K3 Business Technology

FY15 results

Expanding its reach

Software & comp services

FY15 results confirmed that both business divisions continue to grow. Recent software sales have generated higher service revenues with a short-term impact on margins. To more efficiently exploit its own-IP solutions, K3 is focused on expanding its international partner channel. This should drive a higher proportion of software and support revenues in the longer term, reducing the impact of lower-margin services revenues. The stock continues to trade at a discount to its peer group.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
06/14	72.0	6.6	18.5	1.25	15.4	0.4
06/15	83.4	7.2	19.1	1.50	14.9	0.5
06/16e	88.9	9.3	23.7	1.65	12.0	0.6
06/17e	93.8	11.3	28.4	1.82	10.0	0.6

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

FY15 results: Revenue beat, earnings in line

K3 generated 16% revenue growth in FY15, 3.5% ahead of our forecast. Retail and Manufacturing & Distribution (M&D) both grew (20% and 13% respectively) with software sales over the last two years generating strong services and recurring revenues. Investment in resources in M&D resulted in adjusted operating profit 4.6% below our forecast. Lower tax and interest resulted in earnings substantially in line with our forecast. Net debt was reduced 11% in the year.

Continuing to invest in product and channel

The transition to a more product-focused company continues, with further investment in product development, including new retail verticals for ax|is and add-ons for SYSPRO. To maximise the sales potential of these products, K3 is expanding its international partner channel. This should enable K3 to grow software and recurring revenues faster than services revenues, and expand margins over time. We have increased our operating expense assumptions for FY16 to reflect this investment, reducing our operating profit and EPS forecasts by 5.6% and 5.5% respectively. We forecast EPS growth of 24% in FY16 and 20% in FY17 and a reduction in net debt to £4.6m by the end of FY17.

Valuation: Product focus to drive upside

The stock is trading on a P/E multiple of 12.0x FY16e EPS and 10.0x FY17e EPS. Sub-£500m market cap UK software & IT services stocks are trading on c 19x current year and c 16x next year EPS. The continued investment in developing and supporting its own-IP solutions, combined with a focus on growing the SYSPRO business and selling hosting services to a larger proportion of customers gives K3 the potential to grow the business on a multi-year basis. We expect upside triggers to include evidence that K3 continues to win more 'ax|is' contracts and hosting/managed services customers and continues to expand the international partner channel. We have rolled forward our forecasts by a year and believe that the stock could trade up to at least 15x FY16e EPS (355p per share).

16 September 2015

Price	**285.0p**
Market cap	**£91m**
Net debt (£m) at end FY15	12.1
Shares in issue	31.8m
Free float	77%
Code	KBT
Primary exchange	AIM
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	5.8	8.6	30.7
Rel (local)	12.2	17.6	40.1
52-week high/low		285.0p	207.5p

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 event

AGM	9 December 2015

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Edison profile page

K3 Business Technology is a research client of Edison Investment Research Limited

Review of FY15 results

Exhibit 1: Summary FY15 results

£m	FY15e	FY15	Difference (%)	Growth y-o-y (%)
Total revenues	80.17	83.43	4.1	16.0
Gross profit	41.51	42.98	3.5	10.3
Gross margin	51.8%	51.5%	(0.3)	(2.6)
Normalised operating profit*	8.56	8.17	(4.6)	11.5
Operating margin*	10.7%	9.8%	-0.9	(0.4)
Normalised PBT	7.56	7.24	(4.2)	9.4
Normalised net income	6.19	6.16	(0.5)	4.9
Reported EPS (p)	10.8	10.9	0.9	33.6
Normalised EPS (p)	19.3	19.1	(0.8)	3.3
Net debt	14.10	12.08	(14.3)	(11.4)

