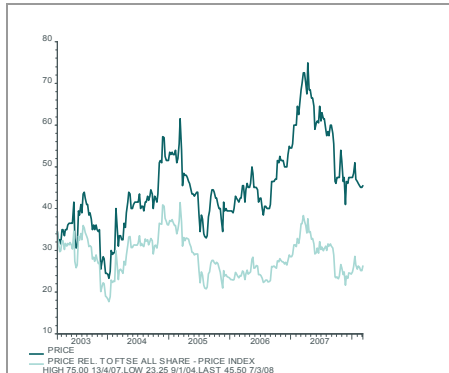


Financial Objects (FIO.L) (remains as) Buy

Price/Target: 46p/69p

FY Results Review

11 March 2008



Source: Thomson Financial

Reuters	FIO.L
Bloomberg	FIO.LN
EVO Sector	Technology
EVO Sub Sector	Software
Listing	AIM
No. of Shares	44m
Free Float	81%

Market Cap	£20m
Net Cash (FY08E)	£7m
Pension Surplus/(Deficit) (E)	£0m
Post Tax ROCE (E)	19%
ROE (E)	15%
Net Debt/(Equity) (E)	N/A
EBIT Interest Cover (E)	0x

Share price performance:	Abs	Rel to FTA
1 mth	-1%	-1%
3 mths	-1%	13%
12 mths	-33%	-27%

Roger Phillips
+44 (0) 20 7071 4463
roger.phillips@evosecurities.com

EVO Securities makes markets in Financial Objects

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Significantly undervalued

- FY07 results ahead in terms of EBIT and cash; 50% increase in dividend
- 08 forecasts unchanged; conservative given strong 2H07A EBIT performance
- Valuation looks anomalous at c60% discount to software sector

Strong FY07A results ahead of expectations

Clean EBIT of £3m was ahead of our £2.8m expectation, as flagged at the January trading update. Cash performance was also strong with bottom line net cash of £4.8m against our £4.4m forecast. The dividend was pushed up 50% to 1.5p reflecting balance sheet strength (cash c25% of market cap). Within the divisions, banking software saw a fall back in revenues from £11.4m to £9.5m and EBIT from £2.5m to £1.8m, but this was more than cancelled out by very strong performances in wealth management (42% rev growth) and credit risk (126%). With 75% of recurring revenue by our definition and no customer concentration risk, the group offers a defensive software investment.

Conservative 08E forecasts

Our 08E-09E profit forecasts are unchanged; we conservatively expect no run-rate improvement in 2H07A EBIT (£1.6m) assumed in 08E clean EBIT forecasts (£3.2m). With banking licence sales of only £0.9m 07A, new senior sales hires into the division, and an emerging markets pipeline, the omens are good for a growth year in banking driven by a recovery in licence sales. Wealth management saw a major increase in 2H07A margins to 12% as lower margin contracts were run-off, leading to our 11% EBIT 08E expectation looking low. Finally, the credit risk business looks capable of further strong growth with traditional energy end-market augmented by potential entry into the banking vertical market in 2008.

Significantly undervalued

The rating of 6x 08E EV/NOPAT is a c60% discount to UK software. Even allowing for the greater financial services focus than average and liquidity discount, we feel this is fundamentally undervalued. With a three year management track record of outperformance, a world leading credit risk solution, conservative forecasts and solid recurring revenue streams, and the potential for a bounceback year for the banking division in 08E, we see the balance of risk as being firmly to the upside.

Year end Dec 31	2006A	2007A	2008E	2009E	2010E
Sales (£m)	19.9	21.2	22.7	24.5	24.9
EBITDA (£m)	2.6	3.3	3.6	4.2	4.4
EVO PBT (£m)	2.3	3.1	3.4	4.0	4.1
EPS (p)	5.4	6.9	7.5	8.2	6.5
DPS (p)	1.0	1.5	1.7	1.8	2.0
Growth PBT (%)	108.0	34.3	10.7	17.6	2.5
Growth EPS (%)	63.6	27.0	9.9	8.8	-20.2
P/E (x)	8.5	6.7	6.1	5.6	7.0
EV/Sales (x)	0.8	0.7	0.6	0.4	0.4
EV/EBITDA (x)	7.6	5.1	4.1	2.9	2.4
EV/NOPAT (x)	10.5	7.1	5.7	4.0	3.4
FCF Yield (%)	6.6	10.0	14.1	14.8	10.6
Yield (%)	2.2	3.3	3.6	4.0	4.4

FY07A Results Overview

Results were ahead of operating expectations, as flagged in a January trading update, with 30% growth in clean EBIT for the year and significant improvement in EBIT margins from 11.6% to 14.2%. Cash performance was also strong with bottom line net cash of £4.8m versus an expectation of £4.4m. The divisional breakdown of results is given below against expectations and also versus 2006.

