Edison investment research

10 March 2008

Financial Objects

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	PE (x)	Yield (%)
12/06	19.9	2.3	5.4	1.00	9.2	2.1
12/07	21.2	3.1	6.9	1.50	7.0	3.1
12/08e	22.8	3.5	7.7	2.00	6.3	4.1
12/09e	24.7	3.9	8.6	2.50	5.6	5.2

Note: *PBT and EPS are normalised, excluding goodwill amortisation and exceptional items

Investment summary: Strategy paying off

Financial Objects continues to deliver on its strategy with a healthy balance between high recurring revenues in the banking sector and the faster growth potential in wealth and risk management and the energy sectors. On a P/E of 6x, against a backdrop of a more uncertain financial services sector, the market is discounting downward pressure on forecasts. However, our forecasts remain broadly unchanged and the unexpected 50% hike in the dividend highlights the board's positive outlook.

Strategy update: Growth underpinned by wealth and risk

The success of management's acquisition strategy was highlighted by wealth management revenues up over 40% and a more than doubling of revenues in the risk management (formerly energy) division. These two businesses added over £1m of incremental profit, comfortably offsetting the expected 25% fall in banking profits.

FY07 results: Margins ahead

Revenues grew 7% (Edison forecast 10%) and stronger than expected operating margins (14.3% v Edison forecast 12.9%) contributed to profits ahead of forecast (better sales mix and good control of central costs). The group continued to convert profit into cash, finishing the year with £4.8m in net cash. The 50% uplift in the dividend to 1.5p was well ahead of forecasts (Edison 1.1p).

Forecasts: Unchanged

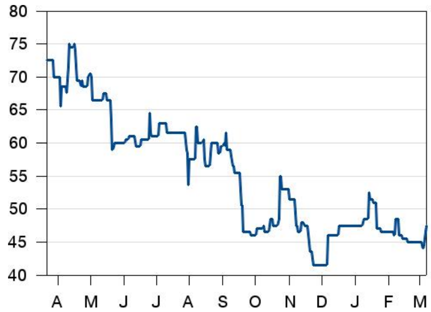
Our forecasts remain broadly unchanged. We forecast flat banking sales and profits but further strong growth in the wealth and risk businesses in reaching normalised EPS forecasts of 7.7p in FY08 and 8.6p in FY09. We forecast FY08 cash of £7.2m.

Valuation: Cheap on most measures

The shares now offer a 3% yield and appear to be trading significantly below fair value and financial software peers on a P/E basis. In this report we have also attempted to get beyond the financial services risk perception to value each of the divisions on a DCF basis. We reach a group valuation of £36m or 80p a share.

Price	48.5p
Market Cap	£22m

Share price graph



Share details

Code	FIO
Listing	AIM
Sector	Software & Computer Services
Shares in issue	45m

Price

	High	Low
52 week	75p	41p

Balance Sheet as at 31 Dec 2007

Debt/Equity (%)	N/A
NAV per share (p)	32
Net cash (£m)	4.8

Business

Financial Objects provides software solutions for the banking, wealth management and risk management sectors.

Valuation

	2007	2008e	2009e
P/E relative	48%	49%	47%
P/CF	8.5	6.0	5.3
EV/Sales	0.7	0.6	0.5
ROE	22%	20%	20%

Geography based on revenues

UK	Europe	US	Other
57%	26%	15%	2%

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Financial Objects is a research client of Edison Investment Research Limited

Investment summary: Strategy paying off

Company description: Microsoft platform software supplier

Financial Objects has built through acquisition an international portfolio of software businesses which are diversified by end market, but most of which operate on a Microsoft platform and offer customers a high ROI in managing and analysing their business processes and risks. The banking sector accounts for around 45% of revenues, wealth management 16% and risk management (currently the energy and utility sectors) 20%. The banking business has a large established customer base which underpins highly profitable recurring income. The wealth and risk management businesses are more nascent but are growing fast in large immature markets. The group has recently strengthened its divisional management and is led by CEO Karim Peermohamed and Finance Director Peter Youngs. The group has 300 employees and operations in the UK, Europe, US and Asia, including a major development centre in Bangalore.

