

Tangent Communications

UK | Media | TNG | TNG LN

2 June 2009

Cash is King

Preliminary results to February 2009

Yr to Feb £m	2006A	2007A	2008A	2009A	2010E
Sales	6.6	8.6	17.4	15.6	16.5
EBITDA	0.9	1.4	2.9	1.6	1.0
adj. EPS (p)	0.8	0.9	1.1	0.5	0.2
EV/EBITDA (x)	3.4	2.4	1.4	2.6	4.4
P/E (x)	5.2	4.7	3.6	8.3	18.4
Div. Yld (%)	0.0	0.0	5.0	5.0	5.0

Recommendation **BUY**

Price **4p**
Target **9p**

Market Cap: £7m
EV: £5m
Shares issued: 170m
Daily ave. volume: <1m

Results to February 2009

Tangent reported revenue of £15.6m, down 10% y-o-y as a result of exposure to the property sector. Annualised revenues outside the property sector were resilient (we estimate up c. 6%). Operating profit was £1.1m (2008: £2.4m) and underlying diluted EPS was 0.48p, (2008: 1.1p). The dividend has been maintained at 0.2p, demonstrating management's confidence in the future prospects of the Group. The dividend is covered 2.5x (2008: 6.2x) by underlying basic EPS.

Strong financial position

Cash conversion was 149% (2008:105%) and net cash at the year end was £2.7m (2008:£2.4m). Management's acquisition strategy is opportunistic and the net cash position is a useful asset in an environment where quality businesses may be up for grabs at attractive multiples.

Recovery potential

In 2008 Ravensworth achieved revenues of £7.4m and an operating margin of 15.3%. The division has meaningful operational gearing and acquiring VLM (Ravensworth's main competitor) in April 2009 was a strategic move to increase market share and, through a stronger market position, further enhance the upside when recovery comes.

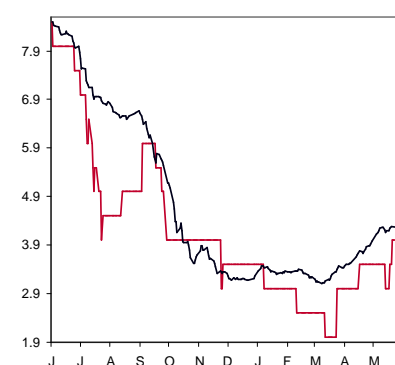
Option value in 3 key initiatives

Management are currently pursuing 3 key initiatives using existing Tangent resources for minimal investment. However, if any one of the ventures is successful it could lead to a significant increase in shareholder value.

Upgrade to BUY – in spite of lack of earnings visibility

We have valued Tangent on a SOTP basis, attributing £6m to Ravensworth (price paid by Tangent) and applying the sector price/ sales multiple (0.9x) to remaining turnover. Adding cash and applying a discount of 20% to reflect a small cap discount gives our target price of 9p. With over 100% upside to the current price and upside risk in the option value from management's 3 key initiatives, we upgrade our recommendation from HOLD to BUY.

Stock Performance



— Tangent Communications — FTSE AIM (Rebased)

Performance	1m	3m	12m
Absolute %	14	60	-53
Relative* %	3	20	-8

Source: Datastream

*Rel to FTSE AIM M

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Results summary

For the year to February 2009 Tangent reported revenue of £15.6m, down 10% on the prior year. Operating profit was £1.1m (2008: £2.4m) and underlying diluted EPS was 0.48p, down 57% y-o-y.

Tangent has had a disappointing year due to the Ravensworth division being highly exposed to the property sector. Annualised revenues outside the property sector were up (we estimate in the region of 6%) thus continuing to demonstrate strong resilience.

Operating margins have declined to 6.9% from 14% in 2008. Whilst this decline is significant, it is almost solely due to the declining revenues from Ravensworth, which is highly operationally geared.

From the reduced cost base at Ravensworth we would expect this margin to quickly rise to 2008 levels or higher when the recovery comes. While Ravensworth's revenues have significantly declined y-o-y, it is worth noting that the division has remained profitable and cash generative.

