completed the latest updates in its "Market Trends" research, in which we set out the changes and opportunities in the UK software and IT services market in the times ahead. The good news is that overall growth rates are currently the highest we have seen since 2000. In fact, we forecast that the UK S/ITS market will grow by 6.4% in 2007 - that's slightly better than in 2006.

A number of positive factors will sustain this relatively strong growth, not least:

• Businesses are putting money behind the growth agenda for IT, which means spending on initiatives that drive revenue growth, competitive differentiation, corporate agility and customer service

• The economy is helping. Despite interest rate and inflation concerns, GDP growth is back to 2.5% and many businesses are feeling confident about investing in IT

• The project services market should stay relatively buoyant in 2007, with consulting and SI growth rates staying at or near post-2000 highs. Growth would be even better without the deflationary effect of global sourcing

• The IT-intensive bit of BPO has returned to health too, with financial services organisations in particular now beginning to act on plans to outsource back-office services, following the confusion over VAT implications

• Growth in the enterprise software space will again outstrip that in the IT services market in the year ahead, with the growth agenda helping to drive purchases of CRM and business intelligence applications in particular

• A slew of new releases in 2007 should drive software and projects investments too. As well as (finally) Microsoft Vista and Office 2007, we see potential for additional enterprise spending in the shape of Oracle's EBS 12, Siebel 8, PeopleSoft 9, 11g database and IBM's Lotus Notes/Domino 8, not to mention the ability of SAP's Netweaver to stimulate platform upgrades.

The next downturn?

Our analysis shows that the industry is in the midst of a "mini-boom" (with the emphasis on the mini!). But some of the vendors we have conversed with recently have spoken of the need to make contingency plans for the "next downturn". Any such downturn would have immediate consequences for S/ITS suppliers, particularly in those areas - notably consulting, training and contract staff supply - that are the first casualties of a tightening in business spending.

That said, nobody (including Ovum) expects any such downturn to be as severe as that which we experienced in 2001-2003. Indeed, we think suppliers should be planning for a gradual decline in growth in the remaining years of the decade, rather than a sudden drop-off. There will be a number of causes of this decline, including:

• Outsourcing market growth rates will fall, particularly in infrastructure outsourcing beyond 2007. Such falls will be driven by the increasing commoditisation of infrastructure deals, downward pressure on pricing and the lack of large new contracts coming to market.

• The project services market will cool down beyond 2007, as the power of the growth agenda to drive spending subsides. The consulting and systems development markets have proved cyclical in the past and we believe that the UK market is currently near the peak of the current cycle.

• The increasing use of offshore and nearshore delivery will continue to exert a deflationary effect on the market. Our projections indicate that cost inflation in India will not halt the progress of global sourcing nor significantly dent its deflationary impact, particularly as suppliers exploit new delivery locations.

• Public sector S/ITS spending remains in double digit territory at present but times are changing. Government is demanding more for less in its IT procurement and, despite a number of large-scale IT-heavy programmes to come in the next few years, growth in overall spend will fall below double digit levels beyond 2008.

• As we enter 2007 it is clear that the productisation of IT services is a significant trend brewing. While productisation may enable growth in the mid-market and even among SMEs, its overall effect on the market will be similar to that of global sourcing - that is, it may help to boost suppliers' profit margins, but it will most probably be deflationary in terms of revenues and thus market growth.

For much more analysis and advice on the future of UK software and IT services market, Holway@Ovum subscribers should refer to the Market Trends updates posted on the Holway@Ovum website during January. If you would like to have access to this research, please contact Suzana Murshid on 020 7551 9071.■

8%
95p

SCISYS RELEASES FIRST TRADING UPDATE SINCE 'GOING IT ALONE'

SciSys, provider of bespoke software systems and solutions to the space and defence industries, as well as to the broader UK public sector, last month released a trading update for the year to 31st December 2006.

Although the company states that it has *"traded well"* during the period, sales and earnings for 2006 will be negatively impacted by delays to one of its largest programmes, as revenue slips into 2007.

Nonetheless, a strong order book across all sectors has resulted in a positive outlook for 2007. SciSys has named a number of new clients in both central and local government, such as the Highways Agency and Hampshire County Council, as well as *"substantial"* new business with existing clients, such as the European Space Agency. As a result, the company is predicting a further growth in sales and profits in the year ahead.

In the first half of the year, SciSys grew revenues in the high single digits; however, this was impacted by *"exceptional"* hardware sales relating to its contract with the Environment Agency. We expect programme delays in the second half are likely to have brought percentage revenue growth for the year as a whole back down into the single digits and in reality, this is a more realistic level of growth for the company going forward.

The company continues to sign up new clients, most notably outside of its traditional space and defence territory, as well as securing new business from its existing client base. However, SciSys spent the vast majority of 2006 as part of the CODASciSys Group; CODA and SciSys demerged at the end of September. It is therefore too early to make judgement on how well SciSys has performed since 'going it alone'.

(Georgina O'Toole)

-8%
171p

LOGICACMG GROWS JUST UNDER 5% IN 2006

LogicaCMG recently issued a trading update for the year to December 2006. The market 'remained positive with increasing volumes and a generally improving pricing environment'. Nevertheless, IT services revenues missed guidance and analyst expectations by growing just under 5% in constant currency and pro-forma terms (counting Unilog and Edinfor as consolidated for the year).

Margins increased in 2006, and full-year cash conversion was in line with expectations, thanks to strong operating cashflow in H2. Expectations for 2007 'remain unchanged'.

