

5 July 2011

## K3 Business Technology

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/08	37.6	5.9	17.9	0.50	12.4	0.2
06/10**	59.8	7.6	23.4	0.75	9.5	0.3
06/11e	53.0	8.3	23.7	0.60	9.4	0.3
06/12e	62.8	10.1	28.2	0.60	7.9	0.3

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

### Investment summary: FY11 trading update

K3 has issued a year-end update stating that trading is in line with expectations despite a tough new business environment, helped by its >40% recurring revenue base. As part of its ongoing acquisition strategy, K3 has bought a UK retail business with a high level of recurring revenues and strong profitability, offering significant cross-selling potential.

### UK Retail acquisition boosts recurring revenues

K3 announced that it has acquired the Retail Merchandising Division of Azurri Computer Solutions for £1m initial consideration. The deal will boost recurring revenues and provides the potential to upgrade customers to K3's Retail solutions. The deal is being funded by a new revolving credit facility.

### FY11 trading in line with expectations

K3 reports that FY11 trading is in line with market expectations, with recent acquisitions performing well. K3 is signing an "encouraging level" of major new contracts despite tough market conditions, and sales to existing customers are continuing to grow. K3 continues to invest in its Hosting and Managed Services offerings and continues to look for complementary acquisitions.

### Changes to estimates

To reflect the acquisition, we have revised up our FY12 revenues by 1.6% and EBITA by 2.8%, resulting in an EPS upgrade of 3.1%. Recent acquisitions and customers moving to payment across the life of a contract drove y/e net debt above our £14.2m forecast to £15.8m. We have increased FY12e net debt from £9.6m to £12.1m.

### Valuation: Still at a discount to the sector

K3 is trading on 9.4x FY11 and 7.9x FY12 normalised EPS. Despite an 18% rise over the last three months, the stock still trades at a discount to both the UK Software and IT Services sectors. We believe that as K3 integrates recent acquisitions and starts to generate cost and revenue synergies (in particular selling Managed Services to the existing customer base), the stock could trade up to nearer 10x FY12 EPS.

Price 222.5p  
Market Cap £57m

Share price graph

#### Share details

Code KBT  
Listing AIM  
Sector Software & Computer Services  
Shares in issue 25.77m

#### Price

52 week High 236.5p Low 115p

#### Balance Sheet as at 31 December 2010

Debt/Equity (%) 32.5  
NAV per share (p) 137  
Net debt (£m) 11.5

#### Business

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

#### Valuation

	2010	2011e	2012e
P/E relative			
P/CF			
EV/Sales			
ROE			

#### Geography based on revenues (2010)

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

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## UK Retail acquisition

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K3 announced yesterday that it had acquired the Retail Merchandising Division of Azurri Computer Solutions Ltd (Azurri Retail). This division provides support to 17 customers using Azurri Retail software. Customers include large retailers such as Matalan, JJB Sports, Littlewoods, Holland & Barratt and the National Trust. The deal will result in six support staff transferring across to the UK Retail division's offices. While the existing business is for the support of Azurri Retail software, we believe that there is the potential for K3 to up-sell its Microsoft-based Retail products to the acquired customer base and further potential to sell Hosting and Managed Services.

### Terms of the deal

In CY10, the division generated revenues of £1.0m, of which more than 60% were recurring (compared to 46% for the group and 35% for the Retail division in CY10). Underlying profit of £0.4m resulted in an EBITA margin of c 40% versus EBITA margins of 19.6% reported by the UK Retail division in H1 11. K3 is paying initial cash consideration of £1.0m and will pay up to a further £0.5m if Azurri Retail reaches gross margin targets over the next two years. Based on the initial consideration, the deal looks good value with K3 paying 1.0x trailing sales and 2.5x trailing EBITA, compared to K3's own EV-based metrics of 1.2x CY10 sales and 8.5x CY10 EBITA. The company has taken out an additional revolving credit facility to fund the purchase.

### Further acquisitions likely

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The company confirmed that it is still seeking complementary acquisitions that will either help develop the group's product/service offerings or will add contracted recurring income through the acquisition of easily integrated customer bases. Recent deals have been a combination – for example the Panacea deal added a range of Sage products and expertise as well as a Microsoft Dynamics NAV/CRM installed customer base and a managed services business with a high level of recurring revenues. In the current difficult new business environment, buying customers using legacy software can be an alternative way to reach new customers for K3's product range.

