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Sanderson Group - Initiation of coverage: Buy at 29p - target price 47p

Key Data	
EPIC	SND
Share Price	29p
Spread	27p - 31p
NMS	2,000
Total no of Shares	43.4 million
Market Cap	£12.6 million
12 Month Range	21.5p - 32p
Market	AIM
Website	www.sanderson.com
Sector	Software & Computer Services
Contact	Adrian Frost Finance Director 01709 787787 Christopher Winn Executive Chairman 02476 555466

We today initiate coverage of Sanderson Group ("Sanderson" or the "Group"), the software and IT services business specialising in the multi-channel retail and manufacturing markets in the UK and Ireland.

At a time where UK business confidence is still questionable, Sanderson is in the enviable position of having a well established installed base of customers. In the first half of this year (the six months ended March 31st) Sanderson increased its recurring revenues from 51% to 54% of total revenues. A further 41% of revenues came from incremental spend by existing customers, a percentage which has remained stable during the last three years. At the interim stage £1 million of adjusted operating profit (over two thirds of total profits) had been generated before any new customer revenue. For the year ending September we are forecasting total revenues of £27.3 million.

However, this is not to say that Sanderson is not well placed to win new customers and to grow revenues. Since the 2009 year end, the order book has grown during every reporting period and now stands at £3.36 million. This growth promises to accelerate further with sales prospect values at the half year end up by over 20% to nearly £20 million.

Based on our forecasts the Group is trading on a 2012 price to earnings ratio of 5.5 times and an EV/EBITDA multiple also of 5.5 times even after including the £3.7 million pension deficit as debt. This is despite a forecast to deliver earnings per share growth of 30% in 2011 and 12% in 2012. The robust revenue model gives us confidence that these forecasts are beatable and have significant downside protection against a further deterioration in the UK economy.

On a PE ratio basis, the sector (FTSE Actuaries Software & Computer Services Sector) is on a multiple of 19.5 times and yielding 1.5%. Whilst this basket of shares takes into account a wide variety of business sizes and growth profiles, and their earnings may not be on an adjusted basis, we see the enormous discount the market has applied to Sanderson as unwarranted.

Sanderson is growing its margins and paying down debt whilst returning cash to shareholders via the payment of a sustainable dividend. On a forward basis the shares offer a yield of over 3%. Valuing the shares on a modest 10 times current year earnings generates a **target price of 47p.** Going forward the shrinking debt balance should allow adjusted pre tax margins to push past the 10% level forecast for the 2012 financial year and as the Group continues to deleverage and grow its order book we expect the rating gap between Sanderson and the sector to narrow further. We initiate coverage at 29p with a stance of **buy**.

Forecasts Table

Year ending 30 September	Revenues (£ million)	Adj. Pre-tax profits (£ million)[1]	Adjusted EPS (p)[1]	PE Ratio (x)	Dividend per share (p)	Yield (%)
2009A	24.9	1.1	4.2	6.9	0.5	1.7
2010A	27.0	1.9	3.6	8.1	0.6	2.1
2011E	27.3	2.4	4.7	6.2	0.8	2.8
2012E	28.5	2.9	5.3	5.5	1.0	3.4

Source: Growth Equities & Company Research

Notes:
1. before exceptional items, share based payments, goodwill impairment and amortisation.

Background

The roots of the Sanderson business can be traced back to 1983 with a listing on AIM in 2004 at which point the Group raised £14 million at an admission price of 50p. At the time of its IPO the Group's largest sector by revenues was manufacturing (including food and process industries) with the remaining sales split relatively evenly between mail order and wholesale distribution.

Between 2005 and 2007 the Group developed its Multi-channel retail business both organically and via acquisition. The acquisitions included browser-based software solutions provider Progressive Computer Systems, for a maximum consideration of £1.75 million. The acquisitions of Megabyte for up to £2.5 million in cash and shares, and Elucid for £1.36 million have helped Sanderson to become a key player in the provision of software and services to the multi-channel retail sector which now represents 75% of revenues.

The biggest acquisition by Sanderson during this period was that of Retail Business Solutions for up to £14 million in cash and shares (bank debt funded) final consideration, net of cash acquired, was nearer £9.5m. This key acquisition, made in late 2007 helped to expand the Group's blue chip customer base, expand the product portfolio and provide trading synergies within the Group.

The above acquisitions were made on an average sales multiple of less than 1 times and were earnings enhancing in their first full year of trading.

