

17 March 2009

K3 Business Technology Group

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/07	34.1	4.7	16.3	0.50	3.7	0.8
12/08	37.6	5.9	17.9	0.50	3.3	0.8
12/09e	39.0	6.5	19.3	0.50	3.1	0.8
12/10e	40.5	7.1	21.1	0.60	2.8	1.0

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

Investment summary: Growing recurring sales

In a tough economic climate, K3 continued to win new business in both its divisions during FY08. This trend has continued into the current year, further enhancing future predictable revenues. Although visibility over the outlook is hampered by the wider economic climate, earnings quality continues to increase and from a valuation perspective, the equity is cheap on any basis.

Annual results: Resilient trading against market backdrop

Annual results reveal resilient trading across the retail and manufacturing software divisions and group turnover progressed 10% to £37.6m. New business wins across both divisions totalled £9m and given recurring revenues of 41%, there is increasing visibility to the earnings stream. Reported operating profits came in a little behind forecasts, but still grew 28% to £7.35m. Given a 30% appreciation of the euro, reported net debt (including €7.3m) is higher than our forecast.

Forecasts and outlook: Positive start to Q1

Winning new business is clearly tough in the current environment, but K3 is still making good progress in both divisions. Given a high proportion of contracted recurring revenues (including a fast growing managed services initiative) and the ability to generate incremental sales from existing customers, there is reasonable FY09 revenue visibility – we are still forecasting healthy progress in sales and profits. The board is looking at options for further M&A, but, in the context of a depressed equity valuation, deals are difficult.

Valuation: All metrics support 100p+

In our view the short-term prospects (K3 is the leader in the higher growth multi-channel retail space) and attractive longer-term business model warrant a higher valuation. The earnings multiple does not give credit for either the quality of earnings or the continued underlying growth and the DCF valuation is double the current share price.

Price 59.5p
Market Cap £14m

Share price graph



Share details

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

Price

52 week High 141p Low 59p

Balance Sheet as at 31 December 2008

Debt/Equity (%) N/A
NAV per share (p) 139.5
Net borrowings (£m) 13.4

Business

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

Valuation

	2008	2009e	2010e
P/E relative	24%	45%	32%
P/CF	2.2	1.8	1.9
EV/Sales	0.7	0.6	0.5
ROE	12%	12%	12%

Geography based on revenues

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

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Annual results

Despite a tougher economic backdrop – which began to have a more noticeable impact throughout H2 – annual results demonstrate that K3 has continued to win new business, generate an increasing proportion of predictable revenues and up-sell a greater range of services to the existing client base. A solid performance in the circumstances and FY09 has started well in terms of winning new business.

Exhibit 1: Summary of annual results for the 12 months to 31 December 2008

£m	2007	2008	%
	12 mths to 31 Dec	12 mths to 31 Dec	
Turnover	34.1	37.6	+10
Gross margin (%)	67%	70%	+
Operating profit (norm)	5.8	7.3	+26
Profit/(loss) before tax (norm)	4.7	5.9	+26
EPS normalised (fd) (p)	16.3	17.9	+10
Cash/(net debt)	(13.4)	(13.0)	(3)

Source: K3

Financial and operational overview

There are two key operational features to highlight from FY08: 1) an expansion in the customer base which provides the backdrop to a greater emphasis on up-selling additional products and services; and 2) investment in the company's own IP to offer a wider range of modules, which enables K3 to capture a greater share of IT spend at better margins. Investment in the latter totalled £1m during 2008, with the most significant emphasis in the multi-channel retail segment.

Group revenues progressed 10% to £37.6m despite lower levels of sales to new clients – which across both divisions totalled £9m – and were supplemented by the stream of recurring sales from licence fee renewals and support, which increased 26% year-on-year to £15.6m to reflect the larger customer base. After a difficult trading period during H2, a flurry of activity in both divisions towards the end of the year meant that K3 only undershot our top line estimate by about £1m. The results also included a full year contribution from the three acquisitions made in FY07 – MBL, Landsteinar Nederland and Index.

Gross margins advanced 3 percentage points to 70% and operating profitability also rose strongly due to both the increased proportion of higher margin sales via up-selling more modules to existing customers and cost cutting. The drive to capture a greater proportion of the IT spend of the client base contributed over 30% to the top line in FY08 and, as discussed below, increases the visibility and predictability of future revenue flows.

After ongoing cost savings in H208 (at a cost of £200k taken through the P&L), together with initiatives in Q109 the group is on track to deliver annualised savings of c £1m.