**Exhibit 1: Financials**

	£'000s	2006	2007	2008	2010*	2011e	2012e
Year end 31 December/ 30 June		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
<b>PROFIT &amp; LOSS</b>							
<b>Revenue</b>		<b>27,350</b>	<b>34,146</b>	<b>37,626</b>	<b>59,783</b>	<b>53,017</b>	<b>62,782</b>
Cost of Sales		(10,641)	(11,415)	(11,285)	(22,460)	(15,375)	(18,207)
Gross Profit		16,709	22,731	26,341	37,323	37,642	44,575
<b>EBITDA</b>		<b>3,365</b>	<b>6,250</b>	<b>7,937</b>	<b>10,327</b>	<b>10,485</b>	<b>12,065</b>
<b>Operating Profit (before am of acq. Intang. and except.)</b>		<b>2,918</b>	<b>5,760</b>	<b>7,354</b>	<b>9,013</b>	<b>9,249</b>	<b>10,945</b>
Amortisation of acquired intangibles		0	(896)	(1,875)	(2,892)	(2,434)	(2,550)
Share-based payments		(85)	(152)	(103)	39	(40)	(40)
Other		0	0	(12)	(28)	(221)	0
<b>Operating Profit</b>		<b>2,833</b>	<b>4,712</b>	<b>5,364</b>	<b>6,132</b>	<b>6,554</b>	<b>8,355</b>
Net Interest		(262)	(1,036)	(1,416)	(1,365)	(907)	(895)
<b>Profit Before Tax (norm)</b>		<b>2,666</b>	<b>4,724</b>	<b>5,926</b>	<b>7,620</b>	<b>8,342</b>	<b>10,500</b>
<b>Profit Before Tax (FRS 3)</b>		<b>2,571</b>	<b>3,676</b>	<b>3,948</b>	<b>4,767</b>	<b>5,647</b>	<b>7,460</b>
Tax		(846)	(761)	(1,137)	(1,018)	(1,418)	(1,909)
<b>Profit After Tax (norm)</b>		<b>1,890</b>	<b>3,650</b>	<b>4,310</b>	<b>5,770</b>	<b>6,124</b>	<b>7,290</b>
<b>Profit After Tax (FRS 3)</b>		<b>1,725</b>	<b>2,915</b>	<b>2,811</b>	<b>3,749</b>	<b>4,229</b>	<b>5,550</b>
Average Number of Shares Outstanding (m)		18.1	21.7	23.7	24.6	25.6	25.6
EPS - normalised (p)		10.5	16.8	18.2	23.5	23.9	28.4
EPS - normalised fully diluted (p)		10.4	16.3	17.9	23.4	23.7	28.2
EPS - FRS 3 (p)		9.5	13.4	11.9	15.2	16.5	21.7
Dividend per share (p)		0.0	0.5	0.5	0.8	0.6	0.6
Gross Margin (%)		61.1	66.6	70.0	62.4	71.0	71.0
EBITDA Margin (%)		12.3	18.3	21.1	17.3	19.8	19.2
Operating Margin (before GW and except.) (%)		10.7	16.9	19.5	15.1	17.4	17.4
<b>BALANCE SHEET</b>							
<b>Fixed Assets</b>		<b>17,962</b>	<b>45,547</b>	<b>47,099</b>	<b>48,478</b>	<b>53,421</b>	<b>51,251</b>
Intangible Assets		273	12,282	12,075	12,565	12,517	10,317
Tangible Assets		416	1,305	1,333	1,393	1,929	1,959
Goodwill		15,684	31,494	33,225	33,954	38,292	38,292
Other		1,589	466	466	566	683	683
<b>Current Assets</b>		<b>10,889</b>	<b>14,069</b>	<b>13,518</b>	<b>14,808</b>	<b>20,236</b>	<b>25,048</b>
Stocks		0	0	0	0	0	0
Debtors		8,622	10,984	10,690	14,439	20,335	23,221
Cash		2,267	3,085	2,828	369	(99)	1,828
<b>Current Liabilities</b>		<b>(13,712)</b>	<b>(19,386)</b>	<b>(19,035)</b>	<b>(20,072)</b>	<b>(21,755)</b>	<b>(22,906)</b>
Creditors		(4,385)	(6,689)	(5,466)	(5,690)	(6,290)	(7,174)
Other Creditors		(8,466)	(8,654)	(8,075)	(10,082)	(9,965)	(9,232)
Short term borrowings		(861)	(4,043)	(5,494)	(4,300)	(5,500)	(6,500)
<b>Long Term Liabilities</b>		<b>(711)</b>	<b>(16,509)</b>	<b>(13,714)</b>	<b>(11,724)</b>	<b>(15,766)</b>	<b>(12,896)</b>
Long term borrowings		(711)	(12,437)	(10,346)	(7,051)	(10,181)	(7,411)
Other long term liabilities		0	(4,072)	(3,368)	(4,673)	(5,585)	(5,485)
<b>Net Assets</b>		<b>14,428</b>	<b>23,721</b>	<b>27,868</b>	<b>31,490</b>	<b>36,136</b>	<b>40,497</b>
<b>CASH FLOW</b>							
<b>Operating Cash Flow</b>		<b>2,208</b>	<b>6,228</b>	<b>6,375</b>	<b>7,331</b>	<b>5,189</b>	<b>10,063</b>
Net Interest		(256)	(1,243)	(1,323)	(1,303)	(907)	(895)
Tax		21	(2,074)	(1,614)	(1,637)	(1,418)	(1,909)
Capex		(375)	(643)	(1,334)	(1,638)	(1,500)	(1,500)
Acquisitions/disposals		(1,395)	(16,493)	(259)	(2,856)	(6,170)	(1,908)
Financing		1,825	263	24	1,434	103	0
Dividends		0	0	(119)	(247)	(141)	(154)
Net Cash Flow		2,028	(13,962)	1,750	1,084	(4,844)	3,697
<b>Opening net debt/(cash)</b>		<b>1,247</b>	<b>(695)</b>	<b>13,395</b>	<b>13,012</b>	<b>10,982</b>	<b>15,770</b>
HP finance leases initiated		0	0	0	0	0	0
Other		(86)	(128)	(1,367)	946	46	0
<b>Closing net debt/(cash)</b>		<b>(695)</b>	<b>13,395</b>	<b>13,012</b>	<b>10,982</b>	<b>15,780</b>	<b>12,083</b>

Source: Edison Investment Research, company accounts

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