The Group has a strong revenue model, with approximately 50% of revenue arising from recurring licence, support and maintenance contracts. A further 40% is derived from its existing customer base, with the balance represented by revenue from new customers. Sanderson has 7 sites across the UK and Ireland with a headcount of around 275 employees.

Overview of Operations

Multi-Channel Retail Solutions ('MCRS')

As a result of its acquisition activity and organic push to develop the Multi-Channel Retail Solutions side of the business, this division now accounts for 75% of Group turnover. We believe that this choice of focus is strategically sound for Sanderson. Whilst e-commerce continues to expand at double digit rates in the UK, the high street is currently under some pressure to grow.

Although, the pure e-commerce software and web design/implementation market is a very crowded space, Sanderson differentiates itself by offering seamless multi channel retail solutions for clients operating in either all, or, some of the following distribution channels; telephone, catalogue sales, mail order, online and high street stores. Products range from electronic point of sale systems to complete solutions incorporating Retail EPoS, Sales & CRM, Marketing & Business Intelligence, Ecommerce, and Supply Chain Management.

Sanderson has more than 600 MCRS customers ranging from small boutique shops with an online presence through to large national retailers and wholesalers. Customers include Harrods, Comet, Wilkinson, Selfridges, Scotts of Stow and Nisa Today. The company's software aims to drive continuous business improvements and Sanderson has won numerous testimonials from its retail client base.

Comments include:

> *"'We can see every customer's history throughout the organisation, whether they bought via the web, from a shop or by mail order."*
>
> *"Their solutions have helped us to significantly improve our in-store systems. Their innovative and flexible approach to IT has provided Comet with a reliable platform on which to adapt to meet the changing needs of the market."*

Manufacturing

The manufacturing business stream encompasses the traditional manufacturing sector as well as operators in the food and print industries. The software can cover all of a business's IT need from web portals through to a product configurator for creating bespoke products, inventory and warehouse management and CRM.

This part of the business was particularly affected during the recession. However the division experienced a surge in orders for its latest products in March and entered the second half of the current financial year with a strong order book worth £860,000, 88% ahead of the March 31st 2010 order book of £457,000.

Interim Results and Current Trading

Sanderson reported interim results for the six months ending 31st March 2011 on 18th May. The Group commented that trading had continued to be impacted by the slow pace of recovery in the UK economy. Although revenues were down marginally, (by 1.3%) to £13.1 million, there was a 3.9% increase in gross profits representing a 350 basis point rise in gross margin to 70.6%. This was achieved by the Group selling a greater proportion of its proprietary software and services. Operating expenses increased by 3.4% to £7.8 million reflecting increased investment in its active sectors. Adjusted operating profits advanced to £1.5 million (£1.4 million). Sanderson managed to reduce its net debt levels by 20% to £7.3 million during the period. The lower debt levels helped to bring finance charges down by 7% to £577,000. Overall adjusted earnings per share increased by 35% to 2.3p giving the Board the confidence to raise the interim dividend by 20% from 0.25p to 0.3p per share.

Looking ahead to the second half the Board cited a note of caution with regard to the general economic outlook for the UK manufacturing and retail markets in which Sanderson operates. However the order book at the period end was up by 10% on six months previously at £3.3 million with much of it scheduled for delivery in the second half. Investors should also have been able to take comfort from the rising contribution from recurring revenues which stood at 54% of total revenues.

The Group continues to innovate, improve its existing products and introduce new functionality. Newer additions include Business Assurance, Factory Automation, a suite of Green IT solutions and most recently, offerings based on 'Software as a Service' ("SaaS") and Cloud delivery models.

Forecasts

2011

Given the improvement in the order book and prospect list we see the decline in first half revenues being more than compensated for in the second half and as such forecast a 1% rise in full year revenues to £27.3 million. We see gross margins settling at the 71% level. We see strong EBITA margins being sustained into the second half and are assuming 11% for multi channel retail and 16.8% for manufacturing resulting in a blended margin of 12.3% some 80 basis points better than 2010 margins. Combined with a £300,000 reduction in net finance charges, driven by reducing debt balances, we forecast an increase in adjusted pre-tax profit of 28% to £2.4 million for the year translating as adjusted diluted earnings per share of 4.7p. We forecast a year on year net debt reduction of £1.2 million to £6.7 million.

