11 October 2010

Edison tech spotlight

After the meteor

In this issue:

- The implications for UK tech businesses from the upcoming Comprehensive Spending Review.
- Why some exposed stocks could rally once certainty is restored.
- Small, nimble, efficiency enhancing businesses look better placed.
- Companies exposed to centralised mega-contracts most at risk.

Looking beyond the Comprehensive Spending Review

It is old news that the upcoming UK budget review will be draconian. Companies have known for some time that large-scale public projects in particular are under severe threat and the UK IT industry will not escape. Eagle-eyed investors will notice though that several niche healthcare IT stocks actually rallied post the announced NHS IT restructuring and £700m budget reduction.

No escape for the behemoths

Social housing related businesses seem to have been the first to notice the slowdown in early 2010 and other centralised, capital intensive programmes (BSF, ID cards for example) have also been early in the firing line. Looking forward, the coalition's strategy of decentralising decisions and cutting out layers of waste would seem to put the spotlight firmly on the mega-caps, as their consultancy service businesses will be a prime target for renegotiation or elimination.

It may pay to be nimble

By contrast, we feel that some of the nimble, product-oriented businesses may fare better than people expect. Given the spiralling cost and delays associated with most major government IT project rollouts, we forget that IT can be an enabler of efficiency gains. Many smaller companies have built their businesses through offering genuine productivity or efficiency benefits (Allocate Software, EMIS and Idox, for example), often in competition with the industry behemoths. They also tend to be less exposed to large centralised budgets and many have been diversifying their businesses either into adjacent markets or globally (Allocate Software and Promethean). As ever, the devil will be in the detail, but few things suppress a share price more than uncertainty. Barring a CSR that turns out to be even more draconian that previously expected, we suspect that the lifting of this uncertainty could prompt a period of better performance. The segment, after all, is very much out of fashion at present.

Analysts

Dan Ridsdale 020 3077 5729
Katherine Thompson 020 3077 5730
Richard Jeans 020 3077 5700
tech@edisoninvestmentresearch.co.uk

For institutional enquiries please contact:

Alex Gunz 020 3077 5746
Gareth Jones 020 3077 5704
institutional@edisoninvestmentresearch.co.uk

Companies mentioned in this report:
Promethean
EMIS Group
Craneware
RM
Sepura
Allocate Software*
System C Healthcare
Globo
SciSys*
OMG

* Edison Investment Research clients

Edison's tech spotlight publication discusses key themes in the sector and is published fortnightly.

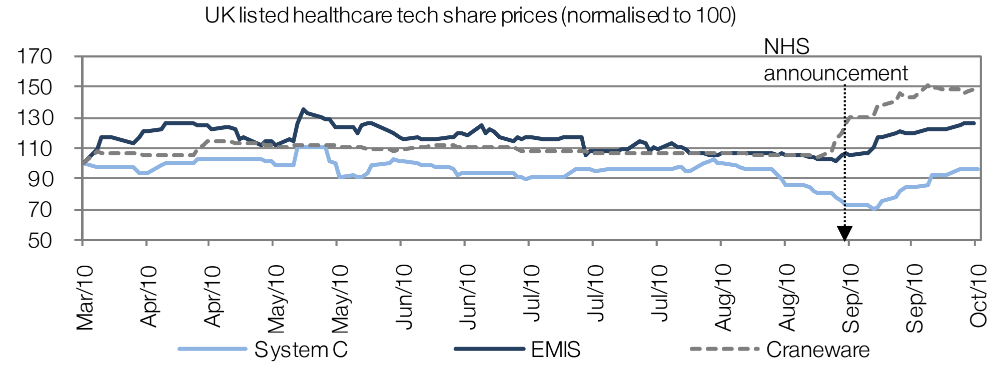
UK Public Spending Review

Anticipating a mass extinction event

While the media may be on tenterhooks awaiting the announcement of the coalition government's Comprehensive Spending Review (CSR) on 20 October, it seems to us that investors may not react that negatively to the announcement. It is true that the Review will inevitably lead to headline budget cuts and some of this will be deflationary. In reality though, the industry is already well aware of this announcement and has been preparing for it through business mix shifts and contingency plans. Consensus estimates will clearly still be too high in some cases, but we contend that some companies will still beat, and valuations are not demanding.

