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SYSTEMHOUSE

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

REDEFINING THE BUSINESS SOLUTIONS INDUSTRY

By Tom Kucharvy

When everything was predictable, participants in the business solutions value chain had a clear role. Huge ISVs (like SAP and Oracle) developed and sold the enterprise application frameworks on which global systems integrators (like Accenture and Capgemini) could implement their clients' unique business processes. These firms and their smaller, more specialised cousins (typically regional SIs) often performed similar roles in tailoring these or more specialised applications (from niche ISVs) for use by smaller customers. Depending on their size and needs, companies purchased their systems and solutions from, and had them implemented by, some combination of vendors, SIs and VARs.

The emergence and rapid maturation and adoption of service-oriented architecture (SOA) is already beginning to transform the roles of key members of this business solutions value chain.

Tom Kucharvy
Senior Vice President
Ovum Summit

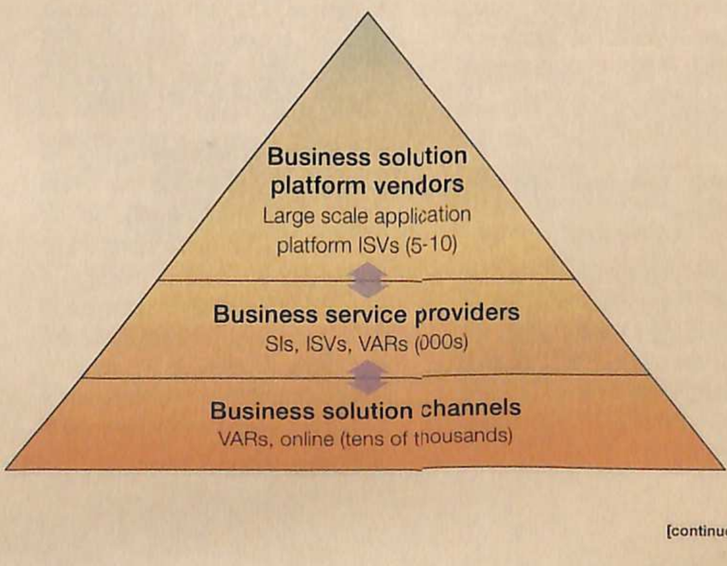
Over the next few years, SOA will:

- obliterate the distinction between application software and business solutions by embedding best practice-based business processes directly into reusable business services components that can be combined to address the specific needs of individual customers

- transform business solution platforms, (such as those from SAP, Oracle and Microsoft) from proprietary, self-contained applications to standards-based, modular SOA platforms with large ecosystems of third-party business services components that integrate easily into the platform

- solidify the roles of SIs as the leading

Figure 1 **The business solutions value chain**



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INDICES
(changes in February 2007)

Ovum S/ITS Index	**+1.8%**	**5933**
FTSE IT (SCS)	**-0.2%**	**590**
techMARK 100	**+1.4%**	**1562**

[continued from front page]

business and IT solutions providers to enterprise customers, bringing together both LoB executives and IT departments around the same business objectives, and as the preferred go-to-market channels for business-platform vendors

• consolidate three primary business-solution-creator models (specialised ISVs, SIs and VARs) as business/IT consultants and creators of libraries of reusable business services that tailor core business platforms to the specific business needs of the customer

• jumpstart SaaS-based business-service outtasking and the creation of online business-service ecosystems.

Redefining the business solutions value chain

These changes will transform the nature and composition of the business solution value chain. It will result in a three-tier go-to-market model (*Figure 1*) in which:

• a handful of platform vendors provide the core business process infrastructures that industry and process specialists (which we call business service providers) will tailor to the needs of specific clients

• initially dozens and eventually thousands of business service providers will work with clients to identify their unique industry and process needs and will build or recombine existing SOA business services into custom business process solutions

• a growing, and eventually huge network of business solutions channels will analyse the needs of smaller, more specialised business customers and either serve as agents to bring business service providers into these accounts, or recombine services into solutions tailored to these customers' needs.

As suggested in *Figure 1*, borders between layers of the solutions value chain are porous. While platform vendors will actively recruit, build and nurture provider and channel ecosystems, most will also create their own libraries of high-level business services that are suitable to large numbers of customers. While these high-level extensions may be sufficient to address the needs of some customers, they will also be provided to service provider partners as building blocks for their own offerings.

Consultants not able to provide sufficient business solutions value or to adapt to an asset-based business model, and ISVs that cannot adapt to a highly consultative model, will drop out of the service provider category, and some will become channels for other service provider offerings. Meanwhile, some channel players will migrate up the value chain to become service providers.

This will create opportunities for players to enter each of the three levels. For example:

• platform providers, although initially consisting primarily of big packaged software vendors, will also include software-as-a-service (SaaS) platform vendors such as Salesforce.com, and probably others, such as NetSuite or Google

• service providers will consist of industry and business consultants, who add asset-based components to their professional service-based business models, and specialised ISVs, who either migrate away from their traditional apps or re-architect them into business services-based extensions to industry-leading platforms.

Redefining business solution value chains

What does this all mean for the business solutions providers and associated value chains? Both are on the cusp of radical transformations, which are being driven by SOA and will be characterised by:

• customer demand for flexible solutions that instantiate business processes into applications that can be delivered in any way the customer prefers (in-house, outsourced or outtasked), but blended into a single service delivery environment

• emergence of a new generation of SOA - based business solution platforms, and business process engines around which large ecosystems of business service providers, consultants and implementers will form

• dramatic growth in the importance and roles of SIs as advisors and outtasking partners to their clients; as business-process design and go-to-market partners to platform ISVs; and increasingly as developers/ vendors of specialised business process software.

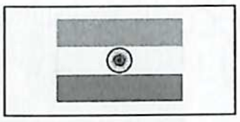
The result? A three-tier business solutions value chain that will consist of:

• five or more ISVs that own a core SOA-based business service platform controlling a large ecosystem of business-service provider and channel partners

• thousands of next-generation systems integrators—business process experts that help customers design, build and manage SOA-based business-process solutions

• tens or hundreds of thousands of SOA solutions channels that design and help customers migrate to SOA-based solutions.

The roles and relationships of all the participants across this value chain will be transformed. So far, the major platform vendors, most of the big SIs and a handful of mid-sized RSIs and specialised ISVs are taking the lead. Over the next several years, all will have to begin adapting to the realities of this new business-solutions value chain.■



INDIA RIDES A WAVE OF OPPORTUNITY: FOR HOW LONG?

Angel Dobardziev
Practice Leader, IT Services

Having taken part in a well attended Nasscom 2007 (the annual event of India's software and IT services -SITS- trade association) it is clear the Indian SITS industry remains on a roll. The Indian players' numbers are impressive: most are growing at between 30-40%, maintaining healthy profit margins of 20-30%. Such growth rates coupled with stellar margins have enabled Indian players to become (multi) billion dollar operations, and darlings of the investment community.

We are impressed by the energy, ambition and entrepreneurship of executives leading these players. Application development and maintenance (ADM) remains the biggest revenue and profit generator for these players, where they have built a sizeable presence on the basis of their low cost, high quality talent pool. But this is no longer enough; the leading players told us about their activities in service lines such as consulting, remote infrastructure management (RIM), BPO and R&D services. It is clear the Indian players are not in the game to match Western IT services players, but to beat them.

We would like to strike a note of caution here. To us, India's SITS industry is like a boat riding a wave. The wave was created by the efforts of the Indian government's education and economic policies, and propelled by a unique set of conditions in the late nineties (e.g. globalisation, cheap connectivity, need for a large number of low cost, quality English speaking software engineers), creating opportunities for Indian SITS companies. Frankly, the force of this wave was such that it was not easy to do badly in this environment.

The challenges for the Indian players will come from three key forces:

- Western players' counter-strategies. IBM, Accenture and EDS are among the biggest recruiters in India today. They are trying to replicate the low cost delivery model which is giving the cost advantage to the Indian players. Combined with their formidable onshore relationships and domain knowledge these players will be tougher to beat on price and offshore delivery alone.

