

K3 Business Technology Group

KBT : AIM : 107p

BUY

Target: 180p

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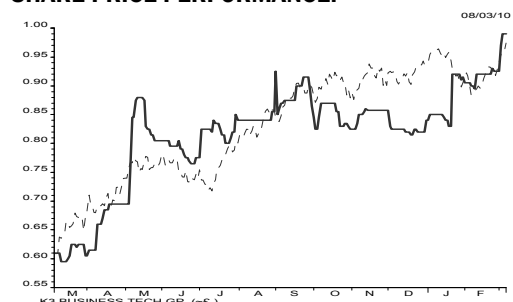
COMPANY STATISTICS:

52-week Range: £0.60 - 0.99
 Avg. Daily Vol. (000s): 15
 Market Cap (M): £27
 Shares Out (M): 26

EARNINGS SUMMARY:

FYE Jun	2010E	2011E
Revenue (M):	£42.0	£44.6
EBITA (M):	£7.3	£8.3
Net (Debt)/Cash (M):	£(11.0)	£(7.1)
EPS (p):	12.1	15.2
adj. FD EPS (p):	18.2	21.1
Dividend per Share:	£0.005	£0.005
EV/Revenue (x):	0.91	0.86
EV/EBITDA (x):	5.1	4.5
P/E (x):	8.8	7.1
adj. FD P/E (x):	5.9	5.1
Dividend Yield %:	0.5	0.5

SHARE PRICE PERFORMANCE:



Source: Thomson Datastream

COMPANY SUMMARY:

K3 is the UK's market leading supplier of Microsoft-based supply chain management solutions to SMEs. The company is focused on two verticals, Retail Software (some 60% of sales) and Manufacturing Software (the residual 40%). 75% of sales are to the UK and just over 40% of revenues are recurring.

*Non-independent research

All amounts in £ unless otherwise noted.
 Share price data COB 5 March 2010.

Technology -- Software -- Software and Services

UPGRADING FORECASTS

Numbers 4-5% ahead of forecasts

K3 produced FY2009 revenues and EPS 4-5% ahead of our forecasts. Cash generation has been especially strong with net debt just £5.4 million versus our forecast £7.4 million. The strong pipeline causes K3 to view its prospects "very positively". We still believe this is one of the more compelling and yet resoundingly undervalued stories in UK tech.

Key figures

FY2009 revenues of £39.5 million were 4% ahead of our forecast of £38 million. This implies H2 revenues up 15% year on year, showing a very strong recovery. Adjusted operating profits were £7 million, in line with our forecasts, though this again implies a 9% increase in the six months to December 2009. Adjusted EPS of 18.2p was 5% ahead of our 17.2p forecast. Net debt of £5.4 million was significantly better than our £7.4 million forecast.

Forecast changes

We are adjusting our forecasts to account for the better than expected 2009 results and also for the two recent acquisitions (DigiMIS and Pebblestone NL). We raise our FY2010 EPS forecasts by 3% from 17.6p to 18.2p and our FY2011 EPS forecasts by 9% from 19.3p to 21.1p.

Valuation – still one of the cheapest stocks we follow

K3 trades on barely more than 5 times June 2011 EPS forecasts. This is one of the cheapest stocks in our coverage universe and yet it has just shown amongst the fastest topline growth (15% on the six months to December 2009). We believe that K3 is both geared to a macro recovery and also to further market share gains from its portfolio of Microsoft based products. We remain very comfortable with our 180p price target which is some 70% ahead of current levels.

H2 REBOUND

Despite what has clearly been a very difficult economic background, it is pleasing to see K3 deliver H2 yoy revenue growth of 15%. It is perhaps even more pleasing to see a nearly 80% hike in major new orders to £11.3 million from £6.4 million. Much of this latter was signed late in Q4 and as such underpins our forecasts for FY2010. Furthermore, K3 points out that it has been winning new business in competition with SAP, IBM and Oracle. As we suggested in our *Initiation* "On the Shoulders of a Giant", 18 January 2010, we are not surprised to see this as we expect Microsoft Dynamics to continue to gain market share against other vendors. While it is perhaps a little surprising that growth has come through so strongly from a depressed UK market, we would expect K3 to now enter a period of consecutive growth for many years.

2010 COULD BE THE YEAR OF AX

Traditionally K3 has principally sold the NAV flavour of Microsoft Dynamics. The acquisition of Index in late 2007 brought with it the distribution rights for AX, the key other Dynamics product in the European market. Selling a higher end, bigger ticket fully fledged ERP system was clearly challenging as the global slowdown began and K3 did not shop a single AX solution in the six months through to end June 2009. However, we note that, as flagged by the company, H2 saw two deals signed and management is now talking about strong pipeline of opportunities for the current year. We think we could see a substantial leg up in this business this year, really kick-starting the AX business and being complementary to the lower end SYSPRO business. We note also that K3 made its first AX sale on the retail side.

