

Mandrakesoft

18 August 2004

Greater financial strength to assist growth

Software & Computer Services

Current price € 5,70

Outperform

France

Target price € 7,00

Rating unchanged

Performance over	1m	3m	12m
Absolute	-12%	36%	151%
Rel. SBF250	-10%	36%	130%
Rel. sector	-6%	41%	123%
12-m- Hi/Lo	€ 6,50/0,00		
Reuters	MAKE.PA		
Bloomberg	MLMAN FP		
Market Cap	€ 27,1m		
Next corporate event	No event.		

FY/e 30.09	2003	2004E	2005E	2006E
Sales (€m)	3,90	4,97	6,51	7,91
EBITDA (€m)	-2,03	0,38	1,23	1,87
Pre-Tax* (€m)	-2,03	0,33	1,15	1,76
Adj EPS* (€)	-0,55	0,08	0,26	0,38
EPS (€)	-0,54	0,17	0,24	0,37
DPS (€)	-	-	-	-
P/E* (x)	-	73,1	22,3	15,0
Yield (%)	-	-	-	-
EV/EBITDA (x)	-	74,9	23,0	14,8

Source: KBC Securities

*Adjusted for goodwill and exceptionals

Mandrakesoft will hold an Extraordinary General Meeting on 13 September. On the agenda will be the launching of the transfer to a regulated market and approval of the issuing of one million new shares and the Edge-IT acquisition. The improvement in profitability visible in the Q3 results released on 27 July should be further strengthened by the increasing popularity of Linux both in the public and private sectors – two examples in the latter being HP's offer of Linux with its business PCs and Carrefour Multimedia and Planet Saturn's offer with their home PCs. Although an investment in Mandrakesoft is not entirely risk-free at this stage in the company's development, the spread of open source software in the public and private sectors opens up significant potential for future growth. By strengthening its financial structure, Mandrakesoft will be better equipped to exploit its solid reputation in the Linux world.

Capital increase and transfer to a regulated market

The upcoming EGM (cf BALO of 13 August 2004) has a full agenda. If passed, the main resolutions will authorise the board to 1) proceed with the issue of marketable securities that will give access, either immediately or in the longer term, to the company's shares (while cancelling preferential subscription rights) and 2) complete the transfer of the listing to a regulated market before 31 December 2005.

Capital increase

The 11th resolution will authorise the board to proceed, either in one go or in several stages before 13 December 2004, with a **reserved capital increase** via the issue of **no more than one million shares**. The nominal value will be set at €2.0 with a **price of between €6.0 and €6.5** (including an issuing premium between €4.0 and €4.5).

Based on the net profits generated so far this year, we estimate that this fairly straightforward operation would lift shareholder equity to around €3.5m, a significant improvement on the –€3.5m at the end of the previous financial year. Available cash would increase to around €8m. **Positive cash and shareholder equity are obligatory before a transfer to a regulated market can proceed.**

The placement with identified shareholders will also enable tighter control when shares are eventually resold on the market.

Shareholders will also be asked to vote on the creation of a maximum of 455,000 new shares in three different operations:

- 70,000 new shares to be issued to the shareholders of Edge-IT, the acquisition of which was announced on 1 July 2004
- 235,000 share subscription warrants for Mandrakesoft personnel
- 150,000 shares as part of the company savings scheme at a price of €2.78 (of which €0.78 is an issuing premium). This will also benefit Mandrakesoft personnel. Subscriptions must be in before 31 December 2004.

Excluding the exercise of share options – which would generate around €1.1m based on current prices – these operations would allow Mandrakesoft to gain between €6.5m and €7m in liquidity before 31 December 2004.

Mandrakesoft will also ask shareholders to approve other financial operations, including share buy-backs.

Transfer to a regulated market

Mandrakesoft has never concealed its ambition to be listed on a regulated market in France (Euronext Paris) or Europe. The transfer has now been made possible by the return to a positive net income and renewed sales and profit growth. The 6th resolution on the agenda authorises the board to move ahead and complete the move before 31 December 2005.