- Supply constraints. The growing attrition rates and accelerating wage inflation suggest that supply of quality talent is becoming restricted, partly as a result of the actions of the Western players. The relevance of the cost issue is how India compares against other offshore locations such as China, Philippines, Indonesia and Russia. And here rampant wage inflation will tip the balance against India.

- Managing growth on a larger scale. Most Indian players add around 30-35% new employees each year. Not only is there the huge challenge of preserving the organisational DNA in such circumstances but in light of the 20% (and rising) attrition rate, Indian players in effect change much of their personnel around every 2 years. For how long can an organisation do this?

These forces will reduce the strength of the Indian wave within the next two to three years. Also key Western IT services players will evolve their Indian (as well as other low cost) delivery strategies to represent credible alternatives to the Indian players. Combining this low cost delivery with their strong onshore resources, relationships and domain knowledge will take the sales initiative. This will mean value migrating away from commodity offshore work back to onshore needs of identification, solution creation and client management – best captured through the current search for 'Innovation'. All of this will put pressure on Indian players' growth rates.

The Indian players will need to evolve and adapt their current offshore-heavy, ADM-led model. They will need a stronger and more diverse service portfolio (in particular, consulting and business process services, as well as remote infrastructure management services) to cater for a broader set of client needs. They will also need a far stronger onshore capability, which will be able to sell and deliver a more complex set of services catering for the less well defined needs of clients. In addition, it means building capability in other sourcing locations, in order to serve other markets (i.e. Germany, France). There are a number of key Indian vendors that are going in this direction, but this is neither universal, nor is all of it at the same pace.

The overall challenge is the execution of these changes while feeding investor expectations of maintaining current growth rates and profitability margins. In light of all the investment in new services lines, expensive onshore resources, and the increasing challenge of managing complex service lines, this task won't be easy, and it might lead to slower growth and lower margins in the interim. But those that don't embark on preparing to catch the next wave might find themselves left behind from 2009 onwards.■

FUJIN

FUJIN AIMS TO REPEAT BUY AND BUILD STRATEGY

Kate Hanaghan
Analyst

In February, Fujin, announced the acquisition of Posetiv. On the surface, this £4.6m purchase of a storage infrastructure solutions reseller doesn't look anything out of the ordinary. But beneath the surface there's an interesting story behind Fujin and its reason for the acquisition.

History lesson

Fujin is something of a name-changer. It's about to be re-named XploIT and was previously known as Offshore Telecom when it first listed on the London Stock Exchange in January 2001. In 2004 Offshore Telecom was renamed Matrix Communications Group. Along the way, many acquisitions were made, just three examples being Intrinsic Networks Limited (IT security solutions and services), Decorum Networks Limited (converged communications solutions and services) and Bedrock Networks Limited (networking solutions and services).

In 2006, Fujin (or Matrix Communications as it was known then) sold up. It netted an aggregate consideration of £40.5m and £10m for the sale of its integration and hardware distribution businesses respectively. It was at this point that it changed its name to Fujin Technology, based on the mobile technology business it chose not to sell.

Where now?

In many ways, Fujin has come full circle. It carried out what was a successful buy and build strategy and it is now hoping to repeat that – starting with the purchase of Posetiv (digital storage solutions). Fujin is focusing on the storage services area specifically and will use Posetiv as the platform from which to carry out further consolidation. Fujin has a very clear idea of the types of companies it wishes to buy. It's looking for privately-held firms that have "reached their pinnacle". In other words, perhaps their owner has accepted that the business will not progress much further in its own right. For some owner/managers it will simply feel like the right time to cash in on the firm they've run for many years.

Of course, targeting these types of companies (of which there are many in the lower end of the S/ITS space) is not a strategy that is particular to Fujin. For example, Computer Software Group – another acquisitive firm – has also targeted owner-run companies. The theory is that with a bit of improved operational management, some extra resource, and the bringing together of several firms, greater scale and prospects can be achieved. We understand that Fujin already has two more acquisitions lined up. The company is confident that it can pin down enough of these types of acquisition to repeat the success it experienced first time around.

Second time around

So having been through this process before, what have the team learned? Firstly, they admit to making many mistakes they wish they hadn't. Hindsight, as they say, is a wonderful thing! One critical issue was around the financial side of the acquisition process. What the company has in place now is a finance team that understands the strategy fully and is capable of running the finances of not just a £5m company, but a £100m company too. Similarly, management have learnt just how important cash flow is. It can be the "biggest pitfall", CEO Ian Smith told us. But Fujin also learnt that some of the softer skills are just as important. Smith says "a little patience goes a long way". And he's right. Think of all the HR implications of buying company after company and then integrating staff – happily!

We think that all of these skills Fujin 'acquired' first time around are invaluable. Indeed, these are the kinds of skills/experience that can mean the difference between success and failure. For that reason, we believe the company stands an excellent chance of executing successfully against its acquisition strategy. We also like the more focused approach it's taking – i.e. around storage – and think that these services will play well to the needs and demands of the mid-market customers it will focus on.

The company is highly ambitious and wants to be turning over £100m within a year. The sale of its two key businesses left Fujin with revenues of almost £400k. The Posetiv business last reported turnover of £14.2m and a PBT margin of 1.2%. Clearly, there's a long way to go to hit that £100m milestone. We think Fujin has some great experience in place and we like its focused approach. The question is whether it can hit the heights it intends to within the timeframe it proposes. Watch this space.■

PRIVATE EQUITY SIGNALS BIG SHIFT IN LOCAL GOVERNMENT BPO

John O'Brian
Analyst

The UK local government BPO market is entering a period of significant change following the recent takeovers of BPO suppliers Vertex and Pearson Government Solutions by US private equity.

These two takeovers by Oak Hill et al and Veritas Capital will result in all four local government pure-play BPO suppliers soon being owned by private equity - the other two players, Liberata and HBS, are already majority owned by General Atlantic, and Terra Firma Partners respectively.

Together these four companies account for approximately two-thirds of the entire local government BPO market, according to Ovum estimates. Although it is still early days, we believe that PE consolidation is likely to have a significant bearing on the future direction of the market.

So why is private equity buying into the local government BPO market? And what does it mean for the BPO players and their customers?

Market dynamics attract investors

A principal reason for the active interest is the opportunity presented by the growth of local government mega-deals. Since the start of 2006, we have tracked a total of eight deals valued in excess of £10m per annum with a substantial BPO component. These represent considerable long-term recurring revenue streams for PE investors with financially secure clients.

There is no sign that the flow of mega-deals will dry up in the near to medium term. Local authorities will spend £719m alone on BPO services in 2007, and we expect this to grow to £893m by 2010. Part of the reason is that BPO remains a key method for authorities to gain quick cost efficiencies and business process improvements. The Comprehensive Spending Review 2007 will continue to drive this trend for at least the next three years, and encourage more broad-ranging IT and BPO deals, with the convergence of white- and blue-collar services a particular theme.

Another attraction for PE is the opportunity presented by the financial difficulties of the BPO pure plays. Their failure to generate healthy recurring profits has made funding new deals difficult, and in turn left them increasingly vulnerable. All the while incumbents like Capita and BT continued to benefit from the buoyant market.

BPO supplier opportunities

BPO pure plays should benefit from PE investment. Expert in financial management and portfolio management, PE is well-placed to take on the role of parent to ailing local government BPO players; it can restructure both financial debt and existing contracts in order to make them more profitable. Additionally it can provide the necessary funding to take on the mega-deals, which require substantial up-front investments. Winning just one of these can help rapidly grow the business, and re-ignite investor interest.

The consolidation of existing PE portfolios offers another opportunity. For example, in addition to Liberata, GA owns major stakes in Xchanging, Genpact, Northgate and Patni. GA has already begun to exploit this opportunity, by outsourcing Liberata's procurement services to Xchanging. In the future we expect there to be further opportunities for GA and other PE investors to exploit their existing assets, particularly around back office administration, application development and increasingly offshore.

