

22 January 2008

## 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	14.3	N/A
12/06	27.3	2.7	10.9	0.00	13.5	N/A
12/07e	36.1	5.0	16.7	0.50	8.8	0.3
12/08e	46.5	7.5	22.4	0.75	6.6	0.5

\*PBT and EPS are normalised, excluding goodwill amortisation, exceptional items & FRS20

### Investment summary: Trading remains robust

K3 has confirmed that FY07 profits are at the upper end of estimates and that the sales pipeline across both divisions remains strong. The underperformance of the shares reflects investors' loss of appetite for the smaller cap technology sector and the group's 60% sales exposure to the retail sector. However, demand from multi-channel retailers, further margin improvements and higher order values in the Manufacturing Software division all support our broadly unchanged FY08 forecast. A P/E of under 7x clearly undervalues the coherent strategy

### Trading update: Demand remains strong

K3 commented that the sales pipeline across both divisions remains strong. Importantly the recent £1.3m contract with the White Company highlights the opportunity for K3 to win more business in the fast growing multi-channel retail sector as well as support existing clients (c.150 in total in the UK) in the roll-out their on-line IT strategy. The acquisition of MBL in March has not only helped the group push up average order values in the Manufacturing division but delivered cost savings of over £0.5m.

### Forecasts: FY08 earnings broadly unchanged

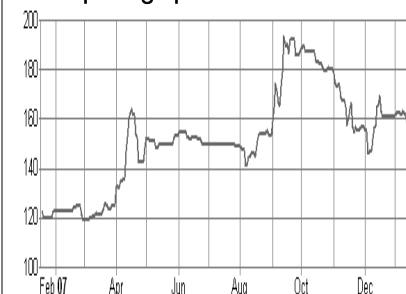
Our earnings forecast for FY08 remains broadly unchanged. We have taken a slightly more prudent view of our revenue growth assumption in the Retail division, but higher order values, cost control and the contribution from the recently acquired Index partially offsets this. We estimate K3 starts FY08 with c.£5m of additional debt facilities to add further acquisitions.

### Valuation: 4x FY08 operating cashflow

Across most of the small cap technology sector there is a disconnect between valuation and fundamentals. We believe the demand outlook remains resilient, K3 continues to strengthen its market proposition across both divisions and that the strategy can be further leveraged organically and through acquisition in 2009/10. A P/E of under 7x undervalues this strategy and our forecast £8m of operating cash and maiden dividend in FY07 underlines the quality of earnings.

Price 147.5p  
Market Cap £35m

#### Share price graph



#### Share details

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

#### Price

52 week High 193p Low 119p

#### 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	95%	73%	57%
P/CF	11.8	5.6	3.9
EV/Sales	0.9	1.2	0.9
ROE	16%	22%	28%

#### Analyst

Andrew Bryant 020 7190 1746  
abryant@edisoninvestmentresearch.co.uk  
Jason Holden 020 7190 1755  
jholden@edisoninvestmentresearch.co.uk

**Exhibit 1: Revenue and margin assumptions**

£m	FY 06	Underlying FY 07	Acquisitions FY 07	FY07E	Underlying FY 08	Acquisitions FY 08	FY 08E
<b>Revenues</b>							
Retail	16.44	20.71	1.6	22.31	21.13	6.67	27.80
Distribution	2.06	0.00		0.00	0.00		0.00
Manufacturing	8.85	9.29	4.50	13.79	9.76	8.90	18.66
	27.35	30.01	6.10	36.11	30.89	15.57	46.45
<b>EBITA</b>							
Retail	1.63	2.08	0.53	2.62	2.26	2.20	4.46
Distribution	0.08	0.00		0.00	0.00		0.00
Manufacturing	1.34	1.67	1.30	2.97	1.76	2.70	4.46
	3.05	3.75	1.83	5.58	4.02	4.90	8.92
<b>EBITA Margins</b>							
Retail	10%	10%	33%	12%	11%	33%	16%
Distribution	4%	N/A	N/A	N/A	N/A	N/A	N/A
Manufacturing	15%	18%	29%	22%	18%	30%	24%
	11%	13%		15%	13%		19%
Intangible Amortisation	(2.20)			(0.90)			(1.80)
Share Options	(0.09)			(0.10)			(0.10)
<b>EBIT</b>	0.76			4.58			7.02