FY07 performance review

	07A	07E	06A
Revenue:			
Banking	9.5	10.0	11.4
Wealth Management	3.4	3.5	2.4
Credit Risk	4.3	4.5	1.9
Other	4.0	4.0	4.2
Total	21.2	22.0	19.9
EBIT:			
Banking	1.9	2.0	2.5
Wealth Management	0.3	0.3	0.1
Energy	1.0	1.0	0.0
Other	0.9	0.6	0.8
Central costs	(1.0)	(1.1)	(1.0)
Total	3.0	2.8	2.3
Interest	0.1	0.0	0.0
PBT	3.1	2.8	2.3
EPS	6.9	6.3	5.4
Net cash	4.8	4.4	2.8

Source: EVO Securities

- ▶ The risk profile of the group improved in 2007 with a greater balance of revenues across all four major divisions. Importantly, the group has no major customer exposure with no single customer accounting for more than 4% of revenue. Across the business, recurring (by our definition) revenue now accounts for c75% of revenue; this comprises 40% maintenance & support revenues (effectively rock-solid) and 35% highly repeatable revenues (services work and add-ons from existing customers that tends to repeat and so has a high degree of visibility, even if not technically recurring).
- ▶ It can be seen that the banking division fell back in 2007 in both revenue and EBIT terms and was slightly below expectations, although margins held steady. However this was more than made up for with strong performances in wealth management and credit risk, both of which saw strong revenue growth, margin improvement and a number of new name wins. Looking at the banking division's performance further, we see that licence sales saw a drop back to £0.9m from £2m in 2006.

Divisional revenue breakdown

07A Revenue (£m)	Banking	Wealth	Risk	Other	Total
Licence	0.9	1.3	1.4	0.4	4.0
Services	3.6	1.4	2.2	1.6	8.8
Support	5.0	0.7	0.7	2.0	8.4
Total	9.5	3.4	4.3	4.0	21.2

Source: EVO Securities

- ▶ Over the long term, this division has reported c£1m in licence sales or above every year; therefore we consider the division to have strong potential to deliver a bounce-back year in 2008, despite market fears over a banking software slowdown. The division is underpinned by >50% of support revenues. Banking margins showed a small uptick 2H on 1H from 19% to 21%. The division saw a significant hire 2H with a new head appointed, from CSC; further recruitment has led to the salesforce numbering six at this point compared to two for 2007. The new year has started well with a significant deal in South Africa signed for a French bank. This deal saw accelerated signature, possibly due to risk control issues, suggesting that Financial Objects may actually see a pull-forward of spend due to sub-prime.
- ▶ Wealth Management had a strong year with revenue up over 40% and EBIT margins more than doubling to 9%, with a 12% margin seen in 2H. New sales hires and a new divisional director with a strong operational management focus has reinvigorated this division, along with the run-off of lower margin projects from previous years and an increased focus on higher value contracts. Further sales resource is expected to be added in FY08.
- ▶ Credit Risk had an excellent year with 126% revenue growth (partly FY inclusion effect) and major contracts signed with Shell, E.ON and Calpine (4Q, a Texas power utility). The ramp in licence from £0.4m to £1.4m saw EBIT margins move to 22%, with a new thin-client solution driving increased interest from the existing installed base and the product being named the world leader for the third consecutive year (by the *Energy Risk* publication).
- ▶ The group reported that c50% of staff are now Bangalore-based (£2m total cost related to Bangalore). Within unallocated central costs (broadly flat at £1m), a one-off cost of £0.2m related to 2007 management changes and was reported within the operating result. Capitalisation of product development broadly netted off against amortisation. The group once again paid no tax with c£6m of tax losses to use, suggesting a negligible tax rate will apply in 2009 and full rate in 2010.

FY08-09E forecast overview

Our 08-09E forecasts are given below. Our profit and EPS forecasts are unchanged while revenue has been tagged back; net cash forecasts are substantially ahead. The reduction in revenue forecasts is entirely due to reducing expectations within banking, with overall margins forecast to be steady FY08E on FY07A.

