Edison investment research

8 March 2010

K3 Business Technology Group

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/07	34.1	4.7	16.3	0.5	6.1	0.5
12/08	37.6	5.9	17.9	0.5	5.5	0.5
06/10e**	58.2	7.6	22.1	0.5	4.5	0.5
06/11e	45.9	7.5	21.4	0.6	4.6	0.6

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles, share based payments and exceptional items. ** 18 months ended 30 June 2010.

Investment summary: Growth in a downturn

In a tough market, K3 beat our forecast to grow revenues y-o-y. Recurring revenues increased to 42.5% (FY08: 41%) and total revenues from existing customers reached 79%. Recent contract wins will generate further higher margin service revenues in 2010 and the DigiMIS acquisition will open up cross-selling opportunities. In our view, the current valuation is undemanding.

CY09: Growth in a weak market

K3 reported CY09 growth of 5%, despite the depressed environment. Key areas of strength were SCS within Manufacturing and UK Retail. Several contracts were won in competition with SAP, IBM and Oracle, highlighting the attraction of K3's industry-specific and cost-effective ERP solutions. Customer deposits on contracts signed near year-end combined with licence fee renewals reduced net debt to £5.4m.

2010: Strong pipeline and expanded service offering

The company has strong pipelines of new business in both divisions. K3 signed several contracts near year-end for which higher margin service revenue will be recognised in CY10. The recent DigiMIS acquisition opens up hosting as an additional offering, enabling K3 to offer a fully outsourced ERP solution.

Expansion of European Retail business

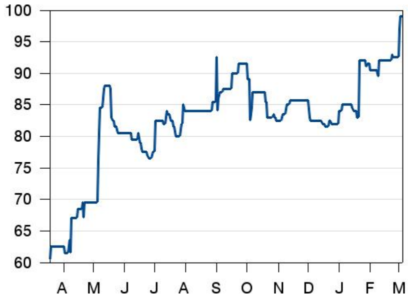
K3 is acquiring the trade and certain assets of Pebblestone Netherlands for an initial cash consideration of €1.4m (£1.25m), and a deferred cash consideration of €0.6m (£0.54m). Based on CY09 PBT of €0.54m and total net consideration, K3 is paying 2.8x trailing PBT versus K3's own trailing multiple of 4.2x. This deal doubles the revenues of K3 Nederland and opens up the specialist fashion retail market to K3.

Valuation: Undemanding

Despite a recent bounce in the share price and evidence that business is recovering, K3 is only trading at 4.8x CY10 adjusted EPS. Our DCF analysis values the company at 138p, implying further upside to the stock at current levels.

Price	99p
Market Cap	£26m

Share price graph



Share details

Code	KBT
Listing	AIM
Sector	Software & Computer Services
Shares in issue	25.5m

Price

52 week	High	Low
	99.0p	59.5p

Balance Sheet as at 31 December 2009

Debt/Equity (%)	17
NAV per share (p)	124
Net borrowings (£m)	5.4

Business

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

Valuation

	2009	2010e	2011e
P/E relative	51%	31%	38%
P/CF	2.7	3.4	3.1
EV/Sales	0.7	0.6	0.7
ROE	14%	18%	17%

Revenues by geography

UK	Europe	US	Other
76%	18%	4%	2%

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Investment summary: Growth in a downturn

Company description: ERP solution provider

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 two industry sectors: retail and manufacturing. The group has a well-balanced business model of predictable, recurring licence income in the manufacturing software sector combined with high growth opportunities in retail software. A series of acquisitions has scaled up the group since 2004 and the company recently added hosting to its suite of services with the acquisition of DigiMIS.

Valuation

K3 is trading on a P/E multiple of 4.8x CY10 forecasts. On an absolute basis, this appears low although looking at peers, it is clear that the small cap IT services sector is trading at depressed levels, despite most stocks having rebounded at least 50% since their 2009 lows. At this point in the cycle, there is still uncertainty as to whether the UK economy is in recovery, with some concerns about a double-dip. During this results cycle, K3 and many of its peers have reported a pick-up in order activity and higher contract values. Bearing this in mind, we believe that 5x P/E is too low. As companies continue to report increased orders, and hence increased confidence from customers, we expect a gradual re-rating of the sector. Our sum-of-the-parts DCF analysis produces a value of 138p, 39% above the current share price.

