NOBLE

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The digital marketing arena

Who will be victorious?

Why now?

Many have tried and failed to benefit from profound change in the media sector. Three companies which we highlight in this Beachcomber piece are seeking to exploit the incessant transition to online and digital platforms. In the small cap space, Digital Marketing Group, Alterian and Phorm are each attempting to carve out a defensible market position using bespoke software to differentiate themselves from the crowd. This is particularly interesting following IBM's announcement on 28 July 2009 regarding an agreed $1.2bn offer for SPSS, a US-based provider of database analytics software. The rating paid was strategic, valuing the business at 22x 2009E EPS, and around 4x sales. Rather than demonstrating the valuation potential for Digital Marketing and Alterian, it highlights the strategic importance of what these small innovators offer.

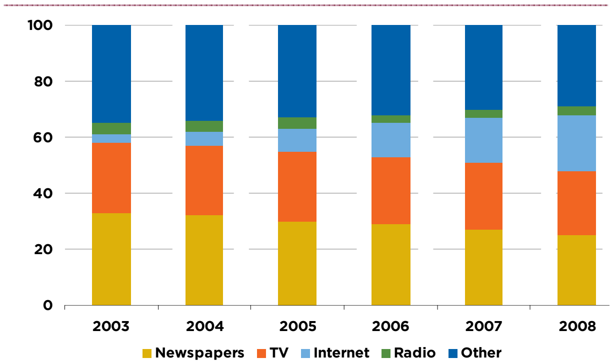
1. **The new usurps the old: web advertising goes from strength to strength**
2. **The three companies: DIGI, ALN and PHORM**

THE NEW USURPS THE OLD: WEB ADVERTISING GOES FROM STRENGTH TO STRENGTH

The dynamics of the media sector over the past five years may be characterized by attempts of its participants to deal with the two challenges of profound structural change and cyclical decline. Thanks to the digitization of content and proliferation of distribution channels, audiences have fragmented and the power traditionally enjoyed by broadcasters has been usurped by those who actually create the content. Numerous established media companies have struggled to cope with this audience fragmentation and loss of negotiating power. The root and branch shift in consumer behaviour in accessing content has seen online advertising grow exponentially over the past five years.

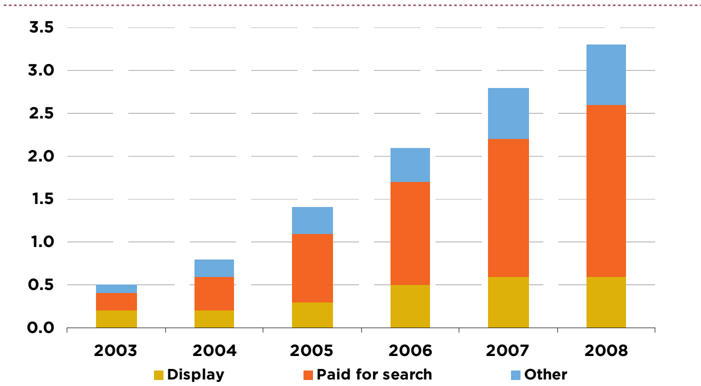
The key website categories which offer free-to-access online content, funded at least in part by advertising, include music streaming sites (e.g. We7 and Spotify), online video sites (e.g. Joost, 4OD, Demand Five and Hulu), social networking sites (e.g. Facebook and MySpace) and newspaper websites providing free to view access to elements of their print content.

Share of advertising by medium (%, UK)



Source: Ofcom

Internet advertising by category (£bn, UK)

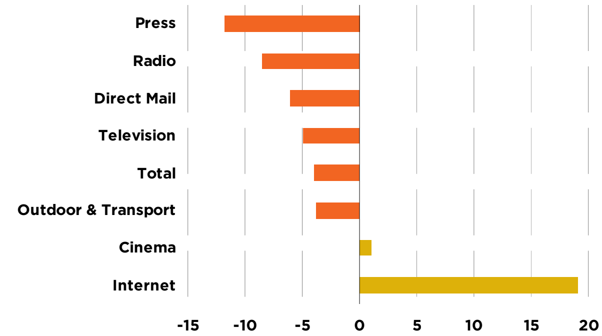


Source: Ofcom

As can be seen from above, most online advertising revenue accrues through paid-for search and the major search engines such as Google, Bing and Yahoo!Search take much of the revenue.

