Review

Edison investment research

13 March 2007

Financial Objects

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	PE (x)	Yield (%)
12/05	13.9	1.0	2.9	0.00	25.2	N/A
12/06	19.9	2.3	5.3	1.00	13.6	1.4
12/07e	22.4	2.8	6.3	1.10	11.4	1.5
12/08e	24.4	3.4	7.4	1.21	9.7	1.7

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

Investment summary: Lots of wealth & energy

Financial Objects has evolved post acquisitions with a clear focus on the financial and energy sectors. We expect that the core banking business will continue to show modest growth, while the newly acquired Wealth Management and Energy Credit businesses have performed well, and will be the drivers of our forecast earnings growth of 19% and 17%. In our view the valuation reflects the acquisitive history of the company, not the significant opportunity in its current core markets.

Investment case: Major opportunities in new markets

Financial Objects has largely built out a focused and complimentary software and service offering on top of its traditional core expertise in banking. The major product development is now largely complete, the customer pipeline is growing and there are major opportunities in the wealth management and energy sectors which are relatively underinvested in IT infrastructure.

FY06 results: Wealth and Energy into profit

Revenues were broadly in line but the EBITA was ahead of our forecast helped by a strong H2 performance in the Wealth and Energy businesses as well as a good contribution from the 'other' software businesses. The Group finished the year with £2.8m of net cash and announced a dividend of 1p a share. The order backlog was £13.1m (£10.4m) and the Board expects 'momentum of growth to continue'.

Forecasts: Approaching 20% earnings growth

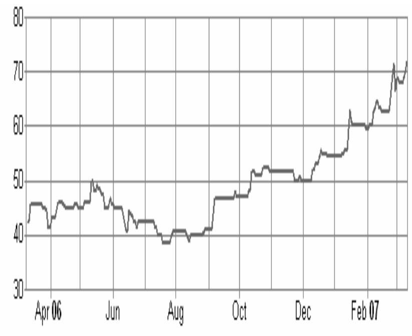
We forecast revenue growth of 13% in FY07 and 9% in FY08 but an increase in margins from 11.5% in FY06 to 12.5% in FY07 and 13.7% in FY08. This will drive EPS growth of 19% and 17%, and strong cash generation.

Valuation: Market focus not priced in

On our forecasts the P/E falls from 11.4x FY07 to 9.7x FY08. This reflects the need for management to 'deliver' on forecasts after recent acquisitions and the build-out of two new reported divisions. We believe current order book visibility is growing, the company has major opportunities in its new markets and execution this year will support a move up in the shares towards a more typical software multiple of 12–14x.

Price	72p
Market Cap	£32m

Share price graph



Share details

Code	FIO
Listing	AIM
Sector	Software & Computer Services
Shares in issue	44m

Price

	High	Low
52 week	72p	38p

Balance Sheet as at 31 Dec 2006

Debt/Equity (%)	N/A
NAV per share (p)	23
Net cash (£m)	2.8

Business

The group provides software solutions for the banking, wealth management and energy sectors.

Valuation

	2006	2007e	2008e
P/E relative	71%	109%	118%
P/CF	14.6	14.6	14.6
EV/Sales	1.4	1.4	1.4
ROE	22%	22%	22%

Geography based on revenues

UK	Europe	US	Other
70%	23%	4%	3%

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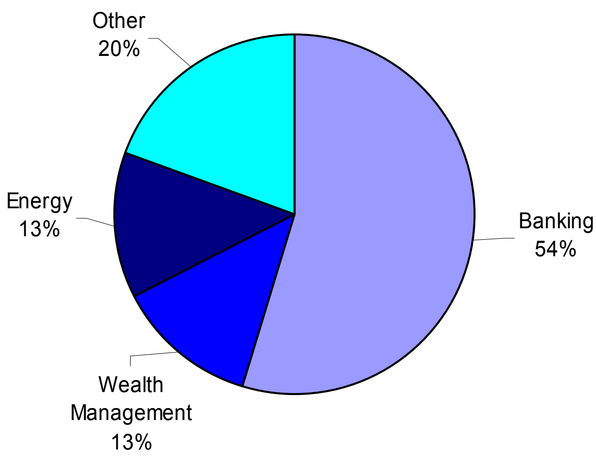
Financial Objects structure: Now positioned for growth

