

12 August 2008

Price: 337p

Financial Services sector

London Capital Group (LCG.L)

London Capital produced another set of robust results. The out-turn contained no surprises after the guidance given with the trading statement in July. But that does not diminish them as a tribute to the effectiveness and discipline of the LCG model. Revenues rose by over 50%, net cash almost doubled and bad debts were de minimis. The combination allowed an aggressive but comfortably affordable doubling of the interim dividend. We expect further growth from this inherently scalable business with the development of CFDs as a possible gateway to the Orient. Estimates and valuation maintained.

Operational Highlights

Revenue comprises	1h07	2h07	FY07	1h08	2h08e	FY08e
Spread betting	6.2	9.9	16.2	11.3	13.6	24.9
Forex	2.1	1.9	3.9	2.2	2.0	4.2
Brokerage	0.5	0.6	1.1	0.8	0.7	1.5
GROSS GRP REVENUE	8.8	12.4	21.2	14.2	16.3	30.5
Spread betting brokerage & hedging costs	0.7	1.555	2.205	1.7	2.0	3.7
Costs%	7.4%	12.5%	10.4%	12.2%	12.0%	12.1%
NET GRP REVENUE	8.1	10.8	19.0	12.5	14.3	26.9

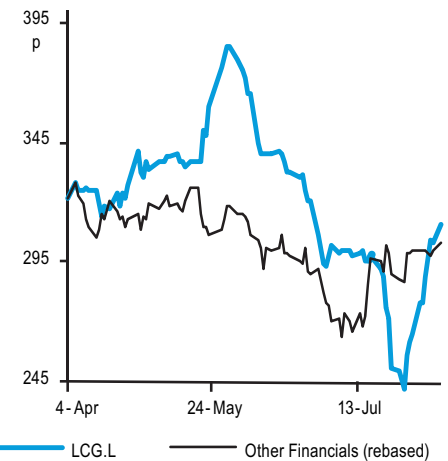
The accompanying table shows the composition of the group net revenue broken down by principal activity. It shows also our estimate of the split during the second half of the current year.

Unsurprisingly it is the spread betting business, Capital Spreads, that is making all of the running – both in absolute size and in growth rates. Forex effectively “flatlined” in the first half but that reflected the removal of two major clients.

Spread betting. Capital Spreads added over 6,700 new clients during the period bringing the total number of “live” accounts to 25,853 (from 13,180). Client acquisition costs were largely unchanged at around £95 per live client. The average number of daily trades (per 100 live accounts) rose to 64 (from 53) although the average value per trade dropped to £4.3 (from £6.0) and the proportion of “active” clients dropped to 37.4% from 43.9%.

In part that is a reflection of the “credit crunched” conditions globally during the first half. It is also a reflection of the different business model operated by some white label partners where clients are signed up, perhaps using promotional deals, with little follow through to convert them from names in a database to active betters.

Price chart (p)



Current fair value of equity

Expected Value	£175.5m
Value per share	£4.58
Pessimistic Scenario	£158.4m
Optimistic Scenario	£229.9m
Value per share (£)	4.14 - 6.00

Company details

Quote	
Shares	
-London AIM	LCG.L
Hi-Lo last 12-mos. (p)	449.75 - 276
Shares issued (m)	38.3
Fully diluted (m)	48.0
Market Cap'n (£m)	129.0
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Nonetheless the all-important size of client funds held on account rose to £23.4m from £15.5m.

Note that although London Capital now has some 15 white-label partners, and increasing numbers of those overseas, in aggregate they represent less than 20% of total transaction volume. Note also that Index trades represent the great majority of the total number of trades. Trades in the top 9 indices (Gold, Oil, FTSE, DAX, DOW, S&P, US\$, GBP and Euro) represent 82% of the total trading volume for Capital Spreads.

During the period Capital Spreads launched a new trading platform in conjunction with a white label partner in Germany. Two other regions have just been or are due to be opened up, one in Denmark and the other in Spain while in Gibraltar, the recently acquired FuturesBetting.com went operational in July.

Over the coming months we expect the “credit crunch” bunker mentality to abate and the London Capital management to effect changes to the conversion rate from live to active clients including those of its white-label partners. Both effects would tend to increase activity rates.

