K3 Business Technology

Interim results

Edison investment research

Building foundations for Retail

Technology

As flagged in its recent trading update, K3 reported a revenue and profitability decline in H1, impacted by the weak retail environment and continued development of the AX for Retail product set. In the medium term, K3 sees the opportunity to sell the new product range to a wider audience with the support of Microsoft. Businesses in other markets continue to perform well; the reduction in our EPS forecasts reflects slightly lower growth assumptions and dilution from the recent placing. The stock trades at a significant discount to the sector but needs to show evidence of a return to growth to re-establish confidence in the stock and drive a re-rating.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
06/11	52.8	8.7	27.0	0.75	3.6	0.8
06/12	68.0	10.1	29.7	1.00	3.3	1.0
06/13e	66.1	6.7	17.4	1.05	5.6	1.1
06/14e	70.5	9.7	24.0	1.10	4.1	1.1

* PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

H113: Good news and bad news

As already flagged in K3's January trading update, the weak retail environment affected Microsoft UK and International revenues with orders being deferred. Ongoing investment in AX for Retail also affected Microsoft UK profitability, with £2.1m expensed in H1, and could be one cause of customer deferrals. Conversely, the manufacturing sector has been strong, with SYSPRO seeing growth in new business. The Sage business is starting to accelerate after a slow start to the year, and is seeing strong demand for X3, Sage's latest ERP solution. Managed Services continues to show steady progress, although deferred deals elsewhere have held back growth.

Outlook and changes to estimates

The company expects to return to growth within the next 12 months. We forecast a 3% decline in FY13 revenues (assuming the signing of deferred UK retail deals in H213) followed by a recovery in FY14, partly driven by adoption of AX for Retail. Although we reduce our revenue forecasts by 4.4% in FY13 and 4.7% in FY14, recent and ongoing restructuring has reduced the impact on our profitability forecasts. On 19 March, the company raised £2.7m from issuing 2.7m shares. The combined impact on our EPS forecasts is a reduction of 9.6% for FY13 and 9.9% for FY14.

Valuation: Re-establishing growth is key

K3's share price has suffered since it withdrew from the sale process last September and fell further after its trading update in January. K3 trades on very depressed P/E multiples: 5.6x FY13e and 4.1x FY14e, at a substantial discount to its peers. In our view, the share price reflects uncertainty over the timing of the signing of the deferred deals. If we assumed a 10% revenue miss in FY13, this would reduce our FY13 EPS forecast by 59%, leaving K3 trading on 13.1x EPS. We believe that K3 could trade up to at least 10x FY13e EPS if confidence returns (174p). Triggers for a re-rating include evidence that deferred Dynamics deals are being signed, debt is reducing y-o-y, and the Managed Services business is winning customers.

20 March 2013

Price	97.5p
Market cap	£31m

Shares in issue	31.4m
Free float	49.4%
Code	KBT
Net debt end H113	£12.3m
Primary exchange	AIM
Other exchanges	N/A

Share price performance

%	1m	3m	12m
Abs	(8.0)	(33.0)	(49.4)
Rel (local)	(9.2)	(38.4)	(53.9)
52-week high/low		207.5p	93.0p

Business description

K3 provides Microsoft- and Sage-based ERP solutions and managed services to SMEs in the retail, distribution and manufacturing sectors.

Next events

Trading update	July 2013

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Edison profile page

K3 Business Technology is a research client of Edison Investment Research Limited

Investment summary

Company description: ERP specialist for the supply chain

K3 is a value-added Microsoft channel partner and owning the channel to market is key to the business model. K3 designs and implements supply chain software solutions – generally based on Microsoft technologies – in the retail, distribution and manufacturing sectors. The group has a well-balanced business model of predictable, recurring licence income in the manufacturing software sector combined with higher growth opportunities in retail software. Recent acquisitions have built out the Managed Services business and added Sage solutions to the product suite. The company is focused on developing its own software to enhance margins and create specialist solutions in target market verticals.

Financials: Profitability maintained

Although we have revised down our revenue forecasts for both years, our PBT and EPS forecast reductions are minimised by recent and ongoing restructuring. We continue to expect the company to reduce debt, and forecast net debt of £11.5m at the end of FY13, falling further to £7.1m by the end of FY14.

