

7 September 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	16.7	N/A
12/06	27.3	2.7	10.9	0.00	15.8	N/A
12/07e	36.1	5.0	16.7	0.50	10.3	0.3
12/08e	46.5	7.5	22.8	0.75	7.6	0.4

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

Investment summary: Revenue target on-track

K3 announced solid interim results, has made a strong start to the second half, and earlier in the week, announced the strategically complimentary acquisition of Dutch retail software business, Landsteinar Nederland. This purchase drives a 19% uplift in our FY08 earnings forecast, and pushes the group closer to its £50m revenue target for FY08 and well above its £7m EBITA target. Management has built a well focused collection of IT service businesses and further reinvestment of cashflow in acquisitions as well as dividends should underline the growing value of the group.

Acquisition: Landsteinar Nederland

K3 is paying up to £13.6m for Landsteinar; a Dutch reseller of Microsoft Dynamics based retail software solutions (to add to the "sister" UK distributor it bought three years ago). The business is very profitable (over 30% margins), has a strong pipeline and its supply agreement with IKEA as well as a robust support and maintenance business model, should support strong growth in sales and profits.

Forecasts: 19% enhancement to FY08

Interim results were in-line with budget. H2 has started very strongly with major contracts closed (pushed over from H1), the recently acquired McGuffie Brunton contributing strongly, all underpinning the seasonally higher cash inflow.

Conservatively, we have not changed our underlying assumptions but have added in our projections for Landsteinar Nederland. We now forecast revenues of £46.5m in FY08 and eps of 22.8p (19% upgrade reflecting the positive contribution from this deal).

Valuation: Undervalued on under 8x FY08

Management have built a collection of complementary and focused IT service businesses and are well on track to beat its original target of £50m of revenue and £7m of EBITA in FY08. We believe the shares are worth well over 200p and the reinvestment of cashflow in further strategically sensible deals and in dividends should continue to demonstrate that over the next 12 months.

Price 172.5p
Market Cap £40m

Share price graph



Share details

Code KBT
Listing AIM
Sector Software & Computer Services
Shares in issue 23.2m

Price

52 week High 175p Low 97p

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	113%	86%	67%
P/CF	14.1	6.7	4.7
EV/Sales	1.1	1.4	1.1
ROE	16%	22%	28%

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Landsteinar Nederland: Strategic and earnings positive

Earlier in the week K3 announced the acquisition of Landsteinar Nederland BV, a Holland-based retail software solutions business. This business is very complimentary to the group's existing retail division.

- **Background:** In October 2004, K3 acquired the UK distributor of Alpha Landsteinar, Microsoft's largest Dynamics reseller in the UK, to form the core of its retail offering. K3 is the UK's largest Dynamics reseller and is a member of Microsoft's 'Inner Circle' of top 50 partners worldwide. The solution provides retailers with a complete 'end-to-end' solution. This means that the same software is running at head office, in the warehouse and on the individual EPOS (Electronic Point of Sale) tills within the stores. The solution, therefore, typically delivers lower cost of ownership than traditional retail solutions that involve separate systems for each of the three retail operations. This seamless architecture provides retailers with greater data accuracy and improved sales analysis as well as being easier for K3 to support.
- **Complimentary:** The acquisition of Landsteinar Nederland is therefore very complementary since both companies market and support the same Microsoft Dynamics-based retail software solution. Landsteinar's key management are being retained, there are existing relationships between both companies, and there should be opportunity to develop complimentary product offerings and develop the customer base.
- **Customers:** Landsteinar Nederland, which has offices in The Hague, was established in 2001. It also holds the worldwide rights to software modules specifically designed for IKEA the global home furnishings business. Landsteinar has a strong domestic and overseas customer base, with over half its customers based outside Holland. In total, the business has some 40 customers (other larger customers include Bulgarian Telecom, Bouwmaat DIY stores and the KIN jewellery chain), supporting 300 stores across 15 countries.
- **Business Model:** Not surprisingly Landsteinar Nederland has a very similar business model to K3 retail operations. In the 12 months to December 2006, the company reported turnover of €6.1m. Services and maintenance account for around 85% of sales, with software licenses the balance. To December 2006, profit before tax was €2.2m (net assets of Landsteinar Nederland were €1.9m). The operating margin of over 30% is significantly higher than K3's current retail operation. To some extent that reflects the company's pricing power and cost base (most new business has come from referrals rather than significant marketing expenditure) but also its maintenance model. Landsteinar Nederland charges customers for a range of upgrade, support, and maintenance options which all contribute to annual recurring service revenues significantly greater (c.30% of the initial license fee) than the industry average.
- **Price** K3 is paying an initial consideration of £9.9m (€14.5m) to be satisfied by £7.4m of cash and the issue (to the vendors) of 1.6m shares at 153p. In addition, a further consideration of up to £3.7m (€5.5m) could be paid through an earn out arrangement linked to Landsteinar Nederland's performance to 31 August 2009. Based on our