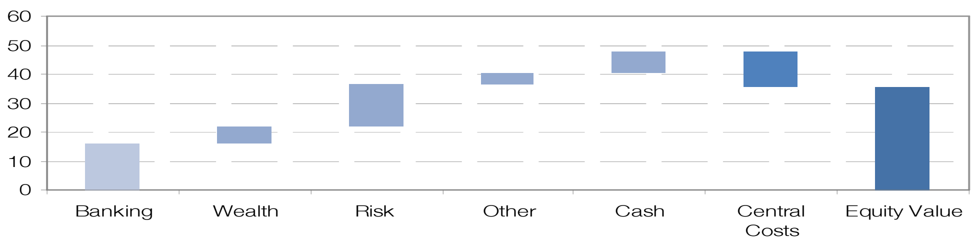
Financials and valuation: Suffering a financial sector 'discount'

The shares have fallen 40% from their highs and now trade on a P/E of c 6x (on an untaxed basis – the group has c £6m of tax losses to carry forward). We believe this largely reflects investor concern about the outlook for banking sector IT budgets. However, we would note: 1) the banking business has a large installed base and maintenance book and is therefore less dependent on new sales (90% of revenues from service and support); and 2) the wealth management and risk businesses are operating in markets with markedly different characteristics and growth prospects. Therefore, in this report we have used a divisional DCF approach to try and value each of the divisions. This approach values the wealth management business at £6m and the risk operation at £15m in reaching a group equity value of £36m (80p a share).

Sensitivities: Managing IT growth

In reaching our forecasts and investment conclusions we would highlight the following sensitivities: 1) the core banking sector is mature, while the group's operations in the energy and wealth markets are still small; 2) we assume that the banking, wealth management and energy sectors continue to grow IT budgets. The recent credit squeeze and any other cyclical pressure on these industries would have a knock-on impact in the short term on Financial Objects; 3) as demand ramps in the energy and wealth sectors, management will need to manage the recruitment and retention of staff to ensure the successful and profitable implementation of its software.

Exhibit 1: DCF divisional valuation

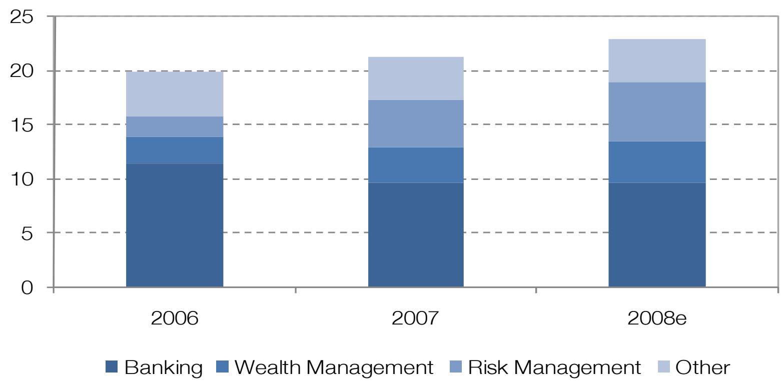


Source: Edison Investment Research

Company description: Diversified software supplier

Over the last four years the group has added to its core banking software business with a number of complimentary acquisitions which have opened up new markets. Today, Financial Objects is focused around four divisions. Importantly, these end customers are highly complimentary in terms of business requirements and process and IT profile.

Exhibit 2: Financial Objects revenue breakdown by division (£m)



Source: Company Reports, Edison Estimates

Business model: High recurring revenues and growth businesses

The Financial Objects businesses are typically Microsoft-based (Financial Objects is one of MSFT's top 20 independent software vendor partners in financial services in Europe and in the top 100 globally) and have an upfront software licence fee (in perpetuity) and an ongoing annual maintenance fee of around 20% of the licence fee. Importantly, over the last two years the company has largely succeeded in increasing the average licence fee across the group. This reflects management focus on the pricing structure and improved selling of the ROI to customers. In addition, the group will typically sell professional services around the implementation and integration of the core software (often doubling the size of the overall sale to the customer). Across the group around 40% of revenues are contracted support with a further 35% highly visible service sales. The divisions are run autonomously (there is a small head office central team) and are supported by the Bangalore Development Centre which employs 50% of the total workforce.

Banking: New management to help from H208

ibis s2 is the group's core solution for the commercial and wholesale banking market. ibis was acquired in 1996 and now offers banking software and services on IBM and Microsoft platforms. The product was designed for international wholesale banks and is split into different modules, each providing functionality to the full range of operations of any major international bank. The product monitors counterparty risk between banks and it is important to note that it is a banking solution as opposed to a trading solution. activebank Retail is the group's leading retail banking solution. Built on an advanced Microsoft .NET platform, with a component-based architecture, activebank Retail provides retail banks and building societies with a clear alternative to legacy core banking systems. radar provides a framework for identifying, measuring and managing operational risk, control and compliance. The system is used by banks to define and measure the risks across their businesses. In general, the banking operations are characterised by fairly modest growth (mature, competitive market, typically a few new order wins each year) but very high recurring revenue (large profitable maintenance income stream). Clearly there is some investor concern about the impact of the subprime crisis on Financial Objects' current and potential customers. However, the company has a wide geographical spread (focusing on Southern Africa, Central Europe and the Asian subcontinent) and target customers are typically mid-tier market banks that are looking to expand their market share and grow quickly. Examples of customers include Gruppo MPS, DnB NOR, Alpha Bank, ICA Banken, and C. Hoare and Co.

