# LMS Capital Eye

June 2009

## 2009: Ready to take advantage of opportunities

**Despite the challenging environment, many of our portfolio companies performed strongly in 2008 and their specialist services continue to be very attractive to customers in 2009. With virtually no gearing in the portfolio and cash available to deploy, we are able to continue to support these businesses and our team is one of the few with both the management resource and the funds to be actively seeking new investment opportunities in 2009.**

**The general business climate is likely to remain tough but we believe that the next 18 months will present attractive opportunities to those management teams able and willing to take advantage of current circumstances. LMS Capital is ready to support such teams.**

A high level of pricing in the marketplace combined with unrealistic business projections led LMS Capital to commit only limited funds to new investments in 2007 and 2008. In 2009, however, with investment capital more scarce, we are seeing the return of more realistic expectations at all levels.

The UK market has seen a first wave of prominent business failures and restructurings. We now appear to be in a period of relative calm and the market is experiencing relatively subdued levels of deal activity. However, many companies are still having to cope with high levels of existing debt and are spending large amounts of management time negotiating with their lenders, only to suffer restructuring or covenant waiver fees and sharp increases in lending margins. More importantly, in such a leveraged environment, management is forced to concentrate solely on debt reduction. Growth ambitions are consequently forcibly scaled back – even for the most credible plans – with dire consequences for future shareholder value and thus the value of management incentives. We believe the full effects of this are only just starting to emerge.

In recent months LMS Capital has started to see enquiries from management teams seeking to regain the initiative and build shareholder value. This can take many forms, for example: the buyout of a business from a distressed parent or taking it private; raising expansion capital to take advantage of growth or acquisition opportunities; or simply raising equity to de-gear a business.

As an investor, we are well placed to help management teams to realise their plans in these circumstances, even in today's environment. Our current portfolio is, on the whole, unleveraged and, in many cases, performing strongly. The cash we have on the balance sheet will allow us to commit financial resources when opportunities arise, both in the current portfolio and to new investments. Our deep sector knowledge and team structure allows us to be quick and decisive when approaching deals and we are able to be flexible on deal structure, for example, doing all equity deals or taking minority positions.

### What are we looking for?

As always, our main focus is on backing motivated teams with a strong and clear plan.

We are specialists in four sectors and will consider opportunities in all of these areas:

- Energy services and technology;
- Applied Technology, including IT infrastructure and business services, software and value added engineering;
- Media and consumer; and
- Healthcare and medical.

In addition, LMS Capital has an interest in Real Estate, for example though Brockton Capital, EMAC and Voreda Capital, which we recently helped to establish.

We have a development capital/growth buyout emphasis and typically invest between **£5m** and **£10m** initially, with more funds available over time. We are flexible on holding period and will often take a longer time perspective which is especially relevant for buy and build situations.

Of particular interest are businesses that display similar characteristics to examples highlighted overleaf by AMR or those that are moving in that direction; businesses which respond to customer needs, protect customer relationships and have strategies in place to improve the quality of their revenue streams.

## Current performance

### Positive revenue trends and new business wins

Overall, our portfolio is making good progress despite the difficult environment. Several companies are displaying healthy growth and some have achieved significant new business wins in recent months. This

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Carlton House, 33 Robert Adam Street, London W1U 3HR
Telephone +44 (0)20 7935 3555, Fax +44 (0)20 7935 3737
www.lmscapital.com

# Recurring revenues: Formulating strategies to maximise quality of earnings

AMR International

**In these testing economic times investors are more than ever looking for certainty. Companies with recurring revenues are highly attractive by virtue of their stable, predictable cashflows and the challenge for businesses with a greater reliance on one-off revenues is to find ways of increasing the share of recurring revenues in the sales mix. Done in the right way, this can create a virtuous cycle by increasing customer loyalty and boosting sales in the core business. It can also have a positive impact on margins and increase valuations.**

