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SYSTEMHOUSE

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

UK S/ITS IN 2006 AND 2007: MODEST GROWTH, EXTREME CHANGE

By Phil Codling

Phil Codling
Principal Analyst

2006 was a year of extremes in the software and IT services market. On the one hand, many suppliers grappled with the unstoppable commoditisation of their products and services. For resellers, this meant another year fighting declining product prices. For IT outsourcers, it meant emerging from a period of intense renewal activity with the realisation that customers now view much of what they have traditionally delivered as essentially a commodity.

Meanwhile, 2006 also saw the strengthening of the "CIO growth agenda". By this we mean the tendency of customers to invest once again in IT as a driver of corporate competitiveness and agility, rather than just a source of cost savings. The growth agenda can, for example, be witnessed in the resurgence of CRM and business intelligence, both of which are driven by the objective of improving competitiveness, and also in the emphasis on "innovation" shown by many suppliers over recent months.

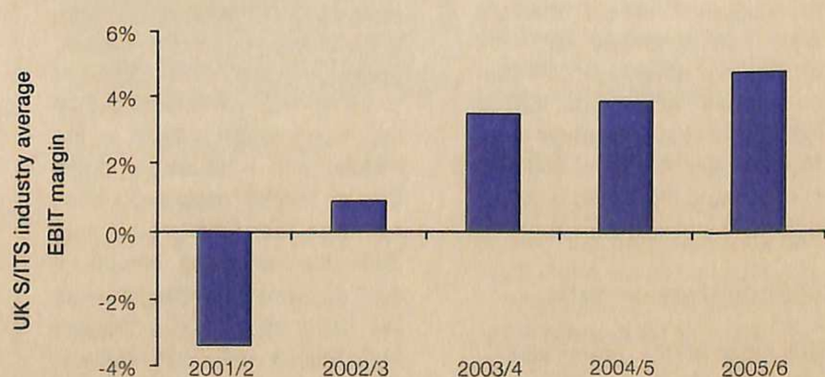
We believe that success in S/ITS in 2007 and beyond will be largely dictated by suppliers' ability to respond to this dual challenge/opportunity, or the "efficiency versus effectiveness dilemma", as Ovum labelled it back in early 2006.

So, against this backdrop, what can suppliers do in order to compete and grow their profits?

Global sourcing: part of the solution

2006 saw the leading IT services suppliers continue to trim their onshore workforces and build out their offshore capability. Accenture and IBM's Indian operations passed the 20,000 and 50,000 employee marks respectively, CSC ran a rapid European headcount reduction

Offshoring and the return to growth have helped boost industry margins, but where will further improvements come from?



Source: Holway@Ovum Financial Health 2006

[continued on page two]

Contents

INDICES
(changes in December 2006)

Ovum S/ITS Index	**+3.8%**	**5572**
FTSE IT (SCS)	**+5.8%**	**586**
techMARK 100	**+5.4%**	**1512**

[continued from front page]

programme and both EDS and Capgemini invested in offshore acquisitions.

Global sourcing is a *sine qua non* of IT services competitiveness, but it's now the industry norm rather than a differentiator in its own right. We see few major contract negotiations where a near/offshore solution isn't at least considered by the customer. But we also see few where global sourcing in itself carries the deal.

Moreover, two factors are limiting the margin-enhancing benefits of global sourcing. Firstly, savvy CIOs are no longer allowing suppliers to pocket the cost savings associated with moving work to cheaper locations. Meanwhile, those locations are tending to become less cheap, as offshore cost inflation shows no sign of abating. In India, for example, average inflation is holding steady at around 15% per annum per employee.

The next evolution

Customers keep demanding lower prices, especially on commoditising services such as infrastructure-led outsourcing, desktop services and application management. They also want ever-improved predictability of service delivery. The global sourcing of labour can only go so far in delivering to these customer needs.

The next leap forward in the industry will come in the shape of industrialisation and productisation. In reality, this means delivering services using a combination of re-usable intellectual property (software modules, methodologies, service templates and automation, discovery, diagnostics tools, etc) to deliver offerings that customers find more cost-effective, predictable, lower-risk and easier to understand. Such standardised services will tend to be delivered remotely, with much of their cost often residing offshore.

The joy of products

There are strong supply-side drivers at work here too. Industrialisation of service delivery and productisation of service propositions promises greater repeatability, which means much improved margin leverage. IT services economics will start to look more like traditional software product economics. That's potentially good news for service providers and even investors - our *Financial Health* analysis this year showed that software players in the UK have EBIT margins twice as high as IT services firms, despite significant improvements in profitability by the latter group over the last couple of years.

Productisation could also be the answer – finally! – to unlocking the potential for outsourcing and managed services in the mid-market and even among SMEs. And as software providers continue to push their productised Software-as-a-service offerings into this part of the market, it will become a major IT services battleground in the years ahead.

So in the year ahead, we expect vendors to invest in the development of more standardised delivery processes and service packages, and in the sales tools to push them out to customers.

There will be threats in this trend for some, not least because productisation means Western firms can potentially hit back at the cost advantage of Indian competitors. At present, IBM is leading the way, and others need to make sure it doesn't succeed in dominating this critical strategic ground, even in the short term.

Delivering business value

But what of the other side of the S/ITS challenge/opportunity: the growth agenda and the need to deliver bespoke solutions that create differentiation for customers? Standardised, mass-produced solutions, albeit predictable and cost-effective ones, will not suffice. This is why IT services providers, and indeed software and hardware vendors, need to foster teams that can handle customised advisory and implementation services. These teams need to be masters of both business issues (often to very detailed, vertical levels) and technological solutions, and most importantly the link between the two. Mostly, they will be located onshore.

Right now we see a lot of demand in the UK for individuals who fit the skills profile described above, and some high salaries to match. What we don't always see is effective linking of these expensive, high-value skills to the more standardised areas of delivery within an IT services business. During the year ahead, that is an organisational and cultural challenge that many larger players still need to address, urgently in our view.

The unhappy medium

Some players don't have this integration headache, because they occupy one end of the spectrum – that is, they gravitate towards either the commodity end or the high-value bespoke end of the industry. That's a tenable position, although we'd be surprised to see many smaller players prospering at the commoditising, productising end of the market, given the clear advantages of scale in this environment. The key is not to get caught in the middle, with a business model that is neither mass-production nor high-end bespoke. During 2007 the damaging effects of such positioning on attractiveness to customers and financial performance will, we believe, become all too obvious.■

HOLWAY COMMENT

AULD LANG SYNE

Richard Holway

As it is the end of a year which has seen Ovum being acquired by Datamonitor, I hope you will indulge me one article of nostalgia.

After starting my analysis company in 1986, I published the first Holway Report in 1988. But readers quickly told me that they needed something more often than once a year. So the first Systemhouse appeared on 1 Nov 1989. It hit a chord. Every other tech publication at the time was "journalistic" and/ or "technical". Systemhouse was highly opinionated right from the start and covered technology from a corporate viewpoint. Both were "firsts"!

For the first ten years I wrote every word in every Systemhouse and I've made a contribution to every issue ever published - 207 editions!

System House

£180m lost in one day

First Edition of System House Launched

We hope that you enjoy this first edition and that you will want to subscribe to receive System House each month.

System House

UK For Sale

The very first edition of SystemHouse majored on the *"Bumper period for Acquisitions"* in 1989. M&A involving UK S/ITS companies had totalled £700m. Put into context, that figure is about 20x higher today and keeps reaching new highs. But what was so interesting back in 1989 was that it was UK companies doing all the buying. Plessey buying Hoskyns, Granada buying DPCE, Systems Designers buying SCICON. Even CAP and Sema was more of a merger than a French takeover back then. But there were early signs of what was to come when that first issue of Systemhouse reported the purchase of UK Istel by AT&T for £180m; the first ever overseas purchase of a major Top Ten UK S/ITS player.