2012

We expect 2012 to demonstrate the benefits of the growing order book, expanding prospect list and improving competitive market position and we forecast a 5% increase in revenues to £28.5 million. We assume flat gross margins at 71% but are of the opinion that operational gearing will enable EBITA margins to advance by a further 80 basis points to 13.1%. We forecast a further £0.1 million reduction in net finance charges and therefore expect adjusted pre-tax profits to move ahead by a further 19% to £2.9 million equating to earnings per share of 5.3p.

With relatively stable working capital flows we estimate operational cash flows of £2 million and a small rise in investment expenditure to £0.42 million. Overall we see net debt falling significantly by a further £1.2 million to £5.5 million providing scope for further net profit margin improvement in future years.

Board of Directors

Christopher Winn, Executive Chairman
Educated at Queen Elizabeth School, Kirkby Lonsdale and Nottingham University, Winn worked for British Olivetti until 1974 when he joined the ACT Group - ACT Group became the second UK IT company to be listed on the London Stock Exchange in 1979. He served on the Group plc Board between 1983 and 1994, undertaking a number of senior

roles and in 1995; he joined the former Sanderson Group, becoming Group Chief Executive later in that year. In 1999, he led a management buyout of the former Sanderson Group with the support and backing of Alchemy Partners. Following restructuring and the demerger of the original Group, the business which was focused primarily on UK commercial markets and which retained the Sanderson Group name, gained admission to the London Stock Exchange AIM market in December 2004.

Adrian Frost, Finance Director
A graduate of Sheffield University, Frost qualified as a Chartered Accountant whilst working for RSM Robson Rhodes. In 1996, he joined Hadley Industries plc as Group Financial Controller. Frost joined Sanderson in 2000, shortly after the management buyout, and worked closely with the Board in restructuring the former Group into three separate businesses Sanderson, Civica and Talgentra. He was appointed Finance Director of Talgentra following the formal demerger of the Group, and rejoined Sanderson Group plc in May 2005.

David Gutteridge, Non-Executive Director
David Gutteridge is the senior independent Non-Executive Director of Sanderson Group plc. He is the Chairman of Tinglobal Limited, an IT infrastructure and support solutions provider, and was, until recently, a Non-Executive Director at AIM listed Cyan Technology plc, a fabless semiconductor company developing configurable low power microcontrollers. He has also acted as an independent consultant involved in strategic business development and corporate transactions. He is a member of the Chartered Institute of Management Accountants. He was co-founder of Financial Objects plc in 1995 and, as Finance Director and then Chief Operating Officer, led several acquisitions and the full listing on the London Stock Exchange in 1998. Prior to this he held a number of senior financial and commercial roles at ACT Group plc, Seiko Epson Ltd and Logica plc.

Philip Kelly, Non-Executive Director
Philip Kelly is a Non-Executive Director of Radius Solutions (UK) Limited (formerly a wholly owned subsidiary of Radius plc, which was taken private with funding from the Alchemy Plan in 1998). He is also a Non-Executive Director of Coalition Holdings Limited, a provider of technical and desktop services. He has more than 20 years' experience as the Chief Executive of private and publicly quoted software companies supplying the commercial and public sectors in the UK, Europe and the USA. Kelly had previously worked for Digital Equipment and 3i Consultants. He was nominated for appointment to the Board by Alchemy Partners.

John Paterson, Non-Executive Director
John Paterson has extensive City experience as an investment analyst. He was Managing Director of Albert E Sharp Securities stockbrokers from 1993 until the acquisition of Albert E Sharp by Old Mutual in 1998, and he was instrumental in setting up Arden Partners in 2002 where he was a Director until November 2004.

Operating Board:

David Mahoney, Managing Director Sanderson RBS
Mahoney has more than 20 years' experience in software and IT services, focused mainly on retail solutions. He joined RBS in 1997, having spent the previous 10 years with Dixons Stores Group (DSG). Early roles concentrated on improving professional services offerings and he was promoted to Operations Director in 2002, having previously held the roles of Development Director and Support Director. His focus during this phase was to define the managed service strategy, to refine the company's structure and to ensure that the organisation was optimised to meet customer expectations. Mahoney was appointed Managing Director in 2008 and continues to promote the managed service offering and reinforce our position as a top tier solution provider.