This was in most senses a pretty upbeat update statement - steady or slightly rising profitability, good market conditions (particularly the rising prices), a return to profitability in Germany and a rocking performance (10% constant-currency growth) in the Netherlands aided by growing demand for offshore-enabled services. The main problems are staff shortages, a flat UK and a French operation that's decelerating.

Staff shortages restricted project-services growth in Q3 and held back operating margins because sub-contractors were needed. LogicaCMG recruited in Q3 and Q4 to nail the staff shortage issue. But the UK is another issue.

Revenues in the UK rose just 2%, excluding pass-through revenues, and probably fell 1% or so overall, caused in part by the slow start-up of a big public-sector order. That's disappointing, given that the company expected overall UK revenue growth in 2006.

Actually, the UK is a well-run margin machine (9.1% operating margin in H1 2006) focused on profitability rather than revenue growth. Having both would be better, but the UK is overweight in the essentially flat public-sector market and under-weight in the growth engine of financial services. I rather suspect UK MD Guy Warren left earlier this month after getting bored with running an essentially defensive strategy.

CEO Martin Read said that priorities in 2007 are the integration of WM-data and on increasing the payback from recent European acquisitions, including Unilog and WM-data. He's absolutely right - LogicaCMG's growth strategy depends on revenue synergies from its Continental European operation - the Netherlands alone can't drive the whole company. LogicaCMG says it's seeing 'good early momentum in cross-selling solutions to Nordic customers, which we expect to convert to orders in 2007'. Yet revenue growth in France was 'in line with the group performance', which is actually disappointing for a project-services specialist in the middle of a consulting and SI boom (H1 saw 7.6% pro-forma growth, indicating a real slowdown in Q4).

We are open-minded about whether LogicaCMG can achieve significant revenue synergies, but there's no proof yet. Geographic expansion into mature markets is clearly not enough. One thing is certain: simple geographic expansion is not enough, and LogicaCMG probably still has work to do in constructing a differentiating and genuinely pan-European portfolio of IT services offerings.

(Douglas Hayward)

MICROSOFT QUARTERLY REVENUE SLOWS BUT FULL YEAR LOOKS STRONG

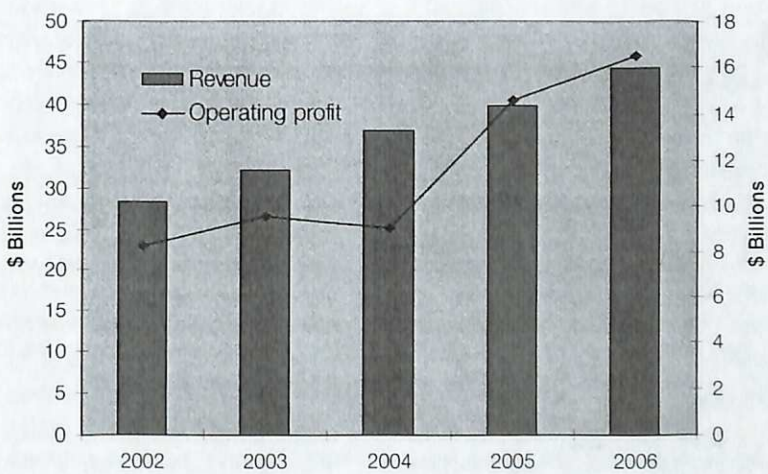
Last month Microsoft published results for its Q2 fiscal 2007 (to December 2006) that show revenue of $12.54bn, a growth of only 6% year-on-year, and decline of 25% in operating income to $3.47bn. Net revenue declined 28% to $2.63bn, Nevertheless, it is forecasting full year revenue of between $50.2bn to $50.7bn, an increase of between 13.4% and 14.5% over fiscal 2006.

The raw figures for this quarter are depressed by the deferral of $1.65bn of revenue from Q3 that has arisen due to the launch of Vista (and a related technical guarantee program which allows many recent buyers of Windows XP and Office 2003 to upgrade to Vista or Office 2007 at little or no additional cost). Microsoft is also deferring some revenue for OEM copies of Vista and Office loaded on unsold PCs in the channel. Once Vista and Office 2007 formally launch to consumers later this month, Microsoft will recognise this revenue (as well as around $50m from Q1), almost all of which will flow straight through to the operating profit, since the associated costs have almost all already been absorbed. Q3 will therefore be a bumper quarter for Microsoft.

Deferring revenue that Microsoft is hardly likely to have to give back may seem over cautious. However, revenue recognition is a very complex issue and, according to our research, a major headache for much of the software industry. Premature or faulty revenue recognition has led to plenty of disgraced companies, and a few executives going to jail as a result. Microsoft is wise to err on the side of caution here, and it's an example the rest of the industry needs to follow.

Our early projections for the uptake of Vista (of up to 15% of business PCs by the end of 2007) may prove to be below the mark. Microsoft says that it is seeing faster acceptance from businesses for both Vista and Office 2007 that it had originally forecast, leading it to raise its guidance for the client business unit to full-year growth of between 11% and 12% (a 2% increase) and 10% to 11% for the Business Division (also a 2% increase). The expectation that the so-called 'Office 2.0' on-line services will do away with the need for Microsoft Office still seems way off the mark, at least for now, but some change is inevitable as even Microsoft acknowledges.

Microsoft Corp. revenues and operating profits



The Business Division is also experiencing strong growth in the uptake of the Dynamics business applications group, which saw a 19% rise year-on-year in billings in Q2. As we've reported before, the success in Dynamics is creating serious skills shortages, especially but not only on Axapta. In order to keep up this growth, Microsoft has to do even more to encourage training in these products or risk a slow-down.