What are the risks?

The investments made by PE are not without risk. Less transparency is a concern since PE operates largely behind closed doors. This is not something that will go down well in local government, and we would advise PE investors to focus on establishing an open and trusted relationship with both its portfolio company, and their customers.

Understanding the changing role of the private sector is also key. HBS's joint proposal with Mouchel Parkman at Oldham Council, for example, aims to create 300 new jobs in the borough and "kick-start widespread regeneration". This kind of ambition will, however, require substantial investment from the private sector partners – understanding this demand will be crucial if PE is to make its investments work successfully.

It is worth noting that so far, PE investments in HBS and Liberata have yet to deliver significant returns for their investors. Veritas and Oak Hill will, therefore, need to ensure they have a clear roadmap for profitable growth without negating the demands of local government. We don't expect this to be a quick win. Public sector organisations will need convincing that PE investors have given firm commitments on the market for the long term.

Therefore, it is crucial that PE now understands the requirements of local government and its role in delivering efficient and effective services, if it is to extract the best value out of the acquisitions.

A more detailed analysis of the impact of Private Equity on the public sector BPO market will appear in the publicsector@ovum advisory service.■

NORTHGATE BUILDS ITS ORGANIC GROWTH STORY

Samad Masood
Analyst

Northgate Information Solutions held a briefing at the end of February to provide an update on its strategy. The key message was that the company is focusing on driving organic growth across its business. Northgate has built a substantial software and services business in local government, criminal justice and human resources, mainly through acquisitions. Now it needs to prove to investors that it is more than the sum of its (acquired) parts – and generating strong organic growth is central to this.

Organic targets

A key target for Northgate is the education sector, which it entered through the acquisition of Sx3 in April 2005. Although most of its business is currently in Northern Ireland, there is an emerging opportunity to target work from the government's Building Schools for the Future (BSF) programme in England. So far Northgate has signed an £8.9m, five-year deal with Bristol City Council to provide ICT services in partnership with Skanska. Northgate sees this partnership model as key to cracking this market, and is boasting a sales pipeline of £60m worth of bids. In two years Northgate expects education revenues to be over £40m.

Outside of the well defined opportunity posed by BSF, Northgate's strategy is generally to increase value-added services to existing software clients. Northgate has a well established position as a software provider in the local government and criminal justice sectors, and can boast 87% of UK local authorities, and all UK Police authorities, as clients. It also has a strong position as a payroll services provider in the UK, claiming that it pays one third of all of the UK's workforce. In simple terms, Northgate is looking to use these software-based footholds to grow organically through providing higher value-added services, driven by more project and services-based work.

A future BPO challenger?

A big part of Northgate's drive to expand into higher value services is to increase its role as a BPO services provider. This is a natural extension for Northgate, and it is not alone in moving in this direction. Increasingly clients are looking to solve their business problems in a holistic manner, with IT being only one part of the solution. BPO relationships are increasingly seen as the next logical step for managing IT. Vendors that can position themselves as BPO prime contractors can find it easier to up sell project-based work – and this is just what Northgate needs to try and do.

In the public sector specifically, mid-size players like Northgate are facing tough times as mega-deals are driving revenue growth for suppliers that can win these deals, but pure project services players are getting squeezed out. Moving into the role of a prime BPO contractor might help. But if Northgate is going to succeed in public sector BPO it needs to look at its partnering strategy. Its existing software relationships with established BPO companies such as Capita and Liberata could hinder its expansion. As Northgate increasingly looks to compete for BPO business in the public sector it will need to manage these relationships very carefully.

In HR Northgate may have a much stronger opportunity. 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 earlier this year, 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 in this way, then Northgate should be well positioned to benefit.

M&A still a key component

Overall though, gaining organic growth across the whole business is going to be tough – particularly in the public sector market where Northgate needs to re-position itself to expand into new markets such as transport and health, and provide more value-added project based services. For this reason acquisitions are still firmly on the agenda, particularly those that can help Northgate add new services capabilities.

Of course, divestments are still a key strategic option for Chris Stone (CE). After all, it was only four months ago when Northgate was considering bids by potential buyers. Those discussions fell through, but Stone says he would still be interested in selling off parts of the business for the right price. It's an interesting proposition, particularly as we do not believe that Northgate's HR and public services businesses provide many cross-selling opportunities. Whatever the long-term outcome for Northgate, its value will be based on its ability to grow organically, and 2007 could be a make or break year for this.■

EDS: THE LONG AND WINDING ROAD TO RECOVERY

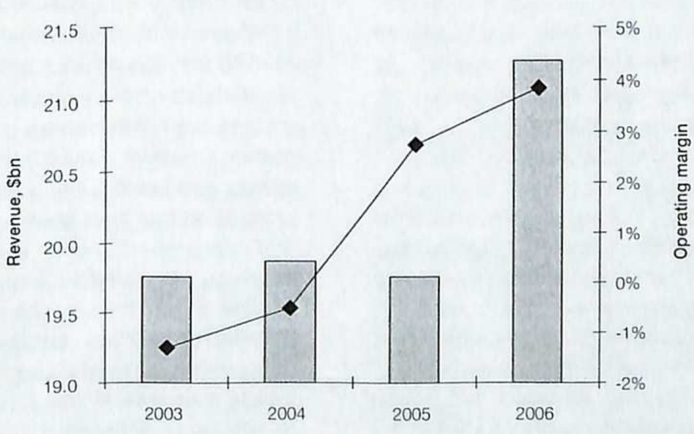
Phil Codling
Principal Analyst

Many IT services companies have gone through some sort of recovery in recent years, following the downturn of 2001/2. And others didn't survive at all. But few large players have been through a turnaround as dramatic as EDS.

The company's 2006 results, as released last month, underline how far the business has come. EDS impressed Wall Street with another increase in margins, topline growth in Q4 of 11% and an upbeat outlook for the coming year.

It was a very different picture four years ago, when previous CEO Dick Brown was forced out of a company that was losing both money and the confidence of customers and analysts. EDS was the sick man of the IT services industry and its competitors were actively targeting its accounts to exploit its weakness and the uncertainties that clouded its future.

EDS revenues and margins, 2003-2006



EDS's turnaround remains a work in progress and nobody would argue that the execution of its turnaround strategy has been flawless or without hiccup. For example, it would hardly have chosen to take so long selling off its AT Kearney consulting business or to lose the Inland Revenue mega-deal to Capgemini. But there are, we feel, plenty of lessons to be learned from the company's experiences and progress in recent years...

Play the long game

During 2003 and 2004 there was huge pressure on Jordan and Co to effect drastic solutions to EDS's problems. Many observers talked of a sale of the company as the best way out of the quagmire. But there are few quick fixes in IT services today, particularly for outsourcers signed up to 5-10 year deals. Turnarounds require a long-term, multi-year plan. And the expectations of investors and staff need to be managed accordingly.

Hug your bears

When he arrived as the new EDS CEO in 2003, Mike Jordan inherited some unpalatable contracts that had been signed in the Brown era. Worst of the lot was the US Navy deal, which was shedding money and had apparently little hope of improvement in sight. EDS took a $500m charge on that deal alone in 2003, but by 2005 the Navy contract was making money and had become a reference for the company.

Back to basics

EDS learned its lessons and stopped signing the bad deals in the first place. It remains more open to risk than some of its competitors, but the revenue-at-all-costs attitude has been replaced by greater realism, smarter ways of projecting revenues and an emphasis on contract execution as well as sales.

Meanwhile, like many of its peers, EDS responded to the realities of the post-boom market by tackling the cost base, reducing headcount in more expensive locations and growing the global sourcing capability. Competitors that have reacted more slowly in this regard have arguably suffered more pain and been slower to see the gain.