Forecast Overview

	08E old	08E new	09E old	09E new
Revenue:				
Banking	10.5	9.0	11.0	9.5
Wealth	4.5	4.5	5.0	5.0
Credit Risk	5.0	5.0	5.5	5.5
Other	4.2	4.2	4.5	4.5
Total	24.2	22.7	26.0	24.5
EBIT:				
Banking	2.1	1.8	2.2	2.1
Wealth	0.5	0.5	0.8	0.7
Credit Risk	1.0	1.0	1.1	1.1
Other	0.7	0.9	0.8	0.9
Central cost	(1.1)	(1.0)	(1.1)	(1.0)
Total	3.2	3.2	3.8	3.8
margin	13.2%	14.1%	14.6%	15.5%
Interest	0.2	0.2	0.2	0.2
PBT	3.4	3.4	4.0	4.0
EPS	7.5	7.5	8.2	8.2
Net cash	6.1	7.1	8.1	9.4

Source: EVO Securities

The outlook for each of the key three divisions is as follows;

- ▶ Our forecast is for a broadly flat year in EBIT for banking on FY07A, but this division could be set for a rebound year following the hiring of significant sales resource in the last six months. The divisional focus is on mid-tier customers (Gruppo MPS in Italy, DnB NOR in Oslo, ICA Banken in Sweden) as opposed to global banks, who are more exposed to spending slowdown concerns. Additionally, the bid pipeline is largely focused on Southern Africa, Central Europe and, increasingly, Asia. Cross-sales from wealth management and credit risk are expected to occur into the banking installed base in 08E, building on the half-dozen sales of wealth management already made into banking. Further integration with Microsoft 2008 product releases (such as Silverlight, SQL08 and Windows Server 08) will be part of maintenance contracts but also drive consultancy revenues.
- ▶ With only £0.9m of licence revenue in 2007 and this having been a year of slower progress than anticipated, the comparison is also easier. The division's results are likely to be second half weighted as the sales team start to deliver,

but we believe this division is not the profit warning waiting to happen that the market seems to think. Margins for 08E overall are forecast as being stable at 20%, albeit slightly below the 21% in 2H07A. Additionally, the market underrates the quality of this division; with the additional sales resource we believe the business is fully competitive with the likes of Temenos and i-Flex as opposed to being a legacy vendor.

- ▶ The Wealth management division currently has three salespeople but this is expected to rise to six; new hires at the head of the division look already to have invigorated the sales and operational processes. With previous lower margin contracts now having been run off, the focus on higher value contracts should deliver ongoing better margins; as such our 08E EBIT forecast of 11% looks conservative compared to the 2H07A 12% delivered. Sales focus will be on family office-type deals in the Middle East, Central & Northern Europe (leveraging successful sales in other divisions) – also India is a potential end-market given the group’s existing strong presence in Bangalore. Cross-selling into geographies such as Luxembourg in tandem with the Banking group is expected to be a feature.
- ▶ Credit Risk is expected to continue to grow strongly with a potential focus on credit risk applications within banks, having been primarily focused on energy trading companies thus far (which is expected to continue as the prime end-market). This market is buoyant and we see potential for further new contract wins and the 07 thin-client upgrade of *energycrredit* driving installed base upgrades. This business remains a world leader with only one major US competitor of note. Following on from a strong licence year in 2007, we would expect to see the recurring element of both the credit risk and wealth management businesses grow and for the businesses to start establishing a material annuity stream of revenue.
- ▶ In technology terms, all products will see staged releases of increased functionality and integration with new Microsoft products. Part of this utilisation of new technologies will be part of existing support contracts, driving consultancy revenues, but part will be licence upgrade-related. Financial Objects is now a top 20 ISV partner with Microsoft in Europe and so can expect a degree of assistance in sales and marketing campaigns. Development work for this is undertaken within Bangalore at minimal cost, ensuring the business remains a lead player and does not move to being a legacy vendor.
- ▶ Meanwhile, unallocated central costs are forecast to remain at £1m despite the £0.2m one-off related to management changes.
- ▶ Ultimately, we see these forecasts as conservative, with no run-rate improvement in overall EBIT assumed from 2H07A (£1.6m) for FY08E (£3.2m) despite the strong growth delivered in the last three years. Management have delivered three years in a row and are backing their outlook with decisions; the 50% hike in dividend is suggestive of confidence, as are the recruitment plans for each division.

Valuation

Financial Objects is best rated on an EV/NOPAT basis; a simple PER gives a figure to within 10% of this, with the assumption of a tax charge (Financial Objects will pay no meaningful tax until 2010) mostly netting off against the strong cash balance (c25% of market cap). With the 50% hike in dividend, the yield now becomes a factor in supporting the current valuation at 3.6% 08E.