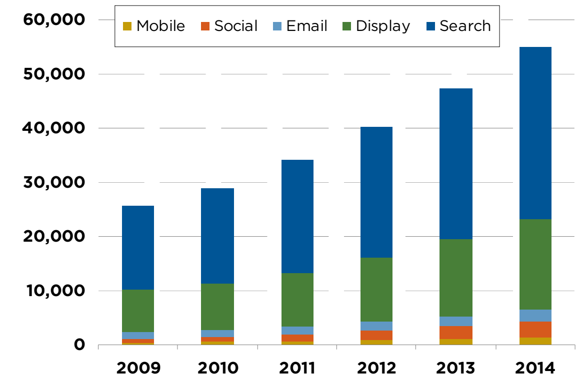
Digital media is driving a world which forces justification of ideas and the measurement of outputs. Everything becomes measurable, so agencies will have to justify their ideas against well-defined, client performance indicators.

Percentage change in advertising spend by medium (UK), 2008 versus 2007



Source: Advertising Statistics Yearbook 2008

Forecast interactive marketing spend, USA ($m)



Source: Forrester

In the UK, the paid search market comprises ~60% of all online advertising spend, corresponding to ~£2bn. Google is the dominant search engine, accounting for 81% of traffic in the first quarter of 2009. Marketing via search engines is unique in that it allows advertisers to measure their return on investment (ROI) and change elements of their campaigns based upon those returns on a daily basis.

With ROI improving, advertisers are likely to continue to increase spending in paid search. Indeed, advertisers are increasingly focused on efficiency of spend and profit, with Google's cost per click falling by a third over the past twelve months. Impression trends have increased significantly over the past year as consumers have used paid search to investigate products before purchasing them.

The marketing industry is going through profound structural change. Many companies are looking to shift from mass communication tools to marketing based on engaging and interacting with the individual. Non-specialist agencies have sought to react to this change and created, usually through some combination of acquisitions and internal development, in-house digital sections.

Last reported financials of *Campaign's* top Direct Marketing and Sales Promotion Agencies (privately owned)

Name	Turnover (£m)	Gross profit (£m)	Notes
Iris Worldwide	68	37	Consider themselves as leaders in integrated digital marketing, focusing on interaction with customers. Employs 35 people in its digital team.
Gyro International	51	34	Offers a range of services, specialising in 4 areas, Business to Business, Branding, Digital and Healthcare. Traditional digital marketing techniques as well as more original solutions.
CHI & Partners	55	24	"A blend of traditional and digital services.
EHS Brann	30	21	Specializes in Direct Marketing, Digital Marketing, Data and Drive and perceives the future to be in digital marketing and is aligning itself to take advantage of this shift. It sees "data analysis as the new creativity."

Source: Marketing's top Direct Marketing and Sales Promotion Agencies, March 2009, and company websites

THE COMPANIES

DMG is one of the few quoted media companies to have the required flexibility to adapt to changing economic conditions and a low cost operating model to enable it to maintain profitability. Its products and services allow the marketing communications of organizations to be streamlined within a single digital channel or integrated across multiple channels to create a relevant message. At first glance, **Alterian** offers a similar product to DMG in that it creates a profile of each customer or prospect based on their purchase history, past marketing responses and visits to the corporation's website, and and adapts the marketing depending on their actions. Other companies, such as **Phorm**, have struggled to position themselves profitably.