Get the right experience for the job

If you are going to turn around a company, there needs to be someone at the helm with relevant experience. Prior to taking on the challenge at EDS, Mike Jordan had fixed up Westinghouse. He was new to the IT industry, but had a highly relevant trackrecord for a company in EDS's position. As Xansa (another company that has implemented a multi-year transformation strategy over a similar timeframe) also found, looking outside the IT industry can be beneficial. Meanwhile, we have to be concerned when a company like Torex Retail installs execs with turnaround consulting expertise but little practical experience.■

7%
1130p

ROYALBLUE KEEPS ON STORMING AHEAD

Software and on-line services provider to the financial services industry Royalblue group grew its revenue to £94.6m in 2006, an increase of 27% over 2005, and all of it organic. Operating profit went up by 29% to £12.4m to give an operating margin of 13.1%. Thanks to an increased tax bill, net profit increased by only 2% to £10.3m.

The company has announced that it intends to change its name to Fidessa group plc, recognition that the company's main product line now carries more 'brand equity' than the company itself. Shareholders will vote on the change at the AGM, so this could be the last report we write on the company under its old name.

These results are testament to the power of delivering solutions to the desktop that mix software and services. Based on a 'thin' client, Fidessa can be offered as a conventional enterprise software suite or as a hosted service, available over a private network or the internet. It combines a trading platform with market data and global connectivity. There are over 10,000 active 'screens' of Fidessa worldwide, an increase of 25% on the year, while the number of customer companies has increased by over 50% to 120.

Royalblue saw excellent growth in its three main geographies, but with 37% growth despite a weak dollar, its North American business is the star. Its revenue of £32.6m is closing on the company's European business, which has revenue of £48.7m and growth of 'only' 21%. Asia still trails in revenue at £13.3m, but growth was a creditable 32%.

Most companies have to spend heavily on sales and marketing to get this kind of market growth. This doesn't seem to be the case at Royalblue, which saw strong cash generation by operations of £25.5m, an increase of 81%. In fact the company has now built itself a nice war-chest of £40. As of 31 December 2006, it says £1 million of this is "to support any acquisition opportunity that becomes available". However, it doesn't seem to be in any hurry, which we think is wise given the number of companies up for sale and the venture capital money washing around.

(David Bradshaw)

32%
62p

XPERTISE FAILS TO GROW ORGANICALLY

Xpertise, a provider of training services, recently announced its results for the year to end December 2006. Total revenue increased 4% to £16m, but excluding the acquisition of Watermans, the existing business actually shrank. Operating margin increased from 1.3% to 1.9%, while the loss before tax improved from £272k in 2005 to £18k.

Xpertise's core business (which consists of the technical training and professional skills training businesses) declined by 3% in 2006. This illustrates just how tough the training market can be. In particular, around technical courses (such as Microsoft skills), price competition is high and we suspect it is hard for players to differentiate themselves in this part of the market. There are some glimmers of hope for Xpertise as it enters 2007, though; a managed training deal with a government organisation along with its appointment as Computacenter's preferred supplier should "contribute strongly" to FY07.

More generally, we think a managed training offering has the potential to drive growth for training companies. Across the IT services industry, managed services (everything from managed staffing to managed email and managed IT support) have tapped into a genuine customer desire to handover certain functions to a specialist. Suppliers, however, have enjoyed varying degrees of success - by which we mean profits. IT staffing is a prime example of where the managed service offering has in many cases just become an opportunity for customers to push prices down further. We think training companies, such as Xpertise, need to very clearly articulate that the benefits of managed training services are not just about cutting costs, but about getting a better service and leaving the customer to focus on their core business.

However, successful managed services are not the only challenge. Xpertise must keep on building the professional services business (which covers skills training such as project management, people management and customer services). But in line with all of this, and especially in light of the decline in revenues of the existing business, Xpertise will need to make more acquisitions. Here the challenge is not just around finding the right purchase - it's around finding the right purchase at the right price.

(Kate Hanaghan)

2%
647p
CAPITA

CAPITA CONFIDENT FOR THE NEXT FEW YEARS

Capita recently released its 2006 results. Revenue is up 21% to £1.7bn. Operating profit (after share-based payments) rose 23% to £225m, giving Capita an operating margin of 12.9% (2005: 12.8%). PBT rose by 18% and earnings per share were up 24% to 23.1p. Capita is paying a 9p dividend, compared to 7p last year. Full-year contract signings and renewals totalled £1.37bn (2005: £1.14bn).

Capita gave a confident view of its future prospects at its results briefing, already having visibility of more than 95% of its 2007 revenue, according to CEO Paul Pindar. And it won't have to rebid any existing major contracts until 2009, giving it almost two full years to focus entirely on achieving new business growth. So where is this growth going to come from?

A lot of it is expected to come from the life & pensions and local government sectors, which, through deals such as with Zurich and Birmingham City Council, have been responsible for much of Capita's growth in 2006. But Capita is also continuing to target more niche markets in the UK such as corporate travel management, or unit trust administration. Capita is also continuing to push into the IFA supply chain with its recent software acquisitions. Pindar mentioned the opportunity to expand further in the retail sector, using its work with DSG International (providing technical and customer support) as a reference.

As Pindar puts it: "The more niche areas we get into, the more value we can add, and the higher our margins will be." We agree with this view - as long as a BPO business can build scale in each of its niches, or at least run them profitably without distracting other areas of its business. So far, Capita's management has proved that they can do this. And to date, this strategy has helped Capita open up several new markets to BPO and enabled it to build a diverse business that is less reliant on the public sector.

(Samad Masood)

BT

BT GLOBAL SERVICES: INTERNATIONAL BUSINESS DRIVES GROWTH

BT Group reported another solid set of results for Q3. However, it's the performance of BT Global Services, with its emphasis on "Networked IT Services", which interests us most. The division, now BT's largest, grew its external revenues by 4% to £2.3bn. Organic, constant currency growth was 5%. EBITDA was up 4% to £232m, while EBIT fell by 17% to £52m (giving an EBIT margin of 2.3%).

BT needs its Global Services operation to provide growth, even if the UK consumer and SME division, BT Retail, is apparently picking up a bit (it reported growth in the quarter - albeit of just 1% - for the first time in four years). But BTGS's overall performance remains less than stellar. That said, we need to remember that BTGS itself runs a lot of "traditional" (in BT's terminology) services in the UK, such as private circuits for large organisations, as well as the growing "new wave" stuff like MPLS networking and IT services. In actual fact, the "new wave" businesses accelerated a little in Q3, returning 7.6% year-on-year growth compared to 6.5% in Q2.

A key factor behind that growth is BTGS's business beyond the UK. John Brougham, BTGS's CFO, told us that total non-UK business grew by 11%, while both Asia Pac and North America delivered better than 20% growth in the quarter. This reflects the division's strategic emphasis on international business, based on its global network presence and supported by niche acquisitions (such as INS in the US and i2i in India in recent weeks).

As well as deepening its overseas presence, BTGS's growth strategy is also pushing more and more into the IT side of its "Networked IT Services" remit. INS is a good example. It consults on and integrates enterprise infrastructure and networks, work that IBM, CSC and EDS (to name but three possible IT services competitors) are also targeting. So as BTGS expands its service range it is, knowingly, entering increasingly competitive waters. In order to compete in the long term, we believe BT's growing but patchy coverage in IT-centric services (with the emphasis very much on the UK, and UK public sector in particular, plus a growing presence in the US) will need more co-ordination and build-out before it can deliver the sorts of standardised, even industrialised, offerings that will increasingly become the key to competitiveness and profit margin improvement in the IT services market.

(Phil Codling)

-1%
170p

LOGICACMG: STEADY, BUT CAN IT DRIVE ORGANIC GROWTH?

LogicaCMG has recently announced its full 2006 results. The company delivered topline revenue growth of 45% to £2.67bn. The operating margin (before amortisation and exceptional items) rose from 6.6% to 8.2%. Earnings per share fell from 7.3p to 6.7p. LogicaCMG is proposing a final dividend of 3.4p (which increases the dividend for the full year by 5%).

Overall, this is a reassuring performance in a year that saw the company assimilate two of Europe's "local hero" IT services players, Unilog and WM-data, and double its headcount in the process.

