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Murgitroyd

231p

Strong interims prompt
another upgrade

16.1.2006



Murgitroyd's first half results presented an encouraging picture with trading robust and the integration of Castles, the London-based Patent and Trade Mark Attorney acquired last January, proceeding smoothly. In response to the strong numbers we are raising our full year adjusted (pre-goodwill) pre-tax profit estimates from £1.726m to £1.748m, giving EPS of 14.6p. We are also raising our 2006/7 adjusted pre-tax profit forecasts from £1.98m to £2m, giving EPS of 16.7p.

Though the contribution from Castles inevitably boosted the figures it is important to recognise that Murgitroyd is also enjoying strong organic growth. We estimate, for instance, that organic growth at the combined business ran in the region of 15% in the first half.

Murgitroyd's shares have held steady since soaring last August when the company delivered a forecast busting set of full year results. The shares now trade on a PE of 14x 2006/7E EPS and offer a 5.1% 2006/7E free cash flow yield. We believe this is undemanding for a company operating in a sector with extremely high barriers to entry (it takes 6-7 years to train a Patent and Trade Mark Attorney) which has historically grown in the region of 10-15% per annum. It is also worth noting that as the only quoted Patent and Trade Mark Attorney in Europe Murgitroyd is well positioned to act as a consolidator in its sector, picking up rival practices and extending its geographical reach. Given the company's low cost of debt (borrowing to fund the Castles deal has been achieved at only 1% over base rate) any such deals are likely to be significantly earnings enhancing. Murgitroyd has a good track record on successfully integrating new practices as evident from the successful acquisition of the French Attorney Cabinet Bonneau in July 2003 and the apparent absence of difficulties absorbing Castles.

Share Price: 231p

12m High: 248p

12m Low: 160p

Market Cap: £19.1m

Shares in Issue: 8.28m

NAV/Share: 22p (excl. intangibles)

Gearing: 32% (incl. intangibles)

Interest Cover: x10

EV/EDITBA: 10.6x 2005/6E

EPIC Code: MUR

SEDOL No: 3106745

Sector: Support Services

Market: London AIM

PR: Cardew Group

Website: murgitroyd.com

Previous Research Note: 30.8.2005
"Results well ahead of expectations,
forecasts upgraded"

Analyst: James Chapman

Y/E	Sales	Declared	Adjusted	Adjusted	P/e ratio	Divi p.	Yield
May	£m	Profit £m	Profit £m	Eps p.			%
2004A	12.3	0.61	0.97	7.9	29	1.99	0.9
2005A	14.5	0.95	1.38	11.4	20	3.32	1.4
2006E	19.1	1.20	1.75	14.6	16	4.55	2.0
2007E	20.4	1.46	2.00	16.7	14	5.22	2.3

First half results

£000	Six months to 30 Nov 2005	Six months to 30 Nov 2004	Variance
Sales	9,482	6,264	+51%
Gross profit	5,722	4,271	+34%
Gross margin	60.3%	68.2%	
Admin Expenses	4,693	3,721	+26%
EBIT	1,029	550	+87%
EBIT margin	10.9%	8.7%	
Interest	101	33	+206%
Adjusted Pre-tax profit	928	517	+79%

First half gross margins were dented by the inclusion of Castles where we understand gross margins ran in the region of 50% prior to its acquisition. These fell well short of the circa 67% traditionally enjoyed at Murgitroyd. While prices are being brought into line with the rest of the group as quickly as commercially sensible this will take time. We anticipate gross margins climbing to 63% in the second half for a full year out-turn of 61.7%. We estimate that that organic growth at the combined business ran in the region of an impressive 15% in the first half.

Administration expenses were lower than we expected. This better than anticipated performance helped boost EBITA margins to 10.9%. The improvement in margins was a solid performance given the inevitable disruption caused by the integration of Castles. We expect some cost inflation in the second half for a full year EBITA margin out-turn of 10.2%. Despite the modest dip this year thanks to the Castles acquisition it is notable that EBITA margins at Murgitroyd continue on an upward trend. The company generated an operating cash inflow of £826,000, representing a cash conversion rate of 81%.

Murgitroyd now has 33 qualified Patent and Trade Mark Attorneys (compared to only 22 in 2004) with an average age of 38. Two new Attorneys (one Patent and one Trade Mark) will join the company shortly. Considering that it takes 6-7 years to train these Attorneys this is a major asset.

Outlook

The outlook statement was upbeat with the management viewing “the remainder of the current financial year with confidence”. 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. Meanwhile the demand for qualified Attorneys

exceeds supply thanks to the high average age demographic prevalent in the profession. Though the latter factor could lead to wage inflation we view it as predominantly positive for Murgitroyd. Firstly it means that there should be plenty of acquisition opportunities (as ageing Attorneys look to sell up). Furthermore this aging demographic should in due course enhance Murgitroyd’s strong presence in the sector given the relatively young average age (38) of its own Attorneys.

Forecasts

In response to the strong interims we are raising our full year sales estimates from £18.7m to £19.06m. However we overestimated the ability of Murgitroyd to bring gross margins at Castles in line with those enjoyed at the rest of the group so we are revising our assumptions in this area for the full year down from 65.6% to 61.7%. These lower gross margin expectations are being mitigated by administrative expenses rising at a slower rate than we anticipated as the group enjoys greater economies of scale. The end result is a modest upgrade in our full year pre-tax profit estimates from £1.726m to £1.748m, giving EPS of 14.6p. We are also nudging our 2006/7 adjusted pre-tax profit forecasts up from £1.98m to £2m (giving EPS of 16.7p) thanks to the better than anticipated EBITA margin performance.