Restructuring expenses of £0.4m were incurred in the year which related to restructuring the business into 5 distinct divisions which included some redundancies and the relocation of Tangent's London and Cheltenham local marketing printing operations into the Newcastle facility. Management estimate that the reorganisation will yield annualised cost savings of c.£0.2m.

The dividend of 0.2p per share has been maintained and is covered 2.5x by underlying basic EPS. Maintaining the dividend demonstrates confidence in the financing and future prospects of the Group.

Cash generation has continued to be positive and cash conversion was 149%, up from 105% a year ago. Tangent has a robust balance sheet and finished the year with net cash of £2.7m (2008: £2.4m). This will allow Tangent to take advantage of bolt-on acquisition opportunities that may emerge in the current environment.

Background

Tangent is a dynamic business and since its inception in 2005 has been growing organically and through acquisition in response to client needs. Tangent Communications plc was formed through the combination of digital print companies Documedia (AIM listed company) and London Digital in May 2005.

The merged company had good digital printing capacity and strong direct marketing capabilities combined with an in-depth knowledge on how to ensure a tangible return on investment for customers. Tangent was therefore already well placed to take advantage of the shift towards more targeted, measurable advertising, something which places it in good relative standing compared to its peer Group in the current environment.

Tangent subsequently made several complimentary acquisitions that have added depth and diversity to the Group. In C360 (acquired in June 2006), now known as Tangent Labs and Tangent One, Tangent acquired an innovative team of software developers and experienced digital marketers. This purchase has ensured that Tangent has remained at the forefront of intelligent marketing technology and digital strategy. The development of Zui

(joint venture), one of Tangent's key initiatives, has arisen as a direct result of work performed by Tangent Labs with SAP products.

In March 2007 Tangent strengthened its position as a leading digital technology company through the acquisition of Ravensworth, a digital marketing business. As well as acquiring the UK's leading site for digital printing it positioned Tangent as the market leader in providing print services to the property market. Furthermore the acquisition created synergies with other Tangent divisions including the opportunity for cross selling into Ravensworth's client base, and the ability to concentrate Tangent's digital printing activities almost exclusively on one site.

Post the Ravensworth acquisition Tangent has continued to evolve. Management have continued to actively develop proprietary technology such as Taobase and Toolkit and have won increasing amounts of work relating to e-commerce (building transactional websites), email marketing and data driven marketing.

In this way they have built on the solid foundation of a quality digital print business to become an end-to-end digital marketing company with market leading proprietary technology and fulfilment capabilities. Furthermore as an end-to-end business, synergies exist within the Group including cross selling of products, yet Tangent is also diversified in its offering.

The end-to-end nature of Tangent's business is now clear following a reorganisation of the divisions within the Group last October. The head office move to new premises in Great Portland Street, putting Tangent at the heart of the media community, also serves to highlight the transition to an agency-led business.

Acquisitions – Taking advantage of the current climate

The current economic environment is providing management with opportunities to purchase distressed businesses at attractive multiples. Management's acquisition strategy is opportunistic rather than aggressive. Tangent's net cash position is a huge asset in an environment where quality businesses may be up for grabs at attractive prices.

We believe that recent acquisitions made by Tangent compliment the Group's positioning as an agency-led business

Lateral

Tangent purchased Lateral in March 2009 when the business was experiencing pressure as a result of the current economic environment.

In acquiring Lateral Tangent effectively acquired a competing team (in recent months Lateral had won significant work that Tangent had also pitched for), with strong creative abilities and doubled the size of Tangent One. The 15-person award winning creative team complements the strong technology offering, enhancing the division's ability to win new business (Tangent One and Lateral have already won their first combined pitch for Boots).

Adding creative strength to the Group complements Tangent's position as an agency-led business, and thus highlights management's approach to strengthening the business in areas where cross selling opportunities are available to the wider Group.

VLM

Tangent purchased VLM in April 2009 as the company struggled as a result of its exposure to the property sector (Tangent effectively acquired the UK license to VLM's software).

VLM is a digital printer and was Ravensworth's key competitor in the property sector with clients such as Savills and Spicer Haart. This strategic acquisition therefore increases Ravensworth's market share (most major estate agent groups are now Tangent clients) and, through an enhanced position in the market, reduces pricing pressure on the division (VLM was the "maverick pricer" in the market).