Exhibit 1: Changes to forecasts

	EPS			PBT			EBITDA		
	Old	New	% chg.	Old	New	% chg.	Old	New	% chg.
2013e	19.2	17.4	-9.6	7.1	6.7	-5.8	9.7	9.6	-0.4
2014e	26.7	24.0	-9.9	9.7	9.7	-0.4	12.1	12.4	2.6

Source: K3 Business Technology and Edison Investment Research

Valuation: Re-establishing growth is the key

K3's share price has suffered since the company withdrew from the sale process last September, and fell further after its trading update in January. On our revised forecasts the company is trading on very depressed multiples: 5.6x FY13e EPS and 4.1x FY14e EPS. This is at a substantial discount to sub-£500m market cap UK software stocks (17.0x current year and 13.8x next year) and UK IT service companies (16.4x current year and 13.7x next year). In our view, the share price reflects uncertainty over the timing of the signing of the deferred deals. If we assumed a 10% revenue miss in FY13 (all licence-based at a gross margin of 60%) this would at most knock 59% off our FY13 EPS forecast, leaving K3 trading on 13.1x EPS, still at a discount to the sector. We believe the stock could trade up to at least 10x FY13e EPS if confidence returns, implying a share price of 174p. We would expect triggers for a re-rating of the stock to include evidence that deferred Dynamics deals are being signed, debt is reducing y-o-y, and the Managed Services business is winning customers.

Sensitivities: Macro risks, technology, acquisition strategy

The main sensitivities or risks to our forecasts are: 1) the macro environment; 2) organic growth, which depends on the ability to hire and retain skilled staff; 3) technology – the Managed Services business uses third-party datacentres and could be negatively impacted by service disruptions; the timing and outcome of product development (including AX for Retail) is uncertain; and 4) acquisitions – deals have transformed the scale of the group and the record so far has been a good one, but risks are greater in any strategy that has recourse to M&A.

Company description: ERP specialist

K3 is a value-added Microsoft channel partner and owning the channel to market is key to the business model. K3 designs and implements supply chain software solutions in three industry sectors: retail, manufacturing and distribution. The group has a well-balanced business model of predictable, recurring licence income in the manufacturing software sector combined with higher growth opportunities in retail software. Recent acquisitions have added Sage solutions to the product suite. K3 is also building a Managed Services business through a combination of in-house development and acquisitions.

Background

K3 started life in 2000 as the result of a buyout of the UK manufacturing Enterprise Resource Planning (ERP) business of Kewill Systems, comprising two business units and c 1,500 customers with a high proportion of recurring revenues. In 2001, K3 joined AIM through a reverse acquisition, and the initial strategy was to hone the group down into a focused IT services company. Since then the company has broadened its ERP offering with a number of acquisitions, and moved into the Managed Services market.

Exhibit 2: Acquisition history

Date	Company	Details
Oct-04	Alpha Landsteinar	One of Microsoft's largest UK Dynamics resellers. Developed a version of Dynamics for retailers
Jun-05	IEG	SYSPRO (a Microsoft-based ERP solution for SME manufacturers) reseller. High recurring revenue business provides upgrade path for existing customers.
Mar-07	MBL	SYSPRO reseller.
Sep-07	Landsteinar Nederland	Dutch sister company of Alpha Landsteinar. Over 50% of revenues from franchised outlets of IKEA.
Dec-07	Index	Microsoft Dynamics AX reseller; specialist in fresh food
Mar-10	DigiMIS	Specialist in hosting ERP applications, particularly SYSPRO.
Mar-10	Pebblestone	Dutch trade & assets. Specialist in fashion retail software.
Jun-10	Pebblestone	Remainder of the business ie IP and international sales channels.
Nov-10	Panacea	Managed services & IT solutions provider: Sage ERP & CRM, Microsoft Dynamics NAV-based distribution solutions, Dynamics CRM, SAP BusinessObjects and Microsoft Business Intelligence.
Dec-10	FD Systems	Sage 200 business.
Mar-11	Sense Enterprise Solutions	Microsoft Dynamics AX reseller.
Mar-11	Clarita	Microsoft Dynamics NAV reseller.
Jul-11	Azurri	Proprietary retail solutions with substantial maintenance base.
Jul-11	FD Systems	Sage Enterprise & e-commerce solutions. Substantial maintenance base.
Dec-11	Unisoft POS	Retail point of sale solutions for the Dutch and Scandinavian market.
Dec-11	IBS	Proprietary "make to contract" manufacturing software with substantial maintenance base.
Dec-11	Retail Systems Group	Microsoft Dynamics RMS reseller focused on smaller UK & Ireland retailers.