The fact that the business was able to return margin growth against a backdrop of such dramatic corporate change and evolution is reassuring. It also roughly kept pace with its addressable market in its topline performance. We suspect the company will take a break from major acquisitions, not least to allow the completion of projects to assimilate Unilog and WM-data and bring them under the one LogicaCMG brand (the latter process being slated for H2 of 2007 and H1 of 2008). But its successful record to-date suggests it will - and indeed should - look to acquisitions once again, most likely in Germany.

The margin performance is especially noteworthy. The UK and Netherlands, as the most mature operations in the business, continue to deliver the highest operating margins (at 10.8% and 9.9% respectively). But LogicaCMG also managed to improve margins in each of its other geographic divisions - France, Nordics, Germany and the broad-based International grouping. The outlook for the year ahead (with additional acquisition synergies to be gained and Germany expecting a swing from losses to "low to mid-single digit" operating margins) suggests another improvement in margins is on the cards in 2007.

If we have a lingering concern, it is growth. LogicaCMG has taken market share through acquisition, but it is not making any gains organically. We would argue that it should be. Right now, the "growth agenda" means that customers are spending money on projects designed to transform the way they compete and do business, for example through radical new implementations of business intelligence systems.

It appears that LogicaCMG is not exploiting such opportunities as it could and risks missing out on the current wave of spending. So in France, a country that saw a marked pick-up in project spend in 2006 and where LogicaCMG acquired a significant local player in IT consulting in Unilog, growth fell in 2006 (to 5.3%). One reason cited for this is "capacity constraints".

And herein lies a challenge for LogicaCMG across its business. It may now be a £3bn-revenue player in the European IT services market, but it is often competing for talent against even bigger and better known players, not just in IT services, but also in consulting. We therefore suspect that its new marketing strapline - "LogicaCMG: Releasing your potential" - is as much aimed at staff and potential recruits as customers.

Another reason for LogicaCMG's less than stellar growth may be a rather subtler factor in its organisational DNA. It is not hard to find fans of the company among CIOs and its reputation for delivery is probably as good as any in the UK industry. However, we're not sure that LogicaCMG has been the most successful S/ITS player at driving up the value of, and finding additional opportunities in, its key accounts. This helps to explain why it hasn't benefited from the current "growth agenda". But with a number of recent changes of senior personnel in the sales and marketing teams, 2007 may see some concerted attempts to refresh and re-energise the company's account management. It'll need to get such things right, as well as continuing to push cross-selling between its acquired businesses, if it is to start delivering organic market share gains to complement its acquisitive growth.

(Phil Codling)

ACCENTURE PUTS THE STRUCTURE IN PLACE FOR "GROW UK"

We met up a few days ago with David Thomlinson, UK MD of Accenture. Thomlinson has been UK MD since September 2006, having transferred over from running the Resources (oil, gas etc) vertical market group.

We were naturally interested to hear about what Accenture calls the "new operating model" - the change to the power matrix that has until recently strongly favoured the vertical market groups over the service lines and the geographies.

The new matrix still has the vertical-market groups owning the primary P&L. Service lines (business consulting, systems integration, and outsourcing) and geographies both have shadow P&Ls. But Accenture is effectively transferring many of its staff - particularly junior and mid-ranking people - from the vertical market groups into the service lines. It's doing this by changing their primary reporting line from vertical group to service line, although they retain dotted line reporting into the verticals. The idea is for staff to move more freely between verticals more easily, meaning Accenture gets less stove-piped.

As the head of one of the 13 major worldwide geographies in the new operating model, Thomlinson now has P&L and revenue targets for the UK. He presides over a geography operating board including the UK heads of the vertical-market groups and the service lines, who now have dotted reporting lines to him. Thus, he has more power over resource (i.e. people) allocation within their borders than his successor. He therefore theoretically has the powers to push through his "Grow UK" programme, to match the successful "Grow America" programme (which doubled Accenture's organic growth rate in the US last year, in part by taking a more holistic view of key geographies).

We see all this as a natural swing of the pendulum back from the very heavily vertical-oriented matrix that Accenture has had during this decade, towards a more balanced matrix, with a "thinner" vertical element and a "thicker" service-line component. One day, the pendulum may well swing back yet again.

Will it work this time? It should do, but Accenture's great strength is its deep domain expertise and the relationships with its customers. So it must be careful here - if its consultants are perceived as having their strong domain expertise diluted, customers won't be impressed.

This comes just at a time when customers want deeper expertise and experience, not less. So the balance is tough between flexibility and specialisation. Accenture is a tough beast that learns on its feet, so it will probably get that balance right, no doubt after teething issues.

We naturally asked Thomlinson for details of Accenture's UK revenues in FY 06 - Accenture had a tough financial year ending in August 2006. Accenture used to publish its UK revenues, but no more, and Thomlinson could only indicate that our estimates are pretty accurate. Our standing estimate, based on Accenture SEC filings, is an 18% dollar-terms drop to $2.16 billion, and a 15% sterling-terms drop to £1.2 billion.

The chief cause was the NHS outsourcing mega-deal which Accenture substantively exited in September 2006. It soaked up resources and diverted attention from more promising opportunities. Even worse, the exit agreement had Accenture reversing (writing-off) $339 million (£189 million) in previously-booked consulting revenues. Had it not had to reverse that revenue, we reckon the UK would "only" have suffered a 5% dollar decline and a 1% Sterling decline - much better, but still shockingly poor for Accenture.

Other causes were a drought in big new deals in 2005 that created relatively little revenue pull-though from big orders during 2006, but also the fact that Accenture took its eye off the ball in some key areas, for example failing to capitalise on some key opportunities such as the revival in business-consulting demand.

The good news, Thomlinson says, is that Accenture UK is once again growing revenues and orders, both in like-for-like (excluding NHS) and absolute measures. In part that's because some big orders from last year (e.g. Unilever) are coming through, and in part because Accenture can concentrate its firepower on opportunities much more rewarding than the NHS turned out to be. Financial services growth is "very strong", and resources is also doing well. Even government, with the NHS behind it, is doing well, he says.

We often compare Accenture to the German football team - most dangerous when it's bouncing back. Accenture UK should be a much stronger competitor this year than it was in its annus horribilis of 2006.

(Douglas Hayward)

Mergers and Acquisitions – February 2007

Buyer	**Acision**
Seller	**LogicaCMG**
Seller Description	A provider of network and communications infrastructure solutions
Acquiring	LogicaCMG's Telecoms Products division
Price	£265m (half cash, half share buy back)
Comment	For some time now LogicaCMG has been rumoured to be discussing a decent exit from the telecoms product business. It is now done, with the sale of the business to a set of private equity funds. Telecom Products will be reborn as a new company, Acision, which will inherit the product portfolio and will operate the business going forward. At a LogicaCMG company level, it is interesting to see that after a few years, the strategy of the company in the telecoms vertical has changed. Over the past few years, LogicaCMG was 'playing the game' of building a service business using commercial channels built out of a product business. Though theoretically interesting, this strategy certainly reaches a dead end when, geographically speaking, your product channels and your service capabilities are not aligned.

Buyer	**Bond International Software**
Seller	**Strictly Education Limited**
Seller Description	A provider of HR, finance, property support and payroll services to over 500 schools across the UK
Acquiring	100%
Price	£2.7m
Comment	There's a lot of change going on in the software industry at the moment and though Bond may not think of it as such, this acquisition is one small step away from the traditional model of software delivery. Increasingly software is being used a platform for the delivery of other services. Indeed, payroll services are a long-standing part of this trend - using software as a service to automate otherwise manually-delivered service from a third party. This is re-drawing the lines between BPO and software in a new, threatening way for the providers of BPO services. If the service is a commodity, then it will become automated, either by incoming SaaS/automated services providers or by BPO providers realising there is no choice but to automate their delivery. The other side of the coin is that the services are specific to the client or vertical, or that processes require decision-making on the part of the supplier. This type of work is mainly suited to specialist BPO suppliers rather than the SaaS or automated services players. If Bond stays focused on the low cost, automated delivery model that suits its software background, it will be on the winning side.

