

17 December 2007

K3 Business Technology Group

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	PE (x)	Yield (%)
12/05	22.0	2.0	10.3	0.00	16.1	N/A
12/06	27.3	2.7	10.9	0.00	15.2	N/A
12/07e	36.1	5.0	16.7	0.50	9.9	0.3
12/08e	46.5	7.5	22.8	0.75	7.3	0.5

Note: *PBT and EPS are normalised, excluding goodwill amortisation and exceptional items

Investment summary: Manufacturing acquisition

K3 has announced the acquisition of Manufacturing Software Supplier Index. The deal extends K3's footprint into the complementary Process Manufacturing marketplace, and extends the Microsoft technology platform to embrace fast growing Microsoft Dynamics Ax. Add in recent retail contract wins with "multi channel" White Company and Clinton Cards and the group appears to be performing strongly underpinning both forecasts and the pay-back from managements' clear strategy.

Index acquisition: New markets, larger contracts

K3 has acquired Computer Systems Limited ("Index") for £2.75m. Based in Surrey, Index is a leading reseller of Microsoft Dynamics AX software. The software system is one of the fastest growing enterprise resource planning ("ERP") solutions worldwide and enables K3 to push into larger customer implementations and broaden into the process manufacturing sector.

White Company contract: £1.3m deal

Last week K3 announced a £1.3m contract with The White Company ("TWC"). TWC is a well known "multi-channel" retail brand, i.e. it sells successfully over web/mail order/shops, etc. K3 will replace its disparate IT systems with one integrated solution. This validates K3's product strategy in this space and, in our view, could open up a number of other opportunities in the fast growing multi-channel retail sector. In addition K3 has also recently signed a £0.5m contract with Clinton Cards to provide a Microsoft Dynamics retail solution across its 1,100 stores.

Forecasts and valuation: Order pipeline remains strong

Since the interims, K3 has announced over £5m of contracts across its retail and manufacturing divisions and has now made two acquisitions. We believe the order pipeline remains strong and therefore our FY07 and FY08 forecasts are unchanged. The high revenue visibility, together with the coherent Microsoft platform strategy and business model, highlights the potential for the group to grow in the longer term towards £100m of sales. 12x our FY08 eps would imply upside to over 250p.

Price 165.5p
Market Cap £39m

Share price graph



Share details

Code KBT
Listing AIM
Sector Software & Computer Services
Shares in issue 23.4m

Price

52 week High Low
194.5p 111.5p

Balance Sheet as at 30 June 2007

Debt/Equity (%) N/A
NAV per share (p) 87.7
Net debt (£m) 8.1

Business

K3 provides Microsoft-based supply chain management solutions to SMEs in the retail and manufacturing sectors.

Valuation

	2006	2007e	2008e
P/E Relative	109%	83%	65%
P/CF	13.5	6.4	4.5
EV/Sales	1.1	1.3	1.0
ROE	16%	22%	28%

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Acquisition of Computer Systems: Complementary

K3 has acquired Index Computer Systems Limited (“Index”), a manufacturing software provider. Based in Surrey, Index was established in 1990 and is a leading reseller of Microsoft Dynamics AX software. The software system is one of the fastest growing enterprise resource planning solutions worldwide and Index is a Microsoft Gold Partner. Index has developed its own complementary modules to extend Dynamics AX’s functionality and IP to support Food and Process Manufacturers

- **Index target market:** Index has a well-established presence in the mid-range manufacturing marketplace, particularly within the food sector and its average order value is in the region of £0.3m. Its customers include: British Bakels, the global ingredient manufacturers; MBM Produce, one of the UK’s leading suppliers of fresh produce; Jeyes Group, the international household and hygiene product manufacturer; and Riverford Organic Vegetables and Abel and Cole, two of the UK’s largest organic delivery companies.
- **Price paid:** For the year ended 30 June 2007, Index generated turnover of £1.8m and profit before tax of c.£0.3m. K3 is paying a total consideration of £2.75m. In addition, a payment of £0.3m is being made in respect of surplus cash in the business at completion. This will be satisfied in a mix of cash and shares. The acquisition is a highly complementary fit to the existing K3 manufacturing software business and is expected to be earnings enhancing. In the four months to October, like-for-like sales and profits were significantly ahead of last year. Therefore, based on our assumption of the profit contribution for Index in FY08, we estimate K3 is paying around 5–6x forward pre-tax profits (in line with its typical deal multiples).

This acquisition enables K3 to enter the complementary market of Process Manufacturing as well as fulfilling K3’s requirement for all its technology offering to be Microsoft-based.

