5th July 2016

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Lombard Risk Management

The all-important sales line is upgraded again

Lombard Risk Management (LRM) has raised £8m+ (gross) to invest in products for growth. The emphasis is on cementing LRM's position in the huge fintech market of banking risk compliance and collateral monitoring for both regulatory and commercial banking purposes. In the past year, certain competitors have refocused emphasis to other fintech markets. LRM in contrast has invested, re-energised its top team and cemented a stronger and broader route to market. Just one example of this is the success selling LRM products with Oracle. LRM holds its AGM tomorrow.

- **Strategy**: Founded 27 years ago, LRM's clients include over 30 of the global 'Top 50' financial institutions. In March it rebranded its enhanced AgileREPORTER® and finalised a Technology License Agreement with Oracle America Inc. This relates to regulatory reporting, a market growing after a pause last year. COLLINE®, its multi-asset collateral management is also expanding.

- **Growth:** Sales growth underperformed trend FY15 and FY16. Progress is now rapid. We upgrade the top line estimates again, to £30.0m and £37.5m for FY17E and FY18E respectively. In May, post results we had raised to £28.5m and £33.5m. The June fund-raise prompts our latest move. LRM makes significant software development and business infrastructure costs, so FY17E PBT is not the focus.

- **Valuation:** The business is set to achieve more than an 80% revenue increase in the three years to FY19E. Steady state, this is a 20%+ PBT margin business. On that basis, we see any valuation below c.2x sales for FY18E as anomalously low.

- **Risks:** The tie-in with Oracle is important to the top line progression and is in its first half year. The business is investing to enable that top line advance and so even pre capex, the group is only cash flow neutral FY17E. It is near free cash flow neutral in FY18E, although this is based on assumptions of high growth in income and in expenditure.

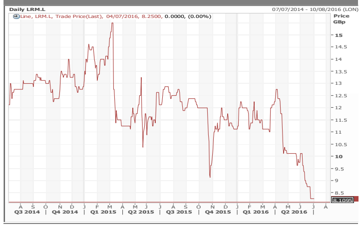
- **Investment view:** 2011-16 sales CAGR is 14.8%. We are confident the recent pause is to be followed by strong growth. FY13, FY14 PBT margins exceeded 20% and this type of business should achieve this once sales are commensurate with its market position. Under refreshed management and sales teams, an exciting proposition. Once the pick-up is seen, the rating will be patently too low.

Financial summary and valuation

Year end Mar (£m)	2014	2015	2016	2017E	2018E	2019E
Sales (£m)	20.40	21.49	23.71	30.00	37.50	44.00
EBITDA (£m)	6.00	4.40	1.90	(1.20)	5.80	10.85
EBIT (£m)	4.46	2.28	(2.19)	(5.30)	1.00	5.40
PBT (£m)	4.46	2.26	(2.21)	(5.30)	1.00	5.40
EPS (p)	2.16	0.86	(0.98)	(1.35)	0.24	1.22
DPS (p)	0.075	0.080	0.035	0.00	0.00	0.00
Net cash (£m)	2.26	2.24	3.34	3.02	2.40	4.68
P/E (x)	3.94	9.84	(8.64)	(6.30)	35.50	6.94
EV/Sales (x)	1.54	1.47	1.28	1.20	0.84	0.66
EV/EBITDA (x)	5.26	7.17	16.00	(25.60)	5.40	2.68
FCF Yield (%)	(1.59)	0.47	(7.95)	(23.76)	(1.85)	6.76
Dividend Yield (%)	0.88	0.94	0.41	0.00	0.00	0.00

Source: Hardman & Co Research

Software and computer services



Source: Thomson Reuters

Market data

EPIC/TKR	LRM.L
Price (p)	8.5
12m High (p)	13
12m Low (p)	8
Shares (m)	395
Mkt Cap (£m)	33.5
EV (£m)	30.5
Free Float*	48%
Market	AIM

**As defined by AIM Rule 26*

Description

Provision of financial services software to banks and asset managers. Solutions are focused on collateral and risk management for regulatory reporting.

