

Macro 4 (MAO)



Macro 4 is a software company in transition. New developments in 2006 should help to resolve shareholders' apparent dilemma: is it a growth tiger or a cash cow? Management is clearly focussed on the former. Its risk is that a third party will finish the task of value creation that it has started.

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I certify that this report represents my own opinions.

Andy Hartwill
Analyst
0870 080 2965
andy@objectivecapital.co.uk

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Key Points

Macro 4 is a software company in transition: from the 1980s rental of productivity enhancements for IBM operating systems to 21st century web-based utilities and document handling. It is a path potentially from cash cow to rising star.

The prize for shareholders would be valuation as a growth company and/ or a trade sale to release some of the value. The risk for management is that a third party attempts to realise its ambition more quickly.

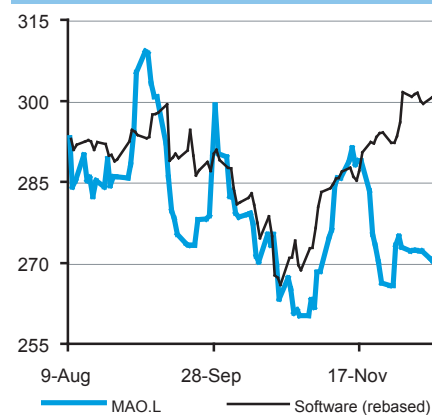
Forecast table

YE June	EBITDA (£m)	PTP (£m)	EPS (fd)	DPS (p)	EV/ EBITDA (x)	PER (x)	DY (net %)
2004a	4.1	1.0	1.9	6.5	11.6	143.9	2.4
2005a	4.6	0.8	2.9	7.0	10.6	94.3	2.6
2006e	4.9	2.1	6.9	8.2	9.9	39.9	3.0
2007e	5.6	2.8	9.0	9.1	8.8	30.5	3.3
2008e	6.8	4.4	13.8	10.0	7.4	19.8	3.7

KEY POINTS

- **Our valuation suggests that Macro 4 is around fair value.** Cost savings and tight working capital control appear to have been recognised as have the perceived organic growth opportunities. Following recent presentations the market is aware of new products to be announced in 2006 and of opportunities for further synergies between SMP and BIL, its two operating units. However we do not expect any significant change in perception, and therefore the share price, until newsflow demonstrates the success of management strategy in raising growth expectations further. We believe that could start at the end of 1Q 2006. Until then investors are likely to remain torn between perceptions of Macro the “growth tiger” and Macro 4 the “cash cow”.
- **2004/ 5 results showed creditable growth.** Both of Macro 4’s operating divisions, SMP and BIL, recorded growth rates of over 30% for License Sales in market conditions described as “difficult”. We do not expect market conditions to ease in 2006 but Macro 4’s strategy of developing new products and new markets should see creditable progress again this year. Significantly, the decline in SMP revenues is expected to be arrested.
- **Meanwhile Macro 4 continues to generate cash,** has significant freehold property interests (not recently re-valued) and substantial unclassified operating costs. We estimate currently some £14m of net cash and freehold interests (some £23m by the end of 2007) against a market cap today of around £60m. Such numbers may act as shark bait around a company wrestling with its perception among long-term growth investors.
- **Management believes that there is further opportunity to develop the individual identity of each of the operating divisions.** However it is keen to point out that the process of “divisionalisation” does not necessarily have as its conclusion the establishment of legally separable entities.

Price chart - MAO.L



Our valuation

Entity value:	£66.0m
Value per share:	265p

Company details

Quote	London Main Market
Constituent of:	FTSE Fledgling techMark100
Ticker	MAO
Hi-Lo last 12-mos. (p)	305.5 - 175.0
Shares issued (m)	21.7
Market Cap'n (£m)	59.4
Management ownership (%)	4.0
- fully diluted (%)	7.6
Stockbroker:	KBC Peel Hunt Ltd
Financial PR:	Citigate Dewe Rogerson www.citigatedr.co.uk

Website: www.Macro4.com

Analyst:

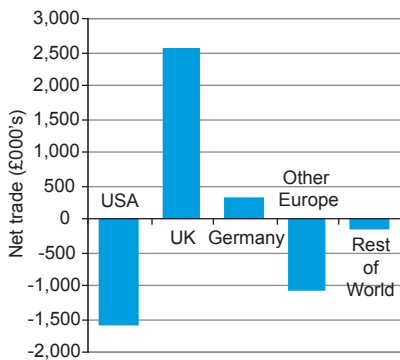
Andy Hartwill
Company Analysis & Head of Research
andy@objectivecapital.co.uk

Overview

Macro 4 develops and sells systems' software solutions.

It has two operating divisions, Systems Management Products (SMP) and Business Information Logistics (BIL). The company is in the advanced stages of reinforcing the divisional structure although the process does not necessarily have as its end point two legally separable entities. SMP products have historically been associated with the IBM mainframe markets although 2006 should see it launch into web-based application tools across a variety of platforms. BIL has evolved from Macro 4's original business mix and now focuses on document and information handling software.

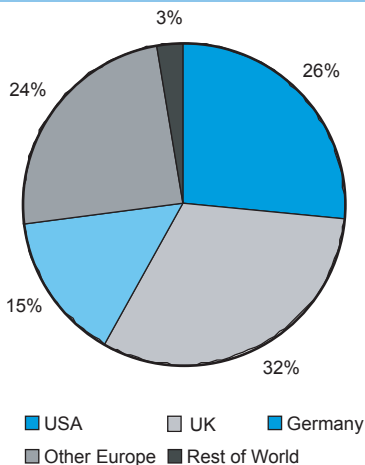
Macro 4's Net Currency Exposure



Geographically diverse, naturally hedged.

Although Macro 4 is headquartered in England, only 24% of 2005 turnover (by destination) arose in the UK. 32% arose in the USA and 27% in Europe outside Germany (14%). Currency sensitivity however is moderated by Macro 4's origination of product outside the UK. In 2005, products originating in the UK represented 32% of turnover, with 26% originating in the USA and 25% in Other Europe. The net trade balance shows the UK as a net exporter i.e., that Macro 4's P&L would be expected modestly to benefit from weaker sterling – especially against the USD. Note that our estimates have assumed similar exchange rates as those prevailing in 2004/5.

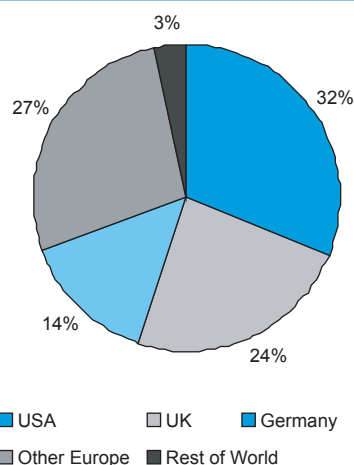
Turnover by Origin



Macro 4 has evolved from its dependency on IBM mainframes.

Macro 4's product range has evolved from productivity tools for IBM mainframes to encompass now systems management and business information. In 2006 SMP is scheduled to launch a series of initiatives to allow its product range to be accessed over the Internet via its Web User Interface (WUI pronounced "Wooi"). BIL is the newer of the two divisions but, on our estimates, should represent over 50% of group turnover this year. We estimate over 11% pa of new sales growth over the next three years.

