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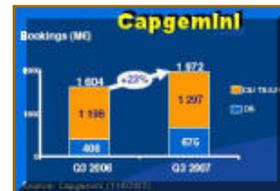
Analysis of Capgemini's Third Quarter Business Results

Growth Continues, But...

Kanbay Acquisition, Surge in New Contracts Boosts Revenue, Outlook, But There Are Some Clouds on Horizon

SCOTTSDALE, Nov 7 - The Kanbay acquisition and a surge in new contract signings boosted Capgemini's revenues and outlook after the third quarter of 2007, for which the company reported today another double-digit revenue jump (up 11% to €2,088 million from €1,881 million the year before). At constant currency and adjusted for Kanbay, the growth was 6.2%.

But perhaps the most impressive figure the company released today was Capgemini's third-quarter bookings, which surged 23% to €1.97 billion, up from €1.6 billion last year. But the outsourcing deals soared even faster, up 66% to €675 million, versus €406 million for the third quarter of 2006 (see the chart).



Capgemini said in a statement that it had extended a 10-year contract with the U.K. tax office by three years. The value of the extension is €1.4 billion on top of the existing €7.5 billion contract, CEO Paul Hermelin told Bloomberg.



The market also liked what it saw in the company's third quarter numbers, pushing the Capgemini shares up over four points on the Paris Bourse. But still leaves them almost 30% below the year's high reached last



April (see the charts). And one should keep in mind that the Paris Bourse closed its trading well before the Dow hit the skids and went the full circle with its second biggest drop of the year (down 360 points).

Some Clouds on Horizon

But there are some clouds on the horizon. Partially offsetting this gain, there has been a reduction in this deal's original scope which will lead to €35 million write-off. As a result of this "rescoping," Capgemini's overall third quarter outsourcing revenue rose only 1%.

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And the U.K. geographic segment's business shrank 3% since a year ago (7% sequentially from the second quarter).

"Aspire," the name for the British tax megadeal, accounts for roughly half of the U.K. revenues, so its impact on this geography "is meaningful," Capgemini executives said in a teleconference that followed the release of its third-quarter results. Nevertheless, the rest of the U.K. business is "very healthy," they added. The executives hinted at a very large deal that's in the wings, but refused to say in what industry sector.

Furthermore, there is still no definitive resolution in the negotiations of the Schneider megadeal. "Should we not be able to find an economically achievable contract to both parties, we've agreed to go down to an amicable termination by the end of December," said Paul Spence, vice president of outsourcing, during the teleconference with analysts.

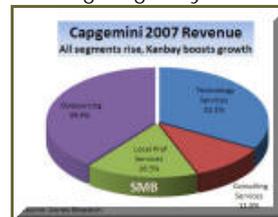
Subprime Issues Cast a Long Shadow, Unleash Financial Tsunami?

Besides these two megadeals, there is continuing concern about the additional fallout from the subprime financial crisis, as each day seemingly brings some more bad news to the market. Capgemini's biggest acquisition of 2006 (Kanbay) carries with some of that risk, despite the brave faces that the company's leaders are putting on. Among its biggest financial services clients are HSBC, Europe's largest bank by market value, and Morgan Stanley.

Capgemini said in September Kanbay's second-half outlook was "reduced" as the collapse of the U.S. subprime-mortgage market prompted financial clients to cut back spending. IBM's third quarter results also took a mild hit in this sector, especially in the mainframe business (see "[On the Button Again](#)," Oct 2007).

"We noticed a little slowdown in July and August, after that it has been going very well," Hermelin told Bloomberg today. Back in September, Capgemini CEO said sales growth at Kanbay will exceed 15% this year.

"We are very happy with the results of the Kanbay integration," Hermelin reiterated today. "The financial crisis has increased banks' appetite, especially in Europe, for low-cost solutions with part of the work in India."



Pierre-Yves Cros, the company's chief strategist, also sounded upbeat about the condition of the financial sector.

"We don't see any signs of the market going down," he said. He cited a number of new deals the company has won in this sector. But he also noted some problems, particularly at HSBC.

"We've had a hit, a small amount, below \$20 million, with that particular client (HSBC)," he said. "The rest (of the deals), (are) very nice. The pipeline is very, very encouraging."

But the drumbeat of subprime losses continued on Wall Street on Wednesday after the Capgemini teleconference. Morgan Stanley, a Capgemini (Kanbay) client, said after the markets closed that it had suffered \$3.7 billion in losses over the last two months on its portfolio of mortgage-related investments. Worse yet, the brokerage said its losses may balloon to \$6 billion if the markets continue to sour. Shares of Morgan Stanley plunged 6.1%, or \$3.32, to close at \$51.19.

