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Murgitroyd

176p

Results well ahead of
expectations, forecasts
upgraded

30.8.2005



Murgitroyd's full year results beat our expectations both in terms of sales (£14.45m versus our forecast of £14.2m) and, more notably, adjusted pre-tax profits (£1.38m versus our forecast of £1.22m). Although the figures incorporate the acquisition of the London-based Patent and Trade Mark Attorney, Castles, in January, we still estimate that organic growth ran at a respectable 7-8%. The strong performance, coupled with an increase in the pay-out ratio, helped the company substantially raise the dividend to 3.32p (compared to 1.99p in 2004). We are upgrading our 2006 adjusted pre-tax profit forecasts by 6% to £1.73m, giving EPS of 14.4p.

The second half of the year was notable for some significant client wins such as the previously announced Rohm & Haas, Jordan's Cereals and Baxter's Food Group. The integration of Castles also appears to be proceeding smoothly, with no fair value adjustments or nasty provisions required to cover the costs of absorbing this business.

Having touched an all time high of 191p earlier this year Murgitroyd's shares have eased back in recent months to trade at 176p. This places the shares on 12.2x 2006E, and means they offer a free cash flow yield of 5.2%. We believe this is an undemanding valuation for a business operating in a niche market, with extremely high barriers to entry, delivering strong earnings growth.

Share Price: 176p

12m High: 191p

12m Low: 114p

Market Cap: £14.6m

Shares in Issue: 8.28m

NAV/Share: 10p (excl. intangibles)

Gearing: 32% (incl. intangibles)

Interest Cover: x12

EV/EDITBA: 8.1x 2006E

EPIC Code: MUR

SEDOL No: 3106745

Sector: Support Services

Market: London AIM

PR: Cardew Group

Website: murgitroyd.com

Previous Research Note: 12.1.2005

Analyst: James Chapman

Y/E	Sales £m	Declared Profit £m	Adjusted Profit £m	Adjusted Eps p.	P/e ratio	Divi p.	Yield %
2004A	12.3	0.61	0.97	7.9	22.3	1.99	1.1
2005A	14.5	0.95	1.38	11.4	15.4	3.32	1.9
2006E	18.7	1.18	1.73	14.4	12.2	4.55	2.6
2007E	20.4	1.44	1.98	16.1	10.9	5.22	3.0

Full year results

Year end 31 May (£000)	2005	2004	Variance
Sales	14,456	12,287	+17.6%
COGS	(4,784)	(4,087)	
Gross Profit	9,672	8,200	
Gross Margin	66.9%	66.7%	+0.2 percentage points
Admin Expenses	(8,170)	(7,168)	
EBIT	1,502	1,032	+46%
EBIT margin	10.4%	8.4%	+2 percentage points
Interest	(126)	(65)	
PBT	1,376	970	+42%

The full year results presented an encouraging picture with good organic growth and solid progress made in absorbing the recent Castles acquisition. Arguably the highlight was the 2 percentage points improvement in EBIT margin despite the inevitable disruption caused by an acquisition. The margin performance was significantly better than we expected.

The inclusion of Castles has enhanced the group's results, being instantly earnings enhancing, but we still estimate that organic sales growth ran in the region of 7-8%. There were no provisions or fair value adjustments relating to the deal.

Murgitroyd now has 32 qualified Patent and Trade Mark Attorneys, compared to 22 in 2004. Considering that it takes 6-7 years to trade these Attorneys this is major asset.

There have been no Director share sales in the past 12 months. On 31 May David Castle purchased 15,000 shares at 182 pence a share.

Castles acquisition

In January Murgitroyd bought the privately owned London-based Patent and Trade Mark Attorney, Castles, for £3.3m in cash, plus the value of its net assets (which were worth £650,000). In the year to December 2003 Castles generated sales of £3.4m and reported pre-tax profits of £221,000 after the payment of substantial bonuses. We believe that sales in the period from 1st January 2004 to 11th January 2005 (when Castles was acquired) were in the region of £3.7m with an improvement in profits to £380,000.