However, a strong engine for growth continues to be the server and tools division, which saw 17% revenue growth. This included a 30% growth in SQL Server, showing just how rapidly Microsoft is moving into new territory in the enterprise database sector. Together with open source databases, Microsoft is putting the squeeze on both IBM and Oracle. The only good news for them is that Microsoft will be pushing through a price hike, but this provides no grounds for complacency.
(David Bradshaw)

15%
589p

Autonomy
making sense of an unstructured world

AUTONOMY ON A HIGH

Cambridge-based Autonomy Corporation recently reported revenues of $251 million for 2006, up by 161% on the 2005 figure of $96.0 million. This came despite stiff competition, particularly in the enterprise search and discovery market. While the gross margins at 91% dropped just a tad from 92%, Autonomy's net profit (under IFRS) was $39.1 million, an increase of 337%.

These are very good results for Autonomy. They validate both the company's acquisition strategy, most notably for Verity (which has resulted in a wide portfolio of search and discovery-related products), and its positioning as a provider of infrastructure software. We believe that these results will reinforce Autonomy's business strategy and demonstrate that the momentum in the infrastructure software market is not showing any signs of slowing down.

As an illustration of the activity and the competition that is now being seen in the enterprise search and discovery market, the company also reported that Research and Development investment was up by 134% year-on-year, and announced the release of its Meaning Analytics Warehouse (MAW), designed to provide analysis of both unstructured and structured information, including video, email, voicemail and databases.

New or upgraded products from Microsoft, IBM and Google are providing additional competition at the lower end (territory covered by the former Verity products) and Oracle is seriously entering the enterprise sector, where FAST and Autonomy are often competing head to head. However, Autonomy has already announced three contacts for Q1 2007, with T-Mobile, the SAAB-Ericsson defence consortium and GlaxoSmithKline. The latter is of major significance because it is for a worldwide deployment.
(Mike Davis)

12%
243p

MISYS

LAWRIE WIELDS THE AXE AFTER MISYS RESULTS DISAPPOINT

CEO Mike Lawrie has made sweeping changes to the board and senior management team at Misys, after the company confirmed that its results for the six months to November were less than satisfactory.

Looking first at the results, total revenue was £468m, up just 0.6% on last year. These numbers exclude the general insurance business that Misys sold in May 2006. Revenue from banking was £133m, up 6.4%. While treasury and capital markets results were good, the core banking part of this business was mixed. Revenue from healthcare was £147m down 6%, a performance that Lawrie describes as "unacceptable". Revenue from the Sesame IFA business was £188m, up 2%.

Group operating profit was £36m, down 12%, and operating margin was 7.7%, a decline of 1.1%. However, like-for-like operating profit was slightly up at 19% to £43m. Net profit was £22.8m.

Lawrie is making sweeping changes in the boardroom, clearing out the old guard who served under former CEO Kevin Lomax. Perhaps worryingly for some, he said that he was *"beginning* to make some management changes" (our emphasis added) in an interview with Cantos. So it seems we are to expect more.

Misys Healthcare CEO Tom Skelton is going, though will stay on pro-tem to help with the transition. Finance director Howard Evans will step down at the end of the current financial year, and a search for his successor has started. Corporate Development Director Jesper McMahon is leaving with immediate effect and the company is in the process of appointing a successor.

In the place of the old guard, Lawrie is recruiting a team of proven executive talent with strong industry track records. For Misys Banking, he is recruiting Guy Warren, to be CEO. Warren was formerly Chief Executive of LogicaCMG UK, and prior to that, leader of Logica's financial services unit. (Acting Misys Banking CEO James Cheesewright will move to a new role when Warren joins.)

To beef up sales overall, Eileen McPartland, formerly SVP of North America Consulting at Oracle (and before that, head of consulting at Siebel), joins as EVP of global sales and Services on 29 January. Finally, Paul Lewis, formerly CEO of data protection solutions provider, Revivo Inc) joined Misys Healthcare on 16 January as SVP of sales and services; he will be interim general manager until a replacement for Skelton is in place.

Finally he added Jeff Ubben to the non-executive board. Ubben and Lawrie were colleagues at VC firm, ValueAct Capital, which is a significant shareholder in Misys.

While it's too early to say how well this executive team will gel, one thing is clear: with Lawrie in charge it will not be business as usual. The only area where it is 'business as usual' is in Sesame. Our long-held view is that Misys should dispose of this unit.
(David Bradshaw)

IBM FINISHES 2006 ON A HIGH NOTE

IBM announced a strong set of Q4 results last month. Total revenue increased 4% at constant currency to $26.3bn compared with Q3 last year. Total gross profit margin was 44.6%, up 0.5% from 2005.

Asia-Pacific and the Americas led with 5% growth in constant currency terms with $4.8bn and $11.1bn, respectively. EMEA was up 3% at $9.3bn. In the business divisions, Software led the way up 11% to $5.6bn. Systems and Technology revenues were flat at $7.1bn. Global Technology Services was up 4% at $8.6bn and Global Business Services was up 4% to $4.2bn. Total signed services contracts hit $17.8bn during the quarter, bringing the backlog to $116bn, up $5bn on a year ago.

Full year results showed a 4% rise in total revenue to $91.4bn up 4% year-on-year and income from continuing operations was up 9% at $9.4bn. EMEA revenues were up 2% at $30.5bn. Software Group was the star performer with revenue of $18.2bn up 7%, its best performance for five years.

In spite of these numbers IBM shares fell 5% in after-hours trading to $99.45 as Wall Street was hoping that the results would exceed expectations even more!