Buyer	**BT**
Seller	**International Network Services (INS)**
Seller Description	US-based provider of IT consulting and software solutions
Acquiring	100%
Price	Undisclosed
Comment	This professional services acquisition will increase BT's presence in North America and will enhance its consulting capabilities and reassert BT's authority as a telco in advanced network and ICT management. INS brings expertise in making networks and the applications they serve run and integrate better. It also brings workflow, network management and collaboration software competencies, which will make a welcome contribution to the growing BT Global Services portfolio. This acquisition is a mid-sized one for BT- INS generates around $140 million a year and - whilst the terms of the deal have not been disclosed - we expect the cost to be close to the $150 million mark (BT says it's between $110 million and $150 million). The business is profitable and employs 900 people and despite being mid-sized, this is a significant deal for BT and one that we generally support, as it helps to underpin BT's network-related IT services business, an increasingly important service line for the telco.

Buyer	**Capita**
Seller	**Harry Weeks Travel & Leisure Group**
Seller Description	Business travel software and services provider
Acquiring	100%
Price	£21m
Comment	Capita first entered the corporate travel market in 2005 with the acquisition of Lonsdale Travel. Harry Weeks should be complementary to this, as its self-service rail booking software products, Evolvi and Travelpackonline, could plug in as a software front-end for Lonsdale's services. Together the two travel businesses should generate around £10m in revenue for Capita. In strategic terms, they form yet another "IP-led" attack on a niche segment of the BPO market by market leader Capita. Our one concern is regarding the price paid for Harry Weeks. The initial payment of £21m is more than five times the most recent year's revenue of £3.6m. And while Capita expects the rail travel market to grow between 3.5% and 5.5% per annum, it is hard to see how that level of growth alone justifies such a price tag. That said, Capita has a large number of existing public and private sector clients that it can cross-sell travel services into, and the self-service software from Harry Weeks might be a catalyst for a lot of cross-sales activity. Given Capita's strong track record of executing on its strategic initiatives, we wouldn't bet against them turning travel services into a profitable growth business.

Mergers and Acquisitions – February 2007

Buyer	**Detica**
Seller	**DFI International**
Seller Description	Consultancy to the US government national security market
Acquiring	100%
Price	£20.2m (cash and shares)
Comment	This deal is consistent with Detica's aim to expand its business in the huge and growing US national security market. DFI quadruples the firm's US headcount overnight (to 270 staff). It also brings into the business some heavy-hitting and well-connected personnel, not least a retired General and Brigadier General among the management team. We spoke to Detica CEO Tom Black who acknowledged that the people at DFI are key to its value but was confident that attrition should not be a problem due to earmarked funds to make sure appropriate remuneration is available. The role of DFI is not just to sell consulting. Detica also needs the business to sell on its technology solutions, most of which (the NetReveal fraud detection solution, for example) have been developed and first delivered in the UK. DFI is a firm of fee-earning consultants, but it's also a sales channel. By combining focused consulting capability with repeatable solutions it has ridden the vagaries of the consulting market and cemented longer-term customer relationships. Many of the UK's smaller standalone consultancies have been less fortunate.

Buyer	**Hitachi Data Services**
Seller	**Archivas Inc.**
Seller Description	Providing content archiving for unstructured information
Acquiring	100%
Price	Undisclosed
Comment	This acquisition is a strategic move, especially at a time when retention and retrieval of information for compliance purposes is placing increasing pressure on CIOs and their organisations. HDS confirmed that despite the acquisition, all of Archivas' existing reseller relationships remain in place including the one with NEC. The demand for archiving systems continues to be driven by the requirement to retain and retrieve (for compliance purposes) rapidly-increasing volumes of information, approximately 80% of which consist of unstructured objects and files or semi-structured data such as email. Even in its first year of sales from June 2005, Archivas reportedly sold 12 systems. With the Archivas acquisition HDS believes it can now push to customers 'an integrated strategy for common storage and data management, across both structured data and applications, and unstructured content'. In this move HDS has recognised that the information retention and retrieval requirements for organisations are now so important to the CIO that she/he will want a single supplier offering the tightest integration between hardware and software.

Buyer	**Kewill Systems**
Seller	**IPACS e-Solutions (S) Pte (a division of IPACS Asia Pte Ltd.)**
Seller Description	A provider of logistics, cargo, warehouse management solutions
Acquiring	100%
Price	£1.85m
Comment	This is a very logical expansion for Kewill. It has already expanded its footprint outside Europe into the US, and the missing piece was a stake in Asia-Pacific. Singapore, Hong Kong and Shanghai are the busiest three ports in the area. With the ever-growing trade between China and both the US and Europe, it is vitally important for Kewill to be in the area. Since we don't know much about IPACS, it is hard to evaluate the strength of the company that Kewill is buying. However, the company has done well with its past, and (in its interims to September 2006) managed to increase the margin (before amortisation) with them, so the precedent is good.

Buyer	**Redstone**
Seller	**Comunica**
Seller Description	A provider of network and communications infrastructure solutions
Acquiring	100%
Price	£22m (part cash and issue of shares)
Comment	Another shopping trip for Redstone, and this time the added bonus is that it has taken out a key competitor in the area. Adding in Comunica's revenues, Redstone will now be a £100m company. In less than two years it has acquired Xpert Group Limited, Symphony Telecom Holdings plc, the Tolerant group of companies, IDN Telecom and now Cominca. That's pretty swift work, and all part of its strategy to gain scale in order to tap into larger deals and bid on multiple projects at one time. One element we like about the Comunica and IDN Telecom acquisitions is the way each purchase fitted straight into an individual unit, therefore minimising any impact on the other units during integration. However, Redstone must be extremely careful that it keeps developing the cross-sale opportunities and keeps on adding to the profitability generated in H1 of this year alongside any future purchases.