forecasts (and assuming the earn-out) K3 is paying around 2x sales but only c4x profits (based on a full year FY08).

- **Forecasts:** Landsteinar Nederland has very good revenue visibility. Its major customer, IKEA (c.45% sales), typically manages a rolling three year store expansion programme. The company is also in discussions with a number of IKEA's franchisees across Europe, Middle East and Australasia that are currently not running their solution. In addition it has a strong pipeline of other customers and the maintenance and support business model provides very high recurring revenues. We forecast that Landsteinar Nederland contributes €2.4m of revenues and €0.8m of profits in FY07 (assumed three months) and €10.0m of revenues and €3.3m of profit in FY08.

Group forecasts

We have conservatively not changed our underlying assumptions for the existing K3 businesses (H2 has started strongly, with some significant new contract wins contributing to significant order pipelines in both manufacturing and retail, the successful consolidation of the McGuffie acquisition and the expected first time contribution from Landsteinar). We now forecast revenues of £36.1m in FY07 and £46.5m in FY08 and eps of 16.7p and 22.8p, respectively. Assuming the seasonally stronger H2 cash inflow we forecast year end net debt of £12.4m (FY08 EBITDA interest cover of over 8x).

Exhibit 1: Revenue and margin assumptions — Post-acquisition

£m	FY 06	FY07E	FY 08E
Revenues			
Retail	16.44	22.31	29.87
Distribution	2.06	0.00	0.00
Manufacturing	8.85	13.79	16.66
	27.35	36.11	46.52
EBITA			
Retail	1.63	2.62	4.45
Distribution	0.08	0.00	0.00
Manufacturing	1.34	2.97	4.16
	3.05	5.58	8.61
EBITA Margins			
Retail	10%	12%	15%
Distribution	4%	N/A	N/A
Manufacturing	15%	22%	25%
	11%	15%	18%
Intangible Amortisation	(2.20)	(1.00)	(1.70)
Share Options	(0.09)	(0.10)	(0.10)
EBIT	0.76	4.48	6.81

Source: Edison Investment Research

Valuation: Management closing in on £50m revenue target

Management have consistently targeted a revenue base of £50m and profit of £7m. We believe that during FY08 the company will beat that target and importantly is building a collection of IT business with significant synergies (the acquisition of Landsteinar and McGuffie have essentially been “rolling-up” similar businesses in its target markets with the associated cross-selling and cost reduction opportunities) that are clearly focused around core Microsoft technology, and the retail and manufacturing sectors. Management's track record would suggest it should meet their targets. Attaching a multiple of only 7x to our £8.4m EBITA forecast and adjusting for our forecast £9m of net debt at the end of FY08 would imply a valuation approaching c.£50m (c.215p a share).

