

29 December 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 | 0.5 | 5.0 | 0.6 |
| 12/08 | 37.6 | 5.9 | 17.9 | 0.5 | 4.6 | 0.6 |
| 12/09e | 36.9 | 6.0 | 18.0 | 0.5 | 4.6 | 0.6 |
| 12/10e | 37.8 | 6.5 | 19.3 | 0.6 | 4.2 | 0.7 |

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

Investment summary: Seasonal cheer

K3 has announced a change in its year end from December to June. This does not hide any issues with trading. The group signed 24 new contracts in H1, and this positive momentum has continued into H2, with several new orders closed in recent weeks. We believe the company is on track to meet current forecasts. The change does reflect the marked seasonality of the Syspro business and also aligns the group with the marketing efforts of its partner Microsoft. K3 continues to deliver on its strategic and financial targets leaving the shares looking cheap on all metrics.

Change in year end

K3 is moving its year end from 31 December to 30 June. The main reason for the change is that profits and cashflows are currently 'back end' weighted by the Syspro licensing, ie £6m of licence renewal income is invoiced every October, of which c £3m drops straight to the bottom line (around one-third of K3's 1,500 customers use Syspro). This clearly skews H1/H2 group reporting. This year, for example, K3 made profits of £1.5m in H1 and we assume £5.5m in H2 to reach our £7.0m year end forecast. Essentially reversing the reporting mix should give suppliers, customers and investors increased confidence in the group's annual financial outlook. The other reason is that it aligns K3 with Microsoft's year end. When Microsoft is conducting a marketing push at its year end (offering discounts and incentives etc), K3 can use this to its advantage in driving its own year end performance.

Valuation and outlook: Good visibility, 100p+ fair value

K3 has historically had a very strong new business sales engine – winning 40-50 new contracts every year – and the very encouraging current order momentum increases confidence in FY10 forecasts. Given that we estimate end December FY09 net debt at £9m, this forecast growth profile means that the group is positioned to pay off all of its debt within 24 months. On this basis, the shares are still extremely cheap on under 5x earnings, particularly given the "strategic value" and own IP the group is building in the retail and manufacturing channels. The value of the cash flows can be seen in a DCF valuation over 50% above the current share price. We expect a more detailed trading update in January.

Price 82p
Market Cap £21m

Share price graph



Share details

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

Price

52 week High Low
92.1p 58.8p

Balance Sheet as at 30 June 2009

Debt/Equity (%) 50
NAV per share (p) 113
Net borrowings (£m) 13.5

Business

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

Valuation

| | 2008 | 2009e | 2010e |
|--------------|------|-------|-------|
| P/E relative | 43% | 37% | 28% |
| P/CF | 3.0 | 2.6 | 3.0 |
| EV/Sales | 0.9 | 0.9 | 0.7 |
| ROE | 12% | 11% | 12% |

Geography based on revenues

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

Analyst

Andrew Bryant 020 3077 5729
abryant@edisoninvestmentresearch.co.uk

Exhibit 1: Divisional forecasts

| Year end 31 December | H108 | H208 | 2008 | | H109 | H209e | 2009e | | 2010e | | |
|----------------------|---------------|---------------|---------------|------------|---------------|--------------|---------------|---------------|-------------|---------------|-----------|
| Revenue | | | Yr | Change | Change | | Yr | Change | Yr | Change | |
| Retail | 10,454 | 11,722 | 22,176 | 8% | 9,826 | (6%) | 10,909 | 20,735 | (7%) | 21,357 | 3% |
| Manufacturing | 6,655 | 8,778 | 15,433 | 14% | 6,115 | (8%) | 10,012 | 16,127 | 5% | 16,450 | 2% |
| | | | 10 | | | | 0 | 0% | 0 | 0% | |
| Total | 17,109 | 20,500 | 37,619 | 10% | 15,941 | (7%) | 20,921 | 36,862 | (2%) | 37,807 | 3% |
| Gross Margins | | | | | | | | | | | |
| Group | | | 70% | | | | 71% | | 71% | | |
| Gross Profit | | | | | | | | | | | |
| Group | | | 26,341 | | | | 26,172 | | 26,843 | | |
| EBITA | | | | | | | | | | | |
| Retail | 1,609 | 2,346 | 3,955 | 36% | 1,161 | (28%) | 1,908 | 3,069 | (22%) | 3,203 | 4% |
| Manufacturing | 1017 | 2,637 | 3,654 | 7% | 525 | (48%) | 3,829 | 4,354 | 19% | 4,442 | 2% |
| Central costs | (305) | | (261) | | (144) | | (256) | (400) | 53% | (400) | |
| Total | 2,321 | 4,983 | 7,348 | 28% | 1,542 | (34%) | 5,481 | 7,023 | (4%) | 7,245 | 3% |