Source: Edison Investment Research

*Acquisitions in FY08 are MBL, LS Netherlands and Index*

## Exhibit 2: Financials

31 December	£'000s	2003	2004	2005	2006	2007 <sup>e</sup>	2008 <sup>e</sup>
		UK GAAP	UK GAAP	UK GAAP	UK GAAP	IAS	IAS
<b>PROFIT &amp; LOSS</b>							
<b>Revenue</b>		<b>7,002</b>	<b>8,529</b>	<b>22,029</b>	<b>27,346</b>	<b>36,107</b>	<b>46,452</b>
Cost of Sales		(958)	(1,727)	(8,136)	(10,641)	(13,893)	(14,863)
Gross Profit		6,044	6,802	13,893	16,705	22,214	31,589
<b>EBITDA</b>		<b>1,256</b>	<b>818</b>	<b>2,749</b>	<b>3,375</b>	<b>5,985</b>	<b>9,417</b>
<b>Operating Profit (before GW, except &amp; FRS20)</b>		<b>1,074</b>	<b>603</b>	<b>2,408</b>	<b>3,046</b>	<b>5,585</b>	<b>8,917</b>
Goodwill Amortisation		(463)	(636)	(1,752)	(2,198)	(900)	(1,800)
Exceptionals		(605)	1,248	0	0	0	0
Other		(100)	0	(142)	(85)	(100)	(100)
<b>Operating Profit</b>		<b>(94)</b>	<b>1,215</b>	<b>514</b>	<b>763</b>	<b>4,585</b>	<b>7,017</b>
Net Interest		(105)	(55)	(287)	(262)	(450)	(1,350)
<b>Profit Before Tax (norm)</b>		<b>869</b>	<b>548</b>	<b>1,979</b>	<b>2,699</b>	<b>5,035</b>	<b>7,467</b>
<b>Profit Before Tax (FRS 3)</b>		<b>(199)</b>	<b>1,160</b>	<b>227</b>	<b>501</b>	<b>4,135</b>	<b>5,667</b>
Tax		(130)	(59)	(493)	(810)	(1,540)	(2,270)
<b>Profit After Tax (norm)</b>		<b>739</b>	<b>489</b>	<b>1,538</b>	<b>1,974</b>	<b>3,594</b>	<b>5,297</b>
<b>Profit After Tax (FRS3)</b>		<b>(329)</b>	<b>1,101</b>	<b>(266)</b>	<b>(309)</b>	<b>2,594</b>	<b>3,397</b>
Average Number of Shares Outstanding (m)		10.2	11.0	15.0	18.1	21.7	23.7
<b>EPS - normalised (p)</b>		<b>7.3</b>	<b>4.5</b>	<b>10.3</b>	<b>10.9</b>	<b>16.6</b>	<b>22.3</b>
<b>EPS - FRS 3 (p)</b>		<b>(3.2)</b>	<b>10.0</b>	<b>(1.8)</b>	<b>(1.7)</b>	<b>12.0</b>	<b>14.3</b>
Dividend per share		0.0	0.0	0.0	0.0	0.5	0.8
Gross Margin (%)		86.3%	79.8%	63.1%	61.1%	61.5%	68.0%
EBITDA Margin (%)		17.9%	9.6%	12.5%	12.3%	16.6%	20.3%
Operating Margin (before GW and except.) (%)		15.3%	7.1%	10.9%	11.1%	15.5%	19.2%
<b>BALANCE SHEET</b>							
<b>Fixed Assets</b>		<b>3,886</b>	<b>10,506</b>	<b>16,352</b>	<b>15,691</b>	<b>33,111</b>	<b>32,961</b>
Intangible Assets		3,354	9,919	15,844	13,877	10,000	10,000
Tangible Assets		342	570	508	416	1,300	1,150
Goodwill		0	0	0	0	21,811	21,811
Other		190	17	0	1,398	0	0
<b>Current Assets</b>		<b>3,784</b>	<b>6,671</b>	<b>7,470</b>	<b>11,045</b>	<b>13,938</b>	<b>15,936</b>
Stocks		0	0	0	0	0	0
Debtors		2,558	6,268	6,596	8,778	10,973	13,716
Cash		1,226	403	874	2,267	2,966	2,220
Other		0	0	0	0	0	0
<b>Current Liabilities</b>		<b>(4,706)</b>	<b>(9,345)</b>	<b>(10,583)</b>	<b>(13,654)</b>	<b>(16,021)</b>	<b>(18,905)</b>
Creditors		(3,128)	(5,881)	(7,703)	(9,124)	(10,949)	(13,139)
Other creditors		(1,527)	(1,831)	(2,091)	(3,669)	(4,511)	(5,506)
Short term borrowings		(51)	(1,633)	(789)	(861)	(561)	(261)
Minority interests		0	0	0	0	0	0
<b>Long Term Liabilities</b>		<b>0</b>	<b>(337)</b>	<b>(2,439)</b>	<b>(711)</b>	<b>(15,500)</b>	<b>(12,000)</b>
Long term borrowings		0	(337)	(1,332)	(711)	(15,500)	(12,000)
Other long term liabilities		0	0	(1,107)	0	0	0
<b>Net Assets</b>		<b>2,964</b>	<b>7,495</b>	<b>10,800</b>	<b>12,371</b>	<b>15,528</b>	<b>17,992</b>
<b>CASH FLOW</b>							
<b>Operating Cash Flow</b>		<b>1,365</b>	<b>1,244</b>	<b>4,267</b>	<b>2,218</b>	<b>5,700</b>	<b>8,114</b>
Net Interest		(23)	(99)	(279)	(235)	(450)	(1,350)
Tax		(11)	(76)	(80)	26	(1,965)	(3,243)
Capex		(99)	(12)	(106)	(335)	(300)	(350)
Acquisitions/disposals		(95)	(2,344)	(5,153)	(1,456)	(19,275)	0
Financing		0	0	1,350	1,825	2,500	0
Dividends		0	0	0	0	0	(116)
Other		0	464	472	(650)	0	0
Net Cash Flow		1,137	(823)	471	1,393	(13,790)	3,055
<b>Opening net debt/(cash)</b>		<b>(38)</b>	<b>(1,175)</b>	<b>1,567</b>	<b>1,247</b>	<b>(695)</b>	<b>13,095</b>
HP finance leases initiated		0	(106)	(88)	(104)	0	0
Other		0	(1,813)	(63)	653	0	(0)
<b>Closing net debt/(cash)</b>		<b>(1,175)</b>	<b>1,567</b>	<b>1,247</b>	<b>(695)</b>	<b>13,095</b>	<b>10,041</b>

Source: Company accounts/Edison Investment Research

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## Edison Investment Research

Bracton House, 34-36 High Holborn, London, WC1V 6AE ■ tel: +44 (0)20 7190 1760 ■ fax: +44 (0)20 7190 1759 ■ www.edisoninvestmentresearch.co.uk  
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