EMEA revenues showed a modest improvement up 3% to $9.3bn; Italy had the best performance and the UK improved year-on-year. Asia-Pacific results also turned the corner and were up 5% with Japanese revenues (50% of Asia-Pacific revenue) at last growing. In emerging countries, India and Russia both grew over 30%, China grew 18% and Brazil grew 7%.

Growth in software revenues was led by IBM's branded middleware software (WebSphere, IM, Lotus, Tivoli and Rational), which grew 21% to represent 56% of IBM's software business. IBM estimates that this was double overall market growth. Growth was both organic and through acquisitions in roughly equal measure (IBM made nine software acquisitions during 2006 including FileNet.) Lotus produced the best results up 24% due to strong momentum in Notes/Domino and the new version of Sametime which shipped in 3Q2006. This success was balanced by a decline in operating systems and other middleware, hit by the general decline in mainframe software prices and reduced i-Series sales. Software pre tax margin was up 4% to $2bn as IBM continues to successfully ride the SOA wave and benefit from its recent acquisition programme.

Global Services brought 2006 to a close with a strengthened performance in both Global Technology Services and Global Business Services. In particular, if you compare Q3 and Q4 it's clear that GBS got back on track. In Q3, growth was just 1% (i.e. no growth at constant currency), but this was transformed into 6% growth in Q4 (or 3% at constant currency). In the second half of the year, IBM shifted its focus in the GBS business from *"operational transformation"* to *"profitable growth"*. In other words, IBM was able to turn internal operation improvements into improved revenue and profits. And the numbers speak for themselves: we've seen improvements in the higher value-add engagements alongside signings up more than 200% year-on-year - *"driven by global delivery capabilities in app management"*. Revenue growth in GBS was matched with improvements in profitability (the pre-tax margin improved by 2.3 points to 11.8%). For this IBM thanks improved utilisation and strong contract management and delivery.

Going forward, IBM will continue to rely on those "global delivery capabilities" for future profitable growth. Indeed, the large application management deals it signed in FY06, such as those won at Vodafone and CMA CGM, are exactly the kinds of business that enable IBM to benefit from the investments it's made in global delivery.

In GTS, pre-tax profitability was down year-on-year (2005 was particularly strong, though) with a margin of 9.3%. There is still lots of work going on behind the scenes, such as the investments in GTS to productise offerings and IBM's drive to improve processes and productivity, which will be particularly intense in H1 07. In fact, IBM is doing a lot of the things that a large outsourcing and consulting & SI company needs to be doing in a market (by which we mean the European market) that has hit maturity. Given this, it could be argued that we should be expecting more from IBM in terms of growth. But as one of the largest services companies in the world, IBM has a greater task than many. Global Services looks pretty confident as it kicks off 2007, based on the strong signings in Q4 and we'd be disappointed if it isn't able to at least sustain this level of growth in the opening months of 2007.

(Ian Wesley & Kate Hanaghan)

Mergers and Acquisitions – January 2007

Buyer	Anite
Seller	Invenova Corp.
Seller Description	San Jose-based developer of testing systems for WiMAX devices
Acquiring	100%
Price	£6.m
Comment	This is Anite's second acquisition in the wireless testing space in three months, following the £65m purchase of Finland's Nemo (now Anite Finland Ltd) in November. Invenova is a much less expensive move for Anite, but it's another sign that the company is serious in its intent to target growth opportunities in the wireless testing market as part of the process of rationalising and focusing its disparate business interests. We expect further acquisitions and disposals to come as this necessary process continues. The potential of WiMAX (or Worldwide Interoperability for Microwave Access) is still much debated, not least by my telecoms market colleagues here at Ovum. In the next few years, WiMAX's impact is likely to be most significant in those areas where fixed broadband is a challenge - notably rural zones and developing nations where fixed penetration is low. In total there are now 170 trials and deployments taking place around the world, with Pipex Wireless, BT (on a very limited basis) and London firm Urban WiMAX Plc developing services in the UK. All in all, WiMAX clearly offers a lot of scope for future growth. The position and potential of Invenova, which claims all the major WiMAX technology developers as customers, could therefore be significant for Anite.

Buyer	Computacenter
Seller	Digica Group
Seller Description	Provider of IT infrastructure and application services
Acquiring	100%
Price	£15.9m
Comment	Digica provides datacentre managed services and SAP/Oracle application services. It also has an offshore centre in Cape Town, employs 248 people and registered revenues of £20m in FY06. There will be some who read this news and gasp: "Why has Digica sold itself to a reseller?!" We'd say, this is a welcome move by Computacenter and a sensible step forward for Digica. CC has a brand issue in services - despite being larger than arguably better-known names in the S/ITS industry. The scale of its resale business, and the lack of clarity around what kind of company CC plc ultimately wants to be, has held back the development of its services brand. So today's acquisition, though relatively small, is important on two levels. Firstly, it gives CC the data centre and application services capability it didn't have before. Secondly, it clarifies that the company is indeed looking to evolve. Both companies operate in the mid-market - Digica perhaps at a lower level than CC. Some of the larger IT services firms (e.g. IBM, BT) are increasing their attempts to target this area. CC's purchase strengthens its position here and, depending on how it manages Digica down the line, gives it the opportunity to become a more dominant force in the mid-market services area. That would make life for the larger services firms, intent on getting into the mid-market, just that bit harder. We understand that CC is going to leave Digica to run as a separate entity - part of the condition of the sale was that management at Digica (including CEO Mark Howling) stay on. This makes absolute sense. The challenge for CC will be in extracting longer-term value from Digica without diluting what is a pretty good brand. Digica seems to have been able to tap-in nicely to the mid-market demand for data centre and application services. Computacenter's challenge is to not only ensure this continues but to make sure it fully leverages the synergies between Digica and the existing CC Services business. In addition, there is very little overlap with customers - so CC must make sure its sales team is fully capable of cross-selling services.