In 2008 Ravensworth generated revenues of £7.4m (11 month contribution) and achieved an operating margin of 15.3%. The division has meaningful operational gearing and acquiring VLM should further enhance the upside on recovery. We believe the stock price is not currently reflecting these factors.

Furthermore, as part of the VLM deal, Tangent acquired the rights to trade under the Digital Print Partnership (DPP) brand. Developing this is now one of management's key initiatives (see below).

Business units

In October last year Tangent completed a process of restructuring that included re-organising the existing Tangent businesses into 5 clear divisions/ brands. While synergies exist between the divisions, the services provided by each brand are now clear and distinct. This ensures that both new and existing Tangent clients are aware of the full suite of services available from the Group.

Tangent Direct

Tangent Direct offers below the line bespoke and direct marketing services, and as such a more measurable return on investment than with more traditional advertising methods. The brand offers 2 key services, both underpinned by the same proprietary technology.

Firstly, there is the creation of highly bespoke marketing materials on a branch-by-branch basis through a web interface. Tangent prints the marketing materials at the Newcastle facility and distributes them to customers. Secondly, Tangent Direct offers data driven direct marketing. This involves collecting information about a client's customers, and using it to send them targeted emails/ texts etc. The return on a client's investment is measurable through response rates for example.

Tangent Direct's clients include Gala Coral Group, Greene King and Procter & Gamble. The division is well placed to benefit as advertising spend moves away from above the line marketing towards a more targeted and measurable approach.

Ravensworth

Ravensworth is a digital marketing business that was built around providing high quality and bespoke design and printing services to the property sector (including sales particulars and HIPS packs). The printing is carried out in the Newcastle facility alongside the majority of all Group printing work.

While Ravensworth is currently experiencing falling revenues due to the slowdown in the property market, as a result of smaller competitors not surviving the recession, Ravensworth is able to win market share both organically and via acquisition (the recent acquisition of VLM highlights this opportunity). Furthermore, when the economic environment starts to improve pricing pressure on Ravensworth will be reduced.

Ravensworth's client base is high quality and reflects its market leading position in the property sector. Following the acquisition of VLM this dominance is even more apparent and most major estate agent groups are now Tangent clients (Countrywide and, acquired from VLM, Savills, Sequence and Spicer Haart).

Tangent One

Tangent One is a full service digital agency offering website building, e-commerce (building transactional websites), search engine optimisation, email and mobile marketing. Tangent's proprietary technology, Taobase (a tool that captures, stores and segments customer data), is applied to the services offered by the division, producing more personalised and effective marketing messages and return on investment tracking, and is a point of differentiation from Tangent's competitors.

The acquisition of Lateral has served to strengthen the creative strength in this division. Among Tangent One's clients are Boots, the Department of Health and Cancer Research UK. Tangent One is benefiting from the move in advertising spend towards below the line marketing. Furthermore this division is perfectly placed to take advantage of the structural move towards on-line.

Tangent On Demand

Tangent On Demand (TOD) offers a premium quality, fast turnaround, short-run on-demand digital print service. TOD uses personalisation technology to produce customised documents ranging from point-of-sale display posters to brochures. The printing is carried out at Tangent's new location in London's West End.

A key strength of TOD is the division's long-standing and diversified client base across several sectors. Clients include KPMG, Monsoon, Nissan and, from the advertising sector, market leading agencies such as WPP Group and Saatchi & Saatchi. Furthermore the new location places TOD in an optimal geographical position to win new business from the surrounding agency and fashion community.

Tangent Labs

Tangent Labs is the technology development centre for Tangent and also works with Tangent Direct and Tangent One on customer projects. The proprietary technology that continues to differentiate Tangent from their competitors was developed in Tangent Labs and the development work in this division ensures that Tangent remains dynamic and well placed for growth.

Tangent Labs originally developed the technology used by Zui, and the joint venture sits alongside this division.