Table 1 Relative valuation of DIGI, ALN and Peers

Name	Ticker	Currency	Price (€,£,$)	Mcap (m)	EV (m)	EV/ Sales	EV/ EBITDA	EV/ EBIT	P/E	Rev CAGR FY0-FY2	EPS CAGR FY0-FY2	FY1 Div Yield	FY1 Net debt(cash)
Havas	HAV FP	EUR	2.0	878	894	0.6	4.8	5.9	10.7	-3%	-11%	2.0%	62.2
Publicis	PUB FP	EUR	25.5	4993	5697	1.2	7.2	8.5	12.9	-1%	-6%	2.4%	649.0
Omnicom	OMC US	USD	35.2	10942	13409	1.1	8.1	9.4	13.2	-5%	-8%	1.7%	1582.5
Interpublic	IPG US	USD	5.9	2853	3942	0.7	6.0	8.9	18.4	-7%	-19%	0.0%	(148.3)
Aegis	AGS LN	GBP	0.9	1060	1332	1.0	7.3	8.7	11.4	0%	-12%	2.8%	294.1
WPP	WPP LN	GBP	4.6	5793	9058	1.0	7.0	8.5	9.7	8%	-9%	3.5%	3127.2
Phorm	PHRM Ln	USD	2.4	25	18	0.4	NM	NM	NM	NM	NM	0.0%	(15.6)
Digital Mktg	DIGI LN	GBP	0.4	28	33	0.5	3.7	4.0	5.7	6%	1%	0.0%	2.4
Alterian	ALN LN	GBP	1.5	86	78	1.8	7.2	7.5	8.4	18%	16%	0.0%	(11.1)

Source: AGS estimates from Noble. PHRM, DIGI and ALN estimates from Reuters. Others from Bloomberg. FY0= Last reported, FY1 = Current year forecasts, FY2 = Next year forecasts. Current EV from Bloomberg. Annualised Multiples.

Digital Marketing Group: small but perfectly formed

The Digital Marketing Group (DIGI) was set up in 2006 and today is the largest digital marketing agency in the UK (Source: Campaign Magazine, Digital Business League, January 2009). DIGI comprises nine smaller companies which offer different digital services (such as email, CRM, pay-per-click, search engine optimization and mobile) and are based around the UK but outside of London. The group can list amongst its clients such names as Panasonic, Sony, the Natural History Museum, TOMY and Reuters.

DIGI has three reporting segments comprising (1) Online Marketing and Media, (2) Data Services and Consultancy and (3) Direct Marketing. The company offers Digital Marketing, Data Intelligence and Direct Strategy. The Data intelligence, driven by its Digital Brain product, is the most important factor which differentiates Digital Marketing Group from other digital marketing agencies. This Digital Brain allows "customer profiles to be built, enabling the most relevant message to be delivered to the customer."

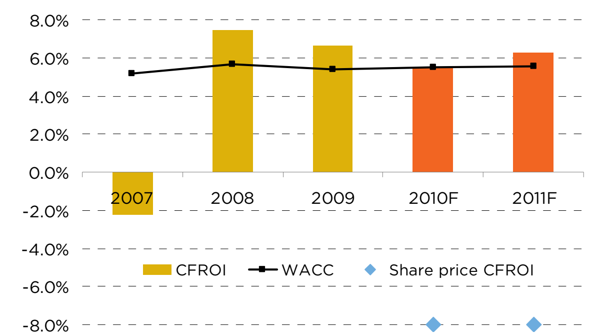
The innovation does not stop there. Combining DMG's paid search expertise and smart statistical modelling techniques, Digital Brain: Search has been created which allows users to analyze all of the search interactions which occur in a customer's journey to purchase. Interestingly, the prevailing model is known as "Last Click Wins", an approach which attributes the sale to the last interaction which a consumer has before acting. This approach means the consumer can be targeted at his first interaction with the brand, providing a return on investment for in the paid search budget. Tracking the different paths to purchase means Digital Brain: Search provides more insight to inform online and offline strategies. Digital Brain: Search draws on pre-existing, non-private data from a number of sources and uses industry standard technologies, making it easy to implement without controversy.

Digital Marketing Group has executed successfully a highly non-trivial task: that of marrying a group of complementary creative agencies into a coherent whole whilst simultaneously underpinning that creativity with a highly analytical, data-driven set of tools to understand consumer behaviour online, regardless of platform. Over the last three years, DMG has grown rapidly through a series of acquisitions but has now stated it is in a period of organic growth over the next 18-24 months. Despite the downturn over the past two years, the company has continued to meet market expectations, continued to grow, both organically and through acquisitions, and been able to capitalize on the growing market share of the digital sector.

That strength has not made it immune to the storm in the broader economy. In its final year report announced on 6 July 2009 for the twelve months to 31 March 2009, Digital Marketing Group's management reported "a difficult end of their financial year and anticipate a slow 2009 before things start to look up again in 2010." In response, no client now accounts for more than 5% of group gross profits and, other than financial services, no sector accounts for more than 10%. Over the course of FY09, £3.9m in gross profits came through cross-referrals across the group, corresponding to 9% of FY09 gross profits, a two percentage improvement over FY08's performance of 7% of gross profits.

