

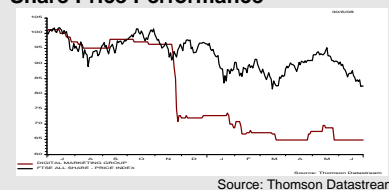
2 July 2008

UNITED KINGDOM • MARKETING SERVICES

BUY

Price at 1 July 2008 (p) 78
Price Target (p) 160
52-week range (p) 78 - 125
Reuter: DIGI.L Bloomberg: DIGI LN
Exchange: AIM Ticker: DIGI

Share Price Performance



Performance(%)	1m	3m	12m
Absolute	-2.5%	-2.5%	-37.6%

Stock Data

Market cap (£'m)	51.8
Shares outstanding (m)	66.5

Key Indicators

Net cash/(debt) (£'m)	0.2
EBITDA margin (%)	22

Activities

Digital direct marketing services; online communications

Directors

Stephen Davidson	Chairman
Ben Langdon	CEO
Sarah Guest	CFO
Gary Stevens	
Andrew Wilson	NED
Ian Robinson	NED
Barry Jenner	NED

Significant Share Holders

Mayfair Ltd	25.3%
Gary & Helena Stevens	10.8%
Martin Boddy	7.5%
Andrew Gardner	7.5%
Katherine Jerman	4.3%
Total	55.4%

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Digital Marketing Group

Validation

Digital Marketing Group (“DMG”) has announced results for the year to March 2008 that are ahead of our expectations. DMG, which is now the fourth largest digital agency in the UK, delivered EBITDA of £7.4m (£2.27m) and EPS of 7.3p (5.13p). Given acquisitions during the period (Graphico and Hyperlaunch in June 2007) we look at proforma figures to track growth. On a proforma basis the Group delivered EBITDA of £7.85m (£5.68m). The outperformance was largely driven by higher than anticipated margins due to a reduction in customer acquisition cost. This validates Management’s strategy of building a fully integrated digital direct marketing agency as cross referrals and joint client wins accounted for £2.4m of the £5.7m proforma organic growth at the gross profit level. We expect a continued strong performance in 2009. The continued switch to digital marketing from traditional services and the strength of the data services business in particular should act as a good insulator from potentially tricky market conditions ahead.

Results

DMG is split into three divisions – Online Marketing and Media, Direct Marketing and Data Services and Consultancy. As expected, Online Marketing delivered significant EBITDA organic growth of 83%, delivering a proforma EBITDA of £3.15m (£1.72m) on the back of gross profits of £11.96m (£9.75m). The key drivers were the continued movement to online media and the strength of DMG’s offering. The division picked up a number of key accounts and industry awards throughout the year including Graphico’s 2008 Revolution Awards for “UK Best Website”, Inbox NMA Effectiveness Award 2007 and Graphico’s Best Innovation at BT’s Digital Music Awards 2007.

The outperformance of the Group largely stemmed from the Data Services division which delivered £3.46m proforma EBITDA (£2.49m) versus our forecast of £2.9m. This is unsurprising in our view as data services are at the core of an effective digital marketing programme and DMG has unique capabilities in data. The Company’s “Digital Brain” incorporates analytics developed specifically for each client and draws on a variety of online and off line data sources to provide real time insights and recommendations that translate into real time decisions. High value added applications include credit assessment and management and bad debt forecasting and provisioning.

