

Mandrakesoft

28 June 2004

Kill Bill

Software & Computer Services

Current price € 5,02

Outperform

France

Target price € 7,00

Initial coverage

Performance over	1m	3m	12m
Absolute	20%	61%	121%
Rel. SBF250	15%	53%	81%
Rel. sector	13%	51%	75%
12-m- Hi/Lo	€ 5,02/2,27		
Reuters	MAKE.PA		
Bloomberg	MLMAN FP		
Market Cap	€ 24m		
Next corporate 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)	-	64,4	19,6	13,2
Yield (%)	0,0	0,0	0,0	19,9
EV/EBITDA (x)	-	66,5	20,3	13,1

Source: KBC Securities

*Adjusted for goodwill and exceptionals

Mandrakesoft is one of the world's leading publishers of Linux operating systems and open source software. Despite difficult conditions over 2001/03, the company has managed to preserve its developer network and continues to offer high quality, user-friendly solutions. The firm's high reputation is therefore intact, a fact underlined by the growth in paying subscribers to its 'club'. Important new public sector contracts – particularly in France – are a sign of growing demand for open source software solutions among governments. But Mandrakesoft needs to invest to take advantage of this trend and strengthen its defences against rivals and future new players. The popularity of Linux is growing fast and the company has begun to make headroads with larger companies and administrations. The necessary ingredients for strong growth do therefore exist. What is missing - and it is by no means a trivial problem - is a solid financial base, hence the company's announced intention to obtain a listing on a regulated market. We are initiating our coverage with an 'outperformance' recommendation and a target price of €7 per share.

Linux and the open-source principle

Without going into a detailed history, Linux is an operating system based on open source software, which means that the programme's source code is available to the public. The main competitor is Microsoft's all-powerful Windows operating system. Linux operates within the framework of a General Public Licence (GPL) defined by the Free Software Foundation (created in 1984) which has set out four guiding principles:

- The freedom to run the programme for any purpose
- The freedom to study how the programme works and adapt it to the user's needs
- The freedom to redistribute copies
- The freedom to improve the programme and release the improvements to the public so the entire community benefits.

Open source software is not necessarily free of charge but authors who develop or modify it have the option to distribute the software at no charge if they wish. Many programmes based on the Linux "kernel" were written with a view to creating full operating systems and companies like the US based Red Hat and Mandrakesoft market what are known as "Linux distributions". These are integrated software packages forming complete operating systems, including installation procedures, whose evolution and stability are ensured by the companies along with teams of developers. In addition to the two companies mentioned above, other important "distributions" are carried out by Novell/Suse and Debian (the latter having no commercial release). Mandrakesoft's focus on integration and simplification aimed at offering turnkey solutions mean its status is close to that of a software publisher.

The growth of Linux is hurting Windows a lot less than the other operating systems, particularly Unix. **Over the 2002 / 2007 period, average annual growth of 16.6% is projected for Linux** compared to 10.5% for Windows and a fall of between 4.5% and 14.5% for other systems. At current growth rates, Linux could represent close to 25% of the installed base by 2007, up from less than 15% in 2003 (source: IDC).

Deliveries of servers and operating systems							
000s of units	2002	2003	2004	2005	2006	2007	TMVA
Windows	3,120	3,486	3,950	4 412	4,805	5,137	10.5%
change	14.8%	11.7%	13.3%	11.7%	8.9%	6.9%	
Linux	1,309	1,437	1,660	1,980	2,365	2,825	16.6%
change	8.4%	9.8%	15.5%	19.3%	19.4%	19.5%	
Unix	622	600	579	558	531	495	- 4.5%
change	- 7.2%	- 3.5%	- 3.5%	- 3.6%	- 4.8%	- 6.8%	
Others (1)	608	481	386	343	307	277	- 14.5%
change	- 22.9%	- 20.9%	- 19.8%	- 11.1%	- 10.5%	- 9.8%	
Total	5,659	6,004	6,575	7,293	8,008	8,734	9.1%
change	5.1%	6.1%	9.5%	10.9%	9.8%	9.1%	

Source: IDC (1) Novell Netware, IBM AS/400, HP/Compaq/Digital OpenVMS, IBM Mainframe, other mainframes, others

Looking out to 2007, IDC anticipates server market share of 58.8% for Windows (55.1% in 2002), **32.7% for Linux (23.1% in 2002)**, 5.7% for Unix (11% in 2002) and 3.2% for other systems (down from 10.7% in 2002).