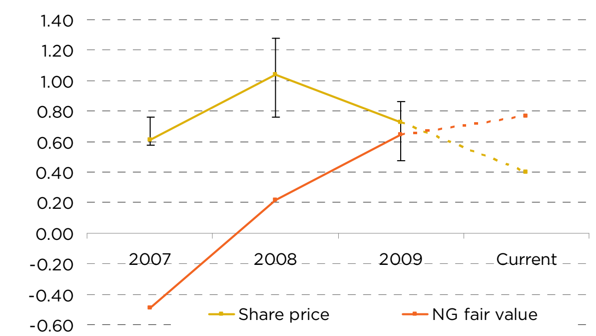
Given that the group has called an end, at least for the next 18 months, to making acquisitions, there is negligible acquisition risk. Even the mightiest macroeconomic bears are not expecting the environment to worsen further, condemning us all rather to an extended period of bouncing along the bottom. Furthermore, thanks to minimal capex and the negative working capital characteristics of the group, the net debt position of £5.9m at 31 March 2009 should fall to ~£2m by March 2010 with the group being net cash to the tune of ~£2m by March 2011. At March 2009, the group had undrawn borrowing facilities of £7.1m.

Historical and forecast CFROI performance



Source: Company reports, Consensus Reuters estimates

Historical and current share price performance



Source: Company reports, Noble Analysis, Reuters estimates

Arising from our CFROI analysis, the prevailing view of DIGI would appear to be one of pessimism, seemingly engendered by the expectation of more bad news to come. Even by our standards that appears a tad conservative. Over the last two reported financial periods, the group has beat its cost of capital with the current "batten down the hatches year" to March 2010, returns are at parity with WACC. The act of tarring all media companies with the same brush has opened a fascinating opportunity here, sitting as it does on an annualized P/E of 5.1x.

Furthermore, doing a reverse DCF, the current share price discounts a CFROI of (8)%, a 14 percentage point gap from that implied by consensus forecasts. This is the Share Price CFROI above. Even if we wrong on that reality gap by, say, five to eight percentage points, that still leaves us with sizeable upside, viz. 30-40%, from current levels. The next scheduled announcement to the market is its pre-close statement for the six months ending September 2009, due in early October.

Alterian: momentum building

At first glance, one of DMG's closest quoted competitors is **Alterian**, which is marketing a suite of applications which help to improve the effectiveness of digital marketing campaigns. Alterian integrates database, email, social media monitoring and web content management applications on a single data infrastructure. It is used by over 1,100 marketing departments and agencies worldwide to "unlock insights, execute integrated online and offline campaigns and report on marketing effectiveness."

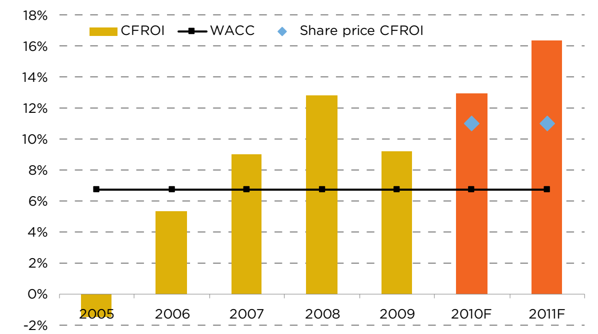
The company was founded in 1997 and floated in 2000 on the LSE raising £35m. Between 2006 and 2009, Alterian has delivered sales and EPS CAGR of 46% and 52% respectively. In the twelve months to March 2009, the company reported net cash of £8.6m, having enjoyed revenue growth of 73% to £33.4m. In its trading statement of 23 July 2009, Alterian observed North America in particular has benefited from initial sales of the Acquire offering, launched in response to the adverse economic conditions and targeted specifically for large national prospect marketers in that region.

Alterian has acquired expertise to improve its offering to clients as well as develop products internally. Two acquisitions of note were the recent acquisition of social media monitoring and analysis software vendor, Techrigy, and last year's purchase of Mediasurface which brought website analytics into the product offering, the two moves reflecting Alterian's strategy of extending the capabilities of its Integrated Marketing Platform with complementary technology in high growth areas of the market.

