

K3 Business Technology

Preliminary results

Turning a corner

As flagged in the recent trading update, FY13 results were negatively affected by the combination of weak retail markets in the UK and Holland, and increased investment in developing K3's AX for Retail solution. Recent order intake for both NAV and AX solutions points to a recovery in the Microsoft UK business, while the other business lines look set for a steady performance in FY14. Trading at a discount to peers, we see scope for upside as evidence of sustained revenue and margin recovery emerges.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
06/12	68.0	10.1	29.7	1.00	4.8	0.7
06/13	63.5	4.4	14.1	1.00	10.2	0.7
06/14e	73.1	6.5	15.7	1.05	9.1	0.7
06/15e	75.4	8.5	21.2	1.10	6.8	0.8

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

FY13 results affected by retail market weakness

FY13 revenues declined 6.5% y-o-y as the weak retail market led to a 24% decline in the Microsoft UK division and suppressed growth in the International division. This pushed the Microsoft UK division into a loss-making position and depressed International margins, with adjusted operating profit falling 55% to generate an 8.1% margin (vs 16.8% in FY12). The performance of SYSPRO and Sage held up in the year, and demand for Sage X3 and SYSPRO 7 should drive growth in FY14. Although Managed Services saw 18% revenue growth in FY13, investment in developing hosting platforms (now complete) resulting in an operating loss. Good working capital management resulted in a better than expected year-end net debt.

Recent order intake points to more positive FY14

The strength of Q4 bookings points to a revenue recovery for the Microsoft UK division in FY14, which in turn could drive demand for hosting in the Managed Services division. As Gemstone development is completed and the software is made available to the international sales channel, there is scope for growth to exceed our conservative FY15 forecast. We forecast revenue growth of 15% in FY14 (with 36% growth in Microsoft UK) followed by 3% in FY15. This drives improving profitability, with operating margins of 9.7% in FY14 and 12.1% in FY15. We forecast a reduction in net debt of £1.6m in FY14 and £3.0m in FY15.

Valuation: Evidence of sustained recovery is key

K3's share price is up 47% since the lows reached after the June trading update but on a P/E of 9.1x FY14e and an EV/sales multiple of 0.8x FY14e, still trades at a material discount to its peers (sub-£200m market cap UK Software P/E 15.6x, EV/sales 1.8x). With operating margins moving towards 10% in FY14 we believe that K3 could trade up to at least 10x FY14e EPS (157p), and with evidence of sustained improvement in the Microsoft UK division and further improvement in margins, could move towards 200p (equivalent to EV/sales of 1x FY14e).

Software & comp services

19 September 2013

Price 143.5p
Market cap £45m

Net debt (£m) end FY13	13.8
Shares in issue	31.4m
Free float	57%
Code	KBT
Primary exchange	AIM
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	15.7	28.7	(2.7)
Rel (local)	14.5	24.0	(14.8)
52-week high/low	163.0p		93.00p

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

FY14 interim results March 2014

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Review of FY13 results

Having guided FY13 revenues and profitability down in June, K3 reported revenues in line and profitability above our forecasts (see Divisional discussion below). Recurring revenues made up 54% of revenues compared to 50% last year. Major new orders declined 11% y-o-y to £11.56m, although 70% of orders by value were received in H213. K3 incurred £0.73m in exceptional reorganisation costs and announced a dividend of 1.0p for the full year, flat versus FY12.

Exhibit 1: FY13 results highlights

£'000s	FY13e	FY13a	Change
Revenues	63,800	63,513	-0.4%
Normalised operating profit*	4,751	5,164	8.7%
Operating margin	7.4%	8.1%	
Normalised PBT*	3,981	4,441	11.6%
Normalised net income*	2,803	4,165	48.6%
Reported EPS (p)	(4.0)	4.3	-206.9%
Normalised EPS (p)*	9.3	14.1	51.0%
Net debt	15,494	13,811	-10.9%

Source: K3 Business Technology and Edison Investment Research. Note: *Excludes share-based payments.

Exhibit 2: Divisional revenues and profitability

	Revenues				Adjusted operating profit*			Adjusted operating margin*		
	FY12	FY13e	FY13a	Growth	FY12	FY13e	FY13a	FY12	FY13e	FY13a
Microsoft UK	24.92	19.72	18.86	-24.3%	2.22	(1.95)	(1.66)	8.9%	-9.9%	-8.8%
International	12.65	12.89	12.86	1.7%	3.67	2.20	2.26	29.0%	17.0%	17.6%
SYSPRO & Sage	24.96	25.6	25.38	1.7%	5.86	5.54	5.58	23.5%	21.6%	22.0%
Managed Services	5.43	5.59	6.41	18.0%	0.00	(0.60)	(0.56)	0.0%	-10.7%	-8.7%
Head office					(0.34)	(0.43)	(0.46)			
Total revenues	67.96	63.80	63.51	-6.5%	11.41	4.75	5.16	16.8%	7.4%	8.1%

Source: K3 Business Technology and Edison Investment Research. Note: *Excludes share-based payments.