### What defines successful recurring revenue models?

As part of commercial due diligence (CDD) and strategy assignments, AMR has analysed numerous businesses which demonstrate a high proportion of recurring revenues. Common themes emerging from these assignments include:

- High visibility of future revenues – typically under long term contracts
- Defensive competitive positions – high barriers to entry
- Interdependence between one-off and recurring revenue streams
- Ability to increase prices – low price sensitivity
- Potential to reduce costs – economies of scale
- Attractive margins and potential for margin growth

A recent example of a business demonstrating many of these characteristics is a provider of specialist Enterprise Resource Planning (ERP) solutions, which AMR looked at as part of a recent CDD assignment. The company's revenues were split roughly 50:50 between one-off sales of licence fees, hardware procurement, installation and training, and a recurring revenue stream made up of software and hardware maintenance and managed service fees (including hosting).

Although the company was selling to customers in a cyclical industry, with large scale one-off sales likely to dry up in the downturn, AMR found that the recurring revenue stream nonetheless displayed a high degree of robustness. The company's services were sufficiently critical, and customer switching costs high enough, that it was possible for the business to push through moderate price rises even at a time when customers were making substantial cost savings in other areas.

In a separate assignment, AMR analysed the European market for sub-metering services relating to the allocation of heating and water costs to individual properties within multi-unit buildings. The market as a whole was characterised by a very high percentage of recurring sales – these being as much as 80-90% of the total. The largest European market was Germany, owing to the absolute size of housing stock and the high share of multi-unit buildings – around two-thirds of the market.

AMR found that customer churn in this market was extremely low, as a result of long term contracts and opaque buying behaviour. Price sensitivity was also very low, since the key decision makers – landlords – were more interested in the quality of service and accuracy of bills than in absolute price, which, in any case, they could pass on to tenants. Moreover, the sector exhibited great potential for cost reduction through the application of more cost effective new technology – for example, electronic remote monitoring replacing manual meter reading.

There are many other business models which display good levels of either recurring revenues or quasi-recurring revenues. Software-as-a-Service models are an excellent example of this but, even in the media sector, which is generally seen as cyclical, a large number of businesses enjoy very high quality earnings and recession resilience as a result of subscription revenues. For example, B2B data services providers, including providers of financial data. Even yellow pages publishers still have a very high percentage of recurring revenues, with customer retention rates typically in the 70-80% range.

### Building successful recurring revenue strategies

With these examples the destination, what course should management teams steer to get there? We discuss three examples of successful migration strategies below.

AMR has conducted a wide range of projects in the industrial products sector, where a frequent theme is diversification away from capital equipment sales to spare products and service contracts. The reasons for this are clear – whereas capital equipment sales are typically low gross margin (typically 20-30% in competitive industries), spares can attract margins of 60-70%, while service contracts are typically 30-40% gross margin. When product sales start to slow, either because the market reaches saturation or because the normal replacement cycle is suspended due to budget cuts, service contracts and spares sales are an important means of maintaining profitability. And, of course, it is possible to use routine maintenance visits by service engineers to stimulate sales of spares – although firms must be careful not to push this too hard.

In the instrumentation segment, we have seen examples of a number of manufacturers which have successfully migrated from pure equipment sales to providing full service solutions. For example, a supplier of sensors used to monitor contamination in various manufacturing processes can push deeper into a customer's organisation and processes by offering software alongside its monitoring equipment to enable the customer to record, analyse and report data generated by the equipment. The next logical step is for the instrumentation provider to take over the monitoring function from the customer. By monitoring several sites remotely under a service level agreement, the customer is able to employ fewer inspection engineers therefore reducing production overheads. The end result of this is to increase the strength and depth of the customer relationship – and create an uplift in new product sales when replacements are due.