Turnover by Destination



But investors appear uncertain as to the nature of the beast.

The wide swings in the recent share price suggest that investors have yet to discount fully the growth ambitions articulated by the management. It first broke above the 260p level in February of this year and has since swung between that level and 305.5p. Management frustration at that behaviour is understandable. But so too is the behaviour of investors if, as we believe, they are uncertain as to the nature of the beast. Is Macro 4 a cash cow with some interesting growth characteristics or, as the management believes, a growth tiger with strong cashflows?

License sales show growth potential even in difficult conditions.

The global economic cycle is entering a more difficult phase. Macro 4's major markets (the USA, UK and EU) are all expected to show lower overall economic activity in 2006. In addition is the relatively new phenomenon of the corporate sector

building up cash reserves – in the USA largely to fund raised dividend payments following the tax cuts introduced two years ago. Indeed, recent estimates suggest that US corporations have transformed their balance sheets over the last three years so that a fiscal deficit of some 1.2% of GDP has become a 1.7% surplus. In other words almost 3% of US GDP has gone to net saving – rather than on capex and other investment.

Against that background the 30% gains in License Sales from both SMP and BIL in 2005 represent strong results. Given that License Sales represent some 33% directly of total Macro 4 turnover and drive a further £7.5m (23%) through Maintenance revenues (excluding SMP legacy business; OC estimate), the results encourage the expectations of growth investors. We estimate that License Sales and associated maintenance revenues will represent some 67% of total revenues in 2007

SMP: arguably the greatest transition.

SMP (Systems Management Products) has arguably developed furthest from Macro 4's origins (BIL products and services effectively did not exist at the outset). Today it offers a family of products covering, amongst other areas, fault diagnosis, data manipulation and interactive testing.

Several of the products have been designed to tackle head-on the equivalent offerings from Compuware, its major competitor, and Macro 4 believes that it is the only company to have such a comprehensive and mutually compatible offering.

Future expansion is based on several strands. Albeit belatedly, SMP is now aggressively pursuing its existing customer base encouraging users of only one product to migrate up the path towards two or more. In addition, 2006 is scheduled to see it roll-out its Java-based WUIs allowing the products to be accessed by companies whose critical data applications have been written in some of the older programming languages such as COBOL.

Even to the extent that SMP supplies the IBM mainframe market, developments there have been encouraging. Since the lows of 2000, the volume and value of IBM mainframe shipments annually has risen steadily from a little over 1000 units and US\$2bn respectively to almost 3000 units and US\$4bn in 2004.

BIL: perceived growth characteristics

BIL (Business Information Logistics) grew organically out of Macro 4's history. Macro 4 has, over recent years, been establishing increasingly separate divisional identities for each of SMP and BIL. The process has included the reclassification of business lines between the two divisions the last significant one of which took place in July 2004.

BIL's business segment has been likened to an electronic Federal Express: it ensures the safe delivery of "business-critical" documents and information from and to a variety of devices. In the process BIL has developed expertise in optimizing business systems, e.g. the use of printers and in the use of internet-based customer access to critical company data and processes e.g. online ordering and checking the status of deliveries. Significant customers for Macro 4 include B&Q, Barclays Bank, Bayer and BMW.

Technically BIL is described as operating in significant areas of "content centric communications" (see graphic on page 16) : one of these is the DOM market (Document Output Management). A 2002 Gartner report highlighted Macro 4 as a "Leader" in that space and the Yankee Group estimated (in November 2003) that the DOM market was worth some US\$4.9bn in 2002 and projected a value of US\$13.3bn in 2007.

Future geographic opportunities.

SMP and BIL have traditionally operated in the USA/ UK and Continental Europe respectively. One of the objectives of the divisionalisation process is for each to help the other in developing sales in their geographic market. The company argues that such sales would be complementary allowing the sales force of one to provide qualified leads to the sales force of the other. Further out, and almost literally, are the plans to develop Macro 4's presence in the Far East, specifically Asia/ Pacific ex Japan (APEJ)

Competition is large; Macro 4 is nimble

SMP's major competitor, and thus of significance for Macro 4 overall, is Compuware. Evidently there is a significant difference in scale: Compuware generates total revenues in excess of US\$1bn annually against Macro 4's £33m in 2005. Compuware generated US\$68m from Software Licenses in Q1 alone; Macro 4 generated £6m in the full year.

Macro 4's only logical response is to be nimble and responsive to customer demands. Hence its contiguous product family at SMP and the cross-fertilisation between SMP and BIL. The difference in scale means also that, while it persists, Compuware may be content to tolerate Macro 4's existence. One of the threats presumably would be in Macro 4's success: if it became sufficient of an irritant Compuware, or others, may decide to take it out. But that is another story.

Macro 4's legendary cashflow – a double-edged sword.

Macro 4 enjoys a reputation for good cashflow. But that is a double-edged sword which may cut to the heart of investor uncertainty as to the nature of the beast. On the one hand cash generation and growth company status are usually strange bed-fellows. On the other hand strong cashflow and net assets can make an attractive combination for certain investors.

On the best of interpretations, Macro 4 has got it all: cashflow and growth. In 2005 net cash rose to £6.0m from £2.3m. That was after paying capex of (only) £1.1m, up from £600,000. On our forecasts net cash could rise again this year to some £10m. Those forecasts recognise that there is little opportunity left to improve further Macro 4's divisional operating cost efficiencies. Consider also that freehold land and property stood at almost £8m at the end of 2005 and that the HQ buildings were last revalued several years ago.

The credentials for Macro 4 as a growth company are easily seen in the 30% growth rates achieved in License sales. Both SMP and BIL operated in difficult conditions. As they improve, and we expect at least the US\$ to strengthen over 2006, so the volume growth achievements should begin to show more clearly. On our estimates BIL revenues should grow by some 12% pa to the end of 2007. Even SMP can demonstrate growth characteristics in the 10% annual growth that we expect from License Sales between the end of FY2004/5 and FY2006/7.

But on the worst of interpretations, Macro 4 is neither one thing nor the other as seen currently by shareholders. Only time and results will resolve the dilemma for shareholders. 2006 will be (another) critical year. We expect that newsflow should begin to highlight the growth characteristics from around the end of the first calendar quarter with early developments from SMP's launch into web-based applications. Until then shareholders may have to contend with sideways trading.

Valuation

Our valuation model reflects the current dilemma that appears to be facing investors: is Macro 4 a cash cow or a growth tiger? The key points, we believe, of investor focus are:

The nature of the beast. Investors appear uncertain: is Macro 4 a cash cow or a growth tiger? Until that dilemma is resolved we believe that the share price will not make significant progress outside the 260p/ 305.5p range in which it has traded for the best part of this year

The success of new products and new markets. The company's growth strategy is predicated in part on the launch of new web-based products at SMP and geographic cross-fertilisation between SMP and BIL i.e. each helping the other to sell in their own back yard. BIL has its own programme of product development.