In fact, as seen in the chart below, some of the recent trading updates from companies outlining the impact from the NHS reform announcement on 9 September have actually led to share price rallies. As ever, the market was transfixed by the uncertainty, not necessarily by the actual earnings forecast revision.

Exhibit 1: End of uncertainty can lead to relief rallies

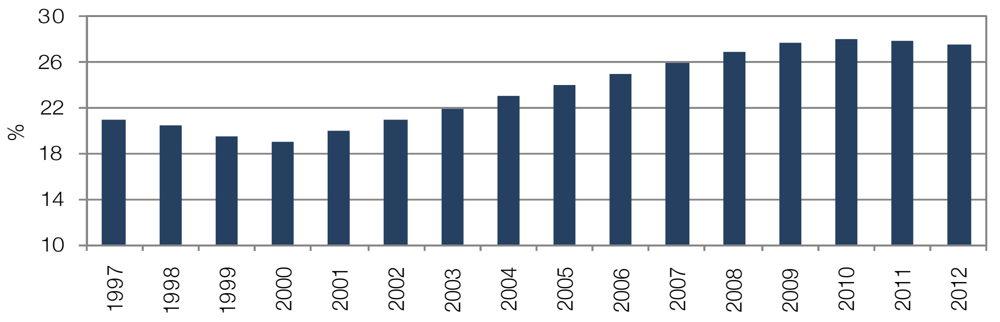


Source: Bloomberg

The climate has changed

With hindsight, we can see that on the back of cyclically strong tax revenues government spending has enjoyed extremely strong growth in the last decade across most western economies. The tech industry has been a prime beneficiary of this spending growth as shown below. Whether this increase in spending was entirely warranted to drive efficiency gains is a moot point, but it does seem likely that public sector spending on IT is likely to revert back to pre-boom levels.

Exhibit 2: Public sector as a % of the total UK software and IT market



Source: TechMarketView.com

The forecasts in the chart above incorporate one third-party market analysis firm's view of the next two years. The data implies that UK government IT spending could fall 6-7% each year. This is certainly unprecedented, but it would seem highly odd if companies were surprised by it at this stage.

No escape for the behemoths

With over 50,000 IT professionals employed within the government and about 4m PCs to maintain across all departments,[1] it is little wonder that IT spend is a major cost for the UK government. It therefore follows that many of the government's top suppliers of goods are likely to be IT providers. The largest of these providers are obviously the multinationals, such as Capgemini, IBM, Logica, CSC, Atos Origin, HP and Microsoft. The cycle for IT consulting day-rates is already firmly in a downward trend and given the coalition's strategy of decentralising decisions and cutting out layers of waste, we feel that these companies' services are a prime target for renegotiation or elimination.

Government CIO highlights the risk to big centralised projects.

To illustrate the above point, the government's chief information officer, John Suffolk, has announced two major initiatives which are driving government IT investment in the medium term.

1) The ICT moratorium. No new contracts above £1m without approval by the Treasury.
2) The ICT project review. This programme is charged with reviewing all core ICT projects with a clear purpose of ROI evaluation. This is divided into two phases (for which there is plenty of high-profile evidence of each especially in the NHS):
    - The project decommissioning phase.
    - The contract renegotiation phase.

On this last point, the 'big guns' in the UK IT market such as Accenture, Logica, Atos Origin and Cap Gemini have all recently announced new contract renegotiations. Consequently, it seems inevitable to us that such renegotiations incorporated effective deflation into existing contracts.

Long anticipated NHS decentralisation finally announced

Following the announcement on 9 September, The National Programme for IT in the NHS (NPfIT) is now effectively canned and the NHS IT budget has been cut from the original £12.7bn to £11.4bn. The Department of Health has concluded that "a centralised, national approach (to IT investment) is no longer required. A new approach to implementation will take a modular approach, allowing NHS organisations to introduce smaller, more manageable change". As niche healthcare IT vendor System C pointed out in its recent trading update, "it is now clear that central development contracts are being shelved or cancelled".

A proportion of this spend will inevitably migrate to less central budgets, although the big question remains how long it will take for those purchase negotiations to translate into contracts. Companies that have structured their business around the central model may go through a painful decision transition.