Wealth management: 43% sales growth

The activebank Wealth Manager product is based on a Microsoft platform, and provides a range of front- and middle-office solutions to streamline the investment management process, and a range of analytical and customer relationship management tools. The product is aimed at asset managers ranging from small private client size brokers right through to the major large integrated portfolio management houses. Traditionally, asset managers have tried to adapt banking software to meet their requirements, and at the low end many continue to store client information (personal details, assets under management, fund allocation etc) in spreadsheets. We believe there are several thousand target accounts in the UK and very sizeable and specific opportunities in Scandinavia, Middle East, Central Europe and eventually the US. In addition, management is set to explore the Indian market where assets under management are set to grow by 30% year-on-year. The wealth management business grew strongly, up 43% in FY07, and we believe it should be capable of sustaining annual growth in the 10%–20% range over the next five years. Importantly, as the group is able to sell more professional services and maintenance around licence sales, the percentage of annual recurring revenue should also increase significantly.

Risk management: Opportunities to expand into financial services

The credit risk software business came with the acquisition of Raft International in March 2006 and has initially focused on the energy and utility sectors. energycredit is an enterprise-wide credit risk management solution. It enables energy and utility companies to capture, measure, monitor and report credit exposure by counterparty, commodity, deal type, country/region, delivery point, industry, external credit rating, trading office, or any combination of these. Importantly, the system is highly configurable by the end customer and highly scaleable across large organisations. The group has implemented its solutions for new Shell, E.ON RWE Trading and Calpine in the energy sector. In total, management estimates there are c 200 major target companies. The high ROI of the solution (as well as monitoring credit risk, customers are often able to claim collateral from counterparties), and the current strength of the energy market has enabled management to scale-up the licence fee structure for the larger deals. Therefore, for a large enterprise-wide solution, the licence fee could be over £0.5m, with potentially double that for professional services to implement and integrate the software. The group has recently added some senior management to the business and we would expect to see the first sales of the solution into the financial services sector in the next 12 months.

FY07 trading: Delivering on the strategy

P&L and balance sheet: Margins ahead

Group revenues increased by 7% to £21.2m (Edison £21.9m), of which £8.4m (40%) was from contracted maintenance revenues, £8.8m from services and £4.0m from licence sales. Around 60% of services and licence sales came from existing customers. Normalised operating profit increased to £3.0m (Edison estimate £2.8m) with operating margins increasing to 14.3% (Edison estimate 12.9%). There was no material corporation tax chargeable in the year (the group has tax losses of over £6m). On an Edison normalised basis EPS was 6.9p, an increase of 11%.

Operating cash flow was in line with forecasts at £2.4m. After the payment of the dividend of £0.4m and capital expenditure of £0.3m, offset by £0.3m from the issues of shares as a result of the exercise of options, the group generated net cash of £2.1m to end the year with net cash of £4.8m.

Divisional review: As expected…

In line with forecasts banking profits dropped year-on-year but the wealth and risk management businesses grew revenues strongly and benefited from the operational leverage.

- Banking Division. A new head of banking was appointed in October 2007, the sales team was expanded and a number of other key management changes made. Management expect to see the benefits from H208. Sales and profits were as expected. Sales were £9.5m (down 16% year-on-year). However, operating margins held up at 20% (22% in FY06) highlighting the profitable maintenance income stream. Contracted maintenance revenues were £5.0m.
- Wealth Management Division. Again management expects several new senior appointments to benefit the division from the second half of this year. Sales of wealth management software were £3.4m and grew by 42% year-on-year. Operating margins improved significantly to 9% (2% FY06).
- Risk Management Division. Sales were £4.3m growing by 126% year-on-year, while margins improved to 23% (4% FY07). During the year the group developed an updated version of the energycredit product, extending its functionality and creating a new thin client version which allows access via the internet and through web portals. The opportunities in the energy and financial services sectors should underpin further strong growth.
- Other software products. Sales of other (non-core) software products were £4.0m. Operating margins improved to 22% (2006: 18%).