Source: K3 Business Technology

Software solutions business model: Grow internal IP

The group supplies ERP products based on Microsoft and Sage solutions and business intelligence solutions from Microsoft and SAP (see Exhibit 3). Group strategy has been to focus on adding internal IP to the product range. As a straight reseller of Microsoft products, K3 would achieve a gross margin of c 50% on software sold. By adding its own proprietary software to customise products for more specific requirements, K3 is able to retain a higher percentage of the software licence fee. K3 also continues to look for complementary acquisitions that will expand product/service lines and feeder businesses that can be migrated to Dynamics, SYSPRO or Sage. The company is organised into four divisions and reports financials on this basis.

Exhibit 3: K3 product range

Microsoft-based	Sage-based	Other
SYSPRO (based on .NET)	Sage 1000	SAP BusinessObjects (business intelligence)
Dynamics NAV	Sage Line 500	Unisoft POS
Dynamics AX	Sage 200	QlikView (business intelligence)
Dynamics CRM	Sage X3	
Dynamics RMS	Sage CRM	
Business Intelligence	Sage SalesLogix	

Source: K3 Business Technology Group

Managed services: Cross-sell and support SYSPRO globally

K3 has developed its Managed Services business through a combination of in-house development and acquisition (DigiMIS, Panacea). In addition to offering outsourced IT support to its customer base, K3 offers application hosting to its 3,100-strong customer base. Only a small proportion of customers have taken the service since its launch in March 2010, and we expect K3 to focus heavily on selling managed services across its customer base. K3 has an agreement with SYSPRO to provide hosting services to the wider 14,000-strong global SYSPRO customer base, providing an additional source of hosting customers.

Microsoft UK (26.8% of H113 revenues)

The division includes Microsoft Dynamics AX and Microsoft Dynamics NAV solutions sold in the UK as well as Azurri's retail business and the Microsoft Dynamics RMS business acquired with RSG.

K3 sells NAV-based solutions to retailers. The Alpha Landsteinar acquisition formed the bulk of this business, enhanced by the Clarita and Panacea acquisitions. The company develops own-IP products such as modules for multi-channel, EPOS, fashion and CRM.

K3 has AX-based solutions for both the retail and manufacturing industries. The most established AX solutions are designed for food and process manufacturers, and incorporate solutions from the Index and Sense Enterprise Solutions acquisitions.

Project Gemstone – AX for Retail opportunity more than just the UK

K3 has been working to bring the functionality of its AX for Retail solutions in line with the existing NAV-based product range covering multi-channel, fashion and wholesale product lines. The target is for the final product to be Certified for Microsoft Dynamics (CFMD) and ultimately K3 wants to be selected as Microsoft's preferred partner for AX retail and wholesale solutions. This should lead to support from Microsoft for international distribution. Based on K3's existing position in the retail market with NAV-based products, helped by the Pebblestone international reseller channel, this appears to be a reasonable goal. Although the company continues to develop the product, K3 signed its first major AX for Retail customer, Eason, in H212. Product development is planned to continue in H213, with the first commercial release in mid-2013 and further releases over the next 12 months. The company may consider small, complementary acquisitions if this enables faster access to AX for Retail IP.

Review of H113 performance

Exhibit 4: Microsoft UK operating performance

	H112	H212	H113	HoH	YoY
Revenues	12.10	12.82	8.47	-33.9%	-30.0%
Operating profit	1.52	0.70	(1.26)		
Operating margin	12.6%	5.4%	-14.9%		

Source: K3 Business Technology Group

Divisional revenues declined 30% y-o-y, or 38% excluding the RSG acquisition. As already flagged in the January trading update, K3 has seen a tough market for new business in the UK, with retailers reluctant to commit to deals. Three deals that had been expected to complete at the end of H113 were deferred and the company continues to negotiate with these potential customers. The company is confident these deals will be signed by the end of FY13. This should allow licence revenues to be recognised in H213, but related service revenues will not be generated until FY14. As well as the tough retail environment, some retailers have been holding off ordering until the AX for Retail product is more fully developed. While this makes for tough short-term trading, it does imply there is pent-up demand for the AX for Retail product when it is fully available.

