

## London Capital Group (LCG)

Financial Services Sector

# 309p

*On 3 July, London Capital Group (LCG) issued a upbeat trading statement, stating it expected pre-tax profit for the first half of 2007 would be some 50% above original management expectations. Volumes in its two main businesses have risen sharply, with growth clearly exceeding forecasts leading to these upgrades; we expect further upgrades if this momentum continues into the second half.*

### KEY POINTS

- **Capital Spreads quarterly client add rate more than doubled** in the second quarter of 2007 compared to the fourth quarter 2006. New clients are the main engine of growth for Capital Spreads. If activity levels remain constant, a doubling of the rate of acquisition bodes well for full year results.
- **Capital Forex quarterly volumes have also more than doubled** over the same period. Capital Forex is a highly scaleable commission-based business that depends on volumes to increase earnings. The doubling of volumes in the second quarter of 2007 is unlikely to have been accompanied by any appreciable increase in costs and therefore should translate into strong earnings growth.
- **Five spread betting white label partnerships have been signed** in the first half of 2007. Although Capital Spreads pays away a portion of earnings to its partners, white-label agreements are a cost-effective way of increasing clients, particularly in overseas markets where the company has no brand awareness. The increase in white-label agreements will continue to fuel growth in the second half.
- **The company intends to pay an interim dividend of 1.25 pence.** This is perhaps the strongest signal in the trading update that 2007 has begun very strongly. The group paid a dividend of 1.7p for 2006, so the proposal of an interim of 1.25p encourages confidence in the full year.

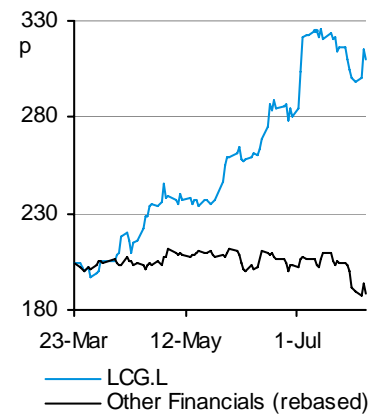
### COMMENT

Although we will have to wait for the publication of the 2007 first half results on 9<sup>th</sup> August for detailed figures, it is clear from the tone of the trading update that this will be a sparkling set of results. The most telling clues being the proposed interim dividend and the volume increases.

Market conditions and in particular volatility, have been favourable for spread-betting this year and the rate of client acquisition has evidently accelerated sharply. We estimate that the number of new clients in the fourth quarter of 2006 was about 1,000, suggesting a figure of 2,000 plus for the second quarter of 2007 and possibly around 3,500 new clients for the first half. The likely impact on earnings can be gauged from comparison with the total number of clients for 2006 of 8,708.

Our initiation report on 17 May 2007 argued that LCG's business model is highly scaleable both for spread betting and Foreign Exchange. This allows the company to handle far higher volumes without a corresponding increase in either staffing levels or overheads. It is clear from the trading update that both Capital Spreads and Capital Forex are enjoying these higher volumes and this will lead to a further increase in profitability.

### Price Chart



### Objective Capital's Valuation

Scenario £m	Core
Capital Spreads	95.8
Capital Forex	21.7
Derivatives	1.0
<b>Value of firm</b>	<b>118.5</b>
Add: starting cash + new funds	3.5
Total current value for firm	122.0
Less: starting & new debt	0.0
Total value to equity claims	122.0
Less: options	6.9
Ordinary Equity Holders	115.2
Value per share (p ps)	<b>3.01</b>

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The company did state that it had introduced IT enhancements to ensure future scalability but we believe that this has been an ongoing process over the last twelve months or so. As such, it is unlikely to prove a discernible brake on profits growth.

Our initiation showed revenue and earnings growth ahead of consensus for 2007 and 2008, an approach we feel has been vindicated. This said the increases and information disclosed lead us to believe our forecasts need to be updated. We have therefore increased our forecasts for revenues in 2007 from £12.6m to £14.15m and in 2008 from £17m to £20.1m. Our forecasts for EBITDA increase from £6.04m to £7.99m for 2007 and from £8.2m to £11.64m for 2008.

While these forecast increases seem large, and may well be ahead of consensus, in our view the company is evidently experiencing sharp volume increases, which the new white-label partnerships will enhance. It is also benefiting from market volatility, which is keeping activity levels high. From November 2007 MiFID, the EU Markets in Financial Instruments Directive, will allow marketing across the EU for the first time. This will further boost growth potential.

Our forecasts for the next eighteen months reflect the premium growth rates that LCG is currently achieving, thereafter we have tapered our forecasts towards the rates that its underlying markets are expected to deliver. These may prove unrealistic in the event either that LCG no longer manages to deliver growth in-line with or ahead of the market, that markets themselves develop more slowly than anticipated or less volatility in financial markets.

<b>Year ended Dec (£000)</b>	<b>2006A</b>	<b>2007E</b>	<b>2008E</b>	<b>2009E</b>	<b>2010E</b>	<b>2011E</b>
<b>Revenues</b>	<b>8,651</b>	<b>14,150</b>	<b>20,114</b>	<b>26,845</b>	<b>34,187</b>	<b>42,618</b>
COGS	-1,798	-2,660	-3,683	-4,774	-5,519	-6,674
Gross profits	6,853	11,489	16,432	22,071	28,668	35,944
Interest on client deposits		610	773	1,017	1,351	1,791
Selling costs	-2,819	-4,105	-5,560	-7,415	-9,454	-11,778
<b>EBITDTA</b>	<b>4,034</b>	<b>7,994</b>	<b>11,645</b>	<b>15,672</b>	<b>20,565</b>	<b>25,957</b>
Depreciation & amortisation	-164	-387	-364	-342	-322	-303
Equity-settled share-based payment	-541					
EBIT	3,329	7,608	11,281	15,330	20,242	25,654
Interest	43	203	258	339	450	597
EBT	3,372	7,811	11,539	15,669	20,693	26,251
Proforma tax	-968	-2,343	-3,462	-4,701	-6,208	-7,875
<b>Earnings</b>	<b>2,404</b>	<b>5,468</b>	<b>8,077</b>	<b>10,968</b>	<b>14,485</b>	<b>18,376</b>
Dividends	0	-1,054	-1,454	-1,974	-2,607	-3,308
<b>Retained earnings</b>	<b>2,404</b>	<b>4,414</b>	<b>6,623</b>	<b>8,994</b>	<b>11,878</b>	<b>15,068</b>

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