

## K3 BUSINESS TECHNOLOGY GROUP

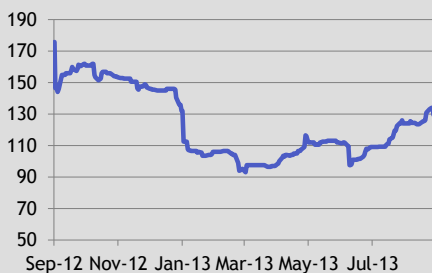
### SOFTWARE & COMPUTER SERVICES

#### KBT.L

129.5p

Market Cap: £40.7m

#### SHARE PRICE PERFORMANCE



12m high/low

176p/93p

Source: LSE Data

#### KEY INFORMATION

Enterprise value	£54.5m
Index/market	FTSE AIM
Next news	AGM Nov 2013
Gearing	34%
Interest cover	12.2x

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## POSITIVE OUTLOOK REITERATED

### In-line numbers and healthy prospects across the divisions

K3 has reported preliminary results for FY13 which are in line with the guidance given in its June pre-close trading update. Revenues are a touch (1%) lower than our estimates with adjusted EBITDA ahead of our number by 7%. Adjusted diluted EPS of 13.9p was some 52% ahead of our expectation thanks to an overall tax credit for the year. The group has maintained the dividend payment at 1.0p. While investment spend and the retail market backdrop influenced the FY13 outturn, the upturn in UK Retail order wins in the final quarter of FY13 and the prospects for Gemstone bode well for future performance. A positive outlook statement reiterates this and emphasises the opportunities across a Group which retains a robust financial position. Our FY14 estimates remain substantially unchanged and we introduce FY15 numbers.

- June's trading update contained positive comments on new orders in Q4 of FY13. They are reiterated today as the Group confirms that it 'finished the period strongly in all Divisions' which should provide a useful tailwind for FY14. The outlook statement notes the robust financial position of the Group and that management is 'encouraged by the prospects for the Group into 2013/14 and beyond'.
- There is a burgeoning pipeline of orders in the Microsoft UK division (mostly for the Gemstone AX solution), the SYSPRO and Sage division has proved resilient and Managed Services should see growth accelerate once Retail customers move into the hosting and support phases of their projects. The International division will reduce costs and should also benefit from Gemstone.
- K3 will be making further releases of Gemstone functionality later in 2013, and expects full product completion in mid-2014. The RNS notes a strong pipeline of interest and K3 has announced several significant initial retail order wins in the UK for Gemstone.
- In addition, the group also says that there are signs that retailers are returning to spending on technology. This is reflected in an upturn in demand for its NAV based retail solution. Demand from IKEA, K3's largest customer, also remains strong.

FYE JUNE	2011	2012	2013	2014E	2015E
Revenue	52.8	68.0	63.5	71.5	77.5
Adjusted EBITDA	10.6	12.9	7.3	9.8	10.5
Adjusted PBT	8.7	10.0	4.4	6.9	7.6
Adjusted EPS	22.8	24.4	13.9	17.7	19.6
EV/Sales	1.0x	0.8x	0.9x	0.8x	0.7x
EV/ Adj. EBITDA	5.2x	4.2x	7.5x	5.6x	5.2x
P/E	5.7x	5.3x	9.3x	7.3x	6.6x