It was the start of a trend. The April 1990 front page had a Big FOR SALE sign over the UK computing services industry. The Sept 1990 front page was *"SD-Scicon "into the claws of eagles"* - a cunning reference to the title of Ken Follett's book on EDS' Ross Pero's exciting rescue of EDS employees from Iran in 1979.

In 1988 nine out of the Top Ten S/ ITS suppliers to the UK were UK owned companies. The 2006 Top Ten is likely to have just two UK-owned entrants - BT and Capita.

"Acquisition Indigestion" was the theme of the Dec 89 front page - a subject we have referred to ever since. We suspect that companies will continue to suffer from – indeed die from – the dreaded after-effects of taking over companies that are too big and of the wrong type. *When will they ever learn!*

Themes

Systemhouse has had so many themes and campaigns over the years that it would be impossible to cover them all here. Personally I am proudest of the following:

Boring Companies – We started this accolade in 1992 and it persists to this day. I hope that one day the OED will include a new definition of the word to mean companies that produce consistently good earnings growth over decades. I'm equally proud that, right from the very first edition when we featured their IPOs, Systemhouse has championed Sage and Capita as the best UK S/ITS companies ever. Not only are they the only Boring Award holders but they are the two best performing shares in our Index which started in 1989. Our Index is up just over 4x since 1989 compared to a 160x gain at Capita and 90x at Sage (and that's before reinvested dividends)

Campaign to reduce CGT on the sale of businesses

We started this campaign in 1996 when CGT was 40%. The then Conservative Chancellor, Kenneth Clarke, wrote to us saying that he had no intention of changing the rate which we thought was both punitive on those who had worked for decades to build their businesses but was also damaging to the country because it just meant that many UK business entrepreneurs moved overseas to avoid it on selling their business. We were amazed when a guy called Gordon Brown called before the 1997 election asking for details of our campaign. Within a couple of years of Labour coming to power the rate was reduced to just 10% on business assets held for two years or more. *Bluntly, EVEN better* *than we had campaigned for!*

"Y2K Microclimate" and the "Y2K hangover will not end with the Alka Selzers"

The fuss about the Millennium Bug seems such a long time ago now. But back in 1997/8 it fuelled 25%+ growth in our sector. In 1998 we were the first to warn that 1999 would see slower growth as systems that had been made ready for 2000 were "locked down". The 1999 "Y2K microclimate" was tough for companies expecting growth to continue at 1998 levels – none more so than the ITSAs who had a torrid time. By mid 1999 the mood was all around major growth returning in 2000. We used *"There may be troubles ahead"* as the first musical theme to our 1999 CSSA (now Intellect) "State of the IT Nation" presentation when we were cast as the Party Poopers by warning that the *"Y2K hangover will not end with the Alka Seltzers".*

"The Emperor's New Clothes", "Dot.Con", "You don't know whose swimming naked until the tide goes out" and "Freejellybeenz.com"

These were all classic Systemhouse front page headlines in 1999/early 2000 as we wrote about the dot. com phenomenon. Although Systemhouse is justly proud of its warnings of the impending crash which came on 6 March 2000, it was also the most electric time to be commentating on the sector. We suspect to this day that our spoof article on how to turn an idea into a company worth £500m on IPO in six months was taken seriously by many. Indeed, *freejellybeenz. com* - the concept of creating a social networking site for Jellybean lovers - was years ahead of its time! In fact the name was made up of three of the main bubble companies – Freecom, Jellyworks (an internet incubator) and Beenz which was to be a "Greenshield stamps" for internet users.

"Lies, damn lies and audited accounts"

Systemhouse has run campaigns for clarity in company R&As since the very start. Bluntly, even with IFRS I think we are no further forward than we were back in 1989. It is still possible to treat software development costs in any way you choose – you can put it on the balance sheet and report profits where none existed (like QSP did for years before they went broke) or you can expense it as you go along. One Systemhouse front page at the time of the Andersen/ Enron scandal carried a cartoon with an auditor (called Arthur) being asked *"What is 1+1?"* with Arthur answering *"What do you want it to be?.*

"Plus c'est la même chose, plus ça change"

"IT's all over now?"

When, in 2002, we introduced the world to the concept that IT's glory growth days were over and that IT would be lucky to keep up with GDP, we were bombarded with comment which at times resembled hate mail. I have an A4 ring binder full of international press coverage on this one subject. I should remind readers that this appeared in Systemhouse nearly a year before Nicholas Carr wrote his "IT doesn't matter" article for the Harvard Business Review in May 2003!

As it turned out, I was far too optimistic. ICT is slowly *declining* in its share of GDP and will continue to do so...for ever. Just like every other mature industry ever known to man.

Martini Moment

My desire to listen to The Archers *"Anytime, Anywhere and from Any Device"* gave birth to my Martini Moment ambition in 2003 at a time when the BBC were yet to launch their "Listen Again" service. Early this year, I wrote of achieving that Martini Moment on an airplane, in a hotel and on a ship in the South China Seas on a holiday to Vietnam. Next year my wife will achieve her ambition by similarly being able to watch Coronation Street.

I consider everything that goes around achieving this Martini Moment and what it now enables us to do as THE most exciting development shaping our sector for the years to come.

"I used to drive a Microsoft, now I fly a Google"

Last year I upset our friends at Microsoft – and Alistair Baker in particular – with this headline. It was nothing personal! I just believe that it's the "Webtop" not the "Desktop" that now matters. Just as it's Web 2.0 not Web 1.0. Just as its SaaS not shrink-wrapped software products.

Actually, just like what happened with Netscape and the Internet, Microsoft will eventually "get it" and then you will all have to "watch out"...again. Just as I have NEVER forecast the demise of IBM, I'm not forecasting Microsoft's passing either!

"Who are you?"

That headline brings us bang up to date with last month's lead article. Understanding "Who you are" and being true to your dna is a lesson I'd quite like all readers to remember.

"Who am I?"

When Ovum acquired Richard Holway Limited in Nov 2000, we shared much common DNA. Indeed, I'd like to think that there is much Holway DNA still in Ovum today and continuing in the future.

Thanks for twenty of the most fantastic years. May we all have many more to come.

We'll tak' a cup o' kindness yet
For auld lang syne

BPO LOOKS TO RECOVER FROM ITS "PERFECT STORM"

Samad Masood
Analyst

The S/ITS-related BPO market represents more than 40% of the UK S/ITS outsourcing market by value, and with growth averaging at 14% annually for the first half of the decade, BPO services have helped keep the S/ITS market afloat through some tough times.

But the BPO market hit an unexpected bad patch in mid-2005, and growth dropped below 9% in 2005 and 2006. This dip was caused by a "perfect storm" of events that hit two of the market's strongest growth sectors: life & pensions administration, and the local government sector.

Given that many S/ITS BPO players built their businesses on the back of these two vertical segments, there have been several casualties. For example, Vertex, Liberata, Unisys and HBS, have all suffered a stagnation in their revenue due to the problems in these sectors. And because the profit model of most of these BPO companies is to grow first and use economies of scale to generate a margin, this slowdown in market growth has also started to hurt profitability.

As such, Vertex, Liberata and Unisys have all rapidly embraced the offshore model recently in order to cut costs, and are also variously looking to improve performance by focusing on operational excellence. Vertex (owned by United Utilities) has now put itself up for sale, while the rumour mill continues to churn out stories about the future ownership of Liberata, Unisys, HBS and the small L&P business of EDS.

But there have still been some winners over this period. Namely, Capita, a BPO company that is diversified enough to have ridden out the initial lull in business from L&P and local government, but that also used its strong reputation in the market to win all but one of the L&P deals that appeared in the latter half of 2005 and in 2006 as the market started to bounce back.

The only other "winner" to come out of the L&P resurgence at the end of 2005 was Tata Consultancy Services, which signed its first ever UK L&P BPO contract with Pearl Group. It used its mature offshore facilities, and the trust it had built up with the client over many years providing applications services to beat many established players to the contract.