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

Exhibit 2: Divisional results

£m	H114	H214	H115	H215	FY14	FY15	FY15 growth
Revenues							
Software	5.69	7.20	7.62	6.22	12.89	13.84	7.4%
Retail	3.39	3.23	4.08	3.06	6.62	7.14	7.9%
Manufacturing & distribution	2.30	3.97	3.54	3.16	6.27	6.7	6.9%
Services	9.19	10.64	11.93	12.92	19.83	24.85	25.3%
Retail	5.47	6.69	7.63	7.48	12.16	15.11	24.3%
Manufacturing & distribution	3.72	3.95	4.30	5.44	7.67	9.74	27.0%
Recurring revenues	17.91	17.50	19.84	20.00	35.41	39.84	12.5%
Retail	4.85	7.47	6.78	7.97	12.32	14.75	19.7%
Manufacturing & distribution	13.06	10.03	13.06	12.03	23.09	25.09	8.7%
Hardware & other revenues	1.67	2.15	2.28	2.62	3.82	4.9	28.3%
Retail	0.96	1.07	1.14	1.60	2.04	2.74	35.0%
Manufacturing & distribution	0.71	1.08	1.14	1.02	1.78	2.16	20.7%
Total revenues	**34.46**	**37.49**	**41.67**	**41.76**	**71.95**	**83.43**	**16.0%**
Retail	14.67	18.46	19.63	20.11	33.14	39.74	19.9%
Manufacturing & distribution	19.79	19.03	22.04	21.65	38.81	43.69	12.6%
Gross profit	**18.92**	**20.04**	**21.11**	**21.87**	**38.96**	**42.98**	**10.3%**
Retail	6.90	9.54	8.56	10.39	16.44	18.95	15.3%
Manufacturing & distribution	12.02	10.5	12.55	11.48	22.52	24.03	6.7%
Gross margin	***54.9%***	***53.5%***	***50.7%***	***52.4%***	***54.1%***	***51.5%***	***-2.6%***
Retail	*47.0%*	*51.7%*	*43.6%*	*48.0%*	*49.6%*	*47.7%*	*-1.9%*
Manufacturing & distribution	*60.7%*	*55.2%*	*56.9%*	*58.0%*	*58.0%*	*55.0%*	*-3.0%*
Operating costs	15.31	16.37	17.00	17.83	31.66	34.83	10.0%
Retail	6.43	7.81	7.5	7.94	14.24	15.44	8.4%
Manufacturing & distribution	8.48	8.55	9.15	9.76	17.03	18.91	11.0%
Head office	0.40	0.01	0.35	0.13	0.39	0.479	22.8%
Adjusted operating profit*	**3.61**	**3.69**	**4.11**	**4.04**	**7.3**	**8.15**	**11.7%**
Retail	0.47	1.73	1.06	2.45	2.2	3.51	59.5%
Manufacturing & distribution	3.54	1.95	3.4	1.72	5.49	5.12	-6.7%
Head office	-0.40	0.01	-0.35	-0.13	-0.39	-0.48	22.8%
Adjusted operating margin*	***10.5%***	***9.8%***	***9.9%***	***9.7%***	***10.1%***	***9.8%***	***-0.4%***
Retail	*3.2%*	*9.4%*	*5.4%*	*12.2%*	*6.6%*	*8.8%*	*2.2%*
Manufacturing & distribution	*17.9%*	*10.2%*	*15.4%*	*7.9%*	*14.1%*	*11.7%*	*-2.4%*

Source: K3 Business Technology. Note: *Includes share-based payments.

K3 reported revenue growth of 16.0% in FY15, 4.1% above our forecast. This resulted in gross profit 3.5% ahead of our forecast, with a group gross margin of 51.5%, compared to 54.1% in FY14. The main reason for the margin decline was the higher proportion of lower-margin services business in FY15. Adjusted operating profit came in 4.6% below our forecast, due to increased investment in the Manufacturing & Distribution division. With lower than forecast interest costs and tax, normalised net income and EPS were substantially in line with our forecasts. Net debt reduced faster than we forecast: better working capital management and lower tax paid more than offset lower than forecast EBITDA and higher than forecast capex. The company announced a dividend of 1.5p per share, +20% y-o-y and ahead of our 1.31p forecast.

Retail – investing in product and sales channels

The Retail business grew 20% y-o-y (2% ahead of our forecast), with the majority of the increase from services (relating to licences signed over the last two years) and recurring revenues (as earlier deals went live and moved to maintenance). Retail gross profit increased 15.3% y-o-y, generating a gross margin of 47.7% (H1: 43.6%, H2: 48.0%). The company had flagged that margins were being negatively affected by the high cost of project delivery, but efforts to increase in-house training and the level of near-shoring brought this cost down in H215 – the services gross margin increased from 21% in H1 to 24% in H2. Operating costs increased 8.4%, resulting in a 60% increase in adjusted operating profit y-o-y, with the operating margin increasing from 6.6% to 8.8%.

The division received new orders worth £11.3m, compared to £17.1m in FY14 and added 129 new customers (up from 92 in FY14). Demand for ax|is remains strong as does demand for the Pebblestone wholesale solution (via both direct and indirect channels). Own-IP revenues grew 24% y-o-y to 35% of divisional revenues. K3 continues to develop ax|is solutions for other verticals in the retail sector, which should help the company drive this percentage even higher.

The Inter IKEA relationship is providing an increasing flow of work, and K3 recently renewed the partnership for a further five years. These strong results were partially offset by weaker demand from fashion and retail in the Netherlands as well as the weak euro. The company has taken steps to reduce costs in the Dutch part of the business – we expect this will start to take effect towards the end of H116. This resulted in exceptional restructuring costs of £0.2m in FY15.

