

Mandrakesoft

4 March 2005

Beefed up professional services

Software & Computer Services

Current price € 7.35

Outperform

France

Target price € 8.50

Rating Upgraded

Performance over	1m	3m	12m
Absolute	-8%	23%	224%
Rel. SBF250	-11%	14%	198%
Relative to sector	-10%	37%	262%
12m Hi/Lo	€ 8.20/2.27		
Reuters	MAKE.PA		
Bloomberg	MLMAN FP		
Market Cap	€ 39m		
Next corporate event			
Ex. General Meeting 04 :	30 March 2005		

FY/e 31.12	2004	2005E	2006E	2007E
Sales (€ m)	5.2	7.2	10.0	12.0
EBITDA (€ m)	1.0	0.8	1.0	1.7
Net earnings (€ m)	1.4	1.4	0.7	1.4
Current EPS* (€)	0.17	0.10	0.14	0.24
Published EPS (€)	0.29	0.25	0.13	0.24
Dividend per share (€)	0.00	0.00	0.00	0.00
P/E (x)	28.2	71.8	51.7	30.1
Dividend yield (%)	0.0%	0.0%	0.0%	0.0%
EV/EBITDA (x)	20.5	39.7	34.3	20.6

Source: KBC Securities

*Adjusted for goodwill and exceptionals

The acquisition of Conectiva is a positive move, even if the impact is today difficult to assess. The two companies already know each other and integration should be relatively easy. Synergies will essentially come from a merger of the two groups' "products" and from mutual benefits derived from combining their R&D activities. The acquisition deal will involve the creation of new shares representing 4.6% of Mandrakesoft's capital, a reasonable increase considering that Conectiva is today a well-balanced activity, which will represent around 25% of Mandrakesoft's annual sales. With the bulk of its sales being generated in the professional services segment, Conectiva will considerably help Mandrakesoft to refocus its business towards corporate clients. We are upgrading our recommendation, and we are raising our target price from € 7.0 to € 8.5.

An interesting acquisition from a number of viewpoints



Conectiva is the Linux leader in Brazil and in South America like Mandrakesoft is the European leader. Bearing in mind the size of these companies, their leader positions are today advantages in the software choice domain since individual users tend to "push" their employers towards Linux migration and administrations tend to favour the national champion by dealing directly with them or requesting their presence within the consortiums.

Conectiva has numerous references, both in the private and the public domain. Its clients include HSBC, IBM, HP, Siemens, plus several administrations including the Brazilian Air Force. In fact, it has excellent experience with administrations and has successfully completed (among other projects) one of the largest migration operations involving 15,000 workstations and 800 servers in Sao Paulo schools.

Mandrakesoft knows Conectiva well and worked with the company to create Linux Core Consortium (which includes Turbolinux and Turbogeny) and which also uses the Linux Standard Base (LSB) 2.0, a standard created by Free Standard Group and recognised by all the major software publishers and hardware manufacturers (Dell, HP, Intel, AMD, Sun, Red Hat, Novell-suSE, etc.). While this standardisation clarifies the "landscape", it also obviates the fragmentation of Linux and guarantees its survival.

The Brazilian market - which represents 70% of the South American market - is still small: only 10% have a computer at home. However Brazil encourages the use of Linux - and Sao Paulo in particular after it opened 86 free IT centres equipped with computers using Open Source software. In other South American countries too (Chile, Venezuela and Peru) numerous programmes have been set up to develop the use of Open Source software. In Peru, the government is even considering banning non-Open Source software!

Conectiva, which like Mandrakesoft experienced a phase of very strong growth followed by a phase of restructuring, has some 60 employees and generates close to 70% of its business in the professional services domain. It also sells "training kits", an activity that makes it possible to sell training to around 15,000 people per year and which accounts for 20% of its current annual sales turnover. Lastly, 10% of group sales comes from a Linux distribution similar to Mandrakelinux products, sold in packs. Most of the workforce is located at the head office in Curitiba (in the Sao Paulo region). Over the last two quarters, the sales turnover was around €0.45m per quarter, with the bottom line breaking even.