Sensitivities

The main sensitivities or risks to our forecasts are: 1) the macro environment – a significant increase in interest rates could impact consumer spending and the IT budgets of retailers, 2) Organic growth – in all divisions this depends on the ability to hire and retain skilled staff; and 3) Acquisitions – deals have transformed the scale of the group and the record so far has been a good one. Potentially, however, the inherent risks are greater in any strategy which has recourse to M&A.

Financials

K3 reported strong CY09 results, with revenue growth of 5% versus our forecast for a 2% decline. Margins improved in the Manufacturing division whereas Retail margins were impacted by a weak first half. Cashflow was strong in the second half, enabling a significant reduction in debt.

Exhibit 1: Changes to forecasts

Note: Figures in £m except per share data.

	EPS			PBT			EBITDA		
	Old	New	% chg.	Old	New	% chg.	Old	New	% chg.
CY09	17.7p	18.2	3	6.0	6.0	0	7.3	7.3	0
FY10e	N/A	22.1	N/A	N/A	7.6	N/A	N/A	9.3	N/A
FY11e	N/A	21.4	N/A	N/A	7.5	N/A	N/A	8.7	N/A

Source: K3 Business Technology Group and Edison Investment Research

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Company description: ERP solution provider

K3: Value-added reseller for retail and manufacturing sectors

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 two industry sectors: retail and manufacturing. The group has a well-balanced business model of predictable, recurring licence income in the manufacturing software sector combined with high growth opportunities in retail software. A series of acquisitions has scaled up the group since 2004 and, with the acquisition of DigiMIS, the company recently added hosting to its suite of services.

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 by RAP Group, a DIY products supplier, 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, the most significant of which are highlighted below.

Exhibit 2: Acquisition history

Date	Company	Sector	Details
Oct-04	Alpha Landsteinar	Retail	One of Microsoft's largest UK Dynamics resellers. Develops a version of Dynamics for retailers
Jun-05	IEG	Manufacturing	Resells SYSPRO, a Microsoft-based ERP solution for SME manufacturers. Adds high recurring revenue business & upgrade path for existing customers.
Mar-07	MBL	Manufacturing	SYSPRO reseller
Sep-07	Landsteinar Nederland	Retail	Dutch sister company of Alpha Landsteinar. Over 50% of revenues from franchised outlets of IKEA.
Dec-07	Index	Manufacturing	Microsoft Dynamics AX reseller
Mar-10	DigiMIS	Hosting	Specialises in hosting ERP applications, particularly SYSPRO.
Mar-10	Pebblestone	Retail	Dutch trade & assets. Specialises in fashion retail software.

Source: K3 Business Technology Group

Business model: Grow internal IP to enhance margins

The group serves as a channel to market for three Microsoft-based ERP solutions:

1) SYSPRO – based on Microsoft.NET
2) Microsoft Dynamics NAV
3) Microsoft Dynamics AX

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. Group gross margin has grown from 61% in FY06 to 71% in CY09 as internal IP has been developed. K3 also continues to look for complementary acquisitions that will expand product/service lines and feeder businesses that can be migrated to Dynamics or SYSPRO.

Manufacturing division: UK-focused, dominant position

The Manufacturing division has more than 1,000 customers and is the largest supplier of supply chain management software to the sector in the UK.

This division reports revenues from three business lines:

1) SCS: this division sells SYSPRO solutions to manufacturing customers and is made up of the combination of IEG and MBL. K3 is the sole distributor of SYSPRO in the UK.

2) K3 AX: this division sells Microsoft Dynamics AX solutions mainly to food and process manufacturers and incorporates the Index acquisition.

3) Walton: this division maintains legacy software that is not Microsoft-based and also develops Microsoft Dynamics CRM software. Customers served by this division often upgrade to one of the solutions offered by K3 AX or SCS.

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.