## FY13 PRELIMINARY RESULTS

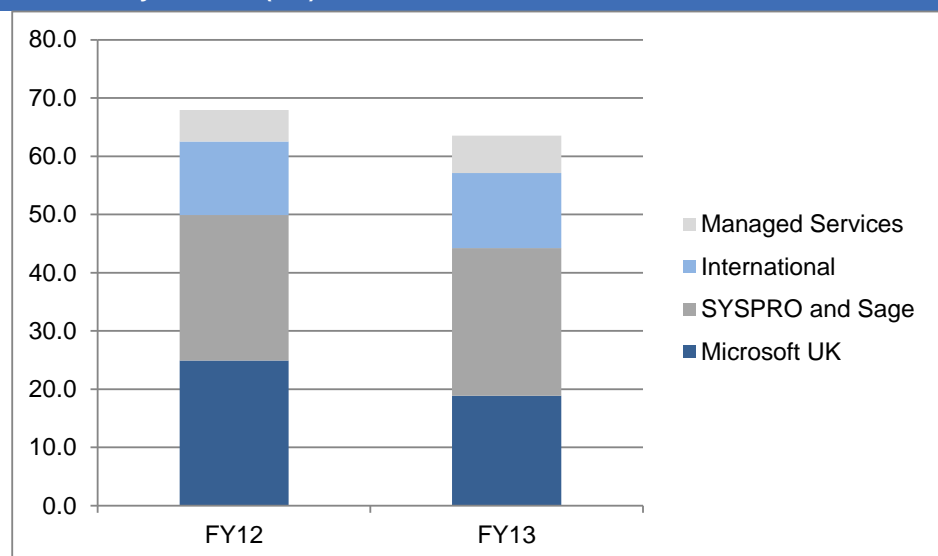
### Highlights

#### In line with the June trading update

**FY13 results in line with guidance**

K3 has reported preliminary results for FY13 which are in line with the guidance given in its June pre-close trading update. Revenues of £63.5 million (FY12: £68.0 million) are a touch (1%) lower than our estimates with adjusted EBITDA ahead of our number by 7%. Adjusted diluted EPS of 13.9p was some 52% ahead of our expectation thanks to an overall tax credit for the year. The group has maintained the dividend payment at 1.0p. While investment spend and the retail market backdrop influenced the FY13 outturn, the upturn in UK Retail order wins in the final quarter of FY13 bodes well for future performance. A positive outlook statement reiterates this, and emphasises the robust financial position of the Group.

Revenue by division (£m)



Source: Company data

#### Encouragement from new orders

**Major new order wins totalled £11.56 million in FY13**

The disappointment of June's trading update was offset at the time by the positive comments on new orders in Q4 of FY13. That is reiterated today as the Group confirms that it 'finished the period strongly in all Divisions'. Major new order wins totalled £11.56 million in FY13 (FY12: £12.94m) of which £8.13 million (70%) were signed in H2 with most in Q4. The outlook statement notes the robust financial position of the Group and is 'encouraged by the prospects for the Group into 2013/14 and beyond'.

## Gemstone progress

K3 will be making further releases of Gemstone functionality later in 2013, and expects full product completion in mid-2014. The RNS notes a strong pipeline of interest and K3 has announced several significant initial retail order wins in the UK for Gemstone.

## Retailers return to spending

In addition, K3 also says that there are signs that retailers are returning to spending on technology. This is reflected in an upturn in demand for its NAV based retail solution. Demand from IKEA, K3's largest customer, also remains strong.

## The Numbers

### Resilient recurring revenue

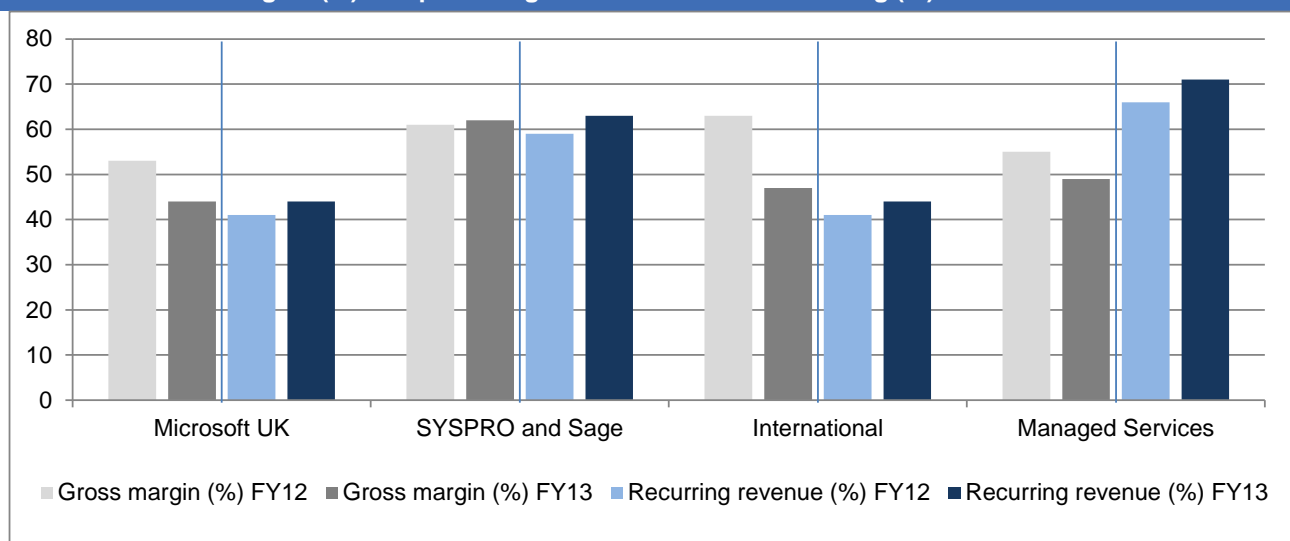
K3 has reported revenues of £63.51 million (FY12: £67.96 million) of which recurring maintenance and support represented £34.54 million (FY12: £33.74 million). Revenues are 1% lower than our estimates with adjusted EBITDA ahead of our number by 7%. Adjusted PBT of £4.37 million (FY12: £10.02 million) was 17% ahead of our estimate as adjusted EBIT came in 6% better than we had expected and central costs were lower than our estimate.