---

[1] Source: UK Government CIO John Suffolk interview with Gartner.

Education budgets under scrutiny too

Niche education equipment vendor **RM** also summarised the changes in the education department: "(in the) recent Emergency Budget, the Chancellor indicated that education remains a relative priority for public spending and that the Government intends to maintain 'frontline' education budgets. However, total education funding was not explicitly protected and it is likely that our UK customers' budgets will come under pressure."

Identifying the fleet of foot

In analysing which technology companies might be affected we screened the top 100 or so UK companies by market capitalisation and documented (or estimated) their approximate exposure to government spending (either UK or globally). We discuss our view on some of the more exposed below, as well as some that may be perceived to be highly exposed, but that in actual fact may be more diverse businesses than people expect.

As ever, the devil here is in the detail but while we do expect casualties, many of these companies have built their businesses through offering genuine productivity or efficiency benefits, often in competition with the industry behemoths. We highlight EMIS, Allocate Software and IDOX in this regard. To compete successfully the product offering has had to be rock solid and the decentralisation of decision making should support strength of product over industry might. Some , such as Allocate and to an extent RM are also now finding good levels of success overseas, while others (Promethean, Sepura) have leveraged early adoption in the UK to develop truly international businesses.

Exhibit 3: UK technology companies with material public sector exposure, as of 11 October

Company	Market cap £m	Est global public sector exposure	Est UK public sector exposure	Market segment
PROMETHEAN	227	80-100%	0-10%	Education equipment
EMIS GROUP PLC	220	80-100%	80-100%	GP software
CRANEWARE PLC	140	80-100%	0%	Hospital software
RM PLC	132	80-100%	60%-80%	Educational hardware/software
SEPURA LTD	58	80-100%	25-30%	TETRA equipment
ALLOCATE SOFTWARE	46	80-100%	40-60%	HR software
SYSTEM C HEALTHCARE	41	80-100%	80-100%	Healthcare IT
IDOX	40	80-100%	80-100%	Local government software
GLOBO PLC	21	60-80%	0-10%	Greek ICT
OMG PLC	18	20-40%	20-40%	Image capturing
SCISYS	13	80%	30-40%	IT services

Source: Bloomberg, Company reports, Edison Investment Research estimates

Promethean (market cap: £227m)

Trading update may assuage concerns

Promethean (PRW) is a UK-based provider of interactive learning technology (predominantly interactive whiteboard displays). The UK market is largely saturated and ex-growth, and accounts for just 9% of our forecast revenue. The US is the largest market, where penetration of electronic whiteboards is just 26% (vs 70% in the UK) and the 'No Child Left Behind Act' can be seen as mandating state- or district-wide adoption of the technology (rather than schools adopting on an *ad hoc* basis). We also forecast strong growth from the RoW segment, driven by increased awareness of the transformational potential of electronic whiteboards. Learning systems (handheld electronic devices) represent a nascent but potentially transformational technology (eg teachers can set tests which get more difficult for more able pupils or easier for those that struggle leading to better learning outcomes for both groups) in which PRW has global market leadership. The UK investment community is clearly still sceptical, in part because (in our view) the company came to market at the wrong price. An apparent GM slippage at the H1 stage has not helped either, although this partly reflected higher ASPs from selling higher-end systems where the overall contribution is larger but also discounting. Fundamentally though, we suspect that the market has not come to terms with the acute H2 weighting of this business and, at 8x consensus earnings, looks to be pricing in a warning. This is, after all, the global number two with a strong technology uptake cycle ahead of it. We suspect that an in line or better Q3 trading update (late October) could prompt a rally in the shares.

EMIS (market cap: £220m)

Dominant GP software supplier to benefit from new NHS direction

With close to 100% of revenues funded by the UK public sector, EMIS appears to be one of the most exposed companies in our screen. However, in our view, the exposure is also much more limited than would initially appear. EMIS's software is used by 53.8% of British GP practices, of which over 60% have been customers for more than 10 years. The software is crucial to the running of surgeries as it manages patients' cradle-to-grave records. EMIS reported recurring revenues of 81% in H110, including software licence fees, support & maintenance and hosting revenues. EMIS software is funded centrally via GPSoC, with the recently accredited EMIS Web contracted until 2013.