Company information

CEO	Alastair Brown
Non-Exec Chairman	Philip Crawford
CFO	Nigel Gurney

020 7593 6700
www.lombardrisk.com

Key shareholders

Directors	3.5%
J Wisbey esq (founder)	22.5%
Liontrust	9.6%
Legal & General	9.1%
Ruffer	7.9%
Hargreave Hale	7.9%

Next event

6th July 2016	AGM
Nov 2016	Interim results
June 2017	Final results

Analysts

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Investment proposition

Partnerships, revenue and cash timing

Lombard Risk (LRM) sells integrated collateral management, regulatory compliance and reporting solutions. The market addressed is large and some of the competition has recently been focusing elsewhere (for example post corporate activity). Products are predominantly sold through five year renewable licences with typically 35-45% paid at the start of the contract. In addition to direct sales, markets are also addressed through Partners selling LRM solutions. Sales from these have been modest some two years in to this extension of the LRM model, but are bearing fruit in calendar 2016. The potential from Oracle, just one of the Partners, is not to be underestimated. Through its March 2016 Agreement, Lombard Risk's AgileREPORTER® forms part of the Oracle Regulatory Reporting Solution. Its regulatory reporting templates integrate with Oracle's Financial Services Data Foundation.

Further, sales will be cash and revenue weighted towards the transaction taking place. Oracle is a major strategic plank which also is supporting cash and profit in our estimates from FY17E on. The current balance sheet gives significant additional fire power to benefit from major opportunities, not just the Oracle increment, in the sights of this 27-year-old global specialist.

Significant direct-sale wins in June

Momentum is good also in its second of two planks: collateral management. It has been appointed (30th June 2016) by two major banking firms in North America to supply its award-winning collateral management, clearing, inventory management and optimisation solution, COLLINE®. This enables firms to move away from managing collateral in business line silos. These new clients' "decisions to move away from costly legacy applications in order to consolidate their systems and margining processes was a major driver in selecting Lombard Risk." [Lombard Risk]. A key is the relative speed and ease of deployment. In-house / legacy systems can be expensive.

Growth in sales, spending and free cash flow potential

To achieve the current position, £19.5m equity has been raised since 2005 (in which year revenues were £4.6m). £8.0m of that figure was in June 2016. This has resulted in a business which we estimate in FY19E generates £10.6m operational cash flow and £2.3m free cash flow (i.e. post £8.3m capital expenditure that year). The investment made would, we estimate, support revenue growth at well over 12% compound annual growth rate (CAGR), possibly 15% CAGR. In the past five years the rate averaged 14.8%. On illustrative long term rises of 10% CAGR in software investment, the free cash flow would be rising circa 30% CAGR.

Creation of economic moat for relatively modest equity outlay

Given the size of the global market addressed and the software investment made, LRM has achieved much with a modest amount of equity raised, we consider. We consider the business proposition to be robust in terms of focus (see below) and, whilst free cash flow is negative until FY19E and is only 6.8% (yield) in that year, the figure rises rapidly. Crucially Lombard Risk's 'economic moat' will have been secured.

The business proposition

Focus: optimisation of sale proposition

Lombard Risk's business proposition has been fully to focus on this 'economic moat'. Since the new top management team took the reins, the potential and momentum inherent in Lombard Risk has been brought further together. This intensified focus on 1) product (see page 4); 2) sales techniques which has begun fully in calendar 2016. LRM had an average five year sales CAGR of mid-teens, even including the more recent slow-down. With gross margins over 99%, pricing decisions were a judgement. They still are, but marketing, which allies customers' requirements to the right sales products and prices, is looked at in a more robust 'senior company' way.

Head of Products' role

In this regard, a new critical post, Global Head of Products, was filled in February 2016, Tina Wilkinson (ex FIS/SunGard where she was Director of Major Accounts). The key point is to develop innovative and agile solutions that meet clients' needs. Those needs will vary and anticipating the right emphasis is crucial to guiding the salesforce what to sell and the CTO and his team's focus on products in which to invest.

As LRM's strength grows and certain competitors re-focus away, the pricing momentum should be robust. The sales team has been expanded and re-trained.

Spending

Leadership team, sales team and software design has to be invested in, especially in FY16 and for a couple of years onwards.