Alterian's recent acquisitions		
Company name	**Price paid, (£m)**	**Rationale**
Mediasurface (July 2008)	£18.1m (EV/sales of 1.3x)	Introduced web content management to Alterian's product suite.
Techrigy	£4.1m plus the assumption of a shareholder loan of £0.9m	Techrigy is a leading social media monitoring and analytics company.

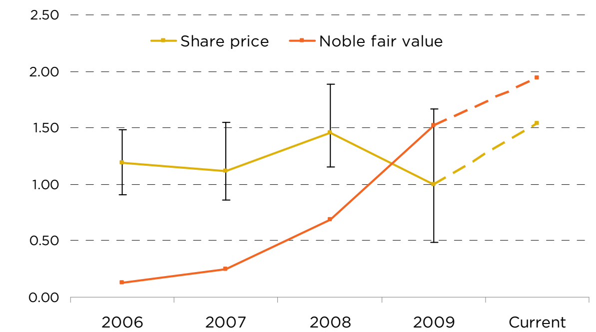
Alterian does not have any “creative agency”-type products within its offering, preferring to form partnerships with creative agencies. Furthermore, it prefers to concentrate on developing innovative new products and so it partners with IT service companies to complete any installation, maintenance or servicing work. That approach has seen gross margins hover in the 85-90% range over the past three years and allowed the group to report EBITDA margins of approximately 20%. With 60% of its revenues recurring, Alterian’s healthily robust CFROI spread over WACC gives succour to management’s statements of its products enjoying relatively low customer attrition rates of 10%.

Historical and forecast CFROI performance



Source: Company reports, Reuters estimates

Historical and current share price performance



Source: Company reports, Noble Analysis, Reuters estimates

Alterian’s successful up-selling thanks to its 150-strong partner channel despite approximately 80% of marketing departments making advertising expenditure cuts of c25% over the past year, suggests that consensus EPS CAGR FY09-FY11 of 16% is well supported by a set of products finding resonance with marketers in the UK and across Europe as well as the US and Asia-Pacific. The mis-pricing less stark here than was the case with DIGI as Alterian’s share price has enjoyed a strong rally over the last three months in tandem with the broader software and services sector. Alterian’s next scheduled announcement to the market is its interim FY10 results in the first week of November 2009.

Phorm: struggling to find a foothold

Phorm is also in the market of targeted digital advertising and has developed a technology called webwise. It plans to sign agreements with ISPs and then monitor the behaviour of internet users and match in what they appear to be interested with appropriate advertisements. Phorm describes itself as unique, in not just creating a new or improved product but creating a whole new paradigm to help the marketing industry combat audience blindness. Phorm believes its offering will benefit ISPs, the customer and the advertiser, and will be easy to opt out of should the consumer not want his/her behaviour monitored.

In 2008, the EU commission highlighted the fact that tracking people over the internet without their permission was actually illegal and that Phorm should be stopped. The commission’s concerns which were reported in the press in August 2008, culminated in the EU starting legal action against Britain on 14 April 2009, for what it called a failure to keep people's online details confidential.

Last year, Phorm and BT received bad publicity after it emerged that they had conducted trials in secret. BT confirmed on 6 July 09 that it has no immediate plans to deploy Phorm as the company is “focusing on more pressing matters, although we [BT] will continue to monitor Phorm’s progress.” On 7 July 2009, TalkTalk terminated its relationship with Phorm.

Currently, the technology is not being used because it is being modified to achieve the required standards for full deployment in the UK. This process has taken longer than anticipated so Phorm has started the process of trying to market its wares in other countries in an attempt to speed up the adoption process. ISPs will be offered the service for free with revenues initially expected to come from advertisers. South Korea has been identified as the best opportunity. Korea will be first market launched into and represents a large market, the sixth largest broadband market in the world. Targeting this new market, Phorm raised new equity capital of £15m on 10 June 2009. In the last two financial years of 2007 and 2008, Phorm’s reported revenues have been nil. Cumulative net losses for that period are US$80m.