The impact of continuing difficult trading conditions. Macro 4's major geographic markets are all expected to suffer a slowdown in economic activity in 2006.

Macro 4's ability to retain its competitive advantage. Macro 4's inherent attributes of flexibility and speed of response to customer needs are essential elements of its competitive advantage. Despite its aggressive cost-cutting, Macro 4's larger, better resourced, competitors may be better able to withstand any further downturn.

Our valuation model assumes that:

- SMP revenue decline slows further as License Sales growth offsets the decline in legacy rental business. In turn that assumes no decline in IBM mainframe shipments, progress in increasing the number of products taken by existing customers, progress in developing SMP sales in Continental Europe and limited initial impact from web-based initiatives. We also expect further strength in the US\$ which should translate into a net positive effect. Overall we expect some 10% growth in License Sales.
- BIL revenues grow at some 12%pa. That is a slowdown over the 19% recorded in 2005 but reflects the inherent uncertainty and consequent "lumpiness" in winning large contracts. It assumes also that there is further progress in developing sales outside its Continental European and UK back yard.
- There is little room further to improve the operating efficiency at divisional level. Significant savings have already been made especially in the management of working capital. We have assumed some easing of that control as a response to probably difficult market conditions and despite Macro 4's effective early warning systems.

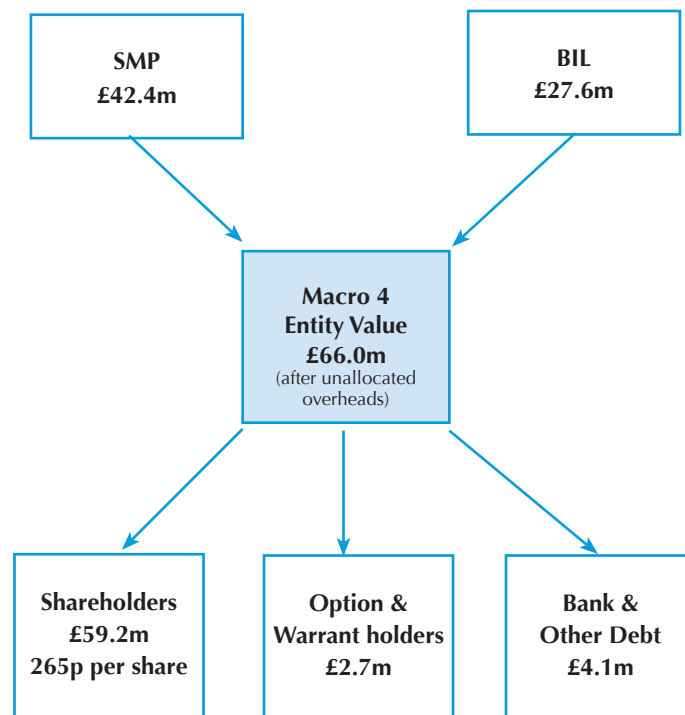
We have not recognised any benefit that may come from rationalisation of Macro 4's property assets or the ability to accelerate BIL through suitable acquisitions.

Valuation Summary (£m)

SMP	42.4
BIL	27.6
Less: Unallocated overhead, capex & WC	14.0
Total Expected Operating Value	56.0
Add: Listed Investments	0.0
Add: Unlisted Investments	0.0
Add: Tax Benefits	0.0
Add: Cash	10.0
Less: Distributions	0.0
Total enterprise value	66.0
Less: Bank & Other Debt	4.1
Less: Traded Debt	0.0
Less: Convertible Debt	0.0
Less: Minorities	0.0
Total Value for Equity Claims	61.9
Less: Warrants + Options	2.7
Value Attributable to Equity Holders	59.2
Ousting Shares (m)*	22.3
Value per share (£)	2.65

* including allowance for EDSIP shares

Components of Macro 4's Entity Value



Where Management is Adding Value

	Existing Performance (m)	Projected Value Enhancement (m)	Total Value (m)	Comment
Macro 4 Expected Operating Value £56.0m				
SMP	£31.6	£10.8	£42.4	Running hard to stand still
BIL	£7.7	£19.9	£27.6	Opportunity to add significant value
Less: Unallocated overheads & WC	-£15.0	£0.9	-£14.1	Limited scope to enhance value by cost savings
Total	£24.3	£31.6	£56	

Alternative views – non-central possibilities

1. Strategic step change:

- Macro 4 succeeds in achieving a step change through:
- success with EDS supporting BIL in gaining significant market presence
 - SMP's WUI products driving faster and broader uptake

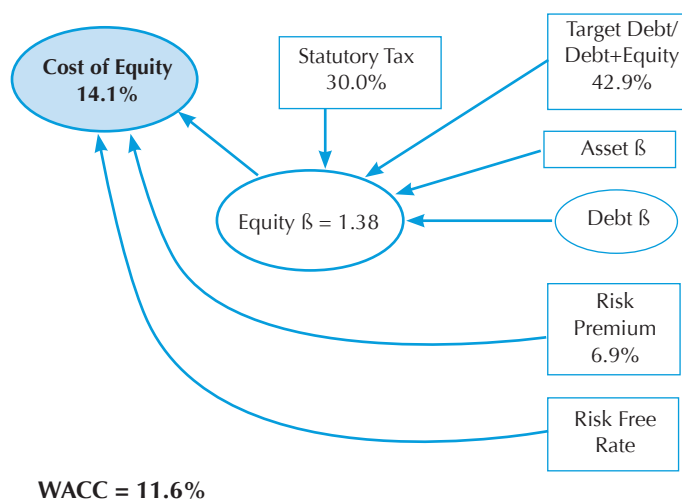
Change in earnings power	-10%	-5%	Base	5%	10%
Value ps (£)	2.43	2.54	2.65	2.76	2.87

2. A predator's view:

A third party may believe they can release value by rationalising excess property assets and corporate restructuring:

Value	£m
Existing valuation	61.9
Add:	
Capitalise overhead savings	15.0
Realisable excess property	4.0
Total Value	80.9
Value per share (£)	3.25

Weighted Cost of Capital



Key Risks

Failure of the growth strategy. Evidently any growth strategy has the attendant risk of failure, if only in terms of market perception. Macro 4's native risk aversion suggests that those may be mitigated. Selling existing products into markets already developed by a sister division is a relatively low-risk route to new growth. So too is generating growth from existing customers by encouraging them to take two or more products where previously they have taken only one. But investors may attach especial significance to the SMP "WUI" launches next year as tokens of Macro 4's "growth-tiger" potential. Management clearly believes in the growth outcome which, as delivered, could drive the share price significantly in excess of 300p. But the market appears to be pricing a degree still of risk aversion, more often associated with a focus on cashflow and net (tangible) assets.

The impact of continuing difficult trading conditions. Macro 4's major markets are widely expected to suffer a slowdown in economic activity in 2006 with signs that corporates, especially in the USA, are accumulating cash at the expense of capex budgets. Recent estimates suggest that US corporations have transformed their balance sheets over the last three years so that a fiscal deficit of some 1.2% of GDP has become a 1.7% surplus. In other words almost 3% of US GDP has gone to net saving – rather than on capex and other investment. Macro 4's inherent attributes of flexibility and speed of response to customer needs are essential elements of its competitive advantage. Despite its aggressive cost-cutting, Macro 4's larger, better resourced, competitors may be better able to withstand any further downturn.

