

1 September 2008

## K3 Business Technology Group

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	PE (x)	Yield (%)
12/06	27.3	2.7	10.4	0.00	11.0	N/A
12/07	34.1	4.7	16.3	0.50	7.0	0.4
12/08e	41.0	7.2	20.3	0.75	5.6	0.7
12/09e	42.7	8.3	23.1	1.00	4.9	0.9

\*PBT and EPS (fully diluted) are normalised, excluding goodwill amortisation, exceptional items and FRS20.

### Investment summary: Margins still shine

Interim results highlight a number of positive features, including a growth in recurring revenues, rising margins and a healthy number of new client wins. In the short-term, investors may focus upon a softening of the retail sector in the UK and its impact on forecasts. However, the investment case and valuation remain very attractive, and the outlook for H2 is encouraging.

### Interim results

Group sales in H1 advanced by 26% to £17.1m, while normalised operating profits rose 82% to £2.32m. This reflects the successful integration of the three acquisitions made in 2007 and a general uplift in earnings quality owing to a rising proportion of recurring revenues. Normalised EPS advanced a substantial 22% to 5.6p, demonstrating the ability of management to quickly bed down acquisitions while simultaneously driving profitability in the existing business.

### Forecasts and outlook

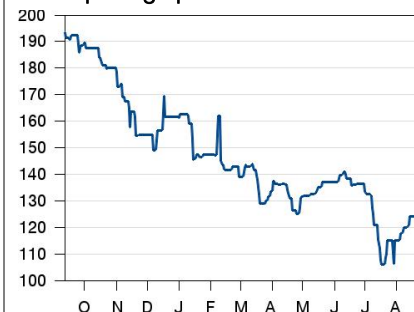
K3's management has delivered rapid and profitable growth over the past four years, creating a group with a unique sector- and technology-focus in its core ERP markets. However, the company is not immune to a tougher macro backdrop, and our revenue expectations have consequently reduced by c 10% in each of the next two years. The impact on profitability in FY08 is mitigated by the focus on driving margins up, and the order pipeline for H2 is still very healthy.

### Valuation

A strong business case and valuation should help mitigate the downside of a generally tougher trading environment. A fundamentally cheap PE around the 5x mark and EPS growth averaging almost 20% are also supported by favourable peer group comparisons. K3 is still forecast to generate £3m+ of net cash flow in each of the next two years, which underpins a DCF base case of 150p+.

Price 114p  
Market Cap £27m

#### Share price graph



#### Share details

Code KBT  
Listing AIM  
Sector Software & Computer Services  
Shares in issue 23.7m

#### Price

52 week High 193.5p  
Low 106.0p

#### Balance Sheet as at 30 June 2008

Debt/Equity (%) 65.0  
NAV per share (p) 104.5  
Net borrowings (£m) 16.0

#### Business

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

#### Valuation

	2007	2008e	2009e
P/E relative	72%	73%	71%
P/CF	5.8	5.1	5.0
EV/Sales	1.4	1.2	1.1
ROE	15%	19%	19%

#### Geography based on revenues

	UK	Europe	US	Other
	74%	14%	11%	1%

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## Margins and investment case still shine

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### Key Microsoft channel partner

K3 is a value-added Microsoft channel partner; owning the 'channel to market' is key to the business model. K3 designs and implements supply-chain software solutions — generally based on Microsoft technologies — principally in two industry sectors, namely retail and manufacturing. The group has a well-balanced business model of predictable, recurring licence income in the manufacturing software sector, combined with high-growth opportunities in retail software. A series of acquisitions has scaled up the group since 2004, and the full benefits of the three purchases made in 2007 are now starting to come through. Opportunities are also arising in other sectors, and this could perhaps eventually lead to the provision of a wider suite of services.