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 1: Financial Objects FY07 estimated revenue breakdown



Source: Edison Investment Research

Business model: Licence and maintenance model

The Financial Objects businesses typically 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, better selling of the ROI to customers and an improvement in mix towards larger clients. Typical licence fees are in the range £100k to £250k, although given the divergent size of the target customers, fees can be either smaller or significantly larger. 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).

Two growth engines: Wealth Management & Energy

We estimate that the core banking software and services offering will account for around 55% of revenues in FY07 and importantly, 69% of profit. Financial Objects has now largely completed the investment in the latest releases of IBIS2 and activebank. These products are based on a Microsoft platform, and offer a complete set of integrated retail and wholesale banking applications. Licence fees typically range in size from £200k to £2m, there is a significant opportunity to sell services and the company starts the year with over £4m of prospective opportunity. However, the banking market is mature, and therefore, while we would expect this customer base to be highly cash generative for Financial Objects, we would expect growth to be modest (we forecast sales growth of 8% in FY07 and 5% in FY08). Going forward we therefore believe that the wealth management and energy sectors will be the major drivers of earnings growth.

Wealth Management: Price and customer momentum

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.

Target customers: Wide range of asset managers

The product is aimed at asset managers ranging in size upwards from small private client size brokers (i.e. may be a small office managing money for high net worth individuals right through to the major large integrated portfolio management houses with billions of pounds under management). Target customers are therefore private banks, financial products providers, fund managers, property investors and boutique asset managers. 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. Management believes there are several thousand target accounts in the UK and there are very sizeable and specific opportunities in the Middle East, Europe and eventually the US.

The product: Analytical tools and CRM functionality key

activebank Wealth Manager has a robust database at the back end which stores all the information but more importantly has a number of key tools:

- Analytical tools. These enable the asset manager to easily review, sort and manage client data. For instance the manager can easily see all the assets owned by an individual client, sort by stock, sector, country etc. across all clients to monitor risk or generate ideas as well as measuring portfolio performance, benchmarking etc.
- Client reporting. As importantly, the software enables the asset manager to provide their clients with sophisticated reports detailing their asset allocation, fund performance etc. in a very 'readable' format. In a competitive marketplace, where clients want to understand the payback for the commission rates they are paying, and regulators are increasingly insisting on transparency of fees and performance, the activebank Wealth Manager can be a major differentiator in client retention, as well as providing a full audit trail of customer interaction.
- Integration. For larger customers in particular the activebank Wealth Manager product can be easily bolted together with activebank enabling banks to have a seamless system from transaction processing at the back end right through to the sophisticated research and CRM tools at the front end.

Competition: Financial Objects growing market share in the UK

As highlighted, many asset managers are currently 'mix and matching' a range of financial services software. However, there are wealth management focused software competitors including Pulse Systems (UK), Advent Software (US), Business Architects (Belgium) and Odyssey Group

(Luxembourg). Currently management believes they are winning a large proportion of business pitched for in the UK and expect to grow share as they expand overseas.

Growth: 10–20% sustainable

With any business with lumpy licence sales, accurately forecasting growth in any accounting period will always be difficult. However, the wealth management business grew strongly, up 42% in FY06, 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. In addition, with improved management focus and a marketing push towards larger customers, we believe the company is being successful in increasing average licence fees per customer and growing the marginal profit contribution.

In November, management announced the activebank Wealth Management team had signed three deals with a total combined value of £1m with options on future software and services for £250,000. While we would expect ongoing R&D costs (most development will be customer funded) we would expect management to focus investment on increases in headcount in sales and implementation. Nevertheless, we expect the business to show operational leverage going forward reflecting the growth in recurring revenue and further opportunities to increase average selling prices.