Limited room to manoeuvre on costs. Macro 4 has already taken out significant overhead costs and working capital requirements but further progress is likely to be limited - working capital measures may even ease. For example, on some measures, debtor days fell below 30 in 2004/5. That is, in our opinion, unlikely to be sustainable (try cracking the whip at B&Q or Bayer) as Macro 4 itself acknowledges.

Unwelcome attention from competitors. For as long as the size difference between Macro 4 and its (much) larger competitors remains significant then they are likely to tolerate its existence. But, as Macro 4 grows and, as it already can demonstrate, at the expense of others then they may take a more unhealthy interest. That interest could come either in the form of a war of attrition or in corporate action.

The ultimate risk may be to management. For as long as market perception remains uncertain as to the nature of the beast, Macro 4's cash and freehold interests are likely to attract unwelcome attention from competitors or from other corporates. We have estimated up to £23m in 2007 of net cash and freehold property against the £60m market cap currently.

Macro 4

Macro 4 began its life on the London stockmarket almost twenty years ago. The business proposition then was rather simple but unusual. It developed software to improve the performance of IBM operating systems. It then distributed to potential customers on a time-limited free-trial basis. To keep the product the user had to sign a rental agreement to get an authorisation code. Without the code, the product effectively destroyed itself.

In the late 1990s most of the previous management was replaced by the existing team. But plans to redirect the company were blown off course first by the bursting of the "Y2K" bubble, then by the tech crash of 2000 and finally by the events of "9/11" in 2001. Only recently have some of the changes become effective and with those a return to profitability. The sharp falls in the share price which began in March 2000 (at £14.32) were arrested in April 2003 (41.5p). Since then there has been a more or less steady recovery.

Today Macro 4 addresses very different markets from those in the 1980s both geographically and by product type. It does so through two operating divisions, SMP and BIL. The following pages describe each in more detail.

Macro 4's major shareholders

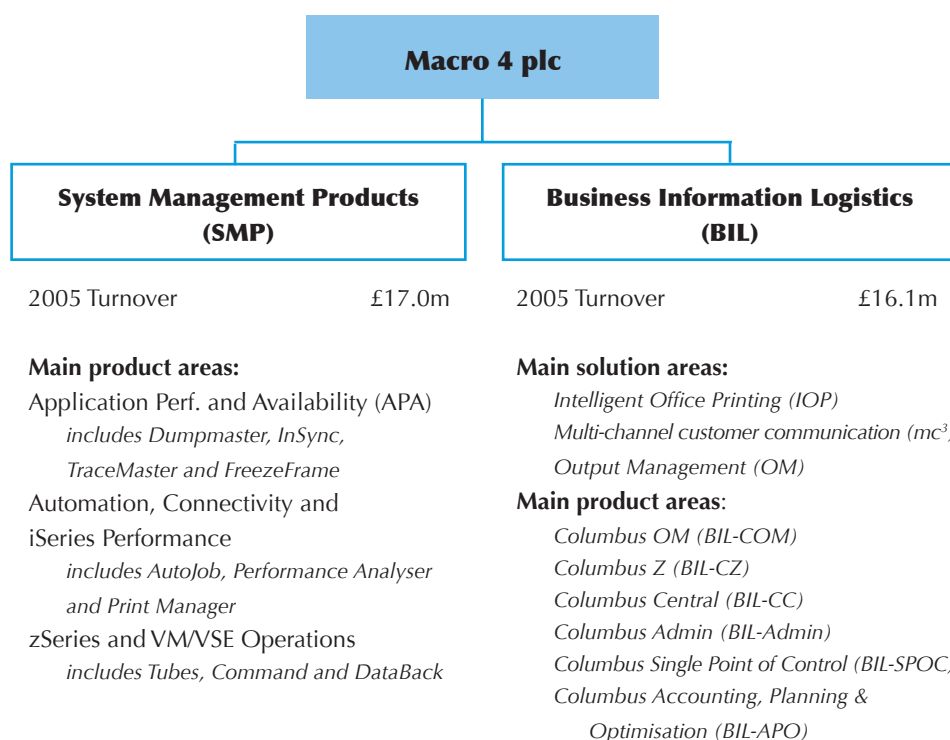
	% holding
Aberforth Partners	23.4%
Schroder Investment Mgmt	8.5%
Framlington Investment Mgmt	8.4%
Morley Fund Mgmt	7.7%
Willbro Nominees Limited ¹	5.9%
K E Piper ²	3.6%
M & G Investment Mgmt	3.4%
Mourant & Co Limited ³	3.3%
Barclays Global Investors	2.7%
Aerion Fund Mgmt	2.1%
Lehman Brothers (SL)	2.1%
Gartmore Investment Mgmt	2.0%
NFU Mutual	1.9%
Barclays Private Banking	1.7%
Marlborough Fund Managers	1.6%

¹ On behalf of Mr Macmillan, a founder of the Company

² former director

³ EDSIP scheme

Macro 4's corporate structure



Systems Management Products (SMP)

SMP's product base has evolved from the now declining "legacy" business of writing software to improve the performance of older IBM operating systems such as VM and VSE. Nor does its business model now centre on the rental of products.

Today the SMP division sells products across a variety of platforms to a customer base that extends from companies such as BASF via HSBC to Tesco. In the 2005 accounts the division represented over 50% of group revenue with some 50% of that arising in the USA.

Its product offerings address three broad areas: Application Performance and Availability (APA) for IBM's z/OS, Automation, Connectivity and iSeries Performance and zSeries and VM/VSE Operations.

APA products assist the development and testing of mainframe applications software allowing new applications to be delivered more quickly and efficiently. The APA product suite includes Dumpmaster, InSync, TraceMaster and FreezeFrame.

iSeries products, such as AutoJob, Performance Analyser and Print Manager, provide automated operations, connectivity and performance management tools for the IBM iSeries environment.

zSeries and VM/VSE products constitute a range of mainframe tools for the MVS, VM and VSE environments including session management, file handling and data integrity. The range includes products such as Tubes, Command and DataBack.

It is in the APA suite that SMP has launched its first foray into the arena of web-based applications. It already has M4Explorer, its WUI (Web User Interface) for TraceMaster with one scheduled next for DumpMaster followed by the other members of the APA suite in due course. Essentially the WUI makes more available the APA product range to programmers more familiar with some of the older, higher level programming languages such as COBOL. Note that SMP has been able to call upon the core of Java expertise within BIL to develop the WUI application.

Macro 4 has over 1,000 customers for DumpMaster. If say 10% adopted the WUI we estimate an uplift to SMP's turnover of between £0.5m to £1.0m.

Macro 4 recognises Compuware (CW) as the major player in their product space and, in 1999, acquired InSync and TraceMaster to develop further its competitive response to CW. Macro 4's DumpMaster, InSync, TraceMaster and FreezeFrame are designed to replace Compuware's Abend-Aid, File-Aid, Expeditor and Strobe respectively. The integrated nature of M4's product offerings against CW allows it now more aggressively to "farm" its existing customer base (and convert that of CW) encouraging migration to two or more products.