Mergers and Acquisitions – January 2007

Buyer	InTechnology
Seller	Evoxus
Seller Description	Evoxus designs, builds and operates a range of voice, data and IT comms products and services
Acquiring	100%
Price	£6.6m
Comment	The combined organisation will deliver communications services to mid-market, multisited organisations and will further enhance InTechnology's Managed Services capabilities, integrating network based IP based solutions with existing equipment and services to create a communications network with minimal capital expenditure.

Buyer	NCC
Seller	Site Confidence
Seller Description	Surrey-based provider of website performance monitoring
Acquiring	100%
Price	£9.1m
Comment	In our view, NCC is a small but well-formed business. It's got good growth and good profitability on its side, but it also shows potential to improve both of these. Although it has suffered in the German market (it does have a recovery strategy in place, however), elsewhere we're confident that NCC will continue to perform well. In its key business, escrow, we expect to see the company working hard to continue to strengthen its links with software vendors in order to build-in the escrow agreement at the point of purchase. The challenge here is that the software agreement and the escrow agreement have to sit side-by-side as two separate legal contracts. This might not sound significant, but it does in fact give the customer 'room' to ultimately take the software without the escrow. We think that as customer attitudes continue to warm to escrow and other assurance services, this will become less of a problem. NCC also announced today the acquisition of Site Confidence. We think this is a good move providing two quite important benefits. Firstly, it represents another string to NCC's bow, broadening its assurance services further and offering good opportunities for cross-sale between escrow, testing and website performance monitoring. Secondly, NCC is a Manchester-based company and Site Confidence is based in Dorking, Surrey. This gives NCC a Southern sales base, but also further facilities for its penetration testing services. More acquisitions could well happen down the line - but we expect NCC to take a careful and considered approach to this, especially when it comes to valuations.

Buyer	Sophos
Seller	Endforce
Seller Description	Ohio-based Network Access Control vendor
Acquiring	100%
Price	Undisclosed
Comment	This acquisition rapidly develops Sophos's base as an anti-virus vendor focussing on the corporate sector, into a more broadly based threat management vendor. It also illustrates that NAC is gaining traction in the market. It controls devices such as laptops that are attempting to connect to corporate networks to ensure that they conform to corporate security policies. NAC has become a standard and Endforce has one of the better implementations of its provisions, with regard to the flexibility of the policies that it can execute. The acquisition brings these into the Sophos fold and, although we believe that Sophos intends to maintain open interfaces to rival vendors' products, it will clearly open up some attractive cross selling opportunities for Sophos's existing product range and raise Sophos's market profile. The acquisition is consistent with Sophos's current development strategy and will help to promote the company to the first division of security vendors.

UK software and IT services share prices and market capitalisation - January 2007