Despite strong cash flow from operations of £6.4m, net debt came in somewhat higher than our estimate of £10.4m mainly due to a 30% appreciation of the euro over sterling, which impacted the currency translation of **€7.3m** of loans at the year end.

Retail software division

The core activity of this division is the development and delivery of retail software solutions based on Microsoft dynamics in the UK and Holland. The business unit made good progress during the year and managed to secure 11 significant new customer wins (there were several pilot projects during the year as well) with orders worth a total of £3.9m. Although this was down from over £5m in the previous year, gross margins advanced 3 percentage points to 60%. This was driven by increased sales of multi-channel software – including the company's own modules – and also uplift in recurring revenues from support and maintenance. One major deal that was expected to be signed in 2008 is now at an advanced stage of negotiation and has an initial value of £1.3m.

Overall, sales grew 8% to £22.18m and the UK remains by far the biggest contributor with turnover of £17.71m, which fell 6% from the previous year – partly due to sales being back-end loaded and therefore associated consultancy sales slipping into FY09. However, operating profits in the UK rose by 12% due to the mix of higher margin income. The balance of sales is made up from K3 Nederlands with the IKEA relationship generating £2.6m from a total of £4.5m.

Manufacturing software division

Sales in this division increased by 14% to £15.4m and recurring revenues of £8.32m (+5%) continue to comprise over 50% of the total. Gross margins held steady at 84% and operating profits grew 7% to £3.7m. SCS is the largest contributor of the three business units with sales of £10.73m from the enlarged entity created by the merger of MBL and IEG last year. It is the UK's sole provider of the SYSPRO range of Microsoft (MS) based enterprise resource planning software for manufacturers and distributors. Over 20 new customers were signed up during the year with deals worth around £2m. Cost saving initiatives are expected to save approximately £0.6m in 2009.

The Walton-on-Thames operation serves a large customer base of smaller manufacturing companies, while K3 AX supplies MS Dynamics AX software via the Index acquisition at the end of 2007 to address new markets in food and process manufacturing. Both units combined had sales of £4.7m and profits of £1.1m.

In terms of future potential, the embryonic managed services business holds out the prospect of significant value creation. Managed services out-sourcing is something of a Holy Grail in the IT services sector as it provides recurring revenue streams that capture all of the IT service infrastructure provision for customers. With over 1,000 customers in total in the manufacturing software division, K3 has only begun to scratch the surface with sales of the service so far having only been made to 50+ companies. Revenues in FY09 will probably total £0.8m, but the longer term upside could see this business make a significant contribution to the top line.

Forecasts and outlook

Demand from the manufacturing sector is likely to continue to slow (although this will be tempered by the high level of recurring maintenance revenues), while the retail sector has been forced to pull-forward price discounts and is clearly not focused in the short term on new IT expenditure.

However, despite the tougher challenges of the current climate, we still expect K3's unique offering to deliver growth during 2009 and to continue to win new business and generate enhanced revenues from the existing customer base. The business model remains a very cash generative one and along with the growth in recurring revenues, is likely to lend stability despite wider economic concerns.

The fact that 41% of revenues were recurring in FY08 lends a welcome element of visibility for the current year and, with an additional 30%+ from sales of additional modules and consultancy to the existing customer base, means that over 70% of group turnover has a strong theme of predictability. After factoring in a slightly lower base from FY08 and uncertainties over the outlook, our top line forecast for FY09 has been reduced by £1.4m while we are now expecting operating profits some £0.7m below previous estimates. In 2010 we are conservatively forecasting only very limited progress, as reflected in Exhibit 2 below.