> **LMS Capital investments with a high/growing proportion of contracted revenue:**
>
> **Wesupply** – Software-as-a-Service B2B supply chain platform
>
> **7Global** – bespoke managed IT services and outsourcing under multi-year contracts
>
> **HMS** – provider of integrated clinical and financial IT solutions and complementary services on long term contracts
>
> **Agilysis** – outsourced IT management for local authorities under multi-year contracts
>
> **Elateral** – Software-as-a-Service marketing services platform facilitating brand communications
>
> **Pims** – UK-based supplier of waste water pumping systems. Over 4,000 maintenance contracts, including a number of large multi-site retail businesses.

In the media sector, Reed Business's Expert HR is a good example of an asset which was successfully migrated to a paid subscription model. Originally a typical B2B magazine with advertising revenues and some readers' subscription revenues, when it became clear that advertising revenues were shifting online, in particular classified recruitment advertising (including to Reed's own Totaljobs.co.uk), the title's business model was put at risk. The solution was to enhance content and reposition the asset online so that it would better meet the needs of the core readership – human resources professionals. In addition to the news updates which had been the staple of the print publication, Expert HR added databases of human resource legislation,

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is especially true of our businesses in the IT infrastructure sector where many customers are continuing to invest in the backbones of their organisations; for example, in the capability, performance and efficiency of their IT networks and data management systems.

**Wesupply** has won a number of significant new contracts in the last few months including one with Sainsbury's in recent weeks (see right) and with EDF Energy in January. Wesupply's 2009 revenue is on track to be double that of the prior year, with growth expected to continue as additional new business wins are announced and current clients add new capabilities to their Wesupply packages and extend the platform to more partners. Businesses already on the Wesupply platform include Screwfix, Jewson and Poundland in the UK and Alstom Transport, Lear Corporation, Lafarge Roofing and Amcor in Europe and the US.

**CopperEye** grew strongly in 2008, more than doubling its revenues and signing eight new enterprises as licence purchasers. The company has recently signed its largest ever licence deal and is well positioned for similar growth this year. CopperEye's data indexing technology enables organisations to more efficiently retain, query and find records in very large data sets, enabling communications companies to comply with recently enacted data retention legislation in the most cost effective manner.

**Entuity**, a network management software business, is also performing ahead of expectations, thanks to new customer wins and contract extensions, including some in the banking sector. 2008 revenue grew by 20% and Q1 2009 has seen further international business wins, with revenue for the quarter the highest in the company's history. Last month Entuity won the Editor's Choice award from Network Computing magazine for its new Green Perspective module which allows organisations to quantify the energy consumption of devices on their networks.

Following a management buyout, part funded by LMS Capital in September 2007, **Healthcare Management Systems (HMS)** has gone from strength to strength. Now providing bespoke integrated clinical and financial IT solutions to over 600 hospitals in North America, the business showed strong revenue and earnings growth in 2008 with its model predicted to maintain momentum as it grows its customer base and rolls out complementary services to established clients.

### Committing resources to growth

Elsewhere, we are supporting a number of our investments as they lay the foundations within their businesses for future growth.

**Elateral**, a marketing services business that facilitates brand communications through the streamlining and automation of the production processes of marketing materials, generated revenues of £5m in 2008 and was recently selected by Toyota GB to provide the web platform for its end to end dealer marketing system in the UK. The business is growing its profits at the same time as investing in the next generation of its software. Elateral's current clients include Coca-Cola, Mercedes Benz, Cisco and SAP.

We have recently committed $2m additional funding to one of our investments in the oilfield services sector, **ITS Engineered Systems, Inc**, to enable it to develop and launch a business line in industrial water treatment. This line complements ITS's offer of oil and gas production equipment, steam generators and pipeline equipment and is off to a flying start with a large contract win at the beginning of April.

### Stronger customer relationships

One of the characteristics that links our portfolio companies that are performing well and, indeed, those we are choosing to commit more resource to, is their ability to meet their customers' needs with a differentiated offering and deliver a greater proportion of recurring revenue. In our view, business models that position a supplier in this way make for successful companies in the long term.