The difficult retail environment has had an impact on recurring revenues which fell 17.8% to £3.59m (42% of revenues) as K3 lost one customer and others reduced the scope of their maintenance contracts. New wins totalled £0.6m versus £8.6m a year ago, showing the impact of the deferred deals. On a more positive note, the total Dynamics pipeline grew to £36.0m from £28.6m a year ago, with an increasing proportion of AX deals in the mix.

Profitability was clearly affected by the lack of new deals, but was also reduced further by investment in the AX for Retail product development. The company expensed £2.15m for the development of AX for Retail and capitalised a further £0.57m of costs.

The other units within the division (non-retail NAV, non-retail AX and legacy products) showed an improved performance, benefiting from restructuring in previous years. RSG also showed a strong performance, generating revenues of £0.93m and operating profit of £0.14m (15.0% margin).

International (17.1% of H113 revenues)

The International division comprises Microsoft NAV-based solutions sold to overseas retailers, particularly European fashion customers, as well as the Unisoft point-of-sales solution. The division is headquartered in the Netherlands and has an office in Singapore to service clients in the region. This division was created by the Landsteinar Nederland acquisition and strengthened by the 2010 Pebblestone acquisitions (which included the international reseller channel for Pebblestone's IP). A significant percentage of the original Landsteinar business's revenues are generated via Inter IKEA Systems BV.[1]: it signed an exclusive five-year agreement at the end of FY12 for K3 to support the IKEA Master Version software used by franchisees outside of the IKEA group. There are 14 franchises based in Europe, the Middle East, the Far East and Australia. While it is unlikely that more franchises will be granted, existing franchisees are encouraged to open up new stores in existing and new countries, and when they do so, IKEA expects them to use K3's solution.

[1] The owner and franchisor of the IKEA concept worldwide.

Review of H113 performance

Exhibit 5: International operating performance

International	H112	H212	H113	HoH	YoY
Revenues	4.84	7.81	5.39	-31.0%	11.4%
Operating profit	1.40	2.27	0.47		
Operating margin	28.9%	29.1%	8.7%		

Source: K3 Business Technology Group

The IKEA business remained strong in H113, generating revenues of £2.0m versus £1.7m a year ago. The Unisoft business (acquired December 2011) generated revenues of £1.43m and minimal profit – Unisoft maintenance billings fall in H2, adding an estimated £0.6m to operating profit in H2. Underlying revenues of £3.96m were down 18.2% y-o-y reflecting weakness in the Dutch fashion market that resulted in lower licence sales. The cost base in the Netherlands is geared to a higher level of revenues and this affected margins. However, from H213 the company is shifting staff from the fashion business to the IKEA team, which should improve profitability. The division signed 21 significant new contracts worth £0.53m (average contract size £25k) versus nine worth £0.5m a year ago (average contract size £56k). The prospects pipeline (excluding IKEA business) grew significantly to £7.1m from £3.3m a year ago, reflecting some deal deferrals and growing interest in AX for Retail. Recurring revenues of £1.93m (36% of H113 sales) grew 1.5% y-o-y.

SYSPRO and Sage (46.3% of H113 revenues)

K3 sells **SYSPRO** solutions to manufacturing customers and is the exclusive distributor of SYSPRO in the UK. K3 charges an annual licence fee renewal in October, creating a heavy weighting of revenues to the second half of the calendar year and contributing to the c £7m in annual recurring revenues. K3 has designed a variety of add-on modules for functions such as advanced planning and scheduling, warehouse management, delivery route planning, recipe management, personnel, and time and attendance systems.

The acquisitions of Panacea and FD Systems added **Sage** solutions to the product range and K3 now has more than 900 Sage customers. Although operating margins tend to be lower than for SYSPRO, Sage customers generate more than £6m in annual recurring revenues.

The division is also home to a group of customers using legacy systems that generate recurring revenues of more than £2m per annum and provide a source of upgrades to other products within the K3 group.

Review of H113 performance

Exhibit 6: SYSPRO and Sage operating performance

	H112	H212	H113	HoH	YoY
Revenues	13.81	11.15	14.60	30.9%	5.7%
Operating profit	4.07	1.79	4.11		
Operating margin	29.5%	16.0%	28.2%		

Source: K3 Business Technology Group

SYSPRO sales were very strong in H113, with the division winning seven deals worth £1.2m (average contract size £171k) versus six worth £0.6m a year ago (average contract size £100k). Licence renewals in H1 totalled £6.0m (+2% y-o-y), with 98% of customers renewing for the year.