Source: Edison Investment Research

Exhibit 2: Summary of DCF SOTP valuation and other metrics

| SOTP DCF valuation | % owned | £m | Per share | EV/EBITDA | EV/Sales | Assumptions | | | |
|---------------------------------|---------|-----------|-----------------------|-----------|----------------|--------------------------------|---|------------|--|
| Retail | 100.0% | 17 | 72 | 5.3x | 0.8x | WACC: 15% | No of shares | 23.7m | |
| Manufacturing | 100.0% | 26 | 108 | 5.7x | 1.6x | WACC: 12% | Shr price | 82.00p | |
| | 100.0% | | 0 | | | | Mkt cap | £19.4m | |
| Other | 100.0% | | 0 | 0.0x | | WACC: 12% | | | |
| Less: taxed central costs NPV | | (4) | (15) | | | WACC: 10% | | | |
| Group Enterprise Value | | 39 | 166 | | | | | | |
| Less: Net Debt FY09 | | (9) | (38) | | | | | | |
| Group Equity Value £m | | 30 | 128 | | | | Up / (down)side from current price | 56% | |
| Ratio Analysis | | | | | | | | | |
| | 2008 | 2009f | Grp DCF Scenario's | | | -----Terminal growth rate----- | | | |
| | | | | | | 3.00% | 5.00% | | |
| EV/Sales | 0.9 | 0.8 | | | 14.00% | 114p | 119p | | |
| EV/EBITDA | 4.2 | 3.9 | | | 13.00% | 127p | 134p | | |
| EV/EBIT | 4.4 | 4.0 | | | 12.00% | 142p | 153p | | |
| Price/Book | 540.7 | 510.5 | | | 11.00% | 162p | 177p | | |
| Price/Earnings | 4.6 | 4.6 | | | 10.00% | 186p | 210p | | |
| Price/Op Cash Flow | 3.0 | 2.6 | | | | | | | |
| ROE | 12% | 11% | | | | | | | |
| | | | | | Breakeven WACC | 17.2% | | | |
| Revenue sensitivity YR 1 | | | | | | | | | |
| | | | Multiple | 0.5x | 1.0x | 1.5x | 2.0x | | |
| | | | Revenue Y1 £m | 37 | 37 | 37 | 37 | | |
| | | | Implied EV £m | 18 | 37 | 55 | 74 | | |
| | | | Net (debt)/cash £m | (9) | (9) | (9) | (9) | | |
| | | | Group equity value £m | 10 | 28 | 46 | 65 | | |
| | | | Per share (p) | 40 | 118 | 196 | 273 | | |