We see three key risks to EMIS's revenues: 1) the government decides to renegotiate down the pricing on the EMIS Web contract, 2) in the light of the recent government decision to phase out PCTs and SHAs in favour of GP commissioning consortia, PCTs stop spending, or 3) due to budget constraints, orders for EMIS Web are delayed. In mitigation, the coalition government has publicly stated that it supports the 'connect all' rather than 'replace all' strategy and wants to move from national to local decision making in order to deliver a patient-centred NHS. EMIS has a track record of selling at a local rather than national level and EMIS software already allows patient access to records. In addition, we believe that much of the forthcoming cost savings are aimed at the administration within the PCTs/SHAs rather than front-line services. With such high penetration of the GP user base, EMIS is well positioned for the move to GP-led commissioning, particularly in light of the fact that it is priced as the most competitive GP system under GPSoC. EMIS Web will enable practices to reduce data inputting and paperwork, reduce patient waiting times, and reduce the risk of prescribing and treatment errors. In addition, trial practices have seen cost savings of over £1,500 per annum per practice from the move to a hosted product, which cuts out capex and maintenance costs for servers as well as the cost of back-up and validation services. To date EMIS has seen no slow down in ordering from PCTs, and orders for EMIS Web (both the full product and the familiarisation service) continue to grow.

Craneware (market cap: £140m)

US healthcare reforms should be favourable

Craneware supplies business intelligence and 'revenue cycle' software to the US healthcare industry. With US healthcare roughly split 50/50 between public and private funding, we estimate that Craneware has about 50% revenue exposure to US government healthcare spending. The recently announced healthcare reforms should make more government funds available for currently uninsured people (if enacted in the current form). At the same time, there is ongoing pressure on hospitals to accurately account for all services rendered in order to get paid on time and in full by the insurance companies. So while on the face of it, having close to 50% exposure to US public sector healthcare spending appears risky, in fact we believe the reforms should work in the company's favour.

RM (market cap: £132m)

Life beyond BSF

The UK public sector accounts for c 80% of sales for the supplier of educational products and services. It is expanding its overseas revenues, but these only accounted for 13% of sales in H1, while the UK private sector accounts for c 9% of turnover. The company became synonymous with the Building Schools for the Future scheme, but, having traded down by 20% in the aftermath of the decision to scrap it, the shares have now regained almost all of this ground, with the pre-close statement indicating that trading was in line and reporting "good sales momentum, with both new contracts, and extensions to existing arrangements". So the question is whether the spending review will deliver another blow or help further salve concerns. Consensus estimates (which have not changed hugely over 12 months) are calling for marginal sales declines this year and next with slight margin expansion. A significant cut to the education budget would certainly be bad news; increased price pressure seems inevitable. However, given initiatives such as the Pupil Premium, education appears to be a relative priority and the indications are that the government intends to maintain 'frontline' education budgets. Schools will still need IT solutions, new buildings or not, and demographics should work in RM's favour eventually. Decisions are likely to be increasingly decentralised, but RM has restructured in readiness for this. Given the share price recovery, investors are clearly no longer pricing in the absolute worst. The rating of 9x is undemanding, but equally not out of kilter for a company which is not expected to grow. We doubt whether the spending review will give us a significant amount of visibility on the directionality of estimates, but by the time of the full year results, due 22 November, things may have become a little clearer.

Sepura (market cap: £58m)

Decision paralysis and austerity measures could strengthen headwinds

Sepura supplies TETRA digital radios, the primary customers for which are emergency services across the globe (excluding the US). The UK is still the most important geography (37% of sales last year) and the highest margin, but is now primarily a replacement market, with only a few fire/ambulance services yet to switch over from analogue, so exposure to the UK should progressively reduce. Nevertheless a significant downsizing of the emergency services budget and forces would probably be the worst case scenario to come out of the CSR. Outside of the UK, which is probably the most mature major market globally, networks have been or are being deployed in most developed and many developing markets, although there are significant regional variations in terms of the rollout strategy and who makes the purchasing decisions. Ultimately though, the majority of spending will come from the public purse and the speed of rollout may well be impacted by spending cuts, while the preceding uncertainty may well delay purchasing decisions. It may be possible that adequate slack has been built into estimates (consensus calls for c 9% growth). Halting the post-IPO downgrade cycle was a priority of CEO Gordon Watling since appointment in October 2008, and thus far delivery on estimates has been good. Longer term, the development of a product platform able to support other standards such as P25 and DMR should significantly enlarge the addressable market, but not until 2013. In the meantime, given the capital nature of TETRA purchasing decisions, we do think that global austerity measures will be a headwind.