Revenue model

K3 operates in the low to mid-range with contract values in the range of £50-250k. Initial contract values will comprise c 50% licence fee and c 50% services to design and integrate the system. Maintenance is charged at 20-25% of the licence fee on an annual basis. K3 also charges an annual licence fee renewal in October, creating a heavy weighting of Manufacturing revenues to the second half of the calendar year. Sales of additional software modules or customised software after the initial licensing are reported as Account Management revenues.

Managed Services

K3 introduced a Managed Services offering in 2007 to provide specialist IT support to customers. For now this service is only available in this division, although the company plans to extend the offering to the Retail division in late 2010/early 2011. The business generated revenues of £600k in FY08 and £730k in CY09. Around 100 customers have signed up to the service at a cost of £2-20k per annum. The move into hosting expands the service into the infrastructure space, and will enable the company to offer a full outsourced IT service to customers.

CY09 operational performance

The Manufacturing business grew 6% in 2009, despite the downturn. All business lines showed growth – the AX business saw a noticeable pick-up in the second half with the signing of two major contracts, one worth over £1m. Profitability improved for SCS, and although AX reported a loss for the year, it turned a loss in H1 into an EBITA margin of 12.9% in H2. The Walton business saw the second stage of a customer upgrade from a legacy system to SYSPRO. Some Walton development staff have been working within the AX business and the plan is to merge both businesses at the same site later this year.

Exhibit 3: Financial performance of Manufacturing division, 2006-2009

					YoY Revenue Growth		
Revenues (£m)	2006	2007	2008	2009	2007	2008	2009
Manufacturing	*8.85*	*13.5*	*15.43*	*16.38*	*53%*	*14%*	*6%*
SCS	5.35	10.40	10.73	11.36	94%	3%	6%
K3 AX	0.00	0.05	2.01	2.23	Nm	3920%	11%
Walton	3.50	3.05	2.70	2.79	-13%	-11%	3%
Adj. Operating Profit (£m)					Operating margin		
Manufacturing	*1.64*	*3.42*	*3.65*	*4.26*	*25.3%*	*23.7%*	*26.0%*
SCS	0.93	2.45	2.53	3.43	23.6%	23.6%	30.2%
K3 AX	0.00	0.00	0.08	-0.12	0.0%	4.0%	-5.4%
Walton	0.71	0.97	1.05	0.95	31.8%	38.9%	34.1%

Source: K3 Business Technology Group

The division signed 23 major new contracts with an average order value of £187k (FY08: 24 contracts at an average of £100k). Recurring revenues totalled £9.1m/55% (versus £8.3m/54% in FY08).

Outlook and forecasts

SCS services capacity is fully booked for the next four months and the division is seeing an increasing number of service days sold to its existing customer base. The AX business has a strong services order book and an improving pipeline of new opportunities entering into 2010. Forecasts for the Hosting business are not included here, but are forecast separately (see p8).

Exhibit 4: Manufacturing division forecasts

Note: *18 month period; ** Year-on-year growth based on 12-month periods ending June 2010 and June 2009.

				YoY Revenue Growth		
Revenues (£m)	FY10*	CY10	FY11	FY10**	CY10	FY11
Manufacturing	*22.90*	*16.76*	*16.99*	*13%*	*2%*	*1%*
SCS	15.42	11.36	11.48	6%	0%	1%
K3 AX	3.43	2.73	2.83	57%	22%	7%
Walton	4.05	2.67	2.68	11%	-4%	-4%
Adj. Operating Profit (£m)				Operating margin		
Manufacturing	*4.97*	*4.49*	*4.55*	21.7%	26.8%	26.8%
SCS	3.69	3.47	3.50	23.9%	30.5%	30.5%
K3 AX	0.02	0.35	0.38	0.7%	12.8%	13.3%
Walton	1.27	0.67	0.67	31.2%	25.0%	25.0%

Source: Edison Investment Research

Retail division: Growth from international expansion

The Retail division has around 150 customers and operates out of two divisions.