- **Up-scales K3’s ERP offering:** Index’s Axapta product is a robust solution in the mid-range discrete manufacturing marketplace (i.e. sales values of over £0.3m). As it is a large credible player, K3 occasionally gets pulled into the mid tier despite it not being a core area of expertise. Indeed it sometimes even wins contracts (e.g. Westland and Dudsons). However, this is not a target market with the current Syspro solution and the addition of Axapta will enable K3 to more proactively focus on the top end of the mid-range (i.e. contracts of £0.3–1.0m).
- **Complementary process markets:** With its Syspro solution K3 already has a target market of c.9,000 discrete manufacturers. This deal moves K3 into the complementary process manufacturing marketplace (Food, Chem, Pharma, etc.), where there are another 5,000 companies to target.
- **Continues Microsoft platform strategy:** It gives access to Microsoft Dynamics AX (formerly known as Axapta), which is a feature rich and powerful ERP platform and in the mid-market is highly competitive with SAP, Peoplesoft and JD Edwards. Microsoft Ax sales in the UK grew 75% last year. This not only enables K3 to participate in this fast growing market but, to an extent, completes its Dynamics Strategy allowing K3 to sell both Navision (low end and medium) and Axapta (medium and large), and strengthens its position in the Microsoft partner strategy.

White Company “multi-channel” deal & Clinton Cards

K3 has announced a £1.3m contract with The White Company (“TWC”). TWC is a well known “multi-channel” retail brand, i.e. it sells successfully over web/mail order/shops, etc. K3 will replace its disparate IT systems with one integrated solution. This contract is important for two reasons:

- **Verifies K3’s solution:** When K3’s management sold Elucid (which marketed an entry level multi-channel system), it outlined a roadmap to redevelop the functionality into K3’s core Microsoft Dynamics product. This contract highlights the scale and depth of K3’s re-developed retail solution.
- **Opens up a major market opportunity:** The White Company, one of the major 'multi-channel' brands, is K3’s first big sale into this market. In our view, this could open up a number of other multi-channel retail customer opportunities. The marketplace is growing quickly with the internet now accounting for 10% of retail sales. Some 30m people now shop online and spending online is forecast to be over c.£7bn this Christmas. There is no dominant solution provider in the multi-channel retail marketplace and contract values for multi-channel solutions can be sizeable.

£0.5m Clinton Cards contract

Last week K3’s Retail Software Division also secured a new contract worth more than £0.5m with Clinton Cards, the largest specialist retailer of greetings cards, plush merchandise (soft toys) and related products in the UK. It operates the Clinton and Birthdays fascias. K3’s retail solution, based on Microsoft’s Dynamics software, will handle all aspects of central merchandising, product and price management, sales analytical reporting as well as auto replenishment for nearly 1,100 stores. It will also be integrated with Clinton’s in house developed EPOS (electronic point of sale) and other head office systems.

Forecasts: visibility high, earnings unchanged

We estimate the Index deal will probably add around 3% to our FY08 earnings forecast but, for now we, leave our forecasts unchanged. We expect the company to provide a trading update in January but in our view H2 contract wins together with recent deals underpin our FY07 and FY08 projections.

- In March K3 acquired MBL to double the size of its Microsoft-based Syspro business unit, expanding Syspro revenues from c.£5m to c.£11m, and growing the user base from 150 to 450 Syspro customers. In addition, the combination with other businesses should drive cost savings of c.£0.7m going forward.
- In September K3 bought LS Netherlands to extend the Retail footprint into Europe. The LNL business has 50% of its revenue underpinned by IKEA, and good visibility of revenues and profits as IKEA has a three-year store opening program.
- Since September K3 has announced over £5m of software deals across its Manufacturing and Retail divisions

Exhibit 1: Revenue and margin assumptions — pre Index deal

£m	FY 06	FY07E	FY 08E
Revenues			
Retail	16.44	22.31	29.87
Distribution	2.06	0.00	0.00
Manufacturing	8.85	13.79	16.66
	27.35	36.11	46.52
EBITA			
Retail	1.63	2.62	4.45
Distribution	0.08	0.00	0.00
Manufacturing	1.34	2.97	4.16
	3.05	5.58	8.61
EBITA Margins			
Retail	10%	12%	15%
Distribution	4%	N/A	N/A
Manufacturing	15%	22%	25%
	11%	15%	18%
Intangible Amortisation	(2.20)	(0.30)	(0.27)
Share Options	(0.09)	(0.10)	(0.10)
EBIT	0.76	5.18	8.24