Allocate Software (market cap: £46m)

Underpinned by rapid RIO and international expansion

Allocate Software is a leading provider of workforce and compliance optimisation solutions, with a primary focus on healthcare end markets, although it is also active in defence and maritime. We estimate that c 45% of revenues are currently derived from UK public spending budgets, but trading thus far has remained robust, with the company announcing good deal flow across its product portfolio in late September.

Moreover the company is making good strides in internationalising its business. Notably the company signed its first significant US customer for Healthroster and a Malaysian contract for the same product in Q1. These deals follow on from the large (£5.5m) deal secured in Australia in Q4. Consequently our confidence in Allocate's ability to expand internationally has moved up a notch.

Back in the UK, the core Healthroster product looks relatively well shielded, in that the rapid payback period should make deploying the software an enabler of efficiency initiatives rather than a victim of them. Dynamic Change could be more affected, with governance and assurance purchasing responsibility being moved to GP consortia from the PCTs. However, these changes are not due to be implemented until 2013 and opportunities to cross-sell Dynamic Change into Allocate's customer base should help offset potential spending weakness in the meantime. A growing proportion of SaaS revenues also adds robustness to Allocate's revenue profile. Consequently we are comfortable with our estimates. The rating of 12x 2011 earnings (8% free cash flow yield) is undemanding considering Allocate's track record, runway for growth and scope for margin expansion.

System C (market cap: £41m)

Adapting to decentralisation

System C is a pure-play supplier of IT products and services to health and social care markets in the UK. In effect the NHS and the Local Service Providers of the NHS IT programme are the business's key customers. We estimate that 90% of revenues are derived from UK public spending budgets. On 15 September, the company issued a trading update that informed the market that its Services business unit would now fall by about 33% y-o-y (ie from c £15m in 2009 to c £10m), which seemed a deterioration from the outlook given in June 2010. The degradation in the guidance from the company was attributed to "a combination of the general reduction in public sector spending and the software delivery problems of other suppliers working under the National Programme for IT". The company also indicated that "it is now clear that central development contracts are being shelved or cancelled". In effect the trading statement was a consequence of the announcement of the ending of the NPfIT. Notably, the new decentralised approach of NHS IT procurement will offer opportunities, driven by the fact that NHS Trusts will be now freed to buy IT systems of choice outside the legacy NPfIT. Companies such as System C which had the foresight to build its product portfolio to take advantage of this can offset some of the inevitable decline from centralised services purchasing. Perhaps most notably for investors though, this announcement from the company marked the bottom for the share price: having fallen 40% from January to September, System C shares have rallied over 30% since the announcement, presumably on the fact that the uncertainty had been removed.

IDOX (market cap: £40m)

Cuts versus opportunity to drive efficiency savings create a two-way pull

IDOX supplies software solutions and services principally to the UK public sector and leads in the provision of applications to local government for core functions relating to land, people and property. Some 70% of UK local authorities are customers. We estimate c 90% of group revenues relate to the public sector (ie assuming roughly half of its smaller unit's revenues are to the public sector) and nearly all is in the UK. In the six months to April 2010, revenues slipped 5%, while normalised pre-tax profits were 10% stronger as gross margins improved. Software revenues fell back partly due to delays in the award of large contracts while recurring revenues jumped to 59% from 50%. While management was cautious on the longer-term outlook, pending the CSR, it is emphatic that a key driver of the business is in improving efficiencies: "while (the CSR) may cause delays in commitment, the healthy level of current tender activity indicates that many local authorities recognise that IDOX and other software suppliers are critical to achieving the necessary efficiencies demanded by government." Hence, while budgets might be constrained by cost cutting, there is an increasing requirement for local authorities to improve efficiencies, and that is what IDOX's applications can help to achieve. Nevertheless, the stock price is reflecting the uncertainties, trading on a modest 7.4x FY10 consensus earnings estimates falling to 7.0x in FY11.