Forex. Capital Forex (15% of group gross revenues (GGR)) added 120 new institutional clients during the first half and saw client funds rise to £22.4m (from £18.4m in 1h '07).

While the growth of institutional business is a clear focus of London Capital's strategy, the first half performance was effectively “flatlined” by the removal of two major clients. During the second half of 2007 one of the two clients put through significant volumes, up to \$4bn in a single day – total Capital Forex volume for the whole of 2h '07 was a little over \$150bn!

However, we understand that the size and manner of his betting was compromising London Capital's providers of liquidity and the decision was taken to terminate his facility.

Against that background, the volume of some \$150bn in the first half, effectively absent two major clients, was a creditable performance.

Institutional broking. Capital Derivatives (less than 6% of GGR) saw modest growth but that was achieved despite a slowdown in the second quarter. Trading volumes rose by almost 19% to 1.6m lots.

Cash, bad debts and dividends

Cash and equivalents ended the first half at £54.4m, an increase of £8.3m. Of that final amount some £22m was attributable to the clients of each of Capital Spreads and Capital Forex . The amount attributable to LCG rose to £9.7m from £4.8m. The London Capital cash-machine rolled on despite the credit crunch; bad debts amounted to £8k across the group.

London Capital's close attention to risk management is, by now, legendary and the results are a further tribute to their application so far.

One result of the jump in group cash is the jump also in the interim dividend, doubled to 2.5p. The cash cost will be some £1m, comfortably within the £9.7m of group net cash. The company has indicated that it has a policy of paying a “sustainable” dividend from the surplus cash after allowing for the earnings and cashflow potential for the group and after allowing for the working capital and capex. Taken together that suggests, on our forecasts, a full year dividend of up to 8p (+23%) – modestly higher than our current forecast.

New platforms, new markets... CFDs: the gateway to the Orient

In July, London Capital launched a new spread-betting platform targeting the German market and has a second alternative platform due to launch later this month.

The cost of associated software development amounted to some £700k, the bulk of the Group’s almost £900k net cash used in investing activities. But it is, in our view, a small price to pay for the strategic advantage that such platforms offer London Capital.

The company believes that the platforms already put it at competitive advantage in its existing markets. Of perhaps even greater significance is the fact that the platforms have been designed to reflect the inherent scalability of the Capital Spread’s business model. Subject to jurisdictional constraints only, the essence of spread-betting is in nature a global business.

The global potential lies behind the latest operations in Denmark and, soon, in Spain. But, in our opinion, the greatest prize may come from a related development. In most of Australasia spread-betting is illegal – as are most forms of gambling. However, Contracts For Differences are, well, different. CFDs are regulated investment instruments and thus trading them is a legal activity throughout much if not all of Australasia.

Little surprise then that London Capital is developing a CFD platform and is making it compatible with its two latest platforms. Management is keen to stress that it will not take its eye off the ball in hand, so to speak. It recognises the limitation of its small size (in other senses a virtue) and that existing opportunities already hold good growth potential. However we will not be surprised to see despatches from the Orient making their way into future trading statements.

Effect on forecasts

The interim results were broadly speaking in line with our model although overall COGS was at almost 21% marginally higher than the 18.5% we have estimated for the full year. The difference amounts to some £0.6m at the gross profit line in the current full year.

As we mentioned earlier, that higher number for COGS is in part a reflection of the development of white-label business and it is the purpose of London Capital’s management to bring operating efficiencies to bear over time. Given London Capital’s track record we are content for now to leave our COGS and thus overall estimates unchanged.