Although margins have reduced, the proportion of recurring revenue has increased

### Margins

At Group level, the Gross Margin reduced from 58% in FY12 to 52% in FY13 as a result of lower services revenues from K3's delivery resources at Microsoft UK Division on the back of deferrals in expected orders. By division, during FY13, the margin rose slightly in the SYSPRO & Sage Division but reduced in the other three operating divisions.

### Divisional Gross Margins (%) and percentage of revenue that is recurring (%)



Source: Company data

## Costs

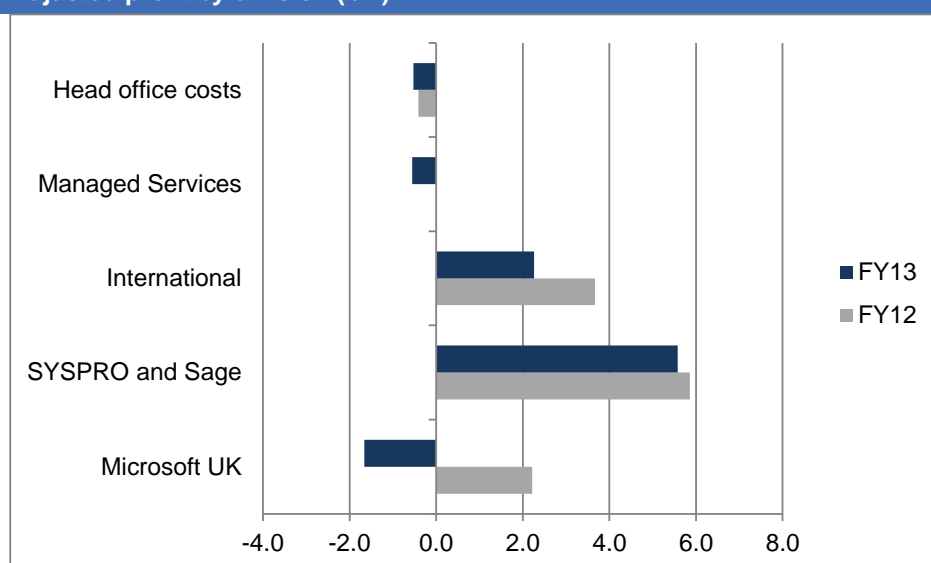
The group was careful to flag the level of investment spend in FY13 and product development costs totalled £3.56m. Of that, £1.45 million related to Gemstone with £0.63 million to Retail NAV and £0.64 million to Pebblestone NAV, with other product IP in Holland being the next largest recipients. The announcement notes that K3's investment in its Managed Services Division is now substantially concluded.

K3 incurred exceptional costs of £0.73m mainly relating to restructuring of the prior year acquisitions.

## Adjusted profits

Adjusted profit from operations over the year decreased to £5.09 million (FY12: £11.33 million). The divisional adjusted profits - calculated before amortisation of acquired intangibles, acquisition costs and exceptional item - are shown in the table below.

### Adjusted profit by division (£m)



Source: Company data

## EPS benefited from a tax credit

Adjusted diluted EPS of 13.9p reflects the recognition of a deferred tax credit of £0.91m in respect of intangibles. Together with the impact of lower profits and R&D credits, the result is an overall tax credit of £0.78 million in FY13 (FY12: charge of £0.32million).

## K3 retains a strong financial position

Cash generated from operations was £8.02 million in FY13 (FY12: £7.28 million) and, as at 30 June 2013, net debt stood at £13.81 million (FY12: £15.68 million). Notable influences include net debt repayments of £2.83 million, £1.94 million payments to the vendors of the acquisitions made in prior years and £2.61 million net proceeds from a share placing. It is perhaps worth noting that the outstanding deferred consideration on acquisitions is now only £0.39m. The Group's banking facilities have been extended through to December 2014 on 'substantially the same terms' to the existing facilities.