Castles employed 20 personnel (including four qualified Trade Mark Attorneys) out of a leased office in south London. The latter is now used as Murgitroyd's principal London office. David Castle, Castles founder and majority shareholder, joined Murgitroyd's Board. Encouragingly there have not been any defections of staff from Castles since it was acquired. Equally pleasing is the absence of

provisions and fair value adjustments relating to the deal.

Outlook

The outlook statement was upbeat with management reporting "an encouraging start" to the current financial year. The Patent and Trade Market has traditionally grown in the region of 10-15% per annum, before this growth was halted in the economic downturn of 2001-2003. In 2004 the number of European Patent filings rose 10% and the growth trend now appears to be firmly re-established. Arguably Murgitroyd should be able to grow even if another downturn arrives thanks to its establishment of a pan European network of Patent and Trade Mark Attorneys (Murgitroyd now has offices in Ireland, Germany, France in addition to its four UK offices). This pan European network has major appeal to US and Japanese corporations who now account for around 50% of all Patent filings in Europe. It is also noteworthy that the accession of ten new states to the EU has increased the potential coverage gained from European Patent filing. This also bodes well for Murgitroyd with its pan-European network of attorneys.

Forecasts

Progress on continuing to increase gross margins has been held back by the absorption of Castles where gross margins ran in the region of 50%. While prices are being brought into line with the rest of the group as quickly as is commercially sensible, the acquisition will still have a detrimental impact on gross margins in the current financial year. The previous dividend policy of distributing 25% of post-tax profits has been reviewed and management is proposing distributing around 29% of post tax profits as a dividend. We expect organic growth in the region of 9-10%, which is in-line with the growth of the European Patent and Trade Mark market. This could prove conservative if Murgitroyd makes market share gains.

Valuation

We think that Murgitroyd's cost of equity is in the region of 8-9%. A purist following the capital asset pricing model would come up with a lower figure thanks to Murgitroyd's beta, which is only 0.17, but in the real world we think that even the most diversified investor would be looking for a return in the order of 8-10% to invest in a small cap company. As our cost of equity we have taken a risk free rate as 4.25% (UK 10 year gilts) and added a 4% equity risk premium. This gives a cost of capital of 7.3% after taking into account the modest level of debt employed. Murgitroyd has fairly predictable earnings and cash flow, which means a discounted cash flow valuation is appropriate.

Assuming a 7.3% cost of capital the current market value discounts growth rates of 2.9% from 2008 (see table below), which is broadly similar to nominal UK GDP levels. We think given its market position Murgitroyd should be able to comfortably exceed GDP levels for at least the next five years, and possibly for much longer. We also think there's scope to raise both gross margins (whose rise has been

slowed by recent acquisitions but are slowly climbing as Murgitroyd raises charging rates) and EBIT margins, thanks to economies of scale. Murgitroyd will probably acquire more Patent and Trade Mark Attorneys. The company has a good record on integrating acquisitions (Castles, Cabinet Bonneau) and as long as the deals generate return in excess of the company's cost of capital there is further scope for value creation.

It is our belief that Murgitroyd is the worlds only quoted Patent and Trade Mark Attorney, and as such it has no direct comparatives. However there are some similarities with AIM traded RWS Holdings, which offers Patent translation and other Intellectual Property services. RWS trades on 16.5 2005E EPS (September year end) and 15.8x 2006E EPS, a significant premium to Murgitroyd.

Regrettably Murgitroyd's shares remain highly illiquid (the Murgitroyd family retains a 50% stake) which means that small share deals can have a disproportionate impact on the share price.

Reverse DCF (growth implied by share price)

£000	2006E	2007E	2008E
Sales	18,700	20,383	Terminal Value
EBIT	1,917	2,153	
EBIT margin	10.3%	10.6%	
Free cash flow	760	812	<u>836</u> 0.073 – 0.029 (see below)
Present Value	708	705	16,500
			<i>Cost of Capital 7.3%</i>
			<i>Long run growth 2.9%</i>
			<i>FV as perpetuity = £19m</i>
Equity value = £14.7m			
Share price = 177p			