1) **UK:** this division sells Microsoft Dynamics NAV-based software to retailers. The Alpha Landsteinar acquisition was integrated into this division.
2) **Netherlands:** this division sells the same NAV-based solution to overseas retailers, particularly European customers. This division was created by the Landsteinar Nederland acquisition. Around 60% of this division's revenues are generated from the IKEA relationship (IKEA mandates that its 12 franchises use K3 for their supply chain software). Franchises are based in Eastern Europe, the Middle East and Australia. While it is unlikely that IKEA will grant more franchises, it encourages the existing franchisees to open up new stores in existing and new countries. To date, non-IKEA business has been demand-led, but a restructuring of the sales effort in this division is driving an

active sales and marketing campaign which we would expect to start contributing to revenues in the short to medium term.

The company develops own IP products such as modules for multi-channel, EPOS, fashion and CRM. K3 also continues to look to acquire filler volume business and strategic product.

Expanding European retail presence

K3 announced today that it has agreed to acquire the trade and certain assets of Pebblestone Netherlands, a reseller and developer of specialist fashion and apparel retail software.

Background on Pebblestone

Pebblestone was established in 1995 and is based in Rotterdam, Holland. After the acquisition, Pebblestone Netherlands will be integrated with and relocated to K3 Nederland's offices. Pebblestone sells Microsoft Dynamics NAV and in-house developed software modules focused on the fashion and apparel segments of retailing. The company has c 140 customers, including brands such as Levi, Claudia Strater and Van Bommel. Pebblestone is a member of the Microsoft President's Club.[1] K3 has previously partnered with Pebblestone.

Deal structure

K3 will pay a total of up to €2.0m (£1.79m) to acquire the trade and certain assets of Pebblestone Netherlands. This is divided into an initial cash payment of €1.4m (£1.25m) and deferred cash consideration of €0.6m (£0.54m), payable over five years and carrying a coupon 6%. After tax deductions, the total net consideration is €1.5m. In CY09, Pebblestone Netherlands generated pro-forma revenues of €3.92m and profit before tax of €0.54m (13.8% pre-tax margin). Based on net consideration, this values the business at 2.8x trailing PBT and 0.4x trailing sales. K3 is trading at 4.2x CY09 PBT, higher than the level it is paying for the Pebblestone business. We estimate that after paying the initial consideration, net debt will reach £11.3m by the end of FY10, falling to £7.5m by the end of FY11.

Revenue model

This division sells systems split roughly one-third licence fee/two-thirds services. Annual maintenance fees are c 25% of the licence fee. Contract sizes are larger in this division, in the region of £250k-£3m.

CY09 operational performance

Exhibit 5: Financial performance of Retail division, 2006-2009

					YoY Revenue Growth		
Revenues (£m)	2006	2007	2008	2009	2007	2008	2009
Retail	*16.44*	*20.47*	*22.18*	*23.08*	*25%*	*8%*	*4%*
UK	16.44	18.86	17.71	19.13	15%	-6%	8%
Netherlands	0	1.61	4.47	3.95	Nm	178%	-12%
Adj. Operating Profit (£m)						Operating margin	
Retail	*1.63*	*2.91*	*3.96*	*3.15*	*14.2%*	*17.8%*	*13.6%*
UK	1.63	2.34	2.63	2.53	12.4%	14.9%	13.2%
Netherlands	0	0.57	1.33	0.62	35.4%	29.8%	15.7%

Source: K3 Business Technology Group

[1] Microsoft Dynamics President's Club recognition honours Microsoft Dynamics resellers in the top 5% of partners within each region whose commitment to customers is reflected in their business performance and high level of sales.

The division signed 11 major new contracts with an average order value of £636k (FY08: 11 contracts at an average of £355k). Recurring revenues rose to £7.7m/33% versus £7.3m/33% in FY08.

In the UK, the business saw growth of 8%, signing eight of the 11 major contracts in the year. Multi-channel solutions were particularly strong and the newly developed Retail AX solution won its first major contract in the second half.

In Holland, the IKEA franchises cut back on spending in 2008 but started investing again towards the latter part of 2009. This business signed three major deals in the year, although saw a 12% decline revenue and hence a drop in margins.

Outlook and forecasts

The UK business is running at close to full capacity and has a strong pipeline of new business. The Dutch market remains tough but the company is currently negotiating new opportunities. The Netherlands business includes forecasts for the recently acquired Pebblestone business.

Exhibit 6: Retail division forecasts

Note: *18 month period; **y-o-y growth based on 12-month periods ending June 2010 and June 2009.