Elsewhere within the Macro 4 product suite, IBM's introduction of the "zSeries" operating system in 2004 appears to have provided opportunities both for its competitors and suppliers. At the time of introduction it announced that it would be dropping customer support for its earlier operating system (OS/390 v2.1) and was "encouraging" customers to upgrade to z/OS v1.4). With an installed base valued in billions of US\$ such an enforced upgrade path provided an obvious opportunity both for competitors and suppliers. At the same time, IBM itself has recognised the need to encourage third party suppliers to augment its own offerings – including most recently the OEM contract awarded to Macro 4.

Dynamics of SMP's Market

SMP's business model is necessarily predicated on the market characteristics of the IBM mainframe market. Estimates vary for the size of the IBM installed base of mainframes and of its growth rates. But rumours of its death appear to be premature. Gartner has estimated that, from a low point of around 1,100 units in 2000, the number of IBM mainframe shipments grew to almost 3,000 in 2005.

Many sources put the installed base of mainframes at between 10,000 and 20,000. And far from abrupt terminal decline IBM has made concerted efforts at least to slow the flow, occasionally reversing it altogether. The 2003 financial results showed a 33% surge in mainframe sales following the introduction of its "z990" mainframe (codenamed "T-Rex"!)). Total system sales in the year amounted to some US\$28.2bn, an increase of 11%. With operating system software estimated to rise to represent up to 40% of the hardware cost by 2006 (see below) the implications for the software market are significant.

But such growth as there may be in the mainframe market is the result of two strategies on the part of IBM: investment in new hardware and investment in porting (transferring) other software platforms onto its own hardware – at one time anathema to IBM. The "z990" was the result of an investment programme amounting to more than US\$1bn – hardly the response of a company planning for terminal decline.

At the same time IBM has modified a version of its VM operating system, called it the Integrated Facility for Linux, and is letting mainframe "Shops" install hundreds of thousands of virtual Linux "instances" on their machines. At US\$18,000 annually per Linux license, the solution is significantly cheaper than monthly tens or hundreds of thousands of dollars for MVS and z/OS operating systems. IBM itself suggests that Linux is now driving approximately 10% of overall mainframe sales – i.e., approximately US\$350m to US\$390m pa. Note that Macro 4 has been using Linux as an environment in which to develop its WUI applications.

Such data imply an IBM mainframe market for hardware with annual revenues approaching US\$4bn. Apart from possible surges on the introduction of new models,

SMP EBIT Forecast

£m		FY2004	FY2005	FY2006E	FY2007E	FY2008E
Recurring	Rental	4	3.4	3.1	2.8	2.5
	Maintenance	7.9	7.2	6.1	6.2	6.3
Total Recurring		11.9	10.6	9.1	9.0	8.8
New Business	License Sales	4.3	5.7	6.3	6.5	7.0
	Other	1.5	0.7	1.5	1.5	1.7
Total New Business		5.8	6.4	7.8	8.0	8.7
Total Revenue		17.7	17.0	16.9	17.0	17.5
Operating expenses						
Direct		7.3	7.4	7.6	7.6	7.4
Indirect		4.7	4.6	4.6	4.5	4.7
General		0.9	1.0	1.0	1.0	1.1
Total SMP OPEX		12.9	13.0	13.2	13.1	13.1
Amortisation		1.1	1.1	1.1	1.1	1.1
SMP EBIT		3.7	2.9	2.6	2.8	3.3

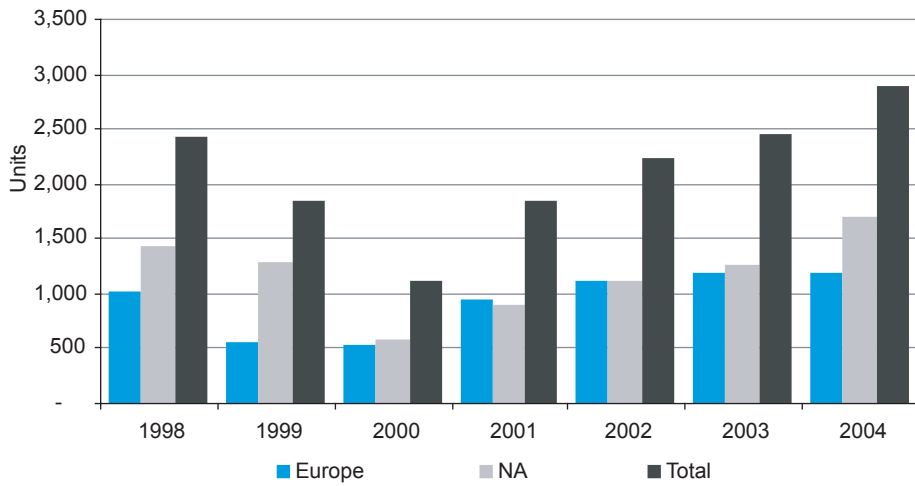
we assume single digit annual growth rates. The real growth rate however comes in the software component. Data and estimates produced by Gartner in mid-2003 suggest that operating system software represented some 6.5% of the CPU hardware cost in 1993. Since then hardware costs have fallen by over 90% to around US\$1,350 per MIPS (millions of instructions per second). But operating system software costs have fallen more slowly on the same measure so that they now represent some 40% of the CPU hardware cost.

So we have an estimate from IBM of a mainframe market for hardware with annual revenues approaching US\$4bn. We also have an estimate from Gartner that operating systems software will represent some 40% of the hardware cost in 2006. Conflating the two suggests a market for operating systems software of around US\$1.6bn annually. Gartner further estimates that, even enterprises with “no growth should probably budget for (up to) 5% growth if they plan to simply stay current on software”

Macro 4's share of that market, as measured through SMP revenues, registers a little over 2%. That may be regarded as of little more than irritant value to the dominant players who may be content to leave Macro 4 feeding from the scraps off the table.

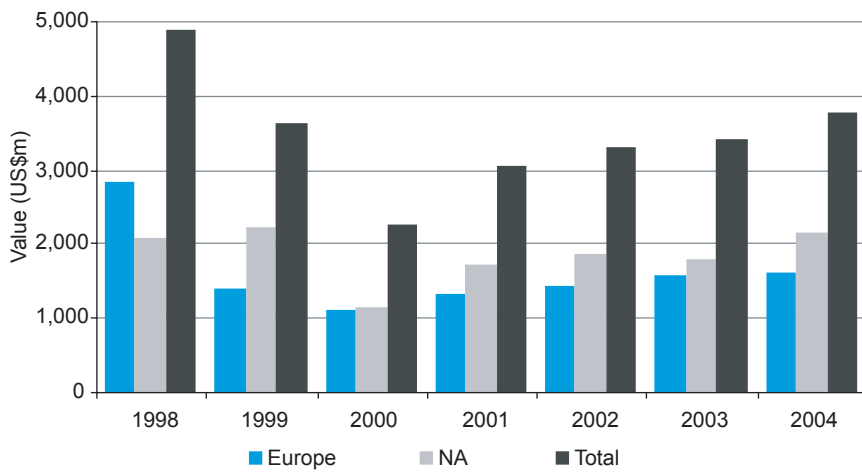
But if Macro 4 can truly develop the growth strategy at what is today widely perceived as a “cash cow” then two other fates open up. Either the oligarchs drop prices/ change practices to squeeze the minnow out of existence or one of them buys the more nimble model that SMP may represent. The likelihood of coordinated action between few, competing dominant players is, we believe, the lower probability outcome.

