FDM Group

Company Description: FDM Group, headquartered in Brighton, is a service provider concentrating on two core areas: IT staffing and managed IT services. They boast an impressive and diverse blue-chip client base.

OVERVIEW

FDM trades on an ex-cash PER of just 4.6x on estimates for 2008 and a prospective EV/EBITDA of 3.2x. Despite general equity market volatility this appears far too cheap for a company showing rapid EPS growth and a unique business model. Over time we see an achievable fair value for the share price of 178p, but even in the short term a move to a sector rating implies 148p is deserved.

The company has a unique business model that combines a training business with sales led staffing/consultancy. Although FDM provides IT freelance contractors to its clients, it also places its own employed consultants known as Mounties.

Mounties are consultants who have passed a rigorous entrance exam to the Mountie Academy, trained in-house to a specified standard in a range of expertises and then placed with employers. In return for the training, candidates are committed to the firm for two years after which they are free to leave.

The success of the model is amply demonstrated by the fact that the London office is at full capacity (the company are currently looking for new premises to double capacity), a new office in Manchester is building up at a very encouraging rate and the company is also considering opening further offices, potentially in cities like Glasgow where it already has a number of key clients.

The company enjoys unusually high margins because it is able to achieve very high utilisation rates (2007: 98%) on Mounties because they provide clients with both value for money and the delivery of a high quality service. For large investment banks and corporations with significant graduate requirements, the Mountie programme is an excellent value proposition: FDM gets its "apprentices" on site and contributing within 6 months, whereas typically it can take an investment bank 12 months to see a return from training staff. FDM bears the training charge, which can be an expensive "stranded cost" for large companies that often lose IT graduates shortly after their training is completed. And if clients like the Mounties who work for them, they have the option to employ them after the end of the 2-year training contract (with FDM taking a placement fee).

We believe that the model has competitive advantages over other staffing/recruitment businesses that lack the requisite skills to run a training business and who have the "body shop" mindset. The major threat is likely to come from training businesses, but they may well be put off by the lower margins and solutions based sales process.

This is not to say that FDM will not face any competition but at present there appears to be little on the horizon. And in any event, studies have shown that the number of computer science graduates in the UK is in insufficient to cover the requirements of business and government in the coming years, and that this alone should ensure that companies attempting to fill this skills gap will see strong demand for the foreseeable future.

EQUITY DEVELOPMENT

FDM Group

FDMG

Date:	**25.03.08**
Share price p	**103**
52 week High/Low p	159.5/102
Issued share cap	**23.22**
Market cap £m	25.310
Year to December	**Pre-tax £m**
2007	4.4
2008 E	5.2
2009 E	6.7

Year to December	**Basic EPS p**	**PER**
2007	12.3	8.4
2008 E	14.8	7.0
2009 E	16.2	6.4

Year to December	**Div p**	**Yield %**
2007	2.7	2.6
2008 E	3.3	3.2
2009 E	4.2	4.1

FDMG is quoted on AIM and investors should be aware that shares traded on AIM are subject to lighter due diligence than shares quoted on the main market and are therefore more likely to carry a higher degree of risk than main market companies.

Equity Development contact

Andy Edmond

020 7405 7777

andy@equitydevelopment.co.uk

2007 RESULTS

The 2007 preliminary final results just released show that the business is doing well on all fronts.

Revenue growth of 10% may appear modest but the company is focussing on margin and a higher value added business. In the **Staffing** group (i.e. placement of IT contractors producing 73% of revenue and 45% of gross margin in 2007), sales were up just 6%. Whereas in the **Mountie** business (27% of revenues and 55% of gross margin in 2007) revenues rose by 31%.

The Group gross margin rose by just over 3%, driven by the increased deployment of Mounties. We expect this trend to continue, albeit at a slower pace as the company sees the staffing/Mountie mix moving from the 73/27 % split in 2007 to a 70/30 ratio in 2008.

Operating expenses were up by 10% representing some 14.5% of revenues. In the absence of acquisitions, we would expect this line to grow in line with revenues as the company invests for growth.

The net interest of £0.2m represents a 5% return on average cash balances.

Profit before tax rose from £2.8m to £4.4m, a rise of 51%. Profit after tax increased by 40% from £2.0m to £2.8m, due to a higher tax charge. EPS came in at 12.3p.

The dividend rose by 31% from 1.6p to 2.1p.

The cash performance was exceptional with a £1.4m *inflow* from working capital as the company tightened up on cash collections. It is unusual for staffing businesses to generate cash from working capital while growing.

The company finished the year with cash balances of nearly £6m, which was £1m ahead of expectations.

EADS contract

On the 17th March FDM also announced a training contract of significant scale with EADS, a global leader in aerospace and defence. FDM will be the prime supplier for a Fire and Rescue Control project covering all the services in that area within England.

The contract is said to be worth c. £2m to the Company for the initial course development with the potential of being up to £6m over an initial three year period, subject to options undertaken.

FORECASTS

Management have said that the current year has started well and that they are comfortable with market forecasts. Although in 2007 some 46% of earnings came from finance and insurance, sectors clearly impacted by the turbulence in the credit markets, there are still plenty of IT initiatives (e.g. Basel II, Mifid, commodity trading systems etc.) that will require these firms to seek outside assistance. Furthermore, the company's core skills are in areas such as managed services should prove reasonably resilient in a downturn when cost effectiveness is at a premium.

In 2008 we are assuming a 10% increase in revenues. This comes from a 6% increase in the staffing business and 24% increase in Mountie revenues. Our confidence in this growth is predicated on the move to a new City office and continued success for the Manchester office.

We are expecting a more modest growth in the gross margin, which we expect to rise from 22.5% to 22.9%.

To reflect the increased investment in the business, operating expenses should rise by some 10%. Operating profit in 2008 is seen at £4.8m and with improved cash management and higher cash balances generating £0.4m of net interest income, we are forecasting PBT of £5.2m.

On a similar tax charge to last year that should yield basic EPS of 14.8p.

VALUATION

As a business that is apparently perceived to be highly cyclical (and is a small cap share), the company's share price has fallen by 30% from its peak of 155p. However, we think that this is unwarranted for financial and business reasons (see Business Overview above).

At 103p the shares trade on an **ex-cash P/E of just 4.6x** for financial 2009 and a prospective **EV/EBITDA multiple of just 3.2x**, which implies that the business will be ex-growth due to a cyclical downturn. We think the strength of the Mountie business and the scale of its contribution to gross profit, and the broad range of its businesses and client types, mean that FDM's earnings are likely to continue to grow and not slow down as the market expects.

Organic growth appears underpinned by growing demand and the planned expansion of offices show management confidence in the scalability of their offering. Acquisitions cannot be ruled out, but the significant shareholdings of current and former directors give comfort that they will only be made on terms beneficial to the earnings outlook.

Given the growth profile of the business (anticipated EPS growth of over 20%), we believe that in the short term the shares should trade on PER of at least 10 times this years earnings (even that rating is only in line with the IT Services sector) and that implies a share price of **148p**. Ongoing validation of the model should build both confidence and a premium rating to the sector: over time winning an 11x PER rating on our forecast 2009 EPS gives a share price of **178p**.

I certify that this report represents my own opinions
John Walter, Senior Analyst
+44-20-7405 7777
johnb@equitydevelopment.co.uk