Energy: Underdeveloped IT market

The energy credit risk software business came with the acquisition of Raft International in March 2006. The core product is a credit risk and operational risk management solution.

What does it do?

Energy Credit 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. Enterprise-wide information can also be easily exchanged with multiple systems throughout the organisation. Importantly, the system is highly configurable by the end customer and highly scaleable across large organisations.

The software therefore enables users to credit score all their counterparties, and view and manage all their credit positions. For instance, credit managers can monitor exposure by energy group (oil, gas, coal etc.), by country, by credit rating (Moodys, Fitch etc.) and even review the legal documentation between them and the counterparty. The really valuable component of the software is the ability to perform analysis on this credit data. For example the system enables users to ask questions like: what happens to my counterparty risk if the oil price goes to $80 a barrel, or if there is an earthquake in Japan, a hurricane in the Atlantic, or conflict in a specific geographic region etc.? This therefore enables the major energy and utility companies to not only manage their day-to-day credit risks but continually review ‘what-if’ scenarios.

Target market and drivers: c.200 energy and utility players

A need to understand credit is an issue for all companies. The software was initially focused on the key financial services market. However, the business is now targeted at the energy and utility markets. The main driver has been the deregulation of the market and the impact on the supply chain. What was a previously fairly integrated industry has now become far more fragmented.

Getting energy from the earth into the home is likely now to involve separate exploration companies, generators, wholesalers and retailers. All these companies will have fluctuating credit positions with each other as well as with the rest of the supply chain and possibly end customers (e.g. an energy retailer needs to know their credit risk down to individual corporate customers). In addition, this break-up of the supply chain has occurred globally leading to a multitude of different international counterparties and therefore a wide mix in credit worthiness.

During the last full year the group implemented its solutions for new clients including Shell, RWE Trading, Constellation Energy, Mirant and Hydro in the energy sector. In total, management estimates there are c.200 major target companies.

Importantly, the energy sector has invested significantly less in IT over the last 20 years than the financial sector. Therefore, while financial services companies are typically sophisticated buyers of IT and the software supply base is mature and intense, the energy and utility sectors have not invested as much ahead of deregulation, and in-house credit systems are therefore relatively simple. This means that whereas mainstream financial services are largely a ‘replacement’ market, the energy and utility sector is broadly a ‘new market’ opportunity for Financial Objects.

Competition: Few focused sector players

Financial Objects’ chief competitor is ROME Corporation, a VC-backed US company. They have clients across the US and Europe, and focus on credit and counterparty risk. However, they do not have a specific focus on the energy sector and Financial Objects won the Shell contract against them in November last year. Major US software company SunGard has a risk product. They are currently focused on the financial services sector but are likely to compete in the energy sector in the medium-term.

Pricing and growth potential: Large ticket sizes

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. Given that this business is currently small (FY06 revenues of £1.9m) and the market appetite very high, we would expect growth over the next three years to be very high. We forecast FY07 revenues of £2.9m and FY08 of £3.6m. Similarly to wealth management, a key opportunity will be to build-up the recurring professional services and maintenance revenues across the customer base.

Further corporate reshaping? No major acquisitions

The group has been very corporately active over the last two years, including recently making the disposal of the Danish consultancy business. We believe the company may consider small disposals and add-on complimentary acquisitions (most likely in the focus areas of wealth management and energy credit) but we do not expect any major deals.

Sensitivities

In reaching our forecasts and investment conclusions we would highlight the following sensitivities: (1) the core banking sector is very mature, while the group's operations in the energy and wealth markets are still small. (2) We assume that the banking and energy sectors continue to raise IT budgets. Any cyclical pressure on either industry 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 in the UK and India to ensure the successful and profitable implementation of their software.