ACCRETIVE ACQUISITIONS

Having shown excellent cash management K3 has been able to make two small but strategic acquisitions over the past week, both of which we believe will be accretive to earnings. K3 announced the acquisition of DigiMIS on 2 March 2010. While DigiMIS already provides hosting services for five K3 customers, we suspect there will be considerable scope to roll it out to the broader client base (c 1500 customers). Today K3 announced the acquisition of Pebblestone, a provider of Microsoft Dynamics based fashion solutions in Holland. The initial consideration is £1.3 million cash with a deferred contribution of £0.5 million. At 36% price to sales and 2.6 times pre-tax profits Pebblestone is very likely to be accretive.

VALUATION REMAINS VERY COMPELLING

We can not think of many (in fact any!) stocks that have just shown 15% highly profitable revenue growth that trade on just 5 times. We can understand that last year there were fears that K3's exposure to the UK retail and manufacturing sector might make trading challenging. However, these results show these fears to have been unfounded.

Furthermore the outlook suggests that they are likely to remain so. Our own view is that K3 represents an excellent play on the continuing market penetration of Microsoft Dynamics in the UK and increasingly abroad. We believe the stock will continue to rerate towards our 180p price target.

Figure 1: K3 Key Financial Metrics

FYE Dec £m	2006	2007	2008	2009	12m Jun 2010E	12m Jun 2011e
P&L						
Retail Software	16.4	20.5	22.2	23.1	24.8	27.9
Manufacturing software	8.8	13.5	15.4	16.4	15.8	16.7
Distribution software	2.1	0.2	0.0	0.0	0.0	0.0
Total revenues	27.3	34.1	37.6	39.5	42.0	44.6
Retail Software	1.6	2.9	4.0	3.2	3.3	4.1
Manufacturing software	1.6	3.4	3.7	4.3	4.4	4.6
Distribution software	0.1	-0.1	0.0	0.0	0.0	0.0
Central costs	-0.4	-0.5	-0.3	-0.4	-0.4	-0.4
Adj. operating profit	2.9	5.8	7.3	7.0	7.3	8.3
Adj. operating profit margin	10.7%	16.9%	19.5%	17.8%	17.4%	18.6%
Amortisation of acquired intangibles	0.0	-0.9	-1.9	-2.0	-2.1	-2.0
SBP	-0.1	-0.2	-0.1	0.0	-0.1	0.0
EBIT	2.8	4.7	5.4	5.0	5.1	6.3
Finance income	0.0	0.0	0.0	0.0	0.0	0.0
Finance expense	-0.3	-1.1	-1.4	-1.0	-0.9	-0.7
Net Financials	-0.3	-1.0	-1.4	-0.9	-0.9	-0.7
Adj PBT	2.7	4.7	5.9	6.0	6.4	7.6
PBT	2.6	3.7	3.9	4.0	4.2	5.6
Tax expense	-0.8	-0.8	-1.1	-1.1	-1.3	-1.7
Net Profit	1.7	2.9	2.8	3.0	2.9	3.9
WA SII	18.1	21.7	23.7	24.2	24.3	25.0
Basic EPS	9.5	13.4	11.8	12.3	12.1	15.2
Adj.FD EPS	9.5	15.3	17.4	18.1	18.2	21.1
Yoy Chg						
Dividend	0.0	0.5	0.5	0.5	0.5	0.5
Cash Flow						
CF from Operations B4 chg in NWC	3.3	6.4	7.9	7.8	8.1	9.3
Chg in NWC	-1.1	-0.1	-1.5	1.1	-1.5	-1.7
CFO	2.2	6.2	6.4	8.9	9.3	5.5
Interest and Tax	-0.2	-3.3	-2.9	-2.1	-2.2	-2.4
Capex	-0.3	-0.6	-1.3	-0.9	-1.0	-1.0
Other Investing activities	-1.4	-16.5	-0.3	0.0	-2.0	-0.2
Financing	1.6	0.1	-0.1	1.3	1.3	-0.1
Other	0.0	-0.2	-0.6	0.1	-2.7	2.1
Chg in net debt	1.8	-14.3	1.1	7.3	2.5	3.9
Cash flow/BS Metrics						
Net Debt	0.7	-13.4	-13.0	-5.7	-11.0	-7.1

Source: Canaccord Adams Limited

Valuation

The median calendar 2010E EV/EBITA rating for the UK software and IT services sector is 8.4 times. Applying a 20% discount gets us to a target multiple of 6.7. This gets us to a target price of 180p.

Investment risks

Spending in K3's software solutions is to a large degree a function of the economic health of the UK retail and manufacturing verticals. K3 has debt facilities through to August 2012 and needs to repay 3.5 million annually to pay this off. K3 resells software from Microsoft, Landsteinar and SYSPRO. All three relationships contribute materially to K3's profits and need to be maintained.

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Price Chart:*



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Global Stock Ratings
(as of 1 March 2010)

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	#	%	#	%
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Speculative Buy	84	12.8%	59.5%	
Hold	161	24.5%	18.6%	
Sell	15	2.3%	0.0%	
	658	100.0%		

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Company	Disclosure
K3 Business Technology Group	1A, 2, 4, 5

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