### Investment case revisited: Opportunity to accelerate growth

K3's sector- and technology-focus makes it stand out from its competitors. K3 has successfully accelerated growth through acquisitions, providing strong management, cultivating synergies between them, and developing new business models and channels to market. We believe the company has a major opportunity to leverage its core market position as one of the UK's leading Microsoft Dynamics partners. In addition, there are opportunities to grow a 'Managed Services' division, organically and through acquisition, that will exploit the strong customer relationships existing within the business. Despite a tougher macro backdrop, recent newsflow has still contained a number of positives to re-inforce the favourable long-term investment case:

- **Order pipeline:** the current order pipeline in Manufacturing Software now stands at £8m (including £4.5m from Index), compared to £2.0m at the same time last year. In Retail Software, the company has a well-qualified pipeline of £18.6m (including £3.6m in the Netherlands).
- **Significant contract wins:** across both divisions, K3 completed 19 major contract wins in the first half of the current year (nine in Retail Software and 10 in Manufacturing Software), which is above the same period in H107.
- **Earnings quality:** K3's earnings visibility is continuing to rise, as evidenced by the continued growth in recurring revenues derived from licence fee renewals and support and maintenance income. In 2007, approximately 22% of Retail Software revenues fell into the 'recurring' category, as did c 50% of Manufacturing Software revenues; both these proportions have continued to rise.
- **Track record:** K3 has been transformed by a number of acquisitions over the past four years, and management has demonstrated a strong track record in both integration and earnings growth over this period. There remains good scope for further acquisitions to move K3 towards target sales approaching £75m over the next three years.

We continue to believe that K3's sector- and technology-focus, together with the careful leveraging of synergies between divisions, will drive earnings growth rates at a premium to the computer services sector. The long-term valuation attractions are apparent given a PE of c 5x and forecast EPS growth of 24% and 13% in each of the next two years.

## Interim results 2008

**Exhibit 1: Summary of interim results for the six months to 30 June 2008**

€m	2008	2007	%
	Six months to 30 June	Six months to 30 June	
Turnover	17.1	13.6	26
Operating margin (%)	13.6%	9.3%	
Operating profit (norm)	2.32	1.27	82
Profit/(loss) before tax (norm)	1.72	1.04	65
EPS normalised (p)	5.6	4.6	22
Net debt	15.96	7.26	

Source: K3

### Financial review: Acquisitions bedding down

One of the major themes of the first half was the successful integration of the three acquisitions made in 2007; sales in the Retail Software Division rose 20% to £10.45m, with Landsteinar Nederland (acquired in August 2007) making a contribution of £2.43m. In the Manufacturing Software Division, sales advanced by 41% to £6.66m and included a full contribution from McGuffie Brunton (MBL), which only had a three-month impact in H107.

As explained below, the economic backdrop for the Retail Software business has not been helpful, but despite this, the group as a whole managed to sign 19 significant contract wins in the first half, which is still a step forward from the first half of 2007. The overall picture in terms of profitability is an extremely encouraging one, with operating margins advancing over four percentage points to deliver normalised operating profits of £2.32m.

### Operational review: Encouraging new business wins

#### Retail Software Division

To accompany the 20% rise in sales, adjusted operating profits rose £0.79m (96%) to £1.61m, mainly as a consequence of the first-time H1 contribution from Landsteinar Nederland of £0.83m. Excluding the impact of acquisitions, underlying turnover was 8% down at £8.02m, and operating profits fell by 5% to £0.78m as a consequence of a generally tougher trading environment and some slippage in the order pipeline.

However, despite the somewhat unhelpful macro backdrop, there were still nine major contract wins in H1 — including five 'new-name' customers from the existing business and two from Landsteinar Nederland. Management is encouraged by the integration of the Dutch-based business, and the appointment of a new sales director has led to a stronger pipeline from non-IKEA customers as the company enters H2. In fact, prospects for H2 remain generally encouraging in the division, with two important deals already signed and a number of others in the pipeline.

## Manufacturing Software Division

This division has seen a strong first half from both the existing and recently acquired businesses with sales, margins and profits all substantially ahead. Along with a 41% rise in turnover, normalised operating profits increased from £0.54m to £1.02m, helped by the contribution of both the businesses acquired in 2007; Index and MBL. MBL was integrated and merged with the existing SYSPRO business in H207, and the enlarged business — renamed K3 Supply Chain Solutions (SCS) — secured 10 new deals in H1 worth £1.0m, compared to eight worth £0.66m in H1 2007. Prospects for further new business wins in H2 from both SCS and Index are encouraging.