Conclusion

Momentum

99% margins

Cash spending………

…. Barriers to competition

- Client-win momentum is here (see 30 June COLLINE®).
- Oracle is just one of several Alliance Partnerships and here, we see revenue 'take-off' in FY17E.
- Gross margins at 99% and a combination of five year contracts with up-front bias to revenue means 1) sales are cash 2) base-line visibility is high.
- Revenue growth FY15,16 has been below trend. This is a matter solely of timing.
- Lombard Risk Management is a software business. Investment in software development 'comes with the territory'. Investors have rightly supported this dynamic. Nonetheless, equity has been raised sparingly: £19.5m since 2005.
- It has now built a certain level of economic moat. It is recently much firmer in its pricing structures, marketing and has high, customer-led, product focus.

Risks

A significant rise in spending:

Costs (operating, software expensed and capitalised) ran at £19.4m FY14; £27.2m FY16. In FY17 we estimate £39.3m

Lombard Risk Management's financial model relies on investment which is running at significant levels relative to historic sales rates achieved. Total costs rise rapidly in FY17E, after strong rises in recent years. There is a modest currency mis-match, with slightly more costs than revenue in £ Sterling. The sales growth relies in part on continuation of successful partnership agreements, which have not been in place for a lengthy period of time yet. Timing of revenue has to some extent in the past been dependent on the timing of various regulatory requirements placed on clients in various differing jurisdictions. The five year (norm) of contracts mitigates some revenue risk (see the deferred revenue line). Software development is intrinsic to the business model. However, the growth could be mitigated if required – though potentially impinging upon future revenue opportunities.

17 June 2016 fund raise announced

Lombard Risk Management successfully undertook a Placing equity fundraise of £8.0m at 8.75p per share. Further, it launched an Open Offer to all Qualifying Shareholders at 8.75p for up to 8,729,464 New Ordinary Shares (1 Open Offer Share for every 35 Ordinary). We anticipate this – for structural reasons – is not anticipated to be fully subscribed.

Key financial ratios

Spending

The amount spent on developing software is increasingly focused and more sales driven. It also is increasing significantly in FY17E, after already rising 48% in the three years to FY16. FY17E rise is 76% in one year alone: to £16.0m. This is then estimated to fall back, but to remain at levels higher than current in absolute terms. In FY19E the ratio of total spend developing and supporting software is 27% of that year's revenue, vs 38% for FY16 and 35% FY15. The spends focus is illustrated by the FY16 impairment of £0.7m which related to some sub-optimal specific planned new products, reviewed by the new leadership team. This is more sales driven, as per our comments above on the sales team and the Global Head of Products.

Product focus: evidence

Financial summary and valuation

Year end Mar (£m)	2015	2016	2017E	2018E	2019E
Sales	21.49	23.71	30.00	37.50	44.00
Total [1] technology costs	7.50	9.10	16.00	12.50	12.00
Above INCLUDES capex	5.48	6.33	8.50	7.50	8.35
Total costs ex technology	9.60	12.90	15.30	19.27	21.19

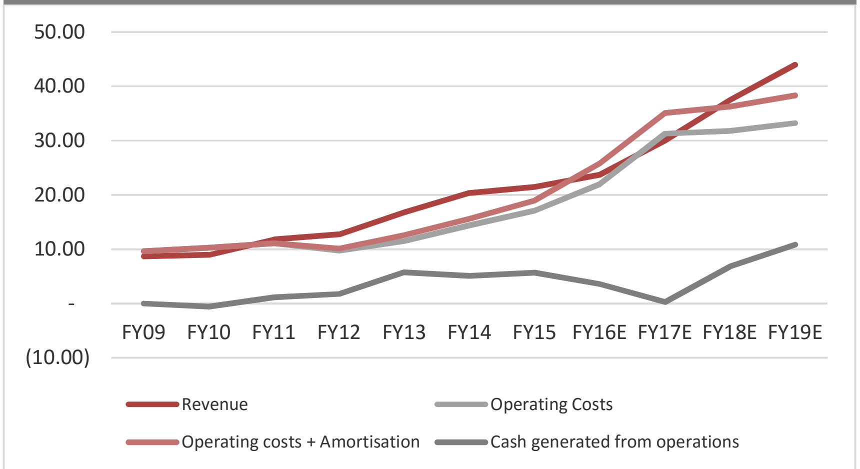
Source: Hardman & Co Research

Note: [1] Comprising both expensed and capitalised costs. FY16 includes a £0.7m accounting write-down in addition to the cash-driven costs

Revenue growth optimisation and competitive advantage

The level of revenue has proven to be a key component behind the cash generation. Given the very large size of the market, and its exacting nature, reducing costs appears to us to be an unattractive option undermining the business' prospects.