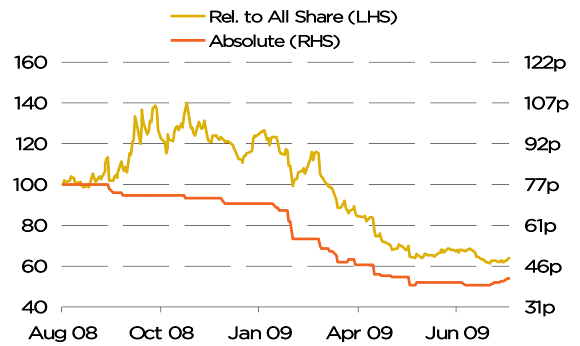
COMPANY BACKGROUND: DIGITAL MARKETING MEDIA

Company data, DIGI.L

Current price	39	52 week range	39-78p
Market Cap	26.3	Avg vol, 3M	22k
£m	Mar-09	March-10E	March-11E
Revenue	56.7	60	64.1
Growth		5.8%	6.8%
EBITDA	9.29	8.8	9.6
Margin	16%	15%	15%
Pre tax profit	3.1	5.3	5.9
EPS (p)	8.8	6.9	8.0
DPS(p)	-	-	-
Net Debt (cash)	5.9	2.4	-1.3
EV/EBITDA	3.5	3.3	2.6
P/E (x)	4.5	5.7	4.9
Div Yield (%)	0.0%	0.0%	0.0%

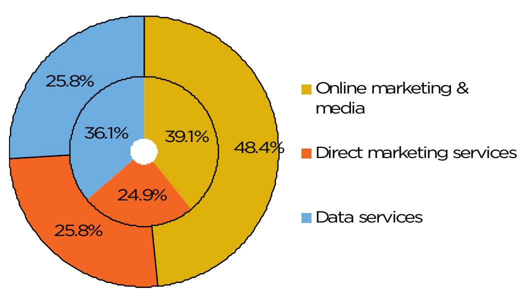
Source: Reuters estimates

Historical share price performance



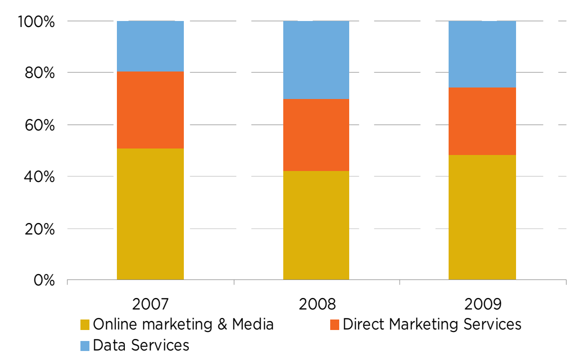
Source: Bloomberg

Last reported split (%) of revenue (outer pie) and operating profit (inner pie)



Source: Reuters estimates

Historical divisional revenues split (%)

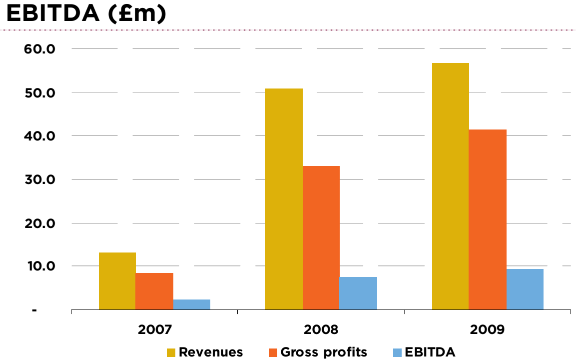


Source: Company reports

Historical gross and EBITDA margins (%)

Source: Reuters estimates

Historical divisional revenues, gross profits & EBITDA (£m)