				YoY Revenue Growth		
Revenues (£m)	FY10*	CY10	FY11	FY10**	CY10	FY11
Retail	*34.84*	*26.97*	*27.87*	*16%*	*17%*	*11%*
UK	27.48	19.68	19.84	12%	3%	1%
Netherlands	7.36	7.30	8.03	32%	85%	50%
Adj. Operating Profit (£m)				Operating margin		
Retail	*4.61*	*3.95*	*4.10*	*13.2%*	*14.7%*	*14.7%*
UK	3.44	2.72	2.75	12.5%	13.8%	13.9%
Netherlands	1.17	1.23	1.35	15.8%	16.9%	16.8%

Source: Edison Investment Research

Hosting division: A recent addition

Last week, K3 acquired DigiMIS, a hosting service provider, for an initial consideration of £803k, potentially rising to £2.1m. This takes K3 into a new but complementary business area, opening up opportunities to sell hosting services to its existing customer base. As the complexity of computing increases and companies are under pressure to reduce costs, many companies are considering outsourcing their IT needs to a reliable service provider. K3's move into hosting enables the company to offer a fully outsourced ERP service to customers. In addition, as customers experience K3's hosting abilities and become comfortable with the concept of their IT systems being hosted and maintained off-site, we believe that this will prepare the ground for offering software-as-a-service.

Background on DigiMIS

DigiMIS has 14 customers at 65 sites using datacentres in London, Edinburgh and New York. DigiMIS hosts SYSPRO, Microsoft Dynamics, Microsoft Outlook, Blackberry, email services and other applications the customer requires. Contracts tend to be multi-year, resulting in a high level of recurring revenues.

Of the 14 customers, seven use SYSPRO, of which five are K3 SYSPRO customers. The remaining seven customers use a variety of software, including Microsoft Dynamics. In the UK, there are no other hosting companies offering SYSPRO services but there are several companies that can host Microsoft Dynamics solutions: 7global (recently acquired by 365iT plc) hosts Microsoft Dynamics CRM and Attenda hosts both Microsoft Dynamics AX and NAV.

Growth strategy

As a starting point, we would expect K3 to offer hosting as an additional service to existing and new SYSPRO customers (K3 has approximately 500 SYSPRO customers). The combined software and hosting offering will enable the customer to outsource to K3 the complete provision and maintenance of ERP software and the hardware it runs on. The customer's staff will then access their business software via an internet connection from any PC. We would also expect K3 to start to sell the hosting service to its other customers (there are 800 non-SYSPRO customers in manufacturing and a further 200 customers in retail) – DigiMIS already hosts Microsoft Dynamics so has the capability to support Microsoft Dynamics AX and NAV customers.

Forecasts

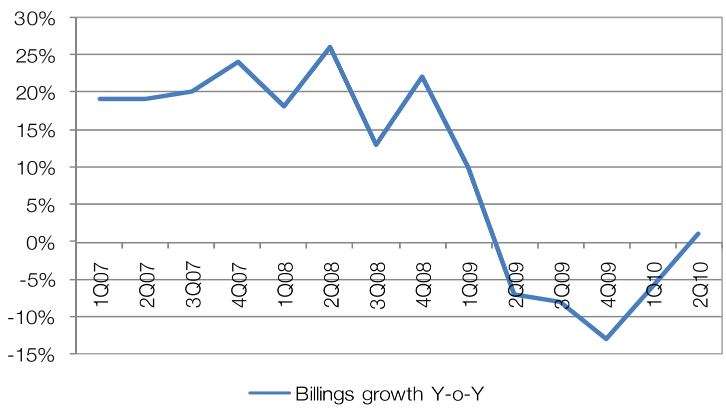
We expect that K3 will report the DigiMIS business as a separate business line. We are forecasting:

- FY10: four months will be included (ie March-June 2010) and we forecast revenues of £417k and EBITA of £40k.
- FY11: we forecast that this division will grow c 20% versus the annualised run rate prior to acquisition, resulting in a revenue forecast of £1.55m. We forecast EBITA of £300k equating to an EBITA margin of 19.4%.