Valuation overview

	07A	08E	09E
PER	6.7	6.1	5.6
EV/Sales	0.7	0.6	0.4
EV/NOPAT	7.1	5.7	4.0
Sector PER	17.0	14.4	-
Sector EV/NOPAT	16.7	13.6	-
EV/NOP discount	58%	59%	-

Source: EVO Securities

The stock's rating is clearly constrained by liquidity and sentiment: banking software exposure is toxic to ratings as seen by the Misys share price performance in the last six months. We believe the market has overreacted to the potential for any slowdown in banking, leading to a strong value opportunity. Moreover, we believe the market has underrated Financial Objects' capability as a leading competitor to the likes of Temenos and i-Flex, the world-leading position enjoyed by the credit risk product, and the potential for additional sales for this product related to subprime. Our target price of 69p implies an 08E EV/NOPAT of 10x, still at a 27% discount to the wider software sector average.

Disclosures & Disclaimers

Analyst Details

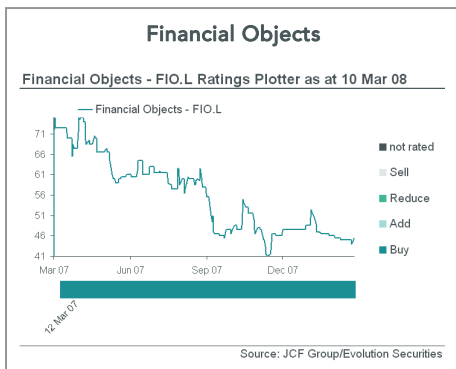
Roger Phillips

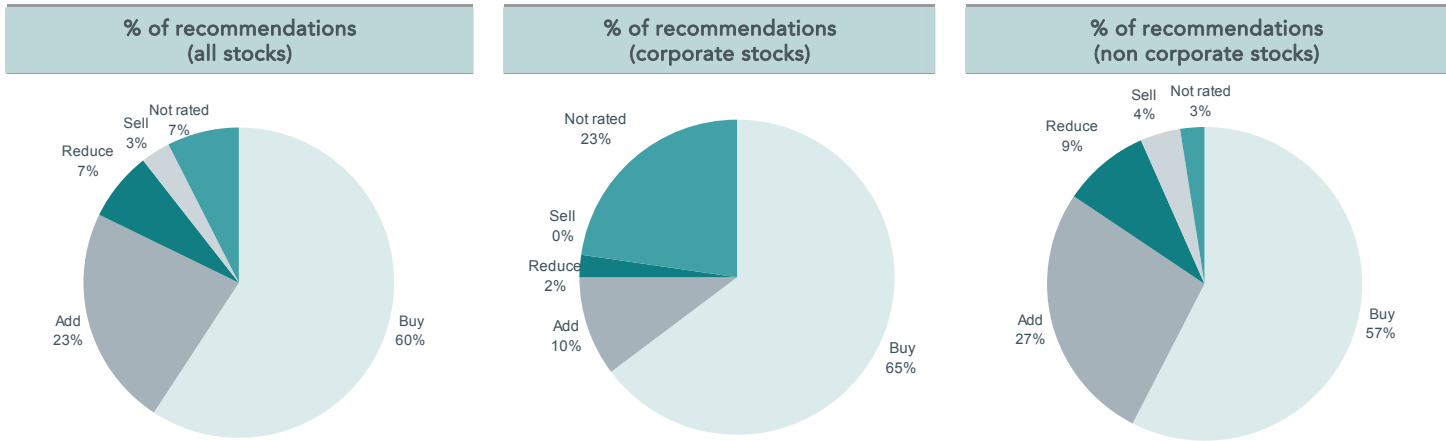
Software & Services Analyst

Autonomy	AVEVA Group	Dimension Data	Fidessa
Financial Objects	Innovation Group	March Networks	Micro Focus
Netcall	Sage Group	SQS	

Key: ◆ = Analyst has financial interest ● = Analyst has material interest ■ = Analyst is a director □ = Analyst has a business interest

Recommendation History Charts (For the last 12 months to previous days closing)





Updated on a quarterly basis; last updated 6 December 2007

Evolution Securities – Recommendation Guide

- Buy:** Expected to outperform the FTSE All-Share Index by 10% or more in the next 12 months
- Add:** Expected to outperform the FTSE All-Share Index by up to 10% in the next 12 months
- Reduce:** Expected to underperform the FTSE All-Share Index by up to 10% in the next 12 months
- Sell:** Expected to underperform the FTSE All-Share Index by 10% or more in the next 12 months

Evolution Securities previous recommendation structure (to 21 July 2006) was similarly segmented into buy, add, reduce and sell recommendations. For FTSE 100 stocks buy and sell recommendations were based on +10% and -10%, respectively, expectations of share price performance; FTSE Mid 250 stocks buy and sell recommendations were based on +15% and -15%, respectively, expectations of share price performance; and for FTSE Small Cap, Fledgling and AIM buy and sell recommendations were based on +25% and -25%, respectively, expectations of share price performance.

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