Source: Company reports

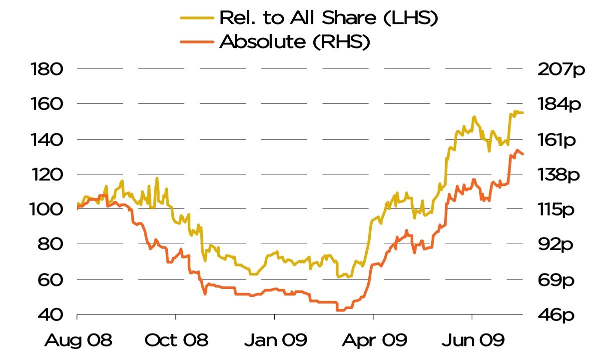
COMPANY BACKGROUND: ALTERIAN

Company data, ALN.L

Current Price	151p	52 Week range			46-154p
Market Cap	£86.8m	Avg Volume -3M			170,873
(£m)			Mar-09A	Mar-10E	Mar-11E
Revenue			33.4	40.700	46.700
Growth			72.6%	21.9%	14.7%
EBITDA			5.6	9.800	12.500
Margin			16.9%	24.1%	26.8%
Pre Tax Profit			5.4	9.9	12.9
EPS (p)			14.9	16.4	20.1
DPS (p)			0.0	0.0	0.0
Net Debt-£m			(8.6)	(11.1)	(20.4)
EV/ EBITDA(x)			14.1	8.1	6.4
P/E (x)			10.1	9.2	7.5
Div Yield (%)			0.0%	0.0%	0.0%

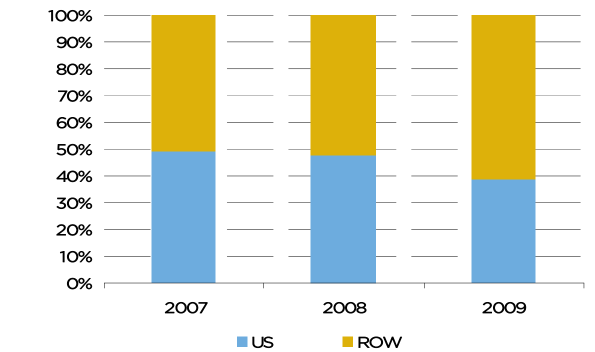
Source: Reuters estimates

Historical share price performance



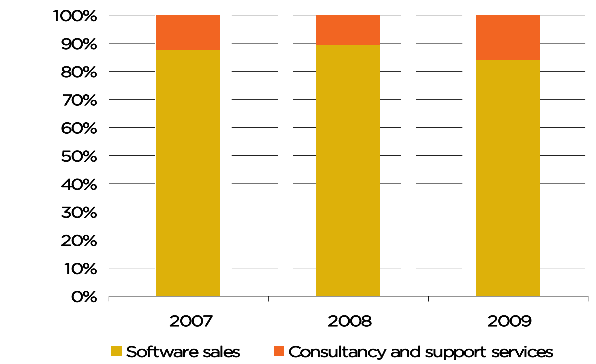
Source: Company reports

Historical geographical revenues split



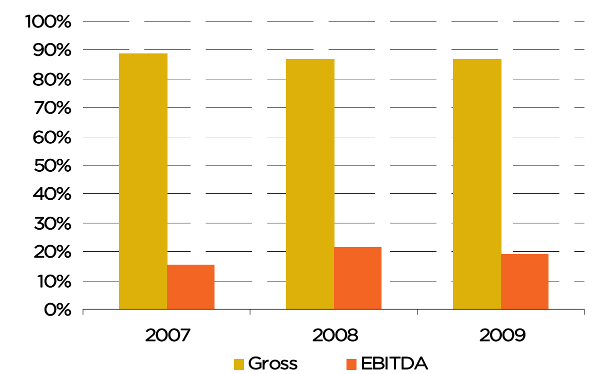
Source: Reuters estimates

Historical divisional revenues split



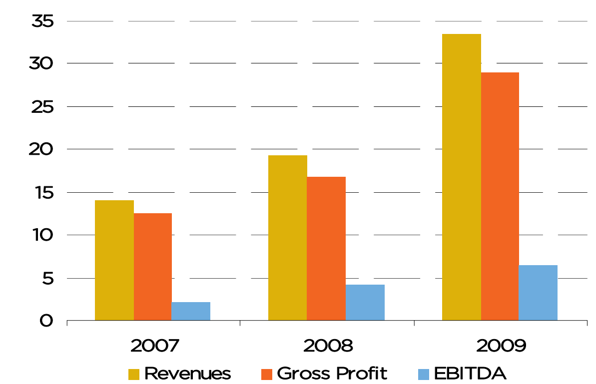
Source: Company reports

Historical gross and EBITDA margins (%)



Source: Reuters estimates

Historical divisional revenues, gross profits & EBITDA



Source: Company reports

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