Financials: Forecasts unchanged

Our forecasts are largely unchanged and reflect a very conservative view of the banking sector (flat sales and profits), compared with the fast growth in wealth and risk management businesses. We forecast revenues of £22.8m in FY08 (previously £24m) and EBITA of £3.4m (unchanged). Our detailed cash flow assumptions are shown in Exhibit 5 but our year end cash forecast of £7.2m remains unchanged.

Exhibit 3: Divisional forecasts

Year end December		2007			2008e		2009e	
Revenue	H1	H2	Yr	Change	Yr	Change	Yr	Change
Banking	4,706	4,789	9,495	-16%	9,495	0%	9,970	5%
Wealth Management	1,790	1,603	3,393	43%	3,902	15%	4,370	12%
Risk Management	2,079	2,255	4,334	123%	5,418	25%	6,230	15%
Other software products	2,070	1,938	4,008	-4%	4,048	1%	4,089	1%
Total	**10,645**	**10,585**	**21,230**	7%	**22,863**	8%	**24,659**	8%
EBITA								
Banking	916	969	1,885	-25%	1,900	1%	2,000	5%
Wealth Management	111	197	308	n/a	450	46%	625	39%
Risk Management	448	541	989	n/a	1,250	26%	1,400	12%
Other software products	367	505	872	14%	850	-3%	850	0%
Total	**1,842**	**2,212**	**4,054**	20%	**4,450**	10%	**4,875**	10%
EBITA Contribution Margin								
Banking	19%	20%	20%		20%		20%	
Wealth Management	6%	12%	9%		12%		14%	
Risk Management	22%	24%	23%		23%		22%	
Other software products	18%	26%	22%		21%		21%	
Total	**17%**	**21%**	**19%**		**19%**		**20%**	
Unallocated Costs	(424)	(600)	(1,024)		(1,060)		(1,085)	
EBITA	**1,418**	**1,612**	**3,030**	30%	**3,390**	12%	**3,790**	12%
Exceptional Items	0	0	0		0		0	
Goodwill	(168)	(167)	(335)		(335)		(335)	
Net Interest	23	35	58		80		100	
PBT	**1,273**	**1,480**	**2,753**		**3,135**		**3,555**	

Source: Edison Investment Research

Valuation: Undervalues banking and new businesses

On simple metrics of earnings, dividends and cash flows Financial Objects looks significantly undervalued (we highlight a c 40% discount to UK financial software peers). In our view investors are not valuing the highly secure and very profitable recurring revenue stream in the banking division, and the major opportunity to upscale the wealth and risk management businesses.

To try and get beyond this we have valued each of the divisions on a DCF basis to reach a 'sum-of-the-parts' valuation. We have made growth assumptions appropriate for each division, faded the operating margins over time, and then applied what we believe is a conservative discount rate to each cash flow stream (we discount banking cash flows at 10% given the high recurring sales, but use 15% for the wealth and risk management businesses given their higher risk/reward). We then adjust for central costs and cash. We also show the 'backed-out' EV/EBITDA for each of the divisions. This approach highlights a group valuation of £36m or 80p a share. We believe if management can demonstrate that it can return the banking division to growth and continue to execute in the wealth and risk management businesses then this valuation could be low.

We have noted before that the financial software market is highly fragmented and we expect corporate activity to remain a feature. Software is important but 'ownership' of the customer relationship is key and therefore larger players will always look to acquire good technology to sell to existing customers. In addition there are a number of smaller UK suppliers of financial software with a potentially synergistic mix of solutions and customers.

Exhibit 4: Valuation

SOTP DCF valuation	% owned	£m	Per share	EV/EBITDA	EV/Sales	Assumptions		
Banking	100.0%	16	36	7.9x	1.7x	WACC: 10%	No of shares	45.0m
Wealth Management	100.0%	6	13	11.6x	1.5x	WACC: 15%	Shr price	46.00p
Risk Management	100.0%	15	33	11.4x	2.7x	WACC: 15%	Mkt cap	£20.7m
Other	100.0%	4	9	4.4x	0.9x	WACC: 12%		
Less: taxed central costs NPV		(12)	(26)			WACC: 10%		
Group Enterprise Value		29	64					
Add: Net Cash		7	16					
Group Equity Value £m		**36**	**80**		**Up / (down)side from current price**		**73%**	

Ratio Analysis	2008f	2009f
EV/Sales	0.6	0.5
EV/EBITDA	3.7	2.7
EV/EBIT	4.0	2.9
Price/Book	1.2	1.1
Price/Earnings	6.0	5.3
Price/Op Cash Flow	6.0	5.4
ROE	20%	20%

Grp DCF Scenario's	-----------------Terminal growth rate-----------------	
WACC	3.00%	5.00%
14.00%	82p	85p
13.00%	90p	95p
12.00%	100p	108p
11.00%	114p	126p
10.00%	131p	151p
Breakeven WACC	23.5%	

