

# Mandrakesoft

20 September 2005

## Hopes now rest on 2006

Software &amp; Computer Services

Current price €5.30

**Outperform**

France

Target price €7.50

Rating Unchanged

Performance over	1m	3m	12m
Absolute	-16%	-18%	-7%
Rel. SBF250	-17%	-24%	-25%
Relative to sector	-18%	-21%	-15%
12m Hi/Lo	€8.20/4.61		
Reuters	MAKE.PA		
Bloomberg	MLMAN FP		
Market Cap	€28m		
Next corporate event			

FY/e 30.09	2004	2005E	2006E	2007E
Sales (€m)	5.2	5.1	8.4	10.9
EBITDA (€m)	1.0	-0.9	0.5	1.2
Net earnings (€m)	1.4	0.1	0.2	0.9
Current EPS* (€)	0.17	-0.23	0.03	0.16
Published EPS (€)	0.29	0.02	0.03	0.16
Dividend per share (€)	0.00	0.00	0.00	0.00
P/E (x)	28.2		170.4	33.9
Dividend yield (%)	0.0%	0.0%	0.0%	0.0%
EV/EBITDA (x)	20.5		52.1	18.9

Source: KBC Securities

\*Adjusted for goodwill and exceptionals

We have slashed our estimates following the publication of the 3Q results and the group's guidance for the fourth quarter. Reasons for the revision include the decision not to launch the latest update of Mandriva Linux (formerly Mandrake Linux) in 2H as part of a switch from a six-monthly update regime to a once-a-year system. The new version will now be available in October, at the start of the next FY. The scale of the investment in professional services also hit the results. The outlook for 2005/2006 looks brighter, even though we only expect a small operating profit. The legal wrangling with Hearst has been resolved but we think reduced short-term earnings visibility and the uncertainty surrounding the listing on a regulated market will weigh on the share in the coming weeks. The longer-term growth potential of Mandriva is not under threat in our view (see growth strategy on page 2), but we are nevertheless lowering our target price from €8.5 to €7.5.

### Third quarter results

Third quarter sales fell 8% to €1.38m from €1.5m in 3Q03/04. Operating revenue gained 1.9% to €1.55m. On a like-for-like basis – i.e. without Connectiva – it declined 15%. The contraction of the gross margin from 83% to 67% stems from the increased weight of professional services, which accounted for 44% of 3Q sales, compared to only 6.8% in 3Q03/04. This high proportion of sales in professional services is a one-off resulting from the decision to withhold the launch of a new version of Mandriva Linux.

3Q operating profit slipped €0.5m after growth of €0.17m in 3Q03/04. Net profit also declined, losing €0.66m on the €0.19m result a year earlier.

Cumulated nine-month sales climbed 3% from €4.02m to €4.14m thanks to the integration of Connectiva in 3Q. Operating profit fell €0.33m to €-0.29m and net profit slid from €0.9m to €0.37m (both the net figures include significant positive one-off items following debt restructurings).

## Our estimates

The absence of a new version of Mandriva Linux in 2H has prompted us to make a sharp downward revision of our forecasts for the current FY, which will also be hit by the spending in professional services and the acquisition of the Brazilian subsidiary Connectiva, where the group is investing in new growth.

Our new forecasts can be seen in the table below:

<b>Provisional earnings statement (€m)</b>					
	<b>Sep-04</b>	<b>Sep-05E</b>	<b>Sep-06E</b>	<b>Sep-07E</b>	<b>Sep-08E</b>
Professional services	0.391	1.250	2.200	3.300	4.000
Products	3.527	1.400	2.700	3.000	3.300
On-line services	1.265	1.800	2.205	2.640	3.025
Connectiva		0.650	1.300	2.000	2.600
Sales	5.183	5.100	8.405	10.940	12.925
	Change	- 1.6%	64.8%	30.2%	18.1%
Other products	1.101	1.200	1.260	1.323	1.389
Total operating revenue	6.284	6.300	9.665	12.263	14.314
Gross margin	4.380	3.691	5.655	6.989	8.191
	% of sales	84.5%	72.4%	67.3%	63.9%
Operating profit	0.862	-1.000	0.275	0.989	1.791
	% of sales	16.6%	- 19.6%	3.3%	9.0%
Published attributable net profit	1.396	0.086	0.160	0.869	1.690

Source: KBC Securities

The year-ending 30 September 2004 benefited from high licence revenues, which had a positive impact on revenues and overall profitability.