Exhibit 2: Financials

	£'000s	2002	2003	2004	2005	2006	2007 ^e	2008 ^e
		UK GAAP	UK GAAP	UK GAAP	UK GAAP	UK GAAP	IAS	IAS
31 December								
PROFIT & LOSS								
Revenue		8,088	7,002	8,529	22,029	27,346	36,107	46,524
Cost of Sales		(1,469)	(958)	(1,727)	(8,136)	(10,641)	(13,893)	(16,071)
Gross Profit		6,619	6,044	6,802	13,893	16,705	22,214	30,453
EBITDA		1,181	1,256	818	2,749	3,375	5,985	9,107
Operating Profit (before GW and except.)		975	1,074	603	2,408	3,046	5,585	8,607
Goodwill Amortisation		(463)	(463)	(636)	(1,752)	(2,198)	(300)	(270)
Exceptionals		(173)	(605)	1,248	0	0	0	0
Other		0	(100)	0	(142)	(85)	(100)	(100)
Operating Profit		339	(94)	1,215	514	763	5,185	8,237
Net Interest		(73)	(105)	(55)	(287)	(262)	(450)	(1,050)
Profit Before Tax (norm)		902	869	548	1,979	2,699	5,035	7,457
Profit Before Tax (FRS 3)		266	(199)	1,160	227	501	4,735	7,187
Tax		108	(130)	(59)	(493)	(810)	(1,540)	(2,267)
Profit After Tax (norm)		1,010	739	489	1,538	1,974	3,594	5,290
Profit After Tax (FRS3)		374	(329)	1,101	(266)	(309)	3,194	4,920
Average Number of Shares Outstanding (m)		10.2	10.2	11.0	15.0	18.1	21.5	23.2
EPS - normalised (p)		9.9	7.3	4.5	10.3	10.9	16.7	22.8
EPS - FRS 3 (p)		3.7	(3.2)	10.0	(1.8)	(1.7)	14.9	21.2
Dividend per share		0.0	0.0	0.0	0.0	0.0	0.5	0.8
Gross Margin (%)		81.8%	86.3%	79.8%	63.1%	61.1%	61.5%	65.5%
EBITDA Margin (%)		14.6%	17.9%	9.6%	12.5%	12.3%	16.6%	19.6%
Operating Margin (before GW and except.) (%)		12.1%	15.3%	7.1%	10.9%	11.1%	15.5%	18.5%
BALANCE SHEET								
Fixed Assets		4,243	3,886	10,506	16,352	15,691	33,111	32,961
Intangible Assets		3,817	3,354	9,919	15,844	13,877	10,000	10,000
Tangible Assets		426	342	570	508	416	1,300	1,150
Goodwill		0	0	0	0	0	21,811	21,811
Other		0	190	17	0	1,398	0	0
Current Assets		4,021	3,784	6,671	7,470	11,045	11,112	14,994
Stocks		0	0	0	0	0	0	0
Debtors		3,868	2,558	6,268	6,596	8,778	10,973	13,716
Cash		123	1,226	403	874	2,267	140	1,278
Other		30	0	0	0	0	0	0
Current Liabilities		(4,869)	(4,706)	(9,345)	(10,583)	(13,654)	(16,021)	(18,912)
Creditors		(4,835)	(3,128)	(5,881)	(7,703)	(9,124)	(10,949)	(13,139)
Other creditors		0	(1,527)	(1,831)	(2,091)	(3,669)	(4,511)	(5,513)
Short term borrowings		(34)	(51)	(1,633)	(789)	(861)	(561)	(261)
Minority interests		0	0	0	0	0	0	0
Long Term Liabilities		(51)	0	(337)	(2,439)	(711)	(12,000)	(10,000)
Long term borrowings		(51)	0	(337)	(1,332)	(711)	(12,000)	(10,000)
Other long term liabilities		0	0	0	(1,107)	0	0	0
Net Assets		3,344	2,984	7,495	10,800	12,371	16,202	19,043
CASH FLOW								
Operating Cash Flow		471	1,365	1,244	4,267	2,218	5,515	8,453
Net Interest		(35)	(23)	(99)	(279)	(235)	(450)	(1,050)
Tax		0	(11)	(76)	(80)	26	(1,965)	(3,241)
Capex		(66)	(99)	(12)	(106)	(335)	(300)	(350)
Acquisitions/disposals		(105)	(95)	(2,344)	(5,153)	(1,456)	(18,100)	0
Financing		0	0	0	1,350	1,825	2,500	0
Dividends		0	0	0	0	0	(116)	(174)
Other		0	0	464	472	(650)	0	0
Net Cash Flow		265	1,137	(823)	471	1,393	(12,916)	3,639
Opening net debt/(cash)		227	(38)	(1,175)	1,567	1,247	(695)	12,421
HP finance leases initiated		0	0	(106)	(88)	(104)	(200)	(200)
Other		0	0	(1,813)	(63)	653	0	0
Closing net debt/(cash)		(38)	(1,175)	1,567	1,247	(695)	12,421	8,983

Source: Company accounts/Edison Investment Research

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