Source: Edison Investment Research

Exhibit 2: Financials

	£'000s	2002	2003	2004	2005	2006	2007 ^a	2008 ^a
31 December		UK GAAP	UK GAAP	UK GAAP	UK GAAP	UK GAAP	IAS	IAS
PROFIT & LOSS								
Revenue		8,088	7,002	8,529	22,029	27,346	36,107	46,524
Cost of Sales		(1,469)	(958)	(1,727)	(8,136)	(10,641)	(13,893)	(16,071)
Gross Profit		6,619	6,044	6,802	13,893	16,705	22,214	30,453
EBITDA		1,181	1,256	818	2,749	3,375	5,985	9,107
Operating Profit (before GW and except.)		975	1,074	603	2,408	3,046	5,585	8,607
Goodwill Amortisation		(463)	(463)	(636)	(1,752)	(2,198)	(300)	(270)
Exceptionals		(173)	(605)	1,248	0	0	0	0
Other		0	(100)	0	(142)	(85)	(100)	(100)
Operating Profit		339	(94)	1,215	514	763	5,185	8,237
Net Interest		(73)	(105)	(55)	(287)	(262)	(450)	(1,050)
Profit Before Tax (norm)		902	869	548	1,979	2,699	5,035	7,457
Profit Before Tax (FRS 3)		266	(199)	1,160	227	501	4,735	7,187
Tax		108	(130)	(59)	(493)	(810)	(1,540)	(2,267)
Profit After Tax (norm)		1,010	739	489	1,538	1,974	3,594	5,290
Profit After Tax (FRS3)		374	(329)	1,101	(266)	(309)	3,194	4,920
Average Number of Shares Outstanding (m)		10.2	10.2	11.0	15.0	18.1	21.5	23.2
EPS - normalised (p)		9.9	7.3	4.5	10.3	10.9	16.7	22.8
EPS - FRS 3 (p)		3.7	(3.2)	10.0	(1.8)	(1.7)	14.9	21.2
Dividend per share		0.0	0.0	0.0	0.0	0.0	0.5	0.8
Gross Margin (%)		81.8%	86.3%	79.8%	63.1%	61.1%	61.5%	65.5%
EBITDA Margin (%)		14.6%	17.9%	9.6%	12.5%	12.3%	16.6%	19.6%
Operating Margin (before GW and except.) (%)		12.1%	15.3%	7.1%	10.9%	11.1%	15.5%	18.5%
BALANCE SHEET								
Fixed Assets		4,243	3,886	10,506	16,352	15,691	33,111	32,961
Intangible Assets		3,817	3,354	9,919	15,844	13,877	10,000	10,000
Tangible Assets		426	342	570	508	416	1,300	1,150
Goodwill		0	0	0	0	0	21,811	21,811
Other		0	190	17	0	1,398	0	0
Current Assets		4,021	3,784	6,671	7,470	11,045	11,112	14,994
Stocks		0	0	0	0	0	0	0
Debtors		3,868	2,558	6,268	6,596	8,778	10,973	13,716
Cash		123	1,226	403	874	2,267	140	1,278
Other		30	0	0	0	0	0	0
Current Liabilities		(4,869)	(4,706)	(9,345)	(10,583)	(13,654)	(16,021)	(18,912)
Creditors		(4,835)	(3,128)	(5,881)	(7,703)	(9,124)	(10,949)	(13,139)
Other creditors		0	(1,527)	(1,831)	(2,091)	(3,669)	(4,511)	(5,513)
Short term borrowings		(34)	(51)	(1,633)	(789)	(861)	(561)	(261)
Minority interests		0	0	0	0	0	0	0
Long Term Liabilities		(51)	0	(337)	(2,439)	(711)	(12,000)	(10,000)
Long term borrowings		(51)	0	(337)	(1,332)	(711)	(12,000)	(10,000)
Other long term liabilities		0	0	0	(1,107)	0	0	0
Net Assets		3,344	2,964	7,495	10,800	12,371	16,202	19,043
CASH FLOW								
Operating Cash Flow		471	1,365	1,244	4,267	2,218	5,515	8,453
Net Interest		(35)	(23)	(99)	(279)	(235)	(450)	(1,050)
Tax		0	(11)	(76)	(80)	26	(1,965)	(3,241)
Capex		(66)	(99)	(12)	(106)	(335)	(300)	(350)
Acquisitions/disposals		(105)	(95)	(2,344)	(5,153)	(1,456)	(18,100)	0
Financing		0	0	0	1,350	1,825	2,500	0
Dividends		0	0	0	0	0	(116)	(174)
Other		0	0	464	472	(650)	0	0
Net Cash Flow		265	1,137	(823)	471	1,393	(12,916)	3,639
Opening net debt/(cash)		227	(38)	(1,175)	1,567	1,247	(695)	12,421
HP finance leases initiated		0	0	(106)	(88)	(104)	(200)	(200)
Other		0	0	(1,813)	(63)	653	0	0
Closing net debt/(cash)		(38)	(1,175)	1,567	1,247	(695)	12,421	8,983

Source: Company accounts/Edison Investment Research

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