

13 March 2007

## K3 Business Technology Group

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	PE (x)	Yield (%)
12/04	8.5	0.5	4.5	0.0	27.0	N/A
12/05	22.0	2.0	10.3	0.0	11.8	N/A
12/06	27.3	2.7	10.9	0.0	11.1	N/A
12/07e	30.0	3.9	14.0	0.1	8.7	0.0

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

### Investment summary: Strong growth

K3's results for FY06 exceeded forecasts, helped by strong growth in the retail division. We expect the benefits of recent investment to support further growth into FY07, albeit H2 weighted. In addition, the Distribution division has been sold and costs have been reduced significantly in the legacy Walton product. This is reflected in our raised forecasts. We now look for sales growth of 10% and EPS growth of 28% in FY07.

### Investment case: Focused growth

The group has a well-balanced business model of predictable, recurring licence income in the manufacturing sector combined with high growth opportunities in the retail sector. There are opportunities to add businesses within the core divisions and to broaden the offering into infrastructure and managed services. The strategy is to build towards £50m of sales and EBITA of £7m by FY08 through a combination of organic growth and acquisition.

### Results for FY06: Forecasts exceeded

Revenue of £27.3m was ahead of forecast (£25.4m), partly reflecting a major deal for c.£2m that was closed just before year end. EBITA was in-line with forecasts at £3.05m, reflecting investment in new staff, in preparation for growth in FY07.

### Forecast for FY07: Revenue of £30m

Despite the loss of £2m of revenue from the disposal of Elucid, we have raised our forecast revenue for FY07 from £28m to £30m. We expect the EBITA margin to increase to 13% (11% in FY06). We forecast EPS will rise to 14.0p in FY07 and we forecast end 2007 net cash of £2.4m (although more acquisitions are possible).

### Valuation and view: Only 9x FY07

The shares trade on only c.9x FY07 earnings. This significantly undervalues the focused strategy. We expect trading to drive an uplift in forecasts and multiples throughout 2007.

Price 121.5p  
Market Cap £24m

#### Share price graph



#### Share details

Code KBT  
Listing AIM  
Sector Software & Computer Services  
Shares in issue 19.7m

#### Price

52 week High 125p Low 89p

#### Balance Sheet at 31 Dec 2006

Debt/Equity (%) N/A  
NAV per share (p) 64.2  
Net cash (£m) 0.7

#### Business

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

#### Valuation

	2005	2006	2007e
P/E relative	81%	88%	95%
P/CF	4.2	9.7	9.7
EV/Sales	0.9	0.8	0.8
ROE	14%	16%	16%

#### Analyst

Andrew Tombs 020 7190 1755  
atombs@edisoninvestmentresearch.co.uk

## Investment summary: Strong growth

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### Company description: Microsoft channel partner

K3 is a value-added, Microsoft channel partner. It designs and implements supply chain software solutions based on Microsoft technologies, targeting the related UK industry sectors of retail and manufacturing. The group has a well-balanced business model of predictable, recurring licence income in the manufacturing sector, combined with high growth opportunities in the retail sector.

### Investment case and valuation: Sector and technology focus

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 K3 has a major opportunity to leverage its core market position as the UK's number one Microsoft Dynamics partner. In addition, there are opportunities to add a Managed Services division, through acquisition, that will exploit the strong customer relationships existing within the Retail division.

### Sensitivities: Recruiting quality staff

The main sensitivities or risks to our forecasts are: 1) a significant increase in interest rates could impact consumer spending and the IT budgets of retailers, 2) organic growth in all divisions will depend on the ability to hire and retain skilled staff and, 3) a move into managed services will require successful adoption of a new division with a different culture to systems development.

## Results for FY06

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Revenue of £27.3m was ahead of forecast (£25.4m) on account of an unexpected deal for c.£2m with Gamestop that was closed just before year end. Despite this, EBITA remained in line with forecasts at £3.05m, as a result of investment in new staff, in preparation for growth in FY07.

Retail revenue of £16.44m represents growth of 30% year on year, with a stronger second half, owing to the investment in building vertical teams for Fashion, Brewery/Drinks, Food, Big Ticket and General Retail.

Manufacturing revenue grew by 17% to £8.85m. This higher than normal rate of growth is due to the inclusion of a full 12-month set of results for IEG, following its acquisition (June 2005).

Manufacturing revenue is unevenly split in favour of H2 on account of 40% of IEG annual revenue being recurring licence fees, all of which is invoiced in October of each year.

Margins for Retail were high in H1 FY06 (13%) due to the rollout of licences at Carpetright. Retail margins in H2 dropped to 7% as staff were hired in preparation for new deals. The high margin for Manufacturing in H2 FY06 (21%) is on account of the licence fees that are invoiced in October.