Strategy

This year has been a difficult one for most Media businesses, and Tangent has not been alone in experiencing some issues as a result of the current economic environment. However Tangent management have not sat still. They have used the opportunity to address the structure of the business, cutting costs and re-organising the group to best drive growth and future profitability. We see 2 key parts to management's strategy.

1) Consolidating the core business and selective acquisition

Tangent has evolved from a high quality digital print business to become an end-to-end digital marketing agency supported by proprietary technology. The recent re-organisation of the business into 5 key brands serves to highlight the transition, and provides a strong foundation on which to drive future growth in the business.

The re-organisation means that future investment in the business can be more focused. The acquisition of Lateral is a good example of management investing to add creative strength to a division of the Group. Acquiring VLM was also a strategic move to increase Ravensworth's market share and, through a stronger market position enhance the upside on recovery.

Tangent has net cash on the balance sheet and management are therefore in a good position to take advantage of opportunities as they arise and are keen to pursue this.

Management are keen that while there are new initiatives for them to focus on going forward, they will continue to drive growth in the established areas on the business through focused investment and technological innovation. Furthermore the end-to-end nature of the evolved Group means that while Tangent is a diversified business, there are a numerous potential synergies within the Group that management are keen to exploit.

2) Driving key initiatives – adding optionality to the share price

Management are currently pursuing three key initiatives. The common theme with all three ventures is that minimal investment is required, and as such the downside risk is minimal. If any one of the ventures is successful it could lead to a significant increase in shareholder value.

i) Digital Print Partnership

Tangent acquired the Digital Print Partnership (DPP) brand as part of the VLM acquisition in April. DPP is a trade digital print service. The initiative aims to exploit the fact that while businesses increasingly want digitally printed product, over 80% of UK printers are yet to make any investment in digital.

Print companies are able to join the DPP for free. When their clients ask for digital printing the DPP member will submit the request to Tangent for a quote. Tangent will then print the materials and deliver them to the print company, who will sell the product on to their client at a mark-up (the level of which is decided by the print company).

The success of Mimeo Marketplace in the US gives an indication of the potential of DPP. Mimeo Marketplace is a division of Mimeo (which last year reported revenues of \$100m), an online, on-demand printing and distribution

business in the US (which counts Hewlett-Packard among its investors). This suggests that this initiative has the *potential* to significantly grow Tangent's revenues in the medium term.

The cost of pursuing this initiative is minimal to Tangent. Little further investment is required. Tangent already has a high quality digital printing facility with capacity (in the short term at least) and distribution capabilities. The running of the DPP interface can be maintained in house and as such the downside risk is minimal. As demonstrated by Mimeo in the US, if the venture proves to be successful it could well produce a significant increase in the underlying value of the Group.

ii) Australian expansion

E-commerce, an area where Tangent has considerable expertise in Tangent One, is particularly underdeveloped in Australia.

This market therefore represents an opportunity for the Group as the market develops. Tangent announced in their trading update in February that Tangent One had won its largest ever contract, to build 5 transactional websites, three of these were in Australia (the remaining two were in New Zealand and Singapore). The client is Angus and Robertson (Australia's leading bookshop and a division of REDgroup Retail, of which Borders Australia, New Zealand and Singapore are also divisions).

The Australian business is now gaining traction and management are hopeful that they will see more business wins soon. Tangent One has no significant competitors in this field in Australia and as such the first mover advantage of expanding into this region is significant.

The virtual nature of the product however enables Tangent One to carry out the design and build of the website in the UK (only two recently appointed account managers are based in Australia). This keeps costs low and means that no significant investment is made in the region until the venture has proven itself to be an ongoing success. Once again the risk-reward profile of this venture is therefore appealing.

iii) ZUI joint venture

ZUI is a 50:50 joint venture between Tangent and De Villiers Walton Ltd offering add-on products to the SAP platform. Using proprietary technology ZUI creates highly customised and user friendly SAP interfaces for customers. ZUI sits alongside Tangent Labs and requires little investment other than the cost of the team. ZUI has just won its first significant contract (which management expect to be worth six-figures), demonstrating the opportunity to commercialise the products in this JV.