Terminal value equates to 0.9x 2007E sales and 14x 2007E earnings

Share price 176p	2002A*	2003A	2004A	2005A	2006E	2007E
Market cap £m	14573	14573	14573	14573	14573	14573
EV	15,069	15,430	15,462	17,782	17,297	16,861
EV/EBITDA	18.8	16.4	12.8	10.5	8.1	7.2
EV/Sales	1.66	1.46	1.26	1.23	0.92	0.83
PER		90	49	28	23	16
PER adjusted	27.9	28.4	22.1	15.5	12.2	10.9
ROCE	5.7%	7.1%	9.3%	10.9%	13.0%	14.9%
ROE (excluding goodwill)	8.3%	13.2%	14.5%	108.0%	28.1%	27.4%
Free cash flow per share (p)	3.59	-2.45	3.89	7.75	9.18	9.81
Free cash flow yield	2.04%	-1.39%	2.21%	4.41%	5.21%	5.57%
Cash conversion		36%	82%	89%	88%	86%
Gearing (inc intangibles)		4.1%	8.2%	8.2%	31.8%	21.1%

Profit and loss, year to 31 May £000	2002A*	2003A	2004A	2005A	2006E	2007E
Turnover	9,054	10,561	12,287	14,456	18,700	20,383
sales change %	16.8%	16.6%	12.5%	16%	29%	9%
cost of sales	(3,150)	(3,403)	(4,087)	(4,784)	(6,433)	(6,930)
Gross profit	5,904	7,158	8,200	9,672	12,267	13,453
<i>Gross profit margin %</i>	<i>65.21%</i>	<i>67.78%</i>	<i>66.70%</i>	<i>67%</i>	<i>65.6%</i>	<i>66%</i>
administrative expenses	(5,192)	(6,401)	(7,168)	(8,170)	(10,350)	(11,300)
Operating profit	712	757	1,032	1,502	1,917	2,153
<i>operating margin</i>	<i>7.9%</i>	<i>7.2%</i>	<i>8.4%</i>	<i>10.4%</i>	<i>10.3%</i>	<i>10.6%</i>
net interest payable	(78)	(54)	(62)	(126)	(191)	(171)
<i>interest cover X</i>	<i>9</i>	<i>14</i>	<i>17</i>	<i>12</i>	<i>10</i>	<i>13</i>
Pre Tax Profit, Adjusted	634	703	970	1,376	1,726	1,982
tax	(190)	(189)	(313)	(434)	(535)	(646)
<i>effective tax rate %</i>	<i>30%</i>	<i>27%</i>	<i>32%</i>	<i>31%</i>	<i>31%</i>	<i>31%</i>
Profit After Tax	444	514	657	942	1,191	1,336
dividends	(110)	(130)	(165)	(275)	(376)	(432)
Goodwill amortisation	(175)	(351)	(360)	(430)	(545)	(545)
retained profit	159	33	132	237	270	359
Avg No. Shares in Issue m.	7.04	8.28	8.28	8.28	8.28	8.28
Adjusted Earnings Per Share	6.3	6.2	7.95	11.4	14.4	16.1
Dividend Per Share	1.39	1.57	2.0	3.32	4.55	5.22
Declared Pre-tax Profit	166	352	610	946	1,181	1,437
Declared Earnings Per Share	1.9	2.0	3.6	6.2	7.7	10.8

**2002 numbers are pro-forma*

Cashflow £000	2002A*	2003A	2004A	2005A	2006E	2007E
Operating profit	712	757	1032	1502	1917	2153
Depreciation	90	181	176	194	220	200
Working Capital	(505)	(664)	(362)	(391)	(450)	(505)
Other (Provisions etc)		2		26		
Operating cash flow	297	276	846	1,331	1,687	1,848
Interest		(54)	(49)	(97)	(172)	(150)
Tax		(179)	(284)	(432)	(535)	(646)
Net Capex		(246)	(191)	(160)	(220)	(240)
Free cash flow	297	(203)	322	642	760	812
Acquisitions and disposals			(194)	(2,630)		
Dividends		(110)	(130)	(165)	(275)	(376)
Other		(48)	(30)	(167)		
Share issue	2,507					
Increase/decrease in net debt		(361)	(32)	(2,320)	485	436
Opening net debt		(496)	(857)	(889)	(3,209)	(2,724)
Closing net debt		(496)	(889)	(3,209)	(2,724)	(2,288)

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