Financials: Margin expansion FY07 and FY08

Forecasts

Our forecasts reflect the expected slower but cash generative growth in the banking and 'other' businesses, compared with the fast growth in Wealth Management and Energy but from a low base. We forecast revenues of £22.4m in FY07 and EBITA of £2.8m.

Exhibit 2: Divisional forecasts

Year end December	2005			2006			2007		2008	
Revenue	H1	H2	Yr	H1	H2	Yr	Yr	Change	Yr	Change
Banking	4,860	5,500	10,360	5,920	5,449	11,369	12,279	8%	12,892	5%
Wealth Management	176	1,061	1,237	996	1,382	2,378	2,854	20%	3,282	15%
Energy	0	0	0	399	1,543	1,942	2,913	50%	3,641	25%
Other	553	1,766	2,319	2,063	2,106	4,169	4,377	5%	4,596	5%
Total	**5,589**	**8,327**	**13,916**	**9,379**	**10,479**	**19,858**	**22,423**	13%	**24,412**	9%
EBITA										
Banking	351	880	1,231	1,400	1,128	2,528	2,700	7%	2,775	3%
Wealth Management	135	20	155	(126)	173	47	300	n/a	600	100%
Energy	0	0	0	(129)	135	6	290	n/a	620	114%
Other Software Products	126	319	445	343	405	748	650	n/a	600	-8%
Total	**612**	**1,219**	**1,831**	**1,488**	**1,841**	**3,329**	**3,940**	18%	**4,595**	17%
EBITA Contribution Margin										
Banking	7%	16%	12%	24%	21%	22%	22%		22%	
Wealth Management	77%	2%	13%	-13%	13%	2%	11%		18%	
Energy	n/a	n/a	n/a	-32%	9%	0%	10%		17%	
Other Software Products	23%	18%	19%	17%	19%	18%	15%		13%	
Total	**11%**	**15%**	**13%**	**16%**	**18%**	**17%**	**18%**		**19%**	
Unallocated Costs	(439)	(440)	(879)	(503)	(537)	(1,040)	(1,144)		(1,258)	
EBITA	**173**	**779**	**952**	**985**	**1,304**	**2,289**	**2,796**	22%	**3,337**	19%
Exceptional Items	(319)	(521)	(840)	109	(17)	92	0		0	
Goodwill	(76)	(285)	(361)	(465)	(513)	(978)	(940)		(900)	
Net Interest	61	5	66	20	(32)	(12)	50		80	
PBT	**(161)**	**(22)**	**(183)**	**649**	**742**	**1,391**	**1,906**		**2,517**	

Source: Edison Investment Research

We expect the operational leverage within the group to be clearly evident in FY08, as the Wealth Management and Energy Credit businesses deliver strong volume and value growth over a more growth constrained costs base (i.e. product development is largely complete and so the only major marginal costs will be in sales and implementation staff which we expect to be added progressively). This all adds up to our forecast group revenue growth of 9% in FY08 but a 19% increase in EBITA to £3.3m. The group has £11m of taxes losses and we assume no tax paid in our forecasts.

Our detailed cash flow assumptions are shown in Exhibit 3. Management has stated that in line with typical software business models they expect profits after tax to largely flow through in cash. We forecast year end FY07 net cash of £4.9m and £7.7m at the end of FY08. The growth in profitability and cash flow clearly demonstrates the strength of the business model, and highlights the potential for the group to continue to pay a progressive dividend going forward (we assume a 10% increase in the payout in FY07 and FY08).

Valuation: Does not reflect opportunity in new markets

Currently, Financial Objects trades on around 1.4x FY07 revenues and 1.3x FY08 revenues. This valuation does not look unreasonable compared with typical valuations for smaller UK software companies which trade in the range 1x to 2x sales.

However, this approach underestimates the operational leverage in the business and the potential for the company to scale-up margins. We forecast that EBITA margins grow from reported 11.5% in FY06 to 12.5% in FY07 and 13.7% in FY08. Therefore the P/E falls from 11.4x FY07 to 9.7x FY08. This compares with typical UK smaller company software valuations in the range 12–14x earnings (the UK's largest financial software company Misys trades on c.16x FY07 earnings and c.1.3x sales).

