

28 March 2007

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	12.0	N/A
12/06	27.3	2.7	10.9	0.00	11.4	N/A
12/07e	34.5	4.6	15.6	0.50	7.9	0.0
12/08e	39.9	5.8	19.1	0.75	6.5	0.0

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

Investment summary: Consolidating the Syspro market

K3 announced today that it has acquired McGuffie Brunton Ltd (M&B), a move that consolidates the resale of Syspro software within the UK market. Syspro is a Microsoft-based ERP solution that is sold to SME manufacturers and distributors; the other UK reseller is IEG which was acquired by K3 in June 2005. This deal is strategically sensible, provides opportunity for cost reduction and we estimate it will enhance FY08 earnings by nearly 30%.

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.

Acquisition: McGuffie Brunton

K3 is paying net £11.8m for a business with revenue of £6.2m in FY06 and EBITA of £1.7m. There are significant cost saving opportunities which are anticipated to be of the order of £600k-£800k per annum.

Forecasts: Increase in FY07 and new FY08 forecast

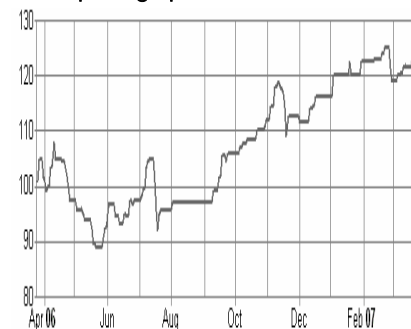
We have raised our revenue expectation to £34.5m for FY07 (previously £30.0m), and we forecast £39.9m for FY08. We forecast EPS will rise to 15.6p in FY07 (previously 14.0p), and we now forecast earnings of 19.1p in FY08.

Valuation and view: Undervalued on under 7x FY08

We estimate that the deal enhances earnings by 11% in FY07 and 29% in FY08. We also believe that, on 6.5x FY08, the market is undervaluing the focused organic and acquisitive strategy as well as the scope to grow earnings and cash. Even valuing the group at 10x (a discount to the sector) would imply a valuation range for the stock of 180p to 200p.

Price 124p
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 126p
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

	2006	2007e	2008e
P/E relative	76%	62%	55%
P/CF	9.7	6.2	5.1
EV/Sales	0.8	0.9	0.8
ROE	16%	30%	41%

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Business case

The deal has strong logic to it. IEG has 150 customers with recurring revenue of £2m, and ticket sizes of typically £150k–£200k, while M&B has 300 slightly smaller customers with recurring revenues of £3m, and ticket sizes of c.£100k. Therefore the two companies rarely compete, although at times M&B have competed against K3's Walton product. This fits well with K3's strategy of migrating existing customers from the legacy Walton product across to Syspro.

M&B had revenue of £6.2m in FY06 with EBITA of £1.7m (FY05 £6.0m and £1.6m). We believe that there are significant cost saving opportunities since M&B is based in Salford, only three miles from IEG. Management estimates that overheads can be trimmed by 10–15%, by consolidating admin and marketing functions. Overall cost savings are expected to be £600k–£800k per year.

Valuation & funding

The agreed price for the company is £14.3m, less £2.5m of cash in the business, resulting in a net cash consideration of £11.8m. The net cash consideration represents c.7x historic EBIT (FY06 £1.7m). However, when compared with forecast EBIT for FY08 the deal looks good value at just under 5x EBIT of £2.4m.

The acquisition will be funded by an £8m bank loan, and a recent equity placing of 2.1m shares at 123.5p each, yielding £2.5m. The balance will be funded by existing cash resources.

Financials: Changes to forecasts

Revenue & margins

The deal should close next week, so K3 will benefit from the inclusion of nine months of M&B in FY07. We forecast M&B to contribute £4.5m of revenue and £1.3m of EBIT in FY07. No significant improvement in margin is expected in FY07 due to the costs of restructuring. We forecast some growth in FY08 and an improvement in margin due to the benefits of restructuring, resulting in expected revenue of £6.9m and EBIT of £2.4m.

Overall, we have raised our revenue expectation to £34.5m for FY07 (previously £30.0m), and forecast £39.9m for FY08. EBITA is expected to rise to £5.1m in FY07 (previously £3.8m), and we forecast EBITA of £6.4m for FY08.

Net debt

The acquisition is in large part being funded by an £8m bank loan. We forecast net debt to rise to £6.3m in FY07 (£700k cash surplus in FY06), and to fall to £5.1m in FY08. However, the net debt position and annual interest charges of £600k look very manageable when compared to our EBITDA forecasts of £5.5m for FY07 and £6.9m for FY08.

Earnings and valuation

We estimate that the deal enhances earnings by 11% in FY07 (EPS 15.6p), and 29% in FY08 (EPS 19.1p). Previously our EPS forecasts had been 14.0p for FY07 and 14.8p for FY08. The current share price of 124p looks undervalued at 6.5x FY08 EPS of 19.1p, and we expect this deal to result in growth of the share price towards 180–190p.