Globo (market cap: £21m)

A Greek lesson

Globo is an IT group delivering proprietary software solutions to enterprises and local government primarily in Greece and the Balkan countries, with an emerging SaaS telecoms business and mobile communication software solutions being marketed globally. The company does not disclose its public and private sector revenue split, but the majority of revenues are from Greece and we assume the majority of those are public sector. Overall we estimate a total public sector exposure of 60-80%. The company is attempting to diversify rapidly and the private sector business grew substantially in 2009 at +80% y-o-y (from a low base clearly). The group is using short-term debt to finance its public sector contracts and long-term debt and equity to finance its product development and infrastructure needs. Ominously, the company highlighted the precarious nature of payment terms in Greece stating that within the first four months of 2010, the group collected €1.93m out of €5.5m invoiced public sector contracts which were due at the year end. Recent interim results showed revenue growth of 50% and PBT of 56%, while international revenues surged to €1.1m, again from a very low base; SaaS revenues also showed strong growth. So clearly – out of necessity – the business is shifting away from Greek government exposure. As an example of this strategy, the company just raised £2.9m to fund international expansion of its mobile applications CitronGO! and GO!Social.

SciSys (market cap: £13m)

Risk of cuts to Warrior and Environmental Agency look priced in

SciSys is an IT services business, providing a range of professional services in support of the planning, development and use of computer systems. While roughly 80% of revenues are related to public sector type customers, this includes revenues outside of the UK (mainly Germany) and much of the UK revenue appears well insulated from the CSR. The key areas at risk are the Environment division and the Warrior replacement programme (within the Government & Defence division). While SciSys's recent interim results were in line with expectations, it said many public sector budgets had been effectively frozen ahead of the CSR and we shaded down our FY10 forecasts while maintaining FY11. The group's Environment division has benefited from significant government initiatives in recent years, including the commitments on carbon reduction, but the outlook is now less clear.

We note two of SciSys's key customers – the Environment Agency and the Coal Authority – were categorised as "Public bodies still under review" on the list of quangos published in the *Telegraph* newspaper on September 24 – the day after SciSys's interim results. Nevertheless, if the Environment Agency and the Coal Authority are absorbed into other bodies this would not necessarily mean lost business for SciSys since much of the near-term business has already been contracted and the issues handled by these public sector bodies will still need to be addressed by someone. Regarding the Warrior replacement programme, it has already been deferred until at least the second quarter of 2011 and as far as we can determine an announcement will not necessarily be forthcoming on 20 October. The worst outcome for SciSys would clearly be the scrapping of Warrior and broad downsizing of environmental sector budgets. However, both of these areas are considered by many to be key priority given the political momentum to improve the environment and the emphasis on providing UK troops in action with the best equipment. SciSys could potentially gain from government outsourcing as a means to reduce costs, though it is unclear to us how such a move could be driven.

OMG (market cap: £18m)

International opportunities should reduce UK exposure

OMG is an Oxford-based provider of image capture, machine vision, surveillance and surveying technology to a diverse array of clients ranging from the game industry to hospitals through to defence forces.

OMG, through its 'Vicon' motion capture business (which sells to hospitals and the video game industry', its '2d3' defence technology (which is incorporated in drone surveillance aeroplanes) and 'Yotta' road and building surveying business has over £5m (>20% of revenues) exposure to the UK public sector market. Its overall exposure to public sector budgets globally is conservatively around 25% of revenues. Its biggest risk exposure is arguably to the Yotta road surveying business though the company is clearly taking advantage of global market opportunities to compensate for this.

EDISON INVESTMENT RESEARCH LIMITED
Edison is Europe's leading investment research company. It has won industry recognition, with awards in both the UK and internationally. The team of more than 50 includes over 30 analysts supported by a department of supervisory analysts, editors and assistants. Edison writes on more than 250 companies across every sector and works directly with corporates, investment banks, brokers and fund managers. Edison's research is read by major institutional investors in the UK and abroad, as well as by the private client broker and international investor communities. Edison was founded in 2003 and is authorised and regulated by the Financial Services Authority (www.fsa.gov.uk/register/firmBasicDetails.do?sid=181584).