Cash flow

The company worked hard to reduce working capital, in particular trade debtors, resulting in cash generated from operations of £8.02m versus £7.28m in FY12. Capitalised R&D of £3.56m in FY13 (up from £1.88m in FY12) included £1.45m for Project Gemstone, £0.63m for Retail NAV, £0.64m for Pebblestone NAV and other product IP in Holland, £0.24m for SYSPRO, £0.33m for fresh Dynamics and £0.26m for hosting. The company raised net proceeds of £2.61m from the issue of 2.848m shares and paid £1.94m in deferred and contingent consideration for recent acquisitions. Overall net debt reduced by £1.9m/12% y-o-y.

Divisional performance

Microsoft UK

Revenues dropped 24.3% y-o-y, affected by the weak retail market and order deferrals in H1, which resulted in lower service revenues. This coincided with investment in Project Gemstone, the development of K3's new Dynamics AX for Retail solution. In the year the company won 59 new orders worth £6.5m, compared to 28 deals worth £6.7m last year. Order values have fallen as customers are taking a more staged approach to investment. As flagged at the June trading update, the company saw a pick-up in orders in H2 as retail customers started ordering again (particularly NAV solutions), with 65% of orders received in Q4. £5m of orders received in FY13 were from retail customers: £4m for Dynamics NAV and £1m for Dynamics AX. Recurring revenues dropped 18% y-o-y, as customers cut back on product support and put pressure on prices. The prospects pipeline

of £38m at year-end increased significantly from £21m a year ago, boosted by a high level of interest in the new AX solution.

Adjusted operating profit dropped from £2.22m in FY12 to a loss of £1.66m in FY13, although losses reduced on a half-on-half basis (H1 -£1.26m, H2 -£0.4m) as H2 revenues increased 23% sequentially due to the NAV retail orders.

Project Gemstone

K3 is working to add retail and wholesale IP to Microsoft's Dynamics AX solution, combining the functionality of K3's NAV multi-channel retail solution and Pebblestone's wholesale solution. Gemstone-specific spend totalled £3.65m in FY13 of which £1.45m was capitalised R&D (£1.01m reported in this division and £0.39m in the International division) and the remainder was spent on sales, deployment and support teams. The company carries out some product development work in Malta and India to reduce costs. The first commercial release was made available in H213 and the company has completed initial implementations at reference sites, resulting in initial orders in Q4. K3 received Gemstone orders worth £1.0m in FY13 from four customers. As customers are placing their orders in stages, management estimates these customers could ultimately generate an additional £8.0m in revenues. The company expects to release version one of the product later this year and expects to have finished development in mid-2014 such that it can start to sell the solution through its international partner channel in 27 countries.

International

Revenues grew 1.7% y-o-y, although operating margins declined from 29.0% in FY12 to 17.6% in FY13. H2 revenues were 39% higher than H1, driving improved margins in H2 (H1: 8.7%, H2: 23.9%). H212 included a one-off project that generated profit of £0.55m, and margins in FY13 were negatively affected by weaker fashion and retail markets in Holland. The Inter IKEA Systems BV relationship remains strong. The international Pebblestone Distribution business saw weakness in H1 but saw strengthening demand in H2. The Unisoft point of sales business contributed sales of £3.48m and operating profit of £0.57m (bought in December 2011, the business contributed sales of £2.4m and profit of £0.66m last year).

The division signed 35 new contracts worth £1.13m in FY13, down from 61 contracts worth £3.3m in FY12. The prospects pipeline increased to £5.9m from £3.7m a year ago (excluding long-term IKEA business).

SYSPRO and Sage

The division grew revenues 1.7% y-o-y with an operating margin of 22.0%. In a tough market, this was down from 23.5% in FY12. The **SYSPRO** business won 10 new orders worth £1.77m (vs nine worth £0.9m in FY12), some of which included extended maintenance deals. Demand from the existing customer base remains strong, and new business leads are up 25% to £2m. SYSPRO 7 is due for launch this year, which should drive sales. More than 98% of customers renewed their SYSPRO licences in FY13, in line with previous years. SYSPRO generated recurring revenue of £6.96m in FY13 (up 7% from FY12).