## Outlook and forecasts

### Exhibit 2: Divisional forecasts

£m	FY 06	FY07	H1 08E	H2 08E	FY 08E	% change	FY 09E	% change
<b>Revenues</b>								
Retail	16.44	20.47	10.45	12.35	22.80	11%	23.94	5%
Distribution	2.06	0.18			0.00	(100%)	0.00	0%
Manufacturing	8.85	13.50	6.66	11.50	18.16	35%	18.80	4%
	<b>27.35</b>	<b>34.15</b>	<b>17.11</b>	<b>23.85</b>	<b>40.96</b>	<b>20%</b>	<b>42.74</b>	<b>4%</b>
<b>Gross Margins</b>								
Group	61%	67%			68%	2%	71%	4%
<b>Gross Profit</b>								
Group	16.71	22.73			27.85	23%	30.34	9%
<b>EBITA</b>								
Retail	1.63	2.91	1.61	2.19	3.80	55%	4.19	10%
Distribution	0.08	(0.08)			0.00		0.00	
Manufacturing	1.34	3.42	0.71	4.01	4.72	184%	4.98	5%
Central costs		(0.49)						
	<b>2.92</b>	<b>5.76</b>	<b>2.32</b>		<b>8.52</b>	<b>48%</b>	<b>9.17</b>	<b>8%</b>
<b>EBITA Margins</b>								
Retail	10%	14%	13.6%	17.7%	16.6%		17.5%	
Distribution	4%	N/A			N/A		N/A	
Manufacturing	15%	25%	5.2%	34.9%	26.0%		26.5%	
	<b>11%</b>	<b>17%</b>			<b>21%</b>		<b>21%</b>	
<b>Intangible Amortisation</b>								
Share Options	0.00	(0.90)			(2.00)		(2.00)	
	(0.09)	(0.15)			(0.15)		(0.15)	
<b>EBIT</b>								
	<b>2.83</b>	<b>4.712</b>			<b>6.37</b>	<b>35%</b>	<b>7.02</b>	<b>10%</b>

Source: Edison Investment Research

K3's performance generally shows a bias towards the second half, not least because the annual licence fees, maintenance and support renewals income for the Manufacturing Software business are generally due in the fourth quarter, generating £6m-£7m of sales. While the Retail Software Division has had to contend with an unhelpful environment in H1, the prospects for further new contract wins in the second half across the group are still encouraging — although, as ever, the timing of new deals will be a factor. The order pipeline in Manufacturing Software currently stands at £8m (including £4.5m from Index), compared to £2m 12 months ago, and is a strong testament to K3's unique sector- and technology-focus in this ERP market. On the Retail Software side, the potential sales pipeline is in the region of £18.6m (including £3.6m from Holland).

In terms of increasing the visibility of the earnings stream, the continued growth in recurring revenues derived from licence fee renewals and support and maintenance remains encouraging. In

2007, approximately 22% of Retail Software turnover came into this category and approximately half in Manufacturing Software and both these proportions are continuing to rise.

In terms of forecasts, the softer market conditions in the retail sector in general have inevitably had an impact on the top line for the UK businesses, while the non-IKEA business of Landsteinar Nederland has also been slower than expected – something which is already showing signs of reversing following the appointment of a new Sales Director in March.

To a degree, this has been offset by the robust performance in the Manufacturing Software Division and generally firm margins, but we have nonetheless reduced our sales forecasts by approximately 10% in each of the next two years. At the earnings level in FY08, this is mitigated by a resilient margin performance owing to a number of factors including strict cost control, management's determination to cherry-pick business and the growth in higher-margin recurring revenues.

#### Exhibit 3: Revision of forecasts

£m	2008		2009	
	Previous est.	New forecast	Previous est.	New forecast
Revenue	44.5	41.0	48.0	42.7
Normalised PBT	7.6	7.2	9.1	8.3
Normalised EPS (p)	21.5	20.9	25.3	23.7

Source: Edison Investment Research

## Valuation and conclusion

There will clearly be a knock to sentiment in the wake of a downward revision of estimates, but value investors will see merit in a low multiple relative to forecast growth, attractive peer group comparisons and a supportive DCF.

