SMALL CAP SHARE COMMENT

Commissioned Commentary

SANDERSON GROUP

(AIM:SND)

Share price 27.5p

Date: **18th May 2011**

Sector: Software & Computer Services

Market Cap: c£11.9m

www.sanderson.com

Operating profit lifted, cash generation strong and net debt reduced further

Interim results from the software and IT services business specialising in multi-channel retail and manufacturing markets in the UK and Ireland showed further progress with an improvement at the operating level, a further reduction in net debt and encouraging order book.

- Results

Revenue for the 6 months ending 31st March 2011 fell marginally to £13.1m (6 months to 31st March 2010: £13.3m) but a 3.5% increase in gross margin to 70.6% (2010: 67.1%) supported an increase in operating profit (before the amortisation of acquisition-related intangibles and before the charge in respect of share-based payments improved) to £1.5m (2010: £1.4m).

Basic earnings per share were 0.7p (31st March 2010: 0.01p).

- Positive cash flow

Continued strong cash generation (Cash generated from operations was £1.7m) has facilitated a further reduction in net debt at 31st March to £7.2m (31st March 2010: £9.0m). In the past three years, since its peak at 31st March 2008 of £12.5m, the Group's net debt has reduced by over 40%.

Management has emphasised that further reductions in net debt form a key part of the Group's plans to strengthen the balance sheet in the short to medium term.

- Benefits of large order book

Management commented that the benefits of the larger order book will be reflected in the results for the second half of the year, during which most of the projects are scheduled for implementation and delivery. Estimates are for second half revenue of £14m to £14.5m.

- Deferred income measure of strength

Deferred income increased by 1.6% from the comparable period, to stand at £6.91m at the half year end (31st March 2010: £6.8m). As reported previously, whilst a creditor, deferred income is an important measure of the strength of the business model, being the amount of recurring revenue paid in advance but deferred for revenue recognition purposes to future accounting periods.

- High proportion of recurring revenue

The Group's business model supports a high proportion of annual pre-contracted recurring revenue consisting of software licences, support contracts and increasingly, managed services. In the period to 31st March 2011, recurring revenues grew by 6% to £7.1m (2010: £6.7m) representing 54% of total revenues (2010: 51%).

- The Business

Sanderson provides a wide range of software solutions to the multi-channel retail and manufacturing markets. These solutions comprise primarily the Group's proprietary software often integrated with other market-leading products, which are installed, supported and serviced by Sanderson staff.

Multi-channel retail

The Group provides end-to-end, comprehensive IT solutions to businesses operating in retail, mail order, fulfilment and wholesale distribution, and increasingly, to those with an online sales presence.

Revenues derived from multi-channel retail operations were broadly flat at £10.1m (31st March 2010:10.2m).

Activity levels were generally good with a noticeable improvement in the level of activity from smaller retailers.

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Within the suite of retail software, the Group has developed a new hospitality and catering module, which utilises the latest tablet PCs and wireless technology to enable customers to achieve savings and efficiencies in catering management.

Salford Royal NHS Foundation Trust has achieved significant savings and both the Bradford Teaching Hospitals NHS Trust, as well as, Whipps Cross University Hospital NHS Trust have now adopted the Sanderson system. The Group is currently trialling its Green 'Power Optimisation System' at a large retailer and early indications are that annual power savings of around £25 per till can be achieved.

A total of eleven new customers were gained in the period (2010: 11 new customers) and the average contract value was £111k compared with £156k in the previous year and £60k two years ago when recession had taken hold. Additionally, large orders were gained from a number of existing customers including Wilkinson, Lakeland and English Heritage.

Manufacturing
The Group's manufacturing business covers the provision of IT solutions to manufacturing companies which operate primarily in the engineering, plastics, aerospace, electronics, print and food process sectors.

Revenue was relatively flat at £3.0m (31st March 2010: £3.1m) but the division experienced a surge in orders for its latest products in March and therefore enters the second half of the financial year with a strong order book worth £860k, which is 88% ahead of the March 2010 order book of £457k.

Two new customers were gained in the period compared with four new customers in the whole of the previous year, which ended 30 September 2010.

Recurring revenues continue to be strong, accounting for 58% of total revenue and the margin from this revenue stream covers 82% of divisional overheads.

- Order book rises

The order book grew by 10% to £3.3m at 31 March 2011 (March 2010: £3.0m) providing a good level of confidence for a satisfactory trading performance for the full year with most of this scheduled for delivery by the financial year ended 30th September 2011.

The Group's strategy is to be the supplier of choice in target markets, offering modern, functionally rich products, which deliver cost effective solutions to customers, backed by a high quality service and will ensure long-term growth in earnings and enhances value to investors.

- Interim dividend +20%

The interim dividend is raised from 0.25p to 0.30p per share equating to just over 1% at the current share price (27.5p). The interim dividend is due to be paid on 19th August 2011 to shareholders on the register at the close of business on 22nd July 2011.

- Improving gross margins reflect growing element of proprietary sales

The 3.5% improvement in the gross margin reflects the delivery of more of the Group's proprietary IPR and other owned services to customers.

- Focus on specialist retail

As expected, there was the usual 'cautious' outlook statement but the Group appears to be well placed in focusing on the small specialist retail space as well as the larger value propositions who continue to perform well.

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- Broker forecasts

For the year ending September 2011 consensus forecasts point to profit before tax of £2.4m and adjusted earnings per share of approx 4.74p.

At the current share price (27.5p) this leaves the shares trading at approx 5.8x 2011 adjusted earnings estimates with a projected yield of c2.9%.

- Refinancing could give earnings a big boost

Net financing costs of £577,000 for the 6 months compared to net operating profit of £782,000 highlights the impact of the former on operating profit, the very high rate of interest and therefore the evident benefits of refinancing on more favourable terms.

The principal secured facility totalling £8,075,000 expires in June 2014.

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