## Forecasts for FY07

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On 12 February it was announced that Elucid, the distribution division, was to be sold to Sanderson for £1.36m. Elucid, which had revenues of £2.06m in FY06, is no longer seen as core to the business. Multi-channel distribution functionality has now been developed for the Retail

solutions, and K3 would prefer to focus the sales effort on the higher value Retail deals. Despite the loss of £2m of revenue from Elucid, we forecast revenue of £30m in FY07 with EBITA of £3.8m.

We expect Retail revenue to be £20.7m, an impressive increase of 26% on the previous year. We see this growth as the outcome of substantial investments made in FY06 to hire more staff, both in technical and sales/marketing roles, and their organisation into vertical teams. This investment is forecast to continue in H1, resulting in a fall of the margin to 9%. However, we forecast the margin to improve to 11% in H2, as the benefits of the investment start to pay off.

We forecast Manufacturing revenue will rise to £9.3m in FY07, in line with its trend annual growth of 5%. There is no longer any investment being made in the Walton product, resulting in some staff being transferred, while others have been made redundant. The consequent restructuring costs of £200k are expected to cause the margin to drop to 8% in H1, rising significantly to 30% in H2 on account of the reduced Walton cost base, and the licence revenue renewals from IEG.

The business is expected to require working capital in the first half of each year and then generate cash in the second half as a large proportion of annual licence renewals are billed in October. We forecast year end net cash of £2.4m.

There is an opportunity for K3 to sell managed services to its customers, and to this end an approach was made in December to acquire Sirvis IT Plc for £4.6m (4p per share). K3 had built up a 29.8% stake (34m shares) in the company at a cost of £1.4m, but it was announced on 9 March that a formal offer would not be made, and 30m of the shares were disposed of on the same day. We expect K3 to search for alternative acquisitions or alliances later in FY07.

The results for FY06 have been prepared using UK GAAP, and our forecasts for FY07 also follow the same standards. However, the actual results for FY07 will be prepared in accordance with IFRS, resulting in the removal of the £2.1m amortisation charge.

#### Exhibit 1: Revenue and margin assumptions

£m	FY 05 A	H1 06 A	H2 06 A	FY 06 A	% change	H1 07 E	H2 07 E	FY 07 E	% change
<b>Revenues</b>									
Retail	12.66	7.79	8.65	16.44	30%	9.82	10.90	20.71	26%
Distribution	1.80	1.00	1.06	2.06	14%	0.00	0.00	0.00	N/A
Manufacturing	7.57	3.95	4.90	8.85	17%	4.15	5.15	9.29	5%
	<b>22.03</b>	<b>12.74</b>	<b>14.61</b>	<b>27.35</b>	<b>24%</b>	<b>13.96</b>	<b>16.04</b>	<b>30.01</b>	<b>10%</b>
<b>EBITA</b>									
Retail	1.22	1.00	0.63	1.63	34%	0.88	1.20	2.08	28%
Distribution	(0.08)	0.01	0.07	0.08	N/A	0.00	0.00	0.00	N/A
Manufacturing	1.27	0.31	1.03	1.34	6%	0.13	1.54	1.67	25%
	<b>2.41</b>	<b>1.32</b>	<b>1.73</b>	<b>3.05</b>	<b>27%</b>	<b>1.01</b>	<b>2.74</b>	<b>3.75</b>	<b>23%</b>
<b>EBITA Margins</b>									
Retail	10%	13%	7%	10%		9%	11%	10%	
Distribution	N/A	1%	7%	4%		N/A	N/A	N/A	
Manufacturing	17%	8%	21%	15%		8%	30%	15%	
	<b>11%</b>	<b>10%</b>	<b>12%</b>	<b>11%</b>		<b>7%</b>	<b>17%</b>	<b>13%</b>	
Goodwill Amortisation	(1.75)			(2.20)				(2.10)	
Share Options	(0.05)			(0.09)				(0.10)	
<b>EBIT</b>	<b>0.61</b>			<b>0.76</b>				<b>1.65</b>	