Sage had a slow start to the year, with sales of Sage 500 and Sage 1000 slowing as customers shifted to the recently launched Sage X3. The business signed 22 new deals worth £0.84m (average contract size £38k) versus 39 worth £1.3m a year ago (average contract size £33k). The company is optimistic about the prospects for the X3 solution, with three new deals signed before the end of H1 and a pipeline of 30 significant deals worth £4.0m at the end of H1. During H1, the company integrated the two Sage businesses, contributing to the group's exceptional restructuring costs of £0.48m, but potentially generating annual cost savings of £0.8m. Management believes it is possible to drive margins in this business up from the typical Sage reseller 10% closer to mid-teens.

Legacy system customers generated revenues of £1.68m (+65% y-o-y), the majority of which is recurring. The acquisition of IBS in December 2011 contributed to the growth.

Overall, the division reported recurring revenues of £9.97m (68% of total revenues), up 13% from H112 (64% of revenues).

The division's pipeline has grown to £14m, up from £9.2m a year ago. Sage business makes up nearly three-quarters of this.

Managed Services (9.8% of H113 revenues)

K3 introduced its Managed Services offering in November 2007 to provide specialist IT support to customers. The move into hosting via the March 2010 DigiMIS acquisition expanded the service into the infrastructure space, and enables the company to offer a full outsourced IT service to customers. K3 now has hosting platforms in place for SYSPRO, Microsoft Dynamics NAV and AX, Sage X3 and Sage 200.

Hosting: Cross-selling opportunity enhanced by SYSPRO deal

K3's hosting business uses datacentres in London, Edinburgh, New York and Toronto. Contracts tend to be multi-year, resulting in a high level of recurring revenues. At the time of the acquisition, DigiMIS was the only SYSPRO hoster in the UK. In February 2011, K3 signed an exclusive agreement with SYSPRO to provide its hosting service on a worldwide basis – SYSPRO's global partner network has more than 14,000 customers globally. More than 500 of K3's 3,100 customers use SYSPRO. SYSPRO's new hosted solution, SYSPRO BusinessLive, can be deployed on an on-demand (subscription) basis or upfront licence fee basis. Customers tend to sign up with K3 to use one element of the service and as they undergo changes in their IT or business processes, eg hardware changes, office moves, software upgrades/changes, they adopt K3's hosting services on a wider basis.

Review of H113 performance

Exhibit 7: Managed Services operating performance

Managed Services	H112	H212	H113	HoH	YoY
Revenues	2.61	2.82	3.09	9.5%	18.4%
Operating profit	0.09	(0.09)	(0.16)		
Operating margin	3.4%	-3.2%	-5.2%		

Source: K3 Business Technology Group

Managed Services grew revenues 18.4% y-o-y and 9.5% sequentially and grew the number of customers from 346 to 398 over the year. Recurring revenues of £2.09m (68% of revenue) grew only 2% y-o-y. By the end of H113, the recurring annualised revenue run rate had grown to £4.4m from £4.2m a year ago. Revenue growth was offset by continued investment in the service, resulting in an operating loss. Revenue growth has been held back by the deferral of large-scale software contracts in other divisions – many of these include a hosting element, in particular SYSPRO and Sage X3 deals. The prospects pipeline was £4.2m by the end of H113, of which close to 80% would be recurring.

Sensitivities

The main factors influencing our forecasts and the share price are:

- **Macro environment.** Consumer spending has an impact on retail and manufacturing demand.
- **Organic growth.** In all divisions, organic growth depends on the ability to hire and retain skilled staff.
- **Technology:** The Managed Services business relies on third party datacentres – any breach in security or service disruption could influence customer demand. The outcome in terms of timing and uptake of new product development is uncertain.
- **Acquisitions.** Deals have transformed the scale of the group and the record so far has been a good one. Potentially, however, the risks are greater in any strategy which has recourse to M&A.

Valuation

K3's share price has suffered since the company withdrew from the sale process[2], and fell further after its trading update in January. On our revised forecasts the company is trading on very depressed multiples: 5.6x FY13e EPS and 4.1x FY14e EPS. This is at a substantial discount to sub-£500m market cap UK software stocks (17.0x current year and 13.8x next year) and UK IT service companies (16.4x current year and 13.7x next year).