Outside of L&P and local government there have also been some surprise success stories. IT services player Atos Origin has expanded considerably in the occupational health BPO market with deals in the private and public sectors. Meanwhile, in the HR outsourcing market Accenture signed its largest ever deal with Unilever. But proving that the HR market is not only reserved for such mega-deals, staffing services firm Alexander Mann also made waves by shifting its focus towards providing specific end-to-end recruitment processes as a sub-segment of HR BPO. Another interesting firm in private sector BPO is The Innovation Group, an insurance software company that managed to salvage its business by shifting its focus to BPO. The company is now growing rapidly in BPO by providing insurance claims administration processes on the back of its claims and policy management software in the UK and Europe.

So what do these success stories tell us about BPO going forward? BPO players that have been successful in 2005 and 2006 have either focused on specific processes or sectors where they can build expertise and a good reputation, or they have leveraged their operational expertise, be it Capita's long established success in a range of BPO services, or TCS's offshore credibility.

Looking ahead

Although growth in L&P and local government is now returning, the market has now changed irreversibly. New revenue is now expected to come to market slower than previously, and we estimate no more than 10% growth annually in the market going forward.

With L&P and local government deals no longer supporting the majority of growth, BPO players must start diversifying to succeed. But this will not be easy.

The bulk of the BPO market is now made up of many small opportunities that are spread across a diverse range of vertical and horizontal sub-segments. And in this situation, very few clients ever sign up to a BPO service for the same reason. As such, there is no obvious "next big thing" that suppliers can focus on for growth in the foreseeable future. In such a circumstance, the keys to success lie in suppliers' ability to focus on existing strengths, and differentiate with these. Operational excellence and profitability must be the main aims. If suppliers can at least get these basics right, then the clients will come. ■

IBM TAKES ON PRODUCTISATION CHALLENGE

Kate Hanaghan
Analyst

Towards the close of 2006, we met separately with several members of the IBM services management team: Bruce Ross, GM of Global Technology Services (GTS) in the UK, Ireland and South Africa (UKISA), Andy Embury, GM of Global Business Services for UKISA, Cheryl Shearer, Strategy and Marketing Executive GTS Northeast Europe and Andrew Creasey, General Manager, IBM Global Services, Northeast Europe.

Comment: Perhaps the most talked-about point in IBM circles over the past months has been the launch of what it is calling "Service Product Lines" (SPLs). This is an internal phrase used to describe a collection of ten services product areas. These areas are groupings of IBM capability – created to solve specific business problems. So for example, there are offerings for "Business Continuity and Resilience", "Storage and Data" and "IT Strategy and Architecture" and so on. Within these lines there are more than 300 specific products for customers to buy, which contain a mix of software, hardware and services – so for customers, it is in theory easier to buy 'IBM'.

There are benefits for IBM too in structuring its services offerings in this way: not least that this is potentially a more profitable way to deliver services because they're more straightforward to sell, and cross-sell. The SPL structure will also force IBM to work harder at internal integration – across GTS and GBS, but also in the software and hardware parts of the business too. For us, there is an irony here. While SPLs are all about making buying/selling easier (and cross-selling more simple), IBM is going to have to address some complex challenges internally in order to make this a success. Key issues will be managing the increasing amount of internal interaction and integration required, and co-ordinating the management of the SPL portfolio globally.

Customer appeal

But will this productised approach appeal to customers? Generally, yes. Provided that the benefits are quick to materialise and that suppliers such as IBM are able to articulate why productisation won't prevent them from being flexible in the way the customer's IT is run. There will also be some concern from clients that pre-defined offerings are another way by which they could become locked-in to IBM. This is a valid concern and one that some clients will struggle with as they try to apply their internal vendor management policies. With service products however, IBM is not hiding the fact that it is offering a complete service and clients should be able to see efficiency benefits from choosing productised IBM services rather than procuring the components separately. A challenge for IBM account management will be to encourage clients to move from "fear of lock-in" to a "willingness to embrace" IBM.

The multi-source challenge

In 2006, we saw the trend for multi-sourcing continue. In other words, many customers still have a preference for splitting large outsourcing arrangements into multiple parts. And, because deals are being split into more parts, average deal sizes are smaller. Dealing with the multi-sourcing trend and the maturation of the UK S/ITS sector more generally are key issues for IBM (and other large suppliers too). Companies the size of IBM need to keep on inking sizeable deals (for IBM that means those in the $500m to $5bn range) in order to sustain growth.

The company has responded to the trend for fewer larger deals by creating a "Pursuit Team" to go after larger opportunities. This approach is in line with a generally re-invigorated attempt by the UK S/ITS industry to get closer to the customer. IBM has a team of 60 senior people from both GTS and GBS working on this – and, so far, IBM claims it has signed "one very large deal". We don't expect to see huge numbers of deals being generated in this way – but then again, just one or two at this size is all that is needed to create revenue growth.

Meanwhile, IBM is also giving renewed consideration to the mid-market. Or rather, it is trying to be cleverer in the way that it goes to market. So, for example, the productised services we spoke about earlier are very appropriate for mid-market customers because they're more cost-effective to sell and less complex to buy. Through better re-use of re-usable assets such as software, diagnostic tools, methodologies, templates, process models and so on, and through the industrialisation of services, larger S/ITS firms stand a chance of gaining a greater share of the mid-market.■

NURTURING INNOVATION IN IT SERVICES

Angel Dobardziev
Practice Leader,
IT Services

Late in 2006 we completed a series of in-depth discussions with 11 major Western and Indian IT services players around innovation. According to vendors, innovation, and being seen as delivering innovation to clients, is critical in the current context of enterprises' growth agenda.

Client innovation needs

Vendors believe clients want innovation to support their growth agenda, more so when they mature as outsourcing clients, and in order to keep abreast of technology changes. Yet, vendors confess to different and often conflicting ideas as to how clients define innovation and what different client stakeholders expect from vendors in terms of innovation.

In order to be even given the opportunity to 'innovate' in client organisations, IT vendors recognise that they must first develop and nurture client intimacy, which will enable them to assess the 'innovation needs and priorities' of that particular client. This means a relationship where the vendor understands the individual client's challenges, the perspectives of different client stakeholders, and the client's specific business drivers. The other side of client intimacy is client trust in the vendor to undertake innovative tasks within current projects or new innovative projects.

However, the nature of the vendor/client relationship can vary from a buyer/seller adversarial relationship with strong focus on tight contract definition and implementation; to a more strategic partnership, with more of a win/win approach and looser contract definition and interpretation. Although most clients and vendors suggest *intention* to seek a strategic partnership with the other side, their *behaviour* often limits how far this can develop. Vendors obviously have a much easier task 'innovating' in a strategic partnership type of relationship, and a very difficult one in a buyer/seller arrangement. However, with most relationships falling somewhere between the two, both sides have the challenge of managing expectations and taking the relationship to a level which enables innovation.

Driving the innovation ecosystem

This research also highlighted the critical role that the portfolio management or the technology office plays in vendors' 'innovation ecosystem'. Sitting between the sales and delivery parts of the organisation at one end, and the R&D labs at the other, this unit draws on and codifies repeatable best practices and innovative solutions from the sales and delivery parts of the organisation. For example, IBM's innovative Component Business Modelling tool was first developed in an engagement for American Express, before being codified and refined for use in other engagements.

Secondly, it draws on the R&D effort and 'productises' the most promising ideas and solutions that are developed there. Also, it acts as a key stimulator, facilitator and filter of ideas and solutions developed/initiated in any part of the organisation. A key element of this is the role of providing incentives and fostering a culture of innovation. Vendors address this with a mix of incentives and tools awards, as well as well defined objectives for ideas generated and progressed through the different stages of their development. The facilitation role is about enabling the processes and tools for the collection of ideas and organising forums for the discussion, development and filtering of ideas.