Drivers to operating cash flow (£m)



Source: Hardman & Co Research

*FY18E: cash from operations * returns to former peak*

(pre capex)*

The cash generation in our model returns to the peak by FY18E and hits 188% of the FY13 peak by FY19E. Current levels of spending are not designed for short term cash generation. Nonetheless, the importance of the top line and its positive effects on cash even in the early years of sales acceleration are marked. The series 'Cash generated from operations' is PRIOR to the CAPEX spend on software. See table at top of page. By FY19E, cash flow post capex returns to a positive level, namely £2.28m in the year.

Financial Analysis

Revenue account, growth and margin ratios						
Revenue Account (£m)	**2014**	**2015**	**2016**	**2017E**	**2018E**	**2019E**
Sales	20.4	21.5	23.7	30.0	37.5	44.0
Gross profit	20.2	21.2	23.5	29.7	37.1	43.6
Costs pre tech development	(12.6)	(14.7)	(18.8)	(23.3)	(26.3)	(29.2)
Tech spend expensed	(1.8)	(2.4)	(3.2)	(8.0)	(5.5)	(4.0)
Tech spend capitalised	(5.3)	(5.1)	(5.9)	(8.0)	(7.0)	(8.0)
EBITDA	6.0	4.4	1.9	(1.2)	5.8	10.9
Operating profit	4.5	2.3	(2.2)	(5.3)	1.0	5.4
PBT Reported	4.4	2.3	(2.2)	(5.3)	1.0	5.4
PBT post tech spend as incurred (non-statutory figure)	0.4	(0.9)	(4.3)	(9.5)	(1.5)	2.5
EPS Reported (p)	2.1	0.9	(1.0)	(1.3)	0.2	1.2
DPS (p)	0.075	0.080	0.035	0.0	0.0	0.0
Growth (%) year on year						
Sales growth (%)	21.6	5.4	10.3	26.5	25.0	17.3
Operating costs ex tech: growth	31.9	15.8	27.9	24.3	12.8	11.2
Total tech spend growth (%)	16.0	5.2	21.3	75.8	-21.9	-4.0
EBITDA growth (%)	13.8	-26.6	-56.7	-163.1	n.a.	87.1
Margins (%)						
EBITDA margins (%)	29.4	20.4	8.0	(4.0)	15.5	24.7

Source: Lombard Risk accounts; Hardman & Co Research estimates

Interim results FY16 (i.e. to September 2015) included a write down of £0.7m (2014: £Nil) against carrying value of capitalised research and development. This is not identified separately in the table above and is included in technology costs expensed.

Cashflow and Balance Sheet						
Cashflow (£m)	**2014**	**2015**	**2016**	**2017E**	**2018E**	**2019E**
Operating cash flow	5.1	5.7	3.6	0.3	6.8	10.9
Interest & tax	0.1	(0.1)	0.0	0.2	0.1	(0.2)
Capex / Acquisitions	(5.7)	(5.5)	(6.3)	(8.5)	(7.5)	(8.4)
Dividends	(0.2)	(0.2)	(0.2)	0.0	0.0	0.0
Equity	2.8	0.0	4.0	7.7	0.0	0.0
Change in net cash	2.1	(0.0)	1.1	(0.3)	(0.6)	2.3
Closing net cash	2.3	2.2	3.3	3.0	2.4	4.7
Balance sheet (£m)						
Goodwill	5.8	5.9	5.9	5.9	5.9	5.9
Capitalised devt costs	10.4	13.8	15.9	20.1	22.6	25.5
Deferred income	(5.2)	(7.2)	(7.3)	(8.8)	(10.3)	(10.8)
Other items	7.1	8.2	7.2	7.2	7.2	9.6
Net assets	18.2	20.7	21.7	24.4	25.4	30.2

Source: Lombard Risk accounts; Hardman & Co Research estimates

Note the deferred income line: an intrinsic part of the five year contracted sales model.

Note no material interest cost. Cash tax is de minimis as a function of allowances for research and development. We assume a 10% tax rate for accounting purposes FY19E, which we consider likely to see a lower outcome than 10%.

The carrying value of non-current assets includes £5.9m in respect of goodwill arising on previous acquisitions.

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