Good cash generation and banking facilities extended

## The Trading Divisions

Below, we highlight some of the main points from the divisional results and commentary. After that, given its importance to the Group, we look at Project Gemstone in a little more detail.

### Microsoft UK Division

- Revenue: £18.9 million (FY12: £24.9 million).
- Adjusted (loss) profit from operations: Loss of £1.7 million (FY12: £2.2 million).
- Tough conditions in the retail sector and investment in Gemstone.
- FY13 margin down by 9% to 44% reflecting low level of services revenues in the year and investment spend.
- Improvement in H2 of FY13 with £4.2 million new orders in Q4.
- Upturn in demand for NAV solution will benefit FY14.
- First commercial release of Gemstone functionality was made available in H2 of FY13.
- Resulting reference sites helped K3 to win some significant initial orders in Q4 of FY13 - £1.0 million initially but expected to lead to £8.0 million of additional revenues.
- Further releases of Gemstone planned for later in calendar 2013.
- Development project to be fully complete in mid-2014.
- Pipeline: £38.0 million (FY12: £21.0 million) of which 80% focused on Gemstone AX solution.

### SYSPRO and Sage Division

- Revenue: £25.4 million (FY12: £25.0 million).
- Adjusted profit from operations: £5.6 million (FY12: £5.9 million).
- Resilient performance in a tough UK market.
- SYSPRO business secured 10 new wins in total worth £1.77m compared with nine worth £0.9m in FY12.
- SYSPRO new business leads up 25% to £2 million with strong demand from existing customers.
- SYSPRO pipeline £3.4 million (2012: £4.4m).
- Sage businesses reorganisation completed in January 2013 with expected annualised cost benefit of £0.8 million (o/w £0.4 million was realised in FY13).
- Sage generated recurring annual income of £6.5 million (FY12: £6.2 million).
- New business wins picked up significantly in H2 of FY13.
- Strong demand for Sage's new X3 Enterprise level solution.

## International Division

- Revenue: £12.9 million (FY12: £12.6 million).
- Adjusted profit from operations: £2.3 million (FY12: £3.7 million).
- Profit reduction was primarily in H1.
- Margin of 47% (FY12: 63%) impacted by lower margins in the Dutch fashion and retail markets plus tough prior year comparator.
- IKEA relationship is strong. Some projects are commencing later than anticipated and will now benefit 2014.
- Dutch fashion market has slowed significantly. K3 has a cost reduction programme in place.
- High margin international Pebblestone Distribution Channel was weaker in H1 but strengthened in H2.
- Unisoft performed ahead of expectations with sales of £3.48 million and a profit of £0.57 million.
- Pipeline £5.9 million (2012: £3.7 million).
- Project Gemstone expected to benefit the Pebblestone international reseller channel.

## Managed Services Division

- Revenue: £6.4 million (FY12: £5.4 million).
- Adjusted loss from operations: Loss of £0.6 million (FY12: n.a.).
- Run-rate recurring income at the year-end showed a 27% increase year on year to £4.55 million (2012: £3.58 million).
- Slowdown in the UK retail sector impacted hosting growth.
- New order wins in the Microsoft UK Division expected to benefit hosting revenues going forward.
- Investment in the development of the hosting platforms complete so divisional cost base will reduce.
- Pipeline of demand for hosting has increased to £3.37 million (FY12: £2.65 million)

## PROJECT GEMSTONE -

# K3 AND MICROSOFT DYNAMICS

### About Microsoft Dynamics

Microsoft Dynamics enterprise resource planning (ERP) business solution software is designed for companies of different sizes to improve profitability -- for instance, through efficiencies, cut costs, or additional investments - and to enable systems to adapt as a business grows. The software allows a company to manage, *inter alia*, its supply chain, procurement, human resources, financials and projects.

Companies can purchase Microsoft Dynamics ERP through a Microsoft partner. They work with the purchaser to determine specific requirements, tailor and implement the product. They also train the purchaser's employees. K3 Business Solutions is among those partners.

### K3 and Dynamics

K3 provides end-to-end solutions for the retail sector through K3 Retail. It provides solutions based on Dynamics RMS for small retailers with, perhaps, less than ten outlets. Dynamics NAV is provided to mid-market companies with Dynamics AX as a solution for enterprise level companies. Dynamics CRM is a customer relationship management solution.