Next, the portfolio management function has a critical role in co-ordinating the linkage between external innovation contributors (such as the partners, suppliers, academia, universities) and start-ups. Most vendors accept that in order to deliver to a full set of client needs they must innovate with partners, academia and all other external entities that can contribute value to clients.

Finally, and perhaps most importantly, its role is to take part in client engagements to contribute ideas and thinking to real client problems, and take both the client issues and the developed solution back across the organisation. This 'cross pollination' role, typically played by the CTO, is perhaps the key part of the innovation ecosystem of an IT services vendor.

Innovation as a differentiator

At a higher level, we believe innovation is an attempt by, what we expect to be, a growing group of Western vendors to differentiate against growing competition in a commoditising services space. To borrow an idea from Kim and Mauborgne's *Blue Ocean Strategy*, the current IT services market is turning into 'red oceans of highly contested spaces'. Competition is intensifying and margins are thin. Innovation, among other things, is an attempt to find the blue oceans of uncontested market spaces where competition is non-existent or irrelevant. These blue oceans will be moving targets, hence the need for constant innovation in collaboration with clients and partners.

For further detail see our forthcoming Innovation: vendor strategies report. ■

2%
86p

NORTHGATE'S INTERIMS FAIL TO EXCITE

Last month Northgate Information Solutions reported its results for the six months ended 31 October 2006. Revenue grew 1.5% to £165m, and operating profit improved by 13% to £20.4m. Northgate HR grew revenue by 7.8% to £60.5m, with a divisional operating profit of £16.2m, up by 14%. Public Services revenue fell by 2% to £47.5m, with operating profit falling by 3.8% to £7.7m. Managed Services revenue fell by 1.4% to £57m with operating profits improved by 65% to £4.3m.

Overall it has been a disappointing period for Northgate, which is still trying to prove that it can generate strong organic growth as well as pursue its aggressive acquisition strategy. Growth in the HR division was all that buoyed up a lacklustre period for Northgate in the public sector and in managed services, and we expect that some of this growth came from its three HR acquisitions in the period.

That said, we are detecting something of a resurgence in interest in HR outsourcing in the UK market. And since Northgate's impressive win at Alliance Boots, it has also signed up a string of other household names such as Business Post and Rentokil Initial, confirming this trend. If demand for HR outsourcing continues to rise, then Northgate should be well positioned to benefit.

But Northgate has a bigger challenge; proving that it is more than the sum of its (acquired) parts. A series of acquisitions over the past two years has built Northgate into a significant player with a broad range of products and service offerings for the HR and government markets. But the company has yet to prove that it has the strategy to really make these separate business lines and products work together to drive market-leading organic growth.
(Samad Masood)

3%
275p

CIVICA: HITTING THE RIGHT SPOTS IN THE PUBLIC SECTOR

Civica continues to grow its core business around its IPR (and increasingly its consulting and managed services capabilities), while reducing its reliance on third-party software resale. Sales of owned software increased by 28% to £21.5m, while turnover on consulting was up 58% to £26.2m, and managed services turnover was up 70% to £26m. At the same time, Civica continues to lift third-party product margins (to 9%) on reduced turnover.

Excluding the contribution from the Comino acquisition at the beginning of 2006, organic growth was 10% (16% in Consulting).

Key contract wins during the year included selection as ICT partner for the preferred consortium for Sheffield City Council's Building Schools for the Future contract and a contract with Manchester City Council's social housing programme. Civica has also successfully launched its library management offering in the UK, on the back of its major contract with the Singapore government.

Civica's results reflect the continued success of its strategy of building a broad IPR-based offering to the local government, education and enforcement markets. The execution of that strategy has in recent years depended on its ability to acquire and successfully integrate complementary public sector players. The addition of Comino to its portfolio marked a scaling up of that acquisition strategy but, even though significantly larger than previous acquisitions, it seems to have been handled equally smoothly and has already had a positive impact on the business. However, we think that Civica could be at an interesting point in the evolution of that strategy with the most significant benefits of the Comino, and other recent acquisitions yet to be realised.

Civica has only just started to leverage its ability to offer a much more comprehensive package of solutions to public sector clients; one that is nicely rounded off by its growing consulting and managed services capabilities. With the efficiency agenda dominating much of future public sector investment, suppliers need to be aligned with either improvement in front-office service or the rationalisation and cost-saving in the back-office, and ideally both. This is not just a question of having the right solutions but also understanding how they can be implemented to offer real efficiency and service gains. It is not surprising that Civica is finding greater demand for its consultancy services. In-depth knowledge of the public sector - and local government

[continued on page nine]

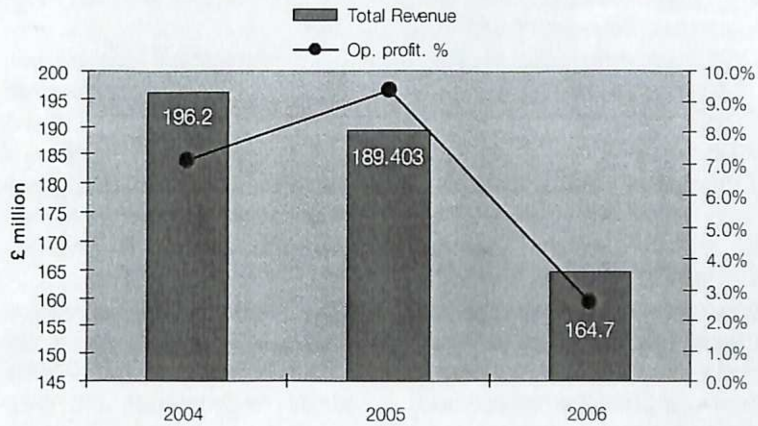
[continued from page eight]

in particular - will become more, rather than less, important in terms of showing provable value in a tough market. We expect Civica to continue to astutely extend its portfolio through acquisition. But it also has a real opportunity to drive organic growth through its front-to-back office solutions, if it can align them with evolving customer requirements.

(Eric Woods)

1%
82p

ANITE SHIFTS EMPHASIS OFF PUBLIC SECTOR



Anite, the software and services provider for the telecoms, travel and public sector markets, has reported a 5% decline in revenue for the first half of its fiscal year.

For the six month period ended 31 October 2006, Anite reported revenue of £78m, down 5.1% from £82.2m for the same period in 2005. Profit before tax remained more or less flat at £10.3m. Net cash also declined during the period to £22.7m, from £25.6m in 2005 - however this does include a £11.3m payment to finally settle the State of Victoria contract, and a £2.2m charge against onerous leases.

Anite is being very much held up by strong demand in its telecoms division, now known as Wireless. This was the only division to grow revenue during the period, up 6.5% to £26.4m. Anite's travel sector business remained flat at £14.6m, however its public sector division is the real weak spot. This saw revenue decline 15% to £31m.

We attended Anite's analyst briefing last month to get a fuller picture of the implications for its three business sectors. The upshot of it is that expansion in wireless and travel is seen as the vehicle for taking Anite forward, while public sector is now being strategically de-emphasised. CE Steve Rowley said that in two years' time he expected the make-up of Anite to look very different from what it is today. To that end, the company is continuing with its plans for disposing of non-core assets, which included that of GMO MC during the period. Rowley now sees the larger Anite Deutschland operation as another asset for disposal at some point in the future.

Wireless is strong thanks to sound strategy based on solid R&D spend (£4.1m in the past six months), and the combination of the Nemo acquisition completed on 30 November, boosts the division to c39% of group revenue on a pro forma basis.

Travel is another sector destined for improved fortunes, and should begin to see a return growth over the next 12 months. Anite's travel application, @com, has capitalised on the market trend for more short breaks, and the popularity of component based travel. @com's ability to support dynamic packaging has brought in new customers, notably Finnair in a multi-year deal worth £7m. But it is in public sector where Anite's future is less certain. The company is getting squeezed by the shift to large-scale outsourcing deals that favour large competitors, as well as a tough environment for discretionary systems integration.