### Premium earnings growth

Even on a reduced level of growth going forward, K3 is still forecast to deliver a CAGR in EPS growth over the next two years of almost 20%. This reflects the drive for profitability in both the existing businesses and those acquired in 2007, profitable growth in new contract wins and an increasing proportion of recurring revenues. Despite this premium growth, the PE multiple is only around the 5x mark in both this year and next, which in the first instance should limit any short-term downside in the share price and at the same time attract investors with longer-term perspectives.

### Peer group analysis

Since our March illustration of how K3 compared to a selection of peers with varying levels of similarity, the relative attractions of the shares have not diminished. K3's PE still occupies a discount of around 50% to the group average, and yet the forecast rate of earnings growth is not out of kilter.

**Exhibit 4: Peer group comparisons based on forecast earnings**

IT Service companies	Yr End	Price (p)	Mkt Cap £m	EPS H	EPS YR 1	EPS YR2	P/E H	P/E YR1	P/E YR2
Anite	April	39	132	3.8	3.7	4.2	10.3	10.4	9.2
Aveva	March	1471	997	50.4	60.5	68.5	29.2	24.3	21.5
Detica	March	441	514	13.5	17.0	20.1	32.7	25.9	21.9
Kewill Systems	March	86	70	3.4	10.2	11.1	n/a	8.4	7.7
Logica CMG	June	134	1964	7.1	11.1	11.7	18.9	12.1	11.5
Microgen	Dec	51	52	4.5	4.5	4.7	11.5	11.5	10.8
Touchstone	March	95	12	15.6	12.7	13.4	6.1	7.4	7.1
<b>Average</b>							<b>15.5</b>	<b>12.5</b>	<b>11.2</b>
<b>KBT (Dec 07)</b>		<b>114</b>	<b>27</b>	<b>16.8</b>	<b>20.3</b>	<b>23.1</b>	<b>6.8</b>	<b>5.6</b>	<b>4.9</b>
<b>P/E Rel.</b>							<b>44</b>	<b>45</b>	<b>44</b>

Source: Edison Investment Research, Hemscott, Yahoo

**Absolute value**

Finally, the DCF analysis summarised below uses our typical assumptions on WACC and perpetuity growth for this type of business and the former at 15% is certainly at the conservative end of the spectrum. Although we would apply the usual caveats to this type of valuation work – mainly based around the sensitivity to small changes in the variables – it nonetheless gives a good indication that there is fundamental value in the stock above current levels and beyond 150p. In a substantial part, this reflects the ability of the business to generate cash via forecast operating margins of c 20%, minimal capex requirements and tight management of working capital.

**Exhibit 5: DCF Valuation based on WACC of 15%**

<b>Discount Rate</b>	<b>15%</b>
NPV Enterprise value £m	49.9
Growth rate in perpetuity	5%
<b>Net debt 2007 £m</b>	<b>13.4</b>
Equity value £m	36.5
<b>Equity Value per share (pence)</b>	<b>157p</b>

Source: Edison Investment Research

In summary, despite a strong business proposition in its core markets, K3 is not immune to wider macroeconomic issues, and some negative sentiment may follow in the wake of a downward revision to forecasts. However, the valuation work above still makes for a strong case and is supported by a capable management team with a proven track record. The longer-term attractions of the stock should not be obscured by a short-term blip and the board's optimism for this year's H2 performance seems well founded on the back of a strong order pipeline and the ongoing improvement in earnings quality.