Exhibit 2: Divisional forecasts

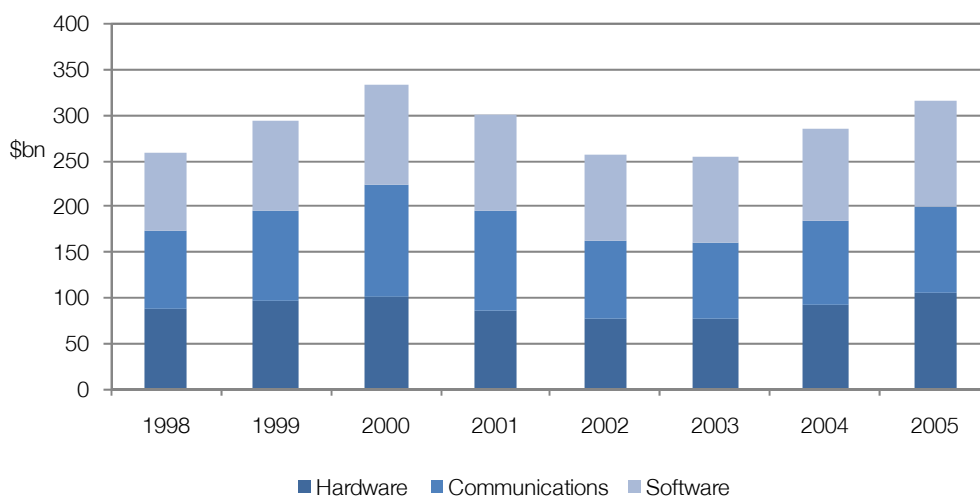
Year end 31 December	2007		H108	H208	2008		2009e		2010e	
	Yr	Change			Yr	Change	Yr	Change	Yr	Change
Revenue										
Retail	20,473	25%	10,450	11,726	22,176	8%	23,063	4%	23,986	4%
Distribution	178	-91%			0		0	0%	0	0%
Manufacturing	13,495	52%	6,660	8,773	15,433	14%	15,973	3.5%	16,532	3.5%
	0				10		0	0%	0	0%
Total	34,146	25%	17,110	20,499	37,619	10%	39,036	4%	40,518	4%
Gross Margins										
Group	67%				70%		71%		71%	
Gross Profit										
Group	22,731				26,341		27,716		28,768	
EBITA										
Retail	2,912	79%	1,610	2,345	3,955	36%	3,805	(4%)	3,958	4%
Distribution	(79)	N/A			0		0		0	
Manufacturing	3,417	N/A	710	2,944	3,654	7%	3,834	5%	3,968	3%
Central costs	(490)				(261)		0	(100%)	0	
Total	5,760	89%	2,320	5,289	7,348	28%	7,639	4%	7,925	4%
EBITA Contribution Margin										
Retail	14%		15.4%	17.0%	17.8%		16.5%		16.5%	
Distribution	(44%)									
Manufacturing	25%		11%	34.0%	23.7%		24.0%		24.0%	
Total	17%		14%	26%	20%		20%		20%	
Unallocated Costs	0				0		0		0	
EBITA	5,760	89%			7,348	28%	7,639	4%	7,925	4%
Intangible amortisation	(896)				(1,875)		(1,875)		(1,875)	
Share options	(152)				(103)		(103)		(103)	
EBIT	4,712				5,370		5,661		5,947	

Source: Edison Investment Research

Market outlook for the IT services sector

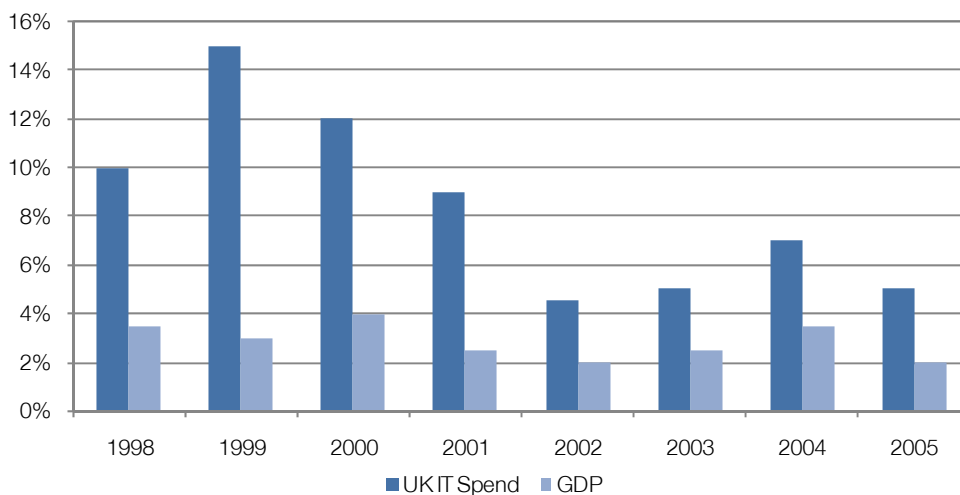
Recent company statements reveal a significant fall-off in hardware expenditure over the last few months and signs of delays and 'push-outs' in major IT infrastructure investment. However, looking back at the industry through 2000-2003 reveals that although IT expenditure fell back materially, it still outperformed GDP growth by 200+ basis points. A flattish outcome for 2009 is therefore possible and in this context, we are still expecting K3 to make top line progress; Q1 has started positively underpinned by the unique sector/technology focus and bank of recurring revenues.