As reported earlier in the year, K3 was accredited as a member of Microsoft's Global ISV programme (one of only 25 companies globally) and in July, K3 became a member of the Microsoft Dynamics Inner Circle[1]. This should help raise K3's profile and is already resulting in referrals from Microsoft.

The company has been investing in its international partner channel, and in H115, K3 won several new customers through this channel, followed by a contract with a major US NFL franchise in H215. The partner channel generated sales of £3.8m in FY15 (+58% y-o-y). The company will continue to invest in this channel in FY16.

The pipeline at year-end was worth £32.2m compared to £33.1m at the end of FY14. The company has just announced that it has won a major 'ax|is fashion' contract in Germany with TriStyle Mode GmbH, a European mail order fashion retailer. This was won via a global systems integrator, and therefore will generate mainly software and support revenues for K3. The deal is K3's first in Germany and the largest via a channel partner.

The combination of revenue growth, more efficient project delivery and cost reduction in the Netherlands should drive an improvement in the division's operating performance in FY16.

Manufacturing & Distribution – solid performance

Manufacturing & Distribution (M&D) revenues grew 12.5% in FY15 (6% ahead of our forecast), with services (+27%) and recurring revenues (+9%) making the biggest contributions to growth. The division won new orders worth £10m in FY15, up from £7.9m in FY14. SYSPRO, Microsoft Dynamics AX and NAV, and Sage X3 all contributed to growth. The Microsoft Dynamics businesses grew 51% y-o-y to £7.4m, with a particularly strong Q4. SYSPRO maintained its 98% licence

[1]Limited to less than 60 of the most successful Microsoft Dynamics partners globally.

renewal rate, contributing to the high level of recurring revenues (57% of divisional revenues). This division has a lower level of own-IP business, making up 9% of divisional revenues.

Gross profit increased 6.7% y-o-y, generating a gross margin of 55.0%. Adjusted operating profit, however, fell 6.7% y-o-y, with an operating margin of 11.7%. The company invested in resources for support and maintenance, increasing overheads in SYSPRO (£0.4m), Microsoft solutions (£1.0m) and CRM (£0.3m).

This division also includes K3's hosting and managed services business and incorporated the Willow Starcom acquisition from April 2015. Annualised subscription revenues increased by £2.7m over the year to £8m – the majority of the increase came from Willow Starcom, although the start of some contracts deferred from H115 and new wins also contributed. From the date of acquisition, Willow Starcom contributed revenues of £0.5m and EBITA of £0.08m.

At the end of FY15, the new deal pipeline was worth £29.8m compared to £29.2m at the end of FY14. The division is focused on expanding the international partner channel and sees good long-term growth potential for the cloud hosting business.

Changes to forecasts

- Revenues: we maintain our FY16 forecast and introduce a growth forecast of 5.6% for FY17.
- Gross margin: we leave this unchanged at 52.3% in FY16 and assume a marginal decrease to 52.2% due to mix.
- Adjusted operating profit: to take into account the costs of investing in the international partner channel, we have increased our operating cost forecast for FY16 by £0.5m. Our adjusted operating profit forecast reduces by 5.6% with a margin of 11.4%. We forecast the margin to increase to 12.7% in FY17.
- Exceptionals: we have factored in a £0.6m cost for restructuring in the Netherlands in FY16.
- Normalised EPS: the higher operating costs factored in to our FY16 forecasts reduce our EPS forecast by 5.5%. FY16 EPS is forecast to grow 24% y-o-y, and we introduce a forecast for FY17 EPS growth of 20%.
- Net debt: as FY15 debt reduction was higher than expected, we expect that net debt will be reduced further to £9.6m by the end of FY16 and to £4.6m by the end of FY17.

Exhibit 3: Changes to forecasts

£m	Old	New		New	Growth	
	FY16e	FY16e	Change (%)	FY17e	FY16e	FY17e
Retail	42.4	41.9	(1.3)	45.0	5.3%	7.5%
Manufacturing & distribution	46.5	47.0	1.2	48.8	7.6%	3.8%
Revenues	**88.85**	**88.85**	**0.0**	**93.80**	**6.5%**	**5.6%**
					Margin	
Retail	4.43	3.98	(10.2)	5.26	9.5%	11.7%
Manufacturing & distribution	6.95	6.70	(3.6)	7.33	14.2%	15.0%
Head office costs	(0.64)	(0.54)	(15.6)	(0.67)		
Normalised operating profit	**10.74**	**10.14**	**(5.6)**	**11.92**		
Operating margin	*12.1%*	*11.4%*	*(0.7)*	*12.7%*		
Normalised PBT	9.84	9.34	(5.1)	11.32		
Normalised net income	8.06	7.65	(5.0)	9.19		
Reported EPS (p)	17.4	15.0	(13.9)	21.4		
Normalised EPS (p)	25.0	23.7	(5.5)	28.4		
Net debt	10.48	9.59	(8.5)	4.56		