Mandrakesoft will hold an AGM and an EGM on 30 March 2005. The 11th resolution - the 1st on the EGM agenda - is to approve the creation of 245,316 new shares at € 7.3 each (of which € 5.3 is issue premium) as payment for the acquisition of Conectiva which is valued at € 1.79m, i.e. 1x sales, that is extrapolating the trend of the last two quarters over four quarters (since revenue for the last financial year was in fact around € 1m). Conectiva has no debt and is at breakeven in terms of profitability.

Outlook

We have integrated Conectiva into six months of the current year's accounts. We do not see any significant impact for the 2004/05 year bearing in mind the time necessary (roughly 3 months) to unleash the first merger synergies. At the R&D level, the acquisition of a team working in much lower-cost region of the globe could be a significant lever for future profitability.

The table below summarizes our forecasts after the integration of Conectiva. The anticipated fall in the gross margin accounts for the growth in the weight of services at Mandrakesoft and for the integration of Conectiva, which generates 70% of its revenue from service-oriented activities. The gross margin at 30 September 2004 (year-end) was also particularly high due to the sale of a large number of licences in 2003/04, and the gross margin on licences is very high.

Summary of our forecasts (€ m)					
	09/2004	09/2005E	09/2006E	09/2007E	09/2008E
Professional services	0.39	1.50	2.20	2.70	3.20
Products	3.53	2.70	3.15	3.50	3.70
Online services	1.26	2.11	2.82	3.57	4.30
Conectiva	-	0.85	1.80	2.20	2.60
Revenue	5.18	7.16	9.97	11.97	13.80
Other revenue	1.10	1.21	1.27	1.34	1.40
Gross margin	84.5 %	71.9 %	68.7 %	68.3 %	68.1 %
Operating profit	0.86	0.60	0.85	1.53	2.00
Operating margin	16.6 %	8.4 %	8.5 %	12.8 %	14.5 %

Source: KBC Securities forecasts

We do not foresee a significant improvement in profitability until 2006/07. We believe that developments currently underway are very clearly positive for the group, and it is reassuring to see Mandrakesoft gaining a better foothold for the development of its corporate clientele; however, this could weigh on margins in the short-term.

In our view, the main growth vectors for Mandrakesoft (apart from the fact that the Linux market is expecting double-digit growth over the coming years) are the following:

- Synergies that can be developed with Conectiva, notably in the services domain to enhance the group's exposure to the corporate sector where real value-added can be created.
- In the business environment, the expansion of the range plus the launch of its Corporate Server and Corporate Desktop products which have a longer upgrade cycle and sell with a 5-yr maintenance pack.
- The new contract signed with HP which will contribute to an increase in the "Products" division's revenue as of next year: today limited to France, the contract involves all HP products from servers to laptops.

The group can also look forward to its "Product" sales being stimulated by the agreement with the French Education Ministry and the winning of more major contracts, either alone or in partnership.

Conclusion

The Mandrakesoft share should be stimulated by its anticipated switch to a regulated stock market now that its shareholder capital has been topped up to the required level. We forecast a sustained, but not exceptional, level of growth (around 12% p.a. on average in our DCF model). With figures in absolute terms still looking weak compared to the market potential, our growth rate forecasts are probably very conservative. We may also see other acquisitions: Mandrakesoft has a cash position of just over € 4m and generates cash (although not much so far).

On the basis of our forecasts and our discount (at 10.1%) of the group's free cash flows, and bearing in mind the number of shares (including those created after the AGM at end-March), we value the Mandrakesoft share at € 7.75.

The application of the ratios of the leader Linux Red Hat (P/sales 02-2006E of 7.6x) to Mandrakesoft would give theoretical price of € 11.2 per share (counting in Conectiva over 12 months). The average of these two approaches gives € 9.5.

Since Mandrakesoft is not yet in the same league as Red Hat (2005E sales of € 273m according to JCF), we are limiting our target price to € 8.5.

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