Exhibit 3: Previous cycle – US IT spend 1998-2005



Source: Forrester research

Exhibit 4: Previous cycle – UK IT spend growth 1998-2005



Source: Kew Associates

In the bubble years at the end of the last decade, IT expenditure growth averaged 10% pa against GDP expansion of 2.0-2.5%. However, since 2002 there has been a pretty stable progress in IT spend of approximately 5% annually and therefore a run-rate of 2-3 percentage points above GDP.

In this context, current industry forecasts still look overly optimistic, with Ovum forecasting growth of between 3-5% in 2009. However, with the UK in particular likely to be looking at negative GDP of c 3% this implies IT spend is likely to be flat at best in the current year.

Exhibit 5: Industry forecasts

	IT Project Services	Software	Information Management	Business Applications	Systems Infrastructure
2009e	2.9%	4.0%	5.5%	3.5%	4.0%
2008	3.8%	4.9%	N/A	N/A	N/A

Source: Ovum

K3 in context

Exposure to the retail software sector in particular means that K3 will certainly not be immune from the effects of a widespread downturn in IT expenditure, but the company also possess a number of defensive characteristics to aid resilience:

- The company has a rising proportion of recurring revenues in both divisions: 50%+ in manufacturing and 33% in retail software.
- Opportunities exist to grow a 'Managed Services' division, organically and via acquisition, that will exploit existing strong customer relationships and improve earnings' quality.
- K3's sector- and technology-focus marks it out from its competitors.
- The order pipeline for 2009 remains encouraging and there have been a number of recent contract wins.
- In particular there is relatively strong underlying growth in demand from multi-channel retailers (catalogue, web, high street, etc). These players are currently enjoying reasonably strong end customer spend (supported by the web offering) and have the enormous IT challenge of managing their IT and infrastructure across the multiple customer channels. This provides a major opportunity for K3 (several potential customers with large IT requirements) and moreover competition in the space is fairly limited.

Valuation and conclusion

A value disconnect in the smaller companies tech space is hardly uncommon, but in the case of K3 there is clearly a vast gulf between a business still generating profitable top line growth and significant new business wins and the valuation benchmarks on any metric. For the first time in the case of K3, we have also produced a DCF sum-of-the-parts analysis to highlight the valuation of the different divisions.

Cheap and increasingly visible earnings stream

A prospective P/E around the 3x mark reflects a total absence of risk appetite from equity investors and in some respects therefore is almost beyond analysis in its own right. The only points we would make are that K3 has a significant bank of recurring revenues; it is still generating new business wins and meanwhile is likely to continue to throw off cash. Should sentiment show a sign of shifting, these are all characteristics that would make for an appealing investment case.

DCF sum-of-the-parts analysis

Our discounted cash flow (DCF) analysis below in Exhibit 6 gives an indication as to how the inherent cash generation of both divisions creates value. We have applied different WACCs to each of the divisions. In the case of Retail – more risk/higher growth – we have applied our typical 15% discount rate to give a basic value of £19m or 79p per share, while in Manufacturing – 50%+ recurring revenues – we have used a slightly less demanding 12% to give £24m or 102p/share. These represent very modest EV/EBITDA multiples of 4.6x and 6.4x, respectively. Our conservative valuation of the retail division in particular probably reflects more the short-term macro uncertainty than potentially the major strategic value of the business as the retail sector picks up. Once debt is deducted, this implies a share price of 127p, which is more than double the current level.

At the current share price, our ratio analysis reveals profit multiples of c 3x and a prospective sales multiple of 0.6x.

Exhibit 6: Summary of DCF SOTP valuation and other metrics

SOTP DCF valuation	% owned	£m	Per share	EV/EBITDA	EV/Sales	Assumptions		
Retail	100.0%	19	79	4.6x	0.8x	WACC: 15%	No of shares	23.7m
Manufacturing	100.0%	24	102	6.4x	1.6x	WACC: 12%	Shr price	59.50p
	100.0%		0				Mkt cap	£14.1m
Other	100.0%		0	0.0x		WACC: 12%		
Less: taxed central costs NPV		0	0			WACC: 10%		
Group Enterprise Value		43	182					
Less: Net Debt		(13)	(55)					
Group Equity Value £m		30	127				Up / (down)side from current price	113%