According to figures from the Ovum research bureau released in January, revenue from Linux software will increase eleven fold from \$280m in 2003 to a little over \$3.1bn in 2008 while that of associated services will rise from \$119m to \$879m (x 7.3) in 2008.

Mandrakesoft's market position

Mandrakesoft's status as a software publisher is underscored by the fact that the vast majority of revenues are generated by product sales (see table on page 5 for details).

A crucial element for the future is the growing trend towards on-line sales, which offer significant advantages over traditional retail sales in stores:

- On-line retail prices have a gross margin of 60 to 70%, higher than the 30 to 40% in stores
- A shorter, one-week production turnaround for specific products
- Payment is immediate compared to 30 to 90 days for retail store sales
- End clients are clearly identified and can be recontacted.

Mandrakesoft develops products for two sorts of customer: the **individual users** and companies. **Mandrakesoft has achieved market leadership status in the former category, with close to 40% market share in 2003 according to Ofbiz.** The three core products – Mandrakelinux Discovery 10.0, Mandrakelinux PowerPack 10.0 and Mandrakelinux PowerPack + 10.0 – target different user categories ranging from beginner to advanced. Every six months an updated version integrating new features and the modifications carried out by voluntary developers is made available.

These products can be bought over the counter in stores, on-line from the Mandrakestore web site, and increasingly by downloading – an online service offered to Mandrakeclub members. Club members take out a standard or ‘Silver’ subscription (respectively €60 and €120 annually), which enable them to download a version of Mandrakelinux matching the subscription. In March 2004, close to 60% of new members opted for Silver subscriptions. The trend towards this solution is clearly visible when we consider that a year previously, 80% of new subscribers chose the standard version.

The growth prospects of the Mandrakeclub will soon receive a significant boost with the creation of a monthly payment option. By offering this payment method, much preferred by subscribers, the company should be able to retain around half of those individual customers who are currently not renewing their subscriptions. The aim is to reach 35,000 subscribers by end-2005. At present, most are based in the US (42%) with France and the UK trailing with respectively 17% and 8%.

Organisation of the Mandrakesoft product offer

	Products	Services
Key accounts	Custom products	Consulting Dedicated support Specialized training
Small and medium enterprises	Solutions (hardware, software, services)	Expert support Standard training
Mass market	Mandrakelinux products	Support

Source: company

On the company side, the US system Red Hat has a comfortable lead, ahead of Novell/Suse and Mandrakesoft. Large accounts represent only 8% of Mandrakesoft’s revenues at present. Mandrakesoft is addressing this weakness however and new contracts are being signed, particularly with administrations. This breakthrough with government bodies and some large companies – Total for example – should enable Mandrakesoft to bury the rather restrictive perception that its products are favoured primarily by experienced users – or to put it less kindly, geeks.

Company solutions include products like Corporate Server 2.1, Multi Network Firewall or Mandrake Clustering. However, the real potential lies in the offer of services.

Expanding the service offer must be a priority

In addition to the Corporate Club, which mainly offers mirror services providing automatic and transparent updates to client companies (for sums that can approach €30,000 annually), Mandrakesoft also manages the migration towards Linux of all or part of existing IT systems.

In concrete terms, this obviously consists of offering consulting, support and training services. But it also entails tailoring the product to the user’s requirements and taking care of maintenance. Mandrakesoft is not responsible for the physical installation of its products – this is the role of the clients’ IT teams or by outside service providers. Service quality is crucial to mounting a credible offer: gone are the days when companies decided to switch system based purely on price criteria. Proof of this is Microsoft’s failure so far to halt the growth of Linux by cutting the price of its licenses to levels approaching the TCO – or total cost of ownership – of its rival, which remains lower. **So although cost remains a key element, other, more dynamic factors are now coming into play: reliability, software stability, security (no viruses) and a desire not to be dependent on a single publisher all influence the decision making process.**

Growth in company contracts (large accounts)