## Exhibit 6: Financials

Year end 31 December	£'000s	2006	2007	2008 <sup>e</sup>	2009 <sup>e</sup>
		IAS	IAS	IAS	IAS
<b>PROFIT &amp; LOSS</b>					
<b>Revenue</b>		<b>27,346</b>	<b>34,146</b>	<b>40,960</b>	<b>42,736</b>
Cost of Sales		(10,641)	(11,415)	(13,106)	(12,393)
Gross Profit		16,705	22,731	27,854	30,342
<b>EBITDA</b>		<b>3,247</b>	<b>6,068</b>	<b>9,019</b>	<b>9,692</b>
<b>Operating Profit (before GW and except.)</b>		<b>2,918</b>	<b>5,760</b>	<b>8,519</b>	<b>9,170</b>
Goodwill Amortisation		0	(896)	(2,000)	(2,000)
IFRS 2 charges		(85)	(152)	(152)	(152)
Other		0	0	0	0
<b>Operating Profit</b>		<b>2,833</b>	<b>4,712</b>	<b>6,367</b>	<b>7,018</b>
Net Interest		(262)	(1,036)	(1,350)	(900)
<b>Profit Before Tax (norm)</b>		<b>2,656</b>	<b>4,724</b>	<b>7,169</b>	<b>8,270</b>
<b>Profit Before Tax (FRS 3)</b>		<b>2,571</b>	<b>3,676</b>	<b>5,017</b>	<b>6,118</b>
Tax		(846)	(761)	(2,151)	(2,481)
<b>Profit After Tax (norm)</b>		<b>1,810</b>	<b>3,963</b>	<b>5,019</b>	<b>5,789</b>
<b>Profit After Tax (FRS3)</b>		<b>1,725</b>	<b>2,915</b>	<b>2,867</b>	<b>3,637</b>
Average Number of Shares Outstanding (m)		18.1	21.7	24.0	24.4
<b>EPS - normalised (p)</b>		<b>10.5</b>	<b>16.8</b>	<b>20.9</b>	<b>23.7</b>
<b>EPS - normalised fully diluted (p)</b>		<b>10.4</b>	<b>16.3</b>	<b>20.3</b>	<b>23.1</b>
<b>EPS - FRS 3 (p)</b>		<b>9.5</b>	<b>13.4</b>	<b>11.9</b>	<b>14.9</b>
Dividend per share		0.0	0.5	0.8	1.0
Gross Margin (%)		61.1%	66.6%	68.0%	71.0%
EBITDA Margin (%)		11.9%	17.8%	22.0%	22.7%
Operating Margin (before GW and except.) (%)		10.7%	16.9%	20.8%	21.5%
<b>BALANCE SHEET</b>					
<b>Fixed Assets</b>		<b>17,962</b>	<b>45,547</b>	<b>43,431</b>	<b>41,309</b>
Intangible Assets		273	12,282	10,282	8,282
Tangible Assets		416	1,305	1,155	1,033
Goodwill		15,684	31,494	31,494	31,494
Other		1,589	466	500	500
<b>Current Assets</b>		<b>10,889</b>	<b>14,069</b>	<b>16,775</b>	<b>19,703</b>
Stocks		0	0	0	0
Debtors		8,622	10,984	13,620	15,744
Cash		2,267	3,085	3,155	3,959
Other		0	0	0	0
<b>Current Liabilities</b>		<b>(13,712)</b>	<b>(19,386)</b>	<b>(20,152)</b>	<b>(20,825)</b>
Creditors		(1,756)	(3,356)	(4,200)	(4,700)
Other creditors		(11,095)	(11,987)	(12,652)	(12,825)
Short term borrowings		(861)	(4,043)	(3,300)	(3,300)
Minority interests		0	0	0	0
<b>Long Term Liabilities</b>		<b>(711)</b>	<b>(16,509)</b>	<b>(13,212)</b>	<b>(9,552)</b>
Long term borrowings		(711)	(12,437)	(9,700)	(6,600)
Other long term liabilities		0	(4,072)	(3,512)	(2,952)
<b>Net Assets</b>		<b>14,428</b>	<b>23,721</b>	<b>26,842</b>	<b>30,635</b>
<b>CASH FLOW</b>					
<b>Operating Cash Flow</b>		<b>2,208</b>	<b>6,228</b>	<b>7,740</b>	<b>8,089</b>
Net Interest		(256)	(1,243)	(1,350)	(900)
Tax		21	(2,074)	(2,374)	(2,712)
Capex		(375)	(643)	(350)	(400)
Acquisitions/disposals		(1,395)	(16,493)	0	0
Financing		1,825	263	0	0
Dividends		0	0	(116)	(174)
Other		0	0	0	0
Net Cash Flow		2,028	(13,962)	3,550	3,904
<b>Opening net debt/(cash)</b>		<b>1,247</b>	<b>(695)</b>	<b>13,395</b>	<b>9,845</b>
HP finance leases initiated		0	0	0	0
Other		(86)	(128)	0	0
<b>Closing net debt/(cash)</b>		<b>(695)</b>	<b>13,395</b>	<b>9,845</b>	<b>5,941</b>

Source: Company accounts/Edison Investment Research

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