Currently, K3 Retail has over 800 customers with two-thirds using Dynamics NAV, more than a quarter using RMS and around 40 using AX (retail and manufacturing). In addition, NAV can be adapted for ERP level sales and this has been key to K3's success with its NAV multi channel capability. In the journey to that position, K3 has made a number of acquisitions including, in 2010, that of Pebblestone which was Microsoft's largest MS NAV-based wholesale distribution (fashion) partner. The acquisition included IP, customers and an established 27 country Independent Software Vendor (ISV).

### A change of focus from Microsoft necessitated a strategy change from K3

Up to the beginning of calendar 2012, K3's focus was on NAV and it boasted two market-leading NAV-based solutions in its Multi Channel Retail (MCR) Solution in K3 Retail and its Wholesale Distribution Solution in K3 Pebblestone.

However, during 2012, K3 Retail's results were materially impacted by Microsoft's focus on promoting AX Retail. The result was some confusion in the NAV market and the lack of an appropriate AX product.

In its results announcement for the financial year to the end of June 2012, the company noted that it saw the (then) new financial year (to the end of June 2013) as a year of investment. The two areas of specific focus were Project Gemstone, its Microsoft Dynamics AX product (in response to Microsoft's positioning) and Managed Services. The announcement also said: *"We anticipate that the benefits of our investment programme should come through during the course of 2013."*

Late in the FY13 financial year, K3 secured its first major order for Microsoft's AX for Retail solution in a contract with a book retailer with Microsoft as the prime delivery contractor and K3 providing the specialist retail modules required. Subsequently, other significant AX deals have included Grafton (building materials merchant), Wynsors (shoes) and Weird Fish (fashion).

## The impact on the business

In FY13, K3 experienced challenging trading conditions - especially in the retail sector. Its flagged investment in Gemstone had an impact on both the interim and full year numbers. Market conditions and uncertainty meant that K3's retail customers were also prone to deferring investment decisions with a resultant reduction in revenue. With some large deals not closing in the first half there was a consequent combination of a deferral of software licence revenue and a loss of services revenue.

The FY13 results show how key the successful development of its AX suite is to K3. The Gemstone project comprises the creation of MCR AX Retail and AX Pebblestone to provide a 'World Class Retail & Wholesale Solution for Dynamics AX'. This will be marketed through the ISV Channel – and K3 already owns one of the largest Microsoft ISVs through the Pebblestone acquisition.

The trading update of 25 June 2013 noted that continuing deferrals combined with the phasing of the software element of new contract wins meant that K3 would report revenue and pre-tax profits below (then) current market forecasts. However, there were some encouraging signs in the update which we refer to earlier in this publication and which are reiterated in the full year results commentary. These include some major new retail order wins for both the AX and NAV solutions which, as we note earlier in this publication, are for initial business of £1.0 million but are expected to lead to £8.0 million of additional revenues when fully delivered. Those deals provided K3 with its first customers for Gemstone which it could use as reference customers for future sales pitches.

## K3's end-to-end offer to the Retail sector

Among its acquisitions, K3 purchased the Retail Systems Group (RSG) – a provider of Microsoft Dynamics RMS to retailers in the UK and Ireland. The deal gave K3 access to the significant market for smaller retailers thus complementing its existing mid-range retail software offering. The product is supported by Microsoft until 2015/6. As well as adding customers, the acquisition of RSG positioned K3 very well to offer migration from RMS to NAV and AX. This is evidence of the group's strategy as it aims to move from being a value-added reseller with its own intellectual property to delivering that on a more global basis while providing Dynamics to retail businesses of all sizes.

## What does K3 Retail offer?

K3 provides a complete multi-channel solution for retailers & wholesalers to create a joined up shopping experience for their customers regardless of how they make their purchases.

## How does K3 interact with Microsoft?

Microsoft's customers are split into four groups:

Enterprise Partner Group (EPG), Corporate Account Managed – Enterprise (CAM E), Corporate Account Managed – Small, Corporate Telephone Managed & Unmanaged.

K3 is engaged with all the customer groups in 2013 compared to just the two smaller groups in 2012. The EPG and CAM E customer categories are those to which Microsoft will introduce the AX product. Within this, joint partnerships will be a big opportunity and K3 will work with Microsoft Consulting Services.



## Accreditation

Microsoft is supporting K3's development programme and the software is being written to Microsoft development standards so that K3's solution will be accredited as 'Certified for Microsoft Dynamics'.