Ian Newcombe, Managing Director Multi-Channel Solutions
Newcombe has more than 30 years' experience in software and IT services. Beginning his career in electronics, he moved into the computer industry in 1979 when he joined ACT Group plc, where as a local board member, he helped establish an international IT support and software services business. In 1996, Newcombe joined Mitsubishi Electric of Japan at UK board level. As International Project Director, he was instrumental in the formation of an ISP (Internet Service Provider) and online financial services business, successfully launching a range of innovative products in the UK and Europe. In 1999, he was appointed Consulting Director of Talgentra Ltd, now an Experian plc company, where he developed a new consulting services business which rapidly expanded overseas. In 2005, Newcombe became Managing Director of what is now the enlarged multi-channel sales division of Sanderson.

Steve Watson, Deputy Chairman Sanderson Retail Division
After graduating from the University of Bristol with a degree in modern languages, Watson qualified as a chartered accountant with Price Waterhouse. He subsequently spent 10 years working for Swiss Bank Corporation in London, where he was an executive director in the bank's investment banking division, specialising in the field of cross-border mergers and acquisitions in the financial services industry. In 1992, he became one of the founder directors of what is now Sanderson RBS. During the 15 year period prior to the acquisition of this company by Sanderson Group plc, Steve held a number of senior roles at Sanderson RBS including Finance Director, Chief Operating Officer and Chief Executive. Watson was appointed Deputy Chairman of the retail division of Sanderson in October 2008.

Significant Shareholders

Shareholder	Holding (%)
Christopher Winn	29.97
Axa Framlington Investment Management	9.21
Isis EP LLP	6.92
Hargreave Hale And Co	6.49
Chelverton Asset Management	6.29
Unicorn Asset Management	3.55
Polar Capital Partners	2.88
Md Barnard & Co	2.69

SWOT Analysis

Strengths

- The business benefits from a high 50% plus recurring revenue rate (licenses and subscriptions) with a further 40% of incremental revenue from existing customers;
- Sanderson systems are business critical to many of its clients meaning that even in the most difficult of times, most of the Group’s revenues are not subject to discretionary spending decisions;
- Sanderson provides best of breed software to the manufacturing and retails sectors rather than spread itself too thinly across multiple industries. It offers functionally rich solutions backed by high service levels; and
- Sanderson is cash generative. In 2010 the Group generated free cash flow of £2.3 million. By the end of the 2012 financial year we estimate that net debt will have fallen by a further 25% to £5.3 million which will help profit margins and give Sanderson the financial flexibility to increase its current dividend payout ratio of 16.6% of adjusted earnings.

Weaknesses

- Revenues fell by just over 1% in the first half of the current financial year. However gross margins are improving as is the Group’s order book; and
- Sanderson contributes to a defined benefit pension scheme which has an IAS 19 deficit of £3.78 million (75% funded by Sanderson). We expect the next actuarial review to be conducted during this calendar year.

Opportunities

- We believe that the core competence of Sanderson multi channel retail systems, is well placed for future growth as more and more terrestrial retailers seek to grab a slice of the online market; and
- Sanderson has a good order book and prospect list and we believe this gives it a good platform from which to accelerate revenue growth.

Threats

- The core customer base of Sanderson comprising UK/Irish retailers and manufacturers are facing an uncertain period ahead with inflation and austerity measures squeezing their domestic consumers. However with online retail continuing to undergo structural growth and manufacturing being partly export led, Sanderson enjoys some element of protection from a deterioration in domestic consumer confidence.

Valuation and Conclusion

Based on our forecasts Sanderson is trading on a 2012 price to earnings ratio of 5.5 times and an EV/EBITDA multiple also of 5.5 times even after including the £3.7 million pension deficit as debt. This is despite the Group forecast to deliver earnings per share growth of 30% in 2011 and 12% in 2012. The robust revenue model also gives us confidence that these forecasts are beatable and Sanderson has significant downside protection against a further deterioration in the UK economy.

Currently 54% of revenues come from annual, pre contracted licence, support and managed service contracts with a further 41% being generated by incremental discretionary spend from existing customers. The final 5% is from new business. Having said that, potential new prospect values at the half year end were up 28% to £19.5 million.

On a PE ratio basis the sector (FTSE Actuaries Software & Computer Services Sector) is on a multiple of 19.5 times and yielding 1.5%. Whilst this basket of shares takes into account a wide variety of business sizes and growth profiles, and their earnings may not be on an adjusted basis, we see the enormous discount the market has applied to Sanderson as unwarranted.

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