

# K3 Business Technology

Trading update

Further downgrades but a glimmer of light

In K3's 25 June trading update management cautioned that while most divisions are performing well, the UK Retail segment remains challenging. Despite securing a significant number of orders late in the period, full-year earnings expectations will not be achieved. With margin compression exacerbated by investment in new product development we reduce our EPS estimates by 46% for 2013 and 30% for 2014. However, recent order wins and an improving pipeline suggest the Microsoft UK division is starting to turn a corner. Given the lowly rating, clear evidence of earnings stability could initiate a share price recovery.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
06/11	52.8	8.7	27.0	0.8	3.6	0.8
06/12	68.0	10.1	29.7	1.0	3.3	1.0
06/13e	63.8	4.0	9.3	1.1	10.4	1.1
06/14e	72.5	7.0	16.9	1.1	5.8	1.1

Note: \*PBT and EPS are normalised, excluding intangible amortisation, exceptional items and share-based payments.

## Weak demand and deferrals in UK retail continue

Trading in H2 continued to be affected by weak demand and deferrals from the UK retail segment. Performance in SYSPRO and the Sage division (37% sales) is said to be "encouraging" and the International division (19% sales) is seeing an improvement. Management reports an increasing pipeline for its managed services offering, although high upfront investment means the division is still loss making. In aggregate, FY results are expected to be materially below expectations.

## Order recovery – transition period coming to an end?

There is evidence to suggest that the Microsoft UK division (37% sales) is now turning a corner, with wins worth an estimated £10m received since January, although revenues will fall mainly into 2014. The wins are across both Microsoft NAV, where K3 is well established and demand is recovering, and AX, where K3 has suffered due to its lack of compatible product. Project 'Gemstone', K3's AX development, is now well underway. Initial lead AX customers have been secured and the pipeline is looking positive.

## Valuation: Earnings stability key to upside

Taking a cautious view on year-end software deal flow, we have cut our revenue 2013 sales estimate by 3.5% to £64.5m, but higher investment levels and operational gearing result in a 46% EPS downgrade. For 2014, we upgrade sales by 2.8% as a result of the UK Microsoft wins, but bring EPS back by 30%, reflecting higher investment levels. Post our cuts, K3 trades on a 2013 P/E of 10.4x and 5.8x 2014e with respective EV/sales multiples of 0.7x and 0.6x, suggesting further downgrades are being priced in. Thus, evidence to support a stabilisation in earnings should justify an upwards re-rating towards 10x 2014 earnings. And, while it is still early days, we believe there are signs that point to a potential recovery, which, if it materialises, could drive substantial upside.

Software &amp; comp services

28 June 2013

**Price** 98.50p  
**Market cap** £28m

Net debt (£m) as at 31 Dec 2012	12.3
Shares in issue	28.6m
Free float	49.4%
Code	KBT
Primary exchange	AIM
Secondary exchange	N/A

### Share price performance



%	1m	3m	12m
Abs	(11.3)	0.5	(41.5)
Rel (local)	(5.8)	2.5	(49.3)
52-week high/low		188.5p	93.0p

### Business description

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

### Next events

FY13 results September 2013

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## Earnings estimates reduced

We feel our estimates for 2013 are now set at a cautious level, assuming that deals pending in the pipeline for this year slip into 2014. The new wins should start to contribute to the 2014 top line, although exact phasing is difficult to predict. Consequently, while we are downgrading revenue forecasts for 2013 by 3.5% to £63.8m, we are upgrading 2014 by 2.8% to £72.5m – this implies growth of 12% year-on-year, factoring in a phased impact of the new order wins in the Microsoft UK division and the eventual signing of deferred orders.

At the operating level, the effects of new wins will be obscured by the incremental Gemstone investment, which will continue into next year, and the margin impact of order deferrals. We reduce our operating margin forecast for 2013 from 11.5% to 7.4% and for 2014 from 14.5% to 10.5%. Consequently our normalised operating profit downgrade is 38% in 2013 to £4.8m and 26% in 2014 to £7.6m.

We increase our forecast restructuring charge to £800,000 in 2013 (from £503,000), and incorporate a further £200,000 for the first time in 2014.