Source: Edison Investment Research

## Exhibit 2: Financials

	£'000s	2002	2003	2004	2005	2006	2007e
31-Dec							
<b>PROFIT &amp; LOSS</b>							
<b>Revenue</b>		<b>8,088</b>	<b>7,002</b>	<b>8,529</b>	<b>22,029</b>	<b>27,346</b>	<b>30,007</b>
Cost of Sales		(1,469)	(958)	(1,727)	(8,136)	(10,641)	(11,991)
Gross Profit		6,619	6,044	6,802	13,893	16,705	18,016
<b>EBITDA</b>		<b>1,181</b>	<b>1,256</b>	<b>818</b>	<b>2,749</b>	<b>3,375</b>	<b>4,101</b>
<b>Operating Profit (before GW and except.)</b>		<b>975</b>	<b>1,074</b>	<b>603</b>	<b>2,408</b>	<b>3,046</b>	<b>3,851</b>
Goodwill Amortisation		(463)	(463)	(636)	(1,752)	(2,198)	(2,100)
Exceptionals		(173)	(605)	1,248	0	0	0
Other		0	(100)	0	(142)	(85)	(100)
<b>Operating Profit</b>		<b>339</b>	<b>(94)</b>	<b>1,215</b>	<b>514</b>	<b>763</b>	<b>1,651</b>
Net Interest		(73)	(105)	(55)	(287)	(262)	100
<b>Profit Before Tax (norm)</b>		<b>902</b>	<b>869</b>	<b>548</b>	<b>1,979</b>	<b>2,699</b>	<b>3,851</b>
<b>Profit Before Tax (FRS 3)</b>		<b>266</b>	<b>(199)</b>	<b>1,160</b>	<b>227</b>	<b>501</b>	<b>1,751</b>
Tax		108	(130)	(59)	(493)	(810)	(1,185)
<b>Profit After Tax (norm)</b>		<b>1,010</b>	<b>739</b>	<b>489</b>	<b>1,538</b>	<b>1,974</b>	<b>2,766</b>
<b>Profit After Tax (FRS3)</b>		<b>374</b>	<b>(329)</b>	<b>1,101</b>	<b>(266)</b>	<b>(309)</b>	<b>566</b>
Average Number of Shares Outstanding (m)		10.2	10.2	11.0	15.0	18.1	19.7
EPS - normalised (p)		9.9	7.3	4.5	10.3	10.9	14.0
EPS - FRS 3 (p)		3.7	(3.2)	10.0	(1.8)	(1.7)	2.9
Dividend per share		0.0	0.0	0.0	0.0	0.0	0.1
Gross Margin (%)		81.8%	86.3%	79.8%	63.1%	61.1%	60.0%
EBITDA Margin (%)		14.6%	17.9%	9.6%	12.5%	12.3%	13.7%
Operating Margin (before GW and except.) (%)		12.1%	15.3%	7.1%	10.9%	11.1%	12.8%
<b>BALANCE SHEET</b>							
<b>Fixed Assets</b>		<b>4,243</b>	<b>3,886</b>	<b>10,506</b>	<b>16,352</b>	<b>15,691</b>	<b>13,591</b>
Intangible Assets		3,817	3,354	9,919	15,844	13,877	11,777
Tangible Assets		426	342	570	508	416	416
Investment in associates		0	0	0	0	1,398	1,398
Unquoted investments		0	190	17	0	0	0
<b>Current Assets</b>		<b>4,021</b>	<b>3,784</b>	<b>6,671</b>	<b>7,470</b>	<b>11,045</b>	<b>14,210</b>
Stocks		0	0	0	0	0	0
Debtors		3,868	2,558	6,268	6,596	8,778	10,973
Cash		123	1,226	403	874	2,267	3,237
Other		30	0	0	0	0	0
<b>Current Liabilities</b>		<b>(4,869)</b>	<b>(4,706)</b>	<b>(9,345)</b>	<b>(10,583)</b>	<b>(13,654)</b>	<b>(14,522)</b>
Creditors		(4,835)	(3,128)	(5,881)	(7,703)	(9,124)	(10,036)
Other creditors		0	(1,527)	(1,831)	(2,091)	(3,669)	(3,925)
Short term borrowings		(34)	(51)	(1,633)	(789)	(861)	(561)
Minority interests		0	0	0	0	0	0
<b>Long Term Liabilities</b>		<b>(51)</b>	<b>0</b>	<b>(337)</b>	<b>(2,439)</b>	<b>(711)</b>	<b>(311)</b>
Long term borrowings		(51)	0	(337)	(1,332)	(711)	(311)
Other long term liabilities		0	0	0	(1,107)	0	0
<b>Net Assets</b>		<b>3,344</b>	<b>2,964</b>	<b>7,495</b>	<b>10,800</b>	<b>12,371</b>	<b>12,967</b>
<b>CASH FLOW</b>							
<b>Operating Cash Flow</b>		<b>471</b>	<b>1,365</b>	<b>1,244</b>	<b>4,267</b>	<b>2,218</b>	<b>2,719</b>
Net Interest		(35)	(23)	(99)	(279)	(235)	100
Tax		0	(11)	(76)	(80)	26	(1,699)
Capex		(66)	(99)	(12)	(106)	(335)	(250)
Acquisitions/disposals		(105)	(95)	(2,344)	(5,153)	(1,456)	1,100
Financing		0	0	0	1,350	1,825	0
Dividends		0	0	0	0	0	(100)
Other		0	0	464	472	(650)	0
Net Cash Flow		265	1,137	(823)	471	1,393	1,870
<b>Opening net debt/(cash)</b>		<b>227</b>	<b>(38)</b>	<b>(1,175)</b>	<b>1,567</b>	<b>1,247</b>	<b>(695)</b>
HP finance leases initiated		0	0	(106)	(88)	(104)	(200)
Other		0	0	(1,813)	(63)	653	0
<b>Closing net debt/(cash)</b>		<b>(38)</b>	<b>(1,175)</b>	<b>1,567</b>	<b>1,247</b>	<b>(695)</b>	<b>(2,365)</b>

Source: Company accounts/Edison Investment Research

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