Although deferred deals and investment product development are likely to dampen margins in FY13 (we forecast operating margins will fall by 530bp in FY13) we still forecast normalised operating margins of 11.5%. We forecast growth in FY14 as the AX for Retail investment starts to pay off and we expect operating margins to improve to 14.5%. In our view, the share price reflects uncertainty over the timing of the signing of the deferred deals. If we assumed a 10% revenue miss in FY13 (all licence-based at a gross margin of 60%) this would at most knock 59% off our FY13 EPS forecast, leaving K3 trading on 13.1x EPS, still at a discount to the sector.

We would expect triggers for a re-rating of the stock to include evidence that deferred Dynamics deals are being signed, debt is reducing y-o-y, and the Managed Services business is winning customers. We believe if confidence in the stock can be re-established, it could trade up to at least 10x FY13e EPS (174p per share).

Financials

Review of H113 results

As reviewed earlier, H113 revenues were negatively affected by deal deferrals, particularly in the retail market. Continued investment in Project Gemstone further depressed normalised operating profit. Net interest expense has reduced to £435k from £685k a year ago, as the level of debt has reduced. The company benefited from a small tax credit, as a deferred tax credit related to amortisation of intangible assets outweighed the current tax charge. Cash generated from operations totalled £6.9m, net of cash

[2] K3 started a strategic review in December 2011 after its largest shareholder made a bid for the company. In April 2012, K3 entered into a sale process. This was officially terminated in September 2012, as no offer was forthcoming at a level which management deemed sufficient to recommend to shareholders.

paid for restructuring and acquisitions of £0.3m (note that H1 benefits from c £6m in SYSPRO renewals received from October to December). The company paid £1.3m in deferred and contingent consideration in H1, capitalised development costs of £1.4m and acquired tangible assets worth £0.5m. After tax (£0.5m) and interest payments (£0.1m), net debt was reduced by £3.3m in H1.

Exhibit 8: H113 results highlights

£'000	H113	H112	Change
Revenues	31,547	33,355	-5.4%
Normalised operating profit	2,976	6,948	-57.2%
Reported operating profit	620	4,660	-86.7%
Normalised profit before tax	2,541	6,263	-59.4%
Normalised net income	1,827	5,105	-64.2%
Reported net income	216	3,457	-93.8%
Reported EPS (p)	0.8	12.3	-93.5%
Normalised EPS (p)	6.3	17.7	-64.3%
Net debt	12,322	13,346	-7.7%

Source: K3 Business Technology Group

Changes to forecasts

With the commercial launch targeted for mid-2013, the company expects AX for Retail to drive strong growth in the medium term. For the group, management expects to see a return to growth within the next 12 months.

- Microsoft UK: We forecast a recovery in revenues in H213 assuming that deferred deals are signed. For FY14, we expect revenues to return to the levels achieved prior to H113, as the AX for Retail product is rolled out.
- International: The IKEA business should remain strong in H213 and FY14, as of the 100 potential stores expected to use K3's solution, only 30 have converted to date. The plan is for Project Gemstone to incorporate the Pebblestone retail business, which in the medium term should reinvigorate the fashion business, regardless of the market environment. We factor in a small y-o-y decline in revenues in H213 reflecting the weakness in the Dutch retail market. We forecast modest growth in FY14, assuming Project Gemstone will not have had a major impact on the Pebblestone business in this time frame.
- Sage and SYSPRO: We forecast 13% y-o-y growth in H213 reflecting demand for Sage X3. We conservatively forecast 2% growth for FY14.
- Managed Services: We assume that the business shows sequential growth as deferred deals with a hosting element are signed. As revenues are recognised on a monthly basis over the life of the contract, there is not likely to be a large step change from period to period.