## Outlook

Although the current year now looks set to be weaker than expected and short-term visibility is poor, we feel more confident on the medium to long-term prospects.

The company is currently in a number of negotiations for major licence contracts. Its bargaining power stems as much from the quality of the product and its user-friendliness (for Linux products in particular) as from the company's 'European' character, which can be a deciding factor for some partners.

Mandriva is also looking to expand its indirect distribution network via strategic accords with equipment builders. This would enable the group to benefit from marketing back-up while increasing the exposure of its products, which is seen as crucial.

The growth strategy – in which **acquisitions play a central role** – is based on several clearly defined objectives:

- **Seal agreements with equipment suppliers:** these can prove time-consuming to negotiate but they generate significant licence revenues. The best recent example of this strategy is the contract with Dell for the US giant's laptop offer to French students.
- **Strengthen business with large clients** in France and Brazil. This strategy will weigh on earnings in the short-term but building references is the best way to generate business, either alone or in a consortium.
- **Home in on emerging country markets:** Mandriva is already well placed in South America after the Connectiva acquisition. We now expect development to gather pace in India, where a number of major international players are interested in Mandriva as a possible partner of reference.
- **Pursue R&D development** (booked under Operating revenues). The number of projects is growing fast: three are underway and two more have been approved. Seven are awaiting a decision and 11 are currently at the study stage.

## Valuation

Our DCF valuation yields a valuation of €5.85, which is close to the current share price. We used a discount rate of 10% and assumed very modest sales (given the potential of Linux) of €24m in 2014 with a margin of 18%.

The current segment leader Red Hat is currently trading at ratios of around 8.5x 2006E sales, and the introduction of Turbolinux, which is similar to Mandrakesoft in terms of size, on the Osaka stock exchange on 10 September was based on a ratio of around 37.5x 2005E sales.

Because there was no new version of Mandriva Linux launched in 2005, we think it sensible to value Mandriva based on estimated 2006 sales.