IBM mainframe shipments



Source: Gartner

Value of IBM mainframe shipments (US\$)



Source: Gartner

Business Information Logistics (BIL)

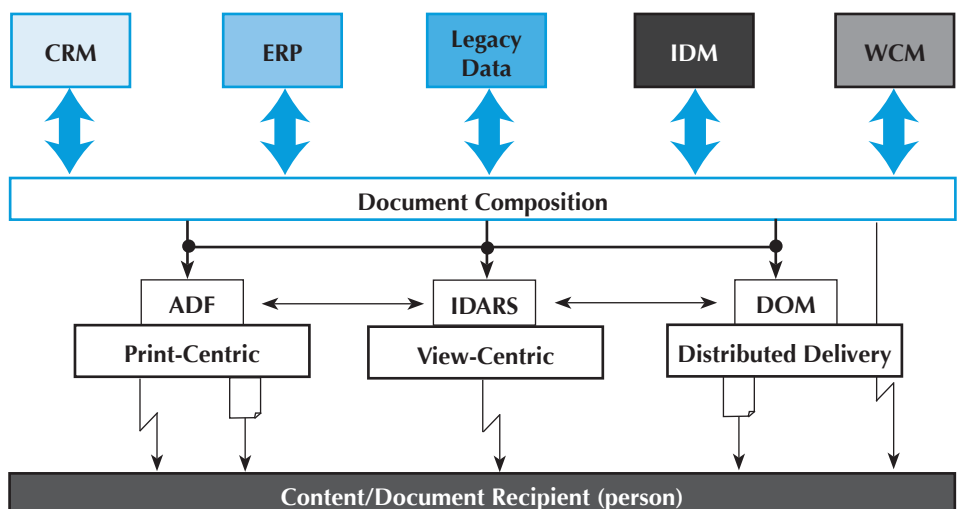
The BIL division has emerged over recent years as a result of organic growth within Macro 4's business mix and a deliberate policy of "divisionalisation" between its product lines and those of SMP. Various lines of business were reclassified under BIL, the last significant such move being effective in July 2004. It is widely perceived as the division with greater growth potential than SMP and we estimate that this year and beyond it will generate more than 50% of group turnover.

BIL provides document handling, transmission and archiving software some of whose services have been described to us as an electronic FedEx! Its range of solutions goes from Intelligent Office Printing through Print Management to Document Warehousing (DW) and Distribution. Its Columbus product suite offering it allows the user to capture documents, images and multimedia content and assures their delivery to multiple electronic & print delivery channels. Columbus Central provides the Business Process Management (BPM) which ties together Macro 4's DOM and IDARS (see below) solutions.

The market research/ consultancy organization InfoTrends/ CAP Ventures recently published estimates of market growth until 2008. It recognizes four broad areas of classification: software licenses; maintenance; professional services and hosted services. Its analysis suggests some 16% annual growth rate worldwide over the intervening period with professional services and hosted services leading the way.

BIL's target market is essentially that for improving the efficiency of data and document handling across corporate IT systems. It is a complex business segment but includes distributed output management (DOM) and integrated document archive and retrieval systems (IDARS). DOM and IDARS are two components of so-called content-centric communications. The purpose, as described by Gartner, is to deliver "the right information in the right format to the right audience at the right

Technologies for Content-Centric Communications



Key

ADF = automated document factory

DOM = distributed output management

IDARS = integrated document and archive retrieval system

IDM = integrated document management

CRM = customer relationship management

ERP = enterprise resource planning

WCM = web content management

Source: Gartner (May 2005)

time...". It is perceived to have widest application in consumer-oriented businesses such as banking, insurance and mobile telephony.

IDARS is described by Gartner as facilitating the least expensive way to deliver bills or statements by "pulling" customers to an archive to view them. DOM supports the automated creation and delivery of documents to printers, other output devices and email in PDF or HTML formats. In a 2003 report, Gartner estimated, that the printing budget for companies was typically some 1% to 3% of turnover. It further estimated that by adopting an appropriate intelligent office printing content-centric communications strategy, it was possible to achieve savings of between 10% and 30% of that budget i.e., 10bp to 90bp of margin enhancement.

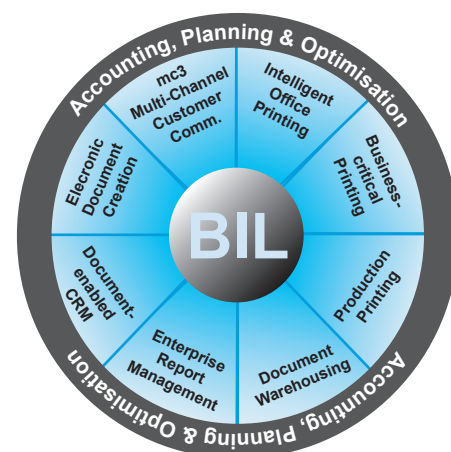
One opportunity for providers such as BIL, is that large companies tend to store critical information in hard copy and/ or electronically in mutually incompatible formats. Opportunities for significant cost savings can arise on mergers and acquisitions as formats are harmonised. Customer service can generally be improved by the use of such systems thus ensuring greater customer loyalty, especially where such service can be (or appear to be) tailored to specific customer requirements.

The graphic shown to the right illustrates the relationships between various elements of content-centric communications.

Assessing BIL's market position is a delicately qualitative task given the nature of the market place (fragmented but consolidating in parts) and the size of its operation compared to that of others. Certainly its developing relationships with XEROX and EDS Global Field Services (GFS) and its contract wins at Barclays and B&Q suggest a force to be reckoned with. Indeed the Gartner 2005 survey for its IDARS Magic Quadrant assessment places BIL (Macro4) among illustrious company including IBM, Computer Associates and Mobius. We note that the survey covers BIL's position in the ECM space. It says nothing of BIL's other focus area, Intelligent Office Printing.