The valuation looks further underpinned by considering the opportunity for the company to generate cash and, in time, return it to shareholders. We forecast normalised but untaxed net income of £3.4m in FY08. Very conservatively assuming a tax rate of 20% (which would imply net income of c.£2.7m), a 40% payout ratio (distributed dividends of £1.1m) and a 3% yield would imply a valuation of £36m (upside of 15%).

We also note 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. Very large players like Misys in the UK and SunGard in the US have been highly acquisitive over the last 10 years, and indeed private equity funds have also been willing to take a bet on the long-term opportunity to generate cash from the sector. In March 2005 a consortium of major private equity houses acquired SunGard Data Systems for $11bn paying an estimated c.2.5x forward sales and c.16x earnings.

Exhibit 3: Financials

Year-ending 31 December		2005	2006	2007e	2008e
Accounting basis	£'000s	UK GAAP	UK GAAP	UK GAAP	UK GAAP
PROFIT & LOSS					
Revenue		13,916	19,858	22,423	24,412
EBITDA		1,233	2,606	3,096	3,627
Operating Profit (before GW and except.)		952	2,289	2,796	3,337
Goodwill Amortisation		(361)	(978)	(940)	(900)
Exceptionals		(840)	92	0	0
Other		0	0	0	0
Operating Profit		(249)	1,403	1,856	2,437
Net Interest		66	(12)	50	80
Profit Before Tax (norm)		1,018	2,277	2,846	3,417
Profit Before Tax (FRS 3)		(183)	1,391	1,906	2,517
Tax		0	893	0	0
Profit After Tax (norm)		1,018	2,277	2,846	3,417
Profit After Tax (FRS3)		(183)	2,284	1,906	2,517
Average Number of Shares Outstanding (m)		36	43	45	46
EPS - normalised (p)		2.9	5.3	6.3	7.4
EPS - FRS 3 (p)		(0.5)	5.3	4.2	5.5
Dividend per share (p)		0.0	1.0	1.1	1.2
EBITDA Margin (%)		9%	13%	14%	15%
Operating Margin (before GW and except.) (%)		7%	12%	12%	14%
BALANCE SHEET					
Fixed Assets		6,181	9,191	9,400	9,500
Intangible Assets		5,838	8,784	9,000	9,100
Tangible Assets		343	407	400	400
Investment in associates		0	0	0	0
Current Assets		8,214	10,605	13,821	17,471
Stocks		0	0	0	0
Debtors		4,822	6,484	7,321	7,971
Cash		3,392	4,121	6,500	9,500
Current Liabilities		(6,766)	(9,183)	(10,192)	(11,152)
Creditors		(6,491)	(8,109)	(8,892)	(9,657)
Short term borrowings		(275)	(1,074)	(1,300)	(1,495)
Long Term Liabilities		(1,002)	(302)	(275)	(275)
Long term borrowings		(481)	(275)	(275)	(275)
Other long term liabilities		(521)	(27)	0	0
Net Assets		6,627	10,311	12,754	15,544
CASH FLOW					
Operating Cash Flow		(570)	2,111	2,941	3,713
Net Interest		50	(12)	50	80
Tax		(1)	(8)	0	0
Capex		(275)	(162)	(350)	(450)
Acquisitions/disposals		441	(1,006)	0	0
Financing		(1,157)	0	0	0
Dividends		0	0	(489)	(537)
Net Cash Flow		(1,512)	923	2,153	2,805
Opening net debt/(cash)		(4,204)	(2,636)	(2,772)	(4,925)
HP finance leases initiated		0	0	0	0
Loans acquired with acquisitions		(1,263)	(799)	0	0
Other		1,207	12	0	0
Closing net debt/(cash)		(3,899)	(2,772)	(4,925)	(7,730)

Source: Company accounts/Edison Investment Research

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