Source: Edison Investment Research

Exhibit 4: Financial summary

£000s	2012	2013	2014	2015e	2016e	2017e
Year-end 30 June	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS						
Revenue	67,961	63,513	71,950	83,427	88,850	93,800
Cost of Sales	(28,491)	(30,375)	(32,990)	(40,446)	(42,365)	(44,809)
Gross Profit	39,470	33,138	38,960	42,981	46,485	48,991
EBITDA	12,942	7,261	9,861	10,975	13,464	15,446
Operating Profit (before am of acq. Intang. and except.)	11,405	5,164	7,328	8,169	10,139	11,921
Amortisation of acquired intangibles	(3,586)	(3,182)	(2,989)	(2,800)	(2,900)	(2,900)
Share-based payments	(72)	(70)	(27)	(18)	(30)	(30)
Other	(395)	(727)	(1,722)	(546)	(600)	0
Operating Profit	7,352	1,185	2,590	4,805	6,609	8,991
Net Interest	(1,309)	(723)	(705)	(926)	(800)	(600)
Profit Before Tax (norm)	10,096	4,441	6,623	7,243	9,339	11,321
Profit Before Tax (FRS 3)	6,043	462	1,885	3,879	5,809	8,391
Tax	(319)	780	675	(436)	(1,046)	(1,585)
Profit After Tax (norm)	8,591	4,165	5,874	6,162	7,653	9,186
Profit After Tax (FRS 3)	5,724	1,242	2,560	3,443	4,763	6,806
Average Number of Shares Outstanding (m)	28.2	29.2	31.4	31.6	31.8	31.8
EPS - normalised (p)	30.4	14.3	18.7	19.5	24.1	28.9
EPS - normalised fully diluted (p)	29.7	14.1	18.5	19.1	23.7	28.4
EPS - FRS 3 (p)	20.3	4.3	8.1	10.9	15.0	21.4
Dividend per share (p)	1.00	1.00	1.25	1.50	1.65	1.82
Gross Margin (%)	58.1	52.2	54.1	51.5	52.3	52.2
EBITDA Margin (%)	19.0	11.4	13.7	13.2	15.2	16.5
Operating Margin (before GW and except.) (%)	16.8	8.1	10.2	9.8	11.4	12.7
BALANCE SHEET						
Fixed Assets	68,325	69,398	67,067	67,497	65,552	63,407
Intangible Assets	21,255	21,040	20,040	20,806	19,106	17,206
Tangible Assets	2,722	2,927	2,439	2,316	2,071	1,826
Goodwill	43,540	44,610	43,952	43,541	43,541	43,541
Other	808	821	636	834	834	834
Current Assets	32,418	25,523	29,535	33,734	36,950	41,908
Stocks	0	0	0	0	0	0
Debtors	30,322	25,251	28,888	31,839	34,566	36,492
Cash	2,096	272	647	1,895	2,384	5,416
Current Liabilities	(48,043)	(39,272)	(40,278)	(32,886)	(32,480)	(37,531)
Creditors	(8,797)	(5,842)	(7,218)	(7,640)	(8,134)	(8,585)
Other Creditors	(21,468)	(19,379)	(18,799)	(21,803)	(20,903)	(19,503)
Short term borrowings	(17,778)	(14,051)	(14,261)	(3,443)	(3,443)	(9,443)
Long Term Liabilities	(5,797)	(4,524)	(3,719)	(14,850)	(12,210)	(3,660)
Long term borrowings	0	(32)	(14)	(10,531)	(8,531)	(531)
Other long term liabilities	(5,797)	(4,492)	(3,705)	(4,319)	(3,679)	(3,129)
Net Assets	46,903	51,125	52,605	53,495	57,812	64,124
CASH FLOW						
Operating Cash Flow	7,284	8,022	5,352	9,600	9,731	12,571
Net Interest	(839)	(820)	(848)	(950)	(800)	(600)
Tax	(1,312)	(1,217)	290	(264)	(1,686)	(2,135)
Capex	(3,160)	(4,613)	(4,487)	(4,564)	(4,280)	(4,280)
Acquisitions/disposals	(7,132)	(1,917)	(129)	(1,998)	0	0
Financing	5,026	2,677	277	69	0	0
Dividends	(214)	(286)	(316)	(397)	(476)	(524)
Net Cash Flow	(347)	1,846	139	1,496	2,489	5,032
Opening net debt/(cash)	15,486	15,682	13,811	13,628	12,079	9,590
HP finance leases initiated	0	0	0	0	0	0
Other	151	25	44	53	0	0
Closing net debt/(cash)	15,682	13,811	13,628	12,079	9,590	4,558

Source: K3 Business Technology, Edison Investment Research

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