Merrill Lynch also disclosed today that the Securities and Exchange Commission is

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investigating matters related to its subprime portfolio. Last month, the company disclosed it would write off \$8.4 billion in assets related to subprime losses, which led to the ouster of its CEO.

Over the weekend, Citigroup also announced that its losses may be as large as \$11 billion in the current quarter.

Closer to home in the IT industry, after the markets closed today, shares of [Cisco Systems](#) dropped more than 9 per cent in after-hours trading on Wednesday as John Chambers, chief executive, said the technology bellwether had "experienced some softness" in orders from big U.S. customers.

Chambers said Cisco, the world's biggest maker of the switches and routers that direct internet traffic, had suffered "dramatic year-on-year decreases in orders" from big US banks, many of which have been left reeling by the subprime [mortgage](#) crisis.

"We continue to expect US enterprise growth to be very lumpy," Mr Chambers said.

The big banks that have been hit by the subprime crisis are among the world's biggest purchasers of IT technology. IT companies, including Cisco, could be vulnerable if subprime losses force them to cut spending on IT projects.

Dennis Powell, Cisco's chief financial officer, said: "Issues with financial services are directly related to what we are seeing with subprime. It's going to take some time for that to work through..."

So clearly, Capgemini can hardly remain immune to the carnage the subprime issue is wreaking in the global economy. It's probably just a matter of time before the company also felt the impact of that financial tsunami, too.

Capgemini's "Plan B" - SMB Market

Fortunately, unlike some other major competitors, Capgemini has a "Plan B." It's the SMB market. While megadeals like the above U.K. tax authority or Schneider tend to impress those who measure a company's bulk, it is the smaller contracts that tend to be more profitable. And the benefits of Capgemini's strategic refocus on the SMB market are starting show up in its financial results.



First, the "Local & Professional Services" (the company's euphemism for SMB) revenues grew the fastest in the quarter (up 11% in constant currency). They now account for 16% of the company's total revenues (see the left charts).

Second, the number of medium size deals (€50 million to €250 million) jumped five-fold since a year ago, while the number of small deals (€10 to €50 million) also increased in double digits (up 12% - see the right charts).

Paul Spence, vice president of outsourcing, said in today's teleconference that, "that engine is really working for us quite well," in reference to the five-fold jump of midsize

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deals. He added that Capgemini signed 19 unique clients in the first nine months of the year which averaged about €48 million in contract value.

The average sell cycle for these deals is a little over six months, while their average duration is about 4.7 years. So average deals are getting shorter in length, Spence noted.

About one-third of the €3.6 billion SMB pipeline is in the U.S., one-fifth in the U.K., and the rest in Central Europe. Capgemini's overall pipeline at the end of the third quarter was €5.1 billion. Which means that SMB now represents more than two-thirds of the sales opportunities the company is pursuing. And that's a pretty good cushion against the subprime financial tsunami and a reasonable "Plan B."

Segment Analysis

Among the geographic segments, Nordic European countries turned in the best performance in the third quarter, surging by 30%, both as reported and organically. Benelux, Iberia, Italy and Asia/Pacific countries also grew in double digits.



The company's second largest market and its home country, France, which accounts for 22% of total revenues, also reported solid growth in the quarter (up 7%). The North American region, now the third largest segment at 21% of total revenues, was also up - 8% year-over-year.

As previously noted, the U.K. and Ireland area revenues declined 3% as reported, and 4% organically since the third quarter of 2006.

Total revenue growth over the first nine months of 2007 was 14.5% as reported, and at 9.7% at constant rates. The main reason for the spread between these two figures is the integration of Kanbay into the 2007 accounts, the company said in a release.

Outlook

The company said its profit margin this year will be higher than previously forecast.

The increased forecast encouraged investors that Cap Gemini's strategy to provide services from lower-wage countries such as India is paying off. The company in February bought Houston-based Kanbay for \$1.25 billion, doubling Cap Gemini's Indian workforce.

Hermelin raised the forecast for 2007 operating profit as a percentage of sales to more than 7%. The company restated the outlook for a 9% revenue increase (at constant currency).

We expect somewhat higher actual results at the top line and about €425 million in bottom line earnings, for a 5% net profit margin. If that were to come to pass, that would be a 45% jump from last year's net, and a tripling of the net profit in 2005, the first of the three years so far that Capgemini's recovery has been under way.

For our detailed Capgemini 2007 forecast, including tables and charts, [Annex clients click here.](#)

Happy bargain hunting!

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