The **Sage** business reorganisation was completed in January 2013, with a single managing director overseeing the merged Panacea and FD Systems businesses. This business generated recurring revenues of £6.5m in FY13 (up 5% from FY12). The business won 60 orders worth £2.05m in FY13 (vs 58 orders worth £2.2m in FY12), with 39 worth £1.55m signed in H2. The company had previously highlighted that it was seeing increasing demand for the Sage X3 Enterprise solution: eight deals were signed in the year (seven in H2) and the pipeline increased 62% to £10.5m at year-end.

Managed Services

Managed Services revenues were stronger than forecast, showing growth of 18% y-o-y, and generating an operating loss of £0.56m. Recurring revenues grew 27% to 71% of revenues, with hosting making up 61% of recurring revenues. Overheads increased in the year as the division developed Sage X3 and Dynamics AX hosting platforms, but the division has reorganised the hosting business unit, which should result in a lower ongoing cost base. The company expects that an uptick in Microsoft UK business would drive increased demand for hosting. The hosting pipeline increased to £3.37m from £2.65m a year ago.

Outlook and changes to forecasts

As the final quarter of the year ended on an upward trajectory, the company views prospects across all divisions as encouraging and expects to see a much improved performance in FY14.

We discuss below our divisional forecasts:

- **Microsoft UK:** our forecast is unchanged. We assume strong revenue growth in FY14 as orders received near the end of FY13 are implemented. With relatively flat revenues in H114 versus H213, we assume the division makes a loss in H114, returning to break-even in H214. For FY15, we factor in modest growth (which could prove to be conservative if Gemstone orders accelerate) and better profitability.
- **International:** our revenue forecast is unchanged. We forecast moderate growth in FY14 of 5% and a more conservative 3% in FY15, with similar operating margins to FY13. While the Dutch market is likely to take time to recover, the IKEA relationship is likely to generate increased orders in FY14.
- **SYSPRO and Sage:** we have factored in revenue growth of 5.9% for FY14, reflecting increased demand for X3 and SYSPRO 7, with a similar operating margin to FY13. We forecast a modest 3% revenue growth for FY15 with a small improvement in the operating margin.
- **Managed Services:** we have increased our forecast to reflect higher than expected revenues in FY13 and the higher year-end pipeline. We forecast a small loss in H114, reaching break-even in H214 before achieving an operating margin of 1% in FY15.

Other changes to forecasts:

- **Acquisitions:** we reduce the amount of deferred/contingent consideration payable to £0.39m reflecting the year-end balance sheet position.
- **Capex:** we have increased our capitalised development cost forecast for FY14 from £2.1m to £3.0m to reflect ongoing investment in Gemstone. We forecast a reduction to £1.8m in FY15. We have reduced our forecast for tangible capex from £1.58m to £0.95m with a similar level forecast in FY15.
- **Net debt:** the company extended its existing borrowing facilities through to December 2014 on substantially the same terms. At the end of FY13, K3 had £12.29m of secured bank loans (down from £15.05m at end FY12) and an overdraft of £1.1m (down from £2.1m). By the end of FY14, we expect a reduction in net debt of £1.56m to £12.25m and a further £3.05m reduction in FY15 to £9.20m.

Exhibit 3: Changes to forecasts

£'000s	Old	New	Change	New
	FY14e	FY14e		FY15e
Microsoft UK	25,588	25,588	0.0%	26,355
International	13,535	13,535	0.0%	13,941
SYSPRO & Sage	26,880	26,880	0.0%	27,686
Managed Services	6,500	7,050	8.5%	7,403
Revenues	72,503	73,052	0.8%	75,385
Microsoft UK	(600)	(600)	0.0%	882
International	2,333	2,411	3.4%	2,367
SYSPRO & Sage	6,510	5,933	-8.9%	6,246
Managed Services	(200)	(200)	0.0%	74
Head office costs	(450)	(470)	4.4%	(470)
Normalised operating profit	7,593	7,074	-6.8%	9,099
Operating margin	10.5%	9.7%		12.1%
Normalised PBT	7,043	6,474	-8.1%	8,549
Normalised net income	5,427	4,997	-7.9%	6,737
Reported EPS (p)	6.5	7.1	8.3%	13.3
Normalised EPS (p)	16.9	15.7	-6.9%	21.2
Net debt	12,780	12,251	-4.1%	9,204