	SCS Cat.	Share Price 31-Jan-07	Capitalisation 31-Jan-07	Historic P/E	PSR Ratio Cap./Rev.	S/ITS Index 31-Jan-07	Share price move since 29-Dec-06	Share price % move in 2007	Capitalisation move since 29-Dec-06
@UK plc	SP	0.13	4.70	NA	3.23	190.84	-31%	-31%	-£2.06m
Alphameric	SP	0.51	66.96	9.6	0.91	231.65	6%	6%	£3.65m
Alterian	SP	1.23	51.63	36.0	4.86	612.50	8%	8%	£3.79m
Anite Group	CS	0.80	280.24	79.8	1.48	466.37	-2%	-2%	-£3.82m
Ascribe	SP	0.47	53.73	45.5	10.05	2,473.68	21%	21%	£12.03m
Atelis plc	SP	0.05	1.22	NA	NA	226.74	-28%	-28%	-£0.47m
Atlantic Global	SP	0.17	3.84	NA	1.79	567.80	24%	24%	£0.76m
Autonomy Corporation	SP	5.89	913.57	NA	7.12	179.78	15%	15%	-£5.05m
Aveva Group	SP	9.00	606.15	74.1	9.19	4,500.00	10%	10%	£61.62m
Axon Group	CS	6.60	388.22	59.0	4.23	3,771.43	8%	8%	£25.83m
Bond International	SP	1.93	58.28	24.1	4.19	2,961.54	12%	12%	£10.26m
Brady	SP	0.51	13.03	NA	5.36	623.46	38%	38%	£3.61m
Business Systems	CS	0.11	8.65	11.7	0.25	94.54	-10%	-10%	-£0.96m
Capita Group	CS	6.34	3914.22	34.7	2.73	171,383.03	4%	4%	£75.31m
Centrom	CS	0.02	2.29	NA	0.36	250.00	0%	0%	£0.00m
Charteris	CS	0.16	6.88	41.0	0.34	177.78	0%	0%	£0.00m
Chelford Group	CS	1.60	11.35	8.8	0.96	278.26	-4%	-4%	-£0.55m
Civica	CS	2.74	170.71	NA	1.61	1,562.44	-1%	-1%	-£0.61m
Clarity Commerce	SP	0.59	11.89	10.1	0.89	468.00	9%	9%	£3.36m
Clinical Computing	SP	0.07	2.21	NA	1.33	58.47	4%	4%	£0.00m
CODA Plc.	SP	1.80	138.55	NA	3.57	1,180.33	11%	11%	NA
Compel Group	CS	1.11	37.68	26.0	0.60	888.00	-6%	-6%	-£2.51m
Computacenter	R	2.87	457.55	17.0	0.20	427.99	7%	7%	£30.46m
Computer Software Group	SP	1.19	72.12	40.8	5.12	1,008.50	-2%	-2%	-£1.21m
Cornwell Management Consultants	CS	0.13	2.20	2.0	0.12	89.77	9%	9%	£0.18m
Corpora	SP	0.07	9.31	NA	3.58	184.21	25%	25%	£1.78m
Dealogic	SP	1.95	137.51	NA	4.44	847.82	24%	24%	£25.09m
Delcam	SP	3.55	21.92	11.0	0.91	1,365.38	14%	14%	£3.10m
Detica	CS	3.67	409.89	41.8	4.04	4,584.38	0%	0%	-£0.28m
Dicom Group	R	2.20	193.81	25.2	0.93	674.43	-5%	-5%	-£9.07m
Dillistone Group	SP	1.44	7.75	NA	NA	1,051.28	-2%	-2%	-£0.16m
Dimension Data	R	0.44	674.75	31.5	0.49	77.71	2%	2%	£12.49m
DRS Data & Research	SP	0.38	12.98	NA	1.04	340.91	1%	1%	£0.18m
eg Solutions	SP	0.66	9.36	15.0	2.73	445.58	-20%	-20%	NA
ELCOM	CS	0.03	13.63	NA	39.33	833.33	0%	0%	NA
Electronic Data Processing	SP	0.70	16.98	20.3	2.44	2,127.99	8%	8%	£1.24m
FDM Group	A	0.95	21.94	22.9	0.67	1,159.51	1%	1%	£0.23m
Ffastfill	SP	0.08	22.78	NA	8.59	66.67	33%	33%	£8.23m
Financial Objects	CS	0.60	26.43	NA	1.90	258.70	9%	9%	£0.60m
Flomerics Group	SP	0.95	13.97	15.1	1.22	3,634.62	26%	26%	£2.94m
Focus Solutions Group	CS	0.53	15.19	117.4	2.80	269.23	8%	8%	£1.33m
GB Group	CS	0.44	37.05	NA	2.89	285.41	-4%	-4%	-£1.47m
Gladstone	SP	0.24	12.64	13.7	1.65	606.25	-5%	-5%	-£0.55m
Glotel	A	0.58	22.54	9.0	0.25	301.30	-8%	-8%	-£1.73m
Gresham Computing	CS	1.52	75.91	NA	5.43	1,629.03	2%	2%	£1.75m
Group NBT	CS	2.45	50.11	24.6	4.44	1,225.00	18%	18%	£7.67m
Hamsard Group	CS	0.06	16.81	NA	2.34	102.80	0%	0%	NA
Harvey Nash Group	A	0.78	50.64	13.9	0.25	442.86	6%	6%	£2.94m
Highams Systems Services	A	0.04	1.39	NA	0.10	121.53	-5%	-5%	-£0.08m
Horizon Technology	CS	0.67	54.32	13.5	0.28	245.48	-3%	-3%	-£1.78m
IBS OPENSystems	CS	1.80	71.80	29.5	4.60	1,177.05	-2%	-2%	-£1.20m
I S Solutions	CS	0.14	3.47	39.5	0.63	521.71	-11%	-11%	-£0.47m
ICM Computer Group	CS	3.16	67.31	20.5	0.89	1,752.78	9%	9%	£6.20m
IDOX	SP	0.06	11.96	NA	0.84	7.86	-4%	-4%	£0.05m
Imaginatik	SP	0.09	10.79	NA	7.70	1,103.82	9%	9%	NA
In Technology	CS	0.44	61.54	30.6	0.22	1,740.00	1%	1%	£0.93m
InterQuest Group	A	1.18	33.93	21.1	1.23	2,052.17	35%	35%	£11.76m
Innovation Group	SP	0.35	219.66	30.4	3.60	151.75	11%	11%	£22.12m
Intelligent Environments	SP	0.09	14.45	133.9	4.63	94.41	42%	42%	£4.36m
Intercede Group	SP	0.62	21.14	NA	11.71	1,037.50	5%	5%	£0.93m
Invu	SP	0.24	29.59	19.2	9.40	2,526.29	-20%	-20%	-£2.69m
iSOFT Group	SP	0.50	116.82	NA	0.45	456.82	-11%	-11%	-£14.53m
iTrain	SP	0.02	1.67	9.6	0.91	25.00	-6%	-6%	-£0.10m
IX Europe	CS	0.61	105.28	NA	4.68	2,000.00	24%	24%	£20.71m
K3 Business Technology	SP	1.24	23.87	NA	1.08	943.62	6%	6%	£4.00m
Kewill	SP	0.78	61.39	22.2	2.30	1,536.56	-2%	-2%	-£0.65m
Knowledge Technology Solutions	SP	0.02	4.99	NA	3.99	300.00	-8%	-8%	£2.96m
LogicaCMG	CS	1.71	2622.39	34.2	1.43	2,338.39	-8%	-8%	-£233.37m
Lorien	A	0.46	8.47	NA	0.07	455.00	7%	7%	£0.14m
Macro 4	SP	2.25	49.80	16.5	1.50	905.24	6%	6%	£0.99m

UK software and IT services share prices and market capitalisation - January 2007