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@UK plc	SP	0.10	3.76	NA	2.59	152.67	-20%	-44%	-£0.94m
Alphameric	SP	0.50	66.63	38.7	1.01	230.50	0%	5%	-£0.33m
Alterian	SP	1.34	56.27	39.3	5.29	667.50	9%	18%	£4.64m
Anite Group	CS	0.81	285.82	81.3	1.51	475.15	2%	0%	£5.58m
Ascribe	SP	0.46	52.01	44.1	9.73	2,394.74	-3%	17%	-£1.71m
Atelis plc	SP	0.06	1.44	NA	NA	267.44	18%	-15%	£0.22m
Atlantic Global	SP	0.17	3.78	NA	1.77	559.32	-1%	22%	-£0.06m
Autonomy Corporation	SP	6.18	1053.77	NA	8.21	188.64	5%	21%	£140.20m
Aveva Group	SP	8.75	589.34	72.1	8.94	4,375.00	-3%	7%	-£16.81m
Axon Group	CS	6.70	394.10	59.9	4.29	3,828.57	2%	10%	£5.88m
Bond International	SP	1.82	54.95	22.7	3.95	2,792.31	-6%	5%	-£3.33m
Brady	SP	0.57	14.71	NA	6.05	703.70	13%	56%	£1.68m
Business Systems	CS	0.11	8.26	11.2	0.24	90.34	-4%	-14%	-£0.38m
Capita Group	CS	6.47	3994.48	29.0	2.35	174,897.19	2%	7%	£80.26m
Centrom	CS	0.01	1.91	NA	0.30	208.33	-17%	-17%	-£0.38m
Charteris	CS	0.20	8.60	51.3	0.43	222.22	25%	25%	£1.72m
Chelford Group	CS	1.49	10.64	8.3	0.90	259.13	-7%	-11%	-£0.71m
Civica	CS	2.72	169.93	NA	1.60	1,555.30	0%	-1%	-£0.78m
Clarity Commerce	SP	0.50	10.16	8.6	0.76	400.00	-15%	-7%	-£1.73m
Clinical Computing	SP	0.06	1.97	NA	1.19	50.40	-14%	-11%	-£0.24m
CODA Plc.	SP	2.08	159.91	NA	4.12	1,282.41	15%	28%	NA
Compel Group	CS	1.15	38.87	26.8	0.61	916.00	3%	-3%	£1.19m
Computacenter	R	2.75	438.04	16.3	0.19	409.70	-4%	2%	-£19.51m
Computer Software Group	SP	1.07	64.81	36.6	4.61	906.38	-10%	-12%	-£7.30m
Cornwell Management Consultants	CS	0.17	2.91	2.6	0.16	118.49	32%	43%	£0.70m
Corpora	SP	0.06	9.31	NA	3.58	152.63	-17%	3%	-£0.00m
Dealogic	SP	1.88	134.79	NA	4.35	815.21	-4%	19%	-£2.72m
Delcam	SP	4.13	25.47	12.8	1.06	1,586.54	16%	32%	£3.55m
Detica	CS	4.01	455.44	45.7	4.49	5,012.50	9%	9%	£45.55m
Dicom Group	R	2.40	211.43	27.5	1.01	735.74	9%	3%	£17.62m
Dillistone Group	SP	1.40	7.56	NA	NA	1,025.64	-2%	-4%	-£0.19m
Dimension Data	R	0.48	744.15	34.8	0.54	85.70	10%	12%	£69.40m
DRS Data & Research	SP	0.33	11.43	NA	0.92	300.00	-12%	-11%	-£1.56m
eg Solutions	SP	0.49	7.00	11.2	2.04	333.33	-25%	-40%	NA
ELCOM	CS	0.02	12.42	NA	35.85	400.00	-52%	-52%	NA
Electronic Data Processing	SP	0.68	16.61	19.8	2.38	2,082.06	-2%	5%	-£0.37m
FDM Group	A	1.09	25.19	26.3	0.76	1,331.29	15%	16%	£3.25m
Ffastfill	SP	0.10	27.49	NA	10.37	79.17	19%	58%	£4.70m
Financial Objects	CS	0.67	29.54	NA	2.12	289.13	12%	22%	£3.11m
Flomerics Group	SP	0.95	13.97	15.1	1.22	3,653.85	1%	27%	£0.00m
Focus Solutions Group	CS	0.46	13.17	101.8	2.42	233.33	-13%	-6%	-£2.02m
GB Group	CS	0.38	31.61	NA	2.46	243.49	-15%	-18%	-£5.44m
Gladstone	SP	0.23	11.99	13.0	1.57	575.00	-5%	-10%	-£0.65m
Glotel	A	0.59	22.73	9.1	0.25	303.90	1%	-7%	£0.19m
Gresham Computing	CS	1.28	64.26	NA	4.60	1,379.03	-15%	-13%	-£11.65m
Group NBT	CS	2.47	60.21	24.8	5.34	1,235.00	1%	19%	£10.09m
Hamsard Group (Renamed Cantono	CS	0.06	16.81	NA	2.34	1,000.00	0%	0%	NA
Harvey Nash Group	A	0.79	51.62	14.1	0.26	451.43	2%	8%	£0.98m
Highams Systems Services	A	0.04	1.39	NA	0.10	121.67	0%	-5%	£0.00m
Horizon Technology	CS	0.69	55.74	13.6	0.29	251.92	3%	-1%	£1.42m
IBS OPENSystems	CS	1.88	75.00	30.8	4.80	1,229.51	4%	3%	£3.20m
I S Solutions	CS	0.16	3.84	43.7	0.70	577.61	11%	-2%	£0.37m
ICM Computer Group	CS	3.30	70.40	21.7	0.93	1,833.33	5%	14%	£3.09m
IDOX	SP	0.08	15.13	NA	1.07	9.95	27%	22%	£3.17m
Imaginatik	SP	0.10	11.08	NA	7.91	1,117.65	3%	12%	NA
In Technology	CS	0.39	55.18	27.4	0.19	1,560.00	-10%	-9%	-£6.37m
InterQuest Group	A	1.31	37.66	23.4	1.36	2,278.26	11%	50%	£3.74m
Innovation Group	SP	0.35	219.73	30.2	3.60	150.66	-1%	10%	£0.07m
Intelligent Environments	SP	0.08	12.21	113.1	3.91	79.79	-15%	20%	-£2.24m
Intercede Group	SP	0.57	19.19	NA	10.63	941.67	-9%	-5%	-£1.95m
Invu	SP	0.21	26.24	16.8	8.33	2,210.51	-13%	-30%	-£3.35m
iSOFT Group	SP	0.45	103.46	NA	0.39	404.55	-11%	-21%	-£13.37m
iTrain	SP	0.02	1.67	9.6	0.91	25.06	0%	-5%	£0.00m
IX Europe	CS	0.74	134.08	NA	5.96	2,426.23	21%	51%	£28.80m
K3 Business Technology	SP	1.19	23.19	NA	1.05	909.24	-4%	3%	-£0.68m
Kewill	SP	0.75	59.41	21.5	2.23	1,487.15	-3%	-5%	-£1.97m
Knowledge Technology Solutions	SP	0.02	5.82	NA	4.65	350.00	17%	8%	£0.83m
LogicaCMG	CS	1.70	2603.46	25.1	0.98	2,321.28	-1%	-9%	-£18.93m
Lorien	A	0.51	9.50	21.4	0.06	510.00	12%	20%	£1.02m
Macro 4	SP	2.37	52.46	17.4	1.58	953.63	5%	12%	£2.66m