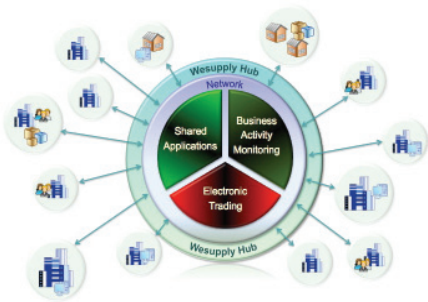
Opposite, we have asked AMR International, the strategy consultants and commercial due diligence specialists, to consider what defines a successful recurring revenue model and the steps example businesses have taken to maximise their quality of earnings in this way. With a great deal of recent experience in this area, in both commercial due diligence assignments for investors and strategy projects for business clients, AMR concludes that a focus on recurring revenue is a fundamental contributor to the attractiveness of a business to investors in the current environment.

## News Update

### Sainsbury's selects Wesupply platform to manage relationship with 4,000 suppliers

**On 9th April, Wesupply announced that its supply chain platform had been chosen by Sainsbury's to manage its electronic trading relationship with 4,000 suppliers. Wesupply will work with IBM to provide a complete outsourced supply chain solution to Sainsbury's, upgrading and migrating existing supplier connections onto one platform as part of the retailer's 'real time supply chain' initiative.**

The Wesupply platform allows customers to integrate their systems internally and with any partner, without the need for specialist hardware and regardless of differences in communications technology, data formats and back-office applications. The new platform will allow Sainsbury's to share real time information with its suppliers and streamline the exchange of orders, shipping information and invoices, benefiting all parties. Sainsbury's will also use Wesupply as a management dashboard, giving greater visibility into its order to cash cycle.




**Wesupply Supply Chain Management Model**

**Martin Pexton, Director, Wesupply writes:**

*Many customers buying supply chain software look to the large international vendors but their software systems often offer only limited connectivity and visibility between organisations. The Wesupply platform is different. It is a managed service, typically on a multi-year contract, facilitating the exchange of data between all proprietary systems. For businesses with a large number of trading partners, the Wesupply platform is a straightforward solution, usually selected by customers and rolled out to suppliers, though in a number of cases, including Amcor, the US PET bottle supplier, it is chosen by a supplier for the more efficient management of its relationship with customers.*

*We are extremely pleased with the progress of the business to date. Sainsbury's selection of the Wesupply platform is a very strong endorsement of the product and underlines our own faith in the Wesupply model. The Software-as-a-Service model is very attractive, particularly in the current environment, both to us as investors where visibility of future revenue is highly valued and to potential customers who no longer need to invest upfront to achieve greater efficiency in their supply chains but can spread the cost over the course of a contract.*

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contract templates, and salary survey data, as well as interactive services such as message boards. This example clearly shows how migrating to a more predictable revenue model in response to a strategic threat can require radical change.

### First principles

Companies with higher recurring or contractual revenues are better placed to survive and thrive and thus a high percentage of recurring revenue can be an indicator of a well run business with strong customer relationships. Our recent CDD experience suggests that investors are of a similar view and we are seeing many paying even more attention to the quality of a business's revenues streams than before and, in particular, to any steps that have been taken to migrate to streams with greater longevity. This theme is also reflected in the direction of the strategy work we are currently being asked to undertake for clients, with a number of our recent projects based on working with businesses to develop strategies to increase their proportion of recurring revenue.

In order to do this we encourage clients to take a broad perspective. Extending contracts alone is not a guarantee of success. Managers need to start by understanding where their business and customers are today and where they are both likely to want to go in the future. Fundamentally, this means analysing the demand side and competitive factors to understand whether there is a real strategic need for change or whether it is possible to identify new or alternative customer needs that a business can be remodelled to fulfil. Only then can they formulate successful strategies to bring the customer with them and move towards a recurring revenue business model.