Valuation

Relative valuation comparisons are difficult to employ since we believe Murgitroyd is the only quoted Trade Mark and Patent Attorney in the world. As such there are not direct comparatives. However there are some similarities with AIM traded RWS Holdings which offers Patent translation and other Intellectual Property services. RWS trades on 21.6x 2006E EPS and 19x 2007E EPS (September year-end). This is a significant premium to Murgitroyd which trades on 16x 2006E EPS and 14x 2007E EPS (May year-end). Murgitroyd also offers a healthy 5.1% free cash flow yield based on 2006/7 estimates.

Profit and loss, year to 31 May £000	2002A*	2003A	2004A	2005A	2006E	2007E
Turnover	9,054	10,561	12,287	14,456	19,062	20,383
sales change %	16.8%	16.6%	12.5%	16%	29%	9%
cost of sales	(3,150)	(3,403)	(4,087)	(4,784)	(7,305)	(7,032)
Gross profit	5,904	7,158	8,200	9,672	11,757	13,351
<i>Gross profit margin %</i>	65.21%	67.78%	66.70%	67%	61.7%	65.5%
administrative expenses	(5,192)	(6,401)	(7,168)	(8,170)	(9,818)	(11,150)
Operating profit	712	757	1,032	1,502	1,939	2,201
<i>operating margin</i>	7.9%	7.2%	8.4%	10.4%	10.2%	10.8%
net interest payable	(78)	(54)	(62)	(126)	(191)	(201)
<i>interest cover X</i>	9	14	17	12	10	11
Pre Tax Profit, Adjusted	634	703	970	1,376	1,748	2,000
tax	(190)	(189)	(313)	(434)	(542)	(620)
<i>effective tax rate %</i>	30%	27%	32%	31%	31%	31%
Profit After Tax	444	514	657	942	1,206	1,380
dividends	(110)	(130)	(165)	(275)	(376)	(432)
Goodwill amortisation	(175)	(351)	(360)	(430)	(545)	(545)
retained profit	159	33	132	237	285	403
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	14.6	16.7
Dividend Per Share	1.39	1.57	2.0	3.32	4.55	5.22
Declared Pre-tax Profit	166	352	610	946	1,203	1,455
Declared Earnings Per Share	1.9	2.0	3.6	6.2	7.7	10.8
*2002 numbers are pro-forma						

Cashflow	2002A	2003A	2004A	2005A	2006E	2007E
Operating profit	712	757	1032	1502	1939	2201
Depreciation	90	181	176	194	220	200
Working Capital	(505)	(664)	(362)	(391)	(478)	(370)
Other (Provisions etc)		2		26		
Operating cash flow	297	276	846	1,331	1,681	2,031
Interest		(54)	(49)	(97)	(172)	(180)
Tax		(179)	(284)	(432)	(542)	(620)
Net Capex		(246)	(191)	(160)	(220)	(240)
Free cash flow	297	(203)	322	642	747	991
Acquisitions and disposals			(194)	(1,099)		
Dividends		(110)	(130)	(165)	(275)	(376)
Other		(48)	(30)	(1,698)	(954)	(500)
Share issue	2,507					
Increase/decrease in net debt		(361)	(32)	(2,320)	(482)	115
Opening net debt		(496)	(857)	(889)	(3,209)	(3,691)
Closing net debt		(496)	(857)	(889)	(3,691)	(3,576)

Balance Sheet, Year to 31 May	2002A*	2003A	2004A	2005A	2006E	2007E
£000						
Fixed Assets						
Intangible Assets	6,852	6,501	6,340	9,211	8,666	8,111
Tangible Assets	1,876	1,988	2,075	2,180	2,180	2,220
Investments	0	9	0	0	0	0
Current Assets						
Work in Progress	241	230	265	434	547	615
Trade Debtors	3,442	4,320	4,394	4,893	7,400	7,986
Other Debtors	246	283	227	447	547	600
Cash	1,147	106	344	477	250	107
Current Liabilities						
Short term debt	(1,350)	(739)	(1,071)	(829)	(850)	(850)
Trade creditors	(2,098)	(2,098)	(1,679)	(1,873)	(2,500)	(2,800)
Other creditors	(461)	(709)	(927)	(2,021)	(3,636)	(3,673)
Total assets less current liabilities	9,895	9,891	9,968	12,919	12,604	12,316
Provisions	(8)	(10)	(1)	0	0	0
LT debt	(272)	(224)	(162)	(2,857)	(3,091)	(2,833)
LT creditors						
Shareholders' Funds inc. Intangibles	9,615	9,657	9,805	10,062	9,513	9,483
Shareholders Funds ex Intangibles	2,763	3,156	3,465	851	847	1,372
Year-end Shares In Issue, No. 000	8280	8280	8280	8280	8280	8280
NAV/Share inc Intangibles,p.	116	117	118	122	115	115
NAV/Share ex Intangibles	33	38	42	10	10	17

*2002 numbers are pro-forma

	2002A	2003A	2004A	2005A	2006E	2007E
Share price 231p						
Market cap £m	19127	19127	19127	19127	19127	19127
EV	19,623	19,984	20,016	22,336	22,818	22,703
EV/EBITDA	24.5	21.3	16.6	13.2	10.6	9.5
EV/Sales	2.17	1.89	1.63	1.55	1.20	1.11
PER		119	65	38	30	22
PER adjusted	37.1	37.7	29.4	20.6	16.1	14.0
ROCE	7.2%	7.7%	10.4%	11.6%	15.4%	17.9%
ROE (excluding goodwill)	16.1%	16.3%	19.0%	110.7%	142.4%	100.6%
Free cash flow per share (p)	3.59	-2.45	3.89	7.75	9.02	11.97
Free cash flow yield	1.53%	-1.05%	1.66%	3.31%	3.86%	5.11%
Cash conversion		36%	82%	89%	87%	92%

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