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Manpower Software	SP	0.47	20.90	NA	4.82	484.54	59%	81%	£7.78m
Maxima Holdings	CS	2.60	47.74	43.5	3.85	1,890.91	14%	13%	£5.69m
Mediasurface	SP	0.22	16.99	22.0	1.76	1,617.65	5%	29%	£0.77m
Micro Focus	SP	2.41	482.14	57.0	6.38	0.00	8%	16%	£35.47m
Microgen	CS	0.53	54.41	NA	1.45	226.50	-5%	-3%	-£2.57m
Minorplanet Systems	SP	0.57	16.29	15.8	0.68	1,153.77	-9%	1%	-£1.59m
Misys	SP	2.34	1169.69	52.1	2.50	2,905.01	-4%	8%	-£44.81m
Mondas (Renamed Corero)	SP	0.16	5.80	NA	0.92	216.67	3%	12%	£0.29m
Morse	R	0.99	154.03	13.3	0.42	394.00	-7%	-9%	-£9.01m
NCC Group	CS	3.09	100.61	22.0	4.85	1,847.31	-5%	11%	-£5.71m
Ncipher	SP	2.46	68.35	NA	3.93	982.00	2%	-3%	£0.75m
Netcall	SP	0.24	16.02	40.7	4.83	489.90	43%	43%	£4.80m
Netstore	CS	0.36	44.65	242.3	1.24	238.33	7%	19%	£1.87m
Networkers International	A	0.41	37.31	67.5	1.96	1,265.63	21%	16%	£6.45m
Northgate Information Solutions	CS	0.82	438.69	17.5	1.32	314.42	-4%	-5%	-£17.11m
NSB Retail Systems	SP	0.31	121.81	8.0	2.52	2,673.91	5%	-10%	£5.94m
OneclickHR	SP	0.06	8.93	140.2	1.51	150.00	-4%	50%	-£0.37m
OPD Group	A	4.30	114.15	30.9	2.61	1,954.54	-9%	-12%	-£11.95m
Parity	A	0.74	27.88	NA	0.20	680.55	-11%	-6%	-£3.60m
Patsystems	SP	0.25	40.22	NA	2.63	228.97	34%	42%	£10.26m
Phoenix IT	CS	3.36	202.55	15.8	1.86	1,245.37	2%	10%	£4.05m
Pilat Media Global	SP	0.77	44.92	22.6	3.45	3,825.00	-6%	-6%	-£2.94m
Pixology	SP	0.24	4.82	NA	1.07	170.16	-9%	-17%	-£0.35m
Portrait Software	CS	0.17	15.83	NA	1.37	108.34	3%	10%	£0.56m
Proactis Holdings	SP	0.63	18.83	25.0	9.91	1,288.66	-7%	-2%	-£1.51m
Prologic	CS	0.73	7.25	16.1	1.05	873.49	0%	-15%	£0.00m
QinetiQ Group	CS	1.92	1350.66	NA	1.28	874.72	-7%	0%	£7.24m
Qonnectis	CS	0.01	1.64	NA	14.98	200.00	0%	0%	£0.00m
Quantica	A	0.39	23.27	9.7	0.60	314.52	16%	28%	£3.28m
Red Squared	CS	0.08	2.20	15.5	0.89	425.82	2%	19%	£0.04m
Revenue Assurance Services	SP	1.15	49.30	NA	1.10	766.67	#REF!	#REF!	#REF!
RM	SP	1.98	175.28	NA	0.67	5,642.86	3%	2%	-£2.01m
Royalblue Group	SP	11.30	379.51	36.2	4.01	6,647.06	7%	9%	£32.97m
Sage Group	SP	2.57	3339.66	21.8	3.57	98,846.15	-5%	-5%	-£144.96m
Sanderson Group	SP	0.52	21.74	10.8	1.35	1,040.00	0%	6%	-£0.00m
SciSys	CS	0.98	25.14	4.0	0.35	759.69	3%	11%	£0.71m
SDL	CS	3.46	216.22	34.9	2.28	2,308.33	28%	47%	£47.70m
ServicePower	SP	0.13	10.45	NA	1.32	130.00	4%	-21%	£0.40m
Sirius Financial	SP	1.73	30.36	332.5	1.39	1,150.00	13%	17%	£3.43m
SiRViS IT plc	CS	0.04	0.41	NA	0.05	31.57	-6%	-6%	-£0.03m
smartFOCUS plc	SP	0.15	11.35	113.0	1.88	1,594.59	4%	-3%	£0.38m
Sopheon	SP	0.23	31.06	NA	6.66	334.53	1%	3%	£0.67m
Spring Group	A	0.66	105.63	NA	0.23	727.78	12%	-5%	£11.30m
SSP Holdings	SP	1.21	86.71	NA	4.85	1,141.51	-1%	0%	NA
StatPro Group	SP	1.01	53.01	NA	4.91	1,262.50	-3%	-3%	-£1.57m
SThree Group plc	A	4.35	600.17	NA	2.48	2,111.65	14%	13%	£75.88m
Stilo International	SP	0.02	2.13	NA	1.03	42.60	-10%	-10%	-£0.25m
Strategic Thought	CS	0.97	25.22	NA	2.20	712.18	-3%	-4%	-£0.65m
SurfControl	SP	4.73	150.32	NA	2.63	2,365.00	-11%	-9%	-£2.02m
Tadpole Technology	SP	0.02	6.96	NA	1.44	42.25	3%	75%	-£0.00m
Tikit Group	CS	2.84	36.22	NA	1.80	2,465.22	-3%	11%	-£0.40m
Total Systems	SP	0.40	4.16	NA	1.19	745.28	-7%	10%	-£0.32m
Touchstone Group	SP	1.79	21.52	NA	1.25	1,704.76	3%	0%	£1.29m
Trace Group	SP	0.96	14.51	11.6	1.01	764.00	-1%	-4%	-£0.15m
Triad Group	CS	0.24	3.64	NA	0.09	177.78	-2%	-4%	-£0.08m
Ubiquity Software	SP	0.37	69.20	NA	9.27	935.93	0%	86%	£0.01m
Ultima Networks	R	0.01	1.79	NA	0.94	21.46	1%	1%	-£0.00m
Ultrasis Group	SP	0.01	19.58	NA	15.76	27.14	-3%	-7%	-£0.59m
Universe Group	SP	0.10	7.36	5.7	0.17	455.56	11%	-27%	£0.72m
Vega Group	CS	2.38	48.35	15.6	0.78	1,946.72	1%	12%	£0.71m
VI group	SP	0.16	5.87	NA	0.61	315.00	17%	11%	£0.93m
Xansa	CS	0.87	301.15	36.3	0.84	2,224.36	4%	0%	£11.31m
Xpertise Group	CS	0.62	3.29	NA	0.21	2,480.00	32%	53%	£0.80m

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

IS THE S/ITS M&A TIDE TURNING?

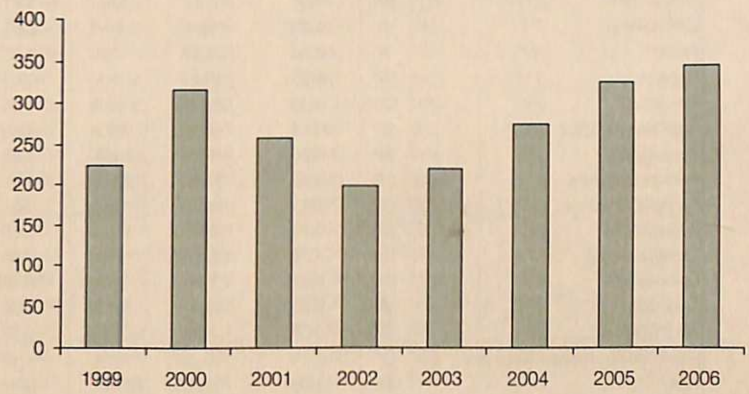
Kate Hanaghan
Analyst

2006 was another year of substantial M&A activity in the European technology sector, according to data from Regent Associates. There were a total of 3,295 transactions, an increase of 8% on the 3,053 deals in the previous year. The combined value of all deals in 2006 was up 24% to $337bn from $272bn in 2005. The software and IT services sector specifically saw a 7% increase in the number of acquisitions to 1,303. The number of S/ITS acquisitions by a UK company edged up almost 6% to 345 for 2006.

High levels of activity in the S/ITS space have been driven by a number of factors, none of which look set to disappear in 2007. After what was a dreadful time for the S/ITS industry in 2001/2002, the profitability of the sector has steadily been improving. This improvement in 'health' has given buyers more confidence in the sector - and therefore more confidence to make acquisitions here. Other drivers of M&A up to and including 2006 (which we analyse in some depth in "Industry Trends 2006: Industry Dynamics") include the high availability of cash - notably among private equity companies. Modest market growth of around 5-6% is another significant factor, as companies look to supplement low single-digit growth with acquisitive growth.

All of these factors are still here and are not going to vanish overnight. For example, we see both the continued drive for profitability (many of the larger IT services firms are looking to hit an 8-12% EBIT margin in two-to-three years' time and will acquire/divest where necessary to achieve this) and the confidence that improving profits cultivates as sustainable drivers of M&A activity.

Figure 1 **The number of S/ITS acquisitions made by UK companies**



Source: Regent Associates

So why is it that while conditions are still good for M&A, Regent's data indicates that we are perhaps starting to see the number of deals plateau? Well, given that we've been through a period of such high activity, it wouldn't be unreasonable to expect many firms to change their focus to start looking at how to integrate and exploit those purchases they have made. We also think that the UK S/ITS market is currently experiencing a 'mini-boom' driven by the CIO Growth Agenda, for example. Project services (as described in our recent Market Trends research) is one area that is benefiting from this. So we think some firms are easing off the acquisition accelerator slightly while they fully exploit any pockets of market potential they have identified.

Offshore buyers in 2007

It's worth mentioning the offshore factor too. Indian companies closed 26 European technology acquisitions in 2006, which in the grand scheme of things is a pretty small number (less than 1% of all deals). Examples include Infotech buying Rhyme Systems (UK banking) and NIIT buying Room (UK financial services). Predictions a couple of years back that offshore companies were about to go on a big spending spree did not come to fruition. However, the UK must take the Indian firms more seriously than ever. They have started to buy and this trend will be sustained. M&A brokers, such as Regent, continue to report heavy interest from the Indian firms and it is inevitable that this interest will be converted into more actual purchases. *(Kate Hanaghan)*

Regent

We are indebted to Regent Associates, M&A advisors to European technology organisations, for providing us exclusively with data on M&A activity.