The survey classifies companies according to their ability to execute and their "completeness of vision". Macro 4 scored highly among the "Visionaries" which, as Gartner defines the label, are those who "have strong vision but are limited in their ability to execute. They generally have good technology and market strategies but may not yet have the management team, financial strength, sales channels or partners to gain a significant market presence". Its entry specifically for Macro 4 says that it "provides IDARS and DOM solutions. Its Columbus DW customer base is predominately in the United Kingdom, but Macro 4 continues to work on expanding its geographic presence. Columbus DW has good transformation, multichannel delivery and repository scalability, as well as workflow capabilities. It is tightly integrated with the other products that form Macro4's (BIL) suite of solutions"

BIL's portfolio of products



Source: Macro 4

BIL EBIT Forecast

£m		FY2004	FY2005	FY2006e	FY2007e	FY2008e
Recurring	Rental	1.5	1.5	1.7	2.0	2.3
	Maintenance	5.6	6.0	6.5	7.0	7.7
Total Recurring		7.1	7.5	8.2	9.0	10.0
New Business	License Sales	4.3	5.5	6.2	7.0	7.8
	Other	2.1	3.1	3.5	4.0	4.4
Total New Business		6.4	8.6	9.7	11.0	12.2
Total Revenue		13.5	16.1	17.9	20.0	22.2
Operating expenses						
Direct		8.4	9.5	10.2	11.2	12.0
Indirect		4.9	4.9	5.2	5.6	6.0
General		1.0	1.1	1.4	1.6	1.8
Total BIL OPEX		14.3	15.5	16.8	18.4	19.8
Amortisation		1.6	1.6	1.7	1.7	1.7
BIL EBIT		-2.4	-1.0	-0.6	-0.1	0.7

We note the definition as including “limited in their ability to execute” and highlight that Macro 4’s rating on Ability to Execute is only a little lower than “Leaders” such as RSD and Systemware and than “Challengers” such as Hyland and EMC. Evidently Macro4 management is alive to the issue and that may form part of the background to the developing relationships with Xerox and EDS GFS to address the Gartner point that they “may not yet have ... sales channels or partners to gain a significant market presence”.

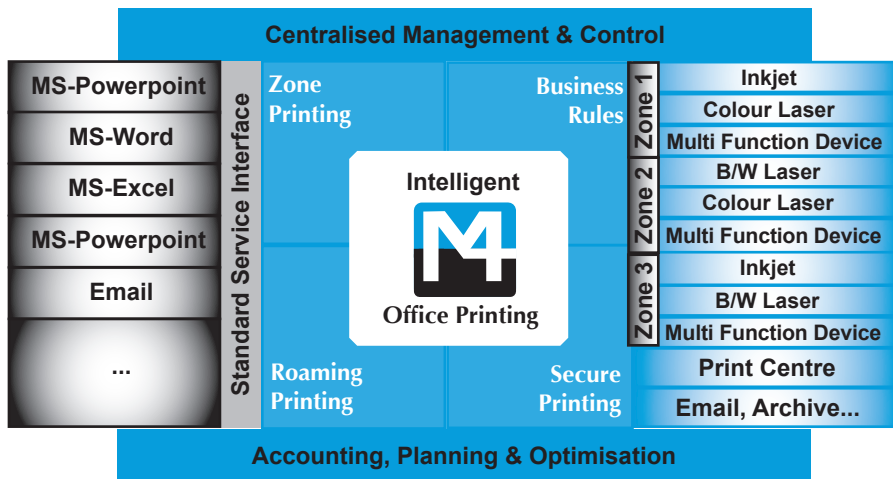
Significantly Gartner draws attention also to the continuing consolidation in the IDARS space. It believes that the process will continue and that by 2007 “IDARS will cease to be a stand-alone market and will become an integral component of an ECM (Enterprise Content Management) suite”. It notes also that IDARS vendors “are considering their position in (the) market” and that Quest Software and SER Solutions sold off their IDARS products to focus on their “core” businesses. It believes that market leadership “will remain with those vendors having strong established customer bases”.

That analysis suggests to us a number of possible evolutionary paths for BIL:

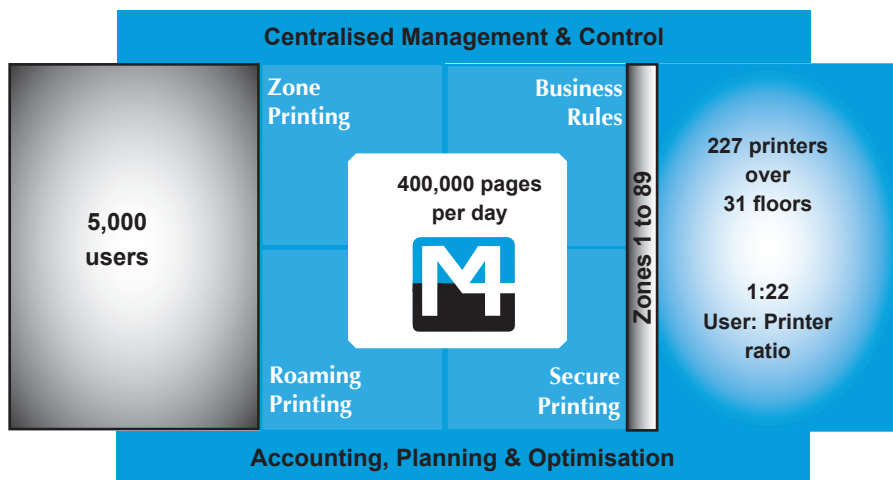
- that its third party distribution strategy proves sufficient to elevate its ranking to “Leader” in the consolidated IDARS space;
- that it further develops its full ECM capability (e.g., in the ADF space), of which IDARS becomes an integrated part;
- or that it exits the IDARS space via a trade sale.

By implication the retention strategies would include moves also to develop the geographic spread of BIL customers. Gartner noted the predominance of UK customers within the IDARS market. But BIL has some 1,100 customers worldwide and, in 2004/5 the UK generated only 39% of turnover with 19% from Germany and 11% from France. Presumably the non-UK markets have a significant element of DOM products.