Market outlook

Microsoft Dynamics is a suite of business management solutions designed for SMEs comprising ERP and CRM products. Competitors include SAP and Oracle, although they tend to be better suited to larger enterprises.

Exhibit 7: Microsoft Dynamics growth in customer billings, y-o-y



Source: K3 Business Technology Group

As would be expected, Dynamics has suffered in the current recession, showing a 7% decline in customer billings in FY09. However, prior to the downturn, Dynamics exhibited strong growth (+16% in FY06, +21% in FY07 and FY08). Exhibit 6 shows that the business appears to have turned a corner, with billings in Q210 showing positive growth for the first time in five quarters. Gartner forecasts that IT spending will grow 4.6% in 2010, and within that, software spending will grow 4.9% after an estimated 2.1% decline in 2009. The market backdrop therefore appears supportive of growth in CY10 for K3.

Sensitivities

The main sensitivities or risks to our forecasts are:

- Macro environment. A significant increase in interest rates could impact consumer spending and the IT budgets of retailers.
- Organic growth. In all divisions, organic growth depends on the ability to hire and retain skilled staff.
- Acquisitions. Deals have transformed the scale of the group and the record so far has been a good one. Potentially, however, the inherent risks are greater in any strategy which has recourse to M&A.

Valuation

Multiples-based valuation: Sector and stock undervalued

K3 is trading on a P/E multiple of 4.8x CY10E adjusted earnings. On an absolute basis, this appears low. Looking at peers, it is clear that the small cap IT services sector is trading at depressed levels, even though most stocks have rebounded at least 50% since their 2009 lows. At this point in the cycle, there is still uncertainty as to whether the UK economy is now in recovery, and some believe that we could be set for a double-dip. This goes some way to explaining the depressed valuation of the sector as a whole. During this results cycle, K3 and many of its peers have reported a pick-up in order activity and overall higher contract values. The Edison view on the UK economy in 2010 is that recovery will continue, albeit in a subdued fashion. Bearing this in mind, we believe that 5x P/E is too low. As more companies continue to report increased orders, and hence increased confidence from customers, we expect the sector will gradually be re-rated.

DCF-based valuation: Undervalued

Our sum-of-the-parts valuation below highlights the different characteristics of the retail and manufacturing divisions by ascribing a higher WACC to the former. Even using extremely cautious assumptions for the discount rate still produces a value of 138p, 39% above the current share price. Reducing the Retail WACC by 1% increases the valuation to 145p (47% upside).

Exhibit 8: Discounted cashflow analysis

SOTP DCF valuation	£m	Per share	Assumptions		
Retail	21	84	WACC: 15%	No of shares	25.5m
Manufacturing	26	102	WACC: 12%	Shr price	99.00p
Hosting	2	7	WACC: 12%	Mkt cap	£25.3m
Less: taxed central costs NPV	(5)	(19)	WACC: 10%		
Group Enterprise Value	45	174			
Less: Adj. Net Debt	(9)	(37)			
Group Equity Value £m	35	138	Up/(downside) from current price		39%

Source: Edison Investment Research

Financials

Review of FY09 results

Despite the downturn, K3 reported better than expected revenues, growing revenues 5% versus our forecast for a 2% decline. Manufacturing saw a strong second half, even when excluding the license renewals in SCS. UK Retail saw year-on-year growth driven by a strong second half. Despite the better than expected revenues, margins fell in several divisions, as the signing of contracts close to year-end resulting in a higher level of software and hardware sales relative to services.

Exhibit 9: Summary of financial performance

	2009	2008	Change
Revenues	39,463	37,619	4.9%
Normalised operating profit	7,010	7,348	-4.6%
Normalised profit before tax	6,037	5,920	2.0%
Normalised net income	4,965	4,783	3.8%
Reported EPS (p)	12.3	11.8	3.7%
Normalised EPS (p)	18.2	17.9	1.7%