The net effect of these changes is to cut our estimated forecast EPS of 17.4p by 46% to 9.3p for the current year, and by 30% to 16.9p for 2014.

### Exhibit 1: Summary forecast changes

	Old	New		Old	New	
£000s	FY13e	FY13e	Change	FY14e	FY14e	Change
Revenue	66,081	63,800	-3.5%	70,514	72,502	2.8%
Normalised operating profit	7,612	4,751	-37.6%	10,218	7,593	-25.7%
Operating margin	11.5%	7.4%		14.5%	10.5%	
Normalised PBT	6,732	3,981	-40.9%	9,668	7,043	-27.2%
Normalised net income	5,224	2,803	-46.3%	7,712	5,427	-29.6%
Reported EPS (p)	5.3	(4.0)	-175.2%	14.4	6.5	-54.7%
Normalised EPS (p)	17.4	9.3	-46.3%	24.0	16.9	-29.6%
Net debt	11,463	15,494	35.2%	7,082	12,780	80.4%

Source: Edison Investment Research

**Exhibit 2: Financial summary**

	£'000s	2010*	2011	2012	2013e	2014e
Year end 30 June		IFRS	IFRS	IFRS	IFRS	IFRS
<b>PROFIT &amp; LOSS</b>						
Revenue		59,783	52,800	67,961	63,800	72,502
Cost of Sales		(22,460)	(23,486)	(28,491)	(27,434)	(30,451)
Gross Profit		37,323	29,314	39,470	36,366	42,051
EBITDA		10,327	10,574	12,942	6,771	9,733
Operating Profit (before am of acq. Intang. and except.)		9,013	9,633	11,405	4,751	7,593
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)	(800)	(200)
Operating Profit		6,160	5,813	7,352	81	3,523
Net Interest		(1,365)	(905)	(1,309)	(770)	(550)
Profit Before Tax (norm)		7,620	8,728	10,096	3,981	7,043
Profit Before Tax (FRS 3)		4,767	4,908	6,043	(689)	2,973
Tax		(1,018)	(428)	(319)	(478)	(916)
Profit After Tax (norm)		5,770	7,108	8,591	2,803	5,427
Profit After Tax (FRS 3)		3,749	4,480	5,724	(1,167)	2,057
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	9.6	17.3
EPS - normalised fully diluted (p)		23.4	27.0	29.7	9.3	16.9
EPS - FRS 3 (p)		15.2	17.5	20.3	(4.0)	6.5
Dividend per share (p)		0.75	0.75	1.00	1.05	1.10
Gross Margin (%)		62.4	55.5	58.1	57.0	58.0
EBITDA Margin (%)		17.3	20.0	19.0	10.6	13.4
Operating Margin (before GW and except.) (%)		15.1	18.2	16.8	7.4	10.5
<b>BALANCE SHEET</b>						
Fixed Assets		48,602	59,457	68,325	66,185	63,925
Intangible Assets		13,176	17,635	21,255	18,355	15,355
Tangible Assets		1,393	1,993	2,722	3,482	4,222
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	28,439	31,796
Stocks		0	0	0	0	0
Debtors		14,439	22,642	30,322	28,755	29,398
Cash		369	814	2,096	(316)	2,398
Current Liabilities		(19,510)	(29,300)	(48,043)	(41,750)	(41,750)
Creditors		(5,491)	(7,874)	(8,797)	(8,454)	(9,004)
Other Creditors		(9,719)	(16,628)	(21,468)	(18,118)	(17,568)
Short term borrowings		(4,300)	(4,798)	(17,778)	(15,178)	(15,178)
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	47,177	48,374
<b>CASH FLOW</b>						
Operating Cash Flow		7,331	5,640	7,284	5,195	9,439
Net Interest		(1,303)	(947)	(839)	(770)	(550)
Tax		(1,637)	(1,368)	(1,312)	(1,478)	(1,616)
Capex		(1,638)	(2,055)	(3,160)	(3,680)	(3,680)
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)	188	2,714
Opening net debt/(cash)		13,012	10,982	15,486	15,682	15,494
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	15,494	12,780

Source: Edison Investment Research, K3 Business Technology accounts

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