Financials

Income statement					
Year ending December (£000's)	2007	2008	2009	2010	2011
Revenues	18,980.0	26,935.3	36,229.9	43,726.0	51,115.8
COGS	(3,774.0)	(4,978.5)	(6,743.2)	(7,549.8)	(8,741.1)
Gross profits	15,206.0	21,956.8	29,486.7	36,176.3	42,374.8
Selling costs	(5,595.0)	(8,080.6)	(10,869.0)	(13,117.8)	(15,334.7)
EBITDA	9,611.0	13,876.2	18,617.7	23,058.4	27,040.0
Depreciation & amortisation	(434.0)	(849.0)	(870.8)	(893.1)	(916.0)
Equity-settled share-based payment	(737.0)	(1,049.3)	(1,410.1)	(1,750.1)	(2,060.2)
EBIT	8,440.0	11,977.9	16,336.8	20,415.2	24,063.8
Interest	134.0	626.5	953.7	1,357.5	1,824.5
EBT	8,574.0	12,604.5	17,290.6	21,772.7	25,888.3
Tax paid	(2,566.0)	(3,781.3)	(5,187.2)	(6,531.8)	(7,766.5)
Earnings	6,008.0	8,823.1	12,103.4	15,240.9	18,121.8
Dividends	(1,129.0)	(2,654.7)	(6,051.7)	(7,620.4)	(9,060.9)
Retained earnings	4,879.0	6,168.4	6,051.7	7,620.4	9,060.9

Cash flow statement					
Year ending December (£000's)	2007	2008	2009	2010	2011
EBIT	8,440.0	11,977.9	16,336.8	20,415.2	24,063.8
Depreciation	434.0	849.0	870.8	893.1	916.0
Equity-settled share-based payment	737.0	1,049.3	1,410.1	1,750.1	2,060.2
(Increase) decrease in receivables	(410.0)	(953.5)	(1,008.9)	(865.5)	(773.9)
Increase (decrease) in payables	3,519.0	211.2	302.8	140.2	200.2
Increase in client deposits	20,995.0	20,823.4	15,955.4	14,518.4	13,194.1
Net cash from Ops	12,720.0	13,134.0	17,911.6	22,333.1	26,466.2
Tax paid	(1,737.0)	(3,781.3)	(5,187.2)	(6,531.8)	(7,766.5)
Dividends	(1,129.0)	(2,654.7)	(6,051.7)	(7,620.4)	(9,060.9)
Net interest received (paid)	134.0	626.5	953.7	1,357.5	1,824.5
New (deposits) borrowings	—	—	—	—	—
Capital expenditure	(2,094.0)	(933.9)	(957.9)	(982.4)	(1,007.6)
Net cash from financing	(4,826.0)	(6,743.5)	(11,243.0)	(13,777.2)	(16,010.5)
Net increase (decrease) in cash	7,894.0	6,390.5	6,668.6	8,555.9	10,455.8

Balance sheet					
Year ending December (£000's)	2007	2008	2009	2010	2011
Fixed assets at NAV	12,684.8	12,702.9	12,790.0	12,879.3	12,970.9
Goodwill	9,303.0	9,303.2	9,303.2	9,303.2	9,303.2
Software plus PP&E	3,314.8	3,399.7	4,069.8	4,150.3	4,232.9
Deferred tax asset	67.0	—	—	—	—
Cash	10,319.0	16,793.7	23,462.3	32,018.2	42,474.0
Client cash on deposit	35,813.0	56,636.4	72,591.9	87,110.2	100,304.3
Receivables	1,096.0	2,049.5	3,058.4	3,923.9	4,697.8
Less Payables	(40,978.0)	(62,012.6)	(78,270.8)	(92,929.3)	—
of which client cash	(35,813.0)	(56,636.4)	(72,591.9)	(87,110.2)	—
trade payables etc	(5,165.0)	(5,376.2)	(5,678.9)	(5,819.1)	(6,019.3)
Net current assets	6,250.0	13,467.0	20,841.7	30,123.0	41,152.6
Less loans	—	—	—	—	—
Capital employed	18,934.8	26,169.9	33,631.7	43,002.3	54,123.4
Represented by					
Shares in issue	3,829.0	3,829.0	3,829.0	3,829.0	3,829.0
Share premium	11,607.0	11,607.0	11,607.0	11,607.0	11,607.0
Add retained profit					
Prior periods	2,708.0	7,639.0	13,807.5	19,859.2	27,479.6
This period	4,931.0	6,168.5	6,051.7	7,620.4	9,060.9
Share option reserve	1,203.8	2,270.4	3,680.5	5,430.6	7,490.8
other reserves	(5,344.0)	(5,344.0)	(5,344.0)	(5,344.0)	(5,344.0)
Shareholders' funds	18,934.8	26,169.9	33,631.7	43,002.3	54,123.4

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