The well-publicised problems with Pericles are finally being ironed out, and implementations are expected to complete in the second half of 2006-07. Anite is pre-empting this by reducing headcount in systems development. However, with the scarcity of new customers on the horizon, achieving break-even is still "not any time soon".

Strong cost control, largely from headcount reductions, are bringing an increase in public sector margins. Having given up on the idea of acquiring to build scale in the public sector, this could be part of a broader strategy for future disposal.

(John O'Brien and Peter Clarke)

16%
209p

MICRO FOCUS REPORTS INCREASED PRE-TAX PROFITS IN INTERIM RESULTS

Micro Focus announced pre-tax profits up 143% to $31.4m for the half year ending 31 October compared to $12.9m for the same period last year. Operating profit rose 55% to $30.4m from $19.6m in FY05 and revenues increased 8% to $79.0m compared to $72.9 for FY05. Basic earnings per share are 12.03 cents, up from 4.66 cents in FY05. Cash balance at 31 October 2006 was $68.1m compared to $38.6m at the same time last year.

In the six months following the close of FY06 in which the company was compelled to revise market estimates twice, Micro Focus has demonstrated strong leadership. The new management team is to be congratulated; they have driven a flurry of new product announcements, held an internal strategy review and delivered a very promising financial performance.

Ovum's earlier concerns with Micro Focus' ability to solve sales execution problems appear to have been resolved in some European territories, delivering strong growth especially in Benelux, France and Italy. However, there is clearly work to be done to further strengthen sales execution in North America.

The strategy review concluded that a firm market exists for four solution areas: COBOL tools, modernisation, migrations and APM (Application Portfolio Management). Micro Focus' core business is based on the first of these, and strong maintenance revenues demonstrate that its strong base of existing users remains committed to using these tools. New licence sales growth up at 7% is also very healthy.

Going forward, Micro Focus has to assimilate HAL Knowledge Solutions into its organisation and strategy. Ovum views the legacy renewal market as an important one for Micro Focus and this will require a joined-up strategy for modernisation, migration and APM tools.

(Gary Barnet)

44%
57p

ISOFT AHEAD OF LOW EXPECTATIONS

Troubled healthcare software vendor iSoft had total revenue of £85.9m for the six months to 31 October 2006. This represents a fall of 12% on last year's total of £97.2m, which iSoft has restated following the furore over its revenue recognition practices. However, the good news is that the revenue is at the higher end of market expectations.

The issues around iSoft are highly emotive due to its role in NPfIT and the ecstasy and pain this seems to have brought the company in roughly equal measures, though we've seen most of the agony over the last year.

Falling revenue is not good in any business, but it is especially disappointing for a software company with mature products, where most of the revenue should be from maintenance and support. Falling revenue would normally mean a mass desertion of the user base. However, iSoft is so closely linked to the vicissitudes of the UK government's NPfIT programme, where revenues are linked to passing project milestones in a way that is not entirely in the company's control. This makes the revenue figures almost impossible to interpret in any normal way. Not surprisingly, given the challenges to the company's finances, new business outside the NHS has been hard to come by.

In other domains, iSoft is making progress, reducing costs ahead of its own targets and re-building its management team, though it still lacks a full-time CEO (chairman John Watson standing in pro-tem). It also has too many product versions that it is supporting - around 30 different versions of some of the core products. But most pressingly, it needs to acquire long-term funding, as its loan agreements with banks will become punitive in the medium term.

The best option for iSoft, therefore, is to be acquired by someone with relatively deep pockets and a strong interest in healthcare, and it announced in October that it is in discussion with various interested parties. The markets obviously think these results will make that more likely, since iSofts' share price rose on the morning, albeit very modestly. The good news is that there is lots of money around for acquisitions right now. The bad news is that at almost $2/£1, iSoft will look very expensive to US-based acquirers, who have the most money to spend. However, there are still players in the UK and Europe for whom the exchange rate will not be such an issue.

(David Bradshaw)

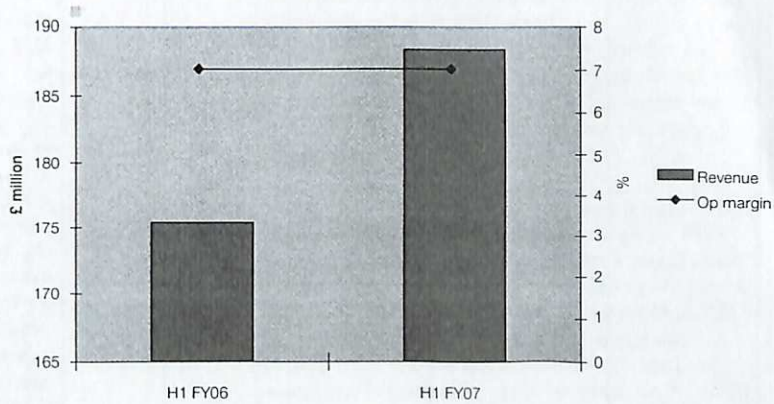
18%
87p

xansa

XANSA: TRANSFORMATION ACHIEVED, WORK TO DO

Xansa reported first half revenues (to end October 2006) up 7.4% to £188.4m. The company's operating margin was flat at 7.0% (or down just slightly to 5.9% if we include the effect of share-based payments). A large increase in working capital led to a negative operating cash flow of £5.9m, compared to +£5.7m in H1 of FY06. The company also confirmed an increase in its order backlog of 6% to £475m. Meanwhile, headcount at the firms Indian operation kept climbing, with 38% year-on-year growth (to 4,661).

Xansa: H1 comparison (06+07)



With year-on-year growth of 7% and further growth projected for the second half, there's no disputing that Xansa has got revenues going in the right direction again. Key to this return to growth is the public sector business, which grew 91% in H1. Government now accounts for 32% of revenue (or £59m), compared to just 11% two years ago (in H1 of FY04). Xansa's experience demonstrates that if you pick the right government account teams and mount a concerted effort in the sector, taking the odd calculated risk (which the NHS finance and accounting JV undoubtedly was), you can grow market share from the position of a relative outsider. UK government is not a walled market.

Xansa sees its Indian capability as a differentiator when selling into public sector, particularly given its experience of managing an onshore/offshore mix on its NHS BPO work. We'd agree that it's well placed here as openness to offshoring in government rises. And so long as the contract wins keep coming, the deflationary effect of offshoring some existing work is unlikely to cancel out the public sector growth engine.

It's in the private sector side of the business that the migration of work offshore has had a dramatic deflationary effect on revenues. But that migration has also tended to have a positive impact on margins. However, times have changed and customers no longer allow suppliers to take the margin benefits of offshoring. Xansa sees itself growing operating margins to "high single digits". To achieve even this modest ambition it'll need to sustain and most probably improve its ability to grow. Expanding existing accounts by selling in new service lines (as it's done so successfully at LloydsTSB) will be vital.

Xansa must also bear in mind that its offshore capability is losing its value as a competitive differentiator. Indian players are growing fast and signing bigger deals, and onshore competitors are catching up with Xansa's Indian assets. CEO Alistair Cox now talks about delivering "services through technology and not just technology services". This suggests that he's thinking, wisely in our view, about taking Xansa to the next stage in the evolution of IT services: productisation and automation. He'll need a lot more in-house IP than he has today to achieve that. He also needs to be careful that the firm avoids being confined to lower value areas of the market. Xansa's offerings in business analytics (with Renault F1 as a flagship customer) are a step in the right direction, but we think that an increased emphasis on consulting and application development/portfolio management would help too. As we keep saying, IT services firms need an answer to customers' cost containment agenda AND their renewed "growth agenda".