Exhibit 9: Divisional forecasts

	Revenues				Revenue growth		
	FY11	FY12	FY13e	FY14e	FY12	FY13e	FY14e
Microsoft UK	22.88	24.92	19.48	22.09	8.9%	-21.8%	13.4%
International	9.05	12.65	12.81	13.11	39.7%	1.3%	2.4%
SYSPRO & Sage	16.17	24.96	27.20	27.75	54.4%	9.0%	2.0%
Managed Services	4.70	5.43	6.59	7.56	15.6%	21.3%	14.7%
Total revenues	52.80	67.96	66.08	70.51	28.7%	-2.8%	6.7%
	Adjusted operating profit				Adj. Operating margin		
	FY11	FY12	FY13e	FY14e	FY12	FY13e	FY14e
Microsoft UK	2.78	2.22	0.28	1.66	8.9%	1.4%	7.5%
International	2.34	3.67	2.18	2.62	29.0%	17.0%	20.0%
SYSPRO & Sage	4.17	5.86	5.75	6.08	23.5%	21.1%	21.9%
Managed Services	0.54	0.00	-0.16	0.36	0.0%	-2.4%	4.8%
Head office	(0.20)	(0.34)	(0.43)	(0.50)			
Total	9.63	11.41	7.61	10.22	16.8%	11.5%	14.5%

Source: K3 Business Technology Group and Edison Investment Research

The table below shows the changes to our forecasts. While we have cut our revenue forecasts to reflect the tough environment for Microsoft UK, we expect less impact on profitability as the company has restructured or is restructuring the cost base where necessary. On 19 March, the company raised £2.7m for general working capital and debt reduction from the issuance of 2.7m shares at 95p/share. Our EPS forecasts reflect the dilution.

For FY13, we forecast a reduction in net debt of £4.2m, based on cash flow from operations of £9.4m, interest paid of £0.88m, tax paid of £1.81m, capex (including capitalised development costs) of £3.4m, payment of deferred/contingent consideration of £1.35m, equity raised (net) of £2.56m and dividends of £0.29m.

The majority of debt is term debt that is due in December 2013; we would expect the company to refinance before then.

Exhibit 10: Changes to forecasts

	Old	New		Old	New	
£'000	FY13E	FY13E	Change	FY14E	FY14E	Change
Revenues	69,090	66,081	-4.4%	73,994	70,514	-4.7%
Normalised operating profit	8,049	7,612	-5.4%	10,360	10,218	-1.4%
Operating margin	11.7%	11.5%		14.0%	14.5%	
Normalised PBT	7,149	6,732	-5.8%	9,710	9,668	-0.4%
Normalised net income	5,591	5,224	-6.6%	7,748	7,712	-0.5%
Reported EPS (p)	8.5	5.3	-38.0%	16.1	14.4	-10.4%
Normalised EPS (p)	19.2	17.4	-9.6%	26.7	24.0	-9.9%
Net debt	13,119	11,463	-12.6%	10,241	7,082	-30.8%

