

25 October 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	17.4	N/A
12/06	27.3	2.7	10.9	0.00	16.5	N/A
12/07e	36.1	5.0	16.7	0.50	10.7	0.3
12/08e	46.5	7.5	22.8	0.75	7.9	0.4

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

Investment summary: Baugur deal positive

K3's core retail software platform, LS Retail, has been bought by retail investment company Baugur Group. This move is something of a surprise in the context of software M&A, but we believe could possibly provide significant revenue and strategic opportunities for K3.

LS Retail: Acquired by the Baugur Group

In its retail vertical (over 60% of group sales) K3 buys MS Dynamics from Microsoft, and buys the "retail wrap round" from LS Retail (based in Iceland). LS Retail has been acquired by Baugur Group, the international investment group which owns high street retailers such as House of Fraser, Goldsmiths and Iceland.

Opportunities for K3: Revenue and strategic

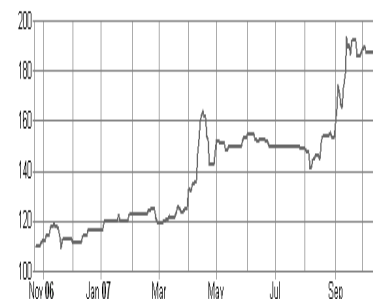
We believe there are few commercial risks to the change of ownership. More importantly we believe Baugur may have made this acquisition to try and "centralise" its IT platforms and possibly attempt to use IT to build a competitive advantage in the retail sector. We estimate that a roll-out of LS Retail across the wide Baugur portfolio of companies could provide a £20m+ revenue opportunity for any IT partner. Given that K3 currently accounts for a significant proportion of LS Retail's revenue we believe it is well positioned in any initial discussions. Longer-term we believe if Baugur demonstrates a willingness to aggressively target improvements in IT within its business, then there are plenty of opportunities for both groups to expand a relationship.

Forecasts and valuation: Over 200p

This news, together with current order momentum, certainly underpins our FY08 forecast. In our view, within an IT services sector, where identifying businesses with a coherent, consistent and growing strategy is challenging, K3 deserves to trade at a premium. Even based on very conservative multiples we believe the shares are worth over 200p.

Price 179.5p
Market Cap £42m

Share price graph



Share details

Code KBT
Listing AIM
Sector Software & Computer Services
Shares in issue 23.4m

Price

52 week High 194.5p Low 109p

Balance Sheet at 30 June 2007

Debt/Equity (%) N/A
NAV per share (p) 87.7
Net net (£m) 8.1

Business

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

Valuation

	2006	2007e	2008e
P/E Relative	118%	90%	71%
P/CF	14.6	7.0	4.9
EV/Sales	1.2	1.4	1.1
ROE	16%	22%	28%

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Baugur purchase of LS Retail: Strategic & P&L positive

Background: K3 a key partner to LS Retail

In October 2004, K3 acquired the UK distributor of LS Retail (used to be called Alpha Landsteinar), Microsoft's largest Dynamics reseller in the UK, to form the core of its retail offering. Last month, K3 announced the acquisition of Landsteinar Nederland (LS Retail's largest continental European distributor) which complemented the UK business and provided major geographic and customer diversification (IKEA is a major customer).

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. Essentially, therefore, K3 buys MS Dynamics from Microsoft, and buys the "retail wrap round" from LS Retail (based in Iceland). K3's business model is based upon a gross margin on the software licence sales (Microsoft and LS Retail), the installation service revenues and follow-up service and maintenance income.

LS Retail acquired by Baugur: one of Europe's largest retailers

Baugur Group, the international investment group (based in Iceland, with a portfolio of assets worth over £2b) which owns high street retailers such as House of Fraser, Booker, Goldsmiths, Karen Millen, Whistles, Oasis and Iceland, has acquired LS Retail. We believe it may have made this acquisition to try and "centralise" its IT platforms and possibly attempt to leverage IT to build a competitive advantage in the retail sector. The group currently has several disparate retail IT systems controlling its businesses and providing management reporting. While its business model is based upon autonomous management structures within the businesses it acquires, we believe it may recommend the LS Retail platform across the group. In our view this could create a number of opportunities for K3.

- **Short-term revenue opportunity.** K3 are the largest LS Retail 'Centre of Competence' globally. Therefore, we believe that if Baugur is reviewing options for installing LS Retail across parts of its group, K3 would be well placed to partner with it. This would probably be on a "brand-by-brand" basis rather than an accelerated group wide roll-up. Nevertheless, we would estimate the potential revenue from installing and maintaining LS Retail across the Baugur Group could be in excess of £20m (more than twice K3's current new business LS Retail revenue). Together, with the strong existing pipeline and recent contract newsflow this opportunity should certainly at the very least underpin our group FY08 forecasts.
- **Risks from the change of ownership?** An obvious risk could be that Baugur has acquired LS Retail to restrict sales purely to its own businesses or in some way dramatically change its sales strategy (currently its business model is based upon an indirect approach through value added distributors of which K3 is the largest). However, Baugur's strategy is based upon encouraging each of its businesses to grow and show an increasing profit. Therefore we would expect the LS Retail business model under Baugur to remain based upon expanding revenues and profits. In addition, K3 has a 10-year distribution agreement for LS Retail (with seven years left to run). This protects its

use of the IPR as well as commercial terms including pricing (i.e. while we would expect Baugur to be very price aggressive in any negotiations with K3 we do not believe it can materially undermine the group's typical pricing and margin terms).

- **Long-term opportunities.** Clearly both companies are going to need to get to know each other over the next couple of years. However, in the longer term Baugur has shown its willingness to aggressively build out its retail empire and buy IT related businesses where it believes they add significant value. While ownership of K3 would seem to make little sense for Baugur in the short term, we believe there could be a range of opportunities for both groups to expand their relationship.

Forecasts and valuation: Management targets well underpinned

We forecast (unchanged) 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). While we have not changed forecasts we believe this announcement significantly underpins our forecast for next year.

Management has consistently targeted a revenue base of £50m and profit of £7m. We believe that during FY08 the company will beat that target. More importantly, through its "roll-up" of key software distributors in the retail and manufacturing sectors, management is building a collection of IT businesses with significant synergies and based on fast growing Microsoft platforms (this years acquisition of Landsteiner and McGuffie have essentially been "rolling-up" similar businesses in its target markets with the associated cross-selling and cost reduction opportunities).

We believe these characteristics should mean that the group trades at a premium within the IT services sector, where identifying businesses with a coherent, consistent and growing strategy, can be challenging for investors. Even based on conservative multiples we believe the shares are worth over 200p (only 7x our FY08 £8.6m EBITA forecast and adjusting for our forecast £9m of net debt would imply a valuation over £50m or c.215p a share).

Exhibit 1: Revenue and margin assumptions

£m	FY06	FY07e	FY08e
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

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		399	(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	2,964	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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