In the past five years, Xansa has boldly embraced not just offshoring but also BPO and government. And while the impact of that transformation of the company can now be seen in its return to growth, Xansa will need to keep moving ahead of the times if it's to succeed as a mid-sized player in a mature market. Its advantage is that frigates are easier to re-direct than supertankers.
(Phil Codling)

Mergers and Acquisitions December

Buyer	Seller	Seller Description	Acquiring	Price	Comment
Axon	Zytalis	US-based SAP house	100%	£7.7m	Ten-year-old Zytalis fits with Axon's US strategy of acquiring vertical-market specialists. It is a certified SAP consulting and NetWeaver partner, with expertise in PLM (product lifecycle management; it's a preferred SAP partner for PLM) and targets high-tech and discrete manufacturing customers. We think this is the right way to go for a mid-sized European player like Axon attacking a market as big as the US. Axon is quietly assembling a reasonably wide service portfolio in the US private sector, complementing its strong public-sector focus in the UK. It will be interesting to see how much it can use this expertise to grow its private-sector business in the UK and Europe. Zytalis has a mid-market practice, targeting fast-growth companies with sub-$700 million revenues with pre-configured SAP solutions. What should we make of this mid-market emphasis, which Zytalis share with the last Axon US acquisition, PremierHR? As with PremierHR, we don't see Axon moving its general focus to the mid-market, but rather using techniques borrowed from the mid-market to speed implementations in clients of any size. But given that US high-tech is an industry with plenty of growing companies (Zytalis is based in California), mid-market expertise is no bad thing to have.
Bond International	Gowi Group plc	Suppier of software and services into human resources, payroll and recruitment	100%	£8.9m	Gowi has principally grown through targeted acquisitions and now employs approximately 120 employees in five locations around the UK. The company's annual turnover is expected to be around £9m, operating margin around 15.5%, with consolidated net assets of (at the date of completion) totalling £3m. Bond's latest results show that the company has been able to maintain a healthy margin while driving growth in its chosen niche in HR software. The acquisition is in line with Bond's strategy to buy firms in related industries – and the Gowi purchase is its largest to date.
Logicalis	CSF Group	Supplier of IT infrastructure solutions	100% (of the solutions business of CSF)	£6m	The business will be integrated into the UK operations of Logicalis, the reseller and services company owned by Datatec. As promised, Logicalis (part of the much larger Datatec) has put its hand in its pocket - well, its parent has! The purchase strengthens its ties to IBM and HP - as a reseller in the enterprise computing and storage areas. But the company will also gain a data centre, which is particularly useful given today's high demand for space. While we don't know who the interested buyer is, we see this type of small, privately-owned managed services business as being attractive to two sets of buyers in particular: Firstly, resellers who are looking to make a cautious acquisition that moves them more into services. Secondly, managed services players who are looking to build-out their portfolios further. So why didn't Logicalis buy this side of the business too? We think it is looking to really focus in on its relationship with IBM, building on its heritage and previous acquisitions in this area. Also, we suspect it already has substantial capability in managed services.

Mergers and Acquisitions December - continued

Buyer	Seller	Seller Description	Acquiring	Price	Comment
Redstone plc	IDN Telecom plc	Provider of telecom solutions and consultancy services to B2B customers	40%	£11.4m	The Redstone Directors believe that the acquisition is a further step towards establishing Redstone as an IT and communications solution provider for B2B customers in the UK and Ireland. Redstone believe that the acquisition provides the Group with the addition of 2,000+ corporate and SME customers and cost savings through synergies from combining the two UK based fixed line telephony businesses.
Veritas Capital (private equity group)	Pearson Government Solutions	Buiness process outsourcer	90%	£306.4m	Veritas' move is part of a trend towards broader private equity (PE) investment in the UK public sector BPO market - it adds to similar investments made in rivals Liberata and HBS. There has also been recent interest in a number of other software and IT services (S/ITS) suppliers with a public sector focus, which leads us to read that there is a real appetite by PE firms to participate in consolidating the UK public sector S/ITS market. The large outsourcing deals that PGS takes on are capital and labour intensive, and Veritas' investment will clearly provide a welcome injection of funds into the business to bid on future public sector BPO deals. It also plans to use some of the investment to fund "bolt-on" acquisitions, and reduce corporate debt. We believe this is a sensible approach to take since competing in the local government BPO market requires significant scale, which is something it currently lacks. It's worth noting that so far, PE investments in HBS and Liberata have yet to deliver significant returns for their investors. Veritas will, therefore, need to ensure it has a clear roadmap for invigorating profitable growth from PGS in the UK. We don't expect this to be a quick win however. Public sector organisations will need convincing that Veritas has given firm commitments on PGS for the long term.

Happy New Year....and new reports from Holway@Ovum

As is traditional at this time of year, the Holway@Ovum team has been working to produce exciting new additions to our "Market Trends" research stream. So, during January, we are publishing five reports that analyse and assess the implications of current and future trends in the UK S/ITS market. Each is focused on a key part of the market: Software, Infrastructure Services, Project Services and Applications Management, Business Process Outsourcing, and there's also a UK market overview.

Meanwhile, Holway@Ovum users may also have noticed the appearance of our annual Industry Trends research, which looks at M&A activity, investor sentiment and financial performance. All three Industry Trends reports are available on our website.

If you are not a Holway@Ovum subscriber and would like to access any of our latest research, please contact Suzana Murshid on +44 20 7551 9071.

UK software and IT services share prices and market capitalisation - December 2006