Comparative Comps (FY08)	EV/Sales	P/E
Focus Solutions	0.7x	9.1x
Intelligent Environments	2.2x	11.7x
Portrait Software	0.9x	8.5x
SSP Holdings	1.8x	9.9x
Average	1.4x	9.8x
Focus Solutions discount	**58%**	**39%**

Revenue sensitivity				
Multiple	0.5x	1.0x	1.5x	2.0x
Revenue Y1 £m	23	23	23	23
Implied EV £m	11	23	34	46
Net (debt)/cash £m	.00	.00	.00	.00
Group equity value £m	11	23	34	46
Per share (p)	**25**	**51**	**76**	**102**

Source: Company accounts/Edison Investment Research

Exhibit 5: Financials

£m 31-December	2005 UK GAAP	2006 UK GAAP	2007 IAS	2008e IAS	2009e IAS
PROFIT & LOSS					
Revenue	13,916	19,858	21,230	22,863	24,659
Cost of Sales	(9,625)	(13,503)	(14,224)	(15,089)	(16,151)
Gross Profit	4,291	6,355	7,006	7,773	8,507
EBITDA	1,233	2,653	3,312	3,670	4,070
Operating Profit (before GW and except.)	952	2,336	3,030	3,390	3,790
Goodwill Amortisation	(361)	(279)	(335)	(335)	(335)
Exceptionals	(840)	0	0	0	0
Other	0	0	0	0	0
Operating Profit	(249)	2,057	2,695	3,055	3,455
Net Interest	66	(12)	58	80	100
Profit Before Tax (norm)	1,018	2,324	3,088	3,470	3,890
Profit Before Tax (FRS 3)	(183)	2,045	2,753	3,135	3,555
Tax	0	607	(38)	0	0
Profit After Tax (norm)	1,018	2,324	3,050	3,470	3,890
Profit After Tax (FRS 3)	(183)	2,652	2,715	3,135	3,555
Average Number of Shares Outstanding (m)	35.7	42.9	44.0	45.0	45.0
EPS - normalised (p)	2.9	5.4	6.9	7.7	8.6
EPS - normalised fully diluted (p)	2.9	5.4	6.9	7.7	8.6
EPS - FRS 3 (p)	(.5)	6.2	6.2	7.0	7.9
Dividend per share (p)	0.0	1.0	1.5	2.0	2.5
Gross Margin (%)	30.8	32.0	33.0	34.0	34.5
EBITDA Margin (%)	8.9	13.4	15.6	16.1	16.5
Operating Margin (before GW and except.) (%)	6.8	11.8	14.3	14.8	15.4
BALANCE SHEET					
Fixed Assets	6,181	11,867	11,346	10,803	10,468
Intangible Assets	5,838	3,073	2,738	2,403	2,068
Tangible Assets	343	407	425	400	400
Investment in associates	0	8,387	8,183	8,000	8,000
Current Assets	8,214	9,705	10,636	13,305	16,269
Stocks	0	0	0	0	0
Debtors	4,822	5,564	5,512	6,086	6,714
Cash	3,392	4,121	5,124	7,219	9,555
Current Liabilities	(6,766)	(9,222)	(6,838)	(6,918)	(7,311)
Creditors	(6,491)	(8,136)	(6,563)	(6,918)	(7,311)
Short term borrowings	(275)	(1,086)	(275)	0	0
Long Term Liabilities	(1,002)	(1,345)	(1,253)	0	0
Long term borrowings	(481)	(275)	0	0	0
Other long term liabilities	(521)	(1,070)	(1,253)	0	0
Net Assets	6,627	11,005	13,891	17,190	19,425
CASH FLOW					
Operating Cash Flow	(570)	2,111	2,394	3,451	3,835
Net Interest	50	(12)	94	80	100
Tax	(1)	(8)	7	0	0
Capex	(275)	(162)	(301)	(500)	(700)
Acquisitions/disposals	441	(1,006)	0	0	0
Financing	(1,157)	0	314	0	0
Dividends	0	0	(431)	(661)	(900)
Net Cash Flow	(1,512)	923	2,077	2,370	2,335
Opening net debt/(cash)	(4,204)	(2,636)	(2,760)	(4,849)	(7,219)
HP finance leases initiated	(1,263)	(799)	0	0	0
Other	1,207	12	12	0	0
Closing net debt/(cash)	(2,636)	(2,772)	(4,849)	(7,219)	(9,555)

Source: Company accounts/Edison Investment Research

Edison Investment Research

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