Source: K3 Business Technology Group

Cashflow & balance sheet: Impact of acquisitions

Due to the high level of customer deposits on new business signed close to year-end, K3 reduced net debt from £13.0m at the end of 2008 to £5.4m at the end of 2009. We note that the Manufacturing business is heavily weighted to H2 when SYSPRO licence fees are renewed eg revenues from manufacturing were split £6.1m/£10.3m H1/H209. This means that a large amount of cash is collected from customers prior to year-end. With the change in year-end, the balance sheet will reflect the position at the end of June, a period when K3 typically has a low cash balance. This is not a cause for concern but merely the impact of the timing of cashflows. K3 has taken a term loan of €1m to partially fund the Pebblestone acquisition. The company will pay down long-term debt at a rate of c £2.8m per annum and on our calculations will have gross debt of £7.6m at the end of FY11 versus £10.6m at the end of CY09. Factoring in both acquisitions, we forecast that K3 will have a net debt position of £7.5m by the end of FY11.

The company announced a dividend of 0.5p per share (flat y-o-y) which will be paid in June.

Outlook

While the market continues to be tough, K3 reported a strong pipeline entering H110. Several of the contracts signed close to year-end will generate service revenues in H110, with a positive impact on margins.

Changes to forecasts: Incorporating hosting and new year-end

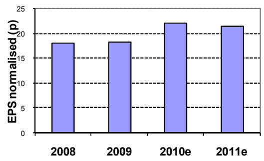
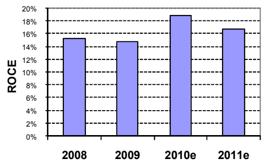
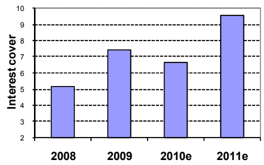
We have revised our forecasts to add in estimates for the recently acquired hosting and Dutch retail businesses. We have also changed our forecasts to reflect the change of year-end from December to June. FY10 will comprise an 18 month period up to June 2010 and FY11 will comprise the 12 months up to June 2011.

Exhibit 10: Financials

Note: FY10 is 18-month period January 2009-June 2010

£'000s	2006	2007	2008	CY09	2010e	2011e
Year end 31 December/ 30 June	IAS	IAS	IAS	IAS	IAS	IAS
PROFIT & LOSS						
Revenue	27,350	34,146	37,619	39,463	58,157	45,862
Cost of Sales	(10,641)	(11,415)	(11,278)	(11,444)	(16,866)	(13,300)
Gross Profit	16,709	22,731	26,341	28,019	41,291	32,562
EBITDA	3,247	6,068	7,671	7,267	9,336	8,736
Operating Profit (before GW and except.)	2,918	5,760	7,348	7,010	8,950	8,406
Goodwill Amortisation	0	(896)	(1,875)	(1,963)	(2,793)	(2,100)
IFRS 2 charges	(85)	(152)	(103)	(35)	(85)	(100)
Other	0	0	(12)	(28)	(28)	0
Operating Profit	2,833	4,712	5,358	4,984	6,044	6,206
Net Interest	(262)	(1,036)	(1,416)	(945)	(1,345)	(883)
Profit Before Tax (norm)	2,656	4,724	5,920	6,037	7,577	7,523
Profit Before Tax (FRS 3)	2,571	3,676	3,942	4,039	4,699	5,323
Tax	(846)	(761)	(1,137)	(1,072)	(1,372)	(1,467)
Profit After Tax (norm)	1,810	3,963	4,783	4,965	6,205	6,056
Profit After Tax (FRS 3)	1,725	2,915	2,805	2,967	3,327	3,856
Average Number of Shares Outstanding (m)	18.1	21.7	23.7	24.2	24.5	25.6
EPS - normalised (p)	10.5	16.8	18.2	18.2	22.1	21.4
EPS - normalised fully diluted (p)	10.4	16.3	17.9	18.2	22.1	21.4
EPS - FRS 3 (p)	9.5	13.4	11.8	12.3	13.6	15.0
Dividend per share (p)	0.0	0.5	0.5	0.5	0.5	0.6
Gross Margin (%)	61.1	66.6	70.0	71.0	71.0	71.0
EBITDA Margin (%)	11.9	17.8	20.4	18.4	16.1	19.0
Operating Margin (before GW and except.) (%)	10.7	16.9	19.5	17.8	15.4	18.3
BALANCE SHEET						
Fixed Assets	17,962	45,547	47,099	44,251	46,573	44,944
Intangible Assets	273	12,282	12,075	10,097	9,138	7,439
Tangible Assets	416	1,305	1,333	1,212	1,173	1,243
Goodwill	15,684	31,494	33,225	32,496	35,816	35,816
Other	1,589	466	466	446	446	446
Current Assets	10,889	14,069	13,518	18,159	12,061	13,935
Stocks	0	0	0	0	0	0
Debtors	8,622	10,984	10,690	12,939	12,939	13,821
Cash	2,267	3,085	2,828	5,220	(878)	114
Current Liabilities	(13,712)	(19,386)	(19,035)	(20,388)	(17,127)	(16,984)
Creditors	(4,385)	(6,689)	(5,466)	(5,840)	(5,640)	(5,716)
Short term borrowings	(861)	(4,043)	(5,494)	(3,111)	(3,111)	(3,111)
Long Term Liabilities	(711)	(16,509)	(13,714)	(10,380)	(11,982)	(8,904)
Long term borrowings	(711)	(12,437)	(10,346)	(7,485)	(7,302)	(4,532)
Other long term liabilities	0	(4,072)	(3,368)	(2,895)	(4,680)	(4,372)
Net Assets	14,428	23,721	27,868	31,642	29,524	32,990
CASH FLOW						
Operating Cash Flow	2,208	6,228	6,375	8,919	7,135	8,109
Net Interest	(256)	(1,243)	(1,323)	(958)	(1,345)	(883)
Tax	21	(2,074)	(1,614)	(1,087)	(2,072)	(1,967)
Capex	(375)	(643)	(1,334)	(937)	(1,410)	(1,200)
Acquisitions/disposals	(1,395)	(16,493)	(259)	(25)	(1,768)	(169)
Financing	1,825	263	24	1,427	1,427	0
Dividends	0	0	(119)	(119)	(247)	(128)
Operating Cash Flow	2,028	(13,962)	1,750	7,220	1,721	3,762
Opening net debt/(cash)	1,247	(695)	13,395	13,012	13,012	11,291
HP finance leases initiated	0	0	0	0	0	0
Other	(86)	(128)	(1,367)	0	0	0
Closing net debt/(cash)	(695)	13,395	13,012	5,792	11,291	7,529