Source: Edison Investment Research

Edison investment research

Exhibit 11: Financial summary

£'000s	2010*	2011	2012	2013e	2014e
Year end 30 June	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue	59,783	52,800	67,961	66,081	70,514
Cost of Sales	(22,460)	(23,486)	(28,491)	(27,754)	(29,616)
Gross Profit	37,323	29,314	39,470	38,327	40,898
EBITDA	10,327	10,574	12,942	9,632	12,358
Operating Profit (before am of acq. Intang. and except.)	9,013	9,633	11,405	7,612	10,218
Amortisation of acquired intangibles	(2,892)	(2,826)	(3,586)	(3,800)	(3,800)
Share-based payments	39	(52)	(72)	(70)	(70)
Other	0	(942)	(395)	(503)	0
Operating Profit	6,160	5,813	7,352	3,239	6,348
Net Interest	(1,365)	(905)	(1,309)	(880)	(550)
Profit Before Tax (norm)	7,620	8,728	10,096	6,732	9,668
Profit Before Tax (FRS 3)	4,767	4,908	6,043	2,359	5,798
Tax	(1,018)	(428)	(319)	(808)	(1,257)
Profit After Tax (norm)	5,770	7,108	8,591	5,224	7,712
Profit After Tax (FRS 3)	3,749	4,480	5,724	1,551	4,542
Average Number of Shares Outstanding (m)	24.6	25.7	28.2	29.3	31.4
EPS - normalised (p)	23.5	27.7	30.4	17.8	24.5
EPS - normalised fully diluted (p)	23.4	27.0	29.7	17.4	24.0
EPS - FRS 3 (p)	15.2	17.5	20.3	5.3	14.4
Dividend per share (p)	0.75	0.75	1.00	1.05	1.10
Gross Margin (%)	62.4	55.5	58.1	58.0	58.0
EBITDA Margin (%)	17.3	20.0	19.0	14.6	17.5
Operating Margin (before GW and except.) (%)	15.1	18.2	16.8	11.5	14.5
BALANCE SHEET					
Fixed Assets	48,602	59,457	68,325	65,905	62,865
Intangible Assets	13,176	17,635	21,255	18,355	14,855
Tangible Assets	1,393	1,993	2,722	3,202	3,662
Goodwill	33,467	39,082	43,540	43,540	43,540
Other	566	747	808	808	808
Current Assets	14,808	23,456	32,418	34,130	36,951
Stocks	0	0	0	0	0
Debtors	14,439	22,642	30,322	30,415	32,456
Cash	369	814	2,096	3,715	4,496
Current Liabilities	(19,510)	(29,300)	(48,043)	(44,443)	(40,643)
Creditors	(5,491)	(7,874)	(8,797)	(9,147)	(9,497)
Other Creditors	(9,719)	(16,628)	(21,468)	(20,118)	(19,568)
Short term borrowings	(4,300)	(4,798)	(17,778)	(15,178)	(11,578)
Long Term Liabilities	(12,457)	(16,371)	(5,797)	(5,697)	(5,597)
Long term borrowings	(7,051)	(11,502)	0	0	0
Other long term liabilities	(5,406)	(4,869)	(5,797)	(5,697)	(5,597)
Net Assets	31,443	37,242	46,903	49,895	53,576
CASH FLOW					
Operating Cash Flow	7,331	5,640	7,284	9,386	10,668
Net Interest	(1,303)	(947)	(839)	(880)	(550)
Tax	(1,637)	(1,368)	(1,312)	(1,808)	(1,957)
Capex	(1,638)	(2,055)	(3,160)	(3,400)	(2,900)
Acquisitions/disposals	(2,856)	(5,407)	(7,132)	(1,350)	(550)
Financing	1,434	174	5,026	2,556	0
Dividends	(247)	(64)	(214)	(285)	(330)
Net Cash Flow	1,084	(4,027)	(347)	4,219	4,381
Opening net debt/(cash)	13,012	10,982	15,486	15,682	11,463
HP finance leases initiated	0	0	0	0	0
Other	946	(477)	151	0	0
Closing net debt/(cash)	10,982	15,486	15,682	11,463	7,082

Source: K3 Business Technology and Edison Investment Research Note: *18 months ended 30 June 2010.

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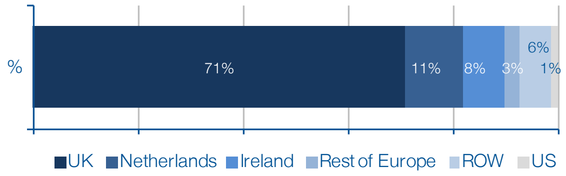
Revenue by geography



CAGR metrics		Profitability metrics		Balance sheet metrics		Sensitivities evaluation	
EPS 10-14	0.6%	ROCE 13e	10.8%	Gearing 13e	23.0%	Litigation/regulatory	○
EPS 12-14e	-10.1%	Avg ROCE 10-14e	13.8%	Interest cover 13e	8.6	Pensions	○
EBITDA 10-14e	4.6%	ROE 13e	10.5%	CA/CL 13e	0.8	Currency	◖
EBITDA 12-14e	-2.3%	Gross margin 13e	58.0%	Stock days 13e	0	Stock overhang	◖
Sales 10-14e	4.2%	Operating margin 13e	11.5%	Debtor days 13e	168	Interest rates	◖
Sales 12-14e	1.9%	Gr mgn / Op mgn 13e	5.0	Creditor days 13e	193	Oil/commodity prices	○

Management team

CEO: Andy Makeham

Andy has over 20 years' experience running or working in IT companies. Previously, he was divisional sales and marketing director at Kewill Systems.

CFO: David Bolton

David qualified as a chartered accountant with Ernst & Young in the mid-70s. He has held finance positions with both quoted and unquoted companies, most notably BTR, where he spent 12 years.

Chairman: Tom Milne

Tom was appointed as chairman of the board in May 2006. He has a wealth of experience in developing successful retail software companies.

Principal shareholders	(%)
P J Claesson	20.9
BlackRock Investment Management (UK) Ltd	8.7
Investec Asset Management Ltd	6.0
Hargreave Hale Ltd	4.8
Herald Investment Management Limited	4.4
David Bolton	3.3
Andy Makeham	3.2

Companies named in this report

Microsoft (NASDAQ: MSFT)