Source: Edison Investment Research

Exhibit 4: Financial summary

	£'000s	2010*	2011	2012	2013	2014e	2015e
Year end 30 June		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS							
Revenue		59,783	52,800	67,961	63,513	73,052	75,385
Cost of Sales		(22,460)	(23,486)	(28,491)	(30,375)	(32,143)	(32,415)
Gross Profit		37,323	29,314	39,470	33,138	40,909	42,969
EBITDA		10,327	10,574	12,942	7,261	9,514	12,139
Operating Profit (before am of acq. Intang. and except.)		9,013	9,633	11,405	5,164	7,074	9,099
Amortisation of acquired intangibles		(2,892)	(2,826)	(3,586)	(3,182)	(3,200)	(3,200)
Share-based payments		39	(52)	(72)	(70)	(70)	(70)
Other		0	(942)	(395)	(727)	(200)	0
Operating Profit		6,160	5,813	7,352	1,185	3,604	5,829
Net Interest		(1,365)	(905)	(1,309)	(723)	(600)	(550)
Profit Before Tax (norm)		7,620	8,728	10,096	4,441	6,474	8,549
Profit Before Tax (FRS 3)		4,767	4,908	6,043	462	3,004	5,279
Tax		(1,018)	(428)	(319)	780	(777)	(1,111)
Profit After Tax (norm)		5,770	7,108	8,591	4,165	4,997	6,737
Profit After Tax (FRS 3)		3,749	4,480	5,724	1,242	2,227	4,167
Average Number of Shares Outstanding (m)		24.6	25.7	28.2	29.2	31.4	31.4
EPS - normalised (p)		23.5	27.7	30.4	14.3	15.9	21.4
EPS - normalised fully diluted (p)		23.4	27.0	29.7	14.1	15.7	21.2
EPS - FRS 3 (p)		15.2	17.5	20.3	4.3	7.1	13.3
Dividend per share (p)		0.75	0.75	1.00	1.00	1.05	1.10
Gross Margin (%)		62.4	55.5	58.1	52.2	56.0	57.0
EBITDA Margin (%)		17.3	20.0	19.0	11.4	13.0	16.1
Operating Margin (before GW and except.) (%)		15.1	18.2	16.8	8.1	9.7	12.1
BALANCE SHEET							
Fixed Assets		48,602	59,457	68,325	69,398	67,708	64,218
Intangible Assets		13,176	17,635	21,255	21,040	19,240	15,640
Tangible Assets		1,393	1,993	2,722	2,927	3,037	3,147
Goodwill		33,467	39,082	43,540	44,610	44,610	44,610
Other		566	747	808	821	821	821
Current Assets		14,808	23,456	32,418	25,523	32,420	32,827
Stocks		0	0	0	0	0	0
Debtors		14,439	22,642	30,322	25,251	28,620	30,980
Cash		369	814	2,096	272	3,800	1,847
Current Liabilities		(19,510)	(29,300)	(48,043)	(39,272)	(42,728)	(36,438)
Creditors		(5,491)	(7,874)	(8,797)	(5,842)	(6,698)	(6,908)
Other Creditors		(9,719)	(16,628)	(21,468)	(19,379)	(19,979)	(18,479)
Short term borrowings		(4,300)	(4,798)	(17,778)	(14,051)	(16,051)	(11,051)
Long Term Liabilities		(12,457)	(16,371)	(5,797)	(4,524)	(4,492)	(4,492)
Long term borrowings		(7,051)	(11,502)	0	(32)	0	0
Other long term liabilities		(5,406)	(4,869)	(5,797)	(4,492)	(4,492)	(4,492)
Net Assets		31,443	37,242	46,903	51,125	52,908	56,115
CASH FLOW							
Operating Cash Flow		7,331	5,640	7,284	8,022	7,801	8,488
Net Interest		(1,303)	(947)	(839)	(820)	(600)	(550)
Tax		(1,637)	(1,368)	(1,312)	(1,217)	(977)	(1,811)
Capex		(1,638)	(2,055)	(3,160)	(4,613)	(3,950)	(2,750)
Acquisitions/disposals		(2,856)	(5,407)	(7,132)	(1,917)	(400)	0
Financing		1,434	174	5,026	2,677	0	0
Dividends		(247)	(64)	(214)	(286)	(314)	(330)
Net Cash Flow		1,084	(4,027)	(347)	1,846	1,560	3,047
Opening net debt/(cash)		13,012	10,982	15,486	15,682	13,811	12,251
HP finance leases initiated		0	0	0	0	0	0
Other		946	(477)	151	25	0	0
Closing net debt/(cash)		10,982	15,486	15,682	13,811	12,251	9,204

Source: K3 Business Technology and Edison Investment Research. Note: *18 month period.

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