Source: Company reports and Edison Investment Research

Growth	Profitability	Balance sheet strength	Sensitivities evaluation	
			Litigation/regulatory	○
			Pensions	○
			Currency	○
			Stock overhang	◐
			Interest rates	◐
			Oil/commodity prices	○

Growth metrics	%	Profitability metrics	%	Balance sheet metrics		Company details	
EPS CAGR 07-11e	7.0	ROCE 10e	18.8	Gearing 10e	38.2	Address:	
EPS CAGR 09-11e	8.4	Avg ROCE 07-11e	16.9	Interest cover 10e	6.7	Baltimore House, 50 Kansas Avenue, Manchester M50 2GL	
EBITDA CAGR 07-11e	9.5	ROE 10e	18.3	CA/CL 10e	0.7		
EBITDA CAGR 09-11e	9.6	Gross margin 10e	71.0	Stock turn 10e	N/A	Phone	(0)161 876 4498
Sales CAGR 07-11e	7.6	Operating margin 10e	15.4	Debtor days 10e	110	Fax	(0)161 876 4502
Sales CAGR 09-11e	7.7	Gr mgn / Op mgn 10e	4.6	Creditor days 10e	117	www.k3btg.com	

Principal shareholders	%
PJ Claesson Esq	21.63
Blackrock Investment Management	8.05
Bluehone Investors LLP	4.21
Hargreave Hale	4.21
Herald Investment Mgt	4.21
Yfm Private Equity Limited	4.02
RBS	3.83
MD Barnard	3.74
DJ Bolton Esq	3.47
NA Makeham Esq	3.28

Forthcoming announcements/catalysts	Date *
AGM	May 2010
Trading update	July 2010
Interim results	September 2010
Note: * = estimated	

Management team
CEO: Andy Makeham
Andy has over 20 years of 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–1970s. 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. Tom has a wealth of experience in developing successful retail software companies.