	SCS Cat.	Share Price 29-Dec-06	Capitalisation 29-Dec-06	Historic P/E	PSR Ratio Cap./Rev.	S/ITS Index 29-Dec-06	Share price move since 30-Nov-06	Share price % move in 2006	Capitalisation move since 30-Nov-06
@UK plc	SP	0.18	6.76	NA	4.65	274.81	-10%	-73%	-£0.75m
Alphameric	SP	0.48	63.32	9.1	0.86	219.04	-9%	-47%	-£6.63m
Alterian	SP	1.14	47.84	33.4	4.50	567.50	12%	-14%	£6.75m
Anite Group	CS	0.82	284.06	81.5	1.50	476.61	1%	20%	£1.74m
Ascribe	SP	0.39	41.70	37.8	7.80	2,052.63	4%	11%	£1.60m
Atelis plc	SP	0.07	1.69	NA	NA	313.95	-7%	-69%	-£0.13m
Atlantic Global	SP	0.14	3.07	NA	1.44	457.63	0%	-37%	£0.00m
Autonomy Corporation	SP	5.12	918.62	120.0	16.75	156.14	-1%	31%	-£8.08m
Aveva Group	SP	8.16	544.52	67.2	8.26	4,080.00	14%	-12%	£67.40m
Axon Group	CS	6.11	362.39	54.6	3.95	3,488.57	16%	123%	£48.97m
Bond International	SP	1.73	48.02	21.6	3.45	2,653.85	11%	74%	£4.59m
Brady	SP	0.37	9.42	NA	3.87	450.62	-5%	16%	-£0.52m
Business Systems	CS	0.13	9.61	13.0	0.28	105.04	14%	-26%	£1.15m
Capita Group	CS	6.07	3838.92	33.2	2.67	164,084.38	6%	46%	£211.87m
Centrom	CS	0.02	2.29	NA	0.36	250.00	0%	-67%	£0.00m
Charteris	CS	0.16	6.88	41.0	0.34	177.78	0%	-56%	£0.00m
Chelford Group	CS	1.68	11.91	9.3	1.00	291.31	-17%	-31%	-£2.49m
Civica	CS	2.75	171.32	NA	1.62	1,572.44	3%	10%	£5.76m
Clarity Commerce	SP	0.54	8.53	9.2	0.64	428.00	-6%	-30%	-£0.56m
Clinical Computing	SP	0.07	2.21	NA	1.33	56.45	-8%	-30%	-£0.20m
CODASciSys	CS	1.62	124.70	NA	1.71	1,255.81	-1%	-61%	-£0.77m
Compel Group	CS	1.19	40.20	27.8	0.63	948.00	17%	32%	£5.94m
Computacenter	R	2.69	427.09	15.9	0.19	400.75	9%	5%	£35.79m
Computer Software Group	SP	1.22	73.33	41.8	5.21	1,034.03	4%	82%	£2.72m
Cornwell Management Consultants	CS	0.12	2.03	1.8	0.11	82.59	-57%	-85%	-£2.73m
Corpora	SP	0.06	7.53	-1.1	2.90	147.89	-6%	-54%	-£0.38m
Dealogic	SP	1.58	112.42	0.8	3.63	684.78	0%	7%	£0.10m
Delcam	SP	3.12	18.83	9.7	0.78	1,200.00	-1%	-6%	-£0.24m
Detica	CS	3.67	410.17	41.9	4.04	4,587.50	22%	53%	£74.88m
Dicom Group	R	2.33	202.88	33.8	0.97	713.52	3%	12%	£5.88m
Dillistone Group	SP	1.47	7.91	NA	NA	1,073.26	1%	7%	£0.11m
Dimension Data	R	0.43	662.26	31.1	0.48	76.38	-3%	7%	-£19.25m
DRS Data & Research	SP	0.37	12.80	NA	1.03	336.36	-3%	-1%	-£0.35m
EG SOLUTIONS	SP	0.82	20.37	1.0	5.94	554.42	-44%	-44%	NA
ELCOM	CS	0.03	13.63	NA	NA	832.00	-17%	-17%	NA
Electronic Data Processing	SP	0.65	15.74	18.8	2.26	1,974.89	5%	-3%	£0.73m
FDM Group	A	0.94	21.71	22.7	0.66	1,147.24	6%	11%	£1.16m
Ffastfill	SP	0.06	14.55	NA	5.49	50.00	20%	55%	£2.42m
Financial Objects	CS	0.55	25.82	NA	1.86	236.96	9%	38%	£2.13m
Flomerics Group	SP	0.75	11.03	11.9	0.97	2,884.62	15%	-14%	£1.40m
Focus Solutions Group	CS	0.49	13.87	108.5	2.55	248.72	-1%	131%	-£0.14m
GB Group	CS	0.46	38.52	NA	3.00	296.70	26%	35%	£7.96m
Gladstone	SP	0.26	13.19	14.4	1.72	637.50	2%	9%	£0.26m
Glotel	A	0.63	24.27	9.8	0.27	327.27	6%	-24%	£1.35m
Gresham Computing	CS	1.48	74.15	NA	5.30	1,591.40	7%	82%	£4.63m
Group NBT	CS	2.08	42.44	20.8	3.76	1,037.50	13%	81%	£5.01m
Harvey Nash Group	A	0.73	47.70	13.1	0.24	417.14	22%	64%	£8.66m
Highams Systems Services	A	0.05	1.47	NA	0.11	128.47	-8%	48%	-£0.12m
Horizon Technology	CS	0.69	56.10	13.7	0.29	253.76	9%	-17%	£4.47m
IBS OPENSystems	CS	1.83	73.00	NA	4.67	1,196.72	-4%	14%	-£3.20m
I S Solutions	CS	0.16	3.94	42.6	0.71	586.93	7%	17%	£0.25m
ICM Computer Group	CS	2.89	61.11	18.7	0.81	1,605.56	11%	-13%	£6.08m
IDOX	SP	0.06	11.90	NA	0.84	8.18	42%	-55%	£3.50m
In Technology	CS	0.43	60.61	NA	0.21	1,720.00	7%	34%	£4.23m
InterQuest Group	A	0.88	22.17	15.6	0.80	1,521.74	4%	103%	£0.76m
Innovation Group	SP	0.31	197.53	27.3	3.24	136.46	11%	4%	£19.12m
Intelligent Environments	SP	0.06	10.09	NA	3.23	66.49	16%	92%	£1.41m
Intercede Group	SP	0.60	20.21	NA	11.19	991.67	-11%	75%	-£2.38m
Invu	SP	0.30	32.28	24.0	10.25	3,157.87	7%	43%	£0.96m
iSOFT Group	SP	0.57	131.35	NA	0.50	513.64	44%	-85%	£40.10m
iTrain	SP	0.02	1.77	10.2	0.97	26.47	-28%	-58%	-£0.69m
IX Europe	CS	0.49	84.57	NA	3.76	1,606.56	10%	61%	£7.77m
K3 Business Technology	SP	1.16	19.88	NA	0.90	886.31	3%	41%	£0.60m
Kewill	SP	0.79	62.04	22.6	2.33	1,561.26	6%	10%	£3.53m
Knowledge Technology Solutions	SP	0.02	2.03	NA	1.63	325.00	18%	-7%	£0.01m
LogicaCMG	CS	1.86	2855.76	37.2	1.56	2,547.24	6%	5%	£149.70m
Lorien	A	0.43	8.33	NA	0.06	425.00	-2%	8%	-£0.20m
Macro 4	SP	2.12	48.81	15.6	1.47	854.84	2%	-19%	£2.23m
Manpower Software	SP	0.26	11.50	NA	2.65	268.04	35%	-10%	£2.99m
Maxima Holdings	CS	2.30	39.96	38.5	3.22	1,672.73	16%	48%	£5.47m