## LMS Capital

**LMS Capital is an international investment company with 30 years' experience of investing its own capital in companies in the UK and US. Since becoming independent we have assembled an experienced investment team and are now actively looking for new funding opportunities. Our objective is to deliver sustained medium to long term growth for shareholders.**

We target development capital and growth buyouts with a typical LMS investment of between £5m and £10m initially. However, our capital structure means we can increase that investment over time to fund organic growth or acquisitions. To date we have invested £20-30m in some individual transactions. We are specialists in Energy services, Applied technology, Media/consumer and Healthcare/medical. However, we retain the freedom to invest outside our core sectors, enabling us to take advantage of opportunities when they arise. With a small, decisive team and short lines of communication we are able to respond quickly to opportunities as they present themselves.

At 31st December 2008, LMS Capital's net asset value was over £240m.

On 2 June 2009 LMS applied to move its listing from AIM to the main market by 30 June 2009.

## Our team

**Our investment team is small but highly skilled and well connected, with experience in a range of sectors across every stage of company. Most importantly, each has substantial operating experience, meaning we know how to best support management teams – we have seen many issues before and understand the importance of making decisions quickly.**

### United Kingdom

**Robbie Rayne**
Established LMS Capital's investment activities in the early 1980s as Investment Director, and later Chief Executive, of London Merchant Securities plc. Expertise in a range of sectors including real estate, media, consumer, technology and energy. Maintains close relationships with other investment firms with whom LMS Capital often co-invests.

**Martin Pexton**
Director of London Merchant Securities plc until 2007 and previously a Director of Allen & Overy and Deloitte, Haskins & Sells. Sector experience includes oil and gas, real estate, professional services and technology. Led the sale in 2008 of Energy Cranes International.

**Tony Sweet**
Previously CFO of Systems Union Group and a partner at PWC where he gained experience in a variety of sectors and geographies. Takes an active role in the group's investment activities, working closely with portfolio companies on strategic planning and funding requirements.

**Pieter Hooft**
Over 15 years' experience in MBOs and development capital in the UK and across Europe. Previously with Apax and JP Morgan Partners. Prior investments include Vue Cinemas, Xerium SA, Nordsee GmbH and Best People Limited. Operational experience as Chairman of one of Germany's largest fitness chains. Leads the group's UK investment activities.

**Edward Snow**
Formerly with Amadeus Capital Partners. Investment and operational experience across infrastructure software, medical technology and comms hardware. Previous investments include the buyout of Content Technologies from Baltimore Technologies, Optos, TeraView and PacketFront. Leads the group's UK technology investment activities.

**Jamie Szpiro**
Extensive experience spanning corporate finance, property finance and leveraged finance. Most recently with Kaupthing, Singer & Friedlander focusing on mid market buyouts. Operational and deal experience having been a senior Director of Wintrust plc and overseeing its sale and integration into Singer & Friedlander.

**Jamie Rhodes**
Specialist in consumer products, retail, leisure, logistics and distribution. Seasoned entrepreneurial experience having previously seed funded, operated and sold three ventures in the food and beverage sector. Works across the group's UK direct investment portfolio as well as being responsible for UK fund investments and quoted stocks.

### United States

**Scott Potter**
Established San Francisco Equity Partners in 2005 in partnership with LMS Capital. Broad operational experience in various senior roles in the technology sector as well as as a corporate finance attorney in the technology sector. SFEP focuses on investing in expansion stage companies in the consumer, information technology and service sectors.

**Brian Bank**
Previously with Ernst & Young consulting in the high tech and healthcare supply chain management sector. Responsible for the group's investments in US venture capital and private equity partnerships as well as overseeing the group's US based co-investment portfolio. Recent investments include HMS and EyeFi.

**Cameron Steele**
Previously a senior equity research analyst with McMorgan & Company, RBC Capital Markets and Dain Rauscher Wessels. Ten years' experience working with expansion stage technology companies both as an advisor and investor.

**Gene Weber**
Founder of Weber Capital management, operator of US investment funds in which LMS Capital invests. Weber Capital Management is a long term private and public investor in growth companies in the US information technology, communication and healthcare sectors.

For full biographies please visit the LMS Capital website.