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Manpower Software	SP	0.30	13.12	NA	3.03	304.12	13%	13%	£1.61m
Maxima Holdings	CS	2.29	42.05	38.3	3.39	1,665.45	0%	0%	£2.09m
Mediasurface	SP	0.21	16.22	21.0	1.68	1,544.12	24%	24%	£3.09m
Micro Focus	SP	2.24	446.67	52.8	5.91	0.00	7%	7%	£31.03m
Microgen	CS	0.56	56.97	13.3	1.40	237.18	2%	2%	£1.61m
Minorplanet Systems	SP	0.62	17.88	17.4	0.75	1,266.08	11%	11%	£1.73m
Misys	SP	2.43	1214.51	54.1	2.60	3,016.99	12%	12%	£132.57m
Mondas	SP	0.16	5.51	NA	0.87	210.00	9%	9%	£0.44m
Morse	R	1.06	163.04	10.9	0.44	425.00	-2%	-2%	-£0.05m
MSB International	A	0.72	14.66	NA	0.16	376.32	0%	0%	£0.00m
NCC Group	CS	3.26	106.32	23.3	5.12	1,952.10	17%	17%	£15.52m
Ncipher	SP	2.40	67.60	35.4	3.89	960.00	-6%	-6%	-£3.94m
Netcall	SP	0.17	11.22	28.6	3.39	343.44	0%	0%	£0.01m
Netstore	CS	0.34	42.77	232.2	1.19	223.33	12%	12%	£5.31m
Networkers International	A	0.34	30.86	55.8	1.62	1,046.88	-4%	-4%	£28.23m
Northgate Information Solutions	CS	0.85	455.80	18.2	1.37	326.92	-1%	-1%	-£2.33m
NSB Retail Systems	SP	0.29	115.87	7.0	2.39	2,543.48	-15%	-15%	-£10.39m
OneclickHR	SP	0.06	9.30	146.1	1.57	156.25	56%	56%	£3.35m
OPD Group	A	4.75	126.10	34.2	2.88	2,159.09	-3%	-3%	-£4.25m
Parity	A	0.83	31.48	NA	0.23	768.52	6%	6%	£1.80m
Patsystems	SP	0.18	29.96	NA	1.94	170.56	6%	6%	£2.40m
Phoenix IT	CS	3.30	198.50	15.5	1.82	1,221.30	8%	8%	£14.90m
Pilat Media Global	SP	0.82	47.86	24.1	3.68	4,075.00	0%	0%	£5.20m
Pixology	SP	0.26	5.17	NA	1.15	186.28	-9%	-9%	-£0.61m
Portrait Software	CS	0.16	15.27	NA	1.32	105.05	7%	7%	£2.32m
Proactis Holdings	SP	0.68	20.33	27.0	10.70	1,391.75	6%	6%	£1.20m
Prologic	CS	0.73	7.25	16.2	1.05	873.49	-15%	-15%	-£1.25m
QinetiQ Group	CS	2.07	1343.42	NA	1.28	940.77	8%	8%	£121.94m
Qonnectis	CS	0.01	1.64	NA	14.98	200.00	0%	0%	£0.00m
Quantica	A	0.34	19.99	8.3	0.51	270.16	10%	10%	-£0.23m
Red Squared	CS	0.08	2.16	15.3	0.88	418.96	17%	17%	£0.85m
Revenue Assurance Services Plc	SP	1.16	52.50	NA	1.17	770.00	-6%	-6%	£5.12m
RM	SP	1.92	177.29	NA	0.68	5,485.71	-1%	-1%	£21.64m
Royalblue Group	SP	10.56	346.54	33.4	4.67	6,208.82	2%	2%	£5.75m
Sage Group	SP	2.69	3484.63	22.8	3.72	103,557.69	-1%	-1%	-£22.65m
Sanderson Group	SP	0.52	21.74	10.8	1.35	1,040.00	6%	6%	£1.25m
SciSys	CS	0.95	24.44	3.9	0.34	738.37	8%	8%	-£100.26m
SDL	CS	2.70	168.52	55.4	2.15	1,798.33	14%	14%	£21.67m
ServicePower	SP	0.13	10.05	NA	1.27	125.00	-24%	-24%	-£3.22m
Sirius Financial	SP	1.53	26.93	294.9	1.24	1,020.00	4%	4%	£0.65m
SiRViS IT plc	CS	0.04	0.44	NA	0.06	33.70	0%	0%	£0.00m
smartFOCUS plc	SP	0.14	10.97	109.2	1.82	1,540.54	-7%	-7%	-£0.77m
Sopheon	SP	0.23	30.39	NA	6.52	330.94	2%	2%	-£0.26m
Spring Group	A	0.59	94.33	87.4	0.21	650.00	-15%	-15%	£10.12m
SSP Holdings	SP	1.23	87.79	NA	4.91	1,155.66	2%	2%	NA
StatPro Group	SP	1.04	54.58	22.7	5.06	1,300.00	0%	0%	£0.35m
SThree Group plc	A	3.80	524.29	23.5	2.16	1,844.66	-2%	-2%	-£8.97m
Stilo International	SP	0.02	2.38	NA	1.15	47.50	0%	0%	£0.24m
Strategic Thought	CS	0.99	25.87	10.1	2.26	730.63	-1%	-1%	-£0.21m
SurfControl	SP	5.30	152.34	NA	2.66	2,650.00	2%	2%	-£11.11m
Tadpole Technology	SP	0.02	6.96	NA	1.44	41.04	70%	70%	£2.98m
Tikit Group	CS	2.92	36.62	166.8	1.82	2,534.78	14%	14%	£4.14m
Torex Retail	SP	0.42	173.19	NA	1.03	1,043.75	-15%	-15%	-£17.28m
Total Systems	SP	0.43	4.47	19.7	1.28	801.89	18%	18%	£0.68m
Touchstone Group	SP	1.74	20.22	69.7	1.17	1,657.14	-3%	-3%	-£0.16m
Trace Group	SP	0.97	14.66	11.7	1.03	772.00	-3%	-3%	-£0.14m
Triad Group	CS	0.25	3.71	NA	0.09	181.48	-2%	-2%	-£0.08m
Ubiquity Software	SP	0.37	69.18	NA	9.27	935.93	86%	86%	£32.64m
Ultima Networks	R	0.01	1.79	NA	0.94	21.34	0%	0%	£0.00m
Ultrasis Group	SP	0.01	20.18	NA	16.23	27.86	-4%	-4%	£1.20m
Universe Group	SP	0.09	6.65	5.1	0.15	411.11	-34%	-34%	-£2.05m
Vega Group	CS	2.34	47.63	15.3	0.77	1,918.03	11%	11%	£4.58m
VI group	SP	0.14	4.94	NA	0.51	270.00	-5%	-5%	-£0.37m
Xansa	CS	0.84	289.84	35.0	0.81	2,141.03	-4%	-4%	-£9.83m
Xpertise Group	CS	0.47	2.49	NA	0.19	1,880.00	16%	16%	£0.37m