Source: Edison Investment Research

Exhibit 3: Financials

| Year end 31 December | £'000s | 2006 | 2007 | 2008 | 2009e | 2010e |
|---|--------|----------------|-----------------|-----------------|-----------------|-----------------|
| | | IAS | IAS | IAS | IAS | IAS |
| PROFIT & LOSS | | | | | | |
| Revenue | | 27,350 | 34,146 | 37,619 | 36,862 | 37,807 |
| Cost of Sales | | (10,641) | (11,415) | (11,278) | (10,690) | (10,964) |
| Gross Profit | | 16,709 | 22,731 | 26,341 | 26,172 | 26,843 |
| EBITDA | | 3,247 | 6,068 | 7,663 | 7,332 | 7,562 |
| Operating Profit (before GW and except.) | | 2,918 | 5,760 | 7,348 | 7,023 | 7,245 |
| Goodwill Amortisation | | 0 | (896) | (1,875) | (1,875) | (1,875) |
| IFRS 2 charges | | (85) | (152) | (103) | (103) | (103) |
| Other | | 0 | 0 | (12) | 0 | 0 |
| Operating Profit | | 2,833 | 4,712 | 5,358 | 5,045 | 5,267 |
| Net Interest | | (262) | (1,036) | (1,416) | (1,000) | (750) |
| Profit Before Tax (norm) | | 2,656 | 4,724 | 5,920 | 6,023 | 6,495 |
| Profit Before Tax (FRS 3) | | 2,571 | 3,676 | 3,942 | 4,045 | 4,517 |
| Tax | | (846) | (761) | (1,137) | (1,686) | (1,819) |
| Profit After Tax (norm) | | 1,810 | 3,963 | 4,783 | 4,337 | 4,676 |
| Profit After Tax (FRS 3) | | 1,725 | 2,915 | 2,805 | 2,359 | 2,698 |
| Average Number of Shares Outstanding (m) | | 18.1 | 21.7 | 23.7 | 23.7 | 23.8 |
| EPS - normalised (p) | | 10.5 | 16.8 | 18.2 | 18.3 | 19.6 |
| EPS - normalised fully diluted (p) | | 10.4 | 16.3 | 17.9 | 18.0 | 19.3 |
| EPS - FRS 3 (p) | | 9.5 | 13.4 | 11.8 | 10.0 | 11.3 |
| Dividend per share (p) | | 0.0 | 0.5 | 0.5 | 0.5 | 0.6 |
| Gross Margin (%) | | 61.1 | 66.6 | 70.0 | 71.0 | 71.0 |
| EBITDA Margin (%) | | 11.9 | 17.8 | 20.4 | 19.9 | 20.0 |
| Operating Margin (before GW and except.) (%) | | 10.7 | 16.9 | 19.5 | 19.1 | 19.2 |
| BALANCE SHEET | | | | | | |
| Fixed Assets | | 17,962 | 45,547 | 47,099 | 45,849 | 44,508 |
| Intangible Assets | | 273 | 12,282 | 12,075 | 10,200 | 8,325 |
| Tangible Assets | | 416 | 1,305 | 1,333 | 1,924 | 2,458 |
| Goodwill | | 15,684 | 31,494 | 33,225 | 33,225 | 33,225 |
| Other | | 1,589 | 466 | 466 | 500 | 500 |
| Current Assets | | 10,889 | 14,069 | 13,518 | 11,312 | 10,875 |
| Stocks | | 0 | 0 | 0 | 0 | 0 |
| Debtors | | 8,622 | 10,984 | 10,690 | 9,475 | 9,718 |
| Cash | | 2,267 | 3,085 | 2,828 | 1,837 | 1,157 |
| Current Liabilities | | (5,246) | (10,732) | (10,960) | (10,006) | (10,147) |
| Creditors | | (4,385) | (6,689) | (5,466) | (5,506) | (5,647) |
| Short term borrowings | | (861) | (4,043) | (5,494) | (4,500) | (4,500) |
| Long Term Liabilities | | (711) | (16,509) | (13,714) | (9,089) | (4,964) |
| Long term borrowings | | (711) | (12,437) | (10,346) | (6,246) | (2,646) |
| Other long term liabilities | | 0 | (4,072) | (3,368) | (2,843) | (2,318) |
| Net Assets | | 22,894 | 32,375 | 35,943 | 38,067 | 40,272 |
| CASH FLOW | | | | | | |
| Operating Cash Flow | | 2,208 | 6,228 | 6,375 | 7,459 | 6,457 |
| Net Interest | | (256) | (1,243) | (1,323) | (1,000) | (750) |
| Tax | | 21 | (2,074) | (1,614) | (1,336) | (1,819) |
| Capex | | (375) | (643) | (1,334) | (900) | (850) |
| Acquisitions/disposals | | (1,395) | (16,493) | (259) | 0 | 0 |
| Financing | | 1,825 | 263 | 24 | 0 | 0 |
| Dividends | | 0 | 0 | (119) | (119) | (119) |
| Operating Cash Flow | | 2,028 | (13,962) | 1,750 | 4,103 | 2,920 |
| Opening net debt/(cash) | | 1,247 | (695) | 13,395 | 13,012 | 8,909 |
| HP finance leases initiated | | 0 | 0 | 0 | 0 | 0 |
| Other | | (86) | (128) | (1,367) | 0 | 0 |
| Closing net debt/(cash) | | (695) | 13,395 | 13,012 | 8,909 | 5,989 |

Source: Company accounts/Edison Investment Research

EDISON INVESTMENT RESEARCH LIMITED

Edison is Europe's leading independent investment research company. It has won industry recognition, with awards in both the UK and internationally. The team of 50 includes over 30 analysts supported by a department of supervisory analysts, editors and assistants. Edison writes on more than 250 companies across every sector and works directly with corporates, investment banks, brokers and fund managers. Edison's research is read by every major institutional investor in the UK, as well as by the private client broker and international investor communities. Edison was founded in 2003 and is authorised and regulated by the Financial Services Authority.

DISCLAIMER

Copyright 2009 Edison Investment Research Limited. All rights reserved. This report has been commissioned by K3 Business Technology Group and prepared and issued by Edison Investment Research Limited for publication in the United Kingdom. All information used in the publication of this report has been compiled from publicly available sources that are believed to be reliable, however we do not guarantee the accuracy or completeness of this report. Opinions contained in this report represent those of the research department of Edison Investment Research Limited at the time of publication. The research in this document is intended for professional advisers in the United Kingdom for use in their roles as advisers. It is not intended for retail investors. This is not a solicitation or inducement to buy, sell, subscribe, or underwrite securities or units. This document is provided for information purposes only and should not be construed as an offer or solicitation for investment. A marketing communication under FSA Rules, this document has not been prepared in accordance with the legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research. Edison Investment Research Limited has a restrictive policy relating to personal dealing. Edison Investment Research Limited is authorised and regulated by the Financial Services Authority for the conduct of investment business. The company does not hold any positions in the securities mentioned in this report. However, its directors, officers, employees and contractors may have a position in any or related securities mentioned in this report. Edison Investment Research Limited or its affiliates may perform services or solicit business from any of the companies mentioned in this report. The value of securities mentioned in this report can fall as well as rise and are subject to large and sudden swings. In addition it may be difficult or not possible to buy, sell or obtain accurate information about the value of securities mentioned in this report. Past performance is not necessarily a guide to future performance.

Edison Investment Research

Lincoln House, 296-302 High Holborn, London, WC1V 7JH ■ tel: +44 (0)20 3077 5700 ■ fax: +44 (0)20 3077 5750 ■ www.edisoninvestmentresearch.co.uk
Registered in England, number 4794244. Edison Investment Research is authorised and regulated by the Financial Services Authority.