As with DPP and Australian expansion, we believe the risk-reward profile of the ZUI initiative is attractive, however there is also the opportunity for further potential upside if ZUI were to be acquired by a stakeholder. For example in 2001 Top Tier Software, a US company providing add-on SAP products, was acquired by SAP at a multiple to sales of c.20x. While this acquisition was towards the end of the tech boom, it highlights the value that a stakeholder such as SAP attributes to having control of a partner company. As such we believe there is option value in ZUI.

Forecasts

Given the current economic environment, particularly in the property sector, we see little in the way of visibility to forecast beyond the current financial year.

The decline in revenues from the property sector was most severe in H2 2008/09. This leads us to expect to continue to see negative y-o-y comparables for H1 2010. For the full year however, Ravensworth's y-o-y comparables will be easing compared to the year just ended and the acquisition of VLM will also make a contribution. Thus we expect to see a decline in Ravensworth revenue in 2010 however one that is less severe than experienced in the year just ended.

We expect the decline in revenue from Ravensworth to be broadly offset by growth in revenues outside the property sector. The recent reorganisation, firmly establishing Tangent as an agency-led Group, should generate growth on an underlying basis through increased cross selling and new business opportunities.

Tangent One and Tangent Direct are also likely to continue to benefit from the move of advertising spend away from traditional above the line advertising methods towards below the line, more accountable methods. Tangent One is also likely to see increasing benefits from the structural shift towards on-line.

We are forecasting revenue of £16.5m for the year to February 2010, representing a broadly flat performance y-o-y on an underlying basis and growth of c.5-6% from the Lateral acquisition. Lateral brings creative strength to Tangent and enhances the Groups ability to win new business.

While we anticipate a rise in the gross margin in the year to February 2010 of c.290bps (due to an increase in the proportion of revenues from the non-property sector), we expect the operational gearing in Ravensworth to result in a decline in margins at an operating level. We are forecasting operating profit of £0.5m for the year to February 2010 (2009: £1.1m) and therefore an operating margin of 3.3%.

With minimal interest being generated on Tangent's positive cash balance due to the current low level of interest rates, this results in underlying PBT of £0.5m for 2010 (2009: and £1.1m) and underlying diluted EPS of 0.22p (2009: 0.48p).

We thus expect Tangent to continue to be profitable in the year to February 2010 and to continue to be cash generative on an operating level (with cash conversion of c.173% (2009: 149%)).

Furthermore, our forecasts attribute no growth from Tangent's three key initiatives, which if any one is success, could lead to a significant increase in shareholder value.

Given management's commitment to paying a dividend in the year to February 2009, we assume that the dividend will be maintained in 2010.

Valuation

Given the Group's substantial net cash position (1.6p per share) we have valued Tangent on a SOTP basis and applied a 20% discount to reflect the current lack of liquidity in the shares. This results in our target price of 9p per share and 105% upside to the current price.

Tangent acquired Ravensworth for £6m in March 2007 and we have attributed this value to the division in our calculation. There is inherent value in Ravensworth and following the strategic acquisition of VLM, its main competitor in the market, Ravensworth has a stronger market position. This business is experiencing a once in a generation cyclical low but there is significant upside when the recovery comes. Thus we believe the purchase price of £6m continues to be justified.

We have valued the remaining Tangent divisions using the average price/sales multiple for the sector (Quest UK Media sector) of 0.9x. (Note that we have excluded Lateral revenue leaving upside risk.)

Figure 1: SOTP valuation

	£m
Cash	2.7
Ravensworth	6.0
Value of remaining turnover	10.5
	<u>19.2</u>
<i>Discount to reflect lack of liquidity (20%)</i>	-3.8
SOTP valuation	15.3
No. of shares (m)	170.1
Price	9.0p

Source: Collins Stewart Research

Tangent has shown that, while it has been a difficult year due to the deterioration in the property sector and visibility remains limited, the Group continues to remain profitable and cash generative. With our price target giving over 100% upside to the current price we therefore upgrade our recommendation from HOLD to BUY.

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Fundamental Research Recommendations issued by Collins Stewart Europe Limited in Q1 2009

Recommendations	Buys	Sells	Hold/Neutral
Percentage of Total	49%	13%	38%
Percentage of which in Corporate Client stocks	15%	0%	9%