Note: We calculate PSR as market capitalisation divided by sales in the most recently announced financial year.
Main **SYSTEM**HOUSE S/ITS Index set at 1000 on 15th April 1989. Any new entrants to the Stock Exchange are allocated an index of 1000 based on the issue price. The SCS Index is not weighted; a change in the share price of the largest company has the same effect as a similar change for the smallest company. **Category Codes: CS** = Computer Services **SP** = Software Product **R** = Reseller **A** = IT Agency **O** = Other

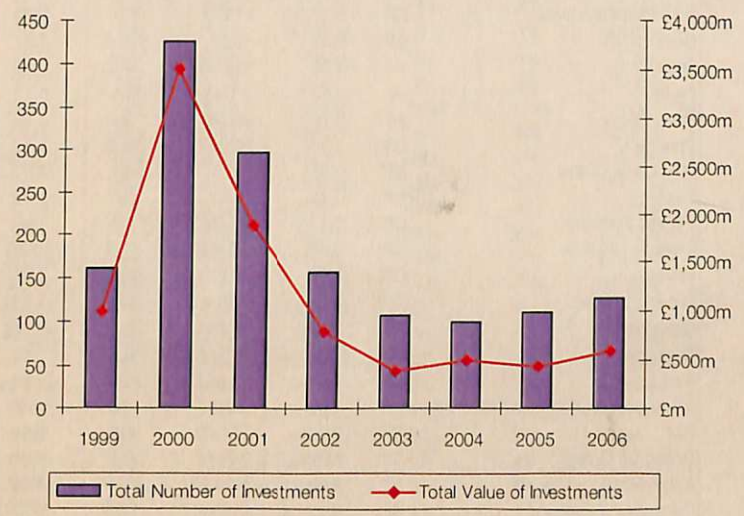
PRIVATE EQUITY – ANOTHER BUBBLE READY TO POP?

Private equity (PE) investments into the UK and Ireland technology sector continued to accelerate last year. The value of PE investments into technology businesses grew by 38% to £601m in 2006, according to the latest data from Cobalt Corporate Finance. This is the highest it has been since 2002 when the dotcom crash put the brakes on PE technology investments. Deal volume is also returning to 2002 levels. The number of PE technology deals shot up by 20% year-on-year to 128 deals in 2006. The average value of each investment also grew on the previous year, up by 16% to £4.7m. So on all counts, PE investment activity is surging ahead.

At this point it would be easy to surmise that we're heading into a new IT investment bubble. After all, the similarities with the dotcom bubble are uncanny. First off, it is the beginning of a new PE investment cycle. Investors spent the last few years recovering from the dotcom crash, sorting out and selling off their existing portfolio companies. But now this backlog has been cleared, they are again looking for new early-stage investment opportunities to re-build their portfolios. The result is that the number and value of first round investments have shot back up to 2001 levels. Over 2006, first round investments accounted for 32% of the overall value and 45% of the total volume of deals. Both these figures are double the equivalent average values between 2002 and 2005.

The second, and perhaps most important, similarity with the dotcom bubble is the high-level of interest in Internet-related technologies and services. More than a third of first round deals in 2006 were in either the Internet software or services space. A lot of this has to do with the emergence of "Web 2.0" - an often misunderstood buzz-word which, in this context, refers to websites that use collaboration and/or user-generated content to drive business. Examples include Viagogo, an online exchange that allows consumers to trade tickets to live events, and Zopa, the peer-to-peer (P2P) lending and borrowing exchange.

Figure 1 **Private equity investment trends in the UK and Ireland 1999 - 2006**



Source: Cobalt Corporate Finance

But the big difference between investment activity now and during the dotcom boom is the lower level of risk that is being assumed. Firstly, 70% of PE technology deals are syndicated, compared to 44% back in 1999. Syndication spreads the risk of investment across a group of firms rather than on the shoulders of a single investor. Risk is further reduced by the lower average deal size: £4.7m in 2006 compared with £6.2m in 1999. Part of the reason is that today's Internet technology companies have lower set-up costs due to the adoption of distributed web architectures such as P2P, and a better understanding of low-cost viral marketing.

The upshot is that while the industry is rapidly returning to 1999 levels of investment, the money is being spread more thinly across target companies. And while activity in 2007 promises to further inflate this new technology bubble, the damaging effects of its eventual popping should be reduced. Of course, there will still be some bad investment decisions made over this year. But as long as investors don't overstretch themselves, this could be the start of a sustained period of growth, rather than another little blip. Hopefully, the dotcom crash is still too recent a memory for hype to take over from sense. *(Samad Masood)*