Period	Length	Companies	Total value (€)
H1 2002/2003	6 months	Total, CEA, regional government of Lower Normandy	60,000
H2 2002/2003	6 months	Total, CEA	24,000
H1 2003/2004	6 months	Total, Ministry of Culture, Ministry of Equipment, Academy of Toulouse, The government of the Basque region	192,000
H2 2003/2004	2 months	Total, Ministry of Culture, Ministry of Equipment, Ministry of Agriculture, Mercury	332,000

Source: company

Two conclusions can be drawn from the above table:

- Clients are not afraid to make Mandrakesoft a longer-term supplier, proof that they are satisfied with the service offered
- The company's solid reputation with the public sector is spreading fast.

The use of a pared down sales team to target government departments began relatively recently. This and the fact that contracts with a ministry normally take between six months and a year to sign explain why the actual speed of the growth is not yet matching the potential of the public sector.

Several governments have already embraced Linux solutions. The French government recently announced its intention to cut back on IT spending, pointing out that a core element of the strategy could be the use of open source software both in infrastructures and applications (Mandrakesoft being absent from the latter domain so far). A government source quoted in the French daily, Le Monde (21.06.04), declared that open source software providers are "today offering highly credible solutions, particularly in terms of security, but also in terms of price and functionality". It was added that the plan could generate savings up to €300m and that the overhaul would not just concern operating systems but could extend to web navigators and e-mail software.

Such a shift clearly favours a company like Mandrakesoft, provided it has the means to exploit the increased demand. Crucial in this respect are the reinforcement of sales teams and ensuring that in-house expertise keeps pace with the steady 'upgrading' of contracts. Given the continuing precarity of the financial situation, a cautious approach is essential, but Mandrakesoft is now armed with a growing list of high-profile references and negotiating experience, particularly with public bodies, and we think the company can take full advantage of existing potential.

Financial health remains weak

At 30 September 2003, shareholder equity was negative at -€5.8m for a net financial debt of €0.47m. On 15 April of this year, the exercise of subscription warrants attributed on 27 May 2002 led to the creation of 1,086,915 new shares with an issuing price of €2.1. The **operation brought in €2.3m**, lifting shareholder equity to -€3.5m. The exercise of the warrants was made possible by the **decision of the Paris Trade Tribunal on 30 March 2004 to lift the Chapter 11-style status** and authorise the company to continue trading. The plan includes €3.3m in interest-free repayments of outstanding debt spread over nine years.

The unaudited first half accounts (ending 31 March) for the FY 2003/2004 revealed for the first time an operating profit of €0.21m (up from -€1.27m, equivalent to an 8.3% margin) and a net profit of €0.31m (versus -€1.23m). This solid performance is due both to the 20% rise in sales from €2.1m to €2.52m **and the strengthening of the gross margin to 84% of sales versus 74% in H1 2002/2003.**

This marked improvement in the margin has come about thanks to the relative decline in distribution of over-the-counter sales in stores, where the distributor's cut weakens margins and a parallel rise in higher-margin sales generated by club subscribers, licence sales to OEMs and direct sales from the Mandrakestore web site.

Estimates								
€ millions	09/2003	% sales	09/2004e	% sales	09/2005e	% sales	09/2006e	% sales
Services	0.411	10.5%	0.65	13.1%	1.20	18.4%	1.70	21.5%
E-commerce	1.064	27.3%	1.20	24.1%	1.35	20.7%	1.50	19.0%
Distribution (retail)	0.901	23.1%	1.00	20.1%	1.10	16.9%	1.20	15.2%
Licences	0.751	19.3%	0.90	18.1%	1.00	15.4%	1.15	14.5%
Club	0.774	19.8%	1.22	24.6%	1.863	28.6%	2.363	29.8%
Sales	3.901	100.0%	4.97	100.0%	6.513	100.0%	7.913	100.0%
Gross margin	75.4%		77.5%		77.6%		77.2%	
Operating profit	-2.167	ns	0.284	5.7%	1.107	17.0%	1.726	21.8%
Attrib. net profit	-2.027		0.828 (1)		1.146		1.755	

Source: company, KBC Securities estimates

(1) including exceptional items of €0.5m

We think the gross margin will receive a boost from strong growth in services and in the number of subscribers to the users' club (we estimate an average of 22,500 individual subscribers paying €90 in 2005/06). In the three years covered by our projections, we have not included taxes, since the company can implement tax-loss carry forwards worth around €25m, which would create tax savings of €8m.