9M results at 30 June 2004

Mandrakesoft has reported a net profit for each of the last three quarters. The quarterly moving average of sales over the last four quarters was €4.74m, up 20.6% on the corresponding period (Q4/Q1/Q2/Q3) in the previous year. In order to reach our projection of €4.97m by 30/9/04, Q4 sales ending 30 September will have to increase by around 23%.

Over the first nine months of the year, sales growth already stands at 26.8%.

Quarterly sales trends								
€ millions	Q4 – 02/03	Change*	Q1 – 03/04	Change*	Q2 – 03/04	Change*	Q3 – 03/04	Change*
Sales	0.724	- 4.2%	1.421	8.3%	1.095	39.8%	1.500	38.8%
Gross margin	0.649	10.4%	1.169	29.9%	0.952	47.6%	1.250	67.1%
Margin rate	89.6%		82.3%		86.9%		83.3%	
Operating income	- 0.433	ns	0.284	ns	- 0.086	ns	0.17	ns
Operating margin	- 59.8%		20.0%		- 0.8%		11.3%	
Attrib. net profit	- 0.386	ns	0.271	ns	0.037	ns	0.19	ns
Net margin	- 53.3%		19.1%		3.4%		12.7%	

Source: company

*Annual change, compared to the previous quarter

The gross margin remains high thanks in particular to the growth in on-line sales, including downloading (MandrakeClub) and the relative decline in distribution to retail outlets. Operating income fluctuated after recruitment earlier this year weighed on short-term profitability. In the above table, net profit for the first half came to €0.31m, but this excludes €0.51m in positive one-off items: the published first half figures, released on July 8, therefore show €0.82m. Before tax and exceptionals, the net margin over the first nine months stood at 7.7%.

Other elements

We have already covered certain recent developments in previous research (cf our Flash of 12 July), notably the important contract with the French Equipment Ministry to manage the migration of 1,500 office and infrastructure servers towards Linux. The deal marks a real step forward for the development of open source software, and underlines the determination of the French government and other public bodies to cut back costs and reduce their dependence on exclusive software publishers like Microsoft.

Other important news recently has been **the growing interest among large retail groups for Linux-based operating systems**. Carrefour is currently offering on its Carrefour Multimedia website the *Compubox*, a desktop PC with Mandrakelinux preinstalled (the operating system + 40 pieces of office software, multimedia and Internet applications) for only €299 without screen. The computer, which offers good value for money, has a network card installed rather than a modem and is targeted for use as a second machine used for office tasks or web surfing. Metro group subsidiary Planet Saturn recognized the potential and in one week sold nearly 1000 similar configurations in France recently at under €300. The offer includes Mandrakelinux, but it is not pre-installed. Most buyers want to run Linux alongside Windows.

Outlook

It is common to calculate the effect of a new share issue on EPS. We estimate that if Mandrakesoft raised the funds required to place the shares on a day-to-day basis at a pre-tax rate of 2%, dilution would increase to 12.5% for the year ending 30 September 2005 and rise to 16% by 30 September 2006. Clearly, this would not be good news. (Note that we have not calculated dilution for the current year due to the proximity of the closure date).

Fortunately however, the company has other ambitions, of particular note being the plans to expand the services division. In order to avoid dilution, Mandrakesoft needs to generate a pre-tax net profit of around 3.7% by 09/2005 and 5.2% by 09/2006 on the raised capital, which we have estimated at €7m for the purpose of our calculations.

This appears attainable given the potential profitability of the services business and Mandrakesoft's significant tax loss carry forwards worth €25m. These are equivalent to tax savings of around €8m and should exempt the group from tax payments for several years.

Conclusion

The operations to be approved at the EGM on 13 September are fully consistent with the continued development of the group. We feel they are essential to accelerating growth both on the professional sector and on the mass consumer market. In comparison with listed Linux distributors like Red Hat (20.6x sales) or soon-to-be-listed players like Linspire (51x sales based on the lower range - 5 \$ - of the proposed IPO price), Mandrakesoft's valuation remains attractive at an expected 5.4x sales by 30/9/04.

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