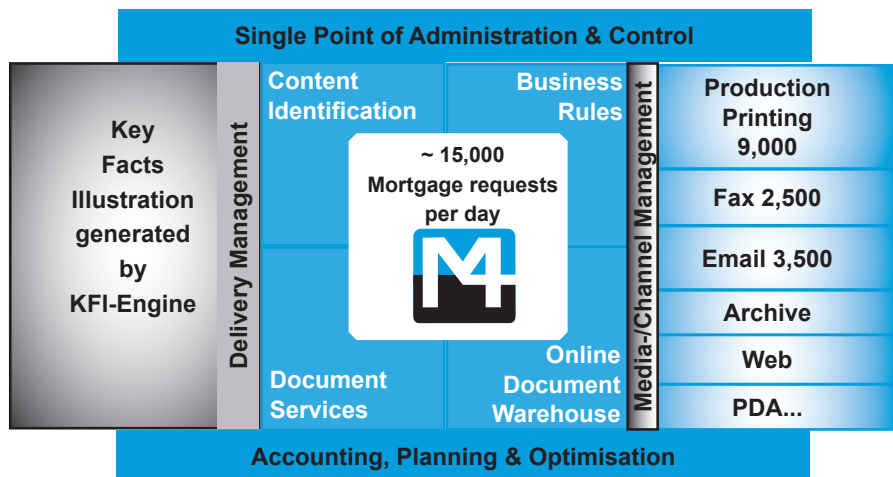
Model of the BIL system



Barclays Bank implementation



Northern Rock implementation



Source: Macro 4

Financials

Macro 4's Summary Profit and Loss

£m		FY2004	FY2005	FY2006E	FY2007E	FY2008E
Turnover	SMP	17.7	17.0	16.9	17.0	17.5
	BIL	13.5	16.1	17.9	20.0	22.2
Total T/O		31.2	33.1	34.8	37.0	39.7
Operating Expenses (pre-exc)						
Staff Costs	Development	3.7	3.9	4.1	4.3	4.5
	Sales & Marketing	6.1	6.4	6.7	7.1	7.4
	Support	2.9	2.8	2.9	3.1	3.2
	Gen & Admin	5.9	5.9	6.2	6.5	6.8
	Total Staff Costs	18.6	19.1	20.1	21.1	22.0
	<i>Staff as % T/O</i>	60%	58%	58%	57%	55%
	<i>Staff as % OPEX</i>	62%	61%	61%	61%	62%
Depreciation		1.0	1.0	1.1	1.2	1.2
Other		7.5	8.4	8.8	9.2	9.7
	<i>Other as % Total OPEX</i>	25%	27%	27%	27%	27%
Amortisation		2.7	2.7	2.8	2.8	2.8
OPEX (pre-exc)		29.8	31.2	32.8	34.3	35.7
EBITae		4.1	4.6	4.9	5.6	6.8
EBIT		1.4	1.9	2.1	2.8	4.0
EBITDA		5.1	5.6	6.0	6.8	8.0
Exceptionals		0.0	-1.1	0.0	0.0	0.0
Net Interest		-0.3	0.0	0.0	0.0	0.4
Pre-Tax		1.0	0.8	2.1	2.8	4.4
<i>Pre-tax; amort; net int</i>		3.8	4.6	4.9	5.4	6.3
Taxation						
UK: current (30%)		1.5	1.3	1.2	1.5	2.0
UK: double tax'n relief		-0.9	-0.5	-0.4	-0.4	-0.4
UK: sub-total		0.6	0.8	0.8	1.1	1.6
Other		0.0	-0.6	-0.3	-0.4	-0.4
Total tax charge		0.6	0.1	0.5	0.7	1.2
<i>Effective tax rate</i>		16%	22%	24%	25%	27%
Profit After Tax		0.4	0.7	1.6	2.1	3.2
Dividend		1.4	1.5	1.8	2.0	2.2

Macro 4's Balance Sheet

Ye 30th June, £m	2004	2005	2006E	2007E	2008E
Fixed Assets					
-intangible	11.8	9.6	9.8	10.0	10.0
-tangible	8.0	7.5	7.6	7.8	8.0
Total FA	19.8	17.1	17.4	17.8	18.0
Current Assets					
-debtors (<1yr)	9.8	8.9	9.4	10.3	11.3
of which, trade =	8.2	7.0	7.2	8.1	8.7
trade days	95.9	76.1	75.0	80.0	80.0
-debtors (>1yr)	0.9	0.2	0.5	0.6	0.6
Total debtors	10.7	9.1	9.9	10.9	11.7
Cash	8.4	10.0	10.2	12.5	12.5
Total CA	19.1	19.2	20.1	23.4	24.2
Creditors (<1yr)	9.3	10.4	10.5	10.7	10.7
-days	108.8	114.7	110	105	98.4
Net Current Assets	9.8	8.8	9.6	12.7	13.5
FA + NCA	29.6	25.8	27.0	30.5	31.5
Creditors (>1yr)	4.1	1.5	1.0	0.5	0.5
Provisions	0.0	0.3	0.0	0.0	0.0
Deferred Income	11.3	10.2	9.3	9.1	8.9
Total LT liabilities	15.4	12.0	10.3	9.6	9.4
Net Assets	14.2	13.8	16.7	20.9	22.0

Macro 4's Cashflow

Ye 30th June, £m	2004	2005	2006E	2007E	2008E
Operating Profit	1.3	0.8	2.0	2.7	4.0
Amortisation	2.7	2.7	2.8	2.8	2.8
Depreciation	1.0	1.0	1.1	1.2	1.2
EDSIP	1.2	1.0	1.0	1.0	1.0
Misc	-0.2	0.0	0.0	0.0	0.0
Decr debtors	3.8	1.8	-0.8	-1.0	-0.8
Change Def'd income	-2.6	-1.1	-0.9	-0.1	-0.2
Incr creditors	0.8	1.1	0.4	0.3	0.0
Net Cash Inflow from op'ns	8.1	7.3	5.6	6.9	8.0
Returns on inv/ finance	-0.3	0.0	0.2	0.4	0.4
Tax paid	-0.2	-0.5	-0.5	-0.5	-0.5
Capex	-0.6	-1.1	-1.3	-1.5	-1.5
Dividends paid	-1.3	-1.4	-1.8	-2.0	-2.2
Mgt liquid resources/ financing	-4.4	-2.5	-2.0	-1.0	0.0
Sub-total	-6.8	-5.5	-5.4	-4.6	-3.8
Increase in cash	1.4	1.7	0.2	2.3	4.2
Reconciliation to change in net cash					
Repayment of term loan	1.0	2.0	2.0	2.0	0.0
Cashflow from					
(decr)/ incr liquid resources	3.1	-0.1	0.0	0.0	0.0
Cashflow from decr lease fin'g	0.3	0.1	0.0	0.0	0.02
Opening net cash/ (debt)	-3.4	2.3	6.0	8.2	12.5
Closing net cash	2.3	6.0	8.2	12.5	16.7

Appendix: Management

Bert Morris, Chairman

Formerly Deputy Group Chief Executive at National Westminster Bank Group Plc, Bert Morris is also Chairman of Lorient PLC and Chairman of Metroline PLC until its take-over by the Del Gro Corporation of Singapore.

Ronnie Wilson, Group Chief Executive Officer

Previously Vice President and General Manager of Europe, Middle East and Africa for Sequent Computers Corporation, Inc. Prior to this he held a number of senior management positions with Unisys Corporation.

Graeme Gordon, Group Finance Director

Previously Group Finance Director of the investment bank Durlacher Corporation plc, and CFO at the IT corporate finance house Regent Technology.

Alan Sloan, Chief Executive of the SMP Division

Previously Business Development Director for Europe, Middle East and Africa for Sequent Computers Corporation, Inc. Prior to Sequent, Alan Sloan was UK Technical Director for Data General.

Michael Brand, Chief Executive of the BIL Division

Previously General Manager for Germany, Austria and Switzerland for Sequent Computer Systems, Inc. Prior to Sequent, Michael held senior positions with Oracle Corporation, Unisys Corporation and Nixdorf.

We are pleased to bring you this report on **Macro 4 plc**.



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Gabriel Didham, CFA
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Andy Hartwill – Head of Research

Andy has more than 20 years experience as a technology analyst and UK & Global Strategist at SG Hambros. Prior to this he was UK and European Strategist for Paribas, and Head of Research at Capital House and Spencer Thornton. He is a regular guest on Bloomberg and CNBC.

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Objective Capital Limited

2nd floor, 145 St. John St.
London EC1V 4PY
Tel: +44-(0)870-080-2965
Fax: +44-(0)870-116-0839
sales@objectivecapital.com

Internationally:
Phone: +44-20-7754 5994

For Marketing & Sales:
Token House
11-12 Tokenhouse Yard
London EC2R 7AS

Corporate: www.ObjectiveCapital.com
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