According to the company, available cash currently stands at around €3m, a little more than the sum obtained from the exercise of the subscription warrants, demonstrating that Mandrakesoft has generated cash since the end of the previous FY. Under the terms of the recovery plan, outstanding liabilities of €3.3m will be paid off over a nine-year period.

Excluding all other operations, the capital increase and our targeted earnings for the current FY should enable slightly positive shareholder equity at the end of the 2005/06 fiscal year.

Risks

Mandrakesoft is currently at the centre of a number of legal disputes. The most important is with the US communication group Hearst concerning the use of the name Mandrake. For printed material at least, Hearst owns the rights to this name for its character Mandrake the magician, and in particular for its brand of the same name. The wrangle prompted Mandrakesoft to set aside a provision of \$0.8m (originally set at €0.855m and unchanged despite euro appreciation).

The company has said that a €1m exceptional gain is possible in the coming months, thanks in particular to a writeback of provisions that are no longer required. These elements have not been integrated into our forecasts. Elsewhere, and despite the denials of the French government, the new European directive covering software patentability could be seen as bad news over the longer term insofar as Mandrakesoft's products integrate numerous functionalities.

Outlook

There can now be no doubt that open source software is here to stay. Companies and administrations are increasingly turning to these solutions both for the cost advantages and the enhanced IT security that they offer.

The challenge for Mandrakesoft must therefore be to harness the growing demand and raise its profile with these potential clients. The company already has a solid reputation with around 5 million individual users, but only the accumulation of more references will enable it to capitalise on the breakthrough with private companies and government departments. In order to achieve this, Mandrakesoft must be capable of responding appropriately to the increasingly complex problems that will arise – and the only way to ensure this is by expanding the skills base. Acquisitions are one way to boost in-house expertise rapidly, but the company's financial weakness renders this difficult, leaving a capital increase as the only realistic solution.

Conclusion

Nobody today disputes that Linux now offers one of the most credible solutions on the market: Microsoft's frantic efforts to mount a counter attack merely serve to highlight the success of open source software. For Mandrakesoft, the priority now is to pursue the development of the private user base via higher-margin sales based on downloading and raise the company's profile in industry and commerce. This campaign has got off to a good start but needs more resources for success to be assured.

At present, Linux specialists with international reach are rare and listed players even more so. Red Hat is a strong player, whose capitalisation (\$4bn, i.e 32x sales and P/E 185) benefits from Microsoft-style dominance on the Linux market with its corporate clients, and no doubt from the very small number of players listed on a regulated market. But Mandrakesoft can mount a credible opposition providing the means can be found to consolidate its development in the corporate world.

A comparison with Red Hat is not particularly useful however: we feel that the difficult period traversed by Mandrakesoft (due largely to misguided investors advice recommending the recruitment of a management team whose efficiency was inversely proportional to its cost) has skewed the competition between the two companies. Moreover, one has a NASDAQ listing and is followed by around 15 brokers; the other is listed on the Marché Libre at Euronext Paris with so far fairly low-key interest from financial analysts.

This is why we have favoured the DCF method to determine our target price and value the company. Note that our terminal value accounts for around 66% of the valuation, compared to 80% on average in the calculation methods commonly used to value Red Hat. The core assumptions are: average annual growth of 18% over the 2004 /2010 period, a discount rate of 12.3%, an operating margin capable of reaching 30% in the longer term, debt of €0.3m and potential tax savings of €8m.

We cannot deny that Mandrakesoft's fragile finances add a degree of speculative risk for investors. At the same time, we feel that the company's solid reputation and steady accumulation of new references on a market offering high growth potential represent very real strengths that should not be ignored. We are initiating our coverage of the stock with an 'outperformance' rating and a target price of €7.

Jacques Falzon
+33 1 53 05 35 51
j.falzon@kbcsecurities.fr

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Brussels
+32 2 417 44 04

London
+44 20 7283 9666

New York
+1 212 489 20 40

Paris
+33 1 53 05 35 55