Exhibit 1: Revenue and margin assumptions — Post-acquisition

£m	Pre-Acq FY 06 A	Pre-Acq H1 07	Pre-Acq H2 07	Pre-Acq FY 07	McGuffie H1 07	McGuffie H2 07	McGuffie FY 07	Post-Acq FY07	Pre-Acq FY 08	McGuffie FY 08	Post-Acq FY 08
Revenues											
Retail	16.44	9.82	10.90	20.71				20.71	23.20		23.20
Distribution	2.06	0.00	0.00	0.00				0.00	0.00		0.00
Manufacturing	8.85	4.15	5.15	9.29	1.00	3.50	4.50	13.79	9.76	6.90	16.66
	27.35	13.96	16.04	30.01				34.51	32.96		39.86
EBITA											
Retail	1.63	0.88	1.20	2.08				2.08	2.25		2.25
Distribution	0.08	0.00	0.00	0.00				0.00	0.00		0.00
Manufacturing	1.34	0.13	1.54	1.67	0.20	1.10	1.30	2.97	1.76	2.40	4.16
	3.05	1.01	2.74	3.75				5.05	4.01		6.41
EBITA Margins											
Retail	10%	9%	11%	10%				10%	10%		10%
Distribution	4%	N/A	N/A	N/A				N/A	N/A		N/A
Manufacturing	15%	8%	30%	18%	20%	31%	29%	22%	18%	35%	25%
	11%	7%	17%	13%				15%	12%		16%
Goodwill Amortisation	(2.20)			(2.10)				(3.00)	(2.10)		(3.20)
Share Options	(0.09)			(0.10)				(0.10)	(0.10)		(0.10)
EBIT	0.76			1.55				1.95	1.81		3.11

Source: Edison Investment Research

Exhibit 2: Financials

	£'000s	2005	2006	2007e	2008e
31 December					
PROFIT & LOSS					
Revenue		22,029	27,346	34,507	39,857
Cost of Sales		(8,136)	(10,641)	(13,893)	(16,071)
Gross Profit		13,893	16,705	20,614	23,786
EBITDA		2,749	3,375	5,451	6,907
Operating Profit (before GW and except.)		2,408	3,046	5,051	6,407
Goodwill Amortisation		(1,752)	(2,198)	(3,000)	(3,200)
Exceptionals		0	0	0	0
Other		(142)	(85)	(100)	(100)
Operating Profit		514	763	1,951	3,107
Net Interest		(287)	(262)	(350)	(500)
Profit Before Tax (norm)		1,979	2,699	4,601	5,807
Profit Before Tax (FRS 3)		227	501	1,601	2,607
Tax		(493)	(810)	(1,410)	(1,772)
Profit After Tax (norm)		1,538	1,974	3,291	4,135
Profit After Tax (FRS3)		(266)	(309)	191	835
Average Number of Shares Outstanding (m)		15.0	18.1	21.1	21.6
EPS - normalised (p)		10.3	10.9	15.6	19.1
EPS - FRS 3 (p)		(1.8)	(1.7)	0.9	3.9
Dividend per share		0.0	0.0	0.5	0.8
Gross Margin (%)		63.1%	61.1%	59.7%	59.7%
EBITDA Margin (%)		12.5%	12.3%	15.8%	17.3%
Operating Margin (before GW and except.) (%)		10.9%	11.1%	14.6%	16.1%
BALANCE SHEET					
Fixed Assets		16,352	15,691	20,591	17,241
Intangible Assets		15,844	13,877	18,877	15,677
Tangible Assets		508	416	316	166
Investment in associates		0	1,398	1,398	1,398
Unquoted investments		0	0	0	0
Current Assets		7,470	11,045	13,591	16,812
Stocks		0	0	0	0
Debtors		6,596	8,778	10,973	13,716
Cash		874	2,267	2,618	3,096
Other		0	0	0	0
Current Liabilities		(10,583)	(13,654)	(14,955)	(16,173)
Creditors		(7,703)	(9,124)	(10,036)	(11,040)
Other creditors		(2,091)	(3,669)	(4,357)	(4,872)
Short term borrowings		(789)	(861)	(561)	(261)
Minority interests		0	0	0	0
Long Term Liabilities		(2,439)	(711)	(8,311)	(7,911)
Long term borrowings		(1,332)	(711)	(8,311)	(7,911)
Other long term liabilities		(1,107)	0	0	0
Net Assets		10,800	12,371	10,916	9,969
CASH FLOW					
Operating Cash Flow		4,267	2,218	4,069	5,067
Net Interest		(279)	(235)	(350)	(500)
Tax		(80)	26	(1,868)	(2,739)
Capex		(106)	(335)	(300)	(350)
Acquisitions/disposals		(5,153)	(1,456)	(10,700)	0
Financing		1,350	1,825	2,500	0
Dividends		0	0	(100)	(100)
Other		472	(650)	0	0
Net Cash Flow		471	1,393	(6,749)	1,378
Opening net debt/(cash)		1,567	1,247	(695)	6,254
HP finance leases initiated		(88)	(104)	(200)	(200)
Other		(63)	653	0	0
Closing net debt/(cash)		1,247	(695)	6,254	5,076

Source: Company accounts/Edison Investment Research

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