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Mediasurface	SP	0.17	13.13	NA	2.43	1,250.00	6%	45%	£0.77m
Micro Focus	SP	2.09	415.64	49.4	5.50	0.00	16%	77%	£57.81m
Microgen	CS	0.55	55.36	13.1	1.36	232.91	-3%	-26%	-£1.52m
Minorplanet Systems	SP	0.56	16.15	14.0	0.68	1,143.56	33%	27%	£4.04m
Misys	SP	2.16	1081.94	40.3	1.13	2,690.40	1%	-9%	£7.50m
Mondas	SP	0.15	5.07	NA	2.43	193.33	-9%	12%	-£0.52m
Morse	R	1.08	163.09	11.1	0.44	432.00	-2%	13%	-£3.02m
MSB International	A	0.72	14.66	NA	0.16	376.32	0%	99%	£0.00m
NCC Group	CS	2.79	90.80	19.9	4.38	1,667.66	7%	20%	£5.71m
Ncipher	SP	2.54	71.55	37.5	4.12	1,016.00	-5%	22%	-£3.52m
Netcall	SP	0.17	11.21	28.3	3.38	343.44	-3%	31%	-£0.33m
Netstore	CS	0.30	37.47	203.4	1.04	200.00	0%	-22%	£0.00m
Networkers International	A	0.35	2.63	58.3	0.14	1,093.75	4%	9%	£0.11m
Northgate Information Solutions	CS	0.86	458.13	18.4	1.38	330.77	2%	1%	£9.32m
NSB Retail Systems	SP	0.34	126.26	8.2	2.61	2,978.26	17%	5%	£18.43m
OneclickHR	SP	0.04	5.95	NA	1.01	100.00	-3%	-9%	-£0.19m
OPD Group	A	4.91	130.35	35.3	2.98	2,231.81	16%	96%	£17.52m
Parity	A	0.79	29.68	NA	0.21	726.85	3%	-52%	£0.76m
Patsystems	SP	0.17	27.55	NA	1.78	161.22	1%	28%	£0.40m
Phoenix IT	CS	3.05	183.60	14.3	1.69	1,129.63	5%	13%	£8.88m
Pilat Media Global	SP	0.82	42.66	24.1	3.28	4,075.00	6%	83%	£2.36m
Pixology	SP	0.29	5.78	NA	1.28	204.19	-2%	-48%	-£0.10m
Portrait Software	CS	0.15	12.95	NA	1.12	98.49	0%	-43%	£0.00m
Proactis Holdings	SP	0.64	19.13	25.4	NA	1,309.28	7%	31%	£1.20m
Prologic	CS	0.85	8.50	18.9	1.23	1,024.10	0%	38%	£0.00m
QinetiQ Group	CS	1.92	1221.48	NA	1.16	872.44	3%	-13%	£6.55m
Qonnectis	CS	0.01	1.64	NA	14.98	200.00	-25%	-65%	-£0.55m
Quantica	A	0.31	20.22	7.6	0.52	245.97	0%	-48%	£0.12m
Red Squared	CS	0.07	1.31	NA	0.53	357.14	8%	-2%	£0.10m
Revenue Assurance Services	SP	1.23	47.37	NA	1.06	820.00	11%	22%	-£0.00m
RM	SP	1.94	155.65	NA	0.59	5,550.00	14%	23%	-£0.69m
Royalblue Group	SP	10.38	340.80	32.8	4.59	6,105.88	9%	45%	£28.89m
Sage Group	SP	2.71	3507.27	22.9	3.75	104,230.77	6%	5%	£190.89m
Sanderson Group	SP	0.49	20.49	10.2	1.27	980.00	-7%	-7%	-£1.46m
SDL	CS	2.36	146.85	48.4	1.87	1,571.67	11%	9%	£14.17m
ServicePower	SP	0.17	13.27	NA	1.67	165.00	27%	-47%	£2.81m
Sirius Financial	SP	1.47	26.28	294.0	1.21	980.00	1%	1%	£0.36m
SiRViS IT plc	CS	0.04	0.44	43.1	0.06	33.70	7%	29%	-£3.69m
smartFOCUS plc	SP	0.15	11.74	116.8	1.94	1,648.65	2%	2%	£0.19m
Sopheon	SP	0.23	30.65	NA	6.57	323.74	6%	15%	£1.70m
Spring Group	A	0.69	84.20	NA	0.19	766.67	6%	11%	-£20.80m
SSP Holdings	SP	1.21	110.23	102.3	6.16	1,136.79	14%	14%	NA
StatPro Group	SP	1.04	54.23	22.7	5.03	1,300.00	9%	58%	£16.70m
SThree Group plc	A	3.87	533.25	23.9	2.20	1,876.21	3%	79%	£13.11m
Stilo International	SP	0.02	2.14	NA	1.03	47.50	-14%	-10%	-£0.34m
Strategic Thought	CS	1.00	26.08	10.2	2.27	738.01	0%	-26%	£0.00m
SurfControl	SP	5.20	163.46	NA	2.86	2,601.25	22%	-1%	£29.93m
Tadpole Technology	SP	0.01	3.98	NA	0.82	24.14	-11%	-72%	-£0.50m
Tikit Group	CS	2.57	32.48	146.7	1.61	2,230.43	11%	46%	£3.27m
Torex Retail	SP	0.49	190.47	NA	1.14	1,225.00	-13%	-54%	-£27.21m
Total Systems	SP	0.36	3.79	16.7	1.09	679.25	-1%	-10%	-£0.05m
Touchstone Group	SP	1.79	20.38	71.6	1.18	1,704.76	-2%	32%	-£0.46m
Trace Group	SP	1.00	14.79	13.8	1.03	796.00	0%	4%	£0.00m
Triad Group	CS	0.25	3.79	NA	0.09	185.19	0%	-51%	£0.00m
Ubiquity Software	SP	0.20	36.54	NA	4.90	502.51	-5%	-47%	-£1.83m
Ultima Networks	R	0.01	1.79	NA	0.94	21.34	-22%	-46%	-£0.51m
Ultrasis Group	SP	0.01	18.98	NA	15.27	29.08	1%	-29%	£0.13m
Universe Group	SP	0.14	8.70	7.8	0.20	622.22	10%	-26%	£0.78m
Vega Group	CS	2.12	43.05	13.9	0.69	1,733.61	4%	4%	£1.63m
VI group	SP	0.14	5.31	NA	0.55	285.00	33%	73%	£1.30m
Xansa	CS	0.87	299.67	36.3	0.84	2,224.36	18%	-4%	£45.77m
Xpertise Group	CS	0.41	2.12	NA	0.16	1,620.00	0%	-51%	£0.00m

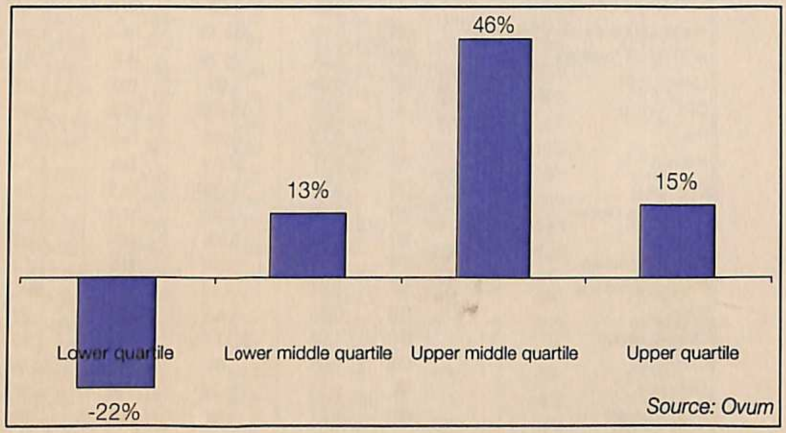
Note: We calculate PSR as market capitalisation divided by sales in the most recently announced financial year.
Main **SYSTEM**HOUSE S/ITS Index set at 1000 on 15th April 1989. Any new entrants to the Stock Exchange are allocated an index of 1000 based on the issue price. The SCS Index is not weighted; 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

THREE THEMES FOR 2007: SIZE, FOCUS AND PRIVATE EQUITY

2006 was another year of slow recovery for the industry in the UK, with the Ovum S/ITS Index growing by just 5.7% during 2006. Unsurprisingly, we're still a long way from the unsustainable peak of 2000. But we're clearly well past the troughs of early 2003, when the index plunged to less than half its current value.

A key theme in 2006 was the correlation between size and stock performance, with the larger S/ITS companies tending to perform better, as we can see in the chart. The reason? Larger companies are benefiting from scale, which not only helps them grow organically in today's mature market, but is also a significant aid in acquisitions – a major factor behind the growth of most of today's best performing S/ITS stocks.

Average share performance of S/ITS companies by market capitalisation in 2006



In fact it was the "upper-middle" quartile (companies with market caps between £26m and £90m) that performed best in our final analysis of the year as a whole. That's partly because these businesses benefit from some scale but also because this tier of players tends to be more focused on specific verticals or service lines. Examples include IX Europe (collocation) and Tikit (services for the legal sector). Such easily-articulated strategic and market focus was the second major driver of share value for S/ITS companies in 2006, and will continue to be crucial for anyone aiming to impress investors in 2007.

It should come as no surprise that in the month of December, the top share price performers across our four S/ITS sub-segments were all in the top two quartiles by market capitalisation. Staffing agencies continued to grow well, with average share prices up 4.5%. The software sub-segment was also up by 4.4%, helped by iSoft's rebound to 57p (up 44% in the month). The company's share value is still, however, 85% lower than at the start of the year.

As a group, computer services didn't perform well because a 57% share price fall from Cornwell Management Consultants (due to a statement regarding poor trading expectations) pulled down the average growth to only 3.4%. Without Cornwell the average share price of computer services companies would have risen by almost 5% – further emphasising the need for investors to focus on specific S/ITS companies based on their strategy and focus rather than just being drawn to an association with IT.

Finally, there was not much seasonal cheer for resellers. Even without the effect of the penny share Ultima Network's fall of 22%, the sub sector only grew by 2%. And despite Computacenter's best efforts (its shares grew 9% in December), the company still fell out of the FTSE 250, only leaving Dimension Data to represent resellers in that tier of UK businesses. But even that may not last too long. At the end of November rumours circulated that DiData was in the frame for a private equity buyout. Regardless of the veracity of this rumour, it emphasises the third big theme of 2006 – private equity interest. Like size and focus, that is a theme that is set to stay with us in 2007. *(Samad Masood and Phil Codling)*