## Next steps

K3 is now in a position to benefit from its year of investment in the Gemstone AX solution. It will be making further releases of Gemstone functionality later in 2013, and expects full product completion in mid-2014. Today's results commentary notes a strong pipeline of interest and has announced several significant initial retail order wins in the UK for Gemstone. Given that retailers are being cautious by taking delivery of software in phase, we expect some of this pipeline to be spread over the coming eighteen months.

## ESTIMATES

When K3 published a disappointing pre-close trading update in June, we made a number of changes to our estimates as which reduced both revenue and EBITDA expectations for the financial year to the end of June 2013.

For FY14, we reduced our overall revenue figure by £1m from £72.5m to £71.5m and reduced our EBITDA figure from £11.9m to £9.8m - partly due to the lower revenue outlook, but also on the basis of reduced margins as the sales mix may contain fewer high-margin software licences.

We are leaving those 2014 estimates substantially unchanged for the moment but note the company's commentary on new business prospects. However, our EPS estimate for FY14 increases from 16.8p to 17.7p due to the net effect of a lower assumption for the effective tax rate partially offset by a higher average fully diluted number of shares in issue for the current financial year.

Our dividend estimate for FY14 reflects the Board's decision to maintain the dividend at 1.0p in FY13 and we now estimate 1.1p for the current financial year. We introduce our FY15 estimates for the first time which can be seen in the table on the following page.

## FINANCIAL FORECASTS

Year ended Jun	FY-11	FY-12	FY-13	FY-14	FY-15
	£m	£m	£m	£m	£m
<b>Profit &amp; Loss</b>	<b>Act</b>	<b>Act</b>	<b>Act</b>	<b>Est</b>	<b>Est</b>
Revenue £m	52.8	68.0	63.5	71.5	77.5
Adj EBITDA £m	10.6	12.9	7.3	9.8	10.5
Adj EBIT £m	9.6	11.4	5.2	7.8	8.5
Reported PBT	4.9	6.0	0.5	3.4	4.1
PBT before exceptionals and AAG	8.7	10.0	4.4	6.9	7.6
Fully adj PBT	8.7	10.1	4.4	7.0	7.7
NOPAT £m	6.7	8.0	3.6	5.4	6.0
Reported EPS	16.7	19.8	4.2	8.6	10.5
EPS before exceptionals and AAG	22.7	24.3	10.4	17.6	19.4
Fully adj EPS	22.8	24.4	13.9	17.7	19.6
Dividend per share p	0.8	1.0	1.0	1.1	1.2
<b>Cash flow &amp; Balance sheet</b>					
Operating cash flow	5.6	7.3	8.0	8.8	9.5
Free Cash flow £m	2.4	3.6	3.9	4.2	4.9
FCF per share p	8.9	12.4	13.2	13.3	15.6
Capex	-2.1	-3.2	-4.6	-3.5	-3.0
Acquisitions	-5.4	-7.1	-1.9	-0.4	-0.4
Net cash flow	-4.2	-5.4	-0.8	1.9	3.1
Shares issued	0.2	5.0	2.7	0.0	0.0
Net cash	-15.5	-15.7	-13.8	-11.9	-8.8

Metrics	FY-11	FY-12	FY-13	FY-14	FY-15
Revenue growth	20.4%	28.7%	-6.5%	12.6%	8.4%
Adj EBITDA growth	27.4%	22.4%	-43.9%	34.5%	7.5%
Adj EBIT growth	28.8%	18.4%	-54.7%	50.4%	9.5%
Adj PBT growth	31.5%	15.7%	-56.0%	56.9%	10.5%
Adj EPS growth	22.7%	7.2%	-43.2%	27.9%	10.5%
Dividend growth	50.0%	33.3%	0.0%	10.0%	9.1%
Adj EBIT margins	18.2%	16.8%	8.1%	10.9%	11.0%
Operating cash conversion	53%	56%	110%	90%	90%
Capex/Depreciation	218%	206%	219%	175%	150%

Valuation	FY-11	FY-12	FY-13	FY-14	FY-15
EV/sales	1.0	0.8	0.9	0.8	0.7
EV/EBITDA	5.2	4.2	7.5	5.6	5.2
EV/NOPAT	8.1	6.8	15.1	10.0	9.2
PER	5.7	5.3	9.3	7.3	6.6
Dividend yield	0.6%	0.8%	0.8%	0.8%	0.9%
FCF yield	6.9%	9.6%	10.2%	10.2%	12.0%

Source: Progressive Equity Research Ltd estimates

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