Forecasts and ratios

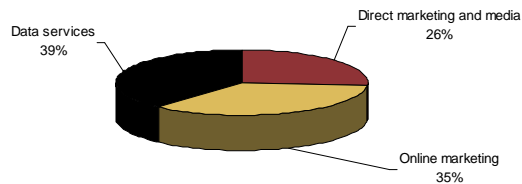
Year End March	2005A	2006A	2007A	2008A	2009E
Gross profit		-	8.4	33.1	39.0
Gross profit proforma	14.3	19.1	29.4	35.0	39.0
EBITDA (£'m)**			2.3	7.4	8.7
PBT* (£'m)			1.7	6.3	7.4
PBT proforma*			4.7	6.7	7.4
EPS (p)*	-	-	5.1	7.3	7.9
% Change	-	-	-	42	8
PER (x)			15.3	10.7	9.9

Source: Cenkos Securities estimates, company data - *less amortisation and share based payment charges;**less charges for share options

Direct Marketing performed in line with expectations with a proforma EBITDA of £2.37m (£2.32m) from gross profits of £11.04m (£9.5m). On a proforma basis this translates to growth in gross profits of 16% and EBITDA organic growth of 2%. This was actually a very good performance as it was affected by the underperformance of one company in this direct marketing segment, HSM, which experienced a scale back in activity from financial services clients. This was more than compensated by outperformance of other parts of the division demonstrating the advantages of diversification. Dig For Fire by comparison achieved good growth of 21% in EBITDA.

The higher than anticipated profit margins across the group are accounted for by a reduction in customer acquisition costs, thus reflecting the power of an integrated offering, the Company's success in integrating the individual businesses and the growing reputation of DMG in the industry. The Company has successfully rationalised its cost base achieving initial annualised cost savings of £100,000.

EBITDA contribution by division*



Source: Cenkos Securities

* Proforma EBITDA to reflect 12 months activity of acquired businesses

Financial flexibility

The year to March 2008 was highly cash generative with an operating profit to cash conversion of just over 100%. As expected, the Group has paid down debt and now has a positive net cash position of £0.18m vs a net debt position of £7.91m in March 2007. The company is ungeared from 47% a year ago and the Company has undrawn borrowing facilities of £11.27m, all of which place the company in a strong position to continue to take advantage of opportunities that arise.

The market

There is no doubt that the general outlook for advertising and marketing spend is not as robust as it was twelve months ago. This is particularly the case for financial services. However the digital space is still expected to grow strongly. There are several other reasons to believe that DMG will weather this storm better than most and use it as an opportunity to grow market share.

- DMG provides clients with the best services in the industry. This is ultimately illustrated through client wins and growing sales. New client wins include Bacardi, AA, Audi, Blackberry, Carlsberg and VW, amongst many other. DMG's businesses were awarded several industry awards for best-in-class performances including the prestigious "2007 Digital Direct Marketing of the Year" award.
- Tighter conditions will undoubtedly accelerate the shift to digital marketing as returns on marketing spend can be assessed more effectively than traditional marketing methods. DMG will benefit from this trend given its sole focus in digital.
- DMG enjoys a leaner cost structure than competitors as its operations are not concentrated in London.
- DMG's one-stop-shop approach will enable its larger clients to save costs by rationalising their supplier base.
- DMG's Data Service operation is a USP. There are few other offerings that can track the effectiveness of a marketing campaign from cradle to grave.

The way forward

DMG's business model has three elements: organic growth from its best-in-class regionally based agencies, growth through cross referrals resulting in higher gross profit margins and the development of new products and solutions. In addition, the Company will continue to evaluate external opportunities on a highly selective basis only when such opportunities would either (i) enable entry into new market sectors within digital marketing or data services, (ii) enable the development of new 'routes to market' (e.g. through the acquisition of digital consultancy services) or (iii) increase the success and profitability of its existing products/services.

Financial forecasts

We are modifying our 2008/09 forecasts to reflect the improved profitability of the divisions. This involves shaving our gross profit forecasts from £41m to £39.0m but leaving our PBT forecast at £7.37m. Our eps forecast has increased from 7.8p to 7.9p. This means that we expect the group to deliver 18% growth in gross profit on an actual basis and 11% growth on a proforma basis.

Valuation

These results reflect a remarkable year for DMG where amongst many other achievements, the eps grew by 42%. The share price by contrast has dropped 38%. This represents an excellent opportunity in our view as DMG will continue to outperform the industry over the coming year.

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