Ratio Analysis	2008	2009f	Grp DCF Scenario's	WACC	Terminal growth rate	
EV/Sales	0.7	0.6		14.00%	3.00%	117p
EV/EBITDA	3.5	2.9			5.00%	123p
EV/EBIT	3.7	3.0		13.00%		132p
Price/Book	0.4	0.4		12.00%		151p
Price/Earnings	3.3	3.1				175p
Price/Op Cash Flow	2.2	1.8		11.00%		194p
ROE	12%	12%		10.00%		205p
				Breakeven WACC		20.1%

	Revenue sensitivity			
Multiple	0.5x	1.0x	1.5x	2.0x
Revenue Y1 £m	38	38	38	38
Implied EV £m	19	38	56	75
Net (debt)/cash £m	1.37	1.37	1.37	1.37
Group equity value £m	20	39	58	77
Per share (p)	85	164	244	323

Source: Edison Investment Research

Exhibit 7: Financials

	£'000s	2007 IAS	2008 IAS	2009e IAS	2010e IAS
Year end 31 December					
PROFIT & LOSS					
Revenue		34,146	37,619	39,036	40,518
Cost of Sales		(11,415)	(11,278)	(11,320)	(11,750)
Gross Profit		22,731	26,341	27,716	28,768
EBITDA		6,068	7,663	7,966	8,265
Operating Profit (before GW and except.)		5,760	7,348	7,639	7,925
Goodwill Amortisation		(896)	(1,875)	(1,875)	(1,875)
IFRS 2 charges		(152)	(103)	(103)	(103)
Other		0	(12)	0	0
Operating Profit		4,712	5,358	5,661	5,947
Net Interest		(1,036)	(1,416)	(1,150)	(800)
Profit Before Tax (norm)		4,724	5,920	6,489	7,125
Profit Before Tax (FRS 3)		3,676	3,942	4,511	5,147
Tax		(761)	(1,137)	(1,842)	(2,020)
Profit After Tax (norm)		3,963	4,783	4,647	5,105
Profit After Tax (FRS 3)		2,915	2,805	2,669	3,127
Average Number of Shares Outstanding (m)					
		21.7	23.7	23.7	23.8
EPS - normalised (p)		16.8	18.2	19.6	21.5
EPS - normalised fully diluted (p)		16.3	17.9	19.3	21.1
EPS - FRS 3 (p)		13.4	11.8	11.3	13.1
Dividend per share (p)		0.5	0.5	0.5	0.6
Gross Margin (%)					
		66.6	70.0	71.0	71.0
EBITDA Margin (%)					
		17.8	20.4	20.4	20.4
Operating Margin (before GW and except.) (%)					
		16.9	19.5	19.6	19.6
BALANCE SHEET					
Fixed Assets		45,547	47,099	45,581	44,217
Intangible Assets		12,282	12,075	10,200	8,325
Tangible Assets		1,305	1,333	1,656	2,167
Goodwill		31,494	33,225	33,225	33,225
Other		466	466	500	500
Current Assets		14,069	13,518	12,857	13,326
Stocks		0	0	0	0
Debtors		10,984	10,690	10,543	10,943
Cash		3,085	2,828	2,314	2,383
Current Liabilities		(10,732)	(10,960)	(10,322)	(10,543)
Creditors		(6,689)	(5,466)	(5,822)	(6,043)
Short term borrowings		(4,043)	(5,494)	(4,500)	(4,500)
Long Term Liabilities		(16,509)	(13,714)	(9,589)	(5,464)
Long term borrowings		(12,437)	(10,346)	(6,746)	(3,146)
Other long term liabilities		(4,072)	(3,368)	(2,843)	(2,318)
Net Assets		32,375	35,943	38,527	41,536
CASH FLOW					
Operating Cash Flow		6,228	6,375	7,841	7,457
Net Interest		(1,243)	(1,323)	(1,150)	(800)
Tax		(2,074)	(1,614)	(1,842)	(2,020)
Capex		(643)	(1,334)	(650)	(850)
Acquisitions/disposals		(16,493)	(259)	0	0
Financing		263	24	0	0
Dividends		0	(119)	(119)	(119)
Net Cash Flow		(13,962)	1,750	4,080	3,669
Opening net debt/(cash)		(695)	13,395	13,012	8,932
HP finance leases initiated		0	0	0	0
Other		(128)	(1,367)	0	0
Closing net debt/(cash)		13,395	13,012	8,932	5,263

Source: Company accounts/Edison Investment Research

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