**Our new target price values Mandriva – formerly known as Mandrakesoft – at 5x 2006E sales.**

## Financial data

<b>Income statement (€m)</b>	<b>2004</b>	<b>2005E</b>	<b>2006E</b>	<b>2007E</b>
Sales	5.2	5.1	8.4	10.9
EBITDA	1.0	-0.9	0.5	1.2
EBITA	0.9	-1.0	0.3	1.0
EBIT	0.9	-1.0	0.3	1.0
Pre-tax earnings	1.4	0.1	0.2	0.9
Net earnings	1.4	0.1	0.2	0.9
Current earnings before goodwill	0.7	-1.1	0.2	0.9
Current cash flow	1.5	0.2	0.3	1.1
<b>Balance sheet (€m)</b>	<b>2004</b>	<b>2005E</b>	<b>2006E</b>	<b>2007E</b>
Goodwill and other intangible assets	0.1	0.0	0.0	0.0
Tangible assets	0.1	0.2	0.2	0.2
Associates and other financial assets	0.1	0.1	0.1	0.1
Net working capital	-3.6	-3.7	-4.0	-4.4
Net debt	-2.5	-5.5	-5.7	-6.9
Provisions and other liabilities	1.1	1.0	0.8	0.8
Minorities	0.0	0.0	0.0	0.0
Equity	-2.0	1.1	1.3	2.2
Capital employed, incl. cum goodwill	1.5	1.6	2.3	2.7
Balance sheet total	4.1	7.6	8.5	10.2
<b>Cash flow statement (€m)</b>	<b>2004</b>	<b>2005E</b>	<b>2006E</b>	<b>2007E</b>
Cash flow from operations	0.5	0.1	0.5	1.1
Net capital expenditure	-0.1	-0.1	-0.1	-0.1
Free cash flow (before acquisitions)	0.5	0.0	0.4	1.0
Acquisitions and disposals	0.0	0.0	0.0	0.0
Dividend payments	0.0	0.0	0.0	0.0
Shares issues	2.3	3.0	0.0	0.0
Other	-0.4	0.0	-0.2	0.2
Change in net debt	-2.9	-3.0	-0.2	-1.2
<b>Performance criteria</b>	<b>2004</b>	<b>2005E</b>	<b>2006E</b>	<b>2007E</b>
Sales growth	32.9%	-1.6%	64.8%	30.2%
EBITDA margin	18.6%	-16.9%	5.4%	10.9%
EBITA margin	16.6%	-19.6%	3.3%	9.0%
EBIT margin	16.6%	-19.6%	3.3%	9.0%
Net debt / equity	126.3%	-486.7%	-445.3%	-322.1%
Net debt / EBITDA	-	-	-	-
EBITDA / net interest	4.3	-	4.6	11.9
Pay-out ratio	0.0%	0.0%	0.0%	0.0%
Net return on equity (avg.)	-	-	-	-
Return on capital employed (avg.)	-	-	-	-
<b>Per share data (€)</b>	<b>2004</b>	<b>2005E</b>	<b>2006E</b>	<b>2007E</b>
Weighted average number of shares (m)	4.21	4.75	5.15	5.56
Published EPS	0.29	0.02	0.03	0.16
Current EPS, before GW	0.17	-0.23	0.03	0.16
Current CFPS	0.36	0.05	0.07	0.19
Free cash flow per share	0.11	-0.01	0.08	0.19
Net book value per share	-0.47	0.24	0.25	0.39
Current EPS (before GW): y/y growth	-	-	-	402.5%
Current CFPS: y/y growth	-	-86.7%	39.1%	191.2%
Current EPS (before GW), fully diluted	0.15	-0.20	0.03	0.16
Dividend per share (€)	0.00	0.00	0.00	0.00
<b>Valuation data</b>	<b>2004</b>	<b>2005E</b>	<b>2006E</b>	<b>2007E</b>
Reference share price (€)	4.67	5.30	5.30	5.30
Reference market capitalisation (€m)	22.2	25.2	29.5	29.5
Enterprise value (€m)	19.7	19.7	23.7	22.5
P/E	28.2	-	170.4	33.9
P/CF (x)	13.1	111.7	80.3	27.6
P/NBV (x)	-11.3	22.3	22.9	13.7
Dividend yield (%)	0.0%	0.0%	0.0%	0.0%
EV/sales (x)	3.8	3.9	2.8	2.1
EV/EBITDA (x)	20.5	-	52.1	18.9
EV/Capital employed (x)	13.3	12.0	10.5	8.5

Source: KBC Securities

\*Historic valuation data are based on historic prices

Analyst certification: The analysts identified in this report each certify, with respect to the companies or securities that the individual analyses that (i) the views expressed in this publication reflect his or her personal views about the subject companies and securities, and (ii) he or she receives compensation that is based upon various factors, including his or her employer's total revenues, a portion of which are generated by his or her employer's investment banking activities, but not in exchange for expressing the specific recommendation(s) in this report.

This publication has been prepared by KBC Securities NV or one of its European subsidiaries (together "KBC Securities"). This publication is provided for informational purposes only and is not intended to be an offer, or the solicitation of any offer, to buy or sell the securities referred to herein. No part of this publication may be reproduced in any manner without the prior written consent of KBC Securities.

The information herein has been obtained from, and any opinions herein are based upon, sources believed reliable, but neither KBC Securities nor its affiliates represent that it is accurate or complete, and it should not be relied upon as such. All opinions, forecasts, and estimates herein reflect our judgement on the date of this publication and are subject to change without notice.

From time to time, KBC Securities, its principals or employees may have a position in the securities referred to herein or hold options, warrants or rights with respect thereto or other securities of such issuers and may make a market or otherwise act as principal in transactions in any of these securities. Any such persons may have purchased securities referred to herein for their own account in advance of the release of this publication. KBC Securities and principals or employees of KBC Securities may from time to time provide investment banking or consulting services to, or serve as a director of a company being reported on herein.

This publication is provided solely for the information and use of professional investors who are expected to make their own investment decisions without undue reliance on this publication. Investors must make their own determination of the appropriateness of an investment in any securities referred to herein based on the merits and risks involved, their own investment strategy and their legal, fiscal and financial position. Past performance is no guarantee for future results. By virtue of this publication, none of KBC Securities or any of its employees shall be responsible for any investment decision.

In the United States this publication is being distributed to U.S. Persons by KBC Financial Products USA, Inc., which accepts responsibility for its contents. Orders in any securities referred to herein by any U.S. investor should be placed with KBC Financial Products USA, Inc. and not with any of its foreign affiliates. KBC FP USA Inc. and/or its affiliates may own 1% or more of the subject company's common equity securities. KBCFP USA Inc. or its affiliates may have managed or co-managed a public offering of the subject company's securities in the past 12 months, or received compensation for investment banking services from the subject company in the past 12 months, or expect to receive or intend to seek compensation for investment banking services from the subject company in the next three months. Any U.S. recipient of this report that is not a bank or broker-dealer and that wishes to receive further information regarding, or to effect any transaction in, any security discussed in this report, should contact and place orders with KBC Financial Products USA Inc. This report is being distributed in the United States solely to investors that are (i) "major U.S. institutional investors" (within the meaning of SEC Rule 15a-6 and applicable interpretations relating thereto) that are also "qualified institutional buyers" (QIBs) within the meaning of SEC Rule 144A promulgated by the United States Securities and Exchange Commission pursuant to the Securities Act of 1933, as amended (the "Securities Act") or (ii) investors that are not "U.S. Persons" within the meaning of Regulation S under the Securities Act and applicable interpretations relating thereto. The offer or sale of certain securities in the United States may be made to QIBs in reliance on Rule 144A. Such securities may include those offered and sold outside the United States in transactions intended to be exempt from registration pursuant to Regulation S. This report does not constitute in any way an offer or a solicitation of interest in any securities to be offered or sold pursuant to Regulation S. Any such securities may not be offered or sold to U.S. Persons at this time and may be resold to U.S. Persons only if such securities are registered under the Securities Act of 1933, as amended, and applicable state securities laws, or pursuant to an exemption from registration. The products sold by KBC Financial Products USA, Inc or any affiliate thereof, including KBC Securities or KBC Financial Products UK Limited, are not insured by the FDIC, are not obligations of or guaranteed by KBC Bank NV or its affiliates, and are subject to investment risks, including possible loss of the entire amount invested.

This publication is for distribution in or from the United Kingdom only to persons who are authorised persons or exempted persons within the meaning of the Financial Services and Markets Act 2000 of the United Kingdom or any order made thereunder or to investment professionals as defined in Section 19 of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001 and is not intended to be distributed or passed on, directly or indirectly, to any other class of persons.

This publication is for distribution in Canada only to pension funds, mutual funds, banks, asset managers and insurance companies.

The distribution of this publication in other jurisdictions may be restricted by law, and persons into whose possession this publication comes should inform themselves about, and observe, any such restrictions. In particular this publication may not be sent into or distributed